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The Great Financial Crisis: 10 Years LaterAccomplishments and Lessons



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The Great Financial Crisis: 10 Years Later Accomplishments and Lessons Learned

After many successive years of benchmark beating performance, clean audits, consistent adherence to risk and compliance standards, low cost of service delivery and wide recognition for thought leadership and professional excellence among industry peers, investment partners and stakeholders, it would be easy to become complacent. That would be a serious mistake. Those unfamiliar with history might presume the SBA has always been in the enviable posture we now enjoy. With the tenth anniversary of the Great Financial Crisis falling during FY18-19, a look back at SBA's journey over that decade provides a reminder that excellence in organizations, cultures, the individuals that comprise them and what they accomplish, is fragile and must be earned and constantly nurtured to be sustained.

If resources (tangible or intangible) are withheld or management is inattentive, weakness somewhere in the organization will result. Initially, weaknesses are potential points of failure; if not addressed they will be points of failure. A 2007 liquidity crisis in an SBA managed cash pool for Florida local governments exposed gaps in SBA's management controls and led to a corrosive decline in credibility at the beginning of the financial crisis. The resulting media and political maelstrom led to the resignation of the Executive Director. A former Trustee, General Bob Milligan, then assumed the role in an acting capacity while working with a search firm to recruit a permanent leader for the SBA. The differences between today's SBA and the SBA of late 2008 when I returned essentially reflect a complete reconstruction of the control environment, extensive enhancement of the investment side and restoration of the soundness of the Florida Hurricane Catastrophe Fund (FHCF).

The first priority was to upgrade the control environment across our "businesses" and portfolios, a foundational responsibility in any investment organization. Consistent with "tone at the top" a new Risk and Compliance unit was created, a new COO/CFO was brought in, together with a new Chief Audit Executive and upgrades to the Internal Audit team were made. I worked closely with the IAC, Audit Committee, Participant Local Government Advisory Committee (repealed 2018) and Trustees on the premise that the resources committed to control and compliance infrastructure were the foundation for coming enhancements on the investment side that would prudently drive net returns and lower the likelihood of avoidable errors that can lose money, breach security, impair performance and erode trust

Upgrading the investment side has been a much larger and more complex undertaking, holistically revisiting what we invest in and how we invest. The most valuable asset in investment management organizations isn't financial, it is human talent with sufficient depth, talent and experience to compete effectively in global capital markets. Building an investment team capable of persistently adding value is tough in the private sector; many would see it as improbable, if not impossible, in government. A caustic comment from Miami lawyer Tom Tew, excerpted below from an October 2009 Institutional Investor article, "Ash Williams Works to Restore Broken Trust at Florida SBA" lays it bare.

"If you don't have auditors and you don't have regulators, what have you got?" Tew says in disbelief. He also questions the ability of low salaried, unlicensed civil servants to manage a multibillion-dollar portfolio of complex financial instruments, given that 40 percent of the funds are managed in-house. Adds Tanya Beder, Tew's partner in the due-diligence task and founder of the Strategy Building and Crisis Control Group, a New York investment and risk advisory firm: "They are in the Dark Ages of risk management."

The Florida SBA has in fact always had heavy audit, advisory and legislative oversight as one would expect in a large public investment operation. Investment funds run by government entities are exempt from SEC registration as are private investment funds maintained by charitable organizations. While the SEC fulfils an important role protecting the public interest in the for profit investment management industry, the idea that regulation is a requirement for investment success would be news to many of the world's leading college and university endowments or charitable foundations who have successfully invested for decades in furtherance of their charitable missions.

The real issue is investment management talent; recruiting, growing and retaining professionals in public investment organizations has always been a challenge for compensation and governance reasons. We faced this challenge head-on, working closely with SBA's Trustees and Investment Advisory Council to redesign SBA's compensation structure. We sought a comp model that would be economically competitive, substantially improve alignment of stakeholder interests among beneficiaries, taxpayers, Florida's public employers, elected policy makers and SBA's Trustees and staff. With the benefit of numerous (more than twenty) public meetings of the IAC Compensation Subcommittee, the full IAC and SBA's Trustees over a period spanning more than five years, we crafted a comp model that achieves the desired objectives in a highly transparent, predictable manner, with clear accountability. In addition the plan and its execution are thoroughly documented, subject to post audit and very cost effective; in short it is institutionally rigorous and prudent for a public investment organization.

