CalPERS Review of Investment Beliefs – Offsite Workshop (2)

Three forms of capital, global governance and ESG

Roger Urwin
Adam Gillett

July 13, 2015

TOWERS WATSON

Summary of this session

- Context of the session – following May 18 IC meeting, it was agreed to explore two areas of beliefs implementation that are unsettled – ESG and risk

- Purpose of the session

  - Unpacking and understanding issues from three forms of capital, global governance and ESG

  - Socializing the debate through strategic dialogue

  - Settling differences where possible

  - Building on Board core values: risk intelligence; ethical and principled leadership

- Structure of the session

  1. Unpacking – Discussion and issue framing – 30 minutes
     A) Brief summary of CalPERS sustainable investing framework
     B) Introduce the conflation challenge
     C) Build 'buckets' (taxonomy) for CalPERS' mission and ESG beliefs

  2. Survey – Questions and Answers – 30 minutes

  3. Table discussion and reports back – 30 minutes
     Aiming for action-oriented outcomes drawn from 'Straw-men'
     Concluding thoughts including 'new reality' considerations

A) CalPERS thinking starts with an economically grounded framework

CalPERS Sustainable Investment

Sustainable Value Creation Framework

Sustainable investment in its simplest form is the ability to continue, and for a long-term investor like CalPERS with long-term liabilities, it is critically important. Long-term value creation requires the effective management of three forms of capital: this is why we are concerned with environmental, social, and governance issues.

Physical Capital - Environment
Includes managing risk posed by climate change, and the use of natural resources and buildings

Financial Capital - Governance
To ensure alignment of interest over equity, debt, public and private investments

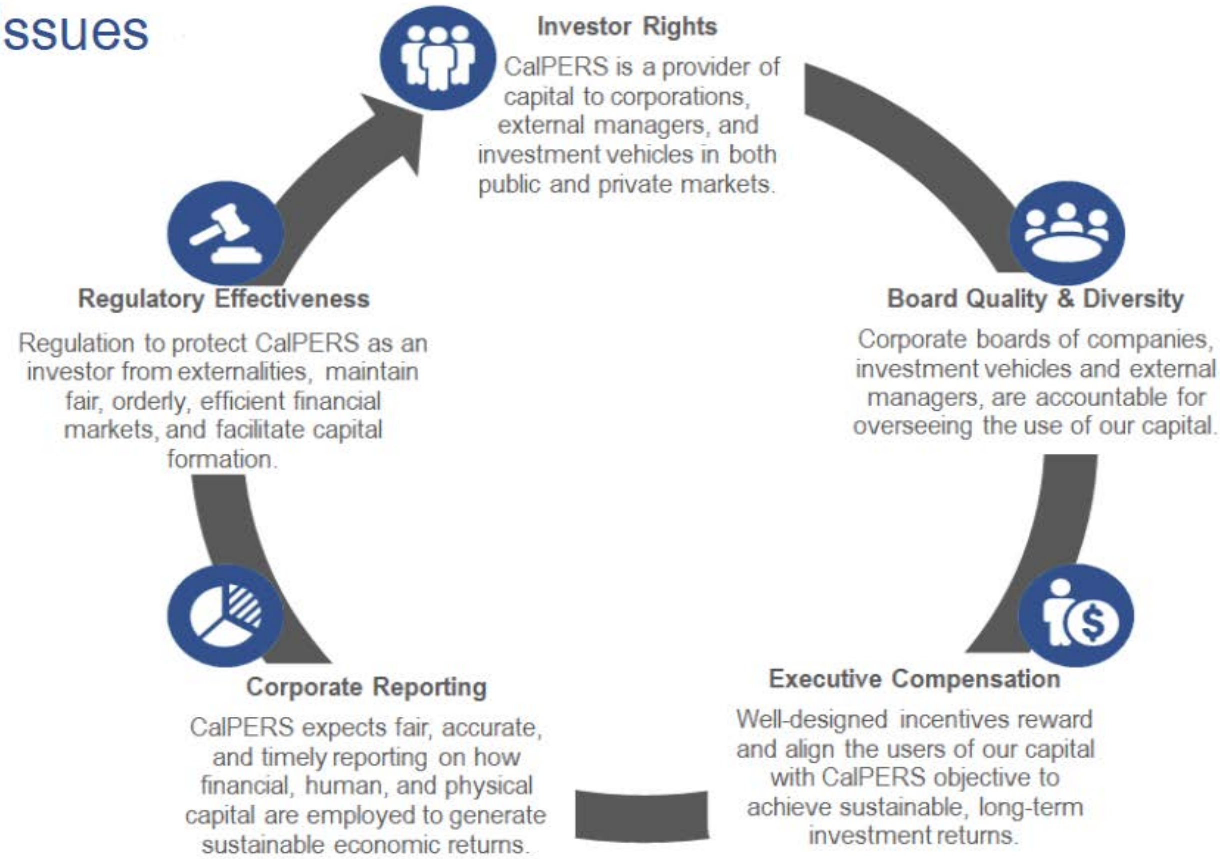
Human Capital - Social
Includes health, safety, and labor practices

CalPERS | Investment Office
Corporate Governance

CalPERS framework is focused on these core issues

Global Governance Program and Environmental, Social and Governance Manager Expectations Update

Core Issues



CalPERS | Investment Office Global Governance

CalPERS framework aligns various sources of thinking

Global Governance Program and Environmental, Social and Governance Manager Expectations Update

Draft Sustainable Investment Guidelines | Framework

CalPERS Investment Beliefs

Investment Belief 2: A long time investment horizon is a responsibility and an advantage.

