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Managing Director & Principal

January 29, 2013

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

Re: Absolute Return Strategies Strategic Plan

Dear Mr. Jones,

You requested our opinion regarding the agenda item from Staff that presents the annual strategic plan for the Absolute Return Strategies program. In this item, Staff raises five important questions about the future course for this program. We address each of these five questions below.

First, the Role of Absolute Return in the CalPERS Portfolio. Staff is proposing changing the purpose of the ARS program from a return enhancer (where ARS is overlaid with equity futures to create an equity-like portfolio) to a stand-alone diversifying program.

Since at least the 2010 asset allocation workshop, we have supported the idea of treating ARS as a diversifier instead of a return-enhancing program, and therefore we agree with this recommendation in concept. We do note, however, that this change will reduce the expected return and expected risk of the Total Fund, especially if the size of the ARS is program is increased, as was discussed in the abstract at the December Investment Committee meeting. In the current market environment, the ARS benchmark of Treasury Bills plus 5% yields an expected return of less than 6%. While the asset class assumptions for the 2013 workshop are not yet completed, we anticipate that the return expectation for equities will be +/-8%. Any meaningful shift in assets from Equities to ARS, or even the simple removal of the equity overlay, will therefore have an impact on the Total Fund expected return and risk.

Second, Staff recommends maintaining the current benchmark at Treasury Bills plus 5%. While this benchmark has been difficult for the program to meet in some periods, this is a generally accepted benchmark for the hedge fund industry. We support leaving this benchmark unchanged.

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Third and fourth, we agree that the future size of the ARS program and the funding source for increases to ARS or destination for assets if ARS is decreased should be determined by the Asset Allocation process currently underway.

Fifth, Staff has proposed an expansion of the ARS team and a shift toward more internally-managed manager selection instead of the historical reliance on external funds of funds. Wherever possible, we have advocated for all asset classes a shift toward more internal resources, especially when the external alternative is as expensive as is found in the hedge fund industry. However, given that the allocation to the ARS program will not be determined in the fall, and could be lower or significantly higher, we suggest that CalPERS should fill any approved and open slots in a cautious manner until all parties better understand the future size and purpose of this program.

In short, Staff has put together an ambitious plan for expanding and improving CalPERS' footprint in the hedge fund marketplace. While we are supportive of any effort to improve CalPERS' capabilities to compete for returns, we recommend that the Investment Committee reserve judgment on several of the elements of this strategic plan until the Asset Allocation Workshop has been completed and the new allocation to Hedge Fund assets has been determined.

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

Best regards,

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