

TEACHERS' RETIREMENT BOARD

INVESTMENT COMMITTEE

Item Number: **9**

SUBJECT: Implementing the CalSTRS Collaborative Model

CONSENT: _____

ATTACHMENT (S): 1

ACTION: _____

DATE OF MEETING: May 8, 2019 / 20 mins.

INFORMATION: X

PRESENTER (S): Scott Chan

POLICY

Implementation decisions such as managing assets internally versus externally are delegated to Staff subject to the CalSTRS Investment Policy and Management Plan (IPMP). The CalSTRS Collaborative Model is an internally-led approach to guide the optimal balance between internal and external management of assets. Decisions to provide additional resources and support to the CalSTRS Collaborative Model are not covered under any specific policy, however, if the Investment Committee approves any recommendations or changes that require policy changes, they will be integrated into the IPMP and any other policy document, as appropriate.

PURPOSE

This agenda item concludes several years of formal study of the CalSTRS Collaborative Model and lays the foundation for executing the model across the CalSTRS Investment Branch.

Investment Beliefs and CalSTRS Collaborative Model:

CalSTRS Investment Beliefs provide a foundational framework for CalSTRS' Staff to invest in a manner consistent with CalSTRS' vision to accomplish its fiduciary goal. The CalSTRS Collaborative Model helps execute on CalSTRS' Investment Beliefs. The Collaborative Model builds internal management capabilities and increases control of risks (Belief 4) to save costs and reduce management fees (Belief 3). In addition, it increases alignment of financial interests between CalSTRS and its advisors (Belief 8) through equity ownership, sharing economics and investing alongside external partners.

Investment Belief Statements

<p>Belief 3 Managing investment costs yields long-term benefits.</p>
<p>Belief 4 Internal management is a critical capability.</p>
<p>Belief 8 Alignment of financial interests between CalSTRS and its advisors is critical.</p>

Investment Staff has a current annual goal to add 40 basis points of excess return (“alpha”) over the policy benchmark. Achieving the alpha target will assist in the critical mission of bringing CalSTRS to full funding. The CalSTRS Collaborative Model is the core framework that the Investment Branch believes supports the required excess return objectives. It is therefore imperative that CalSTRS succeeds in executing the CalSTRS Collaborative Model effectively.

CalSTRS Strategic Plan and CalSTRS Collaborative Model:

A unified effort across CalSTRS is required to implement the CalSTRS Collaborative Model and allow CalSTRS to evolve in a globally competitive marketplace. This effort is reflected in the CalSTRS 2019-2022 Strategic Plan as follows:

Goal 1: Financial/Governance

Ensure a well-governed, financially sound trust fund.

Objective D

Implement investment collaborative model leveraging all of CalSTRS resources.

Goal 4: Organizational Strength

Grow capacity and enhance efficiency in alignment with the mission and vision.

Objective A

Develop board and staff competencies to respond to changing business environments.

Measure & Target: 3. % of identified competencies incorporated within current or new classifications to support the investment collaborative model.

Objective B

Improve business processes and reduce costs.

Measure & Target: 4. # of days to complete the procurement process.

Objective D

Hire, develop and retain staff to meet the needs of our changing business models and growth expectations.

Investment Staff has partnered with other CalSTRS business areas to leverage the support necessary at an enterprise level to successfully implement the Collaborative Model. This work has led to the identification of four “Pillars” of resources across the organization that support the CalSTRS Investment team and the continued growth of the Collaborative Model.

1. Human Resources
2. Procurement
3. Travel
4. Other (Legal, Financial Services, Technology and Communications)

Considerations to change and expand these resources, within the CalSTRS organization, have been incorporated in this agenda item.

HISTORY

While Staff has been studying the CalSTRS Collaborative Model framework intentionally with the Board over the past several years, its evolution began more than twenty years ago in 1987 when CalSTRS first began to manage Fixed Income assets internally. Today, approximately 85% of Fixed Income assets are managed in-house and 45% of the total CalSTRS fund is managed internally.

