Joint Meeting of the Investment Advisory Committee and Board of Trustees

Meeting of the Board of Trustees
May 20, 2014

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JOINT MEETING OF THE
BOARD OF TRUSTEES AND
INVESTMENT ADVISORY COMMITTEE
EMPLOYEES RETIREMENT SYSTEM OF TEXAS

May 20, 2014
ERS Auditorium
200 E. 18th Street
Austin, Texas 78701

COMMITTEE MEMBERS PRESENT
Lenore Sullivan, Chair
Robert Alley, Member
Caroline Cooley, Member
Monty Jones, Member
Ken Mindell, Member
Vernon Torgerson, Member

COMMITTEE MEMBERS ABSENT
James Hille, Vice-Chair
Laura Starks, Member

TRUSTEES PRESENT
Brian Ragland, Chair
Frederick E. Rowe, Jr., Vice-Chair
Cydney Donnell, Member
Yolanda Griego, Member
I. Craig Hester, Member
Cheryl MacBride, Member

ERS STAFF PRESENT
Ann Bishop, Executive Director
Larry Zeplin, Chief Operating Officer
Tom Tull, Chief Investment Officer
Paula Jones, General Counsel and Chief Compliance Officer
William Nail, Deputy Director of Governmental Affairs
Tony Chavez, Internal Auditor
Robert Kukla, Director of Benefit Contracts
Marci Sundbeck, Manager of Enterprise Risk Management
Catherine Terrell, Director of Governmental Affairs
Michael Wheeler, Chief Financial Officer
Carolyn Anderson, Investments
Brannon Andrews, Legal Services
Amanda Burleigh, Legal Services
Kyla Cloutier, Benefit Contracts
Adam Cibik, Investments
Wesley Gipson, Investments
Diana Halcomb, Information Systems
Andrew Hodson, Investments
Lauren Honza, Investments
Jennifer Jones, Governmental Affairs
Sarah James, Benefit Contracts
Sharmila Kassam, Investments

Robert Kramm, Investments
David Lacy, Legal Services
Debbie Leatham, Finance
Robert Lee, Investments
Betty Martin, Investments
Patti Maugham, Executive Office
Nancy McCarthy, Investments
Ken McDowell, Investments
Robert Meyers, Investments
Tim Reynolds, Investments
Tanna Ridgway, Investments
Ralph Salinas, Director of Human Resource
Leighton Shantz, Investments
Robert Sessa, Investments
John Streun, Investments
Kathryn Tesar, Director of Benefits Communications
Chris Tocci, Investments
Mary Jane Wardlow, Governmental Affairs
Annie Xiao, Investments

ALSO PRESENT
Sharon Barnes, Texas Commission on Environmental Quality
Mark Bartmann, R.V. Kuhns & Associates
Togy Berndt, American Association of Retired Persons
Anthony Bookman, Cross River Advisors
Lindsay Chessmore, Careington
Leslie Cunningham, Texas State Employees Union
Kristen Doyle, Hewitt EnnisKnupp
Juan Garcia, Office of the Governor
Joaquin Guadarrama, Office of the Governor
Dan Krivinska, R.V. Kuhns & Associates
Rebecca Larson, Careington
Jon Mathers, Office of Representative Bill Callegari
Jerry McGinty, Texas Department of Criminal Justice
Liz Oberg, Scott & White Health Plan
Steve Voss, Hewitt EnnisKnupp

Ms. Lenore Sullivan, Chair of the Investment Advisory Committee for the Employees Retirement System of Texas called the meeting to order and read the following statement:

> "A public notice of the Joint Meeting of the Board of Trustees (Board) and Investment Advisory Committee (IAC) containing all items on the proposed agenda was filed with the Office of the Secretary of State at 8:56 a.m. on Friday, May 9, 2014 as required by Chapter 551, Texas Government Code, referred to as The Open Meetings Law."

VII. REVIEW AND APPROVAL OF THE MINUTES TO THE FEBRUARY 25, 2014 JOINT MEETING OF THE BOARD OF TRUSTEES AND INVESTMENT ADVISORY COMMITTEE

Ms. Lenore Sullivan opened the floor for a motion to approve the minutes of the February 25, 2014 Joint Meeting of the Board of Trustees and Investment Advisory Committee.

