

**Date:** July 27, 2017

**To:** SBI Investment Advisory Committee (IAC)

**From:** Pension Consulting Alliance, Inc. (PCA)

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**RE:** **Consideration of Draft SBI Investment Beliefs**

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### Summary

At its May 2017 meeting, the CIO and IAC provided direction to PCA to work with the CIO to develop a draft set of SBI investment beliefs by August/September 2017. After undertaking a process that included surveying dozens of SBI-related individuals, meeting with senior management, and conducting additional significant discussions on the matter, PCA and the CIO have developed ten investment beliefs the Board and IAC could consider for adoption.

### Discussion

PCA provided the IAC with an introductory discussion on investment beliefs at the May 2017 IAC meeting. While such beliefs often reflect current investment activities and positioning, they can also prove extremely helpful in guiding institutional decision makers toward sound investment principles. In this respect, decision-makers can view investment belief statements as important foundational reference points when making key investment policy and strategy decisions.

Since the May meeting, Staff and PCA have made significant progress in developing an initial set of investment belief statements for the SBI. After considering approximately five dozen different belief statements, surveying dozens of individuals across Staff, IAC, Board, and other key individuals, and meeting with Staff leadership to take their input on framing investment beliefs, the CIO worked with PCA to collate the survey results and factor in key discussion points to develop the ten attached investment belief statements.

Across all these final beliefs, the different survey groups (Staff, IAC, Board and Others) either strongly agreed or agreed with a specific statement. In other words, there was consensus among all parties for the specific statement. That was not always the case across the several-dozen survey statements, as some groups agreed with some statements while other groups showed disagreement.

As expected, the set of draft investment belief statements help to convey SBI's perspective on several key topical/foundational investment areas. Topics covered include asset allocation in the context of the overall retirement system, cost management, expected rewards from exposure to certain risk premiums, active vs. passive management, and governance.

Upon adoption, these Investment Belief Statements will provide a guiding foundation for future strategic investment decisions of the Board and IAC and be a potential focal point for other various stakeholder groups.

## SBI Investment Beliefs

In September 2017, the State Board of Investment adopted a set of ten Investment Beliefs for managing the assets of the Combined Funds (those funds utilized to support the defined benefit plans of the State's employees). The primary purpose of these Beliefs is to guide the SBI toward sound investing principles related to investing on behalf of the Combined Funds. In this respect, the Beliefs help provide context for SBI's actions, reflect SBI's investment values, and acknowledge SBI's role in supporting the State's broader retirement systems.

**The SBI is a long-term investor whose primary mission is to maintain the viability of the retirement systems it supports.**

*When determining an appropriate level of risk that the systems' assets should bear the SBI must reflect the nature of those systems' liabilities and funding policy.*

**The SBI's strategic allocation policy is the primary determinant of (i) the asset portfolio's long-term investment return and (ii) asset portfolio's risk.**

**While the SBI can sacrifice some short-term liquidity to pursue a greater long-term return, the investment portfolio's net cash flows and ability to pay benefits on a year-by-year basis are key risk considerations.**

**Diversification improves the risk-adjusted return profile of the SBI investment portfolio.**

*Diversification of the SBI investment portfolio takes place across several critical dimensions, such as allocation across global regions and country markets (e.g., U.S. versus Europe, Asia, emerging markets, etc.), allocation among different types of assets (equities, bonds, real estate, etc.), spreading assets across various sectors and industries (e.g., technology, financials, consumer-oriented, etc.), and weighting of different risk factor premiums (e.g., value vs. growth, small companies vs. big companies, carry, illiquidity, etc.). If the correlation (i.e., relationship) among the returns generated by these factors is less than perfect (i.e., less than 1.0), then diversification is beneficial.*

**There are long-term benefits to SBI managing investment costs.**

**The equity risk premium is significantly positive over a long-term investment horizon although it can vary over time.**

*The equity risk premium is also pervasive across several asset classes and its overall exposure should be managed accordingly.*

**Private market investments have an illiquidity premium that the SBI can capture.**

*This risk premium can increase the portfolio's long-term compound return and help diversify the portfolio's risk.*

**It is extremely challenging for a large institutional investor to add significant value over market-representative benchmarks, particularly in the highly-competitive public global equity markets.**

*Passive management should be utilized when there is low confidence that active management can add value. Active management can have potential to add value where information processing is difficult and challenging, allowing for market inefficiencies that are potentially exploitable.*

**The SBI benefits significantly when roles and levels of authority are clearly defined and followed.**

*The role of the members of the State Board of Investment (Board) is to establish investment policies that are in compliance with state statute and guide the ongoing management of the funds. The Board delegates implementation of that policy to the Executive Director/CIO, and exercises oversight with respect to the Executive Director/CIO's implementation activities and the portfolio's active risk level in the context of the portfolio's strategic allocation policy. ~~The Board also ensures adequate resources are available to the SBI staff to perform their work;~~ The Board, through its budgetary authority, will provide the Executive Director/CIO necessary resources to maintain an appropriate operating budget and adequate staffing levels to execute the policies and implement the investment strategies of the SBI.*

*The Investment Advisory Committee (IAC) key role is advising the Board and Executive Director/CIO on general policy matters and methods to enhance the management of the investment portfolio;*

*The Executive Director's/CIO's key role is implementing SBI investment policies and setting the portfolio's active risk level in a prudent manner to achieve value-added over policy benchmarks.*

**Utilizing engagement initiatives to address economic, social, and governance-related (ESG) issues can lead to positive portfolio and governance outcomes.**

*In addition to specific engagement strategies the SBI might apply, proxy rights attached to shareholder interests in public companies are also “plan assets” of the SBI and represent a key mechanism for expressing SBI’s positions relating to specific ESG issues. By taking a leadership role in promoting responsible corporate governance through the proxy voting process, SBI can contribute significantly to implementing ESG best practices which should, in turn, add long-term value to SBI’s investments.*