COMPTROLLER'S
INVESTMENT ADVISORY BOARD MEETING
Thursday, January 28, 2021
Minutes

The Comptroller's Investment Advisory Board (the "Board") virtually met at 10 a.m. on Thursday, January 28, 2021, via Microsoft Teams.

Board Members ("The Board") Present

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

Board Members Absent

None.

Comptroller of Public Accounts Staff Presiding

Comptroller Glenn Hegar

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

Mike Reissig, Chief Executive Officer; Ruchit Shah, Chief Investment Officer ("CIO"); Anca Ion, Deputy Chief Investment Officer; Genoveva Minjares, Chief Financial Officer ("CFO"); Laura Montoya, Chief Operating Officer ("COO"); 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, Director of Risk and Quantitative Analytics; Brad Davis, Portfolio Manager; Nora Arredondo, Program Specialist; and Shantel Geeslin, Program Specialist.

Additional Participants

Roger Willis, Asset Consulting Group ("ACG"); and Joel Perez and Heath Jackson, RSM & Co., LLP.

Call to Order

Comptroller Glenn Hegar declared that a quorum was present and called the meeting to order at 10:02 a.m.

Approval of Minutes of October 15, 2020 Meeting (Tab 1)

A motion was made by Ms. Laurie Dotter to accept and approve the minutes from the October 15, 2020 board meeting. The motion was seconded by Mr. Adolpho Telles and unanimously approved by the Board.

Presentation of Independent Auditor's Report for the Trust Company (under separate cover)

Mr. Joel Perez summarized the audit reports in the handout and reported that RSM & Company issued an unqualified and unmodified financial audit opinion with respect to the Trust Company for the fiscal year ending August 31, 2020. Mr. Heath Jackson reported that no audit adjustments were recorded during the audit engagement that indicate deficiencies in the accounting process, nor was a management letter issued. The Board had further discussions relating to the audit presentation.

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

Ms. Anca Ion presented an economic update since the last board meeting in October. She reported that since the last meeting there is a new more contagious COVID virus variant sweeping the globe and the rollout of a vaccine had been slower than expected. On a more positive note, the second half of the year engendered more optimism in economic markets with a reopening of the economy and an increase in yields in January. The fixed income market continued to be supported by the Federal Reserve (the "Fed"). The Fed balance sheet reached approximately $7 trillion and is expected to reach $8 - $11 trillion. Interest rates are expected to remain low until most likely 2023. The Fed is expected to continue purchasing treasuries and mortgages at the same pace, $80 billion in treasuries and $40 billion in mortgages. Ms. Ion reported that the economy continues to recover from all-time lows. Currently the GDP for the fourth quarter is approximately 4%, slightly lower than expected. Overall GDP for last year was negative. Significant government support has had a positive impact on personal savings and personal income. Personal spending is near pre-pandemic levels but has not made up for the losses in March and April. Unemployment continues to remain high. The housing market remains strong with all-time low mortgage rates contributing to low housing inventory and the highest home prices since 2004. Ms. Ion explained that the Fed would like to see inflation higher than 2%.

Ms. Ion reviewed the Treasury Pool portfolio and reported that the current value was approximately $44 billion, and the yield was approximately 0.55%. She explained that a significant change from last year is the management of overnight liquidity which is a result of the lack of repurchase agreements (repos) and extremely low or even negative yields. There has also been an increase in activity in cash flows over 2020. Ms. Ion reviewed the Treasury Pool allocation and noted the increased allocation to commercial paper which is another way of managing very short liquidity. As of the end of December 2020, the Treasury Pool portfolio composition was 25% commercial paper, 34% treasuries, 12% agencies, 7% each in asset backed securities and cash equivalents, 6% corporate bonds and 2% other. Ms. Ion explained that portfolio yield is expected to decrease by approximately four basis points a month until July then slow down. She and her team remain diligent in seeking higher yields in this low interest rate environment.

Capital Markets Overview and Investment Performance Review for the Quarter Ending September 30, 2020, and Related Matters (Tab 3)

Mr. Roger Willis of ACG presented ACG's view of the economy and market environment. He reemphasized the role the Fed was taking in stabilizing and influencing financial markets in this low interest rate environment. Over the recent twelve-month period, the 2020 recovery in financial markets has been rapid and has exceeded the pre-pandemic level of equity prices. Mr. Willis explained ACG's outlook for the next decade based on their capital market assumptions. In the near term, the COVID virus, along with the implementation and acceleration of the vaccine, will affect baseline economic recovery. Also, the expectation is that even with economic growth of 5% next year, economic growth will revert to a slower pace of long-term growth. Based on the Congressional Budget's Office data, the estimated growth may be approximately 1.7% over the next several decades. ACG expects interest rates to remain low for a longer period. A key driver to economic recovery will also be the return of employment for many. Unemployment has dropped from 14% to 6% - 7%. Mr. Willis discussed inflation and believes sustainable inflation above 2% in the next decade will be a struggle. ACG also believes inflation will hover around 1.7% taking into consideration the velocity of money being low, unemployment still high, and a high savings rate.

