CALSTRS

Investment Committee

Item number 5 – Open session

Subject: Private Equity Policy Revisions – First Reading

Presenter(s): Margot Wirth, Robert Ross, and Georgia Pappas

Item type: Information

Date and time: September 25, 2024 – 20 minutes

Attachment(s): Attachment 1 – Meketa's Private Equity Program Change Policy Review

Attachment 2 – Private Equity Policy – Clean Version

Attachment 3 – Private Equity Policy – Redline Version

PowerPoint presentation(s): PE Policy Update

Item purpose

The purpose of this item is to seek the Investment Committee's approval to update the Private Equity Policy.

The proposed changes primarily fall under the themes of 1) Aligning the Private Equity Policy with the Investment Policy Statement (IPS) to address the use of Total Fund leverage; 2) Alignment of risk and added agility for continued expansion of the Collaborative Model 3) Formalizing other revisions that include routine policy updates and general language clean-up.

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

Recommendation

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

Executive summary

As the Private Equity industry continues to evolve, CalSTRS Private Equity continues to be focused on the Collaborative Model implementation and expansion. Today there are two items in the Private Equity Policy that staff would like to amend:

First, Staff is adding a section on Portfolio Leverage in consideration of the IPS. To date, the Private Equity policy has been silent with regards to leverage and Staff felt it prudent to make the policy more explicit on how leverage might be utilized given the approved changes in the IPS.

Second, Staff is looking to update the Risk Management section of its policy to better align it with the goals of the Collaborative Model, specifically when the use of an independent fiduciary for co-investments and secondary transactions is required. The proposed 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 report unless the co-investment will be greater than $250 million. It also clarifies that secondary transactions (buying or selling) under $250 million will not require an additional independent fiduciary report as any transactions would occur in consultation with the Program Advisor.

Background

Private Equity has been increasing the percentage of the portfolio focused on co-investments driven by the priorities 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%, which has been achieved.

- 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).

- In 2022, CalSTRS Investment Committee approved increasing the delegation of authority and broadening the scope of co-investing to include investments with non-CalSTRS General Partners. This is consistent with other best in class co-investment programs and provides Private Equity greater flexibility to evaluate a broader range of opportunities, including those which may be offered by prospective General Partners that are in the investment pipeline on the partnerships side.

In the current calendar year, Staff anticipates meeting the interim goal of 30% of annual commitments being in the form of co-investments.

PE Policy Alignment with IPS: Private Equity Portfolio Leverage

The added language for leverage in the Private Equity policy does not expand or add to the fund's leverage capacity, but rather clarifies the use of Total Fund leverage tools at the asset class level. Language around leverage is added to the Private Equity Policy to:

1. Reflect alignment with IPS, which provides Total Fund leverage and various liquidity tools for all asset classes including PE; this language explicitly allows PE to use those tools under the discretionary authority granted to the CIO by the Investment Committee.
2. Alignment with policies of major asset classes that have language for use of leverage.

As mentioned in the January 2024 IPS Policy Statement Revision: Market shifts often require the investment team to actively rebalance an increasingly complex CalSTRS portfolio. This complexity stems from the growing private markets portfolio, as well as cash flow streams that vary over time with the business cycle. Enhanced portfolio and liquidity management helps to manage risk and complexity and continue to meet the portfolio's objectives, including: (1) Paying benefits; (2) Avoiding selling assets at discounted prices; (3) Taking advantage of market opportunities; and (4) Rebalancing the portfolio.

Adding policy language that describes the use of leverage within Private Equity is consistent with policies of other major asset classes and provides Private Equity the flexibility to position its portfolio over a business cycle. This additional policy language adds transparency and codifies CalSTRS' potential use of liquidity sources approved for the Total Fund while providing the Investment Committee with reporting and oversight. Further, this will increase Staff's ability to optimally manage the portfolio and support prudent risk management and oversight drawing on: (1) the proven expertise of the team; (2) enhanced risk mitigants; (3) good governance; and (4) monitoring and reporting.

Collaborative Model: PE Policy Enhancement

Since CalSTRS' Private Equity program was set up over two decades ago, Staff has continued to enhance the Collaborative Model to responsibly scale the co-invest program, including hiring a dedicated team of professionals to execute on opportunities. Appropriately, as the program has scaled, the PE program continues to operate under an umbrella of risk controls and best practices, including thorough due diligence of opportunities, reasonable levels of diversification, and appropriate alignment with high-quality private equity partners.

At this stage, the program currently requires an independent fiduciary to verify price on all co-invest opportunities. Staff appreciates the original intent and potential benefit of this practice as it added extra assurance when the co-invest program was in its infancy and had less resources, experience, and sophistication. However, this blanket requirement for all co-investments is now less necessary since the program is out of its infancy given the growth of the program. Further it is likely one of the last holdbacks that prevents CalSTRS PE to be accepted into the "elite" echelon of co-investors by GPs, which include the likes of GIC, CPPIB, OTPP, ADIA, etc. In fact, CalSTRS has been able to attract experienced private equity professionals who in some cases were previously at those "elite" LPs mentioned above.

Participation in co-invest deals is highly competitive, especially with respect to partnering with the best managers and in the best deals. In these instances, it is important for Limited Partners with co-invest programs to move quickly in a professional, efficient manner to continue to secure invitations to these processes amongst other world class institutional investors. Within this peer group of leading national pension funds, sovereign wealth funds. and notable endowments, CalSTRS' independent fiduciary requirement is unusual, if not unique, and has become a programmatic disadvantage to the Collaborative Model.

Specifically, as currently defined, the independent fiduciary verifies the entry valuation of a proposed co-investment, which is an assessment that Staff and the approved General Partner do during their own diligence processes, making the independent fiduciary a third and redundant verification that adds delay and expense for CalSTRS. This process burdens both the General Partner and Staff as it adds more meetings and reviews and requires more time from deal teams, often in the heat of the closing process. Another issue is that the process adds a source of anxiety for the General Partner over confidentiality surrounding the deal process.

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 and secondary transactions where the General Partner (or institutional investor) has not been vetted and recommended by a PE Program Advisor or where individual co-investments and secondary transactions are greater than $250 million. 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 as well as reviewing the entry valuation. Staff will also continue to retain the option to use an independent fiduciary on any deal in which it feels such service will be beneficial to the investment's evaluation. Staff has previously conferred with Meketa, Legal, Investment Compliance, and Fiduciary Counsel on this proposed change.

Strategic Plan linkage: Trusted Stewards

Board Policy linkage: Investment Policy Statement
