

**TOBACCO SETTLEMENT PERMANENT TRUST ACCOUNT INVESTMENT  
ADVISORY COMMITTEE  
Friday, March 27, 2015  
Minutes**

The Tobacco Settlement Permanent Trust Account Investment Advisory Committee (the “**Committee**”) met on Friday, March 27, 2015 at 10:00 a.m. in Room 320, Rusk State Office Building, 208 E. 10<sup>th</sup> Street, Austin, Texas.

**Committee Members Present**

Stuart Ford, Chairman; Judge Dan Gattis; Judge James Teal; Judge Woodrow Gossom, Jr.; Ms. Peggy Deming; Mr. Roy Browning; Mr. Noe Hinojosa; Mr. Fred Greene; Mr. Chuck Norris; and Commissioner Byron Underwood.

**Committee Members Absent**

Commissioner Neil Fritsch.

**Texas Treasury Safekeeping Trust Company (“Trust Company”) Staff Members Present**

Paul Ballard, Chief Executive Officer and Chief Investment Officer; Danny Sachnowitz, Deputy Chief Investment Officer; Frank Zahn, Chief Financial Officer; Marianne S. Dwight, General Counsel; John Wright, Deputy General Counsel; Michael Leifeste, Portfolio Manager; Byron Beasley, Portfolio Manager; Victor Scott, Director of Financial Reporting; Michael Anderson, Compliance Officer; Gena Minjares, Director of General Ledger Accounting; Jorge de LaFuente, Investment Analyst; Laura Montoya, Director of Administration; Nora Arredondo, Special Projects Coordinator; Harry Lindner; Investment Analyst and Corrine Hall, CAPCO Administrator.

**Additional Participants Present**

Mike O’Brien, Padgett, Stratemann & Co. and Tom Janisch, Asset Consulting Group (“ACG”).

**Call to Order**

Chairman Stuart Ford declared that a quorum was present and called the meeting to order at 10:00 a.m.

**Approval of Minutes (Tab 1)**

*A motion was made by Ms. Peggy Deming to approve the October 24, 2014 meeting minutes. The motion was seconded by Judge Dan Gattis and unanimously approved.*

**Presentation of Annual Audit (Handout)**

Mr. Mike O’Brien reported that Padgett, Stratemann & Co. issued an unqualified audit opinion with respect to the Tobacco Settlement Permanent Trust Account (“Account”) for the year ending December 31, 2014. Mr. O’Brien affirmed that the account had been managed in compliance with the Investment Policy and the Distribution Policy. Mr. O’Brien reviewed the distribution calculation process as described in the distribution attestation report. He explained that the audit attests to the calculation process not the decided distribution amount since it has yet to be determined. No audit adjustments were recorded during the audit engagement, nor was a management letter issued.

## **Discussion and Approval of Annual Trust Distribution (Tab 5)**

Mr. Paul Ballard began the discussion by reviewing the basics of the portfolio's rate of return and distribution calculation. He explained that the Trust portfolio is structured to produce an average rate of return of inflation plus 5%. In normal times, the distribution is expected to be 5% of the five-year average value of the Trust, from which 4.5% of that would be distributed to the hospital districts and a half percent (0.5%) would be contributed to the Distribution Stabilization Account ("DSA"). The Trust balance is intended to grow at the rate of inflation. However, in abnormal times, after a market decline such as 2008, there is an alternative distribution plan. An alternative distribution plan is required when the market value of the Trust is less than the value of the corpus, (corpus being the total contributions adjusted for inflation) and a normal distribution cannot be made. Mr. Ballard explained that the inflation adjusted corpus was approximately \$2.270 billion and the value of the Trust was approximately \$2.379 billion as of the end of February. This is the first year since 2008 that the value of the Trust has been greater than the value of corpus. Mr. Ballard reviewed the distributions and contributions to the DSA since 2009 and stated that the Committee's intent was to rebuild the DSA.

