AGENDA ITEM DETAILS

Subject: Consideration of Annual Review of Hedge Funds Program - (Action)
• Consideration of Proposed Hedge Funds Tactical Plan

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 approve the proposed Hedge Funds Tactical Plan for Fiscal Year 2023 as provided in Exhibit A.

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

Move that the Board of Trustees approve the proposed Hedge Funds Tactical Plan for Fiscal Year 2023, as provided in Exhibit A.

Background:

As required by the Employees Retirement System of Texas (ERS) Investment Policy Statement (IPS), this agenda item will provide the annual review of the Hedge Funds Program, including the forecasted 12-month tactical plan for the asset class. Unless otherwise specified, all figures cited in this report represent annualized figures net of external investment expenses as of February 28, 2022. Hedge funds are actively managed investment partnerships whose managers use a wide range of strategies, including the use of leverage buying with borrowed money and trading esoteric assets, in an effort to deliver consistently positive returns for their clients.

STRATEGIC PURPOSE

In 2008, the Board adopted asset allocation parameters that included investing 5% of Trust assets in hedge funds via the Absolute Return Portfolio (ARP or Portfolio). ERS made initial allocations to ARP in 2012. ERS employs this allocation to earn appropriate returns, to maintain adequate liquidity for making benefit payments, and to allow for the rebalancing of assets during periods of financial stress.

In 2013, the Board added hedge funds as an implementation option in other asset classes. In 2014, the Directional Growth Portfolio was funded within the Global Equity Portfolio. In 2019, the ERS PAAMCO Launchpad Portfolio (Launchpad) was initially funded within the Special Situations Portfolio.

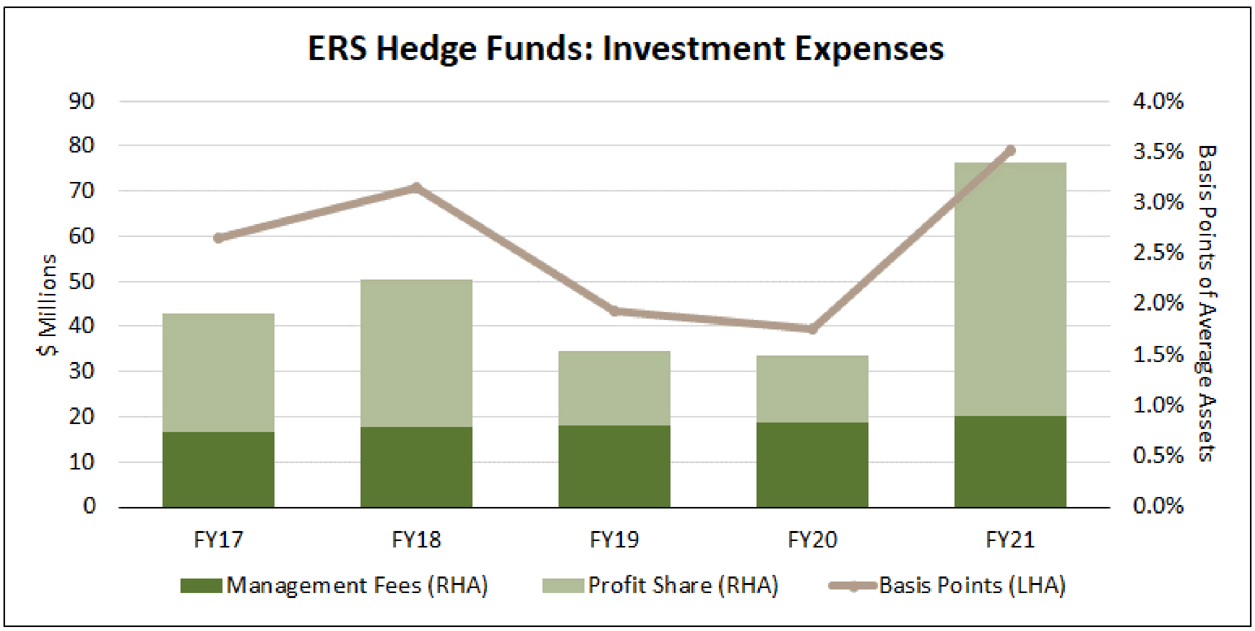
Currently the ERS Hedge Funds Program oversees three separate portfolios:

- Absolute Return: 5% target allocation with a range of 0-10% that serves to provide short-term liquidity for the Trust. As of February 28, 2022, this portfolio was 4.4% of Trust assets.
- Directional Growth: opportunistic allocation within Global Equity that serves as a return-seeking strategy. As of February 28, 2022, this portfolio totaled 1.5% of Trust assets.
- Launchpad: opportunistic allocation within Special Situations that serves as a return-seeking strategy. As of February 28, 2022, this portfolio totaled 0.8% of Trust assets.

IMPLEMENTATION OBJECTIVE

The primary objective for all three portfolios is to outperform their policy benchmarks provided in the IPS over a rolling five-year period while maintaining compliance with the asset class guidelines established in the Investment Implementation Plan (IIP). Over longer time horizons, these objectives have been achieved within all three portfolios, though with less risk than budgeted within the guidelines.

Investment returns for hedge funds are evaluated net of investment expenses, which include both management fees and profit share. The table below summarizes the historical levels of these amounts as detailed in the ERS Annual Comprehensive Financial Report.



As shown in the table above, expenses associated with the allocation to hedge funds was less than 2% of the assets under management for the FY19-FY20. However, the significant outperformance of many funds in the post-pandemic rally resulted in a significant increase in the profit share component for FY21, which staff expects will begin to normalize in FY22 toward levels of 2.5-3% of assets annually as was the case during FY17-18.

The underlying expense breakdowns for each of the three hedge fund portfolios varies due to differences in the manager composition and structure of each portfolio. As reported in the ERS Annual Comprehensive Financial Report, the figures below are for the period from July 1, 2020 through June 30, 2021.

- The Absolute Return Portfolio had total expenses (management fee plus profit share) of \$59.7 million or 4.17% of assets under management. Staff estimates that the internal expenses associated with this portfolio total 17 basis points annually.

- The Directional Growth Portfolio had a total expenses of \$6.2 million 1.24% of assets under management. These figures only include incentive fees since the single manger within the portfolio does not charge a management fee for this account. Staff estimates that the internal expenses associated with this portfolio total 6 basis points annually.

