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May 21, 2013

Henry Jones, Chairman
Investment Committee
California Public Employees' Retirement System
Sacramento, California 95814

Re: 2013 Capital Market Assumptions

Dear Mr. Jones,

The purpose of this letter is to provide the Investment Committee with Pension Consulting Alliance's (PCA) opinion regarding the consensus Capital Market Assumptions presented in this agenda item. In summary, PCA agrees with and recommends that the Investment Committee adopt the Capital Market Assumptions presented by the staff in the agenda item.

CalPERS' staff, consultants to the Board and independent third party investment management organizations with special expertise in the development of expected risks and returns have undertaken a rigorous and, at times, spirited debate/process to assist the Investment Committee in its consideration of this matter. It is important to note that current market conditions across all asset classes, especially the current level of interest rates, were the key drivers of the consensus assumptions.

In order for the asset allocation-asset/liability decision-making process to be reasonable the assumptions for risk, return and correlation among asset classes must be realistic and achievable. The consensus assumptions are, in PCA's opinion, both realistic and achievable.

In comparison to the 2010 Interim Workshop Capital Market Assumptions, the 2013 assumptions differ in two areas by meaningful amounts. The expected annual return for Fixed Income is approximately 1.75% lower (2.76% versus 4.50%) which takes into consideration the current yield to maturity of the broad fixed income market. The expected annual return of the Inflation-Linked class was reduced by over 3.00% (2.95% versus 6.00%) due to declines in long-term expected yields over the last three years, as well as re-configuration of the class.

The consensus view is that inflation, over the planning horizon, will increase at an annual rate of 2.75% which is 0.25% lower than assumed in 2010. In the near term, inflation is not a significant consideration. Over the long term, the impact of the historic high levels of borrowing in almost all developed markets required to address the post-2008 credit crises has significant potential to foster inflationary pressure later in the investment horizon.

The net result, if realized, of the changes detailed above (particularly with respect to fixed income) and the minor changes not detailed will be the reduction of the expected return for the total portfolio. Many other large institutional investors are going through the same decision-making process and most are reaching similar conclusions.

We look forward to addressing any questions or clarifications on this matter at the Investment Committee meeting.

Respectfully,

Allan Emkin