AGENDA ITEM DETAILS

Subject: * Opportunistic Credit Program - Market Update and Consideration of Proposed Opportunistic Credit Annual Tactical Plan for Fiscal Year 2022 – (ACTION)

RECOMMENDED ACTION:

Move that the Investment Advisory Committee recommend that the Board of Trustees of the Employees Retirement System of Texas approve the Opportunistic Credit Program Annual Tactical Plan for Fiscal Year 2022 as presented in Exhibit A.

Contingent upon adoption of the above motion by the Investment Advisory Committee, staff recommends the following motion to the Board of Trustees.

Move that the Board of Trustees of the Employees Retirement System of Texas approve the Opportunistic Credit Program Annual Tactical Plan for Fiscal Year 2022 as presented in Exhibit A.

BACKGROUND:

During the August 23, 2017, Joint Meeting of the Board of Trustees (Board) and the Investment Advisory Committee (IAC), the Board adopted an asset allocation plan that included a new targeted allocation of 3% of the Trust's assets to Opportunistic Credit. During the December 2017 joint meeting, the Board adopted guidelines and procedures for Opportunistic Credit activities. The pace of the deployment of capital to this portfolio was initially delayed due to internal team restructurings. In 2019, the composition of the Opportunistic Credit Team changed from involving three ERS investment teams, down to just one - the ERS Hedge Fund Team. While the ERS Hedge Fund Team has taken sole responsibility for the portfolio and its construction, the team will continue to leverage other ERS investment teams as it pertains to investments in their areas of expertise. More specifically, given the broad mandate, the ERS Hedge Fund Team will seek supporting efforts and expertise from the ERS Infrastructure, Private Equity, Real Estate, and Fixed Income Teams.

Staff is responsible for preparing and presenting an Annual Tactical Plan (Plan) to ERS' Board of Trustees for review and approval. This document is intended for planning purposes, which outlines the necessary steps to be taken over the remainder of Fiscal Year 2021, and for the time period within Fiscal Year 2022 up until the next Board of Trustees meeting regarding the Opportunistic Credit Portfolio. The objective of the Annual Tactical Plan is to meet the objectives of the Opportunistic Credit Portfolio. The plan also addresses considerations relevant to the administration and success of the portfolio. This Annual Tactical Plan is to be viewed as a guiding reference to the construction of the Opportunistic Credit Portfolio.

As an opportunistic allocation, staff will deploy capital only when compelling opportunities are present and not to simply meet an allocation target. Given the broad mandate of the asset class, staff expects to receive support and expertise from the ERS Infrastructure, Private Equity, Real Estate, and Fixed Income teams.

The underlying philosophy of the Opportunistic Credit Portfolio is to seek attractive risk-adjusted returns throughout the credit universe using a diverse set of private investments that are not a focus within the Trust's other asset classes or portfolios. These underlying investments complement existing credit-

oriented strategies already residing within the Trust. The focus of this mandate is on investments that are niche by strategy, sector, and/or geography; investments that exist for only a short period of time, either during or after major economic or regulatory changes or events; or investments that seek to capture and monetize an illiquidity or complexity premium within the markets or structures. Opportunities could also arise due to changes in banking or broader market regulations.

ERS expects to target 0-3 investments in this portfolio in the next 12 months. Allocations would total $300 million, or approximately 1% of the Trust's assets measured as of December 31, 2020, as an upper limit under the proposed tactical plan. As previously noted, capital will not be deployed unless compelling opportunities arise.

Guidance for the ERS Opportunistic Credit Portfolio located in the *ERS Investment Policy* Statement is:

Opportunistic Credit	
Benchmark -	S&P LTSA Leveraged Loan Index (SPBDAL) + 150 bps
Role -	Yield, Diversification, Illiquidity Premium
Primary Risk Control -	Pacing, Regional Diversification, Strategy Diversification
Benchmark Description -	An index designed to mirror the investable universe of the U.S. dollar denominated leveraged loan market (senior secured floating rate bonds).
Management Style -	Active

Portfolio Description:

Opportunistic credit market opportunities continue to expand as private credit markets become more established and developed. Opportunistic credit is a broad asset class; and opportunities can vary by strategy, sector, geography, type of credit instrument, etc. Many of these allocations are yield-oriented investments in non-traditional asset classes or structures. The nature of these investments can offer attractive risk adjusted returns while maintaining low correlations to broader fixed income or equity markets. Overall, opportunistic credit strategies may complement, or serve as a substitute to, traditional fixed income investing with the goal of enhancing portfolio returns and increasing diversification.

