CalPERS

Investment Committee

Agenda Item 6a

April 18, 2016

Item Name: Health Care Fund Asset Allocation Review

Program: Affiliate Investment Program

Item Type: Action

Recommendation
Approve staff's recommendation to maintain the current asset allocation for the Public Employees' Health Care Fund (HCF) reserve fund in the Barclays U.S. Aggregate Bond Index.

Wilshire Associates' opinion letter is provided as Attachment 1.

Executive Summary
This agenda item reports the asset allocation study performed by staff on the HCF reserve fund, and staff seeks approval from the Investment Committee on its recommendation. Staff recommends maintaining the current asset allocation in the Barclays U.S. Aggregate Bond Index for the HCF reserve fund, given the liquidity requirement to fund health care claims, investment income to offset premium costs, and limited ability to absorb investment losses.

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 CalPERS Investment Belief 1, liabilities must influence the asset structure, and Investment Belief 6, strategic asset allocation is the dominant determinant of portfolio risk and return.

Background
The CalPERS Investment Policy for Public Employees' Health Care Fund, in conjunction with the CalPERS Total Fund Investment Policy, mandates a comprehensive asset allocation review every four years to be presented to the Investment Committee for review. The next review for HCF reserve fund is due before May 2016.

The HCF reserve fund was established as a safeguard for the self-funded Preferred Provider Organization (PPO) program if claims are higher than anticipated or upon any cash shortfalls during a potential PPO plan shutdown scenario. Its investment objective is to provide stability of principal, while avoiding large losses, enhance returns within prudent levels of risk, and maintain liquidity to meet cash needs. Since 1997, the HCF reserve fund has been 100% allocated to a U.S. fixed income program with the Barclays U.S. Aggregate Index as the benchmark. As of December 31, 2015, the HCF reserve fund amounts to $423.4 million.

Analysis

Program Attributes

Health care benefits are currently funded through a pay-as-you-go approach, whereby annual health care premium levels are established annually, and are designed to be sufficient to pay expected annual benefits payments only, and not to pre-fund future liabilities.

The HCF reserve fund acts as a reserve for any unforeseeable health care claims and/or for cash flow coverage in a plan shutdown scenario. Accordingly, the HCF reserve fund needs to be invested in an asset class that is liquid, has a relatively stable value and generates modest income during the holding period.

Historical Performance

The HCF reserve fund has been 100% invested in a Barclays U.S. Aggregate Index bond fund, which consists of high quality investment grade bond securities such as U.S. Treasuries, agency, corporate, and securitized instruments (Figure 1 & Figure 2). In the last ten years, the HCF reserve fund has an average annual return of 4.8% and has experienced positive returns in all of those years, while the Barclays U.S. Aggregate Index has experienced an average annual return of 4.5% (Figure 3). As of 12/31/2015, the yield of the HCF reserve bond fund is 3.1%, which is the same as the yield from the Barclays U.S. Aggregate Bond Index.

