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May 22, 2018

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

Re: Affiliate Trust Asset Allocation Review

Dear Mr. Jones:

You requested Wilshire's opinion as it relates to Staff's asset allocation recommendations for the Long-Term Care (LTC) Fund and Health Care Fund (HCF). Collectively, these two Affiliate Funds hold approximately $5 billion in assets (LTC ~$4.4B, HCF ~$0.5B). Below, we discuss Staff's recommendation for each fund separately.

Long-term Care (LTC) Fund

As was the case for the recent asset allocation reviews of the LRS, JRS, JRS II and the three CERBT strategies, Wilshire believes that the methods, inputs and data used to perform the LTC's asset allocation study are appropriate and reasonable. The asset class assumptions used in the process were consistent with those approved and utilized within the PERF's recent ALM review with the modifications that Fixed Income and TIPS assumptions reflect only domestic issues and REITs provide real estate exposure due to liquidity requirements. Minimum constraints were included for TIPS, Commodities, and REITs to ensure a certain level of diversification into the alternative portfolios that might be underappreciated in a pure optimized framework. A maximum constraint of 15% to the Global Equity asset class was also applied to prevent the portfolio from taking on significant growth risk. Wilshire is comfortable with these constraints given the instability of the underlying optimization assumptions, particularly as they relate to the inherent limitations of correlation estimates. This viewpoint also is consistent with Investment Belief 9 (i.e. Risk to CalPERS is multi-faceted and not fully captured through measures such as volatility or tracking error).

In evaluating the optimal candidate policy portfolios, Staff primarily focused on achieving a median expected rate of return consistent with the LTC Fund's 5.25% actuarial discount rate. This approach in combination with Staff's desire to avoid implementation costs that might be incurred by unnecessarily deviating from the current allocation (i.e. in pursuit of insignificant gains in portfolio efficiency) led to Staff's proposed asset allocation, which calls for very minor adjustments in policy weights versus the current asset mix. Wilshire supports Staff's recommendation, which along with being projected to meet the Fund's discount rate, reflects an appropriately modest level of risk given the LTC Fund's funding level and liquidity needs.

Health Care Fund (HCF)

The HCF's funding role (e.g. covering previously incurred health care expenses, providing funding claims that exceed premiums for CalPERS self-funded PPO plans, etc.) drives its primary investment objective of principal stability. The goal of enhancing returns must be confined within prudent levels of risk, while maintaining ample liquidity to meet program needs.

Wilshire believes that Staff's recommendation to maintain a 100% fixed income allocation is consistent with the HCF's investment objectives noted above. The primary potential risks to a 100% fixed income portfolio stem from default and interest rate risk. However, by continuing with its allocation to U.S core bonds the portfolio has very modest exposure to default risk and, as can be seen on slide 13 of Staff's presentation (attachment 1 of this agenda item), exhibits reasonable levels of downside risk against various short-term shifts in interest rates.

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

Best regards,

Steven J. Foresti　　　　Thomas Toth

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