

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

MINUTES OF MEETING
September 13, 2012

Time and Location: The Investment Advisory Committee ("IAC" or the "Committee") met on Thursday, September 13, 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), Steven Jones, Harold Keen, Neal Triplett, and Courtney Tuttle.

Staff: The following staff members were present: Lynda Boulay, Susan Carter, Craig Demko, Joan Fontes, Ronald Funderburk, Kathy Hahn, Robin Hammond, William Hockett, Arlene Jones-McCalla, Bryan Lewis, Chris Morris, Keith Nelson, Elin Papkov, Mike Ruetz, Jeff Smith, Rhonda Smith, Anthony Solari, Blake Thomas, Steve Toole, and Melissa Waller.

Others in Attendance: None.

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.

AGENDA ITEM – APPROVAL OF MINUTES

Chair Cowell asked for any discussion, comments or corrections concerning the minutes of the May 30, 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.

The Department has been working together with the Retirement Systems' actuary, Buck Consultants, to comprehensively analyze the effects upon the Retirement Systems' financial metrics of various potential risks, including an enduring low-return environment and large equity declines. The team leading this effort will report on the results of their analysis at the November 14 Committee meeting.

Mr. Lewis and the Treasurer remarked upon recently announced or proposed changes to accounting standards. New standards enacted by the Governmental Accounting Standards Board (GASB) will, among other things, require immediate recognition of certain fund costs and alter the Retirement Systems' reporting.

Moody's Investor Services also proposed changes to the method by which it calculates government pension plans' liabilities. One particularly important shift proposed by Moody's is the use of a 5.5 percent discount rate. The proposed Moody's method would result in increased volatility in the measures used to report the percentage by which pension plans are funded. At the recent National Association of State Treasurers (NAST) meeting, 24 state treasurers, including Treasurer Cowell, adopted a resolution seeking revisions to Moody's proposal. Treasurer Cowell, who serves as the chair of NAST's Pension and Trust Investment Committee, discussed the Moody's proposal and NAST response.

Mr. Lewis provided an update on the unified risk and performance analytics system being developed by the Department in cooperation with SAS. The project is in the testing phase for the fixed income and global equity portfolios. Protracted legal negotiations with third-party data providers led to slower-than-expected progress for overall system rollout.

Finally, Mr. Lewis provided a brief follow-up to the discussion about Eurozone exposure at the May 30, 2012, IAC meeting. As of July 30, the Retirement Systems' total portfolio had exposure to the Eurozone of approximately 5.5%.

AGENDA ITEM – PORTFOLIO UPDATE

Mr. Lewis provided an update on the portfolio, with data through July 31, 2012. Over the preceding three months, the total Retirement Systems portfolio returned 0.02% net of fees. The portfolio performed 0.55% below its benchmark. Over the preceding twelve months, the portfolio returned 3.63%, which was 0.69% below its benchmark.

Compared to the universe of public funds with more than \$1 billion of assets, the total fund was within the top quartile in terms of gross investment return measured over the past twelve months. The Department continues to incur a lower level of risk than its peers, staying within the lowest-risk quartile of the peer group. On a risk-adjusted basis, the Department is outperforming its peers.

In response to questions from the Committee, Ms. Smith, Mr. Ruetz, and Ms. Jones-McCalla discussed public equity sector performance. Over the last 12 months, the most underperforming sectors in the market are financials, materials, and energy. The Retirement Systems are underweight in those sectors compared to the benchmark, but the sectors' overall underperformance has affected returns.

Mr. Lewis observed that the real estate portfolio obtained a return of 7.9% over the past twelve months, while the benchmark obtained a 13.9% return. As noted in previous IAC meetings, the real estate benchmark does not reflect the Department's strategy, which is more domestically focused. The November IAC meeting will feature a review of the real estate portfolio, including investment strategy and the impact of recent market fluctuations. Ms. Carter stated that the portfolio's returns were generally acceptable in light of market conditions, but the real estate

team was considering making changes to strategy, including taking on slightly more risk, to improve its return on investment.

Ms. Hahn and the Committee discussed the credit and inflation portfolio, which has shifted strategy over the last 18 months as a result of understanding that emerging markets are slowing down. Staff is looking to diversify and reduce exposure to directional commodities. As examples, new commitments were recently made to Capital Dynamics US Solar Energy Fund, which invests in cities and municipalities that use solar technology, and Intervale Capital Fund II, which focuses on oil field services. The Intervale fund displays the Department's strategy to focus on the enhancement and distribution of commodities rather than their creation.

In the period from April 1 through July 31, 2012, new commitments were made to private equity funds managed by New Enterprise Associates and The Halifax Group; real estate funds managed by Hawkeye Partners, Rockwood Capital, Rockpoint Group, and Meadow; a credit strategies portfolio fund managed by Silverback; and inflation portfolio funds managed by Capital Dynamics, Blackstone Group, and GSO Capital Partners.

Mr. Lewis discussed the potential impact of a slowing of growth in China, noting that there was some doubt as to how markets would respond. Another source of instability is the U.S. election coupled with the "fiscal cliff" of spending cuts and tax increases scheduled at the beginning of the New Year if no action is taken by the federal government. IAC members discussed the impact of quantitative easing, particularly the likelihood of inflation over the long term.

