



# Real Return Structure Review

## Part 1

Santa Barbara County Employees' Retirement System  
May 2024



# Review Objectives of Real Return Structure





# Objectives

## Real Return Structure Review

- **Periodic review of individual asset classes is best practice.**
  - The last formal Real Return structure review was completed in 2017.
  - As anticipated in 2017, it required several years to prudently transition to the recommended 60% Private/40% Public target allocation.
    - the target was achieved in mid-2022
    - the current Private/Public split is well-above the target set in 2017
- **Review and evaluate diversification, risk characteristics, performance and fees remain appropriate for its purpose in SBCERS' overall allocation.**
  - Thematic role – is the asset class objective being met?
  - Structure efficiency - are there redundancies and could manager count and fees be reduced?
  - Active/Passive – is active management producing an acceptable level of excess return?
  - Fees – are there any opportunities for fee savings?
- **Confirm implementation through private markets is preferred.**
  - Private assets tend to provide higher return potential and can access investments not available in the public market.

# Objectives

## Real Return Structure Review (continued)

- **Determine what target split between Private and Public investments best meets the needs of SBCERS and the Real Return Portfolio.**
- **Recognizing that Hamilton Lane is the discretionary consultant for the Private Real Return investments, agree upon priorities for the Public Real Return assets.**
  - Sensitivity to inflation
  - Liquidity needs
  - Rebalancing requirements
  - Economics

# Objectives

## Presentation Agenda

To address the objectives on the previous slides, this Review will cover the following topics:

- **Introduction**
  - Where does the Real Return Structure Review Fit in the Investment Decision Making Process?
  - What is Real Return?
  - What Role does an Allocation to Real Return Play?
- **History of SBCERS' Real Return Structure**
- **Review of SBCERS' Current Real Return Structure**
- **Thoughts for SBCERS' Real Return Portfolio**
  - Increase Target to Private Real Return – Why?
- **Redefining the Role of Public Real Return Structure Given Reduced Target**
- **Proposed Timeline**

