

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

ALTERNATIVE INVESTMENTS POLICIES AND PROCEDURES

I. Introduction

The Retirement Systems, as defined under the North Carolina General Statutes (“NCGS”) Section 147-69.2(b)(8), includes the Teachers’ and State Employees’ Retirement System, the Consolidated Judicial Retirement System, the Firemen’s and Rescue Workers’ Pension Fund, the Local Governmental Employees’ Retirement System, the Legislative Retirement System, and the North Carolina National Guard Pension Fund (collectively, the “Retirement Systems” or the “NCRS”). The Treasurer of the State of North Carolina (“Treasurer”), serving as the sole fiduciary of the Retirement Systems, maintains the investment program for the Retirement Systems (the “Pension Fund Program” or the “Fund”). The Investment Management Division (the “IMD”) of the North Carolina Department of State Treasurer (the “Department”) serves as the investment arm of the State Treasurer. Under the direction of the Treasurer, IMD manages the Pension Fund Program and ancillary programs as authorized by the General Assembly.

The investments of the Pension Fund Program include equity investments pursuant to (i) NCGS §147-69.2(b)(8) (the “Public Equity Portfolio”), (ii) NCGS §147-69.2(b)(1) through (6) (the “Fixed Income Portfolio”), (iii) NCGS §147-69.2(b)(7) (the “Real Estate Portfolio”), (iv) NCGS §147-69.2(b)(6c) (the “Credit Portfolio”), (v) NCGS §147-69.2(b)(9a) (the “Inflation Portfolio”), and (vi) NCGS §147-69.2(b)(9) (the “Alternative Investment Portfolio”). Collectively, the systems and funds constituting the NCRS each has a proportionate share of the Public Equity Portfolio, Fixed Income Portfolio, Real Estate Portfolio, Credit Portfolio, Inflation Portfolio, and Alternative Investment Portfolio.

The Treasurer sets forth this Statement of Alternative Investments Guidelines, Policies, and Procedures (“Policies”) on behalf of the Fund. The Policies set forth the long term objectives, guidelines, process, and procedures for the IMD with respect to its portfolio management function for the Fund’s Alternative Investment Portfolio, which is comprised of private equity strategies (the “Private Equity Portfolio”) and hedged strategies (“Hedge Fund Portfolio”).

It is the policy of the Treasurer to invest in a manner which is designed (1) to earn attractive risk adjusted rates of return for the NCRS participants while also providing for (2) safeguards to NCRS from periodic economic shocks; (3) sufficient liquidity to meet the NCRS’s obligations; and (4) compliance with all governing statutes.

II. Purpose and Standard of Care

The purpose of the Policies is to provide strategic objectives for IMD with respect to obtaining, over the long-run, attractive rates of return and enhancing NCRS's total portfolio diversification. The Policies also highlight the primary roles and responsibilities for the Treasurer, Investment Advisory Committee Members ("IAC Members"), the IMD staff, and external consultants (the "Consultants") relating to the oversight and management of alternative investments.

The design of the Alternative Investment Portfolio aims to achieve a level of return, net of all fees and expenses, of approximately 250 basis points above a broad U.S. public equity market benchmark such as the Russell 3000 Index, and secondarily to achieve a competitive level of return relative to an appropriate blend of a broad private equity benchmark such as the Thomson Venture Economics series and a broad hedge fund benchmark such as the Hedge Fund Research, Inc. series. It is expected that the returns of the Alternative Investment Portfolio will be sufficient to compensate the Fund for the long term and illiquid commitments associated with private equity investments. Recognizing the long-term nature of these investments, this relative performance will be measured over a period of multiple market cycles. Portfolio risk shall be mitigated through appropriate risk factor diversification, including subcategory, vintage year/economic cycle, geographic, and industry sector.

Under the direction of the Treasurer, the IMD staff will exercise reasonable skill, care, and due diligence to ensure prudent management of the Fund's Alternative Investment Portfolio. The Policies shall be reviewed periodically by the IMD staff to capture best practices as they continue to evolve. The IMD staff shall recommend revisions to the Treasurer on an as-needed basis.

- A. Fiduciary Responsibility.** The Treasurer is the sole fiduciary with respect to investment of the assets of the Fund for the participants of the Retirement Systems, and the Treasurer is obligated to discharge his or her duties in accordance with NCGS §147-69.7. The IMD staff, and any Consultants recognize that they shall act in accordance with these duties and shall act in a loyal and impartial manner.
- B. Confidentiality Responsibility.** The Treasurer, IAC Members, IMD staff, and any other Consultants involved as liaisons among other divisions of the Treasurer's office or other branches of North Carolina state government recognize they may become aware of or come into possession of proprietary information, including the holdings and strategies of the funds or underlying portfolios. All such matters shall remain strictly confidential and such persons shall observe all applicable insider trading and other laws and policies.

