

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

MEETING MINUTES FOR NOVEMBER 15, 2018

Time and Location: The Investment Advisory Committee (“IAC” or the “Committee”) met on Thursday, November 15, 2018, in the Dogwood Conference Room of the Longleaf Building, 3200 Atlantic Avenue, Raleigh, North Carolina.

Members Present: The following members were present: State Treasurer Dale R. Folwell (Chair), John Aneralla, Lentz Brewer, Loris Colclough, Greg Patterson, and David Hartzell

Members Absent: Mike Mebane

Staff: Ben Garner, Joe Farley, Ronald Funderburk, Renee Guerin, Sam Hayes, Casey High, Gail Kadash, Kathy O’Neill, Matt Krimm, Nicholas Langley, Fran Lawrence, Frank Lester, Neal Motaparthi, Loren de Mey, Chris Morris, Meryl Murtagh, Ty Powers, Jeff Smith, Rhonda Smith, Deana Solomon, Greg Taylor, Chris Ward, Sam Watts, and Jack Wilson

Others in Attendance: Jim Baker (Public), Lee Cohen (Wellington), Brian Kahley (Franklin Templeton), Anne Marie Reinhart (Public), Greg Williams (Wellington), Alan Torrance (CEM)

AGENDA ITEM – OPENING REMARKS

The meeting was called to order at approximately 9:00 a.m., the Chair, Treasurer Folwell began the meeting by leading the Pledge of Allegiance and the Salute to the NC Flag.

Treasurer Folwell welcomed new board member Loris Colclough, and then asked General Counsel, if a quorum were present. The General Counsel confirmed a quorum was met, then the Chair asked the Members present to declare any conflicts of interest and, there being none declared, the meeting commenced.

AGENDA ITEM – APPROVAL OF MINUTES

Treasurer Folwell asked for approval of the minutes of the quarterly meeting held August 23, 2018. Mr. John Aneralla moved to approve the minutes, Mr. Greg Patterson seconded the motion and the committee approved.

AGENDA ITEM – PERFORMANCE UPDATE

The Chair recognized Jeff Smith and Chris Morris 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 increased from \$86.7 million to an approximate annual savings of \$94.5 million over the past quarter. He reminded the Board that the initial goal was savings of \$100 million over a four-year timeframe and that we are nearly exceeding that mark on an annual basis.

Mr. Smith then provided an update on the US economic environment for the past quarter with a brief mention of the current quarter changes. We continue to see much better performance domestically than non-US. Unemployment data reached a 20-year low and consumer confidence hit an 18-year high. Limited inflation concerns and a strong GDP growth led to solid gains in the 3rd quarter. Large caps had the biggest quarter in 5 years, small caps lagged some. Each of the major indices reached all-time records during the quarter. Limited volatility during the quarter shown by no daily move over 1%, compared to

the 1st half of year where there were 36 days with market movements in excess of 1%. Much of this changed in October, and the team will touch on that where possible during the presentations. Mr. Morris presented an update on the Portfolio, as of September 30, 2018.

Total assets under management of the Investment Management Division at \$131 billion, up \$2 billion from the June 30 numbers. This total combines the North Carolina Retirement Systems (\$99.5B), Cash Management program (\$17.6B), Supplemental Retirement assets (\$11.9B), and the Ancillary program (\$2.7B). The Pension Plan (NCRS) is up \$1.3B in the third quarter, but down around \$3 billion quarter to date.

Mr. Morris reviewed current NCRS asset allocation, as of 10/23/2018. The Plan is underweight Growth Assets by 5.2%. The Plan is overweight Rates & Liquidity (4%), Inflation Sensitive & Diversifiers (1.1%), and Multi-Strategy (0.1%). The majority of the Growth Assets underweight is due to Public Equity. The overweight to Rates & Liquidity is consistent to where we have been in the recent past, with the majority of the overweight due to Pension Cash. We have a slight overweight in Investment Grade Fixed Income and have wanted to remain relatively neutral here due to the rising interest rate environment. Our overweight to Rates & Liquidity has benefited the plan during recent weeks with the market volatility in equities.

Mr. Morris continued onto the total net portfolio returns versus benchmarks slide. The Portfolio has beaten both benchmarks in all measured time periods. Only the 3-year and 10-year beat our actuarial assumed rate of return (7.0%). The Plan is down around 3% quarter to date, and slightly north of 0% calendar year to date.

