South Carolina Retirement System Investment Commission
Meeting Minutes

November 8, 2018 9:30 a.m.
Capitol Center
1201 Main Street, 15th Floor
Columbia, South Carolina 29201
Meeting Location: Presentation Center

Commissioners Present:
Dr. Rebecca Gunnlaugsson, Chair
Dr. Ronald Wilder, 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.

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. Edward Giobbe made a motion to approve the proposed agenda as presented. Dr. Rebecca Gunnlaugsson seconded the motion, which was approved unanimously.

The Chair requested a motion to approve the draft minutes from the Commission's meetings held on June 14-15, 2018 and September 13, 2018. The minutes were unanimously approved.

II. CHAIR'S REPORT

The Chair presented the proposed 2019 Meeting Schedule. Mr. Bill Condon suggested that the Commission meet more frequently in order to have more time to discuss the Annual Investment Plan (AIP) and the Statement of Investment Objectives and Policies (SIOP). Mr. Michael Hitchcock, Chief Executive Officer, suggested providing educational sessions between the meetings or holding a two-day meeting prior to the May statutory deadline to adopt the AIP. After further discussion, Mr. Condon requested that the Commission add February 8, 2019 to the proposed meeting schedule. Mr. Condon moved to amend the motion to adopt the 2019 schedule to add February 8, 2019 as an additional meeting date, which was unanimously approved by the Commission.

III. FIDUCIARY PERFORMANCE AUDIT REPORT - FUNSTON ADVISORY SERVICES, LLC

The Chair recognized Mr. Rick Funston, Funston Advisory Services, LLC and his Staff which was selected by the State Auditor to perform a statutorily required fiduciary audit of the Commission. Mr. Funston explained that his team had completed their second review of the Commission, the first review was conducted in 2014. He then introduced his team and their roles in the audit.

After the introductions, Mr. Funston reviewed the 2014 Fiduciary Audit Report which contained 126 recommendations with five overall themes. He noted that 110 recommendations have been fully implemented prior to the new audit, with nine substantially implemented. He stated that RSIC now has a strong leadership team lead by Mr. Hitchcock, the Chief Executive Officer who joined RSIC in 2015. He noted that the relationship between the Commission and General Assembly and the Commission and the State Treasurer's Officer had greatly improved under Mr. Hitchcock's leadership. He stated that the Commissioners are now more involved in the strategic implementation of the Plan, rather than the day to day operations of the Commission. The Audit and Enterprise Risk Committee and Human Resource and Compensation Committee had been were both created. He emphasized that the 2017 Chief Investment Officer Delegation Policy was added and had been beneficial to the Commission.

Mr. Funston stated that there was in methods and process to build trust and confidence within the Commission. He suggested that the Enterprise Risk Management position needed to be filled and explained in detail the importance of the enterprise risk function as a holistic approach across the entire agency. A brief discussion ensued regarding the mechanics of an enterprise risk function and different best practices approaches to staffing that function. Each member of Mr. Funston's team then briefly presented their findings for the 2018 Fiduciary Audit Report.

Mr. Funston complimented the Commission on its hard work since the first audit and noted that the new report contained only 52 recommendations to continue to improve and move toward more best practices in various areas. Lastly, the topic of the Commission becoming more strategic in its approach was discussed. Mr. Geoffrey Berg, Chief Investment Officer commented that it is a goal of the Commission to become more strategic at the Commissioner level. After a brief discussion of strategic planning and process, Mr. Funston concluded his report.

A break was taken from 10:48 a.m. to 11:00 a.m.

IV. AUDIT & ENTERPRISE RISK MANAGEMENT COMMITTEE REPORT

The Chair called the meeting back to order and introduced Mr. Hancock to report on the Audit and Enterprise Risk Management Committee. Mr. Hancock thanked the Chair and began his report by recalling that on October 24th he was selected as Chair of the Audit and Enterprise Risk Management Committee. Mr. Hancock noted that the committee would revisit the chair position on an annual basis. Mr. Hancock then reported that the September 30, 2018 compliance reviews are still in progress, and will be completed by the February meeting of the Commission. Mr. Hancock also noted that the manager compliance questionnaire reviews for fiscal year 2018 were received with a one hundred percent response rate, and that investment and compliance staff has reviewed all the responses.

