



## **Public Pension Funds and Urban Revitalization**

### **California Case Study A: Private Equity CalPERS' California Initiative**

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**Abstract.** This paper argues that pension funds can earn attractive risk-adjusted rates of return on targeted private equity investments in underserved capital markets. Targeted investing is designed to achieve both a financial and social return. Fiduciary duty requires public sector pension funds to put financial obligations at the forefront of their decision-making. However these funds also have a vested interest in ensuring vibrant, healthy communities that in turn underpin employer contributions to the fund. We examine the California Initiative of the California Public Employees Retirement System (CalPERS) as a model of targeted investment. Though this initiative is in its early stages of development, we draw some implications for best practice in targeted investment from this case study.

**Keywords.** Urban revitalization, targeted investment, private equity, public sector pension funds, California Initiative.

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## Executive Summary

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While still in its early stages of development, we use the California Public Employees Retirement System (CalPERS) California Initiative to draw implications for best practice in market-based private equity investment in urban revitalization by public sector pension funds.

### **Engaging in targeted investment**

- Targeted investment usually requires a board level champion to build support at the board and with board consultants to consider this undertaking.
- Once the board agrees to ‘take a look’ at targeted investment, pension fund internal staff are often asked to commission an expert study of these investment opportunities. Generally staff chooses an outside expert they are comfortable with.
- The targeted investment external study can take as much as a year to complete. During this time both staff and board comfort levels are raised.
- Based on the outside expert report, the board will choose the asset class and level of investment most appropriate for targeted investment given their current asset allocation.
- Often staff will be asked to issue an RFP for external money managers in the asset class chosen. Board and staff will look for top quartile performers, with a track record of successful targeted investments. Co-mingled, pooled funds will be attractive to first time investors in targeted investment.

### **Best practice in targeted investment**

- Pension funds provide liquidity to a market for early risk takers, they are not market makers.
- Geographic rather than social targeting.
- Success is measured in terms of risk-adjusted rates of return.
- Boards set broad geographic targets for both internal staff and external money managers.
- Social goals are best achieved by partnering with a local non-profit organization whose purpose is to achieve social outcomes.
- Boards pick top-quartile investment vehicles and stay out of investment selection.
- Appropriate compensation packages must be developed for internal money managers of targeted investment portfolios.
- Sensitivity to emerging trends provides early mover advantage in rapidly shifting markets.
- Track records and relationships remain key to fund manager selection. As with all asset classes, top quartile investment vehicles are always in demand.
- Commingled, pooled funds with reciprocal investment capability provide good opportunities to diversify targeted investment and reduce risk. Fund of funds vehicles can also provide diversification for pension fund investors. In both cases

external money managers insulate pension funds from charges of political interference in investment selection.

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## 1 Introduction

How are communities in decline revived? This question lies at the heart of public sector pension funds' investment in urban revitalization. Investors measure success in all investments including ones targeted at urban revitalization, in terms of positive risk-adjusted rates of return. Such returns are generated by growth. The risk for the investor lies in whether the targeted area can and will grow and prosper. Successful pension fund investors find ways to take advantage of growth in untapped markets while mitigating the risk that these emerging markets pose.

As early as 1992, the California Public Employees Retirement System (CalPERS) began to target investment in the State of California as part of its overall investment policies. Most of its early investment was in real estate.<sup>1</sup> In 1998, CalPERS extended its in-state investment program to include private equity. By 2000 CalPERS added a specific focus on California's underserved capital markets. This paper presents a case study of CalPERS' California Initiative, specifically targeting private equity investment in underserved capital markets. While still in its early stages of development, we use the California Initiative to draw implications for best practice in market-based private equity investment in urban revitalization by public sector pension funds.

Urban revitalization strategies themselves have undergone a dramatic transformation over time. Initially conceived as economically targeted investments (ETIs), urban revitalization was valued as a collateral benefit exogenous to investment returns and relied on government subsidies to bridge the funding gap. This first generation of projects focused on capital preservation combined with collateral benefits as the principle aim of the investment, with acceptable low rates of return guaranteed through

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<sup>1</sup> See Case Study B "Public Sector pension Funds and Urban Revitalization – An examination of CalPERS' California Urban Real Estate Program (CURE) for a more detailed description of this program.

government involvement. By the mid 1990s first generation ETIs co-existed with second-generation projects. In these new projects, urban economic development was endogenous to the rates of return, with resulting investment risks managed through the structure of the private partnerships rather than a reliance on government guarantees. While risks were higher in these projects, so were the potential returns from investment. A third generation of urban revitalization investment projects is now being entered and is potentially the most dynamic phase along this continuum. Urban revitalization in this phase is regarded as an economic opportunity, and the investment is a pure venture capital structure determined solely by potential rates of return. The spill over from urban revitalization impact is a positive but not essential driver (Daniels and Nixon, 2003).

Most pension funds engage in urban revitalization through real estate investment. To date, unsubsidized targeted private equity investment has only been taken up by a few US pension funds with CalPERS chief among them. It could be argued that the location advantages of urban real estate are more obvious for pension fund investors than those found in private equity targeted investments. It could also be argued that the reluctance of many pension funds to participate in these targeted private equity can be attributed to both the risk characteristics and cost implications of these investments.

