

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

**MINUTES OF MEETING
February 29, 2012**

Time and Location: The Investment Advisory Committee ("IAC") met on Wednesday, February 29, 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), Harold Keen, Harold Martin, Neal Triplett and Courtney Tuttle (by telephone).

Staff: The following staff members were present: Casey High, Lynda Boulay, Jay Chaudhuri, Blake Thomas, Shawn Wischmeier, Bryan Lewis, Brett Hall, Jeff Smith, Rodney Overcash, Ronald Funderburk, Rhonda Smith, Craig Demko, Keith Nelson, Chris Morris, Greg Beuris, Mike Ruetz, Steve Toole, Chuck Watts, Joan Fontes, Tony Solari, Susan Carter, Sam Watts, Norm Schiszler and Kathy Hahn.

Others in Attendance: Mitch Armbruster (Smith Anderson, Blount, Dorsett, Mitchell & Jernigan, L.L.P.), Carl Patterson (Smith Anderson), Larry Langer (Buck Consultants), Mike Ribble (Buck Consultants), John Brocklebank (SAS), Balaji Gopalakrishnan (SAS), Prashant Pai (SAS) and Chip Wells (SAS).

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.

AGENDA ITEM – CLOSED EXECUTIVE SESSION

In accordance with N.C.G.S. §§ 132-1.1(a) and 143-318.11(a)(3), the IAC went into closed session for matters concerning a potential legal claim by the Department of State Treasurer. This claim is not yet the subject of a lawsuit. Dr. Martin moved to close session. Mr. Medlin seconded and the motion was approved unanimously.

IAC Member Courtney Tuttle joined the meeting via teleconference during the closed session.

The IAC exited closed session at 10:20 a.m. The Chair noted for the record that no action was taken while in closed session.

AGENDA ITEM – APPROVAL OF MINUTES

Chair Cowell asked for any discussion, comments or corrections concerning the minutes of the November 14, 2011, meeting. The IAC unanimously approved the minutes.

AGENDA ITEM – OUTSTANDING ITEMS

Mr. Wischmeier introduced Larry Langer and Mike Ribble from Buck Consultants, actuaries to the Retirement Systems. Mr. Langer and Mr. Ribble discussed two scenarios for the Systems' investment returns, beneficiary outflows and need for future funding. The first scenario assumed a 7.25 percent investment return; the second scenario assumed a 3.5 percent return. A discussion followed concerning the appropriate target investment return for the Retirement Systems. The IAC members discussed returning to this topic at a later meeting.

Mr. Wischmeier also provided updates on the Department's process for hiring an additional portfolio manager and on the Department's ongoing efforts concerning operational due diligence.

AGENDA ITEM – PORTFOLIO UPDATE

Mr. Wischmeier provided an update on the portfolio, with data through December 31, 2011. Over the past twelve months, the Retirement Systems portfolio returned 2.12 percent net of fees. The portfolio performed one percent under its benchmark.

Mr. Wischmeier noted that the department states two sets of target risk levels: absolute volatility and relative volatility. Both figures have been in line with the department's asset allocation and target. Mr. Wischmeier noted that compared to the universe of public funds with more than \$1 billion of assets, the Retirement Systems incur a much lower level of risk than average (in the lowest quartile), but the Retirement Systems' investment returns over the last ten years have been at the median of the department's peers.

New commitments were recently made to private equity funds managed by Tenaya and Oaktree; real estate funds managed by Westport and Brookfield and inflation portfolio funds managed by EnCap and Parella Weinburg.

In response to a question from Mr. Medlin, the IAC discussed the fee concept called a "European waterfall," in which the general partner does not receive its compensation until the limited partners receive the same. Mr. Wischmeier noted that this fee concept has been included in almost all recent Retirement System fund commitments.

In response to a question from Ms. Tuttle, Mr. Wischmeier and Mr. Beuris provided information about the department's current sector allocations in public equity. Mr. Beuris noted that most managers had chosen to be underweight on the financial sector due to European instability.

AGENDA ITEM – INVESTMENT POLICY DISCUSSION

Mr. Wischmeier and Mr. Lewis led a discussion of the draft Investment Policy included in the IAC meeting materials. Mr. Lewis noted that the policy would be a living and breathing document, reviewed at minimum annually.

In response to a question from the treasurer, Mr. Chaudhuri and Mr. Wischmeier noted that only a few other state defined benefit plans, approximately ten in total, have investment allocations defined by statute. Mr. Medlin and Mr. Lewis discussed highlighting the statutory percentages applicable to each investment category. Mr. Medlin suggested adding a statement of purpose or mission statement.

