FALL 2023

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STATE ASSOCIATION *of* COUNTY RETIREMENT SYSTEMS

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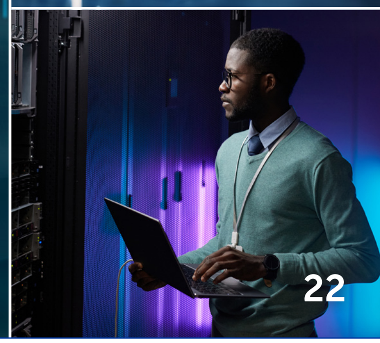

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FROM THE EDITOR

MAKING A DIFFERENCE

“We are already working on our 2024 events, and it will be a memorable year, as SACRS celebrates our 70th Platinum Jubilee!”

Can you believe 2023 is rapidly coming to an end? It has truly been a whirlwind year, but to be with so many of you at our SACRS Annual Fall Conference in Rancho Mirage was a definite highlight!

Our conferences are developed for SACRS members by SACRS members, and each one offers amazing speakers, relevant, need-to-know information, and networking. But this fall is special, because we will make a difference in the lives of Coachella locals, and I am proud of our SACRS Board for pioneering this effort. During the 2023 Fall conference, SACRS announced the Community Hero Award program, which will recognize the efforts of a local non-profit in the community where our conference takes place. Not only will SACRS provide a donation, SACRS members can join in making donations of their own. In Rancho Mirage, Alzheimers Coachella Valley -- a local 501c3 non-profit that provides support and services at low or no-cost for Coachella Valley residents living with cognitive impairment, their families and care partners – were the first recipients of this new award.

SACRS events are specially crafted to appeal to Trustees, Administrators; Affiliates; Attorneys; Accounting/Internal Auditors; Investment; Ops/Benefit; and Safety. There really is something for everyone. We are a diverse group working toward a single goal: supporting pensioners and future pensioners all over California. We are already working on our 2024 events, and it will be a memorable year, as SACRS celebrates our 70th Platinum Jubilee! You must make plans now to be with us at next year’s gatherings.

Here are a few dates for your calendar:

- SACRS Spring Conference: May 7-10 Hilton Santa Barbara Beachfront Resort in Santa Barbara
- SACRS Fall Conference: November 12-15 Hyatt Regency Hotel and Spa Monterey in Monterey

I hope you enjoy this issue of SACRS Magazine, which continues the tradition of articles shared by members. If you have news or ideas for a story, consider submitting an article! You can do that by contacting me at sulema@sacrs.org.

My best to all of you,

Sulema H. Peterson

***Sulema H. Peterson**, SACRS Executive Director, State Association of County Retirement Systems*

HELLO, MY SACRS FAMILY!

"I can't encourage you enough to find ways to get to know your investment staff, investment consultants, and fund managers."

Welcome to another addition of SACRS Magazine.

Just coming off of an incredible Fall Conference 2023, it was so good to see so many of you there. I'm always very excited about our conferences. Not only do we have lots of great content in the scheduled sessions, but we also have very important opportunities to connect with others across the 20 CERL systems. Our conferences are for everybody who touches our retirement systems – administrators, staff, trustees, consultants, asset managers, etc. I am proud to say that all 20 systems were represented in Rancho Mirage to take advantage of all the Fall Conference had to offer.

I can't encourage you enough to find ways to get to know your investment staff, investment consultants, and fund managers. SACRS conferences are one great way to connect with these folks in a casual atmosphere. We must remember the critical importance that investment returns have on our ability to pay pensions. Over 60 cents on every pension dollar are paid for by our investment returns. This makes our pension programs much more economically efficient.

Another way to understand our investments and better know our investment teams is for trustees to go on onsite for due diligence visits. I have done many of these and I appreciate every opportunity to do so. I don't go to look over anyone's shoulder. I go to learn more about where we might be investing. What is the mindset and culture of the company? Asset managers partner with our systems to look after our members. How do these asset managers see themselves as our partners? Also, onsite due diligence visits provide excellent opportunities to see our investment teams in action. The work that our investment teams do is complex and very difficult. Many trustees only know investment team members by reports given at board meetings. But few understand the challenges that investment teams face in striving to achieve returns that surpass our assumption rates. Changing economics, world conflicts, political instability and other factors can greatly complicate navigating the investment terrain. Through participating in onsite due diligence visits, trustees can enhance their knowledge and understanding of this arena.

Finally, to our system administrators and board chairs, please let SACRS know how we can better serve you as an association. SACRS is where the 20 independent CERL systems come together. How can we, collectively and individually, better serve our members? We truly want to hear from you.

Best wishes to all for a healthy and fruitful autumn,

David MacDonald

***David MacDonald**, SACRS President & Contra Costa CERA Trustee*

OUTSOURCING DRUG DEVELOPMENT:

How Advanced Therapies Are Fostering Growing Niches

The successful deployment of vaccines within a year of the COVID-19 pandemic's onset underscored the imperative of rapid, effective drug development.

As well as saving lives threatened by a virus that has killed an estimated 22 million people worldwide, mass vaccination enabled the safer reopening of societies from lengthy – and costly – lockdowns.[1] The IMF estimates that the cumulative economic gain of a successful global vaccine rollout could add up to around US$9 trillion by 2025.[2]

Perhaps unsurprisingly, many have asked 'why can't all drug development be as swift and efficient as the COVID-19 vaccines?' Pandemics aside, drug development remains a time and resource-intensive process. It can typically take a decade or more for a drug to complete three stages of clinical trials before being licensed. Most fail along the way.

To expedite the complex drug development process and leverage capabilities that they may not have themselves, pharmaceutical companies are increasingly turning to specialist partners.

As medical innovation continues to enable better treatments that improve health and quality of life for more people, we outline why we believe opportunities will be created for partners to the industry that find successful niches as the transition to a more inclusive, sustainable economy accelerates.

THE RISE OF OUTSOURCING

The pharmaceutical industry's partners of choice for drug research, trials and commercial support are often contract research organizations (CROs).

> *"CRO capabilities, much like society's attitudes towards animal testing, have advanced considerably over the past 75 years to meet the increasingly complex demands of the pharmaceutical industry and regulators."*

> *“McKinsey expects the CRO industry to continue growing by an annual rate of 7.5% by 2025, driven largely by partnerships with emerging biotechnology companies that are increasingly at the cutting-edge of drug research.”*

Outsourcing certain activities to CROs is not a new phenomenon – Charles River Laboratories was established in Boston in 1947 to meet demand for lab rats. CRO capabilities, much like society's attitudes towards animal testing, have advanced considerably over the past 75 years to meet the increasingly complex demands of the pharmaceutical industry and regulators.

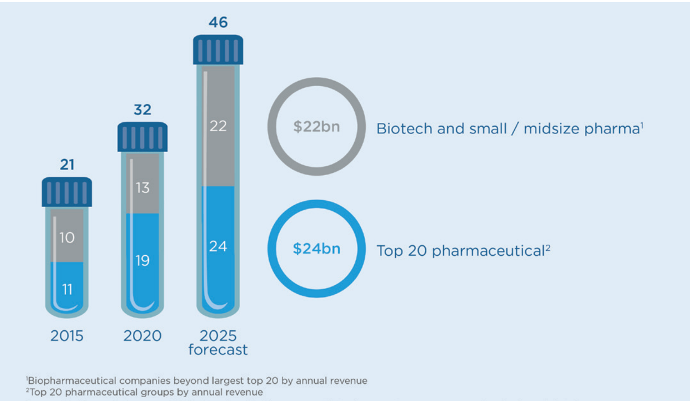
According to analysis by McKinsey, the annual value of the global CRO market had risen to US$32bn in 2020, up from US$21bn in 2015.[3] As scientific innovation continues to push boundaries, we believe two long-term drivers of this growth will continue.

First, innovations in medical science mean ever more specific conditions can be diagnosed, requiring increasingly niche knowledge and solutions. An increasingly complex drug discovery and development process broadens opportunities for CROs to add value, as they can maintain greater use of specialized infrastructure than any customer could alone.

