PSERS regularly employs external asset managers to assist in the management of pension fund assets. Both the PSERS investment policy statement and existing case law make clear that regular review of external managers is a pivotal element of an advisor’s fiduciary duty yet both have left specific requirements to be defined and modified over time by industry professionals. In recognition of this dynamic requirement, IOP (investment office professionals) have designed this manager monitoring policy. It applies a principles-based approach to the endeavor while offering a system of guidelines, processes and industry best practices. IOP will endeavor to review and revise this policy at least bi-annually as part of its investment program.

**Purpose:**

The purpose of the External Investment Manager Monitoring policy is:

* To establish a regular framework for ongoing evaluation of third party managers.
* To offer an objective against which investment professionals may compare their efforts. Ideally, these parameters should also engage staff to consider ways to enhance and improve the manager monitoring process on a regular basis.
* To ensure uniformity of process across external managers, eliminating the risk that segments of the portfolio are neglected.

**Scope:**

While many of the principles outlined in this policy are directly applicable to non-traditional asset classes, this policy has been designed specifically to apply to traditional asset classes including:

* Fixed Income
* Public Equity (irrespective of vehicle structure)
* Commodities
* Master Limited Partnerships
* Risk Parity

**Roles and Responsibilities:** The Investment Policy Statement provides a comprehensive outline of the responsibilities assigned to various individuals, groups and committees within PSERS. The descriptions below detail the specific aspects of these responsibilities with regard to manager monitoring.

* The Board: The Board, as the ultimate governing fiduciary, defines and approves investment policies and carefully monitors compliance with its policies and progress made toward stated goals. It is anticipated that members of the board will have eclectic backgrounds and varied levels of investment sophistication. It is understood that the demanding professional and personal schedules of board members will require them to rely on the expertise and recommendations of career professionals including the IOPP and external consultants. It is also understood that external manager monitoring has been delegated to IOP as outlined in the recommendation memos distributed to the Board prior to manager approval.
* External Consultants: External consultants have been hired to support the IOP in implementing the policy objectives of the board. It is expected that the IOP will regularly task external consultants with key elements of this manager monitoring policy and that the consultants will provide accurate, timely updates regarding managers that have been hired. The general consultant in particular has the responsibility to convey evolving industry standards and best practices to the IOP.
* PSERS Investment Office Professionals (IOP): This includes the investment office professional staff whose primary function is managing investments both internal and external. IOP will direct the execution of this manager monitoring policy utilizing third party resources as needed.
	+ CIO— Serves as the senior staff administrator on all investment matters. The CIO in conjunction with the external consultants will provide guidance to the board regarding investment strategy for the system. The data and other information collected through the manager monitoring process should serve as a resource to inform this guidance.
	+ DCIO Traditional Investments— Is responsible for implementing strategy relating to the traditional asset classes. A core component of this role is directing Senior Portfolio Managers and external consultants in recommending external managers.
	+ Senior Portfolio Managers—Are responsible for conducting manager diligence in their respective asset classes in the absence of formal coverage from the Senior Portfolio Manager (External Managers). They are also charged with improving and enhancing the manager monitoring policy.
	+ Senior Portfolio Manager (External Managers)—Is responsible for organizing the manager monitoring effort and monitoring the traditional asset classes unless delegated to another Senior Portfolio manager. The External Manager team in conjunction with the external consultants is charged with producing the quarterly investment package and participating in regular audits with the Investment Risk Manager. Most importantly, the Senior Portfolio Manager (External Investments) is responsible for making resizing and termination recommendations for the traditional asset classes to the AIC.
	+ Investment Risk Manager—Is responsible for assessing and monitoring risks across the system’s assets. With respect to manager monitoring, the risk manager is responsible for conducting semi-annual process audits to assure that policies adopted here have been followed. Importantly, this audit process also offers an opportunity to address potential weaknesses in the system and suggest improvements.
	+ Investment Operations Group—Coordinates with the external consultant, custodian bank and other vendors to aggregate the data that Senior Portfolio Managers utilize when monitoring managers.
	+ Asset Allocation Committee (AAC)—Recommends to the board and then monitors the strategic asset allocation (SAA). The AAC also votes on tactical asset allocation decisions (TAA), which decisions are made within Board-approved ranges around the SAA.
	+ Allocation Implementation Committee (AIC)—Approves and directs the specific implementation of the SAA and TAA, which can include individual manager additions, re-sizings, terminations and guideline revisions. The AIC also evaluates and approves the remuneration structures of external managers assuring that they are aligned with PSERS goals and consistent with prevailing market standards.
	+ Risk Oversight Committee (ROC)—Assesses the internal control environment and evaluates appropriate objectives for it, and identifies, measures, and responds to risks throughout PSERS’ investment program. IOP

