

# CALSTRS

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## CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM

### **INVESTMENT STRATEGY & RISK: INNOVATIVE STRATEGIES INVESTMENT POLICY**

## INVESTMENT BRANCH

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~~MARCH 2020~~ Decommission March 2024

# N. Innovative Strategies Investment Policy

## EXECUTIVE SUMMARY

In accordance with the CalSTRS Investment Policy and Management Plan (IPMP), the California State Teachers' Retirement System Board (Board) has established an Innovative Strategies portfolio (Portfolio) within the Investment Strategy & Risk asset class. CalSTRS' Innovative Strategies assets (Assets) are to be invested, administered, and managed in a prudent manner for the sole benefit of its participants and beneficiaries, in accordance with the California Constitution, the California State Teachers' Retirement Law, and other applicable statutes. No investment instrument or activity prohibited by the IPMP shall be authorized for the Portfolio. These policies are designed to set boundaries that will ensure prudence and care in the management of the Assets while allowing enough flexibility to capture investment opportunities.

The Portfolio serves as the research arm for the CalSTRS Total Fund (Fund), incubating new investment ideas with the goal of improving the risk and return characteristics of the Fund when fully implemented. The investment scope is fairly broad, covering unique strategies that do not fit any of CalSTRS' existing asset classes.

CalSTRS believes that environmental, social and geopolitical (ESG) issues can affect the performance of our investments. As a result, CalSTRS' Investment Policy for Mitigating Environmental, Social, and Governance Risks has been developed as a tool that both internal and external investment managers are expected to use to assess the impact of ESG risk when making an investment on behalf of CalSTRS.

The internal investment officers and independent fiduciaries operate under the direction of the Chief Investment Officer (CIO). Review of the Portfolio will fall under the Board's general consultant (Consultant), who reports directly to the Investment Committee. If a specialty asset class specific consultant is retained, that consultant will report directly to the Investment Committee.

## PROGRAM OBJECTIVES

CalSTRS' staff will research and invest in strategies that generally fall outside of the traditional asset classes currently used by the Board. The investments may be small incubation allocations to newer investment strategies or larger allocations to cross asset class strategies and short-term opportunistic strategies. The Innovative Strategies portfolio provides the structure for incubating new ideas and investing in strategies seeking to improve the diversification of the Total Fund, enhance its risk-adjusted total return, capture capital appreciation, provide new sources of current income and explore innovative investment structures with better alignment of economic interests.

## **PERFORMANCE OBJECTIVES**

Over the long-term, the Portfolio seeks to produce a positive real return greater than the CalSTRS assumed actuarial rate of return while testing out new investment strategies and/or groups of assets for potential growth within the CalSTRS Total Fund.

## **PROGRAM BENCHMARKS**

Given the specialized nature of the Innovative Strategies portfolio, individual portfolios are measured based on the investable universe as defined in the management agreement. This may include absolute return objectives, broad market indexes, or customized benchmarks. The overall Innovative Strategies portfolio shall have a blended performance benchmark comprised of the weightings for each of the strategies multiplied by their respective benchmarks.

For periods of 10 years or greater, the Innovative Strategies portfolio shall meet the assumed actuarial rate of return for the Fund.

## **PROGRAM STRUCTURE**

### **Components**

The Innovative Strategies portfolio may invest in both public and private assets. The Portfolio will be divided into three sub-portfolios:

#### **1. Incubation Portfolio**

The purpose of this portfolio is to research and invest in a wide spectrum of new investment opportunities that will be required to demonstrate success before committing larger dollar amounts to a specified strategy. Following an incubation period to validate the efficacy of the strategy (generally 3 years), and under the delegation of authority established by this policy, staff will decide if a strategy should be graduated to one of the traditional asset classes, dedicated to a new asset class, transferred to the Innovative Strategies' Strategic Portfolio, or terminated.

#### **2. Strategic Portfolio**

The purpose of this portfolio is to provide a place for strategies, or a group of strategies, that will improve the diversification of the total investment portfolio and enhance its risk-adjusted total return.

Generally, these strategies are long-term strategic investments that do not fit existing asset classes because they invest across multiple asset classes, they do not fit within the current policy definition of an asset class and/or they have characteristics that make them a difficult fit due to benchmark considerations.

This portfolio shall be managed to achieve optimum performance through diversification across investment strategies, geographies, and structures consistent with a prudent level of

risk. Staff will select appropriate investments with structural aspects that provide for the maximum return and diversification while mitigating risk and cost.

### **3. Opportunistic Portfolio**

The purpose of this portfolio is to hold investments that are generally short-term opportunistic strategies seeking to capitalize on tactical opportunities, mispricing, or distress in the capital markets. These opportunistic strategies intend to enhance the return of the Fund.

