



## ITEM 17

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**For Agenda of:**  
April 19, 2017

April 14, 2017

**TO:** President and Members  
Board of Retirement

**FROM:** Steve Davis  
Chief Investment Officer

**SUBJECT:** Presentation of the proposed structure of the revised Master Investment Policy Statement

### **INTRODUCTION / BACKGROUND:**

The SCERS Board approved a new asset allocation at the January 2017 Board meeting. With the introduction of the new asset allocation, a revision to SCERS' Master Investment Policy Statement ('IPS') is also required. SCERS' current IPS is outdated and is also broad, covering the entire investment program at the asset allocation and individual asset class level. The revised Master IPS is intended to be a governing document that is more principles-based, rather than rules-based, and establishes broad policies that will guide SCERS' investment program at a high level, not at the asset class level.

Over the past several years, SCERS has developed individual asset class IPSs for each of SCERS' primary asset classes. Each individual asset class has a separate IPS that represents the objectives, investment guidelines, ranges, permissible investments, benchmarks, monitoring and implementation protocol for that asset class. The individual asset class IPSs are intended to be more detailed and rules-based compared to the Master IPS.

The Master IPS is meant to be a long-standing document with few forward revisions (revisions can occur at the asset class IPS level more frequently). Its primary purpose is to articulate the SCERS Board's view on investment philosophy, objectives and strategy, and set procedures for policy governance and implementation.

Staff and Verus have worked to outline the structure for the Master IPS. The purpose of this presentation is to review the proposed structure with the Board, and describe the additional content that will be incorporated into the Master IPS. During the April Board meeting, Staff and Verus will walk through the proposed structure of the Master IPS, outlined as follows:

1. Description of SCERS/Authority
  - a. Description of how and when SCERS was established, and the primary responsibilities of SCERS.
  - b. Description of the SCERS Board and its responsibilities in governing SCERS.
  - c. The applicable laws that SCERS' investment program is managed in accordance to.
2. Master IPS Purpose
  - a. To establish the policies that will guide the investment program.
3. Governance
  - a. Roles and responsibilities of the Board, Staff, Consultants, Investment Managers and Custodian Bank.
  - b. Implementation Protocols for vendor procurement (investment manager hires and terminations) and rebalancing.
4. Investment philosophy
  - a. The foundational principles on which the investment program is based, and which drive investment decisions.
5. Investment objectives
  - a. Board/plan goals and objectives.
  - b. Performance objectives.
6. Investment strategy
  - a. Rationale for investment strategy.
  - b. Asset allocation framework.
  - c. Description and objectives of asset categories (Growth; Diversifying; Real Return).
    - i. Asset classes will be covered in detail within individual asset class IPSs.
7. Risk management
  - a. Identification of investment portfolio risks.
  - b. High level philosophy on managing risk.
8. Portfolio monitoring
  - a. Structure for ongoing reporting of performance, and monitoring of investment managers and strategic partners.

A detailed outline has been provided with substantive content within each section of the Master IPS. The actual Master IPS document will follow this format and will incorporate much of the content that is provided within the outline. The content in the outline will be expanded upon, or perhaps revised as the actual document is written. However, the attached outline should provide a fairly accurate roadmap of what the actual Master IPS will look like.

A key objective of the April Board meeting is to receive feedback from the SCERS Board related to the general structure and proposed content of the Master IPS. Staff and Verus will then take Board feedback and begin writing the Master IPS document. Once the Master IPS document is completed, it will be presented as a recommended document for the SCERS Board at an upcoming Board meeting.

We would be happy to address any questions.

Respectfully submitted,

Concur:

