

## The investor's perspective: a discussion with CalSTRS

### Introduction

On February 19, 2008, members of the Audit Committee Leadership Network (ACLN) met in Los Angeles for the network's 16th stand-alone meeting. Members began by discussing litigation risk and the audit committee<sup>1</sup> and then turned to a discussion of the investor's perspective with Janice Hester Amey, portfolio manager for corporate governance for the California State Teachers' Retirement System (CalSTRS). For further information about the network and a short biography of Janice Hester Amey, see page 8.

During the discussion with Ms. Hester Amey, members focused on the following areas:

- CalSTRS's policies on corporate governance and its decision-making process
- CalSTRS's priorities for corporate governance changes
- CalSTRS's view on audit committees

Members who participated in the meeting, who collectively sit on the boards of over 20 large-, mid-, and small-cap public companies, include:

- Dick Harrington, Audit Committee Chair, Xerox
- Roland Hernandez, Audit Committee Chair, Wal-Mart
- Judith Richards Hope, Audit Committee Chair, Union Pacific
- Marie Knowles, Audit Committee Chair, McKesson
- Chuck Noski, Audit Committee Chair, Microsoft and Morgan Stanley
- Pam Patsley, Audit Committee Chair, Texas Instruments
- Steve West, Audit Committee Chair, Cisco Systems

Other members participating in the discussion included:

- Tom Flannery, Partner and Director, Audit Committee Communications, Ernst & Young
- Steve Howe, Americas Managing Partner, Ernst & Young

*ViewPoints* reflects the network's use of a modified version of the Chatham House Rule whereby names of members, guests, and company affiliations are a matter of public record, but comments made by members before and during meetings are not attributed to individuals or corporations. However, Ms. Hester Amey has permitted her comments to be attributed.

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<sup>1</sup> See Audit Committee Leadership Network, "Litigation risk and the audit committee," *ViewPoints*, March 14, 2008. Available at [http://www.tapestrynetworks.com/documents/Tapestry\\_EY\\_ACLN\\_Mar08\\_View19.pdf](http://www.tapestrynetworks.com/documents/Tapestry_EY_ACLN_Mar08_View19.pdf)

CalSTRS’s primary responsibility is to provide retirement-related benefits and services to teachers in public schools and community colleges in California. It is the largest U.S. teachers’ retirement fund, with \$173.7 billion under management as of December 31, 2007. These assets, plus a staff of 803 and a membership of 795,000, make CalSTRS the second-largest U.S. public pension fund. The majority of CalSTRS’s income comes from contributions from members and their employing school districts, and from investment earnings. CalSTRS is headquartered in Sacramento, CA.

Asset Allocation	Market Value (in billions of dollars)	% of Total
U.S. Equity	70.26	40.88
Non-U.S. Equity	36.57	21.27
Fixed Income	35.25	20.51
Alternative Investments	12.74	7.41
Real Estate	16.90	9.83
Cash and Cash Equivalent	0.17	0.10
<b>Total Assets (including accruals)</b>	<b>171.90</b>	<b>100.0</b>

**Table 1. CalSTRS’s asset allocation as of June 30, 2007.<sup>2</sup>**

For the fiscal year ending June 30, 2007, CalSTRS’s investment portfolio showed a “strong absolute return of 13.2% ranking in the top quartile among its large pension fund peers.”<sup>3</sup> The return over three years was 13.9%, outperforming 90% of other U.S. public pension funds. The return over five years was 7.5%. The performance is the result of a diversified portfolio focused on long-term investments, including global real estate and private equity. However, according to a cover story in *Institutional Investor*, “CalSTRS faces a pressing challenge: an unfunded actuarial liability of more than \$20 billion – in absolute dollar terms, among the biggest in the nation – that threatens its ability to deliver retirement, disability and survivor benefits.”<sup>4</sup>

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<sup>2</sup> Data in the table are from “CalSTRS Fast Facts,” <http://www.calstrs.com/About%20CalSTRS/fastfacts.aspx>.

