May 14, 2018

Item Name: Revision of the Total Fund 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. The proposed changes can be grouped into two broad categories:

1. **Changes related to the 2018 Governance & Sustainability Principles Review**, including changes as discussed at the March and April 2018 Committee meetings; and

2. **Other changes**, primarily updates to reflect recent organizational changes, reduce complexity and duplicative content, and increase consistency within the Policy.

For ease of review, clean and "mark-up" versions of the revised Policy are provided as Attachments 1 and 2 respectively. Opinion letters from the Board's Investment Consultants are provided as Attachments 3, 4, and 5.

Following feedback from the Committee, staff will plan to return at a subsequent meeting for a second reading of the Policy.

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.

Investment Beliefs
This item supports CalPERS Investment Belief 10, particularly sub-belief C, which states, "CalPERS will be best positioned for success if it 1) has strong governance, 2) operates with effective, clear processes…." Conducting an annual review ensures that the Policy is aligned with the ongoing refinements of the Investment Office's organization and business processes.

Background
General Review Background
This item is being brought to the Committee as part of staff's annual review of the Policy. The annual review process provides a regular opportunity to consider changes to:

- Align the Policy with Board directives (such as strategic allocations changes, etc.).

- Ensure policy language keeps pace with changes in business processes and the organization of the Investment Office.

- Continue evaluating and refining policy language consistent with the goals of recent policy revision projects (relocate “procedural” content, remove duplicative content, clarify for ease of reading, etc.).

1. 2018 Governance & Sustainability Principles Review

The CalPERS Governance and Sustainability Principles (Principles) set out CalPERS’ views on corporate governance best practices and provide guidance for setting CalPERS’ corporate engagement and advocacy priorities. The Principles have been an area of deep focus for both the Committee and staff in recent years:

- March 2015, the Committee established an *ad hoc* subcommittee to conduct an in-depth review of the Principles.

- March 2016, the Committee voted to approve the revised Principles, which distilled over 100 pages into a new, streamlined structure focusing on five core issues:
    - Investor Rights
    - Board Quality: Diversity, Independence and Competence
    - Compensation
    - Corporate Reporting
    - Regulatory Effectiveness

- April 2017, the Committee adopted revisions to the Principles, focusing on board responsibilities in addressing capital allocation to support long-term value creation.

- March-April 2018, the Committee discussed potential changes to the Principles to address topics such as environmental management practices, geopolitical risk, executive compensation “clawback” policies, disclosures including harassment in the workplace, and Indigenous Peoples’ rights.

2. Other Changes

The remaining changes proposed in this item largely focus on ensuring the Policy remains current (reflecting the updates to the business processes and organization structure of the Investment Office). Also, a number of changes seek to continue the refinement of our policy framework consistent with the goals of the 2014-16 Policy Revision Project, specifically, to:

- focus policy content on the key strategic elements required to support the Committee in its oversight capacity, as well as guide staff in the management of the investment program;

- remove language identified as duplicative or primarily editorial or aspirational in nature; and

- revise language to increase clarity and ease of reading, as well as improve consistency throughout CalPERS’ investment policies.

Staff expects these kinds of changes to continue to arise over time as our policy and governance frameworks continue to evolve.

Analysis
Highlights of the proposed revisions to the Policy are outlined in the following sections:
1. 2018 Principles Review
2. Other changes

1. 2018 Principles-Review-Related Changes
CalPERS Principles are included as Appendix 8 to the Policy (pages 59-100 of Attachment 2). In response to the Committee's feedback at the April 2018 meeting, staff has made additional modifications to address the issue of harassment in the workplace, on pages:

a. 84 of 102 – Additional language regarding harassment added to CalPERS' existing clawback-principle-related language

b. 74 of 102 – Additional language related to companies' anti-harassment policies and disclosures to include actions that were taken in response to employee complaints

2. Other Changes
The changes fall into three categories, specifically changes that reflect:

2.1 Organizational changes within the Investment Office

2.2 Updating of legacy content to reflect business-process enhancements

2.3 Continued refinement of policy content consistent with the goals of the 2014-16 Policy Revision Project

A handful of ministerial changes are also included in Attachment 2, but due to the non-substantive nature of those changes they will not be discussed in this item. Additional information on the remaining changes is available in the sections below.