While discussing the portion of the draft Investment Policy concerning asset allocation and rebalancing, the IAC discussed target asset allocations. Mr. Wischmeier and Mr. Lewis noted that “mature” portfolios (investment classes in which the Retirement Systems have been investing for several years) were at or slightly above their targets, while some newer portfolios were slightly beneath their targets. This is because the Retirement Systems are in the process of making additional investments to fill those portfolios and those investments can only be made when a desirable opportunity arises.

The IAC discussed the treatment of derivatives in the draft Investment Policy and whether derivatives should be discussed in a separate, topic-specific policy. Mr. Triplett raised TIPS as an item for discussion at a future meeting.

IAC members and department staff discussed areas in which the draft Investment Policy could be improved or clarified. The department will further refine the draft policy and raise the revised draft for discussion at the next IAC meeting. Mr. Wischmeier noted that in particular, the department expected to provide more detail in the next draft concerning long-short managers and risk management.

AGENDA ITEM – OUTSTANDING ITEMS

(returning to this agenda item)

Mr. Ruetz provided an update on the department’s investments in options. Since November, the department has collected an additional \$20 million in option premiums. Mr. Wischmeier commented that the options program has worked better than expected; in addition to receiving nine months of hedging, the department has gained approximately \$80 million.

Mr. Medlin asked a question regarding securities lending procedures. Mr. Smith responded that the department’s procedures are very restrictive on a going-forward basis, following money market 2a-7 guidelines.

The meeting was adjourned for lunch at approximately 12:00 p.m. The meeting reconvened at approximately 12:45 p.m.

AGENDA ITEM – CREDIT / FIXED INCOME REVIEW

Mr. Overcash and Mr. Smith led a presentation concerning the department's credit and fixed income investment operations. Mr. Overcash noted that the current credit portfolio is approximately four percent of the plan. The legislative limit is five percent and the department is adding additional credit investments over time when favorable opportunities materialize. Among the department's 2012 objectives are increasing the liquidity and diversification of the credit portfolio, implementing the SAS risk management tool and exploring niche credit strategies and international markets' credit opportunities.

Mr. Smith noted that compared to the benchmark, the department's core fixed income portfolio is currently more heavily weighted toward corporate debt and less heavily weighted toward government debt. Treasury yields remain range-bound at historic lows. Although core fixed income has been the top-performing asset class over the last ten years, the Department has no expectation that will continue going forward. For the fixed income portfolio, the Department expects a return over the next five years of approximately 2.5 percent to 4 percent.

The treasurer, Mr. Triplett and other members of the IAC discussed how the department should respond to this expected rate of return for the core fixed income portfolio. The treasurer and Mr. Triplett noted that it would be difficult to reach the fund's overall target return of 7.25 percent if core fixed income, a large part of the fund's overall portfolio, only generates 2.5 percent to 4 percent. The IAC will discuss at upcoming meetings what combination of actions the Department should take to address this issue.

AGENDA ITEM – RISK SYSTEM UPDATE

Mr. Wischmeier and Mr. Ruetz introduced SAS representatives Mr. Brocklebank, Mr. Gopalakrishnan, Mr. Pai and Mr. Wells, who demonstrated along with department staff the progress on the department's unified risk assessment system. Mr. Ruetz explained that the project's goal was to measure risks across the entire system, then aggregate that information *ex post* and *ex ante*. Ultimately, reports will be generated each day providing updated information about risk, return and capital allocation (measured by sector, currency or geographic area). The system will provide information about marginal contribution to risk and component contribution to risk. The goal of the department and SAS is to complete the project by year end.

AGENDA ITEM – IAC MEMBER Q & A

There were no additional questions for Investment Management Division staff from the Investment Management Committee. Mr. Wischmeier noted his upcoming departure from the department and commented that it had been a pleasure working with the IAC. The Treasurer remarked that she appreciated the IAC's support during the transition.

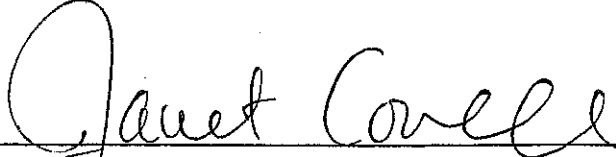
AGENDA ITEM – PUBLIC COMMENT

There were no public comments.

ADJOURNMENT

The meeting was adjourned at approximately 2:00 p.m.

APPROVED BY:



JANET COWELL
STATE TREASURER AND CHAIR