MEETING MATERIALS

City and County of San Francisco
Retiree Health Care Trust Fund

May 22, 2014

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1. **Implementation Recommendations, Timeline, and Asset Allocation Review**
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Implementation Recommendations, Timeline, and Asset Allocation Review

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Implementation Options
Phase II Review and Timeline

Background

- At the January 28, 2014 meeting, the Board was presented with four implementation options to consider for the investment of the RHCTF assets.
- After discussion with Meketa Investment Group, the Board requested additional information on two implementation options: (1) Option 2 – Co-Invest in Passive Investments with SFERS, and (2) Option 3 – California Employers' Retiree Benefit Trust (CERBT).
- Meketa Investment Group was asked to follow up on a number of questions with respect to each option, and to present additional information at the next Board meeting on the timeline and requirements to invest with either option, as well as an asset allocation review of each.
- We believe that each of the remaining two implementation options is a viable direction for the RHCTF Board to consider. There are specific constraints and considerations for each implementation option, and this document outlines those differences.

Implementation Option 2: Co-Invest in Passive Investments with SFERS

Description (as stated in January meeting materials)

- Co-investment with SFERS in three passive investments that cover broad public markets:
  - U.S. equities (SFERS S&P 500 Tobacco Free Index)
  - International equities (Northern Trust MSCI EAFE)
  - Investment grade bonds (BlackRock U.S. Debt Index Fund – benchmarked to the Barclays' Aggregate)
- Estimated management fees for 60/40 stock/bond mix are 5 to 6 basis points, which would be approximately $20,000 currently.
- Custody fees: $25,000 annual fee estimate includes account setup/maintenance, asset servicing, online access, monthly audit reporting, and GASB reporting. This estimated fee for custody was provided by Northern Trust, the current custodian for SFERS. It should be noted that SFERS is in the middle of a custody search process.

Implementation Timeline
Co-Invest in Passive Investments with SFERS

Action Item	Responsible Party	Timeframe for Completion
Adopt Investment Policy Statement	Board	May Meeting
Approve Asset Allocation Targets	Board	May or July Meeting
SFERS Board Approves RHCTF Investment	SFERS Board/SFERS Staff	July Meeting
Sign contract with SFERS	Legal Counsel/Staff	July – September
Custody Contract	Board/Legal Counsel/Staff/Meketa	July – September
Begin Investing Assets	Board/Staff/Meketa	Upon completion of paperwork with SFERS and AA decision: Q3 2014
Quarterly Report to Board	Meketa	Q4 2014

- This implementation option would establish a unique relationship between SFERS and the RHCTF. SFERS does not currently have any co-investors, nor are they seeking to add co-investors. Additional discussions with SFERS, the Controller, and legal counsel would be necessary.
- Once the terms of the relationship with SFERS are agreed upon, discussions with the custodian, currently Northern Trust, would take place to determine custody services and final pricing.
- The Board would need to establish an asset allocation policy to determine the target allocations to U.S. equities, international equities, and investment grade bonds.

Considerations for Co-Investing with SFERS

- The Board would retain control of the asset allocation, to the extent possible, with three broad index options.
- Custody fees of approximately $25,000 would total 6 basis points on a $40 million asset level, 4 basis points on a $60 million asset level, and 3 basis points on an $80 million asset level.
- This option is unlikely to be a long-term solution, given the potential for different objectives and constraints between SFERS and the RHCTF, and the lack of control over the specifics of the allocations (e.g., the passive equity option is a tobacco-free index. This may or may not be aligned with the investment objectives of the RHCTF).

Implementation Option 3: California Employers' Retiree Benefit Trust

Description

- The CalPERS California Employers' Retiree Benefit Trust (CERBT) was established in 2007 to assist public employers in meeting retiree health and OPEB obligations. According to CERBT, the CERBT Fund is a Section 115 Trust set up for the purpose of receiving employer contributions that will prefund health and other post-employment benefit costs for retirees and their beneficiaries.
- Currently, nearly 400 California public employers have investments in CERBT, totaling $3.5 billion.
- CERBT offers three pre-specified portfolio strategies: Moderate, Moderately Conservative, and Conservative.

	Moderate (Strategy 1) (%)	Moderately Conservative (Strategy 2) (%)	Conservative (Strategy 3) (%)
Global Equity	66	50	32
U.S. Nominal Bonds	18	24	42
Global Real Estate	8	8	8
Inflation-linked Bonds	5	15	15
Commodities	3	3	3
Net Expected Return[1]	*7.61*	*7.06*	*6.39*
Expected Risk	*11.73*	*9.46*	*9.27*

- Only the Moderate (strategy 1) option produces a return in line with the actuarial assumed rate of 7.5% that is currently utilized for projections.

[1] Expected risk and returns are based on CalPERS assumptions.

