SCERS DIVERSIFYING ASSET CATEGORY INVESTMENT POLICY STATEMENT

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A. DIVERSIFYING ASSET CATEGORY INVESTMENT OBJECTIVE

The Diversifying asset category seeks to achieve the following investment objectives:

- Help preserve capital in periods of market distress, particularly in periods of low and falling growth.
- Enhance diversification by exhibiting low or negative correlation with both equity and credit markets.
- Maintain a positive return profile over time.

Asset classes within the Diversifying asset category include:

- Public Fixed Income
    - o Core Plus Fixed Income
    - o U.S. Treasury
    - o Global Fixed Income
- Diversifying Absolute Return

Asset class target weights within the Diversifying asset category are as follows:

Asset Class	Minimum	Target Allocation	Maximum
Public Fixed Income	13.0%	**18.0%**	23.0%
Core Plus Fixed Income	8.0%	**10.0%**	12.0%
U.S. Treasury	3.0%	**5.0%**	7.0%
Global Fixed Income	2.0%	**3.0%**	4.0%
Diversifying Absolute Return	5.0%	**7.0%**	9.0%
Diversifying Asset Category		***25.0%***	

Public Fixed Income:

The Public Fixed Income portfolio seeks to achieve multiple investment objectives as outlined below:

- Moderate income and cash flow generation.
- Diversification for SCERS' portfolio, and in particular, as an "anchor to safety" in periods such as a recession, when growth/risk assets fall.
- A source of return enhancement.
- Liquidity.

The Public Fixed Income portfolio is unique because accomplishing the investment objectives will not be based on one singular investment strategy or underlying asset, but rather by virtue of the construction of the Public Fixed Income portfolio and the sum of its components. As an example, credit investments achieve some of the objectives such as moderate income generation and a source of return enhancement, but may detract from objectives of diversification and liquidity. U.S Treasuries on the other hand, lack return enhancement; however, they provide meaningfully toward the objectives of diversification and liquidity for SCERS' overall portfolio.

Diversifying Absolute Return:

The investment objective of the Diversifying Absolute Return portfolio is to emphasize a lower sensitivity to broad market performance (i.e., less correlated returns), while still generating a positive absolute return profile over time. Diversifying absolute return strategies tend to be have less long-biased equity and credit exposures, with lower standard deviations, lower equity and credit beta, and lower correlations than growth absolute return strategies, which reside within the Growth asset category.

B. BENCHMARKS

The Diversifying asset category total performance is evaluated by applying the investment performance of the individual asset class benchmarks weighted by the strategic asset allocation targets weights. The Diversifying asset class benchmarks are as follows:

Public Fixed Income:

❖ Performance of the Public Fixed Income portfolio is expected to exceed the weighted average return of the benchmarks for the underlying Public Fixed Income asset classes as outlined below:

Public Fixed Income Segments	Benchmark	Weighting (relative to total public fixed Income)
Core Plus Fixed Income	Bloomberg Barclays Aggregate Bond Index	55.6%
U.S. Treasury	Bloomberg Barclays United States Treasury Index	27.8%
Global Fixed Income	80% Citi WGBI/20% JPM GBI-EM Index	16.7%
Developed Markets Bonds	*Citigroup World Government Bond Index*	*13.3%*
Emerging Markets Bonds	*JPMorgan GBI-EM Index*	*3.3%*

❖ Performance of each segment within the Public Fixed Income Portfolio will be benchmarked as follows:
  - ➢ Performance of the Core Plus Fixed Income investment strategies are expected to exceed the Bloomberg Barclays Aggregate Bond Index.
  - ➢ Performance of the U.S. Treasury segment is expected to perform in-line with the Bloomberg Barclays United States Treasury Index.
  - ➢ Performance of the Global Fixed Income segment is expected to exceed the weighted average custom index 80% Citi WGBI unhedged and 20% JPM GBI-EM Global Diversified.

Diversifying Absolute Return:

SCERS Diversifying Absolute Return Portfolio	Benchmark	Time Period
Policy Index Benchmark	HFRI FoF Conservative Index, net of fees and expenses	3 to 5 Years
Long-Term Objective	90-day T-Bills + 2%, net of fees and expenses	> 5 Years

❖ Over the medium-term (3-5 years), performance of the Diversifying Absolute Return portfolio is expected to exceed the HFRI FoF Conservative Index, net of fees and expenses. The HFRI FoF Conservative Index will also serve as SCERS' Policy Index.

