City of Cincinnati Retirement System
Investment Committee Meeting
Minutes
November 7, 2024 / 12:00 P.M.
City Hall – Council Chambers and remote

Committee Members Present
Bill Moller, Chair
Tom Gamel, Vice Chair
Kathy Rahtz
Mark Menkhaus, Jr.
Monica Morton
Seth Walsh
Aliya Riddle

Administration
Jon Salstrom

Marquette
Brett Christenson

CALL TO ORDER
Chair Moller called the meeting to order at 12:03 p.m. and a roll call of attendance was taken. Committee members Moller, Gamel, Rahtz, Menkhaus, Morton, Walsh, Riddle and Morris were present.

PUBLIC COMMENT
No public comment.

APPROVAL OF MINUTES
Approval of the minutes of the Investment Committee meeting of August 1, 2024, was moved by Committee member Gamel and seconded by Committee member Menkhaus. The minutes were approved by unanimous roll call vote.

Old Business
Update Investment Manager Contracts

- *Private Credit Contracts* – Director Salstrom explained that all contracts for the Private Credit Managers have been completed, with Bain being the last to finalize. A significant capital call was made by Twin Brook, calling 90% of the $30 million target ($27 million). This brings the total closer to 4.5% of the 6.5% funding target. Capital calls are expected to continue, and it’s hoped the target will be met sooner than expected. There’s around $20 million from HIG Bayside, with $4 million received in the last

quarter. The speed of this capital return could affect reaching the 6.5% target. However, over the next year, progress toward the target is expected.

- *Real Estate – PRISA III* – Director Salstrom explained that the PRISA Reals Estate contract has been completed, but it hasn't been executed on the PRISA side yet. It is expected to close on 12/31, with a slower capital draw anticipated. The goal is to reach the 6.5% target over the next year, although the pace will vary depending on market conditions and the speed at which money is called.

New Business

Brett from Marquette was in attendance to present.

Current Market Environment Report

- Yield Curve & Fixed Income:
  - The yield curve has fallen significantly over the past year, largely due to the Federal Reserve's rate cuts, which helped boost Fixed Income returns (the aggregate index rose 11.6% over the last year).
  - The speed of the yield curve's drop was faster than expected, though the Fed's rate cuts have been relatively modest (currently at 4.5% with a potential 0.25% reduction in the coming months).
  - Markets anticipate rates will eventually settle around 3.5% but the likelihood of a significant rate cut has decreased due to the economy's strength.
  - There has been volatility in the bond market reactions to rate expectations, with some big swings in bond returns, particularly in October.
- Equity Market Performance:
  - The market has performed well, with the Russell 3000 up 21% YTD, and the 1-year return at 35%. International markets (ACWI ex. US) have also seen strong returns, up 14%.
  - There's a notable gap between large-cap growth and small-cap value, with large-cap growth up 24.5% YTD and small-cap value up only 9.2%.
  - The portfolio has a 2.4% allocation to small-cap value, giving it a 7% overweight in this area. It also has a 2.5% allocation to large-value stocks, which are up 16.7% YTD.
  - The portfolio has a 15% value bias toward U.S. equities, which benefited in Q3. Small caps seem to be favored with the gradual rate decrease cycle, and this bias will continue to be monitored.
- Real Estate:
  - The NCREIF NPI showed a slight decline of 30 basis points in Q2, but Q3 results were positive (a small 0.25% return).
  - Income in real estate remains strong at 4-4.5%.
  - All submarkets of real estate have stabilized, except for office spaces, which continue to show weakness. However, office space makes up a smaller portion of the overall portfolio.
  - Overall, it's believed that real estate is nearing the end of its reset phase and will begin to see positive returns in the future.
- Private Equity:
  - Valuations: Valuations in Private Equity have been suppressed, similar to real

estate due to the high interest rate environment. Higher rates mean higher debt payments for leveraged companies, which affects valuations.
    - Deal Flow: There has been a slowdown in deal flow over the past 18 months, but it's starting to improve as rates are expected to gradually decline.
    - Distributions: Distributions from older Private Equity investments have decreased over the last 12-18 months, which is normal across the industry, not just for this portfolio. As deal flow picks up, distributions are expected to ramp up, and valuations should improve slightly.
- Private Credit
    - Investment Strategy: The focus is to get as much of the capital deployed as quickly as possible. The managers are underwriting loans with yields of 12-13%, and they are floating-rate, meaning as interest rates decrease, new loans will be underwritten at lower rates.
    - Yield: Despite the expected rate decreases, the portfolio is still yielding elevated returns, which is favorable for the plan.

