

THE INVESTMENT COMMITTEE
OF THE
MARYLAND STATE RETIREMENT AND PENSION SYSTEM

MINUTES OF OPEN MEETING

February 19, 2019

The Investment Committee convened on Tuesday, February 19, 2019 at 9:05 a.m. in the 16th Floor Board Room of the State Retirement Agency, SunTrust Building, 120 E. Baltimore Street, Baltimore, MD.

Committee Members	Eric Brotman (1)	Richard Norman (1)
Attending:	David Brinkley (1)	Douglas Prouty
	David Hamilton	Michael J. Stafford, Jr.
(1) Via telephone	Sheila Hill	Jamaal Craddock
	F. Patrick Hughes, Chairman (1)	Linda A. Herman, Vice Chair
	Charles W. Johnson (1)	Lamont "Monte" Tarbox
	Theresa Lochte	Peter Franchot
Committee Members	Michael K. Barry	Stephen Kitsoulis
Not Attending:	Nancy K. Kopp	
Also Attending:	Victor Adekoya	Gregory Kasten
	James Atwater (Marathon)	Larry Katsafanas
	Jennifer Barb (Indus Co.)	Dean Kenderdine
	Anish Bedi	Thomas Kurowski (Alex Brown)
	Frank E. Benham (Meketa)	Michael McCord
	Tom Brennan	Mary Mustard (Meketa)
	Robert Burd, Deputy CIO	Stephen Muturi
	Antionette Butcher	Jennifer O'Dell (Labors Union)
	Rachel Cohen, OAG	Andrew Palmer, CIO
	Eric Farls	Stephen Reilly
	David Ferguson	David Rongione, Chief Internal Auditor, Internal Auditing Div.
	Michael Golden	Dan Schick
	Dimitri Grechenko	Jody Shaw, OAG
	Alex Harisiadis, OAG	Frederick "Beau" Smith
	Justin Hayes	Toni Voglino
	Levar Hewlett	Patricia Wild
	Dana Johns	
	Faina Kashtelyan	

Mr. Hughes, Chairman, called the Investment Committee meeting to order at 9:05 a.m.

Item 1: Minutes

On a motion made by Ms. Hill and seconded by Ms. Lochte, the Investment Committee ratified the November 27, 2018 open meeting minutes.

Item 2: Public Member Position- Call for Nominations

Mr. Kenderdine announced the System has issued a call for nominations for a Public Advisor, which would serve a three-year term from July 1, 2019 – June 30, 2022. Michael K. Barry’s term is due to expire June 30, 2019.

Any member of the Committee wishing to submit nominations should provide the names to Mr. Kenderdine by Friday, March 1, 2019.

Item 3: Report from CIO

Mr. Palmer began his report by commenting that the System performed well versus its benchmark and peers for the quarter and trailing twelve months ending December 31, 2018. The performance was driven by private assets and the portfolio structure. The Division is working on a number of initiatives, including the active recruitment of three open positions, and planning to recruit for eight new positions approved in September, pending the work of the Objective Criteria Committee that was completed in January 2019.

Mr. Palmer noted that the private equity secondary sale closed in December 2018 for roughly \$1.2 billion. This sale frees up capital to reinvest in higher return funds, and maintains the target allocation. Progress on internal management continues, with passive TIPS and long government bonds on schedule for a May 1 target launch. However, delays in staffing and systems implementation may push the start date out a few months.

Mr. Palmer noted that the positive relative performance for the year can be attributed to manager performance and portfolio construction, offset somewhat by the impact of a persistent overweight to equities as part of the tactical asset allocation.

Mr. Palmer reported that staff funded \$1.0 billion in risk assets over the end of the year. This additional investment helped the plan return just below 4% for the month. While the absolute return was strong, the plan suffered relative to its policy benchmark, largely because of structural issues that are expected to smooth out through time. Mr. Hughes commented that he was pleased with January performance and the result of the private equity sale.

Mr. Palmer provided an overview of the tactical asset allocation process. He noted that roughly 90% of the System’s return is attributed to the System’s strategic asset allocation, and staff is targeting 10-20% of excess returns being generated by tactical asset allocation. Staff has added value through the tactical asset allocation over time. Mr. Palmer explained that this process has been evolving and improving since its inception and that Staff is focusing on a disciplined approach to rebalancing by reflecting its tactical views. He further noted that Staff has the tools to be able to efficiently make these tactical shifts. Finally, Mr. Palmer referenced the leverage slide to highlight the different sources of leverage by asset class within the System’s portfolio, including embedded leverage, economic leverage, and financial leverage.