- ❖ Over the long-term (greater than 5 years), the objective of the Diversifying Absolute Return portfolio is to exceed the 90-day T-Bills plus 2%, net of fees and expenses.

C. INVESTMENT GUIDELINES

1. Investment Descriptions:

Public Fixed Income:
Investments within the Public Fixed Income portfolio is authorized in a broad array of sub asset classes and strategies including, but not limited to the following:

- Cash and cash equivalents
- Treasuries
- Agencies
- Agency and Non-Agency Mortgage-Backed Securities
- CMBS
- Asset-Backed Securities
- CLO’s and CDO’s
- TIPS or other inflation-linked securities
- Investment Grade Debt
- Municipal securities
- High Yield Debt
- Bank Loans
- 144A and Reg S securities
- IO’s and PO’s
- Hybrid and Capital securities such as preferred equity and trust preferreds
- International / non-dollar fixed income securities
- Emerging Markets Debt
- Foreign exchange

The key segments of the Public Fixed Income portfolio are described below:

- *Core Plus Fixed Income:*
  Core plus bond strategies allow for greater flexibility including: (1) ability to invest in a broader set of exposures across ‘plus’ segments that are higher yielding and diversifying bond sectors such as high yield, bank loans, non-agency MBS/structured credit and non-U.S. securities, as well as; (2) ability to increase/decrease exposures between ‘core’ and ‘plus’ bond segments in order to increase/decrease exposure to sources of yield or safety. Since the security holdings and risk characteristics tend to have deviations with the benchmark (Bloomberg Barclays Aggregate Bond Index) within set limits, core plus bond strategies help to provide some diversification to equities and fulfill the roles of an “anchor to safety” and liquidity, while attempting to balance more capability to generate moderate income. The addition of the ‘plus’ sectors provide for greater diversification across sources of yield, but may detract from the strategy’s ability to be a diversifier to equities as the ‘plus’ sectors are more correlated to equities and the business cycle.

- *U.S. Treasury*

  U.S Treasuries are considered "anchor to safety" assets, and one of the most diversifying components of a portfolio, often generating positive returns when equity returns are negative. Historically when equity assets have been down significantly, investors have tended to gravitate toward safe haven assets such as government bonds, and particularly U.S. Treasuries. Another advantage of having Treasury exposure is that it is one of the most liquid segments of the markets, providing a source of liquidity for SCERS' overall portfolio. U.S. Treasuries will tend to underperform in a rising interest rate environment.

- *Global Fixed Income:*

  Global fixed income strategies seek to diversify sources of fixed income returns as yields become more attractive outside the U.S. at varying points in the cycle. Global fixed income strategies help achieve diversification within the fixed income and the SCERS portfolio because it incorporates additional risk factors and sources of return including non-U.S. country exposure in rates and credit, currencies, and different economic growth cycles of developed and emerging markets. Similar to core plus, global fixed income strategies attempt to retain capital preservation qualities by balancing appropriate G3 government exposure with higher yielding international securities. Accordingly, global fixed income strategies tend to provide some diversification to equities and fulfill the roles of an "anchor to safety" and liquidity, while attempting to balance more capability to generate moderate income. The addition of the credit and emerging market sectors provide for greater diversification across sources of yield, but may detract from the strategy's ability to be a diversifier to equities. Unlike other bond strategies, global currency exposures can help to protect and hedge against an inflationary environment or currency depreciation in the U.S.

Diversifying Absolute Return:

SCERS' overall Absolute Return asset class has a target allocation of 10% and is broken out into two separate segments of SCERS' total portfolio. The Growth Absolute Return portfolio has a 3% target allocation and resides within the Growth asset category. The Diversifying Absolute Return portfolio has a 7% target allocation and resides within the Diversifying asset category. The distinction is to separate those strategies that typically do well during a more favorable economic environment, and have higher correlations and betas to equity and credit markets, from those strategies that have low to negative correlation to equity markets and serve as a diversifier to the more growth oriented segments of SCERS' portfolio.

Diversifying absolute return strategies tend to emphasize a lower sensitivity to broad market performance (i.e., less correlated returns), while still generating a positive absolute return profile over time. Diversifying absolute return strategies tend to be have less long-biased equity and credit exposures, and lower standard deviations and correlations, than growth absolute return strategies, which reside within the Growth asset category.

SCERS' alternative assets consultant breaks the absolute return universe into the following investment strategies. A well-diversified absolute return portfolio will contain allocations to each of these strategies at varying target weights.

- *Equity Long/Short* - Strategies where there is a combination of long and short positions primarily in publicly traded equities, with a net market exposure less than that of the overall equity market. Strategies may be focused on U.S., non-U.S., and/or specialty mandates.

