



Investment Committee

Agenda Item 7a

November 16, 2020

Item Name: Long-Term Care: Asset Allocation and Discount Rate

Program: Trust Level Portfolio Management & Implementation

Item Type: Action

Recommendation

Set the discount rate for the Long-Term Care Fund to between 4.75 percent to 5.00 percent (specific recommendation will be presented at the Investment Committee meeting) with a portfolio volatility (risk) maximum of 9.50 percent and approve the inclusion of private asset classes and the use of leverage in the investment portfolio.

Executive Summary

The CalPERS Long-Term Care (LTC) Program offers voluntary coverage that helps policyholders pay for care when they need long-term care assistance and is funded solely by policyholder premiums and investment income. This agenda item provides an update regarding the LTC Fund strategic asset allocation and investment management review.

At the September 2020 Investment Committee meeting, CalPERS team members discussed challenges facing the CalPERS Long-Term Care current investment portfolio and that the expected return had dropped to 4.00 percent, which will lead to significant premium increases. To address this, CalPERS team members released a Request for Proposal (RFP) for strategic asset allocation and investment management services to determine if the strategic asset allocation can be further optimized and to assess an expanded set of options that could be available for the LTC Fund.

While it was initially anticipated that the strategic asset allocation review and recommendation would be brought to the Investment Committee in November, due to the size and complexity of the RFP responses, the full review will be presented at the February 2021 meeting. For discussion at the November meeting, the team will present findings from conducting a detailed portfolio review of the proposals that support the recommendations for a discount rate, investment risk, and the expansion of asset classes and investment products.

Strategic Plan

This agenda item supports the Strategic Plan Goal: Fund Sustainability in the following ways: 1) conducting the LTC Fund strategic asset allocation ahead of the full 2021/22 ALM process

enables adoption of an optimized allocation in alignment with proposed premium increases in 2021, and 2) evaluating external investment manager expertise and recommendations provides support for an increased expected long-term investment return (with an increase in risk) and a discount rate in the range of 4.75 percent to 5.0 percent.

Investment Beliefs

Strategic asset allocation and management of the LTC Fund supports CalPERS Investment Belief 1: Liabilities must influence the asset structure and Investment Belief 6: Strategic asset allocation is the dominant determination of portfolio risk and return.

Background

The Investment Office manages the LTC Fund asset allocation and investment strategy. In 2012, the LTC Fund strategic asset allocation was updated to allocate 67 percent of the portfolio to fixed income assets, reduce investment return volatility, and set the discount rate at 5.75 percent. Further strategic asset allocation reviews were conducted in 2015 and 2018. No changes were made in 2015, while minor changes and a lowering of the discount rate to 5.25 percent were adopted in 2018. The current strategic allocation to fixed income is 66 percent.

Due to the historically low interest rate environment, the long-term expected returns for fixed income assets have dropped significantly, resulting in a reduction in the expected return of the LTC Fund from 5.43 percent in 2018 to approximately 4.00 percent in 2020. To determine if the strategic asset allocation can be further optimized and to assess an expanded set of options that could be available for the LTC Fund, CalPERS team members requested approval at the September Finance and Administration Committee meeting to release an RFP.

The scope of the RFP includes customized strategic asset allocation with investment management services and seeks information on the array of strategies, products, expertise, and market access that external managers have available for managing the LTC Fund. If a manager is selected, the Investment Committee will retain authority for approving the asset allocation and benchmarks and CalPERS team members will be responsible for monitoring the manager's asset allocation, rebalancing, investment management, and performance.

Analysis

The Request for Proposal was released on September 16, 2020 and contains 140 questions across 14 categories. The proposals, received on October 14, 2020, are each several hundred pages in length, and include question responses, asset allocation analysis and portfolio recommendations, and several appendices of requested documents and disclosures. Given the size and complexity of the proposals, the full review will take more time than was initially anticipated and the recommendation of a specific asset allocation will be brought to the Investment Committee for approval in February 2021.

For discussion at the November meeting, the team will present findings from conducting a portfolio review of the proposals with the goal of determining what discount rate can be supported. The review assessed the manager asset allocation recommendations in the following ways:

1. To determine if the manager recommended portfolios are generally viable, the team qualitatively evaluated elements such as manager capabilities, asset classes, weights, diversification, portfolio construction, risk management, liquidity, and cashflow management. All portfolio recommendations met this qualitative evaluation and the team found that the managers have a broad range of portfolio recommendations, strong capabilities, and can offer incremental expertise such as long-term care and insurance-related asset-liability management experience, sourcing private asset classes for smaller funds, managing leverage, and de-risking strategies.
2. To determine a discount rate that the manager recommended portfolios can support, the team quantitatively analyzed each portfolio's risk and return values by asset class and calculated total portfolio risk and return using three different sources for capital market assumptions (CMAs):
 - a. The managers' 03/31/20 CMAs (per the date requested in the RFP)
 - b. CalPERS' 03/31/20 CMA survey for the ALM Mid-Cycle Review in June 2020
 - c. Wilshire Associates' 09/30/20 CMAs

The findings suggest that there are a number of portfolios that can support a discount rate between 4.75 percent and 5.0 percent, when using a blend of short-term and long-term CMAs, conditional on increasing the range of risk tolerance by 30 percent to an upper threshold of 9.5 percent and including private asset classes and leverage.

