VERMONT PENSION INVESTMENT COMMITTEE
NOVEMBER 27, 2018
DRAFT; NOT YET APPROVED BY COMMITTEE

VPIC Members Present:

TOM GOLONKA, CHAIR
BETH PEARCE, VICE-CHAIR, Vermont State Treasurer
VAUGHN ALTEMUS, Governor's Delegate, term expiring June 30, 2018
KAREN PAUL, (phone) Governor's Delegate, term expiring June 30, 2018
PETER AMONS, (phone) VMERS Representative, term expiring June 30, 2022
JOSEPH MACKEY, (phone) VSTRS Representative, term expiring June 30, 2019

VPIC Members Absent:

ROBERT HOOPER, VSERS, term expiring June 30, 2020

VPIC Alternate Members Present:

LINDA DELIDUKA, (phone) VSTRS *Alternate*, term expiring June 30, 2019
KIMBERLY GLEASON, (phone) VMERS *Alternate*, term expiring June 30, 2022
JEFF BRIGGS, VSERS *Alternate*, term expiring June 30, 2020
DAVID STARR, (phone) Governor's Delegate *Alternate*, term expiring June 30, 2020

VPIC Alternate Members Absent:

None.

Also attending:
Eric Henry, Chief Investment Officer
Katie Green, Investments Manager
Andy Cook, Investments Analyst
Margaret Belmondo & Will Forde, NEPC, LLC
David Borsykowsky & Jesse Moorman, Vermont Attorney General's Office

CALL TO ORDER:

The Chair called the Tuesday, November 27th meeting to order at 8:30 am, which was held in the 4th Floor Governor's Conference Room, 109 State Street, Montpelier, VT.

ITEM 1: Agenda Approval and Announcements

The Chair reviewed the agenda with the Committee and asked if any members of the Committee would like to add or amend any agenda items.

On a motion by Treasurer Pearce, seconded by Vaughn Altemus, the Committee unanimously approved the agenda as written.

ITEM 2: Consent Agenda

The Chair indicated the only item on the Consent Agenda today was approval of the minutes from the October 23rd, 2018 VPIC meeting.

On a motion by Treasurer Pearce, seconded by Vaughn Altemus, the Committee unanimously approved the consent agenda.

ITEM 3: Vermont State Treasurer's Update

Treasurer Pearce informed the Committee that her office will be undertaking an Enterprise Risk Management (ERM) project over the coming months. Newly hired Treasurer's Office employees Eric Henry, Chief Investment Officer, and Will Kriewald, Chief Financial Officer both have extensive ERM experience, which will be utilized during this project. This process will cover both pension risk and operational risk.

Treasurer Pearce next presented a summary of the 6/30/2018 Actuarial Reports for the VSERS, VMERS, and VSTRS systems. She specifically noted changes in the report values from 2017 to 2018. Links to those reports may be found on the Treasurer's Office website at the following locations:

https://www.vermonttreasurer.gov/content/retirement/vmers/financial-reports
https://www.vermonttreasurer.gov/content/retirement/state/financial
https://www.vermonttreasurer.gov/content/retirement/teacher/financial-reports

Members of the Committee noted that the reports produced this year by Segal Consulting were very clear and easy to read.

ITEM 4: Actuarial Report Update

This update was covered by Treasurer Pearce in Item 3 above.

ITEM 5: Chief Investment Officer Report

Mr. Henry presented the *Chief Investment Officer Report* dated November 20, 2018. He responded to questions posed by members of the Committee. Attachment A to these minutes includes this report.

Ms. Green reviewed the *Staff Report* with the Committee. Ms. Green stated that as of October 31, 2018 VPIC's composite assets under management were $4.3 billion. She indicated that each of the broad asset classes remain in line with targets, with the VPIC asset allocation at the end of October (by major asset class) projected to be 53%, 34%, 6% and 7% for equities, fixed income, real assets and absolute return (respectively). As a further point of detail, she noted that VPIC's current private equity exposure is 2.4%, while the long-term target allocation for that asset class is 10%.

On a motion by Treasurer Pearce, seconded by Karen Paul, the Committee unanimously approved maintaining the current allocations to the SSgA Barclay's Aggregate Bond Index and the PIMCO High Yield Fund.

Ms. Green provided an update on the Benefit Street Partners Senior Secured Opportunities Fund (SOF), including an update that the manager is being acquired by Franklin Resources, Inc. Ms. Green responded to questions from the Committee regarding the manager and the proposed acquisition.

Ms. Green provided an update on the Pinnacle Natural Resources, L.P. Fund.

On a motion by Vaughn Altemus, seconded by Treasurer Pearce, the Committee unanimously instructed Staff to redeem the current value of VPIC's July 1st, 2016 contribution to the Pinnacle Natural Resources, L.P. Fund, at that contribution's anniversary date of July 1, 2019.

