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Testimony for Senate Bill 958
State Retirement and Pension System - Investment Committee - Use of Minority Business
Enterprises
Senate Budget and Tax Committee

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3:00 P.M.

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The Board of Trustees for the State Retirement and Pension System (System) wishes to provide the Budget and Taxation Committee with informational testimony regarding Senate Bill 958, State Retirement and Pension System - Investment Committee - Use of Minority Business Enterprises. As introduced, this legislation requires the Investment Committee of the Board to use minority business enterprises to provide at least 20% of the brokerage and investment management services to the Board and to manage at least 20% of the assets of the System. Senate Bill 958 is a reintroduction of Senate Bill 954/House Bill 542 of 2022, as introduced. The first readers of Senate Bill 954 and House Bill 542 raised constitutional issues that were addressed by amending each bill to require that a disparity study be performed to determine if minority business enterprises (MBEs) are underutilized for purposes of investment management to the System. Senate Bill 954 did not pass the House, but House Bill 542 was enacted as Chapter 641. While it appears that Senate Bill 958 includes the same constitutional issues that were raised with Senate Bill 954 and House Bill 542, as each was introduced, we would like to take this opportunity to provide the Budget and Taxation Committee with a brief overview of the efforts the Board and the Investment Division of the State Retirement Agency (Agency) have been making to address the issue of diversity regarding the investment program for the System.

The Board is committed to diversity, equity, and inclusion in all aspects of the administration of the System. The System has long been considered a leader in promoting access and fairness in its manager selection processes. In 2007, the System initiated an emerging manager program to provide access to investment management opportunities for smaller firms that might not be identified through more traditional procurement practices. This program, expanded and transformed into the Terra Maria program in 2008, has resulted in significant representation of minority-owned firms through open access channels. The program expanded into private investments and facilitated a significant expansion of the use of large MBE-owned firms.

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As of June 30, 2022, MBE firms managed 15.4% of total System assets. However, when looking solely at those assets that are externally managed, that percentage increases to 18.0%. These levels of minority participation place the System near the top among other large pension plans across the country. For perspective, minority-owned firms' share of System assets and brokerage was approximately 11% in 2015 and both have been higher than 20% in recent years. In any given year, the percentage is impacted by the effectiveness of specific managers, portfolio implementation needs of the System and the competitive landscape of the equity brokerage business. Two important aspects of implementation are the amount of assets managed by internal agency staff and the amount of assets managed by non-U.S. based managers.

One of the key initiatives of the System is to impact the net return available to beneficiaries by minimizing the fees paid to managers. A primary driver of this initiative is to manage assets directly, with internal staff based in Maryland. As of January 31, 2023, the System was internally managing directly \$10.0 billion in stocks and bonds representing 15.3% of assets.

The System, like most of its peers, is a global investor and partners with managers located outside of the United States to implement its asset allocation. The target allocation to non-U.S. stocks is 19% of the total fund. While the System employs U.S.-based companies to manage a significant portion of this percentage, including many minority-owned firms, several international managers are also utilized. Firms headquartered outside of the U.S. also manage assets on behalf of the System in private equity and real estate. For these strategies, it is important to have a physical presence in the local market to have a complete understanding of the investment opportunity set, regulations and customs. As an example, Asian private equity represents a significant portion of the System's benchmark and attractive investment characteristics like higher population and economic growth rates. Because of this, the System has invested in this sector with some managers located in Asia based on a demonstrated track record and specialized knowledge of the local markets. In many cases, minority managers in the U.S. do not offer these kinds of specialized products. As of December 31, 2022, international firms managed roughly \$11.2 billion for the System, representing 15.8% of the total fund.

Combined, the internal and non-U.S. manager segments of the portfolio sum to 29% of assets as of year-end, with the result that MBE managers were more than 21% of U.S. based external managers.

Access for smaller and MBE firms have historically been challenged by traditional procurement processes driven by consultants. With the Investment Division's leadership, the System's public and private market consultants developed expertise in evaluating emerging managers and sponsored conferences and education sessions for their clients regarding current trends in the emerging and diverse manager industry. In addition to the role of consultants, the hiring practices of many asset owners did not maximize access for small and minority owned businesses. In responses, the Investment Division took specific actions to promote access including:

- providing direct access to both Investment Division staff and the System's consultants and program managers on the Agency's website,
- participating on advisory boards and attending emerging manager conferences,
- speaking at industry events relating to diversity in asset management, and

- hosting diverse managers at events to introduce them to Maryland-based investors.

Through its work in implementing the Terra Maria program, the Investment Division gained a deeper appreciation of the importance of diversity of thought in the investment process, itself. Staff found a disconnect between its focus on MBE managers and the diversity policies and hiring practices of most of the System's non-MBE managers. After 10 years of working to promote diversity through the manager hiring practice, it was apparent that there was little change in the hiring practices of the domestic investment industry. The CIO created the Diversity, Equity and Inclusion Committee in 2017 to provide focus on these issues for the Investment Division, its managers and their investments. The work of that Committee has focused on improving the recruitment and retention practices of the Investment Division and working with managers to improve their use of diversity as an enhancement to their process and products.

Within the Investment Division the Diversity, Equity and Inclusion Committee:

- arranged for two rounds of diversity training on the topics of unconscious and implicit bias that were expanded to the entire Agency;
- worked to revamp the job posting and advertising processes for the Investment Division to ensure inclusive language that encouraged applications from as large and diverse a pool as possible;
- established the practice to have a Committee member participate in every hiring process;
- established contacts with local universities to facilitate recruitment of interns and associates;
- developed an associates program to provide training for junior staff in the Investment Division;
- made a presentation to Morgan State finance students on pension investing;
- began a relationship with United Negro College Fund to expand its Lighted Pathways internship program to Maryland; and
- led the procurement for the services of Lenox Park.

Lenox Park will provide a more comprehensive and accurate assessment of the System's diversity at the manager level and within the total fund. Each manager, minority- and majority-owned, will be asked to complete a diversity survey and will be assigned an impact score. This score will be compared to an industry average and serve as a starting point for conversations regarding the managers' diversity and inclusion policies and how these policies can be strengthened to better promote diversity objectives.

The Board and the Investment Division are committed to promoting diversity and inclusion in everything they do. The Terra Maria program is a recognized leader in the industry for providing access and opportunities to minority-owned firms, and the System's current level of diversity is among the highest among its peer group. The Board and Investment Division believe there are more holistic ways to advance diversity objectives and are in the process of implementing a program that will have greater reach and deeper impact than one focused solely on firm ownership.

We appreciate being given the opportunity to share this information with the Committee and stand ready to provide any further information or services the Committee might request regarding Senate Bill 958.