Agenda Item 7a

May 18, 2015

ITEM NAME: Long-Term Care Fund Asset Allocation Review and Proposed Policy Revisions

PROGRAM: Long-Term Care Program

ITEM TYPE: Asset Allocation, Performance & Risk – Information

EXECUTIVE SUMMARY

CalPERS' Board of Administration (Board) is responsible for the administration and investment of the Long-Term Care (LTC) Fund, which is independent of the Public Employees' Retirement Fund (PERF).

Staff seeks feedback and guidance from the Investment Committee (IC) on the following:

- the recommendation to maintain the current asset allocation for the LTC Fund,
- the proposed revisions to the Statement of Investment Policy for the LTC Fund provided as Attachment 1, and
- the proposed revisions to CalPERS' Total Fund Investment Policy provided as Attachment 2.

Opinion letters from Wilshire Associates and Pension Consulting Alliance Inc. (PCA) are provided as Attachments 3 and 4, respectively.

STRATEGIC PLAN

This agenda item supports the CalPERS Strategic Plan goal of improving long-term pension and health benefit sustainability. This agenda item supports several of CalPERS' Investment Beliefs. The recommended asset allocation approach supports Belief # 1 - Liabilities must influence the asset structure. The proposed modifications to the Statement of Investment Policy for LTC and the Total Fund Investment Policy supports Investment Belief #10 – Strong processes and teamwork and deep resources are needed to achieve CalPERS goals and objectives.

BACKGROUND

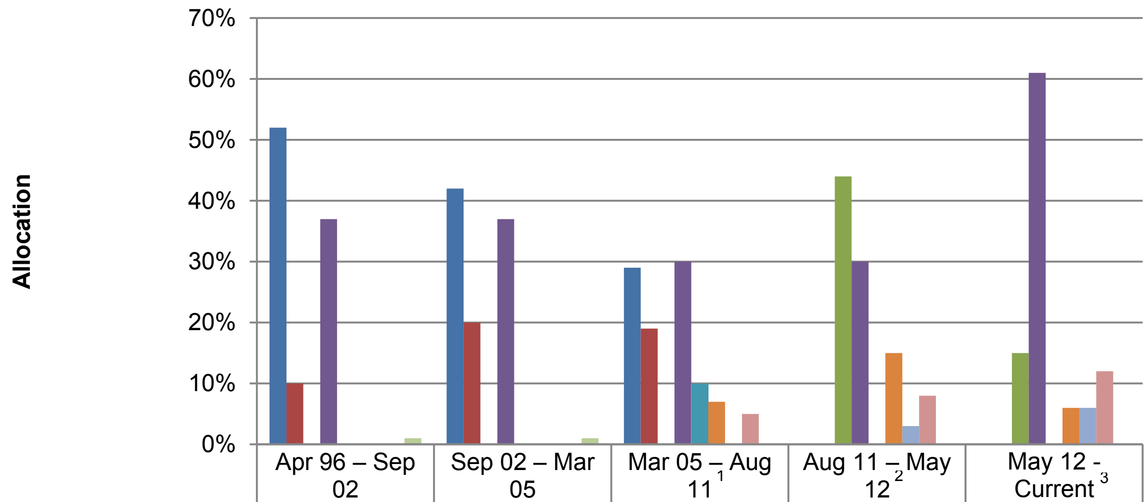
The current Statement of Investment Policy for LTC mandates a comprehensive asset allocation review be presented to the IC at least every three years, with the last comprehensive asset allocation review presented to the IC in May 2012. Hence, an asset allocation review is due for May 2015.

The LTC Program was established in 1995 to administer long-term care for enrolled California public employees and retirees, as well as their spouses, parents, parents-in-law, adult children and adult siblings between the ages of 18 and 79. As of December 31, 2014, the LTC Program has 138,348 active participants and received annual premiums of $293 million. The Program paid out $234 million in benefits to 6,555 active claims in 2014.

In 2012, the Board approved the Stabilization and Open Application Period Project (SOAPP) to stabilize and enhance the long-term sustainability of the LTC Program. Key components of SOAPP included a restructuring of the premiums and benefit packages, and a shift to a more conservative asset allocation strategy as shown in Figure 1 below. The rationale for this shift was based on the LTC Program attributes which included a single source of funding for benefit payments if assets where insufficient to meet liabilities (i.e., the premiums), a high funded status, and a more mature program whereby active enrollments had begun to decline. The decision was supported by the findings from the Long-Term Care Program Market Study stating that the LTC Fund was invested in a much higher allocation to equities than its peers in the insurance industry. Other considerations were more stable and predictable portfolio returns and less expected volatility in the ongoing premium increases.

