SAN JOSE FEDERATED CITY EMPLOYEES' RETIREE HEALTH CARE TRUST FUND

INVESTMENT POLICY STATEMENT

Updated

December 2021

I. San Jose Federated City Employees' Retiree Health Care Trust Fund Goals

The City of San Jose Federated City Employees' Retiree Health Care Trust Fund (the "Fund") was established to subsidize postretirement healthcare benefits for San Jose Federated City Employees' Retirement System members and their families. The Fund's assets are structured to provide growth from capital gains and income, while maintaining sufficient liquidity to meet beneficiary payments.

II. Investment Objectives

The investment strategy of the Fund is designed to ensure the prudent investment of System assets 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

1. To accept the optimal level of risk required to achieve the Fund's return objective as stated immediately below.
2. To target total portfolio investment risk consistent with the investment beliefs and strategic goals set forth by the San Jose Federated City Employees' Retirement System Board.
3. To consider the financial health of the Sponsor when assuming investment risks.
4. To use diversification to minimize exposure to company and industry-specific risks in the aggregate investment portfolio.

B. Return Objective

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

III. Investment Constraints

A. Legal and Regulatory

The terms of the Fund are described in the San Jose Municipal Code.

B. Time Horizon

The Fund will be managed on a going-concern basis. The assets of the Fund will be invested with a long-term time horizon (ten to twenty years or more), consistent with the participant demographics and the purpose of the Fund.

C. Liquidity

The Board members intend to invest only in public markets assets, which are typically liquid on a daily or monthly basis, and in core real estate funds, which are typically liquid within one year.

D. Tax Considerations

The Fund is a tax-exempt entity. Therefore, investments and strategies will be evaluated only on the basis of expected risks and potential returns.

IV. Risk and Return Considerations

The Board members accept the risks associated with investing in the capital markets (market risks), but will minimize wherever possible those risks for which the Fund is unlikely to be compensated (non-market or diversifiable risks).

V. Diversification

The Board members of the San Jose Federated City Employees' Retirement System recognize that an important element of risk control is diversification. Therefore, investments will be allocated across multiple classes of assets, chosen in part for their low correlation of expected returns. Within each asset type, investments will be distributed across many individual holdings, with the intention of further reducing volatility.

The specific degrees of diversification within asset classes will be addressed in each separate account manager's investment guidelines, or in each commingled manager's fund documents.

The purpose of the functional classifications and major asset classes are defined in the language and table below.

A. Functional Sub-portfolios

The investment strategy for the Investment Program employs three functional sub-portfolios to construct the comprehensive asset allocation. The allocation to the sub-portfolios is assessed at least annually and is based on projected capital market assumptions. The Chief Investment Officer ("CIO") shall review the relative size and composition of these sub-portfolios and advise the Investment Committee ("IC") of any necessary revisions to the allocation among the sub-portfolios.

1. **Growth Sub-portfolio**: The purpose of the Growth Sub-portfolio is to grow invested assets over the long term in order to pay future benefits. This portfolio is characterized by a long investment horizon and can, therefore, accept a higher level of volatility. Assets in this portfolio may be volatile, have reduced liquidity, and derive the bulk of their return from capital appreciation. These assets include public equity. The success of this portfolio will be measured primarily by compounded annual growth rates in conjunction with the annualized standard deviation of returns as the primary measure of risk. Performance evaluation will, therefore, focus on the long-term total risk-adjusted return of the portfolio.

2. **Low Beta Sub-Portfolio:** The purpose of the Low Beta Sub-portfolio is to ensure that the overall (total portfolio) a) is relatively immune from market fluctuations while providing a source of alpha b) is a source of capital for purchasing undervalued assets in the Growth sub-portfolio, and c) has adequate assets available to pay benefits over an extended timeframe. It will contain cash and cash-like assets such as short-term bonds and other investments that provide fixed, contractual cash flows with a minimum level of credit risk. The Low Beta portfolio is expected to provide a stable offset to the rest of the portfolio during periods of severe market stress and to effectively dampen the market volatility across the entire portfolio. The success of the Low Beta Sub-portfolio will be measured by its ability to offset declines in value in the Growth Sub-portfolio, as well as its ability to provide liquidity during times of market stress.

