CalPERS

Investment Committee

California Public Employees' Retirement System

Agenda Item 5b

June 17, 2013

ITEM NAME: Revision of the Global Fixed Income Program Policy

PROGRAM: Global Fixed Income

ITEM TYPE: Policy & Delegation – Action

RECOMMENDATION

Approve the revised Global Fixed Income Program (GFI) Policy as shown in Attachment 1, the consultant opinion letter is provided as Attachment 2.

EXECUTIVE SUMMARY

The GFI Policy was presented to the Investment Committee for initial review on May 13, 2013.

The Investment Committee did not request any changes to the proposed Policy at the time of the initial review.

Wilshire Associates, in discussion with Global Fixed Income staff, added one point of clarity to the Debt of Foreign Corporations and Subnational Governments (i.e., Provincial, State, and Municipal) section within the Foreign Debt Policy (FDP). The addition is regarding currency convertibility that mirrors the same clause within the Debt Issued by National Governments section. This change is denoted with yellow highlighting within Attachment 1.

Staff seeks approval of the GFI Policy to incorporate the changes in the benchmark and create greater controls on allocations for international, domestic, and high yield securities as well as interest rate risk.

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 $44 billion and 16% of the Total Fund assets. The International Fixed Income Program (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 April 30, 2013 for the internally managed international program have been quite favorable with excess return versus the benchmark at +196 basis points. Externally managed international fixed income assets, which represent $2.7 billion, have also done well by generating +85 basis points of excess return.

The Dollar-Denominated Fixed Income Program (DFI) is $41 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 April 30, 2013 have been excellent with excess return relative to the benchmark at +127 basis points.

ANALYSIS

The GFI Policy is broken down into three sections: DFI, IFI, and the 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

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