

Minutes of the July 26, 2023 Comptroller's Investment Advisory Board Meeting

The Comptroller's Investment Advisory Board met on Wednesday, July 26, 2023 at the LBJ State Office Building, 111 E. 17th Street, Room 114, Austin, Texas, 78701.

Board Members present:

Laurie Dotter, Jim Hille, Adolpho Telles and Sam Vinson.

Absent: Katie Hubbard and Ben Wall.

Comptroller of Public Accounts Staff Presiding and Present

Comptroller Glenn Hegar and Associate Deputy Comptroller Tom Currah.

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

Mike Reissig, CEO; Anca Ion, CIO; Laura Montoya, COO; Gena Minjares, CFO; Spencer Brown, Deputy General Counsel; Brad Davis, Sr. Portfolio Manager; Jyoti Gupta, Sr. Portfolio Manager; Adam Levine, Sr. Portfolio Manager; Chad Turner, Director of Risk and Quantitative Analytics; Jacob Price, Sr. Investment Analyst; and Nora Arredondo, Program Specialist.

Additional Participants:

Roger Willis and Joe Nugent; Asset Consulting Group ("ACG")

Call to Order

Comptroller Glenn Hegar declared that a quorum was present and called the meeting to order at 10:06 a.m.

Agenda Items:

1. Approval of Minutes of April 18, 2023, Meeting

On a motion by Mr. Adolpho Telles, and seconded by Ms. Laurie Dotter, the Board voted unanimously to approve the April 18, 2023 proposed meeting minutes as presented.

2. Legislative Update

Spencer Brown reported that the Texas Legislature passed several bills that would directly impact or create new funds for the Trust Company. Senate Bill (SB) 1246 extends the term of commercial paper maturities from 270 to 365 days. It also authorizes the Trust Company to conduct repurchase agreement transactions with the Teacher Retirement System of Texas and other eligible state agencies. The implementation would require revisions to the Comptroller's Investment Policy which will be discussed at the next meeting. Other Senate Bills create funds for the Trust Company to manage. Effective September 1, 2023, SB 1332 creates the Historic Infrastructure Sustainability Trust Fund and SB 1333 creates the Texas State Building Preservation Endowment Fund. Funds that become effective January 1, 2024, pending voter approval in November are SB 28 which creates the Texas Water Fund, SB 2627 that creates the Texas Energy Fund, House Bill (HB) 9 which creates the Broadband Infrastructure Fund, SB 1648 that creates the Centennial Parks

Conservation Fund, and HB 1595 which creates the Texas University Fund (Texas Tech, University of Houston, University of North Texas and Texas State University).

3. Texas Economic Stabilization Investment Fund (TESTIF) Asset Allocation and Investment Policy Review and Vote (handout)

Ms. Ion directed the Board to the proposed revisions recommended by the Trust Company staff for the TESTIF investment policy. She explained the drivers of the recommendations to the policy were twofold: 1) cash allocation lowered from 25% to 10% and 2) the continued growth of the portfolio, in accordance with the objective of maintaining the purchasing power of the assets while ensuring the liquidity with an accepted level of volatility. Based on this, she believes the best asset allocation model was Mix E (handout), it provides the highest expected return with a marginal increase in volatility. She explained that the primary changes to the TESTIF investment policy are introducing the concept of illiquidity and new asset classes. She reviewed the proposed revisions in detail.

On a motion by Mr. Jim Hille, and seconded by Mr. Sam Vinson, the Board voted unanimously to recommend the proposed revisions to the TESTIF investment policy as presented to Comptroller Glenn Hegar for approval.

4. Endowment and State Water Implementation Fund for Texas (SWIFT) Investment Policies Review and Update

Ms. Ion directed the Board to the proposed revisions recommended by the Trust Company staff for the Endowment and SWIFT investment policies, details behind Tab 3. A few minor changes to the Endowment would reflect the addition of two new endowments: 1) the Infrastructure Sustainability Endowment and 2) the Texas Buildings Preservation Endowment. These new endowments will have a distribution policy similar to other endowments that the Trust Company manages at 3.5%, with the exception of the Tobacco Endowment which is 3%.

On a motion by Mr. Sam Vinson, and seconded by Ms. Laurie Dotter, the Board voted unanimously to recommend the proposed revisions to the Endowment investment policy as presented to Comptroller Glenn Hegar for approval.

Ms. Ion continued the discussion with a review of the SWIFT investment policy recommended revisions behind Tab 3. The primary change reduces the allocation to hedged equity by 5% to 20% and increases the allocation to global equity by 5% to 10%. This represents a slight increase in risk parameters, while improving portfolio liquidity.

On a motion by Mr. Adolpho Telles, and seconded by Mr. Jim Hille, the Board voted unanimously to recommend the proposed revisions to the SWIFT investment policy as presented to Comptroller Glenn Hegar for approval.

