INVESTMENT ADVISORY COUNCIL
Wednesday, May 9, 2012

MEETING NO. 395

Members present:	Janice (Jan) Carpenter Thomas Fiore, representing Benjamin Barnes* David (Duke) Himmelreich William Murray Denise L. Nappier, Treasurer** Joseph (Joe) D. Roxe, Chairman Carol Thomas Peter Thor***
Absent:	Thomas Barnes Michael Freeman Laurence N. Hale
Others present:	Jonathan Harris, Deputy Treasurer Christine Shaw, Chief of Staff Lee Ann Palladino, Chief Investment Officer Gary Carter, Interim Deputy Chief Investment Officer Donald Kirshbaum, Investment Officer-Policy Catherine LaMarr, General Counsel Shelagh McClure, Director of Compliance Terrence Purcell, Interim Principal Investment Officer Reginald Tucker, Investment Officer Linda Tudan, Executive Assistant Winifred (Winnie) Scalora, Administrative Assistant Ryan Ashley, Toigo Fellow
Guests:	James Atwater, Jr., Marathon Asset Management, L.P. Jennifer Thomas Becker, Armstrong Shaw Associates Inc. Jeanna Cullins, Hewitt EnnisKnupp, Inc. Mary Dunleavy, State Street Bank & Trust Theo Dunoyer, AXA Real Estate Investment Manager Sean Gill, NEPC Robin Kaplan-Cho, Connecticut Education Association Erik Knutzen, NEPC Louis Laccavole, SOC Teachers' Retirement Board Bruce Richards, Marathon Asset Management, L.P. Claire Shaughnessy, Hewitt EnnisKnupp, Inc. Nick Stanojev, BNY Mellon Alex Thomson, Woodcreek Capital Management Kevin Vandolder, Hewitt EnnisKnupp, Inc.

*** Arrived at 9:07 a.m.**
**** Arrived at 9:15 a.m.**
***** Arrived at 10:45 a.m.**

Chairman Joseph D. Roxe called the Investment Advisory Council ("IAC") meeting to order at 9:04 a.m.

Update on the Market and the Connecticut Retirement Plans and Trust Funds Final Performance for the Month Ended March 31, 2012

Lee Ann Palladino, Chief Investment Officer, provided an update on the capital market environment, its impact on the performance of the Connecticut Retirement Plans and Trust Funds ("CRPTF") and the economic outlook. Ms. Palladino began by commenting on several catalysts that created market volatility; she said that the most imminent risks to the economic outlook continued to be centered in Europe and the uncertainty of Greece's new government's commitment to the terms of the most recently negotiated bailout in March 2012. In addition, Ms. Palladino stated that several European countries had fallen into recession and that the situation in Europe was a concern for all investors including the CRPTF. With respect to the U.S., she commented that the very low interest rate environment, the stronger U.S. currency versus other currencies, and the risk-averse environment have proven beneficial for the CRPTF; but going forward, she added that the risks emanating out of Europe would likely have a negative impact on the capital markets.

Next, Ms. Palladino provided an executive summary on the CRPTF for the quarter ended March 31, 2012. In reviewing the one-, three-, five- and ten-year horizons, with the exception of the three-year period, she stated that all returns were below the 8.25% and 8.50% required rates of return. Ms. Palladino reported on the market value of the CRPTF and stated that as of March 31, 2012, the portfolio was at $24.7 billion. She further reported that the first quarter of the 2012 calendar year earned $1.8 billion for a gain of 7.38% for the quarter, with a performance of 1.13% fiscal year-to-date, 15% for the three-year return; and bringing the five-year return into positive territory. Chairman Roxe commented that the performance was still fairly negative relative to the benchmark.

Next, Ms. Palladino commented on the CRPTF's liability position that was used as part of the Asset/Liability Study ("A/L Study"). She noted that the net cash outflow was 4.1%, 5.4% and 1.3% for the TERF, SERF and MERF, respectively. Ms. Palladino reported that the Probate Judges Employees' Retirement Fund and the State Judges Retirement Fund were 141.5% and 64.9% funded, respectively; and yet they also had a negative outflow of cash for the quarter ended March 31, 2012. She stated that returns on investments were generated at the rate of $11.7 billion over the last ten years and that $662 million had been generated over the one-year horizon.

