Agenda Item 6a

September 15, 2014

ITEM NAME: Affiliate Funds Strategic Asset Allocation Targets, Recommendations

PROGRAM: Asset Allocation and Risk Management

ITEM TYPE: Asset Allocation, Performance & Risk – Action

RECOMMENDATION

Approve and subsequently recommend the adoption of the proposed policy portfolios for the Affiliate Funds, outlined in Table 1 below, by CalPERS' Board of Administration (Board) at the September 2014 Board meeting.

Table 1 – Affiliate Fund Recommended Portfolios

Recommended Portfolio	Affiliate Fund
100% Liquidity	Judges' Retirement System (JRS) Fund
P7	Judges' Retirement System II (JRS II) Fund
P2	Legislators' Retirement System (LRS) Fund
P8	California Employers' Retiree Benefit Trust Fund – Strategy 1 (CERBT 1)
P5	California Employers' Retiree Benefit Trust Fund – Strategy 2 (CERBT 2)
P2	California Employers' Retiree Benefit Trust Fund – Strategy 3 (CERBT 3)

Details for the recommended portfolio choices are described in Table 2 on page 3.

EXECUTIVE SUMMARY

CalPERS' Board is responsible for the administration and investment of several trust plans independent of the Public Employees' Retirement Fund (PERF), referred to collectively as "Affiliate Funds."

This item includes the recommendations of the recent strategic asset allocation analysis for the following Affiliate Funds:

- JRS Fund
- JRS II Fund
- LRS Fund
- CERBT Fund

At the August 18, 2014 Investment Committee (IC) meeting, Agenda Item 7c presented outcomes and recommendations of the recent strategic asset allocation analysis for the JRS, JRS II, LRS, and CERBT funds. The strategic asset allocation process has considered the unique characteristics of each plan and, where appropriate, has incorporated actuarial risk considerations such as the funded rate, contribution rate and contribution rate volatility into the asset allocation analysis. The recommendations aim to reduce the expected volatility of returns and add diversification where possible. The degree to which this expected outcome is achievable is impacted by the anticipated effect of any changes on the potential discount rate used to value liabilities. For CERBT, staff has attempted to maintain similar risk profile choices.

Overviews of each of the Affiliate Programs and the Capital Market Assumptions (CMAs) are provided in Attachment 1. Consultant opinion letters from Wilshire Associates and Pension Consulting Alliance Inc. (PCA) are provided as Attachments 2 and 3, respectively.

STRATEGIC PLAN

This agenda item supports the CalPERS' Strategic Plan goal of improving long-term pension and health benefit sustainability.

INVESTMENT BELIEFS

This agenda item supports CalPERS' Investment Belief 1, that liabilities must influence the asset structure and Investment Belief 6, that strategic asset allocation is the dominant determinant of portfolio risk and return.

BACKGROUND

Periodic review and analysis of strategic asset allocation is required by the Affiliate Funds' respective Statements of Investment Policy. These activities were last conducted in 2011. An overview of each of the programs, including their establishment, purpose, and status, can be found in Attachment 1.

ANALYSIS

JRS is recommended to continue with a 100% Liquidity allocation (i.e., cash equivalent securities) because of its unique characteristics and its use as a reserve account.

JRS II, LRS and CERBT fund recommendations and corresponding characteristics such as volatility and return estimates are summarized in Table 2 on page 3. The expected compound return and volatility characteristics of the current policy portfolio have been derived from the CMAs provided in Attachment 1. Within the modeling process, the weights to some of the asset classes have been fixed due to diversification considerations. These constraints are also provided in Attachment 1.

Staff analyzed three alternatives for each applicable Affiliate Fund to identify a recommendation for each fund. To the extent possible, the recommended portfolios reflected:

- Reductions in the overall levels of expected volatility;
- Maintenance of the existing discount rates for programs where CalPERS establishes the applicable discount rates (this excludes the CERBT);
- Broader diversification over the included asset classes; and
- Improvement in the actuarial risk considerations where applicable.

