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

May 22, 2024

ERS
EMPLOYEES RETIREMENT SYSTEM OF TEXAS

Presented for Review and Approval

August 21, 2024

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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
May 22, 2024 – 8:30 a.m.

TRUSTEES PRESENT
Brian Barth, Chair
Craig Hester, Vice-Chair (via WebEx)
Neika Clark, Member
Dr. Stuart Greenfield, Member
Dr. James Kee, Member
John Rutherford, Member

INVESTMENT ADVISORY COMMITTEE (IAC) PRESENT
Laurie Dotter, Chair
Ruby Muñoz Dang, Vice-Chair
Robert Alley, Member
Ryan Bailey, Member
Milton Hixson, Member
Gene Needles, Member
Ken Mindell, Member

ERS DIRECTORS PRESENT
Porter Wilson, Executive Director
Cathy Terrell, Deputy Executive Director
Anne Allensworth, Special Advisor
Jennifer Chambers, Director of Government Relations & Special Projects
Tony Chavez, Director of Internal Audit
Blaise Duran, Director of Group Benefits
Bernie Hajovsky, Director of Enterprise Planning Office
Cynthia Hamilton, General Counsel
Robin Hardaway, Director of Customer Benefits
Shack Nail, Special Projects & Policy Advisor
Machelle Pharr, Chief Financial Officer
Gabrielle Schreiber, Director Office of Procurement & Contract Oversight
DeeDee Sterns, Director of Human Resources
Kathryn Tesar, Director of Benefits Communications
Chuck Turner, Director of Information Services
David T. Veal, Chief Investment Officer

ERS STAFF PRESENT

Amanda Burleigh, Office of the General Counsel
Amy Cureton, Investments
Anthony Curtiss, Investments
Kelley Davenport, Executive Office
Tiffani Jenkins, Benefits Communications
Deborah Legg, Group Benefits

Ricardo Lyra, Investments
John McCaffrey, Investments
Averi Mullins, Group Benefits
Pablo de la Sierra Perez, Investments
Samantha Ramirez, Investments
Evelín Ramos, Investments
Chris Roland, Information Systems
Benjamin Schuman, Investments
Cheryl Scott-Ryan, Office of the General Counsel
Bob Sessa, Investments
Gabe Torres, Executive Office
Georgina Bouton, Group Benefits
Jamey Pauley, Executive Office
Tom Rashman, Investments
Lacy Wolff, Executive Office
Annie Xiao, Investments
Andrew Keese, Executive Office
Lauren Honza, Investments
Valorie Wencka, Group Benefits
Simon Mok, Investments
Ken McDowell, Investments
Jay Hu, Investments
Nancy Lippa, Office of the General Counsel
Aaron Hatt, Office of the General Counsel
Amy Chamberlain, Executive Office
Michele Sowell, Office of Procurement & Contract Oversight
Kathleen Emory, Office of Procurement & Contract Oversight
Lisa Caffarate, Group Benefits
Leah Erard, Executive Office
David Lacy, Office of the General Counsel
Alejandra Pemberton, Office of the General Counsel

VISITORS PRESENT
James Hille, Consultant to the Board
Sam Austin, NEPC LLC
Christina McCormick, NEPC, LLC
Jason Moore, Express Scripts, Inc. (ESI)
Luther Elmore, AFSCME Retirees
Christy Fields, Meketa
Karen Reeves, Meketa
John Posey, Texas Legislative Budget Board
Lee Anderson, Coldwell Banker Richard Ellis (CBRE)
Ilesa Daniels Ross, Former Board Member, Public
Ann Bishop, Texas Public Employees Association (TPEA)
Stephanie DeWitt, Texas Public Employees Association (TPEA)
Ray Hymel, Texas Public Employees Association (TPEA)
Tom Martin, Aksia
Jeff Hardy, UnitedHealthcare (UHC)
Tyler Sheldon, Texas State Employees Union (TSEU)
Claire York, Blue Cross Blue Shield of Texas (BCBSTX)
Kellie Hand, WebMD
Nate Cavender, WebMD
Rachel Grossman, Virgin Pulse
Charlotte Juarez, Virgin Pulse
Susan Thompson, Virgin Pulse

