



Investment Committee

Item Number 6 – Open Session

Subject: Investment Services – Collaborative Model 2.0

Presenter(s): Chairperson

Item Type: Consent Information

Date & Time: March 3, 2022 – 0 minutes

Attachment(s): Attachment 1 - Collaborative Model Impacts
Attachment 2 - New Investment Strategy Process

PowerPoint(s): None

PURPOSE

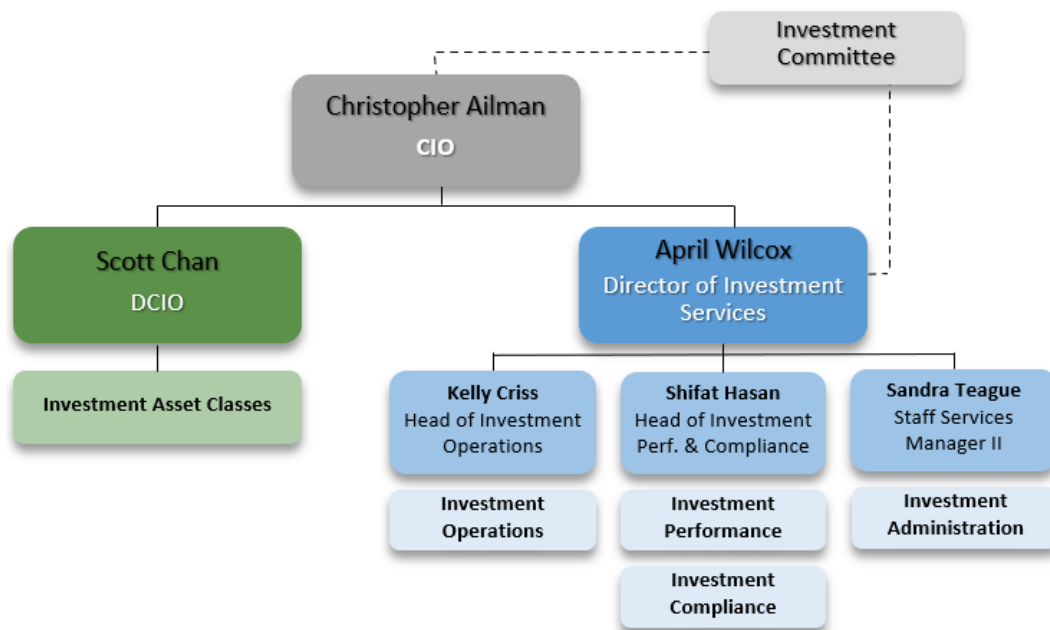
At the request of the board, this agenda item provides the Investment Committee with information on how the Collaborative Model (CM) impacts Investment Services. It provides a high-level overview of the increased complexity and additional investment operations, performance and compliance functions needed for successful implementation of the CM. The CalSTRS CM is an investment strategy to manage more assets internally - to reduce costs, control risks and increase expected returns - and leverage our external partnerships to achieve similar benefits. The CM enables and supports our mission to secure the retirement future of California's educators.

DISCUSSION/SUMMARY

On November 4, 2021, Staff presented [The CM 2.0](#) which outlined the framework and phases of the CM Continuum. The Continuum is a useful framing tool to understanding the future phase of the CM and how each phase needs to be operationalized to be successful. Throughout the phases, CalSTRS continuously reassesses and mitigates associated risks from increased complexity in critical functions such as valuation, technology, benchmark implementation, global capital markets, operational risk oversight and compliance controls. These functions, among many others, are performed by Investment Services.

Structure of Investment Services

Investment Services is managed by the Director of Investment Services, April Wilcox, who reports to the Chief Investment Officer (CIO), Christopher Ailman. Investment Services includes the following areas: Investment Operations, Investment Compliance, Investment Performance, and Investment Administration. These functions are typically referred to as “middle office.” The units within Investment Services are managed by two Portfolio Managers (Heads), and a Staff Services Manager. The Director of Investment Services also has reporting responsibility of non-compliance to investment policies, laws, regulations, and related noteworthy matters to the Investment Committee independent of the asset classes and CIO/DCIO.

