



Board of Retirement Regular Meeting

Sacramento County Employees' Retirement System

Agenda Item 21

MEETING DATE: January 19, 2022

SUBJECT: Asset Class Restructuring: Real Assets

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

RECOMMENDATION

Staff recommends the Board approve the proposed implementation plan and revisions to the structure of the Real Assets asset class as presented by Cliffwater and SCERS' Investment Staff. The specific recommendations include:

- Rename the 'Energy' sub-strategy to 'Energy and Power'.
- Adopt revised sub-strategy target allocations and ranges as follows:
 - 60% target allocation to the Infrastructure sub-strategy with a range of 45% to 75%.
 - 30% target allocation to the Energy and Power sub-strategy with a range of 15% to 45%.
 - 10% target allocation to the Agriculture, Timber, Other sub-strategy with a range of 0% to 20%.
- Adopt revised blended policy index benchmark for Real Assets as follows:
 - 60% Cambridge Associates Private Infrastructure
 - 30% Cambridge Associates Private Energy
 - 10% NCREIF Farmland
- Maintain a range of +/-2% around the 7% Real Assets target allocation.
- Direct staff to make conforming changes to the Real Return Asset Category and Master Investment Policy Statements for approval by the Board at a future meeting.

PURPOSE

This item supports the implementation of the revised strategic asset allocation, which calls for Staff and consultants to identify structuring considerations and implementation plans for each major asset class.

REAL ASSETS STRATEGIC CHANGES

In August 2021, SCERS' Board approved a revised strategic asset allocation, which resulted in the Real Assets target allocation remaining at 7%, with a range of 5%-9%. The actual allocation

to Real Assets is 5.8% as of September 30, 2021. Private market valuations are lagged a quarter. The ‘Implementation Plan’ section for Real Assets below will cover the plan to build the Real Assets allocation and sub-sectors toward the target allocation of 7%.

The Real Assets asset class resides within the Real Return asset category, with the sub-asset class targets shown below. It should be noted that within the prior strategic asset allocation, the Real Return asset category contained an allocation to Treasury Inflation Protected Securities (TIPS), with a 0% target, but the ability to allocate up to 3% if the opportunity presented itself. SCERS has exposure to TIPS within its Liquid Real Return strategies, so it was eliminated as a standalone sector within the revised Real Return asset allocation approved by the Board in August 2021.

SCERS Real Return Portfolio	Minimum	Target	Maximum
Real Estate	7%	9%	11%
Real Assets	5%	7%	9%
Liquid Real Return	0%	2%	3%
Real Return Asset Category		18%	

RECOMMENDED REAL ASSETS STRUCTURE REVISIONS

Below are recommendations to the allocation structure of SCERS’ Real Assets asset class. The recommended changes will go into effect upon Board approval, with an updated Real Return and Master Investment Policy Statement (IPS) to be provided at a later date.

Real Assets resides within the broader Real Return asset category IPS, along with Real Estate and Liquid Real Return.

Real Assets Target and Range:

The Real Assets target allocation remains as previous, 7% with a range of +/- 2%, as presented in the above chart.

Real Assets Sub-Strategy Renaming:

The Real Assets asset class is comprised of three sub-strategies - Infrastructure, Energy, and Agriculture, Timber and Other. Staff and Cliffwater recommend renaming the ‘Energy’ sub-strategy to ‘Energy and Power’, which is more suitable given the Energy industry has been transitioning from oil and gas power generation to renewable energy generation and decarbonization. Oil and gas will still serve as a significant source of energy now and in the future; however, global governments have joined to reduce hydrocarbon emissions by reducing the reliance on oil and gas.

Staff and Cliffwater will continue to monitor the energy industry as it transitions to less reliance on hydrocarbons. Investments in traditional energy (oil and gas) may be made on a tactical basis but more focus will be on long-term strategic investments in the energy transition space (renewables, alternative power distribution, and power generation). Therefore, Staff and

Cliffwater are recommending the new sub-strategy of Energy and Power include the following sub-sectors:

- Upstream (oil and gas)
- Midstream (oil and gas)
- Downstream and Field Services (hydrocarbons and renewables)
- Energy Transition:
 - Renewables (wind, solar, biogas, hydro, etc.)
 - De-carbonization (software and hardware technologies)
 - Renewables adjacent (energy storage, grid efficiency, digitization, etc.)
 - Etc. (future technologies, such as fusion and miniature/modular nuclear)

