California Secure Choice

Investment Beliefs – Phase II

February 1, 2018

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Introduction

- On January 22, 2018 Meketa presented to the CA Secure Choice Board an introduction to Investment Beliefs. The goal was to achieve consensus on the broad topics that should be addressed within the Belief Statement. A healthy, interactive dialogue followed.
- Phase II, in the subsequent pages, reflects a narrowing of the proposed investment belief statements, as well as the addition of two possible belief topics, based on feedback from the Board. We have added supporting educational materials/background on several of the Belief topics under consideration, in order to assist the Board in making educated statements regarding the program beliefs.
- Once we refine the Investment Beliefs, these will be a critical input to the establishment and development of CalSavers' Investment Policy Statement (IPS), as well as to the RFP for Program Administration and Management.
- Staff, together with Meketa, will present a draft IPS for review at the February 26 Board meeting.

List of Consensus Belief Topics

Suggested statements address:

- Transparency[1]
- Simplicity[1]
- Impact of Savings
- Impact of Markets
- Investment Costs
- Breadth of Participant Options
- Active vs. Passive Investments
- Plan Design
- Financial Education
- ESG/Responsible Investments

[1] Transparency and Simplicity were discussed as possible additional areas for Belief statements at the January 22nd meeting.

Investment Belief Supporting Materials

Transparency

We believe it is essential to provide transparency across the Program, including investment and program related costs.

In order to promote and enable greater retirement savings, the transparency of the Program will be critical to its success, so that participants achieve a level of trust and confidence knowing their hard-earned money is working for them. This belief is designed to show participants that the Board understands how important this is for savers. Topics discussed at the last Board meeting regarding this belief include:

- Full transparency and access to savings
  - Having instant access to account information, and knowing exactly how much a participant's balance is on any given day
  - User friendly on-line access
  - Mobile compatibility
- Full transparency into program costs
  - Fee transparency can help increase investor trust level
  - Understanding and outlining all associated costs
    - Investment Management Fees
    - Record-keeping Costs
    - Program Administration Costs

Simplicity

We believe in program simplicity; across all facets of CalSavers; from access, to plan structure, from education, to investment offerings.

The California Secure Choice CalSavers Program aims to make workplace retirement savings possible for roughly 7.5 million Californians who currently do not have access to a retirement plan through their employers.

In order to encourage increased retirement savings, the simplicity of the Program will be critical to its success. Some of the topics discussed regarding this belief include:

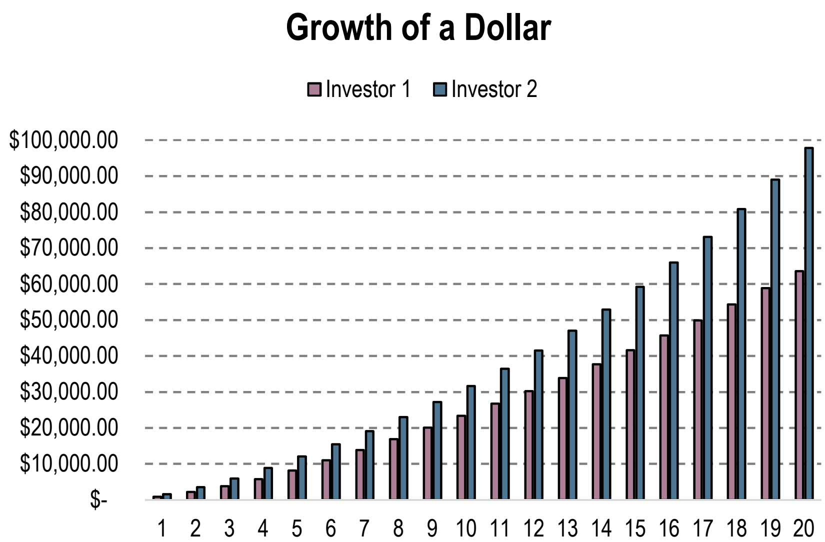
- Keeping investment options simple
  - But also take into account the diversity of the population group
- Offering financial and investment education
  - In a language and format that provides broad-based learning
- Making enrollment easy
  - Employer automatic withdrawals
  - Through default contribution rates and default elections
  - User friendly on-line success
- Creating a portable retirement savings account
  - Changing jobs will not slow down your ability to save

Impact of Savings

Providing a simple vehicle for saving and investing for retirement is critical to the future financial security of retirees.

