Tacoma Employees' Retirement System

INVESTMENT POLICY STATEMENT
November, 2021

A. PURPOSE

The Investment Policy Statement ("IPS") of the Tacoma Employees' Retirement System (the "Plan") will provide the framework for the management of the Plan's assets. The policy sets forth an investment structure for managing Plan assets which include various asset classes, allocations among asset classes, acceptable ranges, and investment management styles that, together, are expected to produce a sufficient level of overall diversification and total investment return over the long-term. It has been designed to allow for sufficient flexibility in the management process to capture investment opportunities as they may occur, yet provide reasonable parameters to ensure prudence and care in the execution of the investment program.

The IPS has been formulated to encourage effective communication between the Board, Staff and the investment consultant and external investment managers. Additionally, the policy establishes criteria for monitoring, evaluating and comparing the performance results achieved by the Plan on a regular basis.

The cornerstone of this policy is the belief that there is a direct correlation between risk and return for any investment alternative. While such a proposition is reasonable, it is also probable based on empirical investigations. It is the stated intent of the Board to diversify between various investments types as deemed suitable.

B. GENERAL INVESTMENT GOALS

The general investment goals are broad in nature to encompass the purpose of the Plan and its investments. They articulate the philosophy by which the Board will manage the Plan's assets within the applicable regulatory constraints.

1. The overall goal of the Plan is to provide benefits to its participants and their beneficiaries through consistent contributions made by both employer and employees and a carefully planned and executed investment program.

2. Over long time periods, to match or exceed the actuarial assumed rate of return as adopted periodically by the Board.

3. The Plan seeks to produce the highest return on investment which is consistent with sufficient liquidity and investment risks that are prudent and reasonable, given prevailing capital market conditions. While the importance of the preservation of capital is recognized, the theory of capital market pricing, which maintains that varying degrees of investment risk should be rewarded with compensating returns, is also recognized. Consequently, prudent risk taking is reasonable and necessary.

4. The Plan's investment program shall at all times comply with applicable local, state and federal regulations.

C. GENERAL INVESTMENT POLICIES

1. In developing the IPS, the Board shall periodically request asset allocation studies that consider the current and expected condition of the Plan, the expected long term capital market outlook and the Plan's risk tolerance. The asset allocation study shall measure the potential impact on pension costs of alternative asset allocation policies based on various degrees of diversification in terms of risk and return and the existing and projected liability structure of the Plan. Planning for the asset allocation studies creates an opportunity for the Board to evaluate the appropriateness of new asset classes or strategies, and may result in the introduction of new asset classes and/or elimination of others. The Board will undertake asset allocation studies no less frequently than every five years, and shall determine (1) the asset classes to be included in the investment portfolio, (2) the targeted or normal commitments to each asset class to achieve the desired level of diversification and return (collectively, the "Strategic Asset Allocation"), and (3) the range in which the commitments are permitted to fluctuate.

2. The Strategic Asset Allocation shall be sufficiently diversified to maintain investment risk at a reasonable level, as determined by the Board, without imprudently sacrificing return and may take into account the following factors:

   a. the historical performance of capital markets adjusted for the perception of the future short and long-term capital market performance;

   b. the historical correlation of returns among the relevant asset classes as well as projections for future correlations;

   c. the perception of future economic conditions, including inflation and interest rate assumptions;

   d. the projected liability stream of benefits and the costs of funding Plan benefits, including liquidity needs;

   e. the relationship between the current and projected assets of the Plan and the projected actuarial liability stream.

3. Taking into account the Strategic Asset Allocation, as it deems appropriate, the Board shall review the allocation of the Plan's investments within the various asset classes. The Board will implement the Strategic Asset Allocation by selecting one or more investment managers with demonstrated experience and expertise in the appropriate investment classes and styles. The Board will set investment guidelines for the managers, which set forth the list of authorized investments, the typical portfolio characteristics, and portfolio constraints where applicable, for each strategy.

The Board will regularly review each manager's investment performance on a total return basis against stated objectives. Formal meetings with the Plan's investment managers will be held at Board meetings as needed, and may discuss objectives, styles and returns or other matters deemed important by the Board.

