

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

**MINUTES OF MEETING
May 30, 2012**

Time and Location: The Investment Advisory Committee ("IAC") met on Wednesday, May 30, 2012, 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), John Medlin (vice-chair), Steven Jones, Harold Keen, Harold Martin, Neal Triplett and Courtney Tuttle. All members were present for all portions of the meeting unless noted otherwise below.

Staff: The following staff members were present: Lynda Boulay, Susan Carter, Jay Chaudhuri, Craig Demko, William Hockett, Arlene Jones-McCalla, Bryan Lewis, Rodney Overcash, Mike Ruetz, Norm Schiszler, Jeff Smith, Rhonda Smith, Tony Solari and Blake Thomas.

Others in Attendance: Ann Chapman, Ron Elmer, Anthony Greco, Michael Kennedy, Jonny Lach, Ed Macheski, Simon Ruddick and Alexandra VanVliet.

AGENDA ITEM – OPENING REMARKS

The meeting was called to order at approximately 10:00 a.m. Treasurer Cowell reminded all IAC members of the Code of Ethics. The Chair asked if any Committee members were aware of any actual or perceived conflicts of interest concerning any item on the meeting agenda. No conflicts were reported.

AGENDA ITEM – APPROVAL OF MINUTES

Treasurer Cowell asked for any discussion, comments or corrections concerning the draft minutes of the February 29, 2012, meeting. The IAC unanimously approved the minutes without any changes to the draft.

AGENDA ITEM – OUTSTANDING ITEMS

Mr. Lewis, the interim Chief Investment Officer, introduced Mr. Ruetz, Director of Risk Management and Asset Allocation, for an update on the unified risk assessment system being developed by the Department in cooperation with SAS. Mr. Ruetz noted that the fixed income and global equity portfolios would be among the first portions of the SAS system to be implemented. Mr. Ruetz also noted that the Department continued to work with Buck Consultants, actuaries to the Retirement Systems, concerning sensitivity analysis of key liability metrics related to various market and economic scenarios. At the September Investment Advisory Committee meeting, an update will be provided concerning this actuarial work.

In response to a question from Mr. Medlin, Mr. Ruetz noted that the Department's risk and performance system will include the impact of credit default swaps. Mr. Ruetz cautioned that most credit default swaps would be found in certain hedge funds; although the Department's hedge fund managers have agreed in all cases thus far to provide that information, access to CDS information could be potentially restricted.

Treasurer Cowell thanked Mr. Ruetz and staff for their work on the SAS project.

Mr. Lewis provided an update on the Department's Emerging Manager of Managers search. The Department received eleven responses to its Request for Information. The project seeks to fill a public equity mandate with a group of smaller-sized, entrepreneurial investment management firms with the strong probability of achieving above-benchmark results. In response to a question from Ms. Tuttle, Mr. Lewis noted that the Emerging Manager of Managers program would take the form of an investment fund that would invest in smaller fund managers. The Department will work with those managers to develop a portfolio.

Mr. Lewis noted that the Department was monitoring the General Accounting Standards Board's statements concerning appropriate discount rates and the proper reporting treatment for unfunded pension fund liabilities.

Dr. Martin joined the Committee meeting at this time.

Mr. Lewis provided remarks on the European financial situation. The core cause of the European crisis appears to be too much debt – both sovereign debt and personal debt. In this sense, the European crisis is similar to other prior financial crises. The major differences here are the larger, more-developed nature of the area at risk and the fact that the area at risk is the gateway to several developing markets. The outcome of the situation remains uncertain. Mr. Lewis discussed several potential outcomes from the crisis, including a slow, protracted low-growth decade; further efforts by the European Union to use monetary policy to help struggling members; or a departure from the euro by one or more nations that could lead to contagion risk, irrational market behavior, and a focus on short-term rather than long-term outlook. Most debt cycles are approximately eight years, and the situation should be expected to take some time to resolve. The June 17 Greek elections were expected to provide a clearer picture of potential future events.

In response to a question from Mr. Triplett, Mr. Lewis stated that the total plan currently had a 5.93% exposure to the Eurozone. Mr. Ruetz noted that this was consistent with applicable benchmarks.

In response to a question from Ms. Tuttle, Mr. Ruetz elaborated by discussing the total plan's exposure specifically to the financial sectors of the Spanish, Italian, and Greek economies. The fixed income portfolio had no exposure. Approximately 0.0035% of the global equity portfolio was invested in companies within the Spanish banking sector. Approximately 0.0022% of the

global equity portfolio was invested in companies within the Italian financial sector. There was less than 0.0001% exposure to the Greek financial sector.

