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

MINUTES OF SPECIAL MEETING
January 8, 2016

Time and Location: The Investment Advisory Committee ("IAC") met on Friday, January 8, 2016, in the Dogwood Conference Room of the Longleaf Building, 3200 Atlantic Avenue, Raleigh, North Carolina.

Members Present: The following members were present in person or by teleconference: State Treasurer Janet Cowell (Chair), John Aneralla, David Hartzell, Steve Jones, Mike Mebane, Neal Triplett (Vice-Chair), and Courtney Tuttle. No members were absent.

Staff in Attendance: Mary Laurie Cece, Tarik Dalton, Craig Demko, Ronald Funderburk II, Alison Garcia, Kathy Kornak, Matt Krimm, Brett Hall, Ryan Hill, John Leraas, Chris Morris, Neal Motaparthy, Tinh Phan, Patrice Ray, Jeff Smith, Kevin SigRist, Christina Strickland, Tessa Tanis, Blake Thomas, Steve Toole, Sam Watts, Chris Ward, and Brad Young.

Others in Attendance: Larry Langer, Ryan Miller, and Kai Peterson. Mr. Langer, Mr. Miller, and Mr. Peterson are all staff of Buck Consulting ("Buck"), actuary for the North Carolina Retirement Systems.

BACKGROUND

As previously discussed at the November 18, 2015 IAC meeting, the North Carolina Retirement Systems ("NCRS") boards of directors (the "Retirement Boards") are scheduled to meet in early 2016 for their periodic study of actuarial assumptions used in NCRS accounting. One of the important actuarial assumptions is the discount rate, or actuarial assumed rate of return. Members of the Retirement Boards are interested in the IAC's perspective on the current 7.25% discount rate. At the November meeting, IAC members expressed interest in refreshing the Asset Liability Study performed by IMD and Buck in 2013-14, which examined the ranges of investment returns that could reasonably be earned by NCRS over various time periods. IAC members were particularly interested in the effect on 2013-14 Study results if the market were to spend a prolonged period in the current low-return environment rather than reverting to historical behavior.

INTRODUCTORY REMARKS

The IAC meeting was called to order at approximately 1:00 p.m. The Chair asked the Members present to indicate any conflicts of interest; nothing was declared. The Chair recognized Mr. SigRist, who referenced the January 5 memorandum sent by staff to IAC members. As stated in the memo, this special meeting would discuss the additional analysis requested by the IAC and explore any consensus among IAC members on projected NCRS investment returns under the current asset allocation policy.

Before turning to the main topic of the meeting, Mr. SigRist briefly remarked on recent volatility in the markets. In the last few months of 2015, the Department periodically defunded fixed income and public equity. The asset allocation's diversification between fixed income and equities had been particularly helpful in recent weeks. Mr. SigRist noted recent analysis by market observers suggesting that the diversifying effect of Treasuries, in particular, has lately been less strong than expected. This may be because China has been a major driver of recent volatility and much of China's reserves have been held in Treasuries. The normal inflow into Treasuries during equity declines has been partially offset by Chinese interests selling at the same time. At the time of the meeting, NCRS was about 2% overweight in fixed income and cash and about 1% underweight in public equity. Mr. SigRist noted that NCRS's allocation to real estate was currently 9% compared to the statutory cap of 10%. Opportunistic fixed income also was approaching its statutory cap. The denominator effect causes some of the alternative asset classes to have their percentages go up when the public equity markets go down.

DISCUSSION OF RETURN EXPECTATIONS

Mr. SigRist reiterated staff's two goals for the meeting: first, to determine whether there is a consensus return expectation from the IAC, over the long-term, from the current asset allocation; and second, to discuss results from modeling an alternative scenario (the "Low Equity Risk Premium Scenario") in order to determine how sensitive long-term expectations were to a different, less favorable set of assumptions. The Low Equity Risk Premium Scenario's assumptions were particularly different for equities and fixed income, based on the possibility to that the markets could see low interest rates and a lower equity risk premium for a long period of time. In the Low Equity Risk Premium Scenario, the yield curve was lowered by approximately 120 basis points, and the equity risk premium was only approximately 350 basis points above cash.

Mr. SigRist indicated that IMD considered the Low Equity Risk Premium Scenario credible; however, he wanted to be clear that this Low Equity Risk Premium Scenario is not IMD's newest and best thinking and does not replace the 2013-14 Asset Liability Study assumptions. IMD, after reviewing the assumptions of the 2013-14 Asset Liability Study, concluded that the Study's long-term assumptions were still close to consensus. Mr. SigRist commented that if IMD were to come up with a new set of Asset Liability Study assumptions that reflected newest and best thinking, assumptions might be a little different, particularly on the fixed income side, but would not be broadly different.

Mr. SigRist and the IAC then discussed the results of the Low Equity Risk Premium Scenario. In that scenario, projected results over the first 10 to 20 years of the 30-year period were expected to be significantly less than 7.25%, with a reversion to historical norms expected to take place in the last 10 to 20 years of the period. In modeling, return expectations appeared like a hockey stick – lower returns in short term, then significantly higher returns thereafter. Several IAC members commented that the next ten years were likely to be tough. Mr. Triplett commented that it seemed logical to expect returns over the next ten years consistent with the Low Equity Risk Premium Scenario, and he encouraged IMD to refresh the asset liability study to reflect less strong near-term results. Several IAC members also expressed a view that over a 30-year period, they were more comfortable with a reversion to historical results and the 2013-14 Asset Liability Study's assumptions.

There was extensive discussion between IAC members and IMD staff, touching on topics including the likelihood of a reversion to median over the last 10 to 20 years of the model, expected inflation in the model (which gradually increases from 0.5% to 3.5%), the role of the IAC and Retirement Boards, TIPS modeling, and risk management strategies in the NCRS multi-strategy portfolio. Mr. SigRist noted that real estate appeared attractive relative to other asset classes; however, the real estate asset allocation was near the statutory limit. He commented that IMD would love to have additional flexibility to increase the allocation.

Mr. SigRist confirmed that IMD will refresh the 2013-14 Study, probably beginning work in March. The work will involve running updated scenarios through actuarial modeling to see impact on funded status, contribution rates, and contribution rate volatility over time.

At the end of the discussion, Mr. Mebane asked Mr. SigRist about how he would sum up the IAC discussion at the January 21 Retirement Boards meeting. Mr. SigRist responded by noting that IAC members expressed a fair amount of pessimism or caution about expected returns, particularly over the next ten years. He stated that he perceived a sense from some IAC members that it could be helpful to fund the NCRS in the shorter-term or intermediate-term consistent with a lower rate of return expectation, regardless of the formal discount rate. Mr. Mebane also asked Mr. SigRist for his own views. Mr. SigRist replied that a 7.25% return is attainable over the long term, but the risk of underperforming a 7.25% assumption is significant, particularly over the next 10 to 20 years.

Finally, Mr. Jones raised the topic of IMD's record of beating the benchmark over time. Mr. Jones stated that his own view was that you respect that record and applaud it, but you don't take it into account when generating assumptions. There was general agreement with this view.

There were no further questions or comments from the IAC. The meeting adjourned at 2:30 p.m.

Janet Cowell

JANET COWELL
STATE TREASURER AND CHAIR