Agenda
SCHOOL AND INSTITUTIONAL TRUST FUND
BOARD OF TRUSTEES
Friday December 18, 2015

350 North State Street, Treasurer's Office
Dial In Number 888-206-2266

Guest 9426154#

1. Call Meeting to Order

2. Approval of Minutes (10 min)
   November 20, 2015

Attached, Exhibit (A)

3. Distribution Policy (5 min)
   a. Update from Tim Donaldson
   b. Review and discuss resolution
   c. Adopt resolution

Attached, Exhibit (B)

4. Investment beliefs (30 min)
   a. Review and discuss
   b. Adopt current draft (?)

The draft of the first section has been provided for review.

Attached, Exhibit (C)

5. Investment Consultant RFP (25 min)
   a. Update

Attached, Exhibit (D)

Review and discuss process and results to date. Recommendations on next steps included.

6. Staffing update (5 min)

7. Investment Review (15 min)

a. Consider methodical reduction of US equity exposure

Consider methodical reduction of US equity exposure to lower bound of target as we approach 2Q 2016 and the addition of possible new mandates. US equity is largest allocation and is the greatest source of risk in the portfolio, thus is expected to be a primary source of capital for new mandates. Selling small tranches over time to raise cash is recommended as a manner of limiting the downside risk of future redemptions. We recommend allowing fixed income to reach a maximum of 28% (by virtue of an increasing cash position) and US equity to reach 42% minimum allocation. This would be accomplished in combination of SITLA contributions and/or 25bps withdrawal weekly on Tuesdays starting in January 2016. This assumes 4.25% cash raised through equity redemptions between January and May. Any contributions from SITLA would go towards our target and is how we might approach 5% over this time frame.

8. 2016 Meeting Days/Times (10 min)
    a. Discussion (and adoption) regarding the proposed meeting day/time for 2016 as the third Wednesday of each month at Noon

    We are required to meet 9 times a year. We are likely to run into problems with scheduling during the year, or will use judgment to cancel meetings where business can be postponed. However, having 12 meeting slots reserved will be the safest bet.

    January 20
    February 17
    March 16
    April 20
    May 18
    June 15
    July 20
    August 17
    September 21
    October 19
    November 16
    December 21

9. Adjourn

One or more members of the Board may participate via electronic conference originated by the Chair, and the meeting may be an electronic meeting, and the anchor location shall be as set forth above, within the meanings accorded by Utah law. In compliance with the Americans with Disabilities Act, individuals requiring special accommodations during the meeting should notify Peter Madsen, Director, at State Capitol Suite 180, 801-538-1472.

School and Institutional Trust Fund Board of Trustees
Resolution 2015-01

WHEREAS: The SITFO Board of Trustees and staff have fiduciary responsibilities to manage the permanent school fund for all current and future beneficiaries, and

WHEREAS: The principle of intergenerational equity is of paramount importance in a perpetual fund; and

WHEREAS: SITFO seeks to equally balance current beneficiaries in any given school year with all the future beneficiaries to come in perpetuity; and

WHEREAS: The “interest and dividends” approach to distributions has become outdated, due to low interest rates, stock buybacks in lieu of dividend payouts, and many investments which do not easily classify returns into the old paradigm of capital gains or interest and dividends; and

WHEREAS: Endowments, foundations, and pensions have found a total return approach to distributions to reduce volatility in distributions, allowing for a more stable payout, slow to send more in good times and slow to send less in bad times; and

WHEREAS: The public schools have a similar interest in a stable distribution, with less year to year volatility; and

WHEREAS: The constraints of an interest and dividends approach can lead us as trust fiduciaries to suboptimal asset allocation in an attempt to artificially strike a proper intergenerational balance; and

WHEREAS: Constitutional protection against an improper drawdown of too much in any given year being distributed is a central concern:

THEREFORE, BE IT RESOLVED, that the SITFO Board of Trustees and staff support legislation and a Constitutional Amendment to provide a Constitutional limit of no more than 4% of a rolling 12 quarter/3 year market value average being distributed in any given school year;

AND BE IT FURTHER RESOLVED that the SITFO Board of Trustees and staff support statutory enactment of a formula which provides for the distribution to be adjusted year to year on the basis of a rolling average of market value, as well as inflation and enrollment growth, provided that the Legislature allows SITFO to continually review the distribution formula and make recommendations to the Legislature for adjustments if necessary.

