NORTH CAROLINA DEPARTMENT OF STATE TREASURER
INVESTMENT MANAGEMENT DIVISION
INVESTMENT ADVISORY COMMITTEE

MINUTES OF MEETING
December 10, 2014

Time and Location: The Investment Advisory Committee ("IAC") met on Wednesday, December 10, 2014, in the Dawson Conference Room of the Albemarle Building, 325 North Salisbury Street, Raleigh, North Carolina.

Members Present: The following members were present: State Treasurer Janet Cowell (Chair), John Aneralla, David Hartzell, Steve Jones, Mike Mebane, and (by teleconference) Courtney Tuttle.

Members Absent: Neal Triplett (Vice-Chair)

Staff: The following staff members were present: Kristen Bierline, Lynda Boulay, Mary Laurie Cece, Ana-Laura Diaz, Craig Demko, Ronald Funderburk, Alison Garcia, Brett Hall, Arlene Jones-McCalla, Fran Lawrence, Bryan Lewis, Troy March, Chris Morris, Neal Motaparthy, Tinh Phan, Norman Schiszler, Kevin SigRist, Jeff Smith, Rhonda M. Smith, Tony Solari, Steve Toole, Sondra Vitols, Zhexing Zhang.

Others in Attendance: Gaynor Fries, Mitch Leonard, Jon Mason, Amy McDuffee, Ken O'Herbourg, Alan Torrance, Josh Wilson, and Thom Wright.

AGENDA ITEM – OPENING REMARKS

The meeting was called to order at approximately 10:00 a.m. The Chair, Treasurer Cowell, announced Mr. Triplett was traveling and offered his apologies and that Ms. Tuttle was attending by teleconference.

The Chair asked the Members present to declare any conflicts of interest and, there being nothing declared, the meeting commenced.

AGENDA ITEM – APPROVAL OF MINUTES

The Chair asked for approval of the minutes of the September 24, 2014, meeting, and the minutes were approved as written.

AGENDA ITEM – CIO UPDATE

The Chair then recognized Mr. SigRist, Chief Investment Officer, to provide an update on the performance of the investments for the North Carolina Retirement Systems ("NCRS").

Mr. SigRist reported that he had taken into account feedback received at the last meeting on presentation style and that a memo had been previously distributed to the IAC with updates. He would address the bigger picture during the meeting and would be happy to take questions and receive further feedback.

- ***NCRS PERFORMANCE***

Performance Review – Mr. SigRist presented to the IAC an overview of the NCRS Asset Allocation as of December 2, 2014. Valuations in the equity market had triggered a downdraft but economic news in the US has been strong since then. Rebalancing is continuing and we will be pulling out of Fixed Income where we are overweight by 2%. The Federal Reserve is moving to tighten policy. We are overweight by around 2.5% in equity markets and will start to pull from public equity and from other asset classes in the face of a rising market.

Investment Policy Statement Benchmarks – The big picture is that a change in the investment policy statement was effective July 1, 2014. At a total fund level, the Long Term Policy Benchmark is a good way to think about performance over long periods of time. The Long Term Policy Benchmark is comprised of 57% global (MSCI ACWI IMI Net Equity Index), 33% long-term treasuries (BOAML 5+ Years US Treasury Index) as well as other short-term tips (Bloomberg Commodities Index and 1-3 Years US Inflation Linked Treasury Index). We have moved away from the most naïve investment programs.

Mr. Jones asked what timeframe is being used to gauge success and Mr. SigRist responded that the IAC should think in terms of the market cycle. Realistically, 10-15 years and longer are time periods we should be looking at. A separate agenda item would be created for the February meeting regarding ways to benchmark. Mr. Jones agreed that we need a long-term cycle, but raised the question of how we will assess performance in the interim? Mr. SigRist reported that the implementation benchmark is a shorter benchmark where we assess individual asset classes and choices of active managers, etc. It is a measure that reflects the opportunities set for a period of time, but we are open to change based on feedback and review from Hewitt. The challenges are that the benchmarks have changed periodically and have not always followed the components of the asset classes. One asset class would be compared to a blend of funds which is a problem. As an example, Core and Non-Core are now split out, but we don’t have a lot of information to compare against for the Non-Core benchmark.

