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WP #10-01

Carleton University | Carleton Centre for Community Innovation

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Abstract:

This paper argues that CalPERS' new principles-based approach to investing in emerging markets stands at the midpoint between its previous alpha-generation policy of complete country-level divestment and its beta-enhancement associated with universal investing in its domestic and developed markets. While CalPERS previous policy addressed macro-level standards at a country level by negatively screening out companies in restricted countries, it precluded CalPERS' normal practice of corporate engagement to raise ESG standards at the company level in these markets. We argue that the new policy brings CalPERS emerging market portfolio more closely in line with its policies of engagement. We describe this policy as 'enhanced alpha-generation'. We further argue that the financial returns on these emerging market investments are more in line with emerging market benchmark returns, while the raised ESG standards allow for risk reduction in the portfolio over time.

We use CalPERS emerging market portfolio holdings data and cross reference these company holdings with KLD data to examine CalPERS' impact on ESG standards in the newly investable companies held in CalPERS' portfolio. We look at these companies' standards before, during, and after CalPERS' investment. Since CalPERS seeks to reduce risk in its emerging market portfolio by taking into consideration the ESG standards of firms, we further examine the share prices of these firms against standard industry benchmarks to determine the approach's

material impact on CalPERS' portfolio. We conduct interviews with CalPERS investment managers to determine how the emerging market investment principles are incorporated in the emerging market investment process. We also interview leading experts at KLD[1] and Verité on the current and future state of ESG standards in and engagement with emerging market companies.

Key words

CalPERS, long-term, ESG investing, activism, corporate engagement, emerging markets, pension funds, extra-financial standards, externalities, economic development, Russia, China, universal ownership, alpha-generation, corporate social responsibility

Acknowledgements

We thank Michelle Lapolla Friedman and Celeste Cole at KLD for their assistance with ESG data collection and interpretation. We are grateful to Charles Fitzpatrick at CalPERS for providing us with the data needed to perform our analysis and to Anne Stausboll for supporting our research. We are endowed to Eric Baggesen of CalPERS and CalPERS' Trustee Priya Mathur, and Dan Viederman of Verité, and other confidential interviewees for the enlightening discussions that shaped our understanding of and enthusiasm for the subject. We would like to acknowledge the support of this research by the Social Sciences and Humanities Research Council of Canada.

[1] KLD is now part of RiskMetrics Group.

I. Introduction

The California Public Employee Retirement System (CalPERS) is one of the largest pension funds in the United-States. It is renowned for its trailblazing institutional activism that results in superior portfolio financial performance and yield global ancillary economic and social benefits. In demonstration of the power of active share ownership, CalPERS' focus list of American companies to be engaged on financial and corporate governance concerns has generated substantial returns to the economy and society at large (Barber, 2005). Generally, CalPERS had historically restricted its active share ownership activities to developed markets.

Beginning in 2002, CalPERS' emerging market equity investments were restricted by a Permissible Emerging Markets Policy. According to this policy, fund managers were disallowed from investing in countries that fell short of an environmental, social and governance (ESG) threshold based on factors such as political stability, transparency and labor practices. By conditionally excluding these countries from their portfolio, CalPERS effectively influenced governments to adopt a more investor friendly macro-environment as an impetus to attract capital inflow. Despite the Permissible Emerging Markets Policy's merits, the policy's restrictive nature disallowed fund managers from investing in booming equity markets such as Russia and China – countries that consistently failed to meet the minimal threshold of permissibility. In 2006 this restriction imposed 2.6% in annual foregone return on CalPERS' emerging market equities portfolio and forced management to reconsider its emerging market investment strategy (Wilshire, 2007).

In late 2007, motivated to capitalize on Russian and Chinese equities and feeling that the best way to influence change in policies and practices was no longer at the government level but at the corporate level (Eccles and Sesia, 2009), CalPERS adopted a new principle-based approach to equity screening at the company-level and thereby permitted investments in all countries listed in the FTSE All Emerging Index (CalPERS, 2007).

This paper argues that CalPERS' new principles-based approach to investing in emerging markets stands at the midpoint between its previous alpha-generation policy of complete country-level divestment and its beta-enhancement associated with universal investing in its domestic and developed markets. While CalPERS previous policy addressed macro-level standards at a country level by negatively screening out companies in restricted countries, it precluded CalPERS' normal practice of corporate engagement to raise ESG standards at the company level in these markets. We argue that the new policy brings CalPERS emerging market portfolio more closely in line with its policies of engagement. We describe this policy as 'enhanced alpha-generation'. We further argue that the financial returns on these emerging market investments are more in line with emerging market benchmark returns, while the raised ESG standards allow for risk reduction in the portfolio over time.

The paper extends the pension fund active share ownership argument (Clark and Hebb 2004, Hawley and Williams 2000, Hebb 2008, Lydenberg 2007) to emerging markets by proposing a new approach to emerging market investing. By, first, screening companies based on extra-financial (ESG) factors and, second, engaging these to raise corporate standards, CalPERS would reduce risk in its emerging market equities portfolio for a given return and thereby achieve a better risk/return trade-off than that of the market investor. We term this approach 'enhanced alpha-generation'. We address how investor initiatives contribute to redressing systematic issues derived from market failures. More specifically, we build on the management literature of 'voice' and 'exit' through the exploration of alpha, beta, and enhanced alpha investment strategies. We delineate the financial and extra-financial motivations behind these strategies and the preconditions for their application. We focus on enhanced alpha investment strategies in the context of foreign institutional investment in emerging markets.

We use data from CalPERS on their portfolio holdings in emerging markets and cross reference these company holdings with KLD Research and Analytics Inc. (KLD) data to examine CalPERS' impact on ESG standards in the companies of interest. We look at these companies' standards before, during, and after CalPERS' investment. Since CalPERS seeks to reduce risk in its emerging market portfolio by taking into consideration the ESG standards of firms, we further examine the share prices of these firms against standard industry benchmarks to determine the approach's material financial impact on CalPERS' portfolio. We conduct interviews with CalPERS investment managers to determine how the emerging market investment principles are incorporated in the emerging market investment process . We also interview leading experts at KLD and Verité on the current and future state of ESG standards in and engagement with emerging market companies.

The paper is structured as follows. The next section reviews the literature and explores our theoretical contribution. Section three studies the history and purpose of CalPERS' Emerging Equity Markets Principles. The following section describes our methodology and methods. Section five discusses our data. Here we examine the financial data that relates to the companies added to CalPERS portfolio. In section six, we draw on a set of semi-structured interviews with CalPERS senior management, trustees and external fund management and extra-financial analysts and data providers. This exercise provides a qualitative analysis from their perspective and allows us to determine how CalPERS' emerging market investment principles are incorporated in the emerging market investment process. These interviews provide a good basis to unmask the current and future state of ESG standards in and engagement with emerging market companies. Section seven we discusses our findings and their implications. We conclude the paper with some final thoughts on limitations and future research.

The Attractiveness of Emerging Market Investments

Emerging markets are in the process of rapid industrialization and dynamic economic development. In contrast to most developed countries, where limited business growth opportunities have dampened investment returns, emerging markets offer exceptional investment opportunities.

