Hybrid EDM Investment Model
Step One – Assessment and Evaluation

Needs of Investors: Review and summarize key elements of EDM investment policies.

The purpose of this exercise is to identify key elements in EDM investment policies, in order to include their priorities within the new models.

CalPERS, CalSTRS, New York City and State (moving into private equity), and MassPRIM are considered the early movers in EDM investment policies. Recently, several other public pension funds have begun to target portions of their portfolios to emerging domestic markets, including the Connecticut Retirement Plans and Trust Funds (CRPTF), Contra Costa County Retirement System, and the Los Angeles City, County, Fire and Police.

It has been estimated that there are approximately $11 billion of public-sector pension fund commitments (across all asset classes) in urban revitalization, emerging domestic markets, or, more broadly, economic development, through either formal targeted investment policies or "one off" investments as of 2007[1]

Dr. Tessa Hebb recently interviewed investment staff at MassPrim, LACERS, New York Common, CalPERS and CalSTRS about their EDM investment policies. In summary, she reported that the most effective policies had six common characteristics:

- Success was measured first in its risk-adjusted market rates of return.
- Investments were geographically rather than socially targeted.
- Investments were policy driven by investment philosophy not social targets.
- Investments were opened up through formal requests for proposals, which served, among other issues, to deflect political intervention.
- Investment policies set broad targets for economic development outcomes.
- Investment policies allowed for top-quartile vehicles to do their job.

The following are more specific summaries of public pension fund investment policies.

[1] Pension Funds & Urban Revitalization website: http://urban.ouce.ox.ac.uk.

Private Equity Investment Policies

Strategic Objectives

- CalPERS' Alternative Investment Management (AIM) Program - Maximizing risk-adjusted rates of return while enhancing the CalPERS position as a premier alternative investment manager. The program is managed to accomplish this objective by:

    1. Enhancing the System's long-term total risk-adjusted return;
    2. Enhancing the System's reputation as a premier alternative investment manager and "investor of choice" within the private equity community;
    3. Hedging against long-term liabilities;
    4. Providing diversification to the System's overall investment program; and
    5. Considering solely the interests of the System's participants and their beneficiaries in accordance with California State Law and the Prudent Expert Standard as defined in Section II of the System's Investment Policy.

- CalPERS' Economically Targeted Investment Policy – Achieving competitive risk-adjusted rates of return for the CalPERS portfolio, while still promoting growth and development of the national and regional economies. It is expected that the asset selection will provide collateral benefits to targeted economic geographic groups, groups of people, or sectors of the economy. Further, prudent investments in emerging domestic markets create jobs and housing, improve the general infrastructure, and serve the broad interests of CalPERS beneficiaries. By strengthening the State's economy and the well being of the employer, economically targeted investments promote the continued maintenance of the employer contribution to CalPERS. The emphasis of the economically targeted investment program is on the promotion of long-term sustainable economic, industrial, and business growth, job creation, and affordable housing. Sets a goal of 2 percent of total portfolio.

- CalPERS' Emerging Domestic Market Investment Policy – Achieving competitive risk-adjusted rates of return while broadening economic opportunity in California's underserved areas. Consistent with this strategy, the objective is to discover and invest in opportunities that may have been bypassed or not reviewed by traditional, more mainstream sources of capital. Prudent investments in EDMs will have a collateral benefit of creating economic value and activity in underserved markets, thereby contributing to the well-being of the California economy. All investments are required to be consistent with the CalPERS fiduciary obligations and serve the long-term interests of the beneficiaries of CalPERS.

- CalSTRS' Policy on California Investments – Achieving the appropriate return at the given level of risk. CalSTRS recognizes that its portfolio represents one of the largest pools of investment capital in the state and that many of its investment activities can have an ancillary benefit of creating economic value and activity that benefits the state and its citizens. Sets a goal of 2 percent of total portfolio in underserved markets, primarily in California.

- CalSTRS Proactive Portfolio – A strategy 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 in (1) 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.

