

TEACHERS' RETIREMENT BOARD

INVESTMENT COMMITTEE

SUBJECT: External Equity – Revised Policy

ITEM NUMBER: 6

ATTACHMENT(S): 2

ACTION: X

DATE OF MEETING: July 7, 2004

INFORMATION:

PRESENTER(S): Elleen Okada

Executive Summary

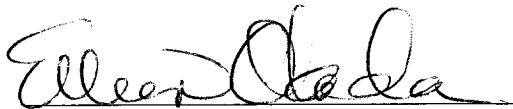
At the June 4, 2004 Investment Committee Meeting, staff presented a first reading of proposed revisions to the Equity Portfolio Policies. The Committee raised no comments or concerns regarding the proposed changes. In summary, the significant revisions to the Policies included the addition of Investment Objectives and the respective benchmarks for the U.S. and Non-U.S. portfolios, plus the inclusion of language addressing portfolio diversification.

Also at the June 4, 2004 Meeting, the Committee approved the co-investment program for the Corporate Governance/Relational Investment Program. Policies governing this program have been incorporated into the Equity Portfolio Policies. This addition is indicated in Attachment 1 with italics and underlined text.

Recommendation

Staff recommends that the Committee approve the revised Equity Portfolio Policies by adopting the attached Resolution (Attachment 2).

Prepared by:



Elleen Y. Okada

Director, Investment Administration & External Relations

Reviewed and Concur:



Christopher J. Ailman

Chief Investment Officer

CalSTRS

CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM

EQUITY PORTFOLIO *Policies*

**INVESTMENT BRANCH
JULY 2004**

California State Teachers' Retirement System
Equity Portfolio
Policies

Introduction

In accordance with the Investment Management Plan, the California State Teachers' Retirement System (CalSTRS) has established an allocation for the equity asset category. CalSTRS requires a policy document to guide the management, monitoring, and evaluation of this asset category. This document is designed to establish guidelines for portfolio structure and to identify performance objectives. In order to insure compliance with investment guidelines and performance objectives, staff assiduously manages and monitors the equity portfolios.

Policies are designed to establish guidelines for portfolio structure and to identify performance objectives. Procedures supply a blueprint for the flow of information between the internal and external managers and the External Equity Unit of CalSTRS.

The policies established by CalSTRS' Investment Committee are designed to promote adherence with accepted fiduciary practices. Policies are designed to provide a foundation to be followed. Changes to the policies will be presented to the Investment Committee for review and approval. Procedures are designed to be dynamic in nature with modifications expected to occur as the marketplace or the External Equity Unit changes.

California State Teachers' Retirement System Equity Portfolio Policies

The following represents policies used in the administration and management of the Equity portfolio segment. The policies are designed to establish the basis for performance expectations and portfolio structure, while creating investment guidelines for equity managers. As with all other plan assets, these policies cannot be altered without explicit direction from the Teachers' Retirement Board (TRB). A flow chart is included to provide the context for the policies within the general process of implementing the Equity Portfolio. Words and terms that may be unfamiliar to the reader are referenced in the Glossary.

1. **Laws and Statutes:** The equity portfolio segment of the California State Teachers' Retirement System (CalSTRS) is to be invested, administered and managed in a prudent manner for the sole benefit of the CalSTRS participants and beneficiaries, in accordance with the Teachers' Retirement Law and other applicable State statutes.
2. **Regulations:** For domestic equities, the asset category will comply with the rules of the Securities and Exchange Commission (SEC), equity exchanges, and other regulatory agencies. For non-U.S. equities, the asset category will comply with the appropriate regulatory body in the respective country.
3. **Asset Objective:** The asset category shall be managed to achieve optimum performance results, diversification of styles and assets, clear and certain disclosure and accountability. Each portfolio will be managed to a certain benchmark, clearly stated in the portfolio manager guidelines and monitored by the External Equity Unit.
4. **Investment Objectives:**

U.S. Equity Portfolio: The U.S. public equity assets shall be invested using both active and passive management strategies. The target for passive management is 70%, with a range of plus (+) or minus (-) 5%. The target for active management is 30%, with a range of plus (+) or minus (-) 5%. The strategic objective is to consistently exceed the total return of the performance benchmark. The performance benchmark for the U.S. equity portfolio is the Russell 3000 tobacco free Index.

