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

# MINUTES OF MEETING
May 22, 2014

Time and Location: The Investment Advisory Committee ("IAC") met on Wednesday, May 22, 2014, 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), John Aneralla, Steve Jones, Mike Mebane, and (by teleconference) Courtney Tuttle.

Members Absent: David Hartzell

Staff: The following staff members were present: Lynda Boulay, Brad Bullock, Susan Carter, Tarik Dalton, Craig Demko, Ronald Funderburk, Allison Garcia, Brett Hall, William Hockett, Arlene Jones McCalla, Troy March, Chris Morris, Neal Motaparthy, Tinh Phan, Norman Schiszler, Kevin SigRist Jeff Smith, Rhonda Smith, Alejandro Sotolongo, Nicholas Sykes, Blake Thomas, Tim Viezer, and Chris Ward.

Others in Attendance: Bridget Fraser, Gaynor Fries, Jonita Mizelle, Riddhi Mehta Neugebauer, and Mitch Leonard.

## AGENDA ITEM – OPENING REMARKS

The meeting was called to order at approximately 10:00 a.m. The Chair, Treasurer Cowell, thanked Ms. Tuttle for attending by teleconference. She also welcomed Messrs. Aneralla and Mebane to their first IAC meeting, whereupon both Members gave a brief introduction about them and confirmed they were happy to serve on the IAC.

The Chair asked the Members present to declare any conflicts of interest and, there being nothing declared, the meeting commenced.

## AGENDA ITEM – APPROVAL OF MINUTES

The Chair asked for approval of the minutes of the February 19, 2014, the minutes were approved as written.

## AGENDA ITEM – UPDATE ON PERFORMANCE

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

**Performance Review** – as at March 31, 2014, assets under management are just north of $100 billion. Mr. SigRist presented several charts to the IAC, giving a picture of the US and global economic environment. We are seeing moderate growth in the US, which is performing better than Europe. Within Europe, Germany and the UK were standing out for growth due to job growth and falling unemployment rates. Inflation was measured at around 2%, with an increase in volatility. Bond rates have dropped by 30 basis points.

Looking at NCRS's asset allocation, we are marginally overweight in Global Equities and the new policy has a Cash allocation. Interest rates are increasing in the near term. Private Equity was underweight and in December, $1.5 billion was raised, pulling down Fixed Income.

**Performance vs Benchmark** – Over the past year, Global Equity has been the largest contributor to the funds' performance. Longer term, the investment rate of the portfolio is down 0.5%. The Inflation Portfolio is showing less than 1% return due to very moderate inflationary pressures.

Global Equity is the strongest performing fund with the next strongest being Credit Strategies. With respect to Hedge Funds – multi-strategy funds have done OK but the more market neutral have not done as well. Fixed Income is a low risk strategy and cash allocation is beneficial.

On a 3-Year basis, the Private Equity benchmark is almost at 20% with really strong performance in venture funds. Fund of funds are at around 15-16% and Buyout is 11% up. With respect to Private Equity returns, we sold 17% of private equity commitments at market value and the funds sold posted good returns - 200 basis points/year of return, which is quite significant. The Private Equity portfolio is posting very strong returns but not on fund-of-funds. Mr. SigRist expected to have a better picture of that for the September meeting.

With respect to Real Estate – we are up 3 basis points with Opportunistic real estate funds giving us the best returns. Mr. SigRist mentioned that Timber is now included in the Real Estate sector and that we were seeing a lot of money floating into Core.

**Comparison to Peers** - our Median Returns are showing at 6.48% over 15 years and at a significantly lower risk than our peers. A graph was presented which showed the NCRS Gross Returns and Risk vs BNY Mellon Universe with $1 billion shown as the trade-off. On a risk-adjusted basis, we are above the line, consistent with a long-term approach of asset allocation. We are seeing a 10-15 point cost advantage.