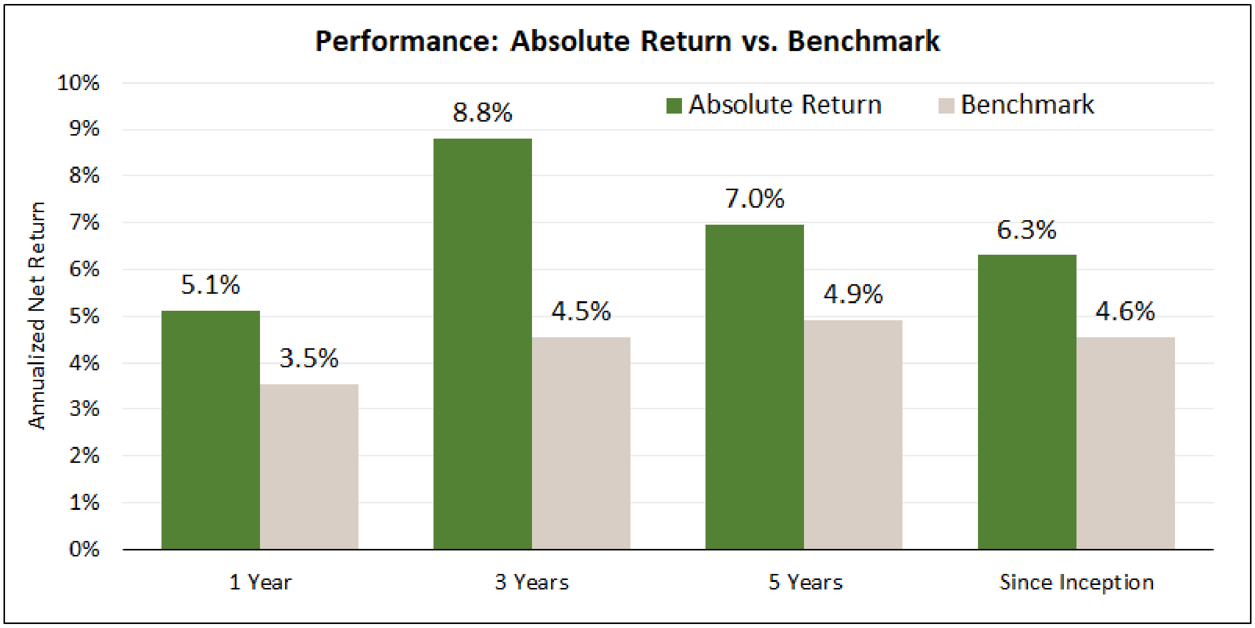
- The Launchpad Portfolio had a total fee expense \$9.3 million of 4.79% of assets under management. These figures include management and incentive fees as well as fees paid to PAAMCO Prisma, our joint venture partner within the Launchpad Portfolio. These figures also include the revenue share that ERS earns from each of the three managers that make up the portfolio. Staff estimates that the internal expenses associated with this portfolio total 19 basis points annually.

ABSOLUTE RETURN PORTFOLIO REVIEW

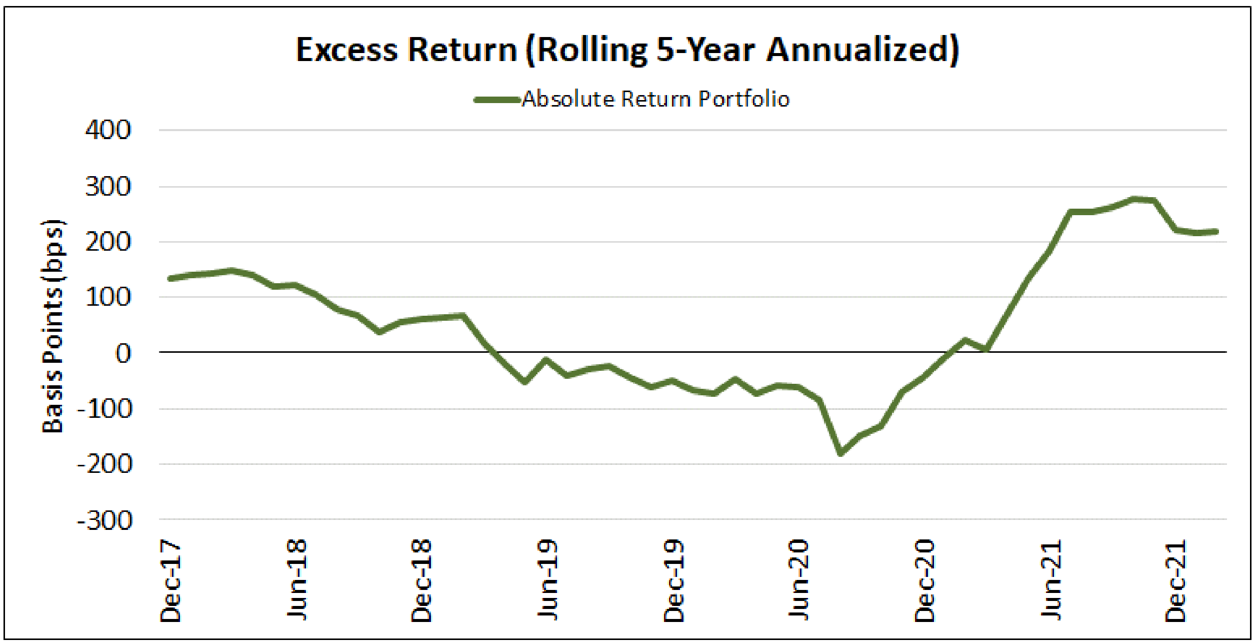
The strategic purpose of the Absolute Return Portfolio within the Trust is risk mitigation. The objectives of the Portfolio are to emphasize capital preservation, to provide attractive risk-adjusted returns, to provide diversification benefits to the Trust, and to reduce overall Trust volatility. The implementation objective for the Portfolio is to outperform the benchmark set forth in the IPS over a rolling five-year period while maintaining compliance with the guidelines provided in the IIP.

	Assets (\$ millions)	Assets (% of Trust)	1 Year	3 Years	5 Years	Since Inception
Absolute Return	**\$1,566**	**4.4%**	**5.11%**	**8.80%**	**6.95%**	**6.31%**
Benchmark			3.53%	4.54%	4.92%	4.55%
Excess Return			1.58%	4.26%	2.03%	1.76%

The primary benchmark for the Absolute Return Portfolio established in the IPS is the return of 90-day T-bills plus 350 basis points, and the Portfolio has outperformed this benchmark over all time horizons. As a reminder, the strategic benchmark is an absolute return benchmark that never experiences negative performance and is not investable. It is also a blended benchmark since the Board reduced the spread component from 400 basis points to 350 basis points in May 2019. Over the last five years, the Absolute Return Portfolio has delivered returns of +7%, which underscores its role in providing positive returns across most market environments.

