



STATE TEACHERS
RETIREMENT SYSTEM
OF OHIO

STRS Ohio Response to Benchmark Financial Services (BFS) Report

Aug. 19, 2021

TABLE OF CONTENTS

Executive Summary..... 1

I. STRS Ohio’s Commitment to Transparency3

II. Oversight.....9

III. 2006 IFS Fiduciary Audit..... 13

IV. Alternative Investments Fees and Performance 21

V. Disclosure of Investment Costs and Performance..... 25

VI. Compliance with the GIPS® Standards 32

VII. Consultant Conflicts of Interest 39

VIII. ERISA Fiduciary Standards and Fiduciary Liability Insurance..... 49

Conclusion.....52

EXECUTIVE SUMMARY

On June 7, 2021, Benchmark Financial Services released a report (the “BFS Report”) titled “Preliminary findings of forensic investigation of the State Teachers Retirement System of Ohio” (“STRS Ohio” or the “Retirement System”). STRS Ohio provided an initial response to the BFS Report on June 11 and is now providing this more thorough and detailed analysis for discussion with the State Teachers Retirement Board (the “Board”) at its meeting on August 19, 2021.

Although the BFS Report title states it is a “forensic investigation” and ORTA referred to it as the “forensic audit,” the BFS Report is neither a forensic investigation nor a forensic audit. A forensic audit or investigation is an examination of a company’s financial records to derive evidence which can be used in a court of law or legal proceeding for the purpose of uncovering criminal behavior such as fraud or embezzlement. The AICPA has issued a “Statement on Standards for Forensic Services” effective January 1, 2020 to govern forensic services provided by certified professional accountants (CPAs).

However, it is important to note that the BFS Report’s author (“Author”) is neither an accountant nor auditor. He is not bound by the professional standards of the Governmental Accounting Standards Board, the American Institute of CPAs, or the Actuarial Standards Board. Though an attorney, his services do not constitute legal advice and he is therefore not bound by legal and ethical standards otherwise applicable to attorneys in the practice of law. He has no contractual or fiduciary duty to STRS Ohio or its participants as a whole, and therefore was free to draw whatever conclusions support his agenda and brand. Finally, and most importantly, we would note that **the BFS Report does not make any specific allegations of fraud or criminal conduct against the system**, and on page 37 states, in part, as follows:

“We were not hired to detect or investigate fraud, concealment or misrepresentations and did not attempt to do so. We were not hired to, and did not attempt to conduct a formal or legal investigation or otherwise to use judicial processes or evidentiary safeguards in conducting our review.”

The BFS Report contains numerous misstatements and allegations which are unsupported by evidence. Many of the conclusions in the BFS Report are offered with little support other than the Author’s opinions. In fact, the phrase “in our opinion” is used approximately 60 times throughout the BFS Report.

The purpose of this detailed analysis is to provide evidence which accurately describes the investment and operational practices of STRS Ohio. In short, we will provide facts to support the following, which refute the eight “findings” or allegations contained in the BFS Report:

- STRS Ohio is committed to the principles of transparency and complies with its obligations under the Ohio Public Records Act.
- Appropriate oversight exists under Ohio law to govern STRS Ohio. STRS Ohio financial statements are audited on an annual basis by an independent public accounting firm, under the oversight of the Ohio Auditor of State. STRS Ohio reports regularly to the Ohio Retirement Study Council (“ORSC”) with regard to system investments and operations. The Retirement System’s assets are custodied with the Ohio Treasurer of State.
- Recommendations from the 2006 IFS Fiduciary Audit were appropriately reviewed and addressed by the State Teachers Retirement Board and staff in early 2007.
- Investment fees are appropriately scrutinized. STRS Ohio does not pay lavish fees to Wall Street for “doing nothing.”
- Investment costs and performance are accurately reported by the Retirement System.
- STRS Ohio is required by law under Ohio Revised Code (“ORC”) 3307.15(B) to report its investment performance in compliance with the performance presentation standards established by CFA Institute (known as the GIPS® standards). There are no false or misleading representations made by STRS Ohio regarding GIPS® Compliance.
- Investment consultant conflicts of interest are adequately disclosed and considered.
- The Board complies with the fiduciary standards stated in ORC 3307.15, which mirror the ERISA fiduciary standards, and the system maintains adequate fiduciary liability insurance.

STRS Ohio did not commission the BFS Report but did give the report a serious examination and is issuing the analysis that follows to address the Author’s unsupported criticisms.

I. STRS OHIO'S COMMITMENT TO TRANSPARENCY

As an Ohio public pension system, STRS Ohio is subject to the Ohio Public Records Act and is fully committed to the principles of transparency. The Retirement System takes seriously its responsibility to provide public documents in accordance with the requirements and limitations of applicable law and responds to about 100 such requests each year.

Earlier this year STRS Ohio received the "Highest Achievement in Open and Transparent Government Award," the highest possible rating from the Ohio Auditor of State's office. This rating was awarded to only 14% of the more than 2,800 audited entities. STRS Ohio was recognized for best practices in six areas in this first year of the StaRS (Star Rating System), which included an audit of public record compliance during the annual financial statement audit of the system. STRS Ohio is committed to its process for responding to public records requests and treats all requests in a consistent manner, regardless of whether a request is from a member, a commercial entity, the general public, or a third party representing specific interests. STRS Ohio complies with its obligations under the Ohio Public Records Act.

A. February 2021 Public Records Request

STRS Ohio believes it is important to resolve any confusion around the underlying public records request sent by the Author's counsel, Marc Dann ("Counsel") dated February 19, 2021 (the "February 2021 Public Records Request"), as inaccurate information has been spread on this topic by the BFS Report Author. STRS Ohio received a single letter, dated February 19, 2021, requesting 45 categories of documents. Over a period of three months, from February to May 2021, STRS Ohio sent 24 emails and a thumb drive to Counsel, amounting to 812 documents and over 22,000 pages. In almost every email, STRS Ohio notified Counsel that many of the requests were overly broad, and that while the system was providing various documents believed to be responsive, Counsel needed to identify with specificity (as required by Ohio law) any additional records being sought.

Since February 19, 2021, STRS Ohio has received only one email from Counsel about this request, and that communication merely sought to confirm the appropriate STRS Ohio contact for another request. BFS had multiple opportunities to clarify but never attempted to do so. Again, negotiation and clarification are necessary to help identify, locate, and deliver requested records in the event of an ambiguous or overly broad request. Instead of providing clarification and/or revising the February 2021 Public Records Request, Counsel decided to simply file two public records mandamus actions in the Ohio Supreme Court, all while publicly making baseless accusations about a purported "lack of transparency" from STRS Ohio. Both cases remain in litigation.

For example, the BFS Report states on page 27, "Not a single prospectus or offering document required to be provided to all investors under the nation's securities laws has been provided to BFS in response to its public records request(s)." First, STRS Ohio was never asked for a

prospectus document. In fact, the word “prospectus” does not appear anywhere in the February 2021 Public Records Request. Second, the request for “offering documents” was overly broad. The use of terms such as “any and/or all” in a public records request are indicative of an overly broad request that may be considered improper under Ohio law. Courts have found a request to be overly broad when it seeks what amounts to a complete duplication of a major category of a public office’s records, for example a duplication of all records having to do with a particular topic, or all records of a particular type.

Forty-three of the forty-five categories of documents listed in the February 2021 Public Records Request included the words “any” and/or “all.” Despite that fact, in the majority of responses STRS Ohio provided documents believed to be responsive and asked repeatedly for further clarification about the particular records being requested. Additionally, STRS Ohio provided Counsel with a link to the 2020 *Annual Comprehensive Financial Report*, one of many reports found on the public STRS Ohio website (www.strsoh.org), in a good faith effort to provide additional information about STRS Ohio’s investments, external managers, and how it maintains and organizes its records. Again, STRS Ohio did not receive any further communications from BFS or its Counsel.

In the two instances in the February 2021 Public Records Request where the category description did *not* include the words “any” and/or “all,” STRS Ohio provided all ten responsive documents to the Requestor without needing further clarification.

Within the BFS Report (pages 3-4), the author references the February 2021 Public Records Request, claiming, “The overwhelming majority of the most critical disclosure information we requested was summarily denied. That is, STRS simply permitted the investment firms involved to unilaterally determine whether the information was sought on behalf of stakeholders had to be disclosed under Ohio law. Not surprisingly, most firms granted the opportunity to oppose public scrutiny of their financial dealings with STRS, chose to do so.”

This statement regarding outside investment firms is completely inaccurate. In short, STRS Ohio complied with its obligations under the Ohio Public Records Act in responding to the February 2021 Public Records Request. The vast majority of the February 2021 Public Records Request was overly broad and improper pursuant to ORC 149.43. Even so, STRS Ohio made a good faith effort to respond by both providing over 800 responsive documents and repeatedly requesting clarifications for requests that were too broad to understand, as required by ORC 149.43(B)(2)(B).¹

Trade Secrets — The Ohio Public Records Act contains several dozen exemptions to the definition of “public record.” For example, ORC 149.43(A)(1)(v) provides for the protection of “records the release of which is prohibited by state or federal law” and is often referred to as

¹ ORC 149.43(B)(2)(B) states: “If a requester makes an ambiguous or overly broad request or has difficulty in making a request for copies or inspection of public records under this section such that the public office or the person responsible for the requested public record cannot reasonably identify what public records are being requested, the public office or the person responsible for the requested public record may deny the request but shall provide the requester with an opportunity to revise the request by informing the requester of the manner in which records are maintained by the public office and accessed in the ordinary course of the public office's or person's duties.

the “catch-all” exemption which prohibits such records from release by a public office. This catch-all exemption includes the Uniform Trade Secrets Act, with trade secrets defined in ORC 1333.61(D). Under the law in Ohio (and almost every other state), an entity may assert a claim to preclude trade secret information from disclosure, and a public office cannot release such information without the consent of the entity asserting the protection.

B. Mediation/Additional Disclosures

The Author issued a statement on July 15, 2021, regarding a confidential mediation session held in the second of the two lawsuits filed in the Ohio Supreme Court related to the February 2021 Public Records Request. As STRS Ohio respects the legal process and rules outlined by the Ohio Supreme Court, we will not be making a statement about the confidential mediation process.

That said, STRS Ohio can separately acknowledge that it has released six unredacted documents to the Author in July 2021, upon obtaining the consent of its vendors CEM and Cliffwater, who initially made redactions due to valid trade secret assertions. As stated above, STRS Ohio, as a public office, may withhold or redact specific records that are covered by an exemption to the Ohio Public Records Act, provided the Retirement System gives an explanation and relevant legal authority.

In the February 2021 Public Records Request, the Author requested the following: “Please provide all reports and analysis produced by CEM Benchmarking related to STRS’s investment management fees, costs, and expenses,” and “Please provide all reports and analysis produced by CEM Benchmarking related to alternative investments.” While noting that the request was overly broad, STRS Ohio identified five reports it believed to be responsive. CEM provided an explanation and relevant legal authority for the redactions it made to protect proprietary formulas and methodologies it deemed to be trade secret. STRS Ohio then provided the redacted five reports and explanation on April 8, 2021.

The BFS Report, on page 58, identified another client of CEM (South Carolina Retirement System Investment Commission) that had posted on its website a CEM report that was similar to the reports provided by STRS Ohio. While efforts to maintain secrecy is important to the evaluation of a trade secret, the law does not require that a trade secret be completely unknown to the public in its entirety. However, STRS Ohio, with CEM’s consent, provided unredacted copies of the five reports in July 2021 in an effort to support transparency since the Author identified the publicly available report from another pension system, as well as publicly stated he had already viewed the full unredacted STRS Ohio CEM reports (Fundfire article dated July 1, 2021).

The other unredacted document provided by STRS Ohio in July 2021 was the Cliffwater Investment Adviser Agreement, in which Cliffwater had asserted trade secret protection over provisions surrounding its compensation structure. In the BFS Report, pages 109-111, the Author identified that the primary compensation paid by STRS Ohio to Cliffwater was already

provided to the Ohio Checkbook by STRS Ohio and questioned the validity of Cliffwater's trade secret assertion. Ultimately, Cliffwater agreed to release the unredacted compensation provision of the Agreement.

Finally, it should be reiterated that the six documents referenced in this section had previously been provided in redacted form by STRS Ohio in April 2021.

C. Mistaken Assertions

The Author asserts that "all of the workings of the pension must be open to full public scrutiny, including, but not limited to, investments." Not only is this unrealistic, but it directly conflicts with public records laws. As stated earlier, the Ohio Public Records Act contains dozens of exemptions excluding documents as "public record." These exemptions exist to protect both individuals and entities from detrimental disclosures. Otherwise, any Ohio public entity would be required to release personally identifiable information (PII), documents relating to security, trade secrets, and other information that is imperative to remain confidential. To state that a private entity must compromise and lose the value of its trade secrets in order to do business with any public office is untenable. Without these exemptions, information technology or investment firms would not risk doing business with government entities for fear that their valuable trade secrets could be disclosed to competitors. To deny public institutions the benefit of these private resources and opportunities would be detrimental to the interests of the public as a whole. FOIA and state public records laws have exemptions specifically to avoid this outcome. STRS Ohio has made a good faith effort to fulfill its transparency obligations within these confines.

On page 55, the BFS Report alleges that STRS Ohio "deferred" to CEM regarding whether information sought from the system should be provided to the public. This is inaccurate. CEM made a valid trade secret assertion in accordance with Ohio law, and STRS Ohio respected the legal rights of CEM to make such an assertion. Once a trade secret assertion is made, a public entity may not provide the unredacted records in question. The BFS Report also stated on page 55 that peer fund information and STRS Ohio data had been redacted from the CEM reports. This is also untrue. No peer information was redacted from the reports, and all data provided by STRS Ohio to CEM could be found in Section 7 (for the 2017, 2018 and 2019 reports) or Section 8 (2015 and 2016 reports), in sections titled "Data Summary."

