AGENDA ITEM DETAILS

Subject: *Review of the Investment Performance for Fourth Calendar Quarter of 2019 and Risk Update

Background:

In accordance with the contract for performance evaluation services and Chapter VI of the Employees Retirement System (ERS) Investment Policy, NEPC, LLC quarterly reviews and evaluates ERS investment performance as calculated by custodian BNY Mellon.

Summary of Investment Markets:
Equities ended 2019 in a blaze of glory with emerging markets leading the way with fourth-quarter returns of 11.8%, bolstered by a trade pact between the United States and China; non-US developed market stocks were up 8.2% and US small-cap equities gained 9.9% during the same period. In the US, growth outperformed value by 3.2%, in line with a trend established in the aftermath of the financial crisis, with the annualized difference totaling 3.6% over the last 10 years. NEPC continues to recommend a balanced exposure across value and growth stocks. While small caps edged out large caps for the three months ended December 31, large caps carried the year with returns of 31.5%, according to the S&P 500 Index, trouncing the Russell 2000 Index's gains of 25.4%. Outside the US, developed market small caps outperformed large caps by 3% with returns of 24.9%.

Private equity fundraising totaled $182 billion globally in the fourth quarter, bringing the total for the year to $614 billion, in line with the past three-year average of $603 billion, according to data from Preqin. Buyout activity in the fourth quarter stood at $140 billion compared to an average of $176 billion over the prior four quarters, according to PitchBook data. Buyout exit activity slowed for the three months ended December 31, totaling $73 billion compared to an average of $88 billion in the earlier four quarters. Buyout activity totaled $318 billion, the lowest since 2012. On the other hand, venture capital deal activity ticked up in the fourth quarter to $34 billion, up $2 billion from the previous quarter. Venture capital exit activity in the same period stood at $19 billion, down from $43 billion in the third quarter; however, for the year, venture capital-backed exit value hit a 10-year high of $256 billion, according to PitchBook.

Fixed-income securities ended 2019 in the black, reversing declines from the year earlier. Spreads on high-yield credit narrowed for most part of the year, but segments in the high yield and bank loan market showed signs of stress towards the end of 2019. On a risk adjusted basis, high-yield and bank loan CCC-bonds posted their worst performance since the financial crisis. US credit ended the year up 13.7%, according to the Bloomberg Barclays Aggregate Index, while the Bloomberg Barclays High Yield Index gained 14.3% in 2019; the S&P LSTA Leveraged Loan Index returned 10.6% during the same period.

Meanwhile, credit hedge funds had a positive quarter, underscoring the flight to quality as investors gravitated towards higher-rated assets while distressed strategies lagged. The HFRI Credit Index was up 6.7% in 2019, while the HFRI ED: Distressed/Restructuring Index returned 2.9% last year. Outside the US, emerging market debt performed robustly but concerns were elevated due to heightened geo-political risks and an overall slowdown in global growth. The JPM EMBI Index was up 15%, while the JPM GBI Index was in the black, gaining 13.4% last year. The significant growth of credit since the financial crisis, combined with deteriorating quality and increasing amounts of leverage, may eventually create opportunities in distressed debt. Niche lending and investment-grade collateralized loan obligations

(CLOs) offer the potential for risk-compensation given their structural nuances and potential for credit selection.

The Bloomberg Commodity Index rose 4.4% in the fourth quarter. Mining, agriculture and energy equities were in the black during the same period, with gains of 12.6%, 9.8% and 6.2%, respectively. Given persistent negative-roll yields for most commodities and low interest rates, NEPC still believes that equities of natural resources—and not direct ownership—offer a more efficient way to gain exposure to this asset class. Midstream energy ended the year up more than 24%. Performance between master limited partnerships (MLPs) and c-corps (any corporation that is taxed separately from its owners and is the most common legal structure for a corporation) diverged significantly in 2019, with the Alerian MLP Index underperforming the Alerian Midstream Energy Index, a broader index inclusive of c-corps.

Real estate investment trusts (REITs), represented by the FTSE NAREIT Composite Index, wavered in the fourth quarter as concerns over valuations put a stop to the year long rally. Still, REITs ended the year as one of the strongest performers within real assets, returning 28%. Property types with robust demographic drivers (data centers, industrial, health care) as well as defensive properties (net lease) led performance. Overall, REITs are trading at a premium of over 15% to consensus net asset values, although discounts can still be found in the retail and office space. In private real estate, core returns were modest compared to the past 10 years, with the NCREIF ODCE Index reporting a third quarter gross return of 1.3% (the most recent quarterly data available). Our view is that core real estate returns will continue to moderate, with most of the gains coming from current income. Retail continues to show weakness as e-commerce cuts into sales of traditional retailers; regional malls are the hardest hit, while grocery-anchored centers have proven resilient.

