

# The Employees' Retirement Fund of the City of Dallas Investment Practices and Performance Review



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# Purpose & Scope

- Purpose: **Independent Review** of the Investment Practices and Performance of the Employees' Retirement Fund of the City of Dallas (the “ERF” or the “Fund”).
- Scope:
  - Identify and review existing investment policies, procedures, and practices.
    - Investment Policy Statement,
    - any informal procedures and practices,
    - not necessary to review past policies, procedures, and practices that are no longer applicable.
  - Compare the existing policies and procedures to industry best practices.
  - Generally, assess whether the ERF Board of Trustees (the “Board”), internal Staff, and external consultants are adhering to the established policies.
  - Identify the strengths and weaknesses of the current policies, procedures, and practices and make recommendations for improvement.
  - Include a detailed description of the criteria considered and methodology used to perform the evaluation, including an explanation of any metrics used and associated calculations.

# Introduction

- The Texas Pension Review Board has provided guidance on the different areas required by statute to be reviewed by independent consulting firms. Evaluations will vary based on specific characteristics of each system's size, governance, and investments.
- Milliman's evaluation identified and reviewed the existing policies and procedures of the ERF as it relates to the oversight and management of the Fund's investments. Our examination included a review of the ERF's Investment Policy Statement and other documents related to the investment of plan assets as well as formal and informal procedures adopted by the ERF management and Staff. We compared the ERF's policies and procedures to industry best practices and assessed the likelihood the Board, internal Staff and external consultants are adhering to the established policies.
- Our evaluation also identified strengths and potential weaknesses of the current policies and procedures and where appropriate we provided recommendations for improvements of any deficiencies we identified.

# Milliman – Independent Firm Disclosure



Milliman Inc. is a consulting, actuarial and outsourcing firm with 3,800 employees and offices in 59 principal cities across the U.S. and worldwide.

- Milliman is privately owned and managed by our employees. Milliman was established 1947.
- Milliman Advisors, LLC is an Investment Advisor with consulting relationships with over 200 institutional clients, \$40 billion in assets under consultation, 120+ investment professionals, average experience 25+ years.
- Milliman Advisors, LLC has no hidden broker/dealer, trust, or money management conflicts and is not involved in directly or indirectly managing investments of the ERF.
- Milliman Advisors, LLC does not receive any remuneration by any firm used by the ERF or from sources other than the ERF directly.

# Components of Evaluation

## Accountability



- The Board and Staff operate under the authority of **Dallas City Code Chapter 40A** (“Chapter 40A”) which addresses the creation of the Board, powers and duties of the Board, administration of the Fund, and contributions.
- The Fund has engaged an Investment Consultant, who is also a fiduciary, to review asset allocations, investment policies, and make recommendations to Staff and the Board. The Fund has also engaged outside legal counsel to review investment contracts. The Board makes all decisions with detailed and comprehensive input from Staff, Investment Consultant, and Legal Counsel.
- The ERF’s Investment Consultant is independent of the investment managers and trading platforms.
- The ERF conducts a Strategic Plan each year to set goals for key issues like investments, communications, customer service, and operational management. Staff then reports to the Board each year on their progress toward these goals.
- The ERF’s current governance structure strikes a good balance between risk and efficiency and is consistent with best practices.

# Components of Evaluation

## Investment Policy Statement (IPS)

The **Investment Policy Statement** is a manifestation of a disciplined process for selecting and monitoring the components in an investment program. It forms a foundation for a fund's investment strategy, formally establishes the governance structure and asset class representation, and defines the processes for investment manager selection and monitoring.

- The ERF has a written IPS for the overall plan as well as sub-asset classes, clearly customized for the ERF.
- It is reviewed annually and the files demonstrate the evolution of targets and expectations.
- The ERF has a formal funding policy, developed with input from Legal Counsel.

# Components of Evaluation

## Investment Policy Statement - cont.

- The IPS is written clearly so existing as well as newly appointed or elected Trustees will find it helpful as an ongoing tool for evaluating the Fund's investment program, consistent with best practices.
- The Manager Guidelines contain specific, measurable objectives for the managers, net of fees, over “a full market cycle” expected to be 3-5 years.
- “Discussion Sheets” in the Board materials provide an example of the Fund following its IPS.
- We found the ERF's IPS is consistent with other plans and best practices.

