CALSTRS

Investment Committee

Item Number 13c – Open Session

Subject: Private Equity Policy Revisions – First Reading

Presenter(s): Margot Wirth & Robert Ross

Item Type: Information

Date & Time: July 8, 2021 – 15 minutes

Attachment(s): Attachment 1 – Current Private Equity Delegation of Authority Limits
Attachment 2 – Private Equity Policy – Clean Version
Attachment 3 – Private Equity Policy – Redline Version
Attachment 4 – Meketa's Private Equity Program Changes Policy Review

PowerPoint(s): Staff's Private Equity Program Strategy Review – First Reading

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POLICY

The CalSTRS Private Equity Investment Policy (Teachers' Retirement Board Policy Manual, Section 1000, Page H-1), which governs the management of the Private Equity program, seeks to ensure that a portfolio of private equity investments is developed to meet the California State Teachers' Retirement System's return objectives within acceptable risk parameters.

PURPOSE

CalSTRS periodically reviews its policies and benchmarks as deemed appropriate in light of evolving market conditions, practices, and opportunities.

The proposed changes primarily fall under the themes of 1) Agility for the Collaborative Model and 2) Benchmark / Sub-Asset Weighting Changes and involve increasing delegation limits, clarifying independent fiduciary usage, and greater co-investment flexibility. Other revisions include routine policy updates and general language clean-up.

This is the first reading of these proposed Private Equity Policy revisions.

DISCUSSION/SUMMARY

Background

Private Equity has been focused in recent years on significantly increasing the size of the Private Equity portfolio while at the same time increasing the percentage of the portfolio invested in co-investments.

Regarding the overall size of the Private Equity Portfolio, at September 30, 2017, the portfolio NAV was $17.9 billion representing 8.1% of the overall CalSTRS portfolio. The overall allocation target established for the asset class was (and remains) 13%. By increasing the program's annual deployment rate over several years, and in combination with strong investment performance, the NAV of the Private Equity portfolio has increased to $35.6 billion as of March 31, 2021, representing 11.2% of the overall CalSTRS portfolio.

The desire to increase the percentage of the Private Equity portfolio invested in co-investments is driven by the imperatives of the Collaborative Model whereby external fees and incentives (i.e., carried interest) can be significantly decreased by shifting the program's deployment mix away from partnership investments towards co-investments.

In more detail:

- In 2017, the Investment Committee increased delegation limits in recognition of the desire by the organization to increase its exposure to private equity.
- In 2018, as part of the Collaborative Model, Staff shared its vision of a larger and more advanced program with an increased emphasis on co-investments. Based on positive feedback and agreed upon interim goals, Staff endeavored to significantly increase overall private equity annual commitments while simultaneously striving to increase the percentage of these commitments involving co-investments from under 5% to over 20%.
- In 2019, Staff proposed policy revisions further embracing the Collaborative Model enabling the program to be more flexible and competitive by broadening the range of co-investments permissible under delegation of authority and by expanding the definition of private equity to include certain nascent strategies (e.g. Longer-Term Strategies & Multi-Strategy).
- Over this period, Staff resources have been significantly bolstered. Staff positions now total 33 with approximately one-third focusing primarily on co-investments. Besides having a larger staff to increase overall deployment capacity, Private Equity has recruited team members with more specialized skills and increased the team's ability to evaluate more specialized and complex co-investments. This "widening of the funnel" has permitted Private Equity to look at and participate in deals that it otherwise would have had to summarily exclude.
- In the current calendar year, Staff anticipates meeting the aforementioned interim goal of 20% of annual commitments being in the form of co-investments.

- Typically, co-investments are held for four or five years and then sold on a gross basis for approximately twice their original cost. In such a scenario, fee and carried interest charges over the life of the investment (for partnership investors) will typically amount to at least 25% to 30% of original cost. Therefore, *projected ultimate* run rate savings for the co-investment program (relative to partnership investments) are measured in the hundreds of millions of dollars.

Following the successful execution of the first phase of the Collaborative Model, Staff is ready to move to the next phase of the Collaborative Model (i.e., Collaborative Model 2.0) which will involve yet more resources, more advanced co-investing strategies, and new co-investment commitment targets. By continuing to increase team resources and capabilities, as well as by expanding the scope of co-investments permissible under delegation of authority, Private Equity believes a goal of deploying 25% to 35% of annual commitments in the form of co-investments in the coming two to four years is reasonable, assuming high-quality deal flow continues. It is reasonable to expect that this new phase of the Collaborative Model will likely increase the amount of saving (from paying less fees and carried interest) by 50% or more over the recently established baseline discussed above. It is also reasonable to assume that these fee and carried interest savings will, in large part, contribute directly to increased net returns for the Private Equity program.

Proposal Overview

In summary, the key points of the proposal are:

- Increases in the delegation limits for partnerships/SMAs, co-investments, and secondary market transactions by various amounts;
- Provides greater flexibility with regard to how CalSTRS can co-invest with general partners or alongside *other institutional investors*;
- Enables Private Equity to co-invest alongside underlying fund managers in the Special Mandate program. Also, it provides Special Mandate managers an expanded ability to invest in emerging managers (e.g., co-investments, secondary market transactions, etc.);
- Clarifies a technical ambiguity in the Risk Management section of the policy as to when the use of an independent fiduciary for co-investments is required. The revised policy clarifies that co-investments alongside existing managers or managers that have been approved by a Private Equity Program Advisor do not require an additional independent fiduciary;
- Updates the ranges and long-term targets in the Diversification section of the policy to reflect the reality of the opportunities available for Staff to invest in a given vintage year and over the longer-term. Aligns geographic regions in the Diversification section to what the administrator tracks; and
- Describes in the Reporting section of the policy who provides specific deliverables to the investment committee (e.g., Staff or Private Equity Board Consultant).

Delegation of Authority Limits

The proposed increases reflect the growth in the size of the Private Equity portfolio as well as the overall CalSTRS portfolio since 2017 when these limits were last changed. This change will help Staff further increase CalSTRS' exposure to Private Equity in the context of the Collaborative Model 2.0, which focuses on both performance and cost savings.

For reference, during the quarter ending September 30, 2017, program NAV was **$17.9 billion NAV** and co-investments represented **7.6% ($1.4 billion).** As of March 31, 2021, program NAV was **$35.6 billion,** and co-investments represent **15.9% ($5.7 billion)**. Looking forward, in 2026, the overall Private Equity portfolio NAV is projected to be over $55 billion of which the co-investment NAV is projected to be approximately $15 to $20 billion.

This increase in co-investments is attributable to several factors including size and quantity of co-investments as well as team growth and sophistication. Building on the successful development of the co-investment program during phase one of the Collaborative Model, Staff is regularly being invited to invest into high-quality companies with industry-leading private equity managers. For example, Staff recently made its first $250 million commitment to a single co-investment, which is the largest amount permitted by policy.

Staff is proposing the follow delegation limit increases:

Strategy	Current Policy	Proposed Policy
Primary Commitments		
New Commingled Limited Partnerships and SMAs	$400 million	$750 million
Existing Commingled Limited Partnerships and SMA	$750 million	$1.5 billion
Co-investments	$250 million	$750 million
Direct investment in GP management companies	$250 million	$750 million
Secondary Market Transactions		
Commingled Limited Partnership Interests and Separately Managed Accounts	Diversified Pools: $1.5 billion Single Interests and Non-Diversified Pools:	Diversified Pools: $1.5 billion Single Interests and Non-Diversified Pools:

	$750 million	$1 billion
Co-investments, General Partner Interests, and Portfolio Companies	Diversified Pools: $500 million Single Interests and Non-Diversified Pools: $250 million	Diversified Pools: $1.5 billion Single Interests and Non-Diversified Pools: $750 million

Increased co-investment flexibility: Changes to the policies regarding co-investments reflect, in large part, the evolution, maturation, and growing complexity of the marketplace – the proposed co-investment policy update herein addresses these industry developments and enables CalSTRS to remain highly competitive in the private equity asset class.

- Staff is proposing a clarification that co-investments can be made alongside both existing and non-CalSTRS general partners and other institutional investors, provided that if a co-investment is alongside a non-CalSTRS general partner, they must be of "institutional quality" as approved by a PE Program Advisor or independent fiduciary. This would provide CalSTRS greater flexibility to evaluate a broader range of opportunities, including those which may be offered by prospective general partners that could be or are currently under consideration by Staff. This change also recognizes that not all co-investments are made in a limited/general partnership legal structure.
- Staff also recognizes that there may be concern by internal stakeholders as well as CalSTRS partners as to the intention of the growing co-investment program. Staff would like to convey that CalSTRS is not aiming to be a general partner making control investments, but rather an institutional investor providing a solution to our partners if they need additional capital for larger investments or to help them maintain diversification targets. To that end, we are adding a straightforward restriction limiting co-investments by CalSTRS to not more than 50% of a financing round. To be clear, a financing round is a legally defined capital raise.
- Staff suggests removing a confusing provision which stipulates that CalSTRS co-investments must be made on the *"same or better terms as provided to the limited partnership"*. This seemingly innocuous and well-intentioned term has precluded CalSTRS from participating (as an example) in a potential investment with a lower return (than the limited partnership investment), but has stronger downside protections (e.g., preferred equity vs common equity). In fact, Policy revisions in 2019 provided Staff the flexibility to make co-investments alongside partnerships in which CalSTRS is not a direct investor, provided that the partnership is managed by an existing general partner relationship. As such, the above-noted provision can be a hindrance at times and is difficult to comply with regarding the terms being offered to CalSTRS in certain instances.

- Based on conversations with the Special Mandate managers, there are many opportunities to co-invest alongside emerging managers, which technically are CalSTRS general partners. Special Mandate managers have requested increased flexibility to invest in emerging managers (e.g. co-investments and secondary market transactions). The intent is to increase overall returns while reducing fees and carry for the program. Staff supports the Special Mandate managers' proposal. Additionally, both Special Mandate managers and Staff believe that CalSTRS should be able to directly co-invest with the underlying fund managers in their portfolio companies; as such, Staff is proposing to be able to co-invest with those same managers using the existing co-investment portion of the policy while limiting the maximum amount to $100 million given the size and stage of these emerging managers.
- The aforementioned changes would result in an ability to build a wider funnel of investment opportunities and help position the program more competitively. Therefore, Staff suggests removing the limitation on co-investing only alongside existing general partners.

