Board of Retirement Regular Meeting

Sacramento County Employees' Retirement System

Agenda Item 18

MEETING DATE: May 21, 2025

SUBJECT: Asset Class Restructuring and Implementation: Credit

SUBMITTED FOR: _X_ Action ___ Information

RECOMMENDATION

Approve revised structure and implementation plan for the Credit asset class, as recommended by Staff, and Verus and Cliffwater. The specific recommendations include:

- Approve a range of +/- 3% around the new Credit target allocation of 9% (6% - 12%)
- Adopt the following Credit sub-strategies and respective ranges for each
  - Illiquid Credit sub-strategy: 60% to 100%
    - Illiquid segments to include:
      - Direct Lending
      - Opportunistic Lending
      - Special Situations
    - Target 10-15 ongoing investment manager relationships
  - Liquid Credit sub-strategy: 0% to 40%
    - Primarily invest in publicly traded credit though flexible mandates that can touch multiple points within the liquid credit universe
    - Target 0-5 ongoing investment manager relationships
  - A range of 75% to 100% for U.S. Credit and a range of 0% to 25% for Non-U.S. Credit.
- Revise and adopt Credit benchmarks as follows:
  - Policy Index Benchmark: Cambridge Associates Private Credit Index
  - Long-Term Objective: Credit Suisse Leveraged Loan Index + 2%
- Adopt the Alternative Assets/Private Markets Implementation Protocol for implementation of the Credit asset class
- Adopt the following implementation measures for the Credit asset class
  - Move the following exposures from SCERS' current Private Equity asset class to the Illiquid Credit sub-strategy
    - Opportunistic Lending
      - Shamrock Capital Content Fund II, L.P. and Shamrock Capital Content Fund III, L.P. - $22 million total of NAV

        - Special Situations
            - Sixth Street Opportunities Partners IV, L.P. and Sixth Street Opportunities Partners V, L.P. - $50 million of total NAV
    - Maintain the 2025 Private Credit budget for the Illiquid Credit sub-strategy, and re-evaluate the budget for 2026
    - Evaluate SCERS' current Public Credit exposure/mandate (Brigade) within the context of the revised Credit structure and universe of Liquid Credit strategies to determine the fit within the Credit portfolio going forward
    - Evaluate investment opportunities for the Liquid Credit sub-strategy based on guidance and recommendations from Verus and Cliffwater
- 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 (Verus and Cliffwater) to identify structuring considerations and implementation plans for each major asset class. This item details the structuring considerations and an implementation plan for the newly created Credit asset class, which aggregates exposures within the Private Credit and Public Credit asset classes.

CREDIT STRATEGIC CHANGES

SCERS' Board approved a revised strategic asset allocation in March of 2025, which resulted in a 1 percentage point reduction of the Global Equity asset class, a consolidation of the Private Credit and Public Credit asset classes into a single Credit asset class with a target allocation of 9%, an increase of 2 percentage points from SCERS' prior aggregated credit target of 7%, and a 1 percentage point decrease in the Real Estate asset class within the Real Return asset category.

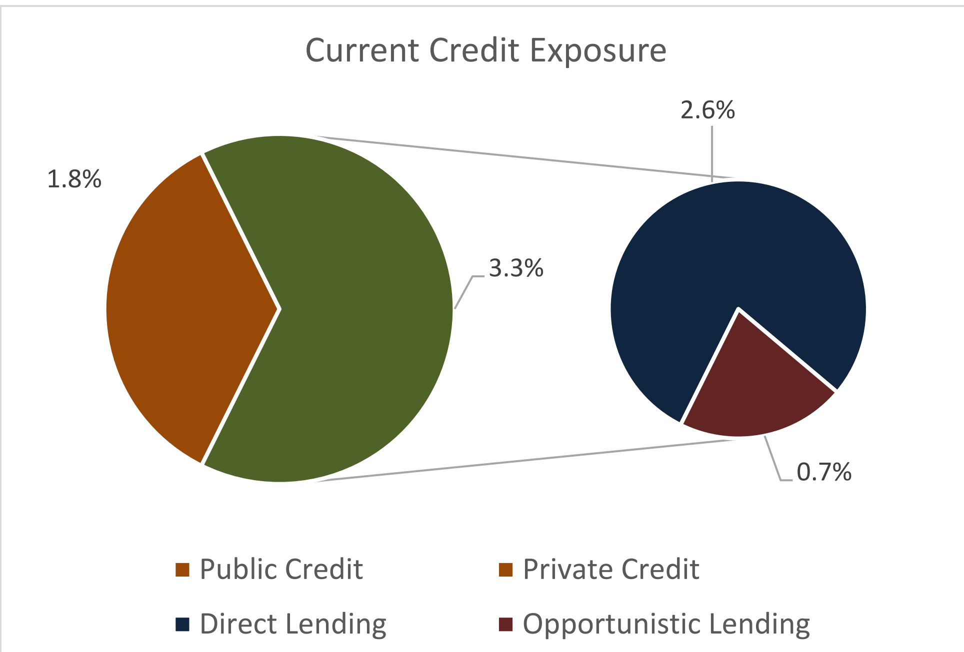
Below are the overall changes that occurred in the Growth asset category, which Credit (and Global Equity) resides within.

