Joint Meeting of the Investment Advisory Committee and Board of Trustees

ERS
Employees Retirement System of Texas

Meeting of the Board of Trustees
February 24, 2015

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

February 24, 2015
ERS Auditorium
200 E. 18th Street
Austin, Texas 78701

COMMITTEE MEMBERS PRESENT
Lenore Sullivan, Chair
James Hille, Vice-Chair
Robert Alley, Member
Monty Jones, Member
Ken Mindell, Member
Laura Starks, Member
Vernon Torgerson, Member

COMMITTEE MEMBERS ABSENT
Caroline Cooley, Member

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

ERS STAFF PRESENT
Ann Bishop, Executive Director
Porter Wilson, Executive Director Designate
Larry Zeplin, Chief Operating Officer
Tom Tull, Chief Investment Officer
Paula Jones, General Counsel and Chief Compliance Officer
William Nail, Deputy Director of Governmental Affairs
Tony Chavez, Internal Auditor
Robert Kukla, Director of Benefit Contracts
Marci Sundbeck, Manager of Enterprise Risk Management
Ralph Salinas, Director of Human Resource
Catherine Terrell, Director of Governmental Affairs
Michael Wheeler, Chief Financial Officer
Carolyn Anderson, Investments
Michelle Collins, Customer Benefits
Kelley Davenport, Executive Office
Leah Erard, Governmental Affairs
Nash Ali, Customer Benefits
Wesley Gipson, Investments
Neil Henze, Investments
Andrew Hodson, Investments
Lauren Honza, Investments

Sharmila Kassam, Investments
Laurie Kuehner, Customer Benefits
Lori Lattrell, Executive office
Robert Lee, Investments
Betty Martin, Investments
Patti Maugham, Executive Office
Liz Molina, Customer Benefits
Tim Reynolds, Investments
Tanna Ridgway, Investments
Leighton Shantz, Investments
Robert Sessa, Investments
Michael Shoop, Investments
Tim Sims, Legal Services
John Streun, Investments
Chris Tocci, Investments
Mary Jane Wardlow, Governmental Affairs
James Wehmeyer, Executive Office
Karla West, Investments

ALSO PRESENT
Suzanna Sanchez, Invesco
Steve Voss, Hewitt EnnisKnupp

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

> "A public notice of the Joint Meeting of the Board of Trustees and Investment Advisory Committee containing all items on the proposed agenda was filed with the Office of the Secretary of State at 2:44 pm on Thursday, February 12, 2015 as required by Chapter 551, Texas Government Code, referred to as 'The Open Meetings Law.'"

XIII. REVIEW AND APPROVAL OF THE MINUTES TO THE DECEMBER 5, 2014 JOINT MEETING OF THE BOARD OF TRUSTEES AND INVESTMENT ADVISORY COMMITTEE

Ms. Lenore Sullivan opened the floor for a motion to approve the minutes of the December 5, 2014 Joint Meeting of the Board of Trustees and Investment Advisory Committee.

The Investment Advisory Committee then took the following action:

MOTION made by Ms. Laura Starks, seconded by Mr. Vernon Torgerson and carried unanimously by the members present that the Investment Advisory Committee approve the minutes of the ERS Joint Meeting of December 5, 2014.

The Board of Trustees (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 of Trustees approve the minutes of the ERS Joint Meeting of December 5, 2014.

XIV. REVIEW AND DISCUSSION OF INVESTMENT PERFORMANCE FOR FOURTH CALENDAR QUARTER OF 2014

Ms. Sharmila Kassam, Deputy Chief Investment Officer of ERS and Mr. Steve Voss from Hewitt EnnisKnupp (HEK) presented the review and discussion of the Investment performance for the fourth calendar quarter of 2014. In accordance with the contract for performance evaluation services and Section 3 of the ERS *Investment Policy*, HEK reviews and evaluates, on a quarterly basis, ERS investment performance as calculated by ERS custodian BNY Mellon.

Mr. Voss began the presentation by discussing the economic state of the US government and emerging markets in the fourth quarter of 2014 (Q4). GDP advanced about 2.6% and unemployment is below 6%. Oil and gas prices have decreased nearly 50% and the US dollar is at an all-time high relative to the euro. Elsewhere, the major news was the severe fall in the price of oil, which fell by over 40% in the fourth quarter, more than halving since its July peak ($115 per BBL to $55 per BBL for Brent Crude).

He continued to explain that the long government bonds have done well and had a 24.66% return for the last year. The interest rates for 30-year government bonds on the long end of the curve continue to go down. There are also attractive returns in the fixed income space.

The S&P 500 rose by 4.9% on a total return basis and 13.7% over the course of the year, which is the strongest performance amongst the major developed markets. The MSCI Europe ex-UK index fell again, this time by 4.3% (-6.6% for the year) while the MSCI UK index fell 4.2% (-5.4% for the year); both areas having been affected by European economic weakness and the lower oil price. The MSCI Emerging Markets index also fell by 4.4% (-2.2% in 2014). The strength of the US dollar was a key factor in these diverging performance paths.

