Opportunistic Credit Program Annual Tactical Plan

for Fiscal Year 2020

ERS®

Employees Retirement System of Texas

March 11, 2019

OPPORTUNISTIC CREDIT PORTFOLIO

ANNUAL TACTICAL PLAN FOR FISCAL YEAR 2020

Effective: March 11, 2020

I. EXECUTIVE SUMMARY

The Employees Retirement System of Texas (ERS or the Trust) will make Opportunistic Credit investments to enhance the total return of the Trust. The total targeted allocation is 3% of Trust assets. The objectives of the Opportunistic Credit allocation are as follows: (1) To enhance the overall return of the Trust, (2) To further diversify the Trust's portfolio, and (3) To further reduce the Trust's overall volatility by increasing investments in private asset classes. The underlying philosophy of the investment program is to seek attractive risk-adjusted returns across the illiquid part of the fixed income universe by allocating to a diverse set of investment strategies. In some instances, these may be unique strategies, which exist either only during or after specific economic environments. Lastly, these investments should complement current credit holdings residing within the Trust given the portfolio construction of other asset classes.

The Opportunistic Credit Annual Tactical Plan for Fiscal Year 2020 (Annual Tactical Plan) has been prepared by the ERS Hedge Fund team. Albourne America LLC (Consultant) conducted the review of the Annual Tactical Plan. This document is intended for planning purposes and outlines the necessary steps to be taken over the next 12 months. The objective of the Annual Tactical Plan is to establish objectives of the Opportunistic Credit portfolio, along with addressing considerations relevant to the administration and success of the portfolio. This Annual Tactical Plan is to serve as a guiding reference to the construction of the Opportunistic Credit portfolio. The Board reviews and approves the plan. At times, this plan may need to be reevaluated in light of economic, political, and other relevant events. This tactical plan is not intended to overrule prudent investment allocation decisions.

This Annual Tactical Plan strives to highlight significant potential opportunities for capital commitments over the coming 12 months. However, as this allocation is an opportunistic allocation, capital will only be deployed when compelling opportunities are present. Capital will not be deployed simply to meet an allocation target. Hence, the portfolio could receive no allocations, or could maintain an underweight within the Trust. As stated earlier, the intention is for the portfolio to act as a tool to provide added flexibility to the underlying asset classes within the Trust, and to act as a complement to existing credit oriented strategies that already reside within the Trust.

II. GENERAL ALLOCATION OVERVIEW

The underlying philosophy of this allocation is to generate attractive risk-adjusted returns throughout the fixed income universe using a diverse set of private investments, which are not a focus within other existing portfolios. Opportunistic allocations could be to niche strategies or opportunities that only exist for a period of time, either during or slightly after an economic cycle is in recession. In addition, banking or other regulations could also be a driver into the future opportunity set.

The 3% allocation will be actively allocated into the Trust by the Hedge Fund Team. The Hedge Fund Team will recommend an investment only when there is strong conviction about a strategy, and is not required to make any allocations to the strategy. Supporting efforts/expertise from the ERS Infrastructure, Private Equity, Real Estate, and Credit teams are expected given the broad mandate. Staff will not treat the allocation as an overflow portfolio for existing credit opportunities already invested in by the Trust.

The portfolio construction and ultimate ownership of the underlying investments will reside with the Hedge Fund Team; in conjunction with the ERS Asset Class Investment Committee, who will approve new allocations to the Opportunistic Credit portfolio. The Hedge Fund team will also work with the Chief Investment Officer, who will provide oversight to the initial and ongoing development of the portfolio.

III. CAPITAL DEPLOYMENT

This new allocation will require significant research to identify unique or niche credit strategies relative to current credit exposures that reside within the Trust.

Initial Deployment

Initial deployment of capital in Fiscal Year 2020 will be strategically slower in this first year. This allows for future opportunities that might present themselves over the coming years, given the maturity of both the economic and credit cycles. Expectations for Fiscal Year 2020 are to focus on three or fewer investments accounting for no more than $300 million or roughly 1% of the Trust's assets. As stressed throughout this document, capital will not be deployed unless compelling opportunities arise. Staff are also expected to overweight other return seeking assets of the Trust at the expense of this allocation when there are not compelling opportunities to invest.

Future Deployment

Over the next 12 months, expectations are for the development and presentation of a pacing model for the Opportunistic Credit portfolio for approval in the next annual tactical plan. A similar model is already in use across many of the private asset classes (i.e. Private Equity, Private Real Estate, and Infrastructure). The pacing model will make projections around the future growth of assets for the Trust, potential distributions from investments, maturing investments, and other relevant aspects relating to closed-end investment allocations. This model will be created with the help of the Consultant and revisited at least annually upon its development to review the underlying assumptions into the model's results.

IV. BENCHMARKING

The Opportunistic Credit portfolio will be formally benchmarked against an absolute return benchmark of +6.5% per annum for the initial three-year allocation phase. Deviating from the official policy benchmark during the initial development of a new allocation allows the portfolio to mature and is similar to the benchmarking strategy used during the development phase of other private market asset classes. The portfolio's stated policy benchmark of S&P LTSA Leveraged Loan Total Return Index (SPBDAL) plus a premium of 150 basis points will commence as the established portfolio benchmark at the end of the three-year phase of the allocation. The Board adopted this benchmark when they adopted the asset class guidelines and procedures, but specified that the premium above the benchmark would be approved at a later time. The staff recommendation is proposed to be 150 basis points above the benchmark, based on the expectations for portfolio construction and objectives of this allocation.

V. PORTFOLIO CONSTRUCTION

Initial focus for staff will be on global multi-strategy credit managers who can rotate between Distressed, Private Lending, Structured Product, and Real Asset & Esoteric Credit. These areas will provide yield-oriented investments structured with strong collateral and covenant requirements with resilience of cash flows throughout the credit cycle, and in some instances, tactical because of dislocations on primary opportunities. After completing a core multi-strategy allocation, staff may consider distressed opportunities should the current economic cycle mature further and, particularly so, if it declines into recession. Distressed investments can have their total return determined primarily by the discounts in purchasing assets and their recovery values more than yield. Long-term expectations are for this portfolio to evolve over time depending upon the period in the credit cycle. Alongside a core multi-strategy credit manager, niche managers, which complement the core-competencies of the multi-strategy credit managers, will also be considered for smaller commitment amounts.

Staff will work with the consultant to review investment opportunities, but the allocation will not be guided by traditional portfolio construction given that it is a true opportunistic allocation, which makes timing around strategies uncertain. Below are the stated portfolio objectives to target with this allocation:

- In aggregate, investments should seek a portfolio target time-weighted return of at least 6.5%
- Investments should emphasize cash flows, with price appreciation as a secondary focus
- Credit managers should manage risk by focusing on investments with strong covenants and/or secured assets backing the investment with limited balance sheet leverage

Expectations are also for J-curve mitigation by paying fees on invested not committed capital as well as periodic cash distributions. As previously mentioned, this portfolio will seek to have downside risk protection by looking to senior structured securities, strong covenants, collateral-backed self-liquidating assets, and sufficient transparency.