Agenda Item 5a

December 16, 2013

ITEM NAME: Revision of the Real Assets Program Policy

PROGRAM: Real Assets – Infrastructure

ITEM TYPE: Policy & Delegation – Action

RECOMMENDATION

Staff recommends approval of the revised "Real Assets Program Policy" as provided in Attachment 1.

An opinion letter from Meketa Investment Group, the Board's Infrastructure Program Consultant, supporting the recommendation is provided as Attachment 2.

EXECUTIVE SUMMARY

This agenda item provides staff's recommendation to revise the Policy for the Infrastructure Program (Policy), which is Attachment B of the Real Assets Policy. The rationale for the proposed changes is to ensure that staff has sufficient latitude for transacting investments that match the Program's objectives, and to provide increased clarity for certain defined terms and Key Policy Parameters.

A revised Real Assets Program Policy was presented to the Investment Committee (IC) for initial review on November 18, 2013. The IC's feedback regarding the revised Policy from the initial review included the following changes:

- Revised the Investment Approaches and Parameters section to remove inserted language "preferred or common."

- Revised the Investment Structures section to correct the spelling of "Co-investment" for consistency purposes.

- Revised the Glossary section to replace the existing definition of "Co-investment" with a definition that is more relevant, and is consistent with the definition in the main body of the Policy.

Changes made to the Real Assets Program Policy based on the IC's feedback are denoted with yellow highlighting within Attachment 1.

STRATEGIC PLAN

This agenda item supports the CalPERS Strategic Plan goal to improve long-term pension and health benefit sustainability. The adoption of the recommended Policy will enhance CalPERS ability to achieve target risk-adjusted investment returns.

INVESTMENT BELIEFS

This agenda item supports CalPERS Investment Belief 1: Liabilities must influence the asset structure. The Proposed revisions will provide staff with greater ability to transact Infrastructure investments which meet the Program's strategic role and objectives.

BACKGROUND

CalPERS Infrastructure Program invests internationally in public and private infrastructure enterprises, principally within the energy, power, water and transportation sectors. The Infrastructure Program resides within CalPERS Real Assets asset class, and the Policy resides within the Statement of Investment Policy for Real Assets. The current Policy was approved in August 2011. Since that date, staff has focused on opportunities to grow the Infrastructure Program through new investment. Staff has observed that current Policy restrictions on permitted leverage impede staff's ability to transact investments that meet the Infrastructure Program's objectives. Staff therefore recommends changes to the Policy's restrictions regarding permitted leverage. Additionally, staff recommends less-substantive changes to the Policy, including the addition of a new concentration limit for commitments to individual managed investment vehicles, and new language to improve clarity of the Policy in certain areas.

ANALYSIS

A summary of the recommended Policy changes and rationale are as follows:

1. Revisions to more clearly define each of the following terms:

    a. Section V.E. – "Defensive Investments,"

    b. Section V.E. – "Extended Investments,"

    c. Section V.F.3.b. – "Developed OECD," and

    d. Section VII.A.4. – "Separate Account."

2. Section V.F.3.d. – Revisions to supplement the existing concentration limits for commitments to managed investment vehicles:

    a. Instituted a new limit pertaining to single-investment concentration, whereby amounts that may be invested in any commingled fund, separate account or other managed vehicle shall not exceed 20% of the Program allocation; and

b. Clarified the scope of the existing single-manager concentration limit (which is 30% of the Program allocation) so that it clearly applies in respect of all types of managed vehicles, without exception.

3. Section X.B. – Leverage. Staff believes that the Program's Policy provisions with respect to permitted leverage hinder staff's ability to pursue suitable investments for the Program. Staff therefore recommends that the Policy be modified to provide staff with sufficient authority to transact suitable new investments carrying greater flexibility for making investments that carry higher degrees of leverage. For instance, staff sees numerous Defensive- and Defensive Plus-quality infrastructure investments levered above 50% of enterprise value with unrated debt. Many such investments are desirable targets for the Infrastructure Program as they match the Program's low-risk, stable return objectives.

   Staff proposes revisions to limits for permitted leverage as follows:

   a. No changes are recommended to the overall Infrastructure Program limit, which is 65% of the market value of assets held within the Program;

   b. Removed the existing leverage limit with respect to individual commingled funds, to provide management flexibility for the Program to make commitments to funds that target lower-risk investments which customarily include and will support higher percentage levels of leverage;

   c. Increased the leverage threshold – above which IC approval is required – from 50% to 65% of enterprise value for new direct equity investments where leverage is not investment-grade rated. This change will provide needed management flexibility to the Program for transacting lower-risk investments which customarily include and will support leverage up to 65% of enterprise value; and

   d. Removed the existing credit rating requirement with respect to new debt investments, to enable the Program to acquire suitable forms of debt securities such as bank debt and other project finance debt instruments which are ordinarily not rated. Staff believes that the requirement that debt investments meet the Defensive / Defensive Plus risk classification is sufficient for ensuring investment quality consistent with the Program's objectives.

4. Staff also considered proposing the elimination of the Policy provision limiting investments in individual commingled funds to a maximum of 25% of the committed capital of any such commingled fund. The rationale for the existing restriction is to limit potential exposure to vehicles that do not raise adequate capital to be viable enterprises. While staff acknowledges this rationale, it

believes that removing the Policy constraint will provide greater latitude to negotiate and structure closely-held commingled investments consistent with the Program's strategic objectives and approach. Based on advice from Meketa, staff has decided not to recommend a change at this time.

BUDGET AND FISCAL IMPACTS
Not Applicable

BENEFITS/RISKS
The proposed revisions to the Policy are principally designed to: 1) enhance the ability of the Program to invest in transactions which meet the Program's strategic objectives; and 2) enhance the clarity of the Policy with respect to certain key definitions.

While staff recognizes that overuse of leverage can limit financial flexibility and increase financial risk, staff also regards prudent, measured use of leverage as an appropriate approach for the efficient financing of investments. Staff believes that its proposed changes to the Policy support appropriate and efficient leverage for investments for the Program, and that adoption of the proposed Policy changes will benefit the Program by expanding access to high-quality investments which meet the Program's low-risk, stable return objectives.

The proposed changes do not conflict with CalPERS Statement of Investment Policy for Leverage.

The proposed modifications and additions to other sections of the Policy are expected to benefit the Program by reducing ambiguity and increasing clarity for interpretation of the Policy and implementation of the Program.

ATTACHMENTS
Attachment 1 – Proposed Revision of the Real Assets Program Policy
Attachment 2 – Meketa Investment Group Opinion Letter

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