

Joint Meeting of  
The Board of Trustees  
and  
Investment Advisory Committee Minutes

December 7, 2022



Presented for Review and Approval

March 1, 2023

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JOINT MEETING OF THE  
BOARD OF TRUSTEES AND  
INVESTMENT ADVISORY COMMITTEE  
EMPLOYEES RETIREMENT SYSTEM OF TEXAS

**ERS Building – 9th Floor Conference Center – Rio Grande Conference Room  
1836 San Jacinto Blvd, Austin, Texas 78701  
December 7, 2022 – 9:00 a.m.**

**TRUSTEES PRESENT**

Dr. James Kee, Chair  
Brian Barth, Vice-Chair  
Neika Clark, Member  
Craig Hester, Member  
Catherine Melvin, Member  
John Rutherford, Member

**INVESTMENT ADVISORY COMMITTEE (IAC) PRESENT**

Gene Needles, Chair  
Laurie Dotter, Vice-Chair  
Bob Alley, Member  
Ryan Bailey, Member  
Jim Hille, Member  
Milton Hixson, Member  
Ken Mindell, Member  
Ruby Muñoz Dang, Member

**ERS DIRECTORS PRESENT**

Porter Wilson, Executive Director  
Cathy Terrell, Deputy Executive Director  
Jennifer Chambers, Director of Government Relations & Special Projects  
Tony Chavez, Director of Internal Audit  
Bernie Hajovsky, Director of Enterprise Planning Office  
Cynthia Hamilton, General Counsel  
Robin Hardaway, Director of Customer Benefits  
Shack Nail, Special Projects & Policy Advisor  
Machelle Pharr, Chief Financial Officer  
Kathryn Tesar, Director of Benefits Communications  
Gabrielle Schreiber, Director Office of Procurement & Contract Oversight  
DeeDee Sterns, Director of Human Resources  
David T. Veal, Chief Investment Officer

**ERS STAFF PRESENT**

Jason Avants, Information Systems  
Amanda Burleigh, Office of General Counsel  
Raquel Colon, Investments  
Kurt Cressotti, Investment Compliance  
Anthony Curtiss, Investments  
Kelley Davenport, Executive Office  
Mitch Holtz, Investments  
Lauren Honza, Investments  
Lanesia Jones, Investments  
Ricardo Lyra, Investments  
Keith Lyons, Investments  
John McCaffrey, Investments  
Mike McCrary, Investments  
John Moreno, Benefits Communications

Benjamin Schuman, Investments  
Cheryl Scott Ryan, Office of General Counsel  
Leighton Shantz, Investments  
Pablo de la Sierra Perez, Investments  
Mary Jane Wardlow, Executive Office  
Ariana Whaley, Executive Office  
Micheal Yuan, Investments

**VISITORS PRESENT**

Sam Austin, NEPC  
Ryan Falls, Gabriel, Roeder, Smith & Company  
Joe Newton, Gabriel, Roeder, Smith & Company

## **Call to Order the Joint Meeting of the ERS Board of Trustees and Investment Advisory Committee**

### **23. Call Meeting of the Board of Trustees to Order**

Dr. James Kee, Chair of the Board of Trustees (Board) for the Employees Retirement System of Texas (ERS), called the board to order to convene with the Investment Advisory Committee (IAC) to take up the following Joint Meeting of the Board of Trustees and Investment Advisory Committee agenda items.

A public notice of the ERS Board of Trustees containing all items on the proposed agenda was filed with the Office of the Secretary of State at 1:21 p.m. on November 28, 2022 as required by Chapter 551, Texas Government Code, referred to as "The Open Meetings Law."

### **24. Call Meeting of the Investment Advisory Committee to Order**

Mr. Gene Needles, Jr., Chair of the IAC for ERS, called the IAC to order.

A public notice of the ERS Board of Trustees containing all items on the proposed agenda was filed with the Office of the Secretary of State at 1:21 p.m. on November 28, 2022 as required by Chapter 551, Texas Government Code, referred to as "The Open Meetings Law."

### **25. Consideration of the Minutes to the December 7, 2022 Joint meeting of the Board of Trustees and Investment Advisory Committee – (Action)**

Mr. Gene Needles, Jr., IAC Chair, opened the floor for a motion on the approval of the minutes from the March 9, 2022, Joint Meeting of the Board of Trustees and Investment Advisory Committee.

The IAC then took the following action:

Motion made that the Investment Advisory Committee of the Employees Retirement System of Texas approve the minutes of the Joint Meeting of the Board and IAC held on August 24, 2022.

