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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: November 1, 2023
RE: Special Mandates Report

Background/Summary

CalSTRS has a history of considering specialized mandates/investment strategies dating back to the 1980s. In December 2015, the CalSTRS Board expressed the desire to formulate an official process for Board Members to refer and approve Special Mandates. In response, a formal Special Mandate Policy was adopted in June 2016. "Special Mandates" are defined as discrete investment strategies promoted by Board Members that include, but are not limited to, environmental, social, governance ("ESG"); in-state investments; or other factors that are expected to have a positive or neutral impact on economic performance of the fund over the long-term. Current special mandates include Developing Manager Program (Global Equity), Clean Tech Investment (Private Equity), and Proactive Program (Private Equity).

In accordance with the Special Mandate policy, Meketa is required to review the special mandates, including an updated review of the original expected economic risks and opportunities and any material developments since approval of the mandate. As such, Meketa has conducted interviews with the key Staff leading the special mandates to discuss the purpose and execution of each program, recent performance, and any issues/concerns with the program moving forward. The Investment Committee must affirmatively vote to continue special mandates every six years, with the next Committee review due in 2024.

Discussion

The Global Equity – Developing Manager Program was funded in August 2004 with an allocation of $600 million. The intention of this program is to invest in emerging/developing managers both domestically and internationally. Through positive investment performance and net cash inflows, the program currently has a market value of $1.9 billion.[1] This program takes a "fund-of-funds" approach to investment strategy selection, in order to gain access to smaller, developing managers. At its inception, the portfolio was structured to be solely invested in active US strategies. Performance during that tenure was lackluster, given the efficiency of domestic markets. But, since the program shifted to include non-US opportunities and the employment of global weights in November 2016, performance has improved.

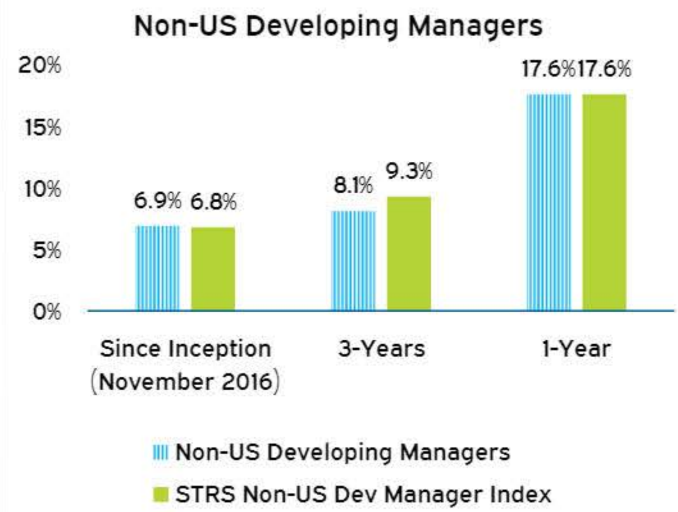
[1] Market value as of June 30, 2023.

