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February 3, 2016

Mr. Henry Jones
Chair of the Global Governance Ad Hoc Subcommittee
California Public Employees' Retirement System
400 Q Street
Sacramento, CA 95814

Re: Proposed Total Fund Policy Revisions

Dear Mr. Jones:

Overview

After nearly a year of work, Staff and the Investment Committee have worked through revisions to almost all of the investment policies that govern CalPERS' investment programs (with the exception of Real Assets, to which changes will be proposed in conjunction with the Strategic Plan this spring). This project started with a revision to the Total Fund Policy, which introduced the format and changes to other policies, with more significant revisions planned for the Total Fund Policy at the conclusion of the policy review project. This item brings the work full circle – back to the Total Fund Policy – with more meaningful revisions as discussed in 2015.

Discussion

There are several important aspects of the proposed policy. First, a number of cross asset class policies have been folded into the Total Fund Policy (Currency Overlay, Liquidity, Low Duration, Securities Lending) which is logical and which Wilshire supports.

Second, *Section VII. Divestment* has been substantially reworked. While CalPERS' preference for engagement is still made clear, the section now lays out the fiduciary duty according to the California Constitution to make it plain where the Investment Committee's focus should rest when considering divestment. Additionally, CalPERS' current practice on equity implementation – a broadly diversified, largely passive approach – provides rationale for understanding why CalPERS owns securities that may be under consideration for divestment.

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Additionally, the language on "Divestment Loss Mitigation" should be debated. As proposed, when divestments perform poorly over some period of time, Staff would "unwind" the divestment. If the Investment Committee approves of a divestment – one that is either appropriate in the view of the Investment Committee or directed by the legislature – it seems appropriate that the unwind decision should go through a similar process as the divestment decision and the Committee should approve of the unwind. The proposed language makes this process automatic. While recognizing that the proposed loss limits are material and CalPERS would not want to incur them, the preconditions for divestment may still exist despite the poor relative performance.

Wilshire and Staff are finalizing how to measure the impact from divestment activities. Wilshire has historically provided a report recapping the performance of CalPERS' various divestment activities, but the report uses several different data points and two methodologies for calculating the impact. Staff and Wilshire will have appropriate language with respect to the methodology included in the second reading of this policy.

Third, there is now language for the investment aspects of the Funding Risk Mitigation Policy, which is included in Appendix 4. As discussed in Agenda Item 8, the asset allocation steps are now predefined based on the current capital markets assumptions. When CalPERS has investment returns that are significantly above the actuarial rate of return, Staff will reduce the investment risk of the portfolio in accordance with the Funding Risk Mitigation Policy.

Last, Wilshire recommends, and Staff intends, for the Total Fund Policy to be reviewed on an annual basis. At that point, the risk mitigation steps can be adjusted (if needed) and other changes can be implemented as the Policy continues to evolve.

Conclusion

As noted above, Wilshire recommends additional discussion on several points in the Total Fund Policy and the Funding Risk Mitigation Policy. Wilshire and Staff will finalize language with respect to the calculation of divestment gains/losses, which will be incorporated into the second reading of this policy.

Should you require anything further or have any questions, please do not hesitate to contact us.

Best regards,

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