Investment Beliefs – Next Steps
Texas Municipal Retirement System
May 28, 2020

Presented in Connection with TMRS Strategic Plan
Goal 1, Objective B
Review of Investment Beliefs Discussions
Definition of Investment Beliefs

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

- Investment beliefs articulate fundamental views of the Board on institutional investing and provide a foundation to guide investment-related decision making.
- Investment beliefs will help define how TMRS will create investment value, in an environment of uncertainty, risk and opportunity.
- A survey\(^1\) of published investment beliefs reveals three essential elements for investment beliefs:
  1. A clear view of the capital markets (the inefficiencies to exploit, the risk/return relation, the relation between asset pricing and investment horizon)
  2. A competent organization (cost-effectiveness, organization-specific values)
  3. A view on societal issues that affect investments (sustainable investments, corporate governance).
- Studies\(^2\) of best practice in institutional fund governance have highlighted the importance of the development of clearly stated investment beliefs as a core first step of an investment process.

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1 The Journal of Portfolio Management, Alfred Slager and Kees Koedijk
2 Best-practice investment management: Lesson for Asset Owner from the Oxford-Towers Watson Project on Governance, Gordon L Clark and Robert Urwin
Definition of Investment Beliefs

By aligning investment beliefs with the Board’s investment objectives and policy, the fiduciaries can connect the interests of the members and beneficiaries, and the philosophy of the Board, with the stated objectives and guidelines given to the ED and staff to achieve.

- Increased transparency and a difficult environment for returns increase the importance of well-thought out investment policies for investors; a coherent set of 8 to 12 investment beliefs provide the basis for a good investment policy. Investment beliefs improve stakeholder governance by setting guidelines for best practice.3

- To ensure organization coherence, the Board’s investment beliefs for TMRS should be collective, not individual. By agreeing upon and codifying 8 to 12 investment beliefs TMRS will be able to update and set a foundation for its future decision making, as well as encourage cultural alignment.

The Board’s investment beliefs should be heard throughout the investment process.

3 The Journal of Portfolio Management, Alfred Slager and Kees Koedijk
# Sample Investment Beliefs

<table>
<thead>
<tr>
<th>Sample 1</th>
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<th>Sample 3</th>
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<th>Sample 5</th>
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<tbody>
<tr>
<td><strong>Invest for the long term.</strong></td>
<td>We are a long-term investor whose primary mission is to maintain the viability of the retirement system.</td>
<td>Diversification strengthens the fund.</td>
<td>Asset class decisions are key</td>
<td>Liabilities must influence the asset structure.</td>
<td>We value effective governance, leadership and strong culture as essential for a world-class investor.</td>
<td>Portfolio construction should focus first on the allocation and balancing of risk; it is the allocation of risk that drives portfolio returns.</td>
<td>Our people drive our success.</td>
</tr>
<tr>
<td><strong>Invest in people.</strong></td>
<td>Our strategic allocation policy is the primary determinant of the asset portfolio’s long-term return and asset portfolio’s risk.</td>
<td>The global public investment markets are largely, but not completely, efficient.</td>
<td>Theories and concepts must be sound.</td>
<td>A long time investment horizon is a responsibility and an advantage.</td>
<td>We work to clear investment goals and accountabilities to meet our liabilities.</td>
<td>Diversification is critical because the future is unknown. Reliable diversification requires a fundamental understanding of the economic drivers of risk and return.</td>
<td>The best investment results come from people who are empowered to make decisions and are accountable for them.</td>
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<tr>
<td><strong>Build a high performance culture.</strong></td>
<td>While we can sacrifice some short-term liquidity to pursue a greater long-term return, the investment portfolio’s net cash flows and ability to pay benefits on a year-by-year basis are key risk considerations.</td>
<td>Managing investment costs yields long-term benefits.</td>
<td>House capital market views are imperative.</td>
<td>System investment decisions may reflect wider stakeholder views, provided they are consistent with its fiduciary duty to members and beneficiaries.</td>
<td>We act as a long-term investor.</td>
<td>Every investment should be examined in the context of its potential return from beta (market return) to alpha (value added return); while separation is not always possible, every effort should be made to distinguish the two distinct return components.</td>
<td>Our brand is a strong and valuable asset.</td>
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<td>We are all risk managers.</td>
<td>Diversification improves the risk-adjusted return profile of the investment portfolio.</td>
<td>Internal management is critical.</td>
<td>Investment strategies must be forward looking.</td>
<td>Long-term value creation requires effective management of three forms of capital: financial, physical and human.</td>
<td>Price matters so we will be patient but ready to act.</td>
<td>Flexibility to opportunistically alter the portfolio away from risk-balanced when markets are driven to extremes as result of short-term economic cycles is an important portfolio management tool.</td>
<td>Taking risk is necessary to earn the returns required to meet our pension obligations.</td>
</tr>
<tr>
<td>Allocate wisely.</td>
<td>There are long-term benefits to managing investment costs.</td>
<td>The system can potentially capture illiquidity risk premium.</td>
<td>Public markets are generally informationally efficient.</td>
<td>The system must articulate its investment goals and performance measures and ensure clear accountability of their execution.</td>
<td>We believe diversification usually reduces risk more than return.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Costs matter.</td>
<td>The equity risk premium is significantly positive over a long-term investment horizon although it can vary over time.</td>
<td>Managing short-term drawdown risk can positively impact the system’s ability to meet its long-term financial obligations.</td>
<td>Market frictions are highly relevant.</td>
<td>Strategic asset allocation is the dominant determinant of portfolio risk and return.</td>
<td>In managing risk we recognize it is multi-faceted and not fully quantifiable.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Collaborate widely.</td>
<td>We benefit significantly when roles and levels of authority are clearly defined and followed.</td>
<td>Responsible corporate governance, including the management of ESG factors can benefit investors.</td>
<td>Internal investment professionals are the foundation of a successful investment program.</td>
<td>Risk to the system is multi-faceted and not fully captured through measure such as volatility or tracking error.</td>
<td>We believe that costs matter and can be managed.</td>
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Collaborate widely.

