



## Investment Committee Agenda Item 7a

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**March 15, 2021**

**Item Name:** Long-Term Care: Asset Allocation

**Program:** Trust Level Portfolio Management & Implementation

**Item Type:** Action

### **Recommendation**

For the Long-Term Care Fund strategic asset allocation, select Candidate Portfolio 1, with expected return of 4.97% and expected risk of 8.29%. The Investment Policy with benchmarks, ranges, and rebalance framework will be brought to the Investment Committee in June 2021. Implementation of the strategic asset allocation will occur after the Investment Policy is approved and manager contracting is complete.

### **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.

In response to challenges facing the LTC Fund portfolio, CalPERS team members recommended, and the Investment Committee approved the following:

- September 2020: Request for Proposal (RFP) for Asset Liability Management and Investment Management
- November 2020: Discount rate of 4.75, upper threshold on portfolio risk (volatility) of 9.50 percent, and the inclusion of private asset classes and the use of leverage.

The team has completed the strategic asset allocation review and will discuss the process and results at the March 2021 Investment Committee meeting. In summary, there are two Candidate Portfolios presented that have strategic asset allocations that support the discount rate, are within the risk threshold, and do not allocate to private assets or include the use of leverage. The discussion will highlight the Candidate Portfolios' strengths and key differences, in support of the strategic asset allocation recommendation for the LTC Fund.

## Strategic Plan

This agenda item supports the Strategic Plan Goal of Fund Sustainability. Conducting the strategic asset allocation review ahead of the full 2021/22 ALM process enables portfolio selection in alignment with proposed premium increases in 2021. Evaluating external investment manager expertise and selecting the recommended portfolio supports an increased expected long-term return (with an increase in risk) and the 4.75 percent discount rate.

## Investment Beliefs

This agenda item supports the following CalPERS Investment Beliefs:

- Investment Belief 1: Liabilities must influence the asset structure.
- Investment Belief 2: A long-term investment horizon is a responsibility and an advantage.
- Investment Belief 6: Strategic asset allocation is the dominant determinant of portfolio risk and return.
- Investment Belief 8: Costs matter and need to be effectively managed.

## Background

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 could be further optimized and to assess an expanded set of options, CalPERS team members conducted a comprehensive review of external manager expertise and strategic asset allocation proposals. The scope of the review included customized strategic asset allocation with investment management services, and information on the array of strategies, products, expertise, and market access that external managers have available for managing the LTC Fund.

## Analysis

The review process was a team effort across the Investment Office, Actuarial Office, Health Policy Division, Legal Office, and the Operations Services Division. General considerations evaluated throughout the process included the asset liability management framework, manager and team capabilities, investment performance, risk, complexity, cost, and competitive advantage. The team followed the multi-phased approach outlined below:

### Phase I: Technical Written Proposal

The RFP team developed an extensive Request for Proposal technical questionnaire. Included with the questionnaire was the necessary data for managers to evaluate the LTC Fund asset liability management profile and construct proposed portfolios. The questionnaire additionally included inquiries about the manager history and structure, personnel and depth of experience, asset liability management and investment management experience, performance track record,

risk management and compliance, trading capabilities, ESG including talent management and diversity and inclusion, investment technology, systems infrastructure and cyber security, and conflicts and disclosures.

The RFP team developed a detailed portfolio analysis framework and a quantitative Manager Assessment Tool (MAT) to standardize and facilitate a consistent and organized evaluation of each manager's proposal. Based on the responses, and in conjunction with the portfolio analysis, MAT scoring, and RFP team deliberation, four managers did not advance to the next phase. A noteworthy reason for not advancing was the high portfolio risk (volatility) levels relative to the 9.50% threshold approved by the Investment Committee.

#### Phase II: Confidential Discussions

The RFP team conducted virtual meetings with the remaining managers. Topics discussed included core competencies, team, proposed portfolio(s) and asset class strategies, capital market assumptions, risk management, investment decision making, and client services.

Based on the confidential discussions, and in conjunction with the RFP team deliberation and the MAT scoring, one manager did not advance to the next phase. A noteworthy reason for not advancing was the level of complexity associated with implementing the portfolio (relatively high-level of illiquidity and outsourcing of investment management services).

#### Phase III: Fee Proposals

The proposed fees for the remaining three managers include asset liability management, investment management and transition management fees. One manager did not advance to the next phase, as their fees were significantly higher than the others.

#### Phase IV: Reference Checks

The RFP team conducted six reference calls (three organizations each for the two managers) with standardized questions covering the following areas: firm capabilities, asset liability management, investment management, long-term care and insurance knowledge, fiduciary duty, operational management, and client service. All references were satisfactory.

#### Phase V: Final Interviews

The RFP team conducted virtual final interviews with the remaining two managers. Topics discussed included capital market assumptions, portfolio optimization, proposed portfolio(s) and asset class strategies, portfolio management, stress testing, risk management, and investment decision making processes. The RFP team advanced both managers for their strategic asset allocation portfolios to be evaluated as Candidate Portfolios.

