



RETIREMENT BOARD CALENDAR SHEET
Retirement Board Meeting of January 13, 2021

To: The Retirement Board

Through: Jay Huish *JH*
Executive Director

From: William J. Coaker, Jr – CFA
Chief Investment Officer

Date: January 13, 2021

Agenda Item:

Review and Approval of Updated SFERS Investment Division Strategic Plan – 2020 to 2030

Background:

In 2014 the Retirement Board approved an investment strategy that emphasized two objectives: 1) To reduce the impact caused by a large market decline through a differentiated approach to asset allocation, and 2) To earn high returns through manager selection. The strategy increased the investment staff from 14 to 26 (including operations). At the time Trust assets totaled just under \$20 billion. The strategy increased expenses by approximately \$4 million a year, or 0.02% per year.

The new strategy increased our allocation to Private Equity (to boost returns), reduced Fixed Income and added Private Credit (to further boost returns), reduced Public Equity (to reduce the potential for a large loss), broadened Real Estate to include Natural Resources and added Absolute Return (to enhance diversification), increased our allocation to private markets to 45% from 28%, and changed our approach to manager selection from generalists to emphasizing unique and niche strategies and managers with specialist skill (to boost returns). In recent years we also implemented a framework for evaluating ESG risk factors.

The results of the strategy have been encouraging. The past 6 ¾ years SFERS returns have ranked in the top 1%, our risk-adjusted returns have ranked in the top 2%, the volatility of our returns ranks in the lowest 8%, and we added \$3.3 billion in value compared to median return of public pension plans with \$1 billion or more in assets. In the prior five years from 2009-2013, SFERS lagged its peers by 0.33% annualized, ranked in the 57th percentile versus

peers, the volatility of our returns was around the median, and we underperformed by \$280 million compared to our peers. In FYE June 30, 2009 SFERS returned -22.06%, lagging our policy benchmark and median peer return of -17.37% and -18.72%, and ranking in the 92nd percentile versus our peers. The large loss and underperformance were factors in the development of SFERS current strategy.

In early 2019 staff noted that we had become under-resourced to sustainably implement our investment strategy. Several things had changed from 2014 to early 2019. First, our assets had increased from under \$20 billion to \$25 billion. Second, our liabilities were set to increase from \$28 billion in 2019 to \$44 billion by 2030, which required a strategy for significant future growth. Third, competition for allocations in private markets had intensified considerably. Fourth, private markets managers who previously returned to market for fundraising about every four years were doing so every three years or less.

In sum, in early 2019 staff noted we needed more resources to continue implementing our existing strategy, or we needed to change our strategy to fit our existing resources. We also needed to modify our strategy, as our large asset size combined with our emphasis on small, niche, specialist strategies who are capacity constrained made it difficult for SFERS to get allocations at the size we need.

In mid-2019 the investment staff began to identify and evaluate possible changes in strategy. The options and benefits and considerations of possible changes are as follows:

Options	Benefits	Considerations
1 - Indexing	- Very low cost - Easy and quick to implement	- 0% excess returns - Increased beta risk
2 - Factor-based Investing	- Easy and quick to implement	- Low excess returns - Increased beta risk
3 - Larger Funds	- Investable	- Modest excess returns - Expensive
4 - Outsource Investments including co-investments	- Easy to implement - Investable	- In many instances our GP's may not be willing to share their ideas - Expensive - Lower expected excess returns
5 - Continue with our strategy toward asset allocation and manager selection	- High excess returns since adoption - Low volatility since implementation - High risk-adjusted returns since adoption of the current strategy	- Labor intensive - Requires additional in-house resources - Requires an enhanced career track for personnel
6 - Co-investments in-house	- Net reduction in cost v. active mgmt - Increased value from existing GP relationships - Additional in-house skill - Fosters new skill for existing staff - Ready pipeline of ideas - High expected returns	- Currently less in-house experience - Co-invests at scale are fairly new for many consultants - Requires successful recruitment of experienced co-investment staff - New staff relationships for GP's - Requires tight deadlines

Staff thinks that aligning resources to our current approach toward asset allocation and manager selection plus adding co-investments is the option that will produce the highest returns going forward. Additionally, due to lower investment management fees, co-investments result in lower total expenses than most active management strategies.

The attached document titled "Investment Division Strategic Plan 2020-2030" subtitled "SFERS is at an Inflection Point and Needs to Evolve to Maintain Recent Success" summarizes Staff's thinking and recommendations.

A summary of the approvals Staff seeks in the Strategic Plan are as follows:

- 1 – Staffing: Increase investment staff levels from 26 to 36 over the next few years. Increased staffing enables SFERS to continue implementing our approach to asset allocation and manager selection while adding co-investments. Increased staffing for most asset classes as well as ESG, Asset Allocation and Risk Management, and Operations will enable each team to delve deeper into their craft and provide SFERS with a deeper team in each silo (currently we are thin in every group). Lastly, recruiting experienced co-investment professionals will provide new in-house skill and enhance the skill set of our existing team.
- 2 – Career Track: Implement an enhanced career track. An improved career track will better enable SFERS to recruit and retain talented staff.
- 3 – Co-Investments: Develop and implement a glide path toward investing of up to 2% of Plan assets annually in co-investments, subject to the restrictions highlighted in the attached document. Co-investments provide attractive investment opportunities at low to very low cost and are expected to provide higher returns compared to the other options staff described earlier in this memo.
- 4 – Delegation: Co-investments require completing work under tight deadlines, usually several weeks and sometimes in a matter of days. Last year the Board authorized delegation of authority to the Executive Director and the CIO for up to 2% of Plan assets annually subject to a limit per investment of 0.25% of Plan assets. The Board's General Consultant will furnish the Retirement Board with a report annually on SFERS co-investment activities.

Retirement staff will provide a written and oral presentation to the Board on this item.

Recommendation:

Approve the updated SFERS Investment Division Strategic Plan – 2020 to 2030

Attachment: Updated *SFERS Investment Division Strategic Plan – 2020 to 2030*



SFERS

San Francisco Employees' Retirement System

Investment Division Strategic Plan 2020 to 2030

SFERS is at an Inflection Point
and Needs to Evolve to Maintain Recent Success

Note: The Strategic Plan for the Investment Division for the next 10 years was approved by the Retirement Board in January 2020. This is an update to the Strategic Plan.

