



Board of Retirement Regular Meeting

Sacramento County Employees' Retirement System

Agenda Item 18

MEETING DATE: December 6, 2023

SUBJECT: Education: Asset Protection

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

RECOMMENDATION

Receive and file presentation from State Street Bank and Trust, Verus Advisory, and Cliffwater.

PURPOSE

This item contributes to the effective management and oversight of investment activities.

DISCUSSION

The objective of this presentation is to provide education to the SCERS Board on where SCERS' assets are held across the portfolio. Earlier in the year, in the aftermath of the Silicon Valley Bank crisis, the Board communicated its interest in better understanding where SCERS' assets, including cash, are held and how they are protected.

The presentation will address this by walking through various tranches of SCERS' investment portfolio. Assets within SCERS' portfolio are held with various custodians, prime brokers, and banking institutions, and also within a variety of investment structures. At a high level, the presentation will differentiate between those assets that are held at SCERS' custodian State Street, versus those assets that are held outside of State Street. The presentation will also differentiate between publicly traded assets, and alternative and privately held assets, as well as by investment structure, such as commingled funds, open-end funds, and closed-end limited partnerships.

The presentation will be provided by a combination of SCERS Staff, SCERS' custodian State Street, SCERS' general investment consultant Verus, and SCERS' alternative assets consultant Cliffwater.

ATTACHMENTS

- Board Order
- Asset Protection Presentation

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
December 6, 2023

AGENDA ITEM:

Education: Asset Protection

THE BOARD OF RETIREMENT hereby accepts the recommendation of staff to receive and file presentation from State Street Bank and Trust, Verus Advisory, and Cliffwater.

I HEREBY CERTIFY that the above order was passed and adopted on December 6, 2023 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



