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MAINTAINING A STEADY FIDUCIARY COURSE THROUGH CHOPPY WATERS

Fiduciary Training and Education for the CalPERS' Board of Administration
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CROSS-CURRENTS AND RIP TIDES

- **Recovery from recession**
- **Volatile global markets**
- **De-risking the portfolio**
- **Hedge fund hysteria**
- **Global ESG challenges**
- **State, county and local budgetary stress**

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CROSS-CURRENTS AND RIP TIDES

- **Members' jobs, pensions and health care security**
- **Changing actuarial assumptions and methodologies**
- **Bankruptcy threats, real and imagined**
- **Public mistrust and political fallout**

THE FIDUCIARY GUIDANCE SYSTEM

FUNDAMENTAL FIDUCIARY DUTIES

- **Exclusive Benefit Rule – to use the assets solely to pay the members' promised retirement benefits**
- **Primary Loyalty Rule – to act in the best interests of *all* members and beneficiaries – both current and future**
- **Prudent Expert Rule – to assure the competency of the assets to meet the liabilities and act as would a prudent person "familiar with these matters"**

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OTHER CONSIDERATIONS THAT ARE NOT "FIDUCIARY"…

- **"Minimizing employer contributions"**
- **Promoting intergenerational equity**
- **Reducing employer rate volatility**
- **Protecting taxpayers**

…AND SOME THAT REQUIRE CONSTANT VIGILANCE

- Corporate governance and shareholder activism
- ESG investing and divesting
- General health and welfare of members
- Improving domestic and global economies
- Political activism

SUCCESSFULLY NAVIGATING THE WATERS

- **An "interested" board, demonstrating superior competencies and exercising collective wisdom**
- **Laser-focus on the mission: deliver the benefits promised to your members**
- **Set priorities**
- **Process is as important as results**
- **Engage in open, public deliberations, transparent actions**

SUCCESSFULLY NAVIGATING THE WATERS

- **Seek expert advice, but maintain a healthy skepticism**
- **Stress-test the system's capabilities ("what if…?")**
- **Establish your collective risk tolerance**
- **Understand "costlessness"**
- **Avoid undue influences**
- **Resist reverse engineering the results**

ABOVE ALL, KEEP YOUR BALANCE!

SCENARIOS FOR DISCUSSION

SCENARIO No. 1

CalPERS' Board is considering a proposal to buy and hold $50 billion in 30-year California bonds to finance new construction of bridges, roads, tunnels, pipelines and desalinization plants within the state. CalPERS would be the sole holder of the bonds. The bonds would be secured and repaid by tolls and other revenue generated by the completed projects, starting in the 7th year. The Investment Office estimates the annualized return on the bonds over 30 years would be 3.75%, and the bonds would receive a BBB- rating.

Three different groups have approached the Board about the proposal:

A. A labor alliance asks the Board to APPROVE the proposal, to promote job growth and improve the state's overall economic climate, which will inure to CalPERS' long-term security by showing how the defined benefit plan can enrich local economies.

B. The League of Cities asks the Board to REJECT the proposal because the risk of the investments and low expected return will dampen the system's ability to achieve its overall assumed rate of return, thus triggering crippling increases in employer contributions and municipal bond rating downgrades.

C. The Chamber of Commerce asks the Board to APPROVE the proposal because it will improve the fortunes (and stock prices) of many Fortune 500 manufacturing and construction companies in which CalPERS invests, thus improving returns on CalPERS' domestic equity holdings.

The Board is deciding what to do.

SCENARIO No. 2

Signature gathering has begun on a statewide voter initiative to reform public employee pensions, including CalPERS, through a Constitutional amendment, in the following ways:

A. The Board must select an annual assumed rate of return that the actuary certifies has at least a 60% chance of probability of being achieved, on average, over the subsequent five year period, based upon the system's current asset allocation.

B. The Board may not amortize the unfunded liability of the system over a period longer than the average projected lifetime of current active members, to promote intergenerational equity.

C. The Board must discount its liabilities at a rate less than the assumed rate of return on its investments.

D. If any employer certifies to the State Auditor that a proposed change in actuarial assumptions would result in an ARC that would (a) threaten its fiscal solvency or (b) require employee layoffs or furloughs, the Board may not impose the change on the employer.

The Board is considering whether or not to take a position on the proposed ballot initiative.

SCENARIO No. 3

CalPERS holds over $10 billion in four Fortune 100 global pharmaceutical companies that have been in a race to develop a cure for diabetes. Such a cure could save the lives of thousands of CalPERS members, extend their productive lives and lower their health care costs.

One company, Pharmacopia, has just applied for FDA approval to market its patented diabetes cure, which it claims has been successfully tested on paid volunteers in sub-Saharan countries. If approved, the shares of the three other competing pharmaceutical companies are sure to plummet, because they are at least three years away from developing competing cures.

Meanwhile, the *Wall Street Journal* is reporting that it suspects Pharmacopia may have bribed an FDA official to speed up the approval process. And a national labor council reports that Pharmacopia has been secretly funding signature-gathering operations for ballot initiatives aimed at undermining defined benefit pension plans in three Western states.

Finally, the California Legislature is considering a bill requiring CalPERS to divest from any company that conducts drug testing exclusively in underdeveloped countries.

The Board is considering what to do, if anything, about the current situation.