Asset Class Benchmark Changes – Performance benchmarks for newly created asset classes reflect the current strategy for all time periods. We have not made significant changes to managed funds. Asset class performance benchmarks reflect those approved in the July 1, 2014 Investment Policy Statement. Non-Core is being compared against Non-Core for all time periods. There are no changes to the Fixed Income benchmark.

Benchmark Return Summary – The return impact for benchmark return series has not shown a significant difference over the 10-year time period. Shorter periods can be very different.

Total Net Portfolio Return vs Benchmarks – Net managed returns on retirement system shows three benchmarks – Long-Term Policy, Implementation and Legacy. Feedback is welcomed from the IAC on the most useful way to present information to them. Mr. Mebane asked if the figures show risk premiums over the year. Mr. SigRist confirmed that much of it can be viewed as a risk premium.

Growth of a Dollar – Mr. SigRist presented a slide showing the comparative growth of a dollar with NCRS vs Long Term Policy Benchmark showing a cumulative effect over a period of time. There has been a return on most time periods by making active managed decisions. Strategies in opportunistic fixed income can be reviewed with rising rates.

<u>NCRS Net Return Attribution</u> – Mr. SigRist presented the contribution to total fund performance split out by individual categories, as at September 30, 2014. We were lagging in the Core Real Estate benchmark and were underweight at the total fund level.

<u>Comparison to BNY Mellon Universe</u> – Mr. SigRist referred to the chart showing a 10-year time period and confirmed that we have a lower risk over time than our peers and we are where we are supposed to be, in the top quartile. Mr. Hartzell asked which organizations were the most outlying points on the chart and Mr. SigRist confirmed that we are not given that information.

Mr. Jones asked, how do other organizations like us do in their asset allocations and what were their returns compared to ours – i.e., how did we perform, in a gross sense? If we are looking at risk adjusted figures, this seems to be a good indication of performance. Mr. SigRist responded that this topic would be added to the February agenda for discussion, and that it would be advisable to bring Hewitt in to speak to this subject. There had been some methodology challenges in sense of numbers, and it was complicated to find the best organizations to benchmark against. We have to consider how inflation sensitive the participants are.

<u>New and Incremental Investment Commitments</u> – Mr. SigRist demonstrated to the IAC the changes that have taken place since the September IAC meeting to our investment commitments. The way we report this information has changed to show incremental changes. Mr. Aneralla asked if all new investments were due to reallocation and Mr. SigRist confirmed that not all were – particularly Tenaya – which is just an attractive investment for us.

❖ ***2014-15 INITIATIVES***

Mr. SigRist gave a brief overview of investment priorities. Best practices are important from the review undertaken, and CEM Benchmarking's report will be a good reminder of that. We can talk about how our program compares against others and will try to pull that in from industry trends for February's meeting.

Ms. Tuttle commented that, as we are making a policy shift and that plays out, she expects we are going to see our figures look different. Mr. SigRist agreed and stated that one of the advantages we will have with the roll out of the risk management system is the ability to get real time numbers. Right now, we are reallocating, but our risk strategy will change.

Ms. Tuttle also commented on current happenings with the energy prices and that nobody knows which way this will go. She felt it will be useful to hear what that does to some of the decisions that are being made and thinks it would be useful when managers consider changes to our portfolio, as that will have a plan impact if this continues for a couple of months. Mr. SigRist replied that, in terms of reallocation in November-December, we had a series of conversions with credit managers and some of the energy managers to look at where we need to be able to add capital and remove dislocation. We will get some opportunistic investments in place. With internally managed portfolios, we have the ability to make changes in real time. We would seek guidance from the IAC in bringing in a strategist to address that area.