Second, there are increasingly specialized and stringent requirements around the testing, manufacturing, and logistics of drugs. This creates opportunities for specialist partners to the pharmaceutical industry at different stages of the drug development process.

McKinsey expects the CRO industry to continue growing by an annual rate of 7.5% by 2025, driven largely by partnerships with emerging biotechnology companies that are increasingly at the cutting-edge of drug research.

Global CRO market, by segment, US$ billion



Sources: McKinsey & Company, 2022. Based on Mickinsey expert interviews, customer surveys and analysis, and data from EvaluatePharma and Frost & Sullivan

THE ADVENT OF ADVANCED THERAPIES

Recent advances in scientific innovation have led to the emergence of groundbreaking 'advanced therapies'. These are medical products that use gene therapy, cell therapy or tissue engineering to treat diseases or injuries.

Cell therapy aims to treat diseases by restoring or altering certain sets of cells or by injecting cells to carry a treatment through the body. These cells, which may come from a donor or the patient, are cultivated or modified outside the body before being injected. Gene therapy, meanwhile, aims to treat diseases by replacing, deactivating or introducing genes into cells, altering the patient's genetic code to recover the functions of critical cellular proteins.

Cell and gene therapies often target historically neglected 'orphan' diseases that are relatively uncommon but carry high unmet medical needs. Five years since the first cell therapy was approved for use in the U.S. in 2017, more than 20 cell or gene therapy products have now been approved in the world's largest drug market.[4]

Approved advanced therapies target illnesses including spinal muscular atrophy, retinal dystrophy and several rare forms of cancer. Among these are several CAR-T-cell therapies that have demonstrated the potential to eradicate very advanced leukemias and lymphomas. They work by reprogramming the patient's own immune system cells, which are then used to target their cancer.

Advanced therapies have the potential to deliver enormous health benefits to those afflicted by chronic illnesses. Where they can cure illnesses that currently require expensive and chronic treatment, they can also reduce long-term costs to health systems, insurers and wider society, despite often being very expensive. Cancer-targeting therapies Abecma and Kymriah, produced by pharmaceutical groups Bristol Myers-Squibb and Novartis respectively, carry list prices above US$400,000 per patient, per course.

Yet the high price tags carried by advanced therapies can be justified by the long-term cost-savings they can achieve. For example, research has found that Gilead's cure for chronic hepatitis C – while priced at US$94,500 to US$150,000 per course – can deliver ongoing cost savings of up to US$1,500 per patient, per month.[5]

The advent of advanced therapies might also usher in a 'payment revolution', whereby drugmakers receive performance-related payment connected to patient outcomes. This represents an opportunity to better align the interests of drugmakers, insurers and patients, and to offer an antidote to resistance towards high-cost drugs that could hold back expensive scientific innovation.

Active clinical trial by therapeutic area

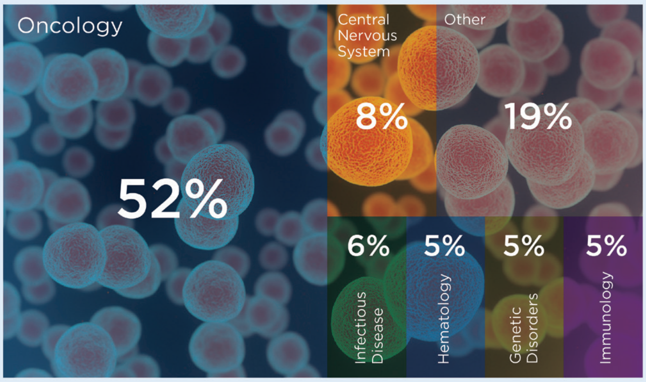


Chart based on the broad categorisation of ongoing trials for advanced therapies, including Phase 1, 2 and 3 clinical trials. Data as at 30 June 2022.

Sources: Alliance for Regenerative Medicine, 2022.

OPPORTUNITIES IN BRINGING ADVANCED THERAPIES TO MARKET

More than 2,000 trials for advanced therapies, around half of which target cancers, were ongoing globally at the end of June 2022.[6] Only a minority will end up being approved, but this illustrates the scale of innovation underway. The global advanced therapy product market was estimated at US$7.9 billion in 2020 and is forecast to expand at an annual rate of 13.2%, almost trebling in value by 2028.[7]

As well as being a fast-growing market, the high-value and resource-intensive nature of advanced therapies creates higher-margin opportunities for outsourcing at four stages across the drug development process.

- **Research** – Especially low tolerances for medical impurities in cell and gene therapies makes collaborating with a specialist research partner necessary for some drug developers with limited in-house capabilities or experience. This is true of many smaller biotech companies that rely on CROs given their own relative lack of drug development infrastructure. Looking ahead, the use of 'panomics' – the integration of complex data to improve understanding of diseases – could significantly enhance both target identification and lead asset selection. Specialist partners to the industry will be well-placed to capitalize on this opportunity.

- **Clinical trials** – Drug trials that target rarer or more specific medical issues need to identify smaller niches of sometimes hard-to-find patients. CROs can leverage in-house data as a competitive moat in the running clinical trials: U.S.-based IQVIA has access to more than 1.2 billion anonymized patient records worldwide, with analytics allowing it to select the most optimal and diverse patient cohorts on behalf of pharmaceutical groups. With such capabilities, it has run over 300 clinical studies related to rare and ultra-rare diseases since 2016.[8] Decentralized clinical trials – which involve the use of remote assessments and at-home tests – can also ensure better representation of the global patient cohort, while simultaneously reducing costs and false negative results. This improves effective drug discovery and more equitable health outcomes.

- **Patient monitoring** – Higher regulatory requirements for advanced therapies often stipulate the need for enhanced monitoring of patient outcomes. We expect this to create opportunities for CROs that can apply their experience and technology to improve patient safety and deliver efficiencies for the industry – clinical monitoring can account for up to half of study costs. IQVIA applies predictive analytics to proactively identify patient risks.

- **Drug transportation** – Cell and gene therapies demand precise, temperature-controlled transportation that protects the integrity of high-value products. U.S. company Cryoport is a leading 'cold chain' logistics partners for the life sciences industry, supporting more than 600 active cell and gene therapy clinical trials and the transportation of several approved products.[9]

> *"Even for larger pharmaceutical groups, who have historically had end-to-end development capabilities in-house, contracting out parts of the process can save time and money."*

SECULAR TRENDS SUPPORTING SPECIALIST PARTNERS

We expect the long-term investment case for niche partners to the pharmaceutical industry to be supported by three major secular trends.

First, ageing global demographics should continue to lead to more investment in drug research and development (R&D) much as it is driving higher overall spending on healthcare. According to the OECD, healthcare spending is forecast to outpace GDP growth in almost all developed economic this decade, reaching 10.2% of GDP in OECD countries by 2030, up from 8.8% in 2018. [10]

Second, smaller and 'virtual' biotech companies are expected to continue playing a growing role in the development of advanced therapies. Biotech firms have a large share of advanced molecules in development across areas including cell and gene therapy, and McKinsey forecasts their R&D spending will grow by 8% a year to 2025 – twice the rate of the 15 largest global pharmaceutical groups.[11]

Third, financial incentives to bring treatments to market as soon as possible continue to put pressure on accelerating clinical development times. Even for larger pharmaceutical groups, who have historically had end-to-end development capabilities in-house, contracting out parts of the process can save time and money. In the case of a 'blockbuster' drug (that generates annual sales of US$1 billion or more), accelerating regulatory approvals by even a few months could eventually yield billions of dollars in extra sales before patent protections end. Recent changes in U.S. legislation that will reduce patent lives for some drugs only contribute to this trend.

By enabling innovative treatments to be brought to market more quickly and efficiently, we believe specialist partners to the pharmaceutical industry can do more than find successful niches – they can also make a material contribution to addressing some of global society's most severe healthcare issues.