Mr. Lewis described the Department's hedging strategies in place against Eurozone market disruption. Mr. Medlin noted that Eurozone-related risk arises not only through investments on European markets, but also through the effect of foreign actions and events upon the market for U.S. stocks and bonds.

Mr. Lewis then began a discussion of the recent news concerning trading losses incurred by JP Morgan on its own trading accounts. This appears to be an internal management and market control issue for JP Morgan. JP Morgan allowed a group of traders to take a very large position, then continue building that position. When the position became apparent to competitors, the size of JP Morgan's position provided opportunities for the competitors to make money at JP Morgan's expense. Turning to the Retirement Systems portfolio, none of the State's managers are allowed to act in the same way as the JP Morgan traders who incurred this loss.

Ms. Tuttle observed that one takeaway message from JP Morgan's mistake was that not all derivatives are the same; certain parts of the market are extremely illiquid. Ms. Tuttle asked about limitations on what percentage of a particular market our managers can hold at any given time. Mr. Ruetz noted that the Department's diligence process examines the size of each manager compared to the relevant market in which that manager will take positions under its approved strategy.

Returning to the topic of the European financial situation, Mr. Jones observed that financial professionals often classify companies based on where they are headquartered, but it may ultimately be more meaningful to classify based on where companies' assets are located. Mr. Jones suggested examining which companies in the Retirement Systems portfolio hold assets in Portugal, Italy, Greece, Spain and other potentially distressed countries. Mr. Lewis responded that the Department was beginning to do that work, examining banks and insurers not on the basis of where they are located, but on the basis of where they are garnering revenue.

Mr. Triplett noted that it could be helpful for the Retirement Systems to gather information on second-party exposure. Mr. Lewis thanked Mr. Triplett.

AGENDA ITEM – PORTFOLIO UPDATE

Mr. Lewis provided an update on the portfolio, with data through March 31, 2012. Over the past quarter, the total Retirement Systems portfolio returned 6.38% net of fees. The portfolio performed 0.50% above its benchmark. Over the past twelve months, the portfolio returned 5.15%, which was 0.49% below its benchmark.

Compared to the universe of public funds with more than \$1 billion of assets, the total fund was within the top quartile in terms of investment return measured over the past twelve months. The

Department has consistently incurred a lower level of risk than its peers, staying within the lowest-risk quartile of the peer group.

Mr. Medlin suggested providing further information at future meetings regarding the performance of all managers and mandates, measured over one-year and five-year periods. Mr. Lewis stated that this information should be relatively simple to compile and bring to future IAC meetings.

In response to requests from Mr. Medlin and Mr. Triplett, Mr. Lewis and Mr. Smith provided updates to the end-of-quarter figures, providing performance measures taken as of April 30 and May 29. The portfolio was affected by the overall downturn in equities that had taken place during the first two months of the second quarter. Mr. Medlin noted that the Department's bond portfolio would, on the other hand, perform better than expected in this market.

Treasurer Cowell, Mr. Medlin, Mr. Triplett and Mr. Lewis discussed whether, in light of the equity market and bond market's difficulties in achieving returns near 7.25%, more flexibility in portfolio balance could be needed to allow the funds to achieve overall returns at a 7.25% level. Mr. Triplett noted that North Carolina's current approach is appropriate, but to get a 7.25% return, lawmakers might have to authorize the Department to incur greater risk.

Throughout the discussion of the performance of the Department's asset portfolios, Mr. Lewis stressed that the Department sought to invest in operators rather than speculators. New commitments were made during the first quarter to private equity funds managed by Mount Kelleet and Accel-KKR; a credit strategies portfolio fund managed by Fortress; and inflation portfolio funds managed by Denham Capital and Red Kite. Going forward, the private equity team will consider smaller allocations to very good funds in order to establish relationships and obtain further opportunities to invest in the future. There was some disconnect between the real estate portfolio and its benchmark because the benchmark's strategy is not equivalent to the Department's strategy, which is more domestically focused. In response to a question from Ms. Tuttle, Mr. Overcash noted that the Department was tracking its exposure to particular commodities and would track that exposure in further detail once the SAS risk management system becomes fully effective.