AGENDA ITEM – INVESTMENT COST EFFECTIVENESS STUDY

Alan Torrance of CEM Benchmarking presented to the group on investment benchmarking results for the 5-year period ending December 2013. Mr. Torrance reported that his company was thorough on data gathering and splitting data out, in order to show real costs and help clients make better decisions based on the data. Their study was looking at return vs risk for the NCRS, in essence what NCRS is spending versus what we are getting. Mr. Aneralla asked why organizations would provide data to CEM for their use and Mr. Torrance replied that they were given a comprehensive free report in exchange for that data. Mr. Jones asked what the relationship was between size and expense and Mr. Torrance responded that large funds have a lot of costs as they have more choice on ways to implement investments. It is not necessarily true that larger funds have higher gross returns, but net costs are lower due to economies of scale.

The peer group for NCRS was companies with a median size of $68 billion, versus our $82 billion. The peer group was also noted to be primarily DB funds, and included only two-three endowments. Our five-year net total return was 10.5% which was below both the US public median and the peer median of 12.1%. The five-year policy return of 10.4% was below both the US Public median of 12% and the peer median of 11.2%.

Cost information including fees, custodian fees and all costs were removed from the gross to provide the net return figures, which should line up with our financials. Mr. Torrance outlined some of the key results from the report. The NCRS five-year policy return was below the US Public median primarily because of the negative impact of the higher weight in one of the poorer performing asset classes (US Bonds) and the negative impact of the lower weight in one of the better performing asset classes (Stocks).

Our five-year net value added was 0.1% which compares to a median of 0.1% for peers and US Public universe and we had positive five-year value added in Stock, Fixed Income and Hedge Funds. We saw a negative in Real Estate and a positive in Hedge Funds. Mr. Torrance presented that our investment costs were $377.8 million in 2013 (45.9 basis points) which was below the peer median of 58.8 bps. Our peer group was made up of 16 funds around our size. We had an excess cost of 2.6 bps over the benchmark for 2013. It appeared that the slightly high cost was related to a higher cost implementation style with more fund of funds and the use of external active management. However, we were paying less than peers for internal management costs and oversight and custodial costs. We used less external active management than our peers.

Differences in Implementation Style – Looking at the figures, in the US Stock – Large Cap class, we were spending over $8 million more than our peers. Mr. Mebane asked if the data was showing that we could save $8 million by bringing management in-house. Mr. SigRist agreed this was possible, but that various factors come into play in the figures. It was also noted that in the Stock – ACWixUS and the Fixed Income – US categories, we were saving over $9 million each relative to our peers.

The net impact of paying more/less for external asset management costs added 1.1 bps – so it was important to consider what we get for what we pay out. Mr. Jones felt that the CIO and team should process the items we are paying much more for and work out what we're getting for our cash and consider entering into fee negotiations with managers, based on our peer group information. Mr. Torrance presented a performance chart for 2013 showing we were in the positive value added, high cost quadrant of cost effectiveness for that one-year period. It was also mentioned that our asset risk was 9.7%, below the US Public median of 10.5%.

Although not highlighted at the meeting, the Research section was available in the papers for the IAC to drill down into. Mr. SigRist concluded by reminding the IAC that we are low cost, but there are areas for improvement. He is of the opinion that this is a good management tool for oversight purposes. Mr. Hartzell asked if an implementation strategy would come out of this and Mr. SigRist confirmed it would. Five years of cost information was pulled together to develop it.

The Chair added that frustrations were seen in trying to make changes but having to go to legislature to ask for improvements. The impact will be tracked and shared with them. Mr. SigRist confirmed that metrics were provided by a third party to create independent reporting and assurances. Mr. Jones asked if this was the first time using CEM and, upon confirming it was, applauded the use of their services. He stressed that the next steps in using the data from the report would be important. The Chair agreed CEM provided really good data and that private equity challenges would be highlighted in the presentation later.

Mr. Mebane asked if anything stood out as a surprise to Mr. SigRist and his team from the research provided. Mr. SigRist commented that we have had various cost analyses provided, but this was definitely more useful. The Chair commented on the Growth of a Dollar slide and how does that tie in with the CEM data. Mr. SigRist responded that slide 3 of the research shows a comparison to Universe. Mr. Jones asked what the calculation was from that chart and Mr. SigRist replied that we want to be conservative. 20 bps of costs were added, but not a lot of return.

