TOBACCO SETTLEMENT PERMANENT TRUST ACCOUNT INVESTMENT ADVISORY COMMITTEE

Friday, July 22, 2016

Minutes

The Tobacco Settlement Permanent Trust Account Investment Advisory Committee (the "**Committee**") met on Friday, July 22, 2016 at 10:00 a.m. in Room 320, Rusk State Office Building, 208 E. 10th Street, Austin, Texas.

Committee Members Present

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

Committee Members Absent

Judge Dan Gattis and Mr. Noe Hinojosa.

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; Gena Minjares, Deputy Chief Financial Officer; Chad Turner, Risk Manager; Jorge de LaFuente, Director of Operational Due Diligence; Patrick Jue, Operational Due Diligence Analyst; Nora Arredondo, Special Projects Coordinator; Susan Colletti, Director of Investment Accounting; and Corrine Hall, CAPCO Administrator.

Additional Participants Present

Lori Mills, Asset Consulting Group ("ACG").

Call to Order

Chairman Stuart Ford declared that a quorum was present and called the meeting to order at 10:31 a.m.

Approval of Minutes of April 1, 2016 Meeting (Tab 1)

A motion was made to approve the minutes from the April 1, 2016 meeting with one correction. The approval of the November 6, 2016 minutes should reflect that Judge Dan Gattis had made the motion to approve the minutes. The motion was seconded by Ms. Peggy Deming and unanimously approved.

A motion was made by Mr. Chuck Norris to approve the corrected April 1, 2016 meeting minutes. The motion was seconded by Mr. Fred Greene and unanimously approved.

Discussion and Recommendation of Revision to the Trust Account Distribution Rule/Spending Policy (Tab 3)

Mr. Paul Ballard referred to the committee's discussion during the April meeting about necessary revisions to the distribution policy for the Tobacco Trust. He explained that the objective of the Trust is to provide a predictable, stable stream of distributions to beneficiaries and to grow distributions at the rate of inflation. He stated that the overall objective of an endowment was to maintain inter-generational equity – not to over-distribute to the current generation at the expense of future generations and vice versa. Traditionally, endowments pay out a percentage of the long-term average value of a trust. If the investment structure and the distribution amount are just right, the average value of the trust should maintain its inflation-adjusted purchasing power over the long term. If the market suffers a uniquely material drawdown as it did in 2008, the distribution amount would slowly decline over time and, as the trust recovered, would slowly grow again.

Mr. Ballard stated that the Trust Company's consultant, Asset Consulting Group (ACG), had modeled different distribution rates for the Tobacco Trust to determine which could reasonably be expected to achieve the objective of maintaining inter-generational equity. He said that this modeling approach was consistent with industry standard best practice and met the legal obligations of a fiduciary. He explained that the fiduciary standard under which these funds were managed was the Prudent Investor Rule, and that "prudence" was determined by process and not by whether an investment made or lost money. As long as a fiduciary follows a process consistent with industry best practice, they met the legal test of prudence. The results of the ACG study demonstrated that an annual distribution rate of 3% of the average value of the Tobacco Trust could be expected to allow corpus and distributions to grow at the rate of inflation over time. Mr. Ballard stated that the current distribution policy was unnecessarily complex. Further, that it should be simplified and its investment objectives could better be met by reducing the distribution rate from 4.5% to 3%. In addition, a set distribution rate would be more predictable for beneficiaries.

Commissioner Underwood asked how lowering the distribution rate from 4.5% to 3% would increase distributions. Mr. Ballard explained that, because of current rule constraints limiting distributions if the value of the trust was less than inflation-adjusted corpus plus the value of the distribution stabilization account (DSA), the Trust distributed $46.8 million this year. Under a 3% distribution rule it would have been $66.8 million. The Tobacco Trust has not made a 4.5% distribution since 2008.

Ms. Lori Mills, reviewed ACG's presentation behind Tab 3. She explained that ACG uses a proprietary portfolio modeling tool called Dynamic Financial Analysis ("DFA"). The model relies on inputs such as expected returns, a unique return distribution for each asset class, includes the standard deviation of asset class returns, and the different correlations of asset classes with one another. The DFA model aids in establishing the structure of an investment portfolio that produces the desired return with the least amount of risk. It also has the capacity to model outcomes given different levels of annual distributions. Ms. Mills explained that current market conditions led ACG to reduce expected returns over the intermediate, ten-year, term. She stated that the asset allocation model demonstrated that a 3% distribution rate should produce a predictable, stable stream of distributions that grow at the rate of inflation over the long-term. Also, that the inflation adjusted value of the corpus is expected to be sustained over the long-term. After much discussion Mr. Ballard suggested that the Committee consider recommending to the Comptroller a reduction in the distribution rate in the rule from its current level of 4.5% to 3% of the 5- year, or twenty quarter average value of the Trust.