Emerging markets were hurt by falling oil prices and dollar strength. The MSCI Emerging Market total return index fell by 4.5% in Q4 as the strong trends in the price of oil and the US dollar had a negative impact. In Europe, Greece stood out as political turmoil and the increased risk of exit from the euro area resulted in a 28.8% quarterly drop in the MSCI Greece index in Q4. During the period, Russian stocks suffered the most, as plummeting prices for the country's major energy exports triggered a 33% fall in Q4. In contrast, the MSCI China index rebounded from its September decline and finished the quarter up 7.2% or 8% for the year as a whole. This is partially because China is an oil importer and therefore a net beneficiary of recent moves in its price.

US economic recovery showed signs of further strength in Q4. The unemployment rate fell again and ended the fourth quarter at 5.6%. Although the Fed tapered its QE program throughout last year and the economic evidence pointed to a good recovery, one of the best investments in 2014 has undoubtedly been long duration in US Treasuries. The Barclays Global Aggregate Bond total return index fell by 1% (up 0.6% for the year) but the US Treasury 20+ year total return index gained an impressive 9.4%, meaning that the index returned 27.5% in 2014. In the corporate sector, there was some weakness in high yield, which fell by another 1% in Q4 while the overall Barclays Global Aggregate Corporate total return Index was up 0.1% (or 3.2% for the year).

Mr. Voss began the summary of the ERS performance. The Fund started the period with $25.3 billion. The net of contributions and withdrawals was a negative $1.1 billion, the investment earnings, or gains, realized and unrealized, appreciation and income was $1.4 billion. There was a 5.5% rate of return for the last period. ERS ended the year with a balance of $25.6 billion. Additionally, 30 basis points of value were added over the last quarter and 20 basis points of value were added for the last year. There has been a total return of 10.6% for the three-year period and 8.7% return for the trailing five-year period. The total fund return quarterly rate of return was 1.33% and the benchmark was .97%.

Global equity was the single largest contributor this quarter and added 41 basis points of value. Global equity is 60% of total investments, which is $15.5 billion. International equity is about 21.7% of the total fund, $5.5 billion. International had a negative return of 3% compared with a benchmark return of 3.9%.

Mr. Voss mentioned the performance of private equity. This asset class is $2.5 billion or 9.7% of the fund. Private equity has had a good positive internal rate of return.

Mr. Shad Rowe asked how staff knows the exact returns of private equity. Mr. Wesley Gipson, Director of Private Equity, was called upon. He explained the most recent performance and how it is compared against the private equity benchmark. He further explained that cash out against the Net Asset Value (NAV) plus cash received is used to calculate exact returns. The life cycle of private equity funds should also be considered in a mature program. Mr. Rowe expressed his concern of the private equity program and it's impact on liquidity. Mr. Gipson replied that Staff annually completes a comprehensive liquidity analysis that measures liquidity risk, which will be presented at the May 2015 Board meeting.

Mr. Voss revisited the asset allocation goals for each asset class. Staff is taking steps to implement a long-term asset allocation. ERS has a strategic allocation that allows staff, with the Board's approval, the flexibility to go in quicker or more slowly into an asset class given the opportunity at the Fund.

Credit has a long-term policy target of 10%. The Fixed Income team has been strategically building towards the allocation goal. The team has made deals that makes sense and have brought assets in-house, managing on a very cost-effective basis with competitive results. .

Ms. Kassam described the transition of funds from Fountain Capital Management. In February, Fountain Capital called Staff to notify ERS that they are no longer going to be managing assets. ERS had a $261 million allocation to Fountain Capital and decided to manage most of those assets in-house. Staff transferred $167 million into the internal high yield portfolio and liquidated about $60 million. There is about $22 million yet to be liquidated. This transition is being completed quickly and efficiently by the Fixed Income team and the Investments Operations team.

Mr. Voss continued the summary of ERS performance. Real assets is also a fairly large target building to 14%. The exposure is about 11% of total funds or $2.7 billion in aggregate assets.

The Rates portfolio is the part of the program that is set aside for stability and liquidity. Liquidity is an important aspect of the Fund. Right now 17.7% or $4.5 billion in aggregate assets of the Fund assets are managed to Barclays Intermediate Treasury Index, which is a very high quality and incredibly liquid benchmark.

Mr. Voss discussed the absolute return portfolio. It is part of the diversifying assets and is comprised of 5% of the total Fund. The performance of that strategy has done quite well and as expected. The one-year return is 4.9% with a 4% benchmark return.

