Investment Practices and Performance Evaluation

of the

Dallas County Hospital District

Retirement Income Plan

April 15, 2020

Table of Contents

SECTION 1

Introduction: Methodology and Report Organization

Introduction: Anodos Advisors ("Anodos") has been engaged by the Dallas County Hospital District d/b/a Parkland Heath & Hospital System (the "District") to conduct the Investment Practices and Performance Review of the District's Defined Benefit Plan (the "Plan") called for by the Texas Government Code at Section 802.109.

Statutory Instructions: The Texas Government Code directs that each covered system is to select an independent party to *"…evaluate the appropriate, adequacy and effectiveness of the retirement system's investment practices and performance and to make recommendations for improving the retirement system's investment policies, procedures and practices."* The statute goes on to note specific areas to be included in this Investment Practices and Performance Report: (1) an analysis of the plan's investment policy[1], (2) the process for determining target allocations[2], (3) the expected risk and return of the portfolio and its asset classes[3], (4) the future cash flow and liquidity needs of the plan[4], (5) a review of investment fees[5], (6) board investment expertise and education[6], and (7) the selection, delegation and monitoring process for the investment managers who have been selected with particular emphasis on any alternative or illiquid managers[7].

Methodology - Policies and Procedures Inventory: Any evaluation of the Plan's governance activities must begin with an inventory of the policies and procedures the Board of Managers ("Board") have already adopted. Anodos has conducted such an inventory by requesting key governance documents such as the current Investment Policy Statement ("IPS"), Resolutions, performance reports produced by the Investment Consultant, Investment Committee meeting minutes, etc. After receiving these governance documents, the policies and procedures within them were evaluated in light of the central duties of care noted in Section 802.203, which establishes the fiduciary responsibilities of the Board.

Evidence of Compliance: After the inventory of key policies and procedures was completed, an investigation was conducted to confirm the Budget and Finance Committee's instructions have been followed by the Investment Committee, staff and Callan to whom administrative responsibilities have been delegated.

---

[1] §802.109(a)(1) – Regarding the duty to prudently administer the trust
[2] §802.109(a)(2)(a) – Regarding the duty to diversify the trust assets
[3] §802.109(a)(2)(b) – Regarding the duty to balance risk and return
[4] §802.109(a)(2)(d) – Regarding the duty to consider liquidity needs of the plan
[5] §802.109(a)(3) – Regarding the duty to incur only reasonable fees
[6] §802.109(a)(4) – Regarding the duty for trustees to be engaged
[7] §802.109(a)(5) – Regarding the duty to prudently select, delegate and monitor

Policy Types: The policies adopted by the Budget and Finance Committee can be broadly categorized into five types: (1) policies that affirm an existing duty of care codified in the Texas Government Code, (2) policies that define what is to be done, (3) policies that define who is responsible for particular administrative functions, (4) policies that define some consideration or process to be followed as the policy is fulfilled and (5) policies that define the frequency of a particular action or set of actions to be taken.

Procedures: Procedures are the series of steps that are taken to fulfill a policy. Rarely do the governance documents dictate *how* the policy is to be fulfilled. For example, a policy may call for the evaluation of the five-year net of fee return of the total Plan but does not define precisely *how* this return is to be calculated. For most policy statements the delegate is trusted to use their judgment, experience and competency to define the procedural steps needed to fulfill the policy. In some rare cases the policy specifically defines the factors that are to be considered (e.g., when to place an investment manager on the Watch List). However, this level of procedural direction is the exception rather than the rule.

Practices: The practices are the work product or evidence that interested parties can point to that demonstrates a particular policy has been fulfilled. In any instance where the governing body takes the time to document a policy that is to be followed, it is appropriate that some tangible evidence exists to demonstrate its fulfillment.

Report Organization: Section 2 of the report is the "Governance Map" which is organized by each fiduciary duty of care and identifies each of the policies included in the Plan's IPS dated February 2019, which is the Plan's sole policy document. Following the recitation of each policy are (1) the evidentiary source of the policy's fulfillment, (2) our findings, (3) our conclusions and where appropriate (4) recommendations we may have. Section 3 of the report summarizes the suggested improvements that we believe should be made to the Plan's governance process and IPS. Section 4 of the report is a response to each of the questions posed by the Pension Review Board.

Document Inventory: *Exhibit A* is the inventory of documents that were reviewed as part of this evaluation.

SECTION 2

Governance Map: Policies, Procedures and Practices

1. Duty of Loyalty

1.1. Investments will be made in the sole interest of the participants and beneficiaries of the Plan (IPS, p. 2 and reaffirmed on p. 11).

- **Source**: Not applicable
- **Finding:** This policy is a reaffirmation of the Duty of Loyalty found at TGC §802.203(a): In making and supervising investments of the reserve funds of a public retirement system…the governing body shall discharge its duties solely in the interest of the participants and beneficiaries.
- **Conclusion:** Not applicable

1.2. The Investment Committee shall be composed of members who are selected based upon their overall investment experience, including managing or supervising similar-sized investment portfolios (IPS, p. 3).

- **Source**: Curriculum vitae collected for each of the Investment Committee members.
- **Finding**: We find that the members of the Investment Committee have extensive experience in investment management, consulting and advisory services for investment portfolios of similar size and complexity as the Parkland Plan.
- **Conclusion**: The policy that the Investment Committee members possess the investment experience consistent with the Plan's size and complexity has been fulfilled.

1.3. All members of the Investment Committee, the Budget and Finance Committee, Parkland staff and the Investment Consultant shall agree to adhere, and shall adhere, to Parkland's conflict of interest policies (IPS, p. 6).

- **Source**: Annual Disclosure Statement by Board members dated November 2019

- **Finding 1:** We find that the System requires the Board members to make an annual affirmation that neither they nor their family members had any ownership interest in, or received benefits – in the form of royalties, compensation, sponsored travel arrangements, meal, et cetera - from any entity that conducts business with, seeks to conduct business with and/or competes with Parkland.

- **Finding 2**: We find no evidence that the members of the Investment Committee, Staff or the Investment consultant make a similar affirmation.

- **Conclusions**: The policy that the Board members affirm their adherence to Parkland's conflict of interest policy has been fulfilled. We do not find evidence that a similar affirmation by the members of the Investment Committee, Staff or the Investment Consultant have made a similar affirmation.

2. Duty of Prudent Administration

2.1. The Investment Committee shall suggest investment goals and objectives for the Plan (IPS, p. 3).

- **Source**: Investment Policy Statement, p. 2

- **Finding**: "The objectives for the Plan are (1) to ensure an adequate pool of assets to support the benefit obligations to participants, retirees and beneficiaries; (2) obtain a reasonable rate of return consistent with a prudent level of portfolio risk, while controlling costs incurred in administering and managing the assets; and (3) improvement in the Plan's funded status, providing improved benefit certainty and benefit levels for employees participating in the Plan and the opportunity to reduce employer contributions to the Plan."

- **Conclusion**: The policy to establish objectives for the Plan has been fulfilled.

2.2. The Investment Consultant shall assist the Investment Committee, the Budget and Finance Committee and Parkland staff with the review of capital markets (IPS, p. 4).

- **Source**: Investment Committee Minutes from 8/26/2019, p. 1

- **Finding**: We find that each quarter the Investment Consultant presents a report and review of the current capital markets. Specifically, the minutes from the Investment Committee record, "The group discussed economic and market conditions..."

- **Conclusion**: The policy to regularly review the capital markets has been fulfilled.

2.3. Parkland staff shall advise the Investment Committee and the Budget and Finance Committee regarding Parkland staff's opinions regarding the performance of the Investment Consultant and the Investment Managers (IPS, p. 5).

- **Source**: Staff response to Secondary Document Request dated 2/28/2020, p. 2

- **Finding**: "That part [of the IPS] should be revised to reflect the roles of the consultant and committee members taking priority over the staff's in evaluating the asset managers. Staff does provide input regarding the investment consultants though the Investment Committee members are quite capable of judging for themselves."

- **Conclusion 1**: Based on staff's input provided on 2/28/2020, the IPS should be modified to subordinate the staff's opinion regarding the performance of the Investment Managers to that of the Investment Consultant and the Investment Committee who are arguably better qualified to opine on this issue.

- **Conclusion 2**: Based on staff's input provided on 2/28/2020, the IPS should be modified to subordinate the staff's opinion regarding the performance of the Investment Consultant to that of the Investment Committee who is arguably better qualified to opine on this issue.

- **Recommendation 1**: We recommend establishing the (1) responsible party, (2) frequency, and (3) format of the staff's evaluation of the Investment Consultant and Investment Managers. (The format may be a simple statement in the minutes noting a review of the Investment Consultant's and Investment Managers' performance.)

- **Recommendation 2**: We recommend that a policy be established which establishes the frequency that an open and competitive search of investment consultant will be conducted.[8]

2.4. The Investment Consultant shall present to the Investment Committee, Budget and Finance Committee and Parkland staff any recommended changes to this Policy (IPS, p. 4).

- **Source**: Callan Investment Policy "Redline" dated 8/28/2019

- **Declaration**: "The [investment] committee reviews the IPS no less than once a year" (Staff response to Secondary Document Request dated 2/28/2020, p. 2).

- **Finding**: Staff provided Callan's IPS "Redline" and the recommended updates that Callan felt were important to bring to the Investment Committee's attention. Evidence of the Budget and Finance Committee's adoption of the suggested amendments will be found in the April 2020 minutes when that item is taken up.

- **Conclusion**: The policy that the Investment Consultant offer recommended changes to the IPS has been fulfilled.

2.5. Parkland staff shall provide recommendations to the Investment Committee and the Budget and Finance Committee regarding potential revisions to this Policy on at least an annual basis (IPS, p. 5).

- **Recommendation 1**: We recommend that this policy be removed because it is duplicative with the Investment Consultant's responsibility to do the same work. We are not seeking to exclude staff from the IPS revision process, but rather identify the best qualified, responsible party to initiate this work each year.

- **Recommendation 2**: If this policy is removed, we recommend that the frequency of the Investment Consultant's suggested amendments and the Committee's adoption of those amendments occur annually. (This is the only place the frequency of the IPS review is noted.)

[8] A formal and competitive process was used when Callan was hired in 2013. A secondary competitive process was also followed in 2018 when Callan's contract was renewed for an additional five years.

