

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

March 1, 2023



Presented for Review and Approval

May 17, 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
March 1, 2023 – 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
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
Diana Kongevick, Director of Group Benefits
Shack Nail, Special Projects & Policy Advisor
Machelle Pharr, Chief Financial Officer
Gabrielle Schreiber, Director Office of Procurement & Contract Oversight
Kathryn Tesar, Director of Benefits Communications
David T. Veal, Chief Investment Officer

ERS STAFF PRESENT

Jason Avants, Information Systems
Chris Beggs, Investments
Amy Chamberlain, Executive Office
Michael Clements, Investments
Raquel Colon, Investments
Kurt Cressotti, Internal Audit
Anthony Curtiss, Investments
Kelley Davenport, Executive Office
Peter Ehret, Investments
Leah Erard, Executive Office
Marcia Gibbs, Benefits Communications
Angelica Harborth, Group Benefits
Lauren Honza, Investments
Richard Inzunza, Investments
Tiffany Jenkins, Benefits Communications

Nancy Lippa, Office of General Counsel
Nick Maffeo, Investments
Leighton Shantz, Investments
Pablo de la Sierra Perez, Investments
Ricardo Lyra, Investments
John McCaffrey, Investments
John Murphy, Investments
Pablo de la Sierra Perez, Investments
Tom Roberts, Investments
Benjamin Schuman, Investments
Cheryl Scott Ryan, Office of General Counsel
Robert Sessa, Investments
Lacy Wolff, Executive Office

VISITORS PRESENT

Jeff Hardt, UHC
Sam Austin, NEPC
Tathata Lohachitkul, Albourne Partners
Thomas Nun, Empower Investments

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

7. Call Meeting of the Board of Trustees to Order

Mr. James (Jim) 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 and Investment Advisory Committee meeting was filed with the Office of the Secretary of State at 4:15 p.m. on Tuesday, February 21, 2023, as required by Chapter 551, Texas Government Code, referred to as "The Open Meetings Act."

8. 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 and Investment Advisory Committee meeting was filed with the Office of the Secretary of State at 4:15 p.m. on Tuesday, February 21, 2023, as required by Chapter 551, Texas Government Code, referred to as "The Open Meetings Act."

9. 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 December 7, 2022, Joint Meeting of the Board of Trustees and Investment Advisory Committee.

The IAC then took the following action:

Move that the Investment Advisory Committee approve the minutes of the Joint Meeting of the Board and IAC held on August 24, 2022.

Motion by Bob Alley, second by Laurie Dotter

Final Resolution: Motion Carries

Aye: Gene Needles, Ryan Bailey, Milton Hixson, Ruby Muñoz Dang

The Board of Trustees then took the following action:

Move that the Board of Trustees approve the minutes of the Joint Meeting of the Board and IAC held on March 9, 2022.

Motion by John Rutherford, second by Craig Hester

Final Resolution: Motion Carries

Aye: Dr. James Kee, Brian Barth, Neika Clark, Catherine Melvin

10. Consideration of TexaSaverSM Investment Performance Review for Calendar Year 2022

Diana Kongevick, Director of Group Benefits, Angelica Harborth, Manager, Deferred Compensation Plans, and Thomas Nun from Empower Investments presented on this agenda item.

Ms. Harborth began the discussion with a review of fund growth and performance. She noted that the size of the Program has doubled since 2012 inception, despite negative investment performance in 2022.

Ms. Harborth outlined the investment offerings, including Target Date Funds, Core Funds, and a self-directed brokerage option. There was some discussion about the level of choices offered within the Core Funds menu, which includes 12 managers.

Ms. Harborth also discussed the Product Review Committee, which includes staff from Group Benefits, Investments, Executive Office, and Investment Advisory Committee members.

Mr. Nun then went into more detail about the various funds offered to Plan participants, and the current fund allocation.

Mr. Rutherford noted that four firms manage a significant concentration of Plan assets.