He concluded his presentation with a short summary of the Fund performance. HEK's report on ERS' investment performance net of fees showed that during the 2014 fourth calendar quarter the Total Fund return of 1.33% outperformed the Total Fund Policy Benchmark by 36 basis points. For the quarter ending in December 31, 2104, the global equity, global credit and rates components contributed positive relative value. The remaining asset classes were flat or detracted from relative performance during the period. The Total Fund outperformed the Total Fund Policy Benchmark by 13 basis points over the previous one-year period. ERS continues to work toward its strategic and long-term allocation targets.

Mr. Craig Hester asked Mr. Voss about the overall portfolio and if Mr. Voss sees any opportunities. Mr. Voss replied that he is seeing opportunities in credit and plans to discuss strategies with the ERS Fixed Income team.

Ms. Kassam moved the discussion to an overview of the asset allocation of the Fund. The asset allocation was adopted at the February Joint Meeting in 2013 and approved by the Board and IAC. The purpose of this presentation is to provide an update on implementation of the asset allocations. The allocations are strategic and subject to available market opportunities. Additionally, this discussion will also explain how a pension fund is different than a retail investor and illustrate how ERS' asset allocations compare with institutional investor peers.

Mr. Voss presented information about the asset liability process. The process is the main driver for setting long-term policy allocations for public pension plans. He explained the four steps in the process: (1) objectives, (2) context, (3) strategy proposal and (4) implementation.

Based upon a study from Aon, Mr. Voss explained the differences between individual or retail 401(k)s and pension plans. The investment structure for individuals is mostly mutual funds, while public pensions use more alternatives and have a strategic focus. Public pension funds tend to use long-term strategies, while individual or retail investments have short-term strategies. Regarding diversification, the individual investments are mostly domestic and low in alternatives, if any private market investments at all. Pension funds use diversification for risk management for more consistent return expectations while managing liquidity.

Mr. Voss also discussed the importance of diversification by showing how ERS' asset allocation compares with institutional investor peers and finding that ERS is consistent in the magnitude of its allocations. He found that ERS is at an advantage compared to a 401(k) investor. He outlined specific advantages of the Plan, such as the size of the global marketplace and the size of the Fund, internally managed investments, fee negotiations and access to niche investment opportunities.

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

XV. REVIEW AND DISCUSSION OF EXTERNAL ADVISORS

Ms. Sharmila Kassam, ERS Deputy Chief Investment Officer and Ms. Lauren Honza, Portfolio Manager for Global Equity presented the review and discussion of ERS External Advisors.

The Investments division established the External Advisor Program to seek quality external investment advisors to increase alpha generation capabilities for the Trust and to achieve competitive returns at a reasonable cost. Staff will review the ERS Emerging Manager Program, which is a component of the External Advisor Program, at the August Joint Meeting of the Board and IAC.

The goals and objectives of the program is to find external advisors that can complement internal management efforts and expand the investment opportunity set with different strategies to provide diversification benefits for risk reduction and increased returns. Currently, two-thirds of the Fund is internally managed, and the last one-third is externally managed.

By managing internal and external portfolios, ERS is able to cost effectively produce optimal returns. Internal management costs less than 10 bps. When blended with the cost of external management, the cost is approximately 30 bps. ERS finds that this is a reasonable approach in terms of net returns. The internal/external mix has proven to be very successful during calendar year 2014 with a performance of 5.48%, 13 bps over the policy benchmark.

Ms. Cydney Donnell discussed the validity of using external managers. She said that there are thousands of managers and only a few consistently outperform the benchmark. Mr. Tom Tull, Chief Investment Officer, explained that there are certain spaces, such as Large Cap that it does not make sense to hire an external advisor; whereas in small cap international, there are more opportunities for outperformance.

Ms. Kassam introduced the Global Public Equity External Advisor team, which is comprised of Ms. Kassam, Ms. Honza and Mr. Chris Tocci, Deputy Director of Global Public Equities. Additionally, the team works closely with portfolio managers and Mr. John Streun, Director of Global Public Equities.

Ms. Honza began her portion of the presentation and explained processes involved with the selection of external advisors. There is a five-step investment process to evaluate investments: (1) research, (2) select, (3) implement, (4) monitor and (5) rebalance. To start the five-step process, the team uses various avenues to research advisors. Conferences and the ERS external advisor website play an important role in finding the best potential external managers. During the "select" step, an advisor is selected through an RFP search and due diligence is performed. If the due diligence is satisfactory, the fund is presented to the Internal Investment Committee (IIC).

If those recommendations are approved by the IIC, the manager is placed in the Select Pool and then investment staff works with ERS legal staff on contracts with these managers. The Select Pool is designed to provide transparency into external advisor selection through formalized searches and also an ongoing monitoring process that seeks to continually refresh the Select Pool. The Select Pool will be refreshed for unfunded external advisors on an as needed basis, but no less than three years from selection for public equity external advisors. Under the direction of the CIO, staff has to revisit whether external advisors in the Select pool are meeting the needs of the Trust or if other managers need to be considered for the Select Pool by conducting new searches.

