CalPERS

Investment Committee

Agenda Item 7a

November 16, 2020

Item Name: Long-Term Care: Asset Allocation and Discount Rate

Program: Trust Level Portfolio Management & Implementation

Item Type: Action

Recommendation

Set the discount rate for the Long-Term Care Fund to between 4.75 percent to 5.00 percent (specific recommendation will be presented at the Investment Committee meeting) with a portfolio volatility (risk) maximum of 9.50 percent and approve the inclusion of private asset classes and the use of leverage in the investment portfolio.

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 and 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 review.

At the September 2020 Investment Committee meeting, CalPERS team members discussed challenges facing the CalPERS Long-Term Care current investment portfolio and that the expected return had dropped to 4.00 percent, which will lead to significant premium increases. To address this, CalPERS team members released a Request for Proposal (RFP) for strategic asset allocation and investment management services to determine if the strategic asset allocation can be further optimized and to assess an expanded set of options that could be available for the LTC Fund.

While it was initially anticipated that the strategic asset allocation review and recommendation would be brought to the Investment Committee in November, due to the size and complexity of the RFP responses, the full review will be presented at the February 2021 meeting. For discussion at the November meeting, the team will present findings from conducting a detailed portfolio review of the proposals that support the recommendations for a discount rate, investment risk, and the expansion of asset classes and investment products.

Strategic Plan

This agenda item supports the Strategic Plan Goal: Fund Sustainability in the following ways: 1) conducting the LTC Fund strategic asset allocation ahead of the full 2021/22 ALM process enables adoption of an optimized allocation in alignment with proposed premium increases in 2021, and 2) evaluating external investment manager expertise and recommendations provides support for an increased expected long-term investment return (with an increase in risk) and a discount rate in the range of 4.75 percent to 5.0 percent.

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.

Background

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 strategic allocation to fixed income is 66 percent.

Due to the historically low interest rate environment, the long-term expected returns for fixed income assets have dropped significantly, resulting in a reduction in the expected return of the LTC Fund from 5.43 percent in 2018 to approximately 4.00 percent in 2020. To determine if the strategic asset allocation can be further optimized and to assess an expanded set of options that could be available for the LTC Fund, CalPERS team members requested approval at the September Finance and Administration Committee meeting to release an RFP.

The scope of the RFP includes customized strategic asset allocation with investment management services and seeks information on the array of strategies, products, expertise, and market access that external managers have available for managing the LTC Fund. If a manager is selected, the Investment Committee will retain authority for approving the asset allocation and benchmarks and CalPERS team members will be responsible for monitoring the manager's asset allocation, rebalancing, investment management, and performance.

Analysis

The Request for Proposal was released on September 16, 2020 and contains 140 questions across 14 categories. The proposals, received on October 14, 2020, are each several hundred pages in length, and include question responses, asset allocation analysis and portfolio recommendations, and several appendices of requested documents and disclosures. Given the size and complexity of the proposals, the full review will take more time than was initially anticipated and the recommendation of a specific asset allocation will be brought to the Investment Committee for approval in February 2021.

For discussion at the November meeting, the team will present findings from conducting a portfolio review of the proposals with the goal of determining what discount rate can be supported. The review assessed the manager asset allocation recommendations in the following ways:

1. To determine if the manager recommended portfolios are generally viable, the team qualitatively evaluated elements such as manager capabilities, asset classes, weights, diversification, portfolio construction, risk management, liquidity, and cashflow management. All portfolio recommendations met this qualitative evaluation and the team found that the managers have a broad range of portfolio recommendations, strong capabilities, and can offer incremental expertise such as long-term care and insurance-related asset-liability management experience, sourcing private asset classes for smaller funds, managing leverage, and de-risking strategies.
2. To determine a discount rate that the manager recommended portfolios can support, the team quantitatively analyzed each portfolio's risk and return values by asset class and calculated total portfolio risk and return using three different sources for capital market assumptions (CMAs):
   a. The managers' 03/31/20 CMAs (per the date requested in the RFP)
   b. CalPERS' 03/31/20 CMA survey for the ALM Mid-Cycle Review in June 2020
   c. Wilshire Associates' 09/30/20 CMAs

   The findings suggest that there are a number of portfolios that can support a discount rate between 4.75 percent and 5.0 percent, when using a blend of short-term and long-term CMAs, conditional on increasing the range of risk tolerance by 30 percent to an upper threshold of 9.5 percent and including private asset classes and leverage.

Budget and Fiscal Impacts

As the technical review phase is currently in process, manager fees have not yet been evaluated. The estimated costs to manage this portfolio will exceed $1 million or more annually. If a new manager is selected, it is anticipated that the manager (contractor) and fees will be reported to the Finance and Administration Committee on the Contracting Prospective Report for the Board's approval in February 2021.

Benefits and Risks

Utilizing external investment management expertise, with greater LTC and insurance experience, appears supportive of modifying the asset allocation to increase expected investment risk and return by adding private assets and leverage. Such action brings several potential benefits and risks:

<u>Benefits</u>:

- Mitigates the need to reduce the discount rate to 4.0 percent by appearing to support a discount rate between 4.75 percent to 5.0 percent.
- The potential for increased investment returns, which could reduce the magnitude of premium increases.
- Increased portfolio diversification with additional asset types.
- External management provides expertise with insurance and Long-Term Care investment funds, liability cash flow management, de-risking glidepaths over the life of liabilities, and the ability to source private assets and manage leverage for smaller funds.

Risks:

- The potential for increased investment returns may not be realized, which could have a negative impact on premiums.
- Financial market evolution which could further reduce future, expected returns.
- Higher portfolio risk will likely increase variability in investment outcomes from year to year, thus increasing the uncertainty regarding the premium levels required to support the liabilities.
- Increased costs for external management.

Maintaining the discount rate and expected investment risk and return at current levels, not including private assets and leverage in the investment portfolio, and not utilizing external management could have the following benefits and risks:

Benefits:

- Less reliance on investment returns, which are uncertain.
- Current level of expected portfolio risk could result in lower variability in investment outcomes year over year.
- No increase to costs.

Risks:

- Significantly higher premium increases.
- Less diversification, more concentration in lower-yielding asset classes.
- Opportunity cost of not discovering and benefitting from external manager expertise in asset allocation, investment management, and risk management that is specific to long-term care and insurance products.

Attachments

Attachment 1 – Long-Term Care: Asset Allocation and Discount Rate Presentation
Attachment 2 – Wilshire Associates Opinion Letter

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