Taking Action: Exploring a New Private Equity Mode

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Making good investments and earning solid returns are more important than ever at CalPERS. Why? We have 71 percent of the assets needed to pay promised retirement benefits and a goal of earning 7 percent over the long-term. These can be daunting and challenging numbers when faced with where to invest CalPERS assets, but they also motivate us to be innovative and take action.

We're Seeking Solutions
Over the last year, we've been undergoing thoughtful research and analysis of new approaches for CalPERS to invest in private equity. Private equity is our highest returning asset class, averaging 10.5 percent annually over the past 20 years. It's critical to our success.

As Dr. Ashby Monk, the executive director of the Stanford Global Projects Center and one of the world's leading experts on design and governance for institutional investors, told the CalPERS Investment Committee: "Private equity is a tough business for funds… in large part because you need it. You can't walk away from private equity."

We're not abandoning an asset class we've been successful at. Earlier this year, CalPERS was ranked in the top three of the world's best performing buyout investment programs in a study by the Private Equity Observatory at the international business school HEC Paris.

But with a $360 billion portfolio, investing in funds within the private equity market isn't enough. We need a forward-looking private equity program to help achieve our 7 percent return target. We want to put 10 percent of our total fund to work, and that requires new thinking and new approaches for CalPERS.

Part of our proposed plan, which is undergoing additional evaluation before the CalPERS Board makes a go/no-go decision, includes an investment program called CalPERS Direct. One part of CalPERS Direct would be dedicated to investing in promising companies in life sciences, healthcare, and bio-technology. The other part would take material stakes in more traditional, established companies.

These models won't replace what we're already doing, they will operate alongside them.

The investments we make through CalPERS Direct would be long term, extending over decades. Private equity funds typically have about a 10-year lifespan, but these new models will have evergreen terms to better correspond with our pension liabilities, which are paid out over decades as well.

CalPERS Direct would operate as a separate partnership with CalPERS as the principal participant. It would have its own board, management team, and staff. The CalPERS Board, however, would retain authority over the program tenure and capital contributions.

We have a lot more work to do before this plan can move forward. But as Dr. Monk said, "I'm encouraged that if you can get the governance right, if you can evolve this into a platform that can recruit the right talent, you can succeed."

Why We're Considering This Approach
The financial marketplace is changing, and we need to change with it.

The competition to find and fund high-quality investments is fierce. The number of private companies going public has been on a sharp decline for 20 years, at the same time the number of investors seeking private equity deals has rapidly grown. The independent structure of CalPERS Direct would enable us to better source and more directly take advantage of the opportunities that we believe can ultimately drive returns higher. And, as our fund continues to grow, it can help us maintain our target of investing about 10 percent of our total portfolio in private equity.

We also think we'll save some money over time. Private equity's overall success can't be ignored, but its fees and expenses are higher than other asset classes. This model will help us address those costs by enabling us to move away from paying asset-based fees and achieving economies of scale. Ultimately, we'll be able to keep more money in the fund.

Our funded status must increase. It'll take time to push it up to 80, 90 percent, but we're committed to getting the total returns we need.

We've Listened to Our Stakeholders
Here's what our stakeholders want: A healthier funded status. Strong returns. Innovative thinking.

Employers, retirees, and labor groups expect us to earn enough from our investments to pay the benefits that have been earned. They want us to build an investment portfolio that drives returns—returns that guarantee we'll be here when the next generation retires, and the generation after that. They want steady, solid earnings that help employers manage their contributions over the long term.

We're driven to provide retirement security to our members. A strong private equity program helps us do that