INVESTMENT ADVISORY COMMITTEE

The Investment Advisory Committee (IAC) held its quarterly meeting on Thursday, June 18, 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
Steve Arwood, LARA
Phillip J. Stoddard, DTMB

In attendance from the Department of Treasury: State Treasurer Andy Dillon, Jon M. Braeutigam, Gregory J. Parker, Peter Woodford, Karen Stout, Brian Liikala, Richard Holcomb, Jack Behar, Jim Elkins, Rick DiBartolomeo, Paul Nelson, Amanda Ellis, Giles Feldpausch, Shawn Winnie, Dan Quigley, Marge McPhee, and Emma Khavari.

Others in attendance: Becky Gratsinger, Jim Voytko, Molly Jason, Ben Spalding, Renaye Manley, and June Morse. Special guests from Apollo: Marc Rowan, Robert Burdick, Jeremy Bergman, and Seth Ruthen.

Call to Order

Chairman Khouri called the June 18, 2013, IAC meeting to order at 9:30 a.m. and thanked everyone for taking time from their busy schedules to attend the June IAC meeting. He began by noting that the agenda was full and included a guest speaker from Apollo Global Management. He noted that the asset class chosen for this meeting's discussion was fixed income which is approximately 13% of the total plan. He noted this is about half of the typical pension plan fund. He also mentioned that everyone is talking more about credit and how it fits into portfolios.

Approval of Minutes of March 7, 2013

Chairman Khouri asked for a motion to approve the minutes of the March 7, 2013, IAC meeting. Mr. James Nicholson so moved, seconded by Mr. Erik Lundberg; there were no objections.

Chairman Khouri turned the meeting over to Mr. Jon Braeutigam to discuss Performance and the Executive Summary sections.

Executive Summary & Performance

Mr. Braeutigam briefly discussed the performance of the plan ending March 31, 2013, noting that the return for the plan was 10.4% for the one year, 9.8% for the three year, and 8.2% for the ten year. This has surpassed the actuarial rate of return for ten years now. The absolute return has been good along with the equity markets being up during this time. Mr. Braeutigam turned the meeting over to Mr. Greg Parker to review the Executive Summary section noting that he would return to performance after Mr. Parker concludes.

Executive Summary

Mr. Parker began by noting that the system has paid out $2.9 billion net of contributions over the past twelve months. This figure represents 5.7% of the March 31, 2013, market value. The plan put to work approximately $1.2 billion into the absolute return and real return/opportunistic strategies over the past year. These monies came from a combination of international equity, long-term fixed income, and real estate. He noted there is about $5.9 billion in outstanding commitments in illiquid asset classes, which is about 11% of the March 31, 2013, market value. These are all important factors to keep in mind when making investment decisions.

He provided a brief update on the capital markets that the interest rates for bonds, over the past twelve months, have dropped. Corporate spreads were about average and high-yield spreads were below normal. He noted for the fixed income portfolio, this would not be a great time to go into high yield. The ten-year sovereign rates in Italy and Spain decreased by 160 basis points over the year, the lowest they have been since late 2010. He noted that over the past one and three years, stocks have outperformed bonds, and small-cap stocks have outperformed large-cap stocks. However, when looking at the sector levels, it is the defensive, safer sectors with lower volatility that have performed better; the U.S. has outperformed foreign stocks with the U.S. usually considered safer than foreign stocks. Also, developed has outperformed emerging.

Mr. Parker discussed the economic backdrop. He mentioned the job market and housing, which both seem to be improving. In the U.S. there has been a recession, but today looking at the real GDP the U.S. is higher than in 2007. Japan and the Eurozone have yet to recover from the 2008 financial crisis. In Japan, in response to the poor economic conditions, Prime Minister Shinzo Abe is attempting to jump-start the economy by pushing through a number of large and controversial measures, which includes a massive fiscal stimulus, aggressive monetary easing, and structural reforms.

Mr. Parker talked about fixed income, noting that the more traditional long-term fixed income has outperformed the passive benchmark in Barclays Aggregate Index. He discussed the concerns with the benchmark today and the rates being influenced by the Federal Reserve policy. Economists have come to believe that the impact to longer term rates is in the neighborhood of 100 to 200 basis points. He noted that the Federal Reserve announced additional QE policy guidelines that are sometimes referred to as the Evans Rule. This rule states that the additional accommodations should remain at least as long as the unemployment rate remains above 6.5%, inflation expectations one to two years out is no more than 2.5%, and long-term inflation expectations are well anchored. He concluded noting that at the end of March 2013, the plan had 13.3% of the total assets allocated to long-term fixed income, with 75% of the assets managed internally with almost 97% in bonds rated as investment grade. There were several questions asked and lengthy discussions regarding the topics in the Executive Summary section.