4. A custodian bank shall hold the Plan's assets, settling purchases and sales of securities, identifying and collecting income which becomes due and payable on assets held, and providing management information and systems for accounting for the assets.

5. The Board may retain independent professional investment consultants to assist in the development and implementation of the IPS, and to monitor, oversee, report on and make recommendations with respect to the activity of current and, if appropriate, prospective investment managers, as well as the asset class structures.

6. It is the responsibility of the Board to manage the investments of the Plan at reasonable cost, being careful to review costs vs. benefits. These costs include, but are not limited to, management and custodial fees, consulting fees, transaction costs and other administrative costs chargeable to the Plan.

7. The Staff will reallocate assets on a periodic basis to balance the overall asset allocation against the target when deviations occur because of capital market fluctuations. All percentage allocations in this policy are based on the market value of assets. Further details on rebalancing can be found in Section E of this document.

8. The Board considers the active voting of proxies an integral part of the investment process. Proxy voting may be delegated to the discretion of investment managers retained by the Board. The managers shall be required to establish a proxy voting policy and maintain records of proxy votes, and shall make these records available quarterly to the Board or its designee as requested. The Board may at its discretion establish an overall policy of voting proxies in which case the managers' proxy voting policy shall be in accordance with that of the Board's. The Board recognizes that in certain non-U.S markets, investment managers may, balancing the costs and benefits, not exercise the Plan's proxy voting rights. In the case of institutional mutual funds selected by the Board, the Board shall vote fund-related proxies and maintain records, recognizing that the Plan owns a pro-rata share of the units of the fund - not the underlying securities. In the case of collective trust funds (CTF), the Board understands that the Plan owns a pro-rata share of the units of the fund - not the underlying securities. The trustee for the CTF shall vote the proxies on behalf of the CTF.

For those institutional mutual funds and CTFs which allow client input to proxy voting on their pro-rata share of the commingled assets via the selection of a pre-formed proxy policy, the Board may choose the proxy policy which best reflects their views.

9. No investment or action pursuant to an investment may be taken unless expressly permitted by the IPS, unless approved by the Board. The Board retains the right to waive any of the above policies if it deems that such waiver is in the best interest of the Plan and/or its participants. The Board acknowledges that when the Plan invests in a collective investment fund or other pooled vehicle, that vehicle may have uniform investment guidelines for all investors. The Board shall use the guidelines herein in evaluating the investment manager and reviewing the vehicle's guidelines, although it may not be able to impose such guidelines on the pooled fund investment manager.

10. The Board intends to review this Investment Policy Statement on an annual basis, but may at any time amend, supplement, or rescind this IPS.

D. CURRENT STRATEGIC ASSET ALLOCATION

The Board has adopted the following Strategic Asset Allocation effective February 2019.

	Target	Allowable Range (over/under)
Total Public Equity	**34.5%**	4.0%
Global Equity	23.0%	
Low Volatility Global Equity	11.5%	
Private Equity*	**10.0%**	4.0%
Fixed Income	**36.5%**	4.0%
Core Fixed Income	19.5%	
High Yield	6.0%	
Bank Loans	3.0%	
Long UST / TIPS	3.0%	
Emerging Market Debt	5.0%	
Private Real Estate	**10.0%**	2.5%
Real Assets**	**9.0%**	2.0%
MLPs	4.0%	
Private Real Assets	5.0%	
Total	**100.0%**	

***** = Due to the illiquidity of Private Equity, uncommitted Private Equity assets will be invested in a public equity index fund. Similarly, to the extent Private Equity is over its target, an off-setting underweight to Public Equity can be considered to bring the exposure to target.

** = Introduced in April 2011. Funding level will be below the minimum until assets are fully deployed.

GLOBAL EQUITY: 23.0%

The Global Equity segment of the portfolio will be allocated to U.S. and International equity-oriented developed and emerging market securities to approximate the global equity market capitalization breakdown between U.S. and International equities. These securities are included to provide the Plan with the potential to earn high rates of return relative to other asset classes, recognizing that equity investments also generate commensurate risk levels. To reduce currency risk, developed market non-U.S. equities will be partly hedged back to the U.S. dollar.

