Investment Committee

California Public Employees' Retirement System

Consent

Agenda Item 4d

February 19, 2013

ITEM NAME: Revision of Global Fixed Income Program Policy

PROGRAM: Global Fixed Income

ITEM TYPE: Policy & Delegation – Consent Action

RECOMMENDATION
Approve the revised Global Fixed Income Program (GFI) Policy (Attachment 1).

EXECUTIVE SUMMARY
This is the second reading for revision of the GFI Policy to allow a maximum of 10% in notional leverage.

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 2), 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. At the December 10, 2012 meeting, a first reading of the GFI Policy with proposed revisions to allow a maximum of 10% in notional leverage was presented to the Investment Committee. Recourse and non-recourse debt will continue to be prohibited.

ANALYSIS
Notional leverage is created when a non-cash-like security is used as an reinvestment vehicle when paired with a derivative. 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. CalPERS investment policy requires that Staff hold cash collateral equal to the notional value of such a derivative. Staff will invest the associated cash collateral into a floating rate note (FRN) with a final maturity date of five to ten years, which would be considered a non-cash-like security due to the maturity being greater

than 91 days; therefore, creating notional leverage. The major driver of return for this strategy is the success of the FRN relative to the floating rate benchmark London Interbank Offered Rate (LIBOR). Fixed Income staff has extensive knowledge and experience in short duration securities and has garnered strong results managing a similar strategy for Global Equity over the past three years.

Additional information on staff's analysis is available in the December 10, 2012 materials provided with the first reading of these proposed policy changes (Attachment 3).

Wilshire Associates' opinion letter is provided as Attachment 4.

The cash will be managed under the existing Low Duration Fixed Income Policy, specifically within the Limited Liquidity Enhanced Return Program (LLER) Attachment A3, which is provided in this item as Attachment 5.

BENEFITS/RISKS
The proposed policy change will allow for staff to pair securities with related futures position in agency mortgages (TBA) to earn a projected 50-100 basis points higher return than an outright position in agency mortgage securities.

ATTACHMENTS
Attachment 1 – Global Fixed Income Program Policy
Attachment 2 – Leverage Policy
Attachment 3 – December 10, 2012 Agenda Item 8 First Reading
Attachment 4 – Wilshire Opinion Letter
Attachment 5 – Limited Liquidity Enhanced Return Program Policy

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