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

MINUTES OF MEETING
December 16, 2013

Time and Location: The Investment Advisory Committee ("IAC") met on Monday, December 16, 2013, 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), Neal Triplett (Vice-Chair), Harold Keen, and David Hartzell. Members participating via teleconference: Harold Martin, Steve Jones,[1] and Courtney Tuttle.

Staff: The following staff members were present: Kevin SigRist, Lynda Boulay, Brad Bullock, Susan Carter, Mary Laurie Cece, Jay Chaudhuri, Tarik Dalton, Craig Demko, Joan Fontes, Ronald Funderburk, Alison Garcia, Kathy Hahn, Brett Hall, Emma Hanson, William Hockett, Schorr Johnson, Arlene Jones-McCalla, Fran Lawrence, Bryan Lewis, Troy March, Bill McGee, Chris Morris, Neal Motaparthy, Keith Nelson, Tinh Phan, Jeff Smith, Anthony Solari, Blake Thomas, Steve Toole, Tim Viezer, Melissa Waller, Sam Watts, Nick Sykes, and Chris Ward.

Others in Attendance: Suzanne Beasley, David Bracken, Hazel Bradford, David Frederick, Scott Heberlein, Dawn Kerry, Wan Kim, Kai Petersen, Gary Robertson, Kip Sturgis, and Kevin Sullivan.

AGENDA ITEM – OPENING REMARKS

The meeting was called to order at approximately 10:00 a.m.

AGENDA ITEM – APPROVAL OF MINUTES

The Chair asked for the approval of the minutes for the September 18, 2013, meeting. Mr. Triplett made the motion for approval, Mr. Hartzell seconded, and the motion passed unanimously.

AGENDA ITEM – UPDATE ON IMD INITIATIVES AND PERFORMANCE

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

Short-term Priorities. IMD is interested in restructuring many of its relationships with public market managers as separate managed accounts. IMD hopes to have this project complete within six months. The global equity group will seek to consolidate index fund managers; the plan is to move from the current three to four managers to one or two, which should provide a

[1] Mr. Jones joined the meeting during the discussion of alternate fixed income structures described below.

cost savings. In the private markets, IMD continued to make a pipeline of commitments, with $1.5 billion more in commitments possible through early 2014. With regard to staffing, Mr. SigRist noted that most of the Director positions have been filled; Keith Nelson will be leaving IMD; and IMD has retained as compliance counsel Suzanne Dugan of the law firm Cohen Milstein. Ms. Dugan previously served as the New York State Comptroller's Special Counsel for Ethics, appointed to that position by Comptroller DiNapoli in 2007.

Medium-term Priorities. Mr. SigRist stated that IMD salaries are 40-50% below market. IMD has pending requests for salary adjustment and for the use of salary reserves to make career progression awards. Turning to other topics, Mr. SigRist stated that IMD was working to get more and better third party research. The IMD is also looking to outsource part of the trade ticket processing to custodian BNY Mellon. This electronic platform should free up time for IMD analysts.

Long-term Priorities. As mentioned in previous IAC meetings, the Treasurer and IMD have made it a top priority to systematically evaluate the investment governance structure for the Retirement Systems. The Treasurer, with the assistance of IMD, was working to form an independent governance commission. The Department has selected Hewitt Ennis Knupp to serve as the commission's consultant and facilitator. Mr. SigRist noted that Hewitt Ennis Knupp was interviewing stakeholders and comparing North Carolina's structure to other governmental and institutional investors. Announcement of the governance commission's members was expected to be made in the new year.

Performance Review. Mr. SigRist then led a discussion of the Retirement Systems investment performance for the period ending September 30, 2013. Mr. SigRist began by describing the general economic environment. The economic outlook was consistent with what had been seen all year. Moderate growth was expected, on the order of 3% for 2014, with contained inflation and an ongoing recovery in the housing and labor markets. Interest rates were expected to remain low, which Mr. SigRist commented should be good for equities. In the developing world, growth was behind previous years' pace, and globally, continued slow growth appeared likely.