Motion by Caroline Cooley, second by James R. Hille

Final Resolution: Motion Carries

Aye: Gene Needles, James R. Hille, Milton Hixson, Ken Mindell, Caroline Cooley, Laurie Dotter

The Board of Trustees then took the following action:

Motion made that the Board of Trustees of the Employees Retirement System of Texas approve the minutes of the Joint Meeting of the Board and IAC held on March 9, 2022.

Motion by Brian Barth, second by Craig Hester

Final Resolution: Motion Carries

Aye: James Kee, Neika Clark, Catherine Melvin, John Rutherford

Catherine Melvin requested to add two items to the meeting record. First, she thanked Optum RX for its work as the pharmacy benefits manager for ERS. Second, she thanked Mr. Bouquet for his public comment made at the meeting on December 6<sup>th</sup>. She noted that while the Board can only discuss items on the agenda, it welcomes and appreciates public comments.

### **26. Consideration and Review of Retirement Program Actuarial Valuations and Financial Status**

Ariana Whaley, Pension Policy Analyst, Ryan Falls and Joe Newton, actuaries from Gabriel, Roeder, Smith, & Company (GRS) presented the Review of Retirement Program Actuarial Valuations and Financial Status.

Mr. Falls noted that the Legacy Payment established in Senate Bill 321 of approximately \$510 million per year has put the fund on track to eliminate its unfunded liability by 2054.

Mr. Falls explained the reasoning and methodology behind actuarial smoothing of the Trust, which resulted in a net \$370 million deferred gain, despite recent market weakness.

Mr. Falls explained that ERS' unfunded liability increased slightly in Fiscal Year 2022, but the funded ratio increased to 68.9% from 68% with annual improvements expected going forward. The unfunded liability should remain close to \$14 billion for several years before beginning to decrease.

Mr. Falls talked about unique near-term dynamics driving the unfunded liability are declining membership and wage inflation. However, the wage inflation is expected to balance out in the long-run with higher payroll contributions.

GRS presented an analysis showing savings to the State under various funding scenarios which reduce interest expense and eliminate the unfunded liability faster.

Porter Wilson explained that the Legacy Payment should be paid on September 1<sup>st</sup>, but that some of the payments are tied to federal funds to the degree that the underlying salaries and benefits are paid for by federal funds. Mr. Wilson explained that ERS has asked the legislature to amend the process in an exceptional item request as part of the Legislative Appropriations Request to use general revenue funds in order to avoid delays in the Legacy Payments associated with the approximately 17% that was originally expected to come from federal funds.

GRS also updated the Board and IAC on the funding status of ERS-administered LECOSRF and JRS2 and the need for increased contributions to prevent the eventual depletion of these funds. In both cases, GRS proposed a payroll increase and lump sum to ultimately eliminate the unfunded liability and cover the normal cost of the plans.

## **27, \*Educational Presentation: Geopolitical Risk and International Investing**

Micheal Yuan, Equity Strategy Portfolio Manager, delivered an educational presentation on Geopolitical Risk and International Investing.

Mr. Yuan explained improved living standards, globalization, and persistent low interest rates created a largely favorable investment environment since the end of WWII. The traditional 60/40 approach to portfolio construction performed quite well during this era as equity markets rose and interest rates declined. Globalization and peace opened up new avenues for portfolio diversification, such as the widespread move into international equities, including those in emerging markets.

Mr. Yuan explained that we could be entering a new era defined by the willingness to trade optimized economic efficiency and higher profits for essential strategic national interests. Important aspects of the modern world may be set to change, including how products are manufactured, how food is grown, how energy is used, how goods are moved about, and how these activities are financed.

To adapt, Mr. Yuan said long-term investors such as ERS will need to consider how the strategies that have worked in recent decades will perform if these dynamics reverse. Such trends are likely to cause the cost of capital to rise, which will favor asset owners such as ERS by raising the bar for investment returns. Other trends may be less favorable, such as the potential for a lower contribution to returns from the market risk premium and a shortage of effective hedges against inflation. Mr. Yuan concluded that a thoughtful approach to country and sector selection can also help capitalize on new opportunities and manage emerging risks in this new era.

A question was asked about what percent of the portfolio is in investments outside of the U.S. Mr. David T. Veal, ERS Chief Investment Officer, responded that it is approximately 20%. A follow-up question was asked about the ease of divesting non-U.S. investments. Mr. Veal explained that some less liquid investments would take more time to divest.

