

# RHI

## Port Arthur Firemen's Relief and Retirement Fund

**SB 322 System Evaluation**

**For the Period Ending December 31, 2019**

**Robert Harrell, Incorporated**

8310 Capital of Texas Highway, North

Suite 320

Austin, TX 78731

Ph 512-795-9100

Fax 512-795-0633

[www.harrell.com](http://www.harrell.com)

**Registered Investment Adviser**

Texas Senate Bill 322  
Public Pension Report

The Port Arthur Firemen’s Relief and Retirement Fund

**Disclosure by Independent Firm**

The evaluation should include the following disclosures by the independent firm:

- 1) a summary outlining the qualifications of the firm;

**Robert Harrell Incorporated (RHI) was founded in 1991 by Robert and Sandra Larsen Harrell as an independent, SEC-registered advisory firm serving the needs of institutions, including public and private defined-benefit plans. RHI, located in Austin, Texas, is a family-owned and operated, HUB-certified adviser that has earned a reputation for honesty, integrity, and superior risk-adjusted returns for 29 years.**

**We are registered with the Securities and Exchange Commission as an adviser and do not have any discretion over any of our public pension accounts.**

- 2) a statement indicating the nature of any existing relationship between the firm and the system being evaluated;

**RHI serves as the pension fund’s consultant.**

- 3) a list of the types of remuneration received by the firm from sources other than the retirement system for services provided to the system; and

**None**

- 4) a statement acknowledging that the firm, or its related entities, is not involved in directly or indirectly managing investments of the system.

**Robert Harrell Incorporated is NOT involved in directly or indirectly “managing” investments of the system.**

Components of Evaluation

This section provides suggested questions and topics for consideration under each of the five areas required to be covered in each evaluation.<sup>ii</sup> The questions below are intended to help systems identify the types of information an evaluation may include. Additionally, these questions may be helpful to systems that will use a request for proposal (RFP) to select a firm to perform the evaluation.

Each evaluation must include:

(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)?

**Yes**

- Are the roles and responsibilities of those involved in governance, investing, consulting, monitoring and custody clearly outlined?

**Yes**

- 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.]?)

**The current IPS does not take into account liabilities or liquidity needs.**

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

**Yes**

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

**Not entirely – there is no language regarding rebalancing or criteria for hiring/firing an external manager.**

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

**No**

- Is there evidence that the system is following its IPS? Is there evidence that the system is not following its IPS?

**There is evidence that the system has been adhering to the asset allocation in the IPS, though there is not manager termination language in the IPS.**

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

**The system practices semi-annual rebalancing and terminating managers when their trailing three-year risk adjusted peer group ranking falls below the 75<sup>th</sup> percentile, which is not a written investment policy and procedure.**

- Are stated investment objectives being met?

**Yes**

- Will the retirement fund be able to sustain a commitment to the policies under stress test scenarios, including those based on the capital markets that have actually been experienced over the past ten, twenty, or thirty years?

**Yes**

- Will the investment managers be able to maintain fidelity to the policy under the same scenarios?

**Yes**

- Will the policy achieve the stated investment objectives under the same scenarios?

**Yes**

- 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?

**The IPS is reviewed annually in the first quarter. The most recent substantial change was January 1, 2018 which updated the assumed rate of return and inflation after the latest actuarial study.**

*(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?

**Yes. The Board reviews the asset allocation study annually at the first quarter meeting.**

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

**N/A**

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

**The Board confers with the consulting firm on a quarterly basis and makes a decision.**

- How is the system's overall risk tolerance expressed and measured? What methodology is used to determine and evaluate the strategic asset allocation?

**Monte Carlo simulations are used to determine and evaluate the strategic asset allocation.**

- How often is the strategic asset allocation reviewed?

**Annually**

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

**Yes**

- 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?

**The actuarial expected rates of return are a major factor in determining the asset allocation.**

- Is the asset allocation approach used by the system based on a specific methodology? Is this methodology prudent, recognized as best practice, and consistently applied?

**Yes, the asset allocation is based on sound modern portfolio theory, which is prudent and consistently applied.**

- Does the system implement a tactical asset allocation? If so, what methodology is used to determine the tactical asset allocation? Who is responsible for making decisions regarding the tactical asset allocation?

**No**

- How does the asset allocation compare to peer systems?

**That is difficult to say. It is very traditional and has limited alternative exposure.**

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

- What are the strategic and tactical allocations?