Mr. Torrance offered that certain things could be adjusted, like moving Passive vs Active. Mr. Jones asked if the difference between the positive value add and negative is the difference in fees. Mr. Torrance replied that they took an average of all US participant benchmarks for private equity. More work could be done and historic value added. The implementation style varies wildly by size of AUM – for example what is seen for $2 billion vs $40 billion is hugely different.

The Chair offered thanks to Mr. Torrance for attending and presenting to the meeting.

AGENDA ITEM – IAC CHARTER AND CODE OF ETHICS

Ms. Amy McDuffee of Hewitt EnnisKnupp attended the meeting to present to the IAC the results of the review of the IAC Charter and Code of Ethics. She reported that she works with pension plans around the country and that our Charter and Code of Ethics were created prior to the creation of the IAC. Some suggested revisions were offered to those documents, to align with best practices and actual practices, as well as to set consistency.

IAC Charter -- Overall, the Charter was generally accurate, however it was noted that no timelines were included which might have changed the natural flow of the IAC's schedule. Several updates were proposed and outlined in the Memo to the IAC, including a section on monitoring the cost effectiveness of the investment program and the reasonableness of benchmarks. Ms. McDuffee asked if the IAC felt comfortable with the recommendations.

The Chair offered that an external Compliance Counsel was involved currently and it would be useful to have that included in the Charter. The Chair also felt it would be useful to clarify the attestation clause outlined in section II. D. of the Charter and Ms. McDuffee agreed that the affirmation should relate to the Code of Ethics, not the Charter. Ms. McDuffee welcomed feedback on standards for the Code of Ethics. Mr. Jones confirmed he was comfortable with the ethics requirements.

Ms. McDuffee reported there was a difference in disclosure requirements for 3 members which might deter people in the future from serving and tweaks were being made to reflect that. Ms. McDuffee asked if the IAC felt that the disclosure section would be a deterrent to future members. Mr. Jones and Mr. Aneralla agreed they had no concerns.

The revised Charter would be presented to the February meeting for approval. Mr. Jones also requested a redlined version of the document to clearly show changes from the previous document, which would help in the review.

IAC Code of Ethics – Ms. Tuttle offered comments that (i) she felt language should be clearer relating to future IAC members working for investment firms and having to recuse themselves, etc. and (ii) that the items of responsibility should be re-ordered. She didn't feel that assessing themselves, for example, should be the second item of the list. Ms. McDuffee agreed that these changes would be made for the February meeting.

The Chair asked if there were any further comments or questions and there being none at this juncture, the Chair adjourned the meeting for a lunch BREAK.

The IAC then reconvened at 1:00 p.m.

AGENDA ITEM – PRIVATE EQUITY REVIEW

Mr. SigRist introduced the Private Equity section to the group and Mr. Demko, in particular, who gave an overview of his background prior to starting work with the DST in 2005.

Private Equity Allocation - Mr. Demko confirmed that Private Equity was below the policy target of 6% at 4.47% and that another $1.2 billion/year would be required to achieve the target. When looking at the policy relative to actual portfolio weights, we were still employing capital to venture but only continuing with high conviction managers. Looking at the GICS Industry Allocation relative to the S&P 600, we are underweight by approximately 8.75%, but we are not concerned with that. IT is underweight by 5%. Healthcare is overweight by about 7%, but we will likely see that reduced moving forward. Our geographic allocation is approximately 70% North America, 30% Europe/Pacific Rim.

Private Equity Performance – the PE IRR through June 30, 2014 is 7.97% which will likely decline. The time weighted performance is lagging the benchmark – the benchmark presented is the Burgess Group Private 1Q Universe. This is 50% buyout, 30% special situations and 20% growth/opportunistic - which changed recently to best fit our needs. Mr. Demko confirmed that one of the challenges had been NC's 100% exposure to VC in the early years vs others. Mr. Jones asked what their definition of VC was and Mr. Demko confirmed it was seen as minority investments or in smaller companies – it was not revenue generating, or if so, very small.

