Oregon Investment Council

Statement
of
Funds Governance

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Glossary of Selected Terms

Terms highlighted in *italics* are explained in the glossary.

1.0 Purpose

1.1 This Statement of Funds Governance (this "Statement") summarizes the governance structure (the "Investment Program") established by the *Oregon Investment Council* (the "Council" or "OIC") to ensure the prudent, effective and efficient investment and management of the investment funds enumerated in ORS 293.701(2).

1.2 The Council approved this governance structure after careful consideration of alternative approaches to governing a very large and growing pension fund as well as other significant investment funds within an increasingly complex financial and investment environment.

1.3 This Statement has been prepared and maintained with five audiences in mind: 1) incumbent, new and prospective Council members; 2) active and retired members of the Oregon Public Employee's Retirement System ("PERS"), which is funded from the Oregon Public Employees' Retirement Fund ("OPERF"), and beneficiaries of other investment funds; 3) the Oregon Legislative Assembly and Governor; 4) the Oregon State Treasurer, acting as the statutory investment officer through relevant staff ("Treasurer" or "OST"); and 5) other qualified persons engaged by the Council to invest or manage assets of investment funds.

1.4 The Statement summarizes more detailed policies and procedures documents prepared and maintained by the OST and numerous other documents that govern the day-to-day management of assets of investment funds.

1.5 The Council regularly assesses the continued suitability of its Investment Program, initiates changes as necessary, and updates this Statement accordingly.

2.0 Guiding Principles

2.1 Three principles guided the Council's development of the Investment Program:

(a) To fulfill its role as primary *governing fiduciary* for the investment and management of the investments funds, the Council retains ultimate responsibility for Investment Program decisions. In accordance with ORS 293.721, the general duty of the Council "is to make [investment funds] moneys as productive as possible," subject to the standard of judgment and care owing under its fiduciary obligations, inclusive of such statutory mandates as found in ORS 293.726. Additionally, assets of OPERF, the State Industrial Accident Fund, and the Common School Fund are trust funds with dedicated purposes, the assists of which cannot be diverted even by legislative enactment, let alone by Council policy, and to the beneficiaries of which the Council owes an exclusive duty of loyalty. *See, e.g., ORS 238.660(2).*

(b) To ensure that investment funds assets are prudently, profitably, and efficiently managed on a day-to-day basis, the Council has chosen to delegate the investment and management of specified assets to the OST and other qualified professionals who, in turn, are subject to corresponding fiduciary obligations. Such delegation is consistent with ORS 293.726(4)(b), which states that the Council must "act with prudence in

deciding whether and how to delegate authority and in the selection and supervision of agents." Council delegates are expected to have the training, expertise, experience, tools and time to cost-effectively implement Council policies.

(c) To ensure effective oversight of delegates, the Council requires timely performance reports that reveal if delegates have complied with their fiduciary duties, including with respect to expressed mandates and guidelines, and indicate how assets under their care have performed relative to established *investment objectives*.

3.0 Decisions Retained by the Council

3.1 The Council retains direct approval of the following determinations:

(a) Total fund investment objectives and asset class benchmarks;

(b) Investment policies, including target asset allocation policies;

(c) Asset allocation re-balancing policies;

(d) Asset class strategies and any structural tilts;

(e) Active management exposure within each asset class;

(f) Manager structure within each asset class; and,

(g) Retaining investment managers within each asset class, excluding the specific delegation provided for in 3.3 below, as well as further delegation which may be provided for in OIC Policy.

3.2 Before approving or amending policy decisions, the Council seeks advice, guidance and recommendations from the OST, Council-retained investment consultants, investment managers and other experts or sources as considered prudent by the Council.

3.3 Alternative investment commitments (private equity, real estate, alternative and opportunity portfolio investments) for *new relationships* exceeding $150 million, or exceeding $250 million for existing relationships, must be brought to the Council for approval.

3.4 OIC functions include, but are not limited to:

a) Coordination with the PERS Board, State Accident Insurance Fund Corporation ("SAIF"), Department of State Lands, Board of Higher Education, and other agencies, on matters of joint concern;

b) Approval of its due-diligence processes;

c) Receipt and review of periodic reports from the OST, consultants, investment managers and other experts;

d) General policy and governance on matters resulting from (c);

e) Response to legislative and or regulatory action that impacts its policies;

f) Coordination with the Oregon Department of Justice on its representation with respect to litigation and general protocols concerning the Investment Program;

g) Coordination with the Treasurer with respect to the Investment Program, including but not limited to OST staffing plans, incentive compensation and the budget for all investment activities under the purview of the OIC and

h) Approving all major personal service and consulting contracts related to investment activities under the purview of the OIC.

4.0 Investment Decisions Delegated to Treasury Staff

4.1 The Council has delegated to qualified Treasury staff the following investment management and implementation decisions:

(a) Re-balancing of total fund, asset class and manager exposures to ensure assets are within the total fund, asset class strategy and manager structure guidelines approved by the Council;

(b) Recommending retaining investment managers within each asset class. Before recommending a manager change, Treasury staff will satisfy the Council that the manager change is supported by a satisfactory level of analysis and due diligence;

(c) Terminating investment managers;

(d) The Equity Investment Officers may negotiate and execute trades in public equities and public equity futures contracts under the general guidance of the Chief Investment Officer for specific strategies defined in OIC Policy;

(e) The Fixed Income Investment Officers may negotiate and execute trades in fixed income securities under the general guidance of the Chief Investment Officer for specific strategies defined in OIC Policy;

(f) Preparing, negotiating and executing investment manager mandates, guidelines and fee agreements;

(g) Overseeing individual investment managers to ensure their portfolios comply with their respective portfolio mandates and guidelines; and

(h) Providing oversight of the master custodian to ensure that the Fund's rights to pursue securities class action litigation are appropriately protected.

