

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

**MINUTES OF MEETING**

**September 24, 2014**

Time and Location: The Investment Advisory Committee (“IAC”) met on Wednesday, September 24, 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, David Hartzell, Steve Jones, Mike Mebane, and (by teleconference) Courtney Tuttle.

Members Absent: None.

Staff: The following staff members and Investment Management Division contractors were present: Lynda Boulay, Reid Chisholm, Tarik Dalton, Craig Demko, Ana-Laura Diaz, Ronald Funderburk, Alison Garcia, Brett Hall, Kathy Hahn, Patrick Hannah, Mitch Leonard, Bryan Lewis, Arlene Jones-McCalla, Troy March, Chris Morris, Neal Motaparthi, Tinh Phan, Kevin SigRist, Jeff Smith, Blake Thomas, Steve Toole, Tim Viezer, and Chris Ward.

Others in Attendance: Gaynor Fries and Kevin Sullivan.

**AGENDA ITEM – OPENING REMARKS**

The meeting was called to order at approximately 10:00 a.m. The Chair, Treasurer Cowell, announced Ms. Tuttle was attending by teleconference. The Chair also announced that the Department of the State Treasurer would be moving office space in the first quarter of next year and more would follow on the move in due course.

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 May 22, 2014, and the minutes were approved as written.

**AGENDA ITEM – CIO 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”).

**❖ NCRS PERFORMANCE**

**Performance Review** – Mr. SigRist presented to the IAC an overview of the US economic environment, showing a mid to late expansion as we come out of recession with 3.5% growth, which is fairly broad-based. Primary weak spots in residential house sales were driven by tighter regulations and

extension of credit and a more conservative approach and shifting of the liability that banks may have if appropriate diligence is not done.

FICO scores have moved more conservatively than pre-2007 and there is higher growth in mortgage credit. Unemployment is down significantly and inflationary pressures are not too much. No wage growth to push inflation, but we can expect more increases in wages going forward so that may increase cost pressure. It is difficult to get excited about rising inflation in the near term.

With respect to the true state of the labor market, the big question is how many folks will come back. As the economy continues to improve, there's uncertainty if these people will come back to the labor force or will stay on the sidelines. Mr. Jones asked for clarification on whether people who were not looking for work were mainly over the age of 55. Mr. SigRist replied that the two main groups were those over the age of 55 and those in the 25-34 age bracket, who had perhaps had difficulty in finding work during the early stage of their careers. With respect to the 55+ age group, it was questionable as to whether they would stay unemployed and out of the workforce altogether.

Mr. SigRist went on to present figures on the global economic environment and mentioned that the Central Bank was trying to manage growth and inflation. We had reasonable growth in US, and saw generally slow growth overseas.

As of June 30, 2014, assets under management were at \$104 billion all in. Reporting presented to the Board was under the old Investment Policy Statement (version 1), which was in effect for the second quarter of 2014 and replaced by a revised policy (version 2) effective July 1, 2014. New benchmarks have been adopted, which are more logical. As outlined on page 6 of the presentation, reporting shows where NCRS is underweight and overweight and the relative dollar amounts. We are around 2% overweight in Growth and around 2% overweight in Rates and Liquidity.

SigRist commented that last year was really a strong year, driven by equities. We had a 25% return on equity portfolios and strong returns in other areas and NCRS beat the benchmark by 50 basis points over a one-year period. In the 5 Year period, we matched benchmarks and exceeded them in all other periods.

Mr. Jones asked if the total plan benchmark was composed of benchmarks for each asset class which changed over time, or if it was a separate benchmark. Mr. SigRist clarified that it is a roll-up of each asset class dynamically weighted benchmark from June 2011. Going forward in future reporting, under the new Investment Policy Statement structure, there will be two levels of benchmarks for the total fund. Another benchmark will reflect each individual asset class at fixed weights. The long-term policy will be going to fixed weights so we can see the effects.

Mr. Jones asked if we were using the same benchmarks all the way back and Mr. SigRist replied that we were not. A couple of different processes would be presented at the fourth quarter meeting that will match the intent going forward. Certain investments change over time, but sometimes there are difficulties as to what fits where. Mr. Jones asked how we did compared against how we wanted to do, and Mr. SigRist responded that we had a good measure overall with the team's decisions.