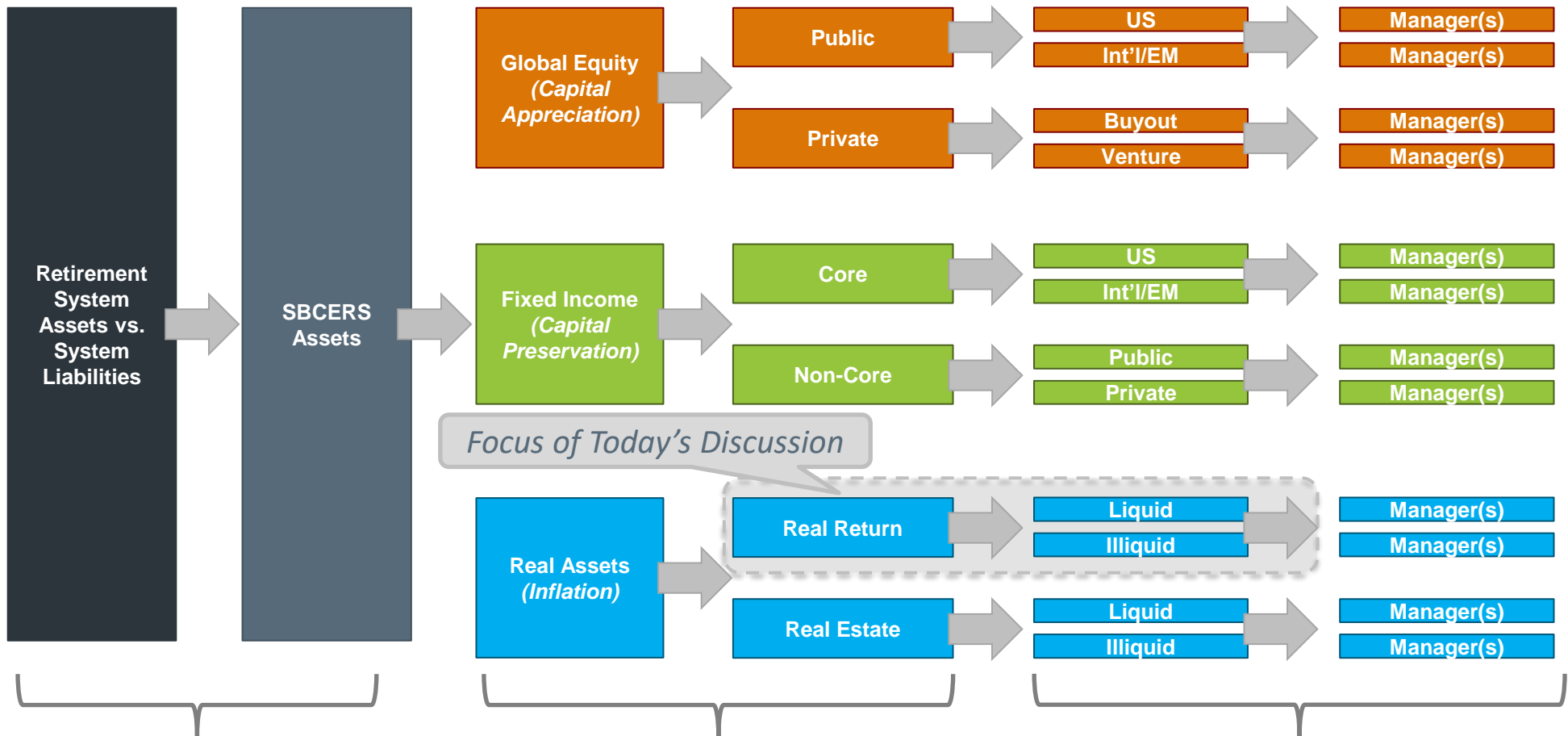
# Introduction

- \*Where does the Real Return Structure Review Fit in the Investment Decision Making Process?*
- \*What is Real Return?*
- \*What Role does an Allocation to Real Return Play?*



# Introduction

## Investment Decision Making Hierarchy



*Focus of Today's Discussion*

### Asset/Liability Study

- Assesses health of the Plan
- Models risk and return parameters including prevailing and expected cash flows
- Links Investment Policy, Contribution Policy and Benefit Policy

### Asset Allocation Study

- Models specific targets to asset classes
- Used to select overall target/policy allocation
- Generally uses passive capital market assumptions

### Asset Class Structure Studies

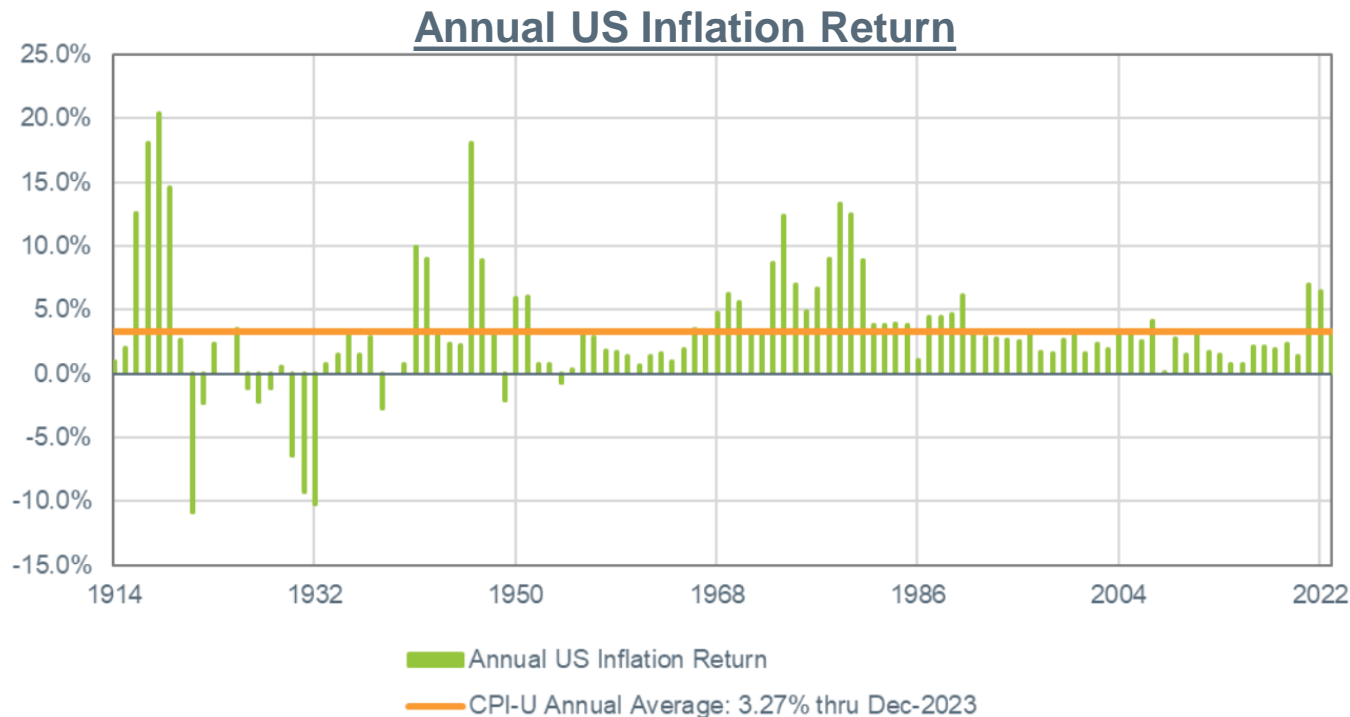
- Implementation guide with targets to sub-asset classes
- Mix of active and passive investments determined
- Optimal mix of managers

# Introduction

## What is Real Return?

A real rate of return is the percentage return realized on an investment, which is adjusted for changes in price due to inflation or other external effects.

