Annual State Retirement and Pension System Investment Overview

Presented to the
Joint Committee on Pensions

Department of Legislative Services
Office of Policy Analysis
Annapolis, Maryland

December 2022

Annual State Retirement and Pension System's Investment Overview

At the request of the Joint Committee on Pensions, the Department of Legislative Services (DLS) annually reviews the investment performance of the State Retirement and Pension System (SRPS) for the preceding fiscal year. This report is intended to provide an overview of SRPS performance, a comparison of this performance to its peers, and an identification of issues meriting further comment by the State Retirement Agency (SRA).

State Retirement and Pension System Investment Performance

Asset Allocation

The SRPS Board of Trustees sets the allocation of assets to each investment class and continuously monitors the appropriateness of the allocation in light of its investment objectives. The SRPS *Investment Policy Manual* sets forth the investment objectives:

> The Board desires to balance the goal of higher long-term returns with the goal of minimizing contribution volatility, recognizing that they are often competing goals. This requires taking both assets and liabilities into account when setting investment strategy, as well as an awareness of external factors such as inflation. Therefore, the investment objectives over extended periods of time (generally, 10 to 20 years) are to achieve an annualized investment return that:
>
> 1. In nominal terms, equals or exceeds the actuarial investment return assumption of the System adopted by the Board. The actuarial investment return assumption is a measure of the long-term rate of growth of the System's assets. In adopting the actuarial return assumption, the board anticipates that the investment portfolio may achieve higher returns in some years and lower returns in other years.
>
> 2. In real terms, exceeds the U.S. inflation rate by at least 3%. The inflation-related objective compares the investment performance against the rate of inflation as measured by the Consumer Price Index (CPI) plus 3%. The inflation measure provides a link to the system's liabilities.
>
> 3. Meets or exceeds the system's Investment Policy Benchmark. The Investment Policy Benchmark is calculated by using a weighted average of the board-established benchmarks for each asset class. The Policy Benchmark enables comparison of the system's actual performance to a passively managed proxy and measures the contribution of active investment management and policy implementation.

The assets allocation is structured into five categories:

- ***Growth Equity:*** public equity (domestic, international developed, and international emerging markets) and private equity investments;

- ***Rate Sensitive:*** investments in bonds, loans, or associated derivatives with an average portfolio credit quality of investment grade;

- ***Credit:*** investments in bonds, loans, or associated derivatives with an average portfolio credit quality of below investment grade;

- ***Real Assets:*** investments whose performance is expected to exceed the rate of inflation over an economic cycle; and

- ***Absolute Return:*** consists of investments that are expected to exceed the three-month U.S. Treasury bill by 4% to 5% over a full market cycle and exhibit low correlation to public stocks.

Included within these asset classes are sub-asset classes. The board approves adjustments to the asset allocations and sets transitional targets. The board also approves target ranges for sub-asset classes as well as constraints on hedge fund exposure, with total hedge fund investments capped across all asset classes. In fall 2021, the board adjusted the system's asset allocation. **Exhibit 1** shows system asset allocations in relation to the strategic targets in effect on June 30, 2021, and under the changes adopted in September 2021.

Exhibit 1
State Retirement and Pension System Asset Allocation

Asset Class	Actual June 30, 2021	Target July 1, 2022
Growth Equity		
U.S. Equity	16%	15%
International Equity	10%	9%
Emerging Markets Equity	11%	10%
Private Equity	13%	16%
Subtotal	***50%***	***50%***
Rate Sensitive		
Long-term Government Bonds	10%	10%
Securitized Bonds	5%	3%
Corporate Bonds	n/a	3%
Inflation-linked Bonds	4%	5%
Subtotal	***19%***	***21%***
Credit/Debt		
High Yield Bonds and Bank Loans	7%	7%
Emerging Market Debt	2%	1%
Subtotal	***9%***	***8%***
Real Assets		
Real Estate	10%	10%
Natural Resources and Infrastructure	4%	5%
Subtotal	***14%***	***15%***
Absolute Return	**8%**	**6%**
Total Fund	**100%**	**100%**

Note: Columns may not add to total due to rounding.