Investment Belief 4: Long-term value creation requires effective management of three forms of capital: financial, physical and human.

Investment Belief 7: CalPERS will take risk only where we have a strong belief we will be rewarded for it.

Investment Belief 9: Risk to CalPERS is multi-faceted and not fully captured through measures such as volatility or tracking error.

UN Principles for Responsible Investment

Principle 1: We will incorporate ESG issues into investment analysis and decision-making processes.

Principle 2: We will be active owners and incorporate ESG issues into our ownership policies and practices. (For equities*)

Principle 3: We will seek appropriate disclosure on ESG issues by the entities in which we invest.

Global Governance Principles

A. CalPERS believes that environmental, social and corporate governance issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, and asset classes through time.)

CalPERS | Investment Office Global Governance

*Depending upon control rights

CalPERS framework combines governance with ESG integration

Global Governance Program and Environmental, Social and Governance Manager Expectations Update

Draft Sustainable Investment Guidelines | Framework

The Guidelines are driven by our Investment Beliefs and in line with the Principles for Responsible Investment (of which CalPERS is a founding signatory) and the Global Governance Principles.

CalPERS | Investment Office Global Governance

CalPERS framework is well-focused by being guided by the evaluation of the costs and benefits to the fund

Global Governance Program Annual Review

Investment Decision Process | Criteria & Core Issues

Staff use the following criteria to prioritize core issues:

CalPERS Principles	To what extent is the issue supported by CalPERS' Investment Beliefs, Principles or Statements of Investment Policy?
Materiality	Does the issue have the potential for a meaningful impact on portfolio risk or return? • Net Portfolio Performance: Relevant to improving portfolio returns or reducing risk. • Capital Exposure: Relevant to CalPERS' capital exposure in $$ terms. • Scale: Relevant to the number of companies in which CalPERS invests. • Evidence: Supported by empirical data, broad market consensus, or strong CalPERS conviction that the issue will improve returns or reduce risk.
Capacity	Do we have the expertise and resources to influence a meaningful outcome? Do we have prior experience with engaging on the issue?
Timeliness	Is the issue time sensitive with a clearly defined deadline?
Likelihood of Success	Is there a likelihood of success that CalPERS' action will influence an outcome which can be measured? Can we partner with others to achieve success? Can we add value to the debate?

CalPERS | Investment Office Global Governance

Note: These criteria have been incorporated into Investment Belief 3

CalPERS' strategy is strong on engagement, advocacy and integration

Global Governance Program

Engagement

- CalPERS exercises its ownership rights through proxy voting and engagement, both individually and in partnership (through PRI, CII, ICGN, Ceres), focusing on core issues of: investor rights, board quality and diversity, compensation, corporate reporting on risk management and return on capital over the long term (for example, the Carbon Asset Review with 46 energy companies, and this seasons campaign on proxy access).

Advocacy

- CalPERS advocates for public policy and regulation which protect its investments (through SEC, EPA, FASB/IASB, Congress, European Commission) focusing on financial market priorities (currently derivatives, credit ratings and housing finance) and sustainable investment priority (currently, climate change - carbon pricing, fossil fuel subsidies, emissions regulation).

Integration

- CalPERS is integrating sustainability considerations into investment decision making through a cross asset class team on sustainable investment tasked with defining relevant and material factors, identifying data and tools, mapping our carbon footprint, and communicating expectations to internal and external managers across the Total Fund (pilot phase for Manager Expectations on Sustainable Investment has just been launched).

CalPERS | Investment Office Global Governance

B) The sustainability challenge is really tough given all the moving parts to sustainability and its short- and long-horizon elements

- Asset owners need clarity on their mission and its long-term and wider stakeholder elements — Difficult
- At the same time, asset owners need their worldview perspective on the fast-moving, multi-strand framing of the investment landscape — Very difficult
- These complex and diverse elements are particularly difficult to integrate into a coherent strategy in the sustainability and ESG area because of conflation* — Very difficult
  - Financial factors (like earnings and earning multiples) and extra-financial factors (like carbon footprint and climate attribution) mixing objective and subjective data; this also mixes values with pure financial considerations, Board decisions with staff decisions and factors that have accepted track records to factors that don't
  - Factors that emerge up front (for example current oil prices) or with a lag (like carbon that will take decades to settle) mixing time horizons
  - The influence of agency roles – for example asset managers with relative return mandates that invest without alignment to the asset owner mission
  - The fusion of the sustainability of the organization to the sustainability of the mission introduces other inter-plays and builds out a wider context to sustainability

