

# Texas Municipal Retirement System

## Review of the Board's Direction on a Process for Retaining, Managing and Terminating Investment Managers

Including Draft Amendments to the Board's Investment Policy Statement

February 13, 2020

*Presented in Connection with TMRS Strategic Plan  
Goal 1 Objective B and Goal 3*

# Board Direction Through the Strategic Plan

Three high level themes were identified by the Board

Work was to occur at each regular meeting leading up to Board offsite/Governance Workshop

Any follow up work to be conducted in the months after the offsite



Governance Structure and Responsibilities Review



Investment Beliefs



TMRS Governance Documents

# Review of Timeline



# Background

Investment Beliefs Survey

Applicable Law

Hierarchy of Institutional Investment Decision Making

# Investment Beliefs

Investment beliefs set the direction for the Board's investment policy, investment practice, organizational structure and culture.

A coherent set of investment beliefs provide the basis for a good investment program. By agreeing upon and codifying investment beliefs, TMRS will be able to set a foundation for its decision making as well as encourage cultural alignment.

- The Board, Executive Director and investment staff are key to translating investment beliefs into investment practice. It is critical that these stakeholders are closely involved in the process of developing the investment beliefs.

**The Board owns the Investment Beliefs.**

Differences in survey responses provide a great opportunity to discuss, analyze and to ultimately agree to a set of investment beliefs.

As background for the review of the Board's Investment Policy Statement, we will take another look at the survey responses focused on Investment Policy and Governance.

# Investment Beliefs Survey and Response

## Investment Policy and Governance

3. What is the best and most effective use of Board members' time? Rank in the order of importance of where you believe the Board should focus its time (#1 most important).

	Average	#1	#2	#3	#4	#5	#6
Total fund investment performance	4/5	7	2	4	3	7	5
Setting and monitoring long-term investment objectives	1	1	1	1	1	1	1
Manager performance monitoring	8	9	5	8	7	8	7
Strategic asset allocation	2	2	6	6	2	2	2
Fees and expenses	7	8	9	5	4	6	8
Manager selection/terminations/updates	9	10	7	9	9	9	9
Asset class structure	6	3	8	7	8	5	3
New investment opportunities	10	4	10	10	10	10	10
Risk assessment	3	5	3	2	5	4	4
Investment education	4/5	6	4	3	6	3	6

# Investment Beliefs Survey and Responses

## Investment Policy and Governance – *Limited Similarity of Views in Survey Responses*

2. The Board's mission, vision and strategic objectives for the System's investment program is appropriate and understood by Board members, TMRS staff and external service providers.

6. The roles and responsibilities of the Board, TMRS staff, consultants and other external service providers are clear to all stakeholders.

7. The Board has a clear understanding of the investment authority it has delegated to TMRS executive staff.

8. The Board has a clear understanding of the authority it has delegated to TMRS investment staff.

9. Delegation of investment duties is clearly documented.

10. The span of control in place is appropriate – for the Board, internal investment committee, staff and consultants.

12. Environmental, social and governance (ESG) factors can impact investment performance and should be considered as important in the TMRS' investment strategy.

13. Integrating corporate governance and corporate responsibility into the TMRS' core investment process is important and adds value.

# Applicable Law

**Trustee fiduciary duty is set forth in Article XVI, Section 67 of the Texas Constitution and Government Code Section 855.303 (TMRS Act).**

**The Constitution and TMRS Act use the “prudent person standard”.**

- This means the Board is expected to act as a prudent person would in the management of their own affairs.

**A prudent trustee adopts a comprehensive investment policy statement and demands accountability for its application.**



# Applicable Law

**TMRS is also subject to certain provisions of the Texas Uniform Prudent Investor Act.**

**Property Code Section 117.011 allows a trustee to delegate certain investment functions when it is prudent to do so.**

**In deciding to delegate and to whom it delegates, the Board must use reasonable care, skill and caution.**

# Applicable Law

**TMRS Trustees retain internal and external investment professionals and are expected to rely on the advice of those professionals unless it is imprudent to do so.**

**Trustees are not expected to have the same level of investment knowledge nor the time necessary to effectuate a complex investment portfolio.**

