A Historical Perspective and Rationale for Increased Exposure: The Role of Alternatives in SBA Portfolio Construction

Asset allocation is central to the SBA executing on its investment mission to generate long term returns within acceptable levels of volatility. Approximately 40 years ago, the pension plan added equities to the portfolio mix to generate the returns necessary to meet benefit obligations. Since then, the financial markets have evolved, offering additional strategies and structures that have the potential to generate returns and/or reduce risk. While such strategies are often generically labeled "Alternatives" and are investments that serve as alternatives to a traditional equity or fixed income investment, they are very much mainstream investments across pension plans, endowments and foundations. Alternative investments provide a differentiated and attractive source of return and often are risk reducing and/or risk diversifying.

Portfolio diversification is an effective way to mitigate risk and protect against volatility. The traditional 60% Equity/ 40% Fixed income portfolio relied on equities to drive long term returns and fixed income to deliver yield and diversification particularly when equity markets declined. Private Equity assets, like equity assets, drive long term return. Private Equity assets are expected to generate returns in excess of the public markets as a result of a number of factors including illiquidity premium, access to high growth and early stage companies, the ability to drive operational improvements and change though significant ownership. Assets in Strategic Investments are another tool in the diversification toolkit. They generally exhibit lower to no correlation to either traditional Equity and Fixed Income markets. In addition, they tend to perform better than equities in down markets, thereby providing further diversification and lowering overall volatility of the plan. Many investments in Alternatives also provide a yield in excess of Fixed Income. Investing in strategies like private credit and real assets among others is an evolution of modern portfolio theory, i.e. that portfolio diversification can enable investors to construct portfolios maximizing returns within risk tolerances.

The below table is a simplistic expression of the benefits of diversification. In any given year, public market or Alternative investments may lead returns. Having exposure to this broad set of assets enables more consistent performance across years and market cycles.

Better Performing

	FY 07-08	FY 08-09	FY 09-10	FY 10-11	FY 11-12	FY 12-13	FY 13-14	FY 14-15	FY 15-16	FY 16-17	FY 17-18	FY 18-19	FY 19-20	FY 20-21
	Real Estate	Fixed Income	Strategic Investments	Global Equity	Real Estate	Global Equity	Global Equity	Private Equity	Real Estate	Global Equity	Private Equity	Private Equity	Fixed Income	Private Equity
	Private Equity	Cash	Private Equity	Strategic Investments	Fixed Income	Strategic Investments	Private Equity	Real Estate	Private Equity	Private Equity	Global Equity	Real Estate	Private Equity	Global Equity
	Fixed Income	Real Estate	Global Equity	Real Estate	Private Equity	Real Estate	Real Estate	Strategic Investments	Fixed Income	Strategic Investments	Strategic Investments	Fixed Income	Global Equity	Strategic Investments
	Cash	Private Equity	Fixed Income	Private Equity	Strategic Investments	Private Equity	Strategic Investments	Fixed Income	Strategic Investments	Real Estate	Real Estate	Strategic Investments	Real Estate	Real Estate
	Strategic Investments	Global Equity	Cash	Fixed Income	Cash	Fixed Income	Fixed Income	Global Equity	Cash	Cash	Cash	Global Equity	Cash	Fixed Income
	Global Equity	Strategic Investments	Real Estate	Cash	Global Equity	Cash	Cash	Cash	Global Equity	Fixed Income	Fixed Income	Cash	Strategic Investments	Cash
Total Fund Return	-4.42%	-19.03%	14.03%	22.09%	0.29%	13.12%	17.40%	3.67%	0.54%	13.77%	8.98%	6.26%	3.08%	29.49%

Just as diversification across asset classes serve to improve returns relative to risk, so too does diversification achieve through manager/fund selection. Within Private Equity and Strategic Investments, we are diversified in types of strategies and the return drivers. Through a robust diligence process and constant evaluation of market opportunity, we seek to identify managers that will outperform over the long term. We do not expect that every strategy will outperform in every year and while we strive to select only strategies that will outperform over the long term, the reality of investing in both public and private markets is that some strategies may not ultimately achieve the objective.

Private Equity: History, Successes and Challenges

Private Equity (PE) investments include buyouts, co-investments, secondary investments, distressed/turnaround investments, and venture capital. The SBA made its first investment in PE in January 1989. At the time Private Equity was considered a sub-strategy within the SBA Domestic Equity asset class. Investments were made in a handful of private equity funds over the next 10 years. In the late 1990s, it was determined that in order to be successful investing in private equity, it needed to be its own asset class. In response, the SBA created the private equity asset class (Private Equity or PE), giving it a dedicated allocation, hiring full-time staff to create and manage the program, and hiring an asset class consultant. The new Private Equity asset class's first investment was made in November 1999.

The target allocation for Private Equity is 6% with a Policy High/Low Range of 10%/2%. As a result of strong performance, Private Equity currently accounts for 9% of the total FRS Trust Fund. The SBA typically invests in Alternative investments as a limited partner in an investment partnership (i.e. a "fund investment"). Private Equity (PE) has invested in a total of 218 fund investments, which are managed by 67 general partner relationships. Since the inception of the asset class through December, 2020, $30.4 billion has been committed. The portfolio has successfully created value in the form of distributions and capital appreciation (net asset value in excess of paid in capital). In total, the PE Asset class has generated $17.3bn in value above amounts invested in the funds.

The Private Equity benchmark is a global public equity benchmark (MSCI ACWI IMI) plus 3%. The asset class has delivered returns well in excess of what could be achieved with broad public market exposure. Not only has the asset class beaten a public market benchmark, but the asset class has demonstrated skill is selecting top performing managers in many areas of Private Equity. For example, 90% of capital that has been committed with venture capital has been with funds that achieved top quartile performance. Across buyouts, distressed/turnaround and secondaries the percent of capital committed with top quartile funds is 59%, 75% and 42%, respectively. In total, across all of these areas of Private Equity, the SBA has delivered performance in the top quartile of Cambridge Associates client returns.

Strategic Investments: History, Successes and Challenges

Strategic Investments include debt, equity, real assets, diversifying strategies, flexible mandates and special situations. This encompasses a wide array of strategy types, such as private credit, long/short equity, infrastructure, insurance and royalties. The Strategic Investments asset class was formed in June 2007. In 2010, a target allocation of 6% was established. This was increased to 11% in 2012 and to 12% in 2014. Both increases were based on consultant recommendations to diversify more into a broader array of investment types that do not necessarily fluctuate with the equity market. The recommended increase moved the SBA more in-line with the practices of its largest public pension fund peers at that time. Today, the target remains at 12% with a High/Low Range of 16%/0% and Strategic Investments currently accounts for 9% of the total FRS Trust Fund. As with PE, the SBA typically accesses Strategic Investments as fund investments. Strategic Investments has a total of 189 active funds managed by 113 separate general partner relationships

The role of Strategic Investments is to generate returns in excess of a 4% real rate of return, reduce volatility of the FRS Pension Plan and outperform the Pension Plan during periods of significant market declines. Because Strategic Investments by design consists of a wide variety of strategies, the performance drivers are varied.