Real Assets Sub-Strategy Diversification Guidelines:

Staff and Cliffwater recommend revising the Real Assets sub-strategy allocation targets and ranges as provided in the chart below. The new sub-strategy ranges reflect the available opportunity set, as discussed below, and the evolving energy sector, as previously discussed. Energy and Power will remain a key component of the asset class; however, the infrastructure segment presents a greater opportunity set, and Staff and Cliffwater expect the majority of the Real Assets asset class to be comprised of these investments. Infrastructure is also more efficiently accessed in larger investment sizes through open-end commingled funds (similar to real estate), which SCERS has made several commitments to over the past several years.

In constructing the Real Assets portfolio, Staff has taken a Core-and-Satellite or Hub-and-Spoke approach, where the core or asset class beta-like exposure represents the Hub or foundational investment. Similar to the approach taken in Real Estate, Staff prefers making foundational investments in open-ended core or core plus fund structures, particularly with infrastructure investments. Open-ended funds provide better diversification, by industry sector and geographic regions, where the investment objective is typically to achieve the majority of the return from cash yield. Complementing the core investments are satellite investments, typically through closed-end fund structures smaller in sizing, that target specific themes and niches, and which have higher alpha generating return assumptions.

As the energy sector began to experience challenges, Staff and Cliffwater felt the upstream energy industry had become too volatile and met fewer of the long-term investment objectives of the Real Assets class and; therefore, implementation has focused less on upstream energy commitments over the past few years. Midstream energy, with its long-term contracted income stream and supply-demand imbalance, continued to offer an attractive risk return profile, which supported additional SCERS commitments, including follow-on investments to two midstream energy managers. Yet, the drop in energy prices during the pandemic equally affected the midstream sector, as many of its upstream customers entered bankruptcy, more so than expected. With the energy sector's lingering difficulties, Staff and Cliffwater have focused more on infrastructure and other real assets opportunities, specifically targeting strategies that have more of the return coming from current cash yield, but that also exhibit less sensitivity to the macro environment.

One real assets sector Staff and Cliffwater have spent a considerable effort identifying opportunities is in global agriculture. Unfortunately, the universe of agriculture funds is very limited, with many of the managers having minimal track records. According to Preqin data, in 2020 there were 12 agriculture funds raised totaling \$2.0 billion, with an average fund size of \$183 million. So far, in 2021, there were 14 funds raised totaling \$2.2 billion, with an average fund size of \$168 million. Compare that with infrastructure funds, where there were 140 funds raised in 2020 totaling \$107.6 billion, with an average fund size of \$875 million. Year-to-date 2021, there were 109 infrastructure funds in the market raising a total of \$119.25 billion at an average fund size of \$1.2 billion.

Although the agriculture sector is vast and global, it has had difficulty attracting institutional capital limiting the opportunity set. Nevertheless, the pandemic has shown how important the food supply and the supply chain is to our everyday life. Staff and Cliffwater continue to target agriculture opportunities but the opportunity set limits the target allocation.

