SCERS
Sacramento County Employees' Retirement System

Board of Retirement Regular Meeting

Sacramento County Employees' Retirement System

Agenda Item 15

MEETING DATE: **June 21, 2023**

SUBJECT: **Strategic Asset Allocation Adjustment**

SUBMITTED FOR: __ Consent _X_ Deliberation and Action ___ Receive and File

RECOMMENDATION

- Revise SCERS' strategic asset allocation by increasing the Cash allocation from 1% to 2% (with a range of 0-3%) and reducing the Liquid Real Return allocation from 2% to 1% (with a range of 0-3%);
- Terminate the Brookfield Diversified Real Assets mandate (currently valued at $108 million or 0.9% of the total portfolio), and authorize the Chief Executive Officer to execute related documents and agreements;
- Authorize Staff to determine the most effective method for transitioning assets and execute any necessary documents or agreements to effectuate the transition of assets;
- Approve revisions to the Master Investment Policy Statement to reflect the asset allocation adjustments; and,
- Authorize Staff to adjust the guidelines of the Overlay Program managed by State Street Global Advisors to incorporate the strategic asset allocation adjustments.

PURPOSE

This item supports the 2023 Annual Investment Plan, which calls for evaluating strategic asset allocation modeling adjustments utilizing updated capital market assumptions.

BACKGROUND

At the February 2023 Board meeting, Verus modeled SCERS' current asset allocation using Verus' updated 2023 capital market assumptions (CMAs). As presented at that meeting, return expectations for several asset classes changed meaningfully compared to the prior year, due to the dramatic rise in interest rates over the past two years, as central banks fight inflation levels that have not been experienced in 40 years. With interest rates reset to higher levels, going forward return expectations for fixed income and cash meaningfully increased. Short duration bonds are now yielding approximately 5% in the current interest rate environment, which offer a compelling return for minimal risk versus other assets.

Staff and Verus also have discussed SCERS' plan cash flow profile with the Board. Like many public pension plans, SCERS is a mature plan with negative cash flows, meaning member benefit payments going out are greater than employer and employee contributions, and net investment income, coming in on an annual basis. A consideration going forward is to maintain a larger target Cash allocation to keep up with the gap between benefit payments and contributions. SCERS' current net cash flow as a percentage of plan assets is -1.7%. The negative cash flow figure is expected to increase to 2% next year, and over 3% over the next four years. Increasing the Cash allocation to serve as a liquidity buffer in line with the cash flow deficit is important to maintaining sufficient plan liquidity and a meaningful illiquid allocation to the private markets.

Staff and Verus communicated that we would evaluate the current strategic asset allocation (SAA) and come back to the Board with any recommended asset allocation adjustments.

DISCUSSION

Staff and Verus recommend revising SCERS' strategic asset allocation by increasing the Cash allocation from 1% to 2%, and reducing the Liquid Real Return (LRR) allocation from 2% to 1%. SCERS' Cash allocation is currently invested in SOFR, which is an influential interest rate that banks use to price U.S. dollar-denominated derivatives and loans. SOFR closely mimics the yield of short duration 90-day T-bills, and is currently yielding approximately 5%.

The Liquid Real Return asset class is split into two mandates, half with the State Street Global Advisors (SSGA) real return overlay program proxy, which is passively managed, and half with an actively managed Diversified Real Assets mandate managed by Brookfield Asset Management. It is recommended that the reduction in the LRR allocation come from the Brookfield Diversified Real Assets mandate, which is currently valued at approximately $108 million (0.9% of the total portfolio). The basis for the Brookfield recommendation is described later in this report.

Verus ran modeling comparing the current SAA with the recommended revisions (reducing LRR by 1% and increasing Cash by 1%). Given that this only represents 1% of the total portfolio, the impact is on the margin. Liquid Real Return has a forecasted return of 5.7%, with a rather high volatility forecast (standard deviation of 16.3%). Liquid Real Return has one of the lower forecasted risk adjusted returns, as measured by its the Sharpe Ratio of 0.15. Verus models cash at 3.3% over the next 10 years, anticipating that higher rates will moderate in the coming years, though the current cash yield is 5%. Cash provides little risk, evidenced by its standard deviation of 1.2%.