# Components of Evaluation

## Asset Allocation

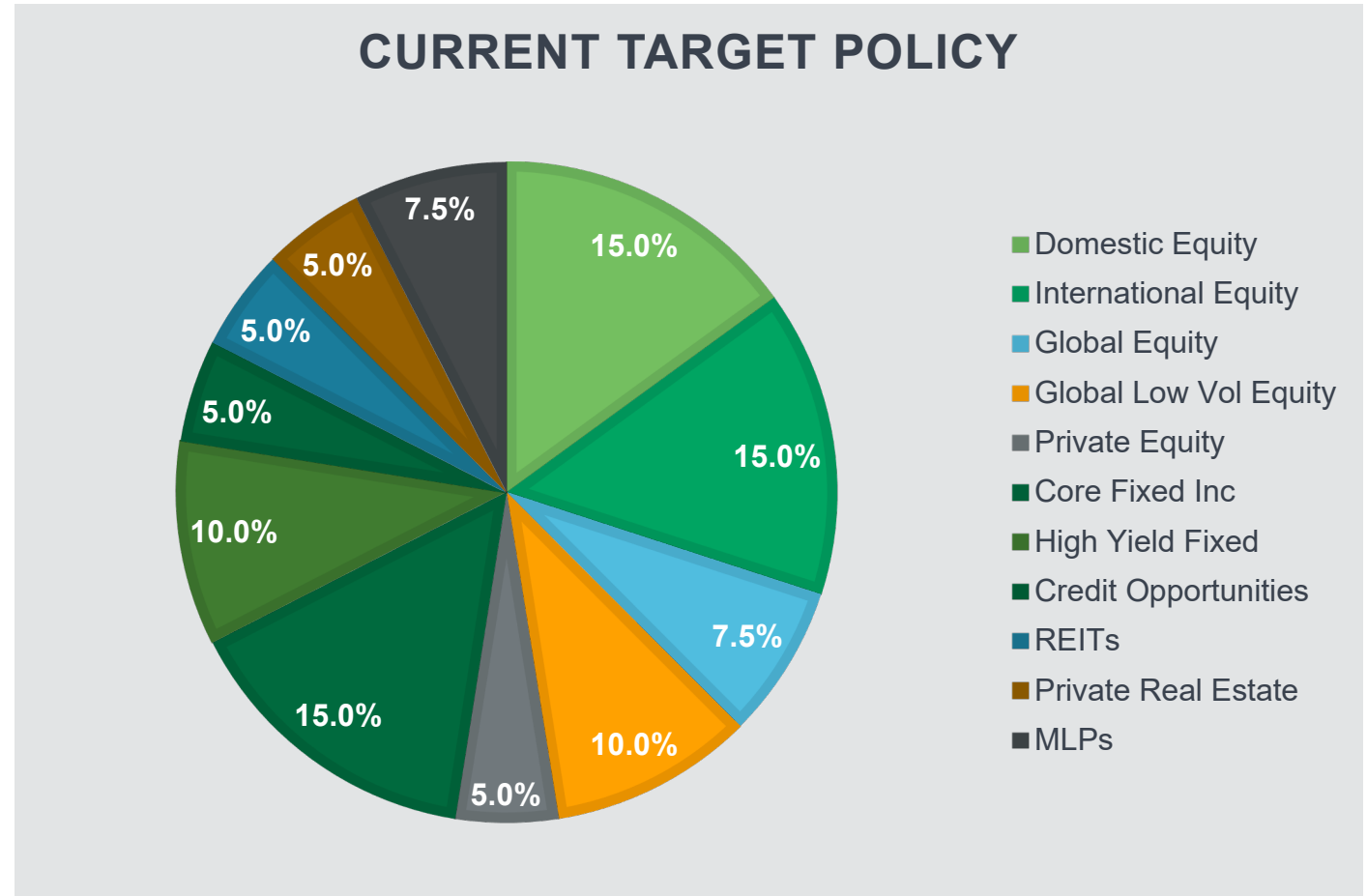
- The ERF has a formal **asset allocation policy** defined within the IPS. It is specific in terms of asset classes used, ranges around target allocations, and evaluation criteria.
- The Staff, working with the Investment Consultant, makes recommendations to the Board for approval. They examine the asset allocation monthly and will rebalance to targets based on defined ranges.
- An asset allocation study is conducted annually, incorporating current capital market assumptions and the Investment Consultant's current views on the market. We found these assumptions to be in-line with peers.
- In the asset allocation study, the ERF will consider new asset classes and their contribution to increasing or stabilizing return and its impact on the ERF's overall risk and standard deviation.
- The ERF's Investment Consultant and Actuary communicate regularly on the expected returns for the ERF. The Actuary examines the Investment Consultant's expectations and compares them to a survey of other capital market expectations from other sources.