Mr. Ballard and Chairman Ford asked the Committee to review several options that are being considered for the 2015 distribution. Option #1 would be to distribute \$46 million, which is less than the 2014 distribution, and add \$32 million to the DSA. Option #2 would allow the Committee to match the 2014 distribution of approximately \$50 million and add \$28 million to the DSA. Option #3 would allow a maximum distribution of \$96 million. This option would represent the maximum allowable distribution and take current 2014 earnings of \$45.9 million, plus positive net earnings of \$32.4 million and deplete the DSA by 50% (\$17 million). Option #4, suggested by Mr. Fred Greene, would be to increase the distribution by the current U.S. rate of healthcare inflation which is 8%. The distribution would be approximately \$54 million and \$24 million to the DSA. When determining the distribution amount, Mr. Ballard reminded the Committee that the investment objective is to provide a predictable, stable stream of distributions, ensure that the inflation adjusted value of the distributions are maintained over the long term, and also ensure that the inflation adjusted value of the corpus (after distributions and fund expenses) is maintained over the long run. The Committee discussed the options and agreed they wanted to increase the distribution from the previous year, since there were positive net earnings, yet they wanted to remind the Trust beneficiaries not to rely on this in the future. The Committee decided that approximately \$55 million should be distributed to the beneficiaries and \$23 million to DSA. Chairman Stuart Ford was asked to send a cautionary letter to the trust beneficiaries explaining the circumstances and advising them of the Committee's intent to maintain stable distributions in the future given the economic uncertainty, and focus on rebuilding the DSA.

***A motion was made by Chairman Stuart Ford to distribute approximately \$55 million to the beneficiaries of the Tobacco Settlement Permanent Trust Account and to contribute approximately \$23 million to DSA. The motion was seconded by Mr. Roy Browning and unanimously approved by the Committee.***

## **Capital Markets Outlook and Discussion (Tab 2)**

Mr. Tom Janisch of ACG presented an economic snapshot since the last meeting in October. He reported that U.S. economic growth was positive for the quarter. Fourth quarter 2014 GDP was up 2.2% and projected 2015 first quarter GDP should be approximately 3.6%. Inflation continues to be low. He reported that ACG believes interest rates will continue to remain low and may likely increase by September at the earliest. Internationally, Mr. Janisch reported that the Central Bank of Europe started quantitative easing, purchasing German bonds, hopeful that this will stimulate the economy. The U.S. dollar had gained strength and was almost at parity with the euro. Overall, the U.S. demonstrated modest growth and stability. ACG remains positive and continues to expect slow domestic economic growth.

Mr. Janisch reviewed capital markets performance for the period ending December 31, 2014. He explained that the U.S. bonds climbed despite signals that interest rates could rise. Global equities, led by U.S. stocks were generally positive with the exception of emerging markets. Commodities were down 17%, posting their largest annual loss since the global financial crisis. Recent performance, for the period ending February 28, 2015, demonstrates year to date positive results for bond markets, U.S. equities and non-U.S. equities; however, commodities posted negative performance year to date.

Mr. Janisch summarized the asset class relative rankings as of the first quarter of 2015 and reported there was one change in the tactical outlook for the quarter. A combination of falling oil prices, currency devaluation and uncertainty of emerging markets going forward contributed to downgrading the emerging market fixed income outlook from overweight to neutral.

### **Endowment Portfolio Update and Related Matters (Tab 3)**

Mr. Paul Ballard presented an overview of the endowment portfolio and reported that it was in compliance with the asset allocation and investment policies. As of December 31, 2014 the portfolio value was approximately \$2.33 billion and the trailing one year return was approximately 5.1%. He explained that the portfolio is put through several stress tests scenarios and the construction of the portfolio has proven to be resilient. Its objective continues to be consistency of performance with downside protection. He reviewed the portfolio characteristics and stated that the portfolio was very liquid, is positioned opportunistically and is extremely diversified. Mr. Ballard and Mr. Sachnowitz reviewed the portfolio's various investment managers, their strategies and performance within each asset class. They discussed managers that have been added or redeemed from the portfolio. They went on to explain several investments with Amherst Capital Management. Mr. Ballard reviewed the contributions, distributions and current value of the portfolio. He explained that the portfolio was funded with approximately \$1.7 billion, \$720 million has been distributed to date and approximately \$2.3 billion is the current value remaining. He reported that the portfolio was performing in line with expectations, given the current economic environment.

### **Presentation and Discussion of Investment Performance for the Period Ending 12/31/14 (Tab 4)**

Mr. Ballard reviewed the investment performance of the endowment funds for the period ending December 31, 2014, on behalf of State Street. The portfolio return was approximately 0.24% for the quarter, which was approximately 59 basis points above the policy benchmark of -0.35%. The portfolio also outperformed the policy benchmark for the trailing one through five year periods. From inception to date, the portfolio's return was approximately 5.55%, outperforming its benchmark by approximately 25 basis points. The portfolio realized a lower level of volatility than its peers.

### **Discussion of Next Meeting and Agenda Items**

Committee members will be contacted to determine the best date for the next meeting.

### **Public Comment**

None.

### **Adjourn**

*Chairman Stuart Ford adjourned the meeting at 12:01pm.*