Savings means different things to different people. To some it means putting away money in a savings account; to others it may mean buying stocks or contributing into a mutual fund.

- Participants are faced with some very important decisions:
  - Actively deciding to save
  - Deciding how much to save
  - Deciding where to save/ invest
- A savings vehicle could prepare savers for unexpected emergency needs in the short-term; an Investment vehicle can help their money grow over a longer time horizon. Both types of investors are likely to be in the CalSavers Program, and the Board may consider their different needs when creating the investment program.
- Returns matter, but returns should reflect the Investor's risk profile and financial goal, as the trade-off between capital preservation and investment growth will vary based on exposure to stocks versus bonds, and other factors.
- The tables on the next slide illustrate two different investors, with different risk/return profiles:
  - **Investor 1** has car expenses occurring over the next 6 months. It's important that she have money set aside for these repairs in the near-term. Her goal is capital preservation, as she cannot afford to lose money. She decides a Savings account is what's more important at this time.
  - **Investor 2** has no real expenses looming ahead. Additionally, she has some money set aside for unexpected emergencies in a Rainy Day Fund. Her goal is to grow her earnings over time, recognizing that she does not need this money for a long time. She decides to contribute money in a U.S. Equity Mutual Fund that has a 6.5% return expectation.



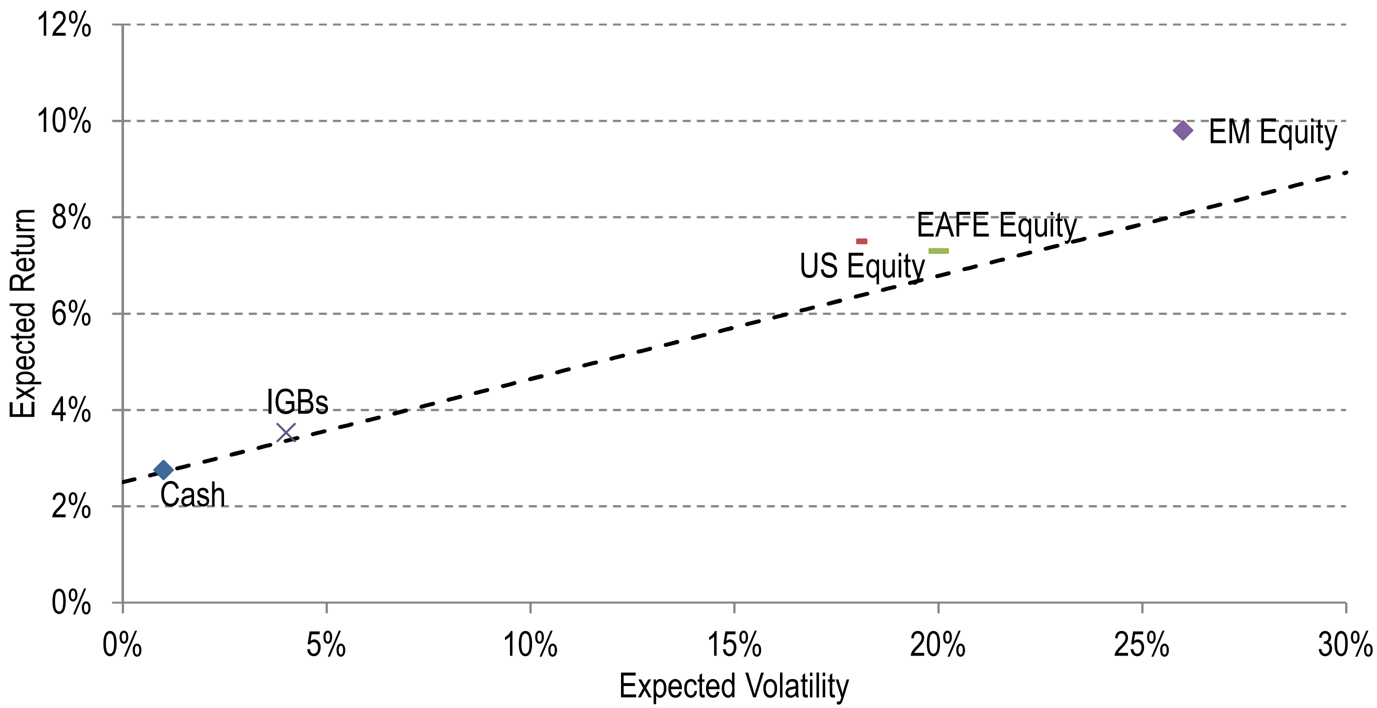
- Returns, compounded, can have a profound effect on the growth of a dollar.
- Returns matter, but returns should reflect the Investor's risk profile and financial goal, as the trade-off between capital preservation and investment growth will vary based on exposure to stocks versus bonds, and other factors.
- Differences in Savings Rates, through default contribution rates and auto-escalation, will also have an impact on total balances.

