

**NORTH CAROLINA DEPARTMENT OF STATE TREASURER  
INVESTMENT ADVISORY COMMITTEE  
MEETING MINUTES FOR February 19, 2020**

Time and Location: The Investment Advisory Committee (“IAC” or the “Committee”) met on Wednesday, February 19, 2020, at 9:00 a.m. in the Dogwood Conference Room of the Longleaf Building, 3200 Atlantic Avenue, Raleigh, North Carolina.

Members Present: State Treasurer Dale R. Folwell (Chair), John Aneralla, Loris Colclough.

Members Attending via Telephone: Michael Mebane, Lentz Brewer

Members Absent: Greg Patterson

Staff Present: Ben Garner, Brett Hall, Frank Lester, Chris Farr, Dan E. Way, Ronald Funderburk, Fran Lawrence, Amy Szalaj, Casey High, Gail Kadash, Kathy O’Neill, Matthew Krimm, Loren de Mey, Craig Demko, Christopher Morris, Linda Nelson, Michael Nichols, Carlene Hughes, Anne Roof, Laura Rowe, Ty Powers, Troy March, Tinh Phan, Jeff Smith, Rhonda Smith, Joe Farley, Greg Taylor, Jack Wilson, Meryl Murtagh, Nicholas Langley, Chris Ward, Sam Watts, Patrick Kinlaw, Dee Jones, Mary Buonfiglio, Debra Thomas.

Others in Attendance: Barbara Gibson, Reuben Paris, David Vanderweide, Daniel Clifton, Ulf Marxen, Noel Henry, Timothy Dale, Frank Hill, Paul Norcross; Lee Cohen - Wellington.

**AGENDA ITEM – Opening Remarks**

The meeting was called to order at approximately 9:00 a.m. and the Treasurer began the meeting by leading the Pledge of Allegiance.

The Treasurer confirmed a quorum was met, then asked the Members present to declare any conflicts of interest and, there being none declared, the meeting commenced.

**AGENDA ITEM – Approval of Minutes**

The approval of minutes was halted until Mike Mebane could rejoin the call.

**AGENDA ITEM – Performance Update**

The Chair recognized Jeff Smith, the interim Co-CIO and Director of Fixed Income, and Chris Morris, the interim Co-CIO and Chief Risk and Operating Officer, to present the Performance update. Mr. Smith provided a brief update on the cost efficiencies initiative underway in the Investment Management Division (IMD). He noted the initiative has realized \$253 million of savings since January of 2017 and the initiative is on pace to reach \$345 million by December 2020.

Mr. Smith then provided an update on the U.S. economic environment for the 4th quarter of 2019 with a brief mention of the current quarter changes. The discussion points included amongst others 1) China trade deal; 2) low unemployment; 3) Federal rate cut of 25bps; 4) yield curve changes with spread tightening; and 5) strong equity returns.

Mr. Morris presented an update on Assets Under Management (AUM), as of December 31, 2019. He stated the total AUM was \$140 billion, an all-time high. He noted that the market value is up about \$3.3 billion in the 4th quarter, mainly driven by strong equity returns.

Mr. Morris reviewed the asset allocation as of December 31, 2019, as well as the current asset allocation. He discussed the over and underweights for both periods.

Mr. Morris continued to the Total Net Portfolio Returns vs. Benchmarks slide, discussing the periodic performance. He noted that we are beating benchmarks in all periods except the prior quarter, 1 year, and 3-year periods. Mr. Morris mentioned that this is the best calendar return we have seen in the last ten (10) years. He also pointed out that we have only exceeded the 7% actuarial rate of return on the 1, 3, and 10-year periods.

Mr. Mebane rejoined the call. Since Mr. Mebane was back on the call, the Treasurer motioned for and received approval for the November 2019 IAC minutes.

Mr. Morris moved onto the Growth of a Dollar Charts, showing how the plan continues to outperform the Long-Term Policy benchmark, citing that alternatives have added value over both the 5- and 10-year horizons.

Mr. Morris moved on to the Contribution to Total Plan Return chart. He discussed the dollar amount each asset class contributed to the earnings of the plan for the prior 1-year period.

Mr. Morris next walked the committee through the Return Attribution charts, noting the portfolio created a value add of -1.0% versus the implementation benchmark, for the 1-year period. The allocation effect detracted -1.7%, while the selection effect added 0.7%. Over the 3 and 5-year horizons, there was positive value add, driven by selection effect.

Mr. Morris presented the Net of Fees Risk Metrics slide, showing values over rolling periods. He also discussed the upside and downside capture metric and a drawdown graph, citing that during down markets the portfolio provided protection relative to the benchmark and equity markets.

The next topic was universe comparison. Mr. Morris mentioned that our portfolio is more conservatively positioned relative to the peer universe, so during bull markets we will underperform peers, and during declining markets we should outperform. This is reflected across a few of the time periods shown. The risk is much lower than peers, typically bottom quartile. The plan typically ranks high on the Sharpe ratio given our low volatility.

Mr. Morris moved on to the Liquidity slides. He discussed the structural liquidity slide, stating that we target to have greater than 70% of AUM in level 1 liquid assets. He commented that currently the portfolio has greater than 70% of AUM in level 1 liquid assets, and therefore there are no concerns of structural liquidity. Mr. Morris also mentioned the portfolio paid close to \$2.5 billion in net benefit payments for calendar year 2019.

Next, Mr. Morris discussed the Alternatives liquidity profile, mentioning that we were cash flow positive at nearly \$1 billion for the previous 12 months.

Mr. Smith reported on Asset Class Performance. He stated that Public Equity, Multi Strat, Core Real Estate, and Fixed Income were the highest performers for the 1-year period. He mentioned that it is interesting to see both Public Equity and Fixed income have double digit returns.

