COMPTROLLER'S
INVESTMENT ADVISORY BOARD MEETING
Wednesday, April 12, 2017
Minutes

The Comptroller's Investment Advisory Board (the "Board") met at 10 a.m. on Wednesday, April 12, 2017 at the LBJ State Office Building, 111 E. 17th Street, Room 114, Austin, Texas.

Board Members ("The Board") Present

Comptroller Glenn Hegar, Laurie Dotter, Jim Hille, Steve Strake, Adolpho Telles and Scott Wise.

Board Members Absent

Tucker Bridwell.

Comptroller of Public Accounts Staff Present

Mike Reissig, Deputy Comptroller.

Texas Treasury Safekeeping Trust Company ("Trust Company") 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; Gena Minjares, Deputy Chief Financial Officer; Mike Samples, Director of Internal Investments; Marianne S. Dwight, General Counsel; Laura Montoya, Chief Operating Officer; Byron Beasley, Portfolio Manager; Michael Leifeste, Portfolio Manager; Lalo Torres, Portfolio Manager; Ruchit Shah, Portfolio Manager; Jyoti Gupta, Portfolio Manager; Jorge de Lafuente, Director of Operational Due Diligence; Adam Levine, Risk Strategist; Anca Ion, Deputy Director of Internal Investments; Patrick Jue, Investment Analyst; Nora Arredondo, Special Projects Coordinator; Brandy Bianco, Project Manager; Chad Turner, Risk Manager; Yunke Yu, Quantitative Data Analyst; Yunjing An, Quantitative Data Analyst; and Corrine Hall, Program Administrator.

Additional Participants

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

Call to Order

Comptroller Glenn Hegar declared that a quorum was present and called the meeting to order at 10:04 a.m.

Approval of Minutes of January 23, 2017 Meeting (Tab 1)

Mr. Scott Wise made a motion to accept and approve the minutes of the January 23, 2017 Comptroller's Investment Advisory Board meeting. The motion was seconded by Mr. Adolpho Telles and unanimously approved by the Board.

Economic Outlook, Investment and Review of Treasury Pool (Tab 2)

Mr. Mike Samples reported on current economic conditions. He presented his view regarding tax reform and explained that he does not believe tax reform would lead to economic growth. He is concerned about inflation. If the current President's proposal to reduce taxes and boost infrastructure spending is realized, inflation could rise by more than expected thus prompting the Federal Reserve (the "Fed") to raise rates again. He also believes there may be early signs of rising inflation evidenced by the rising velocity of money and the continued rise of the consumer price index ("CPI"). Velocity is important for measuring the rate at which money in circulation is used for purchasing goods and services, as this helps investors gauge how robust the economy is. It is also a key input in determining the economy's inflation calculation. Economies that experience a higher velocity of money relative to others tend to have a higher rate of inflation. If the CPI stays steady or increases in coming months, such an inflation reading could strengthen the argument for the Fed to continue to raise interest rates.

Mr. Samples explained that sustainability is important regarding economic growth. The government needs a certain amount of economic growth, not just for a few years, but indefinitely. He reported that the labor force in the U.S. is growing slowly largely due to the aging population. The labor force stabilized five years ago and the growth rate is approximately .6%. He reported that approximately 17% of the U.S. labor force is comprised of immigrants. Without that immigrant population in the labor force, the labor force is cut in half. If the labor force growth rate is slowed then the economic growth rate would also probably be slowed. Mr. Samples is concerned that the U.S. is not going to realize satisfactory economic growth. He expects economic growth to continue at a pace of 1%-2% annually. With this expectation, he and his team are maintaining an average maturity neutral to our benchmark for the treasury pool. They are also cognizant of cash flows as the treasury pool serves as a liquidity provider for some of the debt issued by the state of Texas. He reported that the treasury pool yield was approximately 1.09% as of February 28, 2017, had a market value of approximately $23.87 billion and continued to maintain a AAA rating by Standard & Poor's.