Near the end of the millennium's first decade, as pension funds encountered increased difficulty to meet their liabilities (Watson Wyatt, 2009) because of the financial crisis and the enlarging funding gap (The Economist, 2009), emerging markets became an attractive source of yield pickup (Chan-Lau, 2005). It is therefore expected that large pension funds such as CalPERS will continue to increase the proportion of their equity portfolio allocated to emerging markets. CalPERS emerging market equities portfolio represented 12.3 percent of international equity investments and 5.1 percent of total equity investments as of June 2009. But despite being a potential source of superior financial returns and yield pickup, emerging market investments, as opposed to their developed market counterparts, are generally associated with a higher level of political, financial, and economic risks (Harvey, 2004).[2]

These emerging market risks are mainly attributed to relatively poor public administrative governance and the rudimentary state of legal and regulatory frameworks coupled with poor enforcement and oversight by authorities (La Porta et al, 1997). Compliance with corporate standards required by legal and regulatory frameworks are therefore a plaguing problem in emerging markets. Even when compliance is achieved, the typically low demands of compliance put companies at risk of competitive disparity (Barrett, 2006, McWilliams et al., 2002). In some regions, rapidly changing regulations could put environmental and social laggards at a competitive disadvantage or expose them to litigation risk. And even in the case of no real imminent changes in the regulatory environment, these still run the risk of reputational damage[3]. Such risks affect the attractiveness of emerging market investments.

To compensate for discrepancies between corporate standards that investors expect and those minimally required or enforced by nation-states, voluntary 'civil regulations' have emerged as a relatively new dimension of global business regulation that governs the social and environmental impact of global firms (Haufler, 2001, Vogel, 2008). 'Civil regulations' involve product or producer certification and usually take the form of codes governed by nongovernmental organizations. By voluntarily subscribing to these regulatory standards, emerging market companies pledge to comply with certain levels of extra-financial commitments that are usually above those minimally required at the local and national levels. These commitments can vary by industry and product. They typically concern labour or environmental practices and address issues such as human rights, natural resources management, and waste disposal. For example, the ILO Core Labour Standards aim to improve

[2] See Political Risk Services' International Country Risk Guide (ICRG).

[3] Reputational risk often affects emerging market companies and their investors. Reputational damage can have an important effect on a company's profitability: Among others, it can lead to lost revenue from socially and environmentally conscious customers (Klein et al., 2004) and degraded employee morale (Berger et al, 2007), which can affect workforce productivity. Investors in emerging market equities therefore have important incentives to be concerned with firms' level of social and environmental standards that lie beyond those required by compliance or by enforcement and oversight by local actors.

worker conditions by addressing human rights issues in developing countries and the Global Sullivan Principals of Corporate Social Responsibility.[4]

Many emerging market companies subscribe to these regulatory standards in response to pressure from activist groups' public protests or boycotts from consumers. Others subscribe in response to their environmentally and socially sensitive corporate clients' demand that suppliers adopt such standards in an effort to mitigate the risk of potential reputational damage arising from supply chain procurement activities. Increasingly, however, other companies decide on their own to adopt voluntary standards because it makes good business sense.

Besides averting external pressure and reputational damage, there is an actual business case for heightened corporate standards (Porter and Kramer, 2006, Menon and Menon, 1997, Hart, 1995, McWilliams et al., 2002). For instance: becoming more eco-efficient can reduce business costs (Porter and Van der Linde, 1995); labeling products as socially responsible (eg. fair trade coffee) or eco-friendly (eg. green products, low emission cars) can appeal to niche markets (Linton et al., 2004, Blomqvist and Posner, 2004); better labour practices can lead to improved employee productivity and retention rates (Berger et al., 2007); anticipating changes in the regulatory environment can lead to a competitive advantage (Roome , 1994); etc. Moreover, an emerging market company that has heightened social and environmental standards is at a comparative advantage when it comes to growing its business abroad (Gugler and Shi, 2008).[5]

The above mentioned motives are all strategically important reasons for emerging market companies to subscribe to heightened corporate standards. As such, subscription can translate into material financial benefits for shareholders.[6]

[4] These standards are addressed by CalPERS Emerging Equity Markets Principles Three and Four, respectively. Refer to Appendix I.

[5] Emerging market companies wanting to expand operations abroad to more developed countries must usually meet standards above those locally and nationally required in order to meet the expectations of new stakeholders such as host nation-states, corporate partners, clients and customers upon which the financial success of expansion depends. Heightened corporate standards is therefore an especially important consideration if one expects the company to continue being an attractive investment opportunity as it exhausts national and regional opportunities of growth.

[6] See "Demystifying Responsible Investment Performance" (October 2007) by UNEP Finance Initiative & Mercer for a review of key research on the financial implications of extra-financial (ESG) factors.

There is evidence that adopting stringent environmental standards may, in the long-run, actually be more profitable than defaulting to lower local environmental standards (Dowell et al., 2000). This evidence suggests that "better firms" adopt higher environmental standards and pollute less. In contrast, poorer quality firms would seek to operate in areas with the least stringent environmental requirements in a myopic effort to externalize costs in order to remain momentarily competitive. Thus, according to this evidence, it appears that capital markets treat externalized costs as liabilities that firms will eventually have to meet and the market, it seems, *eventually* amends the valuation of these firms to reflect this perceived extra-financial liability (Heal, 2005). Derwall et al. (2005) provide evidence that eco-efficient investment portfolios provide substantially higher financial returns than its eco-inefficient counterpart. Although no such evidence exists with regards to social standards, the same conclusions are to be expected.

There are three ways by which investors can factor the corporate standards of investments into their investment selection and active management process: alpha-generation, beta-enhancement and enhanced alpha-generation. Short-term investors can seek to generate alpha, excess risk-adjusted returns, by conditionally allocating capital to companies that can temporarily externalize costs to society and thereby deliver attractive return on investments for its investors at the longer-term expense of the rest of the economy and society at large. Similarly, the investor can also screen out companies whose irresponsible behaviour is seen as a significant source of downside market risk and thereby achieve a more favourable level of risk in its portfolio. This latter strategy was the aim of CalPERS' Permissible Emerging Markets Policy. Longer-term investors, however, have an incentive to redress systematic issues derived from market failures. By using 'voice' rather than 'exit' through the exploration of beta-enhancement and enhanced alpha-generation investment strategies, they can influence portfolio companies to adopt more socially, environmentally and, often as a result, more financially sustainable corporate practices.

Next, we delineate the financial and extra-financial motivations behind these strategies and the preconditions for their application. We first explore beta-enhancement strategies and then focus on enhanced alpha investment strategies in the context of foreign institutional investment in emerging markets.

CalPERS' Active Investment in Developed Markets

To understand CalPERS' perspective as an investor in emerging markets, it is useful to first consider its position as an active long-term universal investor in developed markets.

