

# Absolute Return Strategies ANNUAL PROGRAM REVIEW

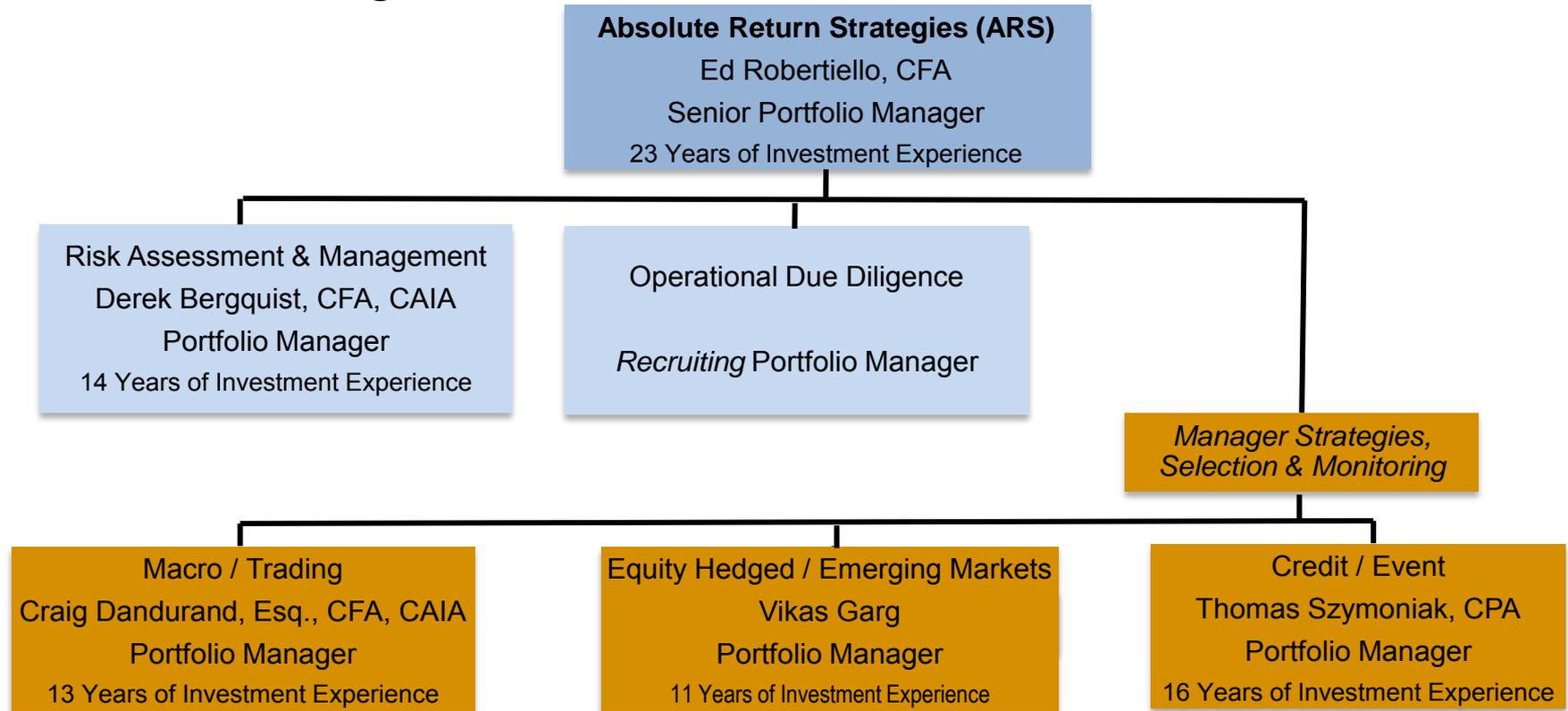
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# Functional Organization Structure



- Dynamic team structure organized around strategy expertise
- Building operational risk assessment and due diligence capabilities
- Staff expansion from 5 to 14 investment professionals during Fiscal Year (FY) 2013-2014
- Actively recruiting 3 additional investment professionals
- Total incremental resources proposed in FY 2013-2014 budget is offset by reduction of fees to advisors and Fund of Hedge Fund (FoHF) managers

# ARS Program Role & Scope

- Act as a Diversifier to equity growth risk in the CalPERS Total Fund
- Provide a return stream that demonstrates low beta to Global Equity
- Produce returns in stressed scenarios
- Maintain Total Fund long-term returns
- Provide insights into markets, risk appetites, and opportunities through partnership with ARS external managers