Eric Frost, Virgin Pulse

Jim Engler, Express Scripts, Inc. (ESI)
Brian Hendrickson, Express Scripts, Inc. (ESI)
Phil Dial, Rudd & Wisdom
Diana Head, Blue Cross Blue Shield of Texas (BCBSTX)
Tara Morales, Blue Cross Blue Shield of Texas (BCBSTX)
David Gezana, Health and Human Services Commission (HHSC)

01. Call Meeting of the ERS Board of Trustees to Order

Brian Barth, 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 meeting was filed with the Office of the Secretary of State at 12:43 p.m. on Tuesday, May 14, 2024, as required by Chapter 551, Texas Government Code, referred to as "The Open Meetings Act."

02. Consideration of Consent Agenda

Mr. Barth introduced the item and asked the Board Members if they would like to remove any items from the Consent Agenda to discuss individually.

Move that the Board approve all items on the Consent Agenda.

Motion by James Kee, seconded by Neika Clark

Final result: Motion carries

Aye: Brian Barth, Neika Clark, Stuart Greenfield, Craig Hester, James Kee, and John Rutherford

03. Executive Session

In accordance with Section 551.071, Texas Government Code, the Board of Trustees met in executive session to consult with its attorney on legal matters, including pending or contemplated litigation and other legal matters in which the duty of the attorney to the Board of Trustees under the Texas Disciplinary Rules of Professional Conduct clearly conflicts with the Open Meetings Act.

04. Call Meeting of the Investment Advisory Committee to Order

Laurie Dotter, Chair of the Investment Advisory Committee for the Employees Retirement System of Texas (ERS), called the Investment Advisory Committee to order to convene with the Board of Trustees to take up the following Joint Meeting of the Board of Trustees and Investment Advisory Committee agenda items.

A public notice of the Joint Board of Trustees/IAC meeting was filed with the Office of the Secretary of State at 12:43 p.m. on Tuesday, May 14, 2024, as required by Chapter 551, Texas Government Code, referred to as "The Open Meetings Act."

05. Consideration of Annual Review of ERS Incentive Compensation Plan Document for Plan Year 2025

DeeDee Sterns, Director of Human Resources, and Jamey Pauley, Incentive Compensation Plan Program Specialist, presented on this item.

Jamey Pauley began the presentation on this item with an overview of ICP Program characteristics and the annual approval process. The goal of the Item in May is to provide a summary of recent awards, review key changes for the upcoming ICP Plan Year, and provide a draft of the ICP Plan document prior to Board approval in August.

Mr. Pauley noted that average Maximum Performance goal realization had reached a five-year high of 89.3% in Plan Year 2022. He noted that this was a result of strong investment performance of the Trust relative to the policy benchmark over all time horizons used for ICP calculations. Lower realizations in prior years had been a function of less consistent relative performance.

Mr. Pauley then discussed two key changes proposed for Plan Year 2025. The first change is a revision of Maximum Performance Goals for Public Markets asset classes. Staff proposes that goals for those asset classes move from being based on a target information ratio to being based on a target excess return. The change would align methodologies with other asset classes and with those of the overall Trust. The excess return goal also aligns with the asset class goals stated in the IPS, which are excess returns in excess of the assigned benchmark. The impact of this proposed change is currently expected to increase the goals for Public Equities, Public Credit, Public Real Estate, Special Situations, and Hedge Funds to 50 basis points. Goals for Rates and Cash asset classes would decrease to reflect the primary role of those asset classes to provide liquidity to the Trust.

This proposal invited a series of comments and questions from Board and IAC members. Craig Hester sought to clarify that return targets will no longer reflect a risk metric; and David Veal confirmed this to be true. Mr. Hester also asked about the hypothetical impact to previous years' payouts had this change been in place. Mr. Pauley noted that the change would have reduced the Plan Year 2022 payout by about 3%, and reduced previous years' payout by a lower amount. Ken Mindell asked about the 50-basis point target for Hedge Funds, given the market-neutral nature of those investments. Mr. Veal noted that the Hedge Fund benchmark is under review as part of the IPS review coming in August, and Mr. Mindell's concern about the target was noted. Mr. Bailey asked Mr. Veal if the performance goal changes would result in changes to staff implementation strategies, and Mr. Veal said they would not.

