# Board of Retirement Regular Meeting

## Sacramento County Employees' Retirement System

**Agenda Item 21**

**MEETING DATE: October 20, 2021**

**SUBJECT: Asset Class Restructuring: Absolute Return**

**SUBMITTED FOR: ___ Consent __X__ Deliberation and Action ___ Receive and File**

**RECOMMENDATION**

Staff recommends the Board approve the proposed implementation plan and revisions to the structure of the Absolute Return asset class as presented by Cliffwater and SCERS' Investment Staff. The specific recommendations include:

- Rename 'Diversifying Absolute Return' asset class to 'Absolute Return'
- Maintain 7% target allocation for Absolute Return asset class with a range of +/- 2% around target allocation (5% - 9%).
- Update portfolio guidelines:
  - Increase the targeted number of portfolio funds from 10 to 12, with a range of 8 to 15 funds
  - Slightly increase market sensitivity
    - Increase the portfolio's target equity beta from <0.1 to <0.2
    - Increase the portfolio's target equity correlation from <0.1 to <0.5
    - Maintain existing portfolio objectives, benchmarks, market exposure, and risk targets
- Adopt implementation plan for liquidation of Growth Absolute Return investments.
- Direct staff to make conforming changes to the Growth Asset Category and Master Investment Policy Statements for approval by the Board at a future meeting.

**PURPOSE**

This item supports the implementation of the revised strategic asset allocation, which calls for Staff and consultants to identify structuring considerations and implementation plans for each major asset class.

## ABSOLUTE RETURN STRATEGIC CHANGES

SCERS' Board approved a revised strategic asset allocation for SCERS in August 2021, which resulted in elimination of the 3% Growth Absolute Return asset class allocation, and maintaining the 7% target allocation for Diversifying Absolute Return. With the elimination of Growth Absolute Return, the Diversifying Absolute Return asset class is recommended to be renamed Absolute Return. As of August 31, 2021, the allocation to Growth Absolute Return was 2.3% and the allocation to Diversifying Absolute Return was 6.2%. The underweight allocation to Absolute Return strategies is the result of extremely strong returns across other segments of the portfolio, notably Private Equity and Public Equity, which are both up over 50% over the past year.

The 'Implementation Plan' section for Absolute Return below will cover the wind-down of the Growth Absolute Return portfolio and changes to the Diversifying Absolute Return portfolio to reach the target 7% allocation.

The Growth Absolute Return resides within the Growth asset category. The following table shows the asset class target allocations for the Growth asset category, including the prior and recently approved target allocations. As highlighted, the revised target allocation for Growth Absolute Return is 0%.

| Asset Class | Prior Target Allocation | Revised Target Allocation | Actual Allocation |
|---|---|---|---|
| Growth Asset Category | 58.0% | 58.0% | |
| Global Equity | 40.0% | 40.0% | |
| Private Equity | 9.0% | 11.0% | |
| Public Credit | 2.0% | 2.0% | |
| Private Credit | 4.0% | 5.0% | |
| Growth Absolute Return | 3.0% | 0.0% | 2.3% |

Diversifying Absolute Return resides within the Diversifying asset category, with the prior and revised target allocations shown below. Diversifying Absolute Return maintained the 7% target allocation, with the current allocation slightly below the target.

| Asset Class | Prior Target Allocation | Revised Target Allocation | Actual Allocation |
|---|---|---|---|
| Diversifying Asset Category | 26.0% | 24.0% | |
| Fixed Income | 15.0% | 16.0% | |
| Global Fixed Income | 3.0% | 0.0% | |
| Diversifying Absolute Return | 7.0% | 7.0% | 6.2% |
| Cash | 1.0% | 1.0% | |

## RECOMMENDED ABSOLUTE RETURN STRUCTURE REVISIONS

Recommendations related to the structure of SCERS' Absolute Return asset class are shown below. The recommended changes will go into effect upon Board approval; however, they will not be reflected in the investment policy statement until a later date. Absolute Return resides within a broader Diversifying asset category IPS, along with Fixed Income and Cash allocations, with the Global Fixed Income allocation eliminated as part of the updated strategic asset allocation. Staff will present a revised Diversifying asset category IPS at a later date that incorporates the proposed revisions to the Absolute Return asset class, as well as the other Diversifying asset classes, once they are all approved by the Board. The Master IPS will also be updated accordingly.

