INVESTMENT ADVISORY COMMITTEE

The Investment Advisory Committee held its quarterly meeting on Thursday, June 14, 2012, at the Bureau of Investments, Great Lakes Conference Room, 2501 Coolidge Road, Suite 400, East Lansing, Michigan.

Members Present:

Nick A. Khouri, Chairman
L. Erik Lundberg
James B. Nicholson
Steven H. Hilfinger, LARA
Phillip J. Stoddard, DTMB

In attendance from the Department of Treasury: State Treasurer Andy Dillon, Jon M. Braeutigam, Gregory J. Parker, Robert L. Brackenbury, Karen Stout, Brian Liikala, Richard Holcomb, Peter Woodford, Paul Nelson, Jack Behar, Jim Elkins, Ed Mikolay, Jane Waligorski, Marge McPhee, and Emma Khavari.

Others in attendance: Becky Gratsinger, Jim Voytko, Dan Krivinskas, Felicity Gates, Michael Lashendock, Alex Harlan, John Ide, Ron Farnum, June Morse, and Jason Diotte.

Call to Order

Chairman Khouri called the June 14, 2012, meeting to order at 9:35 a.m. He thanked everyone for taking time from their busy schedules to attend the meeting.

Approval of Minutes of March 1, 2012

Chairman Khouri asked for a motion to approve the minutes from the March 1, 2012, meeting. Mr. Nicholson so moved; there were no objections.

Opening Remarks

Chairman Khouri noted that these are very interesting times with the continuing rolling crisis in Europe, China and India economies are slowing, and the U.S. macro economy appears to have problems. This is not an easy time to be investing $50 billion for the SMRS funds. He addressed the discussion points of future Investment Advisory Committee (IAC) meetings in that there will be more detail on asset classes at each meeting. This will provide time for the Board members to become familiar with each asset class and the staff to understand the views of the Board members by asking questions and discussing strategies of the particular asset class. He noted that the topic for this meeting is infrastructure with two guests addressing the topic. Chairman Khouri turned the meeting over to Treasurer Dillon.

Treasurer Dillon noted the problems in Europe and China and that it seems to be the same thing every quarter. He also noted he appreciates the idea of digging deeper into the different asset classes and investment topics and would like to review, in depth, the time-weighted rates of return and the rankings of the fund. Treasurer Dillon agreed this would be a great time for staff to pick the brains of the impressive Board as it relates to strategies for the different asset classes. There was a brief discussion about the goal of the fund and trying to adjust for risk and asset allocation, how success is measured, and the value of the relative rankings.

Executive Summary

Mr. Jon Braeutigam discussed the Executive Summary noting how the fund did versus other public plans and the benchmark. He discussed the actual return versus the peer's return and the differences in their rankings and noted that in other asset classes in private markets there may be wide dispersions in the rankings. He stated it is best to look at the actual return versus, first the benchmark and then versus the peers. Some benchmarks are very easy to understand like the S&P 500, but others are more difficult like infrastructure as it is not standardized. The other side of the equation is how much risk is being taken to get these returns.

Mr. Braeutigam discussed the three-year number, which is challenged versus the peers. The five-year returns are right on median and the ten-year returns do not include small or mid-cap stocks for the first half of the decade. Mr. Braeutigam discussed the reasoning used for decisions made regarding the international equity portfolio. He briefly discussed the Investment Policy Statements which included the new infrastructure asset class noting there has been a lot of work in this area to develop and implement what is needed to be effective in this asset class. There was a brief discussion with several ideas being exchanged about the benefits of an experienced infrastructure manager. Mr. Braeutigam agreed that it is very important to select the right manager to achieve the right diversity, and understand both the project(s), and the financing of the project(s).

Performance

Mr. Braeutigam began the discussion regarding the performance of the plan noting that the longer-term returns are more important indicators rather than the yearly return. He discussed the return percentages noting the rankings for each year's return and noted the difference in the comparison of the plan against the benchmark, and the plan against the median. As in previous IAC meetings, he discussed the three-year figure and noted that it was below the peers. There was a discussion regarding the liquidity of the plan, risk, and the diversification of the portfolio.

Mr. Braeutigam reviewed the asset classes noting that over the last five years there has been improvement in domestic equity. Previously the asset class was limited to 33% passive and has now gone to approximately a 50% passive / 50% active plan. There was a discussion regarding the reasoning for the change. Mr. Braeutigam reviewed the international equity asset class noting the tracking error is narrowing and becoming more like the peers. Also, emerging markets have been added over the past few years which makes up approximately 24% of the international portfolio. There was a lengthy discussion regarding currency, hedged versus un-hedged. He discussed private equity noting that this asset class has done very well. Facebook, Inc. was also a topic of a lengthy discussion. Commercial real estate valuations are bouncing back. The NCREIF property index, not an investable index, shows how properties are doing by un-leveraging the property making it clear how property level fundamentals are performing. Mr. Braeutigam discussed bonds, looking at the one-year number which was 7.3% versus the median which was 7.5%. There was a discussion regarding the corporate world accounting system, FASB versus GASB. Mr. Braeutigam discussed absolute return, which is a relatively new asset class, which is doing well versus its benchmark.