Mr. Cook provided an update to the Committee on recent cash flows processed by Staff.

ITEM 6: **Discussion Items and Updates**

- **NEPC, LLC Update**

Mr. Forde presented the *October 2018 Preliminary Investment Summary* and responded to questions from the Committee.

- **Fee Review**

Ms. Belmondo presented the *NEPC Manager Fee Review* and responded to questions and concerns raised by the Committee. Ms. Green then presented the Staff compiled *VPIC Fee Study* and responded to questions from the Committee.

- **Portfolio Investment Review FY1Q19**

Ms. Belmondo presented the *First Fiscal Quarter 2019 Investment Performance Analysis* and responded to questions from the Committee.

- **Proxy Voting Policy Review**

Ms. Green presented the *2018 Proxy Voting Experience* as compiled by Institutional Shareholder Services, VPIC's proxy voting vendor. She then requested direction form the Committee regarding the proposed changes to both the VPIC International and Domestic Proxy Voting Policies.

Chair Golonka created an ad hoc Sub Committee to review VPIC's domestic and international proxy voting guidelines, Treasurer Pearce, Joseph Mackey, and Jeff Briggs were appointed to this Sub Committee.

ITEM 7: NEPC/Staff Deliverables for Upcoming Meetings

- The Committee requested that Staff work with NEPC to develop a review of various fixed income allocation options that would best fit the three sub-plans' asset/liability profiles. The Committee requested that the review include a joint recommendation by Staff and NEPC for an allocation to fixed income specific to each sub-plan, which could possibly take the form of a long term glide path.
- The Committee requested that NEPC, LLC bring a revised Benchmarking Review to a later meeting providing a detailed presentation of the asset allocations employed by the top quartile of fund performers in the Investor Force <$5 Billion Public Fund Universe. Further the Committee requested that Staff update a Peer Review which was undertaken several years ago with the objective of investigating the possibility of creating a custom benchmark of funds that have similar characteristics to VPIC.
- The Committee requested that NEPC and Staff work together to present a detailed Index Provider Search Book focused on Blackrock, Mellon Capital, Northern Trust and State Street Global Advisors to be presented at a future VPIC meeting.

ITEM 7: Future Agenda Topics/New or Other Business

There was no discussion regarding this agenda item.

ITEM 8: Public Comment

None.

ITEM 9: Adjournment

Treasurer Pearce moved, and Jeff Briggs seconded, that the meeting be adjourned. The Committee unanimously approved the motion to adjourn the meeting at 11:34 a.m.

Respectfully submitted,

Investments Staff

Attachment A

Elizabeth A. Pearce
State Treasurer

Retirement Division
Tel: (802) 828-2305
Fax: (802) 828-5182

Unclaimed Property Division
Tel: (802) 828-2407

Accounting Division
Tel: (802) 828-2301
Fax: (802) 828-2884

STATE OF VERMONT
OFFICE OF THE STATE TREASURER

TO: Vermont Pension Investment Committee

FROM: Eric Henry

RE: Chief Investment Officer Report

DATE: November 20, 2018

Opportunities to simplify the portfolio and reduce fees:

As you know, we are approaching another asset allocation study and we plan to undertake it with the following strategic intents:

- The asset allocation for each pension plan should be aligned with its demographic and funding characteristics.
- All things equal, less complicated strategies are supportive of stronger risk management. We should understand what risks we are taking in the portfolio and how we are being compensated for those risks.
- Investment manager fees should be optimized so that we understand the value we receive for those fees.

NEPC's Monte Carlo models will help us understand the first intent, strategic alignment. The other two intents, optimization of fees and risk management, will evolve as we implement any recommendations coming out of the asset allocation study.

To date, we and NEPC have identified areas of the portfolio where we can simplify our investment strategies and optimize fees. Lowering fees should not be a standalone investment goal; instead, we must understand how we are being rewarded for the fees we do pay. For example, we pay industry standard fees of 2%, plus a carry and a fund-of-fund fee in our private equity allocation, but we believe we are rewarded with an illiquidity premium. Investors measure the illiquidity premium by comparing the return on illiquid assets with that of like cash flows invested in a relevant public benchmark. NEPC will begin supplementing our performance analysis reports with these public market equivalent (i.e. cash flow weighted) index returns to show the size of our illiquidity premium.

One area that does appear to present an opportunity to simplify and reduce fees in the short run, without sacrificing outsized returns, is our allocation to absolute return strategies. These strategies include Allianz Structured Alpha, Grosvenor, and Pinnacle Natural Resources.

Allianz Structured Alpha is an overlay strategy that strives to deliver returns non-correlated to traditional markets and that seeks to maximize performance in any environment with a target real return of 5-10% over the beta source. This was implemented through an alpha and beta sleeve when VPIC first hired Allianz with the beta as a synthetic 10-year treasury position that was rolled on a quarterly basis. The alpha is a sleeve of long and short European options on equity indices that are held to expiration. The VPIC shed the beta sleeve in 2016 due to the added complexity.