Mr. Nun acknowledged the concentration and mentioned that most firms manage a significant number of fund products, which contributes to plan diversification.

Mr. Nun reviewed expenses and noted that expenses are competitive across the spectrum of funds offered.

Dr. Kee noted the absence of a domestic equity fund containing all market cap classifications rather offering more segmented funds.

Mr. Nun replied by noting that such a fund could be constructed using the available options which is more in-line with industry practice.

Mr. Nun then gave a comprehensive capital markets update. There was broad discussion around market dynamics, including yield curve impact and commodities specifically.

Mr. Nun then moved to a performance analysis. There was some discussion about the underperformance of certain funds, including target date vintages, which Mr. Nun largely attributed to benchmark dynamics. Mr. Needles asked how regularly target date fund performance should be reviewed because of changing market dynamics. Mr. Nun said that target date funds should be reviewed on a regular basis. Mr. Nun noted that funds are typically reviewed on a three-year basis, as well as monitoring on an ongoing basis and attempted on a quarterly basis.

Dr. Kee noted that a majority of actively-managed funds in the Program seem to have underperformed over a short- and long-term timeframe and Mr. Nun agreed when compared to benchmarks, but noted that performance relative to peers has been more favorable.

Mr. Nun then presented rolling performance for each strategy versus peers.

Mr. Nun then reviewed the funds that ERS currently has on a due to performance challenges, specifically the Wellington Mid-Cap Opportunities fund. ERS conducts extra diligence reviews on watch list funds.

11. Consideration of the Investment Compliance Annual Report

Mr. Kurt Cressotti, Investment Compliance Officer, presented a review of the Investment Compliance Annual Report CY22. After a brief outline of the Program, he noted that there were no significant compliance risks identified. The report did include some low and moderate compliance risk.

The low risk related to personal trade violations, and the moderate issue was related to proxy voting. There was further discussion noting six personal trade violations among thousands of personal trades.

Mr. Cressotti then reviewed some of the compliance procedures in depth and outlined the 2023 Compliance Action Plan.

There was some discussion about the Trust exposure to Russian securities, which were marked to zero value after sanctions were placed on Russian companies.

Mr. Needles asked if the compliance program had sufficient resources, and Mr. Cressotti responded that it does.

There were no further questions on this item.

12. Annual Consideration of Eligibility and Compliance of the Investment Advisory Committee

Mr. Kurt Cressotti, Investment Compliance Officer, reported that all Investment Advisory Committee members are in and compliance criteria. Mr. Cressotti noted that all IAC members are in compliance with stated criteria and eligible for continued service on the IAC. 13. Consideration of Reappointments to the Investment Advisory Committee.

13. Consideration of Reappointments to the Investment Advisory Committee

Mr. David T. Veal, Chief Investment Officer, presented on this agenda item.

Mr. Veal presented a brief overview of the role of Investment Advisory Committee and the reappointment for Milton Hixson, Gene Needles and Jim Hille in 2023.

The Board of Trustees then took the following action:

Move that the Board of Trustees reappoint Mr. Milton Hixon for a three-year term beginning April 1, 2023 and ending March 31, 2026, Mr. Gene L Needles Jr. for a three-year term beginning June 1, 2023 and ending May 31, 2026, and Mr. James Hille for a three-year term beginning September 1, 2023 and ending August 31, 2026.

Motion by Craig Hester, second by John Rutherford

Final Resolution: Motion Carries

Aye: Dr. James Kee, Brian Barth, Neika Clark, Catherine Melvin

15. Consideration of Quarterly Report from Chief Investment Officer

Mr. David T. Veal, Chief Investment Officer, presented on this agenda item giving an overview of the mission, objectives, and strategy of the ERS Investments Division.

Mr. Veal noted that Trust investments, currently valued at \$33.2 billion, have fulfilled their strategic purpose by outperforming the actuarially assumed rate of return over longer-term time horizons, including by 0.2% over the trailing five-year period. Five-year returns of 7.2% represent a 5.9% premium over risk-free returns and 2.6% above the return of 4.6% for a passive public markets portfolio, indicating high rewards for bearing market risk and significant value from the implementation efforts of the Board/IAC and staff.