Figure 1

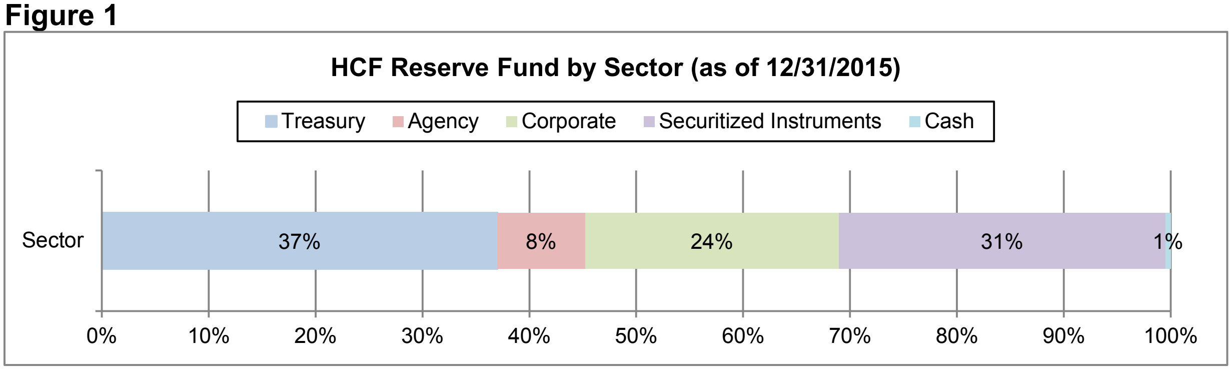


Figure 2

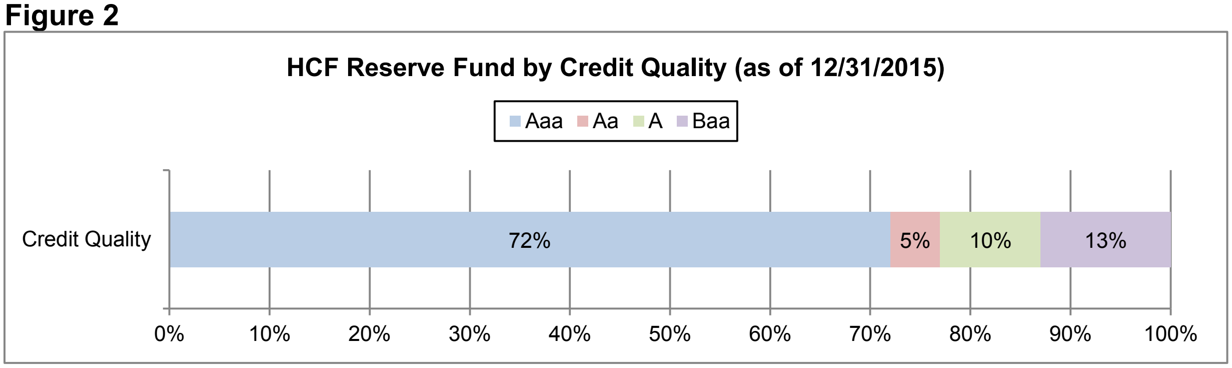


Figure 3

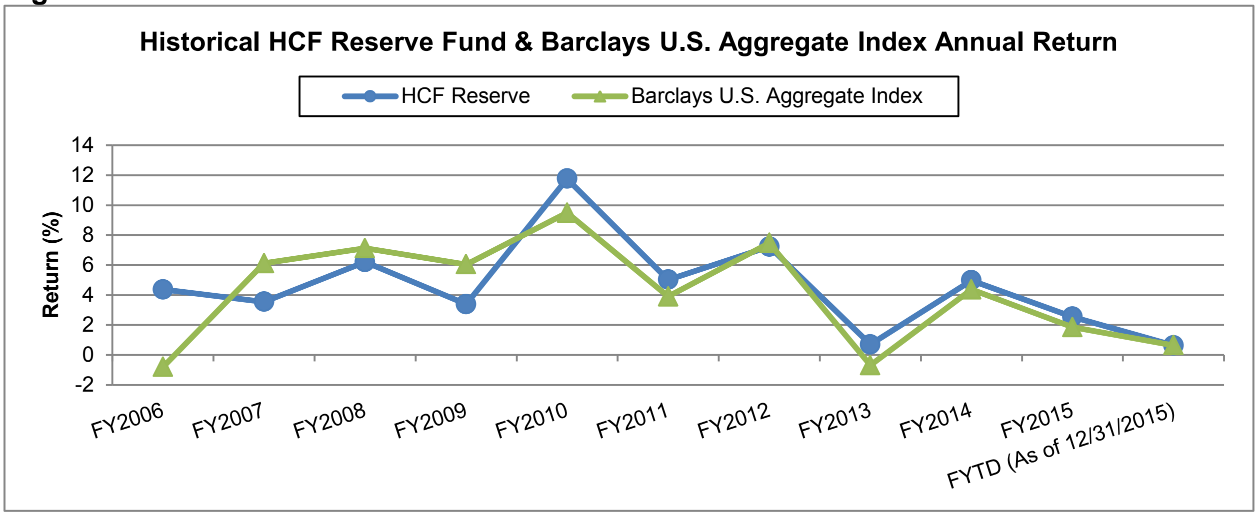


Table 1 summarizes the historical HCF reserve fund performance as of December 31, 2015.