- RVK's current long-term inflation assumption is 2.50%. Historical inflation rates are shown below.
- Although we experienced an uptick in inflation beginning in 2021, inflation has been near or below the long run average since the beginning of the 1980's. As shown in the following chart, the US has experienced several periods of high inflation in the past.





# Introduction

## Role of Real Return Investments

Real Return investments are expected to provide:

1. an inflation hedge,
2. long-term returns above inflation,
3. an income stream,
4. a return stream that is not highly correlated to traditional assets, and
5. meaningful diversification during periods of rising inflation and/or inflation expectations.

**Real Return investments can include both public (liquid) and private (illiquid) strategies and can be both real assets and financial assets.**

<u>Public Investments</u>	<u>Private Investments</u>
<ul style="list-style-type: none"><li>• Treasury Inflation Protected Securities (TIPS)</li><li>• Commodities</li><li>• Natural Resource Equities</li><li>• Listed Infrastructure</li><li>• Real Estate Investment Trust (REITs)</li><li>• Diversified Inflation Strategies (DIS)</li></ul>	<ul style="list-style-type: none"><li>• Private Natural Resources<ul style="list-style-type: none"><li>– Oil and Gas, Mining and Minerals, Timber, Agriculture, Renewables</li></ul></li><li>• Private Infrastructure<ul style="list-style-type: none"><li>– Transportation, Energy, Power, Water, Communications, Social Infrastructure</li></ul></li></ul>

# Introduction

## Role of Real Return Investments

- Similar to GDP growth, inflation seldom changes dramatically from quarter to quarter, but instead follows secular cycles that result from structural changes in the economy and/or government policy.
- As a result, we believe Real Return strategies will provide a return premium above inflation when measured over full market cycles.
  - however, the quarter-to-quarter, and sometimes year-to-year returns may deviate significantly from measured changes in CPI.

# History of SBCERS' Real Return Structure



# SBCERS' Real Return Structure

## History

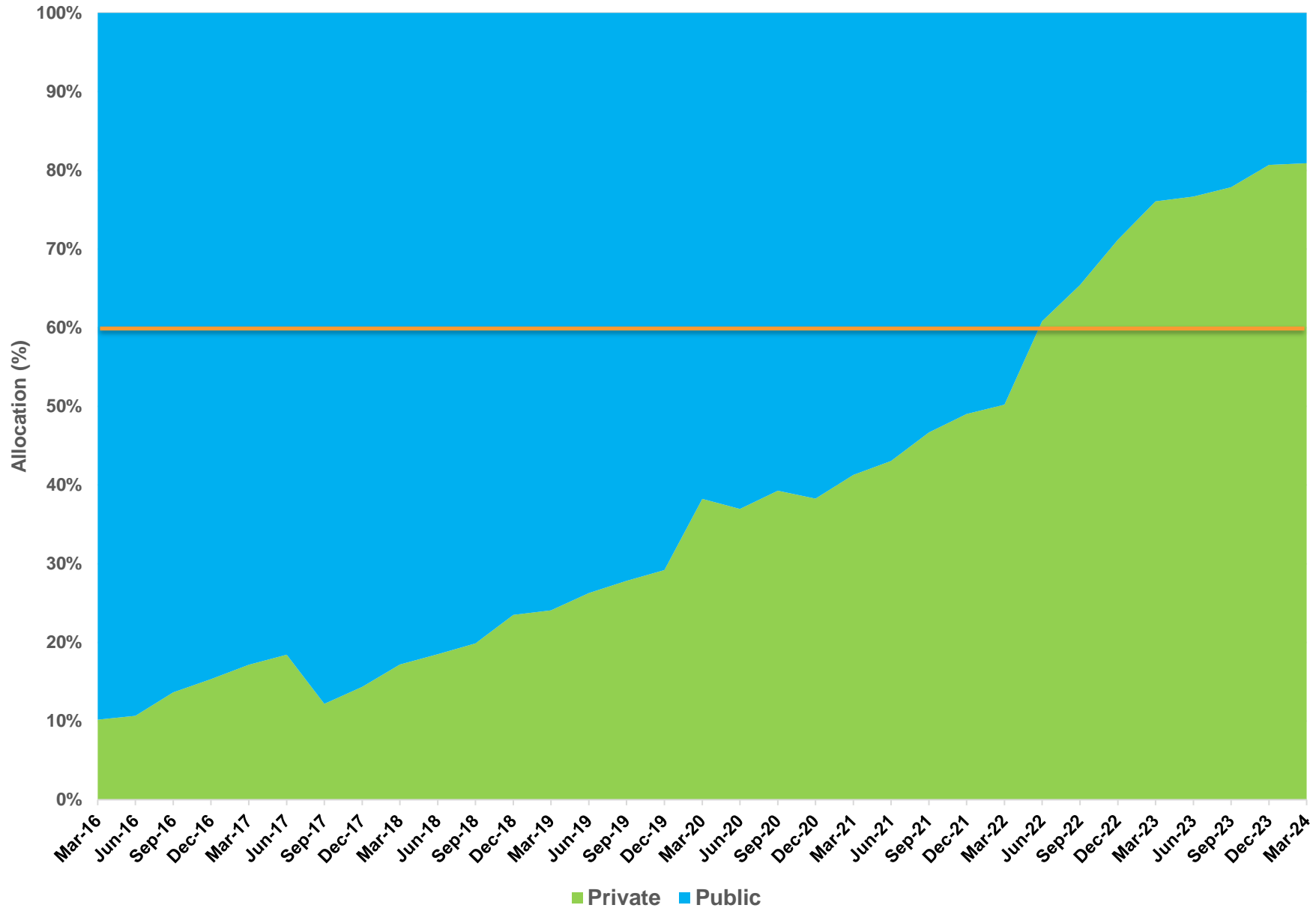
- The Board approved a target of 15% allocation to “Real Return” as part of the September 2016 Asset Allocation Study.
- Prior to RVK’s engagement and the 2016 Asset Allocation Study, SBCERS utilized dedicated targets to six Real Return sub-asset classes.
  - TIPS, Commodities, Private Natural Resources, Public Natural Resources, Private Infrastructure and Public Infrastructure
  - The target split was 25% Private and 75% Public
    - As of April 2016, the actual split was closer to 10% Private and 90% Public
- RVK conducted the last Real Return structure analysis in April of 2017. The Board approved the following recommendations:
  - Implement over time a target allocation to 60% Private and 40% Public Real Return assets
    - understanding that pacing to the 60% Private target would take several years
  - Initiate steps to reallocation the Public Real Return assets to the following structure:
    - 40% TIPS
    - 60% to Diversified Inflation Strategy (DIS) manager(s)
      - Cohen & Steers and Nuveen were hired in August of 2017 as a result of the DIS manager search

