THE INVESTMENT COMMITTEE
OF THE
MARYLAND STATE RETIREMENT AND PENSION SYSTEM

MINUTES OF OPEN MEETING

February 18, 2020

The Investment Committee convened on Tuesday, February 18, 2020 at 9:55 a.m. in the 16th Floor Board Room of the State Retirement Agency, SunTrust Building, 120 E. Baltimore Street, Baltimore, MD.

Committee Members Attending: (1) Via telephone	Michael K. Barry Eric Brotman David Brinkley Jamaal Craddock Peter Franchot Ken Haines David Hamilton Linda A. Herman, Vice-Chair Sheila Hill	F. Patrick Hughes, Chairman (1) Charles W. Johnson (1) Stephen Kitsoulis Nancy K. Kopp Richard Norman Douglas Prouty Michael J. Stafford, Jr. Lamont "Monte" Tarbox
Committee Members Not Attending:		
Also Attending:	Victor Adekoya Anish Bedi Robert Burd, Deputy CIO Antionette Butcher Rachel Cohen, OAG Melody Countess Mike Fang Eric Farls David Ferguson Michael Golden Dimitri Grechenko Alex Harisiadis, OAG Faina Kashtelyan Greg Kasten Larry Katsafanas	Dean Kenderdine Ratna Kota Michael McCord Kyongdo Min Mary Mustard (Meketa) Stephen Muturi Ashu Pal Andrew Palmer, CIO Stephen Reilly David Rongione, Chief Internal Auditor, Internal Auditing Div. Dan Schick Jody Shaw, OAG Frederick "Beau" Smith Toni Voglino Hal Wallach (CBIZ – on phone)

Ms. Herman, Vice-Chair, called the Investment Committee meeting to order at 9:57 a.m.

Item 1: Ratification of Open Session Minutes

On a motion made by Mr. Haines and seconded Mr. Brotman, the Investment Committee ratified the November 19, 2019 open meeting minutes.

Item 2: Investment Division Salary Scale Adjustments

Mr. Hal Wallach from CBIZ Talent & Compensation Solutions presented a recommendation to adjust the Investment Division salary scale annually to help ensure that the salary ranges remain competitive in the marketplace. To determine adjustments, if any, the World at Work Salary Budget Survey (which includes 1,900 participating US firms) and the Employment Cost Index produced by the Bureau of Labor Statistics were utilized. From these sources, CBIZ recommended a 2.3% adjustment to the salary ranges.

Mr. Wallach suggested that after 3-5 years, it would be appropriate to conduct a new comprehensive industry compensation study.

Comptroller Franchot asked what the organizational expenses were prior to the approval of the new salary structure, and what changes has the Board implemented with the new authority. He also asked what the impact has been on the Investment Division and performance.

Mr. Palmer reported that the Board approved eight additional positions to address understaffing across the organization that could not be accomplished under the prior structure. He also noted that most of the eligible investment staff received a 10% salary increase in an effort to move them closer to their respective salary ranges. Mr. Palmer also commented that it is difficult to tie the compensation to performance over the short-term and make reasonable progress on reaching the approved pay scale. In response to the question regarding the impact on performance, Mr. Palmer indicated that the Investment Division hired an individual as a full-time risk manager, which has allowed staff to manage the portfolio much tighter in terms of risk and exposures. Mr. Palmer described staff as stable and competent and indicated that having stable, competent staff should help the System avoid missed opportunities that come from understaffing.

Mr. Stafford asked if the analysis presented in the previous meeting included salary adjustments.

Mr. Palmer responded positively, commenting that the midpoint of salaries was used in the analysis, along with an assumption of maximum incentive pay and annual increases.

Ms. Herman asked what the "other financial vehicles" referenced in the compensation study represented.

Mr. Wallach responded the other financial vehicles were banks, money managers, and the broader finance industry.

Ms. Herman further asked if any adjustment was made for Maryland offering a defined benefit retirement benefit, where most financial firms do not offer such a benefit to investment staff.