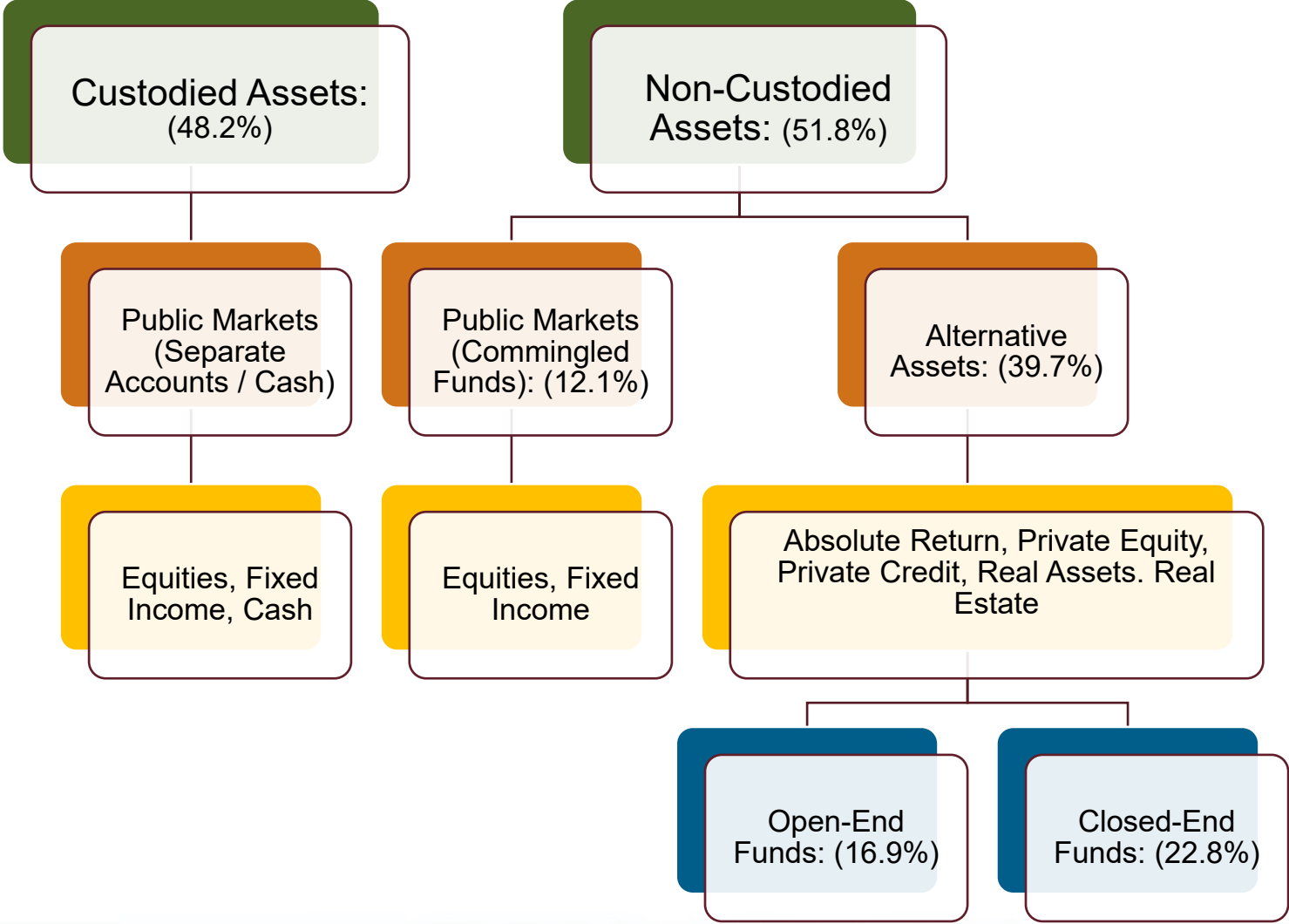
Education – Asset Protection

December 6, 2023

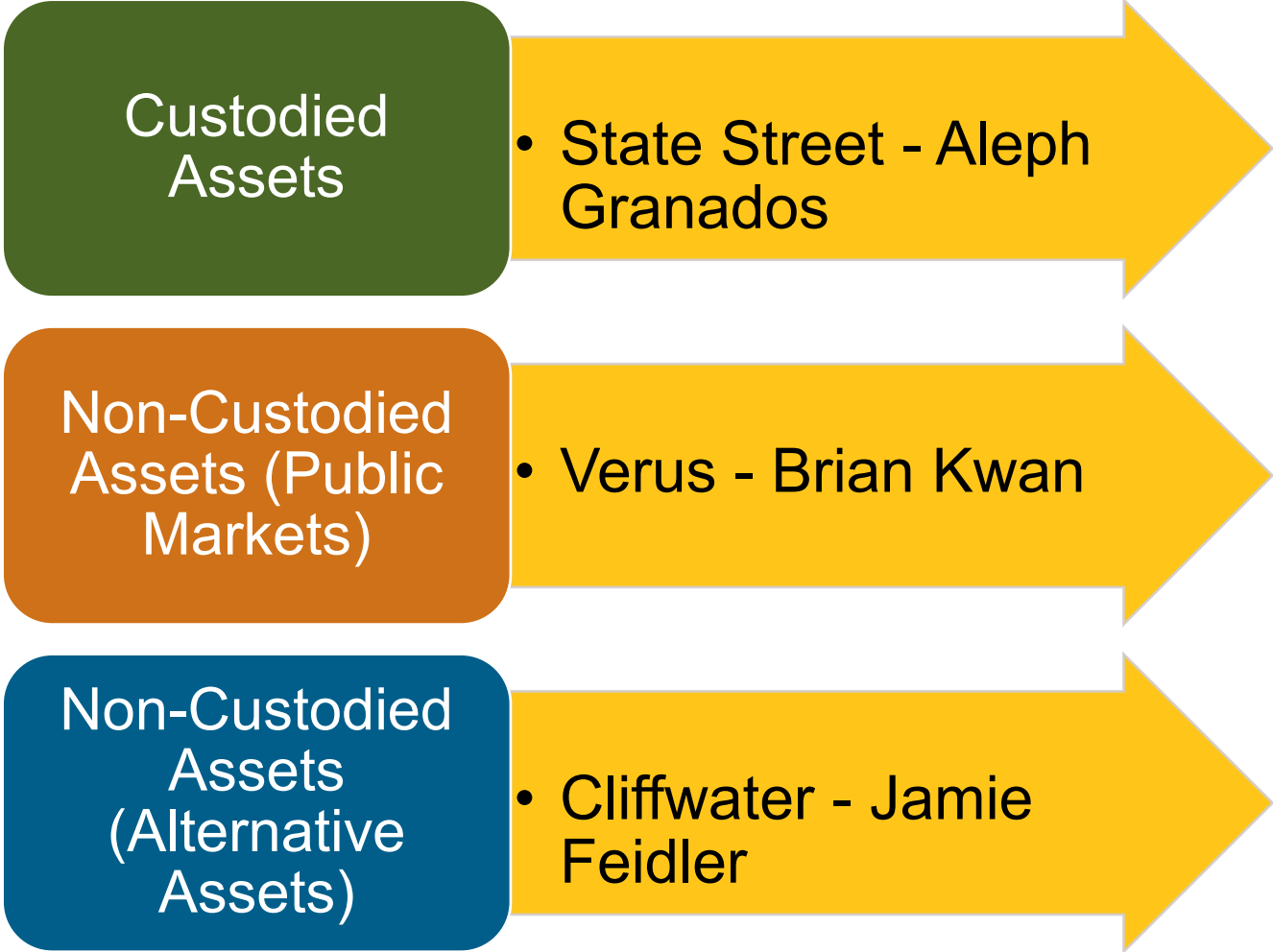
Introduction

- Provide education to the SCERS Board on where SCERS' assets, including cash, are held across the portfolio and how they are protected
- Present through various portfolio tranches
- Group presentation
 - Staff, State Street, Verus, Cliffwater

Portfolio Tranches



Presentation Order















Sacramento County Employees' Retirement System (SCERS)

Assets at State Street
December 6, 2023



State Street at a Glance

 <p>\$39.6T in assets under custody and/or administration¹</p>	<p>\$3.8T in assets under management¹</p>	<p>Responsible for close to 10% of the world's assets²</p>	 <p>4th largest asset manager globally⁵</p>
<p>Servicing 43% of all US mutual funds³</p> 	<p>~43,000 employees worldwide⁴</p> 		
 <p>3rd largest global ETF provider⁵</p>	 <p>2nd US Defined Benefit manager⁵</p>		<p>No. 1 Manager of passive global equity⁵</p>
<p>Presence in 100 geographic markets⁶</p> 	 <p>230 Years of experience</p>		<p>No. 1 in ETF servicing⁷</p>

1. As of June 30, 2023
 2. Represents State Street AUC/A divided by Global Financial Assets, including Global Equity, Global Debt Securities and Global Broad Money (M3), as of December 31, 2022. Sources: SIFMA, OECD, World Bank
 3. Based on State Street mutual fund assets as of December 31, 2022, as compared to total mutual fund assets as reported by the ICI Monthly Trends Report for December 2022.
 4. As of June 30, 2023
 5. *Pensions & Investments* Research Center, as of December 31, 2022
 6. As of June 30, 2023
 7. State Street analysis of ETFGI Global Insights Report November 2022

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State Street Corporation

One of the world's largest providers of financial services to institutional investors. Through our subsidiaries, including our principal banking subsidiary, State Street Bank and Trust Company, we operate in more than 100 markets worldwide.