Last year was a triumphant one for investors. Accommodative monetary policies, falling interest rates and subdued inflation not only helped them meet their return objectives, but also, in many instances, exceed them. As a new year (and decade) begin, this protracted winning streak may leave investors believing that these windfall gains can continue to prevail, and this extended economic expansion can keep a recession at bay even in this late phase of the market cycle.

At NEPC, we believe the returns of 2019 (and the past decade) are unlikely to carry forward into the next 10 years. To this end, we encourage a renewed emphasis on strategic asset allocation to ensure overall investment objectives align with long-term risk-return parameters. While an accommodative monetary policy and fiscal debt growth can continue to power higher equity valuations, risks remain in this late phase of the economic cycle, making diversification and balance paramount. We encourage investors to overweight emerging market equities relative to developed market stocks as emerging markets offer the highest potential for total returns. In addition, defensive assets will continue to play a pivotal role to balance risks in a diversified portfolio and aid investors when markets experience a dislocation, whenever that day may come.

SUMMARY OF ERS PERFORMANCE

In the year ended December 31, 2019 (refer to Figure 1) the Fund return of 14.4% underperformed the policy benchmark by 2.2% and outperformed the actuarial rate of return. The Fund's assets increased from \$26.87 billion to \$29.41 billion in the past year which includes a \$2.98 billion investment gain for the year.

In the three–year period ended December 31, 2019 (refer to Figure 1) the Fund return of 9.3% outperformed the benchmark by 0.5% and outperformed the Plan's actuarial rate of return. On a risk-adjusted basis (refer to figure 2), the Sharpe and Sortino Ratios over this period indicate that the plan generated significantly more return for each unit of risk and each unit of downside risk experienced versus the policy benchmark; therefore, active management added value.

Figure 1

	Market Value($)	3 Mo(%)	Fiscal YTD(%)	1 Yr(%)	3 Yrs(%)	5 Yrs(%)	10 Yrs(%)
Total Fund	29,406,588,242	3.9	4.8	14.4	9.3	7.1	7.9
Total Fund Policy Index		4.3	5.3	16.6	8.8	6.9	7.7
Long Term Public Index		6.9	8.5	22.2	10.3	7.2	7.9

Figure 2

3 Years Ending December 31, 2019	Anlzd Return	Anlzd Standard Deviation	Sharpe Ratio	Sortino Ratio RF
Total Fund	9.31%	5.13%	1.49	1.55
Total Fund Policy Index	8.76%	6.45%	1.10	1.23

5 Years Ending December 31, 2019	Anlzd Return	Anlzd Standard Deviation	Sharpe Ratio	Sortino Ratio RF
Total Fund	7.13%	5.54%	1.10	1.46
Total Fund Policy Index	6.91%	6.75%	0.87	1.20

In the five-year period ended December 31, 2019 (refer to figure 1) the Fund returned 7.1% per year and outperformed the policy benchmark by 0.2%. Referring to Figure 2, the Fund's Sharpe and Sortino Ratios indicate strong returns per unit of risk taken and strong returns per unit of downside risk experienced indicating active management added value.

Referring to Figure 3, asset class exposures are within the target ranges outlined in the strategic asset allocation policy.

Figure 3

Asset Allocation on December 31, 2019	Current	Current	Long-Term Target	Long-Term Target Range
Public Equity	$11,469,049,044	39.0%	37.0%	27.0% - 47.0%
Total Rates	$5,031,067,041	17.1%	11.0%	
Global Credit	$2,813,789,696	9.6%	11.0%	1.0% - 21.0%
Opportunistic Credit	-	-	3.0%	0.0% - 8.0%
Private Equity	$4,312,337,922	14.7%	13.0%	8.0% - 18.0%
Absolute Return	$1,049,552,734	3.6%	5.0%	0.0% - 10.0%
Real Estate - Private	$2,232,727,329	7.6%	9.0%	4.0% -14.0%
Real Estate - Public	$937,570,770	3.2%	3.0%	0.0% - 13.0%
Infrastructure	$886,270,254	3.0%	7.0%	2.0% - 12.0%
Cash	$552,722,422	1.9%	1.0%	0.0% - 1.0%
ERS Launchpad	$121,500,931	0.4%		
Total	**$29,406,588,242**	**100.0%**	**100.0%**	

ATTACHMENT(S):

1. Exhibit A - ERS Investment Performance Book
2. Exhibit B - Trust Performance Summary December 31, 2019
3. Exhibit C - Risk Update Appendix