

CALSTRS

CALIFORNIA STATE TEACHERS'
RETIREMENT SYSTEM

**INFLATION SENSITIVE
INVESTMENT
POLICY**

INVESTMENT BRANCH

SEPTEMBER 2015

Q. Inflation Sensitive Investment Policy

EXECUTIVE SUMMARY

The Inflation Sensitive Investment Portfolio currently consists of: (1) The Global Inflation Linked Portfolio and; (2) The Infrastructure Portfolio. The purpose of the Inflation Sensitive Policy (Policy) is to expand the opportunity set beyond the current portfolio constituents available under the current [Investment Policy and Management Plan](#) (IPMP, pg. A-15). This new Policy includes investments and strategies not covered by the Infrastructure Policy. However, this Policy incorporates the [Infrastructure Policy](#) by reference and recognizes it as an integral component of the Inflation Sensitive asset class structure.

In accordance with the CalSTRS Investment Policy and Management Plan, the California State Teachers' Retirement System Board (Board) has established an Inflation Sensitive Portfolio. The primary objective for the Inflation Sensitive Portfolio (Portfolio) is to invest in strategies that provide further diversification of CalSTRS overall investment Portfolio. The secondary objective of the Inflation Sensitive Portfolio is to construct a portfolio that will invest in strategies that provide protection against inflation and generate a long term return which exceeds both inflation and the performance benchmark while taking reasonable and prudent risk.

CalSTRS Inflation Sensitive assets are to be invested, administered, and managed in a prudent manner for the sole benefit of its participants and beneficiaries, in accordance with the California Constitution, Teachers' Retirement Law, and other applicable statutes. No investment instrument or activity prohibited by the IPMP shall be authorized for the Inflation Sensitive Portfolio.

The Policy ensures that investors, managers, consultants, advisors, or other participants selected by CalSTRS take prudent and careful action while managing the Portfolio. The purchase, management, and sale of all Portfolio products are performed by external and/or internal professionals (managers) who are monitored and evaluated by internal investment officers, a Portfolio consultant, and/or independent fiduciaries.

CalSTRS believes that environmental, social and governance (ESG) issues can affect the performance of our investments. As a result, CalSTRS Risk Factors have been developed as a tool that both internal and external investment managers are expected to use to assess the impact of ESG risk when making an investment on behalf of CalSTRS. CalSTRS ESG Risk Factors can be found in the most current IPMP and may be viewed by accessing www.calstrs.com/investment-policies.

The internal investment officers and independent fiduciaries operate under the direction of the Chief Investment Officer (CIO). Review of the Portfolio falls under the general consultant (Consultant), who reports directly to the Investment Committee. If a specialty asset class consultant is retained, that consultant will report directly to the Investment Committee.

Policies approved by the CalSTRS' Investment Committee cannot be altered without explicit direction from the Board.

Investment Objective

The purpose of the Portfolio is to provide diversification to the CalSTRS portfolio, lower the macroeconomic risks that pervade other major asset classes, and positively capture long-term changes in inflation.

Inflation is defined as a sustained and persistent increase in the general price level of goods and services leading to a subsequent reduction in individual and group purchasing power. Inflation can be driven by an increase in the overall money supply or disequilibrium between supply and demand, in any number of markets, that ripple across the economy. The strategic objective of the Portfolio is to:

- A. Provide inflation protection, diversification and inflation linked returns for the long-term.
- B. To lower CalSTRS' portfolio volatility through a combination of strategies and sector allocations less correlated with long-term growth.
- C. Pursue investments which provide cash flows correlated with inflationary assets that contain adjustable contractual or non-contractual payment streams that will benefit from inflation over the long-term.
- D. Pursue investments expected to benefit from inflation and increase in market value over the long term.

The Portfolio will seek to improve the diversification of the total investment portfolio and enhance its risk-adjusted total return. The assets shall be managed to generate current income and provide a modest level of capital appreciation.

Performance Objectives

The Portfolio is to be structured to achieve a long term total return that is consistent with its policy benchmarks. Each strategy within the Portfolio will have its own specific performance benchmark. Therefore, the portfolio will have a blended weighting comprised of the strategies undertaken within the Portfolio. A blended and weighted benchmark will be the end result. The long term objective of the Portfolio is to exceed US CPI by a reasonable level over a market cycle of three to five years.

Policy Benchmark

The current policy benchmark is blend of The Barclays Inflation Linked Global Series – L Index (representing the Global Inflation Linked Portfolio) and a CPI +4% a year index (representing the Infrastructure portfolio). The future benchmark shall be a blended performance benchmark that will comprise the weightings for each of the strategies undertaken in the Inflation Sensitive Portfolio multiplied by their respective benchmarks.

Portfolio Structure

The Inflation Sensitive Portfolio is a unique hybrid class of multiple asset types that jointly seek to produce a stable return and one that exceeds the specified performance objective. To achieve the stated performance objective, the Portfolio will invest in a diversified portfolio of strategies with a mixture of both internal and external management. Diversification within the Portfolio will be a critical aspect of risk-control. Investments will be aggregated, assessed, and monitored so as to control for unintended biases.

