



Board of Retirement Regular Meeting

Sacramento County Employees' Retirement System

Agenda Item 20

MEETING DATE: April 19, 2023

SUBJECT: Dedicated Cash Allocation

SUBMITTED FOR: Consent **Deliberation and Action** **Receive and File**

RECOMMENDATION

Reallocate Absolute Return redemption proceeds into SCERS' dedicated cash allocation on an interim basis, instead of the Overlay Program, while a replacement search is conducted.

PURPOSE

This item supports the Master Investment Policy Statement, which identifies ranges across SCERS' targeted asset class allocations to allow for marginal adjustments as market opportunities arise.

DISCUSSION

Staff and Verus recommend placing a portion of recently received Absolute Return redemption proceeds into SCERS' dedicated cash allocation, which is invested in the secured overnight financing rate (SOFR), rather than SCERS' Overlay Program to take advantage of a higher yield with less duration and interest rate sensitivity, while also maintaining greater liquidity.

SCERS recently placed two Absolute Return full redemptions from the following funds:

- \$48 million – Two Sigma Risk Premia Enhanced Fund, L.P.
- \$61 million – Sculptor Domestic Partners II, L.P.

The Two Sigma redemption was made to reduce SCERS' overweight to the Absolute Return asset class, with the proceeds received in early April, and which will be designated for upcoming rebalancing within the Global Equity portfolio.

Related to the Sculptor redemption, Staff and Cliffwater expect to initiate a manager search for a replacement Absolute Return fund over the next few quarters. The Sculptor proceeds, most of which were received in early April, will be used to fund the replacement fund. In the interim, Staff

and Verus recommend putting the Sculptor proceeds into SCERS' dedicated cash allocation rather than into the Overlay Program. The dedicated cash allocation invests in SOFR, which is an influential interest rate that banks use to price U.S. dollar-denominated derivatives and loans. SOFR closely mimics the yield of short duration 90-day T-bills, whereas the Overlay Program would replicate the exposure using longer duration bonds (mostly 10-Year duration Treasuries and some mortgage TBAs (government agency bond exposure)).

SOFR is currently yielding approximately 4.8% (same as 90-day T-Bills), as of April 4, 2023, which has increased dramatically as the Federal Reserve has raised interest rates to bring down inflation. SOFR was yielding close to 0% when interest rates were near zero at the start of 2022. The current 4.8% SOFR rate compares to a current 3.3% yield on a 10-year Treasury bond, the lower yield a result of the well-documented inverted yield curve.

SOFR also provides very little interest rate risk compared to longer duration Treasuries. Holding longer dated Treasuries incurs potential volatility due to being more susceptible to interest rate movements. Duration is defined by how long in years a bond investor is repaid a bond's price, and the sensitivity of the price of a bond to a change in interest rates. The longer the maturity, the higher the duration and the greater the sensitivity to interest rates. As interest rates go up, bond prices go down, and as interest rates go down, bond prices go up.

Placing the proceeds in SOFR also allows SCERS to maintain greater liquidity to weather duration/yield curve dynamic changes.

The adjustment will reduce SCERS' Absolute Return exposure below its target allocation, and increase the Dedicated Cash exposure above its target allocation. Both asset classes will still be within the approved ranges:

- Absolute Return will have an actual allocation of 6.5% compared to the 7.0% target allocation, but will be within the range of 5% to 9%
- Dedicated Cash will have an actual allocation of 1.3% compared to the 1.0% target allocation, but will be within the range of 0% to 2%

The adjustment is expected to be temporary until a replacement manager for Sculptor is identified and allocated to over the next few quarters.

However, the adjustment could be a prelude to a future strategic asset allocation revision. A consideration going forward is to maintain a larger target dedicated cash allocation to keep up with the gap between benefit payments going out and contributions coming in. Like many public pension plans, SCERS is a mature plan with negative cash flows, meaning member benefit payments going out are greater than employer and employee contributions, and net investment income, coming in on an annual basis. As presented during SCERS' annual liquidity study in September 2022, SCERS' current net cash flow as a percentage of plan assets is -1.47%. The negative cash flow figure is expected to increase to over 3% over the next five years. Potentially increasing the dedicated cash allocation to serve as a liquidity buffer in line with this forecasted cash flow deficit could become a necessity in order to maintain a meaningful illiquid allocation within the private markets while still having ample cash on hand to meet SCERS' liquidity needs.

