TOBACCO SETTLEMENT PERMANENT TRUST ACCOUNT INVESTMENT ADVISORY COMMITTEE

Friday, April 1, 2016
Minutes

The Tobacco Settlement Permanent Trust Account Investment Advisory Committee (the "**Committee**") met on Friday, April 1, 2016 at 10:00 a.m. in Room 320, Rusk State Office Building, 208 E. 10th Street, Austin, Texas.

Committee Members Present

Stuart Ford,Chairman; Judge Dan Gattis; Judge James Teal; Commissioner Neil Fritsch; Ms. Peggy Deming; Mr. Roy Browning; Mr. Noe Hinojosa; Mr. Fred Greene; Mr. Chuck Norris; and Commissioner Byron Underwood.

Committee Members Absent

Judge Woodrow Gossom, Jr.

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

Paul Ballard, Chief Executive Officer and Chief Investment Officer; Danny Sachnowitz, Deputy Chief Investment Officer; Frank Zahn, Chief Financial Officer; Marianne S. Dwight, General Counsel; Laura Montoya, Chief Operations Officer; John Wright, Deputy General Counsel; Byron Beasley, Portfolio Manager; Gena Minjares, Deputy Chief Financial Officer; Jorge de LaFuente, Director of Operational Due Diligence; Nora Arredondo, Special Projects Coordinator; Susan Colletti, Director of Investment Accounting; and Corrine Hall, CAPCO Administrator.

Additional Participants Present

Mike O'Brien, Padgett, Stratemann & Co. and Lori Mills and Tom Janisch, Asset Consulting Group ("ACG").

Call to Order

Chairman Stuart Ford declared that a quorum was present and called the meeting to order at 10:01 a.m.

Approval of Minutes (Tab 1)

A motion was made by Mr. Chuck Norris to approve the November 6, 2015 meeting minutes. The motion was seconded by Mr. Dan Gattis and unanimously approved.

Presentation of Annual Audit (Handout)

Mr. Mike O'Brien reported that Padgett, Stratemann & Co. issued an unqualified audit opinion with respect to the Tobacco Settlement Permanent Trust Account ("Account") for the year ending December 31, 2015. Mr. O'Brien affirmed that the account had been managed in compliance with the Investment Policy and the Distribution Policy. Mr. O'Brien reviewed the distribution calculation process as described in the distribution attestation report. He explained that the audit attests to the calculation process not the decided distribution amount since it has yet to be determined. No audit adjustments were recorded during the audit engagement, nor was a management letter issued.

Capital Markets Overview and Investment Performance Review for the Quarter ending December 31, 2015 and Related Matters (Tab 2)

Mr. Tom Janisch and Ms. Lori Mills of ACG presented an economic summary since the last meeting in November, 2015. They reported that in December the Federal Reserve (the "Fed") raised interest rates by 0.25% for the first time in nine years. Market volatility in 2015 had increased from the previous two years. Global equities finished 2015 with mixed returns as U.S. equities were foremost and emerging markets lagged developed markets. Global fixed income produced modestly positive returns and commodities were overall negative as a result of continued supply and demand imbalances. For the period ending February 29, 2015, there was tremendous volatility. On February 11, 2016, the markets hit a two-year low and then rallied over 14% since. The price of oil fell to mid-$20/barrel, and OPEC agreed to freeze production. U.S. production decreased and oil production was down 7% from the 2015 peak. Internationally, Great Britain faces the decision in June to stay or leave the European Union. Also, the Bank of Japan reported negative interest rates. At the most recent meeting of the Fed, Chair Janet Yellen indicated there was a less chance the Fed would be raising interest rates now. Overall, the U.S demonstrated modest growth and stability despite volatile economic market environments and ACG remains positive but continues to expect slow domestic economic growth.

Ms. Mills summarized the investment performance of the portfolio for the quarter ending December 31, 2015. The total portfolio returns exceeded the endowment policy benchmark for the trailing one, three, and five year periods, but lagged by .13% for the quarter. Fixed income performed below its benchmark for the quarter and trailing one and three year periods. Equities performed below its benchmark for the quarter, was even for the trailing one year period and led over the three and five year periods. Equities have provided solid positive returns for these trailing periods. Real assets outperformed its benchmark for the quarter as well as the trailing one through five year periods. Ms. Mills reviewed the risk vs. return analysis portion of the report. She reported that the total portfolio generated greater returns and slightly higher risk than the endowment policy over the last three years. The annualized return for the total portfolio was 4.73% while the endowment policy produced an annualized return of 4.38%. Standard deviation for the portfolio was 4.08% and the standard deviation for the policy was 3.55%. The Sharpe ratio for the portfolio was 1.16 vs. a 1.23 Sharpe ratio for the policy. Relative to broad market benchmarks, the total portfolio generated more return with almost half the risk.

Ms. Mills reviewed the State Street peer comparison chart and noted that the portfolio's returns are net of fees and are being compared to a universe that is gross of fees. ACG will help develop a net universe for comparison.

