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

MINUTES OF MEETING
September 21, 2016

Time and Location: The Investment Advisory Committee ("IAC" or the "Committee") met on Wednesday, September 21, 2016, in the Dogwood Conference Room of the Longleaf Building, 3200 Atlantic Avenue, Raleigh, North Carolina.

Members Present: The following members were present: State Treasurer Janet Cowell (Chair), John Aneralla, David Hartzell, Mike Mebane, Steve Jones, Neal Triplett (Vice-Chair), and Courtney Tuttle (by teleconference).

Members Absent: None.

Staff: The following staff members were present: Renee Bezaire, Kim Baker, Brian Bolcar, Angela Cooper, Melvin Davis, Craig Demko, Alison Garcia, Brett Hall, Karen Hammond-Smith, Casey High, Vanessa Hines, Sean Incremona, Arlene Jones-McCalla, Gail Kadash, Kathy Kornak, Mathew Leatherman, Fran Lawrence, Deana Moore-Solomon, Chris Morris, Neal Motaparthy, Laura Rowe, Norman Schiszler, Kevin SigRist, Jeff Smith, Rhonda Smith, Christina Strickland, Tessa Tanis, Greg Taylor, Blake Thomas, Sondra Vitols, Madelaine Wang, Chris Ward, Sam Watts, and Brad Young.

Others in Attendance: Flint Benson (State Employees Association of North Carolina), Bruce Hopkins (CEM Benchmarking, Inc.)

AGENDA ITEM – OPENING REMARKS

The meeting was called to order at approximately 10:00 a.m. Treasurer Cowell took the opportunity to thank all the board members for their service to the IAC during the gas shortage. She reminded the Committee that there will be one more meeting this year, in which she hopes to wrap up some additional policy issues.

AGENDA ITEM – APPROVAL OF MINUTES

The Chair asked for approval of the minutes of the July 28, 2016 quarterly meeting. Mr. Mebane moved to approve the minutes, and Mr. Aneralla seconded. The minutes were approved as written.

AGENDA ITEM – INITIATIVES AND PERFORMANCE UPDATE

Performance Update – 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"). Mr. SigRist indicated in his opening remarks that the performance report contained only one month of data beyond the report presented at the July 28, 2016 IAC meeting, and as a result, he would only touch on a few of the performance slides. Turning to the NCRS asset allocation (as presented at slide 6 of the performance report), Mr. SigRist noted that public equity was one percent overweight from the target, and investment-grade fixed income and cash were near the target. Mr. SigRist commented that the team has chosen to pull down public equity in order to raise cash for benefit payments and capital calls. He noted that opportunistic fixed income was notably underweight from the target due to the team's decision to defund several credit-oriented hedge funds. Mr. SigRist noted that non-core real estate was overweight from the target, and that asset class has outperformed significantly.

New and Incremental Commitments – Turning to slide 26 of the performance review, Mr. SigRist walked through the list of new and incremental commitments since the July 28 IAC meeting. He noted:

1. **Blackstone Core**, a commitment of $250 million to one of Blackstone's new private equity funds. The fund is a longer-duration investment vehicle with a 15-year term. The fund targets lower risk, more defensive portfolio companies. Mr. SigRist noted that the fees are much lower on this product due to a co-investment vehicle into which North Carolina expected to enter later that would invest alongside the main Blackstone Core fund.
2. **Rockwood Development Partners**, a commitment of $200 million. Rockwood is one the department's largest relationships in real estate. This is an ancillary strategy with mixed-use development in gateway markets. Mr. SigRist noted that in this transaction, North Carolina had gotten the benefit of the scale of its relationship with Rockwood by bilaterally negotiating a separate account.
3. **Crow Retail Fund**, a commitment of $100 million. Crow is a longstanding real estate investor for North Carolina. Mr. SigRist noted that this is a smaller fund.
4. **Blackstone Strategic Partners**, a commitment of $50 million. This fund is part of a broader real assets strategy for the inflation sensitive asset class. In the fund, investments are made on the secondary market. The focus is on real assets that are believed to be inflation sensitive, including some real estate secondary interests.

Potential Upcoming Transactions – Turning to slides 27-29 of the performance review, Mr. SigRist provided an update regarding staff's current expectations for potential upcoming transactions in the pipeline through January 2017. Mr. SigRist noted that as we get to the end of Treasurer Cowell's term, he would like to provide as much visibility as possible regarding potential upcoming closings in the private market space.

Mr. SigRist indicated that one challenge is the amount of money coming back to the Department in distributions from existing private market investments. In the 12 months preceding September 14, 2016, $3.90 billion was returned in distributions from assets in the inflation sensitive, multi-strategy, opportunistic fixed income, private equity, and real estate asset classes. If new commitments are not made over time to replace this cash flowing back from the private market asset classes, the asset allocation to those classes will naturally decrease over time.

Mr. SigRist stated that at present, the decision had been made to stay the course with the current pipeline. The Department estimated that on the current pipeline of expected transactions through January 2017, approximately $2.36 billion would be made in new commitments and $1.91 billion would be returned in redemptions, distributions or rebalancings. Slide 29 forecast this expected activity for each asset class.

AGENDA ITEM – POLICIES REVIEW

The Chair then recognized Mr. Thomas, Interim General Counsel, for a review of Department of State Treasurer ("DST") policies. A new statute, N.C.G.S. § 147-69.11, requires formal consultation with the IAC on certain key ethics policies, and the Treasurer is required to adopt policies on these topics if they are not already in place. Mr. Thomas highlighted the goal of the review was input from the IAC on changes, improvements, and any additional topics to cover. The IAC did not suggest changes to DST's Placement Agent Policy, Conflict of Interest Certification, and Code of Ethics.

