Minutes
Investment Advisory Council
November 19, 2013

The Investment Advisory Council (IAC) met at 12:00 P.M. Tuesday, November 19, 2013 in the Board Room – First Floor, 60 Empire Drive, St. Paul, Minnesota.

MEMBERS PRESENT: Denise Anderson, Jeff Bailey, Dave Bergstrom, John Bohan, Doug Gorence, Kim Faust, Laurie Hacking, Kristin Hanson (for Jim Schowalter), Jay Kiedrowski, Gary Martin, Malcolm McDonald, Mary Vanek and Elaine Voss.

MEMBERS ABSENT: Kerry Brick and Dennis Duerst.

SBI STAFF: Mansco Perry, LeaAnn Stagg, Tammy Brusehaver, Patricia Ammann, Stephanie Gleeson, Mike Menssen, Ryan Hill, Steve Kuettel, Aaron Griga, Paul Anderson, John Griebenow, J.J. Kirby, Debbie Griebenow, Charlene Olson and Melissa Mader.

OTHERS ATTENDING: Ann Posey, Callan Associates Inc.; Micah Hines, Bert Black, Celeste Grant, Christie Eller, Richard Baert, Pension & Investments; Margaret Martin, Center of the American Experiment; Carmen Marg-Patton and Cassie Harland, Office of the Legislative Auditor; Don Leathers, John Fisher, REAM and Gordon Voss.

Mr. Bailey welcomed Mr. Perry as the new Executive Director of the SBI and the minutes of the August 20, 2013 meeting were approved.

Executive Director's Report
Mr. Perry, Executive Director, referred members to Tab A of the meeting materials, and he reported that the Combined Funds had outperformed its Composite Index over the ten year period ending September 30, 2013 (Combined Funds 8.4% vs. Composite 8.1%) and had provided a real rate of return over the latest 20 year period (Combined Funds 8.3% vs. CPI 2.4%).

Mr. Perry said that the Combined Funds' assets increased 4.0% for the quarter ending September 30, 2013 due to positive market performance. He said that the asset mix is on target, and he stated that the Combined Funds outperformed its Composite Index for the quarter (Combined Funds 5.1% vs. Composite 4.8%), for the year (Combined Funds 14.9% vs. Composite 13.5%) and over longer periods.

Mr. Perry reported that the domestic stock manager group outperformed its target for the quarter (Domestic Stocks 7.1% vs. Domestic Equity Asset Class Target 6.3%) and for the year (Domestic Stock 23.0% vs. Domestic Equity Asset Class Target 21.6%). He said the international stock manager group underperformed its target for the quarter (International Stock 9.7% vs. International Equity Asset Class Target 10.1%) but outperformed for the year (International Stock 18.2% vs. International Equity Asset Class Target 16.5%). Mr. Perry stated that the bond segment outperformed its target for the quarter (Bonds 0.7% vs. Fixed Income Asset Class Target 0.6%) and for the year (Bonds -0.8% vs. Fixed Income Asset Class Target -1.7%). He stated that the alternative investments returned 2.1% for the quarter and 13.3% for the year. He concluded his report with the comment that, as of September 30, 2013, the SBI was responsible for over $69 billion in assets.

Mr. Perry referred members to Tab B of the meeting materials for an update on the budget and travel for the quarter. He stated that the Legislative Auditor is working on the financial audit of SBI operations and that members will receive a copy as soon as it is available. He added that members will be receiving a draft copy of the annual report and that the final report should be available by year-end. Mr. Perry noted the tentative meeting dates for calendar year 2014. He stated that Tab B contains updated information on Sudan and Iran.

Mr. Perry stated that SBI staff and the Minnesota State Retirement System staff are recommending that legislation be pursued which will give greater flexibility for the investment options in the Supplemental Investment Fund. Mr. Kiedrowski moved approval of the recommendation, as stated in Tab B. Ms. Voss seconded the motion. The motion passed.

Mr. Perry reported that the 529 College Savings Plan's contract will expire in August 2014. He stated that staff is working with the Higher Education Services Organization (HESO) on getting an RFP ready and is also discussing with HESO the possibility of making some changes to the plan to make it more competitive. He added that Commissioner Pogemiller has been in discussions with the Department of Revenue about potential tax incentives. Mr. Perry noted that there is currently no litigation involving the SBI.