*Senior Portfolio Manager **Andrew Braun** is a portfolio manager of U.S. large cap equities for Impax Asset Management and works in the firm's sustainable allocation team. He has held this role since 2017.*

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1 *Economist, 21 September 2022: The pandemic's true death toll*

2 *International Monetary Fund, 2021: A Proposal to End the COVID-19 Pandemic*

3 *McKinsey & Company, 2022: CROs and biotech companies: Fine-tuning the partnership*

4 *US Food & Drug Administration, 2022*

5 *Kaplan, D. E., 2018: Cost/Benefit of Hepatitis C Treatment: It Doesn't End with SVR*

6 *Alliance for Regenerative Medicine, 2022: Regenerative Medicine – The Pipeline Momentum Builds*

7 *Grand View Research, 2020: Advanced Therapy Medicinal Products Market Size, Share & Trends Analysis Report By Therapy Type, By Region, And Segment Forecasts, 2021 - 2028*

8 *IQVIA, 2022*

9 *Cryoport, January 2022*

10 *OECD, 2019: Health spending set to outpace GDP growth to 2030*

11 *McKinsey, 2022: CROs and biotech companies: Fine-tuning the partnership*

FEATURED STORY

Asset Allocation in a NEW and EVOLVING Interest Rate Regime

Revised capital market assumptions create opportunities.

"With real yields on core investment-grade bonds now meaningfully positive, the cost of diversification has declined."

Following the 2008–2009 global financial crisis (GFC), investors grappled with over a decade of 0% interest rate policies and the implications of ultralow rates for their portfolios across both traditional and alternative asset classes. However, in a short period of time, that economic backdrop has reversed course amid an accelerated repricing of rates and inflation expectations, and a reversal of easy monetary policy by the U.S. Federal Reserve and other major central banks.

> *For the first time in over 20 years, we believe public DB plans seeking to enhance portfolio returns now have options other than increasing their exposure to equity and liquidity risk.*

While the impact of this shift unfolds, many U.S. public defined benefit (DB) plans are now studying the implications of the current environment for their allocations, which looks very different from those that followed the GFC.

- For the first time since 2008, a number of asset classes, particularly non-core bonds, such as high yield, bank loans, and emerging market (EM) debt, have the potential to generate returns that are close to or above the expected return-on-asset assumptions of many plans.
- With real yields on core investment-grade bonds now meaningfully positive, the cost of diversification has declined. However, the correlation of stocks and bonds may be less certain.

In our view, increasing portfolio exposure to non-core bonds appears to be a particularly attractive option for plans seeking additional sources of return generation. Lengthening duration within fixed income also could help offset the lower exposures that may have resulted from the asset allocation changes since the GFC. And, given the limitations of long duration as a diversifier when stocks and bonds sell off together, we think plans may want to consider adding other sources of diversification to their portfolios.

Where We Are, and How We Got Here

While each U.S. DB plan is unique, the low or near 0% interest rates that followed the GFC accelerated a structural allocation shift toward assets that offered higher expected returns (Figure 1). This shift to greater risk-taking was notable in several ways:

- On average, public DB plans increased their allocations to private market assets, particularly private equity.
- Average allocations to public fixed income assets dropped significantly (from 30% to 20%, on an asset-weighted basis). Allocations to private credit (with underlying floating rate loans) increased and likely reduced duration further unless duration was extended elsewhere in the portfolio.
- Many public DB plans also reduced their allocations to public equity. However, overall equity factor exposure has increased if we adjust for the higher equity beta for private equity and also include the equity beta often present in some other alternatives. Indeed, we estimate the average public DB plan's equity exposure is actually about 10% higher than the reported notional exposures to public and private equity allocations (Figure 2 next page).

Following the GFC, easy monetary policy combined with a less volatile business cycle provided tailwinds for both fixed income and equity assets—typically boosting the overall performance of diversified portfolios regardless of the specific allocation mix. And, with a few exceptions, high-quality bonds typically provided effective diversification benefits when equities sold off meaningfully.

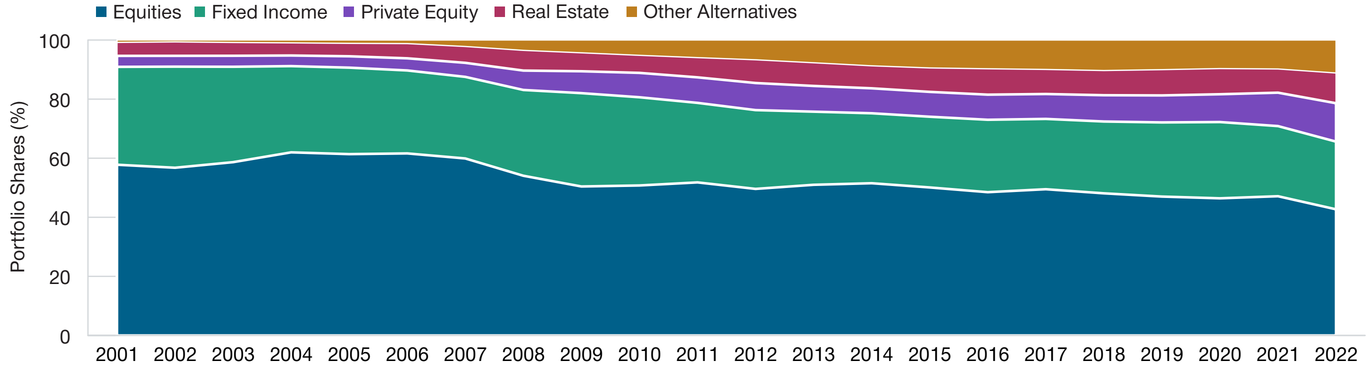
Where Do We Go From Here?

While there is plenty of room to debate when, and at what levels, interest rates will normalize, we believe 2022 marked the end of the long secular decline in rates that began in the early 1980s after the Federal Reserve, under former Chairman Paul Volcker, had raised U.S. rates to historically extreme levels to fight inflation.

For the first time in over 20 years, we believe public DB plans seeking to enhance portfolio returns now have options other than increasing their exposure to equity and liquidity risk.

The Evolution of Public DB Asset Allocation

(Fig. 1) Average asset allocation of U.S. state and local pension plans



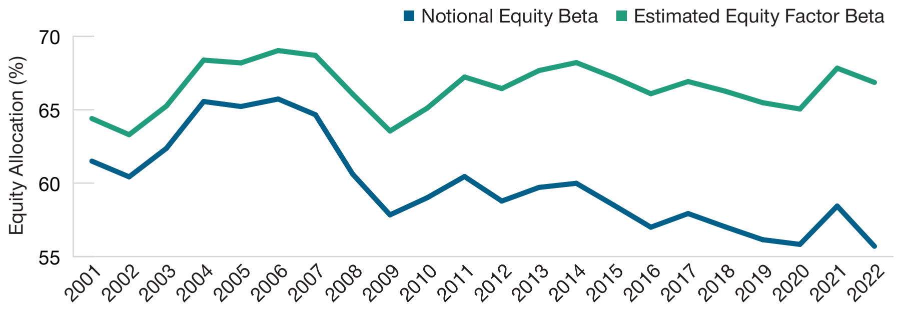
As of December 31, 2022.
Sources: Center for Retirement Research at Boston College, MissionSquare Research Institute, National Association of State Retirement Administrators, and the Government Finance Officers Association. Allocations sourced from public plans data, 2001–2022.

Higher risk-free rates have led many investment managers, including T. Rowe Price's multi-asset team, to raise their long-term capital market assumptions (Figure 3). Specifically, our 10-year annualized return expectation for core investment-grade bonds is now at about 5%, while we expect returns on riskier, non-core bonds (high yield, bank loans, EM debt) to range from 7% to more than 8%. This means that public plans may be able to seek the same or higher returns at similar or lower levels of expected risk, rather than continuing the post-GFC trend of taking on more risk to offset the impact of lower expected returns.

Below are three notable steps that T. Rowe Price has taken in our own multi-asset portfolios that we believe warrant consideration for U.S. public DB plans.