**Delegation of certain functions is prudent and a lawful exercise of the Board's authority.**

**The Board always retains the ultimate authority to modify or eliminate the delegation.**

# Hierarchy of Institutional Investment Decision Making



# Review of August 22, 2019 Board Discussion

## Different Models for Retaining, Managing and Terminating Investment Managers

Option 1 - Consent Agenda (Board Approval)

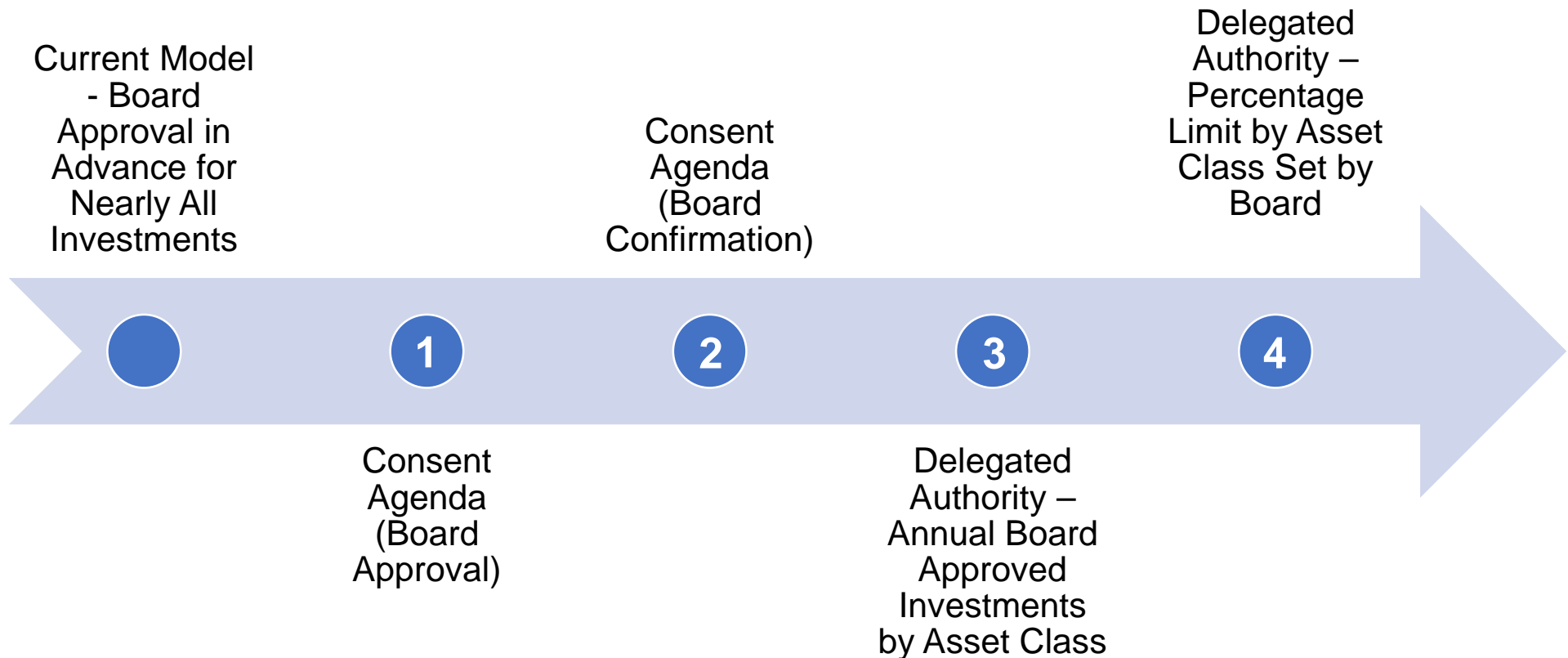
Option 2 - Consent Agenda (Confirmation)

Option 3 - Delegated Authority – Annual Board Approved Investments by Asset Class

Option 4 - Delegated Authority – Percentage Limit by Asset Class Set by Board

# Different Models for Retaining, Managing and Terminating Investment Managers

*(options are listed in order from direct approval to delegated authority)*



# Option 1 - Consent Agenda Model

## How It Would Work

The Board would receive the same materials as they do currently but the materials would be included with other Consent Agenda items

