

**Seattle City Employees' Retirement System
Investment Advisory Committee
Annual Report for Fiscal Year 2020**

To the Seattle City Employees' Retirement System (SCERS) Board of Administration:

The Investment Advisory Committee (IAC) of the Seattle City Employees' Retirement System (SCERS) met with Board members and SCERS staff (Staff) four times during 2019. Additional discussions around pertinent issues for the Investment Committee also occurred throughout the year. Following is the IAC's report for the fiscal year 2020.

I. Statement of Purpose

According to RCW 35.39.090, the IAC shall have the following duties:

1. Make recommendations on general investment policies, practices and procedures to the Board.
2. Review the investment transactions of the Board annually.
3. Prepare a written report of its activities during each fiscal year.

II. IAC Membership

Investment Advisory Committee members will serve three-year terms or until the Board acts to extend or end a member's appointment.

IAC members and their terms are:

- **Joseph Boateng (Chair)**, Chief Investment Officer, Casey Family Programs (term: January 2019 - December 2021)
- **Dr. Cathy Cao**, CFA, Associate Professor of Finance, Seattle University (term: July 2019 - June 2022)
- **Steven Hill**, former Senior Vice President of Human Resources, Weyerhaeuser; former Director, Washington State Department of Retirement Systems (term: July 2019 - June 2022)
- **Dwight McRae**, former Managing Director, Metzler Real Estate (term: January 2019 - December 2021)
- **Keith Traverse**, BMGI (investment manager for the Bill & Melinda Gates Foundation Trust and Cascade Investment, LLC) (term: May 2018 - May 2021)

III. Major Developments for SCERS in 2020

Specific 2020 investment initiatives included:

- Staff identified and began implementing enhancements to the operational due diligence process, including selecting Castle Hall as a specialist service provider.
- SCERS made continued progress on its positive action strategy to advance responsible investing and address environmental, social and governance (ESG) issues. These included initiatives supporting shareholder advocacy, integrating climate change risk into SCERS' investment process, and evaluating sustainability investments.

- Staff and NEPC conducted annual reviews for each asset class to educate and update the Investment Committee on their portfolio role, composition and developments.
- Staff and NEPC continued to provide annual reviews of key strategic topics with the Investment Committee, including the investment risk framework, cost-effectiveness analysis and capital markets review.
- SCERS invited RVK, an investment consulting firm, to present their research into investment committee best practices.
- SCERS modified the securities lending program to modestly increase expected revenue while continuing to maintain a low-risk profile. The primary modification was to allow US government securities as collateral, in addition to the existing cash collateral allowance.
- SCERS changed the investment fund for its excess cash to the BlackRock T-Fund, a more conservative strategy aligned with the overlay program.
- Public Equity: Staff began evaluating Japan active equity strategies and analyzing the potential benefit of shifting from passive management for Japan. The research project is ongoing.
- Private Equity: Adams Street Partners, SCERS' discretionary private equity manager, committed \$47 million to primary funds per the asset class pacing plan.
- Fixed Income: Staff evaluated distressed strategies for the Credit Fixed Income asset class but did not have sufficient conviction to proceed thus far.
- Real Assets: SCERS committed \$17.5 million to Sculptor Real Estate Fund IV within the Real Estate asset class and \$20 million to Stonepeak Infrastructure Fund IV within the Infrastructure asset class. SCERS also began the process of reallocating capital amongst its US core real estate managers.

IV. Performance as of September 30, 2020

	Performance (Annualized)					Volatility
	1Y	3Y	5Y	10Y	30Y	10Y
Fund	7.8%	6.2%	8.3%	7.8%	7.6%	7.8%
Strategic Policy Benchmark	8.6%	6.7%	8.5%	8.3%	7.7%	7.7%
Median Fund*	6.0%	5.5%	7.5%	7.4%	8.4%	7.4%

Note: Performance is net of fees for all periods except for 30 years, which is gross of fees due to data availability

*Peer group consists of public plans in the InvMetrics Public DB Universe, each with assets over \$1 billion

The Fund seeks to achieve a net return over 30 years that matches or exceeds the actuarial rate of return. The Fund has returned 7.6% gross of fees over the last 30 years, which is greater than the current actuarial rate of return of 7.25%.

The Fund also seeks to achieve a net return over five years that matches or exceeds the Strategic Policy Benchmark. The Fund has modestly underperformed the Strategic Policy Benchmark by 0.2% (8.3% Fund, 8.5% Strategic Policy Benchmark) over the last five years. Compared to the median fund, SCERS has a moderately higher allocation to Public Equity and Real Estate and a lower allocation to multi-asset and absolute return strategies.

For the one-year period ending September 30, 2020, the Fund returned 7.8% net of fees, and Fund market value increased from \$3.0 billion to \$3.2 billion. The Fund underperformed the Strategic Policy Benchmark by 0.8% (7.8% Fund, 8.6% Strategic Policy Benchmark). Negative relative performance was primarily attributable to the tilt to value and small-cap stocks in the Public Equity allocation, which was partially offset by outperformance in the Private Equity asset class.

The estimated funding ratio increased from 68.5% to 70.3% on a mark-to-market basis for the one-year period ending September 30, 2020. The funding ratio increased since investment performance modestly exceeded the actuarial rate of return of 7.25%.