Quarterly Investment Report

- Private Equity and Private Debt:
    - Private Equity: The portfolio hasn't made allocations in private equity for a few years, and there's a recommendation to resume these allocations to keep pacing. Recent distribution activity has been lower, but it's expected to pick up as the market improves.
    - Private Credit: The goal is to get capital deployed quickly. Managers like Twin Brook are underwriting loans with high yields (around 12-13%). These floating-rate loans will adjust with interest rate changes but will remain strong in terms of yield.
- Portfolio Activity and Allocations:
    - Redemptions: The portfolio has redeemed significant amounts, including $5 million from Shenkman and several redemptions for real estate managers, but still has about $8-9 million overweight in real estate.
    - Private Debt: The commitment to H.I.G. Bayside is in the distribution phase, and $4-5 million is expected back. New allocations to private debt include $30 million across five managers, with some funds already deployed by Twin Brook and JP Morgan.
    - Asset Allocation: The portfolio is slightly underweight in private debt and fixed income and overweight in private equity by about $74 million, though this is a result of past allocations and is expected to be managed as distributions occur.
- Performance & Returns:
    - Portfolio Growth: The portfolio grew from $2.3 billion to $2.395 billion year-to-date, with $220 million in gains and $120 million in outflows.
    - Asset Allocation vs. Target: The portfolio is underweight by about $40 million in fixed income and $91 million in private debt. There's a slight overweight in private equity and real estate.
    - Risk/Return: The portfolio has taken on slightly more risk than the median, but recent adjustments to reduce risk should help improve the return-to-risk profile.
    - Performance by Sector: Equities, fixed income, and private debt all performed

well, with fixed income seeing a significant contribution to returns. Real estate showed positive returns, and private equity distributions are starting to flow again, though at a slower pace.

- Equity and Fixed Income:
  - Equities: The portfolio is outperforming the Russell 3000, especially with large- and small-cap value stocks.
  - Fixed Income: Fixed income returns were strong, with managers like Diamond Hill, Loomis, and Shenkman performing well in the volatile market.
- Real Estate & Infrastructure:
  - Real Estate: Real estate saw positive returns, and while office spaces continue to be a drag, other submarkets have stabilized. The portfolio is seeing improvement after a long period of stagnation.
  - Infrastructure: Infrastructure investments are performing well, with a strong YTD return of 5.2%, though some individual funds like Alinda are still small and volatile.
- Private Equity:
  - The private equity portfolio has been growing over time, with significant allocations starting in 2007-2008 and more consistent investments from 2014 onward. Distributions have slowed in recent years but are starting to pick up again.

Key points to note:

- Private Equity Adjustments: It was acknowledged that private equity is overweight, but also mentioned that distributions have been slow, especially in a higher interest rate environment. With allocations to private debt, CRS is balancing this risk and aiming for more income-producing assets like fixed income and private debt.
- Fixed Income and Duration: The discussion on duration risk, especially with managers like Diamond Hill and Loomis, is crucial in a higher interest rate environment. The higher duration in Loomis means more sensitivity to rate changes, whereas Diamond Hill's portfolio seems a bit more stable in that respect. We're balancing between corporate bonds (Loomis) and more asset-backed securities (Diamond Hill), aiming for stable returns as interest rates fluctuate.
- Performance Overview: The positive returns were highlighted for the quarter, with fixed income seeing strong performance, especially from managers like Shenkman. The value allocations in equities (large-cap and small-cap) are starting to look favorable as well.
- Peer Comparison: On page 17, there's an analysis of how the portfolio stacks up against peers, which helps to give context for performance relative to similar-sized plans. The slight underweight to hedge funds and the overweight to infrastructure might suggest a tilt toward more real assets and income-producing strategies.

Private Equity Pacing Plan '25 / Private Equity Recommendations for 2025 Investing

- Pacing Model Overview: This pacing model is key to maintaining consistent and gradual investments in private equity without overexposing the portfolio to any specific vintage year. The idea is to spread commitments over time (e.g., around $25 million annually) to ensure that cash flows from capital calls and distributions become more balanced as the program matures.

