Towards Sustainable Investment

TAKING RESPONSIBILITY

CalPERS

Contents

A MESSAGE FROM CalPERS LEADERS

This year marks CalPERS 80th birthday, but while we celebrate our past our focus is firmly on the long horizon.

Rob Feckner

Henry Jones

Anne Stausboll

Joseph Dear

Both now and in the coming decades, the prime duty of our fund is to continue to meet its financial commitments to members and future members. Sustainability in its simplest form is the ability to continue, and for a long-term investor like CalPERS with long-term liabilities, it's at the heart of what we do.

We have a proud history of leadership and innovation in sustainable investment. We have been engaging directly with companies on environmental, social and governance issues for many years and are founding members of global networks such as the United Nations-backed Principles for Responsible Investment (PRI). With our new "total fund" approach to sustainable investment, explained in this report, we believe we are again taking a leadership role in this important area. On page 36 is an index showing where you can find details on each of our PRI commitments.

Still, we tackle the challenge of sustainable investment with a great deal of humility. Sustainability issues are often complex and global in nature and no single actor has the power to solve them. What's more, the CalPERS Fund encompasses a wide array of investment strategies, asset classes and capital forms, some of which are still at the very beginning of the journey towards genuinely sustainable investment.

This report creates a baseline for this journey. It explains the fiduciary framework we have adopted to integrate sustainability across the total fund, sets out the strategic themes, illustrates achievements from the last few years and outlines our vision for the future. We also explain how we integrate ESG into our own operations in the sections, "CalPERS Putting Principles into Practice."

This is no small undertaking. It's a journey that will need CalPERS to make complex changes to its own internal operations, and will need continued collaboration and partnership across both the private and public sectors. It will require us to redouble our efforts to think creatively and boldly about how we capture the opportunities and address the risks posed by sustainability challenges. We aim to be a principled and effective investor guided by our Core Values. Our sustainability objectives are intended to help us achieve those long-term risk adjusted returns on which our members rely.

We welcome your comments and ideas. Please send them to Anne Simpson, our Director of Corporate Governance, at Global_Governance@calpers.ca.gov.

Rob Feckner
CalPERS Board President

Henry Jones
CalPERS Investment Committee Chair

Anne Stausboll
Chief Executive Officer

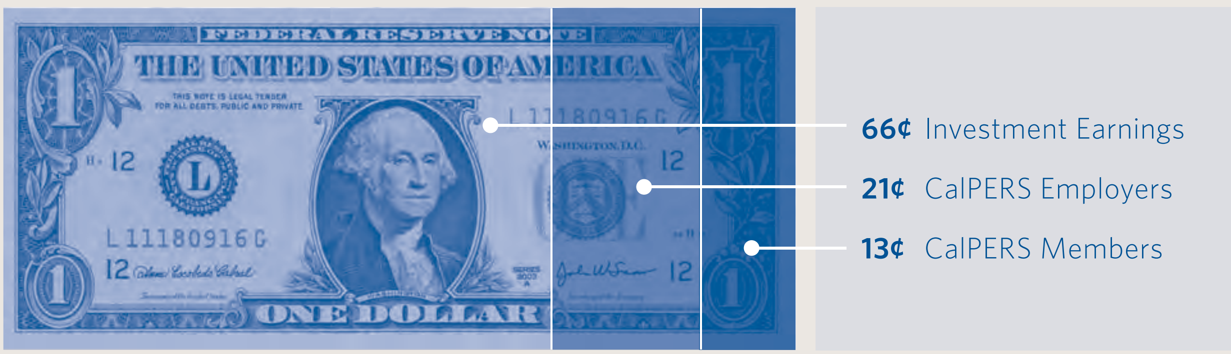
Joseph Dear
Chief Investment Officer

CalPERS INVESTMENT — IN NUMBERS

Our fiduciary duty

CalPERS has a fiduciary duty, which is set out in the California Constitution. This duty means that our Board must at all times work in the best interest of our 1.6 million members. For every dollar paid in CalPERS pensions, 66 cents comes from investment earnings, so it is vital that we achieve successful returns from our investment strategy.

The CalPERS "Pension Buck"



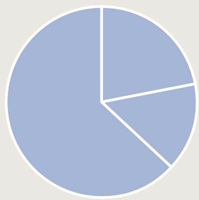
CalPERS pays out approximately $14 billion in pension benefits each year to its members. The payments come from three sources: CalPERS members, contributions from their employers and investment returns. Investments typically provide two-thirds or more of pension payments giving us a need to provide long term sustainable returns.

* Source: CalPERS, Income over the last 20 years as of June 30, 2011.

A total fund approach

Our total investment portfolio is valued at $231.9 billion* and is diversified across stocks, bonds, cash and other investments. The ESG program is led by the Global Governance team, which is composed of investment staff. Our Global Governance team now works across all asset classes. CalPERS ESG program is overseen by a cross enterprise group, which meets regularly. It includes the Board President, Chief Executive Officer, Chief Investment Officer, Chief Operating Investment Officer, General Counsel, Deputy Executive Officer of External Affairs and the Director of Corporate Governance.

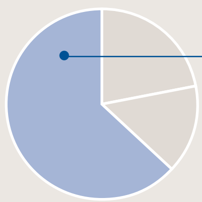
* January 31, 2012



Investment Assets
$231.9 billion*

CalPERS Investments

CalPERS earnings fund 66 cents of every dollar we pay in pension benefits. We earn those payments through investing in different assets. We look for a balance between investments which will grow the fund over the long term, and those which can pay cash. We also have investments which are intended to protect the fund against future uncertainty, like inflation, which can erode returns, and volatility in the market.



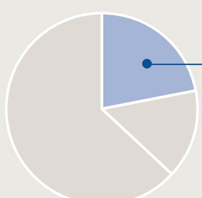
63.2% — Growth Assets, $146.6 billion

$114.5 billion | PUBLIC EQUITY

The majority of CalPERS investments are in shares of public companies — or equity. These grow our fund as the share price increases over time.

$32.1 billion | PRIVATE EQUITY

CalPERS has a significant amount of money invested in companies which are privately held — and not listed on a stock exchange. We invest in these companies using external partners.



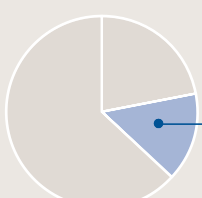
21.9% — Income Assets, $50.8 billion

$40.9 billion | FIXED INCOME

CalPERS pays more than $14 billion a year in pension benefits, so our cash flow from investments is vitally important. We invest in bonds to produce income and reduce fund volatility. Bonds are issued when either a government or a company wants to raise money.

$9.9 billion | LIQUIDITY

To give CalPERS a buffer in the face of market risk, we have a portfolio of investments, which are considered readily convertible into cash, or represent cash balances.



14.9% — Real and Other Assets, $34.5 billion

$21.9 billion | REAL ASSETS

CalPERS has major investments in property and forestry, and are building up our portfolio in infrastructure, which are typically long-term investments in transport links, electricity and water supply.

$7.4 billion | INFLATION

CalPERS inflation linked asset classes are managed to prudently achieve long-term returns above inflation, diversify CalPERS investments and hedge against inflation risks.

$5.2 billion | ABSOLUTE RETURN STRATEGY

CalPERS has a portfolio investing in hedge funds, which we typically use to improve returns or manage risk in the portfolio.

* January 31, 2012

INTRODUCTION

Why sustainable investment

CalPERS principal job is to provide retirement benefits to more than 1.6 million members and their families. Our overriding investment priority is to grow our portfolio in a way that ensures we meet our commitments to our beneficiaries – not just today – but when the graduates of today retire in 40 years' time. This is why sustainability matters to our fund.

Take the example of environmental risk. In the longer term, we recognize that rising demand for food and resources globally, coupled with the likely effects of climate change, will have a potential impact on risk-adjusted returns.

We are also clear that governance matters. The alignment of interests between investors and managers is vitally important. Hence, our focus on issues like voting rights, compensation for executives and performance fees for our fund managers.

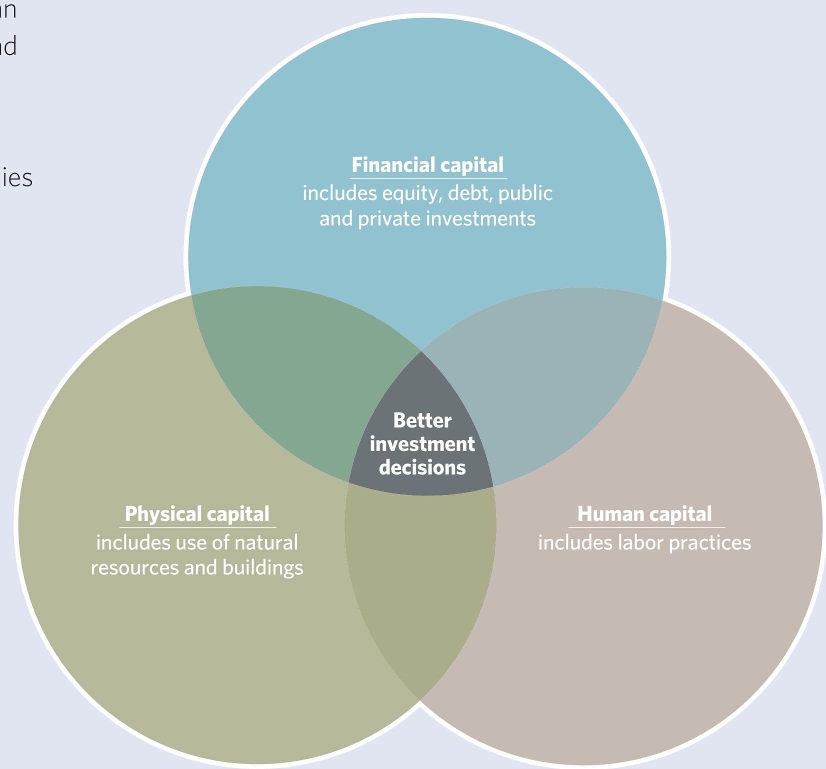
We also know that social issues can affect performance. How a company treats its employees, its reputation in the community and issues like human rights in global supply chains, can present risks and also opportunities.

