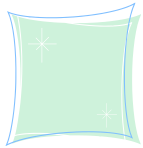




SONOMA COUNTY EMPLOYEES' RETIREMENT ASSOCIATION

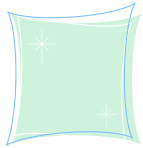
Managing the Investment Function & Investment Consultant Structures

Presentation to
Mendocino County Employees Retirement Association
April 18th, 2018



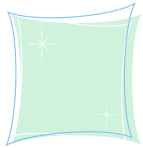
Outline

- Introduction
- Decision Making
- Delegation & Allocation of Responsibilities
- The Outsourced CIO Model
- SCERA's Allocation of Responsibilities



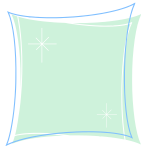
INTRODUCTION





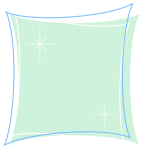
Introductions





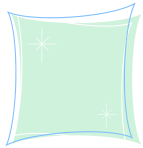
Pension Plans Are Like Super Tankers!





DECISION MAKING

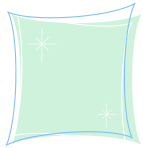




How does your Board make decisions? Majority vote or consensus?

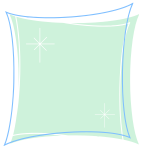


"SO, THAT'S THREE 'YES' AND TWO 'NO' AND ONE
'MAYBE YES MAYBE NO'."



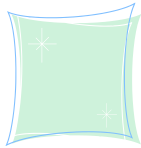
How does your Board make decisions?

- Trustees are not required to be investment experts but are expected to exercise good judgement and in the sole interest of . . .
- You will be “wined & dined” but, of course, . . .
- Is the process formal or more informal
- There is a lot of imprecision in investing
- Some questions don’t have a “right” answer (e.g., asset or perf fee)
- Admittedly, sometimes you can’t develop a consensus
- Sometimes not to make a decision is a decision (e.g., do we change the assumed ROR or not?)
- However, if consensus can be achieved:
 - Direction to staff is clear
 - You have buy-in from all parties
 - May be more likely to avoid pitfalls
 - Investment ideas are more likely to be maintained
 - May take longer to react to opportunities



DELEGATION & ALLOCATION OF RESPONSIBILITIES





Delegation & Allocation of Responsibilities

Duty to Delegate



*Steer the ship, set the course, but allow
the staff/experts to handle the rowing*

*A trustee has a duty personally to perform the responsibilities of trustee **except as a prudent person might delegate those responsibilities to others**. In deciding whether, to whom and in what manner to delegate fiduciary authority in the administration of a trust, and thereafter in supervising agents, the trustee is under a duty to the beneficiaries to **exercise fiduciary discretion and to act as a prudent person would act in similar circumstances**.*

Restatement of Trusts, § 171

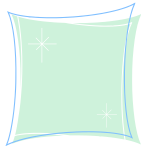
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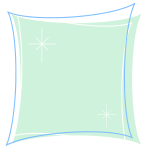
SONOMA COUNTY EMPLOYEES' RETIREMENT ASSOCIATION



Delegation & Allocation of Responsibilities

Delegation Must Be Prudent to Shift Liability

- To be prudent, when delegating, the following generally applies:
 - Duty of prudence in selecting qualified professionals
 - Duty to specify the scope of the delegation
 - Duty to monitor the professionals to ensure the delegation is carried out in the best interest of participants and beneficiaries, and continues to be prudent
 - Duty of loyalty to select the professionals on the basis of the best interests of the participants and beneficiaries



Delegation & Allocation of Responsibilities

Trend Toward Delegation of Certain Investment Functions

Usually Retained

- Adoption of IPS
- Operating budget
- Asset allocation
- Permissible asset classes
- Use of internal management
- Selection of investment consultant
- Selection of custodian

Sometimes Delegated

- Number of managers in each asset class
- Selection and termination of investment managers
- Selection of private equity and real estate deals
- Approval of performance benchmarks
- Active versus passive management
- Manager guidelines

Frequently Delegated

- Rebalancing
- Criteria for manager searches
- Fee negotiations
- Manager due diligence & due diligence on-sites
- Ongoing investment manager monitoring
- RFP Process

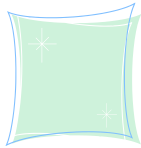
This list of Investment functions is not all-inclusive. Some funds delegate more, others less.

