

California State Auditor

B U R E A U O F S T A T E A U D I T S

California Public Employees' Retirement System:

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



December 2000
99138

The first five copies of each California State Auditor report are free.
Additional copies are \$3 each, payable by check or money order.
You can obtain reports by contacting the Bureau of State Audits
at the following address:

**California State Auditor
Bureau of State Audits
555 Capitol Mall, Suite 300
Sacramento, California 95814
(916) 445-0255 or TDD (916) 445-0255 x 216**

OR

**This report may also be available
on the World Wide Web
<http://www.bsa.ca.gov/bsa/>**

Alternate format reports available upon request.

Permission is granted to reproduce reports.



CALIFORNIA STATE AUDITOR

ELAINE M. HOWLE
STATE AUDITOR

STEVEN M. HENDRICKSON
CHIEF DEPUTY STATE AUDITOR

December 19, 2000

99138

The Governor of California
President pro Tempore of the Senate
Speaker of the Assembly
State Capitol
Sacramento, California 95814

Dear Governor and Legislative Leaders:

As requested by the Joint Legislative Audit Committee, the Bureau of State Audits presents its audit report concerning the California Public Employees' Retirement System's (CalPERS) investment policy and procedures related to its international investments and its investment in five specific foreign companies.

This report concludes that although CalPERS uses external managers to administer its international investment portfolio, it has reasonable procedures for selecting, contracting with, and overseeing these entities. In addition, CalPERS bases its foreign investment policy primarily on financial factors and has limited the investments its external managers make to those financial markets that it has screened for their ability to support large investors, such as CalPERS. These international investment policies are consistent with CalPERS' responsibilities as set forth in both state and federal law. Finally, CalPERS and its external managers evaluated the financial returns and followed federal law when investing in the five companies that were specified in the audit request. Because of a lack of information from credible sources that would also be generally available to institutional investors, we were unable to determine the validity of the allegations raised against these companies.

Respectfully submitted,

ELAINE M. HOWLE
State Auditor

CONTENTS

<i>Summary</i>	1
----------------	---

<i>Introduction</i>	5
---------------------	---

Audit Results

CalPERS Uses Reasonable Procedures to Select, Contract With, and Oversee Its External Managers	11
--	----

CalPERS Bases Its Foreign Investment Policy Primarily on Financial Considerations, and This Practice Is Consistent With State and Federal Laws	18
--	----

CalPERS Evaluated Financial Returns and Followed Federal Law When Investing in Companies Considered Potential Security Risks	30
--	----

<i>Recommendations</i>	33
------------------------	----

Appendix A

CalPERS External Managers for International Equity and Fixed Income Investments as of June 30, 2000	35
---	----

Appendix B

Specific Findings About CalPERS Investments in Five Companies Alleged to Pose Security Risks	37
--	----

Response to the Audit

California Public Employees' Retirement System	41
--	----

<i>California State Auditor's Comments on the Response From the California Public Employees' Retirement System</i>	43
--	----

SUMMARY

Audit Highlights . . .

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

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

RESULTS IN BRIEF

The California Public Employees' Retirement System (CalPERS) manages and administers the retirement benefits of more than one million public members. When it invests retirement system funds in foreign financial markets, CalPERS follows its mission—to provide retirement benefits to its members—as well as relevant state and federal laws. State law also establishes as a fiduciary responsibility for CalPERS the requirement that the retirement system act solely in the best interests of its members. For these reasons, CalPERS directs the external portfolio managers that make its international investments to aim for sufficient rates of return within an acceptable level of risk. CalPERS also requires these managers to rely primarily on financial considerations when making investment decisions. To ensure that its external managers adhere to applicable laws and do not risk members' benefits through investments in foreign financial markets that may be legally and financially unsound, CalPERS restricts the international financial markets in which managers may invest. Further, CalPERS foreign investment policies conform to federal law because CalPERS has not made foreign investments based on factors that might conflict with United States foreign policy and because CalPERS does not purchase shares in companies in which the federal government has indicated it does not want Americans to invest. However, in November 2000, CalPERS adopted additional criteria, including considerations of countries' political stability and labor practices, to determine the emerging markets suitable for CalPERS investment.

The largest public pension fund in the United States, CalPERS has net assets of more than \$172 billion. Its investment portfolio is divided into asset classes that include international and domestic stocks and international and domestic fixed income investments (primarily bonds). The portfolio's size and diversification require CalPERS to contract with external consultants and portfolio managers to manage some of the assets. Because of the expertise and specialized skills required to invest internationally, external managers make all international investments for CalPERS.

We reviewed how CalPERS manages its international investing and found that CalPERS and its external managers follow its policies on foreign investing. CalPERS uses reasonable methods to select, contract with, and monitor the external managers that manage and administer all foreign investments. Because their contracts stipulate a fiduciary duty to CalPERS, these external managers must follow CalPERS policy, including restrictions on the financial markets in which they may invest. CalPERS, in turn, is responsible to its members. According to state law, CalPERS is required to make investing decisions with the interests of its members in mind. In keeping with this legal duty, CalPERS requires the external managers to make investment decisions based primarily on financial factors.

Although CalPERS adequately monitors the performance of its external investment managers, it does not sufficiently monitor its general pension consultant, an international investment industry expert who advises CalPERS on investment policy. CalPERS has just recently begun the year-end review of its general pension consultant for the year ended June 30, 2000. This review is essential because the general pension consultant's contract does not have a defined duration, but continuation of the contract is subject to the review's results.

Our audit also showed that the CalPERS policy on where the retirement system may make investments follows the stated mission of CalPERS and all applicable laws. Using financial criteria, the general pension consultant created a permissible country list (list) disclosing the countries in which external managers may invest. The list specifies which countries' financial markets are suitable for investment by institutional investors such as CalPERS. Criteria for being on this list include the legal and financial stability of the markets but not national security or social issues.

Because the CalPERS investment committee believes that the screening process used to create the list has possible shortcomings, CalPERS is revising the process. First addressed in April 1999, these possible shortcomings still await resolution. In a recent action, the CalPERS Board of Administration voted to consider certain nonfinancial factors when selecting specific emerging markets in which CalPERS may invest.

By basing its international investment policy primarily on financial factors, CalPERS not only meets its fiduciary duty to its members and abides by state law, but the retirement system also

avoids encroaching on the federal government's authority. Under the United States Constitution, the federal government has the power to set foreign policy and could challenge any CalPERS investment policy based on social or political factors that conflict with federal policies. In fact, the Supreme Court recently overturned a Massachusetts law that restricted Massachusetts state entities from buying goods or services from companies doing business in the country of Myanmar, formerly known as Burma.

Recently, questions have been raised about five foreign companies in which CalPERS invested and about the policies behind those investment decisions. A primary concern regarding these companies centered on national security issues. Through the Hong Kong stock market, CalPERS invests in businesses that have parent companies or major shareholders located in mainland China. CalPERS policy directly restricts investments in the Chinese financial markets, but it permits investments through the Hong Kong stock market because the investment community considers Hong Kong, though a Special Administrative Region of China, as separate from China. Hong Kong's regulation of its stock market emphasizes private enterprise, and investors throughout the world have high regard for the Hong Kong market. Also, investment in Chinese companies is not contrary to federal law because the Department of the Treasury's Office of Foreign Assets Control (OFAC), which is the federal office that administers and enforces economic and trade sanctions, allows such investment. Further, none of the questioned companies appears on OFAC's list of Specially Designated Nationals, the document on which OFAC names those individuals and companies in which the federal government does not want Americans to invest.

RECOMMENDATIONS

To ensure that it properly monitors its general pension consultant, CalPERS should finish its review of the consultant for the year ended June 30, 2000, and establish controls so that it performs the review promptly each year.

To ensure that it has adequate, current criteria for determining which countries have permissible markets for investment, CalPERS should finish revising the process for developing its permissible country list and create a timetable for the review of existing criteria.

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

AGENCY COMMENTS

CalPERS agrees that this report accurately presents CalPERS foreign investment practices and concurs with the recommendations. Further, CalPERS is currently proceeding with the implementation of all the recommendations. ■

INTRODUCTION

BACKGROUND

The State established the California Public Employees' Retirement System (CalPERS) in 1932 to provide retirement benefits for state employees. Since its inception, CalPERS has expanded to provide health benefits and long-term care insurance and to include in its membership the employees of other public agencies (such as cities, counties, and local special districts) and nonteaching staff at public schools.¹ Currently, CalPERS manages pension and health benefits for more than 1.2 million California public employees, retirees, and their families, all of whom CalPERS calls members. CalPERS is the nation's largest public pension fund and the world's third largest, with net assets of \$172 billion as of June 30, 2000.