Source: State Street – State Retirement Agency of Maryland – Rates of Return – Net Mgr – Periods Ending June 30, 2021; State Retirement and Pension System, *Investment Policy Manual*

The system's asset allocation is reflective of a decision to restructure the portfolio in fiscal 2008 and 2009. The overall strategy is part of an approach by the board to decrease risk through diversification in the wake of the 2008 financial crisis. Increased investment in private equity has resulted in positive returns for the system with less experienced volatility than public equity. Lower allocations to public equity investments are expected to result in lower returns when public equities are in growth patterns. However, as public equity can be a highly volatile asset class, a more diverse investment allocation should reduce volatility to provide protection when equity markets perform poorly or decline. While mitigating volatility will result in not taking full advantage of highly performing public equity markets, more stable investment returns will also mitigate swings in employer contribution rates. The board of trustees and the investment committee monitor the allocation of assets and continue to discuss the appropriate allocation (in consultation with the system's investment staff and investment consultants) that will achieve the system's investment return needs. Given the certain nature of defined benefit payment obligations, prudent allocation strategy should consider both achieving positive returns as well as being positioned to avoid losses. While investment division staff have some authority to make tactical, short-term adjustments to asset allocations, the *Investment Policy Manual* states an objective of long-term investment strategy, acknowledging the system's long-term investment horizon may lead to short-term volatility. The manual will reflect actions of the board altering the asset allocation and can be found on SRA's website.

Investment Performance

The system's investment return for fiscal 2022 was -2.97% net of management fees below the assumed rate of return of 6.80%. The system exceeded its policy benchmarks for the system as a whole. As shown in **Exhibit 2**, the system's assets' market value totaled $64.6 billion as of June 30, 2022 – a decrease over the $67.9 billion in assets at the end of fiscal 2021.

Exhibit 2

State Retirement and Pension System of Maryland

Fund Investment Performance for Periods Ending June 30, 2022

($ in Millions)

			Time Weighted Total Returns		
	Assets	**% Total**	**1 Year**	**5 Years**	**10 Years**
Growth Equity					
Public Equity	$18,426	28.5%	-19.38%	6.44%	8.90%
Private Equity	13,881	21.5%	24.53%	21.38%	17.69%
Subtotal	***$32,307***	***50.0%***	***-5.04%***	***11.33%***	***11.67%***
Rate Sensitive					
Nominal Fixed Income	$8,535	13.2%	-18.03%	0.77%	1.93%
Inflation Sensitive	2,838	4.4%	-5.61%	3.25%	2.18%
Subtotal	***$11,373***	***17.6%***	***-15.28%***	***1.41%***	***2.16%***
Credit/Debt					
High Yield Bonds and Bank Loans	$2,735	4.2%	-10.03%	2.69%	n/a
Private Credit	1,789	2.8%	15.70%	8.28%	9.79%
Credit Hedge Fund	41	0.1%	-0.40%	-2.02%	0.96%
Non-U.S. Credit	515	0.8%	-19.37%	-1.27%	–1.55%
Subtotal	***$5,080***	***7.9%***	***-4.54%***	***3.44%***	***5.27%***
Real Assets					
Real Estate	$7,127	11.0%	30.64%	10.72%	11.06%
Natural Resources and Infrastructure	2,693	4.2%	13.70%	n/a	n/a
Subtotal	***$9,820***	***15.2%***	***25.70%***	***9.22%***	***4.81%***
Absolute Return	**$4,897**	**7.6%**	**1.40%**	**3.97%**	**3.15%**
Multi Asset	**$246**	**0.4%**	**-19.04%**	**n/a**	**n/a**
Cash	**$912**	**1.4%**	**-0.23%**	**4.23%**	**3.29%**
Total Fund	**$64,634**	**100.0%**	**–2.97%**	**7.93%**	**7.79%**

Note: Returns beyond one year are annualized. Returns are net of fees. Columns may not add to total due to rounding.

Source: State Street – State Retirement Agency of Maryland – Rates of Return – Net Mgr – Periods Ending June 30, 2022

Significant investment gains or losses can impact the allocation of the investment portfolio to certain asset classes. The asset allocation targets set by the board are intended to maintain an acceptable risk tolerance for the system, providing protection for the system against investment volatility. The investment returns of each asset class can result in deviation from the target allocations, requiring additional oversight to maintain the overall asset allocation within the system's established risk tolerance.

In spite of the losses in fiscal 2022, **Exhibit 3** shows that the system performed 0.51% (51 basis points) above the benchmark.

