

**COMPTROLLER'S
INVESTMENT ADVISORY BOARD MEETING
Wednesday, September 21, 2016
Minutes**

The Comptroller's Investment Advisory Board (the "Board") met at 10 a.m. on Wednesday, September 21, 2016 at the LBJ State Office Building, 111 E. 17th Street, Room 114, Austin, Texas.

Board Members ("The Board") Present

Comptroller Glenn Hegar, Tucker Bridwell, Laurie Dotter, Jim Hille, Steve Strake, Adolpho Telles and Scott Wise.

Board Members Absent

None.

Comptroller of Public Accounts Staff Present

Mike Reissig, Deputy Comptroller and Phillip Ashley, Associate Deputy Comptroller.

Texas Treasury Safekeeping Trust Company ("Trust Company") Staff Present

Paul Ballard, Chief Executive Officer and Chief Investment Officer ("CEO"); Danny Sachnowitz, Deputy Director and Deputy Chief Investment Officer; Frank Zahn, Chief Financial Officer; Gena Minjares, Deputy Chief Financial Officer; Mike Samples, Director of Internal Investments; Marianne S. Dwight, General Counsel; Laura Montoya, Chief Operating Officer; John Wright, Deputy General Counsel; Michael Anderson, Compliance Officer; Ruchit Shah, Portfolio Manager; Byron Beasley, Portfolio Manager; Lalo Torres, Portfolio Manager; Jyoti Gupta, Portfolio Manager; Jorge de Lafuente, Director of Operational Due Diligence; Patrick Jue, Operation Due Diligence Analyst; Adam Levine, Risk Strategist; Nora Arredondo, Special Projects Coordinator; Brandy Bianco, Project Manager; Chad Turner, Risk Manager; Yunke Yu, Quantitative Data Analyst; Yunjing An, Quantitative Data Analyst; and Corrine Hall, Program Administrator.

Additional Participants

Lori Mills, Asset Consulting Group ("ACG").

Call to Order

Comptroller Glenn Hegar declared that a quorum was present and called the meeting to order at 10:08 a.m.

Approval of Minutes of June 30, 2016 Meeting (Tab 1)

Ms. Laurie Dotter made a motion to accept and approve the minutes of the June 30, 2016 Comptroller's Investment Advisory Board meeting.

The motion was seconded by Mr. Tucker Bridwell and unanimously approved by the Board.

Economic Outlook, Investment and Review of Treasury Pool (Tab 2)

Mr. Mike Samples reported on current economic conditions. He stated that the Federal Reserve (the “Fed”) was meeting today and there was no indication that they would be raising interest rates this quarter. He believes if they do not raise rates today, they will likely raise them in December. Mr. Samples reported that the Gross Domestic Product (“GDP”) increased by an estimated 1.2% in the second quarter of 2016. Consumer spending was responsible for almost all of the rebound in GDP growth in the quarter. Consumer spending, which accounts for more than two-thirds of the U.S. economic activity, increased at a 4.2% rate. The unemployment rate remained unchanged at approximately 4.9%. Auto sales, new home sales and existing home sales all lagged during the quarter. He explained this has been a very weak economic recovery and if the Fed does tighten (increase interest rates) it would not be because the economy is doing well. He believes the Fed will remain cautious and sensitive to market conditions in Europe. Mr. Samples expects economic growth to continue at a pace of 1%-2% annually.

Mr. Samples presented a summary of the Treasury Pool as of August 31, 2016. He reported that the Pool was producing a net yield of approximately 0.87%, up slightly from the previous quarter, had a market value of approximately \$28.8 billion, and continued to maintain a AAA rating by Standard & Poor’s. Since the expectation is that future interest rate increases will be nominal and gradual, the Treasury Pool management team expects to maintain an average maturity neutral to its benchmark of approximately 310 days. He explained that if the Fed tightens today, the Treasury pool yield may increase above 1%. Mr. Samples reviewed comparative benchmark yields and noted that the Pool had outperformed its benchmark for the quarter and the previous twelve months.