# ARS Program Parameters

Parameter	Approved Benchmark*	Inception – 06/30/2013	
Return Target	1-Year T-Bills + 5%	<u>Actual</u> FYTD: 7.5% 3 Years: 4.1% Inception To Date (ITD): 5.5%	<u>Benchmark</u> 5.3% 5.4% 7.3%
Risk Target	6% - 8% annualized standard deviation regardless of equity market volatility	FYTD: 2.9% 3 Years: 3.4% ITD: 5.4%	N/A
Drawdown Maximum	7% in any one month	Never breached	N/A
Liquidity Target	> 50% of assets convertible to cash in < 90 days in normal conditions	<u>Terms:</u> Daily: 16% Monthly: 47% Quarterly: 35%	<u>Positions**:</u> <30 Days: 42% <60 Days: 27% <90 Days: 1% >90 Days: 2%
Diversification	0.20 or less beta to Global Equity benchmark	2 Years Rolling: 0.14 Last 3 Years: 0.16 Since Inception: 0.24	N/A

\*IC approved, February 2013

\*\*Does not include Funds of Funds (FoFs) which represent 28% of ARS assets. Terms require maximum 90 day redemption

# ARS – Three Pillars

## Alignment of Interests

- Lower management fees - Emphasize performance instead of asset-raising
- Performance fees paid over a longer timeframe - Emphasize long-term value creation

## Control of Assets

- Separate accounts instead of commingled funds
- Allows for customized mandates more suitable to CalPERS needs
- Avoids impact of other fund investors' behavior

## Transparency of Risks and Exposures

- Full security level transparency allows for better risk management
- Trust but verify

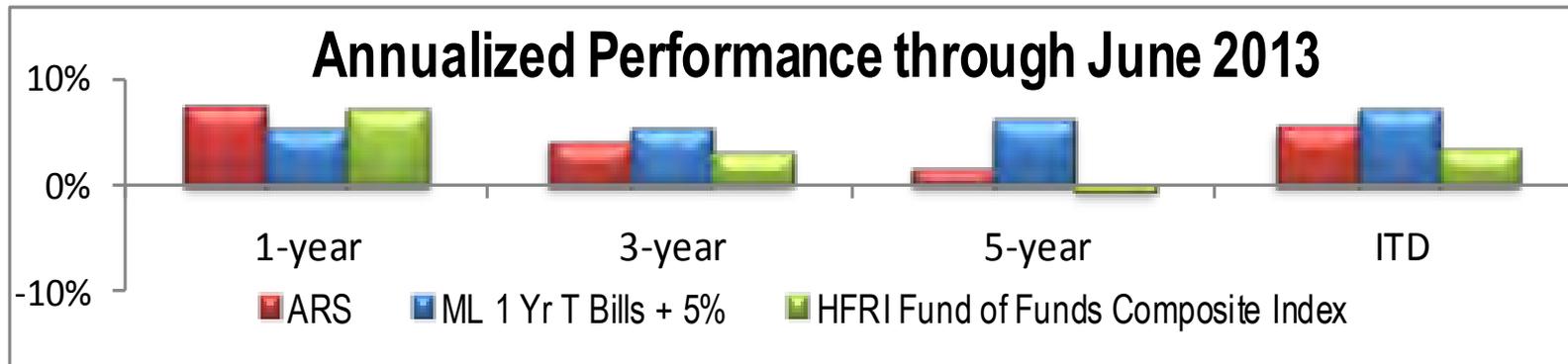
# ARS Investment Beliefs

- CalPERS long-term investment horizon allow staff to generate attractive risk adjusted absolute returns over all market cycles including declining market periods
- Active management adds value. ARS will only take active risk where we strongly believe it will be rewarded
- Costs matter and incentives need to be aligned
- Diversification across strategies is essential in achieving absolute return investing
- Experienced and motivated investment professionals working as a team are required to execute effective investment strategies

# ARS Performance

## Annualized Returns through June 30, 2013

	ARS	ARS Benchmark*	HFRI** FoFs Composite Index
1-year	7.46%	5.33%	7.27%
3-year	4.10%	5.43%	3.00%
5-year	1.60%	6.10%	-0.61%
ITD (4/2002 – 6/2013)	5.55%	7.31%	3.53%