Exhibit 3
State Retirement and Pension System of Maryland
Benchmark Performance for Year Ending June 30, 2022

	Return	Return Benchmark	Excess
Growth Equity	**-5.04%**	**-3.79%**	**-1.25%**
Public Equity	-19.38%	-18.05%	-1.34%
Private Equity	24.53%	24.00%	0.53%
Rate Sensitive	**-15.28%**	**-13.70%**	**-1.58%**
Nominal Fixed Income	-19.97%	-17.74%	-2.23%
Inflation Sensitive	-5.61%	-5.73%	0.11%
Credit	**-4.54%**	**-12.57%**	**8.03%**
High Yield Bonds and Bank Loans	-10.03%	-10.85%	0.82%
Private Credit	15.70%	n/a	n/a
Credit Hedge Fund	-0.40%	-2.80%	2.40%
Non-U.S. Credit	-19.37%	-20.80%	1.43%
Real Assets	**25.70%**	**19.88%**	**5.82%**
Real Estate	30.64%	28.71%	1.94%
Natural Resources and Infrastructure	13.70%	2.28%	11.43%
Absolute Return	**1.40%**	**2.99%**	**-1.59%**
Multi Asset	**-19.04%**	**-3.48%**	**-15.56%**
Cash and Cash Equitization	**-0.23%**	**0.19%**	**-0.43%**
Total Fund	**-2.97%**	**-3.48%**	**0.51%**

Source: State Street – State Retirement Agency of Maryland – Rates of Return – Net Mgr – Periods Ending June 30, 2022

DLS requests SRA to comment on the fiscal 2022 return performance in relation to the policy benchmarks. For any asset classes and asset sub-classes that underperformed the benchmark, SRA should comment on the factors that led to the underperformance, whether those factors are expected to negatively affect performance in fiscal 2023, and what actions are being taken to mitigate those factors from impacting the fiscal 2023 returns.

Performance Relative to Other Systems

One method of evaluating the system's investment performance is to compare the system's investment performance with the performance of other systems. The Wilshire Trust Universe Comparison Service (TUCS) rankings are useful for providing a big picture, snapshot assessment of the system's performance relative to other large public pension plans. In the TUCS analysis, the one-hundredth percentile represents the lowest investment return, and the first percentile is the highest investment return. According to TUCS, the system's fiscal 2022 total fund investment performance was rated in the thirty-seventh percentile among the public pension funds with at least $25 billion in assets, as shown in **Exhibit 4**. As the system has historically had a low allocation to equity investments compared to its peers – and domestic equity in particular – the system's investment policy will have a low TUCS ranking when equity markets are experiencing strong performance, as has been the case for a number of recent years. The long-term relative performance rankings have placed SRPS' relative total fund performance in the bottom quartile, with improvement in recent years. The TUCS rankings are based on returns gross of fees.

Exhibit 4
TUCS Percentile Rankings for Periods Ending June 30
Fiscal 2019-2022

	2019	2020	2021	2022
1 Year	60	53	64	37
3 Years	92	60	57	37
5 Years	88	71	75	43
10 Years	87	87	88	75

TUCS: Wilshire Trust Universe Comparison Service

Note: Rankings for systems greater than $25 billion.

Source: Wilshire Trust Universe Comparison Service

The impact of asset allocation on total system TUCS rankings can be seen in the system's TUCS rankings on performance within individual asset classes. When the system as a whole has experienced relatively low rankings when compared to peer systems, the system has experienced better relative performance by asset class. **Exhibit 5** shows the difference in relative rankings between the system as a whole and the system by asset class. The asset allocation has impacted the relative ranking of the total system return, with the system having lower allocations to public equity and domestic public equity in particular. This effect can also be seen in the ranking for total equity. The system does not have a bias to U.S. equity, which had strong performance in recent years. A system with higher allocations to well performing asset classes will have better relative performance. Fiscal 2022 losses in equity and fixed income were mitigated by the allocations to private equity and real estate performing well above average in those asset classes. The system's 5- and 10-year returns by asset class indicate sustained above average performance in multiple asset classes. With public equity – particularly U.S. public equity – comprising very efficient public investment markets, the system's long-term average performance indicates a measured approach to balance risk and return in those volatile asset classes.

Exhibit 5

TUCS Percentile Rankings for Periods Ending June 30, 2022

Asset Class	1-year	3-year	5-year	10-year
Total Equity	96	88	88	68
U.S. Equity	75	45	55	56
International Developed	55	26	27	65
International Emerging	50	12	31	n/a
Fixed Income	94	22	10	28
Private Equity	20	8	12	1
Real Estate	21	25	29	45

TUCS: Wilshire Trust Universe Comparison Service

Note: Rankings for systems greater than $1 billion.

Source: Wilshire Trust Universe Comparison Service

DLS requests that SRA comment on the relative TUCS performance rankings by asset class and how overall asset allocation impacts the total system's TUCS rankings.