*** Conflation**
(n) The process or result of fusing items into one entity; joining up

The sustainability challenge

- The mission must balance multiple stakeholders' interests; the execution must balance many moving parts over both the long term and the short term
- Extremely strong governance processes needed

Mission & goals → Beliefs → Culture → Strategy → Execution

Mission fuzziness
- multiple stakeholders
+ trade-offs
+ spill-overs

Beliefs ambiguity
- VUCA = volatile /uncertain/complex/ ambiguous
- high noise/ low system stability

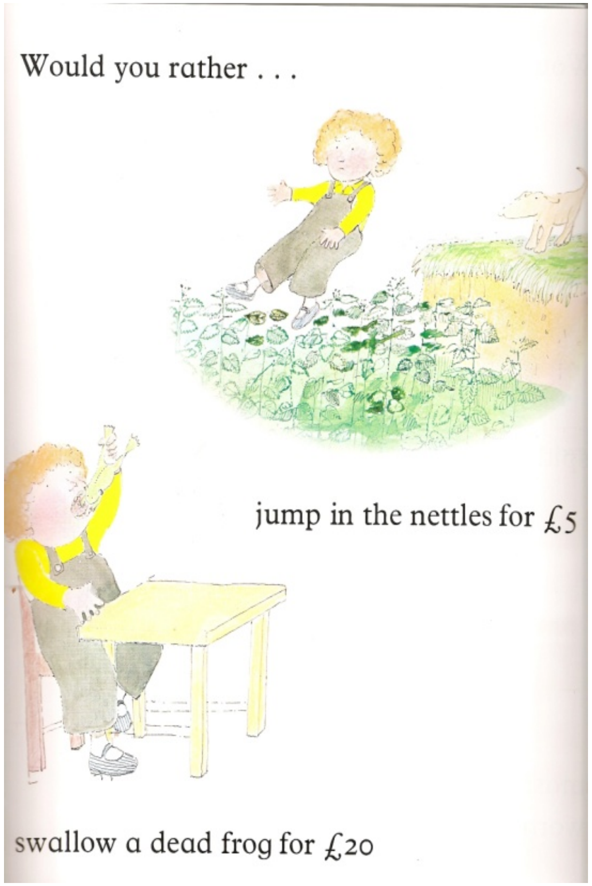
Culture complexity
- hyper-connectivity
- leadership
- values will differ

Strategy complexity
- search engine across choices
- landscape
- 'one shots'

Execution coherence
- subjectivity
- leads/lags
- agency
- conflation

Conflation, trade-offs and spill-overs

- Conflation is the mixing of two or more distinctly different things producing potential confusion
- Often this is mixing the explicit and easy-to-measure with the tacit and hard-to-measure
- Example: sustainability involves allocating 'resources' to two separate 'buckets': one financial, one extra-financial
- *E.g. to use our investments to generate high returns and also support sustainability*
- This is difficult
  - How much weight to each? Why? Who decides?
  - How do you account for trade offs and spill overs?
    Trade-offs when the addition of the benefit of an extra-financial pay-off involves a financial cost
    Spill-overs when the addition of the benefit of an extra-financial pay-off involves a financial benefit
  - How do you measure mission progress and success?



Would You Rather?
John Burningham
Publisher Red Fox Books

The spill-over opportunity in sustainability

- The overlap between extra-financial factors and financial factors is critical to sustainability
- Extra-financial factors are those that lie outside the usual spectrum of financial variables appearing in financial statements that, while difficult to measure and codify, can be inputs to investment decision-taking and will influence financial performance over time
- Extra-financial factors have the capacity to produce financial spill-overs defined as positive financial outcomes that were uncertain at the point of decision but materialised later (and contrast with the situation where a non-financial factor is in a trade-off with a financial cost)

C) CalPERS current sustainable investing framework

1. CalPERS has strong foundations from its investment beliefs

2. But it is not clear that CalPERS has settled how to implement its ESG beliefs

- Staff want to see stronger evidence about connection between these factors and value creation
- There is stronger support among the Board than Staff for targeting capital at specific issues

3. CalPERS needs a more explicit policy framework for deciding which approach to take, when and on what evidence and process

4. Specifically, the policy framework needs to more clearly acknowledge that investment decision-making is the exercise of judgment in the face of uncertainty and more broadly incorporate risk (see Supporting Material – process unpacked)

5. The alternatives for integrating sustainability into investment decisions:

• Engage (e.g., encourage investee companies to act responsibly)	Active Ownership
• Integrate ESG (e.g., mandate managers and portfolios to integrate ESG factors)	Integrated ESG
• Divest (e.g., tobacco, guns) or exclude sectors / countries / securities from the portfolio (e.g., emerging market principles)	Targeted ESG
• Strategic tilt (e.g. towards ESG favorable companies)	Targeted ESG
• Overweight / underweight a specific security (e.g., focus list monetization)	Targeted ESG
• Hold a concentrated position in a security (e.g., corporate governance managers), or hold only securities with positive ESG attributes (e.g., hold Company A instead of B)	Targeted ESG
• Target capital at specific issues / objectives (e.g., clean tech in private equity)	Targeted ESG

