LACERA

September 1, 2023

TO: Trustees – Board of Investments

FROM: Credit and Risk Mitigation Committee

Vache Mahseredjian, CFA, CAIA, FRM, ASA VM
Principal Investment Officer

FOR: September 13, 2023 Board of Investments Meeting

SUBJECT: **CREDIT STRUCTURE REVIEW**

RECOMMENDATION

Approve the initiatives and recommendations within the Credit Structure Review (**Attachment**) as well as amendments proposed and advanced by the Credit and Risk Mitigation Committee. The amendments pertain to delegating manager selection authority for this asset category to the CIO, subject to reporting requirements.

BACKGROUND

A structure review for the Credit functional asset category was presented at the August 9, 2023 meeting of the Credit and Risk Mitigation Committee ("Committee"). That review included several recommendations that are summarized on page 32 of the **Attachment**. In addition to those recommendations, the Committee proposed a recommendation to delegate manager selection authority for this asset category to the CIO, subject to certain conditions. Please refer to **item #2** in the **Deliberations and Opinions Expressed by the Committee** section below. The combined recommendations were advanced from the Committee to the Board of Investments ("BOI") on a vote of 2 to 1.

The recommendations in staff's presentation to the Committee consist of the following: affirming Credit's role and objectives as listed on page 4 of the **Attachment**, and the moderate implementation approach and attributes shown on page 5 and 6. In addition, staff proposed modest modifications to guidelines for Liquid Credit (page 18) and Illiquid Credit (page 27) as described below:

- **Liquid Credit**: Removed geography and currency targets and retained existing maximum levels.
- **Illiquid Credit**: Introduced new guidelines addressing co-investments and contingent capital as described on page 26 of the **Attachment**.

DELIBERATIONS AND OPINIONS EXPRESSED BY THE COMMITTEE

Here is a summary of the discussion that followed staff's presentation:

1. A Trustee raised a question about whether the disappointing performance of emerging market debt ("EMD") in 2022 was widespread or concentrated in a specific region. A consultant responded that EMD performance was a global phenomenon driven by economic and capital markets factors and not limited to a specific region or to LACERA's portfolio implementation. Another Trustee commented that although there may be a retrenchment in globalization, nearshoring is a growing trend; therefore, the relative value of corporate versus sovereign bonds within EMD is worth monitoring.

2. A Trustee suggested granting the CIO discretionary authority for this asset category for reasons including expediting manager selection. Such authority would require that staff perform its customary diligence and underwriting process, including approval by the appropriate internal committee and an independent review culminating in support from the asset category consultant. Furthermore, reports to the BOI summarizing the underwriting process and analysis carried out by staff and the consultant must remain unchanged. Another Trustee expressed support for this idea, noting that it would advance LACERA's goal to transition from allocator to best-in-class investor. A Committee member made an amended motion to include this suggestion, and the motion passed by a vote of 2 to 1, thereby advancing the amended recommendation to the BOI.

3. A Committee member requested that lengthy explanations or complex information be placed in the main body of future presentations rather in footnotes.

OPTIONS AVAILABLE TO THE BOARD

The Board may wish to approve, modify, or reject the recommendation.

RISKS OF ACTION AND INACTION

If the Board approves the recommendation, staff will implement the changed guidelines. Furthermore, the CIO would have manager selection authority subject to the constraints that manager due diligence standards and Board reporting requirements remain unchanged. This would expedite the manager selection and investment process. It should be noted that since the BOI is currently reviewing board governance more generally, any action taken in connection with this structure review might be superseded by the Board's broader governance decisions. Should the Board reject the recommendation, the current structure and guidelines would remain in place. In addition, the CIO would not be delegated authority to approve the selection of Credit managers, thereby leaving the existing method of manager selection unchanged.

CONCLUSION

The Committee advanced the recommendations listed in the structure review and added an amendment for delegated manager selection authority. The combined recommendation is therefore presented to the Board for approval.

Attachment

Noted and Reviewed:

____
Jonathan Grabel
Chief Investment Officer

LACERA

ATTACHMENT

July 28, 2023

TO: Trustees - Credit and Risk Mitigation Committee

FROM: Vache Mahseredjian, CFA, CAIA, FRM, ASA
Principal Investment Officer VM

Chad Timko, CFA, CAIA CT
Senior Investment Officer

Krista Powell KP
Investment Officer

Quoc Nguyen, CFA QN
Investment Officer

Jason Choi, CFA JC
Senior Investment Analyst

FOR: August 9, 2023 Credit and Risk Mitigation Committee Meeting

SUBJECT: **CREDIT STRUCTURE REVIEW**

RECOMMENDATION

Advance the recommendations within the Credit Structure Review (**Attachment A**) to the Board of Investments for approval.

SUMMARY

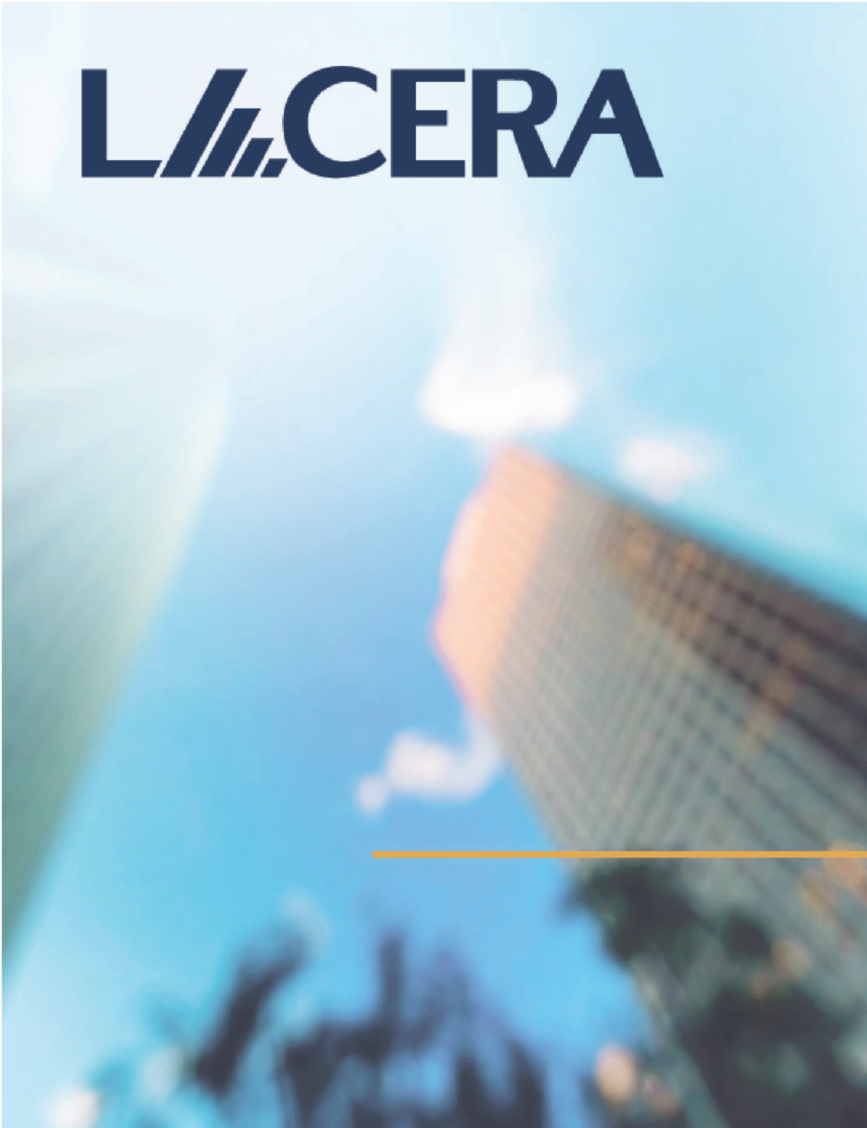
This Structure Review considers the role, implementation framework, performance, and initiatives of the Credit functional asset category. Additionally, it reviews structure, performance, and portfolio guidelines for portfolio components: liquid credit and illiquid credit. The presentation consists of an introductory overview followed by sections dedicated to each of the two portfolio components. A concluding section provides a summary of recommendations (see page 35).

LACERA's consultants Meketa Investment Group and Albourne Partners reviewed the segments of the Structure Review that apply to their respective mandates and are in support. Albourne reviewed the illiquid credit section and Meketa reviewed the rest. Memos from the consultants are included as **Attachments B** and **C**.

