



NORTH CAROLINA
DEPARTMENT OF STATE TREASURER
INVESTMENT MANAGEMENT DIVISION

JANET COWELL
TREASURER

KEVIN SIGRIST
CHIEF INVESTMENT OFFICER

To: Investment Advisory Committee Members
From: Kevin SigRist
CC: Tony Solari, Edgar Starnes, and Blake Thomas
Date: July 22, 2016
Subject: July 28, 2016 Meeting Memo

We will be discussing a number of important topics at the July 28, 2016 Investment Advisory Committee (“IAC”) meeting, including Phase 2 of the NCRS Asset Liability Study. This memorandum provides background on two new IAC activities that result, in part, from actions taken in the recently ended legislative session.

1. IAC Consultation on Policies
2. Third-Party Review of Governance, Operations, and Investment Practices of the State Treasurer

IAC’s Consultation on Policies

House Bill 1137, which was signed by the Governor on June 30, 2016 and is effective January 31, 2017, expands the IAC’s role in providing consultation on policies and portfolio guidelines:

1. On at least a biennial basis, the State Treasurer shall present an investment policy statement to the Investment Advisory Committee for the Committee’s consultation. NCGS § 147-69.10(a)
2. Internally managed portfolios shall be subject to industry standard portfolio guidelines developed with periodic consultation by the Investment Advisory Committee. NCGS § 147-69.2(e)
3. Effective January 31, 2017, the State Treasurer shall formally consult with the Investment Advisory Committee and adopt policies and procedures on the following topics:
 - a. Requiring that the Department of State Treasurer’s Investment Management Division adopt a code of ethics.
 - b. Requiring all employees of the Department who have responsibility for matters related to investments to be provided with training with respect to the discharge of their duties and responsibilities to the funds.
 - c. Governing gifts to employees of the Department who have responsibility for matters related to investments.
 - d. Imposing limitations on external investment managers’ use of placement agents and other persons that appear before the Department to ensure that these persons play only a proper role in investment opportunities.
 - e. As a component of the investment due diligence, negotiations, and contracting process, requiring an independent assessment of whether circumstances exist that create a material risk that professional judgement or actions regarding a potential investment arrangement’s recommendation, approval, or execution have been or will be unduly influenced by a direct or indirect personal interest. NCGS § 147-69.11

We expect to consult with the IAC on these issues during the last two meetings of 2016 so that the next Treasurer, if he so chooses, may adopt these guidelines and policies shortly after the January 31, 2017 effective date of the new law. We expect to bring draft documents related to items #1 and #2 to the November 2016 IAC meeting. We expect to bring draft documents related to #3 to the September IAC 2016 meeting.

Additionally, members of the TSERS and LGERS Boards of Trustees asked staff to study potential consensus legislative proposals or supplemental policies addressing future State Treasurers' commercial corporate board service. We expect to consult with Board members in August and present a set of proposals at the September 2016 IAC meeting. Staff will incorporate this work as a component of #3 above, and the IAC's input on the matter is expected to be provided to the TSERS and LGERS Boards of Trustees at their October 2016 meeting.

Third-Party Review of Governance, Operations, and Investment Practices of the State Treasurer

The 2016 Appropriations Act included the following study ("OSBM Study"):

IMPROVE BUDGETING TRANSPARENCY/OFFICE OF STATE TREASURER

SECTION 27.1.(a) The Office of State Budget and Management shall study the feasibility of converting the following Funds within Budget Code 13410, Department of the State Treasurer, from receipt-supported to General Fund-supported: 1110 General Administration, 1130 Escheat Fund, 1150 Information Services, 1210 Investment Management Division, 1310 Local Government, 1410 Retirement Operations Division Fund, and 1510 Financial Operations Division. The Office of State Budget and Management shall develop a proposed plan and schedule to adjust the Base Budget as follows:

- (1) Show that receipts from the Funds listed in this subsection are used to offset General Fund appropriations.
- (2) Reflect that receipts generated from the Investment Management Division, the Escheat Fund, and the Local Government Operations Division Fund and any interest earnings be deposited as nontax revenue.
- (3) Eliminate all transfers used to pay for administration in Funds 1110, 1150, and 1510 from Funds 1130, 1210, 1310, and 1410.
- (4) Identify any amendments to current law needed to implement the proposed plan.
- (5) Require the Department of the State Treasurer's expenditures be recorded in the North Carolina Accounting System in the appropriate budget code, fund code, and account code and not be charged directly to the Investment Asset Classes.

SECTION 27.1.(b) The Office of State Budget and Management shall present its proposed plan and recommendations to the December 2016 meeting of the Joint Legislative Oversight Committee on General Government. The Office of State Budget and Management shall not make any changes to the presentation of the Treasurer's budget until the General Assembly enacts changes.

The passage of House Bill 1137 also made permanent the following requirement to conduct a periodic "*Independent Expert Evaluation*":¹

At least once every four years, the State Treasurer shall engage a commercial independent expert firm, pursuant to G.S. 147-69.3(g), to evaluate the governance, operations, and investment practices of the State Treasurer in order to develop recommendations for improvement. The State Treasurer must consult with the Investment Advisory Committee to develop the scope of the evaluation. The report of the independent expert firm shall be provided to the Joint Legislative Commission on Governmental Operations, the House of Representatives Appropriations Committee, the Senate Appropriations/Base Budget Committee, and the Fiscal Research Division within 30 days of receipt. NCGS § 147-69.10(b.)