Ms. Palladino then provided the performance results for the TERF and noted that the long-term 24-year mark performance results were 8.06%, which was close to the target of 8.25%. She then commented on the performance of the remaining trusts and noted that over the extended period of ten years, interest rates had continually declined and as a result, the performance of the trusts were highly sensitive to movements in interest rates due to the 75% or higher allocation to fixed income. Chairman Roxe commended Ms. Palladino on her report.

Next, Kevin Vandolder, Principal of Hewitt EnnisKnupp, Inc. ("Hewitt") presented a quarterly report for the CIF. Mr. Vandolder began by highlighting the returns of the major capital markets for the annualized periods ended March 31, 2012.

Claire Shaughnessy, Associate Partner of Hewitt, provided a five-year attribution analysis for the period between 2007 and 2011 to explain the underperformance versus benchmark in the U.S. and non-U.S. equity portfolio for the five-year horizon. In her performance review for the Mutual Equity Fund ("MEF"), Ms. Shaugnessy said that after the market crisis began in 2007, the MEF diversified into active extension strategies and added managers to the Connecticut Horizon Fund ("CHF"), but quantitative strategies, which underperformed in 2009, weighed down performance results. She noted that the MEF outperformed its peers in 2011 due to the benefit of diversification. Discussion ensued in response to Chairman Roxe asking whether selection of managers or strategy caused underperformance. Relative to the Russell 3000, Chairman Roxe said that the MEF underperformed most of the past five years but not by significant amounts and that much of the underperformance was attributable to the selection of strategy rather than the selection of managers. Ms. Palladino stated that the universe being discussed included all the managers, both small and large-cap, and she noted the importance of understanding the universe to which the MEF was being compared in the quarterly reports. She said a comparison with other like-pension funds was necessary to determine how these funds were structured but most importantly, she said that determining and understanding the CRPTF's biases, strategies, demographics and liabilities was necessary when providing a comparison with other public pension funds. Chairman Roxe then asked for a comparison with other public funds at the meeting in June.

<u>Approval of Minutes of the April 11, 2012 IAC Meeting</u>

With a quorum present, Chairman Roxe asked for comments on the Minutes of the April 11, 2012 IAC meeting. **There being no comments, a motion was made by William Murray, seconded by Janice Carpenter, that the Minutes of the April 11, 2012 IAC meeting be accepted as drafted. The motion was passed with the exception of Mr. Himmelreich and Ms. Thomas who abstained due to their absence from the meeting.**

<u>Comments by the Treasurer</u>

Treasurer Denise L. Nappier began her remarks by updating the IAC members on the 2012 session of the Connecticut General Assembly and the revisions to the MacBride Statute, which is specific to the management of pensions and trust funds.

Next, Treasurer Nappier introduced Ryan Ashley, a Toigo Fellow working at the Office of the Treasurer ("OTT") during the summer of 2012. Treasurer Nappier said that Mr. Ashley would focus on the alternative asset class and perform analysis on private equity strategies. Mr. Ashley thanked Treasurer Nappier for her kind words, commented about his fellowship work, and stated that he looked forward to working with the OTT in the coming months.

Treasurer Nappier next commented on the investment performance of the CRPTF as of March 31, 2012. She noted that the three-month performance of 7.83% increased 57 basis points ("bps") from last month and, with the exception of the REF and PIF, all other funds exceeded or were just shy of meeting their benchmarks for the same period. Finally, Treasurer Nappier said that the best performance news for the month ending March 31, 2012 was another excellent three-year investment return at 15.16%.

Treasurer Nappier provided an update on the A/L Study and said that she expected to present the recommended Investment Policy Statement ("IPS") changes that resulted from the A/L Study at the June 13, 2012 IAC meeting. She stated that the OTT would provide public notice in late May, and she would likely adopt the IPS by the August IAC meeting, at which time it would be on the agenda for a vote by the IAC. Treasurer Nappier again thanked everyone for their hard work in moving toward finalizing the last, but very important phase in establishing the new asset allocations for the CRPTF's 14 pension plans and trust funds.