### **Budget and Fiscal Impacts**

Manager fees have not yet been determined. 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 next Contracting Activity Prospective Report.

## **Benefits and Risks**

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

### Benefits:

- Supports the discount rate of 4.75%.
- Higher expected investment returns could increase the funded ratio and help reduce the magnitude of premium increases.
- Increased portfolio diversification with additional sub-asset classes.
- External management provides access to expertise with insurance and Long-Term Care investment funds, liability cash flow management, market coverage, sophisticated proprietary investment technology and models, and innovative investment strategies.

### Risks:

- The potential for increased investment returns may not be realized, which could have a negative impact on the funded ratio and 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.
- External management can introduce risks such as key person risk, investment strategy underperformance, and reputational risk.

## **Attachments**

Attachment 1 – Long-Term Care: Asset Allocation Presentation

Attachment 2 – Wilshire Associates Opinion Letter

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Sterling Gunn  
Managing Investment Director  
Trust Level Portfolio Management & Implementation

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Dan Bienvenue  
Interim Chief Investment Officer

# Long-Term Care: Asset Allocation

Sterling Gunn, Managing Investment Director - TLPPI  
Christine Reese, Investment Director - TLPPI

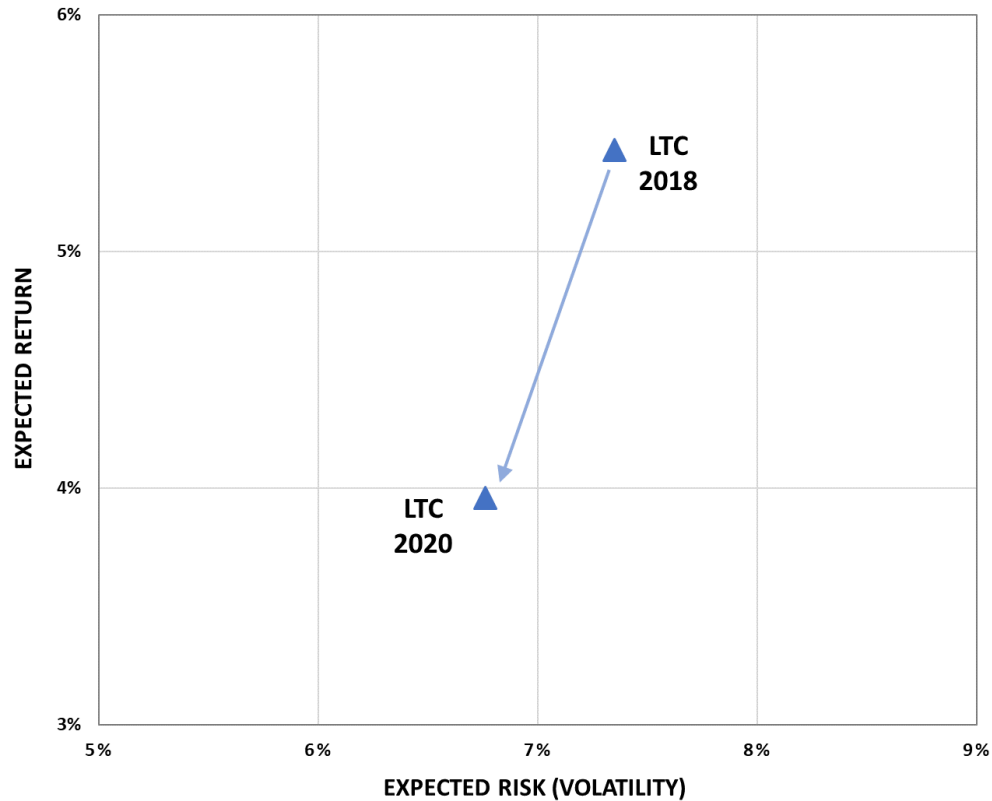
Investment Committee  
March 15, 2021

# Executive Summary: Strategic Asset Allocation Review Results

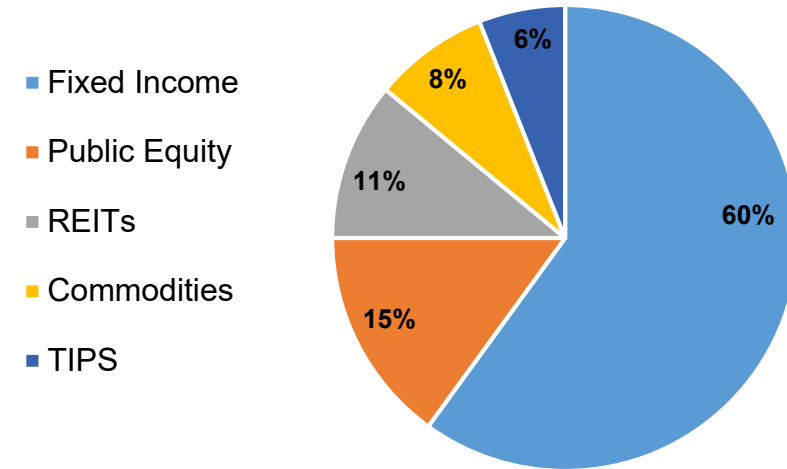
- The current portfolio expected return of approximately 4.00% falls short of the 4.75% discount rate.
- A comprehensive asset allocation study to review several portfolio options has been conducted.
- Candidate Portfolios 1 & 2 are presented for consideration, each with the following attributes:
  - Expected returns meet the 4.75% discount rate with expected risk below the 9.50% threshold.
  - Asset allocations utilize current asset classes, with no allocation to private assets or use of leverage.
  - Active management strategies may contribute excess return above benchmark.
  - Asset liability management services and active management will result in higher fees than the current portfolio.
- Candidate Portfolios 1 & 2 also have key differences that result in and support the recommendation.
- Recommendation: Select the strategic asset allocation of Candidate Portfolio 1, with expected return of 4.97% and expected risk of 8.29%.

# Expected Risk/Return and Allocation: Current Portfolio

Expected Risk/Return

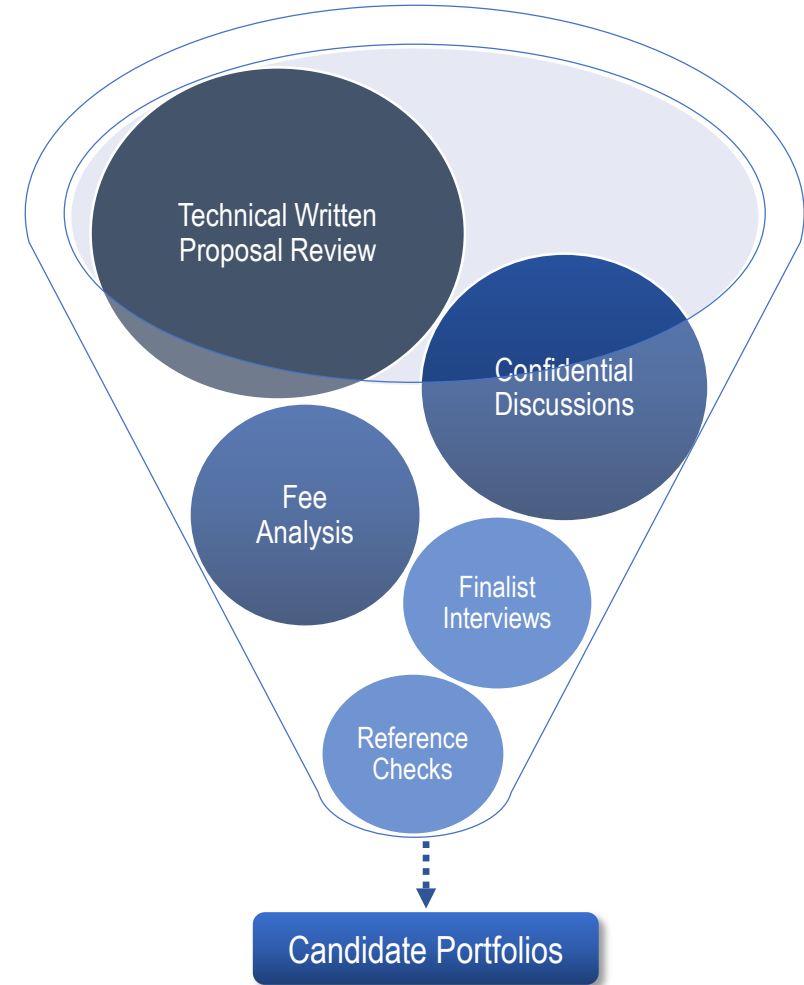
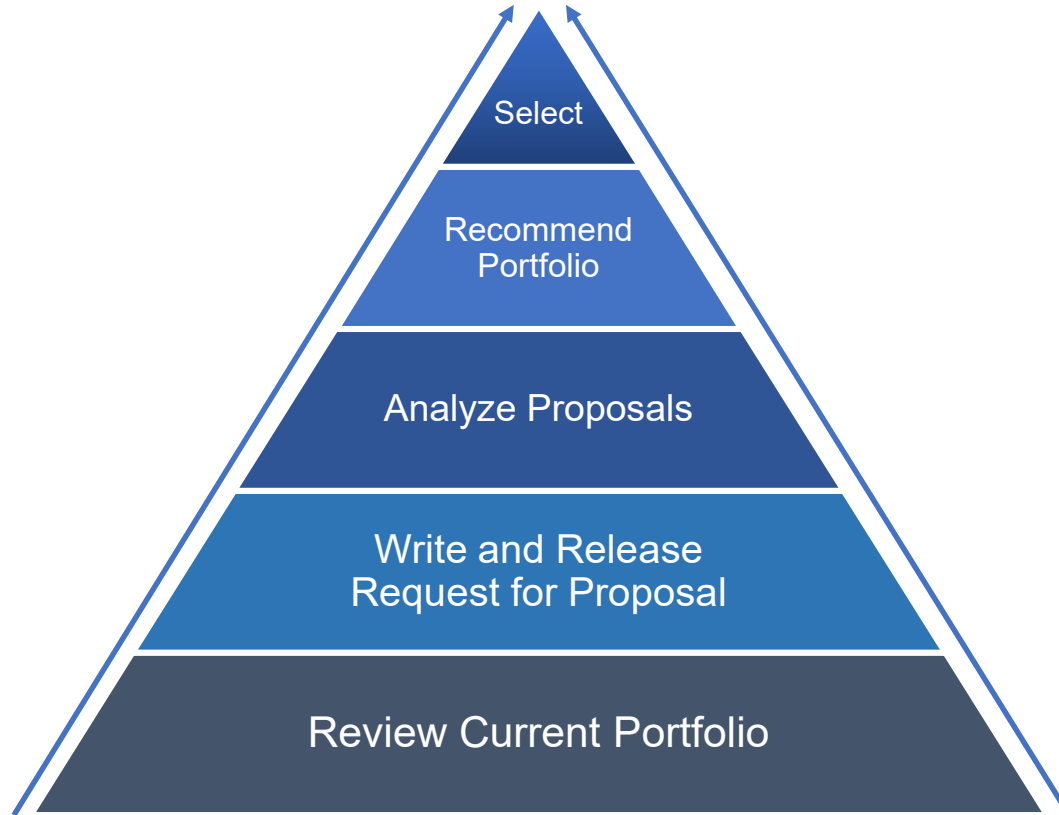