Mr. SigRist referred to a graph showing the NCRS Rolling Total Fund Volatility and the level of tracking error over a 3-year period. It was thought that the SAS Risk System, once implemented, would allow better tracking in the future. In looking at our liquidity profile, Mr. SigRist reported that 80% of the portfolio allocation is highly liquid – meaning, assets could be liquid within 3 days. Mr. Jones asked about scoring lower volatility and how we could adjust for more meaningful figures and Mr. Triplett pointed out the 300 basis points spread. Mr. SigRist responded regarding the asset liability strategy and that assumptions are pretty high. Asset classes have been broken apart to look at them more in depth. Annual numbers show different risk numbers than a long-term basis. In the short-term, the portfolio is being managed by looking at monthly numbers.

Mr. Jones mentioned GAAP and Non-GAAP recordings and asked if we should be looking at Non-GAAP also, as this affects how we assess how we are doing. Mr. SigRist responded that they were looking at that to try and enhance reporting. They were looking at annual numbers and calculating risk.

**New Investments and Commitments** – preferential pricing had been obtained for the Marathon Currituck Fund investment. Mr. SigRist reported that they had made an additional $200 million investment in the Inflation Portfolio. He explained to the IAC that Intervale Capital was related to oil services, while the Orion Mine Finance Fund was trade finance related to mining. At this point, Mr. SigRist asked if the IAC had any questions.

The Chair noted that the liquidity profile is a really good addition to the report. Ms. Tuttle commented on the equity sector allocation, which was very large but less than the benchmark to financials. She asked, were we comfortable with such a large allocation to financials at this point? The Portfolio summary had 12 months' worth of commitment and the Inflation Portfolio was mostly energy. She asked if the level of the total fund exposure to energy sector was being looked at? Mr. SigRist responded that Inflation de-emphasized private equity moving forward and that we have a sense on being cautious and that we are not excited about adding more to the energy sector.

**AGENDA ITEM – PUBLIC EQUITY REVIEW**

The Chair welcomed Tim Viezer, Equity Director, to present the Public Equity Review and Mr. Viezer proceeded to introduce his team to present alongside him: Rhonda Smith, Arlene Jones McCalla, William Hockett, Norman Schiszler, Alex Sotolongo, and Jay Chaudhuri.

Mr. Viezer stated that the NCDST equity portfolio has outperformed over time and generally performs well relative to its peers. The three things that drive excess returns: (i) investment philosophy/strategy; (ii) processes; and (iii) resources, including human resources. The factors that could detract are the organization culture and alignment of interest. We have a limited ability to predict the future but the team believes that market timing is generally unrewarding for us to engage in.

Mr. Viezer asked Ms. Jones McCalla to give the meeting a snapshot of total equity. Ms. Jones McCalla reported that our Non-US equities have been increased and this reflects in the number of Mandates. With respect to Passive vs Active exposure, we can see over time that our passive exposure has increased. Ms. Jones McCalla clarified that, when we classify Domestic vs Non-US, we are looking at the where the company is domiciled. For example, GE is a Domestic company.

Ms. Smith discussed briefly the Total Equity Excess Returns and that over the past 15 years, our returns have been mostly over the 0% mark.

Mr. Schiszler highlighted that performance has been good across the sub-portfolios and that an excess return has been consistently generated over the15 year time period.

Mr. Hockett reported to the IAC that our US Equity Returns were good compared to our peers, while our International Equity Returns were average compared to our peers and had proved to be more challenging.

Ms. Jones McCalla presented to the meeting that prior to the 2008 crisis, the portfolio had shown a negative risk adjusted return but the period from 2009 to 2013 showed that the portfolio's Alpha was good across all composites. Performance has been better after the crisis and ratios have improved. We are more defensively positioned. Prior to the 2008 crisis, the information ratio was 0.45, but after, it is up to 0.91. Mr. Triplett asked what the outperformance could be attributed to and Ms. Jones McCalla replied that the size, momentum and style had proved to be non-significant, but the Alpha of the managers we have had shown to be statistically significant. Mr. SigRist added that manager stock selection has driven returns in recent periods. Mr. Aneralla asked if currency comes into play and Ms. Jones McCalla confirmed that it did, but that it was not meaningful over the long term.