Mr. Ballard explained that in 2006 the distribution rules were changed to redefine "corpus" from its traditional definition of "capital contributed to the trust" to capital contributed increased each year by the rate of inflation. As a result, corpus is a constantly growing number. He explained that growing the trust at the rate of inflation was a long-term investment objective and that the value of the trust was expected to see-saw above and below that level over time, which it has done. Expenditure of corpus is prohibited by statute. He recommended that the definition of corpus be re-aligned with the statute and re-defined as the cumulative value of all contributions made to the Trust account just as it was prior to 2006. Mr. Danny Sachnowitz stated that staff would continue to report the inflation-adjusted value of the corpus to the committee.

Mr. Ballard stated that the DSA was not necessary if a lower distribution rate was adopted and that the DSA added unnecessary complexity to the distribution policy. He explained how the DSA actually makes it more difficult to make a normal distribution. The current rule requires the value of the DSA to be added to inflation-adjusted corpus in establishing a hurdle value. The larger the DSA, the higher the hurdle and only the value of the Trust that is in excess of this total may be used to make a normal distribution. The Trust has struggled to clear this bar since 2008. Mr. Ballard stated that should the committee desire a "circuit breaker," one could be established that would allow a reduced distribution if the Trust falls below $2 billion. Ms. Mills pointed out that ACG's model assumed the current trust starting portfolio value and, assuming a 3% distribution rate, there was a 90% probability the value of the fund would never fall as low as $2 billion. Mr. Ballard pointed out that the Tobacco Trust had distributed $821 million from earnings inception-to-date and that its value was currently $600 million in excess of capital initially contributed to the Trust. Yet none of those earnings were available for distribution because of the constraints of the current distribution rule.

The Committee discussed establishing a distribution range of between 2% and 4% that would be determined annually. Mr. Ballard expressed concern that human emotion prevalent in March of each year would be the driver of the decision and discussed how unreliable human emotion was in making investment decisions and timing market movements. He stated that in order to meet the test of fiduciary prudence, the decision needed to be based on a process and policies consistent with industry standard best practices. He reiterated that a 3% distribution rate had been modeled using a best practice process and demonstrated that it was expected to meet investment objectives of growing corpus and distributions at the rate of inflation over time. Further, Ms. Mills stated that the model was forward-looking for the purpose of forecasting probable outcomes given a particular asset mix and distribution rate. She said it would not be possible to model a distribution rate that was subject to change each year. She recommended the adoption of a set distribution percentage.

The committee clarified that the distribution rate would be based on the 20-quarter or five year moving average value of the trust and agreed that establishing a flat 3% distribution rate was appropriate. Rather than establishing the distribution rate in the Tobacco Trust Administrative

Code, however, the committee agreed that it would provide greater flexibility if the Administrative Code simply referenced the distribution rate set out in the Endowment Investment Policy as the Investment Policy could be more quickly modified than the Code should the need to do so arise. The committee reviewed the proposed changes to the red lined version of the Tobacco Trust rules in the Texas Administrative Code behind Tab A and asked that staff amend the stated distribution rate of 3% to, instead, reference the distribution rate set out in the Investment Policy and to delete section (c) under §18.2 referencing the establishment of a $2 billion threshold "circuit breaker" as it was unnecessary. Similarly, the committee discussed and agreed to the elimination of the DSA as it is no longer necessary.

A motion was made by Mr. Roy Browning, Jr to recommend to the Comptroller the adoption of the revisions to the Tobacco Trust rules in the Texas Administrative Code set out behind Tab A with the following modifications: eliminate a fixed distribution rate in rule 18.2(b) of the Code and insert a reference to the distribution rate set out in the Endowment Investment Policy Statement, and strike section §18.2 (c) referencing a $2 billion "circuit breaker." The Committee instructed the Trust Company General Counsel to address changes to the Texas Administrative Code 34 §§18.1-2 consistent with the intention of the conclusions drawn by the committee.

The motion was seconded by Commissioner Byron Underwood and unanimously approved by the Committee.

Public Comment

Mr. Jim Allison of Allison, Bass and Magee, LLP, spoke of the origins of this Committee and how it was created to advise the Comptroller on investment and investment policies. He commended the Committee today on recommending the changes to the distribution rule that allows for some flexibility.

Capital Markets Overview and Investment Performance Review for the Quarter Ending March 31, 2016 and Related Matters (Tab 2)

No discussion

Discussion of Next Meeting and Agenda Items

Committee members will be contacted to determine a date to meet in October.

Adjourn

Chairman Stuart Ford adjourned the meeting at 12:21 p.m.