

Texas Municipal Retirement System

Different Models for Retaining, Managing and Terminating Investment Managers

August 22, 2019

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

Introduction

- Summary of Governance Workshop Discussion
- Key Outcomes
 - No perceived need for investment committee of the Board
 - Additional discussion desired on alternative authorization processes for specific investment manager related actions
- Today's Focus
 - Recap the results of the investment beliefs survey and current related processes
 - Explore and discuss alternative authorization processes/models
 - Seek Board direction on how to proceed
- Next Steps
 - Align direction with investment beliefs
 - Update governance documentation as needed

Background

Investment Beliefs Survey

Existing Role & Responsibilities and Standards of Care

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

As part of Investment Beliefs Survey, Board members had a high degree of similarity in views regarding manager selection/terminations/updates as it related to the use of Board time.

The Investment Policy Provides for Delegation

Investment Policy Statement, Section VII. Roles and Responsibilities

In adopting this IPS, the Board requires all Trustees and TMRS investment staff involved in the investment of TMRS assets to make all investment decisions in the best interest of the System and abide by the TMRS Ethics Policy.

- A. The Board of Trustees** is responsible for the administration of the System and its investment program. The Board members are individually fiduciaries with respect to the System and must discharge their duties solely in the interest of the members and annuitants for the exclusive purpose of providing benefits to members, retirees and their beneficiaries. The Board also appoints the investment consultants, investment Managers, Executive Director, General Counsel, Internal Auditor, Custodian Bank/Securities Lending Agent, and consulting actuary; and approves the annual operating budget.

As part of their fiduciary obligations, the Board has the legal responsibility for managing the System's overall investment strategy, including:

1. Establishing investment goals and objectives consistent with plan funding needs;
2. Approving an asset allocation strategy;
3. Establishing an explicit, written investment policy consistent with identified goals and objectives, and applicable laws;
4. Delegating responsibilities for day-to-day management of the investment program through the Executive Director to the Chief Investment Officer and investment staff.
5. Hiring investment consultants to advise the Board, and investment Managers for prescribed mandates to implement this IPS, unless Manager hiring and termination responsibilities are delegated to the Executive Director or investment staff in writing through Board Resolution;
6. Monitoring the activities of the investment program for compliance with the provisions of this IPS; and
7. Avoiding conflicts of interest and prohibited transactions.

The Investment Policy Provides for Delegation

Investment Policy Statement, Section VII. Roles and Responsibilities

- B.** The **Executive Director** is appointed by the Board to manage and administer the System and its assets under the supervision and direction of the Board, and in accordance with applicable state and federal laws. In carrying out these responsibilities, the Executive Director has fiduciary responsibilities delegated by the Board under applicable law and is authorized to exercise his/her best judgment and discretion in planning, organizing, and administering the operations and investments of the System and ensuring that internal controls are in place to safeguard System assets. The Executive Director is hereby authorized by the Board to exercise his fiduciary responsibilities to take such action(s) as are necessary or appropriate to protect the assets of the System using his best judgment and discretion, based on advice of the investment consultant(s) and the Chief Investment Officer (or CIO), and as practicable and appropriate, reviewed by Fiduciary Counsel, General Counsel and/or Chairman of the TMRS Board. The Executive Director is also responsible for informing the Board of any such action taken or other situation involving the investment program and investment activities that merit its attention.

Delegation of Co-Investment Authority

For purposes of fulfilling the role as described in this section of this IPS, the Executive Director is authorized to approve co-investment opportunities that meet the guidelines described herein. Co-investment recommendations will be submitted by CIO, Director of the appropriate asset class and the appropriate TMRS consultant to the Executive Director for approval. Co-investments will be reported to the Board immediately after being signed by the Executive Director and will be discussed in more detail at the next Board meeting.

