AGENDA ITEM DETAILS

Subject: *Consideration of Quarterly Report from Chief Investment Officer

Background

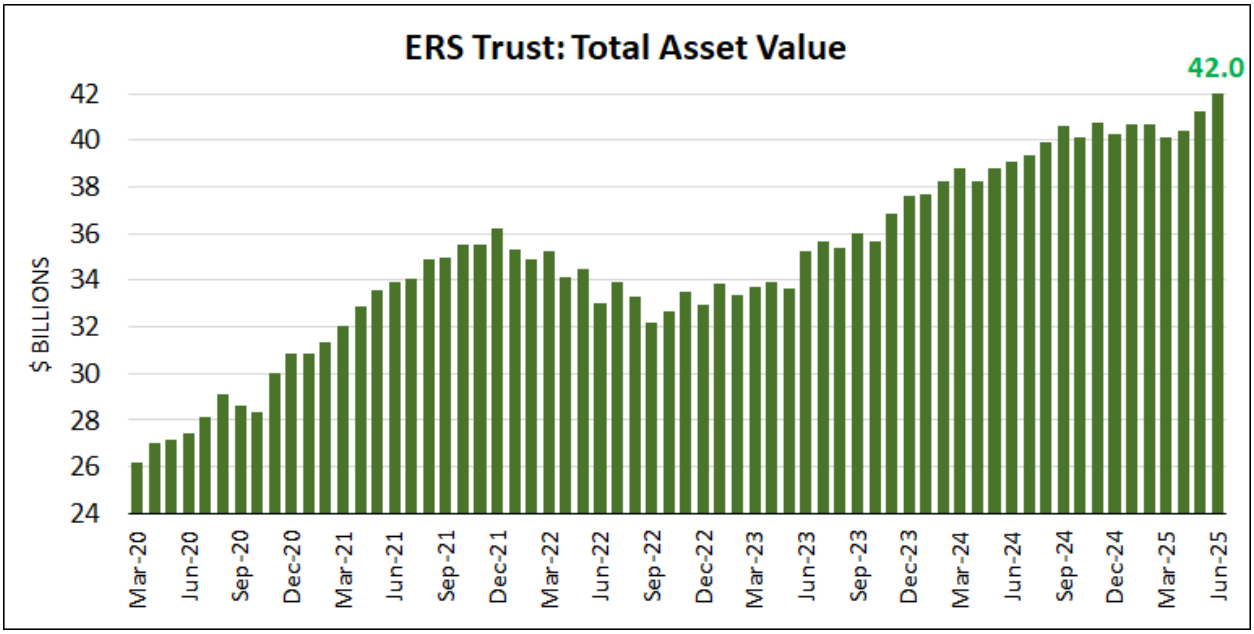
As required by the ERS Investment Policy Statement (IPS), this agenda item provides a report from the Chief Investment Officer regarding the performance of the pension fund investments of the Trust. Unless otherwise specified, the figures cited here represent annualized returns net of external investment expenses for pension fund investments as of June 30, 2025, as reported by the custodian.

Investment Objective

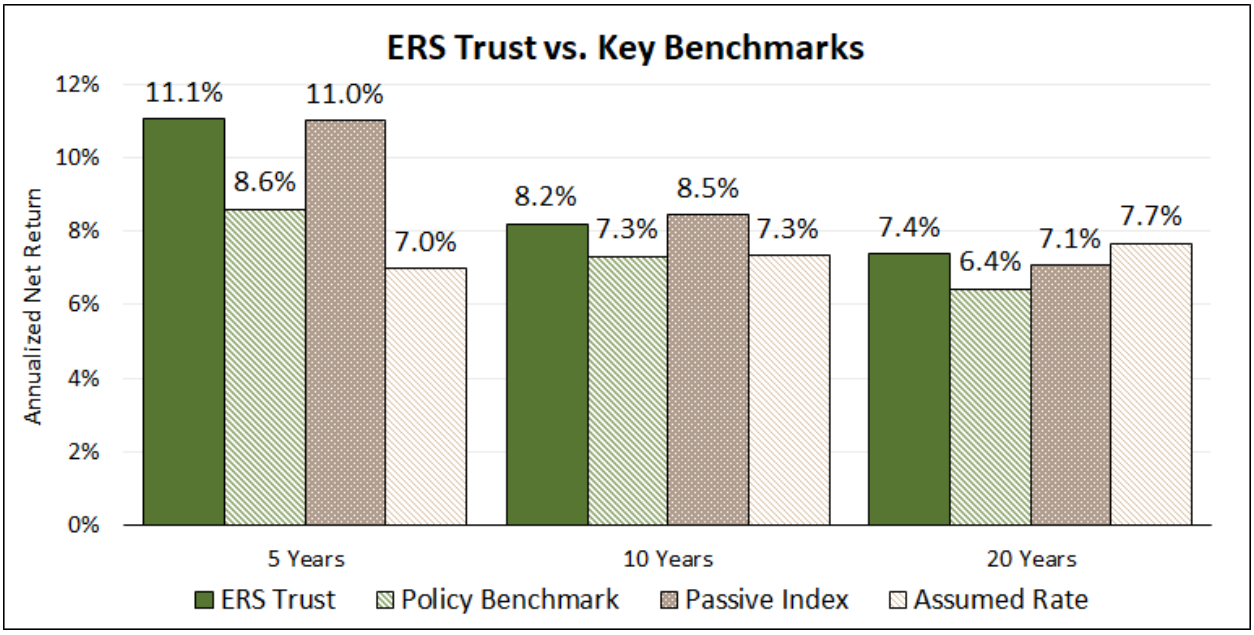
The overall objective of the investment program is to invest prudently in securities at a reasonable and predictable cost to deliver performance that supports the current and future provision of earned benefits for beneficiaries of the Trust funds managed by the System. To that end, the IPS specifies 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 $26 billion at the March 2020 lows to almost $42 billion through the second quarter of 2025. The Trust has continued to grow despite outflows of around $16 billion for annuity payments during this period. The overall increase was due to strong underlying investment returns and more than $2 billion in additional appropriations by the 88th 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, the Trust returned an average of +11.1% annually, which is +405 basis points above the Assumed Rate of Return (i.e., the average return expected over the long-term to provide for benefits). This figure is also +246 basis points above the Policy Benchmark, which represents more than $4 billion of value added cumulatively over that time. This five-year Trust return is +3 basis points above the Passive Index, which has exhibited much more volatiity and is therefore less well-suited to serve the Trust's liabilities.