The authority to administer and invest retirement funds is vested with the CalPERS Board of Administration (CalPERS board), which consists of 13 members: 6 elected by members of the retirement system, 2 appointed by the governor, 1 appointed by the Legislature, and 4 designated by statute. The 4 designated members are the state treasurer, the state controller, the director of the Department of Personnel Administration, and a member appointed by the State Personnel Board. Every member of the CalPERS board serves on the investment committee, which reviews investment transactions, evaluates investment performance, and establishes investment policy and strategy. The board also directs the activities of CalPERS employees, most of whom are based in Sacramento. As of July 1, 2000, CalPERS had 1,500 budgeted positions for all of its activities, including management of investments, health and long-term care benefits, and retirement services.

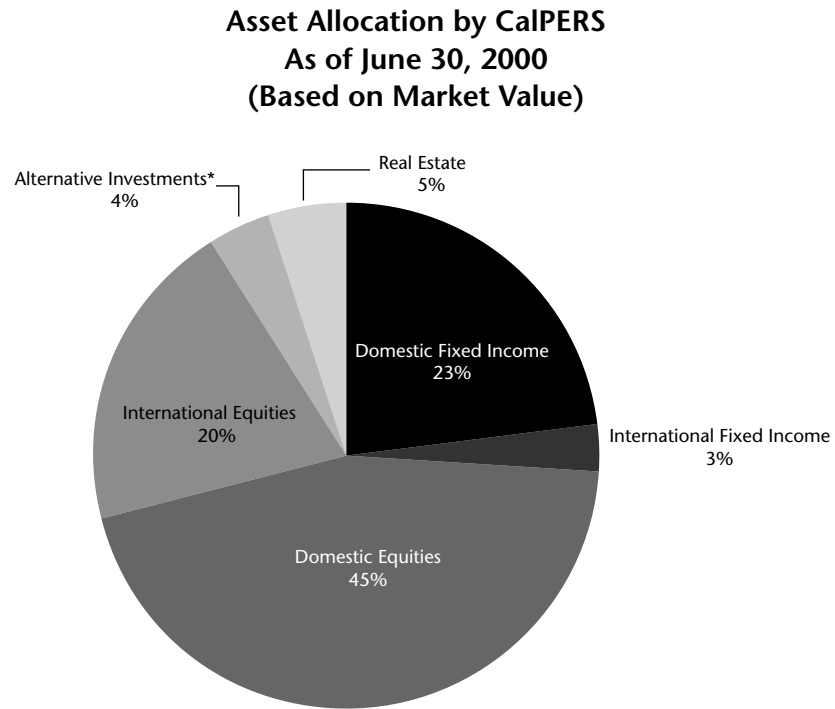
CALPERS INVESTS IN BOTH DOMESTIC AND FOREIGN MARKETS

The investment portfolio makes up more than 98 percent of the total assets that CalPERS holds. The investment portfolio is divided into asset classes, such as equity securities (or stocks),

¹ The California State Teachers' Retirement System administers the retirement benefits for teaching and other certificated staff of public schools.

fixed income securities (primarily bonds), and real estate. Figure 1 shows the allocation of the retirement system's asset classes as of June 30, 2000.

FIGURE 1



Source: California Public Employees' Retirement System

* *Alternative investments* are private equity investments, which include limited partnerships or innovative or specialized investments.

By allocating its portfolio into the different asset classes, the retirement system can diversify its investments and balance its rates of return with the level of risk involved in the investments. For each of these asset classes, CalPERS has developed specific asset allocation strategies that allow the retirement system to take advantage of emerging or rapidly changing market opportunities while providing for the long-term benefit of the retirement fund. The CalPERS board reviews the asset allocations annually and can adjust them. For the year ended June 30, 1999, the most recent year for which an investment report is available, CalPERS stated that it had achieved a fifth straight year of double-digit returns on its investment portfolio.

For its investment activities, CalPERS uses its own investment staff to manage domestic investments and contracted external managers to perform some domestic and all foreign investments. The CalPERS investment staff and the external managers must follow the board's established policies, which cover both domestic and foreign investments. For fiscal year 1999-2000, CalPERS contracted with 12 companies to administer its foreign investments. (Information about these companies appears in Appendix A.) Because CalPERS had \$40.5 billion (23.5 percent) of its portfolio invested as of June 30, 2000, in foreign equity and fixed income securities, the return on foreign investments can affect the total portfolio's performance.

CALPERS MUST FOCUS ON HOW ITS MEMBERS WILL BENEFIT WHEN IT MAKES INVESTMENT DECISIONS

Under state law, CalPERS has a fiduciary duty to the retirement system's members, which means that the CalPERS board must use its informed opinion to determine whether each investment decision is financially prudent. If CalPERS were to rely on factors other than financial ones for its investment decisions, it would not only violate its own mission, but it could also break state law requiring it to make investment decisions in the interest of its members. According to Article XVI, Section 17, of the California Constitution, the boards of public retirement systems, including the CalPERS board, have sole, exclusive fiduciary responsibility over the assets of their respective retirement systems. Moreover, a retirement board's duty to its members takes precedence over any other duty. That section further states that the assets of the retirement funds are trust funds held for the exclusive purpose of providing benefits to its members and their beneficiaries. In addition, Section 20151 of the California Government Code requires the CalPERS board to act solely in the interest of CalPERS members, stating that the exclusive purpose of CalPERS is to provide benefits to the system's members and their beneficiaries. Thus, when making investment decisions, CalPERS and its board should only consider how an investment will affect the benefits due their members.

CalPERS stated mission—"to advance the financial and health security for all who participate in the system"—conforms to the laws described above. For CalPERS to meet this mission, it must fully consider how the financial ramifications of all investments affect its ability to provide financial and health security to its members.

It is important to note that CalPERS does not have absolute discretion in its investment practice, but is required to adhere to state and federal law. Article XVI, Section 17, of the California Constitution grants the Legislature the power to create policy guiding CalPERS investments, as long as those policies do not require CalPERS to abandon its responsibilities to its members. This power came into play in 1987 when the Legislature required all state agencies to stop new investments and subsequently to divest themselves of investments in South Africa. CalPERS' compliance with the Legislature's directive shows that CalPERS can make decisions based on non-financial factors if directed to do so by law. CalPERS investment policies also ban investment in countries that are prohibited for investment by federal law.

THE CORPORATE GOVERNANCE PRACTICES OF CALPERS ARE SOMETIMES CONFUSED WITH SOCIALLY RESPONSIBLE INVESTING PRACTICES

Although the general public often views socially responsible investing and corporate governance as equivalent, the practices are quite different. Corporate governance involves the active participation by shareholders in governing aspects of a corporation, such as deciding whether to restructure a company's board of directors so that a majority of the directors are independent of the company's management. The goal of corporate governance is to improve a company's financial performance. In contrast, the goal of socially responsible investing is to maximize, through the allocation of investment dollars by considering both economic and social criteria, the potential financial and social returns to both the investor and society at large. Organizations that make socially responsible investing a priority consider factors other than financial ones when making an investment, while organizations that emphasize corporate governance attempt to improve a company's or market's performance after these organizations have already made their investments.

CalPERS considers itself a leader in the corporate governance movement and has written policies for achieving its corporate governance goals. In general, this movement is an attempt to improve the performance of a company or investment by exercising shareholder rights and influence. Domestically, CalPERS corporate governance focuses on a list of the poorest

performing companies within its portfolio. CalPERS identifies specific principles, such as board independence, characteristics of individual directors, and shareowner rights, that would enable those companies to perform better. Internationally, with its long-term goal of making foreign markets competitive globally. CalPERS uses corporate governance to raise issues such as accountability, disclosure, and equity in foreign stock markets. Currently, CalPERS has developed corporate governance principles for use in the United Kingdom, France, Japan, and Germany.

SCOPE AND METHODOLOGY

The Joint Legislative Audit Committee (audit committee) requested the Bureau of State Audits to perform an audit of CalPERS investment policy and procedures and its policy concerning the effect of its purchasing decisions on national security issues. The audit committee's primary concerns were whether CalPERS has invested pension funds in companies with ties to the Chinese government, the Chinese army, or China's military intelligence, and whether these investments could pose financial or national security risks.

We reviewed state and federal laws as well as a recent Supreme Court decision that could have an effect on the ability of the retirement system to make its decisions. We evaluated whether CalPERS investment policies were consistent with these state and federal laws. Finally, we compared CalPERS policies on international investments with those of two other large public retirement systems in California and five public retirement systems in other states.

