



Investment Office
P.O. Box 2749
Sacramento, CA 95812-2749
TTY: For Speech & Hearing Impaired - (916) 795-3240
(916) 795-3400

November 15, 2010

AGENDA ITEM 4

TO: MEMBERS OF THE INVESTMENT COMMITTEE

- I. SUBJECT:** Focus List Methodology
- II. PROGRAM:** Global Equity – Corporate Governance
- III. RECOMMENDATION:** Approve the enhanced Focus List Program Methodology

IV. ANALYSIS:

Attachment 1 – Wilshire Report: Corporate Governance Engagement Analysis

Attachment 2 – Focus List Program: Proposed vs. Current

EXECUTIVE SUMMARY

Staff concluded a review of the Focus List Program and its methodology. The goal was to develop a more effective strategy for company engagement by improving the alignment of interest between long-term shareowners and portfolio companies. Staff developed the following recommendations and, if approved, will begin the 2011 Focus List engagement process:

1. Select companies where CalPERS has a larger ownership position by altering the selection universe from “index based” to “ownership based.” Specifically, change the screening universe from the Russell 1000 to CalPERS top 500 domestic equity holdings.
2. The Focus List selection process should be more reactive to market developments by adding one year total stock returns to the existing three and five year returns. The process will continue to be heavily weighted towards the longer-term time periods.
3. The initial screening should consider financial returns and the secondary analysis should consider a range of governance issues. The current Focus List screen combines total stock returns, governance, and financial performance. This approach tends to diminish the emphasis of

underperformance in the selection process and allows “check the box” governance to mask opportunities for improvement.

4. The secondary screening should include additional criteria such as engagement obstacles and opportunities, market expectations, deeper financial analysis, and environmental, social, and governance factors.
5. Greater emphasis on board quality, skill-sets and diversity; the Focus List should be used as a conduit for CalPERS proxy access and shareowner proposal efforts.
6. Work to develop relationships with other investors.
7. The press to be used as a tool to garner investor support for shareowner proposals via proxy solicitation campaigns in order to achieve desired reform.
8. Staff will review the feasibility of an international strategy in late 2011.

BACKGROUND

Established in the 1980s, the CalPERS Focus List Program has provided a strategy for identifying and engaging underperforming U.S. companies in the global equity portfolio to drive positive economic returns. For the first time since inception of the Program, the 2010 Focus List engagements were successfully completed without publicly naming a company. This outcome provided some insight to the current methodology and initiated an internal discussion in regard to the framework.

The financial crisis also illustrated the limits of the current program methodology by not identifying any financial sector companies despite severe losses to the portfolio. Staff responded by initiating a financial sector engagement in order to better understand the relevant governance factors, specifically risk management and board quality, not normally addressed in standard governance assessments.

CALPERS ENGAGEMENT

CalPERS corporate engagement process has the overarching objective of improving alignment of interest between providers of capital and company management. It is CalPERS view that improved alignment of interest will enable the fund to fulfill its fiduciary duty to achieve sustainable risk adjusted returns. There are three main drivers in the corporate engagement program:

- **Financial Performance** – company engagement to address persistent, relative value destruction, through the Focus List Program
- **Values Related Risk** – material environmental, social and governance factors, such as reputational risk , climate change, board diversity and key accountability measures such as majority voting

- **Compliance** – in response to State or Federal legislation, such as Iran and Sudan Acts calling for divestment, which CalPERS mitigates as a risk via engagement

CalPERS engagement activity is market wide, which can be considered as a strategy for improving the quality of beta in the portfolio. CalPERS also has company specific engagement, which can be viewed as a strategy for addressing alpha related risk. Compliance is a requirement and mitigates both financial and reputational risks for CalPERS.

FOCUS LIST PROGRAM REVIEW

The review of the Focus List program drew on lessons learned from the financial sector engagement, and a variety of sources including:

- Academic – literature review and discussion with leaders in the field such as Lucien Bebchuk, Harvard
- Fund Managers – interviews plus review of the strategies and research sources used by CalPERS external activist corporate governance managers and private funds
- Research Providers – proxy advisory firms and governance data providers
- Internal Staff – cross asset class input

Wilshire has annually conducted a review titled “The CalPERS Effect” to assess the financial performance of companies named to the public Focus List announced each March. Public Focus List companies are a sub-group of all engaged companies most of which were not named to a public “name and shame” list. These companies generally make up more than half of the total companies engaged through the Focus List Program in a given year. Companies named to the public Focus List are those that have (1) not been responsive to CalPERS concerns, and (2) continue to underperform following the initial six-month engagement period. Until this review the performance of other companies engaged, which were not named to the public Focus List, have not been included in Wilshire’s review.

To address this gap in the analysis, staff engaged Wilshire to analyze the relative total stock returns of all companies engaged through the Focus List Program over the last ten years. Wilshire completed its study and found that over the last ten years, privately engaged companies significantly outperformed those companies named to the public Focus List for the one, three, and five years after CalPERS made initial contact.

More importantly, all companies engaged through the Focus List Program produced a total cumulative excess return of 15.83% above their respective benchmark after three years, and 9.43% after five years.

