Investment Practices and Performance Evaluation of the Texas Hospital Association Master Trust for Member Hospitals

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Background

Effective June 10, 2019, Texas Government Code §802.109 requires that all Texas public retirement systems with at least $30 million in assets complete an Investment Practices and Performance Evaluation ("Evaluation"). The scope of the Evaluation is defined in Texas Government Code § 802.109 and is supplemented by guidance from the Texas Pension Review Board (PRB), dated September 20, 2019.

The Evaluation must focus on the following five areas: (1) the investment policy; (2) the asset allocation; (3) the appropriateness of investment fees and commissions; (4) governance processes for investment activities; and (5) the investment manager selection and monitoring processes.

Retirement systems with at least $100 million in total assets must conduct the Evaluation once every three years. Retirement systems having at least $30 million but less than $100 million in total assets must complete the Evaluation once every six years.

A report of the Evaluation must be filed with the governing body of the public retirement system no later than May 1 of each year following the year in which the system is evaluated. The governing body must submit the report of the Evaluation to the Texas Pension Review Board ("PRB") no later than 31 days after the date the governing body of the retirement system receives the report.

The Evaluation must be completed by an independent firm with substantial experience in evaluating institutional investment practices and performance. The independent firm is required to evaluate the appropriateness, adequacy, and effectiveness of the retirement system's investment practices and performance and to make recommendations for improving the investment policies, procedures, and practices.

Aon Hewitt Investment Consulting Inc. ("AHIC") is currently providing investment consulting services to the Texas Hospital Association Retirement Plan for Member Hospitals ("Plan") pursuant to April 1, 2007 Master Consulting Agreement. A separate group within AHIC (Fiduciary Services Practice) is providing this Evaluation at the Plan's request pursuant to Texas Government Code §802.109 and the September 20, 2019 PRB guidance.

AHIC is a full-service global investment consulting firm that provides a wide array of services to various client types. AHIC has a dedicated Fiduciary Services Practice that has extensive experience conducting fiduciary audits and investment governance reviews similar in scope to the Evaluation mandated by Texas Government Code §802.109. AHIC's Fiduciary Services Practice has prepared this Evaluation. AHIC is not involved in directly or indirectly managing the investments of the Plan.

General Overview

Our report evaluates all the key areas outlined in the Texas Government Code §802.109, following the format and questions included in the PRB guidance. Through our review we have evaluated the 5 evaluation components (outlined and summarized below), and we have found that The Texas Hospital Association Retirement Plan for Member Hospitals (Plan) is performing most of the functions inquired about within the PRB guidance, and is performing those functions a manner consistent with commensurate peer institutional investors.

Texas Hospital Association (THA) offers outsourced administration of defined benefit plans. In doing so, the Board of Trustees (Board) has created four asset mix options that can be utilized by participating defined benefit plans (Plan Sponsors). Plan Sponsors select from the four asset mixes based on annual recommendations provided by THA's actuary and investment consultant (upon completion of each defined Plan Sponsor's annual actuarial valuation). During our review we have found;

1. The IPS follows best practice, it contains appropriate measurable outcomes, investment results have been mixed, and the IPS is being followed
2. THA is following common practice in its process for establishing and evaluating asset allocation, assets are well diversified (given the restricted use of alternatives for liquidity reasons), and risk positioning is being managed on a Plan Sponsor Basis
3. Fees are appropriately reported to the Board through its performance reporting materials and financials. The Total fee is low given the heavy use of passive management and no alternative investments
4. The Plan demonstrates best governance practices of an efficient, effective structure, meetings and oversight of the Plan.
5. The manager selection process is well defined and robust. Returns are calculated by the Plan's consultant, and all performance is reported net of all investment management fees

Evaluation Component 1: Investment Policy or Strategic Investment Plan and Associated Compliance

The Plan has an IPS document that was last reviewed in December of 2019, and the document was further refined during the review period to reflect our recommendations that are outlined in the report. The IPS generally followed best practice prior to our review and following the implementation of our modest recommendations we consider the document to be in-line with best practice. The document is written sufficiently clear that anyone could manage the portfolio and generally conform to the desired intentions of the Board. The IPS includes investment objectives for the Plan and individual managers, with manager level benchmarks articulated within the performance reporting materials.

Given the circumstances of THA as an outsourced administrator, the process for designing the IPS and funding policy to meet the needs and objectives of each Plan Sponsor is an important element. It is clear that THA has taken strides to allow each Plan Sponsor to customize the investment program to meet its respective needs and objectives. We believe the current policy would have been able to be sustained over recent trailing periods, and the current policy would have achieved the desired performance objectives.

Based on our review of the meeting minutes, board reports, interview of the investment consultant, and interview of Staff, we believe the IPS and other policies are being followed.

The Plan has had mixed results across the four Investment Objectives outlined in the IPS. Nominal performance relative to the actuarial assumption and the investment results relative to inflation both appear to be above expectations over the trailing 10-year period. Individual manager performance has been mixed, and investment results relative to the Plan benchmark have been less strong (underperformance appears to be largely attributable to the portfolio's value bias).

Evaluation Component 2: Investment Asset Allocation

The THA Board selects the strategic asset allocation of the asset mixes that are intended to represent the range of risk that would be desired by Plan Sponsors. THA then works in conjunction with the actuary and the investment consultant to recommend the appropriate asset mix to each Plan Sponsor. The Plan Sponsor then evaluates the recommendation, in conjunction with their own risk preference, and selects an appropriate asset mix. Discount rates are not explicitly reviewed when determining the asset allocation of the offered mixes, but they are considered when recommending an appropriate asset mix to each Plan Sponsor.

It has been determined that illiquid asset classes (alternatives) are not currently part of the investable opportunity set for this Plan, due to liquidity requirements. The asset allocation of the Plan is the result of the underlying Plan Sponsors selecting from the 4 offered asset mixes, and not a direct decision made by the Board. Given this, the Plan has a higher equity allocation than peers, with no alternative investment exposure. The assets of the Plan are diversified across the equity and fixed income opportunity set with heavy usage of passive management. The report details the asset allocation of the Plan relative to peers, the long-term strategic target, and provides the projected risk and return of the Plan and each invested asset class. The Plan does not target tactical asset allocations that differ from the strategic target.

The asset allocation of the offered mixes are evaluated on an ongoing basis, with the most recent review occurring in December of 2019. These reviews typically occur due to changes in the capital markets or based on conversations with the Plan Sponsors. At the time we performed our review, THA did not have a formal and/or written policy for determining and evaluating its asset allocation. Following the completion of our analysis and prior to the distribution of our final report, THA added language to its IPS outlining the timing and high-level analysis which will be performed as part of the process for evaluating the target allocation for the offered mixes.

The consultant and the actuary each use their own capital market assumptions when performing their analysis. This information is shared between the two firms at a high level. Given THA's role as an outsourced administrator of defined benefit plans, performing an asset-liability study is not applicable. THA performs portfolio projections and analysis including stress testing to determine the allocation of the asset mixes. THA is following common practice in its process for establishing and evaluating asset allocation.

Evaluation Component 3: Investment Fees and Commissions

THA does not have a written investment management fee policy. However, investment management fees are compared to peer universes and provided to the Board on a quarterly basis. This type of policy is not common across peer institutional investors.

The Plan does not pay indirect compensation. Direct compensation includes fees paid for administration (general plan administration, custodian, actuary, investment consultant, legal, audit, insurance, etc.) as well as investment management fees paid to the underlying investment managers. The detail of all expenses is outlined in the Plan's financial reports and performance reporting, which are provided to the Board on a quarterly basis.

Investment management fees compare favorably at the Plan level as well as by individual investment strategy. This is primarily due to the meaningful use of passive management and no exposure to alternative investments. On a quarterly basis, the Plan's investment consultant provides analysis which compares the investment expense of each investment mandate against that of a peer group.

Evaluation Component 4: Investment Governance Processes

The governance of the investment-decision making process is documented in the IPS and the Master Trust document. The IPS outlines the roles and responsibilities for the Trustees and investment managers. The Master Trust document outlines plan administration, funding, investment of the trust, powers and fiduciaries responsibilities, and delegation to investment managers. These documents are available to stakeholders upon request.

The Successor Trustee Board, currently comprised of seven appointed members, are appropriately vetted for qualifications and upon appointment, receive sound orientation. The orientation includes the important topics of fiduciary duties, prudence, diversification, adherence to plan documents, and conflicts of interest. There are also mandatory continuing education requirements.

The Board meets on a quarterly basis and spends sufficient time on investment matters. There are detailed minutes of the meetings and appropriate support, guidance and education provided by the investment consultants and legal counsel.

We recommend adoption of a Board Charter (or bylaws or comparable document) to further document the already demonstrated governance best practices by the Plan.

Evaluation Component 5: Investment Manager Selection and Monitoring Processes

The Board's investment consultant produces recommendations for manager selection. The managers presented to the Board for review are all Buy rated by the investment consultant's investment manager research team. The ultimate selection among multiple Buy rated candidates is at the discretion of the Board based on it's review of the consultant's diligence reports, discussions with the consultant, and the Board's own experience.