# Components of Evaluation

## Asset Allocation – Target Allocation

- The changes in the assumed rate of return are reflected in the Actuary's modeling each year when the actuarial valuation is updated.
- The ERF maintains a strategic asset allocation that is monitored and rebalanced as needed.
- The ERF does not implement any tactical asset allocation component but does recognize and attribute its managers' returns by their invested sectors and geographical positioning.
- The ERF's asset allocation is appropriate for a plan their size and is consistent with best practices.



As of 09/30/2019

# Components of Evaluation

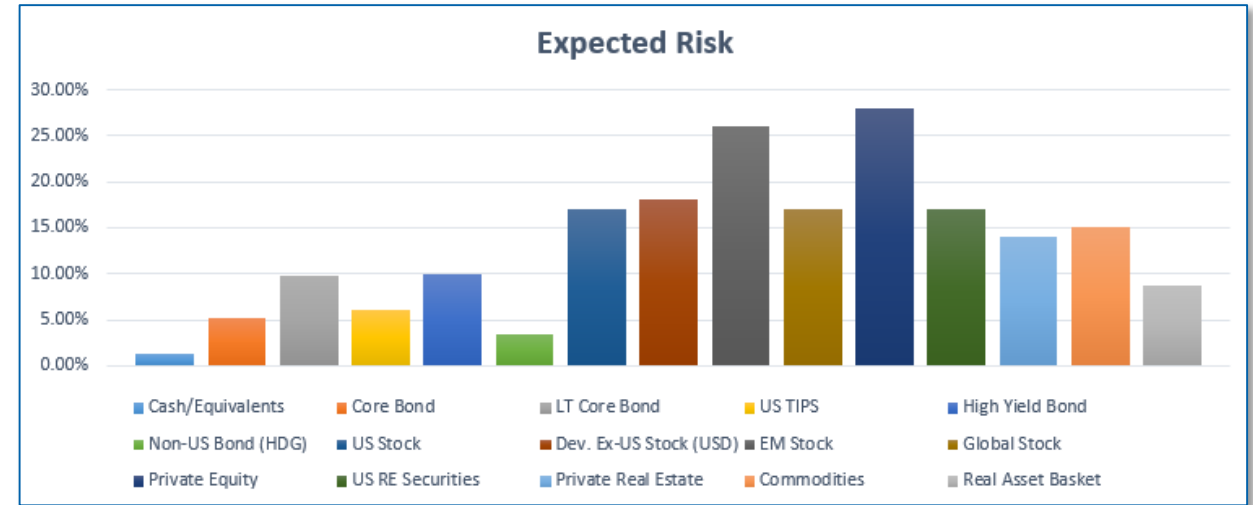
## Asset Allocation – Expected Risk and Return

- The ERF has a target strategic allocation of 70% Equity and 30% Fixed Income.
- Each sub-asset class has its own expected risk and return.
- The ERF's expectations for risk examines standard deviation and opportunities for diversification.
- The ERF is implementing its strategy using both active and passive management.
- The ERF's return and risk expectations used in the asset allocation process are stress tested under different scenarios as well as 5<sup>th</sup> and 95<sup>th</sup> percentile measurements.

# Components of Evaluation

Asset Allocation – Expected Risk and Return – cont.