As of September 30, 2013, IMD had $97.88 billion in assets under management, with $83.15 billion managed for the Retirement Systems. Once again, the Retirement Systems investments were ahead of benchmarks, net of fees, for every period indicated. Global equity and credit investments were the leading contributors to the return attribution. Mr. SigRist observed that within global equity, the large cap managers had done very well in an efficient market. The fixed income portfolio had a negative return for a 12-month period, but was ahead of its benchmark for all time periods listed. Compared to the benchmark, the fixed income investments were more heavily weighted to corporate and lower rated corporate, which was possible in the current low-volatility market. Cash allocation had also improved the return against the benchmark. The real estate and private equity asset classes were lower performers compared to their benchmarks. In response to a question from Mr. Hartzell, Ms. Carter stated that the real estate portfolio is about 30% core. She also noted there are foreign investments in our real estate portfolio that are not reflected in the benchmark.

Mr. SigRist discussed the current asset allocation of each class of investments compared to its strategic target and transitional target. The public equity allocation was above those targets due to the strong markets.[2] Mid-year, IMD performed a rebalancing that came equally from global equity and fixed income due to concerns over rising interest rates.

In response to a question from Treasurer Cowell, Mr. SigRist stated that under present practice, rebalancing is usually performed when the Retirement Systems become one to two percent over target; however, that depends on market conditions and the need for money to fund pension benefits or capital calls private asset class investments. Recently, draw-downs for those purposes have been taken mostly from global equity. Mr. Triplett asked if there was a level beyond which IMD would be uncomfortable with the proportion of the Retirement Systems in the global equity asset class. Mr. SigRist stated that he was at that point currently, and any funding needs would come from global equity.

Mr. SigRist presented a slide comparing the Retirement Systems' performance to the universe of public funds greater than $1 billion, as tracked by BNY Mellon. The Retirement Systems had a comparatively low risk structure and a lower ranking on returns.

Mr. SigRist noted that the credit portfolio was slightly over the asset allocation target. The inflation portfolio was below the target, but had recently made several investments. Treasurer Cowell raised whether the IMD should get ahead of the curve of rising interest rates, moving assets from equities to fixed income. Mr. SigRist noted that in the new year, the Retirement Systems would have the asset liability study to help guide these decisions. Finally, Mr. SigRist presented the list of investments made since the last IAC meeting.

AGENDA ITEM – ASSET LIABILITY STUDY ANALYSIS

The Chair recognized Mr. SigRist for a presentation on the IMD's ongoing asset liability study. Mr. SigRist introduced Kai Petersen of Buck Global Investment Advisors ("Buck"), working with the IMD on the project. Mr. SigRist stated that he had originally planned to have recommendations for the IAC at this meeting. Progress was slightly behind schedule, so instead, Mr. SigRist wanted to present the IAC with some options, receive the IAC's feedback on those options, and get the IAC's thoughts on risk.

Purpose. Mr. SigRist began by outlining the asset liability study's purpose. The study uses a series of modeled results, each based on strategic asset allocations and assumptions about future market conditions, to develop a set of recommendations for strategic asset allocation changes and total plan risk management strategies. More broadly, the focus of the study is how to achieve appropriate performance of the fund 10, 20 and 30 years out.

[2] Although the global equity portfolio was above the Department's voluntary strategic target, it was well within the 65% asset allocation limit set by N.C.G.S. § 147-69.2(b)(8).

Return and risk. In seeking appropriate performance for the fund, one evaluates return and risk. On the subject of return, Mr. SigRist stated that he believes that over time, the equity market will provide a return in the 7% range, but in a low return environment, there is only so much that can be done in terms of getting returns. Mr. SigRist observed that the nation's current reliance on monetary policy creates a certain risk. There is the concern that when the Fed puts so much money into the system, there is limited recourse if market performance does not pick up, particularly if there is a shock to the system. When evaluating risk, IMD keeps in mind its mission to pay benefits. Mr. SigRist noted that two-thirds of pension benefits payments, over the long term, are paid out of investments. Mr. SigRist noted that ideally, the fund would increase its "inflation beta," responding positively if inflation goes up, but lower other betas such as "equity beta" or "bond beta."