The Investment Advisory Committee then took the following action:

MOTION made by Mr. Bob Alley, seconded by Mr. Vernon Torgerson and carried unanimously by the members present that the Investment Advisory Committee approve the minutes of the ERS Joint Meeting of February 25, 2014.

The Board of Trustees then took the following action:

MOTION made by Ms. Cydney Donnell, seconded by Mr. Craig Hester, and carried unanimously by the members present that the Board of Trustees approve the minutes of the ERS Joint Meeting of February 25, 2014.

VIII. REVIEW AND DISCUSSION OF INVESTMENT PERFORMANCE FOR 1ST CALENDAR QUARTER OF 2014

Ms. Kristen Doyle and Mr. Steve Voss from Hewitt EnnisKnupp (HEK) and Mr. Chris Tocci, Public Equities Senior Portfolio Manager for ERS, presented the review and discussion of investment performance for the first calendar quarter of 2014.

Ms. Doyle began the presentation with an overview of major capital markets returns. Trouble in some emerging markets and the rising risk of contagion created strong headwinds for equity market returns. The S&P 500 only managed a 1.8% return for Q1, much of which came in the last week of March as perceived risks eased somewhat. Other developed markets performed a little better, especially in Europe, but emerging markets were generally underperformers.

As global equity markets struggled, the increased risk aversion benefitted global bond returns in the first quarter. The Barclays global aggregate bond total return index rose 2.4%, with a strong contribution from long duration US Treasuries – Barclays US Treasury 20+ year total return index increased by 7.7%. Riskier corporate bonds also posted positive returns but to a lesser extent – Barclays global aggregate corporate total return index rose by 2.6% while the Barclays US corporate high yield index rose by 3% in Q1.

HEK's report on ERS' investment performance net of fees showed that during the 2014 first calendar quarter the Total Fund earned 1.3% compared to the Policy Benchmark return of 1.4%. For the quarter ending March 31, 2014, global credit, real assets, rates, and absolute return components contributed positive relative value. The remaining asset classes were flat or detracted from relative performance during the period. The Total Fund added 69 basis points of relative performance over the Total Fund Policy Benchmark for the trailing one-year period. The investment earnings for the quarter outpaced the benefit payments, therefore continuing the rise in the total fund value. The portfolio was able to find significant value over the benchmark in the strong bull market rally of that period.

Ms. Doyle discussed the allocations for the fund. The fund continues to be overweight in equities and rates, and underweight in the global credit component, as well as real assets.

The portfolio is benefitting from the outperformance driven by global equity and real assets. In the ERS portfolio, the private real estate program posted very strong returns and outpaced its benchmark. The absolute return portfolio had very strong performances last year and was up 411 basis points over the benchmark.

Mr. Craig Hester took a moment to congratulate the ERS investment team on the outperformance of the fund for the last ten years and especially for last year.

Ms. Doyle commented that it was good to see where the team was utilizing time and resources and how they had also adjusted strategy to add more private real estate and real assets. Additionally, allocations in fixed income are helping drive performance.

Ms. Doyle also looked at the performance of individual asset classes. Global equity relative to the MSCI All Country World Index is overweight to the US and is driving the outperformance, which is called the benchmark effect. That is the difference between the exposures and the actual portfolio relative to the benchmark. In the domestic equity portfolio, active managers are driving the outperformance for the quarter and the one-year period. The portfolio manager Omega detracted from performance during the first quarter.

International equity performance was driven by some of the weaker relative performances within the internal international equity advisor such as J. P. Morgan with their emerging markets portfolio. Templeton was very strong in this asset class and outperformed their benchmark by 132 basis points in the quarter.

Ms. Doyle moved on to the private equity portfolio. In 2014, there have been seven additional commitments totaling $480 million. The commitment schedule is progressing at a faster rate than last year.

The next component of the return-seeking portfolio is the global credit portfolio. There has been strong outperformance fiscal year-to-date despite a degree of underperformance due to exposure to emerging market debt, which did not do well last year. The benchmark is a high yield index that actually posted very strong returns last year, so there's a bit of a mix match that is driving the underperformance. Additionally, there is a small underperformance relative to the benchmark in the investment grade portfolio that is transitioning into the rates portfolio.