William Coaker Jr. - CFA
Chief Investment Officer

Recommendation Approved by the Board in January 2020

1. Career track to better recruit and retain talented investment professionals
2. Operations staff dedicated to investment activities related to administration, operations, and compliance
3. A larger team of investment professionals:
 - ❑ To manage the complex, specialist and labor-intensive strategies in which we invest
 - ❑ To evaluate additional such strategies for future investment
 - ❑ To invest more prominently in co-investments
4. Delegation of authority to staff to invest up to 2% of assets annually in co-investments subject to the following:
 - ❑ Maximum of 0.25% in any single investment
 - ❑ Annual review and report by the General Consultant as to adherence to the co-investment framework

Investment Objective

Strategy to Achieve our Objectives

- ▶ Investment Objective: To earn high long-term returns and reduce the negative impact on our funded status caused by a large market decline

- ▶ Strategy to Achieve our Objective:
 - ❑ Asset Allocation: SFERS seeks to reduce the impact of a market decline through a differentiated approach to asset allocation

 - ❑ Manager Selection: SFERS seeks to earn high returns through manager selection, by emphasizing active managers in unique and niche strategies and with specialist skill

SFERS has posted High Returns

- ▶ Returns rank in the top 1% over the past 6 ¾ years *
- ▶ Over the past 6 ¾ years SFERS has added \$3.3 billion more in value vs. the median public plan

Description	1 Yr	3 Yrs	5 Yrs	6.75 Yrs
SFERS	8.05%	8.10%	9.52%	7.98%
Median Peer > \$1b	5.98%	5.48%	7.49%	5.99%
Excess Returns	2.07%	2.62%	2.03%	1.99%
\$ Added v. Median Peer	\$0.3bn	\$1.7bn	\$2.4bn	\$3.3bn
Rank	23	3	5	1
60/40	6.43%	6.01%	7.83%	5.29%
Excess Returns	1.62%	2.09%	1.69%	2.69%

Description	Jan 2014- Sept 2020	2009-2013
Value Added v. Median Peer (% Annlzd.)	1.99%	-0.33%
Value Added v. Median Peer (\$)	\$3.3bn	-0.28 bn
SFERS Peer Ranking	1	57

Note: Returns as of September 30th, 2020. Benchmark is comprised of 60% MSCI ACWI (ND) and 40% Bloomberg Barclays US Aggregate Bond Index.

SFERS has incurred Less Risk

- ▶ SFERS has outperformed peers by about 2% annualized while incurring less risk (measured by volatility) than about 90% of our peers
- ▶ SFERS has generated risk-adjusted returns that rank in the top 2% of our peers

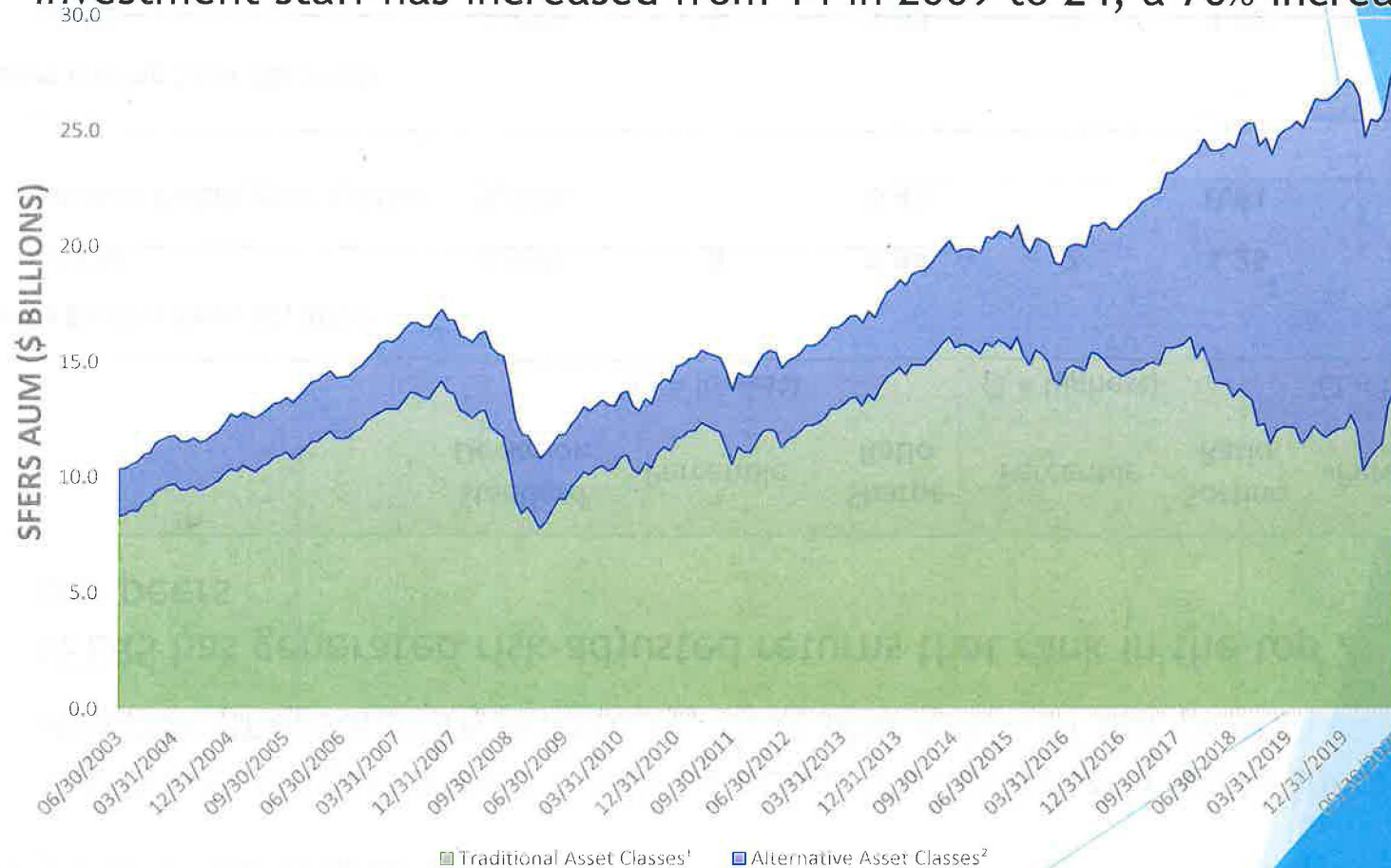
	Standard Deviation	Percentile (1 = lowest)	Sharpe Ratio	Percentile (1 = highest)	Sortino Ratio	Percentile (1 = highest)
3 Years Ending Sept 30, 2020						
SFERS	6.96%	8	0.94	2	1.25	2
Median Public Plan > \$1bn	9.66%		0.43		0.61	
5 Years Ending Sept 30, 2020						
SFERS	6.29%	8	1.33	2	1.62	2
Median Public Plan > \$1bn	8.26%		0.81		0.95	

*Measures Risk
(Lower is better)*

*Measures Returns
per Unit of Risk
(Higher is better)*

Growth of Alternative Investments

- ▶ Investment in Private Equity, Private Credit, Real Assets and Absolute Return have grown from \$3b in 2009 to \$14.6b a 390% increase
- ▶ Investment staff has increased from 14 in 2009 to 24, a 70% increase