The chart on the following page illustrates SBCERS’ progression to the targeted 60% Private exposure.



# SBCERS Real Return Structure

## Private / Public Split



# Review of SBCERS' Current Real Return Structure



# SBCERS Real Return Structure

## Current Structure – Public and Private

Composite/Manager	Market Value (Millions)	Allocation	Composite Target	Active/Passive
<b>Total Real Return</b>	<b>\$612.2</b>	<b>100%</b>	<b>-</b>	<b>98%/2%</b>
<b>Public Real Return</b>	<b>\$116.8</b>	<b>19.1%</b>	<b>40%</b>	<b>80%/20%</b>
BNY Mellon TIPS - NL	\$10.3	1.7%	40%	Passive
Cohen & Steers Real Assets Fund (CIT)	\$53.5	8.7%	30%	Active
Nuveen Real Assets Income Fund (SA)	\$53.0	8.7%	30%	Active
<b>Private Real Return</b>	<b>\$495.4</b>	<b>80.9%</b>	<b>60%</b>	<b>100%/0%</b>
Private Natural Resources	\$191.8	31.32%	25-45%	Active
Private Infrastructure	\$303.6	49.6%	55-75%	Active

### Observations

- The current allocation to Public Real Return is 19% compared to its target of 40%
  - The allocation of Public Real Return is off target due to need for liquidity for capital calls
- The current allocation to Private Real Return is 81% compared to its target of 60%
- The combined Real Return portfolio is heavily weighted to active management (98%)

Data as of March 31, 2024.

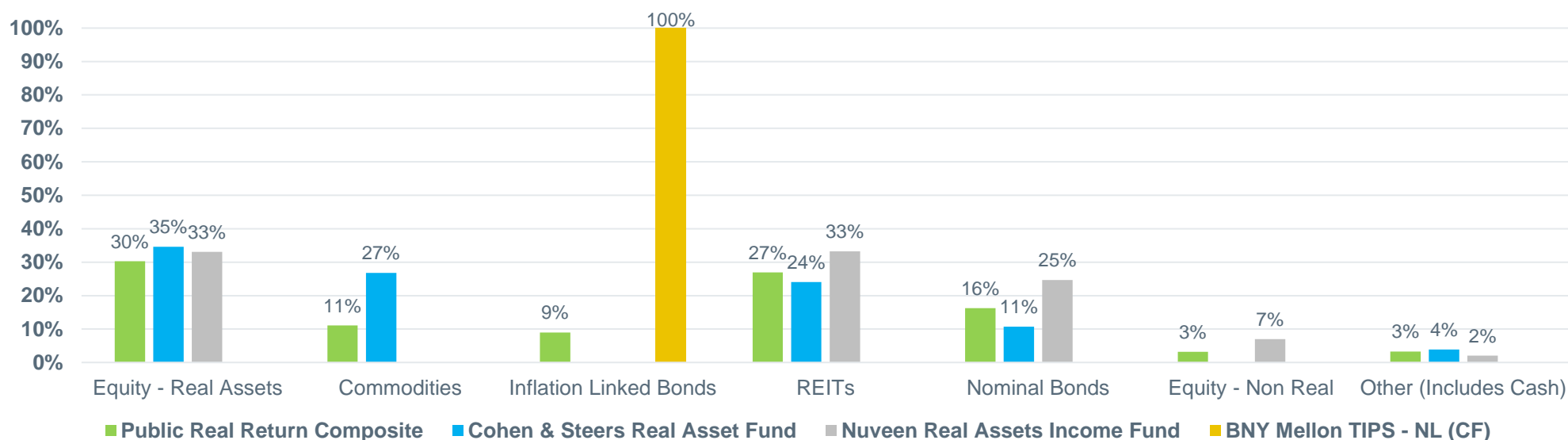
\*Real Return private asset classes cannot judiciously be rebalanced over short time periods in a cost-effective way. As such, the sub-targets are intended as long-term strategic goals, not short-term imperatives.