Asset Allocation



The expected return of the current portfolio allocation has dropped from 5.43% in 2018 to 3.96% in 2020.

# Portfolio Evaluation Process



A comprehensive review has been conducted by the Investment Office, Actuarial Office, and Health Policy Division.

# Strategic Asset Allocation: Current and Candidate Portfolios

Asset Class	Current Portfolio	Candidate Portfolio 1	Candidate Portfolio 2
Global Equities	15%	30%	45%
Fixed Income	60%	54%	50%
U.S. TIPS <sup>1</sup>	6%	6%	5%
Global REITs <sup>2</sup>	11%	7%	-
Commodities	8%	3%	-

Each Candidate Portfolio is constructed using current asset classes, with no inclusion of private assets or leverage.

# Benchmark Composition: Current and Candidate Portfolios

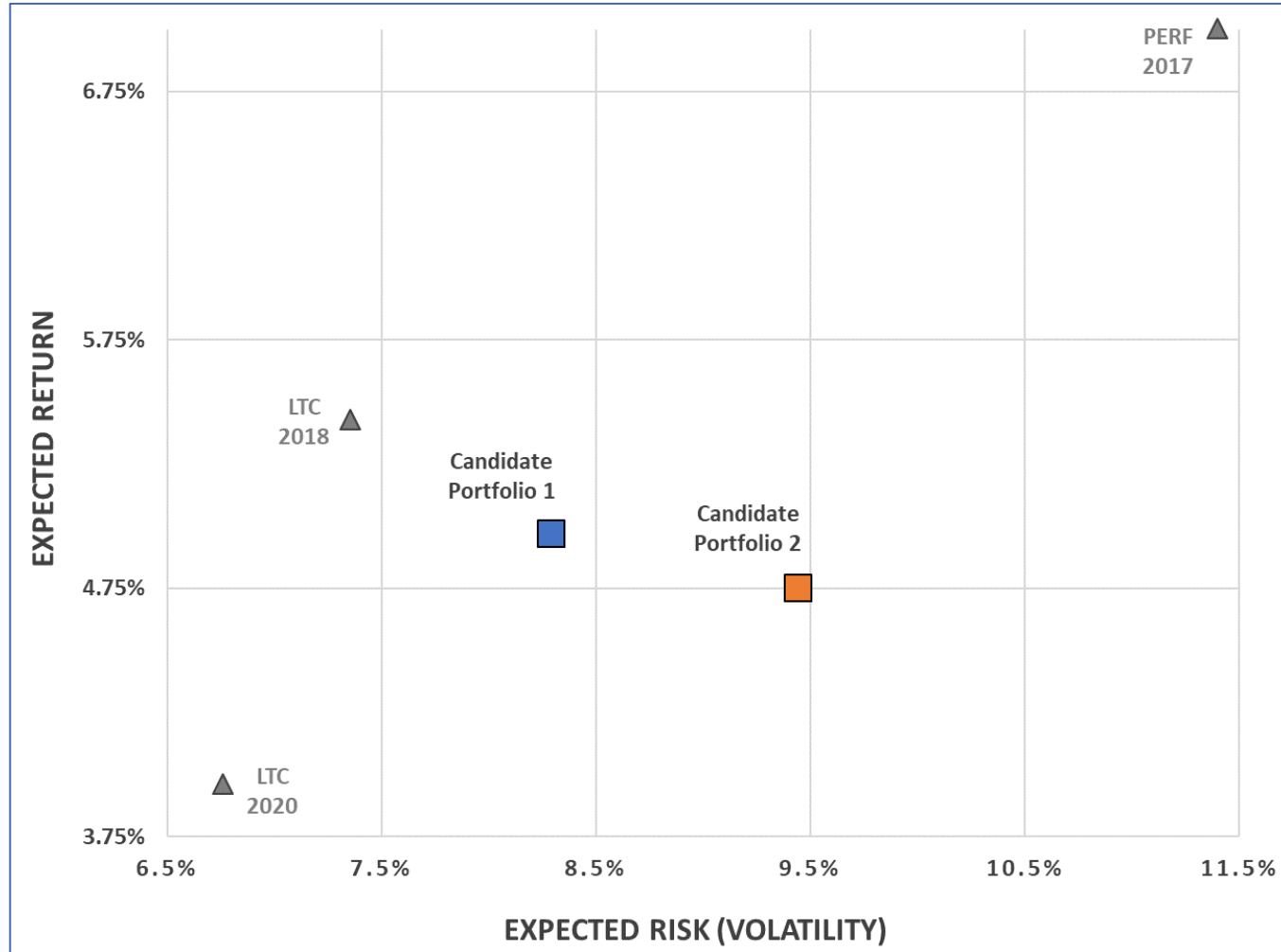
Asset Classes/ Sub-Asset Classes	Current Portfolio	Candidate Portfolio 1	Candidate Portfolio 2
Global Equities	15%		45%
U.S. Large Cap Equities		12%	
Developed Large Cap ex-US Equities		12%	
Emerging Equities		6%	
U.S. Treasuries – Intermediate			10%
U.S. Treasuries – Long	24%		15%
U.S. Agency MBS	18%	3.4%	
U.S. CMBS		2.5%	
U.S. CMBS Sub		2.5%	
U.S. IG Corporates – Intermediate			5%
U.S. IG Credit – Long	14%	18.9%	15%