Board Held to Prudent Person Standard

Investment Policy Statement, Section VI. Standards of Care

A. Standard of Prudence Applicable. All participants in the investment process will act responsibly. The standard of prudence to be applied by the Board and investment staff is as follows:

1. In satisfying this standard, Board members and investment staff shall exercise the degree of judgment and care, under the circumstances, that persons of prudence, discretion, and intelligence exercise in the management of their own affairs, considering the probable income from the securities and probable safety of their capital and in consideration of the purposes, terms, distribution requirements and other circumstances of the trust.
2. Investment and management decisions respecting individual assets will be evaluated not in isolation but in the context of the investment portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust.

Conflict of Interest Prohibited. Members of the Board, investment staff, investment Managers, and consultants involved in the investment of TMRS assets will refrain from any activity that could conflict with the proper execution and management of the TMRS investment program, or that could impair their ability to make impartial recommendations and decisions. These parties are required to disclose, in writing, all relationships that could create or appear to create a conflict of interest in their unbiased involvement in the investment process and when appropriate to cure the conflict in a manner provided by the TMRS Ethics Policy or their contract with TMRS as applicable.

Outside Experts Held to Higher Standard of Care

Investment Policy Statement, Section IX. Investment Consultants

Investment Consultants must act as fiduciaries in their role as an investment consultant assisting and advising the TMRS Board and investment staff on investment matters, be bound by prudent expert standards, be approved registered investment advisors under the Investment Advisor's Act of 1940 as amended, and be independent. Independence is defined as not having other business relationships that could be construed as posing a conflict of interest. Further, with respect to the scope of services required, Consultants must demonstrate substantial expertise and experience in providing investment consulting and assistance in implementing institutional portfolio management, and possess the resources, capacity, qualifications, staff support, databases, contacts, software, and methods to research, assist, and advise the TMRS staff and Board. It is imperative that any Consultant have the independence and ability to inform the Board in the event of any concerns related to investment activity.

- ✓ **The IPS (Section IX) and investment consultant contracts hold the Board's investment consultants to a higher standard of care bound by prudent expert standards**
- ✓ **The IPS (Section XIV) and investment manager contracts also hold TMRS' investment managers to a prudent expert standard**

Standards of Care

Standards of Care

One Size Does Not Fit All

TMRS Act § 855.303 – The Prudent Person Rule

Texas Trust Code §117.003 – The Prudent Investor Standard

Texas Trust Code § 117.011 and TMRS IPS Sections IX and XIV
– The Prudent Expert Standard

What is the Difference Between the Standards?

The Prudent Person – Dealing with One's Own Property

The Prudent Investor – Dealing in a Like Enterprise with Like Aims (ERISA)

The Prudent Expert - Holding One's Self Out to Have Special Skills is Held to a Higher Standard

Does A Prudent Trustee Delegate?

TMRS Act § 855.201(c) – Board may delegate to the Executive Director

Texas Trust Code § 117.011 – Trustee may delegate investment function

In delegating, a Trustee must use reasonable care, caution and skill in:

- Selecting the Agent
- Establishing the Scope and Terms of the Delegation
- Periodically Reviewing the Agent's Actions and Compliance

Why Should a Prudent Trustee Delegate?

The Delegation Raises the Level of Care

A Prudent Person (the Board) Assigns an Agent to Be a Prudent Investor

A Prudent Investor (the Executive Director) Hires a Prudent Expert

The Prudent Expert (Investment Manager and Consultant) Has a Duty to Perform at the Highest Standards.

With each Delegation the Standard of Care Becomes Greater

As a Practical Matter, the Board as a Prudent Person Should Engage the Higher Levels of Expertise

What Can Never Be Delegated?

