CalPERS

Investment Committee
Agenda Item 6a

March 14, 2016

Item Name: Revision of Total Fund Investment Policy, Including Divestment and Repeal of Legacy Policies – Second Reading

Program: Total Fund

Item Type: Information

Executive Summary

An updated version of the Total Fund Investment Policy (Updated Policy) was presented to the Investment Committee (Committee) for review on February 16, 2016. The Committee Chair directed staff to revise specific language and return to the Committee for further review.

The Updated Policy for the second reading is included as Attachment 1. Attachment 1 reflects the further revisions made since the first reading based on feedback from the Committee and subsequent input from the General Pension Consultant, primarily relating to the divestment section. In addition, it reflects additional changes proposed by staff relating to the Terminated Agency Pool Program and Asset Allocation Strategy sections. Changes made to the Updated Policy since the first reading are denoted by track changes and highlighted in yellow in Attachment 2. Attachment 3 provides the full text of the policies recommended for repeal following adoption of the Updated Policy. Attachment 4 contains sample divestment loss calculations. Wilshire Associates' Opinion Letter is provided as Attachment 5.

Pending second reading feedback from the Committee, staff anticipates proposing the following recommendations for Committee action at the April 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- Repeal the five legacy investment policies to be superseded by the consolidated Policy: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

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 Committee'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). The initial effort involved the consolidation of 14 separate investment policies, elimination of procedural language, and removal of untestable elements from investment policy documentation. Staff had committed to bring the Policy back after a one-year period, once further progress had been made on (1) the alignment of the individual program investment policies within the new framework of the Policy, and (2) the incorporation of limits and constraints heretofore located solely within delegated authorities. The Updated Policy reflects those updates as well as the more recent input from the Committee and others as described above.

Analysis

The changes made to the Updated Policy since the first reading in February 2016 are detailed below.

<u>Divestment Section</u>

1. In the last sentence of the 2nd paragraph in the "Purpose" section, additional language has been added to clarify that the prioritization of investment performance over ancillary goals is not intended to preclude ***risk*** as a relevant consideration.

2. The "Divestment Loss Mitigation" section has been greatly simplified as outlined in items (a) – (e) below:

    a. Pursuant to feedback from the Committee, the words "to date" have been removed in line 1 of the 1st paragraph.
    b. The two different divestment loss thresholds ($750 million & $2.5 billion) have been separated into two different clauses, thereby eliminating some complexity and also avoiding the need for the defined term, "Divestment Loss Threshold."
    c. The 2-tier seasoning period for "new" vs. "existing" divestment mandates has been eliminated in favor of a simpler, one-tier approach: Any single divestment initiative – whether new or existing – producing net portfolio losses at or above the $750 million threshold for 12 consecutive quarters will be unwound.
    d. The formula for the cumulative trigger has also been simplified, as follows:
        i. Divestment initiatives that are producing net gains for the portfolio are included in the calculation of net gain or loss for purposes of the cumulative loss threshold, but once the cumulative loss threshold is met, only the divestment initiatives producing net losses will be unwound, subject to the prior notification to the Committee.
        ii. Portfolio losses that trip the first divestment loss threshold on a "single mandate" basis will continue to count toward the cumulative loss threshold following reinvestment. (For sample calculations, see Attachment 4.)
        iii. Staff proposes no "waiting period" for reinvestment once the cumulative loss trigger is met, given the difficulty of crafting a formula that addresses the complexity of multiple mandates producing different loss levels over different periods of time.
    e. A provision has been added that before commencing any reinvestment activity, staff shall notify the Committee that the loss threshold(s) have been met, allowing the Committee to consider exceptions to these reinvestment provisions.

Asset Allocation Strategy Section
Staff proposes that two additions be made to the language of the *Asset Allocation Strategy* section, as follows:

The first proposed change is to the *Asset Allocation Strategy* section, *Investment Approaches and Parameters*, Strategic item A. Staff recommends an additional sentence be added clarifying that the asset allocation targets and ranges for the Affiliate Funds are included in the respective Statements of Investment Policy for each Affiliate Fund.

The second proposed change is within the *Asset Allocation Strategy* section, *Investment Approaches and Parameters*, Implementation item D. The addition, noted below with a double underline, is intended to improve clarity regarding the times and potential reasons a fund's actual asset allocation may temporarily deviate from the policy target and ranges.

> *"D. Asset class allocations shall be managed to seek compliance with existing policy ranges. Allocations may temporarily deviate from policy ranges due to extreme market volatility* or to accommodate *contributions, distributions, or other short-term cash needs. If an asset class allocation exceeds the policy range, staff shall return the asset allocation to within its policy range in a timely manner, with the exact time period primarily dependent on transaction costs and liquidity."*

Staff believes the proposed addition better reflects the operational reality of some of the funds with single asset class allocations, or comparatively narrow ranges relative to policy allocation targets. For example, the Health Care Fund (HCF) has a target allocation of 100% to fixed income, but periodically requires liquidity to pay for fund expenses or to process contributions and redemptions. Staff's proposal would provide sufficient flexibility to address the short-term operational cash needs of funds like the HCF.

Terminated Agency Pool (TAP) Program Section
In the course of staff's subsequent review of the Updated Policy, it was noted that further improvements, in line with the goals and objectives of the Project, could be realized in the TAP Program section and related appendices. Staff's proposals focus on:

1. Simplifying language to improve clarity
2. Removing aspirational or duplicative content, and
3. More accurately reflecting the management of the TAP Program and dependence on actuarial valuations.

Budget and Fiscal Impacts
Not Applicable.

Benefits and 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 – Updated Policy (Proposed)
Attachment 2 – Track-changes version of Updated Policy identifying proposed revisions
Attachment 3 – Policies proposed for repeal
Attachment 4 – Sample Loss Calculations
Attachment 5 – Wilshire Associates' Opinion Letter

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