Budget and Fiscal Impacts

As the technical review phase is currently in process, manager fees have not yet been evaluated. The estimated costs to manage this portfolio will exceed \$1 million or more annually. If a new manager is selected, it is anticipated that the manager (contractor) and fees will be reported to the Finance and Administration Committee on the Contracting Prospective Report for the Board's approval in February 2021.

Benefits and Risks

Utilizing external investment management expertise, with greater LTC and insurance experience, appears supportive of modifying the asset allocation to increase expected investment risk and return by adding private assets and leverage. Such action brings several potential benefits and risks:

Benefits:

- Mitigates the need to reduce the discount rate to 4.0 percent by appearing to support a discount rate between 4.75 percent to 5.0 percent.
- The potential for increased investment returns, which could reduce the magnitude of premium increases.
- Increased portfolio diversification with additional asset types.
- External management provides expertise with insurance and Long-Term Care investment funds, liability cash flow management, de-risking glidepaths over the life of liabilities, and the ability to source private assets and manage leverage for smaller funds.

Risks:

- The potential for increased investment returns may not be realized, which could have a negative impact on premiums.
- Financial market evolution which could further reduce future, expected returns.
- Higher portfolio risk will likely increase variability in investment outcomes from year to year, thus increasing the uncertainty regarding the premium levels required to support the liabilities.
- Increased costs for external management.

Maintaining the discount rate and expected investment risk and return at current levels, not including private assets and leverage in the investment portfolio, and not utilizing external management could have the following benefits and risks:

Benefits:

- Less reliance on investment returns, which are uncertain.
- Current level of expected portfolio risk could result in lower variability in investment outcomes year over year.
- No increase to costs.

Risks:

- Significantly higher premium increases.
- Less diversification, more concentration in lower-yielding asset classes.
- Opportunity cost of not discovering and benefitting from external manager expertise in asset allocation, investment management, and risk management that is specific to long-term care and insurance products.

Attachments

Attachment 1 – Long-Term Care: Asset Allocation and Discount Rate Presentation

Attachment 2 – Wilshire Associates Opinion Letter

Sterling Gunn
Managing Investment Director
Trust Level Portfolio Management & Implementation

Dan Bienvenue
Interim Chief Investment Officer

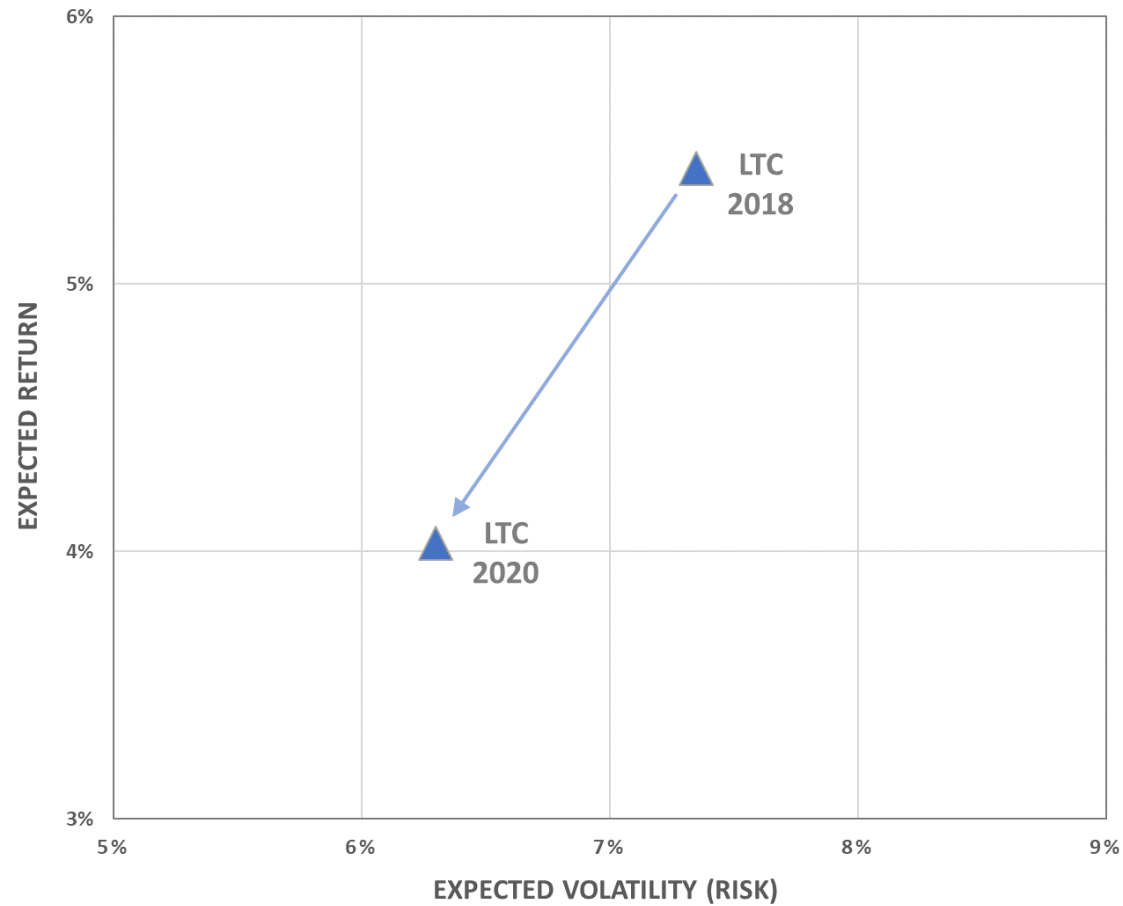
Long-Term Care: Asset Allocation and Discount Rate