Asset Class	Prior Target Allocation	Revised Target Allocation	Change
Global Equity	40%	39%	-1%
Private Equity	11%	11%	0%
Public Credit	2%	-	
Private Credit	5%	-	
Credit	-	9%	2%
Growth Asset Category	**58%**	**59%**	**1%**

The new Credit asset class takes a holistic view of credit across SCERS' portfolio and provides greater flexibility in implementation. While traditional loan origination private credit strategies will make up the bulk of the asset class, as described below, the Credit structure will also have the ability to incorporate liquid credit strategies that invest in publicly traded credit securities. The overall objective of the Credit asset class is to produce enhanced risk adjusted returns and generate income and cash flow.

SCERS' CREDIT PORTFOLIO EXPOSURE

As of May 2, 2025, the allocation to Private Credit was 3.3% and the allocation to Public Credit was 1.8%, for total Credit exposure of 5.1%. The underweight to Private Credit is because SCERS is still building out this allocation. The investment pace will be adjusted to account for the larger allocation to Credit and the proposed Credit structure. The chart below shows the breakout of SCERS' current Credit exposure.



RECOMMENDED CREDIT STRUCTURE

The recently approved Credit asset class has a target allocation of 9%. Staff and Consultants recommend the Credit asset class structure below.

SCERS Credit Portfolio Structure				
	Minimum	Target	Maximum	# Manger Relationships
Total Credit Portfolio	**6%**	**9%**	**12%**	
Illiquid Credit	60%	-	100%	10-15
Direct Lending				
Opportunistic Lending				
Stressed/Special Situations				
Liquid Credit	0%	-	40%	0-5
U.S. Credit	75%	-	100%	
Non-U.S. Credit	0%	-	25%	

Staff and Consultants recommend a range for the Credit asset class of 6% to 12% around the 9% target allocation. The +/- 3% range around the target is similar to that of the similarly sized Private Equity allocation. For comparative purposes, the former Private Credit asset class had a range of 3% to 7% around the 5% target allocation, and the former Public Credit asset class had a range of 1% to 3% around the 2% 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 other asset classes.

Investments in Credit will primarily be made in U.S. domiciled companies; however, non-U.S. domiciled companies can also be included. Staff and Consultants recommend a range of 75% to 100% for U.S. Credit and a range of 0% to 25% for Non-U.S. Credit.

SUB-STRATEGY ALLOCATIONS AND DESCRIPTIONS

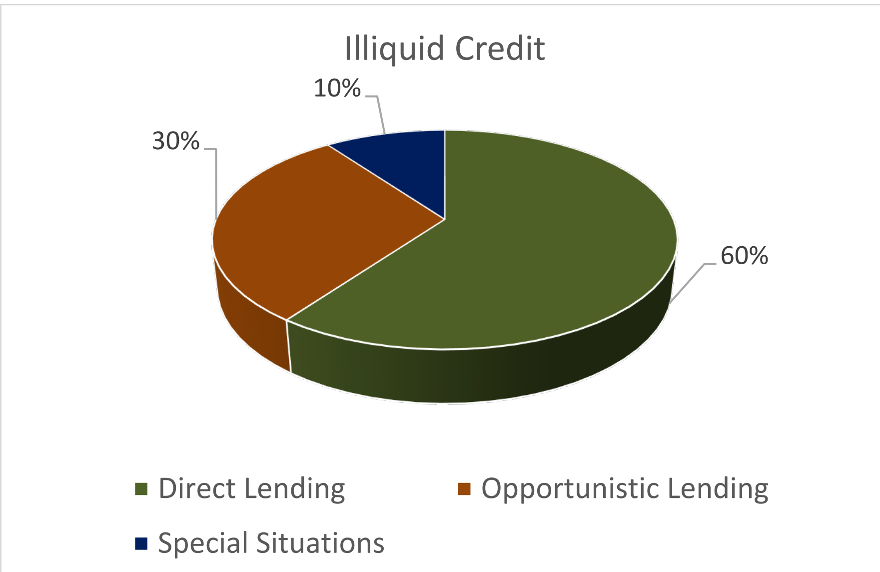
The recommended Credit sub-strategies include Illiquid Credit (formerly called Private Credit) and Liquid Credit (formerly called Public Credit). Staff and Consultants do not believe that there should be specific targets to the sub-strategies, but rather ranges, to allow for greater flexibility in implementation. However, Illiquid Credit will make up the bulk of the Credit asset class, with a range of **60% to 100%**, meaning that SCERS' allocation to Illiquid Credit strategies will be at least 60% of the overall Credit portfolio.

