



## **MINUTES**

**Meeting of the Investment Committee  
of the Board of Trustees of the  
State Universities Retirement System  
12:30 p.m., Thursday, February 6, 2014  
Chicago Board Options Exchange  
400 South LaSalle Street, The Options Institute  
Chicago, Illinois 60605**

The following Trustees were present: Mr. Craig McCrohon, Chair; Ms. Lindsay Anderson, Ms. Jacqueline Berger, Dr. John Engstrom, Mr. Richard Figueroa, Mr. Paul R. T. Johnson Jr., Mr. Andrew Matthews, Ms. Dorinda Miller and Mr. Mitchell Vogel.

Others present: Mr. William Mabe, Executive Director; Mr. Michael Weinstein, General Counsel; Mr. Daniel Allen, Chief Investment Officer; Mr. Douglas Wesley, Deputy Chief Investment Officer; Ms. Kimberly Pollitt and Mr. Joseph Duncan, Senior Investment Officers; Ms. Lou Ann Fillingham, Investment Officer; Ms. Marilyn Branson, Investment Governance and Compliance Officer; Ms. Phyllis Walker, Chief Financial Officer; Mr. Steve Hayward, Director of Internal Audit; Mr. Albert Lee, Associate General Counsel; Mr. Jeffrey Houch, Legislative Liaison; Ms. Karen Hipskind, Executive Assistant; Ms. Mary Pat Burns of Burke, Burns & Pinelli; Mr. Douglas Moseley, Mr. Kevin Leonard and Ms. Kristin Finney-Cooke of NEPC; Ms. Patti Somerville-Koulouris and Ms. Cristina Ilyes of the Northern Trust Company; Mr. Matt Moran and Mr. William Brodsky of the Chicago Board Options Exchange; Ms. Lari Dierks of Speaker Michael Madigan's staff; Ms. Sharon Piet of Podesta & Co., Mr. Keith Lathan of Williams Capital; Mr. Michael Travaglini of Grosvenor Capital Management; Ms. Lennine Occhino of Mayer Brown; Mr. Rick Santelli of CNBC Business News; Mr. Phillip Hatzopoulos and Dr. Richard Co of CME Group.

Investment Committee roll call attendance was taken. Trustee Engstrom, present; Trustee Figueroa, absent; Trustee Johnson, present; Trustee Matthews, present; Trustee McCrohon, present; Trustee Vasquez, absent; Trustee Vogel, present.

## **APPROVAL OF MINUTES**

Trustee Craig McCrohon presented the Minutes from the Investment Committee meetings of November 22, 2013, and December 12, 2013. Trustee Paul R. T. Johnson moved that:

- The Minutes from the November 22, 2013 Executive Session be approved as presented.

- The Minutes from the November 22, 2013 Investment Committee Meeting be approved as presented.
- The Minutes from the December 12, 2013 Executive Session be approved as presented.
- The Minutes from the December 12, 2013 Investment Committee Meeting be approved as presented.

Trustee Andrew Matthews seconded and the motions carried with all Trustees present voting in favor.

Trustee McCrohon further moved that:

- The Minutes from the November 22, 2013, and December 12, 2013, Executive Sessions remain closed.

Trustee Johnson seconded and the motion carried with all Trustees present voting in favor.

Discussion followed regarding the notation of trustee arrivals and departures once the meeting has commenced. It was agreed to record the time that trustees enter and exit within the text of the minutes as has been the practice.

Copies of the staff memorandums, entitled “Report from the December 12, 2013 Investment Committee Meeting” and “Investment Contracts Approved,” are incorporated as a part of these Minutes as [Exhibit 1](#) and [Exhibit 2](#).

### **CHAIRPERSON’S REPORT**

Trustee McCrohon presented an overview regarding the characteristics of alternative investments and the role of these investments within an investment portfolio. Along with the potential for higher returns, certain alternative investments involve erratic deal flow, low liquidity, fees weighted toward the bonus side and higher volatility of returns. Trustee McCrohon advised that contract terms are critical and complicated for alternatives, the wait for investments to be made and capital called can be unpredictable, and recordkeeping is vital. It was noted that the Senate Committee on Pensions and Investments is beginning to focus on this area as an opportunity for minority-, female-, and persons with a disability-owned investment managers in view of the higher fees that are typical of such investments. Mr. William Mabe remarked on the operational risk, noting that additional qualified staff will be needed to implement a strategy that increases active management and investment in alternatives, and he also cautioned the trustees to consider investment expenses and headline risk. Discussion of considerations surrounding alternative investments followed.

### **CHIEF INVESTMENT OFFICER REPORT**

Mr. Daniel Allen extended his appreciation to the staff of the Chicago Board Options Exchange for arranging the meeting space for the Board meetings. Mr. Allen referred to the Comprehensive Annual Financial Report that was provided to the trustees and he advised that

the State Comptroller's letter received on January 31, 2014, set the effective rate of interest used for calculation of retirement benefits under the money purchase formula at 6.75%. Mr. Allen noted the departure of Mr. Gabriel Ayoroa from the staff and he advised that a search for candidates has commenced. Mr. Allen also referenced two letters from Senator Iris Martinez of the Senate Committee on Pensions and Investments, noting that responses to the questions are due by the end of February. Finally, Mr. Allen advised that Ms. Lori Kern is making a good recovery and that Mr. Douglas Wesley will be on medical leave as of February 18, 2014.

