AGENDA ITEM DETAILS

Subject: *Consideration of Quarterly Report from Chief Investment Officer

Background

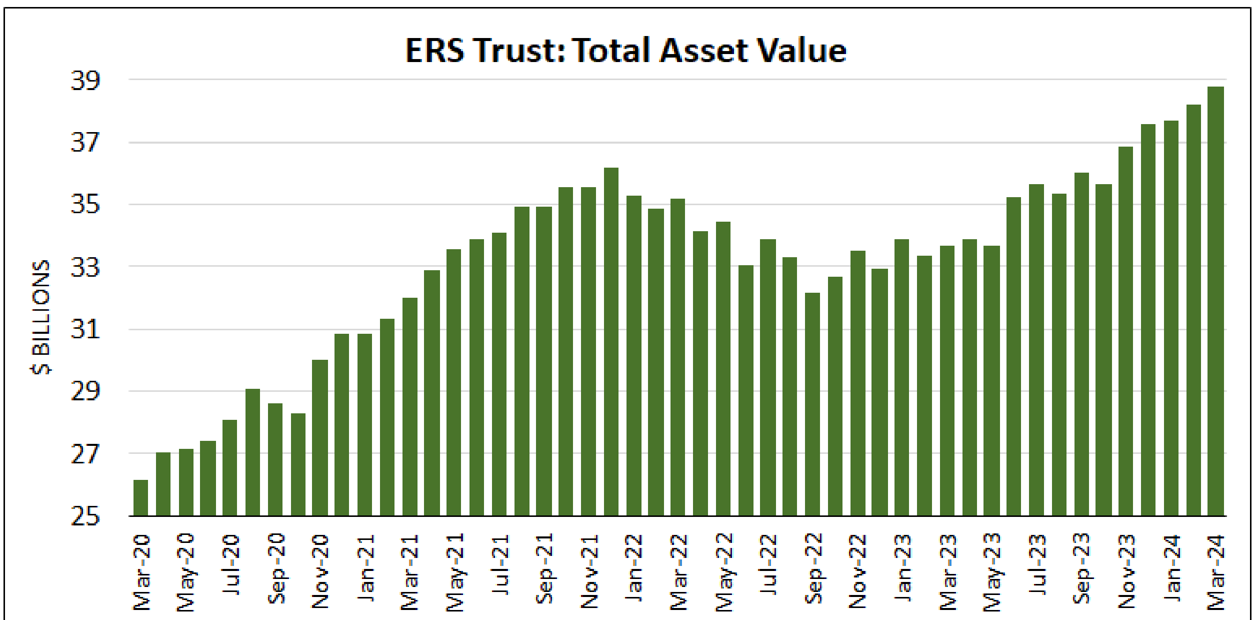
As required by the ERS Investment Policy Statement (IPS), this agenda item provides a report from the Chief Investment Officer regarding the performance of Trust investments (the Trust). Unless otherwise specified, the figures cited here represent annualized returns net of external investment expenses for pension fund investments as of March 31, 2024, as reported by the custodian.

Investment Objective

The overall objective of the investment program is to invest prudently in securities at a reasonable and predictable cost to deliver performance that supports the current and future provision of earned benefits for beneficiaries of the Trust funds managed by the System. To that end, the IPS specifies the following performance objectives for the Trust: (1) obtain returns in excess of the adopted benchmark or the stated return objective, and (2) achieve returns commensurate with the amount of active risk assumed. Performance is to be measured primarily over rolling five-year periods net of investment expenses.

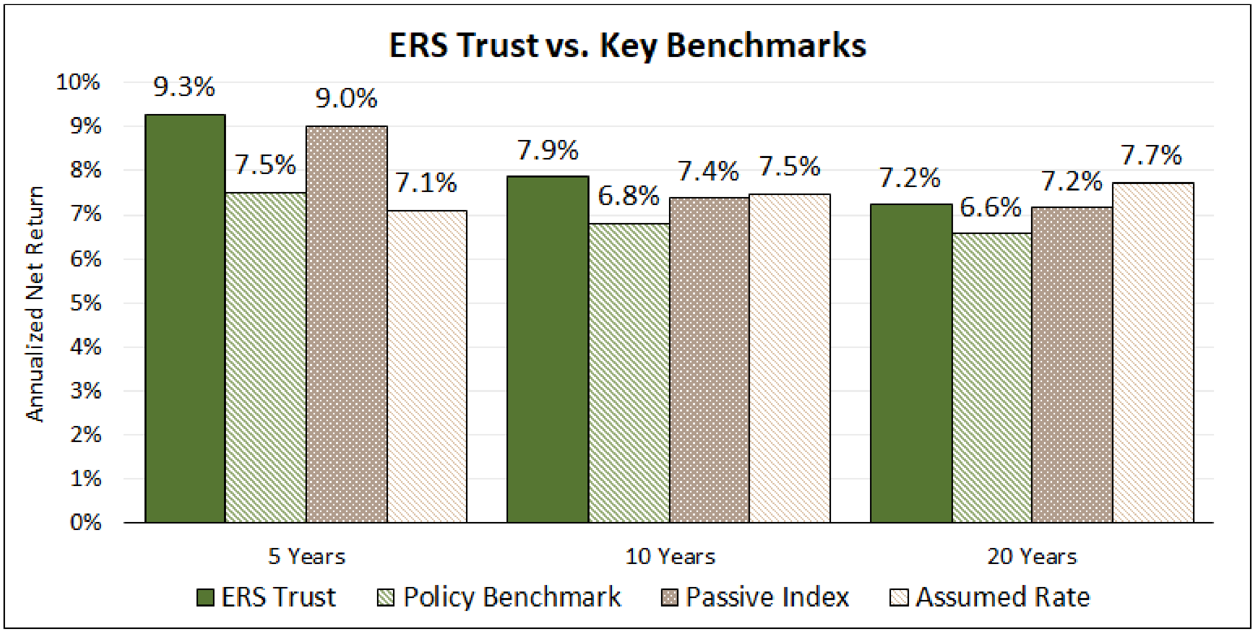
Investment Performance

The total value of the Trust has climbed from $33.2 billion at the end of 2022 to more than $38 billion at the end of the first quarter 2024. The increase was due to strong underlying investment returns and more than $2 billion appropriated by the Texas Legislature to the ERS retirement plans.



