Agenda Item 6a

June 15, 2015

ITEM NAME: Revision of the Total Fund Investment Policy Regarding the Liquidity Asset Class

PROGRAM: Total Fund

ITEM TYPE: Asset Allocation, Performance & Risk – Action

RECOMMENDATION

Select one of two courses of action along with the corresponding policy revisions:

Option 1 – Staff's recommendation, policy changes provided in Attachment 1

- Maintain the existing interim strategic asset allocation targets for Private Equity, Real Assets and Global Equity
- Establish interim strategic asset allocation targets of 1% for Liquidity and 20% for Global Fixed Income (GFI) and expand the range relative to target for the Liquidity asset class to +/- 3%.
- Simplify the strategic objective of the Liquidity asset class to focus solely on ensuring sufficient liquidity to meet CalPERS' obligations in an efficient manner
- Revise CalPERS' Liquidity asset class policy benchmark to a 91-day Treasury Bill benchmark

Option 2 – Policy changes provided in Attachment 2

- Maintain the existing interim strategic asset allocation targets for Private Equity, Real Assets and Global Equity
- Maintain the existing strategic asset allocation target and range for Liquidity asset class
- Simplify the strategic objective of the Liquidity asset class to focus solely on ensuring sufficient liquidity to meet CalPERS' obligations in an efficient manner
- Revise CalPERS' Liquidity asset class policy benchmark to a 91-day Treasury Bill benchmark

EXECUTIVE SUMMARY
Throughout the April and May 2015 Investment Committee meetings several topics and proposals have been discussed:

1) It is appropriate to maintain the existing interim strategic asset allocation targets for Private Equity, Real Assets and Global Equity at this time.
2) The strategic objective of the Liquidity Program should be simplified and focused on ensuring enough liquidity is available to meet CalPERS' obligations.
3) The Liquidity policy benchmark should be changed to a cash-only benchmark.
4) Create a new interim target for Liquidity at 1% (previously 2%) and expand the range around that target to +/- 3% (previously +/-1%), permitting the use of a "borrowed liquidity approach" as a liquidity management tool to address short-term cash imbalances. Add 1% to the target for GFI, thus creating a new interim target for GFI of 20%.

There appeared to be consensus around the first three items, so they are common to both alternatives (Option 1 and Option 2) being considered for action.

<u>Option 1 – Proposed Policy Revisions</u>

Attachment 1 shows the respective policy changes for the Total Fund Investment Policy associated with Option 1, acceptance of all staff's recommendations including revisions to the Liquidity asset class target and range, and increasing the allocation to GFI by 1%.

It should be noted that if the Committee approves the proposed interim asset allocation, the borrowed liquidity approach will not be utilized until Investment Office procedures and reporting enhancements are developed. Staff anticipates this would not be complete until late 2015 or early 2016.

<u>Option 2 – Proposed Policy Revisions</u>

Attachment 2 presents Total Fund Investment Policy changes consistent with Option 2, leaving the target for Liquidity at 2% and the range for Liquidity at +/- 1%.

Wilshire Associates' opinion letter is provided as Attachment 3. The Pension Consulting Alliance Inc. opinion letter provided for the May 2015 item has been reissued for this item and, consistent with the recommendations and content, is unchanged (Attachment 4). A summary of the proposed Total Fund Investment Policy changes and corresponding rationale is provided as Attachment 5.

Revision of the strategic objective of the Liquidity asset class is expected to impact the Liquidity Program Policy; however, in consideration of the upcoming Global Fixed Income Program annual review, the ongoing Investment Policy revision project, and to make the highest use of the Committee's time staff anticipates proposing a consolidated set of proposed changes to the Liquidity Program Policy in the coming months.

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 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.