Attachments

Noted and Reviewed:

Jonathan Grabel
Chief Investment Officer



ATTACHMENT A

Credit

Structure Review

Credit and Risk Mitigation Committee Meeting

August 9, 2023

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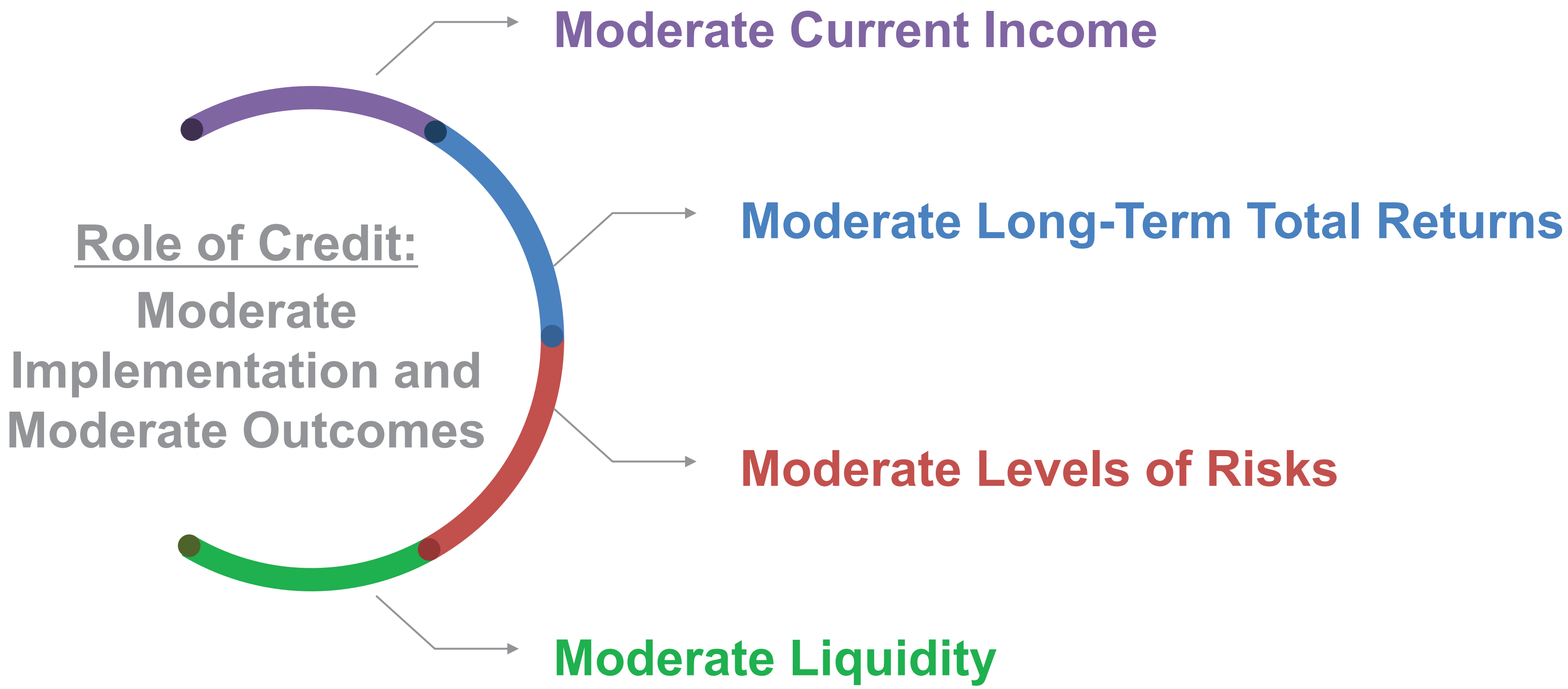
Credit: Role



The role summary articulated above is consistent with LACERA's Investment Policy Statement, which states "LACERA expects assets categorized as Credit to produce current income and moderate long-term total returns"

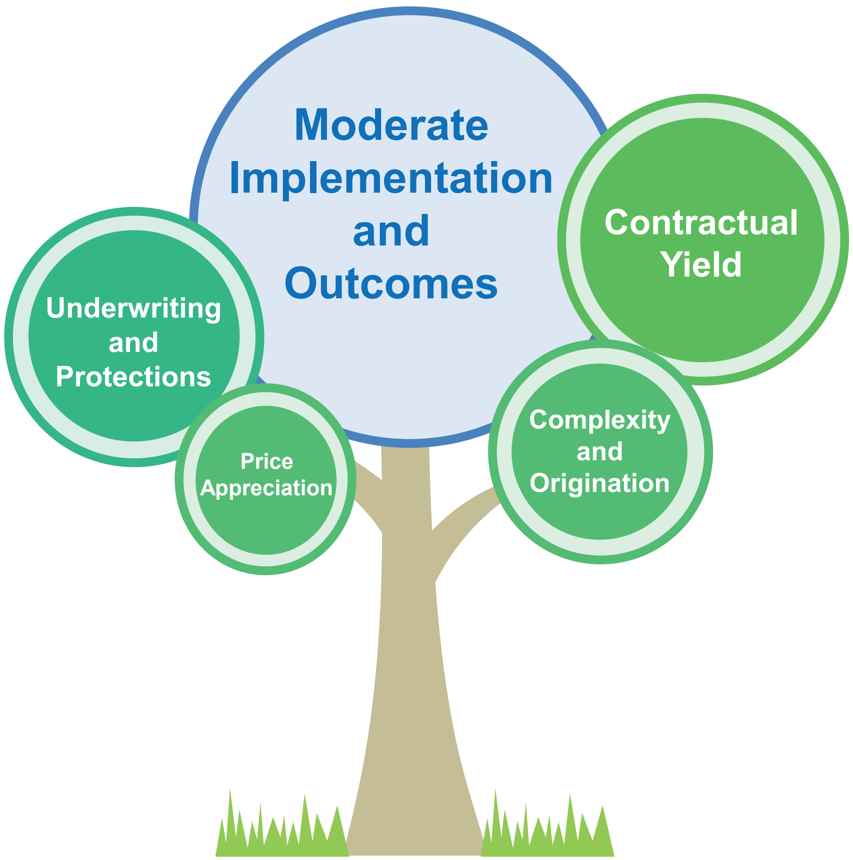
Credit: Role and Objectives

Role

- Moderate Implementation
- Moderate Outcomes

Objectives

- Collect contractual yield
- Emphasize fundamental underwriting and creditor protections
- Profit from complexity and upside optionality
- Be compensated for selective private sourcing or direct origination
- Have limited price appreciation expectations



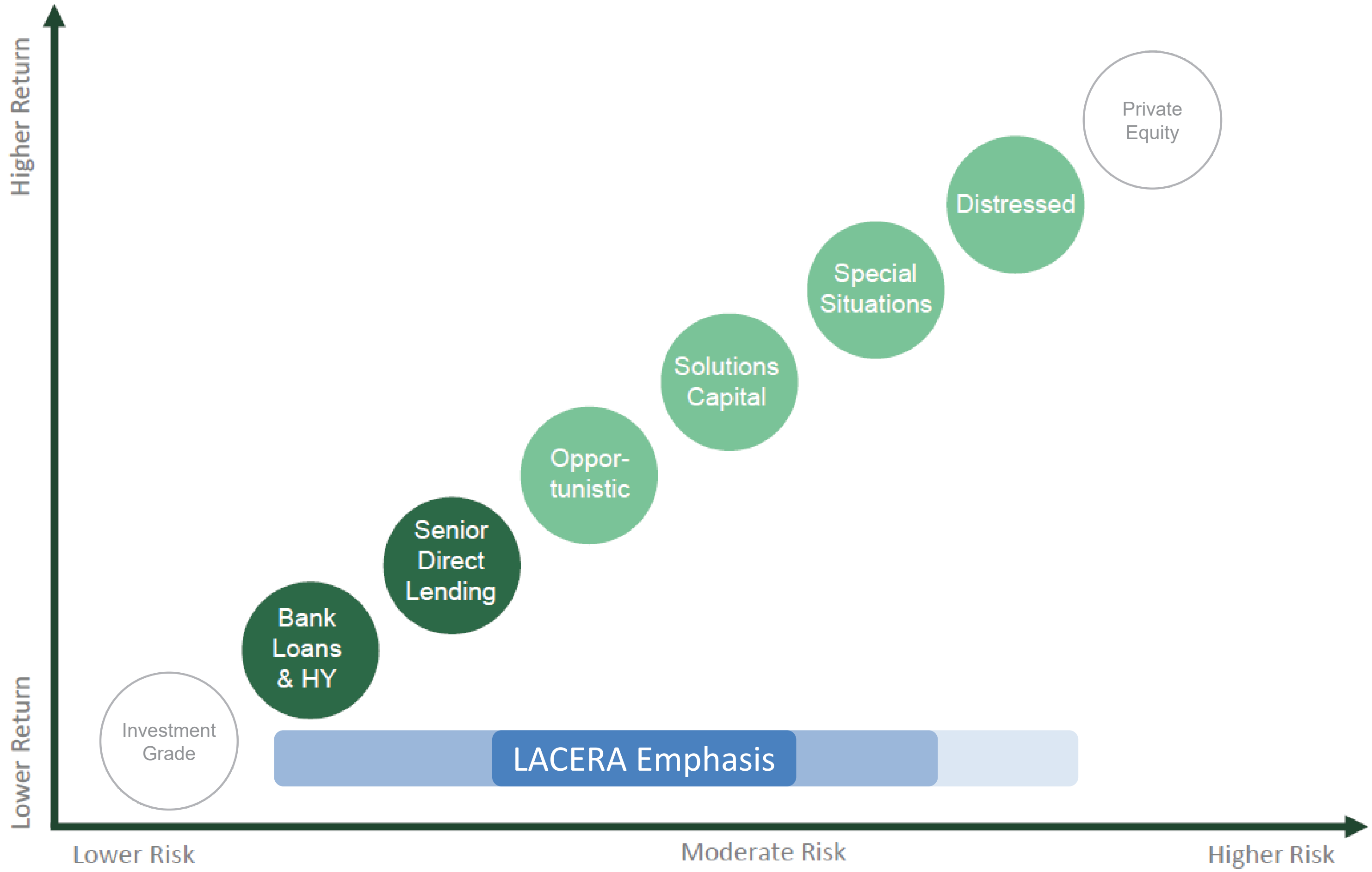
LACERA's Credit Role and Objectives

Credit: Moderate and Broad Implementation

LACERA's credit portfolio implementation would:

- Exhibit moderate risk and return
- Emphasize yield-generating strategies
- Have considerable breadth across types of credit assets and strategies
- Opportunistically invest across risk spectrums
  - Security seniority
  - Geography
  - Borrower profile

HY is an abbreviation for high yield bonds. Return and risk levels are imprecise and shown for illustration purposes. Categories of credit shown are examples and may not be comprehensive or adhere to other listings of credit categories



