

TEACHERS' RETIREMENT BOARD

INVESTMENT COMMITTEE

SUBJECT: Diversity in the Management of Investments –
Semi-annual Report

ITEM NUMBER: 6

CONSENT: _____

ATTACHMENT(S): 2

ACTION: _____

DATE OF MEETING: November 1, 2007 / 25 mins.

INFORMATION: X

PRESENTER(S): Solange F. Brooks

POLICY

The philosophy of diversity in the management of investments is interwoven in all CalSTRS policies, and a need has not arisen to specifically address diversity in a separate policy. It is, however, encompassed in the Board's Values, to wit: *Strength: We ensure the strength of our system by embracing a diversity of ideas and people.*

BOARD STRATEGIC PLAN GOAL

Goal 5: Ensure a financially sound retirement system through adequate contributions and optimal investment returns.

Goal 6: Foster Board culture and practices that promote efficient and effective governance

➤ Objective J: Explore ways to increase diversity on the Board and with vendors.

PURPOSE

This is the first report on diversity, and it will be presented to the Board semi-annually going forward.

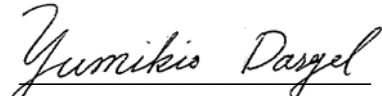
While maintaining a financially sound retirement system, CalSTRS seeks to honor the philosophy of inclusion long reflected in California educators. Diversity in the management of investments is interwoven in the Investment business goals and coexists with the objective of investing to enhance the returns at a prudent level of risk in accordance with Investment Policies, the California Constitution and the Education Code.

The intent of this report is to provide the Board with a historical perspective of CalSTRS Investments' efforts and leadership in this area and discuss recent milestones and current projects.

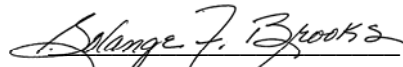
CONCLUSION

CalSTRS has a rich history of inclusion. CalSTRS Investments has received strong support from the Board to incorporate diversity into the management of investment by closely linking diversity to our core values and strategic planning. Further, we are proceeding with this semi-annual report which will track our progress in the area, and will allow Investment leadership to set goals as appropriate.


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Semi-annual Report on Diversity in the Management of Investments

Investments – Investments Executive Unit

BACKGROUND

The California State Teachers' Retirement System's ("CalSTRS") mission is to secure the financial future, and sustain the trust, of California's educators. While maintaining a financially sound retirement system, CalSTRS seeks to honor the philosophy of inclusion long reflected in California educators. Diversity in the management of investments is interwoven in the Investment business goals and coexists with the objective of investing to enhance the returns at a prudent level of risk in accordance with Investment Policies, the California Constitution, and the Education Code.

Historically, teaching has been a progressive profession where women have enjoyed a rich stronghold and where diversity has been fully embraced. However, the investment management industry has not been as far along in its development as educators; it has been bound by traditional ways and beliefs. Thus, diversity in the management of investments is a concept that has gained momentum and has been more prevalent in recent years, partly due to the change in demographics in the United States and partly due to forward-thinking leadership. The intent of this report is to provide you with a historical perspective of CalSTRS Investments' efforts and leadership in this area and discuss recent milestones and current projects.

DISCUSSION: A CHRONOLOGICAL PERSPECTIVE

1989 – GLOBAL EQUITIES

Global Equities was the first asset class to seek opportunities among untapped talent in the management of investments. In the late 1980's, CalSTRS Investments made their first allocation in public equities to African-American owned firms, Brown Capital Management and NCM Capital. The firms were selected through the normal Request for Proposal ("RFP") process and were subject to the same due diligence as any other investment, consistent with our fiduciary responsibility. Through this same process, another allocation was made to a third African-American owned firm, Ariel Capital Management, on February 1, 1999. These three firms have been successful in managing CalSTRS assets with \$2.4 billion assets under management as of August 31, 2007.



2001-2002 – BOARD DIRECTION

One of the objectives of Alternative Investments in fiscal year 2000/2001 was for “*staff to explore the feasibility and potential benefits of private equity investments in under-served rural and urban communities.*” At the September 6, 2000 CalSTRS Board meeting, the Investment Committee directed Staff and the Alternative Investment (“AI”) Advisor to work with an independent consultant to prepare a study to fulfill this objective. A scope of study was developed and approved by the Investment Committee on January 9, 2001. The Milken Institute was selected to conduct the study, which was presented to the Investment Committee on September 5, 2001. At that meeting, a presentation by Staff who, along with the AI Advisor, concluded that this area of investment was undeveloped and required further study before investing any funds. This conclusion was in part based on the Milken Institute’s study, “*Investing in Emerging Domestic Markets: Issues, Opportunities, and Innovative Alternatives*” which stated:

“Given this scant availability of significant, reliable data, and the time frame of this study, many of the detailed questions posed by staff could not be answered in depth. Should CalSTRS decide to pursue an investment strategy, we recommend a more comprehensive analysis of a broader and deeper range of data.”

After a lengthy discussion, the Investment Committee directed Staff and the AI Advisor to develop an implementation plan for investing in underserved urban and rural markets.

On October 10, 2001, the Board adopted the Policy on California Investments. California’s demographics had been rapidly changing and setting a new standard of how well-run organizations addressed matters of diversity. CalSTRS educators were at the forefront of this awareness since their classrooms had been reflecting this change for some time. Again, the teachers’ philosophy of inclusion and awareness about diversity issues, challenges, and opportunities added richness to the policy discussion. Given their knowledge to understand the issues, dynamics, and factors at play, the Board recognized the impact of the multi-billion dollar portfolio’s investment activities within California. Thus, the Policy on California Investments also established a goal of investing 2% of CalSTRS assets in underserved markets, primarily in California. This effective action attempted to tackle the obstacles some sectors were having in terms of access to capital, and, at the same time, recognized the opportunities that may be presented by diversity of investments. The underserved markets are described in the Policy as follows:

California emerging markets investments shall focus on investment opportunities in traditionally underserved markets primarily located in California. For example, underserved markets would include urban and rural communities undergoing, or in need of, revitalization where there are assets (e.g. an available labor pool, underutilized infrastructure, etc.) conducive to business development.