The U.S. passive portfolio includes both internal and external management closely replicating the Russell 3000 ex-tobacco in aggregate. The large cap, or the Russell 1000 portfolios, shall fully replicate the index within 8 basis points per year. The small cap, or Russell 2000 portfolios, optimize out the smallest holdings and are managed within 25 basis points of the index.

The U.S. active portfolio is managed to the Russell 3000 ex-tobacco and is managed externally. One or more managers are selected in each style type, large and small, value, core and growth.

Non-U.S. Equity Portfolio: The Non-U.S. public equity assets shall be invested using both active and passive management strategies. The target for passive management is 50%, with a range of plus (+) or minus (-) 5%. The target for active management is 50% with a range of plus (+) or minus (-) 5%. The strategic objective is to consistently exceed the total return of the performance benchmark. The performance benchmark for the Non-U.S. equity portfolio, in aggregate, is the Morgan Stanley Capital International All Country World (MSCI ACWI) ex-U.S. ex-Tobacco Index.

The Non-U.S. passive portfolio is managed by external managers. This portfolio is benchmarked to the MSCE EAFE ex-tobacco Index and shall replicate the index within 50 basis points per year.

The Non-U.S. active portfolio is totally managed by external managers. One or more managers are selected in each geographic region, i.e., EAFE, Pacific Basin, and Europe.

5. **Diversification:** Diversification within investment portfolios is critical in order to control risk and maximize returns. For the U.S. portfolio, minimum and maximum ranges with respect to investment management style and capitalization size shall be established within the context of the characteristics of the performance benchmark as displayed in Exhibit 1. For the Non-U.S. portfolio, minimum and maximum ranges with respect to geographic region shall be established within the context of the characteristics of the performance benchmark as displayed in Exhibit 2. Such ranges, for both the U.S. and Non-U.S. portfolios, shall be documented within the Procedures Manual and are subject to change as conditions warrant, as determined by the Director of Investment Administration & External Relations.
6. **Delegation of Authority:** The Chief Investment Officer (CIO) or designee has the authority to manage the equity asset category and may use other investment personnel to implement these policies and the processes described in the Procedures Manual.
7. **Co-Investments:** *The approval decision for co-investments for the Corporate Governance Program is delegated to staff considering the following stipulations:*
 - *Co-investments shall be made and disposed of side by side with the CalSTRS external Corporate Governance managers.*
 - *Due diligence process shall be thorough, consistent, and appropriate as defined in the External Equity/Corporate Governance investment portfolio procedures.*
 - *Maximum amount of any single company investment shall not exceed \$75 million at the time of the investment.*
 - *A report on any acquisition or disposition will be presented to the Investment Committee as soon as practical after the transaction is completed.*
 - *Co-investments are limited to the publicly traded stocks domiciled in the United States.*
 - *A co-investment may take the form of equity, convertible preferred equity, and warrants or a comparable instrument which provides an equity type of ownership and return.*

The approval decision under delegation as it relates to co-investments shall be completed following a positive written recommendation by the external corporate governance manager and CalSTRS' staff with approval from the Chief Investment Officer. The investment analysis and due diligence will be conducted by the CalSTRS staff (as identified in the External Equity/Corporate Governance investment portfolio procedures) and management of the investment and corporate governance activities will be guided by the external investment manager.

8. **Authorization Limits:** *The following daily limits apply with respect to the approval of trade activity within the Corporate Governance Co-Investment Program:*

- Investment Officer II \$ 15 million
- Investment Officer III \$ 25 million
- Principal Investment Officer \$ 50 million
- Director of External Equity \$100 million
- Chief Investment Officer \$250 million

79. **Decision Making Authority:** The decision regarding a specific investment manager is delegated to the CIO or designee within the boundaries established by these policies.

