



Agenda Item 6a

September 15, 2014

ITEM NAME: Affiliate Funds Strategic Asset Allocation Targets, Recommendations

PROGRAM: Asset Allocation and Risk Management

ITEM TYPE: Asset Allocation, Performance & Risk – Action

RECOMMENDATION

Approve and subsequently recommend the adoption of the proposed policy portfolios for the Affiliate Funds, outlined in Table 1 below, by CalPERS' Board of Administration (Board) at the September 2014 Board meeting.

Table 1 – Affiliate Fund Recommended Portfolios

Recommended Portfolio	Affiliate Fund
100% Liquidity	Judges' Retirement System (JRS) Fund
P7	Judges' Retirement System II (JRS II) Fund
P2	Legislators' Retirement System (LRS) Fund
P8	California Employers' Retiree Benefit Trust Fund – Strategy 1 (CERBT 1)
P5	California Employers' Retiree Benefit Trust Fund – Strategy 2 (CERBT 2)
P2	California Employers' Retiree Benefit Trust Fund – Strategy 3 (CERBT 3)

Details for the recommended portfolio choices are described in Table 2 on page 3.

EXECUTIVE SUMMARY

CalPERS' Board is responsible for the administration and investment of several trust plans independent of the Public Employees' Retirement Fund (PERF), referred to collectively as "Affiliate Funds."

This item includes the recommendations of the recent strategic asset allocation analysis for the following Affiliate Funds:

- JRS Fund
- JRS II Fund
- LRS Fund
- CERBT Fund

At the August 18, 2014 Investment Committee (IC) meeting, Agenda Item 7c presented outcomes and recommendations of the recent strategic asset allocation analysis for the JRS, JRS II, LRS, and CERBT funds. The strategic asset allocation process has considered the unique characteristics of each plan and, where appropriate, has incorporated actuarial risk considerations such as the funded rate, contribution rate and contribution rate volatility into the asset allocation analysis. The recommendations aim to reduce the expected volatility of returns and add diversification where possible. The degree to which this expected outcome is achievable is impacted by the anticipated effect of any changes on the potential discount rate used to value liabilities. For CERBT, staff has attempted to maintain similar risk profile choices.

Overviews of each of the Affiliate Programs and the Capital Market Assumptions (CMAs) are provided in Attachment 1. Consultant opinion letters from Wilshire Associates and Pension Consulting Alliance Inc. (PCA) are provided as Attachments 2 and 3, respectively.

STRATEGIC PLAN

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

INVESTMENT BELIEFS

This agenda item supports CalPERS' Investment Belief 1, that liabilities must influence the asset structure and Investment Belief 6, that strategic asset allocation is the dominant determinant of portfolio risk and return.

BACKGROUND

Periodic review and analysis of strategic asset allocation is required by the Affiliate Funds' respective Statements of Investment Policy. These activities were last conducted in 2011. An overview of each of the programs, including their establishment, purpose, and status, can be found in Attachment 1.

ANALYSIS

JRS is recommended to continue with a 100% Liquidity allocation (i.e., cash equivalent securities) because of its unique characteristics and its use as a reserve account.

JRS II, LRS and CERBT fund recommendations and corresponding characteristics such as volatility and return estimates are summarized in Table 2 on page 3. The expected compound return and volatility characteristics of the current policy portfolio have been derived from the CMAs provided in Attachment 1. Within the modeling process, the weights to some of the asset classes have been fixed due to diversification considerations. These constraints are also provided in Attachment 1.

Staff analyzed three alternatives for each applicable Affiliate Fund to identify a recommendation for each fund. To the extent possible, the recommended portfolios reflected:

- Reductions in the overall levels of expected volatility;
- Maintenance of the existing discount rates for programs where CalPERS establishes the applicable discount rates (this excludes the CERBT);
- Broader diversification over the included asset classes; and
- Improvement in the actuarial risk considerations where applicable.

The four recommended asset allocations in Table 2 have had the segment weightings rounded to the nearest whole percentage. Assigning target weights using fractional percentages is believed to convey more precision than is warranted by the modeling process. The expected return and risk characteristics have been calculated based on rounded weights, resulting in only slight differences, shown below.

Table 2 – Affiliate Fund Recommended Portfolio Allocations

Asset Class Component	Recommended Portfolios				
	P2	P5	P7	P8	
Global Equity	24%	40%	50%	57%	
Fixed Income	39%	39%	34%	27%	
Treasury Inflation-Protected Securities (TIPS)	26%	10%	5%	5%	
Commodities	3%	3%	3%	3%	
Real Estate Investment Trusts (REITs)	8%	8%	8%	8%	
Expected Compound Return (1-10 yrs.) :	5.42%	6.12%	6.49%	6.71%	
Expected Volatility :	7.14%	9.32%	10.76%	11.74%	
Expected Cash Yield :	2.89%	3.00%	2.99%	2.92%	
Expected Blended Return Net of Fees (1-60 yrs.):	CERBT:	6.12%	6.73%	N/A	7.28%
	LRS:	5.78%	N/A	N/A	N/A
	JRS II:	N/A	N/A	7.06%	N/A
Recommended for plans:	CERBT 3 & LRS	CERBT 2	JRS II	CERBT 1	

The expected blended return is the combination of the short-term (1-10 years from CMAs) and the long-term (11-60 years from CalPERS' Actuarial Office) expected returns after deducting administrative fees.