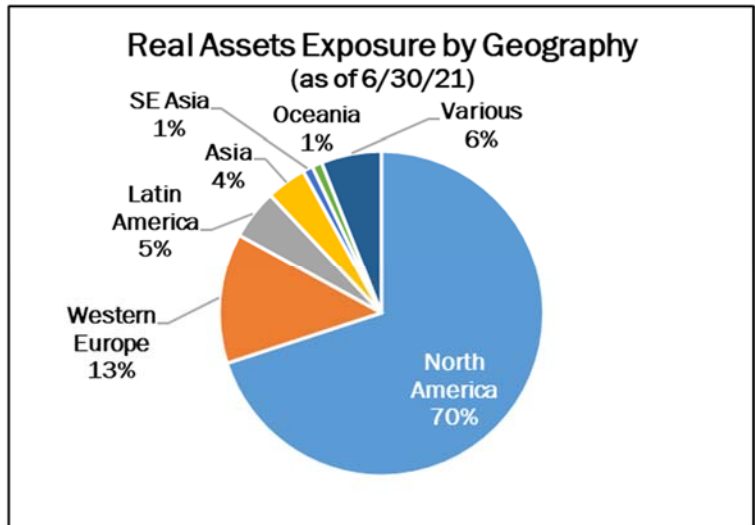
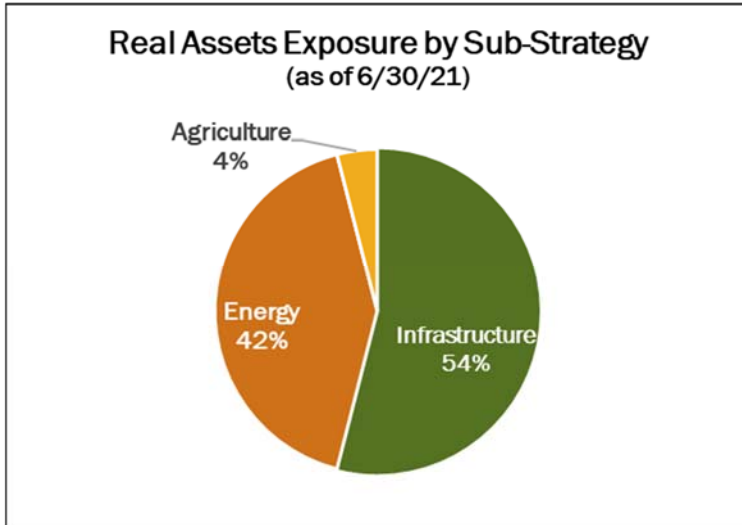
Current Real Assets Sub-Strategy Allocations:

SCERS Real Assets Portfolio Construction (Current)				
	Minimum	Target	Maximum	Policy Index Benchmark
Total Real Assets Portfolio	5%	7%	9%	Custom blend of benchmarks below:
Infrastructure	30%	45%	60%	45% Cambridge Associates Private Infrastructure
Energy	20%	35%	50%	35% Cambridge Associates Private Energy
Agriculture, Timber, Other	10%	20%	30%	10% NCREIF Farmland + 10% NCREIF Timberland

Recommended Real Assets Sub-Strategy Allocations:

SCERS Real Assets Portfolio Construction (Proposed)				
	Minimum	Target	Maximum	Policy Index Benchmark
Total Real Assets Portfolio	5%	7%	9%	Custom blend of benchmarks below:
Infrastructure	45%	60%	75%	60% Cambridge Associates Private Infrastructure
Energy and Power* (new definition)	15%	30%	45%	30% Cambridge Associates Private Energy
Agriculture, Timber, Other	0%	10%	20%	10% NCREIF Farmland

SCERS' current Real Assets exposures by sub-strategy and geography:



REAL ASSETS INVESTMENT PLAN

Staff and Cliffwater will present the 2022 Real Assets capital-pacing plan in February 2022, which highlights annual commitments toward reaching and maintaining the 7% target allocation over the long-term.

The capital budget incorporates several variables and assumptions, such as plan assets, the growth rate of the plan (SCERS' actuarial rate adjusting for plan cash outflows), capital market assumptions for real assets, and capital drawdown and distribution assumptions for underlying funds. Per Cliffwater's preliminary pacing model, SCERS' Real Assets portfolio will reach its 7% target towards the end of 2024, one year later than forecasted in last year's budget.

NEXT STEPS

- Present the 2022 Real Assets Annual Investment Plan in February 2022.
- Incorporate the approved Real Assets structure changes into the Real Return asset category IPS and the Master IPS.

ATTACHMENTS

- Board Order
- Cliffwater Real Assets Portfolio Structuring Considerations Presentation

Prepared by:

/S/

JR Pearce
Senior Investment Officer

/S/

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Chief Investment Officer

/S/

Eric Stern
Chief Executive Officer



Retirement Board Order

Sacramento County Employees' Retirement System

Before the Board of Retirement
January 19, 2022

AGENDA ITEM:

Asset Class Restructuring: Real Assets

THE BOARD OF RETIREMENT hereby accepts the recommendation of staff to approve the following revisions to the structure of the Real Assets asset class.

- Rename the 'Energy' sub-strategy to 'Energy and Power'.
- Adopt revised sub-strategy target allocations and ranges as follows:
 - 60% target allocation to the Infrastructure sub-strategy with a range of 45% to 75%.
 - 30% target allocation to the Energy and Power sub-strategy with a range of 15% to 45%.
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- Maintain a range of +/-2% around the 7% Real Assets target allocation.
- Direct staff to make conforming changes to the Real Return Asset Category and Master Investment Policy Statements for approval by the Board at a future meeting.

