
February 13, 2017**Item Name:** Revision of the Total Fund Investment Policy – First Reading**Program:** Total Fund**Item Type:** Information**Executive Summary**

This item proposes several revisions to the Total Fund Investment Policy (Policy) for the Investment Committee's (Committee's) review and direction:

1. Revision of the divestment section to reflect the Committee's direction at the April 2016 meeting.
2. Incorporation of the Global Governance Program Policy, including the Global Governance Principles, as a new section of the Policy titled the "Governance and Sustainability Strategy." The proposed section also includes template revisions to the original policy content consistent with the goals of the Policy Revision Project (initiated in 2014). No material changes have been proposed for the Principles.

With the establishment of the new Governance and Sustainability Strategy section of the Policy, staff recommends repeal of the legacy Global Governance Program Policy.

In addition to the proposals outlined above, the revision of the interim asset allocation targets for the Public Employees' Retirement Fund (PERF), as previously approved by the Committee, have been included in this item. Those changes are addressed in Appendices 4 and 5 of the Policy.

For ease of review, clean and "mark-up" versions of the revised Policy are provided as Attachments 1 and 2 respectively. The Global Governance Program Policy, recommended for repeal, is provided as Attachment 3. Consultant opinion letters from Wilshire Associates, Pension Consulting Alliance, and StepStone are provided as Attachment 4, Attachment 5, and Attachment 6, respectively.

Strategic Plan

This item supports the CalPERS Strategic Plan goal to cultivate a high-performing, risk intelligent, and innovative organization. The proposed revisions, as part of a clear and actionable policy framework, will contribute to the effective management and oversight of investment activities and continue to strengthen the integration of the CalPERS Sustainable Investment Strategy across the Total Fund.

Background

Many of the changes proposed in this item have been informed by dialogue with the Committee and staff over time, through multiple agenda items and offsite presentations. Key engagements are summarized in the following sections:

1. Divestment Policy Revision and Tobacco Divestment Review
2. Global Governance Program Policy and Strategic Plan Development

1. Divestment Policy Revision and Tobacco Divestment Review

The proposed revisions to the divestment section of the Policy follow a number of agenda items undertaken in 2016 as part of the Policy Revision Project. The table below outlines the key agenda items that have contributed to the development of the revisions proposed in this item.

Ref #	Month(s) and Agenda Item Highlights – Divestment Section
1.1	February 2016 Staff proposed initial draft revisions to the divestment section of the Total Fund Policy to: <ul style="list-style-type: none">• Request up-front reimbursement of transaction costs when divestment is pursuant to legislative mandates.• Incorporate “stop loss” provisions similar to Florida’s Iran/Sudan divestment law.• Incorporate a review process for any new or potential policy-level divestment mandates, in consideration of the Committee members’ fiduciary obligations.
1.2	March 2016 Following feedback from the Committee, staff returned with an updated proposal that: <ul style="list-style-type: none">• Simplified the proposed divestment loss thresholds and formula for determining when a cumulative loss would trigger automatic reinvestment.• Added notification to the Committee prior to any reinvestment activities, allowing for an exception process at the Committee’s discretion.
1.3	April 2016 The Committee adopted the revised Total Fund Policy as proposed, with the exception of the divestment section, which remained as previously approved in 2015. The Committee directed staff to: <ul style="list-style-type: none">• Undertake a separate review and analysis of the CalPERS tobacco restrictions; and• Following the completion of the tobacco investment restrictions review, return with an updated proposal for revision of the divestment section of the Policy.
1.4	December 2016 Staff presented a comprehensive review of the CalPERS tobacco investment restrictions.

2. Global Governance Program Policy and Strategic Plan Development

The proposed incorporation of the Global Governance Program Policy as a section within the Policy follows a multi-year effort reviewing the Global Governance Principles and developing a strategic plan for the CalPERS Sustainable Investment Strategy. The table below outlines the prior agenda items that have contributed to the development of the revisions proposed in this item.

