FOR INFORMATION ONLY

March 25, 2020

TO: Trustees – Board of Investments

FROM: Jonathan Grabel
Chief Investment Officer

SUBJECT: **Functional Asset Category Update – Growth Investments**

The Investments Division will be providing periodic updates on the functional asset categories. Below is the update on the Growth asset category, which includes Global Equity, Private Equity, and Opportunistic Real Estate. This note also includes an update on LACERA's securities lending program.

Global Equity

LACERA has been closely monitoring developments with respect to COVID-19 to ensure that our equity managers are able to provide investment management services and to ensure that there have been no disruptions to business operations including portfolio management, research, trading, and client services.

The Global Equity team reached out to all of our managers to assess the impact of COVID-19 on their staff, investment operations, and portfolios. The managers assured the team that their business continuity, systems, and processes were in place for them to provide uninterrupted service to LACERA. Some of the steps taken by our managers included:

1. Implemented remote and work-from-home operations
2. Restricted nonessential business travel
3. Enacted visitor restrictions policy and self-quarantine guidance to employees
4. Instituted education, training, and preventative measures as recommended by the CDC and other healthcare agencies

The team is having ongoing conversations with our managers to discuss the initial impact to LACERA's portfolios to determine if there were any extraordinary unintended risks as market volatility spiked. As of March 25, 2020, LACERA's Global Equity portfolio has tracked very tightly with the MSCI ACWI IMI index.

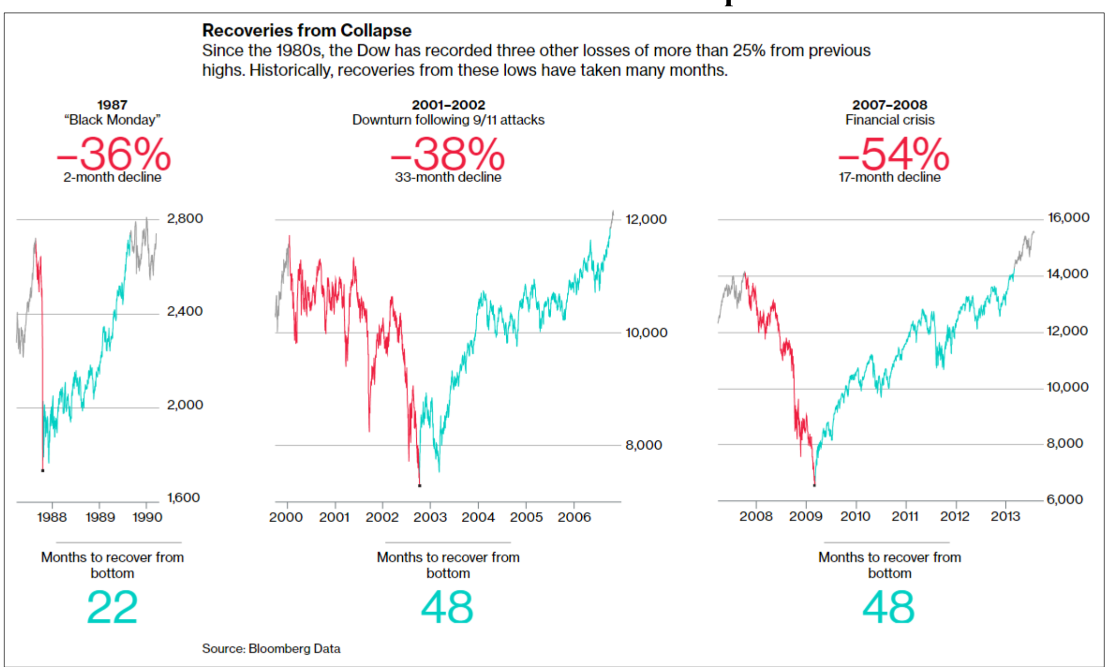
Portfolio Positioning

The Global Equity portfolio is composed of passive, active, and potentially, factor strategy allocations. The passive exposure is performing in-line with the benchmark and is designed to mimic the broad markets. Our active managers are currently positioned defensively during this COVID-19 crisis because they specifically target companies with strong balance sheets that trade at relatively cheaper multiples than comparable companies in their respective markets. During times of market duress, companies with these characteristics tend to be more resilient and can opportunistically gain market share.

