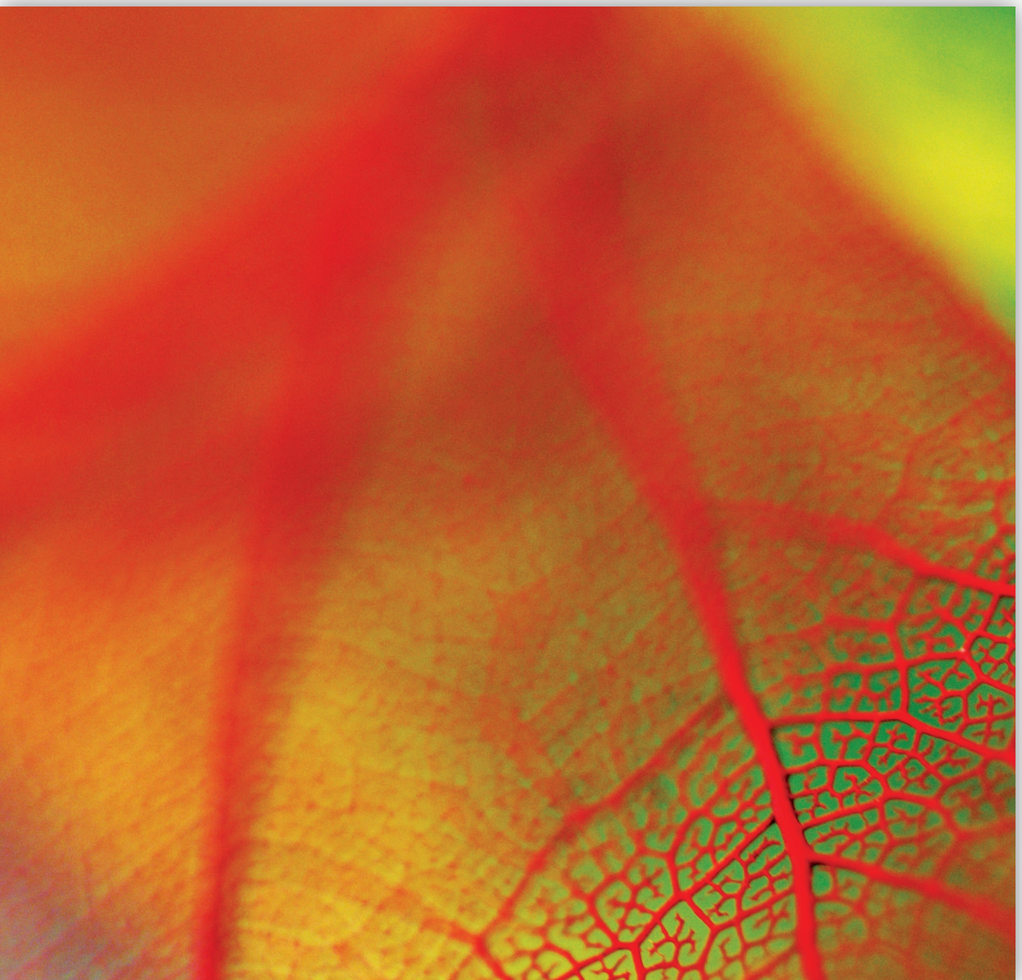
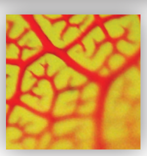
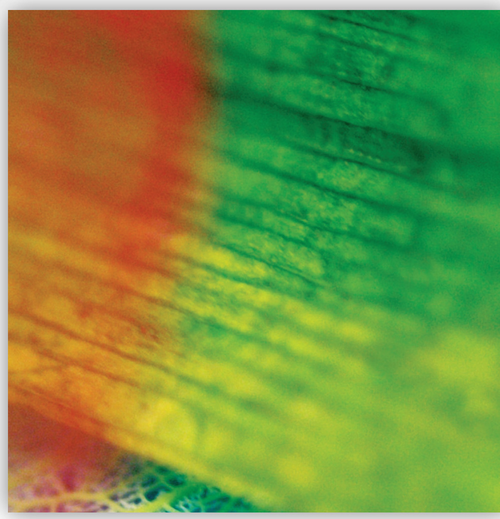
2012 Investment Year in Review







Sacramento County Employees' Retirement System

SCERS

2012 Investment Year in Review

Issued By:

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Introduction

As Chief Executive Officer of the Sacramento County Employees' Retirement System (SCERS), I am pleased to present this report on SCERS' 2012 Investment Year in Review (the 'Report').

The purpose of the Report is to:

- Summarize the major events and developments of the past year, including investment performance;
- Serve as a reminder of what has been accomplished over the year;
- Highlight the decisions that were made, the rationale for those decisions, and the direction going forward; and
- Preview the investment program's projects, issues and objectives for the year to come.

Overall, it is hoped that this annual report of the activity in the investment program will be helpful for tracking SCERS' progress toward achieving its near-term and long-term investment objectives, and in particular, meeting the fundamental goal of providing the bulk of the funding for the benefits paid to SCERS' members.

The primary focus of attention for the investment program in 2011 was establishing an asset allocation structure that reduced risk, increased diversification and improved investment performance across economic environments. In 2012, the primary focus of attention was to apply these same considerations to the construction and implementation of the individual asset classes in the asset allocation structure.

To do this, SCERS leveraged the expertise of its internal investment staff, investment consultants and key investment partners to develop an investment model and manager structure, twelve-month and multi-year investment plans, and an investment implementation protocol for each asset class. The design for each asset class was customized to meet the investment objectives of the asset class and assure that the asset class performs its assigned role relative to the overall investment portfolio. Finally, numerous investment strategies and opportunities were analyzed for potential consideration in the different asset class structures.

Virtually every asset class was impacted by these activities in 2012: Among other things, the domestic and international equity and fixed income asset classes were re-structured; multiple direct investment engagements were established in the private equity and hedge fund asset classes; the strategic partnership platform in the hedge fund asset class was expanded to bring the asset class allocation level closer to its target; and a specialist consultant was engaged for the real estate component of the real assets class and development of a strategic plan for real estate was commenced.

Asset class construction and implementation will continue in 2013, and for the alternative asset classes in particular, implementation will require a few years before the manager structure is fully in place. That being said, the investment program is already seeing the benefit of greater diversification and reduced risk, with 2012 calendar year investment performance of 13.7%, which is 1.1% above the investment portfolio benchmark, and well above SCERS' long term investment return assumption of 7.5%. The investment performance continues to be strong over the long term, with an annualized return of 8.4% for the last twenty-six years.

Going forward, SCERS will remain focused on identifying ways in which value can be added to the investment program so that it continues to be the economic engine for the benefits SCERS provides.

Respectfully Submitted,

Richard Stensrud

Richard Stensrud
Chief Executive Officer

	For the Period Ended December 31, 2012		
	Annualized		
	1 Year	3 Years	5 Years
Domestic Equity			
Total Domestic Equity	17.6%	11.5%	1.5%
Russell 3000	16.4%	11.2%	2.0%
IF All DB US Eq Gross Median	16.2%	11.3%	2.2%
International Equity			
Total International Equity	17.6%	4.0%	-2.1%
MSCI ACWI -ex US Index	17.4%	4.3%	-2.4%
IF All DB ex-US Eq Gross Median	18.7%	4.6%	-2.7%
Fixed Income			
Total Fixed Income	8.4%	8.5%	8.4%
Barclays Aggregate Index	4.2%	6.2%	6.0%
IF All DB US Fix Inc Gross Median	7.8%	7.8%	7.1%
Hedge Funds			
Total Hedge Funds	9.2%	4.2%	-0.2%
91 Day T Bill + 5%	5.1%	5.1%	5.5%
IF All DB Hedge Funds Gross Median	6.9%	3.5%	0.0%
Private Equity			
Total Private Equity	3.0%	6.0%	-11.1%
Russell 1000 + 3% 1 Quarter Lag	33.0%	15.4%	3.2%
IF All DB Private Eq Net Median	8.8%	11.0%	3.6%
Real Assets			
Total Real Assets	11.2%	N/A	N/A
CPI-U Headline + 5%	6.7%	N/A	N/A
Opportunities			
Total opportunities	28.2%	17.5%	6.3%
Barclays Aggregate	4.2%	6.2%	5.9%
Total Fund			
SCERS Total Fund	13.7%	8.9%	2.0%
Allocation Index*	12.6%	N/A	N/A
Policy Index**	13.4%	9.1%	2.8%
IF Public DB > $1B Gross Median	13.0%	9.0%	3.1%

Notes: Returns were prepared by SCERS investment consultant, SIS, and shown on a gross of fee basis and included the overlay effect. Return calculations were prepared using a time weighted rate of return.

* Allocation index benchmark return is the weighted average performance of SCERS' actual allocation accross the asset class benchmarks.

** Policy index consists of 22.5% Russell 3000, 22.5% MSCI ACWI-ex US, 20% Barclays Aggregate, 10% 91 Day T Bill + 5%, 10% Russell 1000 + 3% (1 quarter lag), and 15% CPI-U Headline + 5%.

Staff, Consultants, and Strategic Partners

Under the California Constitution, the SCERS Board has the exclusive authority and fiduciary responsibility for the management of SCERS' investment program. In carrying out this duty, the SCERS Board establishes the strategic direction, asset allocation, return and risk parameters, and investment policies for the retirement system. In making these decisions, the SCERS Board receives guidance from its internal staff of investment professionals (Staff) and from expert investment consultants, all of whom also serve as fiduciaries with respect to the fund.

Given the complexities of managing a large, multi-asset class investment program, the SCERS Board has delegated substantial responsibility for the day-to-day oversight and management of the assets of the retirement system to the internal investment Staff, who in turn, utilize and draw upon the investment expertise and resources of SCERS' investment consultants and key investment partners. SCERS believes that a strong, collaborative partnership between Staff, consultants and investment service providers not only assures the prudent oversight of the fund, but produces significant investment value over time in the form of higher returns, lower risk and lower costs.