SOAPP is still active whereby enrolled members are choosing amongst various premium payments and benefit packages through 2016. The outcome of these decisions will materially affect the future benefits and premium estimates.

Figure 1: Benchmark Policy Asset Allocation History



	Apr 96 – Sep 02	Sep 02 – Mar 05	Mar 05 – Aug 11 [1]	Aug 11 – May 12 [2]	May 12 - Current [3]
US Equity	52%	42%	29%	0	0
International Equity	10%	20%	19%	0	0
Global Equity	0	0	0	44%	15%
US Nominal Bonds	37%	37%	30%	30%	61%
US High Yield	0	0	10%	0%	0%
TIPS	0	0	7%	15%	6%
Commodities	0	0	0%	3%	6%
REITs	0	0	5%	8%	12%
Cash	1%	1%	0%	0%	0%

[1] Implementation started in July 2005
[2] Implementation started in November 2011
[3] Implementation started in November 2012

ANALYSIS

Recommendation

A summary of the recommended strategic asset allocation and investment policy changes and rationale are as follows:

1. Staff recommends maintaining the current strategic asset allocation:
    - The premise for shifting to a more conservative portfolio for LTC still holds. Since the LTC Fund has neither capital reserves nor reinsurance against losses, future benefit payments are at risk should the portfolio suffer large investment losses. The LTC Program continues to have a high funded ratio and total enrollments have continued to decline. Please see Program Attributes below for more detail.

    - Staff continues to closely monitor the LTC Fund portfolio and its performance and portfolio risk forecast remain in line with the strategic level of risk tolerance set by the Board in 2012. Please see Historical Performance and Forecasted Volatility below for more detail.

- Given the uncertainty in the future benefits and premiums estimates as a result of the LTC Program stabilization efforts, staff believes it advisable to avoid transaction costs which would result from any asset allocation repositioning. Instead, staff recommends postponing the full asset allocation review until the SOAPP is fully implemented and there is more clarity on the forecasted benefits and premiums. Moreover, this work may be integrated into the Asset Liability Management cycle being used for the PERF and the other Affiliate Programs.

2. Modification to Statement of Investment Policy: To align the LTC Program strategic asset allocation process with the PERF, staff's recommendation is to reference Appendix 1, Reporting to the IC, Investment Office staff - Asset Allocation, in the Total Fund Investment Policy approved by the IC in May 2014 and included as Attachment 2. This change solidifies the linkage between the work of the Investment Office and Actuarial Office in the Asset Liability Management (ALM) process for LTC, 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.

Please see proposed black-lined changes in Attachment 1.

Staff also recommends a modification to the CalPERS Total Fund Investment Policy whereby following any action by the Board capable of resulting in substantial changes to the forecasted benefits, contributions, or premiums of the program, staff will assess and recommend to the IC at the next month following the Board action, as to whether the strategic asset allocation process should be postponed pending completion of such action. The intent of this modification is to strengthen the operational processes of the Investment Office by avoiding administrative or other expenses associated with a scheduled review of the strategic asset allocation process while the program is undergoing significant changes. Accordingly, staff recommends the proposed black-lined policy language related to this concept be added to the CalPERS Total Fund Investment Policy, Section II, Asset Allocation Strategy under Implementation, section A, included as Attachment 2.

Program Attributes
Since inception in 1995, the LTC Program experienced a peak of 176,314 active, premium-paying enrollees in Fiscal Year ending June 30, 2005. Enrollment has gradually declined to 139,950 as of Fiscal Year ending June 30, 2014. The number of claimants has steadily increased since inception and currently stands at 6,336 as of Fiscal Year ending June 30, 2014 (See Figure 2). The LTC Fund Asset Market Value has increased to $4.1 billion as of Fiscal Year ending June 30, 2014, while the Present Value of Future Benefits minus Premiums was estimated to be $3.35 billion (See Figure 3). The funded status and margin were 123% and 23.49%, respectively, as of Fiscal Year ending June 30, 2014. The high funded status, increasing number of claimants, and the reduction in active, premium paying enrollees support the maintenance of a more conservative portfolio for the LTC Fund.