Barriers to pension fund targeted private equity investment remain plentiful. Private equity investments are essentially illiquid and exiting from them may be difficult, adding to their cost (Chemla, 2004; Healey, 1997). In addition, such investments may be perceived as 'more risky,' (Healey, 1997) both financially and in terms of political risk, where there is limited reward for success while failure is heavily punished. Pension funds are also concerned about the due diligence requirements for these investments, the need for expert advice, and the fact that reliable data including track records and benchmarks are difficult to obtain (Healey, 1997; Zanglein, 2001). Given that these investments are often small, the costs of such due diligence can be prohibitive, especially when measured against the potential returns from other better understood asset classes.

Pension funds that take up private equity investment in urban revitalization use vehicles that range from simple investment in a previously established external fund manager to an internally managed direct private placement of equity in a specific firm (Cross, 1992). However, most pension fund investment falls between these two extremes. Commingled funds with professional management are one of the most successful ways of structuring targeted investments. These are pooled investments run by hired outside managers in which several pension funds participate (Calabrese, 2001).

Such consortiums overcome structural barriers, by pooling the resources of several pension funds (Yago et al, 2003). This structure allows new investors to partner with other funds and diffuse the risk associated with a new investment arena. Large pooled funds provide geographic diversification with reciprocal targeting which allows for greater diversification (and risk reduction) in the targeted portfolio. Several pension funds invest in urban revitalization through a fund of funds that both diversifies the risk in this asset class and allows the fund of funds manager to select the investment vehicles. One benefit of this structure is that it insulates the pension fund from charges of political interference in investment selection.

This paper examines CalPERS' California Initiative as a best practice case study in targeted private equity investment in underserved capital markets. Section two of this case study looks in greater detail at CalPERS' involvement in underserved capital markets, while section three focuses specifically on CalPERS' California Initiative. Section four provides the best practice results that can be drawn from this case study. We conclude this paper by drawing some observations and implications that arise out of CalPERS targeted private equity program.

## **2 CalPERS' involvement in underserved capital markets**

The California Public Employees Retirement System (CalPERS) is the largest defined benefit pension fund in the United States with current assets of \$207 billion US (March 31<sup>st</sup> 2006). This plan covers 1.4 m. public sector employees and retirees in the State of California. As a defined benefit plan, beneficiaries receive a guaranteed pension based on a formula of salary and number of years worked.

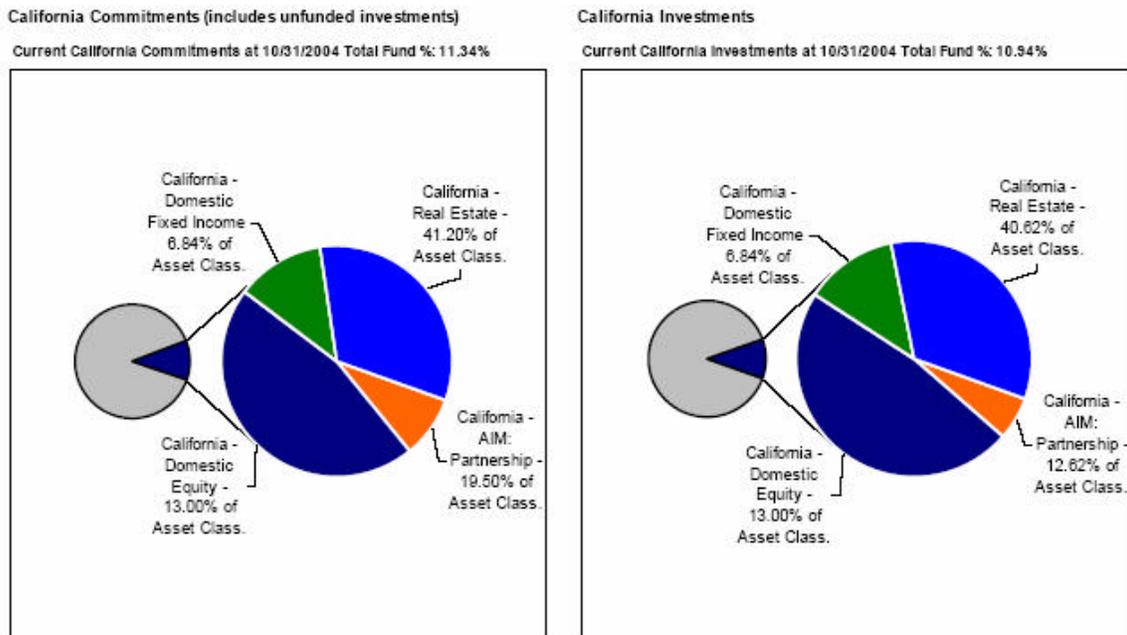
In 1992, CalPERS began to target investment in the State of California as part of its overall investment policies. This long-standing policy of CalPERS' Board began with their decision to invest \$375 million in the development of affordable single-family homes in California as part of their real estate portfolio (see Case Study B – CalPERS' Real Estate Investment for more information on this urban revitalization investment strategy).

By 2004, CalPERS' total in-state California investments were valued at approximately \$20 billion or 11% of the fund. As of October 31, 2004, 19.5% of the California-specific investments were allocated to the AIM Program<sup>2</sup>, 41.25% to California real estate, 13% to public equity headquartered in California, and 6.8% to California fixed income (see Figure 2-1). In 2004, the AIM Program had \$9.1 billion in commitments that were either headquartered in California or had a major presence in the state.