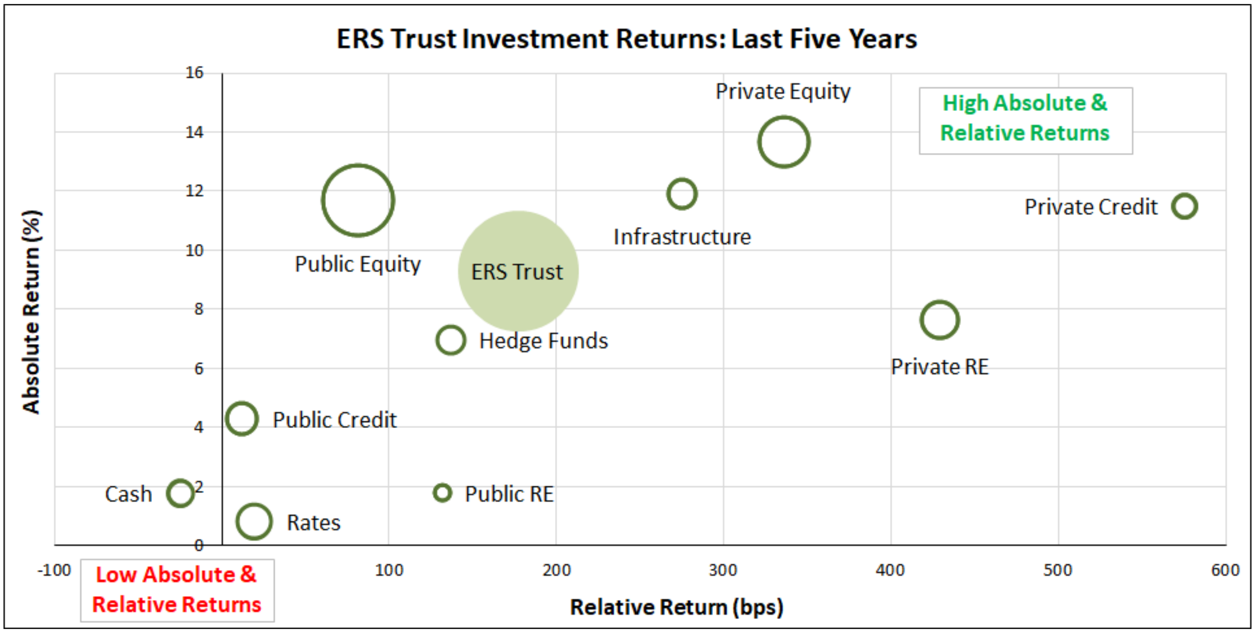
As shown in the chart below, Trust investments continue to fulfill their purpose well. For the trailing five years, which the Board has designated as its primary horizon in policy, the Trust returned an average of

+9.3% annually. This figure is +177 basis points above the Policy Benchmark, which represents almost $3.5 billion of value added cumulatively over that time. It is also +25 basis points better than the Passive Index (i.e., an 80/20 mix of global stocks and domestic bonds) and +217 basis points above the Assumed Rate of Return (i.e., the rate of return expected over the long-term to provide for earned benefits).

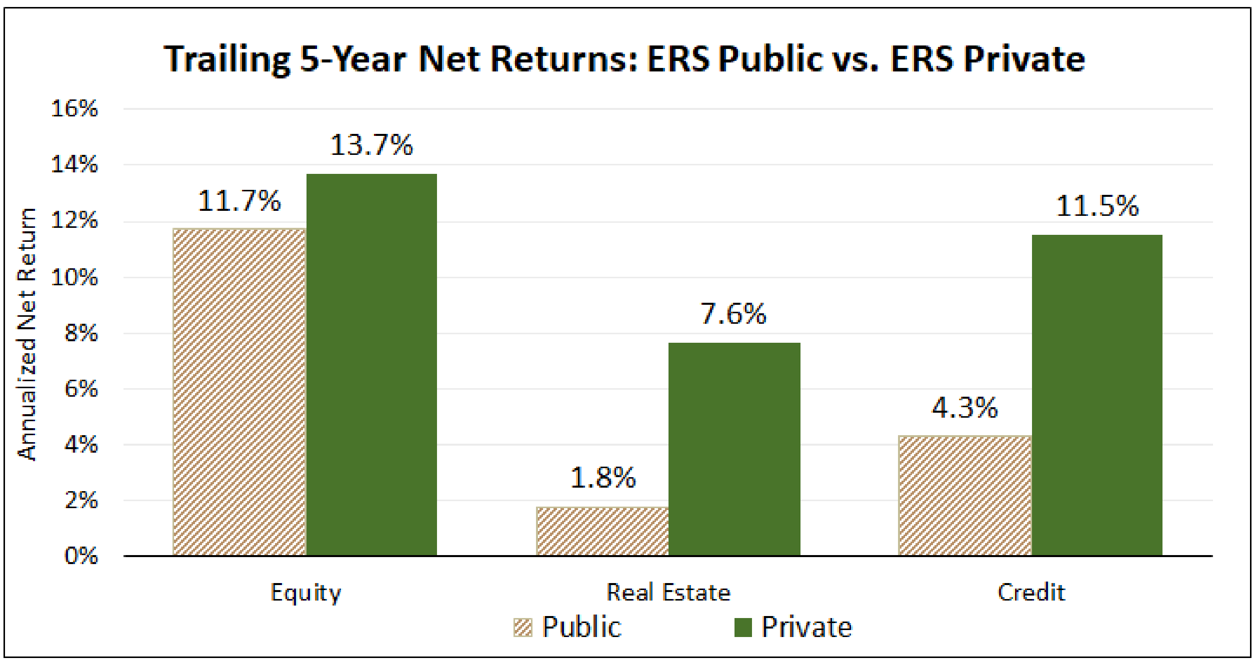


Over longer horizons, the Trust has outperformed the Policy Benchmark by +104 bps annually over the last 10 years and +68 bps over the last 20 years, adding billions of dollars of incremental funding to the Trust. Over the last 20 years, the Trust has outperformed the Policy Benchmark by +68 bps annually.

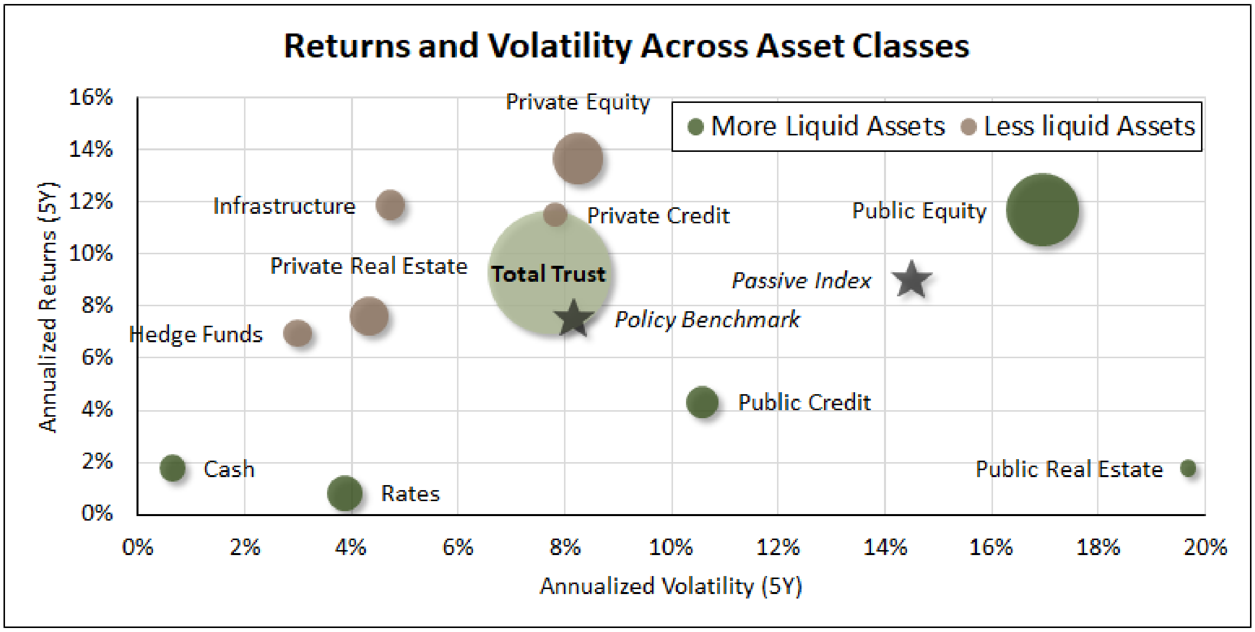
During the last five years, all of the policy asset classes, except Cash, have contributed meaningfully to the absolute and relative returns of the Trust. The chart below depicts the relative returns of various asset classes on the horizontal axis and their absolute returns on the vertical axis, such that the best performance is denoted by bubbles that are in the upper right hand quadrant. Private Equity has delivered the highest absolute performance (averaging +13.7% annually) in part by adding 336 basis points over its benchmark. Private Credit and Infrastructure have also been standout performers. Public Equity has improved meaningfully in recent years to add +81 basis points versus its benchmark over the last five years, which with roughly one-third of Trust assets has been significant to performance overall.