Description (continued)

- All three CERBT strategies utilize the same asset classes, but in different proportions. Four of the five asset classes are passively managed. The U.S. Nominal Bonds allocation is the only asset class that is actively managed. U.S. Nominal Bonds, Inflation-linked Bonds, and Commodities are managed by the internal investment staff at CalPERS. Global Equity and Global Real Estate are managed by State Street Global Advisors (SSgA), according to parameters established by CalPERS investment staff.
- The asset allocation targets for each strategy are formally reviewed once every three years. The last review was completed in 2011, and the 2014 review is expected to be done by August 2014.
- A flat 13 basis point administrative fee is charged by CERBT, with no additional charge for custodial and investment management services. Additionally, 1 basis point of investment management fees is deducted from the SSgA passive investments. However, this fee is not billed separately, since it is taken automatically from the commingled investment. At current asset levels of $43 million, 14 basis points equates to approximately $56,000 per year.

Implementation Timeline
CERBT

Action Item	Responsible Party	Timeframe for Completion
Board Approves CERBT Investment	Board	May Meeting
Adopt Investment Policy Statement	Board	May or July Meeting
CERBT Requirements:		
- Actuarial valuation using OPEB Assumptions Model prescribed by CalPERS	Board/Staff/Actuary	0-1 month (Submit 2012 Valuation)
- Complete and Send Summary of Actuarial Information Required	Staff/Actuary	0-1 month
- Complete and Submit Certification of OPEB Actuarial Information and Funding Policy	Staff/Actuary	0-1 month
- Complete and sign Agreement and Election to Prefund Other Post Employment Benefits	Legal Counsel/Staff	0-1 month
- Complete and Submit Delegation of Authority to Request Disbursements	Staff	0-3 months
- Present Agreement and Delegation of Authority to employer's governing body for adoption and approval	Board/Staff	0-3 months
Begin Investing Assets	Board/Staff/Meketa	Upon completion CERBT requirements
Quarterly Report to Board	Meketa	Q4 2014

- All investors in the CERBT strategies have an actuarial valuation schedule that is completed in even-numbered years. This means that the RHCTF, which has a 2011 valuation and is currently in the middle of a 2013 valuation, would have to complete at 2014 valuation. Subsequently, valuations could be done every two years.

Considerations for Investing in CERBT

- The Board would not have control over the construction of the selected strategy.
- The Board would not have the ability to hire or fire managers in the selected strategy.
- CERBT has up to 150 days to meet redemption notices
- CERBT is currently undertaking their tri-annual asset allocation review, along with CalPERS. This may result in changes to the current structure or expected return of the investment options.

Follow-Up Items for CERBT

- We were asked to review the rebalancing policy associated with CERBT, along with its frequency.
  - Investment Policy sets asset allocation and targets. Staff monitors ranges daily.
  - Rebalancing is officially reviewed quarterly, but monthly cash flows are used to direct assets toward the appropriate asset class, which effectively allows for "rebalancing" twice a month.
- The second issue reviewed was the history of changes to the asset allocation of CERBT.
  - Board policy is to review asset allocation every three years. The last review occurred in 2011, which means that the next review will be conducted in 2014 and the asset allocation for all three CERBT strategies will be evaluated. Any changes should be known by August 2014.
- The Board asked about the use of derivatives within the CERBT strategies.
  - SSgA manages the equity index fund for CERBT and may occasionally use futures in order to fully replicate the index.
  - Commodities are managed internally and do use swaps. They are 100% collateralized and are based on the Goldman Sachs Commodity Index (GSCI).
  - Fixed Income is managed internally and no derivatives are used.
- Finally, we were asked to provide some clarity on the relationship CERBT has with CalPERS, and whether all decisions made with respect to social or other policies would apply to CERBT as well.
  - The same Board is responsible for the policies and decisions, so while CERBT is a distinct and separate trust fund, there would not be conflicting investment policies between the two. CERBT adheres to the applicable CalPERS policies set by the Board.

Summary of Implementation Options

	SFERS Co-invest Passive (Option 2)	CalPERS CERBT (Option 3)
Investments	Three SFERS passive funds: S&P 500, MSCI EAFE, and Barclays Aggregate	Three strategies with pre-defined asset allocation targets
Initial asset classes	U.S. Equities, International Developed Market Equities, Investment Grade Bonds	Global Equities, U.S. Bonds, Global Real Estate, Inflation-Linked Bonds, Commodities
Active/Passive Investments	Passive	Active and Passive
Board Authority Over:		
Asset Allocation	Yes	No (select strategy)
Asset Class Structure	Yes	No
Individual Managers	No	No
Investment Cost	5-6 bps	1 bp
Custody and Admin Cost	$25k per year	14 bps (incl. admin fee)
Est. Cost on $43 million Fund	$45k - $49k (11-12 bps)	$56,000 (14 bps)
Est. Cost on $60 million Fund	$55k - $61k (9-10 bps)	$84,000 (14 bps)
Est. Cost on $80 million Fund	$65k – $73k (8-9 bps)	$112,000 (14 bps)
Considerations	Lowest cost	

Conclusion

- The two remaining implementation options presented are viable methods to invest the assets of the RHCTF.
- There are potential benefits, efficiencies, and drawbacks within each option.
- Regardless of the implementation option chosen by the Board, Meketa Investment Group recommends that the Board establish and approve an Investment Policy Statement for the RHCTF, and to then approve an asset allocation if the Board selects the SFERS option. If the CERBT option is selected, the Board would select one of the pre-determined asset allocations.
- Staff has now been assigned to the RHCTF, which should help streamline the implementation process.
- We do not anticipate that one option would use considerably more staff resources than the other.