Mr. Perry referred members to Tab C of the meeting materials for updated information on the SBI's equity and fixed income managers. He referred members to a memo distributed regarding a review of Knelman Asset Management Group, a domestic equity manager (see **Attachment A**.) He stated that the firm has been cited by the Securities and Exchange Commission for a couple of violations. He noted that the violations did not involve any of the SBI's assets. He added that the firm has also suffered staff turnover and underperformance and that staff is recommending that the SBI terminate the relationship. Mr. McDonald moved approval of the recommendation, as stated in Attachment A. Ms. Hacking seconded the motion. The motion passed.

Mr. Perry referred members to page A-86 of Tab C for updated performance on the non-retirement managers. He said that staff will keep members apprised of any issues as needed going forward. Mr. Bergstrom added that staff performs due diligence on the Deferred Compensation managers as well.

Mr. Griebenow referred members to Tab D of the meeting materials and briefly reviewed new investments with one existing resource manager, Energy Capital Partners and one new private equity manager, Permira. Tom Lister, a Managing General Partner with Permira, then gave members a presentation on the Permira investment. Mr. McDonald moved approval of both recommendations, as stated in Tab D of the meeting materials. Ms. Hacking seconded the motion. The motion passed.

Mr. Perry discussed his view of the role of the IAC, and he thanked members for their service. A lengthy discussion followed regarding several topics such as structure of the IAC, investment approval procedures, and ways to ensure that the IAC is effectively serving and advising the Board members.

Mr. Perry stated that he had asked Ms. Posey to prepare some information regarding the SBI's bond portfolio (see **Attachment B**.) Ms. Posey reviewed the material regarding the potential impact of rising interest rates on the bond portfolio. A discussion followed with several members discussing their organizations' situations. In response to a question from Mr. Kiedrowski, Mr. Perry stated that unfunded alternative assets are included in with the fixed income allocation due to statutory restrictions. Mr. Perry stated that staff will continue to examine the issues in the fixed income area.

The meeting adjourned at 2:00 P.M.

Respectfully submitted,

Mansco Perry III

Mansco Perry III
Executive Director

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DATE: November 19, 2013

TO: Members, Investment Advisory Council

FROM: Tammy Brusehaver
PatC Ammann

SUBJECT: Review of Knelman Asset Management Group LLC, a domestic equity manager

Organization

The SBI hired Knelman Asset Management Group LLC in January 2005 to manage a large cap growth portfolio.

Securities and Exchange Commission sanction

On October 28, SBI staff was informed that the Securities and Exchange Commission sanctioned Knelman for violating the "custody rule" that requires them to meet certain standards when maintaining custody of their clients' funds or securities. In consenting to a censure and cease-and-desist order KAMG (Knelman Asset Management Group) agreed to pay a $60,000 penalty and Kip Knelman agreed to pay a $75,000 penalty and is barred from acting as chief compliance officer for at least three years. All citations were related to a fund of private equity funds named Rancho Partners I, that the SBI did not invest in. Additionally, the SBI's equity mandate with Knelman is custodied at State Street.

Investment Staff

The investment staff has had significant turnover. At the beginning of the year, the staff included Kip Knelman, Senior Managing Director, David Lettenberger, Senior Portfolio Manager/Chief Compliance Officer, and Seth Heimermann, Analyst. Seth left in February 2013. David left in May 2013. Knelman hired Derek Jose as a Senior Portfolio Manager/Chief Compliance Officer and Minzhi Qiu as an intern in July 2013. Kip Knelman remains on the investment staff.

Performance

As of September 2013, the portfolio has underperformed its benchmark for all time periods shown below.

As of September 30, 2013

	One year	Two years	Three years	Four years	Five years	Since inception
Knelman	15.1	21.2	14.3	13.3	10.1	5.8
Russell 1000 Growth	19.3	24.1	16.9	15.9	12.1	7.0
Net performance	**-4.2**	**-2.9**	**-2.6**	**-2.6**	**-2.0**	**-1.2**

Calendar Year Ending

	2012	2011	2010	2009	2008
Knelman	16.6	-3.3	18.1	31.1	-39.9
Russell 1000 Growth	15.3	2.6	16.7	37.2	-38.4
Net performance	**1.3**	**-5.9**	**1.4**	**-6.1**	**-1.5**