I HEREBY CERTIFY that the above order was passed and adopted on January 19, 2022 by the following vote of the Board of Retirement, to wit:



Retirement Board Order

Sacramento County Employees' Retirement System

AYES:

NOES:

ABSENT:

ABSTAIN:

ALTERNATES (Present but not voting):

Richard B. Fowler II
Board President

Eric Stern
Chief Executive Officer and
Board Secretary



Los Angeles • New York

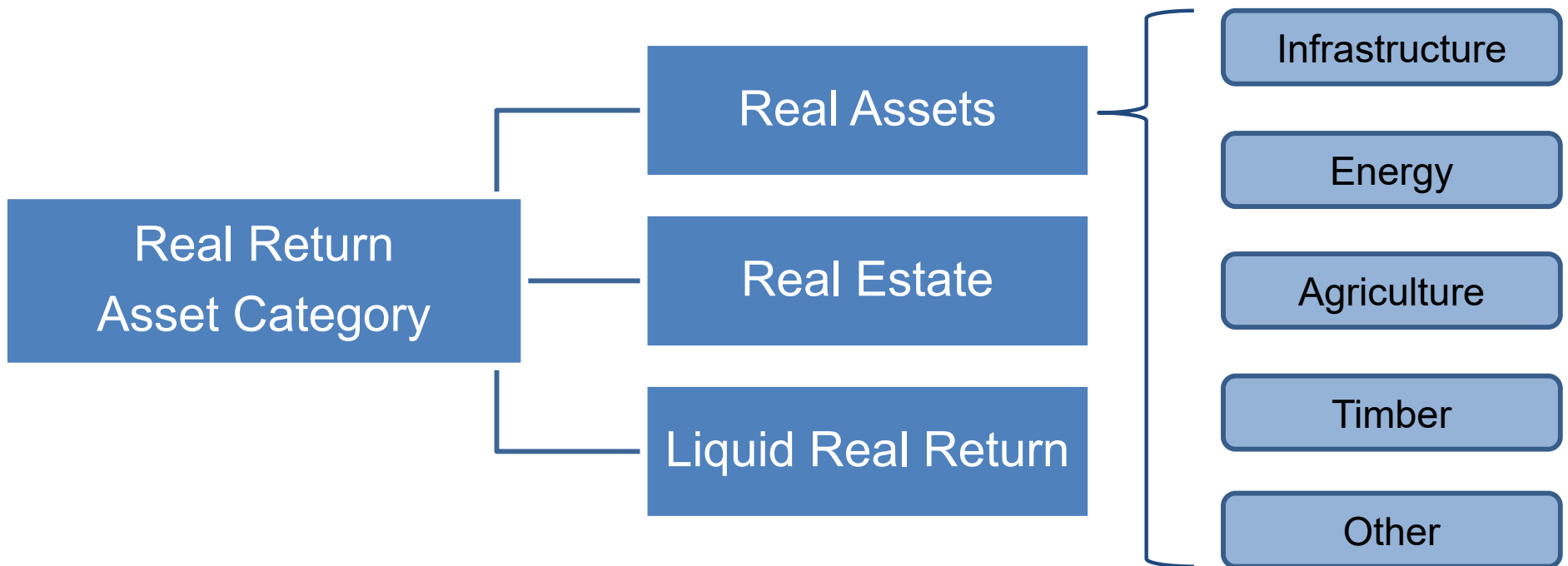
Sacramento County Employees' Retirement System Real Assets Portfolio Structuring Considerations