Several factors distinguish Florida's successful and effective reforms. SBA's statutory governance structure concentrates fiduciary responsibility on three constitutional, statewide elected officers, Florida's Governor, Attorney General and Chief Financial Officer. It also concentrates authority for allocating resources to the SBA. The Trustees are supported by several statutory advisory bodies, notably the Investment Advisory Council and Audit Committee. Appointed by the Trustees, they are composed of individuals with relevant substantive expertise to provide the Trustees policy guidance and SBA oversight. Given their professional qualifications and compliance with Florida's public meetings and records laws, the IAC and Audit Committee have proven their effectiveness and value in addressing complex issues and helping form constructive, fact-based, merit driven recommended solutions. Among public pension funds, transparent, effective compensation decision making is the exception, not the rule. The wisdom and fiduciary prudence of Florida's pension governance model is plainly visible in the results accomplished.

Recruiting, organizing, retaining and growing talent is the obvious central theme; the IAC's sustained leadership and support for rationalizing SBA's compensation plan is clearly paying off in improved motivation, retention and recruitment. Two additional themes have dominated our investment evolution: greater diversification and more internal asset management. First, our portfolios are more global, to capture opportunities and benefit from faster growing economies, wherever they may be. Second, the strategies we use go far beyond those of a decade ago. We still have large liquid equity and fixed income portfolios, increasingly internally managed, with passive cores enhanced by complimented value adding active strategies where the risk and cost are likely to be rewarded. We have a largely unique real estate investment approach, distinguished by a large component of internally managed "principal investments" that reduce costs and disconnect our investment decisions from the artificial timeframes imposed by partnership vehicles. Our private equity program is now mature and thoughtfully constructed with General Partners GPs) who have demonstrated persistent ability to add value through specialization in certain industries, geographies, etc. Strategic Investments, the newest asset class, is structured to capture our long term real return objective through investments minimally or negatively correlated to global equity, reducing total portfolio risk and serving a defensive purpose. With the benefit of healthy turnover, asset class leadership and investment professional staff are excellent and stable, with sufficient depth to support continued growth in internal management of assets and sophisticated partnerships with private firms that extend SBA's reach and potential.

Developing our organization has not been without cost, but the net benefits are clear. Looking across the entire SBA, including the FRS Pension Plan, Investment Plan and the Florida Hurricane Catastrophe Fund, from July 1, 2008 to July 1, 2019, total headcount has grown by 49 people, to a total of 217. Of these, 44 are investment and investment support including Accounting, Financial Operations, IT, Risk & Compliance, Legal, HR, etc. Headcount in the Investment Plan (DC) has grown by one person and the Cat Fund has grown by four.

Focusing on the trailing 10 year period from June 30, 2019, Florida Retirement System Trust Fund assets under management grew from \$99.58 billion to \$163.53 billion (audited), net of \$61.33 billion in benefit payments, for an estimated total investment gain of \$125.88 billion. Total FRS Pension Fund trailing ten year performance is 9.80%, 95 bps ahead of benchmark. That outperformance amounts to \$11.68 billion, a very generous multiple of the entire SBA budget, much less incremental headcount growth or compensation over the period. Maybe those who doubted us in 2009 should reconsider what a focused investment team can accomplish in a public fund; beating benchmarks consistently over a decade is a high level of success for any investment firm, public or private.

I believe the SBA is in its strongest position ever, reflecting the performance of a stable, highly competent team under thoughtful, consistent leadership that recognizes and rewards merit and embraces constructive change. Investment performance is an obvious threshold metric for management success; SBA's performance history clearly demonstrates a pattern of persistent ability to add value over market benchmarks. While solid investment return numbers show value added in all asset classes and total fund relative to benchmarks for the overwhelming majority of measured periods, there is more to the story. Performance has to be considered in the contexts of risk and cost. SBA operates with an explicit risk budget, setting forth standards for each asset class and the total fund. These are monitored and any escalations in risk are evaluated and responded to as appropriate. SBA's costs are also formally monitored through the services of a private third party firm that provides detailed cost and value-added data for North American pension funds. SBA is consistently among the very lowest cost providers among large funds. Economies of scale and internal asset management are the two secrets to holding costs down. The reward for lower costs is higher net returns without taking greater risk. SBA's ability to consistently deliver above benchmark investment results and at the same time remain a low cost provider reflects the quality of our organization and the economic value we create for Florida.

