CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM

Its Policies for Foreign Investing Are Consistent With Its Mission and With Legal Guidelines

REPORT NUMBER 99138, DECEMBER 2000

Audit Highlights . . .

Our review of the California Public Employees' Retirement System's (CalPERS) foreign investment policies found that:

- ☑ ***CalPERS uses a reasonable process to contract for external managers who research and administer its international investment portfolio.***
- ☑ ***CalPERS investment policy is primarily based on financial factors, which is consistent with state and federal law.***
- ☑ ***CalPERS uses a screening process to identify foreign financial markets in which its external managers can invest.***
- ☑ ***The external managers invested in the five questioned companies because they believed the investment would be profitable.***
- ☑ ***The federal government has not prohibited or restricted investment in any of the questioned companies.***

The California Public Employees' Retirement System (CalPERS) manages and administers the retirement benefits of more than one million public members. The largest public pension fund in the United States, CalPERS had net assets at June 30, 2000, of more than $172 billion. Its investment portfolio is divided into asset classes that include international and domestic stocks and international and domestic fixed income investments (primarily bonds). We reviewed CalPERS policies and procedures related to foreign investments and the rationale for investing in the five companies specified in the audit request. Specifically, we found that:

Finding #1: CalPERS uses reasonable procedures to select, contract with, and oversee its external managers.

Because it does not have the expertise and specialized skills required to invest in foreign markets, CalPERS contracts with external managers to research and administer all of its international investments. To choose those external managers, CalPERS follows a process that assures fair competition among a range of qualified applicants. To protect its assets, CalPERS then develops for each external manager a contract that specifies unique investment guidelines, contains repercussions for unsound investment practices, and requires the manager to achieve returns at least equal to a benchmark level. In addition, to make sure the external manager uses appropriate methods to invest and account for funds, CalPERS has a comprehensive oversight process.

Although in most respects CalPERS oversees its external managers adequately, CalPERS can improve the timeliness of its assessment of its general pension consultant's performance. The general pension consultant helps CalPERS determine the investment needs of the portfolio and is responsible for various monitoring procedures related to the external managers. The contract between the general pension consultant and CalPERS does not have a set duration; instead, the contract continues in perpetuity at an annual cost of $1.9 million until one of the parties cancels it. The general pension consultant is subject, however, to a yearly review, which CalPERS has not been performing in a timely fashion. The first year of the current contract expired on June 30, 2000, but CalPERS was just beginning its review as of October 1. We recommended that CalPERS finish its review of the consultant for the year ended June 30, 2000, and establish controls so that it performs the review promptly each year.

CalPERS Action: Corrective action taken.

On December 11, 2000, and October 15, 2001, CalPERS staff presented the results of the annual reviews of the pension consultants to the investment committee. In addition, at its September 2001 meeting, the investment committee approved its staff's recommendation to hire an independent consulting firm to assist in the development and implementation of a new process to evaluate annually the performance of its pension consultants.

Finding #2: CalPERS bases its foreign investment policy primarily on financial considerations, and this practice is consistent with state and federal laws.

CalPERS' policies concerning international investments protect members' retirement benefits by directing the external managers to base their investment decisions primarily on the financial merits of the investments. To that end, CalPERS had its general pension consultant create a permissible country list of countries with financial markets that are suitable for CalPERS investment. In creating this list, the general pension consultant considered factors that make a country's market financially suitable, such as a fair, stable legal system and prudent requirements for companies to be listed on the market.

CalPERS is not the only public retirement system that bases investment decisions primarily on financial factors. Other public retirement systems in the State of California and in other states use financial criteria, rather than social or political criteria, when making investment decisions. Further, for the other asset classes within its portfolio, CalPERS also generally relies on financial criteria when making investment decisions even in instances that arise from socially motivated events. Examples of these types of decisions are the CalPERS Board of Administration's decisions to invest in some redevelopment projects, and the board's recent decision to divest the retirement system's investment in tobacco-related stocks.

If CalPERS were to eliminate a specific country from its permissible country list based on actions of that country's government, CalPERS could be challenged as infringing on the federal government's power to set foreign policy. Specifically, in the foreign policy arena, even if a federal law does not say that it preempts state law, state law must yield to a federal law if Congress intends to enact policy measures or if state law conflicts with federal law. Moreover, the United States Supreme Court has consistently upheld the federal government's exclusive powers in setting foreign policy.

In April 1999, the CalPERS investment committee believed it found possible shortcomings in the methods the general pension consultant used to create the most current list, so CalPERS is amending these methods. These possible shortcomings may have led CalPERS to improperly classify some countries as "limited exposure" or "prohibited." Because it did not promptly create a new screening process after identifying the possible shortcomings in the procedures to develop the original list, CalPERS may be using a list that classifies countries inaccurately. Moreover, CalPERS and its general pension consultant differ in their views of the list's purpose, so the investment committee is working to establish clear objectives for the list. We recommended that CalPERS finish revising the process for developing its permissible country list and create a timetable for the review of existing criteria.

CalPERS Action: Corrective action taken.

The CalPERS investment committee has chosen to use outside research firms to develop screening criteria to be used to create the permissible country list. Two research firms, Oxford Analytica and Verite, are under contract to provide assessments of selected foreign countries. The research firms will provide three written annual reports to the investment committee. The first written report is due to CalPERS on January 1, 2002. Subsequent reports will consist of an annual evaluation of the initial assessment and are due December 1, 2002, and December 1, 2003.

Finding #3: CalPERS evaluated financial returns and followed federal law when investing in companies considered potential security risks.

Investments by CalPERS in five foreign companies have been questioned as having a possible effect on national security issues. Four of these companies are based in Hong Kong, but either the parent company is located in mainland China or the major shareholder is a company based in mainland China. The remaining company, based in Canada, is developing and constructing oil fields and pipelines in the Sudan. Our audit covering fiscal year 1999–2000 revealed that CalPERS and its external managers did not violate state or federal laws or its own policies by investing in the five companies. In each case, the managers determined that the investments would be profitable for the retirement system. Investments in these companies were purchased on either the New York Stock Exchange or the Hong Kong Stock Exchange, both designated unrestricted markets on the CalPERS permissible country list.

Based on the information we obtained, investments by CalPERS in the five questioned companies did not violate any federal laws. Investments in four of the five questioned companies were legal under federal law because the United State government does not prohibit or restrict investment in China or in companies based in China. Investment in the other company, which is based in Canada, was also legal according to federal law because although the company was doing business in the Sudan, the company was not on a federal list of companies in which the United States prohibits investing.

We recommended that if the CalPERS Board of Administration believes that the actions of a specific country's government may be contrary to international standards of human rights or may compromise national security, CalPERS should work with the State Legislature to communicate those concerns to Congress through a legislative resolution.

CalPERS Action: Corrective action taken.

The CalPERS board has sponsored Senate Joint Resolution 9, introduced by Senators Costa and Soto on March 7, 2001. This resolution would call on the President of the United States and the Congress to identify, and to place on a federal list, investments in foreign countries and businesses that pose a threat to the national security interests of the United States and to encourage appropriate federal measures to deny these entities access to capital from the United States. The resolution is held in the Senate Banking, Commerce and International Trade Committee under submission and is not subject to legislative calendar deadlines.

In addition, during the due diligence process, if issues arise regarding human rights and national security risks, the CalPERS board will act accordingly to ensure investments in foreign countries maintain high international standards for human rights and low national security risks.