Economists think of this as three forms of capital, which companies deploy to create value. Companies need financial capital. That's where investors like CalPERS step in. This is why we are concerned with governance.

Companies also then need human capital — the people they employ to put that financial capital to good use. This gives investors an interest in the social dimension.

Thirdly, companies need physical capital such as equipment, electricity, water, transport and buildings for example. This gives us an interest in the environment. This is the context for our thinking on "ESG issues"— they represent the three forms of capital that companies use to create value. Understanding the interplay will inform our investment decisions. And long-term value creation is at the heart of sustainability.

FIGURE 1: **Three forms of capital create value.**



About this report

This is CalPERS first stand-alone Sustainable Investment Report, and we believe it is the first of its kind by a large public pension fund in the United States. We want to demonstrate our active commitment to transparently managing our fund in as sustainable a way as possible.

CalPERS has reported on some of its ESG work previously, but this is the first time we have brought the work together. The scope is our fund as a whole, and our goal is to explain what we are doing across all our investments.

Sustainable investment is a complex arena with each governance, environmental and social issue, each asset class of investment and each sector of the economy all presenting unique challenges to overcome. It is also an emerging area.

One of the aims of this report is to outline what we are doing now so that we can track improvements over time and report our progress on sustainable investment in the future.

Where possible, we want to show how we take responsibility for our impact through the investments we make and through the relationships we have with our investee companies, regulators, contractors, investment peers, and, most importantly, our members.

"We're long-term investors, so it's important that our portfolio companies look out on the horizon as well and implement the kind of ESG policies that will help sustain their success and grow shareowner value."

George Diehr
Vice Chair,
CalPERS Investment Committee

This baseline report is organized around our three strategic themes for sustainable investment: governance – alignment of interests; environmental – climate change; and social – human capital. We welcome feedback on this report and discussions with all our stakeholders as we continue our path towards sustainable investment.

Strategic themes of our ESG work

In 2011, the CalPERS Board approved the adoption of a Total Fund process for integrating ESG issues as a strategic priority in the Investment Office.

We adopted three core themes for integrating CalPERS ESG work. These are:

- **Alignment of interest through corporate governance:** including issues such as shareowner rights, executive compensation, fund manager terms and conditions and investor protection.
- **Climate change:** including issues related to resource scarcity, water stress, carbon emissions, energy efficiency, clean technology and renewable energy.
- **Human capital:** including issues of exploitative labor practices, health and safety, responsible contracting and diversity.

These three strategic themes explain the structure of this report.

To benchmark the current work, we invited 11 of the world's largest asset owners – with collective global assets of $1.5 trillion – to share their experience in the ESG field. The "ESG Peer Exchange" included funds from the U.K., Netherlands, South Africa, Australia, Brazil, Norway and the United States.

You can learn more in a report entitled *Responsible Investment's Next Decade: Developing CalPERS Total Fund Process for ESG Integration.*

Our implementation framework — the "3 Ps"

As a result of this benchmarking process CalPERS adopted a framework for implementing its strategic ESG themes based around "3 Ps": priorities, performance and procurement.

Priorities

The first step was to identify priorities after cataloging more than 100 separate ESG initiatives across CalPERS. There is a wide range of issues, initiatives, campaigns, standards, investment approaches and products in the ESG sector. Our peer exchange showed that, globally, investors are honing their focus on those areas of sustainability that are most relevant to investment objectives.

Performance

The second step will be to identify how sustainability issues can affect risk and returns over time. Despite a growing body of qualitative and quantitative evidence from the market and academia, there is still much discussion on metrics.

Procurement

CalPERS uses both internal and external managers. We want to ensure that all our managers and other investment service providers understand our expectations on ESG.

Being principled and effective

These efforts to align our values with those of our managers help deliver our commitment to achieving risk adjusted returns for our members. We hopefully will also have a wider influence by encouraging a greater availability of sustainable financial products and services in the market.

"CalPERS has always taken a leadership role, and we'll continue to push the boundaries on sustainable investment both through our own efforts and by collaborating with our peers around the world."

Priya Mathur
CalPERS Board Member and
PRI Advisory Council Member

Taking the Lead

We believe that staying ahead of the curve can help us capture opportunities and manage risk. This page reflects both our history of leadership and present efforts to lead the way with our **"total fund"** approach to **sustainable investment.**

1984

Initiated **corporate governance reform program**.

1985

Helped establish **The Council of Institutional Investors**, now a leading voice for good corporate governance and strong shareowner rights.

1987

Launched our annual **"Focus List"** identifying companies that under-perform on relative stock performance and corporate governance criteria.

1989

Helped found **Ceres**, a coalition of investors, environmental organizations and others dedicated to integrating sustainability into capital markets.

1994

Developed **Real Estate's Responsible Contractor Program Policy** aimed to promote fair labor practices such as fair wages and benefits and equal opportunity hiring.

1995

Became a founding member of the **International Corporate Governance Network** (ICGN), now with members in more than 50 countries.

1996

Launched **International Corporate Governance Program**.

1999

Launched **corporate governance website**.

2001

Earmarked $457 million to **11 California emerging private equity firms**.

2002

Launched our **financial market reform initiative** in the wake of the Enron scandal.

2003

With Ceres, launched the **Investor Network on Climate Risk** (INCR), a network of more than 100 investors promoting improved investment processes, policies, disclosure, and corporate governance practices on climate change.

2004

Adopted the **Energy Efficiency Goal** to reduce energy consumption in Real Estate's core portfolio by 20 percent over a five-year period.

Initiated **Environmental Technology Investment Program**.

2005

Joined a multi-stakeholder group of experts coordinated by the United Nations (U.N.), leading to the formation of the **Principles for Responsible Investment** (PRI).

CalPERS Real Estate Unit joins the **U.N. Environmental Program Finance Initiative** focusing on the Property Working Group.

2007

Forestland Policy revised to incorporate governance, environmental and social principles.

Joined the Advisory Board for the **Credit Roundtable**.

2008

The **"Global Principles of Accountable Corporate Governance"** were approved by the CalPERS Board and guide corporate engagement and proxy voting.

2009

Helped draft the **Institutional Limited Partners Association (ILPA) Principles**, encouraging governance best practice for private equity investment.

2010

Formed the **Global Peer ESG Exchange** to benchmark our sustainable investment efforts against 11 leading asset owners.

CalPERS participated in developing the Mercer Report, ***Climate Change Scenarios – Implications for Strategic Asset Allocation***.

CalPERS backed federal financial market reform.

2011

CalPERS Board of Administration decided on a **Total Fund ESG Integration plan**.

CalPERS Real Estate Unit contributed to the UNEP FI's ***An Investor's Perspective on Environmental Metrics for Property***.

CalPERS Real Estate Unit contributed to the UNEP FI's toolkit, ***Implementing Responsible Property Investment Strategies***.

2012

CalPERS Board of Administration approved the implementation plan for **Total Fund ESG Integration**.

Our Goal – to be a Principled and Effective Investor

CalPERS Core Values

CalPERS work is underpinned by our Core Values. These help us to fulfill our mission to advance the financial and health security of our members. Our core values are:

- **Quality:** Striving to "do it right" and exceed customers' needs and expectations.
- **Respect:** Treating every person with kindness, humility and courtesy, and recognizing their unique skills and contributions.
- **Accountability:** Taking ownership of, and responsibility for, actions, risks and results. Making sound decisions and using outcomes as learning opportunities.
- **Integrity:** Acting in an ethical, honest and professional manner; honoring commitments and building trust.
- **Openness:** Remaining open to new ideas, approaching every situation with good intentions, listening, cooperating and sharing in a genuine and transparent manner.
- **Balance:** Supporting a healthy personal and professional balance, maintaining focus on both long-term goals and short-term needs and supporting an optimistic and enjoyable working environment.

Investment Office Purpose Statement

To be a leading public investment organization by engaging the talents of our people and partners in executing innovative and sustainable investment strategies and products that generate superior risk adjusted returns to enhance the financial security for all who participate in our system.

Investment Office Focus

We ground everything we do with a commitment to serve our beneficiaries with excellence. We possess an uncompromised commitment to our fiduciary duty, and a culture of unquestioned integrity.

CalPERS Working with Others

CalPERS works in partnership with others by cooperating and building consensus to promote the ESG goals that contribute to sustainable risk adjusted investment returns for our fund. Those highlighted are active partnerships where CalPERS representatives hold a Board, committee, working group or other leadership role.

Ceres

A leading coalition to integrate sustainability into day-to-day business practices.

Council of Institutional Investors

A group of large U.S. pension funds promoting awareness of good corporate governance and shareowner rights.

The Credit Roundtable

A group of large institutional fixed income managers seeking to enhance investment grade bondholder protection.

Federal Deposit Insurance Corporation

An independent agency created to promote stability and public confidence in the nation's financial system.

International Corporate Governance Network

A global membership organization to raise standards of corporate governance worldwide.

Institutional Limited Partners Association

A global, member-driven organization dedicated to advancing the interests of private equity Limited Partners through education, research, best practice sharing and collaboration.

Los Angeles Trustees Network

A group of public and private pension fund trustees working together to improve national dialogue on issues such as increased investment transparency.

SEC – Public Company Accounting Oversight Board

A non-profit corporation to oversee the audits of public companies, protecting investors and the public.

Principles for Responsible Investment

A global network of international investors backed by the United Nations and working with the Global Compact and UN Environment Programme Finance Initiative.

Robert F. Kennedy Center for Justice & Human Rights

The RFK Center's human rights advocacy programs focus on the power of the individual, working through alliances and organizations, to generate change.

