KATIE KOCH: Welcome to our continuing series of Talks at GS where we have the opportunity to speak to some of the world's great investors. On today's episode I'm in conversation with Chris Ailman who, of course, is the CIO of CalSTRS, the second largest pension in the US and the largest educator-only pension in the world.

Chris, thank you so much for being with us.

CHRIS AILMAN: Well, it's my honor. And I'm not sure I qualify as a great investor. I'm working really hard at being a good investor.

KATIE KOCH: You, of course, have been at the helm yourself for, I think, about 18 years. But I would guess that 2020 has presented some unique challenges. And so, just hopefully you could reflect on us how you were thinking about the portfolio at the onset of the pandemic.

CHRIS AILMAN: I tell you, going into February it was, for us, a normal year. We were really focused in on the low carbon future and that study. We had a fairly neutral asset allocation, but we were a bit cautious. The board asked me every year to list out what they call "inevitable surprises." In other words, big risk events that are likely to happen, but a low probability and will surprise us. In California, the big earthquake is a natural one.

I've been listing a global pandemic for, oh, almost ten years. But I had no expectation, and neither did the board, of the idea of shelter in place, social distancing. I mean, those just weren't words we used when we thought of a pandemic like SARS or some of the others.

KATIE KOCH: And you guys, I think, have a seven percent long-term return target. And you look at equity and fixed income markets now, some people might describe them both as expensive. How do you think about getting to that seven percent target over the long term?

CHRIS AILMAN: Well, and I'm sure I have my critics at Goldman who would say seven is unreasonable. Except, keep in mind, that's a 30-year average. And I really believe, yes, at this point in time with interest rates near zero, fixed income is not going to average seven. It did in the past, in 1982 forward. But we think that there are going to be opportunities in risk assets. You know, certainly in the next five to ten years it's going to be a heck of a struggle. If the Fed stays in and keeps easing, then the equity markets will have a tailwind. But I agree, they're very expensive. I'm very concerned about the value to growth ratio. This looks like 1999 to me. And I'm worried about this election coming up and just some of the real challenges as we get through the health crisis.

There's a huge underlying economic crisis that's not showing up in the numbers. I mean, you can see it in the mom and pop stores going broke. So, we're going to have a long hangover from this health crisis. And that's going to be a challenge for us in this environment. But at the same time, I think we will find some opportunities in risk assets, some of the physical assets like real estate and infrastructure, where over a long haul I think we can average seven.

KATIE KOCH: And in order to get to that long-term target, you're going to hunt for other asset classes, obviously, beyond fixed income and equities. So, what are some other asset classes that will play a big role for you?

CHRIS AILMAN: Well, I think, and I'm not alone, it seems like all the pension plans or sovereign wealth fund are looking at private credit, which makes me nervous when everybody looks at the same area. But I think, you know, we're still seeing some decent returns in some of the core real estate, not exciting. We don't need double digit returns. We just need steady income. Infrastructure, I still believe at some point that's got to open up globally, and certainly in the USA for opportunities for slow, steady income. We're long-term, patient capital. You know? We really do want to have opportunities that are seven, eight percent, maybe leveraged growth opportunities that pay us a steady cash flow. And I think we're going to find a few of those. It's going to be tough going though. The risk on the downside is still going to be, I think, oversized in the next couple of years as we go through the health crisis and potential change in the global economy.

KATIE KOCH: I wanted to pivot a little bit and talk about ESG for a moment. So, when we think about 2020, the pandemic, the murder of Mr. Floyd, the tragic wildfires, obviously, that have ravaged your state, have really brought ESG to the forefront of so many people around the world. I think this is an issue you and CalSTRS have been focused on for a while. But could you expand on your thinking around ESG and how you're incorporating it?

CHRIS AILMAN: We have a social policy dating all the way back to the 1970s. And I think that's because we're a teacher-oriented fund. We really got involved in corporate governance in the 1980s. And we have a dedicated governance unit. And the environmental side really didn't start for us until about 2003. But in 2008 we really brought those all together, those disparate policies to E, S, and G, and really think about sustainability.

And of E, S, and G, you hit it. You know? The S issue with George Floyd brings in income inequality, racial injustice in America. Those issues tend to, frankly, be very sporadic, up and down. Sometimes health. Sometimes social. Sometimes labor. What I have found though is that the E issue is in front of us and is a massive change that's going to occur in our lifetime. Something that will probably last, obviously, for the next 50 years. But something will have to be done in the next ten years. And it's a dramatic change in industries and the way we operate that I think is going to have a huge impact on portfolios. So, we believe that investors absolutely have to be thinking about the climate exposure in their portfolio, companies that can adapt to a new future, versus companies that stay and get stuck in the past. And that's a really challenge in our country because we've had some major industries, you can't just shut down the Midwest and the oil markets. You've got to have a transition, what we call a just transition, into new sorts of energy, new ways of agriculture, new sources of transportation. It will touch every facet of our life. And therefore, every facet of our portfolio.

