

OPPORTUNISTIC CREDIT PROGRAM
ANNUAL TACTICAL PLAN
FOR FISCAL YEAR 2022



MARCH 10, 2021

OPPORTUNISTIC CREDIT PORTFOLIO

ANNUAL TACTICAL PLAN FOR FISCAL YEAR 2021

Effective: March 10, 2021

I. EXECUTIVE SUMMARY

The Employees Retirement System of Texas (ERS or the Trust) will make Opportunistic Credit investments to enhance the total return of the Trust. The total targeted allocation is 3% of Trust assets. The objectives of the Opportunistic Credit allocation are as follows: (1) To enhance the overall return of the Trust, (2) To further diversify the Trust's portfolio, and (3) To further reduce the Trust's overall volatility by increasing investments in private asset classes. The underlying philosophy of the investment program is to seek attractive risk-adjusted returns across the illiquid part of the fixed income universe by allocating to a diverse set of investment strategies. In some instances, these may be unique strategies, which exist only during or after specific economic environments. Lastly, these investments should complement current credit holdings residing within the Trust given the portfolio construction of other asset classes.

The Opportunistic Credit Annual Tactical Plan for Fiscal Year 2021 (Annual Tactical Plan) has been prepared by the ERS Hedge Fund Team. The Consultant used to review the Annual Tactical Plan was Albourne America LLC (Consultant). This document is intended for planning purposes and outlines the necessary steps to be taken over the next 12 months. The objective of the Annual Tactical Plan is to establish objectives of the Opportunistic Credit Portfolio, along with addressing considerations relevant to the administration and success of the portfolio. This Annual Tactical Plan is to serve as a guiding reference to the construction of the Opportunistic Credit Portfolio. The Board reviews and approves the plan. At times, this plan may need to be reevaluated in light of economic, political, and other relevant events or circumstances. This tactical plan is not intended to overrule prudent investment allocation decisions.

This Annual Tactical Plan strives to highlight significant potential opportunities for capital commitments over the coming 12 months. However, as this allocation is an opportunistic allocation, capital will only be deployed when compelling opportunities are present. Capital will not be deployed simply to meet an allocation target. Hence, the portfolio could receive no allocations, or could maintain an underweight within the Trust. As stated earlier, the intention is for the portfolio to act as a tool to provide added flexibility to the underlying asset classes within the Trust, and to act as a complement to existing credit oriented strategies that already reside within the Trust.

II. GENERAL ALLOCATION OVERVIEW

The underlying philosophy of this allocation is to generate attractive risk-adjusted returns throughout the credit universe using a diverse set of private investments, which are not a focus within other existing portfolios. Opportunistic allocations could be to niche strategies or opportunities that only exist for a period of time, either during or slightly after an economic cycle is in recession. In addition, banking or other regulations could also be a driver of the future opportunity set.

The 3% allocation will be actively allocated into the Trust by the Hedge Fund Team. The Hedge Fund Team will recommend an investment only when there is strong conviction about a strategy, and is not required to make any allocations to the strategy. Supporting efforts/expertise from the ERS Infrastructure, Private Equity, Real Estate, and Fixed Income teams are expected, given the broad mandate. Staff will not treat the allocation as an overflow portfolio for existing credit opportunities already invested in by the Trust.

The portfolio construction and ultimate ownership of the underlying investments will reside with the Hedge Fund Team, in conjunction with the ERS Internal Investment Committee, who will approve new allocations to the Opportunistic Credit Portfolio. The Hedge Fund Team will also work with the Chief Investment Officer, who will provide oversight to the initial and ongoing development of the portfolio.

III. CAPITAL DEPLOYMENT

This new allocation will require significant research to identify unique or niche credit strategies relative to current credit exposures that reside within the Trust.

Initial Deployment

Initial deployment of capital during the prior fiscal year (i.e. Fiscal Year 2020) was delayed due to the global pandemic caused by the COVID-19 virus. Deployment of capital in Fiscal Year 2021 may be slower in order to maintain a prudent and comprehensive due diligence process. While the pandemic, caused by the COVID-19 virus, may provide compelling opportunities for the portfolio, the Hedge Fund Team will exercise patience due in part to the maturity of both the economic and credit cycles. Expectations for the next 12 months are to target up to three investments depending on the opportunity set and the ability to execute given the current pandemic-related challenges we face as it relates to proper and thorough due diligence. On the higher end, investments could total up to \$300 million (or more) or roughly 1% of the Trust's assets. However, as stressed throughout this document, capital will not be deployed unless compelling opportunities arise.

Future Deployment

Over the next 12 months, expectations are for the development and presentation of a pacing model for the Opportunistic Credit Portfolio for approval in the next annual tactical plan. A similar model is already in use across many of the private asset classes (i.e. Private Equity, Private Real Estate, and Infrastructure). The pacing model will make projections around the future growth of assets for the Trust, potential distributions from investments, maturing investments, and other relevant aspects relating to closed-end investment allocations. This model will be created with the help of the Consultant and revisited at least annually upon its development to review the underlying assumptions into the model's results.

IV. BENCHMARKING

The Opportunistic Credit Portfolio will be formally benchmarked against an absolute return target of +6.5% per annum for the initial three-year allocation phase. Deviating from the official policy benchmark during the initial development of a new allocation allows the portfolio to mature and is similar to the benchmarking strategy used during the development phase of other private market asset classes. The portfolio's stated policy benchmark of S&P LTSA Leveraged Loan Total Return Index (SPBDAL) plus a premium of 150 basis points will commence as the established portfolio benchmark at the end of the three-year phase of the allocation.

V. PORTFOLIO CONSTRUCTION

Initial focus for staff will be on a global multi-strategy credit manager who can rotate between Distressed, Private Lending, Structured Product, and Real Asset & Esoteric Credit. These areas will provide yield-oriented investments structured with strong collateral and covenant requirements with resilience of cash flows throughout the credit cycle, and in some instances, tactical exposures due to dislocations in primary markets. After completing a core multi-strategy allocation, staff will consider other opportunistic investment opportunities, some of which may have resulted due to the global pandemic related to the COVID-19 virus. All investments under consideration will have to adhere to the portfolio's constraints including an emphasis on senior secured debt, downside protection, a preference for cash flowing assets, and strong covenants

and collateral. Distressed opportunities may also be considered due to the economic fallout caused by the global pandemic. Distressed investment total returns are typically driven by asset price appreciation (i.e. purchasing assets at a discount) more so than yield. Long-term expectations are for the portfolio to evolve depending upon the credit cycle and opportunity set. Alongside a core multi-strategy credit manager, niche managers, which complement the core-competencies of the multi-strategy credit manager, will be considered for smaller commitment amounts.

Staff will work with the consultant to review investment opportunities, but the allocation will not be guided by traditional portfolio construction processes, given that it is a true opportunistic allocation, which makes timing around strategies uncertain. Below are the stated portfolio objectives to target with this allocation:

- In aggregate, investments should seek a portfolio target time-weighted return of at least 6.5%
- Investments should emphasize cash flows, with price appreciation as a secondary focus
- Credit managers should manage risk by focusing on investments with strong covenants and/or secured assets backing the investment with limited balance sheet leverage

Expectations are also for J-curve mitigation by paying fees on invested, not committed capital; as well as receiving periodic cash distributions. As previously mentioned, this portfolio will seek to have downside risk protection by looking to senior structured securities, strong covenants, collateral-backed self-liquidating assets, and sufficient transparency.