Minutes
Investment Advisory Council
February 18, 2014

The Investment Advisory Council (IAC) met at 12:00 P.M. Tuesday, February 18, 2014 in the Board Room – First Floor, 60 Empire Drive, St. Paul, Minnesota.

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

MEMBERS ABSENT: Doug Gorence.

SBI STAFF: Mansco Perry, Jim Heidelberg, LeaAnn Stagg, Tammy Brusehaver, Patricia Ammann, Stephanie Gleeson, 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, Jay Stoffel, Teachers Retirement Association; Edgar Hernandez, SEIU; Joe Marble, House Republican Caucus; and Ashliegh Lietch, Law Student.

The minutes of the November 19, 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 December 31, 2013 (Combined Funds 8.1% vs. Composite 7.8%) and had provided a real rate of return over the latest 20 year period (Combined Funds 8.5% vs. CPI 2.3%).

Mr. Perry said that the Combined Funds' assets increased 5.4% for the quarter ending December 31, 2013 due to positive market performance. He said that the asset mix was rebalanced in January, and he stated that the Combined Funds outperformed its Composite Index for the quarter (Combined Funds 6.4% vs. Composite 5.9%), for the year (Combined Funds 20.2% vs. Composite 18.4%) and over longer periods.

Mr. Perry reported that the domestic stock manager group outperformed its target for the quarter (Domestic Stocks 10.2% vs. Domestic Equity Asset Class Target 10.1%) and for the year (Domestic Stock 35.1% vs. Domestic Equity Asset Class Target 33.6%). He said the international stock manager group outperformed its target for the quarter (International Stock 5.5% vs. International Equity Asset Class Target 4.8%) and for the year (International Stock 17.8% vs. International Equity Asset Class Target 15.3%). Mr. Perry stated that the bond segment outperformed its target for the quarter (Bonds 0.1% vs. Fixed Income Asset Class Target -0.1%) and for the year (Bonds -1.3% vs. Fixed Income Asset Class Target -2.0%). He stated that the alternative investments returned 5.6% for the quarter and 15.8% for the year. He concluded his report with the comment that, as of December 31, 2013, the SBI was responsible for over $73 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 has completed the financial audit of SBI operations and that members will receive a copy as soon as it is available. He noted that there was one minor written finding related to a rebalancing misclassification and two minor verbal findings related to a misclassification in the OPEB funds and allowing the auditors computer access during non-audit periods. He stated that all three findings had been corrected. He stated that Tab B contains updated information on Sudan and Iran.

Mr. Perry gave a brief update on the Executive Director's Workplan. He noted that the review of transition managers and the review of investment options for the Unclassified Plan will be deferred to the FY15 Workplan. He stated that the reviews of using swaps and derivatives in the Fixed Income Program and the review of a municipal bond pool may be deferred to FY15 or later due to stalled regulatory changes and other external factors.

Mr. Perry noted that the recommendation regarding legislative changes for the Supplemental Investment Fund that the IAC approved last quarter was tabled by the Board and he said the recommendation will be presented again at the March 2014 Board meeting with more specific information provided. Mr. Perry stated that discussions continue with the Teachers Retirement Association (TRA) regarding language for a merger bill for Duluth and St. Paul that would allow both plans to invest in the Combined Funds whether they merged with TRA or not.

Mr. Perry stated that there has been some preliminary discussions regarding potential legislation related to the establishment of a Minnesota program similar to MyRA, and he stated that staff is working with legislative staff to better understand the issue. He added that there could be legislation involving the SBI related to the Polymet mining operations if there is interest in setting up any type of trust fund.

Mr. Perry reported that staff worked with the Office of Higher Education (OHE) on an RFP for the selection of a vendor to provide administrative, marketing and investment services for the State's College Savings Plan, an internal revenue code section 529 plan. He noted that the current contract with the current vendor, TIAA-CREF, expires in August 2014. He stated that three responses to the RFP were received and that staff from the SBI and OHE recommend approval of a new five year contract with TIAA-CREF. He noted that negotiations are still ongoing related to some additional concessions regarding administrative fees. Mr. Bohan expressed concern related to the overall structure of the plan and the fact that the Minnesota plan does not have tax incentives built into it. A discussion followed with Mr. Perry and Ms. Stagg explaining the reduced fees that have been negotiated and the limitations the plan has due to its relatively smaller pool of assets. Mr. Heidelberg noted that the SBI has no control over the fact that the plan has no tax incentives associated with it and that legislation would be needed to make that type of change to the overall program. Mr. Bergstrom moved approval of the recommendation as stated in Tab B of the meeting materials. Ms. Faust seconded the motion. The motion passed.

