Investment Committee

California Public Employees' Retirement System

Agenda Item 8b

September 15, 2014

ITEM NAME: Affiliate Funds Strategic Asset Allocation Proposed Policy Modifications – Initial Review

PROGRAM: Asset Allocation and Risk Management

ITEM TYPE: Asset Allocation, Performance & Risk – Information

EXECUTIVE SUMMARY

Upon approval of revised policy portfolios for the four Affiliate Funds, outlined in September 2014 IC Agenda Item 6a by the Investment Committee (IC) and pending subsequent adoption by the CalPERS' Board of Administration (Board), a series of implementation activities will commence. For the Affiliate Funds, staff will modify the relevant Statements of Investment Policy for the following Affiliate Funds:

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

Staff seeks feedback and guidance on the proposed revisions to the Statements of Investment Policy for each fund (Attachments 1 through 4), including the strategic asset allocation ranges. CalPERS Statement of Investment Policy for Asset Allocation Strategy is included as a reference as Attachment 5. Opinion letters from Wilshire Associates and Pension Consulting Alliance Inc. (PCA) are provided as Attachments 6 and 7, respectively. Pending feedback from the IC, staff anticipates returning with an action item seeking adoption of the modified policies at the October 2014 meeting.

STRATEGIC PLAN

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

BACKGROUND

The September 2014 IC Agenda Item 6a presented recommended strategic asset allocations for selection and recommendation to the Board for the Affiliate Funds. Pending adoption by the Board, Table 1 contains the new strategic asset allocations that will constitute the new Policy Portfolios for each of the following Affiliate Funds.

Table 1 – Recommended Affiliate Fund Candidate Portfolios

Asset Class Component	CERBT 3 & LRS	CERBT 2	JRS II	CERBT 1
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%

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.

ANALYSIS

Pending Board approval of the September 2014 IC Agenda Item 6a, implementation of the new Affiliate Funds strategic asset allocations requires that the following associated elements be addressed.

Proposed Policy Modifications

Black-lined versions of the Statements of Investment Policy for the relevant Affiliate Funds are attached (Attachments 1 through 4), reflecting the following recommended changes:

1. Section V.B. – Strategic Asset Allocation Process – To align the Affiliate Funds' (LRS, JRS, JRS II, and CERBT) strategic asset allocation process with the Public Employees' Retirement Fund (PERF), staff's recommendation is to reference the *Asset Allocation Strategy Policy* approved by the IC in May 2014 and included as Attachment 5. This policy includes language solidifying the linkage between the work of the Investment Office and Actuarial Office in the Asset Liability Management (ALM) process, specifically that:
    - The strategic ALM work shall be conducted on a four-year cycle in alignment with the routine review of actuarial assumptions and methods, and
    - A valuation-driven analysis shall be brought to the IC at the midpoint between the ALM processes.
2. Section V.D. – Policy Asset Class Allocation Targets and Ranges – The primary edits are contained within the table in this section, which specify the Affiliate Funds' (LRS, JRS II, and CERBT) targets and the ranges by which exposure may vary from the targets without further input from the IC.

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 within the PERF for the past couple of years based on the belief that the economic environment is conducive to common stock returns. Accordingly, the asset class ranges will reflect the degree of active management intended for each Affiliate Fund. In the case of LRS and JRS II, staff envisions replicating any "active bets" being implemented within PERF into these Affiliate Funds. Therefore, the asset class ranges for LRS and JRS II will be similar to the asset class ranges being used for the PERF. In contrast, the CERBT funds will be passively managed with regards to asset allocation shifts[1], and thus the asset class ranges for the CERBT 1, 2, and 3 will be much narrower than those proposed for LRS and JRS II.

3. Section V.F. – Target Tracking Error - To align the Affiliate Funds' (LRS and JRS II) target tracking error with the PERF, staff's recommendation is to reference the *Asset Allocation Strategy Policy* approved by the IC in May 2014 and included as Attachment 5. This policy includes language that constrains the targeted forecast annual tracking error.

A review of the various asset class ranges has been undertaken along with an assessment of the tracking error implications deriving from the ranges. Table 2 contains a summary of the information. Additionally, the tracking error estimation in Table 2 has been completed using both the CalPERS Risk Management System (BarraOne) and by calculation from the Estimated 2014 Capital Market Assumptions (CMAs).

[1] Specific asset classes are, and may continue to be, actively managed.

