

Memo

To: Kevin SigRist, Chief Investment Officer
Blake Thomas, Assistant General Counsel
North Carolina Department of State Treasurer

From: HEK Fiduciary Services

Date: May 22, 2013

Re: IMD Decision-Making Compliance and Fee Report Findings and Recommendations Summary

The following is a summary of HEK's key findings and recommendations regarding the reasonableness of fees for investments made during the Review Period fees and the IMD's compliance with its decision-making processes. To facilitate your consideration, we have included a recommendation summary matrix in the Report (See Tab 5). The Report notes that the IMD has already started to implement several of the recommendations. Examples include: creation of a charter for the internal investment committee, and enhanced documentation describing the investment selection decision-making process for each asset class. We hope you will find that the Report's findings and recommendations add value to the prudent management of the NCRS. We thank each of the NCDST staff members that worked on this project for their diligent efforts.

Fees:

We conducted an extensive analysis of the fee terms for each of the investment transactions in the review universe. The IMD staff is to be applauded for the results they have achieved in negotiating investment fees. They have done an exceptional job.

Key Findings:

1. The fees for virtually all of the global equity managers reviewed were lower than the median for the universe.
2. The management fees for most of the credit strategies and inflation protection investments are also below industry comparables; other fee components for these investments are generally below average or reasonable.
3. For private equity and real estate, overall the fees are reasonable when compared to a universe of comparable investments.

Recommendations:

We have no recommendations related to fees.

Compliance with Decision-Making Process

Overall we found the IMD's compliance with its decision-making processes to be sound.

Key Findings:

1. The investment decision-making process is founded upon a comprehensive investment policy statement (IPS), adopted by the Treasurer, which is consistent with best practices.
2. The soundness of IMD's decision-making process has been advanced by the recent establishment of an internal investment committee, which we believe is an excellent approach used by cutting-edge institutional investors to promote oversight and compliance.
3. The IMD is fundamentally in compliance with the IPS requirement to document the basis for each manager selection decision.
 - Investment recommendation memos exist for virtually all of the private equity, real estate, credit strategy, and inflation protection investments made during the Review Period; exhaustive legal checklists as well as summary memorandums have also been prepared for most of the investment transactions.
4. Prior to entering into an investment agreement, execution of a placement agent disclosure letter is required, whether or not a placement agent was used. Disclosure letters are on file for virtually all of the investments made during the Review Period. Most of these investments did not involve the use of a placement agent. In most cases where a placement agent was used the management fees were reduced by the placement agent's fees. The fees charged were within the typical range for the applicable asset class.

Recommendations:

Over the last several years the Treasurer and IMD staff have worked diligently to institute best practices and distinguish the DST as a leading institutional investor. The Report identifies several areas that we believe will assist in this effort, foster continued positive change, add value to the decision-making process, and facilitate compliance. Our recommendations can be categorized into two primary areas: (1) promoting the Treasurer's ability to fulfill her fiduciary duties and achieve positive long-term returns and (2) systemization and strengthening of documentation related to the investment selection process.

Key Report recommendations regarding the IMD's decision-making processes are summarized below:

- Seek a statutory amendment to restore the Treasurer's independent procurement authority.
- Establish a compliance certification cover sheet to accompany each investment transaction presented to the Treasurer which certifies that all statutory and policy requirements have been met.
- Develop a systematic process to regularly monitor and report to the Treasurer on policy compliance.
- Create and adopt a charter for the internal investment committee.
- Enhance and consolidate the documentation describing the investment selection decision-making process for each asset class.

- Require the use of investment recommendation memos for all asset classes, including the establishment of a standardized template
- Consider using asset class consultants to better complement and supplement investment resources
- Implement a centralized log and document management system