Figure 2: Historical Number of Active Enrollees and Claimants

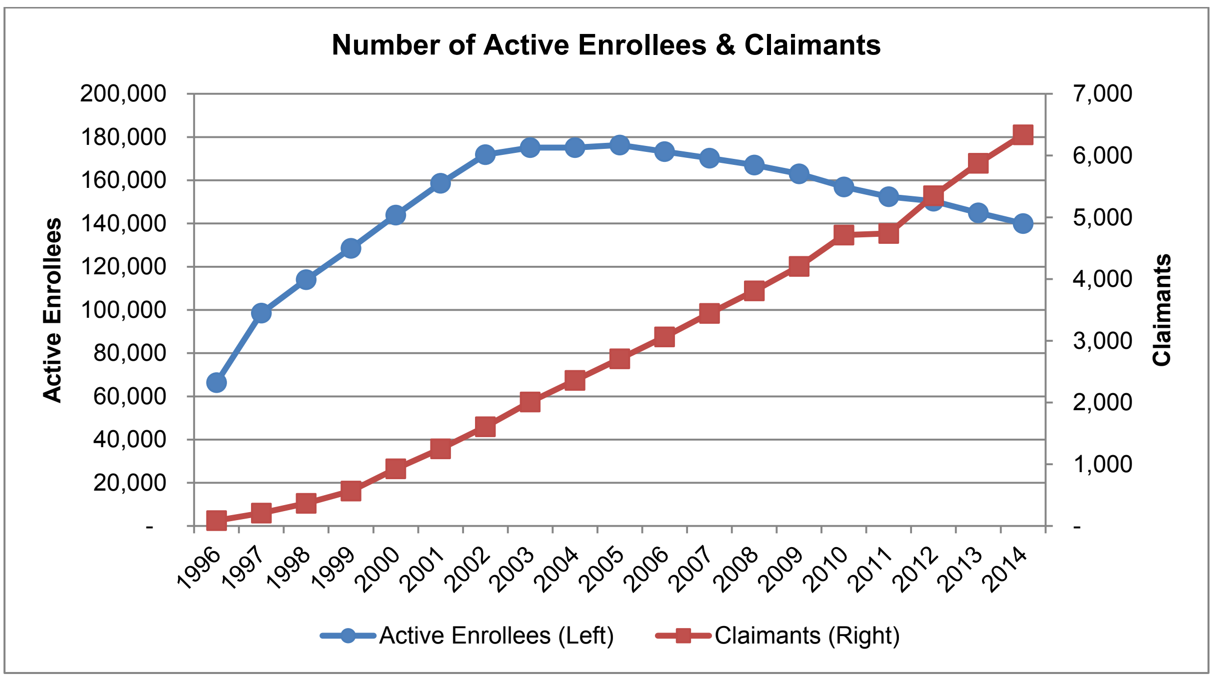
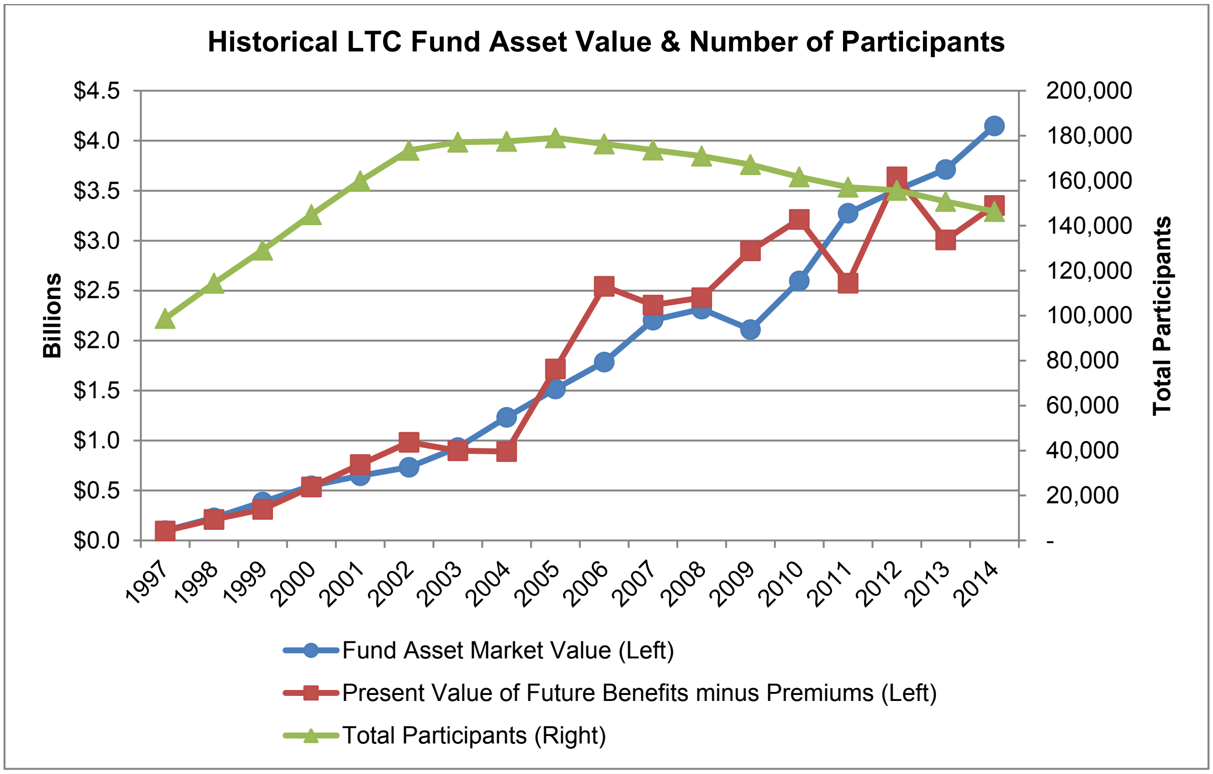