<sup>3</sup> California State Teachers’ Retirement System, *CalSTRS Comprehensive Annual Financial Report, 2006* (Sacramento, CA: California State Teachers’ Retirement System, 2006), 49. Available at [http://www.calstrs.com/help/forms\\_publications/printed/CurrentCAFR/CAFRall.pdf](http://www.calstrs.com/help/forms_publications/printed/CurrentCAFR/CAFRall.pdf).

<sup>4</sup> Steven Brull, “Pensions: The Reeducation of CalSTRS,” *Institutional Investor*, April 12, 2007. Available at <http://www.iimagazine.com/article.aspx?articleID=1325062>.



### Opening remarks by Janice Hester Amey

Ms. Hester Amey began by describing CalSTRS's approach to investing and to corporate governance. Extracts from her opening remarks are included below.

Teachers are among the lowest-paid civil servants in the United States, and working 10 months per year significantly limits opportunities for retirement savings. In California, CalSTRS's benefits are the only retirement benefits teachers receive: in 1955, California public educators made the decision to remain excluded from the Social Security program because the benefits provided through CalSTRS were better.<sup>5</sup> The money we invest is the teachers' money, their sole source of retirement income.

For that reason, we are conservative and stay close to our primary mission and our fiduciary responsibility, which is to provide benefits to participants. CalSTRS's first investment principle is the preservation of principal and maximization of income. With the exception of [refusing to make] investments in tobacco, we are first and foremost interested in the best possible returns for our retirees, followed by our efforts to make public policy improvements. This can be a significant challenge when we are pressured by our current members or California legislators to address other issues, such as Iran, Sudan, or the environment.<sup>6</sup>

We are very interested in corporate governance, with much of our portfolio being passively managed. Over 70% of our U.S. equities portfolio, 90% of our bond portfolio, and 50% of our international equity portfolio is passively managed. In comparison to the California Public Employees' Retirement System (CalPERS), we are more conservative and slower to make significant changes. While we are seen as "the quiet fund," our board is very interested in highlighting our "engagement" – the term we use to describe the bridge we create to boards on corporate governance. We want to engage and talk with board members, and we want to make recommendations, within limits.

For example, we recently created a geopolitical risk policy document that reviewed risks and made recommendations regarding investments in countries all over the world. We passed this on to our investment managers and requested attention to our findings when making investments. That said, we understand that we are too far removed from the investment process to dictate policies. We prefer to suggest guidelines.

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<sup>5</sup> "No Social Security for Many: CalSTRS is Teachers' Sole Retirement," *Policy Report* 1, no. 4 (November 2007). Available at [http://calstrs.com/Newsroom/What's%20New/SocialSecurity\\_rpt.pdf](http://calstrs.com/Newsroom/What's%20New/SocialSecurity_rpt.pdf).

<sup>6</sup> Since it is based in California, CalSTRS must comply with state laws such as the California Public Divest from Iran Act, which was signed by Governor Schwarzenegger in October 2007.

## CalSTRS's policies on corporate governance and its decision-making process

CalSTRS “views its corporate governance role as that of a catalyst for enhanced management accountability, disclosure and performance ... to enhance long-term shareholder returns.”<sup>7</sup> One member said, “*I am very happy to hear that you are focused on returns.*”

The challenge of balancing policies on corporate governance with fiduciary responsibility is a real one for CalSTRS. Ms. Hester Amey was clear that CalSTRS's corporate governance policies are simply guidelines: “*Our policies on corporate governance are guidelines, not a code. There is room for judgment to be applied.*” CalSTRS also has to take a broad portfolio approach to applying its guidelines: “*Sometimes we can't avoid being on both sides of the issue because we are too big. During a takeover, for example, we may have to choose between private equity and the public company because we have investments in both. Often our decision is based on the size of the investments in each.*”

## Dealing with underperforming companies

Members asked Ms. Hester Amey to articulate how CalSTRS decides which companies to target for corporate governance changes. Ms. Hester Amey responded, “*We start by looking at performance. We look at the one-, three-, and five-year performance data and compare it to peers and the market. We also review performance metrics, such as EVA,<sup>8</sup> to see if a company is destroying value.*” Ms. Hester Amey pointed out that “*there is not a lot of financial success in going after boards whose companies are performing well, because we need other shareholders to vote with us, and they won't join in.*”

