

Public Agenda Item #3

Consideration of Internal Audit Reports

May 11, 2022

Tony Chavez, Director of Internal Audit

External Advisor Program

Tony Chavez, Director of Internal Audit

Tressie Landry, Audit Manager

Greg Magness, Project Lead

External Advisor Objectives



Support Member Retirement



Risk-Adjusted Returns



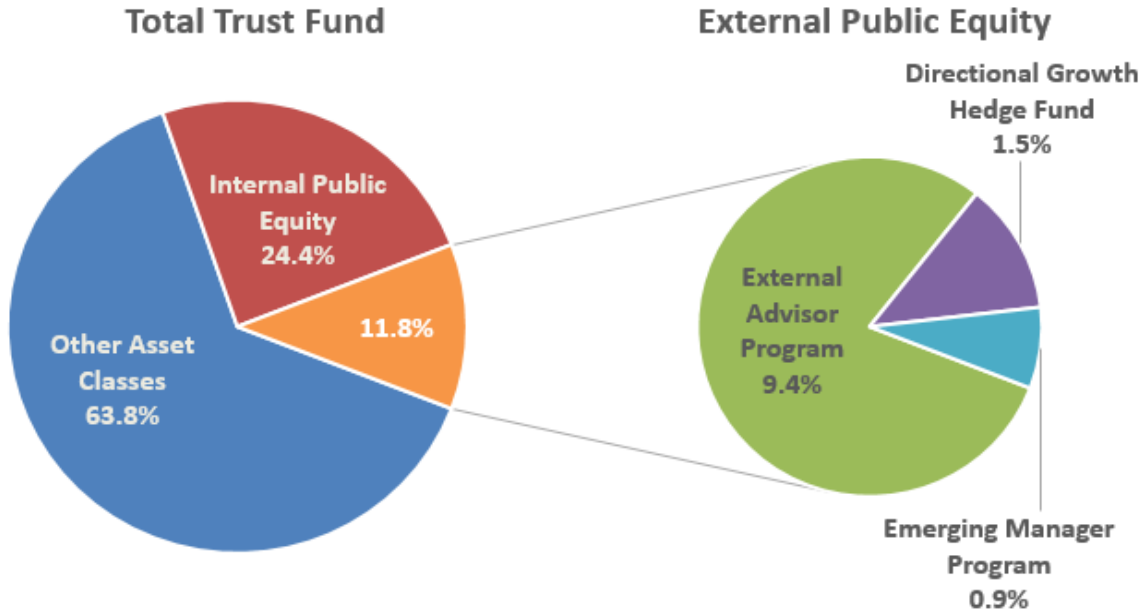
Complement internally managed portfolios

Overall Results – Needs Improvement



SCOPE AREA	SUB-OBJECTIVES	RESULTS/RATING
External Advisor Selection	<ul style="list-style-type: none"> · Are respondents properly vetted to ensure qualified, quality firms? · Are respondents' expertise aligned with investment objectives? · Are investment services authorized based on relevant information? 	<p style="text-align: center;">Satisfactory</p> <p>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.</p>
Portfolio Monitoring	<ul style="list-style-type: none"> · Are portfolios monitored to ensure acceptable performance? · Are investments in accordance with portfolio investment objectives? 	<p style="text-align: center;">Needs Improvement</p> <p>Process to evaluate and assess the value added by external advisors needs improvement. <i>See Observation #1 in report.</i></p>
Governance	<ul style="list-style-type: none"> · Is reliable information provided to stakeholders for proper oversight? · Do performance incentives align with portfolio objectives? 	<p style="text-align: center;">Satisfactory</p> <p>While improvements were identified and communicated to process owners, controls are in place to ensure reliable data is communicated to decision-makers.</p>

External Public Equity



Source: 4th Day Business Reports (Net) – Feb 28, 2022

External Public Equity:

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

External Advisor Program: At a Glance



As of 12/31/2021

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

Advisory Service vs Investment



- External Advisors provide investment services in the form of advice
 - Manage a portfolio without full manager autonomy
- Selection of advisors must follow State procurement laws
 - Formal, well-documented RFP process managed by OPCO
- ERS maintains custody of assets since these are not fund investments
- Trading is generally performed by ERS, unless in best interest of ERS

Benefit of Investment Services



- Advisors are hired to provide Active Management
- Active Management provides value-add (benefit) at a premium (management fees).
- Value-add is earned through a combination of greater return than the market (index) and/or risk reduction (diversification/correlation).
- An inappropriate benchmark increases the risk of ERS “not getting what we selected them for.”