Steve Davis  
Chief Investment Officer

Richard Stensrud  
Chief Executive Officer

Attachment



**PERSPECTIVES  
THAT DRIVE  
ENTERPRISE  
SUCCESS**

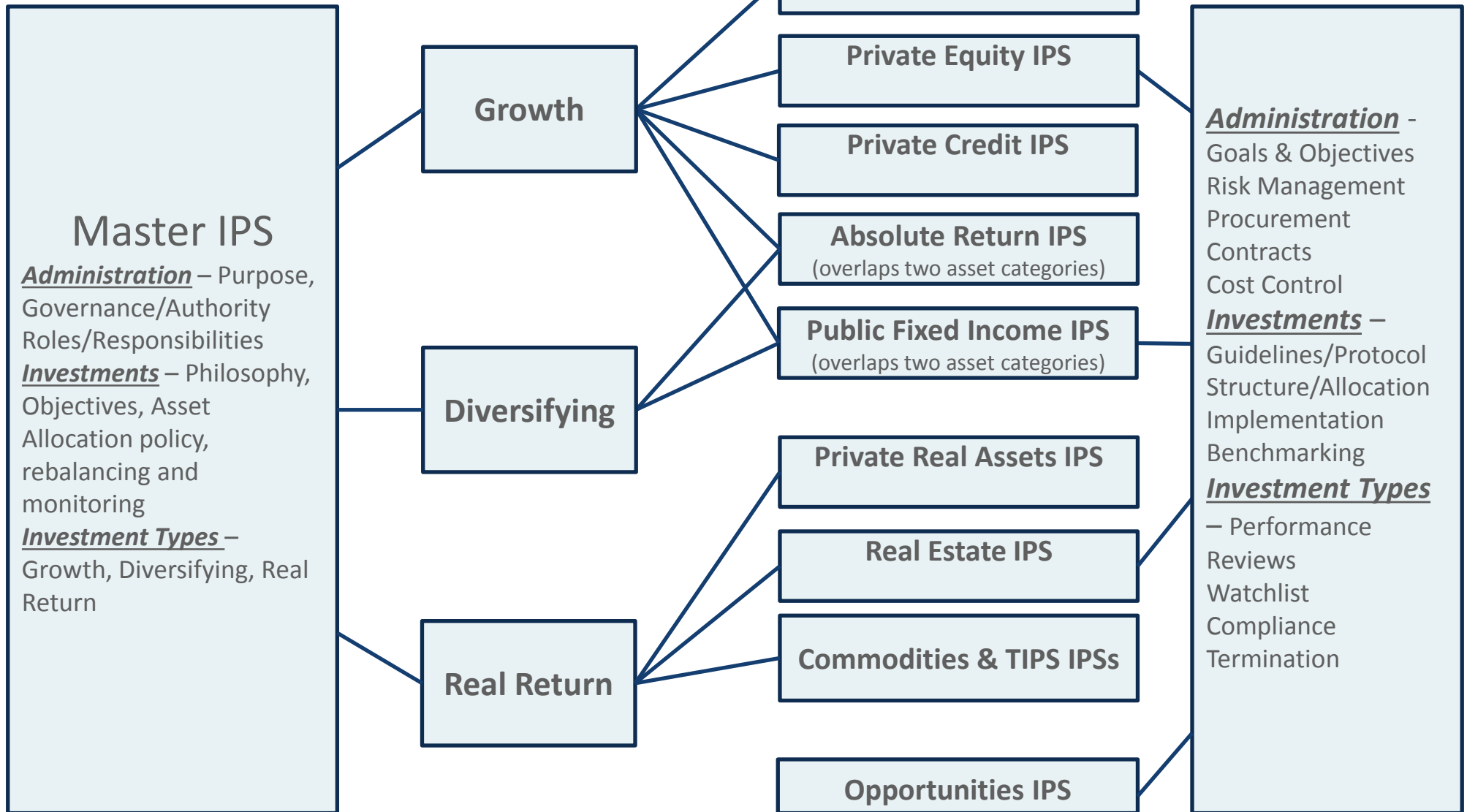


APRIL 2017

SCERS Master Investment Policy Statement ('IPS') Outline

**Sacramento County Employees' Retirement System**

# SCERS MASTER IPS



# Master IPS Purpose

- Formal documentation of the Board's views on key investment policies and procedures.
- Statement of philosophy regarding asset allocation, diversification, risk, performance goals and objectives, administration and compliance.
- Expressions of values, beliefs and operating principles.
- The Main IPS is intended to be more "principles based" while the Asset Class IPSs are more "rules based".
- Discussion of the "why and how" behind the policies.
- Focus on the principles at the core of how we do and do not invest.

