

AGENDA ITEM DETAILS

Subject: *Consideration and Annual Review of the 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

A primary role of the Board of Trustees (Board) of the Employees Retirement System of Texas (ERS) is to establish the Investment Policy Statement (IPS). The IPS governs the strategic asset allocation parameters, defines the portfolio construction process, and communicates to investment staff the Board's investment objectives and constraints for managing Trust assets. Chapter VI of the Investment Policy requires staff to recommend to the Investment Advisory Committee (IAC) and Board at least annually any proposed changes to the IPS. The Board last considered the IPS in August 2022, an extensive process that included a large number of updates that resulted the current version.

With this significant review completed for Fiscal Year 2023, the revisions proposed for Fiscal Year 2024 are far less extensive and represent marginal improvements to a policy that NEPC believes is “among the best in the industry” in its current form. Investments Division leadership developed these proposed changes in collaboration with the Executive Office, Investment Compliance, Office of General Counsel, Finance, and Group Benefits. The proposed changes were reviewed with the IAC and NEPC, both of which recommend their adoption.

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

OVERVIEW OF SIGNIFICANT PROPOSED CHANGES:

1. Adoption of a Charter for the Investment Advisory Committee (IAC)

Board initiative; see new Addendum VI and page 6 in the redline version.

Currently the role and functioning of the Investment Advisory Committee (IAC) is not fully defined within the Investment Policy Statement. Having a specific charter for the IAC will provide additional detail and clarity regarding the role of that important body. The proposed version is inserted as Addendum VI of the IPS, with the Asset Class Investment Committee Charter becoming Addendum VII. The proposed IAC Charter is closely modeled after the Asset Class Investment Committee Charter but is also customized to the IAC. It is also proposed that any text in Chapter III: Governance regarding the IAC that is rendered redundant by addition of the IAC Charter also be deleted.

2. Changes to the allocation parameters regarding cash

Investment Advisory Committee recommendation; see pages 13 and 38 of the redline version.

With interest rates on cash in the US having risen to well above 5%, IAC members have recommended revisiting the strategic asset allocation parameters associated with cash with the aim of increasing return and reducing risk. To address that, the following policy updates are proposed:

- Increase the maximum potential allocation to cash within the ERS Trust from 3% to 5%. Such action would not change the expected risk/return profile of the Trust, but would provide additional scope to generate income and preserve capital during weak market conditions.
- Increase the target allocation to Cash & Equivalents within the Insurance & Benefits Fund (IBF) within the Group Benefits Program from 30% to 50%, with the difference equally taken from Rates and Public Credit as shown below. High inflation, rising interest rates and rapidly rising levels of government debt have caused the volatility of US Treasuries to increase significantly in recent years. This proposed revision would improve the expected risk/return profile of the IBF by roughly 40% while keeping the level of return well above 5%.

	Target Allocation			Expected Performance		
	Cash	Rates	Public Credit	Return	Risk	Risk/Return
Current	30%	50%	20%	5.55%	3.8%	1.46
Proposed	50%	40%	10%	5.33%	2.6%	2.04
Change	+20%	-10%	-10%	-4%	-31%	+40%

- Align Table 2 with Table 4, which indicates that the Cash asset class includes Cash Equivalents such as money market funds, to reflect current practice.

3. Revisions to the Code of Ethics to categorize Restricted Persons into two categories

ERS Investment Compliance Recommendation; see pages 28-30 of the redline version.

This update would categorize Restricted Persons for compliance purposes according to their access and proximity to ERS investment trading information. Those with greater levels of access and proximity would be designated Restriction Persons I while those with less access would be designated Restricted Persons II. All Restricted Persons shall submit a quarterly affirmation of compliance with the Code of Ethics, but the Insider Trading and Confidentiality Policy would not apply to Restricted Persons II. This would treat Restricted Persons II similarly to ERS Trustees and IAC members.

4. Addition of language regarding the statutory duty of diversification

ERS Investment staff recommendation; see page 2 of the redline version.

The Texas Uniform Prudent Investor Act establishes fiduciary standards for the management of investment trusts broadly and Texas Government Code § 815.307 applies to ERS specifically. These statutes require a trustee to:

- Evaluate investment and management decisions as part of an overall investment strategy having risk and return objectives reasonably suited to the trust.
- Exercise its duty of care by considering all investments of the trust as a whole and not by considering the prudence of a single investment in isolation.

Since the Board has determined that no such circumstances currently exist with respect to the Trust, and since the Trust is required to balance long-term growth with the need to make significant distributions consistently, a diversified portfolio shall be maintained.

5. Provide additional detail regarding the roles of investment consultants

ERS Investment staff recommendation; see page 8 of the redline version.

Staff believes that further delineating the specific roles and responsibilities that consultants fulfill within the ERS investment program will support the goal of having best-in-class governance. The proposed language also makes a clearer distinction between the role of the general investment consultant and the asset class consultants. Staff believes that having this additional policy language will also be supportive of the RFQ process for investment consultants that will kick off during Fiscal Year 2024.

OVERVIEW OF MINOR PROPOSED CHANGES:

1. Provide additional clarity on benchmarking approach

ERS Investment staff recommendation; see pages 9 and 18-23 of the redline version.

This proposed language makes an important distinction between:

- Strategic benchmarks, which are set by the Board and used to monitor performance of the Trust overall and its constituent asset classes, and
- Implementation benchmarks, which are set by staff with oversight from the Executive Director and consultant and used to monitor performance of individual investment strategies.

The proposed edits also add reference indices for several private market asset classes to provide measures of performance that supplement the existing strategic benchmarks.

2. Revise governance tables to clarify key responsibilities

NEPC recommendation; see page 11 of the redline version.

In Table 2 (Implementation Level Investment Responsibilities) of Section A in IPS Chapter III, NEPC recommends adding a fourth value of “Responsible for Implementation” for each responsibility to the three existing values in the matrix. The result, if incorporated, yields an updated Table 2 that assigns each stakeholder one of the four existing responsibility values. Since the responsibilities of the CIO and Investment staff are often different, having separate columns would be useful in assigning responsibilities.

3. Add specific prohibition on the advancement of social, political or ideological agendas

ERS Investment staff recommendation; see pages 2 and 8 of the redline version as well as page 3 of Addendum I.

The policy is already clear that investment decisions at ERS are to be made based on financial factors only, and the addition of this language would serve to emphasize this direction further.

4. Delete obsolete language regarding Texas Government Code § 572.054

Office of General Counsel recommendation; see pages 33-34 of the redline version.

This section of Texas law includes requirements related to Personal Financial Disclosure, Standards of Conduct and Conflicts of Interest that apply to certain state appointed officers and state employees. However, the statute applies only to regulatory agencies and not to ERS. As such, these references should be deleted from the document.

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 23, 2023 Joint Meeting of the Board and IAC
2. Exhibit B — Redline version of Draft Investment Policy Statement Proposed for August 23, 2023 Joint Meeting of the Board and IAC
3. Exhibit C — Current version of Investment Implementation Plan dated August 8, 2023
4. Slides — Proposed Updates to ERS Investment Policy Statement