- ✓ Board Communication from the Executive Director
- ✓ Staff Memorandum Recommendation
- ✓ Consultant Memorandum Recommendation

The Executive Director would recommend Board approval through the ED's Board Communication Memorandum recommending the Board adopt the Consent Agenda

- ✓ The Consent Agenda is adopted as one item

Reporting to the Board by Staff and Consultants would not change

- ✓ Chief Investment Officer Management Updates
- ✓ Quarterly Performance Review and Investment Policy Compliance
- ✓ Staff Annual Asset Class Reviews and Pacing
- ✓ Staff Annual Risk Report
- ✓ Staff Annual Compliance Report
- ✓ Internal Audit

## Considerations

The Board still approves, or ratifies, each investment strategy decision, and each investment manager decision to retain or terminate

# Option 2 - Consent Agenda Confirmation Model

## How It Would Work

The Board receives the same materials as it does currently, but they would be included with other Consent Agenda items

- ✓ Board Communication from the Executive Director
- ✓ Staff Memorandum Recommendation
- ✓ Consultant Memorandum Recommendation

The Board would authorize the Executive Director to enter into TMRS investment transactions prior to presentation to the Board, and then the Executive Director would recommend Board confirmation of an investment transaction already entered into by TMRS through the ED's Board Communication Memorandum recommending the Board adopt the Consent Agenda

- ✓ The Consent Agenda is adopted as one item

Reporting to the Board by Staff and Consultants would not change

- ✓ Chief Investment Officer Management Updates
- ✓ Quarterly Performance Review and Investment Policy Compliance
- ✓ Staff Annual Asset Class Reviews and Pacing
- ✓ Staff Annual Risk Report
- ✓ Staff Annual Compliance Report
- ✓ Internal Audit

## Considerations

The Executive Director approves, and the Board confirms, each investment strategy decision, and each investment manager decision to retain or terminate

# Option 3 - Delegated Authority – Approved List of Investment Funds

## How It Would Work

The Board would periodically and prospectively approve a list of recommended investment funds in each asset class. The lists would be recommended by each asset class Director based on the same rigorous analysis and due diligence currently completed by investment staff, and the asset class consultant including vetting by the Staff Investment Committee (SIC).

Once the Board has approved the recommended lists, each asset class director will select investment funds from the list to carry out the annual System-wide Investment Pacing Plan, and the Executive Director would enter into the transaction on behalf of TMRS.

- ✓ Also vetted by the SIC

Reporting to the Board by Staff and Consultants would not change

- ✓ Chief Investment Officer Management Updates including investment fund transactions that have been entered into
- ✓ Quarterly Performance Review and Investment Policy Compliance
- ✓ Staff Annual Asset Class Reviews and Pacing
- ✓ Staff Annual Risk Report
- ✓ Staff Annual Compliance Report
- ✓ Internal Audit

## Considerations

Board time required to review investment funds, complicated implementation. Possible issues:

- Opportunities that arise that have not previously been Board approved.
- Addressing approved investment funds that, over time, fall out of favor with the asset class Director's or consultant's recommendation.



# Option 4 - Delegated Authority – Percentage Limit by Asset Class

## How It Would Work

The Board would authorize the ED, based on recommendations from the SIC, to retain, manage and terminate investment managers within the following limitations:

### Public Markets

- Actively Managed Mandates: Up to 1.50% of the market value of the System's assets
- Factor-based Mandates: Up to 3.00% of the market value of the System's assets
- Passive Mandates: At the discretion of staff consistent with the Board's investment beliefs

### Private Markets

- Up to 0.75% of the market value of the System's assets

Would continue to be vetted and approved by the SIC

Reporting to the Board by Staff and Consultants would not change

- ✓ Chief Investment Officer Management Updates including investment fund transactions that have been entered into
- ✓ Quarterly Performance Review and Investment Policy Compliance
- ✓ Staff Annual Asset Class Reviews and Pacing
- ✓ Staff Annual Risk Report
- ✓ Staff Annual Compliance Report
- ✓ Internal Audit

## Considerations

Allow staff to implement fully-vetted average sized deals that the Board had previously approved. Frees up Board time to focus on policy rather than implementation. Atypical deals outside the approved limits will come to the Board for approval.

