

New Jersey State Investment Council

March 21, 2013, Regular Meeting

Minutes of the Regular Meeting:

Held on March 21, 2013 at 1:00 PM at the Trenton War Memorial, George Washington Ballroom, 1 Memorial Drive, Trenton, New Jersey.

Council Members in Attendance:

Robert Grady, Chair
James E. Hanson
Marty Barrett
Brendan T. Byrne, Jr.
James Joyner
Guy Haselmann
Peter Maurer
Adam Liebtag
Timothy McGuckin (departed at 4:00 PM)
Jeffrey Oram
Michael Greaney
Michael Cleary (departed at 5:04 PM)
Charles Dolan
Mitchell Shivers

Roll Call and Meeting Notice

Mr. Grady called the meeting to order at 1:00 PM. Ms. Christine Eckel performed roll call and reported that notice of the Regular Meeting scheduled for March 21, 2013, was posted to the website of the Division of Investment (the Division) on March 1, 2013, sent via fax to the Times of Trenton, the Star-Ledger, the Bergen Record, the Courier Post on March 1, 2013, and e-mailed to the Secretary of State on March 1, 2013. A copy of the notice was posted at the Division and is on file.

Mr. Grady welcomed Mr. Charles Steindel, Chief Economist for the Department of the Treasury, as the State Treasurer's representative for the meeting.

Chair Grady congratulated Timothy Walsh, Director of the Division (the Director), and the Division on the excellent performance of the fund, which was up almost 10% for the fiscal year through February 2013. He discussed the Division's ability to use its size to get favorable terms, quoting the following language from an article in the February 2013 issue of CIO Magazine, "New Jersey's \$73.7 billion state pension fund is – thanks to a cocktail of strategy, bold leadership, luck, and innovation – getting for its asset management money than almost any other public pension fund in America."

Approval of Minutes for Regular Meeting held on January 17, 2013

Chair Grady advised that the minutes for the January meeting were not available for this meeting but should be available at the next meeting along with this meeting's minutes.

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Audit Committee update

Chair Grady asked Council Member McGuckin, Chair of the Audit Committee, for an update of the audit RFP selection. Mr. McGuckin stated that the RFP went out to bid, the selection committee made a selection, and bidders were notified. One of the bidders filed a protest, which has delayed the process. The hearing process is underway, and the committee is awaiting a ruling.

Guest Speaker: Leon Cooperman, Omega Advisors, Inc.

Chair Grady introduced Mr. Cooperman and gave background information. Mr. Cooperman is currently the Chair of Omega Advisors, the manager of a fund where the Division currently has an investment. Mr. Cooperman reviewed his 2 handouts. The first addressed assets and liabilities and the markets in general. The second addressed Omega's investment philosophy.

Chair Grady asked Mr. Cooperman what he expected to happen when quantitative easing ends. Mr. Cooperman replied that he expected a gradual increase in interest rates would not adversely affect stock prices, because it would be related to an improving economy. Vice Chair Byrne asked Mr. Cooperman if he was recommending an asset allocation away from fixed income and into equities. Mr. Cooperman responded that such decisions should be kept at the tactical level, and that the Division's risk tolerance depends on its individual preferences, including its liquidity needs. Council Member Haselmann noted Mr. Cooperman's positive view of the equity markets, and asked Mr. Cooperman to predict a best-case and worst-case scenario for the equity markets over the next two years. Mr. Cooperman answered that 15 percent growth is possible over the next 2-3 years, with a worst case scenario of a 10-15 percent correction in stock prices. Council Member Dolan asked about Omega's sell discipline.

Chair Grady asked Mr. Maneck Kotwal, Investment Officer/Co-Head Alternatives, about the return on investment with the Omega-managed fund. Mr. Kotwal responded that the initial investment in 2007 was \$75 million and an additional investment of \$150 million was made in January 2013. The initial investment of \$75 million was now valued at \$123 million for a gain of \$48 million as of February 28, 2013.