- *Event Driven* - Strategies such as activist equity, risk arbitrage, merger arbitrage, distressed debt, credit, and other event-driven strategies.

- *Credit/Distressed* - Strategies that typically utilize fundamental credit analysis to invest in below investment grade, stressed, or distressed corporate and asset-backed credit. Managers may take long and short positions in mispriced debt instruments and may become actively involved in a restructuring process.

- *Market Neutral* - Strategies such as equity market neutral, fixed income arbitrage, and convertible bond arbitrage.

- *Global Macro* - Strategies such as all market portfolios, opportunistic long-only, managed futures, currency, dedicated short selling strategies or other specialty strategies.

- *Multi-Strategy* - Strategies where absolute return funds invest using a combination of previously described strategies.

Examples of the more diversifying and uncorrelated absolute return strategies that typically reside within the Diversifying Absolute Return portfolio include market neutral, global macro, and multi-strategy strategies, whereas the Growth segment will generally contain equity long/short, event driven, and credit/distressed strategies. However, in practice SCERS will categorize individual strategies based upon each fund's expected characteristics, including risk, market sensitivity and market exposure, not by a fund's stated strategy, so each absolute return segment could include a variety of fund strategies.

2. Risk and Diversification:

❖ ***Diversification by investment strategy and geography, including target allocation and ranges.***

The construction of the Diversifying asset category is important because a well-developed portfolio can add diversification to the overall SCERS investment portfolio, which is heavily weighted to assets that have higher return and volatility expectations within the Growth asset category. Distinguishing characteristics of the Diversifying asset category are: (1) a wide range of investment strategies across several underlying segments, mostly within the publicly traded markets; and (2) higher exposure to diversifying absolute return investment strategies with higher levels of leverage in the form of total notional gross exposure.

The targeted and range of investment exposures within the various asset classes are shown below. It is also anticipated that SCERS will seek diversification with respect to investment strategies within the asset classes where warranted.

Public Fixed Income

The Public Fixed Income portfolio is constructed in a way to achieve multiple objectives, with each allocation helping to fulfill the different roles and objectives including: (1) moderate income generation; (2) diversifier to growth assets; (3) a source of return enhancement; and (4) liquidity. Allocations across the strategies are also designed to provide sufficient diversification by sources of yield, by bond segment, and by geographic region. Accordingly, the asset allocation within the Public Fixed Income portfolio is targeted to be significantly diversified across fixed income bond strategies as outlined below:

SCERS Public Fixed Income Portfolio Construction			
Asset Class	Minimum	Target Allocation	Maximum
Core Plus Fixed Income	8.0%	**10.0%**	12.0%
U.S. Treasury	3.0%	**5.0%**	7.0%
Global Fixed Income	2.0%	**3.0%**	4.0%

Diversifying Absolute Return:

Absolute return funds represent a distinctive investment style that is different from traditional, long-only funds. A fundamental difference is that absolute return fund managers emphasize absolute, rather than relative returns, and they may also use a wider range of investment techniques, such as leverage, short selling, and derivatives to achieve their objectives. This greater level of investing flexibility results in a wide range of strategies that produce different risk and return characteristics between the strategies and provides the opportunity to diversify risk.

SCERS shall strive to invest in a sufficient number of managers and set constraints on the size of each absolute return manager compared to the Absolute Return portfolio and the total portfolio. This will provide some protection and spread the unique risks of absolute return funds across a larger base. These risks include operational risk, headline risk, event risk, liquidity risk, counterparty risk, leverage risk, and reduced transparency.

Accordingly, investing in a large number of funds across the aggregate SCERS Absolute Return portfolio, and within the Diversifying Absolute Return segment, combined with investing across a range of strategies, can assist in achieving the Diversifying Absolute Return portfolio's objective of emphasizing a lower sensitivity to broad market performance (i.e., less correlated returns), while still generating a positive absolute return profile over time.

For the Diversifying Absolute Return portfolio, the target number and range of funds, and targeted geographic ranges are shown in the table below. In addition, the primary targeted absolute return strategies for the Diversifying Absolute Return portfolio are shown. In practice, SCERS will categorize individual strategies based upon a fund's expected characteristics, including risk, market sensitivity and market exposure, not by a fund's stated strategy, so the Diversifying Absolute Return portfolio can also include a wider variety of fund strategies.

