Investment Committee
Agenda Item 5a

April 17, 2017

Item Name: Revision of the Total Fund Investment Policy – Second Reading

Program: Total Fund

Item Type: Action

Recommendation
Adopt the revised Total Fund Investment Policy, provided in Attachment 1, and repeal the legacy Global Governance Program Policy.

Executive Summary
This item proposes several revisions to the Total Fund Investment Policy (Policy) for consideration and action by the Investment Committee (Committee):

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 CalPERS' Governance and Sustainability Principles.

3. Revision of Appendix 7 for the Liquidity Program, specifically the expansion of the investment universe to include non-dollar treasury bills of foreign sovereign countries (*a new change subsequent to the first reading)*.

4. Other ministerial changes such as revision of the interim asset allocation targets for the Public Employees' Retirement Fund (PERF), as previously approved by the Committee.

For ease of review, clean and "mark-up" versions of the revised Policy are provided as Attachments 1 and 2 respectively. Yellow highlighting has been applied within Attachment 2 to indicate areas where changes have been made to the Policy as previously presented in February 2017.

The legacy Global Governance Program Policy, recommended for repeal, is provided as Attachment 3. Consultant opinion letters from Wilshire Associates, Pension Consulting Alliance, StepStone, and Meketa are provided as Attachment 4, Attachment 5, Attachment 6, and Attachment 7 respectively. Note, in consideration of the largely unchanged nature of the proposed Policy, StepStone has resubmitted their opinion letter for the first reading of the Policy with no changes.

Strategic Plan
This item supports the CalPERS Strategic Plan goal to cultivate a risk-intelligent 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
This item follows a first reading of the proposed revisions to the Policy, item 8a, presented at the February 2017 Committee meeting. As discussed in the February item, many of the changes proposed for this iteration of the Policy have been informed by dialogue with the Committee and staff over time, through multiple agenda items and offsite presentations regarding:

1. CalPERS divestments

2. The Global Governance Principles and development of a five-year strategic plan for CalPERS' sustainable investment work

In March 2017, the Committee conducted the 2017 annual review of the Global Governance Principles and provided feedback on proposed changes, including retitling of the Principles and the addition of a new principle focused on capital allocation. The changes as proposed in the March 2017 item have been incorporated into the revised Policy.

Analysis
Based on feedback from the Committee at the February and March 2017 meetings, staff has prepared an updated "mark-up" and clean copy of the revised Total Fund Policy. Yellow highlighting has been used to indicate where changes have been made to the version of the Policy as presented in February 2017.

Highlights of the "post-first-reading" changes include:

- Revision of Appendix 7 to expand the investment universe for the Liquidity Program

- Revision of the CalPERS Governance and Sustainability Principles (Principles), as proposed at the March 2017 Committee meeting

- Correction of an outdated reference to one of the "legacy" titles for the Principles in Investment Belief 3 (within Appendix 3 of the Policy)

Additional information on the proposed changes to the Policy is outlined in the following sections:
1. Divestment section
2. Incorporation of the Global Governance Program Policy as a new section titled "Governance and Sustainability Strategy"
3. Expansion of the investment universe for the Liquidity Program
4. 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.

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

a. 17-19 of 100 – The body of the policy section with revisions to include reference to CalPERS Investment Belief 3, divestment review processes, and notice and voting considerations.
    - Minor adjustments we made to pages 17 and 19 in response to feedback from the first reading of the revised Policy.

    - CalPERS Investment Belief 3 included a reference to the legacy title of the "Principles, the "Principles of Accountable Corporate Governance." The Principles were renamed and attached to the legacy Global Governance Policy on March 16, 2015. Investment Belief 3 has been updated accordingly, noted on page 43 of 100, and within the Divestment section (page 18 of 100).

b. 38 of 100 – 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.

As discussed in the February 2017 agenda 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 for sustainable investment as 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 as ESG continues to be integrated across the Fund.

- 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.

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

a. 30 of 100 – The body of the new Governance and Sustainability Strategy section.

b. 31 of 100 – 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 100 – 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 100 – 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 100 – The insertion of key responsibilities from the legacy Global Governance Program Policy, and addition of a new requirement to maintain a strategic plan.

f. 61-98 of 100 – The insertion of the Principles as Appendix 8 of the Policy, with changes as proposed at the March 2017 Committee meeting, and a small number of ministerial changes.

3. Expansion of the investment universe for the Liquidity Program

The Global Fixed Income investment team has identified opportunities for increased returns, with attractive risk characteristics, within sovereign debt securities. The short-term sovereign debt securities have historically experienced lower default rates than similarly rated industrial and financial commercial paper investments (currently allowed in the portfolio). Therefore, staff believes the expanded investment universe may result in lower levels of credit risk within the portfolio. Additionally, in the current market conditions, yields for these sovereign debt securities are attractive, even after the cost of a currency hedge back to US dollars is applied to manage currency risk.

Appendix 7, Investment Constraints and Limitations, of the Policy has been revised to note the expanded investment universe, as noted by a new row within the "Credit Risk" table on page 56 of 100.

4. Other revisions
The revised Policy also includes a number of ministerial changes, including:

- 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 100 of Attachment 2.

- 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 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 with 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 provide clearer guidance, reflect the current five-year Governance and Sustainability Strategy, and appropriately exclude procedural and editorial content.

3. Expansion of the investment universe for the Liquidity Program to include non-dollar treasury bills of foreign sovereign countries.
Staff believes the proposed changes will provide the following benefits to the Liquidity Program:

- Increase portfolio diversification; and

- Potentially reduce the credit risk of the portfolio.

Risks will be mitigated by updating risk monitoring and control processes to address the expanded investment universe, and ongoing monitoring of sovereign credit risk.

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 (Real Estate)
Attachment 6 – Board Investment Consultant Opinion Letter – StepStone (Infrastructure)
Attachment 7 – Board Investment Consultant Opinion Letter – Meketa (Private Equity)

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