Discussion followed about the investment implications of declining globalization and persistent higher interest rates. Mr. Veal explained that the Global Equity portfolio was recently restructured to allow a more focused alignment with global trends. Mr. Veal also mentioned that higher risk-free rates could allow ERS to be more selective with its investments.

## **28. Quarterly Report from Chief Investment Officer**

Mr. David T. Veal, ERS Chief Investment Officer, presented the Chief Investment Officer's Report to review the performance, risk, and expenses of the Trust.

Mr. Veal explained that the Trust has outperformed the actuarially assumed rate of return over longer-term time horizons, including excess returns of 0.2% over the trailing five-year period. Five-year returns of 7.2% represent a 6.0% premium over risk-free returns during the period, which indicates that the Trust has earned high rewards for bearing market risk.

Mr. Veal noted that the Trust has delivered +176 basis points of excess return net of external management expenses, which is among the highest levels in its history. Mr. Veal went on to note that NEPC ranks the ERS Trust #1 in its peer group of 39 funds on a fiscal year to date, trailing 1-year, trailing 3-year, and trailing 5-year basis.

Mr. Veal discussed the attribution analysis of the Trust's 176 basis point outperformance versus the Policy Benchmark over a trailing 5-year period. Private Equity represents the largest contributor to the excess return, contributing 101 basis points to Trust-level excess returns during this period.

Mr. Veal went on to discuss risk-adjusted returns. Using both the Sharpe Ratio and the Information ratio, risk-adjusted performance of the Trust has been good.

Mr. Veal discussed the strategic positioning of the trust, which remains within the allocation parameters established in the Investment Policy Statement (IPS). Private Equity has reached 20.1% of Trust assets, above the 16% long-term target but below the 21% policy maximum. An increased allocation to private assets has also increase the percentage of the Trust allocated to illiquid assets in recent years.

Mr. Veal discussed increased investment expenses, which have been tied to the aforementioned increased allocation to Private Markets and higher profit share expense tied to exceptionally strong returns.

Mr. Veal went over strategic initiatives for 2023, including attracting and retaining talent, the reorganization of the Public Equity team and portfolio, process improvements, and the upcoming investment process review.

Discussion followed about recent loss of investment talent due in large part to higher pay. Mr. Veal explained that in some cases the pay gap was insurmountable but that ERS has also lost talent due to marginally higher pay at a competitor organizations. Mr. Veal further explained that Investments and Human Resources are taking steps to improve talent retention.

Discussion followed about ERS investment expenses and if they are in-line with Trust peers. Mr. Veal explained the fees are related to allocation and that ERS uses its size and other characteristics to negotiate competitive fees.

There also was discussion about the public equity portfolio consolidation which Mr. Veal said was taking place across internal and externally managed portfolios.

## **29.\*Consideration of Quarterly Review of Investment Performance and Risk Update**

Mr. David T. Veal, Chief Investment Officer, Mr. John McCaffrey, Managing Director of Portfolio Management, and Mr. Sam Austin, NEPC, presented the investment performance for the third calendar quarter of 2022.

Mr. Austin stated that the total ERS Trust returned -2.18% in the 3<sup>rd</sup> quarter of 2022, outperforming its policy benchmark by 0.04% and ranking in the 5<sup>th</sup> percentile among its peers.

Mr. Austin stated that in the three-year period ended September 30, 2022, the Trust return of 7.96% outperformed the policy benchmark by 2.51% and ranked in the 1<sup>st</sup> percentile of peers.

Mr. Austin stated that in the five-year period ended September 30, 2022, the Trust return of 7.16% outperformed the policy benchmark by 1.76%, ranking in the 1<sup>st</sup> percentile, and outperformed the actuarial rate of return which is currently 7.0%.

Mr. Austin concluded that over the past 10 years, Trust returns have outperformed the policy benchmark by 0.8% and outperformed the Plan's actuarial rate of return of 7.0%. Mr. Austin said that the asset classes contributing to outperformance were Private Equity, Global Credit, Public Real Estate, Private Real Estate, and Absolute Return.

Discussion followed about differences in allocation between peer plans and Mr. Austin noted that the ERS Trust has a higher allocation to rates and private markets relative to peer funds.

Mr. Austin was asked if he had any recommended changes to the IPS. Mr. Austin stated that he is comfortable with the IPS and noted recent improvements as well as the upcoming Governance Audit. Mr. Veal further noted recent improvements to the governance of the Trust.

There was additional discussion regarding whether or not ERS has the right information resources to work within the current complex investment environment. Mr. Veal responded affirmatively, noting that the ERS travel budget and research tools are strong and remain a priority for ERS.