Liquid Credit strategies will be allocated on a more opportunistic basis toward strategies that are capable of generating returns in line with those of Illiquid Credit strategies. The range for Liquid Credit strategies will be **0% to 40%**, meaning that there can be no allocations to Liquid Credit strategies, and in turn a 100% allocation to Illiquid strategies, if the opportunity set is not there. The maximum allocation to Liquid strategies is 40%.

ILLIQUID CREDIT

Staff and Consultants recommend three segments of Illiquid Credit, which include Direct Lending, Opportunistic Lending, and Special Situations. Direct Lending and Opportunistic Lending are carry overs from the current Private Credit asset class, while Special Situations is a new segment that includes allocations to a broad category of assets, typically related to corporate or market dislocations.

The expected weights to each Illiquid Credit segment are shown in the graph below. Direct Lending is expected to make up the bulk of the Illiquid Credit allocation at ~60%, followed by Opportunistic Credit at ~30%, followed by Special Situations Credit at ~10%. However, Staff and Consultants recommend that the expected weights to the Illiquid Credit segments serve as implementation guides, but not actual targets within the Growth asset category IPS, to allow for greater implementation flexibility.



The bulk of Illiquid Credit will be comprised of private lending-oriented strategies (Direct Lending and Opportunistic Lending), similar to what SCERS has been investing in within the legacy Private Credit asset class, and which are illiquid strategies focused on private loans to performing companies. Private lending strategies include primarily debt investments, where an investor expects to receive principal and interest, with the majority of returns being generated from cash flow yield. Private lending strategies are typically structured with floating rate loans, with a spread over a benchmark rate like SOFR, so cash flow income increases as interest rates increase, but can also include fixed rate loans. The Illiquid Credit sub-strategy will also include a small allocation to Special Situations. A description of each Illiquid sub-strategy is below.

Direct Lending

Direct lending investments are directly originated, nontraded, performing loans made to primarily middle market companies. Direct lending investments primarily are comprised of senior secured debt, which can be secured by general corporate collateral or by a company's specific collateral. Equity participation can be structured into the loan, typically through warrants, but this is generally a small component of the strategy. Direct lending investments often utilize leverage (typically in the range of 0.5 to 2.5 times) at the fund level, to enhance returns. Direct lending investments also have broadly diversified sector exposure and include a combination of sponsored (private equity backed companies) and non-sponsored borrowers, as well as purchases of loans in the secondary market. Non-sponsored loans will typically have higher yields and stronger covenants than sponsored loans.

Opportunistic Lending

Opportunistic lending investments are also performing loans like direct lending (not distressed) but represent a broader range of investment types. Opportunistic lending includes mostly senior secured structures, but investments can also include subordinated debt structures, convertible debt, and structured equity. Opportunistic lending is often designated as an asset-backed lending strategy, where eligible collateral comes in the form of specific assets such as receivables, inventory, or royalty streams. Opportunistic lending investments can have meaningful equity participation, depending on the structure. This is often in the form of warrants and convertible bonds but can also include direct equity participation. Opportunistic lending investments typically utilize little to no leverage. Opportunistic lending funds can have a targeted sector focus, which can often include only one sector, and generally are targeted toward non-sponsor borrowers. Opportunistic lending investments can also include acquisition and leasing strategies that produce income and cash flows, such as aircraft leasing and entertainment royalties.

Special Situations

Special Situations are opportunistic investments in a broad category of assets, typically related to corporate or market dislocations. Specific examples of Special Situations investments include sub- and non-performing loans, secondary debt purchases, new originations of debt instruments including rescue financings, and structured credit. Special Situations primarily includes debt investments, although it can include investments with equity participation. Special Situation investments can include investments in companies that are facing financial or operational stress. Special situations is expected to make up a small portion of the Illiquid Credit sub-strategy (around 10%).

