

CalSTRS' Portfolio Restriction Cost Analysis

Background:

This cost analysis tracks the estimated gains and losses associated with CalSTRS' three investment restriction related programs. The current Portfolio Restrictions Policy (effective November 2023) and two Legacy Programs which include the Benchmark Modification program (2000 - 2009) and the Divestment Policy program (2010 – 2023). CalSTRS has excluded several companies, beginning in 2006, when certain companies were excluded due to geopolitical risk concerns, but for the purposes of this analysis the cost of Portfolio Restrictions Policy is calculated as of January 2010.

Prior to 2010, CalSTRS passive strategies excluded all tobacco companies, when they were removed from CalSTRS benchmarks "Benchmark Modification" (Equity as of September 2000 and Debt as of July 2002). During this time there was not a policy requiring restriction for active managers.

The Portfolio Restrictions Policy outlines six current restrictions that are tracked in this analysis based on their implementation dates: tobacco companies (January 2010), firearms companies (May 2013), thermal coal companies (U.S. and Non-U.S. as of July 2017), U.S private prison companies (January 2019) and geopolitical risk (as of January 2010).

Geopolitical Risk corresponds to the exclusion of Iran and other U.S. sanctioned countries. Included in the exclusion cost calculation is the exclusion of Sudan from October 2008 until restrictions were lifted in February 2021. Additionally, in 2018, MSCI added Saudi Arabia to their benchmarks, but CalSTRS chose not to include Saudi Arabia in the custom benchmarks - therefore the cost of excluding Saudi Arabia is captured in the Total Exclusion Impact, but is not tracked separately.

The cost of portfolio restriction is reported at The CalSTRS' Board's request, as a policy requirement.

Methodology:

This cost analysis is a best-effort historical estimate, based on available information. The gain or loss (potential cost) associated with restriction is captured at the Total Plan level, major asset class (Global Equity and Debt), and by program.

To calculate a gain/loss at the Total Plan and asset class level, a return difference is calculated by comparing the monthly return of each asset class levels fully inclusive benchmark versus the CalSTRS' custom version which excludes restricted assets. This return difference is applied to the level's beginning balance to understand that month's gain or loss. The cumulative gain or loss is then compounded each month at the Total Fund's return, net of manager fees.

The program levels use custom indices which exclude only the restricted assets for each program individually. The difference from the standard index is used to estimate each program's ownership percentage of the gain or loss calculated at the Total Plan level.

The Total Fund return serves as the discount rate: the rate of return we would expect had the gain been available to invest, or the return we would have lost had the loss reduced the Total Fund's value. Using a discount / re-investment rate is required to estimate the true value gained or lost over the period and is consistent with industry standard cash flow modeling.

The total restriction impact is captured in terms of two components:

- 1) The Legacy Benchmark Modification Program (the removal of tobacco companies from the CalSTRS' benchmarks -passive strategy divestment), which ran from March 2000 to December 2009, compounded through the present period.*
- 2) The Portfolio Restriction Policy which combines the Divestment Policy Program (captured as of January 2010), with the Portfolio Restrictions Policy Program (captured as of November 2023), compounded through the present period.*