Ms. Herman requested more detail on the private equity secondary transaction. Mr. Palmer noted that this will be provided in future correspondence. Ms. Herman asked about the criteria for the peer group used for “Key Performance Indicators” on page 11 of Mr. Palmer’s presentation. Mr. Palmer noted that the peer group was selected based on the criteria identified in the footnote on that page. Mr. Palmer elaborated that the differences in U.S. equity allocations among peer plans account for a significant portion of the difference in overall fund performance and risk.

Ms. Herman asked about the reporting for the performance of the tactical asset allocation program and where it is quantified. Mr. Palmer noted that the tactical performance should be viewed within the context of alpha and not in isolation. He explained that because Staff employs various tools to implement the tactical strategies, the impact is captured in the attribution section as opposed to the manager performance reports. He also stated that the performance of the tactical shifts was reflected in Meketa's report. Mr. Stafford asked about the flexibility the CIO has for implementing tactical decisions and why there was a \$500 million decrease in the rate sensitive portfolio. Mr. Palmer noted that capital from the rate sensitive asset class was used to fund a large real estate capital call in the beginning of January. Mr. Stafford asked how much leeway Staff has for tactical shifts. Mr. Palmer responded that the IPM provides asset class specific ranges around the target asset allocations, typically 3-5%, but wider for public equities. Mr. Kenderdine informed the Committee that Treasurer Kopp had been re-elected to another 4-year term as the Treasurer.

Items 4 & 5: Meketa Reports

Mr. Benham and Ms. Mustard from Meketa presented Meketa's fourth quarter 2018 review, detailing economic performance in the quarter, the System's performance, economic outlook, capital market expectations and benchmarking. Mr. Benham commented that the fourth quarter of 2018 was bad for all risk assets. He noted that the sell-off was a result of several factors, including the Federal Reserve's comments indicating that it was on "auto-pilot" with regard to reducing its balance sheet, the fading of the tax breaks, central banks stepping back from a decade of intervention, and the lack of experience by central banks of how to unwind extraordinary monetary policy. Mr. Benham commented that the U.S. economy is strong while Japan and the Eurozone could be heading into a recession. He commented that the U.S. is ahead of other central banks in raising rates and has more dry powder as a result. Mr. Benham also noted that China has been slowing and using less debt and that a Brexit solution is likely to be a challenge.

Mr. Brinkley asked if Meketa has any insight into when a recession might occur and how severe it could be. Mr. Benham commented that the full impact of the Fed tightening may not have been felt yet and may take up to 18 months to see its effects.

Ms. Herman asked where the impact of staff's tactical decisions can be viewed and whether the allocation effect in the attribution analysis incorporates staff's tactical decisions. Mr. Benham replied that the allocation effect was negative 13 basis points for the quarter and negative 20 basis points for the trailing year, reflecting tactical decisions, but cautioned that one quarter should not be viewed in isolation. Mr. Tarbox noted the strong relative performance during the quarter, which shows good defensive positioning and is a good outcome.

Comptroller Franchot questioned Meketa on the asset allocation, peer performance and whether the System's asset allocation has been beneficial. Mr. Benham commented that while there was a negative return for the quarter, the plan performed as expected. Mr. Benham discussed the two different peer groups representing peers with assets of >\$1 billion and peers with assets >\$25 billion. He noted that the two peer groups offer different levels of transparency and fee treatment. Mr. Benham continued that the System has become more diversified since the financial crisis and the move to longer maturity treasuries has provided cushion against drawdowns. He commented that while the broader diversification after the financial crisis has hurt the System's performance, it could help going forward as return expectations for U.S. stocks are lower than what has been experienced over the last ten years.