# Board Direction

August 22, 2019

**After discussing the current pillars in place, legal standards of care, and the four different models for retaining, managing and terminating investment managers and their features, benefits, and risks, the Board directed further discussion in September 2019 on the following two models:**

- Model A – A hybrid between Options 2 (Consent Agenda Confirmation) and Option 4 (Asset Class Percentage Limits)
- Model B – Option 4 (Asset Class Percentage Limits)

# Review of September 26, 2019 Board Discussion

## Different Models for Retaining, Managing and Terminating Investment Managers

**Model A – Hybrid Delegated Authority - Consent Agenda Confirmation and Asset Class Percentage Limits**

**Model B - Delegated Authority - Percentage Limit by Asset Class Set by Board**

# Context for the Models

## Both Models Being Presented

- Offer **different degrees of delegated authority** to the Executive Director for the day-to-day implementation of the investment program
  - The final decision on the exercise of delegated authority under either model presented rests solely with the Executive Director, including a decision to reject a recommendation from investment staff and consultants
  - The Executive Director would not propose an alternative but would be able to say “no” and send the matter back for further study
- Designed on a **Variance or Exception** concept so that Board meeting time regarding these matters is focused on
  - Considering atypical investment transactions (and substituting an equally prudent process for routine transactions to flow through)
  - Reviewing performance against pre-established benchmarks with the help of the Board’s independent investment consultants
- Neither of the models completely extinguishes the Board’s approval authority over these matters

# Model A: Hybrid - Consent Agenda Confirmation and Asset Class Percentage Limits

# Module A: Hybrid

## How It Would Work

### Public Markets Transactions

- The Board would authorize the Executive Director (ED), based on the Investment Committee's recommendation (including Investment Consultant), to enter into TMRS investment transactions below certain asset class percentage thresholds for **public markets** investment transactions

#### Public Markets

- Actively Managed Mandates: Up to 3.00% of the market value of the System's assets
  - Passive Mandates: At the discretion of staff consistent with the Board's investment beliefs
  - Reducing assets under management, including full termination of a mandate, may not exceed 5.0% of the market value of the System's assets. However, a mandate may be terminated with the agreement of the Executive Director and Chief Investment Officer at any percent of assets if the removal is deemed necessary to protect the System's assets
- Those investment transactions would be reported to the Board as an information item at the next Board meeting
  - All public markets investment transactions above the asset class percentage thresholds must be brought to the Board for presentation and approval prior to entering into the transaction