Capital Markets Outlook and Investment Performance for the Quarter Ending December 31, 2016 (Tab 3)

Ms. Lori Mills of Asset Consulting Group first provided a review of the current market environment. She reported that this economic recovery has lasted twice as long as the historic average and is the third longest on record. It is also one of the weakest recoveries on record. ACG expects economic growth will continue at a modest rate of 2%-2.5% annually. They believe there will ultimately be a recession but are uncertain of how deep or for how long. ACG believes the economic theme continues to be muted returns with low inflation and low interest rates. They prefer equity to bonds (non-U.S equities preferred to U.S. equities), active management, and long/short opportunities. Ms. Mills reviewed the market environment for the period ending February 28, 2017. She reported that global equities led the way year-to-date with all major indices positive. Global fixed income and commodities also produced marginally positive returns year-to-date.

Ms. Mills reviewed the total portfolio summary for the period ending December 31, 2016. She reported that the portfolio had produced an annualized rate of return of approximately 6.10% over the previous five-years, compared to 5.45% for the policy benchmark. She explained that over the past five years the total portfolio had generated a higher return with similar risk as the endowment policy. Relative to broad market benchmarks, the total portfolio has generated 96% of the return with 50% of the risk. In short, it produced a better risk-adjusted return than the benchmark. She reported that each broad asset class (fixed income, equity and real assets) had contributed positively over the trailing three and five year periods. Equities have been the best performing portion of the portfolio over the five year period and private equities strategies have been the best performing component of the equity portfolio over the three and five year periods. Solid performance from real estate related investments has more than offset the struggles from the natural resources investments.

Ms. Mills reported that the State Water Implementation Fund for Texas ("SWIFT") portfolio produced a 1.49% return for the quarter ending December 31, 2016, outperforming its policy benchmark by .32% and outperforming its dynamic benchmark by 1.19%. Performance for the broad asset classes of fixed income, equity and real assets all exceeded their benchmarks for the quarter and have significantly outperformed since inception. Overall, the portfolio has generated higher returns with lower risk than either the policy or dynamic benchmarks.

Legislative Update

Comptroller Hegar updated the Board on some highlights during this legislative session. He reported that both chambers passed their budgets and from a budgetary standpoint there is more money in the treasury but less cash on hand. More money is going to the transportation sector than in the past. He explained that the Comptroller's office is working on a plan in regards to the Economic Stabilization Fund ("ESF"), also referred to as the Rainy Day Fund. They would like legislation that would split the ESF into two tiers allowing the state to realize a higher return on the Funds.

Lunch Speaker – Jonathan Gray, Blackstone

Mr. Jonathan Gray is Global Head of Real Estate and a member of the board of directors of Blackstone. Mr. Gray helped build the largest real estate platform in the world with $102 billion in investor capital under management. Blackstone is the largest alternative manager in the world with over $320 billion in assets under management. Mr. Gray stated that Blackstone's real estate strategy remains the same: they are opportunistic managers; they buy at a discount, fix it up, and then sell. Mr. Gray shared Blackstone's domestic economic views. They believe lower interest rates for longer periods of time are coming to an end. Blackstone has a positive outlook on the U.S. housing market. He stated that Blackstone's real estate business is one of the largest owners of residential properties in the U.S. and their confidence is largely supported by the basic concept of supply and demand. The housing market was not keeping up with population growth and demand. Ultimately, new construction should pick up to meet this unmet demand and Blackstone continues to look for more ways to get exposure to this multi-year recovery in housing. Mr. Gray explained that there is a significant trend in urbanization in the U.S. Improved quality of life, lower crime rates and the benefit of mobile devices and the sharing economy are drawing young, educated professionals back to urban environments. Blackstone feels inclined to own apartments and warehouses and is more biased toward the west coast. Given the favorable supply/demand picture in both commercial and residential real estate in the U.S., Blackstone continues to maintain exposure in these sectors. The major risk in real estate investing is generally from reckless use of leverage that forces a sale at the wrong time.

