Meeting Date: June 21, 2017

Subject: Private Credit Investment Policy Statement

Submitted for: _X_ Deliberation and Action ___ Consent ___ Receive and File

Recommendation

Staff and Cliffwater recommend the Board approve the proposed Private Credit Investment Policy Statement.

Purpose

To establish the Investment Policy Statement ("IPS") for the Private Credit asset class which, along with all other asset class-specific IPSs, will be a supplement to the SCERS Master IPS.

Background

The Board adopted its revised strategic asset allocation in January 2017. At its May meeting, the board approved the asset allocation structure, investment implementation plan, twelve month investment plan, and implementation protocol for the Private Credit asset class. It is SCERS practice to establish IPS for each individual asset class within SCERS strategic asset allocation. The newly established Private Credit asset class requires its own IPS.

Discussion

The proposed IPS for Private Credit reflects the information previously presented to the Board for discussion and decision including:

1. Investment objective of the asset class;
2. Investment guidelines, including permissible investments, sub-strategy categories, targets and ranges, and risk and diversification considerations;
3. Monitoring; and
4. Investment implementation protocol.
The format of SCERS’ current IPS for Private Equity was used to develop the proposed Private Credit IPS, but with structural content specific to the Private Credit asset class.

By establishing the parameters set forth in the proposed IPS, the Board will assure that SCERS’ Private Credit investment activity is consistent with the guidelines established by the Board. It will also serve as a reference that documents the reasons SCERS has chosen to invest in Private Credit and its role in the overall portfolio.

ATTACHMENT

Proposed Private Credit Investment Policy Statement

Prepared by: ______________________________
Steve Davis
Chief Investment Officer

Reviewed by: ______________________________
Annette St. Urbain
Interim Chief Executive Officer
A. Investment Objective

The investment objective of the Private Credit Program is to produce attractive risk-adjusted returns and generate current cash flow through non-publicly traded lending strategies. Private Credit investments are illiquid and longer-term in nature than publicly traded fixed income investments. To compensate for the illiquidity, the Private Credit Program is expected to generate a rate of return that exceeds the return of publicly traded bank loans over the long-term. Along with earning an ‘illiquidity premium’ as described above, SCERS shall strive to achieve additional excess returns primarily from the selection of investment managers.

Given the above investment objective, the performance of the Private Credit Program will be compared against the following benchmark:

1. The Credit Suisse Leveraged Loan Index plus 2% will serve as SCERS’ Policy Index for Private Credit. Over all measurement periods, including while the program is being invested and after the program is fully invested, performance of the Private Credit Program is expected to exceed the return of the Credit Suisse Leveraged Loan Index by 2%, net of fees and expenses.

B. Investment Guidelines.

1. **Private Credit Investments:** Private credit is an illiquid, lending-oriented strategy focused on private loans to performing companies. It includes primarily debt investments, where an investor expects to receive principal and interest, with the majority of returns being generated from cash flow yield. Private credit is typically structured with floating rate loans, with a spread over Libor, so cash flow income increases as interest rates increase, but can also include fixed rate loans. The average maturity of a loan is generally five years; however, loans tend to be repaid prior to maturity, so the average life of the loans is generally three years. Most loans are senior secured loans. Loans are typically either sponsored (private equity backed companies) or non-sponsored. Non-sponsored loan typically have higher yields than sponsored loans. Private Credit fund terms are typically 5 to 8 years, with investment periods between 2 and 3 years. The potential for fund term extensions of up to three years is typically structured into most Private Credit funds. Investment is authorized in vehicles and investment strategies that invest in two sub-strategies, including:
a. Direct Lending. Direct lending investments are directly originated, non-traded, performing loans made to primarily middle market companies. Direct lending investments primarily are comprised of senior secured debt, which can be secured by general corporate collateral or by a company’s specific collateral. Equity participation can be structured into the loan, typically through warrants, but this is generally a small component of the strategy. Direct lending investments often utilize leverage (typically in the range of 0.5 to 2.5 times) at the fund level. Direct lending investments also have broadly diversified sector exposure, and include a combination of sponsored (private equity backed companies) and non-sponsored borrowers.

The overall expected return, including leverage, for a direct lending strategy will be in the range of 7% to 10%, with a cash yield between 7% and 9%. The majority of investments will be made in companies that are U.S. domiciled, however, non-U.S. domiciled companies can also be included.

b. Opportunistic Credit. Opportunistic credit investments are also performing loans like direct lending (not distressed), but represent a broader range of investment types. Opportunistic credit includes mostly senior secured structures, but can also include subordinated debt structures, convertible debt and structured equity. Opportunistic credit is often designated as an asset-backed lending strategy, where collateral comes in the form of specific assets such as receivables, inventory or royalty streams. Opportunistic credit investments can have meaningful equity participation, depending on the structure. This is often in the form of warrants and convertible bonds, but can also include direct equity participation. Opportunistic credit investments typically utilize little to no leverage. Opportunistic credit funds generally can have a targeted sector focus, which can often include only one sector, and generally are targeted toward non-sponsor borrowers.