Director's Report/Update

Director Walsh reviewed the Director's report. He advised the Council that the Total Pension Fund increased by 2.05 percent in January, slightly below the benchmark of 2.26, and increased by 0.69 percent in February, ahead of the benchmark of 0.32 percent. The Fund was up 9.63 percent, fiscal year to date. Director Walsh noted that the private equity and real estate portfolios, whose reporting lags behind, would likely bring the performance nearer to 10-10.25%. Director Walsh also reviewed the asset class changes that have occurred, highlighting the decision to decrease the Investment Grade Credit allocation at the start of the fiscal year, which has generated approximately \$175 million of increased value for the fund. Chair Grady suggested adding the prior fiscal year's asset allocation

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targets to page 3 of the Director's report to accurately show the time it takes to move such large amounts of money across different asset classes.

Director Walsh also advised the Council that the Division has done some reorganization, moving the trading desk to a more suitable location and moving a few more staff to more central locations.

Mr. McDonough, Deputy Director, reported that the Division is outperforming the benchmark for 1, 3, 5 & 10 years annualized. He also advised the Council that for every 1 basis point of outperformance, the asset value is increased by \$7 million. The Division has generated over \$500 million in value per year by outperforming the benchmark for the last 10 years.

Council member Barrett asked why the pension fund returns are labeled as "Total Pension Fund ex P&F." Mr. McDonough explained that the P&F refer to the Police & Fire mortgages, which are not managed by the Division.

Mr. McDonough gave an overview of performance for each asset class, and provided a comparison to the Division's peers. Mr. Walsh provided further information regarding the continued shortening of duration of the bond portfolio to 2008 levels, and noted the Division's historically low level of holdings of U.S. Treasuries. He also reported that the Treasurer further reduced the assumed rate of return from 7.95 percent to 7.90 percent. Chair Grady noted that the annualized returns of the fund over the past 10 years have exceeded this amount, but recognized that these numbers could change in the future. Councilmember Barrett asked about the effect of this change on the Fund's accrued liabilities and whether it affected State contributions to the Fund. Chair Grady noted the positive effects of positive investment returns, decreased liabilities, and increased contributions on the pension fund.

Director Walsh provided an update on State and local contributions to the pension fund and on the status of the real estate secondary sale process. He also informed the Division of the pending readoption of the Council's regulations.

Simplified Fund Structure presentation

Kathy Jassem, a portfolio manager for the Division, and Director Walsh presented on the common pension fund structure. The Division currently has separate common funds for US Equities (Fund A), Global Fixed Income (Fund B), International Equity (Fund D), and Alternatives (Fund E). Ms. Jassem reported on the difficulties managers face when presented with the opportunity to invest in a stock which doesn't fit the current structure. She cited Lululemon (Canada) and Michael Kors (Hong Kong) as examples of companies that are classified as non-US even though the majority of sales are in the United States. Under a structure the Division is considering proposing for the Council's consideration, a portfolio manager would be permitted to invest globally across the sector.

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TIPS presentation

Phil Pagliaro, a fixed income trader for the Division, presented on Treasury Inflation Protected Securities (TIPS). He gave a brief history of the TIPS program since 1997, and noted the outperformance of TIPS versus Nominal Treasuries over the past 10 years. Chair Grady asked Mr. Pagliaro to explain the Division's more positive assessment of the value of TIPS. Mr. Pagliaro and Mr. Walsh responded that the Division now compares TIPS to other types of investments in the liquidity bucket of asset classes, such as Treasuries.

Bond Duration presentation

Kevin McGrath, a fixed income trader for the Division, presented on Bond Duration. Mr. McGrath gave a primer on bond duration and how the Division uses this information to measure the portfolio's sensitivity to interest rate risk. Mr. McGrath reported that the Division has reduced duration dramatically since June 2011, in order to take the risk of increased inflation out of the portfolio. Councilmember Haselmann noted that the expected increase in inflation may not necessarily occur, but could depend on future government actions.

