Agenda Item 6a

September 16, 2013

ITEM NAME: Adoption of CalPERS Investment Beliefs and Initial Review of CalPERS Investment Beliefs Policy

PROGRAM: Total Fund

ITEM TYPE: Policy & Delegation – Action

RECOMMENDATION
Adopt the CalPERS Investment Beliefs (Investment Beliefs) as presented in Attachment 1 and conduct an initial review of the CalPERS Statement of Investment Policy for Investment Beliefs Policy (Policy) included in Attachment 2.

EXECUTIVE SUMMARY
CalPERS Investment Committee (IC) and CalPERS staff (staff) have participated in a long-term process to develop a set of Investment Beliefs (Attachment 1). Staff recommends adoption of the Investment Beliefs. In addition, staff recommends an initial review of the Policy (Attachment 2) which will provide guidance regarding the purpose and use of the Investment Beliefs. Wilshire and PCA opinion letters regarding the proposed Policy are included as Attachments 3 and 4, respectively.

STRATEGIC PLAN
This agenda item supports the CalPERS Strategic Plan to improve long-term pension and health benefit sustainability. Adopting a set of Investment Beliefs provides a framework for exercising judgment, making investment decisions and ensuring alignment among IC Members and staff.

BACKGROUND
Investment Beliefs provide a basis for strategic management of the investment portfolio, inform organizational priorities and ensure alignment between the IC and staff. In November 2012, a formal project was launched to develop a set of Investment Beliefs for CalPERS with participation from the IC, staff and Board Consultants (Wilshire, PCA). Towers Watson (TW) was engaged to facilitate the process.

The Investment Beliefs project included in-depth one-on-one interviews with IC Members and staff. Board and staff input was analyzed and clustered into themes. In particular, there was a focus on identifying themes that had contentious and unsettled elements that required resolution.

In April 2013, an IC Workshop was held to enable the IC Members to discuss the contentious and unsettled themes and to understand various points of view. Staff conducted a similar exercise and staff views were shared with the IC Members as input to their deliberations. In addition, in March 2013, an Investment Beliefs Stakeholder Panel provided a forum for CalPERS stakeholders (an Employer Representative, Labor Representative and Pension Management Practitioner Representative) to engage in dialogue and share their perspectives on Investment Beliefs.

Staff presented a set of 10 draft Investment Beliefs to the IC Members at the July 2013 Board Offsite and sought feedback. Staff incorporated the feedback received and are presenting the Investment Beliefs for adoption.

The IC received public comment throughout the process. Staff is grateful for the participation and engagement of the full IC, Senior Investment Office staff and stakeholders in the Investment Beliefs development process.

ANALYSIS
Using a thorough and disciplined process, the IC and staff have achieved strong consensus around a set of Investment Beliefs. The proposed Investment Beliefs and sub-beliefs are included in Attachment 1.

Attachment 2 includes the Policy. Staff is requesting initial review of the Policy in September with formal adoption in October. Attachment 2 contains tracked changes which indicate areas where IC Member and public feedback received at the July 2013 Offsite have been incorporated into the Investment Beliefs.

The Policy requires CalPERS to develop and maintain a set of Investment Beliefs. It provides context for how the Investment Beliefs should be used. It makes clear that the Investment Beliefs are a framework for making judgmental decisions; they are not a checklist to be applied by rote to each decision.

The Policy also requires that staff:

1. Facilitate a periodic review of the Investment Beliefs in conjunction with the Strategic Asset Allocation process.

2. Report to the Committee on investment program strategy and its consistency with CalPERS Investment Beliefs.

3. Integrate the Investment Beliefs into Committee and staff orientation and ongoing staff communication programs.

Attachment 1 and 2 includes more detailed sub-beliefs that are actionable statements providing insight as to how the Investment Beliefs will be implemented.

The Investment Beliefs development process identified several topics that will require additional discussion among the IC and staff over time. These topics include investment performance measurement, risk management and measurement, active management and integration of sustainability factors into investment decision making. Staff will work with the IC Chair and Vice Chair to integrate these topics into the 2014 IC Calendar, after completion of the strategic asset allocation process.

