LONG TREASURY PORTFOLIO REVIEW

EMPLOYEES' RETIREMENT SYSTEM OF RHODE ISLAND

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LONG TREASURY PORTFOLIO OVERVIEW

- **The Long Duration Treasury portfolio has a strategic asset allocation target of 5.0%**
  - The allocation resides within the Crisis Protection category (10% target) which is part of the broader Stability category (33% target)
- **Western Asset Management is the single manager within the Long Duration Treasury Portfolio**
- **The portfolio is actively managed and has a fee of ~5 basis points***
- **We believe several adjustments should be made to the portfolio:**
  - Change to passive management
  - Select a new provider to passively manage the strategy
  - Improve operational efficiencies with the portfolio overlay
- **The rationale for the change is provided on the following pages**

*Fee schedule is 5 basis points on the first $500 million and 4 basis points on assets over $500 million. Current assets in the mandate are $538 million

PORTFOLIO SUMMARY

Total Portfolio Assets ($millions)	$11,369
Total Long Treasury Assets ($million)	$538
Number of Long Treasury Managers	1
% Actively Managed	100%
Benchmark	Bloomberg US Long Treasury
Expected Return (10-Year)*	4.0%
Expected Risk (Standard Deviation)*	11.8%

Stated IPS Portfolio Objectives

- **Investments included in the Long Duration Treasury Portfolio are long-dated high-quality bonds (Treasuries and full faith and credit Government-backed Agency securities only). The purpose of the long duration U.S. Treasury portfolio is to smooth the volatility of the overall ERSRI portfolio in times of steep equity market decline, by capturing the "flight to quality" effect in an equity market crisis environment.**

		Current Target	Actual – 6/30/2024
Growth	**Global Equity**	**40.0%**	**38.0%**
	Private Equity	12.5%	16.8%
	Non-Core Real Estate	2.5%	2.2%
	Private Growth	**15.0%**	**19.1%**
	TOTAL GROWTH	**55.0%**	**57.1%**
Income	Equity Options	2.0%	1.8%
	Liquid Credit	5.0%	4.1%
	CLO Mezz/Equity	2.0%	2.3%
	Private Credit	3.0%	3.0%
	TOTAL INCOME	**12.0%**	**11.3%**
Stability	Long Treasuries	5.0%	4.7%
	Systematic Trend	5.0%	4.4%
	CPC	**10.0%**	**9.1%**
	Core Real Estate	4.0%	3.1%
	Private Real Assets (ex-RE)	4.0%	4.0%
	Inflation Protection	**8.0%**	**7.1%**
	Inv. Grade Fixed (ex-Treas.)	6.5%	5.3%
	Absolute Return	6.5%	7.2%
	Strategic Cash	2.0%	1.6%
	Volatility Protection	**15.0%**	**14.2%**
	TOTAL STABILITY	**33.0%**	**30.4%**

Assets as of June 30, 2024. *Expected return and risk based on assumptions from 2023 asset/liability study.

ACTIVE VS PASSIVE MANAGEMENT

- **NEPC prefers to use passive management for government bond mandates**
- **U.S. Treasury markets are highly efficient with very little room for active managers to add value**
  - There are limited ways to add value with the most common approach being a duration bet relative to the benchmark
  - Predicting the direction of interest rates has been challenging for most active managers
  - The long duration Treasury universe contains less than 100 securities, so it is also difficult to add value via security selection
  - Finally, the Treasury market is very liquid and it is difficult to add value by investing in "less liquid" issues
- **Western has had mixed success in terms of adding value over the benchmark**

	Allocation			Performance (%)									
	Market Value ($)	% of Portfolio	Strategic Benchmark Allocation (%)	1 Mo (%)	FYTD (%)	YTD (%)	1 Yr (%)	3 Yrs (%)	5 Yrs (%)	10 Yrs (%)	15 Yrs (%)	Inception (%)	Inception Date
Treasury Duration	528,075,759	4.55	5.00	2.87	5.60	0.56	5.12	-10.18	-5.32	-	-	-0.98	Jun-17
Bloomberg US Treasury Long TR				*2.04*	*5.68*	*0.39*	*4.89*	*-9.84*	*-5.14*	*-*	*-*	*-0.60*	