- Capital Calls & Distributions: Private equity commitments are typically drawn down over 3-5 years. Distributions, however, don't come back until investments are liquidated, which can take years. This slow cycle means you can't just commit all your capital at once; you have to pace it to avoid locking in large amounts of capital during market downturns. The pacing model helps mitigate that risk by spreading the capital calls evenly.
- Managing Private Equity Exposure: The goal is to maintain an 8% target allocation to private equity over time, even though the portfolio is currently overweight at 11%. With proper pacing and a gradual commitment strategy, the portfolio should ideally return to a more balanced exposure as the funds mature and start making distributions.
- Adjustments for Market Conditions: Models can't perfectly predict market conditions (e.g., COVID or the drastic shift in interest rates), so there's some flexibility built into the pacing. Even if distributions take longer than expected, pacing your commitments can help manage risk and stabilize the portfolio's private equity exposure over the long term.
- Future Projections: The model suggests gradually decreasing the annual commitment amounts to around $20-$25 million as the portfolio matures, ultimately hitting around $20-$22 million per year by 2030. This will align more closely with the 8% target over time as older funds begin to distribute more capital.
- Distributions Lagging: The recent dip in distributions (compared to expectations) is important to keep in mind, especially given that the pacing model assumes distributions should start to pick up significantly over the next few years. The lag in distributions (especially from newer funds) is something to monitor closely to ensure that the portfolio stays on track for its long-term target.

Chair Moller made a motion to accept the quarterly Investment Report from Marquette, as well as to approve the private equity recommendations: $12-$15 million to Siguler Guff Fund VI, $7-$10 million to JPM Co-Investment II, and $5 million to Timber Bay Fund III. Trustee Gamel seconded the motion. The motion was approved by unanimous roll call vote.

IPS addition of Selection and Monitoring procedures

Brett explained the target benchmark approach and how it will allow for flexibility and ensures that the benchmark evolves in tandem with any changes in asset allocation. It helps the committee stay aligned with the investment strategy and gives an updated baseline for performance comparison.

Chair Moller made a motion to update the current target benchmark to better reflect the portfolio's investments. The motion included that the target benchmark be reviewed and updated if necessary after the asset allocation study is completed and accepted by the Board, or at least annually after the 4th quarter Investment Report is accepted. Trustee Morris seconded the motion. The motion was approved by unanimous roll call vote.

Value Bias Update and Recommendation

The goal is to eventually move toward using just the Russell 3000 index as the benchmark for the portfolio. Historically, the portfolio has been trying to outperform this index, but it's been challenging, particularly with the value bias strategy. The value bias used to be much more

significant (over 50%) but has now been reduced to around 8%. The goal is to be more timely with these adjustments, aiming to avoid locking into a strategy that's underperforming. While the long-term target is to simplify to the Russell 3000, Brett suggested that the committee still review the value bias and make adjustments every quarter to ensure the portfolio remains aligned with market conditions and goals.

Chair Moller referenced the Investment Policy in the packet and made a motion to accept the amendments made to the CRS Staff definition and the Investment Manager Selection Monitoring and Communication. Trustee Rahtz seconded the motion. The motion was approved by unanimous roll call vote.

Training – Investment Terms and Concepts

The purpose of the training was to discuss various components of a complex plan, involving a $2.5 billion fund, with only four meetings per year. This makes it challenging to stay fully on track amidst global changes. The discussion started with broad concepts before delving into infrastructure and private equity.

Brett began with slide 4, outlining the committee's goal of achieving a 7.5% annual rate of return after fees and expenses, while minimizing risk. The primary strategy is to build a diversified portfolio. Asset allocation is key, as studies have shown that it drives 91% of long-term risk (as measured by return variability), making the choice of subasset classes far more impactful than selecting specific managers or rebalancing. The focus is on achieving returns with the least risk possible.

Brett touched on the power of compound interest-emphasizing that even small differences in returns (e.g., 5% vs. 7% over 40 years) have dramatic effects. However, unlike pension funds, this plan doesn't have the luxury of long-term compounding, as money coming in is typically paid out for benefits. With current payouts around 6.75-7%, earning 7.5% or higher would allow the plan to grow.

Risk was discussed, particularly standard deviation, which measures the variability of dispersion of returns from the expected outcome.

Benefits of Diversification:

- Protects the portfolio across different extremes of the market.
- Reduces risk by spreading investments across various assets and sectors.

Cost Considerations:

- Importance of minimizing management fees, transaction charges, and man-hours of oversight when implementing diversification strategies.
- Emphasis on finding a balance between diversification and associated costs, ensuring cost-effectiveness.

Correlation is the metric used to assess diversification between asset classes.

Correlation scale:

- +1 indicates that two asset classes move in the same direction (highly correlated).

- -1 indicates that two asset classes move in opposite direction negatively correlated).