Credit: Desired Implementation Attributes

Evergreen Mandates
We will not be forced sellers based on fund terms

Hard Hurdle Fee Structures
Only paying performance fees for above-expectation returns

Single-Investor Portfolios
Other investor actions do not impact LACERA; includes dedicated managed accounts

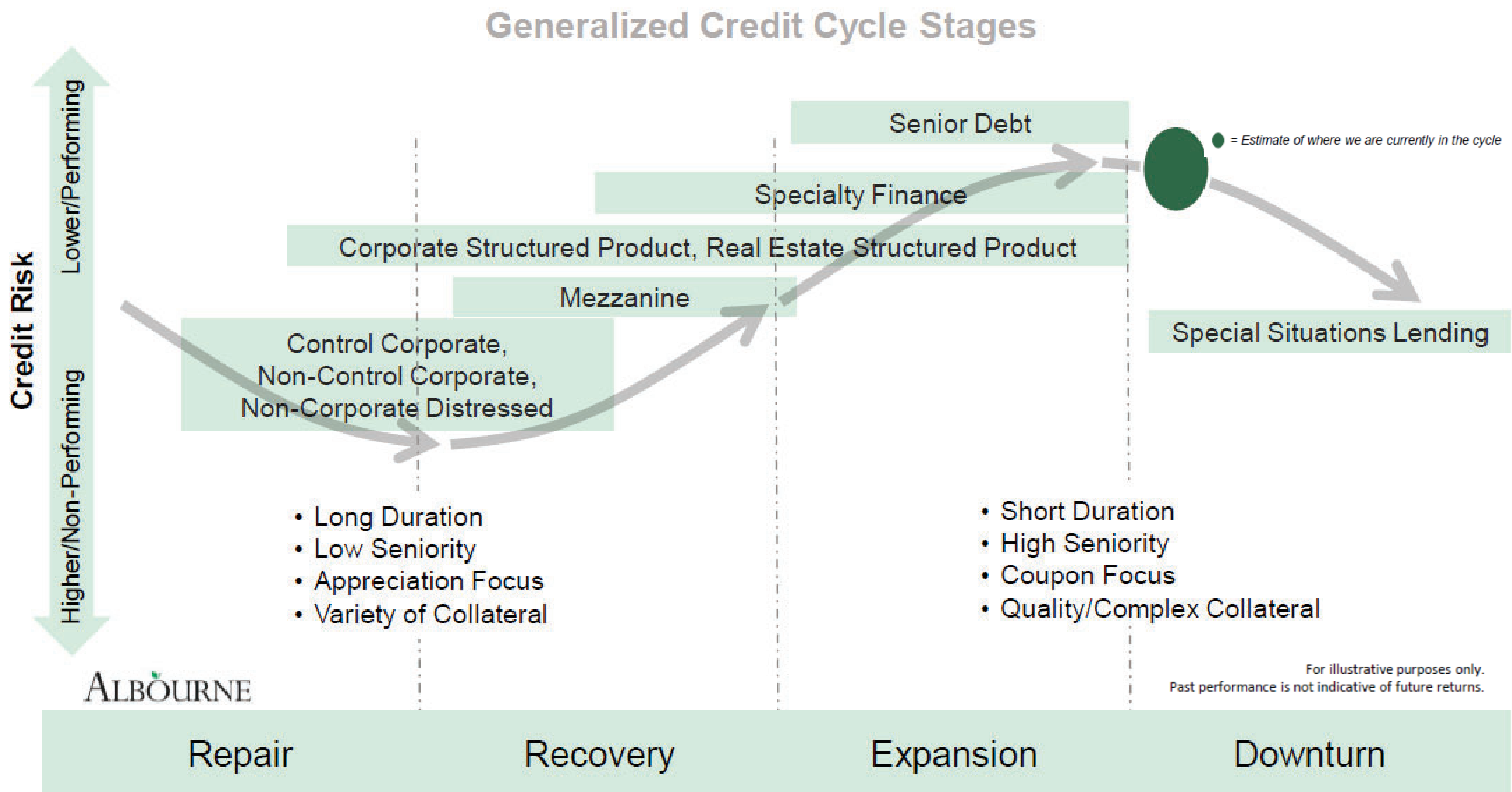
Complementary Exposures
Beyond corporate credit, which is a dominant exposure in LACERA's Growth portfolio

Scale Value
Benefit from LACERA's larger size: fees, transparency, and other terms

Multi-Dimensional and Dynamic
Credit markets are dynamic and inefficient and proper active management can add value

Credit: Multi Dimensional and Dynamic

- Credit markets are dynamic
- Relative best value for new investments changes over time
- Different expertise may shine at different times
- Credit investors can benefit from flexible and adaptive implementations
- Being an enduring investor in credit does not have to be via static buy and hold



Credit: Summary Timeline

- Below is a summary timeline of the credit functional category at LACERA

2018

- **2018 Strategic Asset Allocation**
- Functional framework adopted
- New category for Credit and four subcategories
  - High yield
  - Bank loans
  - Emerging market debt
  - Illiquid credit
- Moved legacy mandates to credit from prior asset categories
  - Fixed income
  - Private equity
  - Real estate
  - Hedge funds

2019

- **2019 Credit Structure Review**
- Approval of LACERA's first new investment for the illiquid credit category

2020

- **2020 Credit Structure Review**
- Refinements of the emerging market debt portfolio to better align it with the benchmark

2021

- **2021 Strategic Asset Allocation**
- Combined high yield, bank loans, and emerging market debt into a new category named liquid credit
- Kept a category for illiquid credit
- **2021 Credit Structure Review**

2022

- Established an emerging manager program in illiquid credit
- Implementation of LACERA's first dedicated managed account investment
- Approval of LACERA's first credit mandate with a co-investment sleeve

2023

- **2023 Credit Structure Review**

⟵ Ongoing implementation of initiatives consistent with the strategic asset allocation, strategic initiatives and credit structure reviews ⟶

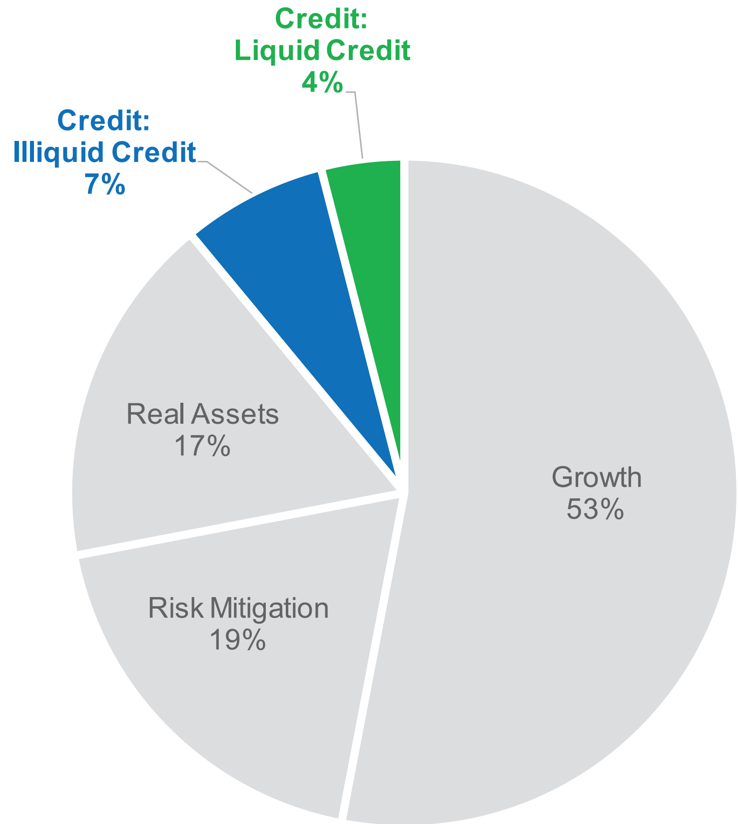
Credit: Allocation Targets

- LACERA's Credit portfolio has an 11% total Fund target allocation with two sub-categories

- Target allocations for the sub-categories are shown in the pie chart, totaling 11%

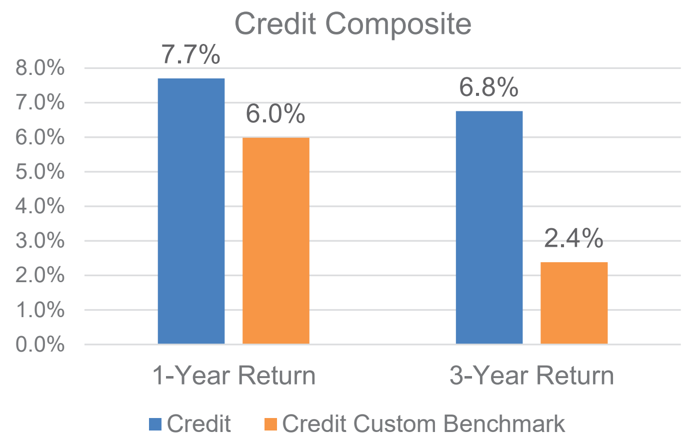
  - Illiquid Credit has a 7% target allocation with a 4-10% range

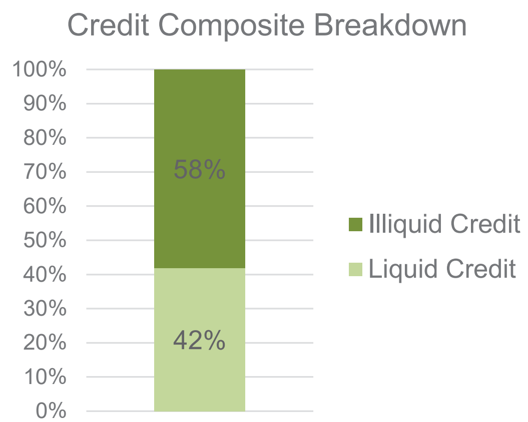
  - Liquid Credit has a 4% target allocation with a 1-7% range