Mr. Viezer reported that the equity performance had outperformed over time and had wondered if this could be attributed to luck. They reviewed how likely it is that a manager with no skill could do it and concluded it was unlikely and that the outperformance was likely due to skillful decisions. As we are at the "gold" standard, how did we outperform? Alex Sotolongo informed the meeting that risks being managed included geographic, beta, market capitalization, style, stability, active management skill and foreign exchange.

Ms. Smith presented one aspect of that – the style dimension of risk. The portfolio has shown a shift from Value to Growth and, therefore, a change in philosophy. There had been a lot of movement in the portfolio recently. 2005 was the first time that the plan had been to pay benefits out of the portfolio. More than $52 billion has been transitioned and had no negative impact on the portfolio.

Ms. Jones McCalla talked to the allocations in US and non-US portfolio and the "structure". She highlighted that it was important for the team to understand the structure of the portfolio to work effectively. Mr. Aneralla asked how the team can be sure that the managers are doing their job and Ms. Smith responded that they speak regularly and perform their due diligence visits, to get beyond process and share ideas. Decisions can lead to changes in our structure and we perform analysis on the returns to make them adhere to investment guidelines and directions if they get out of their guidelines. The team decides if they are no longer a good fit for the portfolio.

Mr. Schiszler presented a graph to the IAC showing the US Equity Portfolio Attribution Analysis over a 20 year period and figures from the S&P 500 had been included to give an indication of favorable and non-favorable returns. If we look over time, we have allocated away the majority of the misfit risk. The majority of excess returns are coming from manager selection. Looking at the excess returns of the Domestic Portfolio over 1 year, of the 197 basis points, 144 of those are due to manager selection.

Mr. Viezer highlighted the International Equity Portfolio Attribution Analysis and stated that the manager effect is more critical on this portfolio. In the last year, we are up 90 basis points.

Ms. Jones McCalla drew the IAC's attention to the tenure of active managers and reported that some of the reasons we may terminate an active manager were due to poor performance, a change in strategy, whether they are a fit with the portfolio structure, or if a key investment professional left the manager's firm. Mr. SigRist stated that it was important that we don't churn turnover in new managers and that an average manager has tenure of 4-5 years.

Mr. Viezer presented some lessons learned to the meeting. We have outperformed over time. Recommendations include that we research which strategies offer best chance of outperformance, evaluate which strategies produce the best structure and revisit the active/passive allocation. Mr. Aneralla asked how many managers we were using and Mr. Viezer reported that there were over 30 mandates, with a total of 23 relationships.

Mr. Viezer continued by showing the objectives for next year, which included implementing a new strategic asset allocation, ensuring compliance, reviewing current portfolio structure, and talking to and training staff remains very important. At this point, Mr. Viezer announced that Mr. Hockett would be leaving the team to pursue an MBA at Duke University and thanked him for his service. Ms. Smith added that the team would be very sad to see him go and would sorely miss his experience and knowledge.

Mr. Hockett went on to report that the team had evaluated 10 years of data on Albourne hedged equity strategy indices. 75% of open funds were willing to accept managed accounts with us, although terms and fees were challenging at the moment. There was a bias towards more risk efficient strategies, but the team didn't see advantages in geographic funds over global funds. Sector funds focused on higher dispersion sectors offer attractive risk return profiles. Mr. Sotolongo limned that the Guidepost portfolio is efficient when compared to Albourne and is more efficient than HFRI Equity Hedge index. Mr. Sotolongo went on to state that in the French-Fama-Carhart analysis, Guidepost has a lower sensitivity to risk factors, producing a positive outlook.

Mr. Hockett outlined the next steps for hedged equity, including hiring a specialist consultant for managed account platform evaluation and a staged portfolio implementation. Mr. Triplett asked if Albourne was similar to other indices and Mr. Hockett stated that there could be a bias towards higher quality funds with 1600 total funds included in their indices, so there could be biases in it. Activist generates about 6% of the statistical return and a passive strategy that replaces Activist would not produce the returns requested. Mr. SigRist stated that there was an issue with how much money is floating into the space.

Ms. Smith reported that in formalizing the corporate governance best practices, we need to ensure we are meeting the needs of retirees.