Mr. Veal was asked about which areas of the market the Trust could seek to be underweight over the next three to five years. Mr. Veal responded that the investment staff is concerned about the effects of recent interest rate hikes on areas such as corporate earnings and housing.

Mr. Veal was asked about Private Real Estate specifically. Mr. Veal noted that ERS expects markdowns of 5% to 8% in Private Real Estate over the near term.

Mr. Veal said that the Trust has a strong liquidity profile, including the Treasury portfolio, and he believes it is sufficiently positioned to meet cash outflow requirements. He noted that ERS works with private equity funds that target strong and improving businesses and are less dependent on the financial engineering enabled by persistently low rates.

Mr. McCaffrey discussed the framework used by staff to gauge the prevailing market regime which tracks real-time movements in real economic growth and inflation across a four-quadrant model. He noted that the model is reflecting a period of high inflation and more modest economic growth.

Mr. McCaffrey noted that recent data points challenged economic growth; stickier than expected inflation, tight financial conditions, equity multiple compression, higher bond yields, and increased correlation between asset classes.

Mr. McCaffrey said going forward, the current economic regime implies higher volatility for the Trust, increasing importance of diversification, and increased liquidity risk.

There were no further questions or comments following the presentation.

### **30. Consideration and Annual Review of Public Equity Program**

Ms. Lauren Honza, Managing Director of Public Equities, and Mr. Keith Lyons, Director of Public Equity, presented the Annual Review of the Public Equity Program.

Ms. Honza began noted that over the last five years, the Public Equity Program has delivered absolute returns of 4.3% though excess returns are slightly negative across longer time horizons.



Ms. Honza explained that during the most recent five year period ending September 30, 2022, the Program delivered absolute returns of 4.3% versus the benchmark return of 4.5%. She noted that this underperformance for the Program overall has occurred despite good historical performance within many of the 26 constituent portfolios that existed prior to the 2022 restructuring that became effective September 1, 2022. Ms. Honza explained that attribution analysis indicates that poor allocation decisions across portfolios had offset more than the value that had been added within those portfolios.

Ms. Honza explained that the IPS sets the risk budget for the Public Equity portfolio at a target of 150 bps and a limit of 300 bps for rolling targeted tracking error versus the benchmark. She explained that tracking error has slightly increased over the past year and is currently slightly above the target, but well below the maximum level, which suggests that the program is taking on more concentrated and/or less correlated positions and thereby becoming less like the index.

Mr. Lyons presented on the recent restructuring of Internal Public Equities. Mr. Lyons noted that the team developed a plan to restructure the Public Equity Program with the goals to improve risk-adjusted performance, simplify portfolio structure, enhance allocation capabilities, and improve alignment of interest.

Mr. Lyons noted that the Program is now comprised of the new Core Portfolio (referred to as the ERS Lone Star Fund), satellite portfolios, and the global tactical portfolio. The portfolio restructuring reduced the number of stocks in the Lone Star portfolio from about 900 to about 260.

Mr. Lyons explained that the Lone Star Fund is managed internally and is considered the centerpiece of the Program. The inception date of the Lone Star Fund is September 1, 2022 and it is benchmarked to the MSCI ACWI ex-China Index. The market value on September 30, 2022 was \$6.9 billion, or 71% of the Program. Mr. Lyons went on to explain more about the strategy and culture of the Lone Star Fund.

Discussion followed about the role of the Internal Investment Committee for the Lone Star Fund, and Mr. Lyons clarified that the Investment Committee approves new portfolio purchases.

There was also discussion about looking beyond the traditional pool of investment professionals for talent. Mr. Lyons noted that the team is looking to add analysts with experience in their covered sectors.

Ms. Honza explained that ERS has 14 strategies in a satellite portfolio designed to complement the core Lone Star portfolio. Five strategies were recently defunded.

There was additional discussion about streamlining the procurement process to make it easier for ERS to add managers to its pool.

Ms. Honza described the role of the Global Tactical ETF portfolio and its benefits in terms of liquidity and tactical flexibility within Public Equity Program.

Ms. Honza explained key priorities for 2023, including further refinement of the investment process, adding complementary strategies, working with the Strategy group to improve monitoring and developing the internal team.

Discussion followed about the current allocation. Ms. Honza noted that the Lone Star Fund is overweight in U.S. equities, but that this exposure is largely offset by external satellite portfolios. She also noted that the Program is also overweight in the Energy Sector.

