

## INVESTMENT ADVISORY COMMITTEE

The Investment Advisory Committee held its quarterly meeting on Thursday, March 1, 2012, at the Bureau of Investments, Great Lakes Conference Room, 2501 Coolidge Road, Suite 400, East Lansing, Michigan.

### Members Present:

Nick A. Khouri, Chairman  
L. Erik Lundberg  
James B. Nicholson  
Steven H. Hilfinger, LARA  
John E. Nixon, DTMB

In attendance from the Department of Treasury: State Treasurer Andy Dillon, Jon M. Braeutigam, Gregory J. Parker, Karen Stout, Brian Liikala, Richard Holcomb, Peter Woodford, Paul Nelson, Jack Behar, Jim Elkins, Giles Feldpausch, Kevin Fedewa, Amanda Ellis, Marybeth Gienapp, Marge McPhee, and Emma Khavari.

Others in attendance: Becky Gratsinger, Jim Voytko, Molly Jason, June Morse, and Jason Diotte.

### **Call to Order and Opening Remarks**

State Treasurer Andy Dillon asked Acting Chairman Steven H. Hilfinger to call the meeting to order. Acting Chairman Hilfinger called the March 1, 2012, meeting to order at 9:31 a.m. A motion was made by Mr. James B. Nicholson to nominate Mr. Nick A. Khouri as Chairman of the Investment Advisory Committee Board. Mr. John E. Nixon seconded the motion. All were in favor. Acting Chairman Hilfinger relinquished his position to newly elected Chairman Khouri.

Chairman Khouri noted that it was an honor to be a part of the Investment Advisory Committee. He mentioned that because of the diversity of all the members of the Board, there will be many different perspectives and viewpoints. He discussed some of the objectives of the Board and that the focus should be on what is learned, what is going to be done differently because of what is learned, and the major issues with which the staff might be struggling. Chairman Khouri encouraged the Board members to ask questions and to learn more details of investing.

Chairman Khouri turned the meeting over to State Treasurer Dillon. Treasurer Dillon welcomed the new Board members. He also noted that it has been a pleasure to work with the BOI team over the past year and that they are a very talented team. Treasurer Dillon asked each Board member to provide a brief background so that the BOI team understands the powerful resources that are available to them.

Mr. John E. Nixon is the State Budget Director and is the head of the Department of Technology, Management and Budget. Formerly he was the State Budget Director of Utah under Governors Huntsman and Herbert. Mr. Nixon worked his way through college as a stock broker. He accepted the position with the State of Michigan for the opportunity to make a difference.

Mr. L. Erik Lundberg has been the Chief Investment Officer at the University of Michigan for approximately the last twelve years. He oversees approximately \$8 billion in an endowment fund and another couple of billion dollars in other investment funds. Prior to his position at the University of Michigan, he managed a large corporate pension fund in Chicago giving him experience in the investment processes.

Chairman Naif 'Nick' A. Khouri has been the Treasurer of DTE Energy for the last ten years. Previously, he worked in federal and state government including the Michigan Senate Fiscal Agency and the Michigan Department of Treasury, as Chief Deputy Treasurer. He began his career in a congressional budget office in macro-economic forecasting.

Mr. James B. Nicholson is in the chemical business and his experience in the markets is with investing his own funds. Previously, he worked at the First National Bank of Chicago, (which became Bank One and then Bank One became Chase). His education was at Stanford University as an undergraduate; the University of Chicago; and a year at the London School of Economics reading and studying economics where he received his Master's Degree.

Mr. Steven H. Hilfinger is the Chief Regulatory Officer for the State of Michigan and is the head of the Department of Licensing and Regulatory Affairs. He is a lawyer and previously worked in private practice for a law firm in Detroit. His focus was on corporate M&A, restructuring, and private finance.

**Resolution for former Chairman David Sowerby** - Chairman Khoury noted that there is a Resolution honoring former Chairman David Sowerby for his dedicated years of service to the Investment Advisory Committee Board. Chairman Khoury asked for a motion to support the Resolution – Mr. Nicholson moved that the Resolution be accepted and Mr. Hilfinger supported. All were in favor.

### **Approval of Minutes of December 1, 2011**

Chairman Khoury asked for a motion to approve the December 1, 2011, minutes. A motion was made to accept the minutes by Mr. James B. Nicholson and seconded by Mr. John E. Nixon, with a minor correction noted by Mr. Steven H. Hilfinger. The minutes were approved.

