



Investment Committee Agenda Item 5f

March 18, 2024

Item Name: Terminated Agency Pool Rebalance

Program: Total Fund Portfolio Management

Item Type: Information Consent

Executive Summary

This agenda item reports the current market value of assets and an analysis of the structure of the immunized segment of the Terminated Agency Pool (TAP) investment program designed to match the anticipated cash flows derived from the TAP liabilities.

Strategic Plan

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

Investment Beliefs

This agenda item supports CalPERS' Investment Belief 1 that liabilities must influence the asset structure.

Background

The TAP program exists to provide benefit payments to members of pension plans of agencies that have terminated their contract with CalPERS. Given the TAP program's limited funding sources, the primary performance objective of the TAP portfolio is to minimize funding risk.

The TAP portfolio consists of an immunized portfolio and a non-immunized portfolio. The immunized portfolio is designed to minimize the likelihood of underfunding by matching the projected future benefit payments with low risk, U.S. government issued securities. The immunized portfolio contains Treasury Inflation Protected Securities (TIPS) and Separate Trading of Registered Interest and Principal Securities (STRIPS) which are invested to match the liability cash flows across a range of inflation scenarios. The immunized portfolio also holds two years of projected benefit payments in a cash reserve account. The second segment, the non-immunized portfolio, constitutes assets in excess of those required to fund the immunized

portfolio and cash reserve account, and is invested in the same way as the rest of the Public Employees' Retirement Fund (PERF).

Analysis

Performance Update

For the fiscal year (FY) ending June 30, 2023, cash flows generated from the immunized portfolio were sufficient to meet the annual benefit payments of \$8.7 million. During FY 2022-2023, the market value of the immunized portfolio decreased from \$215.3 million to \$200.9 million; the non-immunized portfolio, which is invested alongside the PERF, increased from \$146.4 million to \$155.1 million. These values include investment gains/losses, new entrants, and prior rebalance activity in the TAP. The assets in the TAP consist of the following as of June 30, 2023:

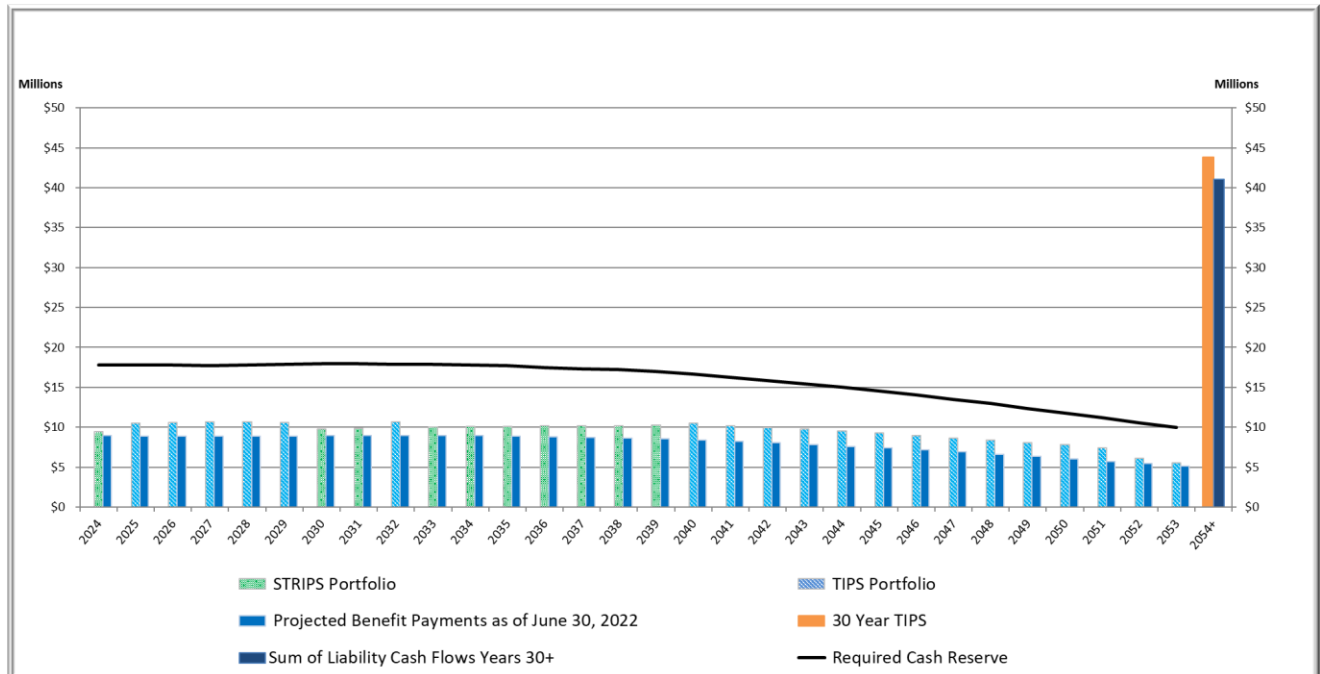
1. Immunized portfolio:
 - \$182.9 million invested in TIPS and STRIPS
 - \$18.0 million invested in Short Term Investment Fund
2. Non-Immunized portfolio:
 - \$155.1 million invested alongside the PERF