The foundation of developed market active long-term universal investing by pension funds is underpinned by two main determinants. First, in an attempt to minimize management fees for developed market investments and thereby maximize real returns for a given level of risk, pension funds such as CalPERS have increasingly resorted to passive indexing as a form of equity investment in developed markets (Karmin, 2009, Walker, 2008). This investment strategy makes them the owners of a cross-section of the whole developed economy – a condition known as universal investing (Hawley and Williams, 2007). Second, because of their sheer size, pension funds cannot divest from developed market companies without eroding share price on exit (Monks 2000). As a result, pension funds tend to be long-term investors in the companies they own. As long-term universal investors, the ability to meet their fiduciary duty depends, not on the outperformance of individual companies or markets, but on the sustainable performance of the economy as a whole (Hawley and Williams 2001). In turn, optimal long-term performance of the whole economy is dependent on the optimal sustainable use of resources as input factors into the production of economic goods (outputs).

In a free-market economy, resource allocation is achieved through market prices and is efficient when all goods are traded at their real value. Unfortunately, market prices today do not reflect the real value of goods because production factors are not priced accurately or, otherwise, certain costs (benefits) of production are being externalized to society as negative (positive) externalities. Consequently, many companies and industries derive their profitability by externalizing their costs to society. This practice is unsustainable and undesirable from the perspective of the long-term universal owner. Externalities from one part of the economy eventually bear on other parts of the economy. And since externalities are not traded (priced) in the market, the result is aggregate economic inefficiency (sub-optimal or unsustainable economic performance). And whereas some short-term investors (eg. traders) can generate excess risk-adjusted returns and capitalize on this flaw in the market system by temporarily allocating capital to those companies and industries that are momentarily capable of externalizing costs to society, pension funds, whose portfolios are a cross section of the economy and which therefore internalize externalities, have an incentive to promote a better, more efficient, market system (Hawley and Williams, 2000).

Seeking optimal economic performance, pension funds, through collaborative frameworks, use the power of their collective share ownership to bring about changes in corporate practices (Ibid, Hawley 2003, Lydenberg, 2007).[7] By engaging with companies on environmental, social, and governance issues through such frameworks, pension funds such as CalPERS seek to raise corporate standards and achieve a higher, more sustainable, return on investment for their beneficiaries. This investment strategy is known as beta-enhancement. Barber (2005) shows that CalPERS' activism generated as much as $89.5 billion from year 1992 to 2005.

Beta-enhancement increases absolute market return. It increases the financial return on a market portfolio, composed of a properly weighted allocation of all tradable assets in the investment universe. Beta-enhancement increases the financial return on the market portfolio as to generate a better financial return for a given level of market risk. In contrast, alpha-generation seeks to exploit market inefficiencies by investing in a selection of assets that are expected to deliver a financial return greater than what is commensurate with its given level of perceived market risk over a certain time horizon. Beta-enhancement has a long-term positive effect on the market, the economy and long-term universal owners' investment portfolios whereas alpha-generation has a short lived positive effect on non-universal investment portfolios and potentially long-term negative effects on the market and the economy (Lydenberg, 2009).

CalPERS' Investment in Emerging Markets

[7] Examples of collaborative frameworks: The International Corporate Governance Network (http://www.icgn.org/), of which member institutional investors represent about $10 trillion in assets under management, and the Institutional Investors Group on Climate Change (http://www.iigcc.org/).

Historically, in contrast to their position in developed markets, pension funds such as CalPERS had little incentive to behave as active long-term universal investors in emerging markets (Soederberg, 2007). Pension fund holdings in emerging market companies were not important enough to deter 'exit' (divestment) strategies or to wield enough power to influence practices and corporate standards in a way that would outweigh the extra costs of that engagement. Moreover, engaging emerging market companies was difficult because high levels of family and/or government ownership rendered companies unreceptive to foreign pension fund and international investor concerns (Peng and Heath, 1996, Yeung, 2006); local shareholders often acted in concert without pension funds' knowledge (Young et al, 2008); and, there was a lack of coordinated action amongst institutional investors (Hagart and Knoepfel, 2007.). For these reasons, there was little perceived opportunity for beta-enhancement centered corporate engagement as there had been in developed markets. These emerging market investment conditions induced CalPERS to pursue an alpha-generation strategy (Hebb and Wójcik, 2005).

According to the alpha-generation strategy, CalPERS would conditionally invest in companies that were thought to provide a financial return greater than that required for its given level of perceived market risk (Jensen, 1972). It was CalPERS' belief that market risk in emerging markets was closely related to a country's "housekeeping" (macro policies, political economy, local financial markets, corporate governance, etc.) and "plumbing" (legal and regulatory framework, settlement proficiency, taxes, etc.).[8] As a result in 2002, CalPERS decided to pursue an alpha-generation strategy guided by a newly instated Permissible Emerging Market Policy. The Permissible Emerging Market Policy mandated screening out the equities of entire countries that did not meet a minimal threshold of permissibility based on factors such as political stability, transparency and labor practices. By prescribing to screen out companies according to the geopolitical properties of countries, the Permissible Emerging Market Policy affirmed CalPERS' status as a short-term investor in emerging market companies.

CalPERS would use exit (disinvestment) rather than voice to engage relevant actors. CalPERS also believed that countries that did not meet the minimal threshold of permissibility were too

[8] See Laderkal and Zervos (2004) for a detailed discussion of the implications of "housekeeping" and "plumbing" as they affect investing.

risky for investment; financial returns in these countries did not adequately compensate investors for the given level of investment risks. CalPERS thus claimed to be able to generate alpha by screening out the companies based in these countries and thereby generate a better financial return for a given level of market risk prevalent in the emerging market equities universe. The policy also sent a clear message to nation-states: CalPERS would disengage with emerging market companies and engage with governments, believeing that it could effectively influence governments to improve the investment macro-environment in emerging markets that were excluded from CalPERS' permissible emerging markets list.[9]

Only thirteen out of twenty-seven emerging countries met CalPERS' minimal threshold for investment that year. For ineligible countries, failure to meet CalPERS' threshold lead to capital drain due to the divestment of CalPERS and other investors that saw CalPERS' disapproval of these markets as an information signal that these regimes were particularly risky for investment (McKinsey, 2004). Obtaining CalPERS' 'seal of approval' became a special concern for those many nation-states wanting to attract foreign direct investment (Hebb and Wójcik, 2005). CalPERS' engagement with these governments influenced many countries to meet the challenge for a more investor friendly environment. By year 2006, 20 emerging markets met CalPERS' invetment threshold.

Unfortunately for CalPERS, although country-level screening may have reduced risk in its portfolio, it had effectively screened out the most promising and lucrative equity markets in the world, among others, Russia and China, and, by late 2006, CalPERS' emerging market portfolio had been subject to 2.6% in annual opportunity cost of foregone return totalling over $400 million in losses from the time of the policy's inception in 2002 until late 2006 (Wilshire, 2007).