Mr. Chaudhuri stated that long term governance enhances investment strategies and that the challenge being faced is to balance the corporate governance agenda with the resources available. Mr. Chaudhuri went on to highlight some accomplishments. He reported that, with respect to proxy voting guidelines, proxy votes carry economic value. He encouraged members to consider joining the Diversity on Boards initiative and attending the one-day training, as they were seeing some success in identifying qualified candidates from this. With respect to company engagement, shareholders should be allowed to elect boards on an annual basis, as this provides better value to companies. With respect to executive compensation – policies for Board membership and payment to members were being reviewed. Access to management was important for long term shareholders. Shareholders continue to have concerns about corporate waste and political spending and have asked for more transparency from companies.

Mr. Chaudhuri presented an outline of the Corporate Governance Sub-Committee charter, which included setting up our own guidelines with respect to proxy matters. While S&P companies may not have women on their boards, it was also highlighted that as well as gender, specializations can all play into diversity. They charter will look at shareholder rights and the Iran and Sudan investment process will be reviewed.

Mr. Mebane asked how the proxy voting process is managed. Mr. Chaudhuri reported that policy advisors will vote for us and sometimes legal does this also. We don't tend to review every vote cast. Mr. SigRist stated that managing engagements is a key issue. Mr. Aneralla asked if all managers give us access to proxy and Ms. Smith responded that all but one domestic manager cast proxy votes on our behalf.

The Chair took the opportunity at this point to wish Mr. Hockett well in his future endeavors and thanked him for his time with the Department.

## AGENDA ITEM – LEGISLATIVE/GOVERNANCE UPDATE

Mr. Andrew Holton provided an update on the North Carolina Investment Fiduciary Governance Commission (the "Commission") which had been established at the Chair's direction. A group of 11 people had been pulled together to form the Commission which had met five times between January and

April 2014. Their mandate was to advise on the best features of an overall governance structure and their assignments included:

- To evaluate the sole trustee and investment advisory committee model vs an investment board of trustees;
- To examine characteristics of structure – for example, number of seats, terms of service, etc.;
- To evaluate resourcing and investment fiduciary independence.

The review of the commission model had taken place at the last two meetings and, although not unanimous, there was a move towards adopting a Board model. Arising from the Commission's meetings, four non-controversial items would be put forward for legislature. It was felt that the process and results were exemplary.

Mr. Mebane and the Chair expressed their thanks to everyone involved for their work on this initiative.

Mr. Tony Solari, Director, confirmed to the IAC that a consensus on structure had not been reached, but that unanimous decisions had been made on a number of issues and that a bill had been drafted to put those issues to the legislature. It is not finalized yet, but contains:

- Audited financial statements annually (using a company outside of the "big four")
- Every four years, a performance review and procedure evaluation will be undertaken by an independent expert
- Expanded and modernized reporting

Issues to be clarified and codified include:

- Improved transparency and accountability with control of resources
- Undertaking a study to look at hiring for investment positions
- Total budget and expenses to be reported annually to legislature
- External organizations to be registered as lobbyists
- Investment policy statements would be required to be unanimous

Currently, 14 positions are being pursued for hiring – 2 of those in Risk Management and 12 as Managers for fund of funds to save $18 million in fees. There were also three retirement-related bills in process to address:

- Changes in administration;
- Reverting to a 5 year vesting period from 10 years and including giving interest back;
- An anti-spiking provision to make sure it gets applied to the most egregious cases.

Mr. Jones asked about the level of support for the bills. Mr. Solari responded that there was a good level of support currently. The Chair reported that there was a sea change on hiring and control of resources and staffing.

Mr. Mebane asked if there was another model like this in state government and Mr. Solari responded that the Banking Commission operates on a similar model.

The Chair offered her thanks to everyone involved in this process and, at this juncture, adjourned the meeting for a 45 minute lunch **BREAK** at 12:00 p.m.

The IAC then reconvened at 12:45 p.m.