**Objective:**

When executed well, manager monitoring serves three primary goals for the IOP:

* Inform and Enhance Current Decision Making: The IOP strive to identify and control unintended portfolio risks on an ex ante basis through rebalancing, terminations and strategic allocations. A regular dialogue with external managers is necessary to maintain an accurate understanding of such risks because the capital markets are dynamic and the personal ambitions of investment managers evolve over time. Additionally, PSERS views external managers as an extension of staff, leveraging their expertise in order to inform and improve internal portfolios.
* Provide Historical Context: Regular collection of manager data and documentation of discussions with underlying portfolio managers provides the system with valuable primary source information. This data can be used to inform future decisions during similar market environments. On a more granular level, it allows IOP to understand how management teams and strategies have evolved over time.
* Create an “Institutional Knowledge Base”: Well-documented and synthesized manager monitoring data creates an “institutional knowledge base” that is easily transferred to new employees, shielding the system against critical points of failure.

Implementation of this policy is divided into the following eleven elements:

* Element 1: Performance Monitoring
* Element 2: Document Review
* Element 3: Manager Meetings and Calls
* Element 4: External Consultant Conference
* Element 5: Quarterly Investment Package
* Element 6: Contract Updates/Fee Review
* Element 7: Operations Due Diligence
* Element 8: Guideline Revisions
* Element 9: Internal Audit
* Element 10: Manager Termination
* Element 11: Asset Class Reviews

**Element 1: Performance Monitoring**

*Principle:* Timely review of manager performance compels allocators to understand when a manager’s results may deviate from long-term expectations.

*Process:* On a monthly basis IOP will track the time-weighted performance for each external manager within the portfolio in comparison to its respective benchmark. Preliminary monthly performance reports for each traditional asset class will generally be distributed to internal staff by the close of the subsequent month. Appendix A provides a sample monthly performance report. While these reports may differ by asset class, they should include trailing one and three-year annualized returns and since inception annualized returns, a measure of volatility, a ratio of risk-adjusted returns and a computation of dollar net alpha delivered. This return data will be stored in IOP internal systems (ex: eVestment, Excel) in order to provide future reports and analysis on a timely basis.

Final performance reporting is the responsibility of the general consultant and is assembled following the procedures outlined separately in the Investment Consultant Performance Reporting Policy. On a lagged monthly basis, IOP will confer with the general consultant to offer any inconsistencies between preliminary data and those recorded by the consultant. The consultant will then resolve any differences. After distribution of the consultant’s performance report, IOP will revise the internal database to update for final numbers.

**Element 2: Document Review**

*Principle:* Regular document review is essential to understanding changes in a manager’s organization, strategy and portfolio. It provides the foundation for dialogue with managers, it allows IOP to compare competing viewpoints and it exposes the recurring themes that drive investment outcomes.