The collaborative partnership between Staff, consultants and investment partners is grounded in the following principles: (1) Staff will focus on and directly engage in those areas where it can add investment value; (2) Consultants will serve as an 'extension of staff' in those areas where they have greater expertise, capabilities and/or resources but Staff will be actively involved in any decisions involving such areas; (3) Both Staff and consultants will be responsible for monitoring and overseeing the investment portfolio; (4) Both Staff and consultants will be charged with developing ways to improve investment performance and manage risk; (5) Strategic partnerships may be established with investment providers when they will (a) allow SCERS to develop an efficient, customized solution to an investment need; (b) allow SCERS to gain access to specialized investment knowledge or expertise; or (c) improve access to niche investment markets or strategies that will add value to the portfolio; and (6) Overlapping expertise and capabilities of Staff, consultants and strategic partners is beneficial because it brings multiple perspectives to the investment decision-making process.

Implicit in this approach is SCERS' belief that a strong internal investment Staff is central to successful execution of the investment program, in that Staff:

- Serves as the 'hub' and coordinator of the activities of consultants and strategic partners;
- Provides a source of analysis independent from those partners;
- Allows SCERS to be a generator of investment ideas and not simply a passive recipient of investment ideas;
- Facilitates investment solutions specific to SCERS' needs; and
- Enables SCERS to capture and institutionalize knowledge and expertise.

The effectiveness of the collaborative partnership between SCERS' Staff, consultants and strategic partners can be seen in the asset class construction and implementation activities and other investment program undertakings that occurred in 2012. Examples include:

- Staff and general investment consultant Strategic Investment Solutions (SIS) identified, evaluated and recommended investment managers for the large cap component of the domestic equity and international equity asset classes. Staff worked with portfolio transition consultant Zeno Consulting to develop a low cost and efficient plan for transitioning the assets from the former managers to the new managers to implement the new manager structures.
- Staff and SIS analyzed and developed a new structure for the fixed income asset class. The identification and evaluation of investment managers for new mandates within the structure is underway, and the new

structure will be fully implemented in 2013.

- Staff and alternative assets consultant Cliffwater identified, evaluated, performed due diligence on and made direct investment commitments to multiple private equity, hedge fund and real assets class investment opportunities pursuant to an investment plan and implementation protocol approved by the SCERS Board.
- Staff and Cliffwater analyzed options and developed and implemented a plan for moving the hedge fund asset class closer to its target allocation level by expanding upon the customized and diversified hedge fund platform established with strategic investment partner Grosvenor Capital Management.
- Staff, SIS and Cliffwater provided multiple education sessions focused on asset class construction, the risk/return profile, and the potential opportunity set in each asset class.
- Recognizing the need for greater expertise and resources to address the real estate component of the real assets class, Staff identified and evaluated potential candidates to serve as a specialist real estate consultant. That search led to the selection of the Townsend Group. Townsend conducted an in-depth review of SCERS' current real estate portfolio, and has been working with Staff and Cliffwater to develop a strategic plan and near-term investment plan for real estate that fulfills the role of real estate in the overall investment portfolio. Those plans will be brought forward in 2013.

In order for SCERS' investment program to continue to make a similar level of progress in 2013 and beyond, it will be important for SCERS to fully build out and maintain the high quality of the professional investment Staff. SCERS has been successful to-date in grooming investment talent within the Staff and then moving individuals into positions of progressively greater responsibility. In 2012, SCERS was able to fill its Chief Investment Officer (CIO) and Deputy CIO positions in this manner. In order for this approach to be successful going forward, however, SCERS will need to have a compensation structure for its investment Staff that allows SCERS to attract and retain top tier investment professionals. It will also require that SCERS reach and maintain full investment staffing levels.

2013 Goals

- Complete the integration of Townsend into the consulting platform with SIS and Cliffwater;
- Continue to build and capitalize on consultant relationships;
- Analyze the merits of developing strategic partnership relationships in the real assets and private equity asset classes; and
- Continue to be an active participant with consultants and strategic partners in crafting investment solutions that meet SCERS' needs.

Portfolio Overview

In 2011, SCERS completed an asset allocation study and established the long-term asset allocation mix outlined in **Table 1** below. SCERS' new long-term asset allocation reduces risk by increasing diversification across asset classes. In particular, the asset allocation structure was developed to achieve the following goals: (1) Perform well across different economic environments and risk factors (such as interest rates, duration, foreign exchange, the equity risk premium, and inflation); and (2) Maximize risk-adjusted returns (optimize returns given an acceptable level of volatility). Overall, SCERS' new asset allocation is projected to increase returns with a similar level of volatility as compared to the prior asset allocation.

Since the new asset allocation significantly changed target allocations for several asset classes, the focus in 2012 was on implementing and executing SCERS' new asset allocation in each asset class. The progress in investing and moving SCERS' physical portfolio closer to the target allocation is displayed in **Table 1**. Please note that SCERS utilizes a portfolio overlay program that takes uncommitted cash in the portfolio to purchase securities that efficiently replicate the asset allocation and bring the portfolio closer to target allocation levels.

Table 1 - SCERS' Actual Asset Allocation Versus Target Policy Allocation

Asset Class	Actual Allocation	Target Policy Allocation	Variance
Domestic Equity	28.4%	22.5%	5.9%
International Equity	23.6%	22.5%	1.1%
Fixed Income	17.3%	20.0%	-2.7%
Hedge Funds	5.2%	10.0%	-4.8%
Real Assets	10.1%	15.0%	-4.9%
Private Equity	2.0%	10.0%	-8.0%
Opportunities	1.2%	0.0%	1.2%
Cash	12.2%	0.0%	12.2%

Successfully structuring the asset classes and selecting the best investment managers can lead to the creation of significant investment value by lowering risk, enhancing returns and lowering costs. Staff prioritized its asset allocation implementation plan on two levels: (1) Identify areas and activities that would create the greatest investment value and impact for SCERS' portfolio; and (2) Maintain strong performance in areas where a successful asset class structure and set of managers was already in place. This yielded the following action plan:

- Restructuring domestic large-cap equities.
- Restructuring international developed equities.
- Establishing direct investments in hedge fund and private equity managers.
- Creating an interim hedge fund component to move the hedge fund portfolio closer to SCERS' target allocation.
- Enhancing the fixed income asset class structure to address issues related to ultra-low Treasury yields and the long-term change in fixed income market dynamics.

The structure of each asset class is intended to produce asset class characteristics consistent with the risk and return expectations of the asset allocation study. Considerations include: (1) The optimal number of investment managers; (2) The types of investment vehicles selected (e.g. mix between commingled funds, co-investments, direct investments, or separate accounts.); and (3) The allocation across the sub-asset class components.

Investment value can be added through the asset class structure by focusing on the following approaches and themes to minimize risk and enhance returns:

1. Minimize risk

   - Define the roles and objectives of asset classes to eliminate overlap of similar risk factors across the fund and create greater diversification.
   - Combine investment strategies which produce lower correlation and covariance in the structure.
   - Minimize uncompensated risks such as a bias in equity styles (growth, value and core).
   - Create an asset class structure which bears an appropriate level of risk that will be compensated by active investment management.
   - Lower volatility.

2. Enhance returns

   - Define the roles and objectives of asset classes to create competition for investment allocations and the ability to assess relative value across different underlying assets with similar risk and return profiles.
   - Identify areas and characteristics where active management adds value.
   - Allocate a greater level of capital to higher conviction investment managers while controlling for risk.

Manager selection is focused on hiring and maintaining the investment managers that have a higher likelihood to outperform over the long-term while terminating existing managers that have a higher likelihood to underperform. Over the past three years, Staff and consultants have developed and continued to refine a process to identify persistent performance through the manager selection process which is detailed in **Appendix 2**.

There are three areas that distinguish SCERS' manager selection process:

- Due diligence focuses not only on the investments and investment strategy, but also on the operational risks and negotiation of appropriate business terms.
- Rather than rely exclusively on consultant recommendations, SCERS' process is integrated, and relies on both Staff and consultants to independently perform the individual components of manager selection outlined in **Appendix 2** including sourcing, vetting and interviewing, legal review, negotiation of terms, determination of allocation of capital, monitoring existing investments, and determination to terminate an investment.
- Staff and consultants possess strengths in assessing risk management processes, analysis at the security level and gathering external references or analysis to validate the manager's capabilities.

SCERS believes that a more exhaustive due diligence process by both Staff and consultants will lead to the superior selection of investment managers and be a source of investment value over the long-term. In each individual asset class section that follows, the actions and efforts taken to structure and select investment managers is described including the qualitative factors underpinning the reason why it is believed the manager selected will lead to the creation of investment value.

Due to differences in asset allocation mixes and risk-return profiles, it is difficult to draw significant conclusions from comparing SCERS' fund performance to other pension funds. Instead, SCERS believes it is more informative to compare performance to what would be expected from the investment markets given SCERS' actual investment portfolio and asset allocation. This is in part why SCERS created two new benchmarks to compare total fund level performance: (1) A policy benchmark that calculates the weighted average performance of SCERS' target asset allocation across the asset class benchmarks; and (2) An allocation index benchmark that factors in the time that it will take to move to SCERS' new target allocation by calculating the weighted average performance of SCERS' actual allocation across the asset class benchmarks.

To illustrate the difference between the two fund level benchmarks, consider SCERS' 5.2% actual allocation to hedge funds at the end of December 2012 versus the target allocation for hedge funds of 10%. The ' allocation index benchmark' would weight and utilize the actual 5.2% allocation and the long-term hedge fund benchmark (T-Bill + 5%) in the calculation of the benchmark return. Despite the 5.2% actual allocation and 4.8% gap to the target allocation, the 'policy benchmark' would weight and utilize the target 10% allocation and the long-term hedge fund benchmark (T-Bill + 5%) in the calculation of the benchmark return. Put another way, the 'policy benchmark' measures how a portfolio should perform under the target asset allocation, whereas the 'allocation index benchmark' has been designed to more accurately compare SCERS' actual portfolio as changes are made each quarter to the asset levels in each asset class.