The "implement", "monitor", and "rebalance" steps involve the constructing and funding of the portfolio. The select pool is monitored quarterly with manager reports, semi-annually by a monitoring form and meeting, and annually with ADV reports and peer asset class reviews. The funded managers are monitored daily in trade reviews, monthly by portfolio reviews, and then monitored quarterly, semi-annually and annually in the same way as a select pool manager. It is imperative to constantly re-examine assumptions to best optimize the return for the plan relative to the risk taken.

Ms. Honza presented the funded members of the select pool: Barrow Hanley, Lazard, BlackRock, Fisher, Templeton and J.P Morgan. She detailed the background of each external advisor and their respective investment process, along with their performance, funding, monitoring status and how the external advisor complements internal management. She also presented the current select pool as of February 2015 and their funding and monitoring status.

Ms. Kassam concluded the presentation by providing an outlook for the future of the external advisor program. As the program grows additional resources are needed, the team is seeking and expects to hire an Investment Analyst I-II for the program in the first quarter of the 2015 calendar year.

The External advisor team will continue to attend conferences and manager meetings to discover innovative and complementary investment strategies and managers for the Trust. This calendar year, staff will implement BackStop, a customer relationship management system (CRM), to more efficiently manage the sourcing and monitoring of external relationships. The external advisor team would like to interact more frequently with advisors to develop internal expertise in various strategies and establish a better alignment of interest between external and internal.

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

XVI. REVIEW, DISCUSSION AND CONSIDERATION OF THE GLOBAL EQUITY STRATEGIES:

A. MARKET UPDATE AND PROGRAM OVERVIEW - Mr. John Streun, Director of Global Equities, Mr. Chris Tocci, Deputy Director of Global Equities, and Mr. Neil Henze, Chief Trader at ERS presented the market update and program overview for the global equity program.

Mr. John Streun discussed the objective and strategy of the global equity program. The investment objective for this asset class is to outperform the Global Public Equity benchmark over rolling five-year periods, while maintaining compliance with the Active Risk Budget. The general investment strategy is to combine lower risk internal portfolio strategies and higher risk external portfolio strategies to produce a stable excess return with a target tracking error of 150 basis points and an excess return ratio of 0.25 or better.

Mr. Streun continued to explain the leadership team and staff of public equities. The leadership team of public equities was formalized in 2014 and is comprised of Mr. Streun, Mr. Tocci, Mr. Andrew Hodson and Mr. Tim Reynolds, all of whom serve as supervising portfolio managers. Over the last 18 months, the focus of the leadership team has centered on improving analyst communication, making portfolios less passively managed and implementing new alpha-generating strategies. In addition to the analysts and portfolio managers in the public equities team, the asset class also receives assistance from Ms. Sharmila Kassam and Ms. Lauren Honza, External Advisor Portfolio Manager, on oversight of external managers.

The Global Public Equity Asset Class outperformed the Policy Benchmark by two basis points in calendar year 2014. The primary driver of the relative outperformance was the overweight position to the United States. Returns on a 5-year basis were also positive as the Global Public Equity Asset Class outperformed the Policy Benchmark by 26 basis points per year.

Mr. Streun discussed the global equities market outlook and major issues regarding the economy. The US has had dynamic growth and only the UK and US have performed better than their pre-financial crisis levels. The US is projected to continue to grow due to low interest rates and inflation. Overall, Europe’s performance has become stagnant and has underperformed. Action from the European Central Bank should stimulate loan activity. So with ample liquidity and a better lending environment, we could possibly see more growth out of the euro zone, which would not only be helpful for the euro zone, but for the rest of the world. Mr. Streun also discussed the economy in parts of Asia and emerging markets. The Bank of Japan is undergoing aggressive monetary stimulus. While Japan looks to be a challenged country due to unfavorable demographics and a burdensome debt load, employment does seem to be tightening and corporations are becoming more shareholder friendly. These positive developments could lead to outperformance over the next few years.

Mr. Streun continued to discuss China and Emerging Markets. The rebalancing of growth in China is one of the dominant themes in emerging markets that will continue in 2015. Under the new leadership, China has started the process of shifting its economy from one focused on fixed asset investment to a more consumption focused economy. In addition to allocating more resources to real estate and infrastructure, over the last ten years China has invested heavily in its manufacturing sector.

Mr. Streun discussed the falling prices of oil and the positive and negative impacts. Over the last year, an increase in the North American supply of oil coupled with weakening emerging market demand has led to a price adjustment and crude prices are down more than 50%. Since oil is priced in dollars, the strong dollar has also played a role in the price decline.

The global consumer benefited the most from the drop in oil prices. In the US alone, AAA estimates that the fall in gas prices will put an additional $75 billion in consumers’ pockets. Energy companies and large energy exporting countries, such as Russia, industrial companies and companies that supply the energy industry were negatively affected and will see a significant drop in orders and earnings.

