

Minutes of the Meeting of the Investment Committee
June 23, 2017

The Investment Committee of the Tennessee Consolidated Retirement System (TCRS) met on June 23, 2017 in the WRS Tennessee Tower. The Honorable David H. Lillard, Jr., State Treasurer, called the meeting to order at 9:00 AM. Investment Committee members in attendance included: Treasurer Lillard; Honorable Tre Hargett, Secretary of State; Bob Wormsley, President/CEO of Local Government Insurance Pool; Bill Kemp, Sumner County Clerk. Additional attendees included: Richard Newton, F&A Division of Budget; Keith Boring, Director of Policy & Research; Mr. Michael Brakebill, Chief Investment Officer; Derrick Dagnan, Deputy Chief Investment Officer; Jill Bachus, Assistant Treasurer for Financial Strategies & Analysis; Michael Keeler, Director of Equities; Thomas Kim, Director of Fixed Income; JP Rachmaninoff, Director of Real Estate; Tim McClure, Assistant Chief Investment Officer and Director of Cash Management; Carrie Green, Senior Portfolio Manager; Daniel Crews, Director of Private Equity; Grant Leslie, Senior Portfolio Manager; Jennifer Selliers, Compliance Officer; Neha Sakaria, Portfolio Manager; Josh Schutzman, Intern; and Daniel Pitcher, Intern.

Treasurer Lillard began the meeting with a motion to approve the minutes from March 31, 2017. The motion was seconded by Secretary Tre Hargett and approved unanimously by voice vote.

The Treasurer began the meeting by asking Mr. Rachmaninoff to discuss the status of the real estate portfolio. Occupancies remain strong with office space having the weakest occupancy rate at 90%. Returns are moderating due to low cap rates. Additionally, appraisals for the industrial property increased recently. Mr. Rachmaninoff reviewed the performance of the portfolio over the three, five and ten year periods. In the three and five year horizons, the portfolio has outperformed the benchmark while slightly lagging the benchmark over the trailing ten years. He expects recent outperformance to continue. Within sectors, the portfolio is modestly underweight to retail with the majority of exposure to necessity based retailers such as grocery anchored properties.

The portfolio is also underweight in office buildings, because the property type is capital intensive due to high tenant requirements. Mr. Rachmaninoff briefly reviewed the progress being made on sales in Seattle, Tampa, and Boston.

Mr. Brakebill then asked Mr. Rachmaninoff to discuss the item on the notification memo. Mr. Rachmaninoff reviewed Treasurer Lillard's approval for the purchase of an infill apartment community in Minneapolis as well as a sale of a suburban office asset in Austin.

Next, Carrie Green reviewed the proposal to invest \$100 million in Bain Capital Fund XII. TCRS has already committed \$75 million to Bain Capital Fund XI and continues to favor both the management team as well as the strategy employed. The fund buys high quality companies with a "Bain Angle" such as corporate carve outs. The team suffered slightly in the mid-2000's because of high management fees that were brought back down to market prior to TCRS's investment in Bain Capital Fund XI. The company continues to be wholly owned by its employees with no plan to go public. Secretary Hargett made a motion to approve the investment. It was seconded by Mr. Kemp and approved.

Grant Leslie then presented a recommendation to invest \$50 million in a BC Partner's sidecar co-investment fund. This will be the Private Equity portfolio's inaugural co-investment. TCRS committed \$200 million to BC X in 2016 and since then, the fund has made three investments in Italy, the USA and the UK. All three investments are generating good returns. BC X was not a co-investment fund. The team

feels the advantages to the co-investment with BC are lower gross to net spreads, more discretion to tailor the portfolio and prior experience with the manager. Treasurer Lillard briefly discussed Mr. Leslie's ongoing work with Jennifer Selliers, Chief Compliance Officer, to develop criteria for this new area of investment. Mr. Brakebill stressed the main difference between BC X and this co-investment. In BC X, the manager finds investments and then draws down on capital from investors. The co-investment will run parallel to BC X and will give TCRS more discretion over the investments. The Treasurer made a motion to approve the investment which was seconded by Mr. Wormsley and approved.

