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November 13, 2001

AGENDA ITEM 6e

TO: MEMBERS OF THE INVESTMENT COMMITTEE

I. SUBJECT: Corporate Governance Program

II. PROGRAM: Public Markets

III. **RECOMMENDATION:** 1) Approve CalPERS' Corporate Governance Strategic Plan, including the framework for pursuing future investments in governance strategies.
2) Approve an additional allocation of $1.2 billion to external governance managers.
3) Approve an investment of $500 million to CalPERS' Internal Relational Program subject to approval of a policy by the Policy Subcommittee and the Investment Committee. Staff is seeking delegation to execute agreements with external managers under this program without prior Committee approval of each relationship (partnership with the external manager). Attachment 4 contains Wilshire's opinion letter.

IV. ANALYSIS:

The purpose of this agenda item is to present the Investment Committee with a Strategic Plan for active management in corporate governance, including:

A) A strategic framework for pursuing potential future investments in this arena;

B) An additional allocation of $1.2 billion to external governance managers[1]; and
C) An implementation plan for CalPERS' Internal Relational Program with a $500 million initial investment.

CalPERS has built valuable experience in corporate governance over the years, including the active management of funds under a governance strategy. Staff has considerable confidence that we can continue to add value to the Fund, above returns available from our core indexing strategy and competitive with external active management, by continuing to enhance and grow active management in the governance arena. Our experience indicates that governance strategies have proven successful, and that now is an opportune time to review our history in active management of funds under the corporate governance strategy. Therefore, we are proposing a strategic plan to the Committee for advancing CalPERS' Corporate Governance Program in regards to the active management of funds.

The governance strategy is an active subset of global equity, therefore, an expansion of the active governance program will require a reallocation from other equity programs. Staff believes that the potential exists for continued returns in excess of market returns and increasing our active management under this strategy will bring additional benefits to CalPERS. Several reasons support this belief:

- active governance strategies help support our broader public markets investments as well as our overall governance message;
- there are potential synergies between our internal Governance Program and our active external managers in this strategy;
- staff can successfully implement this strategic plan (including the active manager search and the Internal Relational Program) with existing resources.

In the discussion that follows, we provide a brief review of the existing active portfolios within CalPERS' Corporate Governance Program. Then, we present a strategic framework for additional investments with external governance managers. We follow with an implementation plan for internal corporate governance investments by staff. Last, we summarize our conclusions and recommendations.

Review of CalPERS Active Corporate Governance Managers

CalPERS' initial investment in an actively managed corporate governance fund was a $200 million investment in Relational Investors LLC in March of 1996.

[1] With the additional allocation represented in B and C, the total commitment to active management in Corporate Governance will be $3 billion.

Since then, CalPERS' actively managed corporate governance funds have grown to three managers with total committed capital of $1.3 billion.

The following table provides an overview of CalPERS' current commitment to external actively managed corporate governance funds.

Table 1

Manager	**Initial Commitment**	**Follow on Commitments**	**Total Commitment**
Relational	$200 Million	$550 Million	$750 Million
Active Value	$200 Million	$150 Million*	$350 Million
Hermes	$200 Million	None	$200 Million

*Represents a co-investment vehicle

Review of Current Active Managers

Relational Investors, who was initially funded in March of 1996, is the oldest and best performing of our corporate governance managers, with current commitments of $750 million. Relational's investment strategy focuses on unlocking intrinsic value in under-performing, publicly traded U.S. companies. The companies, which are selected under Relational's approach, have a strong fundamental business model but are under-performing their peers due to management or board-related issues. Relational generally takes a 3-10% position in each company and seeks to maximize investment value by initiating contact with the company's management, board of directors, and other shareowners to facilitate change.

Active Value, which was initially funded in September of 1998, has a more aggressive approach in dealing with companies. They invest in publicly traded European (primarily U.K.) companies that are strong companies with leading positions in their respective industries but are suffering from poor management. Each investment will be from 10-25% of the company's outstanding shares and the focus tends to be on small capitalization stocks. Once the investment is made, Active Value will push the management team to make corrections in order to unlock the intrinsic value, often using the press as a tool to bring public awareness to issues and cause management to make changes.