Over a five-year horizon, the ERS Private Equity portfolio has outperformed the Public Equity portfolio by an average of 2.0% annually, with both asset classes providing strong returns. In comparison, Private Real Estate outperformed Public Real Estate by 5.8% annually, with the latter having returned an average of only 1.8% annually during this period. Likewise, Private Credit outperformed Public Credit by 7.2%, with the latter having returned only 4.3% on average during this period.

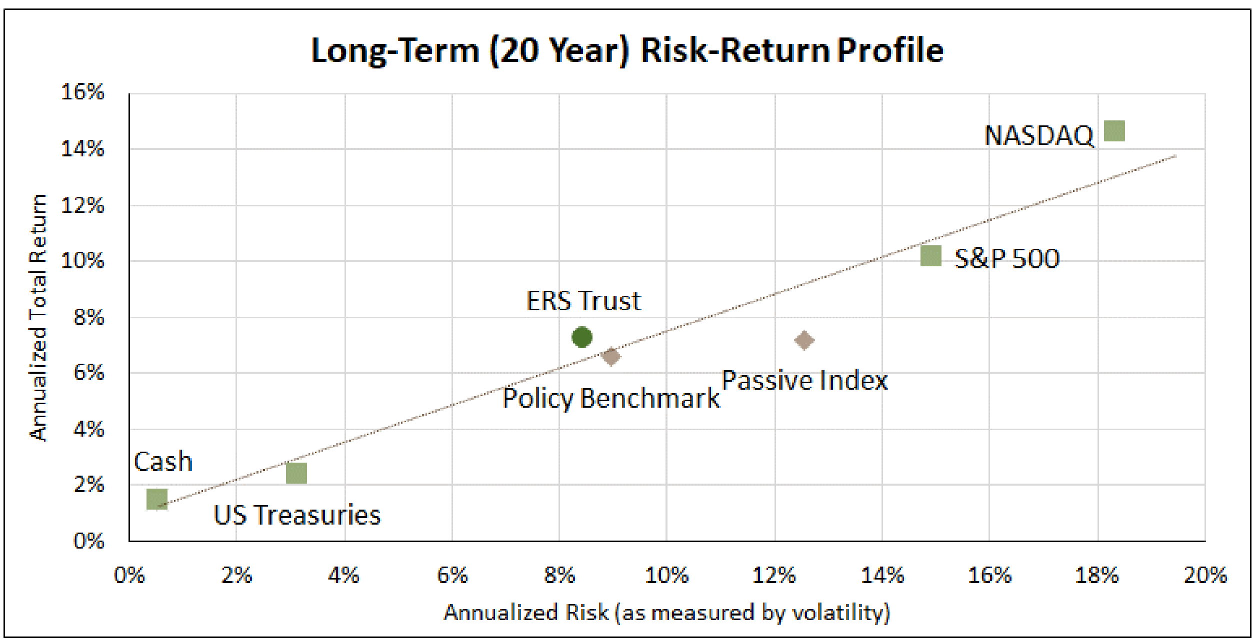


The chart below plots the annualized return and volatility for the Trust, its underlying asset classes, and both the Policy Benchmark and Passive Index for the trailing five-year period. Over the period, private market assets provided higher returns broadly but at a lower level of realized volatility due to the smoothing effects of less frequent valuations. In aggregate, that leads to a lower level of measured volatility for the composite Policy Benchmark relative to the Passive Index.



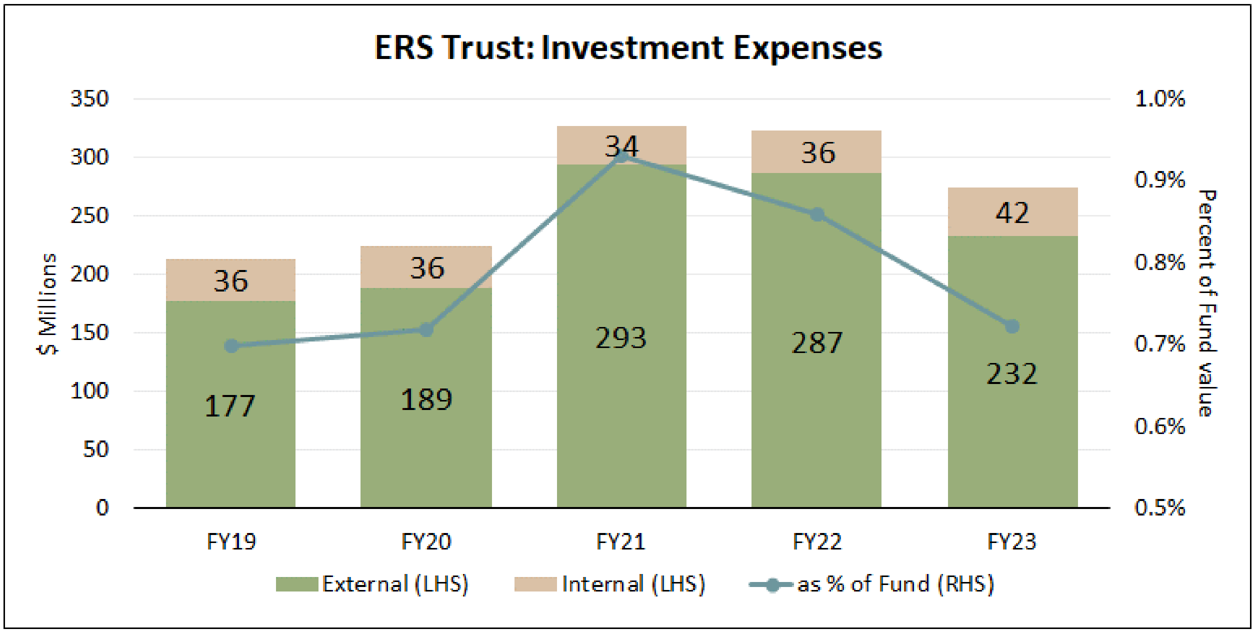
The reductions in volatility are notable in the private asset classes, particularly for real estate where it approaches 75-80%. In comparison, the reduction in volatility within the Private Equity portfolio is around 50% and within the Private Credit portfolio it is around 25%.

This analysis can be extended to longer time horizons to compare asset allocation decisions. The chart shows that the Trust has fulfilled its purpose well over this period, delivering good returns at an acceptable level of volatility.

