Investment Committee

California Public Employees' Retirement System

Agenda Item 9a

February 16, 2016

ITEM NAME: Revision of Total Fund Investment Policy, including Divestment and Repeal of Legacy Policies – First Reading

PROGRAM: Total Fund

ITEM TYPE: Policy & Delegation – Information

EXECUTIVE SUMMARY

This item proposes revisions to the Total Fund Investment Policy (Policy) for Investment Committee (Committee) review and direction.

When the Policy was approved by the Committee in March 2015, staff committed to collect feedback throughout 2015 and return with recommendations for further refinement of the Policy in February 2016. Staff's recommendations have been categorized within this item as follows:

1. Revisions to current policy content;
2. New policy content (unrelated to merging or repealing existing content); and
3. General "clean up" changes to enhance clarity and address non-material inconsistencies and formatting.

Staff has prepared a brief presentation for the Committee included as Attachment 1. The updated version of the Policy (Updated Policy) is provided as Attachment 2. Attachment 3 identifies proposed edits to the current Policy displayed in track changes format differentiating revised text with green background, new policy content with pink background, and general cleanup displayed without background color. Attachment 4 provides the full text of the policies recommended for repeal following adoption of the Updated Policy. Wilshire Associates' Opinion Letter is provided as Attachment 5.

STRATEGIC PLAN

This agenda item supports the CalPERS Strategic Plan goal to cultivate a high-performing, risk-intelligent, and innovative organization. The proposed updates to the Policy, once approved by the Committee, will strengthen CalPERS' ability to achieve the System's investment objectives through maintaining clear, actionable, and testable investment policies.

BACKGROUND
CalPERS Investment Policies represent the Board's primary direction to staff on the management of the CalPERS investment portfolios. The Committee adopted the Policy in March 2015 as a major step toward completion of the Investment Policy Revision Project (Project). The Project is a key initiative of both the 2014-16 Investment Office Roadmap and Target Operating Model (TOM). Staff described this initial effort as a "significant spring cleaning" involving consolidation of 14 separate investment policies, elimination of procedural language, and removal of untestable elements from investment policy documentation.

Following the initial set of revisions approved by the Committee in March 2015, staff embarked on the next phase of the Project as planned, focusing on the alignment of each individual program investment policy within the new framework of the Policy, and the incorporation of limits and constraints heretofore located solely within delegated authorities. The program-level investment policies (with the exception of Real Assets) were presented to the Committee as planned during each program's annual program review. The resulting program-specific policy changes have reduced complexity and the potential for operational risk events through the use of clear and specific language addressing roles and responsibilities for staff, the Committee, and the Committee's consultants. In addition, the consolidation of limits and constraints within investment policy sets the stage for the eventual realignment and simplification of the delegated authorities.

ANALYSIS
The recommendations reflected in the Updated Policy are the product of an iterative process incorporating the Committee's feedback and identifying gaps during the life of the Project to date. Staff has organized the recommendations into three main categories:

1. Revisions to Current Content – Changes required to enhance clarity of existing content, align the Policy with revisions made to underlying policies during the annual program review process, and incorporate several individual "cross-asset class" policies within the Policy.

2. New Content – Inclusion of new language. These additions are primarily driven by the adoption of the Funding Risk Mitigation Policy (FRM Policy) and need for alignment.

3. Clean Up – Non-substantive modifications designed to correct formatting discrepancies, remediate inconsistencies, and correct grammar and syntax.

Key changes within these categories are outlined below and further detailed in Attachment 3 color coded as described in the executive summary above.

1. <u>Revisions to Current Content</u>

a. Divestment Section

The California Constitution requires the members of the CalPERS Board to discharge their duties for the exclusive purposes of providing benefits, minimizing employer contributions, and defraying the reasonable expenses of administering the system. The Legislature may prohibit certain investments when in the public interest to do so provided the prohibition satisfies the above standards of fiduciary care and loyalty.