He also explained risks to consider in global equities. Besides the risk of slowing growth and deflation previously discussed, there are three additional risks worth highlighting: a premature move by the Federal Reserve to raise interest rates; the heightened risk of an emerging market currency crisis leading to financial contagion; and a misstep in geopolitics.

Mr. Streun discussed the Best Ideas Program. It consists of niche alpha generating strategies designed to take advantage of market anomalies. Currently, there are three funded Best Ideas portfolios: Focused Value, Spinoff, and Capitol Hill. These funds represent 2.5% of the total Trust assets and 4.8% of the Public Equity allocation as of December 31, 2014. There were nine submissions on the initial call for best ideas; out of the nine ideas, three ideas were funded. The Best Ideas Program team meets and monitors those three Best Ideas portfolios: Corporate Spinoff, Focused Value and Capitol Hill.

The Focused Value portfolio went live May 1, 2014 with an initial funding of $200 million in securities from the Core Portfolio. Since inception, the portfolio has underperformed the MSCI World Net Dividend Index by 340 basis points due to an overweight in the Materials sector and poor stock selection in Consumer Discretionary. The portfolio benefitted from an overweight in the Healthcare sector and strong stock selection in Industrials.

The Spinoff portfolio went live May 1, 2014 with an initial funding of $200 million in securities from the Core Portfolio. A subsequent addition of $50 million was allocated to the strategy in December 2014. ERS' Spinoff portfolio is off to a strong start versus other Spinoff strategies, but has lagged the Midcap index selected for benchmarking. The performance lag versus the broader S&P Midcap Index was due to 13.5% in foreign securities, an overweight in Energy, and an underweight in Financials.

The Capitol Hill portfolio went live September 1, 2014 with an initial funding of $100 million in securities from the Core Portfolio. A subsequent addition of $50 million was allocated to the strategy in December 2014. Since inception, the Capitol Hill portfolio has exceeded its benchmark (S&P 500) by over 400 basis points. The outperformance was largely driven by overweighting Industrials, Healthcare, Staples and underweighting Energy and Info Tech.

Mr. Tocci discussed the global equities portfolio structure, positioning and rebalancing. He explained the transfer of funds to the different asset classes. Transfers are made across asset classes to achieve asset allocation targets and pay benefits. Most of these flows were affected in the cash market, although some were accomplished with the use of future contracts.

As of December 31, 2014, the Global Public Equity Composite was 54% domestic and 46% international versus the MSCI ACWI allocations of 52% domestic and 48% international. The $13.0 billion Global Public Equity Composite as of December 31, 2014, consisted of eight domestic portfolios, two domestic fund of funds' portfolios, nine international portfolios and two global portfolios.

The $7.0 billion domestic composite is comprised of the two emerging manager fund of fund composites, an internal S&P 1500 composite (containing the S&P 500 portfolio, the Active Core, Mid Cap and Small Cap portfolios), a Special Situations composite (containing three strategies), plus an internal growth portfolio and one externally advised value portfolio.

The $5.9 billion international composite is comprised of an internal MSCI All Country World Index, excluding the United States (ACWIxUS) composite (containing the developed Europe, developed Asia, emerging markets and Canada portfolios), two external strategies benchmarked against the MSCI Europe Australia and Far East (EAFE) index, two external strategies benchmarked against the ACWIxUS benchmark, one external strategy benchmarked against the MSCI Emerging Markets and one strategy benchmarked against the MSCI All Country World Index.

During calendar year 2014, four portfolios were added to the program. These included three domestic portfolios in the Special Situations Portfolio and one externally advised global long/short mandate in the Directional Growth Portfolio.

The market value of the domestic equity program was $7.0 billion at the end of calendar year 2014. Internally managed portfolios account for 88% of the domestic equity assets. The market value of the international equity program was $5.9 billion at the end of the calendar year 2014. Internally managed portfolios accounted for 55% of international equity assets. The program is currently overweight in the United States by approximately 2% compared to the domestic and international weights in the MSCI ACWI.

Mr. Tocci presented the sector exposures and geographical region exposures. At an aggregate level the Global Equity Composite has increased its largest sector underweights in utilities, staples and energy, while the telecom underweight has decreased. Offsetting these underweights are the corresponding overweight positions in healthcare, information technology, and industrials. The Global Equity Composite remained overweight the United States and underweight Asia and Japan. The overweight position in the United States is moderated by 100 basis points, while the underweights in Asia and Japan have slightly increased.

Mr. Neil Henze discussed the trading update for the Global Equity asset class. The ERS trading team is comprised of Mr. Henze, Mr. Michael Clements and Mr. Rob Newhall. The senior members of the team have approximately 20 years of experience. This internal expertise adds value to ERS and the team is able to internally trade 90% of domestic trades and 50% of international trades through algorithms.

Commissions show trading activity. Total commissions for 2014 were 23% higher than 2013. Transition trades for the new global equity portfolios, the Capitol Hill, Focused Value, Global Equity Tactical, and Spinoff assisted in the increase of commissions.

