TEXAS PENSION REVIEW BOARD

Guidance for Investment Practices and Performance Evaluations
(Section 802.109, Texas Government Code)

Section 802.109, Texas Government Code requires Texas public retirement systems with at least $30 million in assets to complete an Investment Practices and Performance Evaluation. The Pension Review Board (PRB) is providing this informal guidance to assist systems in defining the scope and content of the evaluation.

The following provides guidance on the different areas required by statute to be reviewed by the independent firm performing the evaluation and the schedule for completing evaluations. 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.

A thorough evaluation would include the following elements:

1) Identify and review existing investment policies, procedures, and practices. This should include any formally established policies (e.g. Investment Policy Statement) as well any informal procedures and practices used to carry out the investment activities of the system. It is not necessary to review past policies, procedures, and practices that are no longer applicable unless they are deemed helpful to understand current policy or practice.
2) Compare the existing policies and procedures to industry best practices.
3) Generally, assess whether the board, internal staff, and external consultants are adhering to the established policies.
4) Identify the strengths and weaknesses of the current policies, procedures, and practices and make recommendations for improvement.
5) Include a detailed description of the criteria considered and methodology used to perform the evaluation, including an explanation of any metrics used and associated calculations.

Applicability

Systems with assets of **at least $100 million** must complete an evaluation **once every three years**.[1] Systems with assets of **at least $30 million but less than $100 million** must complete an evaluation **once**

[1] Section 802.109(k), Texas Government Code. The Houston Firefighters Relief & Retirement Fund, the Houston Municipal Employees Pension System, and the Houston Police Officers' Pension System may submit the investment evaluation reports in their enabling statutes to satisfy the Section 802.109, Texas Government Code requirements.

every six years. Systems with assets **less than $30 million** are **not required**, but are encouraged, to conduct an evaluation. Systems that have not voluntarily completed an evaluation and have assets less than $30 million will be required to complete an evaluation if, as of the last day of their preceding fiscal year, their assets exceed $30 million. Systems completing their first evaluations must conduct a comprehensive review of all invested asset classes while systems conducting subsequent evaluations may select specific asset classes to focus on.

Subsequent Report Applicability

Once a system's assets exceed the specified thresholds in a fiscal year and the system has completed its first IPPE, a subsequent report will be due once every three or six years, according to the PRB schedule and the reporting requirement will continue based on both total assets and **total pension liability.**[2] A system will remain subject to the reporting requirement and specified reporting frequency unless both the total assets and the total pension liability decrease below the minimum amount of the applicable reporting requirement ($100 million or $30 million).

Deadlines

PRB Reporting Schedule

June 1, 2027	**June 1, 2030**	**June 1, 2033**	**June 1, 2036**
Group 1 & 2	Group 2	Group 1 & 2	Group 2
Applicability based on system reports submitted to PRB by **12/31/2026**	Applicability based on system reports submitted to PRB by **12/31/2029**	Applicability based on system reports submitted to PRB by **12/31/2032**	Applicability based on system reports submitted to PRB by **12/31/2035**

For the purposes of determining applicability, only reports submitted by December 31 of the year prior to the PRB Reporting Schedule due dates will be considered. See below for additional detail and examples of applicability of the reporting schedule and requirements for systems subject to an initial or subsequent evaluation. Any IPPE received within one year prior to the scheduled due date will be considered an early submission for that cycle and accepted by the PRB.

<u>Systems that have not completed an evaluation</u>

A report of the first evaluation must be filed with the PRB by the governing body of the system not later than the next scheduled due date, per the PRB Reporting Schedule above, in which the system is either required to perform or conducts a voluntary evaluation. Note that the initial evaluation must include a comprehensive review of all asset classes.

PRB initial report schedule

[2] Section 802.109(j)(2). "'Total pension liability' means the portion of the present value of projected retirement benefit payments to be provided through the retirement system to active and inactive members that is attributable to those members' past periods of service, in compliance with Statement No. 68 of the Governmental Accounting Standards Board."

System Size[3]	Reporting Cycle	Group
Assets at least $30 million but less than $100 million	Every six years	Group 1
Assets at least $100 million	Every three years	Group 2

Example timeline and deadlines for a system with assets that first exceed $30 million during calendar years 2024-2026 or a system that decides to voluntarily complete an evaluation in 2027:

Fiscal Year Assets Exceed $30 Million	Preparation Recommended Start Date	Evaluation Completed to Start Review-and-Comment Process	Final Report to a System's Governing Body	Report Due to the PRB
2024-2026	October 2026	March 2, 2027	May 1, 2027	June 1, 2027

Systems that previously completed an evaluation

Subsequent evaluations must be submitted to the PRB every three or six years depending on applicability as summarized by the schedule group and due by the day specified in the PRB reporting schedule above.