Asset Classes

Domestic Equity

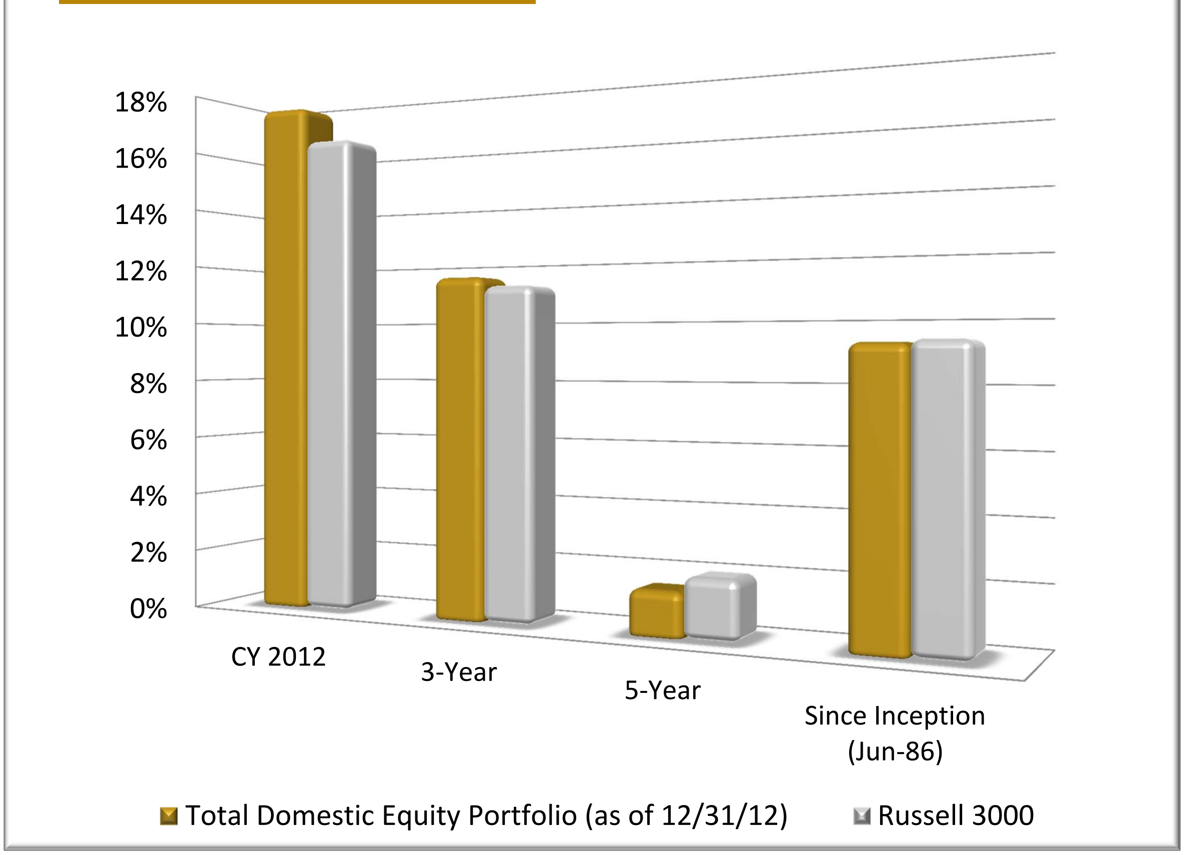
Within domestic equity, the focus in 2012 was on the implementation of the new manager structure that was approved in 2011. SCERS restructured this asset class to enhance returns while minimizing risk. The restructuring included the following considerations:

- Reduction in SCERS' overall domestic equity exposure from 30% to 22.5%.
- Adoption of a 'barbell' approach - Increased the large cap passive allocation and combined it with a smaller allocation to higher active share large cap mandates (i.e., managers that are higher conviction; benchmark agnostic; have higher tracking error; and greater portfolio concentration).
    - This combination maintains similar aggregate tracking error while enhancing the capability to generate active returns.
- Reduction in domestic equity investment manager count by eliminating manager redundancies and focusing on segments where performance could be improved.
- Elimination of growth bias within the domestic equity portfolio in order to achieve style neutrality (style risk is an uncompensated risk).
- A lower cost structure through the larger passive allocation.
- Evaluation of the existing manager lineup within the context of the approved manager structure.
- Addition of domestic REITS to the domestic equity asset class (REITS were previously in another asset class).

2012 Accomplishments

- Invested additional funds in SCERS' existing passive large cap allocation with Alliance Bernstein, to bring the mandate in line with manager structure target weights.
- Engaged in a manager search to identify higher active share large cap strategies, resulting in the hiring of Eagle Capital Management (U.S. large cap core); Huber Capital Management (U.S. large cap value); and Brown Advisory (U.S. large cap growth).
- Terminated Pzena Investment Management (U.S. large cap value); LSV Asset Management (U.S. large cap value); Wells Capital Management (U.S. large cap growth); and Intech Investment Management (U.S. large cap growth).
- As part of implementation of the new manager structure, and to reduce manager redundancies, terminated BlackRock (U.S. enhanced large cap index), BlackRock (130/30) and UBS (130/30).

Performance and Attribution



- *CY 2012: 17.6% vs. 16.4% for benchmark; universe rank 16th percentile.*
- *Outperformance in large cap and small cap.*

2013 Goals

- Complete the implementation of the domestic equity manager structure.
  - Reduce manager redundancies and make allocation adjustments in conjunction with liquidity needs of other asset classes.
  - Continue to assess investment manager lineup.

International Equity

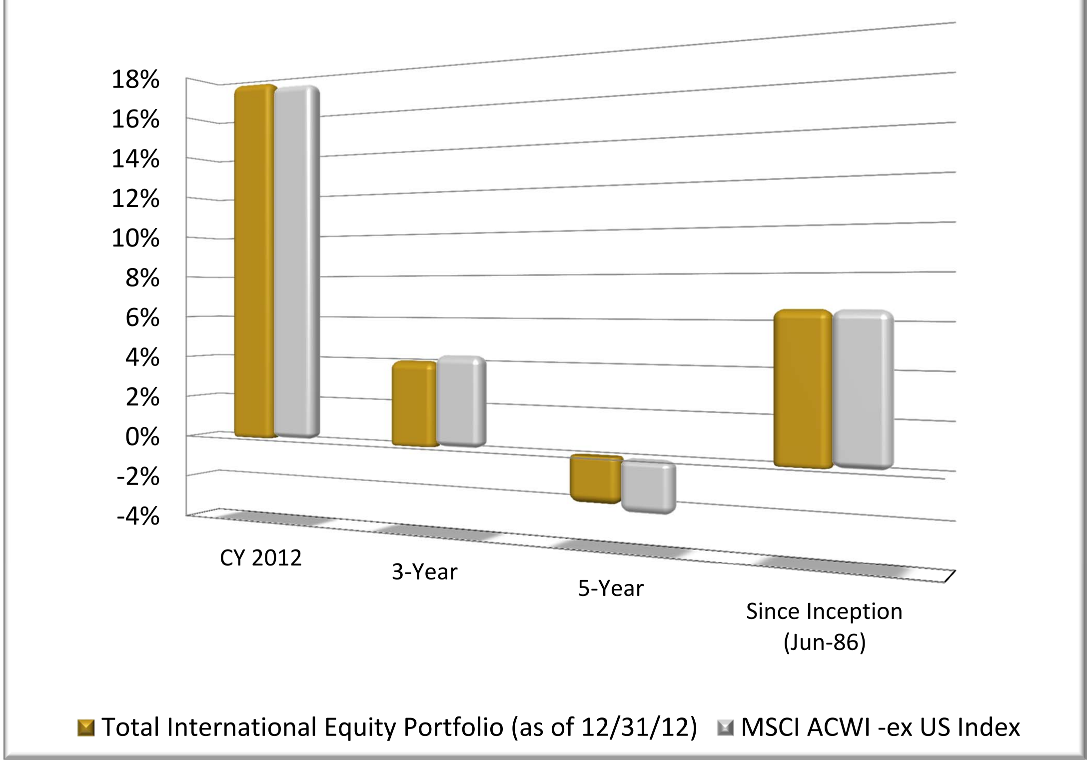
Within international equity, similar to domestic equities, the focus in 2012 was on the implementation of the new manager structure approved in 2011. The overall goal of the restructuring was to diversify regional exposures and enhance returns while reducing risk. The restructuring included the following considerations:

- Increase in SCERS' overall international equity exposure from 20% to 22.5%.
- Elimination of value tilt within the international equity portfolio in order to achieve style neutrality (style risk is an uncompensated risk).
- Addition of an ACWI ex-U.S. Core manager to replace one of SCERS' international developed market managers.
    - An ACWI ex-U.S. mandate invests across both international developed and emerging markets and provides the opportunity for the manager to add to performance by virtue of over or under-weighting emerging markets.
- Evaluation of the existing manager lineup within the context of the new manager structure.
- Addition of international REITS to the international equity asset class (REITs were previously in another asset class).

2012 Accomplishments

- Engaged in a manager search to identify an ACWI ex-U.S. manager, resulting in the hiring of Lazard Asset Management.
- Engaged in a manager search to identify two international developed market managers, resulting in the hiring of Baring Asset Management (international developed market growth) and the retention of an existing manager, LSV Asset Management (international developed market value).
    - LSV was retained due to the potential for the manager's investment strategy and style to outperform in the current market cycle, as well as the diversification benefits from the manager's predicted lower correlation and covariance to the portfolio.
- Refined the benchmarks for the international developed market mandates to enhance diversification.
- Terminated INVESCO (international developed market value) and Capital Guardian (international developed market growth).