LIQUID CREDIT

Liquid Credit strategies primarily invest in liquid/publicly traded credit though flexible mandates that can touch multiple points within the liquid credit universe. Liquid Credit investments typically generate moderate income and also serve as a source of return enhancement. Eligible investments for Liquid Credit are broad and include but are not limited to below investment grade high yield corporate bonds and bank loans, investment grade corporate bonds, derivatives, structured credit, agency and non-agency backed mortgage-backed securities, commercial mortgage backed securities (CMBS), collateralized loan obligations (CLOs) and collateralized debt obligations (CDOs), asset-backed securities, stressed/distressed corporate credit, government bonds, agencies, agency and non-agency mortgage-backed securities, international non-dollar fixed income securities, emerging markets debt, equity securities, and cash. Some strategies could potentially own equity-like securities. While Liquid Credit strategies will mostly invest in liquid/publicly traded markets, there are a growing number of hybrid credit strategies that invest opportunistically across both public and private markets. Any “hybrid” strategies would be placed in the Liquid Credit sub-strategy.

Given that there is not a target allocation to Liquid Credit, and the range of investments can range between 0% up to 40% max, investments will be made within an opportunistic framework, where potential investments will be expected to earn a return in line or greater than Illiquid Credit strategies to be considered for investment.

Liquid Credit will comprise a variety of fund structures. Staff and Consultants expect that most opportunities will be in the form of an open-end fund, but they could also include closed-end drawdown funds. Eligible structure can also include hedge fund structures that implement long/short credit strategies.

RECOMMENDED CREDIT BENCHMARKS

The legacy policy index benchmark for Private Credit is the Credit Suisse Leveraged Loan Index + 2%. When Private Credit was created as an asset class in 2017, there wasn’t a viable peer universe index, like SCERS uses for other private market asset classes. Given the growth in private credit over the past decade, peer universe benchmarks have evolved to the point where Cliffwater, Verus, and Staff recommend revising the benchmark for the Credit asset class.

Similar to the other private market asset classes, Staff, Cliffwater, and Verus recommend using two benchmarks for the Credit asset class, as follows:

Credit Asset Class	Benchmark
Policy Index Benchmark	Cambridge Associates Private Credit Index
Long-Term Objective	Credit Suisse Leveraged Loan Index + 2%

Staff and Consultants recommend adopting the Cambridge Associates Private Credit Index as the policy index benchmark. The Cambridge Associates Private Credit Index contains approximately 150 funds that provide senior secured loans to companies and are structured with floating rate loans above a base rate (i.e., SOFR). With this benchmark, the performance of the SCERS Credit portfolio would be expected to exceed the return of this index for the respective vintage years.

Staff and Consultants recommend converting the current Private Credit benchmark, the Credit Suisse Leveraged Loan Index + 2%, to the long-term objective benchmark. Over the long-term (5-10 years), the objective of the Credit asset class would be to exceed the Credit Suisse Leveraged Loan Index + 2%, net of fees and expenses. In other words, the Credit asset class is expected to earn a premium to a comparable publicly trades index, to compensate for the illiquidity of the asset class.