Hermes Focus Fund is our most recent Corporate Governance manager, which CalPERS funded in November of 1999, with $200 million. Hermes invests in medium to large capitalization, publicly traded U.K. companies. The

investments are in companies in which Hermes has identified areas where value can be improved and in which they have a good working relationship with the board and company executives. Initial positions tend to be small with a 1-3% stake being common, but they will take larger positions as they feel more comfortable that management is willing to adopt changes and respond to shareholder input.

The returns for the corporate governance managers are presented in the following table.

Table 2

Manager	Benchmark	Inception Date	Manager Return*	Benchmark Return*	Excess Return
Relational	S&P 500 +275 bps	3/96	38.09%	9.04%	29.05%
Active Value	FTSE All Share	9/98	-6.10%	-3.38%	-2.72%
Hermes	FTSE 250 +160 bps	11/99	0.18%	-3.75%	3.93%

Source: Wilshire Associates
*All returns are annualized since manager inception through June 30, 2001

Strategic Framework for Further Investments in Corporate Governance

CalPERS' current external governance managers were selected as a result of an opportunistic process intended to identify managers who could add value through corporate governance initiatives. They were not selected through formal search processes, as is generally the case with CalPERS' public markets managers. Instead, these managers were identified as offering a unique opportunity to CalPERS' and that opportunity was pursued. Staff believes that an opportunistic methodology remains the best alternative for pursuing additional investments in the governance area. The original process did not consider a global mandate. As a result, CalPERS' current governance managers are primarily focused only in the U.S. and the U.K.

Staff's experience indicates that this strategy not only offers the opportunity for excess returns, but also offers support for CalPERS broader public markets investments in that it helps promote better corporate governance in the markets in which it is applied. Further, corporate governance strategies have expanded in recent years, both in the number of managers employing this strategy (thus the potential universe of partners), and in the geographic regions in which it is feasible and attractive.

Given these points, it is prudent to analyze CalPERS broader public market exposure and our corporate governance strategy together. Staff proposes that

an analysis comprised of the following three key aspects be used to drive our strategic plan for further investments in the corporate governance arena:

1) an analysis of CalPERS' global equity exposure and our existing investments under the governance strategy;
2) an analysis of geographic regions' and key markets' ability to accommodate a governance strategy; and,
3) an analysis of managers within these markets.

1) CalPERS' Global Equity Exposure

Attachment 1 outlines CalPERS' current public equity exposure globally compared to our active management of governance funds. As can be seen, CalPERS' active management in corporate governance is concentrated in the U.S. and the U.K., and these are markets where CalPERS has significant equity exposure. The other primary markets where CalPERS has significant equity exposure, but little or no active corporate governance funds under management are Japan and Continental Europe.

Given the above (as well as the analysis of these key markets below), staff feels that additional, or initial, investments should be focused on our domestic markets, Japan, and Continental Europe. While we believe other opportunities do exist and will continue to arise, we recommend that CalPERS focus its attention on these key markets in the near-term. We do feel that additional markets will continue to develop in their attractiveness for a governance strategy and that eventually CalPERS should consider expanding its focus under this strategy. However, we feel it is prudent to focus our efforts on implementing this strategy in our key markets first.

2) Key Markets Analysis

To date CalPERS' governance strategy has focused on the U.S. and U.K. markets. However our experience indicates that governance strategies will work in other markets as well. Both Japan and Continental Europe are seeing exciting changes taking place in their markets. Japan is in the process of unwinding large cross shareholdings, which is moving companies to focus more on shareholder issues instead of remaining complacent under the protection of the Keiretsu stakeholders. Europe has also seen radical reform and with the European Union breaking barriers of trade and capital flows, the markets appear ready for additional change.

Listed below are some of the developments in the Japanese and European markets that have occurred in the past few years that make governance strategies attractive to institutional investors.

Japan

- Cross shareholdings have declined from 45.8% to under 35% and will likely continue to decline
- Foreign equity ownership has increased steadily since the mid 1980's and is now approximately 20%
- Merger and acquisition deals in Japan reached a record 1,635 in 2000 up 40% from 1999
- Shareholder lawsuits have risen from less than 30 in 1992 to nearly 300 in 1999
- Implementation of mark to market accounting effective March of 2002
- Foreign acquisitions are becoming more common, for example, Ford taking over Mazda, Renault acquiring Nissan, and GE Capital taking over Japan Leasing
- Financial deregulation laws passed in 1999