Comptroller Franchot suggested that the Investment Committee focus on employer contributions and urge the State to fund the System as promised. Mr. Benham commented that contributions into the plan have the most significant effect on long term funding levels, rather than investment returns. Mr. Stafford commented that the fourth quarter's relative performance was good, and questioned the level of

contributions coming from the State. Mr. Hughes suggested this may be a good topic for the Board to discuss after the Investment Committee meeting. Mr. Kenderdine clarified that the State has been making the required actuarial contributions, and that what has been reduced is the excess contributions. Mr. Brinkley replied that while this is an accurate interpretation, the legislature has not kept its commitment to getting the funding level to 80%.

Ms. Herman questioned the dollar impact of the 20 basis points loss due to tactical decisions and that the Board should not only be focused on contributions, but also the results of investment decisions being made. Mr. Benham replied that 20 basis points equates to roughly \$100 million. He cautioned that the tactical positioning should not be viewed in isolation, but as part of a comprehensive total fund performance analysis. He noted that while tactical decisions detracted approximately \$100 million for the calendar year, the total effect, including active management, generated +80 basis points of excess returns over the policy benchmark, or roughly \$400 million in excess returns. Mr. Palmer noted that tactical decisions have added \$75 million in value to the plan since inception of the program in December 2016.

Mr. Benham discussed Meketa's capital market expectations and provided a description of the models utilized to generate the asset class return forecasts. Mr. Benham cautioned that certain asset class predictions are more accurate than others. He noted that most asset class forecasts have increased since last year due to the poor performance of all asset classes in the fourth quarter of 2018. Ms. Herman questioned why the return forecast for natural resources increased so much since last year. Mr. Benham replied that this is a result of the substantially poor performance of the natural resources asset class in 2018.

Ms. Mustard provided an overview of benchmarking, including an explanation of the characteristics that constitute a good benchmark, the challenges posed by benchmarks, the different approaches to creating benchmarks, and the differences between the strategic and policy benchmark. Mr. Hughes commented that benchmarks are an important tool in evaluating the performance of the CIO and Staff.

Mr. Benham provided a corporate update of Meketa, and explained its merger with PCA, which he described as being beneficial to Meketa and its clients, as PCA clients are mostly public pensions.

Item 6: Investment Policy Manual Recommendations

Mr. Palmer discussed the changes to the IPM language which clarified the authority of the CIO to implement an internal asset management process. He explained that while the IPM currently referenced the authority to implement an internal management program, the proposed amendments more explicitly provide the authorization and establish related policies appropriate for adoption at the Board level. Mr. Palmer commented that staff worked with the Attorney General's office and outside counsel to update the IPM. Mr. Palmer noted that at the November meeting, the Committee deferred approval on a portion of the recommended changes in favor of reviewing all of the changes together. Mr. Palmer recommended for the committee to approve the language.

Mr. Hughes reminded the Investment Committee that any member can propose changes to the language in the IPM. Mr. Stafford asked what happened to the language that was in the IPM previously when assets were managed internally in the past. Mr. Palmer commented that in his review of the documents, no language was removed when the System ceased internal management. Mr. Stafford asked why the ethics language was not in the IPM already. Mr. Palmer noted that the state ethics law has been in place, but the language was included in the recommendation to reflect a reinforcement of its importance as internal management begins. Mr. Stafford asked if there were changes to the IPM that the Investment Committee is not seeing. Mr. Palmer stated that is not the case. Mr. Brinkley asked if additional compliance staff will be added. Mr. Palmer stated that a junior hire is expected in compliance. Mr. Brinkley asked about the consequences for non-compliance of the new policies. Ms. Cohen commented that the investment staff are

at-will employees and the CIO has the authority to terminate investment staff. Mr. Brinkley asked whether the language had been written similar to other plans. Ms. Cohen replied that it had.

Ms. Herman asked how internal management will be measured and reported, and asked what types of securities can be purchased internally since the IPS included language indicating “other securities” could be purchased. Mr. Palmer responded that the reference to “other securities” was in the division’s operations manual, not the IPM. He noted that the recommended IPM changes are included in the section covering public markets, implying that these are public market assets, and added that Staff would be permitted to use any public market strategies that the System’s current external managers use. He also explained that internally managed accounts would be separate line items in performance reporting. Ms. Herman asked whether staff would take views on particular sectors and over/under weight those by purchasing publicly traded companies, to which Mr. Palmer responded the staff would likely be taking broader market views not focused on individual securities in the initial implementation of internal management. Ms. Herman also noted a drafting correction, suggesting the removal of “to be” before “established” on page 22 of the IPM.