The average “all-in” blended commission rate paid by U.S. institutions to brokers on domestic shares was 2.8 cents-per-share. This average rate takes into account commissions on single-stock, program, and direct-market-access electronic trades. ERS’ average commission was 2.1 cents-per-share. ERS Emerging Managers manage their own trading and paid an average commission of 2.7 cents-per-share.

Mr. Henze also discussed commissions by portfolio. The total amount of commissions for 2014 is $9.7 million. The internal portfolios accounted for $7.3 million or 75% of total commissions. The external portfolios accounted for $2.4 million or 25% of total commissions.

Mr. Henze also explained that ERS’ international commission rates remain very competitive relative to their peers and he produced empirical evidence for the Board and IAC.

Mr. Craig Hester asked Mr. Henze about commission trends for 2015. Mr. Henze replied that commission rates have remained flat for several years, but that ERS commissions totals increase with the amount of transition trades. Mr. Streun mentioned that the new advisor, BlackRock, may have an impact on commissions in 2015.

Ms. Laura Starks inquired about how ERS is protecting itself against high frequency traders. Mr. Henze said that they use various strategies to monitor and combat high frequency traders. These high frequency traders were on the rise mostly during 2008 through 2010, but have dwindled due to increased competition over the past couple years. Currently, high frequency technology is available to ERS and their peers.

Mr. John Streun finished the discussion by highlighting the goals and objectives for 2015. Mr. Streun would like the global equity team to become more tactical with the use of ETFs. Staff would like to seek more options for additional alpha and work with the Global Public Equities External Advisor team to evaluate existing managers and potential new managers. Additionally, staff would like to replace analysts that have left ERS and maintain the current staff.

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

B. <u>PROPOSED REVISIONS TO THE GLOBAL EQUITY POLICIES AND PROCEDURES AND ACTIVE RISK BUDGET SUMMARY</u> - Mr. John Streun, Director of Global Equities, presented the proposed revisions to the Global Equity policies and procedures and the Active Risk Budget Summary.

The investment policies of the Employees Retirement System of Texas (ERS) are determined by the Board of Trustees (Board). ERS staff recommends the adoption of Addendum XI, Global Public Equity Policies and Procedures (Global Public Equity Policy) to guide the asset class management while allowing the staff to be more tactical within the asset class pursuant to guidelines, objectives, policies and procedures established by the Board.

ERS staff is no longer using the transition benchmarks of the S&P 1500 for domestic and the MSCI ACWIxUS for International because the portfolio is fully implemented. Staff is managing the asset class against MSCI ACWI rather than having a separate benchmark for domestic and international.

The changes below reflect the utilization of the new MSCI ACWI benchmark. For clarification, the Global Public Equity Policy is consistent with the ERS *Investment Policy* and other addenda, as applicable. In this case, Addendum III, Active Risk Budget Summary, will also be revised to be consistent with the Global Public Equity Policy and Procedures.

Additionally, in *Section I. Investment Objectives, C. Performance, 2. Externally Advised Portfolios* of Addendum XI of the ERS *Investment Policy*, “designated staff” will be changed to “Deputy Chief Investment Officer” for clarification purposes.

And in *Section II. Investment Strategies and Processes, A. Investment Strategies, 11. Hedge Fund Structure* of Addendum XI of the ERS *Investment Policy* , “investment and operational” due diligence procedures will be added for clarification purposes.

Mr. Craig Hester pondered how the change of the benchmark would affect the incentive compensation plan (ICP). Ms. Ann Bishop explained that the MSCI ACWI was used for the Global Public Equity asset class as of the start of fiscal year 2014. Ms. Sharmila Kassam and the consultant presented the new benchmark during the August Board Meeting and it is being used for reporting since September 1, 2014. Ms. Kassam further explained that the strategic change to the benchmark had been set into the *Investment Policy* at the February Board Meeting in 2013.The first benchmark was set as a transition benchmark as Global Public Equity moved to their asset allocation goals.

Ms. Bishop called attention to supplementary materials that showed the approved benchmark from 2013. She said that Incentive Compensation Plan performance measures for Global Public Equity benchmark are set in August prior to the beginning of the plan year so this amendment will not change the incentive compensation performance because BNY Mellon has already begun using the MSCI ACWI benchmark.

Ms. Lenore Sullivan opened the floor for a motion to approve the proposed revisions to the Global equity policies and procedures and active risk budget summary.

The Investment Advisory Committee then took the following action:

MOTION made by Mr. Bob Alley, seconded by Mr. Ken Mindell and carried unanimously by the members present that the Investment Advisory Committee approve the proposed revisions to the Global Equity policies and procedures and active risk budget summary.

The Board of Trustees 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 of Trustees approve the proposed revisions to the Global Equity policies and procedures and active risk budget summary.

