

Putting clients first.



To: Board of Trustees
Texas Emergency Services Retirement System

From: Jonathan Breth
AndCo Consulting

Date: April 17, 2020

Subject: Section 802.109 Texas Government Code

On December 10, 2019, the State Board of Trustees for the Texas Emergency Services Retirement System (System) voted to authorize its investment consultant, AndCo Consulting¹, to conduct an evaluation of the institutional investment practices and performance of the System and to make recommendations for improving the retirement system's investment policies, procedures, and practices. The Board also delegated authority to its Investment Committee to oversee the project and to submit the final report to the leadership and the State Pension Review Board by May 1, 2020, as required by Texas Government Code §802.109.

The Board selected its investment consultant, AndCo Consulting, based upon the recommendation by the System Executive Director and under the authority of Texas Government Code §802.109(c) which enables a public retirement system to select a firm with which it has an existing relationship as long as the firm does not directly or indirectly manage investments of the retirement system.

The Board hired AndCo in January 2017 to serve as the System's investment consultant after a nation-wide competitive search. In its role as investment consultant, AndCo has an advisory relationship with the Board and does not have any direct or indirect authority over the management of retirement system assets. All investment decisions are made by the Board and executed by the Executive Director.

Significant Outcomes of the Report:

AndCo has no recommended changes for the System. The System is actively engaging outside experts to provide legal advice and guidance in areas of investments and actuarial science. These experts are actively serving similar clients in the state of Texas and operate as fiduciaries to the System. The System has demonstrated their willingness to listen and follow the guidance of their outside professionals and there is no evidence of this changing in the future.

AndCo recommends that the System maintain its robust processes to both review the current investment portfolio while also seeking to identify new investments that can improve the System's long term expected risk and return while maintaining liquidity to meet its benefit obligations.

¹ AndCo Consulting is an investment adviser registered with the U.S. Securities and Exchange Commission ("SEC"). Registration as an investment adviser does not constitute an endorsement of the firm by securities regulators nor does it indicate that the adviser has attained a particular level of skill or ability.

(1) Provide analysis of any investment policy or strategic investment plan adopted by the retirement system and the retirement system's compliance with that policy or plan.

The Texas Emergency Services Retirement System (“System”) has an investment policy statement (“IPS”) in place. The IPS outlines the objectives and risk tolerance of the System as well as the various management and administration responsibilities related to the management of the System’s investment portfolio. The IPS defines that the Board of Trustees (“Board”) is responsible for making decisions regarding the System’s investment portfolio. The IPS also identifies and defines the roles of the Investment Committee which is comprised of three Board members selected by the Board chairman. All recommendations for actions in the investment portfolio are reported to and voted on by the full Board.

The Board has hired an outside investment consultant to assist the Board and the consultant’s responsibilities are clearly laid out in the IPS as are the roles of investment managers hired by the Board. The investment consultant is hired to assist the investment committee and Board in making decisions regarding the System’s IPS, strategic asset allocation, manager selection, ongoing manager evaluation, and IPS compliance monitoring. While the above are monitored quarterly, an asset allocation study is reviewed in alternate years. An analysis of the IPS’s key elements are outlined in the table below:

Scope & purpose	The purpose, asset base and organizational structure of the System’s investment portfolio are clearly defined.
Governance structure	Roles and responsibilities for decision making, communication requirements, monitoring oversight, applicable law and future IPS modifications are clearly defined.
Investment, return, and risk objectives	Return objectives, risk tolerance, time horizon, asset allocation targets, investment guidelines, and other relevant portfolio considerations are clearly defined.
Risk management	Performance measurement standards, metrics for portfolio and investment manager evaluation, and compliance requirements are clearly defined.

The Board reviews the System’s IPS on a quarterly basis. The last revision took place in August of 2018 where changes were implemented to reflect the addition of a new asset class within the overall asset allocation. Changes to the IPS are expected in 2020 as a result of the asset liability study conducted by the System’s investment consultant in 2019. The Board monitors compliance to the System’s current IPS during each quarterly performance review with the investment consultant.

We analyzed the System’s IPS and the Board’s compliance with the IPS. AndCo, as an independent, professional investment consulting firm, has determined that the System’s IPS, and the Board’s compliance with the IPS, is appropriate and comparable with what AndCo considers best practice, industry standards. No changes are recommended at this time.

