

## **INVESTMENT ADVISORY COMMITTEE**

The Investment Advisory Committee (IAC) held its quarterly meeting on Thursday, September 5, 2013, 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  
Steve Arwood, LARA  
John E. Nixon, DTMB

In attendance from the Department of Treasury: State Treasurer Andy Dillon, Jon M. Braeutigam, Gregory J. Parker, Robert L. Brackenbury, Peter Woodford, Karen Stout, Brian Liikala, Richard Holcomb, Jack Behar, Jim Elkins, Rick DiBartolomeo, Paul Nelson, Amanda Ellis, Thomas Albert, Giles Feldpausch, Marge McPhee, and Emma Khavari.

Others in attendance: Becky Gratsinger, Jim Voytko, Molly Jason, Mark Guastella, Chuck Abshagen, Joe Curtin, Ryan Austin, Michael Lashendock, and June Morse. Special guest speaker from Principal Global Investors: Randy Mundt.

### **Call to Order**

Chairman Khouri called the September 5, 2013, IAC meeting to order at 9:30 a.m. and thanked everyone for taking time from their busy schedules to attend the September IAC meeting. He began by noting that the agenda was full and included a guest speaker from Principal Global Investors to discuss real estate. Chairman Khouri noted that the S&P is up a good 15%, bonds are up 100 basis points, and the year for the fund has been good through June. He noted that the Board has been reviewing a different asset class at each meeting, with real estate being reviewed at this meeting. He turned the meeting over to Treasurer Dillon.

Treasurer Dillon discussed the anticipated tapering of the Federal Reserve quantitative easing policy with the Board members questioning the impact this will have on the markets and the possibility of hedging or just riding it out. It was noted that one solution was to just ride it out, even though there may be rough spots, as hedging is very expensive. Treasurer Dillon turned the meeting back over to Chairman Khouri.

### **Approval of Minutes of June 18, 2013**

Chairman Khouri asked for a motion to approve the minutes of the June 18, 2013, IAC meeting. Mr. Steve Arwood so moved, seconded by Mr. Erik Lundberg; there were no objections.

Chairman Khouri turned the meeting over to Mr. Jon Braeutigam to discuss the Performance and Executive Summary sections.

### **Executive Summary & Performance**

Mr. Braeutigam briefly discussed the performance of the plan ending June 30, 2013, noting that the return for the plan was 12.2% for the one year, 11.9% for the three year, and 7.4% for the ten year. He noted that there has been a strong performance in absolute return and the stock market has been going up. He reviewed the last ten years, noting that the fund is right on target with peers across the board, with the three year number better than the peers. There was a discussion about high-yield and corporate bonds which alone are unable to provide the required 8% return. So, in order to achieve the target return the portfolio must be diversified with the help from exposure to equities. Mr. Braeutigam also discussed the liability side GASB accounting rule changes which will be in effect in 2014. He noted that there is a challenging gap in the fund between the contributions and the payouts.

Mr. Braeutigam turned the meeting over to Mr. Greg Parker to review the Executive Summary section.

### **Executive Summary**

Mr. Parker began by reviewing the asset allocation sources and uses of cash which provides information on what has been done over the past year in the fund. He noted that over the past 12 months, domestic equity, alternative investments, international equity, and real estate have generated cash, which means investments in these areas were sold. The total net benefit payments were \$2.7 billion. There was a discussion about how to manage equity beta in the pension fund making note that many drivers are used to produce the 8% return with a low correlation to the equity markets.

Mr. Parker noted that 60% of the assets are pure equity: private, domestic, and international, which are tied to growth and corporate profits. He discussed another set of asset classes, which are the stabilizing, income producing assets, short-term cash and fixed income. They do not earn a very high rate of return, but are important to making pension payments. There is also a third bucket which helps to diversify: real estate, real return strategies, opportunistic strategies, and absolute return strategies. There was discussion about correlations when the equity market goes down and what has happened in the past when these events occurred.

There was a lengthy discussion about the cash that has to go out, what has to be sold to produce that cash and the source of stability so something that is severely depressed does not have to be sold to produce that cash. Mr. Parker discussed interest rates, which have gone up since the last meeting, and their impact on the economy. While interest rates have risen, corporate spreads/high-yield spreads are pretty much unchanged. He also discussed rate re-price looking at how existing home sales and autos continue to grow noting that the re-price does not seem to have an influence on the overall economy. Also discussed were different scenarios in emerging markets and

what is happening at the present time in foreign countries. There were several topics discussed with great input from all in attendance.