January 19, 2022

SCERS Real Assets

The SCERS Real Assets portfolio is a component of the Real Return asset category

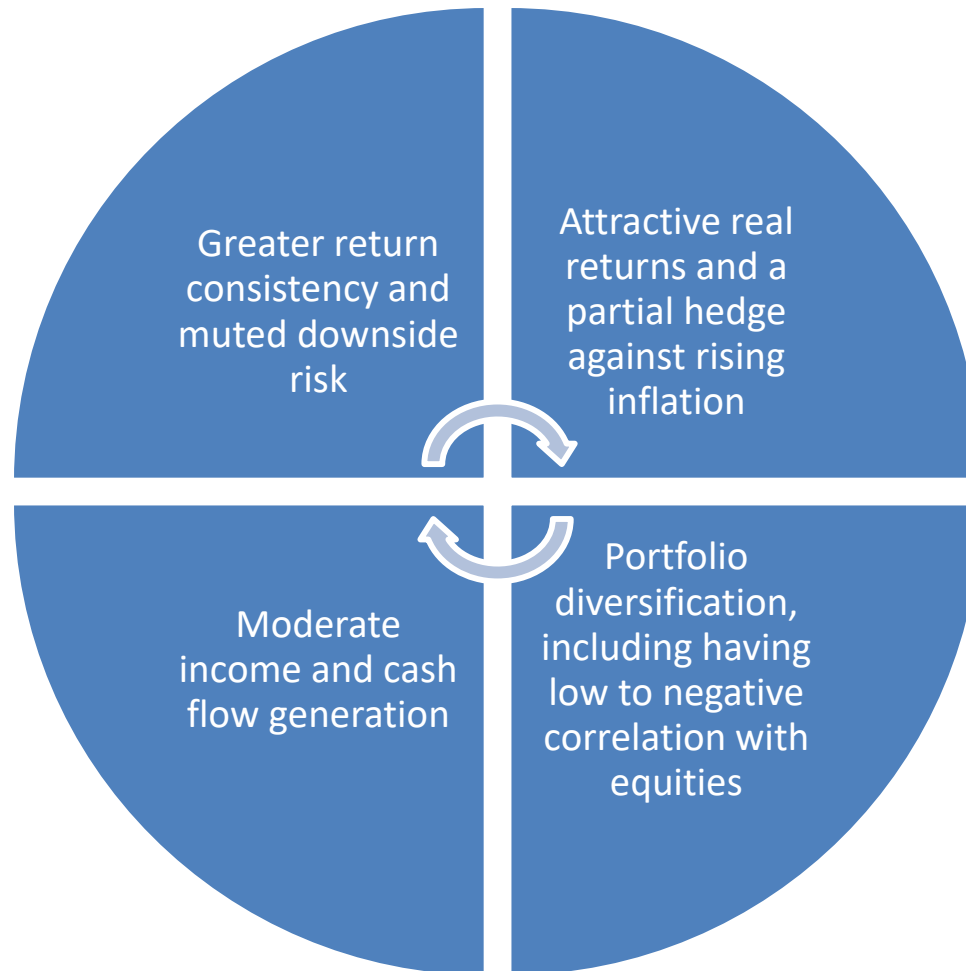
- Real Assets includes private (illiquid) funds, excluding Real Estate
 - Primarily composed of Infrastructure and Energy funds, with some Agriculture and Other



** Liquid Real Return may include inflation linked bonds, floating rate notes, commodities, REITs, infrastructure stocks, and other publicly traded securities*

Real Assets Portfolio Objectives

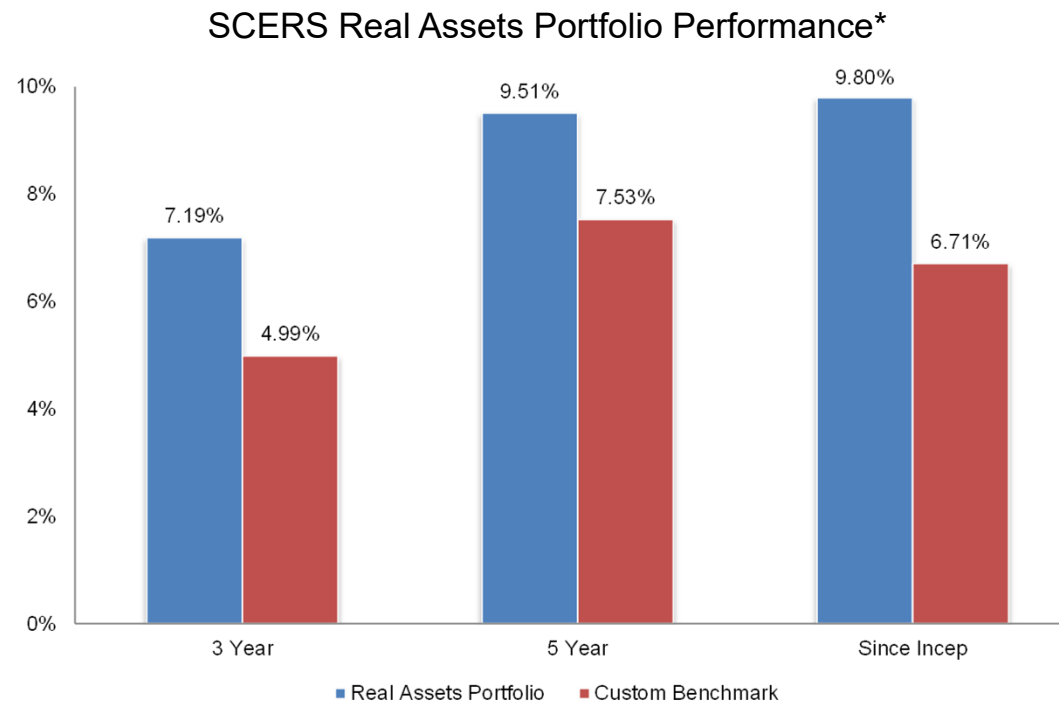
The SCERS Real Assets portfolio is intended to achieve multiple investment objectives



