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

MINUTES OF MEETING
November 14, 2011

Time and Location: The Investment Advisory Committee ("IAC") met on Monday, November 14, 2011 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); Steve Jones; Harold Keen; Neal Triplett; Harold Martin (by phone); and Courtney Tuttle (by phone).

Staff: The following staff was present: Chris Morris, Rodney Overcash, Craig Demko, Arlene Jones-McCalla, Rhonda Smith, Jeff Smith, Susan Carter, Greg Beuris, Bryan Lewis, Shawn Wischmeier, Fran Lawrence, Joan Fontes, Brett Hall, Alison Garcia, Casey High, Keith Nelson, Jay Chaudhuri, and Kara Petteway.

Others in Attendance: Gil Caffray, Chuck Hefren, Becky Luce-Clark, and Chuck Watts

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 – APPROVAL OF MINUTES

Mr. Medlin made a motion to approve the minutes. Mr. Keen seconded the motion. The IAC unanimously approved the minutes of the September 21, 2011 IAC meeting.

AGENDA ITEM – OUTSTANDING ITEMS

Mr. Lewis provided an update on three items. First, he provided an update on a follow-up item from the Ennis Knupp fiduciary review where he noted that the Investment Policy Statement for the Total Fund and each asset class is under internal review. He anticipates that the Investment Policy Statement will be shared at the first meeting IAC meeting in 2012. Second, Mr. Lewis stated that the Investment Management Division ("IMD") has posted a Public Equities Portfolio Manager position, the third Portfolio Manager within that asset class. Third, he said that staff is putting together an operational due diligence procedure for investment managers. Ms. Tuttle recommended vendors to conduct background checks.

AGENDA ITEM – PORTFOLIO UPDATE

Mr. Wischmeier provided a portfolio update. The global equity portfolio was down six percent during the challenging third quarter. Despite volatility of the global equity portfolio, total plan volatility continues to come in below the 10 percent target. Mr. Wischmeier stated that several mandates had been terminated during 2011. Two mandates with the investment firm Alliance Bernstein were recently terminated and totaled approximately two billion dollars. Mr. Wischmeier cited relative poor performance and significant turnover among staff among the reasons for termination. He also mentioned that two Wellington Management Company strategies were terminated earlier this year. These were Wellington Technical Equity and Biotech products. Mr. Wischmeier noted that recent terminations have resulted in a greater level of passive exposure in the portfolio as compared to historical levels. .

Mr. Wischmeier then turned to the portfolio's exposure to Europe. In the equity holdings, Mr. Wischmeier stated that the entire exposure to European financials (such as banks and insurance companies) is 1.3 percent. It was noted that this was a small part of the portfolio. Mr. Wischmeier said that eight active managers operate in Europe; all but one manager is underweight in European financials. Mr. Beuris stated that surveys have been sent to all managers, and staff will continue to send surveys on a quarterly basis. The fixed income portfolio also has limited exposure to Europe.

Mr. Ruetz stated that the investment team is working with Gladius Investment Group, and that they are using options as a tool to rebalance a portion of the portfolio. Mr. Ruetz also stated that some of the option premium collected from the rebalancing program had been used to purchase $1 billion worth of protection on the European equity market.

The fixed income portfolio had a strong return for the quarter with more than a five percent return. However, this return was below the custom fixed income benchmark.
For the private equity portfolio, Mr. Wischmeier noted a change to a new benchmark as of July 1. The old benchmark was tied to the public equities market; the new benchmark provided by Cambridge allows for the portfolio to be benchmarked against a fund peer universe. The portfolio made two commitments: (1) $50 million to Vista and (2) $100 million to Harvest Partners, an existing manager. Staff continues to focus on international opportunities, including a focus on India, China, and Hong Kong. Treasurer Cowell, Mr. Wischmeier, Mr. Demko, and Ms. Carter recently visited these places to better understand these markets.

The credit portfolio recently made two new commitments: (1) Oaktree Value Opportunity and (2) Claren Road.

The inflation portfolio made commitments to (1) Arc Light and (2) EIF. Mr. Overcash briefly discussed the team's visit to Europe. Based on conversations with investment bankers, brokers, and lawyers, they heard a resounding message about uncertainty and volatility in Europe. However, they believe Europe also presents opportunities in the distressed debt market.

Mr. Jones inquired about the variance of fees between the benchmarks and returns on asset classes and investment strategies. Mr. Wischmeier pointed out the performance of assets and strategies are based on net fees while the benchmarks are gross fees.

Mr. Ruetz provided an update on the SAS risk modeling initiative. He said all securities level information has been provided to SAS, and staff is currently working with the seven index providers to provide additional data. Mr. Ruetz expects SAS to conclude its research on the initial set of analytics and risk factors for the Public Equities and Fixed Income portfolios by end of the year.

Mr. Jones inquired about where the total fund gets hit from Europe. Mr. Wischmeier said the fund has a low risk profile compared to other public pension plans. However, he stated that the first hit occurs from the public equities portfolio, which it constitutes 40 percent of the total fund.

