Agenda Item 5a

September 16, 2013

ITEM NAME: Revision of the Total Fund Benchmarks Policy

PROGRAM: Total Fund

ITEM TYPE: Policy & Delegation – Action

RECOMMENDATION
Approve the revised California Public Employees' Retirement System (CalPERS) Total Fund Benchmarks Policy as shown in Attachment 1, the consultant opinion letter is provided as Attachment 2.

EXECUTIVE SUMMARY
The Total Fund Benchmarks Policy was presented to the Investment Committee (IC) for initial review on August 19, 2013.

No further changes were made to the Total Fund Benchmarks Policy based on the Investment Committee's feedback. Reflecting discussion at the IC, this agenda item has been revised to include the following changes:

- Additional guidance regarding consistency of treatment for programs initiated outside the Asset Liability Management (ALM) workshop
- Analysis regarding the effect of including absolute return components within the Total Fund Policy Benchmark has been included to demonstrate the impact on total and active risk (tracking error)

Staff seeks approval of the Total Fund Benchmarks Policy to:
- Update the methodology of calculating the Currency Overlay Program benchmark to align with current industry standards
- Realign the Total Fund Policy Benchmark with the strategic asset allocation by removing the Multi-Asset Class (MAC) Program benchmark scaling process
- Provide more clarity of the calculation of the Total Fund Policy Benchmark by including the interim asset allocation weights

STRATEGIC PLAN
This agenda item supports CalPERS Strategic Plan goal to improve long-term pension and health benefit sustainability. The adoption of the Total Fund Benchmarks Policy revision will ensure that CalPERS is able to effectively achieve the System's investment objectives through clear and current investment policy documentation. This revision shall ensure that the Total Fund Policy Benchmark

remains aligned with the approved strategic asset allocation decisions resulting from the ALM workshop, thus maintaining the target risk and return expectations.

BACKGROUND

Currency Overlay Program Benchmark

The IC approved changes to the Currency Overlay Program on March 16, 2009. The change applied to the currency hedge program at the Total Fund level, changing the strategic hedge ratio from 25% of developed equity foreign currency exposure to 15% of total foreign currency exposure. The Currency Overlay Program benchmark was incorporated in the Total Fund Policy Benchmark by scaling the Total Fund Policy Benchmark to reflect the impact of the currency overlay.

MAC Program Benchmark

The MAC Program benchmark was incorporated into the Total Fund Policy Benchmark on December 10, 2012 by scaling the Total Fund Policy Benchmark to reflect the target weights of the Asset Classes and the target weight of the MAC Program.

Total Fund Policy Benchmarks – Interim Weights

The IC adopted new strategic asset allocation targets in December 2010 after the 2010 ALM workshop. The newly adopted Policy Targets shifted the System's investments from relatively liquid public fixed income instruments to less liquid real assets, thus a transition period was needed to reach the Policy Targets. Interim asset allocation targets were approved for the period from July 1, 2011 to December 31, 2012. In February 2013, the IC approved the extension of the interim asset allocation targets until June 30, 2014.

ANALYSIS

The analysis below is for the Total Fund Policy Benchmark return only and in no case would any of the changes have an impact to the Total Fund portfolio returns or ending market value.

Currency Overlay Program Benchmark

In March 2009, the IC approved changes to the Currency Overlay Program which effectively expanded the scope of the hedge to the majority of foreign asset exposures. At that time, the benchmark implementation resulted in the currency hedge component representing approximately 5% of the strategic allocation.

As part of the effort to enhance performance attribution calculations, the Currency Overlay Program benchmark methodology was reviewed against current industry standards utilized by international index providers to create passive currency overlay benchmarks. Staff recommends updating the Currency Overlay Program benchmark methodology to better align with industry standards and eliminate the scaling methodology that was used previously. The changes required to update the methodology are:

1. Eliminate any strategic allocation weight to the Currency Overlay Program
2. Incorporate all sources of volatility in currency pricing in the calculation of currency impacts.

Updating the calculation methodology has the potential to impact future Total Fund Policy Benchmark returns in either a positive or negative direction. The magnitude of the potential impact is illustrated by the change in benchmark volatility as measured by the standard deviation of returns. The existing methodology has an estimated annualized volatility of 11.47%. The updated methodology is estimated have an annualized volatility of 11.74%, an increase of 0.27%. This estimate implies that annual benchmark performance may be higher or lower by 0.27% approximately two thirds of the time. The actual returns generated by the Total Fund will not be impacted by an update to the benchmark calculation methodology.