Mr. Morris reviewed the estimated contribution to total plan return slide, which shows how the size of asset class and the returns of that asset class contribute to the total plan. Public Equity and Total Alternatives drove returns, while Fixed Income was the only detracting asset class this year. Jeff Smith added that this chart is not reflective of benchmarks, but rather shows asset classes isolated to total plan return contribution.

Mr. Morris reviewed the return attribution charts. For the 1-year time period, the plan outperformed the implementation benchmark by 1.34%. Selection effect accounted for 1.68% of this difference, while the allocation effect totaled -0.33%. This is consistent with the recent past, the plan has had extremely strong selection effect. There was good relative performance across the board with Opportunistic Fixed Income, Inflation Sensitive, and Public Equity leading the way. The 3 year and 5 year charts show similar results, driven by selection effect with a slightly negative allocation effect.

Mr. Morris continued onto the BNY Mellon Universe Comparison charts. Mr. Morris stressed that all of the BNY Mellon data is gross of fees due to most our peers only reporting gross of fee numbers. Treasurer Folwell asked Mr. Morris to elaborate on that because it is an important distinction. Mr. Morris responded that not all plans report and track net of fee numbers. Fees can be difficult to define as well, therefore to keep like numbers BNY Mellon only compares gross of fees. Given that the Plan is lower cost than many peers, if we looked on net of fees our numbers would improve relative to our peers. A discussion commenced regarding how peer public pension plans report fees compared to NCRS.

Mr. Morris continued with the BNY Mellon peer group comparison. The Pension Plan is in the lower quartile of risk and return for almost every time period. This is due to the Plan's conservative asset allocation. Mr. Morris pointed out the compression of returns in the 10-year time period. The 25th and

75th percentiles are only separated by 41 basis points. If we were looking at net of fee information, we would expect to be at or above the median here because of our lower cost structure versus our peers.

Mr. Morris discussed liquidity and monitoring liquidity. This is just to give us an idea of where our portfolio stands versus our policy. Our policy target is 70% level 1 liquidity, and we are presently 73% level 1 liquidity.

Mr. Morris moved onto net benefit payments. The chart shows how much money is drawn out of the portfolio to fund benefit payments. Last year net benefit payments totaled \$2.7 billion. Through November, we are just short of that mark. Mr. Hartzell asked what the gross number would be. Mr. Morris stated that it is roughly double, at about \$6 billion.

Mr. Smith carried on to the next chart describing asset class net of fee performance. Focusing on the 1-year column, growth assets were really strong. Private equity returned over 18%, Non-Core Real Estate over 14%, Public Equity over 10%, and Opportunistic Fixed Income over 8%.

Mr. Smith reviewed the next chart, a calendar year asset class return heat map. This chart shows why diversification is important. The year to date column again shows growth assets towards top. Fixed Income being towards the bottom is what we would anticipate in a normal market, but the asset class still plays an important role due to its downside protection.

Mr. Smith continued onto new and incremental commitments. As of quarter end, all passive domestic equities have been moved internally. The Plan has \$7.8 billion in unfunded commitments, about \$700 million less compared to where it was a quarter ago.

Mr. Aneralla asked now that we have had a big pullback and we are underweight growth assets, do we take a step back and say let's reallocate or do we stick with the current allocation? Mr. Smith responded that the Plan has not made any strategic reallocations at this point. We are only a month into this movement, but that is a discussion that we will continue to have. Mr. Morris adds that the Plan has approximately \$7.8bn (the unfunded commitments), that allows our managers to react to opportunities that present themselves. Rhonda Smith pointed out that this theory has been realized in practice in Public Equity, some managers have been taking advantage of opportunities and calling capital. Treasurer Folwell added that we are seeing opportunities in the secondary markets. There are strong discounts available that our alternatives side is taking advantage of, opportunities are not always within the Equities markets. Jeff Smith concluded that opportunities arise across all asset classes.

Mr. Smith finished up with the top 20 investment managers. 48% of NCRS is internally managed. Mr. Morris added that this number is higher when including the cash management program, but this slide just shows NCRS.

AGENDA ITEMS – INVESTMENT COST-EFFECTIVENESS REVIEW

Treasurer Folwell introduced Alan Torrance from CEM Benchmarking.