Ms. Eller stated that there is currently no litigation involving the SBI.

Mr. Perry referred members to a memo distributed at the meeting regarding the recommendation to transfer the bond segment of the Income Share Account to the external bond managers in the SBI Bond Pool (see **Attachment A**.) Mr. McDonald moved approval of the staff recommendation, as stated in Attachment A. Mr. Bergstrom seconded the motion. The motion passed.

Mr. Perry referred members to Tab C of the meeting materials and noted that Turner Investment Partners has had some recent turnover in staff and that staff will continue to monitor the situation. A brief discussion followed regarding Turner's performance.

Mr. Griebenow referred members to Tab D of the meeting materials and Mr. Kirby presented a brief review of current strategy. Mr. Griebenow and Mr. Kirby briefly summarized the three new investments with one existing resource manager, Energy and Minerals Group and two existing private equity managers, Lexington Capital Partners and Strategic Partners. Mr. Griebenow noted that there was also a recommendation to allow Public Pension Capital the flexibility to close on a minimum amount of $400 million instead of the previously approved $500 million for the fund. In response to questions, Mr. Griebenow and Mr. Perry reaffirmed their support of the Public Pension Capital investment. A brief discussion followed and Mr. Perry stated that he would prefer to get reacquainted with the SBI's alternative portfolio before increasing commitment levels for new investments. Mr. McDonald moved approval of staff's four recommendations, as stated in Tab D of the meeting materials. Ms. Anderson seconded the motion. The motion passed.

Roundtable – Private Debt and Direct Lending

Mr. Perry stated that staff had prepared a presentation for a roundtable discussion on the topic of Private Debt and Direct Lending (see **Attachment B**.) He stated that the presentation includes speakers Louis Salvatore and Doyle Quelly from GSO Capital. A discussion followed the presentation.

Mr. Bailey stated that during the quarter he sent a survey to IAC members to get their feedback on the role of the IAC. He briefly summarized the most frequent responses. Mr. Perry gave his feedback from staffs' perspective and the Board member deputies all stated how important the IAC's investment expertise is to the Board.

Mr. Kiedrowski stated that he would like to discuss the policy of where the excess allocation from alternative investments is held at the next meeting of the IAC.

The meeting adjourned at 2:48 p.m.

Respectfully submitted,

Mansco Perry III

Mansco Perry III
Executive Director

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DATE: February 18, 2014

TO: Members, Investment Advisory Council

FROM: SBI Staff

SUBJECT: Transfer of Bond Segment of the Income Share Account to the Bond Pool

The Income Share Account in the Supplemental Investment Fund is a balanced fund with the 60 percent stock allocation invested in the passively managed stock portfolio managed by BlackRock, the 35 percent bond allocation invested by staff and the 5 percent cash allocation invested by State Street Global Advisors in the same portfolio in which the SIF Money Market Account is invested.

The Income Share Account bond portfolio currently has about $106 million. Staff invests another bond portfolio, called the Internal Bond Pool-Trust, for non-retirement assets. The Internal Bond Pool-Trust has about $815 million. Each requires its own accounting at State Street and within SBI accounting; each has its own cashflow pattern that must be considered; each has its own performance that must be calculated and retained. The separate investment management must be reported and explained to participants.

This portfolio is the only segment of the retirement assets offered by the State Board of Investment that is not managed by our external managers. In order to address management efficiencies and to provide a consistent approach, staff is recommending to transfer the management of the bond segment to the external bond managers in the Bond Pool. The transfer will be made effective before June 30, 2014.

RECOMMENDATION:

Staff recommends that the management of the bond segment of the Income Share Account be transferred to the SBI Bond Pool.

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The Asset Class, The Opportunity Set and The MSBI Portfolio

PRIVATE DEBT / DIRECT LENDING

AGENDA

- What is Private Debt
  - Three strategies
- Direct Lending
- The Alternative Investments View & Live Opportunities
- The Fixed Income View & Live Opportunities
- What are other Institutional Investors doing in this space?
- Conclusions
- Guest Speaker