U.S. IG Credit BBB – Long		4.7%	
U.S. High Yield	2%	11%	5%
Global IG Bonds ex-EM	2%		
EM Bonds (in USD)		11%	
U.S. TIPS <sup>1</sup>	6%		
U.S. TIPS <sup>1</sup> – Long		6%	5%
Global REITs <sup>2</sup>	11%	7%	
Commodities	8%	3%	

- Candidate Portfolio benchmarks will be built using the asset classes / sub-asset classes shown.
- Candidate Portfolio benchmark weights shown are approximate. The weights, ranges, and rebalancing frequency will be confirmed during contract discussions and presented for approval at the June Investment Committee meeting.

Note 1: U.S. TIPS are Treasury Inflation Protected Securities.

Note 2: REITs are Real Estate Investment Trusts.

# Expected Risk/Return: Current and Candidate Portfolios:



Expected risk/return for the Candidate Portfolios was evaluated using a common set of capital market assumptions with the following results:

- Each Candidate Portfolio maintains expected risk below the 9.50% threshold (adopted at November IC) and increases expected return by more than .75% over the current portfolio.
- Candidate Portfolio 1  
 Expected Return = 4.97%  
 Expected Risk = 8.29%
- Candidate Portfolio 2  
 Expected Return = 4.75%  
 Expected Risk = 9.45%

