INVESTMENT ADVISORY COUNCIL
Wednesday, February 13, 2013

MEETING NO. 402

Members present:

Neil G. Budnick, Chairman
Janice (Jan) Carpenter
Thomas Fiore, representing Benjamin Barnes
Michael Freeman
Laurence N. Hale
Joshua Hall
David (Duke) Himmelreich
William Murray
Denise L. Nappier, Treasurer
Carol Thomas*

Absent:

Peter Thor

Others present:

Lee Ann Palladino, Chief Investment Officer
Gary Carter, Interim Deputy Chief Investment Officer
Gregory Franklin, Assistant Treasurer
Catherine LaMarr, General Counsel
Shelagh McClure, Director of Compliance
Joanne Dombrosky, Principal Investment Officer
Terrence Purcell, Interim Principal Investment Officer
Reginald Tucker, Investment Officer
Linda Tudan, Executive Assistant
Winifred (Winnie) Scalora, Executive Secretary

Guests:

Virgilio (Bo) Abesamis, Callan Associates, Inc.
Anthony Bookman, Heard Capital LLC
Robert Carroll, BNY Mellon Asset Servicing
Mary Dunleavy, State Street Bank & Trust Company
George Gilmer, BNY Mellon Asset Servicing
Sean Gill, NEPC
Will Greene, Loop Capital Markets
Jonathan Hogstad, Service Employees International Union
Suzanne Hopgood, The Hopgood Group, LLC
Robin Kaplan-Cho, Connecticut Education Association
Stephen Nazzaro, State Street Bank & Trust Company
Joseph Santoro, Deutsche Bank
Mark Schafer, State Street Bank & Trust Company
Claire Shaughnessy, Hewitt EnnisKnupp, Inc.
Johnson Shum, State Street Bank & Trust Company
Tim Smollen, Deutsche Bank
Nick Stanojev, BNY Mellon Asset Management

*** Arrived at 9:08 a.m.**

Mark Sullivan, BNY Mellon Asset Servicing
Ash Tahbazian, State Street Bank & Trust Company
Jennifer Thomas, Armstrong Shaw Associates Inc.
Anthony Toscano, Deutsche Bank
Kevin Vandolder, Hewitt EnnisKnupp, Inc.

With a quorum present, Chairman Neil G. Budnick called the Investment Advisory Council ("IAC") meeting to order at 9:02 a.m.

Approval of Minutes of the January 9, 2013 IAC Meeting

Chairman Budnick called for a motion to approve the minutes of the January 9, 2013 IAC meeting. **There being no comments, a motion was made by William Murray, seconded by Michael Freeman, that the minutes of the January 9, 2013 IAC meeting be accepted as drafted. The motion was passed unanimously.**

Comments by the Treasurer

Treasurer Denise L. Nappier began her comments by announcing her decision to commit, subject to successful contract negotiations, up to $20 million to Palladium Equity Partners IV, L.P. ("Palladium IV"), a Private Investment Fund ("PIF") opportunity. She reported that she rendered this decision after considering the feedback of the IAC and the due diligence conducted by investment staff and the PIF consultant, Franklin Park Associates, LLC. She added that she was reserving subsequent consideration of an additional commitment, not to exceed a total of $40 million. Treasurer Nappier said that Palladium IV was a private equity fund with a corporate finance strategy focused on lower-middle market companies that are in a position to benefit from the growth of the U.S. Hispanic market. Next, she announced that after giving consideration to the feedback from the IAC and to the due diligence process conducted by investment staff, she decided to rehire The Townsend Group for the Real Estate Fund ("REF") investment consultant to provide real estate investment services to the Connecticut Retirement Plans and Trust Funds ("CRPTF"), contingent upon successful contract negotiations.

Next, Treasurer Nappier made an announcement regarding one of the CRPTF's Emerging Market Debt Fund ("EMDF") managers, ING Investment Management Company ("ING"). She said that on January 28, 2013, her office was informed by ING that the emerging market debt team that managed the CRPTF's account, including both co-heads, was lifted out to a competing firm. After consideration of the analysis prepared by Pension Fund Management ("PFM") staff and general investment consultant, Hewitt EnnisKnupp, which outlined the significant organizational issues at ING Treasurer Nappier said she had terminated ING, and that the assets managed by ING were redeployed within the EMDF to two fully capable current emerging market debt managers, and that the overall risk-return profile of the EMDF would not materially change with the re-allocation of the assets.