Below is the asset allocation of the Fund:

	Strategic Asset Allocation	SCERS Allocation	Strategic Policy Benchmark Weight	Difference, SCERS Allocation vs. Policy Benchmark Weight
	Target	9/30/20	2020	
Public Equity	48.0%	51.6%	51.5%	0.1%
Private Equity	11.0%	10.3%	9.0%	1.3%
Core Fixed Income	18.0%	19.7%	19.5%	0.2%
Credit Fixed Income	7.0%	6.9%	7.0%	-0.1%
Real Estate	12.0%	10.0%	11.0%	-1.0%
Infrastructure	4.0%	1.4%	2.0%	-0.6%
Cash + Overlay	-	0.0%	-	0.0%
Workout	-	0.1%	-	0.1%

V. IAC's 2020 Activities

Investment Committee Meetings

In February, the IAC joined the Investment Committee meeting to discuss the IAC's 2019 annual report and NEPC's investment outlook. Joseph Boateng provided the IAC's recommendations. The IAC also contributed to the review of Q4 2019 performance.

In May, the IAC joined the Investment Committee meeting to discuss the investment risk framework, deep dive on the overlay program and a review of Q1 2020 performance.

In August, the IAC joined the Investment Committee meeting to evaluate a recommendation to modify the securities lending program and participate in NEPC's annual presentation on ESG matters. The IAC also contributed to the review of Q2 2020 performance.

In November, the IAC joined the Investment Committee meeting for a discussion led by RVK on investment committee best practices. The IAC also recommended changing the short-term investment fund and contributed to the review of Q3 2020 performance.

Ad Hoc Involvement

The IAC charter explicitly acknowledges that engagement of IAC members, collectively or individually, outside of regularly scheduled meetings greatly benefits SCERS.

In May, the IAC met with Jeff Davis, Executive Director, to review various operational matters.

RVK interviewed select IAC members to prepare their presentation to the Investment Committee on investment committee best practices.

VI. Strategic Guidance

The IAC offers the following strategic guidance that is intended to endure over the long-term, pertaining to initiatives that are evergreen or with a horizon beyond a year.

- Commitment to Financial Sustainability

Notwithstanding the progress made by the System, we encourage SCERS to 1) use a realistic expected return as a discount rate to more conservatively estimate liabilities; 2) evaluate the impact of funding ratio changes on investment objectives and 3) explore the definition of “safe assets” while assessing the effects of unconventional monetary policy and low interest rates on fund management.

If the realized return falls short of the actuarial rate of return, the plan's underfunded status will increase. Meanwhile, the monies that the City currently has, and anticipates having, available to pay benefits for current and future retirees will be insufficient.

Using conservative assumptions for return and discount rate can help strengthen the plan's financial sustainability and mitigate shortfalls.

Major initiatives undertaken by SCERS under this guidance include:

- Lowered Investment Return Assumption – The City is aware of the plan's underfunded status and decrease in return expectations. SCERS conducted an actuary-led experience study in 2018 that culminated in reducing the investment return assumption from 7.5% to 7.25%, effective January 1, 2020.
 - Commitment to Ongoing Actuarial Studies – SCERS plans to conduct an actuary led experience study every four years, with the next planned for 2022. The study will reassess assumptions on demographics, macroeconomic factors, and investment returns.
 - Commitment to Pay Contributions – As the plan sponsor, the City is committed to paying the actuarially required contribution, covering the 1) normal cost and 2) amortized cost of the unfunded liability.
 - Implemented Tiered System – SCERS understands the sponsor's establishment of a second-tier for new employees was intended to improve the plan's sustainability long-term.
- Focus on Fee Effectiveness

We encourage Staff to continue assessing fee effectiveness with respect to risk and return across asset classes and strategies. SCERS should continue to monitor vendor payments, compensation to plan fiduciaries, and accrued expenses such as carried interest. This is particularly important as SCERS increases its exposure to private market investments.

We note the following initiatives:

- SCERS made key enhancements to the "Cost-Effectiveness and Fee Analysis" in 2019, such as incorporating ILPA fee templates.
- The accounting team made tremendous strides in data collection in the last few years, enabling SCERS to evolve from data collection to analysis of cost effectiveness and portfolio outcomes. This includes conducting comparative analysis of other institutional investors.

- SCERS made significant improvements in the operational due diligence (ODD) process, including working with Castle Hall as a specialist ODD service provider.
 - Compliance monitoring process is currently in place for separately managed accounts and private equity (conducted by Adams Street Partners).
- Align Investment Beliefs with Processes and Resources

We encourage the Executive Director and Staff to assess their investment beliefs and strengthen processes to ensure utilization of SCERS' resources in an aligned approach.

- Support Continual Learning

We encourage Staff and consultants to continue to implement the Board education plan to enhance the Board's understanding of the tradeoff between risk and return over the long-term.

We acknowledge the following actions undertaken in 2020:

- The IAC met with the Executive Director in May, consistent with annual meetings in the last few years.
- The Executive Director has worked with each Board member to develop a customized educational plan that includes training via virtual platforms given the COVID-19 pandemic.

In 2020, Staff continued to utilize Investment Committee meetings to provide education to the Board on recurring topics and asset class deep dives.

VII. 2021 Recommendations

The IAC's specific recommendations for 2021 are as follows:

- Augment Risk Management

We encourage Staff to continue to augment SCERS' risk management framework, including making further progress in evaluating a liability-aware investment approach.

Staff should advance the liability-aware proof of concept developed in 2020 with the aim of incorporating findings in the next strategic asset allocation review in 2023/2024. Working with SCERS' actuary, Staff should better define the characteristics of SCERS' liabilities using scenario analysis and communicate conclusions.

- Proactively Engage

In addition to the quarterly investment performance meetings, the Committee should have interim meetings with the Executive Director to review the Bylaws and evaluate other operational matters.

- Focus on Fee Effectiveness

We encourage Staff to research total costs pertaining to investments with structures where there may be layers of fees and expenses. Examples include Adams Street and Real Estate.