Going forward, staff anticipates that a potential factor strategy will enhance the risk profile of the Global Equity portfolio in a few ways. Factor strategies target securities with the same characteristics that many active managers invest in, but at significantly reduced fees. The liquidity profile of the Global Equity portfolio should be improved given that the typical Factor Strategy manager has a very large capitalization bias and these stocks tend to be very liquid. The credit profile of the Global Equity portfolio should also be enhanced given that these large capitalization companies tend to have more robust balance sheets than the smaller capitalization companies that populate our active managers' portfolio.

The sharp and steep decline of global equity markets has investors speculating on the duration of the market sell-off and its eventual recovery. According to research conducted by Bloomberg, since the 1980s there have been three other periods in which the Dow Jones Industrial Average[1] ("Dow") has lost more than 25% from prior peak, as illustrated in **Chart 1**. On average, U.S. stock markets have taken 39 months to recover from bottom to peak. However, in each of the prior two declines, the market took 48 months to recoup losses.

Chart 1
Dow: Recoveries from Collapse



Source: Bloomberg.com.

Regionally, the broad U.S. markets as measured by MSCI USA IMI Index were down 17.4% for the month ending March 25, 2020 and down 24.3% for the year. Non-U.S. markets, as represented by the MSCI ACWI ex-US IMI Index, matched their U.S. counterparts for the month falling

[1] Dow Jones Industrial Average is a stock market index that measures the stock performance of 30 large companies listed on stock exchanges in the United States.

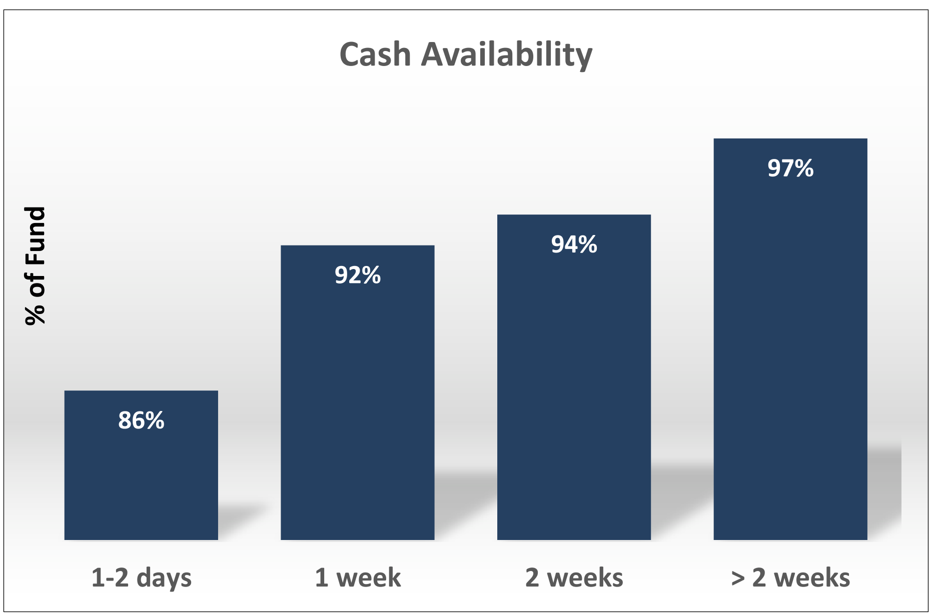
17.4%, and declined 26.2% year-to-date. Emerging markets fell 17.6% during the month and 25.7% year-to-date.

At the sector level, defensive sectors—such as consumer staples, healthcare, and utilities outperformed on a relative basis for the month ending March 25, 2020. The cyclical sectors led by energy stocks were the laggards. Energy stocks lost 31.2% within the month. Real estate, financials, and the industrials sectors also posted sizable losses declining 23.7%, 23.7% and 20.6% respectively for the month.

