Investment Committee

Agenda Item 7a

September 18, 2017

Item Name: Public Asset Class Investment Policies – First Reading

Program: Total Fund

Item Type: Information

Executive Summary

Following the annual review of applicable statements of investment policy by the public asset classes, this item proposes several revisions to the Total Fund Investment Policy (Policy) for the Investment Committee's (Committee's) review and direction:

1. Low Duration Program
   - Removal of the High Quality LIBOR (HQL) and Short Duration (SD) sub-components of the Low Duration Program
   - Establishment of an "implied rating" process for select security types
2. Liquidity Program
   - Revision of the "Purpose" statement and policy benchmark for the program to clearly reflect the program's role within the Total Fund
   - Revision of Appendix 7 for the Liquidity Program, adjusting the minimum credit rating required for non-dollar treasury bills of foreign sovereign countries

In addition to the above changes, minor ministerial changes have been made to reflect recent Investment Office organizational changes, such as the transition of investment risk monitoring responsibilities to the Investment Risk and Performance group.

For ease of review "clean" and "mark-up" versions of the Policy reflecting these proposed revisions are provided as Attachments 1 and 2 respectively. A consultant opinion letter from Wilshire Associates is provided as Attachment 3.

Strategic Plan

This item does not directly support the CalPERS 2017-22 Strategic Plan. The proposed revisions, as part of a clear and actionable policy framework, will contribute to the effective management and oversight of investment activities.

Background

General Annual Review Process

As part of the annual program review cycle, programs within the Investment Office review their respective statements of investment policy, delegations, and related governance documents.

This annual review process helps to ensure the governing documents of the CalPERS Investment Program remain current and accurately reflect business processes, requirements, and guidelines.

Analysis

Low-Duration-Program-Related Changes

Following the appointment of the Opportunistic Strategies Managing Investment Director, program ownership of the Low Duration section of the Policy has transitioned from the Global Fixed Income team to the Opportunistic Strategies team. The HQL and SD subcomponents were identified as inactive programs, prompting their removal from the Policy. The Low Liquidity Enhanced Return (LLER) subcomponent of the Low Duration Program remains active.

The Low Duration section of Appendix 7 has also been updated to reference a new proposed internal rating process for portfolio managers to use, for three specific security types, when the investment team has conviction that the rating given by one or more external credit-rating organizations (*e.g.,* Moody's, S&P, Fitch) does not accurately reflect the economic and risk characteristics of a specific security. Staff proposes use of an "implied rating" process, in which equivalent single-A-rated (or higher) securities would be evaluated to inform an internal rating for a security. Establishing an implied rating will require unanimous agreement by an internal rating committee. This process, and the specific security types to which it applies, would be codified in the Investment Policy Procedures and Guidelines (IPPG) document for the Low Duration Program. All implied ratings would be subject to review by the internal rating committee no less than once per year.

Liquidity-Program-Related Changes

The core purpose of the Liquidity Program is to provide liquidity for the day-to-day liquidity needs of the CalPERS Total Fund. To clearly articulate the program's role in relation to the broader portfolio, staff has proposed:

- An adjustment to the purpose statement in the Policy; and
- Revision of the policy benchmark from a 91-day Treasury Bill to a 30-day Treasury Bill benchmark.

As part of the annual review of the Policy conducted in April 2017, Appendix 7 was updated with respect to the Liquidity Program to define the minimum required credit rating for long-term sovereign securities as Baa1/BBB+/BBB+. While this update enabled access to the majority of the target-investment-opportunity set, the Liquidity investment team believes that a further extension of the permissible universe to include the Baa2/BBB/BBB level is required in order to enable the full implementation of their investment strategy goal. The rationale for the change as presented in the April 2017 agenda item remains unchanged:

> *"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."*

Other Ministerial Changes
Ministerial changes have been made, primarily in Appendices 1 and 2 of the Policy, noting:

1. The establishment of the Opportunistic Strategies Program.

2. The transformation of the "Asset Allocation and Risk Management" group to the "Trust Level Portfolio Management" group, including the transition of several investment risk reporting responsibilities to the Investment Risk and Performance group.

3. Revision of Appendix 1, number 22 to reflect submission of legislatively mandated divestment reports to the Committee as informational items, per guidance from CalPERS General Counsel and the Investment Committee Chair.

4. Notation within Appendix 4 (Benchmarks) relocating from the Total Fund Policy Benchmarks section certain Total-Fund-level program benchmarks (as they do not receive strategic allocations) to more clearly denote them as such.

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.

Establishment of "Implied Rating" Process for Low Duration Program
Staff believes the limited use of implied ratings, through a disciplined predefined process, can potentially reduce the credit risk of the portfolio and support CalPERS' investment objectives. Risk will be mitigated by having clear process documentation, using an internal rating committee with membership from the Global Fixed Income and Opportunistic Strategies teams, and requiring unanimous agreement on all implied ratings. Additionally, all implied ratings will be subject to recurrent review no less than once per year.

Liquidity Program - Long-term Sovereigns Minimum Credit Rating.
Staff believes the expansion of the investable universe to the Baa2/BBB/BBB level will support the anticipated benefits as noted in the April 2017 agenda item, including:

- Increased portfolio diversification; and
- Potential reduction of 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 (including by the Investment Risk and Performance group).

Other Changes
No risks have been identified for the other proposed changes. Removing references to inactive programs and making updates to reflect organizational changes help to mitigate confusion and ensure key governance documents remain current and accurate.

Attachments
Attachment 1 – Revised Total Fund Policy – Clean Version
Attachment 2 – Revised Total Fund Policy – Mark-Up Version
Attachment 3 – Board Investment Consultant Opinion Letter – Wilshire Associates

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