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

MINUTES OF MEETING
February 19, 2014

Time and Location: The Investment Advisory Committee ("IAC") met on Wednesday, February 19, 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), Steve Jones, David Hartzell, and (by teleconference) Courtney Tuttle.[1] There were two vacancies on the IAC.

Staff: The following staff members were present: Kevin SigRist, Lynda Boulay, Brad Bullock, Susan Carter, Craig Demko, Ronald Funderburk, Alison Garcia, Kathy Hahn, Beth Harrison, Brett Hall, William Hockett, Andrew Holton, Carlene Hughes, Fran Lawrence, Bryan Lewis, Troy March, Bill McGee, Neal Motaparthy, Mike Nichols, Jeff Smith, Rhonda Smith, Anthony Solari, Nick Sykes, Blake Thomas, Tim Viezer, Sondra Vitols, and Chris Ward.

Others in Attendance: Riddhi Mehta-Neugebauer, Mitch Leonard, Amy McDuffee, Ryan Miller, Kai Petersen, Kevin Sullivan, and David Vanderweide.

AGENDA ITEM – OPENING REMARKS; APPROVAL OF MINUTES

The meeting was called to order at approximately 10:00 a.m. After welcoming guests and outlining the agenda for the meeting, the Treasurer noted that Harold Keen and Harold Martin had rolled off the IAC. Mr. Keen and Dr. Martin's seats on the IAC are reserved for members of the boards of trustees of the Retirement Systems, and each of them had completed their service on the Retirement Systems board during the previous year. The Treasurer then asked for approval of the minutes for the December 16, 2013, meeting. Mr. Jones made the motion for approval, Mr. Triplett seconded, and the motion passed unanimously.

AGENDA ITEM – UPDATE ON PERFORMANCE

The Chair then recognized Mr. SigRist, the Chief Investment Officer, to provide an update on initiatives within the Investment Management Division ("IMD") and the performance of the investments for the North Carolina Retirement Systems (the "Retirement Systems").

Initiatives. Mr. SigRist briefly highlighted new developments since the December IAC meeting. The Treasurer and SAS agreed to extend their contract for the IMD risk analysis system. In the process, the project was re-scoped. The revised Treasurer-SAS contract calls for approximately 18 further months of work on implementation, followed by a licensing arrangement. Eighty percent of assets will be covered by the risk system after approximately the first 3-6 months of the extended term; then, private market and total fund modeling will be implemented. The contract extension is for up to five years, made up of a one-year fixed term and four one-year extensions at the Treasurer's option. The State also recently selected a vendor for an electronic contact relationship management system serving IMD. The

[1] Due to other scheduling commitments, Ms. Tuttle was able to attend only the portion of the IAC meeting after the lunch break, beginning with the agenda item entitled "Investment Policy Statement."

new system will facilitate tracking of interaction with and due diligence of investment managers. Finally, Mr. SigRist asked IAC members for feedback on the IAC charter and on IAC reporting. Mr. SigRist asked members to contact him if they would like to see a deeper dive or a less deep dive on any reports.

Performance review. As of December 31, 2013, IMD had $99.99 billion in assets under management, with $86.02 billion managed for the Retirement Systems. Due to growth in the public equity portfolio, it was 48.2% of the total Retirement Systems fund, above the 40.5% strategic target and the 43.7% transitional target. Conversely, fixed income was beneath its policy targets.[2]

The Retirement Systems investments were ahead of benchmarks, net of fees, for all time periods indicated. Performance from January 1, 2009, to December 31, 2013, was 10.5%, above the benchmark by 0.1%. Mr. SigRist cautioned that the level of returns seen over the past five years would not persist. He stated that over the long term, the State should hope to be 30 to 50 basis points ahead of the benchmark, net of fees. Mr. SigRist noted that one reason for the elevated performance of public equities over the last few years has been extraordinary monetary and fiscal stimulus.

The one-year return was 12.3% net of fees, above the benchmark by 1.76%. For this 1.76% value added, the key drivers were the global public equity, fixed income, and credit strategies portfolios, which each substantially outperformed their benchmarks. The global equity portfolio's outperformance was driven by IMD's selection of external managers.