To assess whether CalPERS followed its policies during fiscal year 1999-2000, we reviewed the way CalPERS contracts with its external investment managers and the types of communications it has with them. We also evaluated the monitoring of its external managers that CalPERS performs to ensure that they are following its policies. Finally, we reviewed why external managers purchased investments in the companies identified in the audit request.

To support or refute allegations raised against the specific companies identified in the audit request, we reviewed information available from known public sources. We relied on the lists published regularly by the Office of Foreign Assets Control of the federal Department of the Treasury to determine whether investments in these companies have been restricted. Because of

a lack of information from credible sources that would also be generally available to institutional investors, we were unable to determine the validity of the allegations raised against the five companies named in the audit request. The results of our review appear in Appendix B to this report. ■

AUDIT RESULTS

The California Public Employees' Retirement System (CalPERS) adheres to its policy of primarily considering financial factors when it makes decisions on foreign investments. CalPERS bases this policy on its mission statement and on state law, both of which require the retirement system to act solely in the interest of its members. CalPERS follows this policy even though it contracts with investment managers to do all of its international investing. Indeed, CalPERS and its managers complied with this policy as well as state and federal regulations when it invested in five foreign companies named in the audit request as possible national security risks. Further, with its general pension consultant, CalPERS has identified markets appropriate for large institutional investors, and CalPERS monitors the external managers that make its foreign investments. However, CalPERS has not performed a crucial yearly review of its general pension consultant, nor has the retirement system finished revising its method of classifying markets as restricted or prohibited for investment so that it can eliminate what the CalPERS investment committee believes are possible shortcomings in the method.

CALPERS USES REASONABLE PROCEDURES TO SELECT, CONTRACT WITH, AND OVERSEE ITS EXTERNAL MANAGERS

With over \$172 billion in net assets, CalPERS invests more than \$40 billion in international equity and fixed income investments. Because it does not have the expertise and specialized skills required to invest in foreign markets, CalPERS contracts with external managers to research and administer all of its international investments. To choose those external managers, CalPERS follows a process that assures fair competition among a range of qualified applicants. To protect its assets, CalPERS then develops for each external manager a contract that specifies unique investment guidelines, contains repercussions for unsound investment practices, and requires the manager to achieve returns at least equal to a benchmark level. In addition, to make sure the external manager uses appropriate methods to invest and account for funds, CalPERS has a comprehensive oversight process.

CalPERS Properly Selects and Directs Qualified External Managers to Make All Foreign Investments

CalPERS follows sound procedures when it selects and communicates with the external managers that will invest its funds internationally. As of June 30, 2000, eight different external equity managers were administering CalPERS' international equity funds and four external managers administered the international fixed income funds. Appendix A lists the CalPERS external managers for international equity and fixed income investments as of that date. The external managers are responsible for all research, decisions, and purchases required to make international investments. The CalPERS Board of Administration (CalPERS board) does not make determinations about the external managers' individual investments, which are the sole responsibility of the individual external managers provided they follow CalPERS policies.

CalPERS Follows a Competitive Process to Contract With Qualified External Managers

CalPERS performs adequate procedures to ensure that it contracts with qualified investment managers who can help CalPERS meet its requirement to protect the security of members' retirement benefits. Investment managers have unique styles that illustrate how they will operate. CalPERS and its general pension consultant identify the investment styles that will most benefit CalPERS and then try to find external managers that best match the identified styles.

CalPERS contracted with 12 external managers that administer the \$40 billion that CalPERS invests in international financial markets.

For example, in 1994, CalPERS chose the eight external equity managers that it was using in fiscal year 1999-2000. When it selected these external equity managers, CalPERS followed standard state requirements for soliciting proposals by issuing a request-for-proposal document, which helped to ensure consideration of a broad range of external managers. To further identify various candidates, the CalPERS general pension consultant keeps a database listing possible external managers and their individual investment styles.

CalPERS and its general pension consultant work together to identify and hire qualified external managers with varied investing styles. CalPERS staff members also visit the prospective investment manager's office, meet with its employees, and perform detailed research of the firm to assess its financial stability and performance record. Once selected, the external manager must agree

to adhere to certain conditions, including following CalPERS policies, meeting a predetermined benchmark of expected results, and maintaining a fiduciary responsibility to CalPERS. After an external manager signs a contract agreeing to these conditions, CalPERS gives it an amount of funds determined by the size, investment style, and capabilities of the external manager.

CalPERS Properly Develops and Communicates a Unique Set of Investment Guidelines for Each External Manager

Although every external manager must follow the same general CalPERS policies, CalPERS also develops and implements a set of contract provisions that are unique to each external manager. These guidelines help ensure that external managers meet the investment goals that CalPERS sets. CalPERS also effectively oversees its external managers to make sure they conform to these investment guidelines, which cover, among other things, the countries in which the managers may invest, the types of investments the managers may make, what the managers' investment returns should be, and the amount of funds the managers may invest in a country at any one time.

CalPERS considers a manager's size, investment style, and geographic area of expertise when developing these unique provisions, which an external manager is contractually bound to follow. For example, the individual provisions would limit to financial markets within the Pacific Basin the external manager that specializes in Pacific Basin investments and specifically prohibit that manager from investing in European financial markets.

To convey to the individual external managers their unique provisions, CalPERS lists the provisions in the managers' initial contracts and in correspondence that continues throughout the terms of their contracts. By keeping in close contact with the external managers, CalPERS ensures that the external managers are aware of CalPERS investment policy. Also, CalPERS can amend these unique provisions throughout the term of each contract.

External managers must adhere to CalPERS policies regarding types of investments, countries they may invest in, and the amount of funds that may be in specific countries at one time.

If an external manager fails to follow CalPERS policy, it may face repercussions. For example, an external manager may face repercussions if it has employee turnover in key investment positions or if it engages in questionable practices, such as making an investment that leads to an investigation by the federal Securities and Exchange Commission. Currently, CalPERS first places the external manager on a watch list for CalPERS to monitor its progress more closely than usual. If the external

manager remains on the watch list, CalPERS could cancel its contract with that external manager. Although for major policy violations, CalPERS could immediately cancel a contract with an external manager. Our review of the CalPERS investment committee minutes found that CalPERS regulates its external managers to ensure their conformity with policy.

Investment guidelines help ensure that the managers use proper care when investing CalPERS' money.

In each external manager's contract and unique provisions, CalPERS also requires the manager to achieve investment returns that equal or exceed the returns of an identified benchmark so that CalPERS can ensure that the external manager will use proper care when investing CalPERS funds. To determine the benchmarks, CalPERS considers the types of investments the external managers make and in which financial markets they make them. CalPERS either uses existing benchmarks or creates custom benchmarks with the help of its general pension consultant, who is conversant with institutional investment but who does not invest funds for CalPERS. CalPERS offers performance incentives, which it bases on how much external managers exceed their individual benchmarks, that motivate the external managers to invest well and earn higher returns while operating within acceptable risk boundaries. However, if an external manager fails to meet or exceed its benchmark, CalPERS can place it on a watch list, and the manager's underperformance could lead to contract termination.

Contracts between CalPERS and its external managers also state that the external managers have a fiduciary responsibility to CalPERS, which means that the external managers must act solely in the interest of the CalPERS members and use due care in performing all responsibilities. Therefore, the external managers are liable for any money lost as a result of any unauthorized investments. Further, the contracts prohibit external managers from making any investments that break state or federal law. By including these contract provisions, CalPERS has legal recourse if an external manager makes inappropriate investments.

In Most Respects, CalPERS Oversees Its External Managers Adequately

Because external managers make all the international equity investments, oversight of these contractors is vital for the success of the CalPERS portfolio. Comprehensive oversight by CalPERS

helps ensure that the external managers are administering funds according to its policy. After CalPERS chooses its external investment managers, it monitors them in the following three ways:

- The CalPERS investment staff performs ongoing monitoring.
- The custodial bank, which holds all of the assets, tracks both the funds that CalPERS allocates to the external managers and the transactions made by the external managers to ensure that the managers are properly investing and accounting for the funds.
- The general pension consultant for CalPERS monitors the external managers' performance in the market as a whole.

CalPERS Staff Monitors External Managers but Does Not Complete Required Checklists Within Policy Time Frames

Although it performs the ongoing monitoring of the external managers, CalPERS staff does not promptly complete the manager monitoring checklists (checklists) each month. Without the timely completion of these required checklists, CalPERS management does not know if external managers are following the contracts' guidelines.