Chairman Khouri introduced the guest speaker – Mr. Randy Mundt, President and Chief Investment Officer of Principal Real Estate Investors.

**Principal Global Investors Presentation – Mr. Randy Mundt, President and Chief Investment Officer – Principal Real Estate Investors**

Mr. Mundt introduced himself noting that he is the Chief Investment Officer for Principal Real Estate Investors, which is a subsidiary of Principal Global, which is a subsidiary of Principal Financial Group which is a large insurance and financial services group based in Des Moines, Iowa. He has been with the firm for over 30 years and also sits on the economic committee which develops a house-view of the global and U.S. economies. Mr. Mundt talked about the Fed tapering and its impact on the economy and asset prices, and how it filters its way through to commercial real estate. He also looked at what is behind the tapering itself noting that there is an expectation that in the U.S. economy there will be an upshift in its growth.

Mr. Mundt discussed the nominal and real 10-year Treasury rates noting that there was a negative return during the period of January 2012 to May 2013 for real 10-year Treasuries. The result was that money flowed elsewhere which lowered the cost of capital for other parts of the economy, boosting asset prices, and restoring the household wealth effect. Mr. Mundt talked about global de-synchronization and the economic and political reasons the Fed will let all of the holdings run to maturity. He discussed the space market dynamics and the capital markets which are the two macro forces affecting the real estate market. This includes who is building the buildings, who is leasing them, how much it costs to borrow against real estate, and what are the cap rates. Since the end of the global financial crisis, the U.S. real estate industry has benefitted from strong capital market tail winds. The Fed made it very cheap to borrow against real estate, which pushed cap rates down. Publically traded REITs PE ratios have been pushed up. He noted that things are beginning to change in that until now there have been very strong capital markets, tail winds and very slow recovering space markets with the exception of apartments, which have come back very quickly.

Mr. Mundt discussed the four quadrants of real estate, which is a simple way to categorize strategies, public and private, debt and equity. The public equities are the REITs, which are approximately 150 companies that trade on the stock exchange; on the public debt side would be the commercial mortgage-backed securities which are bonds that are backed by commercial mortgages. He noted the shifting dynamics of capital markets and space market forces with the Fed-driven asset reflection with the economic forces contributing to tapering which should continue to support space market recovery. There were many questions addressed during his presentation and with a great overview of what is presently going on in the real estate industry.

## **Real Estate**

Mr. Brian Liikala provided an overview of what is happening in the real estate portfolio of the fund. He provided a brief history of leverage in the real estate portfolio. Mr. Liikala discussed the two internally managed operating platforms, which compose over 30% of the real estate portfolio, which are the retail operating company and the apartment company. There was a discussion of where the real estate portfolio will be in three to five years and how it will look different than today. Mr. Liikala noted that with longer-term leases caution must be demonstrated with the expectation of the possibility of rising interest rates. He also noted that the medical office space is growing. There was a discussion of what is happening, in general, in real estate referring back to the presentation provided by Mr. Randy Mundt.

Chairman Khouri thanked Brian for his insight in reviewing the real estate portfolio and answering all the questions from the Board members.

## **Remarks**

Chairman Khouri discussed options for topics of discussion for the December IAC meeting, asking that any ideas be sent via e-mail. Also, Mr. Braeutigam noted that he found a discussion from General Petraeus on the whole world view very interesting. Mr. Braeutigam noted that he would find out if it would be possible to arrange a video conference call for a discussion on the U.S. going forward and geopolitical current issues with General Petraeus.

## **Asset Allocation, Capital Markets Overview, Economic and Market Review and Outlook, Asset Class Investment Reports, and Basket Clause**

In the spirit of time, these reports were received and filed.

## **Next Meeting Date and Adjournment**

The next Investment Advisory Committee Meeting is scheduled for Tuesday, December 3, 2013. Chairman Khouri adjourned the meeting at 11:45 a.m. and thanked everyone for coming.

Approved:



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Nick Khouri, Chairman