Mr. Hartzell asked about the impact of these returns on the overall pension funding level. Mr. SigRist responded that the IMD did not have a real-time measure of funding level. However, based on discussions with the Retirement Systems' actuary, if all else holds equal there would be some positive impact on the funding status due to favorable investment returns and state employees' salaries not increasing at the 4% level assumed in the actuarial assumptions.

Comparison to peers. Mr. SigRist presented a slide comparing the Retirement Systems' performance to the universe of public funds greater than $1 billion, as tracked by BNY Mellon. Mr. Jones asked for Mr. SigRist's overall assessment of the investment program. Mr. SigRist noted, first, that asset allocation was going to drive 90% of returns. North Carolina has a significantly more conservative asset allocation than its peers, so one should expect North Carolina's risk position to be lower and its returns to lag in periods of growth. Over the last 15 years, North Carolina's risk position was much lower – 84% of peers had more risk than North Carolina's portfolio – but North Carolina's investment return was 38 basis points behind its median peer. Mr. SigRist stated that North Carolina was certainly top quartile, maybe better, in terms of risk-adjusted returns. Another aspect of the program for comparison is fees. On fees, Mr. SigRist stated that IMD would generally describe its peers as being in the $50 billion to $70 billion range. Compared to those funds, North Carolina's investment program is significantly less expensive. Those lower fees shrink the gap in performance between North Carolina's returns and what peers have posted.

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[2] Although the global equity portfolio was above the investment policy statement's strategic target, it was well below the 65% asset allocation limit set by N.C.G.S. § 147-69.2(b)(8). Although the fixed income portfolio was beneath the investment policy statement's strategic target, it was well above the 20% asset allocation minimum set by N.C.G.S. § 147-69.2(b)(6a).

Mr. Jones asked why North Carolina's asset allocation was relatively conservative. Mr. SigRist responded that going back to the Harlan Boyles administration, there has been a strong preference for bonds. The North Carolina pension's excellent funding status is ultimately the result of good long-term investment performance, a conservative amortization period compared with other states, and the legislature fully funding its annual required contribution almost every year.

Particular portfolios. Before turning to the fixed income and credit presentation next on the agenda, Mr. SigRist touched on the performance of a few particular asset classes. In real estate, Mr. SigRist and Mr. Hartzell commented that the core portfolio's one-year performance was well beyond expected returns. Mr. SigRist stated that in general, one should expect for the core portfolio 1-2% appreciation, with the rest being net operating income yield. Private equity performance reflected vintage year distribution. Unfortunately, private equity investments from some particularly strong vintage years were sold by the Retirement Systems on the secondary market following the financial crisis, when the denominator effect caused the Retirement Systems to hit their statutory percentage limits for that portfolio.

Finally, Mr. SigRist presented the list of investments made since the last IAC meeting.

AGENDA ITEM – FIXED INCOME / CREDIT REVIEW

Fixed income asset class. The Chair recognized Mr. Smith, who began by introducing each member of his team. Five staff members are responsible for an internally managed portfolio containing more than $26 billion of Retirement Systems funds. Mr. Smith stated that, in particular, he wanted to recognize the service of Beth Harrison, who has worked at IMD for more than 35 years.

The fixed income asset class had a 3.4% loss for the calendar year, but outperformed the benchmark by approximately 1.1%, saving the pension fund roughly $250 million. General market expectations are for modest rate increases in the near term, with no material changes in approach from the new Federal Reserve chair, Janet Yellen. Mr. Smith commented that over the next five years, the fixed income asset class should have return expectations in the 2% to 4% range.

As a result of the asset liability study discussed at the last IAC meeting, the fixed income portfolio is transitioning to a new set of target percentage allocations between government, corporate, and mortgage obligations.[3] The new targets will modestly reduce government and corporate obligations, modestly increase mortgage obligations, and add a target allocation for cash. In response to a question from Mr. Triplett, Mr. Smith explained that this "cash" allocation is to the IMD Short-Term Investment Fund (STIF), a $13.5 billion commingled fund containing investments for the Retirement Systems and other North Carolina state entities. The STIF's current annualized rate is 48 basis points, substantially better than a pure sweep fund like Mellon's short-term product.