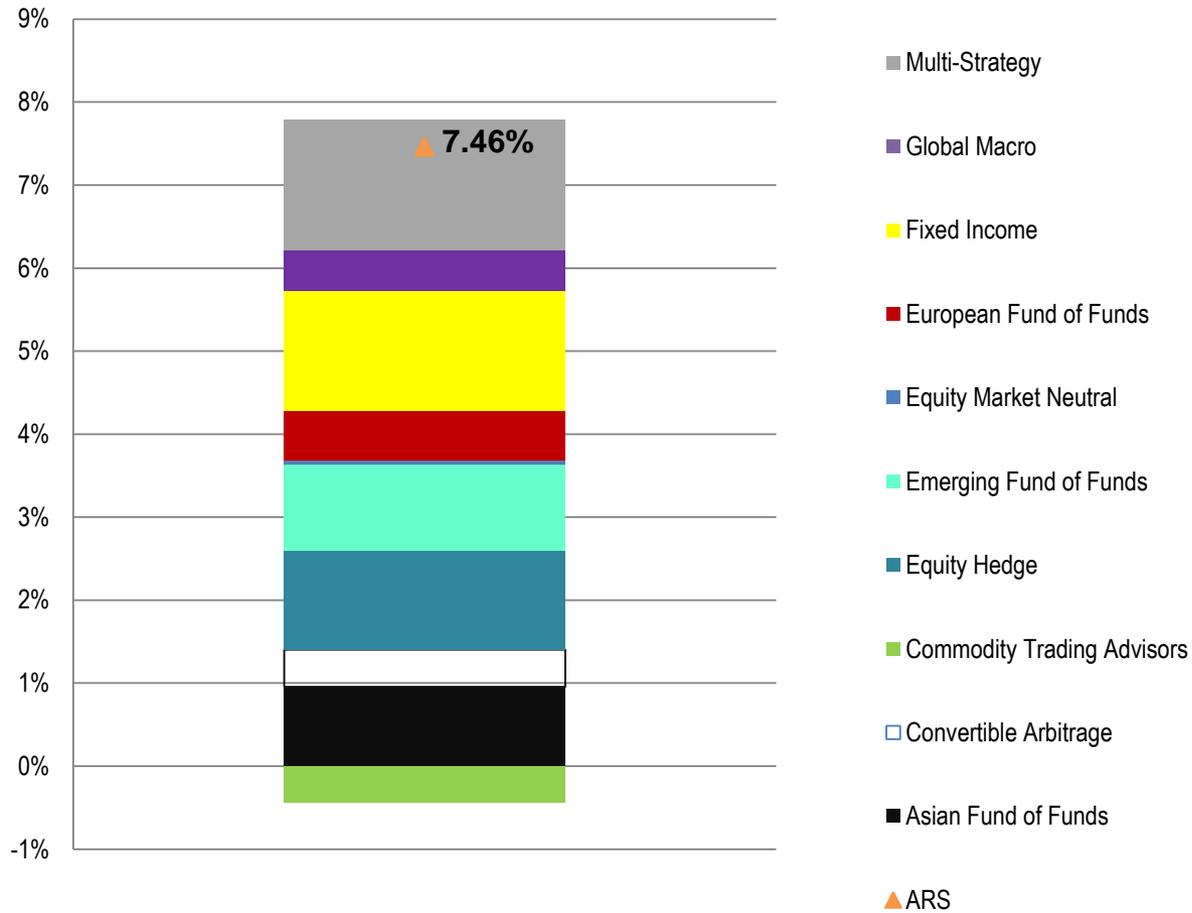


\*ML 1-Year T Bills + 5% ARS benchmark 2005-present; Equity / T Bills + 7% hybrid benchmark 2002-2004

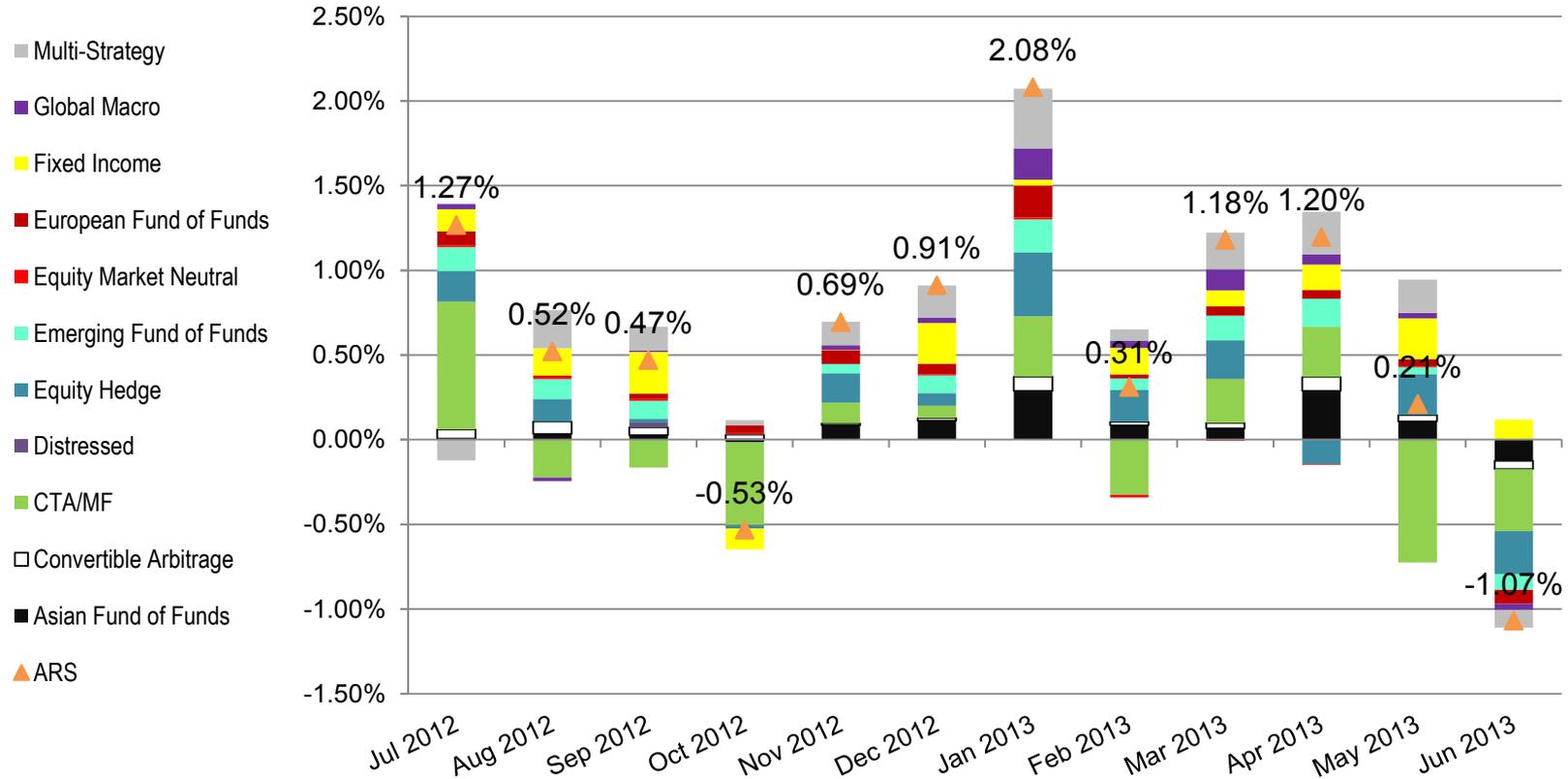
\*\*Hedge Fund Research, Inc.

