CalPERS

Investment Committee

California Public Employees' Retirement System

Agenda Item 8b

August 19, 2013

ITEM NAME: Proposed Revision of the Total Fund Benchmarks Policy – Initial Review

PROGRAM: Total Fund

ITEM TYPE: Policy & Delegation – Information

EXECUTIVE SUMMARY

This is the initial review of proposed changes to the California Public Employees' Retirement System (CalPERS) Total Fund Benchmarks Policy (Policy) to (1) update the Currency Overlay Program benchmark calculation methodology (2) exclude the Multi-Asset Class Partners (MAC) Program benchmark from the Policy and (3) add the approved interim asset allocation target weights to the Policy.

Upon receiving feedback from the Investment Committee (IC), staff will bring the Policy to a subsequent IC meeting for formal action with a July 1, 2013 retroactive effective date.

STRATEGIC PLAN

The agenda item supports CalPERS Strategic Plan goal to improve long-term pension and health benefit sustainability. The adoption of the Total Fund Benchmarks Policy revision will ensure that CalPERS is able to effectively achieve the System's investment objectives through clear and current investment policy documentation.

BACKGROUND

Currency Overlay Program Benchmark

The IC approved changes to the Currency Overlay Program on March 16, 2009. The change applied to the currency hedge program at the Total Fund level, changing the strategic hedge ratio from 25% of developed equity foreign currency exposure to 15% of total foreign currency exposure. The Currency Overlay Program benchmark was incorporated in the Total Fund Policy Benchmark by scaling the Total Fund Policy Benchmark to reflect the impact of the currency overlay.

MAC Program Benchmark

The MAC Program benchmark was incorporated into the Total Fund Policy Benchmark on December 10, 2012 by scaling the Total Fund Policy Benchmark to reflect the target weights of the Asset Classes and the target weight of the MAC Program.

Total Fund Policy Benchmarks – Interim Weights
The IC adopted new strategic asset allocation targets in December 2010 after the 2010 Asset Liability Management workshop. The newly adopted Policy Targets shifted our investments from relatively liquid public fixed income instruments to less liquid real assets, thus a transition period was needed to reach the Policy Targets. Interim asset allocation targets were approved for the period from July 1, 2011 to December 31, 2012. In February 2013, the IC approved the extension of interim asset allocation targets until June 30, 2014.

ANALYSIS
The analysis below is for the Total Fund Policy Benchmark return only and in no case would any of the changes have an impact to the Total Fund portfolio returns or ending market value.

Upon approval from the IC, staff recommends to implement the below changes with a July 1, 2013 retroactive effective date.

Currency Overlay Program Benchmark
In March 2009, the IC approved changes to the Currency Overlay Program which effectively expanded the scope of the hedge to the majority of foreign asset exposures. At that time, the benchmark implementation resulted in the currency hedge component representing approximately 5% of the strategic allocation.

As part of the effort to enhance performance attribution calculations, the Currency Overlay Program benchmark methodology was reviewed against current industry standards utilized by international index providers to create passive currency overlay benchmarks. Staff recommends updating the Currency Overlay Program benchmark methodology to better align with industry standards and eliminate the scaling methodology that was used previously. The changes required to update the methodology are:

1. Eliminate any strategic allocation weight to the Currency Overlay Program
2. Incorporate all sources of volatility in currency pricing in the calculation of currency impacts.

Updating the calculation methodology has the potential to impact future Total Fund Policy Benchmark returns in either a positive or negative direction. The magnitude of the potential impact is illustrated by the change in benchmark volatility as measured by the standard deviation of returns. The existing methodology has an estimated annualized volatility of 11.47%. The updated methodology is estimated have an annualized volatility of 11.74%, an increase of 0.27%. This estimate implies that annual benchmark performance may be higher or lower by 0.27% approximately two thirds of the time. The actual returns generated by the fund will not be impacted by an update to the benchmark calculation methodology.

MAC Program Benchmark
The current process of the scaling the Total Fund Policy Benchmark to incorporate the MAC Program benchmark creates misalignment with the Asset Allocation Targets approved by the IC. The MAC Program does not have a strategic asset allocation target; therefore the approved Asset Class target allocations were proportionally reduced by the allocation to the MAC Program. Staff recommends that the MAC Program be excluded from the Total Fund Policy Benchmark in order to realign the benchmark with the strategic asset allocation approved by the IC.

The practical effect of this benchmark treatment of the MAC Program results in the program representing an “active” (non-benchmark) investment exposure with staff being accountable for any over/under performance generated. No significant benchmark return impacts are anticipated from the proposed change due to the small size of the MAC Program.

Total Fund Policy Benchmark – Interim Weights
The interim asset allocation targets are currently used to calculate the Total Fund Policy Benchmark; however they are not included in the Policy. In order to provide more clarity, staff recommends adding the interim asset allocation targets to the Policy.

BUDGET AND FISCAL IMPACTS
Not Applicable

BENEFIT/RISKS
The recommended changes will provide the IC with a more accurate standard to use in assessing investment performance by:

1. Ensuring we continue to stay aligned with current industry best practices related to the Currency Overlay Program benchmark.
2. Incorporating the MAC Program as a non-policy “active” component will remove any misalignment with the approved strategic asset allocation and ensure staff accountability for the efficacy of the program.
3. Incorporating the interim allocation weights into the Policy will increase the transparency of the calculation of the Total Fund Policy Benchmark, and improve the usefulness of performance attribution.

ATTACHMENTS
Attachment 1 – Revised Total Fund Benchmarks Policy
Attachment 2 – Wilshire Associates Opinion Letter

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