MINUTES

PUBLIC MEETING
OF THE ARIZONA STATE RETIREMENT SYSTEM
INVESTMENT COMMITTEE

March 15, 2021
1:30 p.m.

The Arizona State Retirement System (ASRS) Investment Committee (IC) met telephonically.

Mr. Kevin McCarthy, Vice-chair of the IC, called the meeting to order at 1:35 p.m.

1. Call to Order; Roll Call; Opening Remarks

Present: Mr. Kevin McCarthy, Vice-chair – via teleconference
Mr. Clark Partridge – via teleconference

Excused: Mr. Michael Lofton

A quorum of the IC was present for the purpose of conducting business.

Ms. Joyce Williams, ASRS Board Administrator, provided all attendees with telephonic meeting guidelines.

2. Approval of the Minutes of the December 21, 2020, Public Meeting of the ASRS IC

Motion: Mr. Clark Partridge moved to approve the minutes of the December 21, 2020, public IC meeting. Mr. Kevin McCarthy seconded the motion.

By a roll call vote of 2 in favor, 0 opposed, 0 abstentions, 1 excused, and 0 vacancies, the motion was approved. The trustee votes were as follows:

Mr. Michael Lofton – excused
Mr. Kevin McCarthy – approved
Mr. Clark Partridge – approved

3. Presentation, Discussion, and Appropriate Action Regarding Portfolio Positioning, House Views, and General Discussion

Mr. Samer Ghaddar, Deputy Chief Investment Officer, provided an outlook on US Gross Domestic Product (GDP) growth, noting that the GDP is expected to accelerate in 2021 to an average of 5-6.5%, which is higher than previous projections of 4%. Mr. Ghaddar spoke of the contrast between the US GDP and the European Union (EU) GDP, which is expected to grow by 4.3% in 2021. US high-frequency indicators are still in expansion territory, while the same indicators for the EU indicate continued contraction. Mr. Ghaddar continued, noting that Federal Reserve support will continue in 2021. The S&P 500 quarterly earnings per share (EPS) is higher than at pre-crisis levels in the equity markets. The ASRS Public Equities portfolio is currently overweight across geographies. However, this will be moved to equal weight if rates continue to trend higher. Looking forward to the economic recovery ahead, staff remains optimistic on equities and ready to take advantage of the recovery through tactical positioning in cyclicals and small- to mid-capitalization. Staff is also constructive on global equity markets, with a bias for emerging markets.

Mr. Micheal Copeland, Portfolio Manager, Private Markets, detailed current market conditions for Private Equity, noting that although the pandemic slowed fundraising activities considerably, business confidence levels are increasing. The ASRS Private Equity Team is very selective in making commitments and will keep the pacing model target for 2021 flexible. Mr. Al Alaimo, Deputy Chief Investment Officer, provided an outlook on credit markets, noting that there are compelling investment opportunities to exceed the Credit asset class benchmark's performance over time in Private Debt, Distressed Debt, and Other Credit. Mr. Alaimo added that staff does not believe that public credit markets (i.e., high yield bonds, leveraged loans, and asset-backed securities) offer attractive investment opportunities compared to the private markets. Public market opportunities will likely not meet the rate of return of the Credit class benchmark over an extended, multi-year period. Mr. Alaimo further reviewed Interest Rate Sensitive markets, noting that when equity markets and other risky asset classes sold off, this asset class held its value and remained a good source of liquidity for the portfolio. Although this was beneficial, the efficacy of this asset class has likely diminished. The asset class has less room to appreciate since interest rates have little capacity to fall further unless negative rates are adopted in the US, an unlikely prospect.

Mr. Taylor Mammen, Sr. Managing Director, RCLCO, provided an outlook of the current economic climate and anticipated impacts on the real estate asset class. Original estimates for 2020 results are on track to outpace expectations. GDP growth is expected to outpace job creation, which will likely be inconsistent and vary by industry. The effects of COVID-19 on real estate demand are expected to vary by property type, with transaction volumes rebounding in 2021 for multifamily, industrial, single-family homes (for sale and rent) and select niche property types like medical office buildings and data centers. Office and hotel demand will recover slowly as work-from-home and reduced business travel will be slow to reverse and will likely reduce long-term demand. Mall and shopping center sales will rebound when COVID-related restrictions are lifted. Still, e-commerce is expected to continue taking a more significant retail sales share, resulting in ongoing excess space.

4. Presentation, Discussion, and Appropriate Action Regarding Investment Performance

Mr. Ghaddar initially presented the estimated total Fund returns as of January 31, 2021, for the fiscal year-to-date, 14.17%, and the estimated three-month returns, 9.61%. Also as of January 31, 2021, the Fund was slightly overweight in Equities and Credit and slightly underweight in the Interest Rate Sensitive asset class. Mr. Ghaddar reminded the IC that staff defunded any underperforming strategies in the Public Equity asset class, noting the outperformance in all asset classes for the three months ending January 31, 2021.