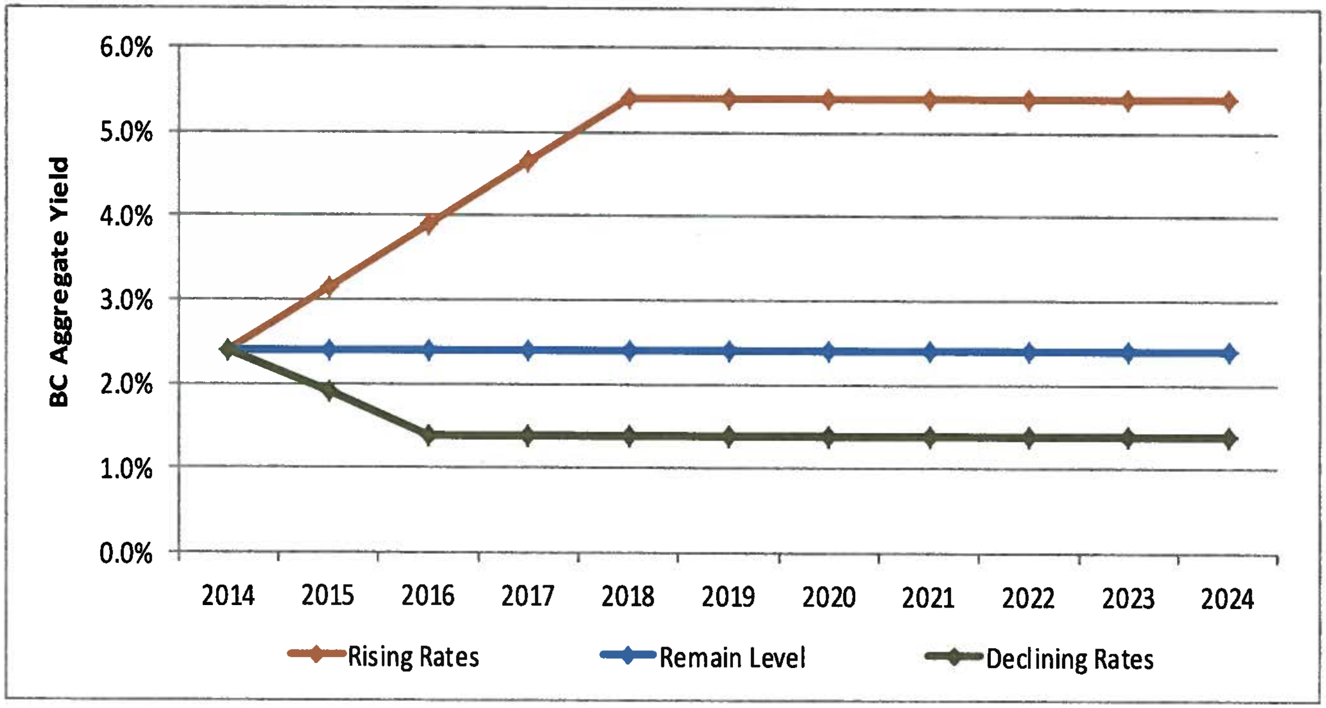
RECOMMENDATION:

Due to the Securities and Exchange Commission sanction, the turnover in investment staff, and underperformance staff recommends that the SBI terminate the relationship with Knelman Asset Management Group LLC.

ATTACHMENT B

Impact of Rising Rates

- **Fixed income returns derive from coupon income, capital gains/losses and reinvestment**
  - A rise in yields may lead to higher returns over the long run.
  - A prolonged period of low rates is not a good environment for long-term investors.
- ***Preliminary* Callan 2014 – 2023 baseline capital market expectations continue to include a rising rates scenario**
- **For a 0.5% parallel rise in the yield curve, all else equal, the BC Aggregate will return 0% over the next year.**