Next, Treasurer Nappier commented that the CRPTF's performance for the calendar year ended December 31, 2012 with a return of 13.47% -- a very robust performance. Treasurer Nappier reported that both the Teachers' Retirement Fund ("TERF") and the State Employees' Retirement Fund ("SERF") posted slightly higher results, at 13.50% and 13.66% respectively, for the same time horizon, which far surpassed their respective actuarial return assumptions of 8.50% and 8.00%. She noted that the Municipal Employees' Retirement Fund ("MERF") also posted strong results, at 12.44% for the 2012 calendar year-end. She also said that the CRPTF's total market value once again pierced the $26 billion mark in January 2013.

On a separate note, Treasurer Nappier said that the State of Connecticut's ("State") Office of the Attorney General joined the U.S. Department of Justice ("DOJ"), along with 15 other states, in filing a civil lawsuit against Standard & Poor's ("S&P") and its parent, McGraw-Hill Companies, citing illegal behavior. She said that the complaint alleged that S&P knowingly understated the credit risks of mortgage bonds and derivatives products in the ratings it assigned to $2.8 trillion of residential subprime and other mortgage-backed securities and $1.2 trillion of collateralized debt obligations from September 2004 through October 2007; and, according to the complaint, S&P misrepresented to investors that its credit ratings were independent and uninfluenced by any conflicts of interests. Treasurer Nappier said that the DOJ was seeking penalties of about $1 million for each violation. She informed the IAC members that she would provide updates on the case as it continued to unfold.

Treasurer Nappier said that three semi-finalist firms for the global master custodian mandate would be presented for consideration. She remarked that this was a lengthy endeavor that included the hiring of a master custodian search consultant, Callan Associates Inc. ("Callan"). Treasurer Nappier indicated that the master custodian search was conducted through a competitive Request for Proposal ("RFP") process; the search plan and the selection and screening criteria were presented and endorsed at the September 12, 2012 IAC meeting. She commented that given the complexities and the evolution of master custodial services and responsibilities, the RFP allowed the respondents to submit proposals for full custody services or for any of the following mandates generally included within a full custody relationship, including: (a) securities lending components; (b) foreign exchange services and/or (c) risk management, performance measurement, reporting and analytics. Treasurer Nappier added that by doing so, the search committee was able to analyze responses to the unbundled and bundled mandates separately and to identify the best provider of services for the CRPTF. She said that three banks responded to the RFP, all of which are highly qualified and capable of providing the CRPTF with master custodian and custodian-related services, and that she was presenting all three banks for consideration: BNY Mellon Asset Servicing - a subsidiary of The Bank of New York Mellon Corporation ("BNY Mellon"), State Street Bank and Trust Company ("State Street") (both proposed to provide the full suite of custodial services); and Deutsche Bank ("Deutsche") (proposed to provide only securities lending services). She noted that the extensive due diligence was led by the Master Custodian Search Committee, which was comprised of staff from PFM, Cash Management, Legal, Compliance, and Callan.

Next, Treasurer Nappier commented on her press release concerning the Other Post-employment Benefits Trust Fund ("OPEB"). She said that the stated investment intent of the OPEB was long term and included a high discount rate used to calculate the present value of the unfunded liability; and in preparation for investing the OPEB's assets long term, the trust fund was designated as a trust of the CRPTF in January 2013 and subsequently transferred from the Short Term Investment Fund ("STIF") to the CRPTF's short bond duration fund, commonly known as the Liquidity Fund ("LF"), which had a higher yield than STIF.

Finally, Treasurer Nappier introduced Suzanne Hopgood, President and CEO of The Hopgood Group, LLC, consultant for corporate governance. Ms. Hopgood provided a brief update on the 2013 corporate governance activity. She said that this had been a very active shareholder resolution proxy season, and she commented on ten companies in which the CRPTF had invested that have shareholder resolutions to be voted during the 2013 proxy season. In response to Chairman Budnick, Ms. Hopgood said the main corporate governance theme was board leadership, followed by diversity and climate change, and she noted that the board leadership issue included transparency and say-on-pay.

