CalPERS

Investment Committee

California Public Employees' Retirement System

Agenda Item 7b

May 18, 2015

ITEM NAME: Proposed Revision of Liquidity Asset Class Target, Range and Benchmark

PROGRAM: Total Fund

ITEM TYPE: Asset Allocation, Performance & Risk – Information

EXECUTIVE SUMMARY

Several topics were discussed in the April 2015 Investment Committee (Committee) meeting under Agenda Item 6a, *Strategic Asset Allocation Interim Targets Review*. Based on the discussion at that meeting staff believes that some of the topics were settled in April and others are still unsettled:

Settled Topics

- Maintain existing interim allocation targets for Private Equity, Real Assets and Global Equity
- Focus the role of the Liquidity Program to ensure sufficient cash to meet CalPERS' obligations
- Modify the Liquidity benchmark to a cash-only benchmark
- If the Liquidity allocation target is reduced, divert any reduction into Global Fixed Income

Unsettled Topic

- Create a new interim target for Liquidity at 1% and expand the range around that target to +/-3%. Implementation of a +/-3% range for the Liquidity target would establish a mechanism for CalPERS to "borrow liquidity" from itself, as an additional liquidity risk management tool through the use of leverage.

The focus of this agenda item is to provide further analysis around the topic of the 1% Liquidity target and expanded range. Staff seeks feedback from the Committee on the preferred course of action between two alternatives:

1. The Liquidity Target is maintained at 2% with a range of +/-1%, the stated role of Liquidity is modified and the Liquidity benchmark is changed to a cash-only benchmark
2. The Liquidity Target is reduced to 1% with a range of +/-3%, the stated role of Liquidity is modified and the Liquidity benchmark is changed to a cash-only benchmark

If the Committee elects the 1% Liquidity target with the +/-3% range, it should be noted that the borrowed liquidity approach will not be incorporated into policy until Investment Office procedures and reporting enhancements are developed.

Policy changes will be brought to the Committee in a future meeting. Opinion letters from the Board's Investment Consultants are provided as Attachments 2 and 3.

STRATEGIC PLAN

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

- Investment Belief #1 (Liabilities must influence the asset structure): The flexibility associated with the expanded range around the Liquidity target will enhance the ability to pay promised benefits during periods of market stress.
- Investment Belief # 6 (Strategic asset allocation is the dominant determinant of portfolio risk and return): The reduction in the Liquidity target enhances the risk/return characteristics of the fund.
- Investment Belief #8 (Costs matter and need to be proactively managed): The sourcing of borrowed liquidity from internally-available cash is more cost-effective than borrowing cash from a bank line of credit.
- Investment Belief #10 (Strong processes and teamwork and deep resources are needed to achieve CalPERS goals and objectives): Strong processes and governance are being established to manage Liquidity.

BACKGROUND

An extensive discussion regarding the background of CalPERS' Liquidity allocation and liquidity management was included in the April 2015 Committee meeting. In summary CalPERS continues to enhance operational processes related to liquidity management and lessons learned from the 2008 crisis:

- A 2% strategic allocation to Liquidity was approved as part of CalPERS' Policy Portfolio in February 2014.
- Over the past year, significant progress has been made with respect to managing cash flows, as a result of a joint effort between the Financial Office (FINO) and the Investment Office (INVO).
- A Treasury Management Policy was approved by the Board in March 2015.

April 2015 Agenda Item 6a stated that a cash reserve account will be held within the Public Employees' Retirement Fund (PERF) for operating cash. Subsequently, FINO and INVO have agreed that maintaining the cash reserve account outside of the

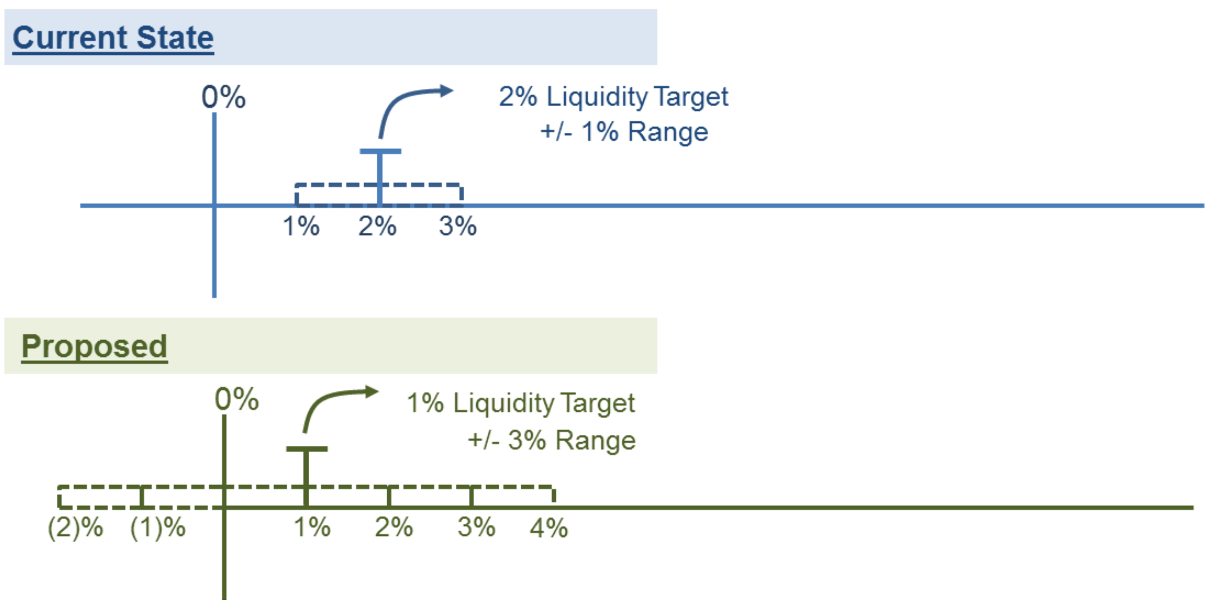
Policy Portfolio would be more manageable and therefore this account will likely not be part of the Liquidity Program. This topic, the operating cash reserve account, will be brought to the Finance & Administration Committee separately in a future meeting.

