CalPERS

Investment Committee

California Public Employees' Retirement System

Agenda Item 5c

June 17, 2013

ITEM NAME: Revision of the Inflation Assets Policy

PROGRAM: Global Fixed Income

ITEM TYPE: Policy & Delegation – Action

RECOMMENDATION

Approve the revised Inflation Assets Program (IA) Policy as shown in Attachment 1, the consultant opinion letter is provided as Attachment 2.

EXECUTIVE SUMMARY

The IA 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 IA Policy to create a FDP and currency ranges that are consistent with the Global Fixed Income Program (GFI) Policy as well as creating greater opportunities through wider deviations from the benchmark. These wider deviations from the benchmark are somewhat offset by stricter ranges around U.S. and investment grade international inflation-linked bonds.

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 April 30, 2013 for the IA is favorable with excess return versus the benchmark at +95 basis points.

ANALYSIS

Staff recommends four changes in the IA Policy that increases the risk limits. These recommendations, by Policy component, are as follows:

1. <u>Section V.A. of the Inflation-Linked Bond Program (ILB) attachment</u>
   Increase the amount of nominal bonds (bonds to pay a fixed coupon until maturity) from a maximum of 10% to 15% to allow for investing in countries that have high real rates but do not have inflation-linked bonds.

2. <u>Section V.D. of the ILB attachment</u>
   Increase the currency range for UK Sterling and Japanese Yen from +/- 10% to +/- 15%. This enables the IA Policy on currency ranges to be consistent with the GFI Policy.

3. <u>FDP Attachment of the IA Policy</u>
   Make the FDP attachment of the IA Policy consistent with the FDP in the GFI Policy. As discussed in May Agenda Item 7b, *Proposed Revision of the Global Fixed Income Program Policy*, 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 increased 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 not introduce any additional countries into the investible universe for the ILB. If new countries issue local currency inflation linked bonds, staff will ensure that any operational issues are identified and addressed prior to investing in these countries.

   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. It should be noted that the ILB attachment of the IA Policy already limits the amount of non-investment grade to 5% of the total program.

4. Section V.B. of the ILB attachment
   Increase the downside duration range limit 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 developing markets by allowing staff the ability to reduce interest rate exposure in half relative to the benchmark.

To offset the increase in risk, staff proposes the following:

1. Section V.C. of the ILB attachment
   Reduce the ranges around the new benchmark with the exception of the United Kingdom. Benchmark changes, as outlined in Agenda Item 5a, that move from five countries to 16 countries require changes to be made to the country and currency ranges in the ILB attachment. The majority of the proposed changes 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 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%,
   - 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.

2. Section V.A. of the ILB attachment
   Staff proposes to lower permitted ranges for U.S. inflation-linked and investment grade international inflation-linked bonds from +/- 20% to +/- 15%.

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, as outlined in Agenda Item 5a, to the benchmark for the IA Program required the establishment of ranges for the new countries being added to the benchmark. The establishment of the new ranges was done in a prudent fashion based on credit quality.

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

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