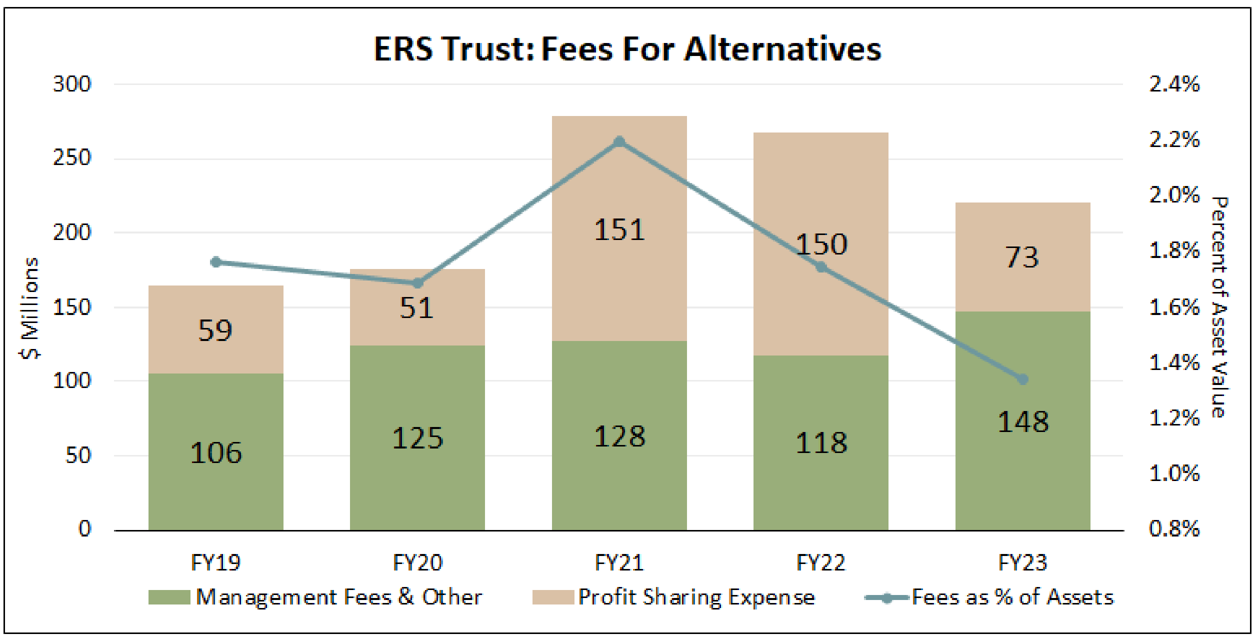


Investment Expenses

In recent years, investment expenses as a percent of Trust assets have remained between 70 and 90 basis points (i.e., 0.7-0.9%) of average Trust assets. During fiscal year 2023, these expenses totaled $274 million, of which 85% was associated with external management. When private market portfolios increase in value, as they did in 2021 and 2022, the associated expenses increase because of the profit sharing aspect of many fee arrangements. During fiscal year 2023, investment expenses declined to 72 basis points of average Trust assets, closer to the pre-pandemic average.



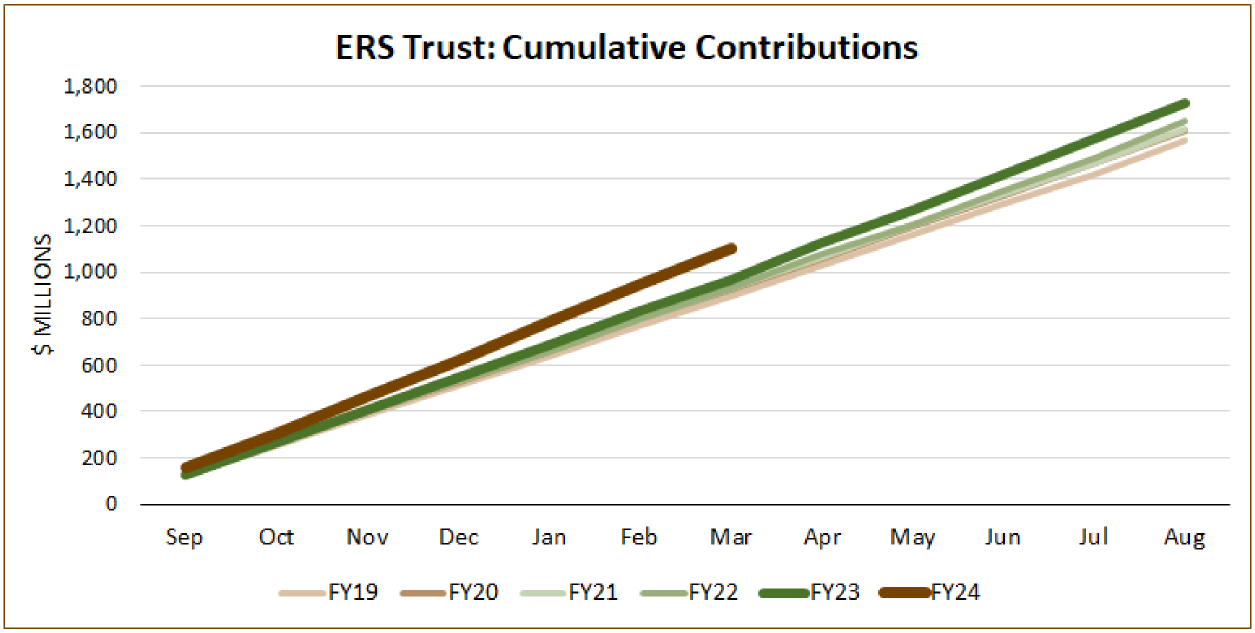
Similarly, investment expenses within private markets have historically ranged from 150-200 basis points of the associated assets. Exceptionally strong returns for private markets strategies during FY21 significantly increased the amount of profit share expense and caused this expense figure to rise above 250 basis points of the associated assets.



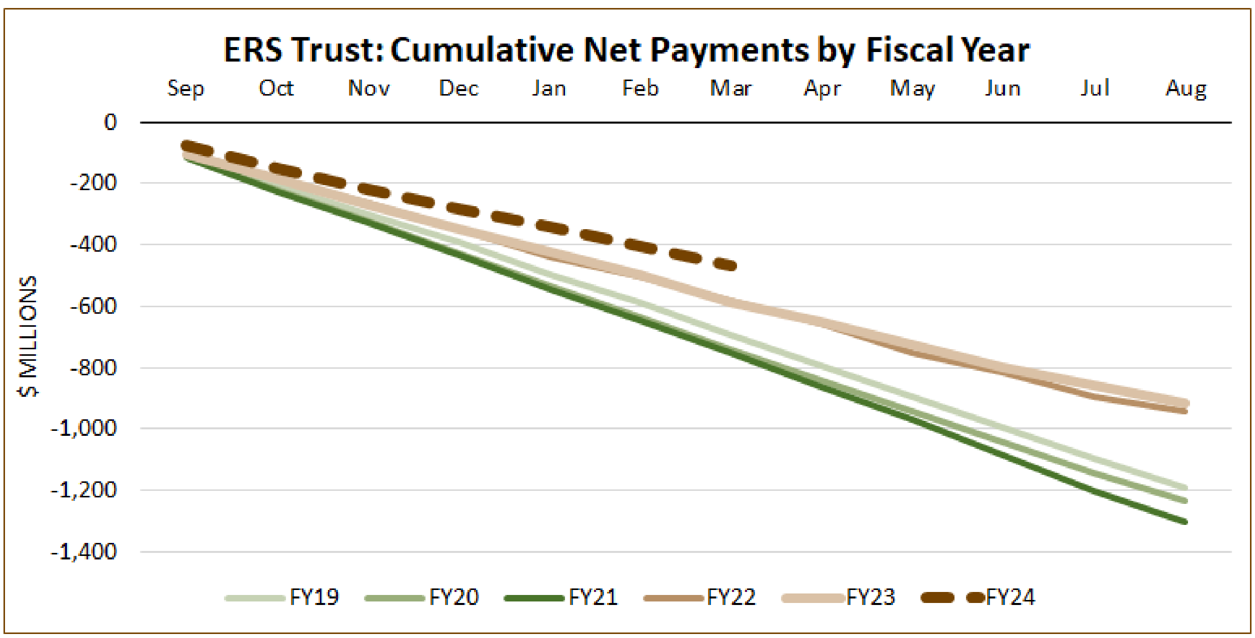
Since then, however, moderating returns within private markets have caused overall fee levels to decrease, reaching $221 million in FY23. This figure represents a significant decrease to 134 basis points of average assets, the lowest level in recent years.

