

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

MEETING MINUTES FOR MAY 17, 2018

Time and Location: The Investment Advisory Committee (“IAC” or the “Committee”) met on Thursday, May 17, 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), Mike Mebane, John Aneralla, Lentz Brewer, and Greg Patterson

Staff: Brian Bolcar, Craig Demko, Chris Farr, Ronald Funderburk, Ben Garner, Renee Guerin, Brett Hall, Casey High, Gail Kadash, Patrick Kinlaw, Kathy Kornak, Matthew Krimm, Nicholas Langley, Steve Toole, Fran Lawrence, Troy March, Loren de Mey, Chris Morris, Neal Motaparthy, Meryl Murtagh, Tinh Phan, Ty Powers, Laura Rowe, Norman Schiszler, Jeff Smith, Rhonda Smith, Deana Solomon, Greg Taylor, Frank Lester, and Chris Ward

Others in Attendance: Lee Cohen – Wellington Capital, Aaron Montano - Alliance Bernstein

AGENDA ITEM – OPENING REMARKS

The meeting was called to order at approximately 9:00 a.m., by the Chair, Treasurer Folwell.

The Chair confirmed a quorum was met then asked the Members present to declare any conflicts of interest and none were declared. A quorum of Members was present, and the meeting, having been duly convened, was ready to proceed with business.

AGENDA ITEM – APPROVAL OF MINUTES

The Chair then asked for approval of the minutes of the quarterly meeting held February 15, 2018.

Mr. Patterson moved to approve the minutes, Mr. Aneralla second 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 delivered a brief update on the cost-efficiencies initiative underway in the Investment Management Division (IMD). He noted the initiative has increased from \$72.0 million to an approximate annual savings of \$76.7 million over the past quarter.

Mr. Smith then provided an update on the US economic environment for the past quarter with a brief mention of the current quarter changes. Equity providing positive returns for last 9 straight quarters. Two interest rate increases since quarter end, 95% predict another increase in June, with 85% predicting another two increases before year end.

Mr. Smith then turned the floor to Chris Morris. Mr. Morris presented an update on current assets under management, as of March 31, 2018. IMD has \$128 billion total assets under management. Assets for the

North Carolina Retirement Systems were \$97.9 billion, approximately \$400 million under where it was at year end.

Mr. Morris reviewed current NCRS asset allocation, noting that the plan remains underweight growth assets by 3.76% and overweight rates and liquidity by 3.35%. There was little change in weightings from the previous quarter, although the overweight to Investment Grade Fixed Income within Rates & Liquidity has been reduced given the short term outlook on the asset class. Mr. Morris continued onto the total net portfolio returns vs. benchmarks slide. Mr. Morris stated that the portfolio had a strong January, an okay February, and a slow March. The first quarter return for NCRS was 0.2%, outpacing the implementation benchmark of -0.6%. The plan has outperformed the implementation benchmark over every time period. The plan has also outperformed the long-term policy benchmark over every time period except the 15 year mark. A discussion ensued around what impact the lowering of the assumed rate of return to 7.0% has on the investment portfolio. Mr. Morris stated that we were not projecting to beat that number, so no operational changes will come from the lowered rate. In the long term it changes the contribution structure, but nothing that will change our day to day operations. It is a more realistic number than the previous 7.2%.

Mr. Morris moved onto the growth of a dollar charts, each comparing the total NCRS portfolio to the Long-Term Policy Benchmark. The portfolio has outperformed the benchmark pretty substantially over 20+ years. The divide has grown significantly in the last 5 years. Over the 5 year time period, the alternatives portfolio has added value.

Mr. Morris walked the committee through the return attribution charts, comparing our portfolio to the implementation benchmark. Mr. Morris explained that value add is the difference between the portfolio return and the policy return. The 1 year ending value add number was 0.96%. Allocation Effect had a negative impact on performance of -0.57%. Selection Effect had a positive impact on performance of 1.53%.

Mr. Morris moved onto gross of fees return and risk vs peer universe. Historically, during strong economic environments we have lagged our peers due to our higher allocation to IG Fixed Income, but over full market cycles have fared pretty well. NCRS has lagged on the 3 and 5yr time periods but is above median on the 10 year timeframe. Moving along to Sharpe ratio, we are in the 30th percentile over 3 years, 36th over 5 years, and 12th over 10 years.

Mr. Morris discussed NCRS' liquidity profile and the newer slide that provide insight on monitoring liquidity. IMD aims to be over 70% level 1 based on our strategy, and we currently are.

Mr. Morris reviewed net benefit payments by calendar year. We have seen the annual payments number float around 3% of the total plan for the last 7 years, 2016 being the only year in that range above 3%.