Next, Mr. Crews briefly discussed Canaan XI, a venture capital fund spun off from GE in 1987. The group likes the management team, the stability, transparency, and strong returns over the last four years. As a result, TCRS has elected to continue investing with them.

Mr. Dagnan reviewed two main changes in the strategic lending portfolio. TCRS has invested funds with Blackrock. One of the companies in Blackrock's fund has performed well and is being carved out to create its own fund. TCRS will keep its \$7 million investment with that company. Additionally, Staff is starting an internal portfolio which will allow them to be opportunistic and reduce investment time lags as well as fees.

After discussing all the updates, Mr. Brakebill reviewed overall performance of TCRS. He noted one important change. The industry norm was to report gross of fees instead of net of fees. There has recently been a movement to net of fees. The difference between TCRS's gross of fees and net of fees returns will be small because the majority of the fund is internally managed. The trailing one year return gross of fees is 10.34% and net of fees return is 10.30%. The trailing three year return gross of fees is 6.18% and the net of fees return is 6.14%. The trailing five year return gross of fees is 7.83% and the net of fees return is 7.78%. Overall, Mr. Brakebill expects TCRS's net of fees returns to be positive relative to peers because TCRS's fees are low.

So far, the total fund return year-to-date is 11.5% which will lag peers because of a lower level of risk. However, the Q1 return of 4.6% surpassed its peers Q1 return of 4.3%. The emerging markets portfolio had a strong quarter and returned 13% with a fiscal year-to-date return of 15.2%. Although the Quant fund struggled last year, the team de-risked and decreased the size of the fund which is reflected in its returns. The sector fund also continues to see improvement. Small cap equities generated the best returns with a year over year return of 25%. Canadian and international equities also performed very well. In the fall, TCRS selected new managers for its international equity portfolio. Each of the managers (Acadian, Fiera, J.P. Morgan, Times Square, and Mondrian) outperformed their benchmarks.

Mr. Brakebill discussed fixed income returns which have been very strong in the long run but have had a soft year because of an increase in interest rates. However, the fiscal year-to-date return is still 70 basis points above the benchmark. He then discussed the reducing the size of the TIPS portfolio due to low risks leading to low returns as well as, the significant decrease in inflation expectations leading to underperformance. The funds will be redirected to the strategic lending portfolio.

The real estate portfolio continues to perform well with returns of 9.7% over one year, 11.5% over three years, 11.1% over five years and 6.1% over ten years. Private equity is the strongest performing asset class with five year returns being very strong (15.6%). Strategic lending returned 12.5% over the past year which is slightly behind the benchmark due to the outperformance of very low credits. TCRS is slightly underweight these credits due to the risk.

Treasurer Lillard then asked Mr. Kim to discuss his views of the ten year U.S. Treasury yield. Mr. Kim believes low interest rates will continue without increased fiscal investments. The dollar continues to weaken and inflation expectations continue to decrease. Mr. Kim suggested a Goldilocks economy with low interest rates, low inflation and strong equity performance. He believes 2.5% will be the top of the ten-year Treasury yield range with the possibility of yields getting as low as 2%. Mr. Brakebill agreed and suggested this is due to a change in fiscal spending expectations and softer economic indicators. The Treasurer also asked about the Federal Reserve's plan to reduce their balance sheet. Mr. Brakebill discussed the Federal Reserve's a plan which was announced without specific timing. Mr. Kim added the next interest rate hike is expected in December 2017.

Finally, Mr. Brakebill discussed key initiatives. He introduced Dan Pitcher and Josh Schutzman, the summer interns. He reviewed personnel changes and changes in the portfolio. The overweight in international equities and emerging markets are being decreased to neutral and the fund no longer has any Thailand exposure in the emerging markets equity portfolio. Also, TCRS will be starting a new overlay fund with \$100 million. This overlay strategy will buy S&P futures and invest the cash into fixed income securities.

Upon seeing no further questions or comments, Treasurer Lillard adjourned the meeting at 9:55 AM.

Respectfully submitted,



Michael Brakebill
Chief Investment Officer

APPROVED:



David H. Lillard, Jr. Chairman
TCRS Board of Trustees

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