# ARS Attribution

ARS Performance Attribution By Strategy - Fiscal Year 2012-13



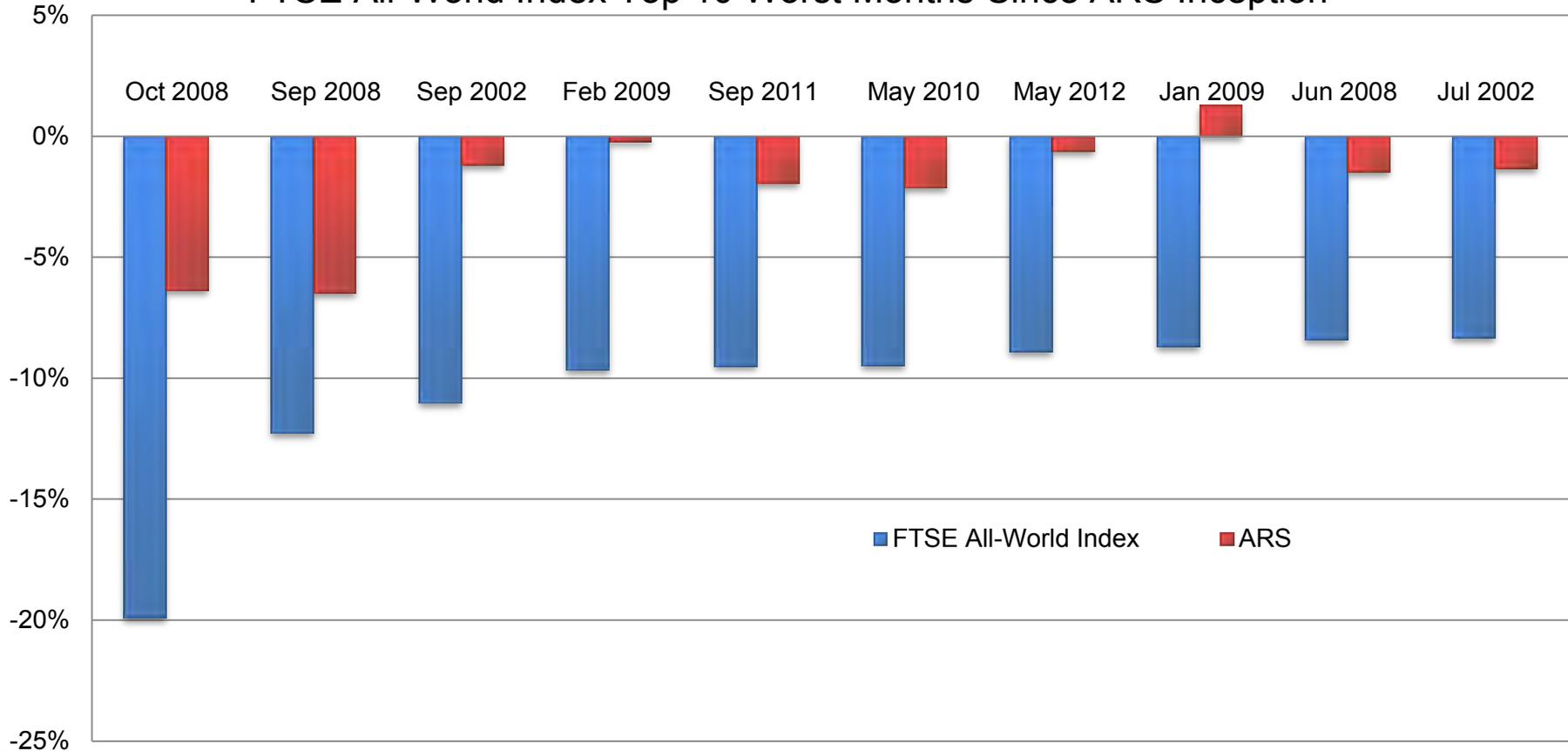
# ARS Monthly Attribution



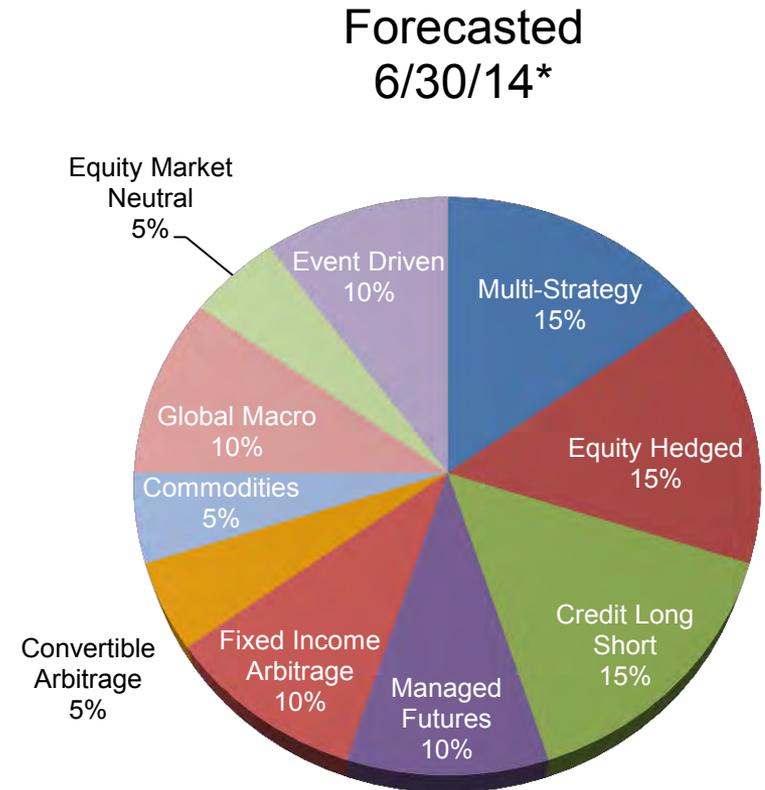
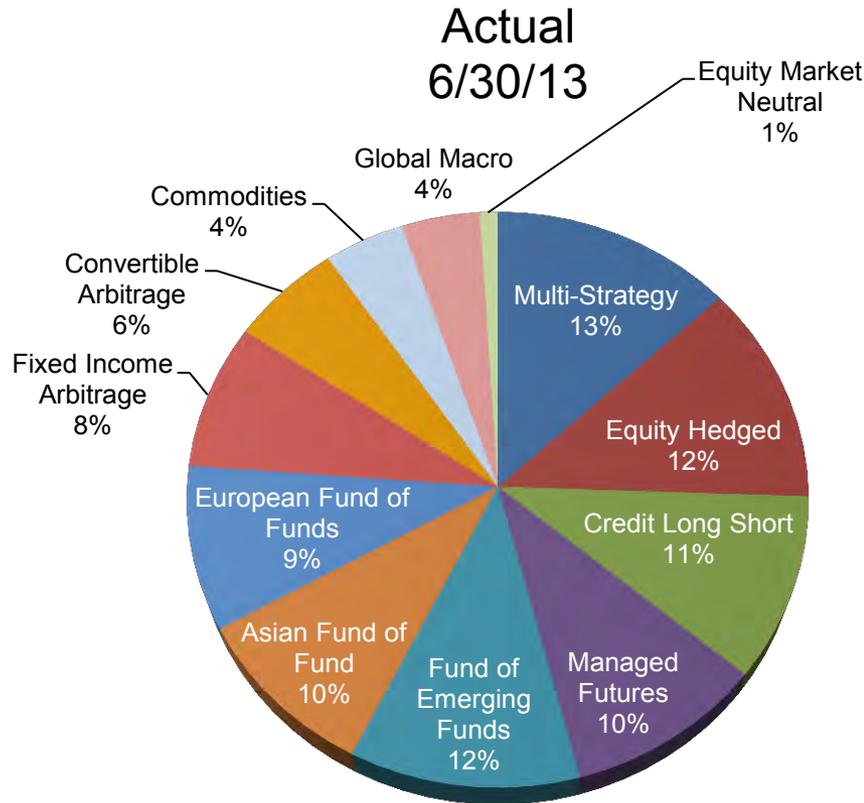
- ARS largest contributor in the FY 2012-13 was the Multi-Strategy sector, which contributed 157 bps. Fixed Income strategies were the second largest performance contributor, providing 145 bps of return
- The one lagging strategy was the Commodity Trading Advisors/Managed Futures (CTAs/MF), which detracted 43 bps of performance. Losses for these managers were concentrated in bonds and rates as the Fed’s comments on potential tapering resulted in an increase in yields

# ARS Performance vs. Equities' Worst Months

FTSE All-World Index Top 10 Worst Months Since ARS Inception



# Portfolio Characteristics: ARS Strategy Allocation



- Add Event Driven
- Add Discretionary Global Macro
- Add Quantitative Equity Market Neutral

\*Emerging Managers represent 10-15% of the ARS allocations and are reflected in each of the strategy buckets.