Recent historical returns have seen both exceptionally strong and exceptionally weak returns in public equity, which demonstrates how highly volatile this asset class is. Allocations that limit exposure to more volatile assets should result in more stable employer contribution rates over time. An allocation that would result in mitigating volatility of returns (whether excess gains, returns below the assumed rate of return, or investment losses) will also mitigate the impact to employer contributions from contribution rate increases. A system's asset allocation should be impacted by a number of considerations that reflect a system's risk tolerance. A system's maturity (ratio of retirees to active members), funded status, assumed rate of return, benefit structure, regularity of full contributions, and other considerations factor into a system's risk tolerance. The importance of these factors will vary from plan to plan, leading to different tolerances for risk, variation in investment allocations, and differences in annual returns.

TUCS provides data on the risk-return profile of its members that shows that the system's level of risk over the three-year period ending June 30, 2022, was below the median for other public funds with assets greater than $25 billion. This is consistent with the system's comparatively lower allocation to public equity that can be a highly volatile asset class. The system's asset allocation strategy is intended to protect against more extreme losses in down markets. Due to the nature of the benefits that the system's investments ultimately fund, there is prudence in setting an asset allocation that achieves the necessary investment returns with the lowest level of risk capable of achieving those returns. The system's allocation strategy has appeared to have achieved its intended result in fiscal 2022. Despite having a return of -2.97%, many other plans experienced significantly higher investment losses that will require even higher future returns to recover the experienced losses.

DLS requests that SRA comment on how the system's asset allocation strategy mitigated investment losses in fiscal 2022 and the impact to the system of those mitigated losses.

Investment Management Fees

As shown in **Exhibit 6**, SRPS incurred $569 million in investment management fees during fiscal 2022, an increase from $544 million in fiscal 2021 fees. Management fees for the plan have grown substantially since the system adjusted its asset allocation to invest more heavily in alternative asset classes with higher fee structures. The shift of public equity assets to global and emerging market equity managers, which are almost all active managers, has also contributed to the growth in fees over the past few years. As a percent of assets under management, management fees in fiscal 2022 were slightly less than in fiscal 2021 by 3 basis points.

Exhibit 6
Asset Management Fees Paid by Asset Class
Fiscal 2021-2022
($ in Millions)

	2021				**2022**			
Asset Class	**Management Fee**	**Incentive Fee**	**Total**	**Fees as % of Asset**	**Management Fee**	**Incentive Fee**	**Total**	**Fees as % of Asset**
Equity	$77.6	$21.0	$98.6	0.53%	$72.9	$12.7	$85.6	0.56%
Rate Sensitive	14.2	19.9	34.1	0.50%	14.5	8.6	23.1	0.41%
Credit	7.5	n/a	7.5	0.17%	7.2	n/a	7.2	0.18%
Private Equity	125.3	n/a	125.3	1.27%	134.8	n/a	134.8	1.01%
Real Estate	38.1	0.4	38.5	0.81%	45.7	8.4	54.0	0.89%
Real Return	14.8	n/a	14.8	0.65%	15.0	0.1	15.1	0.56%
Absolute Return	52.6	91.5	144.1	2.75%	61.1	70.2	131.3	2.45%
Multi Asset	1.1	n/a	1.1	0.18%	1.3	n/a	1.3	0.23%
Private Credit/Debt	21.4	n/a	21.4	1.43%	18.0	n/a	18.0	0.99%
Equity Long Short	14.1	36.3	22.5	2.68%	17.2	72.0	89.2	4.43%
Service Providers	8.1	n/a	8.1	n/a	9.3	n/a		n/a
Total Fund	**$374.9**	**$169.2**	**$544.0**	**0.87%**	**$397.0**	**$172.0**	**$569.0**	**0.84%**

Note: Columns may not sum to total due to rounding. "Fees as % of Asset" column indicates fees as a percentage of the average market value of the asset under management.

Source: State Retirement Agency

Review of the SRPS fees by the system's investment consultant has noted that SRPS has been effective at negotiating more favorable fee arrangements than peer systems. Transitioning assets to internal management is also expected to result in fee savings to the system.

