

INVESTMENT ADVISORY COUNCIL
Wednesday, December 9, 2015

MEETING NO. 428

Members present:

Janice (Jan) Carpenter
Thomas Fiore, representing Benjamin Barnes
Laurence Hale
Joshua Hall
David (Duke) Himmelreich
Michael Kramer
Steven Muench
William Murray
Denise L. Nappier, Treasurer
Carol Thomas, Interim Chair
Peter Thor

Others present:

Richard Gray, Deputy Treasurer
Deborah Spalding, Chief Investment Officer
David Barrett, Director of Communications
Joanne Dombrosky, Principal Investment Officer
Marianne Dziedzic, Executive Secretary
Gregory Franklin, Assistant Treasurer
Kwame Gibbs, IT
Mary Phil Guinan, Assistant Treasurer-Policy
Linda Hershman, Chief of Staff
Wayne Hypolite, Executive Assistant
Catherine E. LaMarr, General Counsel
Christina McGinnis, Executive Secretary
Sarah Sanders, Assistant Treasurer-Debt
Christine Shaw, Chief Compliance Officer
Linda Tudan, Executive Assistant
Lawrence Wilson, Assistant Treasurer-Cash Management

Guests:

Jeffrey Alt, Prudential Fixed Income
Justin Bullion, Payden & Rygel
Kristin Johnson Ceva, Payden & Rygel
MariLu Cleary, Morgan Stanley
Jan Dehn, Ashmore Investment Management Limited
Brian Drainville, Fidelity Institutional Asset Management
Art Greenwood, Fidelity Institutional Asset Management
George Grunebaum, Ashmore Investment Management
Limited
Cathy Hepworth, Prudential Fixed Income
Christoph Hofmann, Ashmore Investment Management
Limited
Arthur Hovsepian, Payden & Rygel

Robin Kaplan-Cho, Connecticut Education Association
Pete Keliuotis, Cliffwater LLC
Jonathan Kelly, Fidelity Institutional Asset Management
Keith Phaneuf, CT Mirror
Claire Shaugnessy, AonHewitt Investment Consulting
Liz Smith, Alliance Bernstein
Diane Smola, AonHewitt Investment Consulting
Arnold West, GIA
Elizabeth M. Westvold, Payden & Rygel

With a quorum present, Interim Chair Carol Thomas called the Investment Advisory Council (“IAC”) meeting to order at 9.00 a.m.

Approval of Minutes of the November 10, 2015 IAC Meeting

Chair Thomas called for a motion to approve the minutes of the November 10, 2015 IAC meeting. **Peter Thor moved to approve the minutes of the November 10, 2015 IAC meeting as drafted. The motion was seconded by Jan Carpenter. There was one abstention, Steven Muench. There being no further discussion, the Chair called for the vote. The motion passed unanimously.**

Comments by the Treasurer

Treasurer Denise L. Nappier began by introducing the discussion of the report entitled Funding Connecticut’s Pension Liabilities: Analysis of Proposals. She assessed the Governor’s proposal to shore up the underfunded pension plans and delivered her fundamental principles and analysis regarding the proposal. Also participating in the discussion were Christine Shaw, Chief Compliance Officer; Deborah Spalding, Chief Investment Officer; Catherine LaMarr, General Counsel; and Richard Gray, Deputy Treasurer. Treasurer Nappier began by reviewing the statement of the pension funding problem and the Governor’s proposal for State Employees’ Retirement Fund (“SERF”) and the Teachers’ Retirement Fund (“TERF”), and detailed her own principles regarding the proposal. Among them, she cited the importance of maintaining a disciplined approach to funding the State’s long-term obligations and protecting the State’s creditworthiness by adhering to this discipline; ensuring the overall soundness and integrity of the SERF and TERF; recognition that the State’s commitment to its retired employees must be inviolable; strive to minimize the financial burden on taxpayers and future generations; preserve and enhance long-term investment performance; and base future assumptions of investment returns on the capital market outlook and asset allocation policy.

Treasurer Nappier next stated that she was in agreement with the Governor on a number of points; among them, lowering the investment return assumption to conform more realistically to expectations for how future capital markets will perform; changing the method for funding the State’s contribution from level percent of payroll to level dollar; converting to a rolling amortization period at a point where the pension plans’ funded status is stronger; and avoiding

gimmicks such as retirement incentive programs. Treasurer Nappier added that she was not in agreement with the suggestion that SERS should split in two: closed plan for Tier 1 retirees and an open plan for all other active employees; saying that it presented significant legal, procedural, tax and actuarial questions.

