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

MINUTES OF MEETING
February 27, 2013

Time and Location: The Investment Advisory Committee ("IAC" or the "Committee") met on Wednesday, February 27, 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 Courtney Tuttle.

Staff: The following staff members were present: Susan Carter, Craig Demko, Ron Funderburk, Kathy Hahn, Brett Hall, William Hockett, Arlene Jones-McCalla, Fran Lawrence, Bryan Lewis, Bill McGee, Chris Morris, Ron Ottavio, Keith Nelson, Kevin SigRist, Jeff Smith, Rhonda Smith, Anthony Solari, Blake Thomas.

Others in Attendance: Jim Baker, Lesley Nettles.

AGENDA ITEM – OPENING REMARKS

The meeting was called to order at approximately 10:00 a.m. The Chair, Treasurer Cowell, reminded all IAC members of the Code of Ethics and asked members to identify any actual, potential, or apparent conflicts of interest. None were reported.

The Chair welcomed the Department's new Chief Investment Officer, Kevin SigRist, who joined the department in mid-January. The Chair noted her continued appreciation for the leadership of Bryan Lewis, who remained with the Investment Management Division as Chief Administrative Officer.

AGENDA ITEM – APPROVAL OF MINUTES

The Chair asked for any discussion, comments or corrections concerning the minutes of the November 14, 2012, meeting. The IAC unanimously approved the minutes without any changes to the draft.

AGENDA ITEM – OUTSTANDING ITEMS

Mr. Lewis led a brief discussion of outstanding items from previous meetings. He noted that the Investment Management Division continued to evaluate potential changes to the real estate benchmark, as discussed at the November 14 meeting.

The Treasurer noted that a spot remained open on the Investment Advisory Committee and stated that staff members were meeting with potential candidates.

AGENDA ITEM – PORTFOLIO UPDATE

Mr. SigRist provided an update on the Retirement Systems' portfolio, presenting year-end data for 2012. Over the fourth quarter, the total Retirement Systems portfolio returned 1.89% net of fees. The portfolio performed 0.19% above its benchmark. For calendar year 2012, the portfolio returned 11.84% net of fees, which was 0.35% above the benchmark. With the gains in the portfolio, the Retirement Systems' assets under management exceeded pre-recession levels, reaching $78.1 billion at the end of December 2012.

The portion of the Retirement Systems in the global equity portfolio was 4.14% above the target allocation for that asset class. The Retirement Systems were beneath the targets for the private equity portfolio ($1.4 billion less than the target), the credit portfolio ($400,000 less than the target), and the inflation portfolio ($1.1 billion less than the target).[1] These shortfalls were the result of North Carolina's intent to methodically and diligently analyze opportunities in the private markets rather than seeking immediate investment of all eligible funds.

Mr. SigRist noted that risk in the portfolio had come down quite a bit over the past year. Overall, the market exhibited greater certainty. Comparing the Retirement Systems to the universe of public funds with more than $1 billion of assets, North Carolina's investments have much lower risk, with about 10% more allocated to fixed income. This will cause a lag in performance in an equity-driven market like the one seen in 2012.

The global equity portfolio was the primary driver of the Retirement Systems' gains, achieving for the calendar year a 17.59% return, 0.69% above the benchmark. The equity investment managers hired by the Department performed well overall when picking investments, particularly international stocks. Good absolute returns were achieved in credit (13.95% return), real estate (8.88% return), and fixed income (7.29% return) for the year. On the weaker side, commodities valuation issues were a major factor in a return of 1.00% for the inflation portfolio, 0.37% beneath the benchmark.

In the real estate portfolio, core and value-added investments performed pretty well, while opportunistic investments performed less strongly. The private equity portfolio showed signs of a vintage year imbalance, with relatively low fresh money to outweigh the 2005-08 vintages.

In the period from October 1 through December 31, 2012, new commitments were made to real estate funds managed by Mesa West Capital and Crow Holdings, a credit portfolio managed by Magnetar Financial, and an inflation portfolio fund managed by Wood Creek Capital.

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[1] Although the global equity, private equity, credit, and inflation allocations were higher or lower than the target, all these allocations were within the acceptable range set forth in the Retirement Systems' Investment Policy Statement.

AGENDA ITEM – IMD PRIORITIES

Mr. SigRist presented for discussion a tentative list of projects expected for the Investment Management Division over the next 18 months. This list was assembled through a series of discussions with the Treasurer, IMD staff, and Hewitt EnnisKnupp.

Mr. SigRist started with short-term priorities, focused upon the next three months. He commented that the Department had a very strong team and an institutional-quality investment program. He stated that he was acutely aware of the "grand tour" that many CIOs put in place upon joining an organization, holding new investments while the CIO meets partners across the country. Instead, Mr. SigRist said that he was inclined, to a certain extent, to stay out of the way and let transactions work through the pipeline.

