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

**MINUTES OF MEETING**
**September 18, 2013**

Time and Location: The Investment Advisory Committee ("IAC") met on Wednesday, September 18, 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), Steve Jones, David Hartzell, Harold Martin, and Courtney Tuttle. Harold Keen was not present.

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, Bryan Lewis, Bill McGee, Chris Morris, Keith Nelson, Jeff Smith, Rhonda Smith, Anthony Solari, Blake Thomas, Brad Bullock, Steve Tool, Joan Fontes, Troy March, Brett Hall, Tim Viezer, Jay Chaudhuri, Melissa Waller, Lynda Boulay, Sam Watts, Emma Hanson and Mary Laurie Cece.

Others in Attendance: Kai Peterson and Marlon Weems.

## AGENDA ITEM – OPENING REMARKS

The meeting was called to order at approximately 10:00 a.m. The Chair, Treasurer Cowell, welcomed Mr. Hartzell to his first Investment Advisory Committee meeting, stating his background in real estate would be helpful to the IAC. 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 noted that the minutes for May 29, 2013 IAC meeting would be approved after the lunch break to give more time for committee members to review.

## AGENDA ITEM – UPDATE ON IMD INITIATIVES AND PERFORMANCE

Mr. SigRist, Chief Investment Officer for the Department of State Treasurer (the "Department"), gave an update on various initiatives within the Investment Management Division (the "IMD") and a performance review of the North Carolina Retirement Systems (the "Retirement Systems").

**Short-term Priorities** – Mr. SigRist stated that the IMD is maintaining its momentum in the private market investment pipeline. With regard to public market initiatives, the IMD sent questionnaires to managers to see whom among them is willing to participate in separate managed accounts. He hopes to have that review done within six months.

The IMD recently filled three Director positions. Tim Viezer is the new Equity Director. Mr. Viezer came to the Treasurer's office from University of Cincinnati and has prior experience in the Ohio public funds. The two other Directors were promoted from within, with Ronald Funderburk promoted to Director of Credit and Inflation and Chris Morris promoted to Director of Risk Management and Asset Allocation. Due to these promotions from within, a few positions remain to be filled in the IMD. In addition, contract employees were added in Real Estate. The IMD will also be hiring a couple of part time administrative assistants and analysts. Mr. SigRist noted that he is talking with the State Office of Personnel and Budget to address below-market pay for the IMD's analysts. Mr. SigRist noted that the IMD has started a cost-effectiveness measurement (CEM) study and provided detailed information; it has become clear already that the IMD is well below peers in terms of overall cost structure.

Mr. SigRist stated that he is continuing to discuss an extension of the risk management project with SAS and hopes to have this resolved in the near future.

**Medium-term Priorities** – Mr. SigRist stated there are several infrastructure fund investments in the pipeline where investments can be made. With regard to the emerging/small niche private equity initiative, Mr. SigRist said he plans to have developed by early 2014 the scope of this program, which would likely involve a mix of direct fund investments and co-investments. The IMD is working with SIS as a consultant on the initiative.

**Long-term Priorities** – Treasurer Cowell stated that now was a good opportunity to review the governance structure of the IMD and its possible impact on long term investment objectives. The Treasurer noted that the North Carolina Treasurer is one of the few sole fiduciaries in the country. The Treasurer stated that the Department was in the process of forming a study commission, including legislators and IAC members among others, to examine the governance structure, personnel structure, and legislative oversight for the Retirement Systems' investment operations. The Treasurer said it was unclear whether anything could be passed in the 2014 legislative short session, but it might be possible to seek statutory changes in the long session of 2015. Mr. SigRist said the IMD will be working with Hewitt Ennis Knupp as consultants to the study commission. Hewitt Ennis Knupp will do an analysis of the strengths and weaknesses of the IMD's current structure and determine the impact on returns. Hewitt Ennis Knupp will look at peers, compare the investment committee model to a sole fiduciary model, and look at other constraints placed by law that affect IMD's ability to achieve returns. Mr. SigRist also stated that the Department and the study commission would also look at enhancing controls around investment oversight and increasing transparency in all aspects of the investment process.

