



Board of Retirement Regular Meeting

Sacramento County Employees' Retirement System

Agenda Item 22

MEETING DATE: January 19, 2022

SUBJECT: Education: Investment Implementation Protocols

SUBMITTED FOR: ___ Consent X Deliberation and Action ___ Receive and File

RECOMMENDATION

Staff recommends the Board receive and file the presentation that discusses SCERS' implementation protocols for selecting external investment managers within the governance structure of SCERS' investment program, and recommends the Board designate an ad hoc investment governance committee to discuss and evaluate implementation protocols, Board reporting, and communication between the Board and Staff.

PURPOSE

This item supports the SCERS Strategic Management Plan objectives to promote a strong Board-Staff partnership and ensure effective oversight of the investment program.

BACKGROUND

This agenda item is intended to refresh the SCERS Board on the current implementation protocols for making investments within the governance structure of SCERS' investment program, which have been in place for the past decade, including why they were put into place, assess how they have performed, and to present implementation protocol considerations and options going forward.

When SCERS selects new investment managers, the Board does not have a hands-on role in reviewing potential candidates or interviewing finalists. While the Board always maintains authority for the final sign-off or approval, under the current implementation protocols established in 2011, the Board delegates the most time intensive elements of the process to Staff and SCERS' investment consultants, while preserving the Board's oversight of the overall investment program and its underlying asset classes.

The move toward greater delegation corresponded with the evolution of SCERS' investment portfolio. This included increasing exposure to alternative asset classes as well as moving to a direct investment approach within alternative assets, and away from fund of funds. Given the number of investments that would have to be made, and have since been made, the need to

make such investments in a timely manner, and the relatively small size of any one investment within the alternative asset classes, the Board determined that it would be advisable to establish protocols for making investments within the alternative asset classes to effectively and efficiently address those issues, while allowing for sufficient oversight by the Board.

The current implementation protocols differentiates between traditional assets/public market investments (Public Equity, Fixed Income, Public Credit, and Liquid Real Return) and alternative assets/private market investments (Absolute Return, Private Equity, Private Credit, Real Estate, and Real Assets). For alternative assets, targeted investments generally fall below \$50 million, but have in the past ranged up to \$100 million for open-end commingled funds and SCERS specific fund of one mandates. Public market asset classes generally involve larger investment commitments, often exceeding \$200 million.

When managing SCERS' assets, Board members must act as prudent fiduciaries. In carrying out these fiduciary duties, the Board can delegate various responsibilities to other parties, but such a delegation must be reasonable, prudent, and properly monitored and controlled. When the current implementation protocols were put into place, the Board determined that because of the knowledge and expertise required to properly identify, screen, and select investment managers and strategies, these tasks were suitable for a prudent fiduciary delegation of responsibilities. The manager selection process across the asset classes reflects the Board's recognition that Staff and the consultants possess the requisite knowledge and expertise to help assure prudent decisions in selecting investment managers across the portfolio.

The current implementation protocols are described within SCERS' Master Investment Policy Statement (IPS), and in greater detail within the asset category IPSs. To summarize, the current protocols authorize Staff and consultants to identify qualified investment manager and fund candidates for investment within the various asset classes based on the long-term asset allocation structure approved by the Board for a particular asset class, and the approved annual investment plan for that asset class.

For traditional assets/public markets, the implementation protocol delegates the most time sensitive elements of the process to Staff and consultant, including the screening and evaluation leading to the recommendation to engage or terminate a particular investment manager. For traditional assets/public market asset classes, the Board makes the final decision regarding engagement or termination of investment managers. Staff and the consultant identify the most qualified candidates for a mandate, and pursues extensive due diligence on the manager candidates. Staff and consultant provide reporting to the Board along the way, culminated by a final recommendation report. At any point in the process, questions or concerns by any trustee regarding a proposed investment or proposed manager is communicated to SCERS' CEO. The manager being recommended for the engagement makes a presentation to the Board at an upcoming Board meeting. Legal review of documentation and negotiation of deal terms also takes place during the process.