Mr. Pauley then reviewed proposed changes to maximum incentive awards for Investment attorneys. The proposed Plan Document will increase the range of maximum incentive awards to 70% to 90%—based on staff position title—from a current level of 65%. The proposed changes are based on recent compensation surveys.

There was no further discussion on this item.

06. Consideration of Quarterly Review of Investment Performance

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

Mr. Austin began the item with an overview of market conditions. He explained that the expectations for 2024 interest rate cuts by the U.S. Federal Reserve have come in significantly, from 5 or 6 earlier in the year to 1 or 2 currently. This change has been the result of persistent inflation, which has stayed above 3% and well above the Fed target of 2%. The general U.S. economy has remained resilient, with 2023 GDP growth of about 2.5%, driven by strong consumer activity and a tight labor market. Mr. Austin highlighted some concerns, including tightening credit conditions and heightened geopolitical tensions.

Turning to markets in the first quarter of Calendar Year 2024, Mr. Austin noted that domestic equities led other asset classes with returns over 10%. This figure was followed by international equities, which outpaced bonds by a wide margin.

Mr. Austin went on to discuss performance of the ERS Trust, beginning with year-to-date numbers. Calendar year-to-date, the Trust return of 4.14% exceeded the policy benchmark of 2.9%. Based on the August 31st-ending fiscal year-to-date, Trust returns of 7.83% have also outpaced the policy benchmark at 6.93%. Mr. Austin went on to note that the Sharpe and Sortino ratios, which reflect investment risk, remain in the top decile relative to peers on a three- and five-year basis. Dr. James Kee inquired as to how many peers make up the peer universe, to which Mr. Austin responded 71 or 72.

Mr. Austin then discussed Trust performance over one-, three-, and five-year periods. He noted that performance exceeds the policy benchmark over all periods and was in the top decile relative to peers over trailing three- and five-year periods. Relative to the 80% equities/20% bonds Passive Index, the Trust outperformed over three- and five-year periods, but underperformed over a one-year period.

Mr. Austin closed his remarks by noting that the rolling 10-year return of the ERS Trust is ahead of both the policy benchmark and Passive Index.

Dr. Stuart Greenfield began a discussion of Mr. Austin's remarks by noting that the Vanguard Balanced Index Fund Admiral Shares (VBIAX), a passive 60% equities/40% bonds fund, would have achieved returns roughly equivalent to the ERS Trust over an unspecified time period. Mr. Austin responded by noting that pensions need to consider drawdown risk and volatility, and that factoring in the amount of annuity payments that come out of the Trust each year would significantly impact the performance in a true comparison. John Rutherford noted that the Board IAC Working Group would like to review Dr. Greenfield's analysis with Mr. Veal and IAC members. Mr. Mindell closed the discussion by pointing out that the S&P 500 is particularly weighted towards the top seven stocks, and would result in very high levels of investment concentration if a large portion of Trust assets were invested in that index.

Mr. McCaffrey then began his discussion of Trust performance. Relative to the policy benchmark, the Trust has outperformed over all time periods, including three months, one year, three years, five years, and ten years. Over the five-year period, which is the Board's primary measurement period, 177 basis points of outperformance equates to about $2.6 billion in added value to the Trust.

Mr. McCaffrey then discussed positioning, noting that all asset class allocations remain within their policy range. The Trust is overweight in Private Markets and Public Equity, which have both delivered strong performance. The Trust also remains overweight in Cash and underweight in Rates, taking advantage of the inverted yield curve, which delivers higher yields on lower-duration securities.

Discussing attribution, Mr. McCaffrey noted that five-year performance versus the policy benchmark has been strong, primarily driven by security and manager selection. All asset classes have contributed to the positive performance, with Private Equity and Private Real Estate contributing the most. Strong five-year performance relative to the policy benchmark has been partially offset by underperformance of the policy benchmark relative to the Passive Index. Relative to the Passive Index, which is 80% equities and 20% bonds, the Trust delivered 25 basis points of excess return.