While not specifically targeted today, areas such as healthcare royalties, rail car financing, and specialty finance can offer steady return streams, offer call or senior debt protection, have little or no competition, and offer little to no correlation with broader equity or fixed income markets. The strategies could also offer protection through a number of market cycles, such as specialty finance or structured real estate lending. Furthermore, strategies with an emphasis on financial or hard asset collateral can provide protection as well as amplified returns, especially during or following major market disruptions. Lastly, opportunistic credit strategies provide investors the flexibility to become liquidity providers (i.e. purchasing 1st lien bonds at a discount) during times of stress, which only enhances the opportunity for outsized returns. Building a portfolio of yield-oriented opportunistic credit investments that are uncorrelated to broader markets should also provide lower overall volatility to the ERS Trust. These are some of the reasons why the team feels that an allocation to the space is warranted.

Current Program Update:

The COVID-19 pandemic has negatively affected 2020 deployment plans. Unfortunately, just days after the Opportunistic Credit Portfolio was presented at the joint Board and IAC meeting on March 11, 2020; ERS, and the rest of the country, began restricted operations. In the initial stages of pandemic operations, the ERS Hedge Fund Team first looked at opportunities offered by managers with whom the Trust had an existing investment relationship. These opportunities included multi-strategy mandates as well as more idiosyncratic market-related opportunities. ERS ultimately decided not to allocate to this short list of managers. Nonetheless, ERS has maintained a rigorous approach to sourcing potential opportunistic credit managers, despite restrictions to travel and onsite manager visits. The team has held over 150 investment calls with opportunistic and private credit managers since March 13, 2020. Looking ahead, the team has developed a due diligence process for investments despite travel restrictions. This process involves more reliance on our private credit consultant, Albourne Partners; as well as further dependence on technology by way of additional video conference calls, virtual meetings, etc.

Expectations for an initial allocation have not changed. ERS is targeting a global credit manager with the ability to construct a customized multi-strategy “Fund-of-One” investment. This potential allocation will serve as the anchor investment in the Opportunistic Credit Portfolio and will have exposures to all of the Fund’s underlying strategy classes, with an overweight to senior secured private lending. While this allocation could overlap marginally with other illiquid credit investments, staff believes it is the most prudent way to conservatively build out the Opportunistic Credit Portfolio. Such an allocation would not only provide downside protection in the event of a sharp selloff, but will also be in a strong position to capture any private credit market inefficiencies that result from a market dislocation. ERS staff believes an initial investment in a multi-strategy, multi-asset class fund is a more prudent and conservative manner to build a new portfolio compared to investing in a single strategy fund. In addition, given this firm’s broad and global reach within the private credit space, it could potentially offer the Opportunistic Credit Portfolio future access to other opportunities.

Market Review and Outlook:

Since the sharp COVID-19 related selloff of March 2020, credit valuations have recovered significantly. However, continued economic uncertainty and risk to levered borrowers remains. Nonetheless, post COVID-19 related selloffs, liquidity conditions were boosted by central bank intervention such that price “stress” was significantly ameliorated, and the pickup in restructuring activity, while varying by region, has proven more modest than previously anticipated.

The decline in return prospects has been more pronounced in certain strategies. Most notably, Asian Distressed Credit has fared relatively well, supported by continued high underwriting internal rates of return and strong opportunities spanning across stressed debt volumes and defaults. Asian Relative Value Credit has also fared well supported by relatively wide high yield spreads, elevated spread dispersion, and active new issuance. By contrast, North American Relative Value Credit has fared relatively poorly due to elevated high yield valuations, limited price “stress”, and reduced spread dispersion. European Distressed Credit has also fared poorly affected by reduced CCC[1] spreads (spreads in lower rated bonds), anemic levels of stressed debt, and low default rates.

