



Board of Retirement Regular Meeting

Sacramento County Employees' Retirement System

Agenda Item 16

MEETING DATE: September 15, 2021

SUBJECT: William Blair International Small Cap – Account Conversion

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

RECOMMENDATION

Staff recommends the Board approve the conversion of the William Blair International Small Cap account from a separately managed account to a commingled fund structure and authorize the Chief Executive Officer to execute any necessary agreements related to the transaction.

PURPOSE

This agenda item complies with SCERS' investment policy statement and contributes to the effective management and oversight of investment activities.

SUMMARY

Staff and Verus recommend that SCERS convert the international small cap public equity mandate with William Blair from a Separately Managed Account (SMA) to the commingled Collective Investment Trust (CIT) fund product. The account conversion will reduce the administrative and regulatory burden on Staff that is required under the SMA structure, including eliminating direct costs associated with meeting regulatory requirements, while also potentially increasing investment performance for the account. Converting the account includes one-time transition costs, which are estimated to be approximately six basis points (\$75,000), consisting of trading costs and fees. The CIT product offers the same management fee that SCERS is currently paying William Blair for the separately managed account. The size of the mandate with William Blair is approximately \$134.1 million as of July 31, 2021, which represents 1.1% of the total SCERS portfolio and 5.5% of the international equity portfolio.

BACKGROUND

William Blair has been an investment manager for the International Small Cap segment of SCERS' public equity portfolio since 2009. Since inception, William Blair has produced strong returns, generating 11.4% annualized returns and outperforming the MSCI World ex-US Small Cap benchmark return of 9.7%. SCERS has been invested with William Blair through a Separately Managed Account (SMA), which allows for a customized Investment Management Agreement with William Blair and custody of securities through SCERS' custodian, State Street Bank. However, for an international equity portfolio with custody of assets and an SMA, SCERS

is required to meet numerous regulatory requirements so the investment manager can gain access and trade securities across a wide range of countries and equity markets. Examples of the requirements include annual regulatory filings certifying SCERS as a qualified foreign institutional investor, filing tax returns in foreign countries (to ensure SCERS is qualifying as a tax-exempt entity and isn't paying tax), and providing power of attorney to foreign sub-custodians of State Street Bank (to act on SCERS' behalf in foreign markets). Fortunately, State Street Bank helps review, monitor, and facilitate the filing of documents necessary to maintain access to the foreign equity markets in which SCERS invests through the international small cap portfolio with William Blair. Despite the assistance from State Street, meeting the regulatory demands requires a significant amount of time from SCERS' investment staff and legal counsel. Additionally, SCERS utilizes outside vendors to file tax returns in foreign countries as needed, which is a direct expense to SCERS. Transitioning the international small cap mandate with William Blair from an SMA to a commingled fund product will reduce both the regulatory burden on Staff and the direct expenses to SCERS.

SCERS has had multiple conversations with William Blair to discuss the option of transitioning the account from an SMA into the Collective Investment Trust (CIT). Topics covered during our conversations included:

- Comparison of CIT versus SCERS' SMA
 - Performance Comparison
 - Liquidity
 - Assets Under Management
- Management Fees
- Legal Considerations
- Transition Process
 - Timing
 - Trading versus Transferring Securities

SMA versus CIT

As noted above, while the SMA offers the benefits of having custody over the securities and a customized investment management agreement, it also comes with the burdens of extensive regulatory requirements and direct expense costs. The regulatory burdens come from the differing laws and regulations across foreign countries and equity markets. The regulatory burdens are predominately from emerging markets countries, particularly India. The international small cap mandate with William Blair includes investments in both developed and emerging markets. SCERS' other investments in international small cap and emerging markets are made through commingled funds. Through the CIT commingled fund structure, the burdens on the investor are significantly reduced because the investment manager maintains custody of the assets and is responsible for ensuring compliance with foreign market regulatory requirements.

From a performance perspective, the CIT structure has outperformed SCERS' SMA, particularly over the past five years (see below). Per discussions with William Blair, the performance difference over the past several years is due to outperformance of Taiwan securities, which are not available to SCERS in the SMA structure. While performance differences tend to even out over time, and could vary from year-to-year, the CIT structure offers the full range of investment opportunities and more fully reflects the composite performance for the strategy.