AGENDA ITEM – REAL ESTATE UPDATE

At this time, Mr. Martin joined the meeting by conference call.

Ms. Susan Carter noted that the last review of the real estate portfolio was done in May 2010. She said that real estate financing environment remains challenged although it has improved moderately since 2010. This is primarily due to the insurance companies reemerging as lenders for core real estate in high barrier to entry markets along the East and West Coasts of the United States. Ms. Carter said the CMBS market still remains non-existent. She discussed the bifurcated nature of the United States real estate explaining that little transactions or price improvements were occurring in the secondary and tertiary markets. She further stated that multi-family and core office in major markets were the two real estate sectors performing well. .

Ms. Carter presented an overview of the GDP expectations of the emerging markets in Asia, South America, Eastern Europe, and Africa. She reported that these markets are expected to drive approximately 40 percent of future growth. As a result, she suggested that these markets should be considered as potential places for investments.

The real estate portfolio is valued at $4.7 billion with 81 investments via 41 managers. This represents 6.8 percent of the total plan. Within the portfolio, 40.9 percent is leveraged and 29.2 percent is liquid. Treasurer Cowell inquired about the status of removing existing managers. Ms. Carter responded that staff continues to make progress in winding down older investments.

International investments represent approximately 24 percent of the Real Estate portfolio. This is slightly less than fourth quarter 2010. Europe represents approximately half of the international exposure with only $25 million invested in Portugal, Italy, Greece, and Spain.

Ms. Carter then discussed the 2010-11 goals and results. She noted that they have focused on building portfolio income, investing in structures that provide a greater level of control, and invest with proven managers with realizations. Ms. Carter introduced Alison Garcia and Brad Creel, Real Estate Portfolio Managers.

Ms. Allison Garcia discussed the opportunities in multi-family housing as a result of demographic trends and the lack of mortgage financing resulting from the housing crisis. Specifically, she said the plan is investing in a multi-family operating platform overseen by

Rockwood Capital. Such a platform allows a higher level of control than through co-mingled funds.

Mr. Brad Creel discussed debt opportunities. He noted that cash is king in this environment. The portfolio has invested in two funds in this space, Blackstone and Lonestar.

Ms. Carter said for the remainder of 2011-2012 the team would be focused on portfolio systems, another platform opportunity, new investments with existing managers, and potential international opportunities. She stated that the international opportunities might include Brazil and India. She briefly mentioned that a diligence trip made to India where they visited with local investors on the ground who are developing residential homes. Mr. Medlin inquired about legal protections with such funds. Ms. Carter responded that such investments were structured under American law.

Mr. Jones inquired about whether multi-family investment was a timing issue or not? Ms. Carter said these multi-family investments were long-term investments.

AGENDA ITEM – HEDGED EQUITY DISCUSSION

Mr. Gil Caffray, Chief Investment Officer of Tiger Management, discussed hedged equities. He noted that such assets provide an additional element of diversification against market exposure. Mr. Caffray also said such funds create additional alpha within the portfolio.

During the discussion, Treasurer Cowell left the meeting.

Ms. Tuttle noted the importance of identifying skills-based managers when selecting investment managers. Mr. Jones asked about what the ideal size for a hedge fund investment.

AGENDA ITEM – EXPANDED LEGISLATIVE AUTHORITY

Mr. Beuris discussed the new expanded legislative authority provided for hedge funds. He stated that 6.5 percent of the future plan assets or approximately $4.5 billion could be invested in hedge funds with 85 percent of the assets in long only assets and 15 percent in long-short assets. The investment objective here is to achieve equity-like returns at lower levels of volatility over a full market cycle. Mr. Triplett noted that the goal for such hedge funds is to reduce equity beta. Mr. Beuris also said such investment sizes will range from $100 million to $500 million that would include between 20 to 25 managers.

Mr. Beuris said that selecting managers within the top quartile is critical. Staff will perform an independent review of the manager as well as use Albourne for due diligence.

Mr. Triplett said staff should also focus on fees as higher fees for hedge funds may erode a lot of alpha. Mr. Wischmeier noted that staff is focusing on strategies that can achieve the desired exposure at an appropriate level of fees. For example, the PAAMCO relationship in the credit portfolio allowed staff to achieve exposure through a fund of fund manager with all-in fees similar to holding a portfolio of direct investments.

AGENDA ITEM –QUESTIONS AND ANSWERS

During the question and answer session, Mr. Wischmeier stated the Investment Policy Statement will be discussed at the next meeting. He also said that staff would like to present and discuss an asset class for each meeting, such that all asset classes would be covered once each year. Mr. Wischmeier also said he remained open to feedback on these meetings as well as suggestions for speakers and topics.

AGENDA ITEM – PUBLIC COMMENT

There were no public comments.

AGENDA ITEM – ADJOURNMENT

Mr. Keen moved to adjourn the meeting. Mr. Triplett seconded the motion, and the motion was approved.

Approved:

Janet Cowell
State Treasurer and Chair