Written Testimony
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By
Russell Read
Chief Investment Officer
California Public Employees' Retirement System

Chairman Baucus, Ranking Member Grassley and members of the Committee, I am pleased to provide the perspective of an institutional investor on the issue of private equity.

The California Public Employees' Retirement System, known as CalPERS, provides pension and health benefits to 1.5 million state, local public agency and school employees, retirees and their families.

A 13-member Board of Administration oversees the management of CalPERS assets, which total more than $240 billion. Our Fund began in 1932, initially investing only in bonds. Over the years, we diversified our assets into four major classes: global equity (public stocks), fixed income, real estate, and – beginning in 1990 – in private equity.

The goal of diversification has always been the same – to balance our portfolio against risk and to add value based on our ability to take advantage of market opportunities.

CalPERS Private Equity: Its Role, Performance History, and Promise

This long-term strategy has paid off over the years. Today, we are fully funded for retirement benefits and our investment returns pay 75 cents of every dollar disbursed in pensions. The remainder is split between the contributions of members and employers.

Our private equity allocation is managed by our Alternative Investment Management (AIM) Program. Over the past 17 years, we have increased our allocation to the AIM Program from 2 percent of total CalPERS assets to 6 percent, with a range of plus or minus 3 percent.

AIM investments had a market value of $17.4 billion as of July 31, 2007, accounting for 7.1 percent of total CalPERS assets. Since the Program began, we have made total commitments of $50 billion. Allocations may increase based on Board action at its scheduled November 2007 asset allocation workshop.

The role of the AIM Program is to maximize risk-adjusted returns, provide a hedge against the Fund's long-term liabilities, and diversify the overall CalPERS portfolio. This is consistent with California state law and our investment policy, which direct us to maximize returns and minimize the need for contributions from employees and employers who rely on taxpayers to make up the difference when investment returns fall short.

The record shows that private equity investments have significantly helped us to maximize our earnings and minimize contributions. As of July 31, 2007, the AIM portfolio had outperformed its public equity benchmark and the CalPERS actuarial rate in all periods.

The AIM portfolio's one-year return was 28 percent compared with its benchmark of 15 percent. Its three-year return was 22 percent against a benchmark of 17 percent. The 10-year return was 8 percent higher than the benchmark. The AIM Program's total return since inception was 14 percent compared with the CalPERS actuarial rate of 7.75 percent – the annualized gain on investment required to fund pension obligations.

More than 5,000 companies have received investment capital through our private equity program, generating more than $12 billion in cash profits to CalPERS since 1990.

Since the AIM Program began, the private equity industry has evolved and expanded. The asset class has become more global and institutional in nature. Private equity funds have increased dramatically. More experienced managers have emerged with differentiated strategies. This transformation has enabled CalPERS to build a diversified portfolio to meet our objectives. Our private equity fund managers invest across the spectrum of a company's life cycle – from its early stage, growth, and to maturity. This investment approach allows the AIM portfolio to be diversified by several parameters including vintage year, strategy, industry, and geography.

Generally, private equity is an attractive asset class to sophisticated investors like CalPERS because of the contribution it can make to an overall portfolio. This contribution is evident in historical quantitative performance and in the unique attributes of this asset class. Here are some examples:

- *High historical returns* – Private equity returns have historically outperformed those of public equities.
- *Portfolio diversification* – As an individual asset class, private equity has greater expected returns and corresponding higher expected risk when compared to other asset classes. However, adding private equity investments to a balanced portfolio can reduce total portfolio risk because their returns are not directly correlated with those of other asset classes. While each asset class carries its own risk, overall portfolio risk is

reduced. Private equity returns may be up while public equity and other asset class returns are down, or vice versa. In addition, sophisticated investors typically further reduce risk in their private equity portfolios by diversifying into different market segments (e.g., venture capital, buyouts, mezzanine debt, etc) and geographies (e.g., US, Europe, Asia, etc.).

- *Exposure to opportunities not appropriate for the public markets* – Investment opportunities such as early stage venture capital, buyouts of smaller-sized companies and purchases of distressed corporate assets are often better suited for the private equity market given their size and/or risk characteristics. These investments may offer superior risk-adjusted returns and may add additional portfolio diversification
- *Exposure to imperfect markets* – While private equity markets have become much more mature and competitive, they continue to be more opaque and difficult to understand than public markets. Yet skilled private equity managers can identify mis-priced assets and take advantage of other unique opportunities to create value.
- *Strong alignment of interests* – Private equity managers are compensated in large part through carried interest, which allocates a portion (typically 20 percent) of investment gains to the manager. This compensation structure aligns the interests of the investor directly with the manager, who in turn generally has the ability to directly influence the management of underlying portfolio companies. CalPERS seeks the same kind of interaction and agreement in its public equity program for the same reason: alignment of companies, boards, and shareowners leads to higher investment returns. The alignment process is more direct in the private than public equity sector, which involves many more shareowners voting at corporate meetings than a relatively much smaller number of decision-makers involved in private companies.
- *Structured securities and operational control* – Because private equity transactions are individually negotiated, private equity firms can optimally structure the terms of each investment to provide downside protection and/or enhance upside returns or liquidity. In the venture capital sector, examples include control rights, convertible preferred stock, liquidation preferences and anti-dilution provisions. In the buyout sector, a private equity firm may completely control management, operational strategy and capital structure strategy
- *Access to information* – Private equity investments are long-term and privately negotiated. Different than public market investments, private equity managers typically can conduct better, more comprehensive due diligence, including extensive interviews with management, review of internal books and records including budgets and projections, all prior to investing. This in-depth due diligence increases the likelihood of success and mitigates the risk of failure. In addition, after investing, private equity fund managers have contractual rights to access management reports and interim financial statements. As board members and owners, private equity fund managers preside over important board committees and