**Performance Review** – Mr. SigRist led a discussion of the Retirement Systems' investment performance for the period ending July 31, 2013.

Several charts were presented giving a picture of the US and global economic environment. Mr. SigRist thinks the market may have gotten ahead of itself in terms of rising interest rates in the US. While the economy is relatively healthy, it is still only growing at a 2% rate and has a lot of headwinds. He stated he does not expect the US economy to normalize until 2014. Internationally, emerging markets continue to have balance of payment problems. Economic growth is tepid. While interest rates will rise over time, it is relatively unlikely to be an immediate rise.

As of July 31, 2013, the IMD had $81.9 billion in assets under management in the Retirement Systems. Total assets managed by the IMD were $96 billion. Mr. SigRist discussed the current asset allocation of each class of investments as compared to its Investment Policy Statement strategic target and transitional target.[1] According to the Investment Policy Statement, whenever an asset class is more than 2.5% underweight or overweight of its transitional target, a rebalancing should take place. During the period, a rebalancing threshold was reached in the Fixed Income and Global Equity asset classes. The managers of these asset classes met internally and discussed potential responses. Given the current view of the economy, there was some risk to adding funds to fixed income, and there were some concerns regarding valuations of the equity market. On balance, the managers felt it was better to be overweight in equity at the moment. At the end of July the Retirement Systems performed a rebalancing. $500 million was used to fund positions in the Credit Portfolio. Those funds were taken equally from Global Equity and Fixed Income. Mr. SigRist stated that he thinks that the asset allocations at the moment are essentially where they will be until the completion of the asset liability study. Mr. SigRist made a final point that historically cash was reported in IAC materials as part of the Fixed Income asset class, but now it will be reported separately. While there is not a policy target for cash, it was approximately 1% of the Fund.

The Retirement Systems' performance was above benchmark for every period. Performance was above the 7.25% goal for 1 and 3 year periods, but beneath that goal for 5, 10 and 15 year periods. The most effective asset classes were Real Estate and Global Equity. Global Equity contributed 82 basis points to the 1.77% by which the Fund beat the benchmark over the 1 year period. There has been strong performance among the active managers. Mr. SigRist stated that the Credit Strategies asset class has also had good returns. The Inflation Protection asset class has been one of the weaker performers, as has Fixed Income, but both are performing respectably when compared to the benchmark. In response to a question from Mr. Jones, Mr. SigRist stated that to evaluate performance and risk versus the benchmark, there needed to be a discussion about how much risk the Retirement Systems were willing to take to beat the benchmark. In response to a question from Mr. Triplett, who pointed out that with regard to non-public markets it is hard to find benchmarks other than peers, Mr. SigRist stated that public funds think in terms of beating the benchmark, but IMD needs to focus more on level of absolute risk (viewed as the risk of not compounding capital at the right level to meet the pension fund's obligations).

Mr. Jones asked what would be the savings if the Fund tried to invest at the benchmark with the lowest possible cost. Mr. SigRist answered it would cut costs in half, maybe to 20 basis

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[1] All funds were within the statutory asset allocation limits set by N.C.G.S. § 147-69.2(b).

points, to go completely passive in Global Equity and Fixed Income. Mr. SigRist pointed out that with the private asset classes, it is necessary to invest directly with managers; as a result, there is no low-cost alternative.

Finally, Mr. SigRist provided a comparison of the portfolio's returns with respect to peers. He stated that in a strong market environment, we will lag our peers because of our risk profile.

**AGENDA ITEM – PRIVATE EQUITY REVIEW**

The Chair recognized Craig Demko, Director of Alternatives and Keith Nelson, Portfolio Manager for Private Equity, for a review of the Alternative Investments portfolio. Mr. Demko stated that Alternatives are currently about 4.65% of the Retirement Systems portfolio. This is beneath the target and legal cap.[2]

Mr. Demko discussed the private equity investments, which is the lion's share of the Alternatives portfolio; a much smaller portion is held in hedge funds. He described the strategic, industry and geographic allocations of the private equity investments, pointing out, however, that the investments are managed based on strategic allocation (buyout, growth venture and special situations). Mr. Jones asked about the sub-categories allocations. Mr. Demko explained that although the portfolio is not managed to these, allocations such as industry and geography are monitored and kept in mind. For example, the private equity investments would not be expected to go above 50% in non-U.S. geographic allocation.

