- Prepares Budget and Management Plans to be submitted to the Staff and Consultant.
- Meets with Staff and Consultant for the Annual Real Estate Portfolio Review.
- Provides Consultant, when requested, Annual Review information.
- Assists the Staff in preparing funding or disposition procedures.

Commingled Fund and Co-investment Managers:

- Adheres to reporting standards established by the CFA Institute and ILPA and complies with generally accepted accounting principles ("GAAP").
- Executes and performs its duties under the terms of the investment vehicle documents.
- Provides timely requests for capital contributions.
- Provides quarterly financial statements and annual reports.
- Conducts no less frequently than annually meetings with Staff and Consultant to discuss important developments regarding portfolio, investment and management issues.

Duties of Legal Counsel

- Outside legal counsel, selected by the Retirement System as a representative for the Plan, will review upon request, all real estate related documents and/or provide advice for special investment situations as needed.

SDCERS

San Diego City Employees' Retirement System

Private Markets Program Policy

September 2018

Introduction

The purpose of this Policy Document (the "Policy") for the San Diego City Employees' Retirement System ("SDCERS" or the "System") is to establish the parameters by which the System may invest through its Private Markets Program (the "Program"). This Program consists of allocations to private equity ("PE") and infrastructure. Private Markets ("PM") will refer to the asset classes of PE and infrastructure.

This Policy will ensure that the managers, advisors and other external resources retained by the System adhere to the investment principles and guidelines of the SDCERS Board of Administration (the "Board"), while:

1. Preserving the flexibility necessary to accomplish its objectives;
2. Minimizing risk and correlation to the System's overall portfolio;
3. Optimizing diversification as appropriate; and
4. Maximizing risk-adjusted returns for the Program.

Program Objectives

SDCERS created an allocation for investments in PM in order to:

1. Increase the risk-adjusted returns of the overall portfolio of the System;
2. Increase the diversification of total System assets; and
3. Take advantage of the illiquidity premium of this asset class, given the System's long-term nature of Liabilities.

In order to meet the above Investment Objectives, the Board approved the following targets in Asset Allocation and Return:

Asset Allocation Targets

The allocation targets are: **ten percent (10%)** market value exposure of the System's total portfolio to **private equity**, and **three percent (3%)** to **infrastructure**.

Actual market value exposure will take time to achieve and that can vary significantly. As *commitments* (not market value) to PM partnerships are drawn over time, these commitments must exceed the target market value exposure in a mature portfolio. The proper level of commitments in order to achieve the desired market value exposure shall be reviewed on an annual basis.

Return Targets

New PM programs will experience a *J Curve*: the tendency to deliver negative returns in early years before investment gains are realized in the outlying years. Therefore, SDCERS will focus on the long-term performance of the Program, *net of all fees*.

<u>Private Equity</u>

The role of private equity is to provide higher absolute returns over equities while improving the portfolio's diversification. Given the illiquid and unique characteristics of private equity, there are no perfect or universally accepted benchmarks. However, the two most common ways of benchmarking private equity investment performance are as follows:

- **Peer Benchmark:** Represents performance of actual private equity investments (compiled by a suitable provider of benchmark universe data) with similar style, geography, and vintages and has the potential to better reflect a comparison relative to a similar private equity composite portfolio;
- **Public Market Index plus Premium:** Acts as a long-term, theoretical benchmark as private equity seeks to provide a premium over public market equity over the long term and can provide an estimated measure of the opportunity cost of the decision to invest in private equity.

As such, the Private Equity portion of the portfolio shall be measured against the following two benchmarks:

1. **<u>Policy Benchmark (relative performance / peer benchmark):</u>** To assess the performance of the PE portfolio relative to other PE portfolios, the performance of individual investments made in SDCERS' PE portfolio shall be measured against the **upper half** performance (top 50th percentile) as stated in **Burgiss' Private IQ**[1] database.
2. **<u>Secondary Benchmark (opportunity cost / public market index plus premium):</u>** To assess the performance of the PE portfolio relative to other investments the System might pursue, the long-term performance of investments made in the PE portfolio shall be measured against the **weighted composite performance** of the **Dow Jones U.S. Total Stock Market Index**[2] **(67% weight)** and the **MSCI ACWI ex USA Index (33% weight)**[3] measured **since inception** of the private equity portfolio **plus 300** basis points.

The private equity benchmarks included above reflect revisions to conform to the recommendations included in the Asset Allocation Review and approved by the SDCERS' Board into policy in March 2018.

[1] Private iQ is database managed by Burgiss, a global provider of investment decision support tools for private capital, that includes the complete transactional history of 8,250 private capital funds representing more than $5.9 trillion in committed capital across the full spectrum of private capital strategies, including private equity, private debt, and real assets.

[2] The Dow Jones U.S. Total Stock Market Index (Ticker: DWCF), a member of the Dow Jones Total Stock Market Indices family, is designed to measure all U.S. equity issues with readily available prices. The index was launched on January 1, 1987 and had 3,766 constituents as of July 31, 2018.