3. <u>Duty to Establish Return Objectives</u>

3.1. The Budget and Finance Committee determined… that the Plan's desired investment objective has a strong probability of being achieved with an acceptable level of risk if the Plan invests in the Asset Classes as described on the following page (IPS, p. 9).

- **Source**: Funding Policy Resolution dated 11/20/2019, p. 3

- **Finding**: A return objective for the plan has been established. That objective is 7.00% for the plan year beginning January 1, 2019, declining by 0.25% per year until it reaches 6.5% on January 1, 2021.

- **Conclusion**: The policy that a return objective be established for the Plan has been fulfilled.

3.2. The aggregate of the Plan's assets will be managed with the goal of achieving an annualized rate of return, as measured by rolling five-year periods, that <u>meets the actuarial assumed return</u> as determined by the Plan's actuary (IPS, p. 16).

- **Source**: Callan Summary Performance Report dated Q4 2019, p. 16

- **Finding 1**: For the five years between January 1, 2015 and December 31, 2019, the Plan's gross of fee return was 6.95% which nearly matches the 7.0% actuarial return target. (The net of fee return for the Plan trailed the actuarial return target by 0.37%.)

- **Finding 2**: The five-year, net of fee return for the plan is presented quarterly to the Investment Committee and staff. However, the *rolling five-year* return is not presented.

- **Conclusion**: The policy that the Plan's actual return be compared to the actuarial assumed target has been fulfilled, though there is not comparison to rolling five-year periods.

- **Recommendation:** We recommend that either the performance report include a rolling five-year return over a defined period, or this requirement be removed from the IPS noting there are already multiple return periods presented.[9]

3.3. The aggregate of the Plan's assets will be managed with the goal of achieving an annualized rate of return, as measured by rolling five-year periods, that outperforms a hypothetical portfolio composed of indices weighted according to the target allocation (IPS, p. 16).

- **Source**: Callan Summary Performance Report dated Q4 2019, p. 16
- **Finding 1**: For the five years between January 1, 2015 and December 31, 2019, the Plan's gross of fee return was 6.95%, which is slightly higher than the 6.58% Policy Index.
- **Finding 2**: The five-year, net of fee return for the plan is presented quarterly to the Investment Committee and staff. However, the *rolling five-year* return is not presented.
- **Conclusion**: The policy that the Plan's actual return be compared to the Policy Index has been fulfilled, though there is not comparison to rolling five-year periods.
- **Recommendation**: We recommend that either the performance report include a rolling five-year return over a defined period, or this requirement be removed from the IPS noting there are already multiple return periods presented (see Footnote #9).

3.4. The return on the aggregate of the Plan's assets will be compared to a weighted average composite of a universe of other public retirement income plans (IPS, p. 16).

- **Source**: Callan Summary Performance Report dated Q4 2019, p. 16
- **Finding**: For the 5 years between January 1, 2015 and December 31, 2019, the Plan's gross of fee performance was 6.95% which is slightly lower than the median performance for the public fund database which was 7.11% during the same period. Seven-year and Ten-year data comparing the Plan vs. the public funds database is also provided.

[9] Rolling periods do not aid in the performance evaluation of an asset class or manager when comparative benchmarks or peer groups are available and multiple performance period exist (1-yr, 3-yr, 5-yr, since inception).

- **Conclusion**: The policy that the Plan's five-year performance be compared to the public fund peer group has been fulfilled.

4. Duty re Risk Expectations

4.1. Investments will be made... in accordance with the following objectives: Obtain a reasonable rate of return consistent with a <u>prudent level of portfolio risk</u> (IPS, p. 2).

- **Source**: Not applicable

- **Finding:** This policy is a reaffirmation of the Duty to Establish Risk Expectations found at TGC §802.203(a)(3): "The governing body shall discharge its duties… to minimize the risk of large losses …" It is also a reaffirmation of the Duty of Prudence found at TGC §802.203(a)(2): "The governing body shall discharge its duty… with the care, skill, prudence and diligence under the prevailing circumstances that a prudent person acting in a like capacity and familiar with matters of the type would use in the conduct of an enterprise with a like character and like aims."

- **Conclusion:** Not applicable

4.2. The aggregate of the Plan's assets will be managed with the goal of achieving… over a rolling five-year period: Comparable volatility of returns, <u>as measured by the standard deviation of quarterly returns of the benchmark index</u> (IPS, p. 16).

- **Source**: Callan Full Performance Report dated Q4 2019, p. 22 (PHHS vs. Policy Index)

- **Finding**: The Plan's 10-year standard deviation is reported as approximately 8.10%, and the standard deviation of the Policy Index over the same period is reported to be 7.88%. However, the *rolling five-year* standard deviation is not presented.

- **Conclusion**: The policy that the Plan's volatility, as measured by standard deviation, be compared to the benchmark index has been fulfilled, though there is not comparison using rolling five-year periods.

- **Recommendation 1**: We recommend that either the performance report include a rolling five-year standard deviation, or this requirement be removed from the IPS noting there are already multiple return periods presented (see Footnote 9).

- **Recommendation 2**: The graph representing the 10-year standard deviation makes it hard to know precisely what the return and standard deviation for the Plan and the Policy Index were during the measurement period. We recommend that the five-year standard deviation be represented numerically rather than graphically.

5. Duty to Consider Liquidity Needs

- The asset structure is to reflect a proper balance of the Plan's need for liquidity, total return and the risk tolerance established (IPS, p. 9).

    - **Source**: Callan 2017 Asset Allocation and Liability Study dated 9/19/2017, p. 18

    - **Finding**: We find that the governing body has conducted an asset-liability study which projects the future cash flow from the plan through 2027. The conclusion of that study is, “The plan is slightly cash flow positive over the next decade, excluding the impact of investment earnings.” Additionally, “The cash flow profile can support a higher allocation to illiquid investments.”

    - **Conclusion**: The policy to consider the Plan’s need for liquidity when setting the asset allocation has been fulfilled.

    - **Recommendation**: We recommend defining the maximum allocation of the Plan that may be invested in illiquid assets. This policy would include (1) a statement affirming an expectation that an illiquidity premium exists, (2) the maximum allocation of illiquid assets that will be allowed in the Plan and (3) how illiquidity will be defined and measured. (This recommendation is particularly important if the Plan is to consider the addition of Private Equity to the portfolio as Investment Committee minutes suggest.)

- Investment Managers will be notified if an unusually large liquidity need is anticipated (IPS, p. 10).

    - **Source**: During the audit period, no unusually large liquidity needs were found.

- **Findings**: Not applicable
- **Conclusion**: Not applicable
- **Recommendation**: We recommend the policy identify the party responsible for its implementation and an explanation of how "unusually large liquidity needs" is defined and tracked.

* Domestic equities shall be restricted to <u>readily marketable securities</u> of companies that are actively traded on major U.S. exchanges (IPS, p. 12).

    - **Source**: BNY Mellon Consolidated DB Statement dated 12/31/2019
    - **Finding 1**: We find that the BNY Large Cap US common collective trust holds exclusively readily marketable securities.
    - **Finding 2**: We find that the LSV US SMID Value SMA and the Wells Fargo SMID Growth SMA hold exclusively marketable securities that have a consistent pricing mechanism to allow for the monitoring of risk, return and market value of these assets.
    - **Conclusion**: The policy that the assets within the US Domestic composite be readily marketable securities has been fulfilled.
    - **Observation 1**: We expect that the rationale for requiring "readily marketable securities" for the Domestic Equities asset class was adopted to ensure that a consistent pricing mechanism existed so that other policies related to the tracking of investment managers' risk, return and market values could be followed. Alternatively, it is possible that the "readily marketable securities" requirement for Domestic Equities could have also – or alternatively – been adopted to ensure that this asset class met an unstated liquidity preference by the governing body.
    - **Observation 2**: This policy *only applies* to the separately managed accounts ("SMAs") within the Domestic Equities asset class, which are currently the LSV US SMID Value SMA and the Wells Fargo SMID Growth SMA. (On page 11 of the IPS, the governing body notes, "Where institutional mutual or commingled funds (including index funds) are used, it is expected that the investments *generally conform* to these guidelines described below, though

the Budget and Finance Committee recognizes that the prospectus or guidelines of the fund supersede those of the Plan.")

- **Recommendation 1:** Given the ambiguity of this policy, we recommend that the Investment Committee clarify whether the policy relates to a liquidity preference, consistent pricing data, or both.

- **Recommendation 2**: We recommend that the Investment Committee articulate whether the policy restriction found in this section applies *only* to managers with the SMA format or to *all* managers, irrespective of format.

- Futures and options can be used as a substitute for equity securities provided that they are 100% collateralized by highly liquid, low volatility fixed income securities and therefore do not represent leveraging of the assets (IPS, p. 12).

  - **Source**: BNY Mellon Consolidated DB Statement dated 12/31/2019

  - **Finding:** We find that no futures or options were being used as a substitute for equity securities according to the BNY Mellon Consolidated Statement.

  - **Conclusion:** The policy that futures and options used as a proxy for equity securities be collateralized by highly liquid, low volatility fixed income securities has no observable examples. As such, we conclude the policy is being complied with.

- At least 65% of all non-U.S. equity holdings shall be highly liquid securities issued by companies headquartered in countries included in the MSCI All Country World ex-U.S. Index (IPS, p. 12).

  - **Source**: BNY Mellon Consolidated DB Statement dated 12/31/2019

  - **Finding 1**: We find that within the Non-U.S. Equities asset class, two of the five managers - MFS International and Dodge & Cox Intl Stock - are held as mutual funds and are, per SEC regulation, highly liquid and have "T+1" settlement. These two mutual funds represent approximately 63% of the Non-U.S. Equities asset class ($189m of $297m).

  - **Finding 2**: Based on the position detail dated 12/31/2019, we find that the securities held within the Mondrian International Small Cap common collective trust are highly liquid. This trust represents approximately 18.5% of the Non-U.S. Equities asset class ($55m of $297m).

- **Finding 3**: We find that although the Genesis Emerging Markets closed-end fund (LSE: GSS) is a liquid security, the average monthly trading volume is significantly lower than the Plan's position in this fund. We do not expect that liquidating these assets could be done without a meaningful discount to the Plan's NAV for this security. As such, we conclude for practical purposes that the position is illiquid.