Credit strategies asset class. Mr. Funderburk led a presentation on the credit asset class. A 2009 law authorized the Retirement Systems to invest up to a certain percentage, currently 7.5%, in

[3] All investments in the Retirement Systems fixed income portfolio must fall within one of the high-quality investment types set out in N.C.G.S. §§ 147-69.1(c)(1) to (7) and 147-69.2(b)(1) to (6).

higher-yield credit investments.[4] Since inception, the credit portfolio has had annualized performance of 12.0%, more than 8% higher than the benchmark. Mr. Funderburk noted that last year, the credit team stated that they would not be able to perform this well on a going-forward basis, and they echoed that statement this year. In response to a question from Mr. Hartzell seeking an attribution analysis for the outperformance, Mr. Funderburk cited manager selection and an illiquidity premium. The Retirement Systems accept some illiquidity with capital commitment vehicles – a longer date of exposure – not found in the benchmark.

Mr. Funderburk stated that in developing the portfolio, the team has taken a high-conviction, concentrated approach. The portfolio has sought to diversify across types of credit investments. On a going-forward basis, the team expects to increase exposure to direct lending. Because of fund-of-funds' layered fees, the credit team has utilized fund-of-funds only where, given IMD's limited resources and staffing, IMD would be unable to enter into those relationships directly. The credit portfolio's primary fund-of-fund relationship is with PAAMCO for a custom-mandate emerging managers strategy.

Ms. Hahn led a discussion on the current credit market environment. In the U.S., economic recovery has left limited upside to being in the high-yield market. There is significant variability between European markets, but in general, more opportunities appear to exist in Europe than the U.S. going forward. The European banking system has a great need to recapitalize and sell assets.

Over time, the team expects to increase exposure to direct lending and increase the allocation to structured credit. IMD has committed to managers with a global mandate so that their mix of investments can change over time as opportunities change. The team will continue to gradually grow the portfolio, moving closer to the target allocation, by selecting opportunities in a methodical manner as they arise.

AGENDA ITEM – LEGISLATIVE / GOVERNANCE UPDATE

Mr. Solari provided a brief update on legislative activity. The House has formed a committee, chaired by Representative Ross, that has within its scope all aspects of retirement system plan design and investment governance. The Treasurer's office will share with this committee the data gathered by the Governance Commission. Mr. Solari also noted that in last year's legislative session, the Treasurer sought additional authority to hire 10-12 employees so that fund-of-funds could be managed internally instead of externally. Members of the General Assembly were interested, but the proposal did not become part of a final bill. The Treasurer's office will continue to pursue this additional hiring authority in the upcoming short legislative session.

Ms. McDuffee, of Hewitt Ennis Knupp, offered an update on the Investment Fiduciary Governance Commission. The Governance Commission, which the Treasurer previewed to the IAC at the December 16, 2013 meeting, officially formed in January. It is made up of eleven members, consisting of industry experts, legislators, and members of the retirement systems. The Governance Commission's chair is Michael Kennedy, who also serves as chair for the Federal Retirement Thrift Investment Board. Mr. Triplett also serves as a member of the Governance Commission. The

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[4] Before the 2009 statute was passed, these investments were authorized as part of the alternatives portfolio. Those investments were transferred to the credit asset class at its inceptions.

Governance Commission would make recommendations at the end of April; those recommendations will be considered by the Treasurer and General Assembly.

The Chair adjourned for a lunch **BREAK** at 11:45 a.m. The IAC reconvened at 12:30 p.m.

AGENDA ITEM – INVESTMENT POLICY STATEMENT

The Chair recognized Mr. SigRist for a discussion of the draft revised investment policy statement ("IPS"). The draft revised IPS is the next step arising from the asset liability study discussed at the September 2013 and December 2013 meetings of the Investment Advisory Committee. Mr. SigRist was joined (via teleconference) by Kai Petersen and Ryan Miller of Buck Consultants, who worked with the IMD on the asset liability study project.

Agenda. Mr. SigRist stated that the goals for the meeting were to review the findings of the asset liability study, walk through the parts of the draft IPS that have been updated based on the study, and get the IAC's feedback on these proposed changes to the IPS. Depending on the IAC's feedback, the draft IPS could either be revised again and discussed at the May meeting, or it could be presented to the Treasurer for execution over the following weeks.

Context. The asset liability study used a series of modeled results to develop a set of recommendations for strategic asset allocation changes and total plan risk management strategies. The study's focus was how to achieve appropriate performance of the fund 10, 20, and 30 years out. Mr. SigRist commented that the portfolio should be structured to have some robustness for particular risk scenarios, including the risk that a systemic shock could affect growth investments and the risk that inflation could increase more than expected.