In February 2002, the Investment Committee approved an implementation plan for investing in underserved urban and rural markets developed and recommended by CalSTRS Staff. In order to deploy CalSTRS capital in a most efficient and cost-effective manner, the plan called for hiring fund-of-fund manager(s) with independent decision-making authority who in turn would commit to general partners. It also incorporated a newly created New and Next Generation Investment Program into the existing program for Urban and Rural Investing, which had been guided by the Policy of California Investments. Subsequently, an initial allocation of \$75 million was made to the CalSTRS/Banc of America Capital Access Fund (“CBACAF”) and

\$100 million to the New and Next Generation Managers Fund (“NNGMF”) managed by INVESCO Private Capital. CBACAF mandate requires that it primarily invests in funds serving underserved markets where people and places have historically lacked access to capital. NNGMF mandate provides that emerging managers, generally defined as first- and second-time institutional funds, be considered for an investment. With this foundation, NNGMF seeks to partner with top performing emerging managers based in the United States and aims to sponsor diverse general partners that represent the demographics of California.

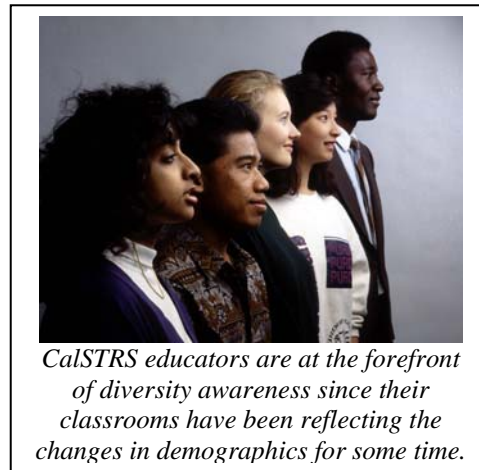
Although the mandates are different, both share the common selection criteria in keeping with a disciplined investment process:

- *Successful past performance (verifiable “track records”)*: Managers must have a demonstrated history of competitive rates of return and a history of returning capital to investors.
- *Continuity and history of the management team*: Factors such as, (1) how the individual team member get along with each other, (2) how long the team members have been working together, (3) what strengths and weaknesses the team members bring to the team, (4) what network of contacts and relationships they bring to the team to source transactions are examined. Private equity is said to invest in people; therefore, the strength of the team is vital.
- *Alignment of interests with CalSTRS*: Alignment of interest is an essential success factor. Managers must have incentives to maximize returns. This is achieved by significant investment contributions by the management team based on ability to pay. The management team must have incentives to remain active with the management of fund assets throughout its lifetime. This is accomplished by having a long vesting period for the team. Finally, all team members should have a stake in the fund’s performance. This is achieved through relatively flat sharing of carried interest (capital gain).

It became clear that the Board’s direction was to enhance the Portfolio returns at a prudent level of risk, but also create economic value to the State and its citizens. Then Treasurer and CalSTRS Board Member Phil Angelides coined the business term the “double bottom line” to describe the practice of maximizing investments returns while also accomplishing many ancillary benefits for the State and its citizens.

Subsequently in September 2002, CalSTRS Board further solidified its worldview by adopting the Values that became the cornerstone of how CalSTRS business is conducted. Specifically, the Values are as follows:

- *Customer Service*: We never compromise on quality as we strive to meet or exceed the expectation of our customers.
- *Accountability*: We operate with transparency and accept responsibility for our actions.
- *Leadership*: We model best practices in our industry and innovate to achieve higher standards.



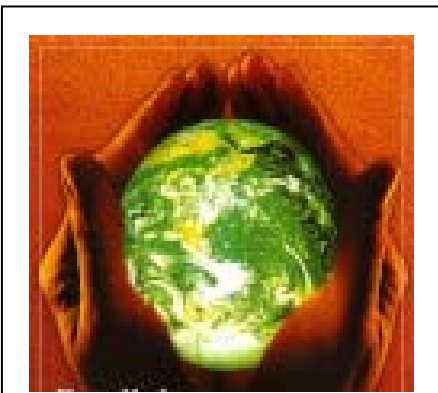
- *Strength:* We ensure the strength of our system by embracing a diversity of ideas and people.
- *Trust:* We conduct ourselves with integrity, acting ethically in every endeavor.
- *Respect:* We respect the needs of our members, co-workers, and others, treating everyone with fairness, honesty and courtesy.
- *Stewardship:* We recognize our fiduciary responsibility as the foundation for all decision-making.

JULY 2003 – DEVELOPING MANAGER RESEARCH

Armed with a clear direction from the CalSTRS Board to gain strength from a diversity of ideas and people, a study regarding developing managers was commissioned. Pension Consulting Alliance, Inc. (“PCA”) conducted the study and presented a research report entitled, “*A Review of Developing Managers and Developing Manager Programs.*” The purpose of the research was to examine the equity marketplace in the United States to determine whether an allocation to small and/or new investment management firms have the same potential to deliver significant risk adjusted performance as mainline firms. This type of research had never been conducted before.