Active Management

While active management of assets results in higher overall fees, the system has benefited from active management. The system has found passive investment strategies to be effective where available. However, active management is able to add more diversification to system investments by investing in assets where active management can generate returns in assets where passive investment is not available or efficient. **Exhibit 7** shows the system's fiscal 2022 performance where active and passive management are utilized. Actively managed emerging market equities slightly underperformed the passively managed assets for the whole fiscal year but did mitigate losses in the short term. With respect to U.S. nominal fixed income, active management outperformed passively managed assets for the fiscal year by avoiding more substantial losses. Longer term performance shows greater benefit from active management with actively managed U.S. equity tracking closely with passive assets, and both active emerging market equity and U.S. nominal fixed income providing significant returns above the passively managed assets.

Exhibit 7
Active and Passive Management Performance
Periods Ending June 30, 2022
($ in Millions)

	Assets	1 Month	3 Months	FYTD	3-year	5-year
U.S. Equity						
Passive Management	$3,075.2	-8.38%	-16.36%	-13.43%	9.33%	10.20%
Active Management	$3,264.5	-7.75%	-17.90%	-18.00%	9.18%	10.26%
Emerging Market Equity						
Passive Management	$36.7	-6.51%	-11.28%	-25.25%	0.73%	2.64%
Active Management	$5,028.4	-5.79%	-11.02%	-25.62%	2.94%	3.68%
U.S. Nominal Fixed Income						
Passive Management	$3,674.3	-1.75%	-10.30%	-17.00%	-1.83%	0.99%
Active Management	$4,082.7	-2.06%	-7.92%	-13.46%	-0.10%	2.09%

FYTD: fiscal year-to-date
Note: Returns are net of fees.

Source: State Street – State Retirement Agency of Maryland – Rates of Return – Net Mgr – Periods Ending June 30, 2022

Absolute Return Fees

Absolute return fee structures typically include base fixed management fees and incentive compensation based on performance. Fees paid for absolute return were $131.3 million in fiscal 2022, which represents approximately 23.1% of all management fees. Absolute return comprises 7.6% of SRPS investments. With the exception of the fiscal 2021 returns, the absolute return investment return has consistently performed well below the system's assumed rate of return as well as additionally performing below the benchmark. The system's *Investment Policy Manual* describes the absolute return asset class as, "investments whose performance is expected to exceed the three-month U.S. Treasury bill by 4% to 5% over a full market cycle and exhibit low correlation to public stocks."

In fiscal 2022, managers achieved returns of 1.40% against a benchmark of 2.99%. Performance relative to benchmarks was mixed within the asset class, with a little less than half of the absolute return managers achieving returns above the asset class benchmark. Returns varied considerably between under- and over-performance. A significant number of investments sustained losses with nine managers underperforming their benchmarks by more than -10%, four underperforming by more than -20%, and one underperforming by almost -50%. Three managers exceeded the benchmark by over 30%.

Absolute return has returned below benchmarks for the 1-, 3-, 5-, and 10-year periods ending June 30, 2022. Since inception, the returns have exceeded the benchmarks, but that return is only 3.48% against a benchmark of 2.73%. In contrast, the system's cash assets (1.4% of total system assets) have returned 3.39% since inception (against a benchmark of 0.52%) and have outperformed the absolute return assets over the 5- and 10-year periods ending June 30, 2022.

Given the historic low rate of return, underperformance relative to benchmarks (less than half the benchmark in fiscal 2022), and high management fee structures, DLS requests SRA to comment on the returns of the absolute return asset class, including the market conditions leading to the low level of returns and benchmark underperformance, and what market conditions would result in markedly improved returns for investments in the asset class.

Private Equity Fees

Management fees for private equity comprised nearly 23.7% of total management fees, while constituting 21.5% of system assets in fiscal 2022. The reason for the higher amount of fees in private equity involves a substantial degree of active management. Fee structures typically include a fixed base management fee, plus a portion of earnings referred to as "carried interest." The management fees only reflect the base fees, not carried interest. Because of the nature of private equity fee arrangements, carried interest fees are tied to performance. When the system pays higher carried interest fees, a higher return on investment is earned by the system. SRA indicates that private equity returns are reported net of management fees and carried interest.

The private equity return was 24.53%, with a benchmark of 24.00%. Investment in private equity has resulted in positive returns for the system with less experienced volatility than public equity. Returns for the 1-, 3-, 5-, and 10-year periods ending June 30, 2022, were 24.53%, 24.67%, 21.38%, and 17.69%, respectively. Returns for those same periods also provided excess returns over the asset class benchmarks. Private equity investment performance has also outperformed peer systems consistently, as noted in Exhibit 5, with the system ranking first for its 10-year returns in the TUCS rankings.