The overall expected return for an opportunistic credit strategy will be in the range of 10% to 15%, with a cash yield between 9% and 11%. The majority of investments will be made in companies that are U.S. domiciled, however, non-U.S. domiciled companies can also be included.

2. Risk and Diversification: Private credit investments, like investments in most asset classes, bear an inherent risk that the actual return of capital, gains, and income will vary from the return and amounts expected. The expected volatility of private credit investments is often in-line with publicly
traded high yield bonds when leverage is factored in. The investment risk associated with private credit shall be addressed in several ways:

a. *Diversification by investment sub-strategy and geography.* The targeted and range of investment exposures to the identified Private Credit investment sub-strategies and geographies are shown in the table below. These exposures should be measured on a fair value basis, once the Private Credit Program is fully invested. The primary geographic focus within the Private Credit Program will be in the United States, though the portfolio can also include non-U.S. investments to increase geographical diversification. It is expected that the non-U.S. investments will be further diversified across different regions.

<table>
<thead>
<tr>
<th></th>
<th>Target Range</th>
<th>Target %</th>
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<tbody>
<tr>
<td>Direct Lending</td>
<td>50% - 100%</td>
<td>70%</td>
</tr>
<tr>
<td>Opportunistic Credit</td>
<td>0% - 50%</td>
<td>30%</td>
</tr>
<tr>
<td>U.S.</td>
<td>75% - 100%</td>
<td>85%</td>
</tr>
<tr>
<td>Non-U.S.</td>
<td>0% - 25%</td>
<td>15%</td>
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i. Note: Non-U.S. exposure refers to private credit funds with a primary investment focus outside of the U.S. and/or significant operations outside of the U.S., rather than to where the underlying investments are domiciled.

b. *Diversification by vintage year.* SCERS shall strive to limit the potential for investments during any given year in the business cycle to negatively impact the long-term results of the Private Credit Program by investing across business cycles and vintage years. It is anticipated that SCERS will commit to private credit over multiple years as a long-term asset class. The Board will determine with SCERS’ investment staff (‘Staff’) and consultant the funding allocation for private credit each year in conjunction with its annual review of the Private Credit Asset Allocation Structure and Twelve Month Private Credit Investment Plan.

c. *Diversification by industry, business sector and borrower.* SCERS shall attempt to limit the potential for any one industry or business sector to negatively impact the long-term results of the Private Credit Program by investing across a variety of industries at the aggregate Private Credit portfolio level. At the individual fund level, investments can be made in industry/sector diversified funds or in industry/sector specific funds. The latter are generally more common to opportunistic credit funds, where an investment manager demonstrates differentiated expertise and experience managing investments within a particular industry/sector over multiple cycles. The Private Credit Program will also diversify
across a variety of borrowers at the individual fund level, in order to minimize the negative impact of potential borrower defaults.

d. *Diversification by investment manager and general partner.* On the one hand, investing with too many managers and funds will make it difficult to achieve the primary investment objective of enhanced returns in the Private Credit program. However, too few managers may create a greater than acceptable level of volatility in the program. Overall, in order to balance the goal of achieving enhanced returns against the risk of loss, SCERS will favor a concentrated approach by allocating approximately 15%-25% of the total Private Credit target allocation to each fund. SCERS will strive to maintain ongoing long-term relationships with approximately 10 private credit managers with an expected range of 8-12 manager relationships. The optimum number of investment vehicles in the portfolio and the maximum exposure to any one investment vehicle varies with time and will be evaluated as part of the Private Credit Asset Allocation Structure.

3. **Investment Vehicles:** A common investment vehicle for private credit investments is a commingled fund, structured as a limited partnership, which is the investment vehicle SCERS utilizes for most investments in other private markets asset classes. Private credit commingled funds are drawdown structures with management fees typically between 0.75% and 2.0%. Direct lending strategies generally have lower fees than other private market strategies, and often only charge management fees on invested capital, not committed capital. Carried interest (performance fees) ranges between 0% and 15%, with a preferred return hurdle typically between 7% and 8%, depending on the complexity of the strategy. Opportunistic funds can have higher management fees and carried interest given their higher return targets.

Separate accounts are also a vehicle that can be used to invest in private credit. Separate accounts are larger and customizable accounts with investment managers that have greater flexibility in the guidelines, greater input from Staff and consultant, and may have lower fees. Separate accounts generally have a size of $100 million or greater.