Definitions

- Emerging Domestic Markets – The term "emerging domestic markets" refers to people, places, or business enterprises with growth potential that face capital constraints due to systemic undervaluation as a result of imperfect market information. These markets include ethnic- and women-owned firms, urban and rural communities, companies that serve low-to-moderate-income populations, and other small- and medium-sized businesses.[i]

  Both CalPERS' and CalSTRS' emerging market investment policies focus on investment opportunities in traditionally underserved markets primarily located in California. As an example, underserved markets would include urban and rural communities undergoing, or in need of, revitalization where there are assets conducive to business development. CalSTRS has internal guidelines and procedures to define underserved areas for each asset class.

Investment Approaches

- Disciplined and Opportunistic – Investments are to be reviewed and managed in a disciplined and opportunistic manner based on specific criteria appropriate to partnership and direct investments. "Top down" strategic assessments shall identify portfolio weightings and identify the most attractive segments of the market for investing. Based on these assessments, staff are required to proactively seek out the most attractive investment opportunities, while maintaining appropriate diversification.

- Fiduciary Duty - Investments must meet sole benefit fiduciary standards as set forth in the California Constitution Article XVI, Section 17 and common law.

- Risk-Return Profile - Investment must meet appropriate risk-return parameters, consistent with other alternatively available investments.

- Secondary Benefits - Collateral benefits must not be considered part of the return to the system, nor shall the impact of the state's economy be considered as part of the risk reduction. Any benefit the investment may confer on other interests is not the responsibility of the system. [Only CalPERS is explicit.]

- Due Diligence – Both CalPERS' and CalSTRS' investment policies similarly state that investments are required to meet similar due diligence as other investment products in the portfolio including meeting legal and investment sufficiency and identification of any potential conflicts of interest. Both CalSTRS and CalPERS investment process requires that **two** fiduciaries approve each investment, i.e. staff and outside fiduciary.

- Unique Quality of EDM Investments - EDM investments shall be monitored by using appropriate benchmarks. EDM investments are not uniform in structure, method, or objective. CalPERS' investment policy notes that this lack of homogeneity makes these instruments difficult evaluate, manage, and market on a large-scale basis. A consistent and methodological means for evaluating all EDM opportunities is of paramount importance to both funds. CalPERS' calls for the creation of a policy for evaluating the risk, return, and liquidity characteristics to assure that these investments are comparable on a risk/return basis with more traditional opportunities and are consistent with other financial requirements. It is CalSTRS' policy to have specific procedures by asset class to assure EDM investments meet similar investment standards to other investments within the asset class, including, but not limited to, the same performance benchmarks.

- Reporting - CalPERS EDM investments are required to be reported to the Investment Committee quarterly and annually. CalSTRS reports semiannually.

Eligible Assets for Overall EDM Investment Policies

CalPERS' and CalSTRS' EDM related investment policies include public equity, fixed income, private equity, real estate, and in companies or investments that substantially reside in underserved areas. This summary focuses on Private Equity and Real Estate.

Long-Term Performance Objective – Private Equity

CalPERS - The long-term expected performance objective of the CalPERS AIM Program is evaluated on the 10-year rolling average for the total return of the CalPERS Wilshire 2500 Index plus a 300-basis point risk premium. The performance objective is net of fees and expenses.

Use of the CalPERS Wilshire 2500 Index reflects the opportunity cost of investing in alternative investments versus publicly traded common stocks. The 10-year rolling average smoothes short-term volatility, is intended to cover at least one complete market cycle, and is consistent with the anticipated average term of the partnership investments and the expected average holding period for direct investments.

CalSTRS - The Alternative Investments Portfolio performance benchmark for CalSTRS is the dollar weighted return for the Russell 3000 Index plus 5% - adjusted for the latest three years contributions at the 3-month T-bill return. Performance calculations are determined by the internal rate of return (IRR) methodology as recommended by the Association of Investment Management and Research (AIMR). CalSTRS is authorized to use an additional performance benchmark, to the extent that it is an industry recognized benchmark (e.g., Cambridge Associates, PrivateEdge), which offers stable, high quality data based on robust methodology, using reliable sources of information.