So the merits of the Permissible Emerging Market Policy eventually came into question. Therefore, in late 2006, CalPERS finally decided to permit stock purchases in selected

[9] Here we note that CalPERS enhanced beta in the excluded countries by influencing them to improve their investor macro-environment. Enhancing beta in these countries was directly corollary to the particular alpha-generation strategy. CalPERS emerging market equities portfolio did not benefit from this beta-enhancement since it was not invested in the countries prior to or during their reform to meet the minimal threshold of permissibility. Other investors might have benefited from this beta-enhancement. The Permissible Emerging Market Policy thereby delivered greater benefits to the economy and society at large in addition to its promises to generate alpha in CalPERS' portfolio.

companies in China and other developing countries. CalPERS required that external managers who wished to invest in a company in a non-permissible market address country and market factors where the company's home country scored below threshold, and explain why the company would meet threshold standards (CalPERS, 2006). Later in 2007, CalPERS formalized the new strategy, calling it the Emerging Equity Markets Principles approach – a principles-based approach to guide external managers who invest in emerging international markets (CalPERS, 2007). This approach enabled external managers to take advantage of market opportunities in all developing countries listed in the FTSE All Emerging Index including China, Colombia, Egypt, Pakistan and Russia, five countries where investments was previously prohibited.

The Virtue of CalPERS' Emerging Equity Markets Principles

Just as CalPERS' 2002 decision to screen at the country-level signalled disengagement with companies, its new principles-based approach signalled a new era of emerging market investing: a move towards CalPERS' typical corporate engagement style: CalPERS would invest in select emerging market companies that are expected to provide excess risk-adjusted return and engage these through dialogue and shareholder activism on specific environmental, social, and governance (ESG) issues in order to raise corporate standards, achieve an even more favourable level of risk, and contribute to more sustainable corporate practices. But whereas the argument for corporate engagement in developed markets is framed around beta-enhancement strategies in answer to CalPERS' position as a long-term universal investor, the argument for corporate engagement in emerging markets is framed around the concept of alpha-generation over the longer-term.

CalPERS is not a universal investor in emerging markets and therefore has no incentive to behave as such through beta-enhancement strategies. Instead, CalPERS would first, screen companies based on extra-financial (ESG) factors and, second, engage these to raise corporate standards and thereby reduce risk in its emerging market equity portfolio and achieve a better risk/return trade-off than that of the market investor. We refer to this investment strategy in emerging markets as enhanced alpha-generation.

Enhanced alpha-generation is different from beta-enhancement in that beta-enhancement seeks to amplify financial returns generated by the whole investment universe for a given level of market risk whereas enhanced alpha-generation seeks to amplify returns of a select, screened number of investments for a given level of market risk. Enhanced alpha-generation is different from alpha-generation in that the latter is a simple screening activity whereas the latter incorporates a longer term investment horizon and engagement activities to influence heightened corporate standards in portfolio companies. By raising corporate standards through the enhanced alpha-generation strategy, CalPERS promotes more sustainable corporate practices and, therefore, in the long-term, more competitive companies, markets, and industries in the developing world.

Methods and Methodology

We use data from CalPERS emerging markets investment portfolio to identify all CCEPR holdings added to CalPERS' portfolio as a result of the investment policy change to the new principles-based approach from years 2007 to 2009. We cross-reference these holdings' Stock Exchange Daily Official List (SEDOL) codes to time series ESG rating data obtained from KLD. These ESG rating data assess a company's ESG practices and involvement in controversies concerning employee health & safety, labor relations, bribery and corruption, discrimination, community relations, human rights, and environmental impact.

KLD Emerging Market Research ESG ratings are used by CalPERS' internal fund management and two of its emerging market equities portfolio external fund managers to assess emerging market companies' corporate standards as they relate to CalPERS Emerging Equities Market Principles Three and Four (See Appendix).[10] Ratings are collected for years 2005 to 2009. This time period allows us to look at these companies' standards before, during, and after CalPERS' investment. We examine KLD ratings of CCEPR holdings to determine whether and in what direction corporate ESG standards changed during CalPERS' investment. This allows us to draw

[10]Principle Three targets "Productive Labor Practices" by disallowing harmful labor practices or use of child labor and requiring compliance, or moving toward compliance, with the International Labor Organization (ILO) Declaration on the Fundamental Principles and Rights at Work. Principle Four targets "Corporate Social Responsibility and Long-term Sustainability". It includes Environmental sustainability and requires compliance, or moving toward compliance, with the Global Sullivan Principles of Corporate Social Responsibility.

conclusions on the extra-financial (ESG) impact of CalPERS' new principles-based approach. We classify companies of interest under three categories according to their ESG performance ratings over the years under examination: (1) improving ESG performance; (2) declining ESG performance, and; (3) recent or consistent ESG underperformance.

We collect benchmark financial return data on these companies based on business type and country of operation. We also collect MSCI Barra CCEPR country specific financial return data. We use these financial data to determine the Emerging Equities Market Principles approach's material financial effect on CalPERS' portfolio. Using these methods, we draw conclusions on the policy's financial and extra-financial impacts and their implications for CalPERS and emerging market companies.

We also conduct semi-structured interviews with CalPERS senior management, trustees and external fund managers to determine how the emerging market investment principles are incorporated in the emerging market investment selection and management process and gain insight into the importance attached to ESG factors for emerging market investments. We draw on Yin (2003) in our case study method. We use these interviews to uncover responses to companies' consistent ESG underperformance and declining ESG performance. We also interview leading experts at KLD and Verité on the current and future state of ESG standards in and engagement with emerging market companies.

ESG Standards in CalPERS' CCEPR Portfolio

On fiscal year-end 30 June 2007, CalPERS' new CCEPR investments totaled $243.3 million in equity market value, adding twenty companies, all Chinese and Russian with the exception of one Egyptian and one Colombian company. These investments represented 35 percent of total newly added emerging market equities' market value. By fiscal year-end 30 June 2008, CalPERS' added new CCEPR investments totalling $343.8 million in equity market value of ninety-three companies, again mostly Chinese and Russian with a few exceptions. These investments represented 53 percent of total newly added emerging market equities' market value. On fiscal year-end 30 June 2009, CalPERS' new CCEPR investments totaled $ 133.8 million in equity market value of one hundred five companies, with a substantial number of

Colombia, Egypt and Pakistan equities. These investments represented 68 percent of total newly added emerging market equities' market value. CCEPR emerging market portfolio equities represented 4.1 percent, 14 percent, 18.7 percent or $243.3 million, $831.8 million and $969.1 million on fiscal year-ends 2007, 2008 and 2009, respectively. On fiscal year-end 30 June 2009, CalPERS' emerging market equities portfolio held 212 CCEPR companies (see Appendix 2 for country distribution).

	New CCEPR companies (number/investment/as percent of total new additions to portfolio)	Total CCEPR (investment / percent of total emerging market equities portfolio)
30 June 2007	20 / $ 243 M / 30 %	$ 243 / 4.1 %
30 June 2008	93 / $ 344 M / 53 %	$ 832 / 14 %
30 June 2009	105 / $ 134 M / 68 %	$ 969 / 18.7 %

Having identified the CCEPR companies of interest, we cross-reference SEDOL codes to time series ESG rating data obtained from KLD Emerging Markets Research for years 2005 to 2009. The KLD data ranks emerging market companies using three ratings: 'Pass', 'Watch List', and 'Red flag'. A 'Red Flag' rating signifies egregious corporate behaviour with regards to CalPERS' Principles Three and Four. A 'Watch List' rating signifies suspected or anticipated egregious corporate behaviour with regards to the same Principles.

