**COMPTROLLER'S**
**INVESTMENT ADVISORY BOARD MEETING**
**Thursday, October 15, 2020**
***Minutes***

The Comptroller's Investment Advisory Board (the "Board") virtually met at 10 a.m. on Thursday, October 15, 2020, via WebEx.

**Board Members ("The Board") Present**

Laurie Dotter, Jim Hille, Steve Strake, Adolpho Telles, Sam Vinson and Ben Wall.

**Board Members Absent**

None.

**Comptroller of Public Accounts Staff Presiding**

Comptroller Glenn Hegar.

**Texas Treasury Safekeeping Trust Company ("Trust Company") Staff Presenters & Facilitators**

Ruchit Shah, Chief Investment Officer ("CIO"); Anca Ion, Deputy Chief Investment Officer; Comptroller; Whitney Blanton, General Counsel; Spencer Brown, Assistant General Counsel; Jyoti Gupta, Portfolio Manager; Michael Leifeste, Portfolio Manager; Adam Levine, Portfolio Manager; Bradley Davis, Portfolio Manager; David Anderson, Portfolio Manager; Chad Turner, Risk Manager; Nora Arredondo, Program Specialist; and Shantel Geeslin, Program Specialist.

**Additional Participants**

Roger Willis, Asset Consulting Group ("ACG").

**Call to Order**

Comptroller Glenn Hegar declared that a quorum was present and called the meeting to order at 10:00 a.m.

**Approval of Minutes of June 23, 2020 Meeting (Tab 1)**

***A motion was made by Ms. Laurie Dotter to accept and approve the minutes from the June 23, 2020 board meeting. The motion was seconded by Mr. Sam Vinson and unanimously approved by the Board.***

**Economic Outlook, Investment and Review of Treasury Pool (Tab 2)**

Ms. Anca Ion presented a microeconomic update since the last board meeting. She reported that for the second quarter of 2020 the Gross Domestic Product ("GDP") was -32% and the expectation for the third quarter GDP should be approximately 24%. Currently the GDP is tracking in the vicinity of 35%; therefore, the overall GDP for 2020 may be approximately -4%. She reported that most economists and CEOs agreed that the U.S. economy would be in shambles if it were not for the Coronavirus Aid Relief and Economic Security Act ("CARES ACT"). Ms. Ion explained that this is the first time in a recession where personal income had gone up, reportedly at 4.5% for the first half of the year, while wages were down by approximately 5.0%. The increase is believed coming from a significant increase in government transfers. There is a shift in precautionary savings and the personal savings rate has more than doubled the pre-pandemic level. Ms. Ion believes this will have an impact on long-term growth and eventually on the interest rate.

Ms. Ion reported that unemployment was down and now in single digit territory of approximately 8.0% as opposed to 14.5% in March. Currently, more people are applying for unemployment benefits. Since the beginning of the year there have been approximately ten to eleven million jobs lost. Unemployment remains a concern. There is some good news in that the housing market has shown resilience. Inventory is low; therefore, prices are high. A higher demand for housing may stem from all-time low mortgage rates. Ms. Ion believes the economy is slowly recovering but has a long way to go before it gets to levels such as in 2019.

Ms. Ion explained that the Federal Reserve Board (the "Fed") has a new approach to inflation referred to as a flexible average inflation target. Instead of looking at the thematic 2% inflation target, a target average over an unspecified period is considered. The Fed is not expected to raise rates until 2023 and the long-term rate is expected to hover around 2.5%. The Fed continues to purchase mortgages and treasuries and does not have a predetermined date of when they plan to halt purchasing.

Ms. Ion reviewed the Treasury Pool portfolio and reported that the current value of the Pool is approximately $45 billion and produced a yield of approximately .70%. Producing a positive yield in the shorter end of the yield curve is challenging, yet the Treasury Pool has stayed ahead of the Fed yield since 2008. She explained that the Treasury Pool received approximately $6 billion from the CARES Act which is expected to be spent by year end or the use of it must be changed. Ms. Ion noted that commercial papers holdings in the Pool have been decreasing as the supply has been declining and spreads have been unattractively very tight. The commercial paper allocation in the Pool is approximately 10% lower than the previous quarter. Fifty-seven percent of the portfolio composition is comprised of treasuries and commercial paper. Ms. Ion explained that since rates are very low, and spreads are very tight, and supply is limited; options are also in short supply. She believes the plan for the portfolio should be defensive and remain very liquid and extremely cautious going into the fourth quarter. Factors that will probably affect market volatility are the widespread distribution of a vaccine, more stimulus aid and the November presidential election.