Don Moulds, Chief Health Director
Scott Terando, Chief Actuary
Sterling Gunn, Managing Investment Director
Christine Reese, Investment Director

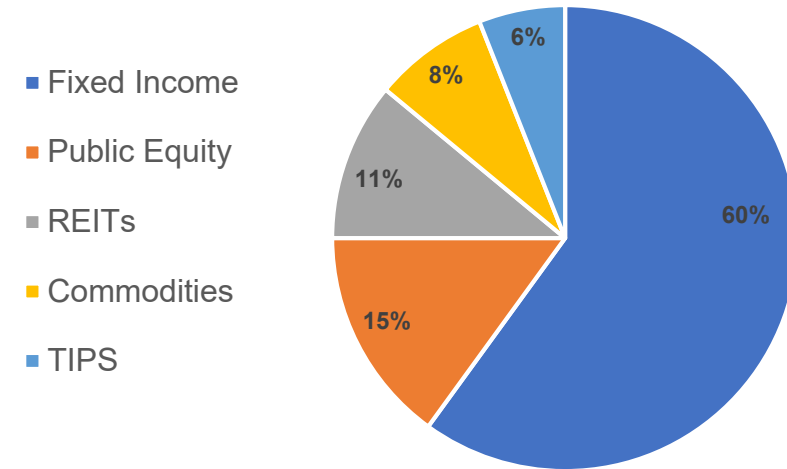
Investment Committee
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Current Portfolio