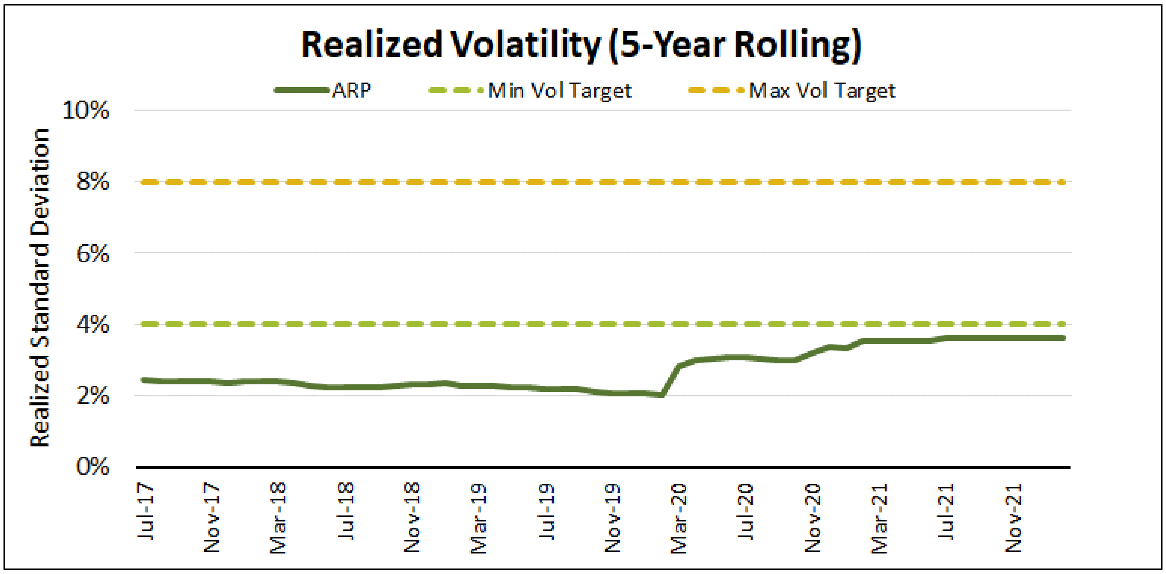


The graph below illustrates the rolling 5-year annualized excess return between the Portfolio and its primary benchmark. It is worth noting that while Portfolio returns were below the benchmark from 2019-2020, absolute returns were still positive throughout the period.



Additionally, this period of underperformance coincided with a period of rising interest rates that saw the returns of the underlying primary benchmark steadily rise. While another period of rising interest rates is underway in the U.S., the Hedge Fund team has upgraded the Portfolio's underlying manager composition since the 2018-2020 period. Notable changes include a complete replacement of two core multi-strategy allocations, as well as full redemptions from two structured credit allocations.

A key guideline for the Portfolio set forth in the IIP is to maintain a low correlation to the overall market including a low beta to the Trust overall. This guideline is measured by a beta (measure of a stock's volatility compared with the overall market) of 0.4 or less, which translates into a target volatility (as measured by annualized standard deviation) range for the portfolio of 4-8%.



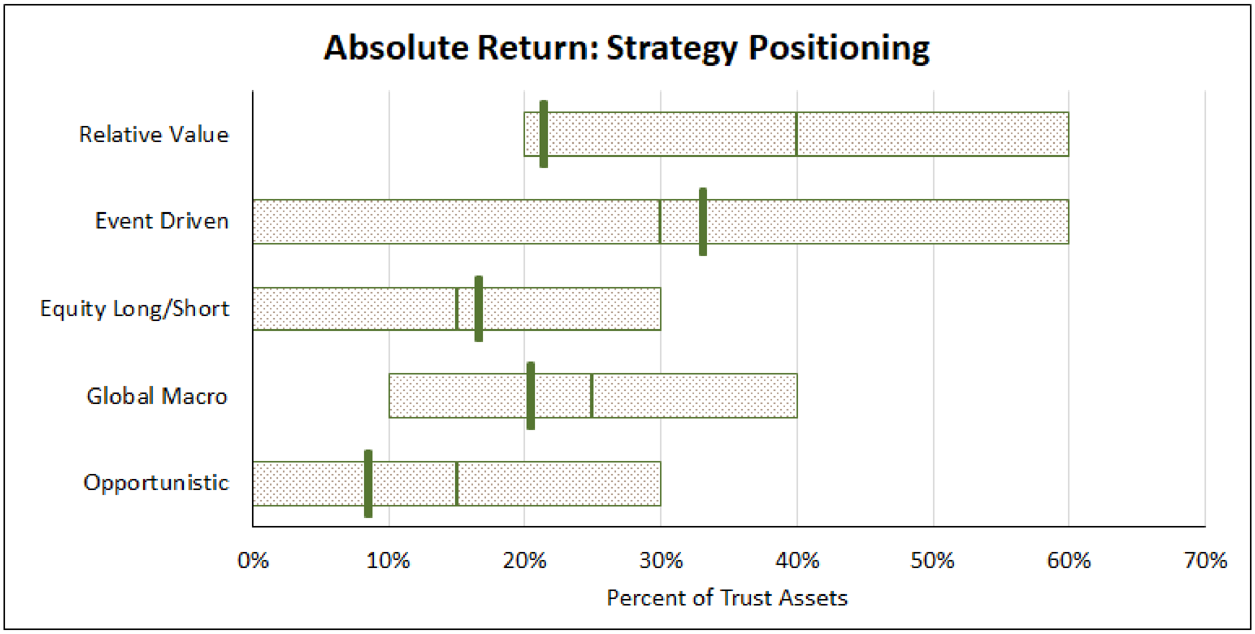
The volatility of the Absolute Return Portfolio has been consistently below the guidelines of 4%-8%. Since inception, the Portfolio has achieved an annualized standard deviation of +3.2%, while on a rolling 5-year annualized basis this measure stands at 3.6%. Such low levels of volatility result in a very high Sharpe Ratio of 1.80 since inception. (Sharpe Ratio is a measure of excess risk-adjusted returns, and a high Sharpe Ratio is preferred since it indicates higher relative returns per unit of risk.) In comparison, most hedge fund indices have delivered Sharpe Ratios of less than 1.0 over the same period.

Historically, the Absolute Return Portfolio has also 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 0.68. This figure has been relatively steady on a year over year basis, but staff expects it to continue to decline as it has over the past year. Expectations are for this to decline as both markets normalize and new allocations or upgrades occur. Beta measures the level of systematic risk, where a low beta indicates a diversifying exposure to the Trust. The beta measure since inception between the Absolute Return Portfolio and the Trust is 0.33, which is within the limit of 0.40 established in the Asset Class Guidelines.