Mr. Mebane asked if the policy is to report net of fees and expenses and Mr. SigRist confirmed that it was indeed the case, and that reports are net of all expenses. Benchmarks for comparison will show net of fees for public investments, although private investments' benchmarks may not always be net of fees.

**Contribution to Total Fund Performance vs Benchmark** – Over the past year, Global Equity had a strong year and Credit Strategies added 24 basis points. The other aspects were slightly flat and Real Estate had detracted from the fund's performance.

**Comparison to BNY Mellon Universe** – Mr. SigRist confirmed that fees are added in on this chart that is found in the meeting materials. Looking at the Median, our returns lagged a little but we had lower risk. The Percentile Rank is quite good at 56 for one year returns.

Looking at the Risk and Return Metrics, the Information Ratio was 25 for the fund, which was quite good compared to peers. Mr. Triplett asked if that was a sharp ratio and Mr. SigRist confirmed that the ratio was annual and smoothed. Mr. Mebane asked if the volatility is just versus our benchmark, not back to the \$10 billion fund. Mr. SigRist replied that asset allocation differences are material and that other peer groups might be a good comparison. Larger plans have economies of scale due to certain types of investments, but small plans can be more nimble; easier to rebalance, etc. Finding the best peer group is always a question. With respect to cost-effectiveness, arguments are strong for large plans due to economies of scale.

**Liquidity** – Looking at the NCRS Liquidity Profile tables, Mr. SigRist reported that an adjustment in the Real Estate column had seen open-ended core funds moved to Level 3 from Level 2. They felt it was more conservative to move into the 'Annual to 24 Month' Redemption Period, but this does not have a huge impact. Mr. Triplett asked if this was adjusted for distributions and Mr. SigRist confirmed it was not. Mr. Triplett asked if we are we starting to track that and Mr. SigRist replied that we were and were monitoring the threshold.

**Global Equity Net Performance** – Mr. SigRist reported that the 1 Year return was around 25% and the large-cap and mid-cap both did fine.

Mr. Jones asked about Equity Rebalance and Mr. SigRist reported that it is a Custom Portfolio that invests in cash, futures and options. It has facilitated a rebalance of stocks and bonds and worked out well. As we have re-thought the investment policy, we have taken it out of equities and moved to multi-strategy.

Mr. SigRist brought to the IAC's attention a list of the new funds and investments since the May meeting and moved on to present the 2014-15 Initiatives.

#### ***❖ 2014-15 INITIATIVES***

Mr. SigRist reported to the IAC that we have taken various investment priorities and initiatives. A memo had been circulated with a year-end summary and new performance management plans. With respect to the capital allocation plan - \$5 billion was traded to go to the next benchmark. Referring to the Investment Grade Fixed Income Transition, Mr. SigRist showed that the timing of the transition was favorable and selling into the trend had worked out very well.

**Progress on Pro Forma Tentative Transition Plan** – There was a \$6.9 billion gap in May, with Sources being overweight and Uses being under weight. There was very little change on the Public Equity side and Non-Core Real Estate had been added. Private Equity and Opportunistic Fixed Income had declined and were under weight, driven by two different things and we had been more aggressive about adding dollars to Opportunistic Fixed Income.

**Net Cash Flows** – we were selling into rising markets for this time period and have been able to add dollars to Inflation Sensitive and Core Real Estate. Non-Core Real Estate money has been coming back to us. Mr. SigRist confirmed that amounts shown are net of distributions and contributions.

**Pro Forma Projected Tentative Commitments** – Mr. SigRist discussed that it was reasonable to be overweight in Public Equity and that Fixed Income would likely be flat. In Non-Core Real Estate, we think there are plenty of opportunities here and are comfortable adding more to the commitments. We are underweight in Private Equity, and think we can bring it down a bit. Opportunistic Fixed Income is neutral and with respect to Inflation Sensitive, the low inflation expectations can be a good time for this. We would like to address the projected gap in the Public Equity rebalance.

