CalPERS

Investment Committee

Agenda Item 6b

June 16, 2025

Item Name: Asset Liability Management: Reference Portfolio Design and Active Risk Limits

Program: Total Fund

Item Type: Information

Executive Summary

This Asset Liability Management (ALM) presentation builds on prior Board education to focus on reference portfolio design and the broad types of equity and bonds indices to be used. Next, it compares the different types of investment return projections used as inputs into ALM. The presentation then considers active risk limits under a Total Portfolio Approach (TPA) using the current portfolio's existing management discretion and active risk. Lastly, it highlights how performance and risk reporting will need to change under TPA.

Strategic Plan

This agenda item supports the CalPERS Strategic Plan goal of strengthening the long-term sustainability of the pension fund. As defined in CalPERS ALM policy, ALM is the process of balancing the expected cost of future pension payments with the expected future investment returns. The periodic review and evaluation of investment and actuarial assumptions are intended to strengthen the sustainability of the pension fund.

This agenda item additionally supports the Strategic Plan goal of Stakeholder Engagement by promoting collaboration, support, and transparency, as stakeholder input is a critical component to the ALM process.

Investment Beliefs

Investment Belief 2: a long-term investment horizon is a responsibility and an advantage.

Investment Belief 7: CalPERS will take risk only where we have a strong belief we will be rewarded for it.

Investment Belief 8: costs matter and need to be effectively managed.

Background

ALM is governed by the CalPERS ALM Policy, and the ALM process is a collaborative effort between the Actuarial Office (ACTO), the Financial Office (FINO), and the Investment Office (INVO), with stakeholder engagement a critical input. ALM operates on a four-year cycle with a mid-cycle review and is the primary process by which investment portfolio and actuarial assumptions evolve to reflect the investment risks and framework, the market opportunity set, demographic assumptions and experience, and plan status. The ALM decision frequency is supported by ACTO's annual actuarial valuation process that determines subsequent employer and employee contribution levels. This process establishes an amortization of each fiscal year's actual experience versus the assumptions underlying the ALM decisions, thus correcting annually for forecast and estimation uncertainty.

Analysis

As CalPERS considers shifting its investment framework to TPA, establishing a reference portfolio as a passive and simple benchmark of equity and bonds is a critical component.

Prior Board education presentations included the outlier equity-bond mixes of 50/50 and 90/10 reference portfolios to show the conceptual extremes but are not recommended for Board adoption. The options to be considered are 65/35, 70/30, 75/25, and 80/20.

Potential reference portfolio equity and bond index types were evaluated on how accessible, investible, feasible and cost effective they are for CalPERS', given its scale. Operational simplicity was viewed as key. With these considerations in mind, we propose that the reference portfolio comprise:

- A global capitalization weighted equity index
- A US Treasury Bonds (1+ year maturity) index

The precise details will be considered as a part of the September and November discussions.

Investment return projections vary by survey provider, methodology, and time horizon. ALM typically uses 20-year capital market assumptions (CMAs), a survey of the largest firms' 20-year forecasts. This generates a range of projected outcomes where the median is used in ALM analysis and final board recommendations.

This ALM cycle, in addition to the CMA approach, we are introducing a new set of expected returns from third party survey providers called Equilibrium, which uses a much longer time horizon than 20 years. Additionally, we are including the Board consultant Wilshire's projections, and our own internal projections to best show the variation of return projections. Lastly, we are including not only the median return, as is past practice, but the full range of return projections to better demonstrate the range of potential outcomes.

Under TPA, active risk is simply defined as the total risk from active management decisions above and beyond the reference portfolio's passive equity and bond indices. Using active management and risk adds value through diversification, use of private assets, active selection, and other sources of complexity. Some active risk strategies can reduce overall portfolio risk as well, while others that bring illiquidity require effective investment liquidity management.

TPA does not require the Board to grant management additional discretion. The current portfolio's active risk usage is approximately 200-250 basis points (bps). The estimated current maximum level of discretion under current policy constraints is approximately 450 bps of active risk. Management anticipates moving towards a portfolio with 250-350 bps of active risk under TPA over the next few years.

Performance reporting will experience significant change under TPA, as shown in March 2025's Investment Committee ALM presentation. Risk reporting becomes much more central compared to the current reporting approach. The key, overarching metric is total return, with a comparison of the reference portfolio against the actual portfolio. From there, active management strategies are compared to reference portfolio strategy benchmarks and external standard asset class comparisons. Reporting will also include risk metric analyses ranging from total risk, active risk, equity market sensitivity, liquidity, operations, sustainability, and counterparty risk.

Budget and Fiscal Impacts

Not applicable.

Benefits and Risks

Not applicable.

Attachments

Attachment 1 – Asset Liability Management: Active Risk Limits Presentation

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