Mr. Torrance explained his presentation is a cost analysis which outlines what we are spending and what we are getting for it.

The cost analysis is for the 2017 calendar year. The Plan's 5 year return of 7.6% is below the US public fund median of 9%. NCRS total returns are less because the policy return is less due to the conservative asset allocation, as Mr. Morris previously mentioned. Your value added of 80bps exceeded the peer median of 30bps. You are below your cost benchmark by 11.3 bps. Asset risk of 9.5% was below us public median of 10.5%. Mr. Aneralla asked about the logistics of the data and what fees are included.

Mr. Morris replied that it includes all costs on how investments are made. Management fees are the largest portion of it, but it also includes other costs associated with how we manage the investments (staff salaries, expenses, etc.). Mr. Aneralla added that distinction is important to note.

The peer group comparison for NCRS is made up of funds between \$48 billion - \$195 billion in assets under management, with a median of \$87 billion compared to NCRS's \$94 billion. This peer group is comprised of 15 funds. Mr. Hartzell asked if the policy return is the same as our long term policy benchmark. Mr. Morris clarified that the policy return is our implementation benchmark.

Mr. Torrance reviewed the next few slides on Policy Return versus peer median. The differences in policy return are caused by the difference in asset mix and benchmarks.

Mr. Torrance thanked NCRS for being a very transparent fund. "It really helps us when we receive quality data." It can be difficult to compare to other funds because not all of the peers' report performance fees. Total fees were 42.5bps this year, down from 50.4bps the prior year. Total investment costs were 42.9bps this year, down from 51.0bps last year. Quite an improvement as long as you are getting the value add, which you are.

Mr. Morris added that the 8 basis points in cost savings is what we have actually saved, as opposed to the cost efficiencies slide where we are projecting cost savings. This chart should continue to improve in years to come. Mr. Aneralla asked if there is a goal in terms of basis points. Mr. Morris answered that we will continue to try to drive costs down, but on a large scale there is not much more room for a drastic decrease in basis points. We are in the 15th percentile this year, compared to the 38th percentile last year.

Mr. Torrance continued about cost savings. The total investment cost of the plan beat the benchmark by 11.3bps. This equates to \$106.32 million worth of savings. Savings of 10.8bps in external investment manager costs versus peers. Treasurer Folwell added that he would like to take a moment to appreciate the IMD staff. "We paid less for similar services, by the time the decisions get to me the ideas have been well researched. All the credit goes to the people in this office."

Mr. Torrance concluded the cost-effectiveness review.

AGENDA ITEMS -- INVESTMENT GRADE FIXED INCOME ASSET CLASS REVIEW

Jeff Smith introduced Brett Hall, a member of the Investment Grade Fixed Income team.

Mr. Hall reviewed the Short Term Portfolio. The monthly STIF rate has slowly improved since October 2017, from 1.25% to 1.76% as of September 30. The October 2018 STIF rate has risen even higher to 1.97%.

Mr. Aneralla noted that he read an article about the potential for increased volatility due to the Fed unwinding its balance sheet. Mr. Smith replied that we have not seen any issues on the cash market at this point.

Mr. Smith discussed the Investment Grade Fixed Income profile. The target allocation is 90% IG Core Fixed/10% IG Cash (STIF), we are slightly biased towards STIF at 11%. One reason we are overweight STIF is to lower overall duration, given the expressed concerns of the Fixed Income outlook. Another reason we are overweight IG Cash is to have the ability to take advantage of a real dislocation with the dry powder. We think that structural changes down the road will present opportunities at some point. Mr. Hartzell asked about the market value of the dry powder. Mr. Smith replied that it is presently in excess

of \$2 billion, at the end of September it was nearly \$3 billion. Treasurer Folwell added that on a total plan level there is more dry powder in the unfunded commitments to the fund managers.

Mr. Smith reviewed the IG Core Fixed portfolio, also called the Long Term Investment Portfolio (LTIP). This portfolio accounts for 89% of the total Investment Grade portfolio. The Yield to Maturity at quarter end was 3.7%, up from below 3% at the end of 2017. Mr. Smith noted that due to a ratings drift we are overweight BBB rated securities. In the near term we will look to bring that allocation closer to neutral at 25%.