The Department was working to move approximately $4 billion, in line with the target asset allocation, from global equity to private market asset classes and hedged equity. The Department also sought in the short term to put money to work in its new emerging manager fund of funds. The global and international manager searches, which had been in abeyance for some time, would be reactivated.

Mr. SigRist turned to IMD's internal organization. The Department had approximately six vacancies to fill, and it planned to post those positions again in the coming weeks. In response to a question from the IAC, Mr. SigRist discussed outsourcing of market research. The Department used organizations like Albourne and Courtland in particular asset classes, but at the total fund level, the Department could use additional external resources to tackle issues such as asset allocation and private market research. The Department would also participate in the CEM (Cost-Effectiveness Measurement) survey examining how North Carolina compares to its peers.

The Treasurer commented that if the final decision from the General Assembly was that the Investment Management Division could not have additional resources, then the Department would have to look at more outsourcing. Mr. Triplett noted that the Duke University Endowment had recently moved in the other direction, toward internal data tracking. Mr. Triplett stated that there was a ten-to-one payback, at least, in savings by moving these positions in-house.

Mr. SigRist noted that there were many manager relationships in the total portfolio but a relatively small staff. Ultimately, the portfolio has to reflect the fact that staff members can only do so much. Reduction in the number of investments can lead to a lower level of risk.

Mr. SigRist commented that the Investment Management Division's day-to-day processes were strong, but he planned to work to update and codify the Division's written policies and procedures. As one element of those new procedures, the Division's internal investment committee had begun to hold more formal meetings to discuss and evaluate particular investments.

Next, Mr. SigRist turned to medium-term issues, focused upon the next three to nine months. There were significant human capital risks; in particular, the Division risked losing portfolio managers and analysts, who have the largest gap to market compensation. Mr. SigRist also noted that within the next six to nine months, he wanted to return to and refresh the asset liability study performed in 2012. The Department was already beginning to prepare this effort.

The Investment Management Division planned in 2013 to focus more heavily on total portfolio management for the Retirement Systems. Mr. SigRist commented that gaps can be thought of not only in terms of risk of loss, but also in terms of investments that are needed but not being made.

On the subject of investment initiatives, Mr. SigRist planned to explore:

- Strategic partners at the total fund level;
- A second tranche of the Innovation Fund;
- Investment in Latin America; and
- ESG / corporate governance themes.

Finally, Mr. SigRist turned to longer-term initiatives, focused upon the next nine to eighteen months. Mr. SigRist commented that for a small organization like the Investment Management Division, creating a talent-development path is difficult. To address this problem, he suggested training and potential short-term outplacement of staff to gain deeper knowledge of particular market segments.

The Department also will explore a global review of its benchmarking and reporting efforts. Mr. SigRist commented that, as a newcomer, it was harder to gauge performance when historical results are reported with changing benchmarks. Mr. Triplett commented that he thought of benchmarks more on a top-down basis rather than a bottom-up aggregation. Mr. SigRist agreed and pointed to total fund risk portfolio management as an example of the idea he wants to investigate comprehensively going forward.

AGENDA ITEM – LEGISLATURE UPDATE

The Chair recognized Anthony Solari and Bill McGee, legislative liaisons for the Department, to discuss the Investment Management Division's 2013 initiatives at the General Assembly.

Mr. Solari began with a discussion of the 2013 investment bill, which developed out of the ideas discussed at the last Investment Advisory Committee meeting. Currently, the Retirement Systems' alternative investments (credit, real estate, public equity hedge funds, inflation protection, and other alternatives such as private equity) are separately capped by state law at various percentages of the total Retirement Systems portfolio, as seen below. The asset allocation bill (entered shortly after the IAC meeting as Senate Bill 558) would replace these separate limits with an overall limit applicable to all alternative investments combined.

	Current Statute	Proposal
Credit Strategies Portfolio – N.C.G.S. § 147-69.2(b)(6c)	5%	40% combined
Real Estate Portfolio – N.C.G.S. § 147-69.2(b)(7)	10%	
Hedge funds or other nonpublic investment vehicles trading primarily in public equity securities – N.C.G.S. § 147-69.2(b)(8)(b.)	6.5%	
Alternatives Portfolio – N.C.G.S. § 147-69.2(b)(9)	7.5%	
Inflation Protection Portfolio – N.C.G.S. § 147-69.2(b)(9a)	5%	
Total	**34%**	**40%**

The ability to allocate flexibly would allow the Department to navigate markets more successfully and take advantage of available opportunities. As shown above, the bill also raises the combined limit for alternative investment classes by six percent. Mr. SigRist commented that this bill would get the Department out of the "pigeonhole problem," trying to determine which statutory category best characterizes an investment opportunity that meets more than one of the statutory sets of criteria. Mr. Solari and Mr. SigRist recognized the guidance of Senator Ralph Hise and Representative Stephen Ross during the bill's development, describing the constructive changes they had made to the bill.