The portion of SBA assets managed in house continues to increase, currently over 45% across the global equity, fixed income, and real estate asset classes, up from 36% since 2009. Successfully growing internal management reflects competent, stable professional talent and support for portfolio and risk analytics, trading, systems, portfolio accounting, compliance, etc. The value of these resources is captured in the cost savings of internal vs. external management. Internally managed assets have achieved desired investment results within stated risk tolerances at a fraction of the cost of external commercial asset management.

Control and compliance are sound; we achieve desired investment results consistent with ethical, legal, regulatory, compliance and fiduciary bounds. These standards are extended to our external investment partners, who are required to annually certify compliance with a range of relevant policies and statutory obligations. Annually, the SBA undergoes numerous audits among our business units and investment holding companies. We are pleased to have had clean financial statement audits since SBA began producing our own financials (as opposed to simply being a component of Florida Consolidated Annual Financial Report) in 2010. Likewise, despite appropriately intensive audit oversight of SBA operations, we have not had any material exceptions in any audits in the past decade. In 2018 we conducted a holistic external review of our "Governance, Risk and Compliance (GRC)" structure, processes and execution. The firm, Funston Associates, concluded that SBA has achieved an "advanced" level of GRC, with extensive best practice adherence and thoughtful management of related issues and processes. Together with our

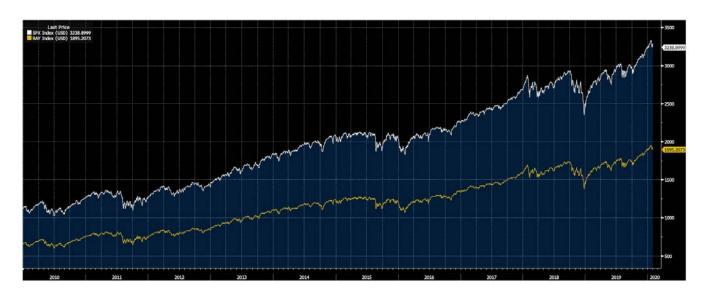
performance and healthy control & compliance history, this suggests we are largely achieving the mission and vision we established for ourselves early in the decade:

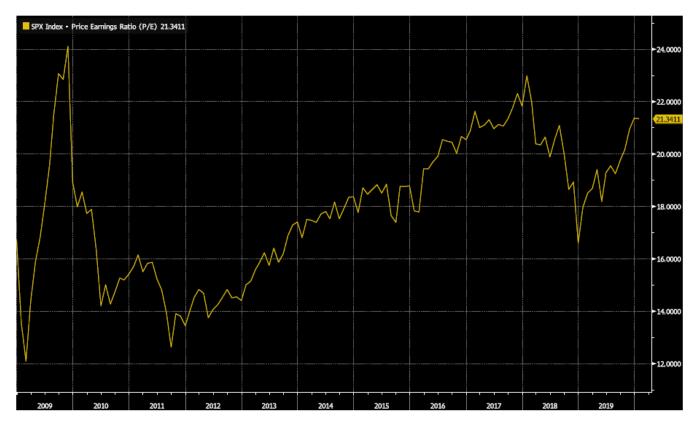
Our mission is to provide superior investment management and trust services by proactively and comprehensively managing risk and adhering to the highest ethical, fiduciary and professional standards. Our vision is to be the best public sector investment and administrative service provider while exemplifying the principles of trust, integrity and performance.

Numerous industry and peer awards, media recognition and invitations to leadership roles in professional, policy and investment industry organizations further affirm the goodness of the organization we have built and the value of the results it has produced. That's nice but unfortunately it is all backward looking. The complexity of what is required to consistently create market beating performance, the hundreds or thousands of small things that must be gotten right for the big things to even have a chance of being right, change every day. Markets change, economies cycle, central bank policies change, relative currency values move, etc. There is no such thing as reaching a state of excellence and stopping there to savor success. On the contrary, maintaining excellence requires commitment to constant renewal of knowledge, focus, strategy, execution, technology, and ethical leadership. As we noted previously, doing these things is aspirational in a private for profit organization solely focused on asset management; in a public pension fund subject to intrusions of politics, media, etc., it if far more challenging.

