


Reprint of interview with Christopher Ailman of CalSTRS

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CalSTRS: Investing in the Public Eye *by Jenny Blinch*

(REPRINT from *Pensions and Investments* interview with Christopher Ailman of CalSTRS)

Jenny Blinch talks to Christopher J. Ailman, CIO of CalSTRS, about the big investment themes of the next few years and the unique complexities of running a public fund in the US

JENNY BLINCH: Has 2006's Pension Protection Act and the debate around accounting standards had much impact on CalSTRS?

CHRISTOPHER J. AILMAN: It has, because we have a lot of private equity and real estate. I don't think it's forced the pension plan to be more short term oriented, but it has introduced more volatility to the short term. As long term investors we are used to making ten- to 15-year investments, but forcing them to develop some sort of market value makes the entire portfolio more volatile and the reason we went into those investments was because they were more stable. You don't really know the return on a ten-year investment after the first couple of years and, especially since they're the kind of investments you are going to hold for a considerable period of time, that inner value frankly is meaningless. I understand why the accountants have pushed for it, but I think it's caused higher levels of volatility for no good reason.

JENNY BLINCH: So you don't believe corporate and public funds should operate under the same accounting standards?

CHRISTOPHER J. AILMAN: I have argued that [point] strongly. With corporates I understand the value of trying to define a liability and a value on a point in time, because they can go out of business. As a state fund, I often tell people, 'as long as there are public school teachers in California, we're going to be in business' - that's a heck of a long time.

JENNY BLINCH: What do you see being the big investment themes of the next couple of years for CalSTRS?

CHRISTOPHER J. AILMAN: Because we're such a large pension plan, we're often looking for themes that are going to exist for a period of time and not just disappear. Climate change is, I think, going to be an enormous theme and if you're in the US for any period of time, what you'll probably be shocked at is the lack of dialogue in our newspapers about it.

If you're in Europe, you're going to see the words 'sustainable' and 'carbon footprint' in some part of the newspaper every day. You just don't see that here at all. We deal with climate change as both a risk and an opportunity. To us, it is a risk in real estate because of storms, it's a risk in fixed income because of the carbon costs, and it's a risk in the equity portfolio because of people who pollute and don't pay for it.

Now the flip side is it's [also] an opportunity in the equity portfolio; we have some sustainable managers, we have managers who tilt the index towards companies that are greener than others. Right now, Wall Street doesn't tend to focus much on climate change, but at some point they will and I think that's when we're going to see a big pop in a lot of our stocks.

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JENNY BLINCH: Why is it that big US pension plans, such as CalSTRS, can see the potential for climate change as a growth theme, but the rest of the US and Wall Street can't?

CHRISTOPHER J. AILMAN: In the US, states are often described as red (Republican) or blue (Democratic), but California is often called the 'green state'. People in this state tend to get it, because we tend to see it more. Also, I think larger funds like ours are to some extent constantly pushed on innovation.

If we were a smaller fund, we could be more nimble and take advantage of something that may only be in place for six to 18 months. We could do that here, but not in size — it takes a long time to invest a huge amount of money, so, if you think about the size of our portfolio, for us to make a difference, we need to invest several billion dollars, and to do that we need a trend that's going to be in place for a period of time, so that's the other reason funds like us tend to look at this stuff — we're looking for longer, bigger trends so we can put a lot of money to work.

I think another big theme, which sits within [climate change], is energy — the fact that the entire global economy is hydro-carbon based. We know that we're somewhere near the peaking point in oil production — there are going to be big winners and big losers, we're already seeing that with General Motors and Toyota.

There are a couple of other big themes. Here in California we're definitely seeing the theme of a demographic shift. We're seeing immigration into our state that rivals what the US saw in the 1800s.

Pretty soon, the majority population in California will be Latino and if you go back and study the immigration patterns from the 1800s, there were ways to make money from that — to get out in front of it and profit from it — and we think this is another shift where we can probably get ahead and make some money from it and we're investing in those areas heavily.

JENNY BLINCH: What would be an example of an investment to exploit that trend?

CHRISTOPHER J.AILMAN: A good example of that would be in retail; different cultures like different shopping environments and Latino shoppers like similar stores, but they prefer an open-air environment instead of a closed-in mall. In the grocery business, they have very different food buying patterns; it doesn't mean that a North American store can't compete, but there are going to be people who capture that market and take advantage of it and those who don't.

JENNY BLINCH: What about interesting areas of investment outside the US?

CHRISTOPHER J. AILMAN: A lot of people say: China, China, China. We're doing our first China-specific [private equity] fund and to us, because we're a giant fund and we live in a glass bowl, China represents a very interesting challenge.

We know it's going to be a growing investment market, yet it is still a communist country, it still behaves and acts in ways that maybe California doesn't like, so how do you make a long term investment in an area knowing there are going to be a lot of bumps along the way? That's going to be a challenge for us. Right now, for most US pension plans, China is not more than even 1% of their asset allocation, the question going forward is, if China does grow and pass the US as an economic power, how much do you have exposed to it going forward?

JENNY BLINCH: On the issue of corporate governance, traditionally shareholders in the US have been seen as having fewer rights than their peers in Europe, for example. Do you feel this gap is now closing?

CHRISTOPHER J. AILMAN: I think so, because we're starting to work more on an international basis. Clearly talking to the regulators, they're going to have different perspectives, so you're not going to get absolute consistency on corporate governance rights around the globe. A big part of it frankly isn't [about] working with the SEC, but is us crossing the river and meeting with

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the business roundtable and the Chamber of Commerce, because ultimately we're interested in the same thing.

We're very long term, four-year horizon investors and we're interested in corporate America — or the global corporation — succeeding, and they are too, so if we can just get past our differences and understand where we have common interests, then maybe we can enter into an honest dialogue.

One of the areas we very much have in common is the whole issue of short termism; I think that's been a huge problem in corporate America — the pressure on quarterly profits, on short term information. CEOs now have a 90-day investment horizon; I want them to have a ten-year investment horizon.

JENNY BLINCH: Much has been made of the conflicts inherent in running what is essentially an investment management firm within a governmental structure. Do you envisage a time when funds like CalSTRS will be able to operate entirely independently?

CHRISTOPHER J. AILMAN: Yes, no question about it. All you have to do is look at the universities in America, look at the endowments, look at the Canadian public pension plans — any time people have tried to run a money management firm inside a different organisation, they've figured out it doesn't work and they've split it off and run it as a money management company.

There'll be some agent for change and I don't know what it is or when it will happen, but I think we're going to see that push here at some point. Right now, most of the state pension plans see [themselves] as part of the government, but we know for a fact that it costs us somewhere between 20 and 40 basis points in returns on an annual basis in this structure and we know it works against us in hiring and retaining investment people and retaining the best outside investment contracts.

What's [also] going to affect us going forward is that we primarily really felt we were our own competition, maybe [also] Hermes, APG, Temasek or GIC. Now, our competition is even bigger; it' China Investment Company, it's Kuwait Investment Authority [etc] — we're going to eventually have to change our model in order to compete against all of those entities as well. •