KERN COUNTY EMPLOYEES'
RETIREMENT ASSOCIATION

KCERA
PRUDENT INVESTMENT • QUALITY SERVICE

January 29, 2021

Members, Board of Retirement
Employee Bargaining Units
Requesting News Media
Other Interested Parties

Subject: Meeting of the Kern County Employees' Retirement Association Investment Committee

Ladies and Gentlemen:

A meeting of the Kern County Employees' Retirement Association Investment Committee will be held on Friday, February 5, 2021 at 1:30 p.m. via teleconference, pursuant to Executive Order N-25-20, issued by Governor Newsom on March 12, 2020, Executive Order N-29-20, issued by Governor Newsom on March 17, 2020, and Executive Order N-35-20, issued by Governor Newsom on March 21, 2020. Items of business will be limited to the matters shown on the attached agenda.

If you wish to listen to the teleconference meeting, please dial one of the following numbers and enter Meeting ID# 289-998-6429:

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If you have any questions or require additional service, please contact KCERA at (661) 381-7700 or send an email to administration@kcera.org.

Sincerely,

Dominic D. Brown

Dominic D. Brown
Executive Director

Attachment

AGENDA:

All agenda item supporting documentation is available for public review on KCERA's website at www.kcera.org following the posting of the agenda. Any supporting documentation that relates to an agenda item for an open session of any regular meeting that is distributed after the agenda is posted and prior to the meeting will also be available for review at the same location.

AMERICANS WITH DISABILITIES ACT
(Government Code §54953.2)

Disabled individuals who need special assistance to listen to and/or participate in the teleconference meeting of the Board of Retirement may request assistance by calling (661) 381-7700 or sending an email to administration@kcera.org. Every effort will be made to reasonably accommodate individuals with disabilities by making meeting materials and access available in alternative formats. Requests for assistance should be made at least two (2) days in advance of a meeting whenever possible.

ROLL CALL

1. Discussion and appropriate action on short duration recommendation presented by Scott Whalen, CFA, Verus, Chief Investment Officer Daryn Miller, CFA, and Retirement Investment Officer Brian Long, CFA – RECOMMEND THE FOLLOWING TO THE BOARD OF RETIREMENT: A) APPROVE INVESTMENT IN BLACKROCK SHORT DURATION INVESTMENT STRATEGY; B) WAIVE ON-SITE DUE DILIGENCE REQUIREMENT PER THE INVESTMENT POLICY STATEMENT (IPS); C) AUTHORIZE EXECUTIVE DIRECTOR TO SIGN, SUBJECT TO LEGAL ADVICE AND REVIEW

PUBLIC COMMENTS

2. The public is provided the opportunity to comment on agenda items at the time those agenda items are discussed by the Committee. This portion of the meeting is reserved for persons to address the Committee on any matter not on this agenda but under the jurisdiction of the Committee. Committee members may respond briefly to statements made or questions posed. They may ask a question for clarification and, through the Chair, make a referral to staff for factual information or request staff to report back to the Committee at a later meeting. Speakers are limited to two minutes. Please state your name for the record prior to making a presentation.

COMMITTEE MEMBER ANNOUNCEMENTS OR REPORTS

3. On their own initiative, Committee members may make a brief announcement, refer matters to staff, subject to KCERA's rules and procedures, or make a brief report on their own activities.

4. Adjournment

Memorandum

To:	Investment Committee, Kern County Employees' Retirement Association
CC:	Daryn Miller, CFA, Chief Investment Officer
From:	Scott J. Whalen, CFA, CAIA, Executive Managing Director | Senior Consultant Stuart Odell, Managing Director | Senior Consultant
Date:	February 5, 2021
RE:	Capital Efficiency Program - Tier II Collateral Manager Due Diligence