Source: CalPERS materials and Towers Watson input

The mission buckets

- In approaching ESG and governance strategy from a mission standpoint, there are a number of possible ways to see the choices, grouped in 'buckets' below
- The Business case responsible mission is captured in 2a and 2b which have different motivations but similar substance
- The Board has ownership and accountability for the decision on the mission in which fiduciary duty is a central codifying factor for CalPERS – see comments over

1. Traditional mission	2a. Business case responsible mission – allow for reputational capital	2b. Business case responsible mission – allow for prosocial stance	3. Dual mission – includes impact stance
Mission is solely focused on financial goals	Mission is 'sustainable' - includes ensuring license to operate and managing reputational capital Conviction that there is no material financial cost to this, the spill-over benefits are at least equal to costs	Mission is 'prosocial' - includes do no harm, do positive good, do what beneficiaries would wish Conviction that there is no material financial cost to this, the spill-over benefits are at least equal to costs	Mission is more explicitly concerned with non-financial impacts Conviction that the financial trade-off from including non-financial impacts is limited

The context of fiduciary duty

- Belief#3 – '*CalPERS investment decisions may reflect wider stakeholder views, provided they are consistent with its fiduciary duty* to members and beneficiaries'* (* 'defined in the California Constitution)

- Fiduciary duty is contextual and subjective in nature

  '*The core issues of fiduciary duty are that those who manage investments on behalf of others are bound by a number of fiduciary obligations. There are four principal forms of this obligation:*

  - Loyalty; putting the interests of beneficiaries first when determining the investment strategy and avoiding conflicts of interest

  - Prudence and care; investing to the standard of care of a prudent expert

  - Diversification; diversify according to the principles of accepted investment theory

  - Impartiality; avoid favouring the interests of a particular beneficiary or class of beneficiaries over others.

  Their interpretation will not be black and white.'

  Source: *Cambridge Handbook of Institutional Investment and Fiduciary Duty | Urwin*

- Fiduciary duty is an evolving concept

  '*Appropriate interpretation of the principles of fiduciary duty should change as investment principles, theory, practice and circumstances evolve. It is reasonable to anticipate some changing context to fiduciary duty. No strict interpretation of fiduciary duty would be expected to fix the concept in time.'…this presents an innate challenge for the new circumstances involved with the field of sustainable investing'.*

  Source: Cambridge Handbook of Institutional Investment and Fiduciary Duty | Urwin

- CalPERS might find the practices of Reference Group funds in the Top 20 asset owners study of interest

  '*The Reference Group (selected for comparison to reflect a combination of their size, transparency and strong governance model – 15 pension funds, 4 SWFs, 1 endowment fund – US$ 6.4 trillion'*

  '4 funds had the traditional mission 1; 16 funds had the responsible business case mission 2a and/or 2b'

  '*No funds have a dual mission, not least because of their respective views of loyalty and impartiality in their interpretation fiduciary duty'*

  Source: Thinking Ahead Institute, Top 20 Study

The ESG strategy buckets

- In approaching ESG and governance strategy from an investment-led standpoint, there are a number of possible ways to see the choices, grouped in 'buckets' below
- For investment-led positions, it is largely staff who should take responsibility for taking the lead here

Collaboration	Targeted ESG
Engage Systemic network effects Beta driver No counterfactuals Moderate convictions required	**Targeted capital | Divest | Strategic tilt |** Systematic (factor level) effects Beta driver Counterfactuals Strong convictions required
Active Ownership	**Integrated ESG**
Engage Idiosyncratic positions (asset-by-asset) Alpha driver No counterfactuals Moderate convictions required	**ESG factor integration** Idiosyncratic decisions (asset-by-asset) Alpha driver No counterfactuals Moderate convictions required

Rough positioning of ESG actions on ‘mission/beliefs grid’

Targeted SI Beliefs - ESG mispricing opportunities - ESG mandates considered			Targeted ESG
Integrated SI Beliefs - ESG risks need management - Ownership needs management		Integrated ESG Active Ownership	
Traditional Investment Beliefs - ESG risks unspecified - Ownership unspecified			
Investment Beliefs/ Strategy / **Mission/ Values/ Goals**	**Traditional Mission**	**Responsible Business-case Mission**	**Responsible Wider Impact Mission**
	- Goals exclusively financial	- Goals exclusively financial but extra-financial factors considered	- Goals predominantly financial but extra-financial goals added
	- Pure finance driven; non-financial factors not considered	- Considers wider stakeholder extra-financial factors but with no performance downside	- Considers wider stakeholder extra-financial factors but with limited performance downside
	- Benchmark and monitor short term vs other funds	- Benchmark and monitor relative to longer-term mission	- Benchmark and monitor relative to longer-term mission

