NORTH CAROLINA DEPARTMENT OF STATE TREASURER
INVESTMENT ADVISORY COMMITTEE

MEETING MINUTES FOR FEBRUARY 15, 2018

Time and Location: The Investment Advisory Committee ("IAC" or the "Committee") met on Thursday, February 15, 2018, in the Dogwood Conference Room of the Longleaf Building, 3200 Atlantic Avenue, Raleigh, North Carolina.

Members Present: The following members were present: State Treasurer Dale R. Folwell (Chair), Mike Mebane, John Aneralla (via phone), Lentz Brewer (via phone), and Steve Jones (via phone).

Members Absent: David Hartzell, Greg Patterson

Staff: Ben Garner, Linda Nelson, Brett Hall, Frank Lester, Joan Fontes, Edgar Starnes, Kim Baker, Craig Demko, Chris Farr, Ronald Funderburk, Renee Guerin, Karen Hammond-Smith, Sam Hayes, Casey High, Gail Kadash, Patrick Kinlaw, Kathy Kornak, Matthew Krimm, Fran Lawrence, Troy March, Neal Motaparthy, Tinh Phan, Loren de Mey, Christopher Morris, Meryl Murtagh, Ty Powers, Laura Rowe, Norman Schiszler, Jeff Smith, Rhonda Smith, Tessa Tanis, Greg Taylor, Steve Toole, and Chris Ward

Others in Attendance: Hazel Bradford – P&I (phone) and Lee Cohen – Wellington Capital Management

AGENDA ITEM – OPENING REMARKS

The meeting was called to order at approximately 9:00 a.m., the Chair, Treasurer Folwell began the meeting by leading the Pledge of Allegiance.

The Chair confirmed a quorum was met then asked the Members present to declare any conflicts of interest and, there being none declared, the meeting commenced.

AGENDA ITEM – APPROVAL OF MINUTES

The Chair then asked for approval of the minutes of the quarterly meeting held November 16, 2017. Mr. Mebane moved to approve the minutes, Mr. Jones second the motion and the committee approved. A quorum of Members was present, and the meeting, having been duly convened, was ready to proceed with business.

AGENDA ITEM –PERFORMANCE UPDATE

The Chair recognized Jeff Smith and Chris Morris to present the Performance update. Mr. Smith provided a brief update on the cost-efficiencies initiative underway in the Investment Management Division (IMD). He noted the initiative has increased from $67.8 million to an approximate annual savings of $76.2 million over the past quarter.

Mr. Smith then provided an update on the US economic environment for the past quarter with a brief mention of the current quarter changes. Volatility and inflation showed up late in the first quarter. This was the ninth straight quarter with an increase in the S&P 500, and the lowest level for the VIX since 1993. Corporate bonds had high supply and demand, the Federal Reserve increased the short term interest rate by 25 basis points. Emerging markets outpaced developed markets. Since the calendar year end, the spike in volatility has pressured Equity markets. Treasury yields have also reached their highest level since the spring.

Mr. Smith then turned the floor to Chris Morris. Mr. Morris presented an update on current assets under management, as of December 31, 2017. He noted that the Department has close to one hundred twenty-eight ($128) billion in assets under management. Assets for the North Carolina Retirement Systems (NCRS) surpassed $100 billion mark for the first time ever in January, prior to the market correction in February.

Mr. Morris reviewed current NCRS asset allocation, noting that the plan remains underweight growth assets by 3.86% and overweight rates and liquidity by 3.39%. Mike Mebane pointed out how difficult it must be to maintain the target asset allocation weights during volatile markets. Mr. Morris agreed, stating that we monitor cash flows and liquidity closely to try and maintain the long term targets, and try to have as much flexibility as we can to be able to react to volatility. Mr. Morris continued onto the total net portfolio returns vs. benchmarks slide referring to the remarkably consistent positive returns for all 2017, and lack of volatility. Every asset class in every quarter had a positive return, leading to the strongest performance since 2009 & third highest since 2000. NCRS exceeded the 7.2% actuarial rate of return for 1 and 5 year time periods, and exceeded the implementation benchmark for all time periods except for 3 month period. Returns have been flat for the year 2018 through the first half of the first quarter. Mr. Morris moved onto the growth of a dollar chart, stating that margin of outperformance versus the long-term policy benchmark has grown in the last several years, similar to what has been shown in prior meetings.

Mr. Morris walked the committee through the return attribution charts, highlighting that the value-add versus the implementation benchmark has been driven by selection effect for the 1, 3, and 5 year time periods. He continued with the universe comparison, gross of fees. During strong equity the portfolio typically lag our peers given our higher allocation to fixed income, and lower allocation to growth assets, primarily public equity. With the higher allocation to fixed income, NCRS' risk profile is lower than most of the peer group

Mr. Morris discussed liquidity and the newer slide that provide insight on monitoring liquidity. He then provided an example: should all unfunded commitments be drawn instantaneously, we would still have roughly 60% in level 1 liquidity. Mr. Morris confirmed that the fund currently has about $8.5 billion in unfunded commitments. The slide referencing the net benefit payments by calendar year was explained, the Chair questioned the 2016 increase, and Mr. Toole advised that legislation passed a one-time benefit payment, lumped into one payment and that pushed it higher than normal.

