Investment Committee

California Public Employees' Retirement System

Agenda Item 5a

November 13, 2012

ITEM NAME: Terminated Agency Pool Investment Strategy

PROGRAM: Affiliate Investment Programs

ITEM TYPE: Asset Allocation, Performance & Risk – Action

RECOMMENDATION

Approve staff's recommended asset allocation investment strategy (Strategy A), as shown in Attachment 1, for the Terminated Agency Pool (TAP). Wilshire Associates' opinion letter is provided as Attachment 2.

EXECUTIVE SUMMARY

This agenda item provides an analysis and asset allocation recommendation for the TAP. In addition to staff's recommendation, this agenda item provides analysis on three additional alternative investment strategies. The TAP asset allocation objectives are to minimize funding risk and to match projected future benefit payments. These objectives can be achieved through an asset-liability management approach.

STRATEGIC PLAN

This agenda item supports the CalPERS Strategic Plan goal to improve long-term pension and health benefit sustainability. Adopting an appropriate asset allocation investment strategy for the TAP will support efforts to ensure the TAP is actively managed and funding risk is addressed.

BACKGROUND

Currently, the TAP exists within the Public Employees' Retirement Fund (PERF) to provide benefit payments to members who are employees of agencies that have terminated their contract with CalPERS. When a contracting agency terminates its CalPERS contract, the associated assets and liabilities of that agency are transferred into the TAP.

The market value of assets attributable to the TAP, as of June 30, 2011, is $184 million and the actuarial liabilities attributable to the TAP are $71 million. This results in a funded ratio of 261%. Total expected benefit payments attributable to the TAP are approximately $4.2 million annually.

Consistent with all pension plans, there is a risk that the TAP could become underfunded at some point in the future. Currently, the TAP is invested in the same asset allocation policy as the rest of the PERF. Although the TAP is very well funded at this time, the funded status could change with the termination of one large employer, or a number of smaller employers. Any such terminations could significantly dilute the funded status of the TAP and substantially increase the risk of underfunding. Additionally, the TAP's funded status could be affected by investment returns and actuarial assumptions (e.g., mortality rates, salary increases) deviating from expected models.

Should the TAP become underfunded, CalPERS has limited recourse against terminated agencies and member benefits may be impacted. Since the TAP is currently very well-funded, an opportunity exists to mitigate investment risks by creating a different asset allocation for the TAP than the rest of the PERF. On August 17, 2011, the Board approved:

- The concept of adopting a more conservative asset allocation strategy for the TAP to match its investment cash flows with future expected benefit payments.

- Initiating the Rulemaking process for the California Code of Regulations to credit income to the TAP based on the more conservative investment strategy. These rules were approved in December 2011.

- Adopting a revised method to determine the discount rate and the setting of actuarial assumptions when calculating the actuarial liabilities of a public agency at the time it terminates its contract with CalPERS and for the annual actuarial valuation of the TAP.

Key Implementation highlights:

- At the May 2012 Investment Committee, staff recommended an asset allocation strategy for the TAP that utilized US Treasury Separate Trading of Registered Interest and Principal of Securities (STRIPS), Direct Inflation Linked Securities and cash.

- In June 2012, the Investment Committee directed staff to analyze other security types and combinations for the asset allocation strategy, such as high quality corporate bonds or a US Treasury Inflation Protected Securities (TIPS) only portfolio.

ANALYSIS

The investment strategy analysis for the TAP is the result of collaboration between the CalPERS Investment Office and the Actuarial Office. The goal is to recommend a policy portfolio that meets the following objectives: minimize likelihood of underfunding and match projected future benefit payments. To attain this goal, staff recommends an asset-liability management approach such as cash flow matching. Attachment 1 shows staff's recommendation and alternative strategies.

The following sections summarize the key factors of each evaluated asset allocation strategy as analyzed by CalPERS Investment Office and Actuarial Office staff:

Staff recommends:

Strategy A which includes STRIPS, TIPS and cash:

- Forecasted benefit payments are explicitly matched with STRIPS which have no reinvestment risk.
- The implementation risk is low.
- The monitoring requirement for staff is low.

Staff does not recommend:

Strategy B which only includes TIPS and cash:

- Cash flow matching is less certain because currently there are no TIPS available with maturities between 21 and 26 years.
- TIPS have higher reinvestment risk.

Strategy C which includes high quality corporate bonds with maturities ranging from one to 30 years, TIPS and cash:

- Corporate bonds have both default and reinvestment risk.
- This strategy has higher requirements for staff to closely monitor default risk.

Strategy D which includes high quality corporate bonds with maturity less than one year, TIPS and cash:

- This strategy is an asset-only approach.
- Corporate bonds have default and reinvestment risk.
- This strategy has the highest implementation risk because staff lacks resources and a monitoring framework to determine when to replace short term corporate bonds with other assets such as STRIPS.

BENEFITS/RISKS

Should the TAP become underfunded, member benefits may be negatively impacted. Staff's recommended investment strategy, Strategy A, targets cash flow matching and mitigates funding risk. However, other liabilities remain such as actuarial risks and the risk of a large employer entering the TAP and diluting the funded status. These unforeseeable risks are more difficult to mitigate. Staff recommends a review of the asset allocation of the TAP at least every three years or sooner should the funded status materially change.

ATTACHMENTS

Attachment 1 – Asset Allocation Investment Strategy for the Terminated Agency Pool
Attachment 2 – Wilshire Associates Opinion Letter

BEN MENG
Senior Portfolio Manager
Asset Allocation

JOSEPH A. DEAR
Chief Investment Officer