The Board is the Ultimate Fiduciary

It Cannot Delegate the Final Responsibility for the Consequences of Its Actions

The Board Sets Policy – The Investment Policy Statement

The Board must consider all aspects of potential market issues; the future liquidity needs of the Plan and understand the role that each class of investment plays in the overall trust portfolio

The Board must exercise reasonable care, skill and diligence

Internal Process for Manager Due Diligence, Including the Staff Investment Committee

Internal Process for Manager Due Diligence

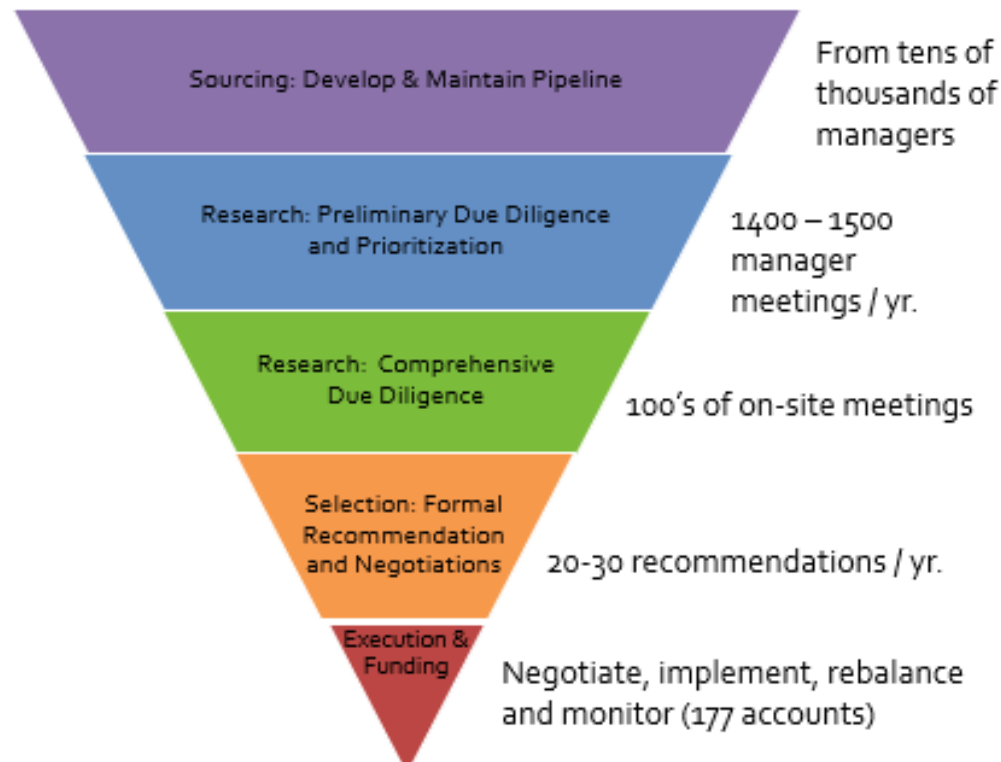
Best in Class

- ✓ Staff adheres to a Best in Class process
- ✓ Internal Investment Procedures
- ✓ Staff Investment Committee
- ✓ Ample documentation to confirm Staff has performed all steps of the approved investment procedures
- ✓ Peers, consultants and investment professionals' sentiment for TMRS' best in class process