# SBCERS Public Real Return Structure

## Current Portfolio

Asset Class	Manager	Market Value (Millions)	Allocation	Composite Target	Active/Passive	Effective Fee
TIPS	BNY Mellon	\$10.3	8.8%	40%	Passive	0.01%
DIS*	Cohen & Steers	\$53.5	45.8%	30%	Active	0.65%
DIS*	Nuveen	\$53.0	45.4%	30%	Active	0.80%
<b>Total</b>		<b>\$116.8</b>	<b>100%</b>	<b>100%</b>	<b>91%/9%</b>	<b>0.66%</b>

## Sector Exposure



Data shown is as of March 31, 2024.

\*DIS = Diversified Inflation Strategies. Allocations may not add up to 100% due to rounding.



# SBCERS Real Return Portfolio

## Performance

	QTD	FYTD	1 Year	3 Years	5 Years	Since Incep.	Inception Date
<b>Total Real Return</b>	<b>1.68</b>	<b>6.12</b>	<b>7.88</b>	<b>10.78</b>	<b>8.47</b>	<b>7.34</b>	<b>7/01/2017</b>
Consumer Price Index+4%	2.82	5.42	7.62	9.87	8.37	7.81	
Difference	<b>-1.14</b>	0.70	0.26	0.91	0.10	<b>-0.47</b>	

	QTD	FYTD	1 Year	3 Years	5 Years	Since Incep.	Inception Date
<b>Private Real Return</b>	<b>1.83</b>	<b>6.43</b>	<b>8.83</b>	<b>16.73</b>	<b>11.71</b>	<b>9.98</b>	<b>7/01/2017</b>
<b>Public Real Return</b>	<b>1.01</b>	<b>5.81</b>	<b>5.56</b>	<b>3.08</b>	<b>4.29</b>	<b>4.23</b>	<b>7/01/2017</b>

	2023	2022	2021	2020	2019	2018
<b>Total Real Return</b>	<b>9.60</b>	<b>6.70</b>	<b>19.39</b>	<b>-1.36</b>	<b>14.06</b>	<b>-3.09</b>
Consumer Price Index+4%	7.49	10.71	11.32	5.42	6.38	5.99
Difference	2.11	<b>-4.01</b>	8.07	<b>-6.78</b>	7.69	<b>-9.08</b>

	2023	2022	2021	2020	2019	2018
<b>Private Real Return</b>	<b>11.06</b>	<b>19.27</b>	<b>25.78</b>	<b>-2.79</b>	<b>5.03</b>	<b>8.14</b>
<b>Public Real Return</b>	<b>5.60</b>	<b>-8.07</b>	<b>15.03</b>	<b>1.34</b>	<b>17.18</b>	<b>-5.60</b>

## Observations

- Private Real Return has outperformed Public Real Return by 575 basis points since inception.
- Private Real Return outperformed Public Real Return over the trailing 3- and 5-year periods, by 1,365 and 742 basis points respectively

Performance shown is net of fees and as of March 31, 2024.

\*Real Return private asset classes cannot judiciously be rebalanced over short time periods in a cost-effective way. As such, the sub-targets are intended as long-term strategic goals, not short-term imperatives.

# SBCERS Private Real Return Structure

## What is included in the Private Investments?

- Hamilton Lane is the discretionary Consultant for the Private Real Return portfolio and invests per the Board's Investment Policy guidelines.
- Hamilton Lane advises the Board on any recommended changes to the private portfolio's structure and permissible investments.