Risk Management section clarification

As currently defined, the independent fiduciary verifies the entry valuation of a proposed co-investment, which is something that Staff and the approved general partner do during their diligence processes, making the independent fiduciary a third and redundant check with marginal value-add in many cases. This process also continues to be a programmatic disadvantage relative to other global co-investors. In fact, when comparing this requirement to those of some other state funds that are actively co-investing, the independent fiduciary requirement can be waived in some cases while others do not even have an independent fiduciary requirement. Furthermore, leading national pension funds, sovereign wealth funds, and notable endowments have no independent fiduciary requirement and are competing with CalSTRS for the same co-investments. Such considerations affect who a general partner's "first call" is when seeking co-investment capital.

With the implementation of the Collaborative Model, CalSTRS has been able to attract experienced private equity professionals who in some cases were previously independent fiduciaries for CalSTRS. While Staff recognizes that there are specific co-investment situations that would require the use of an independent fiduciary, Staff believes this should be applied to co-investments where the general partner (or institutional investor) has not been vetted and recommended by a PE Program Advisor. In those cases, Staff recommends repurposing the role of the independent fiduciary to focus on reviewing the general partner (or institutional investor) and how the co-investment fits with their investment strategy. To that end, Staff believes the proposed Risk Management section revision, if approved, clarifies when Staff will engage an independent fiduciary for co-investments. Staff has conferred with Legal on this proposed change.

Updates to the Diversification section

As required by the investment committee, Staff periodically reviews the ranges and targets (interim and long-term) to make sure they are consistent with where Staff is finding the best investment opportunities. A few updates / clarifications have been suggested in the redlined policy. There was

also a recognition that the geographic diversification as established in the policy does not match what the administrator tracks.

Reporting section update

Historically, this section merely laid out a list of reports that are provided to investment committee for review. Staff believes that this proposed change will provide clarity with regard to who is responsible for developing and presenting a given report to the investment committee. As described in the redlined version, Staff is responsible for the program's vision, strategy, and execution, and provides this information in the form of a business plan, pacing plan, and manager ratings report. The Private Equity Board Consultant reports on Private Equity performance as well as industry trends, both of which are included in their semi-annual reports as well as any additional information requests from the investment committee.

RECOMMENDATION

Staff recommends that the Investment Committee consider the proposed policy revisions and provide feedback. Staff will incorporate the Board's feedback into the policy and bring it back for a second reading (likely at the September Investment Committee meeting in this case) unless the Board decides to approve the recommended changes at this meeting.

Attachment 1 – Current Private Equity Delegation of Authority Limits

Current		Item
$250 m		Co-investments
$750 m		Partnerships – Existing Partner
$400 m		Partnerships – New Partner
$750 m / $400 m		SMA [Existing/First Time]
$1,500 m / $750 m		Secondary Purchases – LP Interests/SMAs [Diversified/Undiversified]
$500 m / $250 m		Secondary Purchases – Co-invests/GP Interests/Portfolio Companies [Diversified/Undiversified]

CALSTRS

CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM

PRIVATE EQUITY INVESTMENT POLICY

INVESTMENT BRANCH

JULY 2021

H. Private Equity Investment Policy

EXECUTIVE SUMMARY

In accordance with the CalSTRS Investment Policy and Management Plan ("IPMP") the California State Teachers' Retirement System Board ("Board") has established an allocation for Private Equity. CalSTRS' Private Equity 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, the Teachers' Retirement Law, and other applicable statutes. No investment instrument or activity prohibited by the IPMP shall be authorized for the Private Equity portfolio.

The document is intended to summarize the fundamental objectives and considerations used in the investment, administration, and management of the Private Equity portfolio. These policies are designed to set boundaries that will ensure prudence and care in the management of the Private Equity assets while allowing sufficient flexibility to capture investment opportunities.

CalSTRS believes that environmental, social, and governance ("ESG") issues can affect the performance of our investments. As a result, CalSTRS' Investment Policy for Mitigating Environmental, Social, and Governance Risks has been developed as a tool that both internal and external investment managers are expected to use to assess the impact of ESG risks when making an investment on behalf of CalSTRS.

Detailed procedures and guidelines for the Private Equity portfolio are maintained separately. As with all other plan assets, these policies cannot be altered without explicit direction from the Board. Investment restrictions included in the IPMP are hereby incorporated by reference. Words and terms that may be unfamiliar to the reader are referenced in the glossary.

PROGRAM OBJECTIVES

The Private Equity program seeks to capture attractive risk-adjusted long-term investment returns by investing in private assets and securities. Relative to publicly traded investment securities, attractive investment opportunities are presented as a result of inefficient markets, longer investment horizons, and advantageous corporate governance structures. This program invests in both equity-based and debt-based opportunities.

In some cases, the mandate for this program overlaps with other CalSTRS asset classes including Real Estate, Inflation Sensitive, Sustainable Investment and Stewardship Strategies ("SISS"), and Innovative Strategies. In such cases, Private Equity will consult with the other asset classes and the Chief Investment Officer to determine where a particular investment opportunity should reside within the overall CalSTRS investment portfolio.

PERFORMANCE OBJECTIVES

The Private Equity program seeks to provide superior risk-adjusted long-term investment returns relative to those available from investing in publicly traded investment securities with similar underlying market characteristics.

The Private Equity program is expected to deliver relatively high long-term investment returns for the overall CalSTRS portfolio. These higher investment returns are accompanied by relatively high levels of investment risk.

PROGRAM BENCHMARKS

Private Equity is a long-term asset class which means, all other factors being equal, longer time periods should be used to measure private equity performance. Although longer measurement periods are preferred, Private Equity is benchmarked over a full spectrum of time periods, consistent with the other asset classes in the CalSTRS portfolio.

The longer-term Private Equity benchmark is based on a public market index plus a spread. Because private equity investments are generally less liquid and more expensive to manage relative to publicly-traded investments, a premium rate-of-return is expected. The shorter-term benchmark is peer-based and is more applicable to evaluating the Private Equity program's performance on a relative basis.

The two program benchmarks for Private Equity are as follows:

A. **For periods of ten years and beyond**: The performance benchmark is the MSCI ACWI IMI plus one and a half percent.

B. **For periods of less than ten years**: The performance benchmark is a dynamically weighted blend of the benchmarks for the Traditional and Non-Traditional sub-asset groups. As discussed in the next section (and shown below in Figure 1), the Traditional sub-asset group includes the Buyout, Venture Capital, and Debt-Related sub-asset classes; the Non-Traditional sub-asset group includes the Longer-Term Strategies, Multi-Strategy, and Private Equity Special Mandates sub-asset classes.

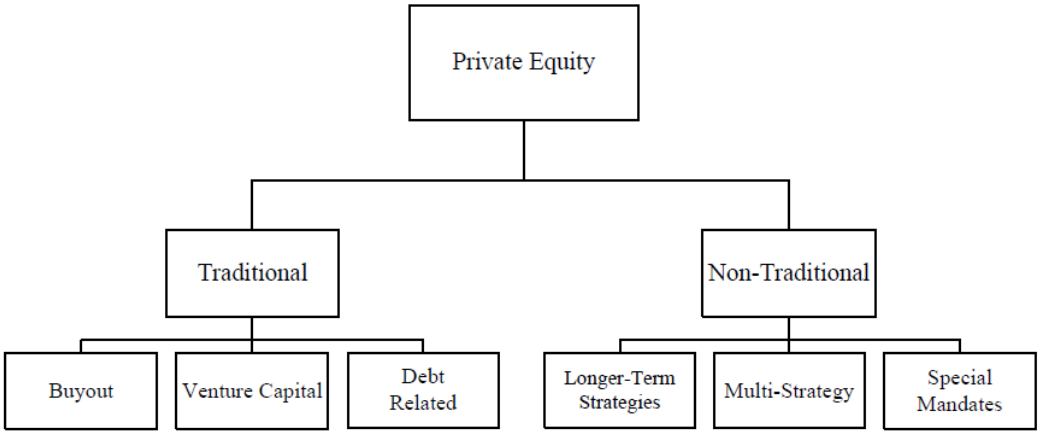

Figure 1: Private Equity Portfolio and Benchmark Structure

B.1 Traditional sub-asset group: The benchmark for this group shall be a weighted blend of these underlying sub-asset benchmarks:

- Buyout: The Buyout portion of the State Street GXPEI customized to reflect the pacing of CalSTRS' Buyout commitments.

- Venture Capital: The Venture Capital portion of the State Street GXPEI customized to reflect the pacing of CalSTRS' Venture Capital commitments.

- Debt Related: The Debt Related portion of the State Street GXPEI customized to reflect the pacing of the CalSTRS' Debt-Related commitments.

The sub-asset components of the Traditional benchmarks shall be weighted according to the interim sub-asset allocation targets. The vintage year customization shall be weighted according to the actual vintage year deployments. Customization will employ a "scaled cash flow" methodology consistent with industry best practices.

B.2 Non-Traditional sub-asset group: The benchmark for this group shall be a weighted blend of these underlying sub-asset benchmarks:

- Longer-Term Strategies: The Buyout portion of the State Street GXPEI multiplied by 90%.

- Multi-Strategy: CalSTRS Custom Tactical Index: –A 60%/40% blend of the Debt Related and Buyout portions respectively of the State Street GXPEI.

- Private Equity Special Mandates Portfolio: The Buyout portion of the State Street GXPEI minus 200 basis points.

The sub-asset components of the Non-Traditional benchmarks shall be weighted according to the interim sub-asset allocation targets.

PROGRAM STRUCTURE

Portfolio Structure, Sub-asset Groups and Sub-asset Classes

The Private Equity portfolio shall be organized and monitored based on the structure shown in Figure 1 (see above). The portfolio is divided into the Traditional and the Non-Traditional sub-asset groups. As discussed previously, the Traditional sub-asset group includes the Buyout, Venture Capital, and Debt-Related sub-asset classes; the Non-Traditional sub-asset group includes the Longer-Term Strategies, Multi-Strategy, and the Private Equity Special Mandates sub-asset classes.

