

## AGENDA ITEM DETAILS

**Subject:** \*Consideration of ERS Investment Policy Statement – (Action)

### **RECOMMENDED ACTION:**

Move that the Investment Advisory Committee recommend that the Board of Trustees approve the Investment Policy Statement attached as **Exhibit A** to this agenda item.

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 approve the Investment Policy Statement attached as **Exhibit A** to this agenda item.

## BACKGROUND

The Board of Trustees (Board) of the Employees Retirement System of Texas (ERS) determines the Investment Policy Statement (IPS). The IPS governs the strategic asset allocation parameters, defines the portfolio construction process, and communicates the Board's investment objectives and constraints for managing Trust assets to investment staff. Chapter VI of the Investment Policy requires staff to recommend proposed changes to the policy to the Investment Advisory Committee (IAC) and Board at least annually. The Board last considered the IPS in August 2021, a process that included various updates to create the current version. The revisions this year are more numerous than previous years as a new Chief Investment Officer, General Counsel and Investment Compliance officer reviewed the document for the first time. As such, the document contains numerous clarifying and stylistic changes. Investments Division leadership developed these proposed changes in collaboration with the Executive Office, Investment Compliance, the Office of General Counsel, Finance, and Group Benefits. A draft of the policy was sent to the Board in advance of the meeting, and the proposed changes were reviewed with each member of the Investment Advisory Committee.

**Exhibit A** presents the draft IPS for which staff is seeking Board approval.

## OVERVIEW OF MAJOR PROPOSED CHANGES:

### 1. **Revisions to Strategic Asset Allocation (SAA) Parameters to Manage Risk:**

The Asset-Liability study shows a long-term trajectory of the ERS plan toward full funding with the Trust having an expected annual rate of return of 6.8% over the next 10 years and 7.3% over the next 30 years. However, this steady improvement in funded status will be accompanied by significant and rising liquidity demands to meet the near-term benefit payment from the Trust. Indeed, net outflows from the Trust are forecast to rise from 3% of assets annually in 2022 to around 4% over the next five years and to remain at those levels for an additional five years. It is only with the advent of the new decade of the 2030s that these liquidity demands begin to ease with the beginning of a gradual return to the 3% level of net outflows in 2045.

To align the Trust with this outlook for coming decades, staff proposed changes to the Strategic Asset Allocation parameters as part of the prior agenda item regarding the Asset-Liability Study. These revisions aim to prepare the Trust for the future by increasing liquidity and reducing equity risk while maintaining the expected return of the Trust. In the event that a different set of

parameters is adopted by the Board or the existing set of parameters is retained, Table 3 (Strategic Targets and Tactical Ranges) of the draft IPS would be updated accordingly.

## **2. Improvements to the ERS Code of Ethics and Standards of Professional Conduct**

Currently the ERS Code of Ethics and Standards of Conduct is the sole focus of Chapter VII of the Investment Policy Statement. This section includes policy language that covers:

- Personal Transactions
- Gifts, Benefits, or Favors
- Attendance at Business Meetings/Functions
- Conflict of Interest
- Use of Placement Agents.
- Insider Trading and Confidentiality
- Ethics Training
- Compliance and Enforcement

In this regard, the policy is already quite comprehensive and consistent with best practices among peers.

This policy is somewhat unique in that it explicitly incorporates by reference the Code of Ethics and Standards of Professional Conduct (CE/SPC) from the CFA Institute (CFAI). This third-party document includes a Code of Ethics that enumerates key principles that CFA Charter holders must follow and includes many useful principles. However, it also includes numerous references to concepts such as interactions with prospective clients that are irrelevant to ERS. Likewise, its Standards of Professional Conduct include a number of important principles, but also makes extensive references to clients, marketing materials, and other aspects of the investment industry that are irrelevant to Covered Persons at ERS.

Indeed, the CFAI's Pension Trustee Code of Conduct (PTCC) provides a more coherent framework for Covered Persons at ERS. This document outlines 10 fundamental ethical principles that CFAI believes to be universally applicable to pension plan trustees. The PTCC was developed by CFAI in cooperation with a multinational coalition of associations after consulting with a broad range of industry participants and stakeholders. CFAI suggests that the fundamental ethical principles embodied in it can enhance the policies and procedures that a pension has already established internally for its governance.

With these potential improvements in mind, the proposed changes would:

- Incorporate into the ERS Code of Ethics those principles from the CFAI Code of Ethics and Standards of Professional Conduct that are relevant to all Covered Persons.
- Incorporate into the ERS Code of Ethics those principles from the CFAI's Pension Trustee Code of Conduct (PTCC) that are relevant to all Covered Persons.
- Require the investment staff to create an Investments Code of Conduct that includes the relevant principles of the CFAI COE/SPC.