typically influence board meeting agendas, strategic reviews and other activities important to close, ongoing supervision of portfolio company activities.

CalPERS Private Equity: Process & Decision-Making

In building our private equity portfolio, CalPERS primarily commits capital alongside other institutional investors and acts as a Limited Partner or “LP” in a Limited Partnership structure, often called a “fund”. One key aspect of the private equity market is that top-quartile performing investment managers dramatically outperform median performing managers. This creates a dynamic where a proven and successful General Partner or “GP” will receive demand for their fund in excess of the fund’s targeted size.

Therefore, the AIM investment process focuses on identifying the highest potential opportunities while maintaining an “investor of choice” reputation in order to access the best funds. In each transaction, our objective is to negotiate a balanced Limited Partnership agreement that includes institutional governance and investor protections, transparency and consistency in investor communication and reporting, and a strong alignment of economic interests between the General Partner and the Limited Partners.

The overall set of partnership terms is designed to help ensure we maximize our returns and minimize our risk. Ultimately, our goal is to be a long-term investment partner with the best investment managers who will generate the best returns for our beneficiaries

In addition to our strong financial returns, we are proud of the fact that since the start of the CalPERS private equity program we have deployed approximately $23 billion in the U.S. economy and $28 billion into the overall global economy. This capital investment, alongside the investment of other Limited Partners in private equity funds, has helped create thousands of new companies and new jobs, making CalPERS and other major private equity investors major catalysts of economic growth at home and abroad. Many companies that proved to be successful investments within the AIM Program have become strong performers in our public markets group, thus creating additional value for CalPERS.

CalPERS has also developed and launched several private equity initiatives that have been designed to achieve our return objectives while also generating a variety of ancillary benefits.

For example, in 2001, CalPERS established the California Initiative Program with a $500 million initial allocation. The primary objective of the program was to earn attractive risk-adjusted returns with the ancillary benefit of having a meaningful impact on California's underserved markets. Many of these markets have been historically overlooked by traditional sources of investment capital.

The California Initiative is a good illustration of the broader impact of private equity. To date, over $357 million has been invested in 144 companies through the program. These companies employ over 5,000 Californians and over 3,000 new jobs have been created across the country. Since inception of the program, its California company investments have experienced 12 percent employment growth compared to 1 percent for the state overall. In addition 90 percent of the companies with fewer than 100 employees offer health insurance (compared with 63 percent nationally) and 60 percent of the companies have women or minority owners and/or senior managers. These ancillary benefits have been obtained while generating a 19 percent total program return and a one-year rate of return of 53 percent. A subsequent $500 million commitment was made to the second phase of the California Initiative in 2006.

Another good example of the broader impact of private equity is the Environmental Technology Program, which was launched in 2004. This program was established to invest in companies that are developing and/or utilizing solutions that are more efficient and less polluting than existing or legacy products, services, or technologies. Examples of companies that have received investment as a result of this program include alternative energy companies, advanced and green building materials companies, and green agriculture companies. Although still early, these companies may evolve over the next few years to be the leading firms that help reduce society's impact on the environment.

The AIM Program's activities are governed by the AIM Program Statement of Investment Policy as adopted by the CalPERS Board of Administration. The CalPERS Investment Committee approves the AIM Annual Plan, oversees performance, delegates decision-making to the CalPERS Investment Staff as appropriate, and authorizes those investment and other decisions which have not been delegated to Staff.

CalPERS collaborates with its consultants to develop an overarching portfolio strategy and a framework for portfolio construction. CalPERS takes both a top-down and bottom-up approach to building its private equity portfolio. This requires a mix of quantitative and qualitative analysis.

We apply a highly disciplined investment process in implementing our investment strategy. Key elements of this process involve searching for and identifying investment opportunities, applying selection criteria, conducting due diligence, negotiating terms and conditions, obtaining necessary investment approvals, and monitoring funds post investment.

