# TOBACCO SETTLEMENT PERMANENT TRUST ACCOUNT INVESTMENT ADVISORY COMMITTEE

**Friday, October 14, 2016**

***Minutes***

The Tobacco Settlement Permanent Trust Account Investment Advisory Committee (the "**Committee**") met on Friday, October 14, 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; Mr. Roy Browning, Jr.; Commissioner Neil Fritsch; Judge Dan Gattis; Judge Woodrow "Woody" Gossom, Jr.; Judge James Teal; and Commissioner Byron Underwood.

**Committee Members Absent**

Ms. Peggy Deming; Mr. Fred Greene; Mr. Chuck Norris; 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; Michael Anderson, Compliance Officer; Jorge de LaFuente, Director of Operational Due Diligence; Patrick Jue, Operational Investment Analyst; Nora Arredondo, Special Projects Coordinator; and Corrine Hall, CAPCO Administrator.

**Additional Participants Present**

Lori Mills 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 10:05 a.m.

**Approval of Minutes (Tab 1)**

***A motion was made by Judge Woodrow Gossom, Jr. to approve the July 22, 2016 meeting minutes. The motion was seconded by Mr. Roy Browning and unanimously approved.***

**Capital Markets Overview and Investment Performance Review for the Quarter Ending June 30, 2016 and Related Matters (Tab 2)**

Mr. Tom Janisch of ACG presented an update on economic conditions since the last meeting in July. He reported that the economy experienced modest growth. The Gross Domestic Product ("GDP") was revised upward for the second quarter of 2016. Employment was slightly less than expected but still increased. The housing market proved steady as supply was below average and mortgages were still fairly easy to obtain. Per a recent Federal Reserve survey, mortgage lending is the easiest it has been in the last twenty years. Mr. Janisch reported that based on leading economic index indicators, the chance for a recession in the next two years is approximately 12%. All of these factors are positive for continued economic growth. He explained that the Federal Reserve Board ("Fed") has had several consecutive meetings and has left interest rates unchanged. Focus on market volatility will be heightened with the impending U.S. Presidential election in November. ACG believes there is still a strong possibility that the Fed will raise interest rates when they meet again in December.

Mr. Janisch explained that the British exit from the European Union is of concern to the Fed and that could affect any decision to increase rates. He reported that since the announcement of Brexit, the British Pound hit a 31 year low. Negotiations of the exit should begin in March of 2017. Mr. Janisch reported that on the positive side of economic news, for the first time since 2008 OPEC announced that it will strike a deal to cut the output of oil, causing oil prices to jump 8%. He stated that actual details would be finalized at the OPEC meeting in November. Other global concerns are tensions with Russia involving the hacking of the U.S. elections and their reported crimes in Syria. Economic uncertainty in China is also of concern to the U.S. since it has been the largest economic driver of the global economy. Overall, the U.S. demonstrated modest growth and stability. ACG remains positive but continues to expect slow domestic economic growth.

Mr. Janisch reviewed performance of the capital markets for the period ending September 30, 2016. All indices were positive year-to-date. Emerging Markets was the leader and up a little more than 16%. Another leading driver has been Small Cap stocks. In the bond market, high yield bonds have demonstrated eight consecutive months of increases and have led both the equity and bond markets. Mr. Janisch reviewed the risk versus return scatter diagram on page two, section two, and reported that the total portfolio has generated 135% of the return with 94% of the risk of the Endowment Policy over the past five years ended June 30, 2016. Relative to broad market benchmarks, the portfolio generated 91% of the return with 51% of the risk. Therefore, the Sharpe Ratio of the Trust portfolio (the amount of return earned for each unit of risk) is significantly higher. The portfolio has been constructed to mitigate volatility.

Mr. Janisch reviewed the performance summary for the quarter ending June 30, 2016. He reported that the Tobacco portfolio returns lagged the Endowment Policy Benchmark over the past year; however, it outperformed the benchmark over the three and five year periods. The fixed income portion of the portfolio outperformed in the second quarter and is exceeding the benchmark over the longer three and five year periods. Equity strategies lagged over the past year, yet continue to outperform over the trailing three and five year periods. The total portfolio produced a 1.84% rate of return for the period ending June 30, 2016 and 3.98% for the five year period. Mr. Janisch reported that the portfolio provided meaningful downside protection while participating in up markets.