The current SAA models with an expected return of 7.44%, with a standard deviation of 11.9%, and a Sharpe Ratio of 0.39. The recommended revised portfolio models with an expected return of 7.40% (a reduction of 0.04%), with a standard deviation of 11.8% (a reduction of 0.1%), and the same Sharpe Ratio of 0.39. The marginal reduction in expected return is acceptable given that the current portfolio is modeling well above the 6.75% actuarial rate of return, and taking a little risk off the table in order to support plan liquidity and cash flows is prudent.

While the revised changes have minimal effect on the risk/return profile of the total portfolio, the key reasons for the recommendations are as follows:

- Increasing the Cash allocation from 1% to 2% will keep SCERS' liquidity buffer in line with the current cash flow gap, improving the cash flow profile of SCERS' plan.
- Short duration bonds are yielding around 5%, making holding higher yielding cash with very little risk compelling.
- Liquid Real Return has meaningful risk exposure through equity and credit holdings in real estate, infrastructure, and energy. These exposures are somewhat redundant to SCERS' public equity and fixed income asset classes. Liquid Real Return has a muted expected return with meaningful volatility. Reducing the Liquid Real Return allocation will take some equity and credit risk off the portfolio.
- Liquid Real Return, as explained below within the recommendation to terminate Brookfield, has less of a role in the SCERS portfolio than it did when it was added in 2019.

A counter argument to the recommendation to reduce the Liquid Real Return asset class is the loss of potential inflation sensitivity if inflation remains high. The Real Return asset category, which is comprised of the Real Estate, Real Assets, and Liquid Real Return asset classes, has served as a valuable inflation hedge during the current high inflationary environment, but this has been driven by the private markets exposures within the Real Assets and Real Estate asset classes, and to a lesser extent by the SSGA Real Return overlay program proxy. The Brookfield mandate, while outperforming the broad public equity and fixed income asset classes, still was down -10.2% in 2022.

BROOKFIELD TERMINATION

The Brookfield LRR mandate was added to the SCERS portfolio in 2019, when SCERS was earlier in its build out of the Real Assets asset class and the allocation was meaningfully underweight to target (5.2% actual vs. 7.0% target on June 30, 2019). The structure of the Brookfield mandate was a better representation of the private market exposures SCERS was implementing, with primary exposure, infrastructure stocks, REITs, and real assets fixed income, and less commodity exposure. The Brookfield mandate contains a 60%/40% split between real asset and real estate equities, and real asset credit (combination of high yield and investment grade), with the objective of generating higher yields and moderate diversification, and having less exposure to commodity risk. The return profile for the Brookfield mandate is closer to that of equities and credit than the SSGA Real Return proxy, which has greater inflation sensitivity through allocations to commodities and TIPS.

Forward to 2023 and SCERS is fully allocated, and overweight to the Real Assets asset class, with an 8.7% allocation vs. the 7.0% target. The overweight is a function of consistently adding funds to the asset class, including core open end infrastructure exposure, one of which was a Brookfield fund, combined with the outperformance of real assets vs. other asset classes during a challenging 2022. There is less of a need for the Brookfield Diversified Real Assets mandate than there was four years ago based on the current weighting to Real Assets, and SCERS' favoring of private market real asset exposure vs. liquid exposure. Private market investments have a higher yield, more consistent performance, and less correlation to equity and credit risk.

The Brookfield mandate has generated moderate returns since it was added in 2019, as it was negatively impacted by the challenging inflationary period of 2022. The SSGA Real Return proxy has provided better inflation protection than the Brookfield mandate.