Expected Risk/Return



Asset Allocation



Portfolio Evaluation

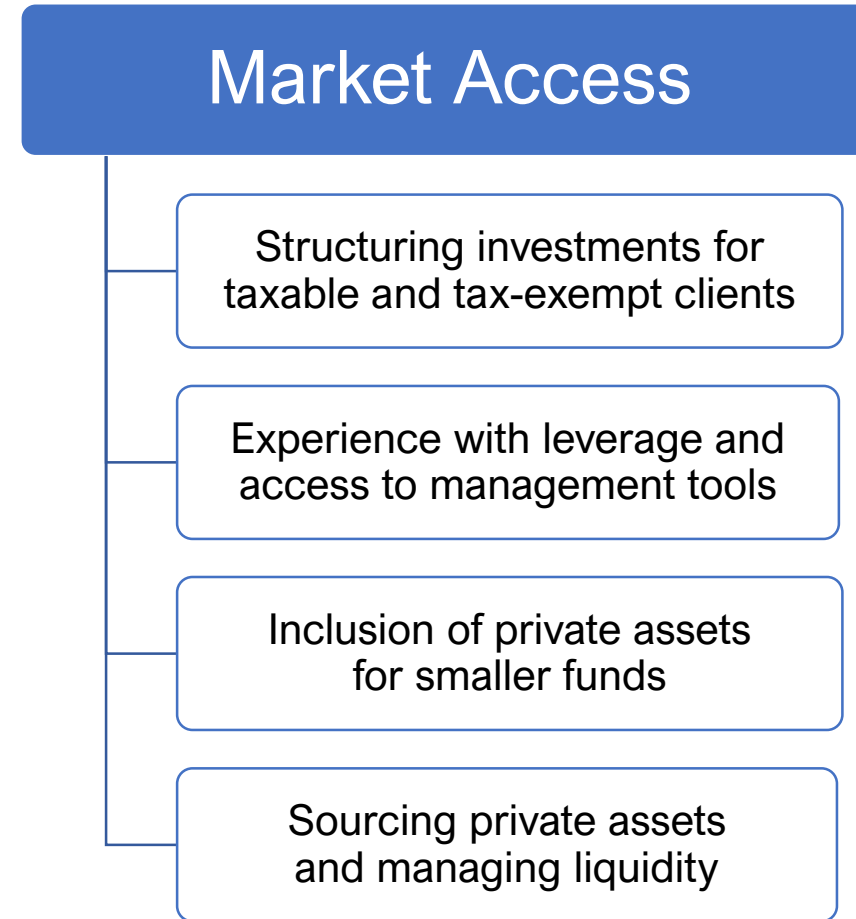
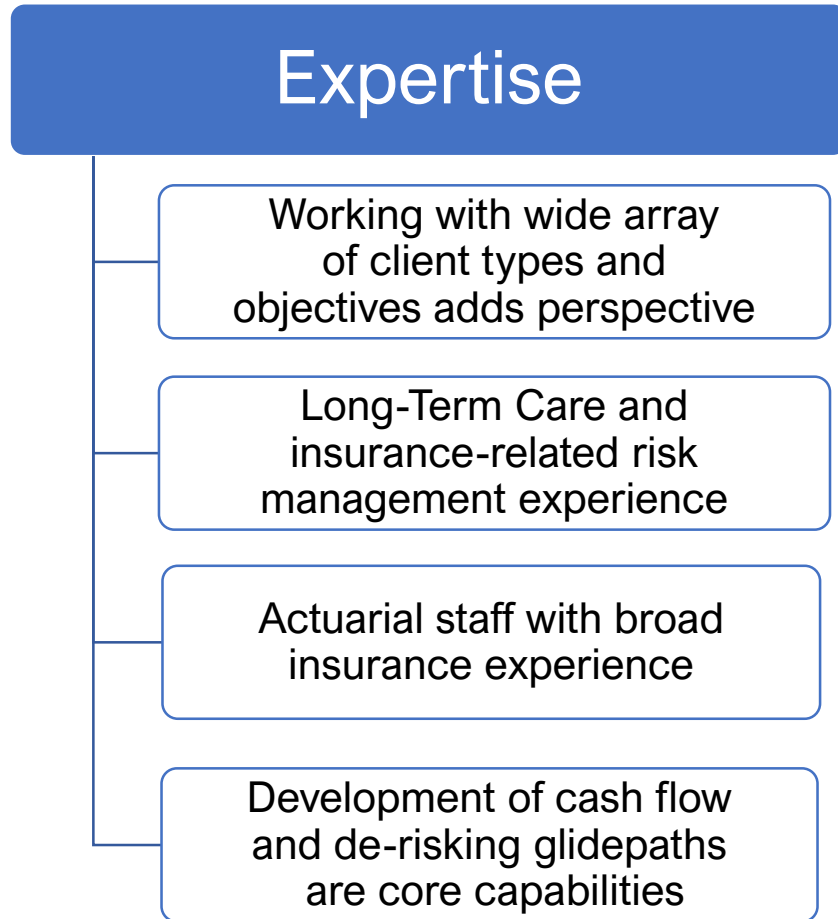
Current

- Market evolution has reduced yield and future return expectations dramatically
- Risk profile in 2018 ALM 7.35% volatility
- Shorter duration than liabilities
- Publicly traded asset classes, institutional commingled funds

