Joint Meeting of the Board of Trustees and Investment Advisory Committee

AUGUST 18, 2015

ERS

Employees Retirement System of Texas

Presented for Review and Approval

DECEMBER 3, 2015

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JOINT MEETING OF THE
BOARD OF TRUSTEES AND
INVESTMENT ADVISORY COMMITTEE
EMPLOYEES RETIREMENT SYSTEM OF TEXAS

August 18, 2015
ERS Auditorium
200 E. 18th Street
Austin, Texas 78701

COMMITTEE MEMBERS PRESENT
Lenore Sullivan, Chair
Robert Alley, Member
Monty Jones, Member
Caroline Cooley, Member
Vernon Torgerson, Member
Laura Starks, Member

COMMITTEE MEMBERS ABSENT
James Hille, Vice-Chair
Ken Mindell, Member

TRUSTEES PRESENT
Brian Ragland, Chair
Frederick E. (Shad) Rowe, Jr., Vice-Chair
Doug Danzeiser, Member
Cydney Donnell, Member
I. Craig Hester, Member
Yolanda M. Griego, Member

ERS STAFF PRESENT
Porter Wilson, Executive Director
Tom Tull, Chief Investment Officer
Paula Jones, General Counsel and Chief Compliance Officer
William Nail, Interim Deputy Executive Director
Tony Chavez, Director of Internal Audit
Robert Kukla, Director of Benefit Contracts
Ralph Salinas, Director of Human Resource
Catherine Terrell, Director of Governmental Affairs
Michael Wheeler, Chief Financial Officer
Kelley Davenport, Executive Office
Pablo de la Sierra Perez, Investments
Leah Erard, Governmental Affairs
Andrew Hodson, Investments
Lauren Honza, Investments
Sharmila Kassam, Investments
Robert Lee, Investments
Betty Martin, Investments
Patti Maugham, Executive Office
Tim Reynolds, Investments
Tanna Ridgway, Investments
Leighton Shantz, Investments
Robert Sessa, Investments
John Streun, Investments
Chris Tocci, Investments
Mary Jane Wardlow, Governmental Affairs
Karla West, Investments
Keith Yawn, Office of Management Support

Anthony Curtiss, Investments
Panayiotis Lambropoulos, Investments
Nicholas Maffeo, Investments
Adriana Ballard, Investments
Lori Blewett, Benefits Communications
Craig White, Investments
Paul Langdale, Investments
Patti Maugham, Executive Office
Rosa Duran-Jaime, Accounting
Beth Gilbert, Internal Audit

ALSO PRESENT
Steve Voss, Aon Hewitt
Kristen Doyle, Aon Hewitt
Mike McCormick, Aon Hewitt
John Claisse, Albourne
James Walsh, Albourne
Billy Charlton, Altius Associates
Jenny Fenton, Altius Associates
James Walsh, Altius Associates
Meredyth Fowler, Office of Speaker Joe Straus

Ms. Lenore Sullivan, Chair of the Investment Advisory Committee for the Employees Retirement System of Texas (ERS), called the meeting to order and read the following statement:

> "A public notice of the Joint Meeting of the Board of Trustees (Board) and Investment Advisory Committee (IAC) containing all items on the proposed agenda was filed with the Office of the Secretary of State at 9:38 am on Thursday, August 6, 2015 as required by Chapter 551, Texas Government Code, referred to as 'The Open Meetings Law.'"

IV. REVIEW AND APPROVAL OF THE MINUTES TO THE MAY 19, 2015 JOINT MEETING OF THE BOARD OF TRUSTEES AND INVESTMENT ADVISORY COMMITTEE

The IAC then took the following action:

MOTION made by Mr. Vernon Torgerson, seconded by Ms. Caroline Cooley and carried unanimously by the members present that the IAC approve the minutes of the May 19, 2015 Joint Meeting of the Board and IAC.

The Board then took the following action:

MOTION made by Mr. Craig Hester, seconded by Ms. Cydney Donnell, and carried unanimously by the members present that the Board approve the minutes of the May 19, 2015 Joint Meeting of the Board and IAC.

V. REVIEW, DISCUSSION AND CONSIDERATION OF INVESTMENT PERFORMANCE

A. Market Overview and Second Calendar Quarter Performance for 2015 – Ms. Sharmila Kassam, Deputy Chief Investment Officer, and consultants Ms. Kristen Doyle and Mr. Steve Voss from Aon Hewitt (Aon) presented the market overview and second calendar quarter performance for 2015. In accordance with the contract for performance evaluation services and Section 3 of the ERS *Investment Policy*, Aon reviews and evaluates, on a quarterly basis, the ERS investment performance as calculated by ERS custodian BNY Mellon.

ERS' investment performance net of fees showed that during the 2015 second calendar quarter, the Total Fund outperformed the Total Fund Policy Benchmark by approximately 65 basis points (bps).