Mr. Demko described the positive cash flow of the portfolio in the past three years, where distributions have exceeded contributions. Mr. Demko went through private equity performance by vintage year and noted that in the 2008 vintage year much of the unfunded amount is funds of funds. 12% of this is related to one fund that may never call capital.

In response to a question from Mr. Hartzell, Mr. Demko stated the funds were mixed between PE and venture capital and that 2000 vintage year commitments were $22 million. There was a discussion as to how the benchmark being used compares with the underlying strategies of the alternatives portfolio. Mr. Demko explained we do not weigh by strategy but by vintage year. Mr. Triplett asked whether the Cambridge universe was representative of the fund's universe and asked whether it is an appropriate benchmark. Mr. Demko stated that a few different providers of benchmarks were looked at, but Cambridge was preferred because of the data options available. Cambridge is also a larger universe. Mr. Triplett suggested that the Department look at public market proxies as well as the universe for comparison.

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[2] The Treasurer and Mr. SigRist noted that the investment cap for this portfolio had changed in the last legislative session. The old Legislative cap was at alternative investments was 7.50% of the total portfolio, and the new cap is 8.75%.

Mr. Demko presented a breakdown of returns by strategy, pointing out that the funds of fund strategy is the weakest performer relative to other strategies. Mr. Demko noted fund of funds' double layer of fees. The special situations strategy, which includes energy, added to the total performance. Since inception, the portfolio performance was 6.18% compared to the benchmark of 8.63%.

Mr. Demko presented returns by vintage year, noting that 2005-2008, in particular, were years when the fund did not surpass the benchmark IRR. Mr. Demko explained that the portfolio is now making new commitments to the 2011, 2012 and 2013 vintage years. He described the current environment of fundraising for private equity. 2013 is on track to be the largest fundraising year in private equity. Average fund size is increasing, and the number of funds is consolidating. Mr. Jones noted that one could read that as saying that returns may be less attractive, as historically returns have been better for smaller funds. Ms. Tuttle asked whether fees are being negotiated in exchange for managers' requests to extend investment periods. Mr. Demko responded there is some type of give back to extend the period.

Mr. Demko discussed how the portfolio going forward is focusing on North America with possible options in Western Europe. Ms. Tuttle inquired about the percentage of fund with each investment. Me. Demko answered the maximum portion of any fund is 20%.

Mr. Demko turned the presentation over to Mr. Nelson to discuss venture capital. He noted that the market is dominated by funds raising $100 million or less, which makes sourcing and funding more difficult. Mr. Triplett asked if IMD is targeting $1 billion funds or larger. Mr. Demko described some recent and upcoming transactions and stated there are limited options in venture capital. Mr. Nelson noted a recent uptick in the IPO market in biotech in the last quarter. He described the plans going forward in deploying capital in venture and growth equity, such as looking at growth-oriented sectors of the economy.

Mr. Demko discussed 2014-2015 strategies. The group is developing a multi-year work plan and tentatively targeting a $1.2 billion per year commitment to reach the 7.25% target rate of return, to be finalized following the asset liability study. Mr. Demko then touched upon fee monitoring, office support, special programs, staff expansion and the possibility of getting a third party to manage residual funds.

**AGENDA ITEM – REAL ESTATE REVIEW**

The Chair recognized Susan Carter, Director of Real Estate, for a presentation on the Real Estate portfolio. The portfolio's holdings are currently 8.13% of the total Retirement Systems fund, slightly above target, with timber currently one-tenth of the 8.13% total. There are 41 managers with approximately 90 different investments. By the end of 2014, this manager count is expected to be down to about 35. Investments are in both closed-end and open-end funds. Six of these funds are to liquidate by end of year 2013 and another 10 in 2014.

