MEKETA

5796 Armada Drive
Suite 110
Carlsbad, CA 92008

760.795.3450
Meketa.com

MEMORANDUM

TO: Investment Committee, CalSTRS
FROM: Stephen McCourt, Allan Emkin, Mika Malone, Stephanie Sorg, Meketa Investment Group
CC: Chris Ailman
DATE: May 1, 2024
RE: Opinion Memo - Special Mandates Review

Summary and Recommendation

CalSTRS has considered specialized mandates/investment strategies since the 1980's. In December 2015, the CalSTRS Board expressed the desire to formulate an official process for Board Members to refer and approve Special Mandates. In response, a formal Special Mandate Policy was adopted in June 2016. "Special Mandates" are defined as discrete investment strategies promoted by Board Members that include, but are not limited to, environmental, social, governance ("ESG"); in-state investments; or other factors that are expected to have a positive or neutral impact on economic performance of the fund over the long-term. Current special mandates include: The Developing Manager Program (Global Equity), Clean Tech Investment (Private Equity), and Proactive Program (Private Equity).

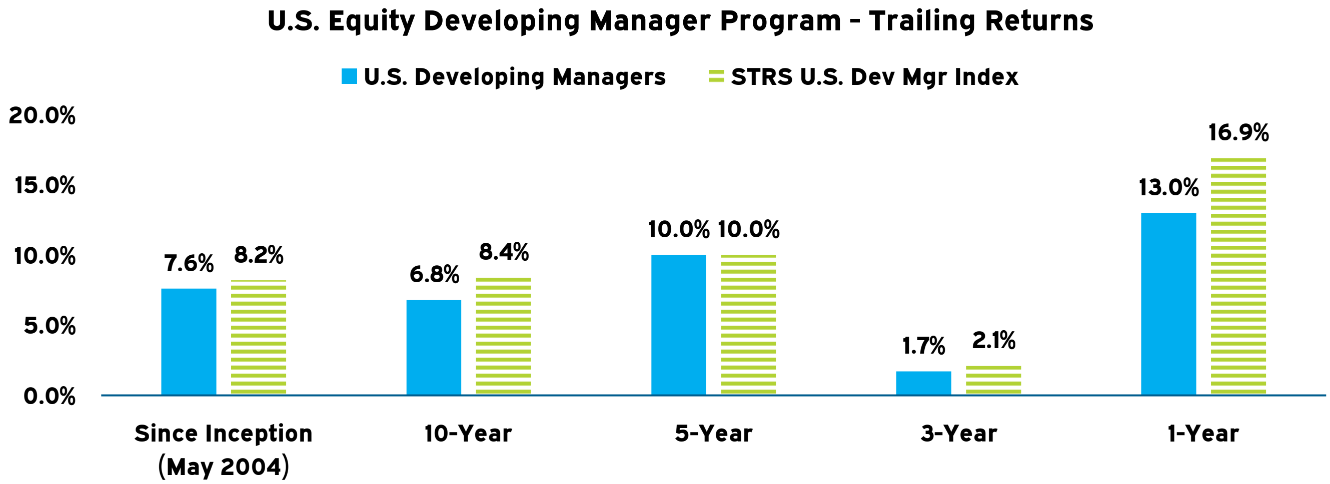
In accordance with the Special Mandate policy, the Investment Committee is required to affirmatively vote to continue each special mandate every six years on terms satisfactory to the Investment Committee. The Investment Committee may also terminate or revise the mandate at any time. ***After independently evaluating the individual Special Mandates and assessing Staff's recommendation, Meketa Investment Group supports the Staff's recommendation to maintain the Developing Manager program, Private Equity-Clean Tech legacy investments, and the Private Equity-Proactive Program, as Special Mandates.***