Update on the Market, the Connecticut Retirement Plans and Trust Funds Final Performance, the Combined Investment Funds and Connecticut Horizon Fund Review as of December 31, 2012

Lee Ann Palladino, Chief Investment Officer ("CIO"), provided an update on the capital market environment, its impact on the performance of the CRPTF, and the economic outlook. Ms. Palladino spoke about PFM's detailed annual money manager review process. She said that the matters reviewed included: performance and fee analysis; firm organization; an assessment of investment guidelines change requests; annual compliance documentation; diversity profile; and review of legal disclosures. Ms. Palladino noted that this was a robust process that followed the requirements of the Investment Policy Statement ("IPS").

With respect to fees, Ms. Palladino said that several fee reductions had been negotiated during the 2012 calendar year and that out of the twelve managers in the CRPTF's Developed Markets International Stock Fund, two managers reduced their fees and three managers were terminated due to strategic fit. Ms. Palladino said that two Mutual Equity Fund managers were terminated, and that two Core Fixed Income Fund managers, one High Yield Bond Fund ("HYBF") manager, one EMDF manager and two LF managers reduced their fees for a total fee reduction of about $1.6 million per year. She then recognized Joanne Dombrosky, Principal Investment Officer, on her excellent work in negotiating these fee reductions. In response to Chairman Budnick, she stated that Hewitt's database was used for fee comparisons within the peer universe.

Ms. Palladino then provided an executive summary of the CRPTF's investments as of December 31, 2012. She reported a strong fiscal year-to-date ("FYTD") return of 7.38%, a one-year return of 13.47%, and a three-year return of 7.9%. Ms. Palladino commented on liability profiles of several plans that had received their actuarial valuation as of June 30, 2012. She noted that the State Employees Retirement Commission had lowered the discount rate by 25 bps to 8%.

Next, Claire Shaughnessy and Kevin Vandolder, Partners of Hewitt, reported on the Combined Investment Funds ("CIF") and the Connecticut Horizon Fund ("CHF") as of December 31, 2012. In her report on the CIF, Ms. Shaughnessy commented on recent market events, noted the strong investment performance of the plans and trusts and solid peer ranking in the top fifth. In response to Thomas Fiore's question regarding peer ranking for the plans, Ms. Shaughnessy said that the asset allocation had created better returns than its peers, due to the higher allocation to international equities. Discussion continued regarding the CRPTF's ranking compared to its peer universe. Ms. Shaughnessy said that Hewitt EnnisKnupp's long-term assumptions were that equities would continue to perform better than fixed income and that there was no specific investment opportunity that was unusually compelling. Chairman Budnick posed questions about the equity risk premium, to which Ms. Shaughnessy said that the equity risk premium varied and was currently at the higher end of the range. Mr. Vandolder added that the illiquidity premium was about 3%; and therefore, private equity should earn an extra three to four percentage points above public market returns.

Next, Ms. Shaughnessy reported on the CHF as of December 31, 2012 and stated that since inception, the CHF essentially matched its benchmark. As illustrated in the quarterly report, she reported on the profile of the CHF across CT-based, women-owned, minority owned and emerging firms; there were 46 total investment strategies across all four investment advisors. In response to Carol Thomas, Ms. Shaughnessy discussed the impact of the fees given the fund-of-fund structure and the payment of fees to underlying managers. Laurence Hale posed a question regarding the frequency of changes to the underlying manager lineup, to which Ms. Shaughnessy responded that several new managers had been added in 2007 as more capital was infused into the program and turnover was also due to graduation or termination for underperformance.

Presentation and Consideration of Three Semi-finalists for Master Custodian

Gary Carter, Interim Deputy CIO, and Virgilio Abesamis, Executive Vice President of Callan, provided opening remarks on the firms that provided presentations for the master custodian: BNY Mellon, Deutsche Bank, and State Street. Mr. Carter commented on the CRPTF's complex $26 billion portfolio, and he discussed the custody features needed to support a global investment portfolio and the necessary enterprise software. Mr. Carter noted that very few custodians possessed the infrastructure to meet the requirements of the RFP submitted by the Office of the State Treasurer ("OTT"). Finally, Mr. Carter detailed the evaluation process and commented on each of the three semi-finalist firms.

David Himmelreich commented on the struggles of master custodians during 2008 and 2009, and asked if the respondents had changed their business practices accordingly. Mr. Abesamis said that the search was structured to allow for close assessment of securities lending, indemnity provisions and access to liquidity.