Liquidity Profile

Based on data for fiscal year 2024 to date, the cash flow profile of the Trust continues to evolve favorably as compared to prior years. Recent improvements have been driven by significant increases in the level of contributions from employers and employees to the Trust. As shown in the chart below, these inflows have totaled $1,105 million for fiscal year 2024 to date. This figure represents an increase in such contributions of more than 14% over the same level a year ago, while distributions from the Trust have increased slightly less than 1%.



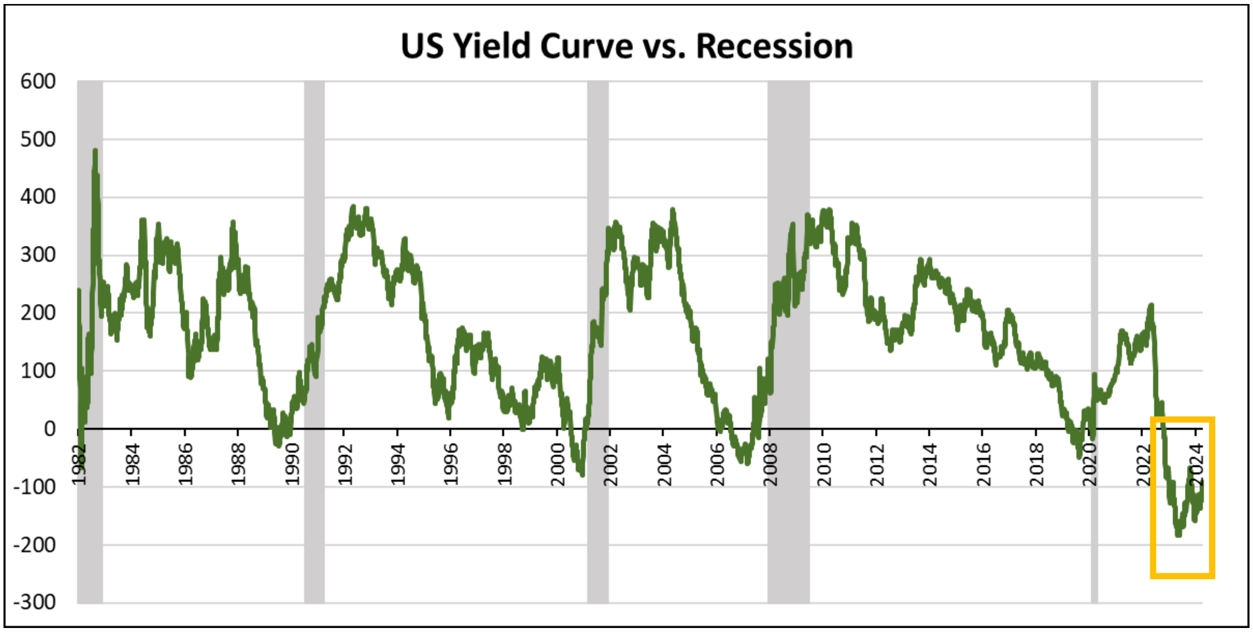
As a result of this meaningful increase in contributions, the liquidity profile of the Trust looks to have improved significantly as compared to prior years. The Trust has paid out $1,869 million of distributions to beneficiaries and received $1,105 million of contributions from employers and employees, resulting in $764 million of net payments to beneficiaries. This figure is materially below the $882 million average for the two prior fiscal years at the same point in the year and just above the $728 million average for the three prior years.



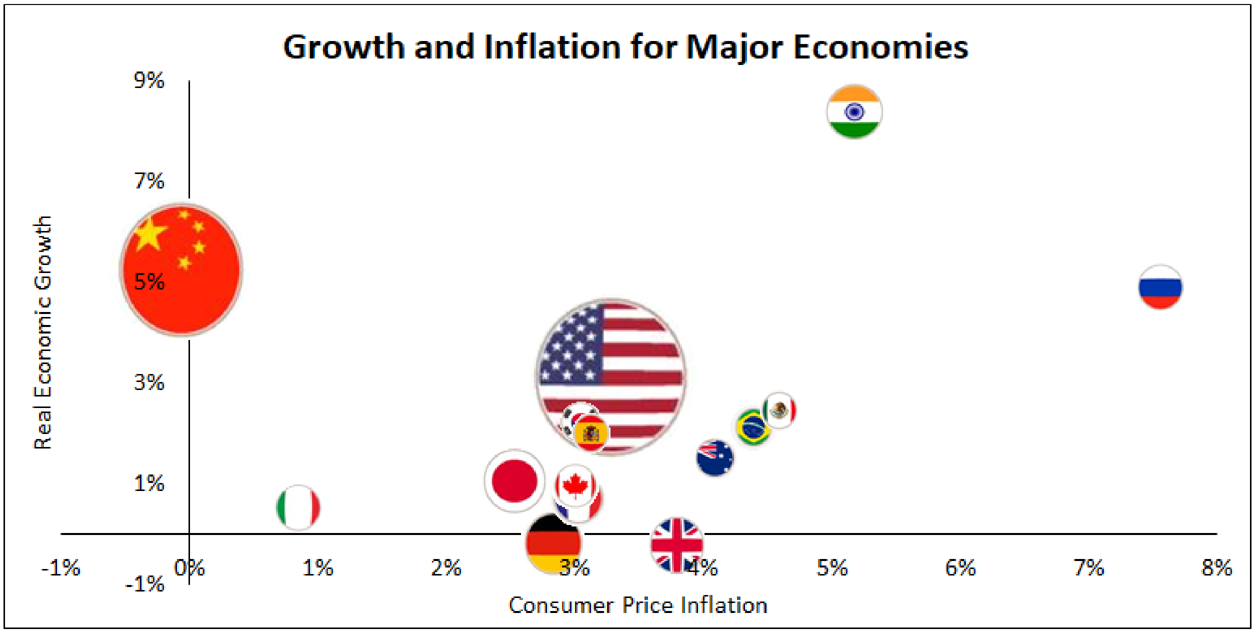
Better still, accounting for the $510 million annual legacy payments from the State of Texas on a monthly prorated basis puts the year-to-date outflows at only $466 million. This figure suggests that the full year liqudity needs will be only around $800 million, which is slightly more than 2% of the Trust. The increase in contributions and the advent of annual legacy payments have reduced the net outflows of the Trust by 40%, compared to Fiscal Year 2021 when this amount totaled $1.3 billion. This development is positive for the Trust in the medium term in that fewer assets must be sold each year to fund ongoing benefit payments, allowing for greater compounding of those assets. If these trends are sustained, the Trust could manage with a less liquid portfolio since the outflows are lower.

