

AGENDA ITEM DETAILS

- Subject:**
- * Consideration of Hedge Funds - (Action)
 - Market Update and Program Overview
 - Proposed Hedge Fund Annual Tactical Plan for Fiscal year 2022 – (Action)

RECOMMENDED ACTION:

ERS' Investment staff recommends the following motion to the **Investment Advisory Committee:**

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

BACKGROUND:

During the August 19, 2008 Joint Meeting of the Board of Trustees (Board) and the Investment Advisory Committee (IAC), the Board adopted an asset allocation plan that included investing 5% of the Trust's assets in hedge funds via an Absolute Return Portfolio (Portfolio). ERS made initial allocations to the Absolute Return Portfolio in August 2012.

During the May 24, 2011 Joint Meeting of the Board and the IAC, ERS selected Albourne America LLC (Albourne) as the agency's hedge fund consultant. ERS renewed the contract with Albourne in August 2019.

During the February 26, 2013 Joint Meeting of the Board and the IAC, the Board adopted an asset allocation plan that allowed the use of hedge funds across asset classes.

The objectives of ERS' Hedge Fund Program are as follows: to emphasize capital preservation, to provide for an attractive risk-adjusted return, to add diversification benefits to the Trust, and to reduce the Trust's overall volatility.

As of April 30, 2021, the Absolute Return Portfolio represented approximately 4.5% of the Trust's total assets. The targeted allocation for the Absolute Return Portfolio remains 5%, but staff has further flexibility given an allowable strategy band of 0-10%.

The ERS Hedge Fund team includes Anthony Curtiss (Director of Hedge Funds), Panayiotis Lambropoulos (Portfolio Manager), Nicholas Maffeo (Portfolio Manager), Courtney Dunn (Analyst), and Andrew Moore (Analyst).

INDUSTRY OVERVIEW

Hedge Funds realized strong performance in 2020, as markets increased due to a continued recovery from the COVID-19 pandemic, vaccine rollouts and fiscal and monetary policy measures globally that led to a rally in risk assets such as equities and credit. The Absolute Return Portfolio took advantage of

trading opportunities that emerged in this environment which further continued into 2021. There were periodic bouts of volatility, but the portfolio sustained positive performance year-to-date.

The hedge fund sector was negatively impacted in early 2021 by popular social media platforms where retail traders coordinated allocations to out of favor equities, including stocks with high short interest held by hedge funds. The targeted stocks were initially those with high short interest. As a result, the final trading days in January saw significant de-grossing – a process where hedge funds sell securities bought with borrowed money – from some equity centric hedge funds due to the retail inflows into popular short positions. Many funds suffered modest losses and were able to recover in early February. However, these actions made many managers revisit the size of their fund’s short positions and increase their monitoring of short interest. In comparison, the Absolute Return Portfolio had strong performance the first quarter of 2021 (+5.68%). The portfolio was positive across all strategies and managers.

The following table illustrates hedge fund performance over different periods. All strategy indices have generated positive returns year-to-date. Equity Market Neutral was the worst performing index strategy in 2020 and next to last in 2021, year to date. Equity Market Neutral strategies employ quantitative techniques analyzing price data to predict information about future price movement and relationships between securities. Fundamental Equity Market Neutral managers construct portfolios of long and short positions based on their relative fundamental characteristics. Sector rotations, elevated factor volatility, and technical pressures from retail and options trading have challenged these managers. Traditional Quantitative Equity Market Neutral strategies take fundamental data, such as analyst earnings estimates, balance sheets and cash flow statement statistics, and systematically rank or score stocks against these metrics in varying proportions. The traditional quantitative portfolio consists of: value (stocks that are mispriced relative to their fundamental value, based on price-to-earnings ratio, book value, or cash flow); quality (based on metrics such as levels of debt, stability of earnings growth, balance sheet strength); and momentum (based on returns over recent time frames from days to months). Losses in momentum have overshadowed gains from value and challenged performance for managers in this strategy. Quality and low volatility factors have also resulted in performance challenges.