Mr. Smith discussed the New and Incremental commitments made since the February IAC Meeting. Including three incremental commitments that were made to the Russell Passive Internal Indices totaling \$2.64 billion. A conversation ensued around the progress of the internal equity portfolio. Rhonda Smith, Director of Public Equity, gave an overview of the progress, stating that we are on target to have all of our passive domestic equity managed internal by the end of the calendar year. Performance is tracked by the team daily and, to date, has been in line with expectations.

A question from the committee led to a discussion around where we are in the cycle when it comes to passive versus active. Mr. Morris stated that overall having the combination of active and passive helps with the downturn, but we are clearly late cycle. The allocation will dictate how the downturn affects us. In terms of the risk profile as a whole, each individual manager has their own expectations of risk and return, we roll them both up into public equity.

AGENDA ITEMS – PRIVATE EQUITY ASSEST CLASS REVIEW

Treasurer Folwell introduced Craig Demko, the Director of Private Equity.

Mr. Demko introduced the Private Equity team portfolio managers, Brian Bolcar and Neal Motaparthly. Mr. Bolcar has been with the Department for 3 years. Mr. Motaparthly has been with the Department for 5 years.

Mr. Motaparthly started out the presentation with the statutory allocation. Private Equity represents 4.99% of the total plan, below the Policy Target of 6.00%. Private Equity and Multi-Strategy combined make up 6.95% of the total plan, well underneath the legislative cap of 8.75%.

Mr. Motaparthly reviewed performance for the Private Equity portfolio. Since inception, the portfolio has an IRR of 8.24%. The vintage funds of 2010 to present show our current strategy. The portfolio's IRR of those funds is 14.34%. The strong performance of the portfolio has been driven by Venture Capital.

Mr. Motaparthly spoke on the composition of the portfolio and the weighting of each strategy. All of the weightings are within the policy range, except for Growth/Venture. Mr. Demko elaborated on this overweight by stating that Growth/Venture is driving our returns and we are comfortable with this overweight.

Mr. Motaparthly continued on with cash flow detail of the portfolio. Distributions have continued to outpace capital calls, which is in line with what we expect. Contributions have only exceed distributions in one calendar year since 2010, we do not anticipate that to change this year. Mr. Demko added that Year to Date we are cash flow positive \$230 million. However distributions have slowed down in the 2nd quarter.

Mr. Demko discussed general market commentary. The first trend discussed was purchase transactions. Transaction count remains strong, despite deal values falling. Deals totaling \$94 billion are currently pending Managers are concentrating on add-on investments as opposed to new investments. . Mr. Demko carried on that valuations were high as well. Managers were waiting until the last moment to make decisions and often walking away from transactions, leading to fewer deals. This year it appears the market is on pace to have a lower year in terms of transaction value.

Mr. Demko moved along to the next market trend: exits. So far this year, exits are off to a slow start both by count and value. However, NC's experience is different as we have been and expect to be receiving more capital as the year continues.

Mr. Demko highlighted the next market trend: venture capital. Our Venture Capital exposure is about one-third of the portfolio and we have seen strong returns.

Mr. Demko moved onto the last market trend: Secondaries. Secondaries are the purchases and sales of limited partners' interests in funds. Secondary buying was huge last year, setting a new market record at \$58 billion. The record year was due to strategy changes and Secondaries being used as a tool to manage allocations. The charts on the right side of this slide show pricing based on strategy and vintage. An important thing to understand about pricing is that NAV isn't the endgame. Intrinsic value is the most important factor. Mr. Demko touched on the new Landmark commitments. This is a cross asset class commitment that closed in March. The Private Equity piece is \$800 million and the Inflation piece is \$450 million. Landmark is a legacy manager that was performing very well and we wanted to continue the relationship. We also have great terms with more control.

AGENDA ITEMS – PRIVATE MARKET DISCRETIONARY INVESTMENT APPROVAL PROCESS

Treasurer Folwell introduced Meryl Murtagh, the assistant general counsel.

Ms. Murtagh reviewed the Private Market Discretionary Investment Approval Process. In compliance with the Treasurer's statutory authority and fiduciary duty there are clear guidelines for external vs internal management. NCRS is implementing investment structures that are a hybrid, external management with some internal controls. Historically, we have had private market deals where the Treasurer held a veto right; as a further evolution of control, this is an affirmative approval process, not just a veto.

Ms. Murtagh reviewed NC general statute §147-69.2(e) (1) (and (2)).

Mr. Aneralla asked questions about the funds ability to review and approve investments quickly. Investment staff responded that it is possible there could be opportunities that are too timely and that we will not be able to act on quick enough, but this is an additional add-on that we will be able to use strategically.