Real Assets Portfolio Performance

The Real Assets portfolio has been meeting its investment objectives overall, although performance has been more volatile than desired, particularly within Energy

- The Real Assets portfolio performance is compared to a blended benchmark that reflects each of the portfolio’s targeted subsector allocations, weighted by the current target weights
 - The underlying benchmark indices are common industry benchmarks for infrastructure, energy, agriculture, and timber



Summary of Real Assets Structuring Recommendations

The recommended changes reflect implementation considerations, following the 2021 asset liability modeling study, driven by continued evolution of the Real Assets subsectors

- No recommended changes to the portfolio’s stated investment objectives

Adopt new Real Assets strategy allocation targets and ranges

- Recommended changes are primarily driven by expectations of future investment opportunities
 - Also intended to more closely align the portfolio’s performance with its investment objectives
- Recommending modest changes to the Real Assets benchmark composition, consistent with the new recommended strategy allocation targets

Rename the “Energy” sub-strategy category to “Energy and Power”

- Intended to reflect a continuing global transition from oil and gas to electrification and decarbonization

Adjust the expected underlying Energy and Power sub-sectors

- Can include non-hydrocarbon “Energy Transition” strategies such as
 - Renewable energy
 - Electrification, power storage and transmission
 - Decarbonization technologies
- Traditional oil and gas investments remain permissible, though will be evaluated for portfolio fit on a case-by-case basis

Real Assets Allocation Targets and Ranges

	Current Target %	Recommended Target %	Recommended Range
Infrastructure	45%	60%	45% - 75%
Energy and Power	35%	30%	15% - 45%
Agriculture, Timber & Other	20%	10%	0% - 20%
Total Real Assets	7%*	7%*	5% - 9%*

Shown above are the current and recommended targets for the Real Assets strategy allocations

– Also included recommended allocation ranges for the new targets

** The Total Real Assets target allocation was reaffirmed with the 2021 asset liability modeling study; no recommended changes to the permissible range.*

Rationale for Changes to Strategy Allocation Targets

Increasing Infrastructure

- Expected performance characteristics, particularly for Core and Value-Add Infrastructure, align closely with each of the Real Assets portfolio's investment objectives
- Larger investment opportunity set as compared to other Real Assets sectors
 - Includes opportunities for larger investment allocations to individual open-end commingled funds, consistent with SCERS' "Hub and Spoke" investment approach in Real Assets

Decreasing Energy and Power

- Overall investment opportunity set expected to continue to decrease, particularly for lower volatility, cash flow generative investment strategies
 - Several Energy Transition strategies are primarily replacing reduced demand for traditional oil and gas investments
 - Nascent Energy Transition sector is largely unproven and includes strategies ranging from Real Asset-like to Private Equity-like
 - While traditional oil and gas investments will continue to be considered, performance characteristics of certain strategies may be better suited for Private Equity than Real Assets

Decreasing Agriculture, Timber, and Other

- Limited opportunity set with relatively low return expectations, particularly for cash flow generative "core" strategies

Recommended Real Assets Benchmark Change

The Real Assets benchmark is a blended benchmark of the portfolio's targeted subsector allocations, weighted by their target weights

- Recommending changing the underlying benchmark weights to be consistent with the new recommended target strategy allocations
- Also recommending simplifying the underlying strategy benchmark for Agriculture, Timber, and Other to reflect that strategy's reduced weighting and expected composition
- The current and recommended benchmark composition is shown below

