PUBLIC AGENDA ITEM - #6a

6a. Review, Discussion and Consideration of Product Changes Related to the U.S. Bond Fund

August 25, 2009

BACKGROUND:

In August of 1999, the Employees Retirement System of Texas (ERS) Board of Trustees (Trustees), as trustee for the Texa$aver Deferred Compensation Program (Texa$aver Program), approved new investment products to be offered in the Texa$aver 401(k) and 457 plans. The Trustees selected ten core mutual funds, a stable value account and a self-directed brokerage account. Prior to the Trustees' selection of these products, the staff, with the assistance of the third party administrator, developed an extensive list of criteria that investment fund candidates were required to meet before being recommended as an investment product in the Texa$aver Program:

- A history of quality investment performance
- Proven ability to manage institutional assets
- Minimum net worth requirements
- Competitive fee structure
- Record free of significant federal or state securities laws violations
- Consistency of fund management and fund personnel
- No loads or sales charges
- Fund performance above the average in its category for at least four of the past five years
- Consistently met the benchmark for the particular investment style
- Expense ratios not exceeding the class average

The criteria used to select these funds are also used by ERS staff to monitor the funds. Core mutual funds are expected to follow their stated fund investment objective and stated style. Funds are also expected to maintain their performance relative to their benchmark and their peer group. In addition, major changes in the management of the fund or the fund's ownership warrant a closer review of the fund's viability in the Texa$aver Program product line-up. Mutual funds failing to maintain the standards and criteria for which they were chosen are subject to removal and replacement.

U.S. Bond Index Fund Issues

As part of its ongoing monitoring of the funds, ERS staff identified two significant items related to the Fidelity U.S. Bond Index Fund: 1) Poor performance relative to the stated benchmark, and 2) high expense ratio.

Benchmark Tracking Record

As seen in the chart below, the Fidelity U.S. Bond Index Fund has poorly tracked to the Barclays Capital U.S. Aggregate Bond Index (formerly the Lehman Brothers U.S. Aggregate Bond Index and recognized as the benchmark for this asset class) in the categories of one and three-year annualized returns. This has significantly reduced investment returns for participants in the two previous calendar years. The poor performance implies the fund manager has not prudently and effectively followed its stated investment objective for the fund.

Annualized Returns

	Barclays Capital Index	Fidelity U.S. Bond	*Tracking Deviation*
1 Year	**5.24**	**3.76**	**-1.48**
3 Years	**5.51**	**4.50**	**-1.01**

As of December 31, 2008

Expense Ratio

Index funds typically have very low expense ratios as they are not actively managed. Investments are adjusted to match a specific market. The expense ratio for the Fidelity U.S. Bond Index Fund is 32 bps. This is exceptionally high compared to other equity and fixed income based passively managed funds.

Issue Resolution Efforts and Actions

The Texa$aver Product Review Committee (PRC), comprised of senior ERS management and experienced investment professionals, addressed the high expense ratio at its November 2007 semi-annual product review meeting. The PRC determined that this fund should have an expense ratio less than 20 basis points.

ERS staff addressed the expense ratio issue with Fidelity, and the response received from Fidelity was that no fee reductions or fund reimbursements can be given to offset the higher fees for its U.S. Bond Index Fund. Fidelity did offer an alternative bond fund, the Total Bond Fund, at a lower expense ratio. Fidelity was asked to provide additional comparisons of the Total Bond Fund versus the U.S. Bond Index Fund, but to date the requested information has not been received. However, after conducting due diligence on the Total Bond Fund, staff found that it has only a five-year track record and holds a higher percentage of high yield bonds in its portfolio than the U.S. Bond Index Fund. High yield bonds are non-investment grade and hold more risk for investors.

Based on the poor performance versus the target benchmark and the high expense ratio for Fidelity's U.S. Bond Index Fund, ERS staff began research on other funds that tracked the Barclays Capital U.S. Aggregate Bond Index.

As part of its role as third party administrator, ING assisted ERS staff in the preliminary selection of a replacement investment product. ING reviewed the universe of all mutual funds that met ERS' stated criteria for selection. ERS then conducted further research through

Morningstar Principia software, consulted with fund managers and ERS pension staff, and reviewed the prospectus' and fund documents of various vendors.

Request for Information and Fund Evaluation Process

ERS posted a Request for Information (RFI) on May 20, 2009 to the Electronic State Business Daily system and closed the request at 2:00 p.m., on June 12, 2009. Barclays Global Investors (BGI) and Mellon Capital (Mellon) submitted their respective bids within the deadline. Benefit Contract division staff reviewed the proposals and the staff evaluations were presented to the PRC.

The PRC requested interviews with the two finalists, which took place in Austin at the ERS office on March 31, 2009. After an extensive interview with each finalist and comprehensive review of each product's performance, the ERS staff and PRC concluded that the performance and cost of the BGI U.S. Debt Index Fund F was most favorable:

	Barclays Capital Index[1] *(Annualized Returns)*	BGI U.S. Debt Index Fund *(Annualized Returns)*	***Tracking Deviation***	Mellon Aggregate Bond Index Fund[3] *(Annualized Returns)*	***Tracking Deviation***
1 Year	**5.24**	**5.27**	**0.03**	**5.58**	**0.34**
3 Year	**5.51**	**5.54**	**0.03**	**5.67**	**0.16**

As of December 31, 2008

[1] Barclays U.S. Capital Aggregate Bond Index (formerly the Lehman Brothers U.S. Aggregate Bond Index)

[2] BGI U.S. Debt Index Fund expense ratio is 6.85 bps

[3] Mellon Capital Bond Index Fund expense ratio is 7 bps

Although the Mellon Capital Aggregate Bond Index Fund met the minimum qualifications of the RFI and outperformed the Fidelity U.S. Bond Index Fund, the PRC recommended the BGI U.S. Debt Index Fund F because of its consistent indexing methodology, strong performance history and minimal tracking error to the Aggregate Bond Index.