Mr. Ghaddar next presented investment performance for periods ending December 31, 2020. Total fund returns of 13.8% underperformed the benchmark by 2.3%. Total Equity overweight was at about 2%, with total Equity comprising 54% of the Fund. Roughly 20% of the Fund was in Credit, 16% in Real Estate, 9% in Interest Rate Sensitive, and 1% in Cash. Mr. Ghaddar explained how the overweight of 2% in Equity added value because of the outperformance in that sector and staff's tactical management. Mr. Ghaddar detailed how defunding the underperforming strategies in US Equity resulted in the total Fund returns of 25.28%, matching its benchmark, the Combined Domestic Equity Index for the fiscal year-to-date, and a 100 bp outperformance in the three-month period. International Equity shows underperformance in the fiscal year-to-date results. This underperformance stems from the timing of tax credits and will reverse later in the year. In the Interest Rate Sensitive asset class, we show an outperformance. In Credit, the time weighted returns for the three month period were 3.1% and the fiscal year-to-date returns were 6.37%. Private Equity returns for the three-months ending December 31, 2020 were 7.17% and the fiscal year-to-date returns were 15.74%. Real Estate returns show outperformance of 2.12% for the three-month period and 3.83% for the fiscal year-to-date. Mr. Ghaddar finished with a brief review of Private Markets IRRs and Dollar Values Added.

Mr. Jomar Ereso, Managing Director, Chief Compliance Officer, and Director of Asset Management, RCLCO, reported real estate returns for periods ending September 30, 2020. Real estate returns of -0.1%, 4.2%, 6.5%, and 9.5% for the one-year, three-year, five-year, and inception periods underperformed their benchmarks by 0.6%% for the one-year period but outperformed by 0.4%, 1.4%, and 1.6% for the one-, five-, and inception-to-date periods. Mr. Ereso noted the consistently strong performance of categories where ASRS retains investment control rights with inception-to-date returns of 9.5% and 15% in the separate account and operating company categories, respectively. Mr. Ereso alerted the IC to a typographical error on page 83 of 237. The legends for the graphs named *Total Separate Accounts Dollar Value Add* and *Life Cycle Risk Dollar Value Add* were inadvertently switched.

5. Presentation, Discussion, and Appropriate Action Regarding Independent Reporting, Monitoring, and Oversight

Mr. Allan Martin, Partner, NEPC, presented the NEPC oversight report for the fourth quarter of 2020. Mr. Martin reviewed compliance with ASRS board goals, noting full or partial compliance except one, to achieve a one-year total fund net return greater than the Strategic Asset Allocation Benchmark. He also stated that ASRS performance compared to other pension plans placed it in the 86th, 48th, 37th, and 24th percentile for the one-, three-, five-, and ten-year periods. Mr. Martin spoke of NEPC's work to capture the very structured process used by the ASRS team to determine the breakdown of private market and real estate returns. Many plans are expecting a reduction in their expected returns of about 20-30 bps due to disruptions in the past year due to the pandemic. Total ASRS fund performance, net-of-fee, time-weighted rate of return, all time-periods, short and long, reflect substantial outperformance, exceeding the 7.5% actuarial rate of return that is the benchmark. As of December 31, 2020, all the long-term results are comfortably in excess of 7.5% (13.8% for the fiscal year). The one-year total fund net return has underperformed, but this is expected to normalize quickly as economic growth recovers. The portfolio has been adjusted to have more diversification than it has had historically. With good performance and adjusted for risk, this Fund is one of the country's top performing. The portfolio is operating close to long-term targets, and the positioning of the portfolio is well suited to an anticipated, more challenging environment in the future. Asset class performance adds value across the board, and staff continues careful monitoring of the external managers we are employing to ensure the best outcomes possible.

6. Presentation, Discussion, and Appropriate Action Regarding Risk Management

Mr. Ghaddar presented the risk report, beginning with a description of regional exposure to risk. Approximately 82% of the Fund's total risk exposure is in the US, about 11% in Europe. The remaining 7% of the Fund's full risk exposure is divided between Asia, Africa, the Middle East, Australia, and others. Total portfolio Value-At-Risk (VaR) was approximately 26%. MSCI estimate of value at risk decreased to 25.69% during the quarter ended December 31, 2020.

7. Presentation, Discussion, and Appropriate Action Regarding Compliance

Ms. Lupita Breland, Investment Operations Manager, presented the compliance report.

- The <u>Internally Managed Portfolios Pre-Trade Compliance System Review Summary</u> included pre-trade compliance performed on all internally managed fixed income and equity portfolios for December 2020 – February 2021. No exceptions occurred during the period under review.
- The <u>State Street Global Services Investment Compliance Program</u> includes compliance reviews on all public markets portfolios and at the Total Fund level investments for December 2020 – February 2021.
    - Public Markets Investment Limits – State Street's review found a few findings resulting from index changes, corporate actions, and informational flags. All conclusions were researched and resolved to both State Street's and ASRS' satisfaction for all periods.
    - Total Fund Monthly Statutory Investment Limits – Total Fund investments passed the five mandated statutes on investment limits, as well as the Arizona Restricted Country Test for all periods.
- The <u>Private Markets Investment Compliance Program</u> includes reviews by two investment consultants for the ASRS.