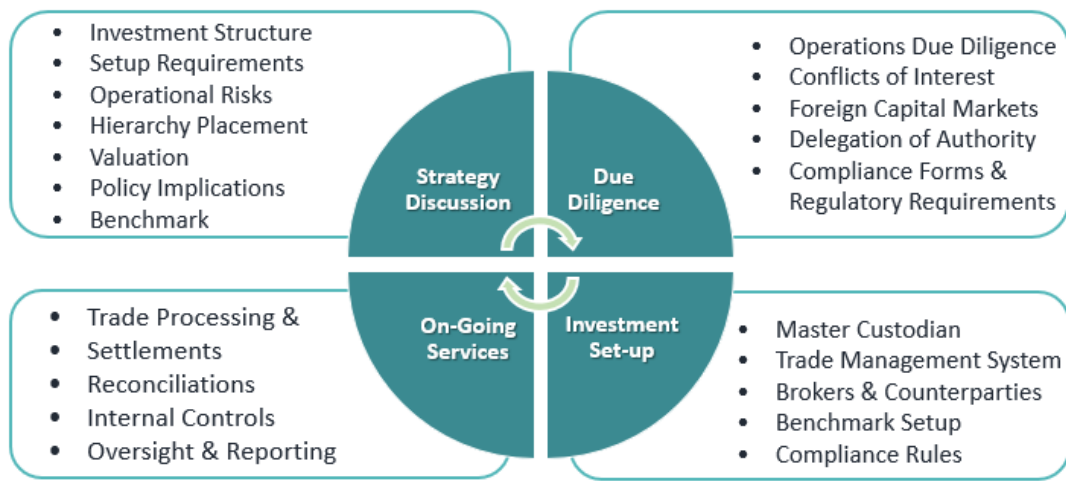


Primary Objectives of Investment Services

Investment Services is referred to as the backbone of the Investment Branch. While the asset classes make and manage investment decisions, Investment Services implements and services those investments.

They are integrated into every investment through different processes across its life cycle, from strategy discussions, due-diligence, investment initiation to the final exit/liquidation. All units within Investment Services are dedicated to not only service the investments, but also act as a critical internal control for the fund, safeguarding its assets.

Figure 2: Investment Life Cycle



In addition to investment knowledge and expertise, their success is driven by having an in-depth understanding of each investment strategy within all asset classes. This includes staying current on the complexities of new investment strategies, market news, regulations, economic outlook, and various other capital market indicators.

Below are the primary objectives and high-level functions of each team within Investment Services.

- **Investment Operations** – Provide investment strategy implementation, trade management and operational and custodial risk mitigation functions for new and existing investments across all asset classes. All trades, wires and market instructions are reviewed and approved by authorized Investment Operations staff before leaving CalSTRS to our custodian. (30 staff)
- **Investment Compliance** – Reduce business risks of the Total Fund while cultivating a culture of integrity. The team monitors investment compliance and ethics activities while advising the asset classes on compliance topics and best practices over the life cycle of an investment or strategy. (10 staff)
- **Investment Performance** – Provide performance attribution and cost analysis. The team ensures performance accuracy through a robust examination. They produce analytics and reporting to help understand the drivers of performance, evaluating short- and long-term investment decisions. They also implement and manage investment benchmarks and composite hierarchy. (5 staff)
- **Investment Administration** - Provide administrative business services for the Investment Branch. The team partners with branches across the agency to provide an accurate, efficient, and innovative approach to support the Investment Branch. They are responsible for project management, the board agenda material process, procurement and other administrative functions. (7 Staff - *Non-Investment Classifications*)

These functions can be further segregated into two main categories of services to investments: (1) New Investment/Strategy Implementation, and (2) Ongoing Investment/Strategy Support.