NEXT STEPS

Following the Board's review and approval of the new Focus List Program methodology, staff will initiate the research and selection process for the 2011 Focus List Program. The list will be presented in March for approval by the Investment Committee. Once approved, staff will engage the companies and report back to the Investment Committee, in August 2011, on the progress of the engagements. This timetable better reflects the deadlines for filing proposals, and allows for more analysis before those deadlines fall.

V. STRATEGIC PLAN:

This item will further the following goals of CalPERS Strategic Plan:

- Goal VIII. Manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits and second, to minimize and stabilize contributions.
- Goal IX. Achieve long-term, sustainable, risk adjusted returns.

VI. RESULTS/COSTS:

Costs are included in existing budget.

CRAIG RHINES
Investment Officer III
Global Equity

ANNE SIMPSON
Senior Portfolio Manager
Global Equity

ERIC BAGGESEN
Senior Investment Officer
Global Equity

JOSEPH A. DEAR
Chief Investment Officer



*Andrew Junkin, CFA, CAIA
Managing Director & Principal*

October 15, 2010

Ms. Anne Simpson
Senior Portfolio Manager – Corporate Governance
California Public Employees’ Retirement System
400 Q Street
Sacramento, CA 95814

Re: Corporate Governance Engagement Analysis

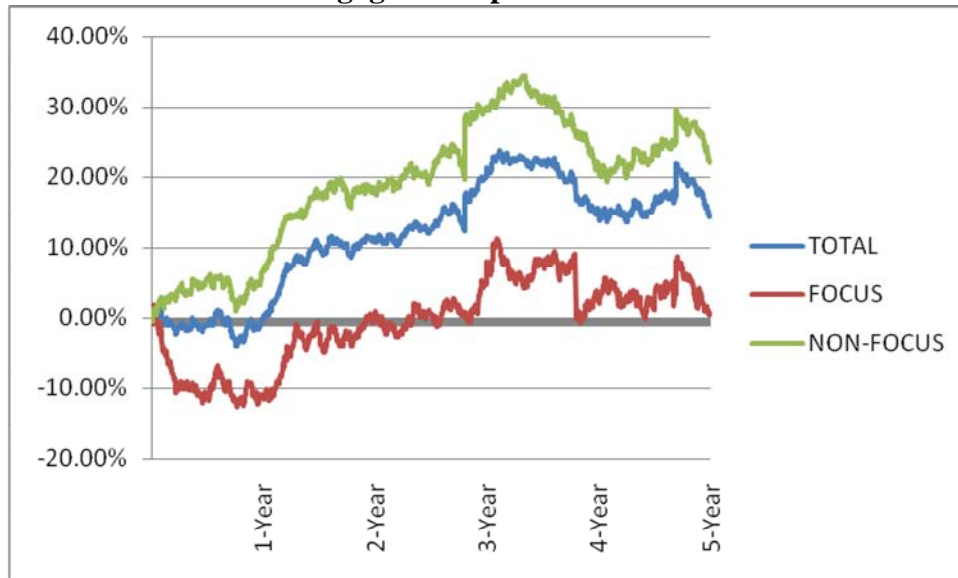
Dear Anne:

At your request, Wilshire has studied the performance of the full corporate governance equity list – those companies CalPERS has engaged on some level (both Focus List and Non-Focus List companies) over the last ten years. The letter summarizes our findings.

Over the last ten cohort years (1999-2008), CalPERS has engaged a total of 155 companies, 59 of which became Focus List companies and 96 which did not. To conduct this analysis, Wilshire examined the daily returns for each company post-initiative date (the initiative dates were provided by CalPERS) and calculated excess returns for each company relative to an appropriate benchmark (S&P 500 companies were benchmarked to the S&P 500; all others were benchmarked to the Wilshire 4500 – this is the same methodology used in the annual “CalPERS Effect” paper) and to the appropriate sector of the Wilshire 5000 (e.g., technology companies were compared to the technology sector of the Wilshire 5000, etc.).

The following graph depicts the average cumulative excess returns for the total sample, the Focus List companies, and the Non-Focus List companies versus the appropriate benchmarks.

Performance of Engaged Companies Relative to Benchmark



As you can see, Non-Focus List companies outperformed the Focus List companies in this analysis. This is perhaps intuitive, in that only the “worst” offenders are those that are “named and shamed” on the Focus List. Others that are contacted and are receptive to or already engaged in some measure of reform (the Non-Focus List) move more quickly to better governance standards, improving the performance of those stocks more and more rapidly.

The following graph depicts the average cumulative excess returns for the total sample, the Focus List companies, and the Non-Focus List companies versus the relevant sectors of the Wilshire 5000.

Performance of Engaged Companies Relative to Benchmark



Again, the Non-Focus List companies outperformed the Focus List companies relative to their respective sectors. Interestingly, the Focus List companies, on average, underperformed their respective sectors. Using the “CalPERS Effect” methodology (prior chart), the Focus List companies had provided positive, albeit marginal, excess returns.