CalSTRS's corporate governance program targets what it calls “annual workplan companies” each year. These are underperforming companies in which CalSTRS holds a significant position. As a courtesy to the companies, CalSTRS does not reveal the names of the targeted companies until several months after it has engaged with the company. For 2008, CalSTRS has identified 32 potential workplan companies, with seven being selected for in-depth reviews.<sup>9</sup>

Ms. Hester Amey highlighted CalSTRS's view that “*governance and economics should trail each other as much as possible.*” As an example, Ms. Hester Amey said, “*We look at other governance issues that may make [companies] more or less attractive to a buyer, i.e., a poison pill or a classified board. The reason for [looking at] governance is we feel it has a tie to performance. This is our bread and butter.*”

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<sup>7</sup> CalSTRS Investment Branch, *Corporate Governance Program Policies* (Sacramento, CA: CalSTRS, 2006), 1. Available at [http://calstrs.com/Investments/CorpGovPolicies\\_200604.pdf](http://calstrs.com/Investments/CorpGovPolicies_200604.pdf).

<sup>8</sup> Economic value added, or EVA, is a performance metric developed by Stern Stewart & Co. that calculates the creation of shareholder value. EVA is calculated by determining what profits remain after the costs of a company's capital – both debt and equity – are deducted from operating profit.

<sup>9</sup> CalSTRS, “Investment Committee Quarterly Activity Report: Global Equities – Corporate Governance,” *Quarterly Investment Reports*, September 30, 2007, 6. Available at <https://trb.calstrs.com/CalSTRSBoardWebSiteWebUI/Page/CommonPage.aspx?PageName=DocumentDownload&Id=0b6377b0-7a84-43c0-97ac-5c73caa86224>.

In order to create change, CalSTRS engages with a board. The engagement can range from writing informal letters to company management expressing concern, to developing shareholder proposals, to (in some cases) participating in litigation.

In response to a member question about how CalSTRS would pursue the CEO of an underperforming company, Ms. Hester Amey said, *“We would focus on how the board manages the CEO. For instance, if there is a history of bad transactions that didn’t create value, we would ask the board why they continued to allow this to happen. At some point, it may be down to getting rid of management. We try to get a turnaround first. We have the director vote, and the directors are supposed to protect our interests. We want to do all we can to empower the board to deal with investor issues.”*

### **Dealing with other portfolio companies**

Although CalSTRS’s engagement approach focuses specifically on underperforming companies, Ms. Hester Amey stated that CalSTRS believes that all its 3,000 portfolio companies could reap improved shareholder returns by improving corporate governance.

As an example of a practice that can improve shareholder returns, Ms. Hester Amey cited the splitting of the CEO and chairman roles. *“We see that cost [to investors] with combined CEO and chair roles – the stocks trade at 5% discount to market. You can have exceptions, but on average, companies that combine the chairman and CEO trade at a discount. We are so hungry for a few [basis] points’ [increase in value] that this is reason for us to go after it. 5% is important and relatively risk free for us.”*

Ms. Hester Amey referred to some of the assessment tools and resources CalSTRS uses in order to make decisions on how to vote on corporate governance issues. *“We subscribe to everything, and we most often pull from ISS [Institutional Shareholder Services] and Glass, Lewis research studies. We know people use [these studies] as benchmarks ... That said, we know they aren’t shareholders and that they look at things in a more academic way.”* One audit chair said, *“I’ve heard that when ISS makes a “no” recommendation on a merger, you can count on a 40% “no” vote from institutional shareholders. How often do you not vote with ISS?”* Ms. Hester Amey reported that CalSTRS voted against ISS policy 42% of the time.