1. New Investment/Strategy Implementation

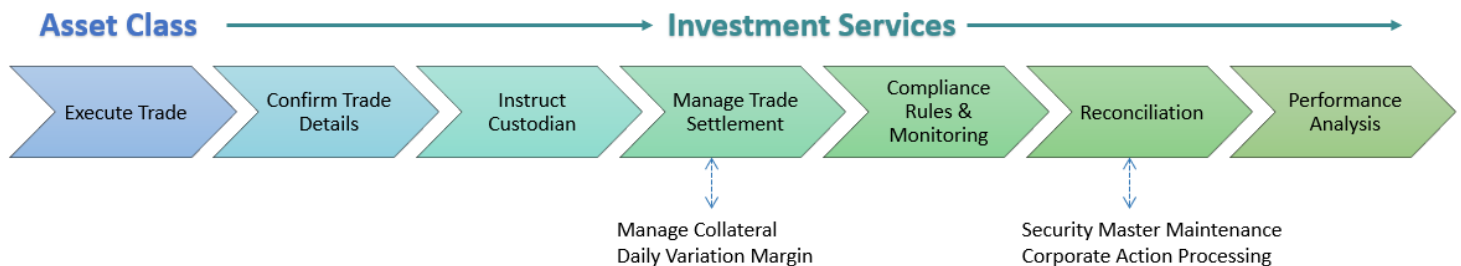
Investment Services coordinates the implementation of new investment strategies. The asset classes collaborate with Investment Services staff when researching a new strategy to discuss a multitude of operational and compliance aspects, such as the structure of the investment, valuation methodology, foreign markets complexities, regulatory requirements, performance methodologies, benchmark implementation and compliance oversight, to name a few. They manage the portfolio implementation process from end-to-end, coordinating with external parties such as the custodian, sub-custodians, brokers, counterparties, clearing agents, external asset managers, security lending agents and consultants.

Investment Services has implemented over **70** new investment strategies/portfolios over the last three fiscal years and expects the numbers to grow with the CM Continuum. Refer to Attachment 2 for a detailed snapshot of the new strategy implementation process.

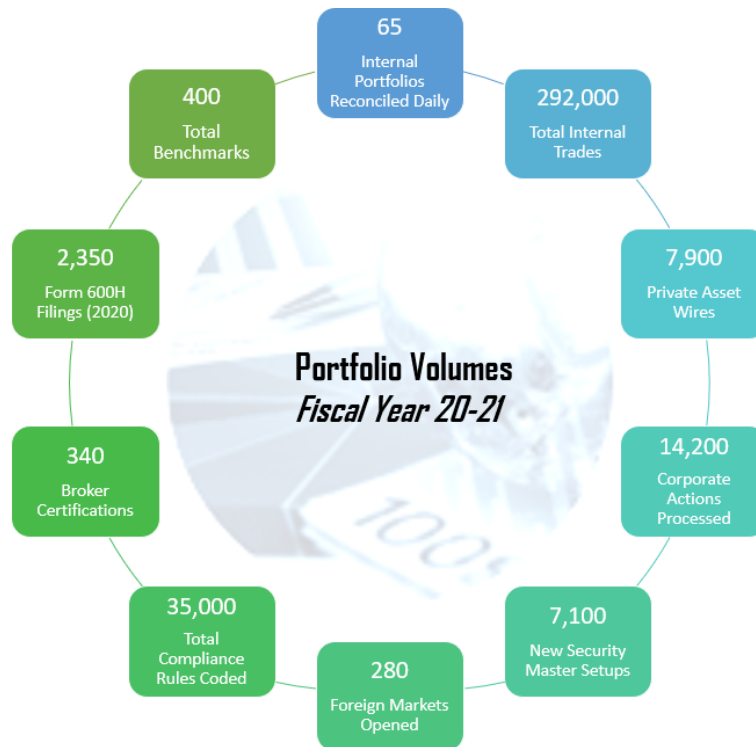
2. Ongoing Investment Strategy Support

After implementation, Investment Services provides an array of ongoing investment support, starting with trade management. The following chart is a high-level view into the Life of a Trade for a public asset.

Figure 3: Life of a Trade: Public Asset



The graphic below is a snapshot of several portfolio volumes specific to ongoing investment functions performed by Investment Services for fiscal year 2020-21. Some noteworthy highlights are: Approximately 292,000 trades managed, 7,900 private asset wires reviewed, 14,200 corporate actions processed, and 2,350 compliance disclosure forms reviewed.



