RETIRED PUBLIC EMPLOYEES' ASSOCIATION OF CALIFORNIA
300 T Street, Sacramento, California, 95811-6912
(916) 441-7732 • Fax: (916) 441-7413 • (800) 443-7732
www.rpea.com • rpeahq@rpea.com
Facebook • www.facebook.com/RPEACalifornia

March 11, 2019

Mr. Henry Jones, President
CalPERS Board of Administration
400 P Street
Sacramento, CA 95814

Dear Henry:

The Retired Public Employees' Association (RPEA) Board of Directors opposes the CalPERS Direct plan for its Pillar III and IV which consists of two semi-autonomous general partner (GP) entities that would secure and administer private equity (PE) and venture capital holdings for CalPERS. We believe all forms of private equity activity can be conducted successfully in-house by hiring some additional PE experts to augment the current staff. This guarantees accountability and transparency. The skill-set required by CalPERS Direct could be quite different from traditional PE in view of the considerable differences between the CalPERS Direct Pillar III/IV model vs. traditional PE behavior. CalPERS has the authority to pay PE experts the "going rate" and can easily arrange a compensation package that discourages the conventional "slash and burn" PE compensation model in favor of a more suitable incentive pay model that would be more appropriate for the CalPERS PE model. The Ontario Teachers PE model is conducted in-house with an admirable performance record.

This CalPERS Direct "plan" is still very much undefined. It clearly needs more development. It is not clear that the staff even understands what is being proposed. Staff asserts that these startup companies will be able to find investment opportunities that the rest of the industry cannot identify. Yet it has offered no reason why this would be true. Staff has acknowledged that for years the costs for the new model will be higher than conventional PE. Yet it is alleged that somehow returns will be higher again with no explanation of how or why.

There is a growing body of evidence that strongly suggests that the luster of private equity has been declining over the past 15 years due to greater demand for participation by more and more "well-heeled" investors and institutions. This is compounded by the growing scarcity of quality candidates for acquisition. Another factor is risk; staff has publicly acknowledged that it doesn't understand the risk in PE which is actually about the same as public equity risk. These factors combine to lessen the appeal for PE and reduces expected return on investment (ROI). Its illiquidity is an added risk factor. The industry looks at "long- term hold" in PE as a negative because ROI usually diminishes over time; traditional PE usually holds three to ten years max. Moreover, the CalPERS long term hold pillar looks more like the Warren Buffet model which is a simpler long-term hold strategy with less emphasis on the traditional PE objective of sell sooner than later. And, Warren Buffet doesn't keep his holdings secret. Finally, Black Rock recently proved that long-term hold PE is not considered prudent by the "smart money" i.e. very little interest has been generated by Black Rock in its long-term hold PE plan. Dr.

Ashby Monk, an early proponent of expanded PE participation by CalPERS, is critical of the "CalPERS Direct" structure related to Pillar's III and IV.

The two general partner model proposed in CalPERS Direct is anti-transparency and adds unnecessary cost that cannot be easily controlled by the CalPERS Board. Capital calls by Pillar III and IV GP's on the lone limited partner (LP), which is CalPERS, would be mandatory even if CalPERS determined that the investment was unwise. The "power of the purse" is less effective after the "horse has left the barn." The general partner staff wins regardless of performance, in large measure, due to the funding and fee structure of the semi-autonomous GP entities. In-house staff would be much more accountable with less administrative cost and less staff compensation would be expended in correcting ill-fated investments.

A "kinder, gentler" PE approach related to the long-term hold pillar (III) should produce better results from acquisitions due to the more nurturing nature of the PE environment that is engendered in this pillar. This supports the notion that a somewhat different skill-set for the PE new hires would be appropriate; a skill-set that focuses on healthy growth of the acquisitions and less on asset stripping, severe leveraging, staff reduction, and other cost-cutting measures inherent in traditional PE. Coinvesting should be re-established along with better LP terms in traditional PE deals and particularly in LP deals in which CalPERS is the lone LP. As the GP, many new opportunities in PE are open to CalPERS in Pillars III and IV and in-house control makes CalPERS nimbler in capitalizing on IPO's and other avenues of investment growth.

Finally, the foregoing paragraphs, strongly support RPEA's position that in-house PE is much more prudent for a successful and cost-effective PE program for CalPERS. The CalPERS PE staff has performed well over the past two years despite the fact they have had no high-profile manager in charge. By hiring a strong PE manager and a few Pillar III/IV PE experts, with healthy company-growth backgrounds, CalPERS could expect even better results from its in-house PE investment unit.

Sincerely,

Al Darby

Al Darby
RPEA President

Cc: CalPERS Board of Administration