SCHOOL & INSTITUTIONAL
TRUST FUNDS OFFICE

200 E SOUTH TEMPLE, SUITE 100
SALT LAKE CITY, UT 84111

801-364-0821
SITFO.UTAH.GOV

# Statement of Investment Beliefs

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*The following document outlines beliefs that SITFO's board and staff agree to use as guiding principles. It is neither policy nor a procedural manual. The primary purpose is to assist in governance and decision making. Board and staff should consider this a living document and discuss improvements as needed.*

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# Who We Are

The Utah State Legislature created the School & Institutional Trust Funds Office (SITFO) as an independent agency within state government. SITFO has a three-person staff and a five-person board of trustees with the state treasurer acting as ex officio chairperson. Trustees are experienced investment professionals nominated via a robust and independent process outlined in statute.

The purpose of SITFO is to invest School and Institutional Trust Lands Administration (SITLA) revenues in a manner that supports distribution policy in perpetuity while providing for intergenerational equity between current and future beneficiaries. Trusts are managed for the sole benefit of their respective beneficiaries.

Trusts are managed with similar asset allocations because return and risk objectives are the same. There is significant benefit of scale for the smaller trusts invested alongside the permanent School Trust Fund, which accounts for 95% of combined assets. In addition to the School Trust Fund, there are 11 smaller institutional trust funds:

- School Trust Fund
- Miners Hospital
- Institute for the Blind
- Reservoirs Fund
- Normal School
- University of Utah
- School of Mines
- Utah State University
- Utah State Hospital
- Deaf School Fund
- State Industrial School

The source of investable financial assets is the same across all trusts, however, the size of contributions differs. The relative importance of contributions is likely to decrease over time because:

- SITFO expects the trusts to grow through compounding of investments
- SITFO takes a conservative approach in evaluating the land assets as a diminishing revenue source

## Characteristics

Board and staff are expected to be fluent in the strengths and weaknesses of modern portfolio theory and bring significant investment experience to the agency.

Operating with a relatively small group of decision makers allows the agency to better avoid governance and behavioral finance pitfalls that seem to prevail with larger institutions.

Significant layers of bureaucracy can delay decision making or create distance between principals and actionable information.

SITFO expects to take advantage of experienced professionals and a beneficial organizational structure to efficiently implement objective, research-oriented recommendations.

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 resources.

A long-term horizon allows the agency to tolerate volatility and illiquidity, should those risks be deemed prudent to meeting investment objectives. SITFO's time horizon is measured in years or even decades, not months.

It is SITFO's fiduciary responsibility to objectively consider investment opportunities and ground its analysis in research and portfolio theory. Prudent analysis should drive investment decision making. Risk and return potential of each investment should be carefully considered. Political considerations are not allowed to affect the portfolio.

Ignorance and arrogance can be detrimental to good decision making. Humility can be an antidote to the errors described in behavioral finance literature. Accordingly, it behooves the agency to remind itself of potential weaknesses, prepare thorough analyses, utilize checklists, adhere to disciplines, and be open-minded and receptive to peer challenges.

### Behavioral

The scope of this document doesn't allow for a complete review of behavioral finance, however, the subject merits attention to facilitate 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, the investment policy statement outlines other protocols to assist in limiting behavioral biases.

### Price and Opportunity Cost Awareness

Understanding the cycle (economic, market, style, strategy) and outlining the portfolio's subset of expected returns in the near to intermediate term can help frame investment decisions such as new mandates, rebalancing, etc.

Investment opportunities with higher expected returns may be less common, considered out of favor, or misunderstood, and should not be discarded based on perceived headline risk or conventional wisdom.

Inertia that includes a recognition of the unknown significantly differs from poorly thought-out and poorly executed decisions. Great opportunities are almost always accompanied by significant uncertainty.

### Governance and Management

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

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

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.

SITFO staff should source and promote the best ideas without bias.

SITFO should spend significant time developing and retaining talent. McKinsey & Company summarize two reasons how top tier public institutions can attract and retain talent: (1) the ability to deploy patient capital with minimal constraints, and (2) the higher purpose of furthering a social good. It's important to facilitate the former and communicate the latter. "Minimal constraints" is understood as avoiding non-investment related constraints and political interference.

### Performance Measure

SITFO selects investments based on expected outcomes in an overall portfolio context not out of fear of being different from the past, peers, or one's own biases.

It is important to use benchmarks and peer groups in investment analysis to foster accountability and support objectivity.

