



Agenda Item 6a

October 13, 2014

ITEM NAME: Revision of Affiliate Funds Policies

PROGRAM: Asset Allocation and Risk Management

ITEM TYPE: Policy & Delegation – Action

RECOMMENDATION

Approve the revised Statements of Investment Policy (Policy Statements), including the strategic asset allocation ranges, 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

The revised Policy Statements are provided as Attachments 1 through 4. CalPERS' Asset Allocation Strategy Policy is included for reference as Attachment 5. Opinion letters from Wilshire Associates and Pension Consulting Alliance Inc. (PCA) are provided as Attachments 6 and 7, respectively.

EXECUTIVE SUMMARY

The four Affiliate Fund Policy Statements were presented to the Investment Committee (IC) for initial review on September 15, 2014. Staff has incorporated the IC's feedback and made other minor adjustments as follows:

- JRS Policy: Added clarifying language which ties future strategic asset allocation analysis to be contingent on a pre-funding of future liabilities, specifies that the asset allocation will be 100% Liquidity, eliminating the need for rebalancing, and establishes minimal tracking error.
- CERBT Policy: Added clarifying language with regards to managing these portfolios in a manner that minimizes tracking error.
- All Policies: Changed the approval date to October 13, 2014.

Changes made to the Policy Statements based on the IC's feedback are denoted with yellow highlighting within Attachments 1 through 4.

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

The new strategic asset allocations for the aforementioned Affiliate Funds were adopted by the IC on September 15, 2014 and referred to the CalPERS' Board of Administration (Board). The Board approved the IC recommendation on September 17, 2014 during Agenda Item 10 "Asset Liability Management – Affiliate Funds."

Additionally, September IC Agenda Item 8b, "Affiliate Funds Strategic Asset Allocation Proposed Policy Modifications – Initial Review," presented the related policy changes required to implement the asset allocation recommendations.

ANALYSIS

A summary of the recommended changes and rationale are as follows:

1. Section V.B. – Strategic Asset Allocation Process – To align the Affiliate Funds' (JRS, JRS II, LRS, 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. JRS has added language that a comprehensive Asset Allocation Strategy will be followed pending the pre-funding of future liabilities.
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' (JRS, JRS II, LRS, and CERBT) asset class targets and the ranges by which exposure may vary from the targets without further input from the IC. The asset class targets are included in Table 1 and the ranges are included in Table 2. JRS has an allocation of 100% Liquidity (i.e., cash equivalent securities) because of its use as a reserve account. Thus, JRS does not require any asset allocation ranges unless it begins to pre-fund future liabilities.

Table 1 – Affiliate Fund Policy 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%

Table 2 – Recommended Affiliate Fund Ranges

Asset Class	Current Asset Allocation Range		Recommended Asset Allocation Range	
	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%
Fixed Income	±5%	±5%	±2%	±5%
TIPS	±2%	±4%	±2%	±3%
Commodities	±2%	±2%	±2%	±3%
REITs	±2%	±2%	±2%	±5%
Cash	+1%	+1%	+2%	+2%

- Section V.F. – Target Tracking Error – To align the Affiliate Funds’ (JRS II and LRS) target tracking error with the PERF, staff’s recommendation is to reference the Asset Allocation Strategy Policy. This policy includes language that constrains the targeted forecast annual tracking error. Additional language has also been added to the Policy Statements of JRS and CERBT to specify that these funds will be managed in a manner which minimizes any tracking error.

BUDGET AND FISCAL IMPACTS

Not Applicable

BENEFITS/RISKS

The proposed 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 Asset Liability Management work cycles.
- Mitigating and managing operational and reputational risks by documenting the changes to the strategic asset allocation targets developed through the most recent strategic asset allocation analysis and approved by the Board in September 2014.
- Enhancing risk management of Affiliate Funds by specifying asset class ranges and allowable tracking error that is most appropriate given staff's intention to passively or actively manage each Affiliate Fund.

A risk associated with the proposed Policy Statement modifications is that they allow staff greater ability to actively manage JRS II and LRS. This may result in larger deviations in actual performance from the Policy Portfolios 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 appropriate, this may pose additional risk for JRS II and LRS. This risk would materialize to the extent that any actively managed positions underperform the Policy Portfolio.

This risk will be mitigated by the continued enhancement of the investment 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
- Attachment 6 – Wilshire Associates Opinion Letter
- Attachment 7 – PCA Opinion Letter

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