For the quarter, the global equity, global credit, real assets, and absolute return components contributed positive relative value. No asset class detracted from relative performance during the period. The Total Fund outperformed the Total Fund Policy Benchmark by 140 bps over the previous 1-year period.

Ms. Doyle began the discussion of the fund performance and the world market outlook. The U.S. equity markets were basically flat for a period and the international markets were up slightly, showing a reversal of underperformance by non-U.S markets. Most regions suffered losses in local currency terms over the quarter as rising bond yields and worries over Greece's sovereign debt crisis continued.

The unemployment rate fell to a post-crisis low of 5.4%, in April, and non-farm payrolls showed an addition of over 200,000 jobs to the US economy in both April and May. Labor markets continue to be strong. The lower oil price and stronger dollar over the previous year continued to weigh on CPI inflation, which remained below zero**.**

The Federal Reserve (Fed) remained cautious, still citing dollar strength as a drag on import prices and inflation. Despite continuing strong gains to the US jobs market and low unemployment, the Fed argues that meager wage growth continues to create slack in the labor market.

Ms. Doyle discussed the asset allocation and diversity of the Fund. The fund is currently strategically overweight to global public equities. Private equity is at its asset allocation target of 10% of the Fund. Global credit and rates are in transition, but as the rates portfolio is defunded, the credit allocation increases; therefore, on track with the strategic allocation schedule. Private real estate is close to their long-term target of 7% with a current allocation of 6% of the Fund. Private infrastructure is at about 1% relative to its target of 4%.

Ms. Doyle then began the presentation of the ERS Trust performance. The total fund is up 2.7% fiscal year-to-date and the fund has outperformed the policy benchmark over recent periods. Over the one-year period, the global public equity component of the portfolio has added the most value to the relative outperformance, as well as global credit, real assets, and the absolute return portfolio.

The public equity asset class outperformed the benchmark by 2.3% and the overweight in US also added value. Private equity has an Internal Rate of Return (IRR) since inception of 11.3% and has completed ten additional deals in 2015 for almost one billion dollars in additional capital committed. International public equity was up about 0.8% relative to the benchmark for this quarter and almost 2% outperformance for the one-year period.

Global credit has outperformed relative to the high yield index over the quarter and the one-year periods. There was also a strong performance by external managers, Sankaty and BlackRock. The real estate investment trust (REIT) portfolio had a negative performance; the international and domestic components, as well as the externally managed REIT portfolio posted negative returns. However, the private real estate part of the portfolio has an IRR since inception of 12%.

Infrastructure struggled this period, but is positive over the three-year period. In calendar year 2015, Infrastructure has added two additional deals of about $105 million, bringing the committed total to $380 million of the portfolio.

Ms. Doyle briefly detailed the performance of the risk producing component of the portfolio. The absolute return portfolio is benchmarked to the 91-day T-bill plus 4% and has outperformed its benchmark with a performance of 4.6% year to date

Mr. Voss commented about the internal management of ERS. He explained the evolution of asset management over the years. ERS has a competitive advantage due to the majority of internal management of funds and therefore is able to manage net of fees to increase value.

Mr. Doug Danzeiser asked about the overall portfolio and if the consultants found excessive risk or exposure. Mr. Voss stated that there was no excessive risk and that investments continue to be strategically allocated.

There were no questions or further discussion, and no action was required on this item.

B. Review and Consideration of Policy Benchmarks - Ms. Sharmila Kassam, ERS Deputy Chief Investment Officer, presented the review and consideration of policy benchmarks. In accordance with the ERS *Investment Policy*, the investment objective is to achieve overall investment returns over the adopted benchmark. The Total Fund Policy Benchmark is a passive representation of the broad asset classes established asset allocation and adopted in the ERS *Investment Policy*.

Ms. Kassam discussed the interim policy benchmarks and the effectiveness of the current benchmark for each asset class. During transition periods, Aon Hewitt (Aon) recommended best practices for Total Fund Policy Benchmark calculation methodology. Private real estate and private equity have nearly completed the transition to the asset allocation adopted by the Board and is on track to reach their policy allocation at the end of calendar year 2015. She explained that private equity will be weighted at its policy weighting of 10% of the Trust for the policy benchmark beginning September 1, 2015, leaving only private infrastructure and credit with interim target weightings. Private infrastructure will continue to be benchmarked at its actual weight and actual returns, with the difference floated to Global Equities that primarily funds Private Infrastructure.

As discussed at the August 2014 Joint Meeting of the Board and IAC, investments in Credit is being deployed by staff as appropriate market opportunities present themselves; therefore, the target weighting for the policy benchmark has increased on an incremental basis to allow for a three-year transition period from the beginning of fiscal year 2015. The interim target weighting of the policy benchmark for Credit as of fiscal year 2016 is 6% of the Trust that will increase quarterly by 50 bps to reach 8% by the end of fiscal year 2016. Credit is expected to reach the final policy target of 10% of the Trust at the end of fiscal year 2017, subject to market conditions.

