CALPERS Presentation from "Capital That Works Conference"

Economically Targeted Investments:
Doing Well and Doing Good

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Thank you Shirley for that very kind introduction. I am honored to be here, to be a part of this important conference, and address an approach that is near and dear to me -- economically targeted investments.

When Bill Crist, President of CalPERS Board of Administration, asked me to speak at this conference some months ago, I accepted without hesitation. I want to convey a strong, positive message about this subject.

Ladies and gentleman, economically targeted investments are profitable. ETI opportunities, when properly identified and sought out, can be prolific. And they, without question, have a proper place in your investment portfolio.

There is a growing interest in labor, management, and public policy circles about the role institutional investors could play in the Canadian economy. Indeed, pension funds form the second largest pool of capital in your country's financial system, after the banks. And some of you may be unsure of how ETIs could work in Canada. Nancy Riche and Nancy Hughes Anthony commented on some of the obstacles you face. And yes, it may require that you go seeking out these opportunities, and that you conduct thorough due diligence to ensure that these investments can stand on their own. But I am convinced that the benefits are well worth it.

In the next 30 minutes, you'll see why I am an unabashed believer in economically targeted investments.

I will share with you the nature and focus on our policy on economically targeted investments, our commitment to such investments, and the reasons we are able to make them. Together, we will explore the methodologies CalPERS uses to maximize returns and minimize risks.

And I'll provide some examples of investments we have made in our private equity and real estate asset classes -- in the hope that you will be able to use our experience as a guide.

Economically targeted investments (ETIs) are most commonly defined as investments "designed to produce a competitive rate of return commensurate with risk as well as to create collateral economic benefits for a targeted geographic area, group of people or sector of the economy."

Some investors will argue that ETIs are no more than "social investments" which would not be made by prudent fiduciaries because they are based partially on considerations other than those in the immediate best interests of the assets.

It is clear to us at CalPERS, however, that the present and future financial health of our trust fund is inextricably linked to the economic health of California.

Beyond the obvious microeconomic analysis that is required to make specific investment decisions, isn't it also necessary for us, as prudent fiduciaries, to simultaneously consider macroeconomic conditions? I believe the answer to that question is a resounding yes! It is also necessary to consider macroeconomic *implications* of our investments.

In other words, it is not just acceptable to consider what are referred to as the collateral economic benefits of any investment, it would be *imprudent* not to include such considerations in the investment decision making process.

CalPERS Board of Administration adopted an ETI policy in April 1993. The geographic area of focus in the policy's definition is, of course, California.

Our policy spells out the parameters. For example, for the sake of an ETI, we will not make a concession of risk and cost adjusted return. We won't distort established asset allocation and geographic diversification guidelines, either.

We don't have a separate ETI asset class with a specific asset allocation or a separate target rate of return. There is no downgrading of investment quality contemplated, implied or assumed. Rather, ETIs can be in any asset class as long as they can be made with risk-adjusted market rate of return expectations.

After an ETI can demonstrate the investment meets the Board's duties under the California Constitution, we can consider the benefits of the investment in this order

- the CalPERS members
- residents of the State
- investments that benefit, support or create jobs for residents of the State; and
- investments that address the economic and social need of U.S. residents with unique major representation in the State.

As a practical matter, the impact of this policy has been and probably will continue to be in just two asset classes — private equity and real estate.

Tomorrow morning, you will hear about some current research that has been conducted by the Canadian Labour and Business Centre. CLBC has compiled some cases studies on innovative investment strategies for pension funds designed to have high investment returns and economic impacts.

CalPERS venture capital investment vehicle, called California Emerging Ventures, is highlighted in this research.

Tonight, I would like to share with your other examples to help you fully appreciate the financial soundness and the potential benefits ETI investments have in California. I want to talk about four examples of ETIs in the private equity arena which I believe demonstrate their value.

Example #1.