**Update on Revisions to the Endowment Investment Policy (Tab 3)**

Mr. Paul Ballard reported to the Committee that the revisions to the Endowment Investment Policy recommended to the Comptroller were adopted effective October 1, 2017. He explained that the revisions to the asset allocation policy were designed to slightly improve expected returns.

Ms. Lori Mills reviewed the Asset Allocation Analysis behind Tab 3. She reviewed current and proposed target allocations and their impact on return and risk. Ms. Mills explained that current market conditions led ACG to reduce expected returns over the intermediate (ten-year) term. She summarized the results of the expected returns of each asset class and allocation using the new asset allocation model. The model relies on inputs such as expected returns, a unique return distribution for each asset class includes the standard deviation (price volatility) of asset class returns, and the correlations of asset classes with one another. Ms. Mills explained that the Trust Company and ACG agreed that no major revisions to the broad asset allocation classes (equity, fixed income and real assets) need occur, but instead made revisions to sub-asset classes by slightly changing their target allocations.

Mr. Ballard and Ms. Mills reviewed the asset allocation target changes within each class. Mr. Ballard explained how the adjustments are reflected in the revised Endowment Investment Policy behind Tab 3. He reviewed other changes such as the revised distribution rate previously agreed to by this board of 3% of the twenty quarter moving average value of the fund, the elimination of the Distribution Stabilization Account ("DSA"), inflation adjustment references, and a simplified definition of net earnings. These and other recommended revisions included behind Tab 3 are expected to be adopted into the Texas Administrative Code in November of 2016.

**Endowment Portfolio Update and Related Matters (Tab 4)**

Mr. Paul Ballard presented an overview of the endowment portfolio and reported that it was in compliance with the asset allocation and investment policies. He explained that new graphs relating to cumulative return contribution (trailing three months and three years) and relative return contribution by asset class have been added to the presentation. As of June 30, 2016 the portfolio value was approximately $2.25 billion. The portfolio produced a 1.84% return for the quarter, slightly trailing the benchmark. The portfolio outperformed in the trailing two year and longer periods. Mr. Ballard explained that the value of the portfolio plus the distributions demonstrated a total value creation of approximately $3 billion since inception. Overall, asset allocation decisions contributed more to returns than manager performance for the quarter.

Mr. Ballard reviewed each asset class and the various investment strategies utilized to diversify returns within the portfolio. He explained which asset classes were overweight or underweight and how that related to the target allocations and returns. He reviewed the portfolio characteristics and stated that the portfolio was very liquid, is positioned opportunistically and is extremely diversified. Mr. Ballard 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 portfolio current Value at Risk ("VaR") is 3.4%, which is lower than the policy VaR of 3.7%. 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. He reported that the year-to-date return on the portfolio through August was approximately 3.9%. The portfolio is performing in line with expectations, given the current economic environment.

**Discussion of 2016 Annual Distribution (Tab 5)**

Mr. Ballard explained that based on the revised rule, the estimated distribution that will be made by April 1, 2017 is approximately $67 million, representing a $20 million increase over the prior year. That calculation is based on 3% of the 20-quarter moving average value of the Trust as of June 30, 2016. He said the final calculation will be based on the 20-quarters ending December 31, 2016. The expected actual distribution should not differ greatly from the $67 million estimate because the calculation is based on a long-term average and 18 of the 20-quarter values are already known.

Mr. Ballard reviewed the "Corpus vs. Market Value" chart behind Tab 5. He explained that at the end of the second quarter of 2016, the market value of the Trust was approximately $2.298 billion and the expected inflation adjusted corpus value was approximately $2.324 billion. He reported that total distributions to date were approximately $821 million as detailed in the report behind Tab 5. Mr. Stuart Ford stated that with the new rule, the inflation adjusted corpus would be eliminated when calculating the distribution but would still be tracked. Mr. Ballard stated that the Committee will decide on the amount of the 2016 distribution at its next meeting.

**Discussion of Next Meeting and Agenda Items**

Committee members will be contacted to determine the best date for the next meeting when a vote of the annual distribution will be taken.

**Public Comment**

Jim Allison, General Counsel from the County Judges and Commissioners Association of Texas, commended the Committee and Trust Company on the changes made to the Endowment Policy.

**Adjourn**

***Chairman Stuart Ford adjourned the meeting at 11:26 a.m.***