Benchmarks and peer performance are important reference points but have their own weaknesses due to construction and sampling issues. On occasion, when approaching extreme points in the market cycle, cap-weighted benchmarks and peer groups can become metrics of herd mentality.

Benchmarking is best done when the factor exposures of the portfolio are considered and well-understood, and when appropriate time horizons are referenced. Additionally, benchmarks at the manager, asset class, and total portfolio level should be constructed to reflect expected outcomes, as well as measure performance relative to applicable factor exposures.

Multiple perspectives can add insight. Therefore, decisions to hire, terminate, or retain investment managers should not be based solely on historical performance. While past performance should be analyzed to better understand the manager's process and

capabilities, these decisions should be holistic and comprehensive in nature. Greater weight should be given to factors that are expected to drive future performance, which could include but are not limited to:

- Organizational strength and culture
- Integrity, talent, and skill of professionals
- Validity of investment philosophy
- Soundness and disciplines of investment process
- Nature of opportunity set
- Risk management

## Efficient Markets Response

While SITFO does not believe markets are strictly efficient, as per the spectrum of forms of the efficient markets hypothesis, there are many skilled investors seeking to profit from inefficiencies and competing with those investors for relative performance is a zero-sum game. Importantly, SITFO believes it is possible to identify skilled managers in advance through a thorough, disciplined, and objective effort conducted by professionals with significant experience and skills pertaining to manager research and selection.

### Passive Management

Passive investing can be an effective way to minimize tracking error and peer risk, reduce fees, reduce business risk, gain efficient access to multiple markets, and optimize the fee budget between lower and higher expected alpha sources. Thus, cap-weighted indices can be a fundamentally important way to gain access to many markets.

Even in markets that may be considered inefficient and therefore present higher potential for active managers, SITFO may consider passive investments to minimize active risks or simply to gain exposure as needed.

### Active Management

Active management can be an important source of incremental returns but talent, skill, and discipline are necessary to exploit this potential. There are active strategies or styles engineered to deliver specific exposures or investment outcomes that are not provided for in a passive format. In these instances, more favorable consideration of active investment decision making is warranted. Uncommon skill, disciplined philosophy and process, rich opportunity set, and appropriate risk management are all necessary for an active manager to outperform. Additionally, an investor must be independent-minded and opportunistic, as well as innovative, relative to other participants.

### Rule-Based Management

Between passive and active management, SITFO may find rules-based strategies that serve its needs.

Many investment strategies can be explained and even replicated by “strategy betas” or factors which are investable. Factor-based investing as demonstrated by French, Fama, Asness, Arnott, and other academics and market participants over the decades strongly suggest there are cost effective rules-based alternatives to consider.

## Risk

A simple, but effective definition of risk is the permanent loss of capital, however, risk can be measured in several ways and is not limited to quantitative elements alone. Qualitative elements also represent significant risks.

As stated above, SITFO’s long time horizon allows it to tolerate volatility and illiquidity. So, it’s appropriate to tolerate risk that might be imprudent for individuals or pension plans with finite horizons or specific liabilities with different objectives.

### Defining Risk

Relevant factors for defining risk may include high valuations, fees, timing, inflation, fraud, illiquidity, downside volatility/drawdowns, equity beta, interest rate beta/duration, credit risk, operational risk, business risk, opportunity cost, leverage, currency, and political risk.

Volatility as a risk measure is helpful and informative, but insufficient alone, as it treats gains and losses identically. Metrics that look at downside volatility and include skew and kurtosis of return profiles add value. As do qualitative overlays such as liquidity or political risk.

Volatility and high valuations are linked to permanent loss of capital, primarily through buying at high valuations and selling at low valuations, which converts an unrealized loss into a permanent loss. It is important to remain objective when selling assets at any point and to consider opportunity costs as well.

Risks that are most likely to lead to permanent loss of capital are inflation, fraud, extremely high valuations, and excessive fees.

### Risk Management

Diversification is one of the most powerful tools in risk management.
Investment correlations and distributions are typically nonstationary and non-normal, though most models reduce parameters to such assumptions. It is important to consider an array of scenarios and measure an investment’s skew and kurtosis before committing assets.

Monitoring risks on a regular basis is important to observe incremental changes that may accrue over time. This also includes qualitative elements of an investment manager.

### Risk Tolerance

Given the difficulty or nuance in defining risk, risk tolerances can be referenced across several aspects of the portfolio, such as the quantitative (volatility, downside volatility, VaR) and the qualitative (illiquidity, fee levels, counterparty risk).

