

---

**May 14, 2018**

**Item Name:** Affiliate Trust Asset Allocation Review: LRS, JRS, JRS II and CERBT

**Program:** Trust Level Portfolio Management & Affiliate Investment Programs

**Item Type:** Action

**Recommendation**

Approve recommended strategic asset allocation for LRS, JRS, JRS II and CERBT.

**Executive Summary**

CalPERS' Board of Administration (Board) is responsible for the administration and investment of several trust plans independent of the Public Employees' Retirement Fund (PERF).

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

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

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 ratio, contribution rate and contribution rate volatility. To a significant degree, the recommendations have been guided by an attempt to keep the existing risk profile of each plan where possible.

An overview of the key inputs and analyses for the Affiliate Funds strategic asset allocation review is provided in Attachment 1. An Opinion letter from Wilshire Associates, Inc. follows as Attachment 2.

**Strategic Plan**

This agenda item supports CalPERS Strategic Plan goal to strengthen the long-term sustainability of the pension fund.

**Investment Beliefs**

This agenda item is consistent with the following CalPERS Investment Beliefs:

- Investment Belief 1. Liabilities must influence the asset structure. Plan characteristics that project future liabilities are determinants of the recommended Policy Portfolio for each Affiliated Fund.
- Investment Belief 2. A long investment horizon is a responsibility and an advantage. The recommended Policy Portfolio for each Affiliate Fund is based on analyses of long-term demographic trends and projections.
- Investment Belief 7. CalPERS will take risk only where we have a strong belief we will be rewarded for it. Staff tried to maintain its existing risk profile for each Affiliate Fund.
- Investment Belief 9. Risk to CalPERS is multi-faceted and not fully captured through measures such as volatility or tracking error. Where appropriate, Staff analyzed risk considerations such as funded ratio, contribution rate and volatility of contribution rate.

## **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 2014 and they are expected to follow PERF's four-year cycle.

### Legislators' Retirement System (LRS) Fund

The LRS Fund was established in 1947 and covers members of the Legislature serving prior to November 7, 1990, and elected Constitutional Officers and Legislative Statutory Officers elected prior to December 31, 2012. The LRS Fund offers a defined benefit plan and provides retirement and ancillary benefits. Effective January 1, 2013, the LRS is closed to new members.

As of the June 30, 2017 actuarial valuation report, the LRS Fund had 247 total participants, of which 8 were active, 7 were inactive and 232 were retired. The LRS Fund had a funded ratio of 115.9% as of June 30, 2017, and an Asset-Under-Management (AUM) of \$117 million as of June 30, 2017. The AUM and number of participants have declined respectively from \$146 million and 361 since 2000. With an Active-to-Retired Ratio (number of active participants in relation to retired participants) of 0.03 as of June 30, 2017, LRS Fund is very mature. The LRS Fund market net asset value to payroll expenses, known as Asset-to-Payroll Ratio, is 97 as of June 30, 2017, implying that its contribution rates are highly sensitive to investment performance. LRS has annual net cash outflows of approximately \$2.6 million that are financed by selling assets.

### Judges' Retirement System (JRS) Fund

The JRS Fund, established in 1937, provides retirement benefits to Supreme and Appellate Court justices, Superior Court judges, and Municipal Court judges appointed or elected prior to November 9, 1994. The employer and employee contribution rate for the JRS plan is set by State statute and equals 8% of payroll. The State currently funds the JRS plan using a pay-as-you-go approach. This approach establishes annual contribution levels sufficient to pay current benefits but not to pre-fund future liabilities. Accordingly, the current JRS Fund AUM is not adequate without future contributions to meet current, or expected, benefit payouts.

As of the June 30, 2017 actuarial valuation report, the JRS Fund had 2,061 participants, of which 192 were active, 8 were inactive, and 1,861 were retired. Currently, the JRS Fund has \$48 million AUM allocated to cash equivalent securities which serve as a reserve account for the benefit payments in the event of a delay in the annual State budget approval process. The

need for a reserve account is derived from the inability of the State Controller's Office to transfer any State General Fund amounts until the State budget is approved. Therefore, an understanding between CalPERS and the Department of Finance is to maintain three months of benefit roll and Extended Service Incentive Program<sup>1</sup> (ESIP) funds in a reserve account to cover cash needs due to budget impasses as well as higher than anticipated ESIP payments.

#### Judges' Retirement System II (JRS II) Fund

The JRS II Fund provides retirement benefits to all Supreme and Appellate Court justices and Superior Court judges appointed or elected on or after November 9, 1994. The JRS II Fund offers a unique combination of two basic types of retirement benefits: a defined monthly benefit or a payment of monetary credits. The defined benefit provides a lifetime monthly benefit of up to 75% of final compensation. The monetary credits may be paid in a one-time lump sum payment, or in the form of lifetime monthly annuity if the judge is eligible for a defined monthly benefit.

As of the June 30, 2017 actuarial valuation report, the JRS II Fund had 1,673 total participants, of which 1,511 were active, 1 was inactive, and 161 were retired. The JRS II Fund had a funded ratio of 99.3% as of June 30, 2017 and \$1.4 billion in AUM as of June 30, 2017. JRS II AUM and the number of participants have grown respectively from \$41 million and 367 since 2000. The JRS II Active-to-Retired Ratio, was 9.4 as of June 30, 2017, implying that while it is maturing, JRS II currently would be categorized as a "young" plan. The JRS II Fund has a relatively low Asset-to-Payroll Ratio (4.7 as of June 30, 2017), implying that its contribution rates are less sensitive to volatile investment performance. The JRS II Fund's cash inflow is slowly declining, but remains positive.

#### California Employers' Retiree Benefit Trust (CERBT) Fund

The CERBT is a State trust fund established by the Public Employees' Medical and Hospital Care Act, Chapter 1, Article 11, Sections 22940-22944.3. It is an Internal Revenue Code (IRC) Section 115 Trust that began operations in 2007. The CERBT allows all IRC Section 115 eligible California public employers to prefund future retiree health and Other Post Employment Benefit (OPEB) costs. As of June 30, 2017, the CERBT Fund had 524 participating public employers, covering 728,570 total participants, of which 461,592 were active and 266,978 were retired.

The CERBT Fund offers three asset allocation strategies (CERBT 1, CERBT 2 and CERBT 3) to accommodate the diversity of program characteristics and risk tolerances of the participating agencies. CERBT 1, with the highest expected return and volatility among the three options, has \$5.7 billion AUM as of June 30, 2017. CERBT 2, with a moderate expected return and volatility profile, has \$880 million AUM as of June 30, 2017. CERBT 3, with the lowest expected return and volatility profile, has \$261 million AUM as of June 30, 2017.

The CERBT Fund's total AUM is \$6.8 billion. Over the last year, the CERBT Fund has grown by \$1.7 billion in AUM with 31 net new employers and approximately 322,510 new participants. The CERBT Fund's combined annual cash inflows, defined as contributions plus current investment cash income minus disbursements for retiree OPEB payments and expenses, equal approximately \$1.1 billion. This positive cash flow is expected to grow to approximately \$2.3 billion over the next five years.