Performance modeling. At the last meeting, Buck and the IMD presented six potential asset allocations for the Retirement Systems. After the meeting, in light of feedback, IMD staff developed a new sample asset allocation that captures the desirable characteristics of Sample B ("enhanced status quo") and Sample C ("de-risking") discussed with the IAC in December. The performance of this new "Sample E" asset allocation was tested in Buck's model.

To ensure that they were testing all potential ideas, the IMD staff also analyzed the performance of a low-complexity strategy made up of 65% stocks and 35% bonds. As shown in Exhibit 2 to the IAC materials, the low-complexity 65% / 35% strategy did not provide attractive performance.

Draft revised IPS. IMD staff recommend the "Sample E" allocation.[5] That allocation was reflected in the draft revised investment policy statement provided to the IAC for this meeting. The draft IPS groups specific types of investments into four categories based on their roles in the overall portfolio:

- "Rates and liquidity," consisting of:
    - Investment grade fixed income (treasury bonds, mortgage agency bonds, and

[5] Mr. Hartzell asked which members of staff made the recommendation. Mr. SigRist responded that the IMD's working group for the asset liability study / IPS revision project brought the proposal to the IMD internal investment committee. That committee developed the proposal, resulting in the document presented to the Treasurer and IAC.

investment grade credit); and
    - Cash or cash-like short duration investments.
- "Growth," consisting of:
    - Long-only public equity and hedged public equity;
    - Private equity;
    - Non-core real estate; and
    - Opportunistic fixed income (the current credit strategies portfolio).
- "Inflation sensitive and diversifiers," consisting of:
    - Inflation-sensitive investments; and
    - Core real estate.
- Dedicated "multi-strategy" investments.

The draft revised IPS states policy targets and ranges for each category and subcategory listed above. In addition, all investments will be subject to the separate asset class restrictions set out in statute.[6]

Mr. SigRist presented several slides comparing the current IPS strategic target, the proposed revised IPS strategic target, the current actual asset allocation, and the average asset allocations of peers. The long-only public equity allocation would not change a great deal from the existing policy target, moving from 40.5% to 39.0%. The current allocation to domestic investment-grade fixed income, which is more than twice as large as the peer average, would be reduced to a 29% target. The policy target for real estate, private equity, opportunistic fixed income, and inflation sensitive investments would increase to 32%, including 4% in publicly-traded treasury inflation-protected securities ("TIPS"), real estate investment trusts ("REITs"), and high-yield credit. The draft IPS stated targets of 39% of the total fund for traditional long-only public equity and 3% of the total fund for hedged public equity.

Questions and discussion. During this portion of the meeting, staff and the IAC engaged in a dialogue on several aspects of the draft IPS, including:

- In response to questions from the Treasurer and Mr. Hartzell, Mr. SigRist and Mr. Funderburk spoke about some specific types of investments that would fit within the proposed IPS "inflation-sensitive" category. It would include short-term TIPS, publicly traded commodities, and private natural resources investments such as timberlands and energy. Energy investments could include infrastructure, midstream, or upstream items.
- In response to a request from Mr. Triplett, Mr. SigRist explained the purpose and process for the multi-strategy portfolio. The goal is to have investment managers that are flexible and can go across different asset classes. Given IMD's view that there are some significant risk scenarios, there should be some relationships where managers can allocate across the capital stack. Rebalancing strategies also could be part of the multi-strategy portfolio.

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[6] Appendix 3 to the draft IPS states a process for ongoing monitoring to ensure compliance with the statutory maximum and minimum classifications. Similar terms may have different meanings between the proposed IPS portfolio classifications and the statutory classifications; for instance, publicly traded shares of a real estate investment trust fall within the "Non-Core Real Estate Portfolio" in the draft IPS, but could be classified as a public equity investment under the statute. Where statutory classifications are often based on the form an investment takes, the proposed IPS classifications would be based on the underlying investments' sector or characteristics.

