South Carolina Retirement System Investment Commission
Meeting Minutes

June 13, 2019 9:30 a.m.
Capitol Center
1201 Main Street, 15th Floor
Columbia, South Carolina 29201
Meeting Location: Presentation Center

Commissioners Present:
Dr. Ronald Wilder, Chair
Dr. Rebecca Gunnlaugsson, Vice Chair
Ms. Peggy Boykin, PEBA Executive Director
Mr. Allen Gillespie
Mr. Edward Giobbe
Mr. Reynolds Williams (Via Telephone)
Mr. William H. Hancock
Mr. William J. Condon, Jr. (Absent)

I. CALL TO ORDER AND CONSENT AGENDA

Chair Dr. Ronald Wilder called to order the meeting of the South Carolina Retirement System Investment Commission ("Commission") at 9:30 a.m. Mr. William Hancock made a motion to approve the proposed agenda as presented, Dr. Rebecca Gunnlaugsson seconded the motion, which was unanimously approved.

Mr. Edward Giobbe made a motion to approve the amended minutes from the February 21, 2019 Commission meeting and the draft minutes from the April 11, 2019 Commission meeting. Dr. Gunnlaugsson seconded the motion, which passed unanimously.

II. CHAIR'S REPORT

The Chair reported that his report would be presented in Executive Session.

III. AUDIT & ENTERPRISE RISK MANAGEMENT COMMITTEE REPORT

Mr. Hancock, Chair of the Audit & Enterprise Risk Management Committee ("Committee"), began his report by stating that the Committee met on June 4, 2019. He reported that, during the meeting, a compliance update was provided, and no material exceptions were noted. In addition, an update on the continuing buildout of the South Carolina Retirement System Investment Commission's ("RSIC") Enterprise Risk Management function was received.

Next, Mr. Hancock noted that an Internal Audit update was provided. The Committee was reminded about the Cash Management Implementation Review, which will likely take place in the latter part of calendar-year 2019. The Committee was also made aware that an agreed-upon procedures review of RSIC's cash disbursements and payroll functions will be conducted for the period ending June 30, 2018.

Mr. Hancock then explained that the Committee met in Executive Session to discuss the recently issued Request for Information ("RFI") for an internal audit and consulting services vendor. Following Executive Session, the Committee voted to select and begin contractual negotiations with one of the vendors. The name of the vendor will be announced to the Commission following the completion of contractual negotiations. Mr. Hancock further explained that the Committee is planning for the vendor to conduct a risk assessment and present a three-year audit plan for approval by the Committee at its August meeting. Thereafter, the vendor will begin executing on the three-year audit plan.

Mr. Hancock concluded by stating that the Committee received presentations on the South Carolina Retirement Systems' Valuation Policy and Procedures as well as RSIC's and Albourne's Operational Due Diligence Procedures.

IV. CEO'S REPORT

Mr. Hitchcock noted that the General Assembly approved the RSIC's fiscal year budget for 2019-2020, which included the RISC's request to reduce the budget by $500,000 from the previous year. Mr. Hitchcock stated that the reduction reflected the RSIC's hard work and commitment to operating the agency as efficiently as possible.

V. CIO'S REPORT

Dr. Wilder recognized Mr. Geoffrey Berg, Chief Investment Officer, for his report. Mr. Berg introduced Mr. David King, Senior Reporting Officer, to provide the investment performance update through April 30, 2019. Mr. King noted that fiscal year to date ("FYTD") the Plan had returned 5.09 percent, versus the policy benchmark return of 4.86 percent. He noted that FYTD the Plan had paid out $929 million in net benefits including $376 million of final TERI payments The Plan's value at the beginning of the fiscal year was $31.3 billion, while its value as of April 30, 2019 stood at $31.9 billion.

Mr. King then turned to the Portfolio exposures versus the policy targets, stating that the Plan continued to hold an overweight in global public equity and cash, noting that this was offset by an underweight in core fixed income and credit. He stated that all asset classes were within the allowable ranges outlined in the Statement of Investment Objectives and Policies.