In 2008, 105 out of 151 rated CCEPR companies were rated 'Pass' by KLD Emerging Markets Research; 38 were rated 'Watch list', and; 8 were rated 'Red Flag'. In 2009, 125 out of 180 rated companies were rated 'Pass'; 43 companies were rated 'Watch List', and; 12 companies were rated 'Red Flag'. Three of the 'Red Flag' rated companies were previously unrated companies and included the China Mengiu Dairy company that was involved in the Chinese tainted milk scandal.

We classify companies of interest under three categories according to their ESG performance ratings over the years under examination: (1) improving ESG performance; (2) declining ESG performance, and; (3) recent or consistent ESG underperformance. We define a "recent or consistent ESG underperformance" as a recent 'Red Flag' rating, or a 'Watch List' or Red Flag' rating that is maintained for at least 3 years over the five years under examination. The companies that fall under one of the three categories are the following.

In summary: four companies saw their ESG rating improve over the years under examination; five companies saw their ESG rating decline; nine companies maintained a consistently poor rating, and; three previously unrated companies were rated 'Red Flag'.

According to information gathered from KLD Emerging Market Research, we identified the following reasons for changes in ESG corporate performance rating.

Companies with improving ESG ratings: Sberbank Rossii was upgraded to 'Watch List' from 'Red Flag' as issues dating April 2001 related to the violation of shareholder rights became dated and there was a lack of recent egregious behaviour that would warrant a 'Red Flag' rating; Sinopec S/Petrochemical was upgraded to 'Watch List' from 'Red Flag' as the subsidiary became sufficiently independent from its parent company to warrant a differential rating, and; China Life Insurance was upgraded to 'Pass' from 'Watch List' as class action relating to corruption issues was later dismissed, warranting a change in rating.

Companies with declining ESG rating: Zijin Mining Group C went from 'Watch List' to 'Red Flag' as it increased its involvement in Burma through a subsidiary; Beijing Capital In went from 'Pass' to 'Watch List' as an employee, who later left the company, was found to be guilty of corporate fraud; China Railway Cons went from 'Pass' to 'Watch List' as workers beat local farmers in a clash over land; El EZZ Steel Rebar went from 'Pass' to watch list after it was discovered that the company operated in Sudan, and; the National Bank of Pakistan went from 'Pass' to 'Watch List' as it was discovered that employees had been involved in money laundering.

The twelve other companies are of interest as their 'Red Flag' rating, consistent ESG underperformance, or perceived high risk of egregious ESG behaviour puts them in conflict with

CalPERS' Emerging Equities Market Principles Three and Four. We discuss the implications of this conflict later in the paper.

We matched the average return of companies in each of these categories to their respective standard industry benchmark. We found the following: companies with improving ESG ratings were Chinese and Russian companies in the finance and process-industries sectors. These companies outperformed their standard industry benchmark by an equal weighted average 3.3 percent per year, delivering -10.4 percent annually over years 2008 and 2009.

Companies with declining ESG ratings were Chinese, Egyptian and Pakistani companies in the non-energy minerals, transportation, industrial services and finance sectors. These companies underperformed their benchmark by an equal weighted average -7.3 percent per year, delivering -32.9 percent annually over years 2008 and 2009.

Companies that were in conflict with CalPERS' Principles Three and Four were Chinese and Russian companies in the energy minerals, non-energy minerals, consumer non-durables, consumer durables, transportation, utilities, and communications sectors. These companies outperformed their benchmark by an equal weighted average 10.3 percent per year, delivering -19.7 percent annually over years 2008 and 2009.

Over years 2008 and 2009, CalPERS' emerging market equity portfolio returned -6.4 percent annually – a return that is on par with the all-emerging market equity benchmark. It is interesting to note that the equal weighted average return of China, Colombia, Egypt, Pakistan and Russia (CCEPR) broad country benchmarks was -16.7 percent per year over the same time period, underperforming the emerging market equity universe by 10 percent annually. In year 2008, CCEPR broad country benchmarks returned -57.5 percent, on an equal weighted average basis, fairing much worse than the rest of the emerging market benchmark country components.

Understanding Enhanced-Alpha Strategies

To gain a deeper understanding of CalPERS' new Emerging Market Principles we conducted five intensive semi-structured interviews with representatives of CalPERS (both staff and trustees), the provider of ESG information KLD Research & Analytics Inc. (KLD), one of CalPERS' external fund managers, and research firm Verité that monitors emerging market company performance.

It was clear from the interviews that emerging markets are becoming increasingly important. Most mentioned the growing role emerging markets are playing as a percentage of total global equity. CalPERS' Global Equities Manager Eric Baggesen noted a shift in CalPERS portfolio since 2007 in favour of emerging markets: "The Global Equity team manages approximately 50% of the overall CalPERS investment portfolio, including emerging markets. In 2007, the team brought a recommendation to the CalPERS Investment Committee to restructure the benchmark used to guide the allocation of these assets due to a significant home market bias. At the time, the benchmark was structured to allocate two-thirds of the assets into the domestic U.S. market and one-third to the international markets. The recommendation was to adopt a market capitalization weighted benchmark that was approximately equally split between the U.S. and international. Since that point in time, the benchmark and portfolio weightings have evolved to about 40% U.S. and 60% international, with emerging markets exposure more than doubling (Baggesen 2010)." "At CalPERS, there is a question as to whether a market capitalization based asset allocation strategy adequately reflects the growth rate in some of the emerging market countries and whether that really positions CalPERS to be able to take advantage of the economic activity in some of these countries. So CalPERS has been talking about taking GDP weighted approach. The feeling is that CalPERS wants to invest more rather than less (Mathur 2010)."

In addition to changes in CalPERS' international asset allocation policy, internal changes occurred in CalPERS' management of its emerging market equities portfolio.. "The Global Equity team was convinced that it needed to change CalPERS' internal management capability, which was solely limited to running passive developed market funds. So CalPERS started an emerging market index sleeve and also opened up a couple of actively managed emerging market portfolio that were done internally (Baggeson 2010)."

CalPERS' previous Permissible Emerging Markets Policy excluded such countries as China and Russia, resulting in a significant underperformance compared to benchmark (as detailed earlier in this paper). Interviewees suggested that the current returns on the portfolio since the policy change to the Emerging Equities Markets Principles approach were now more closely aligned with benchmark performance (benchmark for this portfolio is FTSE All Emerging Index).

But it was not simply financial performance that was an issue with the Permissible Markets policy. It was felt that while the policy had some affect on the governments of small emerging market countries (such as the Philippines), it had very limited impact on larger countries excluded from CalPERS' portfolio. "It was a blunt instrument that didn't effectively deliver a message to companies in Emerging Markets as much of the factors dealt with national policy, such as freedom of the press, rather than issues that companies have direct control over." Nor did it "create an opportunity for companies that behaved well and that were not involved with the human rights, ethical, corporate governance issues to be rewarded or to set up support models for appropriate behaviour on a company basis in these emerging countries. Divestment says your company is not an attractive investment. It doesn't say for what reason. It just doesn't send a clear message that is consistent with why we would be divesting (Mathur 2010)."