Mr. Hall discussed Corporate Relative Value and LTIP Allocation by Sector. At this point, none of the sectors stand out in terms of value. The portfolio is allocated relatively in line with the benchmark, none of the sector weightings has a variance greater than 1.5%. One notable change is the allocation to technology was slightly underweight last year, whereas now we are slightly overweight. The increased allocation has been driven by a bias towards quality, higher rated names. These have lower spreads, but will hold up better in a stressful environment. The utilities sector is a place that typically holds up in stressful environments. At the moment we are relatively underweight, so that is an area that we will lean on in the near future.

Mr. Smith talked about Fed Rate increase expectations. There are modest increase expectations for 2019 and 2020. The 5 Year TIPS breakeven rate of 1.9 signals that there is no material concern of inflation in the marketplace.

Mr. Smith continued on to near term expectations. We run the portfolio through a basic simulation just to get a feel on what the returns would look like in different rate environments. The value of the portfolio can be seen in a flight to quality correction environment. Mr. Smith added that the portfolio's value has not been about return generation in the last 3-5 years, but the downside protection really matters when you bring in the context of the plan as a whole. The asset class outlook is better now than it has been recently due to rising rates pushing up expected returns of the intermediate term.

Mr. Smith concluded the presentation with a discussion on value added to the plan. Internally the team tracks the monthly excess return to the benchmark, and reinvests it into the asset class in order to show what value the team has added to the plan. Since total return data has been available in 1997, that value added by the portfolio is over \$2 billion.

Treasurer Folwell opened the floor for questions from the Committee. Mr. Aneralla asked if the Fed changes their expectations, is that better or worse? Mr. Smith responded that as rates get higher, Fixed Income starts to look different in terms of relative attractiveness. You need to get rates higher so that you have room to lower them when necessary.

Treasurer Folwell thanked and dismissed the Investment Grade Fixed Income team.

AGENDA ITEM – OPPORTUNISTIC FIXED INCOME ASSET CLASS REVIEW

Treasurer Folwell introduced Ronald Funderburk and Ty Powers to review the Opportunistic Fixed Income portfolio.

Mr. Funderburk began with the role of Opportunistic Fixed Income in the portfolio and the prioritization of portfolio strategies. Attractive absolute returns, competitive relative returns, diversification, capital preservation, and deflation protection outline the role of Opportunistic Fixed Income within the total portfolio. Relative to the total plan, the Opportunistic Fixed Income portfolio is underweight by 1.2%. There is additional capacity for more than \$1.1 billion in the asset class.

Mr. Funderburk continued with the weighting of components within the asset class. There are four sub-strategies within Opportunistic Fixed Income. Those components are Special Situations, Hedge Funds, Distressed Credit, and Traditional Corporate Credit. The asset class has an overweight of 14% to Special Situations, and an underweight of 17% to Distressed Credit.

Mr. Funderburk discussed diversification within the portfolio. Since 2014, the number of funds within the asset class has grown while the number of managers has stayed the same. We lean towards using high conviction managers that we have existing relationships with and will continue to build upon that.

Mr. Funderburk moved along to portfolio performance. The portfolio has returned 8.4% in the 1-year time period, beating the benchmark return of -0.5%, by 8.9%. Performance has been very strong as of late. There is only one year that Opportunistic Fixed Income has lagged the benchmark. Distressed Credit had really strong performance in 2016 and we were underweight in that sub-strategy.

Mr. Funderburk reviewed the structure of the asset class. There is a home country bias in our geographical allocation with 85% North America, 12.4% Europe, and 2.6% other. We are leaning away from commingled accounts and moving towards utilizing more separately managed accounts. These provide favorable economic conditions and allow us customization to tailor to our needs. We have had instances where these tailored products outperform the manager's main products.

Mr. Powers reviewed current market conditions. Overall, credit spreads are still historically tight. That being said, the unwinding of the Fed's balance sheet is a big question. We have never gone through a period of Quantitative Easing and balance sheet expansion like we did post global financial crisis. We have never been through an unwinding either, so we have transitioned from Quantitative Easing to Quantitative Tightening. We are not sure how that will manifest into the credit market, but it is something that we are keeping an eye on closely.