The Policy Benchmark reflects a passive implementation of the asset allocation parameters established by the Board, and the Passive Index represents a passive mix of 80% global equities and 20% bonds. The Assumed Rate is the Board's measure of the estimated long-term return potential of the ERS Trust. The Assumed Rate shown is a blended average of the current 7% with prior levels of 7.5% and 8%.

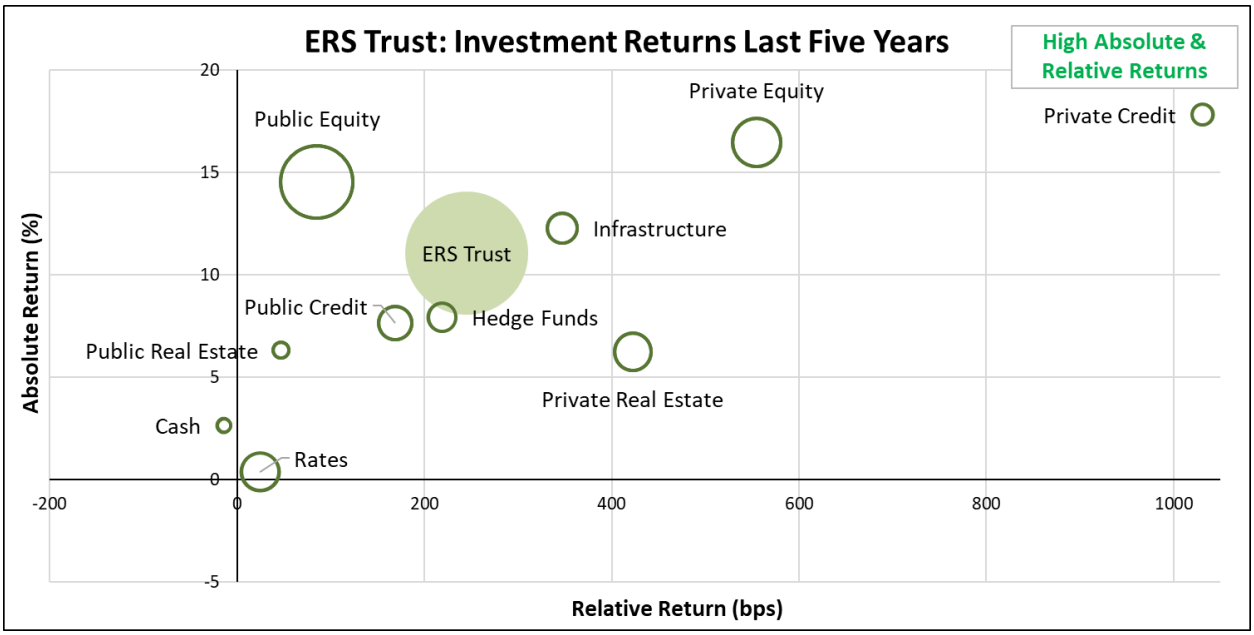
This performance is ranked in the top 1% of the peer group over the trailing five-year period and in the top 8% of its peers on a trailing ten-year basis. Such strong performance has placed the Trust among the top 10% of its peers across 22 of the last 24 relevant periods. Trailing three-year returns ranked in the 46th percentile due in large part to weak returns during late 2022 as US interest rates rose significantly.