Absolute Return Target and Range:

The Diversifying Absolute Return asset class (renamed Absolute Return) retains a target allocation of 7% with a range of +/- 2% around the 7% target as shown below:

| Absolute Return | Target % | Range |
|---|---|---|
| | 7% | 5% - 9% |

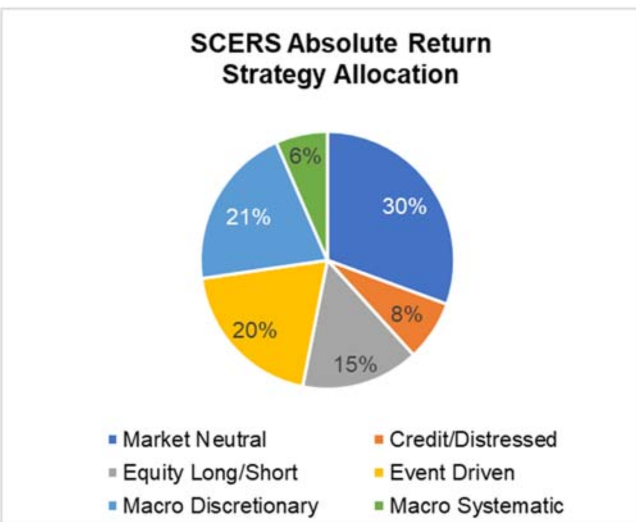
With the target for Absolute Return unchanged at 7%, Staff and Cliffwater also recommend keeping the range at +/- 2% around the target allocation. The range allows for flexibility in managing the portfolio across market cycles, recognizing that market values for liquid market assets such as public equity, can change rapidly and lead to shifts in the relative weight of asset classes. As of August 31st, the Absolute Return portfolio was approximately 6.2% of the total SCERS portfolio, within the previously approved range for the asset class.

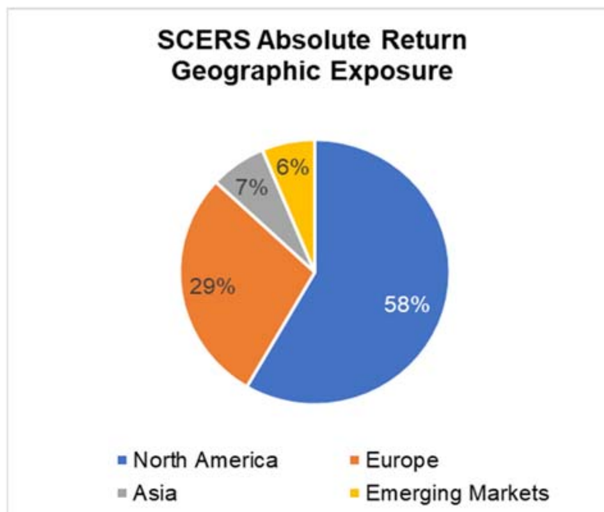
Portfolio Construction Guidelines

In addition to the target allocation and range, portfolio construction guidelines also include the target number of funds and expected U.S. and non-U.S. exposure. As shown in the table below, Staff and Cliffwater recommend updating the guidelines to increase the target and range for number of funds in the portfolio. As of August 31, 2021, SCERS' Diversifying Absolute Return portfolio consists of 11 direct fund investments (not including funds being liquidated), as well as a fund of funds mandate with Grosvenor, which is approximately 25% of the portfolio. As noted above, the portfolio is underweight the target allocation at 6.2% versus the 7% target. The increased targeted number of funds, from 10 to 12, allows for SCERS to add direct fund investments to reach the target 7% allocation, while maintaining diversification without needing to concentrate capital in a smaller number of funds/strategies. Additionally, as the total value of SCERS' overall portfolio value has increased, the average investment size per direct fund investment has also increased. With SCERS' total portfolio value of approximately $12.8 billion, the target average direct fund investment is approximately $56 million, based on the proposed target of 12 funds (with 75% invested in direct fund investments and 25% invested in the Grosvenor FoF portfolio). With the current target of 10 funds, the direct fund target investment amount equates to approximately $67 million, which Staff and Cliffwater believe creates too high of a level of fund concentration.