CalPERS assigns each external manager to a member of the CalPERS staff who is either an investment officer or a portfolio manager; this individual is then responsible for monitoring the external manager. CalPERS staff monitors the external managers through ongoing verbal or electronic communication and through reviewing the external managers' portfolios on the custodial bank's computer system. Because CalPERS staff performs much of the ongoing monitoring on an informal, undocumented basis, each month staff members fill out checklists to document their monitoring practices. Consistent with the stated mission of CalPERS, the category on the checklists given the most importance is the relative performance category, which compares the managers' performance relative to the applicable benchmarks. Once staff completes the checklists, the senior principal investment officer reviews them to ensure they are correctly completed and can then inform the CalPERS investment committee of any major concerns with the external managers' performance.

To see whether staff properly fill out the checklists, we tested the checklists for the external managers that make the international fixed income and equity investments, examining each external manager's checklist for four separate months, one in each quarter, for fiscal year 1999-2000. We found that CalPERS staff properly completed the checklists to ensure that CalPERS management was aware of any possible problems. Our review also revealed that the external managers were performing their contractual duties. Further, we determined that CalPERS staff had access to the resources they needed to complete the checklists properly. These resources included investment reports from the external managers; reports from the custodial bank, such as country allocation reports; access to the external managers' employees; and access to outside resources for verifying information, such as on-line investment research services.

Although they complete the checklists properly, CalPERS staff members are not prompt in preparing the checklists each month. Our review showed that often more than two months pass before the senior principal investment officer receives the checklists for review. CalPERS allows its staff to wait until the end of the quarter to complete the checklists, thus enabling staff to identify possible trends within the investing practices of each external manager. Though the quarterly trend analysis is important, some of the monthly statistics are valuable in their own right. Thus, we believe it is important for CalPERS staff to complete the checklists promptly each month because the checklists offer documentation of the external managers' performance.

Although they properly complete monthly checklists, CalPERS staff often take more than two months to submit the checklists to the senior principal investment officer for review.

The Custodial Bank for CalPERS Monitors the External Managers and Provides Tools for the In-House Staff to Perform Its Oversight

The custodial bank reconciles the actual account balances with the account balances submitted by the external managers, thus ensuring that the external managers are keeping track of and properly valuing their investments. The custodial bank maintains a real-time computer system that allows CalPERS staff to view up-to-the-second changes in the external managers' portfolios. CalPERS staff also use this computer system to carry out monitoring procedures. In addition, the custodial bank prepares various reports that CalPERS investment officers use in their monitoring practices.

For the months we tested, external managers did not invest in prohibited financial markets.

One of the reports the custodial bank prepares for CalPERS is the country allocation report, which lists the holdings each external manager has in every financial market. We tested four such reports for fiscal year 1999-2000 and found that for every month we tested, the external managers did not make purchases in prohibited markets. The country allocation report also shows whether the percentages of funds in certain financial markets exceed the thresholds determined acceptable by CalPERS. Through our testing, we found that the external managers operated within the percentages that CalPERS established. Further, the country allocation report identifies whether external managers may have invested in companies in unknown markets. If the custodial bank's system does not recognize the financial market from which a security was purchased, the country allocation report lists that security in an exception report. CalPERS staff is responsible for researching whether the external managers purchased from allowable markets the securities listed on the exception report. For the months we tested, the external managers purchased securities of such companies from allowable markets.

The General Pension Consultant Needs Regular Performance Reviews From CalPERS

Like the CalPERS external managers, the general pension consultant has a contract with CalPERS that details requirements and conditions. Under the terms of this contract between CalPERS and the general pension consultant, the consultant's performance is subject to a yearly review. However, CalPERS has not been completing this task in a timely manner.

Because of its available resources and size, the general pension consultant is responsible for various monitoring procedures, including calculating custom benchmarks and evaluating the external managers' performance relative to the performance requirements in the managers' contracts. Further, the general pension consultant plays a key role in placing external managers on the watch list and in terminating external managers. CalPERS uses the general pension consultant to prepare analyses on problem managers and to assist CalPERS staff in taking appropriate actions with individual external managers.

In addition to helping oversee existing external managers, the general pension consultant assists CalPERS in selecting new managers and in determining the investment needs of the

CalPERS portfolio. As explained earlier, the consultant aids in identifying beneficial investment styles and in screening external managers for suitability with respect to those styles. The consultant also helps CalPERS search for additional external managers by creating requests for proposals, developing evaluation factors and methods, and maintaining a database of possible external managers.

Although CalPERS asks the general pension consultant to perform all these duties, CalPERS is not adequately monitoring the consultant's services. The contract between the general pension consultant and CalPERS does not have a set duration; instead, the contract continues in perpetuity at an annual cost of \$1.9 million until one of the parties cancels it. The general pension consultant is subject, however, to a yearly review, which CalPERS has not been performing in a timely fashion. If the review indicates that the general pension consultant's performance has been satisfactory, the CalPERS board can then decide if it wishes to continue the contract. However, if the review shows unsatisfactory performance, CalPERS may end the contract. The first year of the current contract expired on June 30, 2000, but CalPERS was just beginning its review as of October 1.

CalPERS was at least four months late in preparing a formal review of its general pension consultant.

CALPERS BASES ITS FOREIGN INVESTMENT POLICY PRIMARILY ON FINANCIAL CONSIDERATIONS, AND THIS PRACTICE IS CONSISTENT WITH STATE AND FEDERAL LAWS

As a public retirement system, CalPERS is required to consider state and federal laws that govern both retirement systems and investments. Under state law, the CalPERS board has a fiduciary responsibility to ensure that its investment decisions are financially prudent. To fulfill this responsibility, CalPERS generally bases its investment policy on financial criteria, except when federal law requires otherwise. However, to continue to ensure that it is making proper investment decisions, CalPERS needs to finish revising its process for identifying countries with financial markets that are unsuitable for CalPERS investments. The resulting permissible country list is a key component of its international investment policy.

CalPERS Bases Its International Investment Policies on the Financial and Legal Stability of Foreign Markets

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

CalPERS Follows Its Investment Policy by Using a List of Financially Suitable International Markets

The list, which the CalPERS general pension consultant created using mainly financial criteria, is central to CalPERS policies on international investment. CalPERS uses the list to decide where external managers may invest. Because it specifies whether a country's markets are financially suitable for investment by institutional investors such as CalPERS, the list helps protect the security of foreign investments that CalPERS makes.

Although called the *permissible country list*, the list actually specifies the financial markets in which the CalPERS external managers may make investments. An individual company may be traded on more than one financial market or stock exchange at the same time. When determining the attractiveness or suitability of a foreign investment, an investor generally must first look to the financial market where the investor can purchase the investment. Because the governance of financial markets comes from within a country's borders (except in the case of the developing European Supranational Market), the strength of the country's legal system and the information that a country's markets require of a company that seeks a listing on the exchanges affect how attractive or suitable the market is to foreign investors. For example, the equity markets in the United States are attractive to foreign investors in part because of the information that the Securities and Exchange Commission requires from companies

CalPERS has developed a permissible country list that identifies those foreign financial markets in which it will invest.

and makes available to investors. The CalPERS list guides the retirement system's foreign investment not by pointing out whether a country's companies are suitable for investment but by indicating whether a country's markets can support investment by institutional investors such as CalPERS.

Each stock market contains numerous companies, both domestic and foreign, in which investors may purchase ownership shares. Companies may list their securities on a foreign stock market by directly listing their securities on that market or through global depository receipts, which are bank-issued certificates that represent shares of a foreign company.

As shown in Table 1, the list has three categories: appropriate, limited exposure, and prohibited. If the list classifies a country as appropriate, an external manager may make purchases from that country's equity markets. For example, because Spain is listed as an appropriate country, an external manager may purchase any company's securities that are sold on a Spanish stock market. If the list shows a country in the limited-exposure category, an external manager may purchase investments only up to a certain percentage of the manager's CalPERS portfolio. If the list categorizes a country as prohibited, an external manager may not make any investments in that country's financial markets.

Figure 2 illustrates that when external managers invest in a permissible country's market, they may be investing in companies that reside in prohibited countries. For example, although CalPERS has designated China's financial markets as prohibited, it has designated Hong Kong's as appropriate. Thus, if a company based in China is registered to sell its securities on the Hong Kong stock market, an external manager for CalPERS would be allowed to purchase those securities. The factor that determines the permissibility of an investment is the market (Hong Kong) in which an external manager purchases the security and not the country (China) where the company is located. Exceptions to this situation are companies with which the United States government does not allow Americans to conduct business, in which case investment is prohibited regardless of the selling market.

