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Managing Director & Principal

September 5, 2013

Mr. Henry Jones
Chair, Investment Committee
California Public Employees' Retirement System
400 P Street, Suite 3492
Sacramento, CA 95814

Re: Changes to Total Fund Benchmark

Dear Mr. Jones,

You requested Wilshire's opinion with respect to the proposal by Staff to make three changes to the Total Fund benchmark.

Recommendation

Wilshire recommends approving the change to the calculation of the currency overlay benchmark as presented by Staff as well as the addition of the interim weights to the policy. Wilshire does not object to the proposed change in how the MAC program will be handled within the benchmark, with the below caveats.

Discussion

We have reviewed materials prepared by Staff regarding the calculation of the currency benchmark, held extensive discussions with Staff, and have reviewed research by third parties regarding the current state of the art for currency benchmarks. In our opinion, the changes presented by Staff are warranted and should be approved.

In regard to the interim weights, the phase-in of the change in the Real Estate allocation was originally proposed by Wilshire following the Asset Liability Modeling exercise three years ago, given the Real Estate environment and the inability of Staff to rapidly rebalance into the asset class, and therefore we do not object to the formal adoption of the interim weights that have resulted.

We have also had several discussions with Staff about the change to how the MAC program will be handled within the Total Fund benchmark. When MAC was created, Staff asked the Investment Committee to modify the Total Fund benchmark to reduce the impact that allocations to MAC will have on the tracking error of the total portfolio versus the benchmark. This proposed change reverses that prior request and, in our opinion and the original opinion of Staff, can lead to increases Total Fund tracking error if the MAC program is invested as was originally outlined to the Investment Committee.

We have reviewed the work by Staff that discusses their conclusion that including MAC in the Total Fund Benchmark will reduce tracking error, but we respectfully disagree with their conclusion. As outlined to the Investment Committee, the point of the MAC program is to return as close to 7.5% as possible with as little volatility as possible through a variety of non-traditional investment strategies. Were the MAC program invested in long-only mixes of equities and fixed income in roughly a 65%/35% mix, then we would agree with Staff's analysis. To date, however, the only manager funded is a multi-strategy hedge fund that seeks to achieve the 7.5% return with little similarity to a 65%/35% portfolio. Many of the other strategies reviewed and selected for future investment are similarly unencumbered by a 65%/35% constraint. In fact, the RFP selection process generally preferred managers who targeted 7.5% over those who sought to outperform the CalPERS Total Fund benchmark.

Under Staff's proposal for eliminating the separate benchmark for MAC, the importance of Staff's responsibility for deciding to allocate to and from the MAC program will increase. If MAC performs as expected and returns in the neighborhood of 7.5% while a strong stock or bond market leads CalPERS to return better than 7.5% for a given year, the Total Fund will underperform its benchmark even if everything else in the portfolio meets the respective benchmarks. Similarly, if the fund performs poorly, a 7.5% return from MAC would help the Total Fund outperform its benchmark. This will lead Staff to consider the allocation to MAC even more closely than it currently does and to take a tactical view since the magnitude of the allocation to MAC is likely to matter more than the MAC managers' performance in some periods. Simply put, the performance result of the decision to allocate or deallocate to MAC in a very strong or weak market could overwhelm the impacts of any manager skill (or lack thereof).

Generally speaking, we do not prefer changes to benchmarks that have the impact of increasing tracking error. While Staff's analysis shows that this proposal may decrease tracking error, we respectfully disagree with that conclusion and believe that tracking error will increase in volatile markets if MAC is invested in the way that was presented to the Investment Committee and generally achieves its return objectives.

However, given that MAC is a new program and Staff is still working their way through how they want to invest and monitor this program, we will not object to approving this agenda item if Staff and the Investment Committee are prepared to accept the consequences of what could be an increase in tracking error, the potential impacts on Total Fund performance relative to benchmark, and the impacts on incentive compensation that would result from this new driver of Total Fund outperformance or underperformance (a greater result from overall market performance than manager selection skill).

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

Best regards,