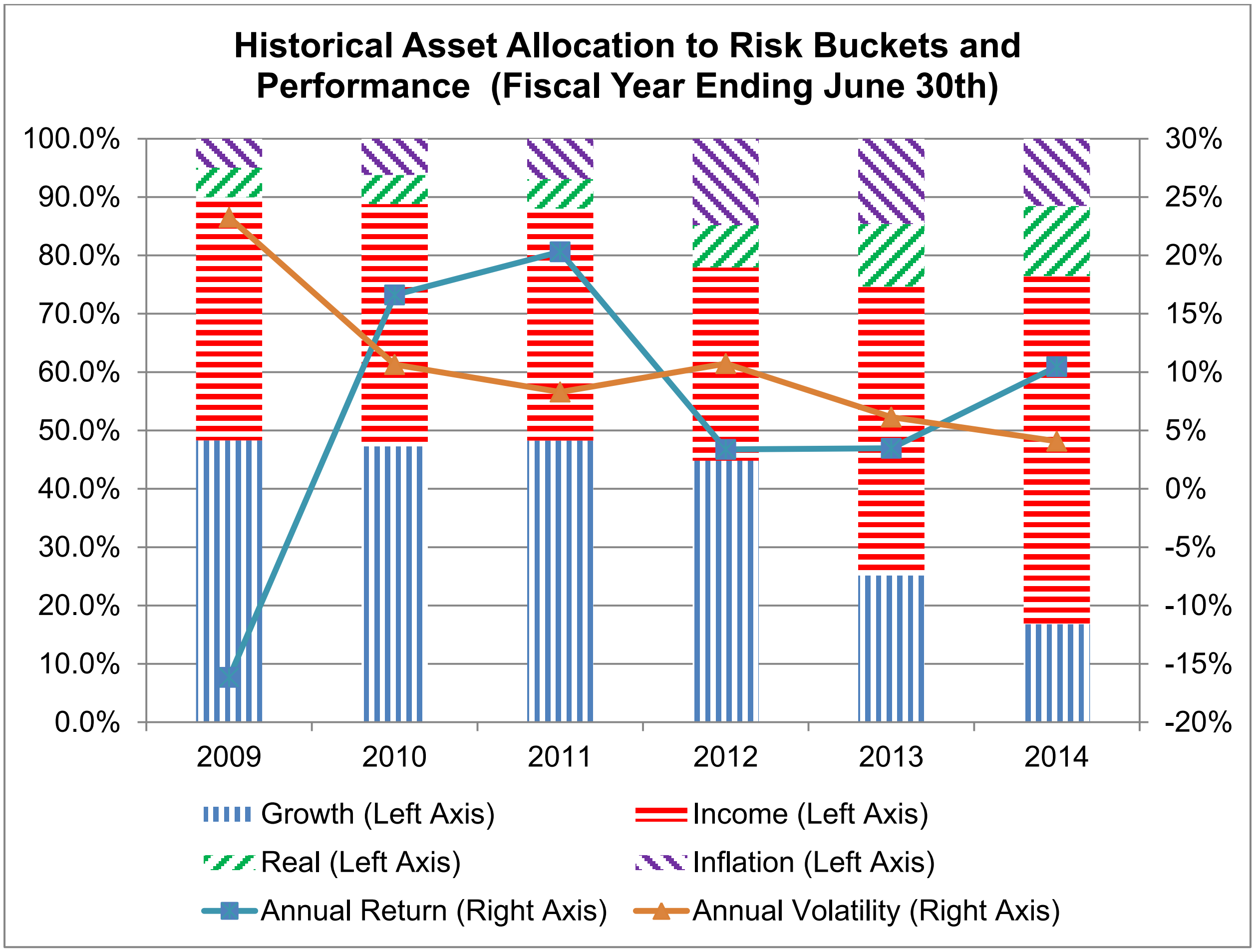
Figure 3: Historical Asset Value and Number of Participants



Historical Performance & Forecasted Volatility

The realized three-year return and volatility for the LTC Fund, as well as the forecasted volatility based on the current asset allocation, fall within the expected return and volatility estimates established by the Board during the Asset Allocation Review of May 2012. As shown in Figure 5 below, the LTC Fund's benchmark historical return volatility has been substantially reduced since 2012 when its allocation to equities was reduced from 44% to 15%. The realized volatility for Fiscal Year ending June 30, 2014 was 4.07%, compared to the Fiscal Year ending June 30, 2012 realized volatility of 10.47%.

