CalPERS

Investment Committee

Agenda Item 7a

June 18, 2018

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

Program: Total Fund

Item Type: Action

Recommendation

Adopt the revised Total Fund Policy (Policy) as provided in Attachment 1.

Executive Summary

Following feedback from the Committee at the May 14, 2018 first reading of the Policy, staff has returned with a revised version of the Policy for consideration by the Committee.

The two broad categories of changes discussed at the May 14, 2018 Committee meeting were:

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.

Subsequent to the first reading, a third category of changes have been incorporated into the Policy, namely, 2017-18 Asset Liability Management (ALM) process-related changes. These changes include updates to the policy benchmarks, allocation targets, and ranges for the Public Employees' Retirement System. In addition to the 2017-18 ALM-related changes, there have also been a handful of additional changes in the "other changes" category.

For ease of review, clean and "mark-up" versions of the revised Policy are provided as Attachments 1 and 2 respectively, with the changes made subsequent to the first reading highlighted in yellow within Attachment 2 (denoted as "*new*" in this agenda item).

Opinion letters from the Board's Investment Consultants are provided as Attachments 3, 4, and 5.

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 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; and
- Continue evaluating and refining policy language consistent with the goals of recent policy revision projects (*e.g.,* relocating "procedural" content, removing duplicative content, and clarifying for ease of reading).

1. 2018 Governance & Sustainability Principles Review
The CalPERS Governance and Sustainability Principles (Principles) articulate 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 focus largely on ensuring the Policy remains current (reflecting 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.

3. *New*, 2017-18 ALM-related Changes – Background
CalPERS' cyclical 4-year ALM process is a collaborative effort to provide an integrated view of the System's assets and liabilities, including the establishment of demographic, actuarial, and economic assumptions. The most recent 4-year review culminated in the adoption of a new strategic asset allocation by the Committee in December 2017.

Analysis
Highlights of the proposed revisions to the Policy are outlined in the following sections:

1. 2018 Principles Review
2. Other changes
3. 2017-18 ALM changes

1. 2018 Principles-Review-Related Changes
CalPERS Principles are included as Appendix 8 to the Policy (pages 62-104 of Attachment 2). In response to the Committee's feedback on the Principles agenda item at the April 2018 meeting, staff made additional modifications to address the issue of harassment in the workplace, on pages:

a. 86 of 104 – Additional language regarding harassment added to CalPERS' existing clawback-principle-related language

b. 76 of 104 – Additional language related to companies' anti-harassment policies and disclosures to include actions that were taken in response to employee complaints

2. Other Changes
These "other" 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 104 – 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 104 – 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…").

    i. *New*, 33 of 104 – The "responsible party" for number 24 (the annual reporting of activities conducted under the auspices of the Opportunistic Program), has been updated from "All Programs" to "TLPM." This change is in alignment with the rationale outlined in item 2.1.b above.

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 were identified that better reflect updates to business processes and roles. The key changes of this type are on pages:

a. 36 of 104 – 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 104. Of course, as noted in the proposed language, staff can help facilitate the process as requested.

    i. *New* – In response to feedback from the Committee at the May 14, 2018 Committee meeting, staff has added additional detail expressing the activity's link to the cyclical 4-year ALM process.

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

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

b. 25 (section B), 34 and 39 of 104– 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 to 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 34.

   - The prior iteration of investment responsibility 38 on page 39 is proposed for removal, as it is a "business as usual" function (controlling the movement of cash and securities at CalPERS' custodian) that does not add value in terms of this Committee's oversight role.

c. 31 of 104 – 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 sections A and A.1 of the Asset Allocation Strategy section of Appendix 7 (page 57 of 104). This change is proposed to make the highest use of the Committee's time in recognition of the Fund's portfolio priority regarding the management of overall volatility.

d. 32 of 104 – Revision of reporting responsibility number 9 to improve clarity and update the required frequency to "as needed" in recognition of the fact that the Total Fund Policy Benchmark (and its component asset class benchmarks) is revised primarily in association with the 4-year ALM process, not annually.