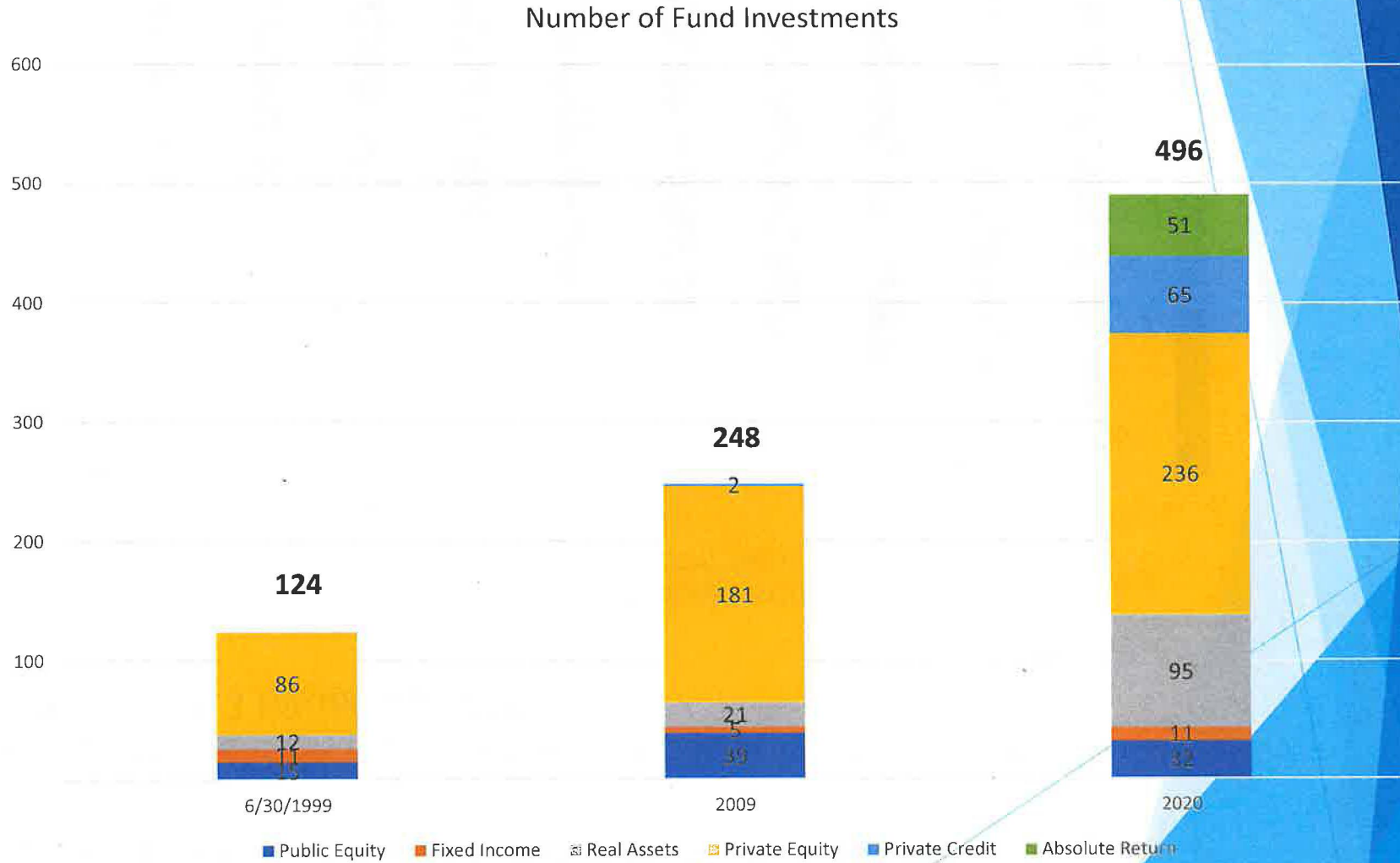


Source: BNY Mellon, Northern Trust and NEPC. ¹ Traditional Asset Classes include Public Equity, Fixed Income and Cash.

² Alternative Asset Classes include Private Equity, Real Assets, Private Credit and Absolute Return. Data as of 9/30/20.

Growth of Fund Investments

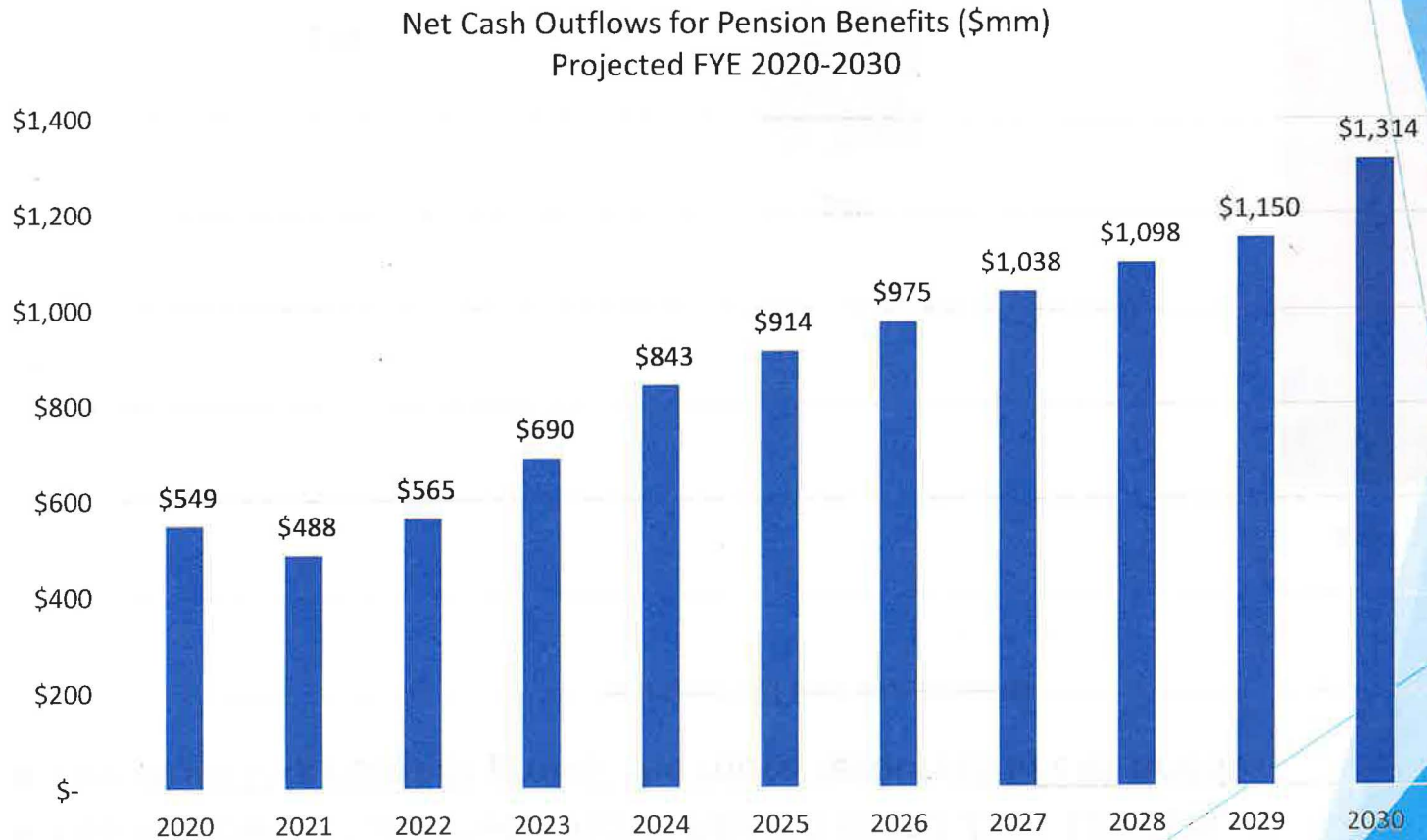
- The number of fund investments has increased 2x in 11 years
- The more this number grows, the more resources SFERS needs