¹ The requirement was first created in the Appropriations Act of 2014.

With respect to the investment programs, there is considerable overlap between the focus of the OSBM Study and the Department's *Independent Expert Evaluation* and both are to be reported to the General Assembly. Staff proposes conducting the *Independent Expert Evaluation* this fall with a target date of delivery to the General Assembly in December 2016.

The *Independent Expert Evaluation* would be conducted with the goal of helping the Department:

1. Adopt national best practices for governance, operations, investment practices, and other programmatic practices at peer organizations with similar program objectives and legal and regulatory requirements;
2. Enhance the ability to produce cost-efficient long-term growth of trust assets with reasonable risk of not achieving investment objectives;
3. Enhance programs' cost-effectiveness, fiscal control, compliance, and risk environments;
4. Enhance transparency for beneficiaries and stakeholders regarding program performance, funding, and budgeting;
5. Enhance accountability of the governing fiduciary or governing board, as applicable
6. Maintain a high-performing organization with access to necessary, qualified, and prudent internal resources and the ability to contract as necessary and prudent with qualified external business partners; and
7. Identify any amendments to current law needed to achieve these goals.

The scope of the *Independent Expert Evaluation* would entail assessing and recommending improvements to:

1. Governance
 - (a.) The powers, duties, and required approvals related to the investment and other programs exercised by the "Fiduciaries" (the State Treasurer, Boards of Trustees, and/or the Department of State Treasurer, as applicable), and by the General Assembly, Office of State Budget and Management, the Office of State Controller, and the Office of State Human Resources;
 - (b.) The laws and other constraints upon use of the trust funds and appropriations under the North Carolina Constitution, statutes, and common law and/or the federal Constitution, statutes, common law, and regulations;
 - (c.) The current sole investment trustee and investment advisory committee model versus an "enhanced investment advisory committee model", an investment board of trustees or other models;
2. Operations
 - (a.) Fiduciary independence, including federal and state laws, regulations, and practice that are applicable to personnel, procurement, and funding and budget decisions, including but not limited to authority for:
 - i. Position creation, personnel hiring/termination, and establishing and administering personnel compensation.
 - ii. Information technology procurement.
 - iii. Charging/apportioning Department expenditures directly to the trust funds as a continuous receipt-supported program while not requiring a General Fund appropriation or reimbursement.
 - iv. Determining the most cost-effective and transparent method to record Department expenditures for financial statement and budget reporting.

- v. Utilizing internal budget transfers to pay for core services within the Department (i.e., IT, HR, accounting, internal audit, etc.).
- (b.) External investment and program oversight, reporting, and monitoring, including but not limited to the sufficiency of:
- i. The Department's expert reviews and audits of the investment programs' cost-effectiveness, fiscal control, compliance, and risk environments.
 - ii. Transparency and reporting of program performance, funding, and budgeting to beneficiaries, the General Assembly, Office of State Budget and Management, and Office of State Controller.

3. Investment Practices

(a.) Macro drivers of investment performance and cost-effectiveness, including but not limited to:

- i. Asset allocation.
- ii. Investment performance (net of investment fees).
- iii. Asset class structure.
- iv. Fees and other costs.
- v. The use of traditional and various alternative investment strategies and vehicles.
- vi. Foreign currency exposure management.
- vii. The use of internal and external investment strategies and/or middle- and back-office support.
- viii. The use of consultants.

(b.) Policies, procedures, and processes, including but not limited to the sufficiency of:

- i. Due diligence and investment manager selection.
- ii. Portfolio and manager monitoring.
- iii. Investment reporting against benchmarks, peers, and universes.
- iv. Risk management and compliance.
- v. Internal staff, organization, and governance.

Staff expects to utilize both an investment consultant and external legal counsel that would work jointly to develop draft work product and the final deliverables. Given the tight timeline, staff believes it would be most efficient to utilize firms that already have significant knowledge of the Department's practices and peer best practice, as well as North Carolina law. The intent would be to have the investment consultant and external legal counsel directly receive input on focus areas of interest from individual IAC members and provide a briefing on work-in-progress at the September 2016 and November 2016 IAC meetings.

Please contact me should there be any questions or additional information IAC members would like to receive before next week's meeting.

Finally, I have attached the Aon Hewitt memo detailing the IAC's self-assessment conducted at the April 2016 meeting.

We look forward to discussing these important topics.

(Attachment)



Confidential Memo (Personnel Matters)

To: The Honorable Janet Cowell
Treasurer of North Carolina

From: Amy McDuffee, Associate Partner, Fiduciary Services Practice, Aon Hewitt Investment Consulting

Cc: Kristen Bierline, Director, Human Resources, Office of the State Treasurer

Date: May 18, 2016

Re: Summary of 2015 IAC Self-Evaluation Discussion

The Investment Advisory Committee (IAC) met on April 19, 2016 in closed session to discuss its overall performance for calendar year 2015 in connection with the performance evaluation of Kevin SigRist, Chief Investment Officer. This memo is intended to summarize the topics and suggested action steps addressed during the IAC's discussion of its own performance.