Mr. Mebane asked, looking at the 10-year period, why the benchmark was improving over time. Mr. Motaparthy replied that our PE portfolio was much smaller and that numbers from PE are mismatched over time. We were also out of the market for a few years. Ms. Tuttle commented that we are seeing a lot of business trade due to high PE returns.

Mr. Demko raised items he was soliciting feedback from the IAC on.

Pacing/Vintage Year Diversification - As the target allocation is 6% vs the actual 4.47%, do we continue to be active but remain underweight reflecting market conditions, or should we aim for a disciplined Vintage Year diversification approach, adding on contributions over a 4-5 year period and relying on Managers, such as Avista Capital, who has shown discipline when putting money to work. Mr. Jones asked what Mr. Demko's inclination was and he commented he would be inclined to continue with the $1.2 billion pacing, that in his experience he has seen a disciplined investment approach by NC's existing managers. He was also concerned North Carolina may not get a 'seat at the table' with some of the high service managers if we were to interrupt the relationship by skipping a fund. Mr. Jones offered that his opinion was the big picture comes first from asset allocation and where you buy in the next cycle. Companies were being valued at all-time highs and he suggested we might hold the $1.2 billion, based on experiences in 2006.

Mr. Aneralla asked for clarification on our not getting a 'seat at the table' if we don't put in a certain level of money. Mr. Demko gave an example of a fund launching that we had been talking to for a year and they were aware of our timescale for involvement however, they had so much interest that they just moved forward and cut us out as we couldn't move fast enough. NC's ability to participate in the next Fund may be challenged. Mr. Mebane asked if we even fit this type of cycle and market and, if we don't, where do we put our money.

Mr. SigRist replied that overweights and underweights and various allocations are a consideration. If we are underweight in PE, we will be overweight somewhere else. Mr. Jones offered that returns are to be related to the risk - we might take the risk but not get the return. Ms. Tuttle mentioned that commitment to a fund does not mean you get the investment active this year. With respect to the issue of fees, there is something to be said with sticking to the fund discipline.

Portfolio Construction - Mr. Demko presented his next area for discussion - whether we tilt our portfolio away from Buyout toward Special Situations to take advantage of market inefficiencies, or do we adhere to our target allocations. We are at target for Buyout if we don't continue to adhere to allocations that will slide.

Number of Relationships/Size of Commitments - Mr. Demko raised that we have over 60 Fund Managers managing over 100 Funds. The question arose as to whether it was time to simplify the number of funds and relationships. We are more heavily skewed on Idiosyncratic Opportunities. As an example, North Carolina is the only new group being considered by a high conviction manager – if North Carolina did not participate now, it's unlikely North Carolina would be able to participate in a subsequent fund. On the other side of the spectrum, we have "Blue Chip" funds. We had discussed several options with relation these larger funds. It was noted some have a very diverse investment strategies.

Mr. Hartzell offered that we might want to consider a middle ground stance, as we don't have to take an 'all or nothing' approach. Mr. Aneralla thought it was interesting that funds do not want to take our money. Mr. Demko responded that many have small growth plans, where they still want to grow but within their own defined plan and time. Mr. Jones offered that long-term investments might be better vs short term.

Geographic Diversification - Mr. Demko raised the issue of whether we should take a systematic geographic target allocation or have it be opportunistic. Mr. SigRist commented that it is not part of a strategic plan currently – we look for opportunities to invest where it makes sense and that Europe may continue to develop.

Thanks were offered to the IAC for their input.

AGENDA ITEM – MARKET-ORIENTED COMPENSATION STUDY

The Chair welcomed Mr. Wilson and Mr. Mason of Mercer to present their Statement of Compensation Objectives to the IAC. In addition, Kristen Bierline from HR and Thom Wright, Project Manager had been consulted on the study. Messrs. Wilson and Mercer gave an overview of their backgrounds to the IAC.

Mr. SigRist gave an overview that, following last year's legislation we had been looking to get the authority for a study on human capital risk and compensation with a view towards reviewing the current compensation program and Mercer had been engaged.

Mr. Wilson outlined the Phases of the Process: Planning and Strategy Development; Competitive Pay Assessment; Compensation Framework Design; and Communication of Results. They had not had an opportunity to speak with anyone in the Legislature yet, but had liaised with the IMD, members of the State Treasurer's Office, the IAC and other stakeholders from the State of North Carolina.

