

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

**MINUTES OF MEETING
November 14, 2012**

Time and Location: The Investment Advisory Committee ("IAC") met on Wednesday, November 14, 2012, 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), Neal Triplett (vice-chair), Harold Keen, and Courtney Tuttle (by telephone).

Staff: The following staff members were present: Lynda Boulay, Susan Carter, Jay Chaudhuri, Brad Creel, Tarik Dalton, Craig Demko, Joan Fontes, Ronald Funderburk, Kathy Hahn, Brett Hall, Alison Garcia, William Hockett, Arlene Jones-McCalla, Bryan Lewis, Chris Morris, Keith Nelson, Mike Ruetz, Jeff Smith, Tony Solari, Blake Thomas, Steve Toole, and Sam Watts.

Others in Attendance: Kai Petersen and Larry Langer (Buck Consultants).

AGENDA ITEM – OPENING REMARKS

The meeting was called to order at approximately 10:00 a.m. Treasurer Cowell reminded all IAC members of the Code of Ethics and asked members to identify any actual, potential, or apparent conflicts of interest. No conflicts, potential conflicts or appearances of conflicts were reported.

AGENDA ITEM – APPROVAL OF MINUTES

Treasurer Cowell asked for any discussion, comments, or corrections concerning the minutes of the September 13, 2012, meeting. The IAC unanimously approved the minutes without any changes to the draft.

AGENDA ITEM – OUTSTANDING ITEMS

Mr. Lewis, the interim Chief Investment Officer, led a discussion of recent developments.

Mr. Lewis noted that the November IAC meeting would be the last for Mike Ruetz, the Department's Director of Risk Management and Asset Allocation. Mr. Lewis thanked Mr. Ruetz for his service and commitment to the Retirement Systems.

Mr. Lewis provided an update on the unified risk and performance analytics system being developed by the Department in cooperation with SAS. The public equity team was heavily engaged with SAS. At the February IAC meeting, the Department expects to provide an update on the functionality and best use of the system for the global equity portfolio.

AGENDA ITEM – PORTFOLIO UPDATE

Mr. Lewis provided an update on the portfolio, with data through September 30, 2012. Over the preceding three months, the total Retirement Systems portfolio returned 4.46% net of fees. The portfolio performed 0.18% above its benchmark. Over the preceding 12 months, the portfolio returned 13.96% net of fees, which was 0.08% above the benchmark.

Mr. Lewis noted that the global equity, fixed income, and credit strategies portfolios, in particular, outperformed their benchmarks and contributed to the overall portfolio's positive performance. Mr. Lewis cautioned that the global equity portfolio, by nature, will display volatility, and staff expect the fixed income and global equity markets may not perform as strongly going forward.

Mr. Lewis provided the Department's customary comparison of the Retirement Systems portfolio to the universe of public funds with more than \$1 billion of assets. (This comparison is made gross of fees, as net performance data are not broadly available.) The Department continues to accept a lower level of risk than its peers, which can result in investment returns lower than peers during time periods in which equities perform strongly. The Retirement Systems exhibited excellent absolute performance, with a 14.45% gross return over a one-year period, but this return was in the next-to-lowest quartile for the peer group over that period. The Systems were in or very near the lowest-risk quartile over one, three, five, and 10-year periods.

The global equity portfolio performed well in the third quarter, as quantitative easing was received positively by the markets. The strongest sectors were energy, financials and materials, while industrials and utilities did not perform as well. The majority of the department's global equity managers outperformed their benchmarks.

The fixed income portfolio outperformed its benchmark by 50 basis points over the quarter, driven primarily by an overweight allocation to corporate bonds. The non-core portion of the portfolio performed particularly well, with a 6.68% return. Mr. Lewis, Mr. Smith, Mr. Triplett, and Mr. Keen discussed potential expansion of the non-core portfolio.

In the discussion of the private equity portfolio, Mr. Lewis commented that while global dealflow increased by 40% during the quarter versus 2011, mergers & acquisitions activity had declined 23% compared to last year and IPO activity had slowed perhaps due to the fiscal cliff deadline. Mr. Lewis then turned to the credit and inflation portfolios. Mr. Lewis noted that the Department is examining direct lending and structured credit. The Department will seek to balance the volatility of commodities with other less volatile investments. There had been no new investments in these portfolios since the September meeting.