The landmark research report shed some light on developing managers, a portion of the investment manager universe that had been left relatively untapped by large institutional investors. Typically, developing managers, or also called emerging managers, refer to small firms with fewer assets under management than the mainline managers, and often reflect the change in demographics found in California. These firms are small, diverse, and often employee-owned.

For the purposes of the research, PCA defined managers in two categories:



“Attractive investment management organizations encourage decisions directed toward creating investment returns, not toward generating fee income for the manager. Such principal-oriented advisers tend to be small, entrepreneurial, and independent.”

David F. Swenson, Yale CIO, in Pioneering Portfolio Management

Developing manager (or management firm) refers to any investment management firm with less than \$2 billion under management.

Mainline manager (or management firm) refers to any investment management firm with more than \$2 billion under management.

PCA found that there is no broad-based difference between the risk adjusted performance of developing and mainline managers. Further, it described that many of the firms in this space are populated by talented, highly educated individuals who have developed their skill while working at some of the best, most well-respected financial institution in the world. It found that many of these men and women possess innovative strategies, have strong performance records, and most of all, possess an entrepreneurial spirit that keeps them on the path to excellence. At the same time, the research describes many of these firms are operationally sound and unencumbered by many of the administrative burdens that often accompany mature and large financial organizations.

Finally, the research suggested elements to follow when establishing a successful developing manager program.

CalSTRS implemented the Developing Manager Program in its Global Equities portfolio as a result of this report. Global Equities directed three fund-of-funds managers - Northern Trust, FIS Group, and Frank Russell - to construct portfolios of external developing manager firms whose investment styles, in aggregate, closely resemble the components of the Russell 3000 Index. The program has been successful with the current market value of the portfolio over \$1 billion. Through this program, CalSTRS has 36 relationships with developing managers, many of whom are women and minority-owned firms. This is the historical progress in allocations to the developing manager program through three fund-of-funds:

End of Fiscal Year 2006/2007:	\$1.1 Billion	(18.8% increase)
End of Fiscal Year 2005/2006:	\$939 Million	(13.8% increase)
End of Fiscal Year 2004/2005:	\$825 Million	(37.5% increase)
End of Fiscal Year 2003/2004:	\$600 Million	

CalSTRS external investment managers have also utilized diverse developing brokers to execute trades as follows:

End of Fiscal Year 2005/2006:	\$2.2 Million	(71.6% increase)
End of Fiscal Year 2004/2005:	\$1.3 Million	(18.7% decrease)
End of Fiscal Year 2003/2004:	\$1.6 Million	(64.0% increase)
End of Fiscal Year 2002/2003	\$1.0 Million	

The road to diversity in the management of investments has not been the same in all asset classes. Each asset class has its own challenges and opportunities; thus, the strategies around diversity have respected the differences among the asset classes, and have been structured opportunities accordingly.

DISCUSSION: A PROACTIVE APPROACH

Successful efforts to increase the diversity of the firms in which CalSTRS invests demand long-range, comprehensive strategy and a proactive approach. In August 2005, CalSTRS embarked on a ground-breaking approach committed to building a disciplined and comprehensive strategy to incorporate diversity into the management of CalSTRS investments. Altura Capital, a Hispanic woman-owned firm, was retained to assist CalSTRS with this effort.

The principal guideline in incorporating diversity into the management of investments has been the Investments mission itself. The goal at CalSTRS Investments is to enhance the returns for its beneficiaries. In order to do so, exposure to a wide gamut of investment opportunities and talent must be insured, and this exposure must be acquired in a comprehensive and strategic manner, consistent with the direction that the CalSTRS Board has given through its core values. Specifically, Diversity in the Management of Investments (“DMI”) operates under the CalSTRS core value of:

Strength – We ensure the strength of our system by embracing a diversity of ideas and people.

This is neither a “program” nor a short-term approach – it is a good, proactive business strategy, which we call the Proactive Portfolio. DMI permeates throughout the asset classes, respecting

the differences among them, building on the collective experience of the CalSTRS Investment Professionals, and structure opportunities accordingly.

THE PROACTIVE PORTFOLIO

The Proactive Portfolio is a strategy which is interwoven in all asset classes within CalSTRS Portfolio whereby a framework is provided for selecting investments in an opportunistic and disciplined manner when these investments are: 1) in the emerging space, and/or; 2) to capture innovative strategies (i.e. new market opportunities and/or new drivers of value creation due to changing demographics, etc.), and/or; 3) investments consistent with the Board's Policy on California Investments. The Proactive Portfolio may take the form of a specific program, or it can be managed by the individual portfolio managers in the normal course of business. Specifically:

Global Equities: The proactive strategy is reflected in the history of utilizing untapped talent in the normal course of business; conducting research for in-depth knowledge; and, creating the Developing Manager Program with assets over \$1 billion. This is in the asset class where the program research, development and management have been evolving through time, and stand as a stellar example of innovative thinking.

Fixed Income: In Fixed Income, the proactive portfolio approach has come about in the normal course of business, and has long kept an open mind to diversity in the management of its investments. Recently, LM Capital (a Latino-owned firm) was funded \$350 million of our \$5.4 billion allocation to our active Core Plus strategy. In addition, EH Williams (an African-American-owned firm) was funded \$300 million of our \$2.4 billion allocation to our active High Yield strategy. Each of these managers was hired through our regular RFP process.

Another positive step in increasing diversity among our managers was to create a developing manager program within Fixed Income, piggy-backing on the success that Global Equity has had. Staff recently issued an RFP to hire several Fund-of-Fund (FOF) managers in both Global Equity and Fixed Income. These FOFs will in turn hire several smaller firms, many of which are often women- and minority-owned firms.