Index	2021 YTD	2020	2019	2018	2017	3 Year	5 Year	10 Year
HFRI All Equity Hedge	11.24%	17.89%	13.71%	-7.14%	13.29%	7.57%	8.26%	5.36%
HFRI EH: Equity MN	4.08%	-0.11%	2.33%	-0.98%	4.88%	0.40%	1.65%	2.27%
HFRI All Event Driven	11.51%	9.26%	7.49%	-2.13%	7.59%	4.75%	6.46%	4.67%
HFRI ED: Distressed/Restructuring	12.54%	11.82%	2.94%	-1.70%	6.25%	4.20%	6.72%	4.47%
HFRI ED: Merger Arbitrage	8.38%	5.20%	6.81%	3.29%	4.31%	5.09%	4.64%	3.71%
HFRI All Macro	8.84%	5.38%	6.50%	-4.08%	2.20%	2.49%	2.14%	1.00%
Barclay CTA	3.26%	4.23%	5.14%	-3.14%	0.79%	2.01%	1.11%	0.51%
HFRI All Relative Value	5.79%	3.38%	7.42%	-0.43%	5.14%	3.41%	4.59%	4.41%
HFRI RV: Fixed Income - Corporate	5.86%	7.68%	9.16%	-1.04%	6.67%	5.17%	6.71%	4.99%
HFRI RV: Multi Strategy	6.73%	6.69%	5.29%	-0.23%	4.09%	3.88%	4.41%	3.93%

Bloomberg Ticker	Index
HFRIEHI Index	HFRI All Equity Hedge
HFRIEMNI Index	HFRI EH: Equity MN
HFRIEDI Index	HFRI All Event Driven
HFRI DSI Index	HFRI ED: Distressed/Restructuring
HFRI MAI Index	HFRI ED: Merger Arbitrage
HFRI MI Index	HFRI All Macro
BARCCTA Index	Barclay CTA
HFRI RVA Index	HFRI All Relative Value
HFRI FIHY Index	HFRI RV: Fixed Income - Corporate
HFRI FI Index	HFRI RV: Multi Strategy

Source: Albourne – Data as of May 2021

The Global Macro strategy performed well in 2020, with over 85% of the strategy’s returns generated from rates trading, followed by equities, foreign exchange (FX), commodities, and credit. Federal government’s policy responses to the COVID-19 pandemic drove returns. The strategy group was able to monetize market dislocations beginning in March and periodic volatility persisting throughout the year. The strategy re-affirmed its value proposition by performing well during this period and using the

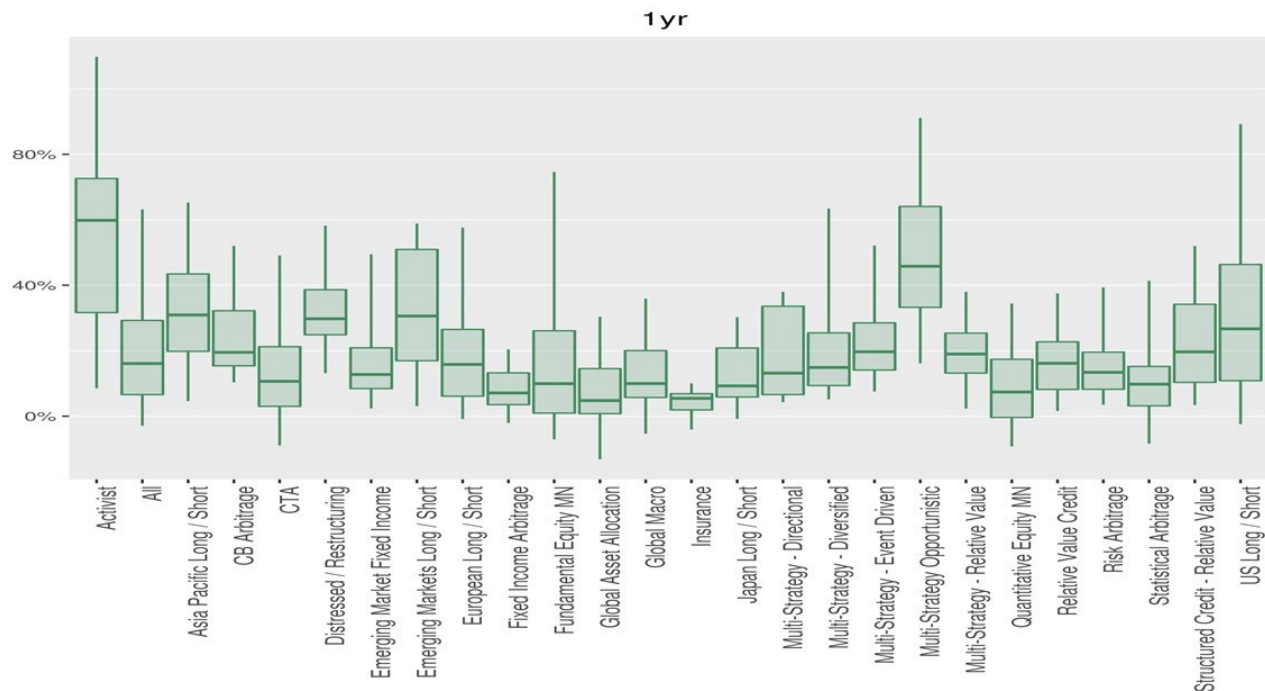
strategy's inherent flexibility to protect capital and generate returns throughout the year. The strategy has evolved significantly in recent years, having shed bloated structures and dated practices, which contributed to strong performance since 2019 and significant gains achieved by many funds in 2020 and in 2021. Over the next several years, the monetary and fiscal policies designed to address the economic impact of the pandemic will likely impact markets, which in turn has the potential to support this strategy.