An alternative view would be that the individual companies should not be equally weighted, but that the yearly cohorts should be. This logic would be supported by the fact that Staff spends a certain amount of time each year on engagement activities and that one year’s efforts should not count more than another simply because there were more companies engaged during a particular year. The table below presents the average of the yearly cohort performance.

	All Engaged Companies Average of Yearly Cohorts		Focus List Companies Average of Yearly Cohorts		Non-Focus List Companies Average of Yearly Cohorts	
	Cumulative		Cumulative		Cumulative	
	Excess vs Sector	Excess vs BM	Excess vs Sector	Excess vs BM	Excess vs Sector	Excess vs BM
1 Year	-0.27%	-0.43%	-10.66%	-9.07%	6.74%	5.86%
3 Years	15.23%	15.83%	-5.29%	-1.02%	25.41%	24.46%
5 Years	9.20%	9.43%	-7.65%	-3.67%	15.93%	14.62%

Again, the Non-Focus List companies that did not need to be fully engaged outperformed the Focus List companies.

Additionally, we've examined various characteristics of the performance, which are presented below.

	Versus Sector	Versus Benchmark
Maximum	389.01%	321.27%
Minimum	-156.70%	-183.93%
Median	-0.06%	0.68%
# Underperforming	47	46
# Outperforming	46	47
# w/o 5 Years of Returns	62	62

Attached to this letter is a summary of performance for each of the yearly cohorts that also includes the average company composite returns and the yearly cohort average returns.

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

Best regards,



	Proposed Focus List Process	Current Focus List Process
Selection Universe	Ownership Based: CalPERS top 500 domestic equity holdings	Index Based: Russell 1000
CalPERS ownership range	Approximate Range : \$15 million – \$1 billion equity plus consideration of fixed income where appropriate	Minimum Ownership threshold: \$2 million
Initial Screening Components	<ul style="list-style-type: none"> • 100% Total Stock Returns (introducing 1YR to improve sensitivity to market conditions, plus 3YR, & 5YR), relative to both broad index and industry group 	<ul style="list-style-type: none"> • 40% Total Stock Returns (3YR & 5YR), relative to both broad index and industry group • 30% Corporate governance practices • 30% ROIC
Secondary Screening Components	<ul style="list-style-type: none"> • No engagement obstacles (such as controlling shareowner, dual class stock, etc). • No solvency concerns <hr/> <ul style="list-style-type: none"> • Engagement opportunities: Key governance factors • Additional financial analysis • Market expectations (valuation) 	<ul style="list-style-type: none"> • No engagement obstacles (such as controlling shareowner, dual class stock, etc.) • No solvency concerns
Key Governance Factors	<ul style="list-style-type: none"> • Board leadership structure (e.g. independent chair) • Board & committee independence • Annual director elections • Majority voting for directors • Supermajority voting requirements • Poison Pill • Executive compensation practices <hr/> <ul style="list-style-type: none"> • Board quality - skill-sets, diversity • Environmental & social issues • Risk management process 	<ul style="list-style-type: none"> • Board leadership structure (e.g. independent chair) • Board & committee independence • Annual director elections • Majority voting for directors • Supermajority voting requirements • Poison Pill • Executive compensation practices <hr/> <ul style="list-style-type: none"> • Claw-back provision (now in Dodd-Frank) • Advisory vote on compensation (now in Dodd-Frank)

	Proposed Focus List Process	Current Focus List Process
Press Strategy	<ul style="list-style-type: none"> • Press used to garner support for shareowner proposals and proxy solicitation campaigns • Used as a positive tool to achieve desired reform 	<ul style="list-style-type: none"> • Public Focus List: press used to “name and shame” • Used to support shareowner proposals and proxy solicitation campaigns
IC Role in Focus List Process	<ul style="list-style-type: none"> • Approve methodology and process • Authorize individual company engagements • Receive informational updates from staff • Receive annual performance review from Wilshire 	<ul style="list-style-type: none"> • Approve methodology and process • Authorize individual company engagements • Approve final public Focus List • Receive annual performance review from Wilshire
File Proposals	Yes	Yes
Consider use of proxy access	Yes	No
Time period of company engagement	<ul style="list-style-type: none"> • Case-by-case: Up to three years pending governance reforms and progress towards improved financial/stock performance 	<ul style="list-style-type: none"> • Generally six months • Up to three years for a company named to either the public Focus List or Monitoring List
International engagement	To be reviewed in second half of 2011	No
Timeline	<ul style="list-style-type: none"> • November 15, 2010: Report to IC, seek approval for new engagement approach • Nov – Feb: Complete company research • Mar: Seek IC approval to engage companies • Mar: Notify selected companies & request to meet • Apr – Jul: Engage companies • Aug: Report back to IC • Ongoing: File shareowner proposals as needed and issue press statements to support these 	<ul style="list-style-type: none"> • Jul – Aug: Complete company research • Sept: Seek IC approval to engage companies • Sept: Notify selected companies & request to meet • Oct – Feb: Engage companies • Mar: Seek IC approval for public Focus List • Late Mar: Issue public press release of Focus List • Ongoing: File shareowner proposals as needed