Investment Committee

California Public Employees' Retirement System

Agenda Item 6a

June 17, 2013

ITEM NAME: Adoption of Capital Market Assumptions

PROGRAM: Total Fund

ITEM TYPE: Asset Allocation, Performance & Risk – Action

RECOMMENDATION

Adopt the Capital Market Assumptions (CMAs), as presented by staff in Attachment 1, for use in the 2013 Asset Liability Management (ALM) Process. Consultant opinion letters from Wilshire Associates and Pension Consulting Alliance are provided as Attachments 2 and 3 respectively.

EXECUTIVE SUMMARY

CMAs are the essential inputs to the Strategic Asset Allocation process. The presented metrics represent the output of a comprehensive and prudent estimation approach. This approach has been informed by multiple sources including outside consultants and internal Senior Investment Officers. Consensus was reached through an open and thorough discussion process.

STRATEGIC PLAN

This item supports the CalPERS Strategic Plan goal of improving long-term pension and health benefit sustainability. CalPERS conducts an in-depth ALM Process every three years to review asset and liability management. These triennial processes culminate in the selection of a Policy Portfolio which is then used to guide and define the strategic asset allocation across the Total Fund.

BACKGROUND

The ALM Process is an important step to help ensure that contributions, plus investment returns, are sufficient to pay the benefits and expenses of the California Public Employees' Retirement System. Every three years staff presents, to the Investment Committee, potential allocations to each asset class that are estimated to allow CalPERS to realize its long-term assumed rate of return while maintaining prudent levels of risk.

CMAs for each asset class are critical inputs to the process that ultimately constructs the Policy Portfolio. CMAs have a direct impact on the composition of the Policy Portfolio and therefore directly affect the risk and return profile of the Total Fund.

CMAs were discussed at the May 13, 2013 Investment Committee workshop. The presentation included an overview of the methodology used to create CMAs, as well as some of the key considerations and caveats associated with CMAs.

ANALYSIS

Identifying CMAs is a critical step in the ALM Process. Not only does it require knowledge and expertise of every asset class in our Policy Portfolio, but also it depends on CalPERS customized benchmarks and investment strategies. In addition, there is inherent uncertainty and difficulty in estimating CMAs. An open and inclusive approach, including surveying all major investment banks, was adopted to gain as much information as possible.

Consensus was reached through open and thorough discussion between consultants and internal staff. For every asset class, this discussion verified the theoretical justification for the underlying valuation models and assumptions used therein. We noted the legitimate dispersion of opinion regarding expectations about the future and made choices consistent with our best knowledge. For example, there is a limited range of dispersion regarding the expected returns of Global Equity because there is widely available information and more industry consensus on fundamental valuation models. On the other hand, expected returns for Real Estate have wider dispersion due to the various benchmarks, methodologies and leverage assumptions used. In that case, we had a deeper discussion and adopted assumptions that were most consistent with our investment strategy for Real Estate. See Attachment 1 for additional detail.

BENEFITS/RISKS

CMAs are the essential inputs and starting points of the ALM Process. All subsequent analyses depend on their identification making the timing of adoption important. Staff recommends adoption of the presented CMAs for the following reasons:

1. Our procedure is time-tested and consistent with industry standards;
2. There are no pending issues nor unresolved concerns;
3. Our consensus was reached through open and thorough discussions;
4. Inherent uncertainty has been adequately noted and will be incorporated into our subsequent analyses.

The benefit of adoption of these metrics is that it allows staff to proceed with the ALM Process and devote more time and effort to subsequent analyses which involve a conscious attempt to compensate for some of the uncertainty inherent in estimating CMAs. The risk of non-adoption would be more time and effort spent without a clear target for improvement.

ATTACHMENTS
Attachment 1 – 2013 Capital Market Assumptions
Attachment 2 – Wilshire Associates Opinion Letter
Attachment 3 – Pension Consulting Alliance Opinion Letter

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