PERFORMANCE AND ATTRIBUTION



- *CY 2012: 17.6% vs. 17.4% for benchmark; universe rank 74th percentile.*
- *Underperformance in developed markets and emerging markets.*

2013 Goals

- Complete the implementation of the international equity manager structure.
  - Make allocation adjustments in conjunction with liquidity needs of other asset classes.
  - Evaluate SCERS' dedicated emerging markets exposure.
  - Evaluate potential small cap emerging markets mandates to enhance market cap diversification.
  - Continue to assess investment manager lineup.

Fixed Income

Based on a recommendation from Staff and SIS, in 2012 the SCERS Board approved a new asset class and manager structure for fixed income. In forming the recommended structure, the analysis focused on: (1) The multiple roles of fixed income (anchor-to-safety, source of income, diversifier, return generator and source of liquidity); (2) The risk factors it exposes investors to (interest rate risk, duration risk, credit risk, pre-payment risk, inflation risk and currency risk); (3) The various types of fixed income strategies that are offered in the institutional investing landscape; (4) The capabilities of SCERS' current core plus managers; and (5) The pros and cons of using dedicated mandates versus broadening guidelines within SCERS' legacy core plus mandates with respect to the 'plus' sectors.

Considerations with Respect to Prior Fixed Income Structure

Historically, SCERS' fixed income managers have outperformed the Barclays Aggregate Index benchmark, in particular SCERS' two core plus managers. However, fixed income markets have witnessed a 30 year secular bond rally, and Treasuries have fallen from a high of 14% to less than 2% at current levels. With yields at extremely low levels, Treasuries will likely not produce the same positive performance during the next market crisis as they did during the 2008 credit crisis. The low yield environment necessitates that more sources of income and yield be explored to balance against the anchor-to-safety role of the asset class.

2012 Accomplishments

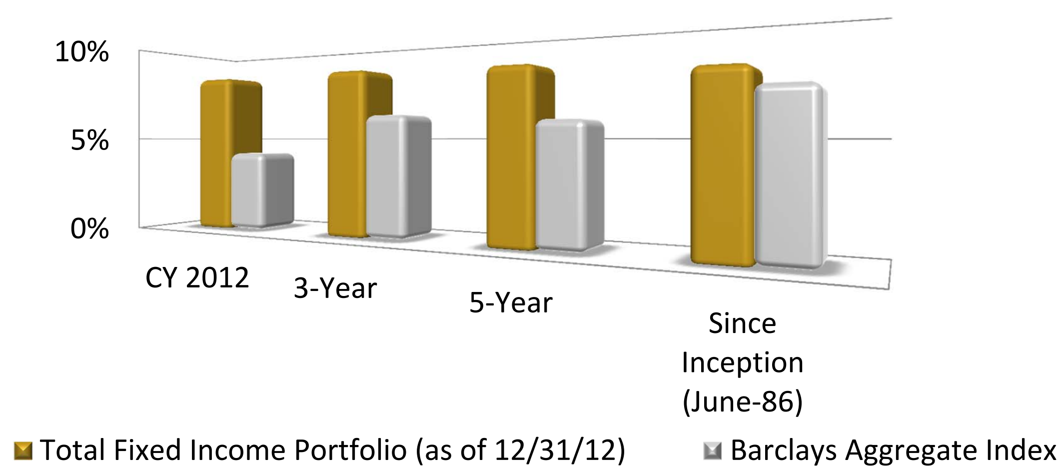
New fixed income manager structure was established:

- Two new mandates were approved to be carved out of the total fixed income portfolio.
  - An opportunistic credit mandate, equal to 10% of the total fixed income allocation (or 2% of SCERS' overall portfolio).
    - Diversified exposure across multiple credit sectors.
    - Flexibility within manager mandates to allocate across the most opportune segments of the credit markets.
  - A non-U.S. mandate, equal to 15% of the total fixed income allocation (or 3% of SCERS' overall portfolio).
    - Diversified across developed markets, emerging market debt, sovereign bonds, corporate bonds and currencies.
    - Meaningful emphasis on emerging market debt.
    - Flexibility within manager mandates to allocate across the most opportune regions, sectors and currencies.
- With the flexibility of the new mandates, managers will be expected to curb downside risk and protect capital in periods of economic and market stress.
- The new structure is expected to provide diversification within the fixed income asset class, as it adds less correlated sectors to the portfolio.
- Investments with existing managers will be maintained, but trimmed, such that the overall fixed income allocation still remains at 20%.
  - Guidelines within the non-core sectors will be broadened for the current core plus managers.

Portfolio Structure		
Strategy	Previous	New
Core	33.4%	25.0%
Core Plus	33.3%	25.0%
Core Plus	33.3%	25.0%
Opportunistic Credit	0.0%	10.0%
International (Developed/EM)	0.0%	15.0%

Allocation to Fixed Income Sectors		
Asset	Previous	New
US Core	90.0%	67.5%
Credit Opportunities	7.0%	15.0%
International Developed	3.0%	6.3%
Emerging Market	0.0%	11.2%

Performance and Attribution



- *CY 2012: 8.4% vs. 4.2% for benchmark; universe rank 44th percentile.*
- *Managers capitalized on an underweight to government bonds and an overweight to spread product.*

2013 Goals

- Complete the opportunistic credit and non-US manager searches.
  - Staff and SIS are currently reviewing potential manager candidates and will identify finalist candidates for more extensive scrutiny.
- Create appropriate custom benchmarks that reflect the objectives of the opportunistic credit and non-US mandates.
- Amend investment guidelines for existing managers to allow greater flexibility to invest in the non-core fixed income sectors.
- Develop and execute a plan for manager structure changes and the transition of assets.

Hedge Funds

In 2012, Staff and Cliffwater continued to build the direct hedge fund program by making investments consistent with the investment plan and investment structure established in 2011. The new structure increased SCERS' hedge fund allocation to 10% and lowered risk by establishing a broadly diversified program consisting of multiple hedge fund strategies, which replaced SCERS' legacy single-strategy portfolio. The multi-strategy portfolio is being implemented through a direct investing platform as well as through a multi-strategy hedge fund separate account portfolio managed by strategic partner Grosvenor Capital Management (SC Absolute Return Fund, LLC – 'SCARF').

2012 Accomplishments

- Cliffwater and Staff identified candidates for direct hedge fund investments.
    - Performed extensive due diligence on candidates, including onsite manager visits and consultations with hedge fund strategic partner, Grosvenor.
    - Prepared multiple reports for the Board evaluating potential investment opportunities.
    - Finalized five direct hedge fund investments:
        - Claren Road Credit Partners, L.P. (long / short credit)
        - Third Point Partners Qualified, L.P. (event driven)
        - Elliott Associates, L.P. (event driven)
        - BlueCrest Capital, L.P. (global macro)
        - Och-Ziff Domestic Partners, L.P. (multi strategy)

Interim Hedge Fund Component

With the expectation that it will take approximately three years to fully implement the direct hedge fund program, several potential interim hedge fund solutions were analyzed for the purpose of filling the gap between SCERS' target hedge fund allocation of 10% and its existing hedge fund investment level of approximately 5%.

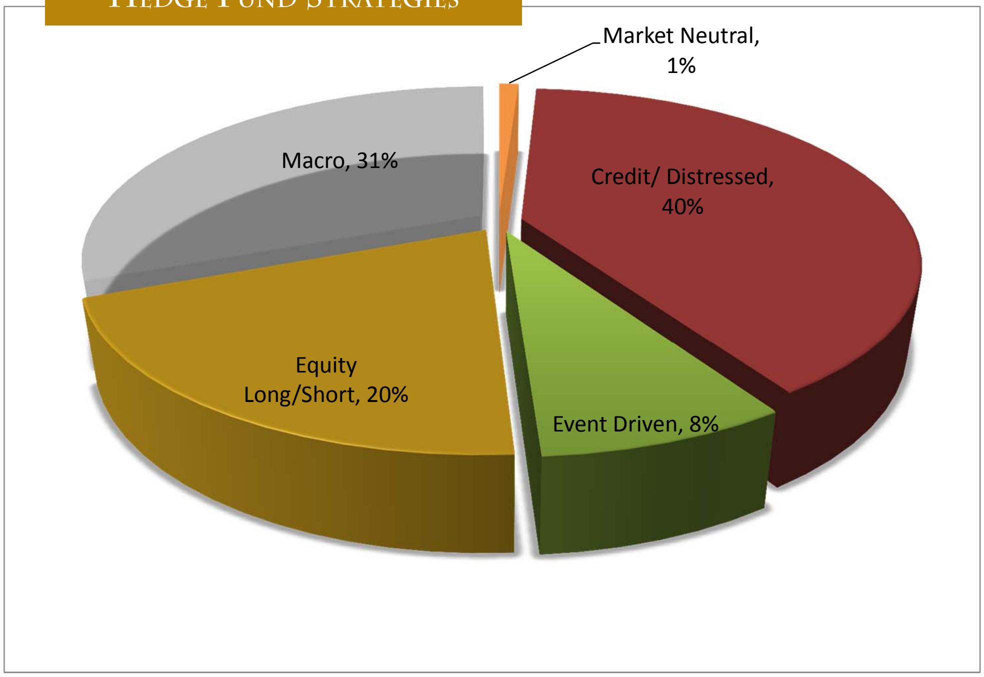
- A customized multi-strategy hedge fund portfolio managed by SCERS' hedge fund strategic partner Grosvenor Capital was recommended as the most appropriate approach ('SCARF-B').
    - SCARF-B is a more liquid version of SCARF, the multi-strategy hedge fund separate account portfolio already managed by strategic partner Grosvenor.
- SCERS Board approved an allocation to SCARF-B in January 2013, and the first tranche of the portfolio was invested in February 2013.