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Delegation & Allocation of Responsibilities

Sample Responsibility Matrix

Investment Responsibility	Board	Investment Committee	CIO	Other Staff	Investment Consultants
Investment policy					
Asset allocation and risk tolerance					
Permissible asset classes					
Performance benchmarks					
Selection of consultants					
Selection of custodian bank					
Internal versus external management					
Active versus passive management					
Number of managers in each asset class					
Selection of investment manager					
Termination of investment manager					
Specific mandates/allocations to each manager					

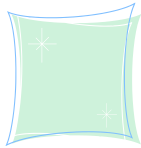
X = Final Authority; **X** = Involved in the Process

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Delegation & Allocation of Responsibilities

Sample Responsibility Matrix (continued)

Investment Responsibility	Board	Investment Committee	CIO	Other Staff	Investment Consultants
Selection of private equity funds					
Selection of real estate funds					
Checklist for manager searches					
Ongoing manager monitoring					
Meeting with managers/due diligence visits					
Periodic call with managers					
Rebalancing activities					
Topical research on new strategies/opportunities					
Documentation of transactions					
Decision about deviations from policies					
Proxy Voting					
Drafting RFPs and reviewing manager responses					

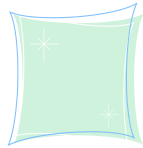
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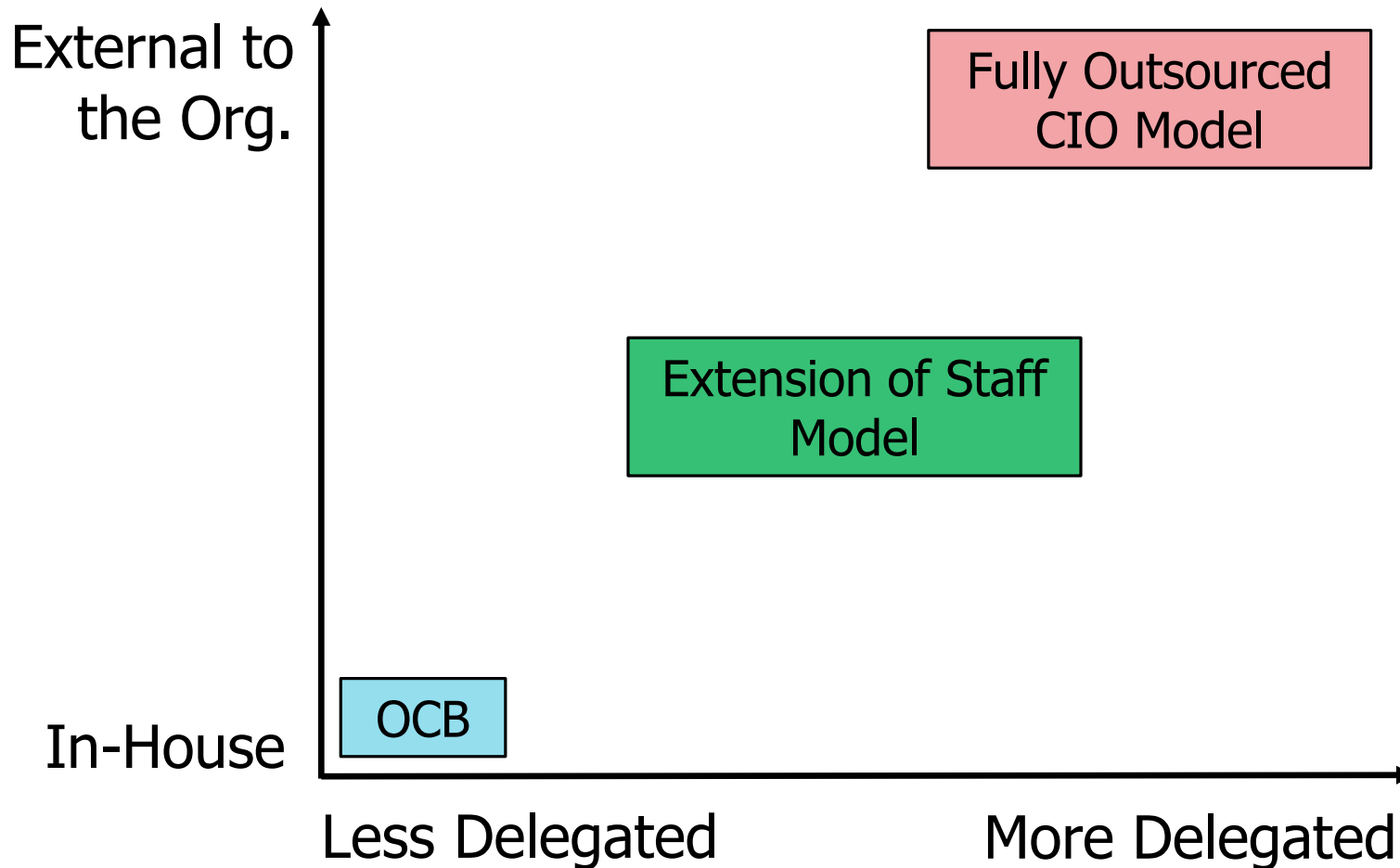
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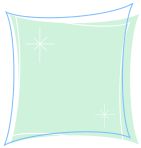
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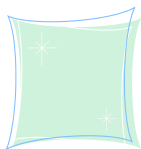
A Continuum of Structures for Investment Staff & Consultant