We are also contributing members of the following networks:

Thought Leaders

- Asian Corporate Governance Association
- Aspen Institute
- European Corporate Governance Institute
- Harvard Law School
- Robert Toigo Foundation
- Stanford — Rock Center for Corporate Governance
- Yale School of Management — Millstein Center for Corporate Governance and Performance

Companies

- The Conference Board
- National Association of Corporate Directors

Investors

- Australian Council of Superannuation Investors
- Global Investor Governance Network

GOVERNANCE
Alignment of interest

Priorities

We believe that strengthening governance will ensure our interests are aligned across the portfolio — we advocate for financial market reforms that protect investors, and engage both the companies we invest in and the fund managers and vehicles which allocate our capital.

We see this alignment as critical to ensuring efficiency, and also effectiveness. Good governance ensures that CalPERS funds are being used for the sole benefit of our members, to produce the long-term, risk adjusted returns that pay pensions.

There are three components to our governance work:
- Financial market reform
- Company engagement
- External managers and vehicles

Financial market reform is of fundamental importance to CalPERS. A fund of our size and global scale, with long-term liabilities, relies upon the market to provide the vast bulk of the risk adjusted returns that will pay members' benefits. This market return is known as the "beta" in our returns. It is what we can achieve through capturing market level returns, which are largely determined by economic growth. This means that the safety and soundness of the markets underpins our investments. Our governance program has a work stream focusing on financial market reform, in which we work with other long-term investors to advocate regulation and legislation which protects investors and promotes market stability. Examples include work to improve transparency through improved international accounting and auditing, and strengthening shareowner rights over compensation through supporting rules to give a "say on pay" to investors. We also advocate for comprehensive and effective regulation to protect investors, for example on complex financial instruments, like derivatives, and the credit ratings industry.

Company engagement is a vital area of CalPERS governance work, and it focuses upon in-depth analysis and discussion with Boards of Directors and senior management on issues of particular concern. Typically, this will be to address long-term financial underperformance, to consider how governance reforms could set the stage for recovery and improvement. The Focus List program takes this approach. We also engage companies on particular issues where legislation has failed, an example being our direct negotiation of majority voting with U.S. companies, to allow shareowners to have an effective voice in director elections. We also undertake company engagement when we need to better understand a new issue, or

Shareowner proposals voted for and against (in the U.S.) by CalPERS in 2011

hear from the Boards of Directors on their perspectives. An example, is our engagement of our largest financial institutions' Boards in the wake of the financial crisis, when we were revising our approach to risk management.

External managers and vehicles represent an important part of the CalPERS portfolio, and the concept of alignment of interest is highly relevant. The terms and conditions for managers and the types of investment vehicle structures have an impact on costs, transparency, and accountability. Our focus has been on identifying best practices which can be rolled out through the industry, for example via the Institutional Limited Partners Association (ILPA) guidelines on reporting in private equity. We have also acted directly to renegotiate fees, and thereby improve efficiency in our investments and improve terms for CalPERS, on behalf of our members. The goal is to ensure that CalPERS interests are represented through the investment chain, and an alignment of interest framework is our strategic theme in the governance of that process.

Performance

Our Global Governance Program engages with more than 100 companies on an annual basis to ensure the high standards of corporate governance that underpin the quality of risk-adjusted returns. All our work in this area is framed by the CalPERS Global Principles of Accountable Corporate Governance, which are reviewed and approved annually by the CalPERS Investment Committee. These Principles set out CalPERS expectations on corporate governance, in particular shareowner rights, disclosure of financial and non-financial information, and our expectations of corporate boards in areas such as diversity, executive compensation, corporate responsibility and market conduct.

Voting for change

One of our key rights as a shareowner is the right to vote the shares of the public companies in which we invest. Shareowner voting rights give us the power to elect directors at annual or special meetings and make our views known to the company management and directors on those issues we believe may affect the value of our shares.

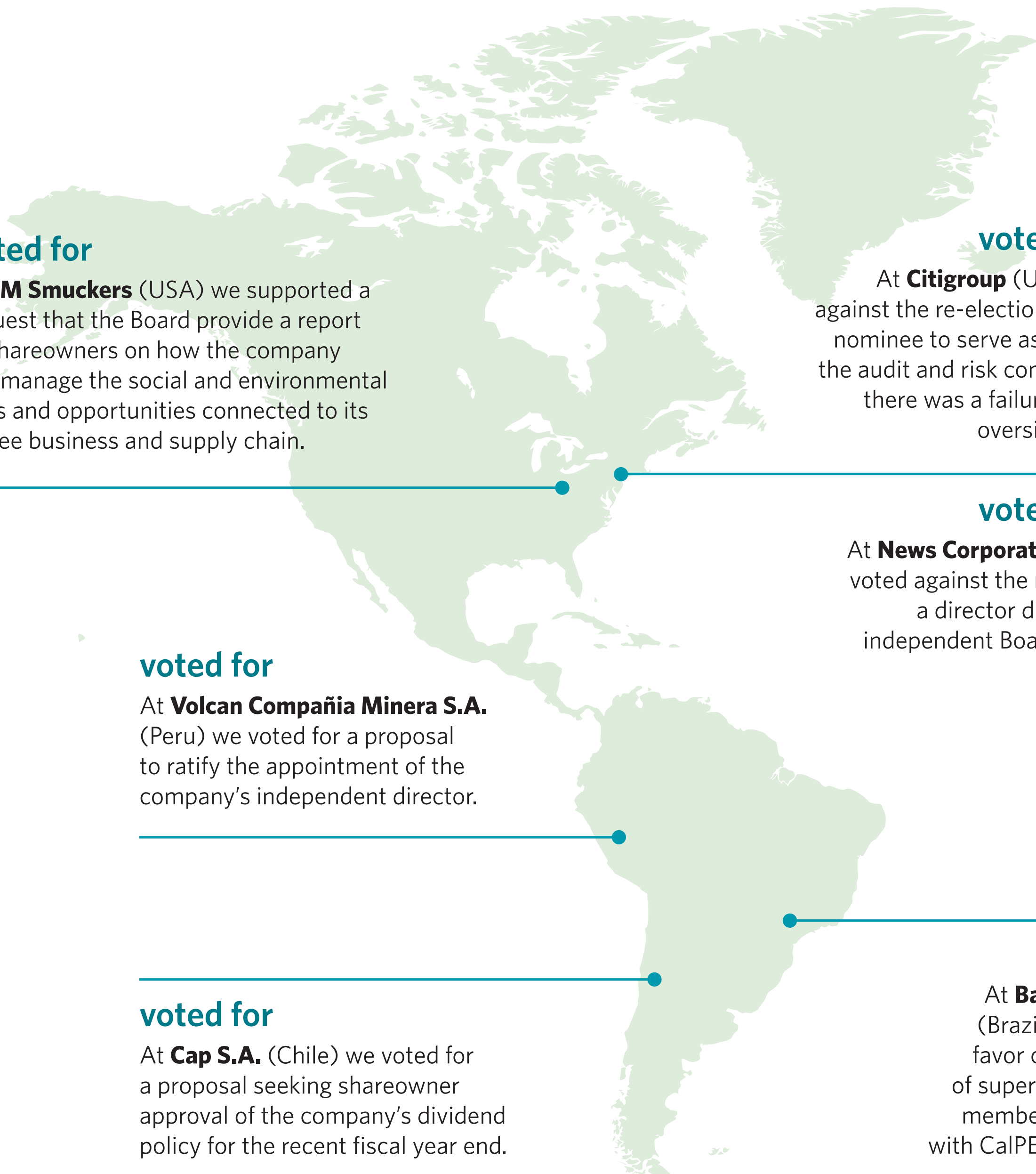
In 2011, CalPERS cast votes at more than 10,000 companies around the world, and voted on a total of 446 shareowner proposals in the United States. We voted "For" the proposal 87 percent of the time.

We also engage directly with relevant companies to further governance reforms that protect investor interests. Some examples of these votes can be found on the world map on pages 12 and 13.

> "We have also learned, and firmly embrace the belief that good corporate governance–that is, accountable corporate governance–means the difference between wallowing for long periods in the depths of the performance cycle, and responding quickly to correct the corporate course."
>
> *CalPERS Global Principles of Accountable Corporate Governance*

CalPERS global proxy-voting examples

Every year, we use our shareowner voting rights to ensure our interests and values are aligned with companies across the 47 markets that we invest in. All our votes are cast in line with CalPERS Global Principles of Accountable Corporate Governance.



voted for

At **JM Smuckers** (USA) we supported a request that the Board provide a report to shareowners on how the company will manage the social and environmental risks and opportunities connected to its coffee business and supply chain.

voted against

At **Citigroup** (USA) we voted against the re-election of a director nominee to serve as a member of the audit and risk committee when there was a failure to establish oversight practices.

voted against

At **News Corporation** (USA) we voted against the nomination of a director due to a lack of independent Board leadership.

voted for

At **Volcan Compañia Minera S.A.** (Peru) we voted for a proposal to ratify the appointment of the company's independent director.