BUDGET AND FISCAL IMPACTS
Not Applicable

BENEFITS/RISKS
Adopting a set of Investment Beliefs provides a framework for exercising judgment, making investment decisions and ensuring alignment among IC Members and staff, including:

- Providing a basis for strategic management of the investment portfolio
- Informing organizational priorities
- Ensuring alignment between the IC Members and staff
- Becoming part of the CalPERS culture

The biggest risk related to the adoption of the Investment Beliefs is that they do not become part of the CalPERS culture and are not reflected in CalPERS investment decisions. Staff is mitigating risk related to adopting the Investment Beliefs by presenting a draft Policy for review and adoption.

ATTACHMENTS
Attachment 1 – CalPERS Investment Beliefs and Sub-beliefs
Attachment 2 – CalPERS Statement of Investment Policy for Investment Beliefs
Attachment 3 – Wilshire Opinion Letter
Attachment 4 – PCA Opinion Letter

ERIC BAGGESEN
Senior Investment Officer
Asset Allocation / Risk Management

JOSEPH A. DEAR
Chief Investment Officer

CalPERS Investment Beliefs

Adopted

September 16, 2013

CalPERS | Investment Office

Investment Belief 1

Liabilities must influence the asset structure

Sub-beliefs:

- Ensuring the ability to pay promised benefits by maintaining an adequate funding status is the primary measure of success for CalPERS
- CalPERS has a large and growing cash requirement and inflation-sensitive liabilities; assets that generate cash and hedge inflation should be an important part of the CalPERS investment strategy
- CalPERS cares about both the income and appreciation components of total return
- Concentrations of illiquid assets must be managed to ensure sufficient availability of cash to meet obligations to beneficiaries

Investment Belief 2

A long time investment horizon is a responsibility and an advantage

Long time horizon **requires** that CalPERS:

- Consider the impact of its actions on future generations of members and taxpayers
- Encourage investee companies and external managers to consider the long-term impact of their actions
- Favor investment strategies that create long-term, sustainable value and recognize the critical importance of a strong and durable economy in the attainment of funding objectives
- Advocate for public policies that promote fair, orderly and effectively regulated capital markets

Long time horizon **enables** CalPERS to:

- Invest in illiquid assets, provided an appropriate premium is earned for illiquidity risk
- Invest in opportunistic strategies, providing liquidity when the market is short of it
- Take advantage of factors that materialize slowly such as demographic trends
- Tolerate some volatility in asset values and returns, as long as sufficient liquidity is available

Investment Belief 3

CalPERS investment decisions may reflect wider stakeholder views, provided they are consistent with its fiduciary duty to members and beneficiaries

Sub-beliefs:

- As a public agency, CalPERS has many stakeholders who express opinions on investment strategy or ask CalPERS to engage on an issue. CalPERS preferred means of responding to issues raised by stakeholders is engagement
- CalPERS primary stakeholders are members/beneficiaries, employers, and California taxpayers as these stakeholders bear the economic consequences of CalPERS investment decisions
- In considering whether to engage on issues raised by stakeholders, CalPERS will use the following prioritization framework:
  - **Principles and Policy** – to what extent is the issue supported by CalPERS Investment Beliefs, Principles of Accountable Corporate Governance or other Investment Policy?
  - **Materiality** – does the issue have the potential for an impact on portfolio risk or return?
  - **Definition and Likelihood of Success** – is success likely, in that CalPERS action will influence an outcome which can be measured? Can we partner with others to achieve success or would someone else be more suited to carry the issue?
  - **Capacity** – does CalPERS have the expertise, resources and standing to influence an outcome?