[3] The MSCI ACWI ex USA Index captures large and mid-cap representation across 22 of 23 Developed Markets (DM) countries (excluding the US) and 24 Emerging Markets (EM) countries. With 2,154 constituents as of July 31, 2018, the index covers approximately 85% of the global equity opportunity set outside the US. DM countries include: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the UK. EM countries include: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Pakistan, Peru, Philippines, Poland, Russia, Qatar, South Africa, Taiwan, Thailand, Turkey and United Arab Emirates. The index was launched on January 1, 2001.

Infrastructure

The role of infrastructure in the portfolio is to provide SDCERS with exposure to investments with lower volatility returns, recession resilient characteristics, lower correlation with other asset classes, inelasticity of demand, yield generating capabilities, and inflation hedging abilities.

Infrastructure shall be measured against one benchmark:

1. Inflation hedge: To assess the performance of the infrastructure portfolio and its role in the total portfolio as an inflation hedge, the long term performance of investments made in infrastructure shall be measured against the performance of the **Consumer Price Index ("CPI") plus 500** basis points (with CPI defined as Core CPI[4] as published by the Bureau of Labor Statistics) **since inception** of the infrastructure portfolio.

This infrastructure benchmark included above reflects revisions to conform to the recommendation approved by the SDCERS' Board into policy in May 2018.

Program Policies

SDCERS' Private Markets Program has 4 general policies:

1. Private Markets Investments: The Program will invest in PM assets and strategies (i.e. PE and infrastructure) globally, and diversify away from assets and strategies that SDCERS already employs (i.e. not invest in: real estate, general stocks and bonds, etc.).
2. Discretionary Authority: The Program will use discretionary advisors. These are fiduciaries approved by the Board who shall acquire and manage, on a discretionary basis, PM investments on behalf of SDCERS in accordance with Program policies.
3. Risk Minimization: The Program will minimize all risks in a prudent manner. These risks include not only the investment risks of PM, but also risks associated with Program operation.
4. Ethical Standards: The Program will adhere at all times to the highest ethical standards and principles.

Additional details for these policies are:

1. Private Markets Investments (Eligible Investments)

The Program will invest in PM assets and strategies *globally*. PM assets are generally defined as direct investments in projects or companies that are privately negotiated and typically do not trade in a capital market. These investments are usually equity interests that are generally illiquid and therefore long-term in nature. Infrastructure is a subset of private equity, defined as permanent "essential" assets society requires to facilitate the orderly operation of its economy, such as roads, water supply, sewers, power and telecommunications.

[4] The "Consumer Price Index for All Urban Consumers: All Items Less Food & Energy" is an aggregate of prices paid by urban consumers for a typical basket of goods, excluding food and energy. This measurement, known as "Core CPI," is widely used by economists because food and energy have very volatile prices.

PM investments can be made directly or more commonly through investments in limited partnerships and other types of investment vehicles that offer limited liability to investors. While the Program can invest directly, its initial focus will be on these limited partnerships and allow the General Partner to select and manage the direct investments.

Examples of PM strategies are:

- Corporate Finance: Buyouts, Acquisitions, Takeovers, Industry-Focused, Specialized Strategies, Non-controlling Interests, Development Capital, Equity Expansion
- Other Private Investments: Secondary Interests, Venture Leasing, Project Financing, Special Situations, Oil and Gas (Energy) Exploration or Production, Clean Technology, Intellectual Property, Co-Investments, Infrastructure
- Mezzanine Financing: Structured Equity, Subordinated Debt, Captive Mezzanine Funds, Third Party Mezzanine Financing
- Venture Capital: Seed Stage, Early Stage, Middle Stage, Late Stage, Balanced Venture Capital Funds, Growth
- Distressed/Restructuring: Turnaround Situations, Restructurings, Distressed Debt

The Program will avoid assets and strategies that SDCERS already employs (i.e. not invest in: real estate, general stocks and bonds, etc.).

2. Discretionary Authority

The Program will use discretionary advisors (the “Advisors”). These are fiduciaries that shall acquire and manage, on a discretionary basis, PM investments on behalf of SDCERS in accordance with these Policies and fiduciary standards of the “prudent expert” rule.

The Board controls the delegation of discretion. However, using such advisors, who specialize in PM and can perform extensive due diligence / selection, is expected to minimize risk. Staff will evaluate and recommend advisors as appropriate. All engagements of advisors will require the approval of the Board.

With each engagement, Advisors will provide:

A. **Their Investment Plan**: This is a document for Board approval that provides guidance as to the management, operations and investments of the Program. Its components are:
    - Pacing Analysis: This is an identification of an optimal average commitment size as well as a total target commitment level to reach the System’s long-term target market value allocation. The Pacing Analysis shall take into account the System’s overall allocation to and investments in PM, within each strategy, and across industries and geography. It will endeavor to maintain even vintage year diversification despite short term market fluctuations and the denominator effect.
    - Investment Approach: Advisors shall review and manage investments using a disciplined but opportunistic management strategy. Given the “blind pool” nature of this asset

class, a primary objective will be **access to the best managers**. Advisors shall seek to identify the best managers and opportunities available and highlight this in their Plan.

