CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO:	Police & Fire Department Retirement Plan and Federated City Employees' Retirement System Investment Committee	**FROM:**	Brian Starr, CFA
SUBJECT:	BlackRock Index Funds Recommendation	**DATE:**	June 27, 2017

Approved /s/ Daryn Miller **Date** 6/19/17

Recommendation

a) Discussion and action on staff's recommendation to invest up to $50 million in the BlackRock US Debt Index Fund and up to $50 million in the BlackRock Global Aggregate ex-USD Currency Hedged Index Non-Lendable Fund[1] and for the Secretary to negotiate and execute an updated agreement with BlackRock Institutional Trust Company on behalf of Federated City Employees' Retirement System.

b) Discussion and action on staff's recommendation to invest up to $75 million in the BlackRock US Debt Index Fund and up to $75 million in the BlackRock Global Aggregate ex-USD Currency Hedged Index Non-Lendable Fund and for the Secretary to negotiate and execute an updated agreement with BlackRock Institutional Trust Company on behalf of Police & Fire Department Retirement Plan.

Background

At the beginning of July, the City will prefund its annual contribution to the plans, resulting in a large influx of cash to the plans. Staff developed a prefunding plan for the contributions. The first part of was presented at the Investment Committee meeting on May 23rd, and the final recommendation has been presented at this June 27th Investment Committee meeting. The prefunding recommendation calls for Federated and Police & Fire to allocate approximately $73 million and $76 million, respectively, to Global Fixed Income (figures exclude Russell overlay notional exposures).

To implement the prefunding plan, staff would like to take advantage of funds that are not currently approved. The two reasons staff would like to use funds not currently approved are risk and liquidity.

[1] For ease of reference, the BlackRock US Debt Index Fund and the BlackRock Global Aggregate ex-USD Currency Hedged Index Non-Lendable Fund shall be collectively referred to as "the BlackRock index funds" for the remainder of the memo.

Both plans have sizable deviations from risk characteristics of the Global Fixed Income benchmark. Maintaining the relative size of these deviations, as the allocation to Global Fixed Income increases, increases the potential performance consequences at the overall plan level (i.e. the same percentage risk on a larger dollar amount is a greater risk in dollar terms). Particularly for Police & Fire, the liquidity profile of the existing manager roster could make it harder to reallocate funds, if that were desired.

The Analysis section of the memo addresses the Global Fixed Income risk exposures as of March 31st, and pro forma for the prefunding recommendation using the BlackRock index funds. It further describes potential alternative methods of getting similar exposure. Finally, it provides information on the BlackRock index funds themselves.

Analysis

Global Fixed Income Exposures

Both plans have maintained underweights to duration and overweights to the US dollar for an extended period of time. Federated holds overweights to government securities and to the US (geography), while Police & Fire has a large overweight in emerging market debt. Exhibit A shows the plans' respective risk exposures before prefunding, and pro forma post-prefunding using the BlackRock index funds.

Exhibit A: Global Fixed Income Exposures

	Federated			Police & Fire		
	As of 3/31/17	Benchmark	Pro-forma	As of 3/31/17	Benchmark	Pro-forma
Sub-asset class allocation						
Global Core	76%	80%	80%	39%	80%	47%
Non-IG Credit	10%	10%	9%	31%	10%	27%
EMD	13%	10%	11%	30%	10%	27%
Duration (years)	4.3	6.4	4.6	3.7	6.4	4.0
Yield	2.7%	2.5%	2.6%	4.1%	2.5%	3.9%
Sector weights						
Government	74%	58%	72%	55%	58%	55%
Securitized	15%	12%	16%	12%	12%	15%
Credit (ex-Sec.)	10%	30%	11%	32%	30%	30%
Geography weights						
US	83%	52%	79%	47%	52%	49%
Developed ex-US	4%	38%	9%	11%	38%	14%
Emerging Mkts	13%	10%	11%	42%	10%	36%
Non-USD currency	7%	51%	5%	26%	51%	20%

Source: ORS

The general trend with all of the exposures is that they move incrementally toward benchmark. The two major exceptions are the non-USD currency exposure and the exposure to securitized. The non-USD currency exposure cannot increase using the BlackRock index funds because the non-US fund is currency-hedged. The increased exposure to securitized helps maintain some of the yield advantage over the benchmark without pulling the duration of the portfolios substantially higher.