Investment Belief 4

Long-term value creation requires effective management of three forms of capital: financial, physical and human

Sub-beliefs:

- Governance is the primary tool to align interests between CalPERS and managers of its capital, including investee companies and external managers
- Strong governance, along with effective management of environmental and human capital factors, increases the likelihood that companies will perform over the long-term and manage risk effectively
- CalPERS may engage investee companies and external managers on their governance and sustainability issues, including:
  - Governance practices, including but not limited to alignment of interests
  - Risk management practices
  - Human capital practices, including but not limited to fair labor practices, health and safety, responsible contracting and diversity
  - Environmental practices, including but not limited to climate change and natural resource availability

Investment Belief 5

CalPERS must articulate its investment goals and performance measures and ensure clear accountability for their execution

Sub-beliefs:

- A key success measure for the CalPERS investment program is delivery of the long-term target return for the fund
- The long time horizon of the fund poses challenges in aligning interests of the fund with staff and external managers
- Staff can be measured on returns relative to an appropriate benchmark, but staff performance plans should include additional objectives or key performance indicators to align staff with the fund's long-term goals
- Each asset class should have explicit alignment of interest principles for its external managers

Investment Belief 6

Strategic asset allocation is the dominant determinant of portfolio risk and return

Sub-beliefs:

- CalPERS strategic asset allocation process transforms the fund's required rate of return to the market exposures that staff will manage
- CalPERS will aim to diversify its overall portfolio across distinct risk factors / return drivers
- CalPERS will seek to add value with disciplined, dynamic asset allocation processes, such as mean reversion. The processes must reflect CalPERS characteristics, such as time horizon and size of assets
- CalPERS will consider investment strategies if they have the potential to have a material impact on portfolio risk and return

Investment Belief 7

CalPERS will take risk only where we have a strong belief we will be rewarded for it

Sub-beliefs:

- An expectation of a return premium is required to take risk; CalPERS aims to maximize return for the risk taken
- Markets are not perfectly efficient, but inefficiencies are difficult to exploit after costs
- CalPERS will use index tracking strategies where we lack conviction or demonstrable evidence that we can add value through active management
- CalPERS should measure its investment performance relative to a reference portfolio of public, passively managed assets to ensure that active risk is being compensated at the Total Fund level over the long-term

Investment Belief 8

Costs matter and need to be effectively managed

Sub-beliefs:

- CalPERS will balance risk, return and cost when choosing and evaluating investment managers and investment strategies
- Transparency of the total costs to manage the CalPERS portfolio is required of CalPERS business partners and itself
- Performance fee arrangements and incentive compensation plans should align the interests of the fund, staff and external managers
- CalPERS will seek to capture a larger share of economic returns by using our size to maximize our negotiating leverage. We will also seek to reduce cost, risk and complexity related to manager selection and oversight
- When deciding how to implement an investment strategy, CalPERS will implement in the most cost effective manner

Investment Belief 9

Risk to CalPERS is multi-faceted and not fully captured through measures such as volatility or tracking error

Sub-beliefs:

- CalPERS shall develop a broad set of investment and actuarial risk measures and clear processes for managing risk
- The path of returns matters, because highly volatile returns can have unexpected impacts on contribution rates and funding status
- As a long-term investor, CalPERS must consider risk factors, for example climate change and natural resource availability, that emerge slowly over long time periods, but could have a material impact on company or portfolio returns

Investment Belief 10

Strong processes and teamwork and deep resources are needed to achieve CalPERS goals and objectives

Sub-beliefs:

- Diversity of talent (including a broad range of education, experience, perspectives and skills) at all levels (Board, staff, external managers, corporate boards) is important
- CalPERS must consider the government agency constraints under which it operates (e.g., compensation, civil service rules, contracting, transparency) when choosing its strategic asset allocation and investment strategies
- CalPERS will be best positioned for success if it:
  - Has strong governance
  - Operates with effective, clear processes
  - Focuses resources on highest value activities
  - Aligns interests through well designed compensation structures
  - Employs professionals who have intellectual rigor, deep domain knowledge, a broad range of experience and a commitment to implement CalPERS Investment Beliefs

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
STATEMENT OF INVESTMENT POLICY

FOR
INVESTMENT BELIEFS

September 16, 2013

This policy is effective immediately upon adoption.

I. PURPOSE

The California Public Employees' Retirement System ("CalPERS") Total Fund Statement of Investment Policy, adopted by the CalPERS Investment Committee ("Committee"), sets forth CalPERS overarching investment purposes and objectives with respect to all its investment programs.