Continental Europe

- June 2000 Publication of Berlin Group's German Code of Corporate Governance
- January 2002 marks the start of new tax reforms in the EU which will limit the capital gains burden for unwinding cross shareholdings
- Germany and France now allow any shareholder with a 5% holding in a company to call an Extraordinary General Meeting
- Privatization of retirement obligations from the state into private sector pension funds in the EU will significantly increase the funds flowing into European equity markets. Globalization of capital markets have forced companies on the Continent to focus on governance issues or be shunned by foreign institutional investors
- Corporate collapses of Metallgesellschaft and Schneider property group in Germany and the financial scandal of Olivetti in Italy are breaking the traditional stakeholders power over these companies

In summary, these markets are at various degrees of development in their ability to accommodate a governance strategy. However, in all cases we feel that there is adequate evidence that further (in the case of the United States and Continental Europe), and initial (in the case of Japan) investments in these markets offers significant opportunity to CalPERS.

3) Manager Analysis

Manager analysis, as well as a continuing analysis of the key markets identified, will be conducted through the strategic framework and review process presented in this item

Additional elements of the strategic plan, such as proposed allocations, the proposed search process, and potential partnerships are discussed below:

Proposed Allocations

As previously noted, the table in Attachment 1 provides an overview of CalPERS' exposure to global equity markets. The bulk of CalPERS' international equity exposure can be grouped into three primary regions, the U.K. Japan, and Continental Europe, which combined make up approximately 85% of our international exposure.

Staff is recommending that the Committee approve a goal of approximately $3 billion globally for corporate governance style investments, comprised of both internal and external management (including our current investments in corporate governance managers).

Staff suggests the following strategic targets as an initial goal for allocation of the System's investments in its Global Corporate Governance Program (divided between international and domestic allocations):

U.S. Markets total allocation:			$ 1.75 billion
Of which:	Current investments	$ 750 million	
	New Allocation	$ 500 million	
	Internal Relational[2] (new)	$ 500 million	
International total allocation:			$ 1.25 billion
Of which:	United Kingdom[3] (existing)	$ 500 million	
	Japan (new)	$ 400 million	
	Continental Europe (mostly new)	$ 350 million	
Total			$ 3.00 billion

These targets are intended to provide an allocation in the governance arena to the major markets where CalPERS has significant public equity exposure and where we have gained confidence that the markets are attractive to institutional

[2] The Investment Committee approved the concept of taking larger positions internally in selected companies through CalPERS' Corporate Governance Program at the February 2001 meeting. Part three of this item provides an implementation plan for this program, which would be called CalPERS' Internal Relational Program.

[3] Both Active Value and Hermes are U.K. based. Staff has represented $500 million as our current allocation to the U.K. despite the fact that our combined commitment to these managers equals $550 million. Active Value's mandate provides for the opportunity to invest a small portion of the fund in Continental Europe. We have conservatively estimated this allocation at $50 million, however, Active Value has only made minimal investments on the Continent to date. This amount is represented in our proposed allocation to Continental Europe of $350 million.

investors through a governance strategy. Any additional allocation to the Corporate Governance Strategy will initially be funded from CalPERS' index funds. The time frames for funding these strategies will vary by region, but staff would expect to incrementally build the investments in external managers up to these allocations over the course of approximately 1.5 years.

Search Process

The search process used to identify additional governance managers will be similar to the process used to identify CalPERS' current corporate governance managers, an opportunistic methodology aimed at evaluating investments in our key markets.

Should the Committee approve this process as part of the Strategic Plan, staff will begin to evaluate opportunities focusing in our key markets, as identified in this strategic plan, under the proposed time frames identified below.

Japan: December 2001 to July 2002

Continental Europe: July 2002 to December 2002

U.S.: December 2002 to July 2003

Given the opportunistic nature of this arena, staff may evaluate opportunities outside of the proposed schedule, and outside of our key markets in some cases. The schedule for evaluating markets is intended to provide a primary focus for our efforts and an overview for the Committee. Staff does not have sufficient resources to focus efforts in all of our key markets simultaneously. Therefore, we believe that the schedule provided as the focus of our primary efforts with the ability to evaluate significant opportunities outside of this schedule will produce the best ultimate product in building these investments.