RECOMMENDED IMPLEMENTATION PROTOCOL

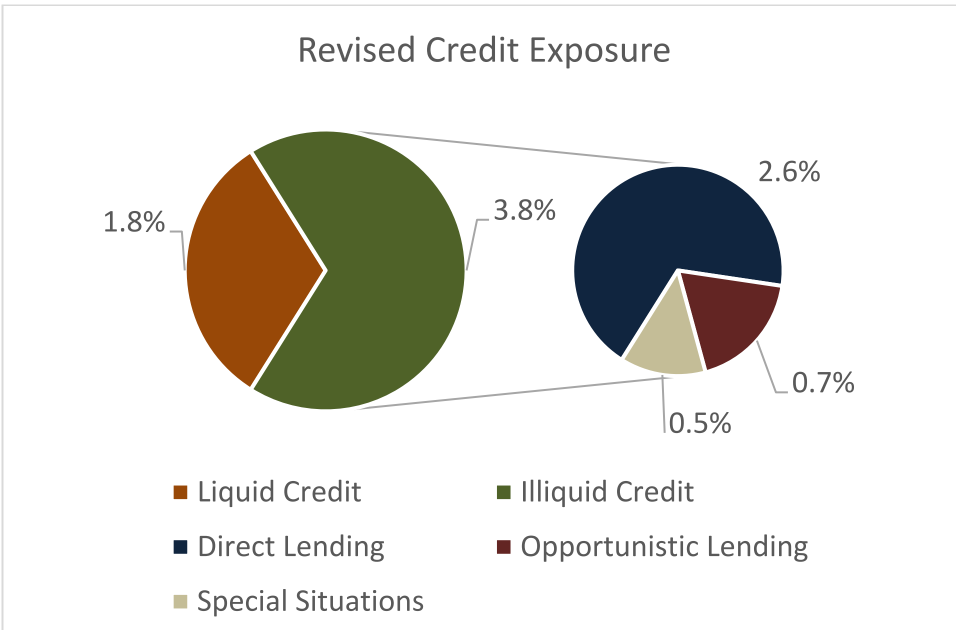
Staff and Consultants recommend adopting SCERS' Alternative Assets/Private Markets Implementation Protocol for the Credit asset class. The bulk of the Credit asset class will be comprised of Illiquid Credit strategies that already fall under this protocol. The Liquid Credit sub-strategy will touch multiple parts of the credit universe with a range of complexity, and through a variety of potential fund structures and liquidity characteristics. Some Liquid Credit strategies could be more characteristic of a traditional/public market investment, while some could look more like an alternative/private market investment, including drawdown vehicles. To maintain an efficient implementation process, Staff and Consultants recommend that the Board adopt one implementation protocol to be used across the Credit asset class. For larger mandates and/or unique fund structures (i.e., fund of one) Staff will inquire with the Board if it prefers to utilize the Traditional Assets/Public Markets implementation protocol.

Related to Consultant coverage, Credit is a broad asset class that will touch all aspects of credit through a variety of fund structures and liquidity profiles. As a result, both Cliffwater and Verus will provide coverage across the Credit asset class. Staff expects that Cliffwater will provide primary coverage within the Illiquid Credit sub-strategy and Verus will provide primary coverage within the Liquid Credit sub-strategy; however, both Consultants could provide cross coverage within either sub-strategy.

CREDIT IMPLEMENTATION PLAN

1) Staff and Cliffwater recommend moving two strategies from the Distressed sub-strategy of SCERS' current Private Equity portfolio to the Illiquid sub-strategy of the Credit asset class, as shown below. These strategies display more of the characteristics of Illiquid Credit than they do in the Distressed segment of Private Equity. The aggregate NAV that would be moved equates to approximately $72, which translates to 0.52% of SCERS' total portfolio, and would increase SCERS total Credit exposure from 5.1% to 5.6%.
   - Opportunistic Lending
     - Shamrock Capital Content Fund II, L.P. and Shamrock Capital Content Fund III, L.P.
       - Acquisition and participation rights generated by entertainment content
       - Debt-like cash flowing strategy with similar characteristics of private lending strategies
       - NAV of approximately $14 million and $8 million, respectively, as of September 30, 2024
       - Vintage years 2019 ($20 million SCERS commitment) and 2022 ($30 million SCERS commitment), respectively
       - Net IRR of 11.3% for Fund II, while Fund III is still early in its investment period
         - Current yield of approximately 13%
   - Special Situations
     - Sixth Street Opportunities Partners IV, L.P. and Sixth Street Opportunities Partners V, L.P.

  - Diversified credit strategy across corporate dislocations, special situations, and destressed-for-control investments
  - NAV of approximately $26 million and $24 million, respectively, as of September 30, 2024
  - Vintage years 2018 ($35 million SCERS commitment) and 2022 ($30 million SCERS commitment), respectively
  - Net IRR of 10.5% and 7.7%, respectively
- SCERS' total current credit exposure in the revised Credit structure (Illiquid/Liquid sub-strategies, and Illiquid segments), including the transfer of the funds noted above looks as show below. Total exposure is 5.6% versus the new Credit target allocation of 9%.



2) Staff and Cliffwater recommend leaving the 2025 Private Credit budget in place and revisit the annual budget for 2026.

3) Staff and Verus will evaluate SCERS' current Public Credit exposure/mandate (Brigade) to determine the fit within new Credit asset class.

4) Staff will work with Cliffwater and Verus to compile a list of Liquid Credit ideas and strategies that could potentially be good fits for the Liquid Credit sub-strategy.

NEXT STEPS

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. Credit resides within a broader Growth asset category IPS, along with Global Equity and Private Equity. Staff will present to the Board a revised Growth asset category IPS that incorporates the proposed revisions to the underlying asset classes, as well as the other asset category IPSs (Diversifying and Real Return) and the Master IPS later in the summer or early fall.

