

## The California Retirement Dialogue

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Operator: Not Introduced  
Host: Patricia K. Macht, Director of External Affairs  
Presenter: Joe Dear, Chief Investment Officer

### Audio Transcript

Operator:

Good afternoon, ladies and gentlemen, and welcome to the Investment Returns and Strategies conference call. At this time all participants are in a “listen only” mode. Later we will conduct a question-and-answer session. Please note that this conference is being recorded. At this time I will turn the conference over to Ms. Pat Macht.

Host:

Good afternoon. I’m Pat Macht, Director of External Affairs at CalPERS. I want to welcome you to the first event of the California Retirement Dialogue (CRD), a series of web conferences and issue forums about retirement issues hosted by CalPERS. The goal of the CRD is to promote greater understanding of public retirement issues by engaging representatives of public employee groups, public employers, and other interested stakeholders and parties in a fact-based dialogue about the future of retirement issues and the vital components that impact benefits.

Today’s webinar features CalPERS Chief Investment Officer, Joe Dear. Joe is going to talk about the future investment landscape at CalPERS and the long-term investment strategies used by public pension funds. He will also address our ability to meet the assumed rate of returns needed to fund benefit obligations in the future.

We’ve scheduled a second webinar on January 7th to discuss employer contribution rates, and to focus on rate smoothing methodologies. You will be receiving registration information on that event very soon.

Finally, I want to encourage you to save the date for two in-person issue forums that we have scheduled for next year. On January 29th we’ll be at the Sacramento Convention Center and on February 12<sup>th</sup> in Los Angeles at the LA Convention Center. For those who may be interested in coming to Los Angeles, the day before there will be a public retirement journal seminar held in the same location. So if you’re interested in attending both of those it will be very convenient for you to do so. We will be getting registration information out soon about all of these events.

Now, here are a few housekeeping items for today’s webinar. First, if you want to speak to an operator, just press star-zero (\* + 0) on your phone. You can

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submit questions by text after on the web via computer or by phone. We also expect this webinar to last about an hour, which will include a Q&A session at the end of Mr. Dear's presentation. By the way, a video of today's webinar will be available online beginning next week on the CalPERS Web site. It's going to be on [www.CalPERSresponds.com](http://www.CalPERSresponds.com). Also, any questions we can't get to today on this webinar will be answered online along with the video. So, on behalf of CalPERS, I want to thank you for joining us today and now I'm going to turn it over to our Chief Investment Officer, Joe Dear.

Presenter:

Thank you very much, Pat. Good afternoon or good day to all our listeners. Thank you so much for taking the time to join in the conversation. I want to make some remarks about the CalPERS portfolio, the issues that we face in the investment world, the challenges, how we're addressing these challenges, and then I look forward to taking your questions. We'll talk about the environment, we'll talk about our programs, and we'll talk about future marketplace activities.

The current investment landscape remains dominated by the impact of the financial crisis of 2008. Although conditions are considerably better a year after, we are still dealing with the impact of the crisis and we are not completely done with managing through the difficulties that the credit implosion and the loss of confidence caused in 2008. The economy appears to be stabilizing as the economic stimulus and financial institution recapitalization are having their intended effect. Policy reform in terms of legislation and regulatory changes are being debated in Washington, D.C. and we'll talk more about those in the course of the presentation. They are vital to creating conditions which will sustain the economic recovery, which in turn, is what our future investment returns depend on. And finally, as the dust settles, more clarity in the financial markets will create greater visibility about the opportunities that investors have going forward.

The market value of the CalPERS portfolio today stands at just over \$200 billion. This represents a \$40 billion improvement from the low we experienced in March, 2009. As of November 30, our 20-year annualized rate of return was 7.85 percent, and that's a very important number because the assumed rate of return for CalPERS investment portfolio is  $7\frac{3}{4}$  percent. That number is critical because it is used to determine the funding of the pension system; and our ability to obtain that target then is critical to the financial success and solvency of the program. I'll also talk more later about why that  $7\frac{3}{4}$  percent return target is an attainable and achievable objective.

Key drivers of market performance these days and the performance of investment portfolios include strategically employing our asset allocation and rebalancing policies. We'll talk about asset allocation in a moment, promoting capital market regulatory reform, and taking advantage of opportunities. Because, amidst all this dislocation and concern and potential fear of investors, there are opportunities for those who have carefully thought through their

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portfolios and understand how to step forward in conditions of uncertainty and therefore reap the gains of moving again.

