COMPTROLLER'S
INVESTMENT ADVISORY BOARD MEETING
Monday, January 24, 2018
Minutes

The Comptroller's Investment Advisory Board (the "Board") met at 10 a.m. on Monday, January 24, 2018, at the LBJ State Office Building, 111 E. 17th Street, Room 114, Austin, Texas.

Board Members ("The Board") Present

Comptroller Glenn Hegar, Tucker Bridwell, Laurie Dotter, Jim Hille, and Adolpho Telles.

Board Members Absent

Steve Strake and Scott Wise.

Comptroller of Public Accounts Staff Present

Mike Reissig, Deputy Comptroller and Cheryl Scott, Internal Auditor.

Texas Treasury Safekeeping Trust Company ("Trust Co.") Staff Present

Paul Ballard, Chief Executive Officer and Chief Investment Officer ("CEO"); Danny Sachnowitz, Deputy Director and Deputy Chief Investment Officer; Frank Zahn, Chief Financial Officer; Mike Samples, Director of Internal Investments; Marianne S. Dwight, General Counsel; Laura Montoya, Chief Operating Officer; Anca Ion, Deputy Director of Internal Investments; John Wright, Deputy Counsel; Whitney Blanton, Assistant Deputy General Counsel; Byron Beasley, Portfolio Manager; Michael Leifeste, Portfolio Manager; Lalo Torres, Portfolio Manager; Jyoti Gupta, Portfolio Manager; Ruchit Shah, Portfolio Manager; Adam Levine, Risk Strategist; Chad Turner, Risk Manager; Yunke Yu, Quantitative Data Analyst; Patrick Jue, Operational Investment Analyst; Susan Colletti, Director of Investment Accounting; Nora Arredondo, Special Projects Coordinator; Mina Kim, Trader; Corrine Hall, Program Administrator; and Elizabeth Moreno, Manager of Financial Accounting.

Additional Participants

Mike O'Brien, RSM & Co., LLP; and Lori Mills and Alex Nixon, Asset Consulting Group ("ACG").

Call to Order

Comptroller Glenn Hegar declared that a quorum was present and called the meeting to order at 10:06 a.m.

Approval of Minutes of October 24, 2017 Meeting (Tab 1)

Mr. Adolpho Telles made a motion to accept and approve the minutes of the October 24, 2017 Comptroller's Investment Advisory Board meeting. The motion was seconded by Ms. Laurie Dotter and unanimously approved by the Board.

Presentation of Independent Auditor's Report for the Trust Company (handout)

Mr. Mike O'Brien summarized the audit reports in the handout and reported that RSM & Company issued an unqualified financial audit opinion with respect to the Trust Company and the SWIFT for the fiscal year ending August 31, 2017. Mr. O'Brien reported that no audit adjustments were recorded during the audit engagement that indicate deficiencies in the accounting process, nor was a management letter issued.

Investment Policy Update and Presentation on Performance Benchmark (Tab 2)

Ms. Lori Mills reported that at the previous board meeting there was discussion relating to the benchmark for the Alternative Fixed Income ("AFI") asset class. ACG and the Trust Company thought it would be beneficial to discuss the analysis in choosing the appropriate benchmark for AFI. Ms. Mills explained that because AFI includes a variety of hedge fund strategies such as global macro, event driven, and relative value, there is not a traditional benchmark (i.e. index) available. Therefore, various peer groups were considered in order to identify what would be most appropriate for the AFI class. After reviewing several alternatives, it was determined that the peer groups maintained by Hedge Fund Research ("HFR") offered the most compelling benchmark solutions. ACG recommended that the Trust Company retain HFRI FOF Conservative as its benchmark for the AFI asset class.

Economic Outlook, Investment and Review of Treasury Pool (Tab 3)

Mr. Mike Samples reported on current economic conditions. He stated that economic growth slowed at the end of 2017 but currently was starting to pick up. He did not believe that the tax cuts were significantly influencing economic growth, but instead attributed it as a cyclical upturn. Mr. Samples reported that the U.S. deficit last year was approximately $656 billion, which is up $80 billion from 2016. He believes the tax cut will simply increase the deficit. In addition, because of higher interest rates, the interest on the debt was up $27 billion last year. He expects the Federal Reserve (the "Fed") will continue to raise interest rates cautiously in the next twelve months. With this expectation, he and his team have positioned the portfolio accordingly.