Investment Performance Peer Ranking *(1 = best, 100 = worst)*

	ERS Trust			Policy Benchmark			Passive Index		
As of date	3 Years	5 Years	10 Years	3 Years	5 Years	10 Years	3 Years	5 Years	10 Years
2023-3Q	1	2	6	28	24	35	68	28	37
2023-4Q	1	5	6	15	42	31	55	4	25
2024-1Q	3	6	10	6	53	39	18	7	22
2024-2Q	1	1	4	7	45	32	17	4	15
2024-3Q	5	3	7	16	38	34	5	1	9
2024-4Q	5	2	8	14	42	38	10	7	9
2025-1Q	4	12	4	29	71	35	1	1	8
2025-2Q	46	1	8	60	48	26	1	1	3

All policy asset classes except cash have made meaningful contributions to both the absolute and relative returns of the Trust over the last five years. The chart below depicts the relative returns of the asset classes on the horizontal axis and their absolute returns on the vertical axis, with the best performance denoted by bubbles that are in the upper right hand quadrant. Private Equity has been a standout

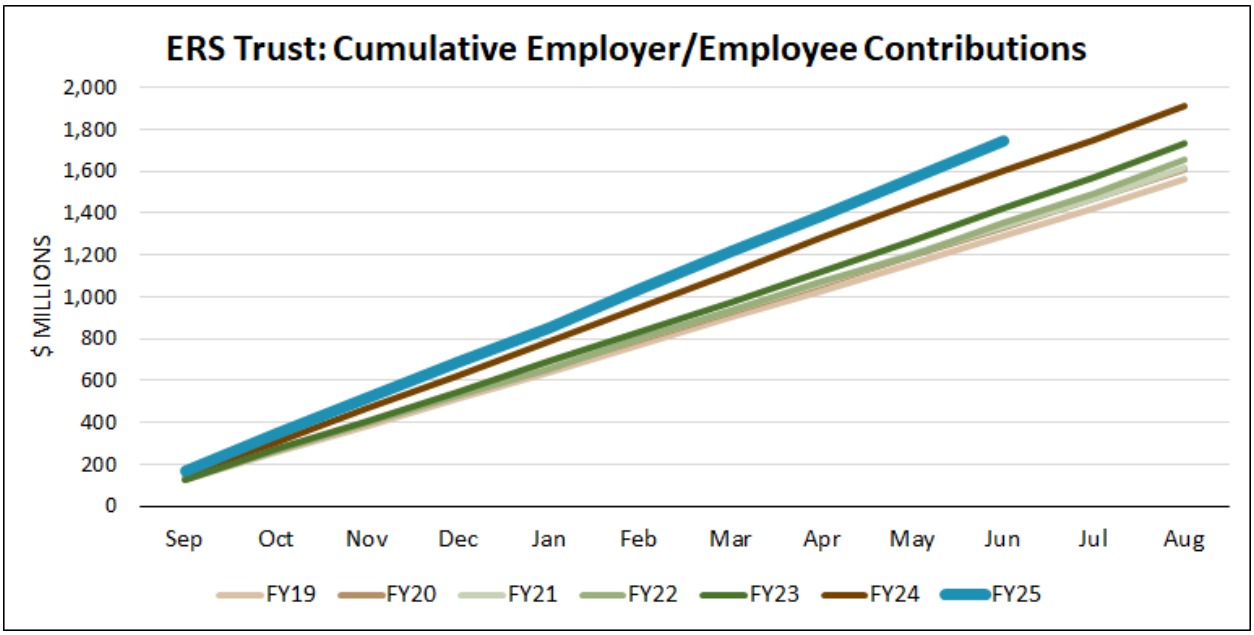
performer with gains averaging +16.5% annually, in part by adding +555 basis points annually over its benchmark. Hedge Funds, Private Credit and Infrastructure have also performed well.