ATTACHMENTS

- Board Order
- Credit Asset Class Structure and Implementation Presentation

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

Before the Board of Retirement
May 21, 2025

AGENDA ITEM:

Asset Class Restructuring and Implementation: Credit

THE BOARD OF RETIREMENT hereby approves the recommendation of staff to approve the revised structure and implementation plan for the Credit asset class, as presented by Staff, and Verus and Cliffwater. The specific recommendations include:

- Approve a range of +/- 3% around the new Credit target allocation of 9% (6% - 12%)
- Adopt the following Credit sub-strategies and respective ranges for each
    - Illiquid Credit sub-strategy: 60% to 100%
        - Illiquid segments to include:
            - Direct Lending
            - Opportunistic Lending
            - Special Situations
        - Target 10-15 ongoing investment manager relationships
    - Liquid Credit sub-strategy: 0% to 40%
        - Primarily invest in publicly traded credit though flexible mandates that can touch multiple points within the liquid credit universe
        - Target 0-5 ongoing investment manager relationships
    - A range of 75% to 100% for U.S. Credit and a range of 0% to 25% for Non-U.S. Credit.
- Revise and adopt Credit benchmarks as follows:
    - Policy Index Benchmark: Cambridge Associates Private Credit Index

    - Long-Term Objective: Credit Suisse Leveraged Loan Index + 2%
- Adopt the Alternative Assets/Private Markets Implementation Protocol for implementation of the Credit asset class
- Adopt the following implementation measures for the Credit asset class
    - Move the following exposures from SCERS' current Private Equity asset class to the Illiquid Credit sub-strategy
        - Opportunistic Lending
            - Shamrock Capital Content Fund II, L.P. and Shamrock Capital Content Fund III, L.P. - $22 million total of NAV
        - Special Situations
            - Sixth Street Opportunities Partners IV, L.P. and Sixth Street Opportunities Partners V, L.P. - $50 million of total NAV
    - Maintain the 2025 Private Credit budget for the Illiquid Credit sub-strategy, and re-evaluate the budget for 2026
    - Evaluate SCERS' current Public Credit exposure/mandate (Brigade) within the context of the revised Credit structure and universe of Liquid Credit strategies to determine the fit within the Credit portfolio going forward
    - Evaluate investment opportunities for the Liquid Credit sub-strategy based on guidance and recommendations from Verus and Cliffwater
- 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 May 21, 2025 by the following vote of the Board of Retirement, to wit:

AYES:

NOES:

ABSENT:

ABSTAIN:

ALTERNATES:
(Present but not voting)

James Diepenbrock
Board President

Eric Stern
Chief Executive Officer and
Board Secretary

SCERS

Credit Asset Class Structure and Implementation

May 21, 2025

Introduction

- Review Credit asset class structure recommendations
  - Sub-strategies, segments, targets, ranges, and benchmarks
- Present implementation plan for Credit asset class
- Present suggested implementation protocol and consultant coverage

Credit Strategic Changes

Asset Class	Prior Target Allocation	Revised Target Allocation	Change
Global Equity	40%	39%	-1%
Private Equity	11%	11%	0%
Public Credit	2%	-	
Private Credit	5%	-	
Credit	-	9%	2%
Growth Asset Category	**58%**	**59%**	**1%**

Asset Class	Prior Target Allocation	Revised Target Allocation	Change
Real Estate	9%	8%	-1%
Real Assets	7%	7%	0%
Liquid Real Return	1%	1%	0%
Real Return Category	**17%**	**16%**	**-1%**