3. **Other Sub-Portfolio:** The purpose of the Other Sub-portfolio is to ensure that the overall portfolio is specifically protected against inflation risks while also providing for further diversification. The success of the Other sub-portfolio will be measured by its ability to protect the portfolio from inflation risk while also providing an additional source of return and diversification.

B. Interaction between the Functional Sub-Portfolios

The allocations to the Growth, Low Beta, and Other sub-portfolios will vary over time. When Growth assets are undervalued, the Low Beta Sub-portfolio will act as a source of funds and when Growth assets are overvalued the Low Beta sub-portfolio will act as a use for harvested Growth portfolio returns. The Growth and Other sub-portfolios will be subject to the volatility of the markets in which each functional sub-portfolio invests. In order to reallocate between the functional sub-portfolios, the CIO and the General Consultant will conduct an annual capital review to assess the relative value and risks associated with each asset class and deliver a review of the capital markets to the Board. The Consultant will provide the Board current forward-looking risk and return assumptions for all major asset classes. In conjunction with this review, the CIO will provide a recommendation of how best to allocate assets within each functional sub-portfolio. If necessary, the CIO will recommend changes in target allocations to the underlying asset classes in order to deploy the Investment Program's assets effectively in the upcoming year. While considering changes to the allocation to each functional sub-portfolio, the CIO will view the totality of all functional portfolios, and consider the impact of changes to the overall risk and return profile of the total portfolio.

Public Equity – *Growth*

The purpose of Public Equity is to provide the Fund exposure to the total return due to equity capital owners, including exposure to capital appreciation from economic growth, while managing volatility relative to the equity market.

Short-Term Investment Grade Bonds – *Low Beta*

The purpose of Short-Term Investment Grade Bonds is to provide the Fund a return while mitigating risk.

Cash – *Low Beta*

The purpose of Cash is to maintain sufficient liquidity for Fund benefit payments and expenses.

Core Real Estate – *Other*

The purpose of Core Real Estate is to produce the Fund income and price appreciation while maintaining a low correlation to both stocks and bonds.

Commodities - Other

The purpose of Commodities is to increase the Fund's portfolio diversification and provide a hedge against unexpected inflation.

Investment Grade Bonds - Other

The purpose of Investment Grade Bonds is to produce returns and income for the Fund by providing exposure to rates and credit risk.

Long-term Government Bonds - Other

The purpose of Long-term Government Bonds is to provide a positive return in highly stressed market environments, with a low correlation to equity risk.

VI. Asset Allocation Policy

Asset Allocation and Portfolio Construction

A. The Board recognizes that establishing an appropriate strategic asset allocation portfolio (SAAP) is critical to the long-term success of the investment program, as asset allocation is the single biggest determinant of the expected risk and return of the Fund.

B. The Policy Benchmark is a weighted average of the underlying benchmarks for each asset class, as outlined in Appendix A.

Asset Allocation Tools & Methods

A. The SAAP will be re-evaluated annually following the results of the annual actuarial study. A formal asset allocation study will be performed approximately every three years or when a significant market correction occurs. The capital market assumptions (CMA) used in such studies shall be reviewed and updated annually or when the S&P 500 experiences a decrease of more than 20% from peak. The Board shall consult with the general investment consultant in connection with such asset allocation studies and CMA reviews.

B. Asset allocation studies shall be designed to ensure rigorous and objective analysis, and minimize decision-making bias by:

1. Requiring the use of a portfolio construction engine ("Engine"); and
2. Requiring that the Board and IC always focus first on establishing the most reasonable and defensible inputs to the Engine. That is, if the Board is uncomfortable with the results of the Engine, it shall respond by reviewing the reasonableness of the inputs to the Engine, rather than simply modifying the results.

C. When arriving at the SAAP, asset allocation studies shall include the four basic steps outlined below:

1. Step 1: Inputs
    a. For each study, the Board shall approve the inputs to the Engine including:
        - Permitted asset classes (Permitted asset classes for the LCPP shall include only public markets and permitted asset classes for the SAA Portfolio shall include both public and private markets);
        - CMAs; and
        - Material constraints (e.g. maximum allocations to certain asset classes), along with supporting rationale.

    b. The CIO shall propose the inputs to the IC, with prior input from the Board's general investment consultant, and work with the investment consultant throughout the process to make subsequent revisions to inputs, based on feedback from the IC.

c. The Board, IC, CIO and investment consultant are expected to reach a consensus regarding the above inputs and the Board shall formally approve them. Staff shall document the process by which it arrives at its recommended inputs.