Notes: 1999 data sourced from Board reports. 2009 and 2020 data sourced from Caissa. Figures are approximate.

SFERS Will Become a Much More Mature Plan by 2030

Annual net pension payments will increase from \approx \$500 million annually in 2020 to \approx \$1.3 billion by 2030



Projected Liabilities based on the assumptions, data, methods, and plan provisions in Cheiron's July 1, 2019 actuarial valuation report with estimated future supplemental COLAs and a 7.4% discount rate.

SFERS Needs to Make Changes to Continue its Success

- ▶ SFERS liabilities are projected to grow to:
 - ▶ \$44.0 billion in 2030
 - ▶ \$64.6 billion in 2040
- ▶ To earn high returns as our liabilities grow, SFERS Retirement Board approved changes in its:
 - ▶ Asset Allocation
 - ▶ Resources
 - ▶ Career track
 - ▶ Decision-making

Why the Retirement Board Approved Changes to Continue SFERS Recent Success

- ▶ Our approach to manager selection requires more resources than SFERS currently has
- ▶ Research and due diligence of the unique, specialist and niche strategies we emphasize is more resource intensive than usual strategies
- ▶ The strategies we emphasize are capacity constrained
- ▶ Building relationships with top managers often takes many years
- ▶ SFERS increasing assets limits our ability to invest in the types of managers we seek at the size we need
- ▶ While maintaining our approach to manager selection, SFERS needs to add Co-Investments at scale to continue our recent success
- ▶ Adding Co-Investments is an extension of SFERS existing strengths in manager selection
- ▶ Co-Investments also require more resources

Investment Options

In view of SFERS growth in assets, what are our investment options?

<p>Option 1:</p>	<p>Manage SFERS with existing resources</p>	<ul style="list-style-type: none"> 1 - Requires Changing the Strategic Asset Allocation 2 - Requires Changing Approach to Manager Selection 3 - Impact: Lower Returns from Asset Allocation, Lower Returns from Manager Selection, Greater Volatility of Returns
<p>Option 2:</p>	<ul style="list-style-type: none"> 1-Larger Investment Staff 2-Larger Operations Staff 3-Co-Investments at 2% NAV annually 4-Delegation of Authority 	<ul style="list-style-type: none"> 1- Implement the Approved Strategic Asset Allocation 2- Maintain Current Approach to Manager Selection 3 - Add Co-Investments 4 - Impact: Higher Returns from Asset Allocation, Higher Returns from Manager Selection and Co-Investments, Lower Volatility, Lower Total Costs, and Higher Total Returns

Difference in Expected Returns of Aligning Resources to Staff's Recommended Strategy versus Changing Strategy to Fit Existing Resources

Options	Description	Staff's Expected Returns
Option 1:	Change the Strategy for Asset Allocation and Manager Selection to Fit Current Resources	6.70%
Option 2:	Align Resources to Maintain the Strategy for Asset Allocation and Manager Selection and add Co-Investments	7.50%

Projected Impact of Aligning Resources to Staff's Recommended Strategy v. Changing Strategy to Fit Existing Resources

Description	Board Approved Asset Allocation and Strategic Plan	Maintain Current Resources	Expected Impact of the Board Approved Asset Allocation and Strategic Plan v. Maintain Current Resources
Public Equity	37%	43%	
Private Equity	23%	17%	
Real Assets	10%	9%	
Growth	70%	69%	
Private Credit	10%	7%	
Liquid Credit	5%	9%	
Treasuries	8%	8%	
Income Assets	23%	24%	
Absolute Return	10%	10%	
Risk Mitigating Assets	10%	10%	
Total	103%	103%	

Median Expected 10-Year Return	7.6%	7.1%	Higher Expected Returns
Median Expected 30-Year Return	8.1%	7.7%	
Standard Deviation (Annual Volatility)	11.8%	11.8%	
Sharpe Ratio 10-Years	0.60	0.55	Higher Expected Risk-Adjusted Returns
Sharpe Ratio 30-Years	0.54	0.50	
1-Year Probability Returns < 0%	26%	27%	
10-Year Probability Returns < 0%	2%	3%	
10-Year Probability Returns > 7.4%	52%	47%	Higher Probability of Achieving 7.4% Annualized Returns
30-Year Probability Returns > 7.4%	63%	55%	
Staff Median Projected Beta Returns	5.74%	5.48%	Higher Expected Beta Returns
Staff Median Projected Alpha Returns	1.76%	1.22%	Higher Expected Alpha Returns
Staff Median Expected Returns	7.50%	6.70%	Higher Expected Returns

Requirements to Implement Option 2

- ▶ Investment Strategy
- ▶ Additional Resources
- ▶ Career Track
- ▶ Co-Investments
- ▶ Decision-Making Process