The Author states, "Federal and state securities laws demand transparency." Indeed, many laws and regulations governing investment advisers and investment managers make an abundance of information public through regular filings with state securities regulators and/or the U.S. Securities and Exchange Commission. STRS Ohio and the public have had, and continue to have, broad access to the information in these filings. Those entities regulate managers accordingly, and the number or type of records that STRS Ohio may maintain on any investment does not directly correlate to that ongoing oversight and regulation.

The Author further states, “Any investment firm unwilling to operate in a fully transparent manner, consistent with applicable public records law, must be considered ineligible to manage public monies or otherwise contract with the pension.” The important phrase here is **“consistent with applicable public records laws.”** Firms contracting with STRS Ohio are made aware that STRS Ohio is subject to the Ohio Public Records Act and agree to comply with applicable laws. That said, there are valid exemptions to those laws, such as the exemption for trade secrets. The Ohio legislature has enacted dozens of exemptions over the years, and the Ohio Supreme Court has even developed factors to consider when evaluating a trade secret claim in a public records lawsuit.

The BFS Report alleges that there are “profound fiduciary breaches and disclosure concerns stakeholders have long raised.” However, like many other allegations in the BFS Report, the Author provides no examples of fiduciary breaches or disclosure concerns. Buzzwords and inflammatory language are unnecessarily used.

The BFS Report criticizes that the word “transparency” is not contained in the governing policies of STRS Ohio. As STRS Ohio is statutorily created under ORC 3307, the system is governed by the laws of the State of Ohio. As a public office, the Retirement System is subject to the Ohio Public Records Act and Open Meetings Laws. The system publishes many documents, including board materials, on its public website. As the Author himself noted, hundreds of STRS Ohio related documents are also available on the ORSC website. STRS Ohio annual expenses are published online on the Ohio Checkbook website. Beginning in February 2021, STRS Ohio began to record its board meetings and livestreams the meetings on its website. These actions and obligations do far more to promote transparency than simply saying you are transparent. It should be noted that the Ohio Public Records Act does not use the word “transparent,” yet its intent and requirements are wholly to promote transparency.

D. BFS Opaque “Transparency”

The Author has written similar reports on public pensions, and a lack of transparency appears to be a consistent theme throughout (in addition to underperformance, high fees, conflicts of interests, and risky alternative investments). His approach to this report and complaints about public records laws are not at all unique to STRS Ohio.

Disclaimers — In the interest of transparency, extensive disclaimers are buried in the center of the BFS Report on pages 37-38:

“This report should be read and evaluated with several caveats in mind. First, many of the subjects addressed in this report are inherently judgmental and not susceptible to absolute or definitive conclusions. We assumed the information we were provided, whether by the service providers or STRS is accurate, and could be relied upon. We were not hired to detect or investigate fraud, concealment or misrepresentations and did not attempt to do so. We werenot hired to, and did not attempt to conduct a

formal or legal investigation or otherwise to use judicial processes or evidentiary safeguards in conducting our review. Our findings and conclusions are based upon our extensive review of limited documents, the limited interviews we conducted with the board and others associated with STRS, independent analysis, and our experience and expertise. This report does not and is not intended to provide legal advice. Although the report considers various legal matters, our analysis, findings and recommendations are not intended to provide legal interpretations, legal conclusions or legal advice. For that reason, action upon such matters should not be taken without obtaining legal advice addressing the appropriate statutory or regulatory interpretation and legal findings regarding such matters. Finally, our observations are necessarily based only on the information we considered as of and during the period we performed our review.”

It is unconscionable for the Author to make repeated baseless allegations implying wrongdoing ***“in our opinion,”*** while also stating that BFS was not hired to detect or investigate fraud and did not attempt to do so.

II. OVERSIGHT

A. Ohio Retirement Study Council

The Ohio Retirement Study Council (ORSC) was created in 1968. ORSC is comprised of three members of the Ohio Senate appointed by the Senate president, three members of the Ohio House of Representatives appointed by the speaker of the House, and three governor's appointees. The executive directors of the five retirement systems, including STRS Ohio, are non-voting members of ORSC. The general purpose of ORSC is to advise and inform the state legislature on all matters relating to the benefits, funding, investment, and administration of the five statewide retirement systems. ORSC hires both a consulting actuary and an investment consultant. The consulting actuary conducts regular reviews independently of the systems' actuaries, including a review of the actuarial analysis required for all retirement legislation having any measurable financial impact on the systems. The independent investment consultant conducts a semiannual review of the policies, objectives, and criteria of the systems' investment programs.

As a part of its duties, ORSC studies all proposed changes to the public retirement laws and reports to the legislature on the probable costs, actuarial implications, and desirability as a matter of sound public policy (ORC 171.04(C)). Documents publicly available on the ORSC website, www.orsc.org, show that the council has regularly performed this duty over the years.

ORSC is also required every ten years to conduct an independent actuarial review of the annual actuarial valuations and quinquennial actuarial investigations prepared by each system (ORC 171.04(E)); and have conducted a fiduciary performance audit of each system (ORC 171.04(F)).

Earlier this year, prior to the release of the BFS Report, ORSC commenced the Request for Proposal (RFP) process for both the upcoming actuarial and fiduciary audits of STRS Ohio. At its August 2021 meeting, ORSC voted to approve the independent firms who will conduct the fiduciary and actuarial audits of STRS Ohio, both scheduled to begin later this year.

Reporting — STRS Ohio submits numerous reports to ORSC on an annual basis. These reports are presented during one of ORSC's scheduled public meetings and made publicly available on the ORSC website. The reports include:

- *Annual Comprehensive Financial Report (Annual Report)*, which includes audited financial statements and an opinion letter by a third-party financial audit firm
- Annual Actuarial Valuation Report, conducted by a third-party actuary firm
- Annual Internal Audit
- Annual Health Care Report
- Annual Disability Report
- Annual Budgets
- 30 Year Funding Plans (when required)

- Annual Iran/Sudan Divestment Report (note: this report is not required by statute but is submitted and presented as a matter of interest to ORSC)

Despite the oversight and availability of the resources outlined above, for its next premise the BFS Report attempts to establish a lack of oversight as a foundation and incorrectly states that “legislative oversight has been compromised for decades.”

B. 2006 IFS Fiduciary Audit

The BFS Report criticizes ORSC for being late to conduct its next fiduciary audit of STRS Ohio. The Chair of ORSC has publicly stated that he is committed to getting the audits back on schedule, and that delays have been a result of the multi-year pension reform legislation as well as the COVID pandemic. A fiduciary audit of each retirement system often takes several years to complete.

A fiduciary audit of STRS Ohio, commissioned by ORSC and conducted by Independent Fiduciary Services Inc. (“IFS”), was completed and presented to ORSC in December 2006 (the “IFS Fiduciary Audit”). The IFS Fiduciary Audit findings were discussed at State Teachers Retirement Board meetings held in both January and February 2007, at which time the Board voted to approve the staff analysis and recommendations as related to the IFS Fiduciary Audit. Although STRS Ohio appropriately addressed the recommendations, the BFS Report incorrectly asserts on pages 5-6 that the audit revealed multiple serious deficiencies which STRS Ohio has failed to address.

More information related to the 2006 IFS Fiduciary Audit will be provided in the Section III of this analysis.

C. Audits and Oversight of STRS Ohio

It would appear from reading the BFS Report that STRS Ohio does not undergo regular audit processes. The BFS Report states, “Any mismanagement or malfeasance which could have been exposed years earlier through timely audits has been allowed to persist, potentially resulting in great risk and cost to the plan.” It has been alleged that STRS Ohio has not had an audit performed in 15 years; however, that is simply not true.

It is important to note that in accordance with Ohio law, **each and every year** STRS Ohio undergoes an annual financial audit conducted by an independent accounting firm hired by the Ohio Auditor of State (currently Crowe LLC). STRS Ohio has consistently received a clean opinion that indicates the financial statements were presented fairly in accordance with generally accepted accounting principles (GAAP). The annual audited financials are reported in the *Annual Comprehensive Financial Report*. The 2017, 2018, 2019 and 2020 Annual Reports are currently available on the STRS Ohio website. Annual expense information can also be found

posted to the online Ohio Checkbook, while monthly expenses are available on the STRS Ohio website.

In addition to the ORSC oversight and annual financial audits performed on behalf of the State Auditor, the Ohio Treasurer serves as the custodian for STRS Ohio assets. The Retirement Board meets at least 10 times per year, and reviews investments, financials and other system operations on an ongoing basis, in addition to approving numerous governing policies for the system on an annual basis. Investment performance reports are provided to the Board on a monthly and/or quarterly basis. The Board also contracts with two investment advisers and an actuary, all of whom serve as fiduciaries to the system. Even outside of ORSC, STRS Ohio has numerous methods of oversight and review.

D. Use of Experts

STRS Ohio prudently works with expert consultants that have contractual and fiduciary obligations to the system in our efforts to develop effective long-term solutions. In addition, STRS Ohio appreciates the ongoing reviews conducted by the ORSC hired consultants for all five Ohio retirement systems.

STRS Ohio's expert consultants base their advice on research, analysis, and professional experience, similar to the consultants who conducted the ORSC fiduciary and actuarial audits. In fact, Milliman expressly stated on page 1 of the 2009 actuarial audit of STRS Ohio, "The reader should recognize that many of the issues that we reviewed and which we will discuss in this report are subject to opinion and professional preference. No two actuaries (or actuarial firms) are likely to use precisely the same methods and assumptions (and, therefore, arrive at precisely the same conclusions) when presented with the exact same problem and set of historical facts. The recommendations of one consultant do not necessarily invalidate the recommendations of another."

E. Pension Protection Act of 2006

The BFS Report references the fact that the Pension Protection Act of 2006 (PPA) established three zones of risk for pension plans and further states that STRS Ohio is in the yellow zone for "endangered" (see BFS Report pages 30-31). First, the PPA does not apply to STRS Ohio as a governmental plan. Second, STRS Ohio is governed by Ohio law. ORC 3307.512 requires that the Board establish a period of not more than thirty years to amortize the system's unfunded actuarial accrued pension liabilities. If, in any year, the amortization period exceeds thirty years, the Board must submit a report indicating how the Board will reduce the amortization period to not more than thirty years. STRS Ohio submitted those reports to the ORSC in 2003, 2004, 2005, 2006, 2007, 2009, 2011, 2013 and 2014.

F. Actuarial Audits and Experience Reviews

STRS Ohio is the subject of multiple actuarial experience reviews and/or audits, performed pursuant to ORC 3307.51 and ORC 171.04(E), respectively. The BFS Report alleges on page 34 that the most recent ORSC actuarial audit completed by Milliman in November 2009 did not cover ten years of valuation reports. To the contrary, ORC 171.04(E) states:

“[The ORSC shall] have prepared for each system by an independent actuary, at least once every ten years, an actuarial review of the actuarial valuations and quinquennial actuarial investigations prepared under sections 145.22, 742.14, 3307.20, 3309.21, and 5505.12 of the Revised Code, including a review of the actuarial assumptions and methods, the data underlying the valuations and investigations, and the adequacy of each system's employee and employer contribution rates to amortize its unfunded actuarial pension liability, if any, and to support the payment of benefits authorized by Chapter 145., 742., 3307., 3309., or 5505. of the Revised Code.”

The statute does not require that the ORSC actuarial audit review cover any set period of time, such as ten years of valuations.

The Author did not make public records requests of STRS Ohio for any actuarial-related materials or reports. He instead relied on information he found (or did not find) on the ORSC website. While the ORSC website does contain a large number of STRS Ohio reports and information generally, it does not appear to contain all of them. Over the time period referenced in the BFS Report, STRS Ohio has directly conducted the following multi-year **actuarial experience reviews**:

7/1/1998–6/30/2003	5-year experience review performed by Mellon
7/1/2003–6/30/2007	4-year experience review performed by Buck
7/1/2003–6/30/2008	5-year experience review performed by PWC
7/1/2008–6/30/2011	3-year experience review performed by PWC
7/1/2011–6/30/2016	5-year experience review performed by Segal

Further, the BFS Report states, “STRS failed to conduct any 5-year actuarial investigation that includes the period July 1, 2008-June 30, 2011.” This is simply not true. As shown above, STRS Ohio had a three-year review performed by PWC during that period. ORC 3307.51(B) states that STRS Ohio shall have an actuarial investigation prepared “at such times as the state teachers retirement board determines, and *at least once* in each quinquennial period.” STRS Ohio is commencing its next actuarial review under 3307.51(B) this fall for the period of July 1, 2016–June 30, 2021, which will be conducted by Cheiron, the Board’s independent actuary.

Finally, it should be reiterated that ORSC issued RFPs in May 2021, and at its August 2021 meeting ORSC voted to approve the independent firms who will conduct the actuarial and fiduciary audits of STRS Ohio, both scheduled to begin later this year.

A. Background of the 2006 IFS Fiduciary Audit

Independent Fiduciary Services, Inc. (IFS) was initially engaged in 2004 by ORSC to conduct a fiduciary audit of STRS Ohio pursuant to ORC 171.04(F). The IFS Fiduciary Audit was completed and presented to ORSC in December 2006. Subsequently, the IFS Fiduciary Audit findings were discussed at State Teachers Retirement Board meetings held in both January and February 2007, at which time the Board voted to approve the staff analysis and recommendations as related to the Audit.

In the executive summary of the IFS Fiduciary Audit, IFS noted, “the results of this review demonstrate that STRS is generally in line with best practices with regard to much of its overall governance, administration and management of its investment program.” It was further noted, “STRS governance policies and rules are impressively comprehensive and they cover all of the significant aspects of governance a sophisticated public pension fund requires.”

As a result of the IFS Fiduciary Audit, there were a total of 85 recommendations made by IFS. In response, STRS Ohio staff prepared a thoughtful and detailed response to each and every recommendation. Again, these responses were reviewed with the Board in January and February 2007, with the Board ultimately voting to approve the staff analysis and recommendations as presented with the amendments offered.