Capital Markets Outlook and Investment Performance for the Quarter Ending June 30, 2016 (Tab 3)

Ms. Lori Mills of Asset Consulting Group provided a review of the market environment for the period ending June 30, 2016. She explained that ACG expects slow and prolonged economic growth and continued inflation. They believe there will ultimately be a recession but not in the near term (6-12 months). The S&P 500 Index set a record high on August 15th but failed to keep the momentum amid speculation of rising interest rates and the declining oil prices. The European economy could likely slow down during the remainder of the year and into the next year due to the United Kingdom exit from the European Union (Brexit). Concerns regarding China’s economy at the beginning of the year seem to have eased. The market environment demonstrated strong positive returns as of June 30, 2016. Commodities were the best performing asset class year to date following a recovery in oil prices. During the third quarter however, commodities gave up a portion of the rally seen during the year but remain positive year to date. Global fixed income remains in positive territory led by U.S. treasuries and their appeal to investors in search for yield amid global uncertainty. As of August 31, 2016, global equities continue to rally with all major indices now positive year to date.

Ms. Mills reviewed the total portfolio return over the trailing one, three, and five year periods for the quarter ending June 30, 2016. She reported that the endowment portfolio produced an annualized return of approximately 1.88%. Although the endowment returns have underperformed the endowment policy benchmark over shorter time periods, they continue to outperform over a five year annualized basis. She explained that the total portfolio has generated higher returns with lower risk than the benchmark over the last five years. Relative to broad market benchmarks, approximately 90% of the portfolio’s return was generated with approximately half of the risk/volatility. The fixed income portion of the portfolio outperformed its benchmark for the quarter while the equity and real assets portions lagged during the quarter and the past year. Ms. Mills discussed the performance of each asset class in detail as described in the presentation.

Ms. Mills reported on the performance of the State Water Implementation Fund for Texas (“SWIFT”). The SWIFT portfolio return lagged its policy benchmark for the period ending June 30, 2016 by twenty seven basis points. However, since inception the portfolio has generated higher returns with lower risk than its benchmark. The inception to date rate of return was approximately 3.18%. Performance for the fixed income and equity portions of the portfolio exceeded their benchmarks for the quarter and significantly outperformed since inception. Real assets produced a positive return for the quarter but still trailed their benchmark. Overall the SWIFT portfolio returns have exceeded the policy and dynamic benchmarks since inception.

Annual Review and Possible Recommended Revisions to Endowment, SWIFT and Texas Economic Stabilization Investment Fund (TESTIF) Investment Policies (Tab 4)

Mr. Ballard reviewed the recommended revisions to the Endowment Investment Policy. He explained that the revisions are designed to slightly improve expected returns and the expected increase in returns will more than compensate for a slightly higher expected level of risk. Ms. Lori Mills reviewed ACG’s Asset Allocation Analysis behind Tab 4. She explained that ACG uses a proprietary portfolio modeling tool called Dynamic Financial Analysis (“DFA”). The model relies on inputs such as expected returns, a unique return distribution for each asset class, includes the standard deviation of asset class returns, and the correlations of asset classes with one another. The DFA model aids in establishing the structure of an investment portfolio that produces the desired return with the least amount of risk. She reviewed current and proposed target allocations and their impact on return and risk. Ms. Mills explained that current market conditions led ACG to reduce expected returns over the intermediate (ten-year) term. ACG and the Trust Company propose changing the asset allocation targets slightly and also recommend changing policy benchmarks as in stated in the draft behind Tab 4. After much discussion Mr. Ballard suggested that the Board consider recommending to the Comptroller the proposed changes to the Endowment Investment Policy.

A motion was made by Mr. Steve Strake to recommend to the Comptroller the adoption of the revisions to the Endowment Investment Policy set out behind Tab 4 with the following modifications: under Chapter II, Section 1, rather than adopting ranges of outcomes, the inflation rate is set at a constant 2.00% and the investment return objective is established at 6.0%.

The motion was seconded by Ms. Laurie Dotter and unanimously approved by the Board.

Next, Ms. Mills presented the Asset Allocation Analysis for SWIFT and reviewed the current and proposed changes to target allocations and the impact on return and risk. Mr. Ballard explained there is not a spending policy associated with SWIFT and funds are distributed when the Water Development Board requires funds. He reviewed the recommended revisions to the SWIFT investment policy. He stated that references in the policy to multi-phased implementation be removed from the investment policy since the fund is fully invested. Changes to the target asset allocation, including the addition of the All Asset Strategies asset class, were recommended by ACG and the Trust Company. Also being recommended are updates of strategy and performance benchmarks. The proposed revisions are included in the presentation behind Tab 4.