Mr. McCaffrey then showed returns of the trust over multiple time periods relative to the assumed rate of return (ARR) and the Passive Index. He noted that the Trust return has exceeded the ARR over all measurement periods. The Passive Index, on the other hand, has delivered highly variable returns relative to the ARR as a result of its higher volatility relative to the Policy allocation.

Mr. McCaffrey moved to peer performance. The Trust achieved returns above the median over the three-month and one-year horizons. Over the longer periods of three-, five-, and 10 years, the Trust delivered returns in the top 10% of its peer group. Peer rankings over these longer time periods have shown a general trend of improvement over the last 10 years.

Mr. McCaffrey then presented peer ranking versus an expanded universe. The primary peer group for the ERS Trust is public pension funds with assets exceeding $1 billion. Mr. McCaffrey showed Trust peer rankings relative to all public defined benefit (DB) plans, all public DB plans under $1 billion, and all DB plans. Peer rankings over short-term periods of three months to one year varied when considering the expanded peer set. Over three-, five-, and 10-year periods, peer rankings remain very strong, similar to those shown relative to the primary peer group.

Mr. Veal noted that some defined benefit funds have negative returns over three years, likely as a result of implementation in private markets, where dispersion of returns is high. Mr. Veal also noted that the three-year return of the ERS Trust is also in the top quartile relative to endowments.

Ryan Bailey asked why the primary peer group isn't set at a higher level of assets. Mr. Austin noted that if the peer group only included plans over $10 billion, the dataset used by NEPC would only include 20 to 22 peers. Therefore, a lower asset threshold is used to facilitate a more significant sample of peers.

There was no further discussion on this item.

07. Consideration of Quarterly Report from Chief Investment Officer

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

Mr. Veal began with a discussion of Trust performance over periods of three-, five-, and 10 years. He showed a matrix comparing observed Trust returns to the actuarial assumed rate of return, the policy benchmark, the Passive Index, and ERS' peer group. Relative returns for the Trust have been positive across each observed time period and relative measurement criteria. Mr. Veal noted that Trust performance is consistently in the top 10% of its peer group, outside of recent results over a one-year time horizon. He explained that the Passive Index has performed better than ERS' peer group over the past year, but that there have also been many observed periods where it underperforms the entire peer group. He said such volatility demonstrates the need for a diversified portfolio with strong implementation.

Mr. Veal went on to show that all asset classes other than cash contributed to both absolute and relative returns, with private markets asset classes delivering the strongest relative returns. Mr. Mindell noted that the chart demonstrates the high level of value added by private markets. Mr. Veal then showed a chart comparing private versus public market returns across equity, real estate, and credit allocations within the Trust. The chart showed that Private Credit and Private Real Estate have delivered much higher five-year returns than their public counterparts. Private Equity has also outperformed Public Equity, albeit by a smaller margin. Mr. Veal went on to note that private asset classes also show lower observed volatility relative to publicly traded counterparts.

Mr. Veal moved on to a chart showing annualized returns and volatility for the Trust over a 20-year time horizon, as compared to various equity indexes, the policy benchmark, and low-risk assets like Cash and U.S. Treasury securities. The chart showed a linear relationship between return and risk across various investments, with the Trust near the middle. Mr. Veal noted that the chart reflected a balanced risk-return profile, which is appropriate for a pension fund.

Mr. Veal then turned to investment expenses. He noted that expenses in Fiscal Year (FY) 2023 were down as a percentage of trust assets due to a decline in profit sharing within private markets. He explained that profit sharing peaked in fiscal years 2021 and 2022, as ERS' managers experienced a high level of realization of private markets investments. Ongoing fees as a percentage of Trust assets are expected to remain near FY23 levels.

The next topic of discussion was Trust liquidity. Mr. Veal explained that net cash outflows have declined since FY21, first from the significant State Legacy Payments and more recently as a result of higher employee contributions. Such contributions were up 14% in FY23, while distributions were only up 1%.