# Module A: Hybrid (cont'd)

## How It Would Work

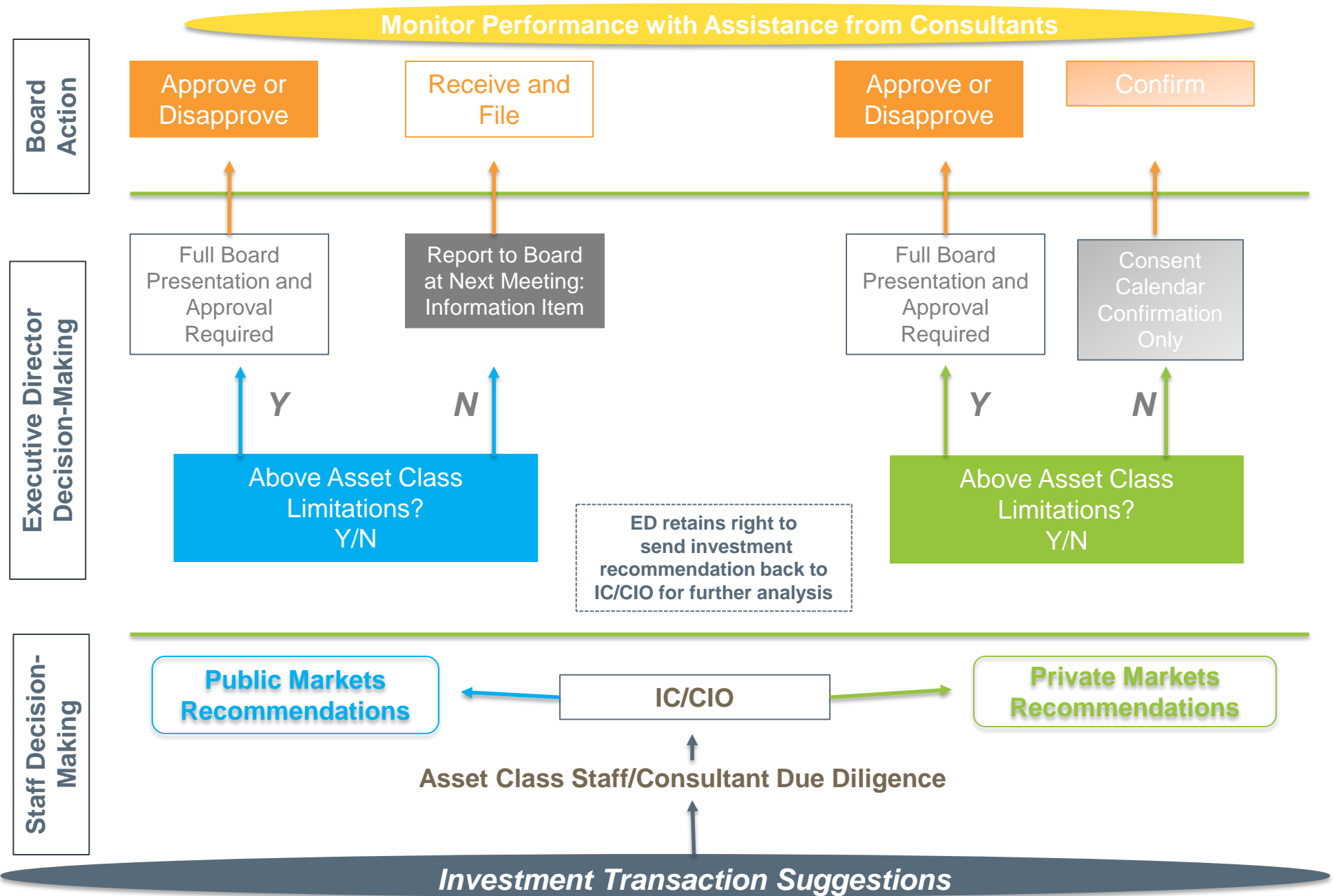
### Private Markets Transactions

- The Board would authorize the ED, based on the Investment Committee's recommendation, to enter into TMRS investment transactions below certain asset class percentage thresholds for **private markets** investment transactions

#### Private Markets

- Up to 0.75% of the market value of the System's assets
  - Reducing assets under management, including full termination of a mandate, may not exceed 5.0% of the market value of the System's assets. However, a mandate may be terminated with the agreement of the Executive Director and Chief Investment Officer at any percent of assets if the removal is deemed necessary to protect the System's assets
- The ED would recommend confirmation of those **private markets** investment transactions already entered into by TMRS and include verification of due diligence process through the ED's Board Communication Memorandum
  - The Consent Agenda is adopted as one item
  - All **private markets** investment transactions above the asset class percentage thresholds must be brought to the Board for presentation and approval prior to entering into the transaction

# How it Looks: Model A: Hybrid





# Reporting Package for Model A

## How It Would Work

The Board would receive the same materials as it does currently for **private market investments**, but they would be included with other Consent Agenda items

- ✓ Board Communication from the Executive Director
- ✓ Staff Memorandum Recommendation
- ✓ Consultant Memorandum Recommendation

Reporting to the Board by Staff and Consultants would not change

- ✓ Chief Investment Officer Management Updates
- ✓ Chief Investment Officers Quarterly Staff Report
- ✓ Consultant Quarterly Performance Review and Investment Policy Compliance
- ✓ Staff Annual Asset Class Reviews and Pacing
- ✓ Staff Annual Risk Report
- ✓ Staff Annual Compliance Report
- ✓ Internal Audit