We will also be examining the alignment of interest with our investment partners. This is an important feature of the public pension fund landscape these days, and we'll talk about that in a minute as well.

And finally, within CalPERS, we are striving to build a comprehensive culture of risk assessment and risk management. Our current asset allocation is shown in this pie chart. The 26.1 represents US domestic equity. Moving around in clockwise fashion, 22 percent is domestic fixed income portfolio. The next at 11.4 percent is our private equity as we call it our Alternative Investment Management (AIM) portfolio. The 28.4 percent represents the non-US equity investments in the portfolio. 2.1 percent represents the non US fixed income component. 6.9 percent is the real estate portfolio. 2.3 percent represents the inflation linked asset class.

This is the actual allocation at the end of the third quarter. This portfolio, therefore, shows the deviation from our target. We are slightly overweight in the equity category, a bit less, but still overweight in fixed income. We are below target weight in AIM and private equity at 11.4 percent. The target there is 14. That asset class is not subject to quick rebalancing because of the nature of those investments. And Real Estate is also under its 10 percent target.

Just a little bit more on the asset allocation. The critical decision of an institutional investor is how to allocate assets. It is the diversification that asset allocation produces which is the primary management tool for risk in the portfolio. CalPERS normally does a full-blown asset liability study every three years and we are scheduled to do that in 2010. However in 2009 our Board wanted to take a look at the Asset Allocation in light of the crisis and determine if the assumptions we made about return correlation variances were still valid and whether any adjustments or tweaks to the portfolio were required. As a result of that review in June 2009, the Board did make some adjustments in the portfolio. The most significant of those was the increase in the private equity by 4 percentage points, from 10 to 14 percent, and by creating a 2 percent allocation to cash.

Some descriptions of this portfolio adjustment described it as taking on a lot more risk. I don't think that's correct. The AIM portfolio, the private equity portfolio, at the time that change was made, was about 13 percent. That's primarily because we had a large number of commitments that were already in the ground. And the drop in the value of public securities, a denominator effect if you will. We did not want to be in a situation where we could not make future private equity investments or had to reduce our current portfolio holdings in order to meet an arbitrary portfolio target and therefore miss opportunities. So we did want to

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expand the private equity allocation. That did increase risk a bit, but not as much as the 4 percent point increase indicated.

To balance that out and also apply lessons we learned in the fall of 2008, we created a 2 percent allocation to cash. This gives us a liquidity reserve and that reduced the risk in the portfolio.

Overall, on a statistical basis, if you measure risk in terms of volatility, which is a typical way of quantitatively measuring risk in an investment portfolio, the portfolio essentially had its risk level unchanged...it went down slightly, fractionally. So we did not change the risk profile. We just made some temporary adjustments in the allocation.

With those targets we have,...I think what's notable in this portfolio,... in addition to the commitment in Real Estate and Private Equity, ...is the Global Equity Allocation we have that we attempt to match our investments in equities on the basis of a global market capitalization,...about 55 percent of all equities outside the United States and about 55 percent of the portfolio equity value held outside the U.S.. Over the coming years, we will be looking at whether we want to be increasing the exposure in the portfolio to emerging markets. We expect more growth to occur in the emerging markets over the long haul as the middle classes in those countries begin to emerge and consumer economies develop.

Let's move on and look at the next slide which talks more about our environment...

But,..we're going to talk about strategic considerations instead.

We're going to maintain our discipline as a long-term investor. This is so important. When we have the kind of dislocation that we have experienced over the past couple of years and portfolios suffer losses, like we did and like every other investor did, there's a challenge to come forth and say that perhaps the portfolio was allocated incorrectly or that strategies upon which we had made assumptions were not appropriate and that changes should be made.

One of the greatest mistakes investors can make is changing a portfolio when it is under pressure. It's vitally important to maintain the courage of one's convictions in markets. And this we've done by maintaining our discipline as a long-term investor. One of the key strategic advantages of a public pension fund is a long-time horizon. We don't have to be expressly concerned about quarterly movements or daily movements in prices. We can think long-term – 5, 10, 15, 20 years – and allocate our assets on that basis. And because we can take that long perspective, we can have some comfort in knowing that we invested in an economic system that is characterized by fluxuations, by ups and downs in economic cycles. Now it's not often as severe as the one we have recently experienced, but these cycles are a fundamental and integral element of these

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systems. And knowing that we can ride through these ups and downs gives us the courage to maintain our convictions in our investment program.

Other strategic considerations: The importance of enhancing risk management; increasing our staff's capacity and the capacity that we engage through our investment partners to manage assets; and always be able to attract, develop and retain skilled staff.

