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Retirement Administrator

FRESNO COUNTY EMPLOYEES' RETIREMENT ASSOCIATION

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DATE: February 3, 2016

TO: Board of Retirement

FROM: Donald C. Kendig, CPA
Retirement Administrator

SUBJECT: Consideration and Selection of the Specialty Consultant for Hedge Funds presented by Donald Kendig, Retirement Administrator – RECEIVE AND FILE; APPROPRIATE ACTION

Background and Discussion

The Issue

How does FCERA prudently invest an 8% (\$300-\$320M) allocation into hedge fund related alternatives?

Today

Verus will be presenting a hedge fund update and will serve the Board as its independent advisor, helping the Board to ask all the necessary questions and to consider all of the relevant facts related to the final presentations of four specialty consultants for hedge funds. The finalists' names were drawn from a hat and will be presenting in the following order:

1. Cliffwater, LLC
2. Aetos Capital
3. Morgan Stanley
4. Grosvenor Capital Management

After hearing from the finalists and considering all of the relevant facts, the Board will determine how to prudently invest 8% of Association assets, possibly selecting one of the finalists to provide consulting, and fund management and account services.

Historical Summary

On May, 6, 2015, Jeff MacLean of Verus provided education on hedge fund implementation options for the additional 4% hedge fund allocation that the Board approved during its asset allocation review in December 2013, increasing its hedge fund allocation from 4% to 8%. The Board's alternatives allocation includes 8% to hedge funds, 6% to private equity, and 8% to private credit, totaling 22%. The options provided by Verus (and attached as reference) on May 6, 2015 were:

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- Increase the mandate of Grosvenor Institutional Partners (GIP), FCERA's existing Hedge Fund of Funds manager allocation for the full 4%, realizing potential fee savings with the larger mandate. (Est. \$2-3M per year)
- Hire one or more additional Fund of Funds managers to compliment Grosvenor, possibly forgoing the potential for notable fee savings and potentially diversifying, or diversifying away, the returns of the already diversified Grosvenor. This option requires a search for an additional Hedge Fund of Fund manager by Verus. (Est. \$2-3M per year)
- Partner with Grosvenor to develop a customized hedge fund of funds portfolio, also known as a Fund of One (with "one" meaning one investor as opposed to a pooled/commingled investment) allowing for the customization of FCERA's hedge fund allocation and moving towards a more direct investment structure, given FCERA's ability under this option to pick and choose specific direct hedge funds. This option requires a contract amendment and the Board's involvement reviewing managers going forward. (Est. \$2-3M per year)
- Hire a specialty hedge fund consultant, with the research capabilities and resources required to vet the myriad of potential hedge fund investment opportunities, and the expertise to help the Board construct a well-diversified direct hedge fund portfolio and to provide some portion of the back office accounting support. There is the potential for substantial staff involvement, which would result in a reduction in fees, but require substantial organizational changes within FCERA. This option requires Staff to conduct a search for alternatives consultant and would likely result in increased levels of staff work and Board oversight; however, certain accounting and reporting aspects could be outsourced. (Est. \$400-550K per year plus \$50K for outsourced administration/accounting)
- Expand relationship with Verus, which has partnered with Aksia (an independent hedge fund specialist consultant), to perform the hedge fund consulting role and to handle the majority of the back office accounting work. As with the hiring of a hedge fund consultant option just previously, this option could require Staff to conduct a search for alternatives consultant, if it would like to assure itself that the Verus-Aksia partnership is the best option. (Est. \$250K per year plus \$50K for outsourced administration/accounting)

Given the size of the hedge fund allocation, FCERA's maturity in the asset class and as part of fulfilling its fiduciary duty to advise the Board on its implementation options, Verus brought all of the above options to FCERA for consideration. An important aspect to Verus' presentation of the options is to fully illuminate best implementation options, inclusive of the lowest possible fees. At the May 6, 2015 meeting, the Board of Retirement requested that Grosvenor return to the Board on June 3, 2015 to provide more education on the options to invest the additional 4% in the Grosvenor commingled Fund-of-Funds (what would the fee savings be) and on what a Fund-of-One relationship would look like.

On June 3, 2015, the Board of Retirement received additional education from Grosvenor on the two options, and the following was discussed:

- How Grosvenor would handle an increased allocation of 4%.
- How FCERA could migrate from a Fund-of-Funds allocation to a customized (Fund-of-One) allocation.
- How FCERA could migrate from a Fund-of-Funds or Fund-of-One allocation with a portion to a direct investment program over time, in this case utilizing Grosvenor's back office, analysis, and expertise.

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It was mentioned by Grosvenor that the Fund-of-One option could expand the allocation and keep the fees paid to Grosvenor relatively constant.

At the meeting the Board of Retirement noted that further information on employing a specialty hedge fund advisor was needed and requested that Staff work with Reed Smith to issue a Request for Information (RFI) for potential \$150-\$320M hedge fund programs, in order to make sure they were looking at all of the options. The Board further requested that the process be conducted separate from Verus' general advisory services.

On June 17, 2015, Staff posted an RFI and placed ads in investment publications referring readers to the RFI. Staff received 55 responses in the following categories: Single Strategy Fund, Multi Strategy Fund, Fund of Funds, Fund of One (Customized Fund of Funds), Specialty Consultant.

The Board determined at its August 5, 2015 meeting that Specialty Consulting was the only significant category requiring further analysis and education, so staff recommended bringing in Cliffwater LLC to the Board for Specialty Consulting Education at its September 2, 2015 Regular Board meeting.

On September 2, 2015, Pete Keliuotis and Jamie Feidler, of Cliffwater LLC, provided a presentation comparing and contrasting specialty consulting to other Hedge Fund Investment Implementation Options, in order to complete the Board's education on Hedge Fund Investment Implementation options. At that time, the Board directed staff to conduct a Request for Proposal (RFP), a.k.a. a search, for Specialty Consultant for Hedge Funds.

On October 10, 2015, an RFP was issued, and by November 20, 2015, Staff received nine responses for analysis, three consulting firms and six hedge fund of funds managers providing advisory services.

On December 16, 2016, Staff presented its analysis to the Board and recommended final presentations for Cliffwater, Grosvenor, and either Aetos or Morgan Stanley, or both. At that time, the Board directed Staff to invite the four firms from the Short List to present to the Board at the February 3, 2016 Regular meeting and to work with Verus to draft questions to ask of the candidates and to provide a hedge fund update.

Fiscal and Financial Impacts

There will be a change in costs associated with adjusting the hedge fund allocation and consulting relationship. Fees could decrease depending on the option chosen, even though there will be a larger commitment. Underlying investment fees would continue to rise with each direct investment. Accounting and Administration will be outsourced keeping staffing relatively stable. The Board and Retirement Administrator would be more involved with non-discretionary manager vetting and contracting, due to the need for legal review by Investment Counsel.

Recommended Action

Hear the update from Verus and finalist presentations, and determine how to proceed after hearing and debating all of the relevant facts.