### **CalSTRS’s priorities for corporate governance changes**

Members asked Ms. Hester Amey to articulate the top issues and priorities CalSTRS’s current members and beneficiaries are interested in pursuing in corporate governance. The top three issues Ms. Hester Amey cited were pay for performance, board diversity, and climate change:

- **Pay for performance.** Reminding audit chairs that CalSTRS’s members are among the lowest paid civil servants in America, Ms. Hester Amey commented, *“We don’t want to see [executive compensation going up] if the company isn’t performing. Union funds have a multiplier of what the highest-level people should be paid based on what the lowest-level people are paid. Our fund says that [formula] is not necessary as long as shareholders are doing well.”*
- **Board diversity.** Ms. Hester Amey pointed out that *“80% of CalSTRS’s teachers are female, yet when we deal with investment companies and management, we don’t see many women.”* CalSTRS is

particularly focused on increasing the number of women on corporate boards. As an example of CalSTRS's efforts in this area, Ms. Hester Amey described a case in which, as a result of litigation, *"We asked for corporate governance reforms, and we got the right to name a board member... We said we wanted a female. The first few times, the search firm brought us male candidates only. They said there were no females. We went back to them, and finally we got [a female candidate]. [The board] got a superior board director, but it took enormous time and effort, and with 3,000 companies in our portfolio, we won't be doing that a lot."*

- **Climate change.** Ms. Hester Amey told members, *"Our CIO [chief investment officer] has said he is looking for technology in the private equity space that will help alleviate the problem. He believes there is money to be made, not just risks to be avoided. In California, we feel we've fixed other big problems, [and] we want to help fix this one."* CalSTRS's focus has been on increasing the level of disclosure on environmental risk, and in particular on climate change risk. Ms. Hester Amey said, *"We are still trying to get the SEC to mandate disclosures in the MD&A as a foreseeable, significant risk."*

### CalSTRS's view on audit committees

Members expressed interest in CalSTRS's perspective on audit committees, including the composition of the committee, the length of service of committee members, and the relationship with the external auditor. Ms. Hester Amey reported that CalSTRS reworked its policies on audit committees in 2002, and based them largely on the National Association of Corporate Directors' Blue Ribbon Commission report.<sup>10</sup>

### Audit committee member rotation

Ms. Hester Amey identified audit committee member rotation as another important matter that CalSTRS asks boards to address. CalSTRS's corporate governance policies, while not explicitly dictating a term limit, state, *"The Board of Directors should also consider limiting the term of Audit Committee service, by automatic rotation or other methods."*<sup>11</sup> Ms. Hester Amey said, *"We hear that people don't want to be on the audit committee or to be an audit committee chair. So we thought they should get paid more. We also thought boards should rotate this role. It would be a forcing mechanism to ensure other board members fill this role. We do this on our own board."* Ms. Hester Amey identified a term limit of seven years as CalSTRS's preference and referenced to CalSTRS's research on the matter, including interviews with audit committee members of portfolio companies.

Members were less enthusiastic about audit committee member rotation; they pointed out that most members need to spend several years learning about the company, its risks, its controls, its financial organization, and other issues before they become truly effective. Members also mentioned the difficulty of identifying candidates for the audit committee. One member quipped, *"Seven years seems like a good number because maybe I can get off soon. But seriously, it takes two years to come up to speed even if you are a financial expert."* Another member went further: *"It takes three years to understand big companies and*

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<sup>10</sup> National Association of Corporate Directors, *Report of the Blue Ribbon Commission on Audit Committees: A Practical Guide* (Washington DC: National Association of Corporate Directors, 2000).

<sup>11</sup> CalSTRS Investment Branch, *Corporate Governance Program Policies*, 12.

*the nuances of the balance sheet. Because the [audit committee role] is more specialized, many boards recruit directly for the audit committee – you need specific skills. Some people on our board are more suited for a strategy committee, [but not the audit committee]. My view is that rotation is complicated.”*

Several members agreed that audit committee rotation could actually be detrimental to the goal of ensuring high-quality oversight of company management: *“This term limit issue benefits management in that they can have a tighter control and know more than the board ... With long tenure, you are better able to challenge management ... CFOs like seeing audit committee turnover; they have greater control over their domain.”* Ms. Hester Amey replied that the average CEO and CFO tenure is less than six years, which might mitigate the concern about rotating audit committee members every seven years.