THE OUTSOURCED CIO MODEL





How are asset owners responding in the current environment?

40% of respondents either currently outsource or are planning on outsourcing their investment program during the next 24 months

Asset Size

< \$500 million	74%
> \$500 million	23%

Smaller plans are three times more likely to outsource, but the likelihood of outsourcing is fairly consistent across large plans.

Investor Type

Corporate DB	31%
Corporate DC	63%
Public Pension	41%
E&F	26%
Healthcare	33%

Outsourcing is impacting all Investor types, most notably DC Plans.

Mandate

Fully Outsource	65%
Partially Outsource*	35%

Of those deploying an OCIO, most investors fully outsource irrespective of their asset size.

* Provider recommends managers.

Source: Chief Investment Officer Magazine, 2017 OCIO survey, 148 respondents surveyed during January 2017

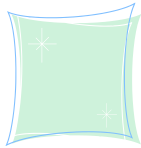
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What are the key reasons for considering outsourcing

Top 5 reasons for moving to or considering an OCIO

1. Lack Internal Resources
2. Additional Fiduciary Oversight
3. Better Risk Management
4. Need to Increase Returns
5. More Timely Decision Making and Implementation

Top trends by client type

- **DB Plans** – Pension risk transfer and de-risking needs are growing
- **DC Plans** - Increasing interest influenced by litigation and the need for expertise
- **E&Fs** - Outsourcing for access to investment expertise and alternative strategies

Source: Chief Investment Officer Magazine, 2017 OCIO survey, 148 respondents surveyed during January 2017

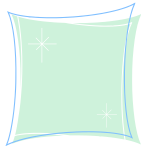
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Outsourced CIO (OCIO) & the Governance Structure



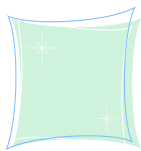
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What key decisions drive results?

“Asset allocation accounts for over 91% of the performance variability among portfolio”

—Brinson Beebower & Singer 1991; Determinants of Portfolio Performance

“Fixed asset allocation solutions are inferior – Investors’ circumstances or opportunities change and therefore their asset allocation should change”

—William Jahnke 1997, Former CEO of Wells Fargo Investment Advisors

Confirmation of the Brinson, Beebower & Singer study that asset allocation is the primary determinant of performance (>90%)

—Roger Ibbotson and Paul Kaplan 2000, Does Asset Allocation Explain 40%, 90% or 100% of Performance

Where does your Investment Committee and staff spend the majority of their time and effort?

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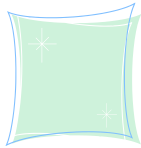
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SONOMA COUNTY EMPLOYEES' RETIREMENT ASSOCIATION



Strategic Partnership Spectrum

Relationship with Investment Committee

	Traditional/Advisory	Partial / Hybrid OCIO	Fully Discretionary – OCIO
Strategy <ul style="list-style-type: none"> Asset Allocation Investment Policy 	Shared with Committee	Shared with Committee	Shared with Committee
Implementation <ul style="list-style-type: none"> Investment Allocation Manager Selection 	<i>Advisory</i>	Advisory or Discretionary	Discretionary
Execution <ul style="list-style-type: none"> Tactical Allocation Rebalancing Trading Risk Management 	<i>Advisory</i>	Advisory or Discretionary	Discretionary
Monitoring <ul style="list-style-type: none"> Assets Goals Reporting 	<i>Advisory</i>	Advisory or Discretionary	Discretionary