Mr. Hancock then turned to internal audit matters. He relayed that the Audit and Enterprise Risk Management Committee had received the updates from the fiduciary performance review. Mr. Hancock also stated that CliftonLarsonAllen had been engaged to perform an agreed upon procedures review and the results were reported to the Committee. Mr. Hancock reported that the Commission is now in compliance with the CFA Institute's Global Investment Performance Standards (GIPS) for the year ending June 30, 2018, and will be seeking GIPS verification annually hereafter. Mr. Hancock noted that ACA Performance Services conducted the verification and tested areas around valuation, compliant presentations, composite construction, account returns, and policies and procedures.

Lastly, Mr. Hancock proposed future Audit and Enterprise Risk Management Committee meeting dates for 2019 as March 5th, June 4th, August 27th, and October 29th.

The Chair then asked if there were any comments or questions. Mr. Hitchcock recognized the actions of the Investment Performance and Reporting team for their hard work in achieving GIPS verification, and gave a special thanks to Director of Investment Reporting & Performance, Mr. Jon Rychener, for suggesting the project. Mr. Hitchcock explained that the GIPS verification is the gold standard of performance reporting and that the Commission is one of only a handful of pension funds to achieve that verification.

The Chair then thankedMr. Rychener and his Investment Performance and Reporting team and turned to Mr. Hitchcock and the CEO's report.

V. CEO'S REPORT

Mr. Hitchcock began his report with a discussion about the Statement of Investment Objectives and Policies ("SIOP"). Mr. Hitchcock reminded the Commission that he, Mr. Berg and Mr. Robert Feinstein, Managing Director, had been making efforts to substantially improve and update the SIOP. To that regard, Mr. Hitchcock noted that an updated SIOP had been posted for the Commissioners to review prior to the meeting, but recommended that approval of the SIOP be carried to the next meeting so that Commissioners would have more time to review the significant changes to the SIOP.

The Chair asked for a motion to carry approval of the SIOP over until the February 8th meeting date. Mr. Hancock made the motion, Mr. Condon seconded, and the motion passed unanimously.

Mr. Hitchcock continued with his report and suggested that the Commission consider whether to include in the SIOP an investment objective for the fund to meet a long term assumed rate of return of 7.25 percent. Mr. Allen Gillespie mentioned that he would like the SIOP risk return correlation table to include all the assets in the return table for the sake of internal consistency and to illustrate basic investment principles. Mr. Gillespie also mentioned that he would like to see more time spent on the rebalancing policy in the SIOP and asked Staff to give thought to rebalancing within asset classes versus the current approach. Mr. Gillespie lastly stated that he would like to see a more robust consideration given to how the rebalancing framework should look. Mr. Hitchcock concluded his report by acknowledging Mr. Gillespie's suggestions.

VI. CIO'S REPORT

The Chair recognized Mr. Berg to provide the CIO's Report. Mr. Berg then introduced Mr. David King, Senior Reporting Officer, to provide the performance update for the first fiscal quarter of the 2018-19 Fiscal Year. Mr. King began by announcing that the Portfolio returned 2.34 percent versus a policy benchmark of 2.53 percent. He reported that $458 million in net benefit payments had been made during the same period, and the Portfolio had gained $721 million from investment performance. Mr. King then provided an update on the Teacher & Employee Retention Incentive ("TERI") Program. Mr. King reported that, of the $458 million of net benefit payments the Plan has recently paid, $373 million constituted outstanding balances from the TERI Program, which are now fully satisfied.

Mr. Condon then inquired about how the conclusion of the TERI Program would impact the Plan's average benefit payments going forward. Mr. Hitchcock responded that the conclusion of the TERI Program would reduce average annual benefit payments. Ms. Peggy Boykin explained that the Plan has in recent years paid out over $3 billion in benefit payments. Of that amount, Ms. Boykin noted that the Plan has received over $2 billion in contributions (employer and employee), with investment returns expected to make up the difference. Ms. Boykin explained that the TERI Program ended on June 30, 2018, and consequently, the TERI Program participants were paid the remainder of their TERI-related benefits during the first quarter of the current FY. She stated that the conclusion of the TERI Program will have an impact on the Plan's cashflow but not the amount of regular retirement benefit payments due. Mr. Berg noted that the net benefit payments for the first quarter of the Fiscal Year were unusually low because additional funds flowed into the Plan as a result of contribution increases enacted by the South Carolina General Assembly. Mr. King stated that the additional funds amounted to more than $100 million. Mr. Berg underscored that the

TERI Program's conclusion reduces cash outflows and provides additional cashflow for new investment opportunities.