Event Driven strategies have recorded strong performance in 2021, following positive performance in 2020. Some of the best performing funds in this peer group had meaningful exposure to, and profits derived from, Special Purpose Acquisition Companies (SPACs). A SPAC is a company formed strictly to raise capital through an Initial Public Offering (IPO). If purchased at a discount to the per unit terminal value, SPACs offer a virtually risk-free profit in what is essentially a liquidating cash pool with inherent long optionality. This long optionality "kicked in" with several SPACs in 2020 upon their announcement of an acquisition and episodic periods of market de-risking provided managers with attractive entry points into SPACs units at a discount to the per unit terminal value. Looking forward, managers are hopeful for a resumption of robust M&A volumes. Increased volumes are generally a positive for the strategy, in that it broadens the opportunity set.

Distressed investing, a sub-strategy within Event Driven, have performed well. The last year illustrated the boom/bust nature of the strategy's opportunity set, amplified by increasingly activist central bank policies. Prior to the emergence of COVID-19, 5% of the high yield bond universe traded at "stressed" levels (e.g., spreads > 1000bps), indicating a modest opportunity set. Spreads quickly increased by 37%, driven by the abrupt deterioration of both fundamental (i.e., corporate cash flows and liquidity) and technical considerations (i.e., selling of a relatively illiquid asset class). The Federal Reserve's response – which for the first time included buying corporate debt, including high yield bonds – supported a massive round of refinancing that addressed immediate corporate liquidity needs and dampened the ensuing uptick in defaults. While default volumes in 2020 were large by historical standards, they mostly affected sectors and companies that were already challenged pre-COVID-19. By the end of 2020, only 3% of performing high yield was trading "stressed", once again indicating a modest opportunity set. Going forward, ERS faces mixed opportunity prospects, with low volumes of performing "stressed" debt, but expectations that restructurings remain elevated given the size of leveraged credit markets and the longer-term impact of COVID-19 on certain sectors.

Equity Long/Short strategies performed well during 2020, with returns largely coming from the short side in the first quarter, and from the long book for all other quarters of the year. The markets rewarded managers that were quick to react to the changing environment due to COVID-19 throughout the year. Managers generally increased exposure to stay-at-home names following March and maintained that exposure for much of the year. This positioning proved lucrative over 2020. Those funds that became bearish following the first quarter market decline missed the ensuing rally and suffered significantly. Growth funds significantly outperformed value-focused funds for the year. Funds with larger exposure to the United States and Asia outperformed those with significant European exposure. Large capitalization funds outperformed over the first part of the year, while small cap funds rallied in the back half of 2020. The largest sector drivers of positive attribution were consumer discretionary and technology on the long side. The opportunity set for these strategies remains attractive due to the technological innovation that is driving change across industries of the economy as well as current dislocations in the market due in part to COVID-19. Managers may be able to take advantage of these changes through both long and short opportunities.

The chart below shows the dispersion of returns classified by strategy across the hedge fund industry. The horizontal line within each respective rectangle represents the median return. The end-points of each line represents the top and bottom decile returns. The chart illustrates that dispersion of returns among managers is high.