Potential Asset Allocations Used in Modeling. Next, Mr. Petersen and Mr. SigRist outlined the process for Buck's modeling. Buck's modeling evaluated six different potential asset allocations for the Retirement Systems:

- **Strategic.** This model matched the strategic target asset allocation found in the current Investment Policy Statement for the Retirement Systems.

- **Actual.** This model matched the actual asset allocation as of July 31, 2013. The actual allocation diverged from the strategic target because of volatility in the public equity market and because the private market asset classes (such as inflation and alternatives) are being slowly funded over time as attractive opportunities arise.

- **Sample A – Short Duration.** This model considered changing the fixed income portfolio structure by shortening the durations of the investments. This could help fixed income in a rising rate market.

- **Sample B – Enhanced Status Quo.** Compared to the strategic asset allocation, this model reduced fixed income and non-hedged public equity allocations, modestly increased allocations to private market classes, and increased the allocation to cash equivalents.

- **Sample C – De-Risking.** This model reduced the public equity allocation to 35% and revised the fixed income structure.

- **Sample D – Return-Seeking.** This model increased the public equity allocation above the current level and sharply reduced the fixed income allocation.

The details of each sample asset allocation were included in a handout provided to the IAC.

Assumptions. Mr. Petersen discussed the study's key assumptions. Mr. Petersen noted some assumption changes had been made since the presentation at the September meeting based on some IAC feedback. The long-term global equity returns were reduced by 100 basis points, and there was some downward adjustment in volatility. With liability forecasts, there was a change in the salary inflation sensitivity projections. Buck assumed there would be no COLA adjustments for the first five years of the forecast, but then standard COLA projections after 5 years.

Evaluation of duration and different fixed income portfolio structures. Mr. SigRist and Mr. Petersen presented a set of cost curve charts evaluating return and contribution volatility for the current strategic asset allocation, the actual asset allocation, and the "Sample A" short duration portfolio structure. On each of these graphs, the better result was up and to the left. Mr. SigRist stated that the models indicated by reducing duration, you give up some volatility but you give up some returns as well. Jeff Smith observed that the charts expressed how flight to quality comes into play, with a shorter duration exposure not reacting as strongly to that type of event. There was discussion between the IAC members, Mr. SigRist, and Mr. Petersen about the scale of the graph applies to real dollars and target amounts for present values. Mr. Hartzell asked whether you can make a market-weighted diversification argument, probing whether if one is underweighted, one may be betting against the market. The IAC discussed how inflation is factored into duration and the effects of a rising rate market.

Mr. Smith noted that the fixed income portfolio was looking at how it might reallocate across different durations and asset classes. Mr. Smith summarized a series of slides evaluating different strategic mixes for the fixed income portfolios. Ultimately, the models showed that a lower duration had a more attractive risk-adjusted expected return. An increased cash position would provide an ability to take advantage of opportunities arising from rate shifts or systemic events.

Evaluation of alternate portfolio strategies. Mr. SigRist and Mr. Petersen discussed a series of cost curve charts evaluating the current strategic asset allocation, the actual allocation, the "Sample B" enhanced status quo structure, the "Sample C" de-risked asset allocation, and the "Sample D" return-seeking asset allocation. Mr. SigRist noted that in the modeling, all the allocations except Sample D produced funded ratios similar to the current structure; Sample D produced higher return, but higher volatility. Mr. SigRist noted that at the 50th percentile, even the de-risked allocation (Sample C) produced a 109% projected funding status after 30 years. Mr. SigRist observed that since the Retirement Systems start as a well-funded pension, the question is how far we be reaching for and whether we should open up investments for more downside risk. Mr. Jones noted the funding situation is just an estimate and he would hope not to take risk off the table.

