

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

November 16, 2016

Time and Location: The Investment Advisory Committee (“IAC” or the “Committee”) met on Wednesday, November 16, 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, Steve Jones, Neal Triplett (Vice-Chair), Mike Mebane (by teleconference) and Courtney Tuttle (by teleconference).

Members Absent: None.

Staff: The following staff members were present: Patrice Alexander, Lisa Allnut, Renee Bezaire, Kim Baker, Kristen Bierline, Brian Bolcar, Mary Laurie Cece, Angela Cooper, Tarik Dalton, Melvin Davis, Lauren De Mey, Craig Demko, Cindy Esparragoza, Joan Fontes, Ronald Funderburk, Alison Garcia, Brett Hall, Karen Hammond-Smith, Casey High, Ryan Hill, Vanessa Hines, Sean Incremona, Taylor Jackson, Arlene Jones-McCalla, Gail Kadash, Kathy Kornak, Matt Krimm, Mathew Leatherman, Fran Lawrence, John Leras, Troy March, Deana Moore-Solomon, Chris Morris, Neal Motaparthi, Meryl Murtagh, Tinh Phan, Ty Powers, Laura Rowe, Norman Schiszler, Kevin SigRist, Jeff Smith, Rhonda Smith, Edgar Starnes, Christina Strickland, Tessa Tanis, Greg Taylor, Blake Thomas, Steve Toole, , Madelaine Wang, Chris Ward, Sam Watts, Tina Wong, Jerrae Williams, Brad Young, Zhexing Zhang.

Others in Attendance: Treasurer-Elect Dale Folwell, Flint Benson (State Employees Association of North Carolina), Josh Wilson (Mercer Associates), Jon Mason (Mercer Associates), Allison Wisialowski (Mercer Associates), David Vanderweide, Suzanne Beasley.

AGENDA ITEM – OPENING REMARKS

The meeting was called to order at approximately 10:00 a.m. The Chair, Treasurer Cowell, announced that Ms. Tuttle and Mr. Mebane were attending by teleconference. The Chair also announced that the Treasurer-Elect, Dale Folwell, would be attending and observing the meeting. She then took the opportunity to thank all the board members for their service on the IAC.

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

It was noted that there was a typo that was corrected in the September 21, 2016 minutes. The Chair then asked for approval of the minutes of the quarterly meeting. The minutes were approved as written.

AGENDA ITEM – INITIATIVES AND PERFORMANCE UPDATE

Major Initiatives – Mr. SigRist provided an update on ongoing, major initiatives since the September 21, 2016 meeting. He noted good progress on the following IMD initiatives:

1. Research and development of ESG policies and strategies is ongoing. Mr. SigRist indicated that the project is moving into the implementation phase.
2. Transitioning oversight of Ancillary Funds, including establishing new long-term fixed income products for certain clients and facilitating movement of assets. He indicated that this is about done.
3. Evaluate restructuring/exiting fund of funds and legacy low-conviction funds/managers. This has been a very long running process. Only one more deep-dive to be completed by Houlihan Lokey on portions of the private equity portfolio before recommendations will be presented to the Treasurer.
4. Implementation of a managed accounts program and initial components of direct hedged equity program. Mr. SigRist indicated that more information regarding this initiative would be provided during the private equity presentation.
5. Implementation of the Venture Capital Multiplier Fund, which is an escheat fund investment has been a nine month project and closed with a commitment of \$60 million.
Conducting a third-party peer review of budget practices, fees, incentives and policy compliance comparing fourteen governmental pension plan peers

Performance Update – Mr. SigRist provided an update on the performance of the investments for the North Carolina Retirement Systems (“NCRS”). Mr. SigRist indicated in his opening remarks that he would quickly highlight some of the performance slides. Turning to the NCRS asset allocation, he noted that investment grade fixed income was overweight from the target, followed by non-core real estate. He noted that private equity and opportunistic fixed income were underweight, while core real estate and inflation sensitive were neutral. Mr. SigRist walked through the list of new and incremental investments since the September 21 meeting.

