

**NORTH CAROLINA DEPARTMENT OF STATE TREASURER
INVESTMENT ADVISORY COMMITTEE
MEETING MINUTES FOR August 19, 2020**

Time and Location: The Investment Advisory Committee (“IAC” or the “Committee”) met on Wednesday, August 19, 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.

Staff Present: Ben Garner, Brett Hall, Chris Farr, Ronald Funderburk, Renee Guerin, Fran Lawrence, Frank Lester, Casey High, Gail Kadash, Kathy O’Neill, Matthew Krimm, Loren de Mey, Craig Demko, Christopher Morris, Deana Moore-Solomon, Anne Roof, Ty Powers, Troy March, Tinh Phan, Jeff Smith, Rhonda Smith, Joe Farley, Greg Taylor, Jack Wilson, Meryl Murtagh, Nicholas Langley, Chris Ward, Sam Watts, Joan Fontes, Brian Bolcar, Doug Mayer, Brian Jackson.

Others in Attendance: Billy Kacyem - JPM, Danielle Correa, Elizabeth Hood - Callan, Gregory Antell - Grosvenor, Lee Brashear - Grosvenor, Lee Cohen - Wellington, Luther Yost – Clearwater Analytics, Weston Lewis - Callan, Anne DarConte, Justin Mitchell.

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 voting via roll call, and the members emailing their vote if no vote was 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. Brewer moved, Mr. Mebane seconded, and there was a member roll call to approve the minutes. The minutes were approved.

Resolution of outgoing member

The Treasurer stated the Resolution for an outgoing IAC Committee Member. The Treasurer commended Dr. David Hartzell, for 7 years of service and leadership, as well as his invaluable contribution. On behalf of the IAC, he expressed deep appreciation and gratitude for Dr. Hartzell’s service.

AGENDA ITEM – PERFORMANCE UPDATE

The Chair recognized Jeff Smith, Interim Co-CIO and Director of Fixed Income, and Chris Morris, Interim 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 \$311 million of savings since January of 2017 and the initiative is on pace to reach \$350 million by December 2020.

Mr. Smith then provided an update on the U.S. economic environment for the 2nd quarter 2020 with a brief mention of the current quarter changes, focusing on the significant economic and market impacts from COVID. He also discussed the unprecedented monetary and fiscal stimulus response. He discussed how the internal fixed income team was able to take advantage of the market dislocation and buy high quality credit at very low prices.

Mr. Morris presented an update on Assets Under Management (AUM), as of June 30, 2020. He stated the total AUM was \$141.6 billion, which is up \$11.1 billion since the first quarter. The NCRS market value increased by \$5.5 bn in the second quarter, while the cash management program increased by \$4bn due to funds received for the Cares Act deposited into STIF before being distributed out across the state.

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

Mr. Mebane questioned how the underweight within growth would be addressed going forward. Mr. Morris discussed how the conservative positioning within the portfolio and how the underweight should continue to decrease as growth assets recover. Mr. Mebane next questioned changes based on the asset liability study and rebalancing. Mr. Morris mentioned that we are looking to conduct an asset liability study in the near future, but are waiting on Retirement and the actuary to complete their experience study as the findings from that study may affect the liability characteristics which we would want reflected in the asset liability study.

Mr. Morris continued to the Total Net Portfolio Returns vs. Benchmarks, discussing the periodic performance. He noted the portfolio was up 6.4% for the second quarter, nearly reversing all the first quarter losses, resulting in the Total Pension being down only 0.5% calendar year-to-date. He mentioned that only the 10-year period exceeded our actuarial assume investment return of 7%, with a return of 7.7%.

Mr. Morris moved onto the Growth of a Dollar Charts, showing how the plan continues to outperform the Long-Term Policy benchmark, citing that Alternatives have added value over both the five and ten-year horizons.

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 Return Attribution charts, noting the portfolio created a value add of 0.8% versus the implementation benchmark, for the 1-year period. He then discussed the difference in allocation effect and selection effect. The allocation effect detracted 0.2%, while the selection effect added 0.9%. Over the three- and five-year horizons, there was positive value add, largely driven by selection effect.

Mr. Morris presented the Net of Fees Risk Metrics slides, highlighting the spike in tracking error during the 1st and 2nd quarters as a result of our benchmark allocation differences and the extreme move in returns. He discussed the upside/downside capture metric and a drawdown graph, showing the significant downside protection of the portfolio relative to the benchmark and broad domestic equities over the last

quarter. Mr. Morris also discussed how the portfolio performs in up markets and down markets with strong downside capture due to conservative nature of the fund.

Mr. Morris next reported on universe comparison. He stated that our portfolio is more conservatively positioned relative to the peer universe, so during bull markets we will underperform peers, and during declining markets we should outperform. This is reflected across a few different time periods. For the 1-year period, we were in the top quartile for returns, and the 95th percentile for risk, which indicates lowest risk of all participants. The plan typically ranks high on the Sharpe ratio given our low volatility.