Discussion

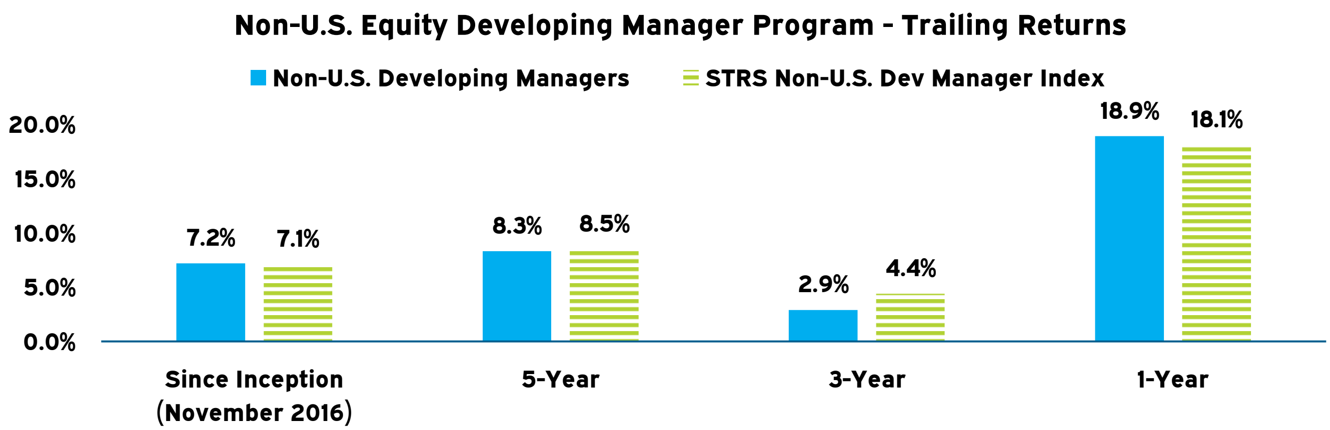
The Global Equity – Developing Manager Program was initiated in August 2004 with an allocation of $600 million. The intention of this program is to invest in emerging/developing managers both domestically and internationally. Through positive investment performance and net cash inflows, the program currently has a market value of $1.97 billion.[1] This program takes a "fund-of-funds" approach to investment strategy selection to gain access to smaller, developing managers. At its inception, the portfolio was structured to be solely invested in active U.S. strategies. Performance during that tenure was lackluster, given the efficiency of domestic markets. However, in November 2016, the program shifted to include non-U.S. opportunities and the employment of global weights, which lead to an improvement in performance.

[1] Market value as of December 31, 2023.

To elaborate, as part of the transition of the Global Equity portfolio to global index weights, the Developing Manager program was restructured away from all U.S. equities to a combination of less efficient U.S. small cap equities and non-U.S. developed market equities, while simultaneously resizing to roughly 4% of the active Global Equity portfolio. As of December 31, 2023, the Developing Manager program represented 7% of all externally managed active portfolios.



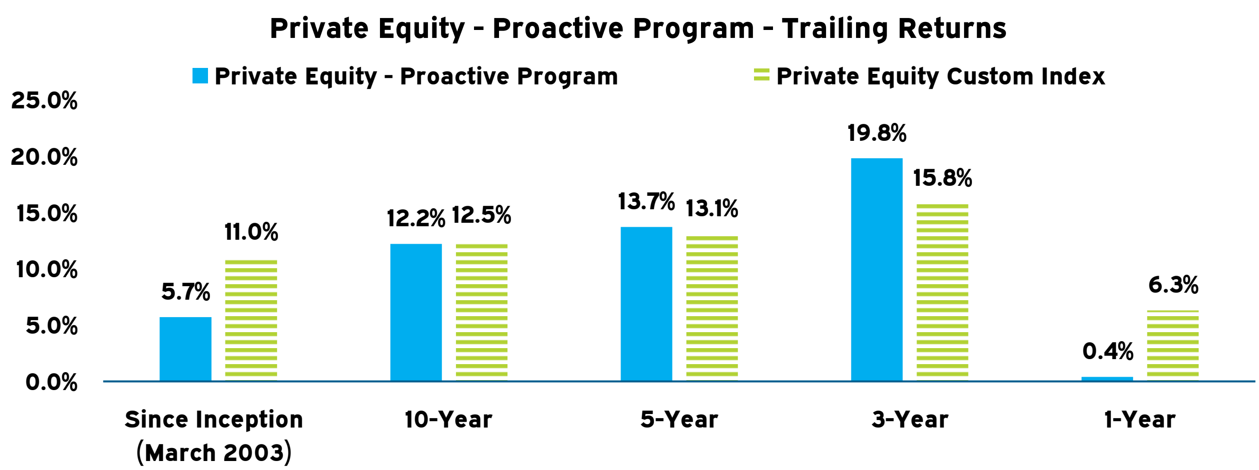
Since inception, the U.S. Developing Manager program has generated an annualized +7.6% return, lagging the STRS U.S. Dev Mgr Index by 60 basis points. With the mandate's shift to small cap equity strategies in 2016, the U.S. Developing Manager portfolio's performance has stabilized, but the portfolio has underperformed its benchmark over most periods through the end of 2023.



Since inception, the Non-U.S. Developing Manager program has generated an annualized +7.2% return, outpacing the STRS Non-U.S. Dev Mgr Index by 10 basis points. Over the trailing one-year period, the program achieved strong double digit absolute results (+18.9%) and outperformed the benchmark by 80 basis points.