International Equities presentation

Karen Paardecamp, a portfolio manager for the Division, presented on International Equities. Ms. Paardecamp discussed the breakout of the Division's holdings between Developed Markets and Emerging Markets and the difficulty in segregating between the two by using Greece and South Korea as examples of markets that could be considered either developed or emerging. Mr. Walsh emphasized how this has become an issue across the funds and that the Division is considering proposing a new regulation to address this concern.

Ms. Paardecamp also discussed the Active (advised and non-advised) versus Passive (benchmark tracking and Exchange Traded Funds (ETFs)) international equities portfolios. She reported that the ETFs have dragged down the Emerging Markets performance; however, they have provided the fund with additional exposure to these markets as required by the asset allocation plan. She reported that the Division was planning to move \$1 billion of \$3 billion from ETFs to the active portfolio. Vice Chair Byrne asked about the relative performance of other ETFs. Councilmember Shivers asked about the improvement in the performance of the emerging market advised portfolios since 2011. Councilmember Haselmann and Chair Grady commented on the relative benefits of advisers and ETFs.

Risk Primer presentation

Melanie Lomas, the Division's risk officer, presented on the risk of the pension fund. She reported that the Division's overall exposures for the combined portfolios are within tolerance levels. She discussed the weightings of sectors in the portfolios, and discussed stress tests applied to the portfolio.

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Proposed Alternative Investments

ValueAct Co-Invest International, LP

Mr. Kotwal of the Division and Jake Walthour of Cliffwater presented a proposed investment of up to \$200 million in ValueAct Co-Invest International, LP Fund. The Division already has \$150 million in another ValueAct fund, ValueAct Capital Partners II, LP, and investment in the new fund is limited to existing ValueAct investors. This recommendation is based on the attractive fee terms and the superior returns of the ValueAct Capital Partners II fund. Chair Grady noted that the fund manager is a very strong, top quartile performer, and stated that the IPC concluded that adequate and appropriate due diligence had been conducted.

KPS Special Situations Fund IV, LP

Jason MacDonald of the Division and Pete Kelioutis of SIS presented a proposed investment of \$200 million in KPS Special Situations Fund IV, LP. The Division previously invested \$25 million in KPS Special Situations Fund III. commented on the fund's unique fee structure and investment strategy, and stated that the fund manager was a top quartile performer. He stated that the IPC discussed the investment and concluded that adequate and appropriate due diligence had been conducted.

Blackstone Real Estate Partners Asia LP

Council members Byrne and Oram recused themselves from this matter.

Director Walsh and Jason MacDonald, and Roman Nemtchov of RV Kuhns, presented a proposed investment of \$500 million in Blackstone Real Estate Partners Asia LP (BREP Asia). Director Walsh stated that the Division is looking to further expand assets internationally across different alternative investment asset classes. Mr. MacDonald summarized his recent trip to Asia, indicating the importance of strong relationships between the fund managers and the locals where their investments are located. Chair Grady confirmed that recent global Blackstone real estate funds were top quartile funds, noted the presence of key personnel on location, and emphasized the attractive fee structure. He stated that the IPC found due diligence was adequate and appropriate for this investment.

Guest Speaker: Peter Fisher, BlackRock

Chair Grady introduced Peter Fisher, senior executive of BlackRock and former Undersecretary of Treasury. Mr. Fisher discussed consumers' expectations of no income growth and low interest rates, and its subsequent effect of discouraging spending and investment.

Chair Grady asked Mr. Fisher the "chicken or egg" question as to whether consumer demand leads to corporate spending or vice versa. Mr. Fisher responded that consumer demand is a much bigger factor in the economy than corporate capital spending. Mr. Fisher stated that his opinion that the Fed is most interested in avoiding deflation, and not as much focused on stimulating growth. Chair Grady and Vice Chair Byrne asked about the process for ending quantitative easing once certain benchmarks are

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reached. Mr. Fisher responded that the Fed would likely begin by tapering off new purchases, followed by increasing rates, followed by reducing the balance sheet. Councilmember Haselmann asked whether the Fed is concerned about negative remittances to the Treasury in connection with its exit strategy, and whether there will be a sell-off of riskier assets at that point. Mr. Fisher responded that a growing economy would alleviate any concern with remittances, and that yield curves tend to readjust after initial steepening. Mr. Steindel questioned how the Fed could set a Federal funds rate in the absence of a Federal funds market. At Chair Grady's request, Mr. Fisher discussed strategies that the Division could consider going forward.