Part 2 - Key questions

Clicker Survey Method

- While accepting its obvious limitations, the clicker survey method can be effective in surfacing where there are difference within and between the Board and staff
- The method should be used to select the issues that might be designated as ‘unsettled’
- These questions are not presented as TW’s views or with the intention of leading or biasing responses

Part 2 - Key questions

Key questions on ESG fundamentals – (Strongly agree to Strongly disagree 5 point Likert scale)

1. There is evidence that carbon is causing material climate change
2. There is evidence that high carbon/ fossil fuel companies are structurally overpriced
3. It is likely that ESG factors have been priced into assets by the market (whether accurately or not)
4. The lack of performance evidence is a limitation for the fund to take any systematic positions on ESG
5. ESG metrics are relatively untested/can be subjective and this acts as a limitation to ESG factors being significant in investors' decisions
6. Should the fund reflect in its mission and strategy reputational capital considerations
7. Should the fund reflect in its mission prosocial considerations (including do no harm and do positive good)
8. If Boards have strong ESG views, they should act irrespective of expected trade-offs
9. If Boards have strong ESG views, they should act once they establish the trade-offs are not significant

Key questions (2)

Key questions on ESG implementation – (Strongly agree to Strongly disagree 5 point Likert scale)

10. It is critical for the Board and staff to build a clear worldview of the sustainability issues encompassing the three forms of capital and integrating the transformational factors at work
11. It is critical for the fund to measure and be clear about sustainability metrics at the individual investment asset level and also portfolio-wide
12. Any Board-directed policies should be captured in the CalPERS 'reference portfolio' so that performance impacts of that stance can be isolated and attributed to the Board's decision
13. Active Ownership/ Global Governance
14. Integrated ESG/ ESG Manager Expectations
15. Divestments in ESG
16. Targeted ESG/ Targeted Capital/ Strategic tilting
17. Wider Engagement/ Working with Others/ Collaboration

{ Are these current CalPERS ESG positions are appropriate for CalPERS' future plans }

Part 3 – Table discussion and report

1. On the questions that have been assessed in this Clicker Survey as 'unsettled':
   - what are the factors involved?
   - what are the actions needed to unblock these differences?
   A …… B……. C ……..

2. On creating a forward plan for ESG implementation, what items in this 'straw-man' list would you give emphasis to and why? (Note that these are not intended as Towers Watson's preferred list or recommendations)

   1. Continuing global governance
      Develop the global governance and engagement plans incrementally
   2. Implementation of manager ESG
      Take steps to ensure the new plan is put into action as effectively as possible
   3. Strategic tilt
      Consider the financial merits of a strategic tilt derived from research on the stranded assets thesis
   4. Exploration of income inequality
      Advance the plans to review this area
   5. Board and staff worldview
      Commit to more time to developing knowledge and understanding of the ESG spectrum; and more time to the strategic dialogue on this between Board and staff
   6. Reporting and improved measurement
      Develop the investment level and portfolio level ESG metrics including the performance evidence

New reality – what CalPERS strategic dialogue might look like

Multi-polar geo-political order + financial system re-order + secular stresses dis-order

Multi-polar power

→ *Decentralised power drives increased uncertainty*
→ *Issues of global agreement*

New world order

→ *New investment landscape/ Financial Services shape*
→ *Natural resource demands*

Aging demographics

→ *Changing balance of savers and dis-savers*
→ *Return on capital issues*

Economic imbalance

→ *Sovereign debt risk*
→ *Inflation outlook*
→ *Risks to growth*

Extreme connectivity/complexity

→ *Increased systemic risk,*
→ *increased correlations*

Resource scarcities

→ *Investment in new technologies*
→ *Regulation of externalities*

Bigger government

→ *Financial services regulation increases*
→ *Cross-jurisdictional issues*

Fiduciary capitalism

→ *Investment industry touch-point with society*
→ *ESG investing/ U-Owners*

Capital market growth

→ *Wider investor opportunities*
→ *Further development in derivatives and securitization*

New reality – what CalPERS position as a Universal Owner might look like

- Defined by
  - **Inter-generational fairness**
    Goal of securing fair outcomes for all stakeholders over time
    - outcomes are financial and extra-financial
    - by another name, inclusive finance
  - **Inter-connected long-term framework and strategy**
    Framework and strategy that integrates long-term extra-financial opportunities
    - opportunities are in asset allocation and ownership – financial and extra-financial
    - by another name, integrated finance
- These asset owners will become more influential over time
- CalPERS to be an outstanding and a much admired and imitated example

New reality – what coping strategies do funds need

Extreme clarity and alignment of mission, beliefs, enablers, policies

Self-understanding

- Assessing organizational capability by breadth and depth
- Ability to adjust internal capability

Meta-understanding

- Understanding what others are doing and why
- Using this to understand and exploit comparative advantage

Change-adaptable

- Preparedness and ability to change mission, strategy and culture
- Requires leadership
- Requires process

Strong-cultured

- Culture as a binding force aligning behaviours
- Culture has edge
- Culture as incremental leaning

Build investment intelligence – capabilities, processes

Background reading

- **Urwin, R:** *Universal Owners – Leadership Calls and Influence Beckons (2011)*

