Investment Committee
California Public Employees' Retirement System

Agenda Item 7b

April 15, 2013

ITEM NAME: Proposed Revision of the Global Fixed Income Program Policy – Initial Review

PROGRAM: Global Fixed Income

ITEM TYPE: Policy & Delegation – Information

EXECUTIVE SUMMARY

This is the initial review of the Global Fixed Income Program (GFI) Policy. Staff proposes to change the international and foreign debt attachments of the GFI Policy. The major changes are restricting the ranges in the international versus domestic assets to +/- 10% versus the benchmark and non-investment grade securities in the International Fixed Income Program (IFI) to a 10% maximum. There are also changes to the Foreign Debt Policy (FDP) to allow for more emerging market country exposure to accommodate the proposed new benchmark changes in Agenda Item 7a, Proposed Revision of the Total Fund Benchmarks Policy to Reflect Global Fixed Income Benchmark and Inflation Assets Benchmark Changes, included in the April 15, 2013 Investment Committee meeting.

STRATEGIC PLAN

This agenda item supports the CalPERS Strategic Plan goal to improve long-term pension and health benefit sustainability. Making the recommended changes to the GFI Policy will support efforts to meet the System's investment objectives and contribute to higher risk adjusted total returns.

BACKGROUND

GFI represents $41 billion or 16% of total fund assets. IFI is $3.2 billion or 1% of total fund assets. IFI assets have traditionally all been managed externally. Effective July 1, 2012, staff began internally managing $500 million in international assets. Fiscal year to date ending February 28, 2013 for the internally managed international program have been quite favorable with excess return versus the benchmark at +123 basis points. Externally managed international fixed income assets, which represent $2.7 billion, have also done well by generating +81 basis points of excess return.

ANALYSIS

The GFI Policy is broken down into three sections: Dollar-Denominated Fixed Income Program (DFI), IFI, and FDP. Suggested changes are concentrated in the IFI and FDP attachments of the GFI Policy. The significant changes are in four areas:

- restricting deviations from benchmark for the total DFI and IFI
- restricting the number of countries that could be +/- 15%

- changing the FDP
- restricting the percentage of non-investment grade securities for IFI.

First staff proposes to add restrictions in ranges relative to the benchmark on DFI and IFI to +/- 10% (Section V in the GFI Policy). In the past, DFI and IFI were separately managed programs with separate allocations. In 2008, the two programs were merged to form the GFI Policy. At that time staff failed to put any restrictions on deviation from benchmark for the DFI and IFI. This recommendation will rectify this oversight.

Second, staff proposes to restrict the amount of countries that could be +/- 15% (Section II.B.10) by changing the definition of the category from reserve currency markets to AA- rated and higher. Since this category was intended for credits that were relatively stable, the unintended consequence of the current policy is to allow Italy or Spain to be in this category. This change will rectify this issue as Spain and Italy will move down to the +/- 10% category.

Third, staff proposes a major revision of the FDP attachment of the GFI Policy. The most significant revision is the elimination of the requirement that the country must be part of the Barclays Capital Global Aggregate Index. The FDP was initially written with the idea of limiting the amount of emerging market exposure and insuring that CalPERS only invested in fairly liquid and fairly well developed markets. With the new changes in benchmark, modifications to the FDP were necessary. These proposed changes will allow for inclusion of the new countries in the benchmark as well as increasing the opportunity set. The following countries will be added to the investible universe: Angola, Bolivia, Costa Rica, Croatia, El Salvador, Gabon, Georgia, Guatemala, Jordan, Mongolia, Nigeria, Paraguay, Serbia, and Vietnam. Lastly, in regards to non-investment grade corporate or subnational government, staff proposes to lower the rating requirement for the country of domicile and country whose laws the debt is issued from AA- to A+. This proposed change also introduces non-investment grade issuers from Slovakia.

Lastly, there currently is no limit on non-investment grade securities in the IFI attachment of the GFI Policy and staff proposes a 10% limit (Section II.C.1). This would allow the IFI to be closer in alignment with the DFI Policy restriction of a 12% maximum on non-investment grade securities.

BENEFITS/RISKS

Revisions to the IFI attachment of the GFI Policy will reduce risk by establishing restrictions where policy was silent. Revisions to the FDP attachment of the GFI Policy will allow for more sovereign issuers from smaller countries; however this is offset by the benefits of diversification.

ATTACHMENTS
Attachment 1 – Global Fixed Income Program Policy
Attachment 2 – Wilshire Associates' Opinion Letter

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