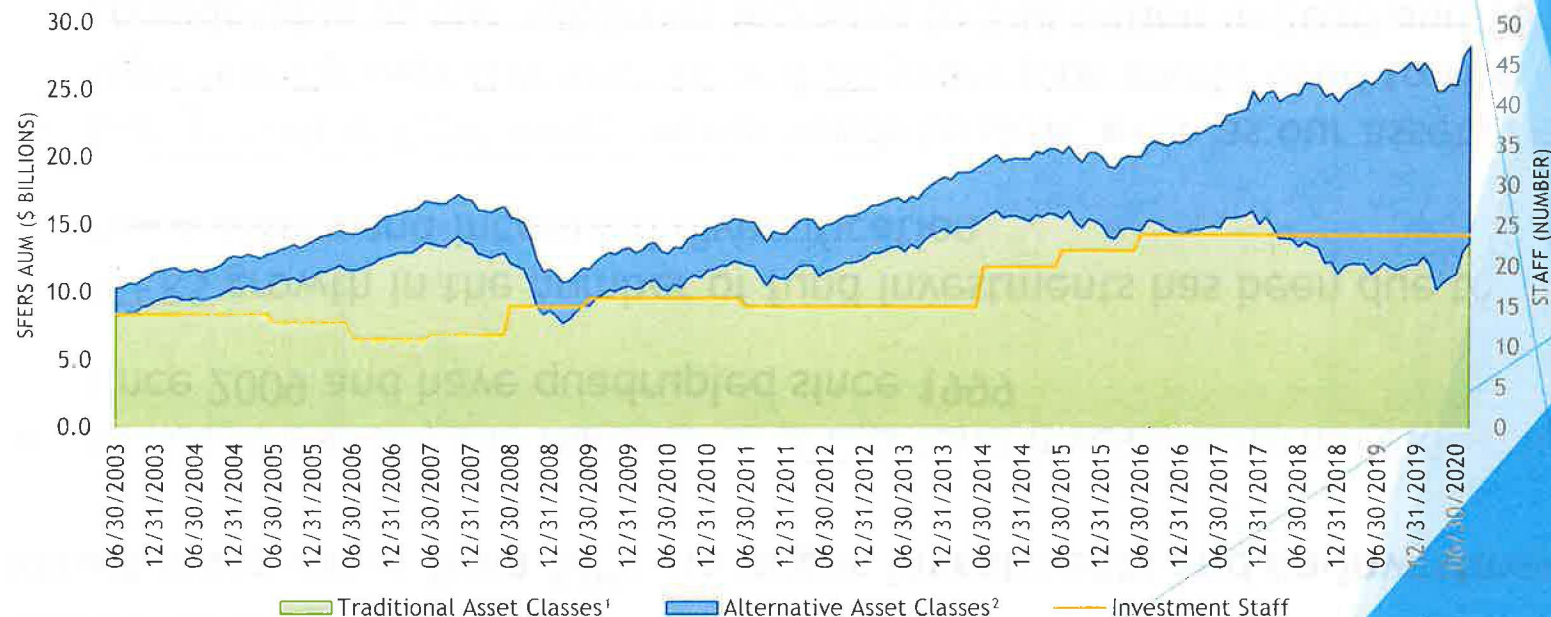
Investment Strategy:

Extract more value from GP's via larger investments and co-investments

- ▶ As noted earlier, the number of SFERS fund investments have doubled since 2009 and have quadrupled since 1999
- ▶ SFERS growth in the number of fund investments has been due to rising assets and increased diversification
- ▶ Our growth in fund investments needs to slow, even as our assets rise significantly over the next 10 and 20 years (our assets need to rise considerably as our liabilities increase to \$44 billion in 2030 and \$64 billion in 2040)
- ▶ Recommended approach: Maintain our philosophy toward asset allocation and manager selection, even in the midst of rising liabilities; How can we do so?
 - ▶ Larger fund investments
 - ▶ Co-Investments

Resources: Increase in Investment Staff

- ▶ From 2009 to December 2020:
- ▶ Assets have increased from \$11b to \$30.6b; Growth of 178%
- ▶ Alternative investments has increased from 20% to 53%, Growth of 165%
- ▶ New/increased initiatives in Private Equity, Private Credit, ESG, Real Assets, Absolute Return, Public Equity, Asset Allocation, and Risk Management
- ▶ Investment staff has increased from 14 to 24 (budget); Growth of 70%
- ▶ Resources have not kept pace with our strategy or initiatives



Source: BNY Mellon, Northern Trust and NEPC. ¹ Traditional Asset Classes include Public Equity, Public Fixed Income and Cash.

² Alternative Asset Classes include Buyouts, Venture Capital, Real Estate, Natural Resources, Private Credit and Absolute Return.

Career Track

- ▶ To achieve success in recruitment and retention, SFERS needs to implement a career track for investment professionals
- ▶ The Strategic Plan increases the number of ranks in the investment division from 5 to 7

Prior to 2014	Current	Recommended
Chief Investment Officer	Chief Investment Officer	Chief Investment Officer
Managing Director	Managing Director	Managing Director
	Director	Director
Senior Portfolio Manager	Senior Portfolio Manager	Senior Portfolio Manager
		Investment Officer (new)
		Senior Analyst (new)
Analyst	Analyst	Analyst

Co-Investments

- ▶ Due to our need to grow future assets, SFERS needs to find new ways to invest that have high expected returns
- ▶ Co-Investments result in lower fees and potentially high returns
- ▶ Co-Investments are a natural extension of our existing external manager relationships
- ▶ SFERS needs to gradually increase Co-Investments from less than 5% to approximately 20% over the next 10 years
- ▶ Co-Investments require additional resources
- ▶ Co-Investments require completing due diligence under strict deadlines, oftentimes in days or weeks
- ▶ Thus, Co-Investments require a different governance and decision-making process than SFERS previously had

Why Both Additional Resources and Delegation of Authority to do Co-Investments is Necessary