For alternative assets/private markets, the execution of the long-term asset allocation structure and annual investment plan, including the selection of investment managers is delegated to Staff, subject to the Board's ability to review, discuss, and object to the recommendations of

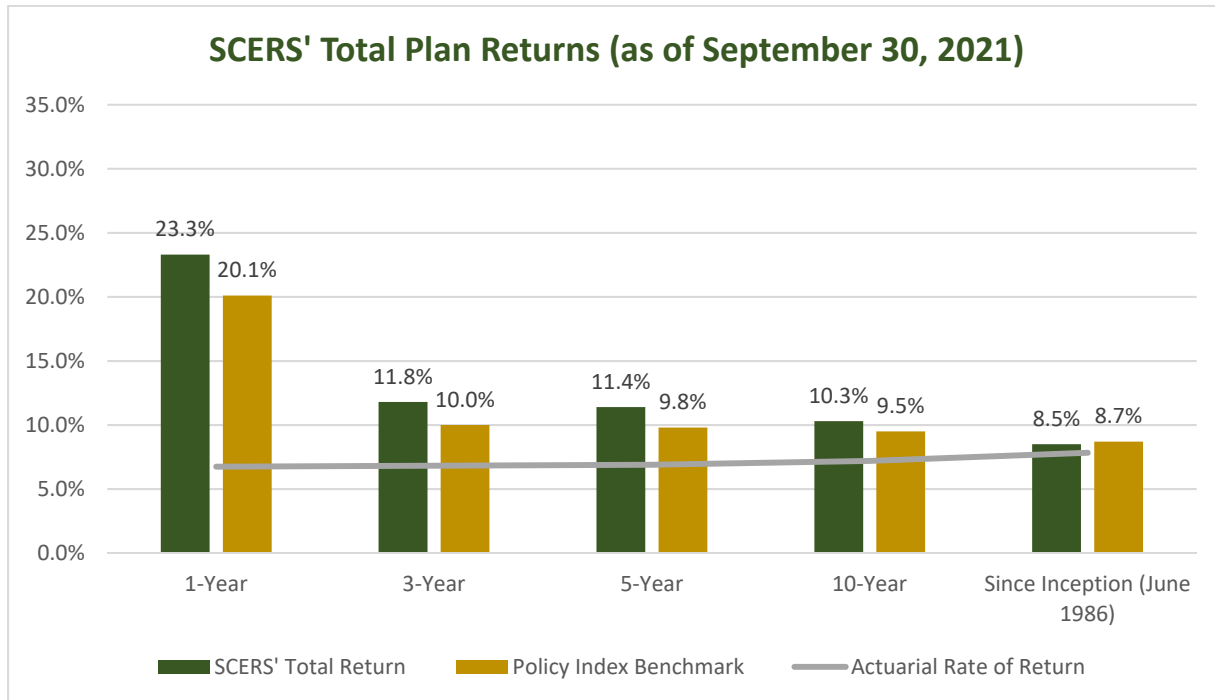
Staff and consultant during the investment protocol process. Staff and consultant identify the most qualified candidates for a prospective investment commitment based on the asset allocation structure for the underlying asset class approved by the Board, and the approved annual investment plan for the underlying asset classes. When a particular manager candidate is identified, Staff and consultant pursues extensive due diligence on the manager candidate, including conducting extended interviews with the portfolio managers and other key members of the investment team. Legal review of fund documentation and negotiation of deal terms also takes place. Staff and consultants provide detailed reporting to the Board during the process, including a final recommendation report. At any point in the process, questions or concerns by any trustee regarding a proposed investment or proposed manager is communicated to SCERS' CEO. Absent questions or concerns by the Board, the proposed investment is finalized and the necessary documentation executed.

The primary difference between the traditional assets/public markets and alternative assets/private markets implementation process is that for alternative assets/private market investments, absent an objection from the Board, Staff and the consultant will make the final decision regarding a specific commitment, whereas for traditional assets/public market investments, the Board makes the final decision at a Board meeting after a presentation by the candidate recommended by Staff and the consultant.

DISCUSSION

Over the past decade, Staff believes that the current implementation protocols have worked efficiently and effectively, and have added value to SCERS. The investment program has grown from approximately \$6 billion in 2011, to the current value of \$12.9 billion today (as of September 30, 2021). The investment strategy count has grown from approximately 50 in 2011 to a current count of approximately 165. Most of this growth has occurred within the alternative asset classes, where moving from a fund of fund approach to a direct approach, has translated to a much higher fund count in order to improve risk adjusted returns, and also lower fees. The overall manager count is lower at approximately 100 today, versus 40 in 2011. Increasing exposure to alternative assets and implementing through a direct approach does lead to greater portfolio complexity, and would have been challenging to implement without the current implementation protocols.