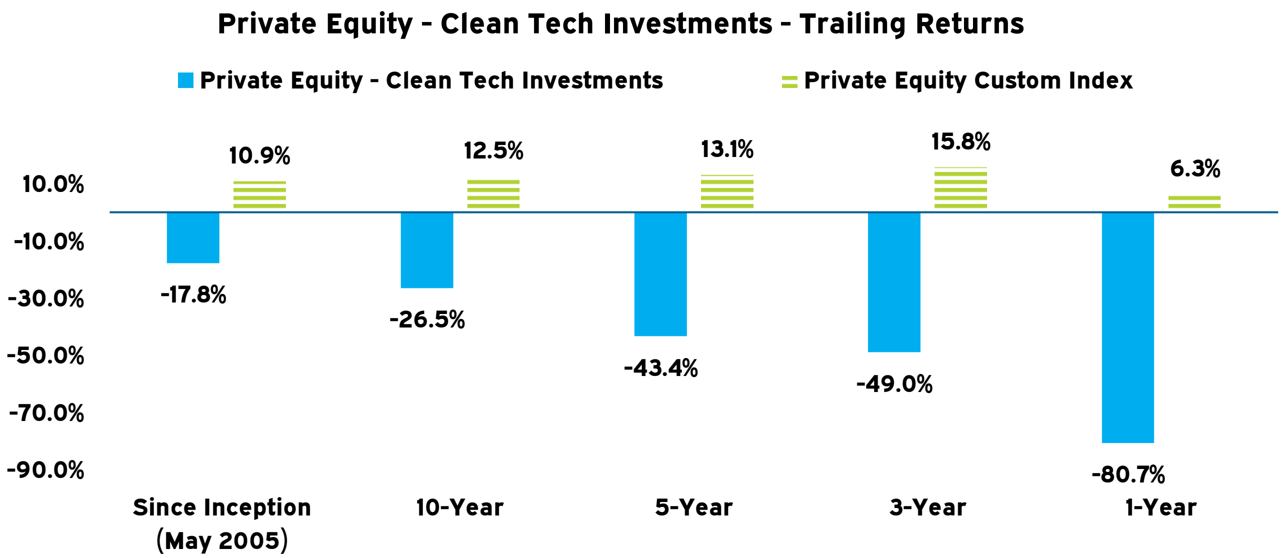
The Private Equity – Proactive Program was created in March 2003, with an allocation of 4% of the overall Private Equity Portfolio. Originally, the program aimed to access emerging private equity managers with an emphasis on Underserved Urban & Rural California strategies. Then, in September 2018, this program merged with the New & Next Generation investments and was renamed the Proactive program. The new program focused on investing in small and emerging private equity managers, using a fund of funds structure. As of December 31, 2023, the program had a market value of $2.0 billion.

Since inception, the program has generated an annualized +5.7% return, lagging the Private Equity Custom Index by 5.3%. Underperformance is due primarily to the program originally making larger commitments directly into partnerships that failed to produce strong returns. This approach has since evolved (starting in 2007) to include more diversified vehicles managed by external firms. Performance subsequently improved and new commitments are now primarily flowing to these diversified vehicles. Over the most recent three-year time period, the Proactive Program produced an annualized +19.8% return and outpaced the Private Equity Custom Index by 400 basis points. Staff believes that the current Private Equity Custom Benchmark is not the most appropriate benchmark given the fact that it does not include fund-of-funds, even though the program is administered primarily through a fund-of-funds structure.



The Private Equity – Clean Tech Investments Program was begun in May 2005 with an allocation of $100 million to venture capital and $400 million to energy-related investments. As the result of the elimination of this special mandate in September 2018, the program had a runoff market value of $3.3 million as of December 31, 2023.

Since inception, the program has generated an annualized -17.8% return, lagging the Private Equity Custom Index by 28.7%. Underperformance is primarily due to both poor market timing, as the capital for this mandate was deployed in the years leading up to the Global Financial Crisis, as well as the mandated deployment into an immature market.



Meketa Investment Group has independently evaluated the two active Special Mandates, which are both operating efficiently and within expectations. Both programs are intended to allow CalSTRS to identify smaller emerging managers earlier in their development, improving the potential pipeline of future asset managers for CalSTRS, and allowing CalSTRS to benefit from any emerging trends or best practices in the asset management industry.

If you have any questions, please feel free to contact us at (760) 795-3450.

SBS/AE/SPM/KM/TF/jls