In the period from August 1 through September 30, 2012, new commitments were made to a private equity fund managed by Carousel Capital Partners, a real estate fund managed by KTR Capital Partners, and an inflation portfolio fund managed by Intervale Capital.

AGENDA ITEM – LIABILITY ANALYSIS

Treasurer Cowell introduced Kai Petersen and Larry Langer from Buck Consultants, the actuary for the Retirement Systems. With the Department's assistance, Buck Consultants used stochastic modeling to analyze the range of hypothetical future asset and liability levels for the Retirement Systems. The Treasurer noted that the Retirement Systems' actuarial assumptions are evaluated on a regular basis every five years, and we are currently in the middle of this five-year cycle. Nonetheless, the Treasurer commented that it seemed appropriate to explore these issues now so that asset allocation discussions with the General Assembly and the Department's implementation of new GASB standards could be informed by the actuaries' modeling of future outcomes.

Mr. Petersen, Mr. Ruetz, Mr. Langer, and Mr. Morris provided a presentation detailing the Buck Consultants project. Mr. Ruetz began by noting that the team sought to understand the sensitivities of key funding metrics. The team produced estimates based on scenario analysis; Mr. Petersen described the modeling method. Using a tool called GEMS, Buck Consultants projected 30 years of portfolio returns and liabilities for 999 hypothetical economic and capital market scenarios. For each of the 999 scenarios, Buck performed actuarial valuations and computed financial metrics.

The Buck Consultants modeling used the Investment Management Division's current strategic targets. These are a 40.5% allocation to global equity, a 36.0% allocation to fixed income, a 6.5% allocation to alternatives (including both private equity and hedge funds), an 8.0% allocation to real estate, a 4.5% allocation to the credit portfolio, and a 4.5% allocation to the inflation portfolio.

The Buck Consultants modeling also used the current funding policy, including a 7.25% assumed portfolio return, asset smoothing, and an actuarial cost method based on individual entry age normal cost. In response to a question from Treasurer Cowell, Mr. Petersen noted that the new GASB standards did not affect accounting on the funding side of the pension system. Mr. Petersen noted that although asset smoothing is very common for purposes of determining contribution amounts, the new GASB standards will diverge from that method, leading to more apparent volatility whenever GASB methods are used to report funding.

Mr. Petersen presented to the IAC a series of slides detailing funding requirements under the 999 economic and capital market scenarios generated using the GEMS modeling tool. Most of these modeling scenarios project an increase in the annual State contribution over the next 10 years. For the years 2025 and later, the scenarios produce a wide range of potential State contribution levels, varying based on projected investment return and whether a cost-of-living adjustment will be provided to members. In the median result from the 999 GEMS scenarios, the Retirement Systems' geometric average return in 2040 (including accumulated interest) is projected to be 8.3%. Mr. Triplett asked about the relationship of this median scenario to historical returns. Mr. Petersen replied that the median scenario does not match the so-called "new norm" discussed by commentators, in which low inflation and low growth extend for several decades, but the median scenario also does not assume complete reversion to the most common historical patterns.

Mr. Ruetz presented a series of slides comparing the funding requirements for three particular scenarios taken from the 999 analyzed by Buck Consultants. These three scenarios were:

- (1) The median of all 999 GEMS scenarios;
- (2) A brief, but large one-time downturn in the markets, featuring a negative 20% return in the first year, then ordinary returns thereafter; and
- (3) Sustained low growth, featuring a decade of weak returns (5% for public equity, 2.5% for fixed income, and 7.5% for private equity) followed by ordinary returns.

A one-time 20% loss would create an immediate need for significantly higher State contributions, but would have little impact on State contributions 15 years after the event. Under the sustained low growth scenario, State funding requirements would be near the levels in the median scenario through 2019, then would rise and continue to be significantly elevated compared to the median scenario until 2035. Mr. Petersen noted that of these three scenarios, the median was most likely, and the probability of the negative 20% return scenario was less than 1%. Mr. Ruetz noted, however, that for the fixed income asset class, the general consensus is that returns will be near or at 2.5% (as forecast in the low growth scenario) over the next five years.

Mr. Langer noted that the Retirement Systems' actuarial assumed mortality rate and other funding policy decisions are more conservative than those used by other public pension funds. When combined with the Retirement Systems' high funding ratio, these funding policy decisions indicate that the Retirement Systems are an exceptionally well-funded plan.