Mr. Willis summarized the information behind Tab 3 relating to capital markets. ACG's capital market assumptions suggest lower returns than the S&P 500 over the next decade. He explained that if the Endowment pool did not have a diversified portfolio as it does, it would be difficult to obtain even a 4% return. With the addition of private assets and assets with more opportunity for appreciation, the Endowment portfolio may produce a return of 5% or higher.

Mr. Willis reviewed the total portfolio performance summary for the period ending September 30, 2020. He reported that for the third quarter ending September 30, 2020, the total portfolio produced a return of 4.76%, modestly outperforming the Endowment policy benchmark by 54 basis points. Relative to broad market benchmarks, the total portfolio generated 74% of the return with 51% of the risk/volatility. Over the last decade, the portfolio outperformed the policy benchmark by 49 basis points but underperformed against the 65/35 benchmark by approximately 94 basis points. He explained that the portfolio is on the lower risk side of the spectrum, having more hedges through hedged equities, and lower interest rate exposure. The fixed income composite significantly lagged the fixed income blend year to date in 2020 by 12.22%, thus contributing to underperformance over the one, three and five-year periods. For the quarter, the fixed income portion outperformed its benchmark by approximately 1.40%. Equity strategies have outperformed over the last ten years. Real assets continued to provide strong relative results longer term, annualizing 92 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 and policy benchmarks over the five-year period with similar returns and slightly lower risk. The portfolio produced a 3.23% return for the quarter and has produced a 4.77% annualized return over the five-year period. Some underperformance is still reflected in the one and three-year periods. Although the fixed income portion of the portfolio produced a 2.03% return for the quarter, it has underperformed over all reported time periods against the benchmark. Volatility strategies have impacted the fixed income portion of the portfolio. The equity portion of the portfolio has fared well relative to the benchmark over the past three and five years. The real assets category outperformed its policy benchmark for the quarter by 4.59% and by 1.76% annualized over the last five years. Overall Mr. Willis believed the portfolio produced sound returns for the quarter.

Mr. Willis explained that the Texas Economic Stabilization Investment Fund ("TESTIF") portfolio is a more conservative portfolio and driven more by rates and credit markets. This portfolio generated slightly higher returns and risk relative to the dynamic benchmark over the past five years, and slightly lower returns relative to the policy benchmark. For the quarter the portfolio produced a return of 0.95%, outperforming both the dynamic and policy benchmarks. Overall, the portfolio produced solid returns on a risk-adjusted basis.

Mr. Willis reported that for the quarter ending December 2020, the Endowment was up 9.25% approximately 200 basis points ahead of the benchmark, SWIFT was up 4.9% and TESTIF was up 1.17%.

The Board continued the discussion into fixed income and alternative fixed income. Mr. Shah stated a further review and analysis of this portfolio will be an agenda item at the next board meeting.

Endowment, SWIFT and TESTIF Portfolio Updates and Related Matters (Tab 4)

At the beginning of the discussion Mr. Hille requested more brevity to the executive summary. Mr. Shah reviewed the summary and noted that there were a few different themes with the new commitments: not a lot of complex strategies, more specialization and more active management. Mr. Shah and the portfolio managers presented an overview of the Endowment portfolio for the third 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 $4.15 billion.

Mr. Shah reviewed the portfolio performance summary and noted that the portfolio did not protect at a desired level in down-capture through the early part of the pandemic. The portfolio did protect very well relative to the 65/35 benchmark but did not protect relative to the policy benchmark. Mr. Shah reviewed the asset allocation summary and noted that the portfolio was underweight in the alternative fixed income strategy. The long-term target for real estate was changed from 20% to 15% and is in the process of reducing real estate exposure. The private equity target allocation changed to 15%. These target changes were recommended to the Comptroller for approval at the previous board meeting.