Short-Term Performance Objective – Private Equity

In order to address differences between the long-term performance objective and young or immature partnership investments, CalPERS uses a short-term performance objective, which they believe, is more appropriate to immature partnership investments as a monitoring device.

The partnership performance is compared to Venture Economics Information Services (Venture Economics) young fund median returns by vintage year. “Young fund and short-term” is defined as the first four years of each individual partnership and the partnership composite portfolio. Exceeding the Venture Economics young fund universe median return, or ranking in the top 50% of the sample universe, as weighted by AIM Partnership portfolio actual sub-asset holdings over the most recent four years, is the short-term performance objective.

The short-term performance objective addresses characteristics of young or immature partnership investments that differ from the long-term rolling ten-year CalPERS Wilshire 2500 Index plus 3% performance objective.

These different characteristics include young partnerships with a shorter time frame, reduced liquidity, and lack of marking-to-market, due to a low number of realizations in the early years. Another characteristic of young and immature partnerships that is recognized in the CalPERS policy is the "J-curve effect," which results in low or negative returns due to payment of annual management fees during a period when investments are typically carried at cost and returns have not yet been realized.

Investment Vehicle and Structures – Private Equity [CalPERS and CalSTRS]

- Strategic investment vehicles include innovative structures that provide a cost effective means to access investment opportunities, exploit the System's strengths, and achieve the maximum risk-adjusted rates of return. Strategic investment vehicles may include partnership and/or direct investments.

- Proposed partnership, direct investment, and strategic investment vehicle opportunities shall be evaluated relative to their fit with the Program's Strategy and Annual Plan.

- Investments shall generally fall within the categories defined as:

    1. Buyout and Corporate Restructuring Capital - Investments in leveraged buyouts, management buyouts, equity buyouts, employee buyouts, buy-and-build, other acquisition strategies and restructurings, and related uses of capital.

    2. Expansion Capital - Investments in established companies for the purpose of growing their businesses.

    3. Venture Capital - Investments in relatively small, rapidly growing, private companies in various stages of development.

    4. Energy and Natural Resources - Investments in the exploration, extraction, accumulation, generation, movement or sale of energy (e.g., oil, gas, coal, electricity), and other natural resources and related service companies.

    5. Distressed Securities - Debt or equity securities investments in troubled companies, under the assumption that the securities will appreciate in value following a restructuring of the company's obligations. This includes, but is not limited to, investments in companies that are insolvent or unable to pay their debts as they come due. This may include companies subject to the Bankruptcy Reform Act, specifically Chapter 7 (Liquidation) and Chapter 11 (Reorganization), and companies under-going restructurings outside of Bankruptcy Court.

    6. Turnarounds - Investments in companies experiencing financial or operating difficulties. These companies may or may not be insolvent.

    7. Special Situations - This includes all other types of investments, e.g., mezzanine strategies, active minority positions, hedge funds, secondary investments, governance strategies, industry specific strategies, and unconventional investments such as debt arrangements, collateralizations, corporate joint ventures, credit enhancements, leasing, off-balance sheet financings, secondary market opportunities, and other types.

Partnership Investment Guidelines – Private Equity

Minimum Requirements/Investment Styles - The principals shall demonstrate relevant experience in or directly applicable to the market in which they propose to work. In addition:

- The principals are required to demonstrate that they are specifically qualified to pursue the proposed strategy.
- The principals are required to demonstrate that they have the requisite skills and experience necessary to execute successfully the proposed strategy, including evidence from similar endeavors of their ability to work successfully together.
- The principals are required to demonstrate that they have the ability to dedicate sufficient time and effort to the proposed opportunity and make, within the context of the particular investment, a meaningful personal financial commitment.
- The proposed strategy and business plan is required to set forth in sufficient detail to permit substantive and meaningful review of the opportunity, verification of the investment concept, and of the risk factors.
- The proposed strategy and business plan is required to provide reasonable assurance that the investment opportunity can produce the required return.
- The risk/reward trade-off in the particular market that is addressed by a partnership proposal is required to be attractive, based on reasonable assumptions.