Global Equity Liquidity Analysis

Staff reached out to each of LACERA's Global Equity managers to assess their liquidity. Summary findings of the liquidity analysis in **Chart 2** indicate that given the current market conditions, 86% of LACERA's Global Equity portfolio (estimated at approximately $16.8 billion) can be converted into cash at approximately market value within one to two days, 92% within a week, 94% within two weeks, and 97% within a period greater than two weeks. The remaining 3% of the portfolio has no short-term liquidity as it is invested in activist funds with average lock-up periods of three to five years.

Chart 2
LACERA Global Equity Portfolio
Liquidity Analysis



Source: LACERA-created with data from State Street.

Staff continues to closely monitor the Global Equity portfolio during this dynamic market environment and will keep the Board apprised of any key developments. To reiterate views expressed in last week's Interim CIO Report, we remain focused on the long-term and will continue to adhere to the strategic allocation approved in the latest structure review.

Private Equity

The Private Equity team reached out to all key LACERA active general partners ("GPs") around the globe to assess the impact of COVID-19 on their firms, portfolio companies, and markets. LACERA inquired about people, operations, financial condition, and projected fund cash flows. From our discussions, several dominant themes became apparent across LACERA's Private Equity portfolio in the U.S., Europe, and Asia.

Across the portfolio, managers undertook a similar sequence of steps as COVID-19 surged in their respective geographies:

1. The GPs first took steps to address the health and safety of the people within their firms and portfolio companies by restricting travel, reducing physical workforce, and enabling remote work solutions for employees.
2. Liquidity is the next immediate focus for both GPs and portfolio company management teams. Many GPs drew down on existing lines of credit and are working with portfolio company management to gain an understanding of near-term debt maturities, ensuring that they have a minimum of three to six months of cash on hand, and are securing bridge loans if necessary.
3. The GPs are working with portfolio company management to better understand how to lessen the operational and financial impact of the downturn, by cutting or deferring variable costs, revising budgets to project slower growth rates, activating business continuity plans, and making adjustments to supply chains, distribution channels, and workforce and product lines to the extent possible.
4. The GPs remain cognizant of the opportunities that might exist during this downturn and continue to monitor the market to identify mispriced or troubled assets.

A handful of LACERA's GPs that were employing lines of credit in place of calling capital from limited partners have subsequently issued large capital calls, freeing up their lines of credit in the event they needed to provide bridge financing to any portfolio companies. Venture capital-backed companies, many of which were not profitable prior to the pandemic and rely primarily on existing balance sheet cash to develop their products, immediately began implementing steps to decelerate cash burn.

While the vast majority of LACERA's portfolio is preliminarily deemed relatively healthy by the GPs, profiles of companies that were more at risk during the pandemic were similar across the globe. Companies in the hospitality, leisure, transportation, energy, retail, travel, and consumer discretionary industries were significantly impacted by the virus-induced downturn. Companies with global supply chains were also negatively impacted by travel restrictions and lockdown measures. Publicly traded companies have suffered as well given the volatility of the public markets across the globe. Companies that were already vulnerable prior to the pandemic now faces more imminent threats that they may not be able to remain a going concern.

Conversely, COVID-19 illuminated favorable characteristics of many companies in the portfolio, some are positioned to thrive in the short term, while others were propelled forward on their expected trajectory. Companies providing telecom infrastructure and services enabling remote work solutions have thrived during this pandemic. Companies providing consumer essentials have also weathered the downturn well. In general, market leaders in their respective industries have fared better than their lesser-known competitors. Many technology-driven companies in the portfolio were not heavily impacted by the pandemic, and staff anticipates that businesses operating with SaaS subscription-based models, providing online or automated services, or having a strong online and social network presence will become even more attractive to private equity sponsors once the economy stabilizes.

Moving forward, GPs anticipate completing deals that have already undergone diligence, and renegotiating valuations and capital structures when not contractually locked in. Staff anticipates that GPs' ability to source, diligence, and execute on attractive deal flow will likely be hampered by ongoing travel restrictions and debt availability constraints. Limited partners with liquidity concerns or portfolio imbalances may also pressure GPs to slow their deployment and fundraising pace.