The Chair, the IAC, and staff discussed the Retirement Systems' 7.25% target portfolio return. Mr. Langer remarked that any change to this target rate (by changing the Systems' discount rate) would result in higher State contributions in earlier years, then lower State contributions in later years. The Chair noted that in recent years, the Retirement Systems had on several occasions not returned 7.25% or more. This raises questions about future expectations. Mr. Smith commented that for the next five-year period, the consensus expected investing environment will make it challenging to meet a 7.25% target.

Mr. Petersen noted that from an actuarial standpoint, the discount rate is not meant to be moved to match the current environment, whether good or bad. Mr. Langer commented that over a longer time horizon (for example, the 30-year period evaluated in this Buck Consultants study), a 7.25% discount rate is appropriate. He observed that Buck Consultants could work to better communicate that actuarial models take into market volatility into account; it should not cause alarm if the discount rate is 7.25%, yet the markets produce 2% during a relatively short (e.g. multi-year) period of time.

The Treasurer turned the conversation to a discussion of the implications of Buck Consultants' study upon investment strategy. Mr. Lewis led a discussion of how to best provide tools for the Department of State Treasurer and staff to meet the 7.25% investment target. Mr. Lewis commented that under the existing asset allocation, the Investment Management Division could

do everything right and still miss the 7.25% target. Mr. Lewis raised the idea of increasing the maximum allocation to alternatives, real estate, credit, and inflation to 40% of the total Retirement Systems portfolio. The General Assembly would have to change existing law to enable such an allocation. Mr. Lewis stressed flexibility based on market conditions, but suggested a 9% target for each of these asset classes, with funds being moved into these asset classes from the fixed income portfolio as good opportunities arise. Mr. Triplett agreed that the State would have to accept higher risk to meet a 7.25% target.

In response to a question from Ms. Tuttle, Mr. Lewis also outlined a more aggressive asset allocation in which the global equity portfolio could be increased to near 50%, with increased hedging. Mr. Lewis and Mr. Ruetz noted that the Department's primary objective is flexibility to take advantage of the changing current market conditions. Either this more aggressive equity allocation with increased hedging or the 40% allocation discussed above is a potential solution. It was noted the Department would still have the flexibility to reallocate funds out of equities and alternatives into fixed income in the future if market conditions change again.

In a dialogue with Ms. Tuttle, Mr. Smith and Mr. Lewis noted that a lower allocation to fixed income would decrease the Retirement Systems' downside protection when the markets decline. As Mr. Smith noted, the fixed income portfolio has provided substantial downside protection, but in the present environment, that protection has a corresponding diminution of return. Ms. Tuttle observed that a higher allocation to private equity would decrease the Retirement Systems' overall liquidity. Ms. Tuttle remarked that she would advise careful consideration before decreasing the fixed income allocation beneath 30%. Mr. Triplett commented that he would be in favor of cautiously moving some funds out of fixed income. Mr. Keen noted that under the current asset allocation, the State had built an extraordinarily well-funded plan. The Treasurer agreed that making an enormous change to the Retirement Systems' risk profile may not be advisable.

Summing up the discussion, the Treasurer asked staff to explore the moderate asset allocation described by Mr. Lewis, with allocations to alternatives, real estate, credit, and inflation as high as 40% in the aggregate if market conditions warrant.

Mr. Smith commented that even under the more aggressive asset allocations discussed above, a 7.25% return could be challenging under present market conditions. Mr. Demko noted the "J-curve" effect, in which any change to asset allocation causes a temporary near-term disruption to returns.

Due to scheduling constraints, the Chair asked that Mr. Langer and Mr. Petersen provide the portion of their presentation focusing on the new GASB standards at the end of the meeting, after the real estate portfolio update. The meeting was adjourned for lunch at approximately 12:10 p.m. The meeting reconvened at approximately 12:45 p.m.

AGENDA ITEM – REAL ESTATE UPDATE

Ms. Carter led a presentation concerning the Retirement Systems' real estate portfolio. As of September 30, 2012, the real estate portfolio represented 7.66% of the total Retirement Systems, below the 8.00% policy target set by the Department and the 10.00% limit set by the General Assembly. Timber investments are 10.7% of the real estate portfolio (0.79% of the total Retirement Systems). The remaining 88.3% of the real estate portfolio is split between core, value-added, and opportunistic investments; the portfolio is currently overweight to opportunistic and underweight to value-added strategies.