Presuming the SBA can retain its edge in professional talent, and investment support resources, how does the forward market environment look compared to what we saw at the dawning of the 2010-2019 decade? In a word, tough! In almost every way, comparing the onset of 2020 from the onset of 2010 from a market context perspective provides contrasts so extreme they are essentially opposites. The comparison is stark; let's consider a few metrics to illustrate:

Equity valuations – Between October of 2007 and the Great Recession market bottom in March 2009, US stocks declined by over 50%. What is now the longest equity bull market in history was just establishing itself in January 2010; by most measures, stocks looked historically cheap. Conversely, equities entered January 2020 after hitting successive all time market highs; stocks, especially US issues, look relatively expensive.

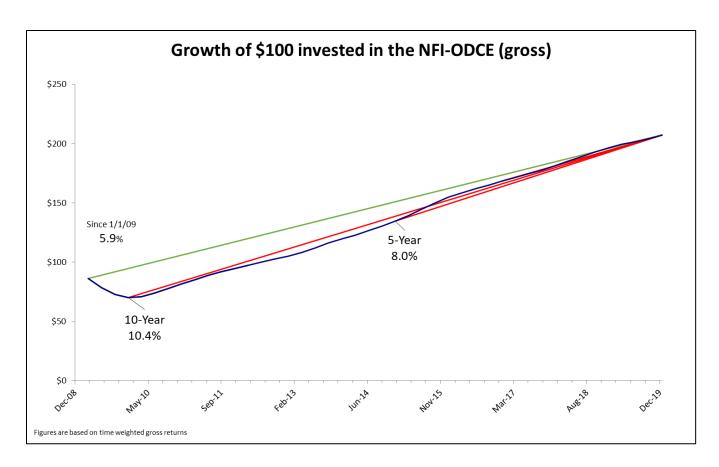




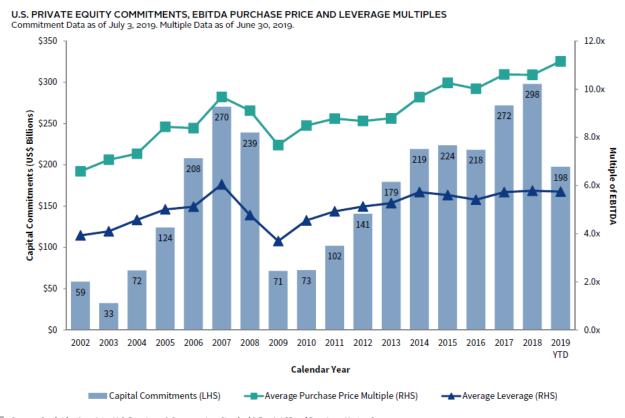
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- Fixed income valuations In 2010, rates had come down substantially as central banks adopted stimulative policies in response to the economic crisis. Since then, rates have gone lower. In 2020, interest rates have been and remain at historic lows. Negative interest rates, previously unimaginable, have become a factor in sovereign and private credit.
- Real estate Asset values that collapsed in the Great Financial crisis remained deeply depressed in 2010. Previously over-levered buyers had become forced sellers after busting debt service, coverage or other covenants and losing credit lines to support their assets. There was an overwhelming imbalance between assets for sale, and interested, able, liquid buyers. Partially completed projects were simply abandoned by failed developers. The onset of 2020 provides a startling contrast, markets long ago recovered from the dislocations of the GFC. Stabilized core real estate (SBA's historical area of emphasis) prices have appreciated so dramatically that SBA has been a net seller for several years now. Real estate is fully valued in virtually every sector and region, especially the U.S.



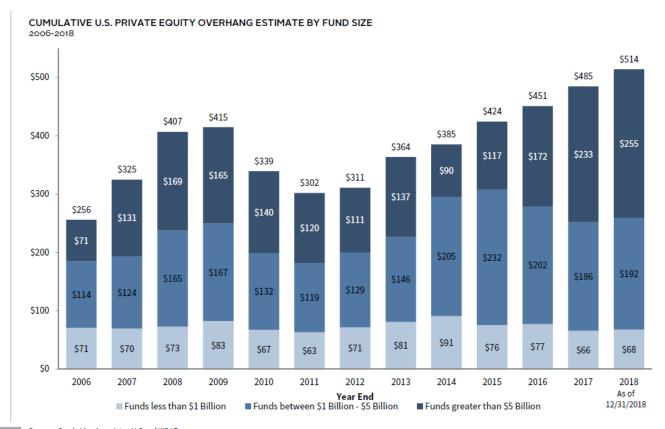
 Private Equity – In 2010, a range of issues existed in PE space. First, many of the largest leveraged buyout (LBO) firms had participated in "club deals" in which they all bought interests in the capital structures of the same large companies whose corporate events had been the basis for some of the largest transactions ever done.