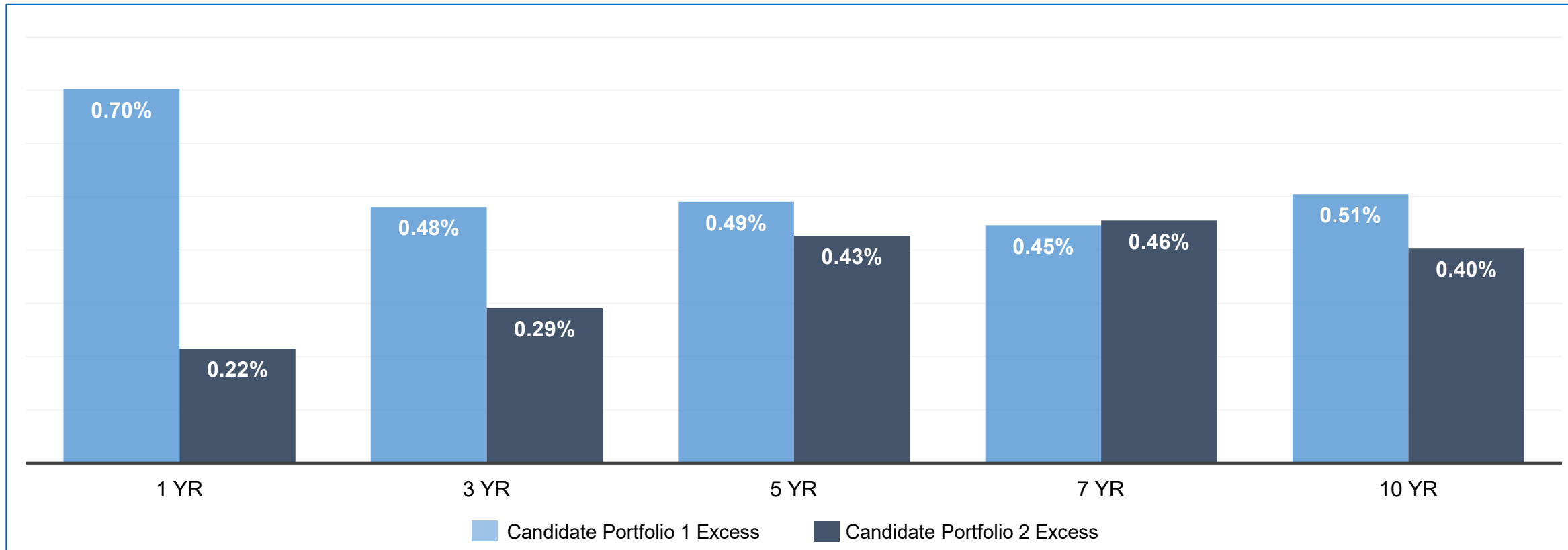
## Detailed Attributes: Current and Candidate Portfolios

Attribute	Current Portfolio	Candidate Portfolio 1	Candidate Portfolio 2
Expected Return <sup>1</sup>	3.96%	4.97%	4.75%
Expected Risk <sup>1</sup>	6.76%	8.29%	9.45%
Expected Return/Risk	0.59	0.60	0.50
Cash Yield	2.19%	3.39%	2.41%

Candidate Portfolio 1 expected return exceeds Candidate Portfolio 2 by .22%, while risk is lower by 1.16%

Note 1: Portfolio expected risk/return values calculated using CalPERS analytical framework and Wilshire Capital Market Assumptions as of 09/30/20.

# Simulated Historical Excess Return: Candidate Portfolios



Across several time periods tested, the simulated historical returns for the Candidate Portfolios are above their respective benchmarks. The excess returns are primarily the result of active management strategies in fixed income.

# Recommendation: Candidate Portfolio 1

For the Long-Term Care Fund, select the strategic asset allocation of Candidate Portfolio 1, to be implemented when contracting with the external manager is complete.

<b>Strategic Asset Allocation - Candidate Portfolio 1</b>	
<b>Asset Class</b>	<b>Asset Class Weights</b>
Global Equities	30%
Fixed Income	54%
U.S. TIPS	6%
Global REITs	7%
Commodities	3%

<b>Portfolio Attribute</b>	<b>Value</b>
Expected Return	4.97%
Expected Risk	8.29%

## Next Steps

Manager Selection Announcement	March 2021
Contracting Discussions Implementation Planning Investment Policy Updates	March – June 2021
Investment Committee	June 2021
Contract Completion	June/July 2021 (estimated)
Asset Allocation Implementation	After Investment Policy approval and completion of contracting.

# Appendix

## Market Stress Scenarios: Candidate Portfolios

Scenario	Candidate Portfolio 1	Candidate Portfolio 2
Global Financial Crisis (2008-09)	-26.94%	-24.88%
European Bond Crisis (2010)	-1.77%	-1.84%
COVID-19 Pandemic (Feb 19 - Mar 23, 2020)	-26.52%	-20.23%

Candidate Portfolio 1 is more sensitive to some historical market shock scenarios than Candidate Portfolio 2, although the long-term expected risk of Candidate Portfolio 1 is lower at 8.29% compared to Candidate Portfolio 2 at 9.45%.

# 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											█					
Adopt Asset Allocation (March IC)												█				
Contracting & Planning													█	█		
Approve Investment Policy (June IC)															█	
Sign Contract and Begin Implementation																█

The Investment Policy, with benchmarks, ranges, and rebalancing will be brought to the June Investment Committee.



**Thomas Toth, CFA**  
**Managing Director**

March 1, 2021

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

Dear Ms. Taylor:

You requested Wilshire's opinion regarding the Long-Term Care (LTC) asset allocation recommendation presented by Staff. Through the RFP process, Staff narrowed the number of asset allocations for comparison down to the current allocation and two alternatives. Wilshire has reviewed these portfolios through the lens of our capital market assumptions. The strategic asset allocation modeling 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.