Chris Morris finished up the performance review with an overview of the alternative assets liquidity profile; at year end inflows were $1.2 billion; with $4.4 billion in contributions and $5.6 billion in distributions received back both net of fees. Mr. Morris ended by stating we continue to monitor these flows.

Mr. Smith point out a new slide that provides the total unfunded private asset class commitments and a chart referencing the strategic allocation policy. Conversation developed over best practices around determination of the strategic allocation, with each asset class advising how they monitor and model cash flows and commitment projections. Account setup is a factor in monitoring cash flows as separate account structures allow for more control over capital deployment. Mr. Smith concluded by stating that unfunded liability dropped from $11.6 billion in 2016 to $8.4 billion in 2017. There were no exited investments during the past quarter.

AGENDA ITEMS – POLICY REVIEW

Treasurer Folwell introduces new legal team members, Ben Garner and Linda Nelson.

Meryl Murtagh then provided a brief policy update/refresher identifying two main categories of policies: ethics and investments. Some policies are specific to the Investment Division, others are applicable to the entire department. She then reviewed the list of policies which had been updated or would be updated in fiscal year 2017 – 2018, namely: the Insider Trading Policy, Investment Valuation Policy and Procedure, the Signatory Authority Policy, the Proxy Voting Guidelines, and the Supplemental Ethics Policy for State Treasurer, Senior Executive Staff and Investment Division.

The Investment Advisory Committee board members had no questions. The Chair suggested they get to know these policies, and emphasized that compliance is key.

AGENDA ITEMS – CAPITAL MARKET ASSUMPTION UPDATE

Christopher Morris introduced the risk team, Matt Krimm and Renee Guerin, stating their value add since joining the division.

The primary driver of this update is for a discussion over whether a new asset liability study should be done immediately. In years past, IMD relied on our actuary to provide data, modeling out the scenarios. However, the actuary has been recently replaced and is still being transitioned. If deemed necessary to prepare the study now, the new actuary could not be used, requiring us to outsource the study which would not be cost efficient.

In July 2014, we changed our strategic allocation, restructuring the portfolio and its sub-categories. The portfolio was broken down with a focus on the function of different assets into the following groups; return seeking/growth; risk reducing/ rates and liquidity; inflation sensitive and diversifiers; and lastly multi-strategy. The main changes were splitting up real estate assets between core and non-core within the growth, and delineating the inflation sensitive/diversifier categories.

In 2016, an updated asset liability study was conducted and the IAC supported IMD's recommendation that no changes to the strategic asset allocation were necessary at that time.

Mr. Krimm explained why an asset liability study is important and reviewed the typical process. The study is essential to setting our policy targets, optimizing what the best long term allocation is for our portfolio. Previously acting as our actuary, Buck Consultants (now known as Conduent) provided forecasts; IMD staff also surveyed other parties, then modified Buck's forecasts based on the other third party forecasts and internal convictions to formulate reasonable 10/20/30 year expectations. Ms. Guerin reviewed the capital market assumption process and an update on industry expectations. Market expectations have come down modestly since the last study in 2016 compared to the data we have throughout 2017. Underlying data is starting to come in for 2018 expectations and show the same downward trend.

Key takeaways: Capital Market Assumptions around returns have come down modestly. Return expectations for high quality fixed income have moved slightly higher as interest rates trend upward.

The recommendation at this time is that there is no urgent need for a full Asset Liability Study. Ms. Guerin stated that we are comfortable where we are, given that none of the inputs have significantly changed. This will be revisited once Cavanaugh Macdonald, the new actuary, is fully in place closer to year-end.

Mike Mebane restated that 3-5 years is best practice for Asset Liability studies. He continued that Treasurer Folwell, as sole fiduciary, has come in during a time with variability in the death studies and other drivers on the liability side. He then confirmed agreement with the recommendation – to complete an asset liability study with the new actuary once they are in place.

The Chair also stated that we are working on a sustainability plan this year which will greatly impact the liability side and due to the timing, agrees with the recommendation.

AGENDA ITEMS – INVESTMENT GRADE FIXED INCOME ASSET CLASS REVIEW

Jeff Smith and Brett Hall are introduced and also introduced their other team members. Mr. Smith also gave a note of thanks to Matt Krimm and Renee Guerin for their contributions to the Division.

Mr. Smith started by stating in brief, they will review the fourth quarter but also touch on the recent trends of 2018. Then turned over to Brett Hall to provide the Short Term Investment Fund (STIF) summary. Mr. Hall stated that the front end rates have increased enabling us to purchase at a higher rate. He then discussed treasury ratios being roughly 55-60% in the 1 year range. The STIF historical rate is the current rate vs iMoneyNet as a benchmark.

