NORTH CAROLINA DEPARTMENT OF STATE TREASURER
INVESTMENT ADVISORY COMMITTEE
MEETING MINUTES FOR November 18, 2020

Time and Location: The Investment Advisory Committee ("IAC" or the "Committee") met on Wednesday, November 18, 2020, at 9:00 a.m. via conference call and WebEx.

Members Present: State Treasurer Dale R. Folwell (Chair), John Aneralla, Lentz Brewer, Michael Mebane, Greg Patterson, Loris Colclough

Not present:

Staff Present: Ben Garner, Casey High, Gail Kadash, Kathy O'Neill, Matthew Krimm, Christopher Morris, Jeff Smith, Brett Hall, Rhonda Smith, Greg Taylor, Jack Wilson, Joe Farley, Loren de Mey, Ron Funderburk, Ty Powers, Anne Roof, Deana Solomon, Fran Lawrence, Michael Nichols, Nicholas Langley, Chris Ward, Brian Bolcar, Brian Jackson, Tinh Phan, Troy March, Marc Brunner, Paul Palermo, Sam Watts.

Others in Attendance: G. Scott Kreft, Anne DarConte, Phaedra Garibaldi, Michael Marino - Wellington, Joshua Solomwitz, Samuel Karasek, Carlton Byrd, John Zilko.

AGENDA ITEM – OPENING REMARKS

The meeting was called to order at approximately 9:00 a.m. by Treasurer Folwell. Meeting etiquette information, and WebEx/Conference line use was shared by Ben Garner. Mr. Garner confirmed quorum and provided procedures for virtual guidelines. No objection to vote via roll call, email if no vote given during call.

The Treasurer confirmed that a quorum was met, then asked the Members present to declare any conflicts of interest and, there being none declared, the meeting commenced.

AGENDA ITEM – APPROVAL OF MINUTES

Mr. Aneralla moved, Mr. Colclough seconded, and there was a member roll call to approve the minutes. The minutes were approved.

AGENDA ITEM – PERFORMANCE UPDATE

The Chair recognized Jeff Smith, Co-CIO and Director of Fixed Income, and Chris Morris, Co-CIO and Chief Risk and Operating Officer, to present the Performance update.

Mr. Smith provided a brief update on the cost efficiencies initiative underway in the Investment Management Division (IMD). He noted the initiative has realized $350 million of savings since January of 2017.

Mr. Smith provided an update on the U.S. economic environment for the 3rd quarter of 2020, mentioning the current quarter changes.

Mr. Morris presented an update on Assets Under Management (AUM), as of September 30, 2020. He stated the total AUM was $148.1 billion, up $6.5 billion since the 2nd quarter. The NCRS market value increased by $3.6 billion, while the cash management program increased by $2.4 billion.

Mr. Morris reviewed the asset allocation as of September 30, 2020. He noted the over and underweights, particularly within the Growth and Rates and Liquidity sleeves. He also discussed how those over and underweights have changed quarter over quarter as equity markets rallied.

Mr. Morris continued to the Total Net Portfolio Returns vs. Benchmarks slide, discussing the periodic performance from both an absolute and relative perspective across multiple time horizons.

Mr. Morris discussed the Growth of a Dollar Charts that illustrate how the total pension and alternatives sleeve have performed relative to the long-term policy benchmark over the 5, and 10-year periods, and since 1997, the start of the pensions performance record.

Mr. Morris moved onto the Contribution to Total Plan Return slide. He discussed the dollar amount each asset class contributed to the earnings of the plan for the prior 1-year period, noting the gains in Investment Grade Fixed Income and in Public Equity, and the detractors within the Alternatives.

Mr. Morris next walked the committee through the Net of Fees Return Attribution charts, noting the portfolio created a value add of 0.4% over the 1-year period. He discussed how the selection effect added value, while the allocation effect detracted value over all three-time horizons.

Mr. Morris presented the Net of Fees Risk Metrics slide variety of metrics. He pointed out the recent rise in volatility and tracking error as general market volatility has been elevated over the last year.

Mr. Morris discussed the peer universe comparison slides, which show our percentile rank still quite favorable relative to peers when considering return and risk.

Mr. Morris moved on to the liquidity slides, hitting on the structural liquidity, benefit payments, and cash flows within the Alternatives sleeve.

There was a discussion on the expectation of higher benefit payments in the future as retirements increase. There was also discussion on the recently conducted actuarial experience review and how potential changes from that review may affect the future net benefit payments and the actuarial required rate of return.