Asset Allocation Policy Review

Introduction to Asset Allocation Policy Review

- This document presents asset allocation options for the RHCTF.
- We show four potential allocations that could be used in the SFERS option, and compare those to the risks faced and expectations associated with the CERBT option.
- The goal of this review is not to declare one portfolio the "right" choice or the only prudent choice, but to highlight the risk and return tradeoffs of different policy portfolios.
- Over long periods of time, riskier assets, such as equities, are likely to produce relatively high rates of return. Consequently, higher allocations to risky assets increase the likelihood of the RHCTF achieving its long-term return expectations. However, riskier assets increase volatility in the short term.
- The asset allocation review process highlights the natural tension between long term goals and short term risks, and should allow the Board to make more informed decisions regarding portfolio positioning.
- As the Fund grows, additional asset allocation options will become available, if the Board elects to invest the assets of the Fund on its own, outside the constraints of the SFERS or CERBT opportunities.

Asset Allocation Options

Asset Allocation Policy Options[1]

	SFERS Co-Invest Policy A	SFERS Co-Invest Policy B	SFERS Co-Invest Policy C	SFERS Co-Invest Policy D	CERBT Moderate Strategy 1
Equities	**60%**	**76%**	**76%**	**74%**	**66%**
U.S. Equities	30	42	38	34	0
International Developed Market Equities	30	34	38	40	0
Emerging Market Equities	0	0	0	0	0
Global Equities	0	0	0	0	66
Fixed Income	**40**	**24**	**24**	**26**	**23**
Investment Grade Bonds	40	24	24	26	18
TIPS	0	0	0	0	5
Real Assets	**0**	**0**	**0**	**0**	**11**
Real Estate	0	0	0	0	8
Commodities	0	0	0	0	3
Expected Return	*6.9*	*7.5*	*7.5*	*7.5*	*7.9*
Standard Deviation	*11.4*	*14.1*	*13.8*	*13.9*	*14.4*

- Recall that with the SFERS co-investment option, only three asset classes (U.S. Equity, International Developed Market Equity, and Investment Grade Bonds) are available for investment.
- The CERBT portfolio shown is the Moderate strategy. The expected return for the CERBT Moderate strategy is 7.6%, using CERBT expectation assumptions, and 7.9% using Meketa Investment Group assumptions.

[1] Expected return and standard deviation are based upon Meketa Investment Group's 2014 Annual Asset Study. Meketa's expected return calculation is a 20-year geometric calculation. Throughout this document, returns for periods longer than one year are annualized.

Review of Proposed Asset Allocation Policies

- SFERS Co-Invest Policy A is a traditional 60/40 portfolio, which does not provide enough expected return to realistically achieve a 7.5% actuarial assumed rate of return.
- SFERS Co-Invest Policies B, C, and D increase the allocation to equities in order to reach the 7.5% assumed actuarial return.
  - Policies C and D earn the same return as Policy B, with less risk, because of a higher allocation to international equities.
  - Policy D is able to have a lower allocation to Equities than Policies B or C, because of its higher allocation to international equities.
- The CERBT Moderate Strategy 1 option has a higher return expectation, and higher expected standard deviation because of its exposure to emerging market equities, and lower fixed income exposure.

Historical Scenario Analysis[1]
(Cumulative Return)

Scenario:	SFERS Co-Invest Policy A (%)	SFERS Co-Invest Policy B (%)	SFERS Co-Invest Policy C (%)	SFERS Co-Invest Policy D (%)	CERBT Moderate Strategy 1 (%)
Calendar Year 2008	-22.1	-29.2	-29.4	-28.7	-30.5
Global Financial Crisis (4Q07 thru 1Q09)	-26.0	-35.0	-35.2	-34.3	-36.4
Interest Rate Spike (1994)	1.2	2.0	2.3	2.4	2.3
Crash of 1987 (September thru November 1987)	-12.4	-17.0	-16.3	-15.4	-15.1
Popping of the dot.com Bubble (2Q00 thru 3Q02)	-15.5	-27.1	-27.3	-25.9	-18.7
Strong US Dollar (1Q81 through 3Q82)	2.7	-0.6	-0.9	-0.7	-0.7
Weak US Dollar (January 1986 thru August 1987)	33.5	38.8	40.3	40.5	36.8
Stagflation (January thru March 1980)	-7.5	-7.1	-7.2	-7.2	-7.0
Stagflation (1Q73 thru 3Q74)	-24.5	-31.7	-31.7	-30.8	-25.4

- The CERBT policy, due to its higher risk profile, is most negatively impacted by historical scenario analysis.