2. Step 2: Modeling and Analysis

   a. The investment consultant will incorporate the approved inputs into the Engine to be used to identify and analyze potential asset allocation choices for each study and present the results to the CIO.

   b. The Board expects that the Engine will rely on mean-variance optimization ("MVO").

   c. The Board shall also consider the results of the MVO analysis under additional constraints to ensure adherence with approved risk limits including:

      - Stress testing, including historical scenario analysis and factor-specific testing;
      - Liquidity analysis under normal and stressed conditions; and
      - Cash flow management requirements

3. Step 3: Recommendations

   a. The CIO will present the current asset allocation and a number of reasonable alternatives along the so-called "efficient frontier" for the Board to consider.

   b. In presenting the alternatives, the CIO initially will present only the return/risk characteristics of each alternative and will <u>not</u> reveal the underlying asset class allocations (i.e. "blind" format). This will allow the Board/IC to focus initially on the return/risk implications of each alternative, rather than the underlying asset allocations.

   c. After the Board has engaged in a preliminary discussion and analysis of the alternatives, the underlying asset allocations of each alternative will be revealed for further consideration.

   d. The Board/IC may provide feedback to the CIO and investment consultant, which may require further analysis and a request for revised recommendations for the Board/IC to consider.

4. Step 4: Approvals

a. The Board/IC will review the final analyses and recommendations from the CIO and general consultant and approve:
   - Strategic Asset Allocation Portfolio weights, targets and ranges (maximum – minimum).

Rebalancing

A. The CIO shall adhere to the SAAP asset and sub-asset class "targets" approved by the Board and shall rebalance to within the approved range at least quarterly if the actual weights at the sub-asset class levels are not within 10% of the approved target, considering the cost of more frequent rebalancing. For example, if the target allocation for an asset class is 20%, re-balancing will be triggered quarterly when the actual allocation for the asset class deviates by +/- 2% (i.e. 10% x 20%, reaching 18% or 22%). The CIO may use discretion to rebalance to within the approved range at more frequent intervals than quarterly, and when actual weights are within 10% of the approved target, subject to an assessment of market risk, active risk, and transactions costs. When a change to the SAAP is made by the Board, the CIO and the investment team will rebalance to the new target weights as expeditiously as possible, or in tranches if directed by the Board. The CIO shall also use his discretion in rebalancing to the new SAAP in the event that instant liquidation of managers within an asset class may work against the interests of the System. Changes to the weights of illiquid asset classes may take several quarters to implement, and the CIO shall keep the IC apprised of progress toward the new SAAP. Synthetic rebalancing through an overlay provider may also be used when appropriate. The Immunized Cash Flows portfolio is exempt from this rebalancing provision, as it is amortizing by design.

B. Total Fund active risk (i.e. tracking error) is to be maintained below 3%. While asset class exposures may fall within acceptable capital allocation ranges as noted above, total Fund tracking error is not to exceed this 3% threshold.

VII. Manager Selection, Retention, Evaluation & Termination Policy

Background

A. The Board has delegated to the CIO the authority to select and terminate all investment managers of the Fund subject to constraints and parameters contained herein. Such authority shall be further subject to Manager Selection, Retention, Evaluation & Termination Procedures ("Procedures"), approved by the CIO, that provide more detailed constraints and parameters.

B. It is the Board's intention that the CIO shall have the necessary authority and resources to effectively select, retain, evaluate, and terminate investment managers.

C. Accordingly, the CIO shall have the authority to:

1. Manage the Investment Personnel of the System, including:

a. Recommending to the CEO the appointment and duties of all professional, technical, and clerical employees of the Investment Division;

b. Directing and supervising all Investment Personnel on a day-to-day basis; and

c. Evaluating all Investment Personnel and managing their professional development.

