



1913 – CALSTRS  
CREATED

1917 – World War I

1919 – Unfunded  
liability of \$26  
million

1929 – STOCK MARKET  
CRASH

1941 – Pearl Harbor  
World War II

1964 – Unfunded  
liability \$2.1 billion

CalSTRS “pay as  
you go” till 1972

1913 – 1970 strictly  
Fixed Income  
investments

1969 – Man lands  
on the moon

1970 – The System  
is grossly under funded  
at less than 25% funded

## THE HISTORY OF CalSTRS INVESTMENT PORTFOLIO

### A NEW CENTURY BEGINS

At the turn of the twentieth century, a wave of progressive reform swiftly crossed the American political scene. Known as the “Progressive Era”, few states were left untouched by the force of this movement. In California, the Progressive movement sweeps the election of 1910. Mandate in hand, the governor, Hiram Johnson, contacts the foremost progressive leaders of the period. Historical legends like Theodore Roosevelt, Robert LaFollete and Woodrow Wilson advise the newly elected Governor to develop a program of legislation never before seen in the State. Business, labor and agriculture are all affected. The changes in education reverberate to this day. Students receive free textbooks and, effective July 1, 1913, the legislature establishes the Public School Teachers’ Retirement Salary Fund (Statutes of 1913-AB1263) as a function of the State Board of Education. The Fund (CalSTRS) is created to provide teachers with a secure financial future during their retirement years and as an incentive to retain a professional career staff in the field of education.

The first funding comes from a provision directing 5 percent of Inheritance Tax revenues toward the newly created CalSTRS. Teachers are granted retirement credit for services provided prior to 1913. CalSTRS opens for business in debt for the future benefits related to this service. In 1919, CalSTRS shows a deficit of \$26 million dollars. While all teachers / members start contributing twelve dollars per year, no employer contributions are required. CalSTRS operates on a pay-as-you-go mode from 1913 till July 1, 1972.

Over the decades, adjustments are made to the contribution schedule among the teachers, employers and the State. Inadequate funding remains the most significant issue facing CalSTRS. The inadequacies of these formulas are forcefully brought to the attention of the legislature in 1964 when the actuarial forecast reports a deficit of \$2.1 billion. By 1975, the total net obligation is \$7.8 billion and growing. Legislative solutions are proposed and enacted but fail to end the deficit.

While the legislature struggles with the issue, eyes turn to other areas of support for the Fund. The investment portfolio provides a major revenue source. Without question, the most closely watched portion of the CalSTRS operation is the Investment Branch.



1970 – 1st equity investments

1973 – Vietnam War ends

1975 – Liability grows to \$7.8 billion, System is 30% funded

1980 – CalSTRS Portfolio **\$7.26 billion.**  
1/5th equity / 4/5th bonds

1982 – CalSTRS Investment Portfolio splits from CalPERS.

CalSTRS starts 100% externally managed

Wilshire Associates serves as consultant

1983 – **\$10 billion**

1984 – Prop 22 “Prudent Investor standard”

Diversification



## POLITICAL RESTRICTIONS

Until 1966, the System is statutorily prohibited from purchasing any asset other than fixed income securities. Proposition 6, an amendment to the California constitution, is passed in the 1970 General Election. It permits the System to invest in real estate and equities, but limits the percentage of exposure. For six years, the CalSTRS equity exposure remains relatively constant between 3-5 percent of the total Investment Portfolio. Thereafter, equity exposure grows and fixed income investments retreat until the end of 1980; the portfolio contains \$1.5 billion in equities and \$5.8 billion in fixed income. For the first time, the System hits 50 percent funded status and climbing.

## SEPARATION

Chapter 1433, Statutes of 1982, required CalSTRS to terminate its interagency agreement with the Public Employees Retirement System (CalPERS) for use of the services of their investment staff to manage the CalSTRS Investment Portfolio (Portfolio) and, in its place, to create an independent investment management program. The Board contracted with an interim chief investment officer (CIO) and three investment firms to serve as portfolio managers, with cash in the custody of the State Treasurer’s Pooled Money Investment Fund. The Board also contracts with a general investment consultant to identify the long-range objectives for CalSTRS and to develop an investment management plan commencing in 1984. Further, the contract calls for recommendations for an organizational and staffing plan to implement the investment structure and for appropriate monitoring. When CalSTRS assumes investment management in 1983, the Portfolio assets are valued at \$10.9 billion.