As staff identifies opportunities, potential managers will be presented to the Investment Committee for interviews and approval. Given the opportunistic nature of this arena and proposed process, staff is not able to specify an exact schedule for bringing proposed managers before the Committee. It is our expectation that we will bring recommendations for investments with external managers to the Committee for approval as opportunities arise. This process is consistent with the Investment Committee's approval of other hybrid investments, such as our current corporate governance managers. Staff will provide an activity report to inform the Committee when we are conducting due diligence on one or more managers.

Consistent with Wilshire's role in previous search processes, staff is requesting that Wilshire aid in this process by providing information, available through their

database or other sources, regarding specific managers that we may wish to review. Furthermore, we are requesting that once staff has conducted an initial level of due diligence, Wilshire conduct independent due diligence on those managers identified by staff as candidates for investments. Wilshire's analysis would be presented as part of staff's presentation and recommendation to the Investment Committee.

Staff will provide a review of the Strategic Plan for Active Corporate Governance no later than August 2003.

Partnerships with governance managers

Staff will consider obtaining an equity stake, as may be appropriate and attractive to CalPERS, in governance managers identified through this search and strategic allocation process. Staff feels that CalPERS' significant commitment to this arena, both in terms of capital and experience are valuable assets to potential partners. Staff also believes that these governance funds are growing in popularity and that as they do CalPERS can benefit from our early entry and through an equity stake in those firms which have the greatest likelihood of success. As such, we feel that it may provide significant long-term value to CalPERS to take an equity stake in some of the firms we partner with. This issue will be considered throughout the search and interview process, and would be negotiated as part of the placement of CalPERS' funds. Staff does not believe that a potential equity stake will be a critical issue, and would continue to evaluate potential partners/managers regardless of the attractiveness and opportunity for an equity stake. In evaluating potential equity stakes, staff will draw on the expertise developed by the Global Equity Unit in its Manager Development Program, as well as our AIM Program. Any proposal to take an equity stake in an external manager through this program will be presented to the Committee for approval, and would likely be subject to negotiations with the specific firm.

3) Implementation Plan for CalPERS' Internal Relational Portfolio

At the February 12, 2001 Investment Committee meeting, the Committee approved the concept of taking larger positions internally in selected companies through CalPERS' Corporate Governance Program (Attachment 2 contains an excerpt). This portfolio would be called CalPERS Internal Relational Program. Staff recommends an initial allocation of $500 million for this program.

CalPERS' Internal Relational Portfolio will be an active internal equity portfolio, based on fundamental analysis and corporate governance.

Should the Committee approve the CalPERS Internal Relational Program, staff will develop a policy and obtain Policy Subcommittee Committee and Investment Committee approval before initiating the program.

Implementation of CalPERS' Internal Relational Portfolio

CalPERS' Internal Relational Portfolio will be centered around partnerships with external governance style managers. CalPERS' staff will gain synergies from the relationship and will build internal expertise, as well as provide added support for our external managers' strategy. Initially, staff will focus on partnering with Relational Investors LLC, but may expand the program to partner with other governance style managers, including managers that have no other contractual relationships with CalPERS. Staff is seeking delegation to co-invest in partnership with external managers under this program without Committee approval of each relationship. The program parameters and the basic mechanism of the research process and investment decision will be as follows:

Parameters of CalPERS Internal Relational Portfolio

Size: Up to $500 million total.

Markets: U.S. publicly traded securities.

Benchmark: CalPERS' Internal Relational Portfolio will be benchmarked against the Custom CalPERS Wilshire 2500.

Fees: Since this portfolio will be essentially internally managed, and only simple letter agreements will exist between CalPERS and partners under this program, no management fees or incentive fees will be applicable.

Expenses: Expenses specific to each investment will be shared between CalPERS and its partner on a pro-rata basis. Estimated expenses will be analyzed as part of the investment decision specific to each proposal. The types of expenses that may be incurred include legal, travel, research, and proxy. CalPERS' Legal Office will provide support for this program, but all expenses related to the Internal Relational Program will be paid from the Investment Office Budget.

Strategy: The portfolio will target undervalued companies which are underperforming due to a correctable deficiency in the company's management or operations. In cooperation with an external manager, CalPERS will work with the company's management, Board of Directors, and other shareholders to build a consensus identifying the deficiency and the means to correct it. Tactics employed to address underperforming

companies will be consistent with the Committee's U.S. Corporate Governance Core Principles and Guidelines.