Regarding the return-seeking part of the portfolio, real assets were up 9% over the one-year period. The US portion of Global REIT Index was up about 5% over the one-year period, whereas the international component was flat. Private real estate was an even stronger component and was up 13% and infrastructure was up 13%, as well. The internal public real estate portfolio was an additive to the positive returns.

Ms. Doyle then moved on to the risk-reducing part of the portfolio. It over performed fiscal year 2013 by about 20 basis points and 30 basis points over the one-year period. Lastly, the absolute return portfolio had a very strong outperformance in this asset class. It outperformed by approximately 400 basis points over the one-year period. All managers except two posted double digit returns.

Mr. Voss followed by summarizing highlights of the fund's performance. He also spoke about the outperformance of the internal portfolio, ERS Large Cap Core Fund, and the newly utilized Large Quant Strategy.

Ms. Cheryl MacBride questioned the diversification of the Hedge Fund portfolio due to the fact that she noticed CTA was an outlier. Mr. Robert Lee III, Hedge Fund Portfolio Manager, responded to her question. He said that the Aspect portfolio is a CTA trend follower. They expect the strategy to "zig when others are zagging" by the quantitative systematic nature of their investment style. The recent markets have not been strong and have subsequently underperformed. The portfolio is a good diversifier when the others are performing poorly, but as an individual investment it has underperformed.

Mr. Shad Rowe posed a question regarding the assumed rate of return. He asked how the fund is doing relative to our actuarial deficit and the funds relative to future liabilities. Mr. Voss mentioned that the panels will address the issue later that day. On an historical basis, relative to actual return, the fund has been able to compound returns at 8.5% over the last 30 years. The investment portfolios account for approximately 65% of funding needs, so it is only part of the big picture. Mr. Craig Hester commented that there are a lot of factors that are outside of the control of the Board and Investments department, so it is important to get on the same page to ensure the soundness of the Trust.

Mr. Tocci presented the reviews of six of the external advisors: one domestic advisor and five international advisors. Based upon recent meetings and performance, the staff has concluded to retain the services of all six advisors.

There were no questions or further discussion, and no action was required on this item.

IX. REVIEW, DISCUSSION AND CONSIDERATION OF ERS REAL ESTATE PROGRAM:

A. MARKET UPDATE AND PROGRAM OVERVIEW

Mr. Bob Sessa, Director of Real Estate for ERS, Ms. Annie Xiao and Ms. Amy Cureton, Portfolio Managers for Real Estate for ERS, and Mr. Dan Krivinskas, consultant and principal for RV Kuhn, presented the market update and program overview for the real estate program.

Mr. Sessa began his presentation with an overview of the real estate portfolio. Real estate is targeted to be 10% of ERS assets. In March 2014, real estate stood at $1.8 billion or 7.1% of the system's assets, which is up from 5.4% or $1.3 billion a year ago. The real estate asset class is comprised of two subgroups: private real estate and publicly traded real estate securities, REITS. Private real estate is targeted to be 70% of the real estate portfolio or 7% of the total fund. It is currently at 4.7% and is expected to be fully funded by 2016.

The REITS comprise 30% of the portfolio or 3% of Trust assets. The current weight is 2.5%, an intentional underweight due to concerns over valuation. Portfolios may be under or over weight in different asset groups based upon market concerns.

Mr. Sessa concluded his presentation by thanking the ERS legal team, operations staff and supporting administrative staff. He then handed over the presentation to Ms. Xiao to discuss the listed securities.

Ms. Xiao began her presentation with an overview of the listed real estate security program and market updates. At the end of the last quarter, the total public real estate portfolio was valued at $622 million, about 2.5% of the fund. 80% of the real estate portfolio is internally managed and 20% is externally advised by Center Square Investment Management.

In terms of geographic exposure, US REITS is 48% of the portfolio and Asia accounts for 30%. As of March 31, 2014, the portfolio was overweight in Europe and underweight in Asia and North America. The Asia underweight is a result of an expectation of weakening fundamentals and the US underweight was due to valuations.