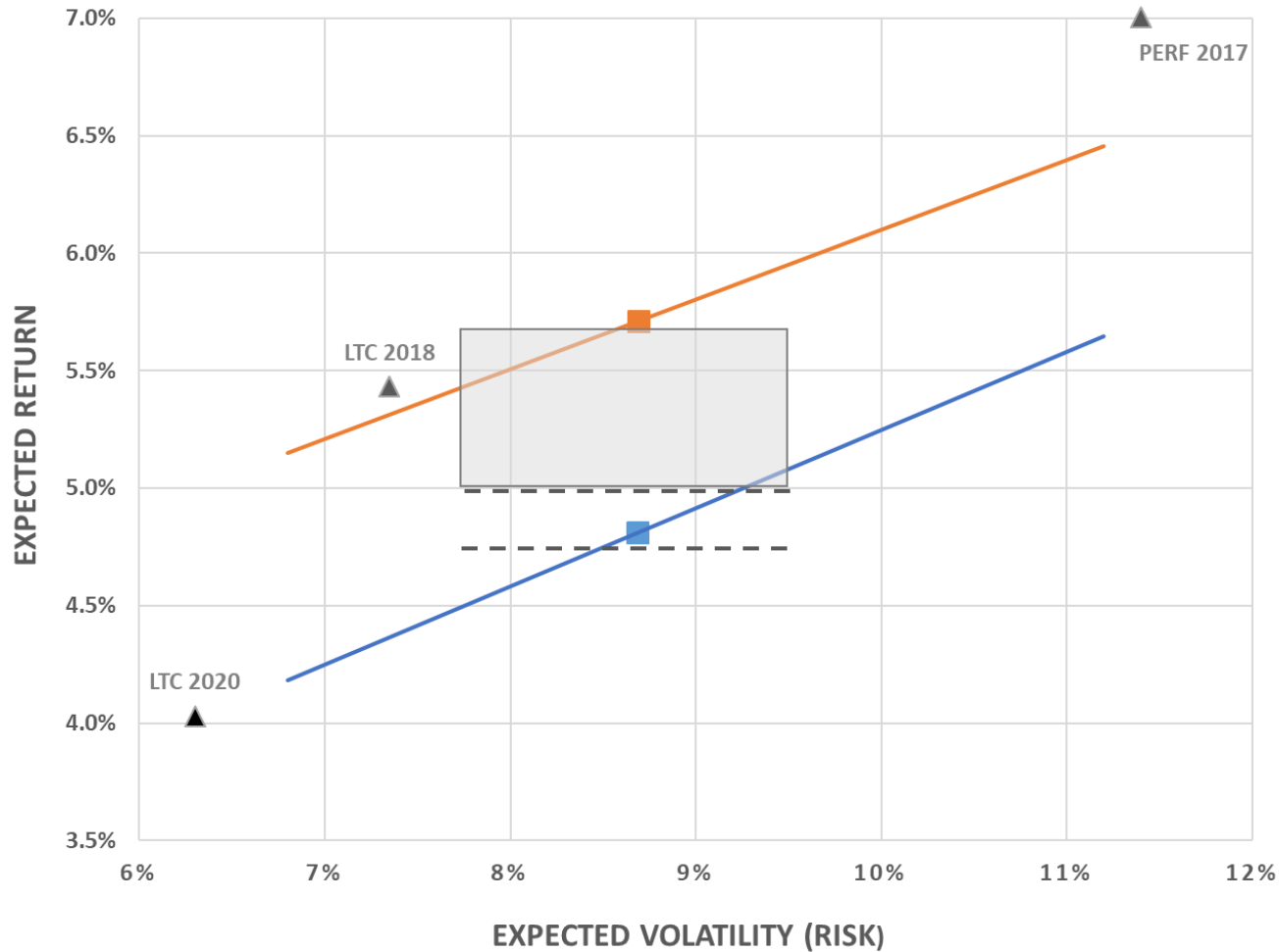
Opportunities

- Search for external expertise with LTC programs
- Liability profile may support increase in risk
- Potential for some private asset inclusion
- Low leverage may warrant some utilization