Investment Outlook

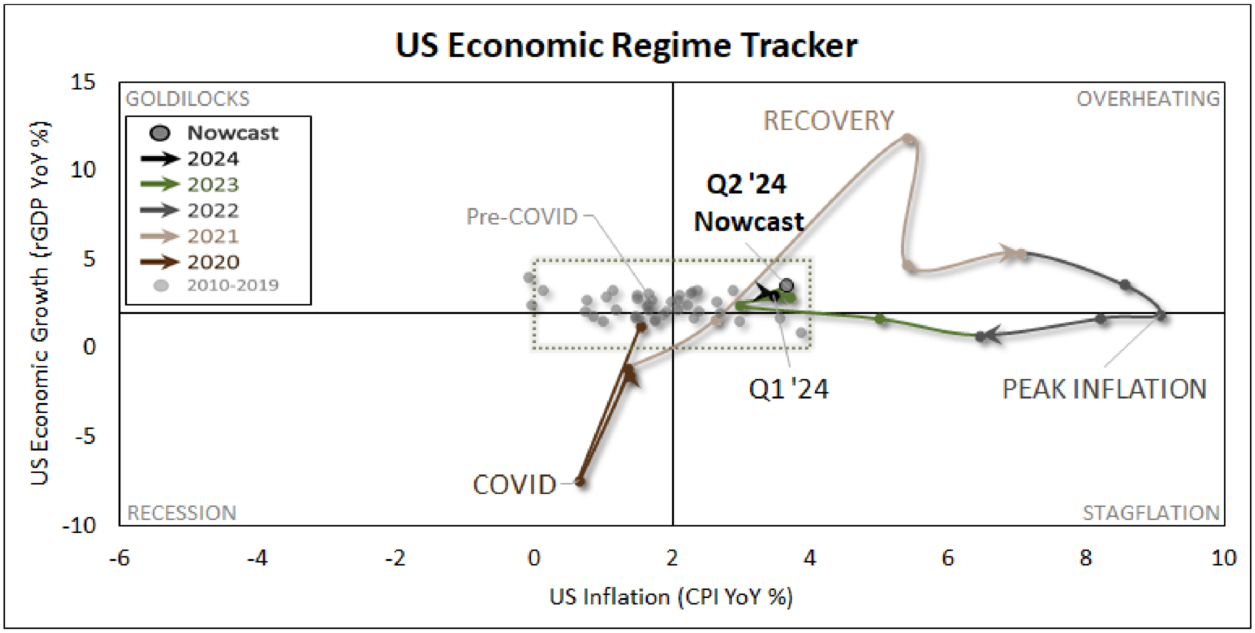
For more than a year now the biggest story has been what has ***not*** happened, which is that the US recession that was widely forecasted and anticipated. Key indicators that have historically been highly reliable have been flashing warning signs. For example, the US yield curve has remained the most deeply inverted for the longest period on record, as shown in the chart below. While this indicator has typically been a harbinger of recession, that has so far turned out to be false.



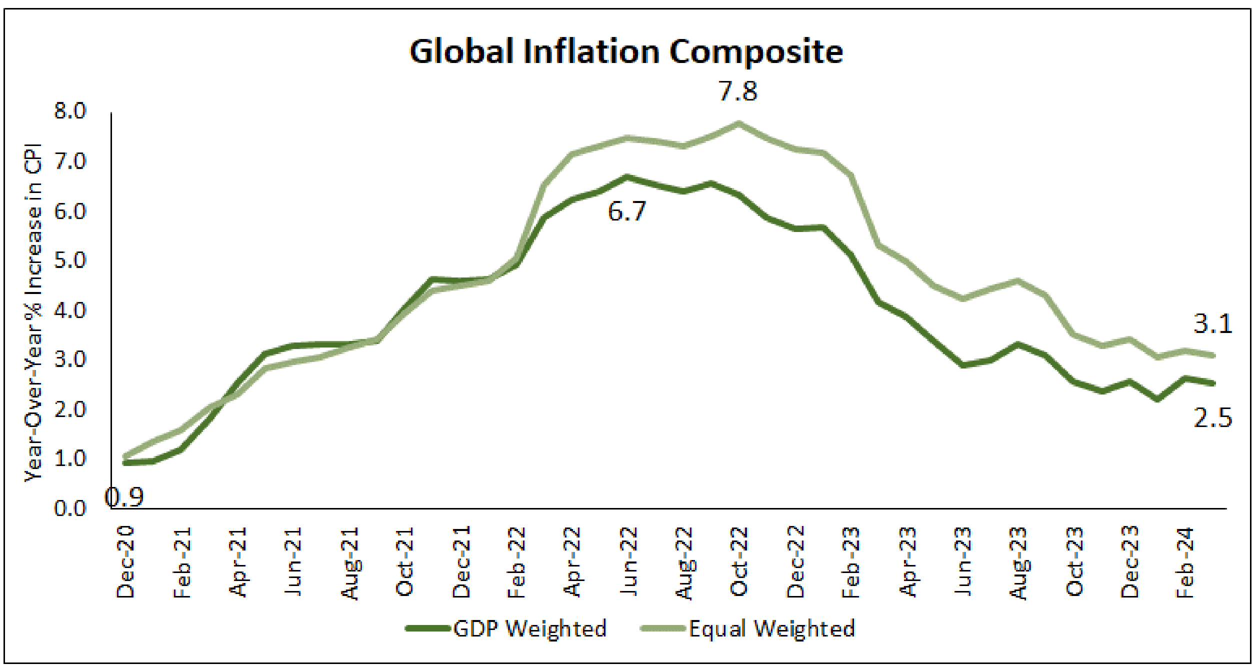
Indeed, economic growth remained strong across most major economies. As shown in the chart below, the US economy expanded at a 3% average pace amid inflation that averaged 4%. Economies in Asia grew the fastest while those in Europe were sluggish, including a negative reading in Germany and the UK. Inflation was elevated in most economies except for China, which suffered bouts of mild deflation.



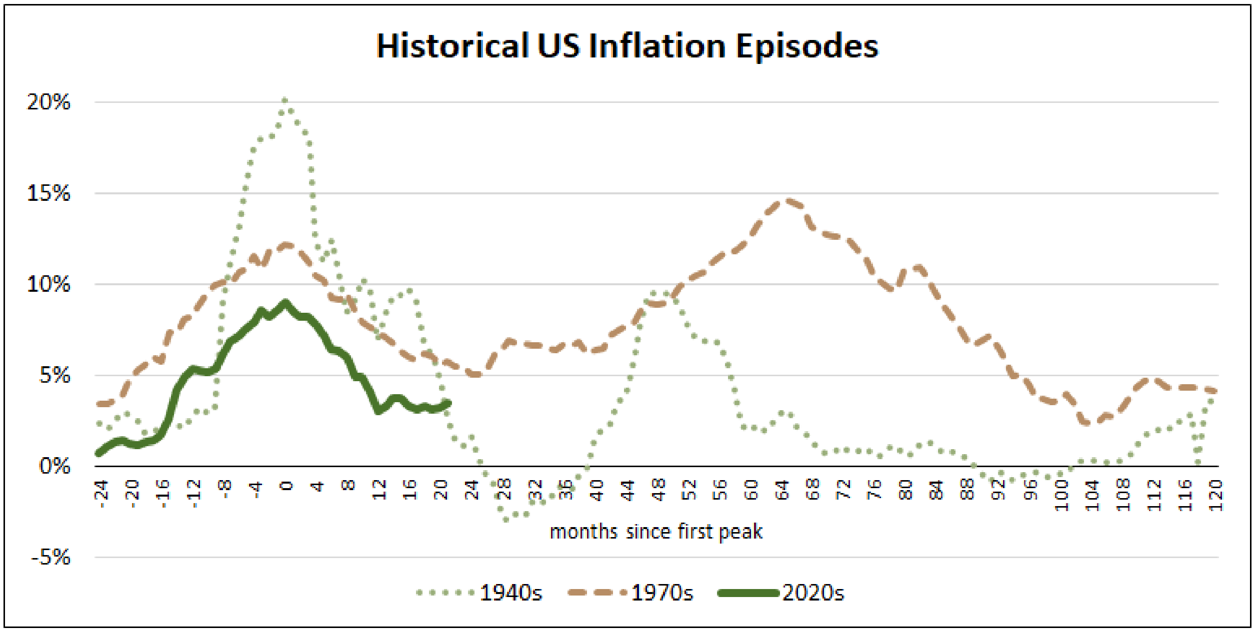
The asset allocation framework for the Trust suggests that economic conditions have normalized, particularly in the United States. During 2023, the US economy moved back into pre-COVID conditions with stable and moderate readings for growth and inflation. As shown in the chart below, growth and inflation in the US are both estimated to be running above 3% at present.