Context: Global best-practice investment governance

The Clark and Urwin study identified 12 factors associated with best-in-class organizations

Core factors	**1. Mission clarity**	Clarity of the mission and the commitment of stakeholders to the mission
	2. Effective time budget	Resourcing each element in the investment process with an appropriate budget considering impact and required capabilities
	3. Leadership	Leadership, being evident at the board, IC and executive (investment team) level, with the key roles being the IC Chairman, CIO and CEO
	4. Strong beliefs	Strong investment philosophy and beliefs that command fund-wide support, align with operational goals and inform all investment decision-making
	5. Risk budget	The risk budget framework captures the key measures of prospective risk and return being aligned to goals and incorporating an accurate view of alpha and beta and factor-exposures
	6. Manager line-up process	The portfolio construction making effective use of external managers, governed by clear mandates, aligned to goals, selected with rigorous application of fit for purpose criteria
Exceptional factors	**7. Investment executive**	The use of a highly investment competent investment function tasked with clearly specified responsibilities, with clear accountabilities to the IC
	8. Required competencies	Selection to the board and senior staff guided by: numeric skills, capacity for logical thinking, ability to think about risk in the probability domain
	9. Effective compensation	Effective compensation practices used to build bench strength and align actions to the mission, different strategies working according to fund context
	10. Competitive positioning	Frame the investment philosophy and process by reference to the institution's comparative advantages and disadvantages
	11. Real-time decisions	Utilise decision-making systems that function in real-time not calendar-time
	12. Learning culture	Work to a learning culture which deliberately encourages change and challenges the commonplace assumptions of the industry

Source: Best-practice investment management: Lessons for asset owners from the Oxford University-Watson Wyatt project on governance, Gordon L Clark and Roger Urwin, September 2007.

Investment beliefs background

Investment beliefs

Investment framework/policies

Portfolio construction

Input from investment theory, data, research, thinking

Inputs from CalPERS context - mission, governance

2. Investment process
- Beliefs guide the investment framework/policies
- Beliefs inform portfolio construction priorities
- Beliefs are an integral part of asset class reviews
- But beliefs do not replace the need for critical judgements

1. Investment beliefs process
- owned by Board, developed by staff and Board
- fund context is captured in values and goals
- investment and governance content
- key alignment/socializing process
- investment theory is weak, so strong thinking and judgements are key

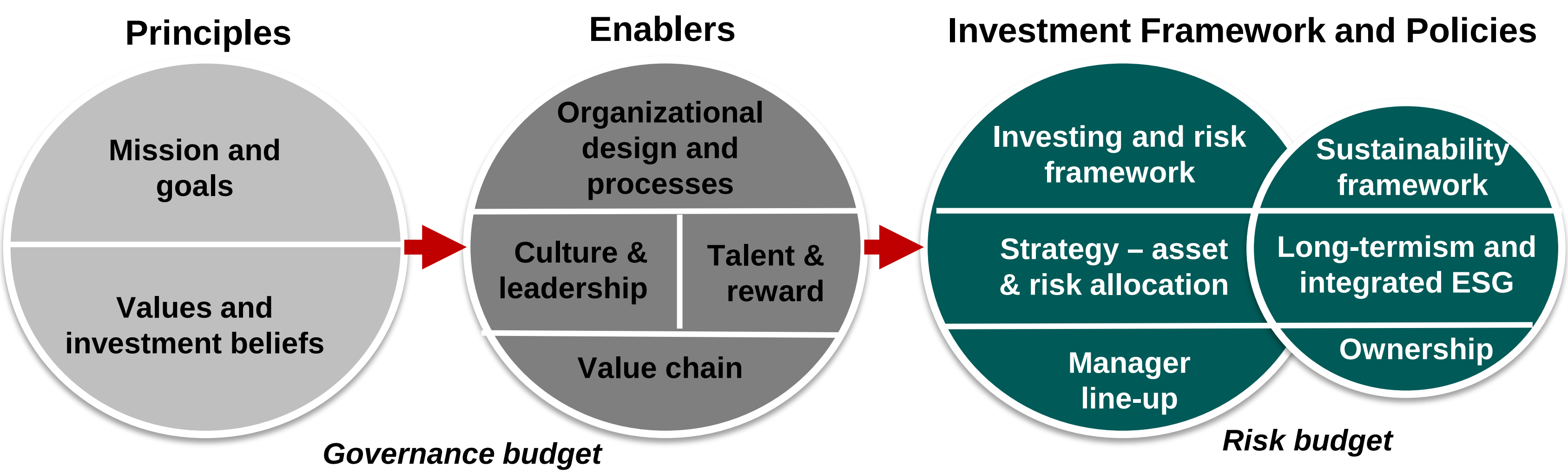
3. Investment beliefs implementation review
- the review looks in detail at current beliefs and is forward looking
- the review tests the implementation of beliefs on five tests
- alignment, applicability, accuracy, actionability and effective governance
- the review strengthens the investment process by enhancing clarity on key issues

