INVESTMENT ADVISORY COMMITTEE

The Investment Advisory Committee (IAC) held its quarterly meeting on Thursday, March 7, 2013, at the Bureau of Investments, Great Lakes Conference Room, 2501 Coolidge Road, Suite 400, East Lansing, Michigan.

Members Present:

Nick A. Khouri, Chairman
James B. Nicholson
L. Erik Lundberg – via Telephone
Mike Zimmer, LARA
John E. Nixon, DTMB

In attendance from the Department of Treasury: Jon Braeutigam, Gregory Parker, Peter Woodford, Karen Stout, Brian Liikala, Richard Holcomb, Jack Behar, Jim Elkins, Rick DiBartolomeo, Paul Nelson, Kevin Fedewa, Indu Sambandam, Marge McPhee, and Emma Khavari.

Others in attendance: Phil Stoddard, Jim Voytko, Molly Jason, Karl Borgquist, Cara Dobie, and June Morse. Special guests from Blackstone: Stephen Schwarzman and John Dionne.

Call to Order

Chairman Khouri called the March 7, 2013, Investment Advisory Committee meeting to order at 9:33 a.m. He thanked everyone for taking time from their busy schedules to attend the March Investment Advisory Committee meeting.

Approval of Minutes of December 6, 2012

Chairman Khouri asked for a motion to approve the minutes of the December 6, 2012, Investment Advisory Committee meeting. Mr. James Nicholson so moved, Mr. John Nixon seconded; there were no objections.

Opening Remarks

Chairman Khouri noted that Mr. Erik Lundberg joined the meeting via telephone as he was in Los Angeles, California. Chairman Khouri gave a brief recap of the progression of the meetings which began several meetings ago with a discussion about asset allocation overall, eventually bringing in the liability side, and then funding ratios under different scenarios. At the last meeting, public equity was the center of the discussion and at this meeting private equity will be the center of the discussion. Private equity is approximately 20% of the portfolio with a market value exceeding $10 billion plus another $4 billion in unfunded commitments. Private equity is challenging in that it is illiquid and there are challenges in benchmarking performance. Last year the return for private equity was 14%. The advantage of being in the private equity space is the ability to access investments that are not available in the public markets. Chairman Khouri asked that the discussion answer the questions of how does it fit into the overall portfolio, what are the goals, what is the risk-adjusted return, and how has performance in the past met those returns. He also noted that there will be a guest speaker, Mr. Stephen Schwarzman from Blackstone to provide insights into the private equity markets. Chairman Khouri turned the meeting over to Mr. Jon Braeutigam.

Executive Summary

Mr. Jon Braeutigam noted that he would discuss the performance portion of the Executive Summary and then Mr. Greg Parker would discuss the asset allocation and touch on the capital markets and the economic backdrop portions of the Executive Summary. Mr. Braeutigam began by discussing the one, three, five, seven, and ten-year annualized returns. These are gross returns and are compared to the gross returns of other large public plans. Mr. Braeutigam discussed the rankings versus the peers noting that the three-year number was good, the seven-year number is on the mark with peers, and the ten-year number is close as well. He also noted that private equity has done very well over the long term, especially over the past ten years. Mr. Braeutigam turned the meeting over to Mr. Greg Parker to review the asset allocation portion of the Executive Summary.

Mr. Greg Parker began the review of the asset allocation portion of the Executive Summary by noting that over the past twelve months, the system paid out $2.9 billion net of contributions. These funds came primarily from the proceeds of the sale of $3.4 billion of domestic equity. He discussed the allocation to international equity, which has increased by 1.7% over the past year due entirely to asset appreciation. He also noted that the split has changed from a 25% active/75% passive to approximately 50% active/50% passive split, which is in line with domestic equity and the strategic target for active/passive split. International has also gone from an 80% developed/20% emerging split to a 70% developed/30% emerging split. Also, the allocation for long-term fixed income is a little over 13% versus the peers which is 24.2%. A higher allocation to long-term fixed income would make it difficult for the plan to earn the 8% target rate. There was a discussion about the long-term fixed income rate of return and the trend to immunize pension plans. During the discussion, Mr. Lundberg recalled a study that stated that about 20% of the corporate liabilities have been immunized and if this went to 30% over the next ten years that would absorb all the available corporate AA investment grade bonds. Credit spreads were also discussed in relation to the immunization of pension plans.