A future strategic asset allocation revision could also reduce some of the complexity and risk within SCERS' portfolio given the more attractive returns from simple investments with less risk.

The implementation of the recommended interim adjustment entails instructing State Street to increase the cash/SOFR allocation by \$61 (the amount of the Sculptor proceeds), and informing SSGA, who manages the Overlay Program of the interim adjustment.

ATTACHMENT

- Board Order
- Presentation on Reallocation of Redemption Proceeds

Prepared by:

Reviewed by:

/S/

/S/

Steve Davis
Chief Investment Officer

Eric Stern
Chief Executive Officer



Retirement Board Order

Sacramento County Employees' Retirement System

Before the Board of Retirement
April 19, 2023

AGENDA ITEM:

Dedicated Cash Allocation

THE BOARD OF RETIREMENT hereby approves Staff's recommendation to reallocate upcoming Absolute Return redemption proceeds into SCERS' dedicated cash allocation on an interim basis, instead of the Overlay Program, while a replacement search is conducted.

I HEREBY CERTIFY that the above order was passed and adopted on April 19, 2023 by the following vote of the Board of Retirement, to wit:

AYES:

NOES:

ABSENT:

ABSTAIN:

ALTERNATES:
(Present but not voting)

Keith DeVore
Board President

Eric Stern
Chief Executive Officer and
Board Secretary



Dedicated Cash Allocation

April 19, 2023

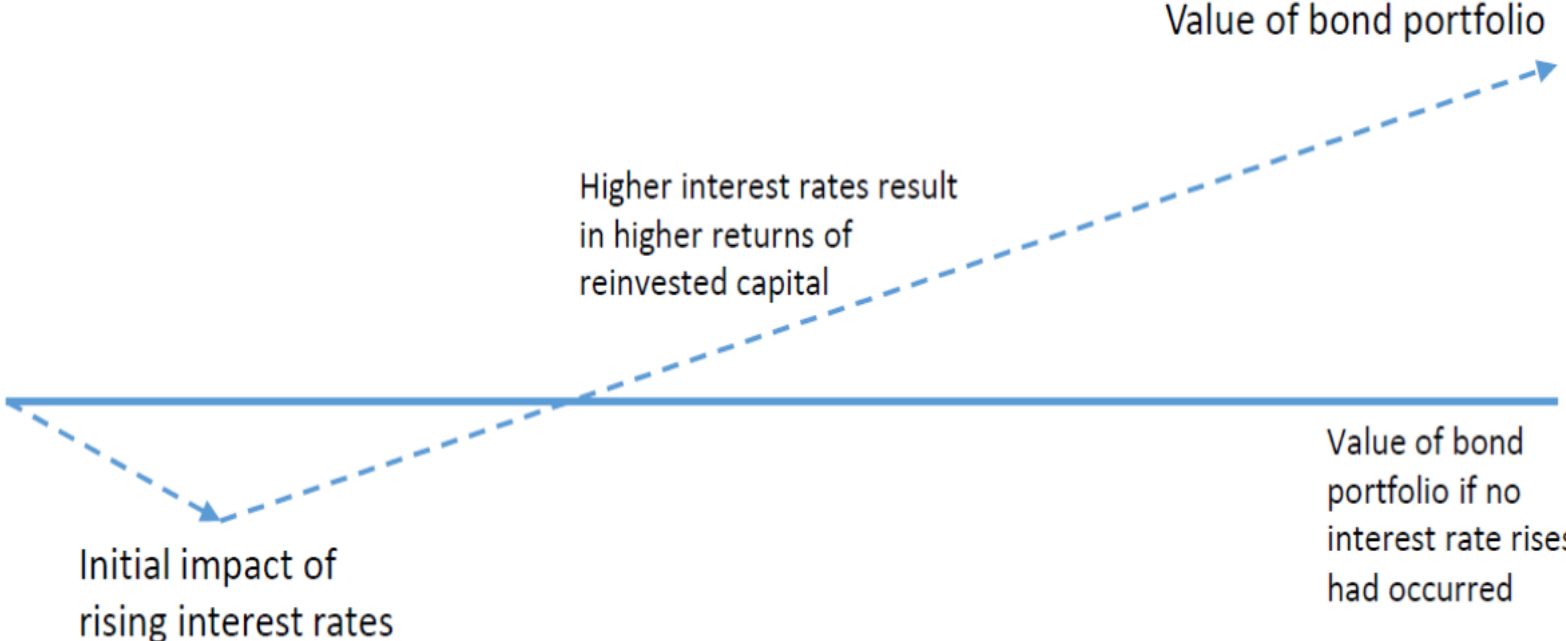
Recommendation

Staff and Verus recommend placing recent Absolute Return redemption proceeds into SCERS' dedicated cash allocation