Since mid-2022, inflation has steadily subsided across the globe, but this pattern has stalled recently. As shown in the chart below, global inflation peaked in mid-2022 at 7-8% globally, and since then has fallen to 2-3%. The outliers in this process have been China, where deflation has taken hold recently with a 1% decline in prices, and Russia, where inflation has reaccelerated to above 7%. The United States is also a notable outlier in this regard, with consumer price inflation rising to 3.5% in March.



Indeed, a study of history from the 1940s and 1970s offers a stark reminder that inflation risk can reassert itself. As shown on the chart below, inflation in the United States has historically come in waves, such as during the 1970s when the first wave troughed 24 months after peaking, and then reaccelerated to new heights over the next three years. Recent data points, including the 3.5% inflation rate registered in March 2024, have raised the specter of a resurgence in inflation.



If such a "double top" scenario were to happen again, the Federal Reserve would likely respond by deferring the interest rate cuts it has signaled recently or perhaps even hiking rates further. Some of this tightening is already evident. In January, the bond market was anticipating a Fed target rate of around 4.5% by year-end, but is now expecting a figure closer to 5.0%. This deferral of rate cut expectations has served to increase interest rates even though no actual rate hikes were implemented.

Private Equity Outlook

The speed and magnitude of the 525 basis point increase in US central bank rates from March 2022 to July 2023 caused private equity managers to pause their activities. As a result, the private equity market has stalled the last 18 months. According to data from industry consultancy Bain & Company, the industry statistics harken back to the 2008-09 global financial crisis:

- The total value and number of deals have fallen 60% and 35%, respectively, from their peaks in 2021. In 2023 alone, deal value fell by 37% and has remained at those levels for 2024 to date.

- The total value of exits is down 66%, including a slide of 44% during 2023. As a result, many limited partners are starved for distributions and are left cash flow negative despite ongoing financial obligations.

- The number of funds closing is down nearly 55%, including 38% fewer buyout funds closed during 2023. Though the level of commitments rose, just 20 of those funds accounted for more than half of all capital raised.

There remains a record level of uncalled commitments to the asset class, of which a sizable amount are aging and must be put to work in coming years. Within private equity funds, nearly half of all global buyout companies have been held for at least four years, leaving sponsors eager to harvest gains.

As a result of these trends, the situation the private equity industry faces today is largely unprecedented. For allocators, the conundrum around a lack of exits has emerged as the most pressing problem. This quandary has caused many limited partners to pull new allocations back from all but the largest and most consistent fund sponsors.

Amid these trends, the ERS Trust remains well positioned. ERS has a moderate allocation to the asset class (16% target for ERS versus an average of 30-35% for large endowments) and moderate liquidity needs (2-3% annually for ERS versus an average of 5% for large endowments). ERS continues to allocate toward the smaller end of spectrum for fund managers, where returns have historically been better due to a greater ability for general partners to add value. This approach to portfolio construction also allows ERS to obtain more favorable terms including lower fees, better contractual terms, and governance rights within the limited partner advisory committees (LPACs) of its fund investments.

Real Assets Outlook

With the current interest rate environment leading to higher borrowing costs, those property sectors within the US that have stronger fundamentals have outperformed others. Data from MSCI indicates that prices in the industrial sector have rebounded in recent months, while the uncertainty around the future for office space have continued to drag down prices for that sector.

- **Industrial:** prices posted a +0.7% monthly gain in March, which amounts to a 5.7% year-over-year gain. It was the only major sector to post gains in pricing from a year earlier. This change annualizes to a yearly gain of 9.2%, suggesting that market conditions are gaining momentum.

- **Retail:** prices posted a 0.1% monthly gain in March, which amounts to a -1.2% year-over-year decline. However, retail was the only sector, other than industrial, to post month-over-month growth. As such, prices for retail appear to have stabilized at levels above 2020 prices.

- **Apartment:** prices posted a -0.9% monthly decline in March, the 20th consecutive monthly drop. This figure amounts to a -8.4% year-over-year decline, though the pace of decline has decelerated in each of the last seven months. Despite those declines, the index of apartment prices is still 11% above its level at the start of the pandemic in April 2020.

- **Office:** prices posted a -1.0% monthly decline in March, which amounts to a -16.6% year-over-year decline. Within this figure, prices for offices in central business district (CBD) are falling far more sharply than those for suburban assets.

    - CBD office prices fell -2.1% on the month and -33.2% from a year ago. These price levels are roughly half of those seen pre-pandemic and are still falling.

    - Suburban office prices fell -0.3% on the month and -11.4% from a year ago. These prices are now roughly in line with pre-pandemic levels and are still falling.

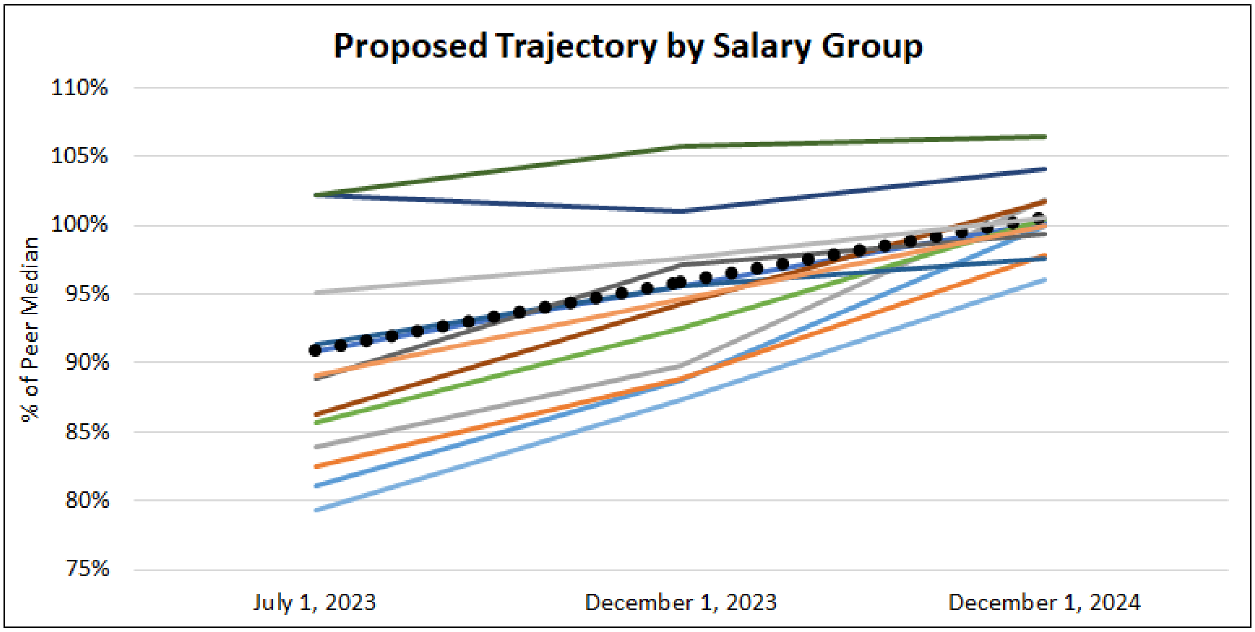
At the overall level, in March the index fell -0.2% from the prior month, which represented a -3.0% decline from a year ago. Led by the strength of the industrial sector, the overall pace of decline in U.S. commercial real estate prices has decelerated for eight consecutive months. As such, the worst may be over for US real estate if interest rates remain stable, though some property types may remain challenging for some time to come.