As such, we and each of our US depository institution subsidiaries are expected to be well capitalized and well managed.

Regulatory Landscape

Dodd-Frank Wall Street Reform and Consumer Protection Act:

- Large bank holding company subject to enhanced supervision and prudential standards, commonly referred to as a 'Systemically Important Financial Institution', or SIFI.

Financial Stability Board & Basel Committee on Banking Supervision:

- 'Global Systemically Important Bank', or G-SIB.

Both of these designations require:

- Hold incrementally higher regulatory capital compared to financial institutions without such designations.
- Subject to extensive regulation and supervision with respect to our operations and activities.
- Undergo significant testing to ensure financial strength and maintain State Street Bank and Trust Company's US FDIC insurance coverage.

The Securities You Custody with State Street

Client securities are segregated from the proprietary assets of State Street, its sub-custodians and depositories and are not available to satisfy the obligations of State Street to our creditors.

- Securities held with State Street:
 - Do not appear on State Street's balance sheet
 - Are identified as client assets on books and records maintained by State Street
- Securities held globally within our network of sub-custodians :
 - Are recorded on the books and records of the sub-custodian as held by State Street on behalf of our clients and segregated from the assets of the sub-custodian.
- Securities maintained at a depository:
 - Are segregated by the use of separately designated participant accounts. In each case, subject to any local market requirements or practice.

Cash Held at State Street and at Its Sub-custodians

Cash, unlike securities, is fungible. Cash cannot be registered in the name of or identified as beneficially owned by a client, nor can it practically be held in physical segregation.