The process performed by the consultant for identifying, further screening, ongoing diligence, and termination of investment managers is robust and is outlined in detail within the report.

The Plan's investment consultant is responsible for measuring and reporting net of fee investment performance. We believe that the performance reports are appropriately formatted and presented to allow Trustees of all investment acumen and expertise to evaluate the investment success associated with the implementation of the investment policy. Given the complex nature of the topic, the additional opportunity to discuss the reports with the Board's investment consultant further alleviates any concern that the reports are overly complex.

Evaluation Component 1.

An 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;

- Does the system have a written investment policy statement (IPS)?

  Conclusions

  The Texas Hospital Association Retirement Plan for Member Hospitals (Plan) has an IPS titled "Statement of Retirement Plan Investment Objectives and Policies". This document was last reviewed in December of 2019.

- Are the roles and responsibilities of those involved in investing decisions clearly outlined?

  Background

  The IPS outlines the roles and responsibilities of the Trustees throughout the document. The policy describes the role of the Trustees with regards to;

  - Risk tolerance
  - Risk preference
  - Establishment of target asset allocations
  - Implementation of the target asset allocation
  - Rebalancing
  - Setting and evaluating performance objectives of managers and the Plan
  - Investment manager retention and oversight

  The IPS notes that it is the result of discussions between the Trustees and its investment consultant.

  The document also outlines the responsibilities (Responsibilities of the Investment Managers) and general guidelines (Investment Guidelines) of the investment managers within two concise segments of the IPS. The IPS does not outline the roles and responsibilities of other service providers.

  Conclusions

  The roles and responsibilities of the Trustees and the investment managers are clearly outlined. The role of the Trustees is outlined throughout the document. We believe the IPS could be enhanced by including a section of the document that outlines the responsibilities of the investment consultant and the actuary. Following the completion of our analysis and prior to the distribution of our final report, THA added language to its IPS outlining the responsibilities of the consultant and the actuary.

- Is the policy carefully designed to meet the real needs and objectives of the retirement plan? Is it integrated with any existing funding or benefit policies? (i.e. does the policy take into account the current funded status of the plan, the specific liquidity needs associated with the difference between expected short-term inflows and outflows, the underlying nature of the liabilities being supported [e.g. pay-based vs. flat $ benefit, automatic COLAs, DROP, etc.])

Background

Texas Hospital Association (THA) offers outsourced administration of defined benefit plans. In doing so, the Board of Trustees (Board) has created four asset mix options that can be utilized by participating defined benefit plans (Plan Sponsors). Plan Sponsors select from the four asset mixes based on annual recommendations provided by THA's actuary and investment consultant (upon completion of each defined Plan Sponsor's annual actuarial valuation).

Investment Policy Statement

The IPS references an additional policy document which outlines how plans are categorized into the four mixes (Operational Protocol for Asset Mix Options for Defined Benefit Plans in Fund A). Plan sponsors may choose any of the asset mixes in any combination, based on the recommendation of THA, the actuary, and the investment consultant. The Board reserve the right to decline to implement any asset mix request. The document notes that the actuary and the investment consultant may take into account the following items when developing their recommendations;

- Frozen or non-frozen status of the plan
  - Nature of such a freeze (e.g., frozen participation or frozen accruals)
- The plan's funding level on various measurement bases (e.g., FASB, GASB, and ERISA/PPA, as appropriate)
- ERISA coverage status
- Certain financial parameters as may be specified by the plan sponsor
  - Such as the level of annual contribution relative to overall plan sponsor cash flow and the relative magnitude of the plan's unfunded obligation as a percentage of the plan sponsor's total balance sheet

The actuary reviews the above factors and develops an asset mix recommendation that is reviewed by the investment consultant and THA. This recommendation is then shared with the plan sponsor and an affirmation of this recommendation or an alternative asset allocation is required of the plan sponsor.

Based on our review, the IPS and the Operational Protocol documents appear to be carefully designed to meet the real needs and objectives of the Plan Sponsors as well as those of the Plan.

Funding Policy

THA maintains a funding policy (Texas Hospital Association Retirement Plan for Member Hospital Amended Funding Policy). This policy includes separate guidelines for ERISA defined benefit plans and non-ERISA defined benefit plans. ERISA defined benefit plans follow the minimum funding requirement under ERISA. The non-ERISA defined benefit plans follow the Texas State Pension Review Board nonbinding guidelines for defined benefit plans.

Conclusions

Given the circumstances of THA as an outsourced administrator, the process for designing the IPS and funding policy to meet the needs and objectives of each Plan Sponsor is an important element. It is clear that THA has taken strides to allow each Plan Sponsor to customize the investment program to meet its respective needs and objectives. Additionally, the associated funding policy does account for the funded ratio and specific circumstances of each Plan Sponsor.

- Is the policy written so clearly and explicitly that anyone could manage a portfolio and conform to the desired intentions?

Conclusions

The policy is written sufficiently clear that anyone could manage a portfolio and generally conform to the desired intentions of the Board. Additional thoughts on how the IPS could be enhanced have been provided in the following response.

- Does the policy follow industry best practices? If not, what are the differences?

Background

There is no uniform standard for the content and no absolute model to follow when drafting an IPS. The IPS should ideally be a highly customized document that is uniquely tailored to the preferences, attitudes, and situation of each investor. Additionally, there are various approaches to developing investment policy to efficiently meet the needs of an organization. We often see two primary approaches to drafting an IPS.

– **Rules Based Investment Policy** – Prescriptive approach that provides guidance on what can and cannot occur. This approach requires significant detail and foresight on future scenarios; it also requires more modifications as the investment environment evolves. The board provides a rule book for staff to follow.

– **Principles Based Investment Policy** – Provides high level guidance which can be applied to many circumstances. The board provides high level guidance to staff and encourages the use of professional judgment when making decisions.

The THA IPS reflects more of a principles-based structure rather than a rules-based structure. We do not see one structure as potentially superior to the other, but the form of the IPS impacts the governance required for ongoing oversight.

To facilitate our review of the IPS, we have included a table outlining what we believe to be the key sections of an IPS and how we think about IPS development. The table includes a broad title of each section type, the type of information we expect to be included in each section, and any comments on the THA IPS. The bullets below align with each area where we think the IPS could be improved (yellow shading) or where we feel there is a more material enhancement opportunity (red shading - none).

1. We believe the IPS could be enhanced by adding language elaborating on the fiduciary duty to the underlying participants of the plans
2. We believe the IPS should include language articulating the process and timing associated with determining the appropriate asset allocation for each asset mix
3. We believe the IPS could be enhanced by adding a section articulating the duties of the investment consultant and actuary
4. We believe the IPS could be enhanced by adding descriptive language on who sets benchmarks, timing for their review, and the rationale for their selection
5. We believe the IPS could be enhanced by the inclusion of high-level language on the importance of diversification and how the Board thought about the benefits of diversification when selecting the asset allocation of the mixes
6. We believe the IPS could be enhanced by including more definitive rebalancing ranges and guidelines
7. We believe the IPS could be enhanced by including a more descriptive timeline of the cycle for reporting on key metrics associated with the governance of the Plan

Section	Purpose of Section	Comments
Introduction	▪ Reference to the purpose and benefit to be provided by the Trust	No comment
	▪ Intended beneficiaries of the Trust	No comment
	▪ Overview of fiduciary obligation	No comment
Statement of Purpose	▪ Investments made for the exclusive purpose of providing benefits to participants ▪ Plan fiduciaries must act in the sole interest of plan participants and beneficiaries and for the exclusive purpose of providing benefits	Comment #1
Investment Goals or Objectives	▪ To preserve the actuarial soundness of the Trust in order to meet benefit obligations	No comment
	▪ To obtain a long-term rate of return, net of fees, equal to or in excess of the policy benchmark	No comment
	▪ The policy benchmark and asset allocation targets should be defined	No comment
Asset Allocation	▪ Purpose is to provide an optimal mix of investments to produce desired returns and meet current and future liabilities, with minimal volatility	No comment
	▪ Frequency and methodology of asset liability modeling and resetting allocation	Comment #2
	▪ Describe permissible asset classes as well as minimum, maximum, and target ranges	No comment
Identification of Roles and Responsibility	▪ Board of Trustees – general and investment related duties	No comment
	▪ External investment consultants – advise on best practices, trends and support staff and Board/IAC with fiduciary responsibilities ▪ Other external providers' duties, expectations and fiduciary responsibilities	Comment #3

Section	Purpose of Section	Comments
Asset Class Guidelines / Benchmarks	▪ Benchmarks – who sets them and how often they are revisited, and their rationale ▪ Diversification - Provide an overview on the importance of diversification and how it is achieved in the Trust	Comment #4 Comment #5
Rebalancing Policy	▪ Purpose of rebalancing – to ensure that the investment program adheres to its strategic asset allocation ▪ Describe how often the portfolio will be reviewed for rebalancing and whether a fixed threshold or proportional threshold will be used	Comment #6
Risk Management	▪ Acknowledgement and definition of risk to be managed in investment portfolio (active risk, credit risk, counterparty risk, market risk, operational risk, etc.) ▪ Define parameters for risk management (what does success look like)	No comment No comment
Monitoring and Reporting	▪ Describe monthly, quarterly, and annual reporting ▪ Outline monitoring and reporting process	Comment #7
Shareholder Activity	▪ Proxy positions − describe the policy and how votes are cast and recorded ▪ Identify core principles of the Board (Board independence, Board management, shareholder rights) and communicate importance of fiduciary duty, integrity, and transparency	No comment
Governance	▪ Identify obligations to the Trust are consistent with the fiduciary obligations of ERISA ▪ Require ongoing review of investment policy statement	No comment No comment

Conclusions

The IPS generally follows best practice. In our response above we have provided 7 ways in which we believe the document could be enhanced, but overall, we believe the document is reasonably constructed.