Grosvenor Strategic Partnership

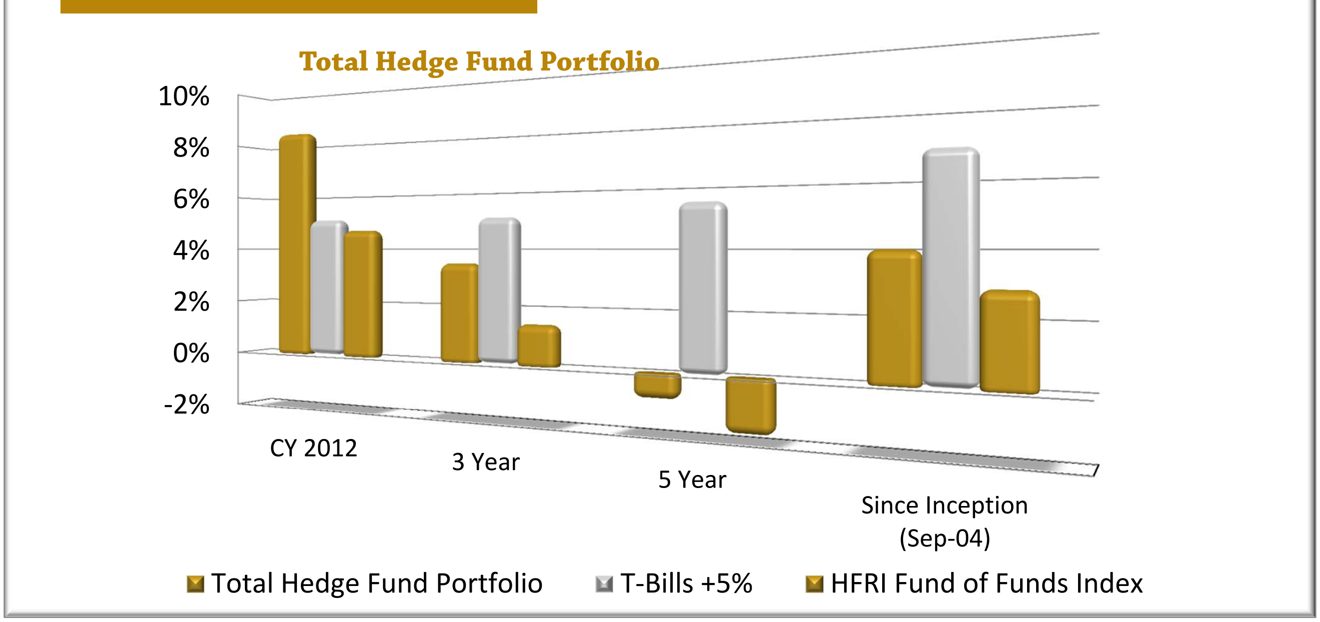
- The decision in 2011 to convert the Grosvenor fund of funds relationship to a strategic partnership bore further fruit in 2012:
    - Grosvenor's expertise serves as an additional source of opinion for Staff's investment due diligence on potential direct hedge fund investments.

- Grosvenor provides additional operational due diligence capabilities for Staff to leverage.
- Grosvenor provides aggregated risk reports for the entire SCERS hedge fund program, in addition to the portfolio(s) managed by Grosvenor.
- An effective, low cost interim hedge fund component emerged from SCERS' relationship with Grosvenor.

HEDGE FUND STRATEGIES

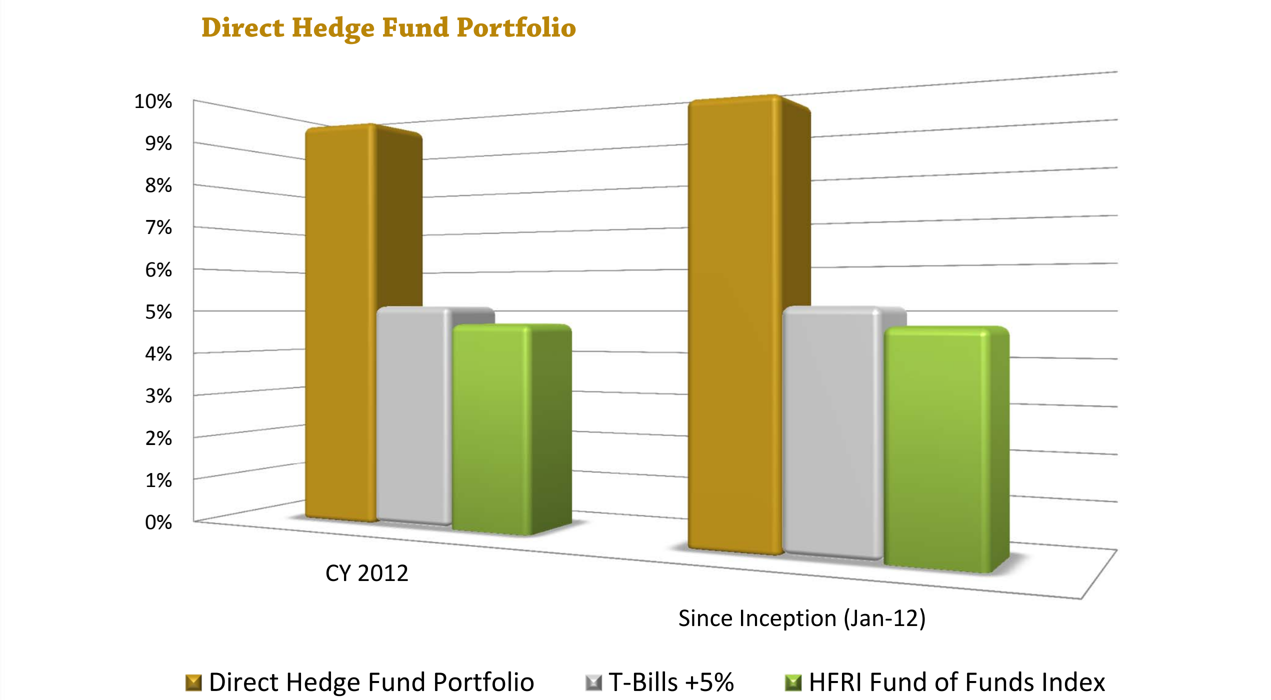


PERFORMANCE AND ATTRIBUTION



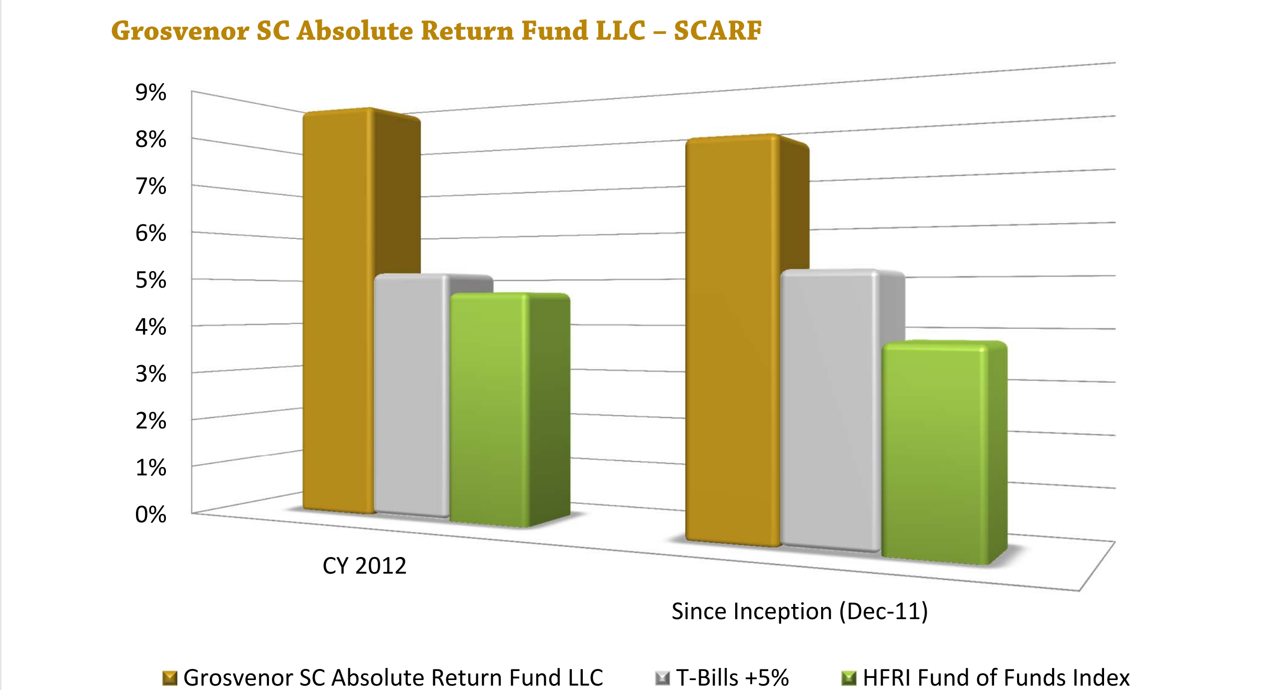
- *CY 2012: 8.5% vs. 5.1% and 4.7% for benchmarks (T-Bills +5% and HFRI Fund of Funds Index, respectively).*

PERFORMANCE AND ATTRIBUTION



- *Since Inception (Jan-12): 9.5% vs. 5.1% and 4.7% for benchmark (T-Bills +5% and HFRI Fund of Funds Index, respectively).*

PERFORMANCE AND ATTRIBUTION



- *Since Inception (Dec-11): 7.6% vs. 5.1% and 3.8% for benchmark (T-Bills +5% and HFRI Fund of Funds Index, respectively).*

Private Equity

In 2012, Staff and Cliffwater continued to build the direct private equity program by making commitments consistent with the investment plan and investment structure established in 2011. This structure established a direct private equity portfolio to complement SCERS' existing fund of funds private equity exposure, to better control and maintain appropriate levels of diversification by strategy, geography and vintage year. SCERS' private equity commitments and activities are focused on a five year plan to reach and maintain the 10% target allocation in private equity by investing across domestic and international buyout, growth equity, distressed, debt, and venture capital strategies.

