
Oregon Investment Council

April 27, 2018

1:00 PM

Special Meeting

**Oregon State Treasury
16290 SW Upper Boones Ferry Road
Tigard, OR 97224**

Rukaiyah Adams
Chair

John Skjervem
Chief Investment Officer

Tobias Read
State Treasurer



OREGON INVESTMENT COUNCIL



Agenda

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Investment Division
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<u>Time</u>	<u>A. Action Items</u>	<u>Presenter</u>	<u>Tab</u>
1:00-1:05	1. Introduction	Rukaiyah Adams <i>OIC Chair</i>	
1:05-2:15	2. Asset Allocation Discussion <i>OPERF</i>	Jim Callahan <i>Callan Associates</i> Allan Emkin <i>Pension Consulting Alliance</i>	1
2:15-2:30	----- BREAK -----		
2:30-3:30	3. Statement of Investment and Management Beliefs	Allan Emkin	2
3:30	4. Open Discussion	Council Members Staff Consultants	


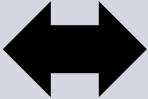








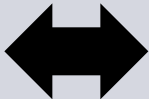



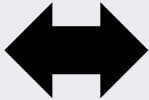
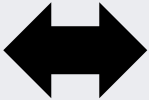
B. Public Comment

TAB 1 – Introduction

TAB 2 – Asset Allocation Discussion

OPERF

Different Frameworks versus Oregon¹


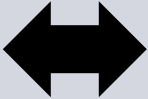








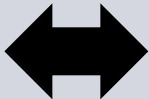





	Low Cost/Passive	U.S. Endowment	Canadian	U.S. Corporate
Staffing Level				
Internal Management				
Alternative Allocation				
Performance				
Staff Discretion	None	Yes	Yes	None

¹ For the ten-year period ending June 30, 2017.

Notes to Previous Slide

	Low Cost/Passive GA, ID, IL MRF, MN, MS, NV, & OK TRS	U.S. Endowment Harvard, Yale, Texas, Stanford, Penn, MIT, Northwestern	Canadian Eight largest Canadian state pension plans	U.S. Corporate
Staffing Level	Generally much lower.	Manually reviewed seven endowments.	Anecdotal	Anecdotal
Internal Management	Ave ~0% based on 2017-09 P&I data.	Anecdotal	Anecdotal	Anecdotal
Alternatives Allocation	Ave ~10% based on 2017-09 P&I data. Criterion for “Low Cost/Passive” is < 33 rd percentile.	NACUBO 2017 report for endowments > \$1B	Manually reviewed seven plans.	BlackRock 2018-03 U.S. Pension Funding Update
Performance	Manually reviewed 10-year performance ending June 2017 for seven U.S. public plans.	NACUBO 2017 report for endowments > \$1B. 10-year performance = 5.0% versus 5.4% for OPERF.	Manual review. Most outperformed OPERF but CAD depreciated.	Callan performance report ending June 2017.
Staff Discretion	Based on proprietary survey data.	Yes	Anecdotal	Anecdotal

Different Frameworks versus Oregon¹

	Low Cost/Passive	U.S. Endowment	Canadian	U.S. Corporate
Staffing Level				
Internal Management				
Alternative Allocation				
Performance				
Staff Discretion	None	Yes	Yes	None

¹ For the twenty-year period ending June 30, 2017.

Notes to Previous Slide

	Low Cost/Passive GA, ID, IL MRF, MN, MS, NV, & OK TRS	U.S. Endowment Harvard, Yale, Texas, Stanford, Penn, MIT, Northwestern	Canadian Eight largest Canadian state pension plans	U.S. Corporate
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Performance	Manually reviewed 20-year performance ending June 2017 for six U.S. public plans.	NACUBO 2017 & 2007 reports for endowments > \$1B and June fiscal year-end.	Manual review of five large Canadian pension funds, ending December 2017.	Callan performance report ending June 2017.
Staff Discretion	Based on proprietary survey data.	Yes	Anecdotal	Anecdotal

TAB 3 – Statement of Investment and Management Beliefs

Date: April 20, 2018

To: Oregon Investment Council ("OIC" or "the Council")

From: Pension Consulting Alliance, LLC ("PCA")

CC: John D. Skjervem, Chief Investment Officer, Oregon State Treasury ("OST")
Allan Emkin, Managing Director, PCA
Neil Rue, CFA, Managing Director, PCA

RE: Update of OIC Investment and Management Beliefs

Since the original adoption of the Statement of Investment and Management Beliefs (the "Beliefs") in 2013, four new members have joined the six-member OIC, and the OST has started to materially improve its investment staffing levels. Furthermore, in an increasingly challenging capital markets environment, heightened focus is required by both the OIC and OST investment staff to successfully manage risk, return, and costs. Considering these developments, PCA was retained to work with the OIC and senior OST investment staff to review and possibly revise the Beliefs. Currently, PCA is working with senior OST staff to present new statement language at the Council's special meeting on April 27, 2018.