- The Investment Consultant develops return expectations using an Income Growth Valuation Model, Dividend Discount Model, and Cyclically Adjusted P/E Model.
- The inputs for the asset allocation modeling are reasonable and the approach used by the system to develop the expected returns and asset mix is disciplined and reviewed regularly. It is consistent with best practices, and results in a well-diversified portfolio appropriate for the plan’s size.
- The ERF’s frequent evaluation of expected returns is an example of a Fund procedure that exceeds best practices.



# Components of Evaluation

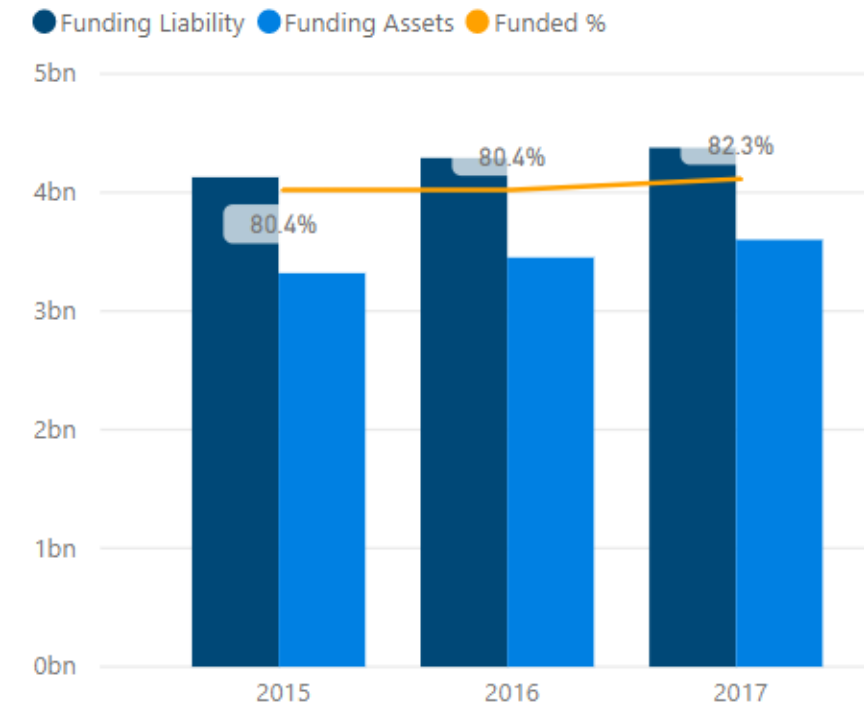
## Asset Allocation – Appropriateness of Alternatives and Illiquid Assets

- The IPS outlines the specific types of **alternatives assets** allowed including ranges and maximum allocations. The ERF's long-term time horizon provides the context for properly setting and measuring performance of these assets as well as defining their target allocations.
- The IPS along with Staff procedures and manager selection help mitigate the implied risk of these asset classes. For example, Private Equity investments are managed in a fund-of-fund structure with multiple managers utilizing two layers of audit and valuation (pricing).
- The targets defined in the IPS are consistent with industry norms. The ERF's target allocations for alternatives are (as of 9-30-2019):
  - Private Real Estate (5.0% target)
  - Private Equity (5.0% target)
- The ERF's Staff has extensive experience with alternative asset investing, both with ERF and prior to joining the ERF. The Staff is actively engaged in monitoring the alternatives and makes a concentrated effort to stay current with industry trends, products, and strategies.
- The ERF's alternative investments are appropriate given its size and level of investment expertise.