810. **Compliance Parameters:** Manager guidelines, objectives, benchmark selection, tracking error, portfolio composition, style characteristics, portfolio restrictions, and trading activities are to be monitored across all Equity portfolios. All investment instruments and/or activities shall be governed by the Investment Resolution adopted by the TRB on October 19, 1984, and amended as required.

911. **Monitoring and Reporting:** The External Equity Unit shall report on compliance results to the CIO or designee. It is expected that compliance reporting will be ongoing and continuous. Ratings of external managers will be reported to the Investment Committee semi-annually.

1012. **Transition Management:** The External Equity Unit will prudently administer and liquidate, if advisable, the existing portfolios of managers that have been relieved of investment management responsibility for CalSTRS.

1113. **Manager Pool:** CalSTRS shall maintain a pool of managers to supplement the existing managers or to replace a terminated manager.

1214. **Annual Business Plan:** The External Equity Program will be managed in accordance with a business plan, which will be prepared on an annual basis and will include a broad overview of the asset class with the key issues associated with the management of the portfolios, as well as future objectives and a resource allocation study.

1315. **Authority Letters:** Authorization letters regarding the transaction of CalSTRS' External Equity Program business will be provided to staff, external investment managers and

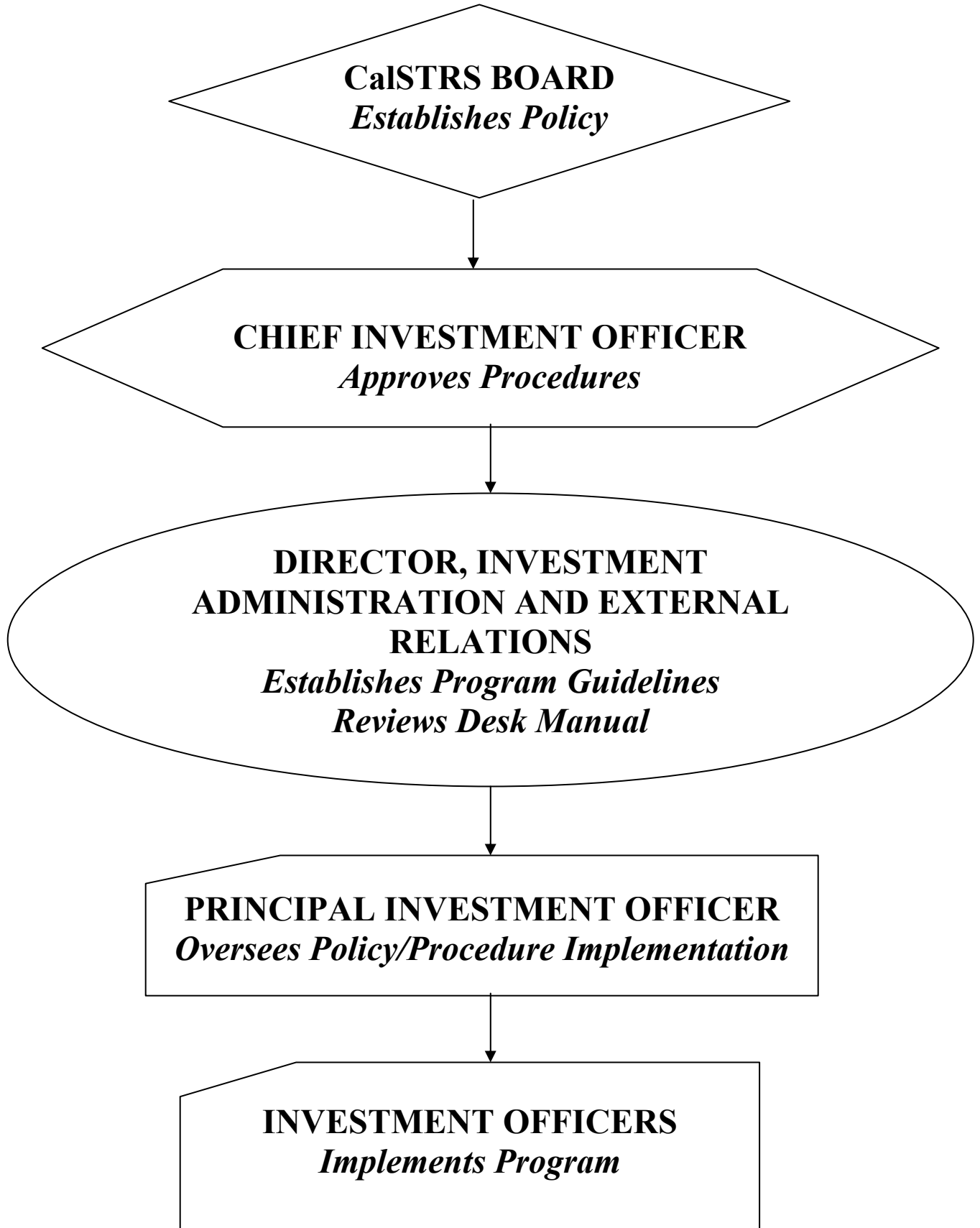
brokers. Whenever there is a change in authorized personnel, a written notice shall be provided to each affected party within 48 hours.