A correlation less than 1 between asset classes is desirable for diversification purposes, as it means the assets are not perfectly correlated and can help reduce overall portfolio risk. Adding asset classes with favorable risk and return characteristics is beneficial, but only if they have correlations less than 1 with other asset classes in the portfolio. This ensures that each asset class adds true diversification by behaving differently under various market conditions. If an asset class offers good return and low risk, it's a positive addition. However, if another asset class offers the same return and risk characteristics, it may not add value to the portfolio.

The aim is to achieve the optimal portfolio on the risk/return spectrum by combining asset classes. Lower correlation between asset classes reduces overall portfolio risk. Choose the portfolio on the "Efficient Frontier" that meets your organization's target return.

Private Equity Overview:

- Private Equity refers to investments in private business, either directly or through funds. It involves investing in companies that are not publicly traded.
- Private Equity Funds: When investing in Private Equity funds (e.g., Siguler Guff), those funds, in turn, invest in other Private Equity funds that invest in businesses.

Buyouts in Private Equity:

- Leveraged Buyouts focus on gaining control of a business, typically using a significant amount of borrowed funds to finance the acquisition.
- Buyouts represent the largest segment of the Private Equity market.
- The primary goals of buyouts include:
    - Taking control of the business.
    - Offering cash flow to support business growth.
    - Providing strategic advice, tools, and expertise to improve operations and create value.

Complexities of Private Equity:

- Private Equity is relatively complicated due to its structure and the various layers of investment (funds-to-funds structure, control strategies etc..)
- Understanding how Private Equity fits within the portfolio's diversification strategy is critical, as it may introduce unique risk/return profiles and require a more in-depth analysis to assess its impact on overall portfolio performance.

Infrastructure Overview:

- Infrastructure represents the physical assets essential for operating society and supporting economic, industrial, and social growth.
- 10% of the Portfolio: The portfolio has exposure to infrastructure through private investments in key assets.
- Managers: There are 3 managers overseeing the infrastructure investments, focusing on private infrastructure assets.

Why we like Infrastructure Investments:

- Essential assets: Infrastructure assets are crucial for the functioning of society. Without

them, economic activity would not be sustainable.

- Long Asset Life: These assets tend to have long lives, offering stability and predictability in terms of cash flows.
- Key Characteristics of Infrastructure Assets:
  - Essential service to society
  - Inflation protection: Infrastructure can act as a hedge against inflation due to steady demand and price adjustments.
  - Long asset life
  - Low elasticity of demand: The demand for these services remains relatively constant.
  - Monopoly or quasi-monopoly: Many infrastructure sectors are dominated by a few players or are naturally monopolistic.
  - Regulatory oversight: These assets are often heavily regulated, offering a degree of protection and predictability.
  - Stable and predictable cash flows: Infrastructure assets tend to generate stable income over time.

Types of Infrastructure:

- Economic Infrastructure: Includes Transportation, Energy & Utilities, and Communications. These are the backbone of economic activities and industrial growth.
- Social Infrastructure: Includes municipalities, universities, schools and hospitals. These assets provide essential services for social well-being.

Infrastructure Characteristics:

- Economic Infrastructure Assets can be categorized into:
  - Throughput assets: Assets that handle the flow of goods/services (e.g., roads, railways).
  - Regulated assets: Assets that are subject to governmental regulation (e.g., utilities).
  - Contracted assets: Assets that operate under long-term contracts (e.g., energy facilities).
- Global Infrastructure Investment: Growing needs for infrastructure in power, roads, and telecommunications may lead to public-private partnerships, expanding investment opportunities.

Infrastructure Benefits vs. Risks:

- Benefits:
  - Expanding opportunity set
  - Long asset life
  - Stable & predictable cash flows
  - Hedge against inflation
  - Strong, consistent performance
  - Low correlation to other asset classes (which aids diversification)
- Risks:
  - Fund-level risks: Specific to management of the fund.
  - System-level risks: Risks related to the broader infrastructure environment.

    - Unsystemic risks: Risks that might be isolated to certain sectors or assets.

Infrastructure Performance:

- Private Infrastructure has consistently generated attractive risk-adjusted returns compared to other asset classes like equities, fixed income, and private real estate.
- Infrastructure Yield: The consistent income growth from underlying infrastructure holdings has resulted in favorable inflation-adjusted yields, outperforming the S&P 500.

Adjournment

Following a motion to adjourn by Trustee Menkhaus and seconded by Trustee Rahtz. The Committee approved the motion by unanimous roll call vote. The meeting was adjourned at 2:01 p.m.

Meeting video link: https://archive.org/details/crs-investment-comm-11-7-24

Next Meeting: Thursday, February 6, 2025, at 12:00 P.M. City Hall Council Chambers and via Zoom

Jon Salstrom
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Secretary