He then turned to a review of the Plan's market value over time. He noted that the Plan's market value as of April 30, 2019 was just under its previous peak in January 2018. Mr.

King noted that since RSIC's inception, the Plan had increased its assets by $6.3 billion and paid out $13.3 billion in net benefit payments.

Mr. King provided a brief review of FYTD performance, noting that almost all asset classes were positive, with strong returns in public REITS and public infrastructure. Looking at relative returns versus the policy benchmark, he noted that the Other Opportunistic allocation was the highest outperforming asset class, followed by private equity and equity options, while private infrastructure, portable alpha hedge funds, and mixed credit were underperforming versus the policy benchmarks.

The Chair noted that the Plan achieved one of its strategic plan goals by exceeding the assumed rate of return over the trailing three years and expressed his pleasure in seeing this occurrence. After a brief discussion, Mr. King concluded his report.

Mr. Berg stated that over the past two and half years, the Commission had spent a great deal of time formulating its approach to co-investing, resulting in a structuring of a private equity co-investment program. He formally announced the commencement of RSIC's partnership with GCM Grosvenor ("GCM"), which is expected to establish RSIC as a preferred limited partner with a reliable, organized, and streamlined decision-making process.

Mr. Berg then introduced Director Mr. James Wingo to provide a presentation on the co-investment platform. Mr. Wingo explained that, as part of its research, RSIC had assembled a very extensive database of transactions, which had helped the Investment Team develop a set of principles on how to approach the co-investment arena.

Mr. Wingo identified the three principles behind the rationale for investing in a co-investment platform in order to build both scale and diversification into the program:

- Co-investments are expected to improve the PE program's net returns without increasing risk;
- The selection of general partners ("GPs") is more important than selection of individual transactions; and
- RSIC's reputation and relationships are the keys to access attractive co-investment flow.

Mr. Wingo explained how these principles informed the process which RSIC and GCM will employ on the co-invest platform. This relationship will allow RSIC to take advantage of GCM's middle-market relationships, as well as utilizing GCM resources that are necessary to capitalize on RSIC's own transaction flow.

Mr. Wingo stated that one of the main goals of the partnership is to improve RSIC's competitive position amongst limited partners in order to build a diversified platform of co-investments, and he explained how the program will be structured so as to allow RSIC to meet the GP's most important goals when they allocate co-investments.

Mr. Wingo defined the important factors in the platform beginning with RSIC being responsive to GP's needs to have LPs with an efficient decision-making process. Secondly, he explained that GPs want to build strategic relationships with investors that can commit in size to their funds. Mr. Wingo noted that RSIC is currently underweight in private equity targets and there is an interest in building extensive primary relationships with new GPs and the program is focused on maintaining excellent communication and transparency with the GPs.

Mr. Wingo stated that another key aspect is flexibility in sizing. The current target sizing is between $10 and $30 million and the partnership retains the flexibility to capitalize on opportunities that are outside that band. Mr. Berg stated that this partnership is going to be a way to improve returns without increasing risk through the reduction of cost. In response to a question from Mr. Gillespie, Mr. Berg explained that the long-term objective is for every dollar invested into private equity, 33 cents would be in co-investments.

After a discussion of past and projected costs related to private equity investments, Mr. Berg stated that the GCM platform should eventually save RSIC tens of millions in fees every year. Mr. Hitchcock added that the platform's fee savings translate into improved returns. There being no further questions, this concluded the CIO's report.

VI. PORTFOLIO FRAMEWORK PROPOSAL

The Chair introduced Mr. Hitchcock and Mr. Berg for the portfolio framework proposal discussion. Mr. Hitchcock recognized Mr. Wingo, Mr. Berg, as well as Messrs. Frank Benham and Aaron Lally, from Meketa Investment Group ("Meketa"), for their hard work on this project. He stated that since the last Commission meeting, Meketa and Staff had worked diligently to make significant progress on the proposed portfolio framework. Mr. Hitchcock noted that the information being presented was to generate conversation and move the Commission towards a consensus on the major decisions that will have to made in order to adopt and implement this framework. He explained that he would like the portfolio framework to become a part of the Statement of Investment Objectives and Policies ("SIOP").