	Diversifying Strategies
Portfolio Objective	Positive absolute return profile over time with limited sensitivity to broad market performance
Target Allocation	7% of total assets
Allocation Range	5% to 9% of total assets
	Market Neutral
Primary Strategies	Global Macro
	Multi Strategy
Number of Funds	Target 10 funds with a range of 6 to 13
Non-U.S. Exposure	Expect 20% to 50% non-U.S. exposure

Within these guidelines, Staff and consultant will allocate funds within each investment style in a manner that, in their judgment, enhances SCERS' ability to achieve the investment objectives of the Diversifying Absolute Return portfolio over the long term. In the event exposure to an absolute return style becomes overly concentrated, Staff is authorized to rebalance assets in a manner consistent with the implementation protocol within this Diversifying Investment Policy Statement.

- *Diversification by selection of individual funds:* SCERS will strive to select individual diversifying absolute return funds based on their ability to diversify SCERS' total fund:

  - Low correlation to equities.
  - Uncorrelated alpha sources.
  - Low beta compared to equities.
  - Low kurtosis in the return distribution (smaller extreme returns both positive and negative).
  - Positive skew in the return distribution (larger and more frequent occurrences of positive returns versus negative).
  - Ability to be up or exhibit significantly less downside in declining equity markets.
  - Capability to manage tail risk.

- *Diversification across geographies, business sectors, and asset classes*: It is expected that absolute return managers will actively, and oftentimes quickly, change the composition of portfolios to take advantage of opportunities in the markets. Accordingly, it will be important to actively monitor and understand the dynamic absolute return environment relative to more general objectives, making portfolio changes when necessary rather than reacting to rigid guidelines. This should allow SCERS to capture the benefits of allowing absolute return managers to execute their strategies without compromising the objectives of SCERS' aggregate fund or total portfolio. These general objectives include:

  - Geographic diversification in non-U.S. regions.
  - Diversification across sectors and industries.
  - Diversification across asset classes.

- *Minimum size of absolute return managers:* Requirements for absolute return funds to register with the SEC and provide greater shareholder transparency and reporting have increased, along with operating costs, benefitting larger funds with the in-house capabilities to manage these issues. However, small and mid-sized funds can often perform better, particularly during the phase when the absolute return partners are more focused on generating returns to build initial wealth. To balance these considerations, SCERS will invest in absolute return funds with minimum assets under management greater than $250 million.

❖ *Absolute Return Risk Considerations:*

There are several risk considerations specific to the Diversifying Absolute Return portfolio:

	Diversifying Strategies
Portfolio Objective	Positive absolute return profile over time with limited sensitivity to broad market performance
Risk Target	Standard Deviation < 25% of global equities
Market Sensitivity	Target an equity beta <0.1 Target equity correlation <0.1
Market Exposure	Total notional gross exposure < 750%

➢ *Absolute Return Risk Targets:* Absolute return portfolio risk is often measured by standard deviation. The target standard deviation for Diversifying Absolute Return is less than 25% of the MSCI ACWI Index.

➢ *Market Sensitivity:* Common measures for market sensitivity for an absolute return portfolio are beta and correlation. The equity beta target for the Diversifying Absolute Return portfolio is <0.1, and the equity correlation target is <0.1.

➢ *Market Exposure/Leverage:* Within absolute return, leverage may be utilized by underlying absolute return managers as part of their strategies, but it will not be employed at the total portfolio level.

Leverage at the total Diversifying Absolute Return portfolio level is the aggregated amount from SCERS' underlying managers and will be defined as the total notional gross exposure, which is equal to the sum of gross long notional exposure plus gross short notional exposure, expressed as a percentage of total invested capital. Total leverage for the Diversifying Absolute Return portfolio will not exceed 750%.

In addition, leverage utilization will be monitored within each individual `hedge fund and investment manager to ensure appropriateness given the respective strategy.

3. Investment Vehicles:

The vehicles for investments within the Diversifying asset category reflect the broad scope of investments.

Public Fixed Income:

The vehicles for Public Fixed Income investments reflect the broad scope of investments. Investment vehicle options for investing in the Public Fixed Income portfolio include separate accounts, in which assets are custodied at SCERS' custodian, and/or commingled funds, including limited partnerships, limited liability companies, offshore corporations and mutual funds. Determinants as to whether SCERS will invest in a separate account versus a commingled fund include availability of a separate account option, complexity of the underlying assets, whether individual country markets require opening (i.e., emerging markets investing via a separate account), fee levels, and transparency.

Diversifying Absolute Return:

Investment vehicles for absolute return investments are typically separate accounts and/or a variety of commingled vehicles, such as limited partnerships, limited liability companies, or offshore corporations.