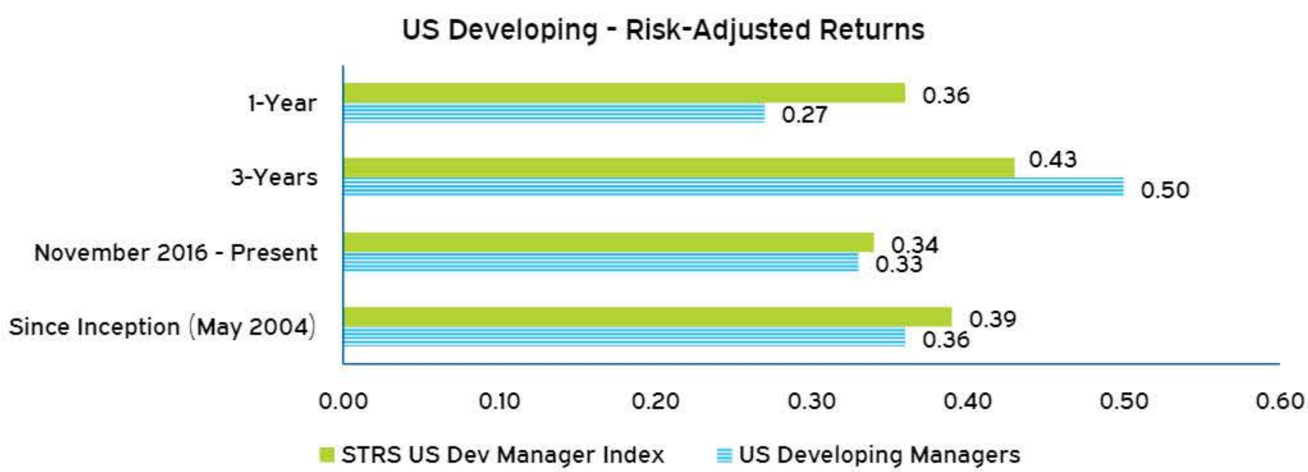
Since inception, the program has generated an annualized +7.2% return, lagging the Total Public Equity Custom Index by 80 basis points. When adjusting for risk,[1] the program achieved a slightly higher Sharpe Ratio than the benchmark (0.44 versus 0.43) since August 2004.

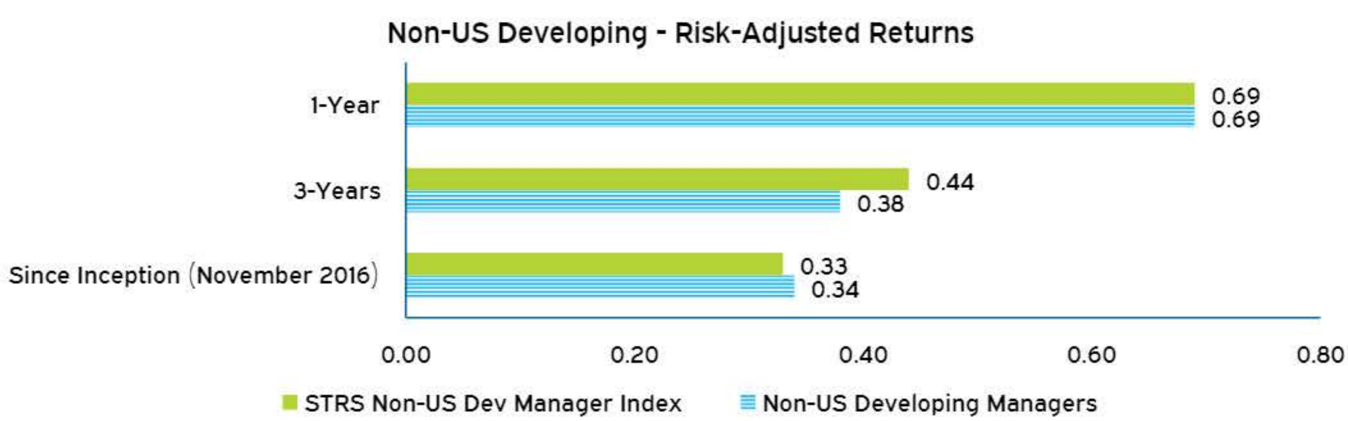
Since the inclusion of the non-US Developing program in November 2016, the Global Equity aggregate appreciated an annualized +7.4%, but lagged the Total Public Equity Custom Index by 260 basis points. The underperformance over this time period is due to the program's structural tilt towards non-US strategies. Since November 2016, the Non-US Developing program, on average, accounted for 79% of the Global Equity Developing Manager program, and in absolute performance terms, lagged the return of the US Developing program by 160 basis points per year (+6.9% versus +8.5%). Over recent time periods, the Developing Manager Program has exhibited strong absolute performance, as it returned +15.9% over the trailing one-year period, and +9.0% over the past three-years.

[1] Measured by the Sharpe Ratio.