### Permissible Investments as defined in the Private Infrastructure and Natural Resources Policy

- **Infrastructure investments:**
  1. Transportation (roads, bridges, tunnels, mass transit, parking, airports, seaports, rail);
  2. Energy (oil, natural gas and liquids, pipelines, storage, and distribution);
  3. Power (transmission, distribution, generation, including renewables);
  4. Water (water storage, transportation, distribution, treatment and wastewater collection, transportation, treatment and processing);
  5. Communications (towers and networks); and
  6. Social Infrastructure (building facilities such as health, education, justice, military).
- **Natural Resources investments:**
  1. Oil and Gas (upstream, midstream, downstream);
  2. Mining and Minerals (exploration, development, production);
  3. Timber (natural forest, plantation forests);
  4. Agriculture (row crop, permanent crop, pastureland); and
  5. Renewables (power generation and fuel).

# Thoughts for SBCERS' Real Return Portfolio

*\*Increase Target to Private Real Return – Why?*



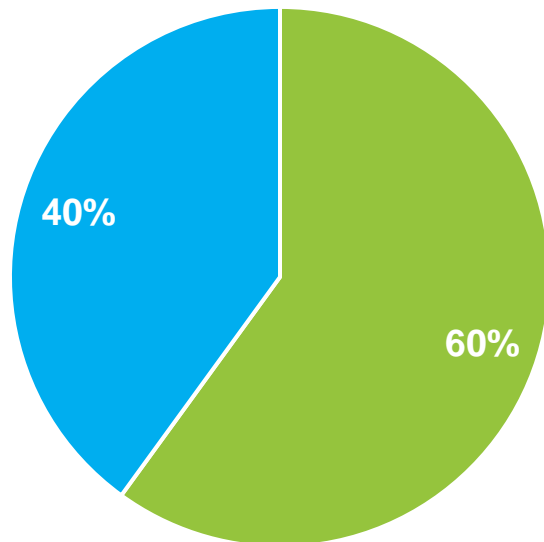
# SBCERS Real Return Structure

## Recommendation for Private and Public Exposure

RVK recommends the Board approve increasing the Private Real Return target to 75% of the portfolio.

### Current Targets

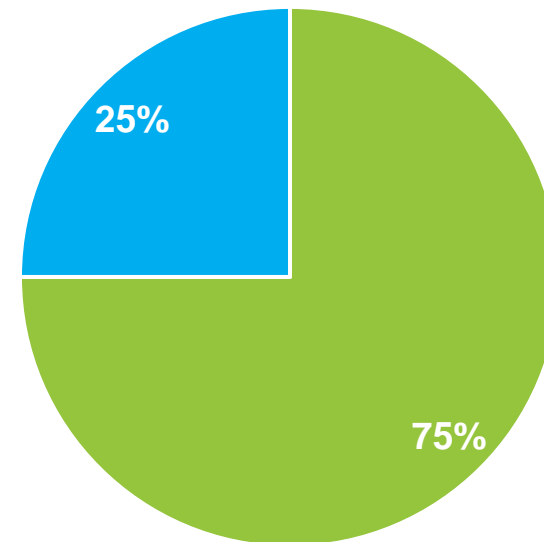
- **60% Private Investments**
  - \$367M
  - 8% of Total Fund
- **40% Public Investments**
  - \$245M
  - 6% of Total Fund



■ Private ■ Public

### Recommended Targets

- **75% Private Investments**
  - \$459M
  - 11% of Total Fund
- **25% Public Investments**
  - \$153M
  - 4% of Total Fund



■ Private ■ Public

Data as of March 31, 2024.



# SBCERS Real Return Portfolio

## Why is RVK Recommending an Increase to Private Investments?

- The Asset Liability Study completed in 2022 indicated through low payout ratios that liquidity is not anticipated to be an investment impediment. This suggests additional illiquidity can be assumed with private assets to achieve a better return/risk ratio.
- Private assets tend to be less influenced by investor sentiment. As a result, they generally exhibit lower volatility, lower drawdown risk, and more attractive correlations over the long term.
- Now that the Private Real Return portfolio has met (and even surpassed) the long-term target of 60%, RVK is comfortable increasing this target further to 75%. We are projecting higher forward-looking returns for Private Real assets than for Public Real assets.

### Real Return Sub-Asset Class Capital Market Assumptions for Private and Public Investments

	Asset Class	Expected Arithmetic Return	Expected Risk	Expected Geometric Return
<b>Private Assets</b>	Private Core Infrastructure	7.25%	15.00%	6.22%
	Private Natural Resources	7.51%	13.68%	6.65%
<b>Public Assets</b>	Diversified Inflation Strategies	6.00%	11.85%	5.34%
	TIPS	4.00%	5.50%	3.85%

Expected arithmetic and geometric returns, and expected risks derived from 2024 RVK Capital Market Assumptions.

