Wilshire

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Managing Director & Principal

June 1, 2012

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

Re: Absolute Return Strategies – Equity Beta Overlay

You requested our opinion regarding the report from Staff regarding the ARS program and Beta Overlay.

Recommendation

Wilshire recommends that if the Investment Committee wishes to continue the Beta overlay, it should change the current overlay amount calculation to simply 100% of the value of ARS, as outlined below.

Background

Last year, our recommendation that the asset allocation policy be changed to include an explicit target allocation to ARS, eliminating the need for an overlay. As Staff's recommendation to add the overlay and exclude ARS from the asset allocation policy was selected by the Investment Committee, we will not rehash old arguments here. Assuming that the Investment Committee wishes to continue to exclude ARS from the asset allocation policy, then we recommend that the overlay continue.

We do, however, object to Staff's calculation methodology for the overlay amount of (1 – Beta) and recommend that the ARS program be overlaid fully with equity futures.

First, Beta is an inexact calculation and cannot be predicted or measured concurrently with great accuracy. A bond portfolio that performs well during a period of positive stock market performance would appear to have some degree of Beta (correlation of returns) even though there is no actual linkage between the portfolio and the stock market. As a result, we believe estimated or forecasted Beta should not be used to make overlay decisions for this portfolio.

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Second, and more important, as our last few reviews of ARS / RMARS have commented, the ARS program has a significant amount of assets invested in macroeconomic and directional strategies. These, by definition, seek to earn returns by intentionally positioning the Beta of the portfolio positioned correctly. The (1-Beta) overlay calculation treats all Beta as accidental, not intentional. As a result, CalPERS could be paying hedge fund fees on the order of a 2% base fee plus 20% carry, possibly even with additional fees from a fund of hedge funds on top of that, for directional positions which Staff then effectively negates with this Beta overlay. The end portfolio will cost hedge fund fees but produce index fund results.

Instead of attempting to calculate or estimate Beta and subtract it from the overlay, Staff could be directed to simply minimize directional managers in the portfolio and shape the ARS portfolio around arbitrage or other strategies that minimize market exposure. Alternatively, CalPERS could simply accept the inclusion of “smart Beta” or “intentional Beta” strategies as a source of Alpha. Either way, the overlay should be implemented at 100% of the underlying strategies’ values in order to avoid negating precisely what CalPERS is seeking.

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

Best regards,

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