PCA | PENSION CONSULTING ALLIANCE

May 5, 2015

Mr. Henry Jones, Chairman
Investment Committee
California Public Employees' Retirement System
Sacramento, California 95814

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

Dear Mr. Jones,

The purpose of this letter is to provide the Investment Committee with Pension Consulting Alliance's (PCA's) opinion regarding Agenda Item 7b for the May Investment Committee meeting. In summary, PCA supports the staff's recommendations for establishing a new target and allocation range for the Liquidity class.

Discussion

Staff is recommending two changes to investment policy related to the Liquidity asset class. These changes are: (i) lower the allocation target to 1% and (ii) widen the range around the new target from +/- 1% to +/-3%. After a review of the documentation and having follow-up conversations with staff on this matter, PCA concurs with staff's recommendations.

Moving to a 1% Liquidity allocation target is reasonable and prudent, particularly given CalPERS' enhancement in the cash management area over the last couple of years. As reviewed and discussed in prior meetings, CalPERS has introduced new technology and procedures to managing its overall investment portfolio liquidity. In light of this evolution, PCA is comfortable with staff's ability to manage overall liquidity around a 1% long-term target, rather than the current 2% target. In addition, as discussed in prior meetings, it is expected that the Liquidity portfolio will also have a lower-risk benchmark (mandate) than utilized previously. So, even though the Liquidity class will be managed at a lower proposed level, it should be considered a marginally safer investment from a protection-of-principal standpoint. Finally, moving to the 1% target allows CalPERS to shift 1% of its assets to higher-returning investments, providing marginal expected increases in investment return over a long-term investment horizon.

The proposed wider allocation range of Liquidity around its target (allowing for an allocation of anywhere from -2% to +4% of total portfolio assets) introduces the concept of explicit leverage into the Liquidity class. Staff indicates that the new allocation range should be viewed more as an additional tool to better manage the ongoing liquidity of the Total Portfolio. In this respect, the potential negative cash balance (i.e., the potential to borrow) can be viewed more as a lending facility to improve ongoing operations. Along these lines, staff has indicated that the wider allocation range will be utilized only in a transitory/interim fashion versus seeking to maintain ongoing leverage in order to increase returns. Given the planning to-date for implementing this wider range, PCA believes staff has acted prudently and deliberately in reviewing and recommending this proposal. Along these lines, staff's proposed use of security lending cash collateral and futures cash collateral as short-term sources of cash/liquidity appears reasonable as long as the projected uses for such liquidity are short-term in nature and restored within reasonable short-term time periods.

To ensure ongoing success of this recommendation, the Investment Committee will likely need to monitor the activities of the Liquidity class closely to ensure the class is meeting its role and objectives on an ongoing basis. In this light, staff's commitment to enhance the Liquidity class reporting process is an important priority.

We look forward to addressing any questions or clarifications on these matters at the Investment Committee meeting.

Respectfully,

Allan Emkin