AGENDA ITEM DETAILS

Subject: *Consideration of Annual Review of Capital Market Assumptions

BACKGROUND

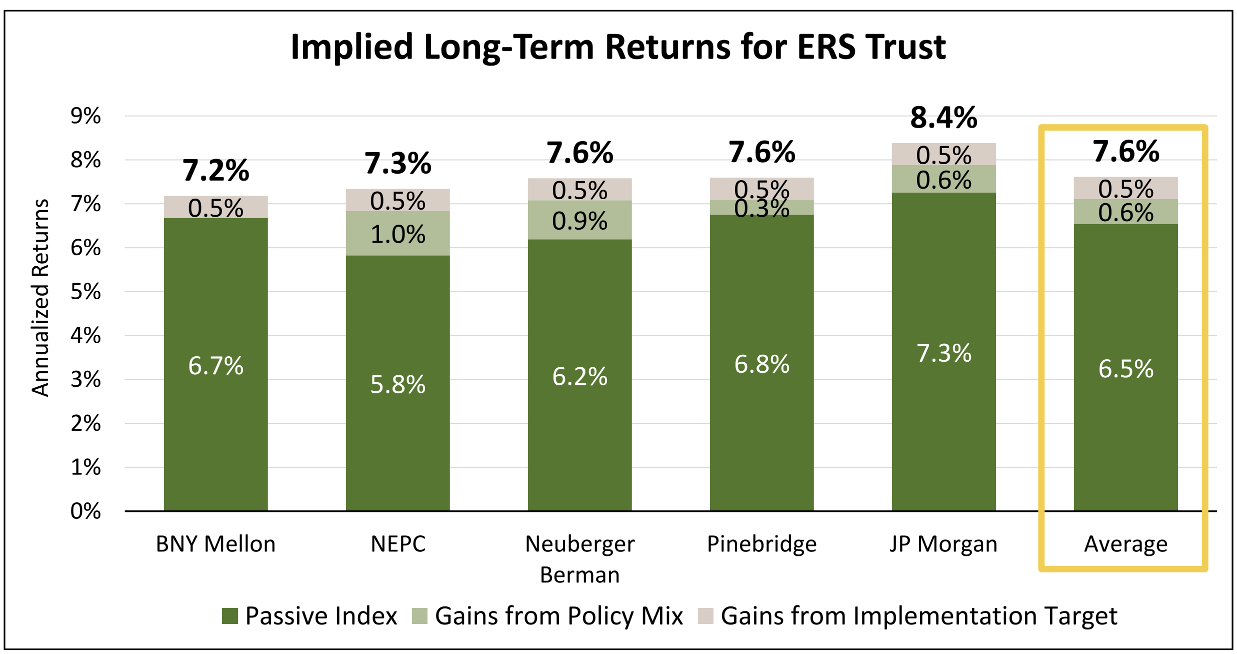
The purpose of this educational agenda item is to provide members of the Board and Investment Advisory Committee insight into capital market conditions and long-term investment trends that could affect the assumptions and outcomes associated with the ERS investment program.

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 ERS' general investment consultant, NEPC, and other well-regarded firms with expertise in these areas.

A significant rise in interest rates during 2022 led to broad declines for stock and bond markets, which caused expected returns to increase significantly during 2023. That improvement bucked a decade-long trend of declining expected returns for most major asset classes. For 2024, however, expected returns have remained comparatively stable. Economic growth has remained resilient and inflation has moderated, improving the outlooks for most asset types throughout the year. Higher expected yields, coupled with the unwinding of policy dislocations that followed, has increased the potential for investment returns in the years to come.