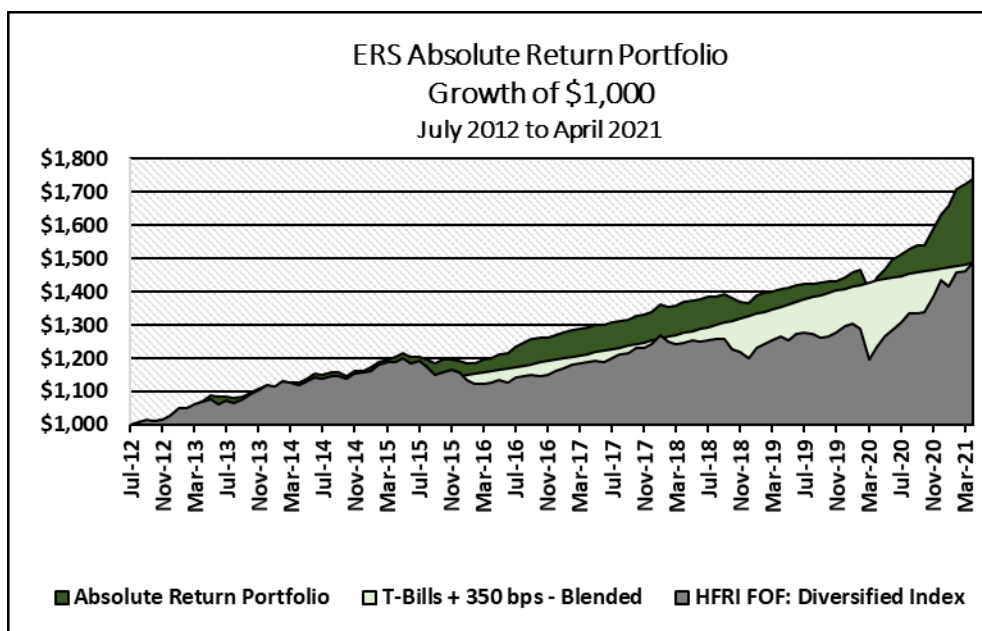
For the 12-month period ending May 31, 2021, index returns, as measured by the HFRI Fund of Fund Conservative Index (Bloomberg: HFRIFOFC Index) and the HFRI Fund of Funds Diversified Index (Bloomberg: HFRIFOFD Index), were +16.84% and +18.32%, respectively, and the HFRX Global Hedge Fund Index (Bloomberg: HFRXGL) increased +13.54%. The ERS Absolute Return Portfolio was up +20.00% during the same period.

PERFORMANCE REVIEW

Absolute Return Portfolio

During FY20, the Absolute Return Portfolio met its objectives as a diversifier to the Trust while providing attractive risk adjusted returns.

As of April 30th, 2021 the annualized inception-to-date return (ITD) for the Absolute Return Portfolio is +6.53%. This return exceeds the portfolio's target return of 90-day T-bills + 350 basis points (Bloomberg: G001 Index (floating component)), which has seen annualized returns of +4.64% over the same period. This is a blended benchmark return. The ERS Board reduced the benchmark's spread component from 400 to 350 basis points during the May 2019 meeting. Similarly, the Absolute Return Portfolio has outperformed the HFRI Fund of Fund Conservative Index +4.22%, HFRI Fund of Funds Diversified Index +4.67%, and the HFRX Global Index +2.66% over the same period. The graph below illustrates the performance of investing \$1,000 in the Absolute Return Portfolio (at inception).



The annualized standard deviation of the Absolute Return Portfolio has not reached the target range of 4%-8%. Inception to date, the portfolio has achieved an annualized standard deviation of +3.20%. This results in a very high annualized Sharpe Ratio of 1.81. The Sharpe Ratio is a measure of excess risk adjusted returns. Within a risk-reducing portfolio, a high Sharpe Ratio is preferred as it indicates higher relative returns per unit of risk. In comparison, the HFRI Fund of Fund Diversified and the HFRX Global Hedge Fund Indices have delivered Sharpe Ratios of 0.85 and 0.47, respectively over the same period. The Sortino Ratio is a variation of the Sharpe Ratio that focuses on downside volatility instead of standard deviation/volatility. This helps from an analysis standpoint, since standard deviation by itself penalizes a manager for upside volatility (large positive moves).

ERS Portfolio & Benchmark	Annualized Return	Annualized Standard Deviation	Sharpe Ratio	Sortino Ratio	Largest Drawdown
Absolute Return Portfolio	6.53%	3.20%	1.81	3.46	-4.01%
90 Day T-Bills + 3.50% (blended)	4.64%	0.26%	34.72	N/A	N/A
HFRI FOF: Diversified Index	4.68%	4.69%	0.85	1.27	-8.19%
HFRI FOF: Conservative Index	4.22%	3.63%	0.97	1.34	-7.64%
HFRX Global Hedge Fund Index	2.66%	4.40%	0.47	0.64	-8.95%