1416. Board Review: The TRB or the Investment Committee may review this policy periodically, as deemed appropriate and in keeping with its fiduciary standards.

ADOPTED BY THE TEACHERS RETIREMENT BOARD ON JUNE 2, 1999
REVISED ON JULY 7, 2004

California State Teachers' Retirement System
Equity Portfolio Policies

FLOWCHART



California State Teachers' Retirement System
External Equities
Policies

GLOSSARY

ACTIVE MANAGEMENT: The active manager attempts to add value by intentionally deviating from the characteristics of a passive benchmark index. These deviations attempt to select superior issues that will produce a higher return than the index. Higher risk usually accompanies active management.

BASIS POINT: One hundredth of one percent or .0001 in decimal form.

BENCHMARK: A yard stick that is used to track the performance of an active portfolio or an investment vehicle that is used to create a passive portfolio.

BEST EXECUTION: Refers to executing Client transactions so that the Client's total cost is the most favorable under the particular prevailing circumstances at that time.

BROKER: Refers to a person or entity registered with the National Association of Security Dealers and provides investment services (research, soft dollar, etc) and/or execution services.

COMMISSION RATES: Fee paid to a broker for executing a trade. The fee is based on the number of shares traded, the dollar amount and the liquidity of the trade.

DIVERSIFICATION: Refers to spreading the risk of an asset category by assuming similar management styles to an appropriate benchmark.

GENERAL CONSULTANT: A consultant that addresses questions concerning general types of investments such as equity and fixed income for both domestic and international securities.

GROWTH STYLE: This style of investment constructs portfolios that have more earnings potential than the benchmark and therefore have the potential to produce superior returns over the benchmark. These portfolios generally exhibit more risk than the benchmark.

INDEXED PORTFOLIO: This type of portfolio is structured to replicate a specific index. The objective is to generate a portfolio that will produce the same return as the index at the same level of risk as the index.

INVESTMENT GUIDELINES: This is a document that establishes the parameters through which the investment manager will invest CalSTRS' assets. These guidelines specify valid securities for the portfolio, the return expected from the manager, how the manager will be evaluated and the period over which the manager will be evaluated.

INVESTMENT MANAGEMENT PLAN: This document outlines CalSTRS' general and financial objectives including specific investment strategy. This document is the result of studies that include the assets and liabilities for the System.

LARGE CAPITALIZATION STYLE: Refers to the investment process that includes a range of styles, from value to growth, that provide active management using large capitalization stocks.

LIQUIDITY: Refers to availability of a stock to be traded. An issue that is readily available is considered to be liquid, an issue that does not trade very often is deemed illiquid.

