DATE: March 1, 2021

SUBJECT: Board Investment Policy Annual Review

TO: Members of the Board

FROM: Joseph W. Sheva, CPA, FRM *JWS*
Senior Risk Manager

At the March Investment Committee meeting the Investment Office (IO) will recommend the final proposed versions of the Board Investment Policies, which includes the Investment Policy Statement (IPS) and 24 Stand-alone Policies for adoption.

For your review, the final clean draft Policies for approval (unchanged from the draft policies sent on February 5th) have been placed in the Red File folder in Diligent in the following subfiles:

- 8.7.5 contains the resolution;
- 8.7.6 contains memos from staff, Aksia, Aon, Constellation, Hamilton Lane, and Cohen Milstein;
- 8.7.7 contains all policies with changes from the last time the board approved the policies (blacklined copies are in the Resource Folder in the folder entitled “2021 Annual Review of Board Investment Policies”); and
- 8.7.8 contains all policies with no changes from last year

Additional information regarding the content of these folders is below.

Board Policy Annual Update Review Process Overview:

1. Beginning in October 2020 the IO, inclusive of all senior management and asset class heads, reviewed all Board Investment Policies. General matters such as, consistency of terminology, usage of defined terms, and consistency between Policies were reviewed. Specific matters, such as limits, were reviewed and deliberation of these internal recommendations occurred.

2. After the above was completed the IO drafted updated Policies and provided them to Aon, the Board’s general investment consultant, asset class specific specialty investment consultants Aksia and Hamilton Lane, and the compliance consultant, Constellation, for their review. Each provided feedback on various Policies for the IO to consider.

3. The IO then provided the Board’s Fiduciary Counsel all Policies to review, inclusive of the consultant feedback. Changes were made based on this feedback

4. The IO provided the Board a draft of the Policies for review on February 5, 2021 for comments.

5. The IO provides responses to comments (none this year) and the final recommendation the Board.

As provided on Diligent, the following is broken down into Policies with recommended changes and Policies with no recommended changes.

POLICIES WITH RECOMMENDED CHANGES:

A. Investment Policy Statement

- Section III. Roles and Responsibilities: Clarified the ability of the CIO to discharge (i.e. sell) interests in the secondary markets.

- Section VI. Asset Allocation: Adjusted Asset Class Ranges based on the framework adopted by the Board in March 2020 and clarified or eliminated information that is no longer applicable. In addition, recommend allowing for a +/-3% Range for the Credit Related Fixed Income allocation and increasing the Range for the Absolute Return allocation from 30% to 40%. Both adjustments will allow for flexibility to implement the asset allocation.

- Sections VI. Asset Allocation and VII. Performance Objectives: Removed reference to the "New Asset Allocation", making the Current Allocation the one voted on in November as being effective April 1, 2021. The elimination of the Current is procedural in that only one Asset Allocation will be effective following the March 2021 Board meeting.

- Section X. Definitions: Added a definition for Tracking Error, as current Policies are silent to the definition.

B. Asset Class Policies: Traditional

- <u>Public Fixed Income Policy</u>

    - Removed a statement regarding leverage ratio constraint to make consistent with other Public Asset Class Policies.
    - Increased Non-U.S. Inflation Protected Tracking Error from 350 to 800bps. See memo titled *"2021-03-04 Memo to the Board - Recommendation for Tracking Error Range - Non-US Infl Protection"* in the Memo sub-folder on Diligent.

- <u>Traditional Investments Due Diligence Policy</u> – changes were made to remain consistent with the Non-Traditional Investments/Due Diligence Policy and to address a recommendation for additional clarity from the compliance consultant, Constellation.

C. Asset Class Policies: Non-Traditional

- Non-Traditional Investments Due Diligence Policy – changes were made to remain consistent with the Traditional Investments/Due Diligence Policy and to address a recommendation for additional clarity from the compliance consultant, Constellation.

- An objective of the following Policies is that they are structured consistently (e.g. each contains Section IV. Investment Philosophy) and where possible, contain similar, asset class-specific, language.

    - Private Equity Policy
    - Private Credit Policy
    - Private Commodity Policy
    - Private Real Estate Policy
    - Private Infrastructure Policy
    - Absolute Return Policy

  The changes, if any, made in all the sections relate to the objective of making these Policies consistent with each other, where applicable, with changes to Section V. Allocation being for flow and how the asset class is currently managed (e.g. the removal of Special Situations in the Private Equity Policy to depict how the asset class is managed).

- Recommended changes beyond those noted above are shown below:

  Section VI. Permissible Investments:

    - Private Equity Co-Investments: recommendation to increase the maximum program size from $1.0 to $1.5 billion since the program is getting close to the $1 billion size.

    - Private Credit Co-Investments: recommendation to increase the maximum program size from $250 to $500 million since the program is getting close to the $250 million size.

    - Private Commodities Co-Investments: recommendation to decrease the maximum program size from $1 billion to $250 million since the program is not anticipated to materially grow in size.

    - Co-Investments and Secondary investments: recommendation to change the single co-investment and secondary investment from initial $50 million and $25 million follow on to a cumulative limit of $75 million.

    - Recommendation to increase the amount of annual capital budget requiring Board approval from $10 to $25 million in the Private Real Estate Policy.

Section VIII. Risk Management:

- Absolute Return: recommendation to increase the maximum allocation to any one partnership or open-ended fund is limited to 10% to 15% and the maximum to a separate account from 12% to 15% to be able to better manage the program with the allocation reduction from 10% to 8%.

D. Investment-Wide Policies:

- Liquidity Policy: recommendation of the following changes in Section VI. Risk Management
  - A. Assets: move a part of section VI.C. into this section, as it is more relevant to this section. Also adding a note regarding tail risk.
  - B. Investment-Related Liabilities: remove "and funds with lock-up periods" and related paragraph, as these are not liabilities, and are expressed in section V.C. where they are described along a spectrum of liquidity
  - Sections C. (formerly Contingency Liquidity Plan) and D. (formerly Contingency Funding): combine into a revised section called Contingency Plan. This section now outlines Board direction should the unlikely event that immediate liquidity is required.
- Leverage Policy: remove Risk Parity and add Long US Treasuries to the Explicitly Leveraged Portfolios list.
- Currency Hedging Policy: add clarifying language regarding the program, including identifying Private Infrastructure and Private Infrastructure Co-investment as being hedged, which is consistent with the IPS hedged benchmark.
- External Investment Managers Insurance Policy:
  - Remove "Investments" from the Policy name.
  - Add additional sections to clarify insurance requirements for various investment management arrangements. As such add section V. Types of Investment Management Arrangements, and provide the requirements for each in the following sections:
    - VI. Insurance Requirements For Separate Account External Managers
    - VII. Insurance Requirements For Commingled Account External Managers
    - VIII. Insurance Requirements For Fund of One Account External Managers

- Tail Risk Mitigation Strategy Policy: move the performance reference, including footnote, from Section V. Allocation to Section VII. Performance Objectives and clarifying that performance will be reflected as an independent line item, rather than "within Equity Exposure".

POLICIES WITH NO RECOMMENDED CHANGES:

- Public Equity Policy
- Public Commodities Policy
- Public Real Estate Policy
- Public Infrastructure Policy
- Derivatives Policy
- Cash Policy
- Qualified Independent Representatives (QIR) Policy
- Securities Lending Policy
- Placement Agents Policy
- Risk Parity Policy – Remove, no longer needed

Both blacklined and clean versions of the Policies have been included in the package for your review.

If you have any questions or comments, please contact me at josheva@pa.gov or 717-720-4632.