AGENDA ITEM DETAILS

Subject: Review of ERS' Asset Allocation and Implementation

BACKGROUND:
At the August 23, 2017 Joint Meeting of the Employees Retirement System of Texas, the Board of Trustees (Board) adopted an investment return assumption of 7.5% based on an analysis by AON Hewitt Investment Consulting (AHIC). AHIC served as the Trust's general investment consultant for the asset allocation study performed in 2017. The recommended asset allocation had an expected return of 7.0% to 7.20% over a 10-year horizon, 7.4% over a 20-year horizon and 7.6% over a 30-year horizon. As part of the motion to adopt the 7.5% return assumption, the Board moved that the return assumption be reviewed in two years. At its December 2018 meeting, the Board awarded the general investment consultant contract to NEPC. At the May 22, 2019 Joint Meeting, the Board reviewed NEPC's 2019 investment return forecast. The reviewed calculations were a forecasted expected return of 6.9% over a five-to-seven year or medium-term time horizon and 7.75% over a 30-year or long-term time horizon.

NEPC updates capital market forecasts annually. The most recent 10-year, 20-year, and 30-year forecasted investment returns using 2020 capital market assumptions are in the chart below.

Statistic	Policy Allocation Capital Market Forecast
Inflation	2.50%
10-Year Expected Return	6.06%
Sharpe Ratio - 10 Yr	0.35
20-Year Expected Return	6.41%
Sharpe Ratio - 20 yr	0.35
30-Year Expected Return	7.14%
Sharpe Ratio - 30 yr	0.40
Estimated Risk	12.04%

Utilizing NEPC's 2020 modeling assumptions in Exhibit A of this report the expected returns for 10 and 30-year periods are 6.06% and 7.14%, respectively. Based on this information, the current asset allocation is not expected to be able to produce 7.5% over the next 30 years.

NEPC's expected return forecasts are based on current market prices and forward-looking estimates. The forward-looking estimates rely on a fundamental 'building blocks' approach that broadly includes intermediate and long-term assumptions for economic growth, supply/demand dynamics, inflation, valuation changes, currency markets, forward-looking global yield curves, and credit spreads. The building blocks are specific to each major asset class and represent the primary drivers of future returns. For example, the equity forecast model is based upon assumptions for real earnings growth with adjustments incorporated for profit margin changes, inflation, dividend yield, and current valuations trending to long-term averages.

Fixed income return forecasts are based upon changes in real interest rates and forward yield curves, with credit sectors including an assumption for changes in credit spreads and credit defaults. Alternative investment strategies are similarly built from the bottom up with a building blocks approach based upon public market beta exposures while also incorporating an appropriate risk premium for illiquidity.

A formal review of the assumption will occur as part of the experience study and asset allocation and liability study.

Staff Recommendation:

This agenda item is provided for informational and discussion purposes only. No action is required.

ATTACHMENT(S):

1. Exhibit A - Asset Allocation Appendix