Mr. Thomas presented a series of options for a supplemental ethics policy on outside activity by the State Treasurer and staff, leading to a detailed discussion among IAC members. One point raised by several IAC members was whether there might occasionally be cases in which the State's investment portfolio might be best served by the State Treasurer joining a board. These members of the committee referenced State Treasurer Moore joining the corporate board of the New York Stock Exchange in the middle of the last decade, which gave Treasurer Moore the ability to provide input into securities regulation practices and, as a result, provide a benefit to the pension funds. A consensus formed in the IAC against a one-size-fits-all approach. The IAC recommended that the State Treasurer agree and the Retirement Boards resolve that before a Treasurer may join any private sector boards in the future, the Treasurer must have a detailed consultation with the IAC and the LGERS and TSERS Boards of Trustees. Under the recommended resolution, the detailed consultation would be required to take place in open session before the State Treasurer obtains any formal opinion from the State Ethics Commission. The IAC also expressed an interest in getting notification if the CIO was considering secondary employment or board service.

AGENDA ITEM – INVESTMENT COST-EFFECTIVENESS REVIEW

The Chair introduced Bruce Hopkins with CEM Benchmarking, Inc. ("CEM") to discuss the results of CEM's benchmarking analysis evaluating NCRS investment cost-effectiveness for the five year period ending December 31, 2005. Mr. Hopkins outlined the results of the CEM report, which compared NCRS cost and return performance to peer funds in CEM's extensive database.[1] CEM measured the NCRS five-year net total return at 6.4%, which is below the peer median of 7.4%. If passively managed in indexed investments in accordance with the NCRS asset allocation policy mix, the NCRS investment policy would have earned a five-year return of 5.7%, which is below the peer median policy return of 7.1%.

Mr. Hopkins then reviewed net value added from active management, cost, and cost-effectiveness. CEM measured the NCRS five-year net value added at 0.7%, which is above the peer median of 0.1%. CEM measured the NCRS investment cost at 47.4 basis points, which is below the peer median of 54.7 basis points. Peers' asset mix is different from NCRS; taking this difference into account, CEM estimated that NCRS was 9.7 basis points less expensive than the "benchmark cost" CEM generated by estimating the costs peers would incur if they had the same asset mix as NCRS. Therefore, CEM estimated that NCRS's cost savings, relative to peers, could be measured at 9.7 basis points – after rounding, the difference between NCRS's 47.4 basis point figure and the benchmark cost of 57.2 basis points. CEM noted that NCRS was lower cost because NCRS paid less than peers for similar services. Finally, Mr. Hopkins added that NCRS's asset risk, measured by CEM at 9.1%, was below the U.S. public fund median of 9.9%.

AGENDA ITEM – ESG PROJECT

[1] The IAC discussed that because many peer funds do not make public the same level of detailed fee information provided in DST's public reports, the CEM methodology uses standardized figures, rather than actual figures, for some measures of cost. Therefore, CEM's reported figures will not necessarily match NCDST's actual data reported in the annual fee reports found at www.nctreasurer.com/inv/Pages/Government-Operations-Reports.aspx . Nonetheless, CEM's standardized methodology allows meaningful comparisons between funds in the peer group.

Mr. SigRist introduced Sondra Vitols to give an overview of the Department's project designed to deliberately and pragmatically assess the fundamental arguments for and against Environmental, Social, and Governance ("ESG") considerations in the investment process. The first phase of this project included compiling and codifying the Investment Management Division's values, mission, vision statements, organizational aspirations, and investment beliefs. The second phase deliberately assessed the fundamental arguments for and against ESG considerations in the investment process, then critically examined how ESG-related investment beliefs could best be implemented through corporate governance, risk management, or portfolio management activities. Staff interviewed more than 90 public pension plans, endowments, foundations, and sovereign wealth funds regarding their policies and investment approaches towards ESG issues. The interviews, performed by phone, allowed staff to probe and gain a nuanced understanding of a fund's ESG activity. The interviewed funds ranged from $1 billion to greater than $100 billion in assets under management.

Ms. Vitols discussed in detail key observations from the research. Academic literature provides mixed evidence as to whether ESG factors affect financial performance; this mixed performance may stem from studies, until recently, failing to distinguish between material and immaterial ESG factors. Foundations showed the highest level of ESG activity; U.S. pension plans and sovereign wealth funds were least active. U.S. pension plans self-reported that their performance from ESG-targeted investment funds had largely been disappointing, particularly for early clean tech investment funds.

Mr. SigRist and Ms. Vitols discussed key conclusions from the research. DST developed preferences for:

- Engaging with companies or managers, rather than simply divesting, in response to ESG concerns;
- Maintaining awareness of material long-term economic, environmental, geopolitical, societal, and technological risks in a bottom-up approach; and
- Systematically integrating governance and other material risk considerations into the investment due diligence and portfolio management processes.

Staff and IAC members then discussed the draft Long-term Stewardship Practices Policy generated from the study.

AGENDA ITEM – PUBLIC EQUITY

This agenda item was deferred to the November 16, 2016 meeting due to time constraints.

AGENDA ITEMS – IAC MEMBER Q&A AND PUBLIC COMMENT

There were no further questions raised by the IAC Members. There were no public comments.

ADJOURNMENT

It was noted that the next IAC meeting was scheduled for November. Ms. Cowell thanked everyone for their attendance and input. Mr. Mebane motioned to close the meeting, seconded by Mr. Triplett. The meeting was adjourned at approximately 2:16 p.m.

JANET COWELL
STATE TREASURER AND CHAIR