ERS staff works closely with Albourne Partners, the Opportunistic Credit consultant, to identify and evaluate market opportunities. The following provides a review of the return and risk prospects for various credit strategies and markets, taken from the semi-annual Albourne Credit Strategy Ranking Report:

United States

North America Private Lending:

Yields on syndicated loans[2] and high yield bonds expanded sharply during the first quarter of 2020; however, incremental spreads on private loans and mezzanine (subordinated) debt have since recovered. During this volatile period, lenders gained certain advantages related to the structuring of deals. For example, new loans featured more restrictive covenants and were collateralized with less leverage compared to the period prior to March 2020.

Middle market debt issuances declined post-March 2020, in part due to buyout activity dropping sharply due to the pandemic. Looking ahead, buyout activity is expected to rebound, partly driven by the sizeable amount of private equity “purchasing power” available in the markets. This ”purchasing power”, or investment capital raised by private equity funds, should be heavily utilized in purchasing what is

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[1] A credit rating is used by credit agencies for bonds and other investments. A CCC credit rating represents an extremely high risk bond or investment. A credit spread is the difference between the quoted rates of return on two different investments, usually of different credit qualities but similar maturities. It is often an indication of the risk premium for one investment product over another.

[2] A syndicated loan is financing that is offered by a group of lenders, often referred to as a syndicate. These can be sourced for a variety of reasons and purposes. These loans are usually split between a 1st lien tranche/slice and a 2nd lien tranche/slice.

expected to be increased middle market debt issuance. As a result, the recent pricing and structuring changes that occurred in early 2020 may not be sustainable. Mitigating some competitive pressure, Business Development Companies[3] (i.e. BDCs) will not raise growth equity, as their shares traded sharply lower post the March 2020 selloff.

North America Loan Portfolios:

Return prospects for this strategy have increased since March 2020. Pre-COVID-19, unresolved balances of re-performing and nonperforming residential mortgages were rather low. This fact may change as some subset of the estimated 8-15% of existing mortgages currently in forbearance (i.e. delayed foreclosure) may eventually become delinquent. Many mortgages are currently under payment deferral programs that were enacted in reaction to COVID-19 in an effort to help consumers and homeowners facing financial challenges. The amount of non-performing loans (NPLs) that may be generated will depend in part on government support, unemployment rates, and housing prices; which has held up during the pandemic. The pace at which such loans are eventually sold is also uncertain. For example, banks today are in better financial standing from a capital perspective compared to the Great Financial Crisis (GFC), and Government Sponsored Entities (GSEs) have significantly reduced their prior NPL and re-performing loan balances. What is also uncertain is the amount of new capital that will be available to take advantage of any future portfolio sales. There has been a lot of capital raised for longer term credit funds post-COVID-19, which may signal future purchases and investment in loan portfolios.

North America Distressed:

Valuations for U.S. distressed asset classes are mixed. These are securities of companies or government entities that are experiencing financial or operational distress, default, or are going through bankruptcy. Following the post-March 2020 rally, spreads of performing bonds rated CCC and below narrowed to 1130 basis points, which was only slightly wider than the post-2008 average (i.e. GFC). Spreads have narrowed despite significant continued economic uncertainty posed by COVID-19. Meanwhile, spreads for leveraged loans[4], rated B/CCC, were comparable despite their seniority and collateral-secured status.

Within collateralized loan obligation[5] (CLO) portfolios, there are still some attractive relative value opportunities, mainly driven by technical pressures such as their limited capacity to own low-credit rated loans. As rating agencies downgrade credits, CLO portfolios must sell these credits if the amount of credit held below a certain credit rating increases.

Separately, trailing recovery rates on defaulted bonds and loans, currently at 15% and 47% respectively, are low compared to their long term averages. Currently, default rates are partly driven by certain structural issues and concerns such as the presence of covenant light structures (i.e. loan agreements that do not contain the usual protective covenants for the benefit of the lending party). From a sector perspective, default rates have been concentrated to COVID-19-impacted sub-sectors such as energy and retail. Should there be some normalization in recovery rates, this could result in attractive upside returns. Finally, levered and reorganization equities, while outperforming as of late, have cumulatively lagged their large capitalization counterparts by a wide margin in the last several years. This suggests potential relative value in reorganization stocks, albeit without obvious catalysts or technical support.

