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March 30, 2015

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

Re: Strategic Asset Allocation Interim Targets Review

Dear Mr. Jones:

Overview

Staff has provided analysis on the interim targets for the Strategic Asset Allocation. This agenda item is intended to generate discussion with between the Investment Committee and Staff. Once Staff receives the Committee's input, policy revisions as appropriate will be brought back to the May meeting.

Investment Beliefs

CalPERS's Investment Beliefs are rife with language that addresses these critical topics. For example, Investment Belief 6 states that "Strategic asset allocation is the dominant determinant of portfolio risk and return." Further, "CalPERS will seek to add value with disciplined, dynamic asset allocation processes, such as mean reversion." This belief argues for setting an appropriate strategic asset allocation, but not becoming so beholden to it as to be unable to execute any dynamic strategies to try to capture excess risk-adjusted returns that may periodically be available in the global financial markets.

Investment Belief 9 states that "Risk to CalPERS is multi-faceted and not fully captured through measures such as volatility or tracking error." Additionally, "The path of returns matters, because highly volatile returns can have unexpected impacts on contribution rates and funding status." This belief emphasizes that CalPERS' asset allocation, while officially set every four years during the Asset-Liability workshop, must be managed in a way that balances

the returns available against the potential for large drawdowns, which could have significantly deleterious impacts on CalPERS.

Discussion

Staff is highlighting three particular items: 1) the need for interim targets in Private Equity and Real Assets, 2) reducing the target for the Liquidity program and revising the Liquidity benchmark, and 3) reallocating proceeds from a Liquidity target reduction to other asset classes. We shall discuss each of these in turn.

First, as we have regularly noted in our economic and market overviews to the Investment Committee, both Private Equity and Real Assets (mainly real estate and infrastructure) are priced richly. While CalPERS is underweight those asset classes, the Investment Committee has urged Staff to remain patient and disciplined rather than forcing capital into expensive markets. We believe that approach remains prudent and Staff maintains a similar view on those markets. Staff is recommending that the interim targets (actual underweights to the approved policy targets) stay in effect for an additional year. Wilshire agrees and finds this action to be in line with Investment Belief 9's desire to avoid large losses or impaired returns going forward due to the current market environment.

Second, through the Treasury Management Project, Staff has determined that the minimum liquidity allocation necessary for smooth and proper functioning of the organization is 1%. Currently, the approved policy target weight is 2%. While more efficient liquidity management practices across the organization should reduce the minimum required amount of liquidity to be held in the portfolio, it merits discussion. Does the Investment Committee view the liquidity portfolio simply as a pool of resources to ensure that benefit payments, capital calls, and other cash needs are met? Or, as has been discussed periodically, does the Investment Committee believe that retaining some liquidity above the minimum would allow CalPERS to be opportunistic should the prospect arise? While either is an appropriate answer, with pros and cons, this should be a discussion point for the Investment Committee. Below are pros and cons for each approach for the Investment Committee to consider.

- CalPERS is cash flow negative (contributions + investment income – distributions) and the allocation to liquidity serves as a buffer to any prolonged market dislocation or unplanned disruption in cash flow.
- A larger allocation to liquidity preserves "dry powder" to see undervalued assets when market dislocations occur.
- Lowering the allocation ensures that capital is used more efficiently and earning an appropriate return rather than waiting for low probability events to occur in order to deploy assets.
- The liquidity allocation can also serve as a diversifier to risk assets.

While all of these points are potential discussion items, the effect on the total fund of a 1% change in any allocation is de minimus.

Staff's recommendation to broaden the range around the 1% to +/- 3% does allow for the use of explicit leverage (borrowed liquidity) in the portfolio. The purpose is to increase flexibility during times of market stress and is intended to be temporary. This use of leverage would require a change to the CalPERS leverage policy and should warrant further discussion should the Investment Committee wish to explore any further use of leverage in the portfolio as a tool to manage market volatility more strategically. Wilshire believes this would provide CalPERS with flexibility to protect the PERF from having to sell assets at distressed prices during market dislocations or otherwise on a temporary basis to fund investments while raising cash in an orderly manner (e.g., funding an opportunistic investment that is only available briefly and before funding can be raised through normal financing activities or through asset sales). The cash reserves would still be available to the organization for normal expenditures (benefit payments, other investing activity, etc.).

With respect to the benchmark change, Wilshire agrees that having a shorter, very liquid benchmark with essentially zero interest rate risk makes sense for the Liquidity program.

Last, assuming the liquidity allocation is reduced by 1%, that 1% (approximately $3 billion) will need to be reallocated. Since Private Equity and Real Assets are already operating under interim (read: lower) targets due to the market environment, neither of those asset classes could easily deploy additional capital at this time. Global Equity and Global Fixed Income are liquid and could easily deploy the capital. While the forecasted risk and return characteristics of the plan do not significantly change if the 1% is deployed to Global Equity versus Global Fixed Income, Staff is recommending that the additional capital be deployed in Global Fixed Income. Based on recent discussions with the Board on the subject of derisking CalPERS, Wilshire believes that reallocating to Global Fixed Income is appropriate and sensible. This decision can be fully reviewed during the next Asset Liability workshop, in the fall of 2017.

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

Best regards,

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