# SBCERS Real Return Portfolio

## What is the “Right” Private/Public Investment Split for SBCERS?

- Illiquid portfolios often have a “liquidity sleeve” consisting of public market investments for safety, rebalancing and cash needs.
- RVK modeled a stressed scenario in which the impact of a sharp decline (30%) in the US equity market was simulated to help determine an appropriate level of liquidity—public market investments—for the Real Return portfolio.
  - While the decline in asset prices during a severe market dislocation is problematic, it is further exacerbated if the Plan is unable to properly rebalance due to liquidity constraints—that has implications on both the resulting risk exposure as well as missing out on return opportunities provided by that very market dislocation.
  - The liquidity sleeve should also reduce tracking error relative to the real return benchmark and lower overall fees.
- A “liquidity sleeve” lessens the burden in times of stress by investing in a liquid strategy that mimics the objective of the asset class -- in this case, a liquid real return portfolio.
- RVK’s modeling estimates that a liquidity sleeve sizing approximately 25% of the Real Return portfolio would provide sufficient liquidity in the event of a severe market downturn.

# Redefining the Role of Public Real Return Structure Given Reduced Target



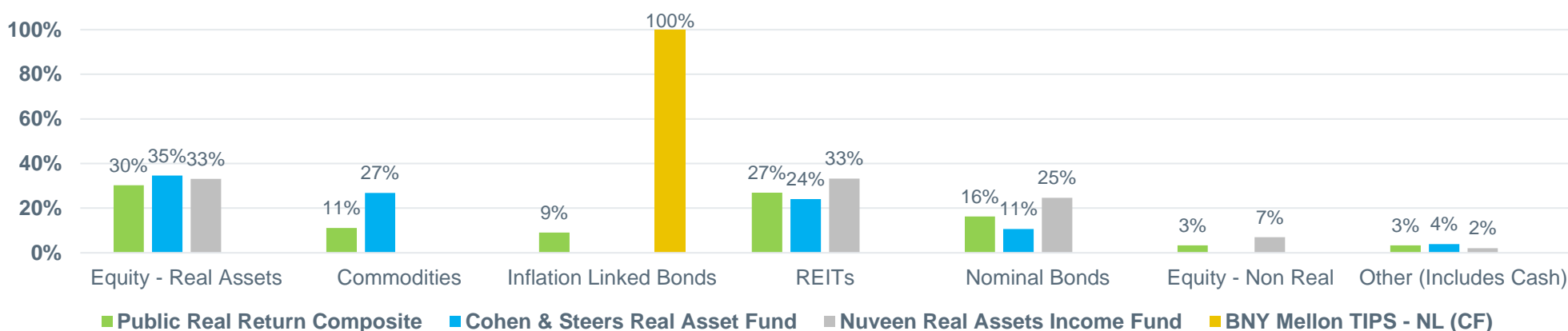
# SBCERS Public Real Return Structure

## Observations on Current Portfolio

- Three investment managers
- Heavily weighted to active management (~90% active/~10% passive)
- Reasonable fees totaling 66 basis points, based on actual allocations as of 03/31/2024
- Diversified sector exposure

Asset Class	Manager	Market Value (Millions)	Allocation	Composite Target	Active/Passive	Effective Fee
TIPS	BNY Mellon	\$10.3	8.8%	40%	Passive	0.01%
DIS*	Cohen & Steers	\$53.5	45.8%	30%	Active	0.65%
DIS*	Nuveen	\$53.0	45.4%	30%	Active	0.80%
<b>Total</b>		<b>\$116.8</b>	<b>100%</b>	<b>100%</b>	<b>91%/9%</b>	<b>0.66%</b>

## Sector Exposure



Data shown is as of March 31, 2024.

\*DIS = Diversified Inflation Strategies. Allocations may not add up to 100% due to rounding.

# SBCERS Public Real Return Structure

## Performance of Current Portfolio

	QTD	FYTD	1 Year	3 Years	5 Years	Since Incep.	Inception Date
<b>BNY Mellon TIPS - NL (CF)</b>	<b>-0.09</b>	<b>1.01</b>	<b>-0.43</b>	<b>-1.05</b>	<b>2.18</b>	<b>2.15</b>	<b>05/01/2019</b>
Bloomberg US Trsy US TIPS Index	-0.08	1.90	0.46	-0.53	2.49	2.46	
Difference	-0.01	-0.89	-0.89	-0.52	-0.31	-0.31	
<b>Cohen &amp; Steers Real Assets Fund (CIT)</b>	<b>1.68</b>	<b>6.71</b>	<b>5.89</b>	<b>6.35</b>	<b>6.33</b>	<b>5.55</b>	<b>09/01/2017</b>
Cohen & Steers Real Assets Custom Index	1.02	6.10	4.55	5.10	4.92	4.59	
Difference	0.66	0.61	1.34	1.25	1.41	0.96	
<b>Nuveen Real Asset Income Fund (SA)</b>	<b>0.57</b>	<b>6.07</b>	<b>6.72</b>	<b>1.56</b>	<b>2.90</b>	<b>3.15</b>	<b>09/01/2017</b>
Nuveen Real Asset Income Blend Index	1.07	7.80	9.44	1.69	3.19	3.25	
Difference	-0.50	-1.73	-2.72	-0.13	-0.29	-0.10	