Another investment vehicle that is common in private credit is private business development companies (‘BDCs’). Private BDCs have similar investment strategies as a private commingled fund, but have a differing structure. These vehicles can have lower fees, lower yields, and the potential to earn a return premium by going public through the IPO markets.
SCERS may also invest directly in fund-of-funds ('FoF') vehicles. In these vehicles, the FoF invests in private credit partnerships on a discretionary basis. FoFs will own the underlying private credit partnerships and SCERS obtains contractual rights to the FoFs' portfolio through a limited partnership. A FoF will have investors other than SCERS.

4. Secondary Investments and Co-investments: Secondary investments are made when an investor purchases the limited partnership interest of another investor in an existing fund. A co-investment is a direct investment in a loan origination where a private credit manager offers investors the opportunity to invest directly in an underlying loan alongside the fund investment. Investments may be made in companies that are either U.S. or non-U.S. domiciled. Neither secondary investments nor co-investments are considered separate investment strategies within private credit. Secondary and co-investments will be categorized according to the underlying strategy and geography and will conform to the guidelines outlined in the above section on risk and diversification. SCERS will seek to allocate to secondary investments and co-investments on an opportunistic basis. It is expected that these investments will constitute a small portion of the overall Private Credit program.

5. Investment Vehicle Concentration: SCERS shall not comprise more than 20% of any one investment vehicle at the initiation of the investment that is a limited partnership, limited liability company, or offshore corporation. The exception to this guideline is an investment in a FoF or a separate account, whereby SCERS may be the sole investor. In these circumstances, SCERS will make reasonable efforts to ensure that it does not generate a majority of the firm’s profits.

6. Liquidity: Private credit investments are illiquid and typically have longer expected holding periods such as 5-8 years. While the majority of investments are tied to coupon payments and cash distributions are returned to investors on a quarterly basis, most investments are held until maturity or full repayment and selling an interest in a fund prior to maturity may result in realizing a sales price that reflects a discount to fair market value. Liquidity risk is therefore managed by minimizing the possibility of forced sales that may arise from exceeding maximum exposure limits, or lowering asset allocation targets to private credit investments. In order to better assess liquidity needs, a capital budget and cash flow forecast will be developed over a ten year horizon and updated as necessary. The assumptions of this forecast are stress tested in the context of the total fund to assess the effect of worst case liquidity scenarios.

7. Distributed Securities: SCERS shall seek to avoid the direct receipt of distributed securities from individual private credit funds. However, if such receipt is unavoidable, then SCERS shall ordinarily direct the sale of
securities distributed by its investment vehicles as soon as practically possible and strive to not impair the value of the security.

8. **Performance Evaluation:**

   a. Performance of the Private Credit Program, as measured by internal rate of return (‘IRR’), will be evaluated quarterly against the following benchmarks and assessed against the investment return objectives:

      i. The Credit Suisse Leveraged Loan Index plus 2%
         1. The Credit Suisse Leveraged Loan Index plus 2% will serve as SCERS’ Policy Index.

   b. Individual investment vehicle performance, as measured by the IRR and the multiple of total value paid in capital (‘TVPI’), may be evaluated on a quarterly basis compared to the performance of respective peer universes and vintage years, to the extent that viable peer universes are available.

   c. It is recognized that immature private credit investments may have some “J-curve effect” that results in low or negative initial returns. However, the majority of private credit investments are tied to coupon payments and private credit funds often charge management fees on invested capital rather than committed capital, which will reduce the J-curve effect of private credit investments compared to private equity investments.

9. **Investment period to ramp-up:** It is recognized that it may take four years or more for a Private Credit Program to be fully invested and that there may be deviations from previously mentioned targets during a Private Credit Program’s ramp-up period. During the Private Credit Program’s ramp-up period, exposures can be estimated using percentages of committed capital. During the ramp-up period for the Private Credit Program, and subsequent to reaching the target allocation, SCERS’ Overlay Program will re-balance the Private Credit Program to the target allocation, using the designated proxy within the investment guidelines for the Overlay Program.

10. **Rebalancing to guidelines:** It is anticipated that the majority of changes to rebalance the Private Credit portfolio will be made on a longer-term basis due to: (1) The illiquidity of the Private Credit asset class with typical investment horizons of 5 – 8 years; and, (2) The significant discount that could be applied if and when Private Credit holdings are liquidated in the secondary market. Accordingly, if these guidelines are exceeded, it is anticipated that reducing exposures will be carried out within a long-term
time frame and over a period that is as soon as is practical to reflect the illiquidity of the private credit vehicles.

