



## Investment Committee

# Agenda Item 6d

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**September 14, 2020**

**Item Name:** Long-Term Care: Asset Allocation

**Program:** Trust Level Portfolio Management & Implementation

**Item Type:** Information

### **Executive Summary**

The CalPERS Long-Term Care (LTC) Program offers voluntary coverage that helps policyholders pay for care when they need long-term care assistance. The LTC Program is funded solely by policyholder premiums and investment income. This agenda item provides an update regarding the LTC Fund strategic asset allocation and investment management, which is an element of the LTC Program stabilization plan to be discussed at the Investment, Finance and Administration, and Pension and Health Benefits committee meetings this month.

Given the unique nature of the characteristics and liabilities of the LTC Fund and current long-term market return expectations, CalPERS team members recommend the release of a Request for Proposal (RFP) Solicitation for an External Investment Manager to provide a customized strategic asset allocation and investment management services for the LTC Fund. An agenda item requesting approval to do so is part of the Finance and Administration Committee's (FAC) upcoming agenda. It is anticipated that the RFP evaluation and LTC Fund strategic asset allocation review will be completed for presentation to the Investment Committee in November 2020 (in advance of the formal start of the Asset-Liability Management Review, which for all other funds is scheduled to begin in 2021).

### **Strategic Plan**

Evaluating options for the LTC Fund strategic asset allocation through the release of an RFP supports the "Fund Sustainability" goal of the CalPERS 2017-2022 Strategic Plan. Evaluating external investment manager strategic asset allocation designs and recommendations for the LTC Fund will aid in determining whether the strategic asset allocation could be further optimized, which will strengthen the long-term sustainability of the LTC Program.

### **Investment Beliefs**

Strategic asset allocation and management of the LTC Fund supports CalPERS Investment Belief 1: Liabilities must influence the asset structure and Investment Belief 6: Strategic asset

allocation is the dominant determination of portfolio risk and return. Care and diligence must be made to evaluate both the liabilities and the strategic asset allocation of the LTC Fund.

## **Background**

Asset Allocation: The Investment Office manages the LTC Fund asset allocation and investment strategy. In 2012, the LTC Fund strategic asset allocation was updated to allocate 67 percent of the portfolio to fixed income assets, reduce investment return volatility, and set the discount rate at 5.75 percent. Further strategic asset allocation reviews were conducted in 2015 and 2018. No changes were made in 2015, while minor changes and a lowering of the discount rate to 5.25 percent were adopted in 2018. The current allocation to fixed income assets is 66 percent.

Due to the historically low interest rate environment, the long-term expected returns for fixed income assets dropped significantly, resulting in a reduction in the expected return of the LTC Fund to approximately 4.00 percent. Releasing an RFP will provide meaningful information and analysis to help determine if the asset allocation can be optimized, in light of market conditions.

Investment Implementation: In 2011, CalPERS issued an RFP for Investment Management Services for several multi-asset class funds, with the LTC Fund among them. State Street Global Advisors was awarded the contract and continues to be the Investment Manager for the multi-asset class funds, including the LTC Fund.

The scope of the 2011 RFP included the investment management of the LTC Fund, but did not include the design and management of the strategic asset allocation, which has been performed by CalPERS team members. The design and management of the strategic asset allocation will be included in the 2020 RFP for CalPERS' consideration. It is anticipated that CalPERS team members will monitor the asset allocation, rebalancing, investment management, and performance for any selected manager.

## **Analysis**

CalPERS team members evaluated preliminary information about alternative approaches to asset allocation relative to the liabilities of the LTC Fund. The Actuarial Office completed their annual experience study and discount rate review for the June 30, 2019 valuation. The analysis indicates that certain actuarial assumptions, including the discount rate, require updates in order to project the LTC Program's funding status. CalPERS team members therefore concluded that releasing an RFP would be beneficial to determine if the strategic asset allocation can be further optimized. The following options were evaluated:

- Option 1: Remain with the current asset allocation process and investment strategy.
- Option 2: Release an RFP to targeted investment managers that specialize in the management of similar funds to determine if the asset allocation of the LTC Fund could be optimized. A cost analysis would also be performed based on the RFP responses from the managers to ensure CalPERS is managing costs appropriately.

The CalPERS team members' request to pursue option 2 will be brought to the FAC for action.

## **Budget and Fiscal Impacts**

The estimated costs to manage this portfolio will exceed \$1 million or more annually. If a new manager is successful in the RFP, the new contractor and all fees will be reported on the FAC's November 2020 Contracting Prospective Report for the Board's approval.

## **Benefits and Risks**

The benefits of conducting an RFP search include:

- The determination, in consultation with market experts and CalPERS investment team members, of whether the asset allocation of the LTC Fund could be further optimized.
- Providing opportunity to discover external management skill and experience, viable asset allocation strategies, and investment structure options for the LTC Fund.

The risks of not conducting an RFP search include:

- Maintaining an asset allocation that may generate lower returns and material premium increases.
- Not discovering external manager skill and experience that could possibly improve the return and/or risk characteristics of the LTC Fund.

## **Attachments**

None.

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