The average cap rates spread is about 100 basis points above the long-term average, which creates a cushion for rising bond yields. The European market has the widest spread. Hong Kong and Singapore have seen significant cap rate compression since 2009, which was driven by strong liquidity, low interest rates and market expectations of rental recovery.

Ms. Xiao ended her portion by discussing the evolution of listed real estate. In 2000, the universe's market cap was approximately $410 billion and it grew to $106 trillion by the end of last year. The US and Asia accounted for the majority of the growth in terms of absolute dollar value. The emerging markets had the strongest growth, increasing from 2% to 15% of the universe. The universe is represented by FTSE EPRA/NAREIT Global Real Estate Index with 458 members. REITs accounts for about 75% of the total universe value. Currently, 28 countries have adopted the REITS structure and 11 additional countries are undergoing a legislative process to adopt the REITS structure.

Mr. Sessa added a comment about the securitization for real estate. He stated that whenever securitization happens, it improves not only liquidity, but also transparency, which helps the private side. Proliferation of REITS around the world makes it more efficient to invest in and is a benefit to the whole real estate market.

Mr. Sessa continued the discussion of private real estate. The private real estate portfolio is at $1.2 billion as of March 31, 2014, which is up from $780 million last March. The portfolio is 83% equity type investments and 17% is debt type investments. The overall loan-to-value stands at 44% and will probably increase over time.

Regarding commitments, the real estate team has committed over $2 billion to 28 funds and 28 managers. For the fiscal year, $344 million was committed to eight funds. Since the inception of the program, over $1 billion in capital has been called and for the fiscal year to date, $243 million has been called.

The real estate portfolio operates as a hybrid of an equity and a fixed income portfolio, so they receive a lot of cash flow from their investments. This year they have received $100 million and since the inception of the program, they have received $235 million.

Ms. Cydney Donnell asked what the anticipated max leveraging amount would be. Mr. Sessa replied that some funds have limitations on them up to 70%. Funds without limitations are frustrating because the risk increases dramatically for each incremental point of leverage. Leverage is an area that the team is focused on. Mr. Krivinskas said that few funds have specific leverage limitations.

Mr. Rowe inquired about the cap rates on quality properties. Mr. Sessa replied that it is 4% or 5%. Mr. Sessa said that the real estate team is trying to stay away from core properties due to their beta play on the market. They are betting more on managers that can identify mispriced properties and under-managed properties that can lift in pricing.

Mr. Sessa continued to discuss the geography of the deployed capital from the fund. The capital is mostly deployed in the US and Europe, but the team is looking to utilize Asia and Latin America. Investors are still cautious about their valuations.

Ms. Amy Cureton began her part of the presentation by discussing risk return and the capital structure position of the portfolio. The committed capital of the portfolio is $2 billion. The risk return of the portfolio is divided into 30% opportunistic, 27% core and 43% value-add. The core stabilizes assets, provides a high percentage of return from income and is in very supply-constrained gateway primary markets. Value add has a significant proportion of return from income, but there is risk at the property level. Opportunistic is the most risky of the set, and generally provides a smaller portion of the return from income. The total capital structure position of the portfolio is 78% equity and 22% debt.

Ms. Cyndey Donnell asked about whether managers are encouraged to sell once the properties stabilize. Mr. Sessa responded that a lot of accelerated dispositions have been seen in the market.

Managers' five-year plans are getting hit during year two or three and are hitting the sell button. He thinks that people are too eager to sell. Mr. Krivinskas mentioned that managers have been taken down in good and bad markets.

Ms. Donnell inquired about the opportunistic category and how the real estate team is focusing on that strategy. Mr. Sessa explained various opportunistic strategies: loan-to-own distress debt, taking on debt, and buying equity.

Ms. Cureton continued her presentation by discussing the portfolio by risk return and by region of committed capital. The fund is heavily weighted in the US at 75% and most of the remaining 25% is invested in Europe. The international exposure is primarily concentrated in the non-core space.