The passage of Proposition 21 in 1984 gives authorization to CalSTRS to manage the investment Portfolio with the flexibility needed for today’s changing financial and economic climate. This proposition removes specific investment restrictions and replaces them with the “prudent expert rule”. Placing the entire portfolio with outside management, the System develops a long-range plan for the establishment of a permanent internal investment office.

## ASSET ALLOCATION AND MODERN PORTFOLIO THEORY

In 1985, the Board adopts an Asset Allocation Plan (Plan). The Plan implements a shift to equities, making domestic equities the largest asset category in the portfolio. This strategic move pays off handsomely during a period of time in which stocks have one of the highest real rates-of-return in market history. Advancement to diversification targets is a major operational feature of the Plan.



Allan Emkin of Wilshire serves as the Board's Consultant

1985 – Member Home Loan starts

1986 – Equity Real Estate Portfolio started

OCTOBER 1987 – STOCK MARKET CRASH

1987 – Internal management of the Portfolio starts

1987 – Master Custodian selected

1988 – Portfolio grows past \$30 billion

1989 – Alternative Investment Program started

1989 – ELDER FULL FUNDING ACT PASSED

System 73% funded

## STRUCTURE AND POLICY DEVELOPED

In 1986, the cornerstone of the new Investment Office is laid with the appointment of the first permanent CIO, coupled with the adoption of a three-year Investment Management Plan (Asset Allocation Policy). The purpose of the plan is to achieve the highest real rate-of-return commensurate with prudent investment practices in the most cost efficient manner. The plan calls for a shift from 80 debt and only 20 percent equity to a more balanced approach of 47 debt and 53 equity. To handle the transition cash is increased to 10 percent of assets. The Fund also shifts from “Book” accounting to full “Marked to Market”. The change results in booking huge profits from age old bond holdings. The Investment Plan strategy also includes internal and external management, with preparation for eventual in-house portfolio management. CalSTRS expands its internal investment staff to eight professionals and seven support personnel. In 1986, CalSTRS Portfolio sits at \$19 billion and is 65 percent funded.

## ADVANCEMENT IN THE 80'S

CalSTRS Investment Office purchases its first real estate property located in Sacramento at 7667 Folsom Blvd, which served as the main offices for the System until 2009. The Investment Office creates three primary divisions: Equities, Fixed Income and Real Estate. In 1985, the Investment Office opens the California Mortgage Conduit Program, the Member Home Loan Program and the Corporate Governance unit. As a result, the internal investment staff begins to grow.

In 1987, CalSTRS hires State Street Bank of Boston as its Master Custodian. The Investment Office implements a Securities Lending Program. The internal staff begins management of the short-term portfolio, which includes the organization of the cash management/forecasting function and internal trading.

In 1989, alternative investments are added to the asset allocation and the Board retains a specialty private equity consultant to monitor, analyze and review alternative investment opportunities. A diversification target is attained by the funding of the first alternative investments.

The Chief of Investments reported to the Board that the Portfolio had grown to \$29 billion. By the end of the 1980's, the System is still only 73 percent funded. Legislature passes the Dave Elder Full Funding Act to get CalSTRS to 100 percent funded over the next 40 years by 2030. Thanks to the historic bull market of the 1990's, the System achieves 100 percent funded status in just 10 years.

1990 – Portfolio  
**\$32 billion**



1991 – Gulf War

CalSTRS 1st to hire  
multiple Securities  
Lending agents

1994 – Portfolio \$40  
billion. System 86%  
funded

1994 – CalSTRS 1st to  
run Credit  
Enhancement

1996 – Greenspan  
warns the market of  
"irrational exuberance"

Dow @ 6,381

1997 – Portfolio is  
**\$75 billion**

1998 – The System hits  
100% funded status

1999 – Portfolio is  
**\$99.9 billion**

Dow hits 9,000

The portfolio grows  
+ \$60 billion in the  
decade of the 90's

## THE 1990'S AND THE END OF THE CENTURY

By 1990, CalSTRS has been in business 77 years and the Investment Office seven years. The Office enters the decade determined to utilize every resource available in the quest for increased investment opportunity, diversification, benefits and potential for higher returns. The Asset Allocation Policy is broadly diversified and expanded into three programs during the decade. The investment universe has developed a truly global perspective. CalSTRS is not to be left behind in the growing global economy.

