MEKETA

5796 Armada Drive
Suite 110
Carlsbad, CA 92008

760.795.3450
Meketa.com

MEMORANDUM

TO: Investment Committee, CalPERS
FROM: Lisa Bacon, Christy Fields, and Steve McCourt, Meketa Investment Group
CC: Dan Bienvenue
DATE: June 10, 2024
RE: Total Fund Policy Revisions Relating to Real Assets—Second Reading

Meketa Investment Group ("Meketa") has been asked in its capacity as Board Consultant for the Infrastructure and Real Estate asset classes to provide an opinion on revisions proposed for the CalPERS Total Fund Investment Policy ("TF Policy"). The Second Reading of the proposal will be presented to the Investment Committee on June 10, 2024 as Item 6b-00, with attachment Items 6b-01 through 6b-05, including respectively: Total Fund Policy Review – Second Reading Presentation; Proposed Total Fund Policy (clean view); Proposed Total Fund Policy (mark-up view); Consultant Opinion Letter – Wilshire Associates (General Pension Consultant); and Consultant Opinion Letter – Meketa Investment Group (Private Asset Class Board Investment Consultant).

In summary, Staff is recommending updating the risk classifications and ranges for Real Assets portfolios in TF Policy Section X. Real Assets under Key Policy Parameters Table 2. Meketa has discussed these proposed policy changes with Staff, and the First Reading recommendations reflect Meketa's feedback on the modified Real Assets items. There were no changes from the First to Second Reading proposal.

As described herein, Meketa concurs with the proposed policy changes. We believe that the changes are appropriate in the context of the Total Fund, the increased target allocation for Real Assets approved in November 2021, and the capacity of Staff to execute the 2021 Real Assets ("RA") Strategic Plan.

Proposed Changes

Total Fund Investment Policy Section X. Real Assets (the "RA Policy")

→ ***Key Policy Parameters Table 2: Risk Classifications (page 28 in blackline)***

- <u>Combine Value Add and Opportunistic into a single Non-Core classification</u>: The current permitted NAV percentage ranges for Value Add and Opportunistic for each of the Real Estate, Infrastructure, Forestland, and aggregate Real Assets portfolios are the same for each classification and each portfolio at 0% to 25%. The proposed change combines Value Add and Opportunistic into a single Non-Core category for each portfolio and the aggregate. The lower end of the Core range for the Real Estate and Forestland portfolios remains unchanged at 75%, which allows for the upper end of the newly combined Non-Core range for Real Estate and Forestland to be set at 25%.

- Decrease the lower end of the range for Core Infrastructure from 60% to 50% and cap aggregate Non-Core at 50%: The proposal lowers the minimum range for Core Infrastructure by ten percentage points to 50%, and in tandem proposes allowing up to 50% Non-Core investments in the Infrastructure portfolio, with the latter change representing a ten percentage point increase (from 40% to 50%) for the aggregate Non-Core upper range compared to current policy. Meketa believes the marginal decrease in the lower end of the Core range and marginal increase in the upper end of the Non-Core range as a percent of NAV is reasonable, consistent with the infrastructure investment opportunity set, and consistent with the RA Strategic Plan.
- Reset the Core and Non-Core ranges for the Real Assets Program at 65% to 100% and 0% to 35%, respectively, in harmony with the other proposed changes. Considering the implied increase in potential Non-Core infrastructure exposure, and the Strategic Plan's goal to increase the size of the total Infrastructure Portfolio as a percentage of the Real Assets Program, the existing minimum of 75% Core for all Real Assets appeared potentially constraining. Meketa supports providing another ten percentage points of room, lowering the minimum to 65%, and setting the Non-Core cap at 35%.
- The table below shows the resulting proposed permitted ranges, which Meketa supports.

	Real Assets	Real Estate	Infrastructure	Forestland
Core	65% - 100%	75% - 100%	50% - 100%	75% - 100%
Non-Core	0% - 35%	0% - 25%	0% - 50%	0% - 25%

- Remove the footnote relating to limits and classifications for Development assets: The following Section X Table 2 footnote is proposed stricken from the TF Policy and moved into the Policy-Related Procedures ("PRP") for the Real Assets Program: "Development assets will have a limit of 10% of the Program and each portfolio. All Development assets will be assigned the "opportunistic" risk classification." It is Meketa's understanding that if the proposed TF Policy changes are approved that Staff will additionally propose a limit of 15% for Non-Core opportunistic assets for inclusion in the PRP. Meketa believes the PRP is an appropriate document for memorializing these guidelines.

Summary Opinion

The proposed revisions are consistent with the global private infrastructure opportunity set in which CalPERS is investing and will provide additional flexibility that will be required to fully execute the Total Fund strategy and the most recently approved 2021 RA Strategic Plan.

Collectively, the proposed changes streamline the set of risk classification ranges and retain CalPERS' commitment to a predominantly Core Real Assets portfolios while providing the Infrastructure portfolio with an additional amount of flexibility to pursue Non-Core investments as Staff continues to deploy capital into Infrastructure at increasing scale, consistent with the target allocation for

Real Assets collectively, and with the objectives for Infrastructure specifically, as outlined in the 2021 RA Strategic Plan.

As we have noted in our quarterly and annual reports, the market for Core infrastructure is extremely competitive and it is challenging to deploy capital at CalPERS' scale while remaining disciplined on pricing. The Non-Core global opportunity set, while also competitive in certain segments, offers CalPERS' investment managers greater possibilities for proprietary deal flow and more limited competition, helping to contain pricing and support higher risk-adjusted returns. As a practical matter, having Value Add and Opportunistic combined into a single Non-Core policy classification will intentionally create more room in particular for Value Add investments above the existing 25% limit, which Meketa views as limiting relative to the opportunity set and CalPERS' return targets for the portfolio. The proposed change also appropriately accounts for two other considerations: first, the fact that individual infrastructure investments can be quite large and create temporary swings around too-tight policy limits, especially while the infrastructure portfolio is scaling up consistent with the RA Strategic Plan; and second, that there can be a certain amount of imprecision associated with clearly delineating Value Add investments from Opportunistic ones.

While the Real Estate portfolio is growing at a slower rate than Infrastructure, the proposed changes will provide the same type of additional flexibilities as Staff follows the RA Strategic Plan and seeks to deploy additional capital into Non-Core domestic and international investments that, like Infrastructure, do not always neatly fall into Value Add or Opportunistic classifications.

We note that Staff proposes to still limit the maximum amount of Opportunistic exposure in any of the individual Real Assets portfolios and in the aggregate by establishing in the PRP a 15% limit for Opportunistic NAV within the Non-Core classification, and retain the 10% limit on Development assets. Staff is proposing to make these changes to the PRP following approval of the proposed changes to Section X of the TF Policy.

In conclusion, Meketa believes that the proposed TF Policy changes as they relate to Real Assets are consistent with CalPERS' Investment Beliefs (specifically, Beliefs 4 and 7 related to long-term value creation and risk-reward management), are consistent with recent policy changes made in 2022 relating to increases in Staff authority limits, and will facilitate Staff's ability to implement the RA Strategic Plan. Meketa is supportive of the changes.

We look forward to further interactions with the Board on this, and other topics. If you have questions, please feel free to contact us at (760) 795-3450.

LB/CF/SPM/jls