Risk management lessons are among the most powerful we have as a result of the crisis. What do I mean by that? Institutional investors and others rely heavily on statistical tools to assess the amount of risk in the system. What we know from the crisis is these tools are useful but they are not sufficient in and of themselves to be guides to all of the risks that must be considered in an investment portfolio. The quantitative tools help, but also what really matters is the qualitative tools. The judgment and experience that investment teams like the one here at CalPERS bring day-to-day to bear on the decisions we make.

So when we talk about enhancing risk management capabilities we are talking about creating a culture that's built and engrained around the consideration of the risk in the portfolio. It's not the job of some group called the risk management group. It's the job of everybody who has managed portfolio management responsibilities in CalPERS to think about risk management. And that at the senior levels a frequent, detailed, challenging conversation about what we measure in terms of risk on the qualitative side and how we judge the risk of the portfolio. This is one of the keys to our success going forward.

Defining our future. We want to identify new investment paradigms. One of the great questions now is in light of the crisis, what's changed, what's different, and what needs to be adapted to and what has not changed? And often in the flow of conversation day-to-day about this, some of the things that really look different aren't. Human nature hasn't changed, for example, and some of the things that may look somewhat similar actually represent more profound, deeper changes.

One of the questions we have is are we in a regime where asset returns will be different as a result of changed behavior, or changed market conditions, and what should we do about that? It's likely that the growth that we've seen coming out of the developed markets in North America and Western Europe is going to continue to shift to emerging markets. Already there's divergent return among the so-called Brit countries, Brazil, Russia, India and China. Chinese growth as a result of their stimulus has helped keep the world economy on track. We want to be able to adapt our strategy to take advantage of this environment.

A large portfolio like CalPERS can't succeed on the basis of lots of little tactical moves the way smaller investment programs can work. But we can take advantage of our ability to use insight and a long horizon to capture bigger and more significant trends and take advantage of those. And I've already mentioned

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ones that are of particular interest to us, the trend in emerging markets. Managing risk investment accordingly, again, is a huge priority for us, as it is for all investors.

And finally, we need to be promoting financial regulatory reform, the policy front to all of this. Government issues are extremely important. One of the contributors to the crisis was the failure of government in private corporation. Investors, corporation regulators, legislators, stakeholders all have to work together to restore integrity, trust, and confidence in the global market.

Financial regulatory reform then becomes unusually important in terms of the public policy consideration for a fund like CalPERS. What do we mean by financial regulatory reform?

First, increase transparency both to regulators and investors about the risks in company portfolios, particularly those of financial institutions and independence for regulatory agencies so they have the authority and the skill and confidence to take action before problems become so big that they cause system wide issues. The independence of regulators in terms of their willingness to act and their funding so that they have the capacity to act is really important.

Corporate Governance reform, a hallmark of CalPERS over the years is its work on corporate government. If the regulators aren't successful in protecting the interest of investors, the next line of defense is the corporate board of directors. They are the owners' representative with management. And if they're aligned with the interest of the shareholders over the long term the governments of the corporations will be better, and research has shown that better governed companies are better investment opportunities.

Financial regulatory reform also may govern the type of investment opportunities that are out there. One of the things that's important to institutional investors is preserving the full set of investment opportunities that's out there. There were proposals in the middle of 2008 to restrict the ability of institutional investors to do certain types of commodity investing. Sophisticated investors should have the full suite of options available to them to invest.

Another element of regulatory reform is systemic risk. Clearly the focus of regulation in the United States,... divided up among different federal entities at the state level, ... no one with a responsibility or the data to look system-wide at what was happening...and lacking the authority to intervene when risk levels became excessive,...was one of the major contributors to the difficulties that we experienced in 2008. This question of systemic regulatory risk and its control is one of the principal issues that is being addressed in the legislation that's moving through the United States Congress.

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Finally, to help answer the question from the investors' perspective as to what should change CalPERS ... A number of other pension funds, former regulators, academics, and investors worked together in 2009 to develop a blueprint for financial regulatory reform. There is a report titled "The Investor's Perspective" on that. And we have been using that to help guide our interactions with policy-makers in D.C. as they consider changes.

Let's talk a little bit more about why, what the tools are for investors that will help improve governance and protect against the impact of another crisis. The first and foremost among the investor tools we see is proxy voting for directors. One of the major functions of a shareowner is to vote the interest they have on the company's proxy. And one of the main things they have on that proxy ballot is the election of directors. Under current rules it is extremely difficult and expensive for investors to propose their own directors.

