



Board of Retirement Regular Meeting

Sacramento County Employees' Retirement System

Agenda Item 19

MEETING DATE: March 20, 2024

SUBJECT: Education: Absolute Return Asset Class

SUBMITTED FOR: Consent Deliberation and Action Receive and File

RECOMMENDATION

Receive and file presentation on Absolute Return asset class.

PURPOSE

This item supports the Strategic Management Plan by contributing to the effective management and oversight of investment activities.

DISCUSSION

At the February 2024 meeting, Staff and Verus started the asset class education series, covering the Global Equity and Fixed Income asset classes. At the March meeting, Staff and Cliffwater will provide an education presentation covering the Absolute Return asset class.

As a reminder, the objective of the asset class educational series is to:

- Assist the Board in understanding the role and objective of each asset class
- Review asset class construction
- Provide an overview of asset class performance in meeting their objectives
- Discuss asset class trends and considerations

The asset class overviews will provide a backdrop for the Board as Verus conducts the ALM study later in the year and presents the Board with asset class mixes for consideration which will include varying weights for the underlying asset classes.

The remaining schedule for the asset class education is as follows:

- March – Absolute Return
- April – Private Equity and Private Credit
- May – Real Assets and Real Estate

ATTACHMENTS

- Board Order
- Absolute Return Overview presentation

Prepared by:

/s/

Brian Miler
Senior Investment Officer

Reviewed by:

/s/

Eric Stern
Chief Executive Officer

/s/

Steve Davis
Chief Investment Officer



Retirement Board Order

Sacramento County Employees' Retirement System

Before the Board of Retirement
March 20, 2024

AGENDA ITEM:

Education: Absolute Return Asset Class

THE BOARD OF RETIREMENT hereby accepts the recommendation of staff to receive and file presentation on Absolute Return asset class.

I HEREBY CERTIFY that the above order was passed and adopted on March 20, 2024 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



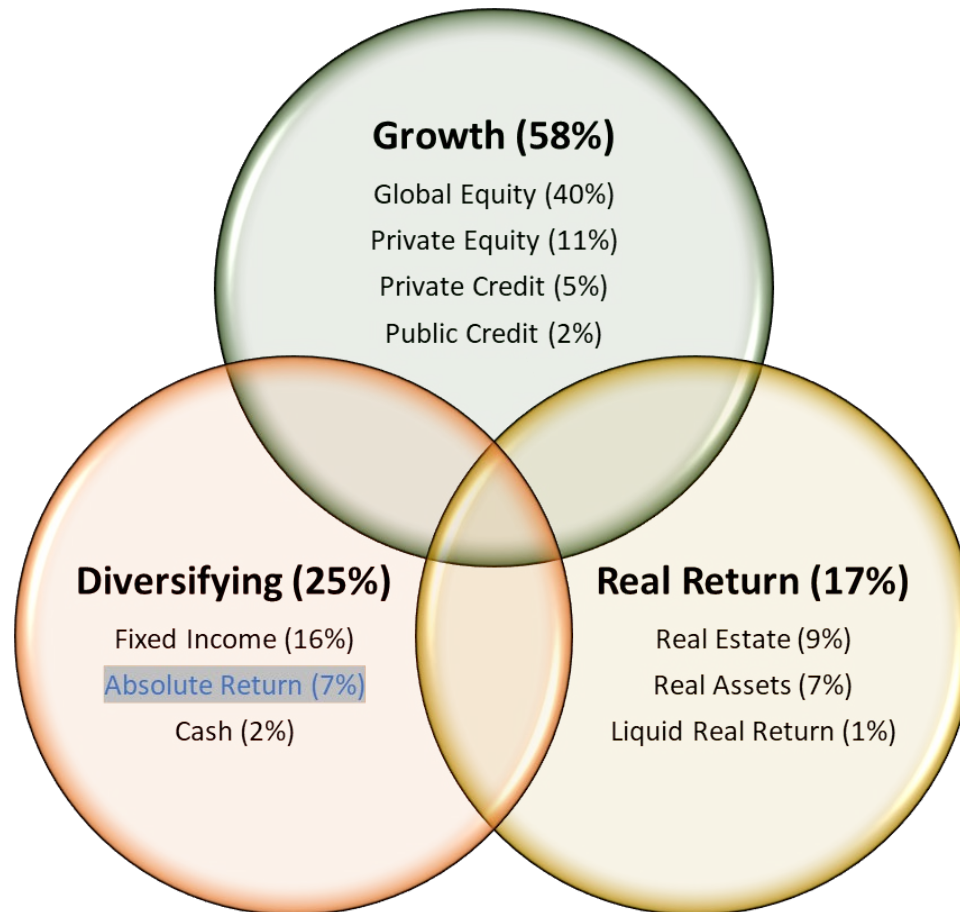
Education – Absolute Return Overview

March 20, 2024

Introduction

- Portfolio Fit
- Roles and Objectives of Absolute Return
- Timeline
- Portfolio Construction
- Performance – Total Returns and Relative to Benchmark
- Asset Class Trends and Considerations

Portfolio Fit



- Absolute Return resides in the Diversifying Asset Category
- Target 7% (5-9% range); 6.3% as of 12/31/2023

Roles and Objectives

Positive return contribution

Low sensitivity to broad market performance (i.e. low correlation, beta, etc.)

Diversification of returns compared to other asset classes

Diversified portfolio across asset classes with downside protection and positive return distribution

Governance

- Alternative assets/private markets protocol
- Includes Absolute Return; Private Equity; Private Credit; Real Estate; and Real Assets
 - The selection of investment managers is delegated to Staff, subject to the Board's ability to review, discuss, and object to the recommendations of Staff and consultant during the investment process.
 - Because management of the Absolute Return portfolio is dynamic and ongoing, Staff and the consultant will also have authority to make adjustments to the Absolute Return portfolio in order to assure that the portfolio is optimally aligned to achieve the objectives of the asset class.
 - Reports provided to the Board on a timely basis regarding actions recommended by Staff and Consultant.

Absolute Return Timeline

2005

- 5% Target Allocation
- Focus on Fund of Funds and Equity Long/Short investments

2017

- Absolute Return split into Growth (3%) and Diversifying (7%) segments
 - Align AR segments with Functional Asset Categories (Growth and Diversifying)
- Separate Growth and Diversifying Targets and Objectives
- Increase Direct fund investments

2012

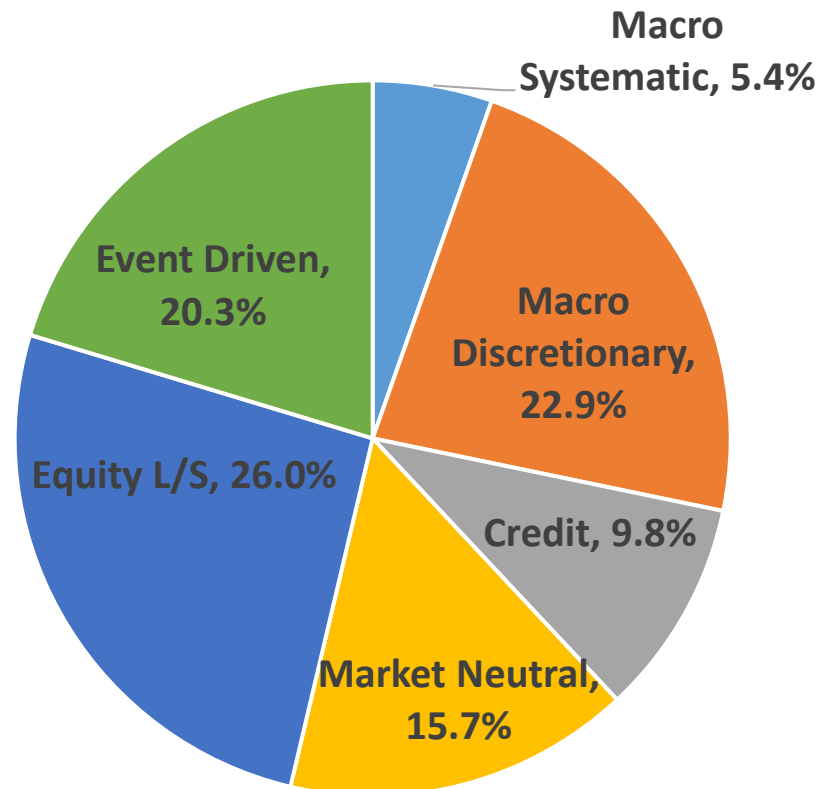
- 10% Target Allocation
- Emphasis on earning equity like returns with half the risk (T-bills + 5%)
- Broadened exposure across full suite of hedge fund strategies
- Primarily direct fund investments complemented by a customized Fund of Funds mandate