## ADVANCEMENT IN THE 90'S

CalSTRS leads the industry by opening the Securities Lending Program to multiple lenders, thereby creating competition for the first time. In 1991, fulfilling another Plan diversification target, the Board introduces an International Equity Program. This global diversification policy provides more stability to the quarterly returns. In 1992, the Board completes an exhaustive review of the Investment Management Plan. By managing the asset allocation, the System minimizes the risk of the principal loss, while producing the highest expected returns.

The Fund institutes a Global Tactical Asset Allocation program, hiring four investment managers specializing in global asset allocation. The managers try to "time the market" and pick between stocks and bonds across all the developed worlds. After a prolonged period of rapid growth, the economy and stock market slow in 1994, and the market takes a downward spiral. The Investment Office continues its pattern of diversification that allows it to show a positive return, while many other pension funds lose principal value.

June of 1994, CalSTRS again breaks new ground by establishing the first Credit Enhancement Program designed to provide liquidity and credit enhancement to municipal and public service securities. This program helps to reduce cost and increases marketability of these securities. The following year, CalSTRS becomes the first institutional lead plaintiff in the Cal-Micro Devices class action lawsuit.

The CalSTRS investment pool remains one of the largest pools of assets in the United States, reaching \$63.5 billion. In 1995, the adoption of a Currency Hedging Program helps protect the investment portfolio should the dollar strengthen. In 1997, the Cash Balance Plan was introduced. The Investment Management Plan was refined to focus on a more active approach. The actual asset allocation was shifted to match the Policy targets. Emphasis was directed to the equity segment, both domestic and international, and a reduction in the fixed-income sector was carried out.



1999 – Euro starts

Dow breaks 10,000 in March 1999

November of 1999 – the Portfolio breaks

**\$100 billion!**

1982 – 2000 bull market for U.S. Stocks peaks in March 2000

Dow @ 11,722

S&P 500 @ 1527

2001 – California Investment Policy adopted

2002 – The Fund drops to \$85 billion

2000 – 2002 Bear Market U.S. stocks drop 45%

Funded status drops to 83%

The U.S. and Non-U.S. market bounce back starting in Oct. 2002



Aggressive asset allocation shifts help the Fund rebound, assets again exceed \$100 billion.

## \$100 BILLION AND INTO THE NEW MILLENNIUM

The asset allocation mix on June 30, 1999 included: 45.9 percent domestic equity, 24.9 percent domestic fixed income, 23.7 percent international equity, 2.6 percent alternative investments, 0.7 percent liquidity and 2.2 percent real estate. The System hits 104 percent funded, and by the fall of 1999, CalSTRS is only the third plan in the U.S. to ever exceed \$100 billion in assets. In just 10 years, the Portfolio has grown over \$75 billion. No one expected, nor planned for, such a growth in assets.

After the Y2K preparations and conversion, the stock market hits the top and in March of 2000, a prolonged bear market begins. On January 14, 2000, the Dow Jones Industrial Average hits an all time high of 11,722.98. The Russell 3000 peaks, along with the NASDAQ market, at 844.78 in March of that year.

Over the next three years, U.S. stocks drop 45 percent in value. Thanks to broad diversification, the Fund only declines -23 percent, down to a low of \$85.5 billion. In 2002, the senior investment staff aggressively rebalances the asset allocation, investing over \$1.6 billion near the market lows. By June 30, 2003, the fund rebounds back over \$100 billion in assets.

As a result of the corporate excesses of the late 1990's, CalSTRS adopts a more aggressive stance in corporate governance. At the fall 2002 workshop, the Board sets a goal of a meaningful increase in corporate governance activism. Sarbanes-Oxley becomes the first significant corporate reform legislation from Washington D.C. in decades. Working with other funds, CalSTRS advocates significant change at the SEC, NYSE and in the corporate board rooms. The CalSTRS class action lawsuit against Homestore.com restores investor confidence and improves the company.