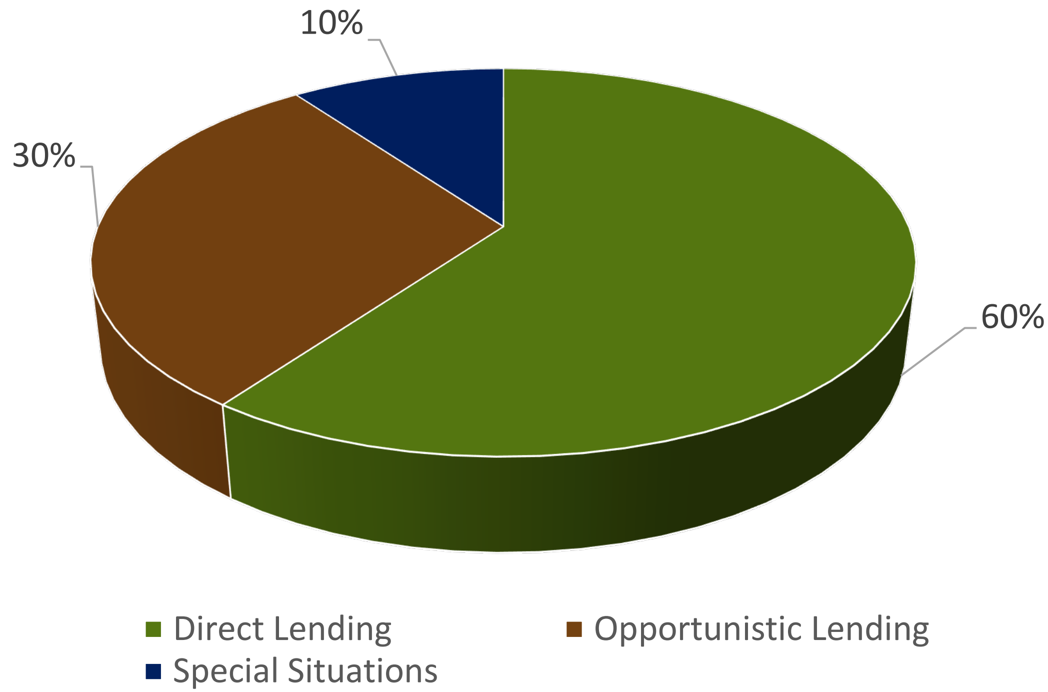
- Consolidated Public and Private Credit into a Credit asset class
  - Aggregate Credit target allocation increased from 7% to 9%
  - Reduced Global Equity and Real Estate by 1% each

Recommended Credit Structure

SCERS Credit Portfolio Structure				
	Minimum	Target	Maximum	# Manger Relationships
Total Credit Portfolio	**6%**	**9%**	**12%**	
Illiquid Credit	60%	-	100%	10-15
Direct Lending				
Opportunistic Lending				
Special Situations				
Liquid Credit	0%	-	40%	0-5
U.S. Credit	75%	-	100%	
Non-U.S. Credit	0%	-	25%	

- The Credit asset class will include two primary sub-strategies
  - Illiquid Credit and Liquid Credit

Illiquid Credit



- No IPS target allocations, but rather expected weights
- Direct Lending and Opportunistic Lending - private lending-oriented strategies similar to legacy Private Credit portfolio; yield oriented/cash flowing strategies; floating rate loans over a base rate
- Special Situations – opportunistic investments related to corporate or market dislocations; historically part of SCERS' Private Equity opportunity set

Illiquid Credit

Direct Lending

- Directly originated, non-traded, mostly senior-secured performing loans to corporate companies
- Sponsored (private equity backed companies) and non-sponsored
- Typically utilize fund level leverage

Opportunistic Lending

- Lending strategies, but a broader range of investments and collateral
- Includes asset backed lending strategies (real assets, royalties)
- Can include equity participation and upside; little to no fund level leverage

Special Situations

- Investments in companies facing financial and operational stress
- Includes sub- and non-performing loans, secondary debt purchases, new originations of debt instruments including rescue financings, and structured credit
- Debt investments but can include equity participation

Liquid Credit

Broad Range of Eligible Publicly Traded Credit

- Includes but not limited to:
  - IG and HY corporate bonds
  - Bank loans
  - Agency and non-agency MBS, CMBS, CLOs, CDOs
  - Structured credit
  - Asset-backed securities
  - Derivatives
  - Stressed/distressed corporate credit
  - Government and agency bonds
  - International non-dollar fixed income securities and EMD
  - Equity securities

Flexible Mandates

- Expect to earn a return in line or greater than Illiquid Credit – no target allocation (range between 0% and 40%)
- Variety of fund structures
  - Open-end funds, closed-end/drawdown funds, long-short credit, fund of ones
- Growing number of “hybrid” credit strategies
  - Opportunistically invest across publics and privates

Recommended Benchmarks

Policy Index Benchmark

- Cambridge Associates Private Credit Index

Long-Term Objective

- Credit Suisse Leveraged Loan Index + 2%

- Propose using both a policy index benchmark and long-term objective
  - Similar to approach used for other alternative asset classes

Implementation

Recommend Alternative Assets/Private Markets Implementation Protocol

- Bulk of Credit asset class comprised of Illiquid Credit – already under this protocol
- Liquid Credit will have a range of fund structures and complexity
- Greater efficiency with one implementation protocol
- Consultant coverage by Cliffwater and Verus

Implementation

- Move four existing Private Equity funds to Credit

Opportunistic Lending - Shamrock Capital Content Funds II and III

- Acquisition and participation rights generated by entertainment content
- NAV of $22 million

