

**Michael C. Schlachter, CFA**  
**Managing Director & Principal**

November 21, 2012

Mr. Henry Jones  
Chair, Investment Committee  
California Public Employees' Retirement System  
400 Q Street  
Sacramento, CA 95814

Re: Revisions to Global Equity Policy

You requested our opinion regarding the presentation by Staff of the consolidated Global Equity policy.

### **Recommendation**

**Wilshire recommends that the Investment Committee approve the policy as presented by Staff. We agree with the need to consolidate the Global Equity policies under one omnibus document. As noted below, the key risk controls imposed on the Global Equity portfolio were developed after much consultation with Wilshire.**

### **Discussion**

Most of the proposed policy combines existing policies without substantive changes and do not require further comment.

Several areas within the Risk Parameters section of this policy (part B) were developed in conjunction with Wilshire and require separate comment.

First, section B.3 imposes a tracking error range of 25 basis points to 50 basis points. This range is consistent with how the portfolio is managed and is intended to allow Staff some flexibility in day to day management of the portfolio without imposing absolute limits on tracking error that would force portfolio changes if market volatility rises. If tracking error exceeds the prescribed range, Staff should report to the Investment Committee but should not be required to make immediate changes to the portfolio that are not in CalPERS' best interest. As Staff completes the overall restructuring of the Global Equity portfolio that has been underway for some time, we expect that Staff may return to the Investment Committee with a request to raise or lower this range as Staff determines that more or less active management is appropriate in the portfolio.



We note that this range is appropriate as an initial estimate of the expected tracking error of the Global Equity portfolio, but should not necessarily be the permanent risk range. CalPERS Staff self-imposed a Total Fund tracking error target of 150 basis points a few years ago, but no targets were ever assigned to each asset class by the risk management team nor was there ever any discussion with the Investment Committee about how Staff will manage risk to this target or how risk limits will be assigned to each asset class. As part of the Asset Allocation and Investment Beliefs discussions that will happen over the next several months, we suggest that the Investment Committee would be well-served by a presentation from Staff regarding how the risk management tools already in place will actually be used, whether that 150 basis point target is still appropriate for CalPERS, and what risk levels for each asset class fit within that framework.

Part B.5 was added to the policy to allow for the leverage that may result from certain derivatives transactions at the level of individual securities and is a useful addition to this policy. Wilshire suggested that Staff add the final sentence in this paragraph, which restricts the Global Equity portfolio to no overall leverage. This will allow Staff the flexibility to use whatever derivative or physical securities that they feel are appropriate for individual investments but may not add any risk from leverage at the asset class level.

In part B.6 and the glossary, "illiquidity" was redefined to limit Staff's investments in external managers that have long lock-up constraints or special securities that are difficult to trade. We believe that this better limits true illiquidity risk in the asset class. The original language restricted Staff's ability to invest in any security that could not be sold in a rapid manner, which could have had the unintended consequence of reducing index fund positions in some market traded small capitalization stocks and other stocks in which CalPERS should have a large position simply due to the sheer size of the Global Equity portfolio.

Should you require anything further or have any questions, please do not hesitate to contact us.

Best regards,

A handwritten signature in black ink, appearing to read 'Michael A. ...'.