The four recommended asset allocations in Table 2 have had the segment weightings rounded to the nearest whole percentage. Assigning target weights using fractional percentages is believed to convey more precision than is warranted by the modeling process. The expected return and risk characteristics have been calculated based on rounded weights, resulting in only slight differences, shown below.

Table 2 – Affiliate Fund Recommended Portfolio Allocations

Asset Class Component		Recommended Portfolios			
		P2	P5	P7	P8
Global Equity		24%	40%	50%	57%
Fixed Income		39%	39%	34%	27%
Treasury Inflation-Protected Securities (TIPS)		26%	10%	5%	5%
Commodities		3%	3%	3%	3%
Real Estate Investment Trusts (REITs)		8%	8%	8%	8%
Expected Compound Return (1-10 yrs.) :		5.42%	6.12%	6.49%	6.71%
Expected Volatility :		7.14%	9.32%	10.76%	11.74%
Expected Cash Yield :		2.89%	3.00%	2.99%	2.92%
Expected Blended Return Net of Fees (1-60 yrs.):	CERBT:	6.12%	6.73%	N/A	7.28%
	LRS:	5.78%	N/A	N/A	N/A
	JRS II:	N/A	N/A	7.06%	N/A
Recommended for plans:		CERBT 3 & LRS	CERBT 2	JRS II	CERBT 1

The expected blended return is the combination of the short-term (1-10 years from CMAs) and the long-term (11-60 years from CalPERS' Actuarial Office) expected returns after deducting administrative fees.

Assessment of Strategic Asset Allocation Targets

Relative to the current strategic asset allocation targets, the asset class changes implied by the selection of the recommended portfolios are shown in Tables 3a through 3f below.

Table 3a – Strategic Asset Allocation Weights – JRS

JRS			
Asset Class Component	Recommended Portfolio	Current Portfolio	Change
Global Equity	0%	0%	0%
Fixed Income	0%	0%	0%
TIPS	0%	0%	0%
Commodities	0%	0%	0%
REITs	0%	0%	0%
Cash	100%	100%	0%

Table 3b – Strategic Asset Allocation Weights – JRS II

JRS II			
Asset Class Component	Recommended Portfolio (P7)	Current Portfolio	Change
Global Equity	50%	63%	-13%
Fixed Income	34%	20%	14%
TIPS	5%	6%	-1%
Commodities	3%	3%	0%
REITs	8%	8%	0%
Cash	0%	0%	0%
Expected Compound Return (1-10 years)	6.49%	6.93%	-0.44%
Expected Volatility	10.76%	12.62%	-1.86%
Expected Cash Yield	2.99%	2.85%	0.14%
Expected Blended Return Net of Fees (1-60 years)	7.06%	7.44%	-0.38%
Discount Rate	[7.00%]*	N/A	N/A

* Potential discount rate is pending approval by CalPERS Finance & Administration Committee.

Table 3c – Strategic Asset Allocation Weights – LRS

LRS			
Asset Class Component	Recommended Portfolio (P2)	Current Portfolio	Change
Global Equity	24%	32%	-8%
Fixed Income	39%	42%	-3%
TIPS	26%	15%	11%
Commodities	3%	3%	0%
REITs	8%	8%	0%
Cash	0%	0%	0%
Expected Compound Return (1-10 years)	5.42%	5.82%	-0.40%
Expected Volatility	7.14%	8.19%	-1.05%
Expected Cash Yield	2.89%	3.00%	-0.11%
Expected Blended Return Net of Fees (1-60 years)	5.78%	6.11%	-0.33%
Discount Rate	[5.75%]*	N/A	N/A

Table 3d – Strategic Asset Allocation Weights – CERBT 1

CERBT 1			
Asset Class Component	Recommended Portfolio (P8)	Current Portfolio	Change
Global Equity	57%	66%	-9%
Fixed Income	27%	18%	9%
TIPS	5%	5%	0%
Commodities	3%	3%	0%
REITs	8%	8%	0%
Cash	0%	0%	0%
Expected Compound Return (1-10 years)	6.71%	7.01%	-0.30%
Expected Volatility	11.74%	13.07%	-1.33%
Expected Cash Yield	2.92%	2.84%	0.09%
Expected Blended Return Net of Fees (1-60 years)	7.28%	7.53%	-0.25%