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<sup>2</sup> CalPERS' calls its private equity asset class its Alternative Investment Management Program or AIM

**Figure 1 CalPERS' commitments and investments**



Source: CalPERS' AIM Report 2004

It must be remembered that with a GDP of \$1.33 trillion, California is the fifth largest economy in the world. CalPERS' policy on risk/return criteria is clear: they do not make concessions on risk-adjusted return, on asset allocation, or on diversification guidelines (Harrigan, 2003).

Within this large in-state portfolio, approximately 2% of the CalPERS' portfolio is earmarked specifically for 'Economically Targeted Investment' (ETI) that includes private equity, real estate and fixed income investments. With full recognition of CalPERS' fiduciary duty to its plan members, the CalPERS' Board of Trustees adopted a policy statement in 2000 that clearly laid out the parameters of the ETI program. This document was revised in 2002 and again in 2004. The February 2000, four page

document titled Statement of Investment Policy for Economically Targeted Investment Program states “...an Economically Targeted Investment is defined as an investment which has collateral intent to assist in the improvement of both national and regional economies and in the economic well being of the State of California, its localities and residents. Economic stimulation includes job creation, development and savings; business creation; increases or improvement in the stock of affordable housing; and improvement of the infrastructure.”<sup>3</sup> It goes on to say that “By strengthening the State’s economy and the well being of employers, ETIs help promote the continued maintenance of employer contributions to the System.” However it is clear in the policy statement that the pension fund will not sacrifice returns to meet these objectives. “The system will consider only ETIs which when judged solely on the basis of economic value, would be financially comparable to alternatively available investments. Comparability will be judged on a risk adjusted basis with the System being willing to accept no less in return and incur no additional risk or cost.” Nor will the system take responsibility for the collateral benefits generated from the investment decision.

In 2002, the ETI policy was revised to include a major section (section V.) on “California Emerging Markets Investment Policy”. This policy further targeted CalPERS’ investments into underserved capital markets in the State. “...the objective of this policy is to discover and invest in opportunities that may have been bypassed or not reviewed by traditional, more mainstream sources of investment capital.” Such markets include rural and urban areas undergoing or in need of revitalization where there are assets (e.g. an available labor pool, underutilized infrastructure) conducive to business development. The long-term goal of the policy is 2% of CalPERS’ total portfolio (currently that would be valued at \$4 billion). This does not imply a mandate to invest in underserved capital markets “but rather should be viewed as an additional set of suggested parameters within which to consider such investment.” This 2% goal includes investment in fixed income,

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<sup>3</sup> All quotes in this and the following paragraph are taken from the Statement for Investment Policy for Economically Targeted Investment Program, February 2000, revised June 17<sup>th</sup> 2002, further revised

private equity and real estate asset classes. Despite the fact that these investments target underserved capital markets, they “...shall be priced at least at market prices and shall be subject to applicable performance measures.” These investments must also receive prudent levels of due diligence, and as part of that process “staff shall consider the current economic condition of the State of California and the prudence of committing assets to underserved areas given that economic condition.”

CalPERS’ investments in California’s emerging markets are conducted through the California Initiative, a \$500 million investment program targeting small business and emerging and developing companies in underserved urban and rural California communities. This Initiative falls under the AIM Program, which makes up about 5% of CalPERS’s portfolio. The AIM program explicitly includes a California-oriented component that is designed to take advantage of: “(i) the unique size characteristics of the California economy; (ii) the existence of a “capital gap” for certain business segments within the state; and (iii) the ability to construct a diversified array of investment vehicles that reflects the state’s large number of business entities.<sup>4</sup>”

### **3 CalPERS’ California Initiative**

#### **3.1 Engagement in targeted private equity investment**

The California Initiative moved CalPERS’ long standing targeted in-state private equity investment program toward a more focused set of investments specifically aimed at California’s underserved capital markets (also known as emerging domestic markets). Because of the perceived risks, uncertainty about the market, and lack of knowledge at the Board and staff level, this shift in focus required both a Board-level champion and an external feasibility study in order to raise the comfort level and knowledge about this market for CalPERS’ Board and staff. The Board-level champion was Phil Angelides,

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September 10<sup>th</sup> 2004.

California State Treasurer, who used his Board position at both CalPERS and CalSTRS (the California State Teachers Retirement System), as well as his role as Treasurer, to advance the ideas associated with investment in underserved capital markets.

In May of 2000, Angelides released a thirty-six page report, “The Double Bottom Line: Investing in California’s Emerging Markets”<sup>5</sup> that detailed the advantages of investment in California’s underserved capital market. Drawing on Michael Porter’s work at the Harvard Business School, he outlined the competitive advantage of these communities. He reinforced CalPERS’ and CalSTRS’ decision to enter these markets with corresponding programs at the California State Treasury. Angelides was successful in persuading fellow Board members to look seriously at investment opportunities in underserved capital markets.

While Angelides provided the catalyst for the California Initiative, the CalPERS’ Board and staff needed additional outside resources to assure themselves of the validity of this approach for the pension fund. The California Initiative was to be part of the private equity asset class or AIM program at CalPERS. In 2000, CalPERS’ Board asked staff for a detailed external, expert study of AIM including its targeted commitment to underserved capital markets. CalPERS’ staff turned to McKinsey Consultants for such a study. This step allowed time for both investment staff and board members to become more familiar with underserved capital markets, and to be reassured that outside experts agreed there were indeed untapped investment opportunities in these markets.

