Agenda Item 9a

March 17, 2014

ITEM NAME: Strategic Asset Allocation Implementation

PROGRAM: Asset Allocation and Risk Management

ITEM TYPE: Asset Allocation, Performance & Risk – Information

EXECUTIVE SUMMARY

In February 2014 the Board adopted a new strategic asset allocation along with selecting several actuarial parameters to be used in establishing valuations and setting contribution rates for the next several years.

The adoption of a new strategic asset allocation starts an implementation process which contains these primary elements:

1. Assessment of any interim asset class target weights
2. Modification of the Statement of Investment Policy for Asset Allocation Strategy
3. Creation of a transition plan for shifting asset class exposure to new target weights
4. Extrapolation of the new strategic asset allocation structure into the relevant affiliate funds and their policy statements

Contained within these primary elements are a number of details which shall require feedback and direction from the Investment Committee (IC). This agenda item seeks to establish an awareness of the needed IC engagement and suggests a timeline for when material may be presented to the IC.

STRATEGIC PLAN

This agenda item supports the CalPERS Strategic Plan goal of improving long-term pension and health benefit sustainability.

BACKGROUND

At the February 2014 IC meeting, Agenda Item 11a presented alternative strategic asset allocations for selection and recommendation to the Board. The IC selected "Portfolio A" from Table 1 below:

Table 1 - Strategic Asset Allocation Alternatives

Candidate Portfolios				Current Policy Portfolio
Asset Class Component	Portfolio A	Portfolio B	Portfolio C	
Global Equity	47%	50%	52%	50%
Global Fixed Income	19%	17%	16%	17%
Inflation Sensitive	6%	5%	4%	4%
Private Equity	12%	12%	12%	14%
Real Estate	11%	11%	11%	9%
Infrastructure and Forestland	3%	3%	3%	2%
Liquidity	2%	2%	2%	4%
Expected Compound Return (1-10 yrs.) :	7.15%	7.27%	7.35%	7.25%
Blended Return (1-60 yrs.)[1] :	7.56%	7.66%	7.72%	7.63%
Expected Volatility :	11.76%	12.22%	12.52%	12.45%
Potential Discount Rate:	7.50%	7.50%	7.50%	7.50%

[1]Blended return is the combination of the short-term (1 to 10 years from CMAs) and the long-term (11 to 60 years from ACTO) expected returns after deducting administrative fees

Relative to the current strategic asset allocation, the asset class changes implied by the selection of “Portfolio A” are shown in Table 2 below:

Table 2 - Asset Class Weight Shift

Asset Class	Portfolio A	Current	Change
Global Equity	47%	50%	-3%
Global Fixed Income	19%	17%	+2%
Inflation Sensitive	6%	4%	+2%
Private Equity	12%	14%	-2%
Real Estate	11%	9%	+2%
Infrastructure & Forest	3%	2%	+1%
Liquidity	2%	4%	-2%

ANALYSIS

The four elements associated with implementation of the new strategic asset allocation have various topics associated with them. The elements are believed to be sequenced in an appropriate manner.

1. Interim Targets – The private asset classes all display constraints on the degree by which exposure is able to be managed relative to the target. A significant aspect of the constraint is driven by the pricing associated with market transactions. An example is the current environment within private equity where higher valuations in the public equity market are incenting private equity managers to sell companies, rather than being buyers. Conditions such as this may recommend an adjustment to the strategic target to avoid pressuring the staff and managers to engage in acquisitions at unfavorable pricing levels.

2. Policy Modification – The structure of the Statement of Investment Policy for Asset Allocation Strategy includes specification of the strategic targets and associated ranges within the body of the policy. Prior to modification of the policy, the consideration of utilizing interim targets must be addressed.

   Coincident with modification of the asset class targets, several other aspects for the policy warrant review:

   a. Asset Class Ranges - Associated with the asset class targets is a range within which the staff is able to manage the exposure. Ranges are used for two purposes. The first is to avoid excessive turnover due to the variance in return demonstrated between the asset classes. The second is to allow staff to express an active judgment about the relative valuation between the asset classes. An example is the overweight to Global Equity that has been maintained for the past couple of years based on the belief that the economic environment is conducive to common stock returns. Should it not be possible to maintain asset class exposure within the range, staff must bring the circumstance before the IC for direction.

b. Tracking Error – The policy contains statements related to the concept of risk budgeting as expressed by "tracking error" as estimated from the risk system for a one year horizon. The current limit on tracking error deriving from asset allocation decisions within the ranges is 0.75%. The overall tracking error limit inclusive of both asset allocation and active management decisions is 1.50%. When this material is reviewed, information regarding the estimated impact on tracking error resulting from deviation from the asset class target weights shall be presented.

c. Strategic Asset Allocation Frequency - The policy currently states that staff shall complete the strategic asset allocation work every three years. This work is referred to by the term "Asset Liability Management" (ALM). As implemented in 2013, the ALM process has merged Actuarial material and considerations into the overall framework. The current Actuarial schedule establishes a review of the various parameters on a four year cycle. Staff intends to recommend shifting the ALM cycle to the four year interval used for the Actuarial work to facilitate a continuation of the coincidence of the two work-streams. A portion of this recommendation shall be the establishment of a market valuation driven analysis to be conducted midway in the ALM cycle.

3. Transition Plan – Upon the establishment of the strategic asset class policy weights, staff shall prepare a schedule of the anticipated timing, expected costs and potential issues associated with any needed trading activity. This material shall be presented in closed session to avoid disadvantaging CalPERS. Another topic to be included in the transition discussion is related to the passive currency hedge. The shift from a passive currency hedge to an active program has implications related to timing, risk tolerance, capital sourcing and performance reporting.

   The transition discussion may not be conclusive on all the various topics and may simply result in the recognition that further work and discussion are needed prior to final direction by the IC.

4. Affiliate Funds – The information and perspective contained within the new strategic asset allocation must be reflected within the appropriate portions of the affiliate program. The affiliate funds having multi asset class exposure and an underlying ALM process are:

- The California Employers' Retiree Benefit Trust (CERBT) Fund
- The Judges' Retirement System II (JRS II) Fund
- The Legislators' Retirement System (LRS) Fund
- The Long Term Care (LTC) Fund

Staff is likely to recommend a consolidated agenda item for CERBT, JRS II, LRS and LTC funds as the asset class structure within these funds is identical. Where these funds vary, is in the target weight assigned to each asset class and the range by which actual exposure is allowed to drift before triggering a rebalance. By implication, the expected return and risk levels of these funds also vary. Should having a single, consolidated affiliate item become too complex when the work is actually begun, staff shall inform the IC Chair and suggest an alternate structure.

The affiliate programs believed to not require a review based on the new ALM work are:

- The Judges Retirement Fund
- The Public Employees' Health Care Fund
- The Supplemental Income Plans (SIP) CalPERS Target Retirement Date and State Peace Officer and Firefighters (POFF) funds
- The Terminated Agency Pool

The proposed schedule for bringing these elements before the IC is reflected in Table 3.

Table 3 – Proposed Schedule

Meeting	Topic
April 2014	Interim Targets
	Asset Allocation Strategy Policy Modification (initial review)
May 2014	Asset Allocation Policy Adoption
	Transition Plan
August 2014	Affiliate Asset Allocation and Policy Modification (initial review)
September 2014	Affiliate Policy Adoption

BUDGET AND FISCAL IMPACTS

Not Applicable

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ERIC BAGGESEN
Senior Investment Officer
Asset Allocation and Risk Management

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THEODORE ELIOPOULOS
Acting Chief Investment Officer