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Executive Summary

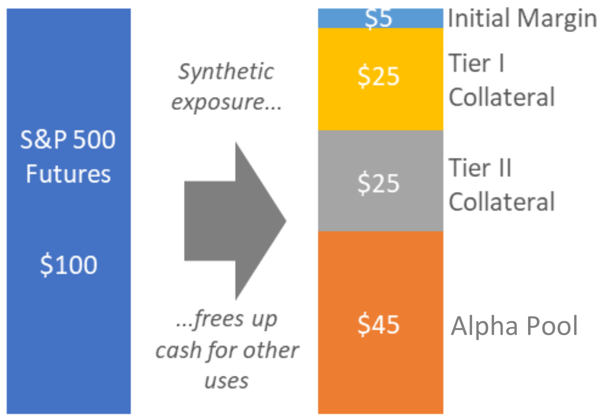
Over the past year, KCERA has assessed, designed, and gradually implemented its Capital Efficiency Program ("CEP"), which was approved at a target allocation of 5% of the total investment portfolio. The next step in the process, which will allow for full implementation, is to select a short duration fixed income investment manager to manage the Tier II Collateral Reserve.

To complete this step, Verus and KCERA Investment Staff have conducted an in-depth assessment that began with a list of 233 possible candidates and ended with detailed (virtual) due diligence visits with five finalists. Following our review, we believe BlackRock provides the best fit for the mandate, primarily due to a broadly diversified investment strategy, deep resources, a consistent risk/reward profile, reasonable fees, and a successful ongoing relationship with KCERA.

Notably, Staff is seeking a policy exception related to the on-site due diligence requirement. Because of travel restrictions caused by the Covid-19 pandemic, due diligence on this strategy was conducted remotely via video conference, rather than on site. Verus conducted its last on-site due diligence with BlackRock in December 2019.

Background and Introduction

In 2020, the KCERA Board approved an allocation of five percent of plan assets to a Capital Efficiency Program ("CEP") as part of design enhancements to improve the investment portfolio's overall risk/return profile. The fundamental structure of the CEP as initially implemented includes gaining synthetic equity exposure through S&P 500 futures. A portion (55%) of the cash freed up by the derivatives exposure is used as collateral for the futures. The remainder is invested in hedge funds (the "alpha pool") in an effort to generate excess returns over time. This structure is described conceptually at a high level in the following exhibit.



The Tier II Collateral pool will be invested in short duration fixed income instruments. The intention is to take on slightly more risk and earn slightly more return than the cash and cash equivalents held as Initial Margin and Tier I Collateral.

Evaluation Process

The evaluation process began with the identification of all short duration investment strategies contained in the EVESTMENT research database, a robust third-party provider of investment manager information. Our first query yielded 233 short duration investment strategies with more than five years of performance history on which we conducted further analysis. We then applied additional screens to remove strategies with low assets under management. Finally, we ranked the managers based on risk, returns, and correlations with the S&P 500 and with LIBOR over various historical time periods. We also reviewed their holdings to get a sense of the investment strategy deployed by each.

The analysis described above resulted in a list of 18 managers of interest to whom we sent a formal Request for Information. The RFI described the CEP mandate, provided a risk-optimized return target of LIBOR + 100-200 basis points, and solicited responses to questions on the topics of organizational structure, investment philosophy, strategy implementation, risk management, investment performance, and fees. From the RFI responses, we narrowed the field to a short-list of five candidate firms and their proposed strategies, listed alphabetically as follows:

- BlackRock – Short Duration Strategy
- Income Research + Management – IR+M 1-3 Year
- PIMCO – Enhanced Cash Plus
- Sit Fixed Income Advisors – Taxable Short Duration
- Western Asset Management Company – WA US Short Duration Constrained

Verus and KCERA Investment Staff conducted in-depth due diligence interviews with the finalist firms, which ultimately led to our final recommendation. Source material for this memo includes manager RFI responses and due diligence presentation materials, manager submissions to the EVESTMENT database, notes from due diligence meetings, and the Verus public markets research group. The remainder of this memo provides details of our review with BlackRock, the candidate we are recommending, an explanation of the high-level reasoning for not selecting the remaining finalist candidates, and the rationale for considering an exception to the policy requiring on-site due diligence.

BlackRock

Firm Background

BlackRock was founded in 1988 and is a provider of asset management, risk management, and advisory services to institutions, intermediaries, and individuals worldwide. The firm manages assets across equity, fixed income, real estate, liquidity, alternatives, and asset allocation/balanced strategies in separate accounts, mutual funds, and other investment vehicles. BlackRock is headquartered in New York and has offices in over 20 countries with more than 15,000 employees. They are publicly owned with no single majority stockholder and a board composed of a majority of independent directors. Institutional investors, employees and the public own roughly 60% of the firm.

