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

MINUTES OF MEETING
September 21, 2011

Time and Location: The Investment Advisory Committee ("IAC") met on September 21, 2011 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; John Medlin (Vice-Chair); Dr. Harold Martin (by teleconference); Neal Triplett (by teleconference); Courtney Tuttle; Steve Jones (by teleconference); and Harold Keen.

Staff: The following staff members were present: Shawn Wischmeier, Bryan Lewis, Michael Ruetz, Jeff Smith, Greg Beuris, Rhonda Smith, Alex Sotolongo, Keith Nelson, Jeff Smith, Chris Morris, Casey High, Rodney Overcash, Elin Papkov, Craig Demko, Susan Carter, Kara Petteway and Jay Chaudhuri.

Others Present: Anthony Greco.

CALL TO ORDER

The meet was called to order at approximately 10:00 a.m. Treasurer Cowell introduced new IAC member Harold Keen. Mr. Keen is a member of the TSERS and LGERS Boards and also serves on the State Banking Commission.

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 June 23, 2011 meeting. The IAC unanimously approved the minutes.

AGENDA ITEM – OUTSTANDING ITEMS

Bryan Lewis, Chief Administrative Officer, provided an update regarding diversity at the Department of State Treasurer ("DST"). DST has taken a metrics-driven approach to quantify diversity within the Department and with regard to the Department's external service providers. The Department also seeks to appoint diverse board members to the boards and commissions that it manages. Staff provided a handout summarizing the Department's efforts.

Shawn Wischmeier, Chief Investment Officer, provided an update regarding fees paid to external managers and service providers. Over the past year, Investment Management Division staff has negotiated fee reductions—across the portfolio—of approximately $15-20 million per year. For example, the Ennis Knupp fiduciary review identified several public managers with higher fees than expected. Staff successfully negotiated fee reductions with all of the public managers identified by Ennis Knupp. Mr. Wischmeier also gave multiple examples of creating more advantageous fee arrangements in private market investments. With regard to private investments, Mr. Wischmeier also stated that NCRS' preferred negotiating terms include a "most favored nation" provision, which requires that NCRS receives the best fee arrangement negotiated by any limited partner in a fund.

AGENDA – PORTFOLIO UPDATE

Mr. Wischmeier provided an update on the portfolio, with data through July 31, 2011. The fund returned 13.58% net of fees.

Global equity performed under its benchmark for two reasons: (1) costs associated with transitioning $15-20 billion, in an effort to achieve more international exposure; and (2) several underperforming managers. With regard to underperforming managers, staff is currently conducting a comprehensive review of all managers in global equity portfolio.

A discussion followed regarding the global equity portfolio's exposure to Europe. Mr. Wischmeier indicated that the plan significantly reduced its total public equity exposure over the last year in advance of recent market turmoil in an effort to better diversify portfolio risk and enhance risk-adjusted returns. Staff is aware of the unique risks in Europe and has been implementing an option based rebalancing program which will allow for opportunistic hedging of a portion of the equity portfolio. Mr. Smith and Mr. Wischmeier commented that it's not only the macroeconomic environment in Europe that needs to be considered, but also the prices of its securities to determine if the risks have been fully considered in security valuations.

The fixed income portfolio has had a positive return on both an absolute and relative basis over one-year and longer time horizons.

The real estate portfolio made commitments to two managers: (1) Lone Star Real Estate Partners and (2) Harrison Street Real Estate Partners. Susan Carter, Director of Real Estate, indicated that staff is reviewing the attractiveness of real estate opportunities in emerging markets.

The credit portfolio continued with its strategy of making commitments to one to two managers per quarter. Staff recently made commitments to two managers: (1) Varde and (2) CarVal. Both managers have strong expertise in Europe.

In the inflation portfolio, commodities investments have had a positive return from inception to date. In general, commodities have a positive return when equities have a negative return. Although this relationship has been challenged over some historical time periods, the relationship worked well for the plan over the last quarter. This is an example of the need for diversification across the plan. Staff is currently focused on energy private equity investments.

Mr. Wischmeier noted that a detailed discussion on the private equity portfolio will be provided during the legislative authority agenda item later in the meeting.

AGENDA ITEM – ENNIS KNUPP FIDUCIARY REVIEW

Mr. Lewis provided a final update on the implementation of the 116 recommended actions identified by the Ennis Knupp fiduciary review, which was completed in 2010. The recommendations were categorized into the following groups: (1) transparency, accountability, ethics; (2) organizational structure; (3) investment policy and asset allocation; (4) investment performance reporting: (5) due diligence; and (6) general investment activities. Eighty-eight (88) percent of the recommendations have been addressed with a deliverable. Highlights include:

- Implementation of a placement agent policy and voluntary compliance with policy on a historical basis;

- Creation and retention of new key positions, including a Department-wide Internal Auditor and an Investment Risk Manager function (Director of Risk Management);

- Retention of key investment positions which were previously vacant, including the CIO, Director of Alternatives, and Director of Global Equity;

- Updated job descriptions across the Investment Management Division;

- Continued to perform annual reviews of asset allocation;

- Implemented the use of risk budgeting as a tool to determine and monitor risk;

- Addressed the classification of timber assets.