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[3] A Business Development Company is a form of unregistered closed-end investment company that invests in small and mid-sized businesses.

[4] A leveraged loan is a type of loan that is extended to companies or individuals that already have considerable amounts of debt or poor credit history.

[5] A Collateralized Loan Obligation or “CLO” is a single security backed by a pool of debt, typically individual corporate loans. This pool of loans is then tranched or sliced, with the most senior and secured tranche rated AAA and the most junior and risky tranche being the equity tranche. An investor in the AAA tranche will get paid back first, while an investor in the equity tranche will be paid last.

The proportion of performing high yield bonds trading at distressed spreads (i.e., >1,000 basis points) declined to below their post-2008 average, despite significant ongoing risks to levered borrowers. Meanwhile, the energy sector (i.e., E&P, drilling) made up an outsized portion of the stressed bond universe. While dominated by sectors that were already struggling pre-COVID-19, default activity has also broadened to companies in sectors that are more directly affected by the pandemic such as travel, leisure, consumer-related products, and healthcare.

Going forward, restructuring volumes are expected to remain elevated given the impact of the slowdown on corporate cash flows. While central bank policy is keeping refinancing markets wide open, and thereby preventing some defaults, an elevated default rate coupled with the sheer size of the leveraged credit markets is expected to generate meaningful restructuring opportunities.

Structured Product:

Structured product spreads have narrowed since their March 2020 levels, although the pace and degree of credit spread tightening have been less compared to other types of credit such as U.S. high yield. Looking at more specific structured products: residential mortgage-backed securities[6] (RMBS) which were structured pre-GFC had bond spreads of approximately 250 basis points, which is narrow in absolute terms, but are deemed to be "low risk" with embedded optionality reliant on certain events such as settlement distributions. Credit risk transfer[7] junior bonds structured post-GFC saw spreads in the 700-1000 basis point range depending on seniority. These recovered from March 2020 lows at a slower pace and offered significant "carry" or yield, albeit with meaningful risk given the "thinness" of the tranches/slices and uncertainty around ultimate defaults post-forbearance. For collateralized loan obligations (CLOs), secondary equity remained deeply discounted (i.e., 40-50 basis points), reflecting both failed over-collateralization tests/cash flow diversion and mounting defaults. Meanwhile, yields on new issue CLO equity are only in the high "single digits", as the benefit of declining liability spreads is offset by falling loan spreads.

Secondary CLO mezzanine spreads in the 800-1675 basis point range, depending on seniority, are still relatively wide and offer significant "carry" and appreciation potential, albeit not without risk given the reduced subordination in a capital structure. Finally, commercial mortgage-backed security[8] (CMBS) spreads (i.e., BBB conduit deals[9] at 550 basis points) have recently recovered, but pricing continues to reflect the fundamental risk to various types of commercial real estate, which is amplified by COVID-19. Offering potential value-add from security selection, dispersion among CMBS bond prices is high, given the heterogeneous nature of the underlying loans.

In terms of opportunity, secondary trading volumes in high yielding structured products are mixed. The forced selling of March 2020 proved brief, and trading in certain asset classes was limited (i.e., CLO equity). Meanwhile, new issuance has recovered unevenly across asset classes, while origination-based strategies (i.e., non-qualifying mortgages) have slowed meaningfully.

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[6] Residential mortgage-backed securities (RMBS) are a debt-based security (similar to a bond), backed by the interest paid on loans for residences.

[7] Credit risk-transfer securities or "CRTs" are securities that are often issued by a government-sponsored agency. They pool thousands of different loans, often mortgages, into a single security. Investors will receive regular payments based on the performance of the pool of underlying loans. These securities are also issued in tranches or slices, where more junior tranches are the first to incur any losses, while more senior tranches are the last. The government-sponsored entity will also retain a share of the risk in each CRT that they issue.

