MEKETA

5796 Armada Drive
Suite 110
Carlsbad, CA 92008
760.795.3450
Meketa.com

MEMORANDUM

TO: Investment Committee, CalSTRS
FROM: Stephen McCourt, Allan Emkin, Mika Malone, Stephanie Sorg, Meketa Investment Group
CC: Chris Ailman
DATE: January 11, 2024
RE: Opinion Memo – Investment Policy Statement Revisions – Leverage and Asset Allocation Bands

Summary and Recommendation

In Fall 2023, Staff began discussions with Meketa regarding a desire to adjust the target asset allocation ranges for the Fund, as well as creating specific leverage restrictions. In December, Staff provided Meketa a proposed IPS with these changes, as well as their memorandum on the topic. ***After independently evaluating the proposed policy, Meketa Investment Group concurs with Staff's recommendation to adopt a modified IPS incorporating new target asset allocation bands and defining the leverage maximum allowance at 10%.***

Discussion

The two recommendations from Staff are intended, in concert, to provide Staff the ability to utilize flexibility within the asset allocation policy ranges, as well as with leverage, to rebalance the portfolio and provide for cash flow/liquidity needs. Wider asset allocation ranges can both allow the portfolio to deviate more from its target allocation in times of significant market events, as well as allow Staff more discretion in determining when and how to reallocate the portfolio. The leverage maximum of 10% would allow Staff, in certain circumstances, to borrow to meet cash needs.

Staff has provided education on liquidity at recent Investment Committee meetings, highlighting the types of environments when this additional leverage might have been deployed (Great Financial Crisis) and the areas where they believe additional flexibility would be valuable. This includes paying benefits, taking advantage of market opportunities, rebalancing, and avoiding forced selling. When combined with the proposed wider asset allocation bands, Staff will have more tools at its disposal to invest the portfolio through a wide variety of economic environments.

A number of risks were considered by Staff, and discussed with Meketa. Meketa would like to highlight that one important risk of both these changes is that they create the potential for larger losses and tracking error relative to benchmarks. Staff highlighted the risk that expanding target ranges could potentially increase the active risk in the portfolio, if/when the portfolio deviates more substantially from targets. Staff conducted analysis that showed a relatively small change in the funding risk to the plan over time, and also highlights the RAC Committee, and other oversight by Meketa and risk managers, to keep these risks in check.

As it relates to leverage, Staff conducted analysis regarding funding risk, and the Investment and Actuarial Resources teams at CalSTRS both concluded that allowing up to 10% leverage poses minimal risk to funding over time. There are other risks when employing leverage, including counterparty risk, reputational risk, execution risks, and maturity risks. Staff feels they have the experience necessary to continue managing these risks in the future, as they have in the past. Internal committees, risk controls, and processes are in place to mitigate the risks associated with leverage.

Importantly, it is worth noting that Staff's intent is NOT to create a strategic asset allocation policy that includes a leveraged total fund. (In other words, the target strategic policy leverage level will be 0%.) Rather, the 10% leverage limit is a new leverage constraint on the total fund. Staff's review clarifies that leverage use is intended only to smooth cash flows and as an intermittent tool to manage the portfolio. Historically, Staff has utilized leverage up to approximately 4% of the portfolio. Their goal is to build on this experience and provide for execution efficiencies in the future.

Staff has noted that the CIO report would include enhanced reporting on the use of total fund leverage. This level will also be monitored through Meketa's semi-annual reporting.

As monitoring explicit leverage at the Total Fund level would be new to the Staff and the Investment Committee, Meketa recommends the Staff provide the Committee additional education on:

→ Whether leverage usage will impact other risk parameters in various policies, such as asset class target ranges, and risk budgets.

→ A more comprehensive description of the types of leverage in the CalSTRS portfolio, which are counted as part of the total Fund leverage, and what types of leverage are not.

→ How leverage employed within certain asset classes is measured and monitored, and whether that asset class-level leverage impacts leverage used at the Total Fund level.

→ What impact would Total Fund leverage usage have on the CalSTRS Policy Benchmark and/or reference benchmark.

These additional points of clarification could be addressed in the normal course of keeping the Committee apprised of Staff's evolving use of leverage in the portfolio.

Meketa has independently reviewed the proposed first reading of the proposed IPS changes and concurs with Staff's recommendations regarding target ranges and leverage.

If you have any questions, please feel free to contact us at (760) 795-3450.

MLM/SPM/SBS/jls