Mr. Jones asked, with respect to our asset allocation target and range, is there a simple way to look at it? Meaning, there is the range and we expect it to end up there – but we may be off target for several years. How should we think about that? Mr. SigRist replied, there is a concept of being in the neighborhood and we should have some comfort if we are in there. We should never be right at the policy, the more cost effective to rebalance, the closer we want to be - that is what we are trying to do. In certain areas we are comfortable being underweight and in some areas we are comfortable being overweight. We want to be close in the allocation policy and that is how we want to manage the process.

Mr. Jones responded that it seemed whether we have 6% more money than target or 6% less than target, the dollar amount is not different but the percentages are. Mr. SigRist confirmed that was correct.

**Staging Portfolio Concepts** – Mr. SigRist raised to the IAC that they were looking for ways to get exposure to certain types of investments – Core Real Estate: we'd like to do more in a separate account and find \$1 million to do more in investment properties to get better fees, returns, etc. This could be an Evergreen for the trust fund over the long-term 5-7 year horizon. Ways to do that would be with 2 newer open-end funds and REIT-related strategy – it could be a parking place for a period of time. Staging Portfolio Concepts are in 3 areas - Hedged Equity, Inflation Sensitive Tradable Portfolio and Core Real Estate.

**Investment Projects and Priorities** – We are looking at other investment initiatives, and want to evaluate restructuring/exiting Fund of Funds and legacy low-conviction funds/managers. Banks are being asked to give proposals. For liquidity and simplification, we think it's a good time to evaluate and go to market to simplify and repurpose costs. The Private Equity market is around 92% of face value. Real estate market is slightly lower –82% of face value. A third party would help us underwrite investments, projections and valuations.

Mr. Jones asked how much money is involved and Mr. SigRist replied that it has not been sized up yet, but is in the range of \$200-400 million, comprised of 60 line items. We still need to have a good sense of our reservation price. We plan on using a firm who can underwrite portfolio assets, rather than just giving us a price for selling.

**Operations and Risk Management Priorities** – Mr. SigRist reported that Mr. Lewis, Chief Operating Officer, was building out an Operating Committee charter. With respect to implementing operating and resource improvements, we were at the interview stage of filling the new Director of Multi-Strategy role. There will be issues that the IAC would be invited to provide input on and a special meeting would be called to discuss compensation; base, incentives, etc. Mr. SigRist also reported that SAS was doing a great job so far on implementing the total fund risk systems and processes.

Mr. SigRist asked the IAC if there were any questions on the information provided and none were raised.

#### **AGENDA ITEM – NON-CORE REAL ESTATE REVIEW**

Ms. Alison Garcia provided a Real Estate update to the IAC on the Non-Core Portfolio. She introduced herself and her background and invited her team members, Troy March and Tinh Phan, to introduce themselves to the IAC also.

Ms. Garcia reported to the IAC that Real Estate currently represents 7.7% of the total NCRS plan with Core at 3% and Non-Core at 4.7%, predominantly in the US. The new policy will transition NCRS to 5% Core and 3% Non-Core and it is expected to take 5-6 years to achieve that longer term goal of 8%. The Non-Core Strategy invests in Opportunistic and Value Add with a small amount of Special Situations. Opportunistic investments are invested through comingled funds. There is ongoing monitoring of performance with respect to the management of the portfolio.

**Diversification** - Ms. Garcia showed comparisons of NCRS against Courtland data, showing that we are well-diversified. With respect to Non-Core diversification, the new benchmark is 80% US and 20% Non-US. We expect to be at benchmark by 2016.

**Real Estate Leverage** – Leverage is below monitoring standard in all strategies. Value Add was at 50.6% vs 60% for Leverage Monitoring Standard and Opportunistic is at 41.1% with 75% as Leverage Monitoring Standard. Managers are employing less leverage. Mr. Triplett asked for detail about the monitoring standard. Mr. SigRist responded, noting that if a manager adds depth but the value stays the same, we think we should be very careful about not creating an artificial limit.

**Real Estate Non-Core Performance Review** – NCRS returns were performing better in the 1 Year and 3 Year periods, but lagging in Year 7 and Year 10. There will be a strong focus on current income and risk-adjusted return. Ms. Garcia reported that information from underlying managers forecasts that 2014 and 2015 distributions are projected to exceed historical highs and showed figures to show the projected vs the actual.