**The strategic allocation is 65% equities and 35% bonds and cash.**

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

Asset Allocation Analysis					
Analysis Inputs					
Case: PAFRRF					
Analysis Inputs					
	Return	Forecast	Risk	Start	Date
Assets					End
Vanguard Total Stock	11.9%		15.3%	Oct 2008	Sep 2019
Vanguard Windsor	11.2%		16.8%	Oct 2008	Sep 2019
Vanguard PRIMECAP	13.1%		15.6%	Oct 2008	Sep 2019
Vanguard Total Inter	5.4%		13.8%	Dec 2010	Sep 2019
Vanguard Inter Gr	9.2%		19.4%	Oct 2008	Sep 2019
Vanguard Total Bond	4.3%		3.4%	Oct 2008	Sep 2019
Vanguard Int Term IG	6.1%		4.6%	Oct 2008	Sep 2019
Vanguard Short-Term	3.4%		2.1%	Oct 2008	Sep 2019
Vanguard Total In Bd	4.5%		2.7%	Jun 2013	Sep 2019
Vanguard Federal Mon	0.5%		0.2%	Oct 2008	Sep 2019
Natixis Loomis Sayle	13.2%		15.7%	Oct 2008	Sep 2019
Vanguard Large-Cap I	11.8%		14.9%	Oct 2008	Sep 2019
Vanguard Equity Inco	11.2%		13.7%	Oct 2008	Sep 2019
William Blair Small-	14.6%		17.2%	Oct 2008	Sep 2019
iShares Russell Mid-	12.2%		17.1%	Oct 2008	Sep 2019
MFS Mid Cap Value Fu	12.0%		16.7%	Oct 2008	Sep 2019
JPMorgan Small Cap G	14.5%		18.7%	Dec 2010	Sep 2019
Vanguard Russell 200	11.8%		16.2%	Oct 2010	Sep 2019
MFS New Discovery Va	11.8%		15.3%	Jun 2011	Sep 2019
T Rowe Price Institu	8.3%		22.6%	Oct 2008	Sep 2019
Invesco Real Estate	10.7%		21.8%	Oct 2008	Sep 2019
Frost Total Return B	5.9%		2.8%	Oct 2008	Sep 2019
PIMCO Income Fund;In	9.0%		4.4%	Oct 2008	Sep 2019
Lord Abbett Floating	5.2%		5.9%	Oct 2008	Sep 2019
BlackRock High Yield	8.9%		9.0%	Oct 2008	Sep 2019
JPMorgan Global Bond	4.9%		3.3%	Oct 2012	Sep 2019
Vanguard Internation	5.8%		18.0%	Oct 2008	Sep 2019
Vanguard Prime Money	0.6%		0.2%	Oct 2008	Sep 2019
Projection Inputs					
Target Return:	8.0%				
Time Horizon:	30 Years				
Initial Value:	49,000,000				

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

**The system uses trailing returns to October of 2008 to give them a better idea of how a given asset will behave over an entire economic cycle. They do not attempt to predict the future with capital market “assumptions”.**

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

**A 65% equities and 35% bonds and cash mix.**

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

**Both are considered for every manager search. All searches are performed on a completely agnostic basis and are net of fees.**

- Is the approach used by the system to formulate asset allocation strategies sound, consistent with best practices, and does it result in a well-diversified portfolio?

**The approach used by the system to formulate asset allocation strategies is sound and consistent with best practices.**

- How often are the strategic and tactical allocations reviewed?

**Annually at the first quarter meeting.**

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

- How are alternative and illiquid assets selected, measured and evaluated?

**They are evaluated first for their utility for the system and whether the specific investment is appropriate given the characteristics of the Fund and the Board.**

**They are then measured against the best fit (R2) benchmark available, which can be challenging depending on what type of alternative investment you are analyzing.**

- Are the system's alternative investments appropriate given its size and level of investment expertise? Does the IPS outline the specific types of alternative and illiquid investments allowed, as well as the maximum allocation allowable?

**Yes, the system's alternative allocation is appropriate, though allowable types and maximum allocations are not found in the IPS.**

- What valuation methodologies are used to measure alternative and illiquid assets? What alternative valuation methodologies exist and what makes the chosen method most appropriate?

**The system does not employ alternative or illiquid assets for our clients that require level 3 pricing or derivatives notional exposure calculations. Typically the System relies on the manager for private real estate valuations.**

*(D) future 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?