- **Conclusion**: The policy for at least 65% of all non-U.S. equity holdings to be in highly liquid securities has been fulfilled. However, we do not know if 65% of the non-U.S. equity holdings are represented within the MSCI ACWI ex US Index.

- **Recommendation 1**: We recommend that the policy that 65% of the non-U.S. equity holdings be highly liquid and represented within the MSCI ACWI ex US Index be included in the Individual Manager Guidelines, and that the party responsible and frequency for monitoring this policy be identified.

- **Recommendation 2**: We recommend that "highly liquid" be defined. Perhaps, the definition of "highly liquid" in this case is inclusion within the MSCI ACWI ex US Index.

- Fixed income investments shall be <u>marketable securities</u> (IPS, p. 12).

  - **Source**: Individual Manager Guidelines (IPS pp. 22-25)

  - **Finding**: The policy that fixed income securities shall be marketable securities is not noted in the Individual Manager Guidelines.

  - **Conclusion**: We cannot find any evidence from the investment managers or reports or data available to the Board that this policy is being followed. Nor do we find any evidence that it is *not* being followed. In short, we cannot demonstrate compliance with this policy.

  - **Recommendation**: We recommend that the policy be included in the Individual Manager Guidelines and that managers reaffirm their respective Guidelines annually.

- Foreign currency fixed income holdings are restricted to issuers in countries represented in the <u>Citigroup World Government Non-U.S. Bond Index</u> (IPS, p. 12).

- **Source**: Individual Manager Guidelines for Stone Harbor Investment Partners (IPS, p.22)

- **Finding**: The Individual Manager Guidelines for Stone Harbor – the only non-U.S. bond manager – expressly authorizes the inclusion of emerging markets debt.

- **Observation**: Though we were unable to find record of a Citigroup World Government *Non-U.S.* Bond Index, there is a Citi World Government Bond Index that was rebranded to the FTSE World Government Bond Index (WGBI) in July 2018 after being acquired by the London Stock Exchange Group.[10] The unintended effect of this policy is to *exclude* emerging market debt securities from foreign currency fixed income holdings.

- **Conclusion**: The policy that fixed income holdings are restricted to issuers in countries represented in the now rebranded FTSE World Government Bond Index is inconsistent with the expressed instructions to the Stone Harbor Investment Partners individual manager guidelines.

- **Recommendation**: We recommend that the Investment Committee reconcile these competing instructions. We suggest that the most expeditious solution is to remove the policy restriction noted on page 12 of the IPS.

- On a quarterly basis, the Investment Managers shall review their investments for compliance with the investment guidelines in Section IV of the IPS (IPS, p. 11).

    - **Source**: Individual Manager Guidelines

    - **Finding**: We find that the investment guidelines established in Section IV of the IPS are not duplicated in the Individual Manager Guidelines. The managers only benefit from the instructions in their respective Individual Manager Guidelines. The policies that are written in Section IV that are not included in the Individual Manager Guidelines follow: (1) marketable requirement for Domestic Equity; (2) liquidity requirements for Non-U.S. equities, (3) marketability requirement for fixed income investments, and (4) prohibition of use of emerging market debt.

[10] Though we were unable to find record of a Citigroup World Government Non-U.S. Bond Index, there is a Citi World Government Bond Index that was rebranded to the FTSE World Government Bond Index (WGBI) in July 2018 after being acquired by the London Stock Exchange Group. The purchase of the Citi indexes is noted at the following websites: https://www.yieldbook.com/f/m/pdf/Rebranding_Details_of_Citi_Fixed_Income_Indexes.pdf and https://www.ftserussell.com/announcement-yield-book-citi-fixed-income-acquisition.

- **Conclusion**: The policy that that Investment Managers are to confirm their investments for compliance with the investment guidelines noted in Section IV of the IPS is not being followed.

- **Recommendation**: If it is important to the Budget and Finance Committee to have the guidelines in Section IV of the IPS followed, the managers must be notified of such.

6. Duty to Diversify: Generally

6.1. Asset allocation targets shall be established by the Budget and Finance Committee to achieve the total return objectives of the Plan within acceptable risk levels, as considered on a prospective basis (IPS, p. 9 and reaffirmed on pp. 11 and 16).

- **Source**: Not applicable

- **Finding:** This policy is a reaffirmation of the Duty to Diversify found at TGC §802.203(a)(3): “The governing body shall discharge its duties… by diversifying the investment of the system to minimize the risk of large losses…”

- **Conclusion:** Not applicable

6.2. The Investment Committee and the Investment Consultant will monitor the asset allocation on a quarterly basis at a minimum (IPS, p. 11).

- **Source 1**: Callan Summary Performance Report dated Q4 2019

- **Source 2**: Investment Committee Minutes from August 2019

- **Finding**: On a quarterly basis Callan provides to the Investment Committee and staff a performance report which includes overall asset allocation for the Plan.

- **Conclusion**: The policy that the Plan’s asset allocation be monitored on a quarterly basis has been fulfilled.

6.3. The asset allocation strategy will be reviewed at least annually (IPS, p. 9).

- **Source**: Callan Defined Benefit Plan Asset Allocation Review dated February 2020

- **Finding**: On an annual basis Callan produces for the Investment Committee and staff an evaluation of the current asset allocation which includes any suggested modifications to the targeted allocation.

- **Conclusion**: The policy to review the Plan's asset allocation at least annually has been fulfilled.

7. Duty to Diversify: Allocation Parameters/Constraints

7.1. The Investment Consultant shall monitor the total investment portfolio for unintended risk associated with over-allocation to certain securities within asset classes, sectors, or geography that may overlap (IPS, p. 5).

- **Source 1 re Security Concentration**: Callan Full Performance Report dated Q4 2019, p. 38

- **Source 2 re Sector Concentration**: Callan Full Performance Report dated Q4 2019, p. 37 (Domestic Equity Composite, for example)

- **Source 3 re Geographic Concentration**: Callan Full Performance Report dated Q4 2019, p. 61 (International Equity Composite, for example)

- **Finding**: On a quarterly basis Callan produces for the Investment Committee and staff reports that monitor the current concentration of the Plan assets by security, sector and geographic allocation.

- **Conclusion**: The policy to monitor the total investment portfolio for excessive concentration by security, sector and geography has been fulfilled.

7.2. Not more than 5% of the total stock portfolio valued at market may be invested in the common stock of any one corporation (IPS, p. 15).

- **Source**: Callan Full Performance Report dated Q4 2019, p. 38

- **Finding**: We find that the largest equity positions at year-end 2019 were Apple with a ~$14.4m allocation and Microsoft a ~$14.1m allocation of the total ~$719m equity portfolio, each representing less than 2.0% of the total stock portfolio.

- **Conclusion**: The policy that no individual security should represent more than 5.0% of the total stock portfolio has been fulfilled.

7.3. Not more than 25% of the total stock portfolio valued at market may be held in any one sector as defined by the Plan's Investment Consultant (IPS, p. 15).

- **Source**: Callan Full Performance Report dated Q4 2019, p. 33 (Domestic Equity Composite) and p. 61 (International Equity Composite)

- **Finding**: We find that the Callan report does not distinctly report on the sector weighting of the *total stock portfolio*, but instead reports on the sector allocation of each of the seven investment managers within the total stock portfolio. This reporting sufficiently confirms that no sector represents more than 25% (~$179m) of the total stock portfolio.

- **Conclusion**: The policy that no individual sector may represent more than 25.0% of the total stock portfolio has been fulfilled.

7.4. Within the Small/Mid Cap Domestic Equity Asset Classes, funds will be divided between growth and value style Investment Managers (IPS, p. 10).

- **Source**: Callan Summary Report dated Q4 2019, p. 20

- **Finding**: We find that the Small/Mid Cap Domestic Equity asset classes are divided almost equally between growth and value.

- **Conclusion**: The policy to divide Small/Mid Cap Domestic Equity asset classes between growth and value has been fulfilled.

7.5. No more than 5% of the fixed income portfolio, at time of purchase, may be invested in issuances of any one company or entity, except for government or agency issues (IPS, p. 13).

- **Source**: BKD Financial Report dated July 31, 2019, p. 14

- **Finding**: The BKD report notes, "As of December 31, 2018 and 2017, the Plan did not hold more than 5% of assets in any single issuer other than mutual funds, collective trusts, U.S. Government obligations, or obligations of U.S. Government chartered entities."

- **Conclusion**: The policy that no individual security may represent more than 5.0% of the total fixed income portfolio has been fulfilled.

7.6. The average effective duration of each fixed income portfolio, reflecting all instruments including CMO and Asset-Backed Securities, should not exceed 150% of the BC Aggregate Bond Index duration (IPS, p. 13).

- **Source**: Callan Full Performance Report dated Q4 2019, p. 98

- **Finding**: We find that the composite duration of the fixed income asset class is 5.68 years. The duration of the BC Aggregate Bond Index is 5.87 years.

- **Conclusion**: The policy that the duration of each fixed income portfolio not exceed 150% of the BC Aggregate Bond Index has been fulfilled.

- **Recommendation 1**: We recommend that all Investment Manager Guidelines for fixed income managers include a duration mandate.

- **Recommendation 2**: We recommend the duration for the BC Aggregate Bond Index be noted in the quarterly performance report.

7.7. The weighted average credit quality of the portfolio will not fall below BBB- or equivalent (IPS, p. 13).

- **Source**: Callan Summary Report dated Q4 2019, p. 35

- **Finding 1**: We find that the average credit quality of the Fixed Income Composite is A+.

- **Finding 2**: We find that the Individual Manager Guidelines for each fixed income manager forces compliance with this policy. The manager guideline for Income Research & Management directs, "The weighted-average quality of the portfolio shall be maintained at a minimum quality of AA- at all times." The manager guideline for Stone Harbor Core Plus directs, "A minimum of 50% of the portfolio will be invested in Investment Grade Fixed Income at any given time."

- **Conclusion**: The policy that the average credit quality of the fixed income portfolio be in excess of BBB- has been fulfilled.

7.8. Cash equivalent reserves shall consist of cash instruments having a quality rating by at least one rating agency of A-1, P-1 or higher with a maturity of 360 days or less (IPS, p. 14).

- **Source**: BNY Mellon Temporary Investment Fund Audited Financials, p. 12

- **Finding 1**: We find that the maximum maturity of 360 days required by the policy is less restrictive than the BNY Mellon fund's maximum allowed average maturity of 60 days.