Next, Treasurer Nappier highlighted May's agenda. She said that proposed project plans to launch investment consultant searches for the REF and the AIF would be presented for consideration. She noted that the contract with OTT's current REF consultant, The Townsend Group ("Townsend"), was due to expire on February 28, 2013; the contract with OTT's current AIF consultant, NEPC, was due to expire on May 31, 2013; and neither agreement allowed for an extension of the contract. Next, Treasurer Nappier said that one of the CRPTF's current Public-Private Investment Program ("PPIP") managers, Marathon Asset Management, LLC ("Marathon"), would present an AIF opportunity, Marathon European Credit Opportunities Fund, L.P. ("Marathon ECO"). She added that this new fund was seeking up to $1.25 billion in commitments and would focus solely on European credit opportunities that arise due to the dislocations taking place in European sovereign, bank and corporate debt. Treasurer Nappier said that she was considering an investment of up to $50 million, for a first alternative investment in the opportunistic space. Next, she said that she would present for consideration a proposed project plan for the CHF-AIF fund-of-hedge fund manager search; as with the two searches previously mentioned, this competitive search would be conducted through an RFP. Treasurer Nappier commented that the expansion of the CHF into alternative investments flowed from the OTT's policy interest in conducting business in accordance with the Diversity Principles as a value-added proposition, and it also blends well with the CRPTF's investment objective to seek alpha on actively managed mandates. As a reminder, Treasurer Nappier said that the CHF public market program had outperformed its benchmark since inception in 2005 by 90 bps, with a market value of $729 million as of December 31, 2011. She noted that the more recent rollout of the PIF arm of the CHF had approximately $37 million of capital drawn and roughly $4 million distributed back to the CRPTF as of September 30, 2011.

<u>Consideration of the Search Process for a REF Consultant</u>

Ms. Palladino provided a project plan timeline and evaluation/selection criteria for a REF consultant. She said that Townsend was currently serving as the REF consultant and they assisted the CRPTF with performing due diligence, quarterly reporting and annual strategic pacing plans. Ms. Palladino reiterated Treasurer Nappier's comments that State procurement practices required a search every five years and that Townsend's contract was due to expire in February 2013. She stated that the last search was done in 2005, in response to the question posed by Ms. Thomas. Ms. Palladino then highlighted the screening and selection criteria. Chairman Roxe requested wording within the selection criteria to include specific references to the particular funds that were being searched. Treasurer Nappier commented that this information was already embedded in the criteria and throughout the due diligence process.

Chairman Roxe asked for a motion to endorse the search process for an REF consultant. **Mr. Himmelreich entered a motion to endorse the Real Estate Fund consultant search. Ms. Thomas seconded the motion. The motion was passed unanimously.**

Consideration of the Search Process for an AIF Consultant

Terrence Purcell, Interim Principal Investment Officer, provided a project plan timeline and evaluation/selection criteria for an AIF consultant. Mr. Purcell said that the timeline and evaluation/selection criteria paralleled the discussion that Ms. Palladino provided for the REF consultant search.

Chairman Roxe asked for a motion to endorse the search process for an AIF consultant. **Ms. Thomas entered a motion to endorse the Alternative Investment Fund consultant search. Mr. Himmelreich seconded the motion. The motion was passed unanimously.**

Chairman Roxe then confirmed the timing of the finalist IAC presentations on the searches and requested that a calendar of upcoming presentations be provided to the IAC members.

Presentation by and Consideration of Marathon ECO

Mr. Purcell provided opening remarks and introduced Marathon ECO, an AIF opportunity. He said that Marathon ECO was formed to take advantage of the dislocation and eventual recovery of European credit markets. Mr. Purcell reiterated Treasurer Nappier's comments about the CRPTF's commitment to Marathon's PPIP fund in 2009, and he noted that this fund had generated a double-digit net return to date. He said that Marathon ECO would be the first opportunistic investment in the AIF, which had a target allocation of 10% to opportunistic investments. He further commented on Marathon ECO's investment strategy, its total fund life, expected returns and fee structure. Next, Mr. Purcell spoke about the $30 trillion European distressed credit market opportunity across bank debt and asset sales, sovereign debt and corporate debt. He said that Marathon ECO's initial target would be European banks as a result of their forced deleveraging. Finally, Mr. Purcell said that Marathon's extensive experience in credit investing uniquely qualified the firm to pursue this opportunity and he commented on Marathon's cohesive investment team.