- Rather than SCERS' Overlay Program
- Take advantage of a higher yield with less duration and interest rate sensitivity
- \$61 million in upcoming Absolute Return proceeds

Higher Yields

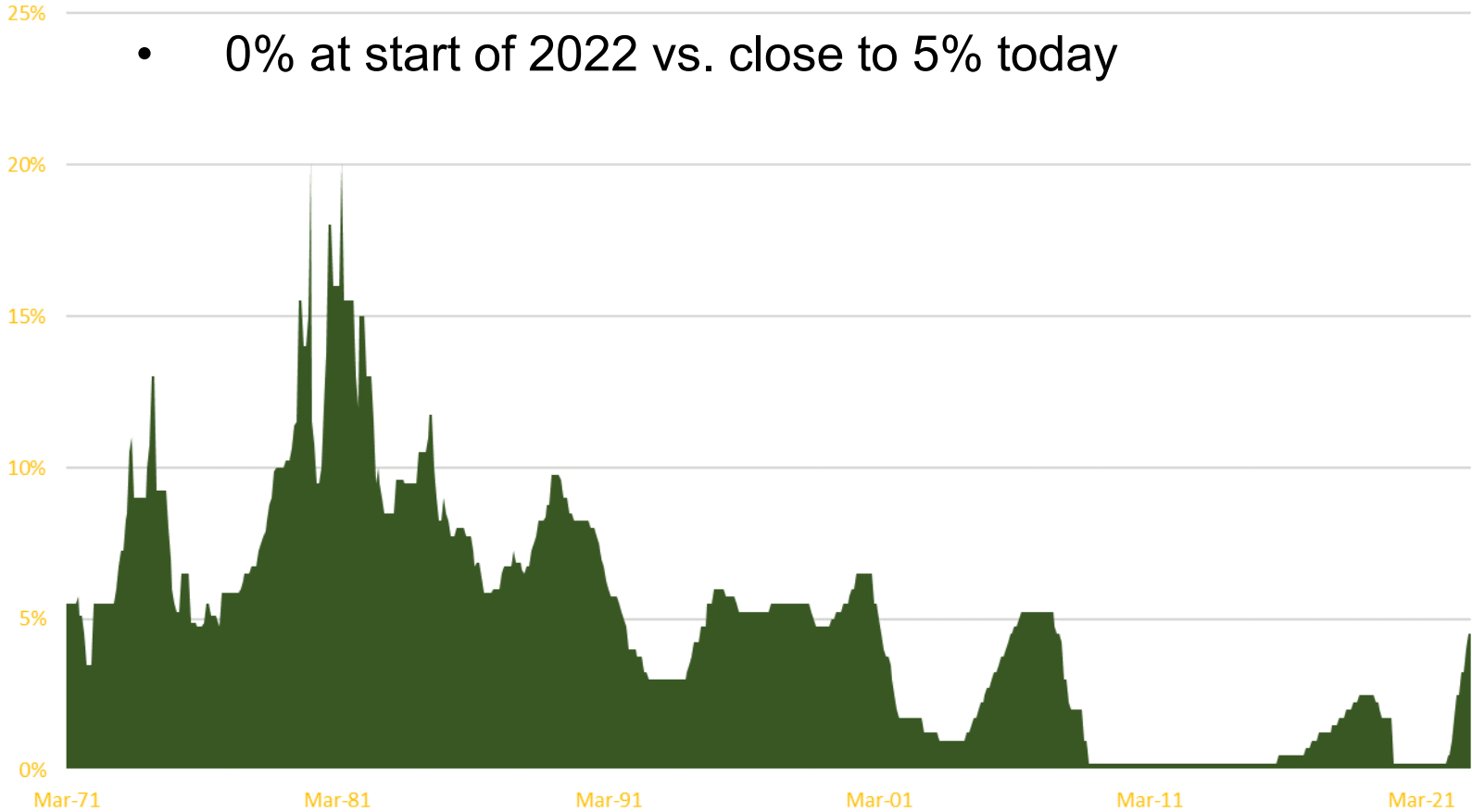
Rising interest rates caused losses in 2022, but could benefit portfolios in the future