  Net IRR of 11.3%; current yield of 13%

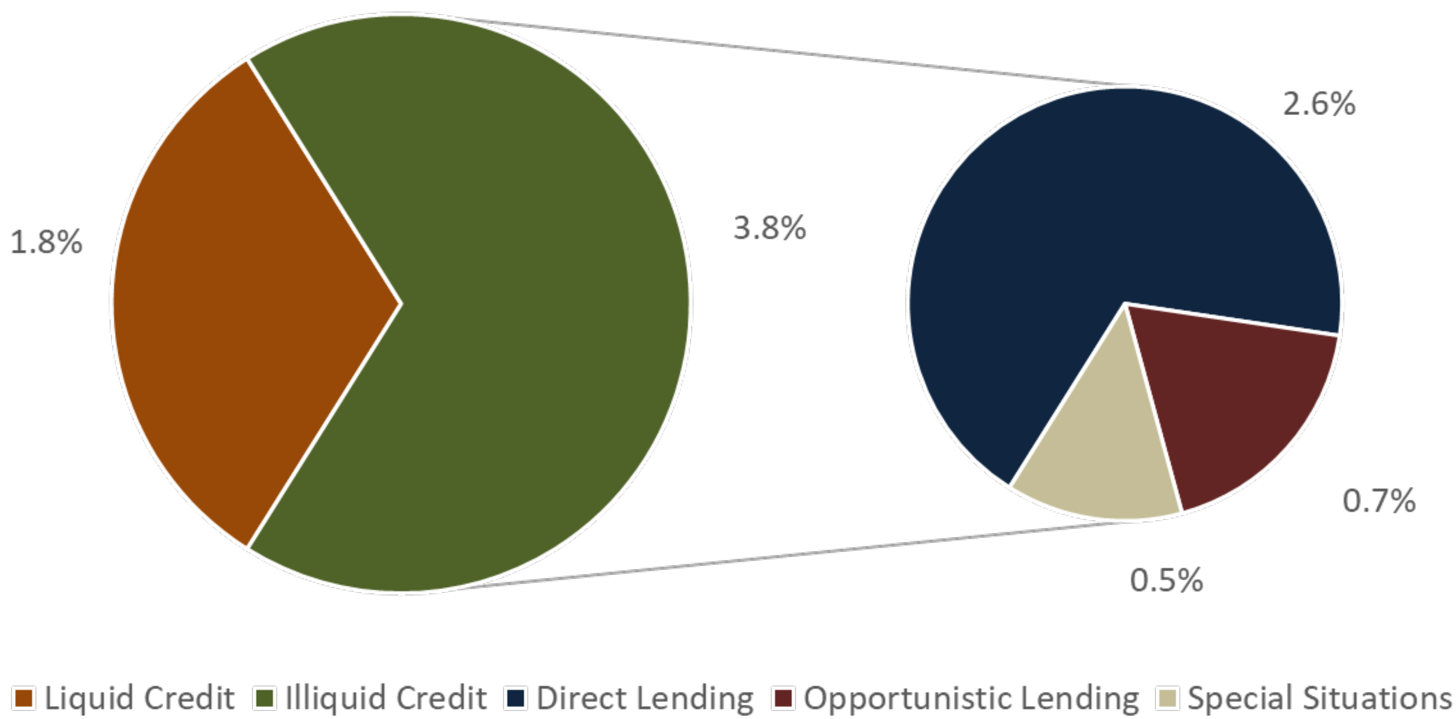
Special Situations - Sixth Street Opportunities Partners IV and V

- Diversified credit strategy across corporate dislocations, special situations, and destressed-for-control investments
- NAV of $50 million

  Net IRR of 10.5% and 7.7%, respectively

- Profile of these strategies closer to Illiquid Credit than Private Equity
- Total exposure of 0.5%

SCERS Credit Exposure



- Current total Credit exposure of 5.6% versus 9% target

Implementation

- Plan to propose Illiquid Credit budget in 2026
  - Leave 2025 Private Credit budget in place
- Evaluate SCERS' current Public Credit exposure/mandate to determine fit within the new Credit asset class
- Work with Cliffwater and Verus to evaluate compelling Liquid Credit strategies for fit within the Liquid Credit sub-strategy.

Next Steps

- Present revised Growth asset category IPS that incorporates the proposed Credit structure (and any other asset class revisions)
  - Also present the other asset category IPSs (Diversifying and Real Return) and the Master IPS
- Later in the summer or early fall