She presented charts that illustrated the portfolio market value of the invested capital or net asset value. The core space of the portfolio represents 52% of the commitments. The core is primarily funded and the majority of new capital being called for investments will be in the opportunistic and value-add space. Core realized good opportunities with great relative pricing early in the cycle, so now the focus is shifting to the non-core space.

Ms. Cureton moved on to discuss the sector concentrations by risk strategy. Core space has the largest allocation in industrial. They invested in a manager that focused on high quality assets in primary logistics, hubs and port markets. In the value add space, there is significant weighting to residential. The opportunistic space is the most diverse. They are able to realize better yields and better returns. Here the real estate team worked with managers that have identified opportunities to reposition and selectively develop assets in higher growth primary and secondary markets.

Mr. Ken Mindell asked about investing in storage space and remarked that the returns are good. Mr. Sessa commented that storage has been overlooked because the institutional investment community feels that it is difficult to deploy large amounts of capital into storage. The breakeven cash flow is typically 40% to 50%, which is different than most other property types.

Mr. Mindell continued to discuss areas of real estate to invest in, such as development space. Mr. Sessa agreed that it was a good path to grow from if a good location is identified and then developed to collect income. Ms. Cureton explained that storage exposure is actually in a mezzanine debt fund, which is getting great yields for the risk.

(Ms. Ann Bishop then dismissed the meeting to reconvene later for the legislative portion of the meeting)

Ms. Cureton continued her section of the presentation. She presented an overview of the exposures by property type and how those exposures compare to the NCREIF Odyssey benchmark. Real estate is overweight in industrial and residential, and underweight in retail and office. Office has been an underperformer, but the real estate team is looking for opportunities with the right strategy.

She explored the geography exposure of the portfolio. The top ten MSA's represent about 53% of the total NAV and are gateway, primary and coastal markets. Dallas and Houston markets made the list based on strong fundamentals and growth in those markets. Currently, 13% of the portfolio is international. It's primarily composed of UK and European exposure, with smaller Asian exposures expected to grow over time. Regarding the US portion, the regional waves are generally in line with the benchmark, although they are overweight to the south and slightly underweight to the east region.

Mr. Sessa concluded the market update and program overview with the accomplishments of the real estate team for the year. The combined real estate portfolio is generating positive returns and has mitigated the J-curve in the private real estate portfolio. They invested in open-ended core funds during a trough in 2010 and 2011, which helped the returns in the private real estate portfolio. The REITS, while positive, did struggle, but are underweight by 3%. The real estate team is collaborating with the hedge fund team to underwrite a hedge fund for the listed securities portfolio. $344 million has been committed to the Private Real Estate portfolio through March 31 and the real estate team has closed eight deals. They are also expected to close on another $100 to $150 million in committed capital by the end of the fiscal year. The legal team has helped negotiate a savings of $27 million for the private real estate portfolio since its inception.

In the next fiscal year, the real estate team is continuing to commit capital to Private Real Estate, projecting $325 million in 3 to 15 commitments. They are hoping to invest in Asia and possibly Latin America. They want to create a co-invest program and consider separate accounts. This will give more control over the investment and lower the operating costs, and be more customizable. In addition, they will continue to monitor the select pool for listed securities advisors.

In the early stages of discussing the real estate platform, a total staff of five to seven people was contemplated with personnel to be added over several years as the program matured. Current staffing is now at five people. It is expected that the real estate team will need one to two additional people over the next three years.

There were no questions or further discussion, and no action was required on this item.

B. PROPOSED PRIVATE REAL ESTATE ANNUAL TACTICAL PLAN FOR FISCAL YEAR 2015

Mr. Sessa began a brief overview of the benefit and purpose of the private real estate tactical plan. The current value of the plan is $1.2 billion. The staff expects to reach the 7% Private Real Estate allocation goal by the end of 2016. They want to have investments of $50 to $100 million, but also small or larger size for niche and/or special situations. There is also $150 million being pulled forward to FY2014.