The Traditional sub-asset group is comprised of private equity investment types that are well established and common in the industry and for which reasonable and reliable peer benchmarks currently exist. These investments can be more readily peer-benchmarked due to the broader availability of comparable investable opportunities and a reasonably long observation period.

The Non-Traditional sub-asset group is comprised of private equity investment types that are not as well established or common in the industry and for which reasonable and reliable peer benchmarks are not as readily available. The benchmarks for these sub-asset classes will tend to be based on proxy metrics rather than peer-based metrics. As a means of measuring the performance of these types of investments, benchmarks are more difficult to devise, involve more subjectivity and when used to measure program performance, may be more prone to misleading or random results. On the other hand, opportunistic investments themselves may in many cases involve the ability to make above average risk-adjusted returns due to first mover advantages, less competition or various miscellaneous arbitrage characteristics.

Permissible Investment Types

The Private Equity program invests in: (1) Commingled Limited Partnerships (and other limited liability vehicles); (2) Separately Managed Accounts; (3) Co-investments; (4) Secondary Market Transactions; and, (5) Direct Investments in General Partner management companies. The Private Equity program can purchase and sell these investments. The subject investments are generally in private vehicles, primarily holding illiquid, private securities, but such vehicles may also hold some publicly-traded securities.

Restrictions Pertaining to Investments Done Under Delegation Authority

The following restrictions apply to investments executed by staff under delegation of authority (as further discussed later in this policy):

Commingled Limited Partnership: A Commingled Limited Partnership is a legal entity (either a partnership, LLC, or other vehicle providing limited liability for investors) controlled by a general partner (or other similar entity) who manages the

operations for a group of limited partners. Limited partners invest capital but have limited liability, are not involved in the day-to-day management of a partnership, and generally cannot lose more than their capital commitment.

Applicable to new Commingled Limited Partnerships sponsored by general partners not already included in CalSTRS' Private Equity portfolio (i.e. applicable to "First Time Limited Partnerships"): The maximum commitment amount shall be the lessor of $750 million or 25 percent of the total amount of the partnership capitalization.

Applicable to Commingled Limited Partnerships sponsored by general partners(s) that are already in the CalSTRS' Private Equity portfolio (i.e. applicable to "Follow-on-Commingled Limited Partnership"): The maximum commitment amount shall be the lessor of $1.5 billion or 25 percent of the total amount of the partnership capitalization.

Separately Managed Account: A Separately Managed Account is an investment vehicle managed for one investor rather than many. The vehicle may have a specialized mandate or may invest alongside a Commingled Limited Partnership.

A Separately Managed Account vehicle must be a Limited Partnership, or limited liability corporation, or other vehicle that provides CalSTRS protection from general partner liability.

The maximum commitment amount shall not exceed $1.5 billion for a "Follow-on Separately Managed Account" vehicle or $750 million for a "First Time Separately Managed Account" vehicle.

Co-investment:A Co-investment is made alongside general partners or other institutional investors in underlying assets and securities, usually with lower management fees and carried interest. Co-investments may be structured as securities held directly by CalSTRS or as an interest in a vehicle managed by the General Partner that invests in such securities.

The maximum Co-investment commitment to a single company (or set of related companies), either at one time or over a period of time shall not exceed $750 million. Also, CalSTRS shall not be more than 50% of a financing round.

CalSTRS may incur due diligence costs, expenses, and break-up fees on potential Co-investments. The budget for these items shall be approved by the Chief Investment Officer, Deputy Chief Investment Officer, or Director of Private Equity, with such approval being made in advance of any potential commitment to the co-investment.

Secondary Market Transactions: For the purpose herein, Secondary Market Transactions are purchases or sales of private equity related interests in which one or more of the original investors divests. Such private equity interests may involve a single interest or pools of interests. Pools may be diversified (four or more interests in a single transaction) or non-diversified (three or less interests in a single transaction).

Private Equity related interests can take the form of: 1) Commingled Limited Partnership Interests; 2) Co-investments; 3) General Partner interests; 4) Separately Managed Accounts; 5) Portfolio Companies, or; 6) a combination of the above.

The maximum commitment amount shall not exceed:

Asset Type	Diversified Pools	Single Interests and Non-Diversified Pools
Commingled Limited Partnership Interests and Separately Managed Accounts	$1.5 billion	$1.0 billion
Co-investments, General Partner Interests, and Portfolio Companies	$1.5 billion	$750 million

A diversified investment shall not include any single interests greater than that allowed under non-diversified investments.

Secondary Market Transactions involving Co-investments or Portfolio Companies shall only be transacted (directly or indirectly) with an existing CalSTRS General Partner. Sales of Co-investments and Portfolio Companies may be transacted independently of a General Partner.

Diversified and non-diversified investment are not defined by the structure of the investment (e.g. Commingled Limited Partnership, Separately Managed Account, Co-investment), but rather by the underlying assets.

Direct Investments in General Partner management companies: In addition to investing as a limited partner, the Private Equity program may acquire (and sell) minority interests in General Partner management companies.

The maximum commitment amount shall not exceed $750 million.

Ownership percentage of a Direct Investment in any one general partnership (or series of general partnerships organized by a particular manager) shall not exceed 25 percent economic interest.

Private Equity Special Mandates: The term "Special Mandate" is defined as a discrete investment strategy, other than divestments, suggested by CalSTRS' Board members that include, but are not limited to: environmental, social, governance, in-state investments; or other factors that are expected to have a positive or neutral impact on the economic performance of the fund over the long term.

Authorized Private Equity Special Mandates are listed below. Additional Special Mandate strategies may be added to the portfolio at the direction of the Investment Committee.

- Proactive Portfolio: The Proactive Portfolio includes the Underserved Urban and Rural Mandate ("UUR") and the New and Next Generation Manager Mandate ("NNG"): The UUR mandate invests with Private Equity managers specializing in underserved urban and rural markets. The NNG mandate invest with Private Equity managers that are of a "new and next generation" nature (generally, but not exclusively, first-, second-, or third-time institutional funds).

  The Proactive Portfolio may be invested in whole or in part through Commingled Limited Partnerships, Separately Managed Accounts, Co-investments, GP Interests, or Fund-of-Fund vehicles. The maximum commitment amount of a Fund-of-Fund vehicle that is new to CalSTRS in the Proactive Portfolio, or with a new strategy, shall not exceed $100 million. Follow-on investments of this type shall not exceed $250 million. Investments in the Proactive Portfolio are limited to investing primarily in the United States, Canada, and Mexico.

  Side-by-Side ("SBS") investments are commitments made to an underlying fund in one of the UUR or NNG Fund-of-Fund vehicles with a positive recommendation from the applicable manager or the Program Advisor. The maximum commitment amount for new and follow-on SBS investments shall be the lessor of $100 million or 30 percent of the total amount of the partnership capitalization.

  Co-investments with GPs in underlying Special Mandate portfolios are permitted under the same restrictions as the Co-investment portion of this policy, but limited to $100 million per financing round

- Clean Energy and Technology Special Mandate ("Clean-Tech"): The Clean Energy and Technology Special Mandate is a diversified portfolio of Venture Capital and Buyout investments across the clean technology and clean energy universe. The program is global in scope and includes both Limited Partnership investments and Co-investments.

RISK MANAGEMENT

Delegation of Authority

The investment, administration, and management of the Private Equity assets and strategies are delegated to staff within the boundaries established by these policies and the processes described within the relevant investment guidelines.

Except as otherwise noted below, all Private Equity investments require a positive written recommendation by CalSTRS' staff and either a Program Advisor, an Independent Fiduciary, or Co-investment Advisor.

In the case of a co-investment alongside a current general partner or one that has been recommended by a PE Program Advisor, an independent fiduciary will not be required.

For the avoidance of doubt, a co-investment opportunity that is neither made alongside an existing CalSTRS general partner nor has been recommended by a PE Program Advisor, requires an independent fiduciary to assess the general partner or institutional investor.

Diversification

Diversification within the Private Equity portfolio is critical to control risk and maximize returns. Investments shall be diversified to control unintended biases. Diversification will be reviewed on a NAV basis over time, and across the following parameters:

Market Segments (sub-asset classes): The market segments are defined as Buyout, Venture Capital, Debt-Related, Longer-Term Strategies, Multi-Strategy, and Private Equity Special Mandates. The following ranges and targets are to be reviewed and updated periodically to the Investment Committee:

	Approved Ranges	Interim Targets	Approved Long-Term Targets
Buyout	60 – 85%	71%	75%
Venture Capital	0 – 15%	10%	7%
Debt-Related	5 – 20%	10%	8%
Longer-Term Strategies	0 – 10%	2%	4%
Multi-Strategy	0 – 5%	1%	2%
Private Equity Special Mandates	0 – 8%	6%	4%

Interim targets represent goals that are generally expected to be achieved in the next 12 to 36 months. Long-term targets represent goals that are generally expected to be achieved over periods exceeding three years.

Geography: Geographic regions are defined by the principal focus of the investment mandate or, for a particular investment vehicle, the domicile of the underlying portfolio companies. The geographic breakdown shall be segregated by North America and Non-North America Markets. The following ranges and targets are to be reviewed and updated periodically to the Investment Committee:

	Approved Ranges	Approved Targets
North America	65 – 85%	75%
Non –North America	15 – 35%	25%

Vintage Year: Vintage Year is defined by the date of first cash flow of the Limited Partnership. Investments within market segments (sub-asset classes) shall be stratified by vintage year to mitigate the impact of fund flow trends within each segment. The vintage year pacing should be done in accordance with long-term allocation plans as periodically discussed and reviewed by the Investment Committee as well as other internal and external parties.

Economic Sector: Economic sectors are described by the Global Industry Classification Standard (GICS). Economic sector diversification is to be monitored and taken into consideration in making investment decisions.