Source: Verus

Fed Funds Rate

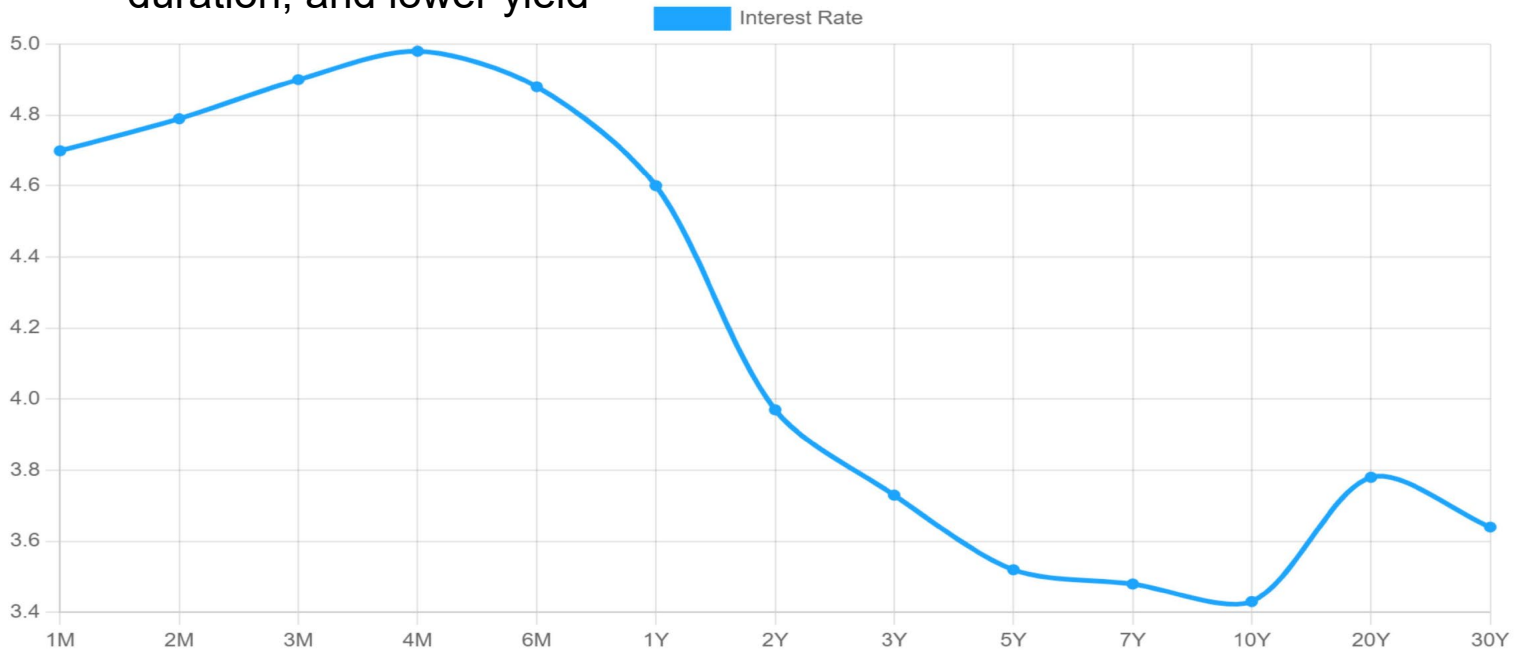
- Short-term interest rates are at their highest point since before the GFC
- 0% at start of 2022 vs. close to 5% today



Source: Federal Reserve, as of 1/31/23; Verus

Yield Curve

- Short-term interest rates yielding higher than longer-term rates – inverted yield curve
 - Less duration and interest rate risk, and greater liquidity
- SCERS implements cash allocation with SOFR; similar tracking to 3-month T-Bills
- Overlay program replicates Bloomberg Aggregate Bond Index – longer rates and duration, and lower yield



Source: ustreasuryyieldcurve.com

SCERS Exposures

Expected Absolute Return and Cash allocations within range

Asset Class	Minimum	Target	Maximum	Expected Actual Allocation
Absolute Return	5%	7%	9%	6.5%
Cash	0%	1%	2%	1.3%

Next Steps

- Instruct State Street to use Absolute Return proceeds to increase cash allocation
- Inform State Street Global Advisors (Overlay Manager) of interim change
- Unwind interim cash allocation once a replacement Absolute Return fund is implemented
- Increased cash adjustment could be a prelude to a future strategic asset allocation revision