This document sets forth the investment policy ("Policy") for CalPERS Investment Beliefs ("Investment Beliefs"). The design of this Policy ensures that the Committee and the CalPERS Investment Staff ("Staff"), along with external managers and investment consultants, take prudent and careful action when managing CalPERS assets. This Policy requires that CalPERS develop and maintain a set of Investment Beliefs.

The Investment Beliefs are included as Attachment A.

II. STRATEGIC OBJECTIVE

CalPERS investment goals are broad in nature. The overall objective of CalPERS investment program is to provide members and beneficiaries with benefits as required by law. This will be accomplished through a carefully planned and executed long-term investment program that efficiently and effectively allocates and manages the assets of CalPERS.

Managing the CalPERS investment program requires exercising judgment in the face of considerable uncertainty. The Investment Beliefs provide a framework for exercising judgment and making investment decisions. Investment Beliefs:

- Provide a basis for strategic management of the investment portfolio
- Inform organizational priorities
- Ensure alignment between the Committee and Staff
- Become part of the CalPERS culture

Investment Beliefs also provide context for CalPERS actions. They reflect CalPERS values and acknowledge CalPERS responsibility to sustain its ability to pay benefits for generations. The Investment Beliefs also acknowledge the critical importance of a strong and durable economy in achieving CalPERS objectives.

The Investment Beliefs are not a checklist to be applied by rote to every decision. They are a guide for making judgmental decisions that often require balancing multiple, inter-related decision factors.

III. RESPONSIBILITIES

A. Staff is responsible for the following:

1. Facilitating a periodic review of the Investment Beliefs in conjunction with the Strategic Asset Allocation process.

2. Reporting to the Committee on investment program strategy and its consistency with the Investment Beliefs.

3. Integrating the Investment Beliefs into Committee and Staff orientation and ongoing Staff communication programs.

B. The General Pension Consultant ("Consultant") is responsible for participating in the periodic review of the Investment Beliefs.

IV. PERFORMANCE OBJECTIVE AND BENCHMARK

Not applicable.

V. CALCULATIONS AND COMPUTATIONS

Not applicable.

VI. GLOSSARY OF TERMS

Key words used in this Policy are defined in CalPERS Master Glossary of Terms.

Adopted by the Investment Committee:

Attachment A

INVESTMENT BELIEFS

September 16, 2013

I. Liabilities must ~~should~~ influence the asset structure.

A. Ensuring the ability to pay promised benefits by maintaining an adequate ~~Improving~~ funding status is the primary ~~a significant~~ measure of success for CalPERS.

B. CalPERS has a large and growing cash requirement and inflation-sensitive liabilities; assets that generate cash and hedge inflation should be an important part of the CalPERS investment strategy.

C. CalPERS cares about both income and appreciation components of total return.

D. Concentrations of illiquid assets must be managed to ensure sufficient availability of cash to meet obligations to beneficiaries.

II. A long time investment horizon is a responsibility and an advantage.

Long time horizon **requires** that CalPERS:

A. Consider the impact of its actions on future generations of members and taxpayers.

B. Encourage investee companies and external managers to consider the long-term impact of their actions.

C. Favor investment strategies that create long-term, sustainable value and recognize the critical importance of a strong and durable economy in the attainment of funding objectives.

D. Advocate for public policies that ~~Play a role in~~ promote~~ing~~ fair, orderly and effectively regulated capital markets.

Long time horizon **enables** CalPERS to:

A. Invest in illiquid assets, provided an appropriate premium is earned for illiquidity risk.

B. Invest in opportunistic strategies, providing liquidity when the market is short of it.

C. Take advantage of factors that materialize slowly such as demographic trends.

D. Tolerate some volatility in asset values and returns, as long as sufficient liquidity is available.

III. CalPERS investment decisions may reflect wider stakeholder views, provided they are consistent with its fiduciary duty to members and beneficiaries.

A. As a public agency, CalPERS has many stakeholders who express opinions on investment strategy or ask CalPERS to engage on an issue. CalPERS preferred means of responding to issues raised by stakeholders is engagement.