Rebalance Update

Staff have analyzed the immunized portfolio's ability to meet the TAP Program's projected benefit payments over a range of inflation scenarios ranging from 0% to 6%.

Figure 1 illustrates that the cash flows generated by the immunized portfolio should be sufficient to cover the projected benefit payments under an inflation assumption of 2.2%. The inflation assumption used in the Actuarial Valuation for the TAP, presented to the Finance and Administration Committee in September 2023, was 2.2%. Due to uncertainties in any inflation forecast, the portfolio was evaluated to cover benefit payments growing up to a 6% inflation rate. Figure 1 illustrates an important challenge in immunizing the portfolio, as the maturities of available US Treasury securities are from 1 year to 30 years, whereas TAP program liabilities are expected to extend beyond 30 years. The 30-year TIPS maturing in fiscal year-end 2054 shown in Figure 1 represents the amount staff estimates will be sufficient to meet TAP's estimated benefit payments due beyond 30 years.

Figure 1: Projected Asset & Benefit Cash Flows



As the portfolio is rebalanced each year, staff will reassess the inflation hedge necessary to immunize the TAP program’s future benefit payments and will extend the duration of the immunized portfolio by rolling the 30-year TIPS into the longest currently available 30-year TIPS, at the time of the rebalance.

Budget and Fiscal Impacts

Not Applicable

Benefits and Risks

Despite the conservative approach used to immunize the TAP program’s future expected liabilities, there are still risks that the actual future benefit payments may be greater than the cash generated from the immunized portfolio. This is due to the challenges in matching TAP’s assets to future benefit payments, which include:

- Uncertainties in inflation forecasts
- Mismatch in the duration of the liabilities compared to the assets:
 - Maturities of available US Treasury securities are from 1 year to 30 years while TAP program liabilities extend significantly beyond 30 years
- Actuarial risks due to assumptions such as mortality and salary increases
- Dilution risk as a result of a large employer or a group of small employers entering the TAP program and diluting the funded status

The rebalancing processes governing the TAP program have been designed to reduce the risks of forecasting inflation and the mismatch in duration of assets and liabilities. Specifically, the rebalance processes incorporate inflation scenarios when matching assets and liability cash flows and extend the duration of the immunized portfolio to include the longest currently available 30-year bond.

The Total Fund Investment Policy (Policy) governing the Terminated Agency Pool further mitigates the risks described above. The Policy outlines the management and reporting requirements by CalPERS Total Fund Portfolio Management team as well as separate monitoring by CalPERS Investment Compliance team. The Policy requires:

- The maintenance of a cash reserve to meet projected benefit payments
- Annual updates on current market value of TAP assets and an analysis of the adequacy of the TAP program allocation to meet the forecasted TAP program liabilities
- A review of the asset allocation policy for the TAP program following any significant change in the assets and liabilities as a result of the addition of a large employer or group of small employers entering the TAP program and diluting the funded status

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