2021

- Absolute Return Target of 7%
- 100% focus on Diversifying AR strategies
- Elimination of Growth Absolute Return asset class

Absolute Return Exposures

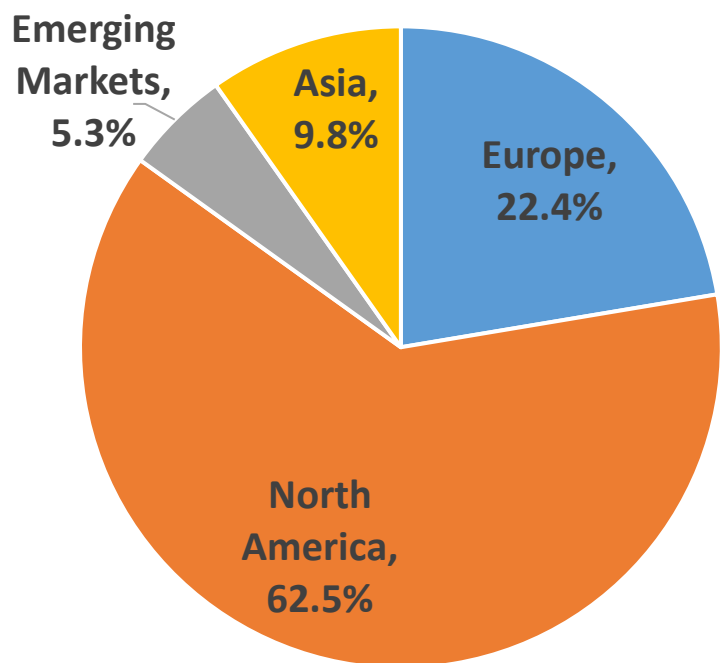
Strategy Exposures



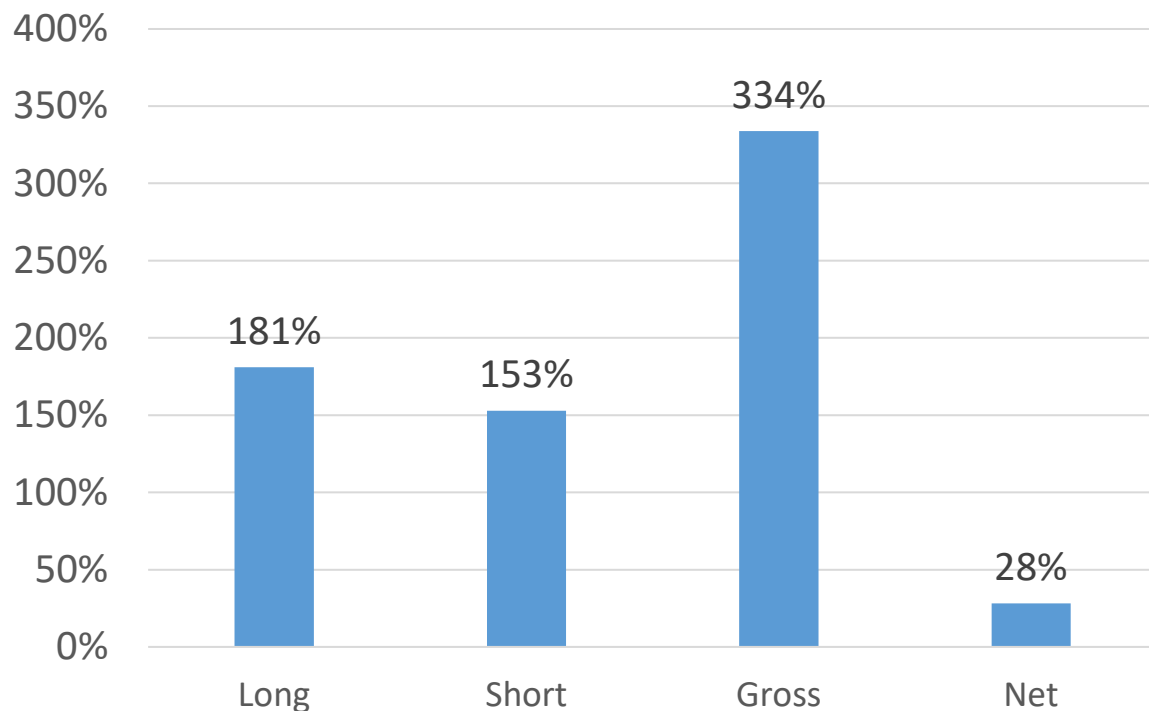
- Exposure adjusted for addition of Junto Capital (Equity L/S) and redemption from LMR Partners (Market Neutral), which occurred Q1 2024
- Includes direct fund investments (70%) and Grosvenor FoF investments (30%)

Absolute Return Exposures

Geographic Exposure



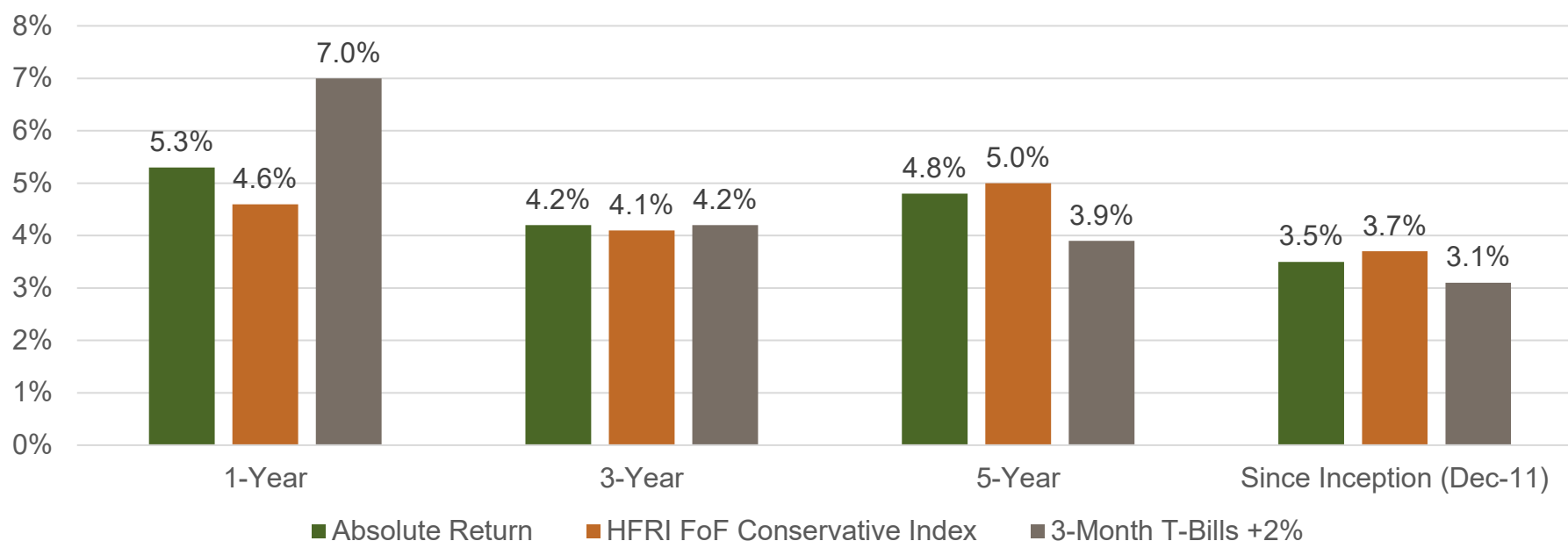
Portfolio Leverage



- Portfolio exposures in line with portfolio construction guidelines
 - Non-U.S. Exposure 20% to 50%
 - Notional Gross Exposure < 750%
 - Target 12 Funds with range of 8 to 15

