

**AGENDA ITEM DETAILS**

**Subject:** Review, Discussion and Consideration of the TexaSaver Program Updates: TexaSaver Product Review Committee Recommendations– (Action)

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**RECOMMENDED ACTION:**

Move that the Board of Trustees of the Employees Retirement System remove the Davis New York Venture A (NYVTX) Fund from the TexaSaver 401(k)/457 Program with the program assets being mapped to the Vanguard Institutional Index (VIIIX) fund.

**Background:**

The Employees Retirement System of Texas (ERS) administers the TexaSaver<sup>SM</sup> 401(k) and 457 Program (TexaSaver program or program) – a voluntary tax-deferred supplemental retirement savings program. TexaSaver is designed to help state and eligible higher education employees save through elective payroll contributions to investment options, which they choose.

The program offers 12 core funds, nine Target Date Funds, and a self-directed brokerage account option. ERS' intent is to provide program participants with low-cost, diversified investment choices. The investment products are the same in the TexaSaver 401(k) and TexaSaver 457 plans.

The program is supported by the TexaSaver Product Review Committee (PRC), which serves in a consultative capacity regarding the investment options, fund managers, and investment advisory services provided to participants of the program. The nine-person committee membership includes internal ERS professionals, as well as external investment professionals.

Additionally, the program benefits from having a Portfolio Strategist assigned to the TexaSaver program from Empower/Great-West Investments (GWI).

During the July 28, 2020 PRC meeting, the GWI Portfolio Strategist facilitated an investment review of the program's existing investment options, strategic investment gap analysis (enhancement opportunities), and a performance review for specific underperformers (due diligence) within the program's investment line-up.

Enhancement Opportunities

In reviewing the TexaSaver program's fund lineup, the PRC determined that the fund line-up includes adequate coverage of major equity and fixed income categories. However, the PRC discussed opportunities to enhance the line-up with a passive international equity and a high yield bond fund.

*Passive international equity.* Although the program currently offers the Fidelity Diversified International (FDIVX) fund, this fund is an actively managed fund. The GWI Portfolio Strategist reported to the PRC that among 43 similar plans researched, 58% offered both an active and passive international fund, 23% offered only an active international fund, and 19% provided only a passive international fund. Overall, the PRC determined that a passive international fund would provide participants greater choice with the opportunity for a lower expense ratio and provide for greater diversification with a high quality rated fund (3- or 4-star Morningstar funds).

*High yield bond.* The GWI Portfolio Strategist also led a discussion of the PRC regarding a high yield bond fund. While not necessarily common as a standalone option, some large state plans offer high yield funds in their core line-up. The PRC determined that a high yield bond fund would provide greater choice

to participants, the ability to diversify fixed income holdings, and provide a source of fixed-income return in a yield-constrained environment.

### Due Diligence

*Performance overview.* As presented during the March 11, 2020 Board meeting, Davis New York Venture A (Davis) has underperformed over the long term. This fund has underperformed 90% of peers over 10 years and performed roughly even with its stated benchmark (S&P 500 Index) in 4Q19. This fund is highly concentrated with 47 stock holdings comprising the entire portfolio. Additionally there is a heavy bias in the financial services sector (>35%) and non-US holdings. These portfolio biases have been openly acknowledged by the fund's portfolio manager. Of note, the Davis fund carries a 1-star rating from Morningstar.

<b>Davis New York Venture A (NYVTX) Fund</b>	
<b>Large cap blend fund</b>	
(As of September 30, 2020)	
Total number of participant accounts:	32,128
Assets under Management (AUM):	\$140,956,898.81
Percent of Texa\$aver Program:	4.4%
Number of 401(k) participant accounts:	18,667
401(k) AUM:	\$106,552,883.90
Number of 457 participant accounts:	13,461
457 AUM:	\$34,404,014.91

### Davis fund annual performance review, July 20, 2020

Members of the PRC attended the Texa\$aver annual investment review scheduled with Davis. Specific issues regarding risk management, portfolio concentrations, and overall performance were discussed with the Davis portfolio management team.

As a result of the discussions with the Davis portfolio management team, the following concerns were presented to the PRC during its July 28, 2020 meeting:

- The Fund's overall poor performance;
- Lack of appropriate risk controls;
- Large sector deviation to financials. The fund's financials stake has been 12.5 to 25 percentage points greater than the 10% allocation of the S&P 500 benchmark. This overweight in financials has not been favorable during a challenging time for the financial services sector; and
- Exposure to international private equities, specifically its 12.1% in Chinese holdings. These holdings include a 3.7% stake in ride-sharing service Didi Chuxing, an illiquid private holding. Davis' international private equities' holdings was one of the highest of the 300 large blend Morningstar Category peers.

### PRC meeting, July 28, 2020

The GWI Portfolio Strategist presented a performance overview for Davis indicating that the fund's overall performance continues to struggle. Year-to-date performance is at -9.8% versus its benchmark. The fund's one year performance is reported at -10.6%. Moreover, the fund has underperformed its benchmark two of the last three calendar quarters. The portfolio's overweight in financial services is attributed to approximately 80% of the fund's underperformance in 1Q20. However, its non-US holdings (> 20%) for this period have played a role in the underperformance, as well.

PRC's determination was to formulate a recommendation for the December 8, 2020 Board meeting to remove the fund from the Texa\$aver lineup.