After a decade of relative stability on the Board, Trustee changes become common, as new appointees are made. In 2002, the law is changed to allow the education members to be elected and the public members to come from any background. Over the next two years, several different Trustees serve on the Board. The investment strategy and staff remain stable as the Fund fully recovers from the market losses of the Internet Bubble of 2000 – 2002. The funding level drops back from 92 percent to 82 percent down, at the low.

In 2003, the Investment Committee (Committee) and staff undertake a comprehensive stochastic asset liability study. Over a series of meetings, the Committee reviews how the System would fair through the worst economic environment, high and low inflation, and changes in the asset allocation. The robust study runs over 1,000 different return scenarios to

By December 2003, the Portfolio grows again to **\$112 billion**

As the funded status declines, the unfunded liability grows to \$23 billion.

By Mid 2004, the Portfolio is fully recovered from the 00-02 Bear Market



Investment staff grows past 80

CalSTRS becomes #2 in the U.S. defined benefits plans.

Funded status starts to rebound back to **86% funded.**



June 30, 2005 – The portfolio closes at a new record high of **\$130 billion!**

CEM reports CalSTRS is the lowest cost investment portfolio among mega funds.

provide a range of possible outcomes. As a result of the study, the Committee reaffirms the asset allocation targets and adopts the first CalSTRS Funding Policy Statement.

### CHANGE IS THE ONLY CONSTANT IN THE 2000'S

In 2004, the Investment Committee and Board received several new members. For the first time in a decade the CalSTRS Board has a full compliment of twelve Trustees on the Board. A Trustee education system is formalized and the schedule is streamlined. Key areas of focus continue to be corporate governance and emerging markets, in addition to considering more active management and income enhancement ideas. The Fund's investment performance continues to rebound with double digit returns raising the Portfolio to a new record high in assets.

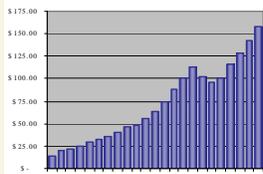
In early 2005, the CalSTRS Board goes through another upheaval, as four Trustees are removed in one day and a fifth is not confirmed. This reduces the Board to seven members. New appointments are slowly made over the next year. A disciplined and consistent investment philosophy helps CalSTRS Investments grow to \$130 billion in assets and over 80 in staff. In Fiscal Year 2004-2005, CalSTRS passed NY Common to become the 2<sup>nd</sup> largest defined benefit plan in the U.S. The Investment Committee approves a new actively managed structure for the Emerging Markets Portfolio. The Committee also approves increasing active and enhanced management in the U.S. Equity Portfolio. A Developing Manager Program is launched to expand the diversity of the external managers.

As Fiscal Year 05-06 dawns, the CalSTRS Board has one member with 25+ years of experience, another with 4 years and two with 2 years, the remaining members are all within their first year of service. The Investment Committee undertakes a new asset allocation study and approves significant changes to the Fixed Income portfolio that include shifting 20 percent to external managers that, for the first time, can invest in a broader opportunity set including non-U.S. bonds. The investment staff continues programs to focus on diversity of investments and climate risk, as well as a steady focus and effort in corporate governance. Due to the overall structure, the CalSTRS Investment Portfolio has the lowest cost compared to 15 mega fund peers.

At June 30, 2006, the Portfolio books it's 3<sup>rd</sup> straight year of double digit positive performance and for the first time in CalSTRS history ranks in the top 20 percent of peers over 1-, 2-, 3- and 4-years. This represents unprecedented sustained strong performance for the Fund. After years of work, in July '06, the Board approves a new portfolio manager series and incentive compensation structure for the top three ranks of the investment staff.

November 2006 – The Portfolio exceeds **\$150 billion!**

Year end 2006 – The Fund closes at \$157.9 billion and posts a double digit return for the 4<sup>th</sup> straight year.



Graph of the growth of assets 1985 – 2006

FY 06-07 – 21% return

Fund grows by \$26 bil.