# Authority

- Statement of SCERS' established authority
  - Sacramento County Ordinance #283
  - County Employees' Retirement Law of 1937
  - California Constitution Article XVI section 17
  - Fiduciary Duties
    - Duty of Loyalty
    - Duty of Care

# Governance

## — Roles and Responsibilities

- Board
- Staff
- General Consultant
- Alternatives Consultants
- Investment Managers
- Custodian

## — Implementation Protocols

- Vendor procurement
  - Manager/consultant hires and terminations
  - Specifics within asset class IPSs
- Rebalancing /Trading/ Overlay



# Investment Philosophy (examples)

- Diversify assets in ways that minimize the risk required to achieve objectives and provide protection in times of poor economic/market periods
- Long-term viewpoint; do not overreact to short-term market events
  - Preserve flexibility to allow for interim adjustments to strategic allocation
- Assume sufficient risk to reasonably achieve long term objectives
- Capture illiquidity premiums in a manner that does not obstruct ability to meet current liabilities
- Employ low cost alternatives in most efficient asset classes
- Seek excess return in less efficient asset classes

# Investment Objectives

## — Enterprise Risk Tolerance – Board Goals

- Sustainability of the Plan
- Avoidance of large drawdowns
- Diversification of assets
- Manage liquidity
- Risk and cost control
- Achieve funding goals

## — Performance Objectives

- Returns at or in excess of actuarial rate of return
- Returns in excess of passively managed policy weights
- Returns in excess of asset class and individual manager benchmarks
- Peer group evaluation; especially for asset classes and managers
- Returns in excess of inflation

# Investment Strategy

- Rationale for the Investment Strategy
  - Align investment program with SCERS' investment objectives and philosophy
  - Strategic asset allocation based on risk/ return expectations, projected actuarial liabilities, liquidity needs and risk tolerances
- Functional Portfolio – links asset classes exposed to similar economic environments and risk factors
  - Growth
    - Includes asset classes that are primarily exposed to the equity and credit risk factors, and that tend to perform best in a rising growth and low/moderate inflationary environment
  - Diversifying
    - Includes asset classes that are expected to protect capital and generally perform better than 'Growth' assets when broad financial markets experience distress
  - Real Return
    - Includes asset classes that hedge against inflation, provide moderate levels of cash flow generation, and additional diversification from growth assets
- Opportunities (tactical)
  - When and why appropriate

# Risk Management

- Measure and manage risk to appropriate levels while focusing on long term value
- Understand exposures to common risk factors, peers, investment categories and asset classes
- Enforce diversification and rebalancing as primary risk management tools throughout market cycles.
- Explore opportunities to lower the expected variability of returns in periods of market stress

# Portfolio Monitoring

- Performance Reporting
- Watch List
- Compliance
- Manager Due Diligence
- Fee Renegotiations

# Next Steps

- Return with recommended Master IPS at future Board meeting

## SCERS MASTER INVESTMENT POLICY STATEMENT ('IPS') OUTLINE

### **1. Description of SCERS/Authority:**

- a. The Sacramento County Employees' Retirement System ('SCERS') is a public employee retirement system that was created on July 1, 1941, by Sacramento County Ordinance #283 as adopted by the Board of Supervisors on April 30, 1941, pursuant to the County Employees' Retirement Law of 1937.
- b. SCERS provides retirement, disability, and death benefits for qualified employees of Sacramento County and eleven participating special districts.
- c. A nine member Board of Retirement (Board) governs SCERS. The Board has sole and exclusive fiduciary responsibility over the assets of the retirement system. The Board has the sole and exclusive responsibility to administer SCERS in a manner that will assure prompt delivery of benefits and related services to the participants and their beneficiaries. The authority of the Board in the above matters is plenary. See California Constitution at Article XVI Section 17.
- d. The Board and its officers shall discharge their duties with respect to the system:
  - i. Solely in the interest of, and for the exclusive purposes of providing benefits to participants and their beneficiaries, minimizing employer contributions thereto, and defraying reasonable expenses of administering the system.
  - ii. With care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of a like character and with like aims.
  - iii. Shall diversify the investments of the system so as to minimize the risk of loss and to maximize the rate of return, unless under the circumstances it is clearly prudent not to do so.

(Cal. Const. Art. XVI Sec. 17(b), (c) and (d); Cal. Gov. Code Sec. 31595 (a), (b) and (c)).
- e. Annual actuarial valuation is used to determine contributions.
  - i. Actuary's role in SCERS' investment program.