| | Previous Guidelines | Updated Guidelines |
|---|---|---|
| Target Allocation | 7% of Total Assets | 7% of Total Assets |
| Allocation Range | 5% to 9% of Total Assets | 5% to 9% of Total Assets |
| Number of Funds | Target 10 funds with a range of 6 to 13 | **Target 12 funds with a range of 8 to 15** |
| Non-U.S. Exposure | Expect 20% to 50% non-U.S. exposure | Expect 20% to 50% non-U.S. exposure |

The Absolute Return portfolio, as of August 31, 2021, has the following strategy and geographic exposures:




<u>Absolute Return Strategy Guidelines:</u>

The strategy guidelines for the Absolute Return portfolio help set parameters and expectations for the portfolio construction and type of investment strategies included within the portfolio. During the previous asset allocation modifications in 2017, when the separate Growth and Diversifying Absolute return asset classes were established, specific guidelines for the Diversifying Absolute Return portfolio were implemented, as shown in the table below.

| | Diversifying Strategies |
|---|---|
| Portfolio Objective | Positive absolute return profile over time with limited sensitivity to broad market performance |
| Benchmark | Policy: HFRI FoF Conservative Index |
| | Long term objective: T-bills + 2% |
| Risk Target | Standard Deviation < 25% of global equities |
| Market Sensitivity | Target an equity beta < 0.1 |
| | Target equity correlation < 0.1 |
| Market Exposure | Total notional gross exposure < 750% [1] |

*1 Total notional gross exposure equals the sum of gross long notional exposure plus gross short notional exposure, expressed as a percentage of total invested capital.*

Based on experience over the past several years since the Diversifying Absolute Return portfolio was established and implemented, Staff and Cliffwater recommend making the following updates to the Absolute Return portfolio guidelines:

***Portfolio Objective and Benchmarks:***

Staff and Cliffwater recommend maintaining the portfolio objective and benchmarks, as they were defined when the asset class was established in 2017. As a key component of SCERS' Diversifying asset category, the Absolute Return asset class should be a positive contributor to the overall portfolio, delivering positive returns over time, with limited sensitivity to broader markets. Benchmarking for an absolute return portfolio is a challenge, as absolute return indices often don't accurately reflect the underlying strategies and market exposure that will be incorporated into SCERS' Absolute Return portfolio. However, recognizing the potential misalignment, at this time the HFRI FoF Conservative Index adequately reflects the overall goals for SCERS' Absolute Return portfolio, and therefore is a reasonable policy benchmark. Staff and Cliffwater may revisit the choice of policy benchmark when the Investment Policy Statement (IPS) for the Diversifying asset category is updated in 2022. The long-term objective of T-Bills + 2% is still a good measure of long-term performance, as many diversifying absolute return strategies seek to deliver positive returns with limited market exposure to equity and credit risks.

***Market Sensitivity:***

Staff and Cliffwater recommend increasing the target equity beta from less than 0.1 to less than 0.2, and the target correlation from less than 0.1 to less than 0.5. Equity beta[1] and correlation[2], which measure the magnitude and directionality of movements in the portfolio in relation to equity markets, are expected to remain relatively limited in conjunction with the broad portfolio objective of "limited sensitivity to broad market performance". However, based on experience, the previous guideline of 0.1 beta and correlation was overly restrictive and didn't accurately reflect the market environment for diversifying strategies. Equity beta and correlation are calculated based on prior market performance and can vary significantly based on changing market conditions. Additionally, as correlation reflects directionality (versus magnitude) of portfolio movement, a higher correlation is reasonably expected given the markets overall tendency for positive performance across a market cycle. Staff and Cliffwater believe that an appropriately diversifying portfolio can be constructed with slightly higher market sensitivity, reflecting the broad range of strategies across the absolute return universe. Revising the equity beta and correlation limits does not impact the current portfolio of investment managers and funds within SCERS' Diversifying Absolute Return portfolio.

***Risk Target:***

Maintain the risk target as standard deviation of the portfolio less than 25% of the standard deviation of global equities. Historically, over the long term, annual standard deviation of global equities has been approximately 17-18%. Maintaining a risk target of 25% of global equities would imply an expected annual volatility of approximately 4.5%. As with market sensitivity measures, volatility is a backward looking statistic that can vary significantly based on market conditions. The risk target is expected over a full market cycle.