We benefit significantly when roles and levels of authority are clearly defined and followed.

Responsible corporate governance, including the management of ESG factors can benefit investors.

Internal investment professionals are the foundation of a successful investment program.

Risk to the system is multi-faceted and not fully captured through measure such as volatility or tracking error.

We believe that costs matter and can be managed.

The returns we can expect will not be constant over time.
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<td>Diversity with care. Act with clarity.</td>
<td>Private market investments have an illiquidity premium that we can capture.</td>
<td>Alignment of financial interest between the system and its advisors is critical.</td>
<td>Trustee expertise should be utilized while ensuring separation between board oversight and staff management.</td>
<td>The system will take risk only where we have a strong belief we will be rewarded for it.</td>
<td>We manage environmental, social and governance issues as they can have an impact on the long-term performance of investments.</td>
<td>Total fund diversification, through effective portfolio construction, is fundamental to our success.</td>
<td></td>
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<tr>
<td>Sustainability impacts investing.</td>
<td>Utilizing engagement initiatives to address environmental, social and governance-related issues can lead to positive portfolio and governance outcomes.</td>
<td></td>
<td>Costs matter and need to be effectively managed.</td>
<td>We seek to achieve alignment of interests between ourselves, our beneficiaries and those acting on our behalf.</td>
<td></td>
<td>Strong relationships support our success.</td>
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<tr>
<td>Innovation counts.</td>
<td>It is extremely challenging for a large institutional investor to add significant value over market-representative benchmarks, particularly in highly-competitive public global equity markets.</td>
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<td></td>
<td></td>
<td></td>
<td>Investing is a business.</td>
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<td></td>
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<td></td>
<td></td>
<td>Good governance is good business and contributes to sustainable values.</td>
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The Investment Belief Survey
Investment Beliefs

The investment beliefs survey was conducted last year and was grouped into four categories: Investment Policy and Governance, Risk, Portfolio Construction, and Implementation.

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

Based on the Board’s direction through the Strategic Plan and on the survey results, the Board worked diligently focusing its attention from July 2019 to February 2020 on Investment Policy and Governance, and in particular on investment authority and roles and responsibilities.
Investment Beliefs

The result → the Board approved amendments to the Investment Policy Statement on February 13, 2020

- provided clarity in areas where survey responses indicated there were dissimilar views
- Policy Development Team: TMRS Executive Director, Chief Investment Officer, General Counsel, Lead Investment Attorney, Fiduciary Counsel, Governance Consultant, and General Investment Consultant
Some Investment Belief Statements to Consider

Category: Investment Policy and Governance
The following four slides show survey results for the majority of the survey statements under the Investment Policy and Governance category.

• **Sample** investment belief statements are included on each slide based on the survey results within this category.

• The **samples** are included for the Board’s consideration and to encourage Board discussion.

The goal over the next several meetings is to arrive at Board consensus on 8 to 12 investment belief statements which encompass all of the four categories: Investment Policy and Governance, Risk, Portfolio Construction, and Implementation.
Investment Policy and Governance Survey Statements

Mission, Vision and Strategic Objective

Survey Question 1: The Board’s role is to focus on mission, vision and policy and to make sure that the governance structure and resources are in place to allow the System to meet its objectives.

Board Response: 83% strongly agree, 17% agree
Staff Response: 87.5% strongly agree, 12.5% agree

Survey Question 2: The Board’s mission, vision and strategic objectives for the System’s investment program are appropriate and understood by Board members, TMRS staff and external service providers.

Board Response: 67% agree, 33% unsure
Staff Response: 12.5% strongly agree, 25% agree, 12.5% unsure, 37.5% disagree, 12.5% strongly disagree

Ties to the Board’s existing Strategic Plan and IPS.

