



# Externally Advised Public Equity Audit

## #2022-03

### May 11, 2022

From the Director:  
Internal Audit has completed its audit of the Externally Advised Public Equity composite of the Employees Retirement System of Texas.

Based on the audit scope areas reviewed, internal controls require improvement and only partially address significant risks related to monitoring the value provided by the External Advisors.

- Process to evaluate and assess the value added by external advisors needs improvement. (Significant)

Other matters deemed less significant were communicated with management directly. We thank management and staff of the Investments, Office of General Counsel, and Office of Procurement and Contract Oversight divisions for their courtesy and cooperation extended to us during the review.

Sincerely,

**Anthony Chavez, CIA, CGAP, CRMA**  
Director, Internal Audit Division

## ERS Internal Audit Division

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# Objectives and Summary Results

**Audit Objective:** To determine if investments in externally advised public equity are in accordance with ERS Investment Policy.

**Overall Results:** Controls are in place to protect the assets of ERS; however, improvements are needed to assess the value added by the External Advisors. **(Needs Improvement)**

SCOPE AREA	SUB-OBJECTIVES		RESULTS/RATING
<b>External Advisor Selection</b>	<ul style="list-style-type: none"> <li>Are respondents properly vetted to ensure qualified, quality firms?</li> <li>Are respondents' expertise aligned with investment objectives?</li> <li>Are investment services authorized based on relevant information?</li> </ul>	<b>Satisfactory</b>	A formal, documented process for assessing and selecting external advisors, including qualitative and quantitative analysis of the Firm, Investment Team, and Investment Strategy is performed. <i>See Appendix A</i>
<b>Portfolio Monitoring</b>	<ul style="list-style-type: none"> <li>Are portfolios monitored to ensure acceptable performance?</li> <li>Are investments in accordance with portfolio investment objectives?</li> </ul>	<b>Needs Improvement</b>	Once funded, improvements are needed to assess the value added by each Advisor. <i>See Observation #1.</i>
<b>Governance</b>	<ul style="list-style-type: none"> <li>Is reliable information provided to stakeholders for proper oversight?</li> <li>Do performance incentives align with portfolio objectives?</li> </ul>	<b>Satisfactory</b>	While improvements were identified and communicated to process owners, controls are in place to ensure reliable data is communicated to decision-makers. <i>See Appendix A</i>

## Audit Rating Legend:

**Exemplary** - Effective, sustainable process

**Satisfactory** - Internal controls effective and working as intended

**Needs Improvement** - Internal controls partially effective

**Unsatisfactory** - Entire control framework in need of repair

# External Advisor Program: At a Glance

As of 12/31/2021

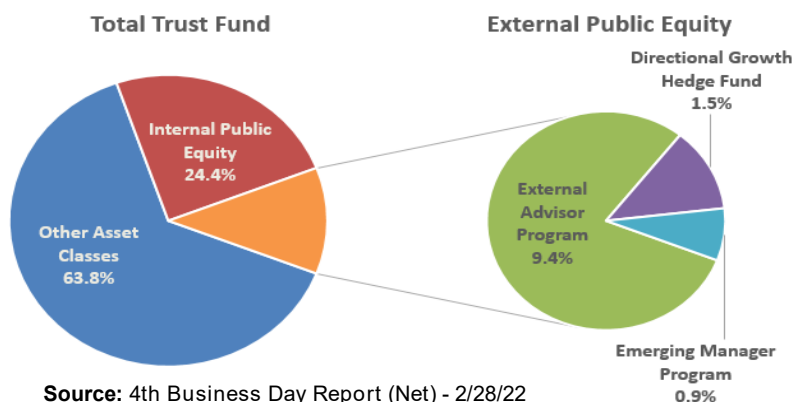
<b>Net Asset Value</b>	<b>Funded Advisors</b>	<b>Fees (FY21)*</b>	<b>Absolute Return (5-yr)</b>
<b>\$4.4 billion</b>	<b>15</b>	<b>\$10.4 million</b>	<b>14.55%</b>
<b>% of Trust</b>	<b>Select Pool</b>	<b>FTEs</b>	<b>Relative Return (5-yr)</b>
<b>9.7%</b>	<b>12 Advisors</b>	<b>3</b>	<b>56 bps</b>

\* See Appendix D for additional information on Costs

## Background

ERS External Public Equity is comprised of three programs:

- External Advisor Program
- Emerging Manager Program
- Directional Growth Hedge Fund Program



*The goal of the External Advisor Program is to compliment the internally managed portfolios by identifying differentiated strategies, unique processes, and firms with resources or expertise that we do not have internally. We look for good managers that can add value to the Trust.*

- ERS External Public Equity Team

## Investment Service vs Direct Investment

A unique attribute of the External Advisor program is ERS does not make direct investments with external advisors. Rather external advisors provide investment services (advice) on public equity securities (stocks) to invest. As such to obtain external advisor services, State procurement laws must be followed. See *Appendix B* for an overview of external advisor selection and funding process.

