

## **FLORIDA RETIREMENT SYSTEM DEFINED BENEFIT PLAN INVESTMENT POLICY STATEMENT**

### **I. DEFINITIONS**

**Absolute Real Target Rate of Return** - The total rate of return by which the FRS Portfolio must grow, in excess of inflation as reported by the U.S. Department of Labor, Bureau of Labor Statistics (Consumer Price Index – All Urban Consumers), in order to achieve the long-run investment objective.

**Asset Class** - An asset class is an aggregation of one or more portfolios with the same principal asset type.<sup>1</sup> For example, all of the portfolios whose principal asset type was stocks would be aggregated together as the Stock asset class. As such, it would contain primarily—but not exclusively—the principal asset type.

**Asset Type** - An asset type is a category of investment instrument such as common stock or bond.

**Portfolio** - A portfolio is the basic organization unit of the FRS Fund. Funds are managed within portfolios. A portfolio will contain one principal asset type (common stocks, for example), but may contain small amounts of other asset types as well. The discretion for this mix of asset types is set out in guidelines for each portfolio.

### **II. OVERVIEW OF THE FRS AND SBA**

The State Board of Administration (Board) provides investment management of assets contributed and held on behalf of the Florida Retirement System (FRS). The investment of retirement assets is one aspect of the activity involved in the overall administration of the Florida Retirement System. The Division of Retirement (DOR), the administrative agency for the FRS, provides full accounting and administration of benefits and contributions, commissions actuarial studies, and proposes rules and regulations for the administration of the FRS. The State Legislature has the responsibility of setting contribution and benefit levels, and providing the statutory guidance for the administration of the FRS.

### **III. THE BOARD**

The State Board of Administration has the authority and responsibility for the investment of FRS assets. The Board consists of the Governor, as Chairman, the Chief Financial Officer, as Treasurer, and the Attorney General, as Secretary. The Board has statutory responsibility for the investment of FRS assets, subject to limitations on investments as outlined in Section 215.47, Florida Statutes.

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<sup>1</sup> The Strategic Investments asset class is an exception, purposefully established to potentially contain a variety of portfolios which may represent asset types and strategies not suitable for inclusion in other asset classes.

The Board shall discharge its fiduciary duties in accordance with the Florida statutory fiduciary standards of care as contained in Sections 215.44(2)(a) and 215.47(9), Florida Statutes.

The Board delegates to the Executive Director the administrative and investment authority, within the statutory limitations and rules, to manage the investment of FRS assets. A six-member Investment Advisory Council (IAC) is appointed by the Board. The IAC meets quarterly, and is charged with the review and study of general portfolio objectives, policies and strategies, including a review of investment performance.

The mission of the State Board of Administration is to provide superior investment and trust services while adhering to the highest ethical, fiduciary and professional standards.

#### **IV. THE EXECUTIVE DIRECTOR**

The Executive Director is charged with the responsibility for managing and directing administrative, personnel, budgeting, and investment functions, including the strategic and tactical allocation of investment assets.

The Executive Director is charged with developing specific individual investment portfolio objectives and policy guidelines, and providing the Board with monthly and quarterly reports of investment activities.

The Executive Director has investment responsibility for maintaining diversified portfolios, and maximizing returns with respect to the broad diversified market standards of individual asset classes, consistent with appropriate risk constraints.

The Executive Director is responsible for evaluating the appropriateness of the goals and objectives in this Plan in light of actuarial studies and recommending changes to the Board when appropriate.

#### **V. INVESTMENT OBJECTIVES**

The investment objective of the Board is to provide investment returns sufficient for the plan to be maintained in a manner that ensures the timely payment of promised benefits to current and future participants and keeps the plan cost at a reasonable level. To achieve this, a long-term real return of 5% per annum (compounded and net of investment expenses) should be attained. This return objective is based on a set of capital market assumptions reflecting current long-term capital market expectations. As additional considerations, the Board seeks to avoid excessive volatility in short-term plan cost levels and excessive risk in long-term cost trends. To manage these risks, the volatility of annual returns should be reasonably controlled.

The Board's principal means for achieving this goal is through investment directives to the Executive Director. The main object of these investment directives is the asset class. The Board directs the Executive Director to manage the asset classes in ways that, in the Board's opinion, will maximize the likelihood of achieving the Board's investment objective. The Board establishes asset classes, sets permissible shares of the total portfolio's value for each and establishes performance benchmarks for them. In addition, it establishes a performance benchmark for the total portfolio.

## **VI. TARGET PORTFOLIO AND ASSET ALLOCATION RANGES**

The Board's investment objective is an absolute one: achieve a specific rate of return, the absolute real target rate of return. In order to achieve it, the Board sets a relative objective for the Executive Director: achieve or exceed the return on a performance benchmark known as the Target Portfolio over time. The Target Portfolio is a portfolio composed of a specific mix of the authorized asset classes. The return on this portfolio is a weighted-average of the returns to passive benchmarks for each of the asset classes. The expectation is that this return will equal or exceed the absolute real target rate of return long-term and will thus assure achievement of the Board's investment objective.