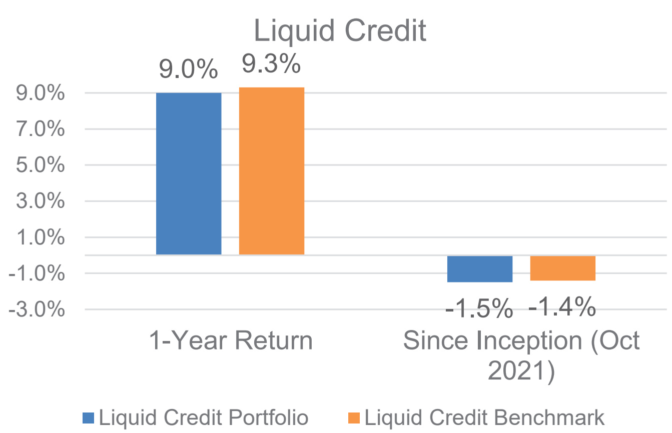
The allocation ranges and targets shown above were established at a strategic asset allocation study that concluded in 2021. LACERA's next strategic asset allocation study is scheduled to conclude in 2024

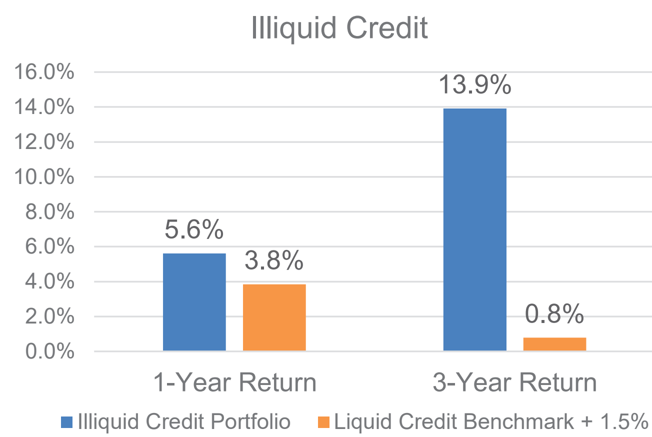
Credit: Performance





- 1 and 3-year overall credit composite returns have outperformed the benchmark
- Composite outperformance was driven by illiquid credit results
- The illiquid credit portfolio has grown in recent years and is now larger than the liquid credit sub-category





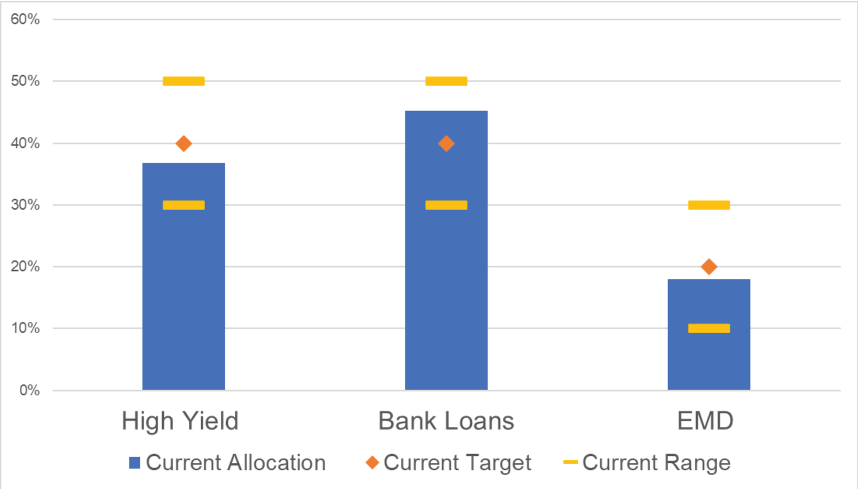
- The liquid credit portfolio has slightly underperformed its benchmark over the 1-year and since inception periods
- The illiquid credit portfolio outperformed its 1 and 3-year benchmark returns by 180 bps and 1310 bps annualized, respectively

Data is from State Street as of June 30, 2023 and is net of fees. Illiquid Credit returns and its benchmark returns are reported on a 1-month lag. Returns beyond 1-year are annualized

Liquid Credit

Liquid Credit: Portfolio Structure

	High Yield (HY)	Bank Loans (BL)	Emerging Market Debt (EMD)
Benchmark	Bloomberg Barclays US Corporate HY Index	CS Leveraged Loan Index	50% J.P. Morgan EMBI GD 25% J.P. Morgan CEMBI BD 25% J.P. Morgan GBI-EM GD
Exposures	Corporate bonds rated below investment grade	Floating rate instruments	Sovereign and corporate bonds issued by developing countries
Implementation	3 Active Mandates	3 Active Mandates	2 Active Mandates



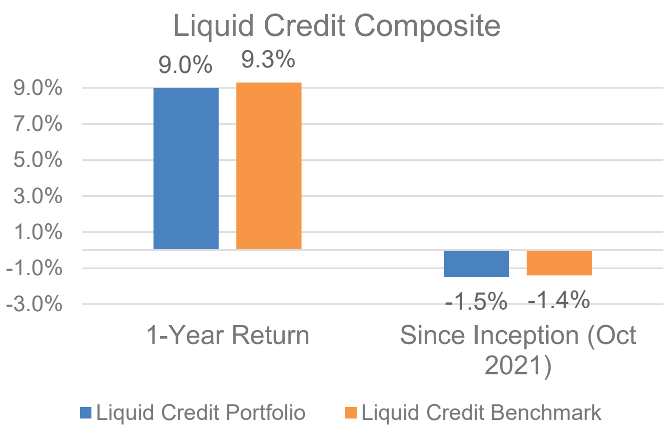
The Board-approved Liquid Credit benchmark is 40% / 40% / 20% (HY / BL / EMD)

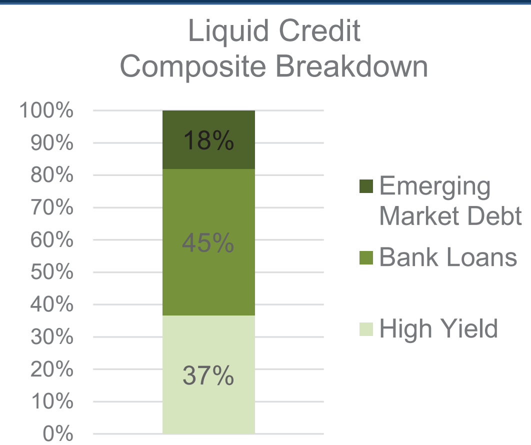
- 20% EMD is split into:
  - 50% J.P. Morgan EMBI GD – U.S. Dollar Sovereign Debt
  - 25% J.P. Morgan CEMBI BD – U.S. Dollar Corporate Debt
  - 25% J.P. Morgan GBI-EM GD – Local Currency Debt

- The current portfolio complies with the liquid credit program guidelines

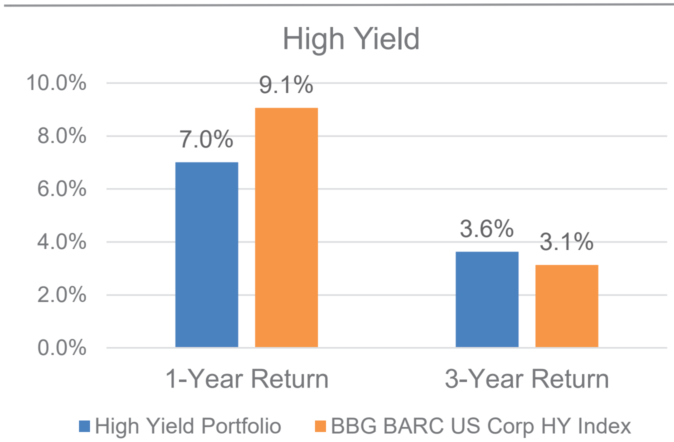
Index descriptions are in the Glossary

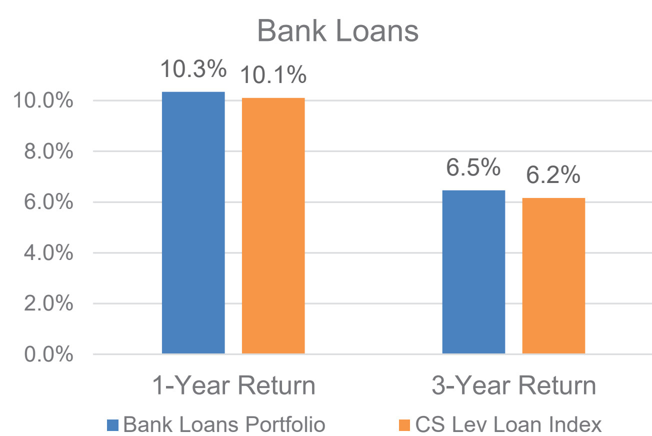
Liquid Credit: Performance

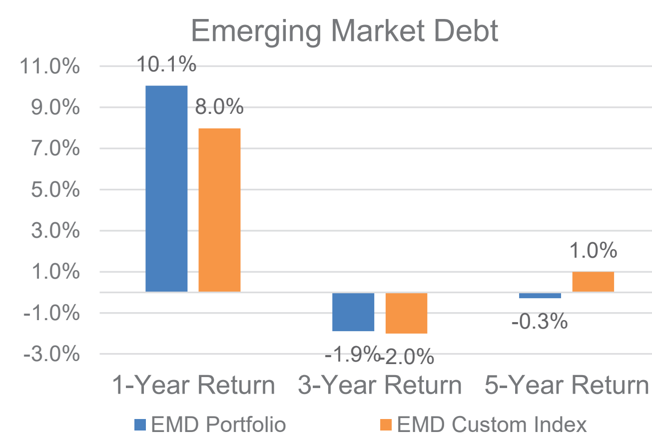




- The high yield portfolio has underperformed its benchmark over the trailing 1-year period and outperformed over the trailing 3-year period
- The bank loan portfolio has outperformed its benchmark over the trailing 1 and 3-year periods and returns have been positive
- EMD has positive performance in the recent trailing 1-year period but has delivered negative returns over longer term periods, underperforming the benchmark on an annualized basis over the trailing 5-year period