KATIE KOCH: How can you go about doing a better assessment of diversity and whether it's valued at your external managers, and how they think about inclusion?

CHRIS AILMAN: So, in our case we're going to follow the CFA guidelines. The first step we're going to take is to define what diversity means from our perspective. The second step then is to go out and measure it and hold our managers accountable. And I think we're really looking for managers that make progress, that recognize this where we see change. Because we're starting from a standpoint where it's often been said our industry is very, like me, pale, male, and stale. And we've got to get off that line. And we've got to diversify our talent, diversify our thought process, get more people in the room, and get them involved.

KATIE KOCH: I wanted to just talk a little bit about investment culture and hopefully get some advice from you as well. The first question I wanted to ask you is, when you're thinking about hiring managers, outside managers, or people on your team, what do you think differentiates between a good investor and a great investor?

CHRIS AILMAN: Understanding the culture of an organization. You're not going to get it by meeting them in a conference room or even, sadly, on a Zoom call. You have to get up and actually sit and spend time in that asset manager and see people in their own environment.

One quick story to share. We were told that this firm used a team process. Everything was a group decision. All the buys, all the trades, all the sells were made by the group. We brought somebody in that was random off the org chart. They were wearing blue jeans, so you knew they weren't ready to see us that day. And we asked them those same questions and they verified, yes, it's a team process. And one of my staff, a younger staff person just oddly asked, "Gee, what do you do about a dissenting vote?" And the person thought and said, "Well, you know, we never have a dissenting vote. It's always unanimous." We're like, "Really?" "Yeah." "Tell us about the voting process." And they said, "Oh, well, the CIO goes first. Gives us their view. And then we go around the table." And I said to the staff, "If you like this manager great, but pay attention to the CIO because nobody else is making up their mind."

KATIE KOCH: That's fascinating.

CHRIS AILMAN: It's things like that, you know, you pick up things. You have to spend the time. And you have to notice-- money managers in another culture might be all about alpha and focusing in on results. They become successful. The AUM grows. Suddenly the discussion is, "Who's your tax attorney? What's your next tax shelter? Where's your second home?" Then all of the sudden the discussion later on is, "What are you going to do with your equity share?" All the meantime the alpha starts disappearing. So, I've said to my staff, "Identify the culture. If the culture starts to change, that's the leading indicator. The alpha is actually the lagging indicator. Don't wait for the alpha to disappear before you take money away from that manager." And it's hard to do because it's human psychology.

KATIE KOCH: When you reflect back on your career, what do you think is the biggest lesson you learned? And possibly on the back of maybe a mistake or an investment decision that didn't work out the way you wanted it to, if you have any of those.

CHRIS AILMAN: Oh, I can recite every mistake all the way back to the '80s. The minute you said that the words "Glendale Federal" came flashing across my mind. You know? Not believing just because I say something doesn't make it true. And you know, people always say, "I wish I would have taken more risk." Well, that's because we now know what the opportunities were and what the risk was. Yeah, I wish I bought Apple at five. You know? I used to bad mouth Amazon when I was with the State of Washington that, "Oh gee, they lost more money. So the stock will go up." Well, you know what, it did, and it still has.

Being humble. Asking tough questions. Knowing that you actually don't know everything. You make a decision at that time based on the information you have. There's no second option other than just good, hard due diligence. And I think there is something to that on the ground effort of talking to people, understanding the culture.

As you said, when you look at a firm and you're trying to analyze an industrial firm, I love it when analysts tell us about that they go down to the warranty desk or they go down to the return office and see what's really happening to this product. Forget what management's telling me, what's going on in the lines?

KATIE KOCH: Final question for you. You've been in this industry for a long time. You've achieved tremendous success. What advice would you have for people that are looking to get into this industry now?

CHRIS AILMAN: I really believe we're fundamentally in a shift away from traditional, fundamental analysis and accounting metrics into a broader risk assessment that involves, you know, less spreadsheets and, I don't know if it's Word documents or notes, but it's a more complex way of looking at stuff. And I think you'll still see the horizon machines, with machine learning, because of the speed. But I still think there's going to be a value in good, fundamental analysis and the ability to really understand risk in different ways.

I appreciate your comment about our success. But it really comes from a little bit better performance each and every year. A little bit lower cost structure each and every year. If you look at the separation of pension plans over ten years, first quartile to fourth quartile is a very narrow group. And so, it really is just adding a little bit all the time that really can move you from the bottom of the rank to the top.

KATIE KOCH: Look, Chris, that's tremendous advice. Again, I want to take this as an opportunity to just thank you so much for spending the time with us today, for being a part of the series, and for sharing these really terrific insights. We're deeply appreciative.

CHRIS AILMAN: Well, I'm very honored to be included. And thank you, appreciate it.