SCERS may also invest directly in fund-of-funds (FoF) vehicles. In these vehicles, the FoF invests in absolute return partnerships on a discretionary basis. FoFs will own the underlying absolute return partnerships and SCERS obtains contractual rights to the FoFs' portfolio through a limited partnership. A FoF will have investors other than SCERS.

SCERS may also invest in separate account relationships established with one or more fiduciary oversight managers. These managers will make commitments to absolute return limited partnerships, or other entities such as limited liability companies or offshore corporations, either on a discretionary or advisory basis.

4. **Co-investments:** A co-investment is a direct investment in an underlying portfolio company where a manager offers investors the opportunity to invest directly in an underlying company alongside the fund investment. Investments may be made in companies that are either U.S. or non-U.S. domiciled. Co-investments are considered separate investment strategies within the Diversifying Asset Category. For example, a co-investment could be in any of the strategies, but are typically most prevalent within the absolute return strategies. Therefore, 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 co-investments on an opportunistic basis. It is expected that these investments will constitute a small portion of the overall Diversifying asset category, and any underlying asset class, if any.

5. Investment Vehicle Concentration:

Public Fixed Income:

SCERS shall typically not comprise more than 20% of an investment strategy's assets under management at the initiation of the investment. Post-investment, SCERS shall monitor the investment strategy asset base, and SCERS' concentration relative to the asset base. An exception to this guideline is an investment in a separate account, whereby SCERS may be the sole investor. In these circumstances, SCERS will endeavor to ensure that it does not generate a majority of the firm's overall profits.

Diversifying Absolute Return:

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:

Overall, the Diversifying asset category will maintain varying levels of liquidity based on the underlying sub-asset classes:

Public Fixed Income:

Investments in public fixed income offers varying degrees of liquidity depending on region and bond sector, however, liquidity is generally high relative to other asset classes. Core bond segments tend to offer the greatest liquidity, while credit-oriented investments and emerging market debt tend to offer less liquidity.

Among investment vehicles, investing through separate accounts typically offer the highest liquidity, as the underlying assets are owned by SCERS, and are held at SCERS' custodian. While the underlying assets of commingled funds offer high liquidity, there is the potential for less immediate liquidity when redeeming assets from a commingled fund. This liquidity can vary from immediate to monthly liquidity, depending on the structure of the fund.

Diversifying Absolute Return:

Individual absolute return fund investments may have specified liquidity parameters defining lock-up periods and withdrawal frequency. Liquidity risk is managed by monitoring and maintaining a schedule of the liquidity of the individual absolute return funds and aggregating it at the total Absolute Return program level.

SCERS may want to take advantage of fee discounts that may be available for funds offering a longer lock-up period or a different share class under certain circumstances and dependent on the underlying characteristics of the absolute return fund. In addition, SCERS may want to invest with absolute return funds that possess strategies where a longer investment horizon is necessary and appropriately matches the illiquidity of the underlying assets invested. While SCERS may want to take advantage of investing in these opportunities, it is not appropriate for the Absolute Return program to consist entirely of illiquid vehicles. Accordingly, guidelines are outlined below to both capture the opportunity set and balance the need for liquidity.

SCERS may invest in absolute return funds that permit voluntary redemptions (Evergreen Portfolio Funds) and absolute return funds that do not permit voluntary redemptions (Self-Liquidating Portfolio Funds).

SCERS shall allocate a minimum of 50% of its capital (at market) to Evergreen Portfolio Funds with quarterly or more frequent liquidity (after applicable "lock ups" expire)

SCERS may not allocate more than 15% of its capital (at cost) to Self-Liquidating Portfolio Funds.

With regard to the capital allocated to Evergreen Portfolio Funds, SCERS may not allocate more than 25% of its Absolute Return capital (collectively, at market) to Evergreen Portfolio Funds that impose a "lock up" (determined either based on the date SCERS first invests in such Evergreen Portfolio Fund or with respect to each investment in such Evergreen Portfolio Fund by SCERS on an investment-by-investment basis, as applicable, and not from the time of any capital commitment to an Evergreen Portfolio Fund) of greater than or equal to 2 years. SCERS may not allocate to Evergreen Portfolio Funds that impose a "lock up" of greater than or equal to 3 years without the consent of SCERS' Board.

In order to facilitate liquidity, SCERS should reasonably limit a portfolio absolute return funds' ability to use side pockets. Side pocket investments should not exceed 10% of SCERS' total absolute return portfolio at fair market value.