In response to Ms. Thomas' question regarding an investment in Marathon ECO, Sean Gill, Partner of NEPC and consultant for the AIF, said that the general partner did co-invest alongside the limited partners. Thomas Fiore asked about Marathon ECO's categorization as an AIF investment as opposed to a bond fund to which Ms. Palladino responded that this particular fund would not fit the parameters of the Core Fixed Income Fund, and that the IPS dictates that those investments which do not fit easily into other combined investment funds would be included as part of the AIF. Chairman Roxe noted that this type of investment did not have a typical J-curve and asked whether this was because Marathon bought deep discounted securities. Mr. Purcell responded that this fund was only similar to the private equity structure because of its finite life, but the actual implementation was much more similar to a hedge fund structure leading to immediate current income. Mr. Gill noted that the other distinction was that the management fee was only charged on invested capital. Discussion continued about historical returns for this type of fund. Chairman Roxe commented that the opportunity set was good, and Mr. Gill cited Marathon's experience with investing during volatile periods.

Presentation by Marathon

Marathon, represented by James Atwater, Jr., Managing Director, and Bruce Richards, Co-Managing Partner & Chief Executive Officer, made a presentation to the IAC. Mr. Atwater began by providing a brief history of the firm, and said that Marathon had been investing in Europe since early 2000. Next, he spoke about Marathon's flagship fund, Marathon Special Opportunities Fund and Marathon's positive PPIP performance for the CRPTF. Focusing specifically on European opportunities, Mr. Richards commented that Marathon ECO was positioned well as a pure-play dedicated fund to capitalize on European credit opportunities and said that the largest distressed opportunities globally over the next two to three years would be in Europe. He noted Marathon's main focus within the European debt markets and the banks' need to deleverage. In closing, Mr. Richards commented on the financial and operating challenges that drove corporate distress and defaults, and he said that Europe's $1.2 trillion of non-investment grade debt would cause default rates to increase and that would lead to opportunities. Finally, he said that Marathon, a distressed credit manager with a robust risk management platform based on integrity and best practices, was focused on investing its clients' capital at attractive rates of returns.

In response to Ms. Thomas, Mr. Richards said that it was still too soon to know how the recent elections in Europe would affect the European economy; he commented about the political atmosphere and economies in several of the European countries, namely Greece, France, Italy, Spain, Portugal, Ireland and Germany. In response to Chairman Roxe, Mr. Richards said that it was still too early to buy Greek sovereign debt, and he commented on the potential defaults and resulting opportunities in Europe.

Roll Call of Reactions to Marathon ECO

Chairman Roxe requested the IAC members to provide input on Marathon ECO. Mr. Fiore, Mr. Himmelreich, Mr. Murray, Ms. Carpenter, Ms. Thomas, Peter Thor and Chairman Roxe were all in favor of the commitment. Mr. Thor commented that there was some risk due to the unpredictable political upheaval, but he was still in favor of the investment.

Chairman Roxe asked for a motion to waive the 45-day comment period for Marathon ECO. **A motion was made by Ms. Thomas, seconded by Mr. Murray, to waive the 45-day comment period for Marathon European Credit Opportunities Fund, LP. The motion was passed unanimously.**

Consideration of the Search Process for the CHF-AIF Consultant

Reginald Tucker, Investment Officer, provided a project plan timeline and screening/selection criteria for a separate account fund-of-hedge fund manager for the CHF-AIF. Mr. Tucker said that this was a continuation of the successful build-out of the CHF program. In response to Chairman Roxe, Mr. Tucker indicated that the preferred structure is the separate account manager which will allow customization of the portfolio so that the CHF universe of smaller, women/minority-owned, Connecticut-based and new opportunities could be specifically targeted versus a general commingled fund.

Chairman Roxe asked for a motion to endorse the search process for a separate account fund-of hedge-fund manager for the CHF-AIF. **Mr. Thor entered a motion to endorse the fund-of-hedge fund manager search for the Connecticut Horizon Fund. Mr. Himmelreich seconded the motion. The motion was passed unanimously.**

Other Business

Chairman Roxe invited IAC members to submit agenda items for the June 13, 2012 IAC meeting.