Mr. Morris moved on to the Liquidity slides. He discussed the Structural Liquidity slide, stating that we target to have greater than 70% of AUM in level 1 liquid assets. He mentioned that in June the portfolio has greater than 70% of AUM in level 1 liquid assets, and there are no concerns of structural liquidity. Liquidity should not change dramatically from quarter to quarter.

Mr. Morris discussed the new Valuation Lag slide that details the value and percentage of the portfolio that has various lags in receipt of valuation and how that lag rolls into performance periods. He noted that roughly 80% of the valuations are at the least monthly with no lag, while the remainder has either monthly or quarterly lag.

Mr. Morris then discussed the Liquidity Profile slide that depicts the net benefits paid through the calendar year. As far as reoccurring benefit payments, there were no surprises through July.

Next, Mr. Morris discussed the Alternatives liquidity profile, mentioning that we were cash flow positive at nearly \$400 million for the prior twelve months. The total Alternatives sent out \$3.4 billion but received \$3.8 billion.

Mr. Smith reported on Asset Class Performance and spoke to the Calendar Year Asset Class Return chart, which highlights the benefits of diversification. The best performer was Investment Grade Fixed Income.

Mr. Smith next discussed new and incremental investments, and uncalled commitments came down to \$5.5 billion from \$5.9 billion at last meeting.

Mr. Smith moved along to Asset Allocation History and the Top 20 Investment Managers, which presented no material changes. Mr. Smith also mentioned that 53% of assets are managed internally.

AGENDA ITEM – PRIVATE EQUITY ASSET CLASS REVIEW

The Treasurer thanked the presenters and introduced Craig Demko, the Director of Private Equity.

Mr. Demko presented the positive IRR and K&S PME (Public Market Equivalent) where the portfolio did extremely well, during vintage years 2010 and forward. Mr. Demko mentioned that Private Equity general partners were playing defense before the magnitude of the pandemic was clear, by working with the management teams and banks to secure and draw down lines of credit to ensure the companies had ample liquidity. The GP's were being cautious with investments, prior to the pandemic, given the economic cycle was in the late stages of an expansion and risks were increasing. They were focused on investing in high quality, defensive companies. They did not expect the pandemic. Once it hit, they used lessons learned in the GFC to take quick action to manage cash and rationalize expenses.

Mr. Demko estimated that private equity is down ten percent in the first quarter, with those valuations flowing into the second quarter given the lag. This was due mainly to Public Equity valuations, which

rebounded to pre-COVID levels in the second quarter. He forecasts that the contribution and distribution cash flows will be much like the 2008 crisis, down substantially from prior years, initially, while GPs are focused on protecting existing investments.

Mr. Demko also stated there is now an opportunity of buying good companies that have been impacted by the pandemic. Not negative balance sheets, but companies, and GPs, where distressed/turnaround investors can make an investment at a lower valuation and recapitalize the balance sheet.

Mr. Aneralla questioned the 11 Fund of Funds, and how can those funds represent zero percent of the portfolio? Mr. Demko highlighted the Footnote. Brian Bolcar explained that the Fund of Funds percentage is already rolled up into the other Strategy percentages, as this analysis looks at individual company industry classifications.

Next, Mr. Bolcar presented the composition and portfolio construction, discussing how managers are chosen and how they have been able to deal with the COVID crisis.

Mr. Bolcar next discussed positive cash flows and co-investment detail. In years 2018-19, the portfolio had \$847 million in excess realizations. The co-investments have shown strong performance, up 7% in valuation as of March 30, 2020, and appreciating 19% as of June 30, 2020, on a preliminary valuation basis. Some investments having benefited from the current COVID pandemic.

Mr. Demko reported on COVID-19 manager reactions. He discussed how managers expected a downturn at some point over the past few years, even without the unexpected downturn in the form of a virus (COVID-19). In doing so, they were able to protect themselves by putting money to work in a higher quality companies that were defensive in nature.

Mr. Demko discussed the sectors breakdown with the largest allocation in information technology, and healthcare being the second. Both sectors had strong performance. The portfolio is reflective of the general healthcare emphasis the markets witnessed stemming from 2017.

Mr. Mebane asked about opportunity in the secondary market. Mr. Demko responded that they would like to do more in secondaries, then discussed investments in the secondary market that they have taken advantage of already. It is expected that there will be increased secondary transactions. The secondary activity will not have the same dynamic as the GFC with forced sellers at lower valuations. It will be more portfolio rebalancing and structured transactions. General Partners will prioritize existing LPs in in any direct secondary transactions.

Mr. Demko replied that back in 2009 activity bottomed and then began to increase in 2010. The 2010-2011 secondary sale accounted for 15% of that timeframe's commitments which had a dramatic effect on that time period's performance, 6.93% for vintages prior to 2010 versus more recent vintages at 12.86%. Mr. Demko mentioned that a similar trend is starting in 2020 and sees an increase in deal flow coming out of 2020.

Mr. Demko next discussed post COVID-19 private equity opportunities. The best opportunities appear to be in the distressed space and structured transactions in the secondary space. The increased deal flow will be seen mainly in primary commitments and investments by funds. Co-investments will still be available, but existing LPs in funds will have priority.