Next, Ms. Shaw presented the preliminary findings that stemmed from an evaluation performed by the Treasurer's staff on the Governor's proposal. She described one key element and subsequent implications of the Governor's proposal, the risks of converting from an actuarially designed plan to a partial, pay-as-you-go system. Ms. Shaw then focused discussion about what if any lost investment opportunity would be presented, as well as the legal, tax and other structural questions regarding the allocation of contributions that Tier 1 retirees have made into the system. She then discussed the mandates of the study conducted by the Center for Retirement Research at Boston College.

Ms. Spalding then discussed the lowering of the investment return assumptions and the implicating factors related to such action. She then discussed how Boston College conducted their study and the market experience between 2000 and 2014. Ms. Spalding continued with the comparison of proposed funding methodology on SERF contributions and then gave an overview of lowering the return investment assumption and changing the amortization schedule. Lastly, she discussed the impact and challenges to the investment program under a Tier 1 split.

Next, Ms. LaMarr spoke about the legal issues and said that after extensive research the proposal to change the method of funding pension obligations raised significant challenges for the State of Connecticut, citing contractual and constitutional issues and the legal risks of the "pay-as-you-go" plan. Ms. LaMarr stated that a major concern was the implementation of the plan with respect to Tier 1 active employee's contributions. Finally, she spoke on the Internal Revenue Service scrutiny and Securities Exchange Commission disclosure requirements.

Next, Mr. Gray spoke about the alternatives that may be proposed – which would remain in adherence to financial principles - and talked about Annual Required Contribution ("ARC") contributions to SERF, principle and interest payments, extension on the amortization schedules and statutory protection. He then discussed a variety of financial vehicles to ensure the statute remained in force, including a standby letter of credit for utilization and sale of pension liabilities to an insurance company, as a potential solution in the event the statute is altered in any manner and/or ARC contributions or benefit payments have not been paid on time. Comments and questions were posed by several IAC members regarding liability with insurance company, tax and legal implications, rating agency, and determining the rate of return, to which Treasurer Nappier answered satisfactorily.

Next, Treasurer Nappier commented on the agenda and stated that four semi-finalist firms would be presented for the IAC's consideration for the Emerging Markets Debt ("EMD") Fund Manager Search. Treasurer Nappier mentioned that this was a culmination of a competitive search process, conducted through a Request for Proposal ("RFP") and the four firms are Ashmore Investment Management Limited ("Ashmore"), Fidelity Institutional Asset

Management (f/k/a Pyramis Global Advisors) (“Fidelity”), Payden & Rygel and Prudential Fixed Income (“Prudential”).

Update on the Market, the Connecticut Retirement Plans and Trust Funds (“CRPTF”) Final Performance for Month Ended October 31, 2015

Ms. Spalding provided an update on the capital market environment, its impact on the performance of the CRPTF and the economic outlook. She reported that as of October 31, the TERF and the SERF, the two largest pension plans, returned -1.02% and -1.00%, respectively, for fiscal year to date 2015. Focusing specifically on TERF, Ms. Spalding stated that the performance was driven by total global equity returns of -2.34%, representing 52.17% of the portfolio; total fixed income returns of -1.27%, representing 20.64% of the portfolio; and a 2.43% return for alternative investments, representing 22.32% of the TERF. Ms. Spalding said the performance remained solid over the longer term, with the TERF and SERF returning 7.23% and 7.29%, respectively, over the five-year horizon.

Presentation by and Consideration of the Semi-Finalists for the Emerging Markets Debt Fund Manager Search

Joanne Dombrosky, Principal Investment Officer, provided opening remarks on the EMD Fund Manager Search and introduced semi-finalists Ashmore, Fidelity, Payden & Rygel and Prudential, adding that two of the managers were incumbent EMD managers (Ashmore and Pyramis) and Padyen & Rygel was an existing manager in another mandate. Ms. Dombrosky noted that all proposals from the 33 investment firms that responded to the RFP underwent extensive due diligence, culminating in the candidates now being presented.

Ms. Dombrosky stated that in addition to qualified, high performing EMD managers, it was important that the portfolio have diversification across countries, currencies, types of securities, credit quality and duration of holdings. Next, she highlighted some of the attributes among the four candidates in terms of their organizations and investment approaches to different markets. She also mentioned the need for emerging markets managers to use both top down and bottom up analyses and to have a strong knowledge of socio-economic issues across countries.

Presentation by Ashmore Investment Management Limited

Ashmore, represented by Jan Dehn, Head of Research, Christoph Hofmann, Head of Distribution, and George Grunebaum, Business Development Executive, made a presentation to the IAC. Mr. Grunebaum began by introducing the executive team.

