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

MINUTES OF MEETING
May 29, 2013

Time and Location: The Investment Advisory Committee ("IAC") met on Wednesday, May 29, 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, Steve Jones, David Hartzell (by telephone), and Courtney Tuttle (by telephone).

Staff: The following staff members were present: Kevin SigRist, Susan Carter, Tarik Dalton, Craig Demko, Ronald Funderburk, Alison Garcia, Kathy Hahn, William Hockett, Schorr Johnson, Arlene Jones, Bryan Lewis, Bill McGee, Chris Morris, Keith Nelson, Jeff Smith, Rhonda Smith, Anthony Solari, Heather Strickland, Blake Thomas, and Marlon Weems.

Others in Attendance: Hazel Bradford, Ben Matheson.

AGENDA ITEM – OPENING REMARKS

The meeting was called to order at approximately 10:00 a.m. The Chair, Treasurer Cowell, welcomed Mr. Hartzell to the Investment Advisory Committee. The Chair 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.

AGENDA ITEM – APPROVAL OF MINUTES

The Chair asked for any discussion, comments or corrections concerning the minutes of the February 27, 2013, meeting. Mr. Triplett moved to approve the minutes without any changes to the draft. Mr. Keen seconded the motion, which was unanimously approved.

AGENDA ITEM – UPDATE ON IMD INITIATIVES

Mr. SigRist, the Chief Investment Officer, led a discussion of ongoing and future projects within the Department of State Treasurer (the "Department") concerning the Investment Management Division ("IMD").

Vacancies. The first round of interviews were complete for three of the open IMD positions, with a second round of interviews scheduled in the near future.

Policies. Mr. SigRist shared proposed drafts for several new IMD policies: the Code of Ethics and Conduct, the External Investment Manager and Vehicle Selection Policy and Procedures, the External Investment Management Conflict of Interest Certification, and the IMD Investment Committee Charter. When developing these policies, IMD consulted with internal and external legal staff, took input from the Aon Hewitt Ennis Knupp consultants who performed the recent compliance review, and performed research concerning similar policies at other institutional investors.

The Code of Ethics and Conduct is modeled after the CFA Institute Code of Ethics and ethical codes at Wall Street firms. It requires affirmative disclosure by Department personnel of conflicts, provides cross-references to the other Department ethics policies applicable to IMD employees, and discusses standards of conduct for IMD personnel.[1]

The Conflict of Interest Certification is a one-page form to be signed, for each transaction or significant contractual amendment, by the State Treasurer, the Chief Investment Officer, the Department's in-house counsel, and the Asset Class Director and Portfolio Manager who performed work on the transaction. On the Certification form, each of these persons will attest for the relevant transaction that they have no conflict of interest and adhered to the Code of Ethics and Conduct.

The External Investment Manager and Vehicle Selection Policy and Procedures (the "Selection Policy") documents IMD's step-by-step process for hiring new external investment managers or making new commitments to private market investment vehicles. Mr. SigRist noted several key features of the Selection Policy. First, it follows a "bottoms-up" approach, having Asset Class Directors and their staff take the primary role in deal flow searches and analyzing opportunities in the market. IMD will have a structured forward calendar of transactions, and staff will seek to have a more policy-focused discussion of overall strategy rather than dealing with each proposed transaction as an individual event. Investment recommendation memoranda will be required for each transaction. The Selection Policy envisions a role for a Compliance Officer to serve as an independent person to review adherence to policies, which Mr. SigRist noted was the best practice for an organization of IMD's size.

The IMD Investment Committee Charter will serve as the governing document for the internal investment committee, made up solely of IMD staff, that has met regularly on a more informal basis for some time. At meetings, the internal committee's members will focus on strategy, policy, and management of the total portfolio, as opposed to underwriting particular investments. For example, the internal committee could discuss trying new and different things within a particular asset class. Staff will be expected to have technical expertise and provide advice within their asset classes, but also will be encouraged to provide guidance outside those asset class areas.

Mr. Triplett commented that the new process for hiring investment managers appeared to be more team-driven. Mr. SigRist responded that under the process, transactions would ordinarily flow through the Asset Class Director to the Chief Investment Officer, then to the Treasurer. Mr. Triplett asked whether the new policies change accountability. Mr. SigRist

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[1] Mr. Jones joined the meeting during this portion of the discussion.

responded that in his view, the policies tighten accountability by requiring the Asset Class Director, Chief Investment Officer, and Treasurer to each approve new investments in writing.