MONITORING AND REPORTING

Management and Monitoring: The Private Equity program will be managed according to an annual business plan whose main business components will encompass an analysis of the investment environment, a review of the investment strategy, a review of the diversification targets, and a resource allocation budget.

Performance Measurement: In general, when reporting solely on Private Equity performance internal rate of return (IRR) methodology is to be preferred in keeping with the CFA Institute's Global Investment Performance Standards. When reporting in conjunction with other asset classes, for the sake of consistency, portfolio and benchmark data is linked on a quarterly basis to produce time-weighted returns (TWR).

Reporting: Staff will periodically report to the investment committee its current vision, strategy, and progress. The Private Equity Board Consultant will report on the PE program's performance as well as industry trends. Specific reports will include:

i. Semi-Annual Reports: The Private Equity Board Consultant will prepare and present portfolio management reports on a semi-annual basis focused on performance and industry trends. The management report will provide information on, among other items, portfolio diversification, largest holdings, investment performance, co-investment holdings, and committed and funded status.

ii. Business Plan: Staff provides

iii. Pacing Plan: Staff provides

iv. Investment Manager Ratings Report: Staff provides

VERSION CONTROL

Adopted June 1998
Revised July 1998
Revised April 1999
Revised to flexibility regarding secondary transactions on April 2001
Revised March 2002
Revised for clarification of returns calculations using dollar-weighted IRR on June 2003
Revised to expand eligible regions to rest of world on June 2004
Revised to change level of delegated authority on July 2005
Revised to increase co-investment limits and layout proactive portfolio process on June 2006
Revised to adjust Benchmark on May 2007
Revised for co-investment ROW, sale policy and direct GP Investment on July 13, 2007
Revised for daily trading authority limits, and sector targets and ranges on November 1, 2007
Revision of financial benchmark July 10, 2008
Revision for separately managed accounts on July 12, 2012
Revised to add ESG Risks Policy reference on September 10, 2013
Revised to clarify the benchmark for different time periods July 11, 2014
Revised to define APM and DCIO trading limits on April 5, 2017
Revised to customize GXPEI benchmark and establish new Sub-assets on June 7, 2017
Revised to update and reflect increased limits, investment types, and structures November 1, 2017
Policy revised to reflect new format, new structure, interim targets, and benchmarks May 8, 2019
Policy revised to reflect new benchmark for periods of ten years and beyond July 11, 2019
Revised to reflect increased limits, clarifies delegations for co-investment, and clean-up TBD

GLOSSARY

BUYOUT – Buyout investments involve the purchase of all or part of the stock or assets of a company utilizing a significant amount of borrowed capital as well as equity capital. Borrowed capital typically consists of some combination of senior and subordinate debt. The company may

be privately or publicly owned, or a subsidiary or division of a privately or publicly owned company.

CARRIED INTEREST –The general partner's carried interest is its share of the partnership's profits, and generally ranges from 10 percent to 30 percent of the total. A 20 percent carried interest is the industry norm for private equity.

CLEAN ENERGY AND TECHNOLOGY SPECIAL MANDATE – The Clean Energy and Technology Special Mandate ("Clean-Tech") is a diversified portfolio of venture capital and buyout investments across the clean technology and clean energy universe. The program is global in scope and includes both fund investments and co-investments. Please see the definition for Private Equity Special Mandates. New commitments discontinued as of September 2018.

CO-INVESTMENT – Co-investments are investments made alongside general partners in underlying assets and securities, usually with lower management fees and carried interest.

CO-INVESTMENT ADVISOR – A co-investment advisor is an investment manager who manages a Separately Managed Account of co-investments on behalf of CalSTRS. Such an advisor may act as an Independent Fiduciary for co-investments that are outside of the Separately Managed Account if at least $25 million is invested in such transaction through the Separately Managed Account that is being managed on behalf of CalSTRS by such Co-investment Advisor.

CO-INVESTMENT TRANSACTION – A financing or series of financings that have an initial close on a given date and a final close no later than 365 days thereafter. Subsequent to the initial close, financings must have essentially the same terms or better to be considered a single transaction.

COMMINGLED LIMITED PARTNERSHIP – Legal Entity made up of a General Partner, who manages the operations, and limited partners, who invest capital but have limited liability. Limited partners are not involved in the day-to-day management of the partnership and generally cannot lose more than their capital commitment.

DEBT-RELATED INVESTMENT STRATEGIES – Debt-related investments (as applied to the Private Equity asset class) involve the purchase and ownership of private securities that are debt-oriented (rather than equity-oriented). There are many different types of debt-related investment strategies including but not limited to mezzanine debt, distressed debt, direct lending, and convertible debt.

DEVELOPED MARKETS – Countries with advanced economies and capital markets as designated by Dow Jones or Standard & Poor's.

DIRECT INVESTMENTS – Direct Investments are those made outside of a limited partnership structure. While a co-investment is made alongside of a limited partnership investment, a direct investment is not. Direct investments need a greater level of due diligence and involve a greater level of risk in comparison to a co-investment. Direct Investments are limited to General Partner

Interests.

DISTRIBUTIONS – Cash and/or securities paid out to the limited partners from the limited partnership.

FIRST TIME LIMITED PARTNERSHIPS – A fund from a management team that has not previously been directly held in CalSTRS' Private Equity Portfolio.

FIRST TIME SEPARATELY MANAGED ACCOUNT – An investment in a vehicle managed for one investor rather than many with a management team that has not previously been directly held in CalSTRS' Private Equity Portfolio.

FOLLOW-ON LIMITED PARTNERSHIPS – The second and all subsequent funds raised by a management team that are directly held in CalSTRS' Private Equity Portfolio.

FOLLOW-ON SEPARATELY MANAGED ACCOUNT – The second and all subsequent separately managed accounts directly held by CalSTRS and managed by a particular general partner.

FUND-OF-FUND (FOF) – An investment strategy of holding a portfolio of other investment funds rather than investing directly in stocks, bonds, or other securities.

GENERAL PARTNER – Managing partner of a limited partnership responsible for performing the day-to-day administrative operations of the partnership and acting as investment advisor to the partnership.

GLOBAL INDUSTRY CLASSIFICATION STANDARD (GICS) – Industry taxonomy developed in 1999 by MSCI and Standard & Poor's (S&P) for use by the global financial community.

GXPEI (OR THE STATE STREET GX PRIVATE EQUITY INDEX) – A peer-based private equity index developed, owned and managed by State Street. The data for this index is derived from the cash flow data of State Street's limited partner clients.

INDEPENDENT FIDUCIARY – A third party organization that provides non-discretionary specialized advisory services to Staff and acts as a fiduciary to CalSTRS and who by law must act in the best interests of CalSTRS and put the interests of CalSTRS above their own.

INITIAL PUBLIC OFFERING (IPO) – The sale or distribution of a stock or a portfolio company to the public for the first time.

INTERNAL RATE OF RETURN (IRR) – The discount rate at which the present value of future cash flows of an investment equals the cost of the investment. It is determined when the net present value of the cash outflows (the cost of the investment) and the cash inflows (returns on the investment) equal zero, the rate of discount being used is the IRR.

LIMITED PARTNER – The investors in a Commingled partnership or Separately Managed Account. Limited partners do not participate in the management of the partnership's activities. However, they normally have the right to vote to approve or disapprove amendments made to the limited partnership agreement.

LONGER-TERM STRATEGIES – Private equity investments that are expected to have lower risk and reward profiles than traditional private equity investments. Such investments will likely be held for longer periods of time than traditional private equity investments. Management fees and carried interest will generally be lower than for traditional private equity investments.

MULTI-STRATEGY – The Multi-Strategy sub-asset class invests in private equity investments along with other private investments with fixed income, real estate, and hedge fund characteristics.

NEW AND NEXT GENERATION MANAGER MANDATE (NNG) – The New and Next Generation Manager Mandate was established by the Investment Committee in 2003. It involves partnerships that are raising their first-, second-, and third-time institutional funds or partnerships formed by junior or senior level partners that have left a prior partnership to form a new general partner. Please see the definition for Private Equity Special Mandates.

NON-DEVELOPED MARKETS – Countries with developing economies and capital markets as designated by Dow Jones or Standard & Poor's.

PORTFOLIO COMPANIES – Portfolio companies are the companies in which the Commingled Limited Partnership, Separate Managed Account, Secondary Limited Partnership, or other similar structure has an investment.

PREFERRED RETURN – A rate of return that must be met before the General Partner can earn carried interest.

PRIVATE EQUITY BOARD CONSULTANT – A Private Equity Board Consultant acts as an independent fiduciary advisor to the Investment Committee and provides expertise and advice related to the overall investment strategy, policies, and practices of the Private Equity Program.

SPECIAL MANDATES – Discrete private equity investment strategies (other than divestments which are covered by a separate policy) suggested by the CalSTRS Investment Committee that include, but are not limited to environmental, social, governance (ESG) matters in-State investments, or other factors that are expected to have a positive or neutral impact on the economic performance of the fund over the long term. See Special Mandate Policy.

PROACTIVE PORTFOLIO – The Proactive Portfolio currently encompasses two Special Mandates: (1) the Underserved Urban and Rural Mandate investing with private equity managers specializing in underserved urban and rural markets and (2) the New and Next Generation Manager Mandate investing in private equity managers that are of a "new and next generation" nature. Please see the definition for Special Mandates.

PROGRAM ADVISOR –A Program Advisor provides expertise, advice and recommendations to support staff in the management and monitoring of an asset class or classes including, but not limited to, screening the universe of general investment opportunities and identifying those meeting CalSTRS' selection criteria, assisting staff in performing due diligence on prospective investment opportunities, issuing investment recommendations, and maintaining a deal log of investment opportunities. A Program Advisor is also an Independent Fiduciary.

SECONDARY LIMITED PARTNERSHIP INTERESTS – Limited Partnership interests that have been transferred from the original limited partner who made the original capital commitment to a limited partnership fund.

SEPARATELY MANAGED ACCOUNT – An investment vehicle managed for one investor rather than many. The vehicle may have a specialized mandate or may invest alongside a Limited Partnership.