Organizational Structure

BlackRock is organized in a largely flat, horizontal structure with a culture that emphasizes, communication, transparency, teamwork, and collaboration across functions. Their organizational structure includes a regional overlay in recognition of the geography-specific needs of clients, as well as the importance of local regulatory structures. BlackRock's structure is designed to achieve three specific goals:

- Maintain strong and consistent investment performance;
- Capture opportunities given the changing investing landscape; and
- Fully leverage the firm's talent in leadership roles where they can have the greatest impact on investment performance.

The proposed strategy is managed by BlackRock's Short Duration Team in collaboration with their Global Fixed Income Platform resources.

Tom Musmanno, CFA, Managing Director, is primarily responsible for the management of the full suite of Short Duration products, including the proposed Short Duration Strategy. As head of the Team, Tom is ultimately accountable for performance. He and Scott MacLellan, CFA, Director, are the lead portfolio managers responsible for the Short Duration Strategy. The two have been with the firm for 29 and 18 years, respectively, and have worked together on the Short Duration team for the past 8 years. The Short Duration team oversees $71 billion in actively managed US short duration portfolios as of June 30, 2020.

Investment Philosophy

BlackRock's investment philosophy seeks to generate consistent excess risk-adjusted returns across all market environments. To do this they attempt to develop deep market insights by utilizing proprietary analytics and the extensive expertise of their investment professionals. They apply a diversified relative-value approach to generate alpha utilizing three primary alpha sources:

- Macro alpha – driven by sector selection and allocation;
- Security alpha – driven by security selection; and
- Portfolio alpha – driven by portfolio construction, rebalancing, and trading.

The Team uses this approach to maximize income through broadly diversified exposure to the best risk-adjusted return opportunities across the short-term fixed income spectrum. In the current market environment, BlackRock believes duration and curve positioning are as important as sector and security selection to navigate a slowing global economy and volatile global fixed income markets.

Implementation

BlackRock's Short Duration investment process is systematic, disciplined, research-driven, and rooted in the firm's culture of teamwork and collaboration. Several meetings are held throughout the week from which the team combines top-down and bottom-up perspectives and insights, which ultimately drive portfolio construction. Portfolio managers attend daily, weekly, and monthly strategy and market focused meetings, and meet regularly with counterparts globally across different asset classes and investment groups, including fixed income, equity, cash, alternatives, and risk management specialists.

The goal of the overall investment decision-making process is to identify and document a specific rationale for each investment. That same rationale is employed to continually review the merits of each investment and to determine the appropriate exit strategy. This investment approach reflects collaboration between the Team's lead portfolio managers, who are responsible for setting the top-down asset allocation framework for portfolio construction, and the Core PM Team, which works directly with sector specialists and traders are responsible for bottom-up idea generation, research, analysis, security selection, and trade execution.

Risk Management

BlackRock has made substantial investments in proprietary risk management systems and personnel.

BlackRock Solutions ("BRS") technology provides integrated automated transaction processing and risk management and supplies information to portfolio managers for their use in making investment decisions and calibrating risk positions. Transaction processing components facilitate operating efficiency by linking trade information, security data, guideline compliance, and portfolio operations.

The Risk and Quantitative Analysis Group ("RQA") leads BlackRock's portfolio risk analytics efforts by providing independent top-down and bottom-up oversight. RQA partners with BlackRock's investment teams to ensure risks in the portfolio are deliberate and consistent with the team's current investment themes, diversified across a number of strategies, and scaled to the fund's return target.

RQA Investment Risk teams meet formally with Portfolio Management teams on a regular basis to review risk positioning in portfolios. The frequency of these meetings varies according to the nature of the mandate and is governed by RQA's Risk Management Policies and Procedures. RQA's meetings with Portfolio Management teams are monitored and the status is reported on a weekly basis to RQA's Executive Committee, which is chaired by BlackRock's Chief Risk Officer.