Mr. Powers discussed the current state of the non-investment grade market. Since the global financial crisis in 2007-2008, the high yield market has grown about 70% in size to just over a trillion dollars. Despite this growth, it is still a pretty inefficient market. There are many opportunities to take advantage of. One third of high yield trading is made up of ETF trading. The bank loan market has seen similar growth, doubling in size since the global financial crisis to over \$1 trillion. LIBOR is up to 2.6% from the low of under 50 basis points, which is great for us. It is not so great for the companies, particularly the ones in cyclical business that have expanded the balance sheet heavily in the last few years. Mr. Funderburk added that the lack of covenants is one reason why we believe in active management of this market. This is why many of our recommendations in the future will be towards active management.

Mr. Powers added that BBB rated bonds now count for 50% of the Investment Grade market in excess of \$2.5 trillion. We are looking at "fallen angels", when they get downgraded, typically a large institution cannot hold non-investment grade paper, and it creates an opportunity for us to buy at material discounts. That is where we can step in being a liquidity provider, giving us the chance to be on the right side of these deals if the opportunity presents itself. Mr. Smith pointed out that there is not a good appreciation for how small that door is going to be when everyone is running for it. The thought process is that it is coming, but it is just a matter of when. He can't overstate the impact of regulation changes. Mr. Funderburk added that we are trying to be proactive so that we can take advantage of this when it arises. Back in 2016, we were able to capitalize on similar opportunities on a limited basis and not to our desired scale. We do not want to be caught flat footed next time. Treasurer Folwell pointed out that when the fallen angels drop out of the Investment Grade classification Jeff's team does not have to liquidate, they just cannot purchase anymore.

Mr. Powers wrapped up with late cycle investment considerations. Rates have increased, making bank loans relatively more attractive. The team is continuing to focus on higher quality, larger issues that may be more defensive in the event of a credit market disruption. Finally, the team is creating investment capacity and preparing for the next large scale investment opportunity.

Treasurer Folwell asked the Committee for any questions, and with none he thanked and dismissed the Opportunistic Fixed Income team.

AGENDA ITEM – IAC MEMBER WELCOME

Treasurer Folwell welcomed Loris Colclough to the Investment Advisory Committee. Over thirty years ago, Loris noticed a massive problem with unfunded healthcare liabilities. As a result of his foresight, Winston Salem currently has an \$87 million healthcare liability but it has nearly \$68 million sitting in the bank to pay it off. For comparison, Charlotte has a five times larger liability and only one fifth of the money.

Mr. Colclough thanked Treasurer Folwell and stated that all of the presentations were remarkable and thanked the staff for everything they are doing for the state employees.

Treasurer Folwell acknowledged that he was wearing a badge today to honor Wake Forest Officer Mickey Hutchens who was killed on duty. It is a reminder of who this money actually belongs to. It does not belong to Wall Street, but rather to the participants of this plan. The badge is a reminder to the Board of who we are here to serve. The people teaching your kids, paving your roads, and protecting your lives is who this pension is for.

Treasurer Folwell added that going forward at least once a year the Investment Advisory Committee meetings will have consultants present to the Board. He thanked the team for all of the hard work this year.

Investment Advisory Committee members were provided with the opportunity to pose questions to the Treasurer and Investment Management Division staff. No questions were posed.

AGENDA ITEM – PUBLIC COMMENT

The Treasurer opened the meeting to public comments. Two public comments were made.

The first speaker, a previous Toys 'R Us employee, who had given public comment at the previous Investment Advisory Committee meeting, provided an update on new developments with regards to the Toys 'R Us bankruptcy. The second speaker, a representative of the Private Equity Stakeholder's project, also provided an update on the Toys 'R Us situation. In summary, they were asking that North Carolina halt new investments and should considering redeeming from investment managers who are involved in this bankruptcy and have refused to take part in creating a hardship fund for former employees.

Treasurer Folwell stated that the Board is serious about their fiduciary responsibility of loyalty to the state employees.

Treasurer Folwell reintroduced Chris Morris to acknowledge new Investment Management Division staff.

Mr. Morris introduced new employees, Jack Wilson and Joe Farley. Jack Wilson is an analyst with the Real Estate team. Joe Farley is an analyst with the Risk & Asset Allocation team.

ADJOURNMENT

Treasurer Folwell made closing remarks thanking the staff and looked to adjourn the meeting. Mr. Aneralla motioned to adjourn the meeting, seconded by Mr. Patterson. The meeting was adjourned at approximately 11:49am, without objection.

A handwritten signature in blue ink, reading "Dale Folwell CPA". The signature is written in a cursive style with a horizontal line underneath it.

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