Absolute Return Performance

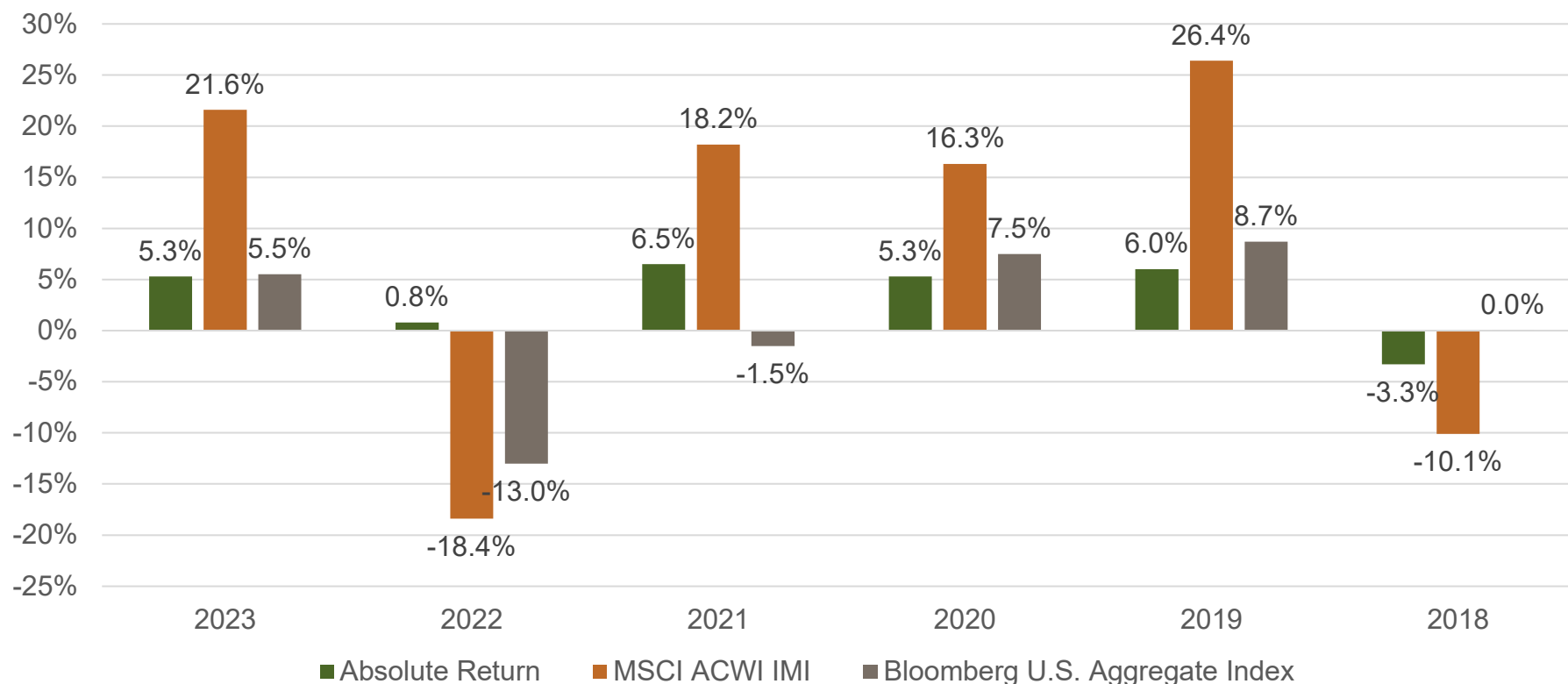
Absolute Return – net of fees as of 12/31/23



- Performance in line with policy benchmark and long-term objective
- Asset class performance difficult to benchmark given dispersion among strategies and construction of benchmark
- Returns have increased over past five years, with increased interest rates and improved opportunity set

Absolute Return Performance

Absolute Return – Calendar Year Net of Fees



- Emphasis on consistency and risk-adjusted returns
 - Higher returns than Fixed Income with less risk
- Conservative portfolio focused on lower volatility, low Beta and Correlation, and protection of capital