*New Recommended Addition to Board Processes or Reports*

- ✓ Executive Director's report to include memorandum on recent investment transactions made under the delegation of authority
- ✓ Quarterly Staff Investment Committee Report
- ✓ Annual Closed Session Review with Consultants

## Model B: Asset Class Percentage Limits

# Model B: Asset Class Percentage Limits

## How It Would Work

### Public Markets Transactions

- The Board would authorize the ED, based on the Investment Committee's recommendation (including the Investment Consultant), to enter into TMRS investment transactions below certain asset class percentage thresholds for **public market** investment transactions
  - Public Markets
    - Actively Managed Mandates: Up to 3.00% of the market value of the System's assets
    - Passive Mandates: At the discretion of staff consistent with the Board's investment beliefs
    - Reducing assets under management, including full termination of a mandate, may not exceed 5.0% of the market value of the System's assets. However, a mandate may be terminated with the agreement of the Executive Director and Chief Investment Officer at any percent of assets if the removal is deemed necessary to protect the System's assets
- Those investment transactions would be reported to the Board as an information item at the next Board meeting.
- All **public market** investment transactions above the asset class percentage thresholds must be brought to the Board for presentation and approval prior to entering into the transaction.

# Model B: Asset Class Percentage Limits (cont'd)

## How It Would Work

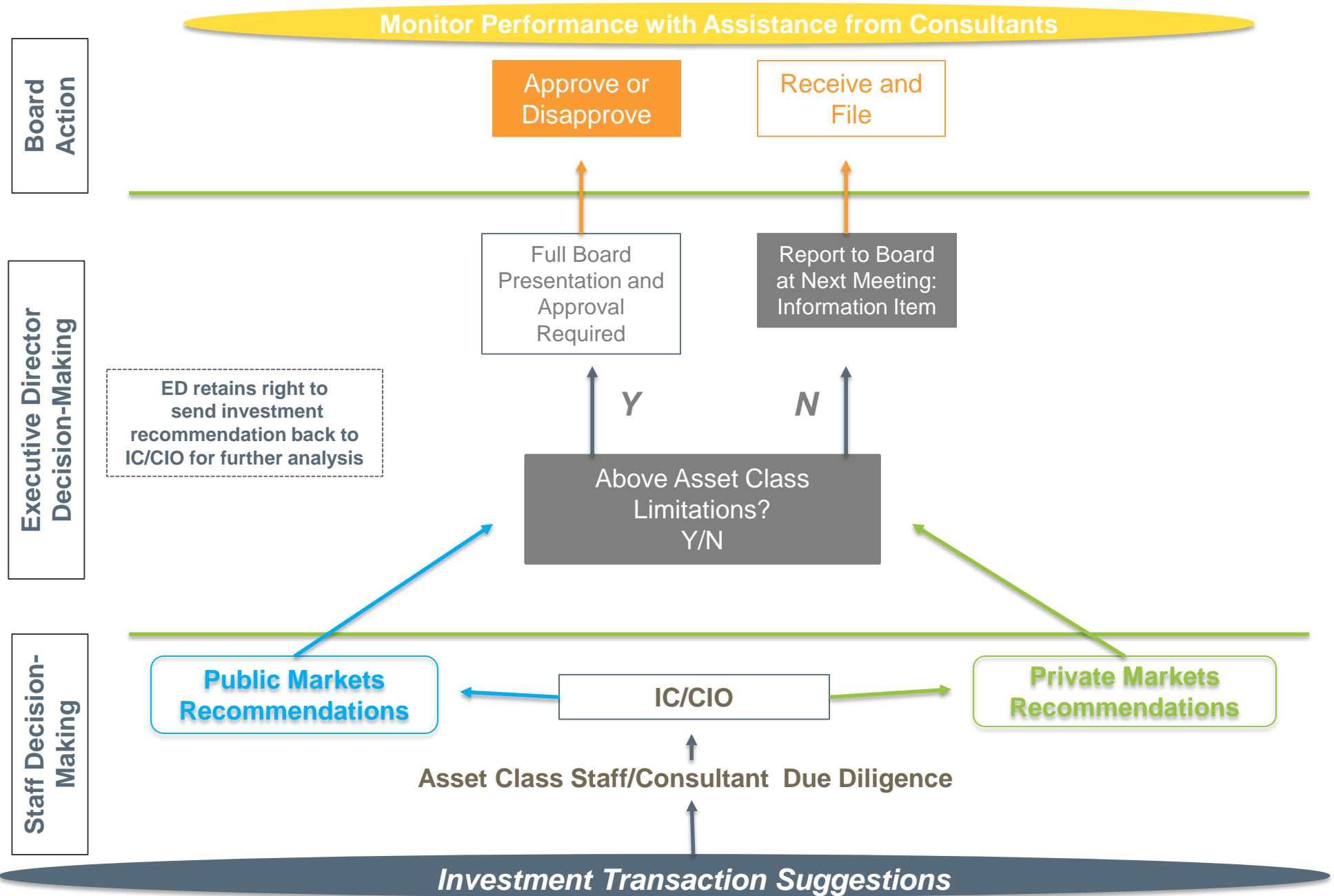
### Private Markets Transactions

- The Board would authorize the ED, based on the Investment Committee's recommendation, to enter into TMRS investment transactions below certain asset class percentage thresholds for **private market** investment transactions

#### Private Markets

- Up to 0.75% of the market value of the System's assets
  - Reducing assets under management, including full termination of a mandate, may not exceed 5.0% of the market value of the System's assets. However, a mandate may be terminated with the agreement of the Executive Director and Chief Investment Officer at any percent of assets if the removal is deemed necessary to protect the System's assets
- Those investment transactions would be reported to the Board as an information item at the next Board meeting.
  - All **private markets** investment transactions above the asset class percentage thresholds must be brought to the Board for presentation and approval prior to entering into the transaction.