Figure 4: Historical Allocation and Performance



As shown in Figure 5 below, the LTC Fund has a one-year return of 6.24% and volatility of 5.23% for the calendar year ending December 31, 2014. Fixed Income and REITs were the largest contributors during this period with one-year returns of 9.95% and 15.98%, respectively, while Commodities had a one-year loss of -40.25%. Fixed Income and TIPS experienced the lowest volatility during the one-year period while Commodities had the highest at 19.78%. The ten-year return was higher for Fixed Income than Global Equity, at 6.75% and 6.49%, respectively, while Fixed Income has a much lower realized volatility at 6.33% than Global Equity at 15.82%. It is important to note that this outcome was largely influenced by the coordinated efforts of global central banks injecting an unprecedented amount of liquidity into the global economy since the financial crisis of 2009.

The three-year annualized realized and excess returns are 5.03% and 0.34%, respectively, while the three-year volatility and active risk are 5.70% and 0.20%, respectively.

Figure 5: Reconstructed Historical LTC Fund Asset Classes Returns & Volatilities using Current Asset Classes (as of March 31, 2015)

Historical Returns	1-Year		3-Year		5-Year		10-Year	
	Return	Excess Return	Return	Excess Return	Return	Excess Return	Return	Excess Return
Total Portfolio	6.24%	0.44%	5.03%	0.34%	6.63%	0.13%	5.74%	0.26%
Global Equity	5.37%	0.24%	11.48%	0.11%	10.03%	0.08%	6.49%	0.04%
U.S. Fixed Income	9.95%	0.05%	5.08%	0.24%	7.11%	0.00%	6.75%	0.50%
TIPS	3.15%	0.03%	0.61%	-0.02%	4.26%	-0.03%	N/A	
Commodities	-40.25%	0.11%	-16.66%	0.24%	N/A		N/A	
REITs	15.98%	0.57%	12.19%	0.35%	11.68%	0.19%	N/A	

Historical Risk	1-Year		3-Year		5-Year		10-Year	
	Risk	Active Risk	Risk	Active Risk	Risk	Active Risk	Risk	Active Risk
Total Portfolio	5.23%	0.19%	5.70%	0.20%	7.69%	0.34%	10.09%	1.05%
Global Equity	8.59%	0.06%	10.41%	0.16%	14.03%	0.12%	15.82%	0.14%
U.S. Fixed Income	5.46%	0.12%	5.48%	0.37%	5.08%	0.91%	6.33%	2.58%
TIPS	5.28%	0.04%	5.37%	0.09%	5.24%	0.16%	N/A	
Commodities	19.78%	0.17%	17.25%	1.21%	N/A		N/A	
REITs	11.25%	0.16%	12.38%	0.24%	15.91%	0.22%	N/A	

Based on the BarraOne Risk Model, the current LTC Fund portfolio has a forecasted volatility of 5.5% as of December 31, 2014, compared to a higher forecasted volatility of 7.1% based on the 2012 asset allocation.

BUDGET AND FISCAL IMPACTS

Not Applicable

BENEFITS/RISKS

The proposed recommendations provide the following benefits:

- Maintain the same target asset allocations which results in the maintenance of approximately the same risk and return profile established in 2012.
- Avoids transaction costs by not re-allocating the LTC assets while the underlying program is undergoing its restructuring and the choices of the member's premium and benefit packages are unknown.
- Aligns the LTC Fund strategic asset allocation process with the PERF.

- Recognizes the need to potentially postpone scheduled asset allocation activities during periods of restructuring or assessment as directed by the Board.

The proposed recommendation carries with it the following risk:

- A risk to maintaining the existing asset allocation is that the current portfolio may be suboptimal given the latest capital market assumptions.

ATTACHMENTS
Attachment 1 – LTC Statement of Investment Policy with Proposed Revisions
Attachment 2 – CalPERS Total Fund Investment Policy with Proposed Revisions
Attachment 3 – Wilshire Associates Opinion Letter
Attachment 4 – PCA Opinion Letter

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