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#### **AGENDA ITEM 4**

#### **TO: MEMBERS OF THE INVESTMENT COMMITTEE**

- I. SUBJECT:** Focus List Methodology
- II. PROGRAM:** Global Equity – Corporate Governance
- III. RECOMMENDATION:** Approve the enhanced Focus List Program Methodology

#### **IV. ANALYSIS:**

**Attachment 1** – Wilshire Report: Corporate Governance Engagement Analysis

**Attachment 2** – Focus List Program: Proposed vs. Current

#### **EXECUTIVE SUMMARY**

Staff concluded a review of the Focus List Program and its methodology. The goal was to develop a more effective strategy for company engagement by improving the alignment of interest between long-term shareowners and portfolio companies. Staff developed the following recommendations and, if approved, will begin the 2011 Focus List engagement process:

1. Select companies where CalPERS has a larger ownership position by altering the selection universe from “index based” to “ownership based.” Specifically, change the screening universe from the Russell 1000 to CalPERS top 500 domestic equity holdings.
2. The Focus List selection process should be more reactive to market developments by adding one year total stock returns to the existing three and five year returns. The process will continue to be heavily weighted towards the longer-term time periods.
3. The initial screening should consider financial returns and the secondary analysis should consider a range of governance issues. The current Focus List screen combines total stock returns, governance, and financial performance. This approach tends to diminish the emphasis of

underperformance in the selection process and allows “check the box” governance to mask opportunities for improvement.

4. The secondary screening should include additional criteria such as engagement obstacles and opportunities, market expectations, deeper financial analysis, and environmental, social, and governance factors.
5. Greater emphasis on board quality, skill-sets and diversity; the Focus List should be used as a conduit for CalPERS proxy access and shareowner proposal efforts.
6. Work to develop relationships with other investors.
7. The press to be used as a tool to garner investor support for shareowner proposals via proxy solicitation campaigns in order to achieve desired reform.
8. Staff will review the feasibility of an international strategy in late 2011.

## **BACKGROUND**

Established in the 1980s, the CalPERS Focus List Program has provided a strategy for identifying and engaging underperforming U.S. companies in the global equity portfolio to drive positive economic returns. For the first time since inception of the Program, the 2010 Focus List engagements were successfully completed without publicly naming a company. This outcome provided some insight to the current methodology and initiated an internal discussion in regard to the framework.

The financial crisis also illustrated the limits of the current program methodology by not identifying any financial sector companies despite severe losses to the portfolio. Staff responded by initiating a financial sector engagement in order to better understand the relevant governance factors, specifically risk management and board quality, not normally addressed in standard governance assessments.

## **CALPERS ENGAGEMENT**

CalPERS corporate engagement process has the overarching objective of improving alignment of interest between providers of capital and company management. It is CalPERS view that improved alignment of interest will enable the fund to fulfill its fiduciary duty to achieve sustainable risk adjusted returns. There are three main drivers in the corporate engagement program:

- **Financial Performance** – company engagement to address persistent, relative value destruction, through the Focus List Program
- **Values Related Risk** – material environmental, social and governance factors, such as reputational risk , climate change, board diversity and key accountability measures such as majority voting

- **Compliance** – in response to State or Federal legislation, such as Iran and Sudan Acts calling for divestment, which CalPERS mitigates as a risk via engagement

CalPERS engagement activity is market wide, which can be considered as a strategy for improving the quality of beta in the portfolio. CalPERS also has company specific engagement, which can be viewed as a strategy for addressing alpha related risk. Compliance is a requirement and mitigates both financial and reputational risks for CalPERS.

### **FOCUS LIST PROGRAM REVIEW**

The review of the Focus List program drew on lessons learned from the financial sector engagement, and a variety of sources including:

- Academic – literature review and discussion with leaders in the field such as Lucien Bebchuk, Harvard
- Fund Managers – interviews plus review of the strategies and research sources used by CalPERS external activist corporate governance managers and private funds
- Research Providers – proxy advisory firms and governance data providers
- Internal Staff – cross asset class input

Wilshire has annually conducted a review titled “The CalPERS Effect” to assess the financial performance of companies named to the public Focus List announced each March. Public Focus List companies are a sub-group of all engaged companies most of which were not named to a public “name and shame” list. These companies generally make up more than half of the total companies engaged through the Focus List Program in a given year. Companies named to the public Focus List are those that have (1) not been responsive to CalPERS concerns, and (2) continue to underperform following the initial six-month engagement period. Until this review the performance of other companies engaged, which were not named to the public Focus List, have not been included in Wilshire’s review.

To address this gap in the analysis, staff engaged Wilshire to analyze the relative total stock returns of all companies engaged through the Focus List Program over the last ten years. Wilshire completed its study and found that over the last ten years, privately engaged companies significantly outperformed those companies named to the public Focus List for the one, three, and five years after CalPERS made initial contact.

More importantly, all companies engaged through the Focus List Program produced a total cumulative excess return of 15.83% above their respective benchmark after three years, and 9.43% after five years.

## **NEXT STEPS**

Following the Board's review and approval of the new Focus List Program methodology, staff will initiate the research and selection process for the 2011 Focus List Program. The list will be presented in March for approval by the Investment Committee. Once approved, staff will engage the companies and report back to the Investment Committee, in August 2011, on the progress of the engagements. This timetable better reflects the deadlines for filing proposals, and allows for more analysis before those deadlines fall.

## **V. STRATEGIC PLAN:**

This item will further the following goals of CalPERS Strategic Plan:

- Goal VIII. Manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits and second, to minimize and stabilize contributions.
- Goal IX. Achieve long-term, sustainable, risk adjusted returns.

## **VI. RESULTS/COSTS:**

Costs are included in existing budget.

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