CALSTRS

Investment Committee

Item Number 6 – Open Session

Subject: Investment Policy Revision – Reference Portfolio Benchmark – First Reading

Presenter(s): Christopher Ailman and Scott Chan

Item Type: Information

Date & Time: September 13, 2023 – 20 minutes

Attachment(s): RVK, Inc Memorandum

PowerPoint(s): None

Item Purpose

The purpose of this item is to amend the Reference Portfolio Benchmark in the Investment Policy Statement to a simpler easier benchmark that is easily comparable to the average member's personal retirement investment fund found in a 403(b) or 401(k).

Recommendation

As the first reading, staff requests the Investment Committee's input and thoughts about the potential benchmark option. Staff and Meketa debated a few options. At the encouragement of the Investment Committee Chair, staff retained a project consultant, RVK, Inc. to help select a final recommendation. After some debate, all three groups agreed and recommended a 60/40 MSCI ACWI and Bloomberg Aggregate index mix as the new Reference Portfolio benchmark.

Executive Summary

- In late 2021, the Retirement Board asked Meketa to look into a simpler Total Fund Benchmark. In 2022, Meketa undertook a lengthy study and survey to gain the Board's input.
- At the January and May 2023 Retirement Board Meetings, Meketa presented a series of ideas and information on various similar benchmarks. The May 2023 Retirement Board agenda item and the Meketa PowerPoint which are linked on the last page as a reference.
- After a comparison of peers and potential benchmarks, it was clear that in order to develop a simple benchmark, no more than two to four benchmarks should be used.

- After a discussion at the May Retirement Board meeting, Meketa in concert with staff, decided on a two-index benchmark with the MSCI All World Country index, the ACWI index to measure global public stocks, and the Bloomberg Barclay's Aggregate index to measure Bonds / Fixed Income.
- These two indices represent very common investment options for retail investors and would represent the simplest form of a benchmark to reference to the CalSTRS investment portfolio.

Background

The original CalSTRS Reference Portfolio Benchmark, the Morningstar, Morningstar Moderate Target Risk index was first added into the Investment Policy and Management Plan back in 2013. This benchmark closely approximated the public market equivalent of the CalSTRS investment portfolio. The intent of the reference portfolio was to give the members and public benchmark they could compare to the CalSTRS portfolio. Ideally, you want a reference benchmark they can invest in for their retirement fund, so it is a benchmark with a similar time horizon and moderate risk / return objective of a typical 403(b) or 401(k) retirement account.

One challenge with the Morningstar index is that it is not easily found on the internet without the precise name. Coupled with the Board's desire to find a "simple" total Fund benchmark, it affords the opportune time to combine the two efforts and revise the IPS Reference Portfolio Benchmark. The overall idea to simplify the benchmarks started back in 2021 with the Retirement Board and the complications of incentive compensation. As mentioned in the Executive Summary, Meketa stepped up and undertook a survey of the Board to help define the benchmark issues. They made presentations in 2022 and 2023 to the Board. After the May presentation, the Retirement Board Chair and Investment Committee Chair shifted the simplified benchmark study to the Investment Committee for the FY 23-24 and directed the CIO to work with a staff consultant and Meketa to develop a recommendation for the Investment Committee.

Discussion

During all the discussions and various options, Meketa concluded, and staff concurred, the simplest benchmark would be two publicly published benchmarks. We often hear the expression of a "60/40 equity/debt portfolio" as an industry-standard benchmark. It is considered the typical Trust Account, "widows and orphans portfolio mix." In considering the CalSTRS portfolio, the team also considered including two non-public benchmarks to track Real Estate and Private Equity, both of which are 15% weights in the CalSTRS Portfolio. The challenge is neither of these benchmarks are published for the public and they are each exceedingly complex, thereby voiding the idea of a "simple" benchmark. Additionally, neither of these areas are easily investable for our members in their traditional retirement accounts, so they don't fulfill the reference portfolio concept of how our members can invest. In the end, the team decided to stick with two public benchmarks, despite the obvious challenges of tracking errors to the actual CalSTRS investment portfolio.

Meketa's May memo excellently displays the tracking error challenge of a simple Reference Benchmark. The Investment Committee, on the advice of staff and the external consultants, have long sought to invest in Real Estate, Private Equity, Infrastructure, and other private market investments to diversify the portfolio and achieve a higher rate of return at a lower level of portfolio risk. Most recently, the Investment Committee, again on the advice of staff and consultant, added new Asset Classes of Inflation Sensitive and Risk Mitigating Strategies to further improve the risk return potential of the massive portfolio. The overall combination of these private and public market areas has greatly expanded the diversification, but also the complexity of the CalSTRS portfolio.

The Investment Committee intentionally uses the investment portfolios' massive size and global reach to find investments that are not open to individual retail investors. These adjustments make the portfolio more complex and tough to benchmark. CalSTRS has also adopted multiple exclusions and tilts to the portfolio. As a result, a simple benchmark of publicly traded stocks and bonds has a very different return and risk pattern from the CalSTRS portfolio. We define this difference in pattern between the two as "tracking error".

It is openly acknowledged that there will be distinct periods, sometimes lasting several years, where the globally diversified private and public CalSTRS portfolio will not be able to beat the two-index simple benchmark. Twice in the past two decades, we have seen the U.S. Federal Reserve drop interest rates to zero to protect and stimulate the U.S. economy. Zero interest rates had never existed before this time period. But in that economic environment, public investments have done exceedingly well and private investments have been slow to move and change in price. As a result, the simple public reference benchmark will outperform the complex portfolio. But over longer time periods, the illiquid private investments have proven out and produced a net better risk return adjusted investment return.

	Expected Return	Expected Risk
CalSTRS Long-Term Asset Mix	7.4%	10.1%
60/40 Equity/Debt Benchmark	6.3%	10.3%

So, using this simple benchmark, we will see a wide return difference from year to year. Over longer time periods, such as ten and twenty years, we believe the more complex and diversified CalSTRS portfolio will outperform. But there will be periods, and potentially prolonged periods over five years, where the simple benchmark exceeds the CalSTRS portfolio. This will create a challenge and pressure to change the strategy. At those points in time, the Investment Committee will need to conduct an asset allocation study and determine if the return premium from private investments and diversification benefits have actually changed.

Strategic Plan Linkage:

Board Policy Linkage: Investment Policy Statement / Investment Policy & Management Plan

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Optional Reference Material:

Retirement Board January 2022: Item #13 Benchmark Review Project; Attachment #1; PowerPoint

Retirement Board January 2023: Item #5 – Benchmark Review Project; Attachment #1; PowerPoint

Retirement Board May 2023: Item #7 – Benchmark Review Project; PowerPoint