---

<sup>1</sup> ESIP provides an incentive to judges who are eligible to receive the maximum retirement benefit to remain in public service by providing a lump sum payment in addition to their normal retirement allowance.

## Analysis

The process to obtain Policy Portfolios for the Affiliate Funds mirrors the one utilized in the PERF Asset Liability Management (ALM) workshop as illustrated on page 13, Attachment 1. As the outcome of step 1 in this process, Capital Market Assumptions (CMAs) have a direct impact on the composition of potential Policy Portfolios. Therefore, CMA's directly affect the risk and return profile of each Affiliate Fund. Where appropriate, CMAs for the Affiliate Funds are adopted from the 2017 PERF ALM process with the following exceptions:

1. Fixed Income and Treasury Inflation-Protected Securities (TIPS) reflect domestic securities only;
2. Global Real Estate Investment Trusts (REITs) are estimated using a Dividend-Discount-model.

Additionally, the asset categories of TIPS, Commodities and REITs have minimum exposure constraints applied in the Mean-Variance Optimization (MVO) process to maintain some degree of exposure to these inflation-sensitive assets despite their somewhat unattractive risk and return profiles. These constraints enforce additional diversification in the final Candidate Portfolio options.

Before reviewing the Candidate Portfolios identified on the efficient frontier generated by the MVO, let us go over to the liability side and recall how plan characteristic will affect the choice of Policy Portfolios.

LRS and JRS II are on the opposite ends of the spectrum of Defined Benefit pension plan characteristics, which leads to distinctive choices for recommended Policy Portfolios. The rationale underlying such distinction includes:

1. A more mature plan whose members are near or already in retirement means that the plan's liability has shorter duration.
2. A plan with net cash outflows are less able to absorb market shocks and needs to manage its liquidity.
3. The contribution rate of a plan with higher Asset-to-Payroll ratio is more sensitive to investment return volatility.

Thus, lower risk may be preferable for such plans and vice versa. The effects of those characteristics applied to LRS and JRS II are summarized in the following table and on page 15, Attachment 1.

Plan Characteristic	Description	Plan Characteristic (If it is...)	Implication for Portfolio (Then ...)	Affiliate Fund
Fund Maturity	A plan's ability to absorb an investment loss is affected by how distant benefit payments are (members retiring later)	Short Duration	Lower risk may be preferable	LRS
		Long Duration	Higher risk may be acceptable	JRS II
Cash Flows	Cash flows affect a plan's ability to absorb market shocks and need to manage liquidity	Cash Outflows	Lower risk may be preferable	LRS
		Cash Inflows	Higher risk may be acceptable	JRS II
Asset-to-Payroll Ratio	A plan's asset-to-payroll ratio affects the sensitivity of employer contribution rate to investment returns	High Sensitivity	Lower risk may be preferable	LRS
		Low Sensitivity	Higher risk may be acceptable	JRS II

The following table, also shown on page 16, Attachment 1 displays the nine Candidate Portfolios on the efficient frontier generated by the MVO process. Each Candidate Portfolio would earn the highest expected return at the given volatility level.

Asset Allocation of Candidate Portfolios											
Asset Class Component	P0*	P1	P2	P3	P4	P5	P6	P7	P8	P9	
Global Equity	--	19%	22%	28%	35%	40%	46%	52%	59%	68%	
Fixed Income	--	41%	49%	54%	48%	43%	37%	32%	25%	16%	
TIPS	--	28%	16%	5%	5%	5%	5%	5%	5%	5%	
Commodities	--	4%	5%	5%	4%	4%	4%	3%	3%	3%	
REITs	--	8%	8%	8%	8%	8%	8%	8%	8%	8%	
Liquidity	100%	--	--	--	--	--	--	--	--	--	
Expected Compound Return (1-10 yrs.) :	2.00%	4.16%	4.41%	4.75%	5.01%	5.22%	5.43%	5.61%	5.85%	6.10%	
Expected Compound Return (11-60 yrs.) :	--	6.43%	6.71%	7.06%	7.30%	7.49%	7.68%	7.85%	8.07%	8.28%	
Expected Volatility :	1.00%	6.85%	7.28%	7.93%	8.59%	9.24%	9.98%	10.72%	11.83%	13.12%	
Expected Blended Return Net of Fees (1-60 yrs.) :	LRS:	--	4.75%	5.00%	5.32%	5.55%	5.75%	5.94%	6.10%	6.32%	6.55%
	JRS II:	--	5.12%	5.38%	5.71%	5.95%	6.14%	6.33%	6.50%	6.72%	6.94%
Expected Time-Weighted Return Net of Fees (1-60 yrs.) :	CERBT:	--	5.95%	6.22%	6.57%	6.82%	7.01%	7.20%	7.37%	7.59%	7.82%
Recommendation for plans:	JRS		CERBT 3 LRS			CERBT2		JRS II	CERBT 1		

The calculation of the Expected Blended Return (net of fees) for LRS & JRS II are based on a weighting structure derived from each fund's benefit payment schedule. Thus, different plans have different blended returns for identical potential asset allocations. The Expected Blended Return calculation for the CERBT funds is based on a time weighted structure as the payment schedule is unknown. Each participating employer would calculate its own plan-specific blended return and set its own discount rate based on its own actuarial valuations.

### JRS Recommendation

Staff recommends maintaining the current strategic allocation, 100% in cash equivalent securities due to the following considerations:

- The State currently funds JRS through a pay-as-you-go approach. A pay-as-you-go approach establishes contribution levels sufficient to pay current benefit payments only and not to pre-fund future liabilities.
- Assets under management provide liquidity necessary to make benefit payments in the event of a delay in the annual State budget approval process.

### LRS Recommendation

A conservative portfolio is recommended for LRS because lower risk may be preferable based on its short duration (mature plan), net cash outflows, and high Asset-to-Payroll ratio. The recommended Policy Portfolio provides inflation protection which is more relevant to a mature plan with net cash outflows and could allow for the current board-approved discount rate to remain unchanged.

### JRS II Recommendation

Maintaining a moderately aggressive portfolio is recommended for JRS II because higher risk may be preferable based on its long duration (young plan), net cash inflows, and low Asset-to-Payroll Ratio. Nevertheless, both its Active-to-Retired ratio (indicator of maturity) and net cash inflows are rapidly decreasing, thus, Staff do not recommend increasing the risk profile of this plan.

For JRS II, Staff also examined the following risk considerations:

1. Funded Ratio: Probability of the funded ratio falling below 50% in any of the next 30 years
2. Contribution Level: Probability of the employer contribution rate exceeding 35% in any of the next 30 years
3. Contribution Volatility: Probability of the year-to-year increase in employer contribution rate exceeding 3.0% in any of the next 30 years

As shown on page 16 of attachment 1, the recommended Policy Portfolio also strikes a balance between lowering the contribution level and lowering the volatility of contribution levels. Finally, the recommended Policy Portfolio could also allow the board-approved discount rate to remain unchanged.

### CERBT Recommendation

Staff attempts to provide adequate and cost-efficient investment choices to allow employers the ability to select a portfolio that matches their risk preferences and plan characteristics to support participating employer's effort in setting their own contribution rates to pre-fund their liabilities. Therefore, Staff recommends three portfolios (conservative, moderate, aggressive) with similar levels of risk as those selected in the last strategic asset allocation review process in 2014.