Ms. Carter gave a break down of the fund by investment type (Core, Value and Opportunistic). She stated that the portfolio is well diversified in terms of sectors and geography. The portfolio is slightly underweight in the Midwest, but the managers are very comfortable with this since this region of the country hasn't experienced the same recovery as other regions. She pointed out that the portfolio is less than 40% leveraged. She stated that it is interesting to see some of the opportunistic managers try to mitigate risk by reducing leverage.

Mr. Jones asked how we categorize timber in terms of asset class. There was a discussion as to whether it should be seen as a commodity or real estate. Ms. Carter explained that we sometimes choose timber managers based on how they intend to use the land as well as cutting the timber. In this case, an asset or investment may be classified in more than one category.

Ms. Carter described transaction size diversity, stating there are limited fund managers that can provide large market transactions, and this gives them a competitive advantage. She pointed out that currently, she is looking for smaller deals because those are a broader market. Ms. Carter gave a review of the real estate portfolio's commitments and cash flows by vintage year. Most of the commitment of capital occurred after 2004 when the Real Estate fund was ramped up. Mr. Hartzell asked whether managers have asked for extensions for payout in funds. Ms. Carter answered yes, but in return we have negotiated fee reductions.

Ms. Carter discussed the performance of the real estate portfolio and of particular managers. She explained that there is a bit of a mismatch with regard to benchmarks since 90% of the benchmark is Core, while only 28% of our portfolio is Core. She pointed out that on a gross-to-gross basis, out portfolio has outperformed the benchmark on all but a five-year basis. She stated that the key performance drivers have been individual fund manager selection, which has been positive with a few exceptions.

Ms. Carter provided some general thoughts about the markets. She stated that capital flows are strong. She noted that the energy corridors and technology-oriented markets continued to see high demand.

Ms. Carter then described several initiatives going forward. Ms. Carter introduced Troy March, who is serving in the role of a portfolio manager. She stated that another analyst will start next week. Investment funding in Real Estate is projected to be $2.3 billion in 2014 in order to maintain the Retirement Systems' allocation targets, but Ms. Carter noted that she anticipates some investment policy modifications based on the upcoming asset liability study. Ms. Carter noted that real estate is having great success with their separate accounts because this gives the fund much more flexibility. She said that they planned to work with familiar separate account managers in order to have better control related to sales, debt and timing of capital invested.

Mr. Hartzell asked whether the 9% allocation to REITs would change. Mr. SigRist answered that we have a consultant looking at the pacing and structure of this asset class and we will evaluate a larger allocation toward REITs. Mr. Triplett asked about concern over having to sell assets if we get close to the 9% cap for the entire portfolio. Treasurer Cowell noted that language in the new legislation states that the portfolio does not have to sell if it bumps up again percentages. Mr. SigRist made the point that in real estate, like private equity, that the staff is doing very close fee monitoring of investment managers.

The Chair adjourned for a lunch **BREAK** at 12:10 p.m. The IAC reconvened at 1:05 p.m.

**AGENDA ITEM -- APPROVAL OF MINUTES**

A motion was make by Mr. Jones to approve the minutes of the May 29, 2013 Investment Advisory Committee. Mr. Triplett seconded and the minutes were unanimously approved.

**AGENDA ITEM – OVERVIEW OF ASSET LIABILITY PROJECT**

Mr. SigRist introduced Kai Peterson of Buck Consultants ("Buck"), who gave a presentation on IMD's asset liability study, which is currently in progress.

Mr. SigRist described the reason behind an asset liability study, explaining it is one of the key risk management tools for defined benefit investment programs. He stated that it was his hope at this IAC meeting to get some feedback regarding the IAC's assumptions and risk appetite so that the IMD could come back with some more definitive recommendations for investment allocation at the November meeting.

Mr. Peterson briefly described the work that Buck had done with regard to modeling. He explained that Buck had previously presented to the IMD in order to educate them on the Retirement Systems' actuarial risks – what risks they have control over, and what risks they do not. The purpose of this study was to look at different strategies or asset allocations for managing risk and return so that the fund will be able to meet beneficiary payment needs.

