

THE INVESTMENT COMMITTEE
OF THE
MARYLAND STATE RETIREMENT AND PENSION SYSTEM

MINUTES OF OPEN MEETING

November 19, 2019

The Investment Committee convened on Tuesday, November 19, 2019 at 11:00 a.m. in the 16th Floor Board Room of the State Retirement Agency, SunTrust Building, 120 E. Baltimore Street, Baltimore, MD.

Committee Members	Michael K. Barry	Charles W. Johnson
Attending:	Eric Brotman	Stephen Kitsoulis
	David Brinkley (1)	Nancy K. Kopp
(1) Via telephone	Jamaal Craddock (1)	Douglas Prouty
	Ken Haines	Michael J. Stafford, Jr.
	David Hamilton	Lamont "Monte" Tarbox
	Linda A. Herman, Vice-Chair	
	Sheila Hill (1)	
Committee Members	Peter Franchot	Richard Norman
Not Attending:	F. Patrick Hughes, Chairman (excused)	
Also Attending:	Victor Adekoya	Dean Kenderdine
	Phillip Anthony (MLIS)	Nicholas Keyword (Landmark)
	Frank E. Benham (Meketa)	Ratna Kota
	Robert Burd, Deputy CIO	Onnie Mayshak (Landmark)
	Antionette Butcher	Barry Miller (Landmark)
	Rachel Cohen, OAG	Mary Mustard (Meketa)
	Melody Countess	Stephen Muturi
	Mike Fang	Ashu Pal
	Eric Farls	Andrew Palmer, CIO
	David Ferguson	Stephen Reilly
	Anne Gawthrop	David Rongione, Chief Internal Auditor, Internal Auditing Div.
	Michael Golden	Dan Schick
	Dimitri Grechenko	Jody Shaw, OAG
	Levar Hewlett	Frederick "Beau" Smith
	Dana Johns	Toni Voglino
	Faina Kashtelyan	Patricia Wild
	Greg Kasten	
	Larry Katsafanas	

Ms. Herman, Vice-Chair, called the Investment Committee meeting to order at 11:03 a.m.

Item 1: Ratification of Open Session Minutes

On a motion by Mr. Tarbox and seconded by Mr. Johnson, the Investment Committee ratified the September 17, 2019 open meeting minutes.

Item 2: Next Year's Investment Committee Meeting Dates

The Committee received potential Investment Committee meeting dates for Calendar Year 2020. The meeting schedule that was presented for the Committee's consideration was as follows: Tuesday, February 18, 2020; Tuesday, May 19, 2020; Tuesday, September 22, 2020; and Tuesday, November 17, 2020.

On a motion made Mr. Johnson and seconded by Mr. Haines, the Investment Committee unanimously approved the 2020 Investment Committee meeting dates as submitted.

Item 3: Report from CIO

Mr. Palmer provided an update on the System's initiative to manage assets internally. Mr. Palmer reviewed the presentation titled "MSRA Investment Program Update".

Mr. Palmer explained three aspects of the program:

- (1) Achieving the right mix in the System's asset allocation,
- (2) Enhancing the implementation of the asset allocation through improved resourcing and process within the investment division.
- (3) Lowering the costs of investment.

In turn, Mr. Palmer highlighted the three primary drivers of investment costs:

- (1) The overall size of System assets
- (2) The mix of assets within the System's policy benchmark
- (3) The implementation costs to achieve the mix of assets.

Regarding the lowering of investment costs, Mr. Palmer discussed implementation tools:

- (1) Negotiate lower fees for external fund managers and employ lower cost strategies
- (2) Manage private assets directly through co-investments
- (3) Internal management, managing public assets directly

Mr. Palmer highlighted slide 76, illustrating that management fees have been reduced through staff negotiations, resulting in annual savings of 11 bps, or \$37 million. He further cited slide 77 to demonstrate that managing private assets through co-investment structures has benefited the System with more than \$8 million in cost savings.