Of the 85 total IFS recommendations, 14 of those recommendations directly addressed the pension oversight responsibilities of ORSC and were noted as needing to be addressed by ORSC directly. Additionally, nine other recommendations required further consideration and/or action by ORSC, the State Treasurer’s Office, and/or the Legislature, and were related to requirements for the Ohio Treasurer to select, contract with, manage and terminate custodial relationships on behalf of the pension systems.

The majority of the IFS recommendations were accepted by the Board in STRS Ohio’s response. Some of these items had already been fully addressed and implemented prior to the release of the IFS Fiduciary Audit in December 2006, and all were addressed with comments and an actual or proposed implementation date. Only 10 of the recommendations were marked as “disagree,” and detailed reasoning was provided as to why STRS Ohio did not agree with the IFS recommendations in those areas and therefore would not be implementing any changes at that time.

B. False allegations regarding a “failure to address serious deficiencies in last fiduciary performance audit”

It should be noted that the 2006 IFS Fiduciary Audit did not find any “serious deficiencies.” For clarity, the purpose of a fiduciary performance audit (according to the most recent RFP issued by ORSC in May 2021 for the STRS Ohio audit) is “to identify areas of strengths and weaknesses in STRS, compare STRS operations with best practices of other public pension plans, and make recommendations for improvement.” As stated above, the 2006 IFS Fiduciary Audit recommendations for improvement were reviewed and evaluated by the STRS Ohio staff, Board and experts to determine whether the recommendations should be accepted or in the alternative provide support for current practices.

The BFS Report attempts to establish that STRS Ohio has failed to “address serious deficiencies” identified in the 2006 IFS Fiduciary Audit. In particular, the author lists two “serious deficiencies,” and then includes a list of other items, some of which were included as recommendations and others which were not discussed in the IFS Fiduciary Audit at all. Again, it is important to reiterate that the State Teachers Retirement Board reviewed and discussed the recommendations and staff responses at its January and February 2007 Board meetings and approved the staff analysis and recommendations. **All IFS recommendations, whether or not accepted for implementation, were certainly “addressed” over 14 years ago by the Board and staff. The BFS Report is completely inaccurate to suggest otherwise.**

1. Alternative Investments Benchmarks

The BFS Report incorrectly asserts that STRS Ohio did not address the alternative investment benchmarking recommendation from the 2006 IFS audit.

As noted above, all recommendations in the 2006 IFS Fiduciary Audit were addressed in a response reviewed and approved by the Board in early 2007. However, the first of the two “serious deficiencies” alleged to remain unaddressed by the BFS Report relates to use of actual performance for benchmarking the alternative investments component of the total fund benchmark since 2002. The BFS Report both inaccurately and imprecisely describes how STRS Ohio alternative investments are benchmarked (as well as the historical context related to alternative investment benchmarking policies). The Author attempts to leverage the inaccurate representation of STRS Ohio alternative investment benchmarking to make inaccurate and misleading comparative returns calculations.

In the IFS Fiduciary Audit, Recommendation A16 (p.104) stated as follows:

“IFS recommends the Fund consider formally adopting a new benchmark to benchmark risk and performance in the Alternative program and to better reflect the benchmarking process outlined in the IPS such as the Wilshire 5000, Russell 3000 or Russell 2000 small cap index, plus an additional risk premium of 500 basis points to compensate the Fund

for additional risk in the private equity markets which is being assumed. The Cambridge Associates Private Equity and Venture Capital benchmarks could also be utilized.”

STRS Ohio investments staff, the Frank Russell Company (the Board’s consultant at the time) and the Board carefully considered the IFS Report recommendations which were initially discussed with the Board during the January 31, 2007, Special Retirement Board meeting.

The response of STRS Ohio, as approved by the Board in February 2007, was that this recommendation would not be implemented due to the following rationale:

“In the latest IPS [Investment Policy Statement], Alternative Investments are targeting a spread of 300 basis points over the Russell 3000 over the long term. Also the 2005 Asset Liability Study establishes a 270 basis points spread over public equities. With respect to benchmarking, IFS seems to agree that the informal three-pronged method used by STRS Ohio to evaluate the performance of this asset class and the manager selection skill of the Fund staff is appropriate but recommends that a relative return benchmark for Alternative Investments be added at the total fund level. We disagree, as does the Board’s investment consultant, because (1) a valid benchmark should be unambiguous, investable, appropriate and specified in advance; (2) available peer group “benchmarks” suffers from survivor bias and small sample sizes; (3) IFS has not shown why the informal method of evaluation is not effective; and (4) short-term Alternative Investment returns could generate serious attribution problems for the total fund. Using Alternative Investment’s actual returns in the total fund benchmark puts proper focus on the ability of the asset class to enhance absolute returns over the long term.”

Therefore, while the total fund benchmark was not changed as a result of the IFS Fiduciary Audit, the recommendation was appropriately reviewed and addressed by the Board, staff and investment consultant Frank Russell Company at that time. Moreover, the Board has approved the use of the alternative investments actual return as a component of the total fund benchmark in connection with every Statement of Investment Objectives and Policy (“SIOP”) from 2002 until the most recent SIOP adopted by the Board at its March 2021 meeting.

As noted in the above response, STRS Ohio’s decision to maintain the alternative investments actual return was based on several factors commonly used to evaluate the appropriateness of performance benchmarks. The BFS Report asserts, however, that the Board’s past decisions on this point were flawed, even suggesting that the benchmark violated ORC 3307.15, which requires the board to comply with the performance presentation standards established by the CFA institute (the CFA Institute Global Investment Performance Standards (GIPS®)). While the Author is entitled to his opinion, his assertion that the benchmark was inconsistent with CFA Institute guidance, the GIPS® standards or Ohio law is false.

CFA Institute Guidance on Benchmarks – The Research Foundation of the CFA Institute published *A Primer for Investment Trustees*² that established criteria for judging performance benchmarks:

1. Unambiguous – the benchmark should be clearly understood by all parties in the investment program.
2. Investable – the benchmark should represent an investable alternative; that is, the trustees could choose to hold the benchmark rather than hire the particular manager.
3. Measurable – the benchmark’s rate of return should be readily calculable.
4. Appropriate – the benchmark should reflect the manager’s typical risk characteristics and areas of expertise.
5. Specified in advance – the benchmark must be specified prior to the evaluation period and known to all interested parties.
6. Owned – the benchmark should be acknowledged and accepted as an appropriate accountability standard by the party responsible for the performance.

Several benchmark criteria identified by CFA Institute were cited in STRS Ohio’s 2007 response to the IFS recommendation. These criteria were properly considered by the Board and its consultants and further evidence the appropriateness of the Board’s decisions on this matter.

GIPS® Standards Benchmark Requirements – For GIPS® compliance purposes, an asset owner must include benchmark returns only when there is an appropriate benchmark that reflects the investment mandate, objective, or strategy of the composite. The GIPS® standards acknowledge that there may be instances when there may not be an appropriate benchmark. Also, it is not uncommon for managers of alternative investments to determine that there is no appropriate benchmark for a given strategy. Interpretive guidance in the GIPS® Standards Handbook states:

“Although there is typically an appropriate benchmark for traditional strategies, it is more common for asset owners with alternative investment strategies to determine that no appropriate benchmark for the alternative strategy exists.”

The GIPS® Standards Handbook provides the following sample disclosure:

“Because the composite’s strategy is absolute return where investments are permitted in all asset classes, no benchmark is presented because we believe that no benchmark that reflects this strategy exists.”

² Source: *A Primer for Investment Trustees*, Bailey, Phillips & Richards; Research Foundation of the CFA Institute January 2011.

As noted in STRS Ohio's response to the IFS Fiduciary Audit, there are challenges in selecting an appropriate benchmark for the alternative investment asset class for shorter time periods. Based on the advice of investment consultants over the years, including its current consultants Callan and Cliffwater, STRS Ohio used the actual alternative investment return for the total fund blended benchmark through June 30, 2021.

As discussed in Section VI of this Response, STRS Ohio's compliance with the GIPS® standards undergoes annual verifications and performance examinations from a third-party verification firm. No GIPS® compliance-related issues regarding this benchmark have been raised in the decade-plus that STRS Ohio has undergone such verifications and performance examinations. In short, the use of the alternative investments actual return within the total fund benchmark neither conflicts with the GIPS® standards nor violates Ohio law.

February 2021 Benchmark Review — The State Teachers Retirement Board reviewed benchmarks with Callan at its December 2020 and February 2021 meetings. At the February 2021 meeting, Callan presented on the performance benchmarks across all asset classes and recommended that the board retain its benchmarks in the areas of Domestic Equity, International Equity, Fixed Income, and Real Estate. Callan recommended that the Board adopt a new set of performance benchmarks at the asset class and total fund level for each of the major components of the alternative investments asset class (private equity, opportunistic and diversified).

Callan stated that due to the nature of private market securities, there are no benchmarks that meet all criteria provided in the CFA Institute's *A Primer for Investment Trustees*. They recommended that STRS Ohio adopt alternative investment portfolio benchmarks that incorporate the following traits:

- Consistency between the asset class itself and the asset class component of the Total Fund Composite.
- Reflective of the investment strategy adopted by STRS Ohio for the asset class.
- Reflective of the investment opportunity set and overall risk and return profile of the asset class.
- Reduces tracking error between the benchmark and the STRS Ohio portfolio.

At the February 2021 Board meeting, Callan recommended, and the Board adopted, the following Private Markets Fund Benchmarks for the Alternative Investments Asset Class and Total Fund Blended Benchmark and the incorporation of those benchmarks, effective July 1, 2021:

- Private Equity — Cambridge Associates Private Equity and Venture Capital Index
- Opportunistic Portfolio — Cambridge Associates Private Credit Index

- Diversified Portfolio — HFRI Fund of Funds Composite Index

Alternative Investments Benchmarking Conclusion – All benchmarks are reviewed and adopted by the Board on a regular basis and are incorporated into policies such as the SIOP adopted annually by the Board. At the time of the 2006 IFS Fiduciary Audit, the Board, after consultation with staff and its investment consultant, DID address the recommendation with regard to use of actual performance for the alternative investment benchmark, but did NOT agree that a change in the alternative investment benchmark was necessary. Use of the actual alternative investment asset class performance as a component of the total fund benchmark performance did not affect the relative return of the total fund either positively or negatively.

More than 14 years have elapsed since the IFS Fiduciary Audit recommendations were presented. The Board has continued to regularly review and adopt investment policies, which have included asset class benchmarks. Much in the world of investments, and particularly alternatives, has changed over the years since the IFS Fiduciary Audit was completed. There is an incredible amount of new information to consider and review when evaluating the current status of the STRS Ohio investment program and benchmarks. While STRS Ohio appropriately considered and addressed recommendations made in the IFS Fiduciary Audit in 2006, a review of any of those recommendations, without taking into account today's information and changes, would be irrelevant.

As mentioned earlier in Section II, the next decennial fiduciary audit of STRS Ohio will be commenced later this year by ORSC. STRS Ohio looks forward to having new and updated expert reviews of its programs and operations and will once again consider any appropriate actions based on an updated review by a professional fiduciary expert.

2. The IFS audit recommendation related to conflicts of interest involving external investment consultants has also been addressed.

The second “serious deficiency” alleged by the BFS Report to be unaddressed was contained in the IFS Fiduciary Audit as recommendation A20 on page 144:

“Russell’s contract with STRS should be amended to require Russell to provide annual disclosure of its business relationships with all investment managers or other providers of investment services. This contractually-required disclosure should include information from Russell on the specific amounts paid by Russell by those investment managers employed by STRS Ohio and on the specific services provided to those managers.”

The Frank J. Russell Company (“Russell”) was the investment consultant to the Board at the time of the IFS report. STRS Ohio’s response to this recommendation, adopted by the Board in February 2007, was as follows:

“STRS Ohio’s current agreement with Russell provides comprehensive protections regarding conflicts of interest. These provisions include a requirement that Russell shall not receive any remuneration with respect to any transaction under the agreement except from STRS Ohio. Additionally, the agreement requires Russell to promptly disclose any potential conflicts of interest. The contract will be amended to reflect this annual disclosure recommendation.”

As indicated in the STRS Ohio response to the audit recommendations, this recommendation was accepted and implemented in March 2007. Additionally, the disclosure requirements were subsequently incorporated into the contracts with the Board’s current investment advisers, Callan and Cliffwater, as well.

The following contractual provisions are included in the current STRS Ohio investment adviser agreements, as related to conflicts of interest:

- A. [Investment Adviser] will act with respect to any transaction arising from or pertaining to this Agreement, or involving any interest of STRS Ohio, only under this Agreement and shall not receive any remuneration in connection with such transaction except under this Agreement or as may be determined by mutual agreement of STRS Ohio and [Investment Adviser] in writing in advance.
- B. [Investment Adviser] has disclosed in writing those actual and potential conflicts of interest that could be reasonably expected to affect the objectivity of the firm or its employees in fulfilling their duties to STRS Ohio and will update STRS Ohio promptly in the event of any additional, actual or potential conflicts of interest.
- C. [Investment Adviser] will provide annual disclosure of its business relationships with all investment managers or other providers of investment services employed by STRS Ohio. This disclosure will include information on the specific services provided and the specific amounts paid to [Investment Adviser].

On page 45 of the BFS Report, the Author concedes that STRS Ohio did indeed include these provisions, as recommended by IFS, in its investment adviser agreements with Callan and Cliffwater. The BFS Report goes on to further state that “it appears that STRS has never received disclosure regarding the specific amounts paid to the two firms by those investment managers, detailing the specific services provided to those managers.”

