

## MONTANA DOMESTIC EQUITY POOL (MDEP) INVESTMENT POLICY STATEMENT

*This policy is effective upon adoption and supersedes all previous Montana Domestic Equity Pool (MDEP) policies.*

### INTRODUCTION

The purpose of this policy statement is to provide a broad strategic framework for domestic equity investments, which are consolidated into the Montana Domestic Equity Pool (MDEP). This statement provides a basis on which to invest in the publicly traded equity securities of domestic companies through the employment of external managers and enables staff to monitor the progress of the domestic equity managers on behalf of the retirement funds and other participants. The public domestic equity investment program consists of several externally managed portfolios. The managers of the portfolios are governed by their respective investment management contracts and investment guidelines.

The array of managers utilized are classified in the following strategy categories:

1. Passive
2. Enhanced index
3. Style-based (Value and Growth)
4. Partial Long/Short (also called 130/30)

### OBJECTIVES

**Strategic:** Attaining investment returns from publicly traded domestic equity markets while diversifying investment risk and manager risk.

- The primary objective of the domestic equity investment program is to provide diversified exposure to the domestic equity market for the benefit of the pension fund and other participants in a prudent and cost effective manner.
- The objective of enhanced index management and other active management strategies is to add value by achieving a rate of return that exceeds the relevant benchmark(s) after fees.
- The objective of passive management is to diversify risk within the program as well as to act as a mechanism for liquidity within the program's strategy and manager allocations. It is also the primary liquidity source to absorb changes to the overall allocation to domestic equities.

**Performance:** The domestic equity investment program provides passive, enhanced index and active investment management strategies in order to achieve the stated investment objectives.

- The return objective for the Montana Domestic Equity Pool is the achievement of an annualized, time-weighted total rate of return exceeding that of the S&P 1500 Index over any three-year rolling period after fees.
- The return objective for all enhanced index and other active domestic equity managers is the achievement of an annualized, time-weighted total rate of return exceeding that of the relevant benchmark over any three-year rolling period after fees: (see Public Equity Manager Evaluation Policy).
- The return objective for all passive domestic equity index funds is the achievement of an annualized, time-weighted total rate of return equaling that of the relevant benchmark on an annual basis before fees (see

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Public Equity Manager Evaluation Policy).

### RISK MANAGEMENT

The domestic equity investment program utilizes active, enhanced index, and passive investment management strategies with various risk tolerance parameters.

- Style-based and partial long/short strategies entail active management. These active domestic equity managers are able to assume greater than market risk subject to the following:
  - Investments will be well diversified among market sectors and individual securities, though deviations from benchmark characteristics may be taken in an effort to add value above benchmark returns.
  - Normally, at least 95% of assets will be invested in common or preferred stocks or securities convertible into common or preferred stocks.
  - Up to 5% of assets may be held in short-term investments.
- Enhanced index domestic equity managers also entail active management, though typically less than the above category. These managers are able to assume above-market risk subject to the following:
  - Investments will be well diversified among market sectors and individual securities.
  - Up to 3% of assets may be held in short-term investments or securitized cash equivalents.
- Passive domestic equity managers are able to assume only the market risk of their respective benchmark. Underlying investments are designed to replicate the relevant benchmark(s) index characteristics in an effort to produce market-like risk and returns.

The description of risk characteristics by type of manager can also be quantified by tracking error, a statistical measure that is defined as the standard deviation of a portfolio's performance relative to the performance of an appropriate benchmark. These are summarized in the table below.

Style Category	Tracking Error Range (in basis points)
Passive	0-20
Enhanced-index	50-250
Style-based (Value & Growth)	400-700
Partial Long/Short	250-500

Staff monitors the overall pool portfolio and individual external managers using various analytical systems designed to show the risk characteristics at the pool and manager level, and the sources of value-added for each manager.

### LIQUIDITY

The liquidity needs for the domestic equity program are low, as participant capital allocated to this program is not expected to change dramatically on short notice. Nevertheless, the underlying assets held are publicly traded securities which can be liquidated in a relatively short period to accommodate broad asset allocation changes between domestic equities and other asset categories held by the participants. Up to 5% of total MDEP

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assets may be held in short-term investments, securitized cash investment vehicles or a combination of both.

### ELIGIBLE INVESTMENTS

**Securities:** Either directly held in separate accounts, or via commingled funds, securities eligible for investment include the equity securities of domestic and foreign-based corporations listed on legal and recognized domestic exchanges. Security types may include ordinary common shares, preferred shares, American Depository Receipts (ADRs), and other security types deemed by the Chief Investment Officer as equivalent to the above listed types.

**Derivatives:** Investment managers are authorized to invest in derivatives such as index futures contracts in accordance with the Investment Manager Guidelines.

### ALLOCATION

Allocation ranges are approved by the Board. The current allocation ranges by strategy category are shown below. It is the responsibility of staff to manage individual manager and strategy allocations within these ranges in order to attain the objectives of the pool.

Strategy	Approved Range
Large Cap Core (passive)	10 – 30%
Large Cap Enhanced	20 – 30%
Large Cap Style-Based (long-only)	20 – 30%
Partial Long/Short (130/30)	10 – 20%
Total Large Cap	82 – 92%
Mid Cap	5 – 11%
Small Cap	3 – 8%

### ROLES AND RESPONSIBILITIES

**Board of Investments** – The Board is responsible for approving the Investment Policy Statement for the Montana Domestic Equity Pool. The Board reviews this document periodically and, as needed, approves any changes to the policy and allocation ranges.

**Chief Investment Officer** - The Chief Investment Officer (CIO), with the support of other staff, is responsible for recommending policy changes, including any changes in allocation ranges, for Board approval.

**Staff** - Staff is responsible for monitoring allocations and external managers, recommending allocation changes to the CIO, and recommending retention or termination of external managers to the CIO (see Public Equities – External Manager Evaluation Policy).

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**Investment Consultant** – The investment consultant assists the CIO and staff with policy recommendations and provides advice to the Board. The investment consultant also assists staff in monitoring all external managers and reports to the Board independently.

**External Managers** – Managers are responsible for all aspects of portfolio management as set forth in the contract specific to each manager. Managers must communicate with staff as needed, regarding investment strategies and results. Managers must also cooperate fully with staff regarding administrative, accounting, and reconciliation issues as well as any requests from the investment consultant and the master custodian.

**LEGAL**

According to the unified investment program directed by Article VIII, section 13, of the 1972 Montana Constitution (MCA 17-6-201: Unified investment program-General Provisions):

- (1) Public funds must be administered by the Board of Investments in accordance with the prudent expert rule, which requires any investment manager to:
  - (a) discharge duties with the care, skill, prudence, and diligence, under the circumstances then prevailing, that a prudent person acting in a like capacity with the same resources and familiar with like matters exercises in the conduct of an enterprise of a like character with like aims;
  - (b) diversify the holdings of each fund within the unified investment program to minimize the risk of loss and to maximize the rate of return unless, under the circumstances, it is clearly prudent not to do so; and
  - (c) discharge duties solely in the interest of and for the benefit of the funds forming the unified investment program.
- (2) Retirement funds may be invested in common stocks of any corporation.