- Risk Minimization: Advisors will also explain how they intend to minimize the risks associated with this asset class. After manager selection, a secondary goal is to be diversified appropriately across strategies, industries, partnerships and geography.

B. **Annual Review of their Investment Plan**: The Advisors will perform an annual review of their Plan for Board approval. This will consist of a comprehensive analysis of what happened in the past year, and any revisions to the Plan moving forward.

C. **Portfolio Monitoring and Reporting**: The Advisors will provide quarterly monitoring reports and a greater level of detail on the annual reports. There will typically be a one quarter valuation delay. These reports are meant to alert Staff to possible adverse developments as well as provide timely updates on the performance and analysis of investments. The reports shall include, but not be limited to, the following:

- The general investment environment and perceived opportunities coming to the PM
- Allocations made across different industries and subclasses of PE
- An assessment of future outcomes of the investments held
- Summary of investment portfolio performance, along with an update on overall market performance
- New commitments made since the last report
- Summary of draw-downs and distributions

In addition to the above, Advisors will adhere to the following:

a. Valuations: Investments in the Program shall be valued on a quarterly basis according to the standards of the Financial Accounting Standards Board.

b. Audits: The advisors' investment vehicles shall be audited annually by an independent third party.

3. Risk Minimization

The Program will minimize all risks in a prudent manner. There are 2 categories of risk: Asset Class risk and Program risk.

Asset Class Risk

Asset Class risks are the risks associated with PM investments. In general, those risks are:

- Manager risk
- Underlying company risk
- Market risk
- Portfolio management risk
- Liquidity risk

There are several ways to minimize Asset Class Risk, which may include:

- Diversification: The portfolio shall be diversified appropriately across strategies, industries, partnerships and geography as explained above. Diversification reduces the impact of any one investment or style affecting a disproportionate share of the total portfolio.

- Minimum Requirements: Advisors will have a high threshold of minimum requirements to ensure investments are with managers of institutional quality that exhibit a high degree of fiduciary responsibility. Some examples are:

  - Managers must have annual audits by independent third parties
  - The Program will not invest in funds that charge sales / marketing fees
  - All investment structures must provide limited liability to the System

Program Risk

The Program shall be planned, implemented, and monitored through the combined efforts of the Board, Staff and Advisors. To ensure smooth coordination between all parties, it is important to have clearly defined roles for each group.

To minimize Program Risk, the delegation of the major responsibilities of each participant are outlined below:

The **Board's** duties include:

- Approve the retention of external resources such as PM advisors and / or back office, monitoring firms
- Perform annual comprehensive reviews of the Program to ensure compliance with the Policy and the achievement of the Objectives of the Program
- Approve the Advisors' Investment Plans and annual updates to their Plans (as prepared by the Advisors in their Annual Reviews)
- Delegate investment approval authority to the Advisors by entering into an investment vehicle with each Advisor to be managed at the discretion of the Advisors, subject to the parameters and limitations of this Policy

The **Staff's** duties include:

- Recommend changes in the Policy to the Board
- Propose, issue and evaluate responses to RFPs for the selection of advisors and make selection recommendations to the Board
- Manage the System's relationships with advisors and other external resources, to ensure that the System obtains the maximum value from those relationships
- Coordinate the activities of, and communications among, advisors
- Understand the attributes of each recommended investment

- Collaborate with the advisors on the selection of investments for the Program and the monitoring of such investments
- Process capital calls issued by Advisors
- Oversee risk management functions performed by Advisors and through portfolio monitoring
- Analyze the results of portfolio monitoring reports and make recommendations with respect to Investment Plans and Pacing
- Monitor Advisor compliance with terms and conditions of all agreements

The **Advisors'** duties include:

- Develop and implement the strategy for the Program
- Manage the Investment Vehicle, subject to the limitations set forth in such vehicle which should include reference to this Policy
- Monitor all the elements of cost of the Investment Vehicle in order to avoid excess costs at all times
- Identify, due diligence, negotiate, execute, and manage commitments and investments through the Investment Vehicle, subject to Policy and Plan
- Oversee the creation of appropriate legal documentation for each commitment
- Monitor investments in the Investment Vehicle and report quarterly to the Board and the Staff on investment performance
- Manage all aspects of investments made by the Investment Vehicle through their lifecycle, including the disposition of those investments
- Review relevant issues in PM through periodic workshops, discussions and distribution of research materials

4. Ethical Standards

The Board, Staff, Advisors and all other participants in the Program will adhere at all times to the highest ethical standards and principles. Items of note are:

- <u>Disclosure</u>: The Board, Staff, Advisors and all other participants in the Program shall strive for transparency on all activities while preserving the confidentiality of trade secrets pursuant to California law. Disclosure of any payments made by an investment manager or advisor to obtain a commitment from SDCERS shall be disclosed to SDCERS prior to an investment.
- <u>Conflicts of Interest</u>: The Board, Staff, Advisors and all other participants in the Program shall avoid all conflicts of interest that may arise. In the event that conflicts of interest are identified, the identifying party shall disclose such conflicts to the Chief Compliance Officer of SDCERS.