While the latter statement will be addressed in greater detail in Section VII of this analysis, a few key points are worthy of note here. First, STRS Ohio knows the names of each Callan money manager client, the types of services they could receive from Callan, and the range of fees they could be charged. Callan discloses the names of those clients to the Retirement Board on a quarterly basis. Further, Callan’s policies and procedures are specifically designed to segregate pension consulting services from money manager services. Finally, both Callan and Cliffwater

provide extensive conflicts disclosure in their Forms ADV, which are filed at least annually with the U.S. Securities and Exchange Commission (SEC).

As mentioned earlier, the role of STRS Ohio consultants is discussed in greater detail throughout this analysis, and potential conflicts of interest are further addressed in Section VII.

C. The BFS Report contains a list of other topics and alleges they remain unaddressed. These topics, to the extent they were included in a recommendation in the 2006 IFS Fiduciary Audit, were appropriately addressed by STRS Ohio.

Finally, pages 6-7 the BFS Report simply list nine items as some of the “concerns raised in the IFS Report” without further context or explanation. These concerns were either (i) inaccurately- or mis-identified, (ii) addressed by STRS Ohio and resolved/implemented or (iii) were simply not included or referenced in the IFS Fiduciary Audit at all.

Since the BFS Report did not provide any additional context, we reiterate that as a result of the IFS Fiduciary Audit, there were a total of 85 recommendations made by IFS. STRS Ohio prepared responses to address each and every recommendation. Again, these responses were reviewed with the Board in January and February 2007, with the Board ultimately voting to approve the staff analysis and recommendations as presented with the amendments offered.

The majority of IFS recommendations were accepted in staff’s response. Some items had even already been addressed and implemented prior to the release of the IFS Fiduciary Audit in December 2006, and all were addressed with comments and an actual or proposed implementation date. Only 10 of the recommendations were marked as “disagree,” and detailed reasoning was provided as to why the system would not be implementing any changes at that time. The IFS Fiduciary Audit and recommendation responses were reviewed and approved by the STRS Ohio Board in February 2007. **Any assertion that the recommendations from the IFS Fiduciary Audit remain unaddressed more than 14 years later is simply inaccurate.**

In conclusion, the overall findings of the IFS Fiduciary Audit were generally positive and all recommendations were appropriately reviewed by the STRS Ohio Board in 2007. The executive summary of the IFS Fiduciary Audit stated, “The results of this review demonstrate that STRS is generally in line with best practices with regard to much of its overall governance, administration and management of its investment program.” It was further noted, “STRS governance policies and rules are impressively comprehensive and they cover all of the significant aspects of governance a sophisticated public pension fund requires.”

IV. ALTERNATIVE INVESTMENTS FEES AND PERFORMANCE

The BFS Report incorrectly asserts that STRS Ohio pays \$143 million annually to managers who perform no services and has suffered billions in losses due to alternative investments. These claims misstate STRS Ohio's investment costs and misrepresent our alternative investment benchmarks and returns.

A. STRS Ohio Does Not Pay \$143 Million Annually in Fees on Unfunded Committed Capital

The BFS Report incorrectly asserts that STRS Ohio pays private fund managers \$143 million annually to do nothing. This claim misrepresents both the amount of management fees STRS Ohio pays on committed capital and the purpose of those fees.

Committed Capital — Investors in private equity funds typically agree to invest a certain amount over a specified period (commonly called the commitment period). Assets committed and not yet funded are referred to as *unfunded committed capital*, and assets already funded are referred to as *invested capital*.

- For example, an investor agrees to commit \$10 million over five years. The timing of those payments would depend on the investment opportunities the fund's manager chose to pursue and the terms of the partnership agreement governing the investment. If the investor funded \$2 million of its commitment in the first year, it would have \$2 million in invested capital and \$8 million in unfunded committed capital, with four years remaining in its commitment period.

The BFS Report correctly notes that it is common practice for private equity funds to charge management fees on unfunded committed capital during the fund's investment period. The BFS Report incorrectly asserts, however, that management fees on unfunded committed capital amount to money for nothing.

Management Fees on Committed Capital — Management fees are intended to compensate a fund manager for its investment services performed for the fund.³ These services include actions taken with respect to both invested capital (e.g., managing portfolio companies in which the fund has invested) and unfunded committed capital (e.g., seeking new investment opportunities consistent with the fund's mandate). Both types of services are necessary for the fund to achieve its overall objectives:

³ Per the Institutional Limited Partners Association ("ILPA"), an advocacy group for limited partners like STRS Ohio, management fees are "used to provide the partnership with resources such as investment and clerical personnel, office space and administrative services required by the partnership."

- Private fund managers actively seek investments during the investment period, which requires travel, marketing, research, and due diligence. Funding these activities requires upfront capital from limited partners and the manager.
- Successful private fund managers acquire companies at reasonable prices and successfully grow these companies, and then sell at a profitable value. The work they perform begins well before a decision is made to buy a company. Management fees on committed capital during an investment period help to align the interests of the manager and its investors by incentivizing the manager to pursue the best opportunities at the best times, rather than rushing into deployment.
- The vast majority of funds that charge management fees on committed capital are not eligible to draw such fees after the investment period has ended. Moreover, in nearly all circumstances, management fees — as well as invested capital — are returned to investors before private fund managers are entitled to a share of any profits (described in greater detail in section V of our response).

In short, the BFS Report’s suggestion that private fund managers perform no investment services until capital has been deployed is simply not true. Moreover, STRS Ohio approaches private funds as long-term investments, whose performance is best measured over the life of the investment, not based on point-in-time expense calculations that give an incomplete view of the fund’s investment process. Management fees are part of that assessment, as are strategy execution, risk management, and return on investment.

STRS Ohio’s Actual Fees on Committed Capital — The BFS Report claims that STRS Ohio pays \$143 million in fees annually on unfunded committed capital. This number — based on the Author’s own calculation — is grossly inaccurate and misleading. First, it inaccurately assumes that STRS Ohio pays a management fee of 2% on all committed capital. Second, it disregards the various strategies STRS Ohio employs to achieve its alternative investments objectives.

As reported in CEM Benchmarking Inc.’s 2019 Investment Cost Effectiveness Analysis, a copy of which was provided to the Author, STRS Ohio’s total investment management costs for calendar year 2019 were \$290.4 million. Of this amount, approximately \$174.7 million were related to alternative investments. To suggest that \$143 million, or 82% of total alternative investment costs, were attributable to fees on unfunded committed capital is incorrect.

Actual management fees paid on unfunded committed capital during calendar year 2019 were \$59 million, or 34% of total alternative investment costs. This amount is based on unfunded committed capital of approximately \$7.9 billion, resulting in an average fee rate of 0.8%, far below the 2% rate assumed by the BFS Report.

Additionally, only 65% of STRS Ohio’s alternative investments commitments are contractually eligible to charge management fees on committed capital. The remaining 35% (typically credit-related managers) charge management fees only on invested capital. STRS Ohio has significantly increased its allocation to credit strategies over the past several years, reducing the percentage of committed capital eligible for management fees. We expect this trend to continue as we further expand our credit strategies going forward.

More broadly, STRS Ohio is committed to lowering fees and managing alternative investments expenses through increased allocations to direct and co-investments, for which managers do not typically receive management fees or carried interest, and by aggressively negotiating fees on commitments where such fees are eligible.

B. The BFS Report Uses Inaccurate Benchmarks and Performance in Support of False Claims

The BFS Report makes a series of unsupported claims about STRS Ohio’s alternative investments performance. These claims misrepresent STRS Ohio alternative investment benchmarks and returns.

STRS Ohio Alternative Investment Benchmarks — STRS Ohio uses benchmarks to measure performance at both the asset class level and the total fund level. As discussed in Section III of this Response, the BFS Report included several inaccurate assertions regarding STRS Ohio’s alternative investment benchmarks, including its use of the alternative investments actual return as a component of the total fund benchmark. While the Author may disagree with the Board’s choice of benchmarks, his comparison of STRS Ohio alternative investment returns to benchmarks not adopted by the Board is misleading. **Specifically, the assertion that comparisons to the *Russell 3000 plus 500 basis points* reveal “losses” of \$8.6 billion or \$2.5 million per trading day over 14 years is completely inaccurate.**

First, *Russell 3000 plus 500 basis points* is not the STRS Ohio alternative investments component of the total fund benchmark, nor does it accurately reflect the return expectations, volatility, or risk characteristics of the alternative investment asset class, particularly over shorter periods. Using it as a benchmark for alternative investments returns, therefore, serves no more value than comparing to a credit index or global markets index. As demonstrated by its asset mix and investment strategies, the objective of the alternative investments asset class is to offer competitive returns with increased diversification and reduced volatility over the long term.

Second, the portfolio characteristics of STRS Ohio alternative investments have evolved significantly over the past fourteen years. Allocations to liquid alternatives, direct and co-investments, and credit investments have changed the asset mix from its predominantly private equity/venture capital origins to a more diverse portfolio with exposure to multiple asset

classes. Accordingly, the criteria that led the Board's investment consultants in 2007 to recommend against adopting *Russell 3000 plus 500 basis points* as a component of the total fund benchmark are even more applicable today. This fact was reinforced during the February 2021 board meeting, when the Board adopted new alternative investments benchmarks that did not include the Russell 3000, or any other public equities benchmarks.

Finally, underperformance relative to any index, let alone an index that does not serve as its benchmark, does not equate to "losses." While hindsight bias may cause one to conclude that pension assets should have been invested exclusively in equities over the past decade, experience tells us otherwise. STRS Ohio's asset mix policy is designed specifically to manage risk and achieve returns over the long-term while incorporating diversification. Alternative investments are a key component of this strategy. Moreover, STRS Ohio's alternative investment returns have exceeded total fund returns over the past one, five, 10 and 20 years ended June 30, 2021, further demonstrating their positive impact on total fund performance.

V. DISCLOSURE OF INVESTMENT COSTS AND PERFORMANCE

The BFS Report alleges that STRS Ohio may have misrepresented its investment costs and performance. As discussed below, the Author misapplies or misstates information from CEM Benchmarking Inc. (CEM), as well as industry practices and standards, to make his spurious claims.

A. CEM Benchmarking

CEM is a private company that aggregates data from participating pension plans to compare various plan-level metrics, including investment costs. CEM receives data from approximately 300 large global institutional investors, including about 150 of the most prominent U.S. pension plans. STRS Ohio has been providing its investment costs and fees to CEM since the 1990s.

CEM Report — CEM prepares an annual Investment Cost Effectiveness Analysis report (CEM Report) for each participating plan, including STRS Ohio, which offers investment cost comparisons and cost benchmarking based on CEM’s aggregate data. STRS Ohio and other participating plans report their investment fees and costs annually using CEM’s best cost practices. CEM aggregates reported data and applies its own methodologies to facilitate meaningful comparisons among peer funds.

- CEM is not charged with independently calculating STRS Ohio’s costs, nor does STRS Ohio rely on CEM for its calculation of performance or analysis of returns.
- Both the Board’s investment consultant (Callan) and ORSC’s investment consultant (RVK) provide extensive rankings and comparisons on STRS Ohio’s absolute and relative/value-add investment performance.
- STRS Ohio complies with the GIPS® standards in connection with its reporting of investment performance and undergoes annual verifications and performance examinations from a third-party verifier (ACA Group).

B. BFS Report Erroneously Claims STRS Ohio Underperformed by \$400 Million Annually

The BFS Report incorrectly asserts that STRS Ohio lost over \$400 million annually from 2014 to 2018 due to active management. This assertion misapplies CEM data regarding STRS Ohio’s policy return.

STRS Ohio Policy Return — The 2018 CEM Report cited in the BFS Report provides a comparison of STRS Ohio’s policy return to its net total fund return. The policy return, also called the Total Fund Blended Benchmark, is the return the fund could expect to earn by

investing in its benchmarks according to its asset mix policy adopted by the Board. STRS Ohio provides its policy returns to CEM in connection with STRS Ohio's annual reporting of investment costs and related data.

- STRS Ohio's policy returns reported in the 2018 CEM Report correctly reflected STRS Ohio's Board-approved benchmarks, including its alternative investments component benchmark, which was the alternative investments actual return. As stated in the CEM Report, STRS Ohio had a 5-year policy return of 6.09%, which CEM compared to STRS Ohio's 5-year net total fund return of 6.25% to arrive at a net value added of 0.16% due to active management.

Substitute PE Benchmark — In the 2018 CEM Report, CEM also noted that had it substituted its own private equity benchmarking calculation (Substitute PE Benchmark) for the Board-approved alternative investments benchmark used in STRS Ohio's policy return, the resulting policy return would have been 0.7% higher than STRS Ohio's policy return, with a corresponding reduction in net value added by management. The Substitute PE Benchmark is not the benchmark adopted by the Board. Rather, it was developed by CEM for comparative purposes only, since there is little consistency among pension plans with respect to private equity benchmarks.

The BFS Report incorrectly asserts that STRS Ohio's policy return should use the Substitute PE Benchmark rather than STRS Ohio's actual alternative investments benchmark. This argument is flawed for two reasons. First, and most obviously, STRS Ohio's alternative investments benchmark is, by definition, the benchmark approved by the Board and reflected in its SIOP, Annual Comprehensive Financial Report, and annual GIPS® compliant presentations. Using any other benchmark, including the Substitute PE Benchmark, would not accurately reflect STRS Ohio's policy return. Second, as explained in more detail below, the Substitute PE Benchmark does not meet the definition of an acceptable or appropriate benchmark for STRS Ohio's alternative investments.

- The Substitute PE Benchmark is not a publicly available or trackable benchmark. CEM developed the Substitute PE Benchmark only as a tool for comparison purposes and did not intend it as a recommendation of suitability as a policy benchmark for STRS Ohio or any other pension plan.
- The beginning and ending periods used for the Substitute PE Benchmark are not known until well after the close of the measurement period, making the benchmark impossible to measure during the measurement period, implement and know in advance.
- The beginning and ending periods used in the Substitute PE Benchmark are different than STRS Ohio's beginning and ending periods.

- Moreover, CEM’s Substitute PE Benchmark was developed using high-level, aggregate performance data from its clients. The Substitute PE Benchmark is not intended to represent the capitalization, geography, size, sector, and other important details of STRS Ohio’s actual portfolio composition.