Liquid Real Return Performance (as of 3/31/2023, net of fees)

	1 Year	3 Year	Since Inception	Calendar Year 2022
Brookfield Liquid Real Return	-8.7%	8.3%	2.4% (2019)	-10.2%
SSGA Liquid Real Return	-4.8%	11.6%	2.2% (2008)	-3.3%

The recommended termination of Brookfield is not related to a loss of conviction in Brookfield, as SCERS has multiple mandates with Brookfield across several asset classes (see below). Staff and consultants view Brookfield as a key partner across the Real Return spectrum. The recommendation to terminate the Brookfield Diversified Real assets mandate is a function of the current fit within SCERS' portfolio.

Fund	Year Invested	Fund Type	Asset Class	SCERS Investment Size ($ million)	SCERS Since Inception Return (TWR as of Q1'23)
Brookfield Diversified Real Assets Strategy	2019	Separate Account	Liquid Real Return	$108	2.4%
Brookfield Infrastructure Fund III	2016	Closed End Fund	Real Assets	$40	12.1%
Brookfield Infrastructure Fund IV	2019	Closed End Fund	Real Assets	$40	10.5%
Brookfield Super-Core Infrastructure Fund	2021	Open End Fund	Real Assets	$100	2.2%
Brookfield Premier Real Estate Partners	2018	Open End Fund	Real Estate	$100	9.7%
Brookfield Infrastructure Debt Fund III	2022	Closed End Fund	Private Credit	$40	N/A

SCERS will reduce fees marginally as a result of replacing the Brookfield Diversified Real assets mandate with cash. The management fee for Brookfield is 60 bps, which equates to approximately $650,000 annually. There is not a cost for the SOFR allocation within the Cash allocation.

TRANSITION PLAN

Staff and Verus also recommend the Board authorize Staff and Verus to develop a transition plan to sell the Brookfield assets and reinvest the proceeds into the Cash allocation. The Brookfield mandate is a separate account in which the assets are held with custodian State Street. The two options to sell the Brookfield assets are to either have Brookfield sell the assets, or hire a transition manager to sell the assets. Staff typically prefers to have a transition manager sell the assets of a terminated manager.

SCERS' Cash allocation is currently invested in SOFR through State Street. Staff will direct State Street to adjust the allocation to Cash from 1% to 2%.

NEXT STEPS

Staff will eliminate the Brookfield Diversified Real Assets mandate and add the proceeds to SCERS' Cash allocation with State Street. Staff will also direct State Street to unwind the interim increase in the Cash allocation related to a recent $61 million Absolute Return fund redemption (April 2023 Board meeting). In addition, Staff will also work with SSGA to incorporate the strategic asset allocation adjustments into the investment guidelines of the Overlay Program.

The Master IPS identifies several investment vehicles to implement the Cash allocation, including short duration bonds (i.e., 90-day T-Bills), demand deposit accounts tied to SOFR, and cash management funds. SCERS is currently using SOFR via State Street; however; Staff and Verus plan on evaluating alternative strategies that best match yields with SCERS' cash flow needs.

ATTACHMENT

- Board Order
- Asset Allocation Adjustment presentation
- Master Investment Policy Statement revision excerpt – redline

Prepared by:	Reviewed by:
/S/	**/S/**
Steve Davis Chief Investment Officer	Eric Stern Chief Executive Officer

Retirement Board Order

Sacramento County Employees’ Retirement System

Before the Board of Retirement
June 21, 2023

AGENDA ITEM:

Strategic Asset Allocation Adjustment

THE BOARD OF RETIREMENT hereby approves Staff’s recommendation to:

- Revise SCERS’ strategic asset allocation by increasing the Cash allocation from 1% to 2% (with a range of 0-3%) and reducing the Liquid Real Return allocation from 2% to 1% (with a range of 0-3%);
- Terminate the Brookfield Diversified Real Assets mandate (currently valued at $108 million or 0.9% of the total portfolio), and authorize the Chief Executive Officer to execute related documents and agreements;
- Authorize Staff to determine the most effective method for transitioning assets and execute any necessary documents or agreements to effectuate the transition of assets;
- Approve revisions to the Master Investment Policy Statement to reflect the asset allocation adjustments; and
- Authorize Staff to adjust the guidelines of the Overlay Program managed by State Street Global Advisors to incorporate the strategic asset allocation adjustments.

