SDCERA Underwriting Model for Private Markets Allocations

Background

Private Market investments, which include Private Equity, Private Real Estate, Private Real Assets, and Private Debt, are long-term and illiquid investments. These investments are contractually entered into using limited partnership agreements that lock up SDCERA's Trust Fund assets for periods of time often exceeding ten years. As a limited partner, SDCERA has no management authority throughout the life of the investment agreement. Investment returns are largely dominated by the asset class, the vintage year of the investment, the skill of the investment manager, and fees.

Until 2016, SDCERA invested in private markets using a "top-down allocation" process, whereby investment staff and consultants recommended, and the Board approved, allocation targets for categories of private market investments. Typically, this was done using the general consultant's capital market assumptions and the application of an efficient frontier-optimization calculation. Staff would then work with the consultant to "source" investment managers and strategies to fill the approved investment categories and maintain the target allocation levels. In 2016, SDCERA investment staff, the general consultant, and the private assets specialist consultant researched five approaches to setting private markets allocations and hiring investment managers.

The result of this research and review process was the adoption of the SDCERA Private Markets Underwriting Model, which focuses on the expected risk and return of each investment compared to investing in public market assets. The approval of a private markets contract by the Board is a two-step process designed to achieve clarity and transparency for these long-term contractual commitments.[1]

SDCERA Private Markets Underwriting Model

The Underwriting Model explicitly recognizes the time-varying returns to private markets investments and the long-term contracts associated with these investments. The Underwriting Model includes a two-step process where the specific investment is presented and reviewed by the Board twice in public at a Board meeting before staff can execute a private markets contract. The Underwriting Model focuses on finding and underwriting (1) strong and capable investment firms, (2) the specific investment teams working on each investment, and (3) the detailed expected risks

[1] The Two-Step Approval Process was originally prensented to and accepted by the Board of Retirement on 16 October 2016: https://sdcera.granicus.com/GeneratedAgendaViewer.php?view_id=12&clip_id=664
The Underwriting analysis Model was presented to and accepted by the Board of Retirement on 25 May 2017: https://sdcera.granicus.com/MediaPlayer.php?view_id=13&clip_id=683&meta_id=76159

and returns of each investment and why they are expected to be above public market equity or debt index investments, which are the passive alternatives.

The underwritten investment firms and specific investment teams are expected to be capable, stable, and strong long-term partners with SDCERA. Each investment is analyzed and must stand on its own. The specific allocations to private markets as percentage of Trust Fund Assets within the IPS guidelines are determined by the specific investment opportunities, not a top-down model-driven percentage. Contracts entered into align the interests and incentives of SDCERA and the investment management firms. Staff reviews the application of the Underwriting Model annually in conjunction with the annual asset allocation review and approval.

The Two-Step Approval Process

The general objectives of the two steps are clarity, transparency, and, given the long-term nature of private investment contracts, a prudent period of time for the Board to understand and evaluate the investment recommendations presented to them for approval.

Step One:

At a Board meeting, when investment staff recommends a private market investment, it will present the following:

- Expected return of the investment
- How the return will be achieved and what risks will be taken to achieve the return

The investment manager will also present the investment opportunity to the Board at the same meeting. Investment staff and the investment manager will be available for questions from the Board. The Board will then vote on whether to approve the investment manager and allow investment staff to work on the investment documents.

Step Two:

At a subsequent Board meeting, investment staff will present the following to the Board:

- Expected return of the investment
- How the return will be achieved and what risks will be taken to achieve the return
- Confirmation that all operational due diligence has been completed, including, but not limited to:
    - Manager site visit
    - Due diligence questionnaire
    - SEC Form ADV review
    - Review of operations, compliance, and trading procedures
    - Review of responsible contracting policy for directly owned real estate

    - Reference check
- Confirmation that all legal documents are in order
    - Limited Partnership Agreement or Investment Management Agreement
    - Private Placement Memorandum
    - Subscription Agreement
    - Side Letter (if applicable)

The Board then decides whether to approve the investment and authorize staff to sign the limited partnership documents.