[8] Commercial mortgage-backed securities (CMBS) are fixed-income investment products that are backed by mortgages on commercial properties rather than residential real estate.

[9] Conduit loans are loans used to purchase commercial property. However, unlike a traditional commercial mortgage, these loans are packaged and sold to investors on the secondary market in a process known as securitization.

North America Relative Value Credit:

This strategy saw a sharp drop in return prospects following March 2020, attributable to elevated valuations and opportunities. High yield bond spreads declined to 505 basis points and are inside their post-2008 average, despite continued economic uncertainty. Albourne estimates the asset class was priced for a constant default rate of approximately 3.5% (assuming a reduced recovery rate of 32.5% and the customary 250 basis point premium over Treasuries). This default rate is below the historical default rate of 6.5%. Meanwhile, leveraged loan spreads at 575 basis points (to a 3-year takeout) are wider than their post-2008 average and high yield bond spreads. However, they also price in a default rate of around 3.5%, assuming a 50% recovery.

Price stress was limited, with only 6.5% of performing high yield bonds trading at “distressed” spreads (i.e., >1,000 basis points), despite significant ongoing risk to levered borrowers. As of September 30, 2020 a similarly modest proportion of loans were trading below 80 cents on the dollar. Spread dispersion declined in-line with the long term average, notwithstanding the uneven impact of COVID-19 across sectors. Lower dispersion tends to be less favorable for the strategy. Somewhat more constructively, the CCC/BB spread differential narrowed to 750 basis points, but has remained above its long term average, and offers potential for compression trades.

Meanwhile, high yield bond issuance volumes have been very robust post-March 2020, facilitating refinancing and new issue trading strategies. Finally, shorting has become less costly in terms of negative “carry” and may be a source of “alpha” or active return for managers identifying those credits that the market will not bail out.

Europe

Europe Private Lending:

Many of the same dynamics in North American Private Lending described above are present in Europe as well. For example, base yields on traded loans have declined, incremental spreads on private loans have widened (albeit not for borrowers unaffected by COVID-19), lenders’ structuring power has improved, and borrowing costs (to apply leverage to the strategy) have risen. Additionally, as seen in North America, buyout activity in Europe declined sharply post-COVID-19, to the detriment of private lending deal flow. While this stands to rebound (given private equity/sponsor buying power), it will be met by large volumes of available private lender capital.

Europe Loan Portfolios:

The return prospects for this strategy have improved. Already sizeable before COVID-19, nonperforming loan balances on European bank balance sheets are expected to grow as a result of the economic shutdown, driven by Southern Europe. With that said, the eventual pace of non-performing loan sales is yet to be determined. Sales volumes have slowed post-COVID-19, and bank regulators have been accommodative in terms of giving banks “time and space”. Where portfolio sales have occurred, pricing has reportedly “cheapened”, in part reflecting increased recovery risk (i.e., collection, enforcement). Additionally, unlevered underwriting internal rates of return (IRR) have widened to 10-25% depending on the country and underlying loan type. The cost of financing has also re-priced, but to a more modest degree.

Europe Distressed:

This strategy saw a precipitous drop in return prospects since March 2020, driven both by valuations and the opportunity set. As a proxy for distressed valuations, spreads for EUR and GBP denominated performing bonds rated CCC and below narrowed sharply from March 2020 peaks to 1260 basis points as of September 2020. This is below the post-2008 average, despite continued economic uncertainty posed by COVID-19. Over the same period, spreads for European loans rated B/CCC narrowed to 910 basis points and are well inside their U.S. counterparts.

As of September 2020, a mere 4% of performing EUR and GBP high yield bonds have traded at distressed spreads (i.e., >1,000 basis points), and 8% of loans have traded below 80 cents on the dollar. Both metrics are well below their long term averages, notwithstanding the weak growth backdrop. Over

the same period, the European high yield default rate has risen to only 2.3%, while the loan default rate of 2.0% is still below the 10-year average.

