Memo to: CalPERS Trustees

From: Howard Marks

Re: The Intelligent Bearing of Risk

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One decision matters more than all other decisions in the portfolio management process, and it should serve as the basis for the rest. It's the choice of what risk posture to target. The absolute level of risk in a portfolio shouldn't be an unwitting consequence of the asset allocation process. **It must be consciously targeted.**

**It's essential to understand that risk and the possibility of loss aren't the same. Although most people think of risk in terms of losing money, that isn't the only risk trustees have to worry about. And for an entity with CalPERS's mission, critical mass, and lifespan, it's not the most important risk.** The trustees must also consider the risk of CalPERS's funded status falling to an unacceptably low level, threatening the sustainability of pension payments. **Thus, it's possible for CalPERS to fall short because it took too little risk.** CalPERS's workplace – the investment arena – and its mission – growing today's capital into enough for pension payments tomorrow – entail a variety of risks. **Trying to avoid them all isn't a reasonable goal. Bearing some risk is unavoidable. Bearing it intelligently is CalPERS's main job.**

**If the risk of falling short is the most important risk for CalPERS, and I'm confident it is, then volatility is the <u>least</u> important risk.** Volatility consists of interim ups and downs, also called "fluctuations." The word "interim" means they go away. A pension fund like CalPERS doesn't have <u>any</u> risk of suddenly having large sums withdrawn or of being shut down. That means, in financial terms, CalPERS is in an <u>ideal</u> position to weather volatility in pursuit of return. Since that's true, ask yourself whether, for CalPERS, volatility isn't just a matter of optics. **The trustees shouldn't worry about fluctuations in value, just about one thing: not having enough money to pay benefits.**

In theory, every investment decision undertaken to raise the level of a portfolio's expected return and to expose it to upside potential beyond that level introduces (a) increased uncertainty (the range of possible outcomes becomes wider and the outcome becomes less predictable) and (b) an increased risk of having returns below the expected return; returns below those on "safer" investments; and, ultimately, losses.

**Investors can strive to maximize return, but doing so requires accepting increased uncertainty and downside risk. Or they can strive to reduce uncertainty and the probability of loss, but that requires sacrificing some upside potential. <u>This has to be viewed of as an inescapable tradeoff.</u>**

If that weren't the case, it would be possible to get a "free lunch" – a higher expected return without a commensurate increase in risk. The dynamic, competitive nature of markets – the thing that leads to so-called "market efficiency" – precludes that.

Thus, in a rational market, there is no "better" or "worse" choice of risk posture in objective terms – no right or wrong answer. **There's only a better choice <u>for CalPERS</u> based on its unique set of circumstances, preferences, and tolerances.**

January 13, 2025