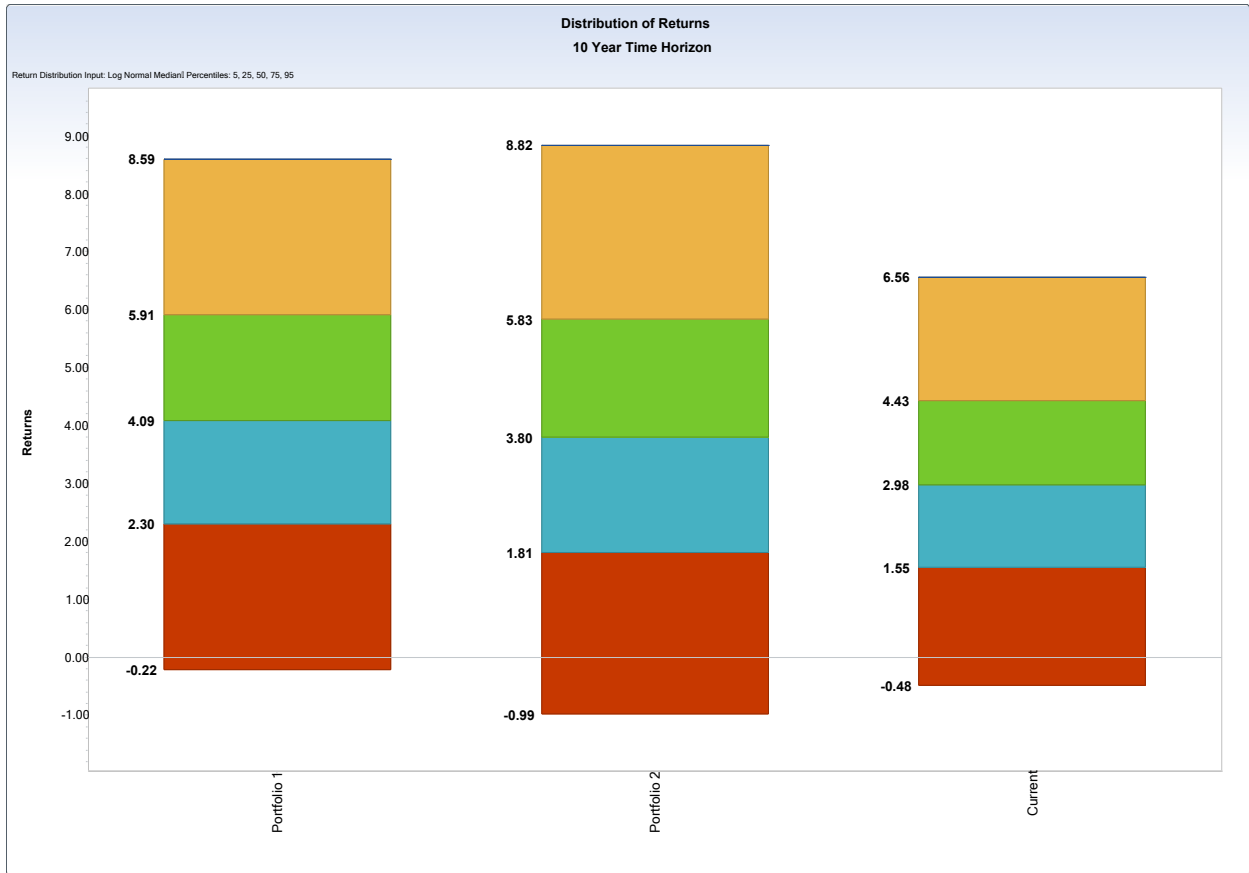
For insight to the (much) longer-term potential returns of a given portfolio, such as within the valuation work conducted by actuaries, a ten-year horizon might be viewed as somewhat short-term. To facilitate these longer-term perspectives, Wilshire has developed a set of "equilibrium" assumptions that can be blended with our ten-year forecasts to generate expectations for holding periods greater than ten years. These equilibrium assumptions are created using a building block approach that starts with very long-term inflation and real yield assumptions, and then adds various risk premia to estimate investor compensation for taking on market risks (duration, credit, equity, etc.). While forecasting over extended periods of time is inherently filled with estimation error, the relative attractiveness when comparing portfolios provides a helpful lens for evaluating the impact of asset allocation changes.



