Wilshire

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Mr. Henry Jones
Chair of the Investment Committee
California Public Employees' Retirement System
400 Q Street
Sacramento, CA 95814

Re: Strategic Asset Allocation Interim Targets Review

Dear Mr. Jones:

Overview

At the April Investment Committee meeting, Staff presented a number of asset allocation points for the Committee's consideration. While there was consensus amongst the Committee members that the interim strategic asset allocation targets proposed should be adopted/continued for the private asset classes, more information was requested with respect to Staff's proposed revision to the target and range for the liquidity program.

Investment Beliefs and Discussion

As Wilshire noted in our opinion letter for the April agenda item, CalPERS's Investment Beliefs contain language that addresses several germane topics. For example, Investment Belief 6 states that "Strategic asset allocation is the dominant determinant of portfolio risk and return." Further, "CalPERS will seek to add value with disciplined, dynamic asset allocation processes, such as mean reversion." This belief argues for setting an appropriate strategic asset allocation, but not becoming so beholden to it as to be unable to execute any dynamic strategies to try to capture excess risk-adjusted returns that may periodically be available in the global financial markets.

Investment Belief 9 states that "Risk to CalPERS is multi-faceted and not fully captured through measures such as volatility or tracking error." Additionally, "The path of returns matters, because highly volatile returns can have unexpected impacts on contribution rates and funding status." This belief emphasizes that CalPERS' asset allocation, while officially set every four years during the Asset-Liability workshop, must be managed in a way that balances

the returns available against the potential for large drawdowns, which could have significantly deleterious impacts on CalPERS.

Both beliefs address, but do not provide clear cut support or opposition for the proposed liquidity target and range. For example, using borrowed liquidity could protect CalPERS from selling assets at fire sale prices to raise liquidity. However, there is no signal from the market as to when asset prices will stop falling and start rising, so using borrowed liquidity – even in an attempt to protect the fund – could ultimately exacerbate the losses that Staff intends to avoid.

Thus, borrowed liquidity is neither inherently good nor bad. It is simply another tool that Staff could use, should the IC approve of the proposed change to the target and ranges of the liquidity program. Additionally, as Staff has noted, CalPERS already makes use of liquidity across its portfolio. Typically, those strategies seek to add returns to unlevered strategies (such as real estate or infrastructure) or to move/port "alpha" from one asset class to another (using a fixed income alpha stream coupled with equity beta (commonly known as portable alpha)).

Wilshire believes that Staff has addressed two essential concerns in this presentation: 1) how the borrowed liquidity would be created; and 2) how long might the borrowed liquidity be utilized. First, Staff is proposing using the securities lending collateral pool as a source of borrowing or using under-collateralized futures. In both cases, the economic exposure of the original portfolio would be maintained and CalPERS would have access to additional liquidity. Equally important, is what structures are not intended to be used to create the borrowed liquidity – namely, a line of credit or other outright borrowing facility.

Second, Staff anticipates that the borrowed liquidity would be used for periods of less than 90 days. Wilshire cautions against making this a hard limit, which simply extends the original need for liquidity for three months. While three months should be sufficient under most scenarios, in the event of a significant market dislocation, it could be the case that extending the borrowed liquidity beyond 90 days might be prudent. This can be addressed in policy language and should be reported on regularly to the Investment Committee (as Staff is proposing).

Conclusion

Wilshire supports the ability for CalPERS to make use of borrowed liquidity in temporary circumstances, provided there is sufficient flexibility, governance and reporting in the approach. Wilshire believes that Staff's proposal meets these characteristics and recommends that the Investment Committee approve the lower, 1% target to Liquidity with the +/3% range.

Should you require anything further or have any questions, please do not hesitate to contact us.

Best regards,

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