Performance as of August 31, 2024

PROPOSED MANAGER CHANGE

- **Russell Investments is being proposed to replace Western Asset Management as the ERSRI long duration Treasury manager**
- **Russell Investments currently manages the rebalancing overlay for the ERSRI portfolio**
  - There is capital efficiency associated with using Russell to manage the long Treasury portfolio as the securities can be pledged as collateral
  - If needed, this will release approximately $17mm in cash currently held as collateral for initial margin for futures positions associated with rebalancing overlay
- **The burden on ERSRI Staff will be reduced as there will be less need to sell assets and transfer cash to the overlay account on a recurring basis**
- **Russell's proposed fee of 3 basis points is lower than the existing Western fee and is competitive with other index providers**

OVERLAY MECHANICS

- **Utilizing Russell as the long Treasury provider will reduce the initial margin requirements for the rebalancing overlay**
- **The proposed approach will also reduce the operational workload on the ERSRI Staff as Treasury securities can be pledged for margin requirements**

Current Approach	Proposed Approach
Collateral ***Initial margin requirement is currently cash only (about $17mm)***	Collateral ***Initial margin requirements satisfied through pledging Treasuries, freeing up cash for other purposes***
Cash Buffer *For variation margin needs – ERSRI Staff periodically needs to sell assets to transfer cash to support derivative positions*	Cash Buffer *The existing $17mm being used for initial margin requirements is freed up and should reduce the frequency with which ERSRI staff need to sell assets to support the derivatives positions*

Additional Detail

- The Overlay becomes more capital efficient
- Currently, ERSRI Staff has the operational burden of transferring additional cash to the Overlay account to satisfy variation margin
- In the proposed solution, Russell becomes an additional source of liquidity
- No special purchases or sales of Treasuries need to occur to satisfy the initial margin requirement

WESTERN – TIMELINE OF EVENTS

- **As noted, Western Asset Management (WAMCO) manages an active long Treasury portfolio for ERSRI**
- **NEPC Research recently placed Western Asset on 'Client Review'**
- **Recent events at the firm may create a distraction for the investment team, potentially affect the firm's investment process, and may lead to increased client asset outflows**

Western Asset Management Timeline

September 2023
Mike Buchanan, Deputy CIO, promoted to co-CIO alongside long-term CIO Ken Leech

April 2024
NEPC Research places WAMCO "On Watch" as John Bellows, Head of Broad Markets, resigns from the firm abruptly

July 2024
Western notifies NEPC Research that the firm is under investigation by the SEC and DOJ related to Treasury derivative trading in certain accounts

August 2024
Western Asset announces that co-CIO, Ken Leech, is taking a leave of absence; NEPC places the firm on 'Client Review'

September 2024
Western experiences net outflows of $4.5 billion in the prior month with additional outflows expected in the coming months

KEY TAKEAWAYS

- **The transition to Russell as the manager of the long Treasury portfolio has several benefits:**
  1. Reduced operational risk for ERSRI Staff
  2. Capital efficiency
  3. Reduction in fees vs. Western*
  4. Transition away from an organization experiencing negative headlines and outflows
- **NEPC believe it is prudent to remove Western as the portfolio's long Treasury manager**
- **We are supportive of using Russell to manage a passive long duration Treasury portfolio**

*Russell proposed fee is 3 basis points (compared to 5 basis points for the current Western Asset mandate)

APPENDIX

NEPC DUE DILIGENCE SUMMARY

NEPC Due Diligence Status Key	
Inform | No Action	Informational items have surfaced; no action is recommended.
Watch	Issues have surfaced to be concerned over; manager can participate in future searches, but current and prospective clients must be made aware of the issues.
Hold	Serious issues have surfaced to be concerned over; manager cannot be in future searches unless a client specifically requests, but current and prospective clients must be made aware of the issues.
Client Review	Very serious issues have surfaced with a manager; manager cannot be in future searches unless a client specifically requests. Current clients must be advised to review the manager.
Terminate	We have lost all confidence in the product; manager would not be recommended for searches and clients would be discouraged from using. The manager cannot be in future searches unless a client specifically requests. Current clients must be advised to replace the manager.

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