4.2 In making these decisions, Treasury staff seeks the advice, guidance and recommendations from Council-retained investment consultants, investment managers and other experts and sources as considered prudent by Treasury Staff.

5.0 Investment Decisions Delegated to Investment Professionals

5.1 The Council has delegated to qualified investment managers the buying and selling of individual securities and/or other investments authorized under the portfolio management guidelines approved by the Council.

5.2 The Council has delegated to a qualified independent third-party the voting of shareholder proxies that accompany the securities and/or investments held by the portfolio with oversight by Treasury staff and in accordance with Council voting guidelines.

6.0 Effective Council Oversight

6.1 The Council approves the criteria for monitoring and evaluating the impact of different investment decisions on total fund, asset class, and manager level performance. Performance is monitored and evaluated with respect to investment risks taken, and investment returns earned.

6.2 The Council monitors staff, investment managers, consultants and other agents to determine that investments are made in accordance with approved policies and to evaluate their performance against established criteria.

6.3 The Council seeks to ensure that the investment act ivies under its purview are conducted in an efficient, effective, and prudent manner and in accordance with approved policies and procedures.

6.4 The Council seeks best and responsible practices and innovations, from the investment management community, when making and implementing policy.

6.5 Investment *risks* are monitored and evaluated quarterly by comparing total fund, asset class and manager holdings to the risk characteristics of suitable *benchmarks*. Additionally, the tracking error of the public asset classes and the total fund is monitored and reported to the Council, quarterly.

6.6 Investment *returns* are monitored monthly and evaluated quarterly by comparing total fund, asset class and manager level returns against suitable benchmarks. Quarterly attribution reports identify the impact that Council, Treasury staff, and investment manager decisions have had on total fund, asset class and manager level returns over different time horizons.

6.7 Before approving or amending the criteria for monitoring and evaluating investment decisions, the Council seeks advice, guidance and recommendations from Treasury staff, Council-retained investment consultants, investment managers and other experts and sources as considered prudent by the Council.

Glossary

Benchmark. A standard by which investment performance can be measured and evaluated. For example, the performance of U.S. equity managers is often measured and evaluated relative to the benchmark performance of the Russell 3000 Index.
Governing, managing and operating fiduciaries. Terminology increasingly used in the pension field to distinguish between the governance, management and operations functions in a pension fund. The governance function is mission choice, funding and investment policy decisions, organizational design decisions, the monitoring of organizational effectiveness, and communication of results to stakeholders. This is the domain of governing fiduciaries. Management acts as advisors to the governing fiduciaries, devises strategies for achieving the fund mission and implementing the policies in a cost-effective manner, and organizes and monitors fund operations. This is the domain of managing fiduciaries. Finally, fund operations in the form of portfolio management, risk monitoring, and information system management and reporting are delegated to operating fiduciaries either inside or outside the pension fund organization. See Ambachtsheer, K. P. and D. Don Ezra, Pension Fund Excellence, Wiley, 1998, "Mapping the Road to Excellence", chapter 3.
Investment Objectives. The investment objectives of OPERF are summarized in the Statement of Investment Objectives and Policy Framework for the Oregon Public Employees Retirement Fund.
New relationship. A general partner or management team with which the OIC has no existing or committed investment exposure.
Oregon Investment Council (OIC). Oregon Revised Statute (ORS) 293.706 establishes the OIC, which consists of five voting members, four of whom are subject to Senate confirmation (the Treasurer serves by position, and is not subject to confirmation). The members appointed by the Governor must be qualified by training and experience in the field of investment or finance. In addition, the Director of the Public Employees Retirement System is an ex-officio member of the OIC. ORS 293.721 and 293.726 establish the following investment objective and standard of judgment and care for the OIC: moneys in the investment funds shall be invested and reinvested to achieve the investment objective of the investment funds, which is to make the moneys as productive as possible, subject to the prudent investor standard.

Oregon Public Employees Retirement Fund (OPERF). Holds the assets of beneficiaries of the Oregon Public Employees Retirement System (PERS). PERS is a statewide-defined benefit retirement plan for units of state government, political subdivisions, community colleges, and school districts. PERS is administered under ORS chapters 237, 238, 238A, and applicable provisions of the Internal Revenue Code by the Public Employees Retirement Board (PERB). Participation by state government units, school districts, and community colleges is mandatory. Participation by most political subdivisions is optional but irrevocable if elected. All system assets accumulated for the payment of benefits may legally be used to pay benefits to any of the plan members or beneficiaries of the system. PERS is responsible for administrating the management of the plan's liability and participant benefits.
Return. The gain or loss in value of an investment over a given period of time, expressed as a percentage of the original amount invested. For example, an initial investment of $100 that grows to $105 over one year has earned a 5% return.
Risk. A statistical measure of price volatility (positive or negative). May also be expressed as the probability of not achieving an expected outcome.
Tracking Error. When using an index or any other benchmarking strategy, the amount by which the performance of the portfolio differed from that of the benchmark. In reality, no index strategy can perfectly match the performance of the index or benchmark, and the tracking error quantifies the degree to which the strategy differed from the index or benchmark. Usually defined as the standard deviation of returns relative to a pre-specified benchmark.

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