### Ranges on Asset Classes

Page 19 of Attachment 1 shows the proposed ranges for each asset class. Those ranges are believed to allow an appropriate level of flexibility to minimize the trading costs associated with the quarterly, systematic re-balancing applied to these funds.

### **Budget and Fiscal Impacts**

Not Applicable.

### **Benefits and Risks**

The benefits of approving recommended Policy Portfolio include:

1. Strengthening the long-term sustainability of LRS, and JRS II.
2. Ensure the smooth operation of JRS.
3. Provide adequate and cost-efficient investment alternatives for employers who participate in CERBT to meet their non-pension, post-retirement benefit obligations.

The risks of approving the proposed Policy Portfolio include:

1. The actual realization of future uncertainties deviates significantly from model projections.
2. Other risk factors, not adequately articulated in our model become dominant forces in determining future outcomes.

### **Attachments**

Attachment 1 – Affiliate Trust Asset Allocation Review: LRS, JRS, JRS II and CERBT

Attachment 2 – Opinion Letter from Wilshire Associates

---

**Daniel Bienvenue**

Managing Investment Director  
Global Equity

---

**Eric Baggesen**

Managing Investment Director  
Trust Level Portfolio Management

---

**Theodore Eliopoulos**

Chief Investment Officer

---

**Scott Terando**

Chief Actuary

# Affiliate Trust Asset Allocation Review: LRS, JRS, JRS II and CERBT

Trust Level Portfolio Management  
Global Equity, Affiliate Investment Program

05/14/2018

# Affiliate Trust Asset Allocation Review: Investment Committee (IC) Engagements in 2018

*Monday, April 16<sup>th</sup>*  
*Investment Committee*

Asset Allocation Review:

- Supplemental Income Plans (SIP)

*Monday, May 14<sup>th</sup>*  
*Investment Committee*

Asset Allocation Review

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

*Monday, June 18<sup>th</sup>*  
*Investment Committee*

Asset Allocation Review:

- Health Care Fund (HCF)
- Long-Term Care Fund (LTC)

## Overview of Program Characteristics

## Strategic Asset Allocation and Recommendations

# Affiliate Funds

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

# Program Overview – Establishment, Purpose, & Status

Plan	Established	Purpose	Status
LRS	1947	Provide defined retirement and ancillary benefits to: <ul style="list-style-type: none"> <li>Members of the Legislature elected prior to November 7, 1990</li> <li>Elected Constitutional and Legislative Statutory Officers elected prior to December 31, 2012</li> </ul>	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
CERBT	2007	Allow employers to pre-fund non-pension, post-employment benefits <ul style="list-style-type: none"> <li>Three policy portfolios available for employers to select (Strategy 1, 2, 3) depending on employer risk preferences</li> </ul>	Open Fund

# Program Overviews – Key Statistics

Program	Assets Under Management (AUM) (\$ millions) <sup>1</sup>	Employer and Employee Contribution Rate (as % of payroll)	Participants <sup>2</sup>				Funded Ratio <sup>3</sup>
			Active	Inactive	Retired	Total	
LRS	\$117	Employer contribution rate is 38.145%. Employee contribution rates vary. <sup>4</sup>	8	7	232	247	115.9%
JRS	\$48	8% for both Employer and Employees.	192	8	1,861	2,061	1.50%
JRS II	\$1,356	Employer contribution rate: 24.66%. Classic Employee contribution rate: 8%. PEPRA Employee contribution rate: 16.00%.	1,511	1	161	1,673	99.3%
CERBT Total	\$6,796	N/A	Participating Employers: 524				N/A
CERBT (strategy 1)	\$5,655		Active Members Covered: 461,592				
CERBT (strategy 2)	\$880		Retired Members Covered: 266,978				
CERBT (strategy 3)	\$261						

<sup>1</sup> As of June 30, 2017, source My State Street.

<sup>2</sup> As of June 30, 2017, source Actuarial Valuation reports. CERBT data from program administrators.

<sup>3</sup> As of June 30, 2017, source Actuarial Valuation reports, based on Market Value of Assets.

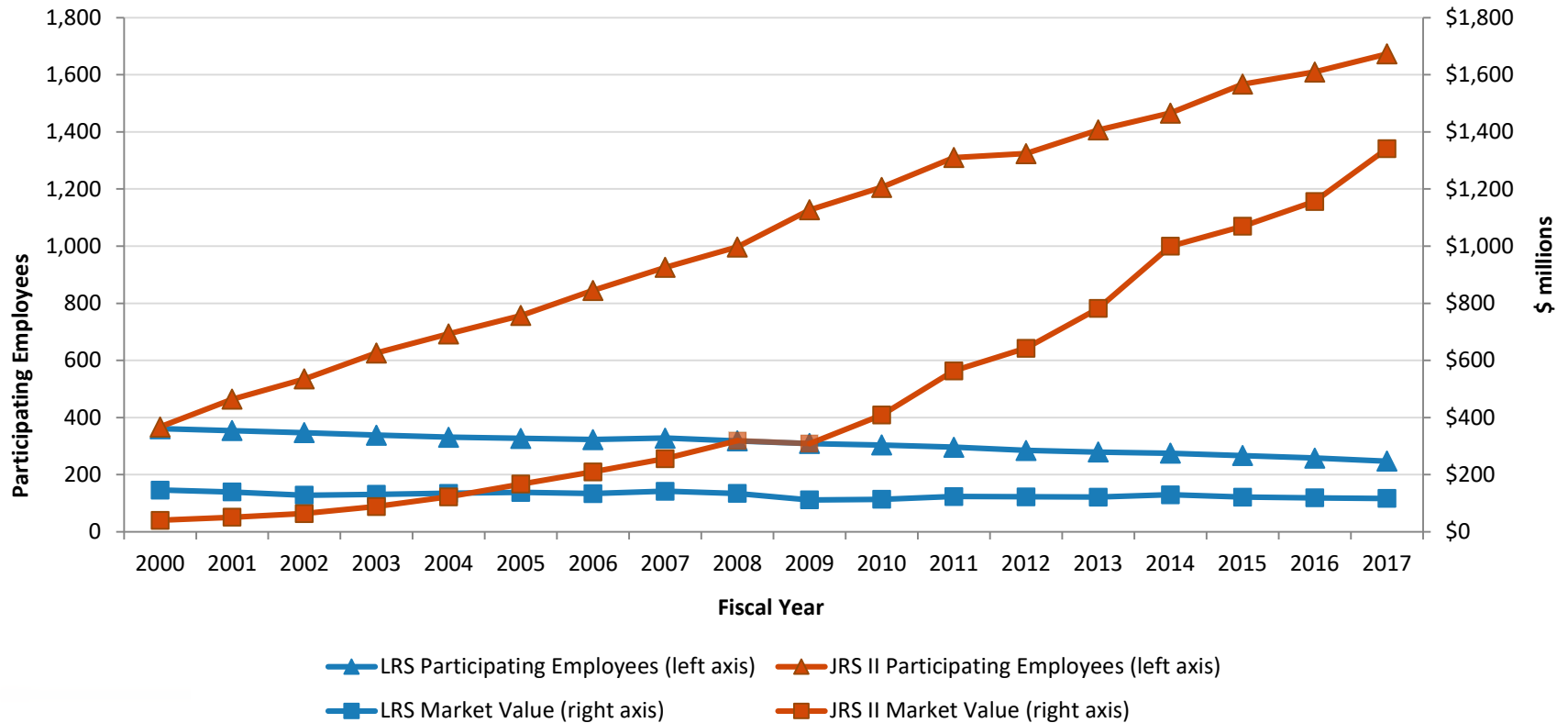
<sup>4</sup> For Legislative and Constitutional Officers, 4% if elected before March 4, 1972, 8% if after.  
For Legislative Statutory Officers, 6.5% if elected before March 4, 1972, 8% if after.