- **Finding 2**: We find that the minimum rating required by the policy (A-1 or P-1) is less restrictive than the rating constraints of the BNY Mellon Temporary Investment Fund.

- **Conclusion**: The policy regarding maximum maturity and minimum credit quality of the cash instruments has been fulfilled.

- **Recommendation**: We suggest that the IPS be modified to specify that the maximum maturity is an *average* of the cash equivalent portfolio in total rather than the maturity of any particular issue within the cash equivalent portfolio. The prospectus for the BNY Mellon Temporary Investment Fund notes that "securities may have maturities that exceed 397 days" but that the "average maturity [of the fund] will be 60 days and the funds maximum weighted average life will be 120 days".

7.9. Exposure of the total Plan assets to cash equivalents on average should not exceed 5% of the total Plan's value on a market value basis (IPS, p. 10).

- **Source**: Callan Summary Report dated Q4 2019, p. 5

- **Finding**: We find that the total cash allocation at year-end 2019 for the Plan was 0.6%.

- **Conclusion**: The policy that cash allocation of the Plan may not exceed 5.0% has been fulfilled.

7.10. The Private Real Estate Asset Class should be broadly diversified, investing primarily in completed, income-producing properties with strong cash flows that are expected to increase over time, providing potential for capital appreciation (IPS, p. 14).

- **Source**: Heitman 2018 Annual Report and JPMCB 2018 Annual Report
- **Finding**: We find that both the Heitman fund and JPM Strategic Property Fund invest primarily in completed income-producing properties with strong cash flows that are expected to produce long term increased income and appreciation.
- **Conclusion**: The policy that the Private Real Estate Asset Class be invested in completed, income-producing properties has been fulfilled.

7.11. The Private Real Estate Asset Class should also be diversified by property types with investments in major property types including office, residential, retail, industrial, hotel and self-storage properties and/or by the various geographic regions of the country (IPS, p. 14).

- **Source**: Heitman 2018 Annual Report and JPMCB 2018 Annual Report
- **Finding**: We find that both the Heitman fund and JPM Strategic Property Fund are broadly diversified by property type (office, industrial, residential, retail, and self-storage) and by geographic region.
- **Conclusion**: The policy that the Private Real Estate Asset Class be broadly diversified by property type and region has been fulfilled.

7.12. Private Real Estate ownership should primarily be through equity interest with the use of leverage being limited to no more than 40% of the total assets in this Asset Class, (IPS, p. 14).

- **Source**: Heitman 2018 Annual Report and JPMCB 2018 Annual Report
- **Finding**: The leverage percentage for the Heitman fund is 24% (p. 69), and the leverage percentage for the JPM funds is 23.7% (p. 16).
- **Conclusion**: The policy that the real estate leverage should be no more than 40% of the total Private Real Estate Asset class has been fulfilled.

8. <u>Duty to Diversify: Rebalancing</u>

8.1. The Budget and Finance Committee <u>delegates authority</u> to Parkland staff to follow and execute the rebalancing policy described in this Policy (IPS, p. 11).

- **Source**: Investment Committee Minutes from 11/2018, 3/2019, 6/2019 and 8/2019

- **Findings**: We find that in each of minutes from the prior four meetings of the Investment Committee, staff initiated rebalancing of the Plan's excess cash.

- **Conclusion**: The policy that Parkland staff initiate and execute needed rebalances to the portfolio has been fulfilled.

8.2. Parkland staff shall review asset allocation on an ongoing basis and <u>initiate portfolio rebalancing</u> pursuant to parameters in this Policy on at least an annual basis (IPS, p. 5).

- **Source**: Parkland Rebalancing Worksheet dated 7/2019

- **Staff Declaration**: As noted in the response to Secondary Document Request dated 2/28/2020 Joe Mayer stated, "I go through the [rebalancing] exercise no less than once a quarter and execute material trades at the most favorable terms for the plan. This includes taking advantage of cross trades for the Genesis emerging market equities and Mondrian international small cap funds in September (both require in and out fees unless crosses are available). The Plan maintains the Mellon EM fund for rebalancing purposes since the Genesis fund is difficult to access and tends to close to contributions."

- **Finding**: We find that Parkland staff have developed and maintain, on a quarterly basis, a rebalance worksheet that compares the (1) Target Portfolio allocation against the (2) Actual portfolio allocation and (3) defines the required rebalance that is needed to bring the portfolio back into balance.

- **Conclusion**: The policy that Parkland staff review the asset allocation and initiate portfolio rebalancing based on the parameters defined in the IPS has been fulfilled.

8.3. If an asset class is outside the specified range, to rebalance, the Plan shall move assets to an amount <u>halfway between the target level and allowable range that is exceeded</u> (IPS, p. 10).

- **Source**: Parkland Rebalancing Worksheet dated 7/2019

- **Finding**: We find that Rebalancing Worksheet developed by Parkland staff identifies the deviation of the actual allocation from the Target Asset Allocation. All asset classes noted in the July 2019 worksheet were within 1.0% of the Target allocation.

- **Conclusion**: The policy that Parkland staff initiate rebalancing when the asset allocation is outside the approved range has been fulfilled.

8.4. The Plan's assets shall be <u>rebalanced by directing new contributions</u> to the under-allocated assets (IPS, p. 10).

- **Source**: Parkland Rebalancing Worksheet dated 7/2019

- **Finding**: We find that the rebalances initiated by Parkland staff was made with new contributions to the plan rather than reallocating capital that was previously deployed. We attribute the close alignment between the Target Asset Allocation and the Actual Allocation to this rebalancing discipline.

- **Conclusion**: The policy that Parkland staff initiate rebalancing with new contributions has been fulfilled.

9. <u>Duty to Pay Fair Fees</u>

9.1. Investments will be made… in accordance with the following objectives… Obtain a reasonable rate of return consistent with a prudent level of portfolio risk, <u>while controlling costs</u> incurred in administering and managing the assets (IPS, p. 2).

- **Source**: Not applicable

- **Finding:** This policy is a reaffirmation of the Duty Incur Only Reasonable Expenses found at TGC §802.203(a)(1)(B): "The governing body shall discharge its duties… by defraying reasonable expenses of administrating the system."

- **Conclusion:** Not applicable

9.2. The Investment Manager's fee schedule should be reasonable in comparison to the relevant investment universe (IPS, p. 7).

- **Source**: Callan Investment Management Fee Study dated 12/2/2019, p. 1

- **Finding**: We find that the Callan Management Fee Study report includes comparison of each investment manager to fees charged by their peer group. The weighted average investment manager fees for the system are 0.42%, and the median weighted fees for the peer group of managers is 0.49%.

- **Conclusion**: The policy that investment advisory fees should be reasonable in comparison to the relevant investment universe has been fulfilled.

- **Recommendation**: We recommend adding a policy identifying who is responsible for conducting this study and with what frequency the study is conducted.

10. Duty to Prudently Select

10.1. The Investment Consultant shall assist the Investment Committee, the Budget and Finance Committee and Parkland staff in an open and competitive process to select Investment Managers (IPS, p. 4).

- **Source**: Source: Callan Core Private Real Estate Search dated 4/2014

- **Finding**: We find that the most recent investment manager selection was for Core Private Real Estate managers in 2014 and included a search among 18 candidate managers who were asked to respond to an open RFP. Of these, 13 were eliminated based on inconsistencies between the manager's response and policy parameters established by Callan, staff and the Investment Committee. Five finalists were identified, and two recommended managers - Heitman and JP Morgan - were selected.

- **Conclusion**: The policy that an open and competitive process be used for the selection of investment managers has been fulfilled.

10.2. The following parameters articulate the general criteria used to select Investment Managers. All or part of these criteria may be employed in choosing an Investment Manager: (1) investment philosophy is clearly defined (2) organization and investment team have been stable (3) sufficient assets under management, (4) manager has employed the strategy for at least three years (IPS, p. 7).

- **Source**: Callan Core Private Real Estate Search dated 4/2014

- **Finding**: We find that as part of the Core Private Real Estate manager search conducted in 2014, there were 29 distinct factors used as evaluation criteria. These factors included, but were not limited, to each candidate's (1) investment philosophy, (2) the stability of the management team, (3) sufficient assets under management and (4) the long-term track record.

- **Conclusion**: The policy that the investment manager search process include the governing body's general criteria for evaluation has been fulfilled.

11. Duty to Prudently Delegate: Investment Authority/Responsibility

11.1. The performance of the strategy managed by each Investment Manager will be expected to achieve minimum performance standards (IPS, p. 17).

- **Source**: Investment Policy Statement, p. 17

- **Finding 1**: The table on page 18 of the IPS defines the minimum performance standards each manager is to achieve—exceeding the 50% percentile of the respective Peer Group and outperforming the respective Benchmark Index net of investment fees.

- **Finding 2**: We find that the Callan Summary and "Full" Reports include a comparison of each manager's net of fee return against the peer group and benchmark defined in the IPS.

- **Conclusion**: The policy to establish performance standards for each investment manager and measure against them has been fulfilled.

11.2. Active managers should rank in the top 50% of an appropriate peer group of actively managed portfolios over rolling three- and five-year periods (IPS, p. 17).

- **Source**: Callan Summary Report dated Q4 2019, p. 10

- **Finding 1**: The table on page 10 of the Callan Summary Report identifies the ranking of the active managers over three-year and five-year periods compared to their respective peer groups.

- **Finding 2**: For the last five-year period, four of the eight active managers are in the top 50% of their peer group, one manager is in the third quartile of its peer group and three managers are in bottom quartile of their peer group.

- **Conclusion**: The policy that each active investment manager be compared to its peer group has been fulfilled, though there is not comparison of *rolling* periods.

- **Recommendation**: We recommend that either the performance report include rolling three-year and five-year returns for the managers and their peer groups, or this requirement be removed from the IPS noting there are already multiple return periods presented (see Footnote 9).

11.3. Active managers should <u>meet or exceed an appropriate benchmark index, net of management fees</u> over rolling three- and five-year periods (IPS, p. 17).

- **Source**: Callan Summary Report dated Q4 2019, p. 10

- **Finding 1**: The table on page 10 of the Callan Summary Report identifies the ranking of the active managers over three-year and five-year periods compared to their respective benchmark index. However, *rolling* three-year and five-year performance is not presented.

