



Agenda Item 7a

September 15, 2015

ITEM NAME: Corporate Engagement: Enhanced Focus List Strategy

PROGRAM: Global Governance and Global Equity

ITEM TYPE: Total Fund – Information

EXECUTIVE SUMMARY

The purpose of this item is to provide an update on work to enhance the Focus List Program (Program). In November 2014, the Investment Committee (Committee) approved the Enhanced Program which provides for greater scale and impact while leveraging partnerships with CalPERS' external equity managers.

In early 2015, Japan was selected for a concentrated market engagement. The rationale for this engagement is that Japan is CalPERS' second largest investment market and there is an opportunity due to recent market governance reforms, our history of activity, poor capital efficiency relative to other developed markets, and increasing foreign ownership.

In spring 2015, staff carried out initial in-person company meetings in Japan with Executive Management and company Board Members to assess potential. Subsequently, staff followed up with each company by letter requesting specific governance reforms. Company responses are pending.

Staff intends to report back to the Committee in 2016, with progress of the company engagements in a case study format.

Attachment 1 provides an Enhanced Focus List implementation update in greater detail.

STRATEGIC PLAN

This item supports the CalPERS Strategic Plan goal to improve long-term pension and health benefit sustainability. The Program is an investment strategy which aims to improve the risk-return profile of the CalPERS Total Fund by enhancing sustainable value creation through improvement of financial, physical, and human capital management practices at engaged companies.

This item supports the following CalPERS' Investment Beliefs:

- Investment Belief 2, regarding the responsibility and advantage of a long-term investment horizon and the sub-beliefs which require that CalPERS encourage companies and external managers to consider the long-term impact of their actions.

- Investment Belief 4, that long-term value creation requires effective management of three forms of capital: financial, physical and human.
- Investment Belief 6, specifically the sub-belief that CalPERS will consider investment strategies if they have the potential to have a material impact on portfolio risk and return.

BACKGROUND

The CalPERS Focus List Program dates back to 1987. The Focus List Program is an active engagement program with the objective to improve company governance practices and thereby drive positive long-term economic returns.

Engagement issues have evolved over time from primarily focusing on traditional corporate governance issues, such as majority voting standards for director elections, classified board structures, and director independence. While these traditional governance issues continue, the Program today also focuses on board quality and diversity, compensation, corporate reporting, and board accountability for business strategy (including capital allocation) through the effective management of three forms of capital:

- Financial Capital: to ensure effective capital allocation and alignment of interest over equity, debt, public and private investments.
- Human Capital: to include diversity and inclusion, health, safety, and labor practices.
- Physical Capital: to include environmental practices, including but not limited to climate change and natural resource availability.

At the November 2014 meeting, the Committee approved an Enhanced Focus List Program with the goal to increase scale and broaden the candidate pool by establishing the Global Equity Aggregate top ~100 investment position overweights as the primary screening universe, with flexibility to expand across the total fund based on relative and absolute dollar investment. The selection process was also refined to leverage the expertise of CalPERS' external managers, by collaborating as a strategic partner for global engagement and assisting with both company and market level research.

Most core elements of the Enhanced Program remain consistent, including deployment of Global Governance staff knowledge, expertise, assessment and implementation of corporate engagement strategies. Engagements continue to be confidential.

ANALYSIS

During the first half of 2015, staff implemented the Program by engaging eight portfolio companies in Japan, which represents CalPERS' second largest investment market. Staff identified an external manager with a strong track-record of corporate engagement in Japan, deep understanding of the culture, ability to assist with both company and market level research, and resources to help coordinate the engagements.

Staff then contacted each company by letter, setting out the meeting agenda and sharing CalPERS' Investment Beliefs (translated to Japanese). In collaboration with the external manager, in-person company meetings were completed in Japan with executive management and company board members. Subsequent to the meetings, staff followed up with each company by letter, expressing CalPERS' appreciation for engagement and suggested specific governance reforms (translated to Japanese). Company responses are pending.

Furthermore, in June 2015, staff executed company proxy votes for the Japanese proxy season. Staff notified each engaged company of CalPERS' vote as supported by CalPERS' Global Governance Principles.

Staff identified the following points to support a Japanese market engagement:

- Investment Exposure: Japan represents the second largest market in CalPERS' global equity portfolio.
- Opportunity: Numerous governance issues are systemic to the Japanese market such as the low percentage of independent directors on Japanese boards, the traditionally poor capital efficiency and low valuation of Japanese companies relative to other developed markets.
- Timing: Significant market push within Japan for governance reforms such as the recent implementation of the Japan Corporate Governance Code. Companies may also be more receptive to shareholder engagement due to increasing foreign ownership.
- Impact: A concentrated market engagement has the potential for greater market-wide impact.
- Efficiency: Focus on a single market to make efficient use of staff resources and travel expenditures.
- History: CalPERS has a history of engagement in Japan through our active participation in the Asian Corporate Governance Association (ACGA). CalPERS endorsed the ACGA Japan White Paper in 2008 and supports the Japan Corporate Governance Code finalized in March 2015.

BUDGET AND FISCAL IMPACTS

There are currently no additional costs or fees associated with the current or enhanced Focus List strategies.

BENEFITS/RISKS

Additional active risk is not expected with regard to implementing the Enhanced Program as staff are engaging portfolio companies with existing overweights.

Benefits of the Enhanced Program include:

- The Focus List Program will be applied on a more meaningful scale, and therefore will have a more material impact on the portfolio.
- Applying the Program to material investments further demonstrates CalPERS' commitment to sustainable investment initiatives and is consistent with the Investment Beliefs, including 2, 4 and 6.

ATTACHMENT

Attachment 1 – Enhanced Focus List Program Implementation Update

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