**Non-Core Cash Flow by Vintage Year of Funds** – Ms. Garcia presented that 2005, 2006 and 2007 were difficult years but that the 2011 vintage year was seeing realizations in 12-18 months, instead of 4-5 years. Mr. Jones asked how these are turning out with respect to life expectancy. Ms. Garcia responded that pre-crisis, it was 14-15 years. Mr. Jones asked if a longer life is bad news rather than good and Ms. Garcia confirmed that it was and only taking 2-5 years to get it back was great. NCRS is cash modeling in-house and going to each source and contracting manager each year for projections. Mr. Mebane asked how many managers we were using; Ms. Garcia responded around 40 managers. Mr. Mebane commented that was a lot of meetings to have. Mr. SigRist commented that having staff with direct Real Estate experience is great when talking to a manager about their strategy. It is a complicated portfolio and there is an interest in simplifying it.

Mr. Aneralla commented that we seem to be gravitating towards a separate account but trying to simplify. Ms. Garcia replied that we are not adding that many incremental assets. Mr. Hartzell asked if there is a separate account for Core, and of the 40 managers, how many co-mingle funds? Ms. Garcia responded that some managers will not be reinvested with. Mr. Triplett said he would encourage us to be opportunistic, even when we're trying to simplify. He commented that his fund has gone to a system to

identify non-active managers to reduce the burdens for them. Mr. SigRist responded that was on the table and they could assign them to administrative or opportunistic accounts.

**Non-Core Performance** – Ms. Garcia presented the net returns information and showed that we had exceeded the benchmark in 1 Year and 3 Years, but had lagged over 7 Years and 10 Years. The lagging was due primarily to three investments. When we look back over the 13 year period, the gap narrows to less than 100 basis points. Mr. Jones commented that a lot of benchmarks are not investible and did that matter? Mr. SigRist replied that the benchmarks are for other investors in our situation. Mr. Hartzell commented that the total returns are based on quarterly annualized numbers which are investible, but have no index you can look at daily. Mr. SigRist responded that they were skewed to public plans and data. Mr. Jones asked if the Burgess pool was classified as Non-Core and Mr. SigRist confirmed it was.

With respect to the Value-Add and Opportunistic Real Estate, Ms. Garcia reported the focus going forward will be on current income and risk-adjusted returns. The Non-Core Vintage Year performance started going up in 2007 and they were seeing a recovery from more difficult vintage years. Managing across vintage years is very important. Benchmark to Allocation was underweight by 247 basis points. Manager selection improved by 149 basis points.

**2013-2014 Commitments** – Ms. Garcia recapped on the past year which had seen an increased focus on core and current income; larger commitments with high conviction managers; reduced fees and better terms; and increased exposure to Europe at an opportune time. Mr. Hartzell asked where debt was allocated, as there was no debt category. Ms. Garcia responded that they had undertaken a debt study to focus on opportunities in Europe and that amounts were smaller than hoped. Mr. Hartzell commented that they appear to flow through.

**Real Estate Market Review** – Ms. Garcia reported that Real Estate is in the middle stages of a fundamentally driven recovery, but that the real story is on the construction side, with construction at a multi-generational low. Multi-families have performed at or above targets and we see continued opportunities going forward.

**US Real Estate Cycle Clock** – Ms. Garcia told the IAC that the cycle hasn't changed – other than multi-family. Mr. Jones asked if the cycle was different back over time in different areas. Mr. Hartzell thought the model should hold up over time and that there would be lower volatility in the multi-family sector. Mr. SigRist suggested that other events such as tax changes or massive over-building can get things out of line.

Ms. Garcia raised that the millennials are a driving force in demand for multi-family homes and that the 25-40 year age group has seen the greatest drop in home ownership. NOI Growth has been strong and likely to continue. With respect to Occupancy and Rent Growth, there was room to grow particularly in office occupancy and retail.