C. Monitoring

Through the monitoring process, Staff and consultant will extend the initial due diligence into a formal quarterly, semi-annual, and annual process which regularly seeks to determine whether the manager is meeting the Private Credit program’s investment objectives and other requirements. In the broadest sense, the monitoring process is intended to determine whether the initial reasons for selecting the strategy and investment vehicle remain valid. The monitoring process should disclose whether there has been any material deviation from the investment philosophy and process; the personnel responsible for managing the investment vehicle are still in place; the organization continues to be stable; performance and risk meet expectations; and the investment vehicle manager adheres to its investment and other requirements. The underlying principle of the monitoring program is to determine whether all risks to which SCERS is exposed through the use of outside investment advisors have been identified, understood, and, to the extent possible, controlled. The monitoring process focuses on four areas:

- Compliance with reporting and valuation requirements;
- Continuity of investment philosophy and process;
- Stability of personnel and organization; and
- Performance and risk management.

Staff and consultant will aggregate investment vehicle data and perform analysis on the overall Private Credit portfolio, paying careful attention to individual investment vehicle allocations and strategy/sector concentrations to strive to achieve proper diversification across the Private Credit Program. Staff and consultant also will conduct due diligence with the respective investment vehicle managers to understand the underlying drivers of performance. Additionally, Staff and consultant shall conduct portfolio reviews and on-site due diligence as necessary. Site visits will also be performed to confirm that appropriate infrastructure is in place to support the investment process. Staff and consultant shall provide the Board with regular performance reports and advise the Board of other matters as appropriate.

If during the monitoring process, SCERS identifies areas of the Private Credit Program that are not compliant with the objectives, guidelines and constraints, identified in this investment policy statement, then reasonable efforts will be made to cure the deficiency. These reasonable efforts will consider the illiquidity of the asset class and transaction costs to be incurred compared to the risk of non-compliance.
D. Implementation Protocol

The following implementation protocol designates the responsibilities shared between SCERS’ Board, Staff and consultants. Overall, the Private Credit implementation protocol delegates the most time intensive elements of the process including development of the long-term and short-term investment plans and the screening and selection process of investment managers to Staff and consultant, while preserving the Board’s oversight of the overall Private Credit Program.

On an annual basis, the Board will approve the long-term Private Credit Allocation Structure and Twelve Month Private Credit Investment Plan as developed and presented by Staff and consultant. The long-term Private Credit Asset Allocation Structure will articulate the long-term direction and objectives of the Private Credit Program including elements such as: (1) An asset allocation target and ranges by strategy, geography and vintage year; (2) A target range for the number of investment managers and types of vehicles; (3) A level of commitments to achieve and maintain SCERS’ asset allocation target; (4) A capital budget and long-term forecast of cash flows; and, (5) The role of Fund of Funds, Co-investments and Secondaries. The Twelve Month Investment Plan will articulate the direction over the next year in taking the necessary steps to achieve the above long-term Asset Allocation Structure.

The execution of the long-term Asset Allocation Structure and Twelve Month Investment Plan including the selection of investment managers will be delegated to Staff, subject to the Board’s ability to review, discuss and object to the recommendations of Staff and consultant during the investment protocol process.

The key features of the proposed private credit investment protocol are as follows:

- Staff and consultant will identify the most qualified candidates for a prospective private credit investment commitment based on: (a) The Private Credit asset allocation structure approved by the Board; and (b) The twelve month private credit investment plan approved by the Board (which takes into account SCERS’ existing private credit investments and prioritizes and targets optimal new investment opportunities expected to come to market in the next twelve months).

- Staff and consultant will prepare a report for the Board outlining why a given private credit manager has been identified for closer scrutiny for a possible private credit commitment.

- Staff and consultant will pursue more extensive due diligence on the manager candidate, including conducting extended interviews with the portfolio managers and other key members of the investment team. The
consultant will complete the investment strategy and operational due diligence reports, if they have not done so already. Legal counsel will begin reviewing the documentation for the possible commitment and preliminary negotiation of deal terms will take place.

- If/When: (a) The due diligence process is completed; (b) Deal terms have been determined; (c) Staff and consultant have concluded that a commitment should be made; then (d) Staff will prepare a report outlining the basis for the decision, the proposed commitment amount, and the target date for closing on the commitment. This report will include an assessment of investment strategy and operational due diligence.

- At any point in the process, questions or concerns by any trustee regarding a proposed investment or proposed manager will be communicated to the Chief Executive Officer (‘CEO’). The CEO will be responsible for assuring that a prompt response is provided. The CEO will also provide the full Board with the response. If the Board member is not satisfied with the response, the Board member can request that the matter be brought to the full Board for consideration. In such a case, the CEO will refer the matter to the Board President who will determine whether the manager search process should be suspended until the matter is resolved. As a general rule, it is anticipated that the process of identifying and vetting a proposed investment will take place over a period of time sufficient to allow, if necessary, for full Board consideration of questions or concerns before a commitment is finalized.

- Absent questions or concerns by the Board, the proposed investment will be finalized and the necessary documentation executed.

- Staff and consultant will then prepare an updated status report on SCERS’ Private Credit portfolio for the Board.

**HISTORY OF SCERS RETIREMENT BOARD ACTION:**

Approved ____________