(2) Provide a review of the retirement system's investment asset allocation, including

(A) Review of the System's process for determining target allocations;

The System's process for determining asset allocation targets is executed and implemented through strategic asset allocation studies conducted by the System's investment consultant. Each strategic asset allocation study uses a combination of 10- to 15-year forward-looking asset class return, risk and correlation assumptions, historical asset class return and risk data, and a long-term (50+ years) building block return methodology to determine a target allocation that the Board believes will have the highest probability of achieving the System's return objectives within the risk tolerance defined in the IPS. The specific asset classes included in each strategic asset allocation study will include both asset classes currently in the System's portfolio as well as other asset classes that may be suitable for inclusion.

In addition to return objectives and risk-tolerance contained in the strategic asset allocation study, the System also considers its ongoing liquidity needs and the maintenance of an appropriate level of diversification in the portfolio when determining the appropriate asset allocation targets for the System. The last strategic allocation study for the System was conducted in March of 2017 at the outset of the relationship with the System's current consultant, AndCo. Changes were implemented during 2017 and 2018 as a result of this study. AndCo completed an asset liability study in the fourth quarter of 2019 which will lead to further allocation changes in 2020. The System's last asset liability study was conducted by the former consultant in mid-2016.

(B) Review the expected risk and expected rate of return, categorized by asset class;

The investment consultant utilizes the 10- to 15-year forward-looking asset class return and risk assumptions produced by a third-party provider, JP Morgan. These 10- to 15-year assumptions are updated annually and have been consistently published for use by asset allocators for 24-years. The investment consultant also maintains an internally developed, stable, long-term (50+ years) building block return methodology for supplemental, long-term asset return assessments. Current year return and risk expectations for each IPS target asset class are detailed in the table below:

Asset Class	10- to 15-year Expected Arithmetic Return*	10- to 15-year Expected Annualized Risk*	Building Block Return Assumption**
Large Cap Equity	6.55%	14.34%	10.00%
Mid Cap Equity	7.12%	16.30%	10.00%
Small Cap Equity	8.12%	18.95%	10.00%
Broad International Equity	9.17%	17.45%	11.00%
SC International Equity	9.17%	17.45%	11.00%
Emerging Market Equity	11.15%	21.12%	11.00%
US Core Fixed Income	3.16%	3.42%	5.00%
Core Real Estate	6.37%	11.07%	7.00%
MLP	5.93%	14.59%	10.00%
Multi-Asset	5.66%	8.16%	7.50%

* Source: 2020 JP Morgan Long-term capital market assumptions

** Source: AndCo Consulting

It is important to note that expected returns do not reflect the effect of active management or contain an expectation of active manager alpha. Projections assume the underlying asset class returns can be achieved net of fees. Finally, where direct asset class expectations are not available for named IPS target asset classes, these allocations are proxied to a similar asset class or combination of asset classes that have assumptions.

The Board is currently evaluating the addition of global infrastructure and non-core fixed income as a result of an asset liability study performed in 2019. From the study it has been recommended that the Board eliminate the allocation to MLPs going forward.

(C) Review the appropriateness of selection and valuation methodologies of alternative and illiquid assets; and

The Board relies on the System's investment consultant, and the investment consultant's experience, to consider the appropriateness of valuation methodologies used by 3rd party investment managers that oversee alternative and illiquid assets for the System. Further, an analysis of the appropriateness of each manager's written valuation policy for their underlying strategy holdings is generally part of the investment consultant's standard due diligence process when they evaluate these types of strategies. Only strategies deemed to have reasonable and appropriate valuation methodologies will be recommended for potential inclusion in the System's portfolio. Neither the Board nor the investment consultant selects the valuation methodology used by 3rd party investment managers that oversee alternative or illiquid assets. The performance and valuation of all 3rd party alternative and illiquid investment strategies that are part of the System's investment portfolio are also reviewed with the Board as part of the quarterly performance review prepared and presented by the investment consultant. The Board utilizes the same process for the selection of alternative assets as it does for the selection of traditional asset managers. This selection process is detailed in question 4.