*Process:* The Tamale database is the primary tool that IOP will utilize to store, access and share all documentation regarding the systems’ investments. When organized effectively, it will be the vehicle for existing staff to leverage prodigious quantities of historical data and for new employees to gain context of prior investment decisions. In cases where documents are not automatically deposited into Tamale, IOP may rely upon Appendix B for filing nomenclature/protocol. When filing, IOP strives to be comprehensive while minimizing redundancy and avoiding inappropriately-categorized filings.

At least quarterly, IOP Senior Portfolio Managers will review the reportable documentation received from each external manager for which they are responsible. Reportable documentation includes the following note types:

* Reports - Financial/Capital/Account Statements
* Reports - Holdings/Valuations **(only monthly reports)**
* Reports - Monthly Package
* Reports - Performance **(only monthly reports)**
* Reports - Quarterly Package
* General - Update/Commentary
* Compliance - ADV Form
* Compliance - Consultant Relationship
* Compliance - Cost Certification
* Compliance - Political Contributions
* Compliance - Soft Dollar

As each required document is reviewed, the “Internal PM review” box should be checked on the Tamale note stored.

**Element 3: Manager Meetings and Calls**

*Principle:* Consistent, robust dialogue with managers is necessary to understand the motivations behind changes in a portfolio, a management team or a vehicle structure. These motivations offer a perspective that cannot be obtained through a simple review of investor letters, portfolio holdings and performance.

*Process:* IOP will conduct updates with each external manager at least quarterly after reviewing distributed investor materials for the period. In most cases, the updates should be conducted with senior investment staff of the external manager. While these updates may be conducted by voice or video conference, it is expected that the external managers or their representatives will visit the PSERS offices at least once per year. Additionally IOP will endeavor to visit each manager on site annually. Key areas to address in each update include:

* **Firm and Team Changes**
* **Regulatory inquiries**
* **Breaches of guidelines or requests to adjust guidelines**
* **Assets Under Management (firm wide and within strategy) vs. stated capacity**
* **Exposure Levels and Changes**
* **Liquidity of the Underlying Portfolio**
* **Changes to Current Macro Economic View**
* **Largest Positions (or model signals for quantitative strategies)**
* **Continued Viability of Edge**
* **Process Changes, if any**
* **Risk Management**
* **Competition**
* **Evidence of Style Drift**

Onsite meetings provide a more expansive view of the organization including junior employees, middle office personal and compliance/operations staff. External consultants will generally be responsible for annual operational due diligence; however, IOP staff should attempt to meet briefly with the essential non-investment personnel (ex: Chief Financial Officer, General Counsel, Chief Compliance Officer) to understand how they interact with the front office during such visits.

The IOP member conducting the update call or meeting will post notes to the Tamale database under the category “Meeting-PM Notes”. If multiple staff members attend a call/meeting, a single set of notes will be required (although multiple perspectives are encouraged). The senior portfolio manager for external investments is ultimately responsible for assuring that at least one set of notes has been deposited each quarter.

**Element 4: External Consultant Conference**

*Principle:* External consultants should function as an extension of staff particularly with regard to manager monitoring and sourcing activities. While IOP is encouraged to leverage the resources of external consultants, these tools are pointless without a regular review and understanding of the Consultant’s work product.

*Process:* IOP staff responsible for each asset class (or the PSERS external manager staff) will conduct calls on a quarterly basis with the consultant responsible for the asset class. IOP will then review any changes in the consultant’s view of each manager and note any incremental information the consultant may have discovered during the quarter. In addition, IOP will solicit opinions regarding how the manager compares to peers and new entrants deploying similar strategies. If portions of this manager monitoring process have been delegated to the external consultant, IOP will review the consultant’s work product and assimilate knowledge gleaned. Notes from the quarterly call should be uploaded in Tamale in the field “Meeting-Consultant Review”.

**Element 5: Quarterly Investment Package**

*Principle:* Regular writing forces an allocator to distill the vast array of data and opinions collected during regular manager monitoring. It demands that the allocator interpret the information received, develop a view and understand potential flaws in that view. Ultimately, this understanding improves decisions. It also creates a historical narrative for the portfolio that is easily transferred to new employees.