Additionally, Fixed Income currently has 17 minority-owned, 3 women-owned, and 3 disabled veteran-owned approved broker/dealer partners. Trading activities with them in fiscal year 2006/2007 stood at \$4.6 billion. This is an increase in trading activities of past years:

Fiscal year ending June 2007	\$ 4,588 Million	(4.9% increase)
Fiscal year ending June 2006	\$ 4,374 Million	(87.3% increase)
Fiscal year ending June 2005	\$ 2,334 Million	(1280.5% increase)
Fiscal year ending June 2004	\$ 169 Million	(3.8% decrease)
Fiscal year ending June 2003	\$ 176 Million	

Private Equity: In the case of private equity, CalSTRS staff has established a separate program, and has incorporated the existing urban and rural investments program and the next and emerging managers program under the Proactive Portfolio. It is managed by the Investments Executive Unit with \$735 million commitment so far.

As mentioned earlier in our discussion of the Board direction, Banc of America Capital Access Fund ("BACAF") and the New and Next Generation Manager Fund ("NNGMF") were selected in order to deploy CalSTRS capital in a most efficient and cost-effective

manner. BACAF targets private equity funds that aim to invest in underserved markets whereas NNGMF focuses on emerging funds that have been formed by experienced professionals with proven track records.

In addition to these two funds-of-funds, CalSTRS has initiated a side-by-side investment program where CalSTRS commits directly to funds. Currently, CalSTRS has 7 direct relationships with emerging and/or minority /women-owned firms, and has committed \$360 million to 8 funds through this program.

The Private Equity Proactive Portfolio continues to evolve; an RFP will be issued by end of 2007 to create a pool of independent fiduciaries whose specialty will be the domestic underserved and/or emerging markets. They will serve in conducting independent due diligence on side-by-side investments within the Private Equity Proactive Portfolio.

Real Estate: Real Estate's proactive efforts are managed internally within normal business practices. Real Estate has allocated \$860 million of direct commitments to seven emerging managers in 2006, out of which \$775 million commitments were made to six minority-/women-/disabled veterans-owned ("MWDV") firms. Emerging managers are defined as those firms that have less than \$100 million in assets under management prior to the CalSTRS partnership. Strategies include: Urban Development & Redevelopment; Environmental Remediation; Ethnic-oriented Retail Centers; Historic Restoration; Urban Infill-limited Service Hospitality; and, Senior Housing. The Real Estate program will continue to work closely with its existing emerging managers and expand those relationships as they become successful investments.

INVESTMENT EXECUTIVE UNIT

In 2004, the Chair of the Legislative Budget Committee - Assembly Subcommittee 4, began a series of questions regarding diversity in the management of CalSTRS investments. In the next two years, the desire of Legislators for this type of information increased. Multiple reports were produced in Investments and all questions have been answered; however, the clear effort in coordination of these responses was a mammoth task, the Legislature appetite for information on diversity in the management of investments increased, and lessons were learned on the best manner to disseminate the correct information in an expeditious manner. In addition, in order to help enlist the cooperation of all Investment Staff in creating options to go to the next level with knowledge about diversity gained from the previous actions, Investments has centralized the monitoring of diversity efforts throughout the portfolio within Investments Executive Unit. Over time, the responsibilities of the CIO have been increasing and broadening to include multiple projects and coordination of various sensitive issues. The unit was created to provide project assistance to the CIO - the Investment Executive. It currently has broader responsibility over California Investments, the Private Equity Proactive Portfolio and the Home Loan Program, in addition to monitoring the Branch's diversity efforts and Balanced Scorecard. Thus, the unit has been properly staffed and it provides Investments' upper management a structure with the capacity to generate effective options for what actions to take for their asset classes in the diversity space. Focused coordination is essential for taking beneficial action that reconciles differences and leads the organization to success.

The following discussion encompasses some of the strategy's broadest, long-term and comprehensive components.

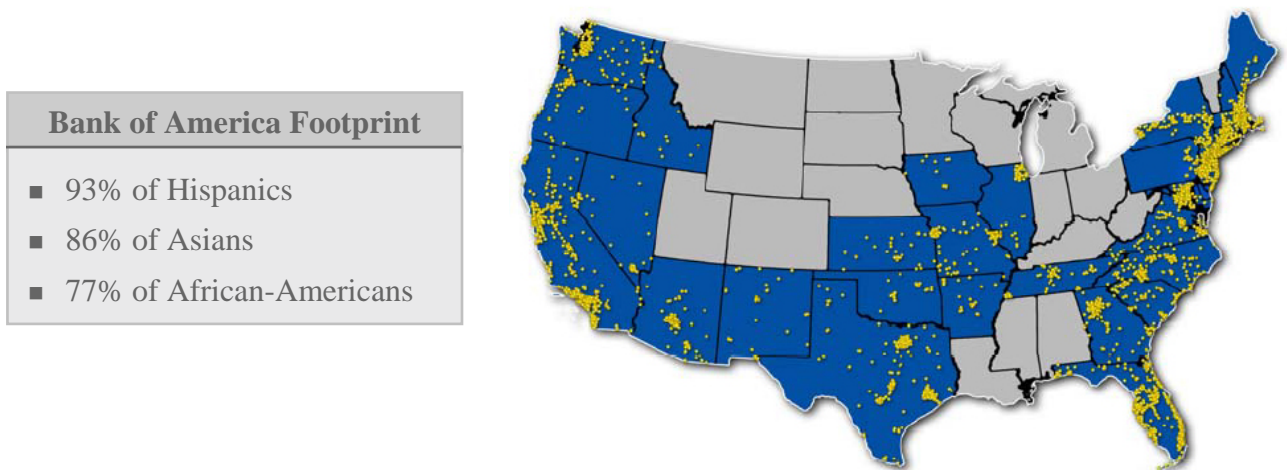
INVESTMENT PERSONNEL

Successful efforts to increase the diversity of the firms in which CalSTRS invests, demand a long-range, comprehensive strategy and a proactive approach. However, the efforts should begin in our own backyard. The demographics in the Golden State have, and continue to, change. We are now a minority-majority state where members of ethnic minorities encompass over 50% of the California population. Investment leadership understands the importance of increasing the value-added opportunities and resources that result from diversity; thus, increasing employee diversity - both ours and our partners - is central to building the workforce of tomorrow.

