Wilshire

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February 7, 2014

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

Re: Strategic Asset Allocation Alternatives

Dear Mr. Jones:

We have reviewed the asset allocation agenda item prepared by Staff for approval at the February Investment Committee meeting. Our recommendation regarding this item is below, as well as further discussion.

Recommendation

While we recognize that the asset allocation process is not an exact science, where precision in projected returns and risk is not possible, we note that mix "B" increases return slightly and decreases risk moderately from the current asset allocation mix, both of which are desirable outcomes, and is preferable to the current asset allocation mix. Mix "A", recommended by Staff, moderately reduces return from the current target allocation but disproportionately decreases risk, making this also an acceptable selection to us. As a result, we recommend the selection of either A or B, depending on the Investment Committee's level of risk tolerance. We do note, below, that we question whether the real estate targets are achievable. In addition, we do not fully agree with Staff's recommendation to eliminate the currency hedge.

Discussion

The alternative asset allocation options are a product of discussions held over the course of two investment committee meetings and the January offsite and are reflective of the discussion held by the Investment Committee. In particular, we note that the allocation to ARS investments as a quasi-asset class is 0% in any of the mixes, as directed by the Investment Committee, and the allocation to cash in all mixes is 2%, matching the recommendation from the CFO. The allocation to Private Equity at 12% across the board corresponds to direction from the Investment Committee to reduce the risk allocated to this asset class from its current level. There was not as clear a direction given by the Investment Committee regarding the allocation to Fixed Income and Global Equities, and the allocation to these asset classes was set at a level which delivers the best overall risk/return tradeoff for each alternative mix.

For Real Estate and Infrastructure, while we do not object to the target allocation contained in any of the mixes, we note that CalPERS has had difficulty over the last few years reaching any higher targets than the current level. In the 2010-2011 asset allocation process, the Real Estate target was originally set at 10% but later reduced to 9% when it was clear CalPERS would be unable to reach that 10% target. The annual plans from the Infrastructure team have routinely reported how expensive transactions have been and how difficult it has been to reach the target allocation level. Over the last three years, Real Estate and Infrastructure have remained expensive and, while Staff has provided us with an explanation of why they are confident these higher targets are now attainable, we continue to question whether CalPERS can actually reach these higher allocation targets in an expedient fashion.

Finally, we remain unconvinced that the currency hedge should be eliminated as this agenda item recommends. As Staff's analysis illustrated at a workshop last fall, the currency hedge has reduced risk slightly for CalPERS without decreasing return. While we understand that maintaining the hedge does lead to unpredictable cash flows, CalPERS has made great strides recently in the area of system-wide cash management that should decrease the uncertainty around this program and the burden of managing it in the future. Given the proven reduction in risk to CalPERS with no impact on return and a decreasing cash flow management problem going forward, we believe that this program should be given more consideration for continuation.

If you have any comments or questions, please let us know.

Sincerely,