[1] See the Appendix for our scenario inputs. In periods where the ideal benchmark was not yet available we used the next closest benchmark(s) as a proxy.

Stress Testing: Impact of Market Movements

(Expected Return under Stressed Conditions)[1]

What happens if (over a 12-month period):	SFERS Co-Invest Policy A (%)	SFERS Co-Invest Policy B (%)	SFERS Co-Invest Policy C (%)	SFERS Co-Invest Policy D (%)	CERBT Moderate Strategy 1 (%)
10-Year T-Bond rates rise 100 bp	4.9	7.0	7.0	6.8	6.8
10-Year T-Bond rates rise 200 bp	1.9	4.7	4.7	4.4	4.4
10-Year T-Bond rates rise 300 bp	-1.6	1.8	1.8	1.3	1.3
BBB Spreads widen by 50 bp, HY by 200 bp	3.4	4.3	4.3	4.2	4.2
BBB Spreads widen by 300 bp, HY by 1000 bp	-24.3	-30.0	-29.6	-28.7	-28.9
Trade-weighted US$ gains 10%	2.2	1.0	0.6	0.5	0.3
Trade-weighted US$ gains 20%	4.3	2.0	1.2	0.9	0.6
Equities decline 10%	-5.4	-7.3	-7.3	-7.1	-7.4
Equities decline 25%	-13.4	-18.2	-18.3	-17.7	-18.4
Equities decline 40%	-21.4	-29.2	-29.2	-28.3	-29.4

- Each policy portfolio has a different sensitivity to four major risk factors: interest rates, credit spreads, currency values, and equity values.
- The Fund's primary risk factor would continue to be an equity market decline, no matter the policy.

[1] Assumes that assets not directly exposed to the factor are affected nonetheless. See the Appendix for further details.

Appendices

Notes and Disclaimers

[1] The returns shown in the Policy Options and Risk Analysis sections rely on estimates of expected return, standard deviation, and correlation developed by Meketa Investment Group. To the extent that actual return patterns to the asset classes differ from our expectations, the results in the table will be incorrect. However, our inputs represent our best unbiased estimates of these simple parameters.

[2] The returns shown in the Policy Options and Risk Analysis sections use a lognormal distribution, which may or may not be an accurate representation of each asset classes' future return distribution. To the extent that it is not accurate in whole or in part, the probabilities listed in the table will be incorrect. As an example, if some asset classes' actual distributions are even more right-skewed than the lognormal distribution (i.e., more frequent low returns and less frequent high returns), then the probability of the portfolio hitting a given annual return will be lower than that stated in the table.

Scenario Return Inputs

Asset Class	Benchmark Used
U.S. Equity	Russell 3000
International Equity (Developed)	MSCI EAFE
International Equity (Emerging)	MSCI Emerging Markets
Investment Grade Bonds	Barclays Aggregate
TIPS	Barclays U.S. TIPS
REITs	NAREIT Equity
Commodities	Summer Haven Commodity

Scenario Return Inputs

	Global Financial Crisis (%)	2008 (%)	Interest Rate spike (1994) (%)	Crash of '87 (Sept - Nov 1987) (%)	Popping of the dot-com Bubble (2Q00 – 3Q02) (%)	Strong U.S. dollar (1Q81-3Q82) (%)	Weak U.S. Dollar (Jan 1986 - Aug 87) (%)	Stagflation (1Q80) (%)	Stagflation (1Q73 – 3Q74) (%)
U.S. Equity	-45.9	-37.3	0.2	-29.8	-43.1	-1.9	31.5	-6.3	-42.6
Public EAFE Equity	-52.1	-43.4	7.8	-14.5	-46.7	-10.7	69.1	-7.0	-42.6
Public EM Equity	-51.2	-53.3	7.8	-14.5	-43.9	-10.7	69.1	-7.0	-42.6
Investment Grade Bonds	8.5	5.2	-2.9	2.2	28.6	16.1	8.4	-8.7	2.8
TIPS	8.2	-2.4	0.2	3.3	37.4	20.5	17.0	-2.7	14.6
REITs	-63.0	-37.7	3.2	-14.0	45.4	5.6	16.2	-4.4	-31.6
Commodities	-32.6	-33.7	11.6	5.6	2.0	-24.4	7.3	-10.4	132.3

Stress Test Return Assumptions[1]