Section VII (Divestment) of the Updated Policy has been revised to:

- Request up-front reimbursement of transaction costs when divestment is pursuant to legislative mandate;
- Add a "stop loss" provision, similar to the one in existing Florida Iran-Sudan divestment law, calling for the re-inclusion of previously excluded investments within the portfolio and the permitted investment universe should portfolio losses related to divestments exceed specified thresholds on a cumulative or "per mandate" basis;
- Add an annual comprehensive review and analysis of divestment activities to date to the reporting section for the General Board Consultant (in Appendix 1);
- Add appropriate detail concerning the role of the Committee in the divestment process (Appendix 2);
- Add appropriate detail to "Investment Office Staff" responsibilities reflecting the recent transition of divestment compliance to ICOR (in Appendix 2);
- Bring the formatting into alignment with the rest of the Policy; and
- Incorporate a reference to the new CalPERS Global Governance Principles.

The substance and core tenets of this section of the existing Policy remain unchanged, namely, that CalPERS prefers a strategy of engagement, advocacy, and ESG integration, with divestment being the chosen course only (A) to the extent investment in the Targeted Company is imprudent and/or inconsistent with the Board's fiduciary duties, (B) to the extent divestment is expected to produce superior, risk-adjusted returns on a total fund basis, or (C) as required by applicable federal or, subject to the Board's fiduciary duties, state law. As before, while portfolio performance is paramount, the preference for engagement over divestment derives at least in part from the fact that, by divesting, investors lose their ability as shareholders to influence portfolio company behavior, making divestment at best a suboptimal tool for effecting change.

Divestment decisions made by staff flowing from the integration of ESG factors into Investment Office risk-return analysis are expected to follow standard investment decision protocols.

In the case of potential new external or Board-driven divestment mandates, staff proposes adopting the following review process to ensure divestment is consistent with the Board's fiduciary duties:

i. Statutory requirements analysis (if applicable) by Investment Compliance and Operational Risk in consultation with the Legal Office;
ii. Completion of any required engagement activities;
iii. Separate analysis by both staff and the General Pension Consultant of the economic impact of the contemplated divestment on the portfolio, to include one-time transaction costs, impact on predicted tracking error from applicable indices, and risk-return trade-offs;
iv. Fiduciary duty analysis by the Legal Office;
v. If requested by the Committee, analysis and provision of a second opinion by an independent consultant of the economic impact of the contemplated divestment on the portfolio, to include one-time transaction costs, predicted tracking error, and risk-return trade-offs; and
vi. Upon completion of the above steps, a divestment decision by the Committee at its next regularly scheduled meeting.

In recognition of the unknowable nature of the direction of future financial markets and asset prices, staff proposes inclusion of the "stop loss" reinvestment component and up-front transaction and analysis cost reimbursement provisions reflected in the proposed new Section VII (Divestment) of the Updated Policy.

b. Benchmarks Section

The Benchmarks section is being revised to more clearly state the purpose of this section of the Policy and identify the specific roles and responsibilities of the Committee and staff.

c. Appendix 5 (Benchmarks)

The SIP Real Assets section of the Investment Benchmarks Appendix in this Policy is being revised to reflect non-substantive changes to the name and construction of benchmarks used by State Street Global Advisors (SSGA), the investment manager of the Supplemental Income Plans (SIP):

i. The name of the benchmark that relates to the SIP Real Assets Program was changed from "Dow Jones – UBS Roll Select Commodity Index" to "Bloomberg Roll Select Commodity Index." The benchmark for the SSGA Real Assets Non-Lending Series Fund is being changed, effective April 1, 2016, to reflect the inclusion of a global infrastructure equity component.

d. Currency Overlay Program Policy

This section of the Policy is being revised to remove references to a "passive" hedging program, which was discontinued in February 2014, as part of the selection of new strategic asset allocation targets.