Ms. Caroline Cooley asked about the benchmark decisions and if there was a method to the adjustment of the benchmarks. She commented that an effective benchmark should not change every time the asset allocation is changed. Ms. Doyle agreed and said that some plans use an absolute return benchmark as a measure to consistently meet their financial objectives. Ms. Kassam said staff would review benchmarking and report to the Board and IAC on a proposed static benchmark at the December meeting.

Ms. Kassam presented the two proposed revisions to the Trust benchmark policy and one minor change to the *Investment Policy*. The first revision is a change to the global public equity asset class. Currently, it is benchmarked against the MSCI All Country World Index Net (MSCI ACWI) consistent with the asset allocation adopted by the Board and IAC in February 2013. Staff, in consultation with Aon, reviewed the MSCI ACWI benchmark and found that a change to the MSCI ACWI IMI with USA Gross (MSCI ACWI IMI) would be a more accurate benchmark for a non-taxable, US-based investor, like ERS. This benchmark covers 99% of the global investable universe.

Mr. Craig Hester asked if the changes to the benchmark would affect the Incentive Compensation Plan (ICP). Ms. Kassam stated that the changes are prospective for fiscal year 2016 and not retroactive and therefore would not affect the current ICP plan.

The second proposed revision is to change the private equity benchmark from the S&P 1500, a U.S. only benchmark, to the MSCI ACWI IMI, which is consistent with private equity's geographically diversified investment strategy. ERS staff and consultants, Aon and Altius Associates, believe the benchmark should be updated to reflect the current international exposure of 42% (as a percentage of Net Asset Value) and is capped at 50%. The MSCI ACWI IMI is approximately 48% international and incorporates a high number of mid and small cap companies. Staff would maintain the current premium of 300 basis points for Private Equity, creating a benchmark of MSCI ACWI IMI plus 300 basis points.

The final proposed revision was a housekeeping item necessary to keep consistent with the approval at the May 2015 Joint Meeting of the Board and IAC to dissolve the Public Infrastructure portfolio and move the 1% allocation to Private Infrastructure; therefore increasing that allocation from

3% to 4% of the Trust. Ms. Kassam explained the proposed revision is to the Active Risk Budget, Addendum III of the ERS *Investment Policy*, which focuses on defining the tracking error tolerance of public asset classes, needed to be revised to reflect that there is no longer a Public Infrastructure asset class.

The IAC then took the following action:

> **MOTION** made by Ms. Caroline Cooley, seconded by Mr. Vernon Torgerson and carried unanimously by the members present that the IAC approve the proposed revisions to the policy benchmark for Global Public Equity and Private Equity throughout the entire ERS *Investment Policy*, including addendums, and the revision to the Active Risk Budget.

The Board then took the following action:

> **MOTION** made by Mr. Craig Hester, seconded by Ms. Cydney Donnell, and carried unanimously by the members present that the Board approve the proposed revisions to the policy benchmark for Global Public Equity and Private Equity throughout the entire ERS *Investment Policy*, including addendums, and the revision to the Active Risk Budget.

VI. REVIEW, DISCUSSION AND CONSIDERATION OF ERS PRIVATE EQUITY PROGRAM:

A. Market Update and Program Overview - Mr. Craig White, Private Equity Portfolio Manager, and Ms. Sharmila Kassam, Deputy Chief Investment Officer, and consultants from Altius Associates, Mr. Billy Charlton, Partner & US Head, presented the private equity market update and program overview.

Mr. White began the presentation by introducing and then detailing the staff and performance of the private equity portfolio. The Private Equity and Infrastructure Team ("PEI") functions as a single organization, covering Private Equity and Infrastructure. All team members contribute to both asset classes, however Mr. Pablo De La Sierra, Portfolio Manager, is primarily focused on Infrastructure and Mr. White is primarily focused on Private Equity. The team also includes Mr. Davis Peacock, Senior Associate and Ms. Adriana Ballard, Private Equity Analyst.

ERS has determined that, over the long term, inclusion of private equity and debt investments (herein after referred to collectively as "private equity") would enhance ERS' expected portfolio investment characteristics. At the Joint meeting of the Board and IAC on August 19, 2008, the Board approved a target allocation of 8% for private equity. Subsequently, at the February 26, 2013 Joint Meeting of the Board and IAC, the Board approved an increase to the private equity allocation from 8% to 10% of the Trust's assets.

Mr. White discussed the diversification of the portfolio. The geographic diversification is weighed heavily towards the U.S. and the international exposure, is capped at 50%. The private equity portfolio is balanced across geographies and strategies with larger exposures to more established markets of the US and Europe and Buyouts, Growth Equity/Venture Capital, and Special Situations.