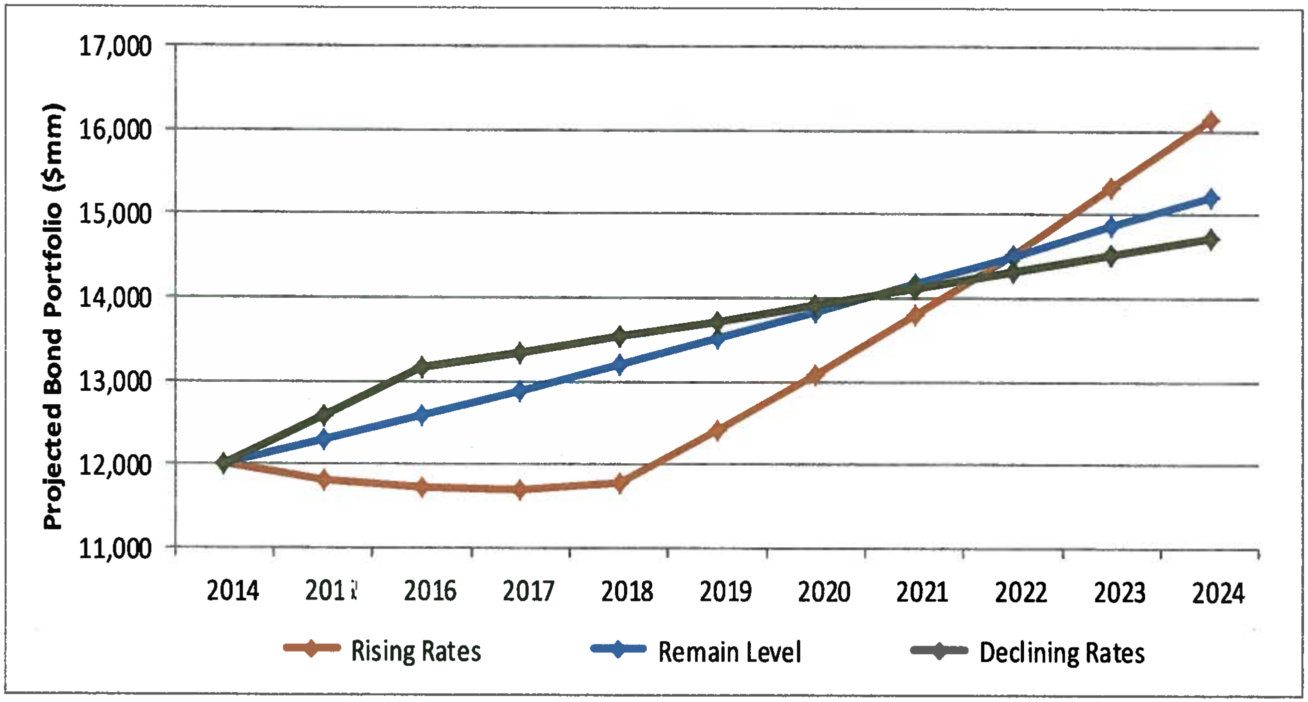
	1-Year*	3-Year*	10-Year*
Rising Rates	-1.5%	-0.8%	3.0%
Level Rates	2.4%	2.4%	2.4%
Declining Rates	5.0%	3.6%	2.1%

** Assumes a constant 5.6 year duration, parallel shift in the yield curve and 100% reinvestment every year.*

Callan

Projected Bond Portfolio Values

- **Rising Rate Scenario**
  - Assets fall in short term
  - Long term, asset are higher due to high income
- **Declining Rate Scenario**
  - Higher asset levels in short term
  - Long term: Worse case outcome.