### **2. Master IPS Purpose:**

- a. Purpose of Master IPS is to establish broad policies that will guide SCERS' investment program.
- b. Formal documentation that articulates the Board's views on SCERS' investment objectives and risk tolerances for the investment program.
- c. Statement on investment structure, including asset categories and asset classes.
- d. Master IPS is intended to be more 'principles based', while asset class IPSs are more 'rules based'.
  - i. Individual asset classes will have their own dedicated investment policy statements.

- e. Setting procedures for policy governance and implementation.
- f. Establish criteria to monitor and evaluate the performance of the investment program.
- g. Focus on the 'why and how' behind the policies.

### **3. Governance:**

- a. Roles and Responsibilities.
  - i. Board.
    - 1. The Board has the authority noted above.
    - 2. The organizational structure of SCERS focuses the attention of the Board on governance and policy and not on the management of the system.
    - 3. The primary responsibility of the Board is strategic in setting the direction of SCERS. This includes declaration of the mission and setting of goals and objectives.
  - ii. Staff.
    - 1. SCERS' Chief Executive Officer (CEO) has the responsibility for the overall management and administration of the system in accordance with the direction, policy and goals set by the Board.
    - 2. Reporting to the CEO as part of the executive staff is the Chief Investment Officer (CIO).
      - a. The CIO has primary responsibility in cooperation with the CEO for SCERS' investment program.
  - iii. General Investment Consultant.
    - 1. Scope of service:
      - a. Asset liability analysis; capital market projections; asset allocation; investment guidelines and policies; market analysis; strategic and tactical investment ideas; investment manager searches; investment manager monitoring and due diligence; performance results and measurement; collaboration with alternative assets and real estate consultants; Board education.
  - iv. Alternative Assets Consultant.
    - 1. Scope of service:
      - a. Construction and development of SCERS' alternative assets portfolio (Private Equity; Private Credit; Absolute Return; Private Real Assets), and long-term strategic plan; conduct initial and ongoing due diligence of alternative asset managers and fund of funds; risk monitoring and management of SCERS' alternative assets; track and project liquidity of SCERS' alternative assets portfolio; performance results and measurement; collaboration with SCERS' Staff, SCERS' Board, and SCERS' other consultants and advisors; review investment contracts, and assist in interpreting and negotiating key terms in contracts and manager fees; Board education.



- v. Real Estate Consultant.
    - 1. Scope of service:
      - a. Develop long-term real estate strategic plan, objectives and guidelines; provide analysis on advisor/manager searches, terminations and replacements and property acquisitions; collaboration with SCERS' Staff, SCERS' Board, and SCERS' other consultants and advisors; performance results and measurement; Board education.
  - vi. Investment Managers.
    - 1. 100% external investment managers.
      - a. In cases where internal management is warranted, Staff and Consultants will advise the Board.
      - b. Combination of active and passive mandates.
    - 2. Responsible for making investment decisions on a discretionary basis (unless stated otherwise in investment contract) regarding assets placed under their jurisdiction and will be accountable for achieving their investment objectives.
    - 3. Investment managers will be Registered Investment Advisors under the 1940 Investment act, unless exempt from registrations (i.e., VC).
      - a. Fiduciary under California law.
  - vii. Custodian Bank.
    - 1. Scope of service:
      - a. Holding assets; reconciliation and settlement; income collection; short-term investments; performance measurement; securities lending; commission recapture; compliance monitoring.
- b. Implementation Protocols.
- i. Vendor procurement - hiring and terminating investment managers.
    - 1. Specifics are identified within individual asset class IPSs.
    - 2. General description within Master IPS:
      - a. Alternative assets (Absolute Return; Private Equity; Private Credit; Private Real Assets; Private Real Estate).
        - i. SCERS' Board approves the long-term asset allocation structure and twelve-month investment plan.
        - ii. Implementation of the long-term asset allocation structure and twelve-month investment plan, including the selection of investment managers, and in some situations the adjustment or termination of investment mandates, is delegated to Staff and Consultant.
        - iii. Staff and Consultant complete due diligence, negotiate deal terms, provide separate due diligence reports to