Internal: In Investments, diversity is about maximizing the inclusion of everyone in the organization and should include each of us. CalSTRS Investments Branch consists of 84 positions. As of September 28, 2007, 41% of all current CalSTRS Investment Staff are members of an ethnic minority and 54% of total employees are women. In the upper management structure of Investments, 33% are members of an ethnic minority and 33% are women.

External: Investments has a number of partner relationships – external managers, advisors, independent fiduciaries, and other partners who help us manage the Fund. Beginning in 2008, we will survey our partners on an annual basis to ask them to share with us any best practices in the diversity area, as well as their diversity composition. This data will be submitted to CalSTRS Board in the normal course of this report and will provide an opportunity to highlight successful models or best practices among our partners. Diversity is an important business issue in the global marketplace. We believe that having the broadest possible investment talent, experiences, and perspectives will enhance our ability to compete. We believe this to be true for our partners as well.

Partner's Best Practice: One good example of best practices and a sophisticated approach to diversity and a demonstrable high caliber partner is Bank of America (“BofA”). BofA is our partner in managing a private equity fund-of-funds that targets the underserved space and also act as one of our advisors in this space. BofA’s national footprint overlaps extensively with emerging domestic markets and business that are experiencing strong growth. Specifically 93% of Hispanics, 86% of Asians, and 77% of African-Americans reside within the BofA’s footprint.



This footprint allows our advisor to take a highly proactive leadership role in active outreach and industry sponsorship of existing and emerging private equity funds focused on underserved markets. BofA is an active participant in the major underserved markets private equity trade associations, and has historically been a financial sponsor of various conferences. Members of our advisor team have spoken at conferences for the National Association of Investment Companies, Rainbow Push Coalition, the Willie Brown Institute, the Emerging Domestic Market's Plan Sponsor events, and events held by the National Minority Supplier Development Council. Through its active outreach and industry sponsorship, they also seeks to enhance the brand of CalSTRS and its commitments to diversity and underserved market investing by publicly discussing the current BofA and CalSTRS relationship via the Banc of America Capital Access Funds.

In 2005, BofA partnered with Dr. Michael Porter's Inner City Economic Forum to create a venue where the introductions of inner-city based companies are made to private equity providers. Inner City Capital Connections ("ICCC") is a national program designed to stimulate equity capital flow to inner city underserved markets by matching inner city businesses with investors. The ICCC Chicago 2007 on November 8 will be the 4th event of its kind, following successful programs in Los Angeles (2005), New York (2006), and Miami (2006). The program is designed to: 1) provide companies with the educational tools and coaching on what equity capital is, what equity capital providers are looking for, what are the key elements of a company presentation, and how to best go about raising equity capital; and 2) facilitate the connection between inner city entrepreneurs and equity capital investors.

Lastly, in cooperation with the Center for Community Capitalism at the University of North Carolina at Chapel Hill, BofA compiles and studies the social impact CBACAFs are making on the communities in which it invests. For instance, as of June 30, 2006:

- 77% of the underlying companies in CBACAF fund portfolio satisfy at least one definition of underserved.
- Approximately 33% of the companies satisfy at least two of CBACAF's definitions of underserved.
- 17 of the 44 companies are in low-to-moderate income geographies.
- 17 are ethnic minority owned and/or have an ethnic minority CEO; 10 of these companies are ethnic minority owned.
- 7 are located in a rural geography.
- 45% of the companies are located in California; 80% of these companies satisfy at least one of CBACAF's definitions of underserved.

In this manner, a comprehensive approach to diversity is summarized on an annual basis capturing the business side and the public returns of our fund-of-funds.

LEADERSHIP

CalSTRS has become a leader in the diversity space while maintaining a fair but disciplined approach.

The recognition by the industry: CalSTRS is actively involved in many different segments of the finance industry. In October 2006, the New America Alliance, an

organization of American Latino business leaders, awarded CalSTRS CIO Christopher Ailman the NAA Distinguished Service Award for Advancing Latinos in American Business during a ceremony at the Sixth Wall Street Summit in New York City. Mr. Ailman was recognized for his innovative approach in uncovering untapped talent in the investment arena and encouraging other institutional investors to seek out and hire emerging managers. During his acceptance speech, Mr. Ailman said, "...the CalSTRS Investment Team have worked tirelessly not only to insure the best possible returns to the Fund, but to do so in a manner that is respectful of the California educators' legacy of inclusion and diversity."



CalSTRS' CIO was recognized for setting diversity as a key strategic business component that creates valuable opportunities.

In 2006, CalSTRS was nominated for Money Manager Letter's *Savviest Plan of the Year* for the groundbreaking initiative to create a database of emerging asset managers and other financial service firms, and then plan to share the research with other public funds to raise awareness of the space. It was noted that nothing this far-reaching has ever been done before.