Mr. Berg began by outlining the topics that would be discussed as part of the portfolio framework topic: (1) portfolio simplification; followed by (2) samples of draft performance reporting; (3) a benchmarking discussion with input by Meketa; and finally, (4) a discussion of the time frames appropriate for evaluating investment decisions. Mr. Berg noted that there would not be a vote taken on the topics; rather, he reiterated that the goal was to help the Commission begin to form a consensus.

(A) <u>Portfolio Simplification</u>

Mr. Berg stated that currently the portfolio consists of 19 asset classes or sub-asset classes that have a target weight in the portfolio, and 21 underlying benchmarks. He noted that six of these asset classes have a target weight of 2 percent or less, and indicated that Meketa's work (initially presented in February) suggested that simplification could yield lower volatility without reducing the portfolio's expected return. Mr. Berg explained that the simplified policy portfolio would have less complexity than the current policy, relying upon five or six major asset classes. He noted that this simplified policy portfolio would serve as a home base and would provide a very straightforward way to weigh any decision to use a more complex approach: if Staff decided to move away from home base, it should be done only if an improvement in returns or a reduction of risk was expected. Mr. Berg directed the Commission's attention to a depiction of the 19 asset classes in the current portfolio (not including cash) and the condensing of those asset classes, first into 11 asset classes ("Mix A" or the "simpler portfolio") and then further consolidated to five major asset class groupings plus portable alpha ("Mix B" or the "simplest portfolio"). He explained the simplest portfolio is projected to have the same return as the current portfolio, but with lower volatility. The Chair asked if all the sub-asset classes continue to be included in the portfolio, why the returns were different in the simpler portfolio. Mr. Berg responded by stating that the return improvement from Mix A to Mix B came from the reduction or elimination of certain strategies, including the reduction of credit as well as the elimination of GTAA as a target from the portfolio. As an example, Mr. Benham noted that reducing certain credit-related risks and making Mix B's Bond asset class more core-oriented resulted in an overall reduction of risk, and an improvement in returns. He noted that the Commission's assignment of benchmarks, as well as the weights assigned to those benchmarks, would indicate where the Plan's default position will be. Mr. Berg explained that in the simplified home base portfolio, the use of investments such as REITs and equity options would be measured to determine whether or not Staff's implementation decision had increased returns and/or lowered risk.

Ms. Boykin stated that the simplification makes a lot of sense, and it makes sense for Staff to be able to evaluate decisions to deviate from that simplified benchmark.

(B) <u>Performance Reporting</u>

Mr. Berg commenced the discussion of performance reporting by emphasizing that the slides presented at the meeting were stylized examples of reporting, noting that an extensive amount of work needed to be done to provide both the Commissioners and the CIO with the performance analysis information they would need to oversee the portfolio according to the proposed portfolio framework. Mr. Berg pointed out that good performance reporting should make it easy to find the right question to ask.

Mr. Berg then discussed the performance analysis framework. He first identified the three key measures of the performance analysis framework - the value from diversification, quality of portfolio structure, and quality of implementation – that would help both the Commissioners and the CIO assess whether and how Staff's implementation decisions added value as compared to (a) the two-asset reference portfolio and (b) the simplified policy benchmark portfolio. Mr. Berg summarized these three key components as follows.

- Value from diversification: the goal of reporting is to help assess whether a diversified portfolio (that is, the simplified policy benchmark portfolio selected by the Commission) produced better returns than the simple, two-asset Reference Portfolio.

- Quality of portfolio structure: Mr. Berg explained that two categories of portfolio structure decisions cause the portfolio to look differently than the policy benchmark portfolio: (i) if the portfolio has an overweight or underweight to an asset class; and (ii) if an asset class is constructed differently than the benchmark. The goal here is to help assess whether these decisions added value.