In 1997, we were approached by a rapidly growing producer and distributor of high quality, frozen ethnic foods — Delimex, a company with $27 million in revenues and $15 million in cash flow.

The company was founded in 1984, and was headquartered in San Diego with manufacturing facilities in San Diego and Monterey, Mexico. They were the leading supplier of frozen taquitos, tamales, and rice bowls to two large California wholesale foodchains.

It looked like a good investment, when you consider that ethnic foods are among those in the fastest growing market segment of the frozen food industry. In fact, Mexican food is replacing the hamburger as the third most popular hot food for school lunches.

Delimex had a proven track record in its warehouse club market, it had been well managed, and to expand, obviously, it needed a partner.

So we invested $25 million - $5 million as a co-investment and $20 million with Fenway Partners, a New York-based private investment firm. As a result, Delimex was able to expand adding a 122,000 square foot production plant and they have subsequently added two new additions. The company doubled sales to over approximately $160 million dollars and tripled profitability.

Good for them. Good for the San Diego economy. And I think you will agree really good for our trust fund.

They were phenomenally successful, and have taken the company to an even higher level of expansion. Last month, Delimex was purchased by H.J. Heinz. We sold off our $25 million stake in Delimex last week. The sell off was valued at $63 million!

A win/win: for them, for San Diego, for California, and for CalPERS.

Example #2.

The opportunities aren't just in San Diego, or Los Angeles or San Francisco. My second example is a company based in a blighted area of downtown Oakland, California.

In October 1999, we took a $50 million investment in a company called Zhone Technologies. Not a household word since it started up in 1999, but take my word for it, it is likely to be as big as an IBM or Microsoft some day.

With the evolution of the Internet, the demand for faster, higher quality communication networks is resulting in a massive growth and change for the telecommunications equipment industry. As you know, the average home has multiple incompatible networks for phone, voice, internet. They are built by competing suppliers, resulting in a lack of choice, high prices and multiple bills for the consumer.

There are many companies focusing on building equipment for the next generation core of networks. While the backbone networks are becoming fast, the next “holy grail” is technology-agnostic “last mile” equipment. “Last mile” is that part of the network from the switching center into your home or business.

Zhone is focused on becoming the industry leader in that “last mile” access equipment segment.

When we were approached to join others in financing this ambitious strategy, we were attracted to the fact that it could revitalize jobs in a downtown urban area, and had the potential for literally hundreds of new jobs. But it mostly was an opportunity with an excellent return/risk ratio.

Our investment in Zhone comes with a strong alignment of interest. The management team contributes $30 million and they agreed they would receive no value from the company until the investors received two times the money or approximately a 30 percent internal rate of return.

Today, Zhone Technology — who met with us in 1999 with nothing more than an idea on a flip chart -- has three new buildings in downtown Oakland. It stands tall and proud in the re-development district of Oakland, takes advantage of local re-development tax breaks, has 500 employees, and $100 million in revenues. Zhone even enjoys an exit off the major interstate with the company's name.

It is forming technology alliances with a variety of communications hardware and software vendors to speed its time to market with products that extend intelligence through the local access network including Ericsson, Hughes Electronics, Qwest and Texas Instruments.

Example #3

My third example is quite unique and one that I'm very proud our Board supported. This is not just one investment, but rather an investment vehicle. We call it The California Initiative.

Last summer, our private equity staff came to the Board with a proposal. They wanted to invest $500 million in an "underserved market" located in California. Now the term "underserved market" may not sound appealing and you might wonder how you can make money in an underserved market. But what I mean by the term “underserved markets” is an urban and rural area that has limited access to needed goods and services.

You see, our staff found that underserved markets largely offer companies untapped assets such as large labor pools, low real estate costs and underutilized infrastructure. Potentially, they are a gold mine for companies wishing to expand and grow and tap underutilized resources.

There are unmet needs in California’s urban and rural markets and we believe our initiative represents a golden opportunity for CalPERS and the state. We could get superior returns for our Fund and our members while fueling the growth of jobs, businesses, and stronger communities.

