Investment Committee

California Public Employees' Retirement System

Agenda Item 5a

December 10, 2012

ITEM NAME: Adoption of the Terminated Agency Pool Investment Strategy and Related Policy

PROGRAM: Affiliate Investment Programs

ITEM TYPE: Asset Allocation, Performance & Risk – Action

RECOMMENDATION

Approve the asset allocation immunization strategy (Attachment 1) and related policy (Attachment 2) for the Terminated Agency Pool (TAP).

EXECUTIVE SUMMARY

This agenda item provides an asset allocation recommendation and related policy for the TAP. At the November 2012 Investment Committee meeting, staff was directed to examine the asset allocation strategy for the TAP by viewing the allocation in two independent segments: the immunization segment and the surplus segment.

Consistent with the discussion at the November Investment Committee meeting and the objectives of minimizing funding risk and immunizing projected future benefit payments, staff is recommending a strategy that (1) includes a blend of U.S. Treasury Separate Trading of Registered Interest and Principal of Securities (STRIPS), U.S. Treasury Inflation Protected Securities (TIPS) and cash or cash equivalents for the immunization segment, and (2) would invest the surplus segment along with and in the same way as the rest of the Public Employees' Retirement Fund (PERF).

The attached TAP policy reflects the recommended investment strategy.

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 Fund is actively managed and funding risk is addressed.

BACKGROUND

Currently, the TAP exists within the PERF to provide benefit payments to members who are employees of agencies whose contracts with CalPERS have been terminated. When the contract between a public agency and CalPERS is terminated, the associated assets and liabilities of that agency are transferred into the TAP.

As of June 30, 2011, the market value of assets attributable to the TAP 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 of the TAP is approximately $4.2 million annually.

Similar to other pension plans, there is a risk that the TAP may become underfunded in the future. Currently, the TAP is invested in accordance with the same asset allocation policy as the PERF. Although the TAP is well funded at this time, the funded status could be significantly diluted with the termination of one large employer or a number of smaller employers. Additionally, the TAP's funded status is affected by investment returns and actuarial assumptions (e.g., mortality rates, salary increases) that may differ from current projections over time. Finally, once the contract termination process outlined in the Public Employees Retirement Law is followed and a public agency is added to the TAP, CalPERS has no further recourse against the terminated agency in the event the TAP were ever to become underfunded. Since the TAP is currently well-funded, an opportunity exists to mitigate investment risks by creating a different asset allocation for the immunization segment of the TAP than the rest of the PERF.

ANALYSIS
The Investment Office and the Actuarial Office collaborated on the analysis and the investment strategy recommendation. The goal is to recommend a policy that meets the objectives of minimizing the likelihood of underfunding and immunizing the projected future benefit payments. To attain these objectives, staff recommends the asset-liability management approach set forth on Attachment 1.

The recommended strategy separates the assets of the TAP into two segments:

1) An immunization segment invested in a combination of STRIPS, TIPS and cash or cash equivalents; and
2) A surplus segment invested with and in the same way as the rest of the PERF.

Benefits of this approach include:

- Explicit immunization of forecasted benefit payments with a blend of STRIPS and TIPS which will minimize underfunding risks and balance reinvestment risk, inflation risk, implementation risk, etc.;
- A higher expected return generated by the surplus segment that will remain invested with the rest of the PERF; and
- Low monitoring requirements for staff.

BENEFITS/RISKS

The recommended investment strategy targets the TAP objectives of minimizing funding risk and immunizing projected future benefit payments. However, other risks such as actuarial risk and dilution risk as a result of a large employer entering the TAP will remain. These unpredictable risks are more difficult to mitigate. Staff requires a review of the asset allocation of the TAP at least once every three years, or as needed should the funded status of the TAP materially change.

ATTACHMENTS

Attachment 1 – Asset Allocation Investment Strategy for Terminated Agency Pool
Attachment 2 – California Public Employee' Retirement System Statement of Investment Policy for Terminated Agency Pool
Attachment 3 – Wilshire Associates Opinion Letter

BEN MENG
Senior Portfolio Manager
Asset Allocation

JOSEPH A. DEAR
Chief Investment Officer