Agenda Item 7c

April 15, 2013

ITEM NAME: Proposed Revision of the Inflation Assets Policy - Initial Review

PROGRAM: Global Fixed Income

ITEM TYPE: Policy & Delegation – Information

EXECUTIVE SUMMARY

This is the initial review of the Inflation Assets Program (IA) Policy. Staff is proposing changes to the fixed income and currency ranges for the Inflation-Linked Bond Program (ILB) and Foreign Debt Policy (FDP) attachments to the IA Policy. The major changes include:

- Reducing the permissible ranges by 5% around the policy target for U.S. and international inflation-linked bonds,
- Increasing the permissible exposure to nominal government bonds by 5%
- Increasing the currency range for the UK Sterling and Japanese Yen by 5%
- Maintaining or reducing the permissible country ranges for both bonds and currencies to reflect proposed changes to the benchmark for the non U.S. segment of the ILB benchmark that increases the number of countries and currencies.

The proposed changes in benchmark for the non U.S. segment of the ILB benchmark are discussed in additional detail 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 IA Policy will support efforts to meet the System's investment objectives and contribute to higher risk adjusted total returns.

BACKGROUND

Inflation assets represent $10 billion or 4% of the total fund assets. The IA is composed of two sub-programs: commodities and inflation-linked bonds. Both programs are internally managed. The fiscal year to date performance ending February 28, 2013 for the IA is favorable with excess return versus the benchmark at +94 basis points.

ANALYSIS
Benchmark changes that move from 5 countries to 16 countries require changes to the ILB attachment of the IA Policy. The majority of proposed changes in country and currency ranges are to either maintain or reduce allowable ranges relative to the benchmark. The current policy allows over-weights for any of the 5 existing countries to be 10%. The proposed change (Section V.C) recommends moving from a specific range for individual countries towards ranges based on ratings. The recommendation allows the United Kingdom to be similar to the existing policy at +/- 10% but restricts other countries with the use of ratings. The countries that are rated AA- and above are restricted to +/- 5% and those countries below AA- are restricted to +/- 3% relative to benchmark weightings. With the greater number of countries added to the investible universe, staff believes that the opportunity set is increased along with risk and attempts to offset the increase in risk by reducing ranges around the new benchmark.

An additional proposed reduction in risk is to lower permitted ranges for U.S. inflation-linked and investment grade international inflation-linked bonds (Section V.A.) from +/- 20% to +/- 15%.

Staff recommends 3 changes in policy that increases the risk limits. These recommendations are as follows:

- increase the amount of nominal bonds (bonds to pay a fixed coupon until maturity) from a maximum of 10% to 15% (Section V.A of the ILB attachment) to allow for investing in countries that have high real rates but do not have inflation-linked bonds.

- increase the currency range for UK Sterling and Japanese Yen from +/- 10% to +/- 15% (Section V.D.). This enables the IA Policy on currency ranges to be consistent with Global Fixed Income Program (GFI) Policy.

- make the FDP attachment of the IA Policy consistent with the FDP in the GFI Policy. As discussed in the Proposed Revision of the Global Fixed Income Program Policy (Agenda Item 7b), the most significant revision in the FDP is the elimination of the requirement that the country must be a part of the Barclays Capital Global Aggregate Index which allows for the benchmark changes and increase opportunity set. Staff believes CalPERS should have one debt policy to be applied to all international fixed income securities to reduce confusion. The proposed changes to the FDP attachment of the IA Policy will introduce the following countries into the investible universe for the ILB: Angola, Bolivia, Costa Rica, Croatia, El Salvador, Gabon, Georgia, Guatemala, Jordan, Mongolia, Nigeria, Paraguay, Serbia, and Vietnam. Another proposed change in FDP is in regards to non-investment grade corporate or subnational government, where staff proposes to lower the rating requirement for the country of domicile and country whose laws that debt is issued from AA- to A+. This would add non-investment grade issuers from Slovakia and is consistent with the FDP in the GFI Policy. As a note, the ILB attachment of the IA Policy already limits the amount of non-investment grade to 5% of the total program.

BENEFITS/RISKS

The revisions to the ILB attachment of the IA Policy reduce risk by decreasing the permissible range of deviation from the benchmark between U.S. and international inflation-linked bonds while allowing a small increase in risk due to an increase of 5% in the permissible range in nominal government bonds. Other changes to the benchmark for the IA Program required the establishment of ranges for the new countries being added to the benchmark. This was done in a prudent fashion based on credit quality.

ATTACHMENTS

Attachment 1 – Inflation Assets Program Policy
Attachment 2 – Wilshire Associates' Opinion Letter

CURTIS D. ISHII
Senior Investment Officer
Global Fixed Income

JOSEPH A. DEAR
Chief Investment Officer