

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

**MINUTES OF MEETING
February 16, 2011**

Time and Location: The Investment Advisory Committee (“IAC”) met on February 16, 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; Neal Triplett; and Courtney Tuttle.

Staff: The following staff members were present: Shawn Wischmeier, Bryan Lewis, Michael Ruetz, Craig Demko, Alison Garcia, Susan Carter, Elin Papkov, Rodney Overcash, Brett Hall, Norman Schiszler, Heather Strickland, Julia Vail, Ron Ottavio, Tony Solari, Jay Chaudhuri, Kara Petteway.

Others in Attendance: Mitch Leonard (State Employees Association of North Carolina); Ed Macheski (Citizen)

CALL TO ORDER

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

Chairman Cowell asked for any discussion, comments, or corrections concerning the minutes of the September 29, 2010 and November 16, 2010 meetings. The minutes of both meetings were approved.

AGENDA ITEM – ORGANIZATIONAL UPDATE

Bryan Lewis, Chief Administrative Officer, provided an update regarding staffing in the Investment Management Division (“IMD”). The Director of Risk Management and Director of Global Equity positions have been filled. In addition, IMD has filled three investment portfolio manager positions, an operations analyst position, and a financial analyst position. IMD is still seeking to fill two additional portfolio manager positions.

Treasurer Cowell noted that in December 2010, Governor Perdue announced a hiring freeze for non-critical positions in Cabinet agencies. Although the Department of State Treasurer (“DST”) is not a Cabinet agency, DST is making every effort to comply with the spirit of the Governor’s

order. Treasurer Cowell noted that most of the above offers were made prior to the Governor's hiring freeze and that DST has deemed IMD positions to be mission critical.

Shawn Wischmeier, Chief Investment Officer, provided a review of follow-up items from the previous IAC meeting (November 16, 2010):

- *Legislative Agenda:* An update regarding the IMD's legislative agenda will be provided in today's Legislative Agenda discussion.
- *Deployment of Capital by Private Equity Managers:* An inquiry concerning the deployment of capital by private equity managers will be addressed during today's Private Equity Review.
- *Macroeconomic Environment:* Comments concerning the current macroeconomic environment will be addressed during today's Portfolio Risk and Risk Parity discussions.
- *Discount Rate:* DST continues to facilitate conversations regarding the proper discount rate, or actuarial assumption, with the Board of Trustees for the TSERS and LGERS systems.
- *Ennis Knupp Recommendations:* IMD has implemented slightly more than half of the 130 recommendations contained in the Ennis Knupp fiduciary review. Staff has prioritized recommendations regarding (1) transparency, accountability and ethics and (2) organizational and investment structure.

AGENDA ITEM – PORTFOLIO UPDATE

Mr. Wischmeier provided an update on the portfolio since the date of the last meeting. As of December 31, 2010, there was approximately \$85 billion in assets under management for the Pension Fund. The one-year portfolio return net of fees and expenses was 11.61 percent, which is below NCRS' benchmark of 12.41 percent.

Mr. Wischmeier noted that private equity valuations do not change as quickly as public equity valuations. When valuations in the private markets are adjusted, staff anticipates that the one-year return figure will be closer to the benchmark than is currently reflected in the 11.61 percent return figure. Ms. Tuttle noted that it is a challenge to benchmark illiquid asset classes. Mr. Wischmeier noted that investments staff are currently studying the appropriate benchmarks for the private asset classes. It is anticipated that recommendations will be made to the State Treasurer by July 1, 2011.

Mr. Medlin asked whether the one-year return figure (11.61 percent) impacts the contribution required by the Legislature in order for the plan to be fully funded at the current actuarial assumption rate (7.25 percent). The higher than expected returns do not impact required contribution rates in the near term. The variance will have a longer-term, positive effect on

contribution rates as such gains will be amortized and serve to lower the required contribution rates in future years.

Global Equity: The global equity portfolio is conducting searches for new managers to facilitate a strategic increase to the international exposure and move away from the current home country bias. Discussions followed regarding (1) whether international revenue of domestic companies was being accounted for when determining whether a stock is domestic or international and (2) the volatility of emerging markets and the ability of managers to enter and exit exposures. Mr. Wischmeier then noted that the higher than normal cash/transition figure reported in the quarterly reporting materials (11.7 percent) reflected the fact that a major portfolio transition was taking place over month-end. As of the date of the meeting, the cash/transition figure was approximately four (4) percent.

Fixed Income: The fixed income portfolio was down approximately two (2) percent this quarter, which reflects a rise in intermediate and long-term interest rates.

Real Estate: The one-year return for the real estate portfolio was positive. Staff is heavily focused on real estate debt opportunities. There are no new investments to report.

Credit: The credit portfolio committed \$500 million to a hedge fund of funds managed by PAAMCO. This investment provides good exposure to smaller managers, with very low fees. Albourne, a consultant focusing on hedge funds, has been retained to provide back office support.

Inflation: There was a negative return in the inflation portfolio, which is due to a conservative valuation of timber assets. Staff is looking to add 2-3 additional managers by the summer. Mr. Triplett inquired as to whether commodities investments were in futures or equity. Mr. Wischmeier responded that the exposure is through futures.

Hedge Funds: Staff is liquidating its two largest fund of hedge fund investments as a means of bringing the alternatives portfolio into compliance with the five (5) percent statutory cap.

Private Equity: There will be a full report on the private equity portfolio in today's meeting. Craig Demko, Director, Private Equity, briefly stated that with respect to the Innovation Fund, there have been five (5) commitments and four (4) co-investments. The opportunities are diversified in terms of sectors and geography.