**Investment Outlook** – Cap rates are near all-time lows in each sector, but are reasonable relative to intrinsic Cap rates. Ms. Garcia highlighted the risk of an interest rate rise that impacts Cap rates/values. The industry consensus is that Cap rates will absorb 80% of the first 100 basis points increase and 40-60% of the next 200-300 basis points increase in rates. Capital flows are more impactful on Cap rates than bond rates. Black Swan event - global turbulence drives capital into Core US real estate as a safe haven. US real estate values and occupancy costs are relatively less expensive than other developed nations. Cap rates in all major sectors have fallen to levels that were unprecedented prior to



the 2006-07 valuation peak and are now at all-time lows in many cases. Accounting for inflation, current pricing does not look as inflated compared to the 2006-07 height of the market when Cap rates were at 1.5% level.

**Most Expensive Markets** - a lot of these groups are in Asia, with London as the most expensive. The most expensive within the US was San Francisco at 15th.

**2014-2015 Areas of Focus** – Investment Themes for the coming year will be: Continuing to take advantage of distress in Europe; Managers that emphasize current income; Focus on managers with a rifle shot approach; Negotiate better terms and simplify; and some Build-to-Core development in either Multi-Family or Industrial. With respect to internal team priorities, they are to build out the team to increase to 1 director, 3 PMs and 2 analysts; Continue to develop existing team members; and continue to refine cash flow model and other analytics.

Mr. Jones commented that we should find people that are doing multi-family rather than investing in a market threatened by internet sites like Amazon.com. Ms. Garcia replied that they had focused on the trends he was talking about and found that the most successful retailers use a combination of brick and mortar, catalogue and online methods. We have been looking for more of these opportunities and have tried other models like industrial, but it all has to line up. Mr. Jones asked if the morphing was as big as suburbia. Mr. Hartzell added that leasing space trends showed they were either the same size per occupant or growing. Ms. Garcia commented they had seen the same pattern in gateway markets.

Ms. Garcia invited questions from the IAC. Mr. Jones asked for Ms. Garcia's thoughts on the allocation for Real Estate – are we too high or too low? Ms. Garcia thought we were definitely not too high and that we are trying to shift from Non-Core to Core with an increased allocation for the next 18 months. Mr. SigRist commented that we were comfortable being in the 8-9% range. Mr. March commented that we were at 7.7% now and should tick up to the 9% range. Mr. SigRist added that it may make a lot of sense to increase to have control over those types of assets long-term

#### **AGENDA ITEM – CLOSED SESSION**

The Chair offered her thanks to everyone and announced that in accordance with N.C.G.S. § 143-318.11 (a)(1) and (a)(6), the IAC would go into a closed session to have its periodic performance review of the Chief Investment Officer and certain investment staff. The session would contain information made confidential by the State Human Resources Act. The closed session would take place over lunch.

The Chair also stated that following this first closed session, the IAC would enter another closed session in accordance with N.C.G.S. § 143-318.11 (a)(1) and (a)(3) to discuss various legal matters in an attorney-client privileged session. The session would contain information made confidential by the sections of the Public Records Act concerning confidential attorney-client communications, which are G.S. 132-1.1(a) and 132-1.9. The Treasurer stated that the session would discuss the ongoing lawsuits against Facebook<sup>1</sup> and the Bank of New York Mellon,<sup>2</sup> along with matters which are not the subject of any currently filed lawsuit.

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<sup>1</sup> Case No. 12-CV-04081 in the U.S. District Court for the Southern District of New York.

<sup>2</sup> Case No. 12-CV-3920 in the North Carolina General Court of Justice, Wake County.

At this juncture, the Chair adjourned the meeting.

The IAC then reconvened at 1:50 p.m.

**AGENDA ITEM – PRIVATE EQUITY REVIEW**

The Chair apologized to Mr. Demko but, due to the late reconvening of the meeting following lengthy discussions in closed session, the Private Equity Review would be deferred to the next meeting.

**AGENDA ITEM – IAC MEMBER Q & A**

The Chair opened up the floor for general questions. There were no further questions or comments from members of the IAC.

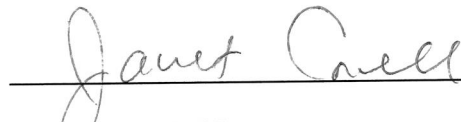
**AGENDA ITEM – PUBLIC COMMENT**

There were no public comments.

**ADJOURNMENT**

The meeting was adjourned at approximately 1:51 p.m.

**APPROVED BY:**

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