

TEACHERS' RETIREMENT BOARD

INVESTMENT COMMITTEE

Item Number: **6**

SUBJECT: Investment Committee Work Plan Project – Co-Investments
and Direct Investment Opportunities

CONSENT: X

ATTACHMENT(S): 0

ACTION: _____

DATE OF MEETING: May 9, 2018

INFORMATION: X

PRESENTER(S): Mike DiRé, Margot Wirth, and Paul Shantic

POLICY

While the decision to manage assets internally versus externally is not covered under any specific policy, if at the conclusion of the study the Investment Committee approves any changes, such changes will be integrated into the Investment Policy and Management Plan (IPMP) and any other policy document, as appropriate.

HISTORY OF THE ITEM

One of the primary objectives of the 2017-18 Work Plan is to review and evaluate how CalSTRS approaches the implementation of internal versus external asset investment strategies across the portfolio, particularly with respect to the private asset classes (Real Estate, Private Equity, and Infrastructure).

As a reminder, external investing implies the use of external managers who choose and manage investments on an investor's behalf. This arrangement generally results in high fee and expense loads, especially if carried interest or incentive compensation is involved. Also, with the use of external managers, investors such as CalSTRS have much less control over how its investments are managed (i.e., much less control over what to buy, when to buy, when to sell and how to manage assets while owned). Internal investing refers to situations in which an investment organization such as CalSTRS makes some or all of these investment decisions itself. In situations in which an investor such as CalSTRS makes all such decisions, it is often referred to as pure "direct investing". There are gradations of direct investing depending upon how many such decisions are made internally. Note that the terms "internal investing" and "direct investing" are somewhat synonymous. Direct investing results in much lower (or no) fees and expenses being paid to outside parties. On the other hand, direct investing results in higher staff costs and perhaps higher risk. However, when implementing a direct investing program, the increase costs associated with hiring a larger internal staff is almost certainly far outweighed by the increased cost savings associated with not paying fees and expenses to external managers.

This review project is presented to the Investment Committee in a series of approximately four presentations. This current presentation is Part 3. [Part 1](#) was presented in November 2017 and provided a general overview of the various types and levels of direct investing currently being done in the CalSTRS portfolio. [Part 2](#) was presented in February 2018. At that meeting, a panel

of experienced investors from investment organizations that noted for their direct investing programs shared their thoughts and insights on the topic. The panel included Mark Wiseman from Blackrock (and formerly from CPPIB) and Jon Hausman from Ontario Teachers. The panel also included Dr. Ashby Monk, the Executive and Research Director of the Stanford Global Projects Center, who studies the various approaches to private asset investing. Staff and the Investment Committee heard how these funds moved from more traditional models to various forms of direct investing. Also discussed were lessons learned and advice for organizations such as CalSTRS who are considering a shift towards more internal/direct forms of investing.

PURPOSE

The purpose of this item is to update and summarize our research to date and to lay out the process staff proposes to follow prior to making any recommendations affecting the level of direct investing to be done at CalSTRS in coming years.

DISCUSSION

Based on the panel discussion from Part 2 of this ongoing review, staff proposes that CalSTRS's approach to private market investing be characterized as the "Collaborative Model". The term "collaborative model" was coined by Dr. Ashby Monk and Rajiv Sharma and it emanates from their research at Stanford University's Global Projects Center. More information is available at this link: [Collaborative Model Summary](#). Basic findings from this research include:

1. *Private market investing in infrastructure, VC, PE, real estate, and timber, is consistent with a long-term investment strategy;*
2. *The direct method of investing is the most cost effective form of investing;*
3. *Alternative external investment managers are required by a large number of institutional investors.*

Against this background, the 'collaborative' model focuses on developing innovative platforms and strategies by enhancing the social capital of investor organizations to improve their organizational effectiveness and invest more efficiently in private market asset classes.

