INVESTMENT ADVISORY COMMITTEE

The Investment Advisory Committee (IAC) held its quarterly meeting on Thursday, March 6, 2014, 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 – via phone
L. Erik Lundberg
Steve Arwood, LARA
Phillip J. Stoddard, DTMB, ORS

In attendance from the Department of Treasury: State Treasurer R. Kevin Clinton, Jon M. Braeutigam, Gregory J. Parker, Robert L. Brackenbury, Jim Elkins, Peter Woodford, Marybeth Gienapp, Brian Liikala, Richard Holcomb, Jack Behar, Dan Quigley, Tim Reynolds, Amanda Ellis, Marge McPhee, and Emma Khavari.

Others in attendance: Becky Gratsinger, Molly Jason, Renaye Manley, John Ide, Haley Rucker, and June Morse.

Call to Order

Chairman Khouri called the March 6, 2014, IAC meeting to order at 9:30 a.m. and thanked everyone for taking time from their busy schedules to attend the meeting. Chairman Khouri reflected on 2013 noting it is a good time to review what was done, what worked, and what it means going forward. He noted that 2013 was a good year.

Approval of Minutes of December 3, 2013

Chairman Khouri asked for a motion to approve the minutes of the December 3, 2013, IAC meeting. Mr. Steve Arwood so moved, seconded by Mr. James Nicholson; there were no objections – so approved.

Executive Summary – Performance Section

Chairman Khouri turned the meeting over to Mr. Jon Braeutigam to discuss the performance section of the Executive Summary. He noted that the absolute returns for the fund have been great the past five years, and the seven and ten years were better than the median plans for that timeframe. The public market was strong, and the S&P 1500 was up 33% in 2013. He discussed the State Street peer group and noted that the plan is compared to the public pension funds greater than $10 billion. There were several questions asked and a lengthy discussion of the public equity markets being oversold / overbought.

Executive Summary – Asset Allocation and Capital Markets Sections

Mr. Braeutigam turned the meeting over to Mr. Greg Parker to review the Asset Allocation Section of the Executive Summary. Mr. Parker reviewed the Sources and Uses of Cash bar chart found under the Asset Allocation tab. He noted that there was $1.8 billion in alternatives and $600 million in real estate, which were used to fund the benefit payments. Funds were raised in domestic equity and re-distributed into international equity; and the absolute return, and real return & opportunistic strategies, recognizing the fact that the U.S. market was strong last year, up 33%, but international equities trailed. There were several questions asked and a discussion of the international equity asset class.

Mr. Parker discussed the fixed income asset class which is underweight verses the peers. Several questions were raised and discussed about the asset allocation to the fixed income asset class and how the assets are managed. Mr. Parker discussed the Capital Markets noting that the U.S. small cap stocks are even stronger than the U.S. large cap stocks. He discussed the long-term interest rates which rose; however, European sovereign's interest rates, specifically Italy and Spain, dropped. Mr. Parker noted a few things he is watching for over the next year – it is his belief that there will be continued normalization of the Fed policy which will be driven by the improvement in the jobs and housing markets; the U.S. corporate profit margins are at all-time highs, will this continue; the global growth will improve slightly; and with the improvement in the balance sheets of consumers and the Federal government, will it promote spending?

<u>Short-Term, Absolute and Real Return</u> **–** Mr. Jim Elkins provided a brief description of the Short-Term Fixed Income, Absolute and Real Return & Opportunistic Division noting that the team also manages the cash for the pension system as well as the common cash. He reviewed the breakdown of the portfolio noting that 77% was in fund-of-funds and 23% was in direct. He discussed the decision, which was made back in 2008/09, of how to invest and to utilize fund-of-funds, noting fees were a consideration in the decision. There was further discussion on the fund-of-funds route and the fees associated with the decision.

He discussed the objectives of the absolute return portfolio, which is targeting returns slightly higher than fixed income, but with similar volatility, and providing diversification for the fund. The benchmark for the absolute return portfolio is the HFRI Fund of Funds Conservative. He discussed the volatility and return target when building the portfolio.

Mr. Elkins reviewed the investments by strategy in the absolute return portfolio, which includes: equity, credit, arbitrage, and Macro/CTA managers. He noted the diversification through each underlying strategy and there is little overlap. He discussed the high number of managers, 114 overall, and that a goal to reduce this number has been set for the second half of 2014. There was a discussion of the sub-categories in the different strategies with clarification of the focus of each category. Mr. Elkins reviewed the returns of the absolute return portfolio noting that the one and three-year net returns were very good beating the benchmark both time periods.

Mr. Elkins discussed the performance objectives of the real return & opportunistic portfolio, which is to exceed the benchmark net of fees and to exceed the actuarial rate of return. The benchmark for the real return portfolio is CPI plus 500 basis points. He noted that it was a difficult task to create the opportunistic benchmark. There was a discussion on what goes into the opportunistic bucket, the investments made on a risk-adjusted basis, and the management of those investments.

Mr. Elkins discussed the investments by strategy in the real return & opportunistic, which are: real return – real assets, energy, credit, and liquid commodities; and opportunistic – opportunistic credit, and opportunistic equity. He noted the different types of sub-categories in the different strategies and clarified the focus of each category. He reviewed the returns of the real return & opportunistic portfolio noting that the three-year return is lagging, which was expected due to the 'j' curve effect, but the one-year return is finally on the plus side and this growth is expected to continue throughout the year.

Asset Allocation, Capital Markets Overview, Economic and Market Review and Outlook, 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 5, 2014. The meeting was adjourned by Mr. Erik Lundberg at 11:20 a.m.

Approved:

Nick Khouri, Chairman