# Program Characteristics – JRS

- The State currently funds JRS through a pay-as-you-go approach<sup>1</sup> since current asset levels are not adequate to meet JRS' expected benefit payouts.
- JRS is a closed system with a funded ratio of 1.50% and an average expected remaining service for current active employees of 4.2 years.
- Assets under management are \$48 million as of June 30, 2017.

# Program Characteristics: Demographic Trends

AUM and Participant Data<sup>1</sup>  
LRS and JRS II as of June 30, 2017



<sup>1</sup> AUM data are from My State Street. Participant data for LRS and JRS II from Actuarial Valuation reports.

# Program Characteristics – Fund Maturity

- A plan can better absorb an investment loss if benefit payments are more distant (members retire later)
- LRS is a very mature plan.
- JRS II is a young pension plan and is well above peers in the number of active participants in relation to retired participants.

Maturity of Plan  
(Active-to-Retired Ratio<sup>1</sup>)

Year	LRS	JRS II	PERF <sup>2</sup>	Public Pension Peers <sup>3</sup>
2008	0.05	65.20	1.78	1.98
2009	0.05	69.31	1.69	1.91
2010	0.05	62.42	1.59	1.82
2011	0.06	42.67	1.50	1.72
2012	0.06	34.76	1.45	1.63
2013	0.04	26.00	1.34	1.55
2014	0.04	19.61	1.02	1.48
2015	0.04	15.31	1.42	1.44
2016	0.04	12.40	1.35	1.42
2017	0.03	9.39	1.33	--

<sup>1</sup> Source: Actuarial Valuation reports for LRS and JRS II.

<sup>2</sup> Public Employees' Retirement Fund (PERF)

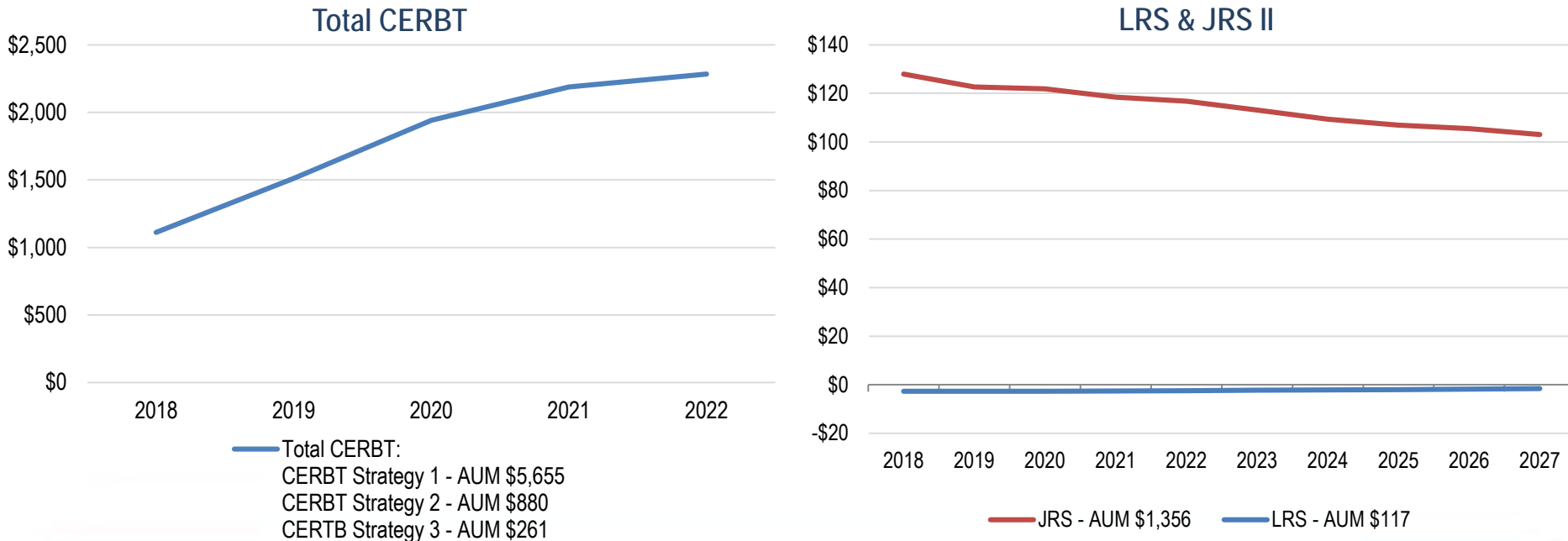
<sup>3</sup> Source: Public Fund Survey (November 2017), Industry Data based on U.S. Public Pension Systems which constitute 85% of all assets under management by U.S. public pension funds.

# Program Characteristics – Forecasted Cash Flows

Cash flows affect a plan’s ability to absorb market shocks and its need to manage liquidity.

- LRS has stable cash outflows.
- JRS II has large but decreasing cash inflows.
- The CERBT strategies have large cash inflows relative to their size.

Cash Flow Forecast for Affiliate Funds (\$ millions)<sup>1</sup>



<sup>1</sup> As of June 30, 2017. Cash flow forecast is calculated by subtracting benefit payments and expenses from contributions plus current investment cash income. Benefit payments and contributions are forecasted based on employer data from Actuarial Valuation reports; investment income is based on the estimated cash yields on current portfolios.

# Program Characteristics – Contribution Rate Sensitivity to Investment Performance

The Asset-to-Payroll Ratio<sup>1</sup>, also known as the Volatility Index, is an indicator of a plan’s contribution rate sensitivity to investment performance.

- LRS contribution rates are highly affected by investment performance.
- JRS II contribution rates are less sensitive to investment performance.