Mr. White explained the J-curve effect as he illustrated the private equity portfolio performance. The J-curve effect is a representation of an early stage of the investment and it would show a negative internal rate of return (IRR). The initial negative performance is due to the cost of the investment and possibly other management fees; it is not indicative of a negative performance. When the investment exits the J-curve positive results can be seen as returns.

Mr. White went on to describe the net asset value (NAV) of the fund. Since inception through June 30, 2015, ERS has closed on 65 private equity funds and 19 co-investments with commitments totaling $5.6 billion (adjusted for currency exchange rates). Since inception through June 30, 2015, cash distributions total $1.4 billion, $520 million of which came in the past calendar year. The ERS Private Equity portfolio has committed $4.7 billion in fiscal year 2014 since inception and held a NAV of $2.7 billion as of June 30, 2015. This represents an increase of $636 million in NAV over the previous year, raising the private equity exposure from 8.9% to 10.4%. The private equity allocation has reached its targeted 10% allocation.

As of June 30, 2015, private equity has produced a Total Value to Paid In Capital ("TVPI") of 1.26x, Distributed to Paid in Capital ("DPI") of 0.44x, and an IRR of 11.6% since inception.[1] The average age of ERS' active commitments is 3.2 years and the average age of underlying investments is 2.7 years.

As of March 31, 2015 ERS' private equity portfolio holdings consisted of 571 portfolio companies (not including underlying investments in fund of funds vehicles) with an unrealized value of 1.1x cost and a TVPI of 1.27x cost. Since 2007 through March 31, 2015, ERS has returned 2.5x cost (based on estimated fees) on its realized portfolio company investments.

Ms. Cydney Donnell asked about the exit side of the market. Mr. Charlton, from Altius, replied that the US markets have been very active in the exit side and there have been more distributions than capital drawn. Primarily exits are strategic through corporations with large cash balances buying a lot of the private companies. There has been less investment from the private equity side, so there is an issue about calling down capital quickly. Right now most funds are not calling down as quickly as they expected and a couple of the committed funds in this portfolio have actually delayed starting the fund for a period of time because capital commitments are not needed at this time.

Mr. Shad Rowe commented that more money is going out than coming in and was concerned about reinvestments and IRR reports. Mr. White replied that the goal is trying to pace the commitments and when they are funded. Staff balances the cash flow, but being able to stay in the market and dollar cost average across cycles is where the best returns are seen. Ms. Donnell says that they would like to see a worst case scenario regarding liquidity of private equity because it is an illiquid asset class. Mr. Craig Hester inquired about the liquidity report in December and Ms. Kassam replied that it will be reported in the December meeting.

Mr. Rowe continued to express concern with the private equity class. Mr. Tom Tull, ERS Chief Investment Officer, explained that the Trust is well diversified, which reduces risk, and stress tests are regularly performed for each asset class of the Trust.

Mr. White continued the presentation and discussed savings through negotiations. Through June 30, 2015, ERS PEI staff have executed 19 private equity co-investments (not including five Infrastructure co-investments), four of which closed in fiscal year 2015. The nineteen deals account for $193 million invested capital and $84 million in estimated fee and carry savings. He discussed how the private equity team and legal team conserves Trust funds through negotiation of economic terms in deals. These negotiations have led to an estimated $115 million in total savings, of which $17.9 million has been realized to date.

$1.4 billion of committed capital has gone into funds in which ERS bilaterally negotiated reduced management fees and carried interest (fee offsets and waterfall parameters are an economically important part of negotiations as well, but ERS is not currently able to track the impact). As with co-investments, the realization of the total savings will depend on the ultimate outcome of the funds and the resulting carried interest savings.

Mr. Charlton presented an overview of the private equity market. IPOs have been strong for a lot of private equity investors and have exceeded capital called for a lot of general partners across the globe. Distributions have also been very strong this past year. As a result, fundraising has increased to pre-crisis levels. The U.S. buyout market has been very active the last two years in buyout funds, along with the exit, venture and growth markets. One of the challenges to private equity is that assets are priced very highly, and managers have to adopt strategies that remedy that issue, such as add-ons.

Mr. Charlton concluded his presentation with a look at the international private equity market. Europe is struggling to deploy capital over the next 18 months. The expectation is that after that time

[1] TVPI = (NAV + Distributions) / Paid in Capital
DPI = Distribution / Paid in Capital

some of the growth will increase as opposed to the most recent flat performance. There was previously growth in the Asia market, but growth in China has slowed due to recent devaluation. Japan is showing more opportunities and is becoming more attractive.

There were no questions or further discussion, and no action was required on this item.