Mr. Adam Cibik presented the proposed private real estate annual tactical plan for fiscal year 2015. He discussed allocation in three fund types: core, value-add, and opportunistic. The team is recommending 20% for the core and 80% for the value-add and opportunistic portfolios. He also detailed the targeted commitments for the next four years. Core will remain between 20% and 30%, which will allow flexibility to make judgment calls on medium risk strategies that often have real value in the US and abroad. Mr. Cibik explained that they expected to be at a little over 70% invested, $1.4 billion going forward to the 100% invested at $2 to $2.5 billion.

He also discussed five key strategic themes: commingled funds or club deals with large investors, niche type funds, co-investments and separate accounts, value add and selective opportunistic funds (debt and equity), and selective international investments – Asia and Latin America.

Ms. Lenore Sullivan opened the floor for a motion to approve the proposed ERS Private Real Estate Portfolio Annual Tactical Plan for Fiscal Year 2015, as presented in Exhibit A, to be Appendix A of the ERS Real Estate Policies and Procedures.

The Investment Advisory Committee then took the following action:

MOTION made by Mr. Ken Mindell, seconded by Mr. Bob Alley and carried unanimously by the members present that the Investment Advisory Committee approve the proposed ERS Private Real Estate Portfolio Annual Tactical Plan for Fiscal Year 2015, as presented in Exhibit A, to be Appendix A of the ERS Real Estate Policies and Procedures.

The Board then took the following action:

MOTION made by Mr. Craig Hester, seconded by Ms. Cydney Donnell, and carried unanimously by the members present that the Board of Trustees approve the proposed ERS Private Real Estate Portfolio Annual Tactical Plan for Fiscal Year 2015, as presented in Exhibit A, to be Appendix A of the ERS Real Estate Policies and Procedures.

XI. REVIEW, DISCUSSION AND CONSIDERATION OF ERS FIXED INCOME PROGRAM:

A. MARKET UPDATE AND PROGRAM OVERVIEW; REVIEW OF SECURITIES LENDING PROGRAM

Mr. Leighton Shantz, Director of Fixed Income for ERS, Mr. Peter Ehret, Internal High Yield Portfolio Manager, and Mr. Tom Roberts, Rates Portfolio Manager for ERS, presented the review, discussion and consideration of the ERS fixed income program.

Mr. Shantz briefly described the duties of the ERS fixed income team. He explained that Mr. Roberts and Ms. Leticia Davila, Fixed Income Portfolio Manager – Securitized Products for ERS, manage the Rates portfolio. Mr. Ehret and Mr. Bob Kramm, Fixed Income Portfolio Manager – Credit, manage the Internal High Yield portfolio with the larger Credit portfolio. Mr. Robert Meyers monitors risk for both the Rates and Credit portfolios, and Mr. Ben Bowman helps with external mandates in Credit.

Mr. Shantz began his presentation by discussing the fixed income strategy from fiscal year 2013 and how the strategy has since been adjusted. Initially, fixed income had a core plus style fixed income mandate, but the Board adjusted the strategy and staff migrated to dual Rates and Credit mandates. Rates provides liquidity for the Trust, while Credit is the return-seeking asset class. If bonds previously held under the core plus mandate did not fit into either category, they were considered Transition assets.

As of the end of March, the Rates portfolio is $1.4 billion overweight due to a lack of attractive opportunities in Credit. The fixed income team was able to obtain meaningful liquidity from transition assets. Transitions assets have been liquidated to $662 million and is approximately 18 months ahead of schedule in changing to the new dual mandates. The Credit portfolio has grown from $719 million to just over $1 billion. Its fiscal year-to-date performance was positive 8.17%, which is over 50 basis points of outperformance relative to its benchmark.

Ms. Cydney Donnell inquired as to what point the team intends to reduce the Rates overweight. Mr. Shantz explained that the overweight in Rates is the consequence of the underweight in Credit. Staff moved aggressively to reduce the Transition assets because of favorable market conditions which concurrently made Credit opportunities less attractive. The Credit book will be expanded as its yields rise. The transition portfolio is presently at $614 million, with an estimated ex-ante tracking error of 1.83% annualized. It has a high tracking error resulted from the remaining assets being less risky than the mandates benchmark. The high tracking error resulted from the remaining assets being much less risky than the mandates benchmark, and staff believes it appropriate to take the existing Transition assets and transfer them into the Rates portfolio to manage around. Currently the Transition and Rates portfolio have approximately the same yield, but Transition has less interest rate risk. As time passes and the remaining Transition assets move to maturity, their tracking error to any widely available benchmark will increase resulting from their de-risking. Staff could liquidate the remaining assets, but that would create an even larger overweight to Rates.