Beware of "Hidden" Equity Beta

(Fig. 2) Equity allocation based on notional and estimated equity factor betas*



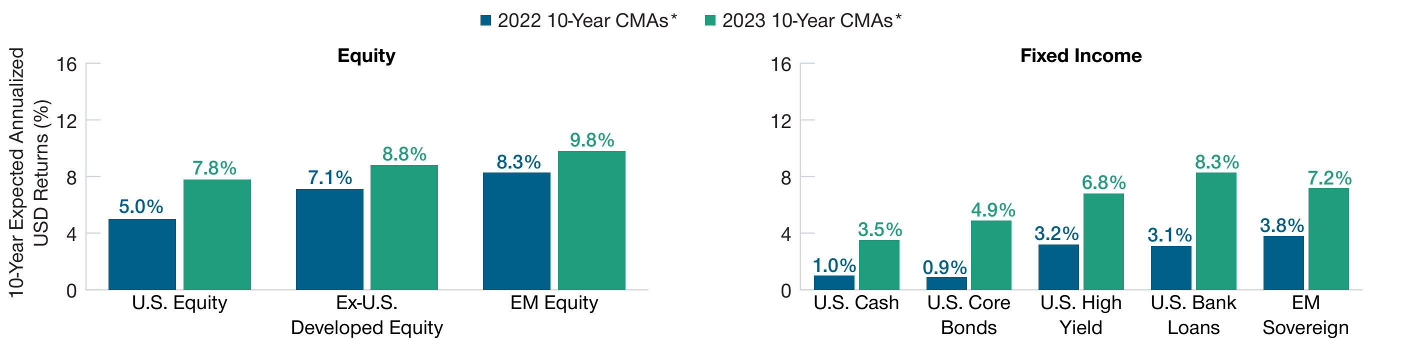
As of December 31, 2022

*Notional equity beta is the allocation to public and private equity without adjustment. Estimated equity factor beta makes an adjustment to private-equity allocations using an estimated beta of 1.2 and includes allocations to real estate, hedge funds, and other alternative asset categories adjusted by an equity factor of 0.4. The estimated betas do not represent a specific implementation and/or actual results and are not indicative of future results.

Sources: Center for Retirement Research at Boston College, MissionSquare Research Institute, National Association of State Retirement Administrators, and the Government Finance Officers Association. Allocations sourced from public plans data, 2001–2022.

Capital Market Assumptions Have Increased

(Fig. 3) T. Rowe Price 10-year capital market assumptions (CMAs)



T. Rowe Price 10-year capital market assumption methodology is consistent with the 5-year methodology with an extended horizon for valuation convergence.

*Source: T. Rowe Price. This information is not intended to be investment advice or a recommendation to take any particular investment action. Forecasts are based on subjective estimates about market environments that may never occur. See the Appendix for our capital market assumption modeling methodology, a representative list of indexes, and Important Information.

Expected returns are shown for asset classes without consideration of fees and expenses.

1. Increasing Allocations to Non-core Bonds

In our view, higher-yielding fixed income, including high yield bonds, bank loans, and EM debt, can now play a larger role in generating returns. As of mid-2023, current yields in many non-core sectors were higher than the median expected return on assets (EROA) for U.S. public DB plans. Even adjusted for defaults and recovery rate expectations, we believe returns are likely to be attractive.

It is true that non-core bonds can be highly correlated with equities in extreme risk-on and extreme risk-off environments. However, they offer other meaningful diversification benefits that potentially make them strong complements to equities as sources of growth.

- Income is the primary, long-term source of expected return, rather than capital appreciation as is the case with equities.
- Bonds sit higher in the capital structure, offering an additional measure of potential protection in a financial crisis in exchange for sacrificing the upside of equities.
- We believe non-core bonds will likely outperform in range-bound equity markets, due to the relatively low dividend yields offered by most equities.

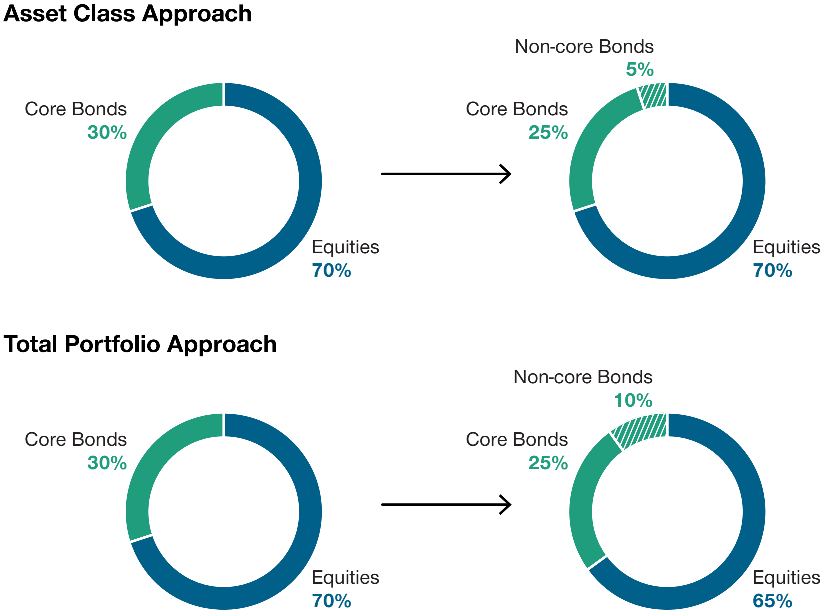
> “We believe U.S. plan sponsors may want to consider a total portfolio approach when funding non-core bond allocations.”

We believe U.S. plan sponsors may want to consider a total portfolio approach when funding non-core bond allocations. This is particularly the case for plans that have lowered their core fixed income allocations to levels that make them impractical to use as a funding source. We believe a total portfolio solution that funds higher non-core bond allocations from a mix of both public equities and core bonds can provide more flexibility while maintaining the current level of risk but still capturing the potential diversification benefits outlined above (Figure 4).

Funding higher non-core bond allocations entirely from existing core allocations could be expected to increase portfolio risk. While a shift toward non-core bonds also would tend to enhance fixed income return potential, some plan sponsors might deem this increase unnecessary for meeting their return targets.

Options for Funding Non-core Bonds

(Fig. 4) Asset class and total portfolio funding approaches



For illustrative purposes only. This is not intended to be investment advice or a recommendation to take any particular investment action. An individual plan's situation will vary.
Source: T. Rowe Price.

2. Adding Other Sources of Diversification

While core fixed income assets largely failed to mitigate equity risk when correlations spiked during the 2022 market sell-off, we believe they still have a valuable role to play in mitigating downside risk. We expect this to be the case once the risk of persistent inflation subsides, giving policymakers room to cut rates in the face of a slowing economy. Unlike much of the past 15 years, the opportunity cost of this risk mitigation is meaningfully lower, in our view, as bonds now provide positive real yields.

That said, inflation risk remains persistent, and we believe plans may want to consider complementing core bonds with other strategies seeking to mitigate risk in market environments like the one seen in 2022. These could include:

- Less directional and more flexible bond strategies that seek absolute returns across the full global opportunity set.
- Equity strategies that aim to reduce volatility and drawdowns by incorporating a mix of low-volatility equities and a dynamic volatility overlay.

3. Extending Core Duration

Most public DB plans use the Bloomberg U.S. Aggregate Bond Index to guide the implementation and measure the performance of their core bond allocations. But we think plan sponsors may want to consider whether that index's characteristics, particularly its duration, are appropriate for them.

We see several reasons for plan sponsors to lengthen the duration of their liquid fixed income allocations and reconsider the sector mix in their core bond allocations:

- While duration has remained relatively stable in many U.S. public DB plan portfolios, dollar duration has declined significantly as allocations to public fixed income have declined.
- Many private credit strategies have relatively low duration because of their underlying exposure to floating rate loans.
- Lower duration and greater credit (and equity) exposure both have the potential to perform poorly during a risk-off event and a flight to quality, leaving plans more exposed to downside risk.
- The shift from public to private fixed income in plan portfolios is likely to have concentrated credit risk in corporate bonds. This creates a potential opportunity to diversify credit risk by raising exposure to other fixed income sectors, such as securitized bonds.

