

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

March 29, 2017

Time and Location: The Investment Advisory Committee (“IAC” or the “Committee”) met on Wednesday, March 29, 2017, in the Dogwood Conference Room of the Longleaf Building, 3200 Atlantic Avenue, Raleigh, North Carolina.

Members Present: State Treasurer Dale R. Folwell (Chair), Neal Triplett (Vice-Chair), John Aneralla, David Hartzell, Steve Jones, and Mike Mebane.

Members Absent: None.

Staff Members Present: Lisa Allnut, Renee Bezaire, Kim Baker, Mary Laurie Cece, Angela Cooper, Tarik Dalton, Loren de Mey, Craig Demko, Joan Fontes, Ronald Funderburk, Alison Garcia, Brett Hall, Karen Hammond-Smith, Sam Hayes, Casey High, Sean Incremona, Taylor Jackson, Arlene Jones-McCalla, Gail Kadash, Kathy Kornak, Matt Krimm, John Leraas, Troy March, Deana Moore-Solomon, Chris Morris, Neal Motaparthly, Meryl Murtagh, Ty Powers, Laura Rowe, Norman Schiszler, Kevin SigRist, Jeff Smith, Rhonda Smith, David Stefanick, Christina Strickland, Tessa Tanis, Greg Taylor, Steve Toole, Madelaine Wang, Chris Ward, Brad Young, and Zhexing Zhang.

Others in Attendance: Mitch Leonard (State Employees Association of North Carolina), Lee Cohen, Brian Bode, Kristen Doyle (AON Hewitt), Katie Comstock (AON Hewitt), Jeanna Cullons (AON Hewitt) and Neal Weinberg (Bloomberg News).

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. The Chair then took the opportunity to recognize members of the UNC Health System. Treasurer Folwell thanked the members for attending the IAC meeting

The Chair asked the Members present to declare any conflicts of interest and, there being nothing declared, the meeting commenced.

AGENDA ITEM – APPROVAL OF MINUTES

The Chair then asked for approval of the minutes of the quarterly meeting held November 16, 2016. Mr. Aneralla moved to approve the minutes, and Mr. Mebane seconded. The minutes were approved as written. A quorum of Members was present, and the meeting, having been duly convened, was ready to proceed with business.

AGENDA ITEM – INITIATIVES AND PERFORMANCE UPDATE

The Chair recognized Kevin SigRist, Chief Investment Officer. Mr. SigRist indicated in his opening remarks that due to time constraints he would move quickly through the slides he had prepared. He began his presentation by providing updates to materially complete initiatives that have been “taken off the list”. These initiatives included:

- Research and develop Long-term Stewardship (“ESG”) policies and strategies;
- Transition oversight of Ancillary Funds, including establish a new long-term fixed income product for certain clients and facilitate movement of assets;
- Implement Managed Accounts Program and initial components of direct Hedged Equity program;
- Update asset-liability study and support review of the NCRS discount rate/investment return assumption;
- Institute 360 degree feedback for senior management;
- Implement BNY Mellon Private Investment Asset Service processes;
- New IMD role with unbundled Supplemental Retirement Plan;
- Implement Venture Capital Multiplier Fund (Escheats Fund); and
- Conduct third-party review of budget practices, fees, incentives and policy compliance.

Major IMD Initiatives – Mr. SigRist provided an update to on ongoing, major initiatives underway since the November 16, 2016 meeting. He noted that there had been good progress on the following IMD initiatives:

- Facilitated the Treasurer’s transition by completing phone calls with 145 investment managers. This initiative is 95% complete. Mr. SigRist mentioned that it is premature to be looking at new commitments at this time.
- Investment program cost-efficiencies initiative. Mr. SigRist walked through the Cost-Efficiencies Initiative slide. He stated the goal of the initiative is to obtain \$100 million of incremental cost-efficiencies for the North Carolina Retirement System (“NCRS”) investment program, consistent with fiduciary requirements and the NCRS investment objectives. The \$100 million goal would be measured on a cumulative basis over a four year timeframe. Mr. SigRist indicated that the initiative is not about cost reductions, but rather cost efficiencies. He stated that NCRS’s investment program is low cost compared to peers, but there is still room for improvement. There needs to be a balance between future returns and risk controls against cost savings. Mr. Jones questioned how the savings will be achieved; just changing investments or letting current process run its course. Mr. SigRist advised that it is still under review as to how the goal will be accomplished. Treasurer Folwell indicated that the \$100 million in reduced fees is the floor, not the ceiling. Performance fees may potentially increase in the short term along with returns which was acknowledged as overall good for the NCRS. Mr. SigRist continued his