TABLE 1

The CalPERS Permissible Country List Shows Availability of International Markets for Investments by External Managers

Appropriate (CalPERS Allows Investment)	Limited Exposure (CalPERS Allows Investment of a Predetermined Percentage of Assets*)	Prohibited (CalPERS Prohibits Investment)
Australia	Argentina	China
Austria	Brazil	Colombia
Belgium	Chile	Egypt
Canada	Czech Republic	Hungary
Denmark	Greece	India
Finland	Indonesia	Jordan
France	Israel	Kenya
Germany	Korea	Morocco
Hong Kong [†]	Malaysia [‡]	Pakistan
Ireland	Mexico	Poland
Italy	Philippines	Russia
Japan	Peru	Slovakia
Luxembourg	South Africa	Sri Lanka
Netherlands	Taiwan	Venezuela
New Zealand	Thailand	Zimbabwe
Norway	Turkey	
Portugal		
Singapore		
Spain		
Sweden		
Switzerland		
United Kingdom		
United States		

Source: California Public Employees' Retirement System

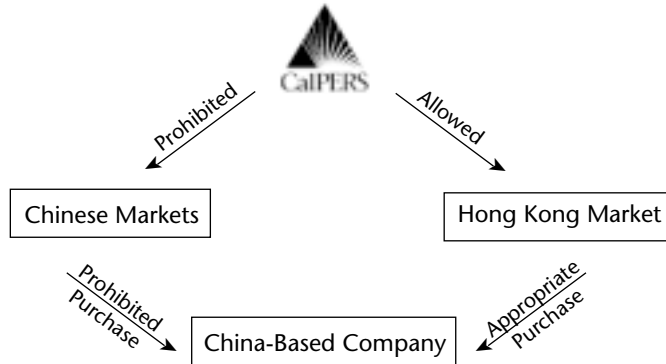
* CalPERS requires external managers to limit exposure to 20 percent of the total portfolio of international securities. Further, investments in each country are limited to 5 percent of the total portfolio.

[†] Hong Kong is a Special Administrative Region of China and has highly regarded laws governing foreign investment. Therefore, the investment community differentiates between investments from the Hong Kong market and investments from China's markets.

[‡] Additional investment in Malaysia is not permitted until it lifts its current capital restrictions.

FIGURE 2

CalPERS May Make International Purchases Only Through Specific Financial Markets



Using the list as a starting point, CalPERS may add restrictions for an individual external manager based on that manager’s style and geographic area of expertise. Specifically, CalPERS prohibits some external managers from making purchases from financial markets in certain countries shown in the appropriate or limited exposure categories on the list. For example, CalPERS considers all investments in non-European countries prohibited for the external manager operating solely within Europe.

The General Pension Consultant’s Use of Financial Criteria to Create the Permissible Country List Is Consistent With CalPERS Policy

To determine if various countries’ markets can support institutional investment, the general pension consultant created the list using a broad range of financial criteria, including some social and political factors that may indicate a market’s financial stability. This emphasis on financial criteria is consistent with the CalPERS policy of managing members’ assets to achieve an acceptable return with an acceptable risk.

First, using market lists prepared by two major investment firms, the consultant determines if countries have developed or emerging markets.² Only if both lists show the country to have a developed market will the general pension consultant place the country in

² The World Bank classifies an emerging market as one having a low- or middle-income economy regardless of its particular stage of development. At the time CalPERS developed the permissible country list, low- and middle-income economies were defined as those with a 1996 gross national product below \$9,400 per capita.

the “appropriate” category. If one or both of the lists show the country as having an emerging market, the general pension consultant uses financial criteria to determine if CalPERS should classify the country as “limited exposure” or “prohibited” on the permissible country list. If a country’s market is too small for investment experts to consider it developed or emerging on either market list, the general pension consultant does not even place the country on the permissible country list. To evaluate the countries, the general pension consultant uses the criteria shown in the text box.

- Criteria That CalPERS Uses to Evaluate Foreign Markets for Its Permissible Country List (listed in order of importance)**
- Market regulation and legal system
 - Market liquidity or volatility
 - Investment restrictions
 - Settlement proficiency
 - Political risk
 - Country development
 - Year 2000 compliance and technological growth
 - Transaction costs

Although the criteria used to create the list is essentially financial, the general pension consultant does consider political or social factors (in the political risk and country development criteria) in assessing the financial suitability of a market. The general pension consultant evaluates political risk by using a country’s type of government as an indicator of a market’s suitability for investment and of that market’s safety, essentially turning the social indicator into a financial indicator. In assessing the country development criteria, the general pension consultant also scores a country’s levels of education and literacy. The consultant then uses these indicators of a country’s development as measures of how educated a country’s labor force is because educational levels may affect the performance of companies and investments from that country’s financial markets. Again, the social indicators in effect become financial indicators.

CalPERS Has Not Finished Revising the Screening Process for the Permissible Country List

The CalPERS investment committee believed it found possible shortcomings in the methods the general pension consultant used to create the most current list, so CalPERS is amending these methods. These possible shortcomings may have led CalPERS to improperly classify some countries as “limited exposure” or “prohibited.” Because it did not promptly create a new screening process after identifying the possible shortcomings in the procedures used to develop the original list, CalPERS may be using a list that classifies countries inaccurately. Moreover, CalPERS and its general pension consultant differ in their views of the list’s purpose, so the investment committee is working to establish clear objectives for the list. To make certain that its

Some seemingly social factors, such as a country's levels of education and literacy rates, can have an effect on the performance of that country's financial markets.

external managers invest in appropriate countries, CalPERS needs to define carefully and keep current both the process that it uses to screen countries for its list and the stated purpose of the list itself.

Over the past 10 years, the general pension consultant has worked with CalPERS to create the permissible country list. Currently, CalPERS uses the list that the general pension consultant created in April 1999 and that the investment committee amended in June of the same year. Also in April 1999, the CalPERS investment committee first discussed shortcomings in the appropriateness and quality of data used to create the list. The following June, citing the possible shortcomings, the CalPERS investment committee decided not to follow all the recommendations made by its general pension consultant. Specifically, the investment committee accepted the recommendations to downgrade the classifications of certain countries, but it rejected the recommendations to upgrade the classifications of other countries. For example, the investment committee accepted the proposal to move Korea from the appropriate to the limited-exposure category on the list, while rejecting the proposal to move Poland from the prohibited to the limited-exposure category. Also in June 1999, the investment committee rejected the screening process for the list. Nonetheless, the April 1999 list with the June amendments remains in use.

Since the rejection of the screening process for the list, CalPERS has conducted a workshop to establish an updated screening process. Further, at the May 2000 investment committee meeting, CalPERS staff and the State Treasurer's Office (treasurer) both presented proposals for the new screening process, neither of which was accepted. The CalPERS proposal focused on economic terms to screen countries. However, the treasurer's proposal emphasized a greater use of social indicators to judge financial performance, specifically calling for CalPERS to consider political freedom and freedom of the press to evaluate the appropriateness of investments within certain countries. The investment committee directed the treasurer and CalPERS staff to work together to refine the proposals. However, as of October 1, 2000, CalPERS had no new screening process to create the list.

The list currently used by CalPERS to determine appropriate investments not only was created with a process that the CalPERS investment committee believes to be incomplete, but it is also outdated. The current screening process used to select

permissible markets assesses year 2000 readiness, which is an obsolete category that has no bearing on the financial appropriateness of a country's market today. Until CalPERS approves and implements a new screening process, the retirement system will continue to use the list created in April 1999. Thus, external managers may be investing CalPERS funds in markets where financial conditions may have changed substantially enough to affect the markets' classifications.

At its November 2000 meeting, the investment committee directed staff to create a screening process that includes additional screens, some of which are seemingly political or social.

At its November 2000 meeting, the investment committee considered some changes to the screening process and to the criteria it uses to select external managers. By a vote of seven to two with four abstentions, the committee directed staff to create a screening process for the list that includes additional screens, some of which are seemingly political or social. These additional screens relate to issues of transparency, political stability, and prohibitions on abusive labor practices. The committee's discussion of whether to include these screens centered primarily on the economic effects this policy change may have on the performance of a possible investment. Also at the November meeting, the investment committee decided to make only direct purchases in emerging markets and to incorporate the Global Sullivan Principles in the process CalPERS uses to select external managers to manage its investments in emerging markets. The principles are not financial in nature but could affect the economic performance of individual companies. At the investment committee meeting in December 2000, CalPERS staff will present details on implementing the new screening process and an analysis of the possible effects of the new policies.