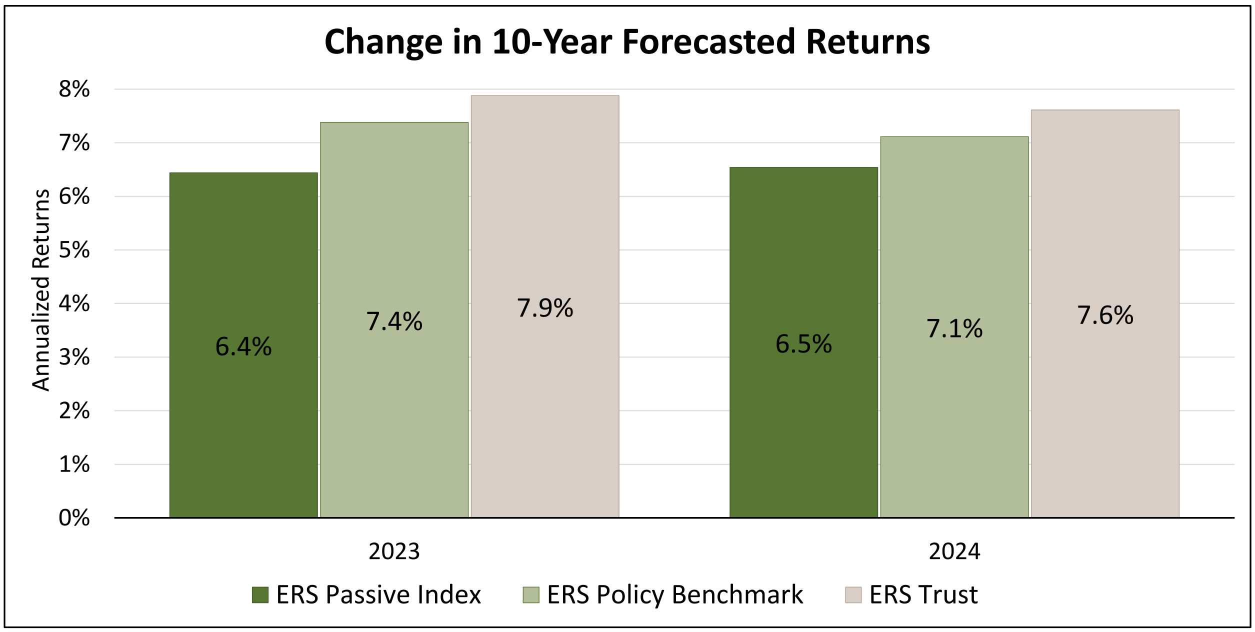
Staff mapped the Strategic Asset Allocation (SAA) parameters of the ERS Trust onto 2024 CMAs from five well-regarded investment firms (NEPC, BNY Mellon, JP Morgan, Neuberger Berman, and Pine Bridge). This analysis produced several key insights that are relevant to the ERS investment program:



- **ERS Passive Index:** applying these CMAs to a portfolio comprised 80% of stocks and bonds, suggests an average annual expected return of 6.5% for the medium term. This figure falls short of the actuarially assumed return for ERS, which underscores the importance of continuing to diversify the Trust via a broad range of asset classes with complementary performance profiles.

- **ERS Policy Benchmark:** applying these CMAs to a passive implementation of the target allocation for the ERS Trust adds 60 basis points to produce an average expected return of 7.1%. This figure exceeds the actuarially assumed return for ERS and includes a reduction in volatility of 170 basis points, both of which are attributable to increased diversification.

- **ERS Trust:** assuming the Trust continues to earn levels of excess returns that are consistent with the Investment division's strategic plan and historical experience results in an average annual expected return of 7.6%. This figure represents a decrease of 30 bps from the 7.9% return implied by this analysis one year ago, but exceeds the actuarially assumed return for ERS. The reduction relative to 2023 is largely attributable to lower expected returns for Private Equity and Credit.



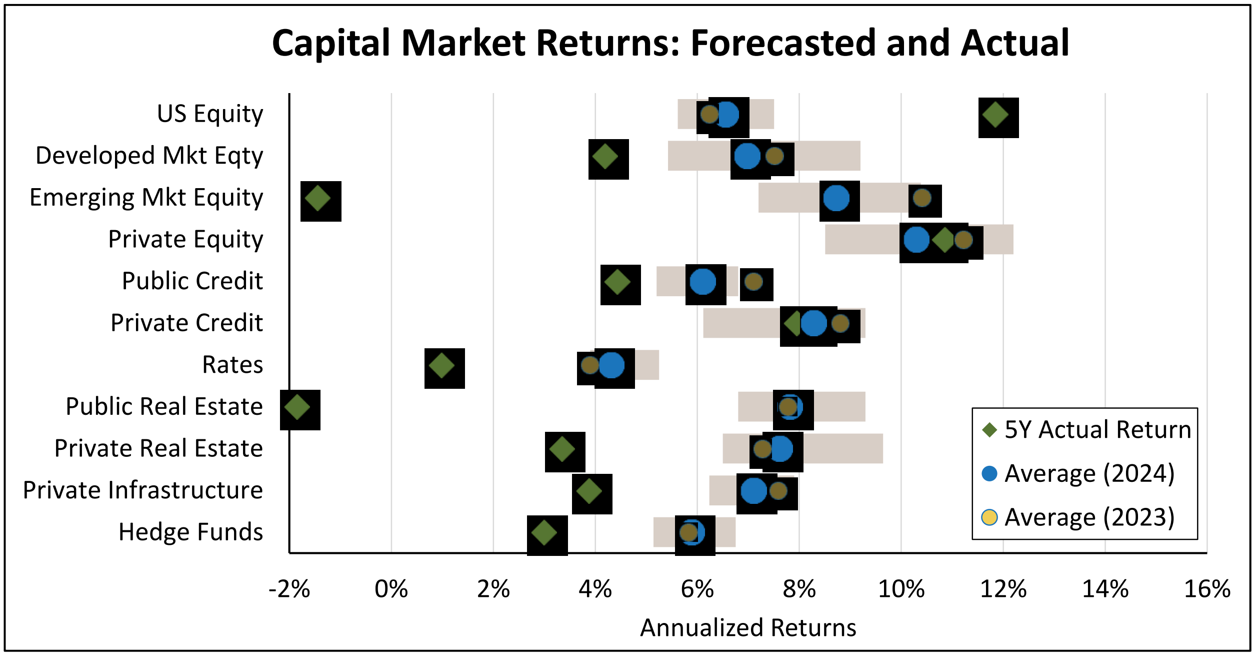
In aggregate, the 10-year expected returns for diversified portfolios are similar to those projected in 2023, though the underlying composition and drivers of performance reflect some nuanced shifts.