Allianz charges a performance fee of 30% of returns in excess of the 90-day T-Bill return. Returns over the 1, 3, 5, 7, and 10-year periods were 3.5%, 5.3%, 6.7%, 7.7%, and 7.6%, respectively, net of fees.

Grosvenor is a fund-of-hedge-funds that invests with a broad mandate in multi-strategy portfolios. The VPIC invested in this exposure for capital preservation during challenging market environments. They expect low volatility and low correlation to global equities and fixed income markets over a 5-7 year period. The fund is considered "absolute return", able to weather on a risk-adjusted basis most market environments. The fund targets an annualized return of 90-day T-bills +5-10% with 8% volatility and a beta vs the S&P500 of less than 0.20. The exposure categories include: Credit (target 20-25%), Relative Value (target 15-20%), Multi-Strategy (3-10%), Event Driven (7-12%), Macro (8-10%), Commodities (2-5%), and Equities (25-30%). The fund invests globally.

The portfolio invests in proprietary funds under the name Grosvenor Capital Management (GCM), which can be of size and often are in the top 10 portfolio fund allocations (14% in aggregate as of 10/1/18). The fund typically holds approximately 50 portfolios across 25-40 unique investment managers. As of 11/1/18, the largest investment in any one investment manager is 7.9% to Citadel. The top 10 investment managers account for 40% of the portfolio assets. The firm with assets of $52bn, manages $27bn in hedge fund mandates (as of 10/31/2018) and of that the fund is $4.8bn. As reference, over the last three years the fund has seen a decline of $1.1bn ($5.9bn as of 11/1/15).

Grosvenor charges a .87% management fee plus 1.33% on underlying funds, plus a performance fee of 17.27% of gross returns in excess of a modest hurdle rate. Performance over the 1, 3, 5, and 7-year periods was 6.4%, 4.3%, 4.1%, and 5.7%, respectively, net of fees.

Pinnacle is a fund-of-funds that invests in long/short commodities; we invested in June 2016. Pinnacle charges a fee of 1% plus 10% of gross returns above a high-water mark, plus fees on underlying funds. Performance over the three month and one-year periods was 1.2% and 11.3%, respectively, net of fees. Pinnacle is an illiquid and opaque strategy. Funds invested are subject to a three-year lockup. Distribution requirements are complicated, as outlined in the staff report, and require significant advanced planning. While Pinnacle's 1-year number is strong, their return pattern tends to be somewhat volatile. As of December 31, 2017, Pinnacle's 1-year return was -7.3.

Last year, we paid approximately $4.5 million in fees on these three absolute return strategies. Redeploying these assets to passive strategies would significantly reduce related asset management fees. We are working with NEPC to assure that doing so would not negatively impact long term returns or risk.

Asset Allocation Study:
In the upcoming asset allocation study, we will be looking at three primary scenarios:
First will be an analysis of the portfolio allocation targets as they stand today. That portfolio has a 30-year expected return of 7.5% and an expected standard deviation of 12.5%.

Second will be an analysis of what the portfolio would look like without an absolute return allocation. This scenario will show us what to expect overtime without Grosvenor, Allianz, or Pinnacle. The assets currently allocated to these strategies would simply be allocated across the remainder of the portfolio. All things equal, we expect this to generate a simplified portfolio and a lower fee level.

Third, we will be analyzing the impact of implementing a broadly diversified indexed passive equity core. If we think about relying on passive strategies for half of our equity exposure as a starting point, then half of our equity return should be equal to the broad market's return. Whether we use a mix of indices to replicate the market's beta, or a global index like the MSCI ACWI IMI, it is relatively easy to replicate global equity returns for just a few basis points. In comparison to average active equity manager fees well north of 50 bp, we would expect to see a reduction in investment manager fees.

The attached spreadsheet shows our current mix of assets and a hypothetical implementation of the two "what if" scenarios described above. **It is hypothetical and for discussion purposes only.** A comprehensive discussion should be informative as we undertake an asset allocation study.

Next Steps:
As we look ahead, potential next steps framed around the strategic intents outlined above could include the following:

- **Finalize asset allocation study** (Jan-Mar)
- **Re-evaluate absolute return allocation** (Dec-Mar, concurrent with study)
- **Consider implementing a passive equity core** (Dec-Mar, concurrent with study)
- **Rationalize and size active equity managers vis-à-vis passive core** (Apr-Sep)
- **Review downside protective strategies and consider supplements to core fixed income** (Jul-Dec)
- **Review inflation protective strategies and consider supplements to TIPS and core real estate** (Jul-Dec)
- **Optimize private equity fees to assure value** (2020-2021)