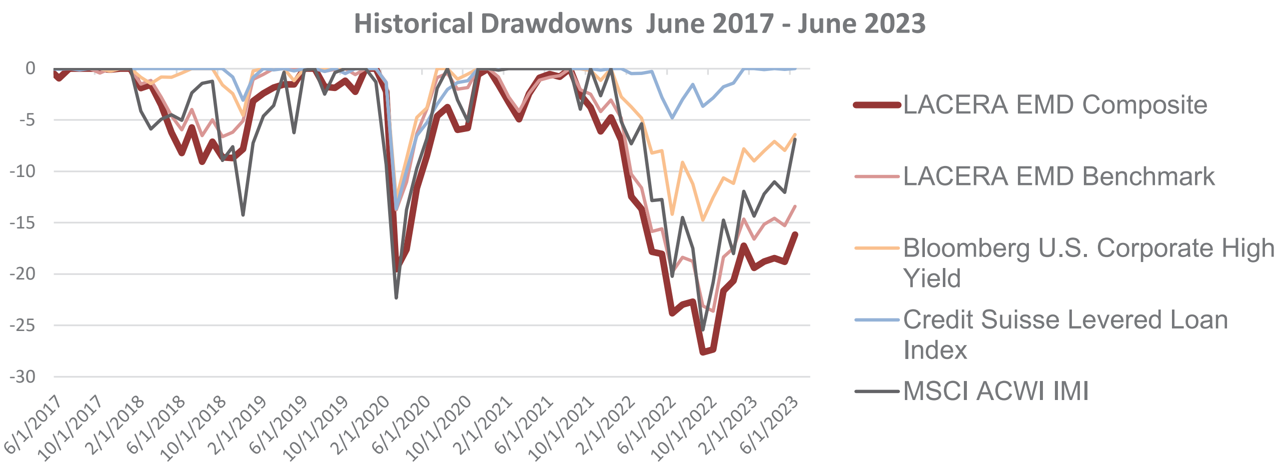






Data is from State Street as of June 30, 2023 and is net of fees. Returns beyond 1-year are annualized. EMD is an abbreviation for Emerging Market Debt
Due to prior Board approved Credit structural changes, the only composite that has a 5-year return history within Credit is EMD

Liquid Credit – EMD: Performance & Risk



RETURN METRICS SINCE EMD PORTFOLIO INCEPTION (JUNE 2017 – JUNE 2023)	ANNUALIZED RETURN	STANDARD DEVIATION	SHARPE RATIO	MAXIMUM DRAWDOWN LOSS VALUE	MAXIMUM DRAWDOWN LENGTH	CORRELATION TO MSCI ACWI IMI INDEX	NUMBER OF DOWN MONTHS (72 TOTAL)	INTEREST RATE DURATION (AS OF 6/30/23)
LACERA EMD Composite	**(0.7)**	**12.0**	**(0.19)**	**(27.6)**	**13**	**0.75**	**33**	**5.8**
LACERA EMD Benchmark	0.6	9.4	(0.10)	(23.6)	14	0.75	28	5.7
Bloomberg U.S. Corporate High Yield	3.2	8.5	0.20	(14.7)	9	0.86	25	3.5
Credit Suisse Leveraged Loan Index	4.1	6.6	0.39	(13.7)	2	0.68	20	0.1
MSCI ACWI IMI Index	8.2	16.8	0.40	(25.7)	9	1.00	24	N/A

- **Key Takeaways**
  - LACERA has not been compensated for the incremental risks incurred from and associated with EMD investments
  - The risk and return profiles of the EMD portfolio and EMD benchmark are not consistent with the moderate risk and return objectives of Credit
  - A majority of EMD's 2022 negative returns were due to the rise in US interest rates for hard currency EMD and foreign currency risk for local currency EMD
  - The EMD portfolio experienced deeper since inception drawdowns than equities (MSCI ACWI IMI Index)
  - The EMD portfolio has delivered negative annualized returns since inception and has underperformed its benchmark
  - The EMD portfolio and EMD benchmark produced negative since inception risk adjusted returns as measured by the Sharpe ratio

LACERA EMD Composite and Benchmark returns data is from State Street and is net of fees. All other index returns data is from Zephyr and/or the index itself
Return metrics calculations are from Zephyr. Interest rate duration data comes from LACERA's managers. EMD is an abbreviation for Emerging Market Debt

Liquid Credit - EMD: 10-Year Expected Returns

MEKETA

2023 Capital Markets Expectations

10-year Geometric Expected Returns
Credit

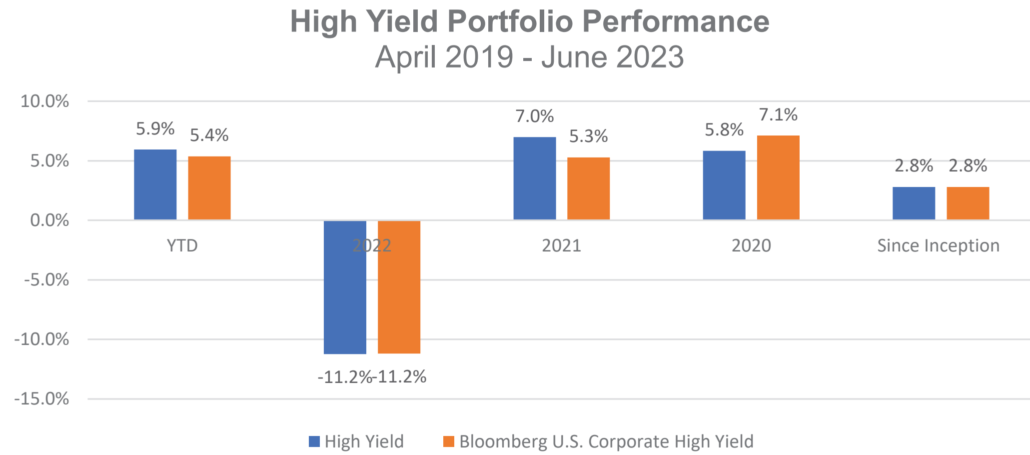
	2023 E(R) (%)	2022 E(R) (%)	Δ From 2022 (%)	Notes
High Yield Bonds	8.0	3.3	4.7	Higher yields
Higher Quality High Yield	7.1	3.0	4.1	Higher yields
Bank Loans	7.6	2.7	4.9	Higher yields
Collateralized Loan Obligations (CLOs)	8.0	3.2	4.8	Higher yields
Convertible Bonds	6.1	2.2	3.9	Higher yields
Emerging Market Bonds (major)	6.7	3.6	3.1	Higher yields
Emerging Market Bonds (local)	6.4	5.0	1.4	Higher yields
Private Debt	9.4	6.7	2.7	Higher yields
Direct Lending	8.5	6.5	2.0	Higher yields
Asset Based Lending	9.4	6.8	2.6	Higher yields
Special Situations Lending	10.8	NA		*New*

- **Key Takeaways based on Meketa's 2023 Credit Capital Market Expectations**
  - The 10-year expected returns for EMD have previously been higher than high yield bonds and bank loans, indicating that investors may be compensated for incremental risks
  - EMD no longer looks attractive relative to other areas of Credit from a 10-year expected return perspective, especially considering EMD's higher level of expected risk

LACERA's BOI is undergoing a strategic asset allocation study planned to conclude in 2024. The BOI has yet to adopt capital market expectations for this study and accordingly, this slide is indicative

Liquid Credit – HY: Performance & Risk

Risk Summary	
Total Risk	7.4
Active Risk	1.0
Portfolio Beta	1.0
Effective Duration	3.5
Yield to Worst (%)	9.0



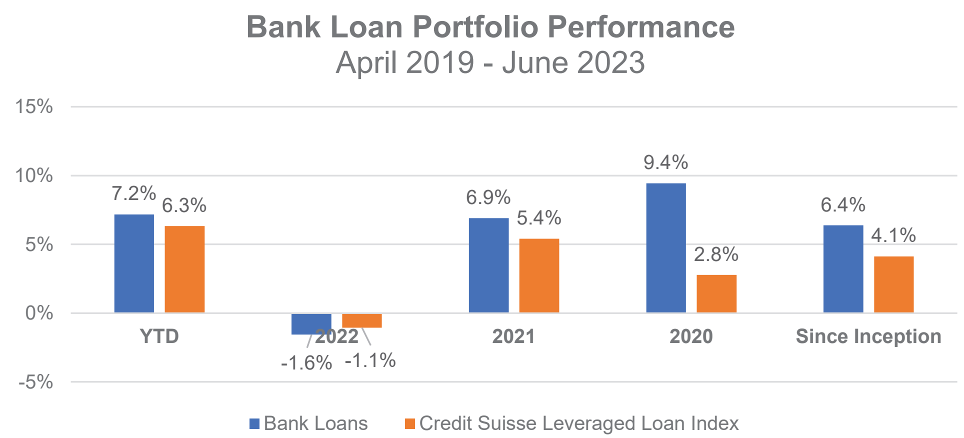
Return Metrics Since Portfolio Inception (April 2019 - June 2023)	Annualized Return (%)	Sharpe Ratio	Standard Deviation (%)	Maximum Drawdown (%)
High Yield Composite	2.8	0.1	9.8	14.2
Bloomberg U.S. Corporate High Yield	2.8	0.1	9.7	14.7

- The high yield portfolio is actively managed with limited flexibility to deviate from the benchmark.
- In shorter term periods, the portfolio has demonstrated some out/(under)performance, however in longer term periods, performance and risk is in line with the benchmark.