This relative return objective is developed in a risk management framework. Risk from the perspective of the Board is failing to earn the absolute real target rate of return over long periods of time, and the asset mix is developed to minimize this risk. In selecting the Target Portfolio, the Board considers information from actuarial valuation reviews and asset/liability studies of the FRS, as well as historical asset class risk and return characteristics. In addition, the timing of cash demands on the portfolio to honor benefit payment liabilities are an important input. Periods of positive cash flow into the fund from net contributions and investment income receipts permit higher exposures to equities, while substantial cash demands on the portfolio may dictate lower equity exposures. Potential asset mixes are thus evaluated with respect to their expected return and volatility as well as risk.

The Target Portfolio defined in Tables 2, 4 and 5 has a long-term expected compound annual real return that approximates the absolute real target rate of return. To achieve the absolute real target rate of return, market risk must be borne, and Table 1 illustrates the potential range of real returns that could result over various investment horizons. Over a 30-year investment horizon there is a 10 percent probability that the Target Portfolio will experience a compound annual real return of 2.46 percent or less. Downside risk is considerably greater over shorter horizons, but the natural investment horizon for the Trust Fund is the very long-term.

**Table 1: Expected Risk in Target Portfolio's Real Returns**

Time Horizon	10 <sup>th</sup> Percentile Real Return	90 <sup>th</sup> Percentile Real Return
1 Year	-8.30%	20.28%
5 Years	-1.16%	11.59%
10 Years	0.62%	9.63%
15 Years	1.41%	8.77%
20 Years	1.89%	8.26%
25 Years	2.21%	7.91%
30 Years	2.46%	7.66%

Although the Target Portfolio has an expected return and risk associated with it, it is important to note that this expected return is neither an explicit nor an implicit goal for the managers of the Florida Retirement System Trust Fund (FRSTF). These figures are used solely in developing directives for fund management that will raise the probability of success in achieving the absolute real target rate of return. The Executive Director is held responsible not for specifically achieving the absolute real target rate of return in each period, but rather for doing at least as well as the market using the Target Portfolio's mix of assets.

In pursuit of incremental investment returns, the Executive Director may vary the asset mix from the target allocation based on market conditions and the investment environment for the individual asset classes. The Executive Director shall adopt an asset allocation policy guideline which specifies the process for making these tactical decisions. The guideline shall concentrate on the analysis of economic conditions, the absolute values of asset class investments and the relative values between asset classes. The Board establishes ranges for tactical allocations, as shown in Table 2:

**Table 2: Authorized Asset Classes, Target Allocations and Policy Ranges**

Asset Class	Target Allocation	Policy Range Low	Policy Range High
Domestic Equities	38%	30%	47%
Foreign Equities	20%	11%	25%
High Yield	2%	0%	7%
Fixed Income	28%	20%	36%
Real Estate	7%	2%	12%
Private Equity	4%	0%	7%
Strategic Investments*	--	0%	10%
Cash Equivalents	1%	0%	9%
Total Fund	100%	--	--

\*In recognition of the dynamic nature of this asset class, there is no specific expected weight. Its actual allocation will vary within the policy range depending on the mix of included strategies at any given time. When the actual allocation of Strategic Investments is greater than zero, all other asset class target allocations shall be reduced pro-rata.

For purposes of determining compliance with these policy ranges, an asset class is considered to be an aggregation of one or more portfolios with substantially the same principal asset type.<sup>2</sup> An asset type is a category of investment instrument such as common stock or bond. For example, all of the portfolios whose principal asset type is bonds would be aggregated together as the Fixed Income asset class. As such, it would contain primarily—but not exclusively—the principal asset type. As a standard management practice, portfolio managers are expected to meet their goals for all assets allocated to their portfolio.

It is expected that the FRS Portfolio will be managed in such a way that the actual allocation mix will remain within these ranges. Investment strategies or market conditions which result in an allocation position for any asset class outside of the enumerated ranges for a period exceeding thirty days shall be reported to the Board, together with a review of conditions causing the persistent deviation and a recommendation for subsequent investment action.

The asset allocation is established in concert with the investment objective, capital market expectations, projected actuarial liabilities, and resulting cash flows. Table 3 indicates estimated net cash flows (employer contributions minus benefit payments) and associated probabilities that are implicit in this policy statement, assuming the Legislature adheres to system funding provisions in current law.

<sup>2</sup> The Strategic Investments asset class is an exception, purposefully established to potentially contain a variety of portfolios which may represent asset types and strategies not suitable for inclusion in other asset classes.