Mr. Solari discussed the Department's efforts to obtain additional IMD positions in the state budget. Despite the Department's advocacy, the Governor's proposed budget did not include these positions. Mr. Keen commented that the proposed IMD positions were not expenses to the State, but represented income to the State. Mr. Solari agreed and responded that the Department was thinking of every position in terms of return on investment.

AGENDA ITEM – CREDIT / FIXED INCOME REVIEW

Mr. Smith provided a presentation on the Retirement Systems' fixed income portfolio. Based on data through January 31, 2013, the fixed income portfolio has outperformed its benchmark over three-month, one-year, three-year, and five-year time periods.

Relative to the benchmark, the portfolio is overweight to corporate debt and underweight to government debt. All core assets in the fixed income portfolio are internally managed. Non-core assets, predominantly RMBS, make up a small portion of the portfolio, but have performed very well, making a material contribution to portfolio performance over time.

Mr. Smith commented on the overall picture for fixed income credit markets. Treasury yields have been slowly progressing higher, but remain beneath the CPI inflation rate. A year ago, the consensus was that 2013 interest rates would be higher than they are today. Although the consensus expectation continues to be that interest rates will eventually return to higher rates, that consensus continues to push outward the year in which these increases will be seen. Mr. Smith noted that if the federal government's sequester were to go into effect, that would push out further in time the inevitable interest rate increase.

In this environment, Mr. Smith is bearish on short-term fixed income portfolio performance. Expected annual returns are in the two percent to four percent range over the next five years.

Mr. Triplett asked whether fixed income investments might have a positive, rather than negative, correlation to public equities in a market downturn. Mr. Triplett raised the possibility of hedging corporate bonds. Mr. SigRist responded that the Department was looking to find out the cost of such hedging, but noted that managing it over time would be a challenge.

Mr. SigRist commented that the worst possible scenario for the Retirement Systems was stagflation, since the overall portfolio is oriented toward growth. He noted that IMD wanted to work through a number of potential scenarios in the coming months and identify potential responses to those market scenarios. In response to a question from the Treasurer, staff outlined a possible stagflation portfolio featuring short-duration credit investments and more flexible mandates with global managers to allow flexibility across markets.

Mr. Smith closed his presentation, and Mr. Triplett commented that the fixed income team was doing a great job. The meeting was adjourned for lunch at approximately 11:45 a.m.

The meeting reconvened at approximately 12:50 p.m., and the Chair recognized Mr. Funderburk and Ms. Hahn for a presentation on the credit portfolio.

At the end of 2012, the credit portfolio was $3.2 billion, 4.1% of the Retirement Systems. The credit portfolio's overall goal is to generate equity-like returns with a fraction of equity's volatility. The credit portfolio has performed well on an absolute and relative basis. Annualized performance since inception is 10.5%, and the credit portfolio has outperformed its benchmark over all time periods measured. Volatility has been at or beneath five percent for almost the entire existence of the portfolio.

Ms. Tuttle asked whether particular parts of the portfolio stood out as the cause of the outperformance. Mr. SigRist and Mr. Funderburk noted that the Department's portfolio was more illiquid than the benchmark. Mr. SigRist noted, however, that this was not a benchmark-centric asset class, and on multiple metrics, the portfolio has outperformed. Global distressed managers and hedge funds have done particularly well.

Mr. Triplett asked about the amount of transparency the Department obtained from its credit investment managers. Mr. Funderburk and Ms. Hahn responded that the Department received a significant amount of data in the SAS system even though it was not yet complete. In response to a question about the overall amount of leverage in the portfolio, Mr. Funderburk responded that most managers did not use leverage.

Turning to the overall credit environment, Ms. Hahn commented that the market is functioning. Spreads are coming down. Mr. Funderburk noted that high-yield issuance is higher than pre-crisis levels, and the "wall" of credit instruments with 2014 maturities, which had caused much concern, had dissipated as new credit was issued.

The credit team performed a portfolio review with Albourne and Investcorp in 2012. Both consultants found that the portfolio had performed well, but forecast that forward-looking expectations should be lower. To achieve high-single-digit returns going forward, Albourne and Investcorp suggest greater exposure to structured credit.

AGENDA ITEM – IAC MEMBER Q & A

The Treasurer provided an additional update on Department operations. Hewitt EnnisKnupp has recently performed a review of the Department's fees and transaction processes. Although the report is still in draft, it appears findings will be positive.

Mr. Keen asked about the status of the SAS risk and performance analytics system. Mr. SigRist responded that system implementation was still behind schedule, but, in his previous experience, implementation often takes longer than expected for analytics systems. The SAS system was in user acceptance testing for the fixed income and public equity portfolios. Private equity was scheduled as the next asset class to be included in the system.

AGENDA ITEM – PUBLIC COMMENT

There were no public comments.

ADJOURNMENT

The meeting was adjourned at approximately 1:30 p.m.

APPROVED BY: Janet Cowell

JANET COWELL
STATE TREASURER AND CHAIR