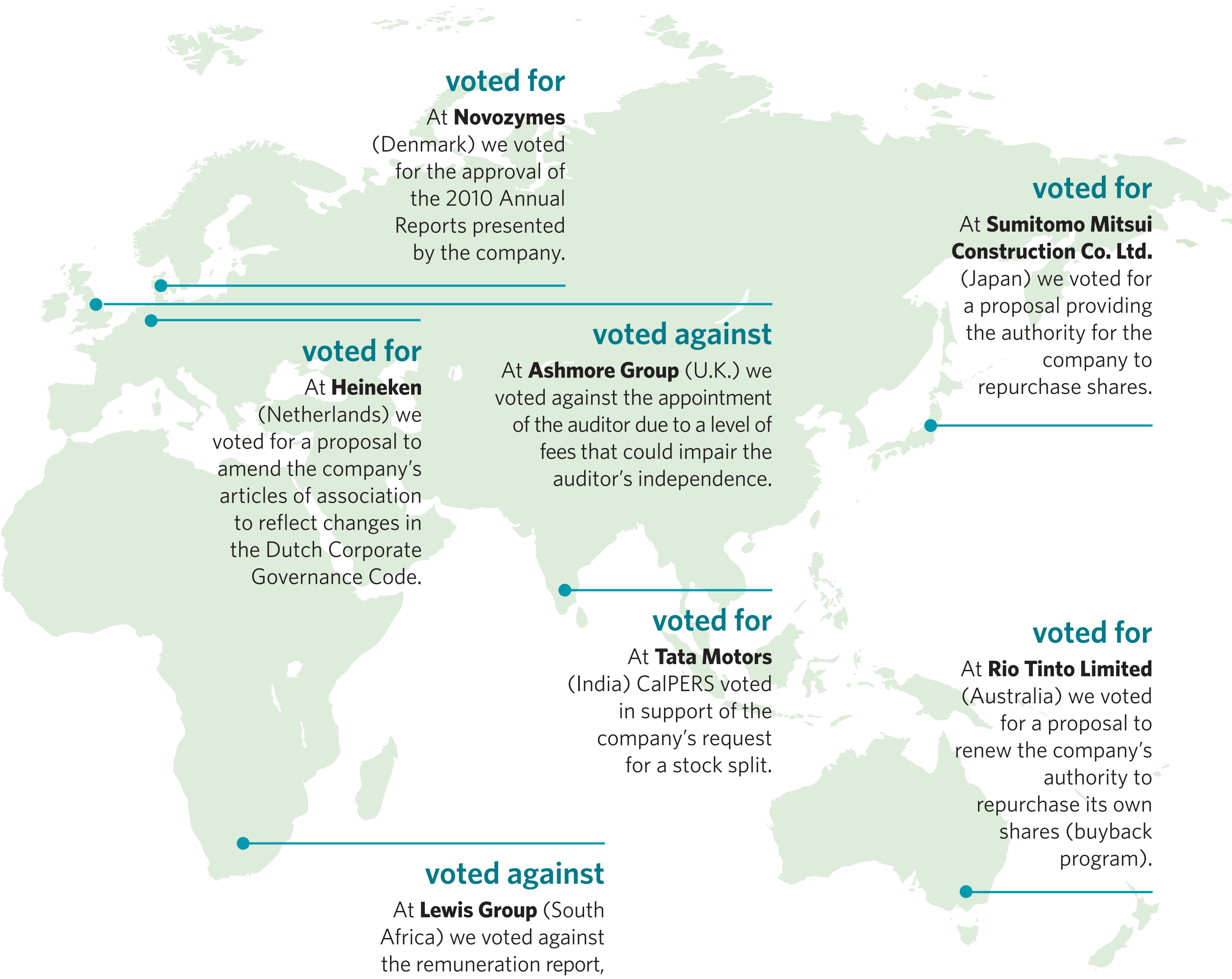
voted for

At **Banco do Brasil** (Brazil) we voted in favor of the election of supervisory council members, consistent with CalPERS Principles.

voted for

At **Cap S.A.** (Chile) we voted for a proposal seeking shareowner approval of the company's dividend policy for the recent fiscal year end.

Western Hemisphere



voted for

At **Novozymes** (Denmark) we voted for the approval of the 2010 Annual Reports presented by the company.

voted for

At **Heineken** (Netherlands) we voted for a proposal to amend the company's articles of association to reflect changes in the Dutch Corporate Governance Code.

voted against

At **Ashmore Group** (U.K.) we voted against the appointment of the auditor due to a level of fees that could impair the auditor's independence.

voted for

At **Sumitomo Mitsui Construction Co. Ltd.** (Japan) we voted for a proposal providing the authority for the company to repurchase shares.

voted for

At **Tata Motors** (India) CalPERS voted in support of the company's request for a stock split.

voted for

At **Rio Tinto Limited** (Australia) we voted for a proposal to renew the company's authority to repurchase its own shares (buyback program).

voted against

At **Lewis Group** (South Africa) we voted against the remuneration report, as long-term incentive awards did not align with our Global Principles.

Eastern Hemisphere

Focus List Program

At the heart of our engagement on corporate governance is our Focus List Program. Each year, we identify companies in our U.S. portfolio that we believe are significantly underperforming on both stock returns and governance factors such as Board quality, poison pills, staggered boards, lack of independent directors, alignment of interest concerning shareowner rights and executive compensation or risk management of environmental and social issues. Those companies are placed on our Focus List and we then engage directly with them and, where necessary, follow up by submitting shareowner proposals.

The Focus List Program is about improving financial performance on an investment over and against the market. By identifying companies with significant governance weaknesses and financial underperformance, and then engaging with them to make improvements, we have been able to make important gains for our members.

We have run a number of studies on the effect of the Focus List since its inception in 1987, and the evidence shows a strong positive connection between sound corporate governance practices and long-term share value. For example, a review of 155 companies that CalPERS had contacted as part of the Focus List Program between 1999–2008 found that, on average, all companies generated a total cumulative excess return of 15.8 percent above their respective benchmarks after three years. This evidence of improved financial performance after being engaged on corporate governance has become known as the "CalPERS Effect."

FIGURE 2: **The Focus List process**

Companies screened and researched
CalPERS reviews domestic equity holdings and chooses lowest ranked companies for engagement.

Fed into the investment process
List of companies is reviewed and approved by the CalPERS Investment Committee.

Company engagement
Focus List companies are notified and CalPERS meets with Board members and senior executives to request specified governance reforms.

Monitoring
The engagement continues until the desired governance reforms are implemented or for up to three years after initial contact. Where necessary, shareowner proposals are put forward.

More information:
www.calpers-governance.org/focuslist/focuslist

Further improvements

In recent years we found that an increasing number of companies adopted improved governance practices subsequent to our discussions. A study conducted by Wilshire, the consultant to the CalPERS Board, concluded that the privately engaged companies consistently outperformed the publicly engaged companies relative to their respective benchmark (as shown in Figure 3).

In 2010, we adopted a new strategy to engage with Focus List companies only through private contacts and proxy actions, such as support for shareowner resolutions at the company's annual meeting. So far, the results have been encouraging.

> "In aggregate, the corporate governance program has accomplished its goal of engaging with companies in order to drive positive long-term shareholder value. CalPERS has a long history of active involvement and discussion of best practices in this area, and the data supports the contention that their involvement has improved investment results."
>
> ***Wilshire Focus List Program Analysis,*** *October 2011*

FIGURE 3:
The "CalPERS effect" on the share price of companies on the Focus List Program, relative to benchmark.*

* Source: Wilshire

Protecting our rights

To align our interests with those of the companies we own, we need to ensure we have the full complement of rights as shareowners. Two areas that we have been especially active on in recent years have been the adoption of majority voting standards and "say on pay" reforms.

Majority voting is a simple system under which board directors must get a majority of votes cast by shareowners in order to win or retain their seats. Although this may seem a common and straightforward electoral system, many elections to corporate boards are held under the "plurality" model—which allows directors to be elected with a single vote, regardless of the number of votes "withheld."

80% of S&P 500 companies have now adopted some form of majority voting standard

In 2010, CalPERS engaged with 38 of our largest holdings that used the plurality model, and last year we engaged with an additional 56 companies on this issue, including filing company management proposals. To date, 77 companies, including Apple Inc. (see case study), have agreed to adopt or are committed to adopting majority voting. Majority voting is quickly becoming the norm in leading U.S. companies. Nearly 80 percent of S&P 500 companies have adopted some form of majority voting standard.

CASE STUDY

Smart governance for Apple

CalPERS is a major investor in Apple Inc., the manufacturer of products such as the iPhone and iPad. We own nearly 2.8 million shares, a stake worth approximately $1.4 billion, and it is one of the largest stockholdings in our pension fund.

We take a keen interest in the company and believe a high standard of governance will underpin the company's future success.

As part of this, we actively engaged with Apple to ask it to change its voting standard for candidates to the Board from a plurality model to a majority standard. The plurality model is considered poor governance because candidates can be elected with a single "For" vote. CalPERS believes board accountability is necessary to provide shareowners better protection for the long term.

At Apple's annual meeting in 2011, CalPERS sponsored a proposal urging Apple to adopt majority voting for Board elections. More than 73 percent of shareowners voting their shares approved the proposal, although as a non-binding proposal, the company was not obliged to act on it.

We raised the issue again at this year's meeting, in February 2012, sponsoring a similar proposal. This time, over 80 percent of the shareowners voted in favor of the proposal.

Apple has now agreed to honor the wishes of its shareowners and implement a majority vote standard for its Board of Directors. We strongly commend the Apple Board for adopting this good governance measure.

Shareowners' inability to hold boards accountable is a fundamental flaw in U.S. capital markets, and the Apple proposal is only part of a broader push for majority-vote elections to corporate boards. Since 2010, we have persuaded 77 large U.S. companies to adopt majority voting, and another 17 have it under consideration.

Similarly, we support "say on pay" reforms, which help shareowners support well-designed compensation programs that align with the long-term interests of shareowners. This gives us the chance to stop excessive and unjustified executive remuneration, and where appropriate, to encourage environmental and social targets in performance assessments.

This year, CalPERS objected to the compensation proposals of nearly 200 companies in our U.S. portfolio and engaged with those companies on "say on pay" reforms.

Private equity

Governance issues have become important in our private equity asset class.

In private equity, we worked with peers at the Institutional Limited Partners Association (ILPA) to create the Private Equity Principles. These Principles encourage transparency, alignment of interests, good governance and have been formally endorsed by more than 140 industry organizations. In 2011, we also worked with ILPA on the release of an industry-sponsored Standardized Reporting Template that is a practical way in which private equity firms (general partners) we invest in can become more transparent and more consistent in their disclosure. In February 2012, CalPERS adopted the ILPA standardized capital call and distribution template for all our general partners.

Fixed income

In fixed income, the concept of sustainable investment is far less evolved. ESG factors do not send clear signals in fixed income portfolios, and areas such as the correlation of ESG criteria with credit ratings and the cost of capital are relatively unexplored.

