

August 15, 2024

Mr. David Miller
Chair of the Investment Committee
California Public Employees' Retirement System
400 P Street
Sacramento, CA 95814

Re: Consultant Trust Level Review

Wilshire's 2024 Trust Level opinion letter covers the "firm" review that is consistent across the individual program reviews provided under separate cover. This opinion letter is focused on a qualitative assessment of INVO's activities this fiscal year to supplement the quantitative performance information provided by both Staff and Wilshire in the Trust Level Review agenda item. In evaluating the quality of an asset management organization, Wilshire assesses factors contributing to the stability of the organization and the alignment of incentives between the team and the organization's long-term objectives. Past Wilshire reviews have highlighted our concerns over Staff stability, as a successful investment program requires a true long term investment horizon that comes from a consistent and enduring investment philosophy. The organization recognizes this importance given Investment Belief #2 – A long time investment horizon is a responsibility and an advantage. Driving strong portfolio returns requires consistency, deep resources, a thorough understanding of the opportunity set, and accountability.

The overall Organization evaluation was reduced given the turnover in the Chief Investment Officer position during the last fiscal year, as well as the retirement of the MID-Private Debt. Stability in leadership is critical to successfully implementing the strategic portfolio approved by the Board. The recruitment process for the new CIO was global in scope, rigorous, inclusive, and cognizant of past experiences. Wilshire expects the broader organization score to increase over time, should greater stability be realized within INVO's leadership team.

The new Chief Investment Officer's tenure began after the end of fiscal year '24, so it is still early but Wilshire's interactions to date have been productive. The CIO's vision around culture, engagement, and leadership development within INVO will take time to establish. The discussion topics to date have touched on a total portfolio approach to investment decision-making, setting a portfolio risk tolerance, active risk taking, investment data & technology, culture, and people. All of these attributes are vital for building a resilient investment program and, in many cases, represent a continuation of the work undertaken within INVO over the past few years under different leadership. We view this continuity positively. Wilshire will continue to engage with the team around these topics, discuss changes in the team structure and highlight them for the Board as necessary.

The CIO understands the importance of buttressing the culture of investment risk taking to improve Total Fund performance. This evolution can occur by improving accountability for performance relative to appropriate benchmarks, at all levels of the portfolio. These initiatives are in line with Investment Beliefs #4 – long-term value creation requires effective management of three forms of capital: financial, physical, and human; and #10 - strong processes and teamwork and deep resources are needed to achieve CalPERS goals and objectives. Active risk management will remain a strategic priority, and the CIO has deep experience in driving value-add activities in institutional portfolios. These opportunities should be measured relative to expectations established as part of a risk budget, further increasing Staff accountability for results. Active return targets (alpha) should be set based on the strategies pursued within the portfolio and, importantly, the desired active risk tolerance of the Board. Set too low, the portfolio is likely to hew closely to the policy benchmark and potentially miss out on active return opportunities. Outsized active return objectives could encourage excessive risk taking or a belief that the objective is unrealistic. This balance is critical in driving consistent performance through time and across different market environments.

Ensuring that CalPERS continues to have the tools necessary to recruit and retain qualified, diverse candidates will be a strong focus for the new CIO, as it was under prior leadership. It is critical to ensure that sufficient resources are in place to execute on the Board's strategic investment direction, and the new CIO is actively engaged across the organization to understand and prioritize resources efficiently. As a governmental entity, CalPERS continues to face some unique organizational risks that for-profit enterprises have greater flexibility in managing, such as the inability to provide employees direct and indirect ownership opportunities. These long-term forms of incentives are common within private sector investment organizations and can serve as significant retention tools. The absence of such compensation structures can expose the organization to the increased risk of losing intellectual capital at the INVO Senior Staff level to asset managers and other financial institutions. We reiterate that the organization has made strides to adjust pay scales to be more competitive in the marketplace, as well as aligning incentive compensation with Total Fund performance objectives.

CalPERS continues to compete for talent in a tight labor market environment and any changes to the compensation structure should be undertaken with a clear understanding of the risks they might introduce. These risks could be personnel related, such as increased turnover or recruiting challenges, or portfolio related, impacting how much active risk is incorporated across investment programs. Personnel turnover is not necessarily undesirable and ensuring investment continuity and improvement is of paramount importance through recruitment of a strong bench.

Investment governance within INVO currently runs through the three committees stood up by the previous CIO. These are made up of the most senior investment professionals, across multiple market segments, providing diversity of experience and insight.

- Operations & Administration focuses on organizational priorities, policy, technology, talent, Board preparation, and communications.

- Total Fund Management directs strategic portfolio design, leverage and liquidity monitoring, and absolute and active risk management.
- Investment Underwriting is responsible for evaluating the investment pipeline, approval of larger investment commitments, overseeing proxy voting, and managing ‘investment and innovation’ working groups. This ensures an additional level of oversight for more impactful investments, with multiple eyes evaluating the opportunities.

The new CIO is evaluating these structures to determine how they align with his vision for managing the PERF. It is likely that the governance process will be adjusted in accordance with the CIO’s approach to portfolio management. As the Board consultant, we will monitor their functions and modifications as the committees evolve, staying attuned to flux in reporting lines and responsibilities which could impact Staff stability.

Sustainable Investments Highlights

In recent years, CalPERS's sustainability team has seen several evolutions, with each change viewed as a positive development for the organization and the broader sustainability efforts. First, in the 2022 fiscal year, the Board Governance & Sustainability Team (BGST) was formed. The BGST combined two previously distinct functions under the interim leadership of the MID who reported to the CEO and had a dotted line to the former interim CIO. In the 2023 fiscal year, the team evolved and expanded through the creation of the Sustainable Investments (SI) team which is part of INVO and reports to the CIO.