Following the completion of our analysis and prior to the distribution of our final report, THA performed an IPS review which addressed each of our proposed enhancements.

- Does the IPS contain measurable outcomes for managers? Does the IPS outline over what time periods performance is to be considered?

Conclusions

The IPS includes a section titled "Investment objectives". The investment objectives section outlines the applicable benchmarks to be utilized for the creation of the Plan benchmark. Manager levels benchmarks are not established within the IPS, and the IPS notes that "Individual investment portfolios will be expected to meet or exceed market benchmarks established separate from the Statement". The performance reporting materials outline the benchmarks utilized by each investment manager.

The IPS outlines the time period for which investment performance should be considered. The IPS states that "The Trustees will evaluate the performance of the investment program and its investment managers with respect to the stated objectives generally in the context of a five-year time horizon."

- Is the system following the investment policy?

Conclusions

Yes. Based on our review of the meeting minutes, board reports, interview of the investment consultant, and interview of Staff, we believe the IPS and other policies are being followed.

- What practices are being followed that are not in, or are counter to, written investment policies and procedures?

Conclusions

Practices that are occurring but are not specifically outlined in investment policy include fee negotiations and IPS review. During our interviews with the investment consultant, we discussed the ongoing fee negotiations that occur from time to time with investment managers. Additionally, we received documentation related to some of these negotiations.

Recent areas where THA and the consultant were able to negotiate more favorable fees over the last few years include custodial fees as well as investment management fees paid to State Street (on two separate occasions).

The IPS has been reviewed annually over recent periods. This annual review is not outlined or mandated within the IPS, but it has been occurring in practice.

- Are stated investment objectives being met?

Background

The IPS outlines multiple objectives in the "Investment Objectives" section. These include;

  – **Outperform Plan Sponsor Assumptions** – Provide returns which improve the funded status of the participating hospitals' defined benefit plans over time and reduce the hospitals' pension costs over the long term

  – **Investment Manager Outperformance** – Deliver favorable performance from the Plan's active managers over a 5-year period

  – **Outperform Real Return Objective** – Outperform the annualized rate of inflation (as measured by the Consumer Price Index) by 5 percentage points

  – **Outperform the Plan benchmark** – Outperform the custom benchmark outlined in the IPS

Each of these performance objectives can be evaluated independently. The following paragraphs evaluate each objective, and if it has been met.

Outperform Plan Sponsor Assumptions – Of the criteria outlined in the IPS, this is the most difficult to evaluate. Each Plan Sponsor has different circumstances. These circumstances could result in positive or negative funded status changes regardless of optimal investment performance. Potentially the best way to evaluate this item is to compare the investment results of the Plan to the actuarial discount rate used by the Plan Sponsors. The current range of discount rates reported by the actuary is 3.12-7.00%. The returns generated by the Plan over longer time periods, outlined in the table below, show that long term performance as of 9/30/2019 appears to be favorable relative to the current actuarial discount rates. In 2010, the actuarial discount rates ranged from 6.42-8%.

Annualized Investment Returns (net of fees)			
3 Years	5 Years	7 Years	10 Years
8.9%	7.3%	9.3%	9.3%

Investment Manager Outperformance – The Plan currently utilizes four active investment mandates. Across these four mandates, 2 managers outperformed their respected benchmarks during the investment objective period of 5-years, and 2 underperformed. The table below outlines the investment results for the active investment mandates utilized by THA over longer time periods.

	Annualized Investment Returns (net of fee)		
Manager	3 Years	5 Years	10 Years
BHM&S	10.6%	7.9%	11.5%
Russell 1000 Value Index	9.4%	7.8%	11.5%
Excess Return	**1.2%**	**0.1%**	**0.0%**
Dodge & Cox International Stock	5.3%	0.6%	4.9%
MSCI EAFE Index	6.5%	3.3%	4.9%
Excess Return	**-1.2%**	**-2.7%**	**0.0%**
Morgan Stanley International Equity Trust	6.0%	2.6%	5.0%
MSCI EAFE Index	6.5%	3.3%	4.9%
Excess Return	**-0.5%**	**-0.7%**	**0.1%**
PIMCO Total Return	3.6%	3.6%	--
Blmbg. Barc. U.S. Aggregate	2.9%	3.4%	--
Excess Return	**0.7%**	**0.2%**	**--**

Outperform Real Return Objective – The table below outlines the trailing investment results of THA relative to the real return benchmark, the Consumer Price Index + 5%. The Plan has outperformed the real return objective over all trailing time periods.

	Annualized Investment Returns (net of fee)		
	3 Years	5 Years	10 Years
THA Retirement Plan	8.9%	7.3%	9.3%
Consumer Price Index + 5%	7.2%	6.6%	6.8%
Difference	**1.7%**	**0.7%**	**2.5%**

Outperform the Plan benchmark – The table below outlines the trailing investment results of THA relative to the custom benchmark outlined in the IPS. The Plan has underperformed the relative return objective over all trailing time periods.

	Annualized Investment Returns (net of fee)			
	3 Years	5 Years	7 Years	10 Years
THA Retirement Plan	8.9%	7.3%	9.3%	9.3%
Consumer Price Index + 5%	9.3%	7.9%	9.6%	9.9%
Difference	**-0.4%**	**-0.6%**	**-0.3%**	**-0.6%**

As noted in the asset allocation review we received, and by our evaluation of the portfolio. The Plan has a bias toward value stocks. Value stocks have substantially underperformed growth stocks over recent periods, and this is likely a meaningful driver of the relative underperformance experienced over trailing periods.

	Annualized Investment Returns		
	3 Years	5 Years	10 Years
Russell 3000 Growth Index	16.4%	13.1%	17.7%
Russell 3000 Value Index	9.2%	7.8%	11.4%
Difference	**7.2%**	**5.3%**	**6.3%**

Conclusions

The Plan has had mixed results across the four Investment Objectives outlined in the IPS. Nominal performance relative to the actuarial assumption and the investment results relative to inflation both appear to be above expectations over the trailing periods outlined above. Individual manager performance shown is mixed, with all 4 actively managed investment mandates producing excess returns over the benchmark over the longest time period shown. Investment results relative to the Plan benchmark have been less strong, but this appears to be largely attributable to the portfolio's value bias.

- Would the retirement fund have been able to sustain a commitment to the policies during the capital markets that have actually been experienced over the past ten, twenty, or thirty years?

Background

As of 9/30/2019 the Plan maintained the target asset allocation outlined in the table below. The target asset allocation represents a weighted average of the target asset allocations of the four offered investment mixes offered by THA, based on the amount of assets allocated to each mix. The target allocation weights are re-calculated on a monthly basis.

Target Asset Allocation (9/30/2019)	Weight
Large Cap U.S. Equity	48.5%
Small Cap U.S. Equity	14.6%
Developed International Equity	9.7%
U.S. Core Fixed Income	26.2%
Cash	1.0%

Each asset classes included in the portfolio is extremely liquid and each has produced relatively strong investment results over the long trailing periods outlined in the question. Given THA's unique circumstances as an administrator for underlying Plan Sponsors, we see no reason why they wouldn't have been able to sustain a commitment to the policies during the capital markets that have actually been experienced over the past ten, twenty, or thirty years.

The table below shows the trailing investment results achieved by the asset classes which the Plan invests in over those time periods.

	Annualized Investment Returns		
	10-Year	20-Year	30-Year
Standard and Poor's 500 Stock Index	13.6%	6.1%	10.0%
Small Cap U.S. Equity*	13.0%	9.0%	10.5%
MSCI Europe, Australia, Far East (EAFE) Index	5.5%	3.3%	4.5%
Bloomberg Barclays Aggregate Bond Index	3.8%	5.0%	5.9%
Bloomberg Barclays U.S. Long Credit Bond Index	8.0%	7.8%	8.1%
Citigroup 3 Month T-Bill Index	0.6%	1.7%	2.8%

*Spliced series consisting of the CRSP U.S. Small Cap Index since 7/2001 and Russell 2000 Index prior

Conclusions

Yes, we believe the Plan would have been able to sustain a commitment to the policies during the capital markets that have actually been experienced over the past ten, twenty, or thirty years.

- Would the policy, if previously implemented, have achieved the objectives and results desired?