Appendix: Models Used to Forecast Most Asset Classes[1]

T. Rowe Price Capital Market Assumptions

Equity Returns

Return = Expected Inflation + Expected Dividend Yield + Average Real EPS Growth + Valuation Impact + Currency Impact

- Inflation, dividend, and real earnings expectations provided by T. Rowe Price investment professionals.
- Valuation changes converge linearly over five-year time horizon.
- Currency impact assumes unhedged exposure.

Fixed Income Returns

Return = Average Yield + Rolldown + Average Spread × Spread Capture + Valuation Impact + Currency Impact

- Cash yields, term premia estimates, average spreads, and spread capture forecasts provided by T. Rowe Price investment professionals.
- Valuation impact reflects changes to both underlying government yields and spreads.
- Currency impact reflects hedging costs and/or yield pickup for some asset classes.

Alternatives Returns

Return = Cash + Alpha + Extimated Beta to Risk Premia × Forecasted Premia

- Cash yields and alpha estimate forecasts provided by T. Rowe Price investment professionals.
- Asset classes such has hedge funds and private equity/real estate derive a significant amount of their value proposition from active management alpha, which includes the illiquidity premium.
- Premia return estimated using estimates of equity risk premium, small-cap premium, emerging markets premium, investment-grade credit premium, and duration premium.

1 Forecasts for certain asset classes, such as real asset equity, gold, and U.S. Treasury inflation protected securities follow slightly different processes to incorporate the uniqueness of the asset classes.

Additionally, since duration can be extended using derivative instruments, plans that have the ability to do so may want to consider redeploying capital into other strategies, such as the more flexible dynamic bond vehicles mentioned here.

> ***"In our view, there has never been a more important time for investors to reexamine their asset allocations to see if return targets can be achieved with more diversified portfolios."***

Conclusions

In our view, there has never been a more important time for investors to reexamine their asset allocations to see if return targets can be achieved with more diversified portfolios. This is particularly true considering that many current allocation policies were influenced by an economic environment that is very different from the one we are in today.

We also believe that the asset allocation changes that have taken place over the past 15 years, combined with a wide range of implementation approaches, may warrant a total portfolio approach that looks across asset classes to capture equity and fixed income exposures that may reside outside their respective asset classes. In our view, taking these steps will allow for more precise measurement of key exposures, thus reducing the likelihood of unexpected outcomes regardless of how asset classes perform going forward.

IN SUMMERY

The period of low yields following the global financial crisis forced many public defined benefit plans to allocate to riskier asset classes.

Higher interest rates and capital market return assumptions provide an opportunity to revisit sources of return and risk at the asset class and strategy levels.

Sponsors may want to reevaluate the multiple roles that different segments of the fixed income universe can now play in their portfolios to make them more efficient.

Representative Indexes—Capital Market Assumptions

	Asset Class	Representative Index
Equity	Ex-U.S. Developed Equity	MSCI World ex-USA Index
Equity	U.S. Equity	Russell 3000 Index
Equity	EM Equity	MSCI Emerging Markets Index
Fixed Income	U.S. Cash	Bloomberg 1-3 Month Treasury Bill Index
Fixed Income	U.S. Core Bonds	Bloomberg U.S. Aggregate Bond Index
Fixed Income	U.S. High Yield	Bloomberg U.S. Corporate High-Yield Bond Index
Fixed Income	U.S. Bank Loans	Morningstar LSTA Leveraged Performing Loan Index
Fixed Income	EM Sovereign	J.P. Morgan EMBI Global Diversified

***Lowell Yura**, CFA, ASA, Head of Multi-Asset Solutions, N. America and Portfolio Manager. Lowell Yura is the Head of Multi-Asset Solutions, North America and Portfolio Manager, in the Multi-Asset Division of T. Rowe Price. He has extensive experience in the design and management of strategies across a range of markets including global balanced, global tactical asset allocation, liquid alternative, and overlay strategies.*

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Large-Cap Growth:

Navigating Index Concentration

“As of June 30, 2023, the cumulative weight of the top 10 constituents in the Russell 1000 Growth Index encompassed approximately 53% of the index’s total weight.”

Over the past decade, large-cap growth indices have delivered strong returns relative to many asset classes. But as index concentration has risen over this period, the largest issuers have become an increasingly sizable portion of the large-cap growth asset class and have been outsized contributors to index performance.

As a result of the growing market concentration, the majority of passive funds have also become top-heavy as their exposure to the largest index constituents moves in lockstep. Passive investors are essentially betting on the future success of a small subset of companies.

Active managers, unlike their passive counterparts, are not anchored to the dominant weights in the index and may be well positioned to navigate an evolving market landscape.

Large-Cap Growth Index Concentration—A Closer Look

The performance of the large-cap growth asset class has been strong over the past decade. The Russell 1000 Growth Index, which is a representative benchmark for the large-cap growth asset class, has returned over 15% per annum for the 10-year period ending June 30, 2023.

This time frame has also coincided with a notable increase in concentration within the index. As of June 30, 2023, the cumulative weight of the top 10 constituents in the Russell 1000 Growth Index encompassed approximately 53% of the index's total weight, as shown in Figure 1. Furthermore, the top five constituents accounted for roughly 41% of the index weight. This presents a substantial increase compared to a decade ago, when the weightings were less than half of these figures in each category.

Moreover, during the late 1990s and at the peak of the dot-com era, the index exhibited heightened concentration. In subsequent years, index leadership diversified. This ensuing period proved to be a strong environment for active management.

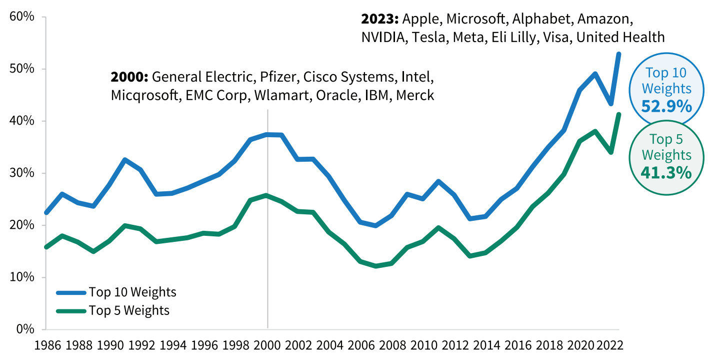
> *"As the goal of most active managers is to outperform their benchmarks over time, weighting differences in individual stocks becomes necessary to generate alpha."*

Growing Index Concentration Challenges Active Management

As concentration within the index has increased, performance leadership has also narrowed. Although the index has delivered strong returns over the past decade, this surge in concentration has led to performance being heavily reliant on a select few companies. As the goal of most active managers is to outperform their benchmarks over time, weighting differences in individual stocks becomes necessary to generate alpha.

However, the rise in index concentration has introduced portfolio construction challenges due to potential risk tolerance concerns in holding large positions in a small number of stocks. Rising concentration has made it challenging for active strategies to outperform passive funds, which typically systematically allocate escalating weights to stocks with the largest market capitalizations in following their respective index.