Stated Policy Benchmark	Bloomberg Ticker
90 Day T-Bills + 3.50% (blended)	G001 INDEX (floating component)
Industry Benchmarks	Bloomberg Ticker
HFRI FOF: Diversified Index	HFRIFOFD INDEX
HFRI FOF: Conservative Index	HFRIFOFC INDEX
HFRX Global Hedge Fund Index	HFRXGL INDEX

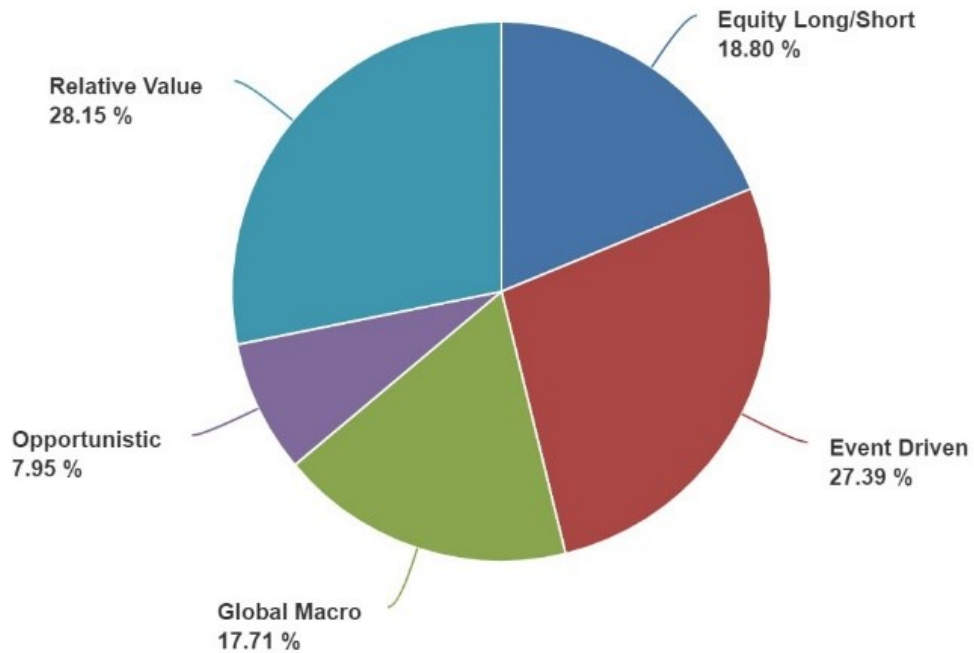
Historically, the Absolute Return Portfolio has delivered both a low correlation and a low beta compared to the Trust. The correlation between the two since the inception of the Absolute Return Portfolio is 0.73. This has been relatively static on a year over year basis, but staff expects it to decline over time. Expectations are for this to decline as both markets normalize and new allocations occur. This also speaks to the fact that the ERS Hedge Fund portfolio is primarily comprised of liquid instruments which have benefited from the ongoing positive performance from public market assets. Beta measures the level of systematic risk, where a low beta indicates a diversifying exposure to the Trust. The beta since

inception between the Absolute Return Portfolio and the Trust is 0.35. This is below the targeted cap of 0.40.

The Absolute Return Portfolio remains diversified by strategy and within the targeted allowable strategy bands. The following charts provide a detailed look at both current and historical strategy exposures as of April 30, 2021.

Strategy Exposures - Hedge Funds - Allocation, %

April-2021



Strategy Exposures - Hedge Funds - Allocation, %

August-2012 to April-2021



Strategy correlation remains relatively low, as displayed in the following table. Correlations across the portfolio have all remained relatively stable, but slightly elevated on a year over year basis. This is most likely due to the ongoing price appreciation within public markets. The only noteworthy change is the uptick between Relative Value and Equity Long/Short from 0.22 to 0.41Y. This most likely occurred due to the underlying multi-strategy hedge funds pivoting to equity related strategies over the last 12 months. Additionally, fixed income arbitrage managers took advantage of spread compression and relative value trading opportunities within fixed income markets. This provided for equity like returns, given the following factors: central bank liquidity, spread compression within credit/fixed income markets, and leverage associated with the strategy. In addition, a credit manager within the relative value sleeve pivoted to SPACs which added to performance, but increased the volatility of the manager's return profile. ERS will have fully exited from this credit manager by the end of FY2021. The correlation between relative value and Event Driven remains elevated but expected given the overlap of multi-strategy exposure. Staff believes it will subside over time with the addition of new niche relative value strategies to the portfolio. The strategy correlations displayed below are from inception to April 30, 2021.