LOW VOLATILITY GLOBAL EQUITY: 11.5%

The Low Volatility Global Equity segment of the portfolio will be allocated to U.S. and International developed and emerging market equity and equity-oriented securities to approximate the global equity market capitalization breakdown between U.S. and International equities. These securities are included to provide the Plan with the potential to earn rates of return similar to traditional Global Equity over extended time periods, with comparatively reduced volatility.

PRIVATE EQUITY: 10.0%

Private equity investments are intended to provide the Plan with the potential to earn high rates of return relative to other asset classes, recognizing that private equity investments also generate commensurate risk levels. Additionally, private equity investments are significantly less liquid than those in the public markets. Private equity investments may include investments in venture capital, buyouts, mezzanine debt, and distressed debt. Uncommitted assets will be invested in equity index funds. Similarly, an over-allocation to private equity may be offset by reducing public equity index fund exposure

FIXED INCOME: 36.5%

The Fixed Income segment of the portfolio will be allocated to Investment Grade Fixed Income, High Yield marketable securities, Long Duration Treasuries/Treasury Inflation Protected Securities (“TIPS”), and Emerging Market Debt. This portfolio will be invested in domestic and international debt issues. The Investment Grade Fixed Income segment is expected to provide cash flow and relatively less volatility than the equity asset classes. The High Yield Fixed Income segment is comprised of bonds and loans which are rated below investment grade, but have been issued by going concern corporations. High Yield bonds exhibit higher yield to maturity than Investment Grade bonds, which improves the Plan’s net cash flow. The Long Duration Treasuries component provides an offset in the event of a sharp equity market selloff, while the TIPS Fixed Income segment would provide an investment that is expected to respond positively to unexpected increases in measured inflation; either of these would also serve as a high quality liquidity buffer. The Emerging Market Debt portion represents debt investments in entities domiciled in developing markets, which may be denominated in currencies other than the U.S. dollar.

PRIVATE REAL ESTATE: 10.0%

The Real Estate segment of the portfolio will be allocated to Private Real Estate. Investments in Private Real Estate securities shall be limited to Core-focused commingled funds, unless specifically approved by the Board. Private Real Estate investments are significantly less liquid that those in the public markets, with third-party appraised valuations provided quarterly.

REAL ASSETS: 9.0%

Investments included in the Real Assets class shall include those assets whose primary purpose is to achieve overall portfolio diversification and to provide a potential hedge against inflationary pressures in the traditional investment markets. Investments in infrastructure, commodities, agriculture, master limited partnerships and/or timberland may have lower correlations to the traditional equity and fixed income markets, and/or may offer attractive returns. Real Assets investments may be in commingled funds or separately managed accounts, and may have reduced liquidity.

CASH EQUIVALENTS

There is no allocation to cash equivalents. It is recognized that residual cash can result from normal trading activity, and sufficient cash is held in the Short Term Investment Fund to accommodate benefit and expense payments, as needed.

E. REBALANCING TO THE STRATEGIC ASSET ALLOCATION

Plan Staff and the Investment Consultants will compare the Plan's actual asset allocation to the Strategic and Interim Asset Allocation Targets to determine if they are within the permitted over/under ranges on a regular basis, and the results will be distributed periodically to the Board. This comparison shall be developed from the daily asset valuations obtained from the Plan's custodian. If this comparison reveals that an asset class is above the upper or below the lower boundary of the designated range, Staff will reallocate assets to return the asset class back into the target range, subject to market liquidity conditions. Cash flows that occur in the normal operation of the Plan may also be used to reallocate towards the Asset Allocation targets on a more informal basis.

F. PERFORMANCE OBJECTIVES

Long term objectives have been established against which the performance of the Plan is to be measured. Because capital markets fluctuate and given the duration of the liability stream, the viability of the asset allocation is to be judged over a period of a full market cycle, which is generally three to five years. The performance objectives are:

1. To generate an investment return that matches or exceeds the Board-approved policy-weighted index that is calculated by weighting the appropriate indices according to the Strategic Asset Allocation. The appropriate asset class benchmarks are laid out in the following table and are subject to change by the Board.