Ref # Month(s) and Agenda Item Highlights – Global Governance Program Policy and Strategic Plan Development

2.1 March – April 2015

The Committee consolidated three legacy policies into the Global Governance Program Policy, and directed staff to return with a recommendation to establish a subcommittee to provide a full vetting of a number of issues including:

- Modifications of the Global Governance Policy
- Modifications to the Legislative and Policy Engagement Guidelines, including references to the Global Governance Principles

2.2 June 2015

The Global Governance Policy Ad Hoc Subcommittee met and reviewed Section A, the core principles, of the Global Governance Principles. The Committee directed staff to return with a revised proposal:

- Consolidating Core, Domestic, and International sections and appendices
- Including “Introduction” and “Purpose” language
- Aligning the framework to reflect the Investment Beliefs and the Global Governance Program’s core issues

2.3 September – December 2015

The Global Governance Policy Ad Hoc Subcommittee undertook a four-phase review to align the Global Governance Principles with the Global Governance Program’s five core issues:

- Investor Rights
- Board Quality
- Compensation
- Corporate Reporting
- Regulatory Effectiveness

2.4 January 2016

The Committee embarked on a six month process to develop a new five-year environmental, social, and governance (ESG) strategy for sustainable investment, focusing on the System’s investment objectives.

2.5 February – March 2016

The Committee conducted first and second readings of the revised Global Governance Principles, with adoption at the March 2016 meeting. Additionally, at the March meeting, staff presented a roadmap for the development of the new five-year plan for the CalPERS Sustainable Investment Strategy.

Ref # Month(s) and Agenda Item Highlights – Global Governance Program Policy and Strategic Plan Development

2.6 April – August 2016

The Committee and staff collaborated to develop a strategic plan, define key performance indicators, and articulate asset class objectives for the CalPERS Sustainable Investment Strategy (focusing on CalPERS' core and strategic work). In August of 2016 the Committee approved the current five-year plan.

Analysis

As outlined in the previous section, the material changes proposed in this agenda item are the product of thorough discussions between the Committee and staff on two important issues:

1. How CalPERS addresses divestment and implications for the management of the System's investment portfolios, in consideration of Committee member and staff fiduciary obligations.
2. How the CalPERS Sustainable Investment Strategy supports the System's investment objectives and is integrated at the Total Fund level.

Key highlights of the proposed changes to the Policy are outlined in the following sections:

1. Divestment section
2. Incorporation of the Global Governance Program Policy as a new section
3. Other revisions

1. Divestment Section

The changes proposed for the divestment section of the Policy (section VII), are largely to add additional content to clarify:

- That, consistent with our Investment Beliefs, CalPERS' preferred approach is engagement.
- The high-level processes that will be used to monitor and ensure that prior divestment decisions remain supportive of the prudent stewardship of the System's assets, consistent with the Committee's fiduciary obligations.
- Notice and voting protocol to ensure that any divestment decisions, including continuation or re-investment, are clearly affirmed by the Committee.

Two statements have been proposed for deletion because they do not appear to be additive to the Policy as it currently exists (maybe having been more relevant in legacy versions).

The changes related to this topic are focused, in the mark-up version provided as Attachment 2, on pages:

- a. 17-19 of 98 – The body of the policy section with revisions to include reference to CalPERS Investment Belief 3, divestment review processes, and notice and voting considerations.

- b. 38 of 98 – The Responsibilities Appendix, in which a new requirement for a “no less than every five years” review of all in-force divestments has been added. Also a minor adjustment to the responsible staff for engagement activities related to divestment.

It should be noted that, as part of the development of this item, staff explored the potential for creating set dollar thresholds that would trigger a review of an in-force divestment by the Committee. However, staff determined that a regular review was preferable to attempting to set a “one-size-fits all” dollar threshold because:

- Divestment mandates are inherently unique – The scope of the affected holdings and the potential impact on the CalPERS portfolios may vary greatly depending on the restrictions and securities in question.
- Set dollar amounts can quickly become irrelevant due to market conditions/factors outside of CalPERS’ control – There may be numerous other factors – beyond any specific dollar amount of past investment losses – that warrant review of an existing divestment initiative.
- Periodic reviews are more aligned with Investment Belief 9, that risk is multifaceted – Past investment losses are not necessarily an indication of future risk.

In addition, staff notes that the Committee may direct that staff prepare an in-depth review of any existing divestment at any time.