Control Observations



Process to evaluate and assess the value added by external advisors needs improvement.

- Inconsistent methodology to determine investment benchmark
- Investment (portfolio) objectives not clearly established
- Manager (Advisor) Scorecard has not been fully implemented
- Control activities to assess performance could not be determined

Questions?

Budgeting Audit

Tony Chavez, Director of Internal Audit

Tressie Landry, Audit Manager

Jonathan Puckett, Audit Lead

Budgeting Audit

Objectives



Fiduciary Duty & Stewardship



Engage Stakeholders for Informed Decision Making



Enhance Agency Performance and Accountability

Overall Results – Satisfactory



SCOPE AREA	SUB-OBJECTIVES	RESULTS/RATING
Budget Management	<ul style="list-style-type: none"> • Are all administrative expenses accounted for in the budget? • Are estimates or assumptions reliable? • Are requests for additional funds and resources supported and justified? 	<p style="text-align: center;">Satisfactory</p> <p>Formally establish and define costs that should be included in the Board approved Operating Budget (Significant) . See Observation #1 Provide historical data to help assess future spending. See Observation #3</p>
Performance Monitoring	<ul style="list-style-type: none"> • Does the budget communicate how resources have been used to achieve strategic goals? • Is performance presented accurate and sufficient to facilitate proper oversight? 	<p style="text-align: center;">Needs Improvement</p> <p>Establish linkage between organization goals, cost, and performance. See Observation #2</p>

Budgeting Audit

Background



ERS Total Budget



Legislative Appropriations Request

- Benefit costs



Major Contract Approvals

- External Admin Costs



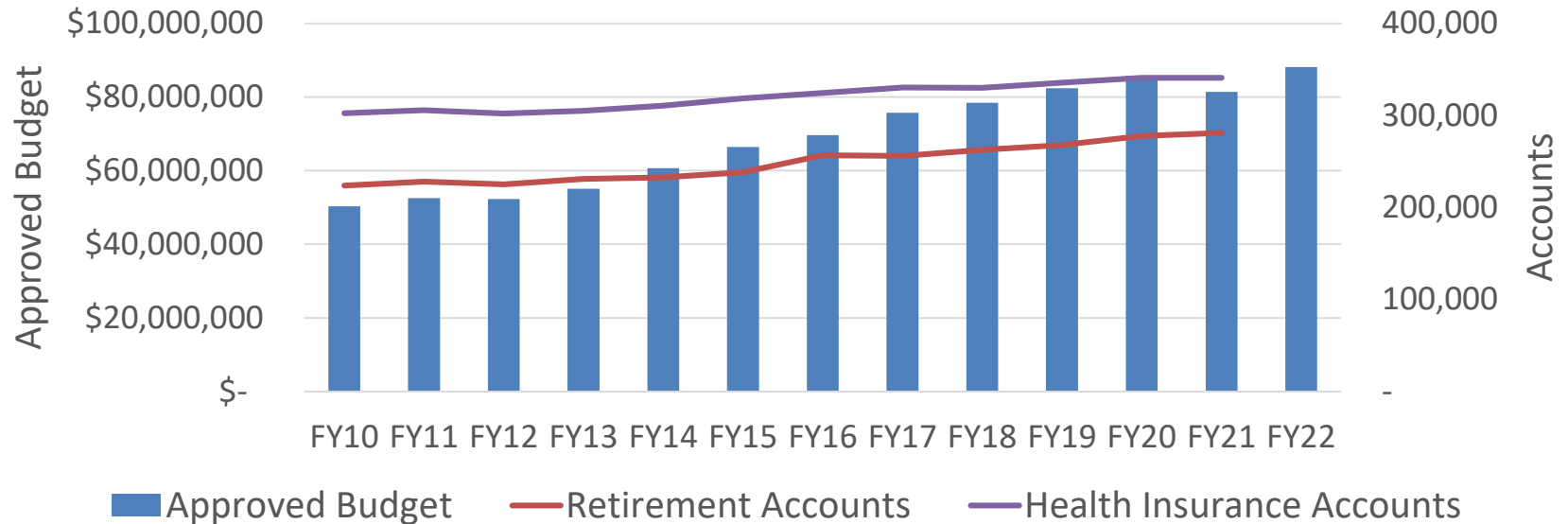
Operating Budget (\$ 815.202)

