PCA PENSION CONSULTING ALLIANCE

MEMORANDUM

Date: April 4, 2014

To: The Investment Committee
California Public Employees' Retirement System (CalPERS)

From: Allan Emkin, Pension Consulting Alliance, Inc. (PCA)

RE: Strategic Asset Allocation Interim Targets Policy Revision

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Capital market conditions produced outsized returns in the public equity market and other asset classes during 2013. Total fund assets grew from $248.8 billion at January 1, 2013 to $283.6 billion at December 31, 2013, an increase of 14%. In 2013 and continuing into 2014, these conditions have encouraged many private market managers (private equity and private real estate) to be net sellers, not buyers. The conditions that contributed to the past fifteen months' outperformance may moderate in 2014 at varying speeds and degrees in each of the asset classes. The attached Revision depicts staff's proposed modifications to the policy's interim targets (moving towards long term asset allocation targets adopted by the Investment Committee). PCA does not believe that "filling an asset allocation bucket" just to meet a long term goal, for the illiquid and most expensive assets to manage, makes sense. PCA believes that the mechanical allocation of non-publicly traded assets that may dilute that asset class' rate of return over time is sub-optimal and encourages the Investment Committee to move towards the target in a more deliberate manner.

PCA, as the Investment Committee's consultant for the Real Estate and Private Equity asset classes as well as the overall portfolio, has the following comments on the proposed Revision:

- Overall, PCA is in agreement with the proposed direction and amount of the policy targets revisions.
- The compression of the Private Equity target from 14% to 12% is consistent with CalPERS experience in the marketplace. The contemplated temporary revision to 10% is also marketplace driven. The projected resumption of a 12% allocation over two years could, in PCA's opinion, potentially result in commitments that will produce a reduced level of future outperformance. This could be mitigated by policy revisions that staff is considering for future presentation to the Investment Committee.
- Real estate marketplace conditions are remarkably similar in substance to those in private equity. Manager distributions are exceeding expectations and competitors are pricing assets at levels which are unattractive for existing, well located properties. This is making it difficult for managers to meet fiscal 2014 capital commitments at budgeted expected income-oriented return levels. CalPERS should be very cautious and patient in pacing its growth of the Real Estate asset class to the target levels.
- The addition of another year to the schedule for Private Equity and Real Estate, as a minimum, and reemphasis on discipline are advisable.

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