Assessment of Strategic Asset Allocation Targets

Relative to the current strategic asset allocation targets, the asset class changes implied by the selection of the recommended portfolios are shown in Tables 3a through 3f below.

Table 3a – Strategic Asset Allocation Weights – JRS

JRS			
Asset Class Component	Recommended Portfolio	Current Portfolio	Change
Global Equity	0%	0%	0%
Fixed Income	0%	0%	0%
TIPS	0%	0%	0%
Commodities	0%	0%	0%
REITs	0%	0%	0%
Cash	100%	100%	0%

Table 3b – Strategic Asset Allocation Weights – JRS II

JRS II			
Asset Class Component	Recommended Portfolio (P7)	Current Portfolio	Change
Global Equity	50%	63%	-13%
Fixed Income	34%	20%	14%
TIPS	5%	6%	-1%
Commodities	3%	3%	0%
REITs	8%	8%	0%
Cash	0%	0%	0%
Expected Compound Return (1-10 years)	6.49%	6.93%	-0.44%
Expected Volatility	10.76%	12.62%	-1.86%
Expected Cash Yield	2.99%	2.85%	0.14%
Expected Blended Return Net of Fees (1-60 years)	7.06%	7.44%	-0.38%
Discount Rate	[7.00%]*	N/A	N/A

* Potential discount rate is pending approval by CalPERS Finance & Administration Committee.

Table 3c – Strategic Asset Allocation Weights – LRS

LRS			
Asset Class Component	Recommended Portfolio (P2)	Current Portfolio	Change
Global Equity	24%	32%	-8%
Fixed Income	39%	42%	-3%
TIPS	26%	15%	11%
Commodities	3%	3%	0%
REITs	8%	8%	0%
Cash	0%	0%	0%
Expected Compound Return (1-10 years)	5.42%	5.82%	-0.40%
Expected Volatility	7.14%	8.19%	-1.05%
Expected Cash Yield	2.89%	3.00%	-0.11%
Expected Blended Return Net of Fees (1-60 years)	5.78%	6.11%	-0.33%
Discount Rate	[5.75%]*	N/A	N/A

Table 3d – Strategic Asset Allocation Weights – CERBT 1

CERBT 1			
Asset Class Component	Recommended Portfolio (P8)	Current Portfolio	Change
Global Equity	57%	66%	-9%
Fixed Income	27%	18%	9%
TIPS	5%	5%	0%
Commodities	3%	3%	0%
REITs	8%	8%	0%
Cash	0%	0%	0%
Expected Compound Return (1-10 years)	6.71%	7.01%	-0.30%
Expected Volatility	11.74%	13.07%	-1.33%
Expected Cash Yield	2.92%	2.84%	0.09%
Expected Blended Return Net of Fees (1-60 years)	7.28%	7.53%	-0.25%

Table 3e – Strategic Asset Allocation Weights – CERBT 2

CERBT 2			
Asset Class Component	Recommended Portfolio (P5)	Current Portfolio	Change
Global Equity	40%	50%	-10%
Fixed Income	39%	24%	15%
TIPS	10%	15%	-5%
Commodities	3%	3%	0%
REITs	8%	8%	0%
Cash	0%	0%	0%
Expected Compound Return (1-10 years)	6.12%	6.47%	-0.35%
Expected Volatility	9.32%	10.58%	-1.26%
Expected Cash Yield	3.00%	2.82%	0.18%
Expected Blended Return Net of Fees (1-60 years)	6.73%	7.04%	-0.31%

* Potential discount rate is pending approval by CalPERS Finance & Administration Committee.

Table 3f – Strategic Asset Allocation Weights – CERBT 3

CERBT 3			
Asset Class Component	Recommended Portfolio (P2)	Current Portfolio	Change
Global Equity	24%	32%	-8%
Fixed Income	39%	42%	-3%
TIPS	26%	15%	11%
Commodities	3%	3%	0%
REITs	8%	8%	0%
Cash	0%	0%	0%
Expected Compound Return (1-10 years)	5.42%	5.82%	-0.40%
Expected Volatility	7.14%	8.19%	-1.05%
Expected Cash Yield	2.89%	3.00%	-0.11%
Expected Blended Return Net of Fees (1-60 years)	6.12%	6.43%	-0.31%

BUDGET AND FISCAL IMPACTS

Not Applicable

BENEFITS/RISKS

Staff's recommendations for the JRS, JRS II, LRS and CERBT funds are believed to reflect the preferences expressed by the IC at the August 18, 2014 meeting. The recommended portfolios attempt to maintain similar choices for CERBT employers, and reduce drawdown risk and concentration risk to the extent possible while minimizing negative impacts to the existing discount rates for JRS II and LRS.

Risks associated with this recommendation are that the actual long-term market returns, volatilities, and correlations eventually experienced may diverge materially from the capital market expectations used in the modeling process. In addition, inflation rates may vary significantly from expectations. These risks are mitigated by the fact that staff will conduct a market valuation driven analysis biennially, and a comprehensive asset allocation strategic review coincident with the review of the actuarial methods and assumptions every four years.

ATTACHMENTS

Attachment 1 – Affiliate Program Overviews and CMAs

Attachment 2 – Wilshire Associates Opinion Letter

Attachment 3 – PCA Opinion Letter

ERIC BAGGESEN
Senior Investment Officer
Asset Allocation and Risk Management

THEODORE ELIOPOULOS
Interim Chief Investment Officer

CHERYL EASON
Chief Financial Officer

ALAN MILLIGAN
Chief Actuary