- As in years past, equity market returns are forecast highest in emerging markets (EM) and lowest in the U.S. However, the spread between regions has narrowed substantially, with expected returns in EM falling 170 basis points (bps) to 8.7% and increasing 35 bps to 6.6% in the U.S. Developed market (DM) equity returns fell 50 bps to 7.0%.

- Private Equity retains the highest expected return across all assets, though this level decreased 90 bps to 10.3% due largely to declining deal flow and rising levels of uncalled capital. Prudent operational improvements and creative deal structures are expected to continue to generate excess value relative to public markets, albeit with a wide dispersion of returns that highlights the importance of manager selection within the asset class.

- Expectations for a higher risk-free rate of return results in a higher baseline return expectation across asset classes. Risk premiums for diversified portfolios above that rate are seen falling back towards long-term averages of 4-5%.

- Correlations among assets continued to rise in 2023, although a range of outcomes exists among firms. Even so, the aggregate 10-year expectations suggest a return to more ordinary market conditions under which market risk 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:

- **Impacts of an Aging Population:** In nearly all major economies, people continue to live longer despite a short, pandemic-driven reversal in recent years. U.S. life expectancy increased from age 70 in 1960 to 77 by 2020. Together with decreasing fertility rates, which have fallen globally from 2-6 births per female to 1-2 over the same period, this aging trend suggests a focus on sectors such as healthcare, technology, and energy that are poised to benefit from or remain resilient to such demographic changes. Moreover, increased household savings for longer retirements and a growing preference for fixed-income investments could reshape market dynamics, influencing interest rates and investment returns. Addressing this challenge effectively requires a comprehensive understanding of the demographic trends and their profound implications on economic growth, consumer behavior, and the broader financial landscape.

- **Heightened Geopolitical Risk:** Two years after the initial Russian invasion of Ukraine, the conflict is mired in a drawn-out struggle that continues to exert macroeconomic and policy forces on the global investment landscape. In the Middle East, tensions have intensified after the Hamas attack on Israel and the response by Israel to invade the Gaza Strip. An expansion of the conflict more widely across the Middle East that draws NATO, the U.S. and other nations would have significant investment implications. Historically, geopolitics have a short-lived market impact, but a 2024 global election "supercycle" increases the likelihood of volatility around surprise events and election outcomes.

- **Expanding Role of Governments:** The shift from a hands-off economic approach to increased government intervention in developed nations marks a significant change in policy direction after the 2008 global financial crisis and the pandemic. This resurgence of industrial policy and state intervention underscores the importance of evaluating such policies based on their design, sustainability, and the political will to implement them. While this shift may boost industries related to the real economy and certain technology sectors, it also raises concerns about inflation, economic uncertainty, and capital costs. Indeed, government debt levels, as well as the cost to service these debts, are at their highest levels globally. The evolving landscape suggests a reevaluation of winners and losers in the market, necessitating adaptability from companies and investors to navigate the new dynamics of state-influenced economic and social priorities.

- **Artificial Intelligence (AI):** AI is reshaping the investment landscape across multiple sectors, offering both opportunities and challenges. In financial services, AI facilitates sophisticated algorithmic trading and personalized banking, while in healthcare, it accelerates drug discovery and enables personalized medicine. The technology sector benefits from AI-driven demand in cloud computing and semiconductors, whereas the automotive industry sees advancements in autonomous vehicles. AI's impact extends to energy, optimizing smart grids and exploration activities, and to retail, enhancing personalized shopping experiences and inventory management. For investors, this evolution presents sector-specific opportunities, especially in companies at the forefront of AI integration. However, it also demands vigilance over risks such as regulatory changes and market disruptions, underscoring the importance of diversification and staying informed about technological and regulatory developments.

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 and asset allocation.

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

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ATTACHMENTS:

1. Slides –Presentation on Capital Market Assumptions