III. Investment Objectives

The Fund is investing in the Alternative Investment Portfolio to accomplish the following objectives:

- A. Attractive Returns.** Provide an attractive return in excess of public equities over the long term by making investments with expected returns commensurate with their respective risk levels.
- B. Portfolio Diversification.** Use private equity and hedge funds to enhance the diversification of the Fund's total investment portfolio given the low or negative historical return correlations of some subcategories of alternative investments with other asset classes.

IV. Roles and Responsibilities

The Roles and Responsibilities with respect to the Alternative Investment Portfolio are as follows:

A. Treasurer's Roles and Responsibilities

- Approve the Policies and any revisions thereto, as prepared and recommended by IMD staff
- Approve investment opportunities as recommended by the IMD staff
- Approve portfolio management plans as recommended by the IMD staff
- Approve performance measurement reports prepared and recommended by IMD staff
- Approve retention of Consultants (e.g., specialist consultants, temporary contractors, etc.) and third-party service providers ("Service Providers," e.g., information databases/records retention, legal counsel, etc.) as recommended by IMD staff
- Recommend statutory revisions

B. IMD Staff Roles and Responsibilities

- Source attractive investment opportunities
- Conduct due diligence on investment opportunities
- Review fit of an investment with policy guidelines
- Prepare investment evaluation reports on an as needed basis
- Recommend to the Treasurer qualified investment opportunities
- Maintain and periodically update the Treasurer on pipeline of opportunities
- Develop portfolio management plans to be recommended to the Treasurer
- Prepare performance measurement reports

- Review no less frequently than annually and, if necessary, make recommendations regarding revisions to the Policies.
- Review resources and make recommendations for the retention of Consultants and Service Providers to assist in the sourcing, due diligence and performance reporting duties on an as needed basis
- Monitor adherence to guidelines as set forth herein
- Recommend statutory revisions
- Assist the Treasurer with respect to all matters related to the Alternative Investment Portfolio

V. Investment Guidelines and Ranges

The investments of the Alternative Investment Portfolio shall be consistent with the following guidelines:

A. Allocation Size. The allocation to alternative investments at any given time shall be no greater than the amount authorized by the Treasurer. The total market value of the Alternative Investment Portfolio shall comprise no more than 5% of the total market value of the invested assets of the Fund at the time of commitment, which amount shall be evaluated and revised, if necessary, by the Treasurer no less than annually. The Alternative Investment Portfolio allocation target is long term in nature and the allocation size will fluctuate according to the relative values among the other asset classes of the Fund.

B. Permissible Investments

1. Subcategory Strategy. The Alternative Investment Portfolio includes a Private Equity Portfolio with strategic subcategory classifications including venture capital, buyouts, growth equity, and special situations and a Hedge Fund Portfolio with diversified investments in equity hedge, event driven, macro, relative value, and fund of hedge funds. The target, minimum, and maximum percentages set forth below for each category are based on committed capital. The IMD staff shall periodically review policy range targets and portfolio structure for adjustments on an as- needed basis or due to statutory revisions.

Private Equity Subcategory	Target	Min.	Max.
Buyouts	50%	40%	60%
Growth Equity	10%	5%	15%
Venture	20%	10%	25%
Special Situations	20%	5%	35%

Hedge Fund Subcategory	Target	Min.	Max.
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Diversified	100%	0%	100%
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2. **Investment Vehicles.** The Alternative Investment Portfolio may include direct limited partnership, limited liability company, or other limited liability investment vehicle investments, standardized and customized funds-of-funds, and co-investments. The IMD staff primarily recommends investments in direct limited liability investment vehicles; however, the IMD staff considers fund-of-funds investments due to limited resources and access constraints. Private Equity Portfolio fund-of-fund investments are subcategorized into venture capital, buyouts, growth equity, and special situations based on the targeted strategy(ies) of the investment. The IMD staff will recommend investments in co-investments as a method to increase potential performance upside and decrease management costs.
3. **Geography.** The Alternative Investment Portfolio may invest in opportunities wherein the vehicle or strategy is domiciled in the U.S. or overseas; provided the management team has a demonstrated ability to be successful to the satisfaction of the Treasurer in its intended investment strategy.
4. **Seasoning.** The Private Equity Portfolio may invest in primary funds and equity interests purchased from the owners thereof, otherwise known as “Secondaries.” Secondaries are typically purchased to provide the Private Equity Portfolio with additional diversification, provide access to certain investment managers, and improve the risk-adjusted returns of the Private Equity Portfolio.

VI. Risk-Return Management Guidelines

The portfolio management and monitoring of the Alternative Investment Portfolio shall be consistent with the following guidelines:

- A. **Return Volatility.** An investment’s risk exposure is generally defined by return volatility. However, volatility guidelines are not well defined herein due to a lack of available information, particularly with respect to private equity investments. Moreover, private equity investments are typically valued infrequently. As a result, private equity returns tend to be less volatile than public equity returns, which are based on daily market valuations.

