NORTH CAROLINA DEPARTMENT OF STATE TREASURER
INVESTMENT ADVISORY COMMITTEE

MEETING MINUTES FOR AUGUST 23, 2018

Time and Location: The Investment Advisory Committee ("IAC" or the "Committee") met on Thursday, August 23, 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), Greg Patterson, John Aneralla, and Mike Mebane (via phone)

Members Absent: Lentz Brewer, David Hartzell

Staff: Craig Demko, Ron Funderburk, Ben Garner, Renee Guerin, Brett Hall, Sam Hayes, Casey High, Gail Kadash, Matt Krimm, Nick Langley, Fran Lawrence, Frank Lester, Troy March, Loren de Mey, Chris Morris, Neal Motaparthy, Ty Powers, Jeff Smith, Rhonda Smith, Greg Taylor, Chris Ward, Jack Wilson, and Meryl Murtagh (via phone)

Others in Attendance: Lee Cohen (Wellington), Jack McGowron (T. Rowe Price), Greg Williams (WMC), Jim Baker (public), Karen Brown (public), Wendy Kaltenbach (public), Ann Marie Reinhart (public)

AGENDA ITEM – OPENING REMARKS

The meeting was called to order at approximately 1:30 p.m., the Chair, Treasurer Folwell began the meeting by leading the Pledge of Allegiance. A quorum of Members was present, and the meeting, having been duly convened, commenced.

The Chair asked the Members present to declare any conflicts of interest and, there being none declared, the meeting commenced. Roll call on the phones: none at this time.

AGENDA ITEMS – RESOLUTION FOR OUTGOING MEMBERS

The Chair recognized outgoing board member Steve Jones, years of service: 2010-2018. The Chair provided a description of Mr. Jones' term and thanked him for his service.

AGENDA ITEM – APPROVAL OF MINUTES

The Chair then asked for approval of the minutes of the quarterly meeting held May 17, 2018.

Mr. Patterson moved to approve the minutes, Mr. Aneralla seconded the motion and the committee approved.

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 $80.6 million to an approximate annual savings of $86.7 million over the past quarter. A large portion of this increase being attributable to Public Equity, who Mr. Smith noted will present later in the meeting.

Mr. Smith then provided an update on the US economic environment for the past quarter with a brief mention of the current quarter changes. Positive geopolitical developments with improved relations between the US and North Korea. Lower volatility levels than what we saw in the first quarter. Positive economic growth and strong jobs numbers. May unemployment hit the lowest levels since 1969 at 3.8%. We saw the Fed increase rates 25 basis points in June. The markets are expecting one more rate increase in September, and roughly a 60% chance for an additional increase in December. ECB indicated that there would be no rate increases until summer 2019. Yield curve rates moved higher and the curve continues to flatten. TIPS market has stayed where it has been, breakeven hovering around 2%. Mr. Smith pointed out a statement from a JP Morgan piece that he thought summed up market positioning at this stage in the economic cycle; "The closer you get to the end of the party, the closer you should dance to the coatroom." Mr. Smith then turned the floor to Chris Morris. Mr. Morris updated that as of June 30, our assets under management were $129.2 Billion, up about $1 Billion since last quarter. $2.7 Billion were paid in net benefit payments last year, we are roughly on pace for that again this year. This equates to $200-300 million paid monthly in net benefit payments.

Mr. Morris reviewed current NCRS asset allocation. The plan continues to be underweight Growth assets by 4.4%. This underweight is split out across Public Equity, Private Equity, and Opportunistic Fixed Income, with a slight overweight to non-core Real Estate. The plan continues to be overweight Rates and Liquidity, mainly due to cash (3.45% overweight). The plan is maintaining a slight overweight to Inflation Sensitive and Diversifiers and a neutral weighting to Multi-Strategy. Since June, our underweight to Public Equity has grown as well as our overweight to cash. This was due to the unwinding of a hedged equity portfolio. Mr. Morris explained that the plan felt that we could get the same exposure as the .4 beta portfolio with much less cost by putting part of it in long only passive equity and the remainder in cash. Although the weightings have changed, from an exposure perspective we are at the same place following the transition, while saving more than $3 million annually.

Mr. Aneralla asked what the average duration is for Investment Grade Fixed Income. Mr. Smith answered that the average duration is around 7 years, on a relative basis we are still short the benchmark.

Mr. Morris continued onto the total net portfolio returns vs. benchmarks slide. The plan returned 1.1% in the second quarter, driven by strong returns in Private Equity and Non-Core Real Estate. The plan returned 7.3% over the fiscal year; beating the 7.0% actuarial return. Only the 1 and 5 year periods exceeded this actuarial return. On a relative basis, the plan outperformed both of the benchmarks this quarter. The plan has outperformed both benchmarks over all time periods except for 15-year period where we are even with the long term policy benchmark.