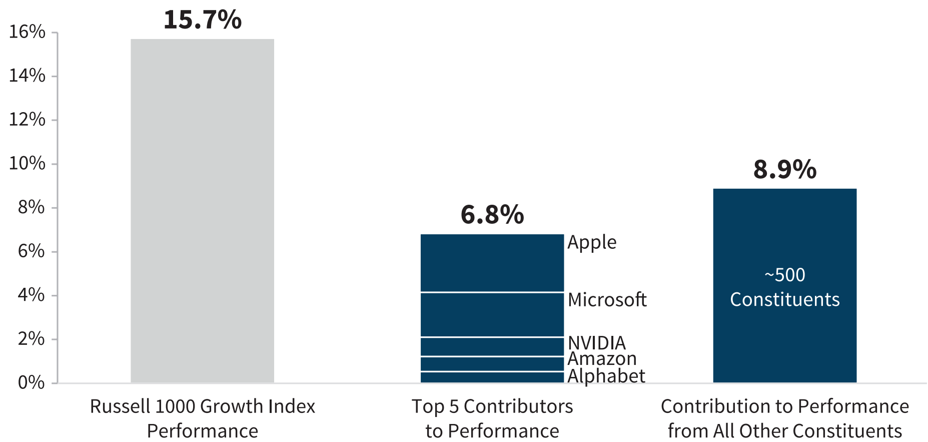
Figure 1. Russell 1000 Growth Index: % Weight in Top Issuers [1, 2, 3]



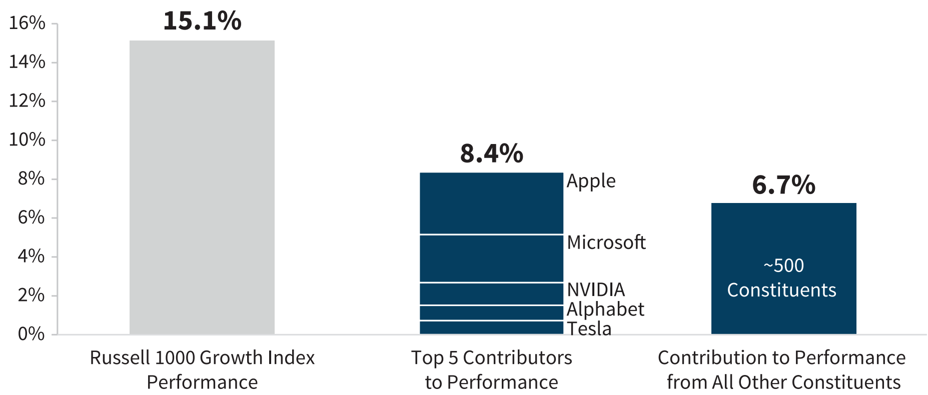
Issuer (6/30/2023)	Index Weight
Apple Inc.	13.4%
Microsoft Corp.	11.7%
Alphabet, Inc.	6.2%
Amazon.com	5.4%
NVIDIA Corp.	4.6%
Tesla, Inc.	3.3%
Meta Platforms	2.9%
Eli Lilly & Company	1.8%
Visa Inc.	1.8%
United Health Group	1.7%
Total	52.9%

Source: FactSet, as of 6/30/2023.

Figure 2. Russell 1000 Growth Index: Annualized Performance Contribution [1, 2, 3] (10-Year Period Ending 6/30/23)

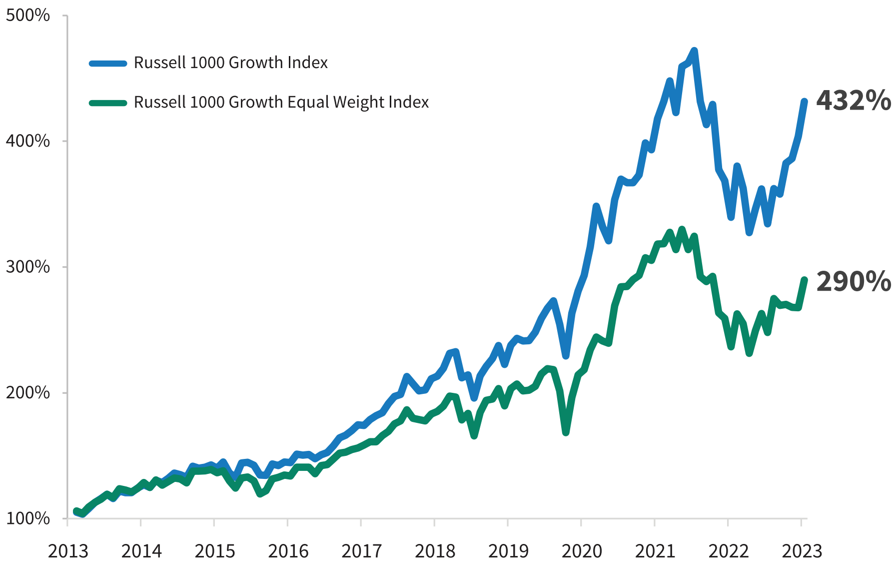


Russell 1000 Growth Index: Annualized Performance Contribution [1, 2, 3] (5-Year Period Ending 6/30/23)



Source: Eagle, as of 6/30/2023.

Figure 3. Russell 1000 Growth Index vs. Rusell 1000 Growth Equal Weight Index [2, 3] (Performance Indexed to 100)



Source: FactSet, as of 6/30/2023. Performance indexed to 100 at 6/30/2023.

Over the 10-year period ending June 30, 2023, the return of the Russell 1000 Growth Index was driven significantly by the performance of five stocks which have accounted for nearly 45% of the index return, as shown in Figure 2. This dynamic was even more pronounced over the five-year period ending June 30, 2023, as the performance of five stocks accounted for nearly 60% of the index return.

Furthermore, Figure 3 highlights the performance difference between the Russell 1000 Growth Index compared to an equal weighted version of the index, with all constituents having the same weighting. This again helps to highlight index performance was driven by a smaller subset of companies over this period.

According to data from eVestment, fewer than 20% of managers in the large-cap growth universe outperformed the index over this time frame. Active management performance appears to have been closely tied to the weighting of a select few companies within portfolios relative to their increasing weight within the index during this period. However, as we discuss next, performance headwinds for active large-cap growth managers may be changing as we look ahead.

> *“The market leaders of today may not necessarily maintain their position as leaders in the future.”*

Shifting Tides May Be Ahead

Predicting market bottoms or peaks remains elusive, often apparent only in hindsight, and a similar principle applies to index concentration and the timing of potential shifts. Nonetheless, what is evident is the current escalated level of concentration within large-cap indices.

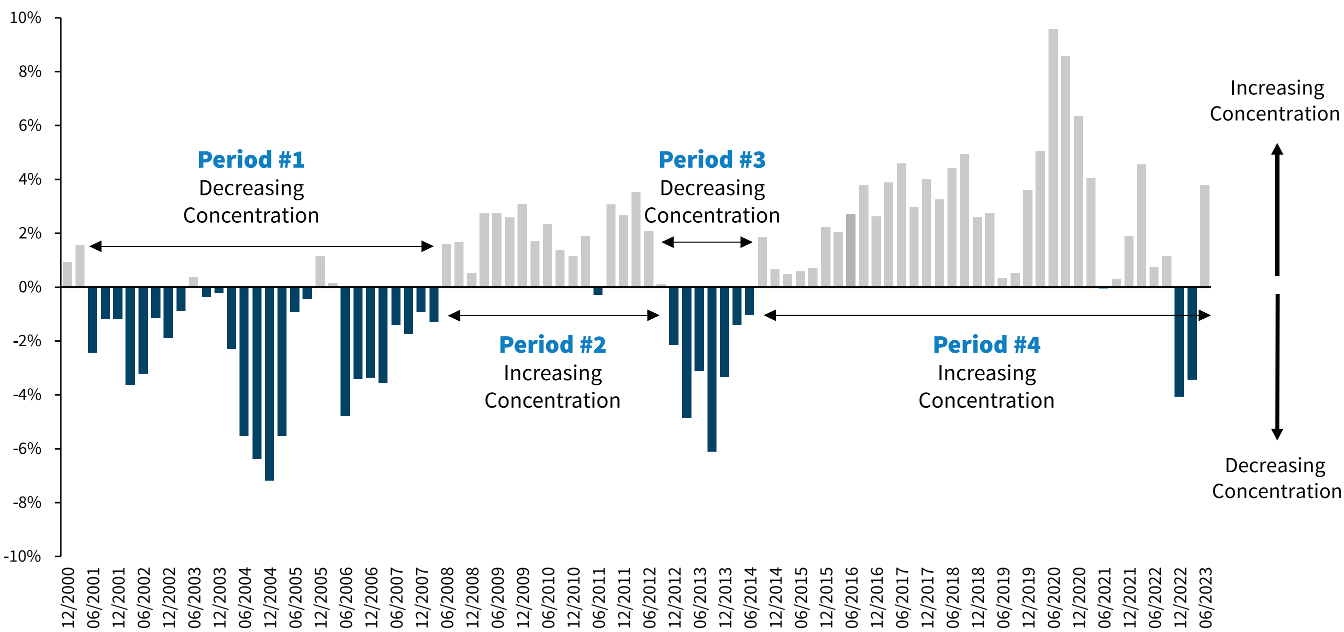
As a result of growing market concentration, most passive funds have a disproportionate exposure to these stocks and do not have the ability to actively manage associated risks. Put another