Global best practice model – Investment Committee/Staff engagement

Best practices in decision-making	Best practice models must address: ▪ Having the correct resources and competencies for decisions ▪ How to ensure the organization is consistently strong in its thinking and communication ▪ How to use the IC as a sounding board to the investment team's ideas while making certain interventions periodically; as a catalyst in bringing new thinking; to energise and hold the investment team to account ▪ How to ensure that both culturally and pragmatically the two parts of the organization work well together
Best practice collaboration	Strong investment decisions predominantly come from people and process factors. But, in collaboration, funds can produce greater effectiveness through an engagement model between IC and the investment team where the IC is an engaged, thoughtful, informed partner
IC role	The Investment Committee's role is: 1. **Decisions** on aspects of the fund 's mission, goals and risk profile, and other key context, including primary responsibility for SAA (strategic asset allocation), using input 2. **Engagement** on investment content: sounding board, challenge, over-ride, prompt to the departments 3. **Encouragement and motivation** of the investment team 4. **Resource and performance management** of the investment leadership, including periodically appointment in key roles
IC staff engagement	**Engagement** is a particularly critical activity, not to produce second-guessing of investment team views, but to: - Act as a sounding board when the investment team has new investment ideas that need testing - Provide challenges where the investment team's paper and presentation is considered incomplete or unconvincing - Over-ride in limited circumstances where alternative decisions are supported; in this area the grounds for having an alternative view are particularly related to context, more than content - Give pro-active prompts on areas IC members believe the investment team should add to its thinking drawing from the IC's diverse experiences Engagement is critical in its second order impact. Good engagement leads to better IC appreciation of investment team competencies leading to better results in relation to encouragement and motivation; and resource and performance management.
Investment staff role	The investment team's role in this collaboration is to take decisions in delegated areas with high quality accompanying communication and input to the IC facilitating their oversight and decision-making roles

Investment organization framework

Delivering investment value requires more than governance; there needs to be sound organizational design	▪ An investment organization needs to align the Investment Framework and Policies with the Enablers in the organization and its Strategic Principles to deliver optimal execution ▪ The same approach can be used to ensure the investment organization can accommodate scale and investment complexity
Complexity and significant growth in assets will place emphasis on organizational design and processes	▪ The key contributors to support the change are the Enablers ▪ In our experience investors typically focus on the Investment Policies. However, understanding and managing the other parts of the organization are critical to operational success



CalPERS Investment Beliefs (A)

1. Liabilities must influence the asset structure.
A. Ensuring the ability to pay promised benefits by maintaining an adequate funding status is the primary measure of success for CalPERS.
B. CalPERS has a large and growing cash requirement and inflation-sensitive liabilities; assets that generate cash and hedge inflation should be an important part of the CalPERS investment strategy.
C. CalPERS cares about both income and appreciation components of total return.
D. Concentrations of illiquid assets must be managed to ensure sufficient availability of cash to meet obligations to beneficiaries.

2. A long time investment horizon is a responsibility and an advantage.
Long time horizon **requires** that CalPERS:
A. Consider the impact of its actions on future generations of members and taxpayers.
B. Encourage investee companies and external managers to consider the long-term impact of their actions.
C. Favor investment strategies that create long-term, sustainable value and recognize the critical importance of a strong and durable economy in the attainment of funding objectives.
D. Advocate for public policies that promote fair, orderly and effectively regulated capital markets.

Long time horizon **enables** CalPERS to:
A. Invest in illiquid assets, provided an appropriate premium is earned for illiquidity risk.
B. Invest in opportunistic strategies, providing liquidity when the market is short of it.
C. Take advantage of factors that materialize slowly such as demographic trends.
D. Tolerate some volatility in asset values and returns, as long as sufficient liquidity is available.

3. CalPERS investment decisions may reflect wider stakeholder views, provided they are consistent with its fiduciary duty to members and beneficiaries.
A. As a public agency, CalPERS has many stakeholders who express opinions on investment strategy or ask CalPERS to engage on an issue. CalPERS preferred means of responding to issues raised by stakeholders is engagement.
B. CalPERS primary stakeholders are members / beneficiaries, employers and California taxpayers as these stakeholders bear the economic consequences of CalPERS investment decisions.
C. In considering whether to engage on issues raised by stakeholders, CalPERS will use the following prioritization framework:
1. Principles and Policy – to what extent is the issue supported by CalPERS Investment Beliefs, Principles of Accountable Corporate Governance or other Investment Policy?
2. Materiality – does the issue have the potential for an impact on portfolio risk or return?
3. Definition and Likelihood of Success – is success likely, in that CalPERS action will influence an outcome which can be measured? Can we partner with others to achieve success or would someone else be more suited to carry the issue?
4. Capacity – does CalPERS have the expertise, resources and standing to influence an outcome?