Mr. Veal went on to review quarterly returns, and noted the impact of higher volatility in recent quarters.

There was some discussion about how to better diversify the trust through assets classes with lower market correlations. Mr. Veal noted the contribution of Private Infrastructure to Trust diversification.

There was additional discussion about the composition of, and strategic differences between identified peers of the ERS Trust.

Mr. Veal went on to discuss the ERS peer ranking over time, which is number one on a 3-year basis, and top 10% on a 1-, 5-, and 10-year basis.

Mr. Veal went on to discuss attribution of fund performance. Mr. Veal noted that Private Equity has been the largest source of excess return.

There was additional discussion about the outlook for Private Equity going forward with the current interest rate environment and economic conditions.

There was additional discussion about the underperformance of Public Equities and the resulting restructuring of that allocation.

Mr. Veal said that absolute risk for the Trust as measured by realized volatility has risen over the last 24 months, which is now at 8.1%. Mr. Veal noted that this level represents an increase from pre-pandemic levels of 5-6%, but that it is now in line with the long-term average of 8%. This metric for the Trust remains below the realized volatility of the Policy Benchmark and, due primarily to the smoothing effects of private market valuations, well below the levels of above 14% that are being observed for the Passive Index.

Mr. Veal discussed tracking error for the Trust. The current realized level of 221 basis points on a trailing five-year basis is above the historical average of 105 basis points, which reflects greater allocations to private markets where the implementation differs materially from the benchmark.

Mr. Veal discussed the Trust Information ratio over the last five years. The information ratio was 0.7 at the end of the quarter, among the highest levels in many years. The strong relative performance of asset classes including private equity helped produce these results.

Mr. Veal went on to briefly cover asset class positioning, investment expenses, and Group Benefits Plan performance.

Mr. Veal then covered key goals and initiatives for 2023.

There was additional discussion about diversification of the trust and its positive contribution to Trust returns.

There was additional discussion about the impact of Public Equity to risk and volatility.

There were no further questions.

16. 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 on this agenda item.

Mr. Austin began with a review of current economic conditions, focusing on interest rates, inflation, employment, and other economic data.

There was broad discussion about the strategy of the Federal Reserve and its efforts to prevent a recession.

Mr. Austin reviewed ERS Trust performance, where ERS lagged its peer group on a one-quarter basis, but performed very well over medium- and long- term time horizons.

John McCaffrey discussed the risk outlook for the ERS Trust.

Mr. McCaffrey provided a broad risk outlook. He noted that the overarching theme entering 2023 is the long-term change occurring within the economic environment. Mr. McCaffrey explained that inflation has fallen from its peak last year but remains well above all previous cycle highs over the last 40 years. Economic growth has slowed but has thus far remained resilient in light of significant headwinds including tighter monetary policy, depleting consumers, and challenges from shifting demographics and geopolitics.

Mr. McCaffrey note that evolving policies of the US Federal Reserve and other central banks continue to be paramount as these officials navigate the conflict between controlling inflationary pressure and the accompanying effects on economic activity.

He explained that the investment landscape is also in flux as cash returns now present a much higher hurdle rate for diversified assets. A near-zero-rate environment over the prior cycle presented

different challenges and opportunities for allocators, who now must re-evaluate the risk and return profiles across assets in the context of higher risk-free rates, correlations, and volatility.

There was some discussion about impact to inflation from the growth in money supply and the U.S. budget deficit. There was some consensus that this factor would make it more difficult for the Federal Reserve to control inflation.

17. Consideration of Annual Review of Capital Market Assumptions

Mr. David T. Veal, Chief Investment Officer, and Mr. John McCaffrey, Managing Director of Portfolio Management, presented on this agenda item.