External Management Value



External Manager Portfolio Evaluation

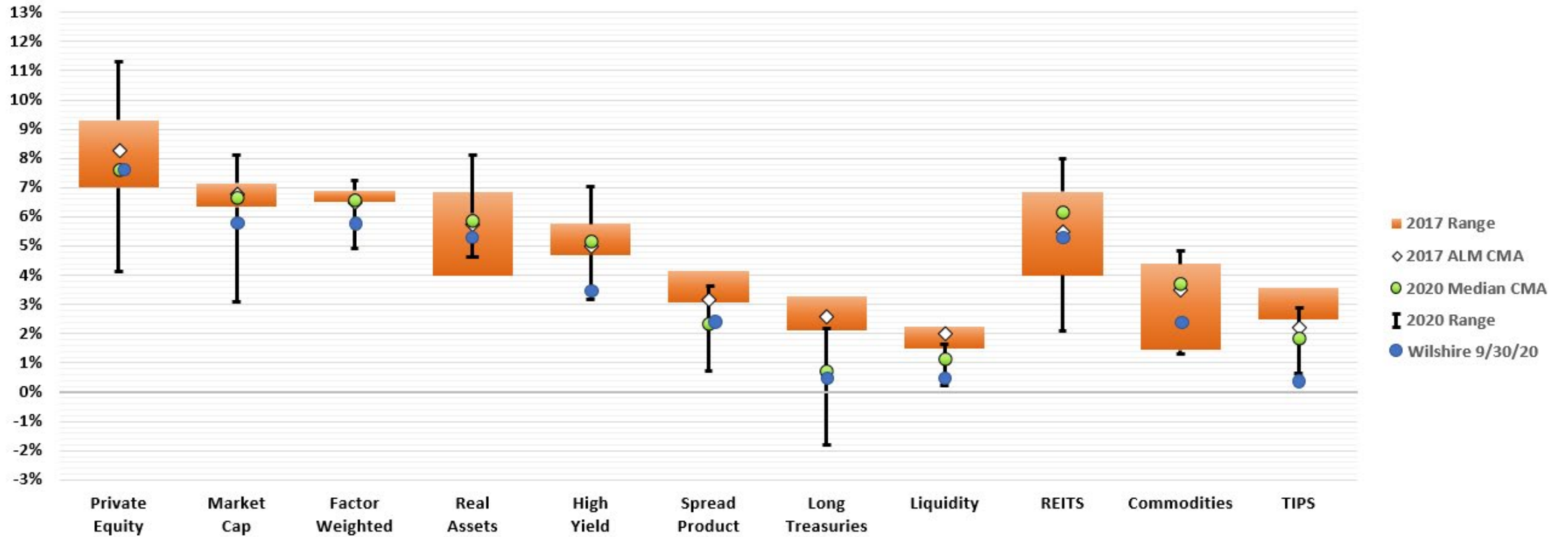


- Several portfolios cluster in an area at or above 5.0% return and below a proposed threshold of 9.5% volatility.
- Increasing risk by up to 30% looks to be supportive of a discount rate in the range of 4.75% to 5.0%.

Legend

- Portfolio 20-year expectations
- Portfolio 10-year expectations
- 20-year average expectations
- 10-year average expectations
- Portfolios with >5% return, <9.5% risk
- Proposed discount rate range 4.75%-5.0%

Capital Market Assumptions



Data Sources:

- 2020 – March 31, 2020 CMA Survey Results from 10+ providers; CalPERS' CMA models
- 2017 - CalPERS 2017 Asset Liability Management Capital Market Assumptions.

Asset Allocation Timeline

Milestone	2020									2021						
	A	M	J	J	A	S	O	N	D	J	F	M	A	M	J	J
Evaluate Current Portfolio	█	█	█													
Conduct Research			█	█												
Draft & Release RFP					█	█										
Receive Proposals							█									
Evaluate Proposals							█	█								
Approve Discount Rate (Nov IC)								█								
Prepare Allocation Recommendation										█						
Approve Allocation (Feb IC)											█					
Contracting & Planning												█	█	█		
Implement Allocation															█	█

Recommendation & Next Steps

Recommendation

1. Long-Term Care discount rate between 4.75% to 5.0% (specific recommendation to be discussed during the Investment Committee meeting)
2. Portfolio risk upper threshold of 9.50%
3. Inclusion of private assets and leverage, to the extent necessary

Next Steps

1. Complete the full strategic asset allocation review
2. Bring asset allocation options and recommendation to IC in February



Thomas Toth, CFA
Managing Director

November 5, 2020

Ms. Theresa Taylor
Chair of the Investment Committee
California Public Employees' Retirement System
400 P Street
Sacramento, CA 95814

Re: Agenda Item 7a: Long-Term Care: Asset Allocation and Discount Rate

Dear Ms. Taylor:

You requested Wilshire's opinion regarding the Long-Term Care (LTC) asset allocation and discount rate. In reviewing the LTC agenda item, Wilshire focused on two questions. First, is the Investment Committee providing an appropriate level of oversight in setting the overall risk tolerance of the LTC portfolio through an asset allocation process? The Investment Committee is being asked to establish a limit on total portfolio risk as an important element of oversight for the portfolio. Further, a goal of utilizing the RFP process discussed earlier this year was to gather information and examine whether additional strategies could be incorporated into the LTC allocation to improve portfolio outcomes. Wilshire views this information gathering process positively to drive better-informed discussion around achieving the portfolio goals of LTC. Wilshire believes the Investment Committee is providing a suitable level of oversight through the process thus far, with additional decisions to be debated in early 2021 to formally approve a target asset allocation.