In developing the Statement of Compensation Objectives, they had considered Pay for Performance, which is what you would see in most private entities. They had also considered whether there should be an Incentive Plan in a state organization. The IAC generally thought that was a good idea and those inside the DST agreed, but were more aware of the challenges in implementing such a plan. It was concluded that an Incentive Plan was not the best result for the DST. The Chair offered that the DST currently has no authority to give increases or bonuses, despite trying to move forward on discretionary powers to do so.

Mr. Mason informed the IAC that 40% of public pension management have bonus systems. He is concerned that by implementing such a structure in NC, the DST would lose some of the ground already gained and suggested that base salaries should be the focus, rather than bringing in an incentive plan. The Chair responded that the perception around bonuses have been affected following the issues around bonuses in the Banking Commission. Mr. Solari offered an opinion that the legislature, generally speaking, does not feel bonuses should be given. Mr. Mason confirmed that paying bonuses in this leglative environment is difficult.

Mr. SigRist confirmed we are currently paying around 30% below market rates for salaries. Mr. Jones asked if there would be any meaningful distinction between a bonus and a supplemented payment to the employee's retirement plan, for example. Would that stand up to scrutiny? Mr. Solari offered that the high turnover rates are the reason that the legislation was authorized and if a plan addressed this this, then the idea might be less negatively perceived. Ms. Tuttle asked if staff would get to keep their vesting if they leave the DST. She also inquired what morale is like right now. Mr. SigRist responded that most staff have come from the private sector and are used to a bonus system or, if they were not receiving regular increases, they would take that as an invitation to leave their job. Mr. Wilson confirmed that the most successful funds have a stable staff base. Compensation is only a small part of the picture, but people are frustrated about pay levels at the DST.

Statement of Compensation Objectives – Mr. Mason presented the prepared statement to the IAC. This was drafted bearing in mind the need to recruit and retain good staff. The ideal situation would be to position DST around the 60th percentile of comparable organizations for salary level. Mr. Mebane asked that states that are underperforming not be included in the benchmark salary analysis (e.g.

Illinois). Mr. Jones felt it would be advantageous to develop a matrix showing continuity of individuals linked to the performance of the funds as a better selling point than just comparing figures.

The Chair asked if the IAC felt the suggested 50-75% range sounded like an acceptable range for the DST and they agreed that it was. Mr. Demko asked if the AUM should be a consideration and Mr. Mason felt that internal and external managers could be a factor. Mr. Mebane felt Mr. SigRist should have some idea of levels he would like to see for the staff. Mr. SigRist responded that if we could get to the median for investment-related roles, we might not be able to push it higher from that point.

Mr. SigRist confirmed he would like to see compensation structure changes for roles of Investment Managers, Directors, Portfolio Managers, Analysts, and he had included General Counsel due to the fiduciary role and the financial managers, CFO etc., due to the key audit issues they deal with.

Mr. Aneralla asked if Mercer was planning to circle back to employees on the compensation structure. Mr. Mason confirmed that, while not a formal step in the process, they could do that if required. Mr. SigRist felt they were pretty transparent about compensation and communicate well with staff. Mr. Mason confirmed they had had employee buy-in on getting the base salaries fixed.

Mr. Mebane asked how many new staff we were planning to hire and Mr. SigRist said that there were 10 new positions and some vacant positions to fill, so 50-60 people would be covered under the new proposed compensation plan. Mr. SigRist asked the IAC what kind of involvement they want to have in the discussions on this and Mr. Jones suggested that they only need to be contacted if it was felt they could offer value to the process. The Chair also suggested that if things deviate wildly from the recommendations in the proposed compensation plan, that the IAC be informed. Further feedback would be given at the February meeting.

AGENDA ITEM – PUBLIC COMMENT

There were no public comments.

ADJOURNMENT

The meeting was adjourned at approximately 2:48 p.m.

APPROVED BY: ______________________________

JANET COWELL
STATE TREASURER AND CHAIR