A friend of mine said the Communist Party should be happy with the type of election system we have for directors in the U.S.. Typically there's no opponent. The only option you have is to vote for them or not vote at all and if the director gets one vote they're re-elected even if all the other shares in the company are withheld.

We learned that the failure of some companies to adequately govern the corporation is one of the principle risks that investors face. And, accordingly, investors need a new tool, a stronger tool to help hold boards accountable. And the principle tool is direct access to the proxy. In those limited circumstances where a company's board just simply failed to heed the voice of investors. Proxy access is a rule that has been proposed by the Securities and Exchange Commission and the clarification of the FCC's authority to adopt that rule is one of the most important elements that were approved by the U.S. House of Representatives when it passed the financial services regulatory Wall Street regulatory reform act of 2009.

Corporate engagement is another tool that investors use to constructively engage in dialogue with companies to address poor performance and poor government's practices. Every year CalPERS identifies 15 companies for its focus list and begins to dialogue with them. Research has shown over time the companies CalPERS identifies underperform before criteria that we use. But after the government's changes are adopted, the five-year performance of those companies is over 3 percent better than the public markets generate. The governance is not just a practice of a permanent owner like CalPERS it's also a good investment tool.

Finally, we are interested in improving the investor collaboration to advance government's best practice at the market level and individual company level through leadership in investment organizations. Ones like the Council of Institutional Investors, which I chair, the institutional limited partners association,

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which joins investors and private equity partnerships together and the international corporate governance network, which on a global basis brings investors together in the interest of improving the regulatory oversight counting oversight policies that govern the practice of markets around the world.

One other issue that has been high on the list of investors and policy-makers in light of the crisis is executive compensation. This is something that even folks on the street get that when pay for failure. When we, companies we invest in, provide outside compensation to executives who may be taking excessive risk and will reap huge short-term benefits but leave share owners and now the government stuck with the consequences of their overly risky behavior. This simply has to stop. One way we want to see that happen is for investors to get a say-on-pay, the opportunity to have an advisory vote on an annual or bi-annual or tri-annual basis about a company's executive compensation program. And use the shareowner vote to communicate to the board and its compensation committee why we think the compensation scheme for the company makes sense. It appropriately rewards success, which we're all interested in, but also doesn't behavior, which is too risky, or, as I said, provides pay for failure, that outside compensation when the earnings of the company simply don't justify.

Environmental disclosure is another area, which CalPERS is leading. And for a long horizon investor the question of the sustainability of our economic system and the markets in which we invest is a critical and extremely interesting question. One of things that investors need is access to information. Markets need information in order to make judgments about the valuations of companies, about their risk exposure to environmental climate change related issues. The Securities and Exchange Commission has proposed changes to disclosure in terms of climate risk information. And we think this is a very important step to be taken to give all investors, not just institutional investors, but all investors the opportunity to include environmental risk considerations as they make their investment decisions.

Another issue that is very important to CalPERS is diversity, expanding the opportunity set, the viewpoint, the reach of expertise to boards of directors and elsewhere in the investment industry. We have commissioned research, which has shown that boards of companies that are more diverse are boards of companies that can have better investment performance. We want companies to be much more active in broadening the search for directors. It's just not good enough to look among the regular friends and insiders in a company, in an industry for directors. We need to expand the opportunity set, expand the candidate pool so that we get more judgment, more viewpoints, and more expertise on company boards of directors.

Diversity in the boardroom can lead to greater creativity, deliberation and integrity and we are working to help build a diverse pool of talented, qualified professional director candidates. This will be come particularly important if our aim to gain

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access to the proxy for director nominations becomes real we'll need to identify candidates who can fulfill that objective.

So let me summarize. Positive outlook on financial markets: It's so much better than it was over a year ago. A little over a year ago investors like me felt like we were staring into the abyss. We weren't sure how it was going to turn out. As a consequence of decisive action by policy makers to shore up credit, to stimulate the economy as a response by investors whose cooler heads were able to prevail and whose confidence could be maintained that could stick with the difficult markets we've seen a remarkable turn. Equity markets in the U.S. are up over 20 percent and emerging markets by more than double that. We remain cautiously optimistic about the future and the prospects for investment.

What will help determine the success of those outcomes? First, now that markets have stabilized and investor confidence has returned we need to see the transition away from government credit support and fiscal stimulus to organic economic growth. This is important for a number of reasons. Organic economic growth will help drive corporate profits. These profits are essential to driving equity prices which we need to continue to see rise so we can meet our financial objectives.