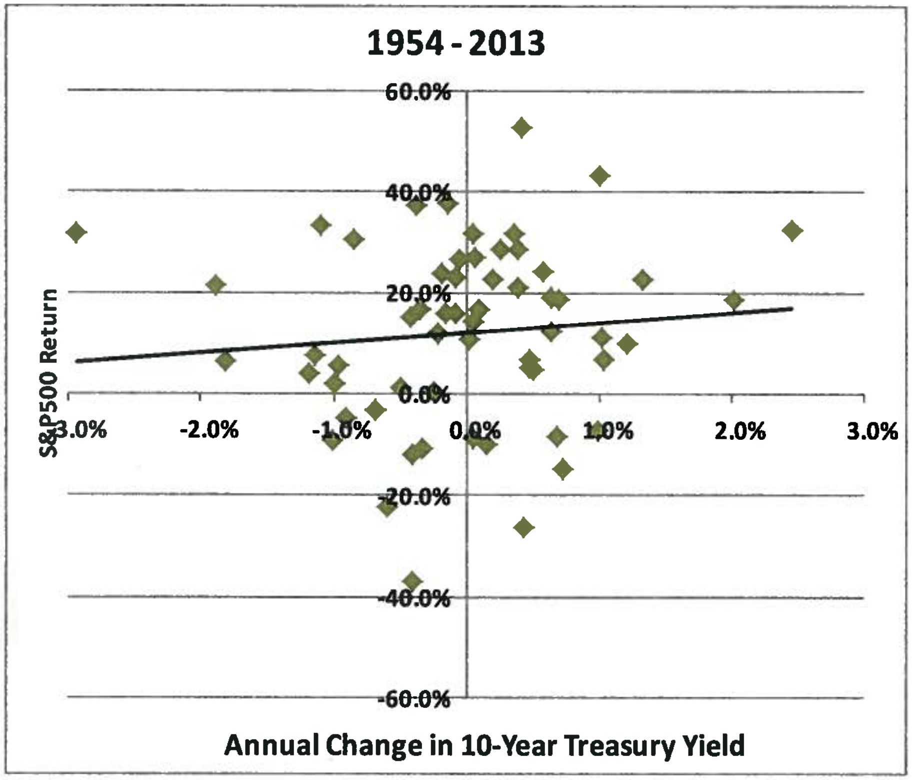


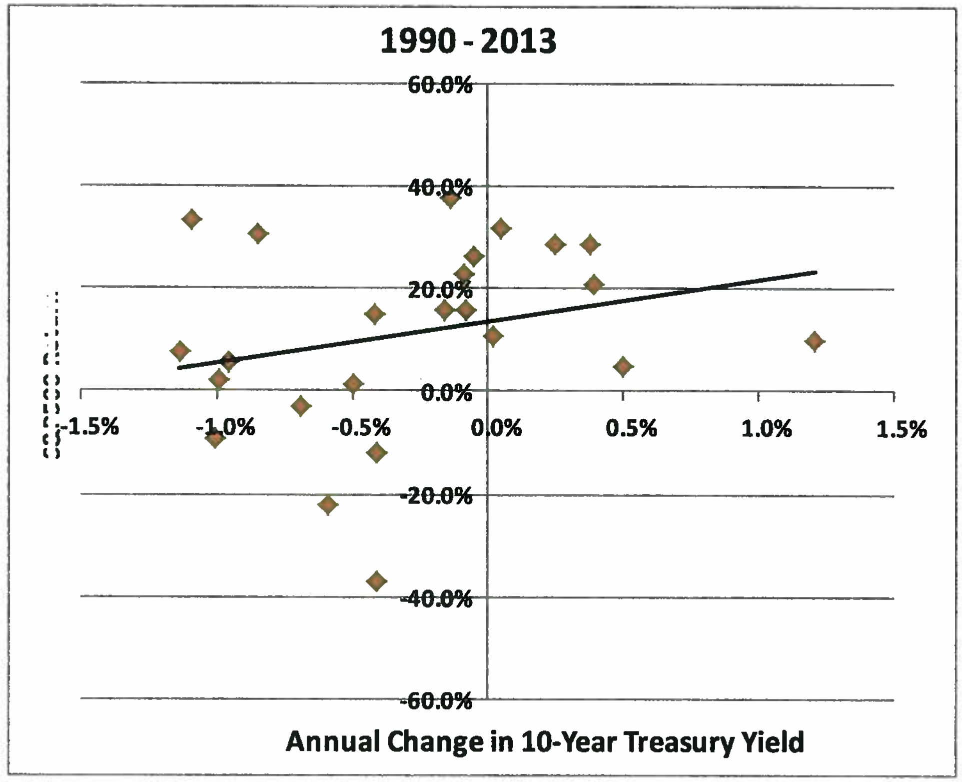
Cumulative Dollar Gain/(Loss) in Bond Portfolio ($mm)

	1-Year*	3-Year*	10-Year*
Rising Rates	($185)	($294)	$4,147
Remain Level	$288	$885	$3,212
Declining Rates	$601	$1,352	$2,717

** Asset Projection is based on yield scenarios in prior slide.*

Equities and Interest Rates





- The above charts illustrate the weak relationship betwee1 equities (S&P500) and interest rates (10-year Treasury yield) over a one-year horizon going back to 1954 and 1990 respectively.
  - The black line is a fitted linear regression line. A flat line indicates no relationship (zero correlation).
- In theory, equities should decline in price as interest rates rise.
  - Not only does the cost of borrowing increase but stocks are less attractive when the risk-free rate is higher.
- Unfortunately, the theory is not supported by empirical evidence (regression line is upward sloping from 1990 – 2013)
  - Rising interest rates may be indicative of a strengthening economy which is naturally an ideal environment for equity.
- Given that rates are (the risk-free rate is) very low today, interest rates may need to rise significantly before impacting the growth prospects for U.S. stocks.