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May 25, 2013

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

Re: Adoption of 2013 Capital Market Assumptions

Dear Mr. Jones,

You requested our opinion regarding the agenda item from Staff that presents the Capital Market Assumptions for return, risk, and correlation for use in the 2013 Asset Liability Modeling process.

**Recommendation**

**Wilshire recommends that the Investment Committee adopt the assumptions as presented for use in the Asset Liability Modeling process.**

**Discussion**

The assumptions presented by Staff will drive the asset allocation process as the Investment Committee considers potential long term target allocations.

In general, Wilshire regards the consensus assumptions as appropriate, given CalPERS' strategic approach to investing and the size of the assets invested. Broadly, these assumptions reflect the current states of various financial markets and the implications for risk and return for a host of asset classes. While forecasting asset class returns is far from a precise science, we believe the proposed returns are reasonable and use justifiable methods of estimation. The assumptions presented were developed jointly by Staff, Wilshire, and others.

We find two observations noteworthy. First, the proposed returns ascribe a higher potential return to assets that are viewed to be more volatile. This risk premium is a widely held belief and has generally proven to be correct over long periods of time. However, there are periods of time, such as the last 6 or 12 years, when the return to risky assets (like stocks) falls below the return of less risky assets (like bonds). Thus, it will be important for the Investment Committee to continue to focus on the full range of possible outcomes, not just the expected case, when evaluating potential asset allocations.

Second, as outlined at the May 2013 workshop, developing these assumptions is an inexact science and the reality of the next ten years will like differ substantially from the predictions contained in this agenda item. As a result, it is paramount that the Investment Committee understand the potential ramifications of higher and lower than expected outcomes and select an asset allocation that balances the need for a given level of return with the desire to mitigate the possibility of significant or unrecoverable losses in this portfolio.

In the event of a significant movement in the financial markets over the next few months, Wilshire recommends revisiting these assumptions as is appropriate to adjust for the new market environment. At this time, we believe that these assumptions, however, are appropriate and reflective of the current environment for use in the November workshop.

**Conclusion**

Wilshire judges that the proposed expected return, risk and correlations are appropriate for use in the 2013 Asset Liability Workshop. Having worked with Staff and other investment professionals in developing these estimates, we believe that they properly account for the current economic and market environments and will help the Investment Committee focus on the potential long term outcomes of various asset allocation scenarios during the 2013 Asset Liability Modeling process.

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

Best regards,

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