Outside of the formal meetings, portfolio management teams interact with RQA on a frequent and ongoing basis. RQA monitors risk to ensure risk levels are consistent with a portfolio's guidelines, and RQA may communicate proactively with portfolio managers to help them position portfolios and fully utilize BRS' analytical capabilities. While RQA is involved in the risk management/monitoring process and can make suggestions to the portfolio management team, ultimate discretion and decision-making authority remains with the Strategy's Portfolio Managers.

The US Short Duration Investment Team is also responsible for decisions regarding the five risk parameters inherent in the management of fixed income securities (i.e., interest rate risk, yield curve risk, cash flow risk, credit risk, and liquidity risk). BlackRock quantifies each of these risk parameters on a daily basis and provides them online and in a daily risk management package. The team manages the strategy risk budgets with a daily review process to ensure portfolios are taking appropriate risks and trades are allocated accordingly.

BlackRock uses a proprietary investment platform called Aladdin to help monitor and manage these risks. Aladdin integrates and instantly connects all functions through the investment management process. From portfolio management and trading to compliance, operations, risk management and oversight, Aladdin brings together people, processes, and systems to support a seamless investment process.

<u>Performance Expectations</u>
The Team's approach to managing fixed income emphasizes sector rotation, security selection, macro strategies, such as yield curve and duration positioning, and portfolio optimization. A market environment with moderate to high volatility levels that provides trading opportunities in conjunction with ample market liquidity to implement trade ideas is the ideal environment for BlackRock's style.

Historically, when there have been long-term secular shifts in market conditions (e.g., post-2016 US election) or a pronounced shift in global monetary policy (e.g., ECB support in 2012), these have also proven to be favorable BlackRock's investment strategy.

There are two market conditions that are less conducive to BlackRock's management style. Both are related to extreme market conditions. The first is when volatility falls to extremely low levels, spreads become compressed, and the rewards for taking credit or structural risk are very low. The second is when liquidity is diminished to the point where it is difficult to execute trades or implement strategies and the ability to capture dislocations in securities or sectors can be compromised. BlackRock still believe they have the capacity to outperform in these environments, but the expected alpha will be lower.

Other Managers
Based on our assessment of the other four finalist candidates relative to our understanding of KCERA's needs, we found they did not fit the mandate as well as BlackRock, the primary reasons for which are summarized below.

<u>IR+M</u>
The majority of IR+M's portfolio is held in the credit sector, and while they have had notable success in achieving their excess return objectives, their reliance on credit has led to higher correlation with equities, particularly during times of significant drawdowns. KCERA needs a

manager with a low correlation to ensure the reserve is serving its primary purpose as collateral for the equity derivatives positions that will be available in the event of a margin call.

<u>PIMCO</u>
PIMCO's strategy is very similar to exposure that already exists in portfolio (i.e., the Stocks+ strategy in the domestic equity sleeve). In addition, PIMCO as a manager is well represented across the portfolio. We knew going in that PIMCO would likely make a strong showing but that the bar would be high given the current exposure. In the end, they were not able to overcome the strategy concentration headwind.

<u>SIT</u>
SIT was very attractive from both a level of excess returns, and actual negative equity correlation. However, given that their strategy relies nearly exclusively on investments in a small segment of the mortgage-backed securities sector of the fixed income market, we ultimately viewed the strategy as overly specialized and overly exposed to a single risk factor (i.e., mortgage prepayment risk) for this mandate.

<u>WAMCO</u>
Similar to PIMCO, KCERA already holds strategic exposure to WAMCO's investment philosophy in their Core+ and High Yield investments in the fixed income portfolio.

Policy Exception
KCERA's current Investment Policy Statement includes language requiring on-site due diligence for managers under consideration, stated as follows:

"Every manager that the Chief Investment Officer and Investment Consultant recommend to the Board must have undergone on-site due diligence not more than one year prior to the recommendation to the Investment Committee. On-site due diligence is to be conducted by the Investment Consultant."