- **Finding 2**: During the five-year period, four of the eight active managers exceeded the return of their benchmark, one manager matched the return of their index and three managers underperformed benchmark.

- **Conclusion**: The policy that active managers be compared to benchmark indexes has been fulfilled, though there is not comparison using rolling periods.

- **Recommendation**: We recommend that either the performance report include rolling three-year and five-year returns to be in compliance with the policy, or this requirement be removed from the IPS noting there are already multiple return periods presented.

11.4. Active managers should maintain a risk level, as measured by the standard deviation of quarterly returns, which is comparable to that of the appropriate benchmark index over rolling three- and five-year periods. To the extent that the Investment Manager takes more/less risk than the market and/or the appropriate peer group, returns are expected to increase/decrease commensurately (IPS, p. 17)

- **Source**: Callan Full Performance Report dated Q4 2019, p.45 (as an example)

- **Finding**: Each active manager's and respective index's 5-year standard deviation is reported in a graphical format. For example, the LSV SMID Value manager had approximately 13% standard deviation compared to its benchmark index's 13% standard deviation. However, the *rolling* three-year and five-year standard deviation is not presented.

- **Conclusion**: The policy that active managers' standard deviation be compared to benchmark indexes has been fulfilled, though there is not comparison of rolling periods.

- **Recommendation 1:** We recommend that either the performance report include rolling three-year and five-year standard deviations, or this requirement be removed from the IPS (see Footnote 9).

- **Recommendation 2**: The graphs representing the 5-year standard deviation make it hard to know precisely what the standard deviation for the manager and benchmark index were during the measurement period. We recommend that standard deviations be represented numerically rather than graphically.

12. Duty to Monitor

12.1. The Budget and Finance Committee shall have the authority and responsibility to monitor the investments of the Plan assets (IPS, p. 3).

- **Source**: Not applicable

- **Finding:** This policy is a reaffirmation of the Duty to Monitor found at TGC §802.206: "The Governing body of a public retirement system... shall at frequent intervals monitor the investments made by any investment managers for the system."

- **Conclusion:** Not applicable

12.2. The Budget and Finance Committee shall have the authority and responsibility for periodic monitoring (at least quarterly) of the investment performance results and a periodic analysis and review (at least quarterly) of the overall investment portfolio (IPS, p. 3).

- **Source**: Callan Summary Report dated Q4 2019

- **Finding**: We find that the Callan reports provide meaningful data on various performance and allocation factors for the total portfolio (pp. 2-17) including, but not limited to (1) the total portfolio allocation, (2) the performance of the total portfolio both gross and net of fees, (3) each investment manager's return compared to their relevant benchmark and peer group, (4) the attribution of return, (5) risk, as measured by standard deviation, for the total portfolio, etc.

- **Conclusion**: The policy that the total portfolio performance and allocation be monitored at least quarterly has been fulfilled.

12.3. The Investment Consultant shall review the performance of the Investment Managers versus their respective benchmarks and relevant peer groups (IPS, p. 4).

- **Source**: Callan Summary Report dated Q4 2019, p. 10 (as an example)

- **Finding**: We find that the Callan performance report includes monitoring of the investment managers' performance versus their respective benchmarks and peer groups[11]. (Page 18 of the IPS lists the respective benchmarks and peer groups.)

- **Conclusion**: The policy that the Investment Consultant compare the performance of each investment manager to their respective benchmarks and peer groups has been fulfilled.

12.4. The Investment Consultant shall periodically revisit each benchmark index for its continued appropriateness (IPS, p. 4).

- **Source**: Callan Investment Policy "Redline" dated 8/28/2019

[11] The comparison of each investment manager to their respective peer group is made on the first page of each section of the performance report dedicated to a particular manager.

- **Finding**: In August of 2019 Callan provided suggested updates to the IPS for the Investment Committee's consideration and adoption. Among these updates were modifications to the existing benchmarks for several asset classes (p. 19). Specifically, the benchmark index used to track the Non-US Small Cap Equity was changed from the MSCI EAFE Small Cap (net) to the MSCI World ex-US Small Cap. We find this was an improvement to the efficacy of this benchmark. Updated benchmarks were also added for the U.S. Equity, Non-U.S. Equity and Fixed Income composites.

- **Conclusion**: The policy that the Investment Consultant revisit the appropriateness of the benchmark indexes has been fulfilled.

12.5. Investment Managers shall supply timely written quarterly reports of investment performance results to Parkland staff (IPS, p. 3).

- **Source**: Wells Fargo Fundamental SMID Cap Growth Equity Quarterly Report dated 2Q 2019

- **Finding**: To test compliance with this policy, we randomly selected the Wells Capital SMID Growth manager and asked Parkland staff to provide to a copy of the Q2 2019 report.

- **Conclusion**: The policy that Investment Managers provide quarterly reports to Parkland staff has been tested and proven to be fulfilled.

12.6. The Investment Consultant shall review and analyze investment performance reports from the Investment Managers, and prepare and deliver comprehensive quarterly reports regarding the Investment Managers' performance to the Investment Committee (IPS, p. 4).

- **Source**: Wells Fargo Fundamental SMID Cap Growth Equity Quarterly Report dated Q2 2019

- **Finding**: To test compliance this policy, we randomly selected the Wells Capital SMID Growth manager and asked Callan to provide to a copy of the Q2 2019 report. Gordon Weightman of Callan provided a copy of this report and confirmed that he or his staff reviewed this report and all manager reports when they are received.

- **Conclusion**: The policy that the Investment Consultant review managers' quarterly performance reports has been tested and proven to be fulfilled.

12.7. The Budget and Finance Committee may place an Investment Manager on the Watch List for any of the following reasons: (1) Not meeting its performance standards for a sustained period, (2) change in key professionals, (3) change in ownership control, (4) changed investment focus, (5) judicial or administrative proceedings, and (6) violation or notice of violation from the SEC rule or regulation (IPS, p. 8).

- **Source**: Callan Summary Report dated Q4 2019, p. 1011

- **Finding 1**: We find that the Investment Manager Watch List is maintained and reported upon each quarter.

- **Finding 2**: We find that despite performance below its respective benchmark and peer group and inferior risk-adjusted return, as measured by the Sharpe Ratio, the LSV SMID Value manager is not included on the Watch List.

- **Conclusion**: The policy that a Watch List be maintained for managers that fall below their performance standards has been fulfilled.

12.8. The Investment Manager shall notify the Investment Committee, the Budget and Finance Committee and Parkland staff in writing of any material deviations from the stated investment approach (IPS, p. 3).

- **Source:** During the audit period, no managers materially deviated from their stated investment approach.

- **Findings:** Not applicable

- **Conclusion:** Not applicable

- **Recommendation**: We recommend that updates be made to Individual Manager Guidelines which note that investment managers are to reaffirm their respective guidelines in writing on an annual basis.

SECTION 3

Summary of Recommendations

Introduction

Following is a summary of our findings and recommendations detailed in the Investment Practices and Performance Report. These recommendations are intended to (1) clarify existing policies where ambiguity may exist, (2) eliminate policies that are duplicative or contradictory to other policies and (3) add policies where no current guidance exists. These recommendations are organized in the order of priority.

1. Policies Related to Liquidity

There is no policy defining the maximum level of illiquidity acceptable within the Plan, though there are several policies that indicate a preference for liquidity. The IPS directs, *"The asset structure is to reflect a proper balance of the Plan's need for liquidity, total return and the risk tolerance established (IPS, p. 9)."*

Defining the maximum level of illiquidity within the Plan is considered a "best practice". The GFOA directs, "Prior to developing an asset allocation plan the governing body is to consider, among other factors, the need for liquidity which is the ability to convert an asset to cash quickly.[12] The CFA Institute recommends that "… governing bodies have a way to monitor portfolio illiquidity—either through liquidity bucketing (see Kentouris 2017) or liquidity cascades."[13]

We recommend that a policy be developed to address the System's liquidity preference. Practically, the policy would be defining the maximum level of illiquidity that the system is willing to accept. This policy would include (1) a statement affirming an expectation that an illiquidity premium exists, (2) the maximum allocation of illiquid assets that will be allowed in the Plan and (3) how illiquidity will be defined and measured. This recommendation is particularly important if the Plan is to consider the addition of Private Equity to the portfolio as Investment Committee minutes suggest.

[12] Governmental Finance Office Association, "Asset Allocation for Defined Benefit Plans", https://gfoa.org/asset-allocation-defined-benefit-plans

[13] CFA Institute Research Foundation, "Investment Governance for Fiduciaries (2019) p. 103", https://www.cfainstitute.org/-/media/documents/book/rf-publication/2019/investment-governance-for-fiduciaries.ashx

2. Fee Review

There is only one governance policy related to investment costs. That policy directs, *"The Investment Manager's fee schedule should be reasonable in comparison to the relevant investment universe" (IPS, p. 7).* In our view, this fundamental duty of care deserves more guidance than the current policy offers.

We recommend expanding this policy to identify (1) who is responsible for conducting this fee study, (2) with what frequency the study is to be conducted and (3) the identification of the factors that are to be considered when conducting this study such as indirect costs, peer group fees, incentive compensation, etc.

3. Revisions and Amendments to the Investment Policy

The staff is primarily responsible for recommending amendments and revisions to the Investment Policy Statement. Specifically, the policy directs, *"Parkland staff shall provide recommendations to the Investment Committee and the Budget and Finance Committee regarding <u>potential revisions to this Policy</u> on at least an annual basis" (IPS, p. 5).*

We recommend that this policy be removed because it is duplicative with the Investment Consultant's responsibility to do the same work (see IPS, p. 4). We would neither expect nor recommend that Staff be excluded from the IPS review and revision process. However, we believe the Investment Consultant is best qualified to initiate this work each year. If this policy is removed and the Investment Consultant is the responsible party for initiating the IPS review, the frequency of the review should be identified.

4. Evaluation of Investment Consultant:

The staff is identified as being responsible for the evaluation of the Investment Consultant. Specifically, the policy directs, *"Parkland staff shall advise the Investment Committee and the Budget and Finance Committee regarding Parkland <u>staff's opinions regarding the performance of the Investment Consultant…"</u> (IPS, p. 5).*

We believe that the Investment Committee, and not the staff, is best qualified to conduct this evaluation. To be sure, the staff will still be involved in this evaluation, but we feel the staff's limited experience with this type of evaluation is best done in support of the Investment Committee rather than on behalf of the Investment Committee. Further, we suggest the policy be expanded to define (1) the frequency of review and (2) the factors that should be considered as part of this review to guide staff or future member of the Investment Committee when this evaluation is being conducted.