**All cash flow projections are based on an open group projection.**

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

**Every three years there is an actuarial study which includes asset growth projections with the growth in the projected liabilities given cash flow projections, DROPS, etc.**

- 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.)?

**The only system-specific issues incorporated in the asset allocation are the liquidity needs of the system and the funded ratio. The actuarial study has a much larger impact on the asset allocation.**

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

**The portfolio is stress-tested annually to get a sense of the potential worst-case scenarios (2 standard deviations from the LT mean).**

(3) a review of the **appropriateness of investment fees and commissions paid** by the retirement system;

- Do the system's policies describe the management and monitoring of direct and indirect compensation paid to investment managers and other service providers? What direct and indirect investment fees and commissions are paid by the system?

**The system's policies do not specifically describe how compensation to managers is monitored, though there are never any indirect fees paid to an investment manager, or consultant.**

- Who is responsible for monitoring and reporting fees to the board? Is this responsibility clearly defined in the system's investment policies?

**It is the responsibility of the consultant to present all fees to the Board on an annual basis.**

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

**Yes**

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

**All manager fees are with one standard deviation from the average.**

- Does the system have appropriate policies and procedures in place to account for and control investment expenses and other asset management fees?

**The Board keeps a very sharp eye on fees, but they are not specifically addressed in the IPS.**

- What other fees are incurred by the system that are not directly related to the management of the portfolio?

**Other fees include funding for travel for education, administrator, insurance.**

- How often are the fees reviewed for reasonableness?

**As they occur**

- Is an attorney reviewing any investment fee arrangements for alternative investments?

**When necessary**

(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;

#### Transparency

- Does the system have a written governance policy statement outlining the governance structure? Is it a stand-alone document or part of the IPS?

#### **TLFFRA Document & Government Code**

- Are all investment-related policy statements easily accessible by the plan members and the public (e.g. posted to system website)?

**Yes**

- How often are board meetings? What are the primary topics of discussion? How much time,

detail, and discussion are devoted to investment issues?

**The board meets monthly. The primary topics of discussion are the minutes from previous meetings, finances, benefit payments, expenses, etc. There is no set time for discussion.**

- Are meeting agendas and minutes available to the public? How detailed are the minutes?

**Yes. Action items are detailed to the extent of the motion made.**

#### Investment Knowledge/Expertise

- What are the backgrounds of the board members? Are there any investment-related educational requirements for board members?

**Per statute, there are 3 firefighters elected by the membership, the finance director, and the mayor. Citizen board members are selected by their willingness to serve and general knowledge.**

- What training is provided and/or required of new board members? How frequently are board members provided investment-related education?

**PRB has set guidelines for board education. Investment education is provided at conferences as well as quarterly, in-house, by our consultant.**

- What are the minimum ethics, governance, and investment education requirements? Have all board members satisfied these minimum requirements?

**Education requirements are set by PRB. Due to COVID-19 all conferences were cancelled for Spring 2020. There are board members that had registered for those conferences to meet the requirements. Those members will reschedule for upcoming educational opportunities.**

- Does the system apply adequate policies and/or procedures to help ensure that all board members understand their fiduciary responsibilities?

**Yes**

- What is the investment management model (i.e. internal vs. external investment managers)?

**External**

- Does the board receive impartial investment advice and guidance?

**Yes**

- How frequently is an RFP issued for investment consultant services?

**As needed**

#### Accountability

- How is the leadership of the board and committee(s), if any, selected?

**The Board elects its officers**

- Who is responsible for making decisions regarding investments, including manager selection and asset allocation? How is authority allocated between the full board, a portion of the board (e.g. an investment committee), and internal staff members and/or outside consultants? Does the IPS clearly outline this information? Is the board consistent in its use of this structure/delegation of authority?

**The full board in consultation with our adviser**

- Does the system have policies in place to review the effectiveness of its investment program,



including the roles of the board, internal staff and outside consultants?

**Not outside of the IPS.**

- Is the current governance structure striking a good balance between risk and efficiency?

**Yes**

- What controls are in place to ensure policies are being followed?

**The Chairman, Administrator and Consultant work together to ensure policies are being followed.**

- How is overall portfolio performance monitored by the board?

**Portfolio performance is monitored monthly by the administrator and through quarterly reports provided by the Consultant.**

- How often are the investment governance processes reviewed for continued appropriateness?

**Annually**

*(5) a review of the retirement system 's investment manager selection and monitoring process.*

- Who is responsible for selecting investment managers?