At this point, the Chair adjourned for a lunch **BREAK** at 12:05 p.m. The IAC reconvened at 12:35 p.m. After the lunch break, the Chair noted that due to an oversight, the conflict of interest statement was not made per usual practice at the start of the meeting. The Chair reminded all IAC members of the Code of Ethics and asked members to identify any actual, potential, or apparent conflicts of interest. Mr. Hartzell noted for the record that ten years ago, he was on the board of CBRE, an investment firm that might be mentioned later in the meeting.

Sensitivity analysis for alternate portfolio strategies. The Treasurer then asked Mr. Petersen to continue with his presentation, and he provided a detailed sensitivity analysis for each of the six samples discussed above. Mr. Hartzell asked for the inflection point at which the favorable return strategy moved from Sample C (de-risking) to Sample D (return-seeking); Mr. Petersen replied it would take some data mining to determine. Mr. Hartzell asked if the sensitivity analysis results were similar when run for 30 years. Mr. Petersen replied that the relative performance should be the same.

At this point, Mr. SigRist asked whether the IAC would like to see more data, options, or other information, and he asked whether there were any general observations or feedback that the IAC members would like to share. Mr. Triplett stated that he thought the presentation was well done and helpful. Mr. Triplett added that knowing the Retirement Systems' break points for contributions and stress points would be beneficial. Mr. Peterson noted that some of this information was found on slide 41 of the Buck presentation.

Treasurer Cowell asked Mr. SigRist to provide additional details regarding which of the sample investment scenarios he favored. Mr. SigRist replied that he prefers to take as little risk as needed. He stated he leaned a little more toward Sample C, which would get to a 6% return, then have a reasonable chance of generating an additional percentage point of return with more active management. He stated that it is IMD's sense that generally, they should take some of the public equity risk off the table. After discussion, Mr. SigRist stated that at the next meeting, he would provide for discussion a markup of the Retirement Systems' Investment Policy Statement with an asset allocation based on a combination of the status quo and Sample C.

AGENDA ITEM – PLACEMENT AGENT REVIEW

The Chair recognized Jay Chaudhuri, the Department's General Counsel, to make a presentation regarding the new IMD Placement Agent Policy. Joining Mr. Chaudhuri were Kip Sturgis of the North Carolina Department of Justice; David Frederick and Wan Kim of the law firm Kellogg, Huber, Hansen, Todd, Evans, & Figel; and Assistant General Counsel Blake Thomas.

Mr. Chaudhuri began by summarizing the background for the new Placement Agent Policy. The investment industry uses the term "placement agent" to refer to third-party solicitors, brokers, or marketing personnel hired and paid by outside investment managers to help market their funds to institutional investors like the Retirement Systems.[3] Mr. Chaudhuri noted that prior to 2009, IMD did not have a placement agent policy. Shortly after taking office in 2009, Treasurer Cowell hired Ennis Knupp to perform a broad review of IMD practices and procedures. In response to early feedback from Ennis Knupp, the Treasurer implemented in Fall 2009 new policies restricting gifts, charitable donations, and the use of placement agents. A "revolving door" policy was also implemented. Shortly after issuing the Placement Agent Policy, IMD asked all its existing outside investment managers to provide retrospective disclosures of their past use of placement agents, completing the disclosure form required for new investments under the new Placement Agent Policy. In response to this request, virtually all IMD's investment managers voluntarily provided disclosures. In 2010, after receiving

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[3] Note that IMD's Placement Agent Policy uses a broader definition of "placement agent" than is sometimes used in the industry, including certain internal marketing personnel as well as external third-party agents.

information from an investment manager that raised concerns, the Department of State Treasurer shared this information with the North Carolina Department of Justice. The Department of Justice retained the Kellogg Huber firm to serve as independent counsel for a special review of the use of placement agents by Department of State Treasurer investment managers.

