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Managing Director & Principal

April 28, 2013

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

Re: Supplemental Income Program Review and First Reading of Associated Policy Changes

Dear Mr. Jones:

You requested Wilshire's opinion with respect to the program review of the Supplemental Income Program (SIP) and the proposed policy changes associated with the various changes Staff is undertaking in the SIP. Staff has engaged an outside consulting firm to review the SIP fund lineup and allocations for the target date funds. This review leads Staff to make several changes to the SIP.

Summary

Wilshire believes that the proposed changes to the SIP funds' lineup and to the glidepaths of the target date funds are appropriate, subject to the issues we raise for consideration in this memo. The proposed policy changes are also appropriate, and provide discussion as noted below.

Discussion

The construction of a three tier lineup (target retirement date funds, asset class funds, brokerage window) has become somewhat of a norm for defined contribution plans over the last few years. There has been considerable discussion in the defined contribution industry as to the use of brokerage windows. Many fund sponsors have offered them as a way to offer more customization to plan participants. Others have opted to not use them, viewing the other tiers as more appropriate vehicles for long term retirement savings. This more paternalistic view has gained momentum of late, spurred by concerns over the role a fiduciary should play in evaluating the brokerage window, discussions around regulations for brokerage windows, and fears that employees may be distracted by active trading within their portfolios.

The Investment Committee, as the ultimate fiduciary, should ensure they are comfortable with the role of the brokerage window in the SIP.

The consultant review of the fund lineup and construction has lead Staff to largely abandon active strategies within the SIP. While the prior active lineup had not added value, we do raise this issue as it is an ongoing topic during the Investment Beliefs project. The projected fee decrease of 46 basis points (as an example used by Staff) is significant and the simplicity of a mainly passive portfolio is attractive. However, to the extent that actively managed funds are desired by participants outside of the brokerage window, regardless of their success rate, the removal of active strategies could decrease the attractiveness of this plan to new or existing employees.

Another change recommended by Staff is the changing the glidepath of the target date funds to become more conservative, gliding “to” retirement rather than “through” retirement. While the logic is largely supported by the CalPERS SIP demographics, it should be noted that basing a glidepath on an average participant will lead to significant errors for those participants that do not look like the average (in this case, those with higher or lower income replacement levels from Social Security and/or the PERF or those who have significantly higher or lower SIP balances than the average participant). By choosing to glide more quickly to a conservative allocation, the fund should protect in declining markets, but may not provide the same level of returns and retirement dollars in normal and rising markets. In fact, some research¹ indicates that glidepaths are not nearly as important as the rate of savings in determining successful retirement outcomes and that static or inverse glidepaths may provide better results.

The proposed Policy changes match the changes to the SIP lineup and construction. However, we discussed with Staff that the roles previously ascribed to the Deputy Executive Officer – Customer Services and Support Branch are not investment roles and we questioned whether they are appropriately contained in an investment policy. This discussion prompted a revision of those roles in the Investment Policy to investment-related roles. We do believe that the rest of the duties should be formalized in some document, but our understanding is that there is not another policy that currently exists where these roles would be appropriately enumerated.

¹ Rob Arnott. “The Glidepath Illusion”, 2012
http://www.researchaffiliates.com/Our%20Ideas/Insights/Fundamentals/Pages/F_2012_Sep_The_Glidepath_Illusion.aspx

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

Best regards,

A handwritten signature in black ink, appearing to read 'Ann J. ...'.