Over the first quarter of 2018, PCA engaged the OIC and senior OST investment staff in a survey to examine the existing Beliefs and solicit updated commentary thereon and potential revisions thereto. The 14 participants provided thoughtful and informative survey responses. Specifically, there was broad agreement that most of the Beliefs continue to reflect consensus, while two Beliefs statements (Statements 1 & 4) generated significant discussion and revision suggestions. In this memo and attached Beliefs material, we consolidate and provide context for the survey feedback, which, for comparative purposes, is highlighted below in red text. The highlighted text and the accompanying footnotes are intended to facilitate discussion as the Board and staff continue to review the Beliefs.

In addition to the survey process, some participants expressed the view that investment management is dichotomous -- part art and part science. This view further states that elements currently represented as art in the institutional investment management community are overstated or inflated in terms of necessity and efficacy. Board and staff have implied that to better calibrate both governance and daily operating activities with a more appropriate balance between art and science, the Beliefs should be anchored where and whenever possible to the best data and thinking as provided by academic research and experiential rigor. As such, PCA recommends adding language that will make this implied belief more explicit.

Lastly, the Beliefs are foundational to the OIC/OST investment program and are designed to facilitate continuity as new Board members and staff join the OIC and OST, respectively. Given this foundational role, future revisions to the Beliefs should occur sparingly, and the frequency at (or circumstances under) which revisions occur should be a discussion topic too.

OREGON INVESTMENT COUNCIL

Statement of Investment and Management Beliefs

1.) THE OIC SETS POLICY AND IS ULTIMATELY RESPONSIBLE FOR THE INVESTMENT PROGRAM

A. Investment management is dichotomous -- part art and part science.¹

- Elements represented as art in the institutional investment management community are overstated or inflated in terms of necessity and efficacy.
- To better calibrate both governance and daily operating activities with a more appropriate balance between art and science, the Beliefs should be anchored where and whenever possible to the best data and thinking as provided by academic research and experiential rigor.

B. The OIC is a policy-setting council that largely² delegates investment management activities to the OST and qualified external fiduciaries.

- The OIC sets strategic policy and tasks both OST staff and external managers with policy implementation.

C. The OIC has authority to set and monitor portfolio risk. Both short-term and long-term risks are critical.

- The OIC must weigh the short-term risk of principal loss against the long-term risk of failing to meet return expectations.

D. To exploit market inefficiencies, the OIC ~~must~~ should³ be long term,⁴ contrarian, innovative, and opportunistic in its investment approach.

- The OIC should generally prepare for and accept periods of extreme price/valuation volatility and/or related market dislocations and endeavor to act expeditiously during such periods if and when deemed advantageous.

E. Internal incentive structures should be carefully evaluated to ensure proper alignment with specific investment objectives.⁵

- Evaluation criteria should be based (in large part) on decisions over which staff members have clear authority and control.
- Total portfolio results (in addition to individual asset class returns) should be considered, and the evaluation period should be consistent with an appropriate investment horizon or market cycle.

F. The OIC should advocate for ~~adequate~~ the resources ~~are~~ required to successfully compete in global capital markets.⁶

- Staffing levels and operating budgets should be determined by capability requirements using benchmark assessments comprised of other well-respected organizations of similar size and portfolio complexity.
- The benefits of OIC member and OST staff continuity should also be recognized.

¹ This belief statement was implied by certain participants.

² Respondents advocated for the removal of “largely” as a qualifier to the statement.

³ Respondents recommended that “must” be changed to “should.”

⁴ Respondents proposed that “long term” should be added to this statement as a “contrarian, innovative, and opportunistic approach” may take time to develop. Additionally, some respondents wanted more clarity around this bullet point.

⁵ Several respondents indicated that this statement should be eliminated as the OIC doesn’t have jurisdiction over OST staff compensation.

⁶ Respondents highlighted that the OIC doesn’t have authority over investment division resources, but that the OIC should play a significant role in advocating for the adequate resourcing of the investment division.

2.) ASSET ALLOCATION DRIVES RISK AND RETURN

A. Asset allocation is the OIC's primary policy tool for managing the investment program's long-term risk/return profile.

- Decisions regarding strategic asset allocation will have the largest impact on the investment program's realized return and risk and hence should be made judiciously and receive special emphasis and attention.
- The timing and magnitude of projected employer contributions and future benefit payments have significant cash flow implications and thus should receive explicit consideration during the OIC's asset allocation decision-making process.

B. Portfolio construction, including diversification and correlation considerations, is essential to maximizing risk-adjusted returns.