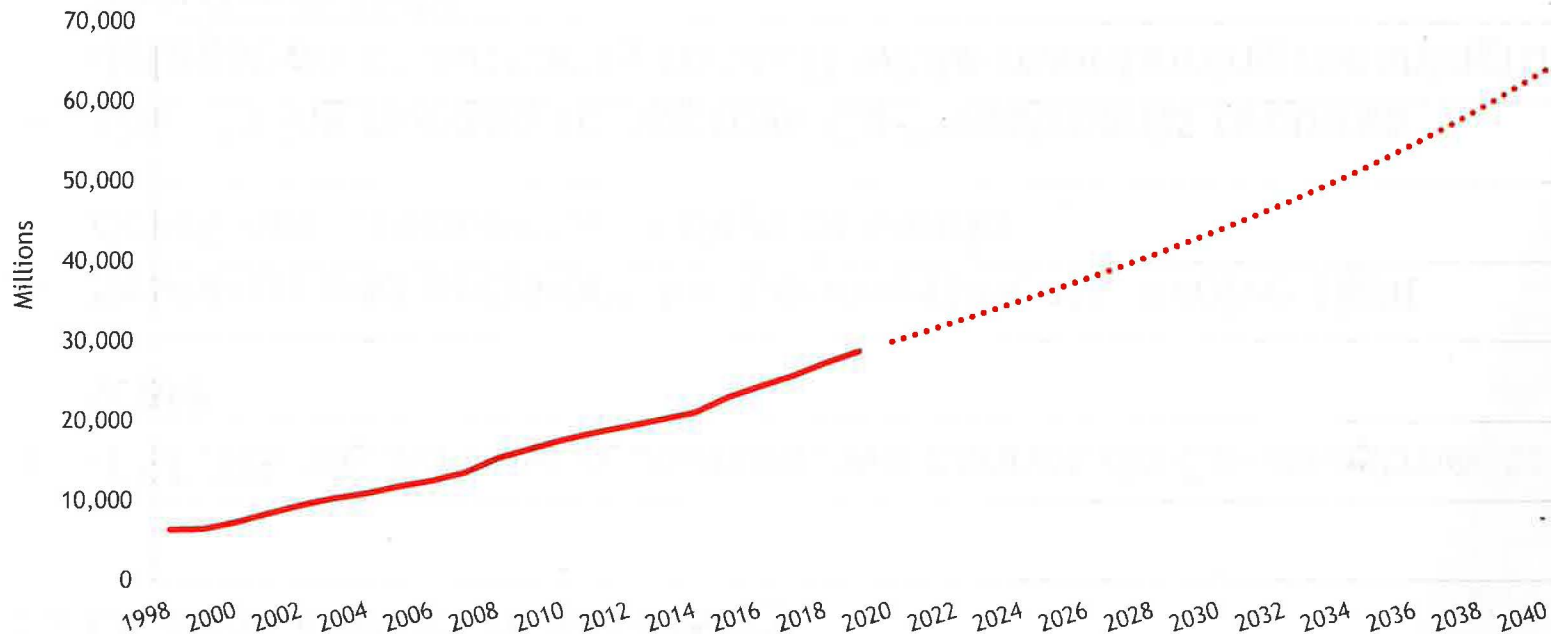
- ▶ If SFERS has no new resources, we cannot do Co-Investments at scale
- ▶ Research and decisions for Co-Investments involve tight deadlines, frequently in days or weeks
- ▶ The timing needed to approve Co-Investments requires delegation of authority to Staff while maintaining meaningful Board oversight
- ▶ To build a Co-Investment to 20% of our Portfolio over 10 years equals 2% of Trust Assets annually (aprx \$600 million in commitments at today's NAV of \$30 billion at 12-31-2020)

Decision-Making: SFERS is a Large Plan and Will Grow Larger

SFERS Needs a Decision-Making Process Aligned with Investing In Co-Investments at Scale

Projected Liabilities - \$44 billion in 2030, \$64 billion in 2040

Actual & Projected Actuarial Liability
as of July 1

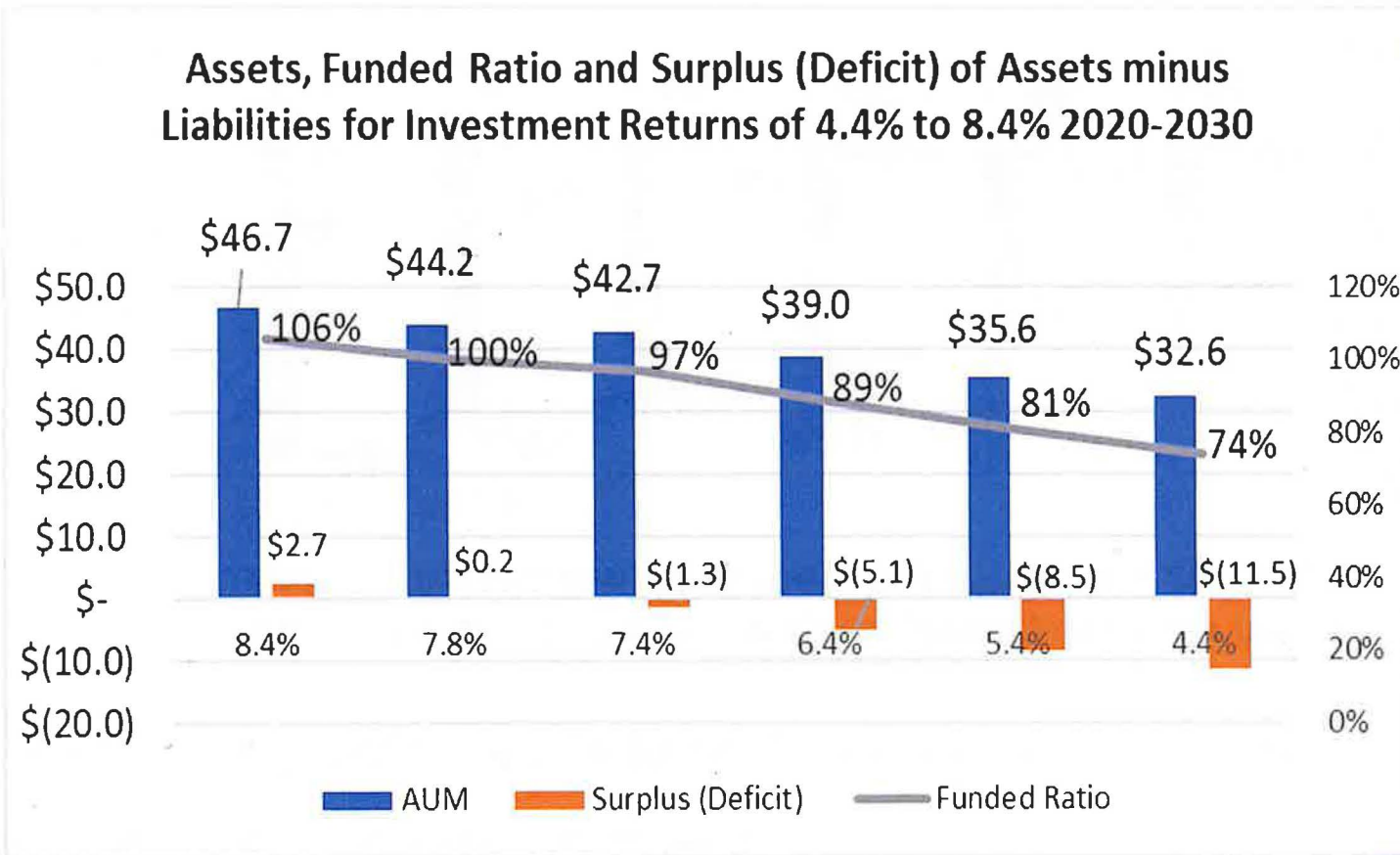


Projected Liabilities based on the assumptions, data, methods, and plan provisions in Cheiron's July 1, 2019 actuarial valuation report with estimated future supplemental COLAs and a 7.4% discount rate.