Mr. Gray explained that globally, Blackstone favors innovation cities such as London, Dublin, Amsterdam, Stockholm, and Berlin, to name a few. In Spain, the housing market is down so they feel it is a good time to buy Spanish real estate. Blackstone is the largest owner of real estate in India and they believe there are good things happening with India. Their government is pro-growth, there is less regulation and there are many highly educated people who can be employed at relatively low rates. In Latin America, two countries make up approximately 80% of the GDP: Mexico and Brazil. There is much volatility in Brazil with very high inflation slowly decreasing. In Mexico, Blackstone favors hotels the most. Overall, Blackstone believes an allocation to real estate in a diversified portfolio can improve a portfolio's overall return while reducing volatility. Real estate provides both current income and appreciation.

Endowment and SWIFT Portfolio Updates and Related Matters (Tab 5)

Mr. Ballard presented the Board an overview of the endowment portfolio and reported that it was in compliance with its investment policy. He reported that as of December 31, 2016, the portfolio value was approximately $3.86 billion. He recapped the executive summary pages and reported that the portfolio was performing as expected. Mr. Adam Levine explained the metrics of how the investment team is capturing the upside and downside relative to the benchmark. He stated that they look at trend analysis in general over snapshot data. Mr. Ballard reviewed the asset allocation sand chart which demonstrates how the portfolio has been built out over the years. He stated that the portfolio was intentionally overweight to Europe because of a view that European equities are undervalued. Mr. Ballard explained that the money received from private equity and real estate investments is being repaid faster than it can be put to work. Mr. Byron Beasley, private equity portfolio manager, reported that over $100 million in private equity commitments were made last year but only $5 million went to new managers. He reported that the portfolio found an interesting secondary fund specializing in clean technology venture funds selling at an approximate 40% discount to their net asset values. Mr. Ruchit Shah reported on new commitments to the alternative fixed income and private debt portions of the portfolio. Alternative fixed income provided healthy returns for the fourth quarter of 2016 and proved to be a big driver in the fixed income sector. He stated that the objective for alternative fixed income hedge funds is to select those capable of producing excess returns over benchmarks, providing uncorrelated returns, and reducing overall portfolio volatility. Ms. Jyoti Gupta discussed hedge and global public equity portfolios. She explained that the hedge equity portfolio was pruned in 2016, therefore increasing its overall net exposure to equity markets. Four U.S. focused managers were removed and a long/short energy manager and two additional strategies were added. Mr. Mike Leifeste reported that $25 million in new commitments were added to the real estate portion of the portfolio. He stated that no new strategies were added to the natural resources sector; however, approximately $5 million was added to the existing Blackstone Resources Select fund.

Mr. Ballard reviewed the Value at Risk (VaR) Analysis and reported that the portfolio and policy benchmark had the same 3.5% VaR. He explained that managers have been increasing risk exposures in their strategies. He also explained the stress test scenarios performed on the portfolio. He compared the expected performance of the total portfolio in various crises relative to a portfolio allocated 65% to global equities and 35% to global fixed income. The analysis continues to demonstrate that the policy portfolio is expected to protect value better than a traditional 65/35 stock/bond portfolio in times of market drawdowns. Mr. Ballard reported that the portfolio produced a 1.5% return for the month of January, 1.1% return for the month of February, and 1.4% return for the month of March, bringing the year to date total to 4.0%.

Mr. Ballard presented an overview of the SWIFT portfolio. The portfolio value as of December 31, 2016 was approximately $1.90 billion and remains very liquid. The portfolio is comprised of 55 different strategies and is well diversified. He reported that the Water Development Board withdrew from the fund approximately $183 million and is expected to draw approximately $180 million in October of 2017. The portfolio has earned $118 million in returns since inception. Mr. Ballard reported that the SWIFT was meeting its performance objectives and thus far its year-to-date return is 1.8%.

Mr. Ballard reviewed the TESTIF portfolio and reported that it was performing as designed by outperforming the Treasury Pool and preserving its purchasing power. It has earned approximately $54 million more than it would have had it remained invested in the treasury pool. The portfolio remains very liquid.

Discussion of Next Meeting and Agenda Items

Comptroller Hegar announced that the next meeting would be scheduled for some time in July. No future agenda items were suggested.

Public Comment

None.

Adjourn

The meeting adjourned at 1:47 p.m.