2. Incorporation of the Global Governance Program Policy as a new section

In acknowledgement of the fact that the CalPERS Sustainable Investment Strategy is a cross-asset class/Total-Fund-level initiative, staff proposes to incorporate it into the Policy as a new section (Section XVI), rather than continue it as a stand-alone policy. In addition to the establishment of the Governance and Sustainability Strategy section, staff has also proposed changes reflecting:

- The streamlining and template goals of the Policy Revision Project in which procedural, redundant, or editorial content has been removed and reporting and responsibilities are consolidated in specific appendices.
- Alignment with the five-year plan approved by the Committee in August 2016 (including structure and language consistency).
- The realignment of the Global Governance Program including the establishment of the Sustainable Investment Program, as a Total-Fund-level hub working across each asset class.
- Clearly specifying elements of the Governance and Sustainability Strategy that apply to all investment asset classes, or program areas, as appropriate, within the Reporting and Responsibilities Appendices.

With the exception of two typographical errors, including a duplicate reference and an orphan footnote, no changes have been made to the Global Governance Principles.

The changes related to this topic are focused, in the mark-up version provided as Attachment 2, on pages:

- a. 30 of 98 – The body of the new Governance and Sustainability Strategy section.
- b. 31 of 98 – The insertion of a new “all Programs” responsibility for reporting on investment program strategy alignment with the in-force Governance and Sustainability Strategy strategic plan, similar to the reporting requirement for alignment with the Investment Beliefs currently addressed through the Annual Program Review process.
- c. 34 of 98 – The insertion of a new reporting responsibility for the Board’s Investment Consultants, similar to the change on page 31, in which the Governance and Sustainability Strategy will be included in the Annual Program Review reporting process.
- d. 36 of 98 – The insertion of a new “all Programs” responsibility to maintain all procedures and guidelines required for the management and implementation of the CalPERS Governance and Sustainability Strategy.
- e. 39 of 98 – The insertion of key responsibilities from the legacy Global Governance Program Policy, and addition of a new requirement to maintain a strategic plan.
- f. 61-96 of 98 – The insertion of the Global Governance Principles as a new Appendix 8 of the Policy.

3. Other revisions

As previously noted in the Executive Summary section of this item, the revised Policy also includes changes to appendices 4 and 5, addressing the interim asset allocation target changes and coinciding changes to composite benchmark weights. These changes are focused on pages 46-47, and 48-50 of 98 of Attachment 2. Additionally, where a Barclays index is referenced, Bloomberg has been appended to the index name, reflecting the relatively recent acquisition and co-branding of Barclays indices by Bloomberg.

A minor adjustment was also made to Appendix 1, the deletion of a near-duplicate of the Private Asset Class Board Investment Consultants reporting responsibility. Specifically, prior item eight required an annual review of “major asset class sub-components, and item nine requires an annual review of the program. The asset class Annual Program Review process is comprehensive, and includes all elements of the respective asset classes.

References to the Targeted Investment Program have also been updated to reflect the current program name, the Investment Manager Engagement Programs.

Budget and Fiscal Impacts

Not Applicable

Benefits and Risks

The benefits and risks associated with the recommended policy changes are outlined in the sections below.

1. Divestment Section

Staff believes the proposed changes will provide the following benefits:

- Added rigor to how divestments are reviewed, strengthening the processes that support committee members in meeting their fiduciary obligations.
- Clarification of divestment-related responsibilities, ownership and roles.
- Further integration of our Investment Beliefs.

No risks have been identified for these proposed changes.

2. Incorporation of the Global Governance Program Policy as a new section

Staff believes the proposed changes will provide the following benefits:

- Strengthening integration of the Governance and Sustainability Strategy by incorporating it into the core Policy.
- Streamlining the policy content to help ensure the statements of investment policy are consistent and focused on issues at the strategic level.
- Improving the clarity through which roles and responsibilities are articulated.

No risks have been identified for the proposed changes. Content from the legacy Global Governance Program Policy has been streamlined and the proposed additions to the Policy provided clearer guidance, reflect the current five-year Governance and Sustainability Strategy, and appropriately exclude procedural and editorial content.

Attachments

Attachment 1 – Revised Total Fund Policy – Clean Version

Attachment 2 – Revised Total Fund Policy – Mark-Up Version

Attachment 3 – Global Governance Program Policy – Marked for Repeal

Attachment 4 – Board Investment Consultant Opinion Letter – Wilshire Associates

Attachment 5 – Board Investment Consultant Opinion Letter – Pension Consulting Alliance

Attachment 6 – Board Investment Consultant Opinion Letter – StepStone

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