



*Public Agenda Item #19

*Review and Discussion of ERS' Investment Practices and
Performance Relating to Senate Bill 322*

March 11, 2020

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OVERVIEW OF SB 322 EVALUATION

EMPLOYEES RETIREMENT SYSTEM OF TEXAS



March 11th, 2020

Sam Austin, Partner and Lead Consultant for ERS Texas



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IMPLEMENTATION OF SB 322

- Senate Bill 322 was introduced in the 86th Session of the Texas Legislature, leading to the adoption of Texas Government Code §802.109 in May 2019
- The new law requires Texas public retirement systems with at least \$100 million in assets to complete an Investment Practices and Performance Evaluation every 3 years
- Impacted systems, including ERS Texas, are required to select an independent firm to prepare an Evaluation Report. Per the legislation, the selected independent firm should have:
 - *substantial experience evaluating the appropriateness, adequacy and effectiveness of institutional investment practices and performance; and*
 - *no conflicts of interest (direct or indirect management of assets) with the retirement system*
- The Pension Review Board (PRB) issued guidance on the scope of evaluations in October 2019
- The first Evaluation Report is due to the PRB 31 days after Board approval, but no later May 31, 2020



PENSION REVIEW BOARD GUIDANCE

The PRB stipulates that a thorough review will:

1. Identify and review existing investment policies, procedures, and practices. This should include any formally established policies (e.g. Investment Policy Statement) as well any informal procedures and practices used to carry out the investment activities of the system.
2. Compare the existing policies and procedures to industry best practices.
3. Generally, assess whether the board, internal staff, and external consultants are adhering to the established policies.
4. Identify the strengths and weaknesses of the current policies, procedures, and practices and make recommendations for improvement.
5. Include a detailed description of the criteria considered and methodology used to perform the evaluation, including an explanation of any metrics used and associated calculations.



SCOPE OF EVALUATION

Texas Gov. Code §802.109 Outlines Five Major Topics for Review:

1. Analysis of any investment policy or strategic investment plan adopted by the retirement system and the retirement system 's compliance with that policy or plan
2. A detailed review of the retirement system 's investment asset allocation including:
 - a) *the process for determining target allocations;*
 - b) *the expected risk and expected rate of return categorized by asset class;*
 - c) *the appropriateness of selection and valuation methodologies of alternative and illiquid assets; and*
 - d) *future cash flow and liquidity needs*
3. A review of the retirement system 's governance processes related to investment activities, including investment decision-making processes, delegation of investment authority, and board investment expertise and education
4. A review of the retirement system 's investment manager selection and monitoring process
5. A review of the appropriateness of investment fees and commissions paid by the System