Mr. King moved onto a discussion of the Plan's policy targets. He noted that the Plan is currently within all asset allocation ranges set by the Commission and close to the policy targets. Mr. King reviewed the Plan's relative performance noting that (a) fiscal year-to-date, the Plan is in the 60th percentile in the BNYMellon universe rankings, and (b) with respect to the rolling three-year period, the Plan is at the 82nd and 83rd percentiles. Mr. Gillespie asked why the peer rankings were so widely dispersed. Mr. Berg replied that he believes the dispersion is caused by other pension plans carrying high levels of conservative assets as required by statutory limitations.

The Chair then asked Mr. King to consider putting both net benefits and receipts in separate bars in reports to the Commission going forward. The Chair stated that he believed doing so would provide a more accurate picture of the Plan's cashflow. Mr. King concluded his presentation by stating that October was a very volatile month in the equity markets. He explained that the All Country World Index was down almost eight percent and estimated that the performance estimate for the month was down about four percent. Mr. King added that the Plan's fiscal year-to-date return through October stood at approximately negative two percent.

Mr. Berg introduced the next item, a discussion of asset allocation principles. Mr. Berg indicated that the purpose of the discussion was to seek the Commission's feedback and support for RSIC Staff ("Staff") to work in collaboration with Meketa Investment Group ("Meketa") to integrate a fuller set of principles into the asset allocation process. He briefly discussed the current asset allocation planning process, and noted that this approach assumes the existing Portfolio is the optimal asset makeup, which results in broader questions not being asked. In addition, this approach does not answer the question of what is the optimal amount of risk for the Portfolio. Mr. Berg explained that by integrating the Plan's unique characteristics and defining the outcomes that should be avoided, the Plan can establish a risk limit for the Portfolio that will help build an asset allocation more reflective of the Plan's needs. Mr. Hitchcock then asked Mr. James Wingo, Director of Quantitative Solutions, to lead the discussion.

Mr. Wingo began by discussing how risk factors impact the Plan's overall asset allocation and highlighted two key risks. The first risk is that the Plan could be derailed from achieving fully funded status within 30 years. Mr. Wingo explained that focusing on this risk would require tailoring the asset allocation in a specific way. The second risk Mr. Wingo identified was that the Plan could experience net cash outflows equal to a large percentage of the Plan. Mr. Wingo explained that focusing on this second risk would require tailoring the asset allocation in another way. He also explained how other risks could be factored into the asset allocation process. Mr. Wingo suggested that the Commission would benefit from seeing a wide range of possible scenarios when considering asset allocation, in order to improve the likelihood of achieving the Plan's funding objectives.

Mr. Gillespie stressed the importance of taking a detailed look at the risk scenarios. Mr. Berg responded in the affirmative and stated that the fundamental question is for the Commission to define what really matters for the Plan. Mr. Berg explained that Staff has ideas about downside mitigation, but the Commission ultimately would need to agree on fundamental principles, so that the appropriate principles and parameters could be integrated by Staff and Meketa. He underscored the importance of having this discussion at the current time, given that markets may be coming to the end of a prolonged bull market cycle. Mr. Berg then explained that determining the Commission's overall goals is crucial because the goals of avoiding downside risk and getting the Plan to fully funded status can conflict.

Mr. Wingo explained that the risk framework being presented to the Commission was not a formal recommendation but a lens through which the Commission could think about analyzing its overarching goals. Mr. Wingo emphasized the importance of not focusing too much on one outcome.

Mr. Berg explained how the framework Mr. Wingo discussed factored into the General Assembly's setting of the assumed rate of return in the Act. Ms. Boykin added that, in 2021, a new experience study would be conducted and produce a new recommendation for setting the assumed rate of return. Mr. Berg opined that the General Assembly was very conservative in setting the current assumed rate of return, which improves the chances of the Plan being fully-funded in the long-term. Ms. Boykin stated that one of the Joint Committee on Pension Systems Review's goals was to make progress toward fully funding the Plan and limiting the impact of short-term market volatility. She also stated that it was a goal of the Joint Committee to impose higher contribution rates so that, even if short-term returns were lower in the initial ten years following the passage of the Act, the Portfolio would be fully funded in the 20 years thereafter.

Dr. Gunnlaugsson asked Mr. Wingo how the framework presented would inform decisions if, in another ten years, the Plan remains around 50 percent funded. Mr. Wingo responded that, at that time, the framework would have to be re-forecasted with a new set of assumptions. He cautioned against using the framework to forecast too far into the future because factors included in the assumptions will change over time. Dr. Gunnlaugsson then asked how the framework is useful to the Commission today. Mr. Hitchcock responded that the framework should be useful for the Commissioners from a strategic decision-making standpoint. The framework provides a list of risk factors the Plan should try to avoid and ensures those risk factors are appropriately considered when asset allocation decisions are made.