Copies of the letters from Senator Martinez dated January 17, 2014, and January 27, 2014, are incorporated as a part of these Minutes as [Exhibit 3](#) and [Exhibit 4](#).

### **DISCUSSION OF EMERGING INVESTMENT MANAGER GOVERNANCE AND OVERSIGHT**

Since this topic was raised previously today, further discussion was deferred.

#### **(Educational Topic) ASSET / LIABILITY STUDY DISCUSSION AND EDUCATION**

The educational session commenced at 1:40 p.m.

Mr. Douglas Moseley remarked on the importance of the Asset/Liability study against the backdrop of the recent pension reform legislation and the recommendation of the State Actuary to consider lowering the actuarial expected rate of return. After presenting NEPC's analysis regarding the current economic conditions and their projections for return expectations for the various asset classes over the next market cycle, Mr. Moseley discussed perceived implications and opportunities for the SURS portfolio. NEPC's recommendations included reduction of equity risk and addition of exposure to emerging markets debt, hedged equities and commodities. Discussion of implementation considerations followed and NEPC was asked to investigate staffing models at pension funds that have invested in these asset classes directly and through fund of funds structures.

Trustee Richard Figueroa arrived during the educational session at 2:10 p.m.

The educational session lasted for 1 hour and 5 minutes, concluding at 2:45 p.m.

Copies of the NEPC presentation, "Asset Allocation Discussion," and the subset of revised pages that was distributed are incorporated as a part of these Minutes as [Exhibit 5](#) and [Exhibit 6](#).

#### **(Educational Topic) ROLE OF FIXED INCOME IN AN INVESTMENT PROGRAM**

The educational session commenced at 3:00 p.m.

Trustee McCrohon noted that time constraints require this session to be abbreviated; however, the education would continue at the Trustee Educational Forum tomorrow.

Mr. Moseley provided an overview regarding the current landscape for fixed income securities, factors that are currently influencing bond yields, concerns about rising interest rates and the potential for higher inflation. Mr. Moseley remarked that SURS' fixed income portfolio is fairly well diversified but consideration of a dedicated allocation to emerging markets debt is recommended. The changing characteristics of fixed income investments as well as problems with use of the Barclays Capital Aggregate Bond Index as a performance benchmark were also discussed.

The educational session lasted for 10 minutes, concluding at 3:10 p.m.

A copy of the NEPC presentation, "Fixed Income Education," is incorporated as a part of these Minutes as [Exhibit 7](#).

### **DISCUSSION OF SURS FIXED INCOME ASSET CLASS**

Mr. Wesley reviewed the current composition of the fixed income portfolio, the estimated amount of tracking error of each component and the weighted average duration of the portfolio. Mr. Wesley advised that duration for the period ending September 30, 2013, was 4.90 as compared to 5.52 for the benchmark, indicating less interest rate sensitivity, which he noted was due in part to the addition of the unconstrained strategy. Mr. Wesley also reported that the fixed income and Treasury Inflation-Protected Securities (TIPS) portfolios have consistently outperformed the benchmark over the one-, three-, five- and ten-year periods as of September 30, 2013. Discussion followed.

Ms. Kimberly Pollitt advised that PIMCO has been added to the Investment Manager Watch List due to the recent announcement of the impending departure of the firm's Chief Executive Officer/Co-Chief Investment Officer. Ms. Pollitt reviewed PIMCO's planned reorganization of high-level personnel and she remarked that the firm has great depth of resources to maintain continuity. After noting a possibility of succession risk in the long term, Ms. Pollitt advised that staff will continue to monitor the situation and keep the trustees informed. Mr. Moseley confirmed that NEPC has recently met with PIMCO and they are also following the situation closely.

Copies of the staff memorandum, "Fixed Income Asset Class Portfolio Review," the document distributed listing fixed income returns and duration, and the staff memorandum, "Executive Summary of the Actively Managed Fixed Income Asset Class," are incorporated as a part of these Minutes as [Exhibit 8](#), [Exhibit 9](#) and [Exhibit 10](#).

### **CONSENT AGENDA – FIXED INCOME ASSET CLASS**

Trustee McCrohon remarked that staff and NEPC have recommended that the existing fixed income managers be retained with no allocation changes. Noting that the recommendation is part of the periodic process set forth in the Investment Policy, Trustee McCrohon advised that background is provided in the sample document that was distributed, which is incorporated as a part of these Minutes as [Exhibit 11](#). After noting that he was informed that

the manager agreements can be terminated with 90 days notice at most, Trustee McCrohon moved to adopt the following motion:

**Consent Agenda Topics**

*Fixed Income and Treasury Inflation-Protected Securities (TIPS)*

*Asset Class Manager Review*

- The Investment Committee of SURS recommends that the Board approve the retention, without additional funding, of the Debt Securities Managers by SURS and that SURS shall maintain its investments with the Debt Securities Managers. Such decision shall be subject to periodic or other review as the Staff or the Board may deem appropriate.