	Rates rise 100 bp (%)	Rates rise 200 bp (%)	Rates rise 300 bp (%)	BBB Spreads widen by 50 bp (%)	BBB Spreads widen by 300 bp (%)	USD Gains 10% (%)	USD Gains 20% (%)	Equities Decline 10% (%)	Equities Decline 25% (%)	Equities Decline 40% (%)
Public Domestic Equity	10.3	9.0	6.9	6.0	-42.0	3.5	7.0	-10.0	-25.0	-40.0
Public Foreign Equity (Developed)	10.3	9.0	6.9	5.5	-33.0	-7.0	-14.0	-10.5	-26.3	-42.0
Public Foreign Equity (Emerging)	10.3	9.0	6.9	5.0	-39.0	-7.0	-14.0	-11.0	-27.5	-44.0
Investment Grade Bonds	-3.4	-8.6	-13.9	-0.4	-4.6	8.0	16.0	2.0	5.0	8.0
TIPS	-7.0	-15.8	-24.6	8.5	12.0	8.0	16.0	1.0	2.5	4.0
REITs	7.9	8.0	6.0	0.5	-36.0	1.0	2.0	-9.5	-23.8	-38.0
Commodities	8.7	4.6	-0.6	-0.5	-21.0	-15.0	-30.0	-7.0	-17.5	-28.0

1 Assumptions are based on performance for each asset class during historical periods that resembled these situations.

Overview of Annual Asset Study Methodology

- In order to construct an optimal portfolio from a risk-return standpoint, conventional financial wisdom dictates that one develop return, volatility, and correlation expectations over the relevant investing horizon.
- Given the uncertainty surrounding financial and economic forecasts, expectations development is challenging, and any of several methodological approaches may meaningfully contribute to this complex task.
- Meketa Investment Group’s process relies on both quantitative and qualitative methodologies.
- First, we employ a large set of quantitative models to arrive at a set of baseline expected ten-year annualized returns for major asset classes.
- These models attempt to forecast a gross “beta” return for each *public market* asset class; that is, we specifically do not model “alpha,” nor do we apply an estimate for management fees or other operational expenses.[1]
- Our models are fundamentally based (based on some theoretically defined return relationship with current observable factors).
- Some of these models are more predictive than others. For this reason, we next overlay a qualitative analysis, which takes the form of a data-driven deliberation among the research team and our Investment Policy Committee.
- Return assumptions for hard-to-predict asset classes as well as those with limited data will be influenced more heavily by our qualitative analysis.
- As a result of this process, we form our ten-year annualized return expectations, which serve as the primary foundation of our longer-term, twenty year expectations.

[1] Our expectations are net of fees where passive management is not available (e.g., private markets and hedge funds).

Overview of Annual Asset Study Methodology (continued)

- We form our twenty-year annualized return expectations by systematically considering historical returns on an asset class by asset class level. Specifically, we construct a weighted average of our ten-year expectations and average historical returns in each asset class.
- The weights are determined by a qualitative assessment of the value of the historical data. Generally, if we have little confidence that the historical average return is representative of what an investor can expect[1], we will weight our ten-year forecast more heavily. Therefore, the weight on our ten-year forecasts ranges from 0.5 to 0.9.
- We develop our twenty-year volatility and correlation expectations differently. We rely primarily on historical averages, with an emphasis given to the experience of the trailing ten years.
- Qualitative adjustments, when applied, usually serve to increase the correlations and volatility over and above the historical estimates (e.g., using the higher correlations usually observed during a volatile market).
- We also make adjustments to the volatility based on the historical skewness of each asset class (e.g., increasing the volatility for an asset class that has been negatively skewed).
- In the case of private markets and other illiquid asset classes where historical volatility and correlations have been artificially dampened, we seek public market equivalents on which to base our estimates before applying any qualitative adjustments.
- These volatility and correlation expectations are then combined with our twenty-year return expectations to assist us in subsequent asset allocation work, including mean-variance optimization and scenario analyses.

[1] For example, we have less confidence in historical data that do not capture many possible market scenarios or that are overly polluted by survivorship bias.

Meketa Investment Group 2014 Annual Asset Study
Twenty-Year Annualized Return and Volatility Expectations for Major Asset Classes

Asset Class	Annualized Average Return (%)	Annualized Compounded Return (%)	Annualized Standard Deviation (%)
Equities			
Public US Equity	9.4	8.2	18.0
Public Developed Market Equity	10.5	9.0	20.0
Public Emerging Market Equity	14.3	12.0	25.0
Fixed Income			
Investment Grade Bonds	3.6	3.5	5.0
TIPS	4.3	4.1	8.0
Real Assets			
REITs	10.5	7.9	26.5
Commodities	8.0	6.5	20.0

Meketa Investment Group 2014 Annual Asset Study
Correlation Expectations

	U.S. Equity	International Developed Market Equity	Emerging Market Equity	Investment Grade Bonds	TIPS	REITs	Commodities
U.S. Equity	1.00						
International Developed Market Equity	0.90	1.00					
Emerging Market Equity	0.80	0.90	1.00				
Investment Grade Bonds	0.05	0.05	0.05	1.00			
TIPS	0.00	0.15	0.15	0.80	1.00		
REITs	0.70	0.70	0.60	0.15	0.20	1.00	
Commodities	0.35	0.55	0.60	0.05	0.35	0.30	1.00

