CALSTRS Investment Committee

Item Number 5b – Open Session

Subject: Global Equity Policy Revision – Benchmark – First Reading

Presenter(s): June Kim and David Murphy

Item Type: Action

Date & Time: May 4, 2023 – 10 minutes

Attachment(s): Attachment 1 – Global Equity Investment Policy – Clean Version

Attachment 2 – Global Equity Investment Policy – Redline Version

Attachment 3 – Meketa Memo

PowerPoint(s): Global Equity Policy Revision

Item Purpose

The Global Equity Investment Policy governs the management of the global equity assets and strategies in order to ensure a diversified portfolio that meets CalSTRS objectives within acceptable risk parameters. The purpose of this item is to recommend Policy revisions for the Investment Committee's consideration.

Recommendation

Staff recommends the following two revisions to the Global Equity Investment Policy for the Investment Committee's consideration. Meketa Investment Group, the Board consultant, agrees with the changes recommended by staff, but the benchmark change is being reviewed by Meketa in the context of the Board's broader benchmarking workstream.

1) Modify the Global Equity Policy benchmark to include a component based on the MSCI ACWI Low Carbon Target Index

2) Add an active risk budget for the Total Public Equity Portfolio of 10 to 60 basis points (bps)

Staff will incorporate feedback from the committee into the Policy and bring it back for a second reading unless the committee decides to approve the recommended changes at this meeting.

Executive Summary

CalSTRS has adopted a pledge to achieve a net zero investment portfolio by 2050 or sooner. The Board has also approved allocating 20% of Public Equity to MSCI ACWI Low Carbon Target Index (LCTI) to assist in achieving this goal. Staff has performed scenario analyses looking at various allocations to the LCTI and determined that a modified policy benchmark is needed. A modified policy benchmark would allow staff to focus on alpha generation and maintain desired factor exposures in the core sleeve of the portfolio while allocations to the LCTI increase over time.

As part of the LCTI implementation, Sustainable Investments and Stewardship Strategies (SISS) will no longer have a stand-alone risk budget but will instead be governed along with Global Equity by a Total Public Equity Risk Budget. Staff has analyzed the Total Public Equity risk budget and recommend establishing an active risk budget range of 10 to 60 bps for the overall Total Public Equity portfolio versus the Total Public Equity benchmark. The Global Equity portfolio will continue to be managed within an annualized forecast active risk range of 10 to 50 bps.

The remaining changes to the Global Equity Investment Policy are minor revisions that provide Policy clarity and align with Investment Branch policy specifications.

Background

At the September 2021 Investment Committee, CalSTRS adopted a pledge to achieve a net zero investment portfolio by 2050 or sooner. Subsequently, at the August 2022 Investment Committee, an action item was approved to set an interim reduction goal of 50% less emissions by 2030 for the Total CalSTRS Fund. Additionally, the Board approved allocating 20% of Public Equity to LCTI to assist in achieving this goal. Staff has developed an implementation plan and reviewed the impacts on benchmarks and risk budgets. As a result of the review, staff determined that a modification to the Global Equity benchmark is needed and that a risk budget for CalSTRS Total Public Equity should be added to Policy. The Total Public Equity Portfolio is the aggregate of the public equity holdings across the CalSTRS portfolio. Currently, public equity holdings are only held within the Global Equity and SISS portfolios.

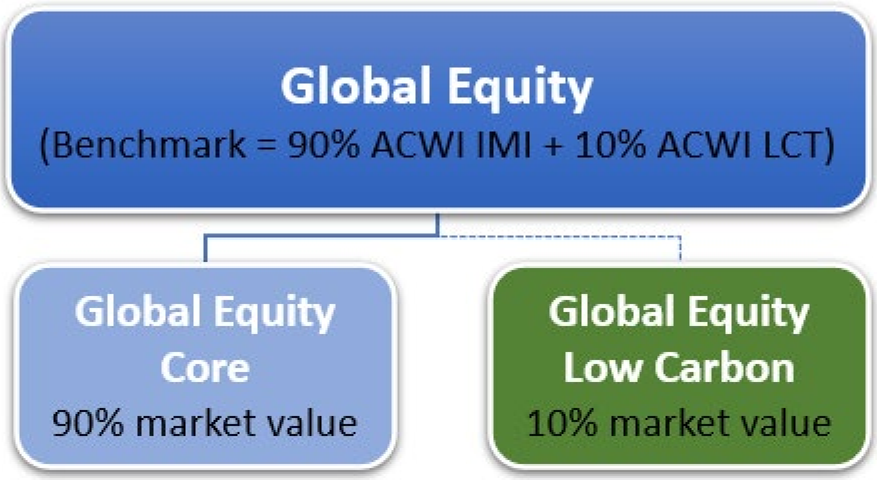
Staff has determined that the LCTI can be implemented within the Global Equity portfolio, with the LCTI portfolio managed as a separate sleeve. The existing Global Equity portfolio would consist of a “core” sleeve managed against the MSCI ACWI IMI Custom benchmark while the LCTI would be managed separately against a MSCI ACWI Custom Low Carbon Target benchmark.