The Emerging Managers and other Financial Service Providers ("EMFSP") Database: As a part of on-going effort to find untapped talents to maximize our investment returns for California teachers, CalSTRS, with the partnership with CalPERS and Altura Capital, launched and completed a project to create a database of emerging managers and other financial service providers. This project has aimed to create an industry reference guide, and to promote information transparency. It also gives public and private pension funds and other institutional investors an exposure to a new universe of emerging investment firms in an effort to boost investment returns by building investment portfolios that tap into the changing demographics and talent emerging in California and the nation.



The database includes 721 emerging managers and financial service providers, many of who have high percentages of employee ownership and diverse experience in historically underserved markets. The result shows that more than 20% of the participated firms are from California, which makes California the second most popular state for emerging managers.

The effort met multiple goals. For the first time, the universe of emerging financial firms was mapped out to help develop a better understanding of the characteristics, trends, capabilities, and untapped

potential of these emerging firms. A reference guide was created and shared with other institutional investors across the nation.

The database will help promote information transparency, as well as provide access to capital in the emerging marketplace, and thus broaden the opportunities for emerging firms to conduct business and add value to the portfolios of institutional investors. This

is consistent with our core value mentioned above – CalSTRS promotes greater diversity within the investment strategies of public and private pension funds. We anticipate updating the database again in 2008, and providing a report that will be shared within the industry.

CalSTRS Diversity Survey: A critical component of the effort to incorporate diversity into the management of investments in a systematic and measured manner also lies in better understanding how women and minorities are perceived in our industry. To this end, CalSTRS has teamed up with Kevin Granger from Phocas Financial and Clayton Jue from Leading Edge Investment Advisors in a survey of the industry regarding attitudes toward women and minorities. The survey is intended to provide a forum for survey participants willing to share their opinions on diversity in the management of investments, assist in recognition of issues and factors regarding diversity in the investment management industry, and help better understand how and where diversity can be used to boost investment returns to benefit plan members. This is a five-part, longitudinal study that began 2005. Both the 2005 and 2006 survey results are available at www.CalSTRS.com. The next survey is anticipated to be conducted in late 2009 in cooperation with an educational institution.

Involvement in Strategic Alliances:

Involvement in strategic alliances has provided the rich cross-cultural education and exposure needed to conduct business in 21st century California. The industry is constantly seeking creative avenues to maximize investment returns. Utilizing a diverse pool of fund managers will enable CalSTRS to capitalize on previously untapped investment opportunities. We can achieve good investment returns by building an investment portfolio that taps into the changing demographics and talent emerging in California and the nation.



1. **Toigo Foundation:** The first strategic alliance has been with the Toigo Foundation, an organization whose mission is “*to change the face of finance.*” CalSTRS CIO, Christopher Ailman, and the Investment Officer for California Investments, Solange Brooks, are Advisory Board members. The mission of the organization is to encourage greater minority presence at senior levels across all areas of finance.

Through its fellowship program, the organization provides minority MBAs a gateway to a circle of opportunity: first, as recipients of all Toigo has to offer, then, when they have established their careers, as donors — sharing expertise, fostering innovation and forging alliances to promote the Toigo mission.

Toigo Fellows receive tuition assistance, but the grants are actually the least important aspect of the fellowship. What’s of incalculable and lasting value are the human resources the foundation provides: mentors and coaches to advise, support and guide; career counseling; continuing education programs; leadership training; and a

host of formal and informal networking opportunities. CalSTRS Professional Staff, including the CIO, are dedicated mentors for Toigo Fellows.

It is important to note that CalSTRS Investments has had student intern programs for post-graduates (from Toigo, University of California, Davis (“UCD”), and California State University, Sacramento (“CSUS”)), for undergraduates (from UCD and CSUS), and for the community college students. The majority of the students involved in the student intern program are from underrepresented groups on Wall Street.

2. **Pacific Pension Institute:** Christopher J. Ailman is the Chair of the Pacific Pension Institute (“PPI”) Board of Directors. PPI is a member-driven, non-profit educational organization that assists pension funds, corporations, financial institutions and endowments worldwide with carrying out their fiduciary responsibility, especially with respect to Asia and the Pacific Region. This provides a great source of networking, education and investment opportunities. This is an organization where CalSTRS can extend influence that is far-reaching and thought-provoking.
3. **New America Alliance:** Christopher Ailman was the first CIO to become a member of the New America Alliance (“NAA”) in 2003. NAA is organized on the principle that American Latino business leaders have the responsibility to lead the process of Latino empowerment and wealth-building by expanding the forms of capital most crucial for economic advancement – economic capital, political capital, human capital and the practice of philanthropy.

The organization adopted CalSTRS suggestion to create a new membership category for public pension plans. In a joint effort with New York City Comptroller William Thompson Jr., CalSTRS CIO announced the new partnership, aimed to build stronger relationships with public and private pension funds, and assist them in expanding their pool of top performing managers. NAA also agreed to assist in establishing initiatives to increase the participation of Latinos in all areas of the pension fund system.

4. **Inner City Economic Forum:** CalSTRS Investments is working with the Inner City Economic Forum (“ICEF”) and Harvard Business School Professor Michael Porter who is the founder and chairman of Initiative for a Competitive Inner City (“ICIC”), on a national project - the *Economically Distressed Area (“EDA”) Investment Certification System*. This is a rating mechanism to: (1) identify investments in economically distressed areas; and (2) measure the impact of those investments on economically distressed communities. ICEF is planning to carry out this initiative through a pilot study in collaboration with leading public pension funds like CalSTRS. This system will serve as a national model that can eventually be used by other public pension funds as a due diligence tool.