The new Emerging Equities Markets Principles approach identified key risk factors at the company level and asked managers to take these risk factors into consideration in their investment selection in emerging markets. Each external fund manager has discretion as to how the ESG data is integrated in investment decision making. But, in emerging markets, data on how companies treat their workers is difficult to get in an environment where most companies operate with a lack of transparency. Dan Viederman of Verité points out that "sectors are wildly different in the level to which they disclose or even understand risks – for example the apparel industry is improving at disclosure, while risks of forced labor faced by workers in construction of plants within the petro-chemical sector are hardly even noticed (Viederman 2010)".

CalPERS uses KLD data on emerging market companies as a screen or filter in its active management of its own portfolio. Unlike CalPERS' domestic portfolios there is limited direct engagement between CalPERS and emerging market companies as CalPERS lacks the capacity to engage companies in its internally managed emerging market portfolio.

The KLD data primarily addresses emerging market companies' performance regarding the Global Sullivan Principles of Corporate Social Responsibility and the ILO Declaration on the Fundamental Principles and Rights at Work standards. CalPERS' internally managed emerging market funds use the ESG data provided by KLD as a screen or filter for stock selection because they have a limited bandwidth to internally generate a value determination on these companies' ESG standards. Global Equities Manager Baggeson suggests that he would prefer that greater positive engagement take place with these companies and that progress on ESG standards be directly tied to the weighting of the stock in the portfolio, a carrot and stick approach to raising standards in these companies that ensures the fund has a seat at the table and incents the company to improve ESG standards in accordance with issues raised in CalPERS' corporate engagement.

Presently, if a company receives a 'red flag' from KLD this is usually enough to warrant removal of the company from the internally managed portfolio, while companies on the 'watch list' are monitored but neither removed or engaged. External emerging market managers are free to take the steps they feel necessary to integrate ESG in their investment decisions. "They make those value tradeoffs between the economic opportunity and the potential risks attached to these aspects of the Principles (Baggeson 2010)." Similarly, CalPERS trustee Priya Mathur suggests that "if there is an opportunity so incredible that it outweighs these risk factors then we are willing to consider that investment possibility. It is not that we would eschew fiduciary duty; we are trying to understand the importance of all these risk factors as they relate to fiduciary duty, sustainable financial returns".

An external emerging market portfolio fund manager for CalPERS suggests that "ESG standards should be used to analyze whether a company's business model is sustainable. When deciding to purchase stock in a company, the price of the asset is the primary driver but you need to know that over time the company will be sustainable. If it mistreats its workers, suppliers and communities it will not be sustainable in the long run no matter what you paid for it."

This external fund manager seldom divests from companies but rather uses the KLD and other ESG data in the decision-making process before investment occurs. Interestingly, all CCEPR companies that were subject to a KLD ESG downgrading as a result of 'unforeseen' egregious behaviour with regards to CalPERS' Principles had been identified as unattractive investments before the occurrence of any such egregious behaviour or downgrading from KLD and had therefore not been allocated capital by this manager. On the other hand, "if a stock looks attractively priced but is the object of a negative KLD ESG rating [that signals potential risks from suspected, anticipated or evident ESG underperformance], our staff will engage with the company (Ibid)." The fund manager has the internal capacity to make the value tradeoffs on these ESG issues. It engages some emerging market companies it invests in: One example is an engagement with a South African company on the issue sub-standard housing for its workers. The issues were resolved. In another instance, when concerns were raised about the treatment of workers by a consistently KLD 'Red Flag' rated CCEPR company in the apparel industry, Yue Yuen Industrial Holdings, it engaged the supply chain and customers of the company and was able to satisfy itself that the standards of the company were satisfactory and did not represent an excessive level of investment risk that would violate the spirit of CalPERS' Principles.

There are challenges to the new approach that CalPERS has taken with the Emerging Market Equities Principles. A certain amount of tension exists as to how much companies can influence, address and mitigate the large country level risks identified in the CalPERS' Principles. In particular trustee Priya Mathur suggests "it does not address some of the bigger, macro, political issues that CalPERS wanted to target." The policy remains limited to CalPERS' public equities emerging market portfolio. It does not extend to emerging market private equity investment, infrastructure or corporate or government bonds in emerging markets. Here CalPERS is working toward mainstreaming ESG factors into all areas of its portfolio.

As trustee Mathur suggests, "ESG factors have long been important but how we prioritize the ESG factors has changed over time. One of the things we are talking about now is how we are trying to mainstream the approach, how do we mainstream that assessment across all asset classes within the portfolio."

Similarly, Michelle Lapolla Friedman at KLD pointed out that, "PRI signatories such as CalPERS should work towards having an ESG philosophy that is consistent across all asset classes, including emerging markets." She adds that, the PRI requirements on disclosure of how the Principles are being incorporated into the investment decision making process will encourage institutional investors to pursue the integration of the principles within all asset classes and product lines, leading to increased attention on ESG issues in emerging markets."

As more institutional investors pay attention to ESG issues in these markets, we are prone to see more collaboration on redressing ESG issues in emerging market companies. As trustee Mathur notes, "on a company basis we have not been as engaged [in emerging markets] particularly because there have not been investment talent in the area that has focused on these issues. It's not like we have internal staff that is on the ground in emerging markets that can really engage there and we have to rely on external managers for that. It really matters who our investment partner is in any given country. It is crucial because we don't have access to the information necessary to adequately evaluate risk."

Implications and Discussion

Moving from a country-level equity market screening and nation-state engagement to a company-level screening and corporate engagement poses the potential for meaningful enhanced alpha-generation. In the interview section, we presented our findings on the way CalPERS' internal and external fund management responds to companies' ESG underperformance. In this section, we expand on two enhanced alpha-generation investment strategies. We also draw deeper insight from our findings, allowing us to map the industries' consensus on the current and future state of ESG standards in and engagement with emerging market companies.

Given the Emerging Equity Markets Principles' emphasis on sustainable financial returns, it is not surprising to see that the portfolio's consistently 'Red Flag' rated CCEPR companies outperformed their benchmark in the period under analysis. CalPERS' Board believes that there is a link between the ESG concepts outlined in the Principles and the ultimate sustainability of the companies they invest in. In the case of CalPERS' 'Red Flag' CCEPR holdings, it was correctly determined that the ESG risks posed by these investments did not outweigh the investments' attractive ability to generate returns over the long-term. It is also not surprising to see that companies with improving ESG ratings also outperformed their benchmark. It is even less surprising to see that companies with declining ESG ratings and previously unrated 'Red Flag' companies underperformed their benchmark.

These findings take a more interesting context when we contrast them against two identified approaches to enhanced alpha-generation: a 'hard-fast screen' approach and a 'value trade-off' approach. As previously stated, although the Principles and their complimentary KLD ESG ratings are not meant to be used as "hard-fast screens", CalPERS internal fund management, because it lacks the internal capacity to make the value tradeoffs between the ESG performance of firms and sustainable financial returns, uses KLD ratings as a "hard-fast screens", meaning that it invariably screens out or divests from 'Red Flag' rated companies. CalPERS' internal fund management thereby encountered two sources of opportunity costs: (1) it was unable to capitalize on the attractive returns of the consistently 'Red Flag' rated portfolio companies (these companies are managed externally), and (2) it was subject to the negative returns generated by the companies that were downgraded by KLD following 'unforeseen' egregious ESG behaviour. Moreover, CalPERS internal fund management has yet to engage with CCEPR companies because it has a "limited bandwidth" to do so.

