



ARIZONA STATE RETIREMENT SYSTEM

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*Paul Matson
Director*

MINUTES PUBLIC MEETING ARIZONA STATE RETIREMENT SYSTEM BOARD

**Friday, February 23, 2018
8:30 a.m.**

The Arizona State Retirement System (ASRS) Board met in the 10th Floor Board Room of the ASRS Office, 3300 N. Central Avenue, Phoenix, Arizona 85012.

Mr. Kevin McCarthy, Chair of the ASRS Board, called the meeting to order at 8:30 a.m.

The meeting was teleconferenced to the ASRS office at 4400 E. Broadway, Tucson, Arizona 85711.

1. Call to Order; Roll Call; Opening Remarks

Present: Mr. Kevin McCarthy, Chair
Mr. Michael Miller
Mr. Clark Partridge (Joined the meeting at 8:34 a.m.)
Mr. Jim Hillyard
Mr. Michael Lofton
Mr. Mr. Rene Guillen (Joined the meeting at 8:38 a.m.)
Mr. Tom Manos

Two vacant positions.

A quorum was present for the purpose of conducting business.

2. Approval of the Minutes of the December 1, 2017 Public Meeting of the ASRS Board.

Motion: Mr. Jim Hillyard moved to approve the minutes of the December 1, 2017 Public Meeting of the ASRS Board. Mr. Tom Manos seconded the motion.

By a vote of 5 in favor, 0 opposed, 0 abstentions, 2 excused, and 2 vacancies, the motion was approved.

3. Presentation, Discussion, and Appropriate Action Regarding ASRS 2018 Legislative Initiatives and Legislative Update

Ms. Jessica Thomas, Government Relations Officer, introduced the topic by stating that four legislative items were approved for the 2018 Legislative agenda. Ms. Thomas provided an update on the following ASRS legislative initiatives:

HB2080 ASRS Investments Contracts - At the request of the ASRS, this Bill was held in Committee due to concerns regarding recommended amendments made by some of the representatives of the Committee that the ASRS felt needed to be vetted. It will not be moving forward in this legislative session.

HB2034 Social Security State Agency Designation – This Bill passed through the House and is currently scheduled to be heard next week by the Senate Finance Committee.

HB2035 Deferred Compensation Plans – This Bill passed through the House and is currently scheduled to be heard next week by the Senate Finance Committee.

SB1054 ASRS Nonparticipating Employers - This Bill was passed as amended by the Senate Finance Committee with a vote of 6 to 1. However, the Universities are proposing additional amendments to the Bill. Ms. Thomas will be meeting with stakeholders and representatives next week to discuss what modifications might be made in order to have the Bill move forward for a floor vote.

In addition to her update, Ms. Thomas noted that a Bill Tracker is provided and posted on the agency website. This report provides the bills that the agency is pursuing, and those that don't have a direct impact on the ASRS, but could impact sister agencies, e.g. Correctional Officers Retirement Plan, etc.

Mr. Clark Partridge arrived at 8:34 a.m.

At the Board's request, Ms. Thomas provided additional information relating to the Universities' requests and suggested amendments. Ms. Thomas stated that The ASRS opposed one of the suggested amendments because it would significantly alter the intent of the bill and potentially adversely affect the fund.

4. Presentation, Discussion, and Appropriate Action Regarding the ASRS Investment Program Updates

Mr. Karl Polen, Chief Investment Officer, opened the topic by providing the Board with a market update and addressed concerns over heightened inflation risks, recent increased volatility and losses in the stock market over the last few weeks. He stated most stock market losses from a couple of weeks have been recovered. However, the stock market is significantly more volatile than it was two months ago.

Mr. Rene Guillen arrived at 8:38 a.m.

Mr. Polen further stated that currencies have become more volatile and the ASRS is seeing a downward trend in the value of bonds as a result of higher interest rates. Mr. Polen reported recent changes made to the Total Fund's positioning since the last report. He noted the fund had been overweight in the stock market, and as a result of the market gain, the fund drifted to approximately 2% overweight in the stock market, therefore, the ASRS has decided to reduce the equity overweight. Additionally, Mr. Polen noted that as of yesterday (February 22, 2018), the ASRS moved approximately \$500 million from the stock market and over the next week or two, the ASRS will be moving the remaining balance. The net effect is to take the stock allocation down to a neutral position. Mr. Polen stated it is important to note that the ASRS is not going against the stock market or calling a recession, but changing the philosophy to maintain a neutral position in the stock market,

and possibly move towards a slight underweight position in the stock market in light of late cycle market dynamics.

