AGENDA ITEM DETAILS

Subject: *Consideration of Annual Review of Capital Market Assumptions

---

BACKGROUND

The purpose of this educational agenda item is to provide the Board and Investment Advisory Committee insight into the long-term investment trends and portfolio construction techniques that could affect the decisions and outcomes of the ERS investment program.

INVESTMENT OBJECTIVE

As part of its responsibility to advise the Board on investment strategy and asset allocation, Staff continually monitors Capital Market Assumptions (CMAs) and related commentary produced by NEPC and other well-regarded firms with expertise in these areas.

Staff mapped the Strategic Asset Allocation (SAA) parameters of the ERS Trust onto 2023 CMAs from six well-regarded investment firms (NEPC, AQR, BNY Mellon, JP Morgan, Pine Bridge, and Wellington). This analysis produced several key insights:

- The 10-year forecasted returns for diversified portfolios are materially higher in 2023 as slowing economic growth and the persistence of elevated inflation resulted in broad, negative repricing across capital market assets during 2022. These lower valuations, coupled with higher yields and the unwinding of policy dislocations to follow, increases potential for returns in the years to come.

- Applying these CMAs to a passive public portfolio suggests an average beta-only expected return of 6.3% for the medium term, which underscores the importance of diversifying the Trust further via the addition of assets with higher expected returns and/or lower correlations.

- Applying these CMAs to the current target asset mix of the Trust suggests an average expected return of 7.2% for the medium term or more assuming that strong historical levels of excess returns from implementation decisions continue. From a risk-adjusted perspective, the additional 90 basis points expected return of the target asset mix relative to a passive public portfolio comes alongside 170 basis points of lower expected volatility.

- The drivers of forecasted CMA returns for the next decade diverge meaningfully from those that drove returns over the last decade. Expectations for a higher risk-free rate of return results in a higher base expectation across asset classes with risk premiums for diversified portfolios falling back towards long-term averages of 4-5%.

- While markets were marked by higher volatility and correlations in 2022, the 10-year forecasted CMA expectations for these metrics portend a return to more ordinary market conditions under which market risks can be reduced by diversifying across uncorrelated assets.

Staff review of the associated commentary also drew out several key themes that are relevant to the investment strategy of the Trust going forward:

- **Weaker Growth, Stronger Markets:** As economic fundamentals continue to deteriorate and recession grows increasingly likely in the near term, a softer labor market and falling inflation should lead to the end of the global rate hiking cycle in the medium term. After one of the worst years on record for diversified portfolios during 2022, where both stocks and bonds suffered large losses, lower asset valuations and higher yields provide improved long-term return assumptions, even in the face of weaker short-term growth expectations.

- **Regionalization (vs De-globalization):** Geopolitical tensions have intensified nationalist sentiment and protectionist headwinds, further disrupting global supply chains and accelerating the trend towards de-globalization. However, firms are unlikely to retrench fully from the benefits provided by decades of globalization, with the more probable scenario being the emergence of regional trading blocs among countries marked by geographic, political, or cultural alignment.

- **Shifting Demographics:** Driven by increasing numbers of people surviving to reproductive age, the gradual increase in human lifespan, and accelerating migration, the global population reached 8 billion in November 2022 and is expected to reach 9 billion within the next 15 years. While a growing population tends to drive economic growth, investment opportunity is not uniform across nations globally and should be evaluated against factors that determine expected marginal per-capita growth rates. These include policies for national and corporate governance, migration, and food/water/energy infrastructure.

- **Depleted Consumers:** After the U.S. personal savings rate reached its highest level in history of 33.8% during the COVID-19 pandemic, pent up demand and high levels of inflation saw the rate plummet to 2.3% in 2022, narrowly avoiding the all-time low of 2.2% and deteriorating the financial cushion accumulated over the prior two years. As a result, most indicators suggest weakening consumer spending, which has historically accounted for two thirds of the US economy.

- **China Uncertainty:** Chinese exports have now surpassed pre-COVID rates, and recent policy announcements signal more government support directed towards national infrastructure development. Yet, the outlook for economic growth in China continues to be uncertain as strict COVID-19 policies and the collapsing property sector limit any upside potential and policymakers have communicated a focus on economic stability rather than stimulus.

Staff believes that these perspectives can help inform the pursuit of strong performance for the Trust through the deployment of a best-in-class approach to investment strategy.

This agenda item is presented for informational purposes only. No action is necessary.

**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. Slides –Presentation on Capital Market Assumptions

.