- SCERS' Board, and determine whether an investment should be made.
    - iv. Delegation is subject to the Board's ability to review, discuss and object to Staff/Consultant recommendations, through communication to SCERS' CEO.
  - b. Traditional/liquid assets (Public Equities; Public Fixed Income; Commodities; TIPS).
    - i. SCERS' Board approves the long-term asset allocation structure and twelve-month investment plan.
    - ii. Implementation of the long-term asset allocation structure and twelve-month investment plan, including the screening, due diligence and evaluation leading to the recommendation to engage or terminate a particular investment manager is delegated to Staff and Consultant.
    - iii. Staff and Consultant complete due diligence, negotiate deal terms, provide separate due diligence reports to SCERS' Board, and determine which investment manager to recommend to SCERS' Board for consideration.
    - iv. Questions or concerns by a Board member regarding a proposed manager are to be communicated to SCERS' CEO.
- 3. Investment manager contracts.
  - a. Standard investment management agreements ('IMAs').
  - b. Limited partnership agreements with corresponding SCERS side letter.
  - c. Specialized contractual agreements for strategic partnership relationships (i.e., LLC).
- ii. Rebalancing.
  - 1. Overlay:
    - a. Strategic Overlay Manager, under supervision from CIO.
    - b. Monitors and rebalances the asset allocation to policy targets.
    - c. Overlay investment objectives.
    - d. Overlay rebalancing methodology.
      - i. Quarterly rebalance with defined bands.
        - 1. Bands defined in Investment Management Agreement for the Overlay Program.
      - ii. Overlay proxies are defined in Investment Management Agreement for the Overlay Program.
  - 2. Physical Rebalancing:

- a. CIO will review SCERS' actual allocations relative to the target asset allocation.
- b. If there are deviations between actual weights and target allocations, CIO will determine if physical rebalancing of any plan assets is warranted over Overlay rebalancing.
  - i. The CIO is delegated authority to conduct portfolio rebalancing in order to maintain allocations within target ranges, and to determine the most effective method for rebalancing assets to execute on such method.
  - ii. Any physical rebalancing of assets to be reported to the Board at the next Board meeting.
- c. On a quarterly basis, the Board will be provided a rebalancing report with any physical rebalancing activity or any recommended physical rebalancing of SCERS' assets.

#### **4. Investment Philosophy:**

- a. Asset allocation has the greatest impact on investment returns and risk.
  - i. Difficult to time market cycles, so diversification is key to meeting plan objectives and to minimize the range of outcomes.
- b. Strategic asset allocation developed with a long-term perspective.
  - i. Don't overact to market corrections and volatility within a market cycle.
  - ii. Preserve flexibility to allow for interim adjustments to strategy allocation.
- c. Assume sufficient risk to reasonably achieve long-term objectives.
- d. Maintain sufficient levels of liquidity while capturing illiquidity premiums within less liquid asset classes.
  - i. Sufficient cash flow generation to meet benefit payment obligations.
- e. Employ low cost alternatives in most efficient asset classes, while seeking excess returns in less efficient asset classes.
  - i. Measure level of fees paid against value the investment plan expects to earn from a given investment, and ensure proper alignment of interest between SCERS and a given investment manager.

#### **5. Investment Objectives:**

- a. Board/Plan goals and objectives:
  - i. Provide for present and future benefit payments.
  - ii. Sustainability of SCERS' plan.
  - iii. Avoidance of large drawdowns.
  - iv. Diversification of plan assets.
  - v. Manage liquidity.
  - vi. Risk and cost control.
  - vii. Achieve funding goals.

- b. Performance objectives:
  - i. Returns at or in excess of actuarial rate of return.
  - ii. Returns in excess of passively managed policy benchmarks.
    - 1. Policy benchmark is a weighted average of benchmarks that make up the underlying asset classes.
    - 2. Asset class benchmarks defined in individual asset class IPSs.
  - iii. Returns in excess of asset class and individual manager benchmarks.
  - iv. Peer group evaluation; especially for asset classes and managers.
  - v. Returns in excess of inflation.