Strategy Correlation	Relative Value	Event Driven	Global Macro	Equity Long/Short	Opportunistic
Relative Value					
Event Driven	0.62				
Global Macro	0.20	0.41			
Equity Long/Short	0.41	0.47	0.41		
Opportunistic	0.10	0.34	0.41	0.17	

The two charts below provide annualized returns for the Absolute Return Portfolio over various periods. The values are through April 30, 2021. The first chart compares the Absolute Return Portfolio to various benchmarks. The second chart displays strategy performance relative to each strategy's respective HFRX benchmark. HFRX indices are investable and carry both positive and negative benchmark attributes.

	YTD	1 Yr. Annualized	3 Yr. Annualized	5 Yr. Annualized	7 Yr. Annualized	ITD
Absolute Return Portfolio	6.59%	20.49%	8.34%	7.68%	6.38%	6.53%
T-Bills + 3.50% (blended)	1.19%	3.62%	5.27%	5.07%	4.78%	4.64%
HFRI FOF: Diversified Index	3.92%	20.77%	6.21%	5.75%	4.21%	4.68%
HFRI FOF: Conservative Index	5.21%	18.64%	5.32%	4.96%	3.61%	4.22%
HFRX Global Hedge Fund Index	2.94%	14.74%	3.99%	4.20%	2.08%	2.66%

Investment Strategy	Current Allocation	MTD	QTD	YTD	3 Yr	5 Yr	ITD
Relative Value	\$417,626,158	0.69%	0.69%	11.36%	13.88%	10.60%	7.90%
HFRX Relative Value Arbitrage Index		0.46%	0.46%	0.36%	4.13%	4.09%	1.86%
Event Driven	\$406,353,952	1.01%	1.01%	5.56%	8.65%	8.08%	6.80%
HFRX Event Driven Index		1.56%	1.56%	3.30%	4.55%	5.43%	3.47%
Equity Long/Short	\$278,914,547	1.54%	1.54%	5.18%	7.88%	6.68%	7.32%
HFRX Equity Hedge Index		2.99%	2.99%	5.73%	3.30%	4.69%	3.21%
Global Macro	\$262,798,869	0.46%	0.46%	3.69%	4.02%	5.09%	4.37%
HFRX Macro Index		1.10%	1.10%	1.63%	2.99%	1.28%	0.85%
Opportunistic	\$118,023,093	0.23%	0.23%	2.54%	3.34%	7.71%	6.92%

The Absolute Return Portfolio has delivered attractive returns on both an absolute and risk adjusted return basis. From a relative performance standpoint, the Absolute Return Portfolio has outperformed its strategic long-term benchmark across all periods. The relative outperformance to the Portfolio's strategic benchmark has been due to strong strategy performance, primarily over longer periods. The strategic benchmark is an absolute benchmark that is both un-investable and never experiences monthly negative performance. As the COVID-19 pandemic unfolded, the Portfolio's managers preserved capital and shifted to attractive strategies that benefited from the ongoing economic recovery, primarily in liquid public markets.

In comparison to peer benchmarks (i.e. fund of funds), the Absolute Return Portfolio has continually outperformed across almost all periods, except for a slight relative underperformance to the HFRI FoF: Diversified Index for its one year annualized performance. This speaks to the portfolio construction of the Absolute Return Portfolio as well as the strength of the ERS Hedge Fund team's ability to select managers.

The Absolute Return Portfolio remains liquid. Approximately 73% of assets could be withdrawn over the next 12 months, subject to the option to exit early by paying redemption fees of 1% of assets. Five managers oversee the majority of the remaining 27% of assets. One is associated with a new investment, which is under lock, which means the funds are not yet accessible. A second investment is associated with a less-liquid opportunistic strategy that has renewed its rolling multi-year lock. This investment focuses on regulatory capital and specialty finance trades. Three investments have investor level gates. A common investor-level gate limits redemptions to a specific percentage of an investor's money over a defined period. In contrast, fund-level gates define redemptions based on a certain percentage of the overall net asset value of hedge funds. Two of the three investments have fund level gates with more generous underlying liquidity rights. When adjusted for these fund-level gates the liquidity profile increases to around 84%.

Directional Growth Portfolio

The Directional Growth portfolio, a collection of strategies evaluated on a standalone basis, has been a positive contributor to the Trust. Managers receive an incentive fee on relative outperformance to a specified equity market index. The Directional Growth Portfolio is comprised of one equity long/short allocation. The current allocation is within policy guidelines and strategy diversification expectations.