- RCLCO, Real Estate Separate Account Investment Compliance Review – RCLCO performed reviews on RE SMA funds and found immaterial inconsistencies related to the NAV, management fee, and expense calculations. All findings have been satisfactorily resolved.
- Meketa Investment Group, Commingled Funds and Non-Real Estate Separate Accounts Investment Compliance Review – Meketa completed the compliance reviews on 35 funds selected for the year ending December 31, 2019, with no material issues regarding conformity with Fund Documents or the policies of the Manager.

8. Presentation, Discussion, and Appropriate Action Regarding ASRS Supplemental Salary Deferral Plans

Ms. Breland presented the annual update, as of December 31, 2020, on the ASRS Defined Contribution (DC) Plans, administered by Nationwide Retirement Solutions, noting the following:

- The SSDP plan was adopted in 2009 with more flexible features, including the availability of loans. There are nearly 6,500 plan participants in the SSDP with over $314 million in combined savings.
- The SRSP plan was created in 1999 but has seen limited reception due to federally required plan features, resulting in the participation of only 139 people with over $13 million in combined savings.

Mr. Matson offered closing comments to the Committee.

- Agenda Item #8: The Governing Committee of the Deferred Compensation (DC) Plans requested that consideration be given to migrate the body of assets currently administered by that Committee (approximately $1.8 billion). Senate Bill 1348 is presently at the Legislature, sponsored by Sen. Livingston. It was created to consolidate this DC plan with the ASRS and to also provide a type of auto-enrollment option into an ASRS plan for employees. This consolidation is expected to ensure low administrative costs and increase efficiency significantly. This bill passed in the Senate and is likely to go to the House Government Committee on March 31, 2021.
- The investment philosophy used by the State Governing Committee of the DC Plans to manage the SSDP and SRSP is very similar to the investment philosophy employed by the ASRS. Participants can select from options based on their level of engagement and investment knowledge.
    1. Proactive and engaged participants can opt-out of investment offerings provided and move into a self-directed brokerage window and make their own investment decisions.
    2. If the participants want to make their own investment decisions but are less engaged in searching for investment options, they can choose from an array of mutual funds that the overseeing Committee determines.
    3. If the participants want less engagement, both have a series of retirement-date funds that they can participate in.
    4. There is also a pro account, an algorithmic based approach offered by both programs that considers several factors and customizes an investment portfolio comprised of options provided by the plans.
- Mr. Matson wanted to offer a helpful data point relative to Agenda Items #3 and #4, House Views and Investment Performance with respect to real estate office occupancy during the pandemic. Approximately 9% of the office space in the 3300 N. Central Ave. building are currently occupied on an average workday, and this occupancy is often not for a full business day. This occupancy number includes multiple tenant types, both public and private sector workers.
- Mr. Matson gave the IC an update regarding Agenda Item #4, Investment Performance, which reflects performance at the end of February. The updated fiscal year to date investment performance of the Fund as of Friday, March 12, is approximately 17.2%. As a result, if there were no changes to the rate of return, and no dividends and interest received, the two-year (pandemic fiscal year and current fiscal year) rate of return would be approximately 9%, which would be above the expected average rate of return of 7.5%.
- Mr. Matson informed the IC of new committee assignments, which will take effect on March 16, 2021. Ms. Diane Landis will replace Mr. Partridge on the IC.
- Mr. Matson referred to an experience study mentioned in Agenda Item #3, House Views. ASRS' external actuarial consultant, Gabriel, Roeder, Smith and Company is conducting an experience study, which the ASRS now has conducted every four years. One key input into the experience study will be the expected rate of return, which could be reduced. Other possible findings:

1. Retirement (versus withdrawal) decisions of our members may be overly conservative.
2. Long-term Disability (LTD) participation continues to fall, which may result in a positive finding.
3. The cost estimate of the permanent benefit increase is likely to fall if our estimated long term rate of return estimate falls
4. Our health benefit supplement utilization estimates could be overly conservative.

Mr. Partridge thanked the staff for all their work with the oversight committee and Mr. Jim Keeler for their ongoing work to provide a good offering for the DC programs. Based on rates of return, they have been doing an excellent job in actively managing those programs well.

9. Request for Future Agenda Items

No requests for future agenda items were made.

10. Call to the Public

No members of the public requested to speak.

11. The next ASRS Investment Committee Meeting is scheduled for Monday, June 14, 2021, at 1:30 p.m.

Mr. McCarthy noted the next IC meeting is scheduled for Monday, June 14, 2021, at 1:30 p.m.

12. Adjournment of the ASRS IC Meeting.

Motion: Mr. Clark Partridge moved to adjourn the meeting. Mr. Kevin McCarthy seconded the motion.

By a roll call vote of 2 in favor, 0 opposed, 0 abstentions, 1 excused, and 0 vacancies, the motion was approved. The trustee votes were as follows:

Mr. Michael Lofton – excused
Mr. Kevin McCarthy – approved
Mr. Clark Partridge – approved

Mr. Kevin McCarthy adjourned the meeting at 3:33 p.m.

Respectfully submitted by:

Joyce Williams
Investment Committee Administrator
ARIZONA STATE RETIREMENT SYSTEM