What is it going to take? Well, the big question is how soon and how strong this transition to sustain economic growth will be. What are we looking for here? Continued improvement in the housing market. A turn-around in the jobs market.

The employment picture in the United States at this time of the year remains distressingly difficult. Unemployment above 10 percent. Although the rate of increase in unemployment has slowed, it is still rising. It's vitally important that new jobs be added to the economy at a rate that is sufficient to begin to drive down the unemployment rate.

This will help improve consumer confidence, and 70 percent of our economy is driven by consumer spending. So consumer confidence is a vital element of the recovery. Economic growth is also critical because this is the best way we have of deleveraging or reducing debt on household, financial institutions and government balance sheets. If we don't have adequate economic growth, the policy options available to government and the investment options available to investors will be much more constrained and will be limited often to very difficult and grim choices. So what we want to see in the year ahead is this transition to organic economic growth. When we see that we will know we're going to come out okay.

This last question, our confidence and our ability to achieve our 7 ¾ percent rate of return. In the near term, we have not been meeting that, even on a 10-year basis. But if you look back at CalPERS history since its inception our rate of return is over 7 ¾ percent. That's a 20 year performance record. So if we look

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forward 20 years, do we believe that equities will be able to out-earn fixed income securities, that economic growth will be there, that the resilience of the capital market system will prove itself again; and new sources of growth and new entrepreneurial energy and new sources of capital will be available. And we'll get the economic growth we need. Yeah, you bet, we do. We're confident in our ability as a long horizon investor with a globally diversified portfolio to meet this objective.

Thank you so much for listening to this presentation. I'd be delighted now to turn to your questions and I believe I have one now to get started and there are multiple ways of accessing the questions.

First Question:

What percentage of the portfolio is California Real Estate?

Answer:

The Real Estate in the portfolio is just below 7 percent and I'll have somebody go get that information to answer it here, but we do have a number of programs in our Real Estate program aimed at the California market including the California Urban Real Estate program and we'll get you the specific percentage. So the first question stumped me.

Question:

How much do you have in hedge funds and why don't you have a separate target allocation to them?

Answer:

We have about six billion dollars invested in what we call our Risk Management Absolute Return Strategies, the RMARS strategy. It is contained within the Global Equity Allocation and it's managed out of that unit and that's actually one of the questions that we're working on today is both the source of capital for the hedge fund program and its organizational home. There are a number of other things about the hedge fund program that are important. It is not just investing in equity or equity related securities it also has commodity-based investments and investments in fixed income products. Its return objective is to beat T-Bill rate by 5 percentage points, and it has been successful over time in doing that. We don't necessarily have a plan to increase the capital allocated to that program although that may adjust incrementally in the near term. But it's clearly more than an equity related program. So it's management and a supervision that's going to be done on a holistic basis across the entire portfolio.

I'm going to get more questions I hope. Then we'll turn over the Q&A, okay, that's what this card says, let's turn this over to the operator. Operator, we're happy to take Q&A from the audience.

Operator:

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Thank you sir. We will now begin the question and answer session. If you have a question, please press star "\*" then one "1" on your touch-tone phone. If you wish to be removed from the Queue, please press the pound sign "#" or the hash key. If you are using a speakerphone you may need to pick up the handset first before pressing the numbers. Once again, if there are any questions please press star "\*" then one "1" on your touch-tone phone. We are now standing by for questions.

I'm showing no questions at this time.

Presenter – Question:

I have a text question. What do you expect for a 2011 increase for local fire district with a 3 percent I guess with the social security?

Answer:

Well, I'm an investment guy and this is a rate question. So I'm not really able to regret, I'm not able to answer that question. I'm the guy that takes the money and invests it. One of my colleagues in the Actuarial Department is the one that works with rates. I'm sure there will be a webinar with him at some point and we'll get this question on. But we can't do that, we'll try to get an answer for you before we terminate this webinar, answer next week.

How about an investment question.

Question:

Do you think agency leveling, as is, will be enough or will a rate increase be needed?

Answer:

Let me speak to this from an investment standpoint, which I've already tried to do. When you think about the total pension dollar that is what's actually paid out to the beneficiaries with whom we work, of that dollar about .75 cents is earned by investments and the remaining portion is roughly split equally between the workers contributions from his or her paycheck, the beneficiary, and the employer contribution. So .25 cents on contribution and .75 cents on investment return.

The job of course is that .75 cents, that piece that is attributable to investment earnings. And what's essential is that the long-term earning assumption, that 7  $\frac{3}{4}$  percent be attained because if it is not then the rates that are attributed from the beneficiaries and from their employers will be insufficient.

