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MEMORANDUM

TO: Investment Committee, CalSTRS
FROM: Stephen McCourt, Allan Emkin, Mika Malone, Stephanie Sorg, Meketa Investment Group
CC: Chris Ailman
DATE: March 6, 2024
RE: Opinion Memo – Investment Policy Statement Revisions – Liquidity Language

Summary and Recommendation

In July 2023, the Investment Committee approved new long-term strategic asset allocation ("SAA") targets and policy with an implementation plan that included a 5% increase to the illiquidity threshold (from 50% to 55%). In January 2024, Staff recommended, and the Investment Committee approved, two changes to the Investment Policy Statement ("IPS") aimed at providing greater flexibility to Staff to manage the SAA and necessary liquidity to achieve CalSTRS' objectives: 1) Widening asset allocation ranges and 2) Adopting an explicit 10% leverage limit at the total fund level (with a 0% policy target allocation). To further align the IPS with the long-term SAA, Staff is recommending revised liquidity language that shifts from the quantitative liquid asset-based policy to a principles-based liquidity policy. Specifically, the recommended policy language: 1) removes the current language that states: "No more than 55% of the total fund shall be invested in instruments that are not regularly publicly traded on a daily basis" and 2) replaces that language with the principles-based language that drives and constrains liquidity by the Asset Liability Management ("ALM") Study. ***After independently evaluating the proposed policy, Meketa Investment Group supports Staff's recommendation to adopt the modified IPS, which reflects the aforementioned updates to the liquidity language.***

Discussion

The two recommendations from Staff are intended, in concert, to align the IPS with the quantitative constraints of liquidity that are already inherently embedded within the approved SAA and asset allocation ranges of the policy. The specific changes are outlined as:

1. Removes the current language that states: "No more than 55 percent of the total fund shall be invested in instruments that are not regularly publicly traded on a daily basis."
2. Replaces with principles that state "The total allocation to liquidity (as defined in glossary) is driven and constrained by the Asset Liability Management Study conducted at least every four years. The Portfolio's liquidity needs, and allocation risks are prudently managed and governed through internal staff committees, policy, guidelines, and periodic reporting. The primary objectives of liquidity management include, meeting financial obligations, taking advantage of market opportunities, and portfolio rebalancing."

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The shift from the current 55% illiquid ceiling to the principles-based metric represents an immaterial change to the way in which Staff executes on the mandates of the portfolio, and better represents existing practiced at CalSTRS. The long-term strategic asset allocation targets and ranges provide a framework/constraint at the asset class level, as maximum exposure limits are articulated at the upper bound of each target range. To illustrate this, under the current SAA and the newly approved target ranges, the maximum exposure (given the upper bound of the respective asset allocation target ranges) to illiquid investments (defined as investments that are not regularly publicly traded on a daily basis) is 60%. It's worth noting that this is an extreme case, to articulate the maximum possible exposure but is highly unlikely to occur in practice. For instance, in this example we assume that the Inflation Sensitive asset class is 100% invested in infrastructure and reaches a 12% maximum Total Portfolio allocation. In reality, Infrastructure represented 55.7% of the Inflation Sensitive asset class as of December 2023, which equated to roughly 3.4% of the overall Total Portfolio.

Illiquid Asset Class	Long-term SAA Target (%)	New Range (%)	Maximum Exposure (%)	Old Range (%)	Old Maximum Exposure (%)
Private Equity	14	+/-5	19	+/-3	17
Real Estate	15	+/-5	20	+/-3	18
Innovative Strategies	0	+/-2.5	2.5	+/-2.5	2.5
Inflation Sensitive	7	+/-5	12	+/-3	10
Fixed Income – Direct Lending	2	0 – 2	2	0 – 2	2
RMS – Trend & SRP	5	3.5 – 7	7	3.5 - 7	7
Total Portfolio Illiquid Exposure	**43**		**60[1]**		**56.5[1]**

Staff's recommendation is based on peer universe research showing that liquidity risks are primarily addressed with principles-based language versus a defined numeric threshold in policy. In addition, Staff found that peers generally focus on "how to manage" liquidity and its associated risks to ensure adequate liquidity, rather than managing to illiquid exposures. For monitoring and reporting purposes, Staff has enhanced the Liquidity Report within the Investment Committee Portfolio Risk Report. Updates include modified language to align with Board discussions on liquidity oversight and the purpose of an appropriate level of liquidity, the addition of the 90-Day Liquid Coverage Ratio ("LCR") (defined as the proportion of cash available to meet stressed liquidity needs over a 90-day period) and the addition of explicit commentary summarizing the current status of liquidity health.

Meketa has independently reviewed the proposed first reading of the proposed IPS changes and concurs with Staff's recommendations regarding updates to the liquidity language.

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

SBS/SPM/MLM/jls

[1] The maximum Total Portfolio Illiquid Exposure is not a summation of the illiquid asset class upper bound range exposures, the value takes into consideration the lower bound limits of the liquid asset classes.