Asset Class	Benchmark/Index	
Global Equity	FTSE Russell Global Index, ½ hedged Developed Currency	Broad measure of world stock markets, including developed and emerging markets
Low Volatility Global Equity	MSCI ACWI Minimum Volatility	Rules-based index of world stock markets, including developed and emerging markets
Core Fixed Income	Bloomberg US Aggregate	Investment Grade U.S. issues with more than one year to maturity
High Yield Fixed Income	BofA Merrill Lynch US High Yield Master II Constrained	Represents the investable U.S. high yield market
Treasury Inflation Protected Securities	Bloomberg US TIPS	Represents Inflation-Protected Securities issued by the U.S. Treasury
Emerging Market Debt	J.P. Morgan EMBI Global Diversified	Broad measure of investable emerging market debt
Private Equity	MSCI ACWI IMI + 3%	Adjust public market returns for an illiquidity premium
Private Real Estate	NFI ODCE Property Index	Private Core real estate holdings
Real Assets	Custom blend of Alerian Midstream Energy Index and CPI+3%	Broad measure of investable MLPs

2. To add value by selecting investment managers who utilize active management where advisable; to invest passively where active management is less pronounced in its benefits.

G. GENERAL INVESTMENT MANAGER GUIDELINES

The investment management for the Plan is to be provided by external investment managers. Each investment manager will acknowledge its fiduciary status and other conformity with applicable state and federal laws. The guidelines for the investment managers are provided below:

1. Each manager shall operate under a set of guidelines specific to the strategic role its portfolio is to fulfill in the overall investment structure and any other applicable investment related policies. Additionally, the individual managers will be judged according to benchmarks that reflect the objectives and characteristics of the strategic role their portfolio is to fulfill.

2. An investment manager under contract to the Board should advise the Board and the Staff as promptly as possible (preferably within three business days) if at any time there is:

   a. a significant change in investment philosophy;

   b. a loss of one or more key management personnel;

   c. a new portfolio manager on the Plan's account;

   d. a material change in ownership structure of its firm;

   e. any occurrence which might potentially impact the management, professionalism, integrity, or financial position of the investment management firm; or

   f. a change in any other matter requiring notice in the contract between the investment manager and the Plan.

3. Sector and security selection, portfolio quality and timing of purchase and sales are delegated to the investment manager subject to the constraints within the manager's specific guidelines.

4. Unless specifically permitted in the investment manager guidelines or other governing document approved by or on behalf of the Board, the following transactions are prohibited: purchase of non-negotiable securities, short sales, selling on margin or "letter" (restricted) stock.

5. Transactions that involve a broker acting as a "principal", where such broker is also the investment manager who is making the transaction are prohibited.

6. Transactions will be made on a best execution basis, taking into consideration cost and prevailing market considerations and any outstanding soft dollar arrangements between the Plan and its vendors as permitted by law.

7. The use of derivatives shall be governed by the Derivatives Investment Guidelines for External Investment Managers, which is included in Appendix A, in the case of single customer accounts managed on behalf of the Plan. The use of derivatives in an overlay program shall be governed by the Derivatives Investment Guidelines for Overlay Managers, which is included in Appendix B.

When investing in a collective investment fund or other pooled vehicle (rather than hiring an investment manager to manage for a single customer account), the Board will use the Derivatives Guidelines to assist in evaluating the manager and reviewing the guidelines established by the manager for the pooled vehicle.

8. In the event of deviations resulting from conditions beyond the manager's control, including but not limited to market fluctuations, contributions into or withdrawals from the account, the manager shall rectify such deviations as soon as reasonably possible and notify the Board of any material deviations and actions taken therein. In the event of deviations resulting from the manager's mistake or any other action within the manager's control, the manager shall rectify such deviations immediately and notify the Board of the deviations and actions taken.

9. For purposes of the guidelines, (a) all percentages apply on a market value basis immediately after a purchase or initial investment and (b) any subsequent change in any applicable percentage resulting from market fluctuations or other changes in total assets does not require immediate elimination of any security from the Portfolio.

H. CONTROL PROCEDURES

As numerous parties are involved in the management of Plan assets, each service provider's specific duties and requirements are laid out in this section.