Internal Process for Manager Due Diligence

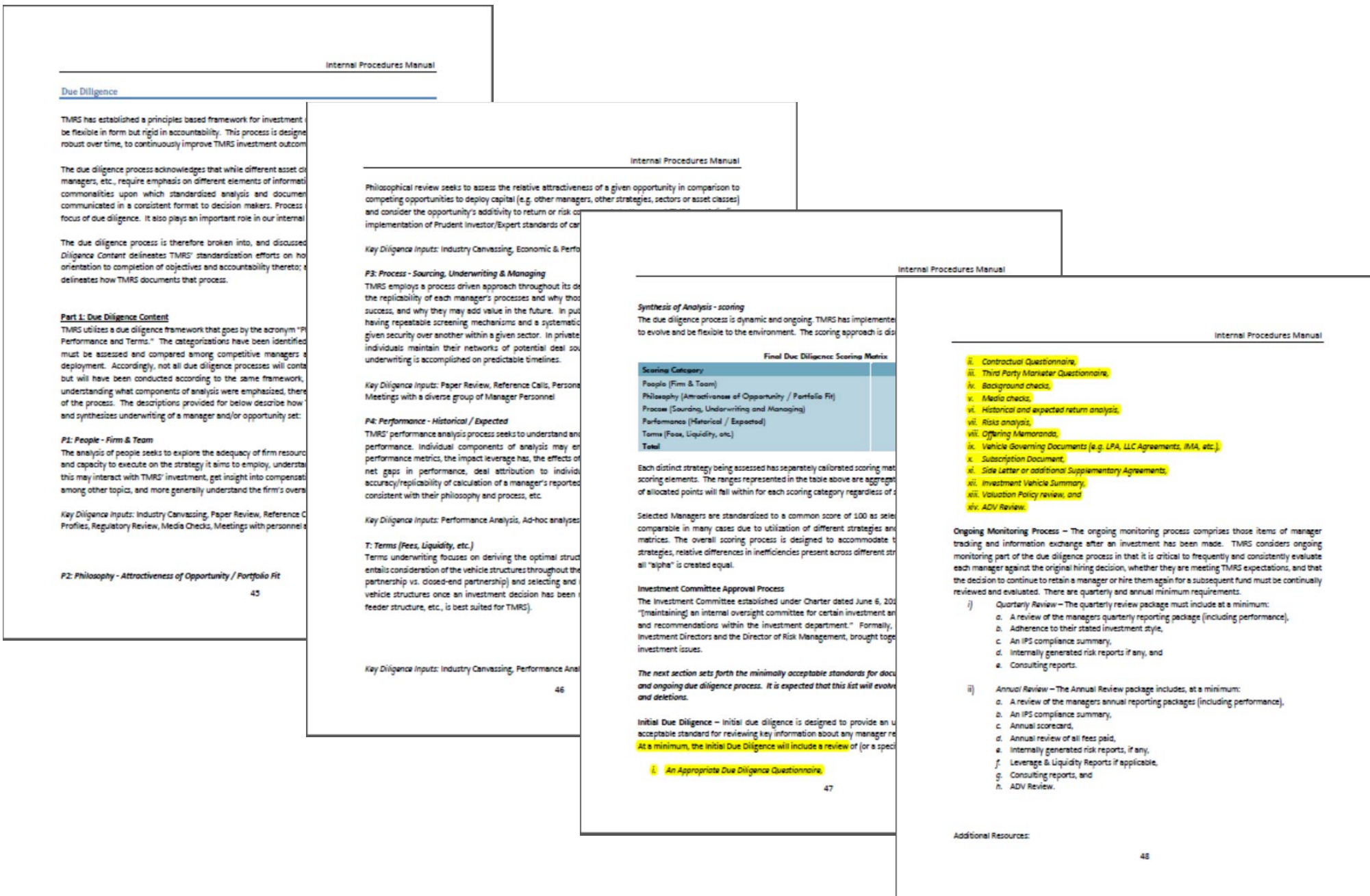
Best in Class

It typically takes 150 to 250 hours of TMRS Staff time to underwrite each public market manager and 200 to 300 hours for each private market manager



Internal Process for Manager Due Diligence

Due Diligence – Internal Procedure Manual



Internal Process for Manager Due Diligence

Staff Investment Committee (SIC)

An internal Staff Investment Committee was established in June of 2016 to ensure thorough vetting of certain topics by the entire Investment team. All items presented to the TMRS Board of Trustees for approval must first be approved by this Committee. Voting members of the Committee include the CIO, Director of Risk Management and all Asset Class Directors. A quorum is defined as 5 of 7 members (one of the 5 must be the CIO) and 5 “yes” votes are needed to approve an item to be presented to the Board (i.e. a new manager, an IPS change recommendation etc.). The CIO has the ability to stop any item, at any time, no matter the vote count. Formal minutes are kept by the Secretary approved by the Committee and signed by the CIO.