*Process*: After completion of quarterly manager meetings and calls, IOP (specifically the portfolio manager responsible for external managers) will produce an external manager package. The external manager package for each asset class should include:

* A current overview of the asset class including common or contrasting themes uncovered during calls with managers and consultants
* A description of the recent performance for the portfolio in aggregate including key manager contributors and detractors
* A forward-looking view to exposures on a look through basis (particularly with regard to leverage)
* A description of changes in manager allocations and sizing
* A manager correlation table
* A discussion of look through liquidity to the portfolio
* An appendix showing the updated manager tear sheets (see description below)
* An appendix showing the Manager Under Consideration (MUC) list for the asset class.

The quarterly package will be distributed **internally to PSERS investment staff only** with the purpose of providing the entire team with the most salient information gathered from external manager interactions. Updated manager tear sheets should be posted to Tamale in the eponymous field of each manager. Tear sheets are designed to provide a quick description and update of the manager. They may differ by asset class and in some cases may be tailored to fit the particulars of a specific manager strategy. Tear sheets will also serve as the repository for key non-structured, temporal data such as AUM changes, largest positions and recent personnel changes.[[1]](#footnote-1) Appendix C displays a sample tear sheet.

**Element 6: Contract Updates/Fee Review**

*Principle:* Prevailing market terms for external investment management services are fluid. A regular review of existing terms ensures the system maintains realistic expectations while achieving the best fee structure available. While IOP will always strive to achieve the most value possible, IOP evaluates fees within the context of overall portfolio efficiency and appropriate alignment of incentives.

*Process:* The portfolio manager responsible for external managers will present each manager’s terms to AIC in advance of each contract renewal and at the contract’s half-life. In the case of LP structures, terms will be reviewed and presented every 2.5 years. The external consultants will serve a critical role during this process by confirming that existing terms are market standard or better. During the presentation, IOP in conjunction with the external consultants will recommend whether to retain the existing fee structure or renew negotiations with the manager. Such recommendations will be stored in the Tamale database for the respective manager under the fee negotiation category. Importantly, while contract renewals provide a catalyst for such discussions, IOP may revise agreements whenever they believe it is in the best interest of the portfolio.

**Element 7: Operations Due Diligence**

*Principle:* Allocators are effectively business partners with the external managers to whom capital has been allocated. Regular review of a manager’s business operations provides insight into critical non-investment issues that can ultimately impact performance, liquidity and the motivations of investment personnel.

Core operational elements include: regulatory audits/actions, personal trading, changes in compliance policy, trade execution and allocation, valuation policy, human resources, litigation, process for cash movement, disaster recovery, data security, vendor changes, allocation of expenses, new business development and legal/regulatory changes.

*Process:* IOP will monitor and document (within the Tamale “PM notes“ category) critical operations data as part of the aforementioned document review and regular manager calls/meetings; however, in many cases a deeper more technically-oriented review will be appropriate and the expertise of external consultants will be leveraged. The external consultant will endeavor to meet with each manager to review operational issues in detail every two years. IOP staff may join the consultant for such on site reviews. Upon completion, the consultant will provide IOP with a report detailing any issues uncovered and comparing the manager’s operational processes to accepted best practices. The PSERS portfolio manager for external managers is responsible for reviewing the consultant report, conferring with the consultant, storing the report in the Tamale database (under the category “consultant reviews“) and bringing any issues to the AIC.

**Element 8: Guideline Revisions**

*Principle:* PSERS strives to ensure that underlying managers have the flexibility to be successful while avoiding unexpected risk or migrating from their core competency.