Ms. Herman asked how internal management would impact the securities lending program. Mr. Palmer explained that securities managed internally would be eligible for securities lending.

Mr. Stafford asked whether Staff can front run managers. Mr. Palmer responded that Staff is not permitted to front run managers. Mr. Stafford asked whether there is a need for a Chinese wall between Staff trading internally and Staff covering external managers. Mr. Palmer explained that any stock discussed with Staff by an external manager would be added to the restricted list. Mr. Tarbox commented that it is unlikely an external manager would discuss trades prior to implementing them. Mr. Hamilton commented that these types of policies can easily be over-drafted, and that the current draft reflects an appropriate level of detail without over-drafting the document. Mr. Palmer added that the current draft has sufficiently covered the possibility of conflicts. Ms. Cohen added that violations of policies are determined by the Code of Ethics. Ms. Herman asked whether the Compliance Officer reports to the CIO or to the Board, and what is meant by the term “other interests in investments.” Mr. Palmer explained that the Compliance Officer reports to the CIO. In the event a violation is committed by the CIO, the Compliance Officer will report to the Executive Director and the Audit Committee. He further explained that the term was included to cover non-traditional securities such as warrants and units in investment trusts. Ms. Herman suggested that it might be better to limit internal management to the specific types of securities that Staff expects to be trading internally such as futures contracts. Mr. Palmer noted that the language was included in the operations manual and that the specific eligible securities would be governed by investment guidelines.

Comptroller Franchot asked whether there is an example among peers of what we are trying to accomplish. Mr. Palmer responded that most peers with an internal management function have similar policies and procedures in place, and the objective is to manage the assets more efficiently and in the best interests of plan beneficiaries. He explained that outsourcing is the best option for some strategies, while it is better to manage assets internally for others. Mr. Palmer explained that many peers already manage assets internally and that scale helps to reduce costs.

Comptroller Franchot asked whether there are examples of conflicts that have occurred among peer plans as a result of internal management. Mr. Palmer responded that examples of conflicts in news reports include such things as trades being directed through a specific broker dealer for kickbacks. Comptroller Franchot asked whether all decisions will be approved by the CIO. Mr. Palmer responded that the guidelines will be set by the CIO and that Staff would have discretion subject to those guidelines and ongoing compliance review.

Ms. Herman inquired whether the System has a gift policy and whether the plan audits its managers regarding gifts. Ms. Voglino responded that the System is subject to a gift policy, which is addressed in the annual manager attestation.

Ms. Herman asked how trading costs and best execution will be monitored. Mr. Palmer responded that there will be periodic reviews by senior staff including the Senior Compliance Officer.

Ms. Hill motioned to approve the proposed changes to the IPM. Mr. Stafford responded that he still has questions. Ms. Hill commented that the Board should focus its meeting time on reviewing and revising policy language in the IPM, not on questioning procedures and process for internal management operations. Ms. Hill suggested that any questions pertaining to internal management or the IPM outside of the proposed changes should be addressed to Mr. Palmer offline.

Mr. Stafford asked whether there would be two different sets of rules regarding conflicts of interest for Staff of internal management and Staff of external management. Ms. Voglino responded that there would not be two different sets of rules. Mr. Stafford asked if the language can be condensed and why there is a concern of heightened risk with internal management. Mr. Palmer responded that internal management introduces different types of risk relative to an external management program, and these risks should be controlled by an expanded set of policies. Mr. Palmer suggested that there should be policies in place to address the concerns of some of the Board members about the potential for a new set of risks to the System and that create a permanent record of the discussions.

Mr. Hughes asked if any Trustee would like to propose any changes to the draft language. Ms. Herman stated that the language in the Operations Manual does not clearly state what securities are permitted to be purchased. In addition, she noted that the reporting of internal management to the Board on both trading activities as well as monitoring was not defined in the Operations Manual. On a motion made by Ms. Hill and seconded by Mr. Norman, the Committee voted to approve the proposed changes to the IPM with the correction noted by Ms. Herman. Ms. Herman and Comptroller Franchot voted against the motion.