Mr. Hamilton asked if the savings applied to existing or new funds. Mr. Palmer clarified that the savings are on existing funds and private investments in companies. The lower fees are the result of investing through co-investment vehicles.

Mr. Palmer then provided an update of the internal management roadmap. He noted that the internal management initiative will bring the System in line with other large public pension peers. He provided an overview of the targeted timeline over the next 10 years, which showed that by targeting a mix of internal and external management, in addition to an expanded co-investment program, an additional 10 basis in projected fee savings could be generated over the next 10 years. This would equate to approximately \$130 million in annual cost savings compared to the 2017 cost profile of the plan, net of all internal and external expenses.

Treasurer Kopp pointed out that "remediate current deficiencies" on pg. 79 should be reworded as it is now outdated. Mr. Palmer concurred that the language was from 2017 when the System's consultant for internal management indicated that the System was under-resourced for its then-current investment program.

After discussing the potential fee savings, Mr. Palmer presented estimates of implementation strategies, staffing mix, and internal costs. Over time, there will be less passive and more enhanced/active management. He stated the projected costs in 2029 would be under 6 basis points.

Mr. Brotman thanked the CIO for this report as this is exactly what the Board was asking for. He asked for clarification on pg. 80 vs 85. Mr. Palmer clarified that pg. 80 includes all manager fees including private equity, whereas pg. 85 shows the internal System costs (the cost savings are \$100 million, not \$82 million). Mr. Brotman commended the plan of projected savings of \$100m for the System despite the \$18m internal costs.

Mr. Barry questioned whether the System is truly achieving cost savings. He mentioned as an example Vanguard, which charges only 1 basis point on an S&P 500 index fund. He suggested using that as a comparison to the cost of internal management and operations. Mr. Palmer responded that if the System was managing only passive index funds, the cost savings would be approximately 5 basis points. However, the investment team will be managing a mix of passive, enhanced index, and active funds.

Mr. Barry and Mr. Stafford questioned whether we have the skill to recruit the right staff to perform internal management, and asked how the System would terminate internal managers that underperform, given that they are state employees. Mr. Palmer responded that the process would be similar to that of external managers, with appropriate management process and protocol. Underperforming managers would be put on a plan for improvement, or a better fit for their skillset would be found. If these remedial plans fail and the underperformance persists, the employee would be terminated. Mr. Kenderdine noted that investment professionals on the staff are “at will” employees. Mr. Palmer explained that his prior experience included both the hiring and firing of investment personnel. He noted that there will be a 3-level oversight and fallback system:

- (1) Internal oversight through committees of peers, akin to mutual fund board
- (2) External oversight from Meketa
- (3) Moving the mandate to an external manager should underperformance persist

Mr. Stafford stated that the Board seems to be re-asking the same questions that were asked three years ago when we decided to go down this path. He asked what the sub-components of the 5 basis points are. Ms. Herman stated that internal management should account for Staff salaries when presenting net performance numbers. Mr. Palmer responded that, as a percentage of assets, staff costs allocated to internal management would be so small that the impact in performance reporting would likely be zero. Ms. Herman mentioned that costs and tracking error must be known. Mr. Palmer responded that costs can be allocated – e.g., passive fund management incurs approximately 10 hours a month in staff time, which would amount to approximately 2/100th of 1 basis point, or 0.0002%. Mr. Palmer also mentioned that by implementing a passive mandate initially, staff is building a rigorous process (e.g. risk management, attribution report, portfolio exposure report, etc.) to develop the culture for future active strategies.

Mr. Brotman asked if the \$100 million in savings is net of maximum incentive compensation. Mr. Palmer replied that it is. Ms. Herman commented that there is no incentive on passive strategies. Mr. Brotman responded that is not what is being suggested. He mentioned that passive (such as smart beta) is not the same as indexed. There is still opportunity to outperform and generate alpha over policy benchmarks using passive approaches. Mr. Stafford asked about the move to quasi-active - when pulling levers to outperform, it would be difficult to determine if it is a failure of active or passive. He stated that the Board will have to understand this in its evaluation of internal management.