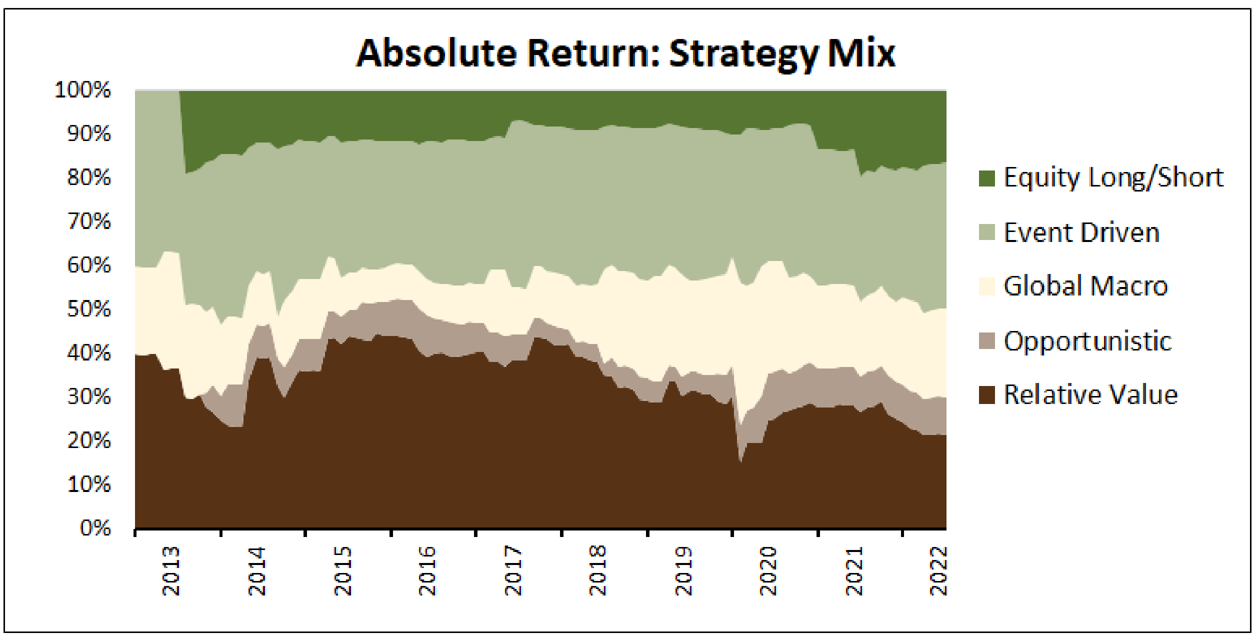
The guidelines also monitor the Absolute Return Portfolio across five strategy categories to ensure that diversification is maintained. Strategy correlations between these categories remain relatively low, as shown in the correlation matrix below. The correlation between relative value and event driven has often been more elevated, mainly due to the overlap of multi-strategy exposure. However, this correlation has marginally declined in FY22, and correlations are expected to continue to remain at levels that provide meaningful diversification.

Strategy Correlation	Relative Value	Event Driven	Global Macro	Equity Long/Short	Opportunistic
Relative Value					
Event Driven	0.55				
Global Macro	0.22	0.38			
Equity Long/Short	0.33	0.45	0.36		
Opportunistic	0.11	0.34	0.40	0.16	

The Portfolio's exposure to these strategy categories will fluctuate depending on underlying manager composition as well as the broader market environment. Even so, the Portfolio has remained diversified by strategy, and the Portfolio is positioned within the strategy bands established in the asset class guidelines. The following charts provide a detailed look at both current and historical strategy exposures.



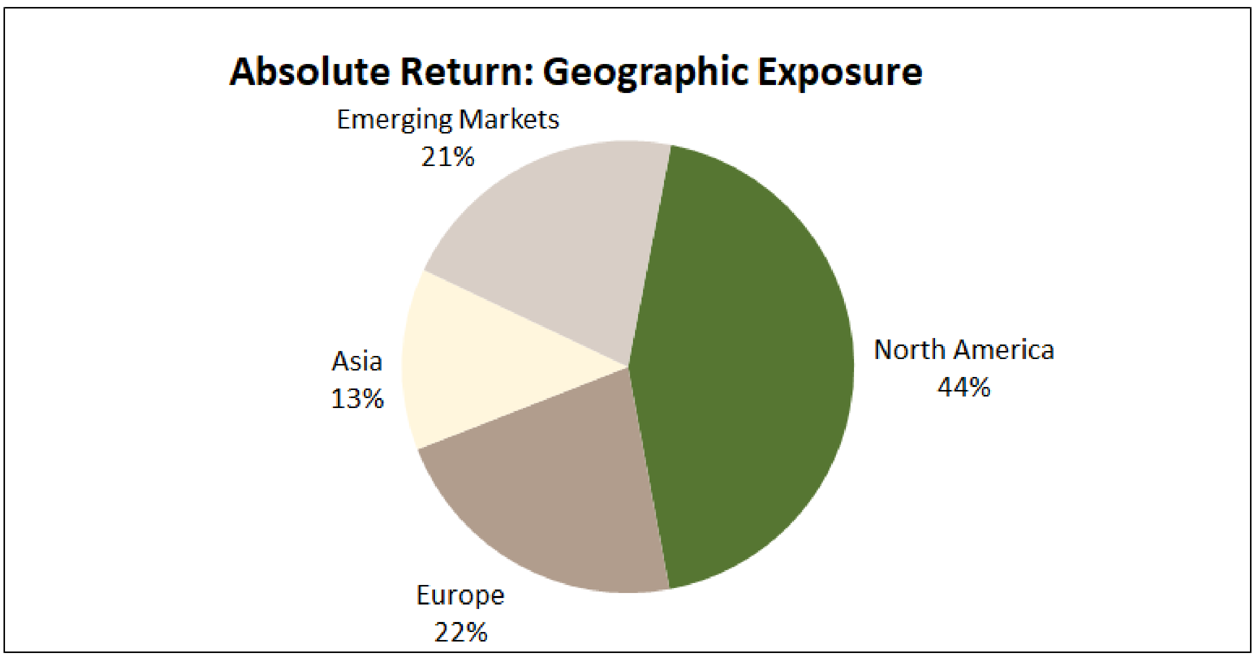
This mix has remained relatively stable in recent years. The Portfolio performed well in the two years that have passed since the beginning of the COVID-19 pandemic. When the pandemic began, the underlying managers preserved capital well. The managers then shifted to attractive strategies that benefited once the economic recovery unfolded, primarily in liquid public markets. As the recovery persisted, the underlying managers maintained these exposures while preserving their risk management discipline. The result was that 2020 and 2021 were the top two calendar years for portfolio performance since inception, including a gain of +13.0% in 2020 and a gain of +9.2% in calendar year 2021.



The chart below depicts the current composition of the Portfolio. Current holdings total 17 positions, which is within the range of 10-25 set forth in the asset class guidelines. The guidelines also specify a maximum allocation of 15% of the Portfolio to core holdings and 10% to satellite holdings, and the largest current allocations represent 11% and 10% respectively.

Absolute Return Portfolio			
Holding Name	Strategy Type	Initial Allocation	Current Value ($MM)
Hudson Bay Fund L.P.	HF - Multi-Strategy Relative Value	Oct-19	$169.2
(PAX) Pacific Alliance Asia Opp Fund L.P.	HF - Multi-Strategy Event Driven	Jan-17	$163.3
Garda Fixed Income Relative Value Opportunity	HF - Fixed Income Arbitrage	Nov-18	$133.9
Apollo Credit Strategies Fund L.P.	HF - Long/Short Credit	Apr-20	$126.4
Taiga Special Opportunities Fund	HF - Opportunistic	Jul-17	$123.2
Laurion Capital L.P.	HF - Multi-Strategy Relative Value	Jan-20	$116.4
Polymer Asia (US) Fund LP	HF - Market Neutral	Feb-21	$107.4
Complus Asia Macro Fund Ltd.	HF - Discretionary Global Macro Asia	Oct-16	$95.7
Iguazu Partners LP	HF - Global Macro	Dec-13	$94.8
Samlyn Onshore Fund LP	HF - Equity Long/Short	Aug-20	$89.5
Graham Absolute Return Trading Ltd.	HF - Discretionary Developed Markets Macro	Feb-18	$88.2
Tenor Opportunity Fund L.P.	HF - Convertible Arbitrage	Nov-21	$75.3
MW European TOPS (US) Fund	HF - Equity Long/Short	Mar-13	$63.2
Glazer Enhanced L.P.	HF - Merger Arbitrage	Jan-16	$62.9
Orion Commodities Fund LP - Base Metals Share	HF - Global Macro	Aug-21	$40.7
PAG - Project Wine - (Side Pocket)	HF - Opportunistic	Jun-19	$10.2
Southpaw Credit Opportunity Partners L.P.	HF - Distressed / Stressed	Aug-12	$5.5

The asset class guidelines also specify a maximum allocation of no more than 50% of the Portfolio to non-developed markets, a level that currently stands at 21%.