MAC Program Benchmark
The MAC Program is not handled in a manner consistent with other Programs that have been created outside the periodic ALM process. Staff recommends that the Total Fund Policy Benchmark remain aligned with the strategic asset allocation output from the ALM process. There are currently three programs that have been created outside the ALM cycle:

Program	Benchmark
1. Absolute Return Strategies (ARS)	1-Year Treasury Bill plus 5%
2. MAC	Absolute 7.5%
3. Opportunistic	Undefined

To date, MAC is the only program that has been incorporated into the Total Fund Policy Benchmark. Staff recommends that the MAC Program be excluded from the Total Fund Policy Benchmark in order to realign the benchmark with the strategic asset allocation choices approved by the IC. Staff further recommends that any future Programs, such as MAC, ARS or Opportunistic, not be included in the Total Fund Policy Benchmark until such time as they receive an allocation through the ALM process. Such programs may appropriately be considered "tactical" prior to ALM adoption.

A common feature of the ARS and MAC Programs is the absolute return nature of the benchmarks assigned to them. Absolute return benchmarks are unique in their positive return and non-volatile characteristics. The only investible asset which consistently demonstrates absolute return attributes is cash. The impacts of including these types of benchmarks within the Total Fund Policy Benchmark calculation are:

1. Reduction in the total risk or volatility (standard deviation of return)
2. Increase in active risk (tracking error).

Tables 1 and 2 below, shows the increasing allocations to ARS Program and MAC Program benchmarks will serve to decrease volatility of the overall benchmark and increase tracking error due to the zero volatility nature of absolute return benchmarks.

Table 1: Total Fund Policy Benchmark versus Conceptual Adjusted Policy Benchmark

Program	Total Risk	Total Active Risk
Current Policy Benchmark vs Current Policy Benchmark	11.44	0.00
Current Policy Benchmark vs Policy Adjust 1 (2% ARS, 1% MAC)	11.38	0.11
Current Policy Benchmark vs Policy Adjust 2 (3% ARS, 2% MAC)	11.34	0.19

Table 2: Predicted Total and Active Risk of ARS and MAC Programs

Program	Total Risk	Total Active Risk
ARS	3.54	3.66
MAC	5.75	5.75

Inclusion of absolute return benchmarks within the Total Fund Policy Benchmark will consume a portion of the risk budget and could limit active risk from being taken in other asset classes. Absolute return benchmarks do not meet the desirable characteristics of a benchmark as established in the Total Fund Benchmark Policy as investable, measurable, and representative. Due to the low, or no, volatility nature of these benchmarks, the Programs will encounter significant active risk when compared against the stated benchmark.

The result of this approach will be to hold staff accountable for the opportunity cost of allocating capital to tactical positions or programs, just as staff would be accountable for over or under allocating to strategic asset classes. In other words, the Total Fund Policy Benchmark should represent the long-term strategic target established during the ALM process and approved by the IC. Any decisions to allocate capital differently than those strategic targets will represent active risk taken by staff.

No significant benchmark return impacts are anticipated from the proposed change due to the small size of the MAC Program.

Total Fund Policy Benchmark – Interim Weights
The interim asset allocation targets are currently used to calculate the Total Fund Policy Benchmark; however they are not included in the Policy. In order to provide more clarity, staff recommends adding the interim asset allocation targets to the Policy.

BUDGET AND FISCAL IMPACTS
Not Applicable

BENEFITS/RISKS
The recommended changes will provide the IC with a more accurate standard to use in assessing investment performance by:

1. Ensuring we continue to stay aligned with current industry best practices related to the Currency Overlay Program benchmark.

2. Incorporating the MAC Program as a non-policy "active" component will remove any misalignment with the approved strategic asset allocation and ensure staff accountability for the efficacy of the program.

3. Incorporating the interim asset allocation weights into the Policy will increase the transparency of the calculation of the Total Fund Policy Benchmark, and improve the usefulness of performance attribution.

ATTACHMENTS
Attachment 1 – Revised Total Fund Benchmarks Policy
Attachment 2 – Wilshire Associates Opinion Letter

_____
ERIC BAGGESEN
Senior Investment Officer
Asset Allocation and Risk Management

_____
JOSEPH A. DEAR
Chief Investment Officer