INVESTMENT ADVISORY COMMITTEE

The Investment Advisory Committee (IAC) held its quarterly meeting on Tuesday, December 3, 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 phone
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, Peter Woodford, Karen Stout, Brian Liikala, Richard Holcomb, Jack Behar, Rick DiBartolomeo, Paul Nelson, Amanda Ellis, Giles Feldpausch, Dan Quigley, Marge McPhee, and Emma Khavari.

Others in attendance: Jim Voytko, Molly Jason, Mark Guastella, and Cara Dobie.

Call to Order

Chairman Khouri called the December 3, 2013, 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 introduced the new State Treasurer, R. Kevin Clinton. Chairman Khouri reflected on 2013, noting it is a good time to review what was done, what worked, what did not work, and what it means going forward. He noted that a review of all of the asset classes was being completed at this meeting. He discussed the performance of the U.S. equities, which had a great run, and noted that Treasuries may have started their long-term trend up. He also briefly discussed the payout to retirees.

Chairman Khouri noted that Mr. Paul Nelson would be retiring at the end of December. Chairman Khouri thanked him for his service and noted that Paul's dedication to the Department of Treasury has been very much appreciated. Chairman Khouri recalled several memorable times when Paul enlightened the Executive Office staff regarding the fixed income area.

Approval of Minutes of September 5, 2013

Chairman Khouri asked for a motion to approve the minutes of the September 5, 2013, IAC meeting. Mr. James Nicholson so moved, seconded by Mr. Steve Arwood; 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. Mr. Braeutigam briefly discussed the performance of the plan ending September 30, 2013, noting that the plan has had a strong performance over the past one and three years, and over ten years has achieved a 7.4% return. Mr. Braeutigam addressed questions regarding the peer group and public plan size noting that at the total plan level, State Street's greater than ten billion for measuring performance is used; at the individual asset class level, the State Street comparison used to measure performance is greater than one billion.

Mr. Braeutigam touched on international equities noting that the fund was over-weighted to emerging markets, yet international equities still beat their benchmarks and in real estate some properties were marked-to-market more aggressively in comparison to open-ended funds. Mr. Braeutigam discussed the importance of interpreting peer performance. There was further discussion on how many plans are in the universe for the individual asset classes noting this information is provided under the Performance tab in the IAC book. Mr. Braeutigam explained that the policy benchmark for the plan is simply the target weights for each asset class of the plan multiplied by their benchmark return, noting that for some asset classes, like alternative investments and real estate, this is imperfect as they usually lag the benchmark.

Mr. Braeutigam turned the meeting over to Mr. Greg Parker to review the Asset Allocation Section of the Executive Summary.

Executive Summary – Asset Allocation Section

Mr. Parker began by reviewing the asset allocation sources and uses of cash which provides information on what has been done over the past year in the fund. He pointed out that alternative investments and domestic equity were two large sources of cash; some was redeployed to absolute return strategies, real estate and infrastructure strategies, and real return and opportunistic strategies, and of course, some cash was used to pay the retiree benefits. There was discussion on how this chart would look at the end of 2014.

Mr. Parker touched on the Capital Markets section of the Executive Summary. He noted that the yield curve is steep and that tapering was big news in 2013, with some tapering expected in 2014, possibly as soon as March. This is something he feels needs to be watched over the next 12 months. There was a discussion on fixed income and the credit side of fixed income with Mr. Parker noting that the asset class has increased its exposure to credit, putting some money to work in high yield. There was a good discussion on the Capital Markets and the opportunities in the markets, and also the philosophy and strategy of the markets.

Domestic Equity **–** Mr. Jack Behar reported on the SMRS domestic equity investments. The market value for the domestic equity holdings as of September 30, 2013, was $15,341 million. Mr. Behar provided a brief history of the Stock Analysis

Division. He went on to explain what has been happening with equities, noting when interest rates are low that drives multiple expansion of the equity markets. It is his opinion that this is what the Fed has been trying to do. Mr. Behar discussed performance noting that on a five year basis total domestic equity, both active and domestic, has outperformed the peer group, net of fees. He noted that the markets were a difficult environment for active management.

Mr. Behar discussed his confidence in the portfolio going forward noting that he does an analysis for the broad equity market. There was a lengthy discussion regarding reasonable performance and what is considered good outperformance. There was also discussion regarding the cycle in active manager outperformance or underperformance, noting there are theories, with no definite reason. Mr. Behar also explained that he has been attempting to reduce the asset management fees. He feels that he has been successful in his strategy. Mr. Behar concluded noting that the asset class is overweight in financials, health care, large cap; and underweight in commodities and small cap.

International Equity **–** Mr. Richard Holcomb reported on the SMRS international equity investments. The total international equity exposure as of September 30, 2013, was $8,153 million. He provided a brief review of the Quantitative Analysis Division noting that they have been managing the international equity exposure and the domestic U.S. index funds since 1988. He explained that they took their derivative experience with U.S. indexing, and used it for international passive investing in a derivative overlay covering foreign indices. Libor notes are held as collateral assets. There was a discussion of emerging markets and the role they play in international equities. Mr. Holcomb commented on the differences between a developed market and an emerging market.