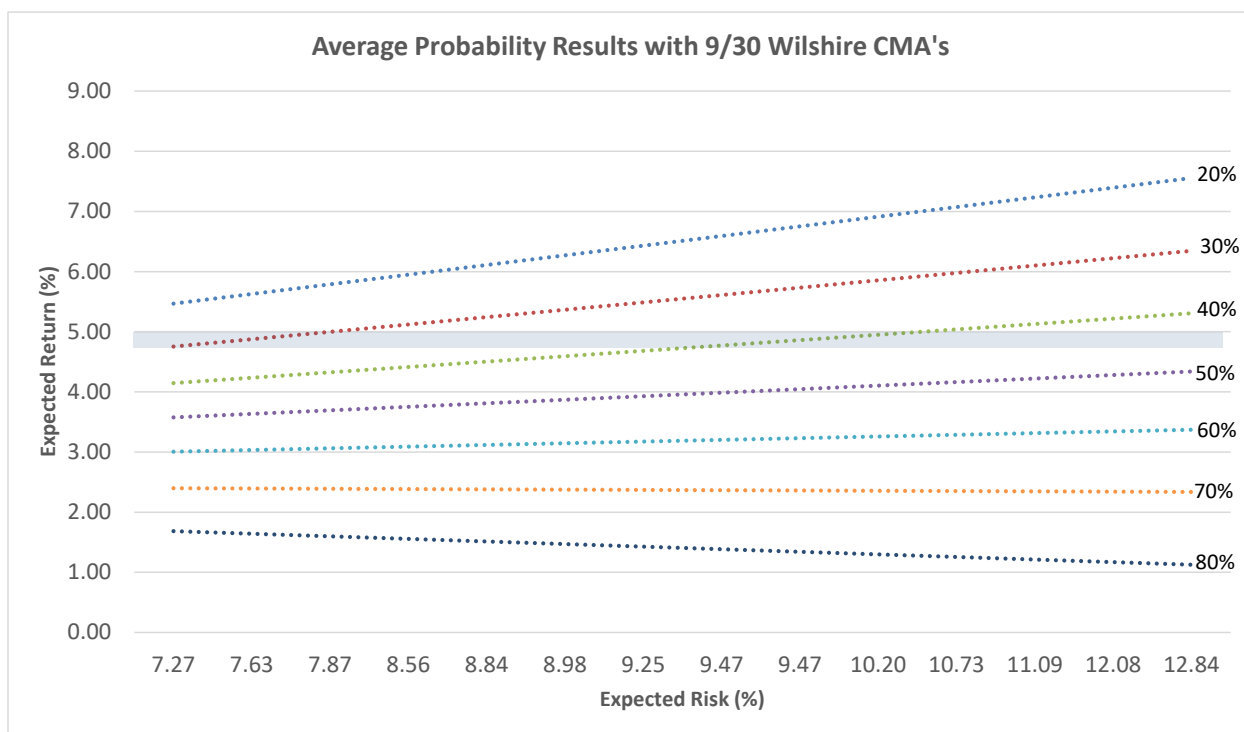
Second, is the proposed discount rate range of 4.75% - 5% reasonable given prevailing asset class return expectations? While the setting of liability discount rates falls under the domain of actuaries rather than within the investment office and/or investment consultants, in order to assist the Committee on this issue we have analyzed the question through the lens of Wilshire's asset class assumptions. Wilshire has independently modeled 14 different asset allocation scenarios (submitted via the RFP process), utilizing more than 30 asset classes and strategies. The strategic asset allocation work that Wilshire provides to CalPERS considers underlying economic and market conditions as well as a discounting of how those conditions might change in the future. Wilshire has been formulating long-term return, risk and correlation assumptions since the early 1980s and now updates asset class forecasts on a quarterly basis.

The asset class assumptions are utilized to provide long-term strategic direction, but that is complicated by the current level of market volatility and economic uncertainty. The pandemic sell off and subsequent rally across risk assets has shifted asset class expectations markedly,