The evolution of SCERS' portfolio has also translated to strong returns. As shown below, SCERS' portfolio returns have exceeded SCERS' actuarial rate of return over all time periods, and has generated excess returns over the policy index benchmark over each measurement period over the past 10 years. Nearly all individual asset classes have also exceeded their respective policy index benchmarks. This strong performance is a result of a well-designed strategic asset allocation, and a thoughtful approach to implementation of the portfolio by the Board, Staff, and SCERS' investment consultants.



During the Enterprise Risk Tolerance (ERT) assessment during last year’s asset liability modeling study, Verus surveyed the Board regarding SCERS’ current governance structure, among many other topics. The aggregate sentiment from the Board was that there was broad trustee comfort with both the current governance structure and delegation. There was also acknowledgement by some trustees that they were open to considering changes to the governance/delegation structure if a specific proposal were brought forward articulating the rationale. A common comment within the ERT was the preference for better summary level information to accompany the large amounts of information provided to the Board within manager due diligence reports, as well as other Board reporting.

After 10 years of experience under the current protocols, Staff is exploring opportunities and discussion with the Board to expand the current delegation while maintaining the appropriate balance of Board transparency and oversight. While the change in delegated authority in 2011 correlated to increased returns as the portfolio evolved into alternative assets/private markets, Staff does not believe that further changes to the current delegation authority would necessarily translate to increasing investment returns, but rather, Staff is pursuing this discussion to improve business process and administrative efficiency.

Across public pension plans that utilize some form of delegation, there are three common approaches, which are highlighted below:

Approach 1: Asset class delegation – delegation protocols vary depending on the asset class.

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- SCERS utilizes this approach with varying amounts of delegation between traditional assets/public markets and alternative assets/private markets.
 - There is greater delegation within alternative assets/private markets than traditional asset/public markets, which have quicker timelines that don't generally align with a scheduled Board meeting. Final Board approval occurs with larger traditional assets/public market mandates.

Approach 2: Threshold delegation – The amount of delegation is determined by a threshold, such as a dollar threshold or a percentage of the portfolio threshold (i.e., \$125 million or 1% of the total portfolio).

- This approach is similar to SCERS' current approach in that greater delegation could occur with smaller mandates (mostly within the alternative asset classes) that have quicker timelines that don't generally align with a scheduled Board meeting, though it would be extended into traditional, public market assets. Final Board approval would still occur with larger mandates for either private or public markets if there is sensitivity to the dollar size of the investment.
- This approach could work better within SCERS' revised strategic asset allocation structure, where there is some blurring between public market assets and alternative assets, particularly within the Global Equity asset classes, where a small segment of this asset classes can potentially allocate to less constrained mandates invested though an absolute return (hedge fund) structure. Absolute return funds currently have a greater level of delegation than a traditional public equity mandate, and are sized at significantly smaller levels.

Approach 3: Standardized delegation – delegation is the same across all investments, with no differential by asset class or threshold level.

- An option within SCERS' portfolio under this approach would be to utilize the current alternative assets/private markets implementation protocols across all asset classes, including traditional assets/public markets.
- This approach is the most administratively efficient, in that it would enable Staff to finalize investment commitments without requiring approval at a Board meeting with presentations from the recommended investment manager.

NEXT STEPS

While the current implementation protocols have been beneficial toward implementing SCERS' investment portfolio to its current state, they have not been evaluated by the Board in 10 years. Staff recommends that the Board assess the current protocols, including various approaches that are currently employed by other public pension plans. Staff believes that an effective approach to doing this is to form a Board ad hoc investment governance committee. An informal, advisory committee could be used as a sounding board for Staff to discuss and evaluate governance, which would include any revisions to the current implementation protocols. It could also be used to assess and discuss the format and content of reporting from Staff, and other communications between Staff and the Board. Ad hoc committees are not public meetings

subject to the Brown Act and would be appropriate in this case due to the confidential nature of internal work products that involve the purchase or sale of public pension investments.

The ad hoc investment governance committee could be comprised of three or four Board members, and meetings would take place as needed over the next six months. Any recommended changes to the implementation protocols would be presented to the full Board for approval.