**Texas Attorney General Opinion GA-0998** determined external advisors provide Investment Advisory Services. As such, the opinion requires Texas pension funds to obtain these services in accordance with the State of Texas' procurement and contracting laws.

Under the External Advisor Program ERS maintains custody of all securities and maintains full discretion as to securities invested. For additional attributes of the External Advisor Program relative to other public equity programs see *Appendix B*.

## Observation 1: Process to evaluate and assess the value added by external advisors needs improvement. (Significant)

- Investment performance (rate of return) to support members retirement income security not attained.
- Externally advised portfolios not meeting investment objectives remain funded.
- Objectives of individual portfolios not aligned with objectives of the asset class.
- Goals beyond investment return not clearly communicated and accepted by stakeholders.

- Funded portfolios have various and differing investments objectives.
- Advisors selected for different value-adds.
- Unique portfolio investment objectives means no “one size fits all” for assessing performance.
- Demonstrating the value add from non-investment return goals (diversification, risk management, correlation, other goals) is difficult.

- External advisors are selected based on qualitative and quantitative factors including firm experience, team experience, proposed investment strategy, risk management and relative performance against a designated benchmark.
- Quantitative analysis includes absolute and relative investment returns and additional metrics to evaluate active risk management (Tracking error, Active Share, Information Ratio).
- Relative performance against designated benchmark and other advisors in benchmark group prioritized over absolute return performance.
- Relative return performance included in Asset Class Investment Committee recommendation as support for recommendations regarding advisors.

- Investment benchmarks incorporated into contracts varied from those used during the selection process without documentation of the rationale for the change. (See *Appendix C* for impact of benchmark in performance assessment.)
- Inconsistent methodology to determine investment benchmark.
- Additional goals and objectives (risk management, diversification, correlation, portfolio fit) to assess overall advisor performance not clearly established and defined for funded advisors.
- Manager (Advisor) Scorecard was communicated to Board as developed for monitoring and assessing external advisors, but has not yet been fully completed/implemented. Scorecard developed does include key performance attributes for assessment.
- No methodology/process on how Manager Scorecard performance attributes will be assessed/rated including source documentation and key considerations.
- Self-reported quarterly external advisor review and monitoring questionnaires were obtained for all external advisors. However, control activities performed to verify accuracy and assess self-reported results could not be determined.
- Quarterly conference calls were held with all external advisors. Agenda items presented included portfolio returns, portfolio positions and attribution analysis. However, control activities performed to assess results and key takeaways could not be determined.

The External Equity Team should clearly establish criteria by which the value added by the funded External Advisors is measured. Advisors are selected based on differentiated strategies, unique processes, and resources or expertise that ERS does not have in-house. The criteria should define when poor performance outweighs the value added by these unique and differentiated strategies.

**Recommendation**

- Establish a framework by which advisors are graded based on qualitative assessment of the firm and investment team, and quantitative analysis of the performance of the advisor, including measurement of returns as well as measurement of deviations from the defined strategy.
- Implement the Managers Scorecard to improve monitoring efforts based on the established framework. The scorecard should include quantitative analysis of risk-adjusted returns, investment costs, and deviations from the defined strategy, as well as assessment of the non-performance value added by the Advisor.
- Determine the actions to be taken when unacceptable performance or deviations from the defined strategy are identified.

Management agrees that improvements should be made to existing frameworks and processes for manager selection, contracting, monitoring, termination and governance.

- Staff will continue to improve existing framework and processes including more diligent documentation of the rationale for any benchmark changes during the life cycle of these relationships. Additional resources will be allocated to the team to help alleviate the staffing constraints that may have limited the ability to make such improvements in the past.

Management agrees that the scorecard approach should be implemented fully, including an action plan for when poor performance or deviations from the defined strategy are identified.

**Management Action Plan**

- Staff will revisit the Manager Scorecard and clearly establish written methodologies and procedures for monitoring and potential termination of funded advisors. A planned increase in the resources available to the team will support making these improvements.

Management agrees that the framework for evaluating the ongoing contribution of unique and/or differentiated strategies to the goals of the program overall could be significantly improved.

- Staff intends to revisit the staffing and structure of the team to ensure that clear lines of responsibility exist including accountability for the performance of individual advisors as well as for the program overall. Such changes may require updates to policies and procedures to ensure that the objectives and structure of the program are well-defined.