As markets began to correct in early 2022, the prudent risk management processes of the underlying managers as well as their ability to shift exposures tactically were emphasized as volatility across most markets increased. This period also highlighted the portfolio construction of the Absolute Return Portfolio, notably the diversification amongst the underlying managers, as well as the strength of the ERS Hedge Fund team's ability to select managers. Despite these challenging conditions, the Absolute Return Portfolio contributed positive returns to the Trust during the first two months of 2022.

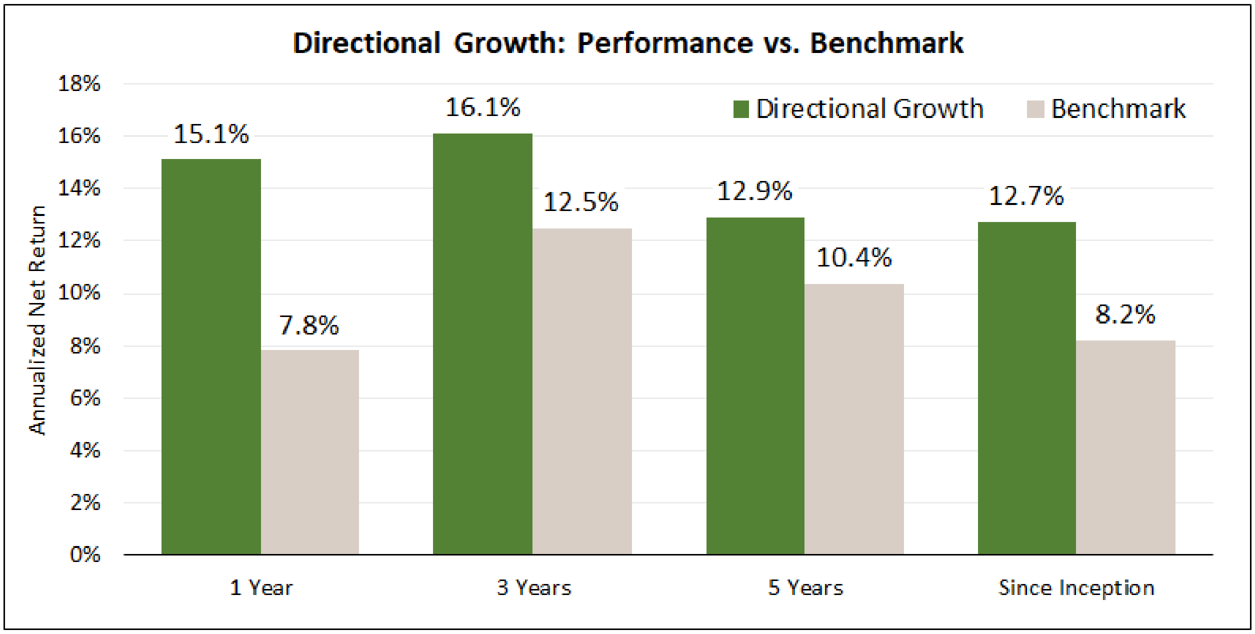
Looking ahead, the current level of outperformance over the primary benchmark will be difficult to maintain. The main reason for this pressure on performance is the projected level of increases in interest rates by the U.S. Federal Reserve. As interest rates rise, the primary benchmark for the Absolute Return Portfolio will rise as well, given its floating rate component. Nevertheless, given the Portfolio's diversification amongst underlying managers, as well as through strong strategy selection, the ERS Hedge Fund team expects the Portfolio to continue to outperform versus its benchmark.

DIRECTIONAL GROWTH PORTFOLIO REVIEW

The strategic purpose of the Directional Growth Portfolio is to provide return-seeking attributes to the Trust. The objectives of the Directional Growth Portfolio are for each allocation to outperform its underlying benchmark, for each allocation to maintain a low beta and correlation to its respective benchmark, and for the broader portfolio to act as a complement to the Trust's External Public Equity Portfolio.

	Assets ($ millions)	Assets (% of Trust)	1 Year	3 Years	5 Years	Since Inception
Directional Growth	**$503**	**1.4%**	**15.12%**	**16.10%**	**12.90%**	**12.74%**
Benchmark			7.81%	12.50%	10.38%	8.19%
Excess Return			7.31%	3.60%	2.52%	4.55%

The implementation objective for the portfolio is to outperform its policy benchmark over a rolling five-year period while maintaining compliance with the asset class guidelines. The following chart depicts annualized portfolio performance over a 1-year, 3-year, 5-year, and inception-to-date basis. As noted earlier, this figure is net of external investment expenses but does not include internal investment expenses, which are estimated at around 6 bps for this portfolio.



The Directional Growth Portfolio has historically been a collection of strategies evaluated on a standalone basis and a positive contributor to the Trust. Today, however, the Directional Growth Portfolio is comprised of a single equity long/short allocation, which is to the MW TOPS World Equities (U.S.) Fund. The asset class guidelines for Global Public Equity limit the allocation to hedge funds to 10%, and this allocation totals only 4%. This single current allocation within the