I HEREBY CERTIFY that the above order was passed and adopted on June 21, 2023 by the following vote of the Board of Retirement, to wit:

AYES:

NOES:

ABSENT:

ABSTAIN:

ALTERNATES:
(Present but not voting)

______________________________ ______________________________

Keith DeVore Board President	Eric Stern Chief Executive Officer and Board Secretary

Verus

PERSPECTIVES
THAT DRIVE
ENTERPRISE
SUCCESS

JUNE 2023

Asset Allocation Adjustment

Sacramento County Employees' Retirement System

Executive summary

— In February, the Board reviewed updated asset class capital market assumptions. In addition to the significant increase in expected returns, we also touched on future liquidity considerations as SCERS becomes an increasingly mature pension plan. During that presentation, Staff/Verus indicated we would likely come back to the Board with potential changes to the policy allocation.

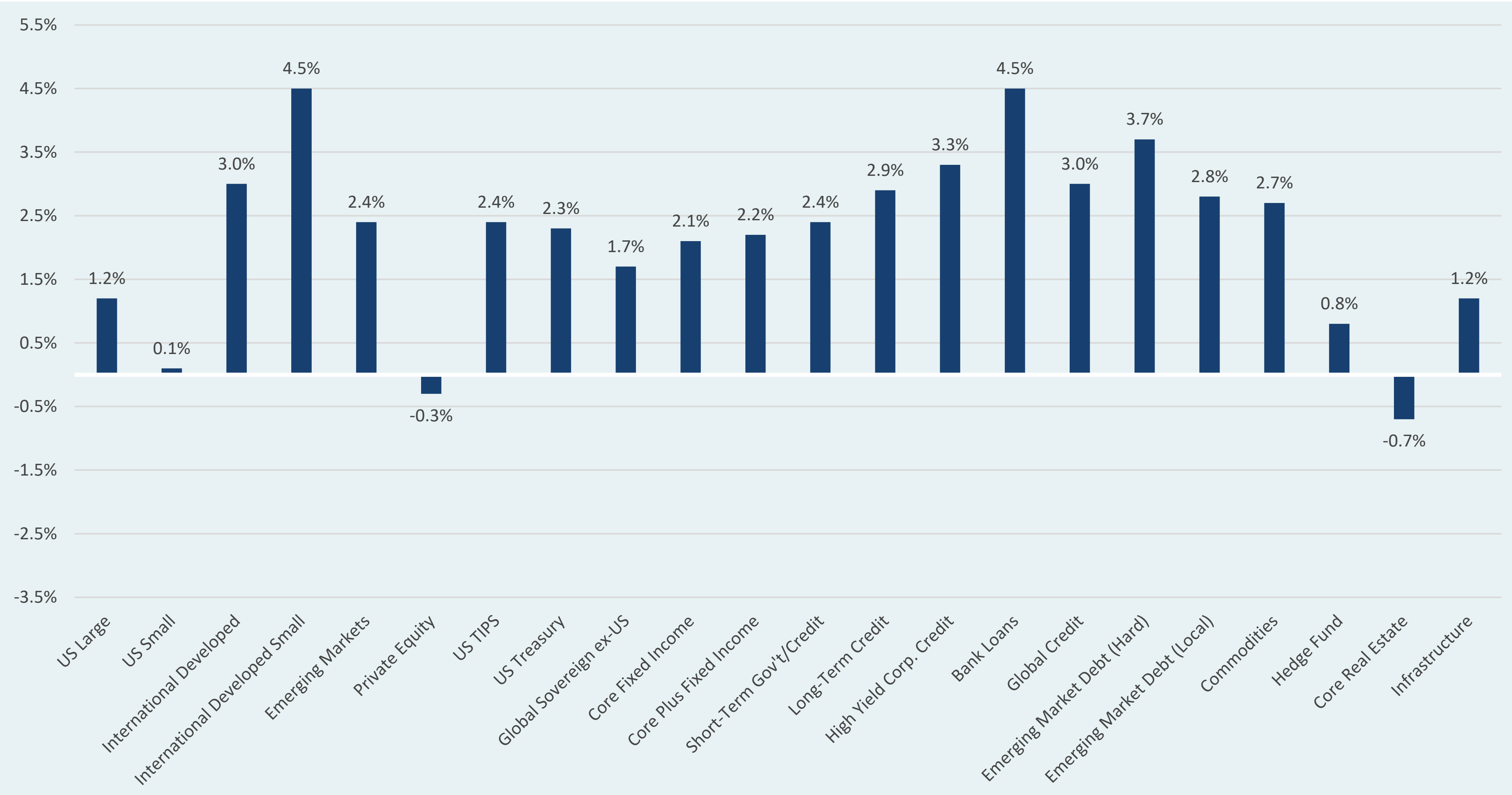
— The higher interest rate environment has fundamentally altered the ability for portfolios to hold elevated levels of cash without suffering a material drag on returns.