Presentation by BNY Mellon Asset Servicing

BNY Mellon -- represented by Robert Carroll, First Vice President, George Gilmer, Managing Director; and Mark Sullivan, Vice President -- made a presentation to the IAC on its master custodian services. Mr. Gilmer provided an overview of BNY Mellon. Mr. Gilmer said that BNY Mellon serviced about 180 public fund clients that represented $1.4 trillion in assets. He stated that BNY spent about $750 million in annual technology investment, was focused on innovation and was committed to excellent client service. He remarked that BNY Mellon's formal process is structured with a project management philosophy to facilitate complete client satisfaction and ease of transition. Next, Mr. Gilmer commented on BNY Mellon's industry expertise, skilled team to service its partnership, ease of transition, platform for growth and operational excellence.

Next, Mr. Sullivan commented on the service that he and the BNY Mellon team would provide. In response to Treasurer Nappier's question regarding the most challenging aspect of a conversion process, Mr. Sullivan said that BNY Mellon's staff detailed every file and line item for a successful conversion. In response to Mr. Hale, Mr. Sullivan commented on BNY Mellon's dedicated resources and staff that would train the OTT staff. Discussion ensued on various technical issues surrounding a master custodian conversion. In response to Mr. Himmelreich regarding what BNY Mellon learned during the 2008/2009 market meltdown, Mr. Gilmer stated that BNY was now more transparent and had a deeper appreciation for the risk involved with each investment.

Presentation by Deutsche Bank

Deutsche Bank -- represented by Joseph Santoro, Director, Tim Smollen and Anthony Toscano, Managing Directors -- made a presentation to the IAC on its firm's securities lending services. Mr. Smollen provided an overview on Deutsche Bank and commented that Deutsche Bank was a European global bank. Mr. Santoro and Mr. Smollen commented on Deutsche Bank's deep and seasoned management team. Mr. Smollen added that its agency securities lending and supporting units, which included risk management, had 66 people across six locations, and he noted that it was investing heavily in its business and added more offices throughout the world. Mr. Santoro commented on Deutsche Bank's pension fund client base, and that Deutsche Bank had been hired to de-risk these funds by placing fewer securities on loan and extracting maximum value. Mr. Santoro said one of the key risks in securities lending was borrower insolvency default risk, and Deutsche Bank offered dual indemnification, which covered counterparty insolvency default and would replace the CRPTF's securities even if the collateral was insufficient to do so, and if cash collateral was invested in a repurchase agreement, Deutsche Bank offered indemnification and had done so since 1997. Chairman Budnick posed questions regarding how Deutsche Bank handled the recent market meltdown of 2008. Mr. Santoro commented on the Lehman Brothers debacle, and said that the Deutsche Bank's contracts allowed it to seize collateral to protect its clients and buy replacement securities.

Next, Mr. Smollen commented on several ways Deutsche Bank differentiated itself from other master custodians and he discussed its securities lending platform. In response to Mr. Hale, Mr. Santoro said that it had productive relationships with both BNY Mellon and State Street Bank.

Presentation by State Street Bank and Trust Company

State Street -- represented by Stephen Nazzaro, Executive Vice President; Mark Schafer and Ash Tahbazian, Senior Vice Presidents; and Mary Dunleavy and Johnson Shum, Vice Presidents -- made a presentation to the IAC on its firm's master custodian services. Mr. Nazzaro began by providing an overview of State Street's relationship with the CRPTF and what State Street would provide the CRPTF going forward. Mr. Nazzaro said that State Street was one of the strongest and highly capitalized banks in its industry. He said that State Street was a trusted partner of the CRPTF, and was well positioned for a changing environment that included regulation evolution and the changing portfolio composition, with more emphasis on alternative assets and private equity.

Mr. Schafer spoke about State Street's dedicated team for its public funds business, and noted that the CRPTF was one of the top rated public funds.

Next, Ms. Dunleavy commented on the services that State Street had already provided to the CRPTF. She commented that State Street understood that more oversight and transparency were necessary, along with the ability to do more with less, and discussed the tools that State Street currently provided the CRPTF to meet its obligations. Next, Ms. Dunleavy said that State Street was proposing a number of enhancements for a higher level of service including an in-house home-grown system to meet the CRPTF's risk management needs.