SRA has also been utilizing co-investments in private equity. Such investments are companion investments to private equity funds that SRPS is already investing in but would not carry the same associated fee structure. Under this approach, SRPS is effectively reducing its fees for any private equity investments it co-invests by increasing the invested funds with the co-invested portion of the investment being subject to a lower fee structure. One potential risk in co-investing is that it can result in decreased diversification by consolidating private equity assets in fewer investments. Management of private equity assets will play a crucial role in the continued success of the asset class.

In the past five years, calls for greater transparency in the reporting of carried interest have led to changes in the investment management industry. Carried interest is earned by investment managers in private markets (*e.g.*, private equity, private real estate) and is the amount that a general partner (investment manager) retains as an ownership interest in the investment profits generated by the partnership. Carried interest typically represents a percentage of the profits generated, with that proportion negotiated among the parties involved. As carried interest represents shared profits that are retained by the general partner rather than paid by the investor, it is not typically reported as investment management fees.

DLS requests SRA to provide an update on estimated carried interest for calendar 2022.

Investment Division Staffing

Chapters 727 and 728 of 2018 granted the board authority to set the compensation of personnel in the SRA Investment Division and to establish positions within the division, subject to certain limitations. Investment Division staff are now to be "off-budget" and funded as system expenses. Investment positions are also now outside the State personnel system. The legislation included the creation of the Objective Criteria Committee (OCC) that is charged with making recommendations to the board on the objective criteria to be used for setting compensation and governing the payment of financial incentives to eligible Investment Division staff. OCC made recommendations to the board, and the board included provisions governing the compensation (including incentive compensation) for division staff.

The stated purpose of the legislation by SRA and the board was twofold. First, SRA's Chief Investment Officer (CIO) noted that the ability to create positions and set compensation would reduce compensation-related turnover in the division and help in recruitment to adequately staff the division to perform its existing functions. Testimony submitted in support of the legislation noted that the authority is expected to enhance system investment performance by maintaining and adding staff. The testimony noted that additional staffing resources will "enable the division to expand the universe of potential managers or investments to pursue, enhance the methodology of evaluating those opportunities, or design tactical strategies to adjust the mix of investments for intermediate-term performance." Additional staffing is also intended to free senior investment staff of administrative duties, resulting in increased focus on enhancing investments. The testimony noted that providing the board with authority over positions and compensation "will not result in paying the existing staff more money for doing the same job, but instead, will allow these positions to be more focused on the investment process rather than the administrative and reporting functions." The request for staffing authority contemplated SRA's need to expand its staff resources, as both the complexity of the fund assets and the size of the assets under management is expected to grow.

Since the passage of Chapters 727 and 728, SRA has been able to hire additional staff and move forward into internal management of assets. The Investment Division has grown by an additional 21 positions since passage of the legislation. Periodic review of the division's operations will evaluate the need for additional future positions. Chapters 727 and 728 included limitations on the amount compensation may be increased in a fiscal year, which had led to issues with disparate compensation for division staff who were hired prior to the compensation authority being granted to the board. Chapter 356 of 2022 gave the board authority to "catch-up" these employees' salaries to the salary midpoint for their position.

DLS requests SRA comment on the use of the compensation adjustment authority provided under Chapter 356 and whether there are any remaining compensation disparity issues.

Incentive Compensation

Fiscal 2020 was the first year in which Investment Division staff and the CIO were eligible for incentive compensation under Chapters 727 and 728. Due to restrictions included in the legislation on payment of incentive compensation in years in which State employees are subject to a furlough, incentive payments are subject to deferral to ensure compliance with this restriction. Incentive compensation is paid out over a two-year period. Incentive compensation is earned based on the performance of assets under an employee's management. The incentive compensation earned is based on the performance of assets related to the system's actuarial rate of return, the system's policy benchmark, and asset class-specific performance benchmarks.

DLS requests SRA update the committee on the use of incentive compensation for recruitment and retention and provide information on the number of division staff eligible for incentive compensation based on fiscal 2022 returns.

Internal Management of Assets

The second purpose under Chapters 727 and 728 was that the authority over positions and compensation would be necessary to expand and begin moving externally managed assets to internal management by division staff. The timeline indicated for internal management contemplated beginning with passively managed assets toward the end of an initial 2-year phase-in. Internal management would be broadened in years 3 through 5 to types of assets directly managed, including co-investment in private assets. By year 10, as much as 50% of assets could be managed internally. One of the arguments for internal management is that it can reduce fees paid for asset management. SRA estimates savings opportunity through internal management of assets. SRA noted that fee savings of just 1 basis point would net the system approximately $5 million. DLS has previously noted that SRA has been effective at negotiating favorable fee arrangements with external managers, and external management provides SRPS with options to select asset managers and to diversify the management of assets among multiple managers. DLS also previously noted that a shift to internal management would require significant operational changes. Performance measures would need to be adopted to monitor and evaluate the effectiveness of internal management of system assets compared to external management. Additionally, guidelines and reporting requirements would need to be implemented to track the internal management of system funds as well as any expansion or reduction of internal management once implemented.