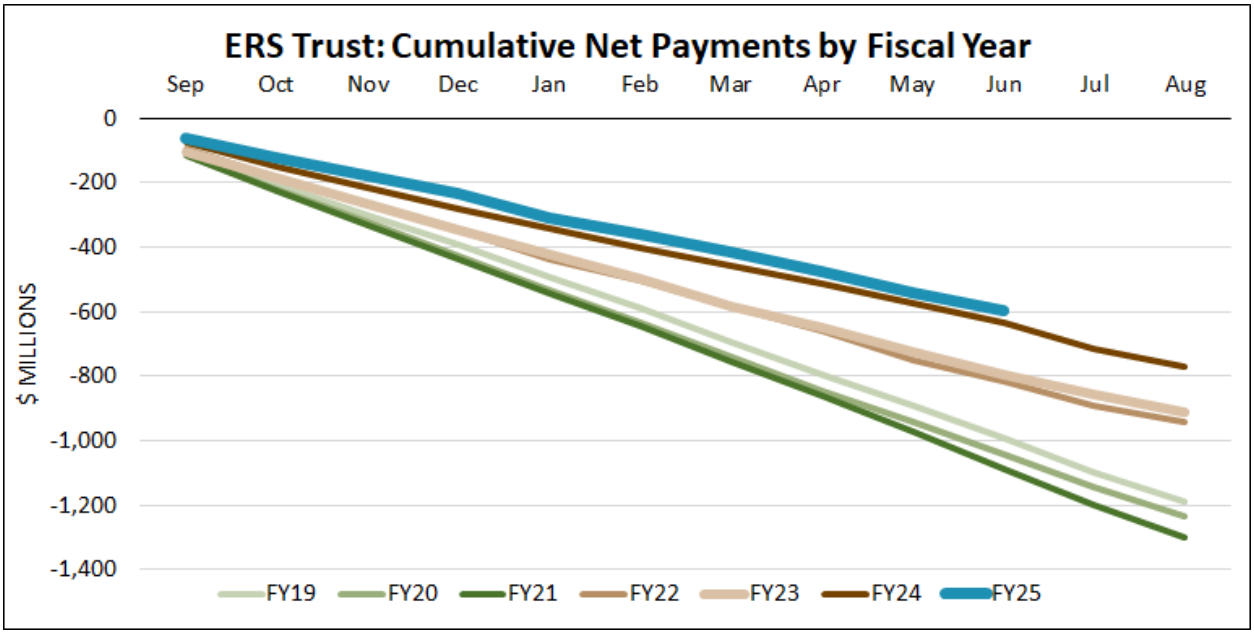
During this time the performance of the Public Equity program has improved meaningfully to add an average of +85 basis points annually versus its benchmark, which has been significant given that public equity is roughly one-third of Trust assets. This contribution has been a meaningful accomplishment in a global equity market marked by heavy concentration in a very narrow set of technology stocks that have been driven to record highs by enthusiasm about artificial intelligence (AI).

Liquidity Profile

Current data indicates that the cash flow profile of the Trust continues to evolve favorably. Recent improvements have been driven by significant increases in the level of contributions from employers and employees to the Trust. As shown below, these inflows totaled just above $1.9 billion for FY24, an increase of 13% over a year ago, while distributions increased 1%. For FY25, such contributions have risen 9% so far and are on track to exceed $2 billion, while distributions have risen only 4%.



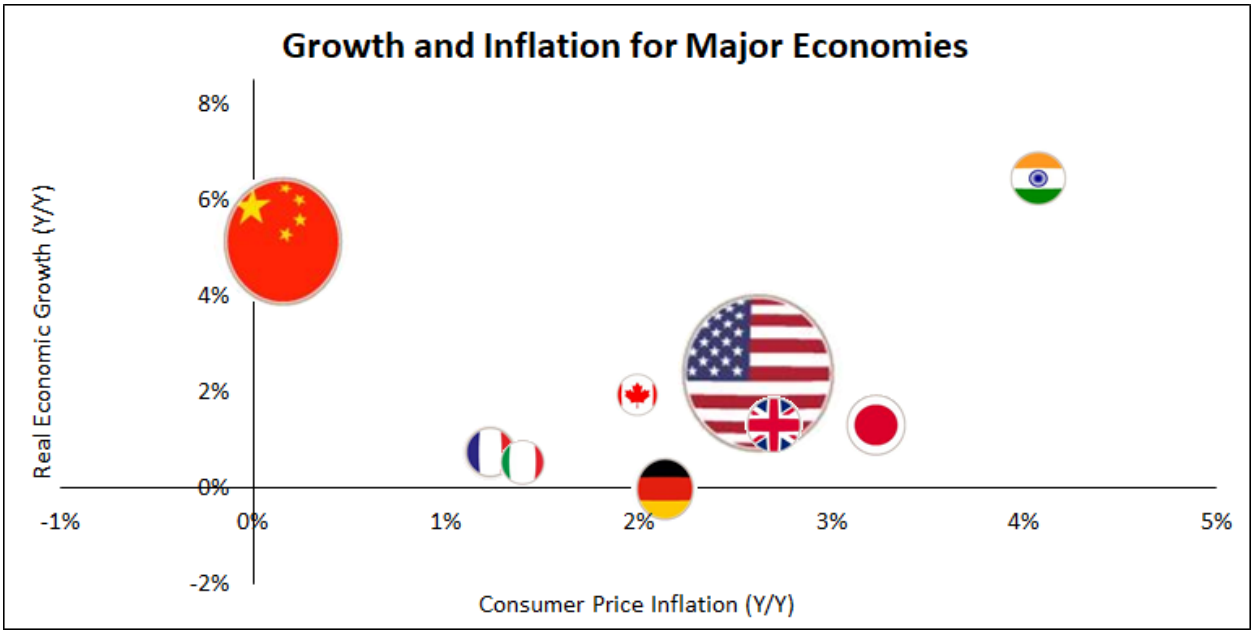
As a result of this contunued rise in contributions, the liquidity profile of the Trust has improved significantly. During FY24 the Trust paid out almost $3.2 billion in distributions to beneficiaries (mostly annuity payments), resulting in $1.3 billion of net payments to beneficiaries. This figure is materially below the average of more than $1.4 billion for the two prior fiscal years at the same point in the year. Better still, accounting for the $510 million annual legacy payments from the State of Texas put the FY24 outflows at only $772 million as shown below, a figure that for FY25 is trending to around $710 million.