7. **Distributed Securities:** Within the Public Fixed Income portfolio, SCERS shall typically seek receipt of distributed securities from investment managers. For separate accounts, assets are custodied at SCERS' custodian, which SCERS can liquidate at its own discretion. For commingled funds, SCERS generally prefers to receive distributed securities, which it can liquidate at its own discretion. The exception is for those funds that require that shares be redeemed from the fund, or if it is more prudent to have a fund redeem shares.

SCERS shall avoid the direct receipt of distributed securities from individual diversifying absolute return funds. However, if such receipt is unavoidable, 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:

- ❖ Performance of the Diversifying asset category will be evaluated quarterly against the weighted average of the policy index benchmarks outlined in the 'Benchmarks' section above.

- ❖ Individual investment vehicle performance will be evaluated on a monthly and quarterly basis for Public Fixed Income and Diversifying Absolute Return.

9. Investment period to ramp-up:

It is recognized that it can take multiple years for segments of the Diversifying asset category to be fully invested, and that there may be deviations from the previously mentioned targets during the ramp-up period. During the ramp-up period for the Diversifying asset category, and subsequent to reaching the target allocation, SCERS' Overlay Program will re-balance the Diversifying asset category to the target allocation, using the designated Diversifying overlay proxy within the investment guidelines for the Overlay Program.

10. Rebalancing to guidelines:

It is anticipated that the majority of changes to rebalance the Diversifying asset category will be made on a long-term basis. SCERS utilizes an Overlay Program, managed by a strategic overlay manager, to equitize cash and to rebalance asset categories within SCERS' total portfolio, including the Diversifying asset category. The asset categories are rebalanced to target allocations when upper or lower bands are breached. Rebalancing occurs quarterly, unless the respective bands are breached intra-quarter, in which case rebalancing occurs upon the breach of a band.

D. 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 Diversifying asset category's, and its underlying asset classes, 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 will 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 Diversifying asset category, and its underlying asset classes, paying careful attention to individual investment vehicle allocations and strategy/sector concentrations to strive to achieve proper diversification across the Diversifying asset category. Staff and consultant will also conduct due diligence with the respective investment vehicle managers to understand the underlying drivers of performance. Additionally, Staff and consultant will 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 will 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 Diversifying asset category 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.

Absolute Return Monitoring

- **Monitoring risks specific to absolute return funds:** Investing in absolute return funds brings additional risks, which will be managed and mitigated through a combination of factors including: (1) the asset allocation and guidelines set forth above (diversification across managers and strategies); (2) due diligence of Staff and consultant on individual funds; and, (3) ongoing monitoring and active investment management by Staff and consultant. This includes:

- *Addressing transparency risk*, or the reluctance of absolute return managers to report individual positions, particularly short positions. While absolute return funds may limit transparency at the position level, SCERS' consultant will hold conference calls to review individual absolute return portfolios on a monthly basis. In addition, both the consultant and Staff will be measuring and monitoring exposures in aggregate, e.g. at the level of investment strategy, regions, industries, countries, and portfolio. Leverage, net exposures, and counterparty risk are all monitored at the fund level and portfolio in aggregate.

- *Addressing liquidity risk*, or the inability to redeem immediately from a fund due to hard to value investments, side pockets, lock-ups, and gates. SCERS' consultant monitors the liquidity based on the days to redeem and the individual manager limited partnership agreements. These factors are incorporated into the due diligence process and part of the decision to invest in a particular fund.

- *Addressing operational risk*, or the risk of failure in operations outside of the investment strategy. SCERS' consultant has developed a specific in-house unit to assess a hedge fund's legal, financial statements/audits, compliance, custodian(s), prime broker(s) and other service vendors, operations, administration, trading functions, asset valuation, and conduct background checks. Alongside the consultant's due diligence, Staff will help select absolute return funds by sourcing funds, interviewing managers, and visiting managers on-site to assess the front- and back-offices.

- *Addressing headline risk* (the risk of an absolute return fund attracting negative media attention leading to investors redeeming). Return dispersion and concentration in a niche strategy or concentration in a small number of investments (the risk of any manager's particular strategy not working as in past periods), event risk (the risk of a sizeable investment loss due to a market event, personnel loss, or regulatory issue), are all part of the due diligence and monitoring process and partly mitigated by guidelines and expectations for diversification across managers, strategies, geographies, and industries.