- Internal Admin Costs

Annual Operating Budget



ERS Budget History



Source: ERS Operating Budget – Fiscal Year 2022 (Exhibit E)

Budgeting Audit

Resources for Budgeting Guidance & Best Practices



Budgeting Audit

Budget Objectives and Best Practices



Control

- Operational document
- Incremental increases in funding
- Limit spending
- Annual outlook



Strategic Planning

- Strategic document
- Decisions based on limited resources
- Budget measures along with performance measures
- Long-term view

Budgeting Audit

Key Controls



- Integrated budgeting system (Anaplan)
- Multiple layers of budget review
- Budget changes require review / approval
- Annual budget presentation

Observation 1 Summary



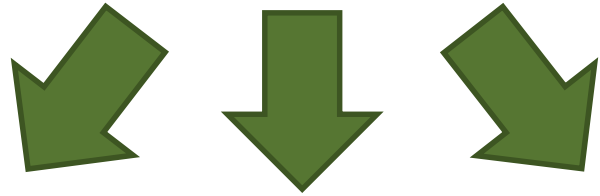
Observation 1: Formally establish and define costs that should be included in the Board approved Operating Budget

- No formal Budget policy established
 - Costs to be included
 - Costs definition (Benefit cost, administrative cost)

Budgeting Audit

Observation 1

ERS Budget



Legislative
Appropriations
Request

\$



Operating Budget
\$ 815.202

\$



Major Contract
Approvals

\$

= \$\$\$\$

Budgeting Audit

Observation 2



Observation 2: Establish linkage between organizational goals, costs and performance through enhanced performance reporting

Budget Management	Strategic Management
Division	Service/Purpose
Activity, Output	Outcomes, Efficiency

Budgeting Audit

Performance Based Budgeting



- The budget process consists of activities that encompass the development, implementation, and evaluation of a plan for the provision of **services**.
- The mission of the budget process is to help decision makers make informed choices about the provision of **services**.
- **Performance measures** serve as a basis for planning future agency actions and resource allocation.
- Presents the **major purpose** for which funds are allocated and sets measurable objectives.

ERS Strategic Goal: Enhance Agency Performance and Accountability

Budgeting Audit

Current Budget Presentation



Division	FY22 Approved Budget
Investments	31,227,497
Information Systems	18,088,677
Customer Benefits	11,784,363
Office of the General Counsel	4,945,828
Executive	4,933,676
Other Divisions	17,133,662
Total	88,113,703
Contingency Account	4,844,058



Budget Line Item	FY22 Approved Budget
Salaries	11,055,984
Investment and Other Electronic Communication Services & Tools	6,377,752
Class. Sal. - Incent. Comp. Plan	4,051,665
Investment Consultants	3,201,499
Other Salary Costs	2,819,874
Investment Banking	1,000,000
Travel	420,000
Computer System Services	121,000
Investment Advisory Fee	63,892
Other	310,732
Total Budget	31,227,497