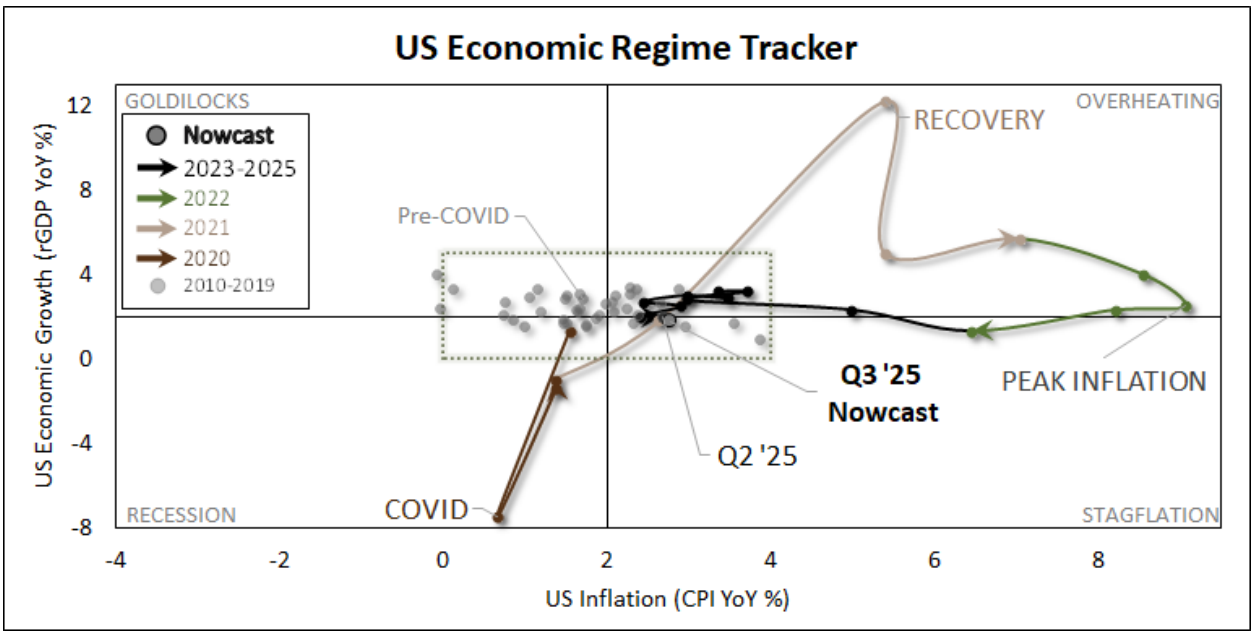
These net outflow figures represented 1.8% of the current value of the Trust at the end of the quarter as compared to the 3.7% as measured at the end of FY2021. This development represents a significant positive for the Trust in the medium term because fewer investment assets must be sold each year to fund ongoing benefit payments, allowing for greater compounding of those assets and enabling the allocation toward a less liquid portfolio.