Mr. Wallach confirmed that employers with both types of retirement benefits are included. Some organizations do not offer a defined benefit plan, but instead pay a larger employer match in defined contribution plans. He also noted that 12 of 17 staff members are below the minimum salary by 25%. Mr. Palmer also responded that the impact of the government defined benefit plan was incorporated in the approved salary structure and is part of the reason that private sector firms typically offer a much bigger base salary. He noted that the annual change in compensation should not be impacted by the existence of a defined benefit plan.

Mr. Palmer asked if the process of adjusting salaries annually, as recommended by CBIZ, has ever resulted in overshooting the targets after the subsequent comprehensive review.

Mr. Wallach indicated that typically annual adjustments do not result is salaries that exceed targets, as the salary structure moves in-line with the market.

On a motion made by Mr. Norman and seconded by Ms. Hill, the Investment Committee voted to approve the Investment Division Salary Scale Adjustments. Ms. Herman and Comptroller Franchot opposed.

Item 3: Public Advisor Position – Call for Nominations
Mr. Kenderdine announced that Mr. Kitsoulis' term will expire June 30, 2020 and that he will not seek another nomination as a public advisor to the Investment Committee. Therefore, the System is seeking nominations for this position.

Mr. Kenderdine stated that the deadline to submit nominations is Friday, March 6, 2020.

Item 4: Report from CIO
Mr. Palmer outlined the topics he would discuss: 1) Follow-up from the Board's request relating to reporting of expenses associated with internal management; 2) ESG report; and 3) Division activities and performance drivers in the quarter.

For item 1, Mr. Palmer surveyed sixty public pension plans asking how they report expenses for internal management. Fourteen plans do not include internal costs in performance reporting. There were only four respondents who do report internal management expenses within the performance. With one exception that has a discrete team working on a discrete portfolio, they do so by including the costs at the plan level performance. With the System's model of combined internal and external management overseen by one team, it is difficult to allocate internal costs at the portfolio level.

Mr. Brotman asked if the costs of the Agency are in the budget or in the fund.

Mr. Palmer indicated that the costs of the Agency in terms of personnel and systems are included in the budget.

Ms. Herman asked if staff was going to break out costs associated with individual portfolios.

Mr. Palmer confirmed that allocating expenses at a portfolio level is very challenging. Staff will provide expenses as the number of portfolios and assets grows over time. He expressed concern about overly focusing on the basis point set up costs. For example, the cost of an order management system would initially all fall to the first one or two portfolios. Focusing on that cost may be misleading in the near term as the order system is necessary for continued build out of additional products. Mr. Palmer noted that it might be more meaningful to allocate costs by total fund and asset classes.

Ms. Herman stated that the Board needs a way to evaluate performance.

Mr. Palmer explained that the process for internal and external management is the same and each should cost about 3.5 basis points to implement. Internal management will not have an additional management layer of fees.

Mr. Hughes indicated that he thought it was appropriate to receive and review overall internal management cost reports and determine the accounting or allocating of those costs later.

For item 2, Mr. Farls was available to make a presentation and answer questions regarding the ESG report to the Board.

Mr. Palmer commented that the System's had made progress in its ESG process and cited scoring by UNPRI, which over the last few years has increased from C's and D's to A's and B's. The internal process has evolved and has seen an increase in adoption of ESG policies among managers. Staff is involved in active engagements with managers where potential improvements are identified.

Mr. Palmer referred to a draft response letter that he had provided the Board relating to divestment. The Treasurer and other state officials had received numerous letters encouraging fossil fuel divestment. The letter explains the System's practice with regard to fossil fuels and other ESG items and provides links to the ESG and Risk reports that are posted on the System's website. Ms. Kopp commented that it was her intention to use the draft letter as a basis to be able to respond to inquiries.

Mr. Brotman asked how labor intensive the ESG analysis is for the Agency.

Mr. Palmer responded that the report is prepared by the Investment Division and that there is an internal ESG Committee in place. The ESG Committee periodically meets to determine how to move forward with ESG. The initiative started with an accounting of ESG efforts across our portfolio. He noted that staff continues to improve the process.