ICEF is an organization that was founded in 2003 as an ambitious and innovative effort to reduce economic inequality in America’s inner cities. ICEF's strategic partners include ICIC, Bank of America, the Ewing Marion Kauffman Foundation, The Rockefeller Foundation, The Ford Foundation, and the Yucaipa Corporate Initiatives Fund.

5. **Joint Conferences:** California has the two largest public pension plans in the country. In an industry where size matters, we are cognizant of the importance of multi-billion portfolios and investment activities across the country.

While the single primary purpose of our investments is to achieve the desired return to secure the financial future of our respective funds, we recognize that many investment activities have multiple ancillary benefits, creating economic value and benefits that enhance the greater good. It is with this understanding that the two funds have joined forces in influencing the attitude towards diversity in the management of investments. Thus, we have united our voice and efforts to make a greater impact. Specifically, CalPERS agreed to co-sponsor the EMFSP database with CalSTRS and Altura Capital. This not only includes sharing the cost of the effort, but also speaking at relevant forums and conferences about diversity and what the database represents. The message is out and the message is clear: the two largest pension plans in the country believe that diversity is good business.

In September 2007, again we joined with other pension plans - CalPERS, The Los Angeles City Employees' Retirement System, Los Angeles Fire and Police Pensions, and Los Angeles County Employees Retirement Association - to host the *California Pension Fund Investment Conference - A Golden Opportunity* to promote investments by the pension plans in the Golden State. The second day of the conference included a trustee-only workshop where discussion about fiduciary responsibility was the focus. One cannot speak about investing in California without addressing investing with a diverse manager pool and diverse ideas. The conference was very successful with over 400 attendants.

6. **The Investment Workshops:** CalSTRS and CalPERS joined forces and held an investment workshop hosted by California Asian Pacific Islander Legislative Caucus in November, 2006. CalSTRS CIO, Christopher Ailman, and CEO, Jack Ehnes, as well as CalPERS CIO, Russell Read and CEO, Fred Buenrostro, presented investment philosophy and strategies at both pension plans, followed by break-up sessions where investment officers explained an investment review process of specific asset class in details at each plan.



As the largest pension funds in U.S., CalSTRS and CalPERS strive to promote diversity in the management of investment.

Similar workshops have also been held and hosted by the California Legislative Black Caucus on June 25, 2007. State Controller John Chiang welcomed the Legislative hosts and addressed attendees in providing them with a perspective of the two pension funds where he is an ex-officio Board Member. CalSTRS CEO, Jack Ehnes, as well as CalPERS CEO, Fred Buenrostro, addressed the gathering and presented the philosophy and strategies at their respective pension plans. It was

followed by breakout sessions, moderated by CalSTRS and CalPERS Board Members, where Investment Officers explained an investment review process of specific asset class in details at each plan. The event was a success in facilitating introductions and brief discussions of the investments programs which leads to the beginning exploration of identifying potential new investment partnerships.

In order to serve our fiduciary duties, CalSTRS will continue to seek and incorporate a wide variety of talents and investment ideas in our investment strategies so that we will maximize potentials for higher investment returns for our teachers.

7. **Emerging Domestic Market Working Group:** Assemblyman Arambula, Chair of the Assembly Committee on Jobs, Economic Development and the Economy and Assembly Budget Subcommittee on State Administration and the Latino Caucus has assembled a working group on how to attract more private investments to California's historically underserved capital markets. CalSTRS CIO and Staff are part of the working group that includes investors, financial professionals, and economic and community developers whose goal is to craft strategies and models to increase private investment opportunities in emerging domestic markets. The working group has convened in Fall 2007 and is scheduled to have an initial report prepared by late January 2008.

CONCLUSION

CalSTRS has a rich history of inclusion from its creation by the California Legislature on July 1, 1913, when students in California first received free textbooks of their own, to the present day efforts of the Home Loan Program aimed at insuring that every California teacher has the opportunity to purchase a home. One can see it in our programs, our policies and our actions that the philosophy exemplified by our core values extends to our investment business practices. It is a philosophy that is strictly adhered to and expounded by the actions of our Board.

In looking for best practices in the inclusion of diversity in organizations, particularly in business settings, we are reminded that, if diversity is to thrive, it must have a strong support from top management and board chair where a written statement of commitment has been made, such as "Diversity" or "Inclusion" is identified as a core value for the organization, and it must be linked to strategic planning process, mission, and vision. We believe that CalSTRS Investments includes all those components. Further, we are proceeding with a reporting system that will track our progress, and allow Investment leadership to set goals as appropriate.

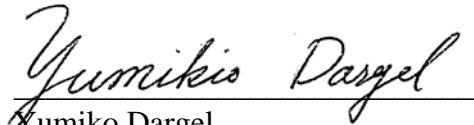
CalSTRS Investments proceeds with the business of securing a strong retirement fund for the teachers of California while remaining consistent with its rich history. Thus, the philosophy of inclusion and diversity is interwoven in the business goals of CalSTRS. Investment goals are to:

- a) Achieve a rate of return on the total assets of the Fund that in the long run exceeds the actuarial discount rate used to value the liabilities of the Retirement Plan for funding purposes, so as to ensure that sufficient assets are available to meet the liabilities on an on-going basis.
- b) Reduce the contributions required to fund those liabilities by maximizing the long-term investment returns on assets at a level of risk that is acceptable to the Board.

- c) Maintain a certain level of stability in pension contributions so as not to adversely impact the long-term viability of the System and its ability to continue to meet its pension obligations.
- d) Manage the investments of the Fund in a prudent manner so as to maintain the confidence of members as well as the general public in the California State Teachers' Retirement System.