presentation by covering the strategic and tactical focus of the initiative and the initiative's progress to date. Mr. Jones commented that the goal of reducing \$100 million in fees should not get in the way of the goal of hitting 7.25%. The Treasurer reiterated that his main goals are to lower costs, reduce complexity, and be transparent.

- Mr. SigRist stated that underway is an evaluation of restructuring/exiting Fund of Funds and legacy low-conviction funds/managers.
- Internal equity index fund implementation is underway and staff is currently reviewing technological and staffing requirements for internal trading.

AGENDA ITEM – COMPLIANCE & FEE APPROVAL

Mr. SigRist turned the floor over to Kristin Doyle with AON Hewitt to walk through the presentation on Compliance and Fee Review. The North Carolina Department of State Treasurer retained Aon Hewitt Investment Consulting ("Aon") to conduct (1) a compliance review of the Investment Management Division's ("IMD") internal investment decision-making policies and processes for the NCRS, and (2) a review of NCRS investment manager fees versus industry medians. The scope of the project covered 142 investments entered into during the period July 1, 2012 to October 20, 2016 across public equity, hedged equity, real estate, private equity, inflation sensitive, opportunistic fixed income and multi-strategy. Ms. Doyle indicated that overall, IMD has been very diligent in producing the required documents for the time period reviewed and has been in compliance with its internal decision-making processes and policies. After reviewing documentation for the 142 funds, Aon identified only a few instances of missing or incomplete documentation. Ms. Doyle summarized some of the other key findings. Overall, IMD has been in compliance with its External Investment Manager and Vehicle Selection Policy in terms of the required documents. In addition, IMD Staff has done an excellent job of negotiating fees. Fees for many managers are below the industry average and, overall, no fee was unreasonable in the aggregate. Treasurer Folwell asked a question regarding the accuracy of actual fees charged by the managers and whether Aon reviewed these. Ms. Doyle advised that fee statements were not reviewed as that was out of the scope of services. There was discussion with staff regarding the current internal process for confirmation by staff that the actual fees charged are accurate. The Treasurer advised he would have liked a different scope of review that included a review of the accuracy of the fees charged to the asset classes.

AGENDA ITEM – INITIATIVES AND PERFORMANCE UPDATE (con't)

Performance Update – Mr. SigRist provided an update on the performance of the investments for the NCRS. He indicated with regard to the overall market environment there are some rising labor cost and some momentum in inflation. The sharp decline in commodity prices has phased out. Commodities, including oil are up. Global markets are behind US markets. NCRS assets currently under management have grown. The Short-Term Investment Fund ("STIF") portfolio is now larger than the Long-Term Fixed Income ("LTFI"). Mr. SigRist then walked through the Asset Allocation

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slide. He stated that several equity managers have been terminated in line with policy decisions to move away from those strategies. Specifically, six global public equity managers, saving \$17 million annually, based on last year's expenses. As IMD terminated managers, the proceeds were redeployed to other asset classes because public equity was overweight. Assets from equity terminations has been moved to Investment Grade Fixed Income and pension cash. Mr. SigRist stated that cash should have more favorable returns in the next year because of Federal Reserve rate increases. He stated that there had been good returns for equity, multi-strategy, real estate and inflation sensitive, while there were weaker returns in fixed-income and cash. In response to a question from Mr. Mebane, Mr. SigRist stated that all returns are net of fees. It was requested by the IAC that this be stated on the performance slides. The Treasurer requested that the slide on NCRS returns compared to benchmarks be simplified. Mr. SigRist reviewed the return attribution. Mr. Jones requested that the difference between implementation benchmark and policy benchmark be defined. Treasurer Folwell noted that it might be better to have IAC meetings after quarter end. Mr. SigRist walked through the list of new and incremental investments since the November 16 meeting. The IAC Committee questioned the future use of alternatives and Mr. SigRist stated that we need to continue to see what the Treasurer's vision will be. Mr. Aneralla asked why there have not been any new investments in 2017. Mr. SigRist explained that it is very important that the Treasurer have comfort with the portfolio before he is ready to proceed on any new investments. He further added that vintage year diversification is an important concept and IMD has some concerns about being out of the market, but will continue to wait for Treasurer's approval to move forward. Mr. SigRist then presented the slide that listed exited investments.