Performance numbers for SCERS' private equity investments are not comparable to benchmark at this point due to SCERS being in the early phase/cycle of investments within this asset class, and the unique cash flow characteristic within private equity. Once a commitment is made to a private equity fund, capital is not drawn down at once, but rather, over a long period, typically 5-6 years. Returns within private equity typically follow a 'j-curve', where negative returns are generated initially followed by significant returns later.

2012 Accomplishments

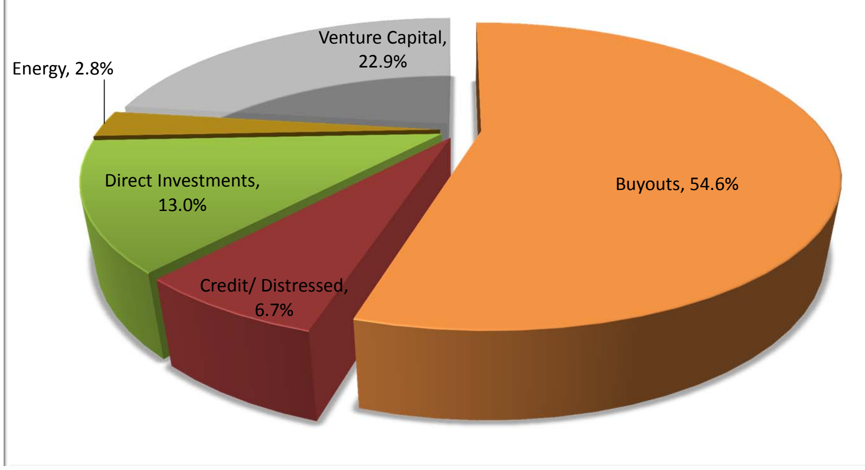
- Presented annual report on private equity and developed the 2012 private equity annual investment plan.
- Cliffwater and Staff identified candidates for direct private equity commitments.
    - Performed extensive due diligence on candidates, including consultations with current private equity fund of funds managers and with SIS.
    - Prepared multiple reports for the Board evaluating potential investment opportunities.
    - Finalized six direct private equity commitments.
        - Garrison Opportunity Fund III, L.P. (distressed debt)
        - Accel-KKR Capital Partners IV, L.P. (U.S. buyout)
        - New Enterprise Associates 14, L.P. (venture capital-growth equity)
        - H.I.G. Bayside Loan Opportunity III Europe, L.P. (European distressed debt)
        - Trinity Ventures XI, L.P. (early-stage venture capital)
        - Wayzata Opportunities Fund III, L.P. (distressed debt for control)
- Accepted invitation to join the Advisory Board for Trinity Ventures XI.

Allocation Summary

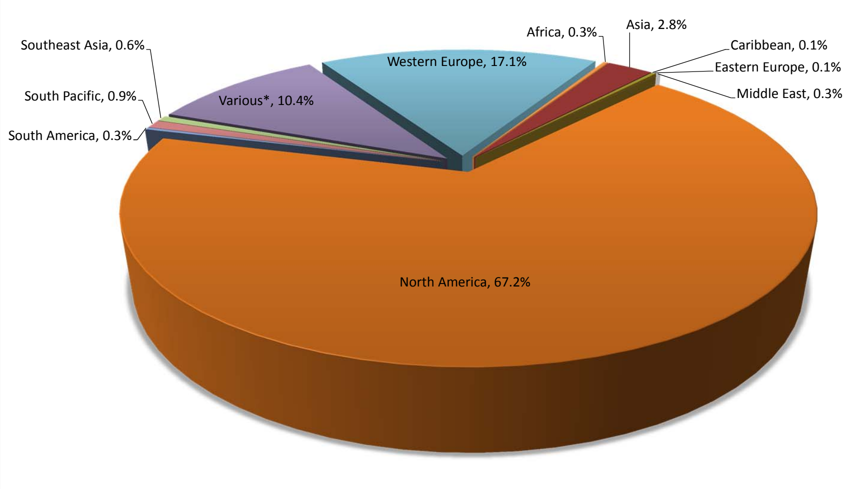
Portfolio Structure

	Target	Range Min	Range Max
U.S.			
Buyout	50%	30%	70%
Distressed	10%	0%	20%
Venture Capital	20%	10%	30%
Other	0%	0%	5%
Non-U.S.			
Buyout	15%	10%	20%
Distressed	2%	0	10%
Venture Capital	3%	0	10%
Other	0%	0	5%

Private Equity - Strategies



Private Equity - Regions



2013 Goals

- Identify, perform due diligence and make commitments to six to nine funds within the direct private equity program.
- Assess the need for the addition of a strategic partner within venture capital, emerging markets, and special situations segments of the private equity portfolio.
- Present the annual report on private equity and the annual investment plan, including a reassessment of the cash flow model due to market conditions.

Real Assets

The real assets asset class is comprised of core real estate, private market real assets (e.g., infrastructure, energy partnerships, timber, and agriculture), commodities, and potentially TIPs. The objectives of the real assets asset class is to provide: (1) Diversification, particularly to the equity risk premium; (2) An inflation hedge; (3) A moderate income stream; and (4) Downside risk protection. The structure of the asset class is designed to be flexible enough to allow for the investment opportunities to compete for a greater allocation level (within a range) based on the comparative risk/return attributes of the investments.

Core real estate constitutes the 'anchor' for the real assets class, with a target allocation of 4% to 9% of the total fund. SCERS' core real estate holdings currently stand at 7.3% and have performed well relative to their benchmark. In 2012, SCERS conducted a search for and hired the specialist real estate consultant Townsend Group to assist Staff in developing a long-term real estate strategy. It is expected that the real estate strategic plan will be presented in 2013, with implementation beginning thereafter.

In 2012, Staff and Cliffwater began to build the private market real assets component of the real assets class by evaluating potential commitments consistent with the investment plan established in 2011. It is anticipated that the building of the private market real assets component will take up to five years to reach and maintain the 6% target allocation in this area.

Commodities currently constitute approximately 2% of the total fund and are in line with the 0% to 3% allocation range for these investments.

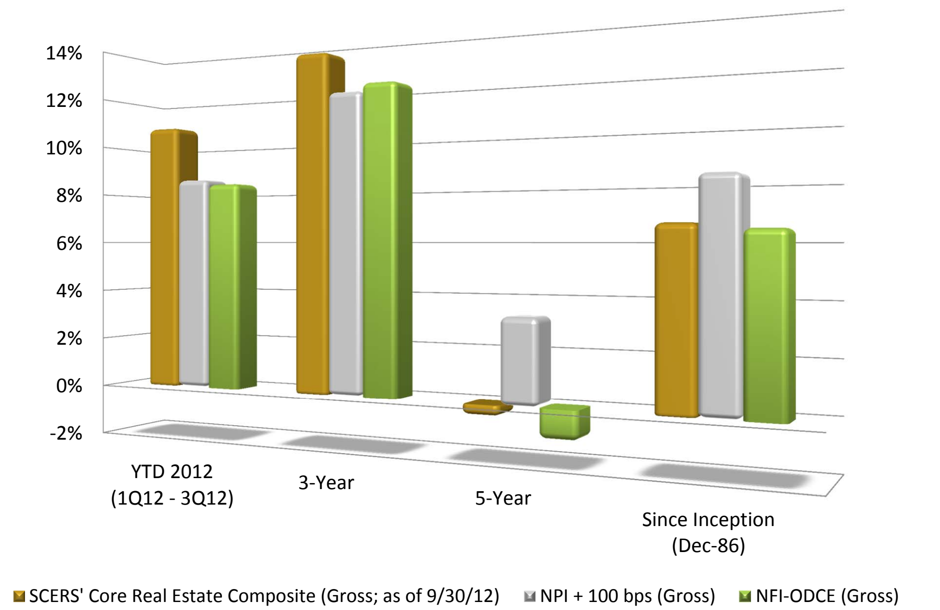
2012 Accomplishments - Core Real Estate

- Continued to press for improvement in the core real estate portfolio:
  - Improved leasing levels in underperforming properties.
  - Capitalized on lower interest rates by leveraging select core properties.
  - Sold lower conviction properties at favorable prices.
  - Purchased a new industrial property.
- Hired and began to work on a real estate strategic plan with real estate consultant, Townsend.
- Developed acquisition and disposition processes.