***Market Exposure:***

Total notional gross exposure is a common measure that many absolute return market participants use to calculate market exposure and leverage of a fund or portfolio. Total notional gross exposure is represented as a percentage of total invested capital. Total gross exposure is the sum of gross long and gross short notional exposures. Stated another way, it is the sum of the value of total long and short positions. Many diversifying absolute return strategies tend to have low net exposure (offsetting long and short exposures), with attractive return distribution profiles, but utilize higher levels of leverage (high gross exposure) to generate returns. Staff and Cliffwater recommend maintaining the guideline of total gross notional exposure of less than 750% for the entire portfolio, recognizing there is a wide range of the use of leverage across diversifying absolute return strategies.

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[1] Beta: Measure of a portfolio (or security) return sensitivity to a market index. The higher the beta coefficient, the greater the sensitivity to the market. A portfolio with a beta of 1.0 should move directly in line with the market index.
[2] Correlation: Measures the degree to which two variables (security, portfolio, etc.) move in relation to each other. A positive correlation shows that the securities are moving in the same direction and a negative one shows that they are moving in different directions. Correlation coefficient ranges between +1.0 and -1.0, reflecting securities that have move perfectly in line with each other or completely inverse, with a zero correlation implying no linear relationship.

The table below highlights the recommended sub-strategy guidelines for the Absolute Return asset class, highlighting the increases to market sensitivity measures, while maintaining other portfolio guidelines.

| | Previous Guidelines | Updated Guidelines |
|---|---|---|
| Portfolio Objective | Positive absolute return profile over time with limited sensitivity to broad market performance | Positive absolute return profile over time with limited sensitivity to broad market performance |
| Benchmark | Policy: HFRI FoF Conservative Index | Policy: HFRI FoF Conservative Index |
| | Long term objective: T-bills + 2% | Long term objective: T-bills + 2% |
| Risk Target | Standard Deviation < 25% of global equities | Standard Deviation < 25% of global equities |
| Market Sensitivity | Target an equity beta < 0.1 | **Target an equity beta < 0.2** |
| | Target equity correlation < 0.1 | **Target equity correlation < 0.5** |
| Market Exposure | Total notional gross exposure < 750% [1] | Total notional gross exposure < 750% [1] |

## ABSOLUTE RETURN IMPLEMENTATION PLAN

Growth Absolute Return

As noted above, the Growth Absolute Return asset class was eliminated as part of the updated strategic asset allocation approved by the Board at the August Board meeting. The Growth Absolute Return portfolio consists of a Fund of Funds portfolio managed by Grosvenor (SCARF-G) and three direct fund investments. As recently communicated to the Board, SCERS has notified Grosvenor of the plan to fully exit the SCARF-G portfolio, and Grosvenor has begun the process of redeeming from investments with the underlying fund managers. Grosvenor estimates that 85% of the fund assets can be distributed to SCERS by the end of 2022, while the remaining 15% could take an additional 18 months.

For the direct investments, Staff and Cliffwater plan to review potential alternatives for each fund SCERS is invested in. The alternatives available for each investment include:

- Redeem from the investment
- Shift the investment into the Diversifying Absolute Return portfolio, if it fits the characteristics of this segment
- Shift the investment into a public markets asset class, such as public equity or public credit, if it fits the characteristics and/or structure of these segments

Each direct absolute return fund investment will be evaluated based on the specific characteristics of each fund. Staff will review the investment strategy and fund characteristics (beta, correlation, gross/net exposure, asset class exposure, etc.) and work with SCERS' consultants (Cliffwater and Verus) to determine if any fund may be an appropriate fit in another segment of SCERS' portfolio, or if the investment should be liquidated. A separate memo will be provided to update the Board on the recommended action taken for each direct fund investment, in accordance with the implementation protocol within the Growth asset category investment policy statement. It is anticipated that the evaluation and recommended action to be taken for the direct fund investments will occur prior to year-end. As necessary, Staff and Cliffwater will review the liquidation requirements for each fund to determine when redemption notice should be provided to each fund manager, with the goal to maximize SCERS' liquidity and ability to re-deploy assets across the portfolio.

Diversifying Absolute Return → Absolute Return

With the elimination of the Growth Absolute Return asset class, the additional descriptor of 'Diversifying' is no longer needed, and Staff and Cliffwater recommend that the Diversifying Absolute Return be renamed Absolute Return. The Absolute Return asset class remains in the Diversifying asset category, and retains the characteristics consistent with a diversifying portfolio. The target allocation of 7%, and range of +/- 2%, is unchanged. With the same target allocation, along with minimal changes to the strategy guidelines, Staff and Cliffwater don't anticipate meaningful changes to portfolio implementation, management, and monitoring.