Partnerships: CalPERS will leverage existing and future relationships with external managers to provide support for this program. The partner will conduct a full analysis, which investment decisions will be based upon. While CalPERS may choose to conduct some level of analysis internally, the partner will conduct a full analysis regardless of the analysis completed by CalPERS. In addition, CalPERS will provide for alignment of interests by requiring a significant investment from the partner on a side-by-side basis. Specific parameters will be detailed in the Internal Relational Policy.

Although the terms may vary case by case, the partnerships will be informal in nature, and no explicit contractual relationship will be formed for the purpose of this program. Each investment will be made under a letter agreement which will address items specific to the investment, such as, purchasing and selling shares, reporting requirements, expenses, confidentiality, and termination. Agreements will only be made after consultation with CalPERS internal and external counsel.

External Reporting Requirements: Due to the nature of relational investing, many investments will involve taking substantial positions, both in terms of the dollars invested and our holdings as a percentage of the company's outstanding shares. At times, investments may fall under group rules for purposes of Securities and Exchange Commission (SEC) Regulation 13(d)[4], and will have filing requirements under this Regulation.

Internal Reporting: Staff will provide a transaction report to the Investment Committee as each investment under this program is completed (When CalPERS has taken its initial position).

Research Process and Investment Decision Mechanism

The following provides an overview of the investment sources, due diligence process and joint investment decision mechanism:

- The external manager (partner) or CalPERS will source investment ideas. It is anticipated that, initially, a majority of the potential investments will be identified by the partner. CalPERS will continue to build its internal expertise

[4] In 1968, Congress enacted legislation requiring beneficial owners of more than 5% of a voting class of equity securities to report to the SEC. The purpose of this reporting requirement, set forth in section 13(d) of the Securities and Exchange Act, was "to provide information to the public and the affected issuer about rapid accumulations of its equity securities in the hands of persons who would then have the potential to change or influence control of the issuer."

to identify potential investments under this strategy. CalPERS' primary source of potential investments internally will be through value and governance screens developed in the Corporate Governance Unit. Potential investments may include current, previous, or potential Focus List companies. However, we expect the number of Focus List companies that will be held in the Internal Relational Portfolio to be limited.

- Initial due diligence will be performed independently by the partner and by CalPERS' staff.
- Viable candidates for this program will be discussed informally between the potential partner and CalPERS. Those potential investments warranting further review will be fully analyzed by the partner. CalPERS may conduct its own research on potential targets, but a complete analysis will be performed by the partner regardless of the analysis performed by CalPERS' internal staff. CalPERS and the partner may choose at this point to sign an agreement letter.
- CalPERS and the partner will make a joint decision to invest in the company, and will finalize a company specific strategy for realizing long-term value from the investment.

Summary of Conclusions and Recommendations

CalPERS' has had significant success in its Corporate Governance Program, both through external managers and through its internal program. Staff believes that active corporate governance strategies offer not only excellent potential to outperform the market, but also support for our broader public market equity exposure.

Staff is recommending that CalPERS adopt a strategic plan addressing both internal and external active governance management (the Strategic Plan is summarized in bullet point form in Attachment 3). This plan is geared toward increasing the System's commitment to active management under a governance strategy.

Staff is recommending an additional allocation of $1.2 billion to external governance managers, and an initial focus on CalPERS key markets where we have our greatest public market equity exposure.

Staff is recommending CalPERS' Internal Relational Program at an initial funding level of $500 million. This program offers CalPERS' the ability to add significant value through its expertise in corporate governance and its strong relationship with external partners in the governance community. The Internal Relational Program will leverage the capabilities of external managers, and will provide the ability for CalPERS staff to gain additional expertise. CalPERS will also add significant value to the partnerships through our own expertise and

reputation in corporate governance. The partnerships formed through this program will be stronger and able to accomplish more than either partner could achieve on their own.

V. STRATEGIC PLAN:

This is not a product of either the Strategic, or the 2001/02 Annual Plans. However, it does support Goal IV, which seeks to assure that sufficient funds are available to pay benefits and to minimize and stabilize employer contributions.

VI. RESULTS/COSTS:

Costs associated with conducting a search for active managers is contained within the Investment Office Budget.