Mr. Morris moved onto the growth of a dollar chart. For the 5 and 10 year charts we have a similar story to the last few quarters. For both time periods, our portfolio outperformed the long term policy benchmark. On a 5-year basis the alternatives portfolio has added value versus the long term policy benchmark, but over the 10-year term it still lags primarily due to drawdowns during the financial crisis. It will be interesting to see how that chart changes as the financial crisis downturn begins to roll off.

The Chair asked, instinctively what do you expect these chart will look like when the downturn begins to roll off? Mr. Morris responded, it will depend on the chart. For the universe comparison chart where we compare ourselves to our peers, because our portfolio is more conservative than our peers and we typically lag during bull markets we will start to look worse in those charts due to the decade long bull market. In other charts, we will see better performance due to the financial crisis rolling off of the 10 year charts. It will depend on the metric that you are looking at, but it will change some of the story.

Mr. Morris then described how each asset classes contributed to the total plan return. Mr. Morris noted Public Equity had a strong return at 12% for the year and also is our largest allocation at 40%. That equated to earnings of $4.5 billion for the fiscal year. From a return perspective, Private Equity was our best performing asset class returning over 16%. However, it has a much smaller allocation at 5%, equating to earnings of $784 million for the fiscal year. Alternatives as a group returned $2.5 billion in earnings over the fiscal year. Mr. Aneralla asked what the allocation to total alternatives is. Mr. Morris summarized it is about 30%, the plan is roughly 40% public equity 30% fixed income, and 30% total alternatives.

The Chair asked what the current yield is on Fixed Income. Mr. Smith replied that the currently yield is about 3.5%. A discussion ensued around marked to market valuations in fixed income versus realized returns when held to maturity.

Mr. Morris walked the committee through the return attribution charts. He highlighted selection effect vs allocation effect. The value add to the plan for the fiscal year of 126 basis points was driven by selection effect. Allocation effect had a negative impact of 44 basis points, while selection effect had a positive impact of 170 basis points. The largest asset class contributors to selection effect was Public Equity at 75 basis points and Opportunistic FI at 45 basis points, with every asset class having a positive selection effect.

Mr. Morris continued on to the peer universe comparison charts summarizing that our fund has a more conservative asset allocation than most of our peers. Higher allocation to Fixed Income, higher quality Fixed Income as well, and a lower allocation to some of the growth assets specifically Public Equity. We typically see that we lag from a return perspective in stronger economic environments, but over a full market cycle we do well. That is how we have positioned ourselves, we have less upside but much less downside in market downturns.

Mr. Morris discussed our liquidity profile and the process for monitoring liquidity. We have a policy target to have greater than 70% in level 1 liquidity assets. Level 1 liquidity is assets that we can get to immediately if needed. Currently we have about 73% in level 1 liquidity assets.

As for net benefit payments, $200-$250 million is paid out on the first business day of each month. The last few years we have averaged $2.7 billion in net benefit payments annually and we are on track to do roughly the same this calendar year. In the second quarter of this year, net benefit payments were $700 million.

Mr. Morris continued on to the Alternatives liquidity profile. The chart shows contributions vs distributions over a 12-month period. We are cash flow positive in aggregate by about $1.8 billion. This is consistent to what we have been seeing and what we expected.

Mr. Smith talked about net of fees performance. Mr. Smith pointed out the strong performance of Core Real Estate among the Inflation Sensitive & Diversifier asset groups. We believe that we are definitely adding value with the Private Equity asset class. Net of fees, private equity has outperformed public equity in every time period except 10 year.

Mr. Smith discussed the variation in how all asset classes have performed each of the last 10 years. Tracking how asset classes have changed illustrates why diversification is so important.

Mr. Smith discussed new and incremental investments. Presently, the plan has unfunded commitments of $8.5 billion, down $800 million from the last IAC meeting. Mr. Aneralla asked, of this unfunded what are we paying fees on? Mr. Morris replied that it depends on the strategy, but we are paying fees on some of this unfunded. We have tried to reduce the amount that we are paying fees on but typically will be paying fees on anything that is in the investment period.

Mr. Smith continued on to the Strategic Asset Allocation Policy History. There have been no changes made to the strategic asset allocation since 2014. We might be having discussions in the next year or so that could alter the strategic asset allocation.

Mr. Smith touched on exited investments. The only investment being a public equity fund. The Public Equity team will expand upon this investment later on in the IAC meeting.

Mr. Smith asked for any questions from the board. With no questions posed, he passed the meeting over to The Chair.

AGENDA ITEMS – PUBLIC EQUITY ASSET CLASS REVIEW

The Chair announced that the board would need to revote on minutes. The motion to accept minutes was made by Mr. Patterson and was seconded by Mr. Aneralla. All board members said aye in favor of approving the minutes.