Sensitivity to Investment Performance  
(Asset-to-Payroll Ratio)

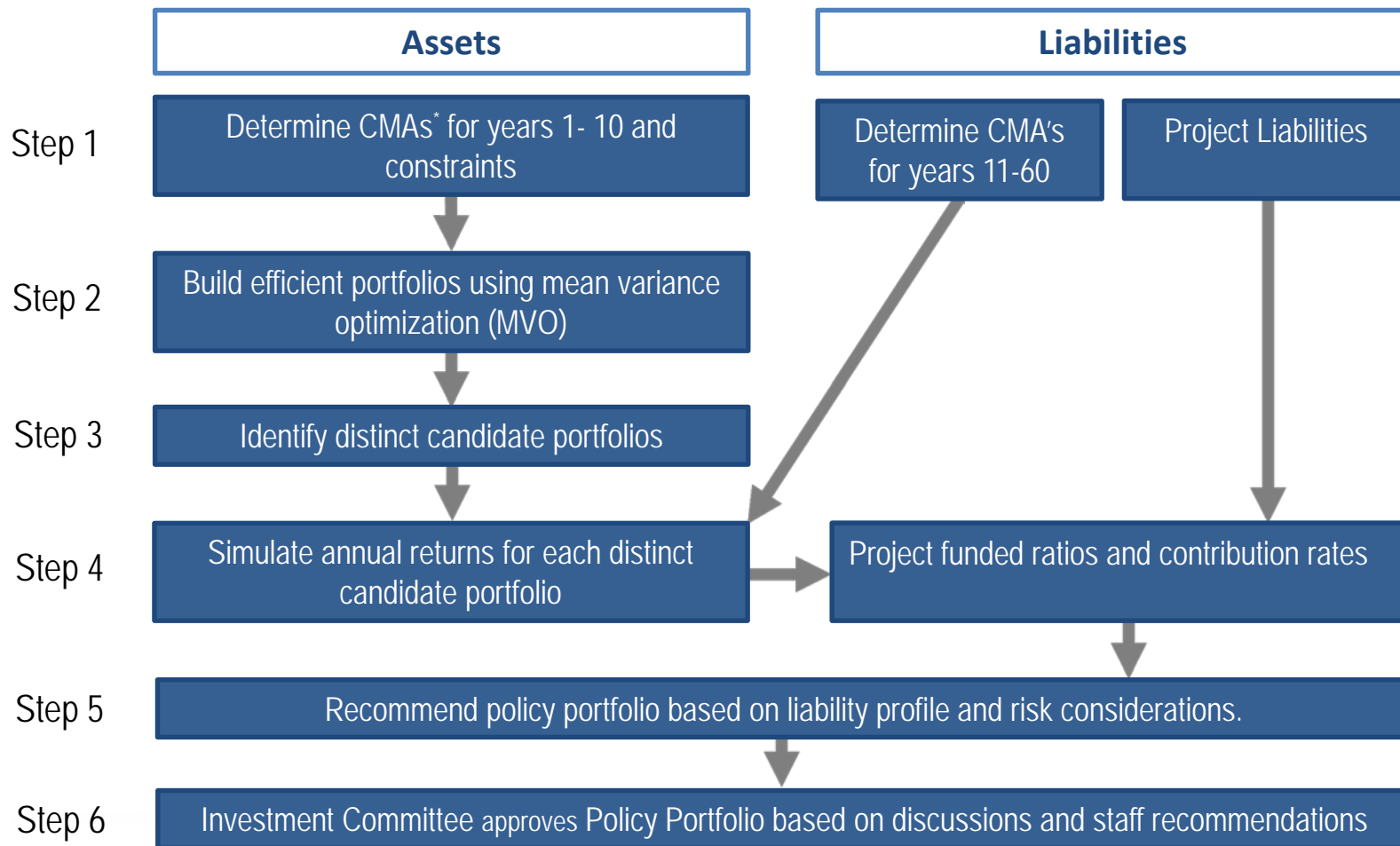
Year	LRS	JRS II	PERF
2008	60.52	1.71	5.38
2009	54.36	1.49	3.97
2010	52.85	1.86	4.48
2011	54.45	2.36	5.51
2012	62.03	2.68	5.56
2013	85.58	3.10	6.14
2014	86.89	3.80	6.70
2015	95.26	3.75	6.37
2016	90.13	4.15	5.98
2017	96.71	4.65	--

<sup>1</sup> Market net asset value to total payroll expenses.

## Overview of Program Characteristics

## Strategic Asset Allocation and Recommendation

# Steps to Obtain Policy Portfolio



\* Capital Market Assumptions (CMAs)

## 2018 CMAs and Constraints for Affiliate Funds

- Global Equity and Commodities CMAs are carried over from the Public Employees' Retirement System 2017-18 Asset Liability Management process.
- Fixed Income and TIPS<sup>1</sup> CMAs are updated to reflect only domestic securities.
- REITs<sup>2</sup> expected returns are estimated using a Dividend Discount Model.
- Constraints are placed on TIPS, Commodities, REITs given the limitations of MVO.

2018 CMAs	Compound Return	Volatility	Average Return	Constraint	
				Floor	Cap
Global Equity	6.80%	17.00%	8.14%	0%	100%
Fixed Income	3.10%	7.83%	3.40%	0%	100%
TIPS <sup>1</sup>	2.25%	5.46%	2.40%	5%	100%
Commodities	3.50%	21.50%	5.71%	3%	100%
REITs <sup>2</sup>	5.50%	17.28%	6.90%	8%	100%

# Plan Characteristics and Effect on Asset Allocation

Plan Characteristic	Description	Plan Characteristic <i>(If it is...)</i>	Implication for Portfolio <i>(Then ...)</i>	Affiliate Fund
Fund Maturity	A plan’s ability to absorb an investment loss is affected by how distant benefit payments are (members retiring later)	Short Duration	Lower risk may be preferable	LRS
		Long Duration	Higher risk may be acceptable	JRS II
Cash Flows	Cash flows affect a plan’s ability to absorb market shocks and need to manage liquidity	Cash Outflows	Lower risk may be preferable	LRS
		Cash Inflows	Higher risk may be acceptable	JRS II
Asset-to-Payroll Ratio	A plan’s asset-to-payroll ratio affects the sensitivity of employer contribution rate to investment returns	High Sensitivity	Lower risk may be preferable	LRS
		Low Sensitivity	Higher risk may be acceptable	JRS II

# Candidate and Recommended Portfolios

Asset Allocation of Candidate Portfolios											
Asset Class Component	P0*	P1	P2	P3	P4	P5	P6	P7	P8	P9	
Global Equity	--	19%	22%	28%	35%	40%	46%	52%	59%	68%	
Fixed Income	--	41%	49%	54%	48%	43%	37%	32%	25%	16%	
TIPS <sup>1</sup>	--	28%	16%	5%	5%	5%	5%	5%	5%	5%	
Commodities <sup>1</sup>	--	4%	5%	5%	4%	4%	4%	3%	3%	3%	
REITs <sup>1</sup>	--	8%	8%	8%	8%	8%	8%	8%	8%	8%	
Liquidity	100%	--	--	--	--	--	--	--	--	--	
Expected Compound Return (1-10 yrs.) :	2.00%	4.16%	4.41%	4.75%	5.01%	5.22%	5.43%	5.61%	5.85%	6.10%	
Expected Compound Return (11-60 yrs.) :	--	6.43%	6.71%	7.06%	7.30%	7.49%	7.68%	7.85%	8.07%	8.28%	
Expected Volatility :	1.00%	6.85%	7.28%	7.93%	8.59%	9.24%	9.98%	10.72%	11.83%	13.12%	
Expected Blended Return Net of Fees (1-60 yrs.) <sup>2</sup> :	LRS:	--	4.75%	5.00%	5.32%	5.55%	5.75%	5.94%	6.10%	6.32%	6.55%
	JRS II:	--	5.12%	5.38%	5.71%	5.95%	6.14%	6.33%	6.50%	6.72%	6.94%
Expected Time-Weighted Return Net of Fees (1-60 yrs.) <sup>2</sup> :	CERBT:	--	5.95%	6.22%	6.57%	6.82%	7.01%	7.20%	7.37%	7.59%	7.82%
Recommendation for plans:	JRS		CERBT 3 LRS			CERBT2		JRS II	CERBT 1		

<sup>1</sup> Lower binding constraints exist in some candidate portfolios.