Over the long-term it's vital that the investment program get that 7  $\frac{3}{4}$  percent return. And that's why I tried to address our confidence in our ability to do that over the long-term. And we're not talking about 7  $\frac{3}{4}$  percent every year or every two years we're talking about 7  $\frac{3}{4}$  percent over the long-term. And our track

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record of the past 20 years through a number of notable cycles, including the last one, shows that we can do that. You've got to believe that capitol markets are going to retain their long term historic earning capabilities. And if that remains true, and there's every reason to believe that is, and we're talking decades of data, then we'll be able to achieve that return objective.

Question:

In light of the crisis of our State can the governor borrow money from the CalPERS retirement fund?

Answer:

No. It's a trust fund. The Board of CalPERS are fiduciaries, essential obligation is to make decisions in the best interest of the funds beneficiaries. This has been tested in the courts and reaffirmed in the State Constitution that the Board has the sole authority and truth of authority to make decisions. And so these funds can't be raided for any purpose. They can only be used to pay benefits that are earned by our beneficiaries.

Question

Are you optimistic about regulatory reform? What reforms do you think are likely?

Answer:

I am determined and CalPERS is determined to see that policy makers take the steps necessary to produce real regulatory reform. One of the great things about our system is that everyone gets to participate in it. And not all interests who are working in D.C. have the same degree of enthusiasm, commitment and belief in the importance of regulatory reform to protect investors. So it's an open question. However, on the positive side, the leadership of Chairman, Barney Frank of the House of Financial Services Committee, in shepherding through the Wall Street reform act that was proved by the House of Representatives a week ago is extremely heartening. This was a comprehensive reform bill. It includes in it corporate governance reforms and other reforms that institutional investors like CalPERS have sought for more than 10 years. It addresses all the principle issues that have come as lessons of the financial services reform.

Does it go as far as it could in every instance? No. It is insufficient with respect to holding credit rating agencies accountable for their work product. I am also concerned that the loopholes that are contained in the provisions which attempt to bring greater transparency to over the counter derivatives. Some of those instruments were ones that contributed in a huge way to the difficulties of the market in 2008. There are too many loopholes left. More derivatives should be brought off the over-the-counter market, these custom exchanges, on to regulated exchanges or clearinghouses so there is transparency for these positions. The House did not go far enough for that and it's very important for the Senate as they consider legislation to do that.

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And also open in this question is how to approach systemic risk and that I think is probably the subject of a significant debate about how the role of the Federal Reserve should be adjusted, adapted to do that. But there should be no question with respect to systemic risk that all active players in the market should be required to furnish position data to a central body which can look at and survey all the markets and then that entity has to have the authority and capability and the means and the willingness to step in when conditions get to risky and that's another part of the debate.

What do I think is likely? I think it's likely the bill will pass. I think the real question here is, is it going to be the reform. Imagine a house that was blown away in a storm and its gotten a new paint job and new landscaping but it's really a rickety structure that will get blown away the next time there is a financial storm. Or is it a real rebuilt structure that can withstand the next big disruption in the markets? And I hope that's what will happen in the year, in the next year.

Question:

Do you intend to keep the availability for participants to purchase "Air Time" in the future?

Answer:

I love these questions and I wish I could answer them but they're just beyond the Investment Office and I will just mark these down and I will get them on our web site or somehow provide these answers to you. But this is not an area I have expertise in and I would not want to mislead you with a speculative answer in that regard.

I think we're looking for a few more questions and I would encourage anyone on the line.

Presenter:

One more question. Keep them coming we have a lot more time.

Question:

Can you explain again, who oversees the CalPERS investment policy? What happens if there is disagreement regarding these policies? Who decides if they should be changed?

Answer:

Our Board of Administration, as it sits, as the Investment Committee at CalPERS, the 13 members of the Board, six elected by beneficiaries and seven appointed by various authorities retain the ultimate authority for CalPERS Investment program. It is they who adopt the investment policies which guide the work of the staff. The Board hires me as the Chief Investment Officer; I in turn hire the rest of the staff. We are accountable for our work to the Board of Administration. In

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addition to adopting policies the Board oversees our performance. It receives independent advice on the performance of staff and independent calculations of investment performance. The Board also oversees the control systems and compliance systems around the program including audits, internal audits, compliance reviews and maintenance of surveillance over the entire control environment for CalPERS. So, it is the Board.