As reported in its executive summary, CEM correctly stated that STRS Ohio’s net total fund return exceeded its policy return over the five-year period ended December 2018. Contrary to the BFS Report’s claims, CEM used STRS Ohio’s actual policy return and Board-approved benchmarks to report the total fund net value added. This information is neither inaccurate nor misleading.

C. BFS Report Misstates CEM Information Regarding STRS Ohio Costs

The BFS Report overstates STRS Ohio’s investment costs and falsely suggests that STRS Ohio was secretly concealing cost information. The Author’s misstatements appear to stem from a misunderstanding of CEM’s role — which is to compare costs among retirement systems using CEM’s proprietary assumptions and formulas, not to calculate performance — and more importantly, that STRS Ohio reports alternative investment performance net of all carried interest, management fees and fund expenses.

STRS Ohio Total Investment Management Cost — STRS Ohio’s total investment management costs in calendar year 2018 were \$279,069,000. STRS Ohio provided this cost information to CEM, which correctly reported our actual investment cost as \$279.1 million or 36.9 basis points. The CEM Report notes that this figure excludes carried interest. This is because carried interest is not an investment cost.

- **Carried Interest** – Carried interest is not a fee. Rather, it is a profit-sharing agreement between a fund’s general partner and limited partners (e.g., STRS Ohio) that entitles the general partner to share in the fund’s profits to the extent they exceed the capital invested by its limited partners — including investment costs, fees and partnership expenses — plus (in most cases) an additional annual return hurdle or “preferred return” owed to the limited partners.
 - Because the general partner is not entitled to receive a carried interest, or share of profits, until it generates a specified return to investors, this arrangement serves to align the interests of investors and managers.
 - Carried interest is typically not awarded to a general partner until an investment (or fund) is monetized, and investors do not pay carried interest out of their own cash flows.

- **Governmental Accounting Standards Board (GASB) accounting standards have not prescribed that carried interest should be reported as an investment fee or expense.**⁴

CEM Adjusted Investment Costs — The 2018 CEM Report provides, for peer group comparative purposes only, an adjusted investment cost for STRS Ohio of \$302.8 million or 40.1 basis points. This figure adds hedge fund carried interest and certain management fee offsets,⁵ which are already reflected in the net asset value and are deducted before STRS Ohio reports its investment performance, to our total investment costs and is therefore not representative of STRS Ohio’s actual total investment costs. CEM reports that this adjusted investment cost is 14.5 basis points lower than STRS Ohio’s peer median benchmark cost of 54.5 basis points and that STRS Ohio is a low-cost fund. As stated previously, CEM’s role is to compare costs among pension funds. CEM does not calculate STRS Ohio investment performance.

- **STRS Ohio Peer Median Benchmark Cost** — As described in the CEM Report, STRS Ohio’s peer median benchmark cost is an estimate of what our cost would be given our actual asset mix and the median costs our peers pay for similar services. In short, it applies the peer group implementation costs to the STRS Ohio actual asset mix.

BFS Report Misrepresents STRS Ohio Investment Cost — The BFS Report states, incorrectly, that STRS Ohio’s actual investment costs are \$463.6 million or 61.3 basis points. To arrive at this erroneous figure, the BFS Report essentially double counts a hypothetical carried interest by adding STRS Ohio’s CEM-adjusted investment cost (\$302.8 million) and CEM’s estimate of carried interest attributed to STRS Ohio investments (\$160.8 million). CEM’s estimate of carried interest (which CEM calls performance fees) is based on its proprietary methodology and is not intended to reflect the actual carried interest attributable to STRS Ohio investments. The BFS Report then concludes, incorrectly, that STRS Ohio’s investment cost was actually “significantly greater than the fund’s benchmark cost of 54.5 basis points, suggesting that STRS was *high cost* compared to its peers.”

- **In addition to comparing numbers that do not reflect STRS Ohio’s actual investment costs, this conclusion ignores that CEM’s benchmark cost calculations, whether for STRS Ohio or any peer fund, do not include carried interest.** Thus, based on an apples-to apples comparison, CEM’s adjusted costs for STRS Ohio were actually 14.5 basis points below its peer median benchmark cost.

In summary, despite the BFS Report’s contention, CEM correctly calculates STRS Ohio’s 14.5 basis points net cost effectiveness relative to our peers. When the Author deducts CEM’s default performance fees from STRS Ohio’s reported net returns — which are always presented

⁴ Current GASB guidance, Statement GASB 67, Section 26 indicates that investment-related costs should be reported as investment expense if they are separable from (a) investment income and (b) the administrative expense of the pension plan.

⁵ Management fee offsets include monitoring, transaction, and other portfolio company related expenses paid to the investment manager that are offset against fund level management fees.

net of all management fees, fund expenses and carried interest — he is double-counting these fees. The BFS report further suggests — without any support — that STRS Ohio fees equal \$1 billion. This claim is grossly misleading and appears intended only to muddy the waters around fee transparency.

D. STRS Ohio has a Robust Fee Monitoring Process

In addition to the fact that STRS Ohio reports alternative investment performance net of all management fees, fund expenses and carried interest, the Retirement System has dedicated considerable time and resource over the past several years to developing and implementing fee monitoring procedures to obtain all fees and costs as well as ensure that all fees and costs directly invoiced or subtracted from the investment by fund managers are proper.

Alternative Investment Fee Transparency — In 2015, STRS Ohio began an initiative to enhance private fund transparency to allow STRS Ohio to better assess compliance with underlying agreements, obtain specific data from our managers in the most cost-efficient manner, and maintain strong working relationships with our managers to meet long-term return objectives.

- Most private fund managers are SEC-registered and subject to SEC examination. These managers have audited financial statements and must comply with fair value standards.
 - Fund valuations are typically audited by credible, nationally recognized audit firms and must adhere to applicable accounting standards. Financial audits require that, to be GAAP compliant, fair value of assets must be determined pursuant to a specific accounting standard known as FASB ASC Topic 820.
- STRS Ohio requests information semi-annually from its managers regarding its proportionate share of management fees (gross, offsets and net) and other fund expenses, as well as carried interest attributed to STRS Ohio investments.
- STRS Ohio requests information annually from managers about findings from SEC and other regulatory examinations.

Other steps taken by STRS Ohio to improve its fee monitoring capabilities include:

- **ILPA (Institutional Limited Partners Association)** — STRS Ohio partnered with ILPA in their fee transparency initiative and helped guide a new fee reporting template that was launched for increased transparency and consistency. Staff encourages our general partners to adopt the ILPA fee template and presses for its inclusion in our limited partnership agreement side letters.

- **Additional Staff** — In 2018, STRS Ohio added a new position to the Finance department with specific responsibility to review and monitor the fees and costs associated with STRS Ohio’s limited partnership funds to expand on the existing review and monitoring that was in place. This position, the Alternative Investment Fund Manager, also works cohesively with investment teams and stays abreast of fee monitoring and reporting best practices.
- **External Audit Firm** — STRS Ohio’s fee monitoring process is discussed annually with the external audit firm as part of their overall financial statement audit. No audit firm recommendations or modifications to the opinion have been received, and the audit firm has obtained support and performed testing on the expenses as part of the financial statements and related notes to the financial statements.

BFS Report’s False Claim Regarding Withdrawal of Fees — The BFS Report claims “with great emphasis that ... STRS investment managers may withdraw their fees from pension accounts in the absence of any diligent monitoring by STRS.” This statement is simply not true. STRS Ohio investment managers cannot withdraw fees from pension accounts. Payment of management fees for alternative investment and real estate follows a multi-step internal process. Direct management fees for separate account external managers are authorized for payment by the Ohio Treasurer of State following a standardized, multi-step internal process.

E. Proper Disclosure of Investment Fees and Expenses

Despite the BFS Report’s contention, STRS Ohio discloses investment fees and expenses in compliance with industry standards.

Net returns for alternative investments and external real estate — STRS Ohio’s total fund return and net total fund return are inherently net of external management fees and costs, as well as carried interest attributable to alternative investments and real estate, because these items are subtracted from the underlying investment *prior* to calculating its net asset value. Disaggregating and separately reporting these items would have no effect on the investment return, market value and net investment income reported in the financial statements.

- The BFS Report’s claim of unreported carried interest fees is not accurate. **When the Author deducts CEM’s default performance fees from STRS Ohio’s reported returns — which are always presented net of all management fees, fund expenses and carried interest — he is double-counting these fees.** Again, carried interest is already reflected in the net asset value, net investment income and performance return.
- Net total fund returns are a requirement per the GIPS® standards, and STRS Ohio has presented net total fund returns annually since 2008, which included ten years of

performance history from 1999 to 2008. Net total fund returns and expanded disclosures have also been added throughout our internal, external and other Board reporting in a best faith effort to increase awareness and transparency around this information.

Annual Financial Statements/GAAP/GASB Compliance — With respect to fully disclosing investment fees and expenses, investment fees are properly reported in STRS Ohio’s financial statements in accordance with generally accepted accounting principles and comply with the Governmental Accounting Standards Board (GASB). STRS Ohio’s financial statements are audited, and a financial audit is performed each year by an external audit firm, currently Crowe LLP, under the oversight of the Ohio Auditor of State. The last audit released, for the fiscal year 2020, was completed by CliftonLarsonAllen LLP.

Board’s Investment Consultant Performance Reporting — The Board’s consultant provides a trustee summary report that includes performance and investment management cost information through each quarter and month-end.

- The **total fund return**, which is the net return for alternative investments and external real estate after all external investment management fees and costs, carried interest and other fund expenses are deducted, and gross return for all other assets, has consistently been reported since the trustee summary report was first developed.
- Additionally, a **net total fund return** is also reported on the trustee summary report, which is the total fund return less all other remaining internal and external investment management fees and costs on all assets.

ORSC Investment Consultant Reporting — ORSC’s investment consultant (currently RVK) reports semi-annually on investment performance and fee information of the five Ohio pension funds.

- Investment fees reported in RVK’s semi-annual investment performance report, as well as investments fees reported in the ORSC annual budget report, follow ORSC’s prescribed method applicable to all five retirement systems.
- While fee reporting for ORSC budget reporting includes brokerage commissions, they are not considered an investment expense for annual financial reporting, GASB and GIPS® purposes. **Importantly, investment returns are always reported net of commissions.**
- Investment costs and fees are reported to ORSC on a frequent basis in addition to investment performance.

VI. COMPLIANCE WITH THE GIPS® STANDARDS

The assertion that STRS Ohio's compliance with the GIPS® standards is problematic or misleading is not credible. The GIPS® standards are considered industry best practice for calculating and reporting investment performance. Moreover, compliance with the GIPS® standards is an effective way of demonstrating STRS Ohio's compliance with legal requirements and a natural extension of the importance the Retirement System places on the calculation of performance.

A. GIPS® Standards for Reporting Performance

STRS Ohio is subject to ORC 3307.15(B), which provides, in part:

When reporting on the performance of investments, the board shall comply with the performance presentation standards established by the CFA institute.⁶

CFA Institute's performance presentation standards are known as the CFA Institute Global Investment Performance Standards (GIPS®). Compliance with the GIPS® standards, which STRS has undertaken for more than a decade, is the most effective way to demonstrate the Board's commitment to its legal and fiduciary obligations.

Origin of the GIPS® Standards — Prior to the GIPS® standards, the lack of reporting uniformity made it difficult for asset owners like pension funds to compare results across managers: calculations could differ, presentation of results could differ and, importantly, results were often cherry-picked by managers to exclude underperforming accounts. CFA institute developed the GIPS® standards specifically so that asset owners and their stakeholders could rely on the results presented by its managers and make proper comparisons. While compliance with the GIPS® standards remains voluntary, institutional asset managers have largely complied due to demand from asset owners. Twenty-four of the top 25 asset managers worldwide claim compliance for all or a part of their business. But compliance is not limited to asset managers. Some of the largest and most influential asset owners in the world, including CalPERS, Norges Bank, CalSTRS, and Saudi Central Bank (SAMA), have also chosen to comply with the GIPS® standards; many of these entities hold significant alternative and/or real estate assets.

Compliance by Pension Funds — Contrary to the BFS Report's opinion, pension fund compliance with the GIPS® standards is not a marketing tool, nor was the Ohio legislature's adoption of CFA Institute's performance presentation standards a gimmick. Compliance with the GIPS® standards demonstrates a commitment to adhere to the highest ethical principles

⁶ CFA Institute is a global, not-for-profit professional organization that provides investment professionals with finance education. It aims to promote the highest standards of ethics, education, and professional excellence in the global investment industry.

and global best practices for the reporting of investment performance. Pension funds that voluntarily comply with the GIPS® standards are required to establish robust investment performance policies and procedures, and compliance allows a pension fund’s board to be confident that the performance data presented to the board is consistent and transparent. In addition, pension funds claiming compliance may choose to undergo annual verification by a third-party verification firm.

B. External GIPS® Standards Verification and Performance Examination

ACA Group — For more than a decade, STRS Ohio annually has undergone both a verification and a performance examination. A verification tests an asset owner’s policies and procedures for complying with the GIPS® standards’ requirements for calculating and presenting performance. A performance examination goes a step further and includes rigorous calculation and testing of investment performance. The verification and performance examination are conducted annually by ACA Group (ACA), a third-party verification firm. ACA is generally regarded as the industry leader, with the largest team in the world providing GIPS® standards verification and performance examination services.

ACA’s testing verifies that STRS Ohio has both complied with key requirements of the GIPS® standards and designed the Retirement System’s policies and procedures to calculate and present performance in compliance with the GIPS® standards. **ACA also performs rigorous testing and validates the calculation of STRS Ohio’s total fund performance and the accuracy of the reporting of that performance. In addition to recalculating the returns or the “math,” ACA independently tests and validates the inputs to performance — the market values and cash flows — to third-party sources and documents.** If any policy is not in compliance or if a practice does not follow the documented policy, ACA would conclude noncompliance with the GIPS® standards and would withhold from issuing a verification opinion.