Staff performed scenario analyses looking at various allocations to the LCTI. The results show that as the allocation to the LCTI increases, the active risk profile of the Global Equity portfolio to the MSCI ACWI IMI Custom benchmark changes. For example, as the allocation increases, more active risk is coming from exposure to different factors, such as larger companies, instead of intentional factor exposures arising from active management positioning. A modified Global

Equity Policy benchmark based on the weights of the respective core and LCTI sleeves would allow staff to focus on alpha generation and maintain desired factor exposures in the core sleeve of the portfolio while allocations to the LCTI increase over time.

Policy Benchmark

As an example, if the holdings of the core and LCTI portfolios comprise 90% and 10% within Global Equity, respectively, the Global Equity benchmark would be weighted 90% to the MSCI ACWI IMI Index and 10% to the MSCI ACWI Low Carbon Target Index. This benchmark construction based on underlying portfolio weights has been used by asset classes in the past when implementing significant allocation shifts (e.g., Global Equity during the 2016-2017 transition to global index weights and Fixed Income in the early 2000's when transitioning to a new benchmark). As an illustration:



The performance objective of the combined portfolio would remain the same, which is to achieve a long-term total excess return versus the Global Equity Policy benchmark. The Global Equity portfolio will continue to be managed within an annualized forecast active risk range of 10 to 50 bps.

The modified Policy benchmark would continue to be aligned with CalSTRS' net zero and performance goals as was determined by the Risk Team's analysis that was included in the August 2022 Investment Committee Net Zero item.

Active Risk Budget

Active risk is also called tracking error, and it measures how closely portfolio returns track benchmark returns over time. It is a straightforward way to measure and monitor how much the Total Public Equity Portfolio differs from Total Public Equity benchmark.

As part of the LCTI implementation, SISS will no longer have a stand-alone risk budget but will instead be governed along with Global Equity by a Total Public Equity Risk Budget.

Global Equity will continue to have an active risk budget of 10-50 bps and will also be beholden to the Total Public Equity Risk Budget.

Global Equity and Investment Strategy & Risk staff independently analyzed the Total Public Equity risk budget. Staff concur and recommend establishing an active risk budget range of 10 to 60 bps for the overall Total Public Equity Portfolio versus the Total Public Equity benchmark. As a frame of reference, as of December 31, 2022, the realized active risk for the Total Public Equity Portfolio was 28 bps.

The Global Equity team is well suited to oversee the Total Public Equity risk budget given their extensive experience managing portfolios at various levels of active risk. Additionally, it is a best practice in the Investment Industry to measure public equity market risk holistically across the portfolio.

The IPMP will incorporate the details surrounding the management of the Total Public Equity risk budget.

The remaining changes to the Global Equity Investment Policy are minor revisions that provide Policy clarity and align with Investment Branch policy specifications. Comments for changes are included in the red-lined version (Attachment 2).

In summary, staff recommends that the Investment Committee consider the proposed revisions to the Global Equity Investment Policy to 1) modify the Global Equity Policy benchmark to include a component based on the MSCI ACWI Low Carbon Target Index; and 2) add an active risk budget for the Total Public Equity Portfolio. Meketa concurs with the proposed revisions to the Global Equity Investment Policy, but the benchmark change is being reviewed by Meketa in the context of the Board's broader benchmarking workstream. If approved, staff will coordinate with SISS on the effective date of the changes.

Staff will incorporate feedback from the committee into the Policy and bring it back for a second reading unless the committee decides to approve the recommended changes at this meeting.

Strategic Plan Linkage: Goal 1 of the CalSTRS Strategic Plan - Trusted Stewards: Ensure a well-governed, financially sound trust fund

Board Policy Linkage: Global Equity Investment Policy