## AGENDA ITEM – INVESTMENT POLICY STATEMENT/NEW STRATEGIC ASSET ALLOCATION

Mr. SigRist presented the tentative transition plan to move to a new strategic asset allocation to the IAC. He reported that we are a year in to the asset liability strategy and are at a point where changes have been made and a final version of the Investment Policy Statement ("IPS") is in place. The effective date for implementation will be July 1, 2014, and revised benchmarks for Private Equity, Non-Core Real Estate, Inflation Sensitive, and Floating Benchmarks weights to facilitate the transition so we are not caught with an incentive to chase new benchmarks. There is an expectation that managers will be in the space to look at that.

Other IPS changes include that dedicated short-only strategies are not authorized; that the Portfolio will systematically increase the share investments through core real estate separate accounts – more of a recording mechanism; and in recommendation memos, a pro-forma analysis of projected cash flows for the recommended investment and existing Portfolios' investments.

Mr. Triplett asked whether it would be a good idea to make a firm timeframe for changes to be made. Mr. SigRist responded that market challenges will affect certain things, but that he was open to considering it. The team had undertaken a lot of planning and is estimating 2016 for it to be live. Quarterly updates will be given to the IAC.

Mr. SigRist reported that, with respect to Non-Core Real Estate portfolio, the Burgiss Group Private iQ indices were more representative of our plans. For the Inflation Sensitive portfolio, a custom index comprised of 33% Bank of America, 17% Dow Jones-UBS and 50% of the dynamically weighted combination of the benchmarks of investments classified within Private Natural Resources. For that 50% portion of the Portfolio's benchmark, industry standard benchmarks will be utilized for each specific strategy – if such benchmarks do not exist for a specific strategy, the benchmark shall be the rate of consumer price inflation plus a premium of 250 basis points.

Mr. SigRist stated that there was no real science behind the 250 basis points number – 200-400 basis points is a standby benchmark. He went on that, if a good benchmark exists, we would use that instead of the 250 basis points. Mr. Triplett asked whether we considered using TIPS rather than the 250 basis points. Mr. SigRist responded that we could consider long term TIPS for the Inflation Sensitive class. Most investment asset classes there should be opportunistic cost measured.

Mr. SigRist reported that these were the present changes to the IPS and that the process was that the Investment Policy Committee would be responsible for finalizing and then ultimately the Treasurer would execute, as Trustee.

The IAC was shown figures comparing new and current strategic asset allocations, as well as actual to new strategic asset allocation. When looking at the new policy, we are not there yet and we need to consider if we do want to go to this strategy. Our Sources (Public Equity, Investment Grade Fixed Income and Non-Core Real Estate) were overweight by $6.9 billion, while our Uses (Private Equity, Opportunistic Fixed Income, Core Real Estate, Inflation Sensitive and Cash) were underweight by $6.9 billion.

Mr. Mebane asked about projections and whether figures - particularly net benefit payments which are underweight by $2.5 billion - would stay that way. Mr. SigRist responded that $2.5 billion is a fair number for projections. The liability study looks over 30 years and cash requirements are looked at over that time.

With respect to the multi-year capital allocation, a review of individual asset classes covered the market environment, the current pipeline vs capacity and the types of investment vehicles (eg closed end funds, inflationary issues). It was determined we should not be trying to push the allocation up. There are fund growth opportunities and there will be trade-offs to consider.

The Private Equity Portfolio benefits from loose credit standards and high appetite for high yield bonds. A lot of money is floating into mega Buyout funds and Private Equity recovered strongly. We need to be careful about adding marginal dollars to Private Equity. It is a sellers' market right now. US buyout money is around to buy platforms and build on acquisitions. Changing the strategy to bolt-on activity is out. Mr. SigRist also mentioned that we have been cash flow positive for the past 3 years.

Attractive subsectors include secondaries, where estimates show $75 billion of capital chasing $100 billion of opportunities. In the Distressed for Control space, sales from financial sector and shared opportunities abound. They will be teaming up with the Inflation Team to take advantage of opportunities by economies of scale as there are no resources to do it alone. Venture Capital and Growth Equity are rewarded for growth.