SECONDARY MARKET TRANSACTIONS – Secondary Market Transactions are purchases or sales of private equity related interests in which one or more of the original parties divests (or has divested). Such private equity interests may involve a single interest or pools of interests. Pools may be diversified (greater than three interests in a single transaction) or non-diversified (three or less interests in a single transaction).

SIDE-BY-SIDE INVESTMENT (SBS) - A commitment to an underlying fund in one of the Special Mandate fund-of-fund vehicles with a positive recommendation from the applicable manager or the Program Advisor.

UNDERSERVED URBAN AND RURAL MANDATE (UUR) – The Underserved Urban and Rural Mandate was established by the Investment Committee in 2001 to seek private equity investment in the inner city and underserved portions of California and the U.S. Please see the definition for Special Mandates.

VENTURE CAPITAL – Venture capital refers to investments in young, emerging growth companies in different stages of development. The stages of venture capital investing include the following:

> **SEED STAGE -** An entrepreneur seeking capital to conduct research or finish a business plan;
>
> **EARLY STAGE –** A company developing products and seeking capital to commence manufacturing;
>
> **LATE STAGE** – A profitable or near-profitable high growth company seeking further expansion capital. The common theme underlying all venture capital investments is the high-growth nature of the industries in which the investee companies operate and the active role played by the investor to identify additional management expertise and provide general business advice.

VINTAGE YEAR – Vintage Year shall be defined in two ways: 1) For the purpose of investment pacing, a vintage year is the calendar year for which a fund commitment is closed; and 2) For the purpose of benchmarking, a vintage year is the calendar year an investment vehicle first draws capital or draws on its credit line. By placing an investment into a particular vintage year, the investor can compare the performance of a given investment with other similar investments that have first drawn capital (or its credit line) during that calendar year.

CALSTRS

CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM

PRIVATE EQUITY INVESTMENT POLICY

INVESTMENT BRANCH

JULY ~~2019~~2021

H. Private Equity Investment Policy

EXECUTIVE SUMMARY

In accordance with the CalSTRS Investment Policy and Management Plan ("IPMP") the California State Teachers' Retirement System Board ("Board") has established an allocation for Private Equity. CalSTRS' Private Equity 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, the Teachers' Retirement Law, and other applicable statutes. No investment instrument or activity prohibited by the IPMP shall be authorized for the Private Equity portfolio.

The document is intended to summarize the fundamental objectives and considerations used in the investment, administration, and management of the Private Equity portfolio. These policies are designed to set boundaries that will ensure prudence and care in the management of the Private Equity assets while allowing sufficient flexibility to capture investment opportunities.

CalSTRS believes that environmental, social, and governance ("ESG") issues can affect the performance of our investments. As a result, CalSTRS' Investment Policy for Mitigating Environmental, Social, and Governance Risks has been developed as a tool that both internal and external investment managers are expected to use to assess the impact of ESG risks when making an investment on behalf of CalSTRS.

Detailed procedures and guidelines for the Private Equity portfolio are maintained separately. As with all other plan assets, these policies cannot be altered without explicit direction from the Board. Investment restrictions included in the IPMP are hereby incorporated by reference. Words and terms that may be unfamiliar to the reader are referenced in the glossary.

PROGRAM OBJECTIVES

The Private Equity program seeks to capture attractive risk-adjusted long-term investment returns by investing in private assets and securities. Relative to publicly traded investment securities, attractive investment opportunities are presented as a result of inefficient markets, longer investment horizons, and advantageous corporate governance structures. This program invests in both equity-based and debt-based opportunities.

In some cases, the mandate for this program overlaps with other CalSTRS asset classes including Real Estate, Inflation Sensitive, Sustainable Investment and Stewardship Strategies ("SISS"), and ~~the Innovation Portfolio~~Innovative Strategies. In such cases, Private Equity will consult with the other asset classes and the Chief Investment Officer to determine where a particular investment opportunity should reside within the overall CalSTRS investment portfolio.

PERFORMANCE OBJECTIVES

The Private Equity program seeks to provide superior risk-adjusted long-term investment returns relative to those available from investing in publicly traded investment securities with similar underlying market characteristics.

The Private Equity program is expected to deliver relatively high long-term investment returns for the overall CalSTRS portfolio. These higher investment returns are accompanied by relatively high levels of investment risk.

PROGRAM BENCHMARKS

Private Equity is a long-term asset class which means, all other factors being equal, longer time periods should be used to measure private equity performance. Although longer measurement periods are preferred, Private Equity is benchmarked over a full spectrum of time periods, consistent with the other asset classes in the CalSTRS portfolio.

The longer-term Private Equity benchmark is based on a public market index plus a spread. Because private equity investments are generally less liquid and more expensive to manage relative to publicly-traded investments, a premium rate-of-return is expected. ~~Program performance relative to the longer-term benchmark considers both the performance of the asset class as a whole (i.e. the whole private equity industry) as well as the relative performance of the CalSTRS Private Equity program~~ The shorter-term benchmark is peer-based and is more applicable to evaluating the Private Equity program's performance on a relative basis.

Commented [Staff1]: Clarified the language, no change in intent.

~~The shorter-term benchmark, which is (when possible) more peer-based and relative performance-based than the longer-term benchmark, is more narrowly applicable to evaluating the Private Equity program's performance on a relative basis.~~

Commented [Staff2]: See comment above.

The two program benchmarks for Private Equity are as follows:

A. **For periods of ten years and beyond**: The performance benchmark is the MSCI ACWI IMI plus one and a half percent.

B. **For periods of less than ten years**: The performance benchmark is a dynamically weighted blend of the benchmarks for the Traditional and Non-Traditional sub-asset groups. As discussed in the next section (and shown below in Figure 1), the Traditional sub-asset group includes the Buyout, Venture Capital, and Debt-Related sub-asset classes; the Non-Traditional sub-asset group includes the Longer-Term Strategies, Multi-Strategy, and Private Equity Special Mandates sub-asset classes.

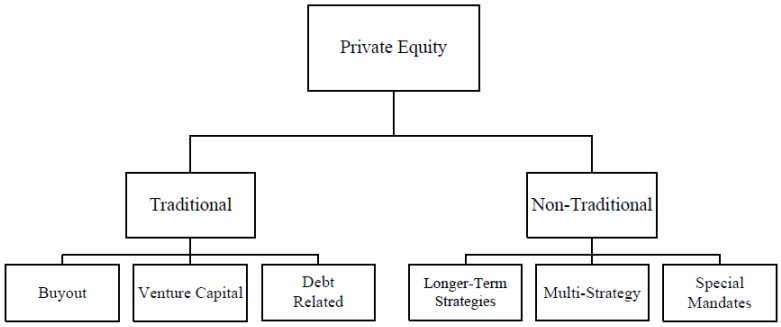

Figure 1: Private Equity Portfolio and Benchmark Structure

B.1 Traditional sub-asset group: The benchmark for this group shall be a weighted blend of these underlying sub-asset benchmarks:

- Buyout: The Buyout portion of the State Street GXPEI customized to reflect the pacing of CalSTRS' Buyout commitments.

- Venture Capital: The Venture Capital portion of the State Street GXPEI customized to reflect the pacing of CalSTRS' Venture Capital commitments.

- Debt Related: The Debt Related portion of the State Street GXPEI customized to reflect the pacing of the CalSTRS' Debt-Related commitments.

The sub-asset components of the Traditional benchmarks shall be weighted according to the interim sub-asset allocation targets. The vintage year customization shall be weighted according to the actual vintage year deployments. Customization will employ a "scaled cash flow" methodology consistent with industry best practices.

B.2 Non-Traditional sub-asset group: The benchmark for this group shall be a weighted blend of these underlying sub-asset benchmarks:

- Longer-Term Strategies: The Buyout portion of the State Street GXPEI multiplied by 90%.

- Multi-Strategy: CalSTRS Custom Tactical Index: –A 60%/40% blend of the Debt Related and Buyout portions respectively of the State Street GXPEI.

- Private Equity Special Mandates Portfolio: The Buyout portion of the State Street GXPEI minus 200 basis points.

The sub-asset components of the Non-Traditional benchmarks shall be weighted according to the interim sub-asset allocation targets.

PROGRAM STRUCTURE

Portfolio Structure, Sub-asset Groups and Sub-asset Classes

The Private Equity portfolio shall be organized and monitored based on the structure shown in Figure 1 (see above). The portfolio is divided into the Traditional and the Non-Traditional sub-asset groups. As discussed previously, the Traditional sub-asset group includes the Buyout, Venture Capital, and Debt-Related sub-asset classes; the Non-Traditional sub-asset group includes the Longer-Term Strategies, Multi-Strategy, and the Private Equity Special Mandates sub-asset classes.

The Traditional sub-asset group is comprised of private equity investment types that are well established and common in the industry and for which reasonable and reliable peer benchmarks currently exist. These investments can be more readily peer-benchmarked due to the broader availability of comparable investable opportunities and a reasonably long observation period.

The Non-Traditional sub-asset group is comprised of private equity investment types that are not as well established or common in the industry and for which reasonable and reliable peer benchmarks are not as readily available. The benchmarks for these sub-asset classes will tend to be based on proxy metrics rather than peer-based metrics. As a means of measuring the performance of these types of investments, benchmarks are more difficult to devise, involve more subjectivity and when used to measure program performance, may be more prone to misleading or random results. On the other hand, opportunistic investments themselves may in many cases involve the ability to make above average risk-adjusted returns due to first mover advantages, less competition or various miscellaneous arbitrage characteristics.

Permissible Investment Types

The Private Equity program invests in: (1) Commingled Limited Partnerships (and other limited liability vehicles); (2) Separately Managed Accounts; (3) Co-investments; (4) Secondary Market Transactions; and, (5) Direct Investments in General Partner management companies. The Private Equity program can purchase and sell these investments. The subject investments are generally in private vehicles, primarily holding illiquid, private securities, but such vehicles may also hold some publicly-traded securities.

Commented [Staff3]: Throughout the policy "Commingled" is added to delineate when more than one investor is invested in a limited partnership.