— Therefore, we are recommending a modest adjustment to the policy allocation that serves to marginally increase liquidity and decrease risk

- Increase Cash allocation by 1% and decrease Liquid Real Return by 1%
- Terminate Brookfield Diversified Real Assets mandate (Liquid Real Return)

— As the modeling indicates, this does not materially change the portfolio's expected outcome. However, holding a higher cash allocation will provide increased flexibility to meet cash flow needs. In addition, we believe funding the increase in Cash from Liquid Real Return is well-timed given the expectations for falling inflation and challenges to risk assets.

2023 vs. 2022 return forecast



Source: Verus, as of 9/30/22

SCERS' Pension Cash Flows

Calendar Year	Beginning of Year Market Value of Assets	Total Contributions	Total Benefit Projection + Expenses	Net Cash Flow %	Net Cash Flow ($)
2023	13,577,844,735	472,512,960	701,967,752	-1.69%	-229,454,792
2024	14,270,908,053	440,100,207	739,306,358	-2.10%	-299,206,151
2025	14,939,210,827	418,104,192	777,922,810	-2.41%	-359,818,618
2026	15,590,565,016	401,430,954	817,285,878	-2.67%	-415,854,924
2027	16,228,558,508	351,180,074	857,016,115	-3.12%	-505,836,041
2028	16,817,828,737	311,299,188	897,188,560	-3.48%	-585,889,372
2029	17,363,910,836	317,368,819	937,780,387	-3.57%	-620,411,568
2030	17,911,695,571	323,656,131	978,760,606	-3.66%	-655,104,475
2031	18,461,123,544	330,174,235	1,019,995,728	-3.74%	-689,821,493

SCERS has a 1-4% cash flow deficit each year, excluding capital calls and distributions from private investments