2.1 Organizational Changes
A number of changes have been made to reflect the evolution of the Trust Level Portfolio Management (TLPM) team's role (as previously discussed in Agenda Item 6a, the August 2017 TLPM Annual Program Review[1]). The majority of these relate to the transition of investment risk and performance reporting duties from TLPM to the Investment Risk & Performance (IRP) team. The key changes of this type are on pages:

a. 31-32 of 102 – Reporting responsibilities 4 and 5 have been removed as TLPM responsibilities, and responsibility 10 (an IRP responsibility) has been updated to "re-home" the core content from responsibilities 4 and 5.

b. 38 of 102 – Elimination of responsibility number 34 because 1) subsequent to the original establishment of this policy language, responsibility for the management of the Opportunistic Program has been consolidated under the TLPM Managing Investment Director (with implementation by the Opportunistic Strategies group within the Investment Office), and 2) ensuring appropriate responsibility for individual investments is addressed in responsibility 6 ("…all elements of portfolio management…").

[1] CalPERS Investment Committee Meeting Archives, August 14, 2017

2.2 Updating of Legacy Content to Reflect Business-Process Enhancements

In addition to the organizational changes that are expected to occur over time, business processes also evolve as new efficiencies can be realized, or roles and requirements shift. As part of this review, teams across the Investment Office reviewed sections where their group has primary ownership. In the course of this review, a number of changes to better reflect updates to business processes and roles were identified. The key changes of this type are on pages:

a. 36 of 102 – To better reflect the Committee's leadership role in the establishment of the Investment Beliefs [2], staff proposes that the responsibility for conducting a periodic review of the Investment Beliefs be identified as a Committee responsibility (a new responsibility number 6 in the first table). This would replace the current staff responsibility number 9 on page 37 of 102. Of course, as noted in the proposed language, staff can help facilitate the process as requested.

b. 25 (section B), 33 and 39 of 102– Simplification of section as well as changing "COIO approval" to "COIO notification" to improve process efficiency and provide flexibility for continuity of operations in the event the COIO is unavailable for an explicit "approval."
   - On a related note, staff will continue monitor the use of transition portfolios. To support appropriate oversight, while making the highest use of the Committee's time, staff proposes to create a new investment responsibility number 38, on page 39, requiring staff to maintain procedures regarding the use and monitoring of transition portfolios, and to strike reporting responsibility 26 on page 33.

   - The prior iteration of investment responsibility 38 is proposed for removal, as it is a "business as usual" function (controlling the movement of cash and securities at CalPERS' custodian) which does not add value to the Policy.

c. 31 of 102 – Establishment of a new reporting responsibility (number 8) requiring notification of the Committee in the event any asset allocation change is undertaken that 1) exceeds 50% of the approved range relative to target and 2) increases the risk profile of the Total Fund. Correspondingly, staff proposes removal of section A, and A.1 of the Asset Allocation Strategy section of Appendix 7 (page 55 of 102). This change is proposed to make highest use of the Committee's time, and acknowledge the Fund's portfolio priorities (namely, managing overall volatility).

d. 32 of 102 – Revision of reporting responsibility number 9 to improve clarity and update the required frequency to "as needed" in acknowledgement that the Total Fund Policy Benchmark (and it's component asset class benchmarks) change primarily in association with the 4-year ALM process, not annually.

---

[2] CalPERS Investment Committee Delegation Resolution, see item (b)(1)

e. 32 of 102 – Revision of reporting responsibility number 15 to simplify the language and minimize the disclosure of counterparty-specific information with the potential to influence the market.

f. 33 of 102 – Revision of reporting responsibility number 18 to simplify the language and reflect the current practice of routinely reporting on liquidity risk considerations (not just in times of market stress).

g. 40 of 102 – Revision of the Private Equity portion of the "Private Asset Class Board Investment Consultant" table to align with the proposed changes to the Private Equity Program Policy, as outlined in Agenda Item 6b, also on the agenda for the May 14, 2018 Committee meeting. Specifically:
    a. Addition of a new row number 3 for "Direct Investments" reflecting that Prudent Person Opinions are required
    b. Reference in row 4 simplified to "Separate Account" only
    c. Deletion of row 5

