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August 26, 2014

Mr. Henry Jones, Chairman
Investment Committee
California Public Employees' Retirement System
Sacramento, California 95814

Re: September IC Agenda Item 8b – Affiliate Fund Strategic Asset Allocation
Proposed Policy Modifications - Initial Review

Dear Mr. Jones,

The purpose of this letter is to provide the Investment Committee with Pension Consulting Alliance's (PCA's) opinion regarding Agenda Item 8b for the September Investment Committee meeting. In summary, PCA supports the staff's recommendations for (i) the alignment of the Strategic Allocation Processes of the Affiliated Funds (as a group) and the PERF and (ii) the proposed allocations ranges associated with the new allocation targets of each of the underlying Affiliated Funds.

With respect to item (ii) above we note that staff's memo highlights tracking error ranges associated with each fund's proposed target allocation. Tracking error estimates basically reflect the IC's tolerance for negative "surprise risk" given that (i) from time-to-time, the portfolio is not in perfect alignment with its allocation targets and (ii) the markets produce investment returns that are considered abnormally negative. The "maximum tracking error" estimates in the memo show how investment performance of the specified portfolio might deviate (either positively or negatively) from the policy return during abnormal periods. Typically, tracking error figures on the order of 100 basis points (1.0%) per year are considered very reasonable and produce long-term return patterns that are equivalent to the intended policy benchmark. As staff discusses in their memo, the selected wider allocation ranges associated with the LRS and JRS II portfolios result in a higher expected maximum tracking error, rising from an estimated 112bp-130bp (midpoint 121bp) to an estimated 125bp-163bp (midpoint 144bp), depending on the measurement technique utilized. In contrast, the estimated maximum tracking errors of the other portfolios are expected to decline. Given that JRS II's and LRS's allocation ranges around the REIT and Commodities classes target are widening, it is intuitive that the estimated maximum tracking errors on these respective portfolios should also rise. We also note that the recommended ranges for all the Affiliate Fund portfolios' risk classes (not including cash) are all tighter than and/or consistent with the ranges applied to the PERF portfolio. We are merely pointing out that the impact of changing the JRS II and LRS ranges is the potential for larger deviations in actual performance versus policy than what has been experienced in the past. Given this observation/caveat, PCA believes the allocations for all the proposed Affiliate Fund portfolios are reasonable.

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As with the deliberations revolving around the PERF policy portfolio recommendations, there should be recognition that the proposed investment allocation targets and ranges for the Affiliate Funds represent longer-term strategies. In this context, PCA believes utilizing the ranges to implement prudent and cost-effective approaches to achieve the new policy allocation levels warrant serious consideration.

We look forward to addressing any questions or clarifications on this matter at the Investment Committee meeting.

Respectfully,

Allan Emkin