- Quality of implementation: Mr. Berg explained that the goal of reporting on this score is to help assess whether the external managers have added value versus expectations (measured in the form of a benchmark appropriate to the manager's mandate).

A wide-ranging discussion ensued. In concluding this portion of his presentation, Mr. Berg stressed that, while the reporting provided to the Commission would ultimately look simpler, there is a great deal of complexity in creating the reports. He recommended that in future meetings the performance reviews alternate between short-term and long-term performance reviews, with all meetings including a review of asset class overweight/underweight positions.

Mr. Berg then presented suggested timeframes for thinking about and judging the quality of different investment decisions. He explained that one can draw different conclusions from evaluating outcomes over short vs. long periods of time. He stated that even the optimal Policy Benchmark Portfolio (over 30 years) will at times appear sub-optimal through a short-term lens but noted that practical limitations prevent serious consideration of ten or 20-year evaluation periods. Accordingly, Staff recommended the following proposed timeframes: value from diversification, five years; quality of portfolio structure, three years; and quality of implementation, three years.

A break was taken from 10:55 a.m. until 11:09 a.m.

Before moving on to the topic of benchmarking, Mr. Berg briefly discussed portable alpha, and explained the program is a way of implementing certain asset class exposures. Mr. Berg posed the question to the Commission as to whether they wanted to (a) continue to have portable alpha be a part of the policy benchmark portfolio, which would make the Commission responsible for the decision whether to use portable alpha, or (b) place portable alpha in the implementation benchmark, making the CIO fully responsible for any use, and performance impact, of portable alpha.

Mr. Giobbe asked Mr. Berg to elaborate more on portable alpha and how it had been used in the last few years. Mr. Berg responded by noting that the Plan had been using portable alpha since July 1, 2016 and explaining that portable alpha entails a marriage of a beta source with an alpha engine. He stated that portable alpha had been used in approximately ten percent of the portfolio, and praised the work done by Mr. Bryan Moore, Managing Director, to reduce the risk in the portable alpha program. He also noted that the

Retirement System's actuaries had assigned a value to portable alpha separate and distinct from the rest of the Plan.

Mr. Hancock asked the other Commissioners whether they would like to discuss this issue, move it to an implementation benchmark or leave it the same. Mr. Gillespie stated that he was of mixed minds because of portable alpha's leverage characteristics, but then stated that he was inclined to keep portable alpha out of the policy portfolio. After further discussion, the Commissioners arrived at a consensus that portable alpha should come out of the policy benchmark and become part of the implementation benchmark.

Benchmarks

Mr. Berg noted that Meketa is exploring different approaches to benchmarking private market asset classes (including private equity, private debt, real estate) and portable alpha hedge funds, as well as the topic of whether a policy benchmark should employ the 'opportunity cost' or simply the actual performance of an appropriate benchmark. Meketa will offer recommendations at the Commission's September 2019 meeting.

(C) Asset Allocation Discussion

Mr. Berg introduced Mr. Wingo to provide the asset allocation presentation. Mr. Wingo identified three key issues: (1) setting the appropriate level of risk for the Plan through selection of the Reference Portfolio; (2) considering appropriate directions of portfolio migration from the perspective of changes to expected risk and return; and (3) confirming a number of portfolio themes consistent with the Plan's directional goals.

Mr. Wingo identified four key factors that influence the appropriate level of risk:

- the Plan's assumed rate of return (maximizing the probability of meeting or exceeding the Plan's assumed rate of return);
- the Plan's funding ratio (maximizing the probability of achieving full funding levels within a given period of time);
- Plan contribution rates (minimizing the probability of having to raise contribution rates); and
- Plan tail risk (minimizing the probability of catastrophic Plan outcomes).

Mr. Wingo discussed these four risk factors, explaining how each affects the Plan. He discussed how both the current Plan and Mix B (the simplest portfolio) compared to peers. There was a discussion between the Commissioners and Messrs. Hitchcock and Berg regarding the value proposition of different potential directional movements Commission's migration to a more simplified portfolio.