Mr. Brotman asked if other plans do this same amount of work, and if the data is already available. He questioned whether each plan is reinventing the wheel, and suggested that by collaborating with peers, the process could be timelier, less cost intensive with enhanced efficiency.

Ms. Herman commented that there is no standardized process of ESG reporting. Plans each have their own processes with different questions and viewpoints.

Mr. Palmer stated that most of the effort focuses on public companies. He noted that he receives a number of emails each day offering products and services to address ESG concerns. Staff's approach is to promote consistent reporting standards. If staff does not understand a manager's ESG policy or a policy does not exist, staff may choose not to proceed with the investment.

Mr. Tarbox stated that the current global ESG effort is similar to proxy voting 25 years ago. It will progress and evolve into a more efficient and standardized process over time.

Mr. Haines commented that the System is comprised of labor capital, and that the Board should make responsible decisions for the benefit of future generations.

Ms. Herman asked if we could have an ESG section on the System's website that addresses proxy voting and ESG reports.

Mr. Barry asked if there was a formal process by which the System evaluates corporate governance requests, and whether the process was posted on the System's website. He noted that the Georgetown endowment had a policy and process in place, which had served them well and suggested that the System consider something similar.

Mr. Kenderdine responded that corporate governance requests are typically reviewed on a case-by-case basis by the Board, and that the System posts its annual risk assessment report, staff's ESG reports and proxy voting records on the website. Ms. Herman suggested adding an ESG section to the System's website.

Ms. Kopp noted that while it is important for the System to develop its own ESG and corporate governance policies, the Board should also have a perspective on what other institutions are doing in this area.

Mr. Palmer then transitioned to discuss Investment Division Initiatives. He referred to page 26 as an executive summary. Of note, the System's long term performance has met its current actuarial return objective for 1, 3, 7 and 10 years. It has exceeded the Policy Benchmark for 3, 7 and 10 years. Also, the portfolio has produced strong risk adjusted returns compared to peers as measured by Sharpe Ratio. For the quarter, the System outperformed in Private Equity, Public Equity, Rate Sensitive and Real Estate and lagged in U.S. Credit, Natural Resources & Infrastructure, and Absolute Return.

Mr. Palmer noted continued success in recruiting as demonstrated by the recent hiring of Jane Daniel in the Accounting group. Various procurements continue to progress as well as internal management efforts as referenced on the Gantt chart on page 36 of the CIO Report. Mr. Palmer highlighted a redesigned one-page factsheet for the asset classes designed with a more consistent format for easier review.

Mr. Palmer suggested deferring more detailed discussion of performance to coordinate with Meketa's presentation

Item 5: Meketa Reports

Ms. Mustard presented an Asset Allocation Primer including the 2020 Capital Market Expectations, Asset Allocation Themes, Real Estate Benchmarking and Peer Comparison.

Ms. Herman asked about the discrepancy in the attribution reports when active performance is reported compared against State Street's performance reports.

Ms. Mustard responded that attribution reports are generally useful for an indication on direction and magnitude, but that absolute values are not going to match exactly with the performance as reported by the custodian. Meketa calculates the attribution using an industry standard approach on a monthly basis, but there will still be some discrepancies due to timing and amount of cash flows.

Ms. Mustard discussed how Meketa updates its capital market expectations each year in January. Changes are driven by many factors including interest rates, credit spreads, and equity prices. In 2019, yields decreased while risk assets increased in value leading to the expected return being lowered from 8.26% to 7.64%. The standard deviation is reduced slightly to 12.3% from 12.4%.

Regarding asset allocation, Ms. Mustard referred to page 19 of the presentation to highlight the plan developed by staff and Meketa to discuss asset allocation themes throughout the coming year, including the use of leverage, the impact of the illiquidity of private markets on modelling of asset allocation with annual return volatility, the potential impact of climate change on asset allocation and portfolio convexity.

Mr. Brotman asked how low volatility and smart beta strategies are accounted for in the System's portfolio.

Mr. Palmer responded that target allocations to such strategies are achieved by looking at the characteristics of individual management styles and sometimes through managers focused specifically on those factors. He noted that these strategies have not performed well lately.