5. Economic Outlook

Ms. Ion discussed the economy and reviewed the charts behind Tab 4. She explained three narratives in the economic market: inflation, interest rates and the possibility of a recession. Inflation is approximately 3% and is positively trending (lower). Interest rates are expected to continue to rise through the remainder of the year. The market pricing indicates cuts, but Chairman Powell has indicated he does not expect to cut interest rates anytime soon. This divergence continues to be a source of volatility. A recession may be pushed into 2024 and it will probably be mild and shallow. Ms. Ion stated the investment team is staying as close as they can to the strategic asset allocation.

6. Capital Markets Overview and Investment Performance Review for Quarter Ending March 31, 2023 and Related Matters

Mr. Roger Willis presented ACG's view of the economy, market conditions and material behind Tab 5. He reported that overall the economy has performed as expected. The unexpected turn was how the financial markets reacted. He reviewed the key themes for the portfolio noting that the overall approach and process toward portfolio construction is to follow policy, be very strategic, while allowing for only measured/modest changes. Mr. Willis explained that with a high probability of a recession, economic growth after a recession is expected to be slow, not only for the developed but also for emerging markets.

Mr. Nugent reviewed the Endowment, SWIFT and TESTIF performance for the periods ending March 31, 2023, as presented behind Tab 5. He reported that the five-year annualized return for the Endowment portfolio was 7.40%, outperforming the policy benchmark of 6.70% and the 65/35 benchmark of 4.02%. Relative to broad market benchmarks, the Endowment portfolio generated a significantly higher return with less than half of the risk. Despite first quarter underperformance in the broad asset classes, the portfolio has outperformed its policy benchmark and 65/35 benchmark over the one, three, five and ten-year periods.

The SWIFT portfolio outperformed the dynamic and policy benchmarks over the first quarter, and the one, three, and five-year periods. The portfolio returned 1.58% for the quarter and 5.01% over the five-year period. Mr. Nugent explained that the real estate assets in the SWIFT portfolio did not perform as well as in the Endowment. There is a higher allocation to credit-oriented real estate strategies, which are more defensive and unable to produce the returns as in the Endowment. The total portfolio generated higher return and similar risk relative to the dynamic benchmark over the past five years.

The TESTIF portfolio has generated higher return with slightly lower risk as compared to the dynamic benchmark over the last five years. During a challenging broad market environment for fixed income, the portfolio produced positive returns over the last five years and outperformed both the dynamic and policy benchmarks over the trailing one, three and five-year periods. The portfolio slightly lagged its policy benchmark for the quarter, 1.64% versus 1.80%.

7. Treasury Pool Review

Ms. Ion directed the Board back to the information behind Tab 4 and reviewed the Treasury Pool. She reported that currently, the Treasury Pool value was approximately \$85 billion, up \$5 billion or 7% from the previous quarter. The current yield was 4.65%, up 40 basis points since April. The Pool captured approximately 80% of the Fed move, 25 basis points in March and 25 basis points in May. The effective duration was approximately 0.48 years. She noted that the Treasury Pool was expecting approximately \$30 billion to flow out through next summer and her staff is mindful of the liquidity that entails.

8. Endowment, SWIFT and TESTIF Portfolio Updates and Related Matters

Ms. Ion provided an in-depth review of the **Endowment** and its performance for the quarter ending March 31, 2023. The Endowment returned 0.5% for the quarter bringing the one-year trailing to -2.2%. The stronger performance was derived from the global public equity and hedged equity portfolios, up 6.1% and 2.6% respectively. The portfolio lagged the benchmark for the quarter due to underperformance in private equity, but particularly the venture portfolio. Real estate also had some lagging effect. She reviewed asset allocations and noted that the equity asset class was underweight by 2.7%. The allocation target for global public equity has been changed from 15% to 20% and the plan is to add opportunistically as the market allows. Allocations to private equity and real estate continue to decrease and move closer to target ranges. Alternative fixed income will continue to remain underweight as less complex opportunities exist in the high interest rate environment. Ms. Ion reported that assets under management was \$5.11 billion which included an \$85 million distribution from the Tobacco fund. No significant changes to the portfolio.

Ms. Ion asked each portfolio manager to review the strategies they managed.

Mr. Davis reported on the fixed income portion of the Endowment portfolio. Global fixed income outperformed the benchmark slightly. As interest rates rose, the portfolio maintained a slightly lower duration. During the banking crisis in March, rates dropped quickly, and the portfolio faced headwinds in that month, but overall the portfolio did well. Alternative fixed income is experiencing a shift in leadership where in 2022, macro-managers were the leaders and event-driven and relative-value managers were neutral or down. This year, the macro-managers have embraced cautious views and have posted losses as broader markets appreciate.

Mr. Price reported on the private debt portfolio. Across broader direct lending, he explained that the higher rates provide lenders an upper hand in negotiations for terms. On the distressed side, which varies by region, Europe is more recession prone today and therefore has more opportunities than the U.S. He expects plenty of stressed and distressed opportunities within specific sectors, which would differ than the broader market dislocation in 2020.

