

PUBLIC AGENDA ITEM - #18b

18b. Review, Discussion and Consideration of Tracking Error Update
for Internally Managed Portfolios

August 25, 2009

BACKGROUND:

As authorized by the ERS Board of Trustees (Board), and in accordance with the Section 3 of the ERS *Investment Policy*, the performance of internal portfolios is evaluated regarding the following investment objectives:

- a. Performance relative to the stated benchmark;
- b. Adherence to tracking error and/or other risk constraints;
- c. Adherence to the investment policies and objectives as adopted by the Trustees.

At the February 24, 2009 joint meeting of ERS Board and Investment Advisory Committee (IAC), ERS staff reported that in accordance with Section 4.1 of the ERS *Investment Policy*, the internally-managed small cap core and mid cap core portfolios had exceeded their tracking error limits during the recent volatile market environment.

The Board and IAC acknowledged that certain portfolios had exceeded their tracking error limits and discussed the need to examine the tracking error limits in consideration of the current extraordinary prevailing circumstances and volatile market environment.

Section 815.307 of the Texas Government Code and Section 4.1 of the ERS *Investment Policy* state that the Board of Trustees must, with respect to making investment decisions, take into consideration the investment of all assets of the trust rather than considering the prudence of a single investment of the trust. Furthermore, among other requirements, Article XVI, Section 16, of the Texas Constitution and Section 4.1 of the ERS *Investment Policy* provide that investments shall be made exercising the judgment and care, under the circumstances prevailing at the time of the investment that a person of ordinary prudence, discretion, and intelligence would make in the management of their own affairs.

The Board and IAC asked staff to research all internally managed portfolios' tracking errors and report their findings at the next joint meeting. These findings were presented at the May 19, 2009 joint meeting of the ERS Board of Trustees and Investment Advisory Committee.

Due to the financial market volatility which is outside of historical norms, the Board approved maintaining the current tracking error targets and limits for the internal portfolios, but allows ERS staff to temporarily go outside of the maximum tracking error limits. ERS staff is to review tracking errors and continue to report occurrences of portfolios exceeding their policy limits to the Board of Trustees and Investment Advisory Committee at each meeting.

Ennis Knupp has reviewed these tracking error targets and limits and their findings are presented in the following table:

Realized Active Risk (Tracking Error) Ending 6/30/2009

ASSET CLASS/STRATEGY	TRACKING ERROR TARGET	TRACKING ERROR LIMIT	ACTUAL TRACKING ERROR (Trailing 3-years)	IN COMPLIANCE WITH INVESTMENT POLICY?
DOMESTIC EQUITY	100 bps	120 bps	100 bps	Yes
Large Cap Passive	10	20	23	No
Large Cap Active Core	125	150	105	Yes
Large Cap Growth ¹	125	150	--	--
Mid Cap Core ¹	275	300	--	--
Small Cap Core	275	300	392	No
INTERNATIONAL EQUITY	150 bps	300 bps	218	Yes
International Active Core	150	300	142	Yes
Emerging Market Core ¹	250	400	--	--
Active Core Fixed Income	70 bps	70 bps	87	No
Public Real Estate	200 bps	300 bps	166	Yes

This agenda item is presented for discussion purposes only.

STAFF RECOMMENDATION:

No action is required.