Mr. Hille asked if the portfolio is defensive and the supply is so limited, what type of changes if any can be made? Ms. Ion stated that issuance of treasuries at the front end of the yield curve, which is already occurring, can lead to yields competitive with commercial paper.

Mr. Telles asked how will the $6 billion from the CARES Act be spent? Comptroller Hegar addressed the question and explained that a portion has already been spent on COVID expenses. The remaining amount will be in the domain of the Governor's office and legislature. The funds are kept in the Treasury until they are dispensed.

Comptroller Hegar reported on the current Texas budget. The budget went from a $3 billion surplus from the revenue estimate provided to the legislature last session, to a current deficit of approximately $3.5 billion. That does not include the Rainy Day fund or the CARES Act fund. He reported that the Texas economy has performed better than anticipated. He explained that the sales tax revenue is approximately 57% - 60% of all tax collections in the state. In May, the sales tax collection was -13%. In the first six months since the start of the recession and the start of the recovery, the state tax revenue has averaged approximately 6%; therefore, the negativity was not as bad as anticipated. Online sales tax revenue was a large contributor since legislation was passed last session at the recommendation of the Comptroller's office. Comptroller Hegar believes the next legislative session will be a tight budget cycle but believes it is a better scenario than three months prior. Uncertainty of economic conditions remains a concern.

**Capital Markets Overview and Investment Performance Review for the Quarter Ending June 30, 2019, and Related Matters (Tab 3)**

Mr. Roger Willis of ACG presented ACG's view of the economy and market environments. He reported that in the risk markets, the S&P 500 in particular, there has been some recovery off the low points in March. He believes the stimulus package was a big driver in that regard. ACG believes there are three broad factors that will impact near-term economic conditions: 1) the continued spread of COVID-19; 2) a possible second stimulus package; and 3) the Presidential election. They do not believe the elections will have much impact on economic policy. Mr. Willis reviewed the Path to Recovery slide for COVID-19. He noted that although there was a resurgence of the virus in the summer, initial jobless claims decreased and continue to stabilize, although we are at higher than pre-pandemic levels. He reported that ACG polled data providers and money managers, and the majority believe inflation will average approximately 2% over the next decade. ACG views equity as an important part of all three portfolios in driving long-term returns. Mr. Willis reviewed the alternative to equities graph and explained the various opportunity sets and yields.

Mr. Willis reviewed the total portfolio performance summary for the period ending June 30, 2020. He reported that for the second quarter ending June 30, 2020, the total portfolio produced a return of 4.45%, slightly outperforming the benchmark by 74 basis points. The portfolio's annualized return was 4.23%. Relative to broad market benchmarks, the total portfolio generated 78% of the return with 51% of the risk/volatility. Over the last decade, the portfolio outperformed the policy benchmark by 34 basis points but underperformed against the 65/35 benchmark by approximately 130 basis points. He explained that the portfolio is on the lower risk side of the spectrum, having more hedge on equities, and lower interest rate exposure. Although the fixed income asset class produced a .90% return for the quarter and outperformed the fixed income blend by 23 basis points, it underperformed over the one, three and five-year periods. Just the opposite for equities which lagged the equity blend by 32 basis points but outperformed the blend over the one, three and five-year periods. Real assets continued to provide strong relative results longer term, annualizing 123 basis points for the trailing five-year period.

Mr. Willis reviewed the performance for the State Water Implementation Fund for Texas ("SWIFT"). He stated that the portfolio was a more defensively positioned portfolio with a lower return target, with the objective to exceed inflation and distributions while maintaining appropriate liquidity in the portfolio. The portfolio returns have outperformed the dynamic benchmark over the five-year period with similar risk. The portfolio produced a 3.21% return for the quarter and has produced a 3.55% annualized return over the five-year period. The fixed income portion of the portfolio has underperformed over all reported time periods. Volatility strategies have impacted the fixed income portion of the portfolio. The equity portion of the portfolio has performed as expected and has outperformed its benchmark over all reported time periods. The real assets category underperformed its policy benchmark for the quarter but outperformed the benchmark by 117 basis points annualized over the last five-year period. Mr. Willis stated that over the five-year period the portfolio was achieving its target.

Mr. Willis reported that the Texas Economic Stabilization Investment Fund ("TESTIF") portfolio generated slightly higher returns and risk relative to the dynamic benchmark, and slightly lower returns relative to the policy benchmark since inception of September 2015. He explained this is a more conservative portfolio and seeks to earn more than inflation and remain highly liquid. The portfolio produced a return of 2.71% for the quarter and 2.51% since inception.