In March 2023, coinciding with the establishment of the SI team, a MID for Sustainable Investments was hired. The SI MID is tasked with setting the vision, strategy, and governance for CalPERS's sustainability work as well as leading all aspects of the fund’s efforts to develop and implement ESG research and processes to support ESG integration into the investment decision-making process. Under the SI MID, there are three teams, each lead by an Investment Director (ID) and supported by additional staff: Sustainable Investments Policy and Partnerships, Sustainable Investments Private Markets Portfolio, and Sustainable Investments Public Markets Portfolio.

This past fiscal year, SI undertook a major recruitment effort, which remains underway. These efforts included hiring a recruiting firm to help source top talent. As of the end of the fiscal year, the team consisted of six contributors, three support staff, and 10 open positions. Several of the open positions are expected to be filled in the coming months, including the SI Private Markets Portfolio ID, which has been a top priority for the team to fill.

Broadly, SI is responsible for a wide range of priorities including those that were previously overseen by the BGST: the board self-evaluation process; financial markets advocacy; human capital management; stakeholder engagement; and diversity, equity and inclusion work. The SI team is also responsible for ESG integration, which involves incorporating ESG into investment making decisions and sustainability data and reporting, all of which are trust-wide efforts across

multiple asset classes. The breadth of the SI team is impressive amongst peers and the depth continues to growth.

We believe that the Sustainable Investments team is appropriately positioned, reporting directly to the CIO and operating as an integrated part of INVO. The SI MID has now been in the role for over a year, effectively leading the team as they built out and have begun to execute the initiatives outlined later in this section.

Given the strength of the existing team and its planned expansion, CalPERS is positioning itself to be best-in-class for sustainable investing. However, it will take time before the team is fully staffed, and it is important that expectations be managed accordingly. Recruiting top talent with the appropriate skill set is a challenge, especially within sustainable investing, which is still an emerging space despite it being a high-profile area in recent years. Notwithstanding CalPERS's unique hiring constraints, this is a challenge seen broadly within the industry and is not exclusive to CalPERS. However, as a thought-leader in sustainable investing best practices, Calpers is positioned as an employer of choice for sustainable investment professionals, which may assist in the recruitment process.

This past year, human capital was a focus for SI, with two critically important advances. First, the Labor Principles were approved by the Board and adopted thereafter. The Labor Principles are incorporated into the CalPERS Governance & Sustainability Principles and are a five-point framework of beliefs that seek to address short-term and long-term labor risks and opportunities. External managers must acknowledge and conform to these principles. Second, meaningful progress was made to refresh the Responsible Contractor Policy (RCP), with an updated RCP expected to be finalized in fiscal year 2025.

Over the year, the SI team worked with the individual asset classes to establish asset class-specific plans, in association with the SI 2030 Strategy. This work involved significant, proactive collaboration across INVO. The asset class plans are foundational as CalPERS looks to invest \$100 billion across climate solutions by 2030. Buy-in was strong and broad-based from the asset classes, as they each developed a robust, comprehensive plan to find and invest in attractive climate solutions. Stemming from these plans, the team has begun to commit capital within private markets, with an advanced pipeline of additional opportunities being evaluated.

Another notable accomplishment this past year was the development of the CalPERS FTSE Climate Transition Index (CTI). The SI team, in collaboration with the Global Equity team, worked with FTSE-Russell to customize the CTI which seeks to mitigate climate risk and capitalize on the transition to a low carbon economy. The CTI was adopted, following Board approval in June 2024. In fiscal year 2025, the Policy Benchmark will reflect the inclusion of CTI within the factor-weighted segment of GPE.

The Emerging & Diverse Manager Program, also called the Mosaic Program, experienced a refresh in fiscal year 2023. In 2022, the private markets focused program made an initial \$1 billion commitment working with external emerging and diverse manager specialists, TPG and GCM Grosvenor. The team continues to build on these initial efforts, collaborating closely with the external advisors with the goal of enhancing returns by investing in next-generation managers.

Under the leadership of the SI MID and his Investment Directors, CalPERS's SI team developed and have begun to implement the Board approved SI 2030 Strategy. The SI 2030 Strategy has five primary objectives including: generating portfolio alpha; improving portfolio resilience; implementing an ambitious Net Zero plan; promoting greater inclusion and representation; and building and promoting efficient and equitable financial markets. These are ambitious efforts that require frequent and effective collaboration across multiple teams, senior buy-in, along with additional staffing to support the efforts. We believe CalPERS is taking the necessary steps to make significant progress towards these goals, including recruiting talent who will contribute towards the 2030 Strategy objectives and add to the team's current strength as an industry leader.

Finally, as CalPERS seeks to have a sustainable program – which SI defines as the ability to maintain and support a process over the long-term and promote the economy, environment and equity – navigating, reporting on, responding to, and capitalizing on the transition to a low carbon economy remain key areas of focus for the organization and the SI team specifically. Here, we note the importance of maintaining a return-driven approach to sustainable investing and having the discipline to refrain from devoting resources to non-return related distractions. Going forward, we expect the SI team to continue to develop and enhance its SI tracking and reporting capabilities regarding emissions data as well as the methodology to account for climate solutions across all CalPERS's investments. We also anticipate the SI team demonstrating its leadership in the space by developing more thought leadership and sharing best practices with peers.

We will incorporate further comments on Sustainable Investments into the other INVO programs where relevant.

Conclusion

In summary, we continue to monitor the stability of the investment organization and believe there remains room for improvement in the overall evaluation score. As for any investment management organization, we would like to see evidence of senior investment team stability and will monitor the initiatives from the new CIO. We are optimistic that the CIO's experience in driving strong portfolio results in large institutional portfolios will continue to push the Total Fund in a positive direction.