- Cash held with State Street:
 - Held in demand deposit accounts (“DDAs”) opened with State Street or one or more of our sub-custodians, as appropriate.
 - As a depositor of State Street or a sub-custodian, a debtor-creditor relationship is established, and you have a repayment obligation due from us or the sub-custodian.
 - For currencies, designated as “on-book” currencies, your credit risk is to State Street, subject to applicable FDIC or other governmental insurance programs.
 - For currencies held “off-book,” your credit risk is to the applicable sub-custodian.
 - The US Dollar Cash Sweep Program (“STIF”) in which you invest your cash, is not considered a bank deposit.

Credit Ratings

	Moody's Investor Services	Standard & Poor's	Fitch, Inc.
State Street Corporation			
Senior Debt	A1	A	AA-
Subordinated Debt	A2	A-	A
Junior Subordinated Debt	A3	BBB	NR
Preferred Stock	Baa1	BBB	BBB+
State Street Bank and Trust Company			
Short-Term Deposits	P-1	A-1+	F1+
Long-Term Deposits	Aa1	AA-	AA+
Senior Debt / Long-Term Issuer	Aa3	AA-	AA
Subordinate Debt	Aa3	A	NR
Outlook	Stable	Stable	Stable
Last Change	04/19/2016	12/02/2015	04/03/2020

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Expiration date: 10.01.2024

SCERS' commingled funds

SCERS is currently invested in 8 commingled funds across public equity and public fixed income:

- ARGA Emerging Markets Equity
- Artisan Partners Global Opportunities
- Brigade Credit Opportunities
- DE Shaw Broad Market Core Alpha
- JP Morgan US Large Cap Core 130/30
- Oaktree Emerging Markets
- Nikko Global Equity
- William Blair International Small Cap Growth

Third-party custodians for the above strategies include:

- Citi
- Northern Trust
- State Street
- Wells Fargo

Commingled funds offer efficiencies when investing internationally (particularly emerging markets) due to varying complexities involved with custody across countries

Summary

- Similar to mutual funds, commingled funds are pooled investment vehicles managed collectively with a common investment strategy.
 - In both cases, investors own shares of the pooled fund at a third-party custodian and do not own any underlying securities directly.
 - Mutual fund shares can be held with each investor’s custodian using an omnibus account.
 - Commingled fund shares, however, remain with the third-party custodian.
- While similar, commingled funds are subject to different regulatory requirements because they are only available to qualified retirement plans; most mutual funds are also available to retail investors.
- Commingled funds have increased in popularity, primarily due to their ability to offer lower overall costs while maintaining fiduciary standards.
- Compared to mutual funds, different regulatory requirements allow commingled funds to have:
 - No SEC filing requirements
 - Lower marketing costs and overhead
 - Lower potential trading costs (through cross-trading)
 - More flexibility in customized pricing
 - Potential tax advantage for international investments

Commingled funds vs. mutual funds

Attribute	Commingled funds	Mutual Funds
Sponsor	Bank or trust company	Asset management company
Investors	Qualified retirement plans	Most retirement plans and retail investors
Regulatory Body	<ul style="list-style-type: none"> • Office of the Comptroller of Currency (OCC) • Internal Revenue Service (IRS) • Department of Labor (DoL) 	<ul style="list-style-type: none"> • U.S. Securities and Exchange Commission (SEC)
Governing Documents	<ul style="list-style-type: none"> • Declaration of trust • Investment guidelines • Participation agreement 	<ul style="list-style-type: none"> • Prospectus • Statement of additional information (SAI) • Account application
Fund Information	May be limited	Extensively available
Reporting	Audited financial statements	Annual report
Share classes	Can have multiple	Can have multiple
Fee disclosures	<ul style="list-style-type: none"> • Disclosed as trustee fee • Expenses can be netted out of the NAV or billed separately to the Plan 	<ul style="list-style-type: none"> • Disclosed as an expense ratio • Expenses are netted out of the NAV
Negotiated pricing	Yes	No
Liquidity	Varies	Daily
Valuation	Varies	Daily