Alternative Investments Subcategory	Relative Volatility
Buyout	Moderate
Growth Equity	Moderate to High
Venture Capital	High
Special Situations	Moderate
Hedge Funds	Lower

- B. Duration.** The average investment holding period will be approximately eight to twelve years for the Private Equity Portfolio. The range of holding periods may vary considerably across subcategory strategies. Venture capital investments will likely maintain longer holding periods, generally ranging from ten to fourteen years; buyout and growth equity investments will have holding periods generally ranging from eight to twelve years; and special situations investments will have holding periods generally ranging from six to twelve years. The Hedge Fund Portfolio will generally maintain, at most, an annual liquidity schedule after a one to two year lock-up period.
- C. Income and Appreciation Return Mix.** Private equity and hedge fund investments offer varying proportions of expected income and appreciation returns depending on their strategy. Venture capital and buyout investment returns are almost exclusively related to appreciation while certain types of special situations investments generate current income. The bulk of the return mix from the Private Equity Portfolio is expected to come from appreciation rather than income. The Hedge Fund Portfolio is expected to provide an uncorrelated return stream that can act as a buffer for the overall portfolio during periods of dislocation in the equity or credit capital markets. The bulk of the return mix from the Hedge Fund Portfolio is expected to come from appreciation rather than income.
- D. Diversification.** The Alternative Investment Portfolio diversification is important in seeking reduced portfolio risk and superior risk-adjusted returns. The impact of investments on portfolio diversification, portfolio risk, and risk-adjusted returns shall be considered when evaluating prospective investments.
- E. Other Risk Factors**
- 1. Leverage.** Leverage is an important risk factor, particularly within the buyouts and across the Hedge Fund Portfolio subcategories. IMD staff shall continuously review the use of leverage to determine the reasonableness in the context of investment strategy.
 - 2. Investor Control.** Control is materially defined through the ability to exit or sell an investment. The Treasurer acknowledges that the nature of private equity investing severely limits discretionary control over such investments. In exceptional circumstances, the Treasurer may seek to gain liquidity through the sale of interests in the secondary market or may act to dissolve a partnership or other investment vehicle in the event the contractual agreements are violated.
 - 3. Investment Manager Concentration.** IMD staff shall consider firm level risk in sizing a commitment to invest for a given opportunity. Ordinarily, the

Alternative Investment Portfolio's assets shall constitute less than a 25% economic interest of a given investment vehicle at the time of making the commitment. This limitation does not apply to customized investment programs where North Carolina is the sole investor other than the investment manager or its affiliate.

4. **Investment Concentration.** IMD staff shall consider concentration risk in sizing a recommended commitment to invest for a given opportunity. Ordinarily, the Alternative Investment Portfolio's commitment to a given opportunity shall constitute less than 30% of a given subcategory within the Alternative Investment Portfolio on an allocation basis at the time of making the commitment. During the implementation phase in creating the portfolio, this limitation may be exceeded with the understanding that additional commitments to that subcategory will reduce the opportunities allocation.
5. **Vintage Year.** The Treasurer seeks to diversify investment exposure across vintage year and, correspondingly, economic and credit cycles. The timing of investments during economic cycles is a primary driver of private equity returns.

VII. Performance Guidelines

The total Private Equity Portfolio's custom benchmark shall be comprised of the Russell 3000 Index lagged 3 months plus 250 basis points, net of all fees and expenses (the "Custom Private Equity Benchmark"). The total Hedge Fund Portfolio's custom benchmark shall be comprised of the 90 Day Treasury Bill rate plus 400 basis points, net all fees and expenses (the "Custom Hedge Fund Benchmark"). The combined Alternative Investment Portfolio's benchmark shall be comprised of 70% Custom Private Equity Benchmark and 30% Custom Hedge Fund Benchmark. In addition, the performance of all investments shall be measured relative to the performance of investment managers employing similar investment strategies, using data provided by Venture Economics, Hedge Fund Research, and other reputable sources.

- A. **Venture Capital.** The performance benchmark is targeted at 400 basis points above the Russell 3000 Index, annualized over the life of the investment vehicle, net of all fees and expenses.
- B. **Growth Equity.** The performance benchmark is targeted at 250 basis points above the Russell 3000 Index, annualized over the life of the investment vehicle, net of all fees and expenses.
- C. **Buyouts.** The performance benchmark is 250 basis points above the Russell 3000 Index, annualized over the life of the investment vehicle, net of all fees and expenses.

