



COMMONWEALTH OF PENNSYLVANIA  
PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM

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Public Investment Memorandum

The Children's Investment Fund, LP  
Global Public Equity

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Raymond J. Schleinkofer, CFA  
Senior Portfolio Manager, Traditional Investment Strategies

Jeffrey R. Burton, CFA, PRM  
Senior Portfolio Manager, Non-US Public Equity

November 8, 2017



### **Recommendation:**

Staff, together with Aksia, recommends that PSERS invest up to \$400 million in The Children's Investment Fund, LP (Fund). This recommendation is based on our assessment of the investment strategy, the manager's demonstrated track record and the strategic fit within the overall global equity program.

### **Firm And Vehicle Overview:**

The Children's Investment Fund, LP (TCI or the Fund) was founded in 2004 by Christopher Hohn after successfully managing a European event-driven portfolio at Perry Capital. TCI seeks to outperform the broad equity markets by applying a private equity approach to listed names. This approach leverages deep fundamental analysis, a long-term time horizon, willingness to engage with management, a value orientation and a concentrated portfolio construction philosophy. The firm manages \$24.6B in total AUM including \$16.7B in the flagship master feeder fund, \$4.7B for an eponymous charitable foundation and \$3.3B in a series of private real estate partnerships. The firm employs 56 individuals including a seven-member investment team based in London. The Fund's investment advisor is registered with both the U.S. SEC (exempt reporting advisor) and the UK Financial Conduct Authority (FCA). Christopher Hohn retains full decision making authority over the portfolio.

The Fund is structured as a Cayman master feeder. TCI does not offer separate accounts and while various share classes offer different liquidity in exchange for more attractive LP economics, the firm has not engaged in side letters offering additional liquidity or lower fees. TCI principals have significant amounts of personal capital invested in the fund and a strong alignment with investors. A majority of the fund's capital crystallizes incentive fees after two or three-year periods further aligning the manager with investors.

### **Investment Strategy:**

TCI targets investments in strong businesses with demonstrated pricing power and sustainable barriers to entry. The manager will build significant positions in such companies when shares are trading at meaningful discounts to estimated fair value. TCI believes that these opportunities occur due to 1) short term views from traditional investors 2) agency issues that can be resolved through engagement with management, and 3) complexity that obscures true economic value. TCI will hold positions for multiple years in order to see its value creation themes realized, riding through quarterly earnings volatility that might trigger sales for other investors. TCI maintains a robust active dialogue with the management teams of the companies it owns to ensure that assets are being utilized most effectively and that management's incentives are appropriately aligned with shareholders. Finally, TCI will deeply analyze each of its positions, understanding complex accounting, legal or regulatory issues that can obfuscate the true value of particular company. The manager implements its strategy through a portfolio of public equities with the following exposure profile:

- Long Biased Equity Exposure
- Global Footprint
- Sector Agnostic
- Large Market Capitalization

### **Portfolio Fit:**

Although TCI is organized in an LP structure and retains the ability utilize modest leverage and opportunistic short selling, we have categorized the investment as part of our global equity allocation. It will be categorized with our non-US equity managers. The group compares against the MSCI AC World Ex-US Index. The exposure profile and historical return data indicate that the Fund is likely to experience the return profile of an equity investment rather than that of a traditional hedge fund.



### **Investment Instruments:**

The vast majority of TCI's positions are expressed through publicly traded equities; however, the manager has opportunistically taken positions in corporate debt when it has identified opportunities that offer a risk return profile similar to that of its public equity positions (up to 5% of NAV at the time of investment may be invested in private equity positions and a maximum of 15% of NAV may be invested in real estate debt). Listed options have occasionally been utilized to hedge the portfolio or refine exposure to a specific equity situation.

### **Investment Team:**

Christopher Hohn (CIO) is supported by a seasoned team of seven equity analysts with an average of 20 years of investing experience. Analysts are loosely divided by sector allowing idea generation to arrive from all sources. Analysts will frequently lead interaction with corporate management; however, the portfolio manager is intimately involved in all significant positions and makes all final decisions.

### **Investment Highlights:**

<b>Track Record</b>
TCI has delivered a compound annualized return of 18.2% since inception vs. 7.0% for the MSCI World Index. The manager has achieved this performance with comparable volatility (16.4% vs 14.6%) and an information ratio of 1.0. 86% of annualized one-year returns have surpassed the benchmark index.
<b>Repeatable Process</b>
The manager's investment process is straightforward, easily underwritten and repeatable, allowing us to accept the tracking error with confidence. Active engagement with corporate management offers a method to control investment outcomes and drive returns.
<b>Serves Our Long Run Portfolio Construction Goals</b>
The manager's deep fundamental work on core positions serves to inform our internal management efforts potentially helping us to lower the overall cost of equity alpha. It also offers a more nimble vehicle for applying a private equity strategy should the market experience a severe correction.
<b>Enhances Overall Portfolio Efficiency</b>
TCI's concentrated portfolio construction approach contrasts with our existing large capitalization managers (Marathon, Baillie Gifford and BlackRock) providing diversification benefits as evidenced by five year excess return correlations of 0.47, -0.02, 0.14, respectively.