The third bullet above has already been accomplished, and all Investment staff have acknowledged their responsibilities under these standards. These principles are set forth on page eight of the Investment Policy Statement, which is attached here as Exhibit D.

## **3. Address Relevant Recommendations from NEPC Governance Report**

In March 2020, NEPC delivered its Evaluation of Investment Policies, Procedures and Practices for ERS pursuant to Texas Government Code § 802.109. In this detailed governance review, NEPC stated that "the ERS IPS compares favorably with the investment policy statements NEPC examined from the peer group of similar investors. ERS' IPS is ahead of many of its peers in the thorough and detailed treatment of governance. In addition to clarity in definition of roles and responsibilities, the Plan's IPS also provides additional detail on processes such as proxy voting, scrutinized investments, and securities litigation."

NEPC goes on to recommend that “in its next annual review of the IPS, ERS should make [the following] revisions to improve clarity, efficiency and accountability within the document.”

- Set the Actuarially Assumed Rate of Return as an explicit performance goal

“We recommend adding language that includes meeting or exceeding the Fund’s actuarial assumed rate of return over the long term.”

Status: DONE on page 4 of the proposed IPS.

- Clarify definitions of Asset/Liability Study and Asset Allocation Study

NEPC also recommends that the definition of an asset allocation study be more precise and that the timing of such studies be more flexible.

Status: DONE on page 12 of the proposed IPS.

- Document more clearly the rebalancing approach of the Trust

“Regarding the Plan’s rebalancing process and policy, NEPC advises ERS to document the frequency of rebalancing, transaction cost considerations, and whether asset classes are to be rebalanced to mid-range or target. This documentation may either reside in the IPS or in the operating procedures for relevant asset classes.”

Status: DONE on page 13 of the proposed IPS and within the Investment Implementation Plan.

- Move the Asset Class Allocations & Ranges Table to an appendix

NEPC suggests moving the current Table 3 of Chapter IV (Asset Class Allocations and Ranges) into the IPS appendix.

Status: NOT DONE, staff respectfully disagrees with this recommendation based on its view that since the SAA parameters are typically updated less frequently than the body of the IPS, a move to make the table more modular for easy updating would not be beneficial.

- Require regular reports to the Board on transaction costs, liquidity risk

“At least once every three years, NEPC recommends a trade cost analysis report to the Board that summarizes explicit commissions as well as implicit costs of trade execution. NEPC also recommends a comprehensive annual report on liquidity risk.”

Status: DONE on page 23 of the proposed IPS.

- Adopt a “watch list” policy and process.

Additionally, as part of prevailing practice for this section, the Plan may wish to consider inclusion of a “watch list” policy and process.

Status: NOT DONE, staff respectfully disagrees with this recommendation based on its view that a “watch list” process implies that a high level of performance monitoring is conducted only in problem cases, when in fact all investment managers are subject to high standards of performance at all times. Such a process also presumes that declines in manager performance tend to occur gradually over long time horizons, when in practice they often occur in short, sharp deviations that even more significant from a statistical perspective.

- Specifically reference the ERS Valuation Committee in policy

NEPC recommends formalizing the purpose, functions, membership, and possible actions of the Valuation Committee

Status: DONE within the Investment Implementation Policy.

- Define the role of the Chief Investment Officer more explicitly

“NEPC believes it may be useful for ERS Texas to explicitly define the role of the Chief Investment Officer in the Governance section of the IPS.”

Status: DONE on page 6 of the proposed IPS.

- Require annual reporting to the Board regarding fees and expenses

“The management and monitoring of direct and indirect compensation paid to investment managers and other service providers should be more clearly defined in the IPS or other policies that state what should be presented to the Board on at least an annual basis.”

Status: DONE on page 22 and 23 of the proposed IPS.

- Develop a comprehensive approach to the Funding Policy

“The Funding Policy is not directly articulated within the IPS. Instead, ERS has a separate Funding Policy document that was approved by the Board in May of 2018. It is not uncommon among public funds of ERS’ size to have a separate Funding Policy.” [...] “ERS should pursue a comprehensive review of the funding policy to help ensure the retirement security of Plan participants and beneficiaries.”

Status: DONE elsewhere within ERS.