B. Proposed Revisions to the ERS Investment Policy, Addendum I: Private Equity Policies and Procedures - Mr. Craig White, Private Equity Portfolio Manager, and Ms. Sharmila Kassam, Deputy Chief Investment Officer, presented the proposed revisions to the ERS Investment Policy for Addendum I, Private Equity Policies and Procedures. Per Section 2.3 of ERS' Investment Policy, ERS staff shall review and recommend changes to the Investment Policy. As a result of the annual review, ERS staff has determined that it is appropriate to revise one area of the Private Equity Policies and Procedures at this time.

Mr. White stated that the first change would be the change of the current benchmark, S&P 1500 with a 300 basis point premium, to the MSCI ACWI IMI benchmark. Also, reference to the peer benchmark database needs to be deleted as it is now discontinued. ERS Staff and Consultant are conducting a review of the two leading Private Equity peer comparison databases and will contract the optimal database beginning in Fiscal Year 2016.

Below is a detailed look at the proposed revisions from Section I.C.1 Total Return (Realized and Unrealized Gain/Loss Plus Income):

> "Over the long-term (rolling 10-year periods) the private equity portfolio is expected to generate a minimum time-weighted return of the ~~S&P 1500 Index~~ **MSCI ACWI IMI** plus 300 basis points, net of all investment management fees and expenses. ERS will also measure the portfolio employing a dollar-weighted, internal rate of return (IRR) calculation. **The portfolio and individual investments will be benchmarked against peer universe databases as recommended by Private Equity Staff and Consultant and as available.**

The IAC then took the following action:

MOTION made by Mr. Bob Alley, seconded by Mr. Vernon Torgerson and carried unanimously by the members present that the IAC approve the proposed revisions to the ERS Private Equity Policies and Procedures.

The Board then took the following action:

MOTION made by Ms. Yolanda Griego, seconded by Mr. Doug Danzeiser, and carried unanimously by the members present that the Board approve the proposed revisions to the ERS Private Equity Policies and Procedures.

C. Proposed Private Equity Annual Tactical Plan for Fiscal Year 2016 - Mr. Craig White, Private Equity Portfolio Manager, and Ms. Sharmila Kassam, Deputy Chief Investment Officer, presented the proposed Private Equity Annual Tactical Plan for Fiscal Year 2016. In accordance with ERS' Private Equity Policies and Procedures, Section III.A.2, staff is charged with preparing and presenting to the Board for its review and approval an Annual Tactical Plan ("Plan"). The Plan reviews the current status of the private equity portfolio, recent historical and prospective, market conditions and proposes steps to be taken over the next year to implement the private equity program.

Mr. White discussed the goals for the tactical plan. Staff will be targeting six to ten new fund commitments and opportunistic co-investments in strategies, including buyouts, turnaround/restructuring, growth equity, venture capital, energy and media and communications. Additionally, staff recommends that the Private Equity Annual Tactical Plan for Fiscal Year 2016 target a commitment of $950 million (with a range of +/- 25% or $712.5 - $1,187.5 million). Geographic focus will principally be in the US, Europe and Asia. The Fiscal Year 2016 Tactical Plan has been reviewed by and is supported by ERS' private equity consultant, Altius Associates.

Mr. Craig Hester asked if the new tactical plan kept the asset class within the 12% ceiling. Ms. Kassam replied that the allocation is in line with the growth of the Trust and that the tactical plan is a guideline, but caps and limits are defined policy constraints set by the Board.

Mr. Shad Rowe inquired as to why the Board and IAC votes to approve the tactical plan. Ms. Kassam replied that the purpose is to give the Board clarity of investment staff's strategy. Because capital is deployed and most commitments will be made at an Internal Investment Committee, the Board is able to have oversight through reporting from staff, but the policies and procedures in conjunction with the tactical plan serve as guidance. Mr. White also reiterated that the tactical plan does not replace prudent investment decisions and that only deals that align with the interest of ERS are recommended.

The IAC then took the following action:

MOTION made by Mr. Bob Alley, seconded by Mr. Vernon Torgerson and carried unanimously by the members present that the IAC approve the ERS Private Equity Annual Tactical Plan for Fiscal Year 2016.

The Board then took the following action:

MOTION made by Mr. Shad Rowe, seconded by Mr. Doug Danzeiser, and carried unanimously by the members present that the Board approve the ERS Private Equity Annual Tactical Plan for Fiscal Year 2016.

VII. REVIEW, DISCUSSION AND CONSIDERATION OF HEDGE FUND PROGRAM:

A. Market Update and Program Overview - Mr. Robert Lee III, Director of Hedge Funds, Mr. Anthony Curtiss, Hedge Fund Portfolio Manager and consultants, Mr. John Claisse, CEO of Albourne and James Walsh, Head of Portfolio Group of Albourne presented the market update and program overview of the ERS Hedge Fund program.