Mr. Polen further reported the Total Fund's performance for one year ending Dec. 31, 2017 was approximately 16%, outperforming its benchmark by about 40 basis points (bps). On a fiscal year-to-date, the Total Fund's returns are approximately 8%. Over the three, five, and ten years the Total Fund has outperformed the benchmark between 50-60 bps, and in terms of dollar-value added, the ASRS has added approximately \$2.5 billion of additional value over the ten year period. The total fund positioning has changed from an overweight in equities moving into shorter duration fixed income securities.

Additionally, Mr. Polen stated that the most consistent contributors to performance have been Private Debt and Real Estate, which over the past five years each have contributed around \$400-\$500 million in additional value compared to their benchmarks. The private opportunistic equity portfolio added approximately \$200 million in additional value compared to its benchmark, notable for its efficiency because this was achieved with peak invested capital of only about \$300 million. Fixed Income performance has been consistently good, but slightly underperformed in the last year due to technicalities of positions within the high yield portfolio. Mr. Polen further noted public equities have persistently underperformed their benchmark. However, extensive work has been done to restructure the portfolio by eliminating traditional active strategies and replacing them with 75% index strategies and 25% factor-based strategies where feasible.

Mr. Polen also reported that performance from the internally managed portfolios has been consistently positive, adding value in all of the one, three, five and ten year reporting periods, outperforming their benchmarks consistently by approximately 10 basis points. The private markets portfolios, added approximately \$800 million in additional value to the fund over the past five years. Mr. Polen then reviewed the risk report from MSCI and noted the downward trend in risk is simply a measure of market risk, therefore, the risk realized in the market in 2017 is very low, and is a reflection of the market, not a change in the ASRS' strategies. Mr. Polen ended his presentation by summarizing recent asset class committee meetings and a number of current projects.

5. Presentation, Discussion, and Appropriate Action Regarding the Allocation and Distribution Method of Retrospective Rate Agreement (RRA) Funds

Mr. Paul Matson, Director, introduced the topic by providing a summary of the background of the RRA funds. He then noted that the amount of the excess funds is approximately \$112 million. Mr. Matson stated this balance is kept in a segregated account and is not part of the actuarial balance sheet and doesn't impact the funded status. Mr. Matson further noted that last year the ASRS staff made a recommendation to the Board to distribute the funds to the members in the form of cash payments. However, since then, the ASRS has performed extensive research and determined that due to tax and legal reasons, cash distribution might not be the most appropriate way to distribute the funds. Mr. Matson stated that prior to distributing the funds, the ASRS would like the Board to consider a different recommendation. The recommendation is to distribute the funds in the form of a reduction in Health Insurance premiums for a set number of months per year rather than through a cash distribution.

Mr. Matson stated there are three important parts to this agenda item. They are (1) to approve a non-cash distribution rollout and reduce Health Insurance program premiums (2) to change the concept from a going concern pool of assets to a pool of assets that would pay down sooner and eventually to zero, and (3) to determine the number of years to pay the pool down; two years, three years or four years.

Mr. Matson then reviewed the Revised Health Insurance Policy; RRA Management and Distribution Policy. He also reviewed the Pro Forma Estimates of First-Year Distribution, which illustrates the initial payout from the RRA corpus to eligible members targeted for mid-2018, showing utilization over two, three and four year periods. He also reviewed the RRA Distribution Methodology Options providing the benefits as well as the concerns of each option, and made a staff recommendation for Board consideration.

Further, Mr. Matson stated there would be a substitution effect and explained how it would impact the health insurance supplement portion of the contribution rate.

A discussion took place regarding the recommended four year roll out and the benefits involved. He also responded to questions regarding any potential complications with respect to the funds roll out and the number of years to complete it and the impact of the substitution effect to include the number of members impacted in each option.

Motion: Mr. Tom Manos moved to approve the Revised Strategic Health Insurance RRA Management and Distribution Policy with a four year distribution of the current RRA account balance. Mr. Jim Hillyard seconded the motion.