The following table provides annualized portfolio performance over various periods, as of April 30, 2021.

Fund Name	YTD	1 YR	3 YR	5 YR	7 YR	ITD
MW TOPS World Equities (US) Fund	12.38%	50.76%	16.34%	17.54%	15.64%	15.46%
MSCI AC World Daily Net Local	9.80%	42.05%	13.50%	13.97%	11.04%	11.00%

Fund	Current Allocation	Inception Date
MW TOPS World Equities (US) Fund L.P.	\$475,867,349	04/01/14

The MW TOPS World Equities (U.S.) Fund continues to produce attractive risk adjusted returns. Historically, this manager has been profitable 72% of the time and has both an attractive Sharpe Ratio of 1.08 and Sortino Ratio of 1.70. The fund has achieved attractive risk adjusted returns while maintaining a high historical correlation of 0.98 and beta of 1.03 to its respective benchmark.

Fund Name & Benchmarks	Annualized Return	Annualized Standard Deviation	Sharpe Ratio	Sortino Ratio	Largest Drawdown
MW TOPS World Equities (US) Fund	15.46%	13.56%	1.08	1.70	-20.81%
MSCI AC World Daily Net Local	11.00%	12.90%	0.79	1.24	-19.97%
Directional Growth Portfolio	13.44%	13.23%	0.95	1.50	-20.05%

Liquidity within the Directional Growth portfolio is high given the emphasis on equities. Assets are available for redemption on a monthly basis, so 100% of the underlying assets could be redeemed in a given month with a standard notice period (i.e. 30 days).

Other Hedge Fund Allocations

The ERS Hedge Fund team continues to work with a third party partner, PAAMCO Prisma, to source and allocate to emerging hedge fund managers. The ERS Launchpad (Launchpad) initiative acts as an enhancement to the existing Hedge Fund program. As a reminder, the Absolute Return Portfolio allocates to institutional hedge fund managers.

A key and differentiating aspect for Launchpad is that ERS seeks a revenue share from all investments in exchange for a longer lock and early-stage investment. These are seeding transactions, and capital allocations to these emerging hedge fund managers are not for working capital purposes. An investment used for working capital purposes inputs capital into a business and designates the investor as a partial owner. This entails holding direct business risk where the invested capital requires either a sale or liquidation to recoup the investment. ERS Launchpad invests only in publically traded securities and not physical businesses.

ERS made the first investment in September 2019 to Cinctive Capital Management. A second investment to Phase 2 Partners occurred in October of 2020. The ERS Board of Trustees approved an additional \$175 million commitment in April of 2021 to Launchpad. This additional commitment will fund up to four new investments over the next three. The ERS Hedge Fund team remains excited about the seeding of new emerging hedge fund managers given the challenging capital-raising environment.

ERS Hedge Fund Holdings

The ERS Hedge Fund program is structured and implemented with a focus on scalability in order to manage and support multiple hedge fund portfolios and asset classes. The following table shows a summary of current hedge fund investments. Each manager underwent due diligence by the ERS Hedge Fund team and was approved by the Asset Class Investment Committee. The Asset Class Investment Committee must approve all allocations.

Absolute Return Portfolio			
Holding Name	Asset Type	Initial Allocation	Current Value
Hudson Bay Fund L.P.	HF - Multi-Strategy Relative Value	10/1/2019	\$162,159,696
Laurion Capital L.P.	HF - Multi-Strategy Relative Value	1/1/2020	\$151,409,623
(PAX) Pacific Alliance Asia Opp Fund L.P.	HF - Multi-Strategy Event Driven	1/1/2017	\$139,452,310
Garda Fixed Income Relative Value Opportunity Fun	HF - Fixed Income Arbitrage	11/1/2018	\$131,181,479
Apollo Credit Strategies Fund L.P.	HF - Long/Short Credit	4/1/2020	\$121,005,930
Taiga Special Opportunities Fund	HF - Opportunistic	7/1/2017	\$104,249,879
Polymer Asia (US) Fund LP	HF - Market Neutral	2/1/2021	\$102,024,697
Complus Asia Macro Fund Ltd.	HF - Discretionary Global Macro Asia	10/1/2016	\$93,727,646
Samlyn Onshore Fund LP	HF - Equity Long/Short	8/1/2020	\$92,387,630
Graham Absolute Return Trading Ltd.	HF - Discretionary Developed Markets Macro	2/1/2018	\$84,561,386
Iguazu Partners LP	HF - Global Macro	12/1/2013	\$84,509,837
MW European TOPS (US) Fund	HF - Equity Long/Short	3/1/2013	\$84,502,220
Glazer Enhanced L.P.	HF - Merger Arbitrage	1/1/2016	\$62,393,393
Magnetar Structured Credit Fund LP	HF - Structured Credit	1/1/2014	\$53,955,207
PAG - Project Wine - (Side Pocket)	HF - Opportunistic	6/30/2019	\$13,773,214
Southpaw Credit Opportunity Partners L.P.	HF - Distressed / Stressed	8/1/2012	\$2,422,472
Directional Growth Portfolio			
MW TOPS World Equities (US) Fund	HF - Equity Long/Short	4/1/2014	\$475,867,349
PAAMCO PRISMA Launchpad			
Cinctive Global Master Fund	HF - Multi-Manager Equity Long/Short	9/1/2019	\$144,671,418
P2 Nexxt Offshore Master Fund	HF - Equity Long/Short	11/1/2020	\$52,252,008
Total Hedge Fund Assets			\$2,156,507,395