AGENDA ITEM – INFLATION SENSITIVE ASSET CLASS REVIEW

Ronald Funderburk and John Leraas were introduced to the meeting as representatives of the Inflation Sensitive Portfolio team. Mr. Funderburk introduced the rest of his team, Kathy Hahn Assistant Director and Zhexing Zhang, Quantitative Investment Analyst. Mr. Funderburk walked through the objectives of the Inflation Sensitive Portfolio and policy subcomponents and strategies. Mr. Mebane asked whether real asset lending is appropriate for inflation protection. Mr. Funderburk responded that the strategy has been vetted and approved for inflation protection. If inflation were to occur, the value of the underlying collateral would be enhanced while earning a current coupon that is higher than the expected inflation rate. In addition, the real asset lending strategies participate in enhanced returns through floating rate mechanisms and equity warrants. He provided a detailed description of diversification of the portfolio. Mr. Funderburk provided a brief history of the portfolio. The portfolio was created January 1, 2010, consisting of legacy investments from the private equity and real estate portfolios. The initial strategy was long commodities serving as a diversifier for the broader plan. Currently, the portfolio holds inflation linked bonds, publically traded natural resources such as commodity futures, natural resources' public debt, privately held natural resources, real assets and other diversifiers. Mr. Leraas walked through the historical allocation of the portfolio. He stated that public natural resources have declined as a percentage of the portfolio. The real asset lending took off in 2012 and TIPS began in 2015. There were additional moves to diversify the strategy in 2014 and 2016 with there being a statutory maximum change in 2014. There are currently 25 mangers and 49

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funds (including five co-invests). Mr. Leraas provided a summary of the current allocation of the portfolio. Inflation Portfolio continued to diversify away from Public Natural Resources and energy related investments consistent with having a balanced portfolio. The increased diversification has benefited 3-year and 5-year performance.

AGENDA ITEM – IAC CHARTER REVIEW/UPDATE

Mr. SigRist recognized Mary Laurie Cece, Assistant General Counsel, to present the Committee with the revised Investment Advisory Committee Charter (“Charter”). Ms. Cece highlighted the revisions of the Charter. Mr. Jones asked if there was a theme behind the changes. Ms. Cece responded that the new Charter provides the Committee with more oversight over IMD policies and procedures. Mr. SigRist added that the revised charter will also add some additional transparency. Mr. Aneralla asked if the Charter would be adopted today.

It was moved by Mr. Aneralla, seconded by Treasurer Folwell, and carried unanimously that the revised Charter is adopted.

AGENDA ITEMS – IAC MEMBER Q&A

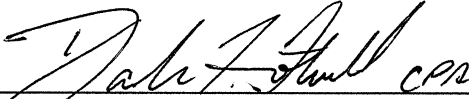
IAC Members were provided with the opportunity to pose questions to the Treasurer, Mr. SigRist and IMD staff. Mr. Jones asked whether the inflation sensitive asset class is attractive based on its returns or is it only for diversification. There was discussion around the purpose of the inflation sensitive asset class, including the need to protect against stagflation for the rest of the fund. Mr. Hartzell commented that he is supportive of the fee reduction strategy, but believes that a commitment to asset class diversity is needed for long term performance. He thinks this is very important.

AGENDA ITEM – PUBLIC COMMENT

Mitch Leonard, Executive Director SEANC, commented on several items including wanting a better performing retirement system for members. He indicated that SEANC would like to see investments hit or exceed return targets and members continued to be concerned about fees. Mr. Leonard is looking forward to working with the Treasurer and staff.

ADJOURNMENT

Treasurer Folwell made closing remarks and thanked everyone for their attendance and input. Mr. Aneralla motioned to close the meeting, seconded by Mr. Mebane. The meeting was adjourned at approximately 12 p.m., without objection.



DALE R. FOLWELL, CPA
STATE TREASURER AND CHAIR