AGENDA ITEM – REAL ESTATE

Alison Garcia, Director, and her team members, Tinh Phan, Troy March, Tessa Tanis and Sean Incremona, were introduced to the meeting to present an update on Real Estate. Ms. Garcia took a few minutes to discuss her perspective on the real estate market. She reported that she is pleased with fundamentals, which look good even though there is lackluster U.S. growth. She indicated that pricing remains strong and cap rates are flattening out in most markets. Capital inflows to real estate are robust, but investors are being cautious. Regulatory changes and debt market conditions are limiting the availability of credit. Ms. Garcia indicated that on the surface the indicators look like 2007, prior to the market crisis, but that the underlying fundamentals are much stronger than they were in 2007, in particular supply and debt are much lower now.

Ms. Garcia then presented a slide showing the team’s fundamental investment approach. She reported that the team uses the same investment approach in managing the core and non-core real estate portfolios. This approach, she believes has resulted in the outperformance of the real estate portfolio. The team utilizes thoughtful and deliberate portfolio construction and leverages the size of the plan and skill

set of the team. The team is able to deliver results by taking a long-term view towards investments and manager relationships. To this point, Ms. Garcia mentioned transitioning from about 40 managers to a goal of 16. Tinh Phan, Real Estate Portfolio Manager, then presented an overview of the real estate portfolio's allocation. As of Monday, November 14, the real estate allocation is currently 8.4 percent and is expected to reach 9.6 percent of the total plan by year end 2017. He indicated that as new commitments are made, the potential impact on the total allocation is reviewed and addressed. Mr. Phan reported that in 2015 \$1.8 billion was distributed from non-core funds and they were on pace to see a similar result in 2016.

Tessa Tanis, Real Estate Portfolio Manager, reported that the plan is to stay tactically overweight in non-core real estate. Ms. Tanis reiterated that the team uses the same investment approach in managing the core and non-core real estate portfolios, but that the non-core has increased risk return flexibility. She reported that there are a variety of opportunities to develop assets in the non-core space. Non-core continues to outperform the benchmark in the three and five year returns. Ms. Tanis closed by stating that the non-core outperformance is achieved through concentration with high conviction managers, utilizing lower than average leverage and risk compared to the overall industry. Ms. Tanis then turned the presentation back over to Ms. Garcia, who walked through the core real estate performance. Core performance is lagging the benchmark due to a developing core portfolio in the J-curve against a mature benchmark. Ms. Garcia reported that \$2.9 billion has been committed to core real estate over the past three years. Core real estate produced 8 percent returns while going through the bottom of the J-curve. She indicated that it is expected that core returns will eventually outperform the benchmark as recent commitments move up through the J-curve.

Mr. March reported on the REIT performance. He noted that the group completed consolidation to a new REIT manager in April to enhance performance and significantly lower fees. The portfolio moved from 100 percent active to 50 percent active and 50 percent passive. Mr. March closed by stating that the one year returns were impacted by the transition period and negative performance of a large single stock position that was sold during the year. Performance of that position overall was strong, but it underperformed the benchmark in the last 12 months. He expects the performance will improve.

AGENDA ITEM – PUBLIC EQUITY

Mr. SigRist began the presentation by introducing the Public Equity team. Rhonda Smith, Public Equity Portfolio Manager, walked through a snapshot of the public equity portfolio including the historical portfolio structure. Mr. SigRist provided a review of the current structure. He reported that Callan Associates, a public equity consultant, was hired to analyze the current and alternate structures for the asset class. Callan reviewed current and historical data on the portfolio and benchmarks and is evaluating alternate portfolio structures. Mr. SigRist reported that a new portfolio structure, the Strawman Portfolio, was currently being reviewed by the team. The team is working on coming up with some additional modeling with Callan and wanted to look at some additional benchmark performance.

Mr. SigRist then introduced Norman Schiszler, Public Equity Portfolio Manager. Mr. Schiszler walked through the managed account platform structure. He explained the benefits of the managed account platform, which include risk oversight, transparency, control and liquidity. He reported that the team on-boarded two active managers to the platform. Annual savings are projected at 35-50 basis points over the traditional investment vehicle. He noted that risk monitoring of the portfolio is done daily and has proven to be a value add. There is a semi-annual review with the prime brokers. Looking forward, the

team is currently engaged with two additional managers and in the process of reassessing the targeted hedge fund portfolio. Mr. Schizler closed his presentation by stating that the team will continue to monitor relationships with prime brokers and further explore engagement with emerging managers.