Responsible Position: Chief Investment Officer

Implementation Date: Annual Public Equity Asset Class Review scheduled for the December 2022 Board meeting

**Managers Scorecard**

OVERALL RATING	5	4	<del>3</del>	2	1		No Change in Rating
FIRM	5	4	<del>3</del>	2	1		No Change in Rating
INVESTMENT TEAM	5	4	<del>3</del>	2	1		No Change in Rating
INVESTMENT STRATEGY	5	4	<del>3</del>	2	1		No Change in Rating
PERFORMANCE	5	4	3	<del>2</del>	1		No Change in Rating
RISK MANAGEMENT	<del>5</del>				F		Pass
OPERATIONS	<del>5</del>				F		Pass
COMPLIANCE	<del>5</del>				N		In Compliance

## Scope and Methodology

We performed this audit in accordance with the FY22 annual audit plan. Internal control activities reviewed include those in place during FY21 up to the time of audit fieldwork testing which ended April 2022.

We conducted this audit in accordance with Generally Accepted Government Auditing Standards and in conformance with the International Standards for the Professional Practice of Internal Auditing. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives.

A defined set of control objectives was utilized to focus on operational goals for the identified scope. The Committee of Sponsoring Organizations of the Treadway Commission Internal Control Integrated Framework was the basis for internal control assessment. Our Internal Audit opinion is an assessment of the condition of the overall control environment based on the effectiveness of internal control activities through the audit period and the degree to which defined control objectives are being met. Our Internal Audit opinion is not a guarantee of operational effectiveness or regulatory compliance, particularly in areas not included in the scope of this audit.

This audit included a review of internal controls considered relevant to audit objectives including review of statutes, policies and procedures, interviews with management and staff, data analysis, and testing procedures.

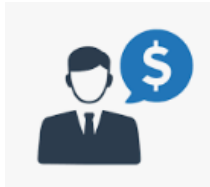
## Related Audits

- Internal Public Equity - Project #2022-02
- Profit Sharing - Project #2019-09
- Management Fees - Project #2018-09

## Areas not Covered

- Internally Managed Public Equity
- Emerging Manager Program
- Directional Growth Hedge Fund Program
- Trading Desk
- Proxy Voting
- Management Fees & Profit Share

# Appendix A - Control Framework



**Risk:** Investing with non-qualified firms/individuals

**Key Controls:**

- Formal procurement process documenting the assessment of all proposed strategies
- Documented operational and investment due diligence based on qualitative and quantitative analysis



**Risk:** Information not collected to monitor performance

**Key Controls:**

- Advisors complete Operational and Investment questionnaires quarterly
- Quarterly Conference Calls held with Advisors, as needed, where Advisor presents performance information



**Risk:** Investment in scrutinized business, as defined by the State of Texas

**Key Controls:**

- Trading performed by ERS is entered into the trading platform by Advisors and reviewed by authorized team members and automated system checks for prevention of improper investments
- Trading performed by Advisors is entered into ERS' trading platform by Investments Operations and reviewed by automated system checks for detection of improper investments. When identified, the External Equity Team is directed to follow-up with the Advisor to remedy the situation



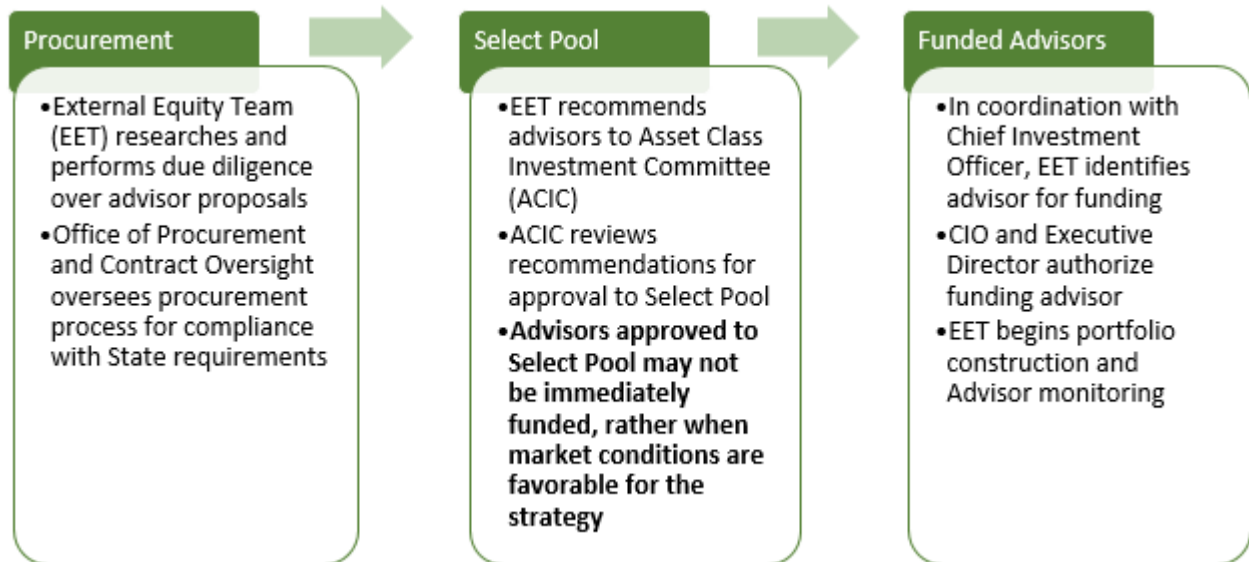
**Risk:** Information provided to stakeholders is inadequate for informed decision making