Investment Services performs many other ongoing investment functions in addition to the trade management services depicted in the chart above. Some examples are:

Investment Operations

Operational & Custodial Risk Mitigation
 Cash Management & Forecasting
 Private Asset Operations & Oversight
 Pricing & Valuation Oversight
 Data Integrity & Accuracy
 Securities Lending Income Calculation
 External Public Manager Fee Calculation
 Investment Technology Initiatives
 Foreign Tax & Withholdings Oversight
 Business Continuity Program (with Inv. Compliance)

Investment Performance

Performance Data & Reporting Oversight
 Performance Attribution & Analytics
 Performance Methodology
 Investment Cost Reporting
 CM Savings Reporting
 Benchmark Management
 Hierarchy Composite Maintenance
 Global Investment Performance Standards (GIPS)

Investment Compliance

Business Risks Oversight
Policy & Trade Compliance
Ethics Training & Advisory Services
Conflicts of Interest & MNPI
Personal Trading Program
Regulatory Reporting & Research
Delegation of Authority
Internal Controls Oversight
Investment Branch Audit Support
Enterprise Risk Management

Investment Administration

Branch Project Management
Board Agenda Material Process
Investment Procurement Management
Travel Expertise
HR, Training & Budgets Liaison
Student Internship Program
Teambuilding

Collaborative Model 2.0 Future Impacts to Investment Services

Since Investment Services provides trade and investment strategy support for every asset class, staff must understand the innerworkings and complexities of different investment strategies across the branch and how they relate to operational industry best practices. In-depth investment knowledge and partnership with the asset classes is critical to not only implementing and servicing the investment strategies, but also mitigating potential costs associated with operational and/or trading errors. With the CM Continuum, a lack of robust operational controls and skilled Investment Services professionals can lead to operational risk, reputational risk and potentially missed investment opportunities with more sophisticated managers and investment partners.

In 2020 alone, the SEC brought 715 enforcement actions¹ to federal court, costing over \$4 billion in penalties and disgorgements. The SEC investigates and recommends actions addressing conduct that spans the securities markets, including conduct involving financial fraud, insider trading, offering fraud, Foreign Corrupt Practices Act violations, misconduct by broker-dealers and investment advisers, and more. Many of these cases could have been mitigated through operational controls and monitoring.

The expansion of the CM will require enhancements and new added responsibilities to our existing essential day-to-day functions. The Investment Services team is taking on new efforts for CM strategies, while continuing to innovate and optimize current tasks to expand bandwidth and increase efficiency. Some examples of potential areas include: cryptocurrency, blockchain, internal derivative strategies, unitization structures, direct company ownership, and hybrid public/private investments. This creates complex valuations, compliance monitoring and operational structures, increased operations due diligence and oversight, and additional material non-public information (MNPI).

¹ Division of Enforcement 2020 Annual Report, U.S. Securities and Exchange Commission, <http://sec.gov/files/enforcement-annual-report-2020.pdf>, (accessed 21 September 2022)

Another area of expansion for Investment Services is around investment technology related to data and analytics solutions. In order to take advantage of the opportunity set and communicate knowledge across teams, we need better ways to track our partners' activities and relationships through enhanced software. New analytics solutions are also needed for dynamic data aggregation to provide deeper analysis on complex investments. Integration of investment systems and analytics software will require a unique skillset of staff with expertise in both investments and technology infrastructure. In the upcoming months, we will begin recruiting for two leadership positions to develop the strategic roadmap, implementation and oversight of these initiatives, a Portfolio Manager, and an Associate Portfolio Manager.

Attachment 1 provides details on other specific areas that will be impacted by the CM Continuum.

CONCLUSION

Investment Services provides critical functions that are integrated into the Investment Branch. Investment expertise and continued industry knowledge is essential for the success of the Total Fund. The CM has a great impact on the Asset Classes, as well as Investment Services, requiring additional expertise, support and resources to ensure a successful implementation. In addition to this item, over the next few months there will be a series of short videos on various Investment Services functions: 1) New Investment Strategies, 2) Foreign Markets, 3) Performance Analytics, 4) Private Asset Operations & Valuation, 5) Trade Services and, 6) Policy and Trade Compliance.