Mr. Smith also spoke about the Calendar Year Asset Class Return chart, which highlights the benefits of diversification.

The next discussion was concerning new and incremental investments, and uncalled commitments. Currently the uncalled commitments sit at \$6.0 billion, which has decreased by nearly \$500 million since the last IAC meeting.

Mr. Aneralla asked about the new world REIT mandate. Troy March mentioned this was an existing strategy and that we just added more assets to it, pulling from a passive REIT.

Mr. Smith moved along to Asset Allocation History and the Top 20 Investment Managers slide, mentioning that nearly 51% of assets are managed internally.

The Treasurer thanked the team.

Mr. Aneralla asked what the next decade will look like. Jeff Smith mentioned that fixed income will not earn 10%. Jeff mentioned that the yield right now (2.3%) is the best estimate of what the next 10 years of returns would look like for fixed income.

#### **AGENDA ITEM – Governance, Operations, and Investment Practice Review - Scope**

Mr. Morris gave an overview of North Carolina General Statute 147-69.10(b) and discussed what our recommended scope is to comply with the statute.

The Treasurer mentioned that we did not add anything in this scope that is duplicative with other laws that we are required to follow.

Mr. Aneralla asked what the process will be to procure a third-party firm to assist with this.

Mr. Morris stated that we would first finalize the scope, and then put out the scope to several consulting firms to obtain bids.

The Treasurer commented that this will likely be a time-consuming task for internal staff.

#### **AGENDA ITEM – Public Policy Outlook**

Treasurer Folwell introduced Dan Clifton from Strategas.

Mr. Clifton recapped where we were one year ago when he presented to the Investment Advisory Committee. He mentioned that policy makers love to get re-elected and that they would implement policies to create an environment that would favor re-election. He discussed the fed action and trade policies that resulted in positive equity returns over the prior year.

Mr. Clifton discussed the intersection of politics, the economy, and financial markets. He discussed how economic volatility is translating into political volatility. He discussed the changing dynamics of political parties in power over the last 7 elections, and the growing populism and nationalism that is occurring

across the globe. This populism results in greater policy uncertainty which has been good for stocks as financial markets influence the loosening of policy if uncertainty becomes too high.

Mr. Clifton discussed how recessions impacted historical elections. He also touched on how Trump's probability of re-election is aligned with the movement in the S&P 500. He discussed how presidents stimulate the economy in the year ahead of the election via fiscal stimulus and fed actions and how that acts as a shock absorber from any election uncertainty.

Mr. Clifton discussed several other topics, including the China trade deal, a potential infrastructure deal, and drug pricing.

Mr. Clifton then answered several questions from the Investment Advisory Committee and the Treasurer. Topics included potential presidential election matchups, S&P earnings and the election, the 10-year Treasury yield levels, and how state and local taxes (SALT) affect migration.

Treasurer Folwell thanked Mr. Clifton for the presentation and introduced Ron Funderburk to present the Inflation Sensitive portfolio.

#### **AGENDA ITEM – Inflation Sensitive Asset Class Review**

Mr. Funderburk announced and introduced the members on his team, Ty Powers, and Renee Guerin.

Mr. Funderburk discussed the role of the inflation portfolio in the overall pension total portfolio.

Mr. Funderburk also discussed the historical performance of the portfolio and excess return relative to the benchmark.

Mr. Funderburk presented the historical strategy allocations within the portfolio and the historical commitments by strategy, overall unfunded commitments, and the historical performance.

Mr. Funderburk discussed the liquidity characteristics of the portfolio and the correlation of the inflation portfolio relative to the other asset classes in the portfolio, highlighting the diversification benefits.

Mr. Funderburk updated the Committee with some of the recent developments in the structure of the underlying investments (better economics, better governance, and customized exposures).

Mr. Funderburk reported on historical inflation and the current consensus view that inflation will remain low into the future, but there could be upward surprises given the low rate environment. He mentioned that housing costs have been increasing at a rate higher than the overall inflation number.

Mr. Funderburk next discussed the risks to the current inflationary outlook, hitting downward pressures, uncertain pressures, and upward pressures.

Mr. Funderburk discussed the strategic considerations for 2020, focusing on high conviction managers, maintaining diversification, and desire to fill out the portfolio where there are currently gaps.

Treasurer Folwell mentioned that energy looks interesting right now, but there are many stresses. The Treasurer also mentioned that we are a participant on the debt side with good coverage.

The Treasurer thanked the team.

#### **AGENDA ITEMS – IAC MEMBER Q&A**

Mr. Mebane, Mr. Lentz and Mr. Colclough thanked everyone on the IMD team for all their hard and consistent service.

**AGENDA ITEM – PUBLIC COMMENT**

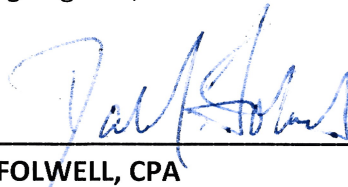
No one signed up for public comments.

**ADJOURNMENT**

The Treasurer mentioned that we are receiving criticism for fossil fuel and Chemours investments. He mentioned that the pension plan is exposed to a lot of these via the passively managed indexed funds, where we do not decide which companies are in or out of the portfolio.

The Treasurer mentioned that we need to stay focused on risk, understand how the plan is funded, and the sensitivity around volatility in the funding requirements of the participants.

The Treasurer made a motion to Adjourn, Mr. Colclough agreed, Mr. Mebane seconded it.



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**DALE R. FOLWELL, CPA**  
**NORTH CAROLINA STATE TREASURER AND CHAIR**