A due diligence review by CalPERS staff and consultants will include the following, as applicable:

- Discussions with principals of the proposed investment;
- Review and analysis of all pertinent offering documents including: offering memorandums, subscription agreements, private placement memorandums and operative investment agreements;
- Consideration of potential conflicts of interest, if any, posed by the proposed investment and prior investments and activities of the principals;
- Review and analysis of the investment concept, including entry and exit strategies and terms including fees, principal participation, and structure;
- Review and analysis of the fit within the AIM Program, including fit with the Strategy, Annual Plan, other constraints and guidelines, and compliance with applicable investment policies;
- Background and reference check of principals;
- Review and analysis of track record including performance of prior and current investments;
- Investigation of special terms and side letter agreements with past or present investors;
- Comparison of the opportunity to existing relationships or other alternatives, including cost comparisons;
- Analysis of the strategy; and
- Review of any lawsuits, litigation involving the General Partner, its principals, employees and prior funds.

We engage appropriate third-party resources to assist in the investment process as required including lawyers, management consultants, accountants, industry specialists, traditional pension fund consultants, and investment bankers.

We give primary due diligence emphasis to the quality and experience of the General Partners in a partnership investment. Additional factors may include, as appropriate:

- Integrity of the General Partner, its employees, and other investors;
- Quality of overall partnership governance, management of the partnership, including controls and reporting systems;
- Relationship with the relevant parts of the investment community;
- Relationship with Limited Partners;
- Nature of value-added involvement with portfolio companies, that is, their ability to generate returns based on their skills and beyond trends of the private equity market, including assisting management in building value in portfolio companies
- Potential for co-investments, where we directly invest in a portfolio as a Limited Partner alongside the General Partner;
- Strength of historical investment performance;
- Workload of General Partners and their availability to make new investments and monitor existing investments; and

- Appropriateness of terms and conditions and alignment of interests with Limited Partners. CalPERS focuses on having a strong alignment of interest between the General Partner and the Limited Partners, where the General Partner's financial interests are positively correlated with the success of the fund's investments. The more money CalPERS makes on its investment, the more money a General Partner makes. If CalPERS does not achieve a predetermined rate of return (typically 8% annually), then the General Partner does not receive carried interest. This philosophy is consistent with our view on the issue of Executive Compensation in the public markets.

CalPERS Private Equity: Fees

As a Limited Partner in several hundred private equity partnerships, CalPERS is very sensitive to the economic terms of private equity investment partnerships. High fees reduce the net returns to Limited Partners. The fees that are charged by General Partners generally include management fees, and carried interest, which is a pre-defined split of the net profits of the partnership. To help align interests of the GP and the LPs, we require the General Partner to make an investment in their funds alongside the Limited Partners.

Each private equity Limited Partnership agreement involves a business and legal negotiation between the General Partner and the Limited Partners. The end result is a unique legal document that reflects the management fee calculation, carried interest participation, General Partner cash commitment and all other economic and non-economic arrangements that have been negotiated for that particular transaction. Funds focused on a similar strategy will have different terms and conditions based on a myriad of factors including fees, historical track record, team composition, and fund size.

Private equity partnerships are long-term investment vehicles, typically with 10-15 year lives. This is a distinguishing factor from hedge funds, whose investment strategies are often much more short term focused. In a private equity fund, the fund manager will make investments in companies during the "investment period", typically the first 5 or 6 years of the fund's life. The fund manager then works to exit (or "harvest") the investments over the following 5 to 10 years.

CalPERS is very focused on actively negotiating all of the terms of a private equity partnership, including the economics to ensure that its interests are protected. In particular we focus on a strong alignment of interest.

Historical performance data shows a strong correlation between past and future top-quartile investment performance in the private equity asset class. As an investor seeking to maximize returns for its 1.5 million pension beneficiaries, CalPERS is focused on investing with the very best General Partners globally.

The very best General Partners often: charge the highest fees, are over-subscribed, and are well positioned to negotiate the legal documentation. The ability for top performing investment managers to structure “premium economics,” which may include higher fees, is not unique to private equity. For example, carried interest for the very best General Partners can reach 30% of net profits compared to the typical 20%. To reiterate, fee structures are: currently variable across funds, heavily negotiated, based on a number of factors, and difficult to reduce for the very best General Partners.

A delicate balance exists for a Limited Partner like CalPERS to be successful: achieve access into the very best private equity investments, while at the same time negotiating appropriate economic incentives for the General Partner.

Due to the interrelated nature of the economics for a private equity fund, it is complicated to say generically how a change in one component will impact the total economics. As each fund is individually negotiated, an adjustment to one component will lead to offsetting negotiations on other components.

From our perspective, investment comparisons and decisions are based on net returns (after fees and expenses) to the investors. The level of fees charged by a General Partner is only one consideration in the analysis of a private equity investment opportunity. CalPERS’ historical performance indicates that on a net basis, attractive returns can be generated compared to both its benchmark and the actuarial rate providing incremental benefit to its beneficiaries from investing in the <u>best</u> private equity funds, <u>not the cheapest</u>.

We have a fiduciary duty under the California Constitution to do all we can to ensure the stability of our public pension fund on behalf of its members and California taxpayers – and to maximize investment returns and minimize contributions.

We are grateful for this opportunity to represent the clerks, custodians, technicians, safety officers, and other public employees who depend on CalPERS for their retirement security. We also are pleased that this Committee is giving this important private equity issue the full consideration and deliberation that it deserves.

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