Ms. Gupta explained that the equity markets in general experienced a strong first quarter despite the Silicon Valley Bank collapse. The global equity portion of the portfolio was up approximately 6% on top of the 10% from the fourth quarter of 2022. She reported that positive performance

was largely driven by hedged funds focused on Europe and technology. The hedged equity portfolio returned 2.6% versus its benchmark's 1.2%. Managers began adding risk in terms of net exposure in the fourth quarter of 2022 and into the first of 2023.

Ms. Gupta reviewed the private equity portfolio. She explained that negative performance was partially due to performance delays in the portfolio companies and effects of the benchmarking. Investors were hesitant to invest in later stage growth of companies. Valuation levels have declined to more historic and pre-COVID averages which allows staff to invest at sensible levels. The buyout private equity portfolio returned -0.3% for the quarter, bringing the one-year performance to 2.6%. The venture capital portfolio generated a -6.1% return for the quarter, derived mostly from post-IPO securities retained within funds and finance companies.

Ms. Ion briefly reviewed the real estate portfolio and stated discussions concerning selling the concentrated single-family rental (SFR) position have been initiated.

Mr. Turner reported no meaningful changes to leverage levels or derivative allocations within strategic all asset and overlays. He reported that for the quarter ending March 31, 2023, the Value at Risk (VaR) for the Endowment portfolio was 3.65% and slightly over the policy VaR of 3.45%, a modest increase from the previous quarter but comfortably below the policy maximum of 4.2%. The portfolio risk measured on a long-term basis is slightly riskier than the policy portfolio, but much less risky than the traditional 65/35 portfolio.

Ms. Ion reported that the Endowment returned -0.01% in April, -0.01% in May and 1.21% in June, bringing the year-to-date return to 1.70%.

Ms. Ion reviewed the **SWIFT** portfolio and reported that the portfolio returned 1.6% for the first quarter of 2023, bringing the trailing one year to 0.8%. The fund's hedged equity, global public equity and private credit portfolios were the leading performance contributors. The portfolio outperformed the benchmark for the quarter by 0.5% and for the year by 100 basis points. The leading performance for the quarter came from hedged equity and real estate. She noted that only marginal changes were made in the allocation of the portfolio. Total assets under management as of June 30, 2023, was \$1.72 billion. She stated that the portfolio is prepared for the liquidity needs from the Water Development Board. The SWIFT portfolio returned 0.33% in April, 0.09% in May and 0.95% in June, bringing the year-to-date return to 2.97% for the year which far exceeded the -3.2% return for the benchmark. Ms. Ion discussed the allocations within the portfolio and noted the cash allocation had decreased after a \$97 million distribution, and the global fixed income allocation had increased and was now slightly above target. Cumulative distributions have totaled \$904 million. The portfolio remains very liquid and with a slight decline in the 0-to-3-month range.

Ms. Gupta reported on equities within this portfolio and stated that portfolio is built with less risk than the Endowment and has outperformed its benchmark for the fourth quarter of 2022 and thus far this year. This portfolio had no dedicated exposure to China or bio-tech funds.

Within the fixed income sector of SWIFT, Mr. Davis reported that some of the more opportunistic managers that tended to have lower duration were replaced with more benchmark-centric managers; therefore, the duration was brought up to 5.5 years versus the 6-year benchmark.

Ms. Ion reviewed the **TESTIF** portfolio for the quarter ending March 31, 2023. She reported that since inception the portfolio delivered 1.8% on an annualized basis which is approximately 40 basis points above the Treasury Pool on an annualized basis and equates to approximately \$700 million. The portfolio was ahead of inflation until last year. As of June, the cash component of the portfolio was approximately 25.5%. The goal is to take that 25% down to approximately 10%. On a monthly basis the portfolio is invested in core fixed income and absolute return strategies. The purchase of treasury notes in the two to five-year range within the absolute return sector has been increased.

Mr. Brad Davis reported TESTIF performance for May was -0.13%, June was 0.07% and July was 0.4%, bringing the year-to-date return to 2.50%. The portfolio remains very liquid and conservative.

9. Alternative Fixed Income Portfolio Review

Mr. Davis presented an overview of the information behind Tab 7 which demonstrates the diversification and balance within the alternative fixed income portfolio. Progress has been made in keeping the overall equity beta in the 0.3% target range or lower which has protected the portfolio from market related stress in 2022. Also, holdings in the Endowment and SWIFT that have higher relative volatility have been reduced. The Endowment, SWIFT and TESTIF portfolios continue to outperform their benchmarks on a cumulative basis. In 2022, the portfolios had strong performance despite volatile equity and credit markets. Global macro strategies provided an effective source of downside protection in stressed markets. Investment strategies have been increased to 12-15 per portfolio over time to help meet objectives and provide diversification. The portfolios have trimmed outsized positions and concentrated managers that may be adding to risk. Considerations going forward include monitoring the portfolios for rebalancing and resizing opportunities, finding low net credit funds with stable beta in stressed markets, the addition of complimentary macro strategies and finding different sources of alpha via further strategy diversification.

10. Next Meeting and Agenda Items

Next meeting will be scheduled for October 2023. No agenda items discussed.

11. Public Comment

No public comments.

Meeting adjourned at 12:35 p.m.