Deficit is projected to grow overtime, reaching 3.7% in 10 years

Deficit is projected to be 2.0% in 2024

Data provided by Segal

SCERS Policy Allocation

	Policy	Proposed	Return (g)	Standard Deviation	Sharpe Ratio (g)
US Large	18.0	18.0	*6.5*	*15.6*	*0.21*
US Small	2.0	2.0	*5.4*	*21.5*	*0.10*
International Developed	9.0	9.0	*9.1*	*17.8*	*0.33*
International Developed Small	2.0	2.0	*9.2*	*22.1*	*0.27*
Emerging Markets	5.0	5.0	*8.5*	*25.2*	*0.21*
Global Equity	4.0	4.0	*7.4*	*17.1*	*0.23*
High Yield Corp. Credit	1.0	1.0	*6.4*	*11.2*	*0.28*
Bank Loans	1.0	1.0	*6.8*	*9.2*	*0.38*
Private Equity	11.0	11.0	*9.2*	*25.8*	*0.23*
Private Credit	5.0	5.0	*8.2*	*13.0*	*0.38*
Total Growth Assets	***58***	***58***			
Core Plus Fixed Income	12.0	12.0	*4.6*	*4.6*	*0.28*
US Treasury	4.0	4.0	*3.8*	*7.1*	*0.07*
Diversifying Absolute Return*	7.0	7.0	*4.8*	*4.8*	*0.31*
Cash	1.0	2.0	*3.3*	*1.2*	*-*
Total Diversifying	***24***	***25***			
Core Real Estate	6.0	6.0	*5.8*	*12.6*	*0.20*
Value Add Real Estate	1.5	1.5	*7.8*	*15.5*	*0.29*
Opportunistic Real Estate	1.5	1.5	*8.8*	*21.3*	*0.26*
Liquid Real Return*	2.0	1.0	*5.7*	*16.3*	*0.15*
Private Real Assets*	7.0	7.0	*7.8*	*17.3*	*0.26*
Total Real Return	***18***	***17***			
Total Allocation	**100**	**100**			

	Policy	Proposed
Mean Variance Analysis		
Forecast 10 Year Return	***7.44***	***7.40***
Standard Deviation	11.9	11.8
Return/Std. Deviation	*0.6*	*0.6*
1st percentile ret. 1 year	*-16.8*	*-16.7*
Sharpe Ratio	0.39	0.39
% in Liquid Assets	61%	61%
% in Illiquid Assets	39%	39%

— Recommend increasing Cash target from 1% to 2%, and decreasing Liquid Real Return target from 2% to 1%

- 2% Cash target puts SCERS in-line with negative cash flow profile of plan
- Cash is currently yielding ~5%
- LRR has poor forecasted risk-adjusted returns

— Recommend terminating Brookfield Diversified Real Assets mandate ($108 million)

**Diversifying Absolute Return modeled with Asymmetric Hedge Funds; Liquid Real Return modeled with Commodities; Private Real Assets modeled with Infrastructure*

Brookfield - Diversified Real Assets

— SCERS hired Brookfield to diversify the Liquid Real Return (LRR) portfolio in 2019. LRR had a 2% target, with a split mandate

- 1% to SSGA (passive strategy) and 1% to Brookfield (active strategy)

— With reduced 1% LRR target, only need one mandate going forward – recommend terminating Brookfield Diversified Real Assets mandate

- Brookfield holds greater levels of equity and credit risk - performance during the recent spike in inflation was materially worse than SSGA
- Plan to retain the SSGA strategy, which has performed better as an inflation hedge and as a source of liquidity to rebalance the Real Return asset category; lower cost too.

— Brookfield remains a key partner across infrastructure, real estate, and private credit

	1-year	3-year	2022	2021	2020
SSgA Real Return (net)	-4.8%	+11.6%	-3.3%	+13.6%	+1.5%
Brookfield LRR (net)	-8.7%	+8.3%	-10.2%	+12.9%	+2.0%
Cash Account (net)	+3.1%	+1.9%	+2.0%	+1.0%	+2.0%

As of March 31, 2023

Next steps

— Authorize Staff to adopt the proposed asset allocation

— Authorize the termination of Brookfield Diversified Real Assets and selling of assets

— Proceeds from Brookfield will be held in SCERS' dedicated Cash allocation (SOFR)

— Adjust Master IPS to reflect revisions

— Unwind the interim increase in the Cash allocation related to a recent Absolute Return fund redemption

— Evaluate alternative Cash mandates to SOFR

Redlined Version

Master Investment Policy Statement Excerpt

See full Master Investment Policy Statement here.