Table 3e – Strategic Asset Allocation Weights – CERBT 2

CERBT 2			
Asset Class Component	Recommended Portfolio (P5)	Current Portfolio	Change
Global Equity	40%	50%	-10%
Fixed Income	39%	24%	15%
TIPS	10%	15%	-5%
Commodities	3%	3%	0%
REITs	8%	8%	0%
Cash	0%	0%	0%
Expected Compound Return (1-10 years)	6.12%	6.47%	-0.35%
Expected Volatility	9.32%	10.58%	-1.26%
Expected Cash Yield	3.00%	2.82%	0.18%
Expected Blended Return Net of Fees (1-60 years)	6.73%	7.04%	-0.31%

* Potential discount rate is pending approval by CalPERS Finance & Administration Committee.

Table 3f – Strategic Asset Allocation Weights – CERBT 3

CERBT 3			
Asset Class Component	Recommended Portfolio (P2)	Current Portfolio	Change
Global Equity	24%	32%	-8%
Fixed Income	39%	42%	-3%
TIPS	26%	15%	11%
Commodities	3%	3%	0%
REITs	8%	8%	0%
Cash	0%	0%	0%
Expected Compound Return (1-10 years)	5.42%	5.82%	-0.40%
Expected Volatility	7.14%	8.19%	-1.05%
Expected Cash Yield	2.89%	3.00%	-0.11%
Expected Blended Return Net of Fees (1-60 years)	6.12%	6.43%	-0.31%

BUDGET AND FISCAL IMPACTS
Not Applicable

BENEFITS/RISKS
Staff's recommendations for the JRS, JRS II, LRS and CERBT funds are believed to reflect the preferences expressed by the IC at the August 18, 2014 meeting. The recommended portfolios attempt to maintain similar choices for CERBT employers, and reduce drawdown risk and concentration risk to the extent possible while minimizing negative impacts to the existing discount rates for JRS II and LRS.

Risks associated with this recommendation are that the actual long-term market returns, volatilities, and correlations eventually experienced may diverge materially from the capital market expectations used in the modeling process. In addition, inflation rates may vary significantly from expectations. These risks are mitigated by the fact that staff will conduct a market valuation driven analysis biennially, and a comprehensive asset allocation strategic review coincident with the review of the actuarial methods and assumptions every four years.

ATTACHMENTS
Attachment 1 – Affiliate Program Overviews and CMAs
Attachment 2 – Wilshire Associates Opinion Letter
Attachment 3 – PCA Opinion Letter

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THEODORE ELIOPOULOS
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Chief Financial Officer

ALAN MILLIGAN
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Program Overviews – Establishment, Purpose, and Status

Plan	Established	Purpose	Status
CERBT	2007	Allow employers to pre-fund non-pension, post-employment benefits • Three policy portfolios available for employers to select (Strategy 1, 2, 3) depending on employer risk preferences	Open Fund
LRS	1947	Provide defined retirement and ancillary benefits to: • Members of the Legislature elected prior to November 7, 1990 • Elected Constitutional and Legislative Statutory Officers elected prior to December 31, 2012	Closed Fund
JRS	1937	Provide defined retirement and ancillary benefits for State Supreme and Appellate Court Justices, and Superior Court and Municipal Court Judges and Justices elected before November 9, 1994	Closed Fund
JRS II	1994	Provide a fully funded retirement and ancillary benefit system for State Supreme and Appellate Court Justices, and Superior Court and Municipal Court Judges and Justices elected on or after November 9, 1994 Options include a defined benefit plan and a monetary credit plan	Open Fund

2014 CMAs and Constraints for Affiliate Funds

2014 CMAs	Compound Return	Volatility	Average Return	Long-Term Compound Return	Cash Yield	Correlation					Constraint	
						Global Equity	Fixed Income	TIPS	Commodities	REITs	Floor	Cap
Global Equity	7.75%	17.40%	9.15%	8.71%	2.73%	1.00	0.21	0.00	0.13	0.70	0%	100%
Fixed Income	4.29%	7.00%	4.52%	5.40%	3.70%	0.21	1.00	0.33	0.00	0.19	0%	100%
TIPS	3.50%	6.50%	3.70%	5.25%	2.00%	0.00	0.33	1.00	0.20	0.10	5%	100%
Commodities	2.84%	17.92%	4.39%	7.95%	0.00%	0.13	0.00	0.20	1.00	0.30	3%	100%
REITs	5.75%	19.50%	7.53%	10.88%	3.35%	0.70	0.19	0.10	0.30	1.00	8%	100%

