



Agenda Item 5b

May 14, 2012

ITEM NAME: Investment Beliefs

PROGRAM: Risk Management

ITEM TYPE: Asset Allocation, Performance & Risk – Action

RECOMMENDATION

Staff recommends that the Investment Committee adopt the following seven Investment Beliefs:

1. Strategic asset allocation is the dominant determinant of return and risk
2. A return premium is required to take on risk
3. Premium is required for illiquidity
4. Long term investment horizon is an advantage
5. Inefficiencies in the market create investment opportunities
6. Costs matter
7. Risk is multi-faceted and not fully quantifiable

EXECUTIVE SUMMARY

Staff is recommending a final set of Investment Beliefs based on review and discussion by Board Members and a broad group of Investment Office staff. These beliefs represent the underlying investment philosophies for the management of the CalPERS investment program.

BACKGROUND

An initial set of Investment Beliefs were presented to the Board Offsite in July 2011 and discussed subsequently at a senior Investment staff workshop. Based upon input and rating by the Board and Investment Office staff, a final set of seven Investment Beliefs has been developed.

ANALYSIS

Investment Beliefs are statements about aspects of capital markets and investor behavior that inform investment strategies and decisions. Several Investment Beliefs are implicit in the evolution of CalPERS strategic asset allocation and portfolio construction. It is important to clarify and make these Investment Beliefs explicit because a clear set of Investment Beliefs:

- a) Provide a basis for strategic management of the investment portfolio to achieve long term objectives.
- b) Serve as a tool for disciplined investment decision making.

- c) Provide a framework for assessing new investment strategies and avoiding making changes on an ad-hoc basis.
- d) Provide a context for active management to add value.
- e) Can improve governance.

Six Investment Beliefs emerged as “high conviction” beliefs from the Board (July 2011 Workshop) and staff rankings as shown in Attachment 1, pages 5 and 6. These Investment Beliefs are listed as numbers one through six in the recommendation section. The statement on risk, originally presented in July, has been modified from “Risk is not fully measurable” to “Risk is multi-faceted and not fully measurable”. This is included as belief number seven.

The remaining four Investment Beliefs initially discussed at the Board Offsite Workshop were not rated as high convictions and required additional discussion. After further consideration amongst staff, it was concluded that some of the initially proposed Investment Beliefs should be considered as operational principles or incorporated within the recommended Investment Beliefs, as follows:

- Staff believes the statement “make it as simple as possible; simple solution is often the best” is valid as an operational principle and not an Investment Belief.
- The Investment Belief “Inefficiencies in the market create investment opportunities” is broad in scope and encompasses the ideas “asset valuations are mean reverting” and “be unconventional – do not follow the herd”. This is because significant deviations in asset prices from fundamental value are an indication of “inefficiency” in market behavior. Also being unconventional or contrarian is to recognize pricing anomalies and to deploy assets accordingly.
- The statement on Environment, Social and Governance (ESG) has been deferred for further discussion by the committee at an upcoming ESG Workshop because Investment Committee and staff voting on the role of ESG in Investment Beliefs was inconclusive. Subsequent staff discussion highlighted the need for clarity on the definition of ESG factors and their potential to have an impact on investment risk and return. The Global Governance team’s 2012-13 objectives include a review of evidence of ESG impact on investment and company performance.

Accordingly, the original list of 11 Investment Beliefs has been condensed into seven statements that provide comprehensive guidance to managing the CalPERS investment programs. The Investment Committee and staff can periodically review the Investment Beliefs in conjunction with the Asset Allocation process.

BENEFITS/RISKS

The risk if these Investment Beliefs are not adopted is that the investment office would lack a framework for making disciplined investment decisions. The benefits to approving the Investment Beliefs would include establishing a framework to improve,

enhance, reinforce the management of the investment portfolios and facilitate disciplined investment decisions.

ATTACHMENTS

Attachment 1 – CalPERS Investment Beliefs

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