# MULTI-ASSET CLASS (MAC) PARTNERS PROGRAM

# MAC Partners Program – Strategic Objective

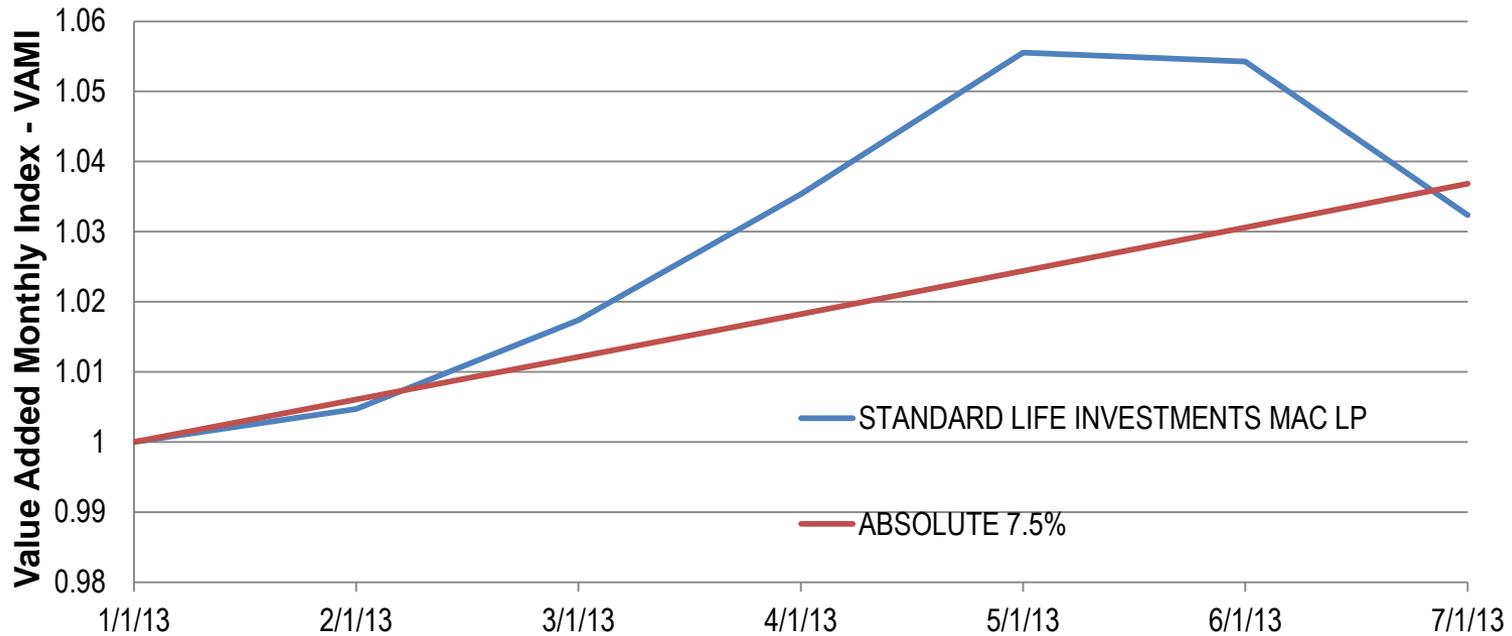
- Outperform CalPERS Total Fund target benchmark return over a market cycle with lower volatility and downside risk
- Facilitate meaningful information transfer from the MAC Partners to staff to help staff develop scalable, sustainable, and efficient methods of increasing the likelihood of meeting CalPERS investment return goals over the long term

# MAC Partners – Return & Risk

- Targeted Return
  - MAC Partners shall generally be expected to outperform the CalPERS target long-term rate of return over a market cycle (approximately five years)
- Targeted Risk
  - MAC Partners shall generally be expected to manage Program portfolios with a targeted annualized volatility of no more than, and with lower downside risk than, the CalPERS Total Fund benchmark