- *Monthly***:** Staff will leverage the consultant's monitoring process, a process that requires frequent contact with the absolute return managers. The consultant reviews each absolute return fund's investor communications and calls the absolute return managers monthly to discuss the fund's organization, strategy, investment process, portfolio characteristics, and performance drivers. Staff will supplement this review process by analyzing the performance and risk of the individual absolute return managers and the overall absolute return portfolio and reviewing absolute return fund investor communications and the consultant monthly reports.

- *Quarterly:* The consultant will produce supplemental quarterly reports that contain performance and risk statistics for the individual absolute return funds and the absolute return portfolio, and portfolio characteristics, including strategy allocations, geographic allocations, and leverage, for the individual absolute return funds and the overall absolute return portfolio.

- *Annually:* The consultant will conduct periodic onsite visits at each absolute return manager's office, but no less frequently than annually. Individual absolute return funds will be re-evaluated annually from both an investment and operational perspective and there will be updated due diligence reports issued. There will be a review of individual absolute return funds' annual audited financial statements. Staff will conduct conference calls with managers and/or conduct on site due diligence at least annually. There will be an annual report re-confirming investment with individual managers and outlining a plan for any Absolute Return portfolio changes/plans for the upcoming year.

- *Other:* The consultant assigns ratings to all absolute return funds as part of its monthly monitoring process. These ratings include placing funds on a "Watch List" where serious organizational or performance concerns exist and the recommendation to terminate a relationship. These investments are not necessarily expected to lose money over their life, but in the opinion of the consultant there is a more likely chance that returns will fall short of expectations. Watch List funds are subject to more intense scrutiny. The consultant will provide Staff with a Watch List report for any absolute return placed on the Watch List. As a final step, the consultant may recommend that Staff exit (redeem) from the fund investment. Absolute return funds can have redemption features that require notification months in advance or limitations such as gates, penalties, and side pocket restrictions. The consultant will assist Staff in developing an exit strategy. A final recourse would be to seek a secondary sale if redeeming is not possible.

E. IMPLEMENTATION PROTOCOL

The following implementation protocol describes the allocation of investment authority and responsibilities between SCERS' Board, Staff, and consultants. Overall, the Diversifying asset category implementation protocol delegates the most time intensive elements of the process to Staff and consultant, while preserving the Board's oversight of the overall Diversifying asset category and its underlying asset classes.

The Board will approve the long-term Asset Allocation Structure for the individual asset classes within the Diversifying asset category, as developed and presented by Staff and Consultant. These include Public Fixed Income and Diversifying Absolute Return. The long-term Asset Allocation Structure for underlying Diversifying asset classes will articulate the long-term direction and objectives of each asset class including elements such as: (1) asset allocation targets and ranges by strategy, geography and style; (2) a target range for the number of investment managers and types of vehicles; and (3) for Diversifying Absolute Return, the role of Fund of Funds and strategic partners.

On an annual basis, the Board will approve the Annual Investment Plan for the individual asset classes within the Diversifying asset category. The Annual Investment Plan will articulate the direction over the next year in taking the necessary steps to achieve the above objectives of the long-term Asset Allocation Structure of the underlying asset classes.

The execution of the long-term Asset Allocation Structure and Annual Investment Plan will vary between that of Public Fixed Income and Diversifying Absolute Return.

1. Public Fixed Income:

Overall, the Public Fixed Income implementation protocol delegates the most time intensive elements of the process to Staff and consultant, including the screening and evaluation leading to the recommendation to engage or terminate a particular investment manager. <u>The Board provides oversight of the overall Public Fixed Income programs and makes the final decision regarding engagement or termination of investment managers.</u>

The key features of the Public Fixed Income implementation protocol are as follows:

- ❖ If Staff and the consultant believe that a change is necessary to the manager structure in order to obtain optimal performance from the asset class, Staff and the consultant will present the Board with a report outlining the basis for their conclusion including how the change under consideration would fit within: (a) the allocation model for the asset class approved by the Board; and (b) the annual investment plan approved by the Board.

- Staff and the consultant will then identify the most qualified candidates to bring into the manager structure based on the full range of relevant factors regarding the manager, its investment team, and strategy. Staff will prepare a report for the Board outlining why the managers in question have been identified for closer scrutiny for a possible commitment. The consultant will also provide investment strategy and operational due diligence reports.

- Staff and the consultant will pursue more extensive due diligence on the manager candidates, including conducting extended interviews with the portfolio managers and other key members of the investment team. Legal counsel will begin reviewing the documentation for the possible engagement 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 the consultant have determined which manager to recommend to the Board; then (d) staff will prepare a report to the Board outlining the basis for the decision, the proposed commitment amount, and the target date for closing on the commitment.