One of the objectives established for the Investments branch 2017/18 Work Plan was to review and evaluate how CalSTRS approaches and supports implementation decisions regarding internal (or “direct”) management versus external asset management across the portfolio. The results of this study (which subsequently Staff refer to as the “CalSTRS Collaborative Model”) have been presented to the Investment Committee in multiple stages.

- [Part 1](#) (November 2017): general overview of the types of direct investing and where they existed in the portfolio.
- [Part 2](#): Staff invited an experienced group of investors that had implemented direct investment structures in their private asset portfolios to address the Board. These investors also highlighted the need to institute significant organizational changes and investment policy revisions to effectively manage the additional responsibilities and workloads created by greater internal management.
- [Part 3](#): identification of general factors affecting all asset classes in the consideration of the CalSTRS Collaborative Model.
- **Part 4** (Fiscal Year 2018-2019): each private asset class presented an overview to the Investment Committee of the merits of increased implementation of the CalSTRS Collaborative Model and the resources needed to support these changes. The presentations sequenced as follows:
 - [July 2018](#): all asset classes business plans; [Real Estate overview](#)
 - September 2018: [Real Estate implementation](#); [Inflation Sensitive overview](#)
 - January 2019: [Inflation Sensitive implementation](#); [Private Equity overview](#) and [Private Equity implementation](#).

The May 2019 presentation concludes Part 4 and will provide a summary of the CalSTRS Collaborative Model and implementation requirements needed to move forward. Addressing these additional resource requirements is imperative for Staff to be competitive and successful in implementing the CalSTRS Collaborative Model.

BACKGROUND

The CalSTRS “Collaborative Model” is an internally-led approach to how CalSTRS engages in the investment marketplace. CalSTRS embraces partnership and collaboration with world-class investment institutions, along with building internal (or ‘direct’) investing capabilities to achieve the benefits of internally managed assets. CalSTRS has developed a strong track record of reducing costs, increasing investment returns, controlling portfolio risk, and expanding investment opportunities – all for the benefit of California educators and their families.

The objective of the CalSTRS Collaborative Model is to continually calibrate the optimum balance between managing assets internally and decreasing costs. The CalSTRS Collaborative Model covers a spectrum of different types of investment strategies and investment ownership structures from simple to very complex. The flowchart below shows the general spectrum of investment options available to institutional investors. As investors move from left to right, the investor gains more control of risk and cost savings but has a greater need for Staff investment discretion, which requires more specialized skills.



Evolution of the CalSTRS Collaborative Model:

CalSTRS has a long history of expanding internal management and collaborative strategies in reaction to new market opportunities, the globalization of the investment portfolio, asset allocation shifts and staffing changes. (See **Attachment 1**)

As the historical summary illustrates, CalSTRS has built internal teams to manage the majority of its public market assets (Global Equity and Fixed Income). However, given the limitations of an investment office being housed within the framework of a government entity, it can be challenging to build the internal capabilities required for all types of investment strategies. These constraints have led Staff in private assets classes (Private Equity, RMS, Real Estate, Inflation Sensitive) to achieve their investment goals differently, predominantly by partnering with external, world class investment organizations. In these asset classes, Staff has developed: partnerships with peers, joint ventures, co-investments, passive and controlling stakes in investment companies, as well as building internal investing capabilities.

Public asset classes: Fixed Income (FI) was a significant portion of the total CalSTRS portfolio in the 1980's; the team has been able to reduce fees and increase risk control by managing assets in house. As asset allocation shifted to equities in the 1990's and 2000's, Global Equity (GE) found savings and better risk control through internal management of the U.S. indexed portfolio and subsequently the international portfolio. Staff's ongoing shifts to internal management in both FI and GE has continued to deliver positive results.

Private asset classes: Private asset class investments were introduced into the CalSTRS portfolio the late 1980s but did not achieve significant allocation and growth until the 2000's. As the private asset classes are not as mature and efficient as the public asset classes, there are more structural and strategic options to collaborate with other market players. Most global institutional investors predominantly invest in the private markets through funds or 'fund of fund' strategies whereby third-party managers have significant control and can charge relatively higher fees. Investment flexibility is more limited.