Mr. Willis and Mr. Shah reviewed the asset allocation of the endowment portfolio material presented behind Tab 3. Mr. Willis stated that the investment objectives were to earn an annual total return that would provide predictable, stable stream of distributions; ensure that the inflation-adjusted value of distributions be maintained over the long-term; ensure that the inflation-adjusted value of the corpus, after distribution and fund expenses, be maintained over the long-term; and achieve the desired portfolio volatility minimizing downside risk through diversification and risk management. He stated that over the ten-year period, the endowment portfolio has met its investment return objective. They explained the current target portfolio against a proposed portfolio which has a 5% increased allocation to private equity and a 5% reduction in real assets. It reduces core and opportunistic in real estate and reallocates to private equity. The results would be a slightly higher return and risk with similar liquidity relative to the current target allocation. Mr. Shah commented that the change in the real estate exposures would be gradual.

**Annual Review of Endowment, SWIFT and TESTIF Investment Policies (Tab 4)**

Mr. Shah reported that there were no proposed revisions to the SWIFT or TESTIF Investment Policies at this time.

He directed the Board to the proposed revisions behind Tab 4. The Trust Company is recommending the elimination of the natural resources section of the policy. He explained that there hasn't been a natural resource allocation for two or three years. Other recommended revisions include increasing the total equity portion of the portfolio from 45% to 50%, which includes increasing the private equity portion from 10% to 15%. By doing so, the real assets portion of the portfolio would decrease from 20% to 15%, which would include that the stable value real estate would decrease from 10% to 7.5% and the enhanced real estate would decrease from 10% to 7.5%. The Board discussed the recommended revisions and reviewed the presentation as set forth in the material behind Tab 4.

***A motion was made by Mr. Steve Strake to recommend to Comptroller Glenn Hegar the proposed revisions to the Endowment Investment Policy as presented by the Trust Company. The motion was seconded by Ms. Laurie Dotter and unanimously approved by the Board.***

**Endowment, SWIFT and TESTIF Portfolio Updates and Related Matters (Tab 5)**

Mr. Shah and the portfolio managers presented an overview of the Endowment portfolio for the second quarter of 2020. Mr. Shah reported that the portfolio was in compliance with its investment and asset allocation policies. He reported that the value of the Endowment portfolio was approximately $3.97 billion which included year to date total distributions to beneficiaries of approximately $2.16 billion. Mr. Shah reported that this quarter marked the end of the portfolio's European and emerging markets over-weights and developed markets tilt in global public equities. The portfolio kept equity exposure in the form of all country world index. Mr. Shah explained that the alternative fixed income portion of the portfolio is being scrutinized, given the market environment. He stated that more opportunities are present in the private equity sector as well as opportunities in specialized sectors such as healthcare. Mr. Shah reviewed the asset allocation summary. He noted that it is a challenge to present all fixed income exposures because of the leverage factor and overlays. Mr. Chad Turner explained how derivative exposure affects the cash reporting of the portion of the allocation. It is important to note that the global fixed income actual allocation is very close to its target when you include all asset and overlays and peel away the derivatives.

Mr. Shah stated the portfolio was approximately 20% liquid and he and his team would like to further examine the portfolio's liquidity and possibly make some recommendations another time, taking into consideration and fully aware of the needs of the beneficiaries and the portfolio.

Mr. Brad Davis reported on the fixed income portion of the portfolio. He explained that since interest rates have been at all-time lows, opportunities are slim. He reported that the duration has increased substantially in recent years. The global fixed income portfolio has 90% the duration of its benchmark and therefore did catch some of the latest declines in rates. Also notable are the recent changes in the longer-term goals of the Fed whereby they are now looking for deviations from maximum employment. Additionally, the Fed has stated its intention to look for average inflation targeting as a methodology. This combination increases the Fed's ability to delay tightening. The Fed now has some willingness to let inflation run modestly above 2%. By their own projections the Fed is expected to meet 2% inflation rate by 2023 and to keep rates low until at least 2023. Mr. Davis explained that the portfolio is trying to out-yield the benchmarks to the extent that is possible in a prudent manner.

Mr. David Anderson reported on the private credit and buyout private equity portion of the Endowment portfolio. Performance in the second quarter was challenging as both the distressed and the special situations portfolio and the performing credit portfolios were marked down. Relative to their benchmarks, the portfolios performed reasonably well. He explained that on the distressed side, many of the investments are in funds that are well diversified by sector and geography, but these diversified funds still were highly affected by the pandemic, such as energy, retail and aviation. He expects there will be pockets of stress in this area for the next few quarters. Mr. Anderson reported that the more income-oriented sleeve of the private credit portfolio has performed reasonably well and has produced positive performance on a one-year basis. Positions in asset-backed specialty lending and in particular, technology lending, have been resilient and have benefitted from the broader economic reopening. He stated that the Trust Co. continues to actively invest in private credit through the pandemic and expects the next few quarters could be an appealing environment for disciplined, distressed and special situations. Although there have been realized losses in energy, Mr. Anderson believes there will be positive improvements in the third quarter.