Mr. SigRist reintroduced Ms. Smith and Casey High, Investment Analyst. Ms. Smith presented a slide detailing the history of the internal Management project and the legislative authority behind it. Mr. High reported that internal management surveyed approximately 24 peer plans and that more than 50% of the US public pension plans who responded to the survey currently manage at least some equity exposure internally. He walked through some of the benefits and requirements of internal equity management. He noted that the plan is to begin mock management of the Russell 200 Index in 2017. Mr. High also stated that it is possible to save \$1-2 million in fees if foreign passive management was brought in-house.

AGENDA ITEM – POLICIES REVIEW

The Chair then recognized Blake Thomas, Interim General Counsel, for a review of Department of State Treasurer (“DST”) policies. At this meeting the policies discussed included: Gift Ban Policy, Charitable Donations Policy, Insider Trading Policy and Employee Training Policy. Mr. Thomas reiterated the goal of the policy review was to obtain input from the IAC on changes, improvements, and any additional topics to cover. Mr. Thomas provided key features of each policy and opened the floor for discussion and feedback from the IAC.

AGENDA ITEM – COMPENSATION PLAN UPDATE

Mr. SigRist outlined the plan for the meeting - firstly, that Mercer representatives would be presenting their slide deck containing their review and recommendations for changes to the compensation structure within the Investment Management Division of Department of State Treasurer generally. Secondly, the meeting would go to a closed session for IAC Members to discuss matters specific to individual positions within the compensation plan structure.

Mr. Thomas confirmed that meeting law requires that general policy questions be conducted in open session and that conversations about individual compensation need to happen in closed session. Therefore, compensation for a type of position can be discussed in open session, but anything related to compensation of a particular position would need to be discussed in closed session.

Mr. SigRist recognized Kristen Bierline, H.R. Director, to provide an update regarding the compensation plan. Ms. Bierline introduced Jon Mason and the rest of the team from Mercer. Mr. Mason briefly provided an overview and update of the compensation structure. He noted that Mercer developed a 16 grade structure using a market positioning between the 50th and 75th percentiles. Investment-related classification titles were slotted into grades based on competitive market benchmarking and relative level compared to other roles within DST. To update the structure, Mercer analyzed the latest market data for the investment-related classification titles within the structure. Mr. Mason noted that they reviewed the data that was used two years ago thought there would be an approximate 3% market move, but rather found an 8% move. Mercer determined on a case-by-case basis whether market adjustments for individual classification titles warranted a grade adjustment. Mercer then compared the new market data to the

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FY2015 market data to determine the market movement for these classification titles. Based on Mercer's analysis of the market data, they do not recommend any grade changes from the 2015 study at this time.

Mr. Thomas asked members of the IAC to make a motion to enter closed session pursuant to N.C.G.S. §143-318.11(a)(1). For purposes of subdivision (a)(1), this board session involves matters that are confidential under N.C.G.S. § 132-1.2(1) and 66-152, the North Carolina Trade Secrets Protection Act. Mr. Triplett moved to close the meeting and the Chair seconded. The motion to close the meeting was approved.

A motion to reopen the meeting was made by Mr. Aneralla and seconded by Mr. Hartzell.

AGENDA ITEMS – IAC MEMBER Q&A AND PUBLIC COMMENT

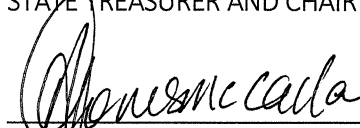
There were no further questions raised by the IAC Members. There were no public comments.

ADJOURNMENT

It was noted that the next IAC meeting was scheduled for March 2017. Ms. Cowell thanked everyone for their attendance and input. Mr. Aneralla motioned to adjourn the meeting, seconded by Mr. Hartzell. The meeting was adjourned.

 NOT THE NC
Treasurer in
2016.

DALE R. FOLWELL, CPA
STATE TREASURER AND CHAIR



ARLENE JONES-MCCALLA
DIRECTOR OF INVESTMENT OPERATIONS AND SECRETARY