Alternatively, some external fund managers use the Principles to analyze whether a company's business model is sustainable and include a spending program to improve conditions in emerging markets. This strategy does not employ a "hard-fast screen" approach against 'Red Flag' rated companies, but rather employs an approach that uses KLD ratings as one of the several inputs into the ESG investment selection and management process. If a 'Red Flag' rated company looks attractive, this fund manager engages with the company instead of "not investing". Moreover, this manager's financial sustainability centered approach to investment selection enabled the screening out of companies that, according to their KLD rating, were perceived to be in line with CalPERS' Principles but that were later downgraded by KLD following 'unforeseen' egregious ESG behaviour.

With this take on enhanced alpha-generation, the fund manager was thereby able to generate greater alpha by benefiting from superior returns from sustainable 'Red Flag' rated companies and by pre-emptively effectively screening out the companies that underperformed benchmark following egregious ESG behaviour and subsequent KLD downgrading. As a result engagement with some of these companies enhances this alpha and contributes to lower investment risk and more sustainable companies and financial returns. Thereby contributing to promoting best practices in emerging market companies, potentially yielding scalable economic development with positive economic and social impact in emerging markets at large

Notwithstanding CalPERS' laudable attempts to enhance investment returns, industry consensus and our findings indicate that it remains difficult and expensive to engage emerging market companies. For this reason, we find that engagement is limited in scope and carried out at the discretion of external portfolio managers. This is reflected in the limited ESG improvement we see in CCEPR companies in CalPERS portfolio over time; raising standards beyond screens and filters remains a narrow and niche activity that is quite rudimentary in contrast to CalPERS' normal engagement policies and activities in its domestic and developed market investments. It is interesting to note that, since the large majority of CCEPR equities were acquired following CalPERS' policy change at the end of 2007, shortly before the economic downturn, CalPERS' emerging market equities portfolio would have fared much better had it refrained from changing its country-level screening policy and thereby effectively eliminated the high downside risk posed by CCEPR investments. It is reasonable to assume that CalPERS would have generated alpha, excess risk adjusted returns, had it kept with the old policy. CCEPR underperformance relative to the all emerging market equity universe is emblematic of the additional country-level macro-level risks posed by these investments.

Despite the bad timing of the policy change, we do find that the Principles approach is more in line with CalPERS' spirit of corporate engagement and closer to unleashing the latent potential to generate greater risk adjusted return, if not greater absolute emerging market portfolio returns, by engaging at the company level. We also find that the preconditions for greater corporate engagement, and 'focus list' style beta-enhancement, in emerging markets are rapidly developing. CalPERS and other institutional investors are presently mainstreaming their responsible investment approach "across all asset classes" and, as the PRI requires the disclosure of how responsible investment principles are being incorporated into the investment selection and management process, more investors are paying attention to ESG issues in emerging markets. With more investors factoring ESG issues into their investment processes, there is greater opportunity to collaborate on ESG engagement opportunities. Collaboration will make engagement activity more feasible as it enables the sharing of valuable information to identify ESG risks and inefficiencies, and it also enables the sharing of the costs of engagement to redress these ESG issues in a way that the benefits of redressing the issues outweigh the costs of the engagement process (Guyatt, 2008).

With these preconditions in place, it will be easier for investors such as CalPERS to contribute to more sustainable and more socially and environmentally responsible corporate practices in the developing world. Moreover, it might even make sense for CalPERS to engage in beta-enhancement targeted active share ownership in emerging markets. In our interviews, CalPERS Global Equities Manager Eric Baggeson suggested that CalPERS adopt a 'carrot-stick' approach with emerging market companies. Notable in this approach, CalPERS would invest, if only a small stake, in companies that are "distasteful" from an ESG perspective only to have a seat at the table and engage, possibly in collaboration with other investors, the company to improve its ESG standards. According to this approach, CalPERS would shift portfolio weights and acquire a greater stake in the company as target management complies with requests brought up in this corporate engagement. Such an approach could deliver substantial returns to the economy and society at large just as CalPERS' universal ownership motivated corporate engagement has done in developed markets. As it moves toward a more inclusive approach, the application of the Emerging Equity Markets Principles with its enhanced alpha-generation stands at the midpoint between its alpha generating policy of complete country level divestment and the beta-enhancement associated with universal investing.

Conclusion

CalPERS' Emerging Equity Markets Principles posed the potential to generate enhanced alpha in its emerging market portfolio. Despite the bad timing of the policy change, we find that CalPERS' emerging market portfolio returns are now closer to benchmark. By cross-referencing KLD ESG ratings to CalPERS' emerging market portfolio company holdings based in the newly permissible equity markets of China, Colombia, Egypt, Pakistan and Russia, we find that consistently 'Red Flag' rated CCEPR companies and companies with improving ESG ratings outperformed their benchmark while companies with declining ESG ratings underperformed their benchmark.

Our interviews revealed two investment philosophies towards the Principles and their complementary KLD ratings. The first, a 'hard-fast screen' approach, presents two sources of opportunity costs: the foregone ability to benefit from the financial performance of sustainable 'Red Flag' rated companies, and; the failure to pre-emptively screen out companies that would later engage in egregious ESG behaviour and create negative alpha. The second, a 'value trade-off' approach, is sustainability-centered and enables greater alpha-generation by allowing the realisation of superior returns from sustainable 'Red Flag' rated companies and by pre-emptively effectively screening out the companies that underperformed benchmark following egregious ESG behaviour. This 'value trade-off' approach also includes an engagement program to enhance this alpha and encourage more sustainable corporate practices in emerging markets.

Our findings indicate that it remains difficult and expensive to engage emerging market companies. For this reason, we find that engagement is limited in scope and carried out at the discretion of external portfolio managers. This is reflected in the limited ESG improvement we see in CCEPR companies in CalPERS' portfolio over time; raising standards beyond screens and filters remains a narrow and niche activity that is quite rudimentary in contrast to CalPERS' normal engagement policies and activities in its domestic and developed market investments.

We also find that emerging markets are becoming more important to institutional investors, CalPERS included. CalPERS is investing a larger portion of its portfolios in these regions. Most interviewees spoke to the increasingly important role of ESG investing in emerging markets. It was suggested that CalPERS employ an investment philosophy whereby it would invest, if only a small stake, in companies that are distasteful from an ESG perspective only to have a seat at the table and engage the company to improve its ESG standards. According to this strategy, the company would be incented to implement ESG recommendations in order to attract more capital from similar ESG minded long-term institutional investors.

Because CalPERS' policy change occurred in late 2007, our study is limited by a short evaluation period. Corporate behaviour does not improve overnight and it can take time for heightened corporate standards to affect positive financial returns. The returns against benchmark were calculated for a two year time period, during which there was the occurrence of a sharp economic downturn, which might have compromised the generalizability of our findings.