Mr. Budnick commented on State Street's positive long-term relationship with the CRPTF and posed a question with respect to State Street's proposed innovative ideas to enhance the CRPTF relationship on an ongoing basis. Mr. Nazzaro commented on State Street's new talent and added that it is a State Street best practice to rotate its relationship managers in order to keep the relationship fresh. Mr. Himmelreich commented that State Street walked the CRPTF through the market meltdown of 2008, and asked what State Street learned and what changes were made to the risk analysis of global lending. Mr. Shum responded that State Street had dedicated cash teams in place, it stopped investing earlier than most of its competitors and it managed well within the guidelines of the CRPTF's IPS. He discussed State Street's portfolio management and added that risk management was a priority for State Street, and he commented on its effective risk management team.

Roll Call of Reactions for the Semi-finalists for the Master Custodian
Chairman Budnick requested feedback from the IAC on BNY Mellon, Deutsche Bank and State Street. In response to Joshua Hall's question, Ms. Palladino stated that risk management, performance attribution, and other points had been focused on during the search process and noted that the two custodian firms agreed to perform an operations review to optimize its services provided to the CRPTF. She noted that State Street was data driven and could create individualized reports, but the process was time consuming; BNY had a bevy of canned reports, which are expedient, but that also put an onus on the CRPTF to define its needs. In response to Mr. Fiore, Mr. Carter stated that one of the challenges of a conversion was the transfer and reconciliation of assets and that the CRPTF reconciliation process between the managers and custodian is probably one of the most robust. Mr. Carter said that with the systems in place, all the semi-finalists were capable of providing the necessary services to the CRPTF. He then discussed the conversion process. Mr. Abesamis commented on the full transition which would take three months; two months for auditing followed by a month for verification. Ms. Palladino clarified that the choice of vendors would be State Street or BNY Mellon for full custodian services or a combination of Deutsche Bank for securities lending, paired with either State Street or BNY Mellon.

Ms. Carpenter preferred Deutsche Bank, followed by State Street and BNY Mellon. Mr. Fiore said that while all three firms were fine, if costs were comparable he preferred BNY Mellon, and noted that he liked Deutsche Bank on securities lending. Mr. Himmelreich added that Deutsche Bank provided an excellent presentation and that State Street performed for the CRPTF during the market meltdown of 2008. Mr. Murray preferred Deutsche Bank's presentation and noted that it was the only one that discussed the CRPTF's account. He was concerned that after 16 years, State Street was not meeting all of the CRPTF's needs, and that BNY Mellon was not sensitive enough to the CRPTF requirements. Mr. Freeman added that he was concerned about both State Street and BNY Mellon's alleged abuses in foreign exchange transactions where Deutsche Bank had no litigation or regulation problems. Mr. Hall added that he preferred Deutsche Bank and would pair it with State Street provided its relationship with the CRPTF continued to move in a positive direction. Mr. Hale agreed that Deutsche Bank knows its business and would couple them with State Street, provided it was willing to customize services and the reports the CRPTF needed. Ms. Thomas added that she liked Deutsche Bank's indemnification and said its presentation was excellent, and added that State Street brought the CRPTF through the market meltdown of 2008; therefore she was comfortable with both. Chairman Budnick agreed with the consensus and added that Deutsche Bank was excellent and he felt that State Street was ready to make changes on behalf of the CRPTF.

Chairman Budnick said that the overall consensus was that all three firms were fine, but the IAC preferred Deutsche Bank in combination with State Street. He added that his belief was that the IAC would support the Treasurer in whatever decision she made. Members of the IAC expressed agreement.

Chairman Budnick called for a motion to waive the 45-day comment period for the three semi-finalists for master custodian. **A motion was made by Mr. Freeman, seconded by Ms. Thomas, to waive the 45-day comment period for BNY Mellon Asset Servicing, Deutsche Bank, and State Street Bank and Trust Company. The motion was passed unanimously.**

Other Business

Chairman Budnick invited the IAC members to submit agenda items for the March 13, 2013 IAC meeting.

Comments by the Chairman

There being no further business, the meeting was adjourned at 12:23 p.m.

This meeting was electronically recorded.

Respectfully submitted,

Denise L. Nappier

DENISE L. NAPPIER
SECRETARY

Reviewed by

Neil G. Budnick

NEIL G. BUDNICK
CHAIRMAN