CalPERS Board agreed with the concept and our staff sought out to find firms that could make this happen. Earlier this summer, our staff recommended that The California Initiative use five different investment approaches, each employing a different type of partner. These five are corporate partnerships, investments through already established CalPERS’ general partners, mid-sized private equity funds, fund-of-funds (a fund that invests in other funds), and innovative new funds that focus on smaller companies and venture opportunities.

We hired 11 private equity firms for The California Initiative and their investment strategies cover a broad range. For example, we gave $200 million to Yucaipa Corporate Initiative Fund, a firm run by Ron Burkle.

Yucaipa is renowned for its ownership role in grocery chains such as Fred Meyer, Ralph’s, Food 4 Less, and Dominicks. The firm has been able to unlock value by adding operational expertise, unique partnerships and managerial oversight. Ron is also well regarded by unions and company management for his track record of adhering to fair business practices.

Yucaipa’s role in The California Initiative will be to build corporate partnerships with retail, distribution, food, manufacturing and commercial product companies that are interested in expanding operations in underserved communities.

On the other end of the scale, we gave $10 million to American River Ventures. American River Ventures is located just outside of our

State's capital in Folsom, California. Their investment focus is to target new and start-up companies in the area located between San Francisco and Reno, Nevada.

American River believes there are attractive investments in Central California for two reasons:

- There are an increasing number of high technology start-up companies in the targeted area: and

- The region is served by many "angel" investors — a few local branch offices of multi-state venture capital firms, and a few small local venture firms that have access to limited resources.

These angel investors have acted as the primary source of capital in this area, and American River Ventures hopes to capture part of the market segment.

Example #4

This next private equity investment takes advantages of business strengths that already exist in California -- in biotechnology. In fact, biotechnology was invented in California.

In the late 1990s, biotechnology was the most underexposed area ripe for investment in California. But between 1992 and 1999, no one wanted to touch it. And while many folks were investing in dot coms, we were quietly researching the strengths of investment in this area. What did we find? -- the industry needed long-term patient capital.

It was poised for tremendous growth given recent technological breakthroughs. Over long periods of time, the industry has delivered and would likely continue to deliver superior returns.

The advent and convergence of powerful new technologies — like genomics (ji-’nO-miks), bioinformatics (bi-O-in-fr-ma-tiks), and combinatorial (kam-bi-na-’tOr-E-l) chemistry -- is leading to faster discovery and development of better therapies for patients. The likelihood of development of new therapies over the next 5 to 20 years include everything from gene therapies, cell therapies, to immunotherapies, engineered tissues, and on and on.

Not to mention the aging population, which will require or desire safer, more effective therapies to treat conditions brought on by old age.

So, we worked carefully, methodologically over an entire year to find an appropriate and successful way to participate. And in June of last year, we approved a biotechnology allocation of up to $500 million.

Our biotechnology fund is set up to develop partnerships with leading pharmaceutical companies and to work with leading universities as well as public and private laboratories to incubate new businesses coming out of research and development. Our goal is also to build new vehicles that other public and private investors can join, so CalPERS can participate in the economics as the vehicles grow over time.

While our fund is new, we believe the benefits to California are many- housing, jobs, secondary industries, and we hope the results will help our own members lead healthier lives.

I'd like to begin closing by giving you one final example of an ETI in our investment portfolio. I leave you with this example because it touches on a challenge that citizens of California are currently facing.

As you may have heard and read in the news, California is in the midst of an energy crisis. The energy crisis has topped the agenda for policymakers in California. Its impact has been widespread on the California economy.

At the same time, CalPERS has witnessed a very unique convergence in California's technology and real estate industries.

Technology is changing the face of the commercial real estate in market. The type, size, location and amenities of commercial real estate buildings are being driven by the demands and needs of technology companies such as Internet, e-commerce and telecommunication firms.