- Empirical rigor, coupled with sound judgment, is required in the portfolio construction process to effect true diversification, while discipline is required to maintain diversification through and across successive market cycles.
- Risk is multi-faceted and may include, but is not limited to, the following types of specific risks: principal loss; opportunity cost; concentration risk; leverage and illiquidity risk; volatility and valuation risk; interest rate and inflation risk; and environmental, social and governance (ESG) risks.⁷

3.) THE EQUITY RISK PREMIUM WILL BE REWARDED

A. Over the long-term, equity-oriented investments provide reliable return premiums relative to risk-free investments.

- Although returns for risk taking are not always monotonic or consistently rewarded over time, bearing equity risk does command a positive expected return premium provided such risk is reasonably priced.

4.) PRIVATE MARKET INVESTMENTS CAN ADD SIGNIFICANT VALUE AND REPRESENT A CORE OIC/OST COMPETENCY

A. The OIC can capitalize on its status as a true, long-term investor by making meaningful allocations to illiquid, private market investments.

- Inefficiencies exist in private markets that provide skilled managers with excess return opportunities relative to public market analogues.
- Private markets may also offer an "illiquidity premium" that can be exploited by patient, long-term investors.⁸

B. Dispersion in private market investment returns is wide; accordingly, top-quartile manager selection,⁹ diversification across vintage year, strategy type, and geography,¹⁰ and careful attention to costs¹¹ are paramount.

⁷ Concepts of risk and associated measurement techniques are evolving. Heretofore underdeveloped, the identification and measurement of ESG risks is improving which will enable new risk management applications in both security selection and portfolio construction processes.

⁸ Respondents want to explore to what extent the illiquidity premium has been captured in the private equity portfolio. Other respondents would like to remove the statement on the illiquidity premium all together.

⁹ The phrase "top-quartile manager selection" was viewed as perhaps too aspirational given the most recent private equity annual review, which noted that OPERF's existing private equity commitments were in fact equally weighted across performance quartiles.

¹⁰ Respondents identified other sources of diversification aside from vintage year that would be beneficial.

¹¹ Respondents were sensitive to the increasing importance of cost in private markets as well as the alternative investment structures that are emerging to dampen such costs.

- Private market investment success is predicated on identifying skilled managers and developing long-term investment relationships with those managers that enable the application of skill to manifest in the form of excess returns.^{8,9}
- Proper investment pacing, including deliberate vintage year diversification is also an integral element of superior private market investment results.

5.) CAPITAL MARKETS HAVE INEFFICIENCIES THAT CAN BE EXPLOITED

A. Inefficiencies that can be exploited by active management may exist in certain segments of the capital markets.

- While largely efficient, select segments of the capital markets can sometimes be successfully¹² exploited by skilled active management.
- The nature (i.e., perceived magnitude and likely duration) of such inefficiencies should inform the proposed active management strategy (e.g., discretionary or systematic).

B. Passive investment management in public markets will outperform the median active manager in those markets over time.

- Active management should therefore be a deliberate choice and applied only to those public market strategies/managers in which the OIC enjoys a high degree of confidence that such strategies/managers will be sufficiently rewarded on a risk-adjusted basis and net of all fees, factor exposures and related transactions costs.

6.) COSTS DIRECTLY IMPACT INVESTMENT RETURNS AND SHOULD BE MONITORED AND MANAGED CAREFULLY

A. All fees, expenses, commissions, and transaction costs should be diligently monitored and managed in order to maximize net investment returns.

- While all costs should be monitored and controlled, these costs should also be evaluated relative to both expected and realized returns.

B. External incentive structures should be carefully evaluated to ensure proper alignment with investment program objectives.

- Fee and incentive structures drive both individual and organizational behavior.
- These structures (particularly in private market strategies) should be carefully evaluated and monitored to ensure that the goals and incentives of individual investment professionals and their respective organizations are well aligned with the specific investment objectives established by the OIC and/or OST staff.

7.) FAIR AND EFFICIENT CAPITAL MARKETS ARE ESSENTIAL FOR THE LONG-TERM SUCCESS OF OIC/OST INVESTMENT ACTIVITIES

A. The OIC recognizes that the quality of regulation and corporate governance can affect the long-term value of its investments.

- The Council promotes competitive and transparent market structures to ensure accurate and timely price discovery/asset valuation.

B. The OIC also recognizes that voting rights have economic value and therefore must be treated as a fund or beneficiary asset.¹³

- The OIC shall vote shares in its capacity as fiduciary and based solely on the economic merits of specific proxy proposals.

¹² The definition of success in this context is excess returns net of all fees, factor exposures and associated transactions costs.

¹³ Respondents want to revisit the language around how shares are voted considering the role Glass Lewis plays in the proxy voting process.

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