Andrew Junkin, CFA, CAIA
Managing Director & Principal

June 1, 2015

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. This information was provided and discussed in the May Investment Committee meeting. Staff is now presenting the proposed changes as an action item.

Recommendation

Wilshire recommends that the Investment Committee approve Option 1, which is also Staff's recommendation. Option 1 allows for the use of leverage in PERF, as has been discussed. Wilshire believes that Staff understands how to implement the use of leverage on a short-term basis to try to protect CalPERS' interests and appreciates the potential risks of doing so.

Investment Beliefs and Discussion

As Wilshire noted in our opinion letter for the April and May agenda items, 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 leverage 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 agrees that it is appropriate to delegate the authority to using leverage to the Chief Investment Officer and that the enhanced reporting is prudent and is a way to appropriately highlight when leverage is being used.

Wilshire has reviewed the proposed policy changes for both Option 1 and Option 2 and believe the proposed changes are suitable, depending on which Option the Investment Committee selects.

Conclusion

Wilshire recommends that the Investment Committee approve Option 1 and approve the corresponding policy changes to allow Staff to implement the revised asset allocation with targets and ranges and the new benchmark for the liquidity portfolio.

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

Best regards,