LACERA High Yield Composite and Benchmark returns data is from State Street and is net of fees. All other index returns data is from Zephyr and/or the index itself
Return metrics calculations are from Zephyr. Risk Summary metrics are from MSCI Barra One as of May 31, 2023. HY is an abbreviation for high yield

Liquid Credit – BL: Performance & Risk

Risk Summary	
Total Risk	4.8
Active Risk	0.7
Portfolio Beta	0.9
Effective Duration	0.4
Yield to Worst (%)	7.7



Return Metrics Since Portfolio Inception (April 2019 - June 2023)	Annualized Return (%)	Sharpe Ratio	Standard Deviation (%)	Maximum Drawdown (%)
Bank Loans	6.4	1.1	4.4	5.0
Credit Suisse Leveraged Loan Index	4.1	0.4	7.7	13.7

- 2020 performance is impacted by lagged data and the funding of a new mandate
- Beyond 2020, the bank loan portfolio appropriately tracks the benchmark

LACERA Bank Loans Composite and Benchmark returns data is from State Street and is net of fees. All other index returns data is from Zephyr and/or the index itself
Return metrics calculations are from Zephyr. Risk Summary metrics are from MSCI Barra One as of May 31, 2023. BL is an abbreviation for bank loans

Liquid Credit: Portfolio Guidelines

- **Guidelines are noted below with notes relative to existing guidelines**

	Proposed	Relative to Existing Guidelines
Return Objective	Meet or exceed the return of the aggregate Board approved benchmark	Replaced "each" with "the aggregate"
Benchmark	40% Bloomberg US Corporate High Yield Index 40% Credit Suisse Leveraged Loan Index 20% of a custom blend of emerging market debt indices (50% J.P. Morgan EMBI GD, 25% J.P. Morgan CEMBI BD, 25% J.P. Morgan GBI-EM GD)	Added specificity to the language while benchmarks themselves remain unchanged
Risk Target	Target tracking error of 2% over 5 years	No change
Sectors	Benchmark weight +/- 10%	No change
Geography	Maximum of 40% non-U.S. exposure	Removed "Target non-U.S. 35%"
Currency	Maximum of 7.5% non-U.S. dollar exposure	Removed "Target non-U.S. dollar 5%"
Credit Quality	Benchmark weight +/- 10%	No change
Leverage	None	No change
Allocation Targets and Ranges	High yield: 40% target +/- 10% Bank loans: 40% target +/- 10% Emerging market debt: 20% +/- 10%	No change No change No change

- The adjustments regarding geography and currency are intended to not impose specific target exposures via these guidelines and instead rely on benchmark exposures and allocation ranges while maintaining geography and currency maximum exposure levels for control and compliance

Index descriptions are in the Glossary

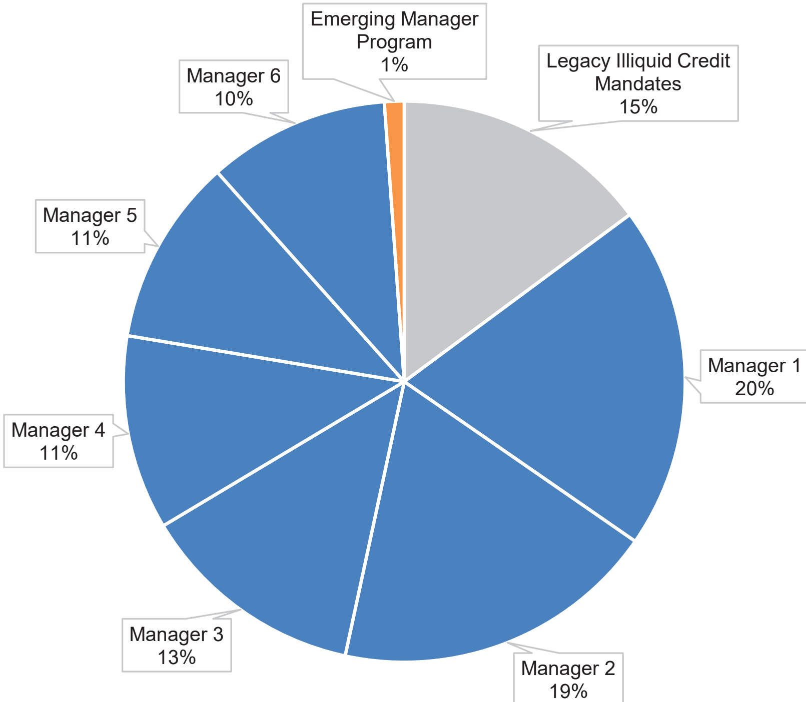
Liquid Credit: Summary

- Advancement and approval of this structure review would result in the following regarding the liquid credit portfolio:
  - Adopt portfolio guidelines as described

Illiquid Credit

Illiquid Credit: Portfolio Structure

Portfolio as of 6/30/23



- The current portfolio complies with the Illiquid Credit program guidelines

Initiatives Underway

- Continue utilizing the board approved Dedicated Management Account ("DMA") platform. Recent new mandates were structured in a DMA designed to increase transparency, benefit expense management, prevent forced selling, and enhance oversight
- Continue tailoring economics to benefit LACERA's membership. Recent new mandates have been implemented with LACERA's hard hurdle fee structure to better align interests and not pay performance fees for average outcomes
- Continue building out emerging manager program towards the board approved target of ~15% of the Illiquid Credit portfolio
- Continue monitoring the portfolio, managers, and underlying exposures

Initiatives That Would Require Future Approvals

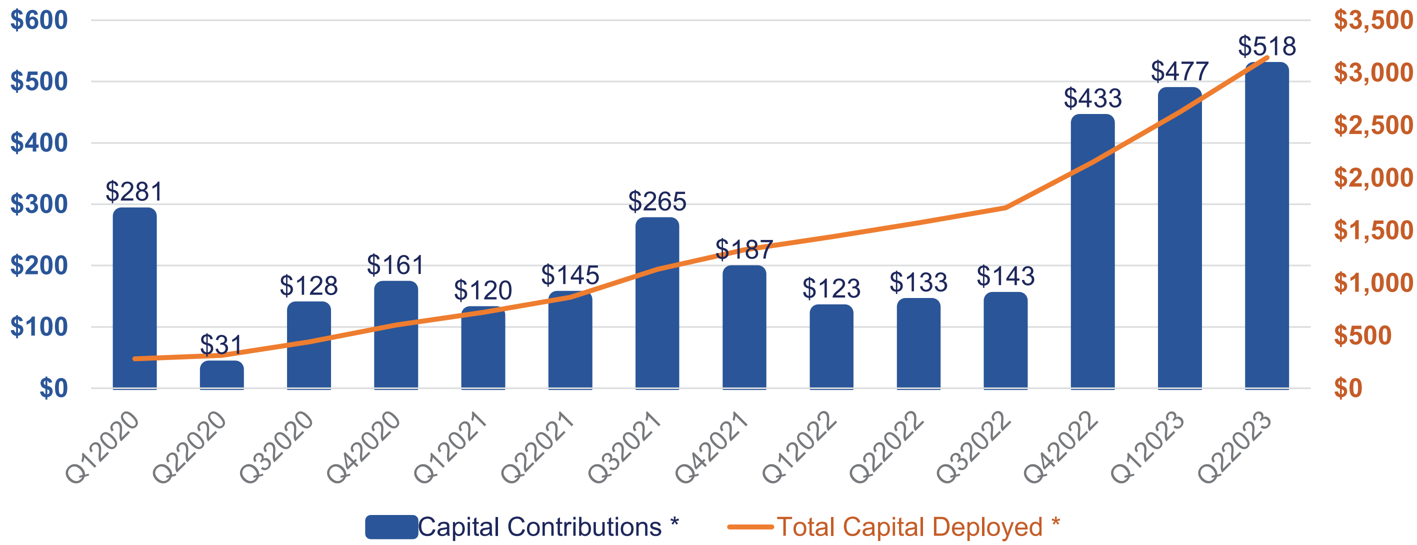
- New investments into or terminations from the main portfolio
- Graduations from the emerging manager program to the main portfolio

Illiquid Credit: Capital Deployment

The Illiquid Credit Portfolio has grown meaningfully since 2019, steadily deploying capital in a prudent manner.