Figure 4. Russell 1000 Growth Index: Top 5 and Top 10 Issuers Weights [1, 2, 3]

2000		2005		2010		2015		2020		6/30/2023	
General Electric	8.1	General Electric	4.4	Exxon Mobil	5.2	Apple	5.7	Apple	11.6	Apple	13.4
Pfizer	5.5	Microsoft	3.8	Apple	4.5	Alphabet	4.2	Microsoft	9.1	Microsoft	11.7
Cisco Systems	5.2	Procter & Gamble	3.0	IBM	2.9	Amazon	2.4	Amazon	7.5	Alphabet	6.2
Intel	3.8	Johnson & Johnson	2.8	Alphabet	2.2	Microsoft	2.4	Alphabet	4.4	Amazon	5.4
Microsoft	3.2	Intel	2.4	Microsoft	2.2	Meta Platforms	2.1	Meta Platforms	3.6	NVIDIA	4.6
Total Top 5 Issuers	**25.8**		**16.4**		**16.9**		**17.0**		**36.1**		**41.3**
EMC Corp.	2.7	Walmart	1.8	Oracle	1.8	Walt Disney	1.7	Tesla	2.9	Tesla	3.3
Walmart	2.5	IBM	1.8	Cisco Systems	1.8	Verizon	1.7	Visa	2.0	Meta Platforms	2.9
Oracle	2.3	Cisco Systems	1.7	Coca-Cola	1.6	Home Depot	1.6	Mastercard	1.7	Eli Lilly	1.8
IBM	2.1	PepsiCo	1.5	Schlumberger	1.5	Coca-Cola	1.6	NVIDIA	1.7	Visa	1.8
Merck & Co.	2.0	Amgen	1.5	HP Inc.	1.5	Visa	1.4	UnitedHealth Group	1.5	UnitedHealth Group	1.7
Total Top 10 Issuers	**37.4**		**24.8**		**25.1**		**25.0**		**45.9**		**52.9**

Source: FactSet, as of 6/30/2023.

Figure 5. Year-Over-Year Change in Top 5 Russell 1000 Growth Index: Constituents Weights [2, 3]



	Period #1 Decreasing Concentration 04/2001 – 03/2008	**Period #2** Increasing Concentration 04/2008 – 09/2012	**Period #3** Decreasing Concentration 10/2012 – 06/2014	**Period #4** Increasing Concentration 07/2014 – 06/2023
U.S. LCG Universe[4]: Annualized Median Manager Excess Return (Gross)	**1.73%**	**-0.68%**	**0.50%**	**-1.34%**
U.S. LCG Universe[4]: Annualized Median Manager Excess Return (Net)	**1.41%**	**-1.18%**	**-0.20%**	**-2.13%**
Russell 1000 Growth Index[2,3]: Annualized Return	**2.07%**	**6.29%**	**21.22%**	**14.57%**
Russell 1000 Growth Index[2,3]: Return Ranking	**81**	**35**	**57**	**16**

Source: FactSet and eVestment,, as of 6/30/2023.

way, an investor who owns passive large-cap growth effectively owns everything in the index, including large position sizes in a small number of companies.

In contrast, active managers have the flexibility to be more selective among companies by overweighting, underweighting, or simply not owning index constituents, as well as trading in real time should company fundamentals, valuations, etc., change. As a result, active managers have the potential benefit of capturing upside and/or avoiding downside, unlike the index given its passive nature. This is important to note as the composition of the index continually evolves, with stocks going in and out of favor as their fundamentals change over time.

The market leaders of today may not necessarily maintain their position as leaders in the future. As we outline in Figure 4, the composition of the largest issuers within the index today is notably distinct from that of the early 2000s.

However, in a departure from previous periods characterized by frequent changes in index leadership, there has been remarkable consistency in the composition of the largest constituents over the past 10 years. The sustainability of this trend is uncertain and assuming that the increased concentration and consistency of the largest constituents will indeed persist into the future constitutes a potential risky bet over the long term.

Historically, during periods of increasing concentration, active managers have lagged the index, as performance is more concentrated in a smaller subset of stocks. Conversely, during periods of decreasing concentration, the median manager in the large-cap growth universe generated positive excess return as the market landscape broadened.

Figure 5 illustrates the year-over-year change in the top five issuer weights of the Russell 1000 Growth Index as a way to measure periods of increasing/decreasing concentration in the index.

During periods of increasing index concentration, depicted as periods #2 and #4 in the chart, the median manager in the large-cap growth universe lagged the index return. During these periods, the index performance ranked in the top 50% of the large-cap growth universe.

Nonetheless, during periods of decreasing index concentration, shown as periods #1 and #3, the median manager outperformed the index return and the index performance ranked in the bottom 50% of the universe.

While gauging when the tide may turn is difficult to predict, it is increasingly clear that the concentration of the index is at all-time-high levels, and when the tide goes out, history suggests active managers may be in a position to benefit.

In Summary

Performance of the large-cap growth asset class has become increasingly top-heavy, with investors biased toward the largest technology and tech-related stocks. We believe mean reversion among the largest constituents in the index is inevitable at some point, although trying to pinpoint when the tide will change can be an exercise of futility.

As active managers, we continue to focus on identifying structurally advantaged, quality growth companies that we believe can outperform over the long term. While gauging when the tide may turn is difficult to predict, it is increasingly clear that the concentration of the index is at all-time-high levels, and when the tide goes out, history suggests active managers may be in a position to benefit.

Aaron Socker *is a portfolio specialist for William Blair's U.S. growth and core equity strategies. Before joining the firm in 2022, he spent six years as a portfolio specialist at Allspring Global Investments (formerly Wells Fargo Asset Management), covering emerging markets equity and U.S. core equity strategies. Before that, he spent five years as a research analyst at Allspring, covering U.S. small- and mid-cap companies across sectors.*

Considering an In-house Modernization? Here's What You Need to Know.

"Why are they doing this? Because they believe that retaining control over their systems, resources and priorities is the best way to continue delivering excellent customer service."

We've seen it many times before: Pension organizations like yours get to a fork in the road where you need to decide whether to rewrite the code of your current system, upgrade with a commercial off-the-shelf vendor, or modernize to a more cohesive technology.

There may be multiple issues that get you to this place:

- Processes that heavily rely on paper or "digital" paper (PDFs) requiring manual entry consume the time of internal resources away from performing value-added services to your membership,
- Outdated legacy technology that is difficult to support with current resources and is difficult to attract talent to maintain, which in turn poses a risk to the organization,
- Insufficient access to comprehensive dashboards with metrics and reports that make it hard to be able to work effectively and to understand the tasks that cause delays in providing timely responses and calculations,
- Minimal front-end validations on employer contribution files allow for incomplete or inaccurate data; IT manual repair of files is costly and time consuming,
- Lack of data security and potential cybersecurity risks,
- The inability to program legislative and technology changes in a timely and cost-effective manner.

Faced with this decision, some pension funds saddled with these issues are choosing to modernize in-house.

Why are they doing this? Because they believe that retaining control over their systems, resources and priorities is the best way to continue delivering excellent customer service.

Going the in-house modernization route has several advantages:

- Controls the priority and pace of change, no longer needing to submit a ticket to an outside provider for a change order,
- Gives your organization an opportunity to streamline your system and use business process improvement strategies,
- Allows your organization to prioritize your implementation schedule and maintain it,
- Ensures your membership needs are being met by technology you control.

> *“These initiatives require lots of internal leadership over a long period of time.”*

However, despite the size of staff, there are many challenges you need to consider. Implementing a new system is a once in a career undertaking and many on staff will not have the experience or expertise to perform this transformation effectively, or there are not enough staff to dedicate their time to assisting in this transformation. The new architecture will be even more complicated to manage technologically and even for large organizations, outside contractors must be used for coding.