It bears repeating that risks unfamiliar to the layperson, such as complex strategies, uncommon geographies, and illiquidity, may be appropriate for SITFO as an organization with an infinite time horizon. SITFO will hold itself and those responsible to a high standard of due diligence to best manage these risks.

## Asset Allocation

Asset allocation is the predominant driver of portfolio return and risk. A long-term or strategic asset allocation is therefore the most significant method of protecting the portfolio from short-term decisions influenced by unsound investment practices, such as emotional decision making, political pressure, or performance chasing. Asset allocation decisions are considered through both a quantitative and qualitative framework that incorporate a variety of risks, scenarios, and outcomes. The asset allocation should reflect the advantage and the ability of the portfolio to withstand a moderate level of risk, including illiquidity, as discussed throughout this document.

### Defining an Asset Class

Asset classes can be defined as a grouping of investment strategies or exposures that perform similarly in most environments, possess relatively high correlations and common risk drivers, are institutionally investable, and add value in a total portfolio framework.

Aggregating asset classes and sub-asset classes into fewer groups by their expected role or purpose in the portfolio (e.g. growth, defensive, inflation protection) can be beneficial. This type of grouping can be a high-level simplification that assists in communicating to stakeholders, improving governance and decision making, and provides for more efficient modeling and implementation.

### Diversification

Diversification is significant to an optimized portfolio that maximizes returns for a given level of risk. Diversification helps protect against any one portfolio segment causing the total portfolio to exceed expected risk and loss parameters.

### Ranges and Rebalancing

Rebalancing is essential to achieving the benefits of diversification.

Adhering to a predetermined asset allocation with narrow ranges around the target weights avoids common behavioral pitfalls by providing fewer opportunities to make mistakes.

Because of volatility, large one-time additions or redemptions can introduce timing risk that SITFO can minimize through a multi-tranche approach.

### Valuations

Adding an additional asset class to the portfolio may make sense from a diversification perspective if, for example, it exhibits relatively low correlation to the current portfolio. However, it may not make sense to add that same asset class at a given point in time due to an expensive valuation. Valuations can be incorporated through forward-looking risk and return assumptions to judiciously implement new investments.

### Evolution

SITFO recognizes the value of adhering to a long-term asset allocation yet also recognizes it is imprudent to ignore changes in markets and innovations or developments in investment strategies. It is prudent to continuously research and examine both the asset allocation and its underlying techniques and be willing to make revisions when evidence suggests it may be beneficial.

## Manager Structure and Selection

While portfolio risk and return characteristics are largely determined by asset allocation decisions, manager structure and selection drives performance at the margins. Furthermore, manager structure and selection are the actual implementation methods by which the portfolio will gain exposure to various asset classes. Selection of managers is akin to security selection at the underlying manager level. Manager structure and selection can add value through a rigorous and consistent due-diligence process, while still allowing flexibility to take advantage of unique strategies.

### Structure and Bias

Manager structure and selection should reflect the purposes of the asset classes as that is the primary channel for implementing the strategic allocation.

Benchmarks represent the neutral position. Therefore, manager biases should be justified by sound investment logic and capture structural inefficiencies associated with their respective asset class.

Co-investments can be an effective way to reduce fees and assist in pacing of private investments. A simple approach to avoid the need to underwrite each co-investment is to commit capital to a given fund with an additional earmarked amount for co-investing. If each co-investment is allocated pro-rata, then discretion remains with the portfolio manager who has already underwritten each investment and is acting as a fiduciary.

### Manager Diversification

Like diversification at the security and asset class level, diversification of managers is a tool to minimize firm risk, avoid concentration of themes, diversify alpha sources, and reduce the risk of underperformance.

Over-diversification only captures asset class betas, as alpha is a zero-sum game. Therefore, it is important to retain alpha-generating ability, while still diversifying enough to mitigate the risks mentioned above.

## Manager Selection

Uncommon skill, disciplined philosophy and process, opportunity set, and risk management are expected to enable an active manager to outperform. The combined experience of staff and consultant, in conjunction with a disciplined process, allows for identifying, hiring, and working with the highest caliber professionals.

Each new manager should be an additive to the portfolio by enhancing diversification, accessing a new asset class, adding a new and/or differentiated alpha generation source, and/or improving risk and return characteristics.

Both quantitative and qualitative aspects should be assessed in identifying skillful managers, including but not limited to:

- Strength and stability of the firm
- Operational support, including back office
- Risk management and compliance functions
- Investment team experience and integration
- Investment philosophy and process
- Portfolio performance and risk characteristics