CalPERS

Investment Committee

Agenda Item 7a

March 15, 2021

Item Name: Long-Term Care: Asset Allocation

Program: Trust Level Portfolio Management & Implementation

Item Type: Action

Recommendation

For the Long-Term Care Fund strategic asset allocation, select Candidate Portfolio 1, with expected return of 4.97% and expected risk of 8.29%. The Investment Policy with benchmarks, ranges, and rebalance framework will be brought to the Investment Committee in June 2021. Implementation of the strategic asset allocation will occur after the Investment Policy is approved and manager contracting is complete.

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.

In response to challenges facing the LTC Fund portfolio, CalPERS team members recommended, and the Investment Committee approved the following:

- September 2020: Request for Proposal (RFP) for Asset Liability Management and Investment Management
- November 2020: Discount rate of 4.75, upper threshold on portfolio risk (volatility) of 9.50 percent, and the inclusion of private asset classes and the use of leverage.

The team has completed the strategic asset allocation review and will discuss the process and results at the March 2021 Investment Committee meeting. In summary, there are two Candidate Portfolios presented that have strategic asset allocations that support the discount rate, are within the risk threshold, and do not allocate to private assets or include the use of leverage. The discussion will highlight the Candidate Portfolios' strengths and key differences, in support of the strategic asset allocation recommendation for the LTC Fund.

Strategic Plan

This agenda item supports the Strategic Plan Goal of Fund Sustainability. Conducting the strategic asset allocation review ahead of the full 2021/22 ALM process enables portfolio selection in alignment with proposed premium increases in 2021. Evaluating external investment manager expertise and selecting the recommended portfolio supports an increased expected long-term return (with an increase in risk) and the 4.75 percent discount rate.

Investment Beliefs

This agenda item supports the following CalPERS Investment Beliefs:

- Investment Belief 1: Liabilities must influence the asset structure.
- Investment Belief 2: A long-term investment horizon is a responsibility and an advantage.
- Investment Belief 6: Strategic asset allocation is the dominant determinant of portfolio risk and return.
- Investment Belief 8: Costs matter and need to be effectively managed.

Background

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 could be further optimized and to assess an expanded set of options, CalPERS team members conducted a comprehensive review of external manager expertise and strategic asset allocation proposals. The scope of the review included customized strategic asset allocation with investment management services, and information on the array of strategies, products, expertise, and market access that external managers have available for managing the LTC Fund.

Analysis

The review process was a team effort across the Investment Office, Actuarial Office, Health Policy Division, Legal Office, and the Operations Services Division. General considerations evaluated throughout the process included the asset liability management framework, manager and team capabilities, investment performance, risk, complexity, cost, and competitive advantage. The team followed the multi-phased approach outlined below:

<u>Phase I: Technical Written Proposal</u>

The RFP team developed an extensive Request for Proposal technical questionnaire. Included with the questionnaire was the necessary data for managers to evaluate the LTC Fund asset liability management profile and construct proposed portfolios. The questionnaire additionally included inquiries about the manager history and structure, personnel and depth of experience, asset liability management and investment management experience, performance track record, risk management and compliance, trading capabilities, ESG including talent management and diversity and inclusion, investment technology, systems infrastructure and cyber security, and conflicts and disclosures.

The RFP team developed a detailed portfolio analysis framework and a quantitative Manager Assessment Tool (MAT) to standardize and facilitate a consistent and organized evaluation of each manager's proposal. Based on the responses, and in conjunction with the portfolio analysis, MAT scoring, and RFP team deliberation, four managers did not advance to the next phase. A noteworthy reason for not advancing was the high portfolio risk (volatility) levels relative to the 9.50% threshold approved by the Investment Committee.

Phase II: Confidential Discussions

The RFP team conducted virtual meetings with the remaining managers. Topics discussed included core competencies, team, proposed portfolio(s) and asset class strategies, capital market assumptions, risk management, investment decision making, and client services.

Based on the confidential discussions, and in conjunction with the RFP team deliberation and the MAT scoring, one manager did not advance to the next phase. A noteworthy reason for not advancing was the level of complexity associated with implementing the portfolio (relatively high-level of illiquidity and outsourcing of investment management services).

Phase III: Fee Proposals

The proposed fees for the remaining three managers include asset liability management, investment management and transition management fees. One manager did not advance to the next phase, as their fees were significantly higher than the others.

Phase IV: Reference Checks

The RFP team conducted six reference calls (three organizations each for the two managers) with standardized questions covering the following areas: firm capabilities, asset liability management, investment management, long-term care and insurance knowledge, fiduciary duty, operational management, and client service. All references were satisfactory.

Phase V: Final Interviews

The RFP team conducted virtual final interviews with the remaining two managers. Topics discussed included capital market assumptions, portfolio optimization, proposed portfolio(s) and asset class strategies, portfolio management, stress testing, risk management, and investment decision making processes. The RFP team advanced both managers for their strategic asset allocation portfolios to be evaluated as Candidate Portfolios.

Budget and Fiscal Impacts

Manager fees have not yet been determined. 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 next Contracting Activity Prospective Report.

Benefits and Risks

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

Benefits:

- Supports the discount rate of 4.75%.
- Higher expected investment returns could increase the funded ratio and help reduce the magnitude of premium increases.
- Increased portfolio diversification with additional sub-asset classes.
- External management provides access to expertise with insurance and Long-Term Care investment funds, liability cash flow management, market coverage, sophisticated proprietary investment technology and models, and innovative investment strategies.

Risks:

- The potential for increased investment returns may not be realized, which could have a negative impact on the funded ratio and 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.
- External management can introduce risks such as key person risk, investment strategy underperformance, and reputational risk.

Attachments

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

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