

LEGISLATIVE PROPOSAL: Investments Procurement and Travel

SUMMARY

This proposal seeks to strengthen CalSTRS' ability to achieve funding goals, exercise fiduciary responsibility and reduce fees through implementation of the Collaborative Model by granting the board prudent flexibility to contract with investment managers and investment advisers and to allow necessary investment-related travel under policies it adopts.

RECOMMENDATION

Sponsor. The board's policy is to support or sponsor legislation that is consistent with the investment policy adopted by the board as presented in the CalSTRS Investment Policy and Management Plan.

REASON FOR THE PROPOSAL

The Collaborative Model is CalSTRS' approach to manage assets internally to save costs, manage risks and develop a pipeline of opportunities. As part of the Collaborative Model, CalSTRS has worked to be a preferred partner for world-class institutional investors. The system has faced significant constraints in applying necessary due diligence and has missed lucrative investment opportunities due to its operation under the umbrella of sometimes inapplicable state procurement requirements and restrictions preventing necessary travel. With this proposal, the board would establish prudent and fiducially responsible policies to procure contracts with world-class institutional investors and managers and to travel as necessary to effectively manage assets, perform due diligence and participate in advocacy, engagement and research related to the fund's assets across the United States.

ANALYSIS

Existing Law:

Investment Procurement

Most California state agencies, including CalSTRS, must abide by state contracting requirements. However, in recognition of the unique nature and mission of certain agencies, the Legislature has granted exemptions to certain proscriptive competitive bidding requirements. Among these, the California Housing Finance Agency and the California Health Benefits Exchange Board have been granted blanket exemptions from state competitive bidding requirements.

As fiduciaries, the board is bound by standards set forth in state and federal law to invest the assets of the plan in a manner that is solely in the interest of members and beneficiaries. These strict standards require fiduciaries to discharge duties in a timely fashion with care, skill, prudence and diligence at a level that exceeds the goals of California's public contracting requirements.

Travel Prohibition

Government Code section 11139.8 prohibits a state agency, department, board or commission from requiring any state employees, officers or members to travel to a state that has enacted a law or acted to support or finance discrimination based on sexual orientation, gender identity or gender expression. In addition, approving a request for state-funded or state-sponsored travel to such a state is prohibited. There are certain exceptions to the travel ban for specific regulatory or

training purposes. The following states are currently subject to California’s ban on state-funded and state-sponsored travel:

- Alabama
- Kentucky
- Oklahoma
- Tennessee
- Iowa
- Mississippi
- South Carolina
- Texas
- Kansas
- North Carolina
- South Dakota

This Proposal:

Consistent with existing authority set forth in the California State Constitution, this proposal authorizes the board to seek and secure the highest value contracts for investment-related expertise and services under the board’s terms and conditions, while still meeting the highest fiduciary standards of due diligence. This proposal also authorizes the board to adopt policies under which staff may be allowed to travel, consistent with state travel rules, to restricted states to invest the assets of the fund exclusively under the board’s due diligence, to maintain and conduct engagement activities related to the system’s current investments and to represent CalSTRS’ views in dialogues at annual meetings, conferences and association gatherings. This increased flexibility would allow CalSTRS to move quickly to capture investment opportunities, negotiate reduced fees or better terms, and perform the work necessary to ensure a responsibly managed fund.

PROGRAM BACKGROUND

Investment Procurement

As fiduciaries, public pension boards are bound by standards set forth in state and federal law to invest the assets of plans in a manner that is solely in the interest of members and beneficiaries. For example, CalSTRS private asset classes use a dual approval process, with staff and external consultants independently vetting investment opportunities and reaching consensus before any action is taken. CalSTRS staff engage in continuous analysis of competitive opportunities within their areas of expertise, regularly reviewing performance of any significant private asset firms extensively before reaching a decision to invest. Within a universe of several hundred private fund managers, only a handful may be worthy of real consideration. This vetting process is aligned with staff’s fiduciary duties and is ongoing, objective and entirely performance based. Conversely, the state procurement process causes staff to exert a great deal of effort reviewing the applications of managers whose past performance would otherwise disqualify them from working with CalSTRS. While completing this process, the landscape of investment opportunities may change, and costs may increase.

Within the broader investment landscape, CalSTRS competes for investment-related services against agile organizations that are not subject to California’s cumbersome procurement requirements. Therefore, it can be less desirable for firms with the extensive investment-related expertise to compete for a CalSTRS contract.

Travel

As fiduciaries, CalSTRS staff have a duty of loyalty – to demonstrate that investment decisions are made solely on an economic basis and for the sole economic interest of plan beneficiaries. With CalSTRS expanding its efforts in the Collaborative Model, it is important that staff maintain direct, in-person contact with partners to implement the strategy and maximize the investments in order to fund benefits for our members.

CalSTRS has accumulated substantial holdings and maintains strategic relationships with significant investment partners within states to which travel is currently restricted. For instance, approximately 15% of CalSTRS' Real Estate portfolio is located within Texas. Purchasing real estate operating companies and forming joint ventures with regional and national property type experts within these regions allows CalSTRS to access robust opportunities, high levels of control and attractive fee structures. As another example, CalSTRS has a Real Estate advisor in Iowa that oversees more than \$6 billion in real estate investments.

CalSTRS is also a leader in corporate governance and engagement with companies to drive change at those companies and within the financial industry. With travel prohibited to certain states, corporate engagement and research on investments related to California statute are hindered. For example, travel to banned states is necessary to engage with oil, gas and energy companies on issues related to climate change.

CalSTRS' current exposure in banned states is \$15.75 billion across asset classes. CalSTRS' inability to travel to restricted states impedes staff's responsibility as fiduciaries to regularly and directly oversee these types of investments, identify new opportunities, represent CalSTRS' interests on a national stage, and participate in due diligence, engagement and research activities, including limited partnership meetings, conferences, advisory group meetings and industry association gatherings.

FISCAL IMPACT

Program Costs/Savings – Greater flexibility in procuring new investment managers and advisors could result in significant improvement in CalSTRS' ability to meet performance objectives by taking advantage of favorable market dynamics, maximizing gains and minimizing losses. As asset classes continue to expand collaborative strategies requiring staff to conduct in-depth due diligence onsite and with partners, increased opportunity for engagement could result in significant improvement of fund performance.

Administrative Costs/Savings – Unknown savings in the form of reduced staff work required for the current procurement process. Unknown savings if direct travel costs may be lower than other methods for performing necessary due diligence pertaining to investments in banned states.

ARGUMENTS

- Pro: Achieves the Collaborative Model's goal of seeking to boost efficacy of guidelines and procedures, increasing responsiveness to investment opportunities as they are presented.
- Enables CalSTRS staff to act as a preferred partner for world-class institutional investors and to capitalize on lucrative and diverse investment opportunities.
- Expands CalSTRS' capacity to partner with peers, form joint ventures, co-invest and develop strong internal investing capabilities, ensuring a well-governed, financially sound trust fund.
- Allows CalSTRS staff to exercise on-site due diligence in managing existing investments.
- Con: Creates possible sensitivity toward continued or expanded investment in states that have infringed upon the rights of marginalized groups and the potential misperception of an effort to limit a competitive bidding process.