Systems Subject[4]	Reporting Cycle	Group
Assets or net pension liability at least $30 million and assets have not exceeded $100 million in a fiscal year	Every six years	Group 1
Assets or net pension liability at least $100 million	Every three years	Group 2

[3] System size based on any report submitted by December 31, of the year prior to the PRB scheduled due date.
[4] Systems subject based on any report submitted by December 31, of the year prior to the PRB scheduled due date.

Formal review-and-comment process

Trigger of review-and-comment	• The evaluating firm has completed its evaluation and the evaluation report is **substantially completed**. • The evaluating firm submits a substantially completed report to the retirement system's board. • The firm requests the system to review and respond on the report
Governing body response	• The system's board will review the report and create a written response to the firm's request. • A response could include a description of actions the system will take or comments regarding any recommendations or findings in the report.
Firm finalizes report with response	• After receipt of the system's response, the evaluating firm will provide to the system a final report. • A final report by the evaluating firm is the firms completed report including the system's response.
System provides final report to the PRB	• The system will provide the final report to the PRB by the scheduled due date after receiving the final report from the firm.

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Independent firm

*(a) … A public retirement system shall select an **independent firm** with substantial experience in evaluating institutional investment practices and performance…*

*(c) Provides that a public retirement system, in selecting an **independent firm** to conduct the evaluation described by Subsection (a):*

> *(1) subject to Subdivision (2), is authorized to select a firm regardless of whether the firm has an existing relationship with the retirement system; and*
>
> *(2) is **prohibited** from selecting a firm that **directly or indirectly manages investments** of the retirement system.*

Directly or Indirectly Managing Investments

A firm is considered to be directly or indirectly managing investments if the firm, a subsidiary, or its parent company, has assets of the system under management, or is solely responsible for selecting or terminating investment managers.

Restriction on Performing the Evaluation

If a firm is identified as directly or indirectly managing investments of the system, the firm is not considered an independent firm and is not eligible to perform the evaluation.

Required Disclosure by Independent Firm

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

1) a summary outlining the qualifications of the firm in evaluating institutional investment practices and performance;
2) a statement that the firm meets the experience requirements;
3) a statement indicating the nature of any existing relationship between the firm and the system being evaluated;
4) a statement acknowledging that the firm, or its related entities, is not involved in directly or indirectly managing investments of the system;
5) a statement identifying any potential conflict of interest or any appearance of a conflict of interest that could impact the analysis between the independent firm and the system or any current/former member of the system's governing body;
6) 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
7) an explanation of the firm's determination regarding whether to include a recommendation for each of the evaluated matters in the report or a lack thereof.

Governmental Entity's Ability to Cover Evaluation Costs

A public retirement system's associated governmental entity may pay for all or part of the costs of the evaluation. Any remaining cost not covered by the governmental entity shall be paid by the system.

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Components of Evaluation

This section provides suggested questions and topics for consideration under each of the five areas required to be covered in each evaluation.[5] The questions below are intended to help systems identify the types of information an evaluation may include. Additionally, these questions may be helpful to systems that will use a request for proposal (RFP) to select a firm to perform the evaluation.

Each evaluation must include:
(1) an analysis of any ***investment policy or strategic investment plan*** *adopted by the retirement system and the retirement system's compliance with that policy or plan;*

- Does the system have a written investment policy statement (IPS)?
- Are the roles and responsibilities of those involved in governance, investing, consulting, monitoring and custody clearly outlined?
- 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.])
- Is the policy written so clearly and explicitly that anyone could manage a portfolio and conform to the desired intentions?
- Does the policy follow industry best practices? If not, what are the differences?
- Does the IPS contain measurable outcomes for managers? Does the IPS outline over what time periods performance is to be considered?
- Is there evidence that the system is following its IPS? Is there evidence that the system is not following its IPS?
- What practices are being followed that are not in, or are counter to, written investment policies and procedures?
- Are stated investment objectives being met?
- 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?
- Will the investment managers be able to maintain fidelity to the policy under the same scenarios?
- Will the policy achieve the stated investment objectives under the same scenarios?
- 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?

Resources
PRB - Investment Policies

[5] Section 802.109(b), Texas Government Code. The first evaluation "must be a comprehensive analysis of the retirement system's investment program that covers all asset classes" while subsequent evaluations "may select particular asset classes on which to focus."

GFOA - Investment Policies for Defined Benefit Plans

*(2) a detailed review of the retirement system's **investment asset allocation**, including:*
(A) the process for determining target allocations;

- Does the system have a formal and/or written policy for determining and evaluating its asset allocation? Is the system following this policy?
- If no formal policy exists, what is occurring in practice?
- Who is responsible for making the decisions regarding strategic asset allocation?
- How is the system's overall risk tolerance expressed and measured? What methodology is used to determine and evaluate the strategic asset allocation?
- How often is the strategic asset allocation reviewed?
- Do the system's investment consultants and actuaries communicate regarding their respective future expectations?
- 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?
- 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?
- 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?
- How does the asset allocation compare to peer systems?