Agreed to this 18th day of December, 2015

______________________________________.

David Damschen, CTP
Utah State Treasurer and Chair, SITFO Board of Trustees

Statement of Investment Beliefs

Utah School & Institutional Trust Fund Office

December 2015

The following document is intended to represent the beliefs which the Board and Staff of SITFO agree to use as guiding principles. This document is neither a policy nor a procedural manual. Its primary purpose is to assist in governance and decision-making. These beliefs or principles should be reviewed annually and freely discussed with the Board and staff. Suggested improvements are welcome at any time.

I. Who we are

I. Mission / Objective(s)

II. Behavior

III. Efficient Markets Response

IV. Risk

- What is risk? A simple, but effective definition of risk is the realized loss of capital. However, risk is nuanced and multifaceted.
- Risk tolerance?

V. Asset Allocation

- Diversification across all investment possibilities
- Mathematical rigor is appropriate, mathematical certainty is not
- Valuations matter
- Rebalancing

VI. Manager Structure / Selection

- What is important
-

I. Who we are

The Utah Legislature created SITFO as an independent agency to invest the revenues from SITLA on behalf of the trusts, which are to be managed for the sole benefit of their respective beneficiaries. While the trusts have different underlying beneficiaries, they are managed with a similar asset allocation, as the return and risk objectives are the same. In addition, there is a significant benefit of scale for the smaller trusts being invested alongside the School Trust fund (95% of the combined total assets are the School Trust; there are 11 other institutional trust funds).

Though there are different underlying beneficiaries across the trusts, the source of financial assets to be invested (SITLA) is the same across all trusts. However, the nature of the cash flows differs between the School Trust and the others. SITLA has contributed an average of $70M annually to the School Trust. The proportional rate of growth of these contributions is likely to decrease over time for the following reasons; i) the School Trust is expected to grow through compounding of investment returns and ii) a prudent view of the land assets would be to consider them a diminishing revenue source.

A. Characteristics

1. SITFO is an independent state agency with a 5-person Board of Trustees and Staff of 3 professionals. We expect that the Trustees and senior staff will be fluent in the strengths and weaknesses of modern portfolio theory and bring significant investment experiences to the effort.

2. An advantage of having a relatively small set of decision makers is the potential to avoid the governance challenges and pitfalls of behavioral finance that seem to prevail with larger institutional investors. In addition to avoiding pitfalls we expect to take advantage of our set of experiences and beneficial structure to implement objective, research-oriented recommendations.

3. In order to mitigate the challenges of a relatively small number of full time professionals, Board and Staff will utilize investment consultants and external investment management to leverage existing resources.

4. Another positive trait we expect to avail ourselves of is our long time horizon. Our time frame allows us to tolerate volatility and illiquidity at moderate levels, should those risks be deemed prudent in order to meet our investment objectives.

5. We believe that ignorance and arrogance are detrimental to good decision making and that humility can be a great antidote to the pitfalls described in behavioral finance literature. Accordingly, we can remind ourselves of the potential weaknesses we live with, prepare thorough analyses, utilize checklists, adhere to disciplines, and be open-minded and available to challenges from one another.

II. Mission/Objective

The focus of the Board and Staff is to grow the invested principal of the School and institutional trusts at a rate that provides for both current and future beneficiaries. The target rate of return aims to support the distribution policy* with specified return and risk parameters found in the investment policy. The growth rate attainable will be subject to several market based factors, as well as the amount of risk the Board agrees as acceptable in setting the portfolio strategy.

**Our intention is to modify the current distribution policy from income-only, to a formula based in statute that is approximately 4% annually.*

III. Behavioral

This document doesn't provide for a complete review of behavioral finance; however it merits some attention in order to provide for discussion and a shared understanding. There is an attempt to address the themes of overconfidence, loss aversion, inertia, group behavior, and other cognitive and emotional biases throughout the document. In addition to this document there will be a process-specific document that outlines protocols to mitigate these and other biases.