Ms. Carter noted that the asset allocation to real estate began to increase in 2005. Post-recession, the real estate staff has sought to decrease the total number of managers and has cautiously positioned the Retirement Systems to take advantage of opportunities in the changed environment.

A large investment in timber was made just prior to the financial crisis. Ms. Carter stated that the timber investments were a drag on returns measured over one-year and three-year periods, decreasing the real estate portfolio's overall performance by more than one percentage point.

Ms. Carter discussed the disconnect between the real estate portfolio's benchmark and the composition of the real estate portfolio. She noted that the benchmark is based upon a core private real estate strategy, which makes up only 26% of the Retirement Systems real estate portfolio. The benchmark does not include value-added or opportunistic real estate investments and does not include timber. The benchmark also is more weighted toward domestic investments than the Retirement Systems real estate portfolio. Ms. Carter suggested broadening the real estate portfolio's benchmark, offered several alternatives to the present benchmark, and proposed the use of a dynamic custom benchmark.

Ms. Carter discussed the outlook for real estate growth. Overall, the domestic economic environment is not positive for real estate. Although commercial real estate appears to have bottomed, the CMBS market has not recovered. The "major markets" of Boston, Chicago, Los Angeles, New York, San Francisco, and Washington, D.C., have performed much better than non-major markets. Investor demand has narrowed, focusing primarily on stable core assets, but Ms. Carter remarked that she sees significant risk in focusing solely on core assets, particularly if interest rates rise.

Ms. Carter concluded her presentation by noting the real estate portfolio's overall areas of focus for 2012 and 2013. These include recommitting funds to the Department's strongest fund managers, redistributing core capital, redistributing real estate investment trusts, exploring sales of existing investments, and improving portfolio analytics through the Department's SAS project or other tools.

Mr. Triplett and Ms. Carter discussed the real estate portfolio benchmark. A more specific benchmark could reduce the Retirement Systems' flexibility in real estate strategies. A dynamic benchmark would leave flexibility intact, but would make it more difficult to evaluate tactical

decisions made by staff in response to changing market conditions. Mr. Lewis noted that staff would present to the IAC at a future meeting any change to the real estate portfolio benchmarks.

AGENDA ITEM – LIABILITY ANALYSIS
(returning to this agenda item)

The Chair recognized Mr. Langer and Mr. Petersen, who provided a summary of GASB Statements 67 and 68. GASB Statement 67 sets out new requirements for financial reporting by pension plans, amending GASB Statement 25. GASB Statement 68 alters pension accounting procedures for employers, amending GASB Statement 27. For the Retirement Systems, the new GASB standards will go into effect in the 2013-2014 fiscal year.

The new GASB statements leave discretion to the pension plan concerning funding policy, but impose specific requirements as to reporting. The net pension liability (essentially, the unfunded liability) will be added to all employers' balance sheets. This amount on the balance sheet will be highly volatile. Compared to other states, the North Carolina Retirement Systems will have one of the smallest net pension liabilities added to employers' balance sheets, at approximately \$200 million in the aggregate. Less well-funded pension plans in other states will have billions of dollars added to employers' balance sheets. Employer financial statements will include net pension liabilities beginning with the 2014-2015 fiscal year.

Mr. Langer stressed that, although the GASB standards will cause an increase in the unfunded liability reported on financial statements, nothing will have changed about the Retirement Systems themselves. The GASB standards affect reporting only. Treasurer Cowell commented that the Department's plan was to adopt the new GASB procedures sooner rather than later.

AGENDA ITEM – IAC MEMBER Q & A

There were no further questions from IAC members.

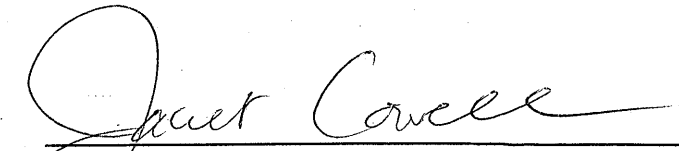
AGENDA ITEM – PUBLIC COMMENT

There were no public comments.

ADJOURNMENT

The meeting was adjourned at approximately 1:50 p.m.

APPROVED BY:



JANET COWELL
STATE TREASURER AND CHAIR