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September 20, 2013

Henry Jones, Chairman
Investment Committee
California Public Employees' Retirement System
Sacramento, California 95814

Re: Revised Global Fixed Income Assumption and Low-Volatility Equity Assumptions

Dear Mr. Jones,

The purpose of this letter is to provide the Investment Committee with Pension Consulting Alliance's (PCA's) opinion regarding (i) the revised recommendations for the Global Fixed Income (GFI) policy asset class and (ii) the capital market assumptions for the Low-Volatility Global Equity (LVGE) asset class. In summary, PCA agrees with the new assumptions for both the GFI and LVGE classes and recommends that the Investment Committee adopt these assumptions as presented by the staff in the agenda item.

With respect to the revision in the GFI assumption, staff is proposing that the arithmetic average return assumption be increased from 3.00% to 3.73%. In May, PCA concurred that the 3.00% level was appropriate. Since May, yields on a wide range of fixed income instruments have spiked dramatically, primarily as a function of recent Fed statements regarding their planned "tapering" of their extensive fixed income purchase program.[1] In fact, independent of staff, in August PCA increased its own expected arithmetic return assumption for fixed income by 0.80% reflecting the same trend. In light of these factors, PCA believes staff's recommended increase in the GFI expected return is warranted.

PCA also recommends that the Investment Committee approve staff's proposed assumptions for LVGE. Over the last few months, there have been significant deliberations among staff, PCA, and Wilshire about both the role and assumptions for low-volatility global equity. In fact, Wilshire's and PCA's independent assumptions are relatively close to one another, particularly when reviewed from a reward-for-risk perspective. In summary, both consultants agree that a properly constructed LVGE class should exhibit materially less risk than traditional public equity

[1] For example, the Barclays Capital Long Liability Index (BCLLI) yield rose from 2.69% on April 30, 2013, to 3.67% on September 19, 2013, nearly a 100bp rise and nearly a 40% increase from its April level. This volatility in yields is very high by historical standards. The duration on the BCLLI is approximately 9 years, reflecting its composition of generally long-duration bonds that coincide more closely with CalPERS' long-dated liabilities than other more standard fixed income indices.

(on the order of 2/3rds the risk of public equity) while exhibiting a long-term expected return that is moderately less than the expected return of public equity. Staff's proposed consensus assumptions reflect these characteristics. Of course, a critical factor in achieving these assumptions will be how the class itself is underwritten and structured. Since LVGE represents, to a degree, a move toward strategy implementation rather than simply strictly gaining exposure to a type of asset, portfolio structuring of the LVGE portfolio should warrant in-depth analysis and scrutiny.

We look forward to addressing any questions or clarifications on these matters at the Investment Committee meeting.

Respectfully,

Allan Emkin