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MEMORANDUM

TO: Investment Committee, CalSTRS
FROM: John Haggerty, Tad Fergusson, Meketa Investment Group
CC: Christopher Ailman
DATE: January 27, 2022
RE: Private Equity Policy Revisions- Second Reading

CalSTRS Investment Staff ("Staff") has provided Meketa Investment Group ("Meketa") with a Second Reading of proposed revisions to the Private Equity Policy ("PE Policy") for review. Meketa has had a number of discussions with Staff about these recommendations. These revisions reflect both the growth in the CalSTRS private equity portfolio and changes in the marketplace. They also reflect the expected flexibility likely to be required to more fully pursue the Collaborative Model. In recent years, the Private Equity staff has grown in number and in specialized transactional experience to pursue the new options these revisions create. Notably, many of these revisions focus on increasing opportunities for co-investments, which could provide considerable cost savings for CalSTRS.

As a brief summary, Staff's recommendation includes the following revisions:

- Modify Program objectives to include overlap strategies (e.g., SISS and Innovative Strategies);
- Increase allowable commitment size across funds, separately managed accounts, co-investments, secondaries, and direct investments in general partner companies;
- Expand the range of co-investment sources and allowable strategies;
- Expand the range of strategies available under the Special Mandates;
- Adjust certain sub-asset class ranges and long term targets;
- Adjust geographies and associated ranges;
- Clarify reporting responsibilities and add Pacing Plans to the list of reports;
- Clarify language and format updates;
- Update and clarify certain definitions and explanations, and;
- Incorporate miscellaneous updates and clarifications.

We understand that Staff will provide a presentation at the Investment Committee meeting that discusses the proposed policy changes, as well as Staff's vision for the future of the Program. We encourage the Investment Committee to review the proposed PE Policy changes and engage Staff in a dialog about the vision they have articulated for the Program's continued implementation of the Collaborative Model through increased co-investment volume and the associated fee savings. We concur with the proposed policy changes (as more fully described below), while highlighting areas that warrant additional reporting to the Investment Committee and on-going monitoring.

We remind the Investment Committee that the PE Policy, like other CalSTRS investment policies, is designed to provide a measure of risk control, as the Staff builds the investment portfolio under delegation from the Investment Committee. These delegations should be viewed from the perspective of the longer-term business plan, expected market conditions and opportunities, and Staff's experience and capabilities.

Below is a summary of the more significant modifications proposed by Staff and, where relevant, commentary from Meketa regarding each proposed change:

- Modify Program objectives to include overlap strategies (e.g., SISS and Innovative Strategies). As CalSTRS continues to implement the Collaborative Model, the PE Policy should be updated to recognize that certain investments will likely not fit neatly within each asset class. Specifically, the SISS and Innovative Strategy policy statements have recently been modified, and, as such, the PE Policy has a corresponding modification.

  We believe this is an appropriate update to the PE Policy and reflects the continued implementation of the Collaborative Model.

- Increase delegated authorities – Diversified Vehicles. We believe it is helpful to view the proposed increases in the investment size of delegated authority from the perspective of diversifiable risk. For diversified investment vehicles such as commingled funds, separate managed accounts, and secondaries, we note that the Program has grown substantially from the last time PE Policy addressed investment size delegation. Going forward, the Program is projected to increase to over $50 billion in the next several years. The increase in potential commitments to diversified investment vehicles reflects both the increased size and scope of the Program and the private equity market overall. Additionally, the proposed policy change retains the 25% maximum percentage that CalSTRS may comprise of a fund, thereby ensuring that the fund has a number of other LPs, in addition to CalSTRS. The increase of delegated authority throughout the proposed PE Policy changes are now stated as a percentage of PE NAV, rather than a static dollar amount.

  We believe the increase in delegated authorities is appropriate given the growth of CalSTRS' PE Program and that the framing of the transaction size in percentage terms will allow the limits to evolve with continued PE Program growth or contraction. With evolving delegated authorities limits, it should be noted that the percentage is to be applied at the time of investment.

- Adjustment to certain sub-asset class range and long term targets. Staff seeks to modify the ranges and long term targets for certain sub-asset classes. Specifically, the range for Longer-Term Strategies would be increased, while targets to Buyouts and Debt-Related strategies would be increased and decreased, respectively.

  We believe these incremental changes to sub-asset class ranges and long term targets are appropriate and reflect CalSTRS' actionable areas within the private equity market.

- Clarify reporting responsibilities and add Pacing Plans to list of reports. The proposed PE Policy changes both clarify certain reporting responsibilities among Staff and the Private

Equity Board Consultant, and add a Pacing Plan to the list of reports provided to the Investment Committee.

We find these changes to be an appropriate clarification of reporting responsibilities.

- Adjustment to geographies and associated ranges. Due to limitations of CalSTRS' benchmark provider, Staff is proposing the elimination of "Non-Developed Markets" (currently with a range of 0-15%, and target of 5%) from the PE Policy. As a result, CalSTRS would have geographies defined as either "North America" or "Non-North America". As the Investment Committee has heard at several meetings, emerging markets are an important area of investment diversification, not only for private equity, but for the total portfolio. They are also an area that encompasses additional risks.

  While we concur with Staff's proposed change, we encourage Staff to continue to report to the Investment Committee important dimensions of geographic diversification and risk in the Program. Meketa will monitor these exposures and report on this in our semi-annual reviews.