The Absolute Return portfolio is currently slightly underweight the 7% target allocation, at 6.3% as of August 31, 2021. As recommended, the target number of direct funds is recommended to increase to twelve, with the portfolio currently including eleven direct fund investments. One additional direct fund investment would bring the portfolio in line with the target number of direct fund investments and also bring the portfolio market value close to the target 7% allocation. Staff and Cliffwater have been evaluating potential investment alternatives and anticipate that an additional investment will be recommended for inclusion in the Absolute Return portfolio over the next few months.

## NEXT STEPS

- Evaluate each direct fund investment in the Growth Absolute Return portfolio and recommend either retaining or liquidating the investment.
- Incorporate approved Absolute Return structure changes into the Diversifying asset category and Master IPSs.

## ATTACHMENTS

- Board Order
- Cliffwater Absolute Return Portfolio Structuring Considerations Presentation

Prepared by: Reviewed by:

/S/

Brian Miller
Senior Investment Officer

/S/

Eric Stern
Chief Executive Officer

/S/

Steve Davis
Chief Investment Officer

# Retirement Board Order

**Sacramento County Employees' Retirement System**

**Before the Board of Retirement**
**October 20, 2021**

MOTION:

**Asset Class Restructuring: Absolute Return**

THE BOARD OF RETIREMENT hereby accepts the recommendation of staff to approve the implementation plan and make the following revisions to the structure of the Absolute Return asset class:

- Rename 'Diversifying Absolute Return' asset class to 'Absolute Return'
- Maintain 7% target allocation for Absolute Return asset class with a range of +/- 2% around target allocation (5% - 9%).
- Update portfolio guidelines:
  - Increase the targeted number of portfolio funds from 10 to 12, with a range of 8 to 15 funds
  - Slightly increase market sensitivity
    - Increase the portfolio's target equity beta from <0.1 to <0.2
    - Increase the portfolio's target equity correlation from <0.1 to <0.5
    - Maintain existing portfolio objectives, benchmarks, market exposure, and risk targets
- Adopt implementation plan for liquidation of Growth Absolute Return investments.
- Direct staff to make conforming changes to the Growth Asset Category and Master Investment Policy Statements for approval by the Board at a future meeting.

I HEREBY CERTIFY that the above order was passed and adopted on October 20, 2021 by the following vote of the Board of Retirement, to wit:

AYES:

NOES:

ABSENT:

ABSTAIN:

ALTERNATES (Present but not voting):

| | |
|---|---|
| Richard B. Fowler II<br>Board President | Eric Stern<br>Chief Executive Officer and<br>Board Secretary |

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Los Angeles • New York

# Sacramento County Employees' Retirement System

## Absolute Return Portfolio Structuring Considerations

October 20, 2021

# Summary of Absolute Return Structure Recommendations

Recommending only modest changes to the Absolute Return portfolio structure*

- Rename “Diversifying Absolute Return” to “Absolute Return”
    - Follows the elimination of Growth Absolute Return in the 2021 asset liability modeling study
- Increase the targeted number of portfolio funds from 10 to 12
    - Recommended range of 8 to 15 funds
- Permit slightly higher market sensitivity in the Absolute Return portfolio
    - Increase the portfolio’s target equity beta from <0.1 to <0.2
    - Increase the portfolio’s target equity correlation from <0.1 to <0.5

Not recommending any changes to portfolio objectives, benchmarks, permissible allocation range, risk targets, or other exposure targets at this time

- Retaining the 5% to 9% permissible allocation range with the 7% target allocation
    - The target allocation was approved in the 2021 asset liability modeling study
    - The current Diversifying Absolute Return allocation is 6.2% as of August 31, 2021

Will separately evaluate the role of the current Growth Absolute Return funds

- Three potential options for these funds given the elimination of Growth Absolute Return:
    - Redeem from the investment
    - Transfer the investment into the Diversifying Absolute Return portfolio
    - Transfer the investment into a traditional asset class (e.g. Global Equity)