However, CalPERS aims to be a leader in efforts to improve sustainable investment in fixed income. We've made it a priority to explore ESG factors in credit analysis, for example looking at whether international rankings by organizations such as the World Bank on transparency, governance, rule of law and ease of doing business can be integrated into our analysis. We also actively participate in the Credit Roundtable, which works to protect bondholder rights. The Credit Roundtable also makes recommendations to regulators and government for appropriate regulatory improvements in areas such as credit rating agency reform.

Real estate

In real estate, we have developed the CalPERS Real Estate Alignment of Interest Principles for separate account investment managers. These Principles are incorporated into operating agreements for the separate account partnership structures and address key concepts such as investment strategy, control rights to be retained by CalPERS and manager compensation. These Principles give managers the discretion they need to maximize returns from underlying investments while managing risk consistent with the approved investment strategy and also acting in the best interest of CalPERS.

Market reform at the macro level

CalPERS encourages and supports global reform to protect investor interests through legislative, regulatory, securities exchange and investor forums. We have established a Financial Market Reform work stream that is responsible for CalPERS analysis and advocacy for market-wide reform. Our priorities are: corporate governance, systemic risk, credit rating agencies and asset-backed securities, derivatives, sustainability, consumer protection, and reform litigation. In addition, we believe large pension funds should retain the flexibility to pursue investment opportunities, and not be excluded from the full range of investments and strategies.

CalPERS is working with a group of global investors to ensure the unfinished business of Dodd-Frank Wall Street Reform and Consumer Protection Act is put into place. We've issued comment letters to legislators and regulators and we were actively engaged during the passage of the Dodd-Frank Act, which was signed into law in 2010. We believe this Act is a progressive step towards protecting markets and advancing shareowner democracy, and a significant number of CalPERS priorities were addressed within it. We continue to help implement these reforms.

Procurement and partnerships

Our Global Principles provide the framework for all our work on corporate governance. These Global Principles have been translated into Chinese, Spanish, and Portuguese and made available widely to networks such as signatories of the Principles for Responsible Investment (PRI).

Our Global Governance website alerts fellow investors to ongoing corporate governance issues and encourages collaboration, for example by putting our voting intentions up in advance. It also welcomes comment and feedback. You can also find information on our Corporate Governance Investment Program, corporate engagements, proxy voting, and market reform initiatives, now with videos on current and upcoming initiatives. Visit us online at www.calpers-governance.org.

"CalPERS strives to advance corporate governance best practices for the purpose of creating sustainable long-term investment returns and protecting the system's rights as a shareowner."

CalPERS Global Principles of Accountable Corporate Governance

CASE STUDY

Principles of Financial Regulation Reform: a model for change

We have five "Principles of Financial Regulation Reform," a framework to help restore trust and confidence in the global capital markets and new accounting standards to help reform the derivatives market and to improve auditor independence. We also work closely with a number of groups to help improve financial reporting and ensure that investors receive transparent and relevant information about the economic performance and condition of businesses. We promote international integrated reporting that brings together financial, environmental, social and governance information in one report.

The five Principles of Financial Regulation Reform are:

- Transparency
- Independence
- Corporate Governance
- Investment Opportunities
- Systemic Risk

"The links between fund governance, investment performance and pension funding are complicated. And the effects of shortcomings in any single area tend to be long-lived. These are big institutions and large amounts of money. But they can be turned around, and, to their credit, the CalPERS Board is moving in the right direction."

Ira M. Millstein
Senior Associate Dean for Corporate Governance & Theodore Nierenberg Adjunct Professor of Corporate Governance, Yale School of Management
Institutional Investor, *March 2012*

10 **reforms introduced by our Governance Review in 2011**

CalPERS putting principles into practice

As the nation's largest public pension fund we take responsibility for ensuring our own governance reflects principles of accountability and transparency and is guided by integrity. We want to ensure the public's trust in our decisions, actions and operations. We also believe good governance will drive the achievement of our financial goals.

Governance reforms

We have put in place significant reforms in the last three years to increase the transparency and accountability of our governance. These include rigorous regulation of placement agents, strict limitations for both Board members and staff on gifts from business partners and a new 24-7 Ethics Helpline to identify fraud and waste. We have also established a Board Governance Committee responsible for managing governance protocols and policies in relation to the Board.

Governance review and adopted reforms

In 2011, we completed a comprehensive review of our governance policies and practices to ensure we meet current international best practice. CalPERS adopted 10 sweeping reforms to improve the effectiveness of our 13-member Board, its committees and governance processes, resulting in the adoption of six Principles for Effective Public Pension Fund Governance.* These reforms include a commitment to invite an independent third party to assess Board performance once every two years and certification of a "no undue influence" document to be signed by all senior executives and investment officers. These Principles reflect each Board Member's commitment to:

1. Being effective and capable fiduciaries.
2. Being ethical leaders.
3. Being open and accountable to our stakeholders.
4. Being risk intelligent and insightful in decisions.
5. Taking a long-term view of the needs of beneficiaries and system participants.
6. Undertaking continuous learning and adaptation to changing conditions.

Detailed descriptions of each principle are available on the CalPERS website. Implementation of these reforms is underway and will continue throughout the coming year.

* http://www.calpers.ca.gov/eip-docs/about/organization/board/02152012-board-governance.pdf

ENVIRONMENTAL
Climate change

Priorities

Environmental issues, and climate change in particular, pose a set of enormous risks and opportunities for CalPERS. Climate change has an increasingly large influence on the energy and water strategies used by our portfolio companies, making it an important fiduciary consideration in our investment process.

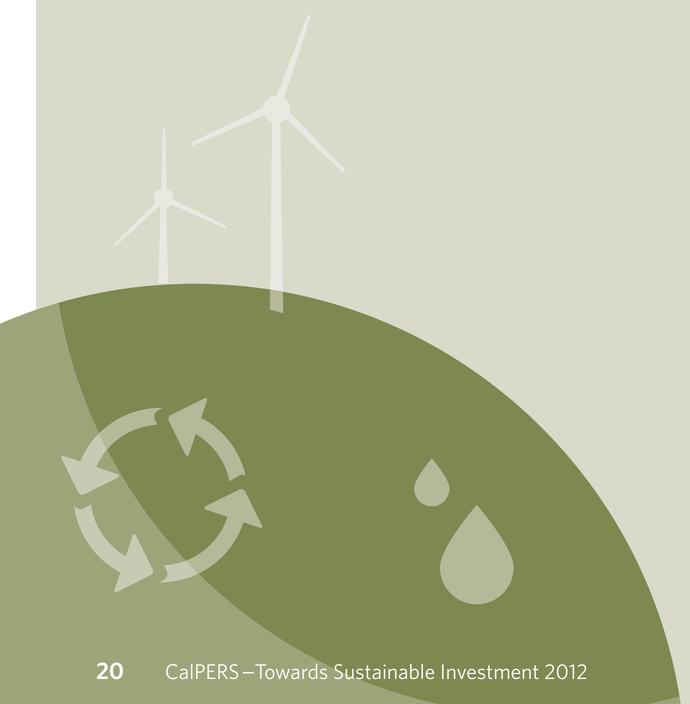
Climate change is a major strategic issue. CalPERS must consider the long-term horizon, as well as meeting today's liabilities, and climate change is expected to have a significant economic impact over this time period. U.K. economist Lord Stern predicted that if no action is taken, climate change could reduce global GDP by as much as 20 percent by 2050. As a large investor with assets across the global economy, this poses a large to medium long-term risk to our portfolio.

The global and long-term nature of climate change issues means that without new policy mechanisms in place, the effects of our actions in terms of environmental impact will remain limited.

Across the total fund, we approach climate change using a mix of targeted investments (in both public and private equity), enlightened procurement and through voting and engagement with companies that we believe need more robust environmental strategies and regulation.

"CalPERS is to be commended for its leadership in analyzing and integrating the impact of climate change and other key environmental issues such as water scarcity into its investment decision-making process. The hard work CalPERS is doing to mitigate these risks and capture related opportunities in its portfolio will serve as a model for other institutional investors in tackling these critical issues."

Mindy Lubber
Ceres President, Director of Investor Network on Climate Risk



Performance

Investing for change in clean technology

One of the ways in which we make an impact on climate change is by providing capital through private equity funds for innovative firms that create more efficient and less polluting technologies than current products.

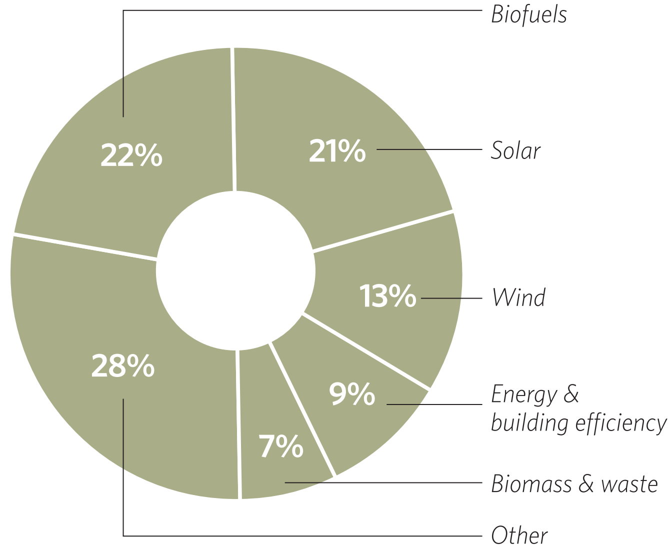
As of September 30, 2011, our Alternative Investment Management (AIM) program has approximately $1.2 billion of aggregate exposure to the alternative energy sector. These commitments include:

- $200 million to clean technology investments through our AIM Environmental Technology Program (Phase I) established in 2005
- An additional $480 million through Phase II, the CalPERS Clean Energy and Environmental Technology Funds
- Partnership commitments to clean energy and technology of more than $500 million

The investment is spread across hundreds of companies with a large allocation to venture capital. Phase I and II of the Environmental Technology Program have a particular emphasis on solar power and biofuels (see Figure 4). There are several promising companies in the solar and biofuels sectors, which are targeting an initial public offering (IPO) soon, but the portfolio is still maturing and thus far, only has a small number of significant winners. Market adoption has been slower than anticipated, and there is a tendency to underestimate capital intensity in product manufacturing and deployment.