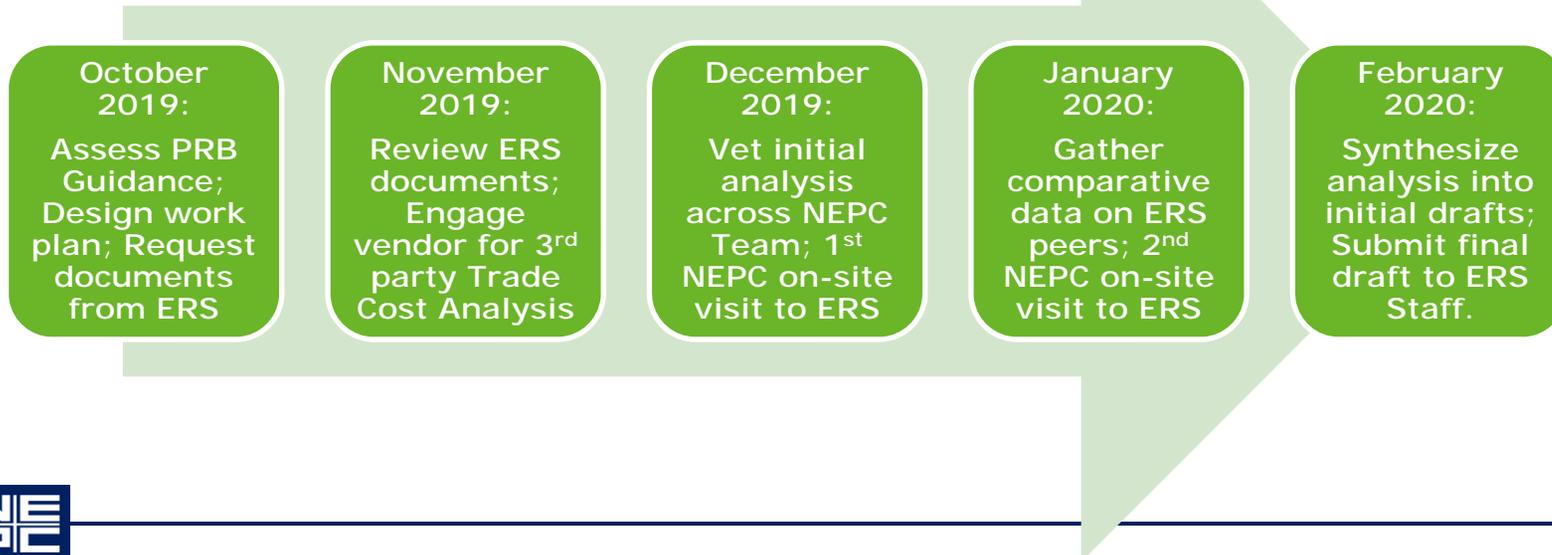
RESOURCES & TIMELINE FOR ERS TEXAS EVALUATION

NEPC Resources Working on the SB 322 Evaluation

Sam Austin, Partner and Lead Consultant for ERS Texas
Bill Bogle, Partner and Chief Compliance Officer
Tim Bruce, Partner and Director of Portfolio Construction
John Krimmel, Partner
Kevin Lau-Hansen, Senior ODD Analyst
Mike Malchenko, Senior Consulting Specialist
Tony Ferrara, Consultant

ERS Texas Resources Working on the SB 322 Evaluation

Porter Wilson
Cathy Terrell
Tom Tull
Betty Martin
Aaron Ismail
Ariana Whaley
Gabrielle Schreiber
John Streun
Leighton Shantz
Ricardo Lyra
Robert Sessa
Pablo de la Sierra Perez
Anthony Curtiss
Michael Clements



SUMMARY OF THE ERS TEXAS SB 322 EVALUATION

- Overall, NEPC finds ERS Texas' policies, procedures and practices to be appropriate, adequate and effective when compared to industry prevailing practice
- NEPC makes one recommendation we characterize as central to the future health of the Retirement System:
 - *NEPC recommends that ERS Texas and its stakeholders develop a comprehensive plan to mitigate the consistent negative cash flow impact to the Trust resulting from underfunding of the Annual Required Contribution from the Plan Sponsor to the Retirement System*



OTHER RECOMMENDATIONS

Additionally, NEPC identified several non-critical areas that ERS Texas and its stakeholders may want to consider for recommended enhancements:

1. NEPC recommends an informal annual review of capital market assumptions.
2. NEPC recommends that more flexible procurement options be explored to allow ERS Texas additional operational flexibility when there is a need to quickly replace an investment manager or take prompt advantage of an opportunistic investment.
3. NEPC recommends that ERS Staff regularly review a more formal process of projecting and reporting on liquidity risk. We suggest this process be a collaboration between the Director of Fixed Income and the Risk Committee. This process should monitor liquidity risk using scenario stress testing.



OTHER RECOMMENDATIONS

4. NEPC suggests that future trade cost analysis should not be limited to the current tracking of explicit commissions, but should also include estimates of market impact, fees and other implicit costs of trading. This more granular analysis will require that ERS Texas maintain a database of time-stamped trade information that is readily accessible by any future third-party firm engaged to conduct the trade cost analysis. A summary of the trade cost analysis should be reported to the Board at least every three years.
5. NEPC recommends an internal review of whether the cost of buying research with hard dollars is lower than the current practice of bundling the cost of research with commissions. We find that, while certainly still permissible in the current regulatory environment, a growing number of Public Funds no longer use a soft dollar program. Instead, many have unbundled trade best execution from payment for research. We acknowledge that ERS Texas has an understandably larger appetite for research given the Trust's relatively high percentage of assets under internal active management in comparison with peers.



OTHER RECOMMENDATIONS

6. NEPC recommends that a comparison of Standard Operating Procedures (“SOPs”) be conducted across asset classes with an objective of formulating a standard format that is more consistent across all asset classes. We acknowledge that some policies and procedures will necessarily be unique to each asset class.
7. In the next annual review of the Investment Policy Statement (“IPS”), NEPC suggests several revisions that could be considered to improve clarity, efficiency and accountability within the document.



SUMMARY AND NEXT STEPS

- ERS Staff provided NEPC with timely access and guidance regarding all requests for documents, interviews and procedures (formal and informal)
- Action on NEPC's primary recommendation to stabilize funding policy is dependent on important factors and stakeholders external to ERS Texas
- Implementation of NEPC's non-critical recommendations should be pursued thoughtfully and over time
- Following the ERS Board vote on this Evaluation Report, there may be minor formatting changes not impacting content before transmittal to PRB in April
- The analysis and recommendations in NEPC's Evaluation Report are intended as helpful resources ERS Texas can use toward accomplishing its mission and objectives



Questions?