Issues that appeared to be settled at the April Committee meeting are not addressed further in this item.

ANALYSIS

To expand CalPERS' operational liquidity management options, staff has proposed the Liquidity target be reduced to 1%, with an expanded range of +/- 3%. The expanded range will provide CalPERS with the flexibility to respond to unforeseen situations where cash in excess of what is available in the Liquidity allocation is required on short notice. As indicated in the background section, it is anticipated that the operating cash reserve account will be managed outside of the Liquidity Program.

Figure 1: Expanded Range and Proposed Target



The expanded range around the Liquidity target is being recommended to:

1. Allow time for decisions to be made on how to deploy or source cash following a large inflow or outflow of cash to or from the PERF
2. Address a timing mismatch associated with a large inflow and outflow of cash
3. Address unusual cash flow requirements that may stem from periods of market stress

Implications: Upper End of Range

The expansion of the upper end of the range will be useful if a large unexpected cash flow is received to allow time to deploy the cash.

- An example would be an unexpected large return of capital from a Private Equity or Real Assets partner.

The upper end of the range may also be used to create an additional cushion for future events if market liquidity is seen to be tightening.

Implications: Lower End of Range

The expansion of the lower end of the range will allow time to access cash without incurring unnecessary expenses should a large operational cash outflow be required. The lower end of the range could provide flexibility to deal with unexpected cash requirements due to market conditions, or simply to address a short-term mismatch on funding.

- For example, a situation may arise where cash is required for a Private Equity or Real Estate investment today and cash is expected from another Private Equity or Real Estate investment a week or two later. The expanded range could prevent the sale and repurchase of public equities to address this scenario.

The borrowed liquidity approach would be for short-term use (expected < 90 days), and would function like "overdraft protection." This approach is preferred because it would utilize CalPERS' existing resources and assets and be implementable quickly with internal controls.

Short-term Borrowed Liquidity

At least two broad potential sources of cash could be accessed in the event that borrowed liquidity was needed on a short-term basis. Attachment 1 provides diagrams that describe two potential sources of borrowed liquidity, a futures cash account, and cash collateral from securities lending. The borrowed liquidity approach is anticipated to be used on an "exception" basis, not as part of routine operations.

Enhanced Policy, Procedure, and Reporting Resources

The use of the borrowed liquidity approach must be accompanied by effective policy, procedure, and reporting resources. In addition to the development of the associated policies and procedures, staff would propose that:

a. Authority for the utilization of borrowed liquidity be delegated to the Chief Investment Officer and implementable through the Investment Strategy Group

b. Enhanced leverage reporting is provided to the Committee on a monthly basis.

A decision-making and reporting flowchart is provided in Attachment 1. Examples of the current leverage reports, provided to the Committee as a part of the semi-annual trust level performance and risk reports are also provided in Attachment 1.

BUDGET AND FISCAL IMPACTS
Not Applicable.

BENEFITS/RISKS
Establishing an interim target for Liquidity at 1% is anticipated to increase the expected return of the PERF by 0.02%, and increase the volatility of the PERF by 0.02%. Any use of the borrowed liquidity approach must comply with the existing risk management guidelines.

Benefits associated with increasing the range around the Liquidity target to +/-3% are anticipated to include:

- Increased operational flexibility
- Reduced transaction costs
- Provision of a "time buffer" to facilitate the investment decision process.

Risks associated with increasing the range include:

- Added leverage which may marginally impact the risk and return profile of the PERF
- Some increase in operational complexity

The benefit of focusing the role of the Liquidity allocation and modifying the benchmark is more focus and reduced complexity within the Liquidity program. The risk profile of the PERF will also be marginally reduced as a result of this change.

ATTACHMENTS
Attachment 1 – Presentation – Interim Allocation Targets Review Follow-up: Liquidity Allocation Role, Target, Range & Implications

Attachment 2 – Wilshire Associates Opinion Letter

Attachment 3 – Pension Consulting Alliance Inc. Opinion Letter

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