AGENDA ITEM – EXPANDED LEGISLATIVE AUTHORITY

Treasurer Cowell reviewed three statutory changes achieved during the most recent legislative session: (1) the cap on private equity investments was changed from 5 percent to 7.5 percent of the portfolio; (2) the global equity portfolio received authority to invest in equity hedge funds; and (3) changes were made which may allow for internal management of the global equity portfolio in the future.

Mr. Triplett sought clarification regarding the classification of hedge funds. Mr. Wischmeier responded that each asset class, with the exception of the internally managed, investment grade fixed income allocation, now has the ability to invest in hedge funds. Hedge funds are not considered an independent asset class.

Craig Demko, Director of Alternatives, addressed how staff will approach the expanded authority to invest in private equity. Investments staff developed a model to monitor existing, and plan future, fund commitments so that the new 7.5% statutory ceiling is not breached. Staff will manage the portfolio to a target of 6.5 percent of plan assets.

Discussions followed regarding purchases on the secondary markets and investments through co-investment vehicles. Mr. Wischmeier commented that co-investments with existing managers are an effective way to achieve additional exposure to desired investments by key managers and do so typically with no fees and no carry. Staff is working to set up a co-investment program to help facilitate the operational aspects of managing a portfolio of such investments and maximize the effectiveness of staff time.

Mr. Demko indicated that the portfolio will "re-up" its relationships with its strongest managers. Mr. Wischmeier added that this strategy is in-line with the IAC's prior discussions concerning a reduction of the overall number of relationships in favor of larger, more significant relationships with fewer managers.

AGENDA ITEM – PORTFOLIO REBALANCING

Mike Ruetz, Director of Risk Management, led a discussion regarding portfolio rebalancing. The benefits of a rebalancing policy include taking advantage of the mean reverting tendencies of the market, and preserving the target asset allocation. A rebalancing policy can add value over time by lowering risk and increasing returns. The rebalancing ranges of the NCRS portfolio are largely predicated on the public equity portfolio, given the large exposure to public markets, which are volatile, and that private investments are illiquid.

Ms. Tuttle and Mr. Triplett inquired as to how much discretion will be afforded to the transition managers. Mr. Wischmeier stated that staff will decide how much money needs to be rebalanced and when the rebalances need to occur. Staff will rely on the transition manager to determine how the rebalance will be managed. Staff will not take on active risk.

Mr. Triplett asked about the managers' compensation. Mr. Ruetz responded that transition managers will be paid a flat fee per transition.

Mr. Ruetz then provided a brief update on the Division's new risk management program, for which it has contracted with SAS. A further update will be provided at the November 2011 meeting.

The meeting was adjourned for lunch at approximately 12:00 p.m.

AGENDA ITEM – INVESTMENT PROCESS

The meeting reconvened at approximately 12:45 p.m.

Pursuant to its Charter, the Investment Advisory Committee is charged with, *inter alia*, reviewing and evaluating the selection and monitoring investment managers. To fulfill this part of the Charter, staff provided a discussion on the investment diligence and approval process.

The CIO is responsible for investment strategy across the portfolio; asset class directors are responsible for overseeing the investment strategy, manager selection and operational issues for their respective asset class; and, portfolio managers and analysts are tasked primarily with operational execution for the asset class to which they are assigned.

Staff recently formed an internal investment committee, which provides peer review of all new investments prior to approval by the Treasurer. The investment committee is viewed as a three-legged stool, comprised of (1) risk, (2) operations and (3) investment review. The risk review centers on whether the plan is being properly compensated for the investment risk. The operations review centers on whether the proposed manager has proper controls, including support staff and disaster recovery capabilities. The CIO and all directors are members of the committee. Any one person can stop an investment from moving forward.

A discussion followed regarding disaster recovery for the Investment Management Division. Mr. Lewis stated that all Investment Management Division data is backed-up at the state's Western technology site. Mr. Medlin inquired as to whether the Department had a continuity of operations plan and whether tests had been performed to ensure that the back-up plan works.

AGENDA ITEM – IAC MEMBER Q&A

IAC members were provided with the opportunity to pose questions to the Investment Management Division staff. Ms. Tuttle asked staff to discuss the biggest risk themes identified, and what steps had been taken to address those themes. Staff responded with a discussion surrounding the importance of asset allocation. Additionally, staff noted the importance of looking at risk allocations and not focusing solely on dollar allocations.

Ms. Tuttle further asked for staff to discuss its "big picture" take on where the plan is going. Mr. Wischmeier responded that during 2011, staff focused on making large-scale "beta" moves to realign the portfolio. For example, staff focused on making commitments in the newly-formed credit and inflation portfolios and reducing the size of the global equity portfolio. In 2012, staff will focus on "portfolio efficiency" and focus on refining the moves made in 2011, such as adding additional mangers to the credit portfolio and firing underperforming public equity managers.

AGENDA ITEM – PUBLIC COMMENT

There was no public comment.

ADJOURNMENT

The meeting was adjourned at approximately 1:55 p.m.

APPROVED BY: Janet Cowell

JANET COWELL
STATE TREASURER AND CHAIR