Mr. Lee began by explaining the two hedge fund portfolios and the hedge fund staff. At the August 19, 2008 Joint Meeting of the Board and the IAC, the Board adopted an asset allocation plan that included investing 5% of the Trust's assets in hedge funds via an Absolute Return Portfolio. At the February 26, 2013 Joint Meeting of the Board and the IAC, the Board adopted an asset allocation plan that provides for the use of hedge funds across asset classes. Hedge fund staff also includes Mr. Nicholas Maffeo, Hedge Funds Analyst, and Mr. Panayiotis Lambropoulos, Hedge Funds Portfolio Manager, who started with ERS on March 16, 2015.

Mr. Curtiss presented an overview of the hedge fund program, beginning with a look at the Absolute Return Portfolio performance. Absolute Return Portfolio is the risk-reducing hedge fund portfolio to the Trust. Relative value, macro, event driven, equity long/short, and opportunistic are the five strategies that staff allocates to Absolute Return Portfolio.

The Absolute Return Portfolio has exceeded return expectations in fiscal year 2015 through May 29, 2015 with returns of 5.13% versus the benchmark return of 3.06% over the same period. As of June 30, 2015 (based on May 29, 2015 NAV), the ARP stood at $1,284.8 million or 4.9% of total Trust assets.

Included in the Real Estate portfolio is a hedge fund that follows a long/short REIT strategy. The allocation, as of June 30, 2015 (based on May 29, 2015 NAV) stood at $94,107,937 or 0.4% of Trust assets. Additionally, the Credit portfolio utilizes a hedge fund that follows a credit-oriented event strategy. The allocation, as of June 30, 2015 (based on May 29, 2015 NAV) stood at $97,649,410 or 0.4% of Trust assets. Both of these allocations are managed internally and by the asset class to which they belong. The hedge fund team assists in ongoing due diligence.

Mr. Lee explained the fiscal year 2015 hedge fund performance has been generally positive, but low as evidenced by the family of HFRI Fund of Fund (HFRI FoF) Composite Indices. The HFRI FoF

Conservative Index returned 3.51% over the fiscal year, while the HFRI FoF Strategic Index returned 6.12%. The HFRI FoF Composite returned 5.44% over the same period. The HFRX Global Index returned 1.07% over FY2015 through May 29, 2015, while the HFRX sub-indices returns ranged from 6.87% for macro to -4.95% for event driven over the same period; however, this is not a representation of ERS' experience over the year. ERS' sub-index returns each beat the associated HFRX sub-index, and the Absolute Return Portfolio and directional growth portfolios exceeded general index returns over the period.

Mr. Lee discussed attribution. Attribution for each of the sub-strategies has been positive for fiscal year-to-date and inception-to-date periods. The primary sources of return for the Absolute Return Portfolio have come from the strategy over weights to both event driven and relative value strategies with annualized attribution of 2.68% and 2.24%, respectively. While the attribution from each sub-strategy in the Absolute Return Portfolio has been positive since inception, it has also been largely uncorrelated to the other sub-strategies. Sub-strategy outperformance is driven by positive manager selection alpha, whereas the total portfolio outperformance is driven by both manager selection and strategy selection.

Mr. Curtiss discussed the performance of the directional growth portfolio. The directional growth portfolio is currently comprised of a single allocation to Marshall Wace World 150/50. The Directional Growth Portfolio has exceeded return expectations in fiscal year 2015 through May 29, 2015 with returns of 15.6% versus the benchmark return over the same period of 9%. As of June 30, 2015 (based on May 29, 2015 NAV), the Directional Growth Portfolio stood at $308.4 million or 1.2% of total Trust assets.

Mr. Lee concluded the ERS portion of the hedge fund program. Staff will pursue new mandates for the Hedge Fund Select Pool for the Absolute Return portfolio to tactically change strategies and managers as needed. The hedge fund team will continue to assist other asset classes and develop the Directional Growth Portfolio, as further discussed in the following Hedge Fund Tactical Plan agenda item. Due to negotiations by the hedge fund team with the assistance of legal staff, the hedge fund program has a fee savings of $21.4 million since inception and $6.6 million fiscal year-to-date through June 2015.

Mr. Claisse gave brief comments about the ERS Hedge Fund program and then handed the presentation over to Mr. Walsh. Mr. Walsh discussed the past performance of the portfolio and the outlook of the hedge fund market. The strategic outlook of the hedge fund market is challenging and risk has increased. However, there is more alpha appearing, which coincides with the Fed conclusion of quantitative easing. In disruptive environments, macro strategies have historically performed well, and the portfolio should shift away from strategies with more beta, which inherently have more risk.