e. 32 of 104 – 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 104 – 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. *Revised*, 40-41 of 104 – Revision of the "Private Asset Class Board Investment Consultant" table to:

   i. Align with the proposed changes to the Private Equity Program Policy, as outlined in Agenda Item 8a, also on the agenda for the June 18, 2018 Committee meeting.
   ii. *New*, increase consistency regarding when the private asset classes require prudent person opinions.
   iii. *New*, add a new footnote (**) under the table specifying that a prudent person opinion is required for Private Equity fund investments below the second quartile.

iv. *New*, replace “N/A” with “Not required” for increased clarity

2.3 Ongoing Content Refinement

As noted earlier in this item, several of the proposed changes are in furtherance of 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 104 – Removal of section “F. Computations and Calculations” as this section does not appear applicable in light of the varying types of analysis contemplated by the Policy, not all of which would require market value or holdings information.

b. 11 and 37 of 104 – 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 104).

c. 28-29, and 39 of 104 – Elimination of the “Custody Management” section of the Policy (including the corresponding responsibilities numbers 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 conflicts of interest, etc. within this section are more properly addressed in, and enforceable through, the contract between CalPERS and the vendor.

d. 36 and 41-42 of 104 – Elimination of references to external manager responsibilities within the Policy. The items, primarily outlined in the “External Manager Responsibilities” table on page 42, 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. 38-39 of 104 – 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 104 – 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. 51-52 of 104 – 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.

h. *New*, 32 of 104 – Deletion of reporting responsibility number 11, as (1) it refers to a general role, not a reporting deliverable, and (2) the content of number 11 is duplicative of responsibility number 17 on page 37 of 104.

3. *New*, 2017-18 ALM-related changes

The changes proposed for this topic are largely to update references to CalPERS asset allocation targets, and the Total Fund Policy Benchmark, to reflect the policy portfolio selected by the Investment Committee in December 2017.

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

a. 47-48 of 104 – Addition of a new "Asset Allocation Targets and Ranges" table and deletion of the "Funding Risk Mitigation Event Asset Allocation Target Changes" table. Note, in February 2017 the Board acted to suspend the Funding Risk Mitigation Policy until FY 2020-21.

    i. While the Funding Risk Mitigation Policy has been suspended, staff is proposing to add a new reference to the Funding Risk Mitigation Policy within Appendix 4, page 47 of 104, to acknowledge the existence of such policy and its potential impact on the CalPERS asset allocation. Correspondingly, former paragraph C referencing the Funding Risk Mitigation Policy and Event Asset Allocation Table has been deleted from page 8 of 104, as it is duplicative of the new language added to Appendix 4.

    ii. Upon the reinstatement of the Funding Risk Mitigation Policy staff will return with an updated table of asset allocation target changes, for use following a Funding Risk Mitigation Event, for consideration by the Committee.

b. 49-51 of 104 – Updates to Table 1, "Total Fund Policy Benchmark," to reflect the new strategic weights. Additionally, references to static interim targets have been removed in recognition of the activities that are underway to transition the Fund to the new strategic targets. Correspondingly, Table 2, "Public Employees' Retirement Fund Policy Benchmarks," has been deleted in the interest of simplification. Additionally, sentences that refer to the use of interim targets have been moved forward to the start of Appendix 5 (previously having been below the tables).

c. 55 of 104 – Increasing the amount of notional leverage and recourse debt allowed for the Liquidity Program from 2% to 5% in recognition of the increased range relative to target for the Liquidity allocation. Liquidity Program leverage is associated with use of the "Borrowed Liquidity" concept, as previously discussed and approved by the Committee in 2015-16. Additional information on the Borrowed Liquidity concept can be found in Agenda Item 8d for the February 16, 2016 Committee meeting[3].

Budget and Fiscal Impacts

Not Applicable.

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[3] CalPERS Investment Committee Meeting Archive, February 16, 2016

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 be 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.

3. *New*, 2017-18 Asset Liability Management (ALM)-related changes

   The Committee and staff participated in extensive discussions regarding the risk and benefits of the actions and decisions undertaken throughout the 2017-18 ALM process. As the changes proposed in this item simply codify those decisions in the Policy, staff does not anticipate any risks associated with the proposed language changes.

   The proposed changes provide the following benefits:

   1. Codifies the Committee's recently adopted strategic asset allocation and brings all affected elements of the policy in alignment therewith.

   2. Simplifies the representation of CalPERS Total Fund Policy Benchmark as asset allocation transition activities continue.

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)

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