1. The Board's responsibilities include, but are not limited to:

   a. Developing and adopting policies to achieve the Plan's general investment goals and objectives.

   b. Reviewing policy recommendations made by Staff and the Investment Consultant.

   c. Approving asset classes for investment and approving a Strategic Asset Allocation, permissible ranges, and benchmarks for each asset class.

   d. Monitoring asset allocation vs. target, and monitoring total fund and investment manager performance vs. benchmarks.

   e. Selecting the appropriate proxy policy for those institutional mutual funds and CTFs which allow client input to proxy voting on their pro-rata share of the commingled assets.

2. The Staff's duties include, but are not limited to:

   a. Engaging with consultants, and other pertinent parties, to seek advice and counsel regarding asset allocation, investment strategy, manager selection and investment results.

b. Providing recommendations on asset allocation, investment strategy, and investment manager selection to the Board.

c. Overseeing the management of the Plan's asset class allocations within ranges approved by the Board, in accordance with IPS guidelines, and reporting to the Board the asset class allocations relative to their targets and ranges on a quarterly basis.

d. Monitoring, evaluating, and reporting periodically, to the Board, on the performance of the Plan relative to the benchmark and the Strategic Asset Allocation.

e. Monitoring and evaluating the investment managers, including maintenance of a formal "Watch List" as needed.

f. Implementing investment actions approved by the Board, when specifically delegated to staff.

3. The Board's independent investment consultant's responsibilities include, but are not limited to:

a. Providing independent review, analysis, and recommendations regarding the development and revision of policies to ensure overall consistency, use of best practices, and implementation of policies.

b. Monitoring, evaluating, and reporting periodically, to the Board, on the performance of the Plan relative to the benchmark and the Strategic Asset Allocation.

c. Monitoring and evaluating the Plan's investment managers and reporting recommendations, if any, directly to the Board on a quarterly basis, in accordance with the terms of its contract.

d. Periodically performing a detailed review of the Plan's asset allocation with specific recommendations.

e. Regular updates of projected asset class total return, volatility and correlation assumptions.

f. Issuing in-depth research reports ("white papers") on pertinent topics.

g. Assisting in fee negotiations with external investment managers, as needed.

4. The External Investment Managers ("manager(s)") are responsible for all aspects of portfolio management as set forth in each manager's contract with the Plan and shall fulfill the following duties:

a. Manage the Plan assets under its care, custody, and/or control in accordance with the objectives and guidelines in the Investment Policy Statement and specific contract.

b. Acknowledge and agree to take fiduciary responsibility in complying with the entire Investment Policy Statement set forth here, and as modified in the future.

c. Communicate with Staff, as needed, regarding investment strategies and investment results and present or report directly to the Board as requested.

d. Monitor, analyze, and evaluate performance relative to the agreed-upon benchmark.

5. The duties of the Advisory Committee are outlined in the Revised Code of Washington (“RCW”), section 35.39.090. The Advisory Committee shall:

a. Make recommendations on investment policies, practices and procedures to the Board.

b. Review the investment transactions of the Retirement Board annually.

c. Prepare a written report of its activities during each fiscal year.

I. OTHER INVESTMENT RELATED POLICIES

The Board from time to time, at its discretion, may adopt investment related policies that address specific issues.

APPENDIX A: DERIVATIVES INVESTMENT GUIDELINES FOR EXTERNAL INVESTMENT MANAGERS

A. BACKGROUND AND PURPOSE

The Tacoma Employees' Retirement System (the "Plan") has retained external investment managers for the express purpose of investing the assets. The Plan is a long-term investor; therefore, the assets are expected to be managed for the generation of long-term gains from investment principally in cash positions in stocks and bonds. Performance results garnered principally through short-term tactics using instruments other than cash market stocks and bonds is inconsistent with the Plan's overall investment strategy.

A "derivative instrument" is defined in these guidelines as an instrument whose value, usefulness and marketability derives from an underlying instrument which represents a direct ownership of an asset or a direct obligation of an issuer, i.e. a "spot" or cash market instrument. The growth of derivative instruments worldwide has facilitated the investment process. As a global institutional investor, the Plan is in a position to take advantage of derivative instruments to ensure overall investment performance objectives are achieved as specified.