Mr. Smith reported on Asset Class Performance and spoke to the Calendar Year Asset Class Return chart, highlighting the strong performance in Public Equity, Private Equity, and IG Fixed Income. He pointed out that calendar year 2020 is the first year in the chart where Public Equity and IG Fixed Income were both toward the top of the performance rank

Mr. Smith next discussed new and incremental investments, and the current level and continue downtrend of unfunded commitments.

Mr. Smith moved along to Asset Allocation History and the Top 20 Investment Managers slide, noting that there have been no material changes to either slide since the prior meeting.

AGENDA ITEM – INVESTMENT COST-EFFECTIVENESS REVIEW

Mr. Morris provided a brief overview and presented Michael Reid, of CEM Benchmarking, Inc. Mr. Reid discussed the process of conducting the annual Investment Cost Effectiveness review that went through 12/31/2019, as well as why the review is important. Key take-aways from the review and the discussion were:

- NCRS was the lowest cost system in the peer universe. The cost of NCRS was 32.1 basis points, while the median peer cost was 51.8 basis points. The largest driver of the lower cost was attributable to paying less than peers for similar services. The staff effectively negotiates with external service providers.
- NCRS has lowered its total cost since 2016 from 50.5 basis points to 32.1 basis points.
- NCRS generated an annualized net total return of 6.5% relative to the peer median of 7.5% over the last 5 years. The largest driver of that underperformance was due to a more conservative risk appetite employed in the allocation of investments.
- NCRS added 60 basis points of value when accounting for the lower risk profile of the investment portfolio.

There was a discussion on where and how additional costs savings could be realized. It was noted that some other pension plans utilize a larger and more costly internal staff model to implement active and private investment strategies. This was identified as an area where NCRS could decrease costs by internalizing these strategies. However, to properly internalize the higher fee and more complex strategies, NCRS would need to increase staff significantly, in a manner that would ensure performance would not be falter.

AGENDA ITEM – I.G. FIXED INCOME ASSET CLASS REVIEW

The Treasurer thanked the Mr. Reid for his report and re-introduced Mr. Smith and Brett Hall.

Mr. Hall gave an overview of the characteristics and cash return of the STIF portfolio. He noted that STIF outperforms comparable money market funds in most periods due to the positively shaped yield curve and longer average maturity of the STIF portfolio.

Mr. Smith and Mr. Hall discussed the Investment Grade Fixed Income portfolio, mentioning the investment allocations within, as well as the benchmark relative performance. They also discussed the characteristics and allocation metrics associated with the Core Fixed Income component of the Investment Grade Fixed Income portfolio.

Mr. Smith and Mr. Hall discussed the change in Treasury bond yields and investment grade corporate bond spreads over the last year. Of note was the significant decrease in yields on US Treasury bonds as a result of the COVID pandemic and resulting expansionary policies of global central banks. They discussed the significant spike in IG credit spreads early in the year with a sharp reversal in those spreads as fiscal and monetary policy was quickly enacted. They discussed how the team opportunistically invested to take advantage if misallocations and fear in the market.

Mr. Smith discussed FOMC economic projections, dot plots, as well as consensus expectations on where Treasury bond yields will be in the coming years. Of note on the dot plot was the dramatic downward shift and clustering of Fed member projections on where the Fed Funds Target Rate will be in the coming years, relative to what was forecasted 1 year prior. He also pointed out the same low for long view as shown by the yield forecasts by market participants. It was also shown that based on the 5-year TIPS breakeven rate, inflation does not appear to be a concern currently. Mr. Smith discussed how the portfolio should perform under various parallel interest rate simulation. He mentioned that when he evaluated these simulations last year, the thought of a 100-basis point downward shift in yields was not even on the realistic radar. Of note, historically when coupons and yields were higher, the income component of total

return would provide a more meaningful buffer against the price depreciation that bonds experience when interest rates increase. That income component is much lower now, given the low level of yields.

Mr. Smith pointed out that over the last number of years, everyone has expected rate increases and modest fixed income returns. That has not been the case.

Mr. Smith opens for questions. With no questions, Mr. Morris thanked the team and introduces Mr. Funderburk to present the Opportunistic Fixed Income Review.