We believe that the exchange of ideas and the direction given to us by CalSTRS Board with regard to issues around diversity of ideas and people are invaluable. We also applaud Legislative interest in our efforts, and the support of CalSTRS leadership to ensure that a wide variety of talent and investment ideas continues to be incorporated in CalSTRS investment strategies, as a smart and responsible way to execute our duties as fiduciaries.

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CalSTRS Historical Tables

Fixed Income: Transactions

(\$millions)	FY2002	FY2003	FY2004	FY2005	FY2006
Emerging Firms					
Number of firms	6	4	9	15	18
Value of transactions processed	\$176	\$169	\$2,334	\$4,373	\$4,588
Percentage to the total value of transactions	0.1%	0.1%	1.3%	2.4%	3.5%
Firms owned by Latino, Black, Asian, Pacific Islander, and Native Americans					
Number of firms	4	2	6	11	9
Value of transactions processed	\$36	\$7	\$262	\$1,515	\$1,548
Percentage to the total value of transactions	0.0%	0.0%	0.1%	0.8%	1.2%
Firms owned by Minority, Women and/or disabled veterans					
Number of firms	6	4	9	15	18
Value of transactions processed	\$176	\$169	\$2,334	\$4,373	\$4,588
Percentage to the total value of transactions	0.1%	0.1%	1.3%	2.4%	3.5%
Total Market Value of Transactions	\$145,733	\$121,203	\$178,544	\$184,345	\$130,287

Note: Above years are fiscal years ending in June. The numbers of total authorized brokers are greater.

Fixed Income: High Yield Portfolio

(\$millions)	2002	2003	2004	2005	2006
Emerging Firms					
Number of firms	0	0	0	0	0
Assets under management	\$0	\$0	\$0	\$0	\$0
Percentage to the total high yield asset under management	0.0%	0.0%	0.0%	0.0%	0.0%
Firms owned by Latino, Black, Asian, Pacific Islander, and Native Americans					
Number of firms	1	1	1	1	1
Assets under management	\$320	\$514	\$520	\$731	\$518
Percentage to the total high yield asset under management	34.9%	28.8%	21.2%	37.9%	33.5%
Firms owned by Minority, Women and/or disabled veterans					
Number of firms	1	1	1	1	1
Assets under management	\$320	\$514	\$520	\$731	\$518
Percentage to the total high yield asset under management	34.9%	28.8%	21.2%	37.9%	33.5%
Total High Yield Portfolio	\$916	\$1,784	\$2,447	\$1,927	\$1,549

Internal Equities: Broker Commissions

(\$)	2002	2003	2004	2005	2006
Emerging Firms					
Number of firms	1	1	2	4	9
Commissions paid	\$294	\$3,015	\$16,057	\$43,432	\$124,683
Percentage to the total commissions paid	0.1%	2.6%	2.4%	4.3%	8.0%
Firms owned by Latino, Black, Asian, Pacific Islander, and Native Americans					
Number of firms	1	1	2	4	7
Commissions paid	\$294	\$3,015	\$16,057	\$43,432	\$108,313
Percentage to the total commissions paid	0.1%	2.6%	2.4%	4.3%	7.0%
Firms owned by Minority, Women and/or disabled veterans					
Number of firms	1	1	2	4	7
Commissions paid	\$294	\$3,015	\$16,057	\$43,432	\$96,921
Percentage to the total commissions paid	0.1%	2.6%	2.4%	4.3%	6.2%
Total commissions paid	\$ 331,120	\$ 115,110	\$ 669,662	\$ 1,010,095	\$ 1,553,554

Note: 2006 is as of Nov 31, 2006. The numbers of firms above are those firms which CalSTRS had transactions with for each year. The numbers of total authorized brokers are greater.

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Real Estate: Investment Commitments

(\$millions)	2002	2003	2004	2005	2006
Emerging Firms					
Number of firms	1	3	3	5	7
Commitments made	\$70	\$308	\$250	\$1,000	\$860
Percentage to the total commitments made	11.3%	26.1%	13.7%	14.5%	9.8%
Firms owned by Latino, Black, Asian, Pacific Islander, and Native Americans					
Number of firms	2	3	3	4	6
Commitments made	\$145	\$243	\$315	\$920	\$775
Percentage to the total commitments made	23.5%	20.6%	17.3%	13.3%	8.9%
Firms owned by Minority, Women and/or disabled veterans					
Number of firms	2	3	3	4	\$6
Commitments made	\$145	\$243	\$315	\$920	\$775
Percentage to the total commitments made	23.5%	20.6%	17.3%	13.3%	8.9%
Total commitments made for the year	\$618	\$1,182	\$1,820	\$6,902	\$8,748

Note: Figures above are commitments made for the year. A return number of each manager is not available at this point or too early to tell as these investments are relatively new.

Alternative Investment Proactive Portfolio: Commitment

(\$millions)	2002	2003	2004	2005	2006
Emerging Firms					
Number of firms	0	1	3	13	20
Commitments outstanding	\$0	\$2	\$11	\$69	\$111
Percentage to the total commitments outstanding	N/A	100.0%	100.0%	100.0%	95.4%
Firms owned by Latino, Black, Asian, Pacific Islander, and Native Americans					
Number of firms	0	1	2	10	15
Commitments outstanding	\$0	\$2	\$6	\$52	\$85
Percentage to the total commitments outstanding	N/A	99.3%	55.5%	75.4%	73.2%
Firms owned by Minority, Women and/or disabled veterans					
Number of firms	0	1	2	10	15
Commitments outstanding	\$0	\$2	\$6	\$52	\$85
Percentage to the total commitments outstanding	N/A	99.3%	55.5%	75.4%	73.2%
Total commitments outstanding	\$0	\$2	\$11	\$69	\$116