B. CalPERS primary stakeholders are members / beneficiaries, employers and California taxpayers as these stakeholders bear the economic consequences of CalPERS investment decisions.

C. In considering whether to engage on issues raised by stakeholders, CalPERS will use the following prioritization framework:

1. Principles and Policy – to what extent is the issue supported by CalPERS Investment Beliefs, Principles of Accountable Corporate Governance or other Investment Policy?

2. Materiality – does the issue have the potential for an impact on portfolio risk or return?

3. Definition and Likelihood of Success – is success likely, in that CalPERS action will influence an outcome which can be measured? Can we partner with others to achieve success or would someone else be more suited to carry the issue?

4. Capacity – does CalPERS have the expertise, resources and standing to influence an outcome?

IV. Long-term value creation requires effective management of three forms of capital: financial, physical and human.

A. Governance is the primary tool to align interests between CalPERS and managers of its capital, including investee companies and external managers.

B. Strong governance, along with effective management of environmental and human capital factors, increases the likelihood that companies will perform over the long-term and manage risk effectively.

C. CalPERS may engage investee companies and external managers on their governance and sustainability issues, including:

1. Governance practices, including alignment of interests.

2. Risk management practices.

3. Human capital practices, including but not limited to fair labor practices, health and safety, responsible contracting and diversity.

4. Environmental practices, including climate change and natural resource availability.

V. CalPERS must ~~shall~~ articulate its investment goals and performance measures and ensure clear accountability for their execution.

A. A key ~~The primary~~ success measure for the CalPERS investment program is delivery of the long-term target return for the fund.

B. The long time horizon of the fund poses challenges in aligning interests of the fund with Staff and external managers.

C. Staff can be measured on returns relative to an appropriate benchmark, but Staff performance plans should include additional objectives or key performance indicators to align Staff with the fund's long-term goals.

D. Each asset class should have explicit alignment of interest principles for its external managers.

VI. Strategic asset allocation is the dominant determinant of portfolio risk and return.

A. CalPERS strategic asset allocation process transforms the fund's required rate of return to the market exposures that Staff will manage.

B. CalPERS will aim to diversify its overall portfolio across distinct risk factors / return drivers.

C. CalPERS will seek to add value with ~~a~~ disciplined, dynamic asset allocation ~~and rebalancing~~ processes, such as mean reversion. The processes must reflect CalPERS characteristics, such as time horizon and size of assets.

D. CalPERS will consider investment strategies if they have the potential to have a material impact on portfolio risk and return.

VII. CalPERS will take risk only where we have a strong belief we will be rewarded for it.

A. An expectation of a return premium is required to take risk; CalPERS aims to maximize return for the risk taken.

B. Markets are not perfectly efficient, but inefficiencies are difficult to exploit after costs~~given CalPERS size~~.

C. CalPERS will use index tracking strategies where we lack conviction, or demonstrable success, that we can add value through active management.

D. CalPERS should measure its investment performance relative to a reference portfolio of public, passively managed assets to ensure that active risk is being compensated at the Total Fund level over the long-term.

VIII. Costs matter and need to be effectively managed.

A. CalPERS will ~~attempts to~~ balance risk, return and cost when choosing and evaluating investment managers and investment strategies.

B. Transparency of the total cost~~s~~ to manage the CalPERS portfolio is required of CalPERS business partners and itself.

C. Performance fee arrangements and incentive compensation plans should ~~attempt to~~ align the interests of the fund, Staff and external managers.

D. CalPERS ~~We~~ will seek to capture a larger share of economic returns by using our size to maximize our negotiating leverage. We will also seek to ~~maximize our negotiating leverage and~~ reduce cost, risk and complexity related to ~~s of~~ manager selection and oversight.

E. When deciding how to implement an investment strategy, CalPERS will implement in the most cost effective manner.

IX. Risk to CalPERS is multi-faceted and not fully captured through measures such as volatility or tracking error.

A. CalPERS shall develop ~~needs~~ a broad set of investment and actuarial risk measures and clear processes for managing risk.