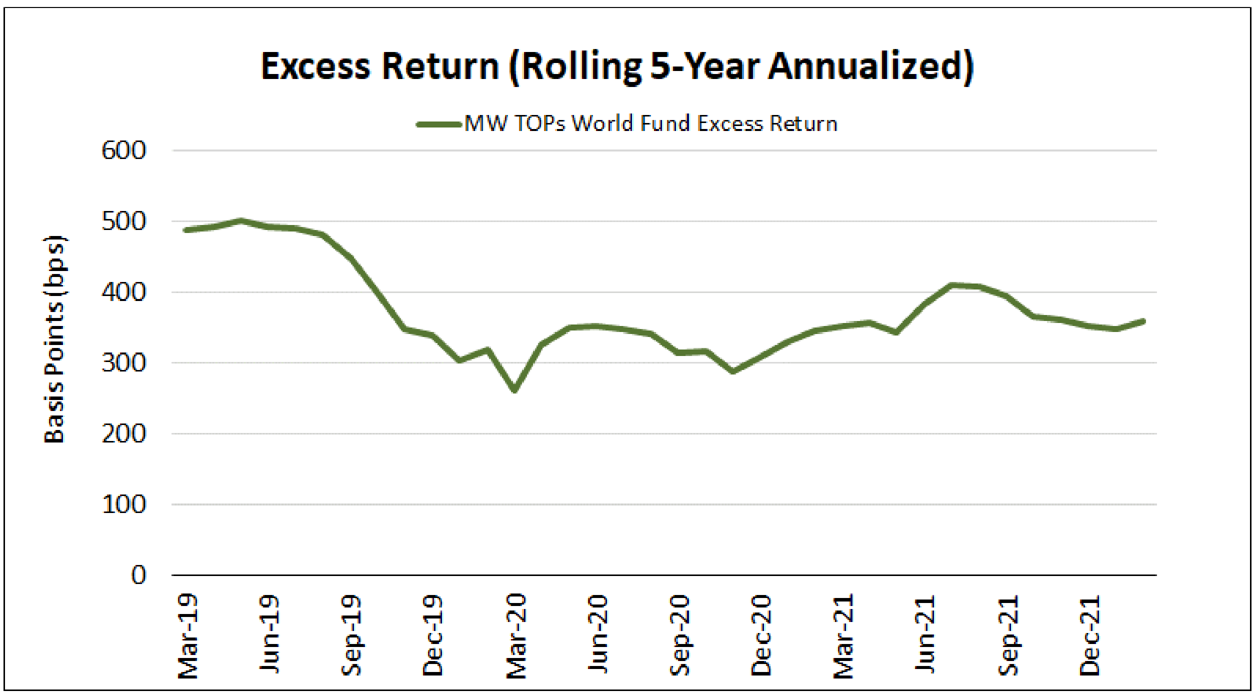
Directional Growth Portfolio targets a tracking error of 200–400 basis points and an Information Ratio of 0.25.

Directional Growth Portfolio			
Holding Name	Strategy Type	Initial Allocation	Current Value ($MM)
MW TOPS World Equities (US) Fund	HF - Equity Long/Short	Apr-14	$503.3

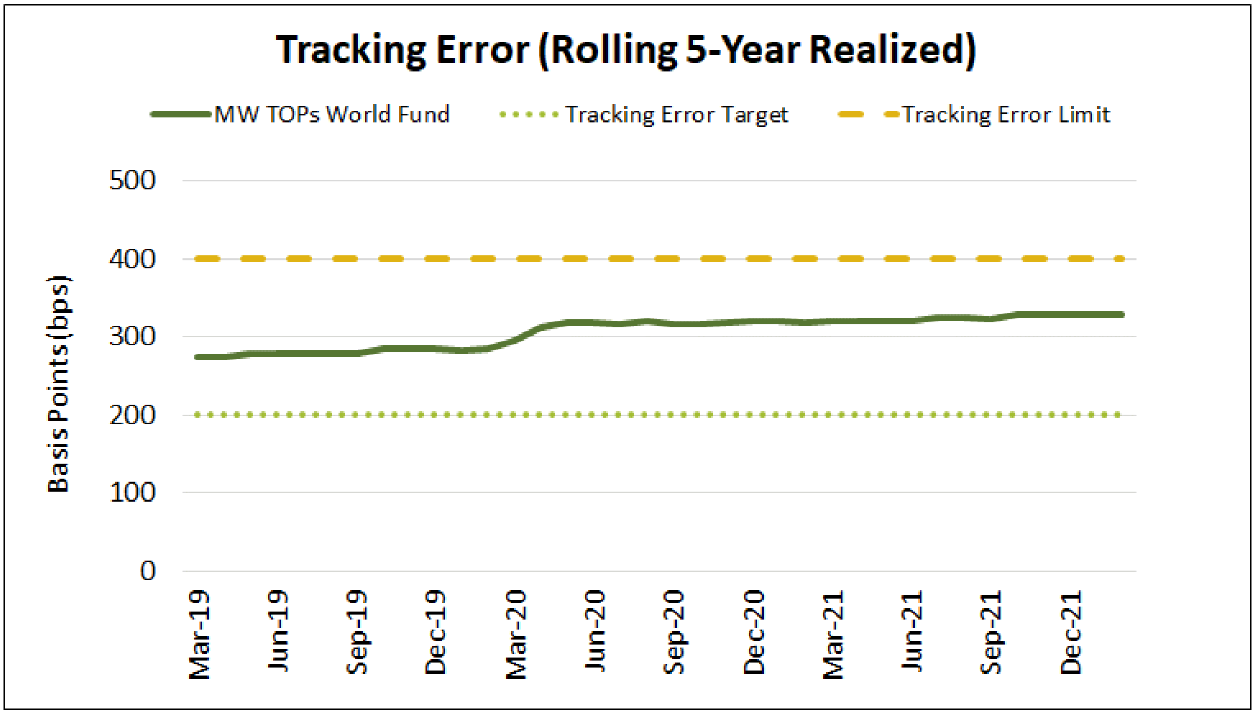
The MW TOPS World Equities (U.S.) Fund continues to produce attractive risk-adjusted returns. Historically, this fund has produced positive returns 71% of the time and has both an attractive Sharpe Ratio of 1.04 and Sortino Ratio of 1.65. The fund has achieved these attractive risk-adjusted returns while maintaining a high historical correlation of 0.98 and beta of 1.02 to its benchmark, which is by design.

Fund Name & Benchmarks	Annualized Return	Annualized Standard Deviation	Sharpe Ratio	Sortino Ratio	Largest Drawdown
MW TOPS World Equities (US) Fund	**14.53%**	**13.25%**	**1.04**	**1.65**	**-20.81%**
MSCI AC World Daily Net Local	10.11%	12.70%	0.74	1.16	-19.97%
Directional Growth Portfolio	**12.74%**	**12.93%**	**0.93**	**1.46**	**-20.05%**

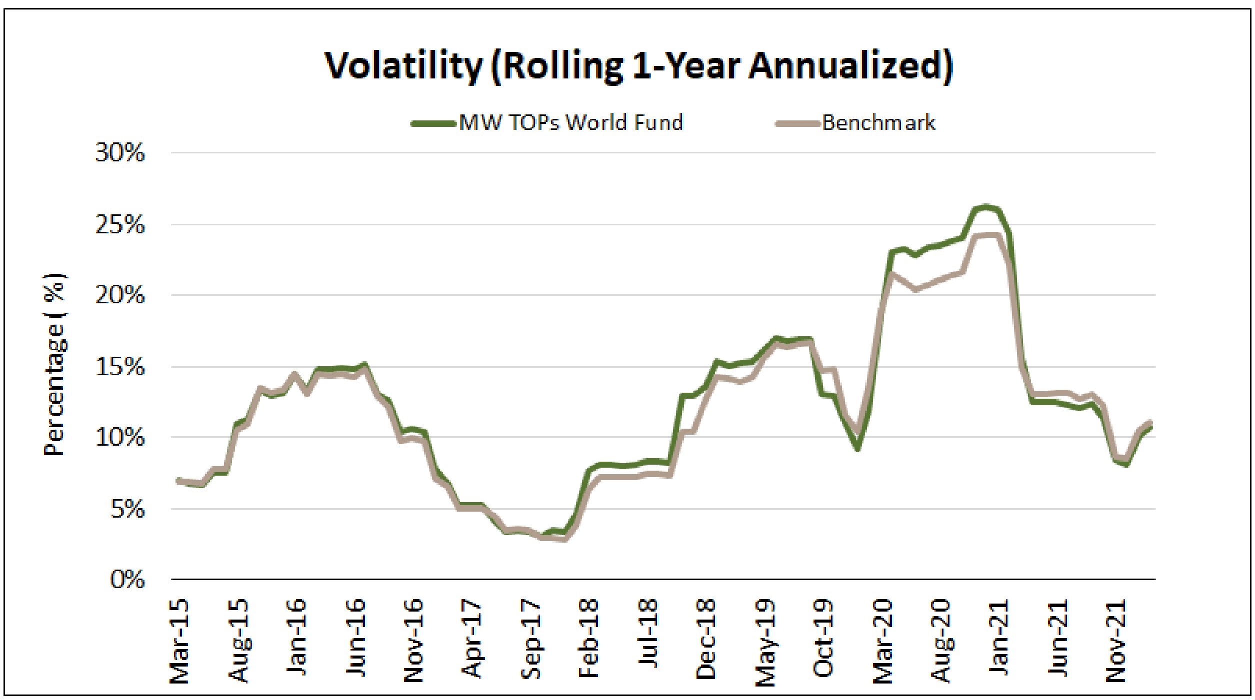
The chart below highlights the allocation's excess return over its primary benchmark on a rolling 5-year annualized return basis. As is evident from the chart, the investment has provided the Trust with consistent level of strong outperformance over its primary benchmark since its inception.