The Chair introduced Rhonda Smith, the Public Equity Asset Class Director. Joined by portfolio managers Casey High and Greg Taylor.

Ms. Smith stated that there haven't been too many changes to the asset class since we last met in November.

Ms. Smith started with a snapshot of Public Equity. The asset class is holding steady at $39 billion AUM. The chart on slide 2 reflecting the number of mandates has changed slightly for the period ending June 2018, with hedged equity mandates down to 4 from 5 due to a portfolio reallocation within hedged equity as detailed later in the presentation. The allocation breakdown has remained stable, at approximately 50/50 us equity/non-us equity. There have been some slight differences in the active vs passive allocation. The difference between December and June on the active allocation is a reflection of a capital call that we had in one of our midcap active strategies. There was some unfunded capital remaining but as of July we are now fully allocated across all public equity strategies.

Mr. Aneralla questioned, out of the passive portfolio, how much is internally managed? Mr. High responded that it is a little over $10 billion currently. Ms. Smith continued: over time we have steadily increased our passive exposure. Mr. Morris replied that $10 billion of the $40 billion equity portfolio is managed internally. The Chair added that the internal number is scheduled to be $14 billion by the end of the year. Rhonda Smith added that all of our domestic passive equity will be managed in house by end of the year.

Ms. Smith summarized that Public Equity had positive performance for the quarter and for the year, largely driven by our Non-US portfolio. Despite the broad market reflecting strong domestic performance over Non-US, our Non-US portfolio led the charge on a relative basis. On an absolute basis, our US portfolio also performed well. We maintained positive performance across all time periods with the exception of the 3-year period where our domestic portfolio slightly trailed the benchmark due to underperformance within our mid and small cap portfolio composites. Nothing to be concerned about at this time – some of the strategies simply struggled as their styles were out of favor and not being rewarded by the markets as growth outperformed value for the period. Small cap outperformed large cap in the markets, however, NCRS large cap performance was strong and outperformed both mid and small cap composites. Hedged equity underperformed for the quarter driven largely by our Japanese activist strategy, but this was offset by strong performance from our market neutral strategy.

Mr. Patterson asked what guides the decision to allocate towards us equity and non-us equity. Ms. Smith replied that we have internal targets derived from the asset allocation study that we did as a plan. We have a target range which we manage, and we try to keep within those targets. Mr. Patterson followed up by asking, are there any decisions made tactically why we manage in and out of different markets? Ms. Smith responded, that we tend to have a longer term outlook and we understand that there is going to be volatility in the markets, but given our long-term outlook, we plan to ride out that volatility. Mr. High added the MSCI ACWI IMI is our long only benchmark, we don't take many tactical bets around that. Mr. Morris added that we made a decision 10 years ago on a policy level to go with a more global benchmark. Prior to that we had more home country bias, but now we feel as though we are properly allocated.

Mr. Taylor provided structural analysis of the equity portfolio. We still have a 4% underweight to US equities, mostly US large cap. There is a broadly equivalent overweight to international large cap. That is our primary source of misfit risk against our benchmark.,

Mr. Taylor discussed portfolio updates. The first being the implementation of a new low cost quasi-passive equity investment allocation in the coming weeks. This allocation will be split into two parts; a newly created domestic passive portfolio which will take $400 million of the $600 million total allocated to the new investment allocation and another $200 million will be managed externally within a Non-US passive approach. For the internal piece, the only distinction from the existing internal strategies is that we will receive data from the external manager for the trades that will be made internally. The remaining $200 million earmarked for the Non-US passive portfolio will be externally managed where the same manager will trade on our behalf. Mr. Aneralla asked why we were not bringing the international equity internal at this point. Ms. Smith answered we still do not have all of the necessary resources in place, and if not implemented correctly it could end up costing us more. Mr. Taylor added that we hope that this is a step in the direction of bringing other assets in house.

Mr. Aneralla asked about our positions in Facebook, did that get liquidated or do we still hold it? Mr. High answered that our holdings in Facebook were $282 million as of 2 days ago. Mr. Taylor added that not holding a position in Facebook would create some tracking error against the index within our passive portfolios.

Mr. High started by reminding the board that at our meeting last November we had just launched our US equity internal passive portfolios with $100 million. We added a third portfolio in March, and will be adding a fourth soon when we take over the strategy Mr. Taylor spoke about. The graph on slide 7 shows how the internal portfolios have grown as of June 30, we had over $9.6 billion being managed internally. By year end, we expect that number to be approaching $14 billion. This growth has been primarily from contributions as we have drawn down from our external managers.

Mr. High moved on to performance. So far we have successfully been able to meet our objective of replicating the indices with very little tracking error. The tracking error is 3 basis points for the Russell 200 internal and 6 basis points for the Russell midcap internal. The tracking error is an annualized number that measures the volatility of excess returns, so over the full year we expect those to be lower.