The discussion then turned to the market environment. Mr. Veal noted that many historical market relationships have weakened recently, especially the inverted yield curve as a predictor of an economic recession. He went on to note that the economy remains relatively healthy, with GDP growth and inflation near the 3% level. Mr. Veal said that his main concern is that resurgent inflation could reduce the appetite for expected rate cuts and result in 1970's-like stagflation.

Mr. Veal then turned to previews of the upcoming asset class reviews, beginning with Private Equity. He noted that industrywide private equity deal value is down 60% from 2021, with exits of underlying investments down 66% in dollar terms. This dynamic has resulted in a decline in distributions, which has led to material liquidity constraints at some peer funds with larger allocations to private equity. However, the ERS Private Equity Program has maintained adequate distributions relative to capital calls, and remains in a position to be opportunistic.

Mr. Mindell inquired as to why deal flow slowed in the general private equity market. Mr. Veal stated than in his opinion, higher interest rates have resulted in diverging views of the value of underlying investments between buyers and sellers.

Next, Mr. Veal turned to Real Estate. He explained the wide dispersion between Real Estate subsectors, using strength in industrial real estate and weakness in multifamily residential and office real estate as prime examples. He noted that prices for office buildings in central business districts are 50% below 2020 levels.

Mr. Veal ended his presentation with an overview of current Investments division initiatives. These includes hiring for several key positions, ongoing implementation of the 2023 compensation survey, the recent completion of the 2024 IPPE report, and upcoming reviews of the Investment Policy Statement and 2025 Capital Plans.

There was no further discussion on this item.

<u>08. Consideration of Annual Review of Real Assets Program</u>

Robert Sessa, Managing Director of Real Assets, Annie Xiao, Director of Public Real Estate, Amy Cureton, Director of Private Real Estate, and Pablo de la Sierra Perez, Director of Infrastructure, presented on this item.

Mr. Sessa opened the presentation with a review of the Program, noting its role as a risk seeking allocation. He described various common aspects of the four distinct Real Assets asset classes, including capital appreciation, income, and inflation protection.

Ms. Xiao then discussed the Public Real Estate allocation. She gave a brief overview of key Program characteristics and noted that the current 1.9% allocation is strategically underweight relative to the 3% target allocation. She noted that the Program is diversified across regions and sectors, and overweight in sectors with shorter lease duration, which perform better during inflationary periods. Ms. Xiao also noted that the Public Real Estate Program is underweight in office properties due to poor fundamentals.

Ms. Xiao noted that the allocation to Public Real Estate has been active, with several meaningful contributions and withdrawals over the last several years. She noted that the allocation decisions have added value and credited the efforts of John McCaffrey and the Portfolio Management team.

Moving onto returns, Ms. Xiao reported that Public Real Estate has delivered strong returns relative returns over one-, three-, five-year, and since-inception time periods. This includes 132 basis points of outperformance over five years, the Board’s primary measurement period. Absolute returns have been challenging over three- and five-year periods, with Ms. Xiao citing the COVID-19 pandemic, rising interest rates, and the regional bank crisis as notable headwinds.

In terms of risk, tracking error remains below the target, but highly efficient use of that risk has led to strong relative returns and an information ratio above one.

Dr. Kee asked about a potential bottom in the office real estate market, and Mr. Sessa noted that it will vary across regions. He pointed out changing government policies in San Francisco as an example of potential drivers of improvement. Mr. Sessa noted further that certain high-amenity office buildings have avoided the downturn altogether.

Ms. Cureton then moved on to discuss the Private Real Estate Program beginning with a brief overview of key characteristics and objectives. She noted that the allocation of 10% remains in the Policy Range.

She then moved onto performance, with strong relative returns over one-, three-, five-, 10-year, and since-inception time periods. This includes 430 basis points of outperformance over five years, the Board’s primary measurement period. Ms. Cureton noted that absolute performance was negative on a one-year basis, but very strong relative to the benchmark.

Ms. Cureton then covered some details of the Program, which remains well diversified across region, property type, and manager. She noted that industrial and international investments have been growing as a percentage of the allocation, which aligns with staff objectives. She also specified the Program's relatively low exposure to single family rentals at 1.9% and no dedicated strategies.

Ms. Cureton presented some data on Program value creation and cash flow, noting that 80% of committed capital has been returned in the form of distributions over the life of the Program.