5. Policies re Restrictions on Investment Managers

There is a series of policies that provide restrictions on how particular asset classes are to be invested. These requirements are that (1) domestic equity be restricted to readily marketable securities, (2) futures and options contracts, if used, be collateralized by highly liquid, low volatility fixed income securities, (3) 65% of all non-U.S. equity holdings shall be highly liquid securities and (4) Emerging Market fixed income holdings be excluded from the Plan.

In our view, these policies are not effective governance instructions because (1) there are undefined terms[14], (2) there are restrictions that apply to some but not other investment managers[15], (3) there are inconsistencies between the policy and the Individual Manager Guidelines[16] and (4) monitoring compliance with the Plan's liquidity preference can be done in a more effective way. If a clear "illiquidity policy" is established as we suggested above, the restrictions in Section IV Paragraphs A-D of the IPS can and should be removed.

Following is a summary of the policies that place restrictions on the Plan's investments:

- Domestic equities shall be restricted to <u>readily marketable securities</u> of companies that are actively traded on major U.S. exchanges (IPS, p. 12).

- Futures and options can be used as a substitute for equity securities provided that they are <u>100% collateralized by highly liquid, low volatility fixed income securities</u> and therefore do not represent leveraging of the assets (IPS, p. 12).

- At least 65% of all non-U.S. equity holdings shall be <u>highly liquid securities</u> issued by companies headquartered in countries included in the MSCI All Country World ex-U.S. Index (IPS, p. 12).

- Foreign currency fixed income holdings are restricted to issuers in countries represented in the <u>Citigroup World Government Non-U.S. Bond Index</u> (IPS, p. 12).

[14] What does "highly liquid" mean?
[15] There are restrictions for SMAs that do not apply to mutual funds or commingled products.
[16] One policy directs that *no* Emerging Market debt be held, and the Individual Manager Guidelines for Stone Harbor expressly approves Emerging Market debt.

- On a quarterly basis, the Investment Managers shall review their investments for compliance with the investment guidelines in Section IV of the IPS (IPS, p. 11).

- The <u>average effective duration</u> of each fixed income portfolio, reflecting all instruments including CMO and Asset-Backed Securities, <u>should not exceed 150%</u> of the BC Aggregate Bond Index duration (IPS, p. 13).

6. <u>Policies re Rolling Return Periods</u>

There are six policies in the IPS that call for measurement of the performance of the Plan or the individual investment managers over rolling 5-year periods. We can find no record that *rolling* 5-year returns are ever reported. To be sure, the annualized return over the prior five years for the Plan and individual investment managers is reported, but this is not the same as reporting the 5-year rolling returns.

Rolling return periods do not aid in the performance evaluation of the portfolio, asset class or investment manager when comparative benchmarks or peer groups are available and multiple performance periods exist (1-yr, 3-yr, 5-yr, since inception). Additionally, none of the investment managers' performance data goes back further than 12 years. For such a short performance set, 5-year rolling returns is not statistically meaningful because only nine performance observations exist (2007-2011, 2008-2012, 2009-2013, etc.).

We recommend that the IPS be modified to remove all references to rolling performance periods and replaced with the *prior* 5-year performance period.

Following are the policies where reporting rolling return periods are required:

- The aggregate of the Plan's assets will be managed with the goal of achieving an annualized rate of return, <u>as measured by rolling five-year periods</u>, that outperforms a hypothetical portfolio composed of indices weighted according to the target allocation (IPS, p. 16).

- The aggregate of the Plan's assets will be managed with the goal of achieving an annualized rate of return, as measured by <u>rolling five-year periods</u>, that meets the actuarial assumed return as determined by the Plan's actuary (IPS, p. 16).

- The aggregate of the Plan's assets will be managed with the goal of achieving… over a <u>rolling five-year period</u>: Comparable volatility of returns, as measured by the standard deviation of quarterly returns of the benchmark index (IPS, p. 16).

- Active managers should rank in the top 50% of an appropriate peer group of actively managed portfolios over rolling three- and five-year periods (IPS, p. 17).

- Active managers should meet or exceed an appropriate benchmark index, net of management fees over rolling three- and five-year periods (IPS, p. 17).

- Active managers should maintain a risk level, as measured by the standard deviation of quarterly returns, which is comparable to that of the appropriate benchmark index over rolling three- and five-year periods. To the extent that the Investment Manager takes more/less risk than the market and/or the appropriate peer group, returns are expected to increase/decrease commensurately (IPS, p. 17).

SECTION 4

Response to TPRB Questions

In October 2019, the Texas Pension Review Board ("TPRB") provided suggested questions and topics for consideration under each of the five areas required to be covered in the Investment Practices and Performance Report ("IPPR"). These questions were intended to help systems identify the types of information an evaluation might include.

"The following provides guidance on the different areas required by statute to be reviewed by the independent firm performing the evaluation. The PRB recognizes that evaluations should and will vary significantly based on the specific characteristics of each system's size, governance structure, and investment program. Therefore, this guidance is intended to inform systems and their stakeholders on the basic aspects of the evaluations and associated reports and is not an exhaustive list of all items that should be reviewed" Guidance for Investment Practices and Performance Evaluation, adopted 10/17/2019).

Following is a listing of the TPRB's questions or topics organized by the five areas of inquiry required by the statute as well as Anodos' response to each question.

- TPRB Questions in **BLACK**
- Text of the statute in **GREEN**
- Anodos Responses in **BLUE**

1	**The evaluation should include the following disclosures by the independent firm:**	
a)	A summary outlining the qualifications of the firm.	Anodos is a governance consulting firm that helps plan trustees develop, maintain and evaluate their governance processes.
b)	A statement indicating the nature of any existing relationship between the firm and the system being evaluated;	Anodos had no existing relationship with the system prior to this engagement.
c)	1c. 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	Anodos receives no form of renumeration from any vendor providing services to the system.
d)	1d. A statement acknowledging that the firm, or its related entities, is not involved in directly or indirectly managing investments of the system.	Anodos, which has no related entities, is not involved in direct or indirect management of investments for the system.

2	**Each evaluation must include 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.**	
a)	Does the system have a written investment policy statement (IPS)?	Yes. The most recent version is dated February 2019. If it has not already been done, this IPS should be filed with the TPRB per §802.202(d)(3).
b)	Are the roles and responsibilities of those involved in governance, investing, consulting, monitoring and custody clearly outlined?	Yes. The delegations of the roles and responsibilities between the governing body (the Budget and Finance Committee, hereafter "B&FC"), the Investment Committee, Staff, the Investment Consultant (Callan) and the various investment managers are clearly defined in the IPS. (IPS, p. 2)
c)	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.])	Yes. The investment policy is consistent with the Plan's return objective, risk expectations and need for liquidity. (IPPR 3.1, 4.2, 5.1)
d)	Is the policy written so clearly and explicitly that anyone could manage a portfolio and conform to the desired intentions?	Yes. On balance, the policies for managing the portfolio are clear and explicit. There are a very few instances in the Investment Practices and Performance Report (IPPR) where Anodos offered suggestions where the policy might be improved, but these suggestions are the exception rather than the rule. Obviously, some level of subjectivity and autonomy is preserved for the party(ies) who are responsible for implementing the policy.
e)	Does the policy follow industry best practices? If not, what are the differences?	Yes. The IPS is organized consistent with the "best practices" identified by the CFA Institute, GFOA, NCPERS and TPRB, including (1) investment principles, (2) objectives (3) approved allocation, (4) manager selection process, and (5) monitoring functions and key performance indicators.
f)	Does the IPS contain measurable outcomes for managers? Does the IPS outline over what time periods performance is to be considered?	Yes. The IPS defines two measurable outcomes for each investment managers: a defined benchmark for each manager and a peer group. The policy also defines that the investment managers relative performance to these key performance indicators will be compared against annual, 3-year rolling and 5-year rolling periods. (IPPR 12.3, 12.4)

g)	Is there evidence that the system is following its IPS? Is there evidence that the system is not following its IPS?	Yes. There is substantial evidence that the system is following its own policies memorialized within the IPS. Anodos' IPPR identifies several minor instances where they are not.
h)	What ~~practices are being followed that are not in, or are counter to,~~ written investment policies and procedures [are NOT being followed]?	The few instances Anodos found where a policy was not being followed are noted in the "SECTION 3 – Summary of Recommendations" of the IPPR.
i)	Are stated investment objectives being met?	Yes. As of December 31, 2019 the objectives for the Plan are to meet or exceed, over a 5-year period, the (1) actuarial defined return and (2) Policy Index (blended benchmark consistent with governing body's approved allocation) and to (3) rank in the top half of peer group plan performance have been met. (IPPR 3.2)
j)	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. The policy instructions are unambiguous and easy to maintain with the professional support of an independent investment consultant (Callan in this case). Everything that can reasonably done has been done. Actual results will depend on the commitment of future governing bodies in following the existing policies.
k)	Will the investment managers be able to maintain fidelity to the policy under the same scenarios?	Yes. The Individual Manager Guidelines are unambiguous. Anodos has no basis to judge the investment managers' ability to maintain fidelity to these instructions. There are sufficient policy instructions for the Investment Consultant, Staff and/or the Investment Committee to monitor the investment managers' fidelity to these instructions. (IPPR 12.3, 12.4)
l)	Will the policy achieve the stated investment objectives under the same scenarios?	Yes. In Anodos' professional and independent opinion, if the policies are followed, the investment objectives will be accomplished if market conditions in the future are similar to those of the past, with a 5% long-term "real" return from equity and 1% long-term "real" return from fixed income.
m)	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, amended as needed and reaffirmed annually. This was most recently done on February 2019. (IPPR 2.5)

