Wilshire

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

Re: Consultant Review of Asset Allocation Targets and Interim Transition Plan

Dear Mr. Jones:

We have reviewed the interim asset allocation agenda item prepared by Staff that maps out a transition plan from the current asset allocation targets to the newly adopted targets. Our recommendation regarding this item is below, as well as further discussion.

Discussion and Recommendation

We have reviewed the transition plan Staff has proposed. As we have noted on several occasions in the past, we have significant concerns about CalPERS' ability to meet the new targets for Real Estate and Infrastructure. Additionally, we have concerns about the changes to the target for the Private Equity allocation and to the interim targets for this asset class.

As a result, we have comments that specifically address the agenda item, as well as comments that present an alternative solution for dealing with these substantial misweights over time.

Discussion regarding recommendations contained in agenda item

Common practice when developing a transition plan is to set interim targets for each asset class allocation that are either one of the beginning or ending points or somewhere in between. For an asset class whose actual allocation is already near the final target, for example, the first interim step may be a significant move from the current (old) target but which is close to the current allocation.

In the plan proposed by Staff, the target for Private Equity violates this best practice by dropping to 10%, outside of the old-new range of 12%-14%. We believe that CalPERS would be more in compliance with common practice by shifting the PE target to the long term target of 12%. While this may result in some degree of tracking error, attempting to minimize such error by violating best practices sets a bad precedent, in our opinion. Compared to the current (old) targets, CalPERS has had a 4% underweight to Private Equities for a while. Shifting to the 12% target instead of an out-of-range target still cuts that underweight in half.

For Real Estate and Infrastructure, as we stated in our letter of February 2014, while we do not object to the new target allocation, 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 recently 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. To this point, the agenda item clearly states how Real Estate and Infrastructure are expensive at current valuations. As a result, a slower phase-in or the development of a contingency plan for a persistently low Real Estate allocation may be appropriate.

Discussion regarding alternative solution

The Investment Committee has expressed a clear preference to not "force" investments into illiquid asset classes at unfavorable valuations simply to meet an allocation target. This has created flexibility in the CalPERS portfolio to restructure the Real Estate portfolio and to build the Infrastructure portfolio methodically, without expensive deals that are likely to impair long term returns. As Staff notes in their agenda item, the Private Equity portfolio faces similar challenges as the private markets are more conducive to exiting existing positions than initiating new positions at significant levels.

In light of these concerns, we recommend that the Investment Committee consider adopting a more comprehensive solution than a single target allocation. Wilshire recommends that CalPERS have two Total Fund Policy Benchmarks. First, the Investment Committee has selected a target strategic allocation based on a lengthy and cooperative process between Investment and Actuarial Staff, the Investment Committee, and outside consultants including Wilshire. This Target Strategic Allocation Benchmark (named solely for reference purposes) should be viewed as the best expression of the Investment Committee's beliefs about risk and return and should be a benchmark for the investment portfolio of CalPERS, without modification. Actual performance will differ from this benchmark due to allocation variances from the target and from active management results across the entire portfolio.

Wilshire believes that a second benchmark should be constructed that recognizes the current status of the portfolio and the environment in which the nation's largest pension plan must operate with associated constraints. Due to its size, CalPERS cannot nimbly move its allocation to illiquid investments. The proposed interim targets are simply an acknowledgement of this fact. However, the interim targets propose a view as to what the "right" timing will be to move from the existing target to the Investment Committee-adopted target strategic allocation. However, the "right" timing should be valuation-aware as the pricing of illiquid assets frequently dictates an investor's ability to be successful in meeting their return goals for those asset classes.

Therefore, Wilshire would propose that CalPERS adopt a second Total Fund Policy Benchmark that dynamically adjusts to the actual weights for each of the illiquid asset classes with the liquid asset classes maintaining their prorated targets weights from the target strategic allocation (for purposes of this letter, the Dynamic Allocation Benchmark). Actual performance will differ from this benchmark due to allocation variances across the public asset classes (those weights are more easily adjusted by the actions of Staff) and from active management results across the entire portfolio.

While these benchmarks would be very similar, Wilshire believes there will be value in having both as they will create immediate transparency with respect to the returns associated with the timing of any variances between the target and actual weights of the illiquid asset classes – either intentional or drive by the market environment. We do note that having two Total Fund Policy Benchmarks is not common. However, Wilshire has other clients that have used the dynamic benchmark allocation when circumstances made it prudent to do so. We believe that CalPERS' size and the Investment Committee's expressed preference for flexibility indicate that this method would be reasonable and appropriate for consideration.

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

Sincerely,

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