### **Investment / Risk Considerations:**

<b>Headline Risk</b>
The majority of TCI's positions have not required active engagement and few have involved contentious campaigns. Nevertheless, TCI will vigorously utilize all available options to protect shareholder rights, occasionally attracting public attention. While this tenacity can be uncomfortable for management, TCI's campaigns remain within the bounds of professional strategic dialogue and honest disagreement.
<b>Keyman Dependence</b>
The strategy is highly dependent on Christopher Hohn and his departure or incapacitation would call the track record's relevance into question. The portfolio manager's substantial personal investment in the fund and complete ownership of the advisor give us confidence that departure is unlikely barring unforeseen health issues. Given the high liquidity of the underlying portfolio and the fund's keyman clause, we expect that liquidity would be achieved quickly after such a departure.
<b>Tracking Error</b>
TCI's strategy is driven by stock selection without regard for benchmark composition. Historical



tracking error has been 11% per annum. Short term periods of underperformance are almost assured. Historically such periods have been followed by violent rebounds on both an absolute and relative basis. We would look to utilize these opportunities to build our position.

**Concentration**

TCI's portfolio is highly concentrated meaning that individual positions will have a meaningful impact on the overall portfolio. This concentration can boost volatility and the downside risk in scenarios where the manager's thesis proves incorrect.

**Liquidity**

TCI has multiple share classes, with varying base fees, profit shares, and lock ups. Lock ups range from none to 3 years. In recent years, TCI has sought to migrate more of its investors to share classes with the longer lock ups, putting TCI between the daily liquidity of traditional public equity funds and the long lock ups of private equity. While the underlying portfolio is highly liquid consisting of large capitalization, exchange-traded equities, migrating its investors to longer lock up, longer duration capital allows the manager to view equities strategically, giving the manager an advantage over other market participants.

**Asset Growth**

TCI has seen assets grow to nearly \$17B through subscriptions and performance. Ultimately, asset growth can force incremental diversification or reduced liquidity. We have reviewed TCI's historical portfolios and gained comfort that the track record has been achieved through large capitalization equities that offer the manager substantial additional room for growth.

**Finance Committee Disclosure:**

Relationship with Aksia:	None Disclosed
Introduction Source:	Aksia; Investment Office Staff
Placement Agent:	None Used
PA Political Contributions:	None Disclosed
Potential Conflicts:	We are not aware of TCI having any material investment conflicts.
PSERS History with the Investment Manager:	This investment will be PSERS' first investment with the manager.
PSERS Allocation Implementation Committee Approval:	November 8, 2017

**Oversight Responsibility:**

Investment Office:	Tom Bauer Raymond J. Schleinkofer Jeffrey R. Burton	Deputy CIO, Traditional Investments Senior Portfolio Manager Senior Portfolio Manager
External Consultant:	Aksia LLC	

Manager Recommendation Memo

November 8, 2017

Board of Trustees  
 Pennsylvania Public School Employees' Retirement System  
 5 North Fifth Street  
 Harrisburg, PA 17101

Re: The Children's Investment Fund LP

Dear Trustees:

Aksia LLC, having been duly authorized by the Board of PSERS, has evaluated and hereby recommends a direct allocation to The Children's Investment Fund ("TCI") in line with PSERS Investment Policy Statement, Objectives, and Guidelines. It is further recommended that PSERS invest up to \$400 million in TCI.

Prior to founding TCI in 2004, Chris Hohn worked at Perry Capital from 1996 to 2003 where he managed a European-focused event-driven portfolio. While at Perry, Chris managed a carve-out in the main fund as well as later managing the Perry Capital European Fund. TCI launched with around \$700mm in assets and grew rapidly through strong performance and inflows. Today, the firm manages roughly \$21.5bn as of February 2017, the bulk of which is managed in the main fund.

TCI pursues a bottom-up, and long-biased strategy that invests globally, primarily in equities although it may take positions in credit. The strategy seeks to be value-oriented, focused on investing in businesses with barriers to entry, positive return on equity, a positive structural growth story, and operating in a monopolistic or oligopolistic industry. The basic premise of the manager is that in select cases, business profitability in such industries is persistent. The manager seeks out situations where poor corporate governance or temporary business and/or macro issues are masking the value of such businesses. As with the case with many other value-oriented firms, TCI is often positioned highly directionally and holds a highly concentrated portfolio with individual names reaching 20% of NAV at times.

Aksia's recommendation is based upon the following analytical factors and is made within the context of PSERS' investment guidelines:

- Due diligence of the investment process, including a review of their investment strategy, investment team personnel and structure, and risk management;
  - Most recent on-site investment due diligence visit conducted August 2, 2016 for the 2017 investment review update. The following is a listing of the other relevant points of contact with the manager, in addition to regular monthly monitoring updates, since the last onsite visit.

Date	Nature of Contact	Aksia Points of Contact
October 25, 2016	Onsite meeting in London	Emily Pritchett
June 5, 2017	Onsite Investor Day in London	Oliver Newton
June 21, 2017	Investor Day in New York	Farhad Dalvi

- Due diligence of operations, including an operations and infrastructure review, regulatory and compliance review, PPM review, Form ADV review, and Financial Statement Review;
  - On-site operational due diligence visit conducted December 7, 2016 for the 2017 operational review update.
- Evaluation of the TCI strategy within the context of the current investment environment; and
- Appropriateness of TCI as a component of the PSERS' portfolio.

This recommendation is given solely for the benefit of PSERS and cannot be relied upon by other investors considering an investment in TCI, since their needs, objectives, and circumstances may not be identical to those of PSERS. The scope of this recommendation is limited to the investment merits of TCI. Aksia manager recommendation memos should be reviewed with other Aksia due diligence materials, including the due diligence reports. In addition, please consult your tax, legal and/or regulatory advisors before allocating to any private investment fund.

Please feel free to contact us should you have any questions about this recommendation.

Respectfully,



Joseph Larucci  
 Partner, Head of Equity Strategies



Simon Fludgate  
 Partner, Head of Operational Due Diligence