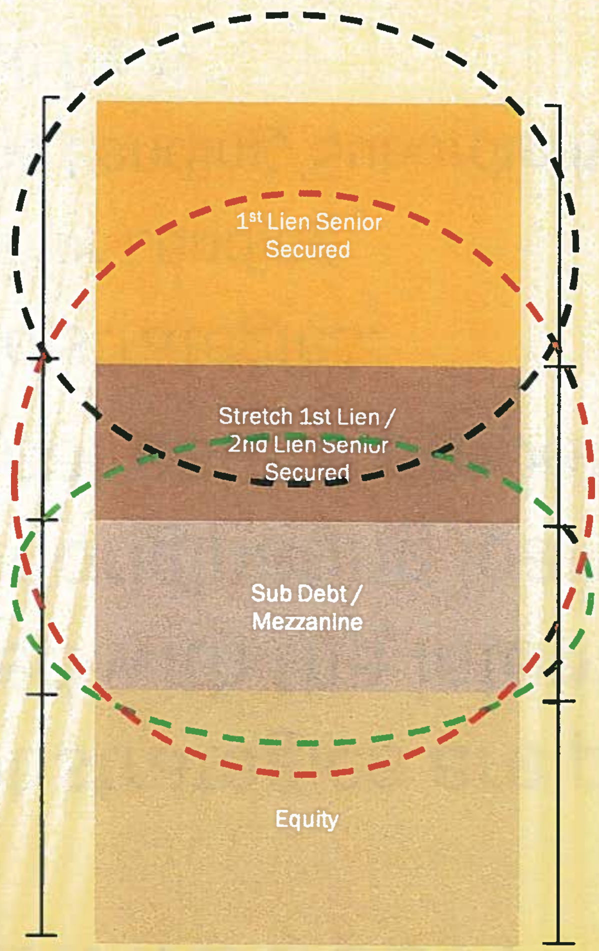
WHAT IS PRIVATE DEBT?

- Private Debt strategies are pools of capital that are organized with the intent of acquiring debt securities or originating loans to corporate entities or real estate properties
  - Three basic strategies:
    - Direct Senior Lending
    - Mezzanine Lending/Subordinated Debt
    - Distressed Debt

CAPITAL STRUCTURE EXAMPLE

Three Private Debt Strategies Target Different Parts of the Corporate Capital Structure

•Mezzanine Lending/Subordinated Debt strategies target the middle (mezzanine) of the capital structure
•Fund manager seeks a diversified portfolio of 10-20 mezzanine loans
•These loans are subordinate to the senior loans and are often unsecured by any of the company's assets
•These loans are often accompanied by "equity kickers" consisting of warrants or options on the company's equity
•Due to the unsecured and subordinated nature of the loans, combined with equity upside, these strategies target returns net to the investor of 10-12%



•Direct Lending strategies target the top of the Capital Structure
•Target returns net to the investor of 8-10%

•Distressed Debt strategies target all parts of the capital structure
•Fund manager seeks to acquire the debt of companies that are financially distressed, often at discounts to par value
•This debt can be publicly traded or private
•The fund manager may seek to acquire control of the company through conversion of debt to equity
•Targeted returns net to the investor of 12%+

DIRECT LENDING

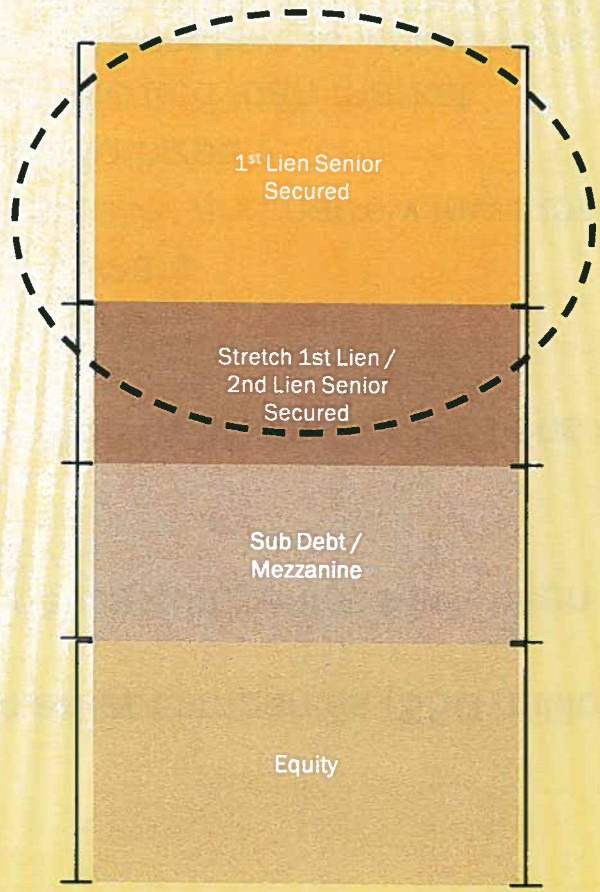
- What is Direct Lending?
  - Originated financings to middle-market companies ($50 million of EBITDA or less)
  - Historically regional banks and finance companies have been primary providers of direct lending capital
- Loan Characteristics
  - Loans are typically senior and secured by 1st and/or 2nd liens on company assets
  - Loans tend to have 5-7 year maturities
  - Loans are often non-callable for 2-3 years
  - Loans have limited liquidity given smaller and narrow investor base
  - Terms are negotiated and highly customized
  - Yields are generally higher than syndicated loan market
    - Recently, middle market senior secured loans have generated unlevered yields ranging from LIBOR plus 4.5% to LIBOR plus 6.5% with a LIBOR floor of 1.5% to 2.5%. The floor protects investors from LIBOR rates that dip below it by providing a minimum base yield in a low interest rate environment.
    - Spread between middle market loans and large corporate loans is wider than historical standards