Background

The table below shows the trailing investment results of the current investment policy over various long-term trailing periods. As shown, the current policy outperformed the Consumer Price Index + 5% in 3 of the 4 periods. Additionally, the current investment policy produced a return above the current range of actuarial discount rates of Plan Sponsors (3.12% - 7.00%) in 3 of the 4 periods.

	Annualized Investment Returns			
	5 Years	10 Years	20 Years	30 Years
Current Investment Policy	8.5%	10.2%	6.2%	8.7%
Consumer Price Index + 5%	6.9%	6.8%	7.2%	7.5%
Difference	**1.6%**	**3.3%**	**-1.0%**	**1.2%**

Conclusions

Yes, we believe the current policy would have achieved the desired performance objectives if previously implemented.

- How often is the policy reviewed and/or updated? When was the most recent substantial change to the policy and why was this change made?

Conclusions

Based on our discussions with the investment consulting team, and our review of the documents received, investment policy has been reviewed on an annual basis over recent periods. However, at the time of our review there was no stated policy associated with the frequency of IPS reviews. Following the completion of our analysis and prior to the distribution of our final report, THA performed a review of the IPS. This review included adding language to the IPS outlining the frequency of reviews.

The most recent substantial change to the policy was completed in December of 2019. The previous changes were made in March 2017. The December 2019 changes were substantial, and the bullets below represent a general overview of the changes;

- General language cleanup and wordsmithing
- Updating language associated with individual Plan Sponsors, and changes associated with Plan Sponsors entering or exiting the Plan
- Removal of detail associated with the asset mix modeling

– Amended rebalancing criteria and timing

– Amending the responsibilities of the investment managers

Following the completion of our analysis and prior to the distribution of our final report, THA performed a review of the IPS. This review included adding language to the IPS outlining the frequency of reviews.

Evaluation Component 2.

A detailed review of the retirement system's investment asset allocation, including:

(A) The process for determining target allocations;

- Does the system have a formal and/or written policy for determining and evaluating its asset allocation? Is the system following this policy?

  Conclusions

  At the time we performed our review, THA did not have a formal and/or written policy for determining and evaluating its asset allocation. Following the completion of our analysis and prior to the distribution of our final report, THA added language to its IPS outlining the timing and high level analysis which will be performed as part of the process for evaluating the target allocation for the offered mixes.

- If no formal policy exists, what is occurring in practice?

  Conclusions

  The asset allocation of the offered mixes is evaluated on an ongoing basis. From our conversations with THA and the investment consultant, it appears that these reviews typically occur due to changes in the capital markets or based on conversations with Plan Sponsors. The most recent review of asset allocation occurred in December of 2019.

  THA believes there is a relationship between the level of risk assumed and the level of return that should be expected. Additionally, they believe that the level of risk assumed should reflect the Plan Sponsors' risk tolerance and risk preference. To facilitate this, THA has created four asset mixes that span the expected risk spectrum. The level of return seeking assets (equity) across the four mixes is 75%, 55%, 35%, and 0%. Additionally, THA allows Plan Sponsors to allocate across multiple mixes to further refine the investment risk within their plan. The most recent review of the asset allocation mixes included;

  – Trailing investment results of the portfolio and the evaluated alternative mix

  – Investment style analysis to assist THA in understanding the regional and style biases within the portfolio as it exists today

  – A comparison of asset allocation relative to peers

  – Proposed refinements to the asset allocation of the current mix and the associated impact to;

    - Expected return (including the distribution of potential outcomes)

    - Expected risk

    - Expected real return
    - Sharpe ratio
    - Investment expense
  - Review of benchmarks and the properties of a valid benchmark

  Once the four asset mixes are determined, through the asset allocation review process outlined above, each Plan Sponsor selects the asset mix which is most appropriate for their circumstances. The appropriateness of the selected mix for each Plan Sponsor is evaluated at the onset, and on an annual basis thereafter. This review is performed by the actuary, the investment consultant, and THA. The recommendation is then provided to the Plan Sponsor for their review and selection of the appropriate investment mix.

- Who is responsible for making the decisions regarding strategic asset allocation?

Conclusions

The Board is responsible for making the decisions regarding strategic asset allocation of the offered mixes. Each Plan Sponsor is responsible for selecting its individual asset mix. Their selection is based off the review and recommendation provided by THA, the actuary, and the investment consultant.

- How is the system's overall risk tolerance expressed and measured?

Background

The IPS document outlines the view that over long periods of time, there is a relationship between the level of risk assumed and the level of return that should be expected. The document defines risk as the variability of investment return (volatility). The document asserts that the level of volatility should be a function of the Plan Sponsors' financial ability to take risk (risk tolerance), and the willingness to accept risk (risk preference) in their investment programs. The "Risk Tolerance" and "Risk Preference" sections of the IPS are provide below (the language has been paraphrased for readability).

Risk Tolerance

The Trustees examine the Plan Sponsors' risk tolerance levels from several perspectives. Factors include frozen/non-frozen status of a plan, nature of such freeze, funding level, ERISA coverage status, and certain financial parameters as may be specified by the plan sponsor, such as the level of annual contribution relative to overall plan sponsor cash flow and the relative magnitude of the plan's unfunded obligation as a percentage of the plan sponsor's total balance sheet.

Risk Preference

The Trustees understand the risk preferences of the underlying health system Plan Sponsors and take this into account as the risk posture is formulated.

The evaluation of risk tolerance and risk preference is key to the selection among the four offered asset mixes. The selection of the asset mix results from the review of the "Risk Tolerance" analysis performed by the actuary, investment consultant, and THA. The Plan Sponsors then consider this recommendation while considering their own "Risk Preference".

Conclusions

The evaluation of "Risk Tolerance" is outlined in the IPS. The review of "Risk Tolerance" is made by the actuary, investment consultant, and THA. The Plan Sponsor then selects an asset mix based on the recommendation and their own "Risk Preference".

- How often is the strategic asset allocation reviewed?

Conclusions

The asset allocation of the offered mixes is evaluated on an ongoing basis. From our conversations with THA and the investment consultant, it appears that these reviews typically occur due to changes in the capital markets or based on conversations with the Plan Sponsors. The most recent review of asset allocation occurred in December of 2019.

- Do the system's investment consultants and actuaries communicate regarding their respective future expectations?

Conclusions

The consultant and the actuary each use their own capital market assumptions when performing their analysis. This information is shared between the two firms at a high level.

- How does the current assumed rate of return used for discounting plan liabilities factor into the discussion and decision-making associated with setting the asset allocation? Is the actuarial expected return on assets a function of the asset allocation or has the asset allocation been chosen to meet the desired actuarial expected return on assets?

Conclusions

THA creates four asset mixes that are intended to represent the range of risk that would be desired by Plan Sponsors. THA then works in conjunction with the actuary and the investment consultant to recommend the appropriate asset mix to the Plan Sponsors. Discount rates are not explicitly reviewed when determining the offered mixes, but they are considered when recommending an appropriate asset mix to each Plan Sponsor.

- Is the system following industry best practices regarding the establishment and evaluation of the asset allocation?

  Conclusions

  THA is following common practice in its process for establishing and evaluating asset allocation.

- How does the asset allocation compare to peer systems?

  Conclusions

  The table below shows the asset allocation of the Plan relative to the peer data provided in the Greenwich Associates 2018 U.S. Institutional Market Trends Study. As shown, the Plan has more U.S. equity exposure, less fixed income exposure, and no alternative investments. Given THA's role as an outsourced administrator of defined benefit plans, and the potential for Plan Sponsors to exit the Plan at any time. It has been determined that illiquid asset classes (alternatives) are not part of the investable opportunity set for this Plan, currently. Additionally, the asset allocation of the Plan is the result of the underlying Plan Sponsors selecting from the 4 offered asset mixes, and not a decision made by the Board.

	THA Plan	Peer Group*
U.S. Equities	63%	28%
Non-U.S. Equities	10%	12%
Global Equities	0%	7%
Emerging Markets Equities	0%	3%
Total Equities	73%	49%
U.S. Fixed Income	26%	38%
Non-U.S. Fixed Income	0%	0%
Global Fixed Income	0%	0%
Emerging Markets Fixed Income	0%	2%
Total Fixed Income	26%	40%
Multi-Asset	0%	4%
Private Real Estate	0%	0%
Private Equity	0%	2%
Hedge Funds	0%	4%
Commodities	0%	0%
Other	0%	1%
Total Alternatives	0%	10%
Cash	1%	1%
Total	100%	100%

*Greenwich Associates 2018 U.S. Institutional Market Trends study U.S. corporate funds' dollar-weighted asset mix of defined benefit plan assets, with assets $501 million – 1 billion

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

- What are the strategic and tactical allocations?

Background

THA offers outsourced administration of defined benefit plans. In doing so, the Board has created four asset mix options that can be utilized by Plan Sponsors. Plan Sponsors select from the four asset mixes based on annual recommendations provided by THA's actuary and investment consultant (upon completion of each defined Plan Sponsor's annual actuarial valuation). The target asset allocation of the 4 offered asset mixes are provided in the table below.