A. Price and opportunity cost awareness

1. Understanding where we are in a cycle (economic cycle, market cycle, style/strategy cycle) and outlining the portfolio components' range of expected returns in the near to intermediate term (e.g. 3-10 years, not an abstract horizon like 25+ years) can help to frame investment decisions such as new mandates, rebalancing, etc.

2. Investment opportunities that have a higher expected return may be less common, considered "out of favor", or misunderstood and should not automatically be discarded based on the perceived headline risk or conventional wisdom.

3. Inertia as a result of ignorance, fear, or lack of preparedness isn't significantly different from poorly thought out and poorly executed decisions. Great opportunities most always are accompanied by significant uncertainty.

B. Governance and management

1. Governance is most helpful when it provides robust checks and balances, and is least helpful when it fosters groupthink, is used as a shield from taking responsibility, or is abused for political purposes.

2. Board members have the benefit of not working day-to-day on the portfolio and are an important source of perspective and inquiry.

3. Board members usually are not doing the level of research and due diligence that staff or consultants should be performing, suggesting staff provide additional support where required by Board members.

4. Management should source and promote the best ideas without bias.

5. Management should spend significant time developing and retaining talent, which often means getting out of the way. McKinsey & Company summarize two reasons why top tier public institutions are able to attract and retain talent; i) “the ability to deploy patient capital with minimal constraints” and ii) “higher purpose of furthering a social good”. Important for us will be to facilitate the first and communicate the latter.

C. Performance Measurement

1. We are outcome-oriented investors. Acting (or not acting) out of fear of being different from the past, different from peers, or different from one's own biases is not a constructive source of return.

2. Benchmark and peer performance are important reference points, but have their own weaknesses due to construction and sampling issues. In addition, cap-weighted benchmarks and peer groups can also be measures of herd mentality and thus perverse indicators in some instances.

3. Benchmarking is best done when the factor exposures of the portfolio are well understood, taken into account, and appropriate time horizons are referenced.

4. Benchmarks at the manager, asset class, and total portfolio level should be constructed to reflect expected outcomes as well as measuring performance relative to relevant factor exposures. Multiple perspectives add insight.

Investment Consultant Search Update

Invitations and Responses

- We sent the RFP to 23 companies
- 13 responded
- Of the 10 that did not respond, 7 were invited and 3 inquired after hearing about the opportunity but didn't meet qualifications
- Of the 7 invited that did not respond, 3 cited concern over fees allowed in government contracts, 4 originally cited concern but later regretted not participating after learning more of the nature of the mandate

Proposals

- The RFP was structured to allow for unbundled (services itemized by cost) proposals
- We opened the proposal to generalist as well as specialist firms, and of course those who do both
- 4 of the 13 firms were specialists and provide advisory services on alternatives
- 7 of the 13 firms were generalists who have capabilities that range from thin to comprehensive alternatives services
- Firms were also asked to bid on a spectrum of services that included outsourcing the operational requirements of working with private market funds
- Proposals can be loosely categorized into one of the these three categories:
    1. Generalists – Those who would require a specialist to provide comprehensive coverage of alternatives
    2. Specialists –Those who are able to provide comprehensive coverage of alternatives
    3. Hybrid – Those who are able to sufficiently provide both generalist and specialist services under one roof

Process

- The review committee (Allen Rollo, Tim Donaldson, Peter Madsen)
- The review process to date included:
    1. Reading and scoring the written proposals
    2. Conference calls with each proposer
    3. Further follow up for clarification, data collection, fee discussions
- All of the proposals came from healthy firms with sufficient capabilities. Our task was to verify the level of services offered, understand their approach and capabilities to determine best alignment for our needs. Important elements included:
    1. Organizational stability, quality/amount of research staff, right sized, service model and team proposed
    2. Investment insights, asset allocation and risk modeling, customization
    3. Evidence of working to uncover opportunities proactively
- Next steps
    1. Board discussion of results thus far
    2. Onsight due diligence visit (January)
    3. Final data gathering, clarification, and negotiation
    4. Board approval (March)

Analysis to Date:

- The table below provides a summary overview of the proposals
- Scoring includes the fee proposal, but it isn't a strongly weighted factor
- Fee proposals range broadly given pricing models, quality of research coverage, and capabilities
  1. The lowest fee providers were **generalist consultants** whose alternatives work only included fund of fund or specialist consultant searches, or was priced separately. The fee proposals ranged between $225k and $385k. These proposals are not ideal given we want to avail ourselves of every opportunity, and would prefer to do so within one comprehensive relationship.
  2. **Specialist alternatives consultants** have a higher pricing model given they are a quasi-investment manager. Their full service pricing ranges from 17bps to 45bps on assets under advisement and some include a performance fee. In this type of relationship we would be receiving a custom separate account that is fully supported. In other words, this would be compared to a fund of fund (FoF) manager in service, capability, and fees. For comparison, FoF fees pricing would be approximately 50bps and would also include a performance fee. Using a specialist consultant we would not only save possibly save up to 50% in fees on alternatives relative to a generalist consultant plus FoF approach, we should expect to have higher returns given their focus on a narrow and challenging sector where differentiation matters. However, we've excluded the specialist consultants at this stage as we believe we are able to secure a relationship that will be effective in alternatives within a single relationship. In the future, should we require a specialist consultant we can revisit our approach.
  3. **Hybrid proposals** were in the sweet spot. These proposals are from 3 generalist consultants who have built a reasonable effort in alternatives and from 1 specialist alternatives consultant whose roots are in general consulting work. These proposals are all available in a flat fee offering which is beneficial as costs won't increase based on asset growth or use of alternatives. The fees from these proposals range from $500k to $950k. Some of the proposals in this category include operational support. It is unclear how much operational support we need but given our small staff size it will be an important feature. We've been spending additional time with these proposers to better understand their support offering, service teams, investment capabilities, and fees (the fees are not final). We are working to adjust fees (lower) as we communicate further.
     - **A**
       - Generalist firm that has invested in alternatives coverage. Their client base is primarily endowment and foundation oriented. Their asset size isn't as large, but they are staffed well and financially healthy. Their fee proposal is attractive and they are eager to win our business and assigning senior staff to us. Their client base is a benefit as it gives them the ability to spend time on inventive concepts that might not be of interest to other client types. In addition, their smaller size is a benefit as the inefficiencies and opportunities that come with smaller managers, less common investment strategies, are usually capacity constrained.
       - Items for further investigation include; depth or quality of research team, quality of coverage in real assets, risk modeling
     - **C**
       - Generalist firm that has invested in alternatives. Founder was affiliated with Harvard endowment many years ago. Many clients are endowment and

foundation oriented. Larger firm with strong research. Financially healthy, recent transition in leadership is of interest, but seems well planned. Given their client base type they have been active in alternatives for a long time. They didn't show as much evidence in seeking the less common investment strategy or manager; however they evidenced proactive investment solutions that are meaningful to their clients. For example, they established a passive/rules-based equity strategy using a set of common factors (de minimis fee capture) that weren't represented in a single vehicle in the market place. The team proposed is strong, the fees are slightly less attractive.

- Items for further investigation include; fees, manager research and selection capability, better understanding of customization and team interaction

▪ **B**

- Alternatives specialist with generalist consulting capabilities and clients. One of the first firms to spin out and focus on alternatives. Deep research capability across capital markets, investment strategies and managers. Proactive in their approach with clients. Evidence of outperforming alternatives benchmarks as they are one of the few who tracks this information and has done well. They have created a rules-based/passive strategy for clients (de minimis fee capture) that invests in BDCs, there is not a manager or vehicle that focuses on that segment of the market. The team proposed is quite strong. It includes a former CEO/CIO of another consulting firm as the primary, and the co-consultant proposed is the current CEO/CIO of the firm.
- While it is clear that this is the best proposal related to alternatives, and there is a case to be made that is where the heaviest lifting and better risk adjusted returns are to be found, the fees are higher. While it isn't a given, it would seem that we would end up with a bias to alternatives when there are possible other solutions.