Restrictions Pertaining to Investments Done Under Delegation Authority

The following restrictions apply to investments executed by staff under delegation of authority (as further discussed later in this policy):

Commingled Limited Partnership: A Commingled Limited Partnership is a legal entity (either a partnership, LLC, or other vehicle providing limited liability for investors) controlled by a general partner (or other similar entity) who manages the

operations for a group of limited partners. Limited partners invest capital but have limited liability, are not involved in the day-to-day management of a partnership, and generally cannot lose more than their capital commitment.

Applicable to new ~~limited partnerships~~Commingled Limited Partnerships sponsored by general partners not already included in CalSTRS' Private Equity portfolio (i.e. applicable to "First Time Limited Partnerships"): The maximum commitment amount shall be the lessor of $~~400~~750 million or 25 percent of the total amount of the partnership capitalization.

Applicable to ~~limited partnerships~~Commingled Limited Partnerships sponsored by general partners(s) that are already in the CalSTRS' Private Equity portfolio (i.e. applicable to "Follow-on-Commingled Limited Partnership"): The maximum commitment amount shall be the lessor of $~~750 million~~1.5 billion or 25 percent of the total amount of the partnership capitalization.

Separately Managed Account: A Separately Managed Account is an investment vehicle managed for one investor rather than many. The vehicle may have a specialized mandate or may invest alongside a Commingled Limited Partnership.

A Separately Managed Account vehicle must be a Limited Partnership, or limited liability corporation, or other vehicle that provides CalSTRS protection from general partner liability.

The maximum commitment amount shall not exceed $~~750 million~~1.5 billion for a "Follow-on Separately Managed Account" vehicle or $~~400~~750 million for a "First Time Separately Managed Account" vehicle.

Co-investment:~~-~~A Co-investment is ~~an investment~~ made alongside general partners or other institutional investors in underlying assets and securities, usually with lower management fees and carried interest. Co-investments may be structured as securities held directly by CalSTRS or as an interest in a vehicle managed by the General Partner that invests in such securities.

~~Co-investments shall be made on the same or better terms as provided to the Limited Partnership that is investing in the same transaction. Co-investments shall only be made alongside existing CalSTRS general partners and such transactions will fit into one of the sub-asset classes.~~

The maximum Co-investment commitment ~~in any one case~~to a single company (or set of related companies), either at one time or over a period of time shall not exceed ~~the lessor of: (1) $250~~$750 million~~; (2) 10 percent~~. Also, CalSTRS shall not be more than 50% of ~~the size of the Limited Partnership investing in the transaction; or (3) 100 percent of the limited partnership's investment in the transaction~~a financing round.

Commented [Staff4]: No change in intent, just further clarification.

Commented [Staff5]: No change in intent, just further clarification.

Commented [Staff6]: Increase in size due to increase in overall PE program and pension fund.

Commented [Staff7]: Increase in size due to increase in overall PE program and pension fund.

Commented [Staff8]: Increase in size due to increase in overall PE program and pension fund.

Commented [Staff9]: Recognizes that co-investments may be made alongside partners that are not just general partners.

Commented [Staff10]: As private equity further embraces the collaborative model and becomes more sophisticated, staff is seeing opportunities to invest in securities that are not directly led by existing GPs. Case in point, there are many high quality GPs that staff does not commit, but may consider in the future. Working alongside a manager on a co-investment is a good way to diligence future GPs – see Risk Management for limitations.

Commented [Staff11]: As private equity further embraces the collaborative model and becomes more sophisticated, staff is proposing limit increases given the size of the overall PE program and pension. As well, staff intends to stay a co-investor and not a lead investor, which is why staff will continue to stay 50% or less of a given financing round. To be clear, $750 million is the total amount of capital allowed in a single company regardless of financing round.

CalSTRS may incur due diligence costs, expenses, and break-up fees on potential Co-investments. The ~~magnitude of~~budget for these items shall be approved ~~in advance of any commitment~~ by the Chief Investment Officer, Deputy Chief Investment Officer, or Director of Private Equity, with such approval being made in advance of any potential commitment to the co-investment.

Commented [Staff12]: No change in intent just further clarification.

Secondary Market Transactions: For the purpose herein, Secondary Market Transactions are purchases or sales of private equity related interests in which one or more of the original ~~parties~~ investors divests~~ (or has divested)~~. Such private equity interests may involve a single interest or pools of interests. Pools may be diversified (~~greater than three~~four or more interests in a single transaction) or non-diversified (three or less interests in a single transaction).

Commented [Staff13]: This is not a change of intent

Commented [Staff14]: This is not a change of intent

Private Equity related interests can take the form of: 1) Commingled Limited Partnership Interests; 2) Co-investments; 3) General Partner interests; 4) Separately Managed Accounts; 5) Portfolio Companies, or; 6) a combination of the above.

The maximum commitment amount shall not exceed:

Commented [Staff15]: The changes in this section reflect the increased size of the pension fund and the PE program.

Asset Type	Diversified Pools	Single Interests and Non-Diversified Pools
Commingled Limited Partnership Interests and Separately Managed Accounts	$1.5 billion	$~~750 million~~1.0 billion
Co-investments, General Partner Interests, and Portfolio Companies	$~~500 million~~1.5 billion	$~~250~~750 million

A diversified investment shall not include any single interests greater than that allowed under non-diversified investments.

Secondary Market Transactions involving Co-investments or Portfolio Companies shall only be transacted (directly or indirectly) with an existing CalSTRS General Partner. Sales of Co-investments and Portfolio Companies may be transacted independently of a General Partner.

Diversified and non-diversified investment are not defined by the structure of the investment (e.g. Commingled Limited Partnership, Separately Managed Account, Co-investment), but rather by the underlying assets.

Direct Investments in General Partner management companies: In addition to investing as a limited partner, the Private Equity program may acquire (and sell) minority interests in General Partner management companies.

The maximum commitment amount shall not exceed $~~250~~750 million.

Commented [Staff16]: The changes in this section reflect the increased size of the pension fund and the PE program. The limit increase is parallel in proportion with the changes in the preceding sections.

Ownership percentage of a Direct Investment in any one general partnership (or series of general partnerships organized by a particular manager) shall not exceed 25 percent economic interest.

Private Equity Special Mandates: The term "Special Mandate" is defined as a discrete investment strategy, other than divestments, suggested by CalSTRS' Board members that include, but are not limited to: environmental, social, governance, in-state investments; or other factors that are expected to have a positive or neutral impact on the economic performance of the fund over the long term.

Authorized Private Equity Special Mandates are listed below. Additional Special Mandate strategies may be added to the portfolio at the direction of the Investment Committee.

- Proactive Portfolio: The Proactive Portfolio includes the Underserved Urban and Rural Mandate ("UUR") and the New and Next Generation Manager Mandate ("NNG"): The UUR mandate invests with Private Equity managers specializing in underserved urban and rural markets. The NNG mandate invest with Private Equity managers that are of a "new and next generation" nature (generally, but not exclusively, first-, second-, or third-time institutional funds).

  The Proactive Portfolio may be invested in whole or in part through Commingled Limited Partnerships, Separately Managed Accounts, Co-investments, GP Interests, or Fund-of-Fund vehicles. The maximum commitment amount of a Fund-of-Fund vehicle that is new to CalSTRS in the Proactive Portfolio, or with a new strategy, shall not exceed $100 million. Follow-on investments of this type shall not exceed $250 million. Investments in the Proactive Portfolio are limited to investing primarily in the United States, Canada, and Mexico.

  Commented [Staff17]: This change make clear that the Proactive Portfolio managers may engage in similarly structured strategies. These changes reflect the changing nature of the industry and this sector.

  Side-by-Side ("SBS") investments are commitments made to an underlying fund in one of the UUR or NNG Fund-of-Fund vehicles with a positive recommendation from the applicable manager or the Program Advisor. The maximum commitment amount for new and follow-on SBS investments shall be the lessor of $100 million or 30 percent of the total amount of the partnership capitalization.

  Co-investments with GPs in underlying Special Mandate portfolios are permitted under the same restrictions as the Co-investment portion of this policy, but limited to $100 million per financing round

  Commented [Staff18]: As private equity further embraces the collaborative model and becomes more sophisticated, staff seeks to source co-investment opportunities from the emerging managers as it allows for better due diligence on potential graduates to the larger PE program. As well, staff is taking conservative approach, by limiting the size of a co-investment with an emerging manager to $100 million.

- Clean Energy and Technology Special Mandate ("Clean-Tech"): The Clean Energy and Technology Special Mandate is a diversified portfolio of

Venture Capital and Buyout investments across the clean technology and clean energy universe. The program is global in scope and includes both Limited Partnership investments and Co-investments.

RISK MANAGEMENT

Delegation of Authority

The investment, administration, and management of the Private Equity assets and strategies are delegated to staff within the boundaries established by these policies and the processes described within the relevant investment guidelines.

Except ~~where noted~~as otherwise noted below, all Private Equity investments require a positive written recommendation by CalSTRS' staff and either a Program Advisor, an Independent Fiduciary, or Co-investment Advisor.

In the case of a co-investment alongside a current general partner or one that has been recommended by a PE Program Advisor, an independent fiduciary will not be required.

For the avoidance of doubt, a co-investment opportunity that is neither made alongside an existing CalSTRS general partner nor has been recommended by a PE Program Advisor, requires an independent fiduciary to assess the general partner or institutional investor.

Diversification

Diversification within the Private Equity portfolio is critical to control risk and maximize returns. Investments shall be diversified to control unintended biases. Diversification ~~shall occur~~will be reviewed on a NAV basis over time, and across the following parameters:

Market Segments (sub-asset classes): The market segments are defined as Buyout, Venture Capital, Debt-Related, Longer-Term Strategies, Multi-Strategy, and Private Equity Special Mandates. The following ranges and targets are to be reviewed and updated periodically to the Investment Committee:

	Approved Ranges	Interim Targets	Approved Long-Term Targets
Buyout	60 – 85%	71%	754%
Venture Capital	0 – 15%	10%	7%
Debt-Related	5 – 20%	10%	8~~9~~%
Longer-Term Strategies	0 – ~~5~~10%	2%	4%
Multi-Strategy	0 – 5%	1%	2%
Private Equity Special Mandates	0 – 8%	6%	4%

Commented [Staff19]: Clarification, no change in intent.

