Retirement News Highlights

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CalPERS' new asset allocation to take on more risk

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The largest pension fund in the United States, the $469 billion CalPERS, is in the middle of an asset liability modelling exercise to set a new asset allocation by June 2022. Chief executive Marcie Frost says it's the most significant decision the board makes with regard to the investment portfolio and that achieving a return target of 6.8 per will require "pushing everyone's risk appetite".

The ALM process, to set a new asset allocation, takes a considerable amount of time and CalPERS is about half way through that four-yearly undertaking. More than half the current board have not been through the process before and getting them fully informed about the capital market assumptions, risks and forecasts is paramount. Most importantly it requires understanding their risk appetite.

"In my opinion we will be pushing everyone's risk appetite if we are going to achieve 6.8 per cent. We have to be very clear about what that means about taking on more risk," Frost said in an interview with Top1000funds.com.

The investment team has put together model portfolios that achieve 6 per cent, 6.25 per cent, 6.5 per cent, 6.8 per cent and 7 per cent in a bid to demonstrate what it looks like to take on more risk.

"We are being very deliberate with the board and helping them with understanding the data which they have to make the decision."

Frost emphasises the importance of this cycle and the team is leading the board through the "most significant decision they make regarding the investment portfolio and how to allocate".

Four years ago when the fund went through this process the assumed rate of return was 7 per cent. This year that was automatically lowered to 6.8 per cent under the funding risk mitigation policy where the 21.3 per cent 2021 financial year return triggered a reduction in the discount rate.

But the current asset allocation, which four years ago was set to reach that 7 per cent target, would now only generate 6 per cent based on new capital market assumptions, Frost says.

"We will have to take on more risk," she says.

The most talked-about way to achieve that is by increasing the 8 per cent allocation to private equity, and to use leverage.

Interim chief investment officer Dan Bienvenue has already spent considerable time with the board discussing the multi-faceted nature of risk, liquidity and the difficult market for returns.

The fund's current asset allocation is dominated by equity risk with an allocation of about 58 per cent in equities. But Bienvenue says risk models estimate the fund has about 90 per cent growth risk.

"We are long equity risk and we are comfortable with that. We don't have a choice of not investing. Where we invest is the question," Bienvenue told Top1000funds.com.

"One of the assumptions of the CAPM model is that investors are homogenous when it comes to risk, we don't believe that."

In July the new asset liability capital market assumptions were presented to the board. These were developed by consulting with 11 external asset managers and consultants and garnering their views on 10, 20, and 30-year returns. This included AllianceBernstein, AQR, Blackrock, SSgA and PIMCO among others. CalPERS also determines its own internal capital market assumptions.

While there was a range of opinions among the managers, they clearly show that returns will be lower and expected risk will be higher, so the risk and return trade-off will be more costly.

"Everything is expensive," Bienvenue says.

In that presentation to the board, Sterling Gunn who is managing investment director of the trust level portfolio management program, also outlined that the higher returning opportunities will be in private assets and emerging market equities.

At the September 13 board meeting the different model portfolios developed by the team will be discussed. Those candidate portfolio include asset allocations to achieve assumed rate of returns at 6.25, 6.5, 6.7, 6.9 and 7.1 per cent as well as the risk involved with each. These will also look at using leverage as a diversifier.

Use of Leverage

One way the fund proposes to allocate more to higher returning assets is through the use of leverage. This is widely used by institutional investors including Canadian pension funds, various sovereign wealth funds and even some US public funds such as Wisconsin and Indiana, which through the use of leverage allocates 115 per cent of assets.

But for CalPERS, which is under constant public scrutiny, discussions such as the use of leverage require careful diplomacy.

Bienvenue explains that the use of leverage is not just to add to returns but as a diversifier of risk.

"If we take a long-only portfolio and try to achieve a return like 6.8 per cent then you have to put everything into some sort of equity," he says. "Leverage will allow us to pull some more diversifying assets such as fixed income and real assets, and these are all things we will work through with the board. We will discuss whether we are comfortable trading out one risk, equity, for another in leverage which has financing and operational risks."

Bienvenue is aware of the sensitivities around leverage and admits some organisations have got themselves into trouble with the use of leverage in the past.

“It will require quite a bit of discussion but there are areas I think leverage is additive and that is as a diversifier. If it is taken too far it’s dangerous.”

But a number of internal organisational changes means that CalPERS is well positioned to implement leverage internally.

“We have laid some foundations over the past five years which has put us in a position to do it at a total fund level internally. We migrated to a centralised total fund perspective on liquidity and leverage and can monitor and address both at the total fund level.”

If CalPERS does decide to use leverage it will be very incremental, Bienvenue says with a pre-determined schedule.

Regardless of where the final asset allocation lands, Bienvenue says there will be more private equity, private debt and real assets in the new asset allocation due to their better risk to return profile.

“Private assets have other risks, they are illiquid and there is the aspect of fees. But if we are going to get the returns we need the portfolio to generate it means choosing which risk,” he says. “We don’t have a low risk choice, we want to get exposure to compensated risks.”

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