ATTACHMENTS

- Board Order
- Investment Implementation Protocol Discussion Presentation

Prepared by:

/S/

Steve Davis
Chief Investment Officer

Reviewed by:

/S/

Eric Stern
Chief Executive Officer



Retirement Board Order

Sacramento County Employees' Retirement System

Before the Board of Retirement
January 19, 2022

AGENDA ITEM:

Education: Investment Implementation Protocols

THE BOARD OF RETIREMENT hereby accepts the recommendation of staff to receive and file the overview of SCERS' implementation protocols for selecting external investment managers, and recommends the Board designate an ad hoc investment governance committee to discuss and evaluate implementation protocols, Board reporting, and communication between the Board and Staff.

I HEREBY CERTIFY that the above order was passed and adopted on January 19, 2022 by the following vote of the Board of Retirement, to wit:

AYES:

NOES:

ABSENT:

ABSTAIN:

ALTERNATES (Present but not voting):

Richard B. Fowler II
Board President

Eric Stern
Chief Executive Officer and
Board Secretary



SCERS
CELEBRATING **80** YEARS

Investment Implementation Protocols

January 19, 2022

SACRAMENTO COUNTY EMPLOYEES' RETIREMENT SYSTEM

Agenda

- ❖ Background on implementation protocols
- ❖ Assessment of current protocols
- ❖ Considerations going forward
- ❖ Next steps

Background on Current Protocols

- ❖ Current protocols in place since 2011
- ❖ Board delegates most time intensive elements of process to Staff and investment consultants
 - ❖ Identification and evaluation of qualified investment managers and funds
 - ❖ Within the guidelines of asset class long-term structures, and annual asset class investments plans

Background on Current Protocols

- ❖ The move toward greater delegation corresponded with evolution of SCERS' investment portfolio
 - ❖ Increasing exposure to alternative assets and move from FoFs to direct investments
 - ❖ Alternative assets investments are made in smaller sizes, and timing can present challenges outside of a Board meeting cycle
 - ❖ Complexity of alternative assets requires requisite knowledge and expertise in making prudent investment decisions

Background on Current Protocols (cont.)

- ❖ Protocols still preserves the Board's oversight of the investment portfolio and underlying asset classes
- ❖ In carrying out fiduciary duties to manage SCERS' assets, the Board can delegate certain responsibilities to other parties
 - ❖ Such delegation must be reasonable, prudent, and properly monitored and controlled
- ❖ Protocols differ for traditional assets/public markets vs. alternative assets/private markets

Traditional Assets/Public Markets Protocols

- ❖ **Includes Public Equities; Fixed Income; Public Credit; Liquid Real Return**
 - ❖ Delegates the most time-intensive elements of the process to Staff and consultant, including screening and evaluation leading to the recommendation to engage or terminate a particular investment manager
 - ❖ Board provides oversight of these segments and makes final decision regarding engagement or termination of investment managers

Alternative Assets/ Private Markets Protocols

- ❖ **Includes Absolute Return; Private Equity; Private Credit; Real Assets; Real Estate**
 - ❖ Selection and termination of investment managers delegated to Staff, subject to the Board's ability to review, discuss, and object to Staff recommendations

