Investment Committee

California Public Employees' Retirement System

Agenda Item 8

December 10, 2012

ITEM NAME: Revision of Global Fixed Income Program Policy

PROGRAM: Global Fixed Income

ITEM TYPE: Policy & Delegation – Information

EXECUTIVE SUMMARY

This is the first reading for revision of the Global Fixed Income Program (GFI) Policy to allow a maximum of 10% in notional leverage. Recourse and non-recourse debt will continue to be prohibited. The proposed policy change will allow for staff to pair short duration securities with an underlying futures position in agency mortgages (TBA) to earn a projected 50-100 basis points higher return than an outright position in a similar fixed income position.

STRATEGIC PLAN

This agenda item supports the CalPERS Strategic Plan goal to improve long-term pension and health benefit sustainability. Updating the GFI Program Policy to allow leverage will enable staff to enhance the returns of the GFI Program and ultimately the Total Fund.

BACKGROUND

The Leverage Policy (Attachment 1), which applies to all programs across the Total Fund, defines and prohibits the use of leverage unless expressly permitted in the asset class or program policy.

The current GFI Policy does not allow the use of leverage.

ANALYSIS

Under the Leverage Policy in Section V.B.4, notional leverage is created when a non-cash-like security is used as the reinvestment vehicle when paired with a derivative. The CalPERS glossary states that cash-like securities are "a fixed income security with a maturity of less than 91 days and a credit rating of A1/P1 or equivalent or higher." The glossary also states that non-cash-like securities are a "security that is not a cash-like security." Therefore, any security with a final maturity greater than 91 days is defined as a non-cash-like security.

Staff intends to invest in a derivative-like security called FNMA or FHLMC TBA. These derivative-like securities are basically an obligation to deliver, in a future month, an agency mortgage pass through security. Staff will then reinvest the cash into a floating rate note (FRN) with a final maturity of 5 to 10 years.

Notional leverage is created because a FRN is considered non-cash due to the maturity being greater than 91 days.

The cash will be managed under the existing Low Duration Fixed Income Policy, specifically within the Limited Liquidity Enhanced Return Program (LLE) Attachment A3, which is provided in this item as Attachment 3. The LLE Policy restricts floating rate securities rated AA and AAA to maturities with a maximum maturity of 10 years. Below AA rated maturities are restricted to a maximum of 7 years.

The major driver of return for this strategy is the success of the FRN relative to the floating rate benchmark LIBOR. Internal staff has extensive knowledge and experience in investing in short duration securities. Staff will focus on the floating rate securities to better match the assumption (one month cash) embedded when purchasing a TBA and therefore, reducing the interest rate risk. CalPERS Fixed Income staff has managed a similar strategy for the CalPERS Global Equity (GE) Program using the LLE Policy for over the past three years with very strong results. Below is a table of the Synthetic Enhanced GE returns relative to benchmark ending October 31, 2012.

Synthetic Enhanced Equity Portfolio Annualized Time Weight Rates of Return as of 10/31/12			
Period	**CalPERS Performance %**	**Benchmark Performance %**	**Alpha**
1-Year	17.11	14.65	2.46
3-Year	13.76	12.07	1.69
Since inception 6/1/09	18.38	14.74	3.64

All notional leverage will be reported by the Risk Unit in their quarterly risk report to the Investment Committee. In order for staff to execute the strategy outlined above, the GFI Policy must be modified to allow for notional leverage. A copy of the GFI Policy showing the proposed revisions is provided as Attachment 2. Key changes include:

- Increasing the maximum limit on notional leverage from 0% to 10%
- Moving the section on leverage to the front of the policy in order to manage leverage more optimally from a program level
- Formatting the leverage section to coincide with the methodology of viewing leverage from three views: recourse, non-recourse, and notional.

These proposed changes are consistent with the Leverage Policy. The GFI Program will continue to prohibit recourse and non-recourse leverage.

ATTACHMENTS
Attachment 1 – Leverage Policy
Attachment 2 – Global Fixed Income Program Policy
Attachment 3 – Limited Liquidity Enhanced Return Program Policy

CURTIS D. ISHII
Senior Investment Officer
Global Fixed Income

JOSEPH A. DEAR
Chief Investment Officer