# MAC Partners

## Standard Life MAC

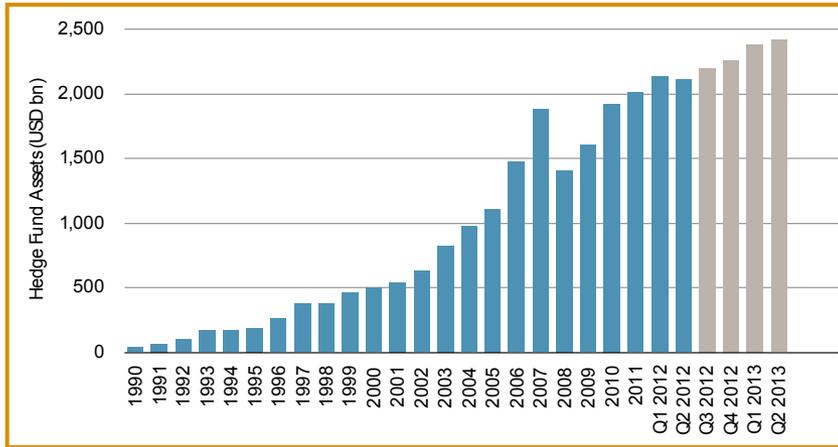


MAC - Performance		
	Q2 2013	ITD (January 1, 2013 - July 31, 2013)
Standard Life Investments MAC LP	-0.29%	3.60%
Benchmark - Absolute 7.5%	1.82%	4.31%

# HEDGE FUND MARKET UPDATE

# Growth of Hedge Fund Industry FY 2012-13

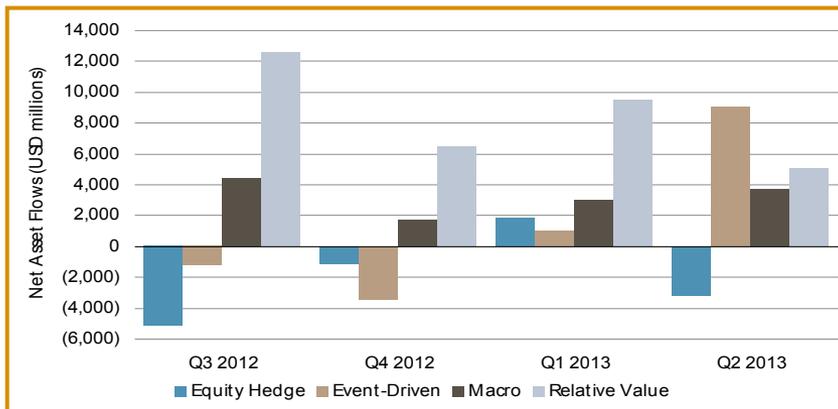
**Hedge Fund Asset Growth Since 1990**



## Hedge Fund Assets Continued to Reach New Highs

- After surpassing prior peak assets in Q1 2012 the hedge fund industry continued to make new highs, reaching \$2.25 trillion as of June 30, 2013 according to Hedge Fund Research
- During CalPERS FY 2012-13, hedge fund industry assets increased steadily in each quarter, gaining approx. 15% (\$313bn) year-on-year
- Net flows during the period were significantly higher in Relative Value (RV) (+\$33bn) compared to other strategies; Equity Hedged was the only major strategy group to experience net outflows (-\$7.7bn)
- Of note, total asset growth was positive across all major strategy groups, with the generally strong performance of Equity Hedged strategies more than offsetting the investor outflows

**Hedge Fund Net Asset Flows by Strategy**



Source: A&Q, HFR (1990 through end of Q2 2013) The use of indices is for illustrative purposes only.

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# Performance Review

## FY 2012-13 Was Particularly Interesting for Hedge Funds

### Calculated HFR Sub-strategy Performance

HFRI Strategy Index	2012-2013 FY Return	2013 Return (through 6/30/2013)
HFRI Event-Driven (Total) Index	12.24%	5.40%
HFRI Equity Hedge (Total) Index	10.53%	4.91%
HFRI Relative Value (Total) Index	9.27%	2.99%
HFRI Emerging Markets (Total) Index	8.87%	-0.60%
HFRI Macro (Total) Index	-0.18%	-1.01%
HFRI EH: Short Bias Index	-20.43%	-10.04%

- Since Mario Draghi's comments in July 2012, market sensitivity to bad news in Europe and other geopolitical hotspots (North Korea, Iran, and the Middle East) trended lower due to continued faith in Central Banks' abilities to mitigate contagion. Liquidity returned to markets and generally volatility declined, providing a relatively positive backdrop across most hedge fund strategies for alpha-oriented managers.
- In 2012, carry-oriented strategies outperformed (such as high yield/distressed, structured products, and reinsurance).
- YTD 2013, fundamentally-driven managers regained ground, notably equity long/short (particularly in the tech and healthcare sectors) as well as systematic market neutral, notably in Asia.
- Most RV strategies produced positive performance throughout the period, including fixed income RV, capital structure RV (including converts), and statistical arbitrage
- While discretionary macro managers fared generally better in 2013, systematic CTAs generally produced losses throughout the FY period

Source: HFR. Calculated performance from 1-Jul 2012 to 30-Jun 2013

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# Upcoming ARS Investment Themes & Opportunities

## European Credit

European corporate distress and restructuring increase with economic challenges and bank deleveraging. \$378 billion maturity wall approaching for European Leveraged Buyout [LBO] loans from 2014-2016. €133 billion of unrated European LBO debt (254 companies) maturing through 2015. Recently adopted bankruptcy laws in key European countries are more creditor-friendly and enhance distressed investment opportunity.