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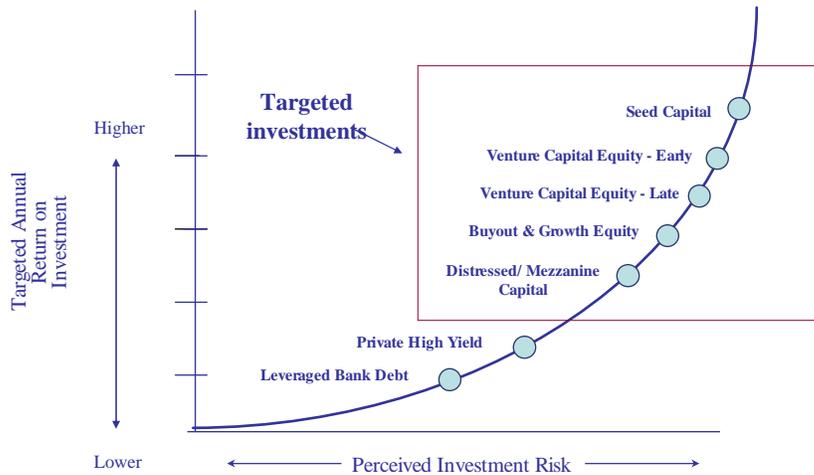
<sup>4</sup> From the Alternative Investment Management Program Quarterly Review Executive Summary, September 2004, <http://www.calpers.ca.gov/eip-docs/investments/assets/equities/aim/private-equity-review/qtrly-perf-review.pdf>

<sup>5</sup> “Double bottom line” investments are those with both financial and social returns. This is a reference to investments (such as ETIs) that both achieve acceptable risk-adjusted rates of return and achieve some type of social collateral benefit as well; for instance, creating jobs or affordable housing in a low-income area (Daniels and Nixon, 2003).

The whole CalPERS' private equity asset class was itself a young portfolio, having been started in 1990 and having an average age of 4 years for its investments. The portfolio as a whole was unrestricted in its investment locations. Overall this asset class had an asset allocation target of 7% of CalPERS total portfolio.

**Figure 2 Types of private equity investments**

## Types of Private Equity Investments



Version 2.0

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Source: CalPERS' AIM Program Report 2002

By June of 2000, the California Initiative was approved by the Board as part of the Economically Targeted Investment Program, opening up the search for suitable investment partners for this program. Its mission statement (adopted May 2001) reads: "The California Initiative will invest in traditionally underserved markets primarily, but not exclusively, located in California. The objective is to discover and invest in

opportunities that may have been bypassed or not reviewed by other sources of investment capital.<sup>6</sup> Initially sixty-seven firms responded to CalPERS' RFP (Request for Proposal) for the California Initiative. CalPERS' staff and consultants went through a process of rigorous due diligence. By May of 2001, ten private equity firms<sup>7</sup> were selected to partner with CalPERS in this endeavor and a capital commitment of \$475 million was allocated to the Initiative.

### **3.2 Targeted investment fund managers**

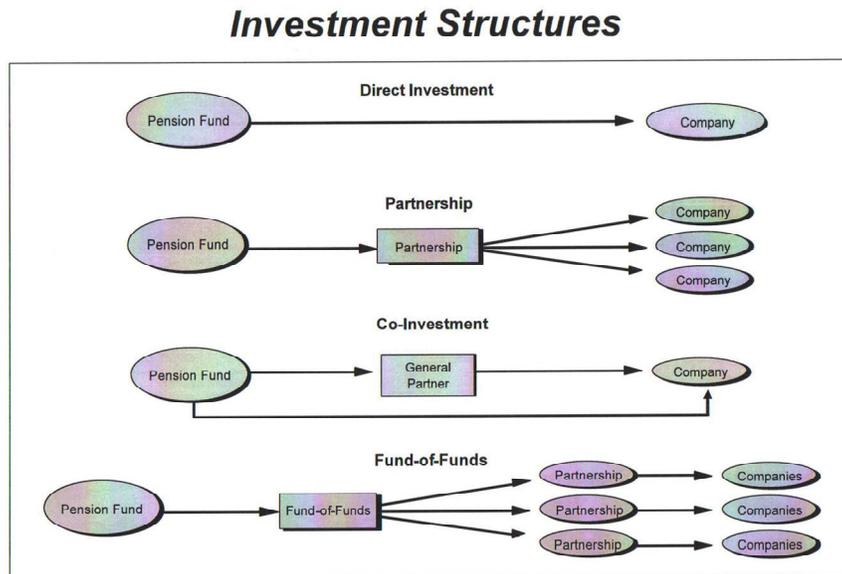
CalPERS uses multiple fund managers in order to cover a range of strategies, such as: corporate partnerships; co-investments; fund of funds; funds that target minority-owned enterprises; etc. (Yago et al., 2003). Although CalPERS structures its investment partnerships in a number of ways, in all cases it looks for the partner vehicle to also invest their own capital in the project.