Sources: Cambridge Associates LLC, Dow Jones & Company, Inc., Standard & Poor's LCD and Dow Jones VentureSource.

Notes: Purchase price multiple is defined as enterprise value over EBITDA and leverage multiple is defined as net debt over EBITDA. Commitments 2002-2007 sourced from Dow Jones & Company, Inc. Commitments 2007-2019 sourced from Dow Jones VentureSource. Commitment data in 2019 is YTD through July 3, 2019.

Post crisis, these transactions failed to fulfil expectations and related securities suffered meaningful declines. In the endowment & foundation community, highly regarded institutions, often with long PE investing histories, found that they had underestimated their liquidity needs and became forced sellers of PE and other callable capital private market investments. To the extent PE firms had investible capital, the opportunity set in the wreckage of the financial crisis was broad, prices attractive and competition limited. In sharp contrast, the onset of 2020 brings a PE industry awash in committed but uninvested capital, higher entry price levels on assets and robust competition to buy these more expensive assets. Another now common phenomenon is that of PE firms using other PE firms as sources of both assets and exits.



Sources: Cambridge Associates LLC and WSJ Pro.

Notes: Data reflect cumulative overhang as of each year end. Private equity includes buyout and growth equity funds. Estimate based on the percent paid into funds tracked by

Cambridge Associates LLC by vintage year. Vintage year is defined based on first cash flow, rather than legal inception date. Cumulative overhang value includes the past six vintages;
for example, cumulative overhang of \$514 includes vintages 2013-2018. Assumes a ten-year life span with a 1.5% fee decreasing linearly over the life of a fund, and no re-investment of
capital.

Liquidity – In 2010 there was no liquidity, literally. Credit markets were frozen, balance sheets of financial market making firms were impaired or in disarray and regulators worldwide were scrambling to forestall a complete collapse of the financial system. With asset values in free fall, forced sellers of assets were everywhere as lenders called loans and cancelled or repriced lines of credit. In 2020, liquidity is ample, if not excessive. With global interest rates hugging historic lows, yield seeking capital is available for any worthy investment – and plenty of unworthy ones too!

The picture this comparison shows is that investment opportunities today just aren't as good as they were a decade ago. Across the globe and across asset classes, assets are now fully valued and being chased by a flood of cheap capital. Can we survive, much less prosper in such an environment? Our expectations for future returns are certainly lower that they were a decade ago, but the quality and depth of our organization, which drives our capacity to unearth investment opportunities and create returns is substantially superior to what it was a decade ago. This somewhat mitigates the relative scarcity of attractive new investment opportunities but our size dictates that our performance will reflect broad markets. Yes, we believe we can add value in good markets or bad, but we cannot create investment results that are completely independent from what the markets are offering.

Summing up the past decade, the SBA has reinvented itself, re-established our position as an investment industry thought leader and restored public confidence in the integrity and capability of our organization. Having re-earned the trust that was impaired by events a little over a decade ago, we should heed the lessons of history and protect what we have created.

Taking a long term view, the continuing success of the SBA will depend on maintaining excellence in all the areas we have reinvented: the team and culture building, policy and strategy formation, resource provision, risk management and execution. Our transparent, merit driven culture of accountability creates the many investment outcomes that sum to the total fund's return. If these are right, the probability of consistent investment outcomes that earn trust, enhance the SBA's reputation and build brand value is vastly enhanced. The result is a virtuous cycle where our credibility and performance help garner critical policy support from key SBA stakeholders (Trustees, Legislature, local governments, beneficiaries, taxpayers, media, etc.), which in turn, positions us as a serious, stable, and desirable investment partner in the marketplace. This enables us to build well-aligned relationships with other exceptional organizations and capture superior deal flow with more favorable terms and pricing, driving the performance that earns trust, enhances reputation and builds brand value. The benefits of maintaining this benevolent cycle are clear, as are the actions required. Let's keep moving forward.

In closing I again thank the Trustees, Investment Advisory Committee and Audit Committee members whose support and leadership has made a real and valuable difference for our team and organization, as well as our beneficiaries and Florida taxpayers.

Sincerely,

Athle William

Ashbel C. Williams,

Executive Director and Chief Investment Officer