2.3 Ongoing Content Refinement

As noted earlier in this item, several changes are proposed in alignment with the goals of the 2014-16 Policy Revision Project, specifically to increase consistency and clarity, and where appropriate remove duplicative content or content that would be more appropriate for staff-level guidelines or procedures. Key changes of this type are found on pages:

a. 4 of 102 – Removal of section "F. Computations and Calculations" as this section does not appear to add value in consideration of the varying kinds of analysis required under the Policy, some of which do not require market value or holdings information.

b. 11 and 37 of 102 – Reorganization of content to improve clarity and remove duplicative content. Further, staff proposes updating the second block to focus on benchmark oversight, rather than "Performance Objective & Benchmark," and establish a new responsibility (number 13, page 37 of 102).

c. 28-29, and 39 of 102 – Elimination of the "Custody Management" section of the Policy (including the corresponding responsibilities number 41-43). The specifications and guidance of this section are inherent in the day-to-day functions of the Investment Servicing Division. Further, terms relating to the custodian's duties, fiduciary duty, ethics and conflict of interest, etc. within this section are more properly addressed in, and enforceable through, the contract between CalPERS and the vendor.

d. 36 and 41 of 102 – Elimination of references to external manager responsibilities within the Policy. The items, primarily outlined in the "External Manager Responsibilities" table on page 41, are "business as usual" and do not add value in terms of Committee oversight. As with custody management, the specific duties and contract terms for CalPERS' external managers are more properly addressed in, and enforceable through, CalPERS' contracts with those managers.

e. 38 of 102 – Elimination of responsibilities 28-31, and 35-36 as they are encompassed by responsibility number 6 (page 37) for "All Programs," which addresses "all aspects of portfolio program management…"

f. 39 of 102 – Elimination of investment responsibilities 39 and 40 for Private Equity and Real Assets staff, as these concepts are addressed 1) within the program policies for Private Equity and Real Assets, as well as 2) responsibility number 6 (page 37) ("all aspects of portfolio management…").

g. 50 of 102 – Addition of line items acknowledging CalPERS Securities Lending Program and the Terminated Agency Pool (TAP). Due to the nature of both the Securities Lending Program and the TAP, traditional benchmarks (like those expressed for other programs) are not applicable. However, in the interest of completeness, and to mitigate potential confusion, staff proposes to treat all policy-level programs equally.

Budget and Fiscal Impacts
Not Applicable.

Benefits and Risks
Staff does not anticipate any risks associated with the proposed policy revisions. Anticipated benefits and other considerations for the broad change categories are outlined below.

1. 2018 Principles Review-Related Changes

As an expression of CalPERS values and a guide for our engagement and policy advocacy work, it is important that our Principles are updated as new issues emerge and CalPERS' priorities evolve over time. Further, this item is an important part of following through on some of the outstanding items identified through the 2015-16 in-depth review.

2. Other Changes

Ensuring that the Policy is updated to reflect organizational changes is a good general business process, and helps ensure lines of responsibility remain clear.

Staff's proposals for the deletion of duplicative and/or "business as usual" content supports the principle that our policy documentation should be clear, focused at the strategic level, and meaningful for the management of the investment program – policy documentation is not intended to be operational, procedural, or a restatement of professional staff's duty statements. Further, the Investment Office continues to enhance our internal governance framework, including the establishment of "Investment-Policy Procedures and Guidelines" as part of the 2015-16 Policy Revision Project. The IPPGs established a new level of documentation for internal staff use, with compliance testing, an annual review process, and a disciplined cross-team-change control process that engages the Board's Investment Consultants.

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
Attachment 4 – Board Investment Consultant Opinion Letter – Pension Consulting Alliance (Real Estate)
Attachment 5 – Board Investment Consultant Opinion Letter – Meketa (Private Equity and Infrastructure)

____

Katherine H. Crocker
Investment Director
Investment Compliance & Operational Risk

____

Matt Flynn
Interim Chief Operating Investment Officer