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<sup>6</sup> From California Initiative Program: Investing in California's Underserved Markets, November 2004

<sup>7</sup> American River Ventures; Bank of America; DFJ Frontier; Nogales Investors; Garage Technology Ventures; Green Equity Investors; Opportunity Capital; Provender Capital; Pacific Community Ventures; and Yucaipa Companies

**Figure 3 Investment structures**



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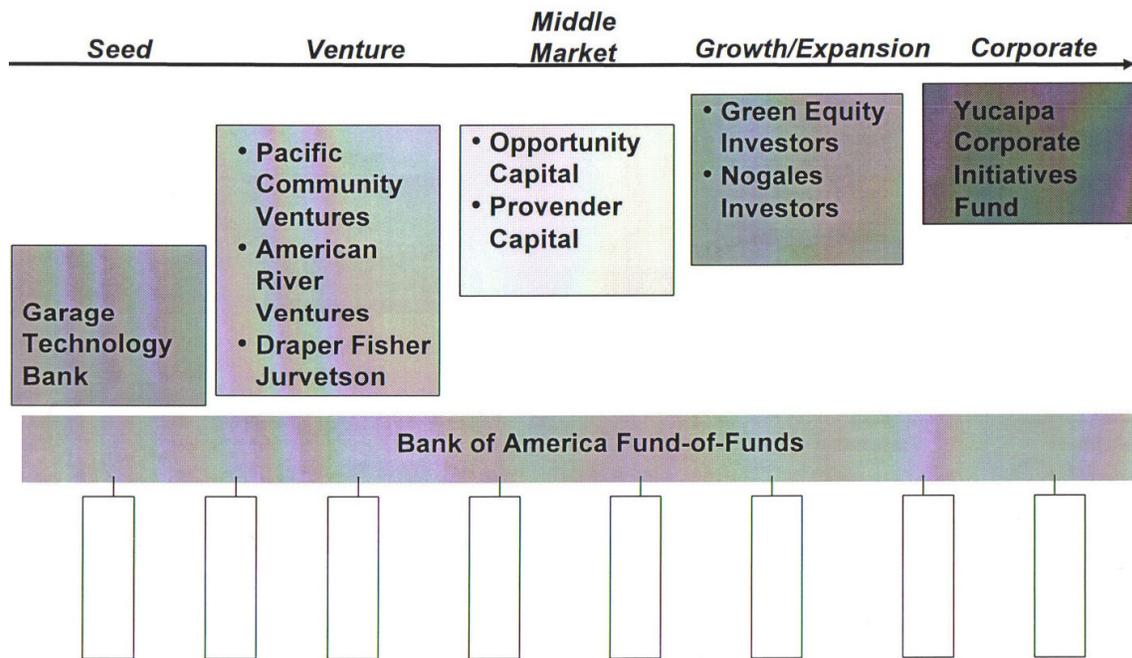
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Source: CalPERS, California Initiative Program Report, July 2003

The largest investment was and still is with Yucaipa Corporate Initiatives Fund, with an initial capital commitment of \$200 million. The second largest commitment was to Bank of America Capital Access Funds at \$100 million. Three funds were already existing general partners (GPs) of CalPERS, while several others were new, innovative small funds with whom CalPERS was prepared to partner (see Figure 3-3). Most of these investments were small by CalPERS' standards, between \$10 and \$25 million. Given that the due diligence required is the same as that for a large investment it was important that the AIM investment staff shared the Boards commitment to the program. The investment funds themselves covered the spectrum of private equity from early stage seed

funds to corporate funds. As of November 2004, \$230 million of the \$475 million committed was invested. By June 30, 2005 these funds had invested in eighty-three companies.

**Figure 4 Investment partners by private equity type**



Source: CalPERS, California Initiative Program Report, July 2003

Not only are the investment partners providing different structures and private equity investment styles, they are also geographically dispersed. As of June 30, 2005 Banc of America California Community Venture Fund (BACCVF) invested in eight private equity funds with two additional commitments. Two thirds of these investments were with funds that ‘focus on identifying, evaluating, and investing in ethnic minority opportunities.’ Half of the funds concentrate on opportunities in or employing people in low-to-moderate income areas. Eight of the ten funds have at least one woman or ethnic minority partner. Eight of the funds have offices in California.

For the remaining nine investment vehicles, forty-eight of the reported sixty-eight investee firms (71%) were in California.<sup>8</sup> Approximately 40% of California employees of these firms live in economically disadvantaged areas of the state. In all cases CalPERS' expectation is that the partner vehicles work closely with community and economic development groups as well as city, county, state and federal agencies.

Key criteria that determine investment decisions in underserved capital markets by these investment funds are:

- 1) That the company is located in a region with limited access to investment capital.
- 2) That there is diversification of company management (either women or ethnic minority).
- 3) That the company employs workers from low and moderate income areas.<sup>9</sup>