Mr. Claisse concluded the presentation by reporting on trends in the industry. The lines between traditional hedge funds and private markets continue to blur. Less liquid investments and co-investments continue to be favorable. The ability to form strategic relationships with some of the hedge fund managers and access to attractive positions has reached a threshold as commingled vehicles are able to do that with even lower fees.

Mr. Claisse also discussed the transparency of the hedge fund program, which allows the team to track underlying risk and exposure from managers. Finally, he touched on liquid alternatives which have been the focus of many retail investors in terms of the major capital flows.

Ms. Donnell asked if the managers use an investment technique of buying securities that are not traded and if the contract limits what the manager can do in terms of illiquid assets. Mr. Lee replied that there are limits on managers, even if they just trade illiquid securities. The hedge fund team tries to incorporate creative strategies that can generate good returns, but they still constrain the manager's ability to trade based upon their expertise.

Staff is recommending no changes this year to the Hedge Fund Policies and Procedures.

There were no questions or further discussion, and no action was required on this item.

B. Proposed Hedge Fund Annual Tactical Plan for Fiscal Year 2016 - Mr. Robert Lee III, Director of Hedge Funds, and Mr. Anthony Curtiss, Hedge Fund Portfolio Manager, presented the proposed Hedge Fund Annual Tactical Plan. In accordance with the *Hedge Fund Program Policies and Procedures*, Section II.E.5, staff is charged with preparing and presenting an Annual Tactical Plan (Plan) to the Board for its review and approval. The Plan is intended to be a planning document and a reference guide and is not intended to overrule prudent hedge fund investment decision-making.

Mr. Curtiss explained staff will continue to monitor and find ways to increase the performance of the two hedge fund portfolios. The Absolute Return Portfolio will continue to be a risk reducing portfolio to the Trust, the directional growth portfolio will be return seeking, and the team will continue to seek allocations into other asset classes.

Mr. Lee explained that under the proposed plan, staff will target up to four new hedge fund commitments, as well as additions to and the replacement of current managers, as prudent. Geographic focus will not be constrained and may include US, Europe, Asia, and/or other Emerging Markets. Additional allocations may be made to existing managers. The Absolute Return Portfolio will rebalance as necessary to remain a 5% total allocation for the Trust.

The proposed Hedge Fund Tactical Plan for Fiscal Year 2016 has been reviewed by and is supported by ERS' hedge fund consultant, Albourne Partners.

The IAC then took the following action:

MOTION made by Mr. Bob Alley, seconded by Mr. Vernon Torgerson and carried unanimously by the members present that the IAC approve the ERS Hedge Fund Program Annual Tactical Plan for Fiscal Year 2016 to be added as an appendix of the ERS Hedge Fund Program Policies and Procedures.

The Board then took the following action:

MOTION made by Mr. Shad Rowe, seconded by Mr. Doug Danzeiser, and carried unanimously by the members present that the Board approve the ERS Hedge Fund Program Annual Tactical Plan for Fiscal Year 2016 to be added as an appendix of the ERS Hedge Fund Program Policies and Procedures.

VIII. REVIEW, DISCUSSION AND CONSIDERATION OF EMERGING MANAGER PROGRAM:

A. Market Update and Program Overview - Ms. Sharmila Kassam, Deputy Chief Investment Officer, presented the review of the Emerging Manager program. Emerging managers are defined by the Texas Legislature as private professional investment managers with assets under management of $2 billion or less.

Ms. Kassam presented the background of the Emerging Manager program. At the February 2014 Joint Meeting of the Board and IAC, the Emerging Manager Program Policies and Procedures was presented and approved by the Board. As of June 30, 2015, ERS had total plan assets of $25.9 billion with approximately 2/3 of plan assets internally managed and 1/3 of plan assets externally advised/managed. Of the $9.8 billion that is externally advised/ managed, approximately $891 million (approximately 9%) has been invested or committed to emerging managers.

Ms. Kassam explained that the Emerging Manager program focuses on identifying and developing emerging managers and uses the ERS Emerging Manager Team, ERS External Advisor Website and managers of emerging managers to assist in accomplishing this goal. ERS also engages in outreach at industry conferences and through strategic partnerships.

ERS began its initial efforts with emerging managers in Global Public Equity, Private Equity and Private Real Estate in 2010. Ms. Lauren Honza initially served as the Emerging Manager Program Director, where she coordinated between the internal asset class teams and emerging managers, as well as the industry outreach efforts to successfully establish the Emerging Manager Program. Ms. Honza continues to oversee the allocation to emerging managers as part of the Global Public Equity External Advisor Program.

Currently, representatives from each asset class manage the emerging manager efforts and are part of the overall ERS Emerging Manager Team under the guidance of Ms. Kassam. This integrated approach with each asset class incorporates the Emerging Manager program into the Investment Program. The daily tasks for emerging manager meeting requests and industry outreach are currently supported by Ms. Karla West, the Emerging Manager Program Coordinator.