(D) Review the future cash flow and liquidity needs;

The System's cash flow and liquidity needs are reviewed by the Board each quarter as part of the investment consultant's quarterly performance review. This review includes discussions regarding the current, expected, and known timing variances of future contributions to, and withdrawals from, the System. Based on the System's current expectation that cash flow (net contributions less withdrawals) will be negative for the foreseeable future without a change in the contribution rate, the portfolio has been positioned to include higher allocations to public, liquid assets. In addition to the portfolio's maintaining larger allocations to the liquid equity and fixed income markets, the System's alternative asset allocations emphasize the production of income and do offer investors at least quarterly liquidity. At this time the System is not pursuing any investments that require multi-year lockups and offer no liquidity to investors. The asset allocation and cash flow needs of the System were analyzed in an asset-liability study in the fourth quarter of 2019. The result of the study indicated that the System could benefit from an increased allocation to real estate while allocations to US large and small/mid equity would be reduced and MLPs would be eliminated. The study also indicated the benefit of adding private infrastructure to the portfolio as well as non-core fixed income.

We reviewed the System's processes for asset allocation including; target determination, expected risk and return, selection and valuation methodologies for alternative and illiquid assets,

as well as cash flow and liquidity needs. While different approaches exist, AndCo, as an independent, professional investment consulting firm, has determined that the System's processes are appropriate and comparable with what AndCo considers best practice, industry standards. No changes are recommended at this time.

(3) Provide a review of the appropriateness of investment fees and commissions paid by the retirement system;

The Board reviews the fees (stated in both dollars and basis points) paid to administer the System's portfolio on a quarterly basis for each of its underlying investment managers and strategies in the quarterly investment review prepared and presented by the investment consultant. The fees for the System's portfolio contained in the most recent quarterly investment review reflect a cost of 0.62%. Based on the 2019 NCPERS Public Retirement Systems Study, published on January 22, 2020, the average fee for the survey's 155 state and local government pension respondents was 0.55%. It is important to note the System also considers fees an important part of the decision-making process and evaluates the potential fee impact for each new investment manager and strategy considered for inclusion in the System's portfolio. The System considers the current fee of 0.62% reasonable and appropriate for its portfolio.

We reviewed the fees paid to administer the System's portfolio and the underlying investment manager fees. AndCo, as an independent, professional investment consulting firm, has determined that the System's fees are appropriate and comparable with what AndCo considers best practice, industry standards. No changes are recommended at this time.

(4) Provide a review of the retirement system's governance processes related to investment activities, including investment decision-making processes, delegation of investment authority, and Board investment expertise and education

The System's IPS contains clear definitions of the Board's responsibilities as well as the role of the Board's professional advisors in assisting the Board in fulfilling its fiduciary duties to the System with respect to the investment of assets. Direct investment authority for the System's assets lies with the Board. As such, all decisions regarding the System's portfolio including return objectives, risk tolerance, investment guidelines, asset allocation targets and manager selection and retention reside with the Board.

The Board utilizes an investment consultant to assist with setting the System's strategic policy and asset allocation targets, as well as, investment manager strategy evaluation and selection. The investment consultant is a fiduciary to the System, and all 3rd party separate account investment managers are required to be fiduciaries to the System. In addition, all comingled fund investment managers must be fiduciaries to the fund that they manage in which the System has invested. The System does not perform any portfolio management functions internally apart from overseeing the administrative activities including legal review and execution of agreements as listed below.

Governance for investment activities and related decision-making is a multi-step process. The process includes the following:

- a. Recommendations (policy, strategy, or both) are made to the Board by the investment consultant.

- b. The Investment Committee and Board reviews, questions, and evaluates the investment consultant's recommendation. This process may include a request for clarification, modification, and/or additional information regarding the recommendation. This process may also include investment manager interviews if a series of comparable investment strategies are being considered.
- c. Once a consensus approach on a recommendation has been reached, the final investment recommendation is officially considered by the Board for action.
- d. The Board accepts motions for action and votes to accept or reject those motions.
- e. Once an action is accepted by the Board, the Board's Executive Director (System staff) works with the investment consultant to execute the Board's desired investment action or decision, and when necessary, with the System's legal counsel for the negotiation and execution of any associated investment agreements.
- f. The Board delegates signatory authority to the Executive Director to execute investment agreements and issue direction to the investment consultant and the investment managers that oversee the various components of the System's investment portfolio. The System's investment consultant does not have any authority to take action on investment or move capital.