2012 Accomplishments - Private Real Assets

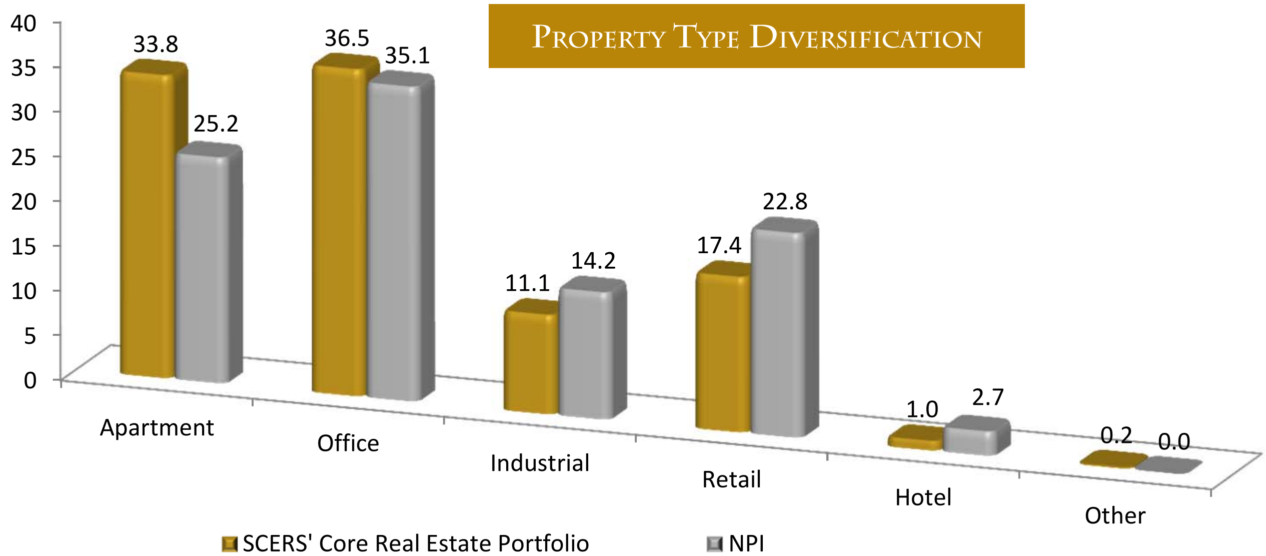
- Performed extensive due diligence on candidates, prepared multiple reports for the Board evaluating potential investments, resulting in finalizing one direct private real assets commitment:
  - EnCap Energy Capital Fund IX, L.P. (oil and gas exploration and production).

PERFORMANCE AND ATTRIBUTION - CORE REAL ESTATE

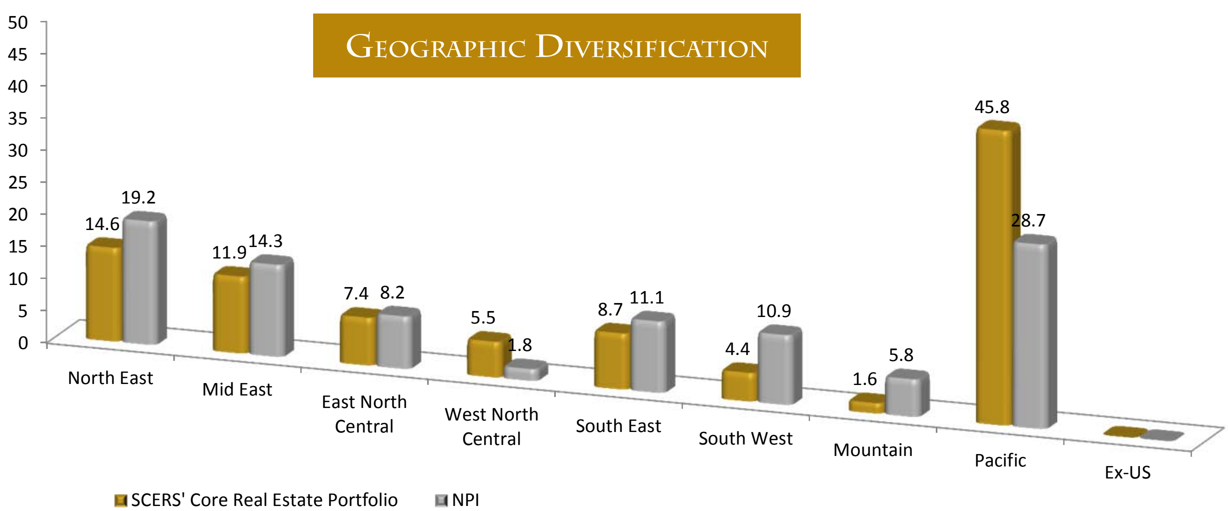


- *Calendar year-to-date as of September 30, performance of 10.8% vs. 8.6% for benchmark (NPI + 100 bps).*
- *Outperformance by separate accounts and underperformance in commingled funds .*

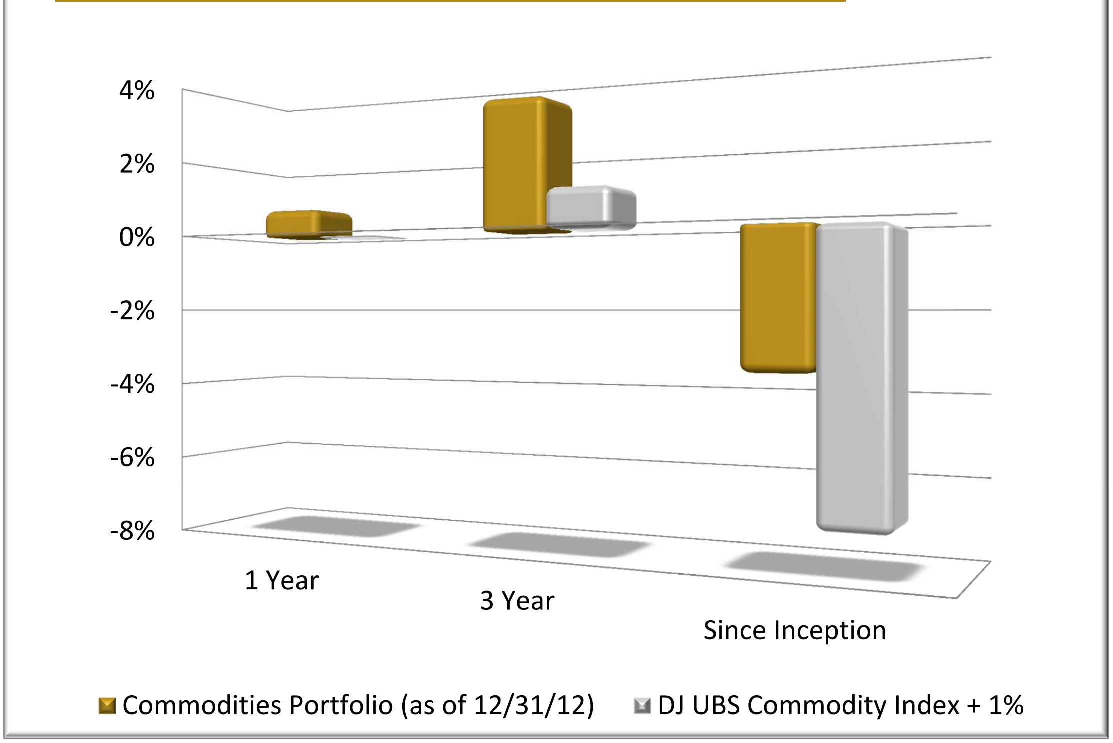
PROPERTY TYPE DIVERSIFICATION



GEOGRAPHIC DIVERSIFICATION



Performance and Attribution - Commodities



- *CY 2012: 0.73% vs. -0.06% for benchmark (DJ UBS Commodity Index +1%).*

2013 Goals - Real Assets

- Develop the long-term strategy and asset class structure for real estate assets with SCERS' consultant, Townsend.
- Identify, perform due diligence and make commitments to two to three energy and infrastructure funds.
- Reassess commodities investment managers.

Opportunities

The opportunities asset class does not have a fixed allocation, but instead has a permissible range of 0% to 5%. The asset class is designed to invest in a tactical investment theme if and when the investment markets present an opportunity with attractive risk and return attributes. Such opportunities may be short term in nature and may exist across a wide range of asset categories. If and when an opportunities investment is identified, the opportunities asset class draws the capital from the asset class with the most comparable risk and return characteristics as the investment. In this way, the potential opportunities investment is measured against and competes for an allocation relative to comparable investment opportunities in other asset classes. Based on this assessment, in some years no investments will be made in the opportunities asset class.

No new investments were made in the opportunities asset class in 2012.

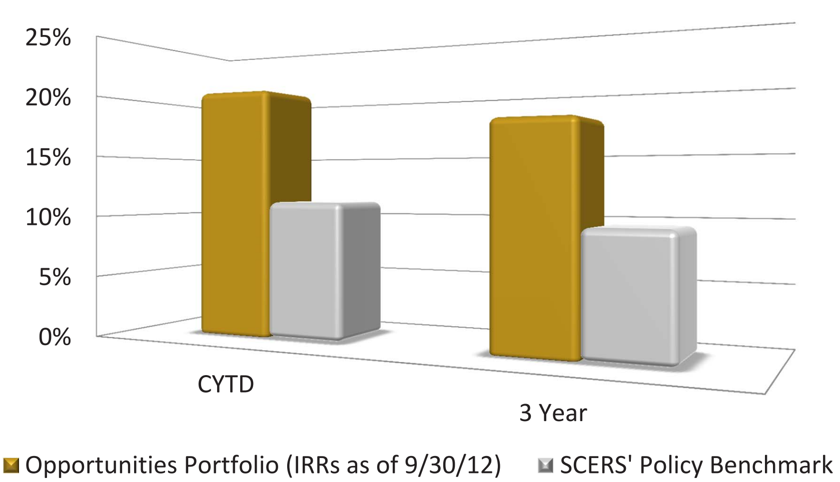
The legacy opportunities asset class currently consists of the following investments:

- SCERS' value-added real estate funds.
- PIMCO Distressed Debt Funds I and II, both of which were established to invest in non-performing mortgage debt. Both funds are in the process of returning capital.
- MetWest Enhanced TALF Strategy, which was established to invest in 2009 vintage asset backed securities as a part of the Term Asset-Backed Securities Loan Facility (TALF) program. This fund is also in the process of returning capital.

2012 Accomplishments

- Continued to realize profits from previous investments.

Performance and Attribution



- *1 Year IRR as of 9/30/12: 19.1% vs. 16.9% for benchmark (SCERS' policy benchmark).*
- *3-Year performance includes commodity performance. Commodities exposure was moved to SCERS' real assets class as of 01/01/12.*

2013 Goals - Opportunities

- Tactical investments with the right risk/return profile will continue to be evaluated in 2013.