Savings Vehicle	Investing Vehicle
Initial Balance: $0.00	Assumes Same Initial Balance of $0.00
Savings Contribution: 3%, with a 1% increase capped at 8% in Years 7-20	Savings Contribution: 5%, with a 1% increase capped at 8% in Years 4-20
20 year Time Horizon	20 year Time Horizon
Investment Return: 3.0%	Investment Return: 6.5%
Starting Annual Compensation: $30,000	Starting Annual Compensation: $30,000
Increase in Annual Compensation of 1%	Increase in Annual Compensation of 1%
Ending Balance: $63,560	Ending Balance: $97,841

Impact of Markets

Given the inherent risk in markets, providing security for participant assets in the early stages of saving is crucial.
Over time, we believe in offering both low- risk savings options and higher risk investment options for retirement portfolios.

Market outcomes will impact a saver's ability to achieve retirement objectives. While history shows us that over the long-term, investing in "risky" assets, such as stocks and bonds, is the only way to compound growth at a rate that is likely to achieve those goals, we also know that savers frequently withdraw their assets, or move money to cash, after negative stock market events. Therefore, it is important to weigh these considerations when creating the appropriate plan lineup. The table below highlights Meketa's forwarding looking 20 year expected returns for major asset classes[1].



[1] IGB stands for Investment Grade Bonds. EM Equity stands for Emerging Market Equity. EAFE means International Equity (Europe/Asia/Far East).

Investment Costs

Costs directly affect retirement outcomes, and keeping them reasonable should be integral to our program structure.

- Investment Management Fees: When mutual funds are utilized, the expense ratio is the percentage of your money that mutual funds charge each year to cover operating expenses.
- A fund with an expense ratio of 1% (or 100 basis points) translates to a $1 cost each year for every $100 invested.
- Fees are often described in "basis points", which are effectively all the increments that add up to 100 (or 1%).
  - Within investment costs, there are several investment "vehicle" options to consider that may impact fees, including mutual funds, ETFs, commingled funds/CITs, or separate accounts. It is important to note that not all investment types are offered in every vehicle type (e.g, a Target Date Fund lineup may not be available via ETF, or a particular investment manager may only offer a mutual fund version of its strategy).
  - Mutual Funds are vehicles that are daily valued, and overseen by the SEC as part of the 1940 Act. They often offer various "classes" of funds, based on the total dollar amount invested in the vehicle, and are typically the most expensive option of those considered below.
- Program Administration and Program sponsor related fees: will be in addition to the investment management fees paid by participants.

Breadth of Participant Options

We believe simplicity is the key to success for the participants of a first time retirement savings vehicle, and the investment lineup should reflect that goal.

Selecting the appropriate Plan lineup of investment options is one of the primary responsibilities of the Board. Meketa Investment Group recommends requesting fee proposals during the RFP process for Option 3, to incorporate the broadest possible range of options. Phase I considerations may include a dollar requirement before moving assets.