<sup>2</sup> LRS & JRS II expected blended return net of fees is the combination of the short-term (1 to 10 yr.) and the long-term (11 to 60 yr.) expected returns after deducting admin fees. CERBT is compounding 1–10 yr. & 11–60 yr. expected returns, less admin fees. Admin fees for affiliate funds: CERBT: 10 bps, LRS: 25 bps, JRS II: 15 bps.

\* Portfolio P0 only appropriate for pay-as-you-go programs.

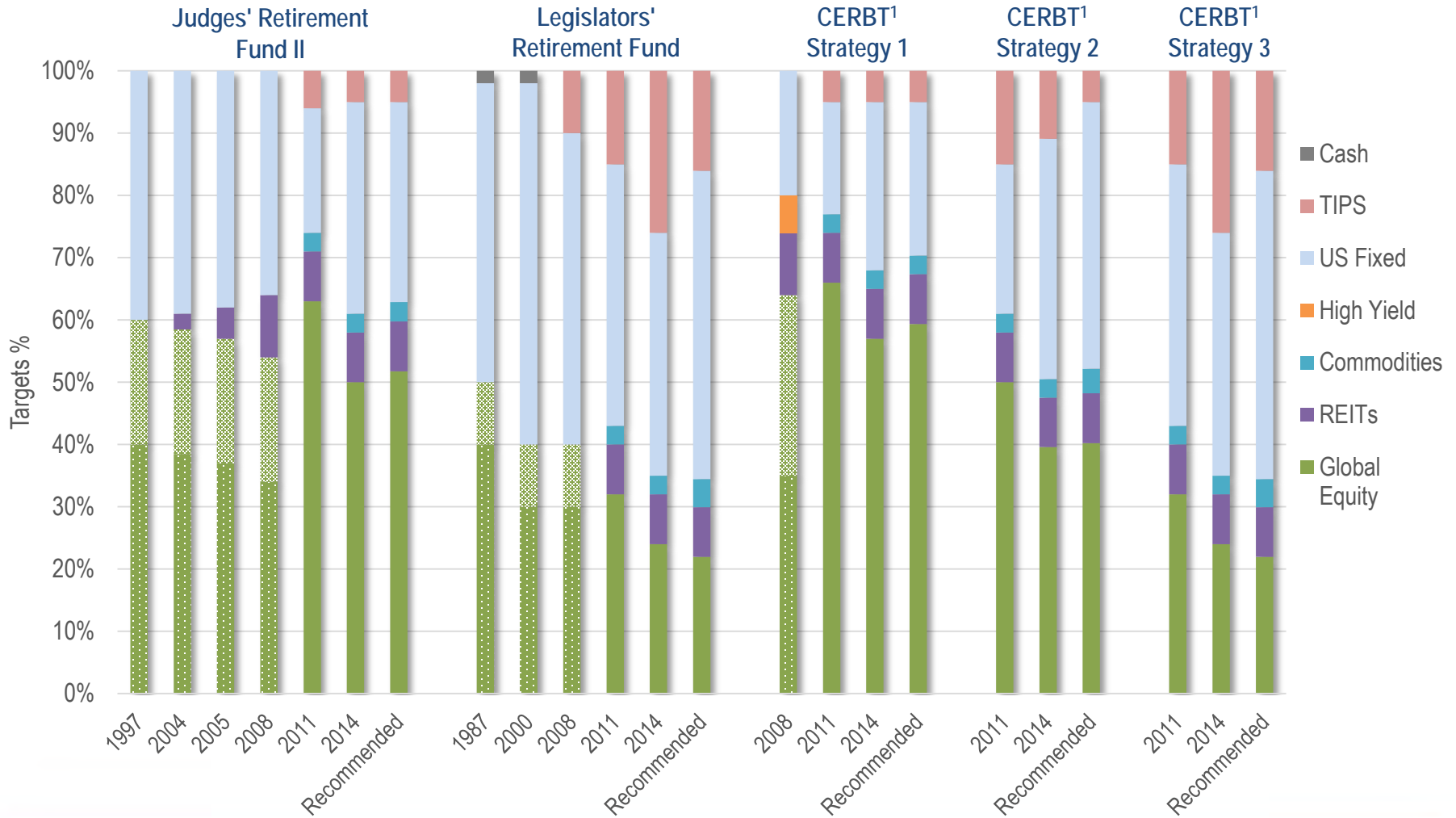
# JRS II Candidate Portfolios & Risk Considerations

## Definitions of Risk Considerations:

- **Funded Ratio:** Probability of the funded ratio falling below 50% in any of the next 30 years
- **Contribution Level:** Probability of the employer contribution rate exceeding 35% in any of the next 30 years
- **Contribution Volatility:** Probability of the year-to-year increase in employer contribution rate exceeding 3.0% in any of the next 30 years

Risk Considerations	Lower Risk Candidate Portfolio (P6)	Recommended Candidate Portfolio (P7)	Higher Risk Candidate Portfolio (P8)	Current Policy Portfolio
Funded Ratio	0%	0%	0%	0%
Contribution Level	11%	2%	2%	2%
Contribution Volatility	3%	5%	7%	4%

# Historical and Recommended Asset Allocation Policies



<sup>1</sup> There was only one asset allocation strategy for the CERBT prior to August 2011. The CERBT was split in 2011 given the diversity of employer plan funded ratios and risk preferences.

# Proposed Asset Class Ranges

Asset Class	LRS	JRS II	CERBT
Global Equity	+/- 5%	+/- 5%	+/- 5%
Fixed Income	+/- 5%	+/- 5%	+/- 5%
TIPS	+/- 3%	+/- 3%	+/- 3%
Commodities	+/- 3%	+/- 3%	+/- 3%
REITs	+/- 5%	+/- 5%	+/- 5%
Liquidity	+ 2%	+2%	+2%

## Objectives:

- Provide flexibility for changing market conditions between portfolio rebalances
- Reduce rebalancing frequency and costs
- Facilitate contribution & distribution activity

# Appendix

# Program Recommendation – JRS

- Staff has evaluated the JRS Program and determined that the current strategic allocation, 100% in Liquidity, should be maintained.
- The existing assets under management provide liquidity necessary to make benefit payments in the event of a delay in the annual State budget approval process.