## Global Macro

Fed Tapering effects on U.S. Treasuries and G3 yields, global equities, USD, credit and gold. Japan reflation will impact USD/JPY, Nikkei, Japanese Government Bonds. Local politicians think they have been successful so far and the popularity of Abenomics is still high. German election/ EU recovering – European Central Bank may be more aggressive in loosening financial conditions. UK economy is improving at a rapid pace and highly accommodative fiscal and monetary policy should add a boost. China slowdown/new economy: recent improving data indicates that growth is picking back up. The new government will focus on the “new economy”, i.e. high quality (health care, clean energy, anti-corruption) vs. “old economy,” i.e., high growth number.

# Upcoming ARS Investment Themes & Opportunities

## Non-Performing Loans (NPLs)

As a result of the recent dislocation in U.S. residential housing since 2007, banks and financial institutions currently own an unprecedented amount of distressed whole loan assets estimated to be in the range of \$500 billion. These loans will be offered out at significant discounts. Partner with a manager that owns servicing capabilities.

## Mortgage Servicing Rights (MSRs)

New Basel III capital requirements for MSRs are prompting banks to reevaluate business strategies. As a result of higher capital charges for MSRs, banks are disposing of legacy MSR assets. In short, banks are being dis-intermediated out of the trade.

# ROADMAP INITIATIVES, COST SAVING AND POLICY REVIEW

# Roadmap Accomplishments

- Restructuring advisory relationship and cost model. Divest from FoHFs
  - Negotiated new Letters of Engagement with advisors
  - Redeemed from 2 FoHFs, notified 4 others
  - Annual savings to date of \$8.8 million
- Allocating directly to hedge fund managers
  - 4 Asia focused managers
  - 4 Credit and Equity related strategies
- Build internal investment team and internalize crucial investment functions
  - Hired 3 investment professionals
  - Active search for 3 additional positions
- Negotiated, structured, and implemented MAC Program with 2 strategic partners

# Future Roadmap Initiatives FY 2013-14

- Continue to restructure advisory relationship
  - Transition allocations of 4 remaining FoFs to direct Hedge Fund investments
  - Further negotiations with advisors
  - Anticipate additional annual savings of \$6.6 million
  
- Continue to build an internal investment team. Internalize crucial investment functions
  - Hire Portfolio Manager for Operational Due Diligence
  - Hire Investment Officer to support staff
  
- Issue Request for Proposal for managed account platform for ARS that enhances ARS technology and legal structures to meet current/future investment requirements

# Total Program Costs as a Percent of AUM\*

Program Actual for FY 2012-13						Projected as of FY End 2013-14			
	% of AUM	Fund Type	Management Fees as % of NAV	Performance Fees as % of NAV	Fees as % of NAV	% of AUM	Management Fees % of NAV	Performance Fees % of NAV	Fees as % of NAV
<b>Direct</b>	20%	Commingled Funds	1.70%	0.98%	2.68%				
	50%	Fund-of-One (Eureka)	1.19%	1.70%	2.89%	100%			
	<b>70%</b>	<b>Sub-Total:</b>	<b>1.33%</b>	<b>1.50%</b>	<b>2.83%</b>	<b>100%</b>	<b>1.20%</b>	<b>1.50%**</b>	<b>2.70%</b>
<b>FoHFs</b>	30%	Custom FoHFs	0.75%	0.04%	0.79%				
		Underlying Managers	1.39%	1.37%	2.75%				
	<b>30%</b>	<b>Sub-Total:</b>	<b>2.14%</b>	<b>1.41%</b>	<b>3.55%</b>				
<b>Direct &amp; FoHF</b>	<b>100%</b>		<b>1.58%</b>	<b>1.47%</b>	<b>3.05%</b>	<b>100%</b>	<b>1.20%</b>	<b>1.50%*</b>	<b>2.70%</b>
<b>Advisory/Admin</b>					<b>0.17%</b>				<b>0.08%</b>
<b>ARS Program</b>		<b>Total</b>	<b>1.58%</b>	<b>1.47%</b>	<b>3.22%</b>		<b>1.20%</b>	<b>1.50%*</b>	<b>2.78%</b>

\*Assets under management

\*\*Assumes 8.0% return; average performance fee is estimated to be 15%

# Statements of Investment Policy Review

- ARS and MAC Partners are each governed by one statement of investment policy:
  - Statement of Investment Policy for ARS Program was adopted April 15, 2013
  - Statement of Investment Policy for MAC Partners Program was adopted October 15, 2012
- Staff have reviewed the Statements of Investment Policy owned by the ARS and MAC Programs and have concluded that all policies are applicable and no changes are required at this time