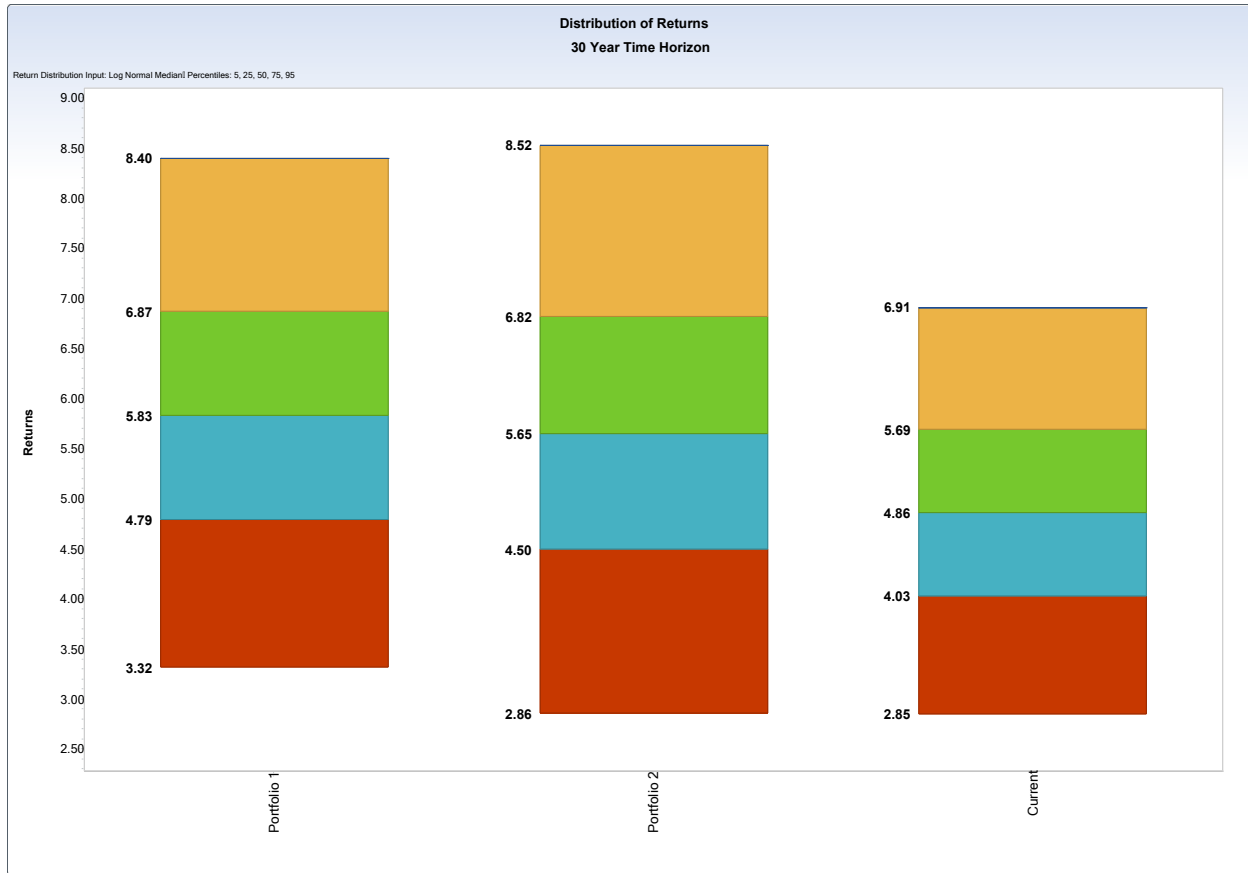
## **Asset Allocation Modeling Results**

The alternative allocations utilize an expanded number of liquid market strategies with an objective of improving projected outcomes for the LTC portfolio. These strategies include a more granular view of securitized fixed income, an increase in below investment grade credit, and exposure to emerging market debt. Wilshire's independent modeling of the three asset allocation scenarios suggests that the portfolio return can be increased from 3.0% to between 3.8% and 4.1% over a 10-year horizon in the expected case and up to 5.8% over a longer term 30-year time horizon. The alternative allocations would increase the portfolio's expected risk level from the current level of 6.8% to between 8.5% and 9.5%, which is in-line with the guidance provided previously by the Investment Committee. This increase in risk is driven by a reduction in exposure to low yielding Treasuries and an increase in more credit-oriented assets. While additional strategies such as interest rate overlays and private assets were contemplated in the initial RFP review, the allocations under consideration do not include either of these segments.

Portfolio 1 exhibits higher risk-adjusted expected returns than both the Current and alternative Portfolio 2. It is also important to consider the potential distribution of returns over multiple time horizons. Below is a comparison of the distribution of expected returns over 10 years. Portfolio 1 has both a higher expected outcome as well as a tighter distribution. In fact, the downside 95<sup>th</sup> percentile return of -0.22% is higher than the Current downside case return of -0.48%, which indicates that the higher expected return can provide compensation for the increased level of volatility compounded over the forecast horizon.



The 30-year horizon return distributions tell a similar story. Of note, Portfolio 1 has a better than 75% probability of returning more than 4.75% over the 30-year forecast horizon.



## Conclusion

Examining the asset allocation modeling results over the 10 and 30-year time horizons along with an assessment of the return distributions across the modeled portfolios are all important data points to consider. Wilshire's analysis indicates that the recommended asset allocation has the potential to deliver enhanced long-term returns, albeit at a higher expected risk level than with the current portfolio. Over long-term strategic horizons, the Long-Term Care portfolio results would be expected to benefit from adopting the recommended allocation of Portfolio 1.

Sincerely,