Asset Class/Style	Mix 4	Mix 3	Mix 2	Mix 1
Large Cap U.S. Equities	50%	37%	23%	
Small Cap U.S. Equities	15%	11%	7%	
International Equities	10%	7%	5%	
Total Equities	**75%**	**55%**	**35%**	**0%**
Intermediate Fixed Income	25%	45%	65%	
Long Duration Fixed Income				100%
Total Fixed Income	**25%**	**45%**	**65%**	**100%**

The strategic asset allocation of the Plan represents a weighted average of the asset mixes outlined above, based on the level of assets allocated to each mix. This target is re-calculated on a monthly basis. The table below outlines the strategic asset allocation as of 9/30/2019.

Target Asset Allocation (9/30/2019)	Weight
Large Cap U.S. Equity	48.5%
Small Cap U.S. Equity	14.6%
Developed International Equity	9.7%
U.S. Core Fixed Income	26.2%
Cash	1.0%

The Plan does not target tactical asset allocations that differ from the strategic target. However, the Plan does maintain a value bias in its investment portfolio. This bias has been held for an extended period of time and is expected to produce excess returns over time. Over recent periods this value bias has detracted from investment results relative to the benchmark.

Conclusions

The table below outlines the strategic asset allocation of the Plan as of 9/30/2019. The Plan does not target tactical asset allocations that differ from the strategic target.

Target Asset Allocation (9/30/2019)	Weight
Large Cap U.S. Equity	48.5%
Small Cap U.S. Equity	14.6%
Developed International Equity	9.7%
U.S. Core Fixed Income	26.2%
Cash	1.0%

- What is the expected risk and expected rate of return of each asset class?

Conclusions

The table below outlines the expected return and risk of each asset class the Plan invests in, as well as the Plan in aggregate. The table utilizes the 10-year capital market assumptions of THA's investment consultant.

Asset Class	Current Targets	Expected Nominal Return	Expected Risk
Large Cap U.S. Equity	49%	6.0%	17.0%
Small Cap U.S. Equity	15%	6.2%	23.0%
Developed International Equity	10%	6.8%	20.0%
Aggregate Bonds	26%	2.4%	4.0%
Long Bonds	0%	2.7%	9.5%
Cash	1%	1.7%	1.0%
Texas Hospital Association Retirement Plan	100.0%	--	--
Estimated Return (Nominal)	***5.5%***		
Estimated Risk	***13.0%***		
Sharpe Ratio[2]	***0.292***		

- How is this risk measured and how are the expected rates of return determined? What is the time horizon?

Background

THA's investment consultant's capital market assumptions are proprietary. They incorporate assumptions on returns, volatilities (standard deviations), and correlations that are updated on a quarterly basis. The capital market projections are developed by the firm's Global Asset Allocation team and represent the team's long–term capital market outlook (10 and 30 years). The output provided in the previous response represents their 10-year assumptions.

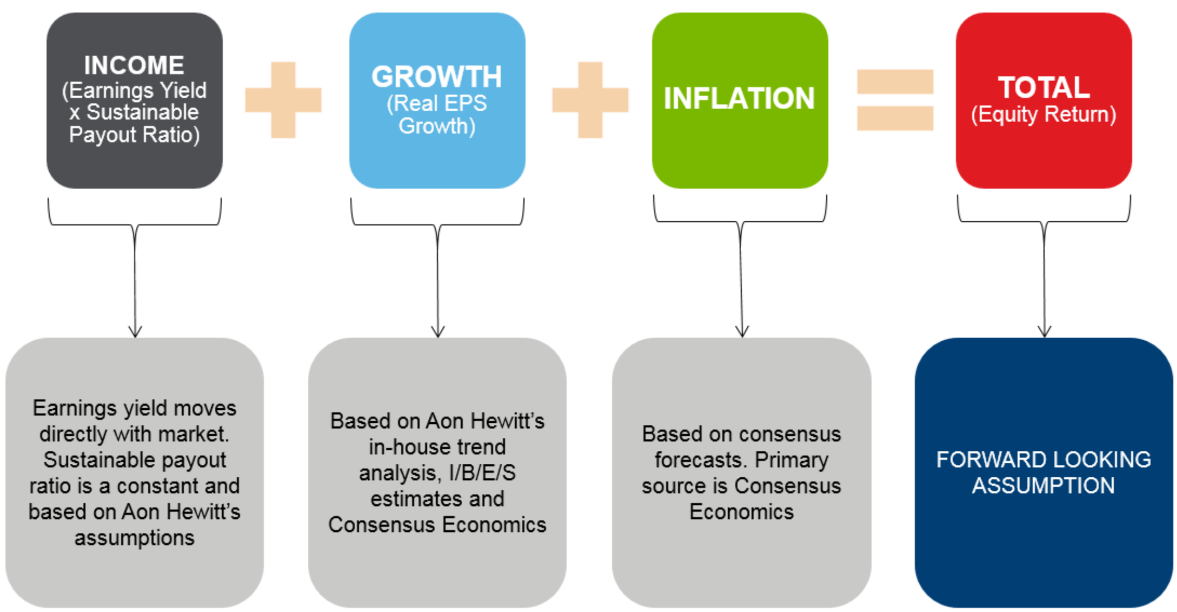
The consultant employs various methodologies for determining the expected return of equities, bonds, and alternatives, incorporating both quantitative and qualitative inputs. Those assumptions reflect current market valuations and future prospects rather than relying solely on historic averages, a particularly important feature when markets move to extremes as they have done over the past few years.

Risk

The consultant uses volatility as a measure of risk, when purely discussing capital market assumptions. Their asset allocation work factors in other forms of risk (liquidity, funded ratio, factor risk, etc.). Assumed volatilities are formulated with reference to implied volatilities priced into option contracts of various terms and with regard to historical volatility levels. Correlation assumptions are generally similar to actual historical results; however, they make adjustments to reflect forward-looking views as well as current market fundamentals.

Equity Assumptions

The chart and table below provide a general overview of how equity assumptions are determined.



	U.S. (2)	U.K.	Europe ex U.K.	Japan	Canada	Switzerland	Australia	Emerging Markets*
Earnings Yield * Sustainable Payout Ratio	2.2%	2.8%	2.7%	2.9%	2.6%	2.3%	2.8%	2.7%
Real Earnings Growth	1.9	1.7	1.6	1.2	1.7	1.7	2.2	2.3
Inflation	2.2	2.1	1.8	0.9	2.0	1.1	2.3	2.4
Methodological Differences(1)	-0.3	-0.3	-0.1	-0.1	-0.2	-0.2	-0.3	0.1
Current Nominal Return Assumption (Local Currency)	**6.0%**	**6.4%**	**6.0%**	**5.0%**	**6.1%**	**4.9%**	**7.0%**	**7.5%***

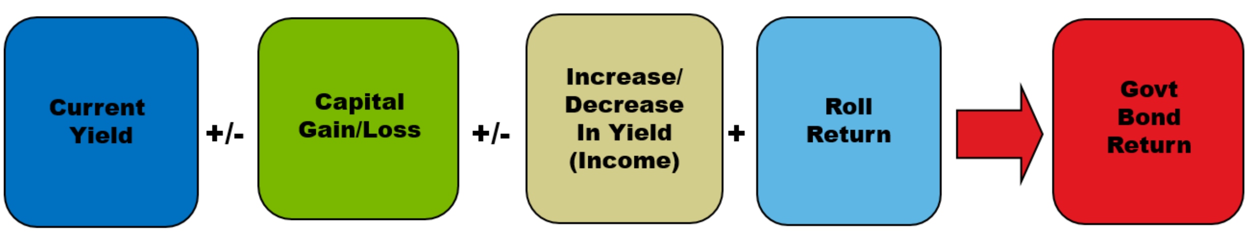
*EM in USD

(1) Model is a Discounted Cash Flow (DCF) model, not an additive building block model

(2) Represents Large Cap

Fixed Income Assumptions

The chart and table below provide a general overview of how government bond return assumptions are determined. The fixed income returns outlined in the previous response include additional fixed income asset classes beyond government bonds, and the formulation of the expected return of that portfolio includes the valuation of other bond components.



- We **start from the current yield curve** for government bonds
- Using a simulation model, we combine the current yield curve with an assumption on the long-term behaviour of the yield curve to **derive how yields are expected to evolve over time**
  - Dominant driver of government returns is what is priced into the yield curve
- **Total return assumptions** are then derived from the forward looking yield curves
- A similar methodology is followed for **inflation-linked bonds** but based on real yields and incorporating our inflation assumptions

Return Component	Q1 2020	
Initial Yield	1.8%	Prevailing market yield
Capital Gain/Loss	-0.1%	Projected yield increase results in projected capital losses. Long Duration bonds suffer larger losses than short
Increase/Decrease in Yield (Income)	0.2%	Projected yield increases leads to ability to reinvest at higher yields in future
Roll Return	0.2%	Roll return on rebalancing has a positive impact on the return assumption
Total 10-Year Return Assumption	**2.0%**	

Conclusion

THA and its consultant use volatility as a measure of risk, when purely discussing capital market assumptions. Other asset allocation work factors in other forms of risk (liquidity, funded ratio, factor risk, etc.).