- Mr. SigRist noted that some investment types have broad policy ranges in the IPS because valuations can be attractive in certain market conditions, but unattractive in others. For example, inflation-linked bonds such as TIPS have a proposed policy range of 0% to 75%, with a target of 33%.
- Mr. Hartzell noted that a rebalancing would be necessary to implement the proposed new strategic asset allocation. Mr. SigRist agreed, noting that the tactical decisions about how to move to the new strategic targets would have to be discussed as they arise.
- Mr. Jones asked if the target allocation to opportunistic fixed income would be as large if not for the credit strategies portfolio's recent performance. He asked whether the credit strategies portfolio's performance and prominence was simply a product of the times. Mr. SigRist responded that Mr. Jones had a very valid point, and stated that for that reason, the lower end of the range in the draft IPS for opportunistic fixed income was 0%. Mr. SigRist commented that right now, given the state of the financial markets, he was pretty comfortable making those strategies a somewhat larger proportion of the portfolio.
- Mr. Hartzell questioned whether the draft investment guidelines for the core real estate portfolio were too restrictive. Mr. Hartzell raised concerns about whether, in some market conditions, the treatment of the total return component could bar good investments that could meet other criteria. Mr. SigRist acknowledged these concerns, which would be reflected in the next draft of the IPS.
- Mr. SigRist pointed out in the IPS a key proposed change to the investment objectives. The draft text includes the statement, "It is acceptable to limit the use of return-seeking strategies in order to avoid excessive volatility." In other words, in order to lower the portfolio's volatility (and, ultimately, reduce the chance that the General Assembly will unexpectedly face a much larger-than-expected required annual contribution that it would struggle to fund), IMD could accept investments producing a lower overall return.
- There was extensive dialogue about IMD's private equity emerging manager initiative, which is under early development. The draft IPS lists the program as a programmatic initiative goal. In response to questions from the IAC, Mr. SigRist stated that he envisioned this emerging manager program initially as a fund-of-funds, but when these managers mature and grow, the IMD would want investments to be direct. The IMD would also look at co-investments with these managers. Ms. Tuttle cautioned that in this space, co-investments often require very fast due diligence and approval, which may be difficult for a public fund. Mr. Triplett and Mr. Hartzell encouraged the IMD to have a target number to allocate to the emerging managers strategy. Mr. Jones questioned whether an emerging markets program would be big enough to matter for overall returns.

Impact on fees and complexity. Mr. SigRist stated that the changes in the proposed IPS would have an impact on fees, chiefly because money would be transitioned away from internally managed fixed income, which costs less than one basis point to manage. The impact on fees could be as great as 10 basis points if everything is fully implemented in the new investment strategy. Mr. SigRist commented that the IMD thinks the 10 basis points is worth spending, given the potential value added. Modeling indicates that the fee increase would be outweighed by enhanced risk-adjusted return. The revised IPS's impact on complexity would be limited, because there would be no new areas or structures in the revised strategy.

Benchmarks. Mr. SigRist discussed the benchmarks by which the Retirement Systems' investment performance would be measured. At the total fund level, Mr. SigRist proposed both (1) an implementation benchmark, based on the weighted performance of the portfolios using implementation target allocations; and (2) a long-term policy benchmark, which would be a simple mix of stocks, bonds, commodities, and TIPS at the same risk level as what was proposed. This long-term policy benchmark would track a strategy that would have a very low cost to implement, so the long-term benchmark would be a good comparative tool to examine whether the IMD's more complex structure adds value.

Mr. SigRist turned to benchmarks for particular asset classes. Non-core real estate remains quite difficult to benchmark. Hewitt Ennis Knupp recommended that the IMD evaluate whether to modify the opportunistic fixed income benchmark, but the current structure still seems to be the best or most neutral benchmark to staff.

Conclusion. The general consensus of the IAC was that, subject to the specific comments provided by IAC members during the meeting, the draft IPS was in good shape. Mr. Hartzell and Mr. Triplett asked that the IAC receive a copy of the final document, but stated that they did not necessarily need to discuss the next draft at the IAC's May meeting.

AGENDA ITEM – PUBLIC COMMENT

There were no public comments.

ADJOURNMENT

Mr. Jones moved to adjourn the meeting, seconded by Mr. Triplett. The motion for adjournment passed unanimously, and the meeting was adjourned at approximately 1:55 p.m.

APPROVED BY:

Janet Cowell

JANET COWELL
STATE TREASURER AND CHAIR