

Pennsylvania Public Pension Management and Asset Investment Review Commission

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Ashbel C. Williams, Executive Director & Chief Investment Officer

Florida State Board of Administration (SBA)

- I. While we have separately provided a summary intro to the SBA, I believe that sharing SBA's mission & vision statement and a high level view of the potential benefits of an effectively managed centralized investment function will help you conceptualize the issues you are weighing.
 - a. Our mission is to provide superior investment management and trust services by proactively and comprehensively managing risk and adhering to the highest ethical, fiduciary and professional standards. Our vision is to be the best public sector investment and administrative service provider while exemplifying the principles of trust, integrity and performance.
 - b. As Executive Director & CIO, my priority is to build and maintain our organization's team, culture, reputation, credibility and resources at a strength that empowers mission and vision fulfillment. This is consistent with the Trustees' delegation of authority to the Executive Director & CIO. Our most visible output is investment results, the goodness or inadequacy of which is readily seen. What is less visible is the team building, policy and strategy formation, risk management and execution. If the team, culture, processes and resources are right, the probability of investment outcomes that earn trust, enhance the SBA's reputation and build brand value is vastly enhanced. The result is a virtuous cycle where our credibility and performance help garner critical policy support from key SBA stakeholders (Trustees, Legislature, local governments, beneficiaries, taxpayers, media, etc.), which in turn, positions us as a serious, stable, and desirable investment partner in the marketplace. This enables us to build well-aligned relationships with other exceptional organizations and capture superior deal flow with more favorable terms and pricing, driving the performance that earns trust, enhances reputation and builds brand value. I make it my business to ensure that the SBA executes effectively at all levels of this cycle.
- II. Considerations relating to consolidation of state investment activities
 - a. Ability to manage multiple mandates - The specialized human and other resources associated with successfully formulating, implementing and sustaining investment policies and strategies are substantial and can be levered to manage multiple investment mandates or programs. Significant economies of scale will likely be captured.
 - i. Investment policy statements and portfolio guidelines can be customized as appropriate for various "clients", exactly as private asset management firms serve multiple clients. Providing investment services does not require managing the programs whose assets are being managed.

- ii. Top management, portfolio management, legal services, risk, compliance, portfolio accounting support and custody for the various mandates can be centralized.
- b. Fiduciary focus, professional competence, prudence and a long term perspective are requirements. Good investment organizations are meritocracies; interests must be aligned, excellence rewarded and deficiency dealt with.
- c. Successful pension systems share three characteristics, reasonable benefits, responsible funding and prudent investment. We are focusing here only on the investment side, but if benefits or funding are imprudently managed, there are ramifications for investment policy.
 - i. Investment returns can be thought of as “rents on capital”; the highest rents are commonly paid on capital that is willing to tolerate illiquidity, volatility or both. Assets reflecting these traits include, in descending order of expected return, venture capital, private equity, public equity, real estate, private debt, public debt and cash.
 - ii. A pension funds ability to maximize returns by investing in asset classes that pay high “rents” can be constrained if funding status is sufficiently weak that the risk of short term market adversity could impair the ability to timely meet benefit obligations.
 - iii. History clearly shows that the most common cause of acute and or chronic pension underfunding is not poor investment results or excessive benefits, it is the failure of plan sponsors to make actuarially indicated payments. The fix for this is funding. The notion of taking on more investment risk to earn one’s way out of underfunding is imprudent and fraught with peril.
 - iv. Florida’s constitution requires annual full funding of the FRS’s actuarial normal cost. Generally speaking, the legislature has been very responsible on funding and provided for reasonable benefits. The SBA has invested prudently and met long term objectives.
- d. Risk management and oversight must earn the confidence of stakeholders. The amounts of money involved and consequences of failure are such that earning and maintaining credibility is critically important. SBA combines the risk oversight business models of private asset management firms and public investment organizations to provide a “belt and suspenders” approach including:
 - i. Independent Audit Committee – appointed by SBA Trustees, meets publicly no less than quarterly
 - ii. Investment Advisory Council - appointed by SBA Trustees, meets publicly no less than quarterly
 - iii. Chief Risk & Compliance Officer, leads risk and compliance team.
 - iv. Chief Audit Executive, leads internal audit team
 - v. Inspector General, takes lead on any allegations of impropriety and conducts investigation as needed.
- e. The value of competent, experienced professional staff cannot be overstated. SBA has established a compensation system that aligns interests of employees and stakeholders and ensures that compensation is competitive and incentivizes the right behaviors. It

contains safeguards that penalize negative behaviors and has a multi-year payout for the earned incentive portion of comp of those eligible. Leaving the SBA or committing risk or compliance violations leads to forfeiture of any unpaid incentive.

- III. Prudent, well documented investment policy is central to success. It provides the compass to manage consistently and follow investment discipline designed to maintain diversification and maintain a rational focus when emotions may suggest otherwise. A sound process for policy development assures sound policy and cements acceptance and shared ownership among all parties to decision making.
- a. SBA's Executive Director & CIO is responsible for preparing Investment Policy Statements (IPS) for the various funds we manage. This is accomplished using internal staff, supported by an independent third-party fiduciary investment consultant. The consultant helps ensure that policies reflect current best practices.
 - b. FL statutes require SBA's Investment Advisory Council review and approve IPS changes prior to Trustees' consideration. This is done in public meeting; all related materials are public records.
 - c. SBA Trustees consider proposed IPS or changes in public meetings; all related materials are public records.
 - d. Well documented policy provides the operating standards against which oversight, risk and compliance management are conducted.
 - e. Policy reflects risk tolerance through target asset allocation percentages and allowable variance around the policy target allocations.
 - f. Portfolio guidelines augment investment policy statements, providing more granular detail such as allowable securities, credit quality, concentration limits, leverage constraints or other strategy specific metrics.
 - g. The Trustees serve as a high level policy board, not an operating investment committee. All operating investment and administrative decisions are delegated by administrative rule to SBA's Executive Director & CIO. This focuses accountability and fosters efficient, merit driven investment decision making.
- IV. An increasing portion of SBA assets are managed in house, currently 43% across the global equity, fixed income, and real estate asset classes, up from 36% since 2009. This holds down costs but requires competent, stable professional talent and support for portfolio and risk analytics, trading, systems, portfolio accounting, compliance, etc. Long-term evidence is that the SBA has been effective in achieving desired investment results, within stated risk tolerances.
- a. All of SBA's major investment mandates have outperformed benchmarks over short, intermediate and long terms. For the 10 years ended 6.30.18, net of all costs, SBA is in the 5th percentile of the TUCS Top Ten Defined Benefit Plan Universe and has added \$9.4 billion over benchmark.
 - b. Total costs for the SBA are among the lowest in the industry, 48.4 basis points.