# Components of Evaluation

## Asset Allocation – Future Cash Flow and Liquidity Needs

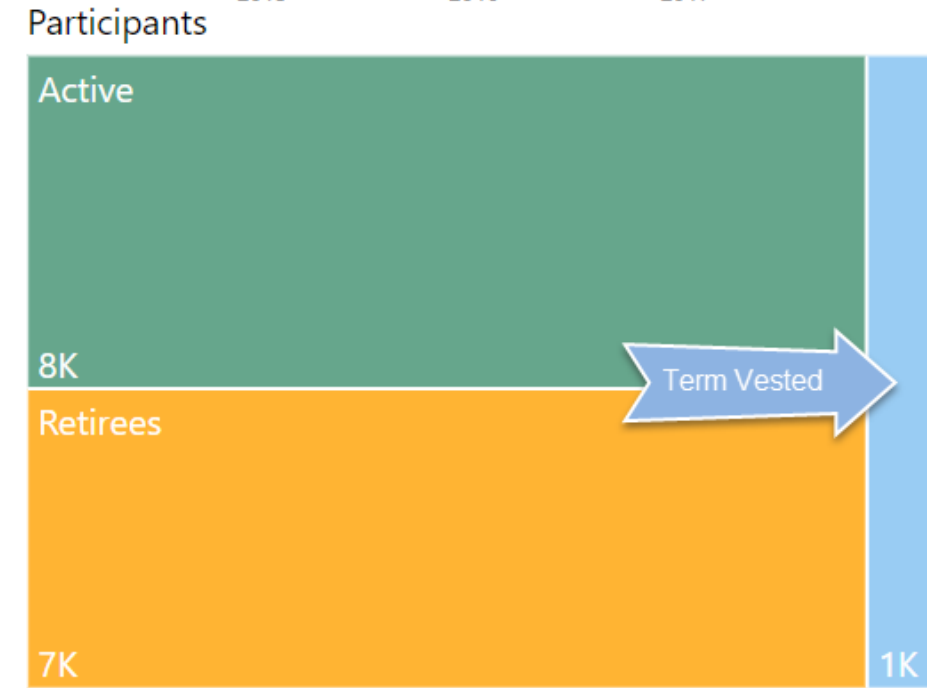
- An **Asset Liability Study** is conducted annually, reflecting the current population and expected cash flow needs.
- Though the Fund is currently experiencing negative net cash flow due to larger benefit payments vs. current contributions, it does not offer lump-sums and the population is very stable and predictable. This in turn provides predictable, stable cash requirements.
- The Asset Liability Study includes stress testing the portfolio in different market environments. The ERF does not expect any stresses applied to the portfolio in these tests to negatively impact the ERF's cash flow or liquidity requirements.
- The Funded Ratio is in line with long-term expectations.



# Components of Evaluation

Asset Allocation – Future Cash Flow and Liquidity Needs – cont.

- The ERF has a formal cash management policy to manage the benefit payments and expenses which includes a process for systematically raising cash from investment managers and rebalancing as needed.
- The ERF examines expected cash flows each year and models the plan's cash timing needs in light of contributions, expected income, and dividends. The ERF's policy for future cash flow and liquidity needs is adequate for the plan's size and consistent with best practices.
- The plan has about the same number of retirees and non-retirees.
- The ERF's annual Asset Liability Study is an example of a Fund procedure that exceeds best practices.



# Components of Evaluation

## Appropriateness of Investment Fees and Commissions

- The ERF has a disciplined and detailed evaluation procedure to **measure, reconcile, and benchmark fees.**
- The ERF's custodian provides reporting on securities trading, brokerage fees, and other risk measures, such as sector weights, country weights, cash levels, etc.
- All fees are transparent and reconciled with service agreements. The ERF does not use commission recapture or directed trades.
- Manager fees as well as trading and commissions are reported monthly and evaluated formally each quarter.
- Staff monitors the utilization of brokers by the managers, noting both new brokers and long-tenured providers.
- Fees deemed to be outside of acceptable variances are flagged, questioned, and reconciled.
- The ERF's discipline around fees is very thorough and we consider these Fund procedures to be beyond what we see with best practices.

# Components of Evaluation

## Governance Related to Investment Activities and Transparency

- The ERF and the Board are organized under Chapter 40A.
- The ERF has Investment Policies related to all asset classes (e.g. International Equity, REITs, Private Equity, Real Asset, etc.) as well as a Manager Selection and Monitoring Policy.
- The ERF's Code of Ethics (this "Code") covers the Board and Staff and addresses topics such as travel, gifts, prohibited transactions, and conflicts of interests.
- This Code also covers the ERF's consultants, advisors, vendors, employees, and other fiduciaries of the ERF.
- This Code is read and enforced **together** with the code of ethics found in Chapter 12A of the Dallas City Code and the travel policy adopted by the Board for itself and its Staff.
- Meeting agendas, minutes, and report materials are easily available to the Board and the public online.
- The ERF's governance policy and transparency of practices is adequate for a plan its size and is consistent with best practices.