The following chart highlights the allocation's tracking error versus its primary benchmark, as reflected by its rolling 5-year realized measure. As shown in the chart below, the allocation has stayed within its tracking error guidelines on a historical basis.



The chart below highlights the volatility of the allocation compared to that of its primary benchmark, as reflected by the rolling one-year annualized standard deviation measures for each. As you can see, the allocation's volatility closely aligns with that of its underlying benchmark, which is by design. When taking the prior charts into consideration, the allocation has been able to produce a steady excess return over the primary benchmark, all while maintaining preferred tracking error and volatility measures vs. the primary benchmark.

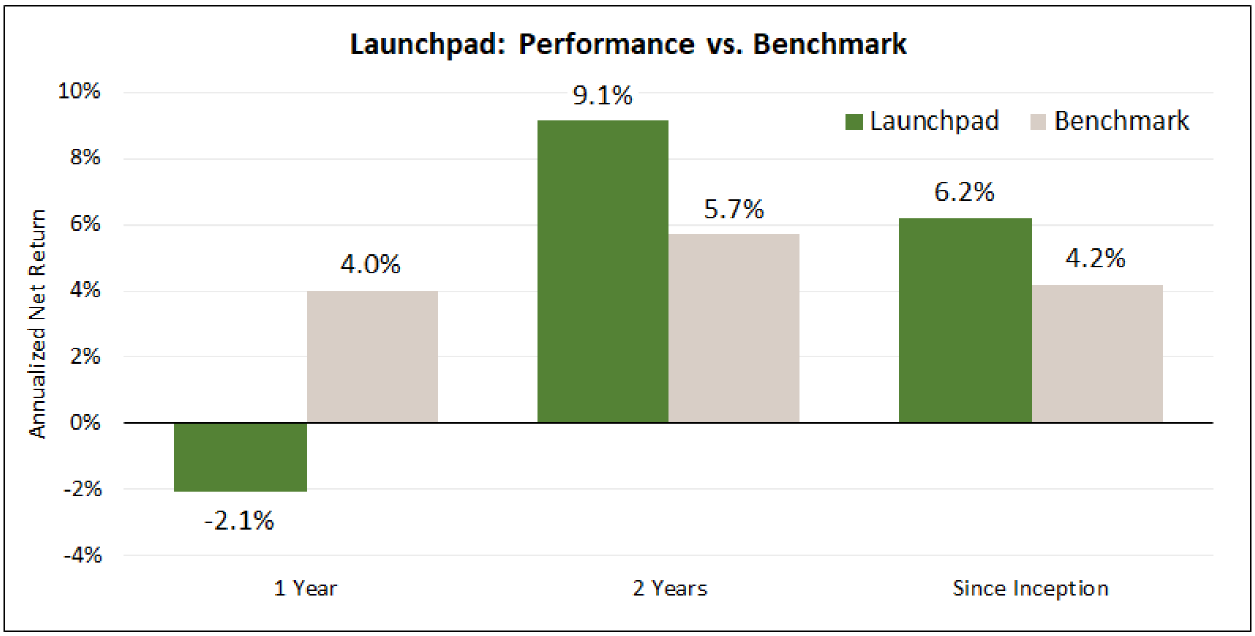


LAUNCHPAD PORTFOLIO REVIEW

The strategic purpose of Launchpad is to provide return-seeking attributes to the Trust. The objectives of Launchpad are to invest in attractive emerging managers who can act as an enhancement to overall Trust returns, to provide a diversifying revenue stream to the Trust via revenue share agreements with each underlying manger, and for each allocation to outperform its underlying benchmark.

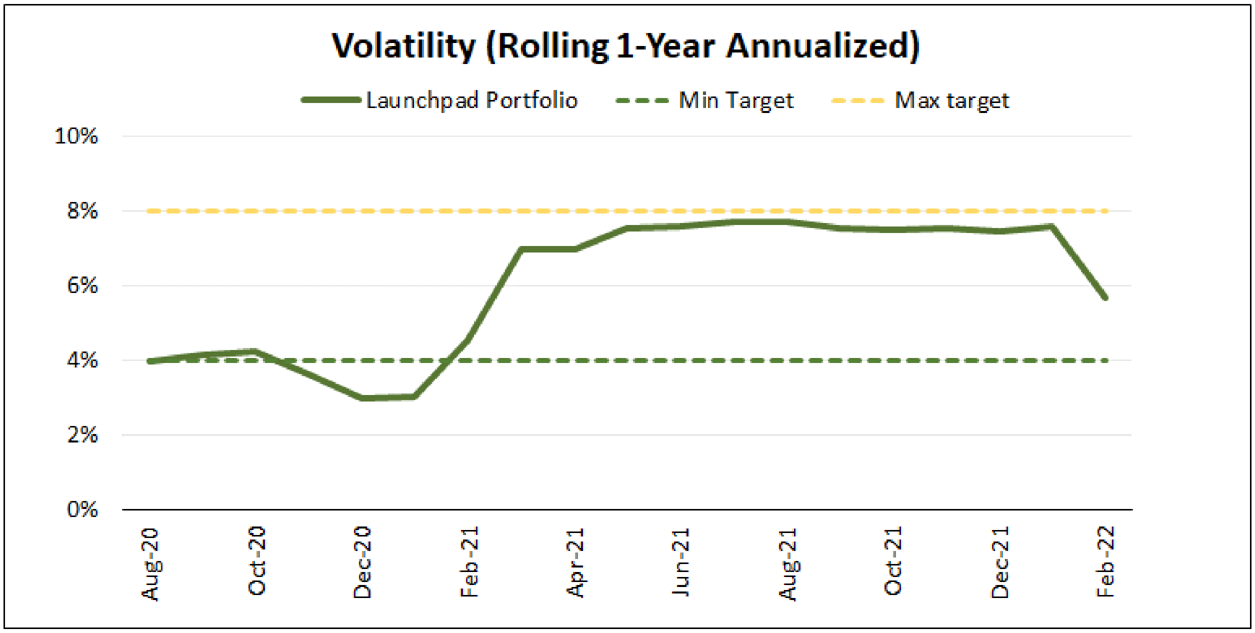
	Assets ($ millions)	Assets (% of Trust)	1 Year	2 Years	3 Years	Since Inception
Launchpad	**$263**	**0.8%**	**-2.05%**	**9.12%**	**N/A**	**6.21%**
Benchmark			4.00%	5.70%	N/A	4.19%
Excess Return			-6.05%	3.42%	N/A	2.02%