4. Long-term value creation requires effective management of three forms of capital: financial, physical and human.
A. Governance is the primary tool to align interests between CalPERS and managers of its capital, including investee companies and external managers.
B. Strong governance, along with effective management of environmental and human capital factors, increases the likelihood that companies will perform over the long-term and manage risk effectively.
C. CalPERS may engage investee companies and external managers on their governance and sustainability issues, including:
1. Governance practices, including but not limited to alignment of interests.
2. Risk management practices.
3. Human capital practices, including but not limited to fair labor practices, health and safety, responsible contracting and diversity.
4. Environmental practices, including but not limited to climate change and natural resource availability

CalPERS Investment Beliefs (B)

5. CalPERS must articulate its investment goals and performance measures and ensure clear accountability for their execution.
A. A key success measure for the CalPERS investment program is delivery of the long-term target return for the fund.
B. The long time horizon of the fund poses challenges in aligning interests of the fund with Staff and external managers.
C. Staff can be measured on returns relative to an appropriate benchmark, but Staff performance plans should include additional objectives or key performance indicators to align Staff with the fund's long-term goals.
D. Each asset class should have explicit alignment of interest principles for its external managers.

6. Strategic asset allocation is the dominant determinant of portfolio risk and return.
A. CalPERS strategic asset allocation process transforms the fund's targeted rate of return to the market exposures that Staff will manage.
B. CalPERS will aim to diversify its overall portfolio across distinct risk factors / return drivers.
C. CalPERS will seek to add value with disciplined, dynamic asset allocation processes, such as mean reversion. The processes must reflect CalPERS characteristics, such as time horizon and size of assets.
D. CalPERS will consider investment strategies if they have the potential to have a material impact on portfolio risk and return.

7. CalPERS will take risk only where we have a strong belief we will be rewarded for it.
A. An expectation of a return premium is required to take risk; CalPERS aims to maximize return for the risk taken.
B. Markets are not perfectly efficient, but inefficiencies are difficult to exploit after costs.
C. CalPERS will use index tracking strategies where we lack conviction or demonstrable evidence that we can add value through active management.
D. CalPERS should measure its investment performance relative to a reference portfolio of public, passively managed assets to ensure that active risk is being compensated at the Total Fund level over the long-term.

8. Costs matter and need to be effectively managed.
A. CalPERS will balance risk, return and cost when choosing and evaluating investment managers and investment strategies.
B. Transparency of the total cost to manage the CalPERS portfolio is required of CalPERS business partners and itself.
C. Performance fee arrangements and incentive compensation plans should align the interests of the fund, Staff and external managers.
D. CalPERS will seek to capture a larger share of economic returns by using our size to maximize our negotiating leverage. We will also seek to reduce cost, risk and complexity related to manager selection and oversight.
E. When deciding how to implement an investment strategy, CalPERS will implement in the most cost effective manner.

9. Risk to CalPERS is multi-faceted and not fully captured through measures such as volatility or tracking error.
A. CalPERS shall develop a broad set of investment and actuarial risk measures and clear processes for managing risk.
B. The path of returns matters, because highly volatile returns can have unexpected impacts on contribution rates and funding status.
C. As a long-term investor, CalPERS must consider risk factors, for example climate change and natural resource availability, that emerge slowly over long time periods, but could have a material impact on company or portfolio returns.

10. Strong processes and teamwork and deep resources are needed to achieve CalPERS goals and objectives.
A. Diversity of talent (including a broad range of education, experience, perspectives and skills) at all levels (Board, Staff, external managers, corporate boards) is important.
B. CalPERS must consider the government agency constraints under which it operates (e.g., compensation, civil service rules, contracting, transparency) when choosing its strategic asset allocation and investment strategies.
C. CalPERS will be best positioned for success if it:
1. Has strong governance.
2. Operates with effective, clear processes.
3. Focuses resources on highest value activities.
4. Aligns interests through well designed compensation structures.
5. Employs professionals who have intellectual rigor, deep domain knowledge, a broad range of experience and a commitment to implement CalPERS Investment Belief.

Contact details and limitations of reliance

- **Roger Urwin**
  - Global Head of Investment Content
  - Watson House | London Road | Reigate | Surrey | RH2 9PQ
  - T +44 1737 284 849
  - roger.urwin@towerswatson.com

Disclaimer

Towers Watson has prepared this material for the California Public Employees' Retirement System ("you") to assist you with any decisions you may take regarding your investment arrangements, under the terms of our agreement with Pension Consulting Alliance Inc. and you.

This material is based on information available to Towers Watson at the date of this material and takes no account of subsequent developments after that date. In preparing this material we have relied upon data supplied to us by third parties. Whilst reasonable care has been taken to gauge the reliability of this data, we provide no guarantee as to the accuracy or completeness of this data and Towers Watson and its affiliates and their respective directors, officers and employees accept no responsibility and will not be liable for any errors or misrepresentations in the data made by any third party.

This material is provided to you solely for your use, for the purpose indicated. It may not be provided to any other party without Towers Watson's prior written permission, except as may be required by law. In the absence of our express written agreement to the contrary, Towers Watson and its affiliates and their respective directors, officers and employees accept no responsibility and will not be liable for any consequences howsoever arising from any third party's use of or reliance on this material or the opinions we have expressed.