Agenda Item 7b

May 13, 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 domestic, international, and foreign debt attachments of the GFI Policy. The major changes are:

- Creating ranges of +/- 10% in over or underweights in the international versus domestic assets versus the benchmark,
- Creating a limit of 10% on non-investment grade securities in the International Fixed Income Program (IFI),
- Changing 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 May 13, 2013 Investment Committee meeting, and
- Increasing the downside duration range limit from -10% to -50% for the dollar-denominated and IFI programs to allow staff to better manage the risk of rising interest rates.

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 $42 billion and 16% of the Total Fund assets. IFI is $3.2 billion or 1% of the 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 returns ending March 31, 2013 for the internally managed international program have been quite favorable with excess return versus the benchmark at +108 basis points. Externally managed international fixed income assets, which represent $2.7 billion, have also done well by generating +90 basis points of excess return.

The Dollar-Denominated Fixed Income Program (DFI) is $39 billion and 15% of the Total Fund assets. Currently, 97% of the DFI assets are internally managed. The fiscal year-to-date returns for DFI ending March 31, 2013 have been excellent with excess return relative to the benchmark at +116 basis points.

ANALYSIS

The GFI Policy is broken down into three sections: DFI, IFI, and FDP. Suggested changes are in all three sections of the GFI Policy. The significant changes are in five areas:

- Restricting deviations from benchmark for the total DFI and IFI,
- Restricting the number of countries that could be +/- 15% in the IFI,
- Changing the FDP,
- Restricting the percentage of non-investment grade securities for IFI, and
- Changing the downside duration range limit from -10% to -50% for both the DFI and 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 liquid and well developed markets. With the new proposed changes in the benchmark, modifications to the FDP were necessary. These 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 local currency bond investible universe (subject to any operational constraints): Croatia, Jordan, Nigeria, and Vietnam. If new countries issue local currency bonds, staff will ensure that any operational issues are identified and addressed prior to investing in these countries. 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 introduces non-investment grade issuers from Slovakia.

Fourth, 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 in closer alignment with the DFI Policy restriction of a 12% maximum on non-investment grade securities.

In the fifth area of significant change, staff proposes to increase the downside duration range limit for DFI (Attachment A Section II.B.2) and for IFI (Attachment B SectionII.B.2) from -10% to -50%. The proposed duration range of -50% to +10% is asymmetric which addresses the historically low level of interest rates and financial repression currently in the developed markets. This will allow staff the ability to reduce interest rate exposure in half relative to the benchmark.

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

CURTIS D. ISHII
Senior Investment Officer
Global Fixed Income

JOSEPH A. DEAR
Chief Investment Officer