Sources: KKR Asset Management, Barclays

DIRECT LENDING (CONT.)

Targets the Top of the Corporate Capital Structure

- Senior Debt/Direct Lending Strategies seek to originate senior secured loans to middle-market companies (EBITDA of $50 million or less)
- Fund managers executing this strategy seek a diversified portfolio of 10-20 loans
- The seniority of these investments in the capital structure reduces their risk, since they are in position to be repaid first in the event of bankruptcy. However, this position also reduces the total return expectations of the investment
- May have low correlation to traditional asset classes
- May provide an interest rate hedge



•Rate of Return Objective: 8-10%

•Interest Rates on Senior Loans are often floating

•Subordinated Loans are often Fixed Rate

DIRECT LENDING (CONT.)

What is the Opportunity Set?

- Traditional sources of capital (regional banks, finance companies) have reduced the amount they lend to middle market companies
  - BASEL III capital requirements forcing banks to hold more capital in reserve against these types of loans
  - Lack of shadow banking market with hedge funds, CLOs, others focused on liquid credit
- This has caused a funding gap for middle market companies
  - Mid-market private equity sponsors have become more active
  - Private debt funds have attempted to fill this funding gap
- Direct Lending strategies may provide an interest rate hedge when interest rates rise
- These characteristics can make Direct Lending attractive to some investors from an overall portfolio perspective

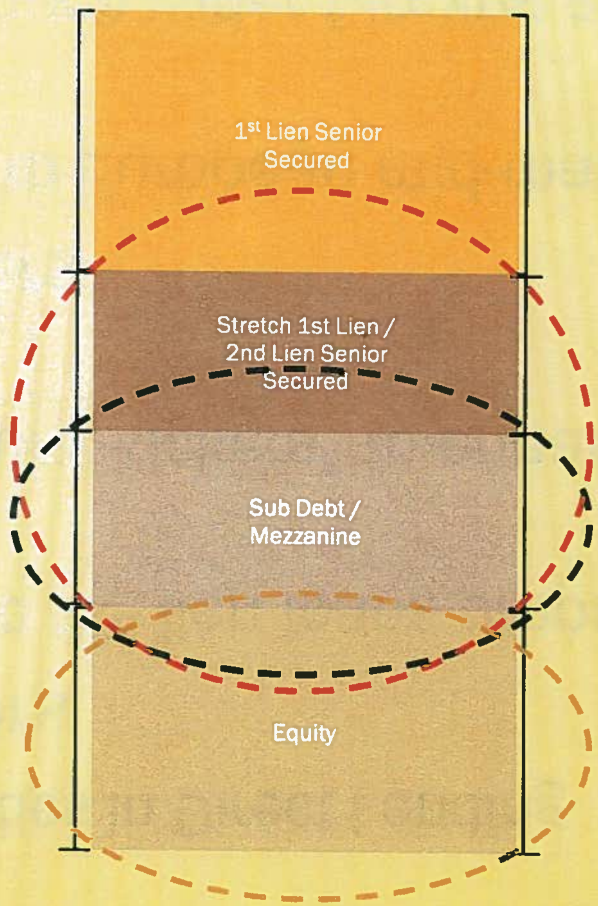
THE ALTERNATIVE INVESTMENTS VIEW

- What CAN go in the Alternatives Portfolio?
  - Commingled Funds where our participation is limited to 20% and there are at least 4 other investors and where our liability is limited to our capital commitment
    - Typically Limited Partnerships
- What HAS gone into the Alternatives Portfolio?
  - Commingled Funds focused on Private Equity, Real Estate, Equity Resources, and Yield-Oriented
  - The Yield-Oriented component has provided current income to the Alternatives portfolio in different ways
    - Corporate mezzanine/sub. debt strategies
    - Producing Properties contractual dividends (Merit Energy)
    - Real Estate Debt strategies (Capital Trust, Carbon Capital)