Mr. Samples presented a summary of the Treasury Pool portfolio as of December 31, 2017. The portfolio produced a net yield of approximately 1.53%, had a market value of approximately $25.2 billion, and continued to maintain a AAA rating by Standard & Poor's.

Capital Markets Outlook and Investment Performance for the Quarter Ending March (Tab 4)

Ms. Lori Mills of Asset Consulting Group (ACG) presented an economic market overview. She explained ACG's baseline assumptions where economic growth would continue at a rate of 2.0% - 2.5% and inflation would approach the Fed's 2.0% target. ACG believes inflation could be an underappreciated risk in the market, and diversified commodities exposure tends to perform well alongside inflation. Other baseline assumptions include equities to track earning growth and short-term bond yields to move consistently higher. Ms. Mills reviewed the downside risks and upside potential when considering these baseline assumptions.

Ms. Mills explained that passage of the U.S. tax reform was met with optimism and expectations are calling for a 0.2% - 0.8% boost to near-term GDP. The reduction in the corporate tax rate from 35% to 21% is expected to enhance earnings per share growth projections. She explained that the fiscal stimulus this short and this late in the cycle may accelerate the Fed to raise interest rates. She stated that ACG will maintain allocation targets in large cap U.S. stocks but remain diligent with rebalancing given valuations and economic sensitivity. They will continue to incorporate hedged strategies for downside protection, especially in the absence of market volatility for extended periods. ACG does not foresee any major protractive downturn in the near year future and believes there is little threat of a U.S. or global recession. ACG expects the Fed to continue raising rates this year.

Ms. Mills visited the five investment themes as described behind Tab 4. Some highlights include the preference of equities over fixed income, increase risk-reducing and private strategies, incorporate absolute return oriented strategies, retain core real estate exposures and employ active managers with niche strategies.

Ms. Mills reviewed the total portfolio summary for the period ending September 30, 2017. She reported that the portfolio had produced a 2.80% return for the quarter and an annualized rate of return of approximately 6.36% over the previous five-years. Relative to broad market benchmarks, the total portfolio generated 92% of the return with 51% of the risk. In short, it produced a better risk-adjusted return than the benchmark.

She reported that the portfolio underperformed the endowment policy benchmark over the most recent quarter by -0.21% but outperformed the benchmark over the one, three and five year periods. The broad asset classes of fixed income and real assets each slightly underperformed their benchmarks for the quarter but continue to outpace over the one, three, and five year periods. The equity strategies matched the returns of the equity blend for the quarter and are outperforming over the longer term.

Ms. Mills reported that the State Water Implementation Fund for Texas ("SWIFT") portfolio produced a 1.95% return for the quarter ending September 30, 2017, underperforming its policy benchmark by -0.47% and underperforming its dynamic benchmark by -0.10%. The SWIFT portfolio has produced a 2.81% return since inception, outperforming its policy benchmark by 2.59% and outperforming its dynamic benchmark by 2.60%. Performance for the broad asset classes of fixed income and equity lagged their benchmarks for the quarter but continue to produce strong returns since inception. Real assets have outperformed over all trailing periods. Overall, the total portfolio generated higher returns and lower risk than the policy and dynamic benchmarks since inception.

The Texas Economic Stabilization Investment Fund ("TESTIF") produced a 0.74% return for quarter ending September 30, 2017. It has produced positive returns for the one, two and inception to date periods. The largest contribution came from the Alternative Fixed Income sector.

Ms. Mills explained the market cycle definition as it pertains to part of the investment policy. (handout).

Lunch Speaker – Danielle DiMartino Booth Bio (Tab 5)

Ms. Booth is a global thought leader in monetary policy and economics. She is the author of *FED UP: An Insider's Take on Why the Federal Reserve is Bad for America* and Founder and President of the Dallas-based economic consulting firm, Money Strong. Ms. Booth is a frequent commentator on the central bank activities on national news networks and she served as an advisor to former Dallas Federal Reserve President, Richard Fisher. Ms. Booth presented her thoughts on the Federal Reserve and her belief that it is time for change. She believes there are still several quarters of economic growth in the near future and she believes the economy will see a 3% growth rate. Ms. Booth expressed her concerns regarding pension funds and stated that pension funds today are underfunded by approximately $30 trillion.