Annual Tactical Plan for Fiscal Year 2022 - (Action)

In accordance with the Hedge Fund Program Asset Class Guidelines, ERS staff must prepare and present an Annual Tactical Plan (Plan) to the ERS Board of Trustees for review and approval. The Plan includes: (1) the status of the Hedge Fund Program; (2) recent, historical, and prospective market conditions; and (3) proposed steps to be implemented within the Hedge Fund Program over the next 12-months. The Plan establishes the objectives for the fiscal year and guides program operations. The Plan does not overrule prudent hedge fund investment decision-making.

The following portfolio summaries provide guidance on the anticipated hedge fund allocations.

Absolute Return Portfolio

As of April 30, 2021, the Absolute Return Portfolio is approximately 4.5% of total Trust assets. The Portfolio is near its targeted allocation of 5%, but has further flexibility due to its allowable strategy bands of 0-10%. Staff expectations are for the allocation to either meet or exceed this target allocation over the coming fiscal year. Allocating above the target would help the Absolute Return Portfolio remain close to its targeted 5% allocation as the Trust's assets continue to recover and increase over the current economic cycle.

Looking into FY22, the current environment remains uncertain with countries managing ongoing pandemic issues. Vaccine distribution remains uneven, with emerging markets struggling the most. In other instances, countries have varying degrees of hesitancy in taking one of the available vaccines. This has created an uneven economic recovery across the world.

The ERS Hedge Fund team remains positive that hedge fund strategies should continue to offer attractive rates of return. The environment will be challenging given low interest rates globally, high valuations within many public markets, and suppressed volatility due to both fiscal and monetary policy. As the global economy continues to reopen and monetary policy is withdrawn, this could lead to bouts of volatility. Generally, that type of operating environment has enhanced returns for hedge fund strategies due to both security selection and positioning (i.e. short exposure).

ERS staff focus remains on finding diversifying strategies that can offer a unique return profile with a low degree of correlation to the Portfolio's existing underlying managers. In other instances, some degree of correlation is acceptable for a degree of diversification to existing strategies, through either strategy or geography. These statements hold true across all five of the strategy sleeves within the Absolute Return Portfolio.

In FY22, the ERS Hedge Fund team will target up to five new hedge fund commitments for the Absolute Return Portfolio (Portfolio). These allocations will include both new strategy exposures and replacements to existing allocations. Regarding the Absolute Return Portfolio, additional consideration is given to investments that reside in relative value, event driven, global macro, and opportunistic.

Directional Growth Portfolio

Until further notice, the ERS Hedge Fund team remains on pause regarding new opportunities for the Directional Growth Portfolio. There are no plans to pursue any new investments in FY22, but the staff will remain open to identifying new opportunities for consideration in the future.

Staff Recommendation

Staff recommends the Board approve the FY22 Annual Tactical Plan with the target allocations summarized in **Exhibit A**, in accordance with ERS' Investment Policy and Asset Class Guidelines.

While the proposed Tactical Plan is prudent and effective for the implementation of the ERS Hedge Fund Program, it may require an amendment based upon the actual opportunities that become available in the market throughout the year.

Albourne Partners has reviewed and supported the proposed Hedge Fund/Absolute Return Annual Tactical Plan for Fiscal Year 2022.

**ERS is 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 - Hedge Fund Annual Tactical Plan for Fiscal Year 2022
2. Slides – Hedge Funds