▪ **D**

- This firm is the largest that is on our radar with a hybrid proposal and interesting fees. They have been proactive with their clients regarding market based recommendations for asset allocation changes, introducing new strategies, and investing across the alternatives spectrum. They have a large research team and are a well-resourced firm. They have strong modeling capabilities and customization.
- Items of concern: Their client base is much more diversified and so they serve more "masters". In addition, having so many assets to put to work is a concern that they might not be able to work with the better managers who are capacity constrained. The team proposed isn't as strong, which may be something we can solve for. Also, the fee proposal isn't final and could go up from here as they initially did not allow for any support on alternatives.

Recommendation:

- We recommend visiting A as they are currently ranked high with a low fee and are a likely choice based on some further work on the research team
- We recommend visiting B and C since both are in the same location and rank well
- We also would like to reserve the option to visit D and C's other offices as they are also in the same area should D's fee proposal come in within the range of the other more attractive proposals

	Score	General Only Fee	Fee w Alts	Fee w Ops Support	Custody	AUM (B)	Research Staff	Total Staff	Strong Modeling	Capital Markets	Innovative	Pros	Cons
A	83%	NA	$588,000	$688,000	$0	$50	23	121	Strong	Strong	Strong	- Focused on endowments and foundations - Inventive in approach to finding investments - Strong capital markets research - Strong team proposed, strong overall bid for our business - Strong evidence of customization	- Risk modeling needs further investigation - Depth of research team needs further investigation
B	79%	$300,000	$700,000	$950,000	$75,000	$78	28	54	Strong	Strong	Strong	- Research intense firm - Strongest effort in alts - Strong evidence of customization - Strong innovative recommedations - Strongest team proposal	- Primarily a specialist consultant - Reporting output isn't as strong as others
C	73%	$330,000	?	$868,500	$0	$341	75	125	Strong	Strong	Strong	- Research intense firm - Strong in alts - Strong evidence of customization - Strong innovative recommedations - Strong team proposed	- Concern about research of smaller managers - Mild concern about profitability - Reporting and modeling questions
D	69%	$385,000	$580,000	?	$0	$900	44	240	Strong	Strong	Strong	- Evidence of proactive advice and customization - Evidence of researching asset class and manager ideas - Strong modeling	- Concern about breadth of all alts and depth of coverage - Concern about team proposal
E	64%	$340,000	NA	NA	$0	$2,000	33	185	Moderate	Moderate	Moderate	- Strong reporting - Strong team proposed	- Not set up for direct investing across alts - Assets are massive and could create capacity issues
F	67%	$449,000	?	$768,000	$0	$2,000	94	300	Strong	Strong	Moderate	- Deep resources - Strong modeling	- Response was lacklustre - Large organization with many entities - Client team not as strong as others
G	66%	$500,000	$500,000	$500,000	$0	$243	50	194	Strong	Moderate	Moderate	- Low fee - Strong modeling - Offering Morgan Stanley custody inclusive	- Part of large bank - Research in alts is limited to Morgan Stanley approved list
H	63%	$225,102	$645,000	NA	$50,000	$700	17	103	Moderate	Moderate	Moderate	-Low fee - Strong team proposal - Familiarity - Strong real estate group - Strong reporting	- FOF only for PE - HF program relatively new - Familiarity (my experiences there are likely similar biases to staff)
I	63%	NA	$848,000	NA	$0	$170	29	83	Strong	Moderate	Moderate	- Good capital markets research - Good modeling	-Concern about innovative - Concern about research constraints
J	57%	$240,695	$840,000	NA	$0		27	84	Moderate	Moderate	Moderate	- Good analytics - Flexible proposal to offset lacking HF coverage	- Alts effort isn't as robust (esp HFs) - Modeling not as strong
Average	*74%*	*$346,225*	*$671,571*	*$754,900*		*$720*	*42*	*149*					
Min	*64%*	*$225,102*	*$500,000*	*$500,000*		*$50*	*17*	*54*					
Max	*83%*	*$385,000*	*$700,000*	*$950,000*		*$2,000*	*75*	*240*					

Notes:

All fees use 7th year fee for comparison.
Waiting for fee clarification from proposers where ? Is shown
Alts only specialists are not shown
In some cases fees were based on % in alternatives, standard assumptions were applied (10% each in HF, RA, PE)

	1.025
200,000	205,000
205,000	210,125
210,125	215,378
215,378	220,763
220,763	226,282
226,282	231,939