## **SUMMARY OF SIGNIFICANT CHANGES BY SECTION:**

- **Table of Contents**

- Repaginated [pages i, ii]

- **Executive Summary**

- Deleted to address concerns that it may oversimplify important aspects of the policy

- **Chapter I: Legal Authority**

- Updated statutory references [pages 1, 2]

- **Chapter II: Philosophy & Objectives**

- Added language in performance objectives to discuss the assumed rate of return (absolute return target) and excess return (relative return target) per NEPC 322 recommendation [page 4]
- Reworked investment beliefs to add clarity without making substantive changes [page 3]

- **Chapter III: Governance**

- Clarifies delegation to Executive Director and staff, with further delegation to staff subject to Executive Director discretion
- Enumerated the role of the CIO more clearly per NEPC 322 review [page 6]
- Minor cleanup around roles & responsibilities [pages 5-8]
- Revised language to clarify the types of investment managers (i.e., internal strategies, external advisors, external managers) [page 7]
- Tightened up tables 1 and 2 to fit on a single page [page 9]

- **Chapter IV: Asset Allocation**

- Updated the SAA table for new proposed Strategic Targets, Tactical Ranges [page 11]

- Added to the rebalancing language per NEPC SB322 recommendation [page 13]
  - Clarified the role of A/L studies and A/A reviews in the SAA process per NEPC 322 recommendation [page 12]
  - Reorganized the asset allocation table [page 11]
  - Cleaned up language around transition periods for asset allocation [page 12]
- **Chapter V: Asset Classes, Leverage, Risk, and Securities Lending**
    - Added legal language necessary to invest in collective investment trusts (CITs) [page 14]
    - Proposed changes to Table 4: [pages 15-17]
    - Break out Public & Private Credit into separate asset classes [pages 15, 16]
    - Break out Public & Private Real Estate into separate line items [page 16]
    - Update ticker for real estate benchmark to be net of tax for international REITs [page 16]
    - Clarified the distinction between strategy leverage and asset allocation leverage [page 18]
    - Added language to expound upon the duties of the Risk Committee [page 19]
    - Added language regarding liquidity needs and the balancing of objectives that results [page 19]
- **Chapter VI: Trust Monitoring and Reporting**
    - Added requirement for annual staff reporting of expenses, trade costs, and liquidity per NEPC SB322 recommendations [page 21]
    - Added section on review of valuations per NEPC SB322 recommendation [page 21]
    - Added section on how Trust-level performance is to be assessed [pages 21, 22]
    - Added detail on the calculation of the key performance benchmarks [page 21]
- **Chapter VII: Code of Ethics**
    - Deleted references to CFAI Code of Ethics and incorporated into the ERS Code of Conduct the key principles from document and the CFAI Pension Trustee Code of Conduct. [page 25, 26]
    - Added requirement that Standards of Professional Practice for Investment staff be incorporated into the IIP (which has already been effected). [page 26]
    - Updates regarding personal transactions from Investment Compliance. [page 25, 26]
- **Chapter VIII: Texas Employees Group Benefits Program Funds (GBP)**
    - Reworked this section to align with statute and current operating practices [page 32-35]
- **Addendum I: Proxy voting policy**
    - No changes except for minor formatting changes, two minor grammatical edits [page 1, 2]
- **Addendum II: Scrutinized Investments**
    - Reworked to better reflect statutory requirements and include OGC comments [page 1, 2]
- **Addendum III: Definition of Securities**
    - Minor edit to statutory reference [page 1]
- **Addendum IV: Placement Agents**
    - Edits to align disclosure requirements with current contracting practices [page 1, 2]
- **Addendum V: Insider Trading**
    - Various clarifying edits and minor cleanup items [page 1, 2]

- **Addendum VI: ACIC Charter**
  - Adds material extensions and redemptions as matters requiring ACIC approval [page 1]
  - ACIC allowed flexibility to choose whether to meet in person or virtually [page 2]
- **Addendum VII: CFA Code of Ethics/Standards of Professional Conduct**
  - Deleted entirely and incorporated ethics items into IPS, code of conduct items into IIP
- **General**
  - More consistent usage of key terms and more consistent formatting throughout
  - Included several references to the IIP to establish clear policy linkage

**STAFF RECOMMENDATION:**

Staff recommends the Board adopt the proposed draft of the ERS Investment Policy Statement included as Exhibit A.

*\* We are 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 — Draft Investment Policy Statement Proposed for August 25, 2022 Joint Meeting of the Board and IAC
2. Exhibit B — Redline version of Draft Investment Policy Statement Proposed for August 25, 2022 Joint Meeting of the Board and IAC
3. Exhibit C — Current version of Investment Implementation Plan dated August 9, 2022
4. Slides — ERS Investment Policy Statement