Mr. Smith reviewed the Investment Grade Fixed Income profile as 90% fixed/10% cash, with an underweight to duration in the long term. He then provided the categorical weightings shown in the presentation. In summary, returns remained in the same place over the last three years. Remaining short duration to reduce interest rate risk worked against the plan as rates grinded lower. However, the portfolio has outperformed the benchmark so far in 2018 due to rising rates.

Brett Hall reviewed the 10 year spread history which came down from the high 700’s to mid 300’s. US agencies has been tightened to roughly 4 basis points. Spreads have depressed closer to what we call fair value. Sectors have tightened to each other. We are slightly overweight energy and telecomm.

Mr. Smith explained that our projections are bearish on the near term returns for fixed income. There is a price return component to fixed income as opposed to the thought of just clipping your coupon and moving on. It’s a bad near term story, but the plus side is yields are the basis for expected returns for a 10 year basis. Mr. Smith explained that the worst case scenario is we stay where we are. The value of the long duration is it typically serves a great hedge during a market correction.

As an illustration of how inflation is impacting the portfolio, Mr. Smith highlighted the difference between the portfolio and the benchmark. As of meeting date returns are -3.0% CYTD and the benchmark is around -3.4%, or roughly a 40 basis point difference.

Mr. Aneralla questioned: what would you look for to feel more comfortable going longer out/taking on duration risk? Mr. Smith responded that more clarity is needed over what the fed’s actions are going to be, including what the new policy changes are going to be. If we backed up another 50 basis points we would take a hard look at what that means for us. If we started to invert, our tune would change greatly.

AGENDA ITEMS – OPPORTUNISTIC FIXED INCOME ASSET CLASS REVIEW

Treasurer Folwell introduced Ronald Funderburk, the asset class director.

Ronald Funderburk began by giving credit to Renee Guerin, Norman Schiszler, and Matt Krimm for their hard work and collaboration. Mr. Funderburk believes Opportunistic Fixed Income's (OFI's) investment mandate is to provide attractive absolute returns, competitive relative returns, diversification, capital preservation, and deflation protection. He further reviewed the portfolio components and underlying strategies associated with the mandate.

Next he discussed the portfolio composition and noted the manager makeup, stating that as our exposure has grown, the manager count has remained relatively low. The investment strategy emphasizes high conviction managers with flexible investment mandates that rotate into the best investment opportunities as they evolve. Currently we have a total of 38 funds managed by 21 managers. Since inception, OFI has performed well on a risk adjusted basis. The portfolio is doing what it was created to do as indicated by the return, volatility, and correlation metrics relative to the portfolio's benchmark. The special situations subcomponent has materially outperformed expectations. We've been able to take advantage of our separately managed accounts and will continue to do so going forward. This approach allows us to obtain favorable economics, enhanced governance, and the flexibility to capitalize on market opportunities as they emerge.

Accomplishments since the OFI team last presented to the Investment Advisory Committee include continued allocation to high conviction managers, reduced exposures to hedge fund of funds, increased exposure to the traditional corporate credit subcomponent, took advantage of the 2016 spread widening, negotiated favorable fees, and transitioned one manager to the Managed Account Platform (MAP).

Mr. Funderburk commented on the market environment. The default rate is low for both high yield and bank loans, another key as to why we should not be fully allocated to distressed credit. The underweight has been helpful to the plan to date.

Takeaways: we are not excited about the current credit environment. Less than 30% of the high yield index trades below par. Not a lot of attractive opportunities to take advantage of in high yield at this time. We will continue to be disciplined investors, monitoring valuations, and currently, we do not see a near term catalyst to create a dislocation with the exception of inflation. However, we want to create investment capacity in order to take advantage of dislocations that may arise.

On a select basis, energy and middle market private lending remain attractive.

Mr. Funderburk summarized his current thinking on strategic considerations, noting he wants to maintain the underweight to credit, as spreads widen we will tactically close the gap, and if spreads maintain we may incrementally close the gap on a select basis. We will continue to utilize our relationships with high conviction managers.

AGENDA ITEMS – CIO SEARCH UPDATE

The Chair mentioned he met with two IAC members (Mr. Hartzell and Mr. Jones), in between advisory board meetings to discuss the CIO search. He is updating the job description to match the mission of the plan and the philosophy of the administration. The Chair is expecting to have the position posted by the end of the second quarter 2018.

AGENDA ITEMS – IAC MEMBER Q&A

IAC Members were provided with the opportunity to pose questions to the Treasurer and IMD staff. No questions were posed.

AGENDA ITEM – PUBLIC COMMENT

No public comments were made.

ADJOURNMENT

Treasurer Folwell made closing remarks thanking the staff and in remembrance of the fallen officers and first responders recently lost here in North Carolina. He noted that he views the responsibility of his position through the perspective of all state workers. He thanked everyone for their attendance and input. Mr. Jones moved to close the meeting, seconded by Mr. Mebane. The meeting was adjourned at approximately 11:30 am, without objection.

____

DALE R. FOLWELL, CPA
NORTH CAROLINA STATE TREASURER AND CHAIR