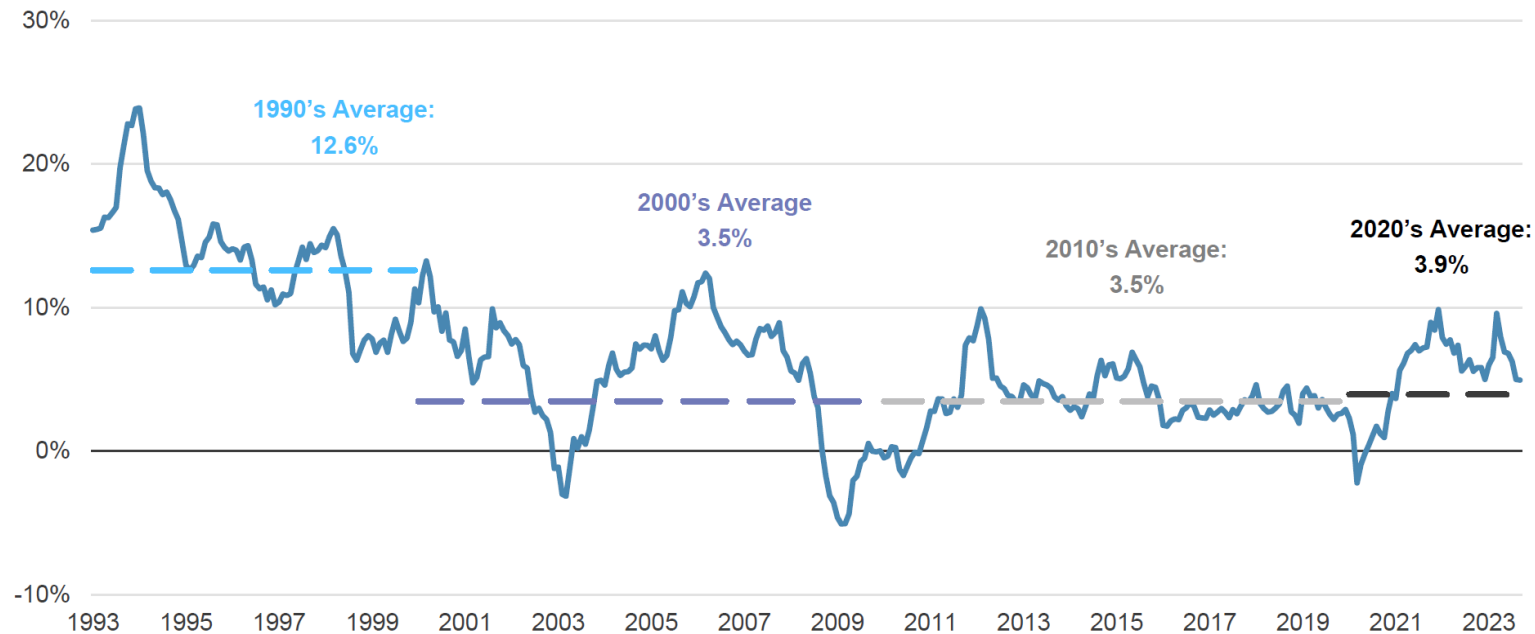
Absolute Return Manager Performance

Manager	AUM 12/31/23 (\$ millions)	Returns Since Inception	Standard Deviation	Sharpe Ratio	Inception Date
Market Neutral					
Aristeia Partners	\$52.8	5.5%	4.1%	0.67	Jan-21
Laurion Capital	\$62.2	7.8%	9.6%	0.66	Mar-14
LMR Partners	\$55.5	5.2%	13.5%	0.29	Nov-19
Event Driven					
BlackRock Event Driven Equity	\$56.6	4.4%	5.3%	0.42	Mar-20
Davidson Kempner Institutional Partners	\$61.8	5.4%	4.6%	0.69	May-19
Elliott International Limited	\$83.8	8.0%	3.2%	1.93	Apr-12
PSquared Event Opportunity Fund	\$55.6	3.2%	5.4%	0.18	Aug-20
Equity Long/Short					
Marshall Wace Global Opportunities	\$59.3	6.0%	7.8%	0.51	Jan-19
Macro Discretionary					
Tudor BVI Global Fund	\$51.7	3.4%	2.6%	N/A	Jan-23
Macro Systematic					
Graham Tactical Trend	\$44.1	3.4%	13.6%	0.16	Feb-17
Fund of Funds					
Grosvenor SCARF-D	\$236.9	2.8%	3.5%	0.42	Dec-11

Absolute Return Performance Expectations

SPREAD BETWEEN HFRI FW COMPOSITE¹ AND CASH²

Trailing 3-year annualized performance of the HFRI FW Composite Index and U.S 3mo T-Bills (1990 – 2023)

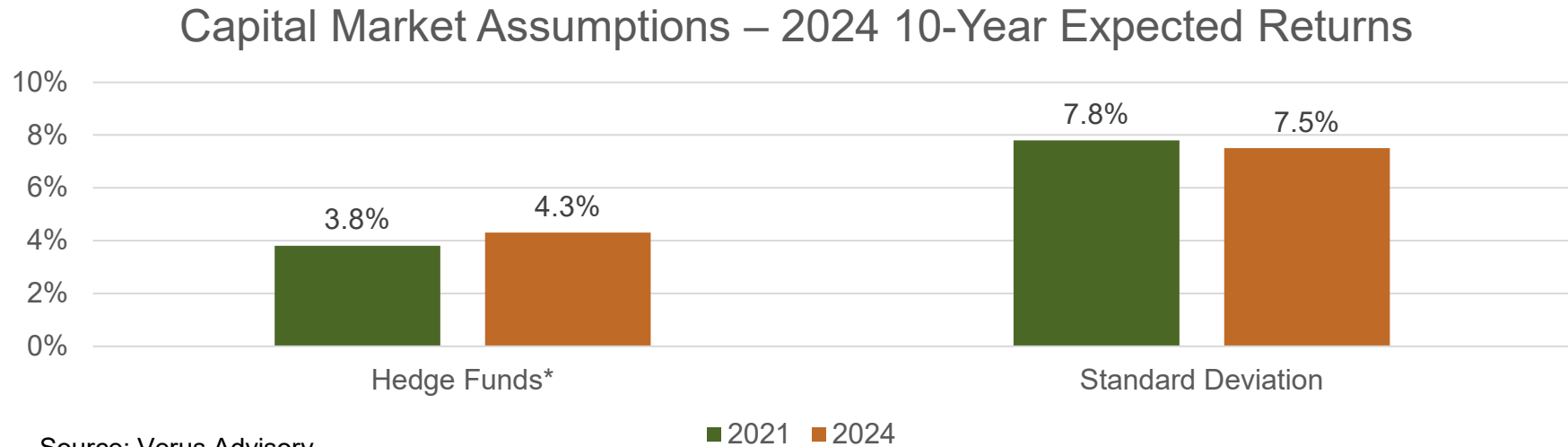


¹ Data source: HFRI Fund Weighted Composite Index (Proxy for Hedge Fund Industry Performance)
² Data source: U.S. 3M FTSE Bills (Cash Proxy)

Source: GCM Grosvenor

- Hedge fund industry has consistently generated a 300+ basis point spread over risk-free rates over the past 30 years
- Higher interest rates provide a performance benefit to hedge fund strategies, particularly market neutral and equity long/short strategies
- Increased dispersion provides greater opportunities for managers to add alpha and increase risk-adjusted returns

Asset Class Trends and Considerations



- Slightly higher CMA return forecast but lower expected Sharpe Ratio due to higher risk-free rate
 - Evaluate sizing of Absolute Return during SAA and sizing of mandates
- Capacity constraints and access to top tier managers
- Higher turnover of managers than other asset classes
 - Manager specific issues and risk, changing terms, performance

Asset Class Trends and Considerations

- Emphasis on Diversification and Risk-Adjusted Returns

	5-year			10-year		
	Ann. Ret.	Std. Dev.	Sharpe Ratio	Ann. Ret.	Std. Dev.	Sharpe Ratio
SCERS' Absolute Return	4.80%	4.06%	0.68	2.84%	3.49%	0.44
Bloomberg U.S. Aggregate Index	1.11%	6.16%	(0.12)	1.81%	4.76%	0.12
MSCI ACWI IMI	11.49%	18.27%	0.59	7.77%	15.02%	0.49

- Changing terms – increased fees and reduced liquidity (pass through fee structure)
 - Potential for unlimited fees and expenses
 - LP's subject to netting risk
 - Longer initial lock-ups and extended investor level gates



Appendix – Absolute Return Concepts and Terminology

Hedge Fund Industry

What is a hedge fund?

A group of investment strategies that utilize a wide range of asset types but with strategies and investment techniques not generally used by traditional long only managers in order to achieve higher risk-adjusted returns.

Asset Types

- Stocks
- Bonds
- Currencies
- Credit
- Commodities

Strategy Types

- Market Neutral
- Credit/Distressed
- Event Driven
- Equity Long/Short
- Global Macro