AGENDA ITEM – PORTFOLIO RISK DISCUSSION

Michael Ruetz, Director of Risk Management, led a discussion on portfolio risk. Mr. Ruetz described four dimensions of risk: (1) absolute, (2) active, (3) tail and (4) operational risk. Mr. Ruetz provided an overview of how each dimension of risk is currently being managed, and staff's proposals to better manage these dimensions of risk in the future. To assist in implementing these changes, staff is currently seeking to retain a third-party portfolio risk analytics system.

A discussion ensued about the reporting structure for the Director of Risk Management position. Administratively, the position reports to the Chief Investment Officer; however, functionally, the reporting structure should be viewed as a "three-legged stool" comprised of the State Treasurer, Chief Investment Officer/investments staff and Director of Risk Management.

AGENDA ITEM – LEGISLATIVE AGENDA

Mr. Wischmeier provided an overview of proposed changes to the statutes governing the IMD, the primary goal of which is to provide diversification of plan assets while reducing risk. Three simple changes are proposed this session. An overhaul of the entire set of statutes may be revisited in the future.

- (1) *Increase the statutory cap on alternative investments from five (5) percent of the total portfolio to ten (10) percent of the total portfolio.* An increased allocation to the alternatives portfolio will allow IMD to continue to make alternatives investments through additional commitments to NCRS' best managers. Staff will aim to manage the alternatives portfolio to a target of seven (7) to eight (8) percent of the total portfolio, so that the statutory cap is not exceeded going-forward.
- (2) *Allow for the ability to engage in long/short equity transactions (hedge funds) in the global equity portfolio.* Currently, hedge funds can be utilized in the alternatives, credit and inflation portfolios, but not in the global equity portfolio. The ability to use hedge funds in the global equity portfolio will reduce risk and assist in breaking the total portfolio's correlation to the public markets.
- (3) *Allow for flexibility to internally manage a portion of the global equity portfolio to benchmarks other than the S&P500.* This flexibility will allow IMD to internally manage assets in the global equity portfolio to broader, more diverse indices that are currently in use by the plan, should NCRS seek to start managing equity assets internally. If NCRS were to receive this statutory flexibility and have the proper level of staffing, internally managing certain global equity investments would result in a cost savings to tax payers.

Investments staff have met with 40-50 legislators and have hosted breakfast meetings to educate legislators on the proposed changes. Staff will provide an update on the status of the proposed statutory changes at the next IAC meeting.

AGENDA ITEM – PRIVATE EQUITY REVIEW

Mr. Demko provided a review of funded (\$3.05 billion) and unfunded (\$2.45 billion) commitments in the private equity portfolio. The portfolio is invested in 92 funds with 55 managers. As of December 31, 2010, the entire alternatives allocation represents 5.13 percent of Pension Fund assets, which exceeds the statutory cap of five (5) percent. Private equity accounts for 4.26 percent and hedge accounts 0.87 percent of the allocation.

A discussion followed regarding unfunded commitments across the total Fund, and whether there should be an internal limitation or cap on the amount of outstanding commitments.

Mr. Demko provided an overview of the geographic allocation of the portfolio, which is predominantly exposed to North American investments. Mr. Triplett inquired as to whether the global equity portfolio's goal of international diversification is applicable to the private equity portfolio. Mr. Wischmeier stated that the ability to make international private equity investments is constrained by staffing levels and the feasibility of conducting international due diligence trips.

Mr. Demko provided an overview of proposed secondary market sales, which will help to bring the alternatives allocation into compliance with the statutory cap. Timing for the sales is good, as current market prices have improved. Staff has engaged a third-party firm to assist in this process. Mr. Triplett inquired as to whether staff would have proceeded with the secondary sales if the alternatives allocation was in compliance with the statutory cap. Mr. Demko responded that absent the statutory cap issue, staff would have proceeded with secondary sales only in exceptional cases. Ms. Tuttle inquired as to how the proposed secondary market sales impact the vintage year diversification of the portfolio, including unfunded commitments. Mr. Demko responded that staff has taken vintage year diversification into account.

The meeting was adjourned for lunch at approximately 12:10 p.m.

AGENDA ITEM – RISK PARITY DISCUSSION

The meeting reconvened at approximately 12:45 p.m.

A guest speaker, Mr. Clifford Asness, Ph.D., Managing and Founding Principal of AQR Capital Management, gave a presentation on risk parity.

AGENDA ITEM – PUBLIC COMMENT

Ed Macheski, citizen, stated that he was pleased that the IMD had filled most of the open positions, and that it may be beneficial to have the IAC understand performance incentives to reward and retain IMD staff. Mr. Macheski inquired whether staff monitors the purchases and sales conducted by outside managers, as there may be efficiencies to be realized. Further, Mr. Macheski stated that he thought it would be beneficial to invite legislators to future IAC meetings. Finally, Mr. Macheski inquired as to whether a timetable as to when additional investments can be managed internally, as this will result in cost savings.

AGENDA ITEM – OTHER BUSINESS / COMMITTEE COMMENTS


Jay Chaudhuri, General Counsel, solicited feedback about the annual IAC self-assessment. The self-assessment will be facilitated by Hewitt Ennis Knupp. A report out will be provided at the next IAC meeting.

In addition, Mr. Chaudhuri provided an overview of a comment letter to be sent the United States Securities and Exchange Commission, on behalf of the IAC, regarding proposed registration requirements for municipal advisors.

ADJOURNMENT

The meeting was adjourned at approximately 2:15 p.m.

APPROVED BY:



JANET COWELL
STATE TREASURER AND CHAIRMAN