Ms. Mustard highlighted the work Meketa has performed and their thoughts on benchmarking. Meketa believes changes should be considered for the Real Estate and Natural Resources & Infrastructure portfolios. She reported that the options being considered include using the NCREIF ODCE Net (with or without a spread) or an 80/20 blended benchmark of the ODCE Net and Burgiss Private Real Estate benchmark.

Regarding Natural Resources & Infrastructure, Ms. Mustard explained that most investors choose either CPI Inflation plus a spread, or a peer group as a benchmark. CPI Inflation plus a spread is a good long-term objective for the portfolio but as a short-intermediate term measure it may overstate tracking error. Instead of CPI plus a spread, a peer group benchmark is a more reasonable and robust benchmark measure. Because staff plans to re-evaluate how the portfolio invests in this asset class, it is premature to recommend a change.

Ms. Mustard reviewed the peer comparison. Five plans, all with greater than $25 billion in assets, were identified as plans located in the top left quadrant of the risk and return scatter plot. Relative to these plans, the System was underweight to private equity and real estate, overweight to public equity (more so in non-US), overweight to fixed income, and overweight to real assets and slightly overweight to hedge funds. Two of the plans utilized plan level leverage and two had particularly high private asset exposure. Overall, the five plans had a larger allocation to private equity and did not make significant asset allocation changes. Three of the five plans had lower exposure to hedge funds. Ms. Mustard noted that two of the plans employed the use of leverage. This leverage resulted in a lower risk profile, but did not add to returns.

Item 6: Meketa Reports

Ms. Mustard commented that the Coronavirus was developing and its outcome on economies and financial markets was uncertain. The late cycle nature of developed markets added to the potential financial impact. The accuracy of data out of China has been questioned making it difficult to interpret. Overall, Meketa expects some slow down followed by a V-shaped recovery but there could be some tail risk.

The System ended the quarter with $56 billion in assets. Emerging markets and global equities were the best absolute performers, while nominal fixed income was the lowest absolute performer.

Ms. Herman asked about the underperformance versus the benchmarks in the U.S. Credit, Natural Resources & Infrastructure and Absolute Return sectors.

Mr. Palmer commented that within U.S. Credit, the managers are generally performing as expected but the mix of private and public managers causes the System to lag when public credit performs particularly well. Private credit is priced with a lag and generally displays less volatility. Mr. Palmer further commented that the System's distressed and mezzanine managers experienced an unusual year with very low returns compared to their historical pattern. Within Natural Resources & Infrastructure, Mr. Palmer noted that the private/public benchmark issue is more significant for this asset class than for the Credit portfolio. Staff is working with Meketa on improving the benchmark and plans to revisit the portfolio implementation this year. Overall, the portfolio is not meeting the plan's objectives. Absolute Return has had a challenging few months led by underperformance of global macro and CTA managers within the asset class. These strategies are not widely used in the HFRI relevant benchmark and are included in the portfolio with the goal of providing protection in downward trending markets. Overall, Mr. Palmer stated that the Absolute Return portfolio is improving.

Mr. Barry noted that the returns in Absolute Return do not seem to be isolated to global macro and CTAs.

Mr. Palmer responded that staff has confidence in most of the managers in the portfolio but recognized that a small number are performing below expectations.

Noting that the May meeting will include a review of the Absolute Return portfolio with Aksia, Treasurer Kopp requested a basic document explaining the history and objectives of the program, as well as challenges and resulting actions.

Ms. Mustard continued by highlighting the TUCS ranking for the Public Plans >$25 Billion Universe of 45% for the 3Q19 and 9% for the one-year ending September 30, 2019. Additionally, as of December 31, 2019, the System's Sharpe Ratio ranks in the 3rd and 5th percentile over three and five years, respectively, using the Investor Force Public Pension Plans > $1 billion universe.

Mr. Palmer highlighted the Real Estate Factsheet. He noted that this is an example of enhanced reporting for the Committee, adding consistency of presentation among asset classes. Mr. Palmer also noted the footnote concerning REITs, and reminded the committee that REITs had been removed from the benchmark in July 2019 but remain a valuable option for the Real Estate portfolio and an important diversifier for the equity portfolio.