### **Permissible Investment Types**

The Innovative Strategies program may invest in both public and private assets using: (1) Limited Partnerships (and other limited liability vehicles); (2) Commingled Funds; (3) Separately Managed Accounts; (4) Co-investments; (5) Secondary Market Transactions; (6) Direct Investments; and (7) Standard investment management agreements.

Within the limits established by this policy, staff is responsible for the selection, allocation, and oversight of the strategies and external managers. If prudent, CalSTRS may elect to manage a strategy internally. Any internally managed strategy must be approved by the CIO and General Consultant. Delegation limits for internally managed assets are reflected in the Investment Policy and Management Plan.

### **Co-investments**

The approval decision for co-investments is delegated to staff considering the following stipulations:

- i. Co-investments shall be made side by side with CalSTRS external investment advisors.
- ii. Due diligence process shall be thorough, consistent, and appropriate as defined in the Innovative Strategies investment portfolio procedures.
- iii. Maximum amount of any single investment shall not exceed \$100 million at the time of the investment.
- iv. Co-investments will be disposed of in coordination with the CalSTRS external investment advisor who recommended the co-investment.

## **RISK MANAGEMENT**

### **Delegation of Authority**

The Chief Investment Officer (CIO) or designee has the authority to manage the Investment Strategy & Risk asset category and may use other investment personnel to implement these policies and the processes described in the Procedures.

The CIO or designee has the authority to approve commitments to strategies within the boundaries established by these policies. All investments are subject to appropriate due diligence as defined in the CalSTRS Innovative Strategies investment portfolio procedures and will only be approved following an affirmative recommendation from the Director of Investment Strategy & Risk and

consultant (if required). All Private Asset investments require a positive written recommendation by CalSTRS' staff and either a Program Advisor, an Independent Fiduciary, or Co-investment Advisor. Public assets selected through the procurement process do not require an Independent Fiduciary.

The assets under management (AUM) in the Investment Strategy and Risk Innovative Strategies Portfolio shall not exceed 2.5 percent of the CalSTRS' Total Fund market value. To provide diversification, the size of each individual strategy shall be limited to a maximum of half-a-percent (0.5%) of the CalSTRS' total fund market value, calculated using the total commitments as of the investment decision date.

## MONITORING AND REPORTING

The following reports will be prepared and presented to the Board, unless otherwise stated, in order to facilitate visibility of monitoring and reporting according to this document:

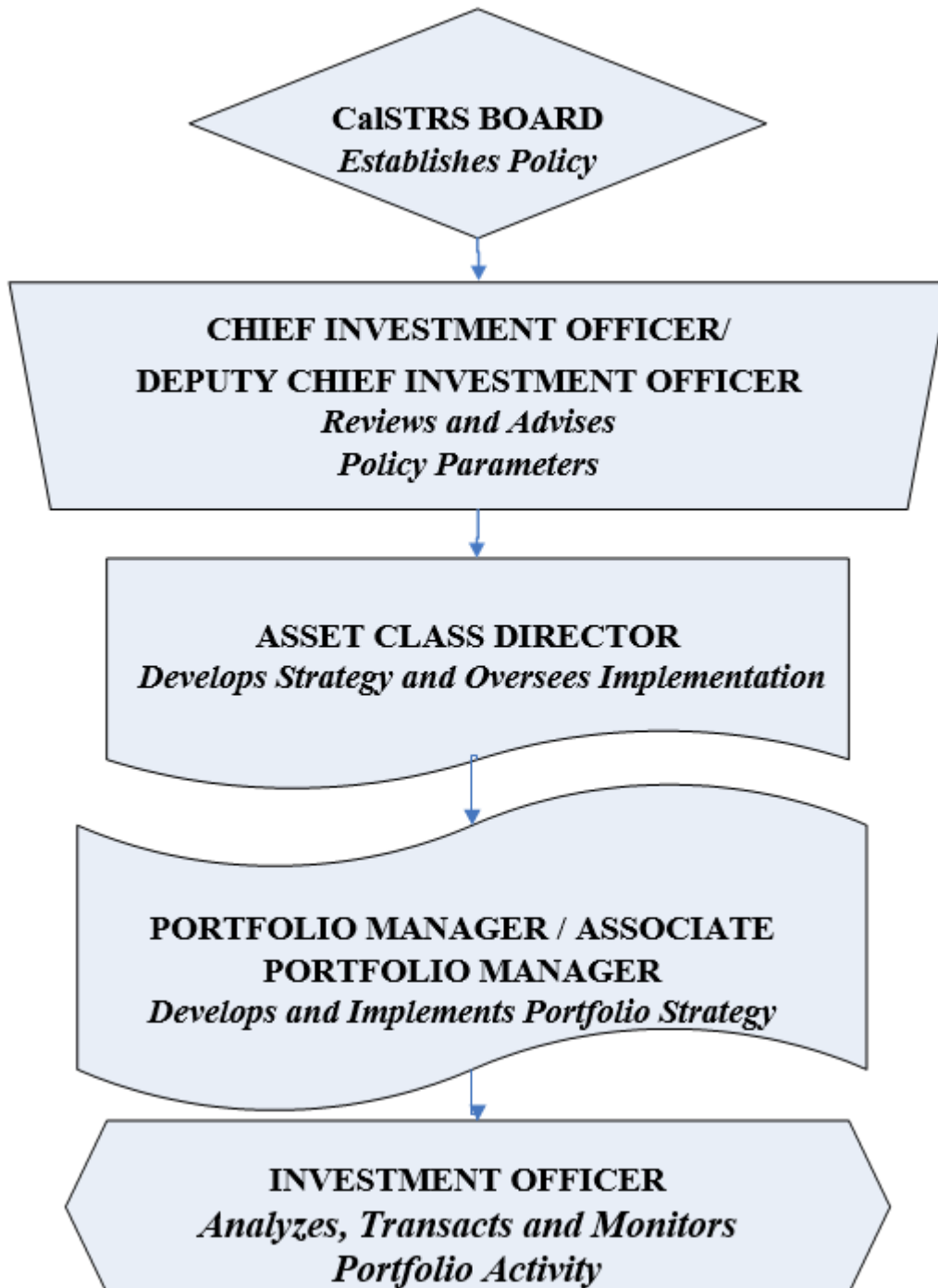
- i. **Semi-Annual Manager Report** – prepared by staff
- ii. **Performance Report** – prepared by master custodian/consultant (semi-annually)
- iii. **Business Plan** – prepared by staff (annually)
- iv. **Co-Investments** - A report on any acquisition or disposition will be presented to the Investment Committee as soon as practical after the transaction is completed.