Wilshire

Julia K. Bonafede, CFA
President of Wilshire Consulting

August 22, 2014

Mr. Henry Jones
Chairman of the Investment Committee
California Public Employees' Retirement System
400 P Street, Suite 3492
Sacramento, CA 95814

Re**:** Affiliate Funds Strategic Asset Allocation Targets, Recommendations

Dear Mr. Jones:

At the August 2014 Investment Committee meeting, Staff presented analysis supporting the proposed recommendations for the following Affiliate Funds:

- California Employers' Retiree Benefit Trust (CERBT)
- Legislators' Retirement Fund (LRS)
- Judges' Retirement Fund (JRS)
- Judges' Retirement II Fund (JRS II).

Wilshire worked closely with staff on these revisions and the resulting changes to the current asset class allocations. Our recommendation is below.

Recommendation

As noted in our opinion letter dated July 31, 2014, Wilshire has reviewed the strategic asset allocation analysis and the recommended policy portfolios and believe the new asset allocation targets to be prudent given the unique liability streams associated with each fund. We find Staff's rationale for each portfolio recommendation to be thoughtful, appropriate, and in line with CalPERS' Investment Beliefs.

As mentioned in our July letter, the policy portfolio recommendations for each of the four Affiliate Funds reflect a reduction in the overall risk profile for each fund, with the exception of JRS. This reduction in risk is a direct result of a meaningful reduction in the equity allocation of each portfolio thereby reducing overall Growth risk. While this reduction in equity exposure should dampen total volatility, it does increase other risk exposures for these Affiliates. Specifically, as the exposure to fixed income increases, the portfolios will be more exposed to performance issues should interest rates rise significantly. Given the current state of low interest rates and the planned wind down of Federal Reserve stimulus in the United States, increasing interest rates are possible.

Even with the prospect of a potential higher interest rate environment the recommended policy portfolios offer a reasonable risk/reward profile given the changing demographics of each fund.

We are always available to answer any questions you may have or receive comments.

Sincerely,

Wilshire Associates
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PCA | PENSION CONSULTING ALLIANCE

August 21, 2014

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

Re: September IC Agenda Item 6a - Strategic Asset Allocation Target Recommendations for Affiliate Funds

Dear Mr. Jones,

The purpose of this letter is to provide the Investment Committee with Pension Consulting Alliance's (PCA's) opinion regarding Agenda Item 6a for the September Investment Committee meeting. In summary, PCA (1) supports the staff's recommendations for the respective policy portfolios for each of the four affiliate funds under review, and (2) believes that the staff has (a) examined a reasonable number of portfolio options for each affiliate fund and (b) has conducted a thorough process and applied assumptions that have been consistent with the process and assumptions utilized under the earlier comprehensive policy review of the PERF portfolio. The final set of recommended policy portfolios provides appropriate risk/return profiles for each of the respective affiliate funds. This opinion follows our review of the predecessor topic, Item 7c, on the August 2014 IC agenda.

The final recommendations for the affiliated fund policy portfolios presented in staff's memo to the Investment Committee are reasonable and prudent. PCA notes that the allocation policies can vary widely due to the unique objectives and risk tolerances of each respective fund.

Given the above context and the various tradeoffs the affiliated funds face, PCA believes that the Committee can make and has made an informed decision on the basis of the information provided in this agenda item and in subsequent IC agendas.

As with the deliberations revolving around the PERF policy portfolio recommendations, there should be recognition that these final choices represent longer-term strategies. In this context, PCA believes prudent and cost-effective implementation approaches to achieve the new policy allocation levels warrant serious consideration.

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

Respectfully,

Allan Emkin

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