### **3.3 Impacts**

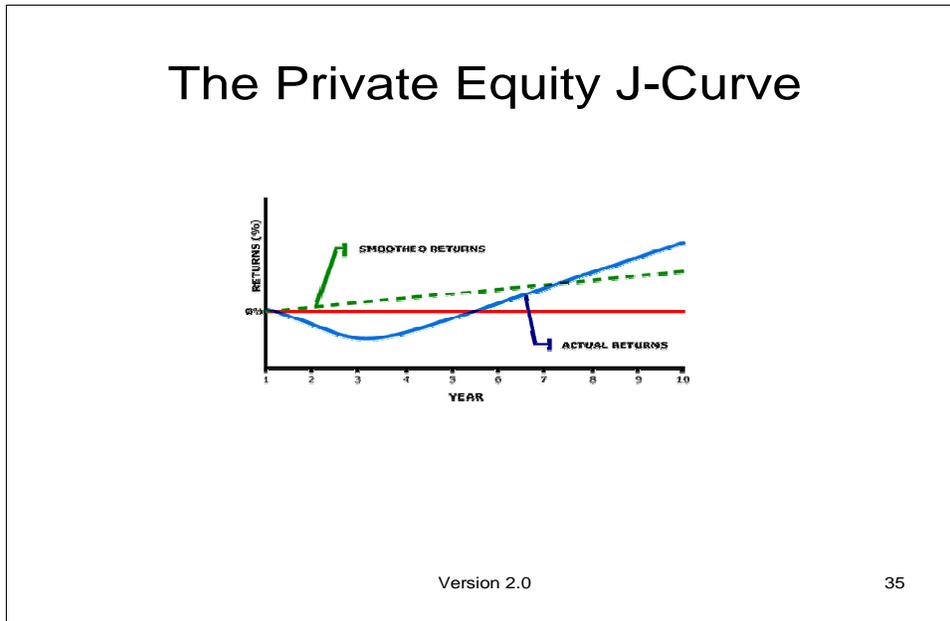
The California Initiative is in its early stages of growth. Much of the capital allocation remains to be invested. The impact on California's underserved capital market is already noticeable. The \$500 million of CalPERS' capital allocation has leveraged commitments for a further \$725 million from other investors. The role of CalPERS as the lead (or first) investor is key. Because most of the investments have not been fully realized (i.e. CalPERS' has not exited from the investments), they are at the early stages of the J-Curve (see Figure 3-4). In the early years, private equity funds will show low or negative returns due to the management fees & expenses and the fact that investments will not yet have been exited. However, investment gains are achieved in later years when the companies have matured and returns can be realized. This is known as the J-Curve effect.

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<sup>8</sup> All data is based on the report "Impacting California's Underserved Communities: An Initial Assessment", 68 of 77 companies responded to this survey with data as of June 30, 2005. Percentages are based on the 68 companies that responded. Banc of America Fund of funds data was reported separately in this report.

<sup>9</sup> Low and moderate income (LMI) areas are defined as 50% and 80% of median income respectively.

Figure 5 Private Equity J-Curve



Source: CalPERS' AIM Program Report 2002

By September 30, 2005 the annual returns on investment of the full California Initiative (now four years old) was 16.3%, well within the 15 to 20% range CalPERS is aiming for. Given that that we are still in the early stages of the J-curve we can expect significant performance as they mature. Table 3-5 demonstrates the impact of recent vintage years on the private equity portfolio. Within the California Initiative, as of Dec. 31<sup>st</sup> 2004, deals exited with cash out equals \$66 million out of \$220 million invested. Fully \$55 million comes from the Green Equity Investors, a long time partner of CalPERS dating back to 1994.

**Table 1 California Initiative preliminary investment returns**

Fund Description	Vintage Year	Capital Committed	Cash		Cash Out & Remaining Value	Net IRR	Investment Multiple
			Cash In	Cash Out			
American River Ventures I, LP	2001	15,000,000	6,000,000	19,114	3,090,648	-29	0.50x
Banc of America Community Venture Fund	2003	100,000,000	4,227,555	0	932,809	-97.2	0.20x
DFJ Frontier Fund, L.P.	2002	20,000,000	5,000,000	0	3,674,877	-23.4	0.70x
Garage California Entrepreneurs Fund, LP	2002	10,000,000	4,000,000	0	3,541,989	-7.5	0.90x
Green Equity Investors II, L.P.	1994	75,000,000	73,658,793	55,461,719	146,609,912	14.7	2.00x
Nogales Investors Fund I, LP	2001	25,000,000	9,979,218	811,243	9,152,636	-12.4	0.90x
Opportunity Capital Partners IV, L.P.	2001	25,000,000	16,169,292	2,566,256	10,811,175	-19	0.70x
Pacific Comm Ventures Invest Ptrs II	2002	10,000,000	4,691,409	0	4,468,173	-3.7	1.00x
Provender Opportunities Fund II	2002	25,000,000	11,826,350	3,338,507	5,634,347	-36.1	0.50x
Yucaipa Corporate Initiatives Fund I, LP	2001	200,000,000	81,680,687	55,963	72,061,955	-15.6	0.90x

Source: CalPERS, AIM Program Fund Performance Review, Dec. 31 2004

Note: Internal rates of return (IRR) and multiples are not meaningful in the early years of a fund nor are they indicative of future performance.

Note: Cash in is the current amount invested, while cash out indicates investments that have been exited.

Beyond rate of return there are a range of ancillary benefits that accrue from the California Initiative. In the June 2005, CalPERS' commissioned a report on the California Initiative assessing the ancillary benefits of these investments. Pacific Community Ventures, LP Capital Advisors and CalPERS developed a set of metrics designed to measure the California Initiative's performance on 1) providing institutional equity capital to areas that have historically had limited access to such funds; 2) employing workers living in economically disadvantaged areas of California; and 3) supporting women and minority entrepreneurs and managers. Of the 68 reporting

companies, 65 met at least one of the three key criteria, 39 met two of the benchmarks, while 18 met all three.<sup>10</sup> In total, 51 companies were located in underserved capital markets, representing over 70% of the California Initiative investment portfolio. Within California, 34 companies were located in areas traditionally underserved by capital markets. This stands in sharp contrast to the fact that over 30% of all venture capital invested globally from 2000 to 2005 was concentrated in 100 postal codes.