And we believe the convergence creates an opportunity for the System to invest in companies that develop real estate technology infrastructure and services, and in real estate assets expected to benefit from providing space or services to tenants in high growth sectors of the economy.

So last year, CalPERS Board created a $500 million program called Global Innovation Partners — a joint program between our real estate and private equity staff. We believed that we could harness the opportunities of this convergence by leveraging our real estate portfolio and the technology relationships we had through our private equity investments.

And we did. We made a $15 million investment through our new fund in a company that provides the most valuable amenity in California’s current environment — low cost energy.

The company is called RealEnergy, and they have created the largest commercial solar power system in the Western Hemisphere.

RealEnergy relies on photovoltaic (foto-vol-tA-ik) power -- essentially on-site energy systems such as solar, microturbine, natural gas engines, and other “green” power alternatives — deployed to generate electricity and heat that displaces power from central plants that otherwise would be consumed during peak daytime hours. Peak-hour electricity from our nation’s power grid is the most expensive, and most vulnerable to spikes, surges, brownouts and blackouts.

Photovoltaic power offers reliable, high quality power to today’s real estate industry that is waking up to the deteriorating reliability and increasing cost of deregulated power. It is expected to be the new perk of real estate.

In a show of confidence in our investment, we teamed up with one of our real estate partners and RealEnergy to install almost an acre of advanced photovoltaic panels that sit atop three Southern California industrial buildings. The project included Carlsbad Pointe, a 320,000 square-foot industrial property owned by CalPERS.

As an investor in California real estate, we believe the advent of office buildings using their own electricity offer us many benefits. For tenants of our building, it provides a hedge against an unstable energy market. It increases the reliability of power systems and minimizes the risk of power outages. This is especially important to today’s high technology corporations.

We’re glad that we have ventured into this area and are positioned to entertain more investments of this type. But most of all, we are proud to be a part of what we believe will be a profitable venture and hope that it will light the way to a better tomorrow for Californians.

As you can see, we have been very successful in our efforts to incorporate ETIs in our investment portfolio. What I've discussed this evening is really only the tip of the iceberg.

Today, CalPERS has more than $20 billion — or 13 percent — of its investment portfolio invested in California. In a survey of State and local government employee retirement systems conducted by the Government Finance Officers Association Research Center, CalPERS ranked the highest state retirement system investing in-state.

CalPERS capital infusion in California is far reaching and no one really knows the true impact of our investments across the State. What we do know is that our investments have brought life to more than 438 emerging California companies. More than 40 of these have gone public.

We own 41 industrial buildings, 15 office complexes, and 23 shopping centers in California. Three of these shopping centers were once dilapidated buildings in the heart of urban Los Angeles and today stand as new signs of growth and urban redevelopment. We have more than $740 million invested California corporate bonds and we are a stock owner in 750 publicly-traded companies headquartered in California.

We also know that capital helps to jump-start the economy. It helps companies grow and expand, it creates jobs, strengthens communities and stimulates the need for supporting goods and services. According to the California Technology, Trade and Commerce Agency, international investment in California topped $3 billion last year. The flow of international capital in our State created approximately 8,200 jobs. Given this statistic, one could estimate that CalPERS $20 billion investment in California created more than 54,000 jobs.

The future for ETI investment in our Golden State looks bright.

I hope I've been successful today in sharing with you CalPERS perspective on ETIs and our experience with them in our investment portfolio. As I said at the start of this evening, there's plenty of room for ETIs in a well-diversified public pension fund portfolio.

I wish you the best in your search for ETI investments here in Canada. I have no doubt that your country holds the ETI opportunities that have been afforded to us and my hope is that you will have success in incorporating them as you deem appropriate.

Undoubtedly, CalPERS will continue to seek out opportunities provided by the markets in the future. And we will do so in ways that generate favorable risk-adjusted market returns while hitting economic targets in the bull’s-eye.

Thank you. I’m happy to answer any of your questions.