ERS utilizes managers of emerging managers as they have demonstrated to have the resources, experience, relationships, and industry knowledge to identify and evaluate emerging managers. ERS currently uses the following managers of emerging managers: GCM Grosvenor, Oak Street Real Estate Capital, Legato Capital Management and Leading Edge Investment Advisors.

Ms. Kassam explained the outreach efforts for emerging managers. ERS and the Teacher Retirement System of Texas (TRS), together with sponsor Grosvenor, held the *2015 Texas Emerging Manager Conference* in Austin. This event had over 700 investment professionals from all over the United States and internationally, representing various asset classes. The 2016 Emerging Manager Conference is scheduled for January 13, 2016. In addition, the *Third Real Estate Emerging Managers Summit ("REEM Summit")* hosted by ERS, TRS and Oak Street Real Estate Capital will be held on January 14-15, 2016 in Austin. The REEM conference in 2014 was very successful and sold-out with 170 participants.

ERS staff has attended the major industry emerging manager conferences to share insight into ERS' Emerging Manager Program and to also keep up to date on industry developments. ERS continues to seek out industry strategic partners who can provide insight and access to smaller, newer, and more diverse managers. These industry strategic partners include: The Robert Toigo Foundation (Toigo), Sponsors for Educational Opportunity (SEO), New America Alliance (NAA), and Association of Asian American Investment Managers (AAAIM), National Association of Investment Companies (NAIC), National Association of Securities Professionals (NASP) and RG and Associates.

Ms. Kassam presented the current allocation to the Emerging Manager Program. As of June 30, 2015, ERS had $891 million (currently 9% of the Trust) invested or committed with emerging managers, which is in line with moving towards the 10% target of the Trust, as outlined in the *Emerging Manager Program Policies and Procedures* and *Tactical Plan*.

Ms. Kassam concluded the presentation by discussing highlights and continued initiatives for the Emerging Manager Program.

There were no questions or further discussion, and no action was required on this item.

B. Proposed Emerging Manager Annual Tactical Plan for Fiscal Year 2016 - Ms. Sharmila Kassam, Deputy Chief Investment Officer, presented the proposed emerging manager annual tactical plan for fiscal year.

Ms. Kassam discussed details of the fiscal year 2016 Emerging Manager Tactical Plan. The Tactical Plan attached to the Emerging Manager Program Policies and Procedures was presented and approved at the February 2014 Joint Meeting of the Board and IAC. Since December 2013, staff has committed an additional $366 million, which leaves ERS approximately $100 million away from the program's $1 billion target across asset classes.

Ms. Kassam recommended no revisions to the Emerging Manager Policies and Procedures. Regarding the Tactical Plan, staff plans to determine a more efficient structure for the Global Public Equity program managers of emerging managers, Legato and Leading Edge. Private Real Estate staff is considering a second allocation to a fund of fund that may source emerging managers. Additionally, Private Equity completed a second mandate to their manager of emerging managers and consultant, Grosvenor.

The IAC then took the following action:

MOTION made by Mr. Vernon Torgerson, seconded by Mr. Bob Alley and carried unanimously by the members present that the IAC approve the Emerging Manager Program Annual Tactical Plan for Fiscal Year 2016.

The Board then took the following action:

MOTION made by Mr. Doug Danzeiser, seconded by Mr. Craig Hester, and carried unanimously by the members present that the Board approve the Emerging Manager Program Annual Tactical Plan for Fiscal Year 2016.

IX. ELECTION OF CHAIR AND VICE CHAIR OF THE ERS INVESTMENT ADVISORY COMMITTEE FOR FISCAL YEARS 2016 AND 2017

Mr. Tom Tull, Chief Investment Officer, presented the election of the Chair and Vice Chair of the ERS IAC. The IAC, consists of at least five and not more than nine members. These members are selected based upon experience in the management of a financial institution or other business in which investment decisions are made, or as a prominent educator in the field of economics or finance. IAC members serve staggered three-year terms at the pleasure of the Board.

In accordance with Section 4.3 of the ERS Investment Policy, the IAC selects a Chair and Vice Chair from its members for a two-year term as liaison to the Board and preside over IAC meetings. Mr. Tull recommended Mr. Jim Hille be elected Chair and Ms. Caroline Cooley be elected Vice Chair.

The IAC then took the following action:

MOTION made by Mr. Vernon Torgerson, seconded by Mr. Bob Alley and carried unanimously by the members present that the IAC approve the election of Chair and Vice Chair of the ERS IAC for fiscal years 2016 and 2017.

X. ADJOURNMENT OF THE INVESTMENT ADVISORY COMMITTEE AND RECESS OF THE BOARD OF TRUSTEES

The August 18, 2015 Joint Meeting of the ERS Board and IAC adjourned at 12:15 pm.