Chief Investment Officer's Report

Missouri State Employees' Retirement System
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October 14, 2016

Dear Members:

I am pleased to present the *Investment Section* of the MOSERS *Comprehensive Annual Financial Report* for the fiscal year ended June 30, 2016.

The MOSERS portfolio generated a time-weighted rate of return, based on fair value, of 0.3% for the year ended June 30, 2016, net of all fees and expenses. The result was below our 8% assumed rate of return and underperformed our policy benchmark by 7.1%. In no uncertain terms – this is a disappointing result.

Since this is my first annual letter, I would like thank Rick Dahl, Gary Findlay, and John Watson for giving me the chance to protect the retirement interests of over 114,000 current and former state employees and their families. However, ultimately it took the confidence of a board to allow me to serve in this role. So, I owe appreciation to Antwaun Smith, Lori Neidel, Laura Davis, Don Martin, Senators Joe Keaveny and Wayne Wallingford, Representatives Mike Leara and Caleb Jones, Treasurer Clint Zweifel and Commissioner Doug Nelson. Rest assured, I come to work every day with the mission of making the board reflect on their decision with pride, by delivering an investment return that allows for a dignified retirement for our state's public servants.

For the second year in a row, the performance of the portfolio has underperformed the 8% assumed rate of return. In addition, time frames that have traditionally been viewed as "long-term" are underperforming the assumed rate of return. Large asset portfolios, like MOSERS, get the return broadly available to the type of portfolio of assets owned. While the CIO can attempt to add value in the margin, return cannot be created where it doesn't exist. Ultimately, assumed asset returns have not materialized. This problem is not unique to MOSERS – much of the institutional asset management community has systematically overestimated the returns from investing for 20 years. We will continue to work at this challenge with the understanding that adding risk to the portfolio is not the answer. Retirement, regardless of the type of plan it comes in, is more expensive today than it was 20 years ago.

The low return environment will be challenging for all investors. While the investment staff can't create returns, we can manage costs by rationalizing active management and improve our diversification to most efficiently earn market returns. We will continue to work on the things we can manage.

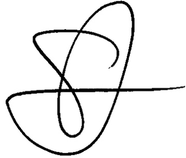
The causes of this year's underperformance are easily diagnosed and understood. However, performance deserves a critical review. This year's result notwithstanding, being different from the benchmark can be positive. The best success with active management comes when the effort is focused on risk management. To this end, traditionally, we have used active management to avoid over-priced risks in favor of risks with higher future returns – and have been successful. The best long-term returns come from those investors willing to take a contrary approach – buying unloved assets while selling adored assets. While this approach has an ability to make one look foolish in the short-term, in the long-term, it has resulted in higher returns and proves patience will financially accrue to the investor willing to focus on large margins of safety.

Our internal strategies, which are heavily biased toward undervalued assets, told us to buy the most cyclically sensitive sectors too early. Internal strategies, like emerging markets and higher actual inflation, caused a portion of this year's underperformance. Being contrary in the financial markets, unfortunately, means you are constantly at odds with the momentum crowd. This friction is created because the momentum crowd determines an asset is worth owning due to its appreciated price. That same crowd ignores the fact that, all else equal, a lower price makes the asset more attractive and represents lower risk in the future (since a majority of the risk was observed in the price decline).

External manager selection stands out as being particularly problematic this year. The last several years, we made changes to benchmarks without corresponding changes to the manager roster. Our external active management was used to deemphasize U.S. corporate growth. The return environment for the assets that diversify US corporate growth has been difficult, which caused our external managers to underperform. We will continue to transform the active manager roster, but are patient enough to ensure the transformation is positive for the fund.

So what does this mean for the future? It means we will focus on the things we can control; namely, management fees, the portfolio's diversification and the portfolio's active management. While the return environment might remain difficult, staff will focus on putting the fund in the best position for success over the long term.

Sincerely,



Seth Kelly
Chief Investment Officer