Cover Memorandum and Investment Policy Statement

MEMORANDUM

To: San Francisco Retiree Health Care Trust Fund Board

From: Mika Malone, Brad Regier, Stephen McCourt
Meketa Investment Group

Date: May 8, 2014

Re: Investment Policy Statement Adoption Recommendation

Meketa Investment Group has worked through the creation of an Investment Policy Statement ("IPS") for the San Francisco Retiree Health Care Trust Fund ("RHCTF"). The IPS has been presented in draft form to the Board Chairman, as well as to Staff, and has gone through multiple iterations and edits. The most recent draft of this document is included in the materials for the upcoming meeting on May 22, 2014.

Given that the RHCTF Board still has two implementation options to consider for investing the assets of the Fund; the SFERS Pension Fund co-investment option, or the CalPERS CERBT investment option; there may still be minor edits required to the IPS. However, we believe the Board may consider adopting an IPS prior to making an investment decision. In this way, there would be a framework in place outlining the objectives, roles, and responsibilities of the various parties. The IPS is designed to be a living document, and making changes once adopted is a reasonably simple process.

We look forward to discussing the IPS and Implementation Plan with you at the May 22, 2014 meeting. If you have any questions, please do not hesitate to contact us at (760) 795-3450.

cc: Matt Podolin
Erik Rapoport

MLM/srt

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City and County of San Francisco
Retiree Health Care Trust Fund

D R A F T

Investment Policy Statement

Updated

May 6, 2014

I. Introduction

The City and County of San Francisco Retiree Health Care Trust Fund ("RHCTF") was created in 2009 for the sole and exclusive purpose of providing a funding source to defray the cost of the City's, and other Participating Employer's, obligations to pay for Health and Welfare Benefits for Retirees and their eligible spouses, registered domestic partners, dependents and survivors entitled to health care coverage under Charter Section A8.428.

The San Francisco Retiree Health Care Trust Fund Board (Board) is the governing fiduciary for the RHCTF, and, as such, is charged with governing the RHCTF.

The purpose of this Investment Policy Statement ("IPS") is to set forth the goals, objectives, and investment constraints of the RHCTF, and to establish guidelines for the implementation of investment strategy.

II. Investment Goals

The Board recognizes that a stable, well-articulated investment policy is crucial to the long-term success of the RHCTF. As such, the Board has developed this IPS with the following goals in mind:

- To clearly and explicitly establish the objectives and constraints that govern the investment of the RHCTF's assets;
- To establish a long-term target asset allocation with a likelihood of meeting the RHCTF's goals and objectives, given the explicit investment constraints;
- To protect the financial health of the RHCTF; and
- To clearly articulate duties of responsible parties.

III. Fiduciary Standards

a. As Trustees of the RHCTF, Board members are fiduciaries. The Board operates under the "RHCTF Board Fiduciary Policy", and intends to act in accordance with that Policy in the context of exercising its investment responsibilities. Accordingly, Board members must:

i. Act solely in the interest of the RHCTF's participants and beneficiaries, for the exclusive purpose of providing benefits and defraying the reasonable costs of managing the RHCTF's assets.

ii. exercise the care, skill, prudence and diligence that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims. .

iii. Diversify the investments of the RHCTF in order to minimize the risks of meaningful losses, unless under the circumstances it is clearly prudent not to do so.

iv. Act in accordance with RHCTF's authorizing statute and governing documents.

b. Fiduciary standards of conduct also apply to the RHCTF's staff, investment managers, custodians, investment consultants, and others who exercise discretionary authority or control over the management or disposition of the RHCTF's assets.

IV. Duties and Responsibilities

a. Board

The Board is responsible for establishing the policies and guidelines by which the RHCTF is managed.

b. Investment Managers

The Board may employ professional investment managers to give them the discretion to manage the RHCTF assets. Each investment manager will operate under a formal contract, which will include, but is not limited to, an outline of the strategy they have been hired to manage, performance expectations, and investment guidelines. The Board will periodically review the investment managers against their stated objectives.

c. Investment Consultant

The Board may retain an Investment Consultant to assist in performance review, asset allocation decisions, manager due diligence, and investment recommendations. The recommendations of the Investment Consultant may be considered by the Board in conjunction with other available information for the purpose of making informed and prudent decisions.

d. Custodian Bank

The Custodian Bank holds the assets of the RHCTF. The Custodian Bank accounts for, and assists in, the settlement and transfer of assets by investment managers and the RHCTF Staff. The Custodian Bank is expected to provide the RHCTF with timely information as related to portfolio holdings, transactions, and performance.