Next, he said there was a litigation matter to be discussed with the IAC. Treasurer Nappier provided an update on pending litigation – three matters involving CRPTF's foreign securities and the malfeasants of others that led to related losses, including the U.S. Supreme Court's June 2010 ruling in *Morrison v. the National Australia Bank*, and said that the OTT is an active plaintiff. Catherine LaMarr, General Counsel, briefed the IAC on the three matters related to the *Morrison* decision. Ms. LaMarr stated that this was the first time the OTT was involved as an active plaintiff in four cases at one time. In April 2012, the Treasurer agreed to join with other public funds – North Carolina, Los Angeles County, Colorado, among others – to file litigation in Texas state court against British Petroleum ("BP"). Ms. LaMarr said that the Supreme Court case essentially wiped out nearly 50 years of jurisprudence that allowed U.S. investors to pursue actions with respect to securities fraud and other corporate malfeasance in U.S. courts, particularly with companies that had substantial operations within the U.S. As a result, Ms. LaMarr said that she was co-chairing a national committee of lawyers that is working to find solutions to the problems that have arisen since the *Morrison* decision. In response to Chairman Roxe, Ms. LaMarr said that the nature of the claim against BP is about common law fraud arising from certain statements by BP management with respect to safety issues and corporate policies on safety and facility operations. She added that the estimated loss for the CRPTF was about $20 million. In response to Mr. Thor, Ms. LaMarr stated that this type of litigation is often protracted, and the matter was filed in Texas state court as there were no avenues to pursue recovery in the United Kingdom. After *Morrison*, investors in foreign securities must pursue litigation outside the U.S. federal court system.

Comments by the Chairman

Chairman Roxe commented on the meeting. He next read the following resolution on behalf of former IAC member Sharon Palmer.

WHEREAS, *the protection and growth of the assets of the Connecticut Retirement Plans and Trust Funds (CRPTF) is essential to the future financial security of government workers and retirees of our State, as well as to the economic strength of the State of Connecticut; and*

WHEREAS, *the Investment Advisory Council is instrumental in the stewardship of the investment of the assets of the CRPTF; and*

WHEREAS, *the Investment Advisory Council and the Office of the State Treasurer wish to recognize Sharon Palmer for her outstanding contributions as a member of the Investment Advisory Council from July 1, 2000 through February 8, 2012; and*

WHEREAS, *during her 11-year tenure, Ms. Palmer helped the CRPTF to navigate through two severe economic downturns, and provided meaningful feedback and advice on nearly $5 billion worth of private equity and real estate commitments; and*

WHEREAS, *Ms. Palmer contributed countless hours to the work of several committees of the IAC, including Personnel, Asset Allocation, Education and Governance, thereby arming the CRPTF with the necessary tools to become more strategic in its investments; and*

WHEREAS, *Ms. Palmer's commitment to serve the people of Connecticut was demonstrated in her long-standing support for fully funding the State's pension obligations, and in her leadership in publicly endorsing efforts to reduce the unfunded liability of the Teachers' Retirement Fund, which resulted in the sale of $2 billion in Pension Obligation Bonds that strengthened the financial health of the Teachers' Retirement Fund; and*

WHEREAS, *the work of the Council has benefited from the overall diligence, keen insight, resourcefulness and resolve she exhibited in meeting the obligations of Council membership; and*

WHEREAS, *Sharon's sincerity, integrity and camaraderie will be greatly missed by her colleagues;*

NOW THEREFORE BE IT RESOLVED, *that the Investment Advisory Council and the Office of the Treasurer, for themselves and on behalf of the people of Connecticut, express their gratitude and deep appreciation, and acknowledge the substantial contributions of Sharon Palmer during her service as a member of the Council.*

Chairman Roxe stated that he and Treasurer Nappier signed the Resolution and presented it to Ms. Palmer on the 11th day of April 2012.

A motion was made by Mr. Himmelreich, seconded by Mr. Thor, to adopt the resolution that the Investment Advisory Council and the Office of the Treasurer, for themselves and on behalf of the people of Connecticut, express gratitude and appreciation and acknowledge the substantial contributions of Sharon Palmer during her service as a member of the Council. The motion was passed unanimously.

There being no further business, the meeting was adjourned at 11:50 a.m.

This meeting was recorded on audio tape.

Respectfully submitted,

DENISE L. NAPPIER
SECRETARY

Reviewed by

JOSEPH D. ROXE
CHAIRMAN