Agenda Item 11a

December 10, 2012

ITEM NAME: Absolute Return Strategies Program Review - Discussion of the Role of the Absolute Return Strategies Program

PROGRAM: Absolute Return Strategies

ITEM TYPE: Program Review – Information

EXECUTIVE SUMMARY

This item presents the 2012 annual review for the Absolute Return Strategies Program and discusses the role of the Absolute Return Strategies Program within the CalPERS Total Fund.

STRATEGIC PLAN

This item supports the CalPERS Strategic Plan goal to improve long-term health benefit and pension sustainability. Providing in-depth program reviews support the Investment Committee in evaluating investment strategies which aim to improve the risk-return profile of the CalPERS Total Fund.

BACKGROUND

The CalPERS Absolute Return Strategies Program (ARS Program) was created in 2000 to enable CalPERS to invest in hedge funds and similar approaches that were not addressed by existing CalPERS asset classes. It was originally conceived as a "hybrid" program with oversight from both the Global Equity and Alternative Investment Management (now known as the Private Equity Program). Blackstone Alternative Asset Management was retained as the strategic and portfolio advisor to the ARS Program, and International Fund Services (IFS, now part of State Street Corporation) was retained as the administrator for the Program.

In April 2002, the ARS Program made its first investments in commingled hedge funds, primarily in equity-oriented strategies such as long/short equity and convertible arbitrage. Capital for ARS investments was drawn from the Global Equity portfolio, and the ARS Program was staffed by the Global Equity Program.

In 2004, Blackstone Alternative Asset Management was replaced as portfolio advisor by UBS Alternative and Quantitative Investment, LLC (UBS A&Q, a unit of UBS AG) and as strategic advisor by Pacific Alternative Asset Management Company

(PAAMCO). Both UBS A&Q and PAAMCO continue to serve in those roles on behalf of the ARS Program, and IFS continues to serve as ARS Program administrator.

From inception through 2004, the ARS Program's benchmark was a 50-50 split between a broad market equity index and one-year Treasury bills plus 7%. In 2005, the benchmark was modified to one-year Treasury bills plus 5%. Concurrent with the modified benchmark was a migration from primarily equity-driven strategies to a more diversified portfolio which included multi-strategy funds, commodity trading advisors, and fixed income-driven strategies.

The ARS Program performed well from 2002 until 2007. In 2008, the global financial crisis affected many investment types. The 2008 ARS portfolio was no exception, declining roughly 20% over the course of the 2008 calendar year. In 2009 ARS staff issued a memo to the Program's managers setting forth the "Three Pillars" under which future ARS investments would be made: (1) improved alignment of interests between managers and CalPERS; (2) a higher degree of CalPERS control of assets; and (3) a higher level of transparency of risks and exposures. The following two years, 2009 and 2010, were predominantly spent restructuring the ARS portfolio to conform with the "Three Pillars" concept, generally by entering into separate account structures with existing ARS managers and/or terminating managers as appropriate.

In July 2011 the ARS Program was spun out of Global Equity into a freestanding unit reporting directly to the CalPERS Chief Investment Officer. Whereas immediately prior to the spin-out ARS had a target allocation of 5% of Global Equity assets, currently there is no existing strategic allocation to the ARS Program. Therefore the ARS Program, at roughly $5 billion of current assets, represents a 2% "out-of-benchmark" exposure for the Total Fund. Because the capital for ARS investments has come from Global Equity, an "overlay" of equity index futures has been deployed to restore the Global Equity portfolio to its "benchmark" exposure. The overlay's size is 100% of the program market value per policy and managed by the Global Equity team.

ANALYSIS

In March 2012, the ARS team presented the Investment Committee with a workshop on absolute return investing. At that time four key questions with respect to the ARS Program were posed:

- What is the <u>role</u> of absolute return investing, and the ARS Program, in the CalPERS portfolio?
- What should the ARS Program's <u>benchmark</u> be?
    - This incorporates not just return targets but also risk and liquidity parameters
- What should the ARS Program's <u>capital source</u> be?
- What should the ARS Program's <u>size</u> be?

A fifth question was subsequently posed by senior Investment Office staff:

- How should the ARS Program be resourced? Should more of the ARS Program's functions be brought in-house?

Staff will propose an answer to the first question – the role of absolute return investing through this agenda item – at the December 2012 Investment Committee meeting. The remaining questions (benchmark, capital source, size, and resourcing) will be addressed when ARS presents its Strategic Plan to the Investment Committee in February 2013.

Staff believes that **the primary role of ARS is to act as a diversifier to the growth risk factor**, which is predominantly found within the Global Equity and Private Equity and which is the dominant risk factor in the Total Fund. The attached presentation (Attachment 1) provides additional information.

ATTACHMENTS
Attachment 1 – ARS Annual Program Review Presentation
Attachment 2 – Wilshire Opinion Letter

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