# Recommended LRS Policy Portfolio and Rationale

Asset Class Component	Recommended Portfolio (P2)	Current Portfolio		Change	
Public Equity	22%	24%		-2%	
Fixed Income	50%	39%		10%	
TIPS	16%	26%		-10%	
Commodities	5%	3%		2%	
REITs	8%	8%		0%	
CMA	2018	2014	2018	Recommended vs Current Portfolio with 2014 CMAs	Recommended vs Current Portfolio (2018 CMAs)
Expected Compound Return (1-10 years)	4.41%	5.40%	4.35%	-0.99%	0.05%
Expected Volatility	7.28%	7.10%	7.21%	0.18%	0.07%
Expected Blended Return Net of Fees <sup>1</sup> (1-60 years)	5.00%	5.76%	4.93%	-0.76%	0.06%
Discount Rate	5.00%	5.75%		N/A	N/A

- P2 is a conservative portfolio that reflects LRS shorter duration, cash outflows, and high contribution rate sensitivity to investment performance.
- Consistent with 5.00% discount rate approved by the Board.

# Recommended JRS II Policy Portfolio and Rationale

Asset Class Component	Recommended Portfolio (P7)	Current Portfolio		Change	
Public Equity	52%	50%		2%	
Fixed Income	32%	34%		-2%	
TIPS	5%	5%		0%	
Commodities	3%	3%		0%	
REITs	8%	8%		0%	
CMA	2018	2014	2018	Recommended vs Current Portfolio with 2014 CMAs	Recommended vs Current Portfolio (2018 CMAs)
Expected Compound Return (1-10 years)	5.61%	6.49%	5.55%	-0.88%	0.06%
Expected Volatility	10.72%	10.75%	10.45%	-0.03%	0.27%
Expected Blended Return Net of Fees <sup>1</sup> (1-60 years)	6.50%	7.05%	6.44%	-0.55%	0.06%
Discount Rate	6.50%	7.00%	N/A	N/A	N/A

- P7 is a moderately aggressive portfolio and reflects the JRS II longer duration, cash inflows, and low contribution rate sensitivity to investment performance.
- P7 exhibits preferable trade-off on risk considerations.
- Consistent with 6.50% discount rate approved by the Board.

# Recommended CERBT 1 Policy Portfolio and Rationale

Asset Class Component	Recommended Portfolio (P8)	Current Portfolio		Change	
Public Equity	59%	57%		2%	
Fixed Income	25%	27%		-2%	
TIPS	5%	5%		0%	
Commodities	3%	3%		0%	
REITs	8%	8%		0%	
CMA	2018	2014	2018	Recommended vs Current Portfolio with 2014 CMAs	Recommended vs Current Portfolio (2018 CMAs)
Expected Compound Return (1-10 years)	5.85%	6.71%	5.78%	-0.86%	0.07%
Expected Volatility	11.83%	11.74%	11.48%	0.09%	0.35%
Expected Time-Weighted Return Net of Fees <sup>1</sup> (1-60 years)	7.59%	7.85%	7.53%	-0.26%	0.07%

- P8 will have slightly higher return and risk than the current portfolio in anticipation of increasing future cash inflow.

1. Expected Time-Weighted Return Net of Fees is annualized compounding of the short-term (1 to 10 year) and the long-term (11 to 60 year) expected returns after deducting administrative fees.

# Recommended CERBT 2 Policy Portfolio and Rationale

Asset Class Component	Recommended Portfolio (P5)	Current Portfolio		Change	
Public Equity	40%	40%		0%	
Fixed Income	43%	39%		4%	
TIPS	5%	11%		-6%	
Commodities	4%	3%		1%	
REITs	8%	8%		0%	
CMA	2018	2014	2018	Recommended vs Current Portfolio with 2014 CMAs	Recommended vs Current Portfolio (2018 CMAs)
Expected Compound Return (1-10 years)	5.22%	6.10%	5.12%	-0.88%	0.10%
Expected Volatility	9.24%	9.24%	9.05%	0.00%	0.19%
Expected Time-Weighted Return Net of Fees <sup>1</sup> (1-60 years)	7.01%	7.28%	6.90%	-0.27%	0.11%

- P5 enables CERBT employers to select a portfolio with similar moderate risk profile as the current portfolio.

1. Expected Time-Weighted Return Net of Fees is annualized compounding of the short-term (1 to 10 year) and the long-term (11 to 60 year) expected returns after deducting administrative fees.

# Recommended CERBT 3 Policy Portfolio and Rationale

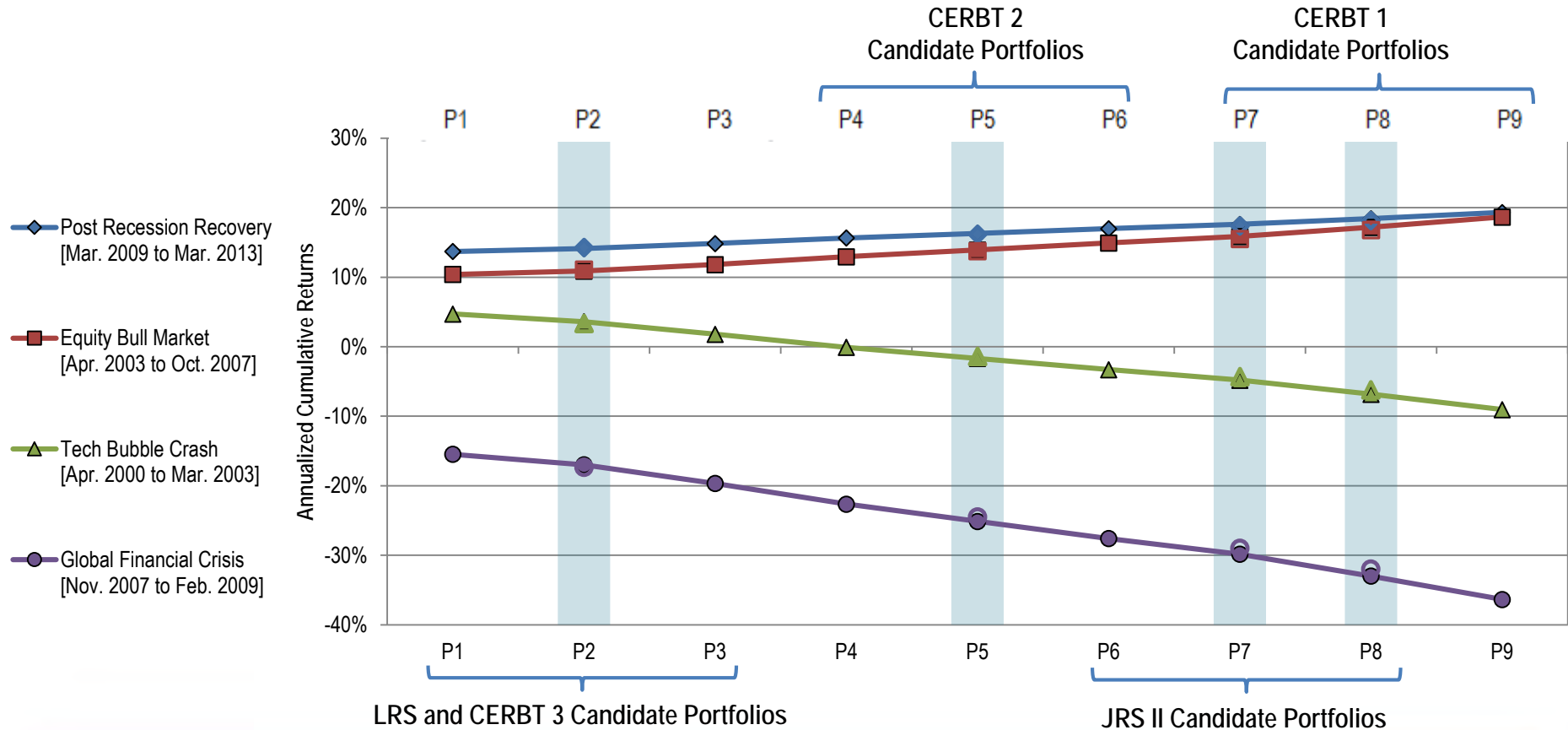
Asset Class Component	Recommended Portfolio (P2)	Current Portfolio		Change	
Public Equity	22%	24%		-2%	
Fixed Income	50%	39%		11%	
TIPS	16%	26%		-10%	
Commodities	5%	3%		2%	
REITs	8%	8%		0%	
CMA	2018	2014	2018	Recommended vs Current Portfolio with 2014 CMAs	Recommended vs Current Portfolio (2018 CMAs)
Expected Compound Return (1-10 years)	4.41%	5.40%	4.35%	-0.99%	0.05%
Expected Volatility	7.28%	7.10%	7.21%	0.18%	0.07%
Expected Time-Weighted Return Net of Fees <sup>1</sup> (1-60 years)	6.22%	6.69%	6.14%	-0.47%	0.08%