Item 7: Investment Reports

The Committee received the following investment reports:

- State Street Performance Reports
- Terra Maria Performance Reports
- Private Markets Performance Reports
- Securities Lending Report
- Division's FY19 Travel Plan - Update
- Quarterly ORP Performance Report
- OPEB-PHBT Update
- New Hire Manager Report

On the Directors Desk:

- Broker Commission Reports
- Class Action Update

Ms. Herman asked Mr. Palmer about the possibility of unitizing the fund to allow the OPEB Trust and ORP participants to invest more directly in the pension fund. Mr. Palmer responded that he had some experience regarding this issue, and that the unitization process was expensive. Ms. Herman noted that her employer was implementing a unitization, and that their analysis, after discussing with other pension/defined contribution plans, does not find the costs to be prohibitive. Ms. Herman requested a report exploring the possibility of unitizing System assets with the purpose of offering the System's investment program to the OPEB.

Item 8: Motion by the Investment Committee to meet in Closed Session

On a motion made by Mr. Prouty and seconded by Ms. Hill, the Investment Committee voted without objection to meet in closed session at 11:36 a.m. for the purpose of reviewing the closed session Investment Committee meeting minutes, pursuant to General Provisions Art., § 3-103(a)(1)(i) the exercise of an administrative function.

CLOSED SESSION

Committee Members Attending:	Eric Brotman (1) David Brinkley (1) David Hamilton	Richard Norman (1) Douglas Prouty Michael J. Stafford, Jr.
(1) Via telephone	Sheila Hill F. Patrick Hughes, Chairman (1) Charles W. Johnson (1) Theresa Lochte	Jamaal Craddock Linda A. Herman, Vice Chair Lamont "Monte" Tarbox Peter Franchot
Committee Members Not Attending:	Michael K. Barry Nancy K. Kopp (excused)	Stephen Kitsoulis
Also Attending:	Victor Adekoya Anish Bedi Frank E. Benham (Meketa) Tom Brennan Robert Burd, Deputy CIO Antionette Butcher Rachel Cohen, OAG Eric Farls David Ferguson Michael Golden Dimitri Grechenko Alex Harisiadis, OAG Justin Hayes Levar Hewlett Dana Johns Faina Kashtelyan	Gregory Kasten Larry Katsafanas Dean Kenderdine Michael McCord Mary Mustard (Meketa) Stephen Muturi Andrew Palmer, CIO Stephen Reilly David Rongione, Chief Internal Auditor, Internal Auditing Div. Dan Schick Jody Shaw, OAG Frederick "Beau" Smith Toni Voglino Patricia Wild

Item 10: Motion by Investment Committee to adjourn closed session

On a motion made and seconded, the Investment Committee voted to adjourn closed session and return to open session at 11:39 a.m.

OPEN SESSION

Committee Members Attending:	Eric Brotman (1) David Brinkley (1) David Hamilton	Richard Norman (1) Douglas Prouty Michael J. Stafford, Jr.
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(1) Via telephone

Sheila Hill
F. Patrick Hughes, Chairman (1)
Charles W. Johnson (1)
Theresa Lochte

Jamaal Craddock
Linda A. Herman, Vice Chair
Lamont "Monte" Tarbox
Peter Franchot

Committee Members
Not Attending:

Michael K. Barry
Nancy K. Kopp (excused)

Stephen Kitsoulis

Also Attending:

Victor Adekoya
Anish Bedi
Frank E. Benham (Meketa)
Tom Brennan
Robert Burd, Deputy CIO
Antionette Butcher
Rachel Cohen, OAG
Eric Farls
David Ferguson
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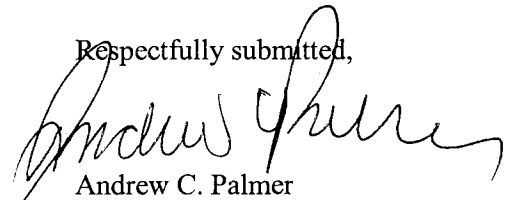
During closed session, the Investment Committee discussed and took action on the following matters:

The Committee reviewed and approved the November 27, 2018 closed session meeting minutes.

Adjournment

There being no further business before the Investment Committee, on a motion made by Mr. Prouty and seconded by Comptroller Franchot, the meeting adjourned at 11:46 a.m.

Respectfully submitted,



Andrew C. Palmer
Chief Investment Officer