- At any point in the process, questions or concerns by a Board member regarding a proposed investment or proposed manager can 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 recommendation is finalized.

- The manager being recommended for the engagement will make a presentation to the Board. At that time the Board can address any questions or concerns regarding the recommended candidate as well as any previously raised questions or concerns regarding another candidate or candidates. The Board can (a) approve engagement of the recommended manager; (b) direct that one or more alternative candidates be brought forward for consideration; (c) request further information regarding a candidate or candidates; or (d) take any other action the Board deems appropriate.

- ❖ If the new investment manager engagement also involves the recommended termination of an existing manager, Staff and the consultant will develop and report to the Board on the reasons for, timeline and plan for terminating the existing engagement, and transitioning the assets from the outgoing manager to the incoming manager. The Board will take action on the recommended termination.

- ❖ If Staff and the consultant determine that it would be advisable to physically re-balance the portfolio at the same time as making the investment manager structure changes, Staff and consultant will prepare a report for the Board outlining the recommended physical re-balancing and why it is necessary and appropriate. The Board will take action on the recommended physical re-balancing.

- ❖ Upon approval by the Board: (a) the new investment engagement will be finalized, and the necessary documentation executed; (b) the engagement with the outgoing manager will be terminated; and (c) the transition plan, and any necessary physical re-balancing, will be implemented.

- ❖ Staff and the consultant will report to the Board when the manager structure changes and any necessary re-balancing have been completed, along with an analysis of the costs associated with the transition.

2. Diversifying Absolute Return:

For the Diversifying Absolute Return portfolio, the execution of the long-term Asset Allocation Structure and Annual Investment Plan including the <u>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.</u> SCERS' Board President or Chief Executive Officer are authorized to execute any and all documents which may reasonably be required to complete any Diversifying Absolute Return investment on behalf of SCERS.

The key features of the proposed Diversifying Absolute Return investment protocol are as follows:

- Staff and consultant will identify the most qualified candidates for a prospective diversifying absolute return investment commitment based on: (a) the Asset Allocation Structure for the underlying asset class approved by the Board; and (b) the Annual Investment Plan for the underlying asset class approved by the Board (which takes into account SCERS' existing diversifying absolute return investments and prioritizes and targets optimal new investment opportunities that complement those investments).

- When a particular manager candidate is identified, Staff and consultant will pursue 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 its investment strategy and operational due diligence reports, if they have not done so already. Legal counsel will begin reviewing the documentation for the possible investment amount and preliminary negotiation of deal terms will take place.

- Staff will prepare a detailed report for the Board outlining the basis for the potential investment, the contemplated investment amount, the target date for closing on the investment, and an assessment of the fit within SCERS' portfolio. The report will include an evaluation of the organization, investment strategy, considerations and risks, and track-record, as well as an operational assessment and a review of the investment's terms.

- If/When: (a) the due diligence process is completed; (b) deal terms have been determined; (c) staff and consultant have concluded that an investment should be made; then (d) staff will prepare a final report for the Board outlining the basis for the decision, the proposed investment amount, and the target date for closing on the investment. The final report will summarize the due diligence items that have been completed in order to move forward with an investment, as well as any considerations that have arisen since the issuance of the initial reports by Staff and the consultant.

- 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 a 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, and funds placed with the manager.

- Staff and consultant will confirm that the investment has been made, and the amount invested by SCERS, at a subsequent Board meeting.

- Because management of the aggregate Absolute Return portfolio is dynamic and ongoing, Staff and the consultant will also have authority to make adjustments to the Diversifying Absolute Return portfolio in order to assure that the portfolio is optimally aligned to achieve the objectives of the asset class. This includes, but is not limited to the authority to: (1) trim or add to existing investment mandates; (2) terminate and/or replace an existing manager; (3) submit redemption requests; (4) determine the appropriate sources for funding a new mandate or adding to an existing mandate; and (5) determine the appropriate application of any returned capital.

- If and when Staff and consultant determine that such actions are necessary, a timely report will be prepared outlining why the action is/was deemed necessary and how it impacts SCERS' Absolute Return portfolio. Notice will be promptly provided to the Board regarding the action and the report will be put on the secure Board website.

F. POLICY HISTORY

Date	Description
10-20-2011	Board adopted Hedge Fund asset class investment policy statement
07-10-2014	Board adopted Fixed Income asset class investment policy statement
11-05-2018	Board adopted reformatted and consolidated Diversifying asset category investment policy statement
03-20-2019	Amended Diversifying asset category investment policy statement