The guidelines shall set forth the permitted circumstances under which derivative instruments may be used and the specific parameters for their use by external managers. The use of derivatives for exposure management by an overlay manager is covered in Appendix B.

B. DESCRIPTION OF DERIVATIVE STRATEGIES

The four basic derivative strategies can be described as follows:

Substitution: when the characteristics of the derivative sufficiently parallel that of the cash market instruments, the derivative may be "substituted" on a short-term basis for the cash market instrument. This strategy is particularly useful when investing new cash flows.

Risk Control: when characteristics of the derivative sufficiently parallel that of the cash instrument that an opposite position from the cash instrument can be taken in the derivative instrument to alter the exposure to or the risk (volatility) of the cash instrument. This strategy is particularly useful to manage risk without having to sell the cash instrument.

Arbitrage: when characteristics of a derivative are more attractive than either the cash instrument or another related derivative that the first derivative is purchased, or the cash instrument is swapped, to garner the short-term return potential from the derivative instrument, alone. This strategy is particularly useful to capture mispricing in the derivative instrument relative to either the cash instrument or another derivative.

Speculation: when the characteristics of the derivative are the sole reason for its purchase or sale where an underlying naked cash position is taken in the portfolio. This strategy also implies the leveraging of the portfolio, which may create an obligation of value in excess of the value of that portfolio.

C. PERMITTED TYPES OF DERIVATIVE STRATEGIES AND INSTRUMENTS

To the extent permitted in its investment management agreement with the Plan, a manager may utilize Substitution and Risk Control strategies. Arbitrage and Speculation are not permitted. The Board may approve in advance a manager's use of other derivative strategies from time to time. Under no circumstances is a manager permitted to leverage its Plan portfolio through the use of derivatives. For this purpose, leverage represents a portfolio having a total economic exposure greater than the net asset value of the portfolio.

An investment manager authorized to invest in derivatives may invest only in those derivatives that are derived from securities and currencies in the underlying cash market in which the manager is permitted to invest under the terms of its management agreement. The exception to this requirement is in hedging back to the U.S. dollar. Subject to the other provisions in these guidelines, a manager is permitted to utilize the following types of derivative instruments.

- Stock Index Futures
- Stock Index Options
- Bond Futures
- Equity Options and Warrants
- Currency Forwards
- Currency Futures

Other derivative instruments may be approved by the Board.

D. LISTING REQUIREMENTS

Derivative instruments may be traded either over-the-counter or may be listed on an exchange. However, over-the-counter options are subject to counterparty risk. To lessen this risk, individual counterparty exposure is limited to 25% of the total market value of exposure created by all derivatives (calculated at the time of purchase). In the event three or fewer counterparties are available, permission may be sought on a case-by-case basis from the Plan to increase the individual counter-party percent exposure.

Counterparty credit status shall be of the highest caliber with care taken to avoid credit guarantees extended through to parties less creditworthy than the primary counterparty to the transaction.

Each manager shall develop and have available for review credit guidelines for evaluating prospective counterparties and a list of approved counterparties for use in derivative transactions.

E. GLOSSARY OF TERMS

Cash Market Instrument: Securities traded on the spot market. Please see below for the definition of spot market.

Counterparty Risk: The risk that the other party in an agreement will default. This is a risk that is incurred when using derivatives.

Forward Contracts: Purchase or sale of a specific quantity of a commodity, government security, foreign currency, or other financial instrument at the current price, with delivery and settlement at a specific future date. Foreign Exchange (FX) transactions may occur between foreign currencies (cross currencies) when made in anticipation of future sales or purchases of securities or when consistent with the investment manager's currency management guidelines.

Futures Contracts: Agreements between two parties to buy or sell a specific amount of a commodity or financial instrument at a particular price on a future date. The buyer of the futures contract is obligated to purchase the underlying commodity or financial instrument unless the contract is sold before the settlement date. Stock index futures, bond futures and currency futures are examples of instruments in the futures market. The Commodities and Futures Trading Commission (CFTC) oversees the futures market.

Hedge/Hedging: Strategy used to offset investment risk. A perfect hedge is one eliminating the possibility of future gain or loss.