Commented [Staff20]: While the collaborative model provides for increased flexibility to take advantage of a wider range of value creating opportunities, staff recognizes that unique situations beyond the scope of this policy should require specialized consultation. This portion of the policy clarifies that in these circumstance an independent fiduciary will be required.

Commented [Staff21]: No change in intent, just greater clarification.

Commented [Staff22]: Minor changes in the long-term targets to reflect the reality of the program.

Interim targets represent goals that are generally expected to be achieved in the next 12 to 36 months. Long-term targets represent goals that are generally expected to be achieved over periods exceeding three years.

Geography: Geographic regions are defined by the principal focus of the investment mandate or, for a particular investment vehicle, the domicile of the underlying portfolio companies. The geographic breakdown shall be segregated by ~~United States, Developed Markets (Non-United States),~~North America and Non-~~Developed~~North America Markets. The following ranges and targets are to be reviewed and updated periodically to the Investment Committee:

	Approved Ranges	Approved Targets
~~United States~~North America	65 – 85%	75%
~~Developed Markets (Non-United States)~~Non –North America	15 – 35%	~~20~~25%
~~Non-Developed Markets~~	~~0 – 15%~~	~~5%~~

Vintage Year: Vintage Year is defined by the date of first cash flow of the Limited Partnership. Investments within market segments (sub-asset classes) shall be stratified by vintage year to mitigate the impact of fund flow trends within each segment. The vintage year pacing should be done in accordance with long-term allocation plans as periodically discussed and reviewed by the Investment Committee as well as other internal and external parties.

Economic Sector: Economic sectors are described by the Global Industry Classification Standard (GICS). Economic sector diversification is to be monitored and taken into consideration in making investment decisions.

~~**Cash Transfer Limitations**~~

~~The following graduated limitations of non-cumulative daily signing authority for Private Equity disbursements are as follows:~~

~~Investment Officer I.....$15 million~~
~~Investment Officer II.....$50 million~~
~~Investment Officer III.....$70 million~~
~~Associate Portfolio Manager.....$85 million~~
~~Portfolio Manager.....$100 million~~
~~Director of Private Equity.....$400 million~~
~~Deputy Chief Investment Officer.....$1.5 billion~~
~~Chief Investment Officer.....$1.5 billion~~

Commented [Staff23]: This change is a reflection of the limitations of our benchmark provider. We are making this proposed change to better align what we can measure to what the policy reads.

Commented [Staff24]: This change is a reflection of the limitation on our benchmark provider. We are making this proposed change to better align what we can measure to what the policy reads.

Commented [Staff25]: Cash transfer limits are now incorporated into the IPMP (as approved by the Board) and have been removed from the individual policies

MONITORING AND REPORTING

Management and Monitoring: The Private Equity program will be managed according to an annual business plan whose main business components will encompass an analysis of the investment environment, a review of the investment strategy, a review of the diversification targets, and a resource allocation budget.

Performance Measurement: In general, when reporting solely on Private Equity performance internal rate of return (IRR) methodology is to be preferred in keeping with the CFA Institute's Global Investment Performance Standards. When reporting in conjunction with other asset classes, for the sake of consistency, portfolio and benchmark data is linked on a quarterly basis to produce time-weighted returns (TWR).

Reporting: Staff ~~The Private Equity Board Consultant~~ will periodically report to the investment committee its current vision, strategy, and progress. The Private Equity Board Consultant will report on the PE program's performance as well as industry trends. Specific reports will include:

i. Semi-Annual Reports: The Private Equity Board Consultant will prepare and present portfolio management reports on a semi-annual basis focused on performance and industry trends. The management report will provide information on, among other items, portfolio diversification, largest holdings, investment performance, co-investment holdings, and committed and funded status.

ii. Business Plan: Staff provides

iii. Pacing Plan: Staff provides

iv. Investment Manager Ratings Report: Staff provides

~~prepare and present portfolio management reports on a semi-annual basis. The management report will provide information on, among other items, portfolio diversification, largest holdings, investment performance, co-investment holdings, and committed and funded status.~~

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

~~i. Semi-Annual Reports~~

~~ii. Investment Manager Ratings Report~~

~~iii. Business Plan~~

Commented [Staff26]: Added to provide an additional report on how PE is evolving relative to the overall program.

Commented [Staff27]: Clarification of the reporting deliverables with regards to preparation and board preparation responsibilities.

VERSION CONTROL

Adopted June 1998
Revised July 1998
Revised April 1999
Revised to flexibility regarding secondary transactions on April 2001
Revised March 2002
Revised for clarification of returns calculations using dollar-weighted IRR on June 2003
Revised to expand eligible regions to rest of world on June 2004
Revised to change level of delegated authority on July 2005
Revised to increase co-investment limits and layout proactive portfolio process on June 2006
Revised to adjust Benchmark on May 2007
Revised for co-investment ROW, sale policy and direct GP Investment on July 13, 2007
Revised for daily trading authority limits, and sector targets and ranges on November 1, 2007
Revision of financial benchmark July 10, 2008
Revision for separately managed accounts on July 12, 2012
Revised to add ESG Risks Policy reference on September 10, 2013
Revised to clarify the benchmark for different time periods~~,~~ July 11, 2014
Revised to define APM and DCIO trading limits on April 5, 2017
Revised to customize GXPEI benchmark and establish new Sub-assets on June 7, 2017
Revised to update and reflect increased limits, investment types, and structures~~,~~ November 1, 2017
Policy revised to reflect new format, new structure, interim targets, and benchmarks~~,~~ May 8, 2019
Policy revised to reflect new benchmark for periods of ten years and beyond~~,~~ July 11, 2019
Revised to reflect increased limits, clarifies delegations for co-investment, and clean-up July 8, 2021

GLOSSARY

Commented [Staff28]: A number of changes were made in the glossary to clarify, update, or expand concepts in the PE program. Hopefully they are additive to the TRB's knowledge of the PE asset class.

BUYOUT – Buyout investments involve the purchase of all or part of the stock or assets of a company utilizing a significant amount of borrowed capital as well as equity capital. Borrowed capital typically consists of some combination of senior and subordinate debt. The company may be privately or publicly owned, or a subsidiary or division of a privately or publicly owned company.

CARRIED INTEREST –The general partner's carried interest is its share of the partnership's profits, and generally ranges from 10 percent to 30 percent of the total. A 20 percent carried interest is the industry norm for private equity.

CLEAN ENERGY AND TECHNOLOGY SPECIAL MANDATE – The Clean Energy and Technology Special Mandate ("Clean-Tech") is a diversified portfolio of venture capital and buyout investments across the clean technology and clean energy universe. The program is global in scope and includes both fund investments and co-investments. Please see the definition for Private Equity Special Mandates. New commitments discontinued as of September 2018.

CO-INVESTMENT – Co-investments are investments made alongside general partners in underlying assets and securities, usually with lower management fees and carried interest.

CO-INVESTMENT ADVISOR – A co-investment advisor is an investment manager who manages a Separately Managed Account of co-investments on behalf of CalSTRS. Such an advisor

may act as an Independent Fiduciary for co-investments that are outside of the Separately Managed Account if at least $25 million is invested in such transaction through the Separately Managed Account that is being managed on behalf of CalSTRS by such Co-investment Advisor.

CO-INVESTMENT TRANSACTION – A financing or series of financings that have an initial close on a given date and a final close no later than 365 days thereafter. Subsequent to the initial close, financings must have essentially the same terms or better to be considered a single transaction.

COMMINGLED LIMITED PARTNERSHIP – ~~Organization~~Legal Entity made up of a General Partner, who manages the operations, and limited partners, who invest capital but have limited liability. Limited partners are not involved in the day-to-day management of the partnership and generally cannot lose more than their capital ~~contribution~~commitment.

DEBT-RELATED INVESTMENT STRATEGIES – Debt-related investments (as applied to the Private Equity asset class) involve the purchase and ownership of private securities that are debt-oriented (rather than equity-oriented). There are many different types of debt-related investment strategies including but not limited to mezzanine debt, distressed debt, direct lending, and convertible debt.

DEVELOPED MARKETS – Countries with advanced economies and capital markets as designated by Dow Jones or Standard & Poor's.

DIRECT INVESTMENTS – Direct Investments are those made outside of a limited partnership structure. While a co-investment is made alongside of a limited partnership investment, a direct investment is not. Direct investments need a greater level of due diligence and involve a greater level of risk in comparison to a co-investment. Direct Investments are limited to General Partner Interests.

DISTRIBUTIONS – Cash and/or securities paid out to the limited partners from the limited partnership.

FIRST TIME LIMITED PARTNERSHIPS – A fund from a management team that has not previously been directly held in CalSTRS' Private Equity Portfolio.

FIRST TIME SEPARATELY MANAGED ACCOUNT – An investment in a vehicle managed for one investor rather than many with a management team that has not previously been directly held in CalSTRS' Private Equity Portfolio.

FOLLOW-ON LIMITED PARTNERSHIPS – The second and all subsequent funds raised by a management team that are ~~included~~directly held in CalSTRS' Private Equity Portfolio.

FOLLOW-ON SEPARATELY MANAGED ACCOUNT – The second and all subsequent separately managed accounts ~~invested~~directly held by CalSTRS and managed by a particular general partner.

FUND-OF-FUND (FOF) – An investment strategy of holding a portfolio of other investment funds rather than investing directly in stocks, bonds, or other securities.

GENERAL PARTNER – Managing partner of a limited partnership responsible for performing the day-to-day administrative operations of the partnership and acting as investment advisor to the partnership.

GLOBAL INDUSTRY CLASSIFICATION STANDARD (GICS) – Industry taxonomy developed in 1999 by MSCI and Standard & Poor's (S&P) for use by the global financial community.

GXPEI (OR THE STATE STREET GX PRIVATE EQUITY INDEX) – A peer-based private equity index developed, owned and managed by State Street. The data for this index is derived from the cash flow data of State Street's limited partner clients.