Table 1 – HCF Reserve Fund Performance (As of December 31, 2015)

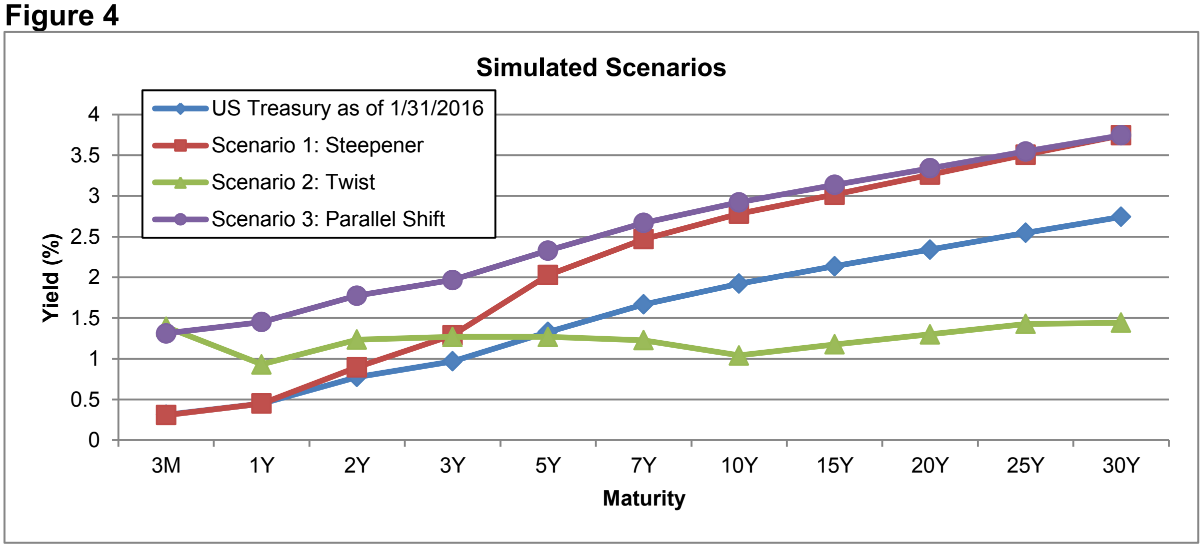
Performance Summary	FYTD	1 Year	3 Year	5 Year	10 Year
Net Return of HCF Reserve Fund	0.6%	0.6%	2.0%	3.8%	4.8%
Excess Return to Benchmark	-0.02%	0.09%	0.59%	0.56%	0.29%

Forecasted Performance

Staff constructed the following three scenarios to examine the price impact of possible rising interest rates, over a twelve months period, on the Barclays U.S. Aggregate Index bond fund (Figure 4):

1. A steepening of the yield curve by 1% at the 30-Year Maturity.
2. A twist of the yield curve with +1% on the 3-Month Maturity and -1% on the 30-Year Maturity.
3. A 1% upward parallel shift throughout all maturities.

Figure 4



The projected price impacts of the three scenarios are summarized in Table 2.

Table 2

	Scenario 1	Scenario 2	Scenario 3
Price Return	-3.7%	2.6%	-5.2%
Income Return (Yield)	3.5%	2.8%	3.9%
12 Months Total Return	-0.2%	5.4%	-1.3%

The duration of the Barclays U.S. Aggregate index is approximately five years, implying that if interest rates instantaneously increase by one percentage point, the HCF reserve fund value will be reduced by 5.2%, or $22 million. However, if the impact is examined over a 12-month period, the income return component should alleviate the value reduction to 1.3%, or $5.5 million[1].

Based on the BarraOne Risk Model, the Barclays U.S. Aggregate Bond Index is forecasted to maintain a low volatility of approximately 4.0%. Even throughout the last financial crisis, the HCF reserve fund retained a strong liquidity profile, and consistently generated positive cash flows. The current 100% allocation to the Barclays U.S. Aggregate Bond Index remains suitable for the HCF reserve fund given the need for liquidity to fund health care claims, the importance of investment income to offset health care premium costs, and the program's limited ability to absorb investment losses in the event that claims are substantially higher than expected.

Budget and Fiscal Impacts

Not Applicable

Benefits and Risks

The proposed Strategic Asset Allocation maintains a low level of expected volatility for the HCF reserve fund to minimize potential negative financial impact to the program, while generating modest income to offset health care premium costs and maintaining robust liquidity to fund health care claims.

The proposed recommendation carries risk that interest rates rise substantially at the same time that health care claims exceed premiums, forcing a drawdown on the HCF reserve fund and a realization of investment losses.

This risk is mitigated by:

- Maintaining a Risk Based Capital required reserve at 300% of the authorized control level[1]
- The annual resetting of the health care premiums.

[1] The Risk Based Capital required reserve is independently developed by the National Association of Insurance Commissioners (NAIC). A level below 200% would require corrective actions.

Attachment
Attachment 1 – Wilshire Associates Opinion Letter

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