**Key Controls:**

- Performance is calculated by third-party (ERS Investment Custodian)
- Accurate data is provided to the Asset Class Investment Committee when approving Advisors to the Select Pool
- Annual Asset Class Review provides accurate data to the Board and their Investment Advisory Committee

# Appendix B - External Equity: Processes & Roles

## External Advisor Program: Procurement & Funding Overview



## Global Public Equity Programs

Program	Custodian of Assets	Trading	Investment Discretion	Procurement of Services
Internally Managed	ERS Custodian	ERS Trade Desk or Brokers	Full Autonomy w/input from ED and CIO	ERS Employee Hiring Process
Externally Advised	ERS Custodian	ERS Trade Desk External Advisor	Advice on Investments	Formal State of Texas Procurement & Contacting (w/OPCO and OGC)
Emerging Manager	Emerging Manager	Emerging Manager	Partial Autonomy reviewed by Legato and ERS	Hybrid Model
Hedge Funds	Hedge Fund Manager	Hedge Fund Manager	Full Autonomy	Internal Research and Due Diligence

**External Investment Manager** - handles all activities related to investing and managing a portfolio.

**External Investment Advisor** - contracts to provide investment services to ERS without full investment discretion.

**Emerging Manager** - Investment manager who has assets under management totaling less than \$2 billion.

**Investment Consultant** - provides ERS with advice and/or planning by advising the system on investment strategies.



## Appendix C: Benchmarks

- Benchmarks are the key component in the cost-benefit analysis of external advisors.
- A benchmark is a standard against which the relative performance of an investment can be measured.
- Relative return is a way to measure results of active management against the “market” (index).
- Active Management is the premium (cost) that is being paid through management fees to earn value-add (benefit).
- Value-add is earned through a combination of greater return than the market (index) and/or risk reduction (diversification/correlation).
- In addition to relative return, Tracking Error, Active Share, and the Information Ratio are calculated in comparison against the stated benchmark.
- **An inappropriate benchmark increases the risk of “ERS not getting what we selected the Advisor for.”**

**Absolute Return** - the investment returns of an investment or portfolio generally stated as a percentage of the value of the investment at the start of the period measured.

**Relative Return** - the difference in the Absolute Return of an investment or portfolio and the Absolute Return of the benchmark. This is also referred to a Alpha or Excess Return.

ERS utilizes Morgan Stanley Capital, Inc. (MSCI) indices as its standard public equity benchmarks based on the following attributes:

Sub-Asset Class	Region/Country	Market Cap	Factor (Style)
Domestic	US	Large Mid Small	Core Value Growth
International	Developed Markets Emerging Markets Canada		

Below is an example of the absolute performance of one external advisor (green line), and demonstrates the various results of relative return as measured against different benchmarks (red and blue lines).



## Appendix D: Cost of External Advisors

External Advisors are compensated through Management Fees generally based on the amount of assets under advisement. In a few cases, the Advisor also receives an Incentive Fee (Profit Share) based on the excess return they produce over the performance of the benchmark.

The difference in the cost of advising the Domestic and International composites are due to having significantly more assets under advisement in the external International portfolios, as well as the higher cost of trading in the International markets.

Fiscal Year	Domestic		International	
	Fees	BPs	Fees	BPs
2015	\$ 2,694,533	33	\$ 9,721,175	45
2016	2,417,313	31	7,660,701	38
2017	1,568,381	22	7,569,549	35
2018	2,734,590	29	8,827,227	46
2019	907,348	24	8,190,730	43
2020	1,532,086	20	8,007,629	51
2021	917,380	24	9,448,325	35
<b>Total</b>	<b>\$ 12,771,631</b>	<b>27</b>	<b>\$ 59,425,337</b>	<b>41</b>