The Treasurer commented that she appreciated all the effort staff had put into the new policies, and she looked forward to finalizing and implementing the policies in the near future.

Legislation. The Treasurer, Mr. SigRist, and Mr. Solari led a discussion of Senate Bill 558, the investment bill proposed by the Department. Mr. SigRist stated that although the bill would increase the portion of the Retirement Systems portfolio that could be allocated to alternative investments, the bill's primary focus was not increasing alternative investment authority, but instead increasing the Department's flexibility among alternative investment asset classes. As an example, the Department was near its statutory limit in the Credit Strategies Portfolio, which has performed very well. Without a change in law to grant additional flexibility, the Department could be required to cease new Credit Strategies investments even though additional attractive investment opportunities exist.

Additional staff. Mr. SigRist stated that Department staff had been meeting with legislators to seek the General Assembly's endorsement for additional Division salaried staff. The Treasurer and Department staff would like to establish internal equity index fund management. Currently, the Department uses a third-party investment manager for equity index funds; moving to internal management would save the State on fees. Legislators have granted the Department statutory authority to manage equity index funds internally, but internal management cannot be accomplished without more Department staff. In addition, the Department would like to be more direct in the Credit Strategies and Inflation Protection Portfolios, rather than utilizing fund-of-funds.

Mr. SigRist stated that if the Department had 12 new staff positions and approximately \$2.5 million in additional spending, it would significantly reduce the \$22 million spent annually on external index fund management and fund-of-funds and/or avoid future such costs.

Mr. Solari commented that legislators and legislative staff understood that this proposal would save the State money, but there was concern about expanding the Department of State Treasurer as other state agencies suffer significant cuts. Some legislators and legislative staff members had asked Mr. Solari and Mr. SigRist whether instead of utilizing internal management, the Department could instead partner with a private sector company to perform these tasks.

Mr. SigRist noted that the Investment Management Division has only 28 investment staff, which is far less than the Division's peers. Other pension funds of similar dollar size have approximately 100 investment staff; no similarly sized public fund has less than 50 staff members. Our personnel have roughly twice as much money under supervision, per person, compared to other large pension plans.

Mr. SigRist and Mr. Solari discussed the ultimate source of funds for Investment Management Division salaries. Ultimately, IMD salaries are paid from the trust funds that IMD manages, not from State tax revenues. In the State budget, dollars are appropriated, then those funds are reimbursed out of the State trust funds to the State's General Fund.

The Treasurer commented that she was optimistic about the Division's legislative initiatives, and she thought a good business case had been made. Mr. Triplett noted that the Division could point to a great performance track record for internal management, citing the longstanding Department internal trading program for fixed income investments.

Mr. Jones stated that from the perspective of a member of one of the State pension plans, he would be very happy to pay $4 million to save $18 million.

SAS. Mr. SigRist provided an update on the SAS risk and performance analytics system. SAS was continuing work on scenario testing and the rollout of the system to the Department's total fund. Asset-class risk models were also under development.

Other projects. The Department hosted the annual meeting of the National Association of State Investment Professionals earlier in the year. Mr. SigRist noted that the staff were looking at infrastructure investments in a number of areas, with commitments expected in the second half of 2013. The Department was also considering a number of approaches to deploy funds in emerging, small, or niche manager space within private equity.

AGENDA ITEM – IMD PERFORMANCE REVIEW

Mr. SigRist led a review of the Retirement Systems portfolio's investment performance, presenting data as of March 31, 2013. The performance review took a new format, consisting of a dialogue with the Asset Class Directors after a report by Mr. SigRist concerning the general economic picture.

Overall economic growth was slow, but with vigorous stock market performance and the recovery in consumer confidence, there was a low near-term risk of recession. Short-term interest rates were expected to stay low through 2014 and to some extent through 2015, as quantitative easing continues. Debt was highly available for large firms, but for middle-sized or small firms, debt was less available and offered only for a significant risk premium. Mr. SigRist commented that there was a dispersion between winners and laggers at the individual company level. In such a market, flexibility is particularly important.