Investment process

- Review fund documents
- Execute subscription agreement and any supporting documents
- Trade details are finalized, and cash is wired from SCERS' custodian to the commingled fund's third-party custodian
- Detailed accounting statements for SCERS regarding shares owned, NAV, cash flows, etc. are provided regularly by the fund administrator
- Contributions and Redemptions:
 - Requests are submitted with trade details to the fund administrator
 - Cash proceeds are wired between SCERS' custodian and third-party custodian

Evaluating third-party custodians

There are 2 primary risks at the custodian-level:

- 1) Insolvency risk
- 2) Operational risk

All assets, other than cash, are held in nominee accounts or in the name of the client itself (separate from bank assets). Therefore, operational risk is the primary risk when assessing commingled fund custodians. Operational due diligence is focused on the following:

- Regulatory: determine the regulatory agency that supervises and monitors the custodian.
 - Have there been any notices or investigations levied by any regulator?
 - What were the results of the latest regulator exam?
- Audit: does the custodian have a SOC-1 report or control report issued by a major audit firm?
 - Are there any deficiencies or issues noted in the report?
 - Is there a proper control environment in place?
 - Are policies and procedures being followed?
 - Are proper technology controls in place?



Los Angeles • New York

Sacramento County Employees' Retirement System
Educational Presentation on Asset Protection for Alternative Investments

December 6, 2023

Alternative Asset Investment Strategies

Important to focus on custody and safety of assets invested in alternative strategies

- Independent custody (“custodied away” from investors)
- Can include esoteric investments, often not exchange traded, public and private
- Multiple counterparties
- Global investment universe
- Cash flows are outside of investors’ control

Cliffwater maintains a dedicated focus on operational due diligence for alternatives

- Evaluate and assess business risk and adherence to operational best practices
- Complements investment and legal due diligence processes, and work done by SCERS

Custody and safety of assets is an important component of the operational due diligence

- Other key areas of focus include governance; operational infrastructure, controls, and processes; investor transparency; valuation; and external service providers

Custody and Safekeeping of Assets

Key Providers

- Custodians
 - Common custodians include State Street, The Bank of New York Mellon, and Northern Trust
- Prime Brokers
 - Typically specialized divisions of large investment banks
 - Provide various portfolio and trading-related services including financing, trade clearing, reporting, and custody services
 - Larger prime brokers include JPMorgan, Goldman Sachs, Morgan Stanley, Citigroup, UBS
- Additional banking relationships
 - Can provide differing services depending on utilization needs

Important aspects of custody

- Can be provided by traditional custodians, prime brokers, or banking institutions
- Assets held in custody are segregated from other client or general use assets and liabilities
- Providers offer additional services related to the holding and safekeeping of assets

Alternative investment managers may have additional service providers that are integrated into these processes, though may not directly control underlying assets

- Common examples include fund administrators and transfer agents

Absolute Return Strategies (Hedge Funds)

Flow of Funds

- Investors typically fund 100% of their desired investment at the inception of the investment
- Money is sent to the hedge fund’s administrator or prime broker
 - The investor is allocated a pro-rata share of the assets within the hedge fund
 - The investor will participate in new investments made by the hedge fund while invested
 - Investors can withdraw capital at their discretion, subject to the hedge fund’s liquidity provisions (i.e. hedge funds are often considered “semi-liquid” investments)

Prime brokers hold the majority of the hedge fund’s assets

- Assets include securities and cash balances
- Assets held at the prime broker are segregated from other client or firm assets

Custodians and large financial institutions/banks may additionally custody cash or physical securities as applicable

Hedge Fund Counterparty Risk Management

Hedge funds must manage the risk of using counterparties, including prime brokers

- This risk is managed to ensure the safety and diversification of fund assets
- Includes utilization of multiple counterparties (prime brokers and others) and contingency plans for transitioning to alternate counterparties

Counterparty risk may be managed by a hedge fund's investment, operations, or treasury/finance professionals, collectively or individually

- Risk management processes include monitoring of counterparty credit ratings, stock price, Credit Default Swap (CDS) spreads, and any negative news reports

Cliffwater, through its operational due diligence, assesses a hedge fund's quality, diversification, and monitoring of counterparties

- Is a component of Cliffwater's initial and ongoing evaluation of hedge fund managers
- Cliffwater further evaluates primary counterparties including prime brokers, administrators, and custodians