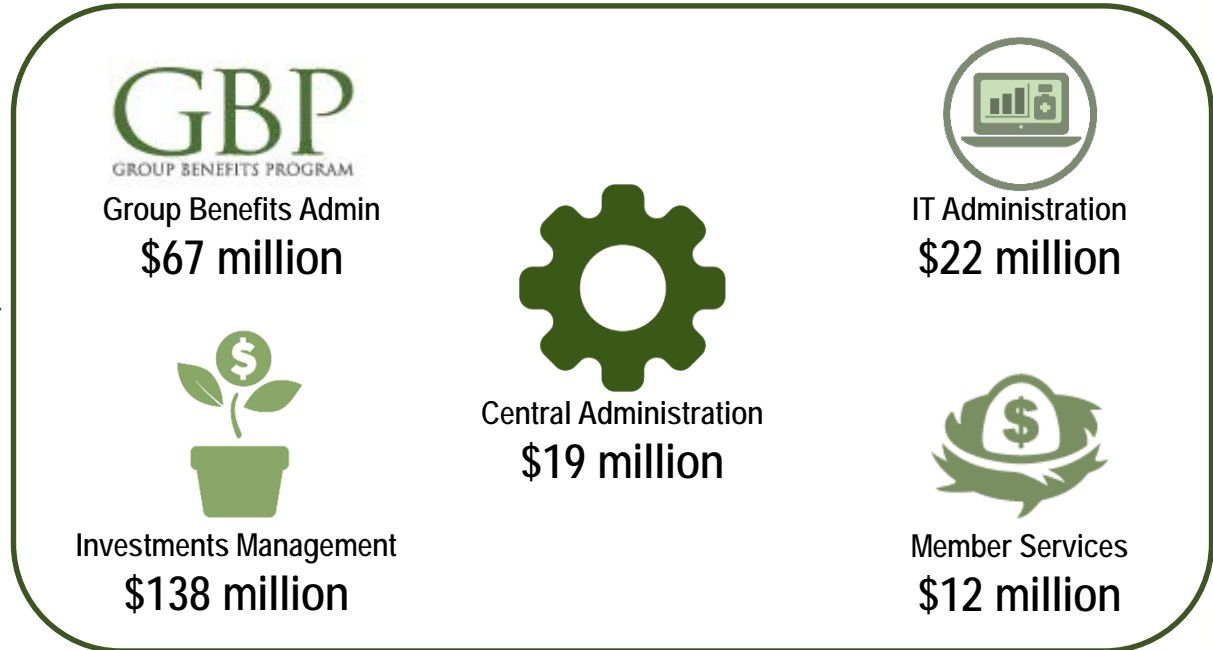
Budgeting Audit

Observation 2



Internal Audit analysis of FY21 Operating Budget and FY21 ACFR: Not official ERS results

Division
Investments
Information Systems
Customer Benefits
General Counsel
Executive
Other Divisions



Budgeting Audit

Observation 2



Investments

- Held 4,812 due-diligence related meetings
- Committed \$175m to Hedge Fund

Finance

- Reconciled over 300 Alternative Investments Funds
- Reconciled cash settlements of over \$1.3 billion in income

Investment Management

Office of General Counsel

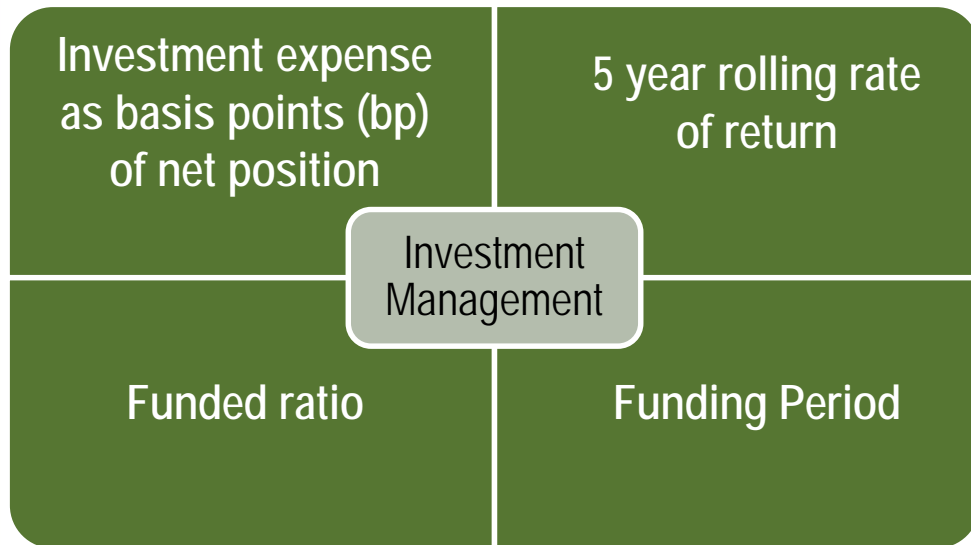
- Closed 23 private market transactions
- Negotiated 84 private market investor actions