### Version Control

*Policy for Innovation Portfolio First Reading February 5, 2009*  
*Policy for Innovation Portfolio Second Reading and Adoption March 5, 2009*  
*Revised to add ESG Risks Policy reference on September 10, 2013*  
*Revised to update portfolio AUM and delegated limits December 2, 2013*  
*Revised to clarify trading limit language April 8, 2016*  
*Revised to define APM and DCIO trading limits on April 5, 2017*  
*Revised to reflect new policy format, long-term benchmark*  
*and support additional mandates on March 4, 2020*  
[Policy Decommissioned and replaced with Collaborative Strategies Portfolio Investment Policy March 6, 2024](#)

**EXHIBIT 1**

**POLICY IMPLEMENTATION FLOWCHART**



## GLOSSARY

**ALPHA** – Portfolio’s return relative to the return of the portfolio’s benchmark.

**ASSET ALLOCATION** – Process of allocating investments optimally across a set of asset classes.

**BASIS POINTS** – Measure to describe the percentage change in value or rate of a financial instrument (1/100<sup>th</sup> of 1%).

**BENCHMARK** – Standard against which the performance of a strategy or portfolio is measured.

**CORRELATION** – Measure of the strength of a relationship between two securities, portfolios, or asset classes.

**CO-INVESTMENT ADVISOR** – A co-investment advisor is an investment manager who manages a Separately Managed Account of co-investments on behalf of CalSTRS.

**DIVERSIFICATION** – Reduction in risk is obtained by investing among several different investment opportunities.

**INCUBATION** - Research and invest in new investment opportunities that will be required to demonstrate success before committing larger dollar amounts.

**INDEPENDENT FIDUCIARY** – A third party organization that provides non-discretionary specialized advisory services to Staff and acts as a fiduciary to CalSTRS and who by law must act in the best interests of CalSTRS and put the interests of CalSTRS above their own.

**INFLATION-LINKED ASSETS** – Security which is expected to deliver a higher return than the rate of inflation.

**INVESTMENT STRATEGY** – A commitment to a single fund, separately managed account, joint venture or internally managed portfolio.

**NON-TRADITIONAL ASSET CLASSES/STRATEGIES** – Investments whose investment performance not correlated with that of stocks, bonds, real estate, private equity, and cash. It may include hedge funds and commodities. CalSTRS may investigate alternative investment strategies for the stock or bond traditional asset class.

**OPPORTUNISTIC** – Invest in strategies that CalSTRS believes will provide a superior return.

**PROGRAM ADVISOR** – A Program Advisor provides expertise, advice and recommendations to support staff in the management and monitoring of an asset class or classes including, but not limited to, screening the universe of general investment opportunities and identifying those meeting CalSTRS’ selection criteria, assisting staff in performing due diligence on prospective investment opportunities, issuing investment recommendations, and maintaining a deal log of investment opportunities. A Program Advisor is also an Independent Fiduciary.

**RISK-ADJUSTED RETURN** – Measure of how much risk is involved to produce the investment return.

**SHARPE RATIO** – Risk-adjusted measure to determine the reward per unit of risk.

**TRADITIONAL ASSET CLASSES** – Stocks, bonds, real estate, private equity, and cash are fundamental components of an investment portfolio.

**VOLATILITY** – Measure of the dispersion of returns for a security or index.