- P2 enables CERBT employers to select a portfolio with a similar low risk profile as the current portfolio.
- P2 diversifies away from the low-yielding TIPS as desired by many participating employers.

1. Expected Time-Weighted Return Net of Fees is annualized compounding of the short-term (1 to 10 year) and the long-term (11 to 60 year) expected returns after deducting administrative fees.

# Stress Test – Cumulative Returns Under Various Economic Scenarios

- Filled markers indicate the 9 candidate portfolios (P1-P9)
- Unfilled markers indicate the 4 current portfolios



# 2017 PERF CMAs and Constraints for PERF

Asset Class	Arithmetic Return	Compound Return	Volatility (Std. Dev)	Correlation						Constraints (%)	
				Global Equity	Private Equity	Fixed Income	Real Asset	Inflation Asset	Liquidity	Floor	Cap
Global Equity	8.14%	6.80%	17.00%	1.00	0.81	0.01	0.59	0.39	0.00	0	100
Private Equity	11.26%	8.30%	25.50%	0.81	1.00	0.00	0.48	0.33	0.00	5	8
Fixed Income	3.21%	3.00%	6.58%	0.01	0.00	1.00	0.09	0.40	0.31	15	100
Real Asset	6.49%	5.75%	12.55%	0.59	0.48	0.09	1.00	0.21	0.00	9	13
Inflation Asset	3.08%	2.77%	8.00%	0.39	0.33	0.40	0.21	1.00	0.08	0	12
Liquidity	2.00%	2.00%	1.00%	0.00	0.00	0.31	0.00	0.08	1.00	1	100

U.S. Inflation Assumption: 2.00%

# Asset Classes and Corresponding Benchmark Policy for CERBT, JRS, JRS II and LRS<sup>1</sup>

Asset Class	LRS	JRS II	CERBT	JRS
Global Equity	CalPERS Custom FTSE Global Composite	CalPERS Custom FTSE Global Composite	MSCI ACWI IMI (Net)	N/A
US Fixed Income	Barclays Long Liability Index	Barclays Long Liability Index	Barclays Long Liability Index	N/A
TIPS	Bloomberg US TIPS Index	Bloomberg US TIPS Index	Bloomberg US TIPS Index	N/A
Commodities	S&P GSCI Total Return Daily	S&P GSCI Total Return Daily	S&P GSCI Total Return Daily	N/A
REITs	FTSE EPRA/NAREIT Developed Index	FTSE EPRA/NAREIT Developed Index	FTSE EPRA/NAREIT Developed Liquid (Net)	N/A
Liquidity	N/A	N/A	N/A	Short-Term Investment Fund

<sup>1</sup> CalPERS Statement of Investment Policy for Benchmarks, March 6, 2014



**Steven J. Foresti**  
**Chief Investment Officer, Wilshire Consulting**

**Thomas Toth**  
**Managing Director, Wilshire Consulting**

April 10, 2018

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

Re: Affiliate Trust Asset Allocation Review

Dear Mr. Jones:

You requested Wilshire's opinion as it relates to Staff's recommended asset allocation for the Affiliate Funds. As of fiscal 2017, the CalPERS' Affiliate Funds had approximately \$8.3B in assets across LRS (\$117m), JRS (\$48m), JRS II (\$1.35B), and the three CERBT strategies (\$6.8B). The last asset allocation study for these Affiliate Funds was conducted in 2014 and the current study reflects adherence to the regular four year asset allocation cycle.

*The Process*

Wilshire believes that the methods, inputs and data used to perform the asset allocation study are appropriate and reasonable. The asset class assumptions used in the process were consistent with those approved and utilized within the PERF's recent ALM review with the modifications that Fixed Income and TIPS assumptions reflect only domestic issues and REITs provide real estate exposure due to liquidity requirements. Minimum constraints were included for TIPS, Commodities, and REITs to force a certain level of diversification into the alternative portfolios that might be underappreciated in a pure optimized framework. 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 also 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 alternative target policy portfolios, Staff primarily focused on achieving a median expected rate of return consistent with the discount rate utilized by the Funds (in the case of JRS II and LRS) or providing portfolios with varying levels of expected risk (in the case of CERBT). JRS is a special case in that it is funded as a pay-as-you-go system and therefore invests entirely in a Liquidity portfolio of short-term fixed income securities.

In addition, Staff took into consideration demographic and fund characteristics in the decision making process, where available. The factors included participant growth trajectories, the ratio of active-to-retired participants, forecasted cash flows, and contribution rate sensitivity. These factors have important implications for the ultimate risk profile of the adopted portfolios, which are laid out in Staff's materials. The importance 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*

Wilshire believes that the recommended asset allocations are appropriately specified for each Fund and take into account relevant decision factors. As can be seen on slide 16 of Staff's presentation deck (attachment 1 of this agenda item), the expected return and risk for the proposed target asset allocations align with established discount rates (slides 22 and 23) and provide asset allocations with varying levels of expected risks and returns (slides 24-26). In addition, Staff lays out the other decision factors, specifically fund maturity and cash flow characteristics, which support the selection of the recommended portfolios for each fund. Lastly, the rebalancing ranges provided on slide 19 are reasonable and consistent across the Funds.

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

Best regards,

Handwritten signature of Steven J. Foresti in black ink.

Steven J. Foresti

Handwritten signature of Thomas Toth in black ink.

Thomas Toth

Wilshire Associates

370 Interlocken Boulevard Suite 620 Broomfield, CO 80021 TEL 303.626.7444 FAX 303.466.1537  
[www.wilshire.com](http://www.wilshire.com)