Costs associated with implementing the Internal Relational Program are expected to be minimal, and can be assumed with the existing Investment Office Budget. Costs associated with specific investments through the Internal Relational Program may vary significantly, and would be analyzed as part of each specific investment on a cost vs. potential return basis. Staff expects that potential returns from this program will be significant, and will far outweigh potential costs.

Devin Lamb
Investment Officer II,
Corporate Governance

Bill McGrew
Investment Officer I,
Corporate Governance

Ted White
Director, Corporate Governance

Mark Anson
Senior Investment Officer

Daniel Szente
Chief Investment Officer

Members of the Investment Committee
November 13, 2001

Attachment 1

Country	Total Market Cap (in millions$)	CalPERS (in millions$)	CalPERS % Market Share	% of CalPERS Global Equity Exposure	Current Governance Exposure*
Europe ex UK					
AUSTRIA	9,316.04	39.38	0.42%	0.05%	
BELGIUM	69,474.19	217.54	0.31%	0.26%	
DENMARK	50,757.92	135.53	0.27%	0.16%	
FINLAND	97,633.21	299.27	0.31%	0.36%	
FRANCE	648,190.73	2,203.44	0.34%	2.62%	
GERMANY	426,753.27	1,411.29	0.33%	1.68%	
GREECE	29,996.24	3.17	0.01%	0.00%	
IRELAND	53,077.56	214.86	0.40%	0.26%	
ITALY	237,669.30	797.25	0.34%	0.95%	
NETHERLANDS	370,224.11	1,434.88	0.39%	1.71%	
NORWAY	31,378.40	88.41	0.28%	0.11%	
PORTUGAL	31,304.92	105.89	0.34%	0.13%	
SPAIN	202,057.18	625.16	0.31%	0.74%	
SWEDEN	135,015.23	387.15	0.29%	0.46%	
SWITZERLAND	468,783.12	1,495.36	0.32%	1.78%	
Total Europe ex UK	2,861,631.42	9,458.58	0.33%	11.24%	
Other Markets					
ARGENTINA	4,139.38	10.81	0.26%	0.01%	
AUSTRALIA	216,231.23	672.76	0.31%	0.80%	
BRAZIL	38,270.11	124.62	0.33%	0.15%	
CANADA	351,352.49	986.14	0.28%	1.17%	
CHILE	12,855.47	28.64	0.22%	0.03%	
HONG KONG	140,835.65	539.17	0.38%	0.64%	
INDONESIA	5,013.10	17.60	0.35%	0.02%	
KOREA	54,917.83	239.61	0.44%	0.28%	
MALAYSIA	33,562.44	61.50	0.18%	0.07%	
MEXICO	56,119.16	181.20	0.32%	0.22%	
NEW ZEALAND	8,346.52	31.48	0.38%	0.04%	
PHILIPPINES	4,507.65	13.48	0.30%	0.02%	
SINGAPORE	44,227.93	205.14	0.46%	0.24%	
SOUTH AFRICA	54,977.15	150.05	0.27%	0.18%	
TAIWAN	44,695.18	137.92	0.31%	0.16%	
THAILAND	6,348.49	22.31	0.35%	0.03%	
TURKEY	4,482.08	8.97	0.20%	0.01%	
Total Other Markets	1,080,881.86	3,431.40	0.32%	4.08%	
JAPAN	1,398,161.50	4,386.05	0.31%	5.21%	
UNITED KINGDOM	1,755,178.51	5,446.94	0.31%	6.47%	9.18%
USA	9,139,379.00	57,993.57	0.63%	68.92%	1.29%
TOTALS	17,316,114.15	84,147.94	0.49%	100.00%	1.54%

Source: State Street Bank as of 9-28-01

*Percentage of CalPERS investment committed to governance strategies. These figures represent CalPERS investments to Hermes, Active Value, and Relational.

Attachment 2 is an excerpt from an agenda item of the February 20, 2001 Investment Committee meeting. The section presented is related to the Internal Relational Strategy.

1) Internal Relational Strategy

Staff recommends that the Board confirm its commitment to corporate governance by adopting an internal relational management strategy. There would be two major components to the internal relational management strategy. However, the foundation of the program would consist of the Committee's current program.