Return Scenario 2020-2030:

Higher Returns = Fully Funded or Surplus

Lower Returns = Unfunded Liabilities of \$5.1 billion to \$11.5 billion

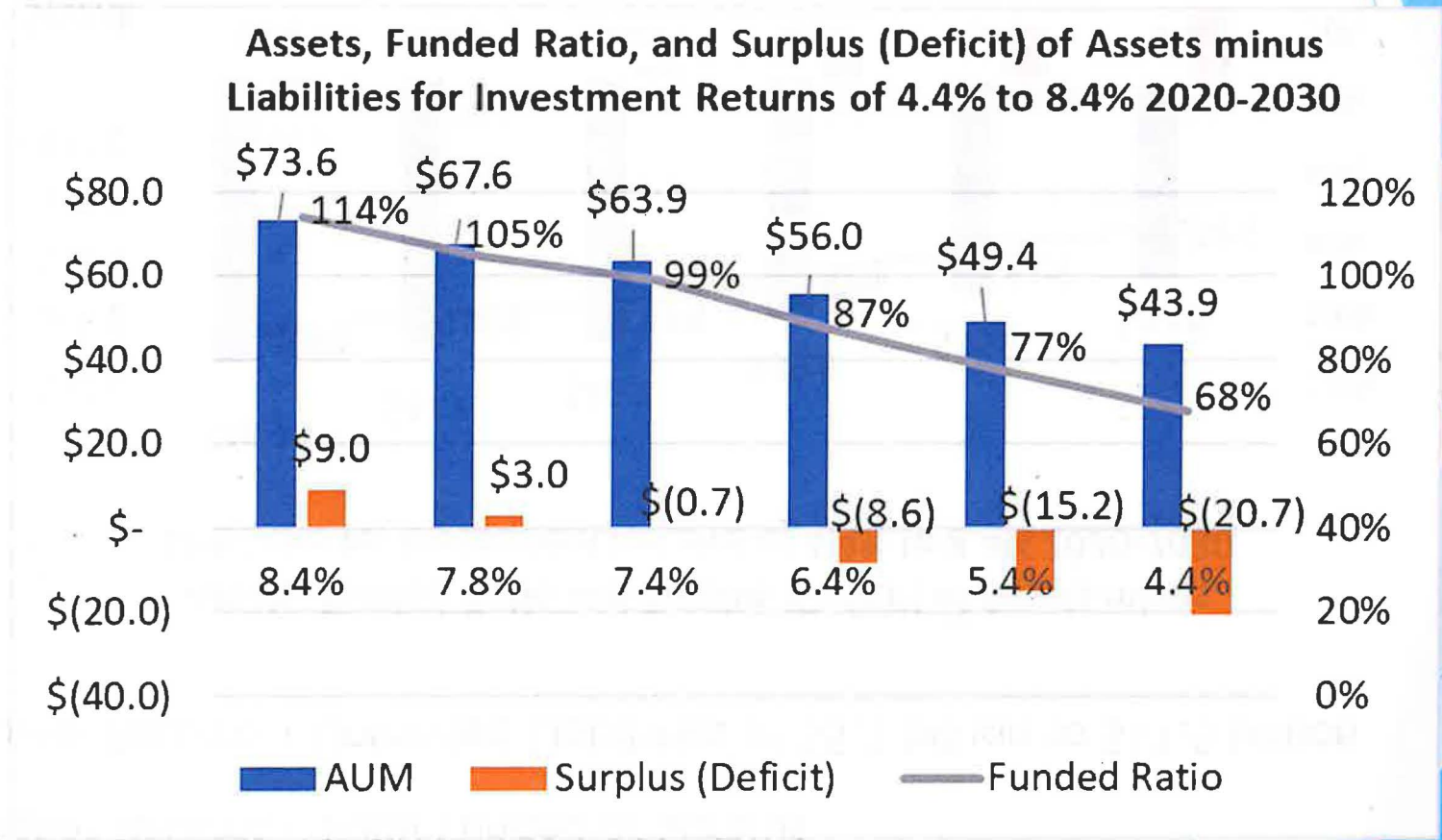


Notes: All data, assumptions, plan provisions and methods are as noted in Cheiron's July 1, 2019 actuarial valuation report.

Return Scenario 2020-2040:

Higher Returns = Fully Funded or Surplus

Lower Returns = Unfunded Liabilities of \$8.6 billion to \$20.7 billion



Notes: All data, assumptions, plan provisions and methods are as noted in Cheiron's July 1, 2019 actuarial valuation report.

Current Investment Staff Budget

FY 2018-19	CIO	----- Public Markets -----			----- Private Markets -----			Abs Ret	--- Direct/Colnv ---	--ESG--	Asset Alloc/Risk	Oper	Total
Chief Investment Officer	CIO												1
Managing Director		Pub Mkts			Priv Mkts			Abs Ret			Asset Alloc/Risk		4
Director		Pub Eq			Buyout		RA			ESG			4
Senior Portfolio Mgr		Pub Eq	Priv Cr	Bonds	VC	Buyout							5
Manager												Oper	1
Investment Officer													0
Senior Analyst													0
Analyst		Pub Eq	Priv Cr	Bonds	VC	Buyout	RA	Abs Ret		ESG	Asset Alloc, Risk		9
Administration												Oper-2	2
		3	2	2	2	3	2	2	0	2	2	3	26
Group Totals	1	8			8			2	0	2	2	3	26

Recommended Investment Staff Budget

FY 2021-22 to 2023-24	CIO	----- Public Markets -----			----- Private Markets -----			Abs Ret	--- Direct/Colnv ---	--ESG--	Asset Alloc/Risk	Oper	Total	2018-19
Chief Investment Officer	CIO											1	1	
Managing Director		Pub Mkts			Priv Mkts			Abs Ret	Directs/Colnv		Asset Alloc, Risk		5	4
Director/Senior PM		Pub Eq	Priv Cr	Bonds	VC	Buyout	RA		Directs/Colnv	ESG			8	9
Manager												Oper	1	1
Assistant Portfolio Mgr.		Pub Eq	Priv Cr		VC	Buyout	RA	Abs Ret		ESG	Asset Alloc, Risk		8	0
Senior Analyst/Analyst	CIO	Pub Eq	Priv Cr	Bonds	VC	Buyout	RA	Abs Ret	Directs/Colnv	ESG	Asset Alloc, Risk		11	9
Administration												Oper-2	2	2
		3	3	2	3	3	3	3	3	3	3	3	36	26
Group Totals	2	9			10			3	3	3	3	3	36	

Recommended Investment Staff Budget

Prior to 2014	Current	Recommended
Chief Investment Officer Managing Director	Chief Investment Officer Managing Director	Chief Investment Officer Managing Director
	Director	Director
Senior Portfolio Manager	Senior Portfolio Manager	Senior Portfolio Manager Assistant Portfolio Manager (new)
		Senior Analyst (new)
Analyst	Analyst	Analyst