Mr. High then spoke on the Russell midcap value index. This strategy was implemented in March and therefore has a shorter performance history relative to the Russell 200 and Russel MidCap portfolios. It is smaller than the other two portfolios at roughly $400 million, but we are realizing a cost savings by managing internally and it has not meaningfully increased the team's workload.

Ms. Smith announced that the equity internal trading desk has passed the EAGLE assessment, a program conducted to reflect the need for "Enhancing Accountability in Government through Leadership and Education" (EAGLE). Department of State Treasurer's Internal Audit Division along with the Financial Operations Division performed testing on internal controls over financial reporting for the internal trading desk and Internal Audit issued a memo on August 21st, 2018 that stated there were no exceptions identified. She then thanked Debra Haynes, Fran Lawrence, Joan Fontes, Kim Moes, Malinda Peters, Sharon Morgan, Mathew Krimm, Jeff Smith, Chris Morris, and Chris Farr for their efforts during this assessment. This was a joint collaboration to ensure we are performing internal controls over financial reporting the right way. The final Internal Audit memo is now being submitted to the North Carolina Internal Audit Council as required by the North Carolina Office of State Budget Management's Internal Audit Office. Fran Lawrence added that the EAGLE assessment is an annual requirement from the State Controller's office.

Mr. Aneralla asked how many employees are managing the $14 billion internal trading desk. Ms. Smith responded the three of us, with a lot of help from others. We leverage our operations folks, we also lean heavily on our interim CIO's Chris Morris and Jeff Smith as well to keep us on track. Managing both internal and external equities is a balance and can be challenging for a small team, but we have a lot of people on staff willing to pitch in where needed. Mr. High added that we also outsource our back office reconciliation process to SS&C for about $1000/mo. per account. That is a lift off of us to not have to perform the back office duties. Mr. Smith added that we have had authority to do this internally for quite a while. With the Treasurer's support, being able to achieve this, and to do it the right way is a really big accomplishment. Mr. Smith commended the team with Ms. Smith's leadership and noted that with Mr.'s High and Taylor's work ethic this initiative has been a great benefit to the plan.

Mr. High stated that by the end of this quarter we expect to bring internally the remaining US passive assets. We view this as next steps to incorporating international internal trading capabilities.

Mr. High spoke on direct expenses. When we add up the expenses and compare it to the fees that an external manager would charge, we estimate that we are realizing a net savings in excess of $500 thousand per year. One item to note is Bloomberg AIM is an existing expense, the Fixed Income team was already using it, so now it is a shared expense between Fixed Income and Public Equity. Mr. Smith pointed out that most of these are fixed costs, as your assets go up the savings will widen.

Mr. Taylor spoke about the Russell indices annual reconstitution. On June 22nd of this year, Russell recalibrated their indices. This included adding/deleting/reweighting companies in their indices. In order to track the indices, we must make the trades to match the reconstitution. On that day, we traded 8.3 million shares valued at $428 million and paid $8,342 in commissions. Mr. Aneralla gave a personal experience of how he was involved with a brokerage that charged $1/share, and that 0.1c/share is very cheap. Ms. Smith added that there was no tracking error incurred during the reconstitution.

Ms. Smith moved onto the hedged equity sleeve. There are presently 4 active strategies and 1 passive strategy. The BlackRock 0.4 Beta strategy was very expensive, and we realized that we could replicate this exposure internally by moving a portion of the assets to passive equity and the balance to cash. We are still maintaining the 0.4 beta hedge, but for much cheaper. It is still available to redeploy if we decide to. Our next steps for hedged equity is to determine what is the objective and role of hedged equity within the equity portfolio, and is our structure appropriate to where it should be.

The Chair asked, when you say it is an expensive strategy, how expensive? Ms. Smith replied that the cost was about $3.4 million, when we transition it, we were able to experience $3.3 million in cost savings. It wasn't intended to last as long as it did.

The Chair asked for any questions and with none being presented he dismissed the public equity team.

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

Four persons signed up for public comment. The Chair welcomes the public commenters to the meeting.

Three people provided personal testimony related to their individual experiences working for Toys R Us and the impact closing had on them. The basis of their concerns being that a liquidation was sought over a buyout option that would benefit the shareholders but not the North Carolina workers and tax payers. The fourth speaker, a representative of the Private Equity Stakeholder project focused on Angelo Gordon, whom NC invested with. In summary the speakers were asking 1) what returns will Angelo Gordon see from investing in the Toy R Us collapse and 2) that we urge Angelo Gordon to join other creditors and contribute to the hardship funds.

The Chair thanked all of the public commenters for speaking.

ADJOURNMENT

Mr. Aneralla moved to close the meeting, seconded by Mr. Patterson. The meeting was adjourned at approximately 3:00 pm, without objection.

Dale R. Folwell CPA

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