7. Asset Allocation

A. Growth Asset Category

The Growth asset category includes assets that are exposed to equity and credit risk factors. They tend to perform best when economic growth is average or above and/or rising, and inflation is moderate and/or falling. Asset classes within the Growth asset category include:

- ◊ Global Equity
- ◊ Public Credit, i.e., high yield credit and bank loans
- ◊ Private Credit
- ◊ Private Equity

B. Diversifying Asset Category

The Diversifying asset category includes assets that are expected to help preserve capital in periods of market distress, particularly in periods of low and falling growth. In such periods, diversifying assets may experience negative returns but are expected to perform better than growth assets, and are expected to enhance diversification by exhibiting low or negative correlation with both equity and credit markets. Diversifying assets are expected to have a positive return profile over market cycles. Asset classes within the Diversifying asset category include:

- ◊ Fixed Income, including US Treasuries and Core and Core-Plus strategies
- ◊ Absolute Return, including absolute return strategies that have low to negative correlation and low beta to equity and credit markets
- ◊ Cash - the dedicated ~~1~~2% cash allocation is included in Diversifying asset category and serves as a liquidity tool. It is intended to close the gap between annual benefit payments and total contributions in an environment where investment earnings fall short of the targeted assumed rate of return, and is used as a source of liquidity prior to other Plan assets during a stressed liquidity environment.

C. Real Return Asset Category

The Real Return asset category includes assets that should perform well in periods of unexpectedly rising inflation while producing positive net real returns over complete market cycles. The category should also provide moderate levels of income and cash flow generation. Additionally, Real Return assets should enhance diversification by exhibiting low or negative correlation with both equities and nominal bonds. Asset classes within the Real Return asset category include:

◊ Real Estate, including both Core and Non-Core exposures

◊ Real Assets, including infrastructure, energy and power, and agriculture/timber

◊ Liquid Real Return

History

Amended June 21, 2023

Amended June 15, 2022

Amended March 17, 2021

Amended September 18, 2019

Amended on March 20, 2019

Restated on July 19, 2017 as "SCERS Master Investment Policy Statement"

Amended on February 18, 2010

Amended on December 18, 2008

Adopted on January 17, 2008 as "SCERS Investment Policy & Objectives"

Appendix I - SCERS' Asset Allocation Policy

Asset Category	Asset Class	Minimum Allocation	Target Allocation	Maximum Allocation	Policy Benchmark
Growth			**58%**		
	Global Equity	36%	40%	44%	MSCI ACWI IMI
	Private Equity	8%	11%	14%	Cambridge Associates PE/VC Index
	Public Credit	1%	2%	3%	50% BofA High Yield/50% CS Leveraged Loan
	Private Credit	3%	5%	7%	CS Leveraged Loan Index + 2%
Diversifying			**25~~4~~%**		
	Fixed Income	12%	16%	20%	75% Bloomberg Barclays Aggregate Index/25% Bloomberg US Treasury Index
	Absolute Return	5%	7%	9%	HFRI FoF Conservative Index
	Cash	0%	~~1~~2%	~~2~~3%	Overnight ~~LIBOR/~~SOFR
Real Return			**17~~8%~~**		
	Real Estate	7%	9%	11%	60% NFI-ODCE/40% NFI-ODCE + 1%
	Real Assets	5%	7%	9%	Real Assets Custom Blend*
	Liquid Real Return	0%	~~2~~1%	3%	SSGA Real Return Overlay Proxy**
			100.0%		

*Real Assets Custom Blend: 60% Cambridge Associates Private Infrastructure Index, 30% Cambridge Associates Private Energy Index, 10% NCREIF Farmland Index.

**SSGA Real Return Overlay Policy: 15% FTSE EPRA/NAREIT Developed Liquid Index, 25% S&P Global Infrastructure Index, 10% S&P Global Large Mid Cap Commodity and Resources Index, 10% Bloomberg Roll select Commodity Index, 30% Bloomberg Barclays 1-10 year US TIPS Index, and 10% Bloomberg Barclays US Dollar Floating Rate <5 Year Index.