Retirement Systems assets under management were $81.1 billion at the end of the first quarter.[2] The Global Equity Portfolio was 5.46% above the strategic target for that asset class.[3] The other asset classes were beneath their strategic targets. These shortfalls were the result of

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[2] Including the State's cash management program and other non-Retirement Systems funds, the Investment Management Division held a total of $94.2 billion in assets under management.

[3] 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).

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 under the Division's Investment Policy Statement, IMD staff should rebalance the portfolio as soon as practicable when a liquid asset class is 2.5% above or below its target weight.

Over the first quarter, the total Retirement Systems portfolio returned 3.53% net of fees. The portfolio performed 0.18% above its benchmark. For a one-year period, the portfolio returned 8.84% net of fees, which was 0.02% above the benchmark. Over that period, the Credit Strategies Portfolio added 0.54% to the total fund's performance compared to the benchmark; the Fixed Income Portfolio added 0.19%; and the Real Estate Portfolio and Private Equity Portfolio suffered from vintage year weighting issues, subtracting 0.30% and 0.36% respectively.

Mr. SigRist noted that on a risk-adjusted basis, North Carolina's performance continued to look very strong compared to its peers. In response to a question from Mr. Jones, Mr. SigRist noted that one advantage of IMD's planned asset liability study would be analyzing risk in a more sophisticated fashion.

Mr. Triplett asked whether the Department knew yet where it would go with the Fixed Income Portfolio target allocation. Mr. SigRist responded that it was too early to know, but that he did not want to lose sight that, over time, fixed income is a strong diversifier over a variety of potential outcomes. Mr. SigRist stated that he did not expect fixed income to ever be a small part of the portfolio.

Mr. SigRist commented that the Retirement Systems liquidity profile was very good. 81.8% of all funds were available within three days; this would be 75.4% even if all outstanding unfunded commitments were funded immediately.

The discussion turned to particular asset classes. The Fixed Income Portfolio showed strong performance for all time periods. Opportunistic / non-core strategies performed particularly well.

The Real Estate Portfolio exhibited good absolute returns. Real estate investment trusts (REITs), value-add private real estate, and core (excluding timber) performed well. Ms. Carter noted that REITs can be a harbinger of what is to come. Ms. Carter stated that commercial real estate was performing differently across geographic markets; energy corridors and technology-oriented markets were in high demand. European Union markets were approximately 18-20 months behind the United States in working through debt issues.

In the Private Equity Portfolio, a number of groups were requesting extensions to their investment periods. Although staff were concerned that managers would try to put money to work in an unstructured way, managers instead have shown prudence. The majority of the Retirement Systems' commitments in the year to date had been in the buyout space. Mr. Demko commented that the turnaround / distressed space was particularly attractive right now.

In the Inflation Protection Portfolio, approximately 70% of capital was in the commodities category. The current market was not favorable for these investments; industrial metals and precious metals were down in the year. Natural gas had performed well. Ms. Hahn commented that staff were seeking to diversify the portfolio. Initiatives included examination of infrastructure managers, a secondaries manager to diversify vintages, and commodity long-short hedge fund managers.

AGENDA ITEM – PUBLIC EQUITY REVIEW

Ms. Jones, Ms. Smith, and Mr. Hockett provided a presentation on the Retirement Systems' Global Equity Portfolio. Based on data through March 31, 2013, the Global Equity Portfolio met or matched its benchmark over three-month, one-year, three-year, five-year, and ten-year time periods. Ms. Jones commented that manager and stock selection had been the driver of return.

Ms. Jones commented that the U.S. market dominated other regions through the first quarter. International equity performance was driven by depressed markets in Italy, the Cyprus banking crisis, and Bank of Japan inflationary policies. Ms. Jones presented comparative valuations of different market regions and sectors. European markets featured the most attractive valuations. The Russell 2000 PE ratio was particularly high.

Ms. Smith discussed the overall Global Equity Portfolio structure. All management of the portfolio is external. A staff of three oversee a total of 25 managers and 46 strategies. The overall goal was higher passive tilt in the domestic space and higher active tilt in the international space. The portfolio has gradually evolved over time. In 2002, the Retirement Systems had pooled investment trust vehicles and was primarily invested with two external active investment managers, in highly diversified portfolios. The Retirement Systems have moved to a system of separate accounts and have transitioned from S&P to Russell benchmarks. Staff have moved to reduce misfit risk and are focusing on strategies that are high-conviction in nature. In the 2012-13 fiscal year, staff have funded the global equity emerging manager program, making two $150 million investments in funds-of-funds managed by Leading Edge (for a Russell 1000 strategy) and FIS Group (for an MSCI ACWI ex-U.S. strategy). Staff have also rebalanced the portfolio.