Trustees receive educational training upon appointment to the Board via an established process managed by the System's Executive Director to comply with the training requirements established by Government Code Section 865.0035. (State Board Member Training). The training program covers the roles of a Trustee, and membership responsibilities for the various Board committees associated with the System's governance structure. In addition to Trustee education provided by the System, the Board members are active participants in industry educational opportunities such as conferences. System trustees follow the requirements of Texas Administrative Code 607. The investment consultant has reviewed the System's tracking of trustee education and affirm it is in line with state requirements. Trustees are also encouraged to actively participate in national conferences and educational programs associated with investment oversight. The Board has designed the investment committee with the goal of including as many seasoned investment professionals as possible on the committee. This leads to a thorough vetting of performance and manager issues in advance of Board discussion and helps maximize the effectiveness of Board discussion on investment.

We reviewed the System's governance processes related to investment activities, investment decision-making, delegation of investment authority, and education. AndCo, as an independent, professional investment consulting firm, has determined that the System's processes are appropriate and comparable with what AndCo considers best practice, industry standards. No changes are recommended at this time.

(5) Review of the retirement system's investment manager selection and monitoring process.

The investment manager selection process for the System is conducted in collaboration with the System's investment consultant. Whether a specific investment strategy review is directed by the Board or the strategy idea comes from the investment consultant's research group, all potential investment strategies must go through the consulting firm's due diligence process and subsequently be presented and approved by the investment consultant's Investment Policy Committee before being shown as potential strategies for the Board to consider for the System's portfolio. Regardless of whether an existing portfolio strategy is being replaced or a new strategy

is being considered for the System's portfolio, the investment consultant will prepare and present a comprehensive manager evaluation report to the Board that includes multiple candidates for consideration, discussion and subsequent interviews with the Board.

Candidates are vetted by the consultant's research group to identify appropriate managers for the System in each investable asset class. The investment consultant is completely independent from the investment management community and receives no compensation for reviewing or including any managers in the search process, nor does the investment consultant receive any compensation from any investment manager or investment products. From the group of best of breed managers, the research group selects a small subset of finalist candidates to present to the System. In terms of System review, all candidates are initially reviewed by the System's investment committee. The investment committee works with the consultant to identify typically two to three finalists that will make final presentations to the System's Board of trustees. After the final presentations are made, a mandate is awarded pending final legal review of the contract documents associated with the investment.

While the investment consultant may make recommendations regarding investment strategies, the ultimate decision to select a specific strategy for inclusion in the System's portfolio resides with the Board. Once a decision is made by the Board, legal counsel reviews and assists the Board in the execution of necessary agreements. In addition, if the selection is a separately managed account, the investment consultant will draft an addendum to the IPS for approval by the Board, and signature by the investment manager, that outlines specific objectives, constraints and benchmarks for the portfolio under the discretionary authority of the investment manager.

The ongoing monitoring of investment managers and strategies is also done collaboratively with the Board and the investment consultant on a regular basis and through quarterly Board meetings the investment consultant attends. The investment consultant prepares summary monthly performance reports and more comprehensive quarterly investment reviews for presentation to, and discussion with, the Board during these meetings. The investment consultant's reports highlight portfolio and investment manager performance and risk relative to the various performance measurement standards established in the IPS. The criteria established in the IPS tracks managers on both a qualitative and quantitative basis. Strategies that repeatedly fail to meet certain standards will be placed on a watchlist or terminated. The criteria are not designed to remove the decision process from the Board, but rather are intended to add objectivity and enhanced scrutiny on managers who are underperforming the criteria contained in the IPS. While the investment consultant may make recommendations regarding the continued retention or termination of an investment strategy in the System's portfolio, the ultimate decision to retain or terminate an investment strategy (within the bindings of the strategy's agreement) resides with the Board.

We reviewed the System's investment manager selection and monitoring process. AndCo, as an independent, professional investment consulting firm, has determined that the System's selection and monitoring of investment managers are appropriate and comparable with what AndCo considers best practice, industry standards. No changes are recommended at this time.

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Important Disclosure Information

This report was prepared at the sole request of the Texas Emergency Services Retirement System. Information presented is typically narrow in scope and provides a general overview of circumstances and processes and should therefore not be construed as exhaustive. AndCo Consulting does not provide legal, tax or accounting advice.

This contains forward-looking statements, estimates and projections which are inherently speculative and subject to various uncertainties whereby the actual outcomes or results could differ materially from those indicated.

The material provided herein is valid as of the date of distribution and not as of any future date and will not be updated or otherwise revised to reflect information that subsequently becomes available, or circumstances existing or changes occurring after such date.