AGENDA ITEM – PUBLIC EQUITY REVIEW

Mr. Lewis, Ms. Smith, Ms. Jones-McCalla and Mr. Hockett led a presentation concerning the Department's public equity portfolio. The portfolio has outperformed the benchmark over short-term, medium-term and long-term time frames. The portfolio was relatively heavily weighted in the consumer discretionary, health care and technology sectors, and the portfolio's performance benefited from these allocations. The portfolio was underweight, relative to the benchmark, to emerging markets and the developed Asian markets.

In response to a question from Mr. Triplett, Mr. Ruetz stated that the beta was 1.02 for the global equity portfolio and 0.44 for the total portfolio.

Mr. Hockett led a discussion of the public equity hedge fund portfolio. The first investment of this type was made on May 1, 2012, with Tiger Tar Heel Partners. Mr. Hockett discussed the search for a proper benchmark. Ultimately, the Department determined that a beta adjusted public equity index best matched the underlying equity strategy, adjusted for the reduction in volatility.

Staff described the structure of the Tiger Tar Heel investment partnership. The Department has entered this space on a long-short basis, but will examine comprehensively the use of hedging strategies. Mr. Lewis stated that Tiger was chosen because it is a strong partner that will allow the Department to quickly enter into this investment space. The model for the partnership envisions direct investments with funds. Tiger's managers will craft an optimized portfolio based on the Department's parameters. Tiger will recommend managers, and the Department will have veto power. Gil Caffray, Tiger's Chief Investment Officer, will be the Department's main point of contact. Mr. Caffray was Tiger Management's chief trader serving beneath Julian Robertson for many years. John Townsend, Tiger's Chief Operating Officer, has also been active on the Department's account.

AGENDA ITEM – CLOSED SESSION

In accordance with N.C.G.S. §§ 132-1.1(a) and 143-318.11(a)(5)(ii), the IAC went into closed session for matters concerning the search for a new Chief Investment Officer being conducted by Mr. Michael Kennedy of Korn/Ferry International. Mr. Jones moved to close the session. Mr. Keen seconded, and the motion was approved unanimously.

The IAC exited closed session at 12:00 p.m. The Chair noted for the record that no action was taken while in closed session.

The meeting was adjourned for lunch immediately thereafter. The meeting reconvened at approximately 12:45 p.m.

AGENDA ITEM – HEDGE FUND LANDSCAPE

Mr. Overcash introduced Mr. Simon Ruddick, Managing Director, Albourne Partners, who led a presentation concerning the hedge fund landscape.

Mr. Ruddick noted that hedge funds are not an asset class, but a business model. They achieve disappointing performance when markets are very efficient or are temporarily inefficient.

Mr. Ruddick commented upon proposed regulation of hedge funds in the U.S. and in Europe, then moved to a discussion of counterparty risk in light of the European financial situation. He explained the operation of the German banking system and compared governmental monetary transfers within the European monetary union to governmental monetary transfers within the United States.

Mr. Ruddick spoke about the Open Protocol Enabling Risk Aggregation ("OPERA"), an initiative under which hedge fund managers will report risk information in a standardized format enabling the easy aggregation of information. Mr. Ruddick is co-chair of the OPERA working group. Additional transparency may serve, among other things, as a disincentive for hedge funds to engage in improper conduct.

Mr. Ruddick commented on the best structure for hedge fund fees. The level of fees is important, but the fee structure, or "shape," is also critical. As an example, Mr. Ruddick cited adjustments of performance fees for beta adjusted returns. Mr. Ruddick urged hedge fund clients to push managers to accept formulas for fees that do not affect trading behavior.

Mr. Triplett asked Mr. Ruddick how successful clients had been in getting funds to accept full position-level transparency. Mr. Ruddick responded that one of the leading managers in the world was now providing detail at Grade 3 of the open protocol. This can be used as a negotiating item to pull other hedge fund managers toward a similar level of transparency.

AGENDA ITEM – IAC MEMBER Q & A

There were no additional questions for Investment Management Division staff from the Investment Management Committee.

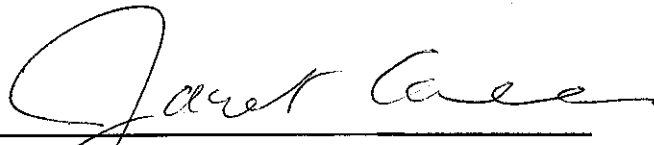
AGENDA ITEM – PUBLIC COMMENT

Mr. Ed Macheski provided a public comment.

ADJOURNMENT

The meeting was adjourned at 1:55 p.m.

APPROVED BY:



JANET COWELL
STATE TREASURER AND CHAIR