AGENDA ITEM – ALTERNATIVES REVIEW

Mr. Demko led a presentation concerning the Retirement Systems' alternatives portfolio. As of the end of the second quarter, alternatives represented 5.15% of the total Retirement Systems, below the 6.50% policy target set by the Department and the 7.50% limit set by the General Assembly. There are currently 55 relationships and 91 active funds in the portfolio. Staff continues to grow the portfolio in a gradual fashion as outstanding opportunities arise.

Within the private equity portfolio, the Alternatives Investment Staff will focus more heavily on buyouts in order to meet its internal sub-strategy target of 50 percent of all the Retirement Systems' private equity investments. Mr. Demko noted that staff keeps track of private equity investments' industry allocation and geographic allocation, but the Department does not invest to meet any particular diversification among industry sectors or geographies.

Mr. Demko discussed the outlook for venture capital growth. Potential limited partners are essentially in competition with one another to invest in the top-performing funds. Among venture capital funds, upper-quartile IRRs have diverged increasingly from median IRRs over the last few years. Many of the Department's peers, particularly state pensions, are now investing in venture capital less frequently due to allocation issues resulting in new opportunities for the Department.

Mr. Triplett and Mr. Demko discussed the best size for venture capital funds; Mr. Triplett cited a Cambridge Associates study that found no venture fund that had raised more than \$500 million had returned double its investment.

Mr. Demko commented that the Department was placing increasing focus on middle market buyout strategies. Many potential investment targets by funds focused in this area are not managed to their ultimate potential. Staff will look for fund opportunities where management improvements can be made that would have a positive effect on returns. Mr. Demko noted that while the smaller end of the buyout market appears more attractive, staff will continue to evaluate managers focused on the larger end of the market as well. Co-investments are another focus area and are particularly attractive due to their inherent lack of fees and carry. Mr. Triplett and Ms. Tuttle commented that co-investments represented a good possibility. On the subject of current initiatives, Mr. Demko noted that the private equity team was studying Pitchbook, an Internet-hosted private equity research platform.

AGENDA ITEM – CLOSED SESSION – LITIGATION UPDATE

In accordance with N.C.G.S. §§ 132-1.1(a) and 143-318.11(a)(3), the IAC went into closed session for matters concerning legal claims by the Department of State Treasurer. The closed session, which began at approximately 11:30 a.m., concerned three existing lawsuits:

<u>Parties</u>	<u>Case No.</u>
The Bank of New York Mellon and The Bank of New York Mellon Corporation	Case No. 12-CV-3920 in the General Court of Justice, Wake County
BP, PLC, et al.	Case No. 12-CV-01272 in the U.S. District Court for the Southern District of Texas
Facebook, Inc., et al.	Case No. 12-CV-04081 in the U.S. District Court for the Southern District of New York; Case No. 12-CV-02662 in the U.S. District Court for the Northern District of California

Other potential claims discussed in the session are not yet the subject of a lawsuit.

AGENDA ITEM – CLOSED SESSION – CIO SEARCH

The IAC voted to exit the attorney-client closed session and then enter a closed session to discuss matters concerning the search for a new Chief Investment Officer. The session discussing the CIO search was closed in accordance with N.C.G.S. §§ 132-1.1(a) and 143-318.11(a)(5)(ii).

END OF CLOSED SESSIONS

The IAC exited closed session at 12:30 p.m. No action was taken in either closed session.

The meeting was adjourned for lunch immediately thereafter. The meeting reconvened at approximately 1:20 p.m.

AGENDA ITEM – IAC MEMBER Q & A

Mr. Lewis led a discussion with the members of the Committee concerning topics and issues to cover during future meetings.

Mr. Jones requested information on asset allocation and investment strategy, along with more clarification on the Department's ability to take risk. The Chair, the members of the Committee, and Mr. Lewis discussed the maximum and minimum allocations set by the General Assembly for particular asset classes within the Retirement Systems portfolio.

The Chair discussed the need for additional investment management staff positions. All positions require approval by the General Assembly, and a challenge is the General Assembly's desire to limit the number of State employees. The Department has sought three positions in risk management. The Department also would like to hire an internal equity manager, but any such position would need to be paid a competitive salary. The Treasurer and Mr. Jones discussed a study of in-house management, comparing North Carolina to other plans nationwide. The Treasurer noted that passive equity funds represent the best opportunity for in-house management.

Mr. Triplett and Ms. Tuttle noted the impact of oil and gasoline pricing on the U.S. economy. They suggested that the oil and gas industries offer the Department investment opportunities.

Finally, the Committee discussed the passing away of John Medlin. Mr. Medlin served the people of this State in many ways, including his work on the Investment Advisory Committee.

The Treasurer appointed Mr. Triplett as IAC Vice-Chair.

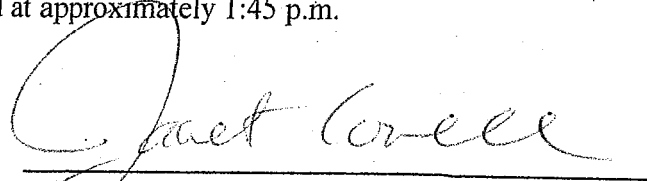
AGENDA ITEM – PUBLIC COMMENT

There were no public comments.

ADJOURNMENT

The meeting was adjourned at approximately 1:45 p.m.

APPROVED BY:



**JANET COWELL
STATE TREASURER AND CHAIR**