

# CALSTRS

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CALIFORNIA STATE TEACHERS'  
RETIREMENT SYSTEM

## INNOVATION PORTFOLIO POLICY

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INVESTMENT BRANCH  
DECEMBER 2013

## **O. Innovation Portfolio 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 Innovation Portfolio. The primary objective for the Innovation Portfolio (Portfolio) is to invest in strategies that do not fit any of CalSTRS' existing asset classes. The goal is to develop a procedure for exploring new concepts that are expected to improve diversification of the overall investment portfolio when fully implemented. The Portfolio's secondary objective is to incubate investment programs that would improve the risk and return characteristics of CalSTRS' Fund.

The CalSTRS Innovation 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 Innovation Portfolio.

The Innovation Portfolio Policy (Policy) ensures that investors, managers, consultants, or other participants selected by CalSTRS take prudent and careful action while managing the Portfolio. The purchase, management, and sale of all Portfolio products are performed by external and/or internal professionals (managers) who are monitored and evaluated by internal investment officers, a Portfolio consultant, and/or independent fiduciaries. CalSTRS believes that environmental, social and geopolitical (ESG) issues can affect the performance of our investments. As a result, the CalSTRS 21 Risk Factors have been developed as a tool that both internal and external investment managers are expected to use to assess the impact of ESG risk when making an investment on behalf of CalSTRS. The internal investment officers and independent fiduciaries operate under the direction of the Chief Investment Officer (CIO). Review of the Portfolio will fall under the general Consultant (Consultant), who reports directly to the Investment Committee. If a specialty asset class specific consultant is retained, that consultant will report directly to the Investment Committee.

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

## **POLICY**

This document outlines the policy for the management of CalSTRS' Innovation Portfolio. These policies are designed to set the boundaries for oversight and management of the Portfolio, while allowing sufficient flexibility in the management process to manage risk and capture investment opportunities.

Policies for the management of the Innovation Portfolio (Portfolio) are listed below:

1. The Portfolio's assets are to be invested in a prudent manner for the sole benefit of its participants and beneficiaries, in accordance with applicable portions of the Teachers' Retirement Law.
2. CalSTRS will invest in investment strategies that generally fall outside of the traditional asset classes currently used by the Board. The purpose is to provide the Board with the opportunity to invest in a wide spectrum of investment opportunities that will be required to demonstrate success before committing larger dollar amounts to a specified strategy. Within three years, CalSTRS will decide if a strategy should continue within the Innovation portfolio, be dedicated to a new asset class, be included with one of the traditional asset classes, or be terminated.
3. Each strategy will have its own specific performance metric. The Portfolio shall have a blended performance benchmark comprised of the weightings for each of the strategies utilized in the Innovation Portfolio multiplied by their respective benchmarks. Over the long-term, the Innovation Portfolio seeks to produce a positive real return.
4. The Portfolio will not hold any securities prohibited by the most recent Investment Resolution.
5. To achieve the stated performance objective, the Portfolio will invest in a diversified portfolio of strategies. Staff will select appropriate alternative investment sources with structural aspects that provide for the maximum return while mitigating risk and cost.
6. CalSTRS may enter into discretionary separate account relationships with investment funds/managers, subject to pre-approved investment guidelines. The Chief Investment Officer must approve any deviations from the approved guidelines. For this reason, investments shall be structured to facilitate alignment of interests between management and CalSTRS, management accountability, investment monitoring, and liquidity.
7. The assets under management (AUM) in the Portfolio shall not exceed 2.5 percent of the CalSTRS' total fund market value. To provide diversification, the size of each individual strategy shall be limited to a maximum of half-a-percent (0.5%) of the CalSTRS' total fund market value.
8. The CIO has the authority to approve commitments to Innovation portfolio strategies within the boundaries established by these policies. All investments are subject to appropriate due diligence as defined in the CalSTRS Innovation Portfolio Guidelines and will only be approved by the CIO following an affirmative recommendation from the Director of

Innovation & Risk and consultant (e.g., general or specialized independent consultant, if required).

9. CalSTRS investment personnel have authority to manage the Portfolio. If prudent, CalSTRS may elect to manage a strategy internally. Any internally managed strategy will be approved by the Chief Investment Office and General Consultant. The delegated limits for approval of the initial commitment to a manager and daily cash transfer limits are designated below. Directors of other asset classes may approve transactions with the consent of the CIO or Director of Innovation and Risk.

Chief Investment Officer	\$500 million
Director of Innovation & Risk	\$300 million
Director	\$300 million
Portfolio Manager	\$200 million
Investment Officer III	\$50 million
Investment Officer I and II	\$15 million

The approval and rejection decision for Innovation investments may be delegated to Staff. All investments are subject to appropriate due diligence as defined in the CalSTRS' Innovation Portfolio Guidelines.

10. Investments in the Portfolio should have clearly articulated and viable exit strategies through which assets can be disposed of or liquidated upon termination of the investment manager.
11. The Chief Investment Officer shall monitor the implementation of the Portfolio in compliance with investment policies. A report to the CalSTRS' Board shall be made annually or as otherwise requested.

*Policy for Innovation Portfolio First Reading February 5, 2009  
Policy for Innovation Portfolio Second Reading and Adoption March 5, 2009  
Revised to add ESG Risks Policy reference on September 10, 2013  
Revised to update portfolio AUM and delegated limits December 2, 2013*

## GLOSSARY

**ALPHA** – Portfolio's return relative to the return of the portfolio's benchmark.

**ASSET ALLOCATION** – Process of allocating investments optimally across a set of asset classes.

**BASIS POINTS** – Measure to describe the percentage change in value or rate of a financial instrument (1/100<sup>th</sup> of 1%).

**BENCHMARK** – Standard against which the performance of a strategy or portfolio is measured.

**CORRELATION** – Measure of the strength of a relationship between two securities, portfolios, or asset classes.

**DIVERSIFICATION** – Reduction in risk is obtained by investing among a number of different investment opportunities.

**INFLATION-LINKED ASSETS** – Security which is expected to deliver a higher return than the rate of inflation.

**NON-TRADITIONAL ASSET CLASSES/STRATEGIES** – Investments whose investment performance not correlated with that of stocks, bonds, real estate, private equity, and cash. It may include hedge funds and commodities. CalSTRS may investigate alternative investment strategies for the stock or bond traditional asset class.

**OPPORTUNISTIC** – Invest in strategies that CalSTRS believes will provide a superior return.

**RISK-ADJUSTED RETURN** – Measure of how much risk is involved to produce the investment return.

**SHARPE RATIO** – Risk-adjusted measure to determine the reward per unit of risk.

**TRADITIONAL ASSET CLASSES** – Stocks, bonds, real estate, private equity, and cash are fundamental components of an investment portfolio.

**VOLATILITY** – Measure of the dispersion of returns for a security or index.