2. Select and terminate investment consultants to assist in the selection, retention, evaluation, and termination of investment managers.

a. The CIO may use the services of the general investment consultant appointed by the Board. Alternatively, if the services of the general consultant can be unbundled to separate manager research services, the CIO may select a consultant(s) of his or her choice to carry out manager research services that would otherwise have been included in the general investment consultant scope of services.

b. The CIO shall ensure that the total fees and expenses associated with the consultants he or she selects are reasonable and shall provide a report of such fees and expenses to the Investment Committee and the Board on at least a quarterly basis.

c. While the CIO shall have the authority to select and terminate investment consultants to assist staff in selecting, retaining, evaluating and terminating investment managers, the Board shall approve all contracts with investment consultants selected by the CIO to ensure such contracts reflect fair and reasonable value for the System.

3. Delegation of authority to the CIO to select and terminate investment managers reflects the Board's desire to:

a. Promote efficiency and effectiveness in the manager selection and termination processes;

b. Focus the Board's time and attention on investment policy, asset allocation, and oversight, rather than manager selection and termination; and

c. Establish clear accountability on the part of the CIO and investment staff for manager selection, retention, evaluation, and termination.

General Constraints and Parameters

A. The CIO's authority to select and terminate investment managers shall be subject to the following general constraints and parameters:

1. Investment managers shall meet the following **minimum qualifications** to be selected to manage any assets of the fund:

    a. Be **registered as an investment advisor** under the Investment Advisor's Act of 1940 or comparable legislation, unless the manager represent and warrants that it is exempt from such registration under applicable law.

    b. Agree to enter into a contract with the System requiring them to perform their services consistent with the fiduciary services established under (a) the Investment Advisor's Act of 1940; (b) California law applicable to fiduciaries of public employee retirement systems, which includes the California State Constitution, Art. XVI sec. 17 and the San Jose Municipal Code and/or (c) terms and conditions substantially comparable to the foregoing that are satisfactory to the System.

2. The nature and size of the manager's mandate shall be consistent with:

    a. The asset allocation policy of the Fund;

    b. Applicable constraints (e.g. **manager or strategy concentrations**) contained in this Investment Policy Statement.

3. Notwithstanding paragraph 2) b) above, the CIO shall not approve the selection of an investment management firm for mandates that exceed the following limits:

Basis*	**Description**	**Strategy Limit**[1]
Vehicle	Separately managed accounts (active)	15%
	Commingled funds and SMAs (public, passive)	No limit[2]
	Commingled funds (public, active)	15%
	Commingled funds (private strategies)	15%[3]
Public Markets	Passive strategies	No limit
	Active strategies	15%

* To be selected, the manager must satisfy the "Vehicle" constraint and the appropriate "Public Markets" or "Private Markets" constraints
** Percentage (%) of total Fund assets

4. When a market movement is the cause of a breach in the above limits, it should be reported to the IC at the earliest of a mutually agreed-upon time during which the Investment Committee could convene with a quorum, or at the next regularly scheduled Investment Committee meeting, along with a report on how the breach was addressed, or a recommendation to address the breach.

[1] Percentage (%) of total Fund assets allowable per investment strategy.
[2] Rationale: Fund is constrained by the asset allocation. This is the "default" option for investing, and scale determines pricing.
[3] For private strategies, limit applies to the capital invested plus future callable commitments.

Appendix A[1]

Asset Allocation Targets[2]

	Target (%)	SAAP Asset Class Benchmarks
Growth	**59**	
Public Equity	59	Public Equity Benchmark[3]
Low Beta	**5**	
Short-Term Investment Grade Bonds	5	ICE BofA 91 Days T-Bills TR
Other	**36**	
Core Real Estate	12	NCREIF ODCE Cap Weighted – Net (Lagged 1 quarter)
Commodities	5	Bloomberg Commodity Index TR USD
Investment Grade Bonds	14	BBgBarc US Aggregate TR
Long-term Government Bonds	5	BBgBarc US Treasury Long TR

[1] Appendix A shall be revised as new Asset Allocation targets are approved by the Board.
[2] Approved by the Board of Administration in March 2021
[3] 50.85% Russell 3000, 23.73% MSCI World ex US IMI Net, 25.42% MSCI Emerging Markets IMI Net.