PASSIVE MANAGEMENT: Refers to the maintenance of a portfolio whose goal is to replicate the return and risk characteristics of the desired index.

PERCENTILE: A percentile is 1/100th of the whole. As used here, it is the rank of a manager's investment performance compared to a universe of its peers. For example, if a manager ranks in the 7th percentile, then the manager's performance is higher than 93% of the other managers in the universe.

PERFORMANCE OBJECTIVE: Refers to each individual external managers' designated benchmark (example, Russell 1000) and their performance target (example, Russell 1000 + 1½%).

POOL MANAGERS: Refers to investment managers who have been selected to take the place of funded managers that may be terminated. The pool managers will correct any imbalance caused by the termination of a manager and quickly correct possible unintended bets or tilts.

REQUEST FOR PROPOSAL: Refers to a search and selection process for hiring external money managers. The process provides minimum qualifications, description of duties, and a detailed questionnaire to be completed by the proposer. Selection is based on the firm's investment process, personnel, performance and fees.

SECTION 28E: “Safe Harbor” Refers to a section in the Security and Exchange Act that provides a safe harbor (in good faith) against claims of breach of fiduciary duty for investment managers using brokerage commissions generated by customer orders to obtain brokerage and research services. Section 28e also addresses whether a product or service provides lawful and appropriate assistance to the investor in the performance of its investment decision-making responsibilities. It also clarifies the application of the safe harbor to third party research, emphasizes the importance of written disclosure of soft dollar arrangements to customers and reiterates the manager's duty of best execution.

SECTOR: The market is segmented into sectors such as Energy, Finance and Consumer Durable.

SMALL CAPITALIZATION STYLE: Refers to a investment process that includes a range of styles, from value to growth, that provide active management using small capitalization stocks.

SOFT DOLLARS: Refers to the use of brokerage commissions to pay for research and other services that are investment related.

TRACKING ERROR: The amount of return that the portfolio differs from the targeted index. This difference could be positive or negative.

UNIVERSE COMPARISON SERVICES: Refers to a service that groups style (growth/value/neutral) and capitalization (small/large/medium) of a large number of funds and provides performance rankings of each group.

TURNOVER: In reference to securities, it is the percentage that the portfolio is traded on an annual basis. It is calculated by dividing the smaller of purchases or sells by the total value of the portfolio.

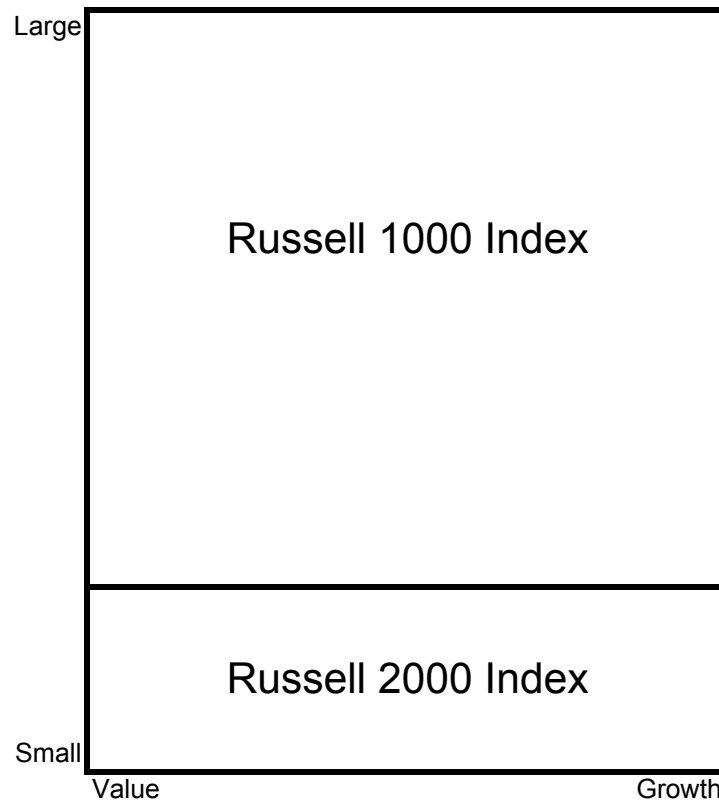
VALUE STYLE: Refers to the investment process, which seeks to identify present value rather than future rewards, select stocks that will maintain their price in falling markets or periods of economic uncertainty, and look for stocks that are undervalued, but fundamentally strong.