THE ALTERNATIVE INVESTMENTS VIEW

Have Targeted Middle and Lower Parts of the Corporate Capital Structure

- The Alternative Investments Portfolio has a high rate of return, long-term investment strategy
- Private Debt has materialized in the Alternatives Portfolio in the form of the higher returning strategies like Mezzanine/Sub. Debt and Distressed Debt
  - Examples:
    - Yield-Oriented Portfolio: Prudential Capital Partners, Audax, Summit Subordinated Debt Funds, Goldman Sachs Mezzanine Partners
    - Private Equity Portfolio: Wayzata Investment Partners (distressed debt-for-control), Varde and CarVal (whole loans, distressed securities, special situations) and Blackstone Real Estate Partners (distressed and opportunistic real estate investments)
- Through 12/31/13, the Yield-Oriented portion of the Alternatives Portfolio has returned 13.1% over the last 10 years



•Private Equity funds invest in the equity portion of a typical capital structure

•Through 12/31/13, the Private Equity portion of the Alternatives Portfolio has returned 16.5% over the last 10 years

THE ALTERNATIVE INVESTMENTS VIEW

Live Opportunities in Direct Lending

- Summit Credit Partners
  - Senior Secured 1st and 2nd lien loans proprietarily sourced
  - Will often acquire "equity kickers" to enhance the return
- Permira Debt Managers
  - Senior Secured loans to European mid-market businesses
  - Take advantage of a much wider funding gap in Europe caused by a structurally weaker banking system relative to the U.S.

THE FIXED INCOME VIEW

- Separate account structure
- Eight investment managers
  - Five portfolios managed using Active strategy
  - Three portfolios managed using Semi-Passive strategy
- Individual portfolio sizes $1.0 - $2.4 billion
- Fixed income portfolio = $13.5 billion

THE FIXED INCOME VIEW

- Eligible investments
  - U.S. and Canadian Government bonds, notes, bills, and mortgages
  - Corporate bonds (including high-yield)
  - MBS, ABS, and CMBS
  - Non-USD and emerging market bonds (IG only; must be in index)
  - Yankee and Eurodollar bonds

THE FIXED INCOME VIEW

Bank Loans

- Floating rate
- Below-investment-grade quality
- Secured by assets of the borrower
- Most senior source of capital in capital structure
- Interest rate paid on loan based on index, plus spread

THE FIXED INCOME VIEW

Bank Loans (cont.)

- Benefits
  - Historically have had low to negative correlation to investment-grade bonds
  - Historically have performed well during periods of rising rates
  - Generally most senior source of capital
  - Very little duration risk
  - Low price volatility

THE FIXED INCOME VIEW

Bank Loans (cont.)

- Risks
  - Credit quality of borrower
  - Technical factors (e.g. market's appetite for risk, liquidity, default environment, etc.)
  - Historically have had a higher correlation to equities than investment-grade and government bonds
  - Less liquid than investment-grade bonds
  - Prepayment risk

THE FIXED INCOME VIEW

Example: BlackRock Bank Loan Portfolio

- Duration = 0.25 years
- YTM = 4.7%
- Average credit quality = B1/B+
- 9% Technology / 7% Healthcare / 6% Gaming / 5% Chemicals / 4% Metals & Mining
- 97% bank loans / 2% high-yield corporates / 1% corporates, CLOs, and cash

WHAT ARE OTHER PUBLIC PENSION FUNDS DOING IN THIS SPACE?

- Staff had conversations with five large public pension plans (Virginia RS, Oregon SIC, MassPRIM, Florida SBA and Washington SIB)
- Each invest in a variety of private debt strategies, including Bank Loans and Direct Lending
- They all account for these strategies differently, but most consider these “Opportunistic” investments

CONCLUSIONS

- Direct Lending and more liquid debt strategies like Bank Loans have attractive risk/return characteristics when viewed as stand-alone investments
- The Direct Lending opportunity is real and likely to persist due to regulatory changes and a persistent spread in the interest rates of private senior secured loans to more liquid, publicly traded debt
- Further investigation by Staff is warranted

GUEST SPEAKER

- Lou Salvatore – GSO Capital Partners (Blackstone)