

PUBLIC AGENDA ITEM - #24

24. Deputy Executive Director of Investments' Report

August 25, 2009

BACKGROUND:

Update on Three-Year Investment Enhancement Plan:

In 2006, the Employees Retirement System of Texas' (ERS) Board of Trustees (Board) engaged the services of its consultant, Callan Associates, to conduct a review of ERS' internal investment program. The objective of that review was to evaluate the program relative to best practices observed in the marketplace and to make recommendations for improvement.

Callan made a number of observations and recommendations about ERS' internal investment program. They observed that, because of stringent laws, ERS had fostered "a culture of risk aversion and cost containment at the expense of investment results relative to peers. The result of this culture has been underinvestment in staffing and systems . . ." The report also noted, "The budget constraints have impacted recruiting for senior positions."

Callan also made the following recommendations in order of priority:

- Improve documentation in support of internal programs.
- Research expansion of the practice of permitting external advisors to execute their trade recommendations.
- Either ramp up international equity research staff or shift the internal program to external advisors.
- Add investment staff to both fixed income and domestic equity teams.
- Invest further in analytical tools for investment staff.
- Accelerate timetable for private markets and absolute return strategies.
- Organize staff along global lines.
- Explore the possibility of additional administrative and managerial support for the Chief Investment Officer.
- Implement an incentive compensation program for key investment staff or for entire investment staff.
- Consider addition of a full-time compliance officer.

ERS Board, IAC and management understood the importance of its investment program and embarked on a three-year growth and improvement plan for ERS' investment program commencing in fiscal year 2007 through 2009. The most obvious outcome was the growth of Investments' operating budget from \$5.06 million in fiscal year 2006 to \$11.2 million in 2007, \$12.5 million in 2008 and \$16.6 million in 2009. The more important outcome was the plan's outperformance to its policy benchmark in fiscal year 2007's bull market and also in 2008-2009's bear market.

First of all, policies and procedures were written or rewritten for all Investments' sections and asset classes. Investments engaged the temporary services of a technical writer to assist in the documentation process and inclusion of the information on the internal website.

New positions were designed and created across the Investments Division from administration to trading, from fixed income to public and private equities. The changes in staffing levels are shown below:

<u>Investments Sections</u>	<u>Budgeted Positions</u>	
	<u>FY06</u>	<u>FY09</u>
Global Equities (includes traders)	11*	25
Global Fixed Income	5	8
Real Estate	0	4
Private Equity	0	3
Strategic Research	0	1
Operations	6	8
Administration	<u>4</u>	<u>7</u>
Total	26	56

**Includes REITS Portfolio Manager*

In addition, staffing was added elsewhere in the agency to support Investments. Legal Services hired two experienced private markets lawyers. Information Systems added a business analyst and technical analyst, both with investment-related experience to support Investments growing technology needs. Investment Accounting added three positions to support the increased number of portfolios. Obviously, this growth in personnel was taxing for Human Resources, but they responded with extraordinary efficiency.

Equity research was organized along global sector lines, and benchmarks for both equities and fixed income were changed to reflect the global nature of investment opportunities. For instance, domestic equities moved from the S&P 500 to the S&P 1500 and international equities from the MSCI EAFE to the MSCI ACWIexUS. Fixed income moved from the BarCap (formerly Lehman) Aggregate to the BarCap Universal.

Analytical tools such as FactSet and Thomson Reuters were added, as well as the new Eagle accounting system.

In 2007, the ERS Board authorized staff to proceed toward targets of 7 percent each for private equity and real estate until the formal asset/liability study was performed in 2008, formally setting the targets at 8 percent. However, frothy markets delayed the availability of qualified candidates for those asset classes. As fate would have it, the delay allowed ERS to come to the private markets at more attractive valuations than were available in 2007.

Effective fiscal year 2007, ERS implemented a performance incentive plan for qualified Investments staff. This plan was later amended for fiscal year 2009. It has been an effective hiring tool and, since the amendment, an effective retention tool.

Investments added experienced staff to its administrative team to support its chief investment officer, and Internal Audit hired a qualified, full-time investment compliance auditor. In addition, a Director of Strategic Research position was added to assist all asset classes with new initiatives. Consultants were hired for both private equity and private real estate. A new consultant was hired for the overall investment plan as well.

Finally, staff has expanded the number of portfolios for the plan. Domestic Equity Mid-Cap was added, Large Cap Growth was moved to internal management and Emerging Markets was recently funded. Real Estate was expanded to include an international REIT portfolio. Private equity commitments are well under way and private real estate will commence soon.

In short, ERS' Board of Trustees, IAC members and Executive Director have been supportive with their ideas and their actions, allowing ERS to develop a world-class investment program.

Outlook for Fiscal Years 2010 – 2012

After three years of rapid growth, it's time for the next three-year plan for fiscal years 2010-2012 that could be called "Reflect and Refresh". Investments staff will continue to have initiatives for each of these years, as you can see from those listed in fiscal year 2010's budget report. However, it's time to pause and examine the many actions taken over the past three years and make adjustments where appropriate. A new Investment Policy is being drafted for Board approval, and ERS' Proxy Voting Guidelines will also be rewritten.

As many of you well know, hiring professional staff is just the first step in growing any organization. The mentoring, networking and reassigning and redesigning of work all play an integral part of the development as well. The Investments team doubled in size in just three years, and team dynamics are more complex than for a team of two dozen. Jim Sherwin has already grouped his Global Equity team into industry sectors and Scott Day has reassigned responsibilities in Global Fixed Income. All supervisors will continue to assess assignments and adjust where necessary.

Staff will review asset class portfolios compared to benchmarks to see where ERS may have too much or not enough focus. Staff will seek to optimize internally managed versus externally advised portfolios, and where it is appropriate to reach for alpha or where beta is the more cost-effective goal.

Patrick O'Hara's Private Equity team will shift from its heavy emphasis on securing new partnerships to a more balanced focus that includes monitoring and maintaining existing relationships. On the other hand, Bob Sessa's new Private Real Estate team will be in the new partnerships mode. Both private markets sections are working together to secure a software package that will assist them with monitoring their portfolios.

Operations are moving to an accounting upgrade with Eagle 9.0 and will undertake custodial and securities lending agent searches. Both Operations and Administration are adjusting to more of everything – more people, more portfolios, more trades, more travel, etc.

Staff will also assess the research and analytical tools added and removed over the past three years to look for “holes” that need filling as well as redundancies that can be cut in order to make the most efficient use of agency resources.

ERS’ Investments staff looks forward to the next three years being just as challenging as the last three.

This item is presented for discussion purposes only.

STAFF RECOMMENDATION:

No action is required on this agenda item.