By a vote of 7 in favor, 0 opposed, 0 abstentions, 0 excused, and 2 vacancies, the motion was approved.

6. Presentation, Discussion, and Appropriate Action Regarding the Role and Duties of Internal Audit and the Hiring Process for Chief Internal Auditor

Mr. Matson opened his presentation by introducing Anthony Guarino, Deputy Director and Chief Operations Officer, Lisa King, Strategic Planning and Analysis, and Harold Mackey, Interim Chief Internal Auditor (CIA).

Mr. Matson stated the previous CIA had retired, which places the ASRS in need to hire a new CIA. According to the Board Governance Policy Handbook, the CIA is not a position the ASRS Director has the authority to appoint or remove. Mr. Matson stated he is requesting the Board to provide the Director authority to appoint a replacement CIA at this time, subject to the participation of the Operations, Audit and Legislative Committee (OALC) Chair.

Additionally, Mr. Matson noted the ASRS conducted an internal analysis of the Internal Audit Division (IAD) to determine if resources are being optimized. As a result, the ASRS staff is recommending the following:

1. Implement 'Option #3: Change duties and Structure of the "Internal Audit Model Options" paper, which would result in the IAD expanding the depth of the operational audits, engaging in internal consultative services, advising on enterprise risk management, incorporating lean auditing processes, and continuing investment audits, fraud hotline management, GASB testing, and ad hoc audits at the direction of the OALC, or the Director.
2. Migrate the remaining responsibilities of ensuring employer compliance to the Member Services Division (MSD), and utilize a risk-based process to determine employer compliance reviews.
3. Recommend selection of new Chief Internal Auditor be delegated to the Director, with participation and oversight by the Chair of the OALC.

Mr. Matson responded to questions from the Board relating to the role MSD would take on with regards to employer audits. Further, Mr. Partridge stated that using the IAD as a resource, would provide flexibility and would allow oversight to the process. Finally, Mr. Matson and the Board discussed the benefits of having this consultative role within the IAD.

Motion: Mr. Clark Partridge moved to implement 'Option #3: Change Duties and Structure' of the attached "Internal Audit Model Options" paper, which would result in the IAD expanding the depth of operational audits, engaging in internal consultative services, advising on enterprise risk management, incorporating lean reviews, and continuing investment audits, fraud hotline management, GASB testing, and ad-hoc audits at the direction of the Operations, Audit and Legislative Committee (OALC), or the Director, and consolidating employer compliance and employer education within the Member Services Division. Mr. Jim Hillyard seconded the motion.

By a vote of 7 in favor, 0 opposed, 0 abstentions, excused, and 2 vacancies, the motion was approved.

7. Presentation, Discussion, and Appropriate Action Regarding Director's Report as well as Current Events

Mr. Paul Matson stated he had nothing further to add regarding the Director's Report, but would answer any questions the Board may have regarding the report; there were none.

8. Presentation and Discussion Regarding Informational Updates from Prior and Upcoming Committee Meetings

a. Operations, Audit and Legislative Committee (OALC)

Mr. Clark Partridge announced the next OALC meeting will be held on April 4, 2018.

b. Investment Committee (IC)

Mr. Clark Partridge announced the next IC meeting is scheduled to be held on March 16, 2018.

c. Appeals Committee (AC)

Mr. Tom Manos announced the next AC meeting is scheduled to be held on April 10, 2018. Mr. Manos noted the Director's Report includes an up-to-date appeal report so the Board can view for the most current information.

9. Board Requests for Future Agenda Items

No requests were made.

10. Call to the Public

No one from the public requested to speak.

11. The next regular ASRS Board meeting is scheduled for Friday, April 27, 2018 at 8:30 a.m., at 3300 N. Central Avenue, 10th Floor Board Room, Phoenix, Arizona.

Mr. McCarthy noted the next Board meeting is scheduled for Friday, April 27, 2018 at 8:30 a.m.

The Board took a recess from 9:53 a.m. to 10:07 a.m. to transition to the 14th floor conference room for the final agenda topic.