External Investment Manager ("manager(s)"): Specifications for each manager's oversight and investment guidelines of a designated portfolio of assets which are included in each of the investment managers' contracts.

Leverage: In general, leverage means creating a net obligation that exceeds the value of the assets assigned to a designated account, and is equivalent to borrowing money to purchase assets.

Liquidity: The capacity of the market place to accommodate a given supply of and/or demand for a security without unreasonable price changes resulting.

Options: Contracts that give the holder the right (not obligation) to buy or sell a particular asset at a specified exercise price within a set time period. A call option gives the option holder the right to buy the asset, while a put option gives the option holder the right to sell the asset. Stock index options, equity options, bond options, and currency options are examples of instruments in the options market.

Spot Market: Market in which securities are sold for cash and delivered immediately. This is in contrast to the futures or options market, where securities are not sold and delivered immediately.

Swap: Exchange of one security for another.

APPENDIX B: DERIVATIVES INVESTMENT GUIDELINES FOR OVERLAY MANAGERS

A. BACKGROUND AND PURPOSE

The Tacoma Employees' Retirement System (the "Plan") may employ an overlay manager to co-ordinate derivatives positions at the plan level. Unlike other external mandates, an overlay manager is not trying to add value through tactical views or active investment strategies. Instead, it seeks to maintain derivative positions to keep the Plan fully invested at all times, keep asset class exposures close to policy targets and to maintain the Plan's policy currency targets. As such, the overlay manager is primarily seen as an implementation specialist who looks to manage exposures to targets contained in the IPS.

A "derivative instrument" is defined in these guidelines as an instrument whose value, usefulness and marketability derives from an underlying instrument which represents a direct ownership of an asset or a direct obligation of an issuer, i.e. a "spot" or cash market instrument.

The guidelines shall set forth the permitted circumstances under which derivative instruments may be used and the specific parameters for their use by overlay managers. The use of derivatives for traditional asset managers is covered in Appendix A.

B. DESCRIPTION OF OVERLAY TECHNIQUES

There are three basic derivative strategies that are coordinated by an overlay manager:

Cash Overlay: The Plan holds cash balances at various times due to operational needs (pension benefit payments, capital calls, etc.) These positions are not motivated by investment views, and are at odds to the Plan's Strategic Asset Allocation, which has no weight assigned to cash. A cash overlay enters into long asset-class derivative positions that mimic an investment of the cash into that asset class. This combination synthetically "invests" the cash into the asset class, effectively replacing the cash exposure with the asset class exposure.

Rebalancing Overlay: Over time, relative performance will move asset class exposures from their target allocations. To rebalance these exposures back to target using cash securities requires co-ordination with managers, custodial operations by Staff, high transaction costs and potentially extended periods of being out of the market. A rebalancing overlay instead seeks to rebalance the portfolio in a manner which leaves the manager balances unaffected, by entering into short derivative positions for the overweight asset class and entering into long derivative positions for the underweight asset class. At the Plan level, this results in asset class exposures remaining closer to the strategic asset allocation without the complications of liquidating/re-investing physical assets.

Currency Overlay: Currency hedging is currently part of the Strategic Asset Allocation, in the form of hedging a portion of the currency exposure contained in developed-market equities back to the US dollar. A currency overlay considers both the physical stock holdings and any derivative positions to derive a net developed-market currency exposure at the total Plan level. The overlay manager then enters into the appropriate currency derivative positions to holistically hedge the currency risk to the desired goal level.

C. PERMITTED TYPES OF DERIVATIVE STRATEGIES AND INSTRUMENTS

To the extent permitted in its investment management agreement with the Plan, an overlay manager can only pursue a cash overlay, a rebalancing overlay, and/or a currency overlay. Tactical positioning, proprietary strategies, and any other strategies predicated upon generating excess returns are prohibited, unless authorized by the Board. Under no circumstances is an overlay manager permitted to leverage the total Plan portfolio through the use of derivatives.

Subject to the other provisions in these guidelines, an overlay manager is primarily expected to use the following instruments:

- Stock Index Futures
- Bond Futures
- Currency Futures and Forwards
- Centrally-Cleared Swaps

In particular, any short derivative position should clearly correspond to a countervailing long physical asset exposure.