The implementation objective for the Portfolio is to outperform its policy benchmark over a rolling five-year period while maintaining compliance with their respective portfolio guidelines. Launchpad overall aims to outperform a blended benchmark comprised of a weighted average of the underlying portfolios. For each underlying allocation within Launchpad, the objective is to outperform its respective benchmark. Each underlying allocation also aims to provide added economics through revenue sharing agreements.



As noted earlier, this figure is net of external investment expenses but does not include internal investment expenses, which are estimated at around 19 bps for this portfolio.

The chart below highlights the volatility of the Launchpad Portfolio, as reflected by the rolling one-year annualized standard deviation measure. It should be noted that given its size and its longevity within the Launchpad Portfolio, the investment with Cinctive carries a heavier weight within the overall volatility measure.



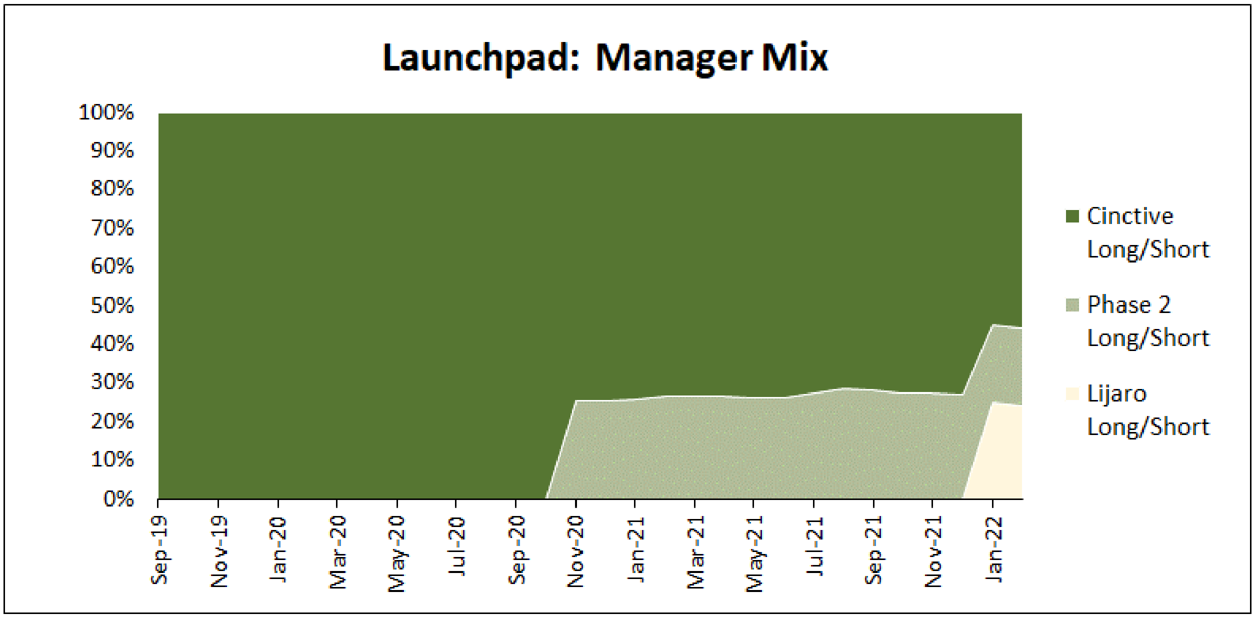
ERS continues to work with a third party partner, PAAMCO Prisma, to source and allocate to emerging hedge fund managers. In this regard, the PAAMCO Prisma team acts as an extension of ERS investment staff. The historical commitments to Launchpad and the associated investments have been as follows:

- March 2018: ERS Board approved an initial commitment of $150 million to Launchpad.
    - September 2019: $125 million invested in Cinctive Global Master Fund.
- July 2020: The Asset Class Investment Committee (ACIC) approved an incremental commitment amount of $22.5 million to Launchpad.
    - October 2020: $47.5 million invested in Phase 2 Nexxt Offshore Master Fund.
- April 2021: ERS Board approved an additional commitment of $175 million to Launchpad.
    - January 2022: $65 million invested in Lijaro VI Global Equity Master Fund.

Staff anticipates that Launchpad may close additional investments during 2022 that could bring the second tranche of funding for Launchpad to fully committed.

Launchpad			
Holding Name	Strategy Type	Initial Allocation	Current Value ($MM)
Cinctive Global Master Fund	HF - Multi-Manager Equity Long/Short	Sep-19	$146.5
Lijaro VI Global Equity Master Fund	HF - Equity Long/Short	Jan-22	$63.1
P2 Nexxt Offshore Master Fund	HF - Equity Long/Short	Nov-20	$52.6

The charts below highlight the manager allocation within Launchpad. The first chart shows the historical breakdown since the first investment was made in September 2019. From then until November 2020, the investment with the Cinctive long/short strategy made up the entirety of the Launchpad Portfolio. The asset class guidelines for Special Situations allow an allocation to relative value hedge funds of up to 100%, and the current allocation totals 100%.



A key and differentiating aspect of Launchpad is that ERS receives a revenue share from every allocation in exchange for a longer lock up of capital and an early-stage investment. As a reminder, these are seeding transactions, and capital allocations to these emerging hedge fund managers are not for working capital purposes. That is, Launchpad invests only in funds of publically traded securities and not the managers themselves.

HEDGE FUNDS PROGRAM INVESTMENT TEAM

Name	Role	Years of Experience	Years with ERS
Nick Maffeo	Director of Hedge Funds	15	9
Panayiotis Lambropoulos	Portfolio Manager	16	7
Courtney Dunn	Investment Analyst	12	5
Andrew Moore	Investment Analyst	9	2

STAFF RECOMMENDATION

Staff recommends the Board approve the FY23 Annual Tactical Plan, attached as 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, the actual opportunities that become available in the market throughout the year could require amendment. Albourne Partners has reviewed and supported the proposed ERS Hedge Fund Capital Plan including the Tactical Plan for Fiscal Year 2023.

ATTACHMENTS:

1. Exhibit A – Proposed Capital Plan for Hedge Funds including Tactical Plan for Fiscal Year 2023
2. Slides – Annual Review of Hedge Funds Program