***Andrew Junkin, CFA, CAIA***
***President, Wilshire Consulting***

September 18, 2017

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

Re: Total Fund Investment Policy Revisions

Dear Mr. Jones:

Staff is proposing revisions to CalPERS Total Fund Investment Policy. The September agenda item is a first reading – thus, no action is expected. While many of the changes are ministerial or fairly minor, there are certain changes that Wilshire believes are substantive and merit Investment Committee discussion. Furthermore, we note one area of disagreement between Staff and Wilshire below.

In addition to reviewing the proposed Policy changes, Wilshire had a number of discussions with Staff, proposed clarifying language where appropriate, and reviewed relevant Investment Policies, Procedures, & Guidelines (IPPGs).

**Overview**

First, Wilshire views the proposed change to the Purpose of the Liquidity Program to be more of a clarification than a true change. However, this language makes it clearer that the role of the Liquidity Program is a day to day function. While this is a nuanced change, Wilshire supports the modification.

This subtle change also makes the proposed change in the Liquidity Program Benchmark – from the 91-day Treasury Bill to the 30-day Treasury Bill – appropriate. "Day to day" liquidity would imply a very short weighted average maturity, whereas the prior Purpose called for "liquid assets that could be converted to cash with little market impact." Wilshire supports this benchmark change.

Additionally, Staff is proposing lowering the minimum credit rating on sovereign securities for the Liquidity Program from Baa1/BBB+/BBB+ to Baa2/BBB/BBB – a one notch decline in credit ratings. The proposed minimum credit ratings are still all investment-grade and the lowest investment grade rating (Baa3/BBB-/BBB-) would still not be permitted. Given the very high quality, very liquid benchmark being proposed, Wilshire expects that the lowered minimum credit rating would have a de minimus impact on the actual portfolio while allowing Staff additional flexibility in the management of the Program.

Staff has also proposed a number of changes to the Low Duration Fixed Income Program, some of which merit discussion and input from the Investment Committee. First, Staff is proposing a change in the name of the Program from Low Duration Fixed Income to Low Duration. While this aligns more closely with CalPERS' organizational structure (the Program is managed by Opportunistic Strategies, not Global Fixed Income), it may be confusing to outside parties as the underlying instruments trade in markets that are generally recognized as "fixed income." Many of the instruments will be floating rate, so not technically "fixed," but industry convention is to call these "fixed income" markets. To the extent the Policy should be easily understood by outside stakeholders, Wilshire recommends retaining "Fixed Income" in the name of the Program.

Next, Staff is proposing creating and maintaining internal credit ratings. While this has been a practice of the Global Fixed Income Program (GFI) for many years, there is one significant change. Within GFI, when an internal rating is different from a rating from one of the rating agencies, the rating agency rating prevails. Staff is proposing that within the Low Duration Fixed Income Program that the internal rating prevails. After discussions, this is an area of disagreement between Staff and Wilshire. Staff considers this from an investment point of view – within the fixed income markets, it is common to try to exploit pricing inefficiencies driven by rating discrepancies between the rating agencies and an investment manager.

Wilshire is viewing this from a policy point of view and has three key issues. First, CalPERS would have contradictory views in Policy about how to treat ratings differences between internal and external ratings. As previously noted, GFI would have external ratings prevail where the Low Duration Fixed Income Program would have the internal ratings prevail. From a best practices standpoint, it's challenging to reconcile two different approaches within one set of policies. Second, because of capacity constraints, Staff would only be able to rate a small portion of the universe of credits. Presumably, Staff would initially screen for attractive credits before establishing internal ratings, which could bring about some bias during the rating process. Last, Wilshire has concerns about appropriate TLPM/ICOR risk and compliance monitoring when using Staff ratings instead of those from a rating agency. How will the ratings be incorporated into appropriate systems? How will updates to ratings be communicated and monitored?

To be clear, Wilshire is not opposed to Staff having internal ratings and using them as part of the investment process. Our concerns are centered around the policy framework and appropriate risk controls. Having discussed this issue with Staff, we felt it best to raise the topic for Investment Committee discussion.

**Conclusion**

Wilshire has reviewed the proposed changes to the Total Fund Investment Policy. Except for the changes noted above, which we noted above that merit additional discussion, most of the changes are modest and reflect the ongoing evolution of CalPERS.

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

Best regards,

Wilshire Associates
370 Interlocken Boulevard Suite 620 Broomfield, CO 80021 **TEL** 303.626.7444 **FAX** 303.466.1537
www.wilshire.com