Inflation Sensitive assets will consist of two major components:

- A. Public – Inflation Sensitive – will include strategies that utilize public securities that have a linkage to changes in inflation and are bought and sold in widely recognized and liquid markets and can include:
 1. Government Inflation Linked Bonds – these strategies invest in US Treasury Inflation Linked securities and/or Global Sovereign Inflation Linked Securities.
 2. Inflation Linked Corporate debt (investment grade) - short-term fixed and floating rate debt and loan securities – these securities may take the form of short term corporate securities that have investment grade ratings. Investment grade ratings are those securities rated Baa3/BBB-/BBB- or higher using two of the three equivalent ratings of Moody's, Standard and Poor's Ratings Service, or Fitch Ratings.
 3. Inflation Linked Corporate debt (high yield) - short-term fixed and floating rate debt and loan securities – these securities may take the form of short term corporate debt in which the investor has first or second lien coverage and have below investment grade credit ratings. Below investment grade ratings are those securities rated Ba1/BB+/BB+ or lower using two of the three equivalent ratings of Moody's, Standard and Poor's Rating Service, or Fitch Ratings.
 4. Commodities and commodity based strategies determined to be aligned with CalSTRS inflation sensitive mandate.
 5. Equity securities and equity based strategies determined to be aligned with CalSTRS inflation sensitive mandate (e.g., MLPs).
- B. Private – Inflation Sensitive – will include strategies that utilize private securities that have a linkage to changes in inflation but are more illiquid and can include:
 1. Infrastructure related equity positions and/or debt securities – these strategies are within the Infrastructure Portfolio and are defined in the [Infrastructure Portfolio Policy](#).

2. Other security types and strategies may include, but are not limited to: timber, agricultural, energy, commodities or other strategies uncovered as part of the Inflation Sensitive unit's normal course of business, strategies spun out of the Innovation and Risk unit, or strategies presented to other units of the Investment Branch that might not fit a particular unit's mandate but might more closely fit the Inflation Sensitive unit's objectives.

Allocation Ranges

Allocation and target ranges for the Inflation Sensitive Portfolio between its two major components are:

Component	Lower Limit	Upper Limit
<ul style="list-style-type: none"> • Public - Inflation Sensitive 	20%	80%
<ul style="list-style-type: none"> • Private – Inflation Sensitive 	20%	80%

Other Strategies

Other securities and or strategies that are deemed by the Director of Inflation Sensitive, the Chief Investment Officer, Deputy Chief Investment Officer, and consultant (e.g., general or specialized consultant - if deemed necessary) that are expected to provide protection against the risks associated with inflation may also be considered under this Policy. Such investments may include, but are not limited to, public and private equity/debt, preferred public and private equity/debt and publicly listed equity with an inflation protection emphasis. The Inflation Sensitive staff may select and utilize: Co-Investments, Separate Accounts, Joint Ventures, Commingled Funds, and appropriate Direct Investments. These vehicles will be selected to provide for appropriate return and control, the highest level of accountability on the part of management, and alignment of interests with CalSTRS, all while mitigating both risk and costs.

Risk Management

- A. Diversification - plays a critical role in a portfolio in order to control risk and maximize returns. The Portfolio is expected to diversify among and across various investment types and structures in order to insure liquidity, maximize income and insure modest capital appreciation. Minimum and maximum ranges with respect to investment sectors, credit exposures, duration, and tracking error will be established, when applicable, to those parts of the Portfolio that have significant debt exposures. The Director of Inflation Sensitive will work with managers and develop guidelines to insure that portfolios and strategies are broadly diversified within the best practices of any particular strategy adopted.

- B. Derivatives - are permitted to assist in the efficient management of risk, asset allocation or market exposures in the Portfolio. Such instruments can include futures, options, swap agreements, or forwards as well as strategies that may employ derivatives as part of their normal course of management. The implementation of any derivative strategy will be thoroughly reviewed by the Director of Inflation Sensitive, Deputy Chief Investment Officer, the Director of Fixed Income, the Chief Investment Officer, or designee. Limitations concerning aggregate risk control and counterparty exposures will be documented in the investment guidelines and not conflict with the IPMP.
- C. Authorized traders – Authorization letters which specify who may transact business for the Portfolio shall be sent a copy of the most recent investment resolution at the time the account is opened and then periodically to all broker/dealers with whom CalSTRS conducts business. Whenever a change in an authorized trader(s) takes place, the broker/dealer shall be notified in writing or via e-mail within 24 hours in the event of a termination, or as soon as possible in the event of a newly authorized trader(s).
- D. Trading parameters – the following trading parameters are non-cumulative and apply with respect to daily trading activity within any internally managed portion of the Portfolio. For transition management portfolios, tighter trading parameters may be applied:

Investment Officer I	up to 2% of related internally managed portfolio
Investment Officer II	up to 4% of related internally managed portfolio
Investment Officer III	up to 6% of related internally managed portfolio
Portfolio Manager	up to 10% of related internally managed portfolio
Director of Inflation Sensitive	up to 5% of total Inflation Sensitive Portfolio
Deputy Chief Investment Officer and Chief Investment Officer	up to 10% of total internal management

- E. Wire and Trade Processing – All transactions relating to internally managed Inflation Sensitive Portfolios shall be traded within the parameters noted above and approved within the confines of guidelines that require, at a minimum, a dual release for all trades. It should be noted that the staff person releasing the trade to the custodian must be from the Investment Operations Unit to ensure a proper separation of duties.
- F. Cash Transfer Limitations – the following limits are non-cumulative and apply with respect to Inflation Sensitive investment officers signing for daily cash disbursements for investment portfolio transactions:

Investment Officer I	\$20 million
Investment Officer II	\$30 million
Investment Officer III	\$50 million
Portfolio Manager	\$75 million
Director of Inflation Sensitive	\$200 million
Deputy Chief Investment Officer	\$500 million
Chief Investment Officer	\$500 million

As investments are added to the Inflation Sensitive Portfolio and the Portfolio matures, the daily cash transfer limits will be reviewed, and a daily transfer limit based on a percentage of the Portfolio will be considered.

Inflation Sensitive Internal/External Management

The Inflation Sensitive Portfolio will be managed through a combination of internal staff and external managers. Within the boundaries established in the procedures, the decision to hire an external manager or utilize internal investment staff for an investment strategy is made by applying a Board-approved criteria matrix (Exhibit 2) to evaluate a variety of factors including, but not limited to, cost effectiveness/control, market transparency and liquidity, market efficiency, active risk, and infrastructure/resource requirements. CalSTRS uses active external management as a tool to implement its inflation sensitive strategies and to allocate risk where it believes there is the greatest opportunity to enhance returns commensurate with the associated risk undertaken.

Within the boundaries and ranges established by this Investment Policy, staff is responsible for the selection, allocation, and oversight of external managers hired to implement an Inflation Sensitive strategy. Manager guidelines, objectives, benchmark selection, portfolio composition, and constraints are to be administered and monitored across all inflation sensitive portfolios.

Portfolio Leverage

CalSTRS will employ leverage in the Portfolio as found within a Fund, Separate Accounts/ Co-invest, Joint Ventures, and applicable Direct Investments. Such leverage may exist at the portfolio, manager or investment level. Since leverage also increases the volatility of the Portfolio, careful consideration will be given to the impact of leverage on investment and portfolio risk. In addition, limitations on the amount of leverage at the individual asset or investment entity level, as well as debt service coverage requirements, will be negotiated or arranged wherever possible.

Leverage at the aggregate Inflation Sensitive portfolio level shall be monitored with a long-term goal of maintaining it at no higher than 50 percent (50%) LTV (i.e., loan-to-value). To preserve the character of the asset class within CalSTRS' total Fund portfolio, the aggregate asset class shall not be overleveraged. This shall be measured quarterly by comparing the principal amount of debt secured by Private Inflation Sensitive investments in the Portfolio to the aggregate gross fair market value. To the extent that leverage exceeds the maximum, CalSTRS shall make reasonable efforts to reduce the leverage ratio to below the maximum allowable, within a reasonable time frame.

Exit Strategies

Investments in the Inflation Sensitive Portfolio should have clearly articulated and viable exit strategies through which assets can be disposed of or liquidated upon termination of the investment manager. The Portfolio is expected to have a combination of liquid and illiquid assets. Some fund structures may have liquidation mechanisms and others may not have clearly defined liquidation events. The Portfolio will seek to diversify among the various structures available based on a careful balance between the need for liquidity, the potential negative effects of inflation and structures emphasizing both income and modest capital appreciation.

Annual Business Plan

The Portfolio will be managed according to an annual business plan.

Monitoring and Reporting

The following reports will be prepared and presented to the Board, unless otherwise stated, in order to facilitate visibility of compliance monitoring and reporting according to this document:

- a. **Inflation Sensitive Quarterly Status Report** – prepared by staff.
- b. **Performance Report** – prepared by master custodian/consultant (semi-annually).
- c. **Semi-Annual Report on Investment Manager Ratings** – prepared by staff
- d. **Business Plan** – prepared by staff (annually).

Policy Monitoring and Modification

The general consultant or specialized Inflation Sensitive consultant, if retained, shall monitor the investment process for compliance with this policy and report to the CalSTRS Investment Committee on a semi-annual basis.

This Inflation Sensitive Investment Policy shall be reviewed periodically to determine if modifications are necessary or desirable. Any changes shall be subject to the approval of the Investment Committee.

Adopted by the Teachers' Retirement Board on September 2, 2015