Mr. McCaffrey presented an analysis mapping the Strategic Asset Allocation parameters of the ERS Trust onto 2023 capital market assumptions from six well-regarded investment firms (NEPC, AQR, BNY Mellon, JP Morgan, Pine Bridge, and Wellington).

Mr. McCaffrey noted that this analysis produced several key insights. Mr. McCaffrey noted that 10-year forecasted returns for diversified portfolios are materially higher in 2023. He went on to explain that applying these assumptions 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. He explained that applying these assumptions 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. Finally, he explained that while markets were marked by higher volatility and correlations in 2022, the 10-year forecasted capital market assumption expectations for these metrics portend a return to more ordinary market conditions under which market risks can be reduced by diversifying across uncorrelated assets.

Mr. McCaffrey also noted several key themes emerging from the analysis: Weaker growth & stronger markets, regionalization, shifting demographics, depleted consumers, and uncertainty in China.

There was discussion about the international diversification of the Trust, which holds approximately 30% of its assets in overseas investments.

There was discussion regarding whether or not the analysis is reflecting the latest inflation expectations. Mr. McCaffrey noted that the expectation of reduced inflation has likely moderated since the analysis was conducted.

There was no further discussion.

18. Consideration of Annual Review of Public Credit, Private Credit and Hedge Fund Programs

Mr. Leighton Shantz, CFA, Managing Director of Credit & Hedge Funds, Mr. Peter Ehret, CFA, Director of Public Credit, Mr. Richard Inzunza, CFA, Director of Private Credit, and Mr. Nick Maffeo, CAIA, Director of Hedge Funds presented on this agenda item.

Mr. Shantz began the presentation with an overview of the Credit Program, which consists of Public Credit and Private Credit. He went on to discuss the policy allocation, style characteristics, risk budget, and expenses.

There was some discussion about duration matching with the benchmark, and Mr. Shantz noted that the Program is opportunistic with its risk allocation.

There was some discussion of expected default rates, which Mr. Shantz noted are 2.5% to 3%.

One-, and five-year relative performance has been good in aggregate. Public Credit has underperformed over five years due to volatile market conditions around the early COVID-19 pandemic.

Mr. Ehret then began a discussion of the Public Credit Program. He discussed key characteristics of the Program, including target weights, style, benchmarking, risk, and expenses. Performance has been strong on a one-year basis, and slightly challenged over five years. Rolling performance suffered in 2020 but rebounded nicely into 2021 and 2022. He noted that the Program has performed well since 2020 through a variety of market conditions, and that the Program added value through allocation decisions independent of relative performance.

Mr. Inzunza then began his discussion of the Private Credit Program. He discussed key characteristics of the Program, including target weights, style, benchmarking, risk, and positioning. He discussed relative performance, which has been strong for the Private Credit Program since inception and over all reported periods.

There was some discussion about the cash flow characteristics of the Program, where strong cash distributions have contributed to strong overall returns.

Mr. Inzunza reviewed planned commitments of 2023, which are sized to maintain the overall size of the allocation.

Mr. Maffeo then began a discussion of the Hedge Fund Program. He discussed key characteristics of the Program, including target weights, style, benchmarking, risk, and expenses.

Mr. Maffeo discussed relative performance, which has been strong since inception, and over three- and five-year timeframes. One-year performance has been challenged by exposure to equity long-short strategies.

Mr. Maffeo then discussed the Absolute Return Portfolio. He discussed key characteristics of the Program, including target weights, style, benchmarking, risk, and expenses.

There was some discussion about the benchmark, and if T-bills + 3.5% is an appropriate benchmark. Mr. Maffeo and Mr. Veal noted that the benchmark has some challenges and is under review.

Mr. Maffeo discussed relative performance of the Absolute Return Portfolio, which has been strong since inception, and over three- and five-year timeframes. One-year performance has been challenged by exposure to equity long-short strategies.

Mr. Maffeo notes that risk levels, as measured by volatility, have been below targets. There was some discussion about seeking higher returns by bringing volatility up to the target range.