Top 1% of all Pensions

2007 – CalSTRS “Large Public Plan of the Year!” - MMN

**GARY LYNES** retires after 25 yrs on the Board

December 2007 – The Portfolio stands at **\$175 billion**

**Fall 2007 –** Sub-Prime Mortgage Meltdown, defaults rise

In September 2006, the Investment Committee approves a new long-term asset target of 20 percent fixed income and 80 percent equity-like investments. This represents a significant step towards increasing the return of the investment portfolio to help fully fund the system.

At the start of 2007, the Board receives a new State Treasurer and State Controller. The fund stands at \$157 billion in assets and books returns that place CalSTRS again in the top 20 percent of its peers. The investment staff completes the hiring of new managers in fixed income, enhanced U.S. equity index, emerging markets, corporate governance activism, as well as environmentally focused managers and firms to expand the developing manager program. This represents the final steps in the expansion of active management in fixed income and U.S. equity. CalSTRS now has more active management in each asset class than ever before. While investment management costs will rise, the goal is higher net returns after all fees and expenses.

As the size of the Portfolio grows, many of the investment managers’ accounts exceed \$1 billion in assets. The typical size investment in alternative investment and real estate generally exceeds \$400 million. The largest single investment is Exxon Mobile stock, worth nearly \$2 billion alone.

In FY 06-07, the Fund has its highest return in twenty years, earning 21 percent and placing in the top one percent of all public pension plans. The string of successful years puts CalSTRS in the top five percent of all public pensions over 1-, 3-and 5-years. This is the highest peer group ranking in CalSTRS history. The Fund is nominated by Money Management News (MMN) magazine as one of the Large Plan Sponsors of the Year and the CIO is nominated by Institutional Investor magazine as Public Fund CIO of the Year.

In December 2007, Gary Lynes, the longest serving Trustee in CalSTRS history, retires from 40 years of classroom teaching and 25 years on the CalSTRS Board. Gary has served as Investment Committee Chair for over a decade. In addition, he was awarded the Institute for Fiduciary Education Leadership award for 2007. Harry Keiley is elected to fill Gary’s active teacher K-12 slot.

In the first half of FY 07-08, the Fund struggles to generate a positive return as the sub-prime mortgage problem looms over the global markets. However, there were precious few signals of the cliff that laid ahead in 2008. In the Fall of 2007, 16 percent of the subprime mortgages were 90 days late. During this period, CalSTRS signs the United Nations Principles for Responsible Investment and attends the P-8 summit on climate change with Prince Charles.

**March 2008 –**  
Bear Stearns defaults

June 2008, The  
Portfolio stands at  
**\$162 billion**

**Sept 8, 2008 –**  
Fannie Mae & Freddie  
Mac go bankrupt

**Sept 16, 2008 –**  
Lehman Brothers  
declares bankruptcy

Merrill Lynch sold to  
B of A

**Global Stock Markets  
crash, U.S. Markets  
down -42% in just 55  
days**

CalSTRS portfolio  
declines \$50 billion in  
just 190 days as every  
asset class declines

**FY 08-09 – 25% return**

Fund drops \$44 billion  
in the worst fiscal year  
in history.



On a positive note, in  
July 2009, CalSTRS  
moves into new West  
Sacramento HQs

## THE INVESTMENT WORLD CHANGES FOREVER IN 2008

As 2008 starts the subprime mortgage problem causes Bear Stearns, the 6<sup>th</sup> largest broker dealer, to default on March 17<sup>th</sup>, 2008. The U.S Government led by Treasury Secretary Henry Paulson orchestrates a take over by J. P Morgan to avert a full bankruptcy. While CalSTRS has avoided subprime mortgages (still mostly rated AAA) and other exotic debt instruments; the fixed income market begins to struggle with all debt financing.

The U.S. and global stock markets trend sideways during the spring of '08 and trend slightly upward in the summer of '08, again not displaying the waterfall that was to come in the fall. At June 30, 2008, the CalSTRS Investment Portfolio sits at \$162 billion, down just 3.7 percent over the past year. The ten-year return already reflects the struggles of the decade of the 2000's and rests at 6.9 percent for the period of 1999 to 2008. Even so, CalSTRS ranks in the top quartile of all public funds.

Five and a half months after the Bear Stearns collapse, the subprime delinquency rate has risen to 25 percent. On September 8, 2008, FNMA and Freddie Mac, quasi-government backed mortgage companies, are placed into conservatorship. The financial markets are shocked as the debt markets begin to constrict and equity markets hold their collective breath.

