May 15, 2024

Mr. David Miller
Chair of the Investment Committee
California Public Employees' Retirement System
400 P Street
Sacramento, CA 95814

Re: Agenda Item 6a: Asset Liability Management Mid-Cycle Review: Affiliate Funds

---

Dear Mr. Miller:

You requested Wilshire's opinion as it relates to Staff's recommendations related to the Affiliate Funds mid-cycle Asset-Liability Management (ALM) review. The funds included in this review (listed below) had approximately $23.5B in assets as of March 31, 2024. The last asset allocation study for the Affiliate Funds was conducted in 2021-2022 and this review reflects adherence to the mid-point of the regular four-year asset allocation cycle. A recommendation for the Long-term Care Fund is scheduled to be presented during the September Investment Committee meeting.

- Health Care Fund (HCF): $73M
- Legislators' Retirement System Fund (LRS): $95M
- Judges' Retirement System Fund (JRS): $51M
- Judges' Retirement System II Fund (JRSII): $2.6B
- CA Employers' Retiree Benefit Trust Fund (CERBT): $20.5B (3 strategies)
- CA Employers' Pension Prefunding Trust Fund (CEPPT): $224M (2 strategies)

The Process

Wilshire believes that the methods, inputs, and data used to perform the asset allocation review are appropriate and reasonable. The capital market assumptions (CMAs) used in the process were consistent with and followed the same CMA survey methodology utilized in conducting the PERF's recent mid-cycle review (as approved during the March 2024 Investment Committee meeting). Where included in the asset class opportunity set, minimum constraints were established for Global REITs (8%), TIPS (5%), and Commodities (3%) to force a certain level of diversification into the candidate portfolios that might be underappreciated in a pure mathematically optimized framework. Additionally, modest maximum constraints were also imposed on TIPS (10%-20%) and Commodities (5%-10%). Wilshire is comfortable with these constraints given the instability of the underlying optimization assumptions, particularly as they relate to the inherent limitations of correlation estimates. This viewpoint is consistent with Investment Belief 9 (i.e., Risk to CalPERS is multi-faceted and not fully captured through measures such as volatility or tracking error).

In evaluating the candidate target policy portfolios, Staff followed the same quantitative approach of maximizing projected return at various levels of expected downside risk as was used in the PERF's recent mid-cycle ALM review. In addition, and where appropriate, CalPERS' actuarial team contributed to the process as Staff took into consideration demographic and fund characteristics in the recommendation process. These factors have important implications for the ultimate risk profile of the candidate portfolios. The consideration of liability information in the analysis is consistent with Investment Belief 1 (i.e., liabilities must influence the asset structure).

Selection of Asset Allocation Target Portfolios

In total, there are nine allocation recommendations (one each for HCF, LRS, JRS & JRSII, three for the CERBT, and two for the CEPPT). Wilshire believes that Staff's recommended asset mixes are appropriately specified for each Fund and take into account relevant decision factors such as, for example, funding status and contribution rates where applicable. As can be seen on slides 5 and 6 of Staffs' presentation materials, many embedded asset classes have improved return/risk characteristics versus those used during the 2021-2022 ALM study. These improvements are most notable within fixed income segments and, in several cases, provide an opportunity to reduce some of the risk increases accepted in the 2021-2022 environment.

In response to these expectations, Staff's recommended portfolio allocations reflect comparable or lower levels of risk-taking than is expressed in current allocation mixes. Wilshire is comfortable with Staff's recommended allocation changes for the HCF, LRS and JRSII funds, which reflect a proposed reduction in expected risk. The modest reductions in expected return (versus maintaining current risk levels) appear to offer prudent trade-offs for the associated and notable reductions in drawdown and volatility risk. Using the JRSII fund as an example, the small -0.1% sacrifice in expected return comes with meaningful reductions in forecasted drawdown and volatility risk of -2.6% and -1.0%, respectively. The HCF and LRS funds reveal larger risk savings, though with slightly higher reductions in expected returns.

Specific to the risk reduction reflected within the Health Care Fund allocation, Staff has recommended shifting its defensive mix from 100% bonds to 100% cash equivalents. Consistent with the initiation of this explicit cash allocation is the need to assign an appropriate asset class benchmark, for which Wilshire recommends utilizing the ICE BofA US 3-Month Treasury Bill Index (i.e., the same cash benchmark as is used for the JRS fund).

Finally, Wilshire remains comfortable with Staff's recommendation to maintain current asset allocation targets for each of the JRS, the three CERBT, and two CEPPT funds. Maintaining a 100% cash equivalents allocation for the JRS fund is entirely consistent with the fund's short-term liquidity needs and low risk profile. In the case of the CERBT and CEPPT funds, their structural objectives of providing participants with the option to select targeted risk portfolios demands greater adherence to these targeted levels of risk and is, therefore, less sensitive to evolving capital market prospects. As such, Staff's recommendation to maintain current asset allocation targets seems appropriate and prudent.

We look forward to further discussing these recommendations with you in June; however, please do not hesitate to contact us should you require anything further or have any questions.

Best regards,

Steven J. Foresti
Senior Advisor, Investments
Wilshire Advisors