Mr. Maffeo then discussed the Launchpad Portfolio. He discussed key characteristics of the Program, including target weights, style, benchmarking, risk, and expenses. He discussed relative performance of the Launchpad Portfolio, which has been strong since inception, and over one-, three- and five-year timeframes. Mr. Maffeo reviewed the history of the Launchpad Portfolio, where ERS provides seed capital to emerging hedge fund managers in return for revenue sharing, in a partnership with PAAMCO Prisma.

Mr. Maffeo reviewed the historical composition of the Launchpad Portfolio and its objectives for 2023. There was some discussion about the Program size and Mr. Maffeo mentioned that liquidity constraints add some risk, and he is comfortable with the current fund size.

Mr. Maffeo covered initiatives for the Hedge Fund Program. He discussed addressing a minor underweight to the Absolute Return Portfolio to get the Program to its allocation target of 5%. There was some discussion about adjusting manager hedge ratios. Mr. Maffeo said ERS can adjust exposures by allocating to managers with different risk characteristics.

There was no further discussion.

19. Consideration of Annual Review of Securities Lending Program

Mr. Leighton Shantz, CFA, Managing Director of Credit & Hedge Funds, delivered a brief overview of the purpose and history of the Securities Lending Program. He noted that the Program is unique in its pursuit of risk-adjusted returns.

There was some discussion about the role of the Securities Lending Agent, which is Deutsche Bank. Mr. Shantz explained that the agent receives 10% of the lending revenue, and that the program is subject to strict risk controls around its agent.

Mr. Shantz reviewed the historical revenue composition of the Program and closed by saying that the Program is running smoothly with limited resources and that he recommends no changes.

There was no further discussion.

20. Consideration of Annual Review of Treasury and Trading Programs

Mr. Tom Roberts, CFA, CMT, Managing Director of Treasury & Trading, and Mr. Michael Clements, CMT, Director of Trading, presented on this item.

Mr. Roberts began the presentation with an overview of the Program. He notes that the Rates Program is designed to provide liquidity and capital preservation while earning superior risk-adjusted returns. The Cash Program is designed to meet the operating needs of the system. The Trading Program provides low-cost execution and intelligence on market conditions.

Mr. Roberts noted that the Treasury Program manages approximately \$7 billion and that the Trading Program trades over \$7 billion annually.

Mr. Roberts then discussed key characteristics of the Rates Portfolio, including target weights, style, benchmarking, risk, and expenses. He discussed relative performance of the Rates Portfolio, which have been positive over all reported periods. Mr. Roberts noted that Rates Portfolio risk, measured by tracking error, is below the target range for the Program.

Mr. Roberts discussed allocation of the Rates Portfolio, which is 79% Treasuries, 20% Mortgage Backed Securities, and 1% Commercial Mortgage Backed Securities. He then discussed key characteristics of the Cash Portfolio, including target weights, style, benchmarking, risk, and expenses.

Mr. Roberts discussed relative performance of the Cash Portfolio, which have been positive over one- and five- year time periods, but slightly negative on a three-year basis. He reviewed cash program guidelines and the Liquidity Direct Program, which provides access to higher yielding securities that meet the needs of an institutional cash portfolio.

Mr. Clements then discussed key characteristics of the Trading Program, including its role, objective, and benchmark methodology. He notes that trading volume spiked in 2022 with the Public Equities restructuring, but has since normalized.

Mr. Clements went on to discuss Trading performance versus its benchmark, noting \$32 million in value added from fiscal 2018 through Fiscal Year 2022. There was some discussion about the Program's allocation to cash. Mr. Roberts noted that the Program can allocate to cash, but is constrained by tracking error guidelines. Mr. Veal committed to looking at the maximum cash allocation of 3% at the next Investment Policy Statement review.

There was no further discussion.

21. Reminder Regarding Future Meetings of the Board of Trustees, Investment Advisory Committee, and Audit Committee

The upcoming Fiscal Year 2023 meeting dates are May 17, 2023 and August 23, 2023

**22. 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 3:20 p.m.