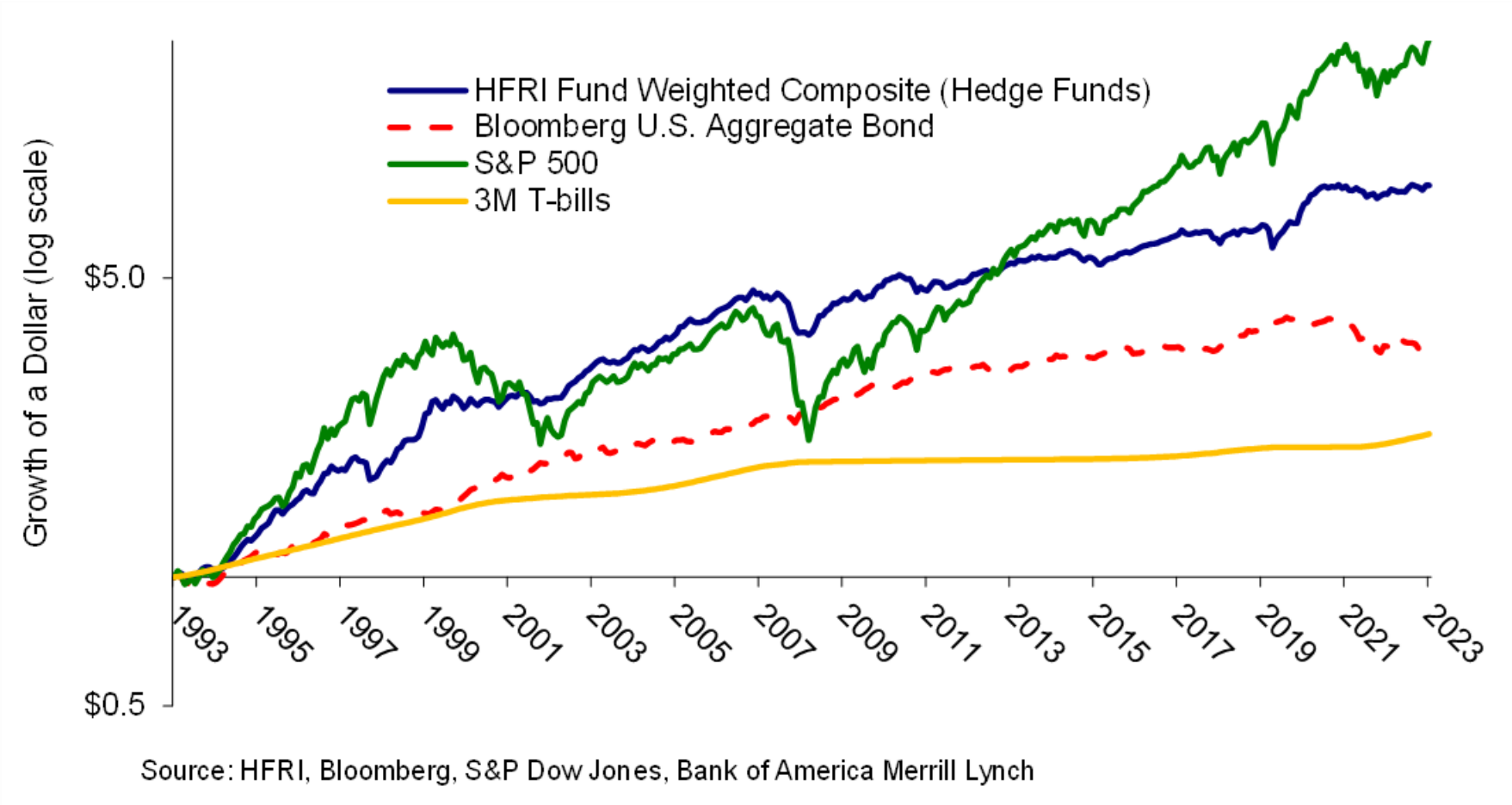
Investment Techniques

- Shorting
- Leverage
- Derivatives
- Private Investments
- High Frequency Trading

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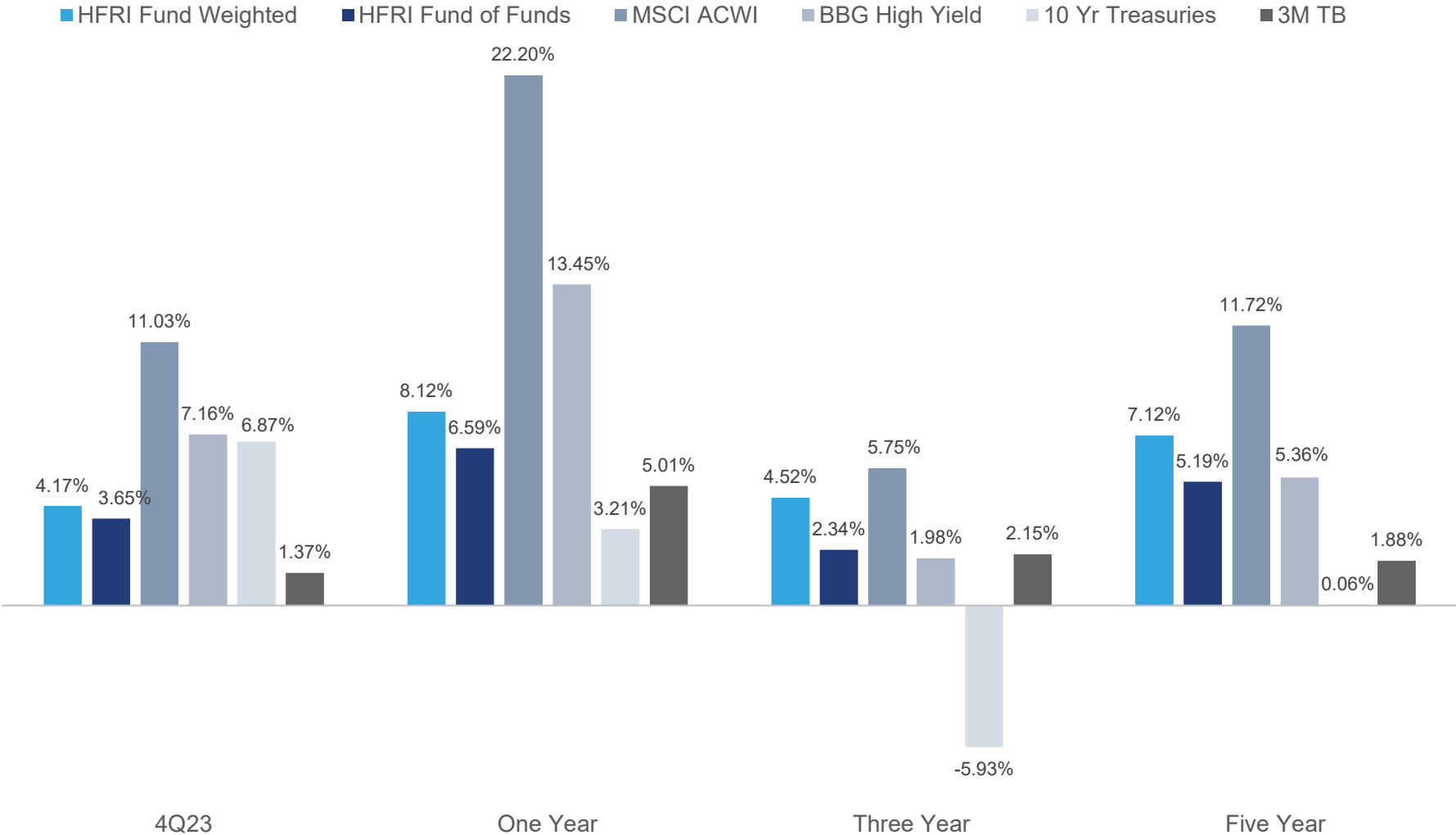
Hedge Fund Performance

Hedge Fund Performance, 1993 to 2023



Hedge Fund Performance

Hedge Fund Performance as of December 31, 2023



Source: Hedge Fund Research, Inc., Bloomberg. The index returns are provided for information only. Past performance is not indicative of future returns, which may vary.