Future research is needed on the financial materiality of environmental and social externalities in emerging markets. In emerging markets, what environmental and social behaviour leads to superior financial performance for what companies? What are the financial implications of corporate externalities on other emerging market companies' profitability? And, how can institutional investors best address systematic issues in emerging markets?

Our current research suggests that responsible investment is going through a mainstreaming phase that should lead to greater collaboration on ESG corporate engagement initiatives in emerging markets, potentially yielding scalable economic development with positive economic and social impact in emerging markets at large. Such investor behaviour in emerging markets could deliver beta-enhancement type returns to the economy and society by fiduciary duty similar to those motivated by universal ownership in developed markets.

Appendix 1: CalPERS' Emerging Equity Markets Principles

CalPERS' emerging markets managers shall evaluate their investment in emerging markets according to the following Emerging Equity Market Principles:

Principle One: Political Stability - Progress toward the development of basic democratic institutions and principles, including such things as: (1) a strong and impartial legal system; and (2) respect and enforcement of property and shareowner rights. Political stability encompasses: Political risk, (including external conflicts and law and order), civil liberties (including freedom of expression, and human and economic rights), and independent judiciary and legal protection (including the extent to which there is a trusted legal framework that honours contracts, clearly delineates ownership and protects financial assets.

Principle Two: Transparency – Financial transparency, including elements of a free press necessary for investors to have truthful, accurate and relevant information. Transparency encompasses: freedom of the press, monetary and fiscal transparency, stock exchange listing requirements and accounting standards

Principle Three: Productive Labour Practices - No harmful labour practices or use of child labour. In compliance, or moving toward compliance, with the International Labour Organization (ILO) Declaration on the Fundamental Principles and Rights at Work. Productive Labor Practices encompasses: ILO ratification, quality of enabling legislation, institutional capacity to enforce ILO standards, and evidence that enforcement procedures exist and are working effectively.

Principle Four: Corporate Social Responsibility and Long-term Sustainability - Includes Environmental sustainability. In compliance, or moving toward compliance, with the Global Sullivan Principles of Corporate Social Responsibility.

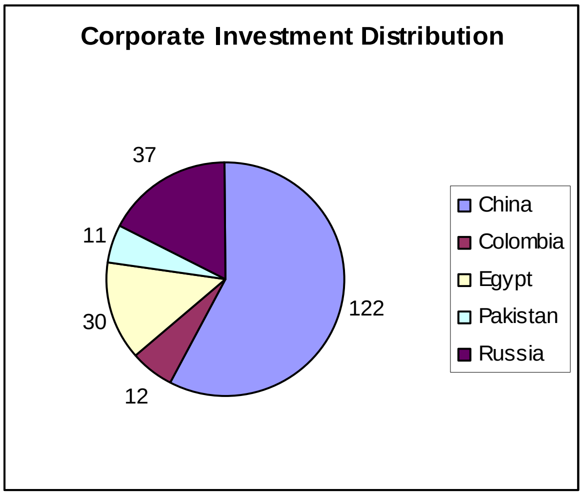
Principle Five: Market Regulation and Liquidity - Little to no repatriation risk. Potential market and currency volatility are adequately rewarded. Market regulation and liquidity encompasses: market capitalization, change in market capitalization, average monthly trading volume, growth in listed companies, market volatility as measured by standard deviation, and return/risk ratio.

Principle Six: Capital Market Openness - Free market policies, openness to foreign investors, and legal protection for foreign investors. Capital market openness encompasses: foreign investment (including the degree to which there are restrictions on foreign ownership of local assets, repatriation restrictions or un-equal treatment of foreigners and locals under the law), trade policy: degree to which there are deterrents to free trade such as trade barriers and punitive tariffs), and banking and finance (including the degree of government ownership of banks and allocation of credit and protectionist banking regulations against foreigners).

Principle Seven: Settlement Proficiency/Transaction Costs - Reasonable trading and settlement proficiency and reasonable transaction costs. Settlement proficiency/transaction costs encompasses: trading and settlement proficiency (including the degree to which a country's trading and settlement is automated and the success of the market in settling transactions in a timely, efficient manner); transaction costs (including the costs associated with trading in a particular market and the amount of taxes).

Principle Eight: Appropriate Disclosure - On environmental, social, and corporate governance issues.

Appendix 2: Distribution of CCEPR Company Holdings on Fiscal Year-end 30 June 2009



Appendix 3

SEDOL	Name	FactSet Sector	Country	2009	2008	2007	2006	2005
6559335	CHINA TELECOM CORP	Communications	CHINA	WL	WL	WL	WL	WL
B0B8Z18	CHINA COSCO HLDGS	Transportation	CHINA	WL	WL	WL	WL	N/A
6142780	HUADIAN POWER INTL	Utilities	CHINA	WL	WL	N/A	WL	WL
B00LYN3	SBERBANK ROSSII	Finance	RUSSIA	WL	WL	WL	WL	RF
6797458	SINOPEC S/PETROCHE	Process Industries	CHINA	WL	WL	RF	RF	RF
B00G0S5	CNOOC LTD	Energy Minerals	HONG KONG	RF	RF	RF	RF	RF
5140989	GAZPROM	Energy Minerals	RUSSIA	RF	RF	RF	RF	RF
368287207	GAZPROM O A O	Energy Minerals	RUSSIA	RF	RF	RF	RF	RF
2768243	JSC MMC NORILSK NICK	Non-Energy Minerals	USA	RF	RF	RF	RF	RF
3189876	LUKOIL OIL COMPANY	Energy Minerals	RUSSIA	RF	RF	RF	RF	RF
B114RK6	MMC NORILSK NICKEL	Non-Energy Minerals	RUSSIA	RF	RF	RF	RF	RF
2537432	OIL CO LUKOIL	Energy Minerals	RUSSIA	RF	RF	RF	RF	RF
B0PH5N3	DONGFENG MOTOR GRO	Consumer Durables	CHINA	RF	RF	N/A	N/A	N/A
B0N7G09	EVRAZ GROUP S A	Non-Energy Minerals	LUXEMBOURG	RF	N/A	N/A	N/A	N/A
6586537	YUE YUEN INDL HLDG	Cons. Non-Durables	HONG KONG	RF	N/A	N/A	N/A	N/A
B01B1L9	CHINA MENGNIU DAIRY	Cons. Non-Durables	HONG KONG	RF	N/A	N/A	N/A	N/A

6725299	ZIJIN MINING GROUP C	Non-Energy Minerals	CHINA	RF	WL	N/A	N/A	N/A
6208422	BEIJING CAPITAL IN	Transportation	CHINA	WL	Pass	N/A	N/A	N/A
B2PFVH7	CHINA RAILWAY CONS	Industrial Services	CHINA	WL	Pass	N/A	N/A	N/A
6162614	EL EZZ STEEL REBAR	Non-Energy Minerals	EGYPT	WL	Pass	N/A	N/A	N/A
6419332	NATIONAL BK OF PAK	Finance	PAKISTAN	WL	Pass	N/A	N/A	N/A
2196963	CHINA LIFE INS CO LT	Finance	CHINA	Pass	WL	N/A	N/A	N/A
6718976	CHINA LIFE INSURANCE	Finance	CHINA	Pass	WL	N/A	N/A	N/A

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