*The information provided is for illustrative purposes only

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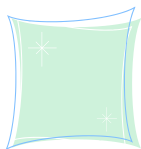
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SONOMA COUNTY EMPLOYEES' RETIREMENT ASSOCIATION

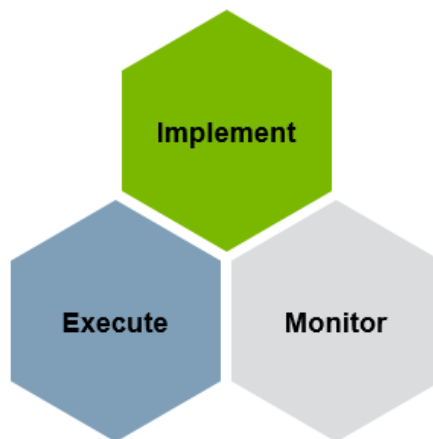


The “Extension of Staff” Model

Extension of Staff Models can be an effective solution to complement existing in-house capabilities.

Integrated Decision Making

Example: Form a joint fiduciary committee to explore new asset classes and make portfolio investment allocation decisions.



Integrated Processes

Example: Outsource rebalancing and cash flow management.

Integrated Systems

Example: Outsource the daily monitoring and reporting of assets, liabilities, and investment guidelines.

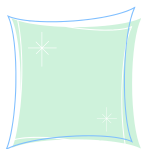
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Considerations When Selecting an OCIO



Know your organization's needs, strengths and deficiencies

- What problem are you trying to solve?
- How are you resourced?
- Is there clear alignment between organization's objectives and investment structure?



What resources/expertise do you currently have and what do you need to add

- How are resources allocated between core business and investment solutions?
- Is there the appropriate leadership/governance to strategize and implement effectively?



Prioritize important characteristics for a strong partnership

- Breadth of capabilities – will they meet ongoing needs
- Cultural alignment – experienced, knowledgeable and independent
- Ability to customize – your needs will evolve over time, can your partner
- Strength of expertise – deep, experienced teams of researchers and executors
- Independence – no conflicts of interest



Ongoing requirements for staff, committee and the organization

- Dedicated practice with an organizational commitment
- Client service – ability to proactively provide thought leadership, market insights and adjust solutions
- Innovation



Define how you expect to benefit from delegating to a strategic partner

- Efficiency
- Expanding expertise
- Increased and holistic focus on investment solution and risk management
- Cost effective and transparent

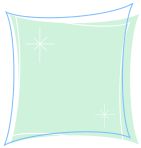
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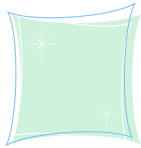
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SCERA'S ALLOCATION OF RESPONSIBILITIES





SCERA's Allocation of Responsibilities

RETIREMENT BOARD

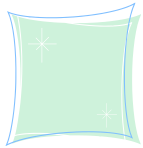
SCERA STAFF / CONSULTANT

MANAGERS

US Equity / Non-US Equity / Global Equity / Fixed Income /
Real Assets / Opportunistic / Global Asset Allocation / Hedge
Funds / Private Equity / Cash Overlay & Rebalancing

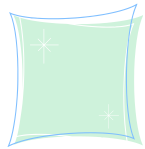
CUSTODY & ADMINISTRATION

Custodian/Performance Measurement/Prime Broker/Securities Attorneys/Trade
Cost Consultant(s)/Transition Manager(s)/Securities Lending Agent/Proxy Service
Provider/Foreign Tax Agents/Cost Management Consultant/Independent Auditor



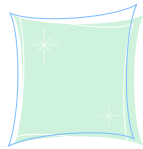
SCERA's Retirement Board

- Establishes overall strategy – return objective, risk tolerance, etc.
- Approves Investment Policy Statement and investment guidelines
- Approves recommended managers & other service providers
- Oversees/directs investment staff



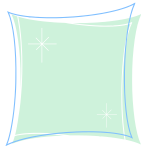
SCERA's Investment Staff

- Coordinates and directs other service providers
- Due diligence on investment consultant
- Ongoing due diligence on managers and custodian
- Rebalancing asset allocation with physicals
- Leads manager selection process
- Leads project planning for investments
- Monthly market & performance highlights for Board mtgs
- Manages system liquidity
- Analyzes risk, market trends, legislation, litigation & other external forces impacting investment strategy
- Oversees integrity of investment process & quality of trading activities and ensures compliance with the Board's investment policy & guidelines