**Table 3: Estimated Net Cash Flow (\$ millions)**

	In 5 Years	In 10 Years
10 <sup>th</sup> Percentile	-6,413	-8,661
25 <sup>th</sup> Percentile	-5,808	-8,585
Median	-4,381	-6,074
75 <sup>th</sup> Percentile	-3,491	-4,479
90 <sup>th</sup> Percentile	-3,157	-1,953

## VII. PERFORMANCE MEASUREMENT

Asset class performance is measured in accordance with a broad market index appropriate to the asset class. The indices identified in Table 4 are used as the primary benchmarks for the authorized asset classes:

**Table 4: Authorized Target Indices**

Asset Class	Index
Domestic Equities	The Russell 3000 Index
Foreign Equities	A custom version of the Morgan Stanley Capital International ACWI Investable Market Index, excluding the U.S., in dollar terms, net of withholding taxes on non-resident institutional investors, adjusted to reflect investments in strategies which are required to comply with the provisions of the Protecting Florida's Investments Act
Fixed Income	The Barclays Capital U.S. Aggregate Bond Index
High Yield	The Barclays Capital U.S. High Yield Ba/B 2% Issuer Capped Index
Real Estate	An average of the National Council of Real Estate Investment Fiduciaries (NCREIF) Fund Index – Open-ended Diversified Core Equity, gross of fees, weighted at 90%, and the Wilshire Real Estate Securities Index, weighted at 10%
Private Equity	The Domestic Equities target index return plus a fixed premium return of 450 basis points per annum
Strategic Investments	An average of individual portfolio level benchmark returns
Cash Equivalent	iMoneyNet First Tier Institutional Money Market Funds Gross Index

The return on the Target Portfolio shall be calculated as an average of the returns to the target indices indicated in Table 4 weighted by the target allocations indicated by Table 2, but adjusted for floating allocations indicated by Table 5.

Measurement of asset allocation performance shall be made by comparing the actual asset allocation times the return for the appropriate indices to the target allocation times the index returns. For asset classes with floating allocations, as defined in Table 5, the basis of tactical measurement shall be the asset class's actual share. Differences between these actual shares and the target shares stated in Table 2 shall be allocated as indicated in Table 5.

Performance measurement of the effectiveness of the implementation of the Private Equity asset class shall be based on an internal rate of return methodology, applied over significant periods of time. Performance measurement of the effectiveness of the implementation of the Strategic Investments asset class over short periods shall be assessed relative to an aggregation of its individual portfolios' benchmarks; over long periods of time it shall be assessed relative to the CPI, as reported by the U.S. Department of Labor, Bureau of Labor Statistics (Consumer Price Index – All Urban Consumers), plus 5%. Fundamentally, the Strategic Investments asset class is expected to improve the risk-adjusted return of the total fund over multiple market cycles.

**Table 5: Asset Classes with Floating Allocations**

Asset Class with Floating Allocation	Allocation of Difference Between Target and Actual Allocations
Private Equity	To Domestic Equities
Real Estate	40% to Domestic Equities and 60% to Fixed Income

## VIII. ASSET CLASS PORTFOLIO MANAGEMENT

### General Portfolio Guidelines

The Executive Director is responsible for developing asset class and individual portfolio policies and guidelines which reflect the goals and objectives of this Investment Policy Statement. In doing so, he is authorized to use all investment authority spelled out in Section 215.47, Florida Statutes, except as limited by this Plan or SBA Rules. The Executive Director shall develop guidelines for the selection and retention of portfolios, and shall manage all external contractual relationships in accordance with the fiduciary responsibilities of the Board.

All asset classes shall be invested to achieve or exceed the return on their respective benchmarks over a long period of time. The portfolios shall also be well diversified with respect to the benchmark.

The Executive Director shall develop and implement policies as appropriate for the orderly and effective implementation of the provisions of Chapter 2007-88, Laws of Florida, the "Protecting Florida's Investments Act." Actions taken and determinations made pursuant to said policies are hereby incorporated by reference into this Investment Policy Statement, as required by subsection 215.473(6), Florida Statutes.

## **IX. REPORTING**

The Board directs the Executive Director to coordinate the preparation of quarterly reports of the investment performance of the FRS by the Board's independent performance evaluation consultant.

The following formal periodic reports to the Board shall be the responsibility of the Executive Director:

- An annual report on the SBA and its investment portfolios, including that of the FRS.
- A monthly report on performance and investment actions taken.
- Special investment reports pursuant to Section 215.47(6), Florida Statutes.

## **X. IMPLEMENTATION SCHEDULE**

This plan shall be effective upon approval. However, the change to a custom version of the Morgan Stanley Capital International Investable Market Index authorized in section VII shall be effective retroactively on April 1, 2008. The change to an aggregate benchmark to measure the effectiveness of the implementation of the Strategic Investments asset class authorized in section VII shall be effective retroactively on June 1, 2007.