Mr. Parker highlighted the capital markets portion of the Executive Summary noting that interest rates are low and European sovereign rates are contracting as well. Foreign stocks were strong over the past twelve months returning 17.4%. He mentioned that the way valuation is viewed by staff in developed international markets and U.S. markets is very close, although emerging markets continue to sell at a discount to these markets. Large cap stocks are still favored over small caps stocks because of the valuation discrepancy. He touched on hedge funds and noted that many peers are turning to hedge funds as a solution to earning higher returns. He indicated that hedge funds as measured by the HFRI Fund-of-Funds Conservative Index over the past twenty years returned only 5.6%.

Mr. Parker reviewed the economic backdrop portion of the Executive Summary noting that there are four aspects that he reviews which are GDP, jobs, housing, and corporate profits. The GDP had measured basically negligible growth and some of the reasons that economists point to are the 'fiscal cliff' debate in the fourth quarter and Hurricane Sandy. Economists are predicting a 2% economic growth for 2013. He noted that the number of jobs lost have still not been fully recovered and are not likely to be recovered for another two years. This is the longest jobs recovery short of the Great Depression. He discussed housing starts and housing sales, which are at low levels, but are off the bottom. Housing prices have recovered and are showing positive rates of return. He also noted that corporate profits peeked a year ago and are now lower at the end of 2012 than in 2011. Profit and profit margins are at all-time highs and he discussed some of the reasons for this, which are outsourcing, technology, and reduce capital spending levels where companies are not reinvesting back into their business. He concluded noting that long-term strategic allocation to the private equity asset class is 16%; however, today it is at 20.6%.

Chairman Khouri introduced Mr. Stephen Schwarzman, Chairman, CEO, and Co-founder of Blackstone, which is one of the largest private equity firms in the world. Chairman Khouri asked Mr. Schwarzman to talk about private equity, how the business has changed over the past ten years, going forward, and what large investors should look for in private equity.

Blackstone Presentation – *Mr. Stephen Schwarzman, Chairman, CEO and Co-Founder of Blackstone*

Mr. Stephen Schwarzman thanked everyone for inviting him here and for supporting Blackstone since 1992. He noted that he and a partner started the business and employed one secretary. At the present time Blackstone has approximately 1,800 people at the firm and another 400 permanent consultants, and they have 24 offices around the world. They started the business with $400,000 and they now have approximately $210 billion in assets. They are in several different types of businesses (private equity, real estate, hedge funds, and credit, to name a few) and have 81 companies in private equity alone. He discussed their method of operations, and noted that they have a joint meeting every Monday morning with members of their team, in every one of their offices around the world. During this meeting there is much discussion of what is happening in the world. This method keeps everyone up-to-date on world events and capital markets allowing for informed choices in their investing while continually teaching those in the company. He noted that in Europe there is little to no growth because they have mismanaged their economies along with their banking system and as a result it is tough to buy private equity in Europe. He discussed real estate and noted that Blackstone is the largest real estate owner in the world, other than governments. He indicated in real estate you are provided all the statistics unlike in private equity.

Mr. Schwarzman also discussed the Federal deficit and answered and discussed several questions pertaining to the Federal budget and Federal Reserve interest rate policy. Mr. Schwarzman discussed how Blackstone's approach to private equity had changed over the past five years stating his belief that the more you do, the better you get. He noted that the business has changed in that there is now more overhead. The overhead is in hiring people who are operational experts in businesses. He discussed how Blackstone has changed and reduced their costs for health care and technology by taking their individual companies and grouping them and receiving discounts because of their size. Mr. Schwarzman discussed an investment that was done in the energy space for the plan that has done very well. He concluded his presentation answering questions and discussing several different asset classes.

Performance, Asset Allocation, Capital Markets Overview, Economic and Market Review and Outlook, Asset Class Investment Reports, and Basket Clause

In the spirit of time, these reports were received and filed.

Next Meeting Date and Adjournment

The next Investment Advisory Committee Meeting is scheduled for Thursday, June 6, 2013. Chairman Khouri adjourned the meeting at 11:45 a.m.

Approved:

Nick Khouri, Chairman