Due to the "cross asset class" nature of the currency hedging program, staff is recommending that language regarding currency hedging be incorporated into the Asset Allocation Strategy section of the Policy. The current stand-alone policy will be repealed upon adoption of the Updated Policy.

e. Liquidity Program Policy

Due to the "cross asset class" nature of the Liquidity Program, staff proposes to incorporate the Liquidity Program into the Policy as new section VIII. This policy was reviewed and approved by the Committee in November 2015 and the content is being consolidated within the Policy without modification. The current stand-alone policy will be repealed upon adoption of the Updated Policy.

f. Low Duration Fixed Income Program

Due to the "cross asset class" nature of these investment strategies, staff proposes to include this program in the Policy as new section IX. The current stand-alone policy was reviewed and approved by the Committee at the November 2015 meeting and the content is being consolidated within the Policy without modification. The current stand-alone policy will be repealed upon adoption of the Updated Policy.

g. Multi-Asset Class Partners Program

To support the overall Project goals to streamline CalPERS' investment policy documentation, staff recommends that the current stand-alone Multi-Asset Class Partners (MAC) Program be repealed. The MAC Program was funded as an investment under the Opportunistic Program (a section of the Policy), and will continue to be managed as a portfolio within the Opportunistic Program.

h. Securities Lending Policy

Due to the "cross asset class" nature of the Securities Lending Program, staff proposes to include this program in the Policy as new section XI. The current stand-alone policy for this program was reviewed and approved by the Committee at the November 2015 meeting and the content is being consolidated within the Policy without modification. The current stand-alone policy will be repealed upon adoption of the Updated Policy.

2. <u>New Content</u>

The adoption by the Finance & Administration Committee of the FRM Policy prompted revision of Section II (Asset Allocation Strategy) of the Policy to provide for a mid-ALM-cycle revision of the "asset allocation targets" upon the occurrence of a Funding Risk Mitigation Event, as defined in the FRM Policy. The specific adjustments triggered by such an event are detailed in Appendix 4, Table 2, of the Updated Policy.

3. <u>General Clean Up</u>

These changes are non-substantive and seek to:

- Align format of sections with program policies for consistency;
- Edit content to improve cohesiveness among the different sections of the Policy;
- Enhance clarity by identifying inconsistencies and bridging any gaps created by inclusion of new sections and revisions to existing sections; and
- Incorporate changes dictated by proper syntax and grammatical correctness.

Pending feedback from the Committee, staff anticipates proposing the following recommendations for Committee action at the March 2016 meeting:

- Adopt the Updated Policy as presented, which will supersede and replace the current Policy; and

- Repeal the five legacy investment policies to be superseded by the consolidated Policy:
    1. Currency Overlay Program
    2. Liquidity Program
    3. Low Duration Fixed Income Program
    4. Multi-Asset Class Partners Program
    5. Securities Lending Policy

BUDGET AND FISCAL IMPACTS
Not Applicable.

BENEFITS/RISKS
Staff's recommendations are consistent with the TOM objectives to design, develop, and implement a robust operating model that minimizes complexity, improves transparency, and strengthens processes, systems, governance, and controls. The recommendations are also consistent with CalPERS' Investment Belief 10, which stresses the need for strong processes and governance.

The revised Policy is expected to provide the following benefits:

- Reduce operational risk through the use of clear and specific language considering both the Committee and staff's roles and responsibilities

- Enhance alignment and consistency with the program-specific policies that were revised during the 2015 annual program review cycle

- Strengthen overall governance by ensuring that investment policies are consistent with one another and tie to enterprise policies when applicable

- Enhance staff's ability to more effectively monitor compliance by clearly specifying and centralizing limits and constraints within the appendices to the Policy

- Reduce duplication and complexity by consolidating and repealing legacy policies

Risks associated with not adopting the recommendations include:

- Potential elevation in operational risk related events due to unclear, conflicting or difficult–to-locate Committee directives, limits, and constraints

ATTACHMENTS

Attachment 1 – Presentation Slides
Attachment 2 – Updated Policy (Proposed)
Attachment 3 – Track-changes version of Updated Policy identifying proposed revisions
Attachment 4 – Policies proposed for repeal
Attachment 5 – Wilshire Associates' Opinion Letter

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