### Excerpts from CalSTRS’s corporate governance policies on audit committees<sup>12</sup>

- **Value and purpose of the audit committee.** “The Audit Committee has a unique role in the capital markets and the overall governance structure ... The Audit Committee shall adopt a formal, written charter and provide a report that references the charter and disclosure, in the company’s annual report/proxy statement, whether the Audit Committee has complied with its charter responsibilities.”
- **Composition of the audit committee.** “The Audit Committee shall have at least 3 members and no more than 5. All members of the Audit Committee will be persons whose past/current employment experience/education demonstrates expertise in finance and/or accounting, including being or having been a CEO or other senior executive officer with financial oversight responsibilities ... The Board of Directors should also consider limiting the term of Audit Committee service, by automatic rotation or other methods.”
- **Relationship with the external auditor.** “The Audit Committee shall regularly evaluate the relationship between management and the external and internal auditors ... The Audit Committee shall have responsibility and authority to select, retain/replace and evaluate the external auditor, including any issues that may impair the external auditor’s independence and direct the scope of the duties to be performed ... CalSTRS supports the limitation of non-audit services that an external auditor can provide to an audit client ... CalSTRS supports limiting external auditor firms to seven consecutive years of audit service to portfolio companies.”

### External audit firm rotation

In addition to supporting term limits for audit committee service, CalSTRS supports limiting external auditor firms to seven consecutive years of audit service to its portfolio companies. One audit chair asked, *“In terms of activating your policy, would you vote no on adoption of the external auditor after seven years in order to change the auditors?”* Ms. Hester Amey replied, *“No. We know there are not enough auditing*

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<sup>12</sup> Excerpts from CalSTRS, *Corporate Governance Program Policies*, 10–12.

*firms. If there is a problem, then we would suggest the need for a change. Again, we look at performance indicators first, and our policies are guidelines, not mandates.”*

Members were concerned about mandating term limits for audit firms due to knowledge and quality concerns. In Italy, where audit firm rotation has been required for over 30 years, a study found that rotating auditors “yields no benefits and is counterproductive overall.”<sup>13</sup> According to the study by the SDA Bocconi Institute in Milan, audit firms were more likely to be cautioned by the stock market regulator in their first year with a company than in any other year. One member stated, “As an ex-CFO, and seeing how long it takes to come up to speed, I would rather have a person on the audit committee be knowledgeable, and it’s the same with auditors. I’m very reluctant to change auditors every seven years.” Another member agreed: “It’s also an audit quality concern. It takes them years to understand what’s going on.” Ms. Hester Amey said she would take members’ comments back to the board and chief investment officer of CalSTRS for their consideration.

### **Appendix: Short biography of Janice Hester Amey**

Janice Hester Amey is a portfolio manager in the global equities, corporate governance asset group at the California State Teachers’ Retirement System (CalSTRS). Ms. Hester Amey is responsible for the day-to-day management and development of policies and guidelines for investment manager relations and corporate governance at the fund. Ms. Hester Amey is a graduate of Trinity College in Hartford, Connecticut.

### **About this document**

The Audit Committee Network is a select group of audit committee chairs from leading North American companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is convened by Ernst & Young and orchestrated by Tapestry Networks to access emerging best practices and share insights into issues that dominate the new audit environment.

*ViewPoints* is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, and their advisers as they endeavor to fulfill their respective responsibilities to the investing public. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues. Anyone who receives *ViewPoints* may share it with those in their own network. The more board members, management, and advisers who become systematically engaged in this dialogue, the more value will be created for all.

*The views expressed in this document represent those of the Audit Committee Leadership Network and Ms. Janice Hester Amey. They do not reflect the views nor constitute the advice of network members, their companies, Ernst & Young, or Tapestry Networks. Please consult your counselors for specific advice. Ernst & Young refers to all members of the global Ernst & Young organization, including the U.S. member firm of Ernst & Young LLP.*

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