While Private Equity at CalSTRS began with investments in third-party managed funds, it soon expanded to include international investments and a limited set of Co-investments. Real Estate took a different path to adopting collaborative strategies, evolving from predominantly fund investing to shifting to investing in joint ventures in 2002 and the group's first Real Estate operating company investment in 2007. The Inflation Sensitive asset class was introduced in 2010 and immediately began collaborative investing in infrastructure strategies alongside more standard fund investments.

Over the last year, all three private asset classes have made detailed presentations to the Investment Committee regarding the opportunities, costs and risks associated with either expanding or creating new collaborative strategies and structures.

Over the past twenty years, CalSTRS has developed a successful track record and a strong brand in the marketplace with world class partners and experienced staff. CalSTRS is in a great position to continue to evolve and capitalize on this success moving forward.

Cost Savings from the CalSTRS Collaborative Model:

The adoption of the CalSTRS Collaborative Model has already led to significant cost savings as evidenced by a third-party peer comparison study, which showed that in 2017, the CalSTRS Investment branch saved \$132 million compared to peers, given the same asset mix.

According to the [2017 Cost Report](#), CalSTRS managed roughly 44 percent of its assets internally and 56 percent externally. In 2017, CalSTRS costs to manage the internal assets amounted to only \$30 million whereas it cost \$1.8 billion (including incentive fees) to manage external assets. Staff's primary focus in further expanding the CalSTRS Collaborative Model is therefore in reviewing the degree of externally managed investments and evaluating different collaboration strategies with external partners, where further significant cost savings could be achieved.

In considering the optimum balance between managing more assets internally and collaborating with external partners, it is critical that CalSTRS continues to invest in staff and other essential resources to support the model. This includes staff and resources both in the Investment branch and across CalSTRS functional areas - such as Travel, Procurement, Human Resources, Technology, Financial Services, Legal and Communications.

DISCUSSION

Staff has identified the following three key risks that need to be managed appropriately to ensure the successful implementation of the CalSTRS Collaborative Model: the competitive landscape, resources (specifically four resource 'Pillars') and the regulatory environment.

(I) Competitive Landscape:

While there are a few innovative U.S. funds, increasingly CalSTRS' competition is global. During Part 2 of the CalSTRS Collaborative Model study, Staff invited a group of investors with deep experience in implementing internally-managed investments. Staff's research indicates that in many cases CalSTRS competes for investment opportunities against larger, more well-resourced and more flexible/nimble organizations. In order to successfully compete for these opportunities, CalSTRS needs to be able to match the strengths of its peer group.

Accordingly, one of the hallmarks of the CalSTRS Collaborative Model is the flexibility to adapt investment strategies to the competitive landscape and to CalSTRS' competitive advantages. This includes the Investment Branch being able to evaluate investment strategies across a spectrum of externally managed (or 'indirect') options to internally managed (or 'direct') investing options. The spectrum includes: partnering with peers, forming joint ventures, co-investing, purchasing passive and controlling stakes in investment companies, as well as building internal investing capabilities.

Examples of the most significant Collaborative Model investment strategies currently being executed across the asset classes include:

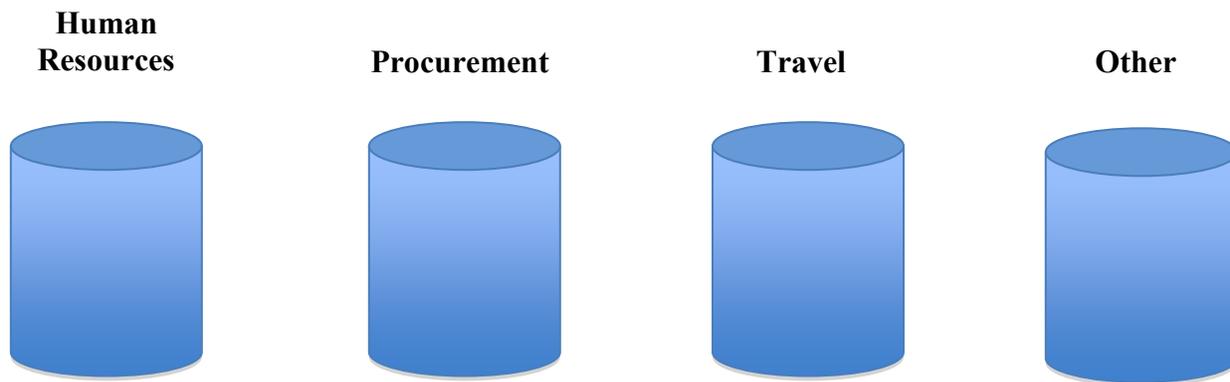
- Global Equity and Fixed Income: Expanding internal asset management capabilities and leveraging CalSTRS' existing internal trading desks and experienced asset management teams to bring more assets in house.
- Risk Mitigating Strategies: Bringing external advisory services in-house for portfolio management and manager selection, as well as internally managing strategies to reduce management fees and increased profit sharing.
- Sustainable Investment and Stewardship Strategies (SISS): Reducing overall fees by reducing the SISS portfolio's exposure to active managers and identifying more co-investment opportunities.
- Real Estate: Purchasing real estate operating companies and forming joint ventures with regional and national property type experts to access robust opportunities, high levels of control, and attractive fee structures.
- Private Equity: Establishing a bespoke collaborative arrangement with global co-investment firms to provide significant knowledge sharing, increase speed of decision-making, expand co-investment reach and improve CalSTRS' desirability as a co-investment partner.
- Inflation Sensitive: Collaborating closely with global institutional investors across multiple investments and vehicles to gain beneficial informational exchanges, tailored portfolio construction, and a wider view of the marketplace with increased investment opportunities.

Staff devotes significant effort to minimizing the implementation risks of these strategies:

- Ensuring that the identified strategies play to CalSTRS' competitive advantages including leveraging CalSTRS' size and scale, long-term investment horizon, experienced staff, world class partners and brand.
- Taking a progressive or phased approach. Staff possesses a successful track record of executing these strategies and is now looking to expand by doing more of the same or going one step further along the spectrum. Each asset class is evolving differently across the spectrum of investment strategies, but none are leapfrogging ahead without the expertise, resources or strengths to succeed in the face of global competition.

(II) The Four 'Resource' Pillars

To be successful in implementing the CalSTRS Collaborative Model, CalSTRS needs to expand and improve resources across the Investment Division, as well as business areas across CalSTRS, in a unified effort. In partnership with other CalSTRS business areas, Staff has identified four critical resource Pillars that support the CalSTRS Collaborative Model. Having appropriate strategies and resources in these functions will allow CalSTRS to minimize implementation risks and continue to compete effectively in a dynamic market environment.



Human Resources

By far the most important resource needed to support the CalSTRS Collaborative Model is the significant addition of internal staff with profiles that are difficult to recruit for - high levels of experience and specialized expertise. Internal investment management requires specialized skills to evaluate investment opportunities in a fast pace environment. Unlike fund investing with external managers or with General Partners, Staff's involvement includes every major decision on strategy, asset purchase, sale, renovation, as well as all leverage decisions. More personnel resources will also be required in support areas including Human Resources, the Legal office, Information Technology, and the Financial Services teams to support the expansion of the CalSTRS Collaborative Model.

Accordingly, the major implementation challenge will be managing talent acquisition. CalSTRS will need to reinvent its recruitment approach of investment professionals to attract world class talent, including partnering with external resources such as professional recruitment firms, along with building CalSTRS own Human Resources team. In addition, the ability to hire the right individuals also hinges on remaining competitive with overall compensation packages.

CalSTRS faces additional challenges as a government agency. Significant issues revolve around inflexibility in the hiring process, difficulty in creating new positions, procuring headcount, and setting compensation and incentives for all investment positions. These constraints will pose difficulties in CalSTRS' ability to attract talent, despite efforts to improve recruiting and streamline processes.

With the current demographics of the CalSTRS Investment office, succession planning is also of great importance. The success of the CalSTRS Collaborative Model is likely to be limited going forward without a deliberate effort to identify and develop potential successors to ensure leadership continuity and expertise in managing an increasingly complex investment portfolio.