The June 2005 report estimated that over 2,000 jobs have been created as a result of the California Initiative. These investee companies employ approximately 5,000 Californians, 40% of California residents employed by these investee firms (2,000 individuals) live in economically disadvantaged areas of the state

**Table 2 California Initiative impact on underserved markets**

Impact on Underserved Markets	Benchmark Criteria		
	Limited access to capital	LMI workforce	Women and minority
48 California Companies	34	26	29
68 Total CI Companies*	51	39	32

\* of the 68 reporting companies

Source: CalPERS, Impacting California's Underserved Communities: An Initial Assessment, June 2005

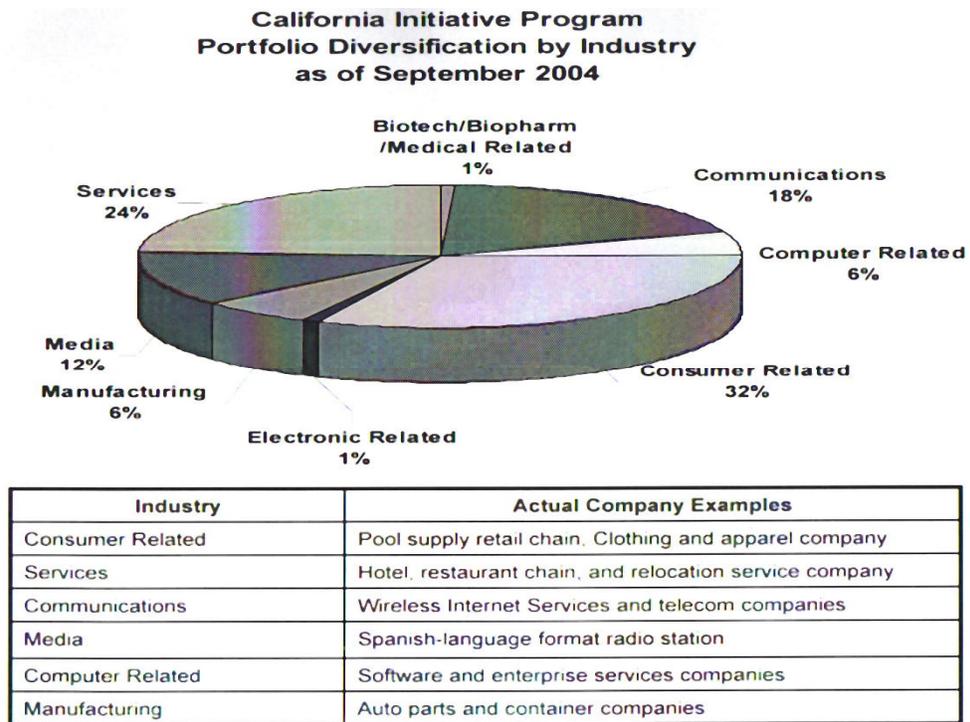
<sup>10</sup> The report "Impacting California's Underserved Communities, June, 2005 does not include data for 7 investee firms in Banc of America BACCVF portfolio which are reported separately, nor does it have data on 8 firms that did not report.

These investments have varying structures and represent a wide diversity of industries<sup>11</sup>. For instance, the Bank of America Capital Access Funds is actually a fund of funds which is diversified across a wide number of industries. On the other hand, the Pacific Community Ventures Investment Partners (PCV) fund is a hybrid organization with a for-profit investment fund arm and a non-profit workforce development arm. PCV directly invests in businesses such as Evergreen Lodge, a San Francisco lodging business that also has the social goal of helping at-risk Bay Area youth to develop stable careers and lives. Another Pacific Community Ventures investment is in Beacon Fire & Safety, which provides sales and service of fire safety equipment while employing low-income workers from at least six different communities in California. Provender Capital has provided financing for Carver Bancorp, Inc., the largest African-American operated savings bank in the United States. In 2002, Yucaipa invested in a restaurant chain called Picadilly Cafeterias, Inc, which was facing bankruptcy, and would have gone out of business without the Yucaipa investment. The investment impact is significant in the number of saved jobs. Picadilly Cafeterias' workforce is made up of 65% minorities and 74% of the restaurants are located in underserved communities.

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<sup>11</sup> The information in this paragraph comes from the websites of the participating funds (<http://pacificcommunityventures.org/portfolio/>; <http://www.provender-capital.com/portfolio.html>; [http://www.fbheron.org/stories\\_03\\_part3.pdf](http://www.fbheron.org/stories_03_part3.pdf); <http://www.bacapitalaccessfunds.com/portfolio/index.asp>)

**Figure 6 California Initiative portfolio diversification by industry**



Source: CalPERS, California Initiative Program Report, November 2004

#### **4 Best practice implications**

It is important to understand that the role of pension funds should not be to create the market in which they invest. Pension funds, given their fiduciary duty, are inherently conventional in their investment policies and do not take the kind of risks required of early market makers. Pension funds provide liquidity in markets and exit opportunities for individuals and organizations that engage in early risk-taking. To be successful, investing in targeted private equity must be a profitable endeavor.

The most important best practice drawn from this case study is that success in pension fund investment in urban revitalization is measured in terms of the risk-adjusted rate of

return rather than social impacts obtained. To paraphrase Lowenstein (1996), “we manage what we measure.” Such focus allows the fund managers to meet their fiduciary responsibilities without distraction. This is also the best way to benefit the community, since theory suggests that, by filling capital gaps, the investor should both receive excess returns and support economic development. If the investor does not receive an appropriate return, it may be that they are not filling a true capital gap (i.e. a gap that an efficient market would have funded), but are instead investing in projects that an efficient market would have left unfunded. Calabrese (2001) lists the comparability of fund returns to an appropriate benchmark as one of the common characteristics of leading successful alternative investment programs. CalPERS does not make concessions on risk/return criteria (Harrigan, 2003).