The discussions concerning the permissible country screening process are further complicated by the lack of agreement between CalPERS and its general pension consultant over the purpose of the list. The CalPERS investment committee states that the list's purpose is to allow foreign investments only in countries deemed "appropriate" for CalPERS investment. However, CalPERS has not defined what an appropriate market is, creating further problems in delineating the purpose of the list. On the other hand, the CalPERS general pension consultant considers that the objective of the list is to determine whether a market can support institutional investment. CalPERS needs to ensure that the screening process will create results that conform to the stated purpose of the list.

In a development that may affect the screening process in the future, the federal government has been examining ways it can ensure that foreign investments do not threaten national security. The Market Security Act of 1999, proposed in Congress this past year, called for establishing an office in the Securities and Exchange Commission to examine the national security risks associated with foreign investments. The office would then report to Congress, which, theoretically, could act on the risks. Although the bill did not pass, it shows that the federal government is discussing the significance of where Americans make foreign investments.

The CalPERS Policies for Foreign Investments Are Consistent With Policies of Other Public Retirement Systems

CalPERS is not the only public retirement system that bases investment decisions primarily on financial factors. Other public retirement systems in the State of California and the country use financial criteria, rather than social or political criteria, when making investment decisions. In California, neither the University of California Retirement System (UCRS) nor the Los Angeles County Employee Retirement Association (association) uses social criteria when making investment decisions. We contacted UCRS and the association because they are the third and fourth largest public pension plans, respectively, in California after CalPERS and the California State Teachers' Retirement System (STRS). We did not contact STRS because two of the board members for STRS also serve on the CalPERS board. The investment policies of CalPERS and the association are very similar. Like CalPERS, the association must act solely in the interest of its members. In addition, both the association and CalPERS use external managers that must achieve specific performance objectives, while members of the retirement systems' own investment staff monitor the performance of the external managers.

In the United States, staff at public retirement systems for public employees in New York, Missouri, Kansas, Texas, and Wisconsin told us that these systems primarily use financial criteria when making investment decisions. Staff at four of the five retirement systems said they do not use social criteria when making investment decisions. Wisconsin uses the annual publication of Freedom House (a nonprofit organization devoted to promoting democracy and freedom) to restrict investment in companies

Six of the seven other public retirement systems we contacted also base investing decisions primarily on financial factors.

that operate mainly in countries the report rates as “not free.” Wisconsin’s stance on social issues is that companies engaged in socially irresponsible practices will experience economic consequences in the marketplace, which makes these companies unsuitable for investment.

The Criteria CalPERS Uses for Foreign Investments Are Consistent With Its Criteria for Other Types of Investments

For the other asset classes within its portfolio, CalPERS also generally relies on financial criteria when making investment decisions. CalPERS staff uses financial criteria even in instances in which it makes decisions on questions that arise from socially motivated events. Examples of these types of decisions are the CalPERS board’s decision to invest in some redevelopment projects and the board’s recent decision to divest the retirement system’s investment in tobacco-related stocks.

All investments by CalPERS must have the potential for a sufficient rate of return accompanied by an acceptable level of risk. According to CalPERS, it must base all investment decisions on their financial merits, even those investments that could be considered “socially responsible.” For example, the California Urban Investment Partners (CUIP) is a partnership between CalPERS and a developer dedicated to the redevelopment of California inner cities, yet CalPERS made the CUIP investment based on the project’s financial merits. CalPERS investment staff presented the CalPERS investment committee with financial research that supported the staff’s recommendation to invest in CUIP, and in 1995 the CalPERS investment committee authorized a \$50 million investment in CUIP.

CalPERS uses financial criteria to make decisions even on investments that could be considered “socially responsible.”

A more recent example of how CalPERS relies on financial criteria for investment choices is the CalPERS board’s decision to divest its tobacco stocks. In April 2000, in response to pending legislation, the investment committee requested an analysis of a possible tobacco divestiture. The following June, CalPERS staff presented to the committee a review that focused exclusively on the financial implications of a tobacco divestiture and determined that CalPERS would incur costs associated with the divestiture. The costs would result from brokerage fees, opportunity costs incurred because of possible decreases in market value while a trade is in process, and market impact costs incurred because of changes in the market resulting from a large public investor

making sales. Further, the staff concluded that the divestiture would decrease the domestic funds' diversification, thus increasing the risk and volatility of the domestic portfolio. The staff also concluded that the stock market had already properly devalued the tobacco stock because of the pending litigation against the tobacco companies. Based on these financial factors, CalPERS staff recommended in June 2000 that the board not divest the tobacco stock. At that time, the CalPERS board asked its staff to prepare a financial distress divestment policy using criteria similar to those developed for STRS.

The vote in October 2000 to divest tobacco stocks reflected a board with differing opinions.

In October 2000, when it presented the CalPERS investment committee with the financial distress divestment policy, CalPERS staff said it had assessed the retirement system's tobacco holdings against that policy and continued to recommend that CalPERS not divest its tobacco holdings. Although the board was ultimately divided in its decision, it actively debated the issues entirely on the basis of financial rather than social issues. At the same meeting, a panel of five experts in the field of investments, four of whom do not currently contract with CalPERS, discussed the financial impacts of holding versus divesting tobacco stocks. The topics included the effects on portfolio risk and volatility of divesting a relatively small number of tobacco companies; the question of whether the tobacco industry was subject to more legal, regulatory, and investor pressures than are other industries; and the impact of these pressures on tobacco companies' financial performance. The CalPERS board took an active role and focused the discussion on whether the financial markets were completely reflecting the effect of the large legal settlements rendered against the tobacco industry or if the industry had longer-term liabilities not fully reflected in the per-share valuations. After considerable discussion in the investment committee meeting, the CalPERS board did not follow the recommendation of its staff. Instead, the board voted to divest seven of CalPERS' internally managed funds of tobacco stocks. The vote of seven ayes, five noes, and one abstention reflected the divided opinions of the board members on this matter. This decision, however, does not affect the external managers who are holding tobacco stocks in either domestic or international portfolios.

CalPERS Does Not Infringe on the Powers Given to the Federal Government by the United States Constitution

Investing in foreign markets has allowed CalPERS to diversify its portfolio, and this practice mirrors the investment practices of many other large businesses. However, as a California public entity, CalPERS must also consider fundamental divisions of power between the state and federal governments.

Article 1, Section 8, of the United States Constitution confers on the United States Congress the power to regulate commerce with foreign nations. In addition, Article 2, Section 2, of the Constitution vests the President of the United States with the power, by and with the advice and consent of the Senate, to make treaties. Several court decisions have found that the power to regulate foreign policy is entrusted to the federal government and that states may not intrude into this exclusive federal domain.

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

Using financial factors to screen out a country's financial market does not conflict with the federal government's power to set foreign policy.

In a recent United States Supreme Court decision, the court declared a Massachusetts law unconstitutional because it barred Massachusetts state entities from buying goods or services from companies doing business in the country of Myanmar, formerly known as Burma. Among other findings, the court decided that the state law interfered with Congress's intention to limit economic pressure against the Burmese government to a specific range. In addition, the court found that the state law undermined the president's capacity for effective diplomacy, limiting the president's authority to speak for the United States in developing a comprehensive strategy related to Burma. Although this Supreme Court decision does not have direct applicability to CalPERS, it is conceivable that the retirement system would be challenged in court if it were to consider foreign policy factors other than those decreed by the federal government to limit investments in specific countries.

CALPERS EVALUATED FINANCIAL RETURNS AND FOLLOWED FEDERAL LAW WHEN INVESTING IN COMPANIES CONSIDERED POTENTIAL SECURITY RISKS

Investments by CalPERS in five foreign companies have been questioned as having a possible effect on national security issues. Four of these companies are based in Hong Kong, but either the parent company is located in mainland China or the major shareholder is a company based in mainland China. The remaining company, based in Canada, is developing and constructing oil fields and pipelines in the Sudan. Our audit covering fiscal year 1999–2000 revealed that CalPERS and its external managers did not violate state or federal laws or its own policies by investing in the five companies, which external managers determined had potential for growth. The results of our review of the specific allegations concerning national security issues appear in Appendix B to this report.

External Managers Had Sound Financial Reasons for Investing in the Five Companies

The external managers who invested in the five companies reasoned that the investments would be profitable for CalPERS.

As Appendix B shows, the CalPERS external managers used financial criteria to evaluate investments in the five companies about which CalPERS has been questioned. External managers invested directly in three of the companies' stocks and indirectly in four of the companies that are included in index funds. In each case, the managers determined that the investments would be profitable for the retirement system.