The transition portfolio is currently mostly investment grade corporates worth roughly $300 million. These will mature over the next four years. Additionally in the portfolio, there is an additional $50 million in short duration ABS securities and the remainder is CMBS. CMBS is estimated to be approximately $200 million in 5 years, but is expected to materially de-risk itself. The fixed income team believes they can manage around the risk.

Mr. Shantz concluded his presentation by discussing the various fixed income portfolios. The new Internal High Yield ("IHY") launched by Mr. Ehret and Mr. Kramm has earned 9.68% since inception, outperforming its benchmark by 302 basis points. It has significantly outperformed while maintaining a higher average credit quality than its benchmark. An emerging market portfolio is up 15.5%. Securities lending has added another 200 basis points of excess return to this portfolio, which is not reflected in the custodian's performance numbers. Staff held such a large stake in the assets intentionally to earn this higher yield and thought it meaningful to point it out to the Board.

Mr. Tom Roberts began his portion of the presentation. The assets in the fixed income portfolio include cash, government agency securities, agency mortgages, and US Treasury securities. The agency mortgages have performed strongly, resulting in the over-all Rates portfolio outperforming its benchmark by 25 basis points. With the agency mortgages, there is more duration risk which is offset by holding shorter duration. Treasury securities and other assets are compared to the benchmark. The objective of Rates is to provide liquidity for the Trust, but Staff is confident in their ability to add incremental return currently without jeopardizing liquidity. Overall, the Rates portfolio has approximately 96% of the duration, or interest rate risk, compared to the benchmark.

He discussed the integration of the transition portfolio. If the portfolios are combined, Rate's OAS would increase by 10 basis points and the effective duration decreases.

Mr. Roberts then switched to focus to the interest rates that now dominate the performance of the Rates portfolio. He also discussed monetary policy as a primary driver of interest rates. Right now, the Federal Reserve has front-end rates pegged much lower than expected. He concluded that it is important to pay attention to the Fed and their intentions.

Mr. Roberts continued with a look at economic data, noting that historically there has been a meaningful correlation between interest rates and growth. Despite recent improvements in labor, rates are still uncharacteristically low.

Mr. Roberts concluded his portion with a discussion about the Fed's influence agency MBS space. The Fed QE3 program has initially purchased $40 billion a month of MBS, and while they are actively tapering these purchases, new mortgages originations have fallen. As a result, the Fed is still buying 75% of the new agency issues in the market.

Mr. Ehret began his portion of the presentation discussing the new IHY portfolio. It is a new effort in which infrastructure was built out for the portfolio's management and security selection and counter party relationships were established to effectively access the market from a new issues standpoint as well as secondary trading. The performance record began in October of 2013 and has been performing very well.

Mr. Ehret mentioned that Mr. Bob Kramm moved from the Transitions portfolio to work on the IHY portfolio and has been assisting in growing the portfolio in line with opportunity. Staff intends on adding additional resources, beginning with hiring a new analyst this calendar year.

Mr. Ehret demonstrated that high yield is full of drama by presenting a graph that showed 20 years of the below investment grade index's spread history. The asset spreads fluctuates from being easy to attain to too difficult. In the credit crisis of 2008, the spreads on high yield widened to all-time highs. There are peaceful times in high yield space, as well. Spread cycles tend to closely lead default cycles. High-yield companies are very cyclical, and during the credit cycle, business failure rates can increase.

The IHY portfolio held 126 issues across several industries at the end of the quarter. Its yield is less than market, and they are trying to approach things from a conservative side as staff believes we are in the later stages of the credit expansion cycle. The average yield on below investment grade rated bonds is near 5%, a record low. As a result the portfolio is underweight in the triple-C rated issues, which are the riskiest segment of the market. That creates a yield disadvantage for the portfolio and is a performance drag, especially if this "quiet period" lasts for years.