Since the passage of Chapters 727 and 728, the system has begun to move assets under internal management. A U.S. Treasury Inflation Protected Securities passive portfolio was initially funded for July 1, 2019. A Long Government Bond portfolio was funded for March 1, 2020. The Russell 1000 portfolio was funded for October 1, 2020. The Corporate Bond portfolio was funded at the end of fiscal 2021. In fiscal 2022, portfolios for securitized bonds and small capital domestic equity were funded. **Exhibit 8** shows the performance of the system's internal management program. While these assets all experienced losses during the fiscal year, they all tracked closely with the asset benchmarks. The internally managed assets do not carry the same fee expenses as externally managed assets, and the performance shown in Exhibit 8 does not reflect fee savings.

Exhibit 8

SRPS Internal Management Performance

Investment Performance for Periods Ending June 30, 2022
($ in Millions)

	Total Assets	Fiscal 2022 Actual	Fiscal 2022 Benchmark	Inception Actual	Inception Benchmark	Inception Date
MD TIPS	$2,615.1	-5.77%	-5.73%	2.95%	2.97%	7/1/2019
MD Long Government Bonds	2,542.9	-21.45%	-21.20%	-10.22%	-10.28%	3/1/2020
MD U.S. Large Cap Equity	2,726.0	-12.98%	-13.04%	7.60%	7.60%	10/1/2020
MD Investment Grade Corporate Bonds	609.0	-14.76%	-14.19%	-14.76%	-14.19%	7/1/2021
MD Securitized Bonds	522.5	n/a	n/a	-9.19%	-9.05%	10/1/2021
MD US Small Cap Equity	349.2	n/a	n/a	-14.31%	-14.37%	10/1/2021

MD: Maryland
TIPS: Treasury inflation-protected securities

Source: State Retirement Agency

DLS requests SRA to comment on the estimated fee savings attributable for internally managed assets.

Additionally, DLS requests SRA to provide an update on the Investment Division's internal management of system assets and the development of necessary compliance and controls on the use of internal asset management. More specifically, SRA should comment on how the Investment Division:

- **has developed proficiency in managing assets currently being managed internally;**
- **will develop proficiency before expanding into internal management of additional asset classes;**
- **will evaluate the performance of internal management compared to available external management services; and**
- **will develop methodologies for determining fee savings achieved through internal management.**

Investment Climate Risk

The impact of climate change on the invested assets of public (and private) retirement systems has been receiving increasing attention over the last few years. As climate-related risk to investments is becoming more well understood and manifest, investment fiduciaries are becoming more aware of the potential risks to current assets and the potential for future opportunities to invest as climate risks manifest. Much of the discussion around climate risk has focused on divesting from carbon-producing and -using businesses or severing relationships with entities who are divesting from carbon producing and using businesses. In 2022, the Maryland General Assembly adopted an approach centered around the requirement for system fiduciaries to prudently invest the assets of the system. Chapters 24 and 25 of 2022 codified the responsibility of a fiduciary of SRPS, when managing assets of the system and in accordance with statutory fiduciary responsibilities, to consider the potential systemic risks of the impact of climate change on the system's assets.

The legislation does not require the system to take any specific action from any particular asset. Instead, the goal of the legislation is to ensure that the system fiduciaries are well informed of the potential climate related risks to system assets, just as they have duties to stay informed of any other financial risks to system assets. The legislation is intended to ensure that the system is aware of developing information regarding climate risk so that it is able to respond prudently and efficiently when climate related risk – or opportunity – arises. In many ways, the legislation codifies activity that the system has already established as regular practice. The system has received analysis from its primary investment consultant modeling the impact of climate risk to the system's assets during the system's periodic review of the asset allocation. Previously, the system has noted its ownership interests in businesses have provided access to engage with companies on climate risk issues. The system's *Investment Policy Manual* also has a number of policies for shareholder proxy voting on climate-related issues.