We hope that through our pioneering investments in the last decade we have played a part in helping the alternative energy sector to grow. For example, our capital commitments to Phase II of the AIM Environmental Technology Program helped catalyze an additional $4 billion of capital commitments into the alternative energy sector.

FIGURE 4:
CalPERS-invested capital by sector of Clean Energy and Environmental Technology program, June 2011



In public equities, there are a number of potential investment opportunities to be grasped by identifying those companies that have been forward-thinking on climate change. In 2010, we allocated $500 million to an internally managed public stocks environmental index fund. This strategy is modeled on the HSBC Global Climate Change Benchmark Index and invests in approximately 380 securities around the world that derive a material portion of their revenues from environmentally friendly sectors such as low-carbon energy production, energy efficiency management and carbon-trading.

CASE STUDY

Climate change and asset allocation

In 2010, we partnered with 13 fellow large investors from around the world in a study, coordinated by Mercer Consulting, to consider climate change factors in strategic asset allocation. Our partners included some of the world's biggest funds such as AP1 from Sweden, VicSuper in Australia, and the Government of Singapore Investment Corporation who collectively manage over $2 trillion in assets.

The study analyzed the potential financial impacts of climate change on the portfolios of pension funds such as CalPERS, using a series of four climate change scenarios playing out to 2030. Among a series of conclusions the study found that:

- Climate change could contribute as much as 10 percent to portfolio risk over the next 20 years.
- Investment opportunities in low carbon technology could be as high as $5 trillion by 2030.
- Climate change increases uncertainty for long-term investors like our pension fund and needs to be proactively managed.

These findings are a useful part of our preparation for our next strategic asset allocation review and will feed in to that process. The full report on this study can be found online on the CalPERS website.*

* http://www.calpers-governance.org/utilities/redirect-page?url=http://www.mercer.com/climatechange&name=Mercer

Improving our approach

Growing in forestland

CalPERS has a long-standing investment in forestlands. The investment target is one percent of the total investment fund representing approximately $2.3 billion invested in forestland located in the U.S. and internationally.

Our forestland investments are channelled through external managers and are primarily plantations. Well-planted forests produce more goods and services from less land than natural forests. Timber is a renewable resource and with high growth rates, plantations can reduce CO_2 emissions through carbon sequestration.

Taking steps to measure our impact

One of the most difficult aspects of the climate theme is identifying the right metrics by which to measure the environmental impacts of our investments or the carbon footprint of our portfolios.

"Forestland ownership has attractive risk-adjusted returns, is un-correlated with most other investments, and is a great diversifier in an investment portfolio. Furthermore, environmental and social benefits include: renewable building products, carbon neutral energy sources, clean water and family-wage rural employment. CalPERS forestland investments have received the Conservation Leadership Award for Biodiversity Research for the protection and restoration of longleaf pine woodlands in East Texas."

John Gilleland
President & Chairman, The Campbell Group, LLC
CalPERS Fund Manager

Real estate

In 2004, the CalPERS Investment Committee established a goal of reducing energy consumption of the underlying assets in its Core Real Estate portfolio by 20 percent by 2009. At the end of this five-year program, the investment managers exceeded this target, reporting a total energy reduction of 22.8 percent. The cumulative energy reduction is equivalent to preventing an estimated 126,000 tons of CO2 emissions, the same effect as removing around 22,000 cars from U.S. roadways or powering approximately 9,750 homes for a year.

The Real Estate Unit is now participating in the Total Fund process and working with peers on ways to better track energy usage and carbon footprint. One of the areas under consideration is working with the Greenprint Foundation—a worldwide alliance of real estate owners, investors, financial institutions and others, which is committed to reducing carbon emissions across the global property industry. Greenprint has created a mechanism to calculate the carbon footprint of all the participating properties and provide a benchmark to measure the investors' performance.

30% reduction in CalPERS greenhouse gas emissions from 2008–10

Private equity

In the private equity asset class, there have also been a number of notable items of progress where our managers have been able to quantify the impact of improvements they have made both financially and in terms of environmental metrics—as was the case with KKR (see below).

CASE STUDY

KKR—Greening private equity holdings

One of our general partners developed a set of analytic tools and measurements that help its portfolio companies measure and improve their environmental performance.

Kohlberg Kravis Roberts & Co. L.P. (together with its affiliates, KKR) has, for three years now, partnered with the Environmental Defense Fund, a non-governmental organization (NGO), in its Green Portfolio Program. Results from the third year of KKR portfolio companies reporting into the program show that a total of 13 companies have cumulatively saved $365 million and avoided emitting 810,000 metric tons of greenhouse gas emissions since 2008 through energy efficiency, waste handling, process improvements, and other initiatives.

The portfolio companies have been able to use the Green Portfolio Program tools to measure and improve environmental performance, including greenhouse gas emissions, waste generation, and use of water, forest resources and priority chemicals. These tools help managers improve efficiency and reduce waste, which leads to cost savings.

Closing the information gap

We are particularly active at encouraging all companies to disclose relevant information on climate change in a transparent and standardized manner. Given the scale of this challenge, we often work with a wide range of international partners including Ceres and the Carbon Disclosure Project (CDP). For example, Ceres has produced the Ceres Roadmap to help companies assess their long-term risks and opportunities. As an investor signatory to the CDP, we are encouraged that 81 percent of Global 500 companies responded to the CDP in 2011.

When disclosing sustainability information, CalPERS recommends that companies consider the Global Reporting Initiative (GRI) and apply the Global Framework for Climate Risk Disclosure. As discussed earlier in this report, we are also actively involved in work to encourage integrated financial reporting. In 2011, we joined other investors to publicly state our support for the King III report in South Africa, which calls for South African companies to publish an annual integrated report that focuses on the economic, environmental and social impact of their organizations.

As with all sustainability issues, CalPERS is also prepared to engage directly with companies in its portfolio to discuss issues relating to climate change. We have engaged companies in recent years to offer suggested improvements to their environmental management systems and climate change strategies. Our engagement with BP following the Deepwater Horizon oil spill is an example of this (see below).

CASE STUDY

BP – Environmental issues and business risk

In April 2010, a gas release and explosion on the Deepwater Horizon oil rig in the Gulf of Mexico near the Louisiana coastline resulted in the deaths of 11 people and widespread pollution. It took BP 87 days to cap the well and stop the leaking.

As a major investor in BP, with 60.6 million shares at the time of the Deepwater Horizon disaster, we were concerned about the lack of safety oversight by the Board. For CalPERS, it was not just a matter of environmental and social responsibility but also financial concern: BP shares hit a 14-year low in the wake of the Deepwater Horizon spill.

The event also came only a few years after a fatal explosion at BP's Texas City refinery in 2005 and an oil spill in Alaska the following year.

We and other shareowners engaged with BP to find out what had gone wrong and what changes were needed in the company structures and management systems. We met with the BP chairman and executives in July 2010.

Sir William Castell has decided not to stand for re-election as chair of the BP safety, ethics and environmental insurance committee.

BP has taken significant steps:

- A new safety and operational risk organization, reporting directly to the CEO, has been created to audit global standards, including for environmental risk.
- Enhanced drilling standards have been introduced.
- Better risk management practices have been put in place.

Procurement and partnerships

We ask many of our managers to consider environmental issues in their management of our assets. Ensuring a consistent approach on this across all our internal and external managers is one of our core challenges.

Our Alternative Investment Management (AIM) team has taken a lead in this by working with the PRI to send a detailed questionnaire to their private equity managers asking them to disclose the extent to which they incorporate ESG issues into their underlying assets.

The Real Estate Unit established and met a goal to reduce energy consumption by 20 percent in the core portfolio. This effort illustrated that energy reduction can be achieved for a relatively low cost and is good business practice. Bentall Kennedy, an investment manager in CalPERS Real Estate Portfolio, is an example of a firm that has a long-standing commitment to sustainability (see page 26).

Climate change is also a global challenge, and we work with global partners wherever possible. In 2011, we participated in high-level meetings addressing climate change investment risks and opportunities, hosted by the U.N. and the inter-governmental Climate Change Summit in Durban, South Africa. One outcome is an Investor Action Plan on Climate Change Risks and Opportunities. CalPERS contributed to the drafting of this Action Plan, which communicates investor commitments to address the opportunities and risks posed by climate change, consistent with our fiduciary duties. The Action Plan calls for effective policies on climate change and clean energy, improved regulation and transparent reporting.

CASE STUDY

Blackstone and Center Parcs

One of our general partners, Blackstone, reported on the environmental initiatives it has undertaken with a number of its underlying assets, including leisure company Center Parcs. Center Parcs (which is owned by Blackstone) operates 17 holiday villages throughout Europe. It has recently taken steps to minimize its environmental impact by installing energy meters, intelligent thermostats, water-saving devices, variable speed water pumps and energy-efficient light bulbs in its guest villas as well as replacing 25 percent of its vehicle fleet with electric vans. The environmental initiatives undertaken by the company have reduced energy usage by 13 percent, water usage by 14 percent and carbon emissions by 8.5 percent annually.

"Our environmental due diligence and our emphasis on sustainability in the companies in our portfolio are important to us. They have a direct effect on profitability and thus the returns we are able to earn for the millions of Americans who have invested with us. Equally important, they remind us that we are stewards of our portfolio not only for our limited partners but for the broader communities in which they operate."

Steve Schwarzman
Chairman, CEO and Co-Founder, Blackstone Group

CASE STUDY

Aligning our interest in energy efficiency

Real Estate assets that are built and managed with environmental sustainability in mind are likely to result in cost savings and value protection over the long-term. Bentall Kennedy has established itself as an industry leader in responsible property investment.

In 2010, Bentall Kennedy had many achievements including:

- Energy Star Partner of the Year Award in the U.S., recognizing their ongoing commitment to sound energy management principles, and ultimately, reduction of energy use.
- Certified 37 additional buildings to LEED in Canada and the U.S.
- Placed in the top quartile of their peer set for ESG performance for each of the six PRI principles.
- Attained four TOBY awards (The Outstanding Building of the Year) through the Building Owners and Managers Association (BOMA) of Canada.