** All references to changes are with respect to the current Diversifying Absolute Return portfolio.*


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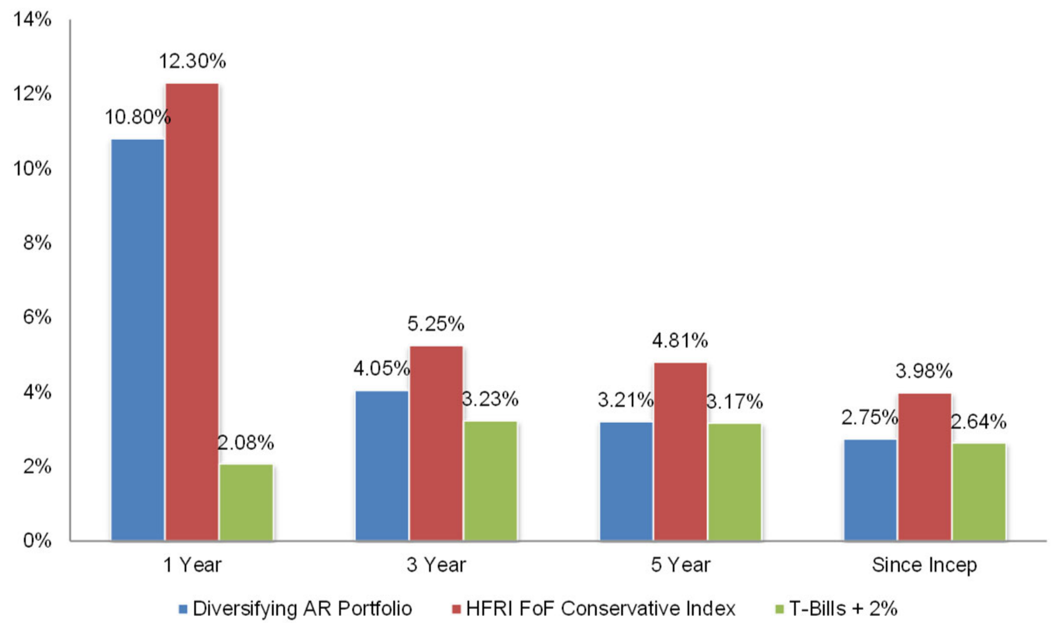
# Absolute Return Portfolio Objectives

The SCERS Diversifying Absolute Return portfolio is intended to produce positive returns over time with limited sensitivity to broad market performance

- Compare performance to a policy benchmark (HFRI FoF Conservative Index) and a long-term objective (T-bills + 2%)

The Diversifying Absolute Return portfolio has generally been meeting its objectives and there are no recommended changes to the stated portfolio objectives

SCERS Diversifying Absolute Return Portfolio Performance*




Since Inception Portfolio Statistics:

- Equity beta of 0.13
- Equity correlation of 0.49
- Standard deviation of 3.47% v. global equity standard deviation of 13.12%



* *Net returns as of August 31, 2021*

# Diversifying Absolute Return Portfolio Parameters

Below are the current and recommended Diversifying Absolute Return parameters

– Any changes to portfolio parameters would be reflected in future revisions to the IPS

- Changed parameters highlighted in the table below

| | Current | Proposed |
|---|---|---|
| Portfolio Objective | Positive absolute return profile over time with limited sensitivity to broad market performance | Positive absolute return profile over time with limited sensitivity to broad market performance |
| Benchmark | Policy: HFRI FoF Conservative Index<br>Long term objective: T-bills + 2% | Policy: HFRI FoF Conservative Index<br>Long term objective: T-bills + 2% |
| Risk Target | Standard Deviation < 25% of global equities | Standard Deviation < 25% of global equities |
| Market Sensitivity | Target an equity beta < 0.1<br>Target equity correlation < 0.1 | Target an equity beta < 0.2<br>Target equity correlation < 0.5 |
| Market Exposure | Total notional gross exposure < 750% [1] | Total notional gross exposure < 750% [1] |

[1] Total notional gross exposure equals the sum of gross long notional exposure plus gross short notional exposure, expressed as a percentage of total invested capital.