**Presentation by R.V. Kuhns & Associates** – Ms. Rebecca Gratsinger, CEO and Principal; and Mr. James Voytko, President, COO, and Director of Research

Ms. Rebecca (Becky) Gratsinger began the presentation by providing a brief review of R.V. Kuhns and Associates and the services that are provided to the Bureau of Investments. She also noted, for the benefit of the new Board Members, the organizational structure, the team and consulting philosophy, and a snap-shot of the firm. She also provided a representative client list, an overview of their consulting services, and the uniqueness of R.V. Kuhns and Associates.

There were a few questions from the Board members about the number of partners the firm has and if they allow inactive partners. A brief history of the R.V. Kuhns and Associates was provided in response to some of these questions. Ms. Gratsinger then turned the presentation over to Mr. Voytko to give a brief review of the Michigan Public School Employees' Retirement System (MPERS) asset liability study.

Mr. Jim Voytko began his portion of the presentation with some background of an asset liability study, which is a large undertaking and typically results in a 100+ page deliverable. He selected several bullet points for topics of discussion from the last MPERS Liability Study which was completed in June 2011. He noted that the Asset Liability Study is like the ultimate report card for a pension plan, which brings together all of the major factors that bear on the financial health of the plan. He noted that large defined benefit plans change at a glacial pace, so patience and long-term thinking are mandatory. The Plan is starting out in a deep financial hole with insufficient assets and a large unfunded actuarial liability, along with the cost of the recent early retirement program, and the dominance of the higher cost old Plan members versus those in the new Plan; these are all major financial challenges. He discussed the contribution policy and the benefit policy.

Mr. Voytko discussed the asset mix, the returns, and the new assumed rate, which is 7% for the new Public School Employees. Mr. Voytko noted these factors are challenging, that the assumed rate is not a reflection of investments but is a tool for setting the contribution policy. This is a way of leaning toward contribution and away from dependence on investment income alone. Several questions were asked by the Board members which led to a lengthy and informative discussion regarding the factors that have an influence on the rates of return and the asset allocation mix. He continued with a discussion of the changes to the Plan coupled with its actuarially calculated Annual Required Contribution (ARC) policy. These factors appear to place the Plan on a more conservative path for pension funding and long-term pension health.

Mr. Voytko discussed the deterministic analysis results and noted the projected market funded ratio if certain criteria are met each and every year. He noted that the central part of the asset liability study is where five or six significantly different approaches are taken which express different asset allocations and then match them against the liabilities and note the potential consequences on a stochastic basis because each of the asset allocation has dramatically different volatilities associated with it and distributions. Mr. Voytko concluded his presentation with a discussion about the problems that public plans are facing as they mature and how their demographics are changing. He noted that almost all public defined benefit plans have too many retirees and not enough

contributing workers. Mr. Voytko and Ms. Gratsinger answered many questions from Board members and provided a very informative and enlightening discussion.

### **Prefunding of Health Care**

Mr. Jon M. Braeutigam provided a brief history of the State of Michigan Comprehensive Financial Report which is produced annually by the Office of Financial Services with assistance from the Office of Retirement Services and the Bureau of Investments, with regard to health care. He gave an overview of recent law changes and contribution rates to retiree health care. He noted that there will have to be some accounting changes that will be worked out with several different State of Michigan agencies. He also discussed and solicited thoughts and ideas from the Board members of how and where the funds will be invested. There were many ideas discussed and questions asked by the Board Members to be better informed of the situation. The Board's desire was to invest similar to pension assets.

### **Performance**

Mr. Braeutigam reported on the performance of the SMRS' portfolio for the time period ending December 31, 2011. He noted the S&P 500, which was flat in 2011, but as of February 29, 2012, it was up 8.6% year-to-date, which gives a sense of the volatility in the markets. He also discussed the foreign markets, which were down last year and the allocations of International versus the target and peers. Mr. Braeutigam explained the index to emerging and the currency issues, being 20% hedged with regards to the Euro, the Pound, and the Yen. Over the past decade the International portfolio performance has been challenging versus peers because the portfolio was hedged and the peers are completely unhedged. There was a lengthy discussion with several questions regarding hedged versus unhedged investments. Treasurer Dillon also suggested that the Board members read a book called *The Currency Wars*.