Investment Environment

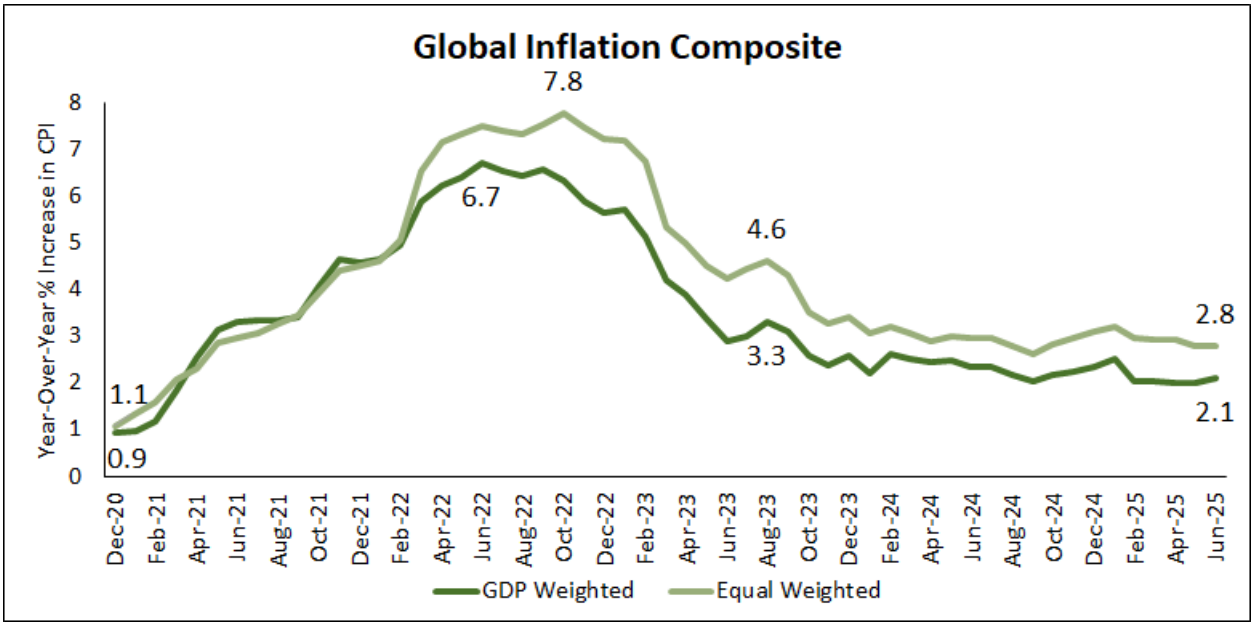
Economic growth has remained strong across most major economies, at least through the end of the first quarter of 2025. As shown in the chart below, the US economy has expanded recently at a 3% average pace amid inflation that also averaged 3%. Economies in Asia grew the fastest while those in Europe were sluggish, including a negative reading in Germany. Inflation was elevated in many economies with the most notable exception being China, which has suffered mild deflation.



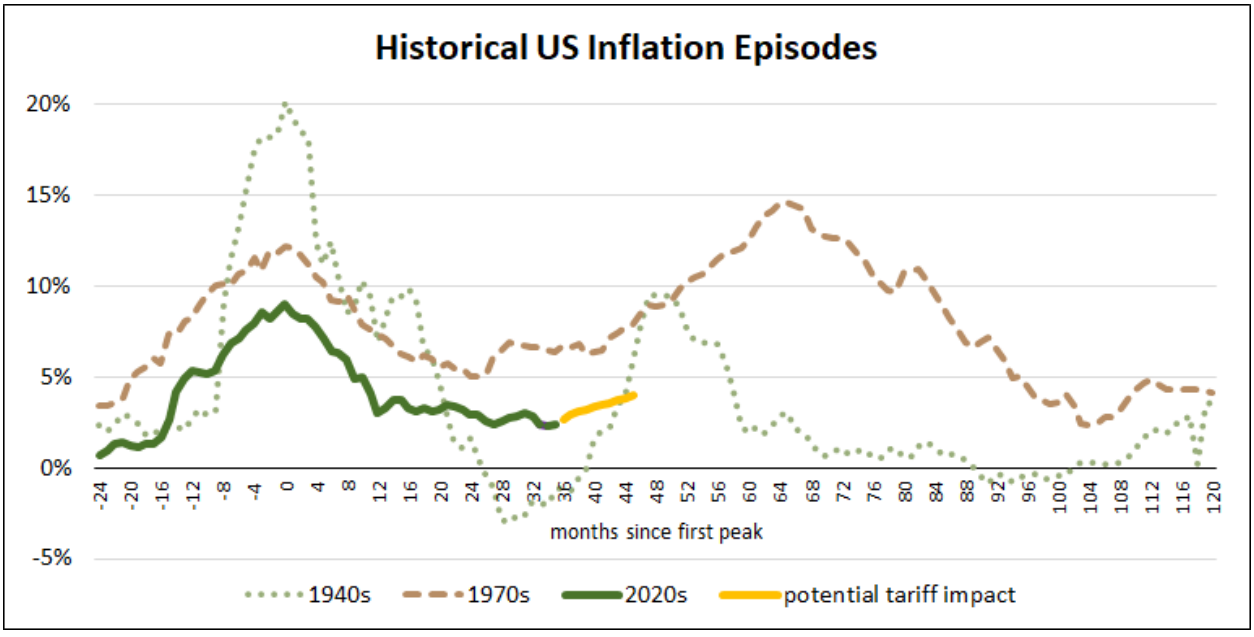
The asset allocation framework for the Trust suggests that economic conditions have normalized, particularly in the United States. During 2023 the US economy moved back into pre-COVID conditions with stable and moderate readings for growth and inflation. As shown in the chart below, growth and inflation in the US were both estimated to be running 2-3% at the end of the second quarter of 2025 as measured on a year-over-year basis.