The current interest is on more opportunity focused funds, deep in their sectors. Europe is an attractive market right now, but we are not attracted to the Emerging Markets sector. We have spoken with colleagues who have invested in those markets and regretted it. Non-Core Real Estate is slower to attract capital and earlier in the cycle. Core goes into our diversification bucket, while Non-Core is in the growth bucket.

Ms. Carter spoke to the meeting about attractive subsectors of the Real Estate sector. She reported that we are seeing changes in distribution driven by technology in the Industrial sector. With respect to European Debt and Equity – we are focused on UK and Germany and a little exposure in Spain. No allocation vs opportunities there. Co-Investments and JVs – there is opportunity in the hotel space, if we can move quickly enough. Income Strategies – more income is needed, more money has gone into Value in the past years.

We have a large exposure to Multi-Family and are comfortable with this, mainly because there has been no new supply from 2010 to 2012, there is a growing number of obsolete units and there needs to be 280,000 units per year to meet the current demand. Opportunistic Fixed Income Market Environment shows the spread change over 10 years. We are more focused on long/short strategies and direct lending is also attractive. Whole loans are showing significant premiums with 10-12% earnings. Ms. Carter reported that we are currently less attracted to Global Long only High Yield Bonds and Leveraged Loans, US and EU CLOs and Sovereign Emerging Market debt.

Mr. Mebane asked how the direct lending structure sits on the balance sheet. Mr. SigRist responded that we have a limited liability structure with complete transparency on a real time basis.

Inflation Sensitive Market Environment – direct liquid inflation hedging strategies are unattractive. TIPS are expensive and long-only commodities have heightened volatility with uncertain supply/demand fundamentals. Private Energy strategies have received large capital flows for several years and we would like to de-emphasize that. Attractive opportunities being looked at on an ongoing basis include whole loans, specialty financing, ABS, transportation, drug royalty, metals & mining and long/short commodities. Less attractive opportunities include the Power sector – the pricing has changed too much to make them attractive

Mr. SigRist went on to show the Top-Down Components of Capital Allocation and highlighted the economic views. Modest economic growth will bring improved US labor and housing markets; inflationary pressures remain muted into 2015 and gradual Federal Reserve rate increases will occur in 2015, Public Equity valuations span are neutral to modestly stretched, with the US markets subject to more volatility. Recommended trades-offs across broad categories include reducing the 4% underweight to Inflation Sensitive and Diversifiers – this is a big exposure and needs to be lowered. Recommended floor trade-offs within broad categories include reducing underweight to Opportunistic Fixed Income vs reducing overweight to Non-Core Real Estate vs reducing underweight to Private Equity – there are some opportunities still there. We should prioritize reducing underweight to Inflation Sensitive vs reducing underweight to Core Real Estate.

The projected impact of the Tentative Transition Plan was reviewed, showing the current gap vs the projected 2016 gap. The current gap from Sources was $6.9 billion and this is projected to close to between $600 million to $2.6 billion by circa 2016. The current gap from Uses is -$6.9 billion and this is projected to change to -$2.6 billion to -$600 million by circa 2016.

The timing and amounts of "pro forma" commitments are subject to change and express directional intent over the next 1-3 years. Fees, structures and liquidity remain important to long-term success.

At this juncture, Mr. SigRist concluded his presentation and invited questions. None were raised.

**AGENDA ITEM – IAC MEMBER Q & A**

The Chair opened up the floor for general questions. Ms. Tuttle commented that, with respect to Private Equity, all observations she had heard at today's meeting were 'spot-on' and she commended the team for their work. Mr. Jones commented that he had been very impressed with thoughts raised on alternatives and the timescale and ways for us to get there. Mr. SigRist responded that they had been expansive in their thinking and what to do with the portfolio ahead of inflation.

There were no further questions or comments from members of the IAC.

**AGENDA ITEM – PUBLIC COMMENT**

There were no public comments.

**ADJOURNMENT**

The meeting was adjourned at approximately 1:55 p.m.

**APPROVED BY:** Janet Cowell

**JANET COWELL**
**STATE TREASURER AND CHAIR**