



*Michael C. Schlachter, CFA
Managing Director & Principal*

July 8, 2009

Mr. Joseph Dear
Chief Investment Officer
California Public Employees' Retirement System
400 P Street, Suite 3492
Sacramento, CA 95814

Re: Annual Review – Securities Lending – Open Session Item 8a

Dear Joe,

You requested Wilshire's opinion regarding Staff's annual review of the Securities Lending program.

In reviewing the performance of this program, it is important to separate it into two functions – securities lending and collateral investment. Over the past two years, the two parts of this program have had very different results. In total, over the lifespan of this entire program, securities lending has been profitable for CalPERS and has added value to the investment portfolio, despite the impact of the realized and unrealized losses in the collateral pool.

CalPERS' Securities Lending program has generated over \$1.4 billion in total net income to the PERF over its history (through calendar year end 2008). Annual earnings generally rise and fall with the value of the overall portfolio, resulting in earnings for 2008 that will likely exceed 2009.

CalPERS Staff has taken a judicious approach to securities lending, focusing on the most profitable securities in the portfolio, and have been able to enter into some unique transactions due to the size of the lendable pool CalPERS has to offer. For example, the move several years ago into auction-based programs has allowed CalPERS to maximize its profit from each transaction and avoid pursuing lower lending income in the market.

It should be noted that despite the failure or merger of several large counterparties over the past year, CalPERS has suffered no losses from defaults on any of its securities on loan. CalPERS, like other lenders, requires over-collateralization for all loans, and has simply kept the collateral (for no gain or loss) when a counterparty defaulted or declared bankruptcy.

Mr. Joe Dear
July 8, 2009
Page 2

As a result of the continued success of the program, we recommend no changes to this lending portion of the program at this time.

At the current time, however, there is a significant unrealized loss in the collateral pool for this program, likely resulting in a total eventual loss to CalPERS of between \$500 million and \$1 billion. The significant dislocation in the credit markets over the past year has had a large impact on the credit spreads demanded by investors for some of the instruments CalPERS has purchased, resulting in a rapid drop in prices for some instruments. Some of these securities have also defaulted or are expected to default, resulting in significant realized losses.

In the interim, as Staff works out the damage to the collateral pool, the Board should be aware that Staff has restricted all new investments to overnight securities, preventing any additional losses. This is a very conservative approach that will also limit yield opportunities but is appropriate until the full damage is assessed and understood. We expect that Staff will present new policies to the Policy Subcommittee shortly that will reduce the potential for a repeat of the past year in the future.

As you are aware, Wilshire conducts due diligence on behalf of the Investment Committee on all internally-managed programs at least annually. Our review of the investment processes attendant to the securities lending collateral pool is presented in another agenda item in August.

If you have any additional questions, please do not hesitate to contact me.

Sincerely,

A handwritten signature in black ink, appearing to be "Michael A. ...", written in a cursive style.