SBCERS

Santa Barbara County Employees' Retirement System

DATE: October 25, 2023

TO: SBCERS BOARD OF RETIREMENT

FROM: SBCERS Investment Staff

RE: **China Divestment Discussion**

Recommendation

That the Board of Retirement receive the presentation by Principals and Co-Lead Consultants Marcia Beard and Matthias Bauer, CFA of RVK, Inc. and SBCERS Investment Officer Rebecca M. Valdez regarding the potential process to divest the SBCERS portfolio from investments with exposure to China; and

A. Approve the recommendation to maintain the current investment mandate with all active managers.

Summary

An educational presentation on investing in China was presented to the Board of Retirement at its September 27, 2023 meeting. As of August 31, 2024 SBCERS has 1.78% of the total portfolio invested directly in China domiciled equities, which comes from 5 different investment managers. SBCERS maintains several other investments directly in China across its fixed income, real return, and private assets portfolios.

Following the educational presentation, issues surrounding divestment from China were also discussed with the Board of Retirement. The discussion included long-term return assumptions on China equities and the summary of the pros and cons of investing in China equities. The discussion also addressed current prohibitions by the U.S. Government on certain Chinese businesses, other investment restrictions and the impact of tariffs. At the request of Trustees, RVK and SBCERS Staff were instructed to return to the October 25th Board Meeting to bring forward a proposed timeline for divestment from China so that the Board can vote on the issue of divestment.

In this agenda item, Staff and RVK present a process developed for divestment from China that employs what Staff and Consultants view to be a best practices approach for making significant allocation decisions. If approved by the Board of Retirement, it is estimated that divestment from China could take up to 2 years. The process for divestment would be as follows:

1. Operations Committee: Define the degree of divestment

2. Operations Committee, RVK and Staff: Define process to address the possibility other countries, sectors, or securities are suggested for divestment
3. Operations Committee, RVK and Staff: Review and modify the Investment Policy Statement
4. RVK: Revise the Capital Market Assumptions
5. RVK: Complete an Asset Allocation Study
6. RVK: Complete Asset Class Structure Studies
7. Staff: Address contract and guideline changes with Hamilton Lane
8. RVK: Manager search and selection
9. Staff: Manager contract review and execution
10. RVK and Staff: Prioritize steps for implementation
11. RVK and Staff: Complete a transition manager bid and selection process
12. RVK and Staff: Begin implementation

Staff recommends that the Board of Retirement should continue to maintain current exposure through active managers to China and thus does not recommend implementation of a divestment process. Staff's view is that SBCERS investment managers have fully evaluated the current risks and rewards of all markets in their mandate and have used their delegated discretion to select the securities held on SBCERS behalf. The Board employs managers to make tactical and strategic long-term investment decisions after carefully considering the information available to the market. SBCERS existing investment mandates provide the managers with the discretion to exit Chinese markets when and if economic, regulatory or geopolitical conditions become such that the manager longer believes China to be the best place for SBCERS capital to be allocated. The Board's current manager monitoring and evaluation tools allow it to assess manager performance in a meaningful way both through performance against benchmarks, but also against a manager's peers. Thus, the Board has a qualitative and quantitative process for evaluating investment manager decisions relative to China. Beyond fiduciary and policy considerations, staff notes that divestment from China is likely to increase rather than decrease portfolio risk by limiting diversification and manager discretion. This view is consistent with CALPERS published statements on divestment, which also noted that divestment decisions are often followed by losses rather than gains.

In preparing the above plan, Staff also consulted with Counsel who also recommends against immediate action to implement divestment from investments in China because such a decision would be made absent a strong factual record supporting the necessity of such action, and would be made in the absence of a comprehensive policy guiding the Board of Retirement's exercise of discretion in implementing such mandates. Counsel noted that making such an ad hoc decision without a defined policy also risks embarking on a slippery slope. If the Board of Retirement takes action to divest from investments in China, what other markets or industries may follow under similar rationales. For this reason, if adopted, the presented implementation plan recommends referring the Board's investment policy to the Operations Committee for revision as a first step.

An alternative course to implementing a divestment process would be to request that Staff and Consultants continue to monitor SBCERS investment activities in China and to report back periodically to the Board on how investments in China performed relative to other emerging markets as well as keeping the board apprised of current economic, regulatory or geopolitical conditions that affect those investments. Such action would raise awareness among SBCERS investment managers about the Board's concern for current conditions present in China and how continued change in those conditions may impact SBCERS investments. Such action would also provide a stronger factual record to support any future decision regarding divestment, as well as the opportunity for the Board to develop policy criteria governing divestment decisions consistent with the fulfillment of its fiduciary responsibilities.

Attachments

- 2023-10 China Equity Discussion Part 2