Ms. Jyoti Gupta discussed the equity portion of the total portfolio: global equity and hedged equity portfolios. She reported that this portion of the total portfolio performed very well, delivering 19% returns with selective managers ranging from 15% - 51% in returns. Two-thirds of the portfolio is exposed to ACWI in a passive manner which helps the portfolio have that long equity exposure but also provides the ability to facilitate a leverage program. The remaining one-third is in active managers. Ms. Gupta reported that during the quarter, several investment opportunities emerged. One strategy of particular interest which emerged from the market dislocation was in healthcare, which she expects to add more exposure to in the global equity portfolio. With the recent changes, narrowing the gap between the global equity portfolio and the benchmark is likely and the goal is to exceed benchmark performance. She reported that the hedged equity portfolio performed well and delivered 17% returns with managers ranging performance from 8% to 63%. Managers increased exposures to technology. She explained that managers were doing well with exposure and continue to improve the up-capture of this portfolio. Ms. Gupta presented a brief recap of the venture portfolio and reported that performance was -1.4% for the quarter versus the benchmark which was down a little over -5.0%. She reported that co-investment opportunities have been robust. Presently the portfolio is invested in six co-investments.

Mr. Mike Leifeste reviewed the information related to real assets. He reported that the industrial sector had done quite well during the pandemic. The multi-family sector is struggling; however, due to a shortage of single-family homes, there is long-term momentum. The commercial office sector remains puzzling. Although most employees are working from home and are not sure of when they will return to an office, short-term leases continue to be signed. Retail space has significantly been impacted by COVID with the exception of grocery anchors. The annual return for the stable value portfolio was 5.1% and 1.7% for the enhanced return. The total real estate portfolio produced an annualized return of approximately 4.0%. Mr. Leifeste noted that allocation to the stable strategy is overweight compared to the enhanced strategy. There were more opportunities in stable, which is less leveraged. Hence there should be less volatility. This should benefit the portfolio over the next few quarters.

Mr. Shah reviewed strategic all asset and overlays portion of the portfolio. He explained that the derivatives exposure is a function of what percentage of the opportunity set in long-only public equity and long-only fixed income are actively managed versus the benchmark. At this point a bit more active management may be added depending on opportunities in fixed income and public equity.

Mr. Chad Turner reviewed the Value at Risk ("VaR") analysis. He reported that as of June 30, 2021, the VaR was 3.6% and slightly higher than the policy VaR of 3.5%. The portfolio risk measured in the long-term basis is a bit riskier than the policy portfolio but quite a bit less risky than the traditional 65/35 portfolio.

Mr. Shah reported that the portfolio returned 2.9% for July and 1.93% for August. Year to date, the rate of return was -1.24%.

Mr. Shah reviewed the SWIFT portfolio and reported that the portfolio was in compliance with its investment policy for the quarter. The portfolio value as of June 30, 2020 was approximately $1.63 billion and produced a 3.2% return for the quarter. The leading performance driver for the quarter was hedged equity. For the quarter, the top performing portfolios were hedged equity and global public equity. The portfolio performance return for July was 1.51%, for August it was 1.58%, bringing in the year to date return of -1.55%. The VaR was 2.2% versus the policy VaR of 1.9%. Mr. Shah reported that the portfolio remained highly liquid and was meeting its investment objectives.

Mr. Shah reviewed the TESTIF portfolio and reported that it was performing as designed by preserving its purchasing power by earning more than inflation. Since inception, the portfolio has returned 2.59% annualized, while earning over $250 million in excess returns over the state's Treasury Pool. During the same period, the portfolio has earned nearly $260 million over inflation. The portfolio remains highly liquid, with over 85% able to be converted to cash within a week.

**Broker/Dealer Update (Tab 6)**

Mr. Spencer Brown presented the current broker/dealer list to the Board. He explained that the Trust Company annually reviews and recommends a broker/dealer list for the Comptroller's signature. That list is then presented to the Board. Policy provides that primary dealers that have been approved by the Fed can be considered and non-primary dealers with Texas offices can also be considered. Fifty-five applicants were invited to participate this year and the results are listed behind Tab 6.

**Discussion of Next Meeting and Agenda Items**

Comptroller Hegar announced that the next meeting would be scheduled for some time in January and will likely be virtual. Ms. Arredondo will be contacting the Board. No future agenda items were suggested.

**Public Comment**

None

**Adjourn**

The meeting adjourned at 12:42 p.m.