THA's consultant employs various methodologies for determining the expected return of equities, bonds, and alternatives, incorporating both quantitative and qualitative inputs. Their assumptions reflect current market valuations and future prospects rather than relying solely on historic averages, a particularly important feature when markets move to extremes as they have done over the past few years. Additional detail on the calculation of the consultant's capital market assumptions is provided in the overview above. More detail is available if desired.

The consultant's capital market projections are developed by the firm's Global Asset Allocation team and represent the team's long–term capital market outlook (10 and 30 years). The output provided above represents 10-year assumptions.

- What mix of assets is necessary to achieve the plan's investment return and risk objectives?

Conclusion

Not applicable to THA given THA's role as an outsourced administrator. However, each Plan Sponsor selects an asset mix consistent with its own risk tolerance, given characteristics evaluated by the Plan Sponsor, including the plan's funded status, the Plan Sponsor's balance sheet and other metrics, including the results of the Operational Protocol for Asset Mix Options for Defined Benefit Plans in Fund A. The actuary then evaluates the asset mix chosen by the Plan Sponsor and determines a long-term investment return assumption based upon that asset mix and expectations of return for each component asset class.

- What consideration is given to active vs. passive management?

Background

The THA IPS document outlines that the Plan will implement the asset mix with a portfolio structure that may combine active and passive management in order to balance the objectives of enhanced return and cost control. Additionally, an education presentation was provided to THA with an in-depth review of active vs passive in May 2019. The presentation reviewed;

- The consultant's views on active management
- The evolution of the use of passive management over time
- Investment theory supporting the use of passive management
- Motivations for the use of active and passive investment by institutional investors
- The consultant's research on the success of active management
- The consultant's views on how to increase the probability of success in active management

From our discussions with the investment consultant, reviewing the education materials, and our review of the portfolio it is apparent that heavy consideration is given toward active vs passive investment management. The table below outlines the level of active vs passive utilized across the portfolio as of 9/30/2019. During our interview process we were made aware that the U.S. equity component of the Plan will be transitioning to a 100% passive position in the near future.

Total Plan	
Active	35%
Passive	65%
U.S. Equity	
Active	20%
Passive	80%
International Equity	
Active	100%
Passive	0%
Fixed Income	
Active	50%
Passive	50%

Conclusion

From our discussions with the investment consultant, our review of meeting materials (including the May 2019 education materials), and our review of the portfolio it is apparent that heavy consideration is given toward the active vs passive investment management decision.

- Are the investments reasonably diversified?

Background

The Plan invests in U.S. equity, non-U.S. equity, and investment grade bonds. Within each of these components the Plan is fairly diversified across the investable opportunity set. As shown in the table below.

	THA	Market
U.S. Equity	**100%**	**100%**
U.S. Large Cap Equity	78%	77%
U.S. Small Cap Equity	22%	23%
Non-U.S. Equity	**100%**	**100%**
Developed Non-U.S. Large Cap Equity	80%	63%
Developed Non-U.S. Small Cap Equity	7%	11%
Emerging Markets Equity	13%	25%
Fixed Income	**100%**	**100%**
Credit	35%	30%
Gov't	43%	41%
Other	20%	30%
Cash	1%	0%

As of 9/30/2019, the U.S. equity market represents ~55% of the investable global equity opportunity set. U.S. equity represented 87% of the Plan's equity exposure as of the same date. The table below compares the Plan's allocation across equities to the investable equity opportunity set (represented as the MSCI All Country World IMI Index).

	THA	Opportunity Set	Peers
U.S. Equity	73%	55%	65%
International Equity	13%	45%	35%

As shown, the Plan has a higher allocation to U.S. equity than the opportunity set and peers. Given the size of the Plan, we would typically expect it to be further diversified into alternative asset classes. However, based on the liquidity needs of the portfolio, alternatives (which are less liquid than traditional stocks and bonds) have been deemed outside the Plan's investable opportunity set. The Plan's bias towards U.S. equities has been additive to investment results over recent periods.

We believe the Plan could benefit from continued evaluation on how alternative investments could be utilized for diversification purposes but continue to meet the required liquidity needs of the Plan Sponsors. Additionally, we believe the Plan could benefit from continued consideration of further diversifying into developed and emerging international markets.

Conclusion

Yes, the investments are reasonably diversified given the liquidity requirements of the Plan. Most peer investment programs of the Plan's size have diversified into alternative investments. However, given the Plan's liquidity needs these investments have been deemed outside the Plan's investable opportunity set.

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

Conclusion

Given THA's role as an outsourced administrator of defined benefit plans, and the potential for Plan Sponsors to exit the Plan at any time, it has been determined that illiquid asset classes (alternatives) are not part of the investable opportunity set for this Plan currently. Questions related to the selection and valuation methodologies of alternative and illiquid assets are not applicable.

(D) F uture cash flow and liquidity needs;

- What are the plan's anticipated future cash flow and liquidity needs? Is this based on an open or closed group projection?

Conclusion

Anticipated future cash flow and liquidity needs vary across the various Plan Sponsors. This type of information is considered when selecting an appropriate asset mix. Given that the Plan currently invests in public equity and investment grade bonds, the portfolio is extremely liquid and shouldn't have difficulty producing the liquidity required by the underlying Plan Sponsors. Based on our review of the Operational Protocol for Asset Mix Options for Defined Benefit Plans in Fund A policy, it appears that open group projections are being considered when selecting an asset mix.

- When was the last time an asset-liability study was performed?

Background

Given THA's role as an outsourced administrator of defined benefit plans, performing an asset-liability study is not applicable. THA has created four asset mix options that can be utilized by participating Plan Sponsors. Plan Sponsors select from the four asset mixes based upon a recommendation provided by THA, the actuary, and the investment consultant (upon completion of each defined Plan

Sponsor's annual actuarial valuation). The appropriateness of the selected mix for each Plan Sponsor is evaluated on an annual basis.

The asset allocation of the offered investment mixes was last evaluated in the third quarter of 2019.

Conclusion

An asset allocation review of the offered asset mixes was performed in the third quarter of 2019.

- How are system-specific issues incorporated in the asset allocation process? What is the current funded status of the plan and what impact does it have? What changes should be considered when the plan is severely underfunded, approaching full funding, or in a surplus? How does the difference between expected short-term inflows (contributions, dividends, interest, etc.) and outflows (distributions and expenses) impact the allocation? How does the underlying nature of the liabilities impact the allocation (e.g. pay-based vs. flat $ benefit, automatic COLAs, DROP, etc.)?

Background

System-specific issues are incorporated in the asset allocation process during the selection of the appropriate asset mix, and not the development of the four offered mixes. Plan Sponsors may choose any of the asset mixes in any combination, based on the recommendation of THA, the actuary, and the investment consultant. THA reserves the right to decline to implement any asset mix request. The actuary and the investment consultant may consider the following items when developing their recommendations;

- Frozen or non-frozen status of the plan
    - Nature of such a freeze (e.g., frozen participation or frozen accruals)
- The plan's funding level on various measurement bases (e.g., FASB, GASB, and ERISA/PPA, as appropriate)
- ERISA coverage status
- Certain financial parameters as may be specified by the plan sponsor
    - Such as the level of annual contribution relative to overall plan sponsor cash flow and the relative magnitude of the plan's unfunded obligation as a percentage of the plan sponsor's total balance sheet

Conclusions

THA has structured the investment offering/mixes to allow flexibility to the Plan Sponsors to customize their respective portfolios to meet the specific needs and circumstances of their benefit programs. Additionally, THA's actuary and investment consultant are performing analysis to take these circumstances into account prior to THA providing an asset mix recommendation. If a Plan Sponsor desired additional analysis on their investment program it could be requested, or they could perform this analysis.

- What types of stress testing are incorporated in the process?

  Conclusion

  During the asset allocation review performed in December 2019, the Board was provided with forward looking return distributions. These distributions represented the range of potential outcomes ranging from the 5th to the 95th percentile, over various time periods. This type of analysis can serve in providing the Board with an understanding of the type of returns that can be expected in a stressed market environment. The asset allocation review did not include deterministic scenario analysis, or stress tests. However, we feel that the analysis included serves the same purpose for the Board.

Evaluation Component 3.

A review of the appropriateness of investment fees and commissions paid by the retirement system;

- Does the system have a written investment management fee policy?

  Conclusion

  THA does not have a written investment management fee policy. However, investment management fees are compared to peer universes and provided to the Board on a quarterly basis.

- What direct and indirect investment fees and commissions are paid by the system?

  Conclusion

  The Plan does not pay indirect compensation. Direct compensation includes fees paid for administration (general plan administration, custodian, actuary, investment consultant, legal, audit, insurance, etc.) as well as investment management fees paid to the underlying investment managers. The detail of these expenses is outlined in the Plan's financial reports, which are provided to the Board on a quarterly basis.

- How are the fees reported to the board?