Option 1	Option 2	Option 3
1. Capital Preservation Fund[1] 2. Target Date or Risk-Based Suite of Funds	1. Capital Preservation Fund 2. High Quality Bond Fund 3. Global Equity Index Fund 4. Target Date or Risk-Based Suite of Funds	1. Capital Preservation Fund 2. High Quality Bond Fund 3. Global Equity Index Fund 4. Target Date or Risk-Based Suite of Funds 5. ESG/Socially Responsible Fund

Observations:

- **Option 1** offers a vehicle for the Saver, and the diversified Investor, and is focused on simplicity.
- **Option 2** offers a vehicle for the Saver, expands on offerings for the Investor.
- **Option 2** offers the Participant the choice to build their own portfolio mix of bonds and stocks, or choose a diversified portfolio constructed for them based on age or risk tolerance levels.
- **Option 2** offers Participants who are more focused on growth, a stand-alone Global Equity Fund.
- **Option 3** expands on the Option line-up to consider Participants' preference for environmental, social and governance issues to play a role in their portfolio.

[1] Capital Preservation Funds are typically money market, stable value (low risk bond funds) or other investments that have a low probability of losing money during a downturn. Target Date Funds are designed to target a participant's retirement year, and become more conservatively allocated as people age. Risk Based Funds are designed to create a stable, blended pool of stock and bond assets to meet the needs of conservative, moderate, or aggressive investors, regardless of age.

An Illustrative Example: OregonSaves

Oregon's Program offers three distinct types of investment options:

- A Capital Preservation Fund
- Age-based/ Target Date Funds
- A Growth Fund

Investments:

- The first $1,000 in contributions are invested in the Oregon Saves Capital Preservation Fund.
- All subsequent default contributions are invested in the Target Retirement Fund based on the participant's age and year of retirement (assuming a retirement age of 65).
- Participants retain the flexibility to make different elections, and to choose any mix of investments from the menu offered by the program from Day 1.
- It is important to note that the CA Secure Choice Board retains the ability to structure the Program however they believe best suits their participants, and does not have to model it after another State's program.

Active vs. Passive Investments

Passive investments should be the primary investment tool for our participants.
As the Program matures, there may be opportunities for actively managed funds to play a secondary role.

Passive investing is an investing strategy that tracks a market-weighted index or portfolio. The most popular method is to mimic the performance of a specified index by buying an "index fund". Active investing is an investing strategy that attempts to outperform the market, with portfolio managers buying only those stocks represented within a specified index, that the portfolio manager believes are superior and could outperform.

	Active	Passive
Investment Objective	Outperform the Market	Track the Market
Investment Process	Research-Driven	Rules-Based Driven
Investment Universe	Purchase of Sub-set of the Universe or Index to Buy the "Better" Stocks	Purchase of the Entire Universe to Gain Market Exposure
Management Team	Makes investment Decisions	Does not make investment decisions
Cost	Higher, You Pay for the Portfolio Manager's "Skill" in Stock Selection	Lower, Stock Selection not a Part of the Process
Average Cost (Global Equity)[1]	0.92%	0.10%

Do investment results justify the higher fees of active management? In some asset classes, such as large capitalization U.S. Equities (think of companies in the Dow Jones Industrial Average or S&P 500 index), it's very difficult to justify active fees. Some statistics below highlight the challenges faced by active managers in the large cap equity space.

Over the one-year period ending December 31, 2016:

- 66% of large cap U.S. managers ***underperformed*** the Index (S&P 500)

Over a five-year period, results did not change significantly:

- 88% of large cap managers ***underperformed*** their Index

[1] Using data from Evestment Alliance and Morningstar.

Plan Design

Plan Design, such as auto enrollment, matters, and will influence the success of savers.

- There are several types of features that fall under “Plan Design”:
  - Auto-Enrollment
  - Auto-Escalation
  - Default Contribution Rate
  - Default Investment Options such as:
    - Capital Preservation
    - Target Date or Risk Fund
  - Investment Vehicles to utilize (Institutional Mutual Fund, CIT, ETF, Separate Account)[1]
  - Any considerations around how the capital preservation strategy will operate – E.g., Money market fund, or other “safe” vehicle, and a possible threshold on savings a critical mass, before transferring assets to a “risky” investment vehicle.
- All the items above (and others) should be discussed by the Board, so that the Plan design can have the positive impact on savers that it is intended to.