3	**Each evaluation must include a detailed review of the retirement system's investment asset allocation, including the process for determining target allocations.**	
a)	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 system has adopted a policy that the Target Allocation is reviewed and reapproved annually. The system is in compliance with this policy. (IPPR 6.3)
b)	If no formal policy exists, what is occurring in practice?	N/A
c)	Who is responsible for making the decisions regarding strategic asset allocation?	The governing body (the B&FC) is responsible for establishing the strategic asset allocation based on recommendations of the Investment Committee, Staff and the Investment Consultant. (IPS, p. 9)
d)	How is the system's overall risk tolerance expressed and measured?	The expected risk is expressed as the standard deviation of the portfolio and is measured against that of the Policy Index (blended benchmark consistent with the approved allocation) and peer group systems. (IPPR 4.2)
e)	What methodology is used to determine and evaluate the strategic asset allocation?	The approved allocation, which is reviewed annually, is based on the capital market assumptions (projected risk and return by asset classes) developed by the Investment Consultant and compared to the capital market expectations of the Actuary (Milliman). (IPPR 6.2)
f)	How often is the strategic asset allocation reviewed?	The policy calls for annual review and testing of the current approved allocation. This policy has been complied with. (IPPR 6.2)
g)	Do the system's investment consultants and actuaries communicate regarding their respective future expectations?	Yes. Both the Investment Consultant and the Actuary produce their own capital market assumptions. Based on a review of these expectations, the B&FC defines the assumed return – the discount rate – the Actuary is to use.
h)	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 discount rate used to determine the system's funding liability in the GASB 67/68 report is established by the B&FC based on input by the Investment Consultant and the Actuary. Once the discount rate is established, the asset allocation believed to reasonably accomplish this return objective is adopted. The governing body has been systematically reducing the discount rate from 8.0% to a targeted 6.5%, which will be arrived at in 2021. (IPPR 3.1, 3.2)
i)	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 methodology used for the development of the approved allocation is based on long established and prudent methodologies including (1) capital market expectations, (2) inflation assumptions, (3)

		consideration of the economic environment, and (4) a long-term investment horizon.
j)	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?	The System does not have a tactical allocation. There is only one approved allocation, which is sometimes called the Target Allocation. This approved allocation is reviewed and reaffirmed annually. Modest tactical changes to the asset allocation are made infrequently.
k)	How does the asset allocation compare to peer systems?	The asset allocation of the Fund is compared quarterly to a peer group of other public funds with similar long-term objectives. The Fund's allocation is substantially similar to the median peer group allocation. • **Domestic Equity**: 36.01% vs. 33.70% median • **Int'l Equity**: 25.37% vs. 18.97% median • **Real Estate**: 9.23% vs. 8.44% median • **Fixed Income**: 28.80% vs. 26.34% median

4	**Each evaluation must include the expected risk and expected rate of return, categorized by asset class.**	
a)	What are the strategic ~~and tactical~~ allocations?	<table><tr><th>Asset Class</th><th>%</th></tr><tr><td>Total US Equity</td><td>33.0%</td></tr><tr><td>Total Non-US Equity</td><td>27.0%</td></tr><tr><td>Total Fixed Income</td><td>30.0%</td></tr><tr><td>Total Real Estate</td><td>10.0%</td></tr><tr><td>Total Strategic Allocation</td><td>100.0%</td></tr></table>*(IPS, p. 10)*
b)	What is the expected risk and expected rate of return of each asset class?	<table><tr><th>Asset Class</th><th>Risk</th><th>Return</th></tr><tr><td>US Large Cap Equity</td><td>17.7%</td><td>7.00%</td></tr><tr><td>US Small-Mid Cap Equity</td><td>21.2%</td><td>7.25%</td></tr><tr><td>Global Equity ex US</td><td>20.5%</td><td>7.25%</td></tr><tr><td>Domestic Fixed Income</td><td>3.75%</td><td>2.75%</td></tr><tr><td>Real Estate</td><td>14.0%</td><td>6.25%</td></tr></table>*(Callan Feb 2020 Asset Allocation Review)*
c)	How is this risk measured and how are the expected rates of return determined? What is the time horizon?	The risk of the total portfolio and the individual asset classes are measured by standard deviation. The expected return for each asset class is estimated by the Investment Consultant based on their capital markets assumptions. (IPPR 4.2) The time horizon for the total portfolio is perpetual.
d)	What mix of assets is ~~necessary~~ expected to achieve the plan's investment return and risk objectives?	The current targeted asset allocation, which was approved in February of 2020, is expected to achieve the Plan's actuarially defined return objective of 7.0%. The expected risk to realize this targeted return, as measured by standard deviation, is projected to be 11.7%. *(Callan Feb 2020 Asset Allocation Review)*
e)	What consideration is given to active vs. passive management?	No expressed policy on passive management has been made. In practice, passive management is used for the US Large Cap asset class only, and active management is used in all other asset classes. Active investment managers are expected to exceed their policy benchmark after fees and be within the upper 50% of peer group managers over 5-year periods. Of the eight active investment managers, five have met or exceeded these objectives and three have not. (IPPR 11.3)
f)	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 to formulate the asset allocation is prudent. Primary design considerations are offered by the Investment Consultant and affirmed by the Investment Committee before the B&FC adopts the

		proposed design. The result is a well-diversified portfolio. (IPPR 6.1)
g)	How often are the strategic and tactical allocations reviewed?	There is only one approved allocation, which is sometimes referred to as the Target Allocation. The portfolio's holdings are compared to the Target Allocation on a quarterly basis. The Target Allocation is reviewed, modified as needed, and affirmed annually. (IPPR 6.2, 12.2)

5	**Each evaluation must include the appropriateness of selection and valuation methodologies of alternative and illiquid assets.**	
a)	How are alternative and illiquid assets selected, measured and evaluated?	The system has no "alternative" investments, namely, hedge funds or private equity. The selection, measurement and evaluation of all investment managers, whether investing in illiquid assets (real estate) or marketable securities (all other asset classes), is the same. A competitive evaluation and selection process is followed. A selection is made by the governing body. A written delegation is made which defines the key performance indicators that will be used to evaluate the manager, and quarterly monitoring of the managers' actual performance outcomes against the KPIs is performed. (IPPR 10.1, 11.1, and 12.2)
b)	Are the system's alternative investments ~~appropriate~~ reasonable given its size and level of investment expertise?	No managers of alternative assets, namely hedge funds or private equity, have been hired by the System. This manager type is excluded from inclusion by policy. (IPS, p. 14)
c)	Does the IPS outline the specific types of alternative and illiquid investments allowed, as well as the maximum allocation allowable?	Alternative investments are excluded by policy. As such, no maximum allocation is defined. The Real Estate asset class, the only illiquid investment type, is restricted to 10% of the total portfolio. (IPS, p. 10)
d)	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 two Real Estate investment managers are the only managers who hold illiquid assets. Both firms have hired an independent appraisal firm that conducts a full appraisal of each property within each real estate fund annually and provides adjustments to the appraised value quarterly based on newly available information. (Heitman Annual Report p. 70 and JP Morgan Annual Report p. 31)

6	**Each evaluation must include an evaluation of the plans policies relating to the future cash flow and liquidity needs.**	
a)	What are the plan's anticipated future cash flow and liquidity needs? Is this based on an open or closed group projection?	The most recent Asset Liability Study was conducted in 2017. That study found, "The Plan is slightly cash flow positive over the next decade." The projected contributions in each of the next 10 years exceeds the projected disbursements by approximately ~$5m per year. The Asset Liability Study is based on a closed group.
b)	When was the last time an asset-liability study was performed?	The last Asset Liability Study was conducted in September of 2017.
c)	What is the current funded status of the plan and what impact does it have?	According to the Plan's funding policy dated November 20, 2019, the funding ratio for the Plan was 71.53%.
d)	What changes should be considered when the plan is severely underfunded~~, approaching full funding, or in a surplus~~?	Because this plan is over 25% underfunded ,the Plan has taken the following steps: (1) developed a funding policy that includes, but is not limited to, achieving a goal of full funding within a defined period of time (not less than 30 years), (2) increased contributions being made to the Plan, (3) reduced return assumptions for future plan years, and (4) fully amortizing the unfunded liability within a period of 25 years.
e)	How does the difference between expected short-term inflows (contributions, dividends, interest, etc.) and outflows (distributions and expenses) impact the allocation?	In this case, the total contributions to the plan – excluding dividends and interest – exceed the projected distributions over the next decade. This "cash flow positive" state could be used to rationalize a lower level of liquidity of the plan assets. (Currently, only 10% of the Plan is allocated to illiquid assets through Real Estate.)
f)	How does the underlying nature of the future liabilities impact the allocation (e.g. pay-based vs. flat $ benefit, automatic COLAs, DROP, etc.)?	The long time horizon for the Plan and the low need for current liquidity (current contributions exceed projected liabilities over the next 10 years) informs the allocation.
g)	What types of stress testing are incorporated in the process?	The Actuary conducts a stress test each year in which they project the future deficit or surplus if the long-term performance is 1.0% lower and 1.0% higher than the current projection.

7	**Each evaluation must include a review of the appropriateness of investment fees and commissions paid by the retirement system.**	
a)	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 Policy related to the monitoring of expenses does not distinguish between direct and indirect expenses. Because the policy makes no distinction between direct and indirect expenses, by implication, both are to be tracked. The December 2020 fee study notes both the direct fees paid to each separate account manager and the indirect fees paid to the funds or comingled managers. According to the fee study $1.087m is paid in both direct and indirect compensation to investment managers which is equivalent to 0.42%. Callan's report concludes that this fee is below the average for funds of similar size. (IPPS 9.2)
b)	Who is responsible for monitoring and reporting fees to the board? Is this responsibility clearly defined in the system's investment policies?	The policy does not directly identify (1) who is responsible for monitoring fees or (2) the frequency this analysis should be done. (IPPS 9.2)
c)	Are all forms of manager compensation included in reported fees?	Reported fees in the Annual Financial Report are only those that are directly debited from the plan. As such, the fees charged by mutual funds or commingled funds are charged internally are *not* included in the CAFR report. These indirect fees are not deductible to the plan and appropriately *not* reported on the CAFR report. These indirect fees *were* included in the Callan 2019 fee study.
d)	How do these fees compare to peer group and industry averages for similar services? How are the fee benchmarks determined?	Callan's fee study finds that the total fees for the Plan (0.42%) are below the average of comparable plans. Anodos has tested the average direct fees paid by Parkland as compared to other Texas systems and find that the level of direct fees incurred by Parkland are in the bottom quartile as measured by both percentage of assets under management and investment fees per participant.
e)	Does the system have appropriate policies and procedures in place to account for and control investment expenses and other asset management fees?	No. Anodos has suggested the governing body adopt policies defining the (1) frequency of fee reviews, (2) the party responsible for these studies and (3) procedural guidelines to be followed. (IPPS 9.2)
f)	What other fees are incurred by the system that are not directly related to the management of the portfolio?	Administrative fees, as distinct from investment advisory fees, are reported in the 12/31/2018 CAFR report. Administrative fees for the 2018 year were $241,000, which ranked in the bottom quartile of covered Texas plans.

g)	How often are the fees reviewed for reasonableness?	The direct and indirect fees were most recently reviewed in December of 2019. No policy directs the frequency of review.
h)	Is an attorney reviewing any investment fee arrangements for alternative investments?	All investment contracts are reviewed by an attorney. No alternative investments are held by the Plan.

