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Managing Director & Principal

September 24, 2012

Mr. Henry Jones
Chair, Investment Committee
California Public Employees' Retirement System
400 Q Street
Sacramento, CA 95814

Re: Policy for New Multi-Asset Class Partners Program

You requested our opinion regarding the new policy for the Multi-Asset Class Partners Program presented by Staff.

Recommendation

Staff is presenting to the Investment Committee for approval the new policy which will govern the new Multi-Asset Class Partners Program. After almost a year of work, Staff has identified a handful of managers which it wishes to add to the investment portfolio to manage portfolios intended to track the 7.5% return assumption as closely as possible. Wilshire has been involved in this search for these new managers since fairly early in the process, starting after the initial screening was completed that narrowed the field to 14 semi-finalists.

Wilshire recommends that the Investment Committee approve this policy subject to clarification from Staff concerning several items that we believe require further information, outlined below.

Discussion

First, we have raised with Staff the issue of how this new program will fit into the Total Fund return and benchmark, and Staff is reviewing possible options that it can recommend to the Investment Committee for approval. Given that this program is intended to earn 7.5% or better in all market environments and at significantly lower volatility levels relative to the rest of the PERF portfolio, it does not fit well with any of the benchmarks for the other asset classes. In the event that Staff was to fund all four of the selected managers up to the size of portfolios that have been previously discussed with the Investment Committee, this could have a meaningful impact on Total Fund outperformance or underperformance. Staff has previously made a strong case to the Investment Committee during the debate over the ARS benchmark and overlay issues that the Asset Allocation and Total Fund Benchmark should not be altered in the intervening period between asset allocation studies. As a result, we are unclear as to how this portfolio will fit with the Total Fund. If the 7.5% benchmark is not included in the Total Fund benchmark and the total size of the MAC Program were 1% to 2% of assets, a significant movement by the stock and bond markets could cause Total Fund outperformance or underperformance not due to skill but rather due to the absence of this program from the benchmark, thus impacting Incentive Compensation. In our opinion, prior to funding these managers, Staff should provide the Investment Committee with a recommendation that details the source of funds that will be used for these managers and also a recommendation regarding how the benchmark issue we have raised can be ameliorated by the Investment Committee prior to the next Asset Allocation workshop in the Fall of 2013.

Second, this program was originally presented to the Investment Committee as a usage of the Opportunistic "Bucket" – the first such usage since Staff asked for and was granted opportunistic authority. In practice, Staff wishes to make the MAC Program subject to its own polices as the Opportunistic Program policies would not allow sufficient flexibility for the contemplated strategies. While we do not object to that idea, per se, we agree with Staff that any allocation to the MAC managers should be counted against the total dollar amount of delegated authority for the Opportunistic Program

Third, after participating in the reviews of the RFPs, the initial interviews, the on-site interviews, and multiple discussions with Staff, we remain doubtful about the potential for "meaningful information transfer" back to Staff for use in the internal asset allocation process. Two of the recommended managers run short-term, high volume trading strategies that are unlikely to translate well to anything Staff could replicate internally. Another manager is offering a multi-strategy hedge fund approach to investing, not entirely dissimilar to the internal ARS program, and likely subject to the same scalability problems with all hedge funds that have been addressed by this Investment Committee on many occasions. The final manager is offering a multi-asset portfolio with "tail risk hedging" which may have its own scalability problems for the Total Fund.

While we do not disagree that any of these portfolios could very well deliver returns as promised to CalPERS and meet the 7.5% threshold, we simply have significant reservations about how much actionable information CalPERS will receive from these managers that will make a difference with the rest of the fund. We believe that all parties involved, including Staff and the Investment Committee, should have a realistic understanding that the MAC program, in our opinion, will likely generate far less actionable "information transfer" than has been previously discussed.

Fourth, position limits for certain types of derivatives as defined by the Dodd Frank legislation are still under negotiation. Some of these managers may use significant leverage in their portfolios, resulting in gross exposure that could be multiples of CalPERS' investment. Combined with CalPERS' existing positions to equitize cash and overlay the ARS portfolio, CalPERS could find itself breeching the position limits defined in the legislation once the details are fully determined. Staff should commit to the Investment Committee that this issue will be monitored as the legislation is implemented and will make adjustments to the allocation to this and other strategies as becomes necessary to stay within the limits of the law. We also recommend that an exhibit be added to Staff's risk report that it presents to the Investment Committee that contains details on the total size of relevant derivatives positions and the potential breech of these limits.

Should you require anything further or have any questions, please do not hesitate to contact us.

Best regards,