Discussion and Approval of Annual Trust Distribution (Tab 3)

Mr. Paul Ballard began the discussion by reviewing the basics of the portfolio's rate of return and distribution calculation. He explained that the Trust portfolio is structured to produce an average rate of return of inflation plus 5%. In normal times, the distribution is expected to be 5% of the five-year average value of the Trust. Of that amount, 4.5% would be distributed to hospital districts and a half percent (0.5%) would be contributed to the Distribution Stabilization Account ("DSA"). The Trust balance is intended to grow at the rate of inflation. However, in abnormal times, after a market decline such as 2008 and the very low interest rate environment, there is an alternative distribution plan. An alternative distribution plan is required when the market value of the Trust is less than the value of the corpus, (corpus being the total contributions adjusted for inflation) and a normal distribution cannot be made. Mr. Ballard explained that the inflation adjusted corpus was approximately $2.29 billion. The value of the Trust was approximately $2.26 billion as of the year end, which is approximately $34 million less than inflation adjusted corpus but $575 million more than total contributions to the Trust. Current earnings total $14.1 million and positive net earnings were zero. Mr. Ballard reported that distributions produced by investment returns from inception-to-date were approximately $774 million. He explained that the DSA is a reserve account that, under normal circumstances, is funded each year with a portion of the annual distribution. It may be used to supplement distributions when a normal distribution would require expending corpus or the Trust value is less than the corpus value. A maximum of 50% of the DSA balance may be withdrawn in the distribution year. The current DSA balance is approximately $65.3 million and half would be approximately $32.7 million.

Mr. Ballard and Chairman Ford asked the Committee to review several options that are being considered for the 2016 distribution. As a point of reference, he stated that approximately $55 million was distributed last year. Option #1 would be to distribute approximately $14 million, which is less than the 2015 distribution, and has zero impact on the DSA. Option #2 would be to distribute the maximum allowable distribution of approximately $46.8 million, taking the 2015 earnings of $14 million plus 50% of the DSA, approximately $33 million. When determining the distribution amount, Mr. Ballard reminded the Committee that the investment objective is to provide a predictable, stable stream of distributions, ensure that the inflation adjusted value of the distributions are maintained over the long term, and also ensure that the inflation adjusted value of the corpus (after distributions and fund expenses) is maintained over the long run. The Committee discussed the options and agreed they wanted to distribute the maximum allowable amount. Chairman Stuart Ford was asked to send a cautionary letter to the trust beneficiaries explaining the circumstances and advising them of the Committee's intent to maintain stable distributions in the future given the economic uncertainty but not to except more than the 2016 distribution.

A motion was made by Mr. Noe Hinojosa to distribute the maximum allowable amount of approximately $46,761,489 million to the beneficiaries of the Tobacco Settlement Permanent Trust Account. The motion was seconded by Mr. Fred Greene and unanimously approved by the Committee.

Discussion of Trust Account Distribution Rule/Spending Policy (handout)

Mr. Ballard led the discussion and explained that a review of the current distribution policy or rule may be appropriate at this time. He reviewed the investment objectives of the Trust. It is to provide a predictable, stable stream of distribution; ensure that the inflation-adjusted value of distributions is maintained over the long-term; ensure that the inflation-adjusted value of the corpus, after distributions and fund expenses, is maintained over the long-term; and to achieve the desired portfolio volatility and minimize downside risk through diversification and risk management. The problem, he explained, is that that corpus, as defined in the distribution rule, is the cumulative value of all contributions to the trust account, plus, all inflation adjustments. Despite the fact that the value of the Trust is greater than the total capital initially contributed, the difference, or these earnings may not be used to make annual distributions because the Trust value is less than corpus as defined in the distribution rule. The current expansive definition of corpus in the distribution rule is defeating the Trust's ability to provide a predictable and stable stream of distributions. Mr. Ballard reviewed possible solutions: redefine corpus as money paid into the account; adopt a more conservative spending policy that would allow the Trust to maintain its purchasing power over the long-run. He discussed using 3% rather than a 4.5% distribution rate and perhaps establish a range with an upper limit. He suggested the Committee meet again this summer for further discussion and decide on revising the current Administrative Code relating to the distribution policy. He reminded the Committee that it takes a calendar quarter from the time a decision is reached until an amended rule can go into effect. So if a rule change is made it needed to be sufficiently in advance to be in effect before the next distribution period.

Endowment Portfolio Update and Related Matters (Tab 3)

Mr. Paul Ballard presented an overview of the endowment portfolio and reported that it was in compliance with the asset allocation and investment policies. As of December 31, 2015 the portfolio value was approximately $2.26 billion, down approximately 43 basis points for the year. He explained that the portfolio is put through several stress tests scenarios and the construction of the portfolio has proven to be resilient. Its objective continues to be consistency of performance with downside protection. He reviewed the portfolio characteristics and stated that the portfolio was very liquid, is positioned opportunistically and is extremely diversified. Mr. Ballard and Mr. Sachnowitz reviewed the portfolio's various investment managers, their strategies and performance within each asset class. They discussed managers that have been added or redeemed from the portfolio. He explained the opportunities in the private credit, European and Asian markets. He reported that the portfolio was performing in line with expectations, given the current economic environment.

Discussion of Next Meeting and Agenda Items

Committee members will be contacted to determine a date to meet in the summer.

Public Comment

None.

Adjourn

Chairman Stuart Ford adjourned the meeting at 12:00pm.