XVII. ANNUAL REVIEW AND DISCUSSION OF PROXY VOTING AND CORPORATE GOVERNANCE

Mr. Scott Hodgson, Equity Analyst, presented the annual review and discussion of proxy voting and corporate governance.

As stated in Section 4.20 of ERS' *Investment Policy*, the right to vote proxies for securities held by ERS has economic value, and the fiduciary act of managing ERS' securities includes the management of the voting rights appurtenant to those securities. In voting proxies, ERS shall consider only factors that relate to the economic value of ERS' investment and cast votes in accordance with ERS' economic best interest.[1]

ERS uses Institutional Shareholder Services (ISS) to process proxy votes. The ISS system allows them to "code" ERS' proxy voting guidelines, so that agenda items are matched to the codes and voted electronically. ERS retains the ability to override the vote posted by the ISS automated system before the actual vote is sent to the company. In cases where ERS' guidelines do not address the topic of the proposed vote or ERS' guidelines require an internal case-by-case analysis of the proposal, the vote is referred back to analysts and portfolio managers. That occurred about 2.1% of the time in 2014, in line with 2013.

Ms. Cydney Donnell commented that the SEC advised not to rely on the ISS, but to default to them. Mr. Hodgson agreed and said that staff arduously goes through each guideline for each proposal.

In 2014, there were 24,321 total voteable proposals and ERS voted with management 91% of the votes. Globally, ERS has voted in 2,158 meetings in 49 separate markets; The US accounted for 45% of those meetings.

Mr. Hodgson presented the results of the proxy voting. The "Other Shareholder Proposals" category, which excludes social/environmental issues, continued to have the lowest percentage of ERS' votes with management at 59% of the time. This category includes items such as amending bylaws, reincorporation, supermajority vote requirements and general governance related items. In 2013, ERS voted with management 50% of the time. The difference primarily stems from proposals concerning the "Right to Act by Written Consent".

The "Social/Environmental Issues" category held steady with 69% of votes with management versus 67% in 2013. 2013 and 2014 showed an increased percentage of shareholder proposals calling for disclosure of political contributions and lobbying payments and policies, which ERS tends to support. These proposals represented 36% of all "Social/Environmental Issues" proposals ERS voted in 2014 versus 38% in 2013.

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[1] In the rare case of overlapping or conflicting interests within the fund (e.g., ERS ownership of both equity and debt securities), staff will consider *all* holdings and seek to maximize the expected value of the combined position.

The “Shareholder Rights and Defenses” category rebounded to 2012 levels, posting 92% of votes with management after a fall to 87% in 2013. In 2014, ERS registered a higher percentage of votes for management in most segments of the “Shareholder Rights and Defenses” category. In 2013, results were skewed lower by one category where only 30% of the proposals in the category requested authorization for the company to call an extraordinary general meeting with a notice of only two weeks, which ERS tends to vote with management. In 2012, these proposals represented a larger 43% of total proposals in this category.

Mr. Hodgson explained that compensation was an issue in this proxy season. Say-on-Pay is a law that gives shareholders the right to vote on management's pay. It was implemented in 2011 as part of Dodd Frank. Management Say-on-Pay, (“MSoP”) proposals increased 10% over 2013, driven by the fact that many companies adopted triennial MSoP voting frequency in 2011. Shareholders approved management compensation programs 91.3% of the time, in line with recent years. The main reason MSoP proposals tend to fail is related to pay for performance issues.

Activism and activist investing was one of the interesting proxy issues. One of the most publicized examples of activism is the hedge fund group Starboard Value Fund, which wrote a critique of Darden restaurants. The fund proposed that reducing the amount of bread sticks would help dwindling performance of Darden stock. Strong activist performances in 2013 ushered in a crowded landscape for 2014 as more funds focused on fewer opportunities.

Mr. Hodgson continued to explain the impact of environmental and social governance in proxy voting. He reiterated that ERS’ policy is to invest and vote based solely upon the economic benefit of the Trust, and not social or environmental factors. Environmental and Social Governance is comprised of the following areas: board diversity, climate change, human rights, lobbying activity, and sustainability reporting. In the 2014 proxy season, 460 environmental and social proposals were filed; only 399 of these proposals were filed in 2013. Additionally, shareholder support of 21.8% was a new high and reflects the growing attention this area is receiving from investors.

Board nominee support continued to rise this year to 96%, largely driven by strong equity markets and greater investor engagement. Lack of investor engagement or absenteeism by boards was the primary cause for failed nominee elections.

The second quarter saw 20 contested elections. Through settlement or votes, dissidents won at least one seat 59% of the time. Many companies had successful outcomes by engaging with investors to find mutually acceptable terms and board nominees. The size of companies targeted was also larger and had a median market cap of $260 million versus $141 million in 2013.