Mission: Providing secure, reliable retirement benefits
Vision: To be the model for empowering retirement
Core Values: Accountability, Excellence, Integrity, Respect and Teamwork

Sample Investment Belief:

Alignment of interests between the System, our beneficiaries and our advisors is critical to our success in meeting our strategic objectives.
**Investment Policy and Governance Survey Statements**

**Most Effective Use of Board Time**

**Survey Question 3:** What is the best and most effective use of Board members’ time? (1 – most important, 10 least important)

| Board Response: | #1 Setting and Monitoring long-term investment objectives, #2 Strategic Asset Allocation #9 Manager Selection/terminations/updates, #10 New Investment Opportunities |
| Staff Response: | #1 Setting and Monitoring long-term investment objectives, #2 Strategic Asset Allocation #9 New Investment Opportunities, #10 Manager Selection/terminations/updates |

**Sample Investment Belief:**

*The most effective use of the Board’s expertise and time is to set overall investment objectives and clearly articulate investment direction through the System’s Investment Policy Statement while continually monitoring its compliance.*
Good Governance

Survey Question 5: Effective Governance, strong culture and talented staff are important drivers of a successful investment program.

Board Response: 83% strongly agree, 17% unsure
Staff Response: 87.5% strongly agree, 12.5% agree

Survey Question 11: Good governance is good business and contributes to the success of the investment program.

Board Response: 83% strongly agree, 17% agree
Staff Response: 87.5% strongly agree, 12.5% strongly disagree

Sample Investment Belief(s):

**Good governance contributes to the success of the System’s investment program.**

**A clearly defined culture ensures all stakeholders are working towards the same goals. Our System’s culture embraces Accountability, Excellence, Integrity, Respect and Teamwork.**

**Good governance is good business.**

**Effective investment governance enables good stewardship.**
Investment Policy and Governance Survey Statements

Investment Authority / Roles and Responsibilities

Survey Question 4: Delegating investment responsibilities to internal investment staff allows the Board to leverage governance resources and should be considered in order to improve efficiencies and the opportunities for successful investment outcomes.

Board Response: 17% strongly agree, 50% agree, 16% unsure, 17% strongly disagree
Staff Response: 87.5% strongly agree, 12.5% agree

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

Board Response: 33% agree, 67% unsure
Staff Response: 12.5% agree, 12.5% unsure, 37.5% disagree, 37.5% strongly disagree

Survey Question 7: The Board has a clear understanding of the investment authority it has delegated to TMRS Executive staff.

Board Response: 67% agree, 33% unsure
Staff Response: 25% agree, 12.5% unsure, 37.5% disagree, 25% strongly disagree

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

Board Response: 50% agree, 50% unsure
Staff Response: 25% agree, 25% unsure, 37.5% disagree, 12.5% strongly disagree

Survey Question 9: The span of control in place is appropriate for the Board, internal investment committee, staff & consultants.

Board Response: 67% agree, 33% disagree
Staff Response: 12.5% agree, 12.5% unsure, 75% strongly disagree

Sample Investment Belief(s):

The System benefits significantly when roles and responsibilities are clearly defined.

The best investment results come by empowering staff to make decisions and holding them accountable.
Investment Beliefs - Next Steps
Investment Beliefs – Next Steps

Recommended Process to Complete the Investment Beliefs Project

Based on Survey Results:

✓ Provide background and education
✓ Address Board’s questions and discuss potential belief statements
✓ Agree upon the particular belief statement
✓ Set aside and move on to the next investment belief until the IPS review at which time the Investment Beliefs will be added to Section V. of the IPS

As the next step, we suggest the Board continue to address the survey statements centered around Investment Policy and Governance including the statements on the following slide related to Environmental, Social and Governance (ESG) factors.
Investment Policy and Governance Survey Statements

Environmental, Social and Governance (ESG) Factors

Survey Question 12: Environmental, social and governance factors can impact investment performance and should be considered as important in TMRS’ investment strategy.

  Board Response: 17% strongly agree, 50% agree, 33% disagree
  Staff Response: 50% agree, 25% unsure, 12.5% disagree, 12.5% strongly disagree

Survey Question 13: Integrating corporate governance and corporate responsibility in TMRS’ core investment process is important and adds value.

  Board Response: 33% strongly agree, 33% agree, 34% unsure
  Staff Response: 25% strongly agree, 25% agree, 25% unsure, 25% disagree

To prepare for the ESG discussion, the Board will receive information on the following related topics:

  What is ESG?
  What are other public funds doing?
  What are managers doing to meet the increased interest in ESG mandates?
  How to measure the risk?
  How to benchmark performance?

Separate, but also related to Investment Policy and Governance is to explore the Board’s views on proxy voting.
Board Direction

- What additional questions does the Board have concerning Investment Beliefs and the Process?

- Is the Board comfortable with the proposed next steps?
TMRS’ Hierarchy of Investment Decision Making
Hierarchy of Investment Decision Making

DID NOT Delegate

Duties the Board Delegated (informational Items for the Board)

Duties the Board Delegated