Background and General Observations

The IAC has conducted an overall performance evaluation for a number of years. The customary practice has been for the IAC evaluation to occur immediately prior to the IAC's evaluation of the Chief Investment Officer. The process used was consistent with past practice.

The IAC's discussion was based on the results of a questionnaire that we administered in November 2015. Committee members were also provided the opportunity to refresh their individual responses immediately prior to the April IAC meeting. The questionnaire collected individual Committee member sentiments regarding various aspects of overall Committee operations to determine the degree to which performance is perceived as satisfactory or in need of enhancement.

Although only two of the six IAC members were present for the discussion, we tabulated responses from all six of the Committee members and produced a summary report which was provided at the meeting. A five-point scale was used where 5 means "strongly agree" and 1 means "strongly disagree". We consider a score of 3 or lower to be a potential area for improvement. The average ratings for 2015 ranged from 3.86 to 4.71. The ratings are slightly higher from calendar year 2014, which ranged from 3.00 to 4.80.

It is clear from the results that the IAC perceives that it is continuing to perform at a high level. Based upon our knowledge of the IAC's practices and the responses to the overall evaluation, we concur. The following is a summary of four major themes arising from the IAC's discussion, as well as possible next steps identified during the meeting.

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Topics and Possible Next Steps Addressed

1. **Committee Attendance.** Securing consistent attendance from Committee members was noted as a recent challenge. Over the past year there has been an increase in the number of meetings where Committee members have participated in the proceedings through teleconference. While this was viewed as acceptable when urgent or unexpected situations arise, the IAC articulated its preference for an in-person, interactive format as the standard to which the IAC should strive.

It was noted that meeting this standard could be particularly difficult for Committee members who reside out-of state; however, the Committee member, the IAC and the staff all benefit greatly from in-person interaction. Two suggestions arose from the discussion, as follows: (1) the size of the IAC should be increased in the future, when possible, and there should be an in-state residency requirement for Committee membership. If the intent is to seek thoughtful input from professionals and academics engaged in the institutional investment industry, a larger Committee size would expand the diversity of the input offered and also mute the effect of one or two periodic, excused absences. Seeking local candidates would also aid in enhancing Committee attendance, which ultimately increases the overall value of the IAC.

Suggested next steps: Consider expanding the size of the Investment Advisory Committee at some point in the future and focusing Committee membership on those professionals or academics in-state.

2. **Meeting Frequency.** The IAC discussed its current quarterly meeting format. It was noted that staff expends significant time and effort in preparing for the meetings. IAC input should be meaningful in terms of the insights provided. There was consensus among the Committee that a three meeting per year schedule would be a better fit for purpose.

Suggested next steps: Consider migrating the IAC's meeting schedule to a three-meeting-per year meeting format.

3. **Manager and Consultant Fee Arrangements.** The IAC discussed the continued importance of overseeing the fees associated with the investment program, specifically those of the investment managers and various consultants used by staff. It was noted that the CEM benchmarking reviews coordinated by staff have been helpful to the IAC in fulfilling its oversight. The IAC appreciated staff's continued sensitivity to investment program fees. The last comprehensive independent review of manager fees was conducted in 2013 by Hewitt EnnisKnupp, now Aon Hewitt Investment Consulting. The IAC members thought it might be beneficial to consider engaging in that type of analysis again.

Additionally, the IAC noted that staff engages a number of consultants to provide specialty expertise and advise; however, it has not reviewed the process that staff uses to regularly evaluate its consultants, or determine the reasonableness of overall consultant fees. The IAC

is unaware of the total dollar amount of fees spent annually on program consultants. This was mentioned as a potential area of interest to the IAC in the future.

Suggested next steps:

- Consider the costs and benefits of engaging an independent firm to review manager fee structures and actual fees.
 - Place for discussion on a future IAC agenda the process staff uses to evaluate consultants, and determine reasonableness of fees.
4. **Interaction with the LGERS/TSERS Boards.** The IAC discussed the recent level of its interaction with the LGERS/TSERS Boards regarding the actuarially assumed rate of return assumption. These discussions were viewed as beneficial. A general desire was articulated to seek out additional opportunities to foster this type of interaction where the funding/administration and investing aspects of NCRS' governance could be viewed holistically. One possibility offered was to convene the LGERS/TSERS Boards and IAC together in a special purpose education meeting or offsite session to exchange views on specific issues of joint interest. The IAC agreed that it would be worthwhile and in the best interest of the NCRS to explore this and other such opportunities further.

Suggested next steps: Consider convening the LGERS/TSERS Boards and IAC together in a special purpose education meeting or offsite session.

I hope that this summary is beneficial. I believe that I captured the discussions accurately, but if I inadvertently missed a topic or misstated the discussions, please let me know. If you have any questions or would like to discuss any of the items within this memo further, I'd be happy to schedule a time that is convenient for you. It was a pleasure to have been of service to you and the IAC.