These initiatives require lots of internal leadership over a long period of time. Because the change is substantial, your leadership needs to get behind this, and will need to continue motivating others over the course of several years to ensure that staff and stakeholders can also get behind the changes. They also require documented governance structures for decision-making, and that structure needs to be followed or there will be breakdowns in how important decisions are made and are accepted by others.

> ***“Before fully going down the path of a modernization, your organization needs to conduct a full assessment to address Risks/Timelines and Budgets based on market knowledge, peer interviews and vendor demos.”***

These projects also require lots of resources, and typically more resources than currently exist on staff. Purchasing commercial-off-the-shelf (COTS) software means you are outsourcing many things to a vendor; if you decide to do this in-house, it means those resources need to be available internally, or need to be hired (many just for this project, and others in an ongoing capacity.)

There are ways to address these challenges and they involve proper planning and oversight of the project.

First, before fully going down the path of a modernization, your organization needs to conduct a full assessment to address Risks/Timelines and Budgets based on market knowledge, peer interviews and vendor demos. This needs to be performed to ensure you are confident in the path selected and it is the best fit based on your organization’s priorities, needs, and skillsets.

If your organization determines that the in-house modernization route is the correct one, you will need to ensure you have tracking of the project, testing plans in place before you begin, training for stakeholders on how your new system will work, and development of a cybersecurity structure in tandem.

Some other key areas that will help you accomplish your goals:

- Develop a full staffing plan for both the implementation project, which is a one-time thing, and for the future maintenance and operations with the new system,
- Implement an Organizational Change Management program, these projects will not be successful without the buy-in of your staff,
- Implement a Business Process Improvement Initiative to document the current state and desired future state,
  - This makes sure the organization is not going like for like, but like for better,
- Continually review Future State Architecture/Technical/Operations Goals for key guidelines and objectives,
- Supplement your staff with external resources to either focus on the modernization or to back-fill key roles to be seconded to the project.

These are some of the key activities necessary to begin your modernization journey.

*Linea Solutions’ **Kevin Lynch**, senior VP of Client Solutions, has been involved in solutioning for the Pension administration business for over 20 years across a variety of roles and organizations in North America. Kevin has worked on both public and private sector pension plans in Canada and the United States and has experience in pension administration operations, implementation, and business development. He has worked for multiple pension administration providers in both a third-party administration capacity and at a software vendor. His expertise lies across pension administration best practices, process improvements, and customer satisfaction initiatives.*

> “While there were several areas of public policymaking that captured the Legislature’s attention this year, labor and employment policy primarily dominated the legislative landscape.”

State Association of County Retirement Systems

LEGISLATIVE REPORT

The California Legislature closed out its work for the 2023 legislative session on the evening of September 14, sending approximately 900 bills to the Governor for consideration. The Governor had until October 14 to act on those measures.

While there were several areas of public policymaking that captured the Legislature's attention this year, labor and employment policy primarily dominated the legislative landscape. This was driven by ongoing strikes affecting the entertainment and Southern California lodging industries. Additionally, threatened strikes by healthcare workers, state and local public employee unions, UPS, pending statewide ballot measures, and a referendum to overturn a recently enacted restaurant wage law, the media deemed summer 2023 to be California's "Hot Labor Summer".

The Democrat dominated and labor-friendly Legislature responded with dozens of legislative proposals aimed at assisting its most important constituency: organized labor. With overwhelming 3/4 supermajorities in each house of the Legislature, labor-backed, Democrat-authored labor bills are almost certain to pass. Among the many labor-backed bills that the Governor has acted on are:

SB 799 (Portantino) Unemployment Insurance for Striking Workers -- VETOED

This bill would have made striking workers who have been on strike for more than two weeks eligible for unemployment insurance benefits.

SB 616 (Gonzalez) – Paid Sick Leave -- SIGNED

This bill would extend the annual amount of paid sick leave required to be given to an employee from three days to five days.

The Governor has not yet acted on AB 1 which would allow legislative employees to join a union and collectively bargain for their wages and working conditions.

LEGISLATION OF INTEREST

***As of this writing**

SB 885 (Committee on Labor, Public Employment and Retirement)

This is the annual committee omnibus bill that contains various cleanup provisions for CalSTRS, CalPERS and CERL systems. The amendments to the CERL make non-substantive, technical changes, as well as conform provisions on Required Minimum Distributions to federal law under the SECURE ACT 2.0 by referencing the federal law instead of a specific age.

The Governor signed this bill into law.

AB 1020 (Grayson) – CERL Disability Presumptions

This bill would establish several new disability retirement presumptions for various injuries and illnesses in the CERL, similar to provisions that exist in the Labor Code. The bill is sponsored by the California Professional Firefighters. The author and sponsor agreed to technical clarifications proposed by SACRS that were amended into the bill in June. CSAC remains opposed to the bill.

The bill is on the Governor's desk.

AB 1637 (Irwin) - Local Government Websites and Email Addresses

Would, no later than January 1, 2029, require a local agency, as defined, that maintains an internet website for use by the public to ensure that the internet website utilizes a ".gov" top-level domain or a ".ca.gov" second-level domain and would require a local agency that maintains an internet website that is noncompliant with that requirement to redirect that internet website to a domain name that does utilize a ".gov" or "ca.gov" domain. This bill, no later than January 1, 2029, would also require a local agency that maintains public email addresses to ensure that each email address provided to its employees utilizes a ".gov" domain name or a ".ca.gov" domain name. By adding to the duties of local officials, the bill would impose a state-mandated local program.

The bill is on the Governor's desk.

AB 557 (Hart) - Brown Act Emergency Teleconferencing Sunset Extension

This bill would remove the sunset in current law to allow teleconferencing during certain emergencies, as well as increase the time period when the Board must renew the findings of an emergency or need for social distancing from 30 days to 45 days.

The bill is on the Governor's desk.

SB 537 (Becker) - Teleconference Flexibilities

This bill would allow expanded teleconference flexibilities for multijurisdictional, cross county legislative bodies if certain requirements are met, along with adding to the list of circumstances where a member is permitted to participate remotely. The bill has been narrowed considerably as it advanced through various policy committees in each house.

The bill was held on the Assembly Floor and may be considered when the

Legislature returns in January.

2024 LEGISLATIVE PREVIEW

The legislative committee reviewed proposals for consideration at the 2023 SACRS fall conference.

***Michael R. Robson** has worked since 1990 in California politics and has been lobbying since 2001 when he joined Edelstein, Gilbert, Robson & Smith LLC. Prior to joining the firm, he began a successful career with Senator Dede Alpert as a legislative aide soon after she was elected to the Assembly in 1990. He became staff director/chief of staff in 1998, while the Senator served in the position of Chair of the Senate Appropriations Committee. He is experienced in all public policy areas with particular expertise in environmental safety, utilities, revenue and taxation, local government finance, education, and the budget.*

***Trent E. Smith** worked for over 12 years in the State Capitol prior to joining the Edelstein, Gilbert, Robson & Smith LLC. He started his career in 1990 working for the well-respected late Senate Republican Leader Ken Maddy. He was later awarded one of 16 positions in the prestigious Senate Fellowship Program. Upon completion, he started working in various positions in the State Assembly. He worked as a Chief of Staff to Assembly Member Tom Woods of Redding and later to Orange County Assembly Member, Patricia Bates, who served as Vice Chair of the Assembly Appropriations Committee. In this position, he gained a unique and valuable knowledge of the State budget and related fiscal policy matters. In addition, he has extensive experience in numerous policy areas.*

***Bridget McGowan** joined Edelstein Gilbert Robson & Smith in 2018. Prior to joining the firm, she gained policy experience in the California State Assembly. Through internships in the district office of her local Assemblymember and later, in the office of the Chief Clerk, McGowan developed her knowledge of California's legislative process, rules and procedures. A graduate from UC Davis in 2018 with a Bachelor of Arts in International Relations, she is currently pursuing a Master of Public Administration from the University of Southern California Price School of Public Policy.*

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