Mr. Demko added that Private Equity asset class has currently allocated \$300 million of capacity to the discretionary strategy that we can choose to utilize, or not. Although we may participate with other LPs in some of the investment structures with the overall fund relationship, NCRS is the sole investor in the overall strategy.

Mr. Mebane asked, will we be making decisions as partners? Treasurer Folwell responded yes, the staff would do the analysis and present the Treasurer with their findings. Mr. Demko added that we will do our own work, but the General Partner has datasets in place to capitalize on opportunities. (Market Values, intrinsic values, etc.)

AGENDA ITEMS – INFLATION SENSITIVE ASSEST CLASS REVIEW

Treasurer Folwell introduced Ronald Funderburk, the asset class director.

Mr. Funderburk introduced the Inflation Sensitive team portfolio managers Renee Guerin and Ty Powers.

Mr. Funderburk began with Inflation Sensitive's role in the portfolio. The role is stated in the Investment Policy Statement. It is comprised of inflation protection, attractive absolute returns, competitive relative returns, diversification, and liquidity.

Mr. Funderburk continued to discuss portfolio performance. He stated that 3 year, 5 year, and longer are the data points to focus on and the portfolio has performed reasonably well over these time periods.

Mrs. Guerin next reviewed performance by portfolio component. Other Real Assets & Diversifiers and Inflation-Linked Bonds have outperformed their respective benchmarks since inclusion into the portfolio.

Mrs. Guerin moved along to review the liquidity profile of the portfolio. Mrs. Guerin reviewed the correlation matrix to highlight how the inflation sensitive portfolio has added value through diversification.

Mr. Powers discussed recent accomplishments of the portfolio, centralized around the Landmark commitments. Landmark is a high conviction manager. We were able to partner with the private equity team to improve deal terms for the organization. The team worked with DoubleLine and BlackRock on separate accounts that are customized to fit the portfolio's goals along with enhanced governance provisions.

Mr. Powers continued on to say that core CPI has been stable, around 2% since the global recession. Headline CPI has bounced around a bit. Breakeven rates have converged at 2.1%. The team is of the general opinion that inflation may increase in near term as signaled by tightness in the labor market.

Mr. Powers moved on to talk about the Federal Reserve outlook. We expect them to continue to increase rates. There is a 45% chance of 3 more rate hikes this year, even greater chance for 2 hikes and 1 hike.

Mr. Funderburk summarized that the team's future focus is on high conviction opportunities. We continue to monitor and manage portfolio liquidity. We will also continue to evaluate sub-strategies and make sure they maintain linkages to inflation. Maintaining vintage diversification and strategy diversification is important. Balance is key.

Mr. Aneralla asked, should we continue to allocate towards inflation sensitive? Your correlation graph shows why you need to be diversified. Mr. Powers responded that the stars are aligning to see a short term spike that could take the markets by surprise. Mr. Smith added that the issue the fed has is they need to increase rates in order to deal with inflation later on.

Mr. Mebane asked if Timber valuations are increasing. Mr. Funderburk responded yes, valuations are increasing, but not to the level we expect or witnessed in the lumber markets. Some of that has to do with how assets are valued, lags in valuation, pricing power and other things that we cannot control. Mr. Powers added that the trend is looking good for lumber and hopefully that spills over to timber. Mrs. Guerin noted that there have been positive developments this year. The managers are harvesting more timber than in recent quarters due to the increase in pricing. Mr. Funderburk expressed concern related to rising interest rates given the terminal value of timber is priced according to the discount rate.

Mr. Aneralla questioned if there were any tariff issues related to timber. Mr. Funderburk answered that the tariffs have not materially impacted the portfolio to date.

AGENDA ITEMS – IAC MEMBER Q&A

Treasurer Folwell announced that he received a letter of resignation from Board Member Steve Jones. The Treasurer thanked Mr. Jones for his service and wished him the best going forward.

Mr. Aneralla asked for an update on the CIO search. Treasurer Folwell responded that there is no update at this time, and that nothing has been posted to date. He is extremely happy with the interim CIOs. The spirits of the team appear stable and that is a reflection of these gentlemen. The current stability of the division is more important than bringing on a new CIO.

AGENDA ITEM – PUBLIC COMMENT

The Treasurer asked for any public comments. No public comments were made.

ADJOURNMENT

Treasurer highlighted national police officers month was a good time to honor police officers and the work that they do. They protect us from crime and the investment staff remembers that the money in the Retirement Systems belongs to police officers and their families.

Mr. Aneralla moved to close the meeting, seconded by Mr. Patterson. The meeting was adjourned at approximately 11:36 am, without objection.

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