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 near zero change in prices, and Russia, where inflation has reaccelerated to above 9%. The United States is similar in this regard, with inflation having dropped currently below 3% but ticking up in recent months.



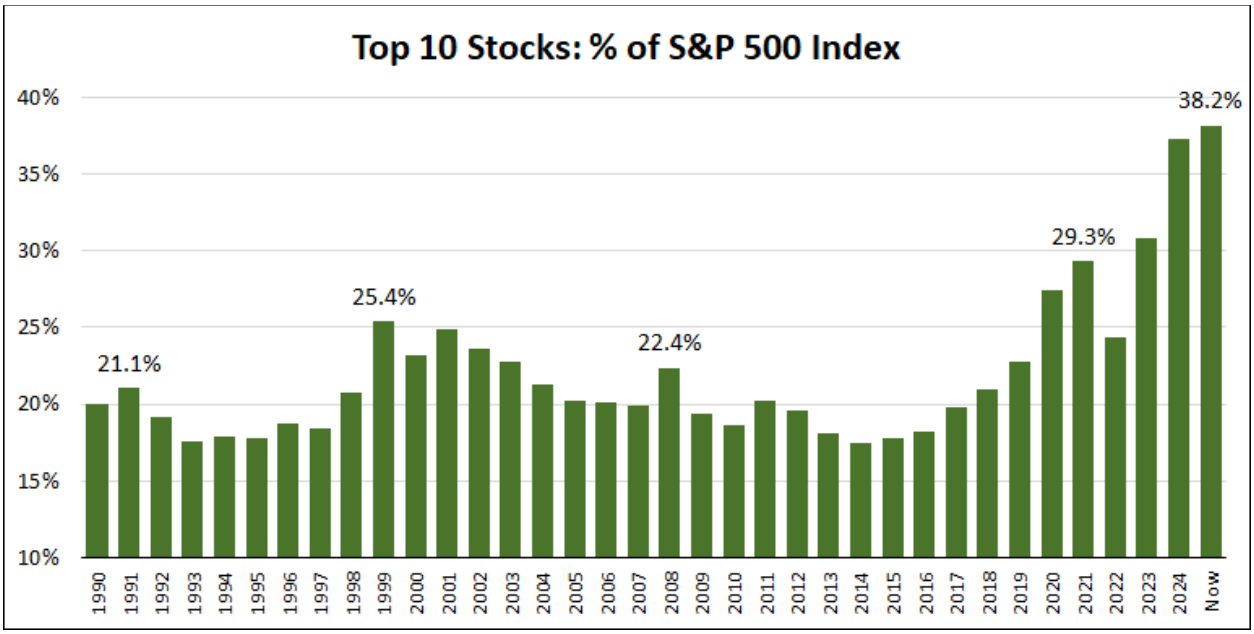
However, a study of history from the 1940s and 1970s offers a stark reminder that inflation risk can reassert itself. As shown on the chart below, inflation in the United States has historically come in waves, such as during the 1970s when the first wave hit bottom 24 months after peaking, and then reaccelerated to new heights over the next three years. Recent data points, including the small uptick in the inflation rate registered in March 2025, have eased concern about a potential resurgence in inflation. However, the imposition of meaningful tariffs on global trade could be one such catalyst for higher inflation, and the best estimates from asset managers suggest a rise to around 5% in the year ahead.



Such a scenario could put the US Federal Reserve (Fed) in a difficult position with respect to its dual responsibilities of fostering maximum employment and stable prices. Fed Chair Powell continues to state publicly that price stability is essential to achieving long periods of strong labor market conditions. He has also highlighted that the Fed has an obligation to keep longer-term inflation expectations well anchored and to make certain that a one-time increase in the price level does not become an ongoing inflation problem. As such, it seems likely that the Fed may continue to err on the side of controlling inflation, keeping rates unchanged or raising them as needed to ensure that expectations remain subdued.

Update on Market Concentration

The S&P 500 index remains the best performing equity index globally over the long term. This distinction has been especially true in recent years, though those outsized gains have been concentrated in a small handful of stocks. As of the end of July 2025, the "Magnificent 7" stocks have returned 13.4% versus 10.3% for the S&P 500 equal weighted index. As a result, the top 10 stocks made up almost 40% of the S&P 500 index, well above the prior peak of 25.4% seen during the technology bubble in 1999.



Within this group, NVIDIA makes up more than 8% of the index, while Microsoft and Apple are each more than 7% and 6% respectively. NVIDIA now has a market capitalization above $4 trillion, which makes it more valuable than all of the 183 companies in the MSCI Japan Index combined. Such high concentration also means that the S&P 500 index fails to meet the definition of a diversified fund contained in the Investment Company Act of 1940, which limits the holdings of any single issuer to 5%.