As the discussion concluded, Mr. Berg noted that, ultimately, asset allocation is a balancing act with multiple factors being considered within the constraints of what is statutorily permissible for the Plan. Mr. Hitchcock stated he would like this framework to be flexible enough to glean intelligence from what other pension plans are doing but ultimately make decisions that are the right fit for the Portfolio. The Chair suggested continuing the discussion at the Commission's next meeting and thanked Mr. Wingo and Mr. Berg for the presentation.

In the interests of time, the Chair suggested dispensing with the performance review for the Fiscal Year 2017-18 that was to be provided by Meketa. He stated that the Commissioners could review the materials provided by Meketa following the meeting, and the other Commissioners agreed.

A break was taken from 12:27 p.m. to 12:41 p.m.

VII. CONSULTANT REPORT

The Chair called the meeting back to order and gave the floor to Meketa Consultant Mr. Frank Benham who began a discussion on non-U.S. markets. Mr. Benham introduced the topic with an overview of the pros and cons of investing in assets outside the U.S.

Mr. Benham then shifted to give three reasons why investors should invest outside the U.S.: diversification, growth opportunities, and valuations. Mr. Benham explained each of these reasons to the Commission. He then looked to RSIC's current investments outside the U.S., and stated that RSIC is about 26 percent non-U.S. dollar. Mr. Benham then compared the RSIC plan average with the peer group average of 25 percent non-U.S. dollar, and said that the RSIC plan looks very similar to its peers. Mr. Benham finished the discussion of emerging markets by advising that RSIC continue to invest in emerging markets at its current exposure.

Mr. Giobbe asked whether Meketa's opinion on emerging markets considers a forward-looking approach, including variables like emerging middle classes coming into market power. Mr. Benham replied that Meketa's outlook does include forward looking variables, and replied that U.S. returns are still very strong including the forward-looking variables. Mr. Benham also referenced that an extremely strong dollar is impacting growth in emerging markets.

Mr. Condon then asked whether Meketa looked to public markets or private markets when looking at emerging markets. Mr. Benham replied that Meketa looks at both.

The Chair then asked Mr. Benham if Meketa projected currency fluctuations and in-county performance separately or blended multiple countries performance statistics together in Meketa's projection approach. Mr. Benham replied that they are done together, and caps currency effects at one percent.

Mr. Berg also asked whether Meketa had any long-term conclusions as to U.S. versus non-U.S. equity returns, should RSIC forecast more modest returns for non-U.S. equity, or is there a return to mean? Mr. Benham replied that he is not confident that the price earnings ratio is ever going to return to average, and Meketa does not recommend any changes to RSIC investment levels in emerging markets today.

Mr. Benham then switched to a discussion of currency hedging. Mr. Benham began by explaining that an investment in non-us dollar asset takes on the risk of investing in that currency, and the risk that that currency will fluctuate with the U.S. dollar in both the short term and in the long term. Mr. Benham then showed a chart displaying fluctuations of three percent per year on average.

Next, Mr. Benham discussed the cost of hedging. Mr. Benham said that, in theory, the cost of hedging is the difference between the interest rate in the home country and the foreign country, plus additional costs. Mr. Benham noted that historically, the cost of hedging emerging markets has always been positive, meaning it has always cost money to hedge. Mr. Benham then spoke to whether RSIC would have been better off hedging emerging markets exposure. Mr. Benham displayed a chart that showed that RSIC would have been decidedly better off leaving emerging markets unhedged, but it would have made sense to hedge RSIC's developed market portfolio from a risk return standpoint.

Mr. Benham then considered several methods of hedging if RSIC were to decide to hedge. Mr. Benham first explained that RSIC could have staff implement hedging in-house, however Mr. Benham noted that RSIC may not be currently prepared to perform that function. Mr. Benham also described that hedging could be done by hiring an external manager, have them passively hedge, and set up rules and guidelines. Mr. Benham contrasted passive external currency management managers by saying that active managers would be taking tactical views, which would engender active risk.

Mr. Giobbe then asked Mr. Berg whether RSIC has any significant amount of non-U.S., internally managed assets. Mr. Berg responded that RSIC has Non-U.S. exposure in overlay and exposure in removing currency that RSIC has affirmatively put on to mimic having actual securities in certain markets.