Mr. Chaudhuri noted that the special review was designed to make policy reform recommendations. He stated that Kellogg Huber's report could be divided into two parts. The first part consisted of Kellogg Huber's findings of fact concerning investment managers. The second part consisted of a series of recommendations for policy reforms. As of the date of the IAC meeting, the Department had implemented roughly 90% of these recommendations. Mr. Chaudhuri commented that he believes the Treasurer's office now has one of the toughest placement agent policies in the country. Mr. Chaudhuri stated that as a result of the review, the Department had engaged several fund managers to discuss concerns; these negotiations resulted in monetary recoveries, along with agreements with several managers to change their policies. Mr. Chaudhuri thanked all parties involved in the review process, then asked Mr. SigRist if he had any comments.

Mr. SigRist said that what informed IMD's approach when engaging investment managers was the IMD's role as a fiduciary. IMD wanted its managers to demonstrate their long-term commitment to IMD and to respond positively to IMD's concerns about removing conflicts from the investment process. Mr. SigRist noted that IMD could not reach an agreement with one manager, CBRE, and investments will not be made with that manager going forward.

The Chair recognized David Frederick, who began his part of the presentation by thanking the Treasurer, staff, and the North Carolina Department of Justice. Mr. Frederick stated that Kellogg Huber started its process by looking at a group of managers, selected based on information such as their Placement Agent Policy disclosure forms or Department of State Treasurer documents. Kellogg Huber and the Department of Justice then followed up by making additional requests from these managers, gathering additional information to help Kellogg Huber make recommendations about policies to improve practices going forward. Since Kellogg Huber provided its initial set of recommendations, the Department of State Treasurer has developed a range of new policies and procedures. Mr. Frederick noted that the Department has adopted 27 of Kellogg Huber's recommendations; an additional four were not adopted because of certain limitations upon the Department, such as having too small a staff or requiring a change in state law to implement the recommendation. Kellogg Huber made a series of recommendations for statutory reforms, including having an investment committee with veto power to supplement the sole fiduciary model, authorizing funding for an in-house compliance counsel position, and widening the definition of lobbyists under state law to include placement agents.

After these remarks, the Chair offered an opportunity for IAC members to ask questions to the panel. Ms. Tuttle asked how IMD's situation compares to other matters concerning placement agents across the country. Mr. Frederick stated that Kellogg Huber did not do the outside review for CalPERS and New York, but he felt that the pay-to-play issues were much more serious in those states. In his view, the North Carolina review was more of a policy implementation process. Ms. Tuttle asked about the cost of the three year process and about the recovery from investment managers. Mr. Chaudhuri stated the cost of the legal review was $1.2 million over the three-year period. The amount recovered was approximately $15 million in cash and fee discounts for the Retirement Systems.

In response to a question from the IAC, Mr. Frederick and Mr. Thomas noted that all the problematic acts discussed in the Kellogg Huber were prior to Treasurer Cowell's term. Mr. Hartzell asked about the appropriate role for placement agents. Mr. Chaudhuri stated that the U.S. Securities and Exchange Commission has decided not to ban placement agents, instead heightening their oversight and registration. Mr. Thomas stated that since IMD implemented its Placement Agent Policy, roughly half of the external investment managers have disclosed they utilized an internal or third-party placement agent. Mr. SigRist stated that some small managers don't have a business development staff and may use third-party placement agents in that capacity.

Mr. Triplett asked about ongoing monitoring. Mr. Thomas replied that one of Kellogg Huber's most important recommendations was hiring compliance counsel; Suzanne Dugan was hired in that role and will receive and review Placement Agent Policy disclosures for approval. Mr. Keen asked whether the investigatory part of the review was completed or ongoing. Mr. Frederick answered that Kellogg Huber's part of the process was complete. He noted that Kellogg Huber had recommended that in the coming months outside legal counsel should perform a follow-up evaluation of the new policies' implementation. It was also noted that the North Carolina Department of Justice had referred one matter to the United States Department of Justice.

Ms. Cowell stated that the written report detailing the placement agent review would be made available on the Department's website, and counsel would be available after the meeting to answer any questions from the public or press.

AGENDA ITEM – PUBLIC COMMENT

There were no public comments.

ADJOURNMENT

The meeting was adjourned at approximately 1:45 p.m.

APPROVED BY: Janet Cowell

JANET COWELL
STATE TREASURER AND CHAIR