Evaluation Criteria

Primary emphasis will be on the quality and experience of the general partners in a partnership investment. Additional factors may include, but are not limited to, its fit within the overall program strategy, annual work plan, or alternative investment portfolio; the integrity of the general partner, its employees, and other investors; and the quality of the overall partnership governance, management of the partnership, including controls and reporting systems. More specific objectives include:

- Relationship with the relevant parts of the investment community.
- Relationship with limited partners.
- Nature of value added involvement.
- Potentials for co-investments.
- Creativity of the general partners.
- Past financial performance.
- Reasonable ratio of investees to general partners.
- Reasonable ratio of committed capital to general partners.

- Appropriateness of terms and conditions and alignment of interests with limited partners.

Direct Investment Guidelines – Private Equity

Given the size of institutional investors such as CalPERS and CalSTRS, fiduciary duty dictates that these funds consider whether direct investment opportunities are of the size and scope to materially benefit the investment program. EDM funds may find that co-investment and fund-to-fund structures may be more applicable.

Minimum Requirements - Management shall have a sufficient level of relevant business and management experience and be appropriately capitalized.

Evaluation Criteria **-** Primary emphasis shall be on the following:

- Integrity of the general partner, its employees, and other investors.
- The historical and prospective financial condition of the company.
- The market position of the company, including its relative competitive position within the industry.
- The growth prospects of the company and its industry in light of existing and anticipated economic conditions.
- The underlying stability of the company's business.
- The quality and sustainability of earnings, if appropriate.
- The quality of the company's assets, such as manufacturing facilities, inventories, receivables, and other assets, including intangibles, essential to the company's operations.
- Appropriate capital structure.
- The quality, stability, and experience of the management team, the Board of Directors, and other investors, including the quality of their interaction.
- The quality of financial and operating controls and quality of reporting to management and investors.
- The quality of the corporate governance. The return potential of the investment, given its terms and conditions, compared to the perceived risks and the relative return/risk profile of comparable investments. At a minimum, additional factors shall include the following:

    1. The specific objectives and goals of the company and its management team.
    2. The strategy to be employed to achieve the aforementioned objectives and goals. Management and investors should have a well thought-out plan for creating and realizing value from the company.
    3. Controlling shareowner(s) and other institutional investors.

4. The relationship with the management team, the Board of Directors, other investors, and any controlling shareowners.

5. Potential for future follow-on investment opportunities.

Other Parameters

- Method of Participation - CalPERS generally participates as a preferred or common stockholder or as a senior or subordinated debt investor with a common stock participation.

- Hostile Transactions – CalPERS requires having the right to examine transactions which might be construed as hostile transactions, with the right to decline participation.

- Corporate Governance

  (1) Voting: CalPERS requires full voting rights with respect to any class of securities in which it might invest. When appropriate, CalPERS may choose to participate as part of a voting trust agreement under which a third party (e.g., a lead investor) retains its proxy to vote the System's interests.

  (2) Board of Directors Representation: As circumstances dictate, CalPERS may ask to retain the right to have an independent representative or representatives of the System appointed to a portfolio company's Board of Directors.

- Visitations Rights - As circumstances dictate, CalPERS will obtain the right to attend, as an observer, a portfolio company's Board of Directors meeting.

- Board of Directors Composition - As circumstances dictate, the System should obtain agreements as to the composition of a Board of Directors, including guidelines on the number of outside Directors and the composition of key committees.

- Special Voting Rights - As circumstances dictate, CalPERS will obtain special class voting rights with respect to specific corporate governance matters such as proposals deemed contrary to the System's interests, for example, as in the case of hostile takeovers.

Other Information on Co-Investments and Fund-to-Fund Investments

Given the size of institutional investors such as CalPERS and CalSTRS, fiduciary duty dictates that these funds must carefully consider whether investment opportunities are of the size and scope to materially benefit the investment program. These funds can provide investment opportunities which do not fit directly within its portfolio by creating private equity partnerships and co-investment vehicles.