AGENDA ITEM – OPPORTUNISTIC FIXED INCOME ASSET CLASS REVIEW

Ronald Funderburk introduces another member of his team, Ty Powers and begins with introduction slides. Mr. Funderburk reminds the Board of the role that the asset class plays within the overall portfolio, and discussed the various components and strategies employed within the portfolio.

Mr. Funderburk noted that the allocation to the asset class is below its target allocation, as there have not been many attractive opportunities to allocate capital in the space over the last few years. He does however anticipate opportunities to allocate capital to the distressed sleeve of the portfolio soon as the financial impacts from COVID filters through the economy. The team will look to allocate new monies to distressed managers as opportunities arise.

Mr. Funderburk reviewed the performance over various time horizons and strategies. He mentioned that over the long-term, the portfolio has been accretive to the total plan returns. In the shorter term the portfolio has been moderately better than benchmark. He noted that every strategy within the portfolio outperformed its benchmark across all shown time periods, with the exception of the 1-year horizon. The special situations strategy was the largest underperformer as securitized strategies within mainly the commercial real estate space were hit hard as a result of COVID.

Mr. Funderburk discussed how the team was able to deploy capital during the early part of COVID pandemic to take advantage of structural dislocation in credit markets. He mentioned that the team has and still desires to build out a structure and capacity that allows for the ability to quickly capitalize on attractive market dislocations.

Mr. Funderburk discussed the current composition of the portfolio, noting that hedged strategies represent 43% of the assets while distressed strategies represent only 6%. He noted that 8 years ago distressed strategies represented nearly one third of the portfolio. He also discussed the geographical allocations, highlighting that the allocation to Europe has decreased over the years as the distressed allocations came down as the European market is where the vast majority of the distressed opportunities were. He discussed the portfolio's liquidity, capital structure, and industry sector allocations as well.

Mr. Powers provided a credit market update highlighting key items in each investment type within the portfolio. Structured Credit has not had the same bounce back as corporate credit and equity markets as fiscal/monetary stimulus to the securitized markets was relatively small and targeted. They anticipate that continued positive vaccine news will create a recovery catalyst within the CMBS space. Credit spreads on non-investment grade corporate bonds have reverted back to long term averages, even though there is still a lot of stress on Corporate balance sheets as credit downgrades have outpaced upgrades and leverage multiples have expanded, which typically leads to defaults, distress, and recapitalizations. The team believes this should create opportunities to put money to work and will offer attractive returns.

Mr. Funderburk believes that allocations to distressed managers can be made in a fee sensitive manner. This is almost like dusting off the playbook we used following the GFC in 2008/2009. There should be an additional focus on Separately Managed Accounts relative to Comingled Accounts. Slide 17 shows our distressed credit exposure has been minimal the last few years by design. Default rates were low, and opportunities were minimal. A significant amount of capital has been distributed back to us in the distressed space. Mr. Powers added that early in 2010-2012, this team was committed to the distressed managers. Over time we have gotten about 300mm distributed back from those allocations.

Mr. Funderburk stated that to take advantage of the opportunity set, we believe that setting up dislocation arrangements ahead of time is key. Pre-fund or pre-commit capital so that there is a shorter fuse in getting the capital allocated when the dislocations arise. He also mentioned that implementing a systematic fallen angel strategy could create a lower risk profile while providing opportunities for incremental returns as you provide liquidity to forced sellers. Mr. Funderburk finished his presentation and opened for questions.

No questions from the IAC or the audience.

AGENDA ITEMS – IAC MEMBER Q&A

IAC Members were provided with the opportunity to pose questions to the Treasurer and IMD staff. There were no additional comments.

AGENDA ITEM – PUBLIC COMMENT

No one signed up for public comments.

ADJOURNMENT

The IAC board members all thanked the Treasurer and his staff, and mention they are looking forward to another successful four years.

The Treasurer stated that he would like to adjourn in honor of Sheriff Ryan Hendricks of the Henderson County Sheriff's Department, who was killed in the line of duty this year.

The Treasurer next thanked Jeff Smith, Christopher Morris and the IMD Team for stepping up for their roles, his tremendous amount of confidence and stability in the Investment Management Division and asks for motions to adjourn the meeting.

Mr. Patterson motioned to adjourn. Mr. Aneralla seconded the motion.

Mr. Colclough, Mr. Brewer, Mr. Mebane all agreed to adjourn.

The Treasurer officially adjourns meeting approximately at 11:40 am.

DALE R. FOLWELL, CPA
NORTH CAROLINA STATE TREASURER AND CHAIR