Approval of Alternative Investment Modification Procedures

Rubin Weiner, legal specialist for the Division, discussed procedures for modifications to alternative investments.

Council Member Shivers proposed that the language of the procedures regarding post-approval notifications to the IPC be amended to read, "in writing as soon as practicable, but no later than at its next regularly scheduled meeting." He also proposed that under the types of modifications, the language be amended to read that the Director shall have the authority to "consent to certain of the modifications listed" rather than "consent too many of the modifications listed."

Mr. Liebtag proposed amending the procedures to include pre-approval notification to the SIC regarding "an increase in the fees or carry paid to the manager of a fund" and "a net increase in the incentive compensation paid to the manager of a fund." Councilmember Barrett asked about the procedure for investing additional capital to an existing fund. He proposed adding changes to the minimum size of a fund to the types of modifications. He also asked what would constitute a substantial redemption from a fund, and proposed that the procedures be modified to include subsequent notification of the Council as well as the IPC. Chair Grady motioned to approve the modification procedures as amended, with Mr. Byrne seconding the motion. The motion was approved unanimously by Council members then present at the meeting (Council members McGuckin and Cleary were no longer present).

Deferred Compensation Plan Update

Deputy Director McDonough reported on the New Jersey State Employees Deferred Compensation Plan (DCP). Deputy Director McDonough noted that the investment lineup had not changed over the past year, but mentioned that the Plan had completed implementation in 2012 of a change in duration for the Stable Value Fund from 5 years to 3.5 years to protect the fund from future increases in the interest rate.

Director's Report on Iran Divestment

Susan Sarnowski, Compliance Officer for the Division, presented the report to the Legislature on the Iran Divestment Statute. She noted that the Division does not currently own any holdings in the companies on the divestment list. She advised the Council that the Division changed research providers from MSCI

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to IW Financial, and that IWF has a substantial amount of companies on their database that are not on the divestment list. She advised the Council of the procedure the Division uses in determining which companies on the IWF database will be placed on the divestment list.

Treasurer's Report

Mr. Steindel reported on New Jersey's economic outlook. At the Council's request, Mr. Steindel discussed the impact of Hurricane Sandy on New Jersey's economy.

Public Comment

An unregistered speaker, representing UNITEHere, a union of hotel and casino employees, addressed the Council regarding the activities of TPG Partners V, which has invested in Caesar's Entertainment. He expressed particular concern about transaction monitoring and other fees being paid to TPG by the casino.

Chair Grady responded that the Council generally supports a 100 percent offset for these types of fees, but that he was unaware of the arrangement for the Division's investment in TPG funds, which was made under the prior Director and Council members. He noted that the Division is a market leader in negotiating lower fees as the speaker recommended, and stated the Council and Division would consider the material presented by the speaker. Councilmember Liebtag noted the intersection between labor and investment interests, citing to the investment in KPS, which Mr. Liebtag noted has a good track record in dealing with labor unions, and asked the Division to follow up on the speaker's concerns. Councilmember Barrett confirmed with the speaker that he was not alleging any criminal activity.

Another unregistered speaker, a DCP participant, asked if there is any discussion of allowing participants to invest in the original DCP State-managed funds, or low cost index funds. Director Walsh indicated that two State-managed funds, small cap and large cap equity, are expected to become available after a pending procurement process for a plan administrator is completed.

Adjournment

Councilmember Maurer motioned to adjourn the meeting, with Chair Grady seconding the motion. All voted in favor. The meeting was adjourned at 6:02 p.m.