- **ACA Verification Follows Same Standards Used by CPA Audit Firms** — Any firm that is hired to conduct a verification or performance examination must conduct its engagement in accordance with the requirements of the GIPS® Standards for Verifiers. A CPA audit firm in the U.S. that is hired to conduct a GIPS® standards verification or performance examination engagement is required to conduct the engagement in accordance with, among other requirements, AT-C Section 105, *Concepts Common to all Attestation Engagements*, and AT-C Section 205, *Examination Engagements*, and to issue reports in compliance with the AICPA Statement of Position 20-1, which directly refers the CPA firm to the GIPS® Standards for Verifiers. **The level of assurance provided by a GIPS® standards verification or performance examination is analogous to the level of assurance provided in a financial statement audit.** Similarities between GIPS® standards

verification and performance examination engagements and financial statement audits include the following:

- Management representations are provided in both types of engagements, and both types of engagements result in opinion letters.
- Both engagements carry with them liability for the person or group that opines, and there is no difference in the degree of liability.
- Under AICPA attestation standards, which address providing assurance on information other than financial statements, the term examination is used, and not “audit.” A GIPS® standards verification or performance examination engagement is considered an examination engagement under AICPA guidance. **It is understood throughout the industry that a GIPS® standards verification or performance examination is the same type of engagement as a financial statement audit because both provide reasonable assurance.**

Nonetheless, the BFS Report contends that STRS Ohio’s compliance with the GIPS® standards is flawed due to (1) the valuation of less liquid alternative assets, and (2) the use of external investment managers that do not claim GIPS® compliance. These baseless criticisms reflect a fundamental misunderstanding of the GIPS® standards.

C. Valuation of Less Liquid Assets

STRS Ohio Valuation Policy — STRS Ohio’s asset mix includes allocations to real estate and alternative investments. Unlike stocks traded on an exchange, real estate and alternative investment assets cannot be valued based on daily market prices. Consistent with industry practice, STRS Ohio has adopted valuation policies governing the valuation of less liquid assets. These valuation policies have been vetted with our consultants, external audit firm and external performance verification firm. STRS Ohio’s valuation policies use a fair value methodology that complies with the GIPS® standards and GASB fair value standards (presented in Note 7 of the Fiscal 2020 Comprehensive Annual Financial Report).

Audit Review — STRS Ohio’s valuation policies and monthly performance procedures are provided to the external financial audit firm (Crowe LLC) and external performance verification firm (ACA).

- **ACA Verification** — STRS Ohio’s valuation policies and procedures are reviewed and tested by ACA during its annual GIPS® standards verification and performance examination. In connection with its review, ACA conducts testing to determine that real estate assets are valued using market-based inputs that are comparable but subjective in nature, and that alternative investment assets are valued by the

underlying investment manager with supporting financial statements. These methods of valuing less liquid assets are consistent with STRS Ohio's valuation policy, the GIPS® standards and GASB fair value standards.

Alternative Investment Valuations — Despite STRS Ohio's rigorous valuation policies, procedures and oversight noted above, the BFS Report's Author further maligns STRS Ohio's performance reporting by positing that alternative asset valuations received from general partners simply cannot be trusted, implying that general partners are free to make up their own numbers. To arrive at this conclusion, he mischaracterizes the fund valuation process and ignores the considerable checks and balances in place to ensure fair valuations:

- **Fiduciary Duty** — General Partners have fiduciary duties to their limited partners. Falsifying valuations would violate their contractual and legal obligations, subjecting them to both legal and regulatory liability.
- **Regulatory Oversight** — The vast majority of STRS Ohio's alternative investments managers are registered with the SEC and are therefore subject to SEC oversight. Broadly speaking, most U.S. private capital managers were forced to register with the SEC as part of the 2010 Dodd-Frank Act.⁷
- **Third-Party Audits** — Fund valuations are typically audited by credible, nationally recognized audit firms and must adhere to applicable accounting standards. In addition, STRS Ohio's external audit firm and external performance verification firm review select alternative investment valuations in connection with annual testing.
- **LPAC Oversight** — Fund valuations are typically reviewed by limited partner advisory committees (LPACs), which act as a check on the general partner. STRS Ohio actively seeks inclusion on LPACs when negotiating investment opportunities and reviews fund valuation policies as part of its due diligence.
- **Alignment** — Management fees are typically structured to not incentivize managers to inflate unrealized valuations. Management fees are typically charged on committed capital (as is common in private equity investment periods), on invested capital (as is common in some credit strategies or after the investment period for private equity funds) and/or on the cost basis of investment assets (as is common in senior credit strategies), and carried interest (profit sharing arrangement with general partner) is only paid on realized results.

Importantly, STRS Ohio's alternative investments portfolio is over 20 years old, with tens of billions in cumulative invested capital across thousands of line-items. During this time, STRS Ohio has observed the full maturation of numerous funds and would have been able to detect if there were material differences between unrealized valuations and realized valuations in those funds. Our experience has shown this not to be the case.

⁷ Exemptions from SEC registration are available to investment advisers that advise exclusively venture capital funds and advisers solely to private funds with less than \$150 million in assets under management.

Real Estate Valuations — STRS Ohio’s valuation policy for real estate valuations complies with the GIPS® standards’ valuation requirements and the GASB fair value standards. STRS Ohio real estate assets undergo periodic third-party valuations in accordance with the Retirement System’s valuation policy.

Whether real estate or alternative investments, the Author ignores the fundamental reality that there is no purely objective method (e.g., daily market quotes) for pricing less liquid assets. While quick to disparage widely followed investment and accounting standards developed to improve the reliability of fair market valuations, he offers no alternatives. Pension funds, oversight boards and other stakeholders, however, need practical solutions. Compliance with the GIPS® standards is an important part of that solution.

D. GIPS® Compliance by External Asset Managers

The BFS Report makes several false assertions regarding the applicability of the GIPS® standards to external managers.

External Investment Manager Requirements — Contrary to assertions in the BFS Report, STRS Ohio may hire external managers that do not claim compliance with the GIPS® standards without jeopardizing the Retirement System’s own compliance. Under the GIPS® standards, external managers are not required to be compliant for the asset owner itself to comply. However, an asset owner retains responsibility for its claim of compliance for all its assets, including those managed by external managers. If an asset owner places reliance on information from external managers, it must ensure that the records and information provided by the external manager meet the requirements of the GIPS® standards. This is one of the tasks STRS Ohio performs during its external manager due diligence process. That said, the vast majority of STRS Ohio’s public market external managers do claim GIPS® compliance.

- **ORC 3309.15 Does Not Apply** — The BFS Report incorrectly states that STRS Ohio is subject to ORC 3309.15, which requires external managers to comply with the GIPS® standards. This provision is from ORC Chapter 3309, which applies to the School Employees Retirement System, not STRS Ohio. ORC Chapter 3307, which governs STRS Ohio, includes no such requirement for external managers.
- **External Investment Managers do not Calculate Performance for STRS Ohio** — It is important to note that STRS Ohio calculates performance internally, with oversight and verification from our external auditors and ACA, rather than relying on external manager performance calculations. Thus, whether an external investment manager claims compliance with the GIPS® standards is less important than whether information provided by the manager adheres to the requirements of the GIPS® standards, to the extent STRS Ohio relies on that information for its own performance calculations.

- **No RFP Process for Alternative Investments** — The BFS Report seems to confuse the difference between hiring an external manager pursuant to an investment management agreement, as STRS Ohio does for certain public market portfolios, and investing in an alternative investment fund. When investing in alternative investment funds, STRS Ohio does not retain the fund’s manager to provide investment management services to the Retirement System. Rather, it chooses to invest in the fund itself. Accordingly, there is no RFP process related to the fund or manager. Rather, STRS Ohio performs due diligence on the potential investment opportunity, including an extensive analysis of the fund’s manager.

In summary, STRS Ohio has valuation and performance policies that cover all asset classes including those with external managers. The Retirement System does not rely on external managers to calculate our performance. Moreover, valuations of investments are supported by third-party independent sources: custodians appointed by the Ohio Treasurer of State, third-party valuation services, and real estate third-party valuation appraisers as examples.

E. Internal Procedures Governing Performance

In addition to compliance with the GIPS® standards, STRS Ohio’s calculations and reporting of performance benefits from procedures and governance.

Segregation of Performance Reporting — STRS Ohio has extensive internal controls, segregation of duties, and established policies and procedures for verifying and reporting proper fair value of investments, including positions and prices, cash flows, and performance returns that encompass each asset class and total fund. The segregation of duties and responsibilities between Investments and Finance, as well as key controls within our investment systems, are integral to this process. STRS Ohio’s investment accounting and performance team reports to the chief financial officer and operates independently from the Investments department.

- Prior to the 2006 fiduciary audit, Russell (the Board’s investment consultant at that time) undertook a review of the STRS Ohio performance measurement system and reported the system was robust and accurate to generally accepted industry standards. In its report, Russell stated, “The system allows a level of quality control that is unlikely to be found with an external provider.”
- In its 2006 fiduciary audit, IFS reviewed the STRS Ohio performance measurement system and observed, “Based on IFS’ evaluation of the Fund’s investment performance measurement and reporting process, IFS believes the investment performance measurement process is sufficiently independent, objective and reliable and the overall process is satisfactory to support performance based incentive compensation decisions by members of Fund staff or the Board.”

External Financial Audit — STRS Ohio undergoes an external financial audit each year with its independent, third-party auditing firm (for the current year Crowe LLP, previously CliftonLarsonAllen LLP) under the oversight of the Ohio Auditor of State. The audit covers financial reporting, including the investment asset values and net investment income reported in the financial statements. Additionally, performance return disclosures, as required per GASB 68 and 75 in the Required Supplementary Information for Pensions and OPEB, are part of the annual comprehensive financial report and the external audit firm applies certain limited procedures in accordance with auditing standards on this information.

Internal Audit — Internal Audit, which reports directly to the Board’s audit committee, performs annual review of investment performance-based incentives and audits the various investment areas on a rotational basis.

Board’s Investment Consultants Report on Performance — The Board’s independent investment consultant presents investment performance quarterly to the Board. Additionally, an investment consultant specializing in alternative investments presents investment performance results semi-annually. This provides an additional level of oversight and routine review of performance information.

ORSC’s Investment Consultant Reports on Performance — ORSC’s independent investment performance consultant (currently RVK) presents a semi-annual report on the five Ohio public pension funds. This report and oversight review has been in place since 1999.

VII. CONSULTANT CONFLICTS OF INTEREST

The BFS Report alleges that STRS Ohio has failed to monitor external consultant conflicts of interest, resulting in billions of dollars in losses. This extraordinary claim does not stand up to scrutiny.

A. Misapplication of GAO Findings

The BFS Report includes assertions regarding investment consultant conflicts of interests (see pg. 87 of the BFS Report). Citing a 2007 report by the Government Accountability Office (GAO Report), the BFS Report states (emphases in original):

Most significantly, conflicts of interest at investment consulting firms were found to result in *substantial financial harm* to plans by the Government Accountability Office in a 2007 report. Benchmark assisted the GAO in its review.

In its report, the GAO took the extraordinary step of quantifying the harm a conflicted adviser to a plan can cause. "Defined Benefit plans using these 13 consultants (with undisclosed conflicts of interest) had annual returns generally 1.3 percent lower ... in 2006, these 13 consultants had over \$4.5 trillion in U.S. assets under advisement," the report stated.

If the GAO estimates are correct, investment consultant conflicts of interest could cost an \$90 billion pension, such as STRS, over \$1 billion annually or approximately **\$20 billion** over a ten-year period with compounding. As mentioned elsewhere, the unfunded actuarial liability of the pension is \$22.3 billion. *Thus, the estimated cost of conflicts nearly equals the unfunded liability, or, alternatively stated, "but for" the conflicts the pension would be nearly fully funded.*

The BFS Report's assertion that STRS Ohio has suffered annual losses exceeding \$1 billion due to investment consultant conflicts of interest reflects a gross misunderstanding or mischaracterization of the findings of the GAO Report.

The GAO Report concluded, in summary:

A conflict of interest typically exists when someone in a position of trust, such as a pension consultant, has competing professional or personal interests. Though data are limited on the prevalence of conflicts involving plan fiduciaries and consultants, a 2005 SEC staff report (SEC Staff Report) examining 24 registered pension consultants identified 13 that failed to disclose significant conflicts. The GAO's analysis found that, in 2006, these 13 consultants had over \$4.5 trillion in U.S. assets under advisement. The

GAO also analyzed a sample of ongoing DB plans associated with the 13 consultants that, as of year-end 2004, had total assets of \$183.5 billion and average assets of \$155.3 million. Additional sample analysis showed that the DB plans using these 13 consultants had annual returns generally 1.3 percent lower than those that did not. Because many factors can affect returns, and data as well as modeling limitations limit the ability to generalize and interpret the results, this finding should not be considered as proof of causality between consultants and lower rates of return, although it suggests the importance of detecting the presence of conflicts among pension plans. Whether specific financial harm was caused by a conflict of interest is difficult to determine without a detailed audit.

The BFS Report misstates or fails to disclose several significant facts that would help to put the potential applicability of the GAO Report's findings into proper context.

- 1) The presence of a conflict of interest did not, in itself, result in a breach of fiduciary duty. Rather, the GAO Report's findings related solely to pension consultants that were found to have had significant disclosure issues.
- 2) Most of the conflicts identified by the GAO are not applicable to STRS Ohio.
- 3) The pension consulting industry has undertaken positive steps to improve conflicts disclosure since the SEC's findings in 2005.
- 4) The GAO Report acknowledged a number of concerns expressed about its findings, including its methodology and generalizations of results.