Hedge Fund Industry

Hedge funds build a different return profile than traditional managers

The Three Sources of Return



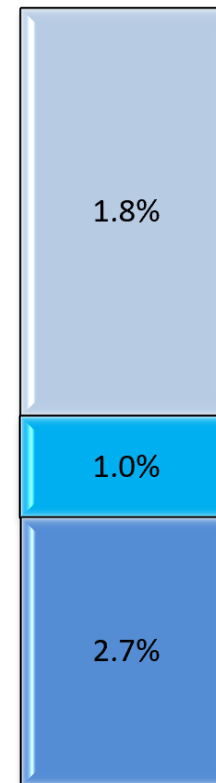
Typical Long Only Equity Manager



Increases alpha (return) by unique strategies/better selection

Reduces beta (risk) by hedging and investment in multiple asset types

Typical Hedge Fund Manager



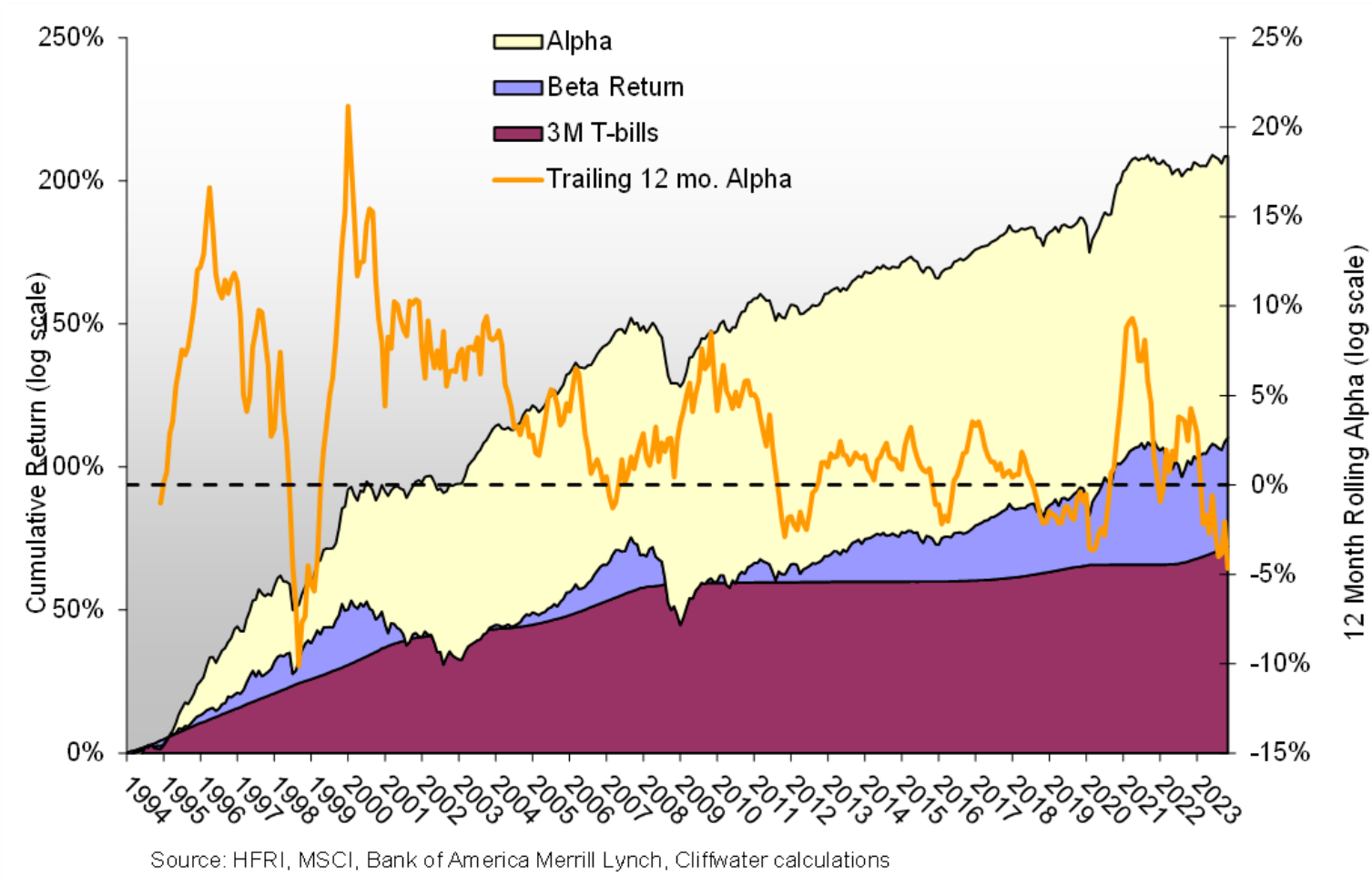
Expect Lower Absolute Returns but Better Risk-Adjusted Performance

Return figures are illustrative.



Hedge Fund Return Components

Sources of Hedge Fund Returns – Alpha, Beta, and T-bills, 1994 to 2023



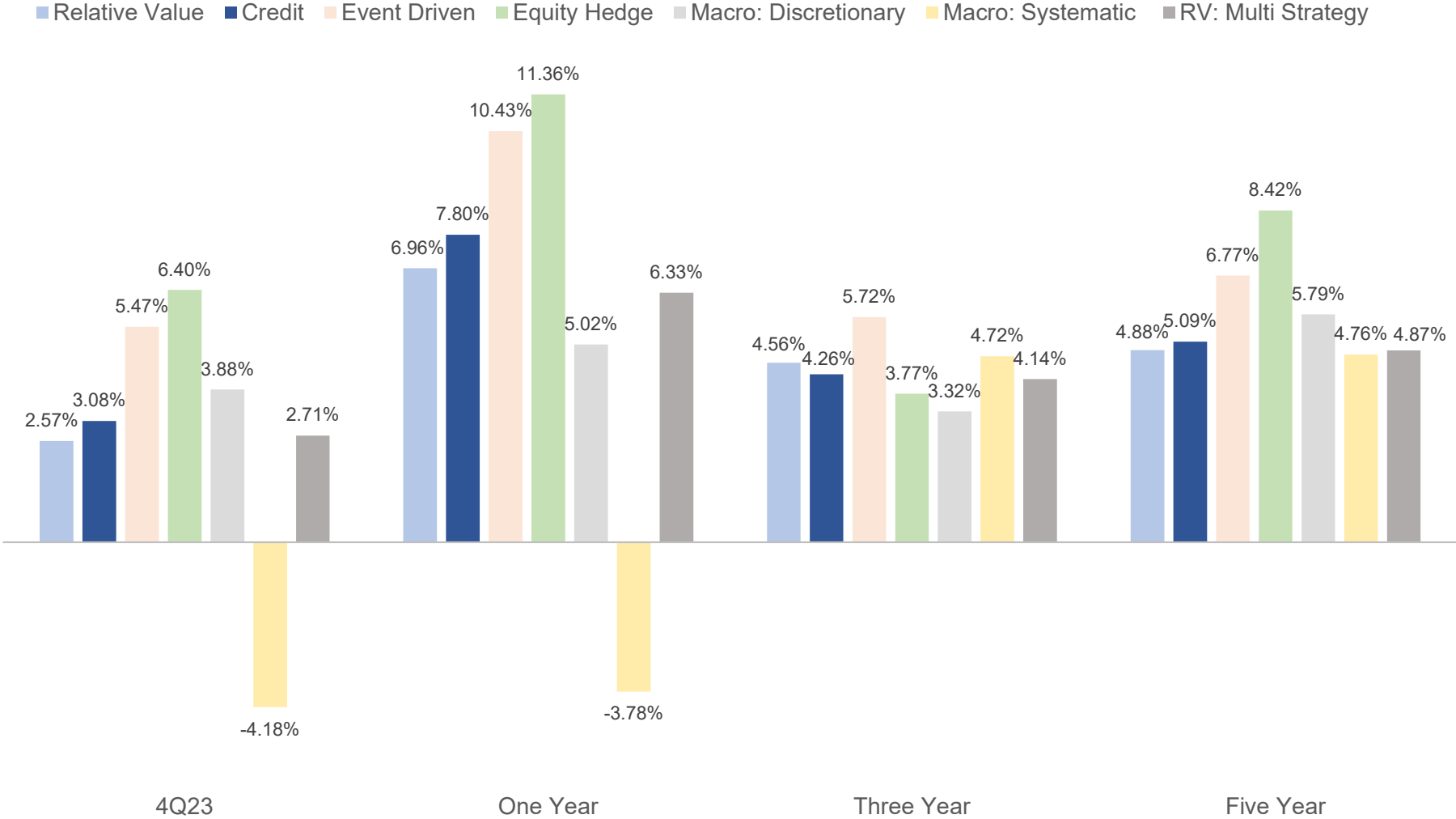
Hedge Fund Strategies

Broad hedge fund strategies include:

1. *Market Neutral* – Includes convertible arbitrage, fixed income arbitrage, and equity market neutral strategies that are intended to earn positive returns regardless of market direction by hedging away all stock or bond market risk.
2. *Credit/Distressed* – Invest long and short in higher risk debt securities (corporate, mortgage, asset-backed, and other) and sometimes equity in troubled and/or post-bankruptcy companies.
3. *Event Driven* – Aims to profit from the mispricing of securities related to hard and/or soft catalysts. Examples include mergers (merger arbitrage), restructurings, bankruptcies, litigation, regulatory and legislative changes. Activist investors who seek value creation through board participation or management changes are also included in this category.
4. *Equity Long/Short* – Primarily allocates capital to long and short positions in equities and equity derivatives. Exposures range from net long to market neutral to dedicated short. Some equity long/short funds focus on specific sectors (e.g., technology and healthcare) or regions.
5. *Macro-Discretionary* – Focus on employing a top-down approach to invest in any market in order to capture extended market movements. Global macro managers generally have broad mandates to invest globally across all asset classes. These managers tend to employ leverage and have exposure to global interest rates, currencies, commodities and equities.
6. *Macro-Systematic (CTA)* – Trades currencies, interest rates, equity markets and commodities using technical systems premised mostly on the notion that market indices will trend over time, thus portfolio positions will move in the same direction as markets.
7. *Multi-Strategy* – Hedge funds employing several hedge fund strategies and opportunistically move capital among strategies as they perceive relative opportunity.