*Process:* During regular updates with managers, IOP will inquire and assess whether the guidelines have become too restrictive or should be changed. When IOP determines that a change to the guidelines is appropriate, a brief recommendation will be drafted and sent to the PSERS Risk Manager. If the Risk Manager agrees that the guideline revisions advance the purpose of the manager mandate without allowing an unacceptable level of risk (ex: concentration, leverage, liquidity, correlation), the recommendation will be forwarded to the ROC for a formal vote. Upon a majority vote (including approval of the CIO) the guidelines will be revised. The risk management team will be responsible for documenting approval and changes within Tamale.

**Element 9: Internal Process Review**

*Principle:*  Regular testing of processes provides a basis for improvement and avoids complacency. It also fosters a culture of compliance, accountability and good faith.

*Process:* On an annual basis, the PSERS Investment Risk Manager will call a Process Review meeting with members of the PSERS IOP and/or external consultants for the purpose of reviewing compliance with this manager monitoring policy. Topics will not necessarily be known to staff in advance but may include:

* Formal testing of adherence to these principles
* Solicitation of views regarding needed changes to the policy
* Introduction of industry best practices not yet implemented
* Review of action items from the prior compliance review
* Any new areas of concern

The risk manager will document findings and suggested action items. Both of these will be presented to the Risk Oversight Committee (ROC) for further suggestions. The risk manager will then return to the IOP with conclusions and action items to be addressed at the next Process Review Meeting.

**Element 10: Manager Termination**

*Principle:* PSERS seeks to develop long lasting partnerships with the managers it hires. Manager terminations should be well reasoned and grounded in a forward-looking view of the manager’s prospects. Historical outperformance or underperformance alone offers an insufficient basis for retaining or terminating a manager.

*Process:* When either the IOP or the external consultant determine that a manager relationship should be terminated, the PM responsible for the manager relationship will draft a brief termination memo. The memo should offer a clear rationale for termination. Ideally, the termination memo should reference the original Investment Memorandum highlighting new issues or changes that have since taken place. Key catalysts for manager terminations include:

* AUM growth beyond levels where alpha can be sustained
* Turnover of key personnel
* Potential liquidity mismatch between terms and underlying portfolio investments
* Style drift
* Demonstration of poor judgement by the manager (either professionally or personally)
* Desire to reallocate to another manager that better serves the mandate
* Operational issues/risk factors
* Identification of a flaw in the initial thesis
* A change in PSERS programmatic allocations
* Unexplained and recurring deviations from expected performance

IOP will circulate the termination memo to the AIC for solicitation of votes to approve the termination. Upon majority approval (including the approval of the CIO) the CIO will notify the members of the Board consistent with the protocol established in the IPS and the manager will be instructed to begin the process of liquidating the account or redeeming shares.

**Element 11: Asset Class Reviews**

*Principle:* As components of an overall portfolio, manager allocations combine with each other and with passive allocations to reflect the IOPs targeted expression of a given asset class. Regular evaluation of this expression is necessary to assure that these components are playing the desired role.

*Process:* Twice per year the external consultant and/or IOP will present a review of each asset class to the Board. The presentation may include a review of performance at the category level, a discussion of the asset class’ deviations from benchmarks, commentary on specific components of the asset class and a prospective view on key events that may drive the asset class’ performance.

**Review and Revision**

IOP will review and revise, if necessary, this policy at least bi-annually as part of its investment program. Any changes to the policy must be approved by the AIC.

**Approval**

Recommended by: \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ Date: \_\_\_\_\_\_\_\_\_\_

Recommended by DCIO: \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ Date: \_\_\_\_\_\_\_\_\_\_

Recommended by AIC: \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ Date: \_\_\_\_\_\_\_\_\_\_

Approved by CIO: \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ Date: \_\_\_\_\_\_\_\_\_\_

1. Note: IOP staff may use reasonable estimates of data that is not immediately available. IOP is also encouraged to use their best professional judgement regarding the appropriate classifications of data when they believe that an underlying data sources’ assignment is misleading. [↑](#footnote-ref-1)