Barclays Global Investors

Index Tracking – BGI's U.S. Debt Index Fund F closely replicates half of the approximately 9,000 fixed income securities in the Barclays Capital Aggregate Bond Index. The U.S. Debt Index Fund F closely tracks its index with minimal tracking error and is a well seasoned portfolio of fixed income securities.

The tracking of the BGI U.S. Debt Index Fund F to the Barclays Capital U.S. Aggregate Bond Index was reviewed by the PRC. It was discussed that BGI is able to track closely to its index because the fund has an extensive portfolio of over 4,000 bonds. This Barclays bond portfolio is one of the largest bond fund portfolios in the industry for an index bond fund.

Fund Selection – The key processes BGI uses to pick high-quality investments include detailed knowledge of the benchmark, thorough performance analysis, rigorous portfolio construction to match benchmark risks, and efficient trading.

Portfolio Construction – The portfolio is constructed using a stratified sampling. This methodology divides securities into subsets (cells) based upon where it falls in government bonds, mortgage-backed securities, and credit and asset-backed securities based on their maturity, sector and credit quality. BGI has a strong investment team of 195 people.

Risk Management – In addition, 70 people are dedicated to risk management. BGI takes risk management very seriously and has a system that independently reports to senior management. The fund only invests in cash and bonds. It does not short the market or invest in derivatives.

Collective Trust – The BGI U.S. Debt Index Fund F is a collective trust (CTF). As a market trend, larger plan sponsors are seeking to reduce fund fees by utilizing CTFs that reduce fund expenses on average 30-50 percent compared to traditional mutual funds. A CTF is not a retail mutual fund. The main difference in a CTF is in disclosures, such as daily tracking in the media, but this leads to significant advantages. Benefits include:

- transaction costs can be isolated to avoid affecting participants from costs of other plans;
- although not published in the newspaper or other media, daily NAV pricing is available to participants on the Texa$aver website and quarterly fund fact sheets;
- flexibility in adding or removing the fund -- it can be named whatever is suitable for the plan sponsor; and
- "branding" requirements are less costly to manage than retail mutual funds.

Fund Expense – The BGI U.S. Debt Index Fund F is currently offering a fund expense of 6.85 bps and expenses are capped at 8 bps. This includes a cap of 6 bps for management and a maximum of 2 bps for operating and administrative expenses, which is currently at 0.85 bps. The PRC noted that this is a significant savings for participants compared to the Fidelity fund at 32 bps expense ratio.

Coordination with Third Party Administrator – BGI also has the capacity to work with Great-West Retirement Services as third party administrator. Great-West Retirement Services will be the third party administrator for the Texa$aver Program effective September 1, 2009.

STAFF RECOMMENDATION:

Based on recommendation by and counsel with the Texa$aver PRC, ERS staff recommends that ERS not renew its contract with Fidelity Investments Institutional Operations Company, Inc., and no longer offer the Fidelity U.S. Bond Index Fund as an investment option in the Texa$aver deferred compensation program effective on or after September 1, 2009. It is further recommended that as a replacement in the bond index fund asset class, the Barclays Global Investors U.S. Debt Index Fund F be added as an investment option to the Texa$aver Program product line-up. In the event that a contract fully satisfactory to ERS is not timely executed with

Barclays Global Investors, then it is recommended that a replacement in the bond index fund asset class be Mellon Capital Aggregate Bond Index Fund.

ATTACHMENTS – 1

Exhibit A – Historical Performance of Fidelity U.S. Bond Index Fund

PROPOSED ACTION - #6a

6a. Review, Discussion and Consideration of Product Changes Related to the U.S. Bond Fund

August 25, 2009

Staff and PRC recommend the following motion to the Board of Trustees:

> I move that the Board of Trustees of the Employees Retirement System of Texas remove the Fidelity U.S. Bond Index Fund as an investment option in the Texa$aver deferred compensation program, and as a replacement for the Fidelity U.S. Bond Index Fund, approve the selection of Barclays Global Investors U.S. Debt Index Fund F, as the U.S. Bond Index Fund in the Texa$aver deferred compensation program conditioned on Barclays Global Investors' agreement to and timely execution of contract terms fully acceptable to ERS.
>
> I further move that ERS' Executive Director be authorized to negotiate, execute, and administer the contract agreed to by the parties, and it is anticipated that the contract's term will begin on or after September 1, 2009 until such time as the contract is terminated, subject to the terms of the contract. In the event that a contract fully satisfactory to ERS is not timely executed with Barclays Global Investors, or if it appears to the Executive Director during the term of an executed contract that Barclays Global Investors will not be capable of performing the required services as U.S. Bond Index Fund in the Texa$aver deferred compensation program, to ERS' satisfaction, then I move that the Board authorize the Executive Director to resume contract negotiations with Mellon Capital and to negotiate and execute contract terms with Mellon Capital that are fully acceptable to ERS, and to authorize the Executive Director to thereafter administer the contract agreed to by the parties.