These items are each discussed in greater detail below:

1. Presence of a conflict of interest does not equal breach of fiduciary duty.

Despite the BFS Report Author's contention, the GAO Report did not find that the presence of pension consultant conflicts of interest resulted in "substantial financial harm" to pension plans. Rather, the GAO's findings suggested that DB plans advised by consultants *with significant disclosure issues* underperformed plans advised by consultants that adequately disclosed their conflicts of interest. Further, the GAO Report fully acknowledged that a conflict does not itself constitute a breach of fiduciary duty. **In other words, where there was adequate disclosure of conflicts by plan consultants, the GAO found no negative correlation with plan performance.**

In support of its findings, the GAO compared the returns of a sampling of DB plans advised by 13 investment consultants found by the SEC to have failed to disclose significant conflicts and 11 investment consultants found to have had less significant disclosure issues. Plans advised only by consultants with significant disclosure problems were found to have returned 1.2% to 1.3% less annually than plans advised by the other consultants over the five-year period from

2000-2004. The GAO did not find significant differences in the returns of plans advised by both types of consultants.

The BFS Report's contention that STRS Ohio's consultants do not adequately disclose their conflicts is not supported by the facts. As the BFS Report acknowledges, Callan and Cliffwater provide extensive disclosure of conflicts of interest in their Forms ADV (the Form ADV is a mandatory disclosure document filed at least annually by all SEC-registered investment advisers). In addition, Callan discloses a list of money manager clients to STRS Ohio quarterly. These disclosures make clear the types of services Callan could provide to money manager clients and the costs of those services. As stated in the BFS Report, anyone reading Callan's Form ADV can determine both the median amount and maximum amount of compensation Callan could receive from its money manager clients (*see* pg. 109 of the BFS Report). Moreover, as discussed below, both the manner in which STRS Ohio uses consulting services and the processes in place with those consultants further mitigate potential conflicts of interest.

2. Many of the conflicts identified in the GAO Report are not applicable to STRS Ohio.

The GAO Report focused on a sampling of private sector DB plans with average assets of \$155.3 million. (By comparison, STRS Ohio manages over \$90 billion in assets — more than 500 times this size.) These smaller sized plans lack internal management capabilities and are often overseen by employees of the company whose work with the DB plan is ancillary to their other professional responsibilities. Accordingly, the GAO noted that “pension plans and their fiduciaries often rely on consultants and other service providers to assist them in plan administration and asset management, which include selecting money managers and monitoring money managers' performance and brokerage transactions.” (*see* GAO Report, Background section, para. 3). As described in the GAO Report, consultant involvement in brokerage selection and trade allocation often resulted in potential conflicts of interest relating to directed brokerage, soft dollar arrangements, and use of affiliated brokers. In addition, the GAO expressed concern that consultants would only recommend money managers that pay them fees. Private sector DB plan fiduciaries with little experience in asset management, the GAO surmised, would be quick to embrace these recommendations, particularly if they did not receive adequate disclosure of potential conflicts.

Like most large public sector pension systems, STRS Ohio does not fit the private employer DB plan model. Rather, STRS Ohio is a sophisticated institutional investor that exists solely for the purpose of managing and administering a pension plan. To accomplish this, STRS Ohio employs a robust investment staff that manages approximately 70% of system assets internally. The Board's investment consultants, Callan and Cliffwater, do not provide, and are not relied on to provide, the broader range of services typically delivered to smaller private sector DB plans. A review of the Callan and Cliffwater Investment Advisor Agreements provided to the Author pursuant to his public records request shows that Callan's and Cliffwater's services are focused primarily on strategy-level consulting to the Board. They are not involved in brokerage

selection, trade allocation, or other execution-related functions. In addition, their role in manager selection is more limited due to the involvement of STRS Ohio's internal investment staff. Callan's role for external equity and fixed income managers is limited to narrowing RFP submissions to a select group of the most qualified, and while Cliffwater advises on alternative investments selected by STRS Ohio investment staff, it does not recommend funds or managers other than hedge funds, which represent a dwindling fraction of the overall alternative investments portfolio. Likewise, while Callan and Cliffwater monitor and report on money manager performance to the Board, STRS Ohio's investment staff also perform extensive ongoing due diligence and monitoring of money manager performance. This level of internal expertise and management, combined with the more limited scope of external consulting services, is a far cry from the management structure of the average DB plan included in the GAO's sampling.

3. The pension consulting industry has undertaken positive steps to improve conflicts disclosure since the SEC's findings in 2005.

The SEC Staff Report examined pension consultant data gathered from January 1, 2002, to November 30, 2003. Based on data gathered nearly twenty years ago, SEC staff found that certain conflicts possessed by the 24 pension consultants it examined were not disclosed in their Forms ADV. These undisclosed conflicts included:

- 1) Two pension consultants had brokerage referral arrangements with unaffiliated broker-dealers.
- 2) Nine pension consultants employed advisory representatives that were also registered representatives of a broker-dealer and were typically compensated with commissions paid on trades placed by the client through the consultant's affiliated broker-dealer firm.
- 3) Of the 19 consultants or their affiliates that provided products/services to money managers, three provided no disclosure of these other services and 16 provided only limited disclosure (i.e., the disclosure did not state that these services could cause a conflict and/or provide sufficient information to enable a reasonable person to discern the potential harm; for example, only one consultant made client-specific disclosure that it had provided products and services to the same money managers it was recommending to the client).

In addition to failures in disclosure, the SEC found that many consultants did not maintain procedures addressing how they prevent or manage conflicts of interest or the disclosure of conflicts to clients. The SEC noted, however, that since kicking off its sweep, several pension consultants had indicated they had taken steps to eliminate or mitigate conflicts of interest, including by closing or selling business lines that provided services to money managers, or

creating information barriers between consulting and other business lines. The GAO Report reiterated this point:

Following up on its examinations of 24 pension consultants, in late 2005, SEC staff subsequently sought to determine what steps these firms had taken to address the findings from the earlier examinations. According to SEC staff, in general, most pension consulting firms it had examined had taken positive steps to reevaluate, revise, and implement changes to their policies and procedures. Specifically, pension consultants implemented policies and procedures to insulate their advisory activities from other activities, including for example, creating separate reporting lines and firewalls between employees that perform these separate functions, and considering employee compensation and incentives. In addition, SEC staff said that most consultants they examined had updated their policies and procedures to improve their disclosure of material conflicts of interest to pension plan clients and potential clients. Many pension consultants the SEC staff examined also reviewed and improved their policies and procedures to prevent conflicts of interest with respect to brokerage commissions, gifts, gratuities, entertainment, contributions, and donations provided to clients or received by money managers.

As previously noted, Callan and Cliffwater provide extensive conflicts disclosure in their Forms ADV. Callan's disclosure describes the types of services provided to money managers as well as the fees for those services. In addition, Callan's Form ADV describes the procedures Callan has adopted to segregate its pension consulting activities from services provided to money managers. One of the ways Callan maintains separation between business lines is by walling off money manager fee data from its pension consulting staff. This ensures that pension consulting staff decisions do not take into account the actual revenue Callan receives from specific money managers. In order to maintain this wall, Callan does not publicly disclose specific fee amounts received from money manager clients. Doing so would provide its pension consulting staff with access to the very information it seeks to segregate. Nonetheless, as the noted in the BFS Report, Callan's pension clients have sufficient information to determine the range of fees paid by money managers and may request specific fee information by money manager if desired. The incremental value of such information is significantly diminished by the facts that:

- 1) STRS Ohio already knows the names of each Callan money manager client (the list includes over 200 firms, many of which are large, well-known entities with extensive track records), the types of services they could receive from Callan, and the range of fees they could be charged;
- 2) Callan's policies and procedures are specifically designed to segregate pension consulting services from money manager services;
- 3) While Callan assists in the screening of prospective money managers (which often number 50 to 100 during the RFP process) by narrowing RFP submissions to a select

group of the most qualified, STRS Ohio's internal investment staff maintains sole responsibility for selecting and interviewing finalists and for making the ultimate selection based on their own due diligence and analysis⁸; and

- 4) STRS Ohio relies on its internal investment staff, in addition to Callan, to perform ongoing monitoring of money managers.

Likewise, Cliffwater discloses conflicts of interest in its Form ADV, including potential conflicts associated with its clients' affiliates. Moreover, certain criminal, regulatory (including action taken by the SEC) and civil judicial action is required to be disclosed on the Form ADV; neither Callan nor Cliffwater have any such matters to report, respectively. While the SEC expressed concerns about the adequacy of pension consultant disclosures in 2005 (based on its sampling of firms in 2002–2003), the extensive disclosures provided in Callan's and Cliffwater's Forms ADV and the absence of regulatory or judicial action in the fifteen years following the SEC Staff Report suggest that neither firm poses the types of disclosure concerns raised in the SEC Staff Report and the GAO Report.

1. The GAO Report acknowledged concerns with its findings.

In a written response to the GAO Report dated June 25, 2007, the Employee Benefits Security Administration (EBSA)⁹ expressed the following concerns regarding the GAO's findings:

Concerns about the GAO's Econometric Analysis:

Due to the unusually short review period for the draft report, we have been unable to confirm the validity of the GAO's novel methodology. The results are provocative, as they suggest that the exclusive use of "conflicted" consultants may lead to substantially lower returns on a plan's investments. However, because of our concerns regarding the novelty of the methods and the potential weaknesses in the data (some of which are cited by GAO statisticians in the draft report), the Department feels that peer review of this analysis would have been useful in evaluating these concerns. As the GAO notes, the non-random data sample used "limits the ability to generalize the results." Our additional statistical concerns include the rather skewed data sets (described in the report as "the imbalance between the large number of plans associated exclusively with conflicted consultants and the small number of those that were not"), the mixing of "conflicted" and "non-conflicted" consultants in groups labeled "non-conflicted," and the use of an estimate for the critical variable of investment returns. Statistical

⁸ The BFS Report identifies 23 managers retained by STRS Ohio that were also listed as money manager clients of Callan. Of these firms, one was terminated by STRS Ohio in 2019 and nine manage alternative investments or real estate, for which Callan has no role in manager selection. In addition, STRS Ohio currently has four external equity and fixed income managers that are not money manager clients of Callan.

⁹ The ESBA is an agency within the U.S. Department of Labor that offers information and assistance on private sector employer-sponsored retirement benefit and health benefit plans.

descriptions of all the variables, by consultant type, would help facilitate a better assessment of the validity and implications of the report's findings.

In response to EBSA's concerns, the GAO included the following disclosure in Appendix II of its report:

Limitations of Our Econometric Model:

Like many statistical analyses, the results should be interpreted with care. Although the panel data provides many advantages and can produce more valid and efficient estimates, drawing causal inferences is still difficult. Even with control variables and the fixed-effects models there are a number of threats to the validity of our results. First, although the fixed-effects estimator is robust to the omission of any relevant time-invariant variables, if there are time-varying differences that have been omitted the result could be biased. Although the analysis controlled for plan size, funding level, the performance of asset markets and other key variables, other unknown, omitted factors could still influence the results of our analysis or account for the differences in estimated returns. There may be additional biases resulting from the vector decomposition procedure used to obtain the fixed-effect estimates. Second, the existence of statistical relationship is not in and of itself, enough to assert causality. Fixed-effects, while strengthening the validity of model's parameters, do not completely solve the problem of drawing causal inferences. Third, the use of the 5500 data could lead to measurement error in the dependent variable (plan returns). We assume that any errors are random and therefore do not impact the validity of the parameter estimates. Similarly, although we were careful in identifying and reviewing the plans associated with the two types of pension consultants any error, random or non-random, would impact the parameter estimates. Moreover, we used a potentially unrepresentative sample of pension consultants to identify the pension plans included in our investigation that therefore limits the ability to generalize the results. A few pension consultants that had significant conflicts of interest that impacted their activity could very well drive the observed negative relationship. Further, the imbalance between the large number of plans associated exclusively with conflicted consultants and the small number of those that were not raise additional statistical issues and limits the ability to generalize the results. Lastly, given the short time period analyzed, it could be possible that some plans' return were abnormally low due to their investment strategies, and would have higher returns had the time period analyzed been lengthened.

Clearly, the GAO Report did not conclude that pension consultant conflicts of interest caused lower rates of return, much less specify a formula for calculating the amount of such "losses", as the BFS Report suggests.

Taking into account the breadth of conflicts disclosure provided by Callan and Cliffwater, the nature of the consulting services they provide — and don't provide — to STRS Ohio, the structure and responsibilities of STRS Ohio's internal investment staff vis-à-vis the selection and monitoring of external managers, and the flaws inherent in the GAO Report's methodology, there is no reasonable basis for concluding that STRS Ohio has lost any funds, much less \$1 billion annually, as a result of consultant conflicts. Outside of its misapplication of GAO findings, the BFS Report offers no other data or information to support this extraordinary claim.

B. Past Claims Involving Consultants

The BFS Report dedicates several pages to a handful of past legal and regulatory matters involving Callan. Below is additional information provided by Callan regarding each of these matters:

The report highlights four past legal and regulatory matters related to Callan, all of which were settled over a decade ago, and have been fully disclosed to both clients and prospects. This section provides a brief discussion of each matter including a description of its conclusion.

As a general comment, Callan has never engaged in pay-to-play practices (as the Report insinuates), nor has it ever been the subject of an adverse regulatory ruling or a legal settlement where it was found to have engaged in pay-to-play practices.

Hawaii State Audit, 2002: In 2002, the Hawaii state auditor engaged a competitor of Callan to conduct an audit of the Hawaii Employees Retirement System pension plan. Callan was the general consultant to the plan at the time. The audit was triggered by the plan's poor relative performance. The poor performance was largely the result of a strategic overweight to non-US equities, specifically Japan, put in place by the Board.

Among other things, the report raised concerns around the potential conflicts of interest created by the consultant's business model. Callan responded to these concerns directly and transparently with the Board. As the New York Times article (quoted in the Report) acknowledges, "Hawaii's trustees stood by Callan after the audit, issuing a statement calling it 'a highly regarded investment advisory firm with an unblemished reputation for integrity.'"