"As the largest public pension fund in the U.S. and in keeping with its commitment to ESG, CalPERS will play a key leadership role in developing a broad range of innovative initiatives to drive sustainability in the public institutional sector... CalPERS is striving toward the creation and integration of strategic priorities in ESG across the total fund that focus on sustainability as well as managing risks to help meet the investment objectives of the fund."

Michael McKee
CEO of Bentall Kennedy U.S.

CalPERS putting principles into practice

As advocates for addressing environmental issues, we have made concerted efforts to improve the environmental footprint of our main buildings. We have a complex of three buildings at our headquarters in Sacramento. The buildings are LEED certified to the Gold level. The LEED® green building certification program is the nationally accepted benchmark for the design, construction, and operation of green buildings.

We have been reporting our greenhouse gas emissions since 2006, and we reduced them by almost 30 percent, from 9,099 metric tons in 2008 to 6,443 metric tons in 2010. Many of these savings result from our LEED certification program, which identified steps we could take to improve our performance. For example, our building management control system ensures the building is operated at the highest efficiency, including the automated heating and air conditioning system. Low-energy light bulbs have been fitted as have new restroom fixtures that decrease water consumption. We also purchase 50 percent certified green renewable power through our local utility company, the Sacramento Municipal Utility District.

Reducing waste to landfill

As a California State agency, we have a target to divert at least 50 percent of solid waste from landfills with the goal of sending waste to landfills at a rate below 0.6 pounds per person per day. In 2010, CalPERS exceeded this goal by achieving a Per Capita Disposal Rate of 0.4 pounds per person per day and reducing the amount of waste sent to landfills by approximately 24 percent from the previous calendar year. We have achieved this through having separate recycling containers at workstations, in break rooms and at coffee stations. As well as recycling paper, cardboard, plastic, batteries, cans and glass, we also have recycling programs for used toner and ink cartridges.

92%

of our printing and writing paper comes from recycled sources, exceeding the State requirement of 50%

Buying recycled

We have a State requirement to certify that at least 50 percent of our purchases within each product category meet the minimum post-consumer recycled content for that product category. For the 2010–11 fiscal year, we exceeded the 50 percent goal for each product category reported with 58 percent compliance in paper products, 75 percent compliance in metal products, 83 percent compliance in plastic products and 92 percent compliance in printing and writing paper.

SOCIAL
Human capital

Priorities

CalPERS believes that the companies we invest in need a healthy, productive and motivated workforce to build a sustainable business model and deliver the returns we expect. Human capital plays a vital role in the value creation that underpins investment returns.

If companies in our investment portfolios go against the law or international standards— for example, through exploitative labor practices, poor health and safety standards or use of child labor, it exposes them to potential litigation and reputational risk and calls their "license to operate" into question. Conversely, companies with good employee relations tend to recruit and retain talent and, according to some academic research, enjoy better credit ratings.*

We are identifying the issues which affect global investors, like CalPERS, and investigating the tools, metrics and best practices for analyzing, applying and measuring human capital issues in a way that's relevant to achieving risk-adjusted returns.

Social issues are also a major feature in our work with emerging markets. We are making good progress. Our Responsible Contractor Policy in Real Estate is a key measure in this area, as is our work on board diversity. We also engage with companies directly on a number of issues, including fair labor practices in supply chains.

CalPERS complies with state law that calls on us to monitor, engage or divest from companies doing business in Sudan, Iran, Northern Ireland and companies with a legacy related to the Holocaust. Our approach is framed throughout, by our fiduciary duty to our members.

Our Emerging Equity Market Principles help CalPERS to influence progress by advancing a dialogue and offering guidance about these important investment issues.

* Corporate Environmental Management and Credit Risk, Daniel Hann, Jeroen Derwall and Rob Bauer. University of Maastricht, September 2010

Performance

Taking a principled approach to emerging markets

CalPERS has significant investments in emerging markets. These are countries classified by the FTSE index as having a low or middle-income economy and include groupings such as the BRICs (Brazil, Russia, India and China). Such countries constitute approximately 80 percent of the global population.

Every country is very different, but in general, these markets tend to be characterized by rising GDP levels and offer important opportunities for investment growth. Alongside these growth opportunities, there also tend to be higher risks in areas such as human rights and health and safety. Emerging market companies often have incomplete disclosure levels on sustainability information.

Until 2007, we did not invest in a large number of emerging markets due to risks that we might invest in companies or other entities that abuse labor or violate human rights. We had a "Permissible Country List" that in effect screened out any equity investment in these countries. When we reviewed this approach in 2007, we concluded that it both hurt our returns by reducing our investable universe and reduced our ability to be a positive influence on these markets.

At CalPERS, we encourage positive innovation, and we concluded that where we found unacceptable social issues, it would be more effective to exclude individual companies, rather than entire countries. Where possible, we use engagement to improve standards and generate enhanced performance. This led to the establishment of our Emerging Equity Market Principles (available online*), which state our basic requirements in terms of productive labor practices, transparency, political stability, corporate social responsibility, market regulation, transaction costs and capital market openness.

Each year, we ask a third party (currently MSCI) to analyze the emerging market companies we invest in to ensure that there has been no infringement of these principles, a process explained in Figure 5. This approach has led us to greatly increase our investments in these countries; for example,

FIGURE 5:
Putting our emerging market principles into practice

1. Data provider analyzes all firms in our emerging markets' universe (around 1,700 companies of all sizes) to ensure no infringement of international standards, such as the International Labor Organization (ILO) core labor conventions or the Global Sullivan Principles of corporate responsibility. Official filings, media reports, NGO research and other sources are used.

2. Each company is rated with either a "pass," "watch list" or "red flag." A red flag indicates egregious violations of these standards, "watch list" raises serious concerns but means that a violation is not totally clear and a "pass" indicates full compliance.

3. We invest only in companies which are rated "pass" or "watch list" and do not invest in "red flag" companies.

4. The information from the exercise and results are then fed into the CalPERS investment process.

companies in China now constitute more than 17 percent of our emerging markets universe.

Many of these countries are developing more enlightened labor practices, and our Emerging Equity Market Principles help CalPERS to influence progress by advancing a dialogue and offering guidance about these important investment issues.

* http://www.calpers.ca.gov/eip-docs/investments/policies/inv-asset-classes/equity/ext-equity/emerging-eqty-market-prinicples.pdf

CASE STUDY

Massey — Tackling ESG Risks

As an investor in, and therefore a part owner of, coal producer Massey Energy, we were appalled by the Upper Big Branch mining tragedy in West Virginia in April 2010. The disaster killed 29 people and was one of the worst U.S. coal mining disasters in 40 years. Alongside the tragic loss of life, there also were severe financial consequences for Massey shareowners.

Among the issues that emerged in the wake of the tragedy was the lack of accountability of the Board to its owners. For example, only a third of Massey's directors faced re-election in any given year, making it difficult for shareowners to push for change. The company listened to this criticism and now requires all Board members to stand for re-election every year.

Massey also has enacted an important improvement in standards by establishing a separate Safety and Environmental Committee made up entirely of independent directors.

The company also made a number of other changes to improve the accountability of the Board to its owners. These included allowing majority voting in non-contested director elections and amending its Corporate Governance Guidelines to clarify the responsibilities of the lead independent director. CalPERS hired a proxy solicitor in order to reach the 80 percent vote requirement that was needed to instigate these changes.

We believe these changes constitute an important step in the right direction and will help bring about a marked improvement in how the company manages safety risks and protects long-term value.

Shareowners and boards working together

A mix of skills and experience is an important part of achieving board diversity. For example, as part of a 2008 settlement between CalPERS and UnitedHealth Group, the company agreed to ensure that at least one nominee for the Board of Directors would be a shareowner-nominated candidate. This has led CalPERS and UnitedHealth Group to work closely together to create a process to search for and select a qualified Board candidate, resulting in the appointment of Rodger A. Lawson to the company's Board in February 2011.

"We believe this engagement between CalPERS and UnitedHealth Group and the exchange of ideas and approaches was highly productive for both organizations."

Michelle Hooper
Independent Board member,
UnitedHealth Group

Building a pool of talent for boards — The Diverse Director DataSource (3D)

Research suggests that companies with more diverse boards perform better. This complements our own experience—that when a board has a wide profile in terms of skill sets, ethnicity and gender it taps into the wide range of thoughts, perspectives and competencies that define good leadership teams.

Shareowners have the opportunity to ensure boards have the skills, experience and diversity they need to succeed. Between 2008 and 2010, companies with more diverse top teams were also top financial performers—ROEs and EBIT margins were 53 percent and 14 percent higher on average.*

* "Is there payoff from top-team diversity?" McKinsey Quarterly, April 2012

To support this, we have worked with the California State Teachers' Retirement System (CalSTRS) and a broad alliance of institutional investors, search firms, corporates, academics and diversity advocates to develop the Diverse Director DataSource, better known as "3D." 3D is a new digital library that helps corporate boards to find untapped talent from the full spectrum of social backgrounds and a broad range of experiences. It began receiving details from potential candidates for corporate Boards in September 2011, and we look forward to reporting on its progress in future reports. More information on 3D can be found at www.gmi3d.com.

"CalPERS believes that Boards that strive for active cooperation between corporations and stakeholders will be most likely to create wealth, employment and sustainable economies."

CalPERS Global Principles of Accountable Corporate Governance

Procurement and partnerships

There are a number of ways in which we build social issues into our procurement processes. For example, all external managers for our emerging market portfolios must explain how the Emerging Equity Market Principles will be adopted in order to progress through the initial recruitment process.

Probably the most important initiative in this area is our Responsible Contracting Program Policy (RCP). In 1994, we adopted the RCP within Real Estate to support and encourage fair wages and benefits for workers employed by our contractors and subcontractors at CalPERS RCP investments. The policy is available online and an extract from the introduction is shown on page 32. It defines a responsible contractor as "a business that pays workers a fair wage and a fair benefit," although we recognize that what constitutes responsible contracting may differ from one geographical location to another, depending on market realities.