The underlying programs within Global Equity, US Developing and Non-US Developing, exhibit positive absolute returns over trailing time periods, but show mixed results on a relative basis, as displayed in the charts below. Over recent time periods, the Non-US Developing program posted a +17.6% trailing one-year return, which attributed to 77% of the Global Equity program's +15.9% performance.

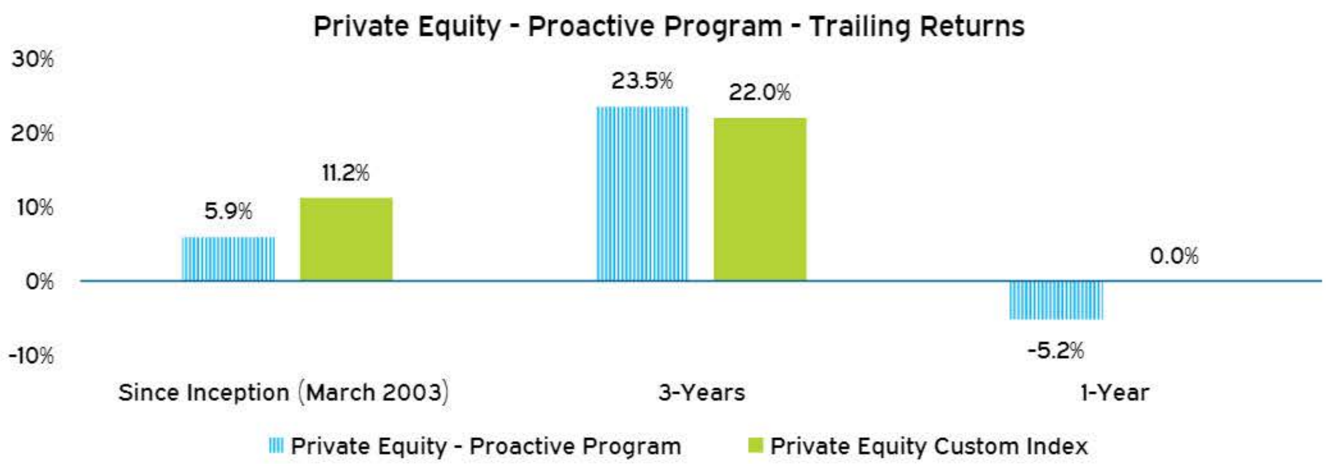






The Private Equity – Proactive Program was funded in March 2003, with an allocation of 4% of the overall Private Equity Portfolio. Originally, the program aimed to access emerging private equity managers with an emphasis on underserved urban & rural California strategies. It later evolved into a program that focused on investing in small and emerging private equity managers, using a fund of funds structure. As of June 30, 2023, the program had a market value of $2.0 billion and was invested across three private equity fund-of-funds managers.

Since inception, the program has generated an annualized +5.9% return, lagging the Private Equity Custom Index by 5.3%. Underperformance is due primarily to the program originally making larger commitments directly into partnerships that failed to produce strong returns. This approach has since evolved (starting in 2007) to utilizing more diversified vehicles managed by external firms. Performance subsequently improved and all new commitments are now flowing to these diversified vehicles. Over the most recent three-year time period, the Proactive Program produced an annualized +23.5% return and outpaced the Private Equity Custom Index by 150 basis points.



The Private Equity – Clean Tech Investments Program was funded in May 2005 with an allocation of $100 million to venture capital and $400 million to energy-related investments. As the result of the elimination of this special mandate in September 2018, the program had a runoff market value of $8.0 million as of June 30, 2023.

Meketa Investment Group has independently evaluated the two active Special Mandates, which are both operating efficiently and within expectations. Both programs are intended to allow CalSTRS to identify smaller, emerging managers earlier in their development, improving the potential pipeline of future asset managers for CalSTRS, and allowing CalSTRS to benefit from any emerging trends or best practices in the asset management industry.

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

SPM/SBS/AE/jls