A) Increased Commitment to the Focus List Program:

Staff is seeking an endorsement from the Committee to increase its commitment to the current Focus List program. To some degree this has already been accomplished through the implementation of the Three-Year Monitoring List. The purpose of the Monitoring List is to monitor the performance of Focus List companies and to continue to work with them regarding the implementation of agreements that may have been made with CalPERS or other shareholders. The Monitoring List will contain all the companies CalPERS' Corporate Governance Program is involved with, including both the Focus List, and the Corporate Partners List. Under the Internal Relational Strategy, staff proposes to work closely with these companies regarding these issues, and more significantly, to continue to evaluate the company's strategic direction and governance profile. In some cases staff will pursue a more aggressive strategy as circumstances warrant. Potential courses of action may include: the use of external consultants for in-depth business reviews; continued use of shareholder proposals; the formation of partnerships with other shareholders to pursue value creating initiatives; seeking the removal of one or more members of management; and proposing dissident slates of directors.

B) Provide the Ability to Take Larger Positions in Selected Companies:

Staff is seeking the discretion to take more significant positions in selected companies in which CalPERS' Governance Program will be involved with. In general, the cases where CalPERS may take more significant positions will be limited to those where compelling value can be identified, the situation is conducive to CalPERS' involvement, and clear and compelling governance issues are present. The number of companies that CalPERS would take larger positions in would be minimal, at any given time, due to the nature of the strategy. CalPERS will seek strategic partners in many cases to leverage our strengths and the strengths of the partner. Potential partners may include existing CalPERS external managers, such as Relational Investors, other investors, or specialized consultants. For example, LENS is now providing services that would fit this category.

Should the Committee approve this concept, staff will develop an implementation plan and present it to the Committee.

Attachment 3

Strategic Plan, 2002 and 2003
CalPERS' External Active Corporate Governance Management November 13, 2001

CalPERS will strive to maintain a leadership role in corporate governance globally. The Investment Committee continues to believe that the System can attain attractive risk adjusted returns, and further CalPERS' goal of enhancing corporate governance through the active management of funds under a governance strategy.

CalPERS is committed to the following strategic goals in regards to the active management of funds in the governance arena in 2002 and 2003:

- Continue to analyze markets globally for opportunities in corporate governance related investments, with an initial focus on the four key markets where CalPERS has significant equity exposure (U.S., U.K., Japan, and Continental Europe).
- Using the Investment Committee's approved selection process, evaluate potential managers and partners and bring recommendations to the Committee.
- As CalPERS strategic goal, allocate funds under a governance strategy as follows (including existing investments):
  - U.S. $1.75 billion (including Internal Relational)
  - U.K. $500 million
  - Japan $400 million
  - Continental Europe $350 million
- Review CalPERS' Strategic Plan for Active Corporate Governance Management and report to the Committee by the August 2003.

ATTACHMENT 4

Rosalind M. Hewsenian
Managing Director

November 1, 2001

Mr. Daniel Szente
Chief Investment Officer
California Public Employees' Retirement System
400 P Street
Sacramento, CA 95814

Re: Corporate Governance Program

Dear Dan,

You had requested Wilshire's opinion with respect to Staff's recommendation regarding expansion of corporate governance investments. Wilshire concurs with Staff's recommendation.

Discussion

As part of its responsibilities to the CalPERS Investment Committee, Wilshire has measured the effect of CalPERS' existing corporate governance program. In short it has worked. The program has added value and enabled CalPERS to enhance return in an area of public markets investing where in effect CalPERS is a permanent owner of companies. This program so far has been based solely on the positions that exist in CalPERS' index funds.

CalPERS has begun a program of investing in external corporate governance funds, a form of hybrid investing,[1] that thus far has proven to be successful particularly in light of extreme market conditions both here and in the UK. Therefore, expanding the program is reasonable in the face of this documented success.

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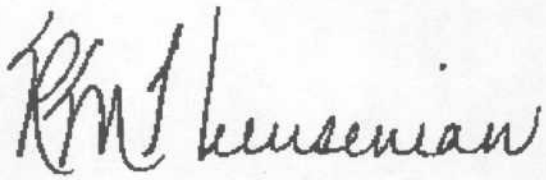
[1] Hybrid investments are those offered in a limited partnership format where the underlying investment is publicly-traded. Thus the investment is a hybrid between private, AIM Program-like investments and traditional publicly-traded investments. The Investment Committee approved hybrid investing in 1998.

some of this risk. Ultimately, selecting the appropriate Target Company will be a key driver of success.

Should you require anything further, please do not hesitate to contact me.

Sincerely,