PENSION CONSULTING ALLIANCE

March 31, 2015

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

Re: Review of Strategic Allocation Interim Targets

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 6a for the April Investment Committee meeting. In summary, PCA (1) supports the staff's recommendations for maintaining the interim targets for Global Equity, Private Equity and Real Estate, and (2) supports adjusting the interim target for Liquidity from 2% to 1%. There are, however, some important considerations the Investment Committee should review before adopting these recommendations.

Status of Current Allocation versus Interim and Long –term Targets

In their memo, staff indicates that an important consideration in determining interim targets is the market conditions that CalPERS currently operates under as well as potential conditions in the future. Specifically, staff points out that it is highly likely that the Federal Reserve will begin to raise short-term interest in the near future. In addition, staff highlights the current relatively high valuations associated with private markets investments. Given these phenomenon, staff believes that increasing allocations to these classes within the short-term merely to achieve a long-term target may prove detrimental to the longer-term risk-adjusted return outcome of the total portfolio. PCA concurs with this assessment.

In terms of over-versus-under weightings, CalPERS currently overweights Global Equity versus both long-term and interim targets, while underweighting other classes by varying degrees (see table below).

15760 Ventura Boulevard, Suite 700
Encino, CA 91436
Tel: 818.995.8713 Fax: 818.990.7403
www.pensionconsulting.com

PCA | PENSION CONSULTING ALLIANCE

CalPERS Current Allocation versus Proposed Interim Targets and CalPERS' Long-term Target

Asset Class	Current Allocation*	Proposed Interim Target (Case A/Case B)	Current - Interim Target Difference	Long-term Target	Current - Long-term Target Difference
Global Equity	55	51/52	+4/+3	47	+8
Priv. Equity	10	10	0	12	-2
Total Growth	65	61/62	+4/+3	59	+6
Global Fixed Income	18	20/19	-2/-1	19	-1
Real Estate	9	10	-1	11	-2
Infrastructure & Forestland	1	2	-1	3	-2
Total Real Assets	10	12	-2	14	-4
Inflation-oriented	5	6	-1	6	-1
Liquidity	2	1	+1	2	0
Total		100	0	100	0

*PCA's allocation levels differ slightly from that found in staff's memo due to how the 1.2% of the ARS class allocation is treated. The table above pro rates the 1.2% allocation across all classes.

As the table above highlights, the largest allocation deviations relate to Growth assets (+6% over-weighted versus long-term target and also over-weighted regardless of the proposed interim weighting target selected) and Real Assets (-4% under-weighted versus long-term target and also under-weighted versus its interim target). Global Fixed Income and Inflation-oriented are also underweighted versus both their interim and long-term targets.

From a private markets perspective, both interim target options (Case A or Case B in staff's memo) will likely lead to a marginal slowdown in commitments to Private Equity in the near term while commitment pacing to Real Assets (of all types) will likely be maintained, or even rise. The rationale is that since the actual Private Equity allocation would be at its target, additional flexibility would accrue to CalPERS as it examined its commitment pacing trends. In the Real Assets space, however, given that the current allocation levels to those assets remain below both interim and long-term targets, incremental commitments would still be required to achieve both interim and long-term allocation targets.

Also, given that Global Equity is currently over-weighted versus policy while Global Fixed Income is under-weighted suggests that moving the Liquidity over-weight to Global Fixed Income should better align the portfolio to policy targets rather than increasing the growth-risk bias in the total portfolio.

Given the staff's assurances that CalPERS' cash flow monitoring and management procedures continue to improve, PCA believes the reduction in the interim Liquidity target is reasonable. Staff is also proposing what PCA views as a modestly more conservative benchmark for the Liquidity class. PCA believes this recommendation is appropriate.

PCA PENSION CONSULTING ALLIANCE

Proposed Range around Proposed Liquidity Target

Finally, staff is proposing the allocation range around the interim Liquidity target of 1% be widened to +/-3%. This means that the Liquidity allocation could be negative (i.e., CalPERS incurs financial leverage) while still adhering to policy. PCA believes the Investment Committee should have a thorough understanding of the potential impact (both positive and negative) that a cash position on the order of -2% could have on the total portfolio. In such instances, CalPERS could find itself in a debtor (rather than creditor) position, which could have certain counterparty implications during high-market-stress periods. The Investment Committee should, at a minimum, have an awareness of the potential qualitative and quantitative outcomes that could arise during such scenarios.

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

Respectfully,

Allan Emkin