Alternatives to the BlackRock index funds

The most obvious alternative to utilizing new funds would be to use the plans' existing manager roster. For Federated, it is possible to stay liquid, and manage the duration exposure via the Northern Trust index funds and the BlackRock Long Government index fund. Securitized exposure could be achieved through Voya Securitized Credit. The consequence would be diluting exposure to credit and developed ex-US geographies. For Police & Fire, it is not particularly feasible to manage the exposures well with the existing funds. The BlackRock Long Government index fund is a very blunt instrument for managing duration. The other funds that provide exposure to government securities (Colchester and Franklin Templeton) have emerging market debt exposures of roughly 30% and 88%, respectively. For credit exposure, it would be necessary to use hedge fund structures that do not provide full beta exposure and reduce liquidity.

Synthetic implementation is another option. Russell uses government bond futures contracts across the curves of the US, UK, Germany, and Japan to replicate index key rate duration. Like the BlackRock Global Aggregate ex-USD, Russell's replication is does not provide foreign currency exposure. Russell does provide the ability (with an overlay strategy or with the BlackRock fund) to self-direct currency exposure to replicate the benchmark's main currency exposures. However, the Russell overlay also does not provide credit exposure. A more esoteric option would be to enter into a total return swap with a replicated version of the benchmark index. This is the most direct method of getting benchmark exposure, and it would also be possible to gain exposure to the high yield portion of the benchmark. That being said, it adds operational complexity, counterparty risk, headline risk, and falls into a category of "different" that may be unappealing to the Board.

As time is of the essence in deploying the prefunding contribution, it was necessary to consider only managers with whom the plans have existing contracts that could be easily amended. BlackRock was the only one with existing commingled funds that could come close to replicating the Barclays Global Aggregate index. A separate account is not a viable solution given the size of the capital being deployed and the anticipated time horizon (until completion of the Global Fixed Income RFI process). The BlackRock index funds can be added to the agreement with BlackRock that was negotiated when the BlackRock Long Government index fund was approved.

BlackRock index funds

Together, the BlackRock index funds represent a currency hedged version of the plans' benchmark for the Global Core sub-asset class (which is 80% of the Global Fixed Income benchmark). Both funds have extremely low tracking error compared with their targeted benchmark. The US fund has approximately

10bps of tracking error, and the non-US fund has approximately 20bps of tracking error. Since the non-US fund is currency hedged, there will be meaningful tracking error compared with the unhedged benchmark that the plans reference. Given the relatively small allocation, the plans' history of preferring US dollar exposure, and the plans' US dollar-denominated liabilities, staff considers this risk to be acceptable pending a more formalized approach to tactical currency decisions. If desired, staff can also work with Russell Investments to implement a currency overlay for the non-US portion of the index. As expected, BlackRock offers an attractive fee proposal of 3.5bps on the US fund and 7.5bps on the non-US fund. For more information on the recommended funds, the fund fact sheets published by BlackRock are attached to this memo.

Conclusion

Staff recommends both the Federated and Police & Fire Investment Committees approve investments in the BlackRock US Debt Index Fund and the BlackRock Global Aggregate ex-USD Currency Hedged Index Non-Lendable Fund. Consistent with the prefunding recommendation memo, initial investment amounts would be as follows:

	US Debt Index Fund	**Global Aggregate ex-USD Currency Hedged Index Non-Lendable Fund**
Federated	$25.5 million	$29.1 million
Police & Fire	$34.2 million	$26.6 million

__/s/ Brian Starr_____________
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Investment Officer