Debt Securities Managers:

PIMCO (as a treasury inflation-protected securities, fixed income, and unconstrained fixed income manager)

TCW MetWest

Neuberger Berman

Taplin, Canida & Habacht

LM Capital Management

Smith Graham

Garcia Hamilton & Associates, L.P.

Chicago Equity Partners

Pugh Capital

Longfellow Investment Management

New Century Advisors

Trustee Johnson seconded and the motion carried with all Trustees present voting in favor.

After the motion, Trustee Johnson introduced Mr. Rick Santelli of CNBC Business News who spoke to the trustees regarding the current environment and outlook for fixed income investments.

**CLOSED SESSION**

Trustee McCrohon advised that outside legal counsel was invited to provide an update regarding an ongoing negotiation and he suggested that discussion take place in closed session. Trustee Mitchell Vogel moved that the Committee go into closed session under the Open Meetings Act to consider the sale or purchase of securities or investments, or to consider an investment contract, pursuant to §2(c)(7). Trustee John Engstrom seconded and the motion carried in a roll call vote:

Trustee Engstrom - aye  
Trustee Figueroa - aye  
Trustee Johnson - aye  
Trustee Matthews - aye

Trustee McCrohon - aye  
Trustee Vasquez - absent  
Trustee Vogel - aye

### **RETURN TO OPEN SESSION**

The Investment Committee returned to open session.

At this juncture, Trustee Johnson introduced Mr. William Brodsky, Executive Chairman of the CBOE, who welcomed the trustees and remarked on the benefits that can accrue from the opportunities offered by option exchanges.

### **STATUS OF CASH OVERLAY MANAGER SEARCH**

Mr. Allen advised that six candidates responded to the request for proposal (RFP) issued for the cash overlay manager search. Interviews with the candidates have been scheduled on February 12 and 13, 2014, in Champaign and Mr. Allen invited the trustees to participate. It is anticipated that finalist candidates will make presentations to the Committee at the March meeting.

A copy of the staff memorandum, "Cash Overlay Search Update," is incorporated as a part of these Minutes as [Exhibit 12](#).

### **DISCUSSION OF OPTION STRATEGIES**

After introducing Mr. Phillip Hatzopoulos and Dr. Richard Co of the CME Group, Trustee Johnson provided a presentation on the use of options as a strategy to capture revenue from the portfolio rebalancing process. Trustee Johnson remarked on the mechanics of investing in options, the strategy's potential as a cash management tool and the transparency of the options markets. Lengthy discussion of the strategy followed during which the potential to reduce risk and increase returns, as well as the positive and negative aspects of investing in options, were probed. The possibility of bringing in capable managers as part of the cash overlay search was raised; however, due to the informational nature of the session, Ms. Burns recommended that approval of an option strategy be included on the next meeting agenda. Ultimately, it was planned to ask the cash overlay candidates for their views regarding the options strategy during the interviews next week since the cash overlay RFP was written broadly enough to allow for discussion of the topic. Ms. Burns recommended that the questions on this topic be posed by staff or NEPC since the trustees are currently in quiet period.

Copies of Trustee Johnson's memorandum, "Consideration of Option Strategies," the CME Group article, "Options on Index Futures as a Rebalancing Tool," and the Cambridge Associates paper, "Highlights from The Benefits of Selling Volatility," are incorporated as a part of these Minutes as [Exhibit 13](#), [Exhibit 14](#) and [Exhibit 15](#).

## **INFORMATIONAL ITEMS NOT REQUIRING COMMITTEE ACTION**

Mr. Allen referenced the update regarding the outside legal counsel search that was provided in the agenda materials.

The following items were provided for reference and are incorporated as a part of these Minutes:

1. [Exhibit 16](#) - SURS Projected Funding Status through December 2013.
2. [Exhibit 17](#) - Staff memorandum entitled "Investment Manager Watch List Update."
3. [Exhibit 18](#) - PIMCO transition notification dated January 21, 2014.
4. [Exhibit 19](#) - Staff memorandum entitled "December 2013 Investment Manager Watch List."
5. [Exhibit 20](#) - Staff memorandum entitled "Status Update of Outside Counsel Search."
6. [Exhibit 21](#) - Investment Compliance Activities 2014.
7. [Exhibit 22](#) - Fiscal Years 2014-15 Summary Work Plan Investment Committee Schedule.
8. [Exhibit 23](#) - Schedule of Formal Reviews for SURS Investment Managers: Defined Benefit Plan & SMP.
9. [Exhibit 24](#) - Staff memorandum entitled "Schedule of Investment Committee Meetings."

## **PUBLIC COMMENT**

There were no public comments presented to the Investment Committee.

Since there was no further business before the Committee, Trustee Vogel moved that the meeting be adjourned. The motion was seconded by Trustee Engstrom and carried with all Trustees present voting in favor.

Respectfully submitted,



Mr. William E. Mabe  
Secretary, Board of Trustees

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