  Conclusion

  Fees of the investment managers are reported to the Board on a quarterly basis in the performance report received from the investment consultant. The quarterly financial reports delivered to the Board outline administrative expenses in detail.

- Are all forms of manager compensation included in reported fees?

  Conclusion

  Yes, all forms of the Plan's manager compensation are outlined in the investment consultant report.

- How do these fees compare to peer group and industry averages for similar services? How are the fee benchmarks determined?

  Background

  Investment management fee levels are often highly correlated to the asset allocation and structure of an investment program. Investment programs with higher allocations to alternatives and active investment management will tend to have higher investment management fees. The THA plan does not invest in alternative asset classes and has significant exposure to passive investment management. Given the plan's asset allocation and investment structure, the fee level of the Plan is below that of peers.

On a quarterly basis, the Plan's investment consultant provides analysis which compares the investment expense of each investment mandate against that of a peer group. The Plan's commingled fund and separate account investments are compared to an eVestment Alliance universe based on analysis of investments of similar style and size. The mutual fund investments are compared to a Morningstar mutual fund universe based on investment style. Both universe groups are standard practice in the industry. The analysis, provided below, shows that six of the seven investment strategies maintained an investment expense below median.

	Vehicle[1]	Ticker	Fund Annual Fee	Separate Account/ Commingled Fund Median Annual Expense Ratio[2]	Mutual Fund Median Annual Expense Ratio[3]
U.S. Fixed Income					
PIMCO Total Return – Institutional	MF	PTTRX	0.46%	--	0.49%
State Street Barclays Aggregate Index NL Fund	CF	--	0.04%	0.05%	--
U.S. Equity					
BHM&S	SA	--	0.37%	0.51%	--
State Street S&P 500 Index NL Fund	CF	--	0.02%	0.04%	--
Vanguard Small Cap Index – Institutional Plus	MF	VSCIX	0.04%	--	0.23%
International Equity					
Dodge & Cox International Stock	MF	DODFX	0.63%	--	0.91%
Morgan Stanley	CF	--	0.74%	0.62%	--

1 CF = Commingled Fund, MF = Mutual Fund, and SA = Separate Account.
2 Source: eVestment Alliance; based on analysis of investments of similar style and size as of September 30, 2019.
3 Source: Aon Hewitt Investment Consulting analysis of Morningstar's mutual fund universe using data as of December 31, 2018.

Conclusion

The Plan's investment management fees compare favorably at the Plan level as well as by individual investment strategy. On a quarterly basis, the Plan's investment consultant provides analysis which compares the investment expense of each investment mandate against that of a peer group. The Plan's commingled fund and separate account investments are compared to an eVestment Alliance universe based on analysis of investments of similar style and size. The mutual fund investments are compared to a Morningstar mutual fund universe based on investment style. Both universe groups are standard practice in the industry.

- How often are the fees reviewed for reasonableness?

  Conclusion

  Investment management fees are reviewed for reasonableness on a quarterly basis. The financials of the Plan are also provided to the Board for review on a quarterly basis.

- Are there any fees not directly related to the management of the portfolio?

  Conclusion

  No, there are no fees not directly related to the management of the portfolio.

Evaluation Component 4.

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;

Background

The governance of the Plan is set forth in the IPS and more detailed in the January 1, 2003 Texas Hospital Association Master Trust for Member Hospital document. As explained above in Evaluation Component 1., the IPS outlines the roles and responsibilities of the investment decision making processes for the Trustees and investment managers. Through the Master Trust document, THA designated the Trustees (Successor Trustee Board) to act as trustee for the Master Trust and to fulfill the purposes of the Trust. The Master Trust document outlines plan administration, funding, investment of the trust, powers and fiduciary responsibility of the trustee, and delegation to investment managers. Investment-related policy statements are available upon request.

The Successor Trustee Board is currently composed of seven appointed members. The Trustees are senior executive officers from the plan sponsor and THA. The Nominating Committee of the THA Board is responsible for vetting and making recommendations to the THA Board of appointees. The THA Board acts upon the recommendations. Successor Trustees serve a two-year term, with no term limits and the ability to be reappointed.

Newly appointed Successor Trustees are given new trustee orientation, which covers fiduciary duties of loyalty, prudence, diversification, and adherence to plan documents. The training also details prohibited transactions, conflicts of interest, and the roles of staff, the actuary, plan administrator, record keeper, custodian, and legal counsel. Successor Trustees also complete mandatory continuing education requirements and associated filings.

The Successor Board meets on a quarterly basis. The Trustees receive meeting agendas and board materials in advance of the meetings. There are detailed minutes of each meeting which are approved at the next quarterly meeting. The assigned investment consultants from AHIC provide quarterly investment updates and legal counsel provides legal reports and fiduciary guidance to the Trustees. AHIC also regularly provides periodic investment education to the Trustees.

Conclusion

While the IPS and Master Trust Document generally outline the governance of the investment-decision making process, we recommend adoption of a Board Charter (or bylaws or comparable document) for the Successor Board. A charter defines the governance framework and is an importance governance tool that assists Trustees in performing their fiduciary duties. The use of a Board Charter is a recognized governance best practice and can assist the Plan in formally documenting its already demonstrated best practices of efficient and effective structure, meetings, and oversight of the Plan.

We understand legal counsel has drafted bylaws for consideration which will address this area. Generally recommended components to bylaws/charter include:

- Overview and Purpose
- Scope of the Board's Authority
- General Statement Regarding Authority Retained and Authority Delegated
- Board Composition
- Roles, Responsibilities, and Terms of the Trustees
- Trustee Orientation, Training, and On-going Training
- Resignations, Vacancies, and Removal
- Meeting Protocol, Voting, Attendance Requirements, Meeting Agenda Items
- Staffing
- Reporting Requirements
- Charter Review Frequency and Amendments

Evaluation Component 5.

A review of the retirement system 's investment manager selection and monitoring process.

- Who is responsible for selecting investment managers?

  Conclusion

  The Board's investment consultant produces recommendations for manager selection. The managers presented to the Board for review are all Buy rated by the investment consultant's investment manager research team. The Board then chooses among the Buy rated alternatives utilizing the materials provided by the consultant and the consultant's verbal advice.

- How are the managers identified as potential candidates?

  Background

  THA's investment consultant identifies investment managers that should be considered as potential candidates. The consultant uses a proprietary quantitative InForm model to analyze the broad opportunity set of strategies across each asset class.

  The InForm model uses a quantitative approach to score managers based on elements of the fundamental insight that they use in identifying managers for due diligence. There are seven factors that are part of the model, which are listed below. Each of these factors has several underlying subfactors and a score applied to each subfactor based on each subfactor's importance. The use of the various factors/subfactors, as well as the score applicable to each subfactor, is based on a combination of well-regarded academic research and the consultant's experience on the predictability of variables in determining the success of an investment strategy.

  – Business

  – Investment staff

  – Investment process

  – Investment risk

  – Performance

  – Terms and conditions

  – Operations

  This initial scoring process allows the research professionals to identify investment products that they believe have the strongest potential of ultimately obtaining a "Buy" rating after extensive due diligence and the rating process. In addition, the model drives creativity in portfolio design as it is able to identify strong and cutting edge, yet perhaps less well-known investment products for consideration and full vetting by staff.

The initial screening process helps identify a shortlist of products/strategies for comprehensive due diligence, which is the second stage of the research process. Products that meet predetermined scores based on the quantitative screens proceed through to comprehensive due diligence:

Manager Visits

The consultant actively meets and corresponds with the managers that they monitor. They conduct over 3,300 manager visits annually (*as of December 31, 2019*). They also hold special meetings and calls with managers when material developments occur at their organizations, such as when there is a change in ownership or when a key investment decision-maker on a client's portfolio departs the firm. In such instances, they conduct additional due diligence as needed and often will communicate findings to clients in the form of a memorandum or flash report.

Conclusion

Potential candidates are identified by the Board's investment consultant based on their standard diligence process outlined above.

- What are the selection criteria for including potential candidates?

Background

Based on our discussions with the investment consultant, an investment manager will be considered and recommended for inclusion in the Plan if it is Buy rated by the consultant's manager research team and it fits the desired role identified by the Board and the investment consultant.

To achieve a Buy rating, the consultant's due diligence focuses on the factors listed below, which ultimately obtain a score in order to develop a rating on a product/strategy.

- **Business**: Profitability, stability, and spread of ownership, client base, remuneration policy
- **Staff**: Quality, depth of resource, team dynamic, staff turnover
- **Investment Process**: Competitive advantage, repeatability, skill, implementation
- **Risk**: Embedded in process, independent verification, mix of measurements
- **Performance Analysis**: Consistent with stated process, risk adjusted, persistent
- **Terms and Conditions**: Client service, fees, ESG, best practices in documentation
- **Operational Due Diligence**: Operational controls, valuation of assets, independent directors, third-party vendors

Upon conclusion of the due diligence by the manager research team, each product is scored and rated through a formal voting process of senior research professionals. The voting process is intended to help foster a robust debate of issues related to a product/strategy among the senior investment professionals responsible for conducting manager research. The products are voted on by the individuals who conducted the due diligence on a strategy, in addition to three independent senior voters. If a rating conclusion cannot be agreed upon based on the research conducted, follow-up due diligence is carried out. Managers are rated a “Buy,” “Sell,” or “Qualified.” Each manager must pass an operational due diligence process to receive a “Buy” rating.