SCERS Real Assets Policy Index Benchmark

	Current Benchmark	Recommended Benchmark
Total Real Assets	Custom blend of benchmarks below	Custom blend of benchmarks below
Infrastructure	45% Cambridge Associates Private Infrastructure	60% Cambridge Associates Private Infrastructure
Energy and Power	35% Cambridge Associates Private Energy	30% Cambridge Associates Private Energy
Agriculture, Timber & Other	10% NCREIF Farmland + 10%NCREIF Timberland	10% NCREIF Farmland

Real Assets Current Portfolio Allocations

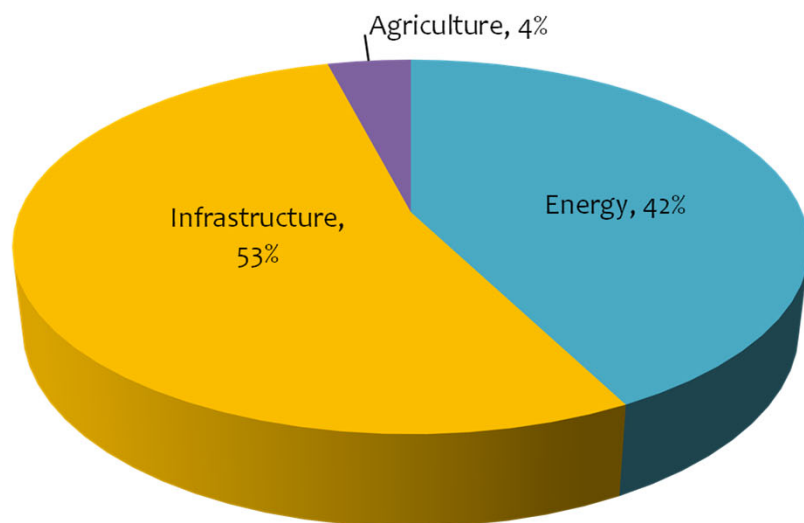
Real Assets represents 5.8% of the total SCERS portfolio as of 9/30/21

- Currently forecasting reaching the 7% target allocation in approximately 3 years
 - Will provide updated commitment pacing recommendations in the 2022 Real Assets Annual Investment Plan

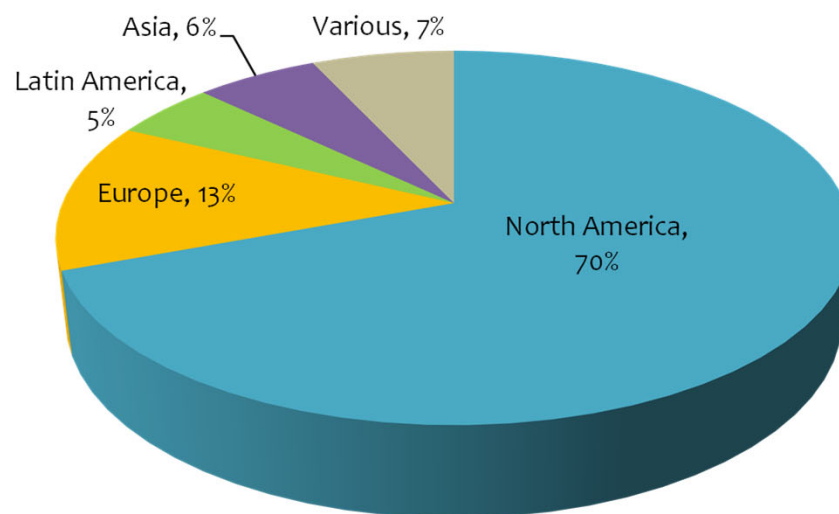
The current portfolio strategy and geographic allocations are shown below

- Strategy allocations are reasonably close to the targets and within the proposed ranges
- The portfolio is global, with a majority of the exposure in North America

Market Value Strategy Exposure*



Market Value Geographic Exposure*



Next Steps

Recommend Investment Policy Statement changes

- The recommended Real Assets structure changes go into effect upon Board approval
- The Real Return asset category IPS will be revised at a later date
 - The IPS revisions will include Real Assets updates and other Real Return asset class updates
 - The Master IPS will also be revised at a later date

Present the 2022 Real Assets Annual Investment Plan in Q1 2022

- Will include recommended commitment pacing

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