Some external managers for CalPERS invested directly in three of the five companies because both the companies and the Chinese economy had the potential for growth. For these three Hong Kong-based companies, the external managers' research was critical to the investment decisions. Our review found the external managers' reasons for the investments were consistent among them and focused on two main perceptions: the expected growth of the investments' value and the companies' increased financial opportunities from the opening of the Chinese economy. Aware that the three companies' majority shareholders or parent companies were located in mainland China, external managers purchased the companies' stock on the Hong Kong Stock Exchange, which CalPERS has designated as an unrestricted market. As of June 30, 2000, CalPERS held investments totaling \$7.6 million in two of these three companies. (CalPERS no longer holds China Resource Holdings as a direct investment.)

CalPERS still holds investments in all five companies.

One of the external managers also purchased shares in four of the five questioned companies when it invested for the CalPERS commingled index fund, also referred to as a passive equity fund. The external manager that administers this fund invests in various stock markets' index funds, which are funds that contain a mix of a stock market's companies that investors expect will perform better than that market's index. Because the external manager looks to each fund's performance as the basis on which to make the investment decision, the manager does not perform research on the individual companies that make up the index fund. CalPERS does not question the external manager's individual holdings in the passive equity fund as long as the manager invested in acceptable markets. As of June 30, 2000, CalPERS held passive equity investments of \$38.8 million in the four companies.

Highly Regarded Stock Exchanges Listed the Five Companies

Of the five companies questioned as appropriate for CalPERS investments, one was listed on the New York Stock Exchange and the external manager purchased ownership units in the company as part of an index fund. External managers purchased shares or ownership units in the other four companies through the Hong Kong Stock Exchange. Although restricting investment in China, CalPERS permits investment in the Hong Kong stock market because the investment community considers Hong Kong separate from China. The Chinese government has designated Hong Kong as a Special Administrative Region, allowing Hong Kong to retain its highly regarded stock market policies. Investors in companies listed on the Hong Kong Stock Exchange have access to the same kinds of information about the companies that the New York Stock Exchange provides and, therefore, can perform thorough research on prospective investments.

Most economists still consider Hong Kong to be the world's freest economy. Established while Britain governed Hong Kong, the Hong Kong stock market inherited its legal and economic system from the Anglo-Saxon capitalist model. Since the reunification of China in 1997, Hong Kong has continued to emphasize the private sector. This emphasis was a hallmark of Hong Kong's economic policy before the unification.

The Federal Government Allows Investments in the Five Questioned Companies

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

None of the five companies are on the federal government's list of entities in which Americans are prohibited from investing.

The federal agency that administers and enforces United States economic and trade sanctions is the Office of Foreign Assets Control (OFAC) of the United States Treasury Department. OFAC maintains a list of countries on which the federal government has imposed sanctions that limit various activities, from travel to investment. (The list is available to the public through OFAC's Web site or through the Code of Federal Regulations.) Because China does not appear on the OFAC list as a country that has trade sanctions leveled against it, the federal government permits investment in China.

On another list the OFAC maintains, called the Specially Designated Nationals list, are companies and individuals on which the federal government has imposed sanctions because of ties to drug trafficking, terrorist activity, or to the countries listed on the main OFAC list. However, the five questioned companies identified in the audit request do not appear on that list either.

Additionally, the United States embassy in China prepares a Country Commercial Guide for China. Embassies create such guides to promote investing and to help investors succeed in their countries, but they do not create guides for countries that have sanctions leveled against them. Because it has created a Country Commercial Guide for China, the federal government appears to encourage investment in China or Chinese companies.

Although the federal government permits investments in China, it prohibits investments in the Sudan, which is on the OFAC list because of its alleged human rights abuses. Some Sudan-based companies also appear on the Specially Designated Nationals

list. However, this list does not include the Canada-based company that does business in the Sudan and that is one of the five questioned companies. Based on the information that we obtained, investment in this company does not violate United States law.

RECOMMENDATIONS

To ensure that it properly monitors its general pension consultant, CalPERS should finish its review of the consultant for the year ended June 30, 2000, and establish controls so that CalPERS performs the review promptly each year.

To ensure that it has adequate and current criteria for determining which countries have permissible markets for investment, CalPERS should finish revising the process for developing its permissible country list and create a timetable for the review of existing criteria.

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

We conducted this review under the authority vested in the California State Auditor by Section 8543 et seq. of the California Government Code and according to generally accepted government auditing standards. We limited our review to those areas specified in the audit scope section of this report.

Respectfully submitted,



ELAINE M. HOWLE
State Auditor

Date: December 19, 2000

Staff: Nancy C. Woodward, CPA
Fred Bolger

Blank page inserted for reproduction purposes only.

APPENDIX A

CalPERS External Managers for International Equity and Fixed Income Investments as of June 30, 2000

Name of External Manager	Investment Type	Geographic Area of Expertise	Total Assets Managed as of June 30, 2000 (In Millions)
Deutsche Asset Management	Equity (stocks)	Worldwide	\$1,207
Newport Pacific Management, Inc.	Equity (stocks)	Pacific Basin	270
Nomura Asset Management U.S.A., Inc.	Equity (stocks)	Pacific Basin	1,154
Oechsle International Advisors, L.P.	Equity (stocks)	Worldwide	1,422
Paribas Asset Management, Inc.	Equity (stocks)	Europe	1,683
Schroder Investment Management North America, Inc.	Equity (stocks)	Worldwide	1,225
ValueQuest/TA, LLC	Equity (stocks)	Worldwide	244
Subtotal for Equity Managers			7,205
State Street Global Advisors	Passive Equity (index funds)	Worldwide	26,989
Subtotal for Equity and Passive Equity Managers			34,194
Baring International Investment Limited	Fixed Income (bonds)	Worldwide	1,577
Fiduciary Trust Company International	Fixed Income (bonds)	Worldwide	1,213
Julius Baer Investment Management, Inc.	Fixed Income (bonds)	Worldwide	1,545
Mercury Asset Management International, Ltd	Fixed Income (bonds)	Worldwide	1,505
Subtotal for Fixed Income Managers			5,840
Total Assets Managed by All International External Managers			\$40,034

Blank page inserted for reproduction purposes only.

APPENDIX B

Specific Findings About CalPERS Investments in Five Companies Alleged to Pose Security Risks

The audit request cited allegations that are circulating about five companies in which the California Public Employees' Retirement System (CalPERS) has made investments. These allegations have been published in books and newspapers, but the authors did not always cite the original sources of the information. We researched known public sources for information that would support or refute these allegations, but we were unable to establish the validity of the allegations. This appendix shows the allegations, the information available to CalPERS external managers as part of their research into the investments, and whether the federal government has sanctioned the companies noted as documented by the federal Department of the Treasury's Office of Foreign Assets Control (OFAC).

TABLE 2

Company Name	Allegations in Audit Request and Source	Public Information About Company	Type of Holding and Manager Who Purchased	On OFAC List?*
Cosco Pacific Ltd.	<p>The book <i>Year of the Rat</i> stated that Cosco owned a ship that was caught attempting to smuggle 2,000 fully automatic rifles into the United States.</p> <p><i>Year of the Rat</i> describes Cosco as “essentially a naval arm of the People’s Liberation Army.”[†]</p> <p>The <i>Washington Times</i> has reported that Cosco has delivered nuclear weapons components to Pakistan and Iran.</p>	<p>According to Newport Pacific Management, a CalPERS external manager for the international active equity portfolio, Cosco Pacific Ltd. is a large, established company that many brokerage and research houses follow.</p> <p>Although Deutsche Asset Management, a CalPERS external manager for the international active equity portfolio, has not invested in this company, it identified Cosco Pacific as a Chinese conglomerate listed on the Hong Kong Stock Exchange. Cosco Pacific’s two main lines of operations are container leasing and port operations in China. As of January 2000, Deutsche considered this company to have stable growth but uninspiring earnings, which made the company an unattractive investment for this external manager.</p>	<p>Included in commingled equity index fund[‡]</p> <p>State Street Global Advisors</p>	No
CITIC Pacific Ltd.	<p>According to the book <i>Red Chips: And the Globalisation of China’s Enterprises</i>, CITIC Pacific Ltd. is controlled by China Investment Trust and Investment Corporation (CITIC).</p> <p>The audit request did not cite a source for the statement that “CITIC is headed by Wang Jun, who is allegedly connected to the attempt to smuggle the AK-47 assault rifles into the United States.”</p>	<p>According to Newport Pacific Management, a CalPERS external manager for the international active equity portfolio, the allegations are against a company that is not listed but is a 30 percent shareholder of the Hong Kong shares of CITIC Pacific. The ultimate largest shareholder is in mainland China, but the immediate parent is in Hong Kong, and the stock itself is registered on the Hong Kong Stock Exchange. Newport Pacific Management decided to purchase shares because the company is a well-run, diversified Hong Kong conglomerate with high-yielding investments in telecommunications, power plants in China, toll roads, bridges, and airlines (Cathay Pacific and Dragon Air).</p>	<p>Included in commingled equity index fund[‡]</p> <p>State Street Global Advisors</p> <p>and</p> <p>Active equity security</p> <p>Newport Pacific Management</p>	No

* The list prepared by the federal Department of the Treasury’s Office of Foreign Assets Control.