Mr. Ehret continued discussing the strategy for the IHY portfolio. He discussed that credit is getting too easy to attain. There is a low rate environment causing people to push more for the opportunities that remain and risky behaviors are intensifying. So, the market is getting increasingly risky as yields and spreads come down. Additionally, it is very important to watch the returns. Buying during the highest periods of risk historically results in the best subsequent returns.

Ms. Caroline Cooley asked how they have been able to outperform while taking on so much risk. Mr. Ehret said that the team had been very selective and they do not have a legacy portfolio, diluting their efforts, and some strategies came from the best ideas portfolio. The fixed income team added value in trading and it was effective. Partners, as well as relationships, have aided in returns. The counterparty relationship with credit also helped with returns.

Ms. Sullivan asked for more information regarding the availability of bonds. Mr. Ehret said that the availability of bonds is very tight. He acknowledged that the challenge is identifying something to buy, finding it, and then finding it at a reasonable price. It is a long process and right now they are able to execute about one out of six possible ideas. He also addressed the concern about liquidity when investors do not want that asset class anymore.

Mr. Shantz interjected that the Fund is in a position where they can sell liquidity. In the market right now, daily money, ETF's, and mutual funds which have no control over their redemptions have increased materially in size and can quickly become absolute price-takers in order to raise liquidity to meet redemptions. In combination with the over 75% reduction in dealer balance sheets to make markets in these credits, a relatively minor event could create a large disruption. .

Mr. Jones inquired about the next disruption to the market. He said that both the real estate and fixed income team are being conservative and managing in the right way – versus benchmarks, but what would happen to the unfunded liability if the ten-year goes to 5%? He wonders how that would impact on interest rates, fixed income, and the price of the private equity.

Mr. Shantz stated that he worries about not having enough in Rates to fund both benefits and redeploying cash to risky assets during very large disruption. The Trust's liabilities have a longer duration than its Rates assets, and will decrease in value relatively as a result of an interest rate increase. If there is a big disturbance, ERS' funded status would still likely go down because the effective duration of equity exceeds that of the liabilities. The biggest risk to the Trust is that it exhausts the Rates portfolio and must sell return seeking assets at large losses to make benefit payments. So long as a drawdown is constrained enough for the Rates portfolio to fund a reallocation to risk assets and pay benefits, the Trust can rebound.

Ms. Cydney Donnell reiterated that this was a question regarding an increase in rates was appropriate for the real estate team too, given inflation fears and yield spread compression on real estate. There is a spread cushion with pricing of the assets versus treasuries, but at a point it doesn't matter if the rate comes up you're going to have a decrease in asset value.

Mr. Shantz said that in every historical scenario shown to the Board and IAC in this agenda item, credit spreads tightened when interest rates were increasing or widening while interest rates fell. The re-normalization of monetary policy by the Fed could result in a correlation closer to one. The reason why staff took duration down so short is so that the Trust can't afford to have its liquidity source move against it.

There were no questions or further discussion, and no action was required on this item.

B. <u>PROPOSED REVISIONS TO THE ERS INVESTMENT POLICY ADDENDUM XII: FIXED INCOME POLICIES AND PROCEDURES</u>

Mr. Shantz explained staff recommends that the remainder of the Transition Portfolio be moved to the Rates Portfolio effective the beginning of fiscal year 2015 and made such appropriate revisions to the Fixed Income Policies and Procedures, Addendum XII of the ERS' Investment Policy, to reflect this recommendation.

Ms. Lenore Sullivan opened the floor for a motion to approve the proposed of the Fixed Income Policies and Procedures as reflected in Exhibit A of this agenda item.

The Investment Advisory Committee then took the following action:

MOTION made by Mr. Vernon Torgerson, seconded by Mr. Monty Jones and carried unanimously by the members present that the Investment Advisory Committee approve the proposed Fixed Income Policies and Procedures as reflected in Exhibit A of this agenda item.

The Board then took the following action:

MOTION made by Mr. Craig Hester, seconded by Ms. Cheryl MacBride, and carried unanimously by the members present that the Board approve the proposed Fixed Income Policies and Procedures as reflected in Exhibit A of this agenda item.