Hedge Fund Performance by Strategy

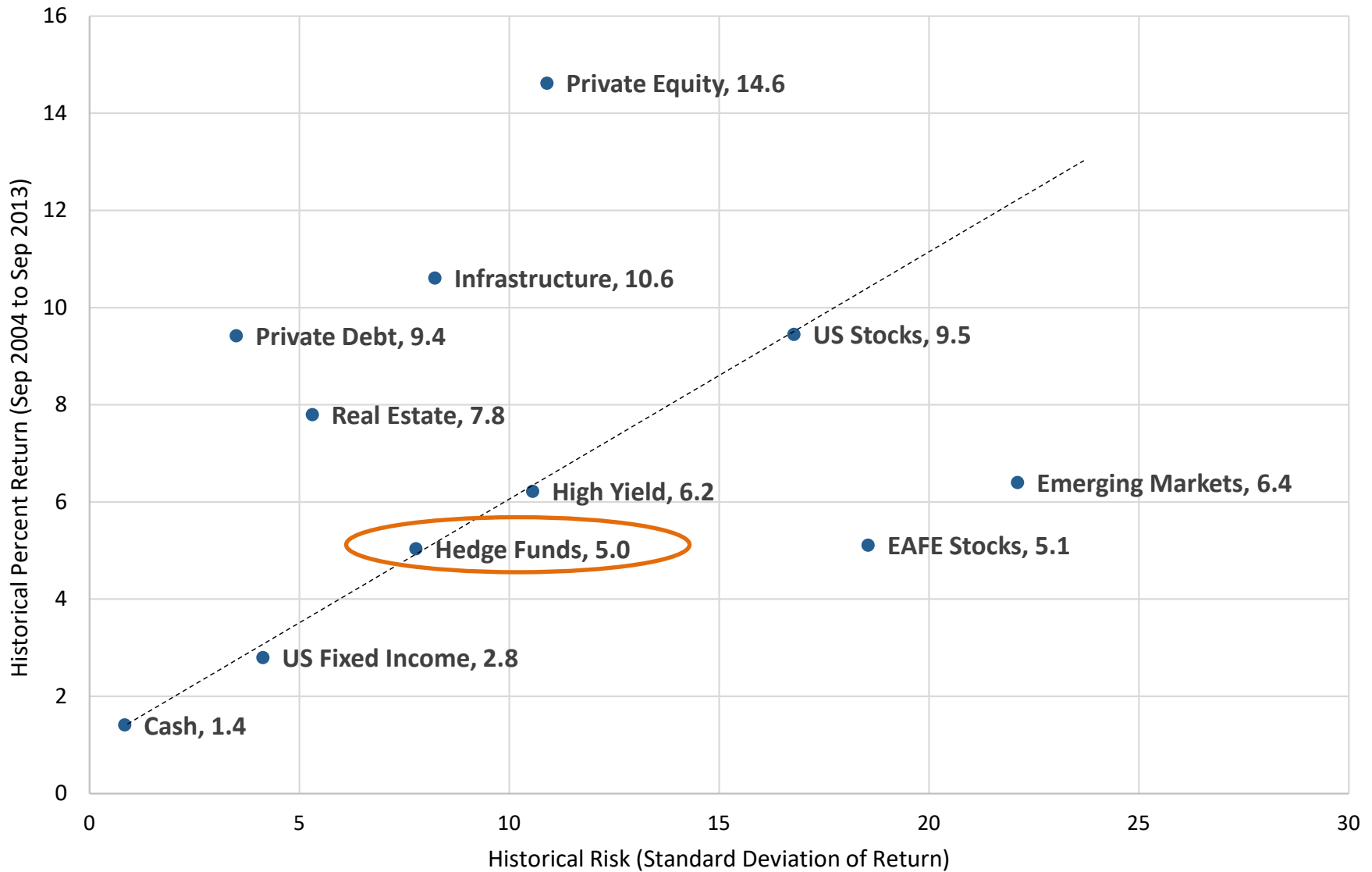
Hedge Fund Strategy Performance as of Dec. 31, 2023



Source: Hedge Fund Research, Inc. The index returns are provided for information only. Past performance is not indicative of future returns, which may vary.



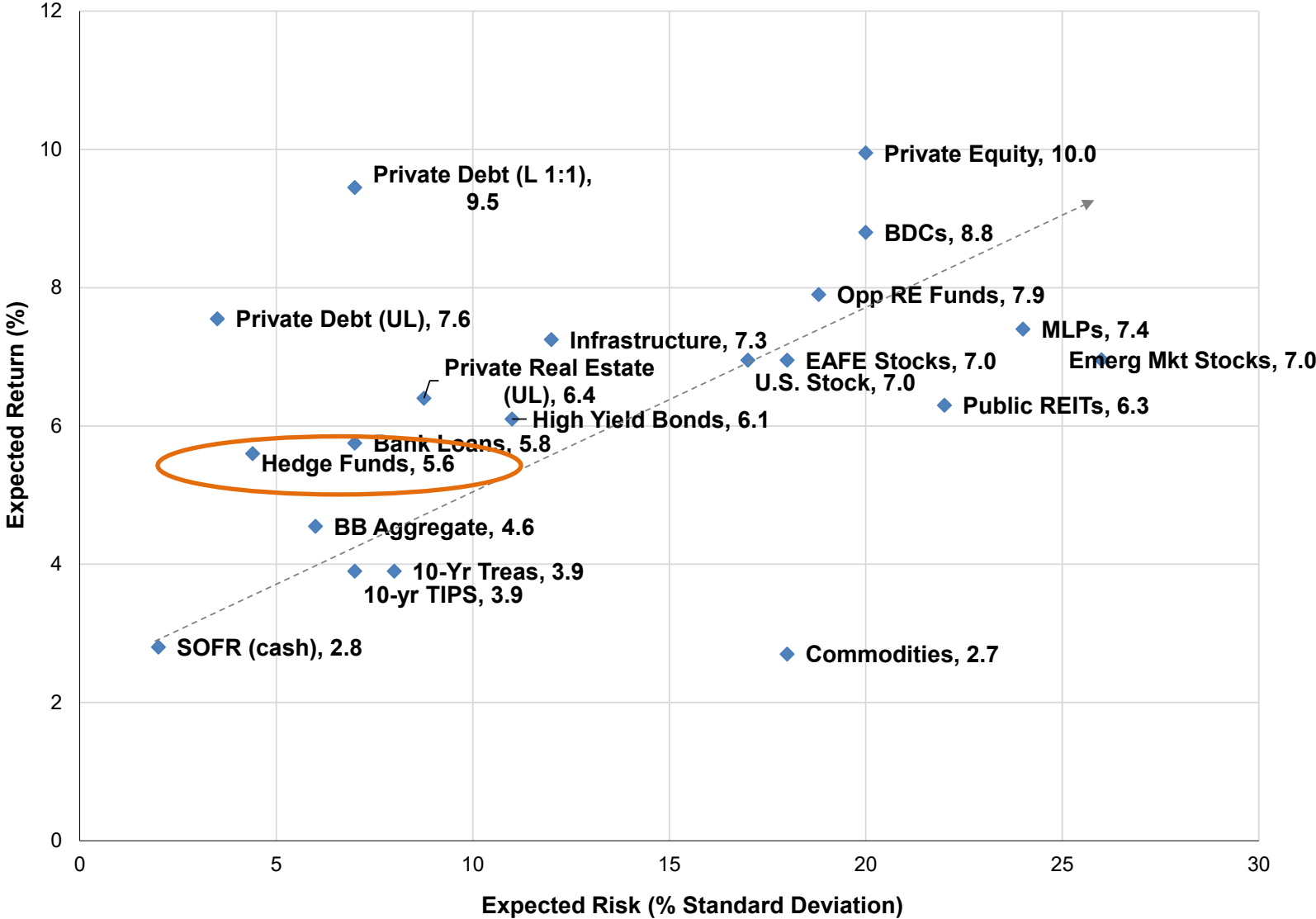
Asset Class Historical Return and Risk



September 2004 – September 2023. Past performance is not indicative of future returns.