B. The path of returns matters, because highly volatile returns can have unexpected impacts on ~~as it impacts actuarial risk considerations such as~~ contribution rates and funding status.

C. As a long-term investor, CalPERS must consider risk factors that emerge slowly over long time periods, but could have a material impact on company or portfolio returns, such as natural resource availability.

X. Strong processes and teamwork and deep resources are needed to achieve CalPERS goals and objectives.

A. Diversity of talent (including a broad range of education, experience, perspectives and skills) at all levels (Board, Staff, external managers, corporate boards) is important.

B. CalPERS must consider the government agency constraints under which it operates (e.g., compensation, civil service rules, contracting, transparency) when choosing its strategic asset allocation and investment strategies.

C. CalPERS will be best positioned for success if it:

1. Has strong governance.

2. Operates with effective, clear processes.

3. Focuses resources on highest value activities.

4. Aligns interests through well designed compensation structures.

5. Employs professionals who have intellectual rigor, deep domain knowledge, a broad range of experience and a commitment to implement CalPERS Investment Beliefs.

Asset Class Glossary: CalPERS Investment Policy Statement
Policy: Investment Beliefs

General Pension Consultant
An individual or organization that provides specialized professional assistance to the Investment Committee in determining the pension fund's asset allocation model or optimal combination of investments in order to maximize risk-adjusted investment returns in a manner consistent with the State's long-term pension liabilities.

Michael C. Schlachter, CFA
Managing Director & Principal

August 22, 2013

Mr. Henry Jones
Chair, Investment Committee
California Public Employees' Retirement System
400 Q Street
Sacramento, CA 95814

Re: Adoption of Investment Beliefs and Review of Investment Beliefs Policy

Dear Mr. Jones,

You requested our opinion regarding this agenda item that begins the process of formally adopting the investment beliefs.

Recommendation

As the Investment Beliefs are the result of an exhaustive body of work by the Board and Staff and reflect the best thinking of both, and based on the observation that there was near-unanimous consensus on these beliefs at the July off-site, we recommend approval of the Investment Beliefs.

Discussion

Given the number of opportunities that the Board has had to contribute to the development of these beliefs, as well as the aforementioned near-consensus on the beliefs in their present form, we believe that they reflect the thinking of the majority of the Board and should be approved.

We believe that the policy presented also fairly represents the Beliefs at this time and we do not recommend any changes to the specifics contained within the beliefs as stated in the policy.

We do recommend, however, that the policy be altered to more clearly reflect the nature of the "periodic review" of the beliefs. Will this be a simple re-ratification of the existing beliefs or will the Board spend six months to a year every three years (as is does with the asset allocation process) to review and adopt a new set of beliefs. While we do allow for circumstances to change over time, we believe there is value in establishing the scope of the review process up front.

Second, while it may not be appropriate to contain in the actual policy, more direction from Staff regarding the extent and periodicity of the reporting to the Investment Committee regarding the compliance with these beliefs is also appropriate to discuss before these beliefs are set in place.

Should you require anything further or have any questions, please do not hesitate to contact us.

Best regards,

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Mr. Henry Jones, Chairman
Investment Committee
California Public Employees' Retirement System
400 "P" Street
Sacramento, California 95814

Re: Statement of Investment Policy for Investment Beliefs, Agenda Item 6a

Dear Mr. Jones:

The purpose of this letter is to recommend that The Investment Committee (The Committee) adopt the proposed Statement of Investment Policy for Investment Beliefs as detailed in attachment to Agenda Item 6a.

We believe that the processes that led to the proposed policy were innovative, thoughtful, comprehensive and deliberate. The Committee, with support and input from Staff, consultants, and a range of stakeholders, participated in a dynamic and productive decision-making process that resulted in the proposed policy.

The proposed policy provides a well thought out and inclusive framework for exercising judgment in the investment decision making process. PCA had the privilege of being included in the evolution of the proposed policy from its inception. During that evolution, the creativity, openness, and commitment of time and energy from the Committee and Staff were unprecedented.

We look forward to addressing any questions you may have at the Committee meeting.

Sincerely,

Allan Emkin,
Managing Director