Mr. Barry asked if side-by-side cost comparisons can be provided for internal vs. external managers. Mr. Palmer responded that management fees associated with passive portfolios are low, and will not generate

the targeted cost savings. He stated that while internal management of passive portfolios will generate savings, more active strategies can add significant value. He provided an example of the Japanese pension plan, being so large that it cannot differentiate itself from the market. Maryland is in the middle from a size perspective, where adding more managers is the equivalent of becoming more like the market. He said the goal is to maintain concentrated external mandates, and manage the portion that looks more like passive with enhanced strategies to generate excess returns. Mr. Barry said that he is not sure why we think we will have greater success recruiting internal portfolio managers for the System versus external managers.

Ms. Herman suggested continuing the discussion at the next Investment Committee meeting. She asked that staff review peers and best practices for allocating costs across products. Mr. Stafford commented that showing how performance will be presented before funding is a fair request. Mr. Palmer said that it will be shown on the State Street performance report just like external mandates. Ms. Herman asked if all expenses are fed to State Street. Mr. Palmer said we can provide the information in the fee report. Mr. Stafford said that he was concerned about the move from internal passive to active/hybrid strategies due to evaluation of performance and the potential cost of not going with the “pro’s” at Vanguard.

Treasurer Kopp asked if the Board could have periodic progress indicators in the implementation timeline. On pg. 84, she asked how staff overseeing external managers are projected to be reduced so drastically from 2019 to 2021. Mr. Palmer clarified that staff would have both internal and external management responsibilities, and there is an overlap not clearly reflected in the table. A footnote will be added to that effect.

Ms. Herman asked why the internally managed TIPS portfolio is underperforming its benchmark. Mr. Palmer responded that SSgA is running a full-replication strategy and they too show the same underperformance. This is due to variety of factors, including index pricing sources, timing of inflation accrual, and performance adjustments for the System. Overall, the tracking error is low and the underperformance (or outperformance) tends to correct itself over time. Ms. Herman responded that she was only looking at Maryland portfolio relative to the benchmark. Mr. Palmer replied that there is noise created by the State Street performance reporting process. Mr. Stafford asked how pricing can be different. Mr. Palmer said that the benchmark does not use IDC.

Ms. Herman mentioned that the asset class categories on pg. 36 and 41 (performance report) are inconsistent and asked if they could be synchronized. Mr. Palmer responded in the affirmative.

Mr. Palmer closed this part of the session by recognizing new employees Ratna Kota and Philip Tyler, and congratulating Pat Wild on her retirement in December after 33 years of service.

Item 4: Meketa Reports

Ms. Herman requested the Meketa representatives to highlight the main issues in their presentation booklet due to the meeting running behind schedule. Ms. Mustard provided a summary of quarterly performance and attribution. Nominal Fixed Income, Private Equity and Natural Resources markets performed the best. In terms of attribution, active fixed income managers detracted value but internal overlay strategies added value.

Ms. Herman asked Meketa to remind the Board what the interaction effect is. Ms. Mustard noted that the concept is defined on page 19 of the report. She explained that the interaction effect is the residual amount in the attribution analysis not attributable to the allocation effect and the active management effect. It captures how these two factors interact with one another. For example, if the System is overweight an underperforming asset class it will have a negative interaction effect.

Ms. Mustard mentioned the System ranked well relative to peers in 3Q and for 1-year period. In their InvMetrics universe of 41 plans that report performance net of fees, the System was in the 5th percentile for the quarter and 2nd percentile for the trailing year (better than 98% of the universe). The Wilshire TUCS >\$25 billion universe reports performance gross of reported fees and showed the System in the 58th percentile for the quarter and 21st percentile for the trailing year. In addition, the System continues to rank well in terms of risk-adjusted return. Overall, the System ranks higher when public equities are not as strong.