While restructuring activity is expected to increase amidst slower economic growth (especially if fiscal stimulus is tapered), default rates are not expected to jump massively, due to central bank policy, availability of refinancing markets, and modest pending high yield maturities.

Asia

Asia Private Lending:

While Asian high yield bond spreads (as a starting point for pricing private debt) have declined meaningfully since their March 2020 peaks, private lenders are in a strong position to command incremental spreads and to demand strong structuring elements (i.e., collateral, covenants, guarantees, etc.).

In terms of the opportunity set, deal flow is healthy across middle market lending (ex-China), real estate lending (i.e., China, Australia), acquisition financing (i.e., offshore purchases by China-based companies), and "solution financing" for family-owned groups. Competition to provide financing solutions is low relative to the opportunity set, with many banks in Asian countries being capital constrained, and capital formation by private lending funds being limited due to the high barrier to entry nature of the strategy.

Asia Distressed:

Albeit subjective, underwriting internal rates of return are deemed to be high for various types of Asian distressed opportunities spanning across rescue financings, the purchase of performing assets from stressed sellers, China nonperforming loans (NPLs), etc. Meanwhile, yields for low-rated performing bonds, at around 14%, have declined compared to their long term average, but still offer a good risk/reward given the nature of the underlying borrowers (i.e., China-based property companies).

In terms of other opportunities, the volume of bonds trading at stressed levels has moderated since their March 2020 peaks but remains elevated by historic standards. Asian default rates have picked up and are expected to increase further due to the impact of COVID-19 on economic growth. Default rates are not expected to become excessive, given fair (if uneven) economic growth rates across the region, government policy responses, and accommodative refinancing markets.

Specific to India, a 12-month suspension of the bankruptcy code (amidst COVID-19) represented the loss of a tool for creditors to force resolution. However, there continue to be opportunities where managers buy distressed loans and arrange prepack-like restructurings. Meanwhile, Indian Non-Banking Financial Companies remain under pressure with limited funding and have been selling assets.

Asia Relative Value Credit:

While well off their March 2020 peaks, Asian high yield bond spreads have remained wide compared to historic levels, and well wide of similarly rated U.S. bonds. Meanwhile, spread dispersion has remained elevated, and the volume of bonds trading at stressed levels, while down, is high by historic standards. Supportive of the strategy, new issue markets have rebounded well post-March 2020.

Global

Emerging Market (ex-Asia) Distressed:

Emerging Market (ex-Asia) high yield bond spreads have narrowed materially since their March 2020 peaks, although non-investment grade sovereign spreads have remained wide of their post-2008 average. As of September 2020, non-investment grade corporate spreads are inside their long term average, but are wide of similarly rated U.S. bonds, notwithstanding lower emerging market default losses.

In terms of opportunities, the amount of performing non-investment grade bonds trading at distressed spreads (i.e., >1,000 basis points), as of September 2020, has declined materially to 10% for sovereign

bonds and 8% for corporate bonds (ex-Asia). For both metrics, Argentina has been the main contributor, with a wide range of other countries contributing thereafter.

In terms of opportunities, corporate default rates have ticked up to varying degrees by region but, on an annualized basis, are lower than U.S. default rates. There was an expectation opportunities would increase somewhat amidst COVID-19 related softness; however, they are not expected to become excessive given global central bank policies, broad opening of new issue markets, and some stabilization of commodity prices.

STAFF RECOMMENDATION:

Staff recommends that the Board and IAC adopt the Opportunistic Credit Program for Fiscal Year 2022 Tactical Plan as attached in Exhibit A.

** We are accredited by the State Pension Review Board (PRB) as a Minimum Educational Training (MET) sponsor for Texas public retirement systems. This accreditation does not constitute an endorsement by the PRB as to the quality of our MET program. This agenda item may be considered in-house training provided by ERS to board trustees and the system administrator for purposes of fulfilling the MET program requirements. ERS is an accredited sponsor of MET for its system administrator and trustees for continuing education.*

ATTACHMENTS:

1. Exhibit A – Opportunistic Credit Program Tactical Plan for Fiscal Year 2022
2. Exhibit B – Program Asset Class Guidelines
3. Slides – Opportunistic Credit Program