Mr. Kitsoulis asked if tracking error and excess returns targets are mandated by the Investment Committee.

Mr. Palmer responded that Staff sets tracking error and excess return targets and ensures guidelines do not allow for an excessive level of risk.

Mr. Kitsoulis further asked how a risk budget fits into portfolio construction.

Mr. Palmer responded that staff has historically implemented and measured risk through a bottom-up process. Currently staff is trying to drive risk directly within asset classes and correlations among asset classes. He noted that the current tracking error target of approximately 100 basis points (1%) is consistent with the investment policy manual and is appropriate for a $50 billion plan. He noted that it is difficult to drive tracking error much higher without changing the character of the risks embedded in the investment policy.

Mr. Stafford asked about Infrastructure and Natural Resources, and which benchmark performed better.

Mr. Palmer responded that Infrastructure performed better over the most recent periods.

Mr. Stafford stated that Infrastructure should do well when rates fall, and if it makes little sense to include both Natural Resources and Infrastructure in the asset allocation as they will tend to offset each other.

Ms. Mustard commented that one of the objectives of these two portfolios is to provide inflation protection over the long-term. The Natural Resources component will likely be more sensitive to shocks to commodity prices, while Infrastructure would benefit more from a more orderly and gradual increases in inflation and interest rates.

Mr. Franchot asked about the System's exposure to the recent news of Franklin Resources purchasing Legg Mason.

Mr. Palmer responded that the System invests with Western Asset Management and Clarion, which are both asset managers owned by Legg Mason.

<u>Item 7: Review of the Investment Committee Charter</u>

Mr. Palmer explained that this informational item is intended to be reviewed on a yearly basis to ensure everyone has reviewed the Charter and to offer an opportunity to consider revisions as necessary compliance with requirements, and to amend as necessary.

<u>Item 8: Investment Reports</u>

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
- Class Action Update

Item 9: Motion by the Investment Committee to meet in Closed Session

On a motion made by Mr. Haines and seconded by Mr. Brotman, the Investment Committee voted without objection to meet in closed session at 12:30 p.m. for the purposes of a) reviewing the closed session Investment Committee minutes, pursuant to General Provisions Art., § 3-103(a)(1)(i), the exercise of an administrative function, and General Provisions Art., § 3-305(b)(13), to comply with a specific statutory requirement that prevents public disclosure, namely, General Provisions Art., § 3-306(c)(3)(ii), requiring that the minutes of a closed session be sealed and not be open to public inspection; and

b) considering proposed salary adjustments for employees of the Investment Division, pursuant to General Provisions Art., Section 3-305(b)(1)(i), to discuss the appointment, employment, assignment, promotion, discipline, demotion, compensation, removal, resignation, or performance evaluation of appointees, employees, or officials over whom it has jurisdiction

CLOSED SESSION

Committee Members Attending: (1) Via telephone	Michael K. Barry Eric Brotman Jamaal Craddock Peter Franchot Ken Haines David Hamilton Linda A. Herman, Vice-Chair Sheila Hill (1) F. Patrick Hughes, Chairman (1)	Charles W. Johnson (1) Stephen Kitsoulis Nancy K. Kopp Richard Norman Douglas Prouty Michael J. Stafford, Jr. Lamont "Monte" Tarbox
Committee Members Not Attending:	David Brinkley (excused)	
Also Attending:	Dean Kenderdine Andrew Palmer, CIO Robert Burd, Deputy CIO Rachel Cohen, OAG (Item 10 - closed minutes only)	

Item 12: Motion by Investment Committee to adjourn closed session

On a motion made by Ms. Hill 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 matters:

The Committee reviewed and ratified the Closed Session minutes from the November 19, 2019 meeting; and

The Committee voted to adopt the Chief Investment Officer's compensation recommendations for employees of the Investment Division, for recommendation to the Board of Trustees.

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,

Andrew C. Palmer
Chief Investment Officer