# How it Looks: Model B: Asset Class Percentage Limits



# Reporting Package for Model B

## How It Would Work

Reporting to the Board by Staff and Consultants would not change

- ✓ Chief Investment Officer Management Updates
- ✓ Chief Investment Officers Quarterly Staff Report
- ✓ Consultant Quarterly Performance Review and Investment Policy Compliance
- ✓ Staff Annual Asset Class Reviews and Pacing
- ✓ Staff Annual Risk Report
- ✓ Staff Annual Compliance Report
- ✓ Internal Audit

*New Recommended Addition to Board Processes or Reports*

- ✓ Executive Director's report to include memorandum on recent investment transactions made under the delegation of authority
- ✓ Quarterly Investment Committee Report
- ✓ Annual Closed Session Review with Consultants

# Board Direction

September 26, 2019

**After discussing the current pillars in place, legal standards of care, and the two models for retaining, managing and terminating investment managers and their features, benefits, and risks, the Board agreed on the Model A: Hybrid with minor modifications and directed staff and consultants to proceed drafting revisions to the Board's Investment Policy Statement.**

**February 13, 2020**

**Draft Investment Policy Statement**



# Some Reminders for Today

**Policy Development Team:** TMRS Executive Director, Chief Investment Officer, General Counsel, Lead Investment Attorney, Fiduciary Counsel, Governance Consultant, and General Investment Consultant

**Timeline:** October – December 2019

**Activities:** In person meetings, teleconferences, and back/forth drafting communications

**Work Product:** Red-lined draft presented in December 2019 is provided today with no changes for further review, discussion, and possible adoption

## **Important Principles:**

- The Executive Director will receive certain delegated responsibilities from the Board
- The Board will monitor that its policies have been followed via ED communication at Board meetings, and staff and consultants reports

# Board Direction

# Board Direction

- What additional questions does the Board have about the Model A?
- Are there any questions about how Model A has been codified in the draft policy?
- How would the Board like to proceed?

# Next Steps

## If Investment Policy Statement is Adopted

- Internal team, with the assistance of the Board's consultants, will implement this process as outlined in the Investment Policy Statement
- The Board can move on to develop their Investment Beliefs statements
  - First – develop an investment belief statement around this authorization model
  - Return to survey results and prioritize next topics for development of the Board's Investment Beliefs
    - Examples: Environmental, Social and Governance  
Internal Management

**Thank You!**