How do we handle disagreements? Well at the staff level we have wonderful debates. Vigorous debates among knowledgeable informed, passionate investors about what the best course forward is. And it is that debate that creates a staff view. We engage in a dialogue with our board about the investment program and they ask a lot of questions. They get out and around, they read, they challenge us to come up with new ideas, to be innovative and they ask us questions about our support portfolio where performance needs to improve. I would say then that it's a dialogue, it's a collaborative process between our board, the ultimate fiduciaries and staff like me who suggest and recommend action to the board, they decide and then we implement. We see what happens, we evaluate, we learn and we go forward.

Question:

Oh, I have a two-part question here. All right. It seems apparent that investments are connected to the performance of so many entities throughout the world. With so many economic factors that seem to indicate that recovery will be very slow, do you think the 7 ¾ percentage rate of return on investment is a realistic number that can be achieved in the near future?

Answer:

That's a wonderful question. Do I think 7 ¾ percent can be achieved in the near future? I'm not tremendously worried about 7 ¾ percent on very a short time periods of a year or less. Our portfolio at the end of June on a 12 month basis was down just over 24 percent, a huge, huge decline. For the 12 months that ended November 30, 2009 the portfolio was up almost 12 percent. Now think about that in terms of a swing. If you would have asked me that in June and I said I thought we could get 7 ¾ percent you'd go, this guy in unreasonably optimistic. You ask me today and the return for the past 12 months is well above 7 ¾ percent. What matters about the resumed rate of return is our ability to achieve it over a longer time period, 5, 10, 15, 20 years. In that, as I said earlier, I am confident that we can do that. We've seen cycles in our economic system throughout its history. Investors who can ride the ups and downs maintain confidence in their investment program, accept the risk to come from investing in capital markets and don't abandon their plans when their under stress, when things are difficult. We'll succeed in the long term. That's why I believe that the 7 ¾ percent is something we can do in spite of the increasing difficulty and challenge of investing in an increasingly complicated world.

Question:

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All right, another question. How can the CalPERS participant support the move to regulatory reforms? What is the best way to follow legislation and know when to support reform to our elected officers?

Answer:

I think there's a limit about our ability to advocate certain activity using public means. Be informed. Recognize that the expression of your voice, your concern to your elected officials can and does have an impact. Our web site contains information on the elements of the market reform we support. The web site and the member of congress in whose district you live will have this information and links and the popular in business press cover the financial services regulatory reform to date in great detail. There are many sources, but at the end, what you should be asking for is transparency so that all market participants have access to information. The independence of regulators, the accountability of all actors in the system, the investors, the regulators, the investment organizations are putting our money to work. The ability of investors...sophisticated investors to have access to the full range of investments changes in corporate governance like the ones we talked about given proxy access and closing gaps in the regulatory system bringing all actors, private equity and hedge fund in all products like derivative within the control of the regulatory system. If we get that we'll be better off.

Question:

Next Question. Are there other benchmarks other than 7 ¾ percent assumed rate of return against which outsiders can judge CalPERS investment performance?

Answer:

Well another tool that's used to gauge the performance of public pension plans is a peer universe. How do we do relative to other pension funds? So that's one way to judge the performance. I have to say that the 7 ¾ percent target is among the more conservative per state. By far, more plans have targets of 8 percent which means a slightly more risky portfolio to achieve that return and some have return assumptions above 8 percent. But a peer universe, and we publish that data in our quarterly performance reports which we publish to the web site, is another way of judging our performance. The problem with peer universe is it tells you the return, it does not tell you the risk the different funds took to get those returns. So you can reward those funds that take more risk in the short term and have short periods of out performance, but than can suffer periods of underperformance, not unlike other investment managers. I think its way more important to focus on a funds performance against its benchmarks. We have an aggregate benchmark of 7 ¾ percent and we have benchmarks for each asset class for Domestic Equity, for International Equity, for Private Equity, for Real Estate and so forth. If you're really interested in that, you can see on our

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website all of that performance information and then you can ask questions about why is this asset class performing underneath its benchmark. I report to the board often and deal with that in some detail.

Question:

Okay, another two-part question. Since the stock market goes up and down what will you do to protect investments from experiencing such a significant loss of 24 percent in the future? What have you learned from this significant loss?