Mr. Demko also stated he expects there to be an opportunity of buying good companies levered that have been unexpectedly impacted by the pandemic, and the balance sheet needs to be recapitalized. This is expected to be an opportunity over the next few years. There was a final note of a correction to the presentation on page 3: the gain/loss of \$4.095bn is correct, but for vintages 2010 to present it should be \$1,917bn, not \$1.536bn.

AGENDA ITEM – PUBLIC EQUITY ASSET CLASS REVIEW

Rhonda Smith introduced the Public Equity asset class team, Casey High and Greg Taylor. Ms. Smith stated this team is built on years of experience which affords value to the department by collaborating tools and talents which create greater efficiency and cost reduction. This includes our resources that we have with researchers, vendors, and managers that have allowed us to benefit from the access to information during the COVID time.

Ms. Smith stated “There was nowhere to hide” for Public Equity in first quarter 2020. She reported that equities were down nearly 33% from the peak in February, to the lowest point on March 23rd, recovering slightly thereafter to end the quarter down nearly 20%. Ms. Smith reported that the equity performance year to date is down 9%, with small cap stocks largely outperforming large cap stocks. Foreign markets saw double digits across developed and emerging market sectors, while growth sectors outperformed value.

Ms. Smith presented that first quarter equity was valued at \$28.9 billion, with its relative underperformance trailing the benchmark by 1.5 basis points. The second quarter reversal allowed us to recover which positioned the Plan at \$33 billion. The strong comeback is reflected as positive rates of return across all time periods.

Ms. Smith also noted that North Carolina’s total equity portfolio has a modest growth bias that we will continue to monitor. Ms. Smith further discussed the fiscal and monetary efforts to revive the economy.

Mr. High presented the domestic equity performance outperforming benchmarks in all periods for the past ten years. Over the past five years, the portfolio has maintained a lower risk profile as monitored by standard deviation, which has contributed to a higher Sharpe Ratio vs. index which will be monitored continually.

Ms. Smith reported on the reduction of active managers over the recent years in the portfolio, allowing us to concentrate on the better performing active managers.

Mr. Taylor next discussed international portfolio performance, outperforming benchmarks in all time periods. Strong manager performance and being overweight to growth sectors were contributing factors. Ms. Smith reported the managers that Public Equity uses are best in class in the non-US space and have been with us for quite some time with exceptional performance.

Mr. High discusses internal passive portfolio and the Russell indices annual reconstitution. This is the major rebalancing event, for the portfolio, that occurs at the end of June for the year. Total shares transferred last year was around 7.5 mm and increased to around 13mm. These transfers were done between the Russell accounts (RMidcap and R200 indexes) at our custodian bank, allowing us to save money on the expense of having to go out to buy and sell these on the open market.

Mr. High discussed the minimal tracking error which is around zero for internal passive.

Ms. Smith continued market observations, discussing value versus growth.

The Treasurer thanked the team for their presentations.

AGENDA ITEM – IAC CODE OF ETHICS UPDATE

Meryl Murtagh presented the annual review and reminder about code of ethics for IAC members. This is meant to capture ground rules about conflicts of interest and interests of the retirement system, especially, if not required by state ethics act. The Department maintains high standard by completing this code of ethics.

Ms. Murtagh discussed preventing conflict of interest, decisions, evaluation and advice. She stated that the members are prohibited from taking fees, considerations, and gifts.

The Investment Advisory Committee should reach out to our Legal Division if there any questions or concerns, or if a member needs to be recused of a vote.

Ms. Murtagh reported that the annual certification affirms awareness of the policy and adherence to it.

AGENDA ITEMS – IAC MEMBER Q&A

IAC Members were provided with the opportunity to pose questions to the Treasurer and IMD staff.

Mr. Aneralla discussed the COVID pandemic, along with a current pipeline issue he must deal with as Mayor. He mentioned his continued support, and that he was impressed with the consolidation of asset managers and commends IMD staff in simplifying the plan.

Mr. Brewer and Mr. Patterson mentioned their impressions to the IMD team's due diligence to follow the mission and consistency in an inconsistent world.

Treasurer Folwell commended Mr. Patterson's job as he also serves on the TSERS board and presents the information from the IAC to the board.

Mr. Colclough commended Treasurer Folwell and team on the comeback from the first quarter into the second quarter.

AGENDA ITEM – PUBLIC COMMENT

No one was signed up for public comments.

ADJOURNMENT

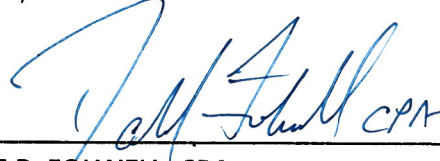
The Treasurer mentioned that part of IAC is not only about risk and return, it is also about funders. The Treasurer mentioned meeting with several local and state leaders, discussing their troubles through the pandemic and concerns over the upcoming experience study being performed.

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

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

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

The Treasurer officially adjourns meeting approximately at 11:00 am.



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