Office of Procurement and Contract Oversight

Procured International Investment Advisory Services

Budgeting Audit

Observation 2



In government there is no single overall performance measure such as net income or earnings per share. The user of governmental financial reports must therefore assess accountability by evaluating performance through a variety of measures.

ERS Strategic Goal: Enhance Agency Performance and Accountability

Observation 3: Provide historical budget data (actual expenses) to help assess future spending

- Actual expenditures not included in Operating Budget
- No procedures in place to evaluate the reasonableness of forecasted amounts (estimates)
 - Forecasted amounts are used to support the proposed Operating Budget amounts.

Budgeting Audit

Observation 3



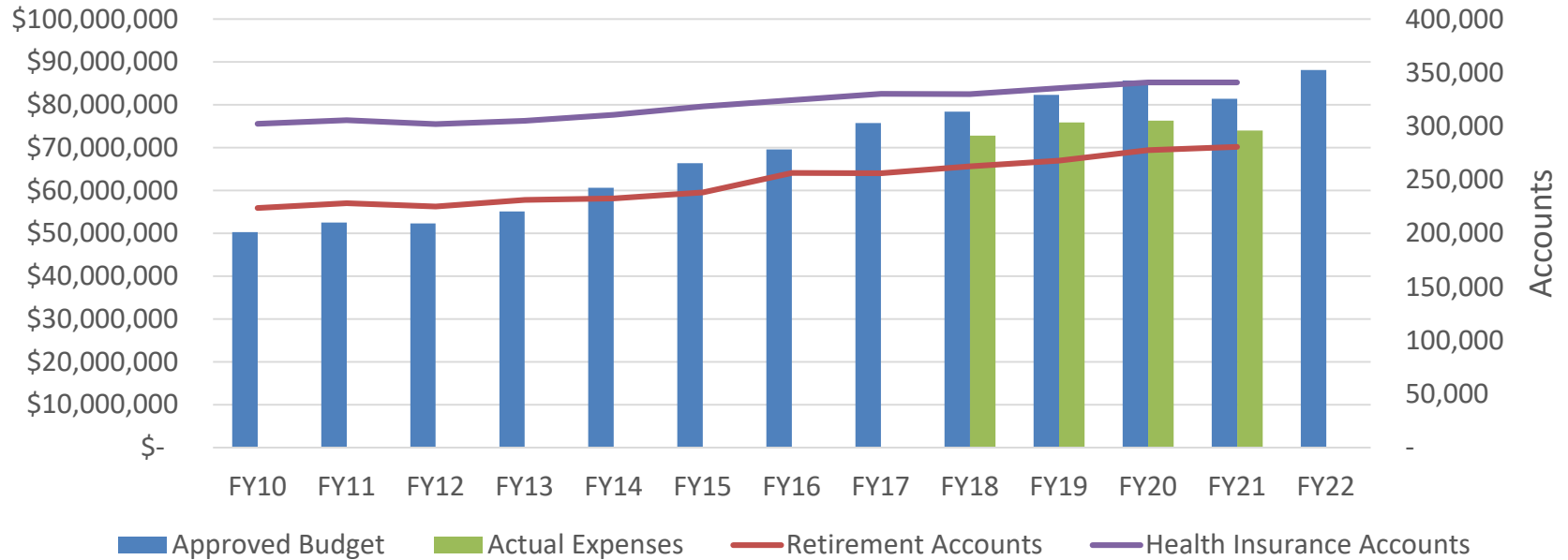
Comparisons of actual results to legally adopted budget can provide information to help users assess whether resources were obtained and expended as anticipated.

Budgeting Audit

Observation 3



ERS Budget History



Source: Fiscal Year 2022 Approved Operating Budget – Exhibit E; Anaplan data – Actual Expenses

Questions?