CalSTRS Domestic Equity Structure

70% Passive / 30% Active

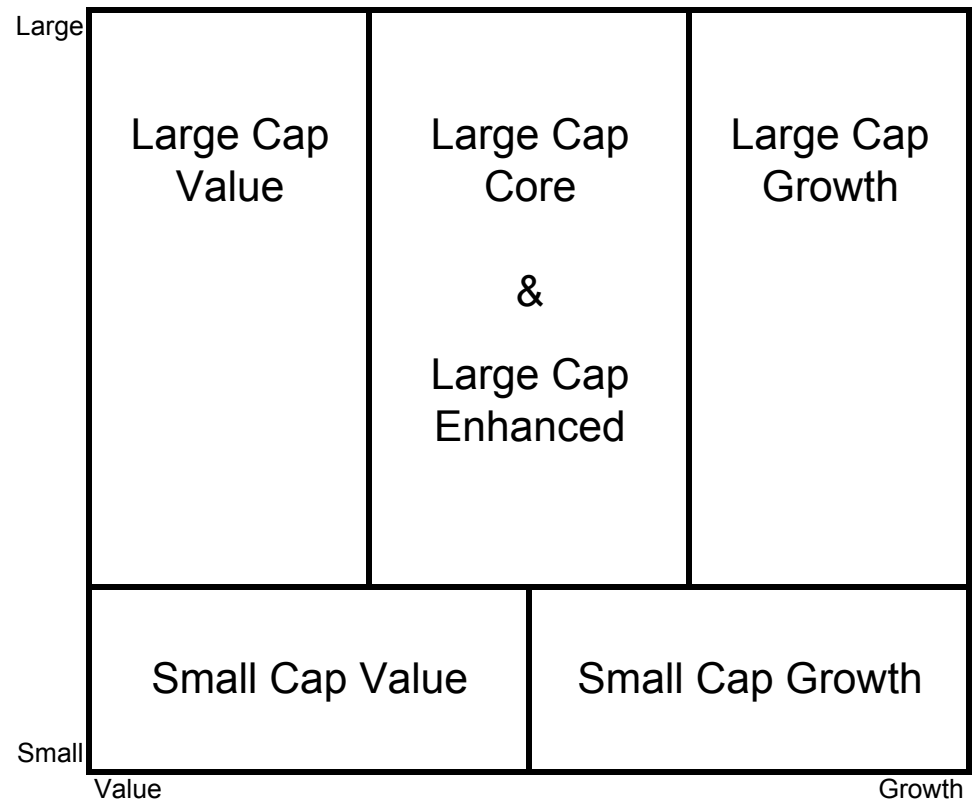
PASSIVE STRUCTURE

70% of Domestic Equity
Passive aggregate represents Russell 3000



ACTIVE STRUCTURE

30% of Domestic Equity
Active aggregate represents Russell 3000

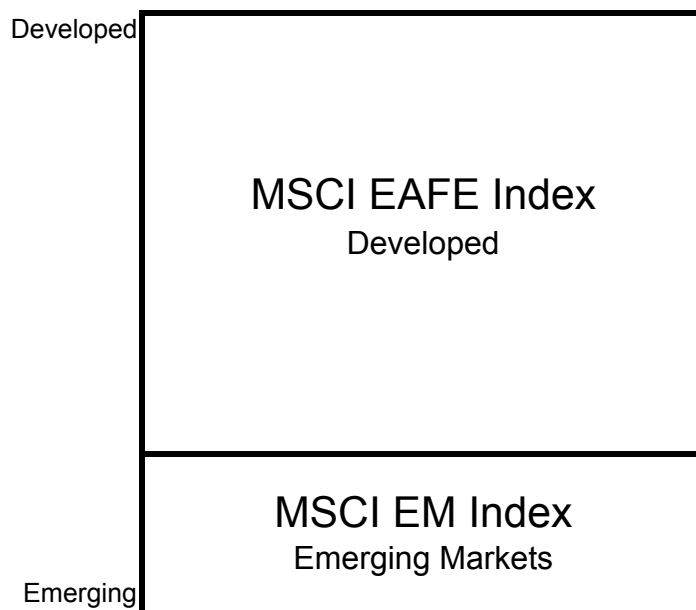


CalSTRS Non-US Equity Structure

50% Passive / 50% Active

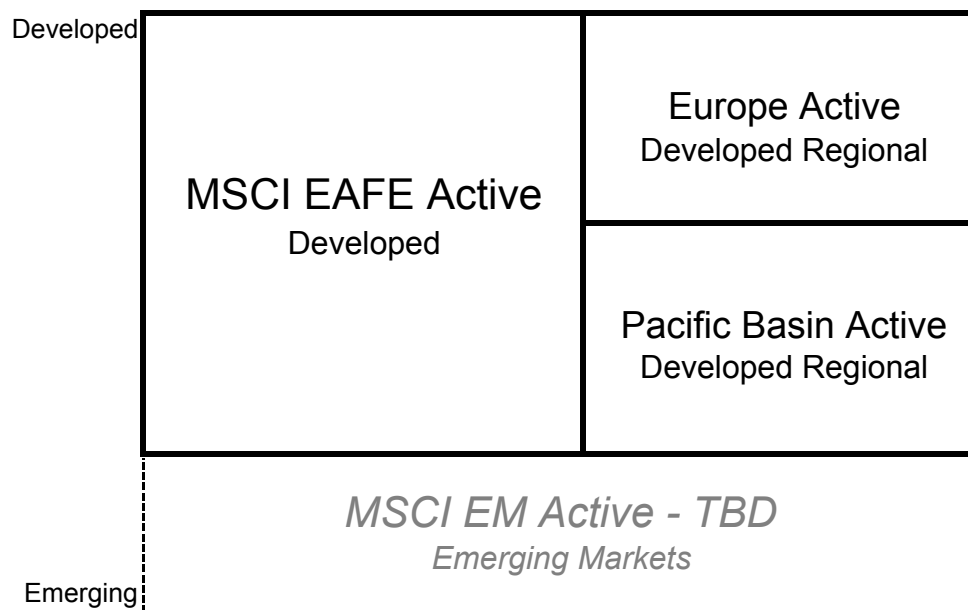
PASSIVE STRUCTURE

50% of Non-US Equity
Passive aggregate represents MSCI ACWI Ex-US



ACTIVE STRUCTURE

50% of Non-US Equity
Active Regional aggregate represents MSCI EAFE



**PROPOSED
RESOLUTION OF THE
TEACHERS' RETIREMENT BOARD
INVESTMENT COMMITTEE**

SUBJECT: Equity Portfolio Policies

Resolution Number _____

WHEREAS, the Investment Committee of the California State Teachers' Retirement Board is responsible for recommendations to the Board, investment policy and overall investment strategy for the management of the Teachers' Retirement Fund, a multi-billion dollar public pension plan; and

WHEREAS, the Investment Committee is charged with developing the Fund's Investment Policies and Management Plan including the policies for individual asset classes such as public equities; and

WHEREAS, the Investment Committee has reviewed the written material and oral presentation from staff on the Equity Portfolio Policies; Therefore, be it

RESOLVED, that the Investment Committee approves the Equity Portfolio Policies.

Adopted by:
Investment Committee
on July 7, 2004

Jack Ehnes
Chief Executive Officer