Amid these trends, the ERS Trust remains well-positioned. ERS has a conservative portfolio within private real estate with relatively low leverage compared to the market average. Though the portfolio has been underweight industrial sector for some time, staff has been working to close this gap both by allocating new funds to the sector and redeeming from funds outside of it.

Organizational Priorities for 2024

During 2024, the Investments division will continue to build upon the successes of 2023 by taking additional actions in the year ahead to make the organization even more effective.

- **Compensation Survey.** The compensation survey data was used to create a two-year strategic plan for compensation within the division that would move salary levels in the division overall toward 100% of the peer median. Phase two of this plan will be reflected in the ERS annual budget for FY25 for approval by the Board in August, which would allow the associated personnel actions to be processed during November and December.



- **Investment Practices and Performance Report:** Section 802.109 of the Texas Government Code requires ERS to engage an independent consultant every three years to conduct an evaluation of the appropriateness, adequacy and effectiveness of its investment policies, procedures and practices. Such reports cover five evaluation topics that are broadly defined in statute:

  - An analysis of any investment policy or strategic investment plan adopted by the System;
  - A review of the System's strategic asset allocation, including the associated methodologies;
  - A review of the appropriateness of investment fees and commissions paid by the System;
  - A review of the System's governance processes related to investment activities; and
  - A review of the System's investment manager selection and monitoring process.

  NEPC conducted the first such review in 2019 and delivered the associated report to the Board in March 2020. The findings of that report were systematically addressed by staff and the results reported to the Board in subsequent meetings.

  The process for the current report began in January 2023 with NEPC reviewing key documents and interviewing a number of employees. NEPC presented its findings to the Board/IAC during the March 2024 meeting and will deliver the final report to ERS in May 2024. The report is due to the Pension Review Board (PRB) on June 1, 2024. Staff expects to review the final recommendations in detail and develop implementation strategies that benefit the Trust as appropriate.

- **Investment Consulting RFQ:** The current contract with the general investment consultant (NEPC) expires on December 31, 2024. This relationship is a key control in the ERS governance model as the consultant serves as a strategic advisor to the Board. In addition, the contracts for several of the current asset class consultants will expire within two years. These relationships are also a key component of the ERS governance structure in that they provide investment due diligence reports that inform the Asset Class Investment Committee (ACIC) process and help in the development of capital plans for each of the private market asset classes.

  On April 17, ERS posted a Request for Quotation (RFQ) related to investment consulting services, which will include one contract for general investment consulting, five for asset class consulting, and one for governance reviews. Taken together, these contracts are currently valued at more than $3 million annually, and staff seeks to achieve service level improvements and cost savings by procuring the entire suite of services in one process. Staff expects to make a recommendation to the Board in December 2024 in a way that allows for an orderly transition if necessary. This process will also include input from at least one member of the ERS Investment Advisory Committee (IAC).

- **Separation of the Retirement Trust and the Insurance & Benefits Fund:** the separation of the ERS Retirement Trust and GBP Insurance & Benefits Fund (IBF) assets aims to simplify administration for these asset pools and allow each to pursue an independent investment strategy tailored to its individual purpose. After several weeks of planning that spanned several internal teams, a transition plan was approved In April and execution began soon thereafter.

  - **Rates** (approximately $1.26 billion)**:** On May 1, the ERS Rates portfolio and its sub-accounts were divided into two sets of corresponding accounts (one for IBF and another for the Retirement Trust) proportional to their ownership as of April 30. The underlying securities were then distributed in-kind to the resulting separate pools. For holdings that were not readily divisible, the IBF received equivalent value from the Core Treasury account. This approach avoided the need to sell odd lots of individual securities, which could result in a loss of value for ERS. The securities in the IBF Rates account will be liquidated in coming months and the resulting cash used to purchase exchange-traded funds (ETFs) to provide market exposure for the IBF.

  - **Public Credit** (approximately $450 million): Starting on April 17, every Wednesday, $25 million in cash is being transferred from the ERS Retirement Funds to the IBF in exchange for equivalent units of the ERS Total Public Credit pool. As these regular transfers occur, the cash received by the IBF is being used to purchase ETFs to maintain market exposure for the IBF. An initial trade was conducted on April 3 that allowed staff to verify that both the operational aspects (account setup, etc.) and financial aspects (unit accounting, etc.) of this process were functioning appropriately. This process will continue each week until completion, which is expected before the end of the ERS fiscal year.

  This separation process overall is being coordinated by the Portfolio Management team, which is working with the Treasury & Trading team, investment operations, and the Finance division to smoothly transition from a pooled account structure. Responsibility for managing the IBF going forward will be moved from the Rates team to the Portfolio Management team, since the portfolio will become an allocation-oriented portfolio of ETFs and mutual funds rather than a selection-oriented portfolio of individual bond holdings.

- **Policy Review:** The IPS requires the Board, with the aid of staff and the General Investment Consultant, to review that document at least annually to ensure that it continues to reflect the Board's objectives. Staff has historically made recommendations to the Board regarding potential improvements to the IPS during the August Board/IAC meeting and expects to do so again this year. Potential areas for discussion include:

  - Incorporation of any revisions that may be warranted based on the Investment Practices Evaluation for 2023 that will be submitted to the Texas Pension Review Board by NEPC in June.

  - Revisiting the use of performance benchmarks that are no longer appropriate and/or not investable, such as those used for hedge funds (currently T-bills plus 350 basis points annually) and private infrastructure (currently the Consumer Price Index + 400 basis points annually).

  - Updates to the risk budget and information ratio targets to align more closely with the strategic objective of compound returns for the Trust that are +50 basis points or more annually above the Policy Benchmark.

- **Capital Planning:** The IPS requires Staff to present to the Board at least annually a long-term capital plan for each asset class within private markets, including a forecasted 12-month tactical plan. Staff continues to believe that the Board is best served by reviewing all of these plans together just prior to the beginning of the fiscal year, rather than individually as part of each annual asset class reviews that occur over several meetings. As such, staff will once again bring these recommendations as a separate agenda item to the August Board/IAC meeting.

CONCLUSION

Investment performance continues to deliver well on the overall objectives for the Trust, including strong absolute returns. High levels of excess returns and top rankings among peers across most time horizons are indicative of effective implementation. The Trust remains properly positioned for the current market environment and staff continues to monitor the key risks to the long-term outlook. To sustain this success in the years to come, the organization continues to make investments in its people and processes that are made possible by support from key stakeholders.

This is not an action item and is intended for discussion purposes only.

** ERS is 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 – Current version of ERS Investment Policy Statement (effective 2023-09-01)
2. Exhibit B – Current version of ERS Investment Implementation Plan (effective 2024-01-23)
3. Exhibit C – NEPC IPPE Report for ERS 2024
4. Slides – Chief Investment Officer Update.