

Public Agenda Item #15

**Consideration of Investment Practices Review*

March 20, 2024

Sam Austin, Partner, NEPC



2024 IPPE REPORT SUMMARY

EMPLOYEES RETIREMENT
SYSTEM OF TEXAS

MARCH 2024

Sam Austin, Partner



REQUIREMENTS & SCOPE OF EVALUATION

Pursuant to Section 802.109 of Texas Government Code, NEPC has been engaged by the Employees Retirement System of Texas to conduct an independent evaluation of the appropriateness, adequacy and effectiveness of ERS' investment policies and practices. The 2024 Investment Practices and Performance Evaluation (IPPE) report for ERS Texas covers five Evaluation Topics recommended for review by the Texas Pension Review Board:

- A review of the retirement system's governance processes related to investment activities;
- An analysis of any investment policy or strategic investment plan adopted by the retirement system;
- A detailed review of the retirement system's investment asset allocation;
- A review of the retirement system's investment manager selection and monitoring process; and
- A review of the appropriateness of investment fees and commissions

TIMELINE FOR COMPLETING EVALUATION

January 24, 2023 - Initial Meeting for ERS Texas Staff and NEPC to discuss scope of Evaluation and required source documents

March 24, 2023 - ERS Texas delivers substantially all source documents to NEPC

May 18, 2023 - Four NEPC Evaluators conduct on-site interviews with 20 ERS Staff professionals

October 11, 2023 - NEPC Director of HR conducts phone interviews with ERS Texas Head of HR and ICP Program Director

February 22, 2024 – NEPC submits substantially-complete IPPE report to ERS Staff

March 20, 2024 – NEPC presents executive summary of IPPE report to ERS Board

April 1, 2024 - Target date for ERS review and comment

May 1, 2024 - Final IPPE Report is due to ERS

June 1, 2024 - Final Report is submitted to Texas Pension Review Board

EVALUATION METHODOLOGY

- NEPC reviewed more than 40 source documents from ERS Texas as well as guidance from the Texas Pension Review Board.
- Interviews were conducted with 22 leaders within the ERS Texas staff.
- NEPC compared ERS investment policies and practices with the equivalent policies and procedures at 17 institutional investors identified by ERS as peer investors.
- ERS Texas policies and practices were compared with industry standards articulated by GASB, ASB, APPFA, CFA Institute and GFOA.
- ERS Texas policies and procedures were compared against those of NEPC's 70 other public fund clients, representing \$775 billion of assets under advisement.
- The 2024 IPPE report covers the fiscal year ending August 31, 2023, unless otherwise specified.

EXECUTIVE SUMMARY

Overview of Findings

NEPC finds ERS' policies, procedures and practices to be appropriate, adequate and effective when compared to industry prevailing practice.

Overview of Recommendations

NEPC found that ERS Texas took significant steps over the last four years toward addressing the eight recommendations identified in the 2020 Investment Policies and Practices Evaluation. The 2024 IPPE report recommends seven non-critical actions ERS Texas could undertake which can mitigate potential impediments to efficiency and optimal investment results.

2024 RECOMMENDATIONS

1. **ERS Texas should continue to develop innovative policies focused on recruiting, compensation, quality-of-work-environment, and career development to secure and retain investment talent.**

- The ability to hire, retain and offer competitive compensation to investment professionals is a key requirement for achieving the Trust's investment objectives with optimal efficiency.
- ERS is competing with private sector employers and other public pension plans that may be larger.
- Perceived advantages in lifestyle and cost of living in Austin, Texas have faded as housing costs have risen dramatically and remote work options have proliferated.
- Several asset class directors mentioned that they have lost key personnel or been unable to fill needed positions in the last two years.
- Technology issues and travel policies were also mentioned by Staff as a quality-of-work-environment hindrance to efficient due diligence visits with asset managers.

2024 RECOMMENDATIONS

2. To the extent permitted under Texas Law, ERS should seek statutory procurement flexibility similar to that applicable to other large Texas public funds among the peer group.

- Current RFP process can take up to a year to complete.
- Successful achievement of procurement flexibility will give ERS additional operational flexibility when there is a need to quickly replace a struggling investment manager or take prompt advantage of an opportunistic investment.

2024 RECOMMENDATIONS

3. ERS should periodically re-evaluate the most useful fee benchmarks and universes of manager data when reporting on manager fees.

- There can be a wide range of variation between median fees reported by various databases of manager data.
- Fee comparisons are subject to several important biases including investment strategy bias (the extent to which strategies in the ERS portfolio are different than the universe data) and scale bias (the extent to which an investor may be able to negotiate fees based on their size);
- It is particularly important to re-evaluate every few years the breadth of data and the methodology used by private market universes of manager fees.

2024 RECOMMENDATIONS

4. ERS Texas should also periodically re-evaluate the current practice of bundling the cost of research with total trade costs.

- While permissible in the current regulatory environment, a growing number of Public Funds no longer use a soft dollar program.
- NEPC acknowledges that ERS considered this same recommendation in the 2020 IPPE report and decided not to make a change because Staff strongly believes the current practice is best suited for the Trust.
- ERS Texas has an understandably larger appetite for research than most public funds given the Trust's larger percentage of assets under internal active management in comparison with peers.
- As a practical matter, NEPC acknowledges that paying for research directly can be a challenge in an unbundled environment.

2024 RECOMMENDATIONS

5. NEPC recommends regular review of asset class benchmarks.

- This is particularly important for asset classes like private markets and hedge funds that, by their nature, do not have benchmarks that meet the investable and reflective characteristics of CFA Institute's SAMURAI model. For these asset classes, there is no perfect benchmark.
- Therefore, it is reasonable to periodically assess the appropriateness of other existing benchmark options in wide use by peer institutions and to evaluate new benchmarks that are being developed.

2024 RECOMMENDATIONS

6. ERS should consider establishing a more rigorous manager monitoring process.

- A more robust, systematic methodology can be useful in evaluating investment strategies that are not performing as expected.
- Pursuing a more rigorous manager monitoring process can be a useful tool in the decision of how long to stay with a strategy that is struggling.
- It is important to distinguish between poor performance because of style drift or loss of key investment personnel (which should trigger an immediate re-evaluation) versus poor performance while the manager is consistently executing on the role for which they were added to the portfolio.

2024 RECOMMENDATIONS

7. Improvements to the SOPs for Investment Compliance and automation of the personal account monitoring function should be considered.

- The Evaluation takes note that the ERS Texas Investment Compliance team currently has only one full-time dedicated member.
- NEPC recommends that existing processes for the Investment Compliance function can be better codified and enhanced to the level of documentation in other ERS Standard Operating Procedures.
- This review notes that a transition to automation for personal account trade monitoring, and heavy manual processes, was under consideration by the end of 2023.

Discussion