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October 29, 2012

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

Re: Alternative Asset Mixes for the Terminated Agency Pool

You requested our opinion regarding the presentation by Staff that presents additional asset mixes for the Terminated Agency Pool.

Recommendation

Wilshire recommends that the Investment Committee discuss the various asset allocation mixes presented by Staff and select the mix that best minimizes the risks that the Investment Committee considers to be the most important.

Discussion

At the August Investment Committee meeting, the Investment Committee requested information regarding some alternative asset mixes to the proposed asset allocation plan, given the current low interest rate environment. Staff has presented three of these alternatives in this document.

In our opinion, each of these asset mixes, including the option that was originally selected, A, all pose unique risks. Mix A minimizes the chance of loss or future underfunding, but will fare poorly from a total return perspective in a rising rate environment. Mix B will generate better returns than mix A if higher levels of inflation accompany higher interest rates, but will be more difficult to implement over time. Mixes C and D have the potential for higher rates of return but are significantly exposed to the risk of default through their large allocations to corporate securities.

In our opinion, the Investment Committee should select the mix most suited for matching the greatest consensus fear. If the Investment Committee is concerned about credit risk and underfunding, Mix A is appropriate. If the greatest concern is high inflation, mix B is most appropriate. If the Investment Committee wishes to maximize returns, mix C is the best selection. If the Committee wishes to maximize returns but minimize the impact of a rising rate environment, then mix D is most appropriate.

Other mixes, such as a combination of STRIPS to match cash flows and short duration corporate bonds to generate higher returns on the balance of the program combine the benefits and risks of some the other options and could be explored if the Committee wishes to look at a broader set of options.

Finally, we note that the inflationary stress tests used by Staff are unrealistic and should not dictate the Investment Committee's decision-making process. The worst case scenario presented by Staff assumes an 18% inflation rate for each of the next 30 years. The middle case has a 6% assumption for inflation every year. Both of these are far higher than any sustained historical levels, including a long time period that includes the early 1980s. While these stress tests are instructive to see the sensitivity of these asset mixes to above-expected inflation, we do not recommend selecting an asset mix based on the extreme case.

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

Best regards,