Mr. Braeutigam reviewed the time-weighted rates-of-return for the period ending December 31, 2011. He responded to several questions regarding the reasons for the difference between the 3.3% fund return rate and the 1.8% rate for the one-year peer return on the total plan. Mr. Braeutigam discussed private equity and real estate, noting that they both had a good year. He also discussed hedge funds, absolute return, correlation and diversity of the funds, and fund-to-funds strategy. There was a discussion about infrastructure and how it is a difficult asset class because there are several different types of assets with different characteristics. The desire is to have a bond-like return. It is a very slow process to allocate more to infrastructure from real estate and will take some time for this to be accomplished.

Mr. Braeutigam discussed, at the request of the State Treasurer, the chart of the Annual Total Returns of Key Asset Classes from the Performance section. This chart shows the different asset classes and how they performed over the years from 1992 to 2011. He pointed out that this chart shows why it is important to diversify your portfolio and studying the chart can be very helpful for the future. Mr. Braeutigam concluded his

Performance presentation noting that small and mid-cap stocks had a great run in the early 2000s and the SMRS exposure in small and mid-cap stocks did not begin until 2005.

### **Asset Allocation**

Mr. Braeutigam reported on the SMRS' asset allocation. The SMRS portfolio for the time period ending December 31, 2011, had a market value of \$48.123 billion. He noted that the short-term cash at the end of December was \$2.2 billion. There was a brief discussion on the amount of cash being held and the reasons for holding cash. Mr. Braeutigam concluded his Asset Allocation presentation noting his major concern is the problem in Iran and Israel, and his other concern is Europe.

### **Capital Markets Overview**

In the spirit of time, the Capital Markets Overview was received and filed.

### **Economic and Market Review and Outlook**

In the spirit of time the Economic and Market Review and Outlook was received and filed.

### **Investment Reports**

**Active Domestic Equity** – Mr. Jack Behar reported on the SMRS' active domestic equity investments. The market value for the active domestic equity holdings as of December 31, 2011, was \$14,583 million. He discussed how the Stock Analysis Division functions, how the Division fits into the big picture, and how they think. He explained the three internal funds which are supported by seven industry analysts who lend their opinions and insights across funds. He noted that there are two smaller funds, one is an all-cap strategy and the second is a high-dividend yield, low-volatility strategy. Mr. Behar explained that there are 23 external managers across the large-cap, mid-cap, and small-cap spaces led by a team of four individuals in the Division. The team works very closely with R.V. Kuhns and Associates in the external manager space.

Mr. Behar responded to questions regarding the size of the internal and external portfolios and also the mix within the portfolios. He noted that the split between the active and passive is currently 60/40 and this is in the process of being changed to a 50/50 split. There was a discussion regarding the decrease in exposure in the small-cap and mid-cap space and the way that this decrease is being accomplished without terminating relationships with managers. Mr. Behar noted the overweight in financials, health care, and information technology. There was a discussion regarding the European banks and their balance sheets and the U.S. large-cap banks, which are more solid than they have been.

**Alternative Investments** – The total market value of the alternative investments portfolio as of December 31, 2011, was \$10,487 million. In the spirit of time the alternative investments report was received and filed.

**Absolute Return, Real Return and Opportunistic** – The market value of the absolute, real return and opportunistic portfolio as of December 31, 2011, was \$3,189 million. In the spirit of time the absolute, real return and opportunistic report was received and filed.

**Real Estate and Infrastructure** – The market value for the real estate and infrastructure portfolio as of December 31, 2011, was \$5,047 million. In the spirit of time the real estate and infrastructure report was received and filed.

**International Equity** – The market value of the international equity exposure as of December 31, 2011, was \$6,146 million. In the spirit of time the international equity report was received and filed.

**Indexed Domestic Equity** – The market value of the indexed domestic equity portfolio as of December 31, 2011, was \$5,923 million. In the spirit of time the indexed domestic equity report was received and filed.

**Fixed Income** – The market value of the fixed income portfolio as of December 31, 2011, was \$6,458 million. In the spirit of time the fixed income report was received and filed.

**Basket Clause** – The fair market value of the basket clause investments as of December 30, 2011, was \$2,829 million or 5.878% of the total portfolio market value of \$48.123 billion. In the spirit of time the basket clause report was received and filed.

**Next Meeting Date and Adjournment**

Chairman Khouri adjourned the meeting at 11:50 a.m.

Approved:



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Nick Khouri, Chairman