**The consultant, in coordination with the Board, is responsible for selecting investment managers.**

- How are the managers identified as potential candidates?

**A group of managers is first identified by their respective beta exposures (market beta, capitalization size, book-to-market, and momentum for domestic equity and market, term and quality for Fixed Income). The risk-adjusted Alpha is calculated for the group, and they are ranked. Other parameters are used to eliminate certain candidates, and a short list is compiled. For those managers deemed suitable for further examination, a questionnaire is submitted to the managers. Their quantifiable characteristics are debated or confirmed with the managers.**

**Many qualitative factors also go into an evaluation of an investment management organization. Major factors include the age of the firm, affiliates or parent companies, prior incarnations of the firm, ownership structure, and work history of the principals.**

**RHI evaluates risk management and controls inside the organization, such as technology dependence, disaster recovery plans, depth of research bench, amount of staff to support the portfolio manager, compensation structure, pedigree, location, office environment, age and quality of equipment/software, litigation, and background checks if warranted. We also consider the number of strategies and how competency and full attention can be allocated to multiple strategies (if applicable). Meeting with the finalist numerous times is usually preferable to make certain their story does not change.**

**From an historical performance perspective, the returns furnished by the manager are scrutinized by our analysts before any reports are generated. Many times, the qualitative aspects of a manager are seen in the data stream. For example, we have evaluated managers who purposely did not take their fee out of the first several years of the return stream to artificially inflate early-year returns. This type of deceptive behavior speaks to the qualitative character of the manager as well as having a direct impact on the reported net returns of the manager.**

**Once the questionnaire is completed to our satisfaction, an impact report is prepared. Using the**

prospective managers' own returns, we model those returns for the fund we are trying to replace to get a sense of the impact the new manager will make on the total equity portfolio. By weighting the beta exposures, we can more accurately determine the net effect of a new manager. If the impact of the new manager is positive, a recommendation is made and each of the finalists is presented to the Trustees for a final review and decision.

- What are the selection criteria for including potential candidates?

**Having met all the qualitative criteria, a candidate would need to be in the top quartile on a trailing three-year risk-adjusted basis net of fees in a narrow peer group.**

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

**All else being equal, name recognition and using an institutional mutual fund over an SMA if they are equal in all other ways are the selection criteria.**

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

**The adviser does not have any affiliation with any manager; therefore, there is never a conflict. We also do not have any Board members associated with a particular investment management company.**

- Who is responsible for developing and/or reviewing investment consultant and/or manager contracts?

**Members of the Board in coordination with their legal counsel.**

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

**It is a quarterly process which involves recasting peer groups and measuring relative risk-adjusted strength of each manager plus the equity and fixed income composite.**

- Who is responsible for measuring the performance?

**The consultant**

- What benchmarks are used to evaluate performance?

**Each manager has a specific benchmark hopefully with an R2 of .90 or above for fitness.**

- 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?

**Risk adjusted relative performance reports are provided to the Board in a very easy-to-digest way.**

- How frequently is net-of-fee and gross-of-fee investment manager performance reviewed? Is net-of-fee and gross-of-fee manager performance compared against benchmarks and/or peers?

**The consultant only reports performance net of fees. The Board can impute the annual cost out of the custom benchmark performance.**

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

**As important as how a manager is hired, many trustees want to know under what conditions a manager is terminated. In short, we begin to seriously consider terminating a manager when his/her alpha production on a relative basis has fallen below the 75th percentile rank (1st being the highest alpha rank) over the trailing three-year period. We are not suggesting that a plan wait three years to terminate a manager, only that the magnitude of the recent underperformance is best measured at the trailing three-year mark. A manager may stay on the**

**watch list when approaching this threshold. We will not recommend keeping a manager beyond this point because the statistical hole the manager is in becomes too great to overcome. Further, the steps a desperate manager will take intra-quarter to enhance his/her returns might not be what was authorized or mandated by the Plan.**

**We are happy to discuss this fully and why it serves historically as the best barometer for a manager's ability to recover from recent underperformance. Our willingness to conduct fresh manager searches when the time is right drives our superior equity composite performance. Our current and former clients are very happy with our work – they know we are always willing to do a search from scratch when needed.**

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

**Individual performance is evaluated on a quarterly basis, while asset allocation and risk decision are reviewed annually. This keeps the allocation steady and changes made after sufficient deliberation.**