CalPERS

Investment Committee
Agenda Item 7b

November 15, 2021

Item Name: Asset Liability Management: Public Employees' Retirement Fund Policy Portfolio and Discount Rate Selection

Program: Trust Level Portfolio Management and Implementation

Item Type: Action

Recommendation

Adopt a discount rate and policy portfolio that aligns with Board risk tolerance.
Adopt the use of leverage in the strategic asset allocation.

Executive Summary

This agenda item presents Candidate Portfolios for the Public Employees' Retirement Fund for consideration in the Investment Committee's selection and adoption of a Policy Portfolio and Discount Rate. Feedback from the September Investment Committee meeting and stakeholders has been taken into consideration when developing the Candidate Portfolios and they have been designed to align with CalPERS objectives of minimizing potential losses, maximizing projected returns, maintaining sufficient liquidity, and minimizing costs.

Analysis of each Candidate Portfolio's projected long-term investment return resulted in proposed discount rates of 6.5%, 6.8%, or 7.0%, depending on the portfolio selected. For each portfolio, this item includes information about asset allocation, projected risk and projected return, asset class diversification, an allocation to leverage as a diversifier, discount rates, projected employer contribution rates and funding ratio risk, projected employee contribution impact, and pros and cons to consider for each portfolio. Also included are portfolio stress tests that measure portfolio performance in a variety of economic and market scenarios, and several actuarial analyses for employer plans that have high, medium, and low funded statuses.

Strategic Plan

This agenda item supports the CalPERS Strategic Plan goal to strengthen the long-term sustainability of the pension fund. As defined in CalPERS ALM policy, Asset Liability Management (ALM) is the process of balancing the expected cost of future pension payments with the expected future investment returns. The periodic review of Candidate Portfolios and the

selection of the Policy Portfolio and Discount Rate are intended to strengthen the sustainability of the pension fund.

Investment Beliefs

This agenda item supports the following CalPERS Investment Beliefs:

- Investment Belief 2: A long term investment horizon is a responsibility and an advantage;
- Investment Belief 6: Strategic asset allocation is the dominant determinant of portfolio risk and return;
- Investment Belief 7: CalPERS will take risk only where we have a strong belief we will be rewarded for it; and
- Investment Belief 8: Costs matter and need to be effectively managed.

Background

Governed by CalPERS Asset Liability Management Policy, the ALM process is a collaborative effort between the Actuarial Office (ACTO), the Financial Office (FINO), and the Investment Office (INVO) and currently occurs every four years with a mid-point review. This ALM cycle is the primary process by which investment portfolio and actuarial assumptions evolve to reflect the market opportunity set, demographic assumptions and experience, and plan status. The ALM decision frequency is supported by ACTO's annual actuarial valuation process that determines subsequent employer and employee contribution levels. This process establishes an amortization of each fiscal year's actual experience versus the assumptions underlying the ALM decisions, thus correcting annually for forecast and estimation uncertainty.

The review of Candidate Portfolios and the selection of the Policy Portfolio and Discount Rate is the culmination of a significant body of work that has been undertaken by the ALM team during the past year and is a progression in the ALM process from the following presentations made earlier in the year to the Investment Committee:

- February 2021 – Asset Liability Management: Timeline, Concepts, and Framework
- March 2021 - Asset Liability Management: Risk Concepts and Examples
- June 2021 – Current Market Environment
- July 2021- Capital Market Assumption Education, Capital Market Assumptions: Survey & Methodology, and Creating and Assessing Candidate Portfolios
- September 2021 – Asset Liability Management: Discussion of Candidate Portfolios

This agenda item, Asset Liability Management: Public Employees' Retirement Fund Policy Portfolio and Discount Rate Selection, is intended to provide comprehensive information and analysis to support the Investment Committee in selecting the Policy Portfolio and Discount Rate for adoption.

Analysis

Not applicable.

Budget and Fiscal Impacts

Not Applicable.

Benefits and Risks

The benefits of reviewing Candidate Portfolios and selecting a Policy Portfolio and Discount Rate for adoption are:

1. Reviewing Candidate Portfolios and proposed Discount Rates provides support for comparing and contrasting the pros and cons of each selection as weighed against risk tolerance.

2. Selecting a Policy Portfolio that has been designed with updated market information may improve the portfolio return/risk profile, as compared to the current portfolio strategic asset allocation, which was set in 2017.

3. Selecting a Discount Rate that has been developed with updated demographic assumptions and aligned with a new strategic asset allocation may improve the asset/liability profile for the pension fund.

The risks of reviewing Candidate Portfolios to select a Policy Portfolio and Discount Rate for adoption are:

1. Reviewing Candidate Portfolios and proposed Discount Rates requires evaluating and balancing a variety of risks to different stakeholders.

2. Selecting a Policy Portfolio and Discount Rate requires reliance on investment and actuarial assumptions, which are inherently uncertain.

3. Extreme volatility in the short-term may lower confidence in the selected Policy Portfolio and Discount Rate.

Attachments

Attachment 1 – Asset Liability Management: Public Employees' Retirement Fund Policy Portfolio and Discount Rate Selection

Attachment 2 – Wilshire Opinion Letter

James Sterling Gunn
Managing Investment Director
Trust Level Portfolio Management

Scott Terando
Chief Actuary

Dan Bienvenue
Interim Chief Investment Officer