Mr. Bailey asked about valuation methodology and what metrics ERS and its managers prefer to use. Ms. Cureton responded that the methodology varies based on the specific market. She noted that comparable transaction is the best method, but with slower transaction volume, the industry has become more reliant on an income approach.

Mr. Perez then began his review of the Infrastructure Program, beginning with a brief overview of key characteristics and objectives.

In terms of performance, Mr. Perez noted strong relative returns over one-, three-, five-year, and since-inception time periods. This includes 275 basis points of outperformance over five years, the Board's primary measurement period.

He provided additional details on the Infrastructure Program, which is diversified across sectors, regions, and managers. He noted that 33% of Infrastructure investments are co-investments.

Mr. Perez presented a chart on value creation and cash flow, noting that about 50% of committed capital has been returned in the form of distributions over the life of the Program.

There was some discussion on this item. Mr. Mindell asked about alternative benchmarks for Infrastructure. Mr. Perez responded that no benchmarks are particularly strong, but that peer-based benchmarks are improving. Mr. Mindell also asked about observed correlation of infrastructure investments to inflation. Mr. Perez noted that a majority of underlying investments in the Program have revenue linked to CPI or another inflation measure. Mr. Veal then pointed out the strong absolute returns of Infrastructure during the recent inflationary period as evidence that the asset class has been delivering inflation protection to the Trust. There was also discussion of leverage, which Mr. Perez estimates at 50% Program-wide.

There was no further discussion on this item.

09. Consideration of Annual Review of Private Equity Program

Ricardo Lyra, Managing Director of Private Equity, and Thomas Rashman, Private Equity Portfolio Manager, presented on this item.

Mr. Lyra began his comments with a brief overview of Program characteristics, noting that the current $12.9 billion allocation is within the Policy range at 16% of the overall Trust.

Moving onto performance, Mr. Lyra commented that one-year performance is in line with the benchmark, with three-, five-, and 10-year performance exceeding the benchmark. Over 10 years, the Private Equity Program has generated an annualized excess return of 230 basis points.

In terms of cash flow, Mr. Lyra noted that 93% of called capital has been returned to the Trust via distribution alongside significant unrealized value creation. Some discussion on this topic ensued. Mr. Mindell asked about how close the Program has come to positive cash flow. Mr. Lyra noted that cash flow is projected to be positive $100 million in fiscal 2024, but that an increase in deal flow could result in future periods of negative cash flow. Mr. Veal noted that many peer funds have experienced negative cash flow due to reduced distributions, which is a strong point of differentiation for the ERS Private Equity Program.

Mr. Mindell then asked why the allocation to Private Equity has come down as a percentage of the Trust. Mr. Lyra attributed the decline to an overall increase in Trust value, driven primarily by positive returns in Public Equity.

Dr. Greenfield then asked Mr. Lyra if existing opportunities are sufficient to execute the current plan. Mr. Lyra responded yes, that the opportunity set remains strong, driven by strong fundamentals at the underlying investment level. He also noted that ERS' strong liquidity position adds an advantageous position to participate in near-term opportunities.

Mr. Lyra provided an overview of internal rate of return (IRR) by strategy. He noted that all strategies had delivered strong five-year IRRs, with the exception of Energy following a poor 12 months. Mr. Rashman noted that Energy investments had been a source of strong distributions despite the lagging IRR.

Mr. Rashman then presented some details on the Program, noting strong diversification across geography, strategy, sector, and manager. He explained that expenses were down significantly in 2022 and 2023 due to lower profit sharing expense. Blended expenses are 1% management fee and 12.1% profit share, well below the industry standard 2% and 20%. The lower fees are primarily the result of the co-investment program. In addition to the fee savings, Mr. Rashman noted that the average IRR on co-investments is 40% higher than that on fund investments.

Mr. Lyra ended the presentation with a brief overview of Program goals, including hiring an analyst, improve monitoring/reporting systems, and increasing the sourcing co-investments.

There was no further discussion on this item.

10. Adjournment of the Joint Meeting of the Board of Trustees and Investment Advisory Committee

The meeting adjourned at 4:15 PM.