Lastly, government fiscal and monetary policy measures can have a significant economic impact, with many countries adopting comprehensive policy measures ranging from generous tax incentives to improve liquidity, paying large portions of companies' payroll to prevent massive layoffs, and central banks functioning as a lender of last resort with loans to companies at low to zero interest rates.

While LACERA's illiquid Private Equity portfolio is not expected to be as volatile as the public markets, a significant valuation adjustment will likely occur in the second quarter of 2020. In these turbulent times, LACERA remains focused on prudent and judicious deployment of capital in the private equity market. Staff is evaluating every general partner fund commitment, analyzing every co-investment opportunity, and inquiring of secondary opportunities coming to the marketplace with the primary objective of continuing to fulfill private equity's objective in the growth portfolio.

Opportunistic Real Estate

Opportunistic Real Estate investments in the growth portfolio consist primarily of development projects. Investments are made utilizing both separate accounts (including funds-of one) as well as commingled funds. Most of LACERA’s Opportunistic Real Estate investments via commingled funds are international. While it is too early to assess how liquidity within these investments will be impacted by COVID-19, there are signs that construction and leasing may be negatively impacted in the near term. Although construction continues at most projects within the U.S. unabated by the current economic environment, several municipalities, such as Boston, have temporarily suspended construction.

Leasing has slowed considerably, given the difficulty of conducting in-person leasing appointments and home containment measures. Virtual leasing is taking place, but at a slower than desired pace. Projects may take longer than planned to stabilize given the market uncertainty, which will put pressure on developers to use budgeted reserves to cover operating expenses, including debt service. Once reserves have been exhausted, projects may require additional financing, which can be difficult to obtain during the downturn. Given these unprecedented times, some developers have intentionally postponed construction in order to preserve liquidity Fortunately, construction lenders so far remain willing to meet funding obligations. The LACERA separate account portfolio consists primarily of apartment and industrial projects, and staff anticipates that these remain the two property types to be least impacted during this downturn.

Securities Lending

LACERA has two securities lending providers, State Street Bank, which is also LACERA's custodian, and Goldman Sachs Agency Lending ("GSAL"). State Street lends LACERA's non-U.S. equities, U.S. Treasuries, and U.S. Agency securities, whereas GSAL lends LACERA's domestic equities and corporate bonds. State Street is also responsible for reinvesting the cash collateral received from both lending programs in a separate account customized to LACERA's guidelines. The two firms are among the largest, highest-ranked providers in the securities lending industry, and are affiliates of large financial institutions deemed Systemically Important Financial Institutions ("SIFIs"). As such, they are subject to the highest levels of regulatory scrutiny and capital requirements.

Both lending desks are staffed by experienced professionals who have been through market upheavals before. Staff has been in frequent communication with both firms throughout the current crisis, and the consistent message staff has received is that the current market volatility is not having a significant impact on their businesses, and the mechanisms in place to manage risk are performing as intended. Both firms are monitoring counterparty credit closely, and to date, there have been no challenges. In addition, there have been no credit impairments or liquidity challenges in the cash collateral pool that State Street manages.

When LACERA's securities are lent out, we receive collateral, either in the form of cash, or other securities. As of March 24, 2020, LACERA had approximately \$16.8 billion in assets available for lending. About \$1.43 billion of this amount was on loan, resulting in an 8.5% utilization rate. The value of collateral received in exchange for the \$1.43 billion in securities was \$1.5 billion, equal to a 105% collateralization ratio. State Street reports that on average, the securities they lend on LACERA's behalf have more equity market exposure than the collateral they receive in return, so that as equity prices have declined, excess collateral has increased. The value of securities on loan has remained fairly consistent for the past few weeks. The interest LACERA earns on securities lending has increased as the costs associated with lending have decreased in line with the Fed's rate cuts, while our reinvestment portfolio yield has declined more slowly. Portfolio yield declines gradually, as securities mature and the proceeds are reinvested.

Next week there will be an update on the Risk Reduction and Mitigation functional asset category.