Mr. Dehn then continued with a brief overview of the firm and said they were a dedicated emerging market investment management firm, headquartered in London with over 280 employees globally, established in 1992. Mr. Dehn then reviewed the strategy, performance summary and spoke about the external debt versus blended debt. He then discussed the investment philosophy and stated that they were value-driven, macro top down active manager.

Lastly, Mr. Dehn discussed the investment committee process which consisted of a macro overview, country analysis, corporate credit analysis, emerging market foreign exchange analytical framework and theme allocation.

Thomas Fiore and Mr. Thor posed a question, to which Mr. Dehn answered satisfactorily.

Presentation by Payden & Rygel

Payden & Rygel, represented by Kristin Johnson Ceva, Managing Principal, Justin G. Bullion, Managing Principal, Arthur Hovsepian, Principal and Elizabeth M. Westvold, Sr. Vice President, made a presentation to the IAC. Ms. Westvold introduced the team and gave an overview of the firm.

Ms. Johnson Ceva then discussed the firm's investment process and philosophy, fundamental country analysis and its internal country scorecard. She further explained the country dollar-pay spread forecast and its process, as well as portfolio construction, asset allocation and the emerging market risk management process.

Next, Mr. Hovsepian discussed the strength and credibility of the local bank and the core criteria for local market investments, and also reviewed the forecast and local market positioning.

Chair Thomas posed a question regarding the small team size and whether the firm had plans to build it out if given the mandate, to which Ms. Johnson Ceva replied that they were in the process of hiring an additional country analyst and they have been adding analysts as market growth, development and new countries emerge. Mr. Fiore asked the team to comment on the emerging market debt forecast.

Presentation by Fidelity Institutional Asset Management (f/k/a Pyramis Global Advisors)

Fidelity, represented by Jonathan Kelly, Portfolio Manager, Brian Drainville, Institutional Portfolio Manager, and Art Greenwood, Senior Vice President and Relationship Manager, made a presentation to the IAC. Mr. Greenwood began by introducing the team and gave a brief overview on diversity, corporate citizenship and investment management fees.

Mr. Drainville then discussed the firm and the team and stated that they manage approximately \$13B in emerging market debt. He said the main competitive advantages they have was their knowledge base and longevity within the team.

Next, Mr. Kelly presented the hard/local currency asset allocation process, investment philosophy and process, corporate bonds and portfolio construction. He then explained risk management, characteristics, performance and positioning of the portfolio.

Mr. Fiore had asked them to comment on the emerging market debt "bubble" that's set to deflate to which Mr. Kelly answered satisfactorily.

Presentation by Prudential Fixed Income

Prudential, represented by Cathy Hepworth, Managing Director & Sr. Portfolio Manager, and Jeffrey Alt, Managing Director, made a presentation to the IAC. Mr. Alt began by introducing Ms. Hepworth, who gave an overview on the firm and the team. She remarked on the hard/local currency blend detailed the investment performance and process. Ms. Hepworth then discussed the global backdrop and portfolio strategy, country analysis, asset and security selection which included hard currency sovereigns; corporate bonds; and local rates. In closing, she described the firm's portfolio construction and composition.

Mr. Murray commented that although Prudential was supportive of corporate citizenship, its support of Teach for America is troublesome for Connecticut teachers and unions. Neither Ms. Hepworth nor Mr. Alt were familiar with the organization and indicated they would follow up with Ms. Dombrosky.

Roll Call of Reactions to the Emerging Markets Debt Fund Manager Search

Laurence Hale, Joshua Hall, Duke Himmelreich, Ms. Carpenter, Michael Kramer, Messrs. Thor, Murray, Muench, Fiore and Chair Thomas provided feedback to the Treasurer and supported all four firms. Messrs. Hale, Hall, Himmelreich, Muench, Kramer, Thor, Murray, Fiore, Ms. Carpenter and Chair Thomas supported all four firms and least favored Prudential.

Other Business

Chair Thomas invited the IAC members to submit agenda items for the January 13, 2016 IAC meeting.

There being no further business, Chair Thomas called for a motion to adjourn the meeting. **Mr. Himmelreich moved to adjourn the meeting and the motion was seconded by Mr. Hale. There being no discussion, the meeting was adjourned at 12:46 p.m.**

This meeting was electronically recorded.

Respectfully submitted,


DENISE L. NAPPIER
SECRETARY

Reviewed by



CAROL THOMAS
INTERIM CHAIR