Answer:

Wonderful question. Again, the most important risk management tool any investor has including institutional investors is diversification. Diversification among types of assets, stocks, bonds, private equity, real estate, hedge funds, inflation link assets like infrastructure across time, across geographies and across styles and skills and types of managers. There are products that allow investors to buy insurance, if you will, derivative products which can provide floors and ceilings to investment returns. Those tools are some we have considered using. But some of the tools that individuals or smaller investors can use are difficult to apply to a portfolio the size of CalPERS. For example if we were to try to protect the equity portfolio against losses, it's a hundred billion dollar portfolio there are not a lot of counter parties that would get on the other side of that if we were trying to put collar on that portfolio. Again the time tested tools of diversification are the best.

The question an investor has in assessing risk is; you can de-risk a portfolio by investing in more conservative and safer instruments. That will reduce the volatility of the portfolio which is a good thing if you're trying to avoid these ups and downs. But it also reduces the return of the portfolio which increases the cost of the system if you think about that .75 cent investment earning a .25 cent contribution, contribution rate, to the overall dollar of pension benefits, reducing risk means it would be more like .70, .30. So that's one of the balances we have to take.

What did we learn from this significant loss is that at the outset of this presentation I talked about the importance of improving risk management both from the standpoint of the quantitative but also by using better qualitative tools by developing a risk aware, a risk intelligent organization with respect to that. To me that's probably the most important set of lessons is that whatever we thought we knew of that risk and however important we thought risk management was to success of the investment program it is more important and more imperative that we improve our work in that regard. And that is a major priority for us now.

Question:

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Can you comment on the mood of our staff? Some of us have heard that it is dragging because of the apparent ethical lapses of former directors and others.

Answer:

I believe in the staff that I am a part of in the Investment Office. I know that they are confident and committed professionals. We work in a very challenging environment. One of the things that made our job even more difficult recently was the three days a month of furlough that most of the staff have to take. It's been very difficult and it has had, to be perfectly honest, an impact on morale. The controversies that have been publicized around the activities of placement agents and others are of significant importance and they are being addressed in a number of ways. We have engaged independent private council to conduct a special review of all the activities associated with placement agents. And that is a search for the facts wherever they take us.

In May our Board adopted a comprehensive set of policies regarding the disclosure of placement agent activity. That policy was the basis of a State law approved by the Legislature and signed by the Governor which applies to all California pension funds. And just today, the CalPERS Board of Administration endorsed the legislation that would bring placement agents under the political reform act, in other words define them as Lobbyists, and place them under the restrictions of that. Gifts disclosure and limitations on incentive compensation that should make everyone confident that anything that they do will be known, will be visible and that investment decisions made by CalPERS will be made solely on the basis of our fiduciary duty using the strictest standards of investment criteria and make judgments of what we invest in and don't invest in.

Question:

OK, next question. How much exposure did...does CalPERS have to the subprime loan market?

Answer:

We had very limited losses in our fixed income portfolio, the subprime loans. All of our domestic fixed income is managed internally by a CalPERS staff. We do have Morgan securities in the portfolio but we largely avoided those that were comprised of subprime loans. In addition, one of the things that magnified the losses of those were the combination of these individual mortgages and to mortgage backed securities, particularly the collateral to debt obligations which produced some of the stunning losses for banks and other investors. We did have participation in Structured Investment Vehicle, an SIV, in our collateral loan program too that did produce significant losses. Those were triple A rated securities purchased by an outside manager which turned out not to be triple A by any means which we suffered a considerable loss. But the losses suffered in the CalPERS portfolio that produced the 24 percent loss in 2009 were largely a consequence of the general market decline the global, no-place-to-hide decline

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and that's at value everywhere around the world. And that's why we expect the portfolio to return to help markets recover.

Question:

This is the last question. How has CalPERS investment performed compared to your benchmarks in the various asset classes?

Answer:

The performance report portfolio against its benchmark needs improvement. Just recently performance on the total fund did exceed its benchmark performance. But because of losses in real estate and private equity, we're down over longer time periods against the benchmark in two asset classes in particular, in real estate and private equity alternative investment management and performances is well below the benchmark. Now some of that is attributable to the limitations of benchmarks in liquid asset classes. But I have to say, as Chief Investment Officer, I'm very keen on the need to improve performance there and we have a number of actions under way now intended to do that.

In fixed income there was significant underperformance in recent time periods through June 30, but because of improvement in the credit market and the position of that portfolio, the fixed income portfolio is now exceeding its benchmark by a considerable margin. And the global equity portfolio is slightly below benchmark. I expect that to return to above benchmark performance as a result of the restructuring which is going on now.

Presenter:

And that's the last question. I thank you so much for tuning in to this first webinar on the dialogue on CalPERS Investment.

Operator:

Thank you Ladies and Gentlemen. That concludes today's conference. Thank you for participating. You may all disconnect.