There also was discussion about the program's exposure to China. Mr. Lyons and Ms. Honza explained that Chinese equities have been removed from the Lone Star Portfolio benchmark due to their idiosyncratic characteristics. They also explained that China remains in our investment universe due to their inclusion in the benchmarks for the asset class and the Trust overall.

### **31. Consideration and Annual Review of Proxy Voting Program**

Mr. David T. Veal, Chief Investment Officer, and Ben Schuman, Investments Chief of Staff, presented on the Annual Review of Proxy Voting.

Mr. Schuman explained that ERS votes over 30,000 proxies annually and uses Institutional Shareholder Services (ISS) as its proxy advisor to manage this volume of votes.

He noted that according to the IPS, proxy voting is considered a fiduciary act that is required to be conducted solely in accordance with the economic best interest of ERS.

Mr. Schuman explained how the ERS proxy guidelines contain specific instructions and are subject to annual internal review. He went on to explain how the guidelines are executed through the ISS system and ERS staff review.

Mr. Veal clarified that ERS has a custom proxy voting policy with ISS rather than using an off-the shelf set of ISS benchmarks.

Mr. Schuman gave background information about changes in the proxy voting environment which, including new SEC guidance that has resulted in an increasing number of shareholder proposals on environmental and social issues.

Mr. Schuman reviewed the ERS voting track record. ERS tends to vote in alignment with management on management proposals, as well as more frequently supporting management on shareholder proposals.

Discussion followed about the ERS process to review ISS codes. Mr. Schuman noted that there is an annual review of ISS policy as well as an ongoing process to ensure ISS compliance with ERS policy.

There also was some discussion about the role of the portfolio managers in the proxy voting process and Mr. Schuman explained that while voting is centralized with two senior staff members, portfolio managers can be consulted on relevant votes.

There were no further questions or discussion on this agenda item.

### **32. Consideration and Annual Review of Emerging Manager Program**

Mr. David T. Veal, Chief Investment Officer, Ms. Lauren Honza, Managing Director of Public Equities, and Ms. Lanesia Jones, External Public Equity Analyst, presented the Annual Review of the Emerging Manager Program.

Ms. Jones explained that the ERS Emerging Manager Program focuses on identifying and developing emerging manager relationships. Those managers are statutorily defined as those with \$2 billion or less in assets under management.

Ms. Jones explained that the Emerging Manager team was created in 2010. The current team is:

- Public Equity: Lanesia Jones
- Private Equity: Thomas Rashman
- Real Assets: Amy Cureton
- Hedge Funds: Panayiotis Lambropoulos, CFA, FRM, CAIA
- Global Credit: Richard Inzunza, CFA

Ms. Jones explained that ERS has multiple channels for sourcing Emerging Managers, including the ERS External Advisor website.

There was discussion of how ERS determines and classifies diversity within the program.

Ms. Jones explained the role of fund-of-funds partners and consultants which have helped source emerging managers.

Ms. Jones highlighted a number of successful Emerging Manager events hosted by ERS and its partners.

Ms. Jones noted that 13.8% of externally-managed assets are with Emerging Managers, well ahead of the internal goal of 10%.

Ms. Jones provided a brief overview of Emerging Manager commitments and performance across each asset classes.

There was some discussion about fund-of-funds versus direct investment considering strong performance of ERS' direct investments. Ms. Honza noted that the fund-of-funds partners can introduce smaller managers and enable smaller investment sizes. She also noted that the fee structure with Legato Capital Management, the Program's Public Equity advisor, has improved.

There was some discussion about fee negotiation and seeding new programs. Ms. Honza and Mr. Veal noted that seeding funds and appropriate sizing of fees are areas of focus for ERS.

There were no further questions on this agenda item.

### **33. \*Annual Ethics Training**

Ms. Cynthia Hamilton, General Counsel, and Mr. Kurt Cressotti, Investment Compliance Officer, presented on Investment ethics. Ms. Hamilton provided an in-depth review of various rules and implications related to investment ethics from a legal standpoint. Mr. Cressotti focused his presentation on the ERS Code of Ethics.

### **34. Investment Advisory Committee Member Recognition**

Mr. David T. Veal recognized Ms. Caroline Cooley for her outstanding contribution to the IAC over nine years. He noted her participation in 35 of 39 IAC meetings, contribution to the Hedge Fund Asset Class investment Committees, and the CIO search.

### **35. Adjournment of the Joint Board of Trustees and Investment Advisory Committee and Reminder of Upcoming Meeting Dates**

The Joint Meeting of The Board of Trustees and Investment Advisory Committee Meeting adjourned at 3:09 p.m.