Performance through 7/31/21	YTD	1 Year	3 Year	5 Year	10 Year
SCER's gross	10.99	36.10	14.99	13.67	10.46
CIT gross	11.50	38.25	16.14	14.13	10.45
Relative Performance	-0.51	-2.14	-1.16	-0.46	0.01

The CIT fund offers daily valuations and liquidity. It does not have a gating provisions or restrictions on rebalancing. In some cases, the CIT structure can provide a better liquidity profile than a SMA, depending on the level of assets under management in the SMA, as rebalancing out of a less liquid position in an SMA may require several days to liquidate (without causing a negative price impact on the security). As of July 31, 2021, total assets under management in the strategy were approximately \$3.4 billion, which was comprised of \$2 billion in separately managed accounts, \$960 million in the CIT, and \$380 million in mutual fund assets.

Management Fees

The CIT fund offers the same tiered management fee that SCERS is currently paying for the separately managed account. The management fee schedule for the both the CIT and SMA is:

Investment Amounts	Investment Management Fee
First \$20 million of assets	1.00%
Next \$30 million of assets	0.90%
Next \$50 million of assets	0.85%
Next \$50 million of assets	0.80%
Over \$150 million of assets	0.75%

Based on SCERS' current AUM with William Blair of approximately \$134 million, the effective fee rate is 0.87% annually. The CIT does charge operating expenses to the fund, with a cap of 10 basis points. Per discussion with William Blair the actual operating expense charge has been approximately 4 basis points in recent years. The operating expense charge is partially offset by the reduced expenses charged by service providers, such as accountants hired by SCERS to file foreign tax returns.

Legal Considerations

The separately managed account has the benefit of allowing SCERS to enter into a customized investment management agreement, including customized investment guidelines. However, one of the downsides to the SMA is the inability to access certain markets, such as Taiwan, due to burdensome regulatory requirements. Additionally, SCERS has needed to adjust investment guidelines, based on changing market conditions, which requires legal review. The CIT structure allows for the full range of investment opportunities, without the heavy legal and regulatory requirements, which are handled by the investment manager. Additionally, while SCERS is bound to the overall investment guidelines of the CIT fund, SCERS will enter into a separate side letter with William Blair, to enforce SCERS' specific policies (such as Fiduciary Duty and Placement Agent Policies), as well as California specific legal requirements. SCERS previously negotiated a side letter agreement with William Blair when it was invested in their Small Cap Emerging Markets Equity Fund, which is a commingled fund similar to the CIT structure. SCERS

will ensure adequate side letter language is approved prior to transitioning the account to the CIT fund.

Transition Process

SCERS has had discussions with William Blair on the different options available for transferring its investment from a SMA into the CIT Fund. Per discussions with William Blair, the majority of securities held in custody by SCERS could transfer in-kind to the CIT. This would reduce transaction costs while also allowing SCERS to maintain market exposure during the transition. William Blair estimated that approximately 85% of the portfolio could transfer in-kind, while the remaining 15% would need to be liquidated and re-purchased. There are certain foreign markets (i.e. India, Brazil, China) that don't allow a transfer in beneficial ownership of securities, and would therefore require the sale of securities and corresponding purchase of shares in the CIT. SCERS will work with William Blair on the most efficient manner to execute the transition, with the goal of minimizing costs and maintaining desired market exposure throughout the process.

Next Steps

Following Board approval, SCERS will begin legal review of the CIT Fund documents and negotiation of a SCERS specific side letter. As mentioned previously, given our ongoing discussions with William Blair, and the previously negotiated side letter for the EM Small Cap fund investment, we are hopeful that there will be minimal issues from the legal review process. With the daily liquidity of the CIT Fund, SCERS has flexibility to work with William Blair to determine appropriate timing for the signing of documents and transition of assets. We expect the transition to be completed in the fourth quarter of 2021.

ATTACHMENTS

- Board Order

Prepared by:

/S/

Brian Miller
Senior Investment Officer

Reviewed by:

/S/

Steve Davis
Chief Investment Officer

/S/

Eric Stern
Chief Executive Officer



Retirement Board Order

Sacramento County Employees' Retirement System

**Before the Board of Retirement
September 15, 2021**

MOTION:

William Blair International Small Cap – Account Conversion

THE BOARD OF RETIREMENT hereby accepts the recommendation of staff to convert the William Blair International Small Cap account from a separately managed account to a commingled fund structure and authorize the Chief Executive Officer to execute any necessary agreements related to the transaction.

I HEREBY CERTIFY that the above order was passed and adopted on September 15, 2021 by the following vote of the Board of Retirement, to wit:

AYES:

NOES:

ABSENT:

ABSTAIN:

ALTERNATES (Present but not voting):

Richard B. Fowler II
Board President

Eric Stern
Chief Executive Officer and
Board Secretary