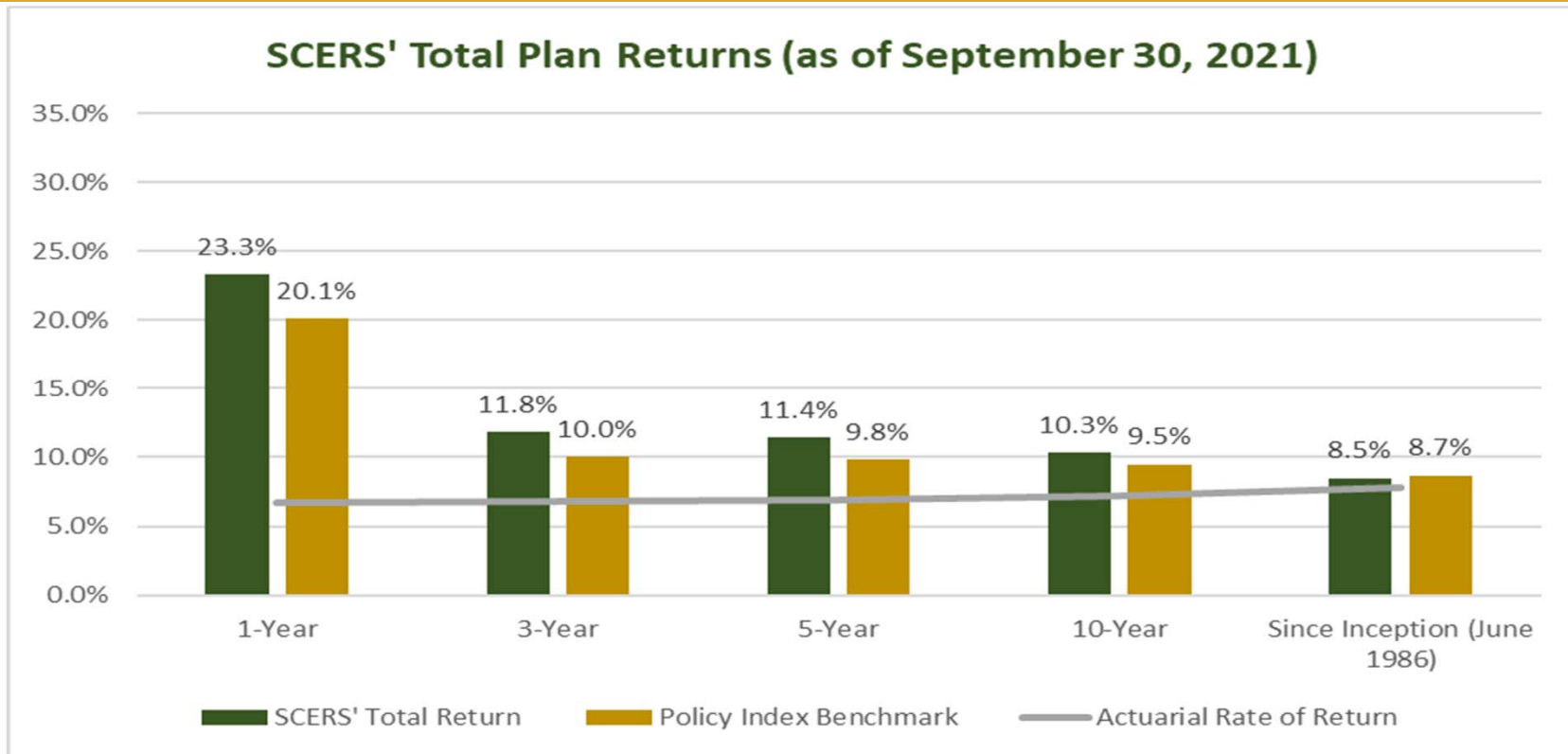
Assessment of Protocols

- ❖ Since protocols put in place:

| | 2011 | 2021 |
|-----------------------|---------------|----------------|
| SCERS Assets | \$6.1 billion | \$12.9 billion |
| Investment Strategies | 50 | 165 |
| Investment Managers | 40 | 100 |

- ❖ Growth in strategies and managers fueled by alternative assets
 - ❖ Would have been challenging to implement without current protocols

Assessment of Protocols - Performance



- ❖ Strong investment returns during current protocol period
 - ❖ Outperformance versus the actuarial rate and versus the policy index benchmark
 - ❖ Strong peer universe rankings
 - ❖ Excess returns consistent across asset classes

Considerations Going Forward

❖ **Board ERT assessment**

- ❖ Conducted by Verus in 2021 during ALM Study
- ❖ Sentiment from the Board that there is comfort with current governance structure and delegation
- ❖ Open to considering changes if rational approach was presented

❖ **Delegation among peer public plans**

- ❖ Has become more common across public plans, but with varying approaches
- ❖ Three common approaches to delegation

Delegation Approaches

| Asset Class Delegation | Threshold Delegation | Standardized Delegation |
|--|--|--|
| * <i>Current SCERS approach</i> | | |
| <p>* Amount of delegation varies depending on the asset class</p> <p>* i.e., greater delegation within alternative assets/private markets than traditional assets/public markets</p> | <p>* Amount of delegation is determined by a threshold (% or dollar based)</p> <p>* i.e., delegation on anything up to 1% of the total portfolio or a \$125 million investment</p> | <p>* Delegation is the same across all investments</p> <p>* No differentiation by asset class or threshold level</p> |

Next Steps

- ❖ **Evaluate any revised approaches to the governance structure and the investment implementation protocols**
- ❖ **Staff recommends creating a Board ad hoc investment governance committee to:**
 - ❖ Evaluate current implementation protocols
 - ❖ Assess format and content of reporting from staff, and other communications between staff and the Board
- ❖ **Any recommended revisions to the implementation protocols would be brought back to the full Board for approval**