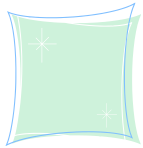
SCERA's Investment Consultant

- Brings expert investment advice in and across asset classes
- Asset/Liability modeling
- Asset class expertise when hiring managers and considering investment structures and guidelines within asset classes
- Manager operational due diligence & ongoing due diligence of managers and custodian
- Recommends investment ideas (e.g., Davidson Kempner for opportunistic)
- Provides pool of vetted managers for manager searches
- Presents annual manager reviews
- Conducts annual risk budgeting analysis
- Provides Medium Term Views and capital market assumptions
- Topical educational presentations
- Quarterly performance & analytics reports and related presentations
- Attends monthly meetings to provide insights & consultant perspective



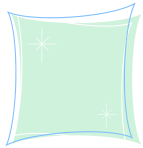
SCERA's Investment Managers

- Manage portfolios with agreed upon objectives and within guidelines
- Monthly reconciliations of holdings to custodian
- Separate account trade activity reported to custodian
- Reporting to staff & consultant – performance, positioning, organizational changes
- Cash overlay manager also rebalances the Plan's asset allocation using derivatives



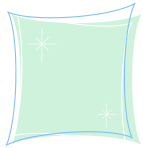
Custody & Administration at SCERA

- State Street Custody
 - Custody of assets
 - Selects & manages relationships w/ non-US subcustodians
 - Market values & monthly returns for benchmarks and portfolios
 - Quarterly “universe” reports – performance & asset allocations
 - Filing securities class action claims - domestic
- State Street Securities Finance
 - Securities lending
- State Street Global Markets
 - Transition management
 - Interim management
 - Commission recapture
- Prime Broker
 - Custody of assets and facilitation of borrowing & lending



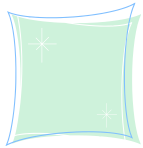
Custody & Administration at SCERA (cont.)

- Trade Cost Consultants
 - GTA - Ongoing qtrly US and non-US equity as well as fixed income trade cost analysis & reporting
 - KlarifyFX - Periodic quarterly currency trade cost reporting
- Foreign Tax Agents
 - Non-US tax filings
- Proxy Service Providers
 - Recommendations to managers on how to vote proxy issues
 - Cast proxy votes for managers
- Independent Auditor
 - Checks SCERA books/accounting
 - Reviews integrity of valuation processes
- Securities Litigation – domestic & foreign
 - Law firms Cohen & Milstein and Berman DeValerio monitoring



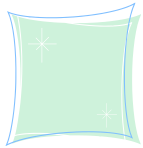
The Investment Policy Statement (IPS)

- The IPS is often conceived of as foundational document which, like the Constitutional, provides overall guidance
- The IPS could be a single or multiple documents?
 - Asset class or strategy guidelines could be in separate documents
- The IPS may be narrow and specific or looser and more accommodating
- Is it stable and unchanging or a “living” document?
(the more specific it is the more likely it is subject to change)



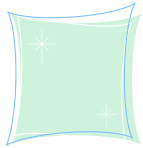
SCERA's IPS

- Investment philosophy statement
- Risk philosophy statement
- Duties & responsibilities
 - The Board, the Investment Committee, investment consultant, investment managers, custodian, prime broker, custodian, auditor, actuary
- Hiring and reviewing external service providers
- Investment objectives
 - Return, risk, time horizon, liquidity requirements, special purpose investments (ESG?)
- Asset allocation targets and ranges
- Rebalancing and cash management
 - Rebalancing with derivatives
 - Rebalancing with physicals



SCERA's IPS (continued)

- Investment guidelines and portfolio structure
 - Core Fixed Income, Alt Fixed Income, Real Assets, US equities, Non-US & Global Equities, Overlay Strategies (Cash & EIRP Overlay), Opportunistic
- Prohibited investments
- Derivatives (kinds, uses, limitations)
- Required reporting
- Control procedures (perf reviews, ongoing due diligence)
- Managers on "Watch"
- Performance objectives
- Commission recapture
- Securities lending
- Perf measurement standards (benchmarks & peer universes)
- Securities litigation (separate policy)
- Proxy voting (separate policy)



Planning

- The annual budget
- The organization's annual plan
- Periodic off-site meetings
(e.g., SCERA's Annual Planning Session)
- Periodic (Monthly/Qtrly) Investment Committee meetings
 - Rotation for manager/service provider presentations
 - Investment projects for the year / by calendar quarter
 - Committee inputs to project list