In 2010–11, the Real Estate program achieved a 97.5 percent compliance rate with CalPERS RCP goals and requirements and its managers paid in excess of $647 million towards RCP contracts.*

Since February 2010, core managers have been piloting the Neutrality Trial Responsible Contractor Program (Neutrality Trial RCP) Policy and its corresponding Neutrality Trial Program (NTP). The program ensures that CalPERS and its investment managers, contractors and subcontractors remain "neutral" on employee and union organizing efforts. We currently are analyzing the impact of the Neutrality Trial RCP.

* http://www.calpers.ca.gov/eip-docs/about/board-cal-agenda/agendas/invest/201202/item07c-00.pdf

$6.3 billion

committed to emerging managers

$1.1 billion

committed to through AIM's Emerging Domestic Private Equity Program

Alternative Investment Management (AIM)

In private equity, our AIM fund is committed to ensuring that it does not only award mandates to the largest or most established managers, but also supports smaller emerging managers. In this context, we define an emerging manager as a partnership raising a first or second time fund. These emerging managers have the ability to invest in certain strategies and businesses that have historically lacked access to capital, including rural and urban markets.

Emerging managers typically pursue investment opportunities in small and lower middle market businesses, which can be overlooked by established private equity partnerships. Emerging managers are typically not as closely followed by most institutional investors, and so we believe this is an area of opportunity. Since AIM's inception, we have committed $6.3 billion to emerging managers, of which $1.1 billion was committed through AIM's Emerging Domestic Private Equity Program.

Global partnerships

As part of our efforts on social issues, we also collaborate with peers around the world and through bodies such as the U.N. Global Compact. For example, through the U.N. Global Compact and PRI, we have led an Expert Group on responsible business in conflict-affected and high-risk areas. This has led to new guidance being published for large companies that operate in conflict zones on what global investors constitute as responsible business.

"CalPERS has a deep interest in the condition of workers employed by CalPERS and its Managers and Delegates … [CalPERS] supports and encourages fair wages and benefits for workers employed by its contractors and subcontractors, subject to fiduciary principles concerning duties of loyalty and prudence … CalPERS endorses small business development, market competition, and control of operating costs. CalPERS supports many of the ideals espoused by labor unions and encourages participation by labor unions and their signatory contractors in the development and management of CalPERS real estate and infrastructure investments. CalPERS believes that an adequately compensated and trained worker delivers a higher quality product and service."

CalPERS Responsible Contractor Program Policy

CalPERS putting principles into practice

Our workforce

CalPERS strives to find the highest caliber of talent and reflect the State's diverse population. Our core values of quality, respect, accountability, integrity, openness and balance permeate our culture and are fundamental to CalPERS success both in day-to-day operations and long-term strategies. The majority of CalPERS approximately 2,300 employees are located at the main campus in Sacramento; however, a statewide presence is maintained through eight regional offices. CalPERS investment office is located near the CalPERS Sacramento Regional Office that assists our members.

Diversity Outreach Program

We recognize that a diverse workforce enhances the way we do business and enables us to better serve our increasingly diverse customer base. Since 2003, CalPERS Diversity Outreach Program has worked to foster an inclusive environment through employee resource groups like the CalPERS Disability Advisory Council and the Diversity Outreach Committee. At CalPERS, diversity and inclusion is about making our workplace environment inclusive for everyone.

Tone at the top

These efforts start with leadership from the very top. In 2009, our CEO created the Diversity Executive Steering Committee, and charged it with supporting development and implementation of enterprise initiatives and outreach efforts. CalPERS also has a Board member, Henry Jones, who serves as a special advisor to the Board President on diversity.

Our workplace

CalPERS is committed to cultivating an environment that facilitates growth and professional development. We invest heavily in the development of all our employees, by providing training and development opportunities that encourage our employees to meet both their personal and professional goals. CalPERS Wellness Program promotes healthy lifestyles for employees by offering an onsite fitness center running 25 group exercise classes per week, wellness information and tools at a very low cost. Based on the national average, the return on investment (ROI) for wellness programs is $3.14 for every dollar spent. This can be measured by improved employee attendance, lower health care costs, lower workers' compensation costs, increased productivity and reduced employee turnover.

We also provide an onsite day care center, offer a Career Services Program that provides services, resources, and tools to assist CalPERS employees in meeting their personal career goals and an Alternative Commute Program including a telework option and a bike share program making some bicycles available to employees.

NEXT STEPS
Looking ahead

CalPERS has adopted a framework for implementing ESG across the total fund. We are undertaking three core projects in the next phase and will report progress in our next Sustainable Investment Report.

We are undertaking three initiatives for the total fund as a whole, detailed below, while each asset class is also taking on individual ESG projects in their specific areas.

Priorities — Developing Total Fund Principles on Sustainability

Our focus is on reducing and rationalizing the list of more than 100 initiatives on ESG issues that affect CalPERS across the total fund, in line with the core themes outlined in this baseline report.

To achieve this, we will establish a set of Total Fund Principles on Sustainability and an agreed list of ESG initiatives based on their outcomes, their applicability to our fiduciary duty, capacity to deliver and impact. This will form the basis of a Board discussion later in the year.

Performance — Reviewing the evidence

There remains a global lack of consensus on the evidence for how ESG factors influence financial performance. Our own discussions on this also have highlighted the need for clarity on the definition of sustainability and its impact on investment risk and return across each asset class.

We are undertaking research to assess how sustainability issues impact all our investments, from commodities to currencies, and will review the evidence. With this knowledge, we will be better able to define what is relevant and what best aligns with our core values. This will enable us to address which specific tools and metrics each asset class needs to consider in order to fully implement the total fund strategy.

Procurement — Setting manager expectations

CalPERS largely uses internal managers for its public asset classes and external managers for its private assets.

Public Equity has piloted a manager questionnaire on ESG and is working to include the responses in the qualitative assessment of manager skill. This concept will be rolled out across the other asset classes to establish a core set of ESG questions to be included in manager appraisals and tailored as needed for each area of our investment strategy.

These questions will address two aspects of the potential manager's capacity: their institutional policy and practices on ESG and their investment policy and practices on ESG, if any. The result of this work will be a CalPERS Expectations Document on sustainable investment for both internal and external managers.

To find out more, contact Ashley Taylor at Global_Governance@calpers.ca.gov

"Shareowners can be instrumental in encouraging corporate citizenship. CalPERS believes that environmental, social and corporate governance issues can affect the performance of investment portfolios."

CalPERS Global Principles of Accountable Corporate Governance

PRI Index

CalPERS Commitment to the UN-backed Principles for Responsible Investment

CalPERS is a founding signatory to the UN-backed Principles for Responsible Investment (PRI) and participates in its annual assessment process each year. The following index offers an indication of how items in this report relate to our implementation of the six Principles of the PRI.

Examples of best practice	*Where you'll find illustrations in this report*
Principle 1: We will incorporate ESG issues into investment analysis and decision-making processes	
Address ESG issues in investment policy statements	Page 7, 11, 17–18, 29 and 31–32
Support the development of tools and metrics for benchmarking the integration of ESG issues	Page 14–15, 23, 25 and 29
Assess the capabilities of external investment managers to incorporate ESG issues	Page 6, 11, 25, 31 and 34
Ask investment service providers (such as financial analysts, consultants, brokers, research firms or rating companies) to integrate ESG factors into evolving research and analysis	Page 6, 15, 25 and 29
Principle 2: We will be active owners and incorporate ESG issues into our ownership policies and practices	
Develop and disclose an active ownership policy consistent with the Principles	Page 6 and 10–19
Exercise voting rights consistent with long-term ESG considerations and monitor compliance of outsourced voting service providers	Page 10–13, 16 and 20
Engage with companies on ESG issues	Page 10–11, 14–16, 20, 24 and 28–30
Participate in collaborative engagement initiatives	Page 9 and 32
Ask investment managers to undertake and report on ESG-related engagement	Page 6, 23, 25 and 34
Principle 3: We will seek appropriate disclosure on ESG issues by the entities in which we invest	
Ask for ESG issues to be integrated within annual financial reports	Page 18 and 24
Ask companies for ESG information—where possible using standardized reporting tools	Page 17 and 24
Support shareowner initiatives and resolutions promoting ESG disclosure	Page 11–16
Disclose annual voting records, with an analysis of key votes	Page 11–13, 16 and 18
Principle 4: We will promote acceptance and implementation of the Principles within the investment industry	
Include Principles-related requirements in requests for proposals. Also align investment mandates, monitoring procedures, performance indicators and incentive structures	Page 25, 31 and 34
Engage in dialogue or support government policy or industry regulations related to ESG issues	Page 18
Communicate ESG expectations to investment service providers	Page 6–8, 11, 25, 31 and 34
Principle 5: We will work together to enhance our effectiveness in implementing the Principles	
Support/participate in networks and information platforms to share tools, pool resources and make use of investor reporting as a source of learning	Page 9
Collectively address relevant emerging issues	Page 22 and 32
Develop or support appropriate collaborative initiatives	Page 5, 7, 22 and 32
Principle 6: We will each report on our activities and progress towards implementing the Principles	
Disclose active ownership activities (voting, engagement, and/or policy dialogue)	Page 11–16, 18, 24 and 30
Communicate with beneficiaries about ESG issues and the Principles	Throughout report
Make use of reporting to raise awareness among a broader group of stakeholders	Throughout report

CalPERS is the largest public pension fund in the U.S. with approximately $231.9 billion in assets, providing retirement benefits to more than 1.6 million State, public school, and local public agency employees, retirees, and their families, and health benefits to more than 1.3 million members. The average CalPERS pension is $2,332 per month. The average benefit for those who retired in the most recent fiscal year that ended June 30, 2011, is $3,065 per month.

For more information about CalPERS, visit **www.calpers.ca.gov.**

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