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# Diversifying Absolute Return Diversification Guidelines

Below are the portfolio's current and recommended diversification guidelines

- Any changes to these guidelines would also be reflected in future revisions to the IPS
  - Changed guidelines highlighted in the table below

| | Current | Proposed |
|---|---|---|
| Target Allocation | 7% of Total Assets | 7% of Total Assets |
| Allocation Range | 5% to 9% of Total Assets | 5% to 9% of Total Assets |
| Number of Funds | Target 10 funds with a range of 6 to 13 | Target 12 funds with a range of 8 to 15 |
| Non-U.S. Exposure | Expect 20% to 50% non-U.S. exposure | Expect 20% to 50% non-U.S. exposure |



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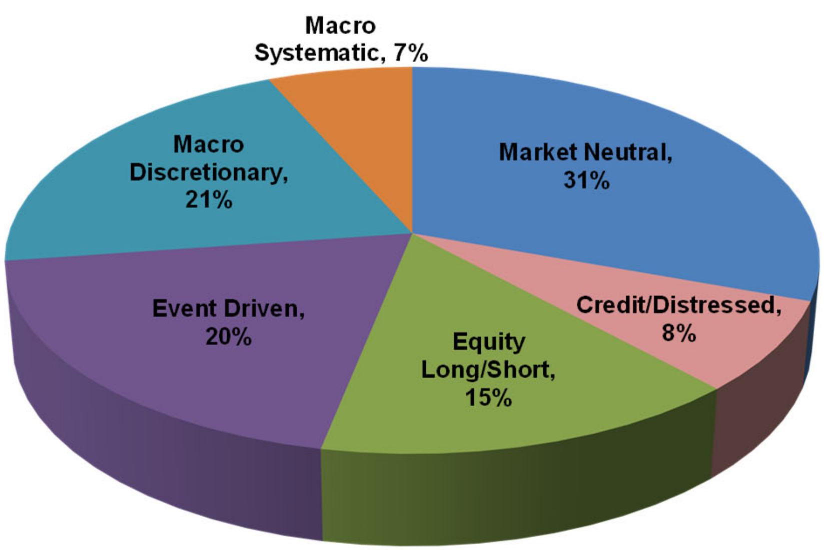
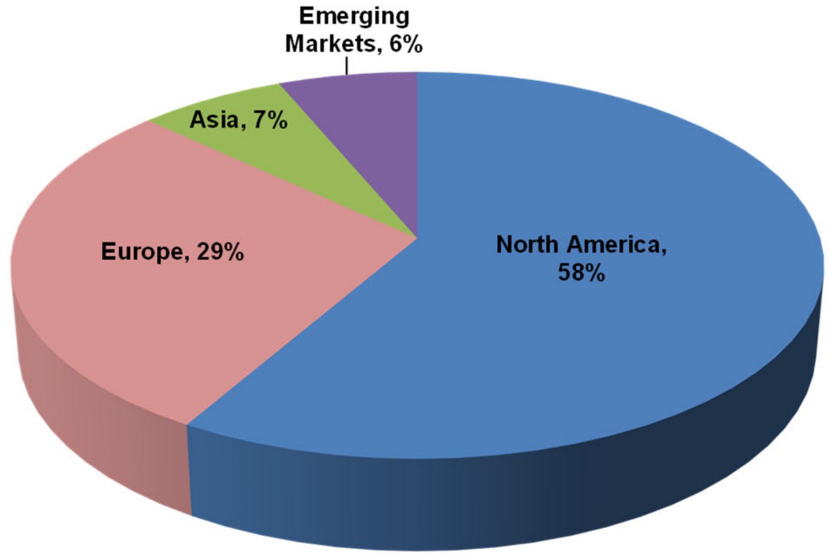
# SCERS Diversifying Absolute Return Portfolio Exposures

Portfolio Strategy Exposures
as of August 31, 2021




Portfolio Geographic Exposures
as of August 31, 2021




The portfolio's exposures are in-line with current portfolio parameters and guidelines

– The current Diversifying Absolute Return allocation is 6.2% as of August 31, 2021



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# Next Steps

## Recommend Investment Policy Statement changes

- The recommended Absolute Return structure changes go into effect upon Board approval
- The Diversifying asset category IPS will be revised at a later date
  - The IPS revisions will include Absolute Return updates and other Diversifying asset class updates
  - The Master IPS will also be revised at a later date

## Evaluate the role of the current Growth Absolute Return funds

- Three potential options for these funds given the elimination of Growth Absolute Return:
  - Redeem from the investment
  - Transfer the investment into the Diversifying Absolute Return portfolio
  - Transfer the investment into a traditional asset class (e.g. Global Equity)
- Each fund will be evaluated based upon its specific characteristics
  - Will impact the decision to redeem or retain the investment, and which asset class is most appropriate for any retained investments
- Any recommended actions for these funds would be subsequently provided to SCERS' Board



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