	2019	2020	2021	2022	June 30, 2023
YE NAV	$0.9b	$1.6b	$3.1b	$3.7b	$4.8b
Total Plan Allocation	1.5%	2.4%	4.0%	5.3%	6.6%

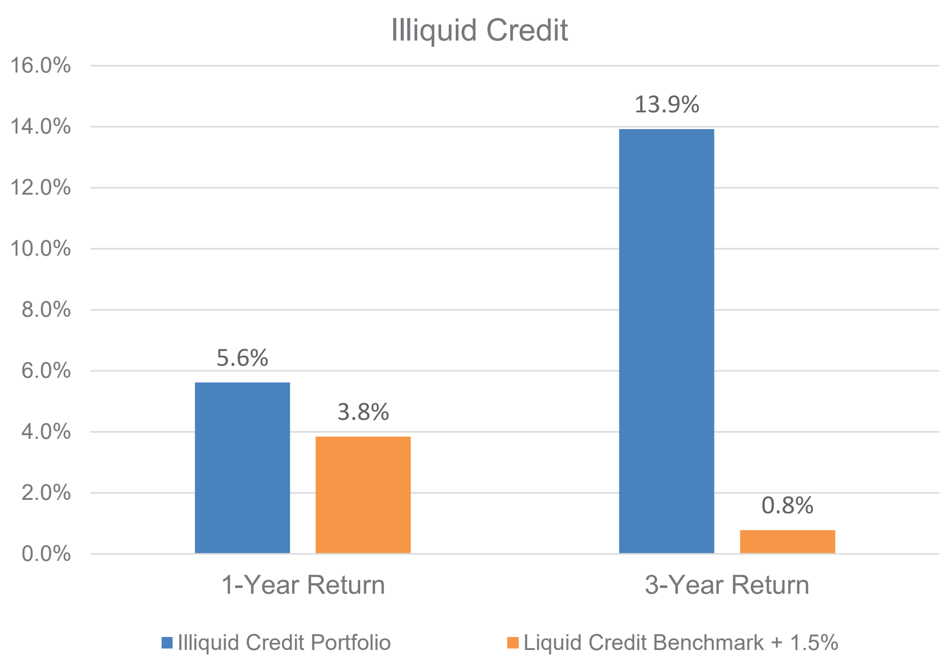
Quarterly Illiquid Credit Deployment since Q12020



* $ in millions
Data is from State Street as of June 30, 2023

Illiquid Credit: Performance

Trailing 1-year and 3-year returns as of 6/30/2023



- Outperformance over the 1 and 3-year periods
- The flexible illiquid credit mandates in the portfolio have maneuvered well over recent years and in 2022, which was a challenging year for the broad public credit and growth markets
- LACERA's Board-approved dedicated managed account evergreen structures and tailored economic terms have benefited performance
- Considering LACERA's illiquid credit mandates and terms:
  - $50 - $70 million of estimated annual return optimization from fee efficiency compared to conventional fund structures and fee terms*

Data is from State Street as of June 30, 2023 and is net of fees. Illiquid Credit returns and its benchmark returns are reported on a 1-month lag. Returns beyond 1-year are annualized

* The annual fee efficiency estimate represents 1.2% to 1.6% of incremental net return. The annual fee efficiency estimate considers fund expenses, management fees, and performance fees applicable to the five most recently established mandates in LACERA's illiquid credit portfolio compared to commingled fund alternatives in a year with a 9% gross return. The low end of the savings range compares LACERA to commingled direct lending funds with a 1.1% management fee and a 13.1% performance fee, as compiled from a survey of 49 firms conducted by Cliffwater in 2022. This universe of direct lending funds may have lower complexity than LACERA's subject mandates. The high end of the savings range compares LACERA to commingled funds with a 1.5% management fee and a 15% performance fee. Additional savings from co-investments are not considered. Indirect or non-economic benefits of the dedicated managed account structure such as increased transparency and influence on reimbursable expenses are not quantified in the fee efficiency estimate

Illiquid Credit Co-investment: Performance

Summary of Illiquid Credit Co-investment Program as of May 31, 2023	
Number of Co-investments	3
Net Asset Value	$39 million
BOI Approved Maximum Amount	$175 million
Co-investment Portfolio Inception	2022 (approved by BOI in 2021 as a sleeve of an illiquid credit investment)
Inception to Date Return[1]	17.7%
Fees on Co-investments	None

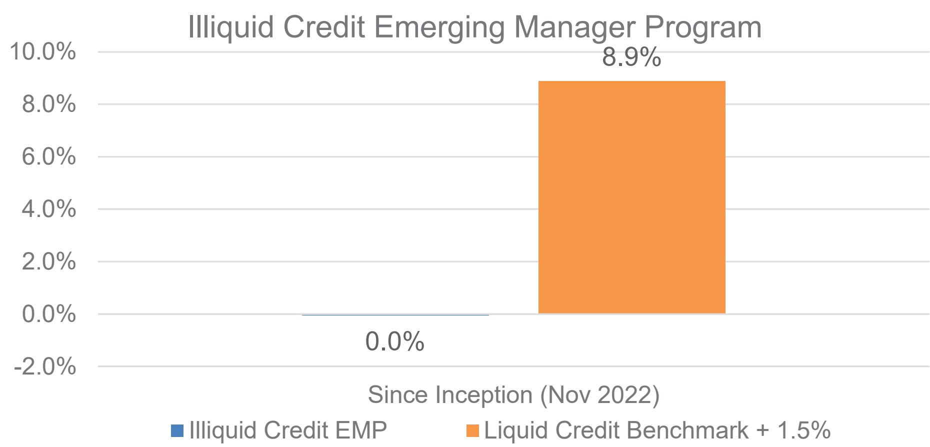
Key takeaways:

- The illiquid credit co-investment framework has worked well, specifically with regard to performance, execution timing, guideline adherence, reducing overall fees, and LACERA's strategic objectives
- Staff will seek additional co-investment opportunities in a similar framework for future consideration

[1] Returns data is net of fees and from Citco Fund Services with an inception date of September 1, 2022, the independent administrator of the subject illiquid credit investment account

Illiquid Credit: Emerging Manager Program Update

Snapshot of Program as of June 30, 2023	
Separate Account Manager	Stable Asset Management
Portfolio Net Asset Value	$55 million
Portfolio Inception	2022
Emerging Managers	1
Revenue Sharing Accounts	1



Key Takeaways

- The Program launched in November 2022 and has made one investment in a music royalties fund, committing $100m to the strategy
  - Given the early stage and closed-end fund structure of the first investment, strategy performance is impacted by the J-curve and a reporting lag
- The Program is expected to have ~10 emerging manager line items and a net asset value of around $750m when fully ramped
- Revenue sharing is likely a component in several of the mandates, where LACERA would share in the success of the emerging managers

Data is from State Street as of June 30, 2023 and is net of fees. Illiquid Credit EMP returns and its benchmark returns are reported on a 1-month lag

Illiquid Credit: Co-Investment & Contingent Capital

With the backdrop of LACERA's strategic initiatives, credit markets being dynamic, credit investing benefitting from adaptive flexibility, and market dislocations being short-lived, co-investment and contingent capital strategies can add value. Below is a framework to add both co-investment and contingent capital options for a good-standing credit manager.

- Credit manager in good standing
- Guideline compliance
- LACERA strategic initiative alignment
- LACERA consent right via team committee and CIO

Co-Investment Capital

- Upsize to an existing credit investment
- Co-investment not to exceed 20% of the investment manager's mandate (maximum single position size at time of investment)
- Co-investment not to exceed 3% of the credit portfolio (maximum single position size at time of investment)
- Fee savings or fee netting with the broad mandate

Contingent Capital

- Capital that may be available to fund compelling opportunities; different from the strategic allocation target of a mandate
- Compelling case for available but temporary outsized risk-adjusted returns, such as:
  - Broad market dislocation
  - Rushed portfolio transaction from a non-economic seller
  - Opportunity related to a right of first refusal
- Fee savings or fee netting with the broad mandate

- When considering whether to exercise its consent right, LACERA would evaluate available funding, portfolio fit, exposure concentrations, the manager's portfolio construction and credit underwriting capabilities, the manager's LACERA scorecard evaluations, and LACERA's strategic initiatives
- LACERA has one credit mandate with a co-investment sleeve and one credit mandate with a contingent capital component, each of which the BOI approved as part of an individual investment recommendation. The contingent capital component of the existing credit mandate is a specified commitment without a LACERA consent right
- If approved, the above framework could be applied to prospective or existing mandates in good standing to further advance several of LACERA's strategic initiatives
- LACERA's dedicated managed account platform can track performance of co-investments separately and may be the preferred structure for mandates with this feature

Illiquid Credit: Portfolio Guidelines

- **Guidelines are noted below with notes relative to existing guidelines**

	Proposed	Relative to Existing Guidelines
Return Objective	Greater than liquid credit markets; more than compensating for incremental risk	No change
Benchmark	LACERA's Custom Liquid Credit Benchmark plus 1.5% per year	No change
U.S. Exposure	Minimum of 50% invested in the U.S. market	No change
Geographic Exposure	Maximum of 15% invested in non-developed markets	No change
Currency Exposure	Minimum of 90% invested in assets that are denominated in or hedged to the U.S. dollar	No change
Manager Count	~ 10 direct portfolio and ~ 10 emerging manager portfolio	No change
Emerging Manager Program	Evergreen separate account emerging manager program 15% target allocation with a 10-20% range (of the Illiquid Credit portfolio)	No change
Co-investments	Permitted for managers in good standing; not to exceed 20% of a manager's mandate or 3% of the credit portfolio with LACERA maintaining a portfolio fit veto	New guideline
Contingent Capital	Permitted for managers in good standing with LACERA maintaining a portfolio fit veto	New guideline

- The new guidelines added above are designed to frame scalable approaches for co-investments and contingent capital deployment within illiquid credit, as described on the preceding page

Illiquid Credit: Portfolio Guidelines

- **Guidelines for the illiquid credit emerging manager program (EMP) are below**
- **These guidelines are in addition to the program-level guidelines from the previous page**