Mr. Holcomb discussed his view of the global economy noting that most strategists think the Euro will weaken over the next year. Mr. Parker pointed out that the ECB is not expanding its balance sheet, and it is actually contracting. The U.S. Federal Reserve is increasing its balance sheet quite dramatically. Mr. Holcomb noted that the Yen decreased quite a bit in the trailing year.

Short-Term, Absolute and Real Return **–** Mr. Jon Braeutigam provided a brief update on the absolute return, and real return and opportunistic portfolio as Mr. Jim Elkins was unable to attend the meeting. Mr. Braeutigam explained that money has been put into absolute return, and real return and opportunistic from equities, alternatives, and domestic U.S. equities which helps to diversify the fund. He noted that absolute return is a portfolio of basically hedge funds and mostly through a fund-to-funds type of strategy, with some individual direct hedge funds. He discussed the role that hedge funds play in the asset class and how much meaningful diversification they add to the asset class. There was a discussion about the absolute return portfolio and what view is taken of the portfolio.

Mr. Braeutigam discussed real return and opportunistic noting that it is in kind of a ‘J’ curve where monies are invested while it takes time to get the returns up. He noted that a lot of this money is in direct lending and some in credit strategies along with other areas. The direct lending managers have found opportunities and expect transactions to progress at a steady pace. The investments range from low to high risk, investments that might not fit into other asset classes and are totally uncorrelated. There were many questions asked and a good discussion of the asset class.

Fixed Income **–** Mr. Paul Nelson reported on the SMRS' fixed income investments. The total market value for the fixed income portfolio as of September 30, 2013, was $6,711 million. He noted that the long-term fixed income returns outperformed the Barclays Aggregate for all time periods except the three year. Mr. Nelson discussed the option of adding below investment grade issue with the credit risk somewhat offset by lower interest rate risk in high yield investments. He noted that interest rates are close to the lowest that they have been in 60 years, which is part of the reason why a short duration is best, figuring the rates will go back up. There was a discussion regarding credit risk and below investment grade external managers.

Mr. Nelson pointed out the difference in the average duration of Barclays compared to the fund. He then highlighted the Long-Term U.S. Government Bond Yields chart which shows 200 plus years of trends noting the three different 60-year cycles. At the present time the chart indicates that the government bond yields are 30 years into a new cycle. There was a brief discussion on some of the past notes purchased and the largest holdings in the 1980s, and also decisions that were made during that time.

Alternative Investments **–** Mr. Peter Woodford reported on the Alternative Investments. The total market value as of September 30, 2013, was $10,217 million. Mr. Woodford noted that Alternative Investments consists of 86 sponsors, 266 partnerships, and almost 3,400 companies with investing in private equity since the early 1980s. He noted that the one, five, and ten year returns were 14.9%, 7.8%, and 14.2% respectively. Alternative Investments invests across a broad spectrum of illiquid assets including buyout, venture capital, mezzanine, distressed, fund of funds, secondary funds, and special situation funds. These investments are approximately 75% in North America, 20% in Europe, and 5% in Asia. Mr. Woodford noted some of the desirable qualities when searching for a manager, which are: deep sector expertise, a focused strategy, a stable team with low turnover, and an attractive track record. These managers will have the ability of replicate their success over challenging economic cycles. He noted that a top down approach, which includes strategy, geography, and industry, as well as a bottom up approach which focuses on people, performance, philosophy, process, and price are used to make investment decisions.

Mr. Woodford discussed the macro outlook for private equity noting that although in the midst of an economic recovery, growth is likely to be structurally lower than in past recoveries. Markets should remain relatively calm in the near-term based on the current Fed's posture. He noted that the real question is the timing and impact of the Fed tapering. Credit availability and its historically low costs will not be available indefinitely. He also discussed the leverage multiples being at pre-crisis levels, with historically low borrowing costs that are driving purchase price multiples.

Mr. Woodford discussed the different markets noting that the U.S. buyout market continues to show relative strength compared to other regions due to relatively benign economic outlook, high levels of IPO and M&A activity, and accommodative credit markets. Mr. Woodford discussed the InvestMichigan program, which was developed in 2008 to attract new companies to Michigan and to fund in-State companies with innovative technologies. Initially the program capital was $330 million and in 2012 an additional $180 million was allocated to the program increasing the total funding to $510 million. He noted that to date the program has invested approximately $240 million across 43 deals and the performance has been good.

Asset Allocation, Capital Markets Overview, Economic and Market Review and Outlook, Real Estate Asset Class Investment Report, 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, March 6, 2014. Chairman Khouri adjourned the meeting at 11:35 a.m. and thanked everyone for coming.

Approved:

Nick Khouri, Chairman