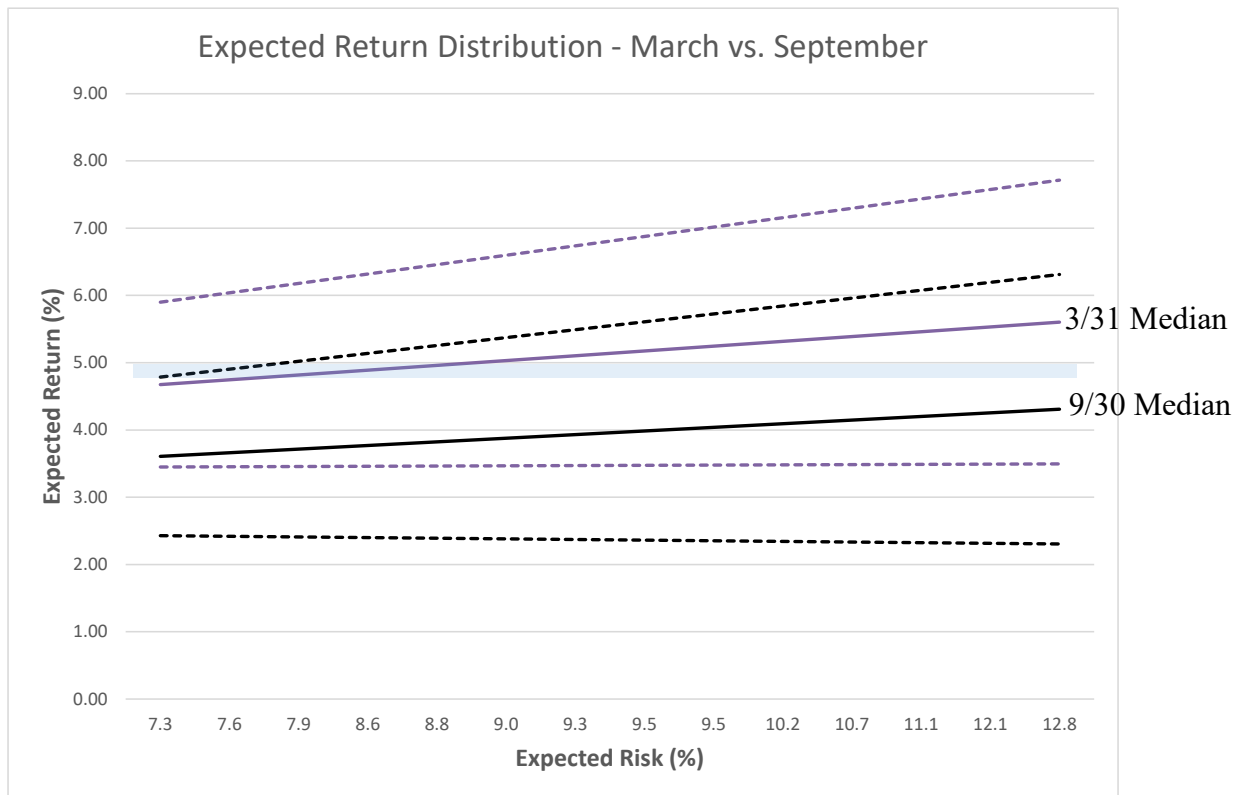
which makes relying on a point in time estimate of expected returns more challenging. That said, given Wilshire’s September 30th, 2020 asset class expectations, the current portfolio is forecast to return 2.9% over 10 years. This is a material shift from March 31st, when expected return stood at 3.5%, and 4.1% at the start of the year. This drop in expected return is primarily a reflection of the extraordinarily low interest rate environment brought on by the pandemic, which we have discussed a number of times with the Investment Committee. Falling interest rates have positively impacted the performance of the LTC portfolio in the last few months, but comes at the expense of reduced forward expected returns. This “Investor’s Challenge” impacts how institutional investors of all types are thinking about portfolio positioning, and necessitates continued evaluation of portfolio strategies.

Additional strategies being contemplated within the LTC portfolio include interest rate overlays, higher levels of credit oriented fixed income, and private opportunities. The expansion of strategies contemplated through the process can help improve the projected outcomes for the LTC portfolio. Wilshire’s modeling of the 14 asset allocation scenarios suggests that, on average, the return can be increased to about 4% over a 10-year horizon in the expected case and 5.85% over a longer term 30-year time horizon. On average, the alternative allocations would significantly increase the portfolio’s expected risk level from the current portfolio’s expected risk of 6.6% to 9.6% (i.e. a nearly 50% increase in expected risk) driven by a reduction in exposure to low yielding Treasuries and an increase in more credit-oriented assets. The average probability of achieving different returns across different risk levels is plotted in the chart below.





It is also important to understand that focusing on only the median outcome at one point in time is not advisable when the short-term market environment is particularly volatile. As the chart below illustrates, the probabilities have shifted meaningfully from March (purple) to September (black), suggesting that the Committee should not solely focus on one particular set of date-specific assumptions in setting the discount rate, though we would defer further guidance on that point to your actuarial staff.





Conclusion

Wilshire has taken a multi-faceted view in addressing the primary questions set out initially. It is important to clearly note that Wilshire does not provide actuarial services to CalPERS and cannot, therefore, opine on a specific liability discount rate. We do believe that the process used to assess potential long-term portfolio returns underpinning the proposed discount rate range was reasonable, with multiple inputs, and supports the appropriate level of Investment Committee oversight for the Long-Term Care portfolio. Examining the modeling results over the 10 and 30-year time horizon, an assessment of the extraordinary rate environment, and a view of the return distributions across the modeled portfolios are all important data points to consider. Our analysis indicates that the asset allocations under discussion have the potential to deliver long-term returns in the range of 4.75% - 5%, albeit at higher expected risk levels than are expected in the current portfolio.

Sincerely,

A handwritten signature in black ink, appearing to be 'T. R.' followed by a flourish.