Highlights of the SIC charter include:

- Final recommendation(s) on the selection of new investment managers (to be recommended to the Board) in accordance with the TMRS IPS.
- Decisions related to the termination recommendations for existing investment managers (in most cases)
- Addition or deletion to the manager Watch List
- IMA/Side Letter revision requests including modification, additions and deletions to investment manager guidelines and any changes to fee structures
- Custodian related issues including, but not limited to, cash management, securities lending, manager compliance, FX or other areas of high importance
- Annual Asset Class and investment manager reviews for all asset classes
- Annual Asset Allocation review, including a review of the capital market assumption set and the actuarial required rate of return
- Tactical opportunity discussions
- Certain matters related to the Risk Management Program

Different Models for Retaining, Managing and Terminating Investment Managers

Option 1 - Consent Agenda (Board Approval)

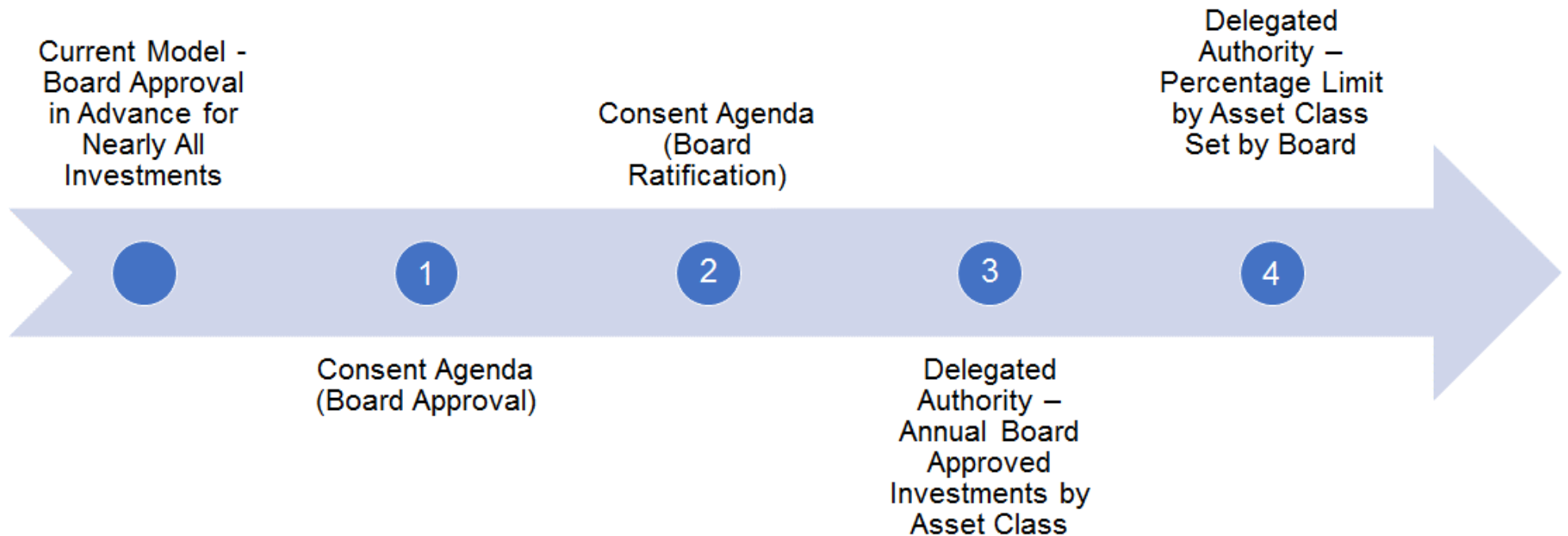
Option 2 - Consent Agenda (Ratification)

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

(listed in order from direct approval to delegated authority)



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

Implementation

As soon as the September 2019 Board meeting

Investment Decision Making – Consent Agenda



Consent Agenda Ratification 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 ratification 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 ratifies, each investment strategy decision, and each investment manager decision to retain or terminate.

Implementation

As soon as the September 2019 Board meeting

Investment Decision Making – Ratification by Consent Agenda



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.

Implementation

January 2020

Delegated Authority – Approved Investments by Asset Class



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.