Table 2 – Range and Tracking Error Assessment

Asset Class		Current Asset Allocation Range		Recommended Asset Allocation Range		PERF[2]
		Current Range for CERBT 1 & JRS II	Current Range for CERBT 2, CERBT 3 & LRS	Recommended Range for CERBT 1, CERBT 2 & CERBT 3	Recommended Range for LRS & JRS II	
Global Equity		±5%	±5%	±2%	±5%	±7%
Fixed Income		±5%	±5%	±2%	±5%	±5%
TIPS		±2%	±4%	±2%	±3%	±3%
Commodities		±2%	±2%	±2%	±3%	
REITs		±2%	±2%	±2%	±5%	±5% (Private Real Estate)
Cash		+1%	+1%	+2%	+2%	±1%
Maximum Tracking Error	Estimated by BarraOne	98 bps	112-117 bps	54 bps	125 bps	129 bps
	Estimated with 2014 CMAs	117 bps	124-130 bps	68-70 bps	163 bps	167 bps

The Maximum Tracking Errors were estimated by two separate methodologies, one based on BarraOne and another based on the CMAs. BarraOne uses historical data to project the volatilities of the asset classes with a half-life of one year. In comparison, the CMAs were based on a long term forecast of the asset classes through a collaborative analysis amongst staff, the Board's Investment Consultants, and CalPERS' Actuarial Office. Due to the recent low volatility levels across all asset classes, the BarraOne volatility estimates are substantially lower than the CMAs. Thus, the Tracking Error estimates from BarraOne are lower than those predicted by the CMAs. Table 3 below provides a comparison of the volatility estimates under each methodology.

Table 3 – Comparison of Volatility Estimates from BarraOne and Estimated 2014 CMAs

Volatility	Global Equity	Fixed Income	TIPS	Commodities	REITs
2014 CMAs	17.40%	7.00%	6.50%	17.92%	19.50%
BarraOne	13.60%	5.77%	4.75%	15.79%	13.72%
Difference	3.80%	1.23%	1.75%	2.13%	5.78%

Based on the BarraOne estimates, if the full asset class ranges were used to create the most extreme tracking error possible, the proposed asset allocation ranges for CERBT are expected to reduce the maximum tracking error from 98 basis points for CERBT 1, 112 basis points for CERBT 2, and 116 basis points for CERBT 3 to a maximum of 54 basis points for all CERBT strategies. Based on the 2014 CMAs, the maximum tracking errors are expected to drop from 117 basis points for CERBT 1, 124 basis points for CERBT 2, and 130 basis points from CERBT 3 to a maximum of 68-70 basis points.

In the case of LRS and JRS II, higher asset allocation ranges would be expected to increase the tracking error from 117 basis points for LRS and 98 basis points for JRS II to a maximum of 125 basis points based on the BarraOne estimates. Based on the CMAs, the tracking error for LRS and JRS II would be expected to increase from 130 basis points for LRS and 117 basis points for JRS II to a maximum of 163 basis points.

In addition to the asset class range constraints described above, LRS and JRS II shall be further constrained within the same targeted forecast annual tracking error as the PERF and established in the CalPERS Statement of Investment Policy for Asset Allocation Strategy. The current target forecast annual tracking error for the PERF Asset Allocation Strategy is 0.75%, while the PERF total fund is managed with a target forecast annual tracking error of 1.5%, inclusive of active asset allocation and other active management decisions. This constraint for the PERF is described in CalPERS Statement of Investment Policy for Asset Allocation Strategy, Section VI.F. Target Tracking Error, included on pages seven and eight of Attachment 5.

BUDGET AND FISCAL IMPACTS
Not Applicable

BENEFITS/RISKS
The proposed policy revisions provide the following benefits:

- Increasing alignment between the affected Affiliate Fund policies and the revised Asset Allocation Strategy Policy which articulates the link between the strategic asset allocation analysis and the ALM work cycles.

- Mitigating and managing operational and reputational risks by documenting the changes to the strategic asset allocation targets and ranges developed through the most recent strategic asset allocation analysis and approved by the Board in September 2014.

The risk to the proposed policy modifications is that it allows staff greater ability to actively manage LRS and JRS II than is currently in place. This may result in larger deviations in actual performance from the Policy Portfolio performance than what has been experienced in the past. While the intent is to allow greater consistency in the manner that the Affiliate Programs and the PERF are managed, where staff has deemed it is appropriate, this may pose additional risk for LRS and JRS II to the extent that any actively managed bets underperform the Policy Portfolio performance.

This risk will be mitigated by staff's plans to enhance the risk management, monitoring, and reporting of the Affiliate Funds in a manner that is consistent with the processes used for the PERF.

ATTACHMENTS
Attachment 1 – JRS Statement of Investment Policy with Proposed Revisions
Attachment 2 – JRS II Statement of Investment Policy with Proposed Revisions
Attachment 3 – LRS Statement of Investment Policy with Proposed Revisions
Attachment 4 – CERBT Statement of Investment Policy with Proposed Revisions
Attachment 5 – CalPERS Statement of Investment Policy for Asset Allocation Strategy (for reference)
Attachment 6 – Wilshire Associates Opinion Letter
Attachment 7 – PCA Opinion Letter

ERIC BAGGESEN
Senior Investment Officer
Asset Allocation and Risk Management

THEODORE ELIOPOULOS
Interim Chief Investment Officer