- D. Special Situations.** The performance benchmark is 300 basis points above the Russell 3000 Index, annualized over the life of the investment vehicle, net of all fees and expenses.
- E. International.** There is no separate performance guideline for international private equity investments; it is expected that international investments will help the Private Equity Portfolio achieve its overall performance objectives.
- F. Hedge Fund Portfolio.** The performance benchmark is 400 basis points above the 90 Day Treasury Bill, annualized over the life of the investment vehicle, net of all fees and expenses.

VIII. Reporting Requirements

Quarterly performance measurement reports, which shall reasonably describe the performance of the Alternative Investment Portfolio, shall be calculated in compliance with industry standards and compared to the benchmarks previously outlined. Quarterly reports shall monitor each of the risk factors previously described to evaluate compliance with portfolio guidelines.

IX. Selection of Investment Managers

As part of the risk mitigation efforts previously outlined, investments acquired or disposed of will be accompanied by a detailed report documenting a reasonable level of comprehensive due diligence compiled by the IMD staff with the assistance of Consultants and Service Providers, as determined by the Treasurer. Due diligence performed by IMD staff includes, but is not limited to, evaluation of the following criteria:

- Analyze past investment manager returns and performance
- Meet with the investment manager's principals in their office and the office of the IMD
- Review the business backgrounds of key personnel of the investment manager and perform interviews, reference checks and other evaluations of competence and expertise
- If applicable, review the most recently audited financial statements of existing investments
- Review the proposed business plan and exit strategies for the underlying portfolio's holdings
- Review investment allocation process, amount remaining to be invested, and reserve policy for active investments
- Identify key issues relating to prospective investments and resolve them
- Review the proposed terms, conditions, and fees of a prospective investment
- Evaluate firm culture, reputations, and significant firm developments over time (e.g. sale or litigation)

- Review compensation structure, personnel turnover, and succession plans within the organization
- Assess research capability, areas of expertise, and experience
- Assess ability to source investments consistent with the articulated investment strategy
- Assess reasonableness of investment strategy given current market conditions
- Assess alignment of interest and management of potential conflicts associated with issues pertaining to market valuations
- Assess client list and service history

The actual due diligence process shall be regularly reviewed and adjusted based on the type of investment. The IMD staff with the assistance of Consultants and Service Providers shall recommend to the Treasurer the due diligence required for each alternative investment.

X. Investment Manager Monitoring Procedure

Investment managers will be monitored to:

- Evaluate achievement of investment objectives
- Ensure adherence to established investment approach/style and expected risk profile
- Identify issues or trends that have the potential to result in losses to the Fund
- Alert the Treasurer when investments are not performing to expectations and recommend appropriate action.

A. Evaluation. Investment managers will be evaluated on the basis of the following: organization, personnel turnover and succession within the organization, research capability, past performance, areas of expertise and experience, performance of investment strategy, ability to source investments consistent with investment strategy, investment allocation process and amount remaining to be invested, and client activity.

B. Criteria. The subjective criteria reviewed shall include, but not be limited to, the following: the firm culture, significant firm developments (e.g. sale or litigation), reasonableness of investment strategy given current market conditions, ability to execute strategy, firm reputation, and service history with clients.

XI. Valuation Policy

Generally, the IMD will rely on the valuation of investments as reported by the investment managers. IMD staff shall seek to comply with industry best practices with respect to monitoring the valuation policy used by the investment managers.

Investment managers shall be contractually obligated to provide annual financial statements audited to be compliant with United States generally accepted accounting principles (“GAAP”), preferably by a nationally recognized audit firm.

If the investment manager is not fulfilling its obligation to provide GAAP-compliant statements to IMD staff in a contractually timely manner or within a reasonable period shortly thereafter, the Treasurer may engage special Service Providers to assist IMD staff in assessment of current fair market value.

The Treasurer, as recommended by the IMD staff, shall strive to participate in alternative investments that align investor and investment manager interests.

XII. Legal and Other Special Services Policy

Legal review will primarily be conducted by Service Providers working with the IMD or outside Consultants on behalf of the Treasurer.

In rare instances, it may be necessary for the Treasurer to engage private investigative services to investigate principals for integrity, ethical problems, tax-related issues, etc. prior to an investment subscription.

XIII. Contract Review Process

If the investment manager is acting in accordance with all applicable policies and governing agreements, then the investment manager shall maintain an “In Compliance” status. If during the course of ongoing monitoring, IMD staff determines that an investment manager’s performance, style integrity, organizational stability, compliance, or client service have breached contractual terms, IMD staff on behalf of the Treasurer, may subject certain investment managers to a contract review process. The IMD staff may recommend that the Treasurer seek to terminate the investment manager for cause, to the extent consistent with governing agreements. The Treasurer understands that many private equity investments are held in limited partnerships, limited liability companies, and other illiquid vehicles and, as such, the Treasurer’s ability to replace an investment manager or withdraw capital may be limited.