# Components of Evaluation

## Investment Knowledge/Expertise

- The Board members are required to complete the **PRB Trustee education** with the ERF filing annual disclosure statements.
- Many members come to the Board with prior professional investment experience.
- The Board members and Staff attend educational training and conferences and are required to report back on what they learn.
- The Board and Staff also frequently attend their Investment Consultant's Client Conference covering investment and fiduciary topics.
- The ERF issues RFPs for their Investment Consultant typically every 5 years.

# Components of Evaluation

## Manager Selection and Monitoring Process

- Managers are selected by issuing an RFP for each asset class. Working with the Investment Consultant, Staff will recommend candidates for due diligence visits for Board approval. After conducting due diligence, Staff then recommends finalist candidates to present to the Board.
- Once hired, managers are required to meet with the Board as needed, typically once every two years.
- The ERF reviews performance monthly, examining both gross and net returns compared to index benchmarks and alpha-adjusted benchmarks.
- Quarterly, the ERF examines managers compared to peer groups, net of fees, attributing returns to sector, timing, and manager skill.
- Managers can be placed on “watch” for different periods of time depending on the market environment for that manager’s asset class. The Board is provided special information related to watch manager evaluation criteria and the expectations on timing and conditions for improvement.
- The manager selection and monitoring process is consistent with the IPS and in-line with industry standards. The use of net-of-alpha benchmarks in the IPS and monitor reports are an example of the ERF’s processes being above standard best practices.

# SB 322 Evaluation Summary

## Investment Practices and Performance Review

- The ERF's current governance structure **strikes a good balance between risk and efficiency.**
- It is consistent with best practices and is ample for a plan of its size.
- We found the **ERF Investment Policy Statement is consistent with other plans and best practices**, and their asset allocation is appropriate for a plan their size and is consistent with best practices.
- The **Capital Market Assumptions are reasonable** and consistent with best practices, and results in a well-diversified portfolio appropriate for the plan's size.
- The **ERF's alternative investments are appropriate** given its size and level of investment expertise.

# SB 322 Evaluation Summary

## Investment Practices and Performance Review – cont.

- **The manager selection and monitoring process is consistent with the Investment Policy Statement** and in-line with industry standards.
- **The ERF's discipline around fees is very thorough and consistent** with best practices.
- **The ERF confirms the services and fees provided by its independent Investment Consultant by periodically soliciting open bids through a RFP process.**
- In our review of the ERF's processes, procedures and documentation, **we found no clear deviances from industry standards or prescribed norms** for similar funds. The ERF's management and Staff maintain a well defined set of policies and procedures designed to oversee, manage, and report the performance and current status of the ERF.

# SB 322 Evaluation Summary

Investment Practices and Performance Review – cont.

Recommendations:

- Maintain current rigorous reviews of the ERF's performance, providers, and consultants.
- Maintain a focus on transparency.
- Adjust training and education requirements as needed to stay abreast of evolving investment strategies in a very dynamic and global environment.



**Thank you**

# Evaluation Footnotes

- The Pension Review Board has provided guidance on the different areas required by statute to be reviewed by independent consulting firms. The PRB recognizes that evaluations should and will vary significantly based on the specific characteristics of each system's size, governance structure, and investment program.
- This evaluation of the Employees' Retirement Fund of the City of Dallas was conducted independently by Milliman Advisors, LLC based on guidelines provided by the Pension Review Board and legislation enacted in the State of Texas under Senate Bill 322 (86R).
- SB 322 requires systems with assets of at least \$100 million must complete an evaluation once every 3 years.
- Information for this review was found in public filings of Board agendas, meeting minutes and other supporting documentation including meetings with Staff, and transcripts of Board meetings.

# Caveats and Disclaimers

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