[1] Institutional Mutual funds have ticker symbols that are easily trackable, provide daily valuation, and minimum thresholds to provide fees that are lower than retail funds, and are available in most widely utilized asset classes. CITs (also called commingled funds) are pooled vehicles where several or many larger investor pools are merged into one pool of assets, thereby reducing fees and administrative costs. ETFs are traded intra-day, not widely utilized in institutional defined contribution plans as excessive trading is one of the areas plans often try to restrict, and come with low fees but some pricing volatility. Separate Accounts are vehicles that would only include assets of the CalSavers program, but the program would also bear the cost of custodial fees. The vehicles themselves, with sufficient assets, also have the lowest costs of the above options, typically. It is very likely that many investment managers offer strategies that come in various vehicle “choices” above.

Financial Education

Participants need access to simple, relevant financial and investment education.

- Financial education is typically offered on a Program website, through tools created either by the Program Administrator, or a third party. It is important to note that these materials are widely available in the financial community, and will not typically require creating something unique, but rather creating access to already circulated material/models/tools.
- Important Financial topics include:
  - The compounding effects of saving and investing
  - Estimating future retirement costs and savings needs
  - How costs impact investment results
  - Descriptions of investment options/asset classes
  - Budgeting
  - Analyzing your current financial picture

ESG/Socially Responsible Investments

Socially and environmentally responsible investing is an issue important to some savers, and an investment option reflecting that belief should be offered within the lineup.[1]

- There are a number of areas that can fall under "responsible" investments, including environmentally focused investments, socially focused investments, targeted sustainable investments, and more.
- Examples of Environmental Social Governance Criteria used by investors can include the following:

Environmental	Social	Governance
Consideration for Green Building	Workplace Safety	Board Diversity
Concern of Pollution/ Toxics	Workplace Diversity	Board Independence
Water Use and Conservation Efforts	Labor Relations	Executive Compensation

- Based on available Plan data, less than 10% of defined contribution Plans currently offer a socially responsible investment option. However, it is an area of growing interest/demand by participants.
- While it can be difficult to find a "one size fits all" approach to this area, there are various investment vehicles that can be offered/considered in order to provide investors a way to express their views.
- Should the Board consider ESG/Socially Responsible Investing to be a key belief for the Program, Meketa believes the most efficient approach is to offer a standalone single option to the participants.

[1] The language for this belief was altered based on feedback from the Board, but may need to be further discussed to accurately represent the belief of the Board.

Investment Belief Statements – Proposed Language

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Belief Area	Proposed Investment Belief
Transparency	We believe it is essential to provide transparency across the Program, including investment and program related costs.
Simplicity	We believe in program simplicity; across all facets of CalSavers; from access, to plan structure, from education, to investment offerings.
Impact of Savings	Providing a simple vehicle for saving and investing for retirement is critical to the future financial security of retirees.
Impact of Markets[1]	Given the inherent risk in markets, providing security for participant assets in the early stages of saving is crucial. Over time, we believe in offering both low-risk savings options and higher risk investment options for retirement portfolios.
Investment Costs	Costs directly affect retirement outcomes, and keeping them reasonable should be integral to our program structure.

[1] We utilized the feedback from Board members regarding the time horizon of the plan to adjust the language of this Belief to reflect near term vs longer term goals.

Investment Belief Statements – Proposed Language (continued)

Belief Area	Proposed Investment Belief
Breadth of Participant Options	We believe simplicity is the key to success for the participants of a first time retirement savings vehicle, and the investment lineup should reflect that goal.[1]
Active vs. Passive Investments	Passive investments should be the primary investment tool for our participants. As the Program matures, there may be opportunities for actively managed funds to play a secondary role.
Plan Design	Plan Design, such as auto enrollment, matters, and will influence the success of savers.
Financial Education	Participants need access to simple, relevant financial and investment education.
ESG/Responsible Investments	Socially and environmentally responsible investing is an issue important to some savers, and an investment option reflecting that belief should be offered within the lineup.[2]

1 Given the new Belief "Simplicity", this belief may be redundant, and could be eliminated.
2 The language for this belief was altered based on feedback from the Board, but may need to be further discussed to accurately represent the belief of the Board.

Summary

- After discussing the proposed Investment Beliefs and some background information, it is Meketa Investment Group's hope that the Board can begin to come to consensus around several (or all) belief statements, in order to develop an Appendix to the IPS, as well as for inclusion in the RFP for Program Administration.
- Proposed language adjustments can be made prior to the February 26 meeting.