On the weekend of September 12 to 15, 2008, the financial world changes forever. The CIO sends an e-mail alerting the Board that Lehman Brothers, the third largest broker dealer, will likely fail and either be merged or taken over by the U.S. Treasury, as Bear Stearns had been months before. Inside the NY Federal Reserve, on Saturday Sept 13, then NY Fed President Timothy Geithner calls an emergency meeting for the liquidation of Lehman's assets. No buyer is found. On Sunday, September 14, Bank of America announces it is purchasing the largest broker dealer Merrill Lynch. To the surprise and shock of the global financial markets, the 150 year old Lehman Brothers, an investment grade credit on Friday, declares bankruptcy on Monday. All short-term debt and long-term debts are virtually worthless.

The global financial stocks begin a freefall in price; in just 55 days the U.S. market drops 42 percent in value. Non-U.S. stocks drop roughly 20 percent in the same period. The decline in value forces a cash squeeze and the normally fluid U.S commercial paper and cash market completely locks up. Even General Electric, a solid credit, can barely borrow money overnight. U.S. banks begin to fail; Washington Mutual, the largest Bank failure in U.S. history, occurs on Sept 26<sup>th</sup>. AIG, the world's largest insurance firm, files for bankruptcy. To avert a depression, on October 3<sup>rd</sup>, the U.S. Government reluctantly approved a \$700 billion bailout program called TARP. As the fiscal year ends, the CalSTRS Portfolio has dropped to \$118 billion, down 25 percent in just one year.

June 2009, the Portfolio closes at

**\$118 billion**

Fall 2009 – President Barack Obama is elected

CalSTRS creates an Innovation & Risk Unit in the Investments Branch.

The U.S. stock market bottoms on March 9, 2009 at 6,547 from a high of 14,164 in October of 2007.

### The LOST DECADE

The decade of the 2000's is the worst in 150 years.

The CalSTRS funded status drops back into the Mid 70 percent range, similar to 1990.

FY 09-10 – 12.7% return

CalSTRS posts the first positive return in three years.



June 2010, the Portfolio closes at **\$129 billion**

The Investment staff stands at 105.

As 2009 begins, the financial devastation has spread to the entire globe. Mortgage defaults have climbed substantially. Home prices in the U.S. and California have fallen 30 percent from the high in 2007. Newly elected, President Obama describes the market crash as a near depression event. The U.S. economy declines 5 percent and is thrown into the worst recession since the Great Depression of the 1930's. In the winter of 2009, The FDIC announces over 700 banks are at the risk of failure.

Despite all the negative news, the U.S. stock market hits bottom on March 9, 2009 and begins to rally back. However, the damage has been done, from the market peak in 2007 to the bottom in 2009, the U.S. market and most major stock markets had declined 50 percent in value. As a result, the U.S. remains mired in a deep recession and slow economy for over two plus years.

### THE LOST DECADE

As we close the book on the decade of the 2000's, now referred to as "the naughts", the U.S. stock market return posts the first negative return for a decade since the Civil War. While 2008 was devastating, it is the loss of an entire ten year period that severely harms the CalSTRS funded status. For the ten years ending Dec. 31, 2009, CalSTRS squeaks out a meager 2.9 percent annualized return, the S&P 500 index over the same period is -0.95 percent. The three percent return is well below the actuarial assumed rate of eight percent and the Plan's funded status drops back to the level of the late 1980's and early 1990's.

For the first time, CalSTRS can project that, even if the investment portfolio earned a consistent eight percent return year-in and year-out, the portfolio would drop to zero by 2044. The Board and senior leadership are fully engaged in an effort to raise contribution levels with the legislature.

As 2010 comes to a close, the U.S. stock market has rebounded back to over 70 percent from the low of March 2009, but remains well below the all time high in 2007. The CalSTRS Portfolio has risen along with the markets to over \$140 billion in assets.

In 2010, the Investment Committee approves new incubation efforts in Global Macro hedge funds and commodities. A new asset class of inflation sensitive investments is funded with TIPS and infrastructure as the Trustees and investment staff prepares to meet the challenges of a new decade.