A look back in history offers a cautionary tale for such an environment. In the aftermath of the technology bubble of the late 1990s, the largest stocks in the S&P 500 index performed quite poorly for years to come. For example, since their peak in September 2000, shares of General Electric have returned an average of less than 1% annually, which included a cumulative loss of more than 80% at the market lows of 2009. Indeed, several darlings of this era have never recovered. For example, today shares of Nokia trade at less than 7% of their price at the March 2000 peak.

Ten Largest S&P 500 Stocks at Year End 1999

Company Name	Index Weight on 12/31/99	Annualized Returns Next 5 Years
MICROSOFT	4.9%	-12.4%
GENERAL ELECTRIC	4.1%	-4.7%
CISCO SYSTEMS	2.9%	-18.5%
WALMART	2.5%	-4.6%
EXXON MOBIL	2.3%	7.5%
INTEL	2.2%	-10.4%
NOKIA OF AMERICA	1.9%	-42.0%
INTL BUSINESS MACHINES	1.6%	-1.2%
CITIGROUP	1.5%	6.6%
TIME WARNER	1.4%	-23.8%
TOTAL	**25.4%**	**-10.1%**

Market Performance

Index Name	Annualized Returns 2000-2004
S&P 500 EQUAL WEIGHT	8.1%
US TREASURIES	7.5%
MSCI EMERGING MARKETS	4.3%
DOW INDUSTRIALS	0.7%
MSCI ACWI EX-US	-0.3%
S&P 500	-2.3%
NASDAQ 100	-15.1%

Based on the significant weakness in what had become its largest holdings, the S&P 500 would struggle in the years ahead. It would return -3% per year for the next five years and -1% over the next ten years, which is often called a “lost decade” for that index. It is also instructive to note that the S&P 500 equal weighted index, which owns the same amount of each constituent, actually returned 8.1% per year in the years after the bubble. This figure suggests that the average American company was performing well during this era even though a pocket of significant softness drove a bear market for the index overall.

Organizational Priorities

During the remainder of calendar year 2025, the Investments division will seek to sustain best-in-class organizational performance:

- **Asset Liability Study:** The IPS states that setting the parameters of the long-term asset allocation is the most important investment decision the Board makes. As such, the IPS requires that the General Investment Consultant shall conduct asset/liability studies regularly to assess the trajectory of the Trust’s liabilities, its risk tolerance and liquidity profile, and the probability of achieving its long-term return goals. These studies include a detailed review of the asset allocation parameters and a comprehensive assessment of the liquidity needs of the Trust, and serve as the primary basis upon which significant changes may be made to the Strategic Asset Allocation (SAA) parameters for the Trust.

  RVK began work on the 2025 Asset Liability study in December 2024. Staff has participated in this effort by facilitating data exchange between RVK and the system’s pension actuary, by helping RVK customize its capital market assumptions to the implementation approach of ERS, and by assisting in the development of model portfolios for the analysis. The draft 2025 Asset Liability study was presented to the Board in May 2025 for feedback and review. The final 2025 Asset Liability study and the associated recommendations are attached to the relevant agenda items for Board consideration in August 2025.

- **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 has done so again this year. Potential areas for discussion include:

    - Revisiting the use of performance benchmarks for appropriateness and/or suitability for investment. For this update, the focus is on removing foreign adversary countries from the public markets benchmarks. In the year ahead, staff expects to review the use of benchmarks in public markets for cost effectiveness and those in private markets in light of the considerable progress that has been made in that area.

    - Revisions to adopt the recommendations regarding the strategic asset allocation parameters as a result of the 2025 Asset Liability study.

    - Revisions to support the ongoing development of a more nimble selection process for external advisors. Such a process would allow for operational flexibility when there is a need to quickly replace a struggling investment manager or to take advantage of an opportunistic investment in a timelier fashion.

    - Revisions to support the adoption of a more formal recruitment policy for new IAC members as memorialized in the Investment Advisory Member Recruitment Standard Operating Procedures (SOPs) attached to this agenda item.

    - Revisions to support the pending adoption of a more comprehensive ethics policy for the agency.

- **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 best practice is for the Board to review all of these plans together just

prior to the beginning of the fiscal year, rather than individually as part of the annual asset class reviews that occur over several meetings starting in March. As such, staff is once again bringing these recommendations as a single subsequent agenda item for this meeting.

- **Leadership transition:** Robert (Bob) Sessa, Managing Director of Real Assets, announced recently that he plans to retire at the end of August 2025 after more than 25 years of service to ERS. The entire agency is grateful for his many contributions through the years and his presence will be missed. Staff has initiated the process to fill this leadership role in the coming months.

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, 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 the Board of 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 2024-09-01)
2. Exhibit B – Current version of ERS Investment Implementation Plan (effective 2025-01-28)
3. Exhibit C – Draft Investment Advisory Committee Member Recruitment SOP
4. Slides – Chief Investment Officer Update