Mr. Berg continued to generally discuss non-U.S. currency hedging and cautioned that if the Commission does consider hedging more deeply, that the hedging would be phased in over several years, and to pick a point in the future to have built a hedge program for a certain percentage of RSIC's developed non-U.S. portfolio. Mr. Berg also cautioned that it would need to be determined exactly which portfolio components would be a candidate for hedging and which components would be less appropriate to hedge. Mr. Berg relayed that RSIC has between 20 and 25 percent non-U.S. asset exposure, and the majority of that is developed non-emerging. Mr. Berg then rephrased his statement and concluded that RSIC has about 22 percent of its portfolio with currency risk, and the overwhelming majority of that coming from the public equity fund.

Mr. Benham explained that the downsides to hedging are that it will make RSIC look different from its peers, adding additional tracking error and tracking error divergence from RSIC's benchmark-- which would make benchmarks and performance attribution more complex and hard to calculate. Mr. Benham also explained that it might be difficult to explain to RSIC stakeholders. Mr. Benham concluded by saying that from an academic perspective, it makes sense to hedge RSIC developed market exposure, not emerging markets, and that the Commission should think about engaging a strategic hedge for developed markets.

Mr. Berg asked Mr. Benham what the impact of implementing a strategic hedge would be compared to RSIC's peer group over a year long period. Mr. Benham replied that the difference on average has been 30 basis points per year, but it could be as much as 300 or 400 basis points in a given year versus the peer group.

Mr. Giobbe noted that non-U.S. currency markets can be hard to predict, and it might be better off for RSIC to not try to hedge them. Towards that sentiment, Mr. Berg proposed having RSIC staff observe and map out potential hedging strategies. Mr. Hancock agreed and suggested that RSIC staff back test through the different proposed methods. Mr. Gillespie agreed with Mr. Giobbe and said that he is generally against hedging. Mr. Berg said that he would have his team investigate and report back to the Commission in February. Mr. Gillespie reminded the Commission to consider that state-owned businesses may be disproportionately affecting the non-U.S. indexes.

The Chair thanked Mr. Benham and commented that his presentation adds to commissioner education, and it was very helpful. Mr. Gillespie added another comment to Mr. Benham's discussion by saying that it may help to consider individual businesses investments in emerging market countries, as a basis for whether to develop hedges in those countries overall. Mr. Gillespie added that he has seen that business' management teams are currently moving out of the U.S. in accordance with demographic shifts globally.

VIII. DELEGATED INVESTMENT REPORT

The Chair then recognized Mr. Berg for the delegated investment report. Mr. Berg noted that Staff had recently closed seven new investments. The investments closed and the amounts committed to each are as follows: Providence Equity Partners VIII L.P. ($150 million); Numeric Emerging Markets Small Cap Core Offshore Fund Ltd. (initial investment of $300 million, allocation is up to 1% of Plan assets); Hellman & Friedman Capital Partners IX, L.P. ($60 million); Brookfield Capital Partners V LP ($150 million); Brookfield Strategic Real Estate Partners III-B L.P. ($100 million); Owl

Rock First Lien Fund, L.P. ($200 million); and KKR Lending Partners III L.P. ($215 million) (collectively, the "Delegated Investments"). Mr. Berg referenced the recorded presentation materials for the Delegated Investments and entertained several questions from the Commissioners regarding the debt-related strategies.

IX. EXECUTIVE SESSION

Mr. Giobbe moved the Commission recede into Executive Session to discuss investment matters pursuant to S.C. Code Sections 9-16-80 and 9-16-320; to discuss personnel matters related to CEO's review of CIO's performance and CEO performance and compensation pursuant to S.C. Code Section 30-4-70(a)(1); and receive advice from legal counsel pursuant to S.C. Code Section 30-4-70(a)(2), which was seconded by Ms. Gunnlaugsson and was unanimously approved.

X. POTENTIAL ACTION RESULTING FROM EXECUTIVE SESSION

Upon return to open session Mr. Hitchcock noted that the Commission did not take any reportable action while in Executive Session and that any action that did occur while in Executive Session pursuant to S.C. Code Ann §9-16-80 and 9-16-320 would be publicized when doing so would not jeopardize the Commission's ability to achieve its investment objectives or implement a portion of the Annual Investment Plan.

XI. ADJOURNMENT

The Commission moved to adjourn, which was unanimously approved. The meeting adjourned at 5:46 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., at 5:02 p.m. on November 6, 2018]