Endowment and SWIFT Portfolio Updates and Related Matters (Tab 6)

Mr. Ballard presented an overview of the Endowment portfolio for the third quarter of 2017 and reported that the portfolio was in compliance with its investment policy. He reported that as of September 30, 2017, the Endowment portfolio value was approximately $4 billion. He explained that the portfolio performed as expected and as he reviewed the asset allocation summary, he explained that each asset class was within their target ranges.

Mr. Ballard recapped the executive summary pages and noted that the top three performing strategies in each asset class were global public equity (4.7%), private equity (3.8%) and hedged equity (3.8%).

Mr. Lalo Torres reported on global fixed income He explained that the portfolio's absolute and relative performance was driven by its domestic and global credit exposures. All major domestic and global fixed income sectors posted positive returns for the quarter. He reported that the Global Fixed Income strategy contributed 0.1% for the quarter and 0.3% towards the one-year performance of the total Endowment returns.

Mr. Ruchit Shah discussed the alternative fixed income and private credit strategies. He reported that relative value strategies, especially convertible bond arbitrage and long-short credit funds, were strong contributors. Event driven strategies were mixed and distressed strategies produced modest returns. Mr. Shah discussed the macro-economics of emerging markets and our emerging market position exposure within the portfolio. He reported that the portfolio was increasing its emerging market exposure. And that macro funds produced slightly positive performance throughout the quarter.

Ms. Jyoti Gupta discussed the hedged and global public equity portfolios. She anticipates changes to the global public equity sector and would also like to increase emerging market exposure. She reported that Hedge Equity managers performed well especially in the healthcare and telecom, media and technology sectors. One detractor in the performance was an energy focused strategy.

Mr. Byron Beasley reviewed the private equity portion of the portfolio. He reported $70-$100 million in commitments were made last year keeping in pace with projections. The portfolio recorded significant gains in the valuations of global and European buyout funds during the quarter. Also, direct investment funds posted strong performance for the quarter. Mr. Beasley reported that private equities contributed 1.4% towards the one year performance of the total portfolio.

Mr. Mike Leifeste reported on the real estate portion of the portfolio. He explained that commercial real estate ("CRE") markets have appreciated in metro areas and CRE cap rates continue to remain low, despite rising interest rates in recent months. Apartment vacancies were rising gradually, retail vacancies remained flat and the industrial sector was benefiting from e-commerce growth. The enhanced portfolio experienced significant distributions therefore making allocation targets difficult to maintain. The stable real estate positions outperformed for the quarter primarily due to the single family rental portfolio. He reported that he was closely monitoring the commodities sector of the portfolio.

Mr. Ballard reported that the all asset strategies performed well for the quarter. There were no new commitments in this sector. The single manager in this sector continued to deliver on both an absolute and relative basis.

Mr. Ballard explained that was relatively little volatility in most asset classes for the quarter. The current value at risk ("VaR") was in line with the policy VaR.

Mr. Ballard updated the Board on the current performance for the Endowment portfolio. The return for October was approximately 1.3% bringing the year-to-date performance to 10%.

Mr. Ballard presented an overview of the SWIFT portfolio. The portfolio value as of September 30, 2017 was approximately $2.01 billion and remains very liquid. He reported that the Water Development Board withdrew from the fund approximately $108 million in 2015, $75 million in 2016, and $133 million in October of 2017. The current portfolio value is approximately $1.92 billion, after the most recent distribution. The portfolio produced a 1.9% return for the quarter and a trailing one year return of 7.9%. The estimated portfolio performance of the SWIFT for the calendar year ending December 31, 2017 is approximately 8.0%. Mr. Ballard reported that the SWIFT was meeting its investment objectives.

Mr. Ballard reviewed the TESTIF portfolio and reported that it was performing as designed by outperforming the Treasury Pool and preserving its purchasing power. The portfolio value as of October

31, 2017 was approximately $3.2 billion. The portfolio has produced an annualized return from inception through October of approximately 2.3%.

Discussion of Next Meeting and Agenda Items

Comptroller Hegar suggested that the next meeting would be scheduled sometime in April 2018. No future agenda items were suggested.

Public Comment

None.

Adjourn

The meeting adjourned at 2:00 p.m.