## **6. Investment Strategy:**

- a. Rationale for investment strategy.
  - i. Align investment program with SCERS' investment objectives and philosophy.
- b. Asset Allocation.
  - i. SCERS' Board has adopted a strategic asset allocation based on the plan's projected actuarial liabilities, liquidity needs, risk tolerances and risk/return expectations for various asset classes.
  - ii. Seeks to optimize long-term returns for a given level of risk.
  - iii. Current asset allocation can be found in Appendix .....
  - iv. Since projected liability and risk/return expectations will change over time, SCERS' Board will conduct a periodic review of the strategic asset allocation against plan liabilities to maintain an expected optimal allocation.
  - v. SCERS' asset allocation and portfolio is viewed through a functional and outcome based framework.
  - vi. Links asset classes that are exposed to similar economic environments and risk factors, and which would be expected to have similar roles and outcomes in a portfolio.
    - 1. Risk factors (equity; credit; inflation; rates; currency; hedge fund/alternatives).
    - 2. Economic regimes/environments – growth (rising/falling) and inflation (rising/falling).
- c. Asset Categories
  - i. Growth.
    - 1. Includes asset class segments that are primarily exposed to the equity and credit risk factors, and that tend to perform best in a high growth and low/moderate inflationary environment.
    - 2. Includes the following asset class segments.
      - a. Domestic Equities.
      - b. International Equities.
      - c. Public Credit.
        - i. High yield/bank loans.
      - d. Private Credit.

- e. Growth Absolute Return.
    - ii. Diversifying.
      - 1. Includes asset classes that are expected to protect capital during dislocated market environments.
      - 2. Expected to generally perform better than the growth asset classes of SCERS' portfolio when broad financial markets experience distress.
      - 3. Diversifying assets can still experience periods of negative returns; however, they are expected to have a positive return profile over longer periods of time.
      - 4. Includes the following asset class segments.
        - a. Public Fixed Income.
          - i. Core/core plus bonds.
          - ii. U.S. Treasuries.
          - iii. Global bonds.
        - b. Diversifying Absolute Return.
  - iii. Real Return.
    - 1. Includes a wide range of asset class segments that fulfill several common roles and objectives.
      - a. Hedge against inflation by investing in assets that respond positively to unanticipated inflation.
      - b. Provide attractive return on a real (net of inflation) basis.
      - c. Provide moderate levels of income and cash flow generation.
      - d. Provide greater consistency in the return distribution and muted downside risk.
      - e. Provide additional layer of portfolio diversification, including low or negative correlation to equities.
    - 2. Includes the following asset class segments.
      - a. Private Real Estate.
      - b. Private Real Assets.
      - c. Commodities.
      - d. TIPS.
- d. Opportunities.
  - i. Includes a wide range of shorter duration investments that serve the role of enhancing risk adjusted returns by investing in tactical opportunities across asset classes.
  - ii. Target allocation is 0%, but ranges between 0% and 5% based on attractiveness of opportunities in the market.
  - iii. Draws capital from the underlying asset class segment which the opportunity most closely resembles.

## **7. Risk Management:**

- a. Types of risk.
  - i. Risk factors (equity; credit; inflation; rates; currency; hedge fund/alternatives).
  - ii. Volatility/Standard Deviation.
  - iii. Capital at loss/drawdown risk.
  - iv. Falling short of investment return assumption.
  - v. Liquidity (inability to meet benefit obligations).
  - vi. Regulatory.
  - vii. Counterparty.
  - viii. Environmental.
  - ix. Currency.
- b. Risks are inherent in an institutional investment portfolio.
- c. Different asset categories will have varying levels of risk and return expectations.
- d. Risk management objective is to maintain a well-diversified portfolio across asset categories, asset classes, sectors, geographies and investment managers to ensure an acceptable level of risk for a given level of return, while focusing on long-term value.
- e. Portfolio rebalancing is used as a risk management tool.
- f. Explore investment opportunities to lower the expected variability of returns in periods of market stress.

## **8. Portfolio Monitoring:**

- a. Quarterly Reporting.
  - i. Consultants' quarterly reports.
- b. Compliance monitoring.
  - i. Consultants.
  - ii. SCERS.
    - 1. Compliance monitoring system for equity and fixed income investments.
  - iii. Watch List.
    - 1. For investment managers experiencing poor performance and/or organizational changes.
- c. Manager due diligence.
  - i. On-site manager visits.