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

- What are the strategic and tactical allocations?
- What is the expected risk and expected rate of return of each asset class?
- How is this risk measured and how are the expected rates of return determined? What is the time horizon?
- What mix of assets is necessary to achieve the plan's investment return and risk objectives?
- What consideration is given to active vs. passive management?
- 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?
- How often are the strategic and tactical allocations reviewed?

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

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

- Are the system's alternative investments appropriate given its size and level of investment expertise? Does the IPS outline the specific types of alternative and illiquid investments allowed, as well as the maximum allocation allowable?
- What valuation methodologies are used to measure alternative and illiquid assets? What alternative valuation methodologies exist and what makes the chosen method most appropriate?

(D) future cash flow and liquidity needs;

- What are the plan's anticipated future cash flow and liquidity needs? Is this based on an open or closed group projection?
- When was the last time an asset-liability study was performed?
- How are system-specific issues incorporated in the asset allocation process? What is the current funded status of the plan and what impact does it have? What changes should be considered when the plan is severely underfunded, approaching full funding, or in a surplus? How does the difference between expected short-term inflows (contributions, dividends, interest, etc.) and outflows (distributions and expenses) impact the allocation? How does the underlying nature of the liabilities impact the allocation (e.g. pay-based vs. flat $ benefit, automatic COLAs, DROP, etc.)?
- What types of stress testing are incorporated in the process?

Resources
GFOA – Asset Allocation for Defined Benefit Plans

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

- Do the system's policies describe the management and monitoring of direct and indirect compensation paid to investment managers and other service providers? What direct and indirect investment fees and commissions are paid by the system?
- Who is responsible for monitoring and reporting fees to the board? Is this responsibility clearly defined in the system's investment policies?
- Are all forms of manager compensation included in reported fees?
- How do these fees compare to peer group and industry averages for similar services? How are the fee benchmarks determined?
- Does the system have appropriate policies and procedures in place to account for and control investment expenses and other asset management fees?
- What other fees are incurred by the system that are not directly related to the management of the portfolio?
- How often are the fees reviewed for reasonableness?
- Is an attorney reviewing any investment fee arrangements for alternative investments?

Resources
GFOA - Investment Fee Guidelines for External Management of Defined Benefit Plans

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(4) *a review of the retirement system's* ***governance processes related to investment activities****, including investment decision-making processes, delegation of investment authority, and board investment expertise and education;*

Transparency

- Does the system have a written governance policy statement outlining the governance structure? Is it a stand-alone document or part of the IPS?
- Are all investment-related policy statements easily accessible by the plan members and the public (e.g. posted to system website)?
- How often are board meetings? What are the primary topics of discussion? How much time, detail, and discussion are devoted to investment issues?
- Are meeting agendas and minutes available to the public? How detailed are the minutes?

Investment Knowledge/Expertise

- What are the backgrounds of the board members? Are there any investment-related educational requirements for board members?
- What training is provided and/or required of new board members? How frequently are board members provided investment-related education?
- What are the minimum ethics, governance, and investment education requirements? Have all board members satisfied these minimum requirements?
- Does the system apply adequate policies and/or procedures to help ensure that all board members understand their fiduciary responsibilities?
- What is the investment management model (i.e. internal vs. external investment managers)?
- Does the board receive impartial investment advice and guidance?
- How frequently is an RFP issued for investment consultant services?

Accountability

- How is the leadership of the board and committee(s), if any, selected?
- Who is responsible for making decisions regarding investments, including manager selection and asset allocation? How is authority allocated between the full board, a portion of the board (e.g. an investment committee), and internal staff members and/or outside consultants? Does the IPS clearly outline this information? Is the board consistent in its use of this structure/delegation of authority?
- 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?
- Is the current governance structure striking a good balance between risk and efficiency?
- What controls are in place to ensure policies are being followed?
- How is overall portfolio performance monitored by the board?
- How often are the investment governance processes reviewed for continued appropriateness?

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Resources

NASRA - Public Pension Governance

PEW - Making State Pension Investments More Transparent

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

- Who is responsible for selecting investment managers?
- How are the managers identified as potential candidates?
- What are the selection criteria for including potential candidates?
- What are the selection criteria when deciding between multiple candidates?
- How does the selection process address ethical considerations and potential conflicts of interest for both investment managers and board members?
- Who is responsible for developing and/or reviewing investment consultant and/or manager contracts?
- What is the process for monitoring individual and overall fund performance?
- Who is responsible for measuring the performance?
- What benchmarks are used to evaluate performance?
- 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?
- 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?
- What is the process for determining when an investment manager should be replaced?
- How is individual performance evaluation integrated with other investment decisions such as asset allocation and investment risk decisions?

Resources

GFOA - Investment Fee Guidelines for External Management of Defined Benefit Plans

GFOA - Selecting Third-Party Investment Professionals for Pension Fund Assets

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