Other Investment Activities

2012 Accomplishments in Other Investment Activities

- Oversaw and monitored existing managers.
- Modified portfolio overlay program.
- Retained Zeno Consulting to analyze currency trading of equity investment managers.
- Created and modified several investment policies:
  - Hedge fund counterparty risk policy
  - Hedge fund lock-up policy
  - Private equity fiduciary duty policy
  - Advisory board policy
- Wrote individual Investment Policy Statement (IPS) for each alternative asset class (hedge fund; private equity; real assets; and opportunities).
- Enhanced transition management:
  - Selected from broader universe of transition managers.
  - Executed two large and complex transitions in 2012 – domestic and international equities.
  - Retained Zeno Consulting to assist with transitions.

2013 Goals for Other Investment Activities

- Revise and update the overall IPS to reflect changes to the asset allocation and asset class structures.
- Modify portfolio overlay program to incorporate SCERS' current asset allocation, by adjusting for targets, ranges and proxies.
- Conduct on-site due diligence on existing managers and existing real estate properties.
- Research risk management systems for SCERS' investment program.
- Continue to assess the securities lending program.
- Conduct an investment Board retreat.

Investment Education

Investment education was an important part of the investment program in 2012, and will continue to be so in 2013.

2012 Board Education

- Fixed income – Staff and SIS:
    - The primary roles of fixed income.
    - The mechanics of bonds and bond pricing.
    - Structuring fixed income portfolios relative to a representative benchmark.
    - The various types of institutional fixed income strategies offered.
    - SCERS' fixed income structure in 2012, and key considerations for the fixed income manager structure analysis.
- Presentation by Elliott Associates on the multi-strategy, event driven hedge fund portfolio they manage for SCERS.
- Private equity investing in emerging markets – Staff and Cliffwater.
- Foreign currency trading – Staff.

2013 Board Education

- Hedge fund investment manager presentations.
- Private equity investment manager presentations.
- Development of an investment Board retreat.

Appendix

Appendix 1 - 2011/2012/2013 Road Map

Topic	2012 Preview	2012 Actual	2013 Preview
Consultant Roster	- Reassess the need and scope of a real estate consultant	- Hired real estate consultant, the Townsend Group	- Complete integration of Townsend into the consulting platform
Asset Liability Study	-Implement new target asset allocation	- Target asset allocation closer to being reached in hedge funds through direct investments and interim hedge fund component	- Reach target asset allocation in equities by completing transitions
			- Work toward hedge fund, private equity and real assets target allocations
Equities	-Terminate equity managers	- Reduced manager redundancies	- Complete equity asset transitions to bring equity allocation in line with target
	-Complete equity manager searches	- Restructured large cap equity manager structure. Hired 3 large cap managers to replace existing managers - Conducted manager search for the international developed mandate. Replaced two existing managers, hired a new manager, and increased allocation to an existing manager	- Evaluate a dedicated emerging market mandate, in particular small cap emerging market exposure - Reduce redundancies in domestic manager lineup
	-Increase passive strategies	- Increased allocation to large cap passive mandate	
Fixed Income	-Complete fixed income manager structure and consider issues outlined in 2010 and 2011 preview	- Created an enhanced fixed income asset class and manager structure	
	-Consider a static portion of liquid debt (Treasuries) in the core bond managers' mandates	- Recommended two new fixed income mandates, which were approved by the Board, an opportunistic credit mandate and a non-US mandate	- Complete manager searches for the two new fixed income mandates - Amend guidelines for existing managers for greater flexibility to invest in non-core sectors
	-Consider a change in benchmarks		- Create custom benchmarks for the new mandates
	-Begin to implement manager structure changes, if any		

Appendix 1 - 2011/2012/2013 Road Map (Continued)

Topic	2012 Preview	2012 Actual	2013 Preview
Hedge Funds	-Perform on-site due diligence and invest in 7 hedge funds directly	- Made 5 direct hedge fund investments	- Evaluate additional potential direct hedge fund investments and invest in 6-8 funds directly
		- Recommended hedge fund interim component, which the Board approved, to reach target hedge fund allocation	- Execute and fund interim hedge fund component
		- Integrated Grosvenor partnership with Staff hedge fund due diligence process	
Private Equity	-Make 6-9 commitments	- Made 6 direct private equity investments	- Identify and commit to 6-9 potential direct private equity investments
		- Presented annual report on private equity and approved 2012 Private Equity annual investment plan	- Assess the need for strategic partners and advisors for private equity segments such as emerging markets, venture capital, etc.
Real Estate / Real Assets	-Make commitments to three to five funds targeting energy and infrastructure	- Made first private real assets investment, which was a private energy fund	- Identify and commit to 2-3 private real assets funds (infrastructure and energy)
	-Assess whether any modifications need to be made in the real estate portfolio	- Refined acquisition / disposition process for core real estate separate accounts - Acquired and disposed of one property. - Improved leasing levels of existing properties	- Develop the long-term strategy and asset class structure with consultant Townsend and begin to implement the investment plan
	-Assess whether any modifications need to be made in the commodities portfolio		- Reassess commodities managers

Appendix 1 - 2011/2012/2013 Road Map (Continued)

Topic	2012 Preview	2012 Actual	2013 Preview
Opportunities	-Investigate distressed real estate, distressed European debt, structured credit and illiquid credit	- Implementation protocol modified	-Investigate potential distressed European debt and structured credit investments
Other Investment Activities	-Conduct on-site due diligence on existing managers and existing real estate holdings	- Oversaw and monitored existing managers	- Conduct on-site due diligence of existing managers and real estate investments
	-Continue to assess and monitor the direction for securities lending	- Modified overlay program	- Complete modification of overlay program
	-Analyze the effectiveness of foreign exchange trading	- Retained a consultant to analyze equity investment manager currency trading	- Assess securities lending program
		- Enhanced transition management - Executed two complex asset transitions	- Research risk management systems
	-Revise the overall investment policy statement to reflect changes	- Created and modified several investment policies	-Revise overall investment policy to incorporate individual asset class policies
	-Assess the commission recapture program and the use of 'soft dollar' benefits by managers		

1- Public Markets

a. Staff and SIS develop a list of initial manager candidates.

b. Staff and SIS select a pool of semi-finalist managers to interview at SCERS' office. The number of semi-finalist managers tends to be between 6 and 10, and each interview lasts approximately two hours.

c. Staff writes a comprehensive initial report to SCERS' Board communicating the background of the search and giving a description of each manager, including the strengths and weaknesses of each.

d. Staff and SIS select and recommend to SCERS' Board finalist candidate(s) for the mandate.

e. Staff and SCERS' fiduciary counsel develop an investment management agreement ("IMA") and negotiate terms with the new manager(s), including fees.

f. Staff writes a comprehensive final report to SCERS' Board, communicating the decision to recommend the final candidate(s).

g. The final candidate(s) present to SCERS' Board. SCERS' Board votes on the approval of the manager recommendation, in addition to potential terminations of existing managers.

h. Staff communicates the hiring and termination decisions to the respective managers.

i. Staff and SCERS' fiduciary counsel finalizes the negotiation of IMA terms with the new manager(s).

j. Staff develops a plan to transition assets (often with assistance from a transition consultant – Zeno Consulting) from terminated managers to newly hired managers. Components of the transition include:

   i. The development of cash flow movement projections among the relevant managers.

   ii. The coordination with SCERS' custodian, State Street, to transition all assets within one transition account.

   iii. The selection and hiring of a transition manager to transition all assets in aggregate within SCERS' transition account.

   iv. The coordination with the transition manager, custodian, investment managers and transition consultant.

   v. The overseeing of the execution of the transition.

   vi. The reporting of the results from Staff to SCERS' Board.

k. Staff coordinates with the new manager(s) to file Form 700, provide necessary reporting to SCERS on an ongoing basis and to participate in SCERS' commission recapture program.

l. The newly hired manager(s) take control of the custodied account(s), and initiates active management of the account(s).

2- **Alternative investments**

a. Staff and Cliffwater identify strategies and managers that fit within SCERS' strategic allocation in hedge funds, private equity, or real assets and twelve-month investment plan, for inclusion within SCERS' alternatives program.

b. Staff reviews Cliffwater investment and operational due diligence reports, as well as investment documentation provided by prospective managers.

c. In the case of hedge funds, Staff travels to prospective manager offices for comprehensive due diligence meetings, where Staff meets with several key members of a manager's investment and operations staff. The meetings typically last over two hours.

d. Staff furthers the due diligence process by leveraging other strategic partners within the investment program. An example is SCERS' hedge fund strategic partner Grosvenor or SCERS' private equity fund of funds manager Harbourvest. Partners provide Staff with their viewpoints on managers that Staff is considering within SCERS' alternative asset program.

e. Staff and Cliffwater identify manager(s) that SCERS seeks to make an allocation to as a limited partner. Several managers in the due diligence process get eliminated from consideration due to a lack of fit within SCERS' existing alternatives portfolio, investment-related issues with a manager or operational-related issues with a manager.

f. Staff writes an initial due diligence report to SCERS' Board, identifying a manager under consideration.

g. Staff reaches out to the manager for all investment documentation, including the private placement memorandum, the limited partnership agreement and the subscription documents. These documents are reviewed by SCERS' outside legal counsel, internal legal counsel, as well as SCERS' Staff.

h. Negotiations are entered into with the manager's counsel by SCERS' outside legal counsel, internal counsel and Staff. The negotiations include the development of a side letter to the fund's legal documents.

i. Staff writes a comprehensive final due diligence report to SCERS' Board communicating the decision to allocate to the fund, and the reasons why an allocation is being made.

j. SCERS' Board has the opportunity to express questions or concerns throughout this process.

k. Staff arranges for signature and counter-signature of all documents, followed by the wiring of funds to the manager in the case of a hedge fund.

SCERS
Sacramento County
Employees'
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