Mr. Brotman commented that the S&P ranks 1st percentile in every long-term category in the TUCS report, and that an S&P hiccup is a positive for Maryland's relative performance. He said that we are "sticking to our guns" and was impressed that the first time there was an S&P drawdown, it was a big positive for Maryland.

Ms. Herman commented, that while the System was compensated for its lower equity exposure during the quarter, over the past 10 years had the System's exposure to equities been higher, millions of dollars would have been added to the Trust resulting in an improved funded status and lower employer contributions.

Mr. Brotman said that chasing returns is a bad idea.

Ms. Herman pointed to p. 22 of Meketa's report, which shows that the System is taking less risk than the peer median.

Ms. Herman asked what peer plans are doing that have a better return with the same risk. Mr. Palmer responded that plans such as Washington and Oregon have very large private equity and private real estate portfolios. These asset classes have provided higher returns, but private investments do not exhibit as much volatility. Ms. Herman asked that Meketa explore what other plans are doing differently.

Ms. Herman inquired about the risk report required by 2018 legislation. Mr. Palmer responded that it is prepared annually and due in January 2020.

Item 5: Landmark Investment Partners

Following the CIO report, Ms. Herman briefly recessed the committee at approximately 12:05 PM. When she re-called the meeting to order at 12:20 PM, Mr. Ferguson introduced Barry Miller, Nicholas Keyword, and Onnie Mayshak from Landmark Investment Partners, who provided an evaluation of the System's Private Equity portfolio.

Landmark reviewed the Private Equity portfolio and provided an update of the private equity market. Landmark said the portfolio provided positive absolute and relative returns, and that a significant percentage of funds provided 2x (returned more than twice the invested capital) returns, while only very small positions are underperforming. They commented that Project Regatta, the System's private equity secondary sale, reduced underperforming manager exposure. Landmark's diagnosis of the portfolio was that it exhibited strong manager selection and appropriate sizing. They noted that one half of the bottom performers for the System have outperformed the median.

Landmark discussed their pacing analytics, which included using their proprietary model to provide commitment levels in an environment similar to historical experience, and a low growth environment.

Mr. Barry asked what is the right level of the unfunded commitment and the right level of pacing. Landmark responded that the System has averaged roughly \$2 billion in annual commitments historically, and recent active management has created more headroom. Mr. Ferguson noted that pacing is based on expected cash flows, and if they are modeled accurately, the unfunded commitment level takes care of itself. Mr. Barry

stated that overcommitting in any one year should be avoided as to minimize vintage risk. Mr. Ferguson concurred, and said the team feels confident about the pacing plan, which consists mostly re-ups with existing managers.

Mr. Stafford asked what index is being used for private equity performance evaluation. Mr. Ferguson responded that the System uses the benchmark developed and maintained by State Street. He added that benchmarking private equity is a difficult task and they also look at Burgiss benchmarks, or a spread over public market indices such S&P500 or MSCI ACWI.

Mr. Stafford asked what environment would cause the Board to decrease the private equity allocation. Landmark indicated that peers are increasing allocations as this is where they can generate higher returns. Mr. Stafford responded that he knows they are, but if we are in a private equity bubble, it would take a long time to reduce the allocation. Landmark said that to reduce downside risk, the System can shift the mix of funds - for example, more credit and less venture capital. Mr. Ferguson responded that the System's venture capital exposure is relatively low. Landmark concurred that Maryland's exposure to venture capital is low for a pension plan. Mr. Stafford mentioned that the worst investments he has seen have been in private equity, and wants to know the environment where we should decrease the allocation. Mr. Ferguson noted that with valuations relatively high, the System de-risked the portfolio through a secondary sale last year, which took about six months to execute. Rather than interrupt the pacing of new investments, which will be invested in a different environment, the System might choose to execute a further secondary sale to reduce exposure if the expected forward return from the funds or subset of funds fell appreciably.