Asset Allocation

The SMRS portfolio for the time period ending March 31, 2012, had a market value of $50.565 billion. In the spirit of time, the Asset Allocation was received and filed.

Capital Markets Overview

In the spirit of time, the Capital Markets Overview was received and filed.

Infrastructure Presentation by R.V. Kuhns – Mr. Dan Krivinskas, Chicago Office

Ms. Rebecca Gratsinger introduced Mr. Dan Krivinskas, Real Estate and Infrastructure expert from the R.V. Kuhns Chicago Office.

Mr. Krivinskas began his presentation by defining infrastructure and what characteristics this asset class demonstrates. He defined infrastructure as basic facilities needed for the functions of a community or society. Some of the characteristics are: it is essential to society or the economy, has a long useful life, has a monopolistic or quasi-monopolistic market position, has stable predictable cash flows often linked to inflation, and is difficult to replicate due to high construction costs. He noted a few examples which included toll roads, airports, schools, and hospitals. He discussed the different types of infrastructure, noting that the industry recognizes transportation which includes airports and toll roads; utilities and regulated industries such as electrical lines, oil and gas pipelines; communications infrastructure which includes cell phone towers, satellites and cable systems. He also discussed social infrastructure which includes both fixed income and real estate such as school buildings, hospitals, courthouses, and government leasing buildings; and he reviewed water-related infrastructure and natural resources, which includes water aquifers and coal mines.

Mr. Krivinskas reviewed in detail the four main infrastructure types giving information regarding the asset types, examples of the investment needed, the ownership, revenues, liquidity, and the life span of the different types of projects. Several questions were discussed and many thoughts were exchanged in reference to toll roads and airports in order to better understand infrastructure. He noted, with regard to transportation, the revenues associated with these assets tend to be positively correlated with growth rates as well as with inflation. Mr. Krivinskas discussed the return characteristics noting how the capital appreciation and income returns differ depending on the infrastructure type. He gave examples of single asset concessions, social infrastructure projects, airports and unregulated utilities, and regulated utilities focusing on the revenues as well as the liquidity/illiquidity associated with each of these different infrastructure types. He reviewed the number of deals and geography of deals by private infrastructure funds.

Mr. Krivinskas concluded his presentation noting that infrastructure is an asset class worthy of investment consideration. The asset class provides significant portfolio benefits with low correlation, stable cash flows, but prudent evaluation is essential noting that a diversified approach works best to gain benefit. He stated caution is essential in reference to the fee profile and leverage used. Mr. Krivinskas answered many questions from staff and Board members and discussed in detail many aspects of the asset class providing many ideas to assist in building a solid infrastructure asset class in the SMRS porfolio.

Infrastructure Presentation by Citi Capital Advisors – Ms. Felicity Gates, Partner and Co-Head of Citi Infrastructure Investors

Ms. Gates began her presentation providing greater detail on a few items that had already been mentioned. She gave a brief history regarding fees, noting that in Australia in 1994 she set up the first infrastructure portfolio for New South Wales State Super Pension plan. At that time, there was a fairly standard model used across all of the funds where the base fees should cover the costs of the business plus a reasonable profit. It depended on the size of the investment, risk, but it was all about aligning interest between the investors and the team. She noted that currently there does not seem to be a standard model across infrastructure, maybe more in private equity, but less in infrastructure because there are so many different ways to structure deals. She noted it is important to access what works for the client's portfolio and for the manager.

Ms. Gates explained that every entity in infrastructure is some sort of public/private partnership. Some entities are completely run by local municipalities, cities, states, and do serve the public. There is some sort of partnership, the customers are the public and the public is typically paying. She discussed concession agreements, which is like a long-term lease. She noted the different partnerships with the amount of risk taken by the private sector and the degree of involvement of the private sector. She provided examples of water utilities, roads, ports, and fully privately-owned energy companies. Ms. Gates provided details of where infrastructure investments are available and the different types of infrastructure investments that were available in those areas. She discussed different opportunities noting things to think about before investing.

Ms. Gates noted that real estate is about location and infrastructure is about stakeholders and a long-term investor must look at all the interested parties involved taking them all into account for the long term. A long-term investor will go through dips in the economy, recessions and all interested parties must be taken into account, everyone is looked after and everyone gets something out of the deal. This is a very important part in infrastructure. Ms. Gates concluded answering several questions regarding the Detroit airport, Chicago parking, the Chicago Skyway, the Indiana Toll Road and several other topics, a lengthy discussion with many ideas being shared to benefit the SMRS portfolio.

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 IAC Meeting is scheduled for Thursday, September 6, 2012. Chairman Khouri adjourned the meeting at 11:55 a.m.

Approved:

Nick Khouri, Chairman