Private/Illiquid Assets

Flow of Funds

- Investors (limited partners, “LPs”) make a commitment to the private partnership (fund) through subscription agreements
 - Represents the amount of capital the LP is willing to invest in the fund over time
- Little to no capital is typically invested at the inception of a new commitment
 - These are generally de-novo, closed end funds
- Capital is “called” by the fund’s general partner (“GP”) for distinct fund investments over time*
 - The majority of these capital calls occur during the fund’s investment period
 - Investment periods typically run for the first 3 to 6 years of a fund’s life
 - The GP or fund administrator provides capital call notices to LPs as needed
 - Notices state the amount of and reason for the capital call, due date, and wire instructions
 - LPs then provide funding for the capital calls
- The GP returns capital to LPs through capital distributions upon the sale, partial sale, or other liquidity event related to a fund’s investments
 - Cash generated from individual “realizations” of investments is not continuously held within the fund
 - The majority of distributions typically occur during years 3 through 7 of a fund’s life
- Third party fund administrators and/or internal finance professionals from the fund typically oversee these processes

* Capital is also called to pay fund fees and expenses over time

Funding Capital Calls

Where does the money go when SCERS funds a capital call?

- Capital calls are generally sent from SCERS' custodian to an institutional bank (e.g. JPMorgan Chase) to be held in custody until the investment funding date
 - Cash from capital calls is typically held for only short periods of time

How do subscription lines of credit impact capital calls?

- Subscription lines may be utilized on a short-term basis in lieu of calling capital from LPs
 - Outstanding borrowings under the credit line are paid back to the provider of the credit facility based upon the negotiated terms of the lending agreement
 - Uncalled capital commitments are typically used as collateral for these short-term loans
 - The provider of the subscription facility is oftentimes the same as the fund's primary bank
- Amounts borrowed through subscription lines are normally repaid via subsequent capital calls funded by LPs

Safekeeping of Assets for Private Closed End Funds

Cash received from capital calls or investment realizations is typically held at a custodian or other banking institution

- Normally held only on a short-term basis

Ownership certificates and legal documentation for a fund's private investments are typically held at a custodian, law firm, or otherwise vaulted for safekeeping

- Physical securities also undergo an annual confirmation process with the fund's auditors
- The confirmation process includes confirmation of asset existence and ownership

Portfolio cash (i.e. cash on balance sheets of the fund's underlying portfolio companies) is maintained in banking accounts that are separate from fund-level cash

- This cash may be maintained at the banks on an ongoing basis
- Portfolio cash may also be invested in various "cash equivalent" short-term investments

Assets of the GP/management company, including operating capital (cash), are generally held with the fund's primary banking relationship

- GP/management company assets are segregated from fund assets

Risk Monitoring, Evaluation, and Management

The failure of Silicon Valley Bank and other regional banks sharpened managers' focus on processes and controls related to banking relationships and risk management

- Private asset funds have also implemented additional safeguards as a result
 - Onboarding additional or backup banking relationships
 - Managing bank-held cash balances around FDIC insurance coverage limits
 - More active cash management investment approach

As with hedge funds, Cliffwater's operational due diligence assesses the diversification and monitoring of counterparties by private assets managers, in addition to:

- Governance issues related to legal and regulatory matters, compliance, Advisory Boards, and business risk management processes
- Operational infrastructure including non-investment personnel and physical infrastructure, segregation of duties and internal controls, external service providers, and technology systems
- Operational processes related to portfolio financing, investor communications, transparency, and disclosures
- Valuation practices including valuation policies and procedures, pricing sources, and accounting review processes

Assets Held in Other Alternative Investment Structures

SCERS has also invested in alternative strategies through other open-end or evergreen fund structures

- Alternative asset open-end funds
 - Includes private real asset (infrastructure) and real estate funds
 - Operate more similarly to traditional commingled funds
 - Asset protection considerations reflect those of the underlying, non-traditional, assets held
 - Asset protections for private “hard assets” include confirmation of existence, and confirmation of asset ownership, conducted by an independent audit firm
 - Private Credit fund of one
 - Executing a typical private direct lending strategy, but SCERS is the sole LP in the fund
 - Provides SCERS with additional flexibility, subject to the characteristics of the fund’s underlying assets
 - Non-control trading-oriented strategies incorporated into a private asset fund
 - Certain distressed and other credit-based strategies
 - Have operational elements of typical private funds and hedge funds

Operational considerations are driven both by structure and investment strategy

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