Board Approved: Co-Investments and Staff Authority

Framework for Co-Investments

- ▶ Each Co-Investment will be subject to the following framework:
 - ▶ Sourced from high conviction managers
 - ▶ In the managers “strike zone” of expertise
 - ▶ Additional Underwriting conducted by Staff
 - ▶ Maximum of 0.25% in any single investment
 - ▶ Permitted investments include Buyout, Growth Equity, and Late Stage Venture; permitted investments could include Public Equity after discussion with the Board, candidate qualifications, and investment guidelines
 - ▶ Maximum of 2.0% of Plan Assets in a calendar year
 - ▶ Annual report by the General Consultant to the Board on the adherence of the framework on each co-investment as well as the performance of the co-investment program

Staff's Recommendation Results in Lower Total Costs and Higher Expected Returns

- ▶ SFERS costs Do Not Impact City's General Fund, they do not take away from City resources
- ▶ Unfunded pension liabilities Do Impact the City's budget
- ▶ An increase in the City's costs to the pension plan would take away from other City services
- ▶ Unfunded liabilities may also require an increase in employee contributions
- ▶ Staff's recommendation results in lower total expenses; increased resources minus lower fees to external managers = lower total costs
- ▶ Staff's recommendation results in higher expected returns
- ▶ In 2014 when SFERS increased its resources, the increased costs from 2014-2020 totaled \$26mm and generated \$3.3 billion in excess returns v. median peer (see page 28)

Projected Cost of Staff's Request

Increased Spending \$26mm from 2014-2020

Outperformed by \$3.3b from 2014-2020

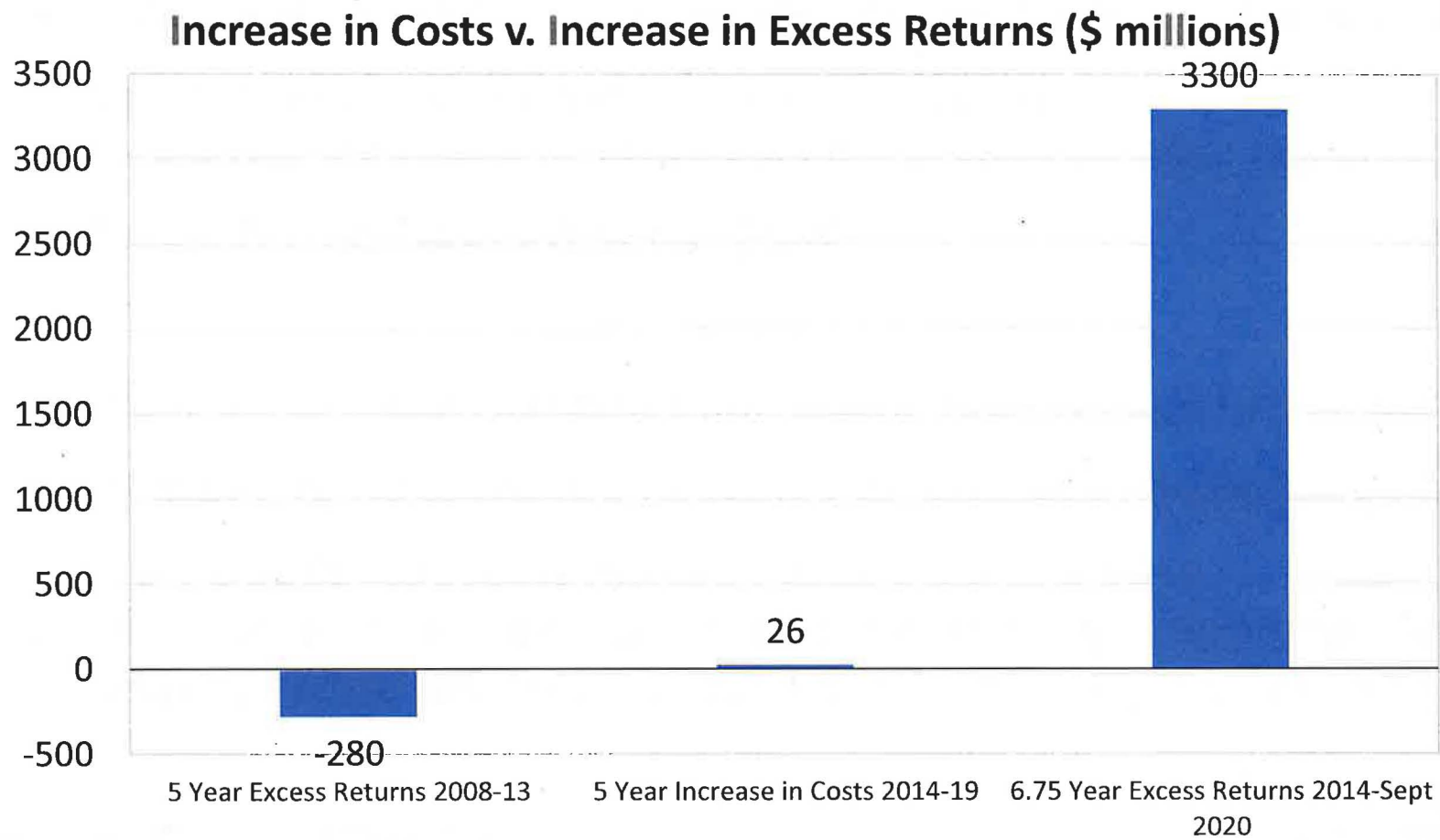
	2014-20	FY 2020-21 to 2023-24
Staff:		
Investment Professionals		
Administration and Operations		
TOTAL	26	36
Incremental Change:		
Staff	+12	+10
Cost per year	\$4.0 mm	\$4.0 mm
Cost % of Trust Assets ¹ (based on base year)	0.021%	0.013%
6.75 Years Total Cost	\$26 mm	
6.75 Years Excess Returns v. Median Peer	\$3.3 bn	

Notes: Incremental cost per year includes salary, benefits, travel, equipment and furniture, utilities, occupancy, and other costs.

¹ Incremental cost per year in basis points assumes no change in plan assets.

2014-2020: Increased Returns \$3.3b Net of Increased Costs

- SFERS increased resources and costs beginning in 2014
- From 2014 to Sept 2020 SFERS increased its resources costing a totaling \$26 million
- From 2014 to Sept 2020 SFERS outperformed its median peer by \$3.3 billion
- Previously from 2009-13 SFERS underperformed its median peer by \$280 million



Staff's Recommendation

- ▶ Growth of assets and current resources limit Staff's ability to implement the Board Approved Strategic Asset Allocation and invest in the types of managers we seek at the size we need
- ▶ Liabilities will increase to \$44 billion in 2030 and \$64 billion in 2040
- ▶ SFERS is at an inflection point and needs to make changes now
- ▶ Recommendation and Expected Result:
- ▶ Maintain our approach to asset allocation and manager selection and invest up to 2% per year to co-investments.
- ▶ Approve new resources, an enhanced career track, co-investments to increase value from existing GP relationships, and delegation of authority while maintaining meaningful Board oversight.
- ▶ The recommendation results in lower total costs (new resources minus lower management fees) and higher expected returns.