Item 6: Private Equity Review

Mr. Ferguson provided an overview of private equity portfolio activity, which has been focused on streamlining to a core set of managers.

From 105 external private equity managers for the System, staff has retained 47 core managers representing \$6 billion in market value. It also retained 21 non-core managers with \$1 billion in market value. The remaining 21 managers with \$1.1 billion in value were sold in a secondary sale. The sale was structured so that the System receives a deferred payment from the buyer in exchange for netting the System a profit on the sale. The execution price was 101, compared to the price of 92-93 without the deferred payment structure.

Mr. Barry commended the team on the success of the secondary portfolio sale. Mr. Stafford and Ms. Herman also commended the team.

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
- TUCS Report
- Division's FY20 Travel Plan - Update
- Quarterly ORP Performance Report
- OPEB-PHBT Update
- New Hire Manager Report

On the Directors Desk:

- Broker Commission Reports

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

On a motion made by Mr. Brotman and seconded by Mr. Haines, the Investment Committee voted without objection to meet in closed session at 1:07 p.m. for the purposes of (a) reviewing the closed session Investment Committee minutes, pursuant to General Provisions Art., Section 3-103(a)(1)(i), the exercise of an administrative function; and (b) presenting by staff of a sample Manager Due Diligence report including the analysis of staff and Mercer (formerly Pavilion Alternatives Group), the System's private equity consultant pursuant to General Provisions Art., Section 3-305(b)(13), to comply with a specific statutory requirement that prevents public disclosure of trade secrets and confidential commercial or financial information, and State Personnel and Pensions Article, Section 21-123(f) and Code of Maryland Regulations 22.01.02.03E, protecting from disclosure certain investment records.

CLOSED SESSION

Committee Members	Michael K. Barry	Charles W. Johnson
Attending:	Eric Brotman	Stephen Kitsoulis
	David Brinkley (1)	Nancy K. Kopp
(1) Via telephone	Jamaal Craddock (1)	Douglas Prouty
	Ken Haines	Michael J. Stafford, Jr.
	David Hamilton	Lamont "Monte" Tarbox
	Linda A. Herman, Vice-Chair	
	Sheila Hill (1)	
Also Attending:	Victor Adekoya	Larry Katsafanas
	Robert Burd, Deputy CIO	Dean Kenderdine
	Antionette Butcher	Ratna Kota
	Rachel Cohen, OAG	Stephen Muturi
	Melody Countess	Ashu Pal
	Mike Fang	Andrew Palmer, CIO
	Eric Farls	Stephen Reilly
	David Ferguson	Dan Schick
	Dimitri Grechenko	Jody Shaw, OAG
	Levar Hewlett	Frederick "Beau" Smith
	Dana Johns	
	Faina Kashtelyan	

Item 11: Motion by Investment Committee to adjourn closed session

On a motion made by Mr. Brotman and seconded by Mr. Haines, the Investment Committee voted to adjourn closed session and return to open session at 1:26 p.m.

During closed session, the Investment Committee discussed and took action on the following matter:

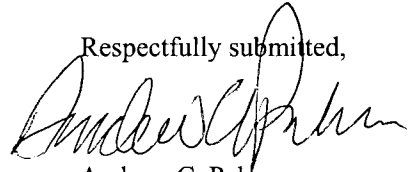
The Investment Committee reviewed and ratified the Closed Session minutes from the September 17, 2019 meeting; and

The Committee received and discussed a sample Manager Due Diligence report including the analysis of staff and Mercer (formerly Pavilion Alternatives Group).

Adjournment

There being no further business before the Investment Committee, on a motion by Mr. Prouty and seconded by Mr. Stafford, the meeting adjourned at 1:26 p.m.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Andrew C. Palmer". The signature is fluid and cursive, with a large initial "A" and "P".

Andrew C. Palmer
Chief Investment Officer