8	**Each evaluation must include a review of 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.**	
a)	Does the system have a written governance policy statement outlining the governance structure? Is it a stand-alone document or part of the IPS?	The System's governance policies and procedures are memorialized in the Investment Policy Statement.
b)	Are all investment-related policy statements easily accessible by the plan members and the public (e.g. posted to system website)?	The Investment Policy Statement is available to the public and participants upon request to the Finance Department. The IPS is not published online.
c)	How often are board meetings? What are the primary topics of discussion? How much time, detail, and discussion are devoted to investment issues?	The Investment Committee meets quarterly and the entire agenda is devoted to investment related topics. The Investment Committee's findings and recommendations are presented to the Budget and Finance Committee during their quarterly meeting.
d)	Are meeting agendas and minutes available to the public? How detailed are the minutes?	The minutes from the Investment Committee and the B&FC are available to the public upon request to the Finance Department. These documents are not published online.
e)	What are the backgrounds of the board members? Are there any investment-related educational requirements for board members?	Each of the five members of the Investment Committee have decades of experience in the investment advisory industry. The members of the B&FC are bound by and have met the minimum educational training requirements set by the TPRB. (MET Report dated 2019-06-06)
f)	What training is provided and/or required of new board members? How frequently are board members provided investment-related education?	Rule 607.110 of the Texas Administrative Code directs the Minimum Educational Training Requirements for new trustees. The educational material required to meet this first year and subsequent training is provided by the educational sponsors approved by the TPRB. https://www.prb.texas.gov/resource-center/met-program-sponsor-information/minimum-educational-training-met-program-accredited-sponsors/
g)	What are the minimum ethics, governance, and investment education requirements? Have all board members satisfied these minimum requirements?	The trustees are required to annually review and affirm the ethics policy for the system. All board members have fulfilled this responsibility. (IPPR 1.3) The Minimum Education Training Program Form (PRB-2000) was filed on 6/6/2019.

h)	Does the system apply adequate policies and/or procedures to help ensure that all board members understand their fiduciary responsibilities?	The minimum educational training required by the TPRB and engaged in by the trustee sufficiently ensures that board members understand their fiduciary responsibilities.
i)	What is the investment management model (i.e. internal vs. external investment managers)?	No plan assets are internally managed. Investment management responsibility has been delegated to institutional SEC-registered managers.
j)	Does the board receive impartial investment advice and guidance?	Callan serves as the independent investment consultant to the governing body.
k)	How frequently is an RFP issued for investment consultant services?	A competitive RFP process for investment consulting services was conducted in 2013 when Callan was originally hired and then again in 2017 when Callan was rehired for a second 5-year contract that is scheduled to terminate in 2021.
l)	How is the leadership of the board and committee(s), if any, selected?	The members of the Board are selected by the County Commissioner. The Board members select their leadership who make committee appointments including the B&FC. The B&FC appoints the members of the Investment Committee who in turn select their leadership.
m)	Who is responsible for making decisions regarding investments, including manager selection and asset allocation?	The B&FC is the ultimate governing body for the Plan. The Investment Committee, seated with five experienced investment professionals, serves in an advisory capacity to the B&FC. Staff and the Investment Consultant conduct the administrative, monitoring and reporting functions that serve the Investment Committee and B&FC.
n)	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?	The IPS is clear on those authorities and duties that have been retained and those that have been delegated by the B&FC. In summary, authority rests exclusively with the B&FC. Apart from rebalancing responsibility, which has been delegated to staff within clear guidelines, the B&FC has not delegated any authority to any party. Monitoring responsibilities have been delegated to the Investment Committee, Staff and Investment Consultant. But each of these parties has no authority to act upon the observations they offer the B&FC.
o)	Is the board consistent in its use of this structure/delegation of authority?	Yes. All evidence that Anodos has seen suggests the governance hierarchy, roles, responsibilities, delegation and duties have been followed consistent with the instruction in the IPS.
p)	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?	The System does have polices in place to review the effectiveness of the investment program. The review of the effectiveness of the members of the B&FC

		Committee and Staff, who have other responsibilities within the System, is outside the scope of the IPPR.
q)	Is the current governance structure striking a good balance between risk and efficiency?	Yes. Given the administrative burden of the B&FC for all financial responsibilities for this medical system, it is appropriate that a distinct Investment Committee be used, seated with highly experienced members who are independent of the System. It would be overly cumbersome for the governing body to administer.
r)	What controls are in place to ensure policies are being followed?	Every three years an investment practices and performance evaluation is conducted by an independent party.
s)	How is overall portfolio performance monitored by the board?	Overall portfolio performance and the performance of the individual investment managers is monitored monthly and compared against a variety of key performance indicators including an actuarially defined return objective, manager benchmarks, a blended portfolio benchmark, and peer groups.
t)	How often are the investment governance processes reviewed for continued appropriateness?	On an annual basis the IPS is reviewed and reaffirmed by the B&FC based on input by the Investment Committee, Staff and the Investment Consultant. The IPS was most recently reviewed and reaffirmed on February 2019.

9	**Each evaluation must include a review of the retirement system's investment manager selection and monitoring process.**	
a)	Who is responsible for selecting investment managers?	Authority for selecting investment managers rests with the B&FC based on advice and analysis offered by the Investment Committee, Staff and the Investment Consultant. (IPS, p. 2)
b)	How are the managers identified as potential candidates?	After the need for a new manager is affirmed by the B&FC, the Investment Consultant identifies candidate managers that meet the criteria identified by the B&FC in the IPS. (IPS, p. 7)
c)	What are the selection criteria for including potential candidates?	The qualifying criteria for investment manager candidates are, among other factors, (1) a clearly defined investment philosophy, (2) stable investment team, (3) sufficient assets under management, and (4) experience and tenure in managing the strategy. (IPS, p. 7)
d)	What are the selection criteria when deciding between multiple candidates?	The experience, judgment and recommendations of the Investment Committee, Staff, and Investment Consultant inform the B&FC's eventual selection decision.
e)	How does the selection process address ethical considerations and potential conflicts of interest for both investment managers and board members?	The Investment Committee, Staff, Investment Consultant and candidate investment managers serve as fiduciaries to the Plan and affirm in writing that no conflict of interest exist. (IPPR 1.3)
f)	Who is responsible for developing and/or reviewing investment consultant and/or manager contracts?	Legal and Finance staff are responsible for reviewing all investment consultant and manager contracts. Outside legal experts are, when needed, also consulted.
g)	What is the process for monitoring individual and overall fund performance?	The performance of the total Fund and the individual investment managers is calculated using time-weighted rate of return, both gross of fee and net of fee, and is compared to defined key performance indicators – benchmarks, indexes, peer groups, and targeted returns. (IPPR 3.3, 3.4, 11.3)
h)	Who is responsible for measuring the performance?	The Investment Consultant is responsible for calculating and presenting the performance of the overall Fund, the individual investment managers and the key performance indicators used to measure against.
i)	What benchmarks are used to evaluate performance?	The total Fund Performance is measured against a hypothetical portfolio composed of indices weighted according to the target allocation. Each investment manager is compared against an appropriate benchmark established by the Investment Consultant

		and the Investment Committee which is memorialized in the IPS. (IPS, p. 18)
j)	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?	The performance reports produced by the Investment Consultant are comprehensive and include time series returns (1, 3, 5, 10-year), gross and net of fee performance, and comparison of performance to appropriate benchmark and peer groups.
k)	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?	Gross of fee and net of fee performance is presented quarterly and is compared to appropriate benchmarks and peer groups. (IPS, p. 18).
l)	What is the process for determining when an investment manager should be replaced?	Investment managers are to be placed on a "Watch List" when the following occurs: (1) failure of the manager to meet their performance standards for a sustained period, (2) change in key members of the investment team, (3) change of ownership of the investment management firm, (4) change in focus of the investment manager, (5) judicial or administrative proceedings have been brought against the manager, (6) a violation of an SEC rule has been committed or (7) based other factors determined by the Investment Committee. (IPS, p. 8)
m)	How is individual performance evaluation integrated with other investment decisions such as asset allocation and investment risk decisions?	The risk and return outcomes by each manager are compared against the capital market expectations by asset class when the approved allocation is affirmed annually. (IPPR 6.3)

EXHIBIT A

Document Inventory

1. System Documents
    a. Investment Policy Statement reaffirmed on February 2019
    b. Individual Manager Guidelines (IPS pp. 22-25)
    c. Investment Policy "Redline" dated 8/28/2019
    d. Funding Policy Resolution dated 11/20/2019, p. 3
    e. Investment Committee Minutes from 11/2018
    f. Investment Committee Minutes from 3/2019
    g. Investment Committee Minutes from 6/2019
    h. Investment Committee Minutes from 8/2019
    i. Parkland Rebalancing Worksheet dated 7/2019

2. Callan Documents
    a. Callan Summary Performance Report dated Q4 2019
    b. Callan Full Performance Report dated Q4 2019
    c. Callan 2017 Asset Allocation and Liability Study dated 9/19/2017
    d. Callan Defined Benefit Plan Asset Allocation Review dated February 2020
    e. Callan Investment Management Fee Study dated 12/2/2019
    f. Callan Core Private Real Estate Search dated 4/2014

3. Other Documents
    a. BNY Mellon Consolidated DB Statement dated 12/31/2019
    b. BKD Financial Report dated July 31, 2019
    c. Curriculum vitae collected for each of the Investment Committee members
    d. BNY Mellon Temporary Investment Fund Audited Financials
    e. JPMCB 2018 Annual Report
    f. Wells Fargo Fundamental SMID Cap Growth Equity Quarterly Report dated 2Q 2019