V. Investment Objectives

The investment strategy of the RHCTF is designed to ensure the prudent investment of funds in such a manner as to provide real growth of assets over time while protecting the value of the assets from undue volatility or risk of loss.

a. Risk Objectives

i. The Board recognizes that in order for the RHCTF to reach its target rate of return and meet its expected liabilities, the RHCTF must allocate a portion of assets to riskier, higher returning assets.

ii. The RHCTF will use diversification to minimize company-specific, industry-specific, country-specific, and other idiosyncratic risks in the aggregate investment portfolio.

iii. The RHCTF will monitor liquidity risk, thus maximizing the RHCTF's ability to meet disbursement needs during adverse market conditions. The Board anticipates that liquidity will not be a factor for a long period of time, given the legal structure around the RHCTF.

b. Return Objectives

i. In a manner consistent with the goals stated in Section II above, to manage the Fund's assets so as to achieve the highest, reasonably prudent real return possible.

VI. Investment Constraints

a. Legal and Regulatory

The Board intends that the RHCTF assets be at all times invested in accordance with applicable laws. The Board will retain legal counsel when appropriate to review contracts and provide advice with respect to applicable statutes and regulations.

b. Time Horizon

The RHCTF will be managed on a going-concern basis. The assets of the RHCTF will be invested with a long-term time horizon (twenty years or more), consistent with the goals stated in Section II above.

c. Liquidity

The Board intends to monitor the percentage of assets that it will invest in illiquid vehicles, defined as those vehicles that do not allow withdrawals to occur on at least a monthly basis.

d. Tax Considerations

The RHCTF is exempt from U.S. federal, state, and local income taxes. Therefore, investments and strategies will be evaluated on a basis of expected risk and return regardless of taxable status, except where the prospect of Unrelated Business Income Tax (UBIT) is a concern.

VII. Diversification

The Board of the RHCTF recognizes that the important element of risk control is diversification. Therefore, investments will be allocated across multiple asset classes, chosen in part for the expected correlation of their returns. Within each asset type, the Board will seek to distribute investments across individual holdings, thus further minimizing volatility. In addition, for appropriate investment managers, investment guidelines will specify diversification requirements, including, but not limited to, the maximum permissible investment in any one asset.

VIII. Asset Allocation

The Board recognizes that the allocation of monies to various asset classes will be the major determinant of the RHCTF's return and risk experience over time. Therefore, the Board intends to allocate investments across those asset classes that, based on historical and expected returns and risks, provide the highest likelihood of meeting the RHCTF's investment objectives. The Board retains the right to choose to invest the assets of the RHCTF alongside similar investors, in a pre-determined asset allocation structure. The Board acknowledges that, due to the size of the RHCTF assets, certain asset classes may not be investable until such time as the Fund becomes large enough to meet minimum investment criteria, or accept the illiquidity risk associated with such investments.

a. Permissible Asset Classes

Because investment in any particular asset class may or may not be consistent with the objectives of the RHCTF, the Board has specifically indicated in Appendix A those asset classes that may be utilized when investing the RHCTF assets.

b. Expected Returns, Risks, and Correlations for Permissible Asset Classes

The risk and return behavior of the RHCTF will be driven primarily by the allocation of investments across asset classes. In determining the appropriate allocation, the expected return and risk behavior of each asset class and the likely interaction of various asset classes in a portfolio are to be considered. Appendix B lists the expected return, volatility, and correlations for each permissible asset class.

c. Long-Term Target Allocations

Based on the investment objectives and constraints of the RHCTF, and on the expected behavior of the permissible asset classes, the Board will specify a long-term target allocation for each class of permissible assets. These targets will be expressed as a percentage of the RHCTF's overall market value, surrounded by a band of permissible variation resulting from market forces.

The long-term target allocations are intended as strategic goals, not short-term imperatives. Thus, it is permissible for the overall RHCTF's asset allocation to deviate from the long-term target, as would likely occur during manager transitions, asset class restructurings, and other temporary changes in the RHCTF. Deviations from targets that occur due to capital market changes are discussed below.

The RHCTF's target allocations for all permissible asset classes are shown in Appendix C.

d. Rebalancing

In general, cash flows to and from the RHCTF will be allocated in such a manner as to move each asset class toward its target allocation.

The Board recognizes that, periodically, market forces may move the RHCTF's allocations outside the target ranges. The Board also recognizes that failing to rebalance the allocations would unintentionally change the RHCTF's structure and risk posture. Consequently, the Board has established the following process to rebalance the allocations periodically.

On at least an annual basis, if any strategic allocation is outside the specified target range, assets will be shifted to return the strategy to within the target range. The specific plan for rebalancing will identify those assets that can be shifted at the lowest possible risk and cost, if the rebalancing cannot be accomplished solely by allocating contributions and withdrawals.

IX. Review of Investment Policy, Asset Allocation, and Performance

The Investment Policy Statement will be reviewed at least annually to ensure that the objectives and constraints remain relevant. However, the Board recognizes the need for a stable long-term policy for the San Francisco Retiree Health Care Trust Fund, and major changes to this policy statement will be made only when significant developments in the circumstances, objectives, or constraints of the RHCTF occur.