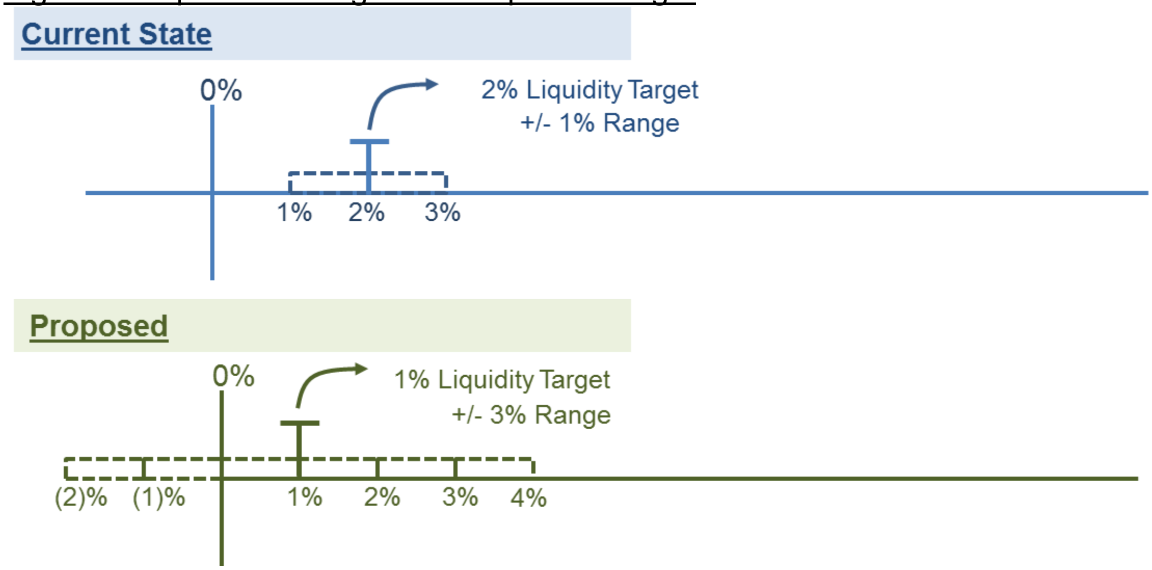
BACKGROUND
An extensive discussion regarding the background of CalPERS' Liquidity allocation and liquidity management was included in the April and May 2015 Committee meetings. An interim Liquidity target of 1% with a range of +/-3% was proposed in April.

During the April meeting several Board members requested a more detailed discussion on the use of the borrowed liquidity approach and the associated leverage implications. These topics were discussed in more detail during the May Committee meeting, including a description of situations where the borrowed liquidity approach may be used, how it would be implemented and key governance considerations associated with the use of borrowed liquidity. It was also discussed that the operating cash reserve account associated with CalPERS' Treasury Management Policy is anticipated to be managed outside of the Liquidity program. A summary is provided in the following section.

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 (such as a short-term "mismatch" between incoming and outgoing cash flows).

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 Public Employees' Retirement Fund (PERF)
2. Address short-term timing mismatches associated with a large inflow and outflow of cash
3. Enhance ability to manage unusual cash flow requirements that may stem from periods of market stress

The expanded range is intended to:

- Be used on a short-term basis (anticipated <90 days)
- Be a liquidity management tool
- Minimize transactions to meet frictional cash flows
- Provide time for investment decisions

The expanded range is:

- Not establishing long-term leverage on the Total Fund
- Not intended to materially impact returns
- Not intended to impact CalPERS' treasury management reserve
- Not to be undertaken without corresponding enhancements to policy, procedures, and reporting

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 is proposing that:

a. Authority for the utilization of borrowed liquidity is delegated to the Chief Investment Officer and implementable through the Investment Strategy Group.
b. Enhanced leverage reporting is provided to the Committee whenever the actual Liquidity allocation declines below 0.

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 will 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 and maximize CalPERS' economic interests

Risks associated with increasing the range include:

- Temporary leverage which may marginally impact the risk and return profile of the PERF
- Some increase in operational complexity. However, staff believes the benefits of the expanded range, as an additional liquidity management tool, outweigh the potential complexity.

The benefit of simplifying the role of the Liquidity allocation and modifying the benchmark is more focus and reduced complexity within the Liquidity Program.

ATTACHMENTS

Attachment 1 – Option 1: Revised Total Fund Investment Policy (all proposals incorporated)

Attachment 2 – Option 2: Revised Total Fund Investment Policy (Liquidity target and range remain unchanged)

Attachment 3 – Wilshire Associates Opinion Letter

Attachment 4 – Pension Consulting Alliance Inc. Opinion Letter

Attachment 5 – Summary of Proposed Total Fund Investment Policy Changes

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