Given the current remote work environment and restrictions on travel, on-site due diligence was not possible for this evaluation. However, we believe the risk associated with not performing an on-site visit to BlackRock is virtually eliminated based on the following factors:

- Verus conducted an on-site visit with BlackRock in December 2019, just outside of the 1-year window;
- Verus conducted deep investment due diligence remotely, which culminated in a two-hour video conference with KCERA Staff and 11 members of BlackRock's investment and Risk teams;
- BlackRock is a large, multi-national, financial services institution with a robust compliance function; and
- KCERA has had an ongoing and successful relationship with BlackRock since 2003.

We believe that under the circumstances permitting a variance to the on-site due diligence policy is a reasonable course of action.

Recommendation and Next Steps
Verus and KCERA Investment Staff have reached the consensus view that Blackrock's Short Duration strategy is the best fit for the given mandate. Attractive qualities of the BlackRock Short Duration investment strategy include:

- Low risk
    - Volatility
    - Correlation to S&P 500;
- Strong risk management capabilities;
- Reasonable and consistent excess returns;
- Reasonable fees (KCERA Staff negotiated lowering their separate account minimum and a roughly 8% discount to their standard fee schedule);
- Successful long-term relationship; and
- Large firm (i.e., "safe" choice).

If the Investment Committee agrees with this assessment, next steps include gaining approval from the full Board and strategy implementation, which consists of selecting an appropriate investment vehicle, negotiating a satisfactory and suitable fee structure, and conducting a successful document review.

Attachments:
Comparative Fee Schedules
Comparative Performance and Risk Statistics

Comparative Fee Schedule

	BlackRock	IR+M	PIMCO	Sit	WAMCO
Mutual Fund	Mgt. Fee 29 bps Net Op. Exp.: 20 bps Tot. Fee and Exp: 49 bps	N/A	N/A	N/A	N/A
Commingled Fund	N/A	N/A	N/A	N/A	N/A
Separate Account	First $100MM: 23 bps Next $150MM: 20 bps Balance: 28 bps	First $50MM: 20 bps Next $50MM: 15 bps Over $100MM: 10 bps	Based on total plan assets with PMCO First $600MM: 32.5 bps Next $700MM: 30 bps Balance: 25 bps	First $50MM: 34 bps Negotiable over $50MM	12.5 bps on all assets as long as total plan assets with WAMCO remain over $400MM; otherwise: First $100MM: 25 bps Balance 12.5 bps

Comparative Performance and Risk Characteristics

	BlackRock Short Duration	IR+M 1-3 Year	PIMCO* Custom/Low Duration - Fully Restricted	Sit Taxable Short Duration	WAMCO* Custom/WA US Short Duration
Correlation w/ S&P 500					
3 Year	0.22	0.27	0.12	-0.35	0.12
5 Year	0.11	0.19	0.07	-0.34	0.12
10 Year	0.11	0.22	0.09	-0.23	0.16
Annualized Std Dev					
1 Year	2.29	1.89	0.97	1.55	1.17
3 Year	1.85	1.39	0.84	1.83	1.16
5 Year	1.68	1.20	0.79	1.78	1.04
7 Year	1.55	1.08	0.77	1.69	0.94
10 Year	1.50	1.03	0.84	1.60	0.85
Excess Returns over LIBOR (GF)					
1 Year	3.33	3.21	2.90	3.00	1.89
3 Year	1.66	1.37	1.25	1.94	1.27
5 Year	1.26	1.07	1.08	1.59	1.21
7 Year	1.34	1.09	1.00	2.09	1.10
10 Year	1.49	1.31	0.97	2.41	1.01
Risk Metrics					
Sharpe Ratio (3-Year)	0.39	1.17	0.30	1.25	0.74
Effective Duration	1.58	1.72	1.13	2.37	0.98
Credit Spread Duration	2.62	N/A	2.77	3.90	2.65
Average Credit Quality	A	A	AA-	Agency	A
YTM	1.47	0.93	1.15	4.14	1.94

*Note: PIMCO and WAMCO proposed custom solutions not tracked by EVESTMENT. Therefore, for performance metrics, we substituted PIMCO's Low Duration - Fully Restricted strategy and WAMCO's WA US Short Duration Constrained strategy as reasonable proxies. Risk metrics were provided by the managers and reflect the actual custom strategies.