Mr. Peterson described the funding status of the ten retirement systems over which IMD has responsibility. Overall, the funding status is good. Mr. SigRist stated that the analysis will show the Retirement Systems' cash flow profile over a range of market environments, from stressed to less stressed. Mr. Jones asked if the last year's TSERS cash flow pay out was typical. Mr. Watts answered that it was typical and should be expected for the next 10-15 years, based on retiring baby boomers. Mr. SigRist pointed out that the different funds in the Retirement Systems had different payout issues and different assumed investment returns. Mr. SigRist questioned whether we should evaluate investment policies differently for different plans. Mr. SigRist pointed out that there is a ten-year perspective which is not as rosy as the thirty-year number as a means to cover benefit payments. Mr. Triplett asked if health benefits were included in the presentation number. Treasurer Cowell stated that they were not included.

Mr. Peterson then pointed out that one of the particularly important drivers of liability and costs is cost of living adjustments. Mr. Peterson pointed out that the model would include a

COLA figure. Treasurer Cowell asked for the model to include COLA increases. Dr. Martin asked if we are seeing a sizeable rate of growth in new members joining the Plans. Mr. Watts answered that membership is remaining flat. Mr. Peterson stated that in the modeling, there was an assumption of zero growth or a decline in membership.

Mr. SigRist shifted to the next portion of the presentation, asking the IAC to review and question modeling assumptions. Mr. Peterson then gave an overview of the study's asset liability modeling. It uses the GEMS model developed by Conning and Company. Different models are used for different asset classes. Mr. Peterson asked if the IAC had any thoughts on the GEMS output or assumptions. Ms. Tuttle noted that the total returns for bonds seemed low. Mr. Hartzell inquired if the inputs can be changed; in response, Mr. Peterson noted that this is a blended scenario with many variables leading to modeled returns.

Mr. Triplett asked whether it was correct to use conservative 10 year assumptions rather than more aggressive 20 year and 30 year assumptions. Mr. Peterson answered that the model necessarily starts in a low-yield environment. In response to a question from Mr. Jones, Mr. SigRist identified that credit investments were under the Distressed and High Yield categories. Mr. Triplett asked how Buck was modeling hedge funds and private equity, which traditionally are very difficult to model. Mr. Peterson stated that the data comes from a University of Massachusetts Data Stream; Mr. SigRist observed that for the purposes of this study, hedge funds represent only about 70 basis points of the Retirement Systems assets, so it probably would not be modeled as its own category. Finally, Mr. Peterson noted that private equity in this model has returns tightly correlated with public equity.

Mr. Triplett pointed out that real estate does have assumed diversification effects. He states that his experience at Duke is that modeling alternatives is difficult and tends to overestimate return and underestimate diversification. Mr. SigRist stated that there is an artificiality to these numbers, but if our goal is to get a 7.25% return, we should have some quantitative backup for these numbers. Mr. Triplett observed that current assumed numbers appear to be very conservative or very low, and Ms. Tuttle observed that high yield returns appeared low.

Mr. SigRist then turned the topic of risk sensitivity. Mr. SigRist noted it is hard to obtain 7.25% return without taking additional market risk. Mr. SigRist observed that the Retirement Systems could increase public equity, but that would create extra volatility in returns and in the contribution required from General Assembly. Mr. SigRist added that we should be careful in how we try to achieve the 7.25% return.[3]

Treasurer Cowell and Mr. SigRist thanked IAC members for their input and stated that the IMD will come back to the IAC at the next meeting with something more in depth.

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[3] As the meeting was running over its scheduled end time, Mr. Jones left the meeting at this point in the conversation.

**AGENDA ITEM – IAC MEMBER Q & A**

There were no further questions from members of the IAC.

**AGENDA ITEM – PUBLIC COMMENT**

There were no public comments.

**ADJOURNMENT**

The meeting was adjourned at approximately 2:10 p.m.

**APPROVED BY:** Janet Cowell

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