Agenda Item 7c

March 18, 2013

ITEM NAME: Proposed Revision of the Absolute Return Strategies Program Policy

PROGRAM: Absolute Return Strategies

ITEM TYPE: Policy & Delegation – Information

EXECUTIVE SUMMARY

This item extends the discussion of the Absolute Return Strategies Strategic Plan from the December 2012 and February 2013 Investment Committee meetings by proposing a revised Absolute Return Strategies Policy.

STRATEGIC PLAN

This item supports the CalPERS Strategic Plan goal to improve long-term health benefit and pension sustainability. This goal is supported by the development of policies and programs which aim to improve the risk-return profile of the CalPERS Total Fund.

BACKGROUND

In March 2012, the Absolute Return Strategies (ARS) team presented the Investment Committee with a workshop on absolute return investing. At that time four key questions with respect to the ARS Program were posed:

- What is the role of absolute return investing, and the ARS Program, in the CalPERS portfolio?
- What should the ARS Program's benchmark be?
  - This incorporates not just return targets but also risk and liquidity parameters
- What should the ARS Program's capital source be?
- What should the ARS Program's size be?

A fifth question was subsequently posed by senior Investment Office staff:

- How should the ARS Program be resourced? Should more of the ARS Program's functions be brought in-house?

At the December 2012 Investment Committee meeting, it was determined that the primary role of the ARS Program would be to act as a diversifier to the growth risk factor, which is predominantly found within the Global Equity and Private Equity programs and which is the dominant risk factor in the Total Fund.

ANALYSIS

At the February 2013 Investment Committee meeting, it was determined that the return and risk parameters for the ARS Program should be as follows:

- A return target of T-bills plus 5% per annum (unchanged from the current return target)
- Annualized volatility of 6-8%
- Equity beta of 0.2 or less
- Maximum drawdown in any one month of 7%

The ARS Program Policy has been revised to reflect these updated parameters.

The capital source and Program size decision will be determined through the 2013 Strategic Asset Allocation Decision Process.

A properly executed ARS Program provides an additional means of diversification to the Total Fund by prudently taking exposure to risks distinct from those currently within the Total Fund. The net benefit should be a Total Fund portfolio with an improved risk-return profile without sacrificing potential return. This improves the likelihood of meeting Total Fund performance goals.

Additionally, as with any program deploying capital to external managers, the ARS Program is exposed to manager-specific risks which cannot be entirely mitigated through manager selection and investment structuring. However, the ARS "Three Pillars" framework, which focuses on alignment of interests, control of assets, and transparency of risks and exposures, increases the likelihood of effective investment risk-taking and manager-specific risk mitigation.

ATTACHMENTS
Attachment 1 – Proposed Revised Absolute Return Strategies Program Policy
Attachment 2 – Wilshire Associate's Opinion Letter

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