INDEPENDENT FIDUCIARY – A third party organization that provides non-discretionary specialized advisory services to Staff and acts as a fiduciary to CalSTRS and who by law must act in the best interests of CalSTRS and put the interests of CalSTRS above their own.

INITIAL PUBLIC OFFERING (IPO) – The sale or distribution of a stock or a portfolio company to the public for the first time.

INTERNAL RATE OF RETURN (IRR) – The discount rate at which the present value of future cash flows of an investment equals the cost of the investment. It is determined when the net present value of the cash outflows (the cost of the investment) and the cash inflows (returns on the investment) equal zero, the rate of discount being used is the IRR.

LIMITED PARTNER – The investors in a ~~limited~~Commingled partnership~~, generally providing 99 percent of the capital and receiving 80 percent of the profits~~ or Separately Managed Account. Limited partners do not participate in the management of the partnership's activities. However, they normally have the right to vote to approve or disapprove amendments made to the limited partnership agreement.

~~**LIMITED PARTNERSHIP** – Organization made up of a General Partner, who manages the operations, and limited partners, who invest capital but have limited liability. Limited partners are not involved in the day-to-day management of the partnership and generally cannot lose more than their capital contribution.~~

LONGER-TERM STRATEGIES – Private equity investments that are expected to have lower risk and reward profiles than traditional private equity investments. Such investments will likely be held for longer periods of time than traditional private equity investments. Management fees and carried interest will generally be lower than for traditional private equity investments.

MULTI-~~STRATEGIES~~STRATEGY – The Multi-~~strategies~~Strategy sub-asset class invests in private equity investments along with other private investments with fixed income, real estate, and

hedge fund characteristics.

NEW AND NEXT GENERATION MANAGER MANDATE (NNG) – The New and Next Generation Manager Mandate was established by the Investment Committee in 2003. It involves partnerships that are raising their first-, second-, and third-time institutional funds or partnerships formed by junior or senior level partners that have left a prior partnership to form a new general partner. Please see the definition for Private Equity Special Mandates.

NON-DEVELOPED MARKETS – Countries with developing economies and capital markets as designated by Dow Jones or Standard & Poor's.

PORTFOLIO COMPANIES – Portfolio companies are the companies in which the Commingled Limited Partnership, Separate Managed Account, Secondary Limited Partnership, or other similar structure has an investment.

PREFERRED RETURN – A rate of return that must be met before the General Partner can earn carried interest.

PRIVATE EQUITY BOARD CONSULTANT – A Private Equity Board Consultant acts as an independent fiduciary advisor to the Investment Committee and provides expertise and advice related to the overall investment strategy, policies, and practices of the Private Equity Program.

~~PRIVATE EQUITY~~ SPECIAL MANDATES – Discrete private equity investment strategies (other than divestments which are covered by a separate policy) suggested by the CalSTRS Investment Committee that include, but are not limited to environmental, social, governance (ESG) matters in-State investments, or other factors that are expected to have a positive or neutral impact on the economic performance of the fund over the long term. See Special Mandate Policy.

PROACTIVE PORTFOLIO – The Proactive Portfolio currently encompasses two ~~Private Equity~~ Special Mandates: (1) the Underserved Urban and Rural Mandate investing with private equity managers specializing in underserved urban and rural markets and (2) the New and Next Generation Manager Mandate investing in private equity managers that are of a "new and next generation" nature. Please see the definition for ~~Private Equity~~ Special Mandates.

PROGRAM ADVISOR –A Program Advisor provides expertise, advice and recommendations to support staff in the management and monitoring of an asset class or classes including, but not limited to, screening the universe of general investment opportunities and identifying those meeting CalSTRS' selection criteria, assisting staff in performing due diligence on prospective investment opportunities, issuing investment recommendations, and maintaining a deal log of investment opportunities. A Program Advisor is also an Independent Fiduciary.

SECONDARY LIMITED PARTNERSHIP INTERESTS – Limited Partnership interests that have been transferred from the original limited partner who made the original capital commitment to a limited partnership fund.

SEPARATELY MANAGED ACCOUNT – An investment vehicle managed for one investor

rather than many. The vehicle may have a specialized mandate or may invest alongside a Limited Partnership.

SECONDARY MARKET TRANSACTIONS – Secondary Market Transactions are purchases or sales of private equity related interests in which one or more of the original parties divests (or has divested). Such private equity interests may involve a single interest or pools of interests. Pools may be diversified (greater than three interests in a single transaction) or non-diversified (three or less interests in a single transaction).

SIDE-BY-SIDE INVESTMENT (SBS) - A commitment to an underlying fund in one of the ~~UUR or NNG~~Special Mandate fund-of-fund vehicles with a positive recommendation from the applicable manager or the Program Advisor.

UNDERSERVED URBAN AND RURAL MANDATE (UUR) – The Underserved Urban and Rural Mandate was established by the Investment Committee in 2001 to seek private equity investment in the inner city and underserved portions of California and the U.S. Please see the definition for ~~Private Equity~~ Special Mandates.

VENTURE CAPITAL – Venture capital refers to investments in young, emerging growth companies in different stages of development. The stages of venture capital investing include the following:

> **SEED STAGE -** An entrepreneur seeking capital to conduct research or finish a business plan;
>
> **EARLY STAGE –** A company developing products and seeking capital to commence manufacturing;
>
> **LATE STAGE** – A profitable or near-profitable high growth company seeking further expansion capital. The common theme underlying all venture capital investments is the high-growth nature of the industries in which the investee companies operate and the active role played by the investor to identify additional management expertise and provide general business advice.

VINTAGE YEAR – Vintage Year ~~can~~shall be defined in two ways: 1) For the purpose of investment pacing, a vintage year is the calendar year for which a fund commitment is closed; ~~or~~and 2) For the purpose of benchmarking, a vintage year is the calendar year an investment vehicle first draws capital or draws on its credit line. By placing an investment into a particular vintage year, the investor can compare the performance of a given investment with other similar investments that have first drawn capital (or its credit line) during that calendar year.

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MEMORANDUM

TO: Investment Committee, CalSTRS
FROM: Steve Hartt, John Haggerty, Meketa Investment Group
CC: Christopher Ailman
DATE: July 8, 2021
RE: Private Equity Policy Revisions

CalSTRS Investment Staff ("Staff") has provided Meketa Investment Group with a First 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 are the most significant to the PE Policy in at least a decade. They reflect the both 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;
- Eliminate concurring fiduciary opinions for certain co-investment transactions;
- Expand the range of strategies available under the Proactive Portfolio;
- 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 a number of the proposed changes, as well as Staff's vision for the future of the Program. We encourage the Board to review all of the items related to the proposed PE Policy changes and engage

Staff in a dialog about their vision for the Program. While we concur with many of the proposed policy changes (as more fully described below), we also identify certain items we recommend for further discussion.

We remind the Board 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 Board. 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 are items that should be a clear benefit to the PE Program:

- 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 the 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.
- Increase delegated authorities – Diversified Vehicles. We believe it is helpful to view the proposed increases in the dollar amount 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.
- 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. As Staff notes, these changes are relatively small, 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 Board.
- 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 Board has heard at several meetings, emerging markets are an important area of investment diversification, not only for private equity, but for the total portfolio. ***While we concur with Staff's proposed change, we suggest that Staff continue to report to the Board important dimensions of geographic diversification in the Program.***

Below are items that should benefit the PE Program but involve some measure of additional risk and merit additional discussion with Staff:

- 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 PE current 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 $750 million 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).

  Potential risks: Additional volatility from larger undiversified investments and misalignments with the GPs.

- 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 also has a fund commitment. 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 in its portfolio, and expands the range of co-investment sponsors to include not only other non-CalSTRS GPs, but other institutional investors (non-GPs).

Potential risks: Lower levels of knowledge about (and alignment with) GP co-investment partners and non-GPs that are not in the CalSTRS portfolio.

- Modification of concurring fiduciary opinions for certain co-investment transactions. We note that the co-investment marketplace has become more competitive, with decision speed and certainty of close increasingly important to co-investment sponsors. It is in this backdrop that Staff is seeking the elimination of the fiduciary opinion requirement for the large majority of future co-investments. Currently, private equity investments made by CalSTRS requires a concurring opinion from an independent fiduciary. These fiduciary opinion letters provide a conclusion that the proposed investment is "prudent" as defined under California law. While these opinions are not focused on the specific investment merits, nor do they guarantee that the investment will be successful, they do ensure that another fiduciary has reviewed the transaction on behalf of CalSTRS. Currently, CalSTRS required fiduciary opinions for all other private equity commitments.

  Staff's proposed PE Policy seeks to eliminate the fiduciary opinion letter requirement for co-investments executed alongside current CalSTRS GPs. Additionally, co-investments with general partners that have been "recommended" by a PE Program Advisor, whether for CalSTRS (or other clients potentially with different standards than CalSTRS) would similarly not require a fiduciary opinion letter.

  Potential Risks: Eliminating fiduciary opinion letters may reduce valuable protections to the PE Program and to CalSTRS.

- Expansion of the range of investments available under the Proactive Portfolio. The Proactive portfolio can be a source of attractive investment opportunities. However, given these managers tend to be less proven than other GPs, investment returns from Proactive managers can be more volatile than more proven managers. Staff seeks to expand the range of investments it can consider under the Proactive Portfolio to include co-investments and GP interests. Specifically under the Proactive Portfolio, Staff would have delegation to make co-investments up to $100 million per financing round, and that other proposed elimination of current requirements in the PE Policy (e.g., being a GP in the CalSTRS portfolio, certain fiduciary opinion letter requirements, etc.) be similarly eliminated as well.

  While we believe that an expansion of Proactive Portfolio investments makes sense for CalSTRS, we suggest that for the First Reading the Board discuss with Staff the proposed expansion of the Proactive Portfolio investment strategies with particular focus on undiversified investments with non-CalSTRS GPs and other sponsors, as well as the elimination of certain fiduciary opinion requirements.

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 first 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 meaningful expansion of Staff's delegated authority, specifically around Staff's ability to source investments and commit more capital to such investments.

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.

SH/JH/SPM/jls