Wilshire

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July 31, 2014

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

Re: Proposed Revisions to the Affiliate Funds' Asset Allocations

Dear Mr. Jones:

Wilshire worked extensively with Staff on the proposed revisions to the asset allocation targets for the following Affiliate Funds:

- California Employers' Retiree Benefit Trust (CERBT)
- Legislators' Retirement Fund (LRS)
- Judges' Retirement Fund (JRS)
- Judges' Retirement II Fund (JRS II).

Our recommendation regarding this item is below, as well as further discussion.

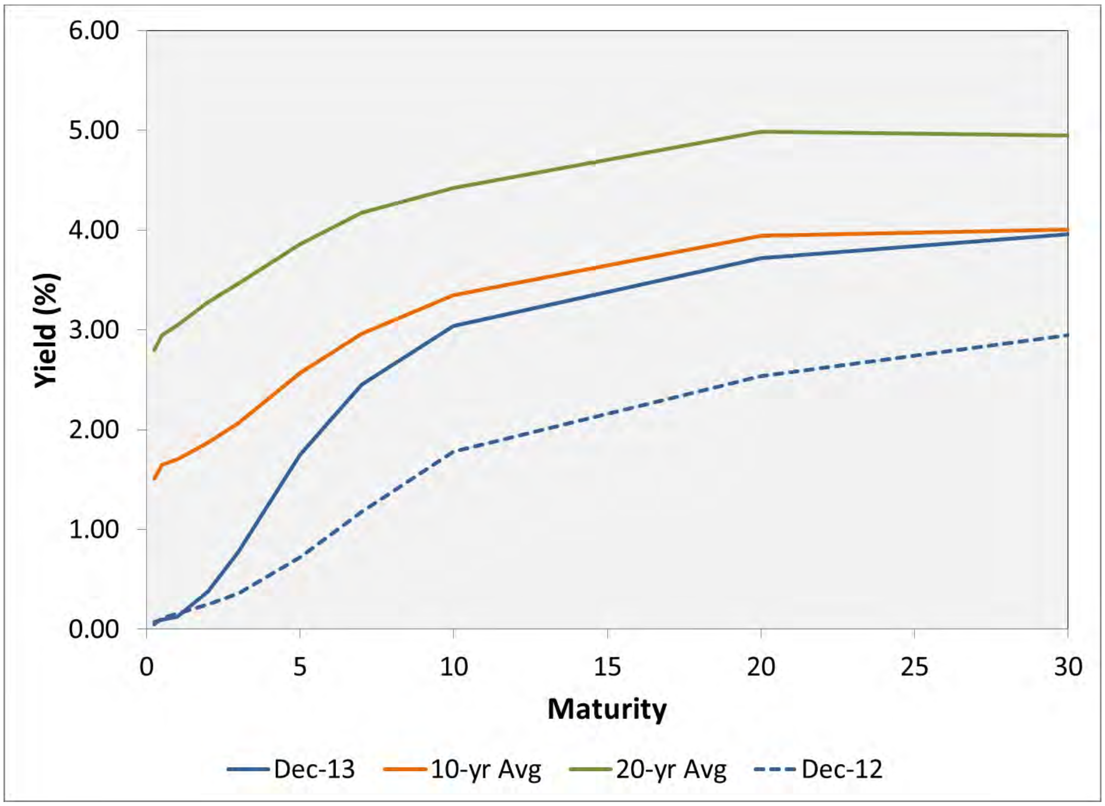
Recommendation

Wilshire has reviewed the strategic asset allocation analysis and the recommended policy portfolios and believe the new asset allocation targets to be prudent given the unique liability streams associated with each fund. We find Staff's rationale for each portfolio recommendation to be thoughtful, appropriate, and in line with CalPERS' Investment Beliefs. In general, the recommended portfolios reduce the expected volatility profile of these Affiliate Funds by reducing equity exposure and increasing fixed income or TIPS.

Discussion

As with the ALM process for the PERF, the asset allocation process used for the Affiliate Funds requires certain data inputs to produce risk/return efficient portfolios. The Capital Market Assumptions (CMAs) that Staff and Consultants discuss, scrutinize, and agree on, reflect the long-term focus of CalPERS and the prevailing capital market environment at the time of the strategic asset allocation analysis. Comparing the PERF CMAs from the 2013 ALM workshop to the Affiliate Fund CMAs, you will note that the forecasted return for Fixed Income has increased. This change is warranted due to an increase in interest rates during 2013. A similar adjustment was made to TIPS. The chart below shows the change in rates from December 31, 2012 to December 31, 2013.

Exhibit 1. Yield Curve Movements
Dec 31, 2013



One significant ongoing difference between the PERF and the Affiliate Funds is the use of private asset classes in the PERF. The Affiliate Funds use publicly traded assets only, so private equity, private real estate, infrastructure, and forestland are not used as components of the Affiliate Fund portfolios. As a surrogate for real estate exposure, the Affiliate Funds invest in REITs. While the underlying assets are largely the same for REITs and private real estate, the publicly traded nature of REITs causes them to behave differently. These differences manifest themselves in the expected return, volatility and correlations to other asset classes. In short, REITs are less attractive than private real estate but play an important strategic role in the Affiliate Fund portfolios: diversification and exposure to real assets.

The portfolio optimization process also often requires that minimum and maximum allocation constraints be placed on particular asset classes due to the instability of correlations over discrete time periods and the sensitivity of return assumptions to short-and medium-term market volatility. These characteristics can make individual asset classes unattractive in the optimization process at any given time. Constraints ensure adequate diversification in the resulting portfolios. Wilshire agrees with the constraints placed on the Commodity, REIT and TIPS asset classes and the respective allocations produced in the resulting efficient portfolio solutions.

The policy portfolio recommendations for each of the four Affiliate Funds reflect a reduction in the overall risk profile for each fund, with the exception of JRS. This reduction in risk is a direct result of a meaningful reduction in the equity allocation of each portfolio thereby reducing overall Growth risk. This reduction in equity exposure will dampen volatility but increases exposure to fixed income and therefore increases the sensitivity of the portfolio to changes in interest rates.

Even with the prospect of a potential higher interest rate environment the recommended policy portfolios offer a reasonable risk/reward profile given the changing demographics of each fund.

If you have any questions or comments, p lease contact us.

Sincerely,