As Chapters 24 and 25 included requirements that would either continue current practices or require the build out of new activities for the system's Investment Division, it is expected that additional positions and consultants may be needed. Fortunately, as noted previously, Chapters 727 and 728 granted the Board of Trustees the authority to establish positions within the Investment Division. Recently, the system created and filled a new Senior Governance Manager position in the division to oversee activity related to environmental, social, and governance investment matters.

DLS requests SRA to provide an update on the implementation of Chapters 24 and 25.

Terra Maria Program

The Terra Maria program is the system's emerging manager program. One of the Terra Maria program's stated goals is to achieve returns in excess of benchmarks. The program has demonstrated the ability to achieve excess returns over benchmarks, with instances of significant returns over benchmarks at times. Over the past few years, SRPS reorganized the program to better utilize the asset diversification that the program can bring to SRPS. The program transition included eliminating mandates for allocations to large-cap domestic equity and increasing mandates for international small-cap and emerging markets. The program consolidated under five program managers. Program investments in domestic equity in recent years were tracking close to markets, making it more difficult to achieve excess returns in an asset class where it is already difficult to outperform the market in addition to incurring active management fees. The program has maintained a diverse roster of managers through the transition.

Total assets devoted to the program decreased to $2.2 billion in fiscal 2022, down from $2.7 billion in fiscal 2021. As a proportion of total assets, Terra Maria decreased from 4.0% of total assets in fiscal 2021 to 3.4% in fiscal 2022. **Exhibit 9** provides an overview of the Terra Maria program by program manager and asset class.

Exhibit 9
Terra Maria Program Performance
Investment Performance for Periods Ending June 30, 2022
($ in Millions)

		Performance			
	Total Assets	**Fiscal 2022 Actual**	**Fiscal 2022 Benchmark**	**Inception Actual**	**Inception Benchmark**
Program Manager					
Attucks International Equity	$538.0	-20.69%	-16.76%	9.39%	6.41%
Attucks US Equity/Rate Sensitive	938.6	-14.13%	-15.19%	10.52%	10.20%
Xponance	292.0	-21.95%	-23.21%	7.97%	8.25%
Leading Edge	422.6	-25.42%	-16.76%	8.11%	6.41%
Asset Class(1)					
U.S. Equity	$306.7	-22.26%	-25.10%	6.97%	6.97%
International Developed Equity	1,250.2	-22.61%	-18.55%	2.51%	1.50%
Rate Sensitive	578.5	-9.20%	-9.15%	1.59%	1.21%
Credit/Debt	53.4	-8.22%	-8.17%	1.90%	1.70%
Total	**$2,191.3**	**-19.17%**	**-17.17%**	**8.11%**	**6.41%**

(1) Excludes $2.5 million in emerging market investments.

Note: Actual returns are net of fees; returns beyond one year are annualized. Total assets may not sum to total due to rounding.

Source: State Street – State Retirement Agency of Maryland – Rates of Return – Net Mgr – Periods Ending June 30, 2021

In fiscal 2021, the program experienced return losses of -19.17%, underperforming the program benchmark by -2.00%%. Three of the four program managers had returns below the benchmark. By asset class, only U.S. equity outperformed the benchmark. Since inception, all four program managers have had returns above the system's assumed rate of return, with three of the four outperforming their benchmarks.

Of particular note, the actively managed Terra Maria portfolio had significantly better performance in its rate sensitive assets compared to non-Terra Maria assets. For U.S. nominal fixed income investments, Terra Maria returned -9.20% compared to returns of -13.46% for actively managed non-Terra Maria investments and -17.00% for passively managed investments.

Currency Program

Adopted in fiscal 2009, the program is designed to protect against losing value when the dollar appreciates relative to some foreign currencies in countries in which the system holds assets. During periods when the dollar is weak, the currency management program's cost manifests as a slight drag on international equity holdings. However, when the dollar appreciates, the program provides gains that help offset the currency losses generated by the strengthening dollar. As of June 30, 2021, the currency program added total value of $385.9 million since inception (up from $274.7 million through June 30, 2021). Gains when the dollar is strong should outweigh losses when the dollar is weak, and the system has taken steps to lock in program gains. The primary objective of the program is to lower volatility related to currency fluctuations.

The currency hedging program has limited application and is only applied to a relatively small portion of the system's total assets. In addition, not all foreign currencies are included in the hedging program. Due to liquidity constraints and higher transaction costs in some currencies, the program is currently limited to the euro, Japanese yen, Swedish krona, Swiss franc, Canadian dollar, Australian dollar, and British pound.