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June 2, 2016

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

Re: Interim Asset Allocation Targets Review

Dear Mr. Jones:

You requested Wilshire's opinion with respect to the interim asset allocation targets review. In May of 2014, at the culmination of CalPERS' 2013-14 ALM process, the Investment Committee (Committee) took action to revise the Total Fund Investment Policy (Total Fund Policy). The Committee's action in setting the Total Fund Policy also required that a market-valuation-based analysis be brought to the Committee at the midpoint of the established four-year ALM cycle, or as warranted by changes in market conditions. This is the first such midpoint asset allocation review.

Consistent with CalPERS' Investment Belief #6, which states that strategic asset allocation is the dominant determinant of portfolio risk and return, establishing an appropriate asset allocation mix is the primary means by which CalPERS can manage its investment risk profile. Other Investment Beliefs that are related to setting and monitoring the strategic asset allocation policy include Investment Beliefs #2 - that a long-term investment horizon is a responsibility and an advantage, #3 - that CalPERS investment decisions may reflect wider stakeholder views provided they are consistent with its fiduciary duty to members and beneficiaries, and #8 - that costs matter and need to be effectively managed.

Similar to the economic backdrop that existed when CalPERS' 2013 capital market assumptions were established – those that were used to set the current allocation policy - current market pricing and valuation levels are reflective of a general low yield environment. Despite a mild tightening by the U.S. Federal Reserve, global monetary policy remains quite accommodative. However, we are now three additional years removed from the global financial crisis and further along in the current credit cycle. These are all important considerations when reviewing the asset allocation policy.

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Below we present Wilshire's current forward-looking assumptions across CalPERS' major asset class groupings and contrast them with the same forecasts from three years earlier to provide some context on how our view of long-term market prospects have changed; the third panel of figures shows the change in return and risk assumptions over this three-year period.

	March 2013		March 2016		Difference	
	Return	Risk	Return	Risk	Return	Risk
Global Equity	7.75	17.30	6.70	17.1	-1.05	-0.2
Fixed Income	3.35	6.90	3.20	6.9	-0.15	0.0
Private Equity	10.45	27.50	9.40	27.5	-1.05	0.0
Real Estate	6.00	12.25	5.95	14.0	-0.05	1.8
Infrastructure & Forestland	7.10	10.40	6.75	10.8	-0.35	0.4
Inflation Assets	3.30	6.05	3.15	6.4	-0.15	0.4
Liquidity	1.50	1.25	1.40	1.3	-0.10	0.0
Total Fund	7.10	12.10	6.40	12.4	-0.70	0.3

Applying the above asset class assumptions to CalPERS' current interim asset allocation targets, suggests a 6.40% forecast today versus 7.10% three years ago. The 70 basis points reduction in return expectation at comparable risk levels suggests a modest decrease in return per unit of risk taken (i.e. a lower expected Sharpe Ratio).

While the reduced portfolio return expectation versus three years ago could encourage additional risk-taking in an attempt to maintain a higher expected return, such action would seem contrary to the Committee's long-term plans for portfolio de-risking. Along with Wilshire's standard asset class assumptions, which are meant to represent a ten-year horizon, we maintain a set of equilibrium assumptions for assessing return prospects over longer-term horizons. Using these assumptions to generate a 30-year forecast – something that is more in line with CalPERS' investment horizon - we forecast a portfolio level return of 7.80% today versus 8.05% three years ago, or just a quarter-percent reduction.

As can be seen in the table above, the lower return at the total fund level results from broad reductions in return expectations across asset class groupings. These similar directional moves in asset class assumptions suggest that current long-term market prospects remain generally consistent with the risk profile expressed within the current interim target allocation.

Wilshire, therefore, supports Staff's recommendation to maintain the interim strategic asset allocation targets, as approved in 2015. It should be noted that the recommendation to maintain current interim asset allocation targets does not take into consideration future de-risking shifts that may occur as part of the preplanned investment risk mitigation strategy. Furthermore, the Committee will have the opportunity to explore the strategic asset allocation policy along with updated capital market assumptions in the course of the 2017-18 ALM process.

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Please do not hesitate to contact us should you have questions or require anything further.

Best regards,

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