- Increase in delegated authorities - Undiversified Vehicles. We note that co-investments, undiversified secondaries, and investments in general partner direct companies do not offer the same level of diversification as funds, SMAs, or diversified secondaries. A key issue is that undiversified investments can have a wider set of return outcomes (both positive and negative) compared to diversified investment structures. However, co-investments and other undiversified investments are appropriate investments within the broader context of the very diversified Private Equity Program and can provide fee savings. Additionally, as we noted above, the Program is expected to continue to grow thereby making any one co-investment/undiversified investment less meaningful as a percent of the total Program.

  The current PE Policy seeks to mitigate risk in undiversified investments by both limiting the size (currently $250 million), as well as require that the GP sponsoring the co-investment make a significant investment in the transaction. Staff's proposed PE Policy makes changes in both areas.

  - *Investment Size*: Staff has recommended increasing the investment limit from $250 million to 2% of PE NAV (representing approximately $880 million of current PE NAV of $45 billion) for individual co-investments, undiversified secondaries and direct General Partner investments.
  - *Alignment:* Currently, the PE Policy requires that the GP sponsoring the co-investment has at least the same amount of capital as CalSTRS in the co-investment transaction. This requirement is eliminated in Staff's proposed PE Policy changes. As a replacement, Staff's proposed changes adds a condition that CalSTRS represent no more than 50% of the financing round, ensuring that the co-investment has at least one other meaningful investor (whether that is the sponsor or another investor).

  Meketa believes that the higher limits for individual co-investments, secondaries, and direct general partner investments are aligned with the Investment Committee's direction on the Collaborative Model, particularly given the increased size of CalSTRS' PE Program. We also

believe that relaxing the requirement for GP commitment amount in co-invests expands Staff's ability to execute more co-investments. While these changes have the potential to add volatility from larger undiversified investments and from less alignment with the GPs, Meketa will monitor activities in these areas of expanded delegation and report to the Committee in its semi-annual reviews, ensuring the Committee is prudently monitoring any emerging risks that are not properly compensated.

- Expand the range of co-investment sources and allowable strategies. Staff has made significant efforts to grow and develop its co-investment program in recent years. Additionally, recent performance of the co-investment program has been strong. CalSTRS has increased its market presence and is now known as one of the largest and most sophisticated co-investment programs. Staff has proposed certain changes to both the range and type of co-investments it may seek in order to provide CalSTRS with a larger set of investment opportunities. Currently, CalSTRS can only make co-investments alongside GPs where it has an existing relationship. This condition allows Staff to benefit from the research and due diligence it has done to understand the GP's strengths and weaknesses, particularly as it can apply to co-investments (e.g., the GP is relatively strong in technology investments, but relatively weak in the consumer sector). Additionally, because the GP has a significant amount of CalSTRS capital committed to their comingled fund, it is further aligned with CalSTRS. Staff's proposed PE Policy change eliminates the requirement that the co-investment be sponsored by a GP with an existing relationship, and expands the range of co-investment sponsors to include not only other non-CalSTRS GPs, but other institutional investors (non-GPs).

  Meketa believes that expanding the range of co-investment sources and allowable strategies are aligned with the Investment Committee's direction on the Collaborative Model. While these transactions may incorporate some increased risks due to lower levels of knowledge about (and alignment with) GP co-investment partners and non-GPs that are not in the CalSTRS portfolio, PE program advisors work with Staff on each co-investment deal, mitigating the risk of lower levels of transaction sponsor knowledge. Meketa will monitor this area of expanded delegation and report on activity in these areas to the Committee in its semi-annual reviews.

- Expansion of the range of investments available under the Special Mandates. The Special Mandates can be a source of attractive investment opportunities. However, given these managers tend to be less proven than other GPs, investment returns from Special Mandate managers can be more volatile than more proven managers. Staff seeks to expand the range of investments it can consider under Special Mandates to include co-investments and GP interests. Specifically under Special Mandates, Staff would have delegation to make co-investments up to $100 million per financing round.

  We believe that an expansion of Special Mandate investments makes sense for CalSTRS, and acknowledge that the proposed expansion of the Special Mandate investment strategies to include undiversified investments with potentially less proven GPs may increase risk through a broader range of transaction outcomes. Meketa will monitor this expanded delegation and report on this area in our semi-annual reviews.

Conclusions

In general, the revisions to the Private Equity Policy are aimed at empowering the Private Equity Staff to more fully pursue the Collaborative Model and position the CalSTRS Private Equity Program to best leverage its size and reputation in the marketplace. The private equity market has continued to develop, while the PE Program has grown in size, specialization, and sophistication. The PE Policy should be viewed both from where the Program is now, as well as where it will be in the near future. It is appropriate, and necessary, that the PE Policy be reviewed and modified over time.

Staff has proposed these changes to the PE Policy for a second reading. We suggest that the Board carefully review these changes and hear from Staff about their vision for how the Program would develop in the coming years. Several of the proposed changes to PE Policy involve expansion of Staff's delegated authority, specifically around Staff's ability to source investments and commit more capital to such investments.

Meketa believes that it is appropriate for the Investment Committee, as a policy-oriented committee, to expand Staff delegation in areas where such expansion relates to areas where Staff has shown an ability to execute successfully and where the changes align with CalSTRS' strategic goals (in this case, the continuing evolution of the Collaborative Model). At the same time, it is appropriate for the Investment Committee to closely monitor the expanded delegation to ensure that such delegation results in the benefits anticipated by the Policy changes. To this end, Meketa will add to its semi-annual reporting to the Investment Committee specific reporting on the policy changes that have the potential to elevate risk in the Program.

In conclusion, Meketa believes that the proposed PE Policy changes will facilitate Staff's ability to implement the Collaborative Model and is supportive of the changes.

We look forward to further interactions with the Board on this, and other topics. If you have questions, please feel free to contact us at (760) 795-3450.

JH/TF/SPM/JLS