A motion was made by Mr. Tucker Bridwell to recommend to the Comptroller the adoption of the revisions to the SWIFT Investment Policy set out behind Tab 4.

The motion was seconded by Mr. Steve Strake and unanimously approved by the Board.

Mr. Ballard informed the Board that the only recommended revision to the TESTIF Investment Policy involved changing the fixed income benchmark to the Bloomberg Barclays U.S. Universal Bond Index.

A motion was made by Mr. Jim Hille to recommend to the Comptroller the adoption of the revisions to the TESTIF Investment Policy set out behind Tab 4.

The motion was seconded by Mr. Steve Strake and unanimously approved.

Lunch Speaker – Steve Ricchiuto, Mizuho Securities USA (Tab 5, handout)

Mr. Ricchiuto is a managing Director and Chief Economist of Mizuho Securities. He has over thirty years of experience in the financial services industry and has appeared on various radio and television business programs. He believes economic growth in the U.S. is expected to stay in the 1.5%- 2.5% range through the year. Mr. Ricchiuto reviewed the handout and discussed Mizuho's U.S. macroeconomic forecast.

Endowment, SWIFT and TESTIF Portfolio Updates and Related Matters (Tab 6)

Mr. Ballard explained that new graphs relating to cumulative return contribution (trailing three months and three years) and relative return contribution by asset class have been added to the presentation. He presented the Board with an overview of the endowment portfolio and reported that it was in compliance with its investment policy. He reported that as of June 30, 2016, the portfolio value was approximately \$3.76 billion. The portfolio produced a 1.9% return for the quarter, matching the benchmark. For the trailing one year period the portfolio was down -1.9% compared to the -0.9% for the benchmark. The natural resources portion of the portfolio was the best performer and produced an almost 12% return for the quarter, contributing more than fifty basis points to the overall return.

Mr. Ballard reviewed each asset class and the various investment strategies utilized to diversify returns within the portfolio. He explained which asset classes were overweight or underweight and how that related to the target allocations and returns. Mr. Ballard and Mr. Danny Sachnowitz discussed new fund commitments to private debt (1), private equity (3), and real estate (1). New strategies were added to global fixed income and hedged equity. Mr. Ballard explained the stress test scenarios performed on the portfolio. He compared the expected performance of the total portfolio in various crises relative to a portfolio allocated 65% to global equities and 35% to global fixed income. The portfolio current Value at Risk ("VaR") is 3.4%, which is lower than the policy VaR of 3.7%. The analysis continues to demonstrate that the policy portfolio is expected to protect value better than a traditional 65/35 stock/bond portfolio in times of market drawdowns. Mr. Ballard updated the performance table and stated that July performance was 1.7% and August was approximately 0.65% for 2016. The year-to-date return through August was approximately 3.3%.

Mr. Ballard presented an overview of the SWIFT portfolio. The portfolio value as of June 30, 2016 was approximately \$1.89 billion. For the quarter, the portfolio produced a 2.1% return, outperforming its dynamic benchmark by 1% and underperforming its policy benchmark by 0.3%. The portfolio's overweight allocation to fixed income was the main contributor to positive performance for the quarter, but real estate was the highest performer for the trailing one year period, returning 11.5%. The Water Development Board is expected to draw something in excess of \$70 million in October, which should bring overweight allocations back to target range. Mr. Ballard reported that the portfolio return in July was approximately 1.5% bringing the year to date approximate return to .66%. He reported that the SWIFT was meeting its performance objectives.

Mr. Ballard reviewed the TESTIF portfolio and reported it was performing as expected. The portfolio value as of July 31, 2016 was approximately \$2.7 billion. The portfolio produced a return of approximately .49% for the month of July and returned 2.31% calendar year-to-date through July. The portfolio remains highly liquid.

Broker/Dealer Update (Tab 7)

Mr. Ballard reported four new broker/dealers have been added to the approved list: Hilltop Securities Inc., Incapital LLC, Ladenburg Thalmann & Co., Inc., and Multi-Bank Securities, Inc.

Discussion of Next Meeting and Agenda Items

Comptroller Hegar announced that the next meeting will be scheduled for December. The Board will be contacted to set a date. No future agenda items were suggested.

Public Comment

None.

Adjourn

The meeting adjourned at 1:43 p.m.