Overall Rating	What does this mean?
Buy	Recommend clients invest with or maintain their existing allocation to Buy-rated high conviction products
Buy (Closed)	Recommend clients invest with or maintain their existing allocation to Buy-rated high conviction products; however, it is closed to new investors
Qualified	A number of criteria have been met and we consider the investment manager to be qualified to manage client assets
Sell	Recommend termination of client investments in this product

Conclusion

Based on our discussions with the investment consultant, an investment manager will be considered and recommended for inclusion in the Plan if it is Buy rated by the consultant’s manager research team and the manager fits the desired role identified by the Board and the investment consultant. The process for rating investment managers is outlined in detail above.

- What are the selection criteria when deciding between multiple candidates?

Conclusion

Once the opportunity set of potential managers is reduced to a handful of fully diligenced Buy-rated investment strategies, the selection among multiple candidates is at the discretion of the Board based on it’s review of the consultant’s diligence reports, discussions with the consultant, and the Board’s own experience.

- How does the selection process address ethical considerations and potential conflicts of interest for both investment managers and board members?

Background

The Board’s investment consultant builds on the UN PRI Principles to form a view on the level of a manager’s Responsible Investment Approach for each investment strategy that it diligences. In doing so, it reviews the level of a manager’s Responsible Investment Approach in terms of:

- **ESG integration:** The level of integration of ESG risk factors which is evident in a manager's investment decision making processes
- **Active Ownership:** The level of active share ownership a manager can evidence alongside active proxy voting policies
- **Engagement:** The willingness of a manager to engage with underperforming companies with respect to ESG factors and the ability of a manager to progress these issues
- **Collaboration:** The extent of external collaboration a manager undertakes in order to work with the wider Responsible Investment community, furthering best practice and understanding

The ESG ratings are assessed on a 1-4 scale, with 1 being poor and 4 being best.

1. The Fund Management Team appears unaware or unconcerned with ESG risks in the investment strategy and has not taken any material steps to address ESG considerations in the portfolio.

2. The Fund Management Team is aware of potential ESG risks in the investment strategy and has taken some steps to identify, evaluate, and potentially mitigate these risks.

3. The Fund Management Team demonstrates an above average awareness of potential ESG risks in the investment strategy and has taken essential steps to identify, evaluate, and potentially mitigate these risks.

4. The Fund Management Team demonstrates high awareness of all known and potentially financially material ESG risks in the investment strategy and, at present, has incorporated appropriate processes to identify, evaluate, and potentially mitigate these risks across the entire portfolio.

Separate qualitative ESG Ratings (distinct from investment and ODD ratings) allow clients to consider a manager's Responsible Investment capability separately from other rating assessment criteria should they wish to do so.

Conclusion

The Board's investment consultant generates ESG scores to allow clients to consider a manager's Responsible Investment capability separately from other rating assessment criteria should they wish to do so.

- What is the process for monitoring individual and overall fund performance?

Conclusion

The Plan's investment consultant produces a performance report on a quarterly basis. The consultant attends the quarterly investment meetings and presents investment results to the Board. The report includes analysis of the Plan and the underlying investment managers relative to their appropriate benchmarks.

- Who is responsible for measuring the performance?

Conclusion

The Plan's investment consultant is responsible for measuring investment performance.

- What benchmarks are used to evaluate performance?

Conclusion

The table below outlines the total Plan benchmark as of 9/30/2019.

Total Fund Benchmark Components	Weight (9/30/2019)
Standard and Poor's 500 Stock Index	49%
CRSP U.S. Small Cap Index	15%
MSCI Europe, Australia, Far East (EAFE) Index	10%
Bloomberg Barclays Aggregate Bond Index	26%
Citigroup 3 Month T-Bill Index	1%

The Plan also has a secondary benchmark, which is to outperform the consumer price index + 5% over time. Additionally, each investment manager is benchmarked in the quarterly performance reports, and those benchmarks are outlined in the table below.

Manager Benchmarks
Standard and Poor's 500 Stock Index
Russell 1000 Value Index
CRSP U.S. Small Cap Index
MSCI Europe, Australia, Far East (EAFE) Index
Bloomberg Barclays Aggregate Bond Index

All of the benchmarks outlined above are included in the quarterly performance reports.

- What types of performance evaluation reports are provided to the board? Are they provided in a digestible format accessible to trustees with differing levels of investment knowledge/expertise?

Background

The Board receives a meeting packet which includes the various topics that will be discussed during a given meeting. The packet is provided as a PDF document for review. From our review, the packets typically include;

- Prior meeting minutes
- Investment reports from the investment consultant
- Financial\budget updates
- Actuarial reports
- Administrator report
- Legal updates

The investment report provided to the Board in 9/30/2019 was 13 pages of content (excluding appendices and blank pages). Within these pages, the consultant report reviews;

- Historical performance of the capital markets
- The asset allocation targets for the four offered asset mixes
- Financial reconciliation of the Plan over trailing periods (beginning market value, additions/withdrawals, investment earnings, and ending market value)
- Trailing investment results of the Plan (net of investment management fees) relative to the primary benchmark and the consumer price index + 5%
- Trailing investment results of the underlying investment managers (net of investment management fees) relative to their respective benchmarks
- Risk-adjusted investment results of the Plan relative to the benchmarks over a 5-year period
- Various risk statistics of the Plan and the benchmark over the trailing 5-year period
- Rolling standard deviation of the Plan and its benchmark
- Asset allocation of the Plan relative to the policy targets
- Investment management fees of each investment mandate relative to that of a peer group
- Fee schedules for each investment mandate and the aggregation to the total Plan fee

We found the reports provided to the Board to be detailed yet digestible for Board members of various levels of investment knowledge and expertise. Given the opportunity for further discussion and dialogue at the quarterly meetings, we find these reports to be appropriate in terms of meeting the Board’s needs.

Conclusion

The types of performance reports provided to the Board have been outlined above. We believe that the reports are appropriately formatted and presented to allow Trustees of all investment acumen and expertise to evaluate the investment success associated with the implementation of the investment policy. Given the complex nature of the topic, the additional opportunity to discuss the reports with the Board's investment consultant further alleviates any concern that the reports are overly complex.

- How frequently is performance reviewed?

Conclusion

Investment performance is reviewed on a quarterly basis.

- Are fees considered when reviewing investment performance?

Background

Investment management fees are considered in two ways when reviewing investment performance;

1. All investment results reported to the Board by the investment consultant are net of all investment management fees

2. Investment management fees are compared to peer median fees on a quarterly basis within the report delivered to the Board

By receiving investment results net of all investment management fees, the Board is ensuring that they are fully considering investment management fees when evaluating the success of implementing the investment policy. Additionally, evaluating the level of expense of each investment mandate relative to a peer universe on a quarterly basis ensures that the Board is aware and comfortable with the level of expense they are incurring to implement the investment policy.

Conclusion

Yes, fees are considered when reviewing investment performance.

- What is the process for determining when an investment manager should be replaced?

Background

The decision to terminate an investment manager is typically (but not always) the result of a termination recommendation coming from the Board's investment consultant. The primary considerations for the consultant recommending replacing a manager, in order of frequency are;

1. The departure of one or more key professionals
2. A material or adverse change in the management or ownership of the firm
3. A fundamental change in the investment philosophy or process
4. Poor investment performance

In cases in which a manager's performance is unsatisfactory, the consultant attempts to identify the factors that caused the poor results. This begins with internal analysis. The consultant may contact the manager and revisit the investment philosophy, process, and implementation. The consultant reviews the personnel and support services to assure that there have been no material changes. After the necessary analysis is conducted, the consultant may assign a "Sell" rating if deemed appropriate to do so.

The consultant believes an ultimate decision to retain or terminate a fund cannot be made by a formula. It is ultimately the consultant's confidence in the investment manager's ability to accomplish its stated objectives and the extent to which such objectives are consistent with the investment goals and philosophy of THA that will determine whether an investment manager/option will be recommended for retention or elimination.

Conclusion

The decision to terminate an investment manager is typically the result of a termination recommendation coming from the Board's investment consultant. Background on how the consultant reaches this recommendation is provided above. The primary considerations for the consultant recommending replacing a manager, in order of frequency are;

1. The departure of one or more key professionals
2. A material or adverse change in the management or ownership of the firm
3. A fundamental change in the investment philosophy or process
4. Poor investment performance

- How is individual performance evaluation integrated with other investment decisions such as asset allocation and investment risk decisions?

Conclusion

Individual performance evaluation is not typically integrated with other investment decisions. All asset allocation and investment risk decisions are typically the result of recommendations from the investment consultant. Asset allocation and risk recommendations made by the investment consultant are forward- looking. The historical investment performance of an investment manager is a factor in developing forward- looking expectations, but it is not an explicit component within the asset allocation or investment risk decision- making process.