Additional findings derived thus far from this review process and staff's experience includes the following:

- Direct investing is a broad category that can include various gradations. It can include everything from co-investment to custom accounts to managing assets directly and everything in between (see Graph 1 below).
- Direct investing efforts and strategies are more successful if they:
 - Match the strengths of the investor institution;
 - Fit the market opportunity by asset class;

- Emphasize collaboration with private market participants and other like-minded investors.
- Having adequate resources for direct investing efforts is an issue for any investment organization that endeavors to do such. The challenge is often more pronounced for public pension plans.
- Direct investing approaches are more readily applied to less-complex, lower-risk, and longer-term investment opportunities. However, through collaboration with others, experience and increased staffing levels, investment organizations can move further along the risk-reward spectrum and thus expand the scope of its direct investment activities.

The February panel emphasized that the first step in optimizing an investment organization's direct investment efforts is to assess the organization's strengths. An organization may then analyze how various direct strategies can be utilized to effectuate better investment results. As discussed by the panel, competitive strengths can be distinguished between those that reside naturally within an organization because of its very nature and those that have been cultivated and are therefore specific to the organization.

Natural strengths emanating from the very nature of CalSTRS's size and mission are as follows:

- 1) **Scale:** As a very large public pension fund, CalSTRS naturally benefits from economies-of-scale giving the opportunity to negotiate lower fees. In addition, scale represents a competitive advantage due to market inefficiencies. For large investment opportunities (e.g., infrastructure deals) the significant capital requirements often eliminate all but the largest players from being relevant. Less competition often leads to better purchase prices and higher returns.
- 2) **Long-term investment horizon:** With long-term liabilities (such as those associated with pensions to be paid far into the future) comes a long-term investment horizon. A long-term investment horizon enables an organization to invest in long-term assets. In many circumstances, this limits competition as not all investors are comfortable locking up capital for extended periods of time. Again, less competition leads to lower purchase prices. Also, longer hold periods for assets result in less churn, and therefore lower overall intermediation and transactional costs. However, liquidity can be very limited depending on the ownership structure and the level of investor discretion.

Cultivated strengths specific to CalSTRS's private asset classes include (in staff's opinion):

- 1) **Positive brand name recognition (i.e., positive reputation):** CalSTRS is known throughout the world as an investment organization guided by mission and integrity. CalSTRS has performed well on behalf of its beneficiaries while investing in socially-responsible ways. Within the private markets, CalSTRS is known as an industry leader and has a reputation for being prudent, thoughtful and, at times, innovative. For example, in the wake of the global financial crisis, CalSTRS has taken a leadership role in industry groups such as ILPA and PREA in addressing changes needed to improve alignment of interests between limited and general partners.

- 2) **An experienced, knowledgeable, and highly connected staff:** CalSTRS is known throughout the investment industry for its stable and solid investment staff. Among the ranks of CalSTRS investment staff are both professionals with extensive outside investment experience as well as those who have in large part spent most of their career at CalSTRS and been developed in-house. Low turnover and a culture of empowerment and collaboration over many years have resulted in a staff of sophisticated investors who act rationally confidently. This is important as the best partners and counterparties in the industry will naturally gravitate towards those whose actions are rational, commercial, and understandable. Also, given the investment market’s decreasing time frame available to make decisions, CalSTRS strives to be a decisive investor with a rigorous but timely and reasonable investment decision process.

These strengths, coupled with those specific to each asset class, will allow staff to craft collaborative strategies that fit with the market opportunities. Staff will work with our various consultants to gain their insights and input prior to presenting a formal recommendation at a future board meeting. Such recommendation will include analysis of staffing needs, estimates of total cost savings, and a timeframe for implementation.

This is an information item. Staff will be providing a short presentation and will be seeking direction from the Investment Committee

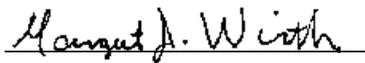
ATTACHMENTS/POWERPOINT

None

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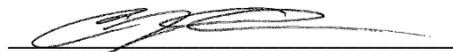


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