Memo

To: Nebraska Investment Council

From: Max Kotary, CFA
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       Chris Sanders

Date: November 18, 2021

Re: Fixed Income Structure Review

Action: That the Nebraska Investment Council approve the new fixed income allocations and benchmarks for the Defined Benefit, Cash Balance Benefit, Omaha School Employees Retirement System, General Endowments, Excess Liability, and Investor Select Fund as outlined on pages 5-7 of the Fixed Income Review presentation. To implement the new allocations, approval also includes the dismissal of managers Neuberger Berman, Wellington, Franklin Templeton and Loomis Sayles' bank loan portfolio. The State Investment Officer has the authority to enter into necessary legal agreements, subject to completion of legal review and satisfactory agreement of terms.

Overview and Summary

We have included in our materials a presentation that summarizes the review of the Plans’ fixed income component that was completed by the Nebraska Investment Council staff and Aon. Our presentation consists of a recommended structure for the fixed income component for each portfolio and includes a recommendation to update fixed income component benchmarking.

Summary of the process that was followed and a recommended structure for the fixed income component.

The Fixed Income Blank Sheet review began in October 2019. Thirteen investment managers were asked to participate and share their best ideas for the fixed income portfolios. Over several months, meetings were held with the managers and NIC staff to discuss the fixed income portfolio solutions. Staff then shared with Aon all of the manager presentations, a summary of the key takeaways, and an outline of several ideas/topics that fit the portfolios. Aon and staff then spent several months discussing various ideas and potential structures for the portfolios’ fixed income allocation. Ultimately, Aon and staff agreed on a proposed fixed income structure to present to the Board.
March 2021: Aon and staff presented an update and overview to the Board of the fixed income structure recommendations. The Board requested more information on illiquid credit and on active vs. passive management in core/core-plus fixed income.

June 2021: Aon presented information on active versus passive investing in core/core-plus fixed income portfolios. Aon also provided the Board with a review of illiquid credit (specifically, direct lending).

September 2021: Aon and staff presented the fixed income structure recommendation to the Board as well as a change to the way the fixed income portfolios are benchmarked. The recommendation included adding three new managers/funds to the portfolio (including Baird Advisors, Barings and PIMCO). The Board requested additional information on Baird.

  o Michael Walden-Newman, staff and Aon spoke with Baird Advisors after the September Council meeting. To follow-up on Board questions and concerns, additional materials were shared with the Board (9/27/21) including information on the Nebraska Investment Council’s largest actively managed exposures, detail on Baird’s assets under management by investment strategy, and Baird’s largest separate account relationships.

December 2021: The presentation includes a fixed income structure recommendation for the Defined Benefit Plans, the Cash Balance Benefit Plans, OSERS, the Investor Select investment option, the General Endowments and Excess Liability fund. There is also a recommendation to approve changes to the way the fixed income allocations are benchmarked. A summary of each recommendation can be found below with more detail located in the presentation.

**DB/CBB/OSERS** (30% of the total portfolio) – page 5
5% BlackRock (passive)
5% PIMCO (core-plus)
5% BlackRock (core-plus)
5% Baird (core-plus)
3.4% Loomis Sayles (multi-sector)
3.3% PIMCO (multi-asset credit)
3.3% Barings (multi-asset credit)
* The OSERS portfolio will be invested per the interim plan but will move towards the long-term target allocation.

**Investor Select (30% of the total portfolio) – page 5**
- 5% BlackRock (passive)
- 7.5% PIMCO (core-plus)
- 7.5% BlackRock (core-plus)
- 10% PIMCO (multi-asset credit)

Per state statute 84-1310.01, the investor select fund is offered as an investment option in the Defined Contribution Plan and should be invested with an asset allocation and investment strategy substantially similar to that of the Defined Benefit Plan. Therefore, we are proposing an update for the investor select fund that would result in a fixed income allocation that is similar to what is being proposed for the Defined Benefit Plan. The investor select fund is a daily priced fund and has less than $30 million in assets, so it is not feasible for the fund to invest exactly like the Defined Benefit Plan. The goal is for the fund to be invested in a substantially similar fashion using available products.

**General Endowments (50% of the total portfolio) – page 6**
- 15% BlackRock (passive)
- 10% PIMCO (core-plus)
- 10% Baird (core-plus)
- 7.5% Loomis Sayles (multi-sector)
- 7.5% PIMCO (multi-asset credit)

The Excess Liability fund is invested 100% in fixed income. The current portfolio is invested with the same asset allocation as the fixed income portfolio in the General Endowments. Our recommendation would be for any changes made to the General Endowment fixed income portfolio to also be implemented within the Excess Liability fund (adjusted for 100% fixed income).

**Benchmark Recommendation – page 7**
We are proposing formally separating the target allocations to fixed income into risk-reducing fixed income and return-seeking fixed income for reporting and benchmarking purposes.
- Risk-reducing fixed income (DB/CBB/OSERS, General Endowments, Excess Liability, and Investor Select)
  - Allocation benchmark = Bloomberg US Aggregate Bond Index
  - We are also proposing changing the manager benchmark for the core-plus managers to the Bloomberg US Aggregate Bond Index.
- Return-seeking fixed income
  - For the return-seeking fixed income allocations, we propose using market-based benchmarks that reasonably align with each allocation’s manager opportunity sets
    - NIC’s return-seeking fixed income allocations in the DB/CBB/OSERS Plans, General Endowments/Excess Liability Fund, and Investor Select Fund will all be constructed differently and will have somewhat different exposures
    - Proposed return-seeking allocation benchmarks
      - **DB/CBB/OSERS** = a mix of 25% IG corporate bonds, 25% HY corporate bonds, 25% bank loans, and 25% USD EMD
      - **General Endowments/Excess Liability** = a mix of 50% IG corporate bonds, 30% HY corporate bonds, and 20% USD EMD
      - **Investor Select** = a mix of 1/3 IG corporate bonds, 1/3 HY corporate bonds, and 1/3 USD EMD
  - At the individual manager level, we recommend using benchmarks that best reflect each manager’s opportunity set