- Annual Business Plan – The CalPERS and CalSTRS alternative investment portfolios are managed according to an annual business plan whose main business components encompass an analysis of the investment environment, a review of investment strategy, a review of diversification targets, and a resource allocation budget.

- Investment Decisions – Both CalPERS and CalSTRS require that each investment opportunity receive at least two green lights; one from an internal and one from an external investment advisor.

- Investment Authority – The Chief Investment Officer, Director of Alternative Investments, and Portfolio managers all have delegated investment authority. As a standard operating practice, individual investment decisions do not go to the board, rather they are best made by investment staff working from the investment policies approved by the board. This makes understanding the delegated investment authority parameters key to successfully accessing capital from institutional investors. Examples of delegated investment parameters for co-investments include, but are not limited to:
    - The due diligence process must be consistent with and appropriate to Alternative Investment Portfolio.
    - Maximum amount of each commitment may not exceed the smallest of $125 million, 5% of the size of the partnership, or 80% of the CalSTRS General Partner's commitment to the transaction.
    - Co-investments may take the form of equity, convertible preferred equity or a comparable instrument which provides an equity type of return.
    - Co-investments can be made alongside an existing general partner, provided the strategy and objectives of the partnership investing in the transaction are consistent with those of the partnership in which CalPERS and CalSTRS invested.
- CalSTRS Proactive Portfolio - Within the CalSTRS Alternative Investment Portfolio there is a Proactive Portfolio which includes the Urban and Rural Program and the New and Next Generation Program. Given the unique nature of these programs, CalSTRS uses Fund-of-Fund Managers that specialize within the different segments of the portfolio. New Co-investment/FOF Side-by-side investments are required to be made on the same or better terms and conditions as provided by the Partnership. The maximum amount of each commitment under delegation to staff may not exceed $55 million or 30% of the CalSTRS total commitment to that Partnership, whichever is less. The direct commitments under the Proactive Portfolio currently range from $20-$150 million.

EDM Funds with CalPERS and CalSTRS Moneys

Below are the four EDM Funds that have CalPERS and/or CalSTRS moneys which can be deployed to smaller EDM funds.

1. The **Golden State Investment Fund (GSIF)** is the second phase of the CalPERS California Initiative and is managed by **Hamilton Lane**. It seeks compelling private equity investment opportunities, both partnerships and co-investments, focused in the State of California. Their website is:
   information@gsif.com
   Golden State Investment Fund
   Hamilton Lane
   100 California Street, Suite 750
   San Francisco, CA 94111
   (415) 365-1070

2. The **Capital Link Fund**, managed by **Centinela Capital Partners**, is an independent alternative investment management firm that provides discretionary services in alternative investments, with an emphasis on discovering new opportunities, particularly emerging managers. Their website is:
   admin@centinelacapital.com

Centinela Capital Partners, LLC
Lyudmila Polupanova
152 W. 57th St., 34th Floor
New York, NY 10019
(212) 792-7552

3. The **Banc of America Capital Access Funds** manages fund-of-funds focused on underserved markets in the United States. The Bank of America California Community Venture Fund, LLC makes investments in private equity funds focused on underserved markets primarily in California across a broad range of industries. Bank of America is a national leader in investing in underserved markets, including investments in funds targeting women - or ethnic minority owned, - managed, or - targeted companies, or located in urban, rural, and low- and moderate-income areas.
http://www.bacapitalaccessfunds.com/
Banc of America Capital Access Funds
Guillermo Borda
Los Angeles, California
(310) 860-2542
guillermo.borda@bankofamerica.com

4. The **New and Next Generation Manager Fund**, managed by **Invesco Private Capital**, primarily invests in funds serving underserved markets where people and places have historically lacked access to capital. The investment mandate provides that emerging managers, generally defined as first- and second-time institutional funds, be considered for an investment. With this foundation, the fund 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.
INVESCO Private Capital
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[i] Glenn Yago, Arron Pankratz, "The Minority Business Challenge" Milken Institute and the United States Department of Commerce (2000)