City of San Diego, 2006: In 2005, the City of San Diego filed a complaint against Callan alleging that San Diego City Employees Retirement System (SDCERS) had been damaged by Callan's negligent performance of its duties as SDCERS' investment consultant. SDCERS, who had been a Callan consulting client for over 20 years, was not a party to the suit.

In 2006, Callan and the City of San Diego agreed to resolve this complaint outside of court for an amount that was below Callan’s insurance policy limits. Importantly, the City of San Diego acknowledged that they “found no evidence that Callan engaged in any wrong-doing or unfair business practices in connection with the hiring of money managers.” In fact, SDCERS rebid the consulting relationship later in 2006, and after a competitive process, rehired Callan as their full-retainer consultant.

SEC order, 2006: In 2003, the SEC launched an examination into the practices of the investment consulting industry, which included Callan and most of the other large investment consulting firms.

In 2005, the SEC staff informed Callan that they believed some of its past disclosures describing our 1998 sale of Alpha Management (Callan’s former broker affiliate) to a subsidiary of the Bank of New York (“BNY”) were incomplete or misleading. Per communications Callan received from the SEC at that time, this was the only open issue they had related to this two-year examination.

When advised of the SEC’s concern regarding the disclosure in 2005 Callan immediately updated its Form ADV to enhance the disclosure and forwarded a copy of the form ADV to all clients. In 2006 the SEC concluded its examination and issued an order requiring Callan to cease and desist from committing or causing any violations and any future violations of Section 207 of the Advisers Act. Callan received no fine and no censure related to this matter.

Patrick Patt (Illinois State Teachers), 2009: in 2006, Callan was served with a complaint filed by Patrick Patt, a participant in the Illinois Teachers Retirement System (“ITRS”) defined benefit plan. Callan served as the real estate consultant to ITRS at the time. ITRS did not file the complaint nor were they a party to it. In June 2009, the parties reached a settlement, without any admission of liability by Callan, for significantly less than the anticipated litigation cost and well below Callan’s insurance policy limits. In the midst of these proceedings, of which ITRS was aware, ITRS rebid the Real Estate consulting relationship and rehired Callan Associates after a competitive process.

The BFS Report also dedicates several pages to Cliffwater’s background, focusing primarily on four items:

1. The BFS Report insinuates that Stephen Nesbitt, Cliffwater’s Chief Executive Officer, had issues with his previous employer. Cliffwater responds:

After approximately two decades of successfully leading the consulting division of Wilshire Associates, Mr. Nesbitt left Wilshire on his own accord to form Cliffwater. At the time of Mr. Nesbitt’s departure from Wilshire, Pension&Investments noted that he was “one of the country’s best-known investment consulting executives” (P&I February

9, 2004) and his former employer commended him for his expertise and contribution to the firm.

2. The BFS Report comments on Cliffwater's Form ADV disclosure regarding compensation it may receive from investment adviser clients. As previously noted, Cliffwater does not recommend funds or general partners for STRS Ohio's alternative investment asset class, outside of hedge funds, which represent a dwindling fraction of the overall alternatives portfolio. Further, Cliffwater has confirmed it has not received compensation from any hedge fund manager it has recommended to STRS Ohio.
3. The BFS Report attempts to summarize ongoing litigation filed by a money manager, Blueprint Capital Advisors, against the New Jersey Division of Investment, BlackRock Alternative Advisors, and Cliffwater. According to the BFS Report, the litigation involves, among other things, alleged theft of Blueprint's intellectual property and trade secrets. Interestingly, the BFS Report does not suggest that Blueprint should have waived all intellectual property and trade secret rights when it sought to provide services to a state entity. Cliffwater, and the other defendants, have moved to dismiss the entire case. The court has stayed all discovery pending a decision on the motions to dismiss.
4. The BFS Report discusses discretionary asset management services disclosed in Cliffwater's Form ADV, insinuating that Cliffwater may seek to recommend itself as a discretionary manager to STRS Ohio or somehow disadvantage STRS Ohio relative to its discretionary clients. In doing so, the BFS Report mischaracterizes Cliffwater's consulting services for STRS Ohio as "reviewing and recommending investment advisors to manage, on a discretionary basis, the pension's assets." As discussed above, while Cliffwater advises on alternative investments underwritten by STRS investment staff, Cliffwater does not recommend funds or managers outside of hedge funds, as this process is managed internally by STRS Ohio investment staff.

In summary, the above items, while seemingly designed to impugn, do not contribute meaningfully to the discussion of investment consultant conflicts.

VIII. ERISA FIDUCIARY STANDARDS AND FIDUCIARY LIABILITY INSURANCE

A. ERISA Fiduciary Standards

The BFS Report incorrectly asserts that the State Teachers Retirement Board does not adhere to ERISA-level fiduciary standards. The Report is further critical of STRS Ohio agreements with the Board's investment advisers which impose fiduciary obligations under Ohio law, as well as require the consultants to adhere to the standard of care under ERISA and any other applicable federal and state laws.

As a governmental plan, STRS Ohio is not subject to the provisions of ERISA. However, many state and governmental plans are subject to fiduciary standards based on those imposed by ERISA, and Ohio is no exception. The Ohio Revised Code language governing STRS Ohio generally mirrors ERISA and ORC 3307.15 specifically includes the ERISA fiduciary standards, including the duties of prudence, loyalty, exclusive benefit and diversification. Additionally, ORC 3307.181 closely mirrors ERISA's prohibited transaction provisions.

On page 123, the BFS Report recommends that the State Teachers Retirement Board adhere to the ERISA fiduciary standards to improve the management of the pension. As outlined above, the Board does indeed adhere to these standards, as required by Ohio law. New Board members receive information regarding their fiduciary duties during board orientation and the entire Retirement Board undergoes annual Fiduciary and Ethics Training sessions, typically at the November Board Education and Planning Session. The Retirement System periodically brings in outside consultants to present as well, such as earlier this year when attorneys from Groom Law provided an additional fiduciary training session at the March 2021 Board meeting. STRS Ohio staff and board members take their fiduciary roles seriously and continuing education is an important element of that role.

B. Fiduciary Insurance

The basic purpose of insurance is to provide a level of financial protection against reasonable loss and is a form of risk management used by both individuals and entities. Fiduciary insurance, also known as management liability insurance, protects an entity in the event of allegations or claims of breach of fiduciary duty.

BFS Report Allegations — On page 124, the BFS Report states that STRS Ohio's \$25MM in fiduciary liability insurance is "absurdly low and offers virtually no protection for a \$90 Billion pension. Virtually any fiduciary breach may result in actual damages amounting to tens or hundreds of millions of dollars." Unfortunately, the Author does not state what level of protection he *does* believe would be appropriate coverage; therefore, it is not possible for STRS Ohio to evaluate any perceived recommendation(s) in this area. It is also unclear what

insurance-related qualifications the Author has to form his opinions. It is important to note that a retirement system does not establish insurance policy limits based simply on the amount of total fund assets and would likely be criticized if it did insure in such a manner. In other words, it would be impossible to carry a \$90 billion fiduciary insurance policy.

The BFS Report cites ORC 3307.10(B), which states that “the Board may secure insurance coverage designed to indemnify board members and employees for their actions or conduct in the performance of official duties and may pay required premiums for such coverage from the expense fund.” However, the Author fails to reference ORC 3307.181 (E), which further states that “each fiduciary of the system shall be bonded or insured to an amount of not less than *one million dollars* for loss by reasons of fraud or dishonesty.” STRS Ohio’s current insurance coverage is more than sufficient to fulfill its obligations under Ohio law.

According to information provided in 2020 related to 40 peer group retirement systems, 24 of those systems, including STRS Ohio, maintain primary layer limits of \$10MM in fiduciary liability coverage. In determining its level of coverage, STRS Ohio relies on the information and analysis provided by its expert consultants.

Vendor Insurance — Further, the BFS Report states that the contractual insurance requirements (\$5MM) for the Callan and Cliffwater Investment Adviser Agreements are “woefully inadequate.” Again, no recommendation is provided as to what might be considered adequate coverage, and no evidence is provided to support the allegation that \$5MM is “woefully inadequate.” While Callan and Cliffwater both serve as fiduciaries in their roles as investment advisers for the Board, they serve in a non-discretionary capacity which means they do not make investment decisions. Those decisions are ultimately the responsibility of STRS Ohio, as directed by the policies set forth and adopted by the Board on an ongoing basis.

According to Board consultant Callan, in their experience, insurance coverage of \$5MM is well within industry standards for non-discretionary consulting contracts with large institutional investors like STRS Ohio. Callan has rarely seen a case where a large fund has required more than \$10MM in insurance coverage for a non-discretionary consulting relationship, and \$5MM is more common. As a practical matter, Callan currently carries \$10MM in insurance.

It is important to remember that the amount of insurance coverage maintained by a vendor does not define or limit what potential liability may exist. Each contract negotiation with a vendor involves an evaluation of potential risk, considering items such as vendor size, longevity, and reputation. Large vendors likely have substantial cash and other assets, in addition to insurance amounts, that could be used to pay a claim. The contractually required insurance coverage is just part of the overall amount that could be recovered by STRS Ohio in the event of a successful claim against a vendor. Finally, it should be noted that many contracts with STRS Ohio vendors and consultants do not contain monetary caps on vendor liability.

STRS Ohio Insurance Program — Since 2012, STRS Ohio has been a part of a group insurance purchase plan including Ohio Public Employees Retirement System, Ohio Deferred Compensation, School Employees Retirement System of Ohio and Ohio Highway Patrol Retirement System. The group members completed a joint RFQ/RFP process in 2012 and again in 2017. The group unanimously selected ARC Excess and Surplus LLC (ARC Excess) as their brokers of record to advise in all areas of the procurement and placement of Management (Fiduciary) Liability Insurance.

ARC Excess is a wholesale insurance broker established in 1986, with eight offices throughout the United States. Among other duties, ARC Excess provides advice to STRS Ohio regarding insurance coverage issues. The group insurance plan leverages the five insurance programs for better premiums and terms and conditions. However, each group member has its own individual brokerage contract and insurance policies that meet the needs of each individual system.

STRS Ohio also engages the professional services of a risk management consultant. The risk management consultant provides expertise and guidance to STRS Ohio in identifying risks, objectively reviewing the adequacy of protection, reasonableness of costs, insurance policy review, facilitate renewals and other related services. Our current consultant is Alpha Risk Management, who has been engaged in providing insurance and risk management consulting services for nearly 50 years.

Finally, STRS Ohio works with its management liability lines broker to consider and analyze exposures, industry insurance claims and settlements and peer group data in a detailed, thoughtful process. The analysis is completed annually at the time of our fiduciary insurance renewals. Ultimately, STRS Ohio considers the best available data to procure prudent fiduciary insurance limits in order to best protect the system.

CONCLUSION

As we have discussed throughout this analysis, the BFS Report includes numerous unsupported opinions and assertions related to STRS Ohio investments and operations. To be clear:

- STRS Ohio is committed to the principles of transparency and complies with its obligations under the Ohio Public Records Act.
- Appropriate oversight exists under Ohio law to govern STRS Ohio. STRS Ohio financial statements are audited on an annual basis by an independent public accounting firm, under the oversight of the Ohio Auditor of State. STRS Ohio reports regularly to ORSC with regard to system investments and operations. The Retirement System's assets are custodied with the Ohio Treasurer of State.
- Recommendations from the 2006 IFS Fiduciary Audit were appropriately reviewed and addressed by the State Teachers Retirement Board and staff in early 2007.
- Investment fees are appropriately scrutinized. STRS Ohio does not pay lavish fees to Wall Street for "doing nothing."
- Investment costs and performance are accurately reported by the Retirement System.
- STRS Ohio is required by law under ORC 3307.15(B) to report its investment performance in compliance with the performance presentation standards established by CFA Institute (known as the GIPS® standards). There are no false or misleading representations made regarding GIPS® Compliance.
- Investment consultant conflicts of interest are adequately disclosed and considered.
- The Board complies with the fiduciary standards stated in ORC 3307.15, which mirror the ERISA fiduciary standards, and the system maintains adequate fiduciary liability insurance.

For fiscal year 2021 (July 1, 2020–June 30, 2021), STRS Ohio's investment return was more than 29% and total investment assets as of June 30, 2021, exceeded \$94.8 Billion. As stated previously, STRS Ohio's investment performance consistently ranks among the top funds in the country, with a lower risk portfolio than most of our peers and low overall investment costs. We will continue to seek to increase efficiency and deliver positive results for the fund and for our membership.

STRS Ohio has an important year ahead as we begin various studies to help provide guidance on funding, investment return expectations and system operations.

These studies, all scheduled to commence this fall, include (1) an asset-liability study to help determine investment risk-return expectations and a sustainable asset mix; (2) an actuarial experience review to set reasonable economic and demographic assumptions for the retirement system; (3) a fiduciary audit, conducted under the oversight of the Ohio Retirement Study Council, to evaluate STRS Ohio's organizational design, structure and practices; (4) an actuarial audit, also conducted under the oversight of the Ohio Retirement Study Council, to provide an independent review of the Board's consulting actuary (Cheiron); and (5) our annual pension and health care valuation reports that provide a detailed look at the financial and actuarial health of the pension and health care funds. As always, STRS Ohio will continue to use our website, newsletters, social media and eUPDATE email news service to keep our members, retirees and other system stakeholders informed about the results of these studies and our next steps.

STRS Ohio was the first statewide, actuarially based teacher retirement system in the United States and has been a leading provider of retirement benefits and quality service to its members for more than a century. The Retirement System serves more than 500,000 active, inactive and retired educators. The State Teachers Retirement Board is composed of 11 members, all of whom are fiduciaries to the system and devote hundreds of volunteer hours in service to STRS Ohio. Likewise, the 500+ individuals on staff at STRS Ohio are committed to working every day for the benefit of the system's members and benefit recipients.