Mr. SigRist discussed the Global Equity work plan going forward. There are three major initiatives. First, the Department would explore consolidating among index fund providers to leverage cost savings. Second, given the large number of strategies and managers, the Department would consider streamlining the long-only side, emphasizing high-conviction managers and general simplification. Third, the Department would explore differentiated strategies such as activist investing, a low-volatility strategy, and hedged equity.

Mr. Hockett presented the team's thoughts on building out the hedged equity portfolio. The team's target was a high-single-digits to low-double-digits risk level for hedged equity. In investment structure, there is a trade-off between maximizing access to the manager universe and maximizing control of assets. Some managers will not allow a fund of one. The Department's preference is managed account infrastructure and funds of one. Mr. Hockett discussed various forms of hybrid fund-of-funds or strategic partnerships.

Mr. SigRist noted that the fastest way to move into the hedged equity space was through fund-of-funds structures, but fees and loss of control were downsides. He commented that he was uncomfortable moving too quickly, and the cost of implementation adds up. Over the next six to twelve months, the Department would move forward in a way that creates transparency, control, and the ability to unwind these investments. The allocation to hedged equity should be informed by the asset liability study and the analysis of the overall Retirement Systems asset allocation.

Mr. Triplett commented that this was a great thing to look at for the portfolio, but it is incredibly operationally intensive to do oneself. He noted that his organization had seen significant degradation of alpha in long-short equity over recent years. He attributed this degradation of alpha to improved technology.

The Chair adjourned for a lunch break at 12:30 p.m. The IAC reconvened at 1:20 p.m.

AGENDA ITEM – AON HEWITT COMPLIANCE REVIEW DISCUSSION

Jeanna Cullins of Aon Hewitt Ennis Knupp ("HEK") joined the IAC for a presentation on the investment compliance and fee review project recently completed by HEK.

The Treasurer began by reviewing the history of the compliance review project. As the Department neared the end of the Treasurer's first term, it seemed prudent to look at all the transactions in that term from a fiduciary and compliance standpoint. The Treasurer and the Department hoped to identify through the project improvements that could be made to its processes and procedures. The Treasurer and Mr. Lewis thanked staff and HEK for their work on the project.

The HEK project examined, for each investment made during the period January 1, 2009, to June 30, 2012, the reasonableness of fees and the Investment Management Division's compliance with its decision-making processes. Ms. Cullins noted that HEK had also performed a review of the Retirement Systems investment program in 2010, and HEK had far fewer recommendations in 2013 than in 2010.

On the subject of fees, HEK had no recommendations. All fees were reasonable or below average.

On the subject of compliance with decision-making practices, the 2013 report had twenty recommendations, which Ms. Cullins characterized as enhancements to tighten IMD processes. Overall, HEK found that IMD's processes and compliance with policies was very sound. Most of the HEK recommendations dealt with the need for additional documentation. Ms. Cullins noted the need to better document the basis for each investment selection. HEK recommended a summary of the rationale for each investment, including documentation of the reason why that investment fits in a particular asset class. A centralized document retention system was also recommended. HEK recommended modifying the Placement Agent Policy disclosure form to identify the specific investment fund to which it pertains. HEK also recommended compliance checklists be completed for each investment transaction.

Mr. SigRist commented that he appreciated HEK's work, which had been viewed by as staff as very constructive. Many of HEK's recommendations had already been addressed by the new IMD policies discussed earlier in the meeting. The Treasurer stated that the IAC would revisit HEK's recommendations within the next two to three meetings; by that time, the Treasurer hoped all the recommendations would be implemented.

AGENDA ITEM – IAC MEMBER Q & A

At the IAC's request, Mr. SigRist previewed the subjects likely to be covered at the next IAC meeting. There were no additional questions from IAC members.

AGENDA ITEM – PUBLIC COMMENT

There were no public comments.

ADJOURNMENT

The meeting was adjourned at approximately 1:50 p.m.

APPROVED BY: Janet Cowell

JANET COWELL
STATE TREASURER AND CHAIR