Another best practice is the use of broad geographic rather than social targeting. This allows the fund to focus on diversification and return, by allowing for some flexibility in the way it meets social goals. CalPERS’ does not distort established asset allocation and geographic diversification guidelines in order to achieve their social goals (Harrigan, 2003). Investment managers are more likely to pick deals with stronger business plans and greater chances of financial success if they are unencumbered by the need to achieve social rather than geographic targets. One must assume that if the appropriate geographic target has been identified and if the business is successful, ancillary benefits to the community will follow. Social goals are best achieved by partnering with a local non-profit organization whose purpose is to achieve social outcomes, rather than the pension fund becoming engaged in the delivery of social outcomes.

The role of the board in this process is to set broad policy directions or targets. Boards should instruct staff to ‘take a look at ...’ or ‘do more of ...’ certain targeted investments. As suggested above, a geographic focus is more likely to yield success than targeting social outcomes. Boards should not drive the deals, but rather target the end goal.

We find trustee boards are often sensitive to emerging trends within the community at large and convey these trends to internal staff and external fund managers. As a result the pension funds are often positioned with an early mover advantage in rapidly shifting markets. This is certainly the case for CalPERS when early investments in Latino companies paid off handsomely.<sup>12</sup>

For internal investment staff, the structure of the compensation packages for targeted investment portfolios is important for success. These investments are often small and illiquid, yet require the same or greater due diligence on the part of internal staff as that needed for larger deals with bigger and faster payouts. It is not uncommon for internal money managers to look at a hundred or more targeted investment deals in order to pick just one. Without economies of scale targeted investing can be costly.

There are also best practices in terms of the way pension funds structure their targeted investments. Partnering with private equity general partners allows fiduciary concerns to be addressed by confirming that risk-return goals, diversification, and due diligence are being appropriately dealt with. We find targeted investments no different than all private equity when it comes to choosing external fund managers and general partners. Track records and relationships are key, and as always, top-quartile performers are in demand. While it is important to avoid having too little in-house oversight, it is equally important to avoid having too much oversight. Once selected, external money managers must be sensitive to the targets set, but potential rates of return must be the overriding consideration in investment decision-making.

One best practice that many successful alternative investment programs use is that of geographic diversification through reciprocal targeting. This allows pension funds to invest a sum of money in a diversified portfolio with the understanding that the same

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<sup>12</sup> Early recognition of the growing Latino markets in California and indeed nationally, paid off in ‘home run’ investments for CalPERS’ in such firms as Delimex, Telemundo and a variety of Latino radio stations.

amount of money will be invested, from the broad portfolio, within their geographic area. Commingled funds with professional management allow for pooling of capital by the pension funds and can help reduce costs and increase economies of scale, while at the same time allowing for direction by professionally hired management. This strategy also insulates the pension fund from charges of political interference.

## **5 Conclusion**

CalPERS undertook the California Initiative as an intentional investment strategy to achieve both a market risk-adjusted rate of return and invest in California's underserved capital markets. While this program is still in its infancy, CalPERS hopes to generate positive returns from its long-term investments by being early entrants into these markets. Additionally the fund hopes to strengthen the economic health of California and by extension to underpin the ability of employers to maintain their contributions to the pension plan. Finally, CalPERS believes that economically vibrant and healthy communities indirectly benefit the pension plan, its members and retirees.

The California Initiative is a new program, and the investment portfolio is still young. As of September 30, 2005 its four-year old program gained 16.3% annual returns on investment. This return is well within the 15% to 20% that CalPERS hopes from the program. It is expected that once the whole California Initiative portfolio reaches maturity, it will be returning results comparable to CalPERS' private equity portfolio (AIM) as a whole.

CalPERS' total investment in the California Initiative is \$500 million, representing 0.25% of CalPERS' total portfolio. CalPERS' investment officers bring a long-term investment horizon to this asset class and feel strongly that Board level sensitivity to these markets allows CalPERS first-mover advantage, entering the market ahead of other investors and as a result capturing significant returns. This has certainly been the case

with CalPERS' other targeted program, the California Urban Real Estate Program (CURE) with a performance since inception IRR of 22.2% (PCA, 2005) see Case Study B for more detail.

While financial concerns are the primary drivers of any investment decision-making, CalPERS' targeted investments have delivered significant collateral benefits that strengthen the economic underpinnings of the State. These collateral benefits are measured in greater employment, opportunities for women and minority-owned businesses, increased affordable housing, and stronger and healthier communities.

As a public employee pension plan, CalPERS is aware of the political climate in which it operates. When asked, almost all Board and staff of the fund say that the California Initiative will be judged by the financial returns it generates over time. In order to ensure out-performance, CalPERS is extremely careful in its investment manager selection process and looks for managers with known track records of success. As a consequence it is hard for new investment vehicles to receive CalPERS' funding.

The biggest obstacle facing the fund will be the patience required for long term results to be achieved. As several pension fund officials have stated, there is limited reward for success in non-traditional investment decisions, while failure is heavily punished (primarily through negative media attention). This is particularly challenging when CalPERS is required by law to post publicly its quarterly performance results for all private equity investment managers.

CalPERS has chosen a deliberate targeted investment strategy focused on California's underserved capital markets. It is still too soon to judge the California Initiative in terms of its financial contribution to the pension plan. This remains to be seen in years to come. Though the California Initiative is a young investment program we feel this case study allows us to draw some good examples of best practice.

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