<u>Performance</u>

Mr. Braeutigam continued with the performance section digging deeper into the different asset classes and their rates of return. He noted that domestic equities have been strong and in comparing them to their peers, the trend appears to be good; and alternatives, with a high quality portfolio, have always done well relative to peers. He discussed reducing the allocation in alternatives, which is a slow process that will be done in a thoughtful, deliberate manner. He discussed the changes in international equities, which now includes emerging markets and an increase in the number of external managers. Mr. Braeutigam reviewed the three newer asset classes, real return and opportunistic, absolute return, and infrastructure which can, as newer classes, have a 'J' curve offset as seen in the real return and opportunistic asset class. He noted that the absolute return portfolio has, in his opinion, one of the best numbers in public funds in the U.S. He also discussed the hedge funds in the absolute return portfolio. He noted the 11.8% return in the infrastructure portfolio stating that there has been much thought into the projects, the GPs, and the co-investments that are being made, which has resulted in excellent returns. There was a brief discussion on the opportunities in infrastructure and how infrastructure helps to diversify the fund.

<u>Remarks</u>

Chairman Khouri discussed the topic options for the next few meetings, noting that performance and asset allocation are a normal part of the agenda. He noted that an asset liability study was discussed at one meeting and then deeper dives into asset classes have been discussed at other meetings, which included equities and infrastructure with fixed income being discussed at this meeting. Real estate will be the asset class discussed at the September meeting.

Chairman Khouri introduced the guest of honor – Mr. Marc Rowan, Co-founder and Senior Managing Director of Apollo Global Management, LLC. Chairman Khouri noted that Mr. Rowan is one of the founding partners of Apollo Management. He asked him to talk a little about the firm, about the space, how it has changed over the last five years, and what he sees going forward over the next five years. He thanked Mr. Rowan for coming to the IAC meeting.

<u>Apollo Presentation</u> – *Mr. Marc Rowan, Co-founder and Senior Managing Director of Apollo Global Management, LLC*

Mr. Rowan thanked everyone for the invitation noting that it is a pleasure to be at the meeting. He provided a brief description of their business noting that he is one of three founders of Apollo, which has been around for 23 years, and the three of them have been together for 29 years. He noted that Apollo is on the New York Stock Exchange with roughly an $11 million market cap, and globally they have approximately 650 employees. He discussed the structure of the firm, which is in the top ten in terms of size with roughly $114 billion of assets under management, with $69 billion of credit and $45 billion of equity and their client base includes state retirement plans, endowment funds, and high net worth individuals. He noted that their equity business is driven by opportunity; and that he does not believe that their equity business will be or should be any bigger in five years. He discussed the credit business indicating that five years from now it will be $150 billion to $200 billion conservatively with the growth being driven by what has happened around us; and ironically, government intervention and regulation has been the single most positive driver of their business. Also, the destruction and deregulation of the banking system has driven risk out of all matter of fiduciaries which basically pushed credit into the investment market place for the first time. There were several questions asked and answered about credit and the banking industry.

Mr. Rowan discussed the markets noting that so much of what has happened to the equity or fixed income markets has been the right place / the right time. Interest rates going to near zero has been an unbelievable impact on every asset class. The retirement systems have not been big winners in this game, with the SMRS being an exception. He noted that many people, as a reaction to the financial crisis, took all the risk off the table. Mr. Rowan believes that the SMRS staff has done a lot of sensible things during the financial crisis with a positive impact on the returns. He discussed the size of the government intervention in Japan, and noted that limitless amounts of money can be printed, then sold to their own system which created inflation in an aging population with no immigration, with declining productivity, and declining demand. He discussed the investment world post crisis noting that their reaction to risk has been to take risk off, and to go short and liquid. Many have made money because interest rates have fallen, but it is masking a lot of problems in the lack of strategy, and this is not a long-term solution. He discussed the increase of volatility, noting that the volatility in Japan is off the chart. He noted that weekly high yield bonds are up in terms of redemption.

Mr. Rowan discussed credit opportunities which are generally driven by three sources: secular, which is the result of changes in behavior of market participants often the result of regulatory changes. The second is cyclical, which is the result of significant market dislocation, usually transitory in nature, and are happening faster and faster. The third is proprietary origination, which is believed to be unique opportunities sourced in specific market segments as a result of specialized knowledge. He believes that all three are good sources of credit opportunities and all three have a place in the portfolio. He discussed how the markets are subject to volatility spikes and that flexibility is key. He noted the secondary loan obligation of BBB versus loan spreads, and the BB versus high yield bond spreads, where the bank loan pays more in interest than the higher bond – senior credit pays more than junior credit. He discussed the proprietary opportunities in different types of businesses and how they have driven the businesses today, some positively and some negatively. He talked about how fixed income has shifted over the past few years. Fixed income used to do two things: it provided returns and was liquid – one regime covered both things. He noted that he believes that today there is a choice to have liquidity or yield, but you can not really have both, which is why the typical fixed income bucket is now 15% to 20% of the portfolio, versus 25% to 30%, and has migrated to credit. There were lengthy discussions about the various topics in the fixed income area and greater insight was provided by Mr. Rowan from his presentation.

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, September 5, 2013. Chairman Khouri adjourned the meeting at 11:31 a.m. and thanked everyone for coming.

Approved:

Nick Khouri, Chairman