The asset allocation and investment structure of the RHCTF will be reviewed on an on-going basis, and at least annually. When necessary, such reviews may result in a rebalancing of asset allocation. In general, the Board intends that the RHCTF will adhere to its long-term target allocations, and that major changes to these targets will be made only in response to significant developments in the circumstances, objectives, or constraints of the RHCTF or in the capital market opportunities.

The Board will specifically evaluate the performance of the RHCTF relative to its objectives and to the returns available from the capital markets during the period under review, within the constraints created by size and structure. In general, the Board will utilize relative, rather than absolute, benchmarks in evaluating performance. The total performance of the RHCTF will be evaluated relative to the investment objectives and constraints identified in this investment policy statement. Specifically, the total Fund performance will be evaluated relative to a "custom benchmark" that weights the returns of available market indices on the basis of the RHCTF's target investment structure, to assess the implementation of the RHCTF's investment strategy.

X. Investment Manager/Provider Review

The RHCTF's investment managers will be reviewed periodically to verify that they remain appropriate for the RHCTF. Each manager's suitability as an investment manager for the RHCTF will be judged from a variety of perspectives including, but not limited to, stability and capability of professional staff, adherence to investment disciplines for which the manager was retained, business practices, prudent management of risk, investment performance, and client communication. If an outside structure is utilized to invest the assets, then the provider of the investment fund will be reviewed for consistency with RHCTF objectives.

XI. Investment Costs

The Board intends to monitor and control investment costs at every level of the RHCTF.

- Professional fees will be negotiated whenever possible; existing fees will be reviewed periodically and re-negotiated, as appropriate.
- Where appropriate, passive portfolios will be used to minimize management fees and portfolio turnover.
- If possible, assets will be transferred in-kind during manager transitions and portfolio restructurings to eliminate unnecessary expenses.
- Managers will be instructed to minimize brokerage, execution, and other costs.

XII. Voting of Proxies

The Board recognizes that the voting of proxies is important to the overall performance of the RHCTF investments. The Board may delegate the responsibility of voting all proxies to the investment manager[s] or a third party. The Board expects that all proxies will be executed in a timely fashion. The Board intends to review the voting actions periodically. The Board retains the right to exercise acquired voting rights at any time.

XIII. Socially Responsible Investments

The Board Recognizes that there may be unique circumstances which require the Board to consider socially responsible investments (or divestment) or other restrictions. The Board intends to consider such matters when appropriate, and when the size of the RHCTF is large enough that separate account mandates could be considered. The Board acknowledges that within commingled accounts or mutual funds, it may not have the ability to direct the specific inclusion or exclusion of securities.

XIV. Forbidden Assets and Strategies

Appropriate investment managers retained by the RHCTF may be furnished by the investment consultant with a list of asset types and investment strategies that are forbidden as part of their investment manager guidelines.

APPENDIX A

PERMISSIBLE ASSET CLASSES

Asset Class
Domestic Equity
International Equity
Investment Grade Bonds
Global Equity
U.S. Nominal Bonds
Inflation-linked Bonds
Global Real Estate
Commodities

APPENDIX B

MEKETA INVESTMENT GROUP – 2014 ASSET STUDY
TWENTY-YEAR, SINGLE ASSET CLASS FORECAST

Asset Class	Expected Return (%)	Volatility (%)
Fixed Income		
Cash Equivalents	2.3	1.0
Investment Grade Bonds	3.5	4.5
TIPS	4.0	7.5
Equities		
US Equity	7.8	18.0
Developed Market Equity	8.5	20.0
Emerging Market Equity	11.2	25.0
Global Equity	8.7	20.0
Real Assets		
Real Estate	7.6	18.0
REITs	7.0	26.5
Commodities	6.0	20.0

MEKETA INVESTMENT GROUP – 2014 ASSET STUDY
EXPECTED CORRELATIONS AMONG ASSET CLASSES

	Investment Grade Bonds	TIPS	U.S. Equity	Developed Market Equity	Emerging Market Equity	Global Equity	Real Estate	REITs	Commodities
Investment Grade Bonds	1.00								
TIPS	0.80	1.00							
U.S. Equity	0.05	0.00	1.00						
Developed Market Equity	0.05	0.15	0.90	1.00					
Emerging Market Equity	0.05	0.15	0.80	0.90	1.00				
Global Equity	0.05	0.10	0.90	0.95	0.90	1.00			
Real Estate	0.20	0.10	0.50	0.45	0.40	0.45	1.00		
REITs	0.15	0.20	0.70	0.70	0.60	0.70	0.80	1.00	
Commodities	0.05	0.35	0.35	0.55	0.60	0.50	0.15	0.30	1.00

APPENDIX C

ASSET ALLOCATION TARGETS- TBD

Asset Class	Target	Range	Composite Benchmark