A PRC sub-committee was appointed from the following PRC members and ERS staff: Brannon Andrews, Carlos Chujoy, Lauren Honza, Leighton Shantz, and Dr. Laura Starks. Gene Needles was named as an alternate, to serve if necessary. The PRC sub-committee had three specific objectives.

- Sub-committee Objective #1: Determine if a replacement fund would be needed if the Board supports the PRC's recommendation for removing Davis from the line-up.
- Sub-committee objective #2: Determine options for a passive international fund.\*
- Sub-committee objective #3: Determine options for a high yield bond fund.\*

*\*The passive international and high yield bond funds would be additions to the program's line-up. Since these would not be replacement funds, there would not be an initial transfer of assets into these offering, if implemented.*

The PRC sub-committee met on three occasions (September 2, October 5, and October 13) to formulate its recommendations to the PRC.

#### Sub-committee meeting, September 2, 2020

**PURPOSE:** Identify the destination fund that would receive the transfer of assets from the Davis fund elimination

*Sub-committee objective #1*

**CONCLUSION:** Finalized a recommendation for the PRC to transfer assets from the Davis large cap blend fund into the existing Vanguard Institutional Index (VIIIX), which is also a large cap blend fund.

The sub-committee determined that the Vanguard large cap blend fund was a prudent fund for asset class. The Vanguard large cap blend fund employs an indexing investment approach designed to track the performance of the S&P 500 Index. The fund advisor attempts to replicate the target index by investing all, or substantially all, of its assets in the stocks that make up the index, holding each stock in approximately the same proportion as its weighting in the index. This index fund effectively diversifies risk and accurately represents the composition of the US large cap market.

Morningstar has designated the Vanguard large cap blend fund with a Gold rating. Morningstar analysts assign Gold ratings to strategies that they have the most conviction will outperform a relevant index, or most peers, over a market cycle.

★★★★★  Gold

Analyst rating as of Mar 6, 2020

The sub-committee is confident with the stable performance, fund methodology and sector exposures. Also noteworthy is the fund's low expense ratio at 2.0 basis points.

The sub-committee did not believe it was prudent, or necessary, to go through an external fund search process for a fund to replace Davis when the Vanguard Institutional Index Fund is a viable, large cap blend fund already in place within the program's core fund line-up.

**PURPOSE(S):** Establish estimated timing on the due diligence process for passive international equity fund and high yield bond fund searches

*Sub-committee objective #2 and sub-committee objective #3, respectively*

**CONCLUSION:** After the Strategic Investment Review discussion on July 28, 2020, the sub-committee determined that it would be worthwhile to perform due diligence on the following:

- Large cap value fund; and
- High yield bond fund.

These two funds would be additions to the program with no asset transfers from existing funds. The due diligence for these funds would be conducted following the passive international fund search.

In its discussion the sub-committee also concluded that due diligence for a large cap value fund would be included in its overall recommendation to the PRC. Approximately 69% of similar state plans offer a large cap value fund within their core fund line-ups.

Noting that the passive international equity search would be concluded in 1Q21, the high yield bond fund and large cap value fund searches would be performed in subsequent periods in CY21, but may be done concurrently.

#### Sub-committee meeting, October 5, 2020

**PURPOSE:** Discuss and consider fund search parameters for a passive international fund search to include minimum fund size, fund objective, investment style and benchmark (Sub-committee Objective 2).

*Sub-committee objective #2*

**CONCLUSION:** Established fund search parameters and initial draft of the due diligence questionnaire (DDQ) for the passive international fund.

The DDQ clearly stated that the passive international equity is a new fund to the Texa\$aver fund lineup; therefore, there will be no asset transfers into this new fund offering. The proposed new fund will be made available to participants with the expectation that some percentage of assets in the plan's current actively managed international fund may migrate into the new passive strategy.

#### Sub-committee meeting, October 13, 2020

**PURPOSE:** Finalize the passive international fund DDQ

*Sub-committee objective #2*

**CONCLUSION:** Finalized the DDQ; presented findings and recommendations to present to the PRC on October 26, 2020

#### PRC meeting, October 26, 2020

The sub-committee, together with the GWI Portfolio Strategist, presented the sub-committee's proposal to include a large cap value fund to its due diligence processes. This fund would be researched with the high yield bond fund in CY21, prioritizing the passive international equity fund for 1Q21.

Next, the PRC and the GWI Portfolio Strategist summarized the issues to the PRC that led to the additional Davis fund due diligence and determination to proceed with the recommendation to the Board to eliminate Davis from the Texa\$aver fund line-up. These concerns are noted above and include overall poor performance, lack of appropriate risk controls, large sector deviations when compared to benchmark – specifically its overweight in financial services sector, and the fund's exposure to international private equities.

Additionally, the sub-committee made its recommendation to have the Davis assets mapped to the Vanguard Institutional Index Fund. PRC voted to accept the sub-committee's recommendation and move forward with presenting the fund removal and mapping recommendations to the Board on December 8, 2020.

If approved by the Board, a communication strategy to notify participants of the upcoming change will be launched in collaboration with Empower Retirement.

**RECOMMENDATION**

The Texa\$aver Product Review Committee recommends the Board of Trustees of the Employees Retirement System remove the Davis New York Venture A (NYVTX) Fund from the Texa\$aver 401(k)/457 Program with the program assets being mapped to the Vanguard Institutional Index (VIIIX) fund.

**ATTACHMENTS:**

1. Exhibit A – Fund Analysis, September 30, 2020
2. Slides – Texa\$aver Product Review Committee Recommendations