Implementation

January 2020

Delegated Authority – Percentage Limit by Asset Class



Checks and Balances

Checks and Balances

Assurances – Delegate but Verify

- ✓ Investment Policy Statement (reviewed and updated annually)
- ✓ Qualified Professional Staff
 - Investments
 - Risk Management
 - Operations
 - Compliance
- ✓ Overlapping Independent External Consultants
- ✓ Appropriate Separation of Duties
 - Finance - \$\$ Movement
 - Reconciliation of Custodian to Financials
- ✓ Internal Legal Investment Expertise
- ✓ External Legal and External Fiduciary Counsel
- ✓ Internal Auditors
- ✓ External Auditors
- ✓ Reports to the Board
 - Quarterly Investment Report and IPS Compliance Review from the Board's Consultant
 - Annual Asset Class Reviews
 - Quarterly and Annual Risk Review
 - Quarterly and Annual Compliance Review
 - Quarterly Fee Report
 - Consultant Reviews

Checks and Balances

Assurances – Delegate but Verify

Internal Procedures Manual

Internal Procedures Manual

Investment Department

JUNE 2019

Page 1 of 107

Internal Procedures Manual

Contents

Investment Data Warehouse (IDW) Operating Procedures	
Alternative Investment Valuations for Interest Credit and CAFR	
Asset Allocation Study	
Background Checks	
Background Checks - Invoice Review	
Benchmark Selection Procedures	
Budget Proposal and Approval Process	
Business Continuity Plan (BCP)	
Co-Investment Underwriting Procedures	
Consultant Search, Selection and Oversight	
Contracting Procedures (Initial Investment)	
Credit Card Procedures	
Currency Repatriation and FX Spot Transaction Procedure	
Due Diligence	
eCFM Procedures	
Emergency Investment Manager Termination	
Employee Off-Boarding	
Employee On-Boarding	
Investment Committee and Board Agenda Item Preparation Procedures	
Investment Department Email Usage and Retention	
Investment Funding Sources	
Investment Manager Transitions	
IPS Review and Amendment (Annual and Ad Hoc)	
Investment Risk Management	
Israel Boycott	
Manager Onboarding: Contacts	
Manager Onboarding: FTP Set Up	
Manager Operations Exception Resolution	
Meeting Tracking and Reporting	

Page 2 of 107

Internal Procedures Manual

Monthly Close	77
New Account Procedures	78
Non-TMRS Technology Access	80
Paying SMA Management Fees	81
Powers of Attorney (POAs) for Proxy Voting	82
Procedures: Ad Hoc Addition of New/Updated Procedures	83
Procedures: Annual Review	85
Proxy Voting	86
Publicly Disclosed Material - Required Disclaimer	87
Quarterly Staff Report	88
Rebalancing	89
Reimbursement for Attendance at Private Investment Fund/Industry Advisory Board Meetings or Due Diligence Travel	91
Requests for Information (PIA Requests, Requests for Board Materials, Media Participation)	93
Securities Litigation Procedures	96
Taxation and Regulatory Reporting	99
Trade Activity Falls	100
Watch List Addition and Removal	101
Website Updates	102
APPENDIX	103
Appendix A. Annual Certification of Compliance with Procedures	104
Appendix B. Account Data Warehouse – Field Descriptions Table	105
Appendix C. Portfolio Rebalancing Transaction Report	108
Appendix D. Manager Search Staff Memo Template for Investment Committee Meeting	109
Appendix E. Manager Search Recommendation Templates for Board Meeting	109
Appendix F. Annual Asset Class Review Check Lists	109

Page 3 of 107

Checks and Balances

Internal Audit as the Third Line of Defense

Internal Audit as the Third Line of Defense



Conclusion

Conclusions

TMRS already has many of the pillars of an effective delegation of authority structure in place.

The Board, which is held to a prudent person standard, would benefit by delegating investment manager selection/approval and termination to those who are held to a higher standard of care.

We collectively, as the Board's consultants, recommend the Board direct us and staff to update any governance documentation and procedures necessary to implement Option #4: Delegated Authority – Percentage Limit by Asset Class, and bring such documentation back to the Board for final review and approval.