Mr. Wingo noted that a 70 percent equities / 30 percent bonds portfolio appeared to best approximate the Plan's risk target. A lengthy discussion among the Commissioners ensued.

(D) Asset Allocation Discussion with Meketa

Mr. Benham directed the Commissioners to the portion of Meketa's asset allocation discussion dealing with the Reference Portfolio. He first summarized the purpose and composition of a reference portfolio, and then noted that Meketa and Staff had agreed to use global equities and domestic bonds for the Reference Portfolio. Mr. Benham noted that Meketa selected global equity for the equity portion of its recommended reference portfolio because it represents a fair expression of the opportunity set of liquid, commonly invested and risky assets. With respect to bonds, he explained that U.S. Treasuries serve as a long-term, "risk free" asset, although they do contain some inherent interest rate risk. Based on the current asset allocation targets, Mr. Benham stated that Meketa believes that the mix that most closely resembles the risk of the portfolio would be a 70 percent global equity and 30 percent U.S. Treasury benchmark. He then noted that Messrs. Berg and Hitchcock had asked Meketa to look back at the Portfolio over the last five years to determine what the closest reference portfolio would have been historically. Mr. Benham explained that the Commission's reference portfolio would have been much more conservative just a few years ago, more closely resembling a 60/40 mix, but then gradually evolving to 65/35 and now to 70/30 as a result of the Commission's changes in asset allocation.

Mr. Benham noted that Meketa supported Staff's efforts to develop a simplified portfolio but stressed two things: (a) no changes are needed at this time, as the current portfolio is very efficient as currently structured, and (b) making frequent asset allocation changes can be detrimental to long-term goals. On the latter score, Mr. Benham reminded the Commissioners of the survey it had presented at the Commission's February 2019 meeting regarding the frequency of asset allocation changes of peer plans, noting that the vast majority of the plans Meketa advises revisits asset allocation only every three to five years. Meketa believes that asset allocation should be viewed as a strategic, long term decision by a board, with staff given the latitude to make shorter-term tactical decisions.
Mr. Benham then reviewed other asset allocation-related concepts and themes, including embracing simplicity at the policy level (noting that most peer plans set policy targets for ten or fewer asset classes).

Areas of Consensus

Mr. Hitchcock summarized the Commission's deliberations. He first summarized the consensus that had been reached regarding portable alpha's inclusion in the implementation benchmark. Mr. Hitchcock observed a consensus among the Commissioners with regard to using the 70/30 portfolio recommended by Meketa and Staff as the Reference Portfolio. As to the extent and type of simplification which the Commission would like to see, it was the consensus of the Commission that Staff and Meketa should conduct further work, including building out a revised reporting framework, based on Mix B (the simplest portfolio) without portable alpha, as the starting point for further consideration of the portfolio framework.

VII. DELEGATED INVESTMENT REPORT

Mr. Berg noted that two delegated investments had closed since the last Commission meeting, a private equity investment with TA Associates XIII ("TA"), which closed on May 2, 2019 in the amount of $75 million, and an infrastructure investment with Actis Long Life Infrastructure Fund in the amount of $75 million, which closed on April 30, 2019.

VIII. EXECUTIVE SESSION

Mr. Gillespie moved that the Commission recede into Executive Session to discuss investment matters pursuant to S.C. Code Sections 9-16-80 and 9-16-320; and to receive advice from legal counsel pursuant to S.C. Code Section 30-4-70(a)(2). Mr. Hancock seconded the motion, which passed unanimously.

IX. POTENTIAL ACTION RESULTING FROM EXECUTIVE SESSION

The Chair reported that the Commission took no action in Executive Session.

X. ADJOURNMENT

After Executive Session, the meeting adjourned by unanimous consent at 1:52 p.m.

[Staff Note: In compliance with S.C. Code Section 30-4-0, public notice of and the agenda for this meeting was delivered to the press and to parties who requested notice and were posted at the entrance, in the lobbies and near the 15th Floor Presentation Center at 1201 Main Street, Columbia, S.C.,3:45 p.m. on June 10, 2019]