† This quote from the book *Year of the Rat* is based on a July 18, 1991, article in the *Far Eastern Economic Review*. According to the book’s authors, the newspaper attributed its facts to intelligence sources. No other support was cited for connecting Cosco to the Chinese military.

‡ Holdings by CalPERS in these companies result from CalPERS owning units of a commingled fund. The commingled fund contains holdings of indices or funds that include the individual companies.

Company Name	Allegations in Audit Request and Source	Public Information About Company	Type of Holding and Manager Who Purchased	On OFAC List?*
CITIC Ka Wah Bank	According to the book <i>Red Chips: And the Globalisation of China's Enterprises</i> , CITIC Ka Wah Bank has remained directly in the hands of CITIC in Beijing.	CITIC Ka Wah Bank is majority owned by CITIC-Beijing. According to ValueQuest/TA, a CalPERS external manager for the international active equity portfolio, CITIC-Beijing has major stakes or partnerships with hundreds of private and listed companies worldwide that are listed in several leading stock exchanges and included in globally recognized and respected indexes. The external manager also found that in this global economy, it is difficult to find a company operating in Greater China with zero links to CITIC-Beijing. ValueQuest/TA found no publicly available source of information indicating that either CITIC-Beijing or CITIC Ka Wah was involved in any illegal or unethical activity.	Active equity security Value Quest/TA	No
China Resource Holdings	The audit request did not cite a source for the statement that "a Defense Intelligence Agency analyst wrote that at least one vice president of the company is often a military officer who coordinates the collection activities of other intelligence personnel under (the company's) cover." However, there is a similar statement in the <i>Year of the Rat</i> .	<p>According to Newport Pacific Management, a CalPERS external manager for the international active equity portfolio, China Resource Holdings is a large, established company that many brokerage and research houses follow. What attracted the external manager to invest was that the company was inexpensive and a Hong Kong developer of large-scale residential projects (70 percent of its earnings). It also had the prospect of its parent company in China injecting additional assets in the form of telecommunications and information technology businesses.</p> <p>Although Deutsche Asset Management, a CalPERS external manager for the international active equity portfolio, has not invested in this company, it identified China Resource Holdings as a Hong Kong conglomerate with a Chinese parent. The company has various lines of business including a Chinese brewery, Hong Kong property, and a supermarket chain. As of January 2000, the external manager considered this stock to be fully valued.</p>	<p>Included in commingled equity index fund[‡]</p> <p>State Street Global Advisors</p> <p><i>and</i></p> <p>Active equity security</p> <p>Newport Pacific Management</p>	No

* The list prepared by the federal Department of the Treasury's Office of Foreign Assets Control.

‡ Holdings by CalPERS in these companies result from CalPERS owning units of a commingled fund. The commingled fund contains holdings of indices or funds that include the individual companies.

Company Name	Allegations in Audit Request and Source	Public Information About Company	Type of Holding and Manager Who Purchased	On OFAC List?*
Talisman Energy Inc.	The audit request did not cite a source for the statement that "Talisman is a partner with the China National Petroleum Corporation (CNPC) for the development and construction of oil fields and pipelines in Sudan. A percentage of the revenues will be paid to the Sudanese government, which has been engaged in a decades-long war against the non-Muslim south."	The company's Web site describes Talisman Energy Inc. as the largest independent oil and gas producer based in Canada. The site also states that the company's main operating areas are Canada, the North Sea, Indonesia, and the Sudan. In the Sudan, Talisman has a 25 percent interest in the Greater Nile Oil Project. Talisman owns a 25 percent interest in the Greater Nile Petroleum Operating Company (GNPOC), the jointly owned company that operates the Sudan oil project. In February 2000, the federal Department of the Treasury added GNPOC to the list of "Specially Designated Nationals and Blocked Persons" to which the United States sanctions are applied. Talisman itself is not on any of the Treasury Department lists.	Included in commingled equity index fund* State Street Global Advisors	No

* The list prepared by the federal Department of the Treasury's Office of Foreign Assets Control.

‡ Holdings by CalPERS in these companies result from CalPERS owning units of a commingled fund. The commingled fund contains holdings of indices or funds that include the individual companies.

Agency's comments provided as text only.

CalPERS
Executive Office
P.O. Box 942701
Sacramento, CA 94229-2701
(916) 326-3829 FAX 326-3410

December 5, 2000

Elaine Howle, State Auditor*
Bureau of State Audits
555 Capitol Mall, Suite 300
Sacramento, CA 95814

SUBJECT: AUDIT REPORT NO. 99138

Dear Ms. Howle:

First, I want to commend you and your staff for your professionalism and, secondly, for a very well-written report about a complex aspect of the investment activities of the CalPERS system. You present fairly and accurately the characteristics of the process CalPERS follows in its foreign investment activities. We also appreciate the opportunity to meet with your staff to discuss your preliminary results and to further clarify our process to you.

With respect to your three recommendations, we agree with all of them and provide the following explanations of our plans moving forward:

Recommendation: *To ensure it properly monitors its general pension consultant, CalPERS should finish the review for the year ended June 30, 2000 and establish controls that ensure it performs the review promptly each year.*

This review is completed and will be reported to the Investment Committee at the December 11, 2000 meeting. We will incorporate the annual review requirement into our enterprise-wide contracts database reporting capability so that, in future years, we complete a timely review.

Recommendation: *To ensure that it has adequate, current criteria for determining permissible countries for investment, CalPERS should finish revising the criteria for determining permissible countries for investment, as well as create a timetable for the review of existing criteria.*

Our staff will continue to work with the Board to finalize the permissible country process. An agenda item is scheduled for the December 11, 2000 Investment Committee meeting to address this issue. While there may be further discussions at later Board meetings, we believe progress in completing the criteria will be achieved in the near term.

* California State Auditor's comments appear on page 43.

Elaine Howle
December 5, 2000
Page 2

Recommendation: *If the CalPERS Board believes the actions of a specific country's government may be contrary to international standards of human rights, or may compromise national security, CalPERS should work with the State Legislature to communicate these concerns to Congress through a legislative resolution.*

Where the CalPERS Board concludes, after due diligence, that any issue – including human rights and national security – financially impacts CalPERS investments, we will adjust investment policy accordingly. Where that financial link is absent, however, and yet concerns about the quality of a country's standards exist, we will communicate these concerns to the State Legislature and work with the State Legislature in communicating them on to Congress.

In addition, for the sake of accuracy, we note one portion of the report that we believe needs clarification.

- Page 32*: The report references the emerging market proposal by the State Treasurer's Office, considered by CalPERS' Investment Committee in May 2000. The report also mentions that the Investment Committee directed staff to work with the Treasurer's Office to refine the various proposals in this area. However, the report does not mention that these additional discussions produced another proposal, jointly authored by the Treasurer and Board Member Sean Harrigan. It was this latter proposal (circulated to Board Members in September) that was considered at the November 2000 Investment Committee. Not mentioning this latter report leaves an incorrect perception of the Committee's deliberative process. ①

Thank you for your consideration of these comments. If you or your staff have any additional questions, we would be happy to address them.

Sincerely,

(Signed by: James E. Burton)

JAMES E. BURTON
Chief Executive Officer

*This page number refers to an earlier draft of the report.

COMMENTS

California State Auditor's Comments on the Response From the California Public Employees' Retirement System

To provide clarity and perspective, we are commenting on the California Public Employees' Retirement System's (CalPERS) response to our audit report. The number below corresponds to the number we have placed in the response.

- ① We do not believe that our description of the results of the CalPERS investment committee meeting in November 2000 incorrectly characterizes the committee's deliberative process. In our discussion of the CalPERS investment committee meeting on page 25, we do not mention the proposals that were before the committee. Our reading of the transcripts of the investment committee meeting identified at least three different proposals that the committee considered. Rather than discussing all of the proposals that led to the committee's decision, our discussion focused on the ultimate results and effect of the committee's decision.

cc: Members of the Legislature
Office of the Lieutenant Governor
Milton Marks Commission on California State
Government Organization and Economy
Department of Finance
Attorney General
State Controller
State Treasurer
Legislative Analyst
Senate Office of Research
California Research Bureau
Capitol Press