

AGENDA ITEM DETAILS

Subject: Consideration of Opportunistic Credit Asset Allocation – (Action)

RECOMMENDED ACTION:

Move that the Investment Advisory Committee recommend that the Board of Trustees of the Employees Retirement System of Texas eliminate Opportunistic Credit as an asset class and redistribute the current 3% allocation to Fixed Income at 2% and Special Situations at 1%.

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 eliminate Opportunistic Credit as an asset class and redistribute the current 3% allocation to Fixed Income at 2% and Special Situations at 1%.

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 added a targeted allocation of 3% of the Trust's assets to Opportunistic Credit. During the December 2017 joint meeting, the Board adopted guidelines and procedures governing Opportunistic Credit activities. Internal team restructurings initially delayed the pace of capital deployment to this portfolio. In 2019, ERS reduced the three investment teams managing Opportunistic Credit investments to one - the ERS Hedge Fund Team.

Implementation of the Opportunistic Credit strategy was further constrained by COVID-19 which impeded due diligence efforts and lowered expected rates of return by the time the Trust was able to invest in the class. In the interim, the Fixed Income team added depth to the Global Credit Portfolio, which is approximately 20% managed by external advisors and has \$1 billion invested. This portion of the portfolio is opportunistically driven and intended to be complementary to the internally managed portfolio. After a considerable thought process and review of internal resources, we believe Opportunistic Credit investments are more appropriately managed by Fixed Income which now has a dedicated team experienced in opportunistic credit.

External portfolio investments include capital deployment in the following broad credit segments: structured credit, distressed and special situations, direct lending, real estate, and other idiosyncratic strategies. Investments in these areas tend to be higher risk and less liquid than traditional fixed income strategies. As with other asset classes, ERS commits capital only when compelling opportunities are present and not to simply meet an allocation target. The focus of the external portion of ERS Credit investing is entirely on niche strategies that are resource intensive or expected to exist for only short periods. ERS targets these investments to capture and monetize an identified premium.

The adjustment in asset allocation will have a negligible effect on Trust return assumptions as provided in the charts below. NEPC has updated their numbers as of March 31, 2021 with asset allocation modeling provided in Exhibit A. Chart 1 below compares the asset allocation and return assumption approved by the Board at the May 20, 2020 meeting with the recommendation being proposed. The net effect based on original assumptions is a one basis point decline for the 10-year period to 6.81% and a 2 basis point decline for the 30-year period to 7.38%. To put this decline in perspective it is important to note that

Investment returns have declined in general due to market appreciation of respective asset classes since the initial asset allocation was adopted.

2020 & 2021 TOTAL FUND CAPITAL MARKET ASSUMPTIONS

	Asset Class	Current Policy Modeling as of 3/31/2020	Modeling Without Credit Opp. As of 3/31/2020	Current Policy Modeling as of 3/31/2021	Modeling Without Credit Opp. as of 3/31/2021
Risk Seeking	Global Equity	37	37	37	37
	Private Equity	13	13	13	13
	Total Global Equity	50	50	50	50
	Global Credit	11	13 	11	13 
	Opportunistic Credit	3	0 	3	0 
	REITs	3	3	3	3
	Infrastructure	7	7	7	7
	Private Real Estate	9	9	9	9
	Real Assets	19	19	19	19
Risk Reduction/ Liquidity Assets	Fixed Income - Rates	11	11	11	11
	Absolute Return**	5	5	5	5
	Cash	1	1	1	1
	Special Situations		1 		1 
Expected Return (10 Yr)		6.82%	6.81%	5.63%	5.61%
Expected Return (30 Yr)		7.40%	7.38%	6.78%	6.76%
Standard Deviation		12.03%	12.07%	12.30%	12.32%
Sharpe Ratio (30 Yr)		0.47	0.46	0.36	0.35
Probability of 30-Year Return Under 7%		42.8%	43.2%	53.8%	54.3%
Probability of 30-Year Return Under 7.25%		47.3%	47.7%	58.2%	58.7%
Probability of 30-Year Return Under 7.5%		51.9%	52.2%	62.5%	62.9%

Source: NEPC

CAPITAL MARKET FORECAST COMPARISON

	Asset Class	Policy Asset Allocation (%)	10 Yr. as of	30 Yr. as of	As of	10 Yr. as of	30 Yr. as of	As of	2021 - 2020	2021 - 2020	2021 - 2020
			3/31/2020	3/31/2020	3/31/2020	3/31/2021	3/31/2021	3/31/2021	10 Yr	30 Yr	2020
			Return	Return	Risk	Return	Return	Risk	Return	Return	Risk
Risk Seeking: 79%	Global Equity	37	7.7%	8.1%	17.8%	5.8%	6.9%	17.9%	-1.9%	-1.2%	0.1%
	Private Equity	13	9.7%	10.0%	19.7%	7.9%	8.9%	19.6%	-1.8%	-1.1%	-0.1%
	Total Global Equity	50	8.3%	8.7%	18.0%	6.4%	7.5%	18.1%	-1.9%	-1.2%	0.1%
	Global Credit	11	5.8%	5.8%	11.9%	3.9%	5.4%	11.3%	-1.9%	-0.3%	-0.6%
	Opportunistic Credit	3	6.5%	6.8%	9.3%	5.4%	6.7%	9.1%	-1.1%	-0.1%	-0.2%
	REITs	3	7.0%	7.6%	20.0%	5.0%	6.6%	21.4%	-2.0%	-1.0%	1.4%
	Private Real Assets - Infrastructure/Land	7	6.2%	7.2%	12.0%	6.0%	6.6%	12.5%	-0.2%	-0.6%	0.5%
	Private Real Estate	9	5.2%	6.7%	15.9%	5.4%	6.6%	17.6%	0.2%	-0.1%	1.7%
	Real Assets	19	6.1%	7.3%	12.8%	5.6%	6.9%	14.1%	-0.5%	-0.4%	1.3%
Risk Reduction/ Liquidity Assets: 21%	Fixed Income - Rates	11	0.7%	1.9%	4.7%	1.6%	2.6%	4.4%	0.9%	0.7%	-0.3%
	Absolute Return**	5	6.5%	6.5%	3.4%	6.5%	6.5%	3.4%	0.0%	0.0%	0.0%
	Cash	1	0.7%	1.8%	1.0%	1.3%	2.4%	0.6%	0.6%	0.6%	-0.4%
	Special Situations	0	7.0%	7.0%	3.4%	7.0%	7.0%	3.4%	0.0%	0.0%	0.0%

Source: NEPC

STAFF RECOMMENDATION:

Staff recommends that the Board and IAC eliminate Opportunistic Credit as an asset class and redistribute the current 3% allocation to Fixed Income at 2% and Special Situations at 1%.

ATTACHMENT

1. Exhibit A – Asset Allocation Modeling
2. Slides - Opportunistic Credit Asset Allocation