



MoDOT & Patrol Employees' Retirement System

TO: MPERS' Investment Committee

FROM: Larry Krumpfen, Chief Investment Officer

DATE: August 12, 2021

SUBJECT: Restructuring of MPERS' Public Equity Portfolio
MPERS' Investment Committee Meeting – August 24, 2021

The purpose of this memo is to update MPERS' Investment Committee on changes to and the future structure of MPERS' public equity portfolio.

Background:

In calendar year 2020, MPERS' investment staff and NEPC began a top-down review of MPERS' public equity portfolio. The initial findings of that review were shared with MPERS' Investment Committee in September of 2020. At that time, the equity portfolio was underperforming the broader equity benchmarks; however, staff and NEPC were confident the current portfolio structure would serve the System well over the long term and concluded that it was not the time to make any immediate adjustments. As the table below shows, the performance relative to the public equity benchmark has since progressed in MPERS' favor.

Attribution Summary							
1 Year Ending June 30, 2021							
	Weighted Actual Return	Weighted Index Return	Excess Return	Selection Effect	Allocation Effect	Interaction Effects	Total Effects
Public Equities	47.7%	39.3%	8.4%	3.0%	-0.4%	-0.1%	2.5%
Private Equity	52.2%	60.9%	-8.7%	-0.8%	1.7%	-0.4%	0.5%
Traditional Fixed Income	1.5%	-0.4%	1.9%	0.5%	1.9%	-0.2%	2.3%
Opportunistic Debt	27.4%	15.4%	12.0%	0.9%	-0.3%	0.4%	1.1%
Real Assets	14.9%	9.6%	5.3%	0.6%	-0.3%	0.1%	0.4%
Real Estate	12.8%	8.0%	4.8%	0.5%	0.3%	-0.1%	0.7%
Cash Composite	0.1%	0.1%	0.0%	0.0%	-0.2%	0.0%	-0.2%
Total	30.8%	23.5%	7.3%	4.9%	2.7%	-0.4%	7.3%

Source: NEPC Quarterly Board Report from June Board Meeting

The quick rebound in performance demonstrates that having long-term vision during tough times is rewarded. Given the rebound in MPERS' performance relative to the benchmark, staff and NEPC now believe the timing is right to make some modest adjustments to the public equity portfolio. Those changes are intended to both improve the efficiency of the portfolio (in terms of ease of implementation and overall cost) and create a more consistent excess return profile relative to the global public equity benchmark. The next section of this memo will discuss the planned implementation in more detail.

Public Equity Restructuring

As part of the review of MPERS' public equity portfolio, staff performed a top-down statistical analysis of the portfolio to identify the factors that led to the differences between the portfolio's actual performance relative to the global equity benchmarks. The key observations from this analysis are as follows:

1. The security selection process of MPERS' active equity managers, which is commonly referred to as stock selection risk, has led to a consistent overweight to small capitalization and value return factors.
2. The current roster of direct hedge fund investments utilized within the hedged equity allocation was not adding long-term value relative to the underlying equity indices.

Upon completing this review, staff believes a modest restructuring of the equity portfolio can achieve the following objectives:

1. Increase portfolio efficiency (reduce active equity manager fees) through the use of investable factor indices.

The small cap and value biases that were identified in the analysis can be maintained and more effectively managed through derivative exposures in widely recognized, liquid indices (versus more costly active management structures). Staff and NEPC believe we are in the early stages of a long-term secular recovery in value-based strategies, and can more effectively manage the desired factor exposure by using investable index derivatives versus relying on the stock selection criteria of active managers. The positioning of the equity portfolio will be simpler to understand because the targeted factor exposures are more transparent relative to the underlying holdings of the active equity managers. This will also reduce the stock specific concentration risk within MPERS' public equity portfolio that is produced by the active manager's security selection processes.

2. Provide an equity portfolio that is easier to implement and monitor, given MPERS' current resources.

Given the limited staffing at MPERS, the ongoing due diligence of the public equity portfolio (including the direct hedge funds within the hedged equity allocation) has historically been shared by various team members. The recent staff departures has made this difficult to manage and maintain. The new targeted structure will include an immediate termination of six active managers (summarized below) and consolidation of the majority of MPERS' hedge fund strategies under a new relationship with Blackstone Alternative Asset Management. The new and remaining manager relationships fit nicely into the skillsets of MPERS' existing staff and therefore, can be monitored more effectively. Together with the transparency provided by using investable factor indices (detailed above), the oversight of this portfolio will be much simpler than MPERS' historical approach.

Staff believes the restructured equity portfolio will more consistently outperform MPERS' public equity benchmark as it simplifies the implementation process, and creates a more efficient and diversified excess return (alpha) source. However, this strategy is not without risk and should not be expected to generate positive returns over all periods. This strategy will not prevent all losses (i.e., it will not work every month or even every year), but staff believes it will provide higher and more consistent excess returns relative to the current allocation.

Manager Hires and Terminations

In order to implement the new equity structure, MPERS' staff will hire or terminate several external managers. A summary of these movements is provided below and additional information on each manager can be found in the respective hiring or termination memos once the process is finalized.

Pending Hires

PIMCO Stocks Plus: PIMCO is a global leader in bond management with over \$1 trillion dollars in assets. PIMCO Stocks Plus uses equity index derivatives to achieve the market return and buys bonds to outperform the financing costs. While excess return is expected from PIMCO's bond management, they can also provide MPERS' staff insight on the current opportunities in the bond market. Those opportunities are potentially actionable in the MPERS' internally managed bond portfolio.

Blackstone Alternative Asset Management (BAAM): BAAM is a global leader in hedge fund-of-funds management. BAAM is a subsidiary of the publicly traded The Blackstone Group Inc. (ticker symbol: BX). With over \$82 billion under management, BAAM is the largest discretionary allocator in the hedge fund space. As early investors in the hedge fund space, BAAM has capacity with closed managers that have the longest tenure and highest returning track records. BAAM's experience and access set them apart from similar managers. As part of the hiring and transition, BAAM will oversee the majority of MPERS' overall hedge fund exposure going forward.

Pending Terminations

The following managers will be liquidated to accommodate the transition to the new equity structure:

- Acadian Non-US Smallcap (active equity manager)
- Acadian International Microcap (active equity manager)
- Silchester International (active equity manager)
- Alpstone (hedge fund)
- Indus Pacific Opportunities Fund (hedge fund)
- Pentwater (hedge fund)

In all cases, the manager's performance has been satisfactory; however, we believe the new equity structure will provide better returns going forward. We also expect the

allocations to Millennium and Bridgewater (both hedge fund strategies) will be reduced over the coming year as staff fully implements the new program.

Final Portfolio

Staff estimates it will take up to six months to fully transition the portfolio from the current allocations to the new allocations. A snapshot of the new target portfolio using June 30, 2021 dollar values is listed below:

Future Portfolio		
Global Public Equities		\$1,106,300,163.00
Diversified Beta		
Beta Overlay		
	Parametric	\$917,427,972.00
Collateral Pool		
	Bond Collateral – Internal	\$132,518,547.65
	Blackstone	\$250,000,000.00
	Bridgewater	\$18,233,586.00
	Millennium	\$18,840,765.00
	Cash	\$497,835,073.35
Active Managers		
	PIMCO	\$100,000,000.00
	Kennedy Microcap	\$47,213,968.00
	Kennedy Small Cap Banking	\$41,658,223.00

Source: Staff projections and Northern Trust