12. Presentation, Discussion, and Appropriate Action Regarding the Board Governance Evaluations

- a) Trustees' 2017 Self-Evaluation
- b) Board 2017 Self-Evaluation
- c) Key issues in 2017
- d) Focus areas for 2018

The Overall Board Evaluation document taken from the Board Governance Policy Handbook prompts the Trustees to consider the following statements while reviewing their performance:

1. The Board maintains an effective oversight role with regard to benefits and investment issues.
2. The Board knows and understands the ASRS Strategic Plan, and reflects this understanding when addressing key issues throughout the year.
3. The Board engages in long-range strategic thinking and planning.
4. The Board has achieved the business objectives it set out to accomplish this past year.
5. The Board stays abreast of issues and trends affecting the ASRS, using this information to assess and guide the ASRS over the long term.
6. The Board conducts a comprehensive evaluation of the Director annually.
7. The Board ensures that new Trustees receive a prompt, thorough orientation.
8. Board meetings are conducted in a manner that ensures open communication, meaningful participation, and sound resolution of issues.
9. The Board meeting agendas are well-balanced, allowing time for the most critical issues.
10. The Board and Committee meetings are handled efficiently.
11. The Committees are effective, focusing on pertinent topics and allocating reasonable time.
12. The Board is well-educated on both benefit and investment issues.
13. The Board recognizes its policy-making role and reconsiders and revises policies as necessary.
14. The Board is consistently prepared for meetings.
15. The Board as a whole, and Trustees as individuals, evaluates their performance on an annual basis.

16. The Board reviews and adopts a reasonable operating budget that is followed and monitored throughout the year.
17. The Board periodically monitors investment performance and measures it against relevant benchmarks.
18. The Board periodically monitors service to members.
19. The Board comprehends and respects the difference between its policy-making role and the Director's management role.
20. Board goals, expectations, and concerns are promptly, candidly and effectively communicated to the Director.
21. The Board anticipates issues and does not often find itself reacting to "crisis" situations.

All scores were favorable, which is consistent with previous years. The Trustees discussed at some length a few of the overall comments submitted and item #12 from the Overall Board Evaluation document, offering input regarding effective meetings, oversight, and possessing an effective knowledge base. Trustees provided positive feedback regarding 2017 Board interactions.

Further, the Board shared their satisfaction with the ASRS' Chief Investment Officer's level of expertise and knowledge. They also discussed the importance of having investment expertise within the Board for reassurance of direction taken when making investment decisions. Additionally, the Board discussed the idea of suggesting an investment educational workshop focusing on investment law and the benefit structure in general, to be facilitated at the ASRS. The Board will seek advice from the ASRS Assistant Attorney General to ensure the proper protocol is followed when scheduling the educational workshop should there be a quorum of the Board or one of its committees in attendance.

The Board also discussed the frequency of reviews of actuarial assumptions and expressed they would prefer more frequent reviews.

Finally, the Board discussed Mr. Matson's input and provided positive feedback regarding Mr. Matson's comments on the key characteristics of the board and cordiality.

13. Presentation, Discussion, and Appropriate Action Regarding the Role and Duties of Internal Audit and the Hiring Process for Chief Internal Auditor (Board Agenda Item #6)

The Board recalled agenda Item #6 in order to amend the previous motion. It was discovered the recommended motion included on the motion sheet was incomplete. However, it was provided as part of the materials for that agenda item.

Amended Motion: Mr. Clark Partridge moved to amend the previous motion by adding to the motion that the selection of the new Chief Internal Auditor be delegated to the Director, with participation and oversight by the Chair of the OALC.

By a vote of 7 in favor, 0 opposed, 0 abstentions, 0 excused, and 2 vacancies, the motion was approved.

For the record, the complete amended motion is:

Moved to implement 'Option #3: Change Duties and Structure' of the attached "Internal Audit Model Options" paper, which would result in the IAD expanding the depth of operational audits, engaging in internal consultative services, advising on enterprise risk management, incorporating lean reviews, and continuing investment audits, fraud hotline management, GASB testing, and ad-hoc audits at the

direction of the Operations, Audit and Legislative Committee (OALC), or the Director, and consolidating employer compliance and employer education within the Member Services Division. Selection of the new Chief Internal Auditor is delegated to the Director, with participation and oversight by the Chair of the OALC.

14. Adjournment of the ASRS Board

Mr. McCarthy adjourned the February 23, 2018, Board Meeting at 10:41 a.m.

Respectfully Submitted by:

Alicia Guzman
Board Administrator
ARIZONA STATE RETIREMENT SYSTEM