Mr. Shah stated the portfolio was approximately 20% liquid within three months. He stated that 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 reviewed the fixed income portion of the portfolio and explained that moderate rate increases are important, and that inflation is not expected to get materially higher. Mr. Davis agreed that more work is required in the alternative fixed income strategy. Although yields are low, yield given up quarter over quarter was better than what the benchmark was giving up quarter over quarter.

Mr. David Anderson reported on the private credit and buyout private equity portions of the Endowment portfolio. He reported that the private credit portion of the portfolio had a relatively strong rebound after a difficult first and second quarter. He explained that he will slowly be maneuvering the allocation of performing private credit to an overweight status because he believes the combination of substantial cash yield, excess spread relative to public market fixed income and a lower volatility return pattern than distressed credit, will contribute to a successful investment. He expects volatility to continue for a few more quarters in the distressed strategy since many of the managers have made investments in companies that were highly affected by the pandemic. Mr. Anderson stated he will continue to re-up with the strongest distressed and special situations managers, but opportunities may be underwhelming. For the moment the preference is a range of performing credit strategies from diversified corporate lending to asset-based specialty finance with geographic diversification.

Ms. Jyoti Gupta discussed the equity portion of the total portfolio: global equity and hedged equity portfolios. She reported that global equity was up 10% versus 8% for the benchmark. Performance on a year to date basis for the managers ranged from 3% - 44%. The 3% came from the European long-only strategy which in general lacked broader markets, and the 44% came from a U.S. focused activist manager. She believes performance for the fourth quarter will continue to be strong. Ms. Gupta noted that a healthcare opportunity fund was added and funded in July. Also, the activist strategy was moved to the global equity strategy from the hedged equity strategy. She reported that the hedged equity portfolio performed well at close to 6.0%. Performance from the managers ranged from 3% deriving from China focused long/short strategy, to 16% deriving from European focused industrial investments. Ms. Gupta estimates the portfolio will deliver an approximate 15% return for the quarter versus 11% for the benchmark.

Mr. Mike Leifeste reviewed the information related to real assets. He explained that much of the negative performance in the second quarter was due to an interest rate hedge that one of the managers had. Now much of that negative performance has been reversed. Compared to the industrial sector, the retail sector has been a poor performer. 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. He explained that the portfolio continues to be overweight in residential, much of which is single family rental which has done well. Also overweight in industrial which has also done well. Mr. Leifeste stated he is looking for opportunities in digital real estate and life science. He will continue to remain cautious in the retail and office sectors and heed Ms. Dotter's advice regarding the definition of core and be cognizant of true core exposure.

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. This portion of the portfolio is performing as expected and delivering strong performance with a little bit of leverage in the range of approximately 7.0%.

Mr. Chad Turner reviewed the Value at Risk ("VaR") analysis. He reported that as of September 30, 2020, the VaR was 3.8% 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. Turner stated that a new stress test was added. The Russian Devaluation Crisis was replaced with the 2020 COVID Crisis.

Mr. Shah reported that the portfolio returned 0.81% for October, 5.03% for November and approximately 3.2% for December. The rate of return for the year was approximately 7.77%. Over the three and five-year periods the portfolio is ahead of the policy benchmark.

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 September 30, 2020 was approximately $1.68 billion, up by approximately $50 million from the previous quarter and produced a 3.2% return for the quarter. The leading performance driver for the quarter was hedged equity followed by private debt. The portfolio returned -0.36% for October, 3.32% for November and 1.98% for December, bringing in the year to date return of approximately 3.37%. 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. As of December 2020, the estimated portfolio balance was approximately $1.698 billion. The SWIFT portfolio distributed approximately $772 million as of October 31, 2020.

Mr. Shah reviewed the TESTIF portfolio for the quarter ending September 30, 2020 and reported that it was performing as designed and preserving its purchasing power by earning more than inflation. Since inception, the portfolio has returned 2.54% annualized, while earning over $275 million in excess returns over the state's Treasury Pool. During the same period, the portfolio has earned nearly $245 million over inflation. As of December 31, the TESTIF portfolio returned more than $355 million over the Treasury Pool and earned approximately $290 million over inflation as measured by headline CPI-U. During the fourth quarter the portfolio received another $800 million of inflows. The portfolio remains highly liquid, with approximately 84% able to be converted to cash within a week.

Comptroller Hegar explained that the dollars Texas received from the last COVID bill from Congress for COVID related expenditures is now extended to December 31, 2021 from December 31, 2020. This will help swap out general revenue funding for federal dollars which may lessen the burden on the State's savings account.

Discussion of Next Meeting and Agenda Items

Comptroller Hegar announced that the next meeting would be scheduled for some time in April 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 12:56 p.m.