New investment strategies are currently identified based on CalSTRS' existing strengths and current staffing levels. Staff will proceed prudently as resources are onboarded and opportunities present themselves to minimize execution risks.

Procurement

CalSTRS competes for investments against agile organizations which are not subject to any procurement rules. Ultimately, CalSTRS must comply with state procurement codes, which places a constraint on CalSTRS' capability to move as quickly as the competition.

The goal of this pillar is to decrease the time frame to hire outside advisors, consultants and managers, which facilitates quicker decision-making and better execution in the market. Staff will address the changes needed to procure resources, without increasing risk or sacrificing a competitive process, to shorten the time frames of hiring the outside resources needed to improve efficiency.

Travel

As the asset classes continue to expand collaborative strategies that requires staff to conduct in-depth due diligence onsite and with partners, the teams will see an increase in global travel with shorter lead times in response to a dynamic marketplace. Staff will explore technology solutions, the efficacy of current internal guidelines and procedures to increase responsiveness to investment opportunities as they are presented.

Other: Legal, Technology, Financial Services and Communications

Increasing resources in legal, technology, financials services and communications is a long-term commitment of shifting from external costs to more efficient internal resources. As Staff increase the level of analysis required in direct investment decisions, legal oversight and services will increase, in addition to technology requirements, to support the analysis and direct transactions.

Since the CalSTRS Collaborative Model requires an enterprise-wide expansion effort, financial services will assist in forecasting costs of additional resources across CalSTRS' business divisions. Importantly, Staff will develop a communications strategy to report transparently back to the Board, stakeholders and partners regarding progress, resource needs, incremental costs, cost savings and implementation risks.

(III) Regulatory Environment:

CalSTRS works under the umbrella of the state of California and faces many regulatory requirements, which in most cases cannot change and must be taken as constraints in the investment decision process. These constraints pose significant challenges to the progress which realistically can be made in evolving the four resource Pillars closer to competitive, global market dynamics. This is precisely why partnering across the organization systematically to effectively resource and make improvements in the four resource Pillars is critically important. Despite constraints, Staff can still make significant progress and addressing the four Pillars is expected to continue to further expand the implementation of the CalSTRS Collaborative model and lead to strong results, primarily in the form of cost savings.

NEXT STEPS

CalSTRS has undergone a significant evolution expanding internal management and collaborative strategies since the 1980's. The CalSTRS Collaborative Model is the result of an ongoing evolution of these existing practices and strengths. As a result, CalSTRS is in a great position to expand and capitalize on its significant experience, world class partners and existing successes.

The Investment branch is focused on enhancing CalSTRS' reputation and brand by hiring and retaining world-class talent, creating strong partnerships, and strengthening asset class teams and

strategies. Fully implementing the CalSTRS Collaborative Model will span multiple years and will be transparent and measurable to the Investment Committee. Staff believes CalSTRS is at an inflection point with execution of the CalSTRS Collaborative Model and believes that strategies for the four resource Pillars are critical to its further success expansion.

Staff will hire a specialized consultant from the investment consultant pool to work through the myriad of details and timing of the implementation and expansion of the CalSTRS Collaborative Model to efficiently move this project along and will report back to the Investment Committee on this engagement.

In the near-term, there are two additional items in May which relate to resourcing the Collaborative Model, including *(1) Teachers' Retirement Board – Regular Meeting, Item 13e: Internal Investment Management BCP; and (2) Teachers' Retirement Board – Compensation Committee Item 4: Collaborative Model Compensation Planning.*

Within the Investment Staff, project teams have been developed around the four resource Pillars to team up with other business areas and develop and prioritize strategies for each.

Staff will develop a broader project plan for the four resource Pillars and report back to the Board on conclusions and requests for resources within the normal governance processes. Staff plans to provide regular updates as part of the 2019-2020 Investment Committee work plan.

ATTACHMENTS/POWERPOINT

Attachment 1 – Evolution of the CalSTRS Collaborative Model

PowerPoint – Implementing the CalSTRS Collaborative Model

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Evolution of the CalSTRS Collaborative Model