Mr. Hodgson concluded his presentation with a discussion on the Council of Institutional Investors (CII) and its potential impact on corporate governance. ERS is a member of CII, a nonprofit association of pension funds and other employee benefit funds, foundations and endowments with combined assets exceeding $3 trillion. CII educates its members, policymakers and the public on good corporate governance, shareholder rights and related investment issues while advocating on its members’ behalf.

Both the Board Chair and the Executive Director of CII have been selected to serve on the SEC Investor Advisory Committee. Their service ensures that CII members have a voice during the rule making process. In addition, CII is represented in groups such as: Public Company Accounting Oversight Board (PCAOB) Standing Advisory Group; PCAOB Investor Advisory Group; Nasdaq Listing Council; Vote Confirmation Working Group (comprised of the Business Roundtable, the National Investor Relations Institute and the Society of Corporate Secretaries and Governance Professionals).

CII membership approved two policy drafts in 2014. The first policy established guidelines for a board director with conflicts of interest in the case of a potential transaction. The second policy approved by members addressed bylaw provisions that could limit the pool of board candidates.

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

XVIII. CHIEF INVESTMENT OFFICER'S REPORT

Mr. Tom Tull, Chief Investment Officer of ERS, presented the Chief Investment Officer's report.

Investment staff continues to work with the Executive Director, Board of Trustees, Investment Advisory Committee and other divisions within the Agency to build a premier and competitive investment organization with the best interest of the Trust and its beneficiaries.

Mr. Tull outlined the philosophy and objectives of the Trust. The objective is to fund the Trust for the future for the sole benefit of its members and retirees and to establish investment policies, objectives, and strategies for the purpose of earning a competitive risk-adjusted rate of return at a reasonable cost.

He described the investment challenges for FY2015. There are US and European economic issues contributing to the strengthening of the US dollar and the weakening of the euro. The Trust also has to consider the political environment, the debt ceiling, increasing government regulations, and Lame Duck Administration risk.

With markets climbing a wall of worry, we are seeing a constructive trend for FY2015. Commodities and emerging markets appear oversold. In addition, most world markets are undervalued compared to the U.S. ERS is currently narrowing the underweight in the international markets.

Regarding staffing, the Investments division had 14 promotions, four new employees and one retirement in fiscal year 2014. Approval has been granted to add additional people for the current fiscal year, and four hiring packages out of seven are being processed.

Mr. Tull provided an update of the asset allocation. Staff is continuing to accelerate the transition to the new asset allocation, subject to tactical opportunities and economics. Private equity and private real estate are receiving more distributions and are on track to meet asset allocation guidelines by calendar year-end, instead of the previous target of 2017. Hedge funds have met their target of 5% for the fiscal year. The credit portfolio is also on track to meet the short-term guideline weighting of approximately 6% by the end of the fiscal year.

Mr. Tull discussed economics of the Trust and how the Investment division conserves funds of the Trust. The cost of internal management is 10 basis points versus more than 40 basis points for external management. Additionally in calendar year 2014, Investment staff and Legal have saved the Trust approximately $24.4 million due to fee negotiations and terms.

Mr. Tull provided an update in private infrastructure and announced that progress of the program will be presented at the May Board meeting. Staff hopes to transition the 1% asset allocation from Public Infrastructure to the Private Infrastructure portfolio.

Mr. Tull continued to outline additional initiatives for fiscal year 2015. One initiative is to create a business plan for third-party asset management. Another initiative is to explore creative investment opportunities, such as direct deals using fund vehicles. Recently, real estate was involved with a direct deal in storage through a fund vehicle. For these direct investments through fund vehicles, ERS requires a 3% alignment of interest, but for this deal the Executive Director was able to waive that provision and reduce the percentage to 2% pursuant to her discretionary authority under the ERS *Investment Policy* and staff will seek revision to this particular provision of the ERS *Investment Policy* in May 2015 during the annual review of the Real Estate program. Staff plans to continue to seek more direct investment opportunities in other private market asset classes, such as private equity and private infrastructure.

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

XIX. SET DATE FOR THE NEXT JOINT MEETING OF THE ERS BOARD OF TRUSTEES AND INVESTMENT ADVISORY COMMITTEE, AND THE NEXT MEETING OF THE BOARD OF TRUSTEES AND THE NEXT MEETING OF THE AUDIT COMMITTEE

The dates for the 2015 meetings Joint Meeting of the ERS Board of Trustees and Investment Advisory Committee, the Meeting of the Board of Trustees and the Meeting of the Audit Committee were as follows:

Joint Meeting Dates:
Tuesday, February 24, 2015
Tuesday, May 19, 2015
Tuesday, August 18, 2015

2-Day Workshop:
Thursday - Friday, December 3 & 4, 2015

XX. ADJOURNMENT OF THE JOINT MEETING OF THE BOARD OF TRUSTEES AND INVESTMENT ADVISORY COMMITTEE

The February 25, 2014 Joint Meeting of the ERS Board of Trustees and Investment Advisory Committee adjourned at 4:49 pm.