	2023	2022	2021	2020	2019	2018
<b>BNY Mellon TIPS - NL (CF)</b>	<b>2.56</b>	<b>-12.02</b>	<b>5.87</b>	<b>11.08</b>	<b>8.42</b>	<b>-1.30</b>
Bloomberg US Trsy US TIPS Index	3.90	-11.85	5.96	10.99	8.43	-1.26
Difference	-1.34	-0.17	-0.09	0.09	-0.01	-0.04
<b>Cohen &amp; Steers Real Assets Fund (CIT)</b>	<b>3.92</b>	<b>-2.00</b>	<b>23.61</b>	<b>-0.50</b>	<b>17.62</b>	<b>-8.18</b>
Cohen & Steers Real Assets Custom Index	3.23	-3.01	21.23	-2.00	16.53	-7.48
Difference	0.69	1.01	2.38	1.50	1.09	-0.70
<b>Nuveen Real Asset Income Fund (SA)</b>	<b>8.09</b>	<b>-11.98</b>	<b>12.04</b>	<b>-2.89</b>	<b>23.06</b>	<b>-5.93</b>
Nuveen Real Asset Income Blend Index	11.49	-14.24	11.22	0.81	20.01	6.59
Difference	-3.40	2.26	0.82	-3.70	3.05	0.66

Performance shown is net of fees and as of March 31, 2024.



# SBCERS Public Real Return Portfolio

## Redefining its Role?

With the recommendation to increase the split to the Private Real Return portfolio, the Public Real Return portfolio's role shifts to a "liquidity sleeve" for safety, rebalancing, and cash needs.

- **Objectives**
  - Liquidity
  - Match the role / objective / theme of the Real Return Allocation
- **Considerations**
  - ✓ Less assets to invest
    - While the current public mandates have served SBCERS well, the reduced size of the Public Real Return portfolio makes it difficult to retain three separate managers and their associated minimum investment requirements.
  - ✓ Fees
  - ✓ Is Passive a possibility?
  - ✓ Simplify

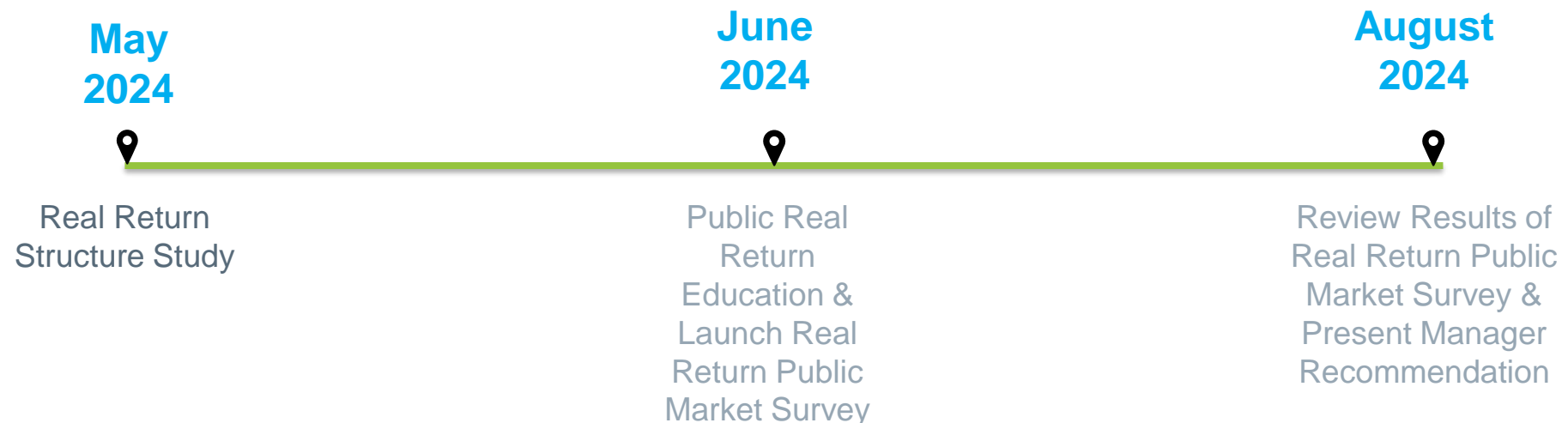
# Summary of Recommendation and Proposed Timeline



# SBCERS Public Real Return Portfolio

## RVK Recommendations

- RVK recommends the Board increase the Target exposure to 75% Private Real Return from 60%.
- If the Board supports the increase to Private Real Return, RVK recommends additional discussion on potential structures for the Public Real Return assets given the role change to a “liquidity sleeve”.



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