	Proposed	Relative to Existing Guidelines
Program Framework	Evergreen separate account emerging manager program	No change
Allocation Target and Range	15% target allocation with a 10-20% range (of the illiquid credit portfolio)	No change
Emerging Manager Definition	An emerging illiquid credit manager meets the three following criteria at initial investment: - Organization/team has less than $1 billion of assets under management; - Organization/team has managed external capital in an institutional vehicle for less than 5 years; and - Organization/team is at least 66% owned by managing principals and employees	Added "at initial investment" Added "/team" Added "/team" Added "/team"
Graduation Description	Graduation entails re-categorizing an investment from LACERA's emerging manager program to LACERA's primary portfolio that may adjust the size of the investment	New guideline
Graduation Target Timeframe	3 - 12 years after an initial investment or within 2 years of a subject closed-end fund coming to the end of its life noting that this guideline is a target and a goal	New guideline
Graduation Authority	Graduation would require approval like any new non-EMP investment as articulated in the IPS	New guideline
Redemption Description	Redemption entails redeeming from an open ended investment in lieu of holding it or a graduation event; closed end fund vehicles may have a natural wind-down process that is not initiated by a fund investor	New guideline
Redemption Guideline	Absent graduation intentions for an open ended investment, a redemption event should commence no later than 12 years after an initial investment noting that nuanced circumstances may delay the redemption	New guideline

- Several new guidelines added above are designed to define and frame approaches to both graduation and redemption
- Merit, objectives, strategic initiatives, context, portfolio fit, and case specifics would be evaluated for graduation or redemption decisions
- Not included in the proposed guidelines is past language that an existing manager would no longer be emerging if: 1) organization assets under management exceed $2 billion for the trailing 24 months and the fund has a 60-month performance track record, 2) LACERA’s initial investment occurred greater than 7 years ago, or 3) the organization is not at least 66% owned by managing principals or employees

Illiquid Credit: Summary

- Advancement and approval of this structure review would result in the following regarding the illiquid credit portfolio:
  - Adopt portfolio guidelines as described
  - Approve a co-investment and contingent capital framework

Credit

Credit: Initiatives

Completed

- Establishment of an emerging manager program in the illiquid credit portfolio with a 15% target allocation
- Implementation of LACERA's first dedicated managed account investment
- Material portfolio adjustments in response to LACERA's 2021 strategic asset allocation study

In Process

- Wind down of select legacy credit mandates as consistent with prior approvals and structure reviews
- Capital deployment into the illiquid credit emerging manager program
- Rebalancing activity and new investments to support asset allocation targets within credit
- Investment due diligence on credit strategies that are best suited with LACERA strategic initiatives and goals

Upcoming

- Continue to implement the portfolio in accordance with approved guidelines and objectives
- Illiquid Credit Emerging Manager Program development and potential graduations
- As part of a strategic asset allocation study, consider the credit portfolio's framework, discrete components, liquidity, and benchmarking
- Initiate RFP search for asset category consultant(s) pending BOI approval of MQs and searches – hedge fund and credit portfolios

Credit: Summary Recommendations

- **Summarized below are the recommendations in this structure review:**

Credit

- Affirm role, moderate implementation approach, and desired implementation attributes

Liquid Credit

- Adopt proposed portfolio guidelines

Illiquid Credit

- Adopt proposed portfolio guidelines
- Approve a co-investment and contingent capital framework

Appendix

Attachment 1 – Glossary of Terms

Term	Definition
Active Risk	A measure of the difference relative to a benchmark. For example, if a portfolio's return is 5%, and the benchmark's return is 3%, then the portfolio's active return is 2%. A portfolio's active risk is the risk associated with the volatility of active returns. Active weight is the portfolio's weight in an asset minus the benchmark's weight in the same asset. Active exposure is the portfolio's exposure to a factor minus the benchmark's exposure to that same factor.
Beta	A measure of the sensitivity of an asset to movements in the market or other benchmark; thus, a measure of its non-diversifiable or systematic risk. A beta of one 1.0 indicates that, on average, the asset is expected to move in tandem with the market or benchmark.
Bloomberg Barclays US Corporate HY Index	A commonly used benchmark index for high yield, fixed-rate corporate bonds.
Bps or bps	An acronym for basis points where one bps equals one hundredth of one percent or 0.01%.
Correlation	Correlation measures how closely related the variances of two return series are.
Credit Suisse Leveraged Loan Index	A commonly used benchmark index for high yield, floating-rate corporate bonds.
Dedicated Managed Account Platform	A DMA platform allows an investor such as LACERA to invest in a single-investor structure where assets within the account are held in custody for the sole benefit of the investor. Benefits include the potential for: increased options for control of assets, reduction of investment and non-investment related costs, and increased transparency. A DMA platform manager, such as Innocap for LACERA, acts as a fiduciary, has oversight responsibilities, and administers day-to-day functions of the account.
Duration (or Effective Duration)	A measure of the price sensitivity of bonds with respect to a parallel shift of the discount curve that is particularly useful for bonds with embedded options (e.g., callable bonds, putable bonds, and mortgage-backed securities).

Attachment 1 – Glossary of Terms (continued)

Term	Definition
Floating rate instruments	A financial debt instrument that has a variable coupon rate.
Hard Currency Debt	Sovereign currency debt issued in U.S. dollars.
Hard Hurdle Performance Fee Structure	A fee structure where performance fees are paid to the manager only on a percentage of the profits that exceed a negotiated hurdle rate.
J.P. Morgan CEMBI BD	J.P. Morgan Corporate Emerging Market Bond Index Broad Diversified is an index of emerging market corporate bonds issued in U.S. dollars.
J.P. Morgan EMBI GD	J.P. Morgan EMBI Emerging Market Bond Index is an index of emerging market sovereign bonds issued in U.S. dollars.
J.P. Morgan GBI-EM GD	J.P. Morgan Government Bond Index-Emerging Markets Global Diversified is an index of emerging market government bonds issued in local currency.
J-Curve	Used to describe the shape of a fund's anticipated performance, as plotted on a graph, from inception through to exit. This shape represents low expected returns at the start, followed by a gradual expected increase and recovery to a point that is higher than at the start.
Local Currency Debt	Fixed income debt that is issued by countries with developing economies as well as by corporations within those nations.
Maximum Drawdown	The compounded but not annualized maximum loss over a time period.
MSCI ACWI IMI Index	A global equity market index that captures large, mid and small cap representation across developed and emerging market countries.
Sharpe Ratio	Measures risk-adjusted performance of an investment compared to a risk-free asset.

Attachment 1 – Glossary of Terms (continued)

Term	Definition
Standard Deviation	Volatility of monthly returns that measures the average deviation from the mean.
Total Risk	The total (gross) risk to an asset, which is the standard deviation of the asset's total return distribution, expressed in percent. The total risk for an asset depends on the asset's exposures to the risk factors, the factor variance/covariance matrix, and the forecast selection risk of the asset.
Tracking Error	Tracking error is the difference in actual performance between a portfolio and its corresponding benchmark.
Yield to Worst	The lowest expected potential yield that a bondholder could receive on a callable bond or portfolio.

ATTACHMENT B

MEKETA
INVESTMENT GROUP

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MEMORANDUM

TO: Each Member, Credit and Risk Mitigation Committee
FROM: Tim Filla, Aysun Kilic, and Imran Zahid
CC: Jon Grabel, CIO - LACERA
DATE: August 9, 2023
RE: Credit Structure Review

The purpose of this memo is for Meketa Investment Group to formalize its support for staff's recommendation to adopt the updated portfolio guidelines contained in LACERA's 2023 Credit Structure Review.

We reviewed staff's observations related to near term and longer term performance from High Yield, Bank Loans, and Emerging Markets Debt segments and agree that LACERA has not been compensated for the inherent risks associated with investing in the Emerging Markets Debt asset class. This view is also consistent with Meketa's 2023 10-Year Capital Market Return Expectations where the asset class appears less attractive from a risk/return standpoint when compared to other areas of public credit markets including Bank Loans and High Yield. Meketa plans to further address LACERA's Emerging Markets Debt allocation during the Strategic Asset Allocation Review.

Meketa agrees with the proposed guidelines contained in the presentation related to the various categories within Liquid Credit including return objective, benchmark, geography, and currency. We are supportive of the added specificity to the language contained in the updated guidelines. Meketa concurs with the recommendation related to managing LACERA's liquid credit portfolio more closely to benchmark exposures and LACERA's allocation ranges while maintaining geography and currency maximum exposure levels for control and compliance reasons. We believe a benchmark centric approach is a prudent way to manage risk in the Liquid Credit category.

If you have any questions, please feel free to reach us at 760-795-3450. We thank you for your continued trust in Meketa. We look forward to speaking with you soon.

TF/AK/IZ/sf

ALBOURNE

LACERA Illiquid Credit Structure Review Concurrence Memo

July 28, 2023

To: Each Member
Credit and Risk Mitigation Committee
Board of Investments

From: James Walsh, G. Stephen Kennedy
Albourne America LLC

For: August 9, 2023 Credit and Risk Mitigation Committee Meeting

Recommendation: Albourne America LLC ("Albourne") recommends that the 2023 Structure Review of LACERA's Illiquid Credit Portfolio be advanced to the Board of Investments for approval.

Background: Staff has prepared the 2023 Illiquid Credit Structure Review for the Credit and Risk Mitigation Committee and the Board of Investments for its consideration and ultimately its approval. Albourne has reviewed the Structure Review and agrees with the recommendations.

The Structure Review re-asserts the Investment Role and Objectives as updated in September 2021 and approved in October 2021, which emphasize current income, moderate returns, to profit from complexity, illiquidity and upside optionality. The Structure Review notes that, with the approval the portfolio will continue to be built out to a 7% Strategic Target. The Next Phase of this build out is anticipated to be implemented over 1-3 years adding bench Core Managers and to continue the implementation of the Emerging Manager Program.

Conclusion: Staff's Structure Review outlines the focus on risk mitigation and expanding the size of the program, and the actions necessary to move in that direction.

Sincerely,

James Walsh
Head of Portfolio Group

G. Stephen Kennedy
Senior Analyst

LACERA Illiquid Credit Structure Review Concurrence Memo

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