Expected Asset Class Return and Risk*



*Cliffwater expectations. Please see Cliffwater's 2024 Asset Allocation Report for additional details and disclosures. Past performance is not indicative of future returns.



Hedge Fund Terms - General

Alpha	That portion of a fund's total return that is attributable only to manager skill and which excludes return attributable to general market (i.e. stock) movements. A fund's total return is comprised of three return components: alpha, beta, and risk-free.
Beta	Measure of a portfolio's return sensitivity to a market index. The higher the beta coefficient, the greater the sensitivity to the market. A portfolio with a beta of 1.0 should move directly in line with the market index. Lower beta portfolios have lower risk and hedge funds exhibit an average equity market beta of 0.30. Hedge funds with lower beta are generally viewed as desirable.
Beta Return	That portion of a fund's total return that is attributable to general market (i.e. stock) movements. It is generally calculated by multiplying the fund's portfolio beta times the market return net of Libor. A fund's total return is comprised of three return components: alpha, beta, and Libor.
Lock-up	The period of time before an investor is eligible to redeem assets from a hedge fund. Lock-ups of one or two years are typical. The liquidity of the strategy and underlying positions typically influences the length of the lock-up. For example, distressed funds typically have longer lock-up periods than macro and equity long/short funds.
<i>Hard Lock-Up</i>	Assets cannot be redeemed during the lock-up period.
<i>Soft Lock-Up</i>	Assets may be redeemed prior to expiration of the lock-up period, but an early withdrawal penalty must be paid to the fund.
Long positions	Long positions describe securities that were purchased. Long positions benefit from increase in securities prices.
Short Position	Short positions describe securities that are borrowed (generally from a dealer or securities lender) and sold. Short positions will benefit from decreases in securities prices.

Hedge Fund Terms - Exposure

Exposure	The value of security positions (excluding cash) as a percent of net asset value (NAV). For example, if security positions are valued at \$100 and NAV also equals \$100, then the portfolio is said to have a long exposure of 100%. If instead, the security positions are valued at \$50 with the rest in cash, the long exposure is said to be 50%. Leverage (borrowing) allows exposures to exceed 100% and shorting can allow exposures to be negative. For example, a manager that holds \$100 in stock (100% long exposure) and also borrows \$100 in stock (from a securities lender) and sells that stock short in the market (100% short exposure), is said to have a total exposure of 200% (100% long exposure plus 100% short exposure).
<i>Notional Exposure</i>	Notional exposure, as opposed to physical exposure, includes the value of reference securities/indexes of derivative securities and swaps in the calculation of exposure. For example, a hedge fund manager with a 50% long exposure to stocks may also have sold a Russell 3000 index futures on contracts worth 50% of fund NAV as a market hedge. While no physical securities are shorted, the futures positions have a “notional” value equal to 50% of NAV. Total gross notional exposure in this example is 100%, equal to the 50% long physical stock positions plus the 50% short futures contract. The most common industry practice is to include notional values in the calculation of portfolio exposures.
<i>Gross Long</i>	The total notional exposure of all long positions in a portfolio. In the example above, gross long exposure equals 50%. Gross long positions benefit from increases in securities prices.
<i>Gross Short</i>	The total notional exposure of all short positions in a portfolio. In the example above, gross short exposure equals 50%, the notional value of the short Russell 3000 futures contracts. Short positions benefit from decreases in securities prices.
<i>Net Exposure</i>	Net exposure equals the difference between a portfolio’s gross long and gross short exposures. In the example above, the portfolio has a net exposure of 0%, equal to the 50% gross long exposure minus the 50% gross short position. A positive net long exposure indicates a higher portion of long positions in the portfolio, and that the portfolio should generally benefit from an increase in asset prices. A net short exposure indicates a higher value of short positions in the portfolio, which will likely produce profits if security values fall.
<i>Total Gross</i>	The sum of a portfolio’s gross long and gross short exposures. Gross exposure in the example above equals 100%, equal to the 50% gross long exposure plus the 50% gross short exposure.

Hedge Fund Terms - Leverage

Leverage

The use of explicit debt (i.e. borrowing) or implicit debt (i.e. derivatives) to achieve investment positions that exceed invested capital (NAV). The use of leverage may amplify returns but may also increase risk. However, if leverage is achieved by adding short exposure that offsets an existing long position, portfolio risk might actually decline due to the use of leverage. A common leverage calculation is the ratio of gross notional exposure to invested capital. For example, a \$100 investment in BP stock coupled with a \$100 short sale of Exxon stock yields gross notional exposure of \$200. Leverage in this example can be described in at least two ways:

- a. The portfolio has 200% gross exposure (equal to \$200 gross notional exposure divided by \$100 NAV)
- b. The portfolio is one time (1x) levered (equal to \$100 in debt divided by \$100 NAV)

As illustrated in the example, the \$200 gross notional exposure equals the absolute value total of both \$100 long (“gross long”) and \$100 short (“gross short”) asset exposures. The measurement of gross notional exposure varies by asset class:

- *Equities* – the market value of long and short positions
- *Corporate Debt and Municipal Bonds* – the market value of long and short positions
- *US Treasuries (and other highly rated government debt)* – the market value of long and short positions, adjusted to a 10 year bond equivalent maturity (approximate 9 year duration), so that a \$100 exposure to a 2 year duration bond is recognized as a lower risk compared to a \$100 20 year duration bond. The \$100 3 year duration bond is said to have a \$33 10 year bond equivalent exposure (\$100 times 3, divided by 9) while the \$100 20 year duration bond is said to have a \$222 10 year bond equivalent exposure (\$100 times 20, divided by 9)
- *Options* – the delta adjusted exposure rather than the total notional value of the underlying reference asset. Delta adjusted exposure represents the implied shares/holdings necessary to hedge the options position
- *Credit Default Swaps* – total notional exposure of the underlying reference credit
- *Interest Rate Swaps* – total notional exposure (expressed as 10-year bond equivalent, per the duration adjustment process described above) to reference security or index
- *Futures/Forwards* – total notional exposure to reference security or index

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- U.S. Stocks: The Russell 3000 Index is a capitalization-weighted stock market index that seeks to track the entire U.S stock market. It measures the performance of the 3,000 largest publicly held companies incorporated in the United States based on market capitalization.
- The MSCI All Country World Index (MSCI ACWI) captures large and mid cap representation across 23 developed markets and 23 emerging markets countries. With over 2,400 constituents, the index covers approximately 85% of the global investable equity opportunity set.
- The Bloomberg U.S. Aggregate Bond Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.
- The Bloomberg 5-10y U.S. TIPS Index is a universe of 5-10-Year U.S. Treasury Inflation Protected Securities (“TIPS”).
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- The Alerian MLP Index is a float-adjusted, capitalization-weighted index, whose constituents represent approximately 85% of total float-adjusted market capitalization of publicly traded Master Limited Partnerships.
- The HFRI Fund Weighted Composite Index is a global, equal-weighted index of over 2,000 single-manager funds that report to HFR Database. Constituent funds report monthly net of all fees performance in U.S. Dollars and have a minimum of \$50 million under management or a 12-month track record of active performance. The index does not include funds of hedge funds.