MINUTES

PUBLIC MEETING
OF THE ARIZONA STATE RETIREMENT SYSTEM
INVESTMENT COMMITTEE

June 23, 2021
9:00 a.m.

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

Mr. Michael Lofton, Vice-chair of the IC, called the meeting to order at 9:01 a.m.

1. Call to Order; Roll Call; Opening Remarks

Present: Mr. Michael Lofton, Chair – via teleconference
Mr. Kevin McCarthy, Vice-chair – via teleconference
Ms. Diane Landis – via teleconference *(Ms. Landis rejoined the meeting at 9:07 a.m.)*

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 March 15, 2021, Public Meeting of the ASRS IC

Motion: Mr. Kevin McCarthy moved to approve the minutes of the March 15, 2021 public IC meeting. Mr. Michael Lofton seconded the motion.

By a roll call vote of 3 in favor, 0 opposed, 0 abstentions, 0 excused, and 0 vacancies, the motion was approved. The trustee votes were as follows:

Mr. Michael Lofton – approved
Mr. Kevin McCarthy – approved
Ms. Diane Landis – approved

(Ms. Landis rejoined the meeting at 9:07 a.m.)

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

Mr. Paul Matson, Director, introduced the new Chief Investment Officer, Mr. Michael Viteri, to the Committee members, who turned the presentation over to Mr. Samer Ghaddar, Deputy Chief Investment Officer. Mr. Ghaddar provided an outlook on US Gross Domestic Product (GDP) growth, noting that the GDP is expected to accelerate in 2021 to an average of 6.5%-plus. This is higher than previous projections of 5-6.5%. The unemployment rate is still high but is expected to drop to 4.2% in 2022. Inflation is higher than anticipated, with the April Consumer Price Index (CPI) increase primarily driven by energy and used car prices. GDP growth in the European Union is projected to reach 4.5% in 2021, and Emerging Markets GDP growth is projected to reach 5.2% in 2021, after both recorded contractions in 2020. The 10-Year yield is inching upwards; however, real rates are still at all-time lows. Monetary policy enacted by the Federal Reserve is still supportive, with inflation at its highest point since the start of the pandemic. Mr. Ghaddar also provided house views to the Trustees on public equities and gave a preliminary update on the outperformance of the ASRS' fiscal YTD Public Equity portfolio.

Mr. Micheal Copeland, Portfolio Manager, Private Markets, detailed current market conditions for Private Equity, noting that private equity markets are performing very well with respect to fundraising, capital deployment, and exits. Previewing the performance report, Mr. Copeland shared the preliminary net returns of 39% in the ASRS' private equity portfolio, which was mainly driven by buyouts in tech, the recovery in commodity prices, and the portfolio's overweight to energy. The ASRS private equity portfolio is still primarily in the buyout section. Staff is focusing on private equity opportunities structured as ten-year, locked-up commitments. Additionally, staff is focused on the strategic goals of the portfolio, including becoming more diversified from a geographic standpoint, seeking more global opportunities, becoming more neutral in sector exposure relative to the Cambridge benchmarks, and identifying sector specialists.

Mr. Al Alaimo, Deputy Chief Investment Officer, presented house views on the Credit asset class. Mr. Alaimo noted that there are compelling investment opportunities to exceed the performance of the Credit asset class benchmark over time in Private Debt, Distressed Debt, and Other Credit. These opportunities are almost exclusively in private rather than public markets or are in areas of the market, such as distressed debt, which typically require investments in locked-up vehicles with limited liquidity. Staff does not generally believe that public credit markets offer attractive investment opportunities compared to the private markets. Public market opportunities will likely not meet the return of the Credit asset class benchmark over an extended, multi-year period. Moreover, in contrast to the private markets, the public credit markets do not provide investors with the opportunity for complete due diligence and custom-tailored deal terms. The ASRS' credit program is different than most pension plans because, in 2012, staff created the private debt portfolio to exclude commingled funds. All of the ASRS' active private debt partnerships are now funds-of-one. Care has been taken to select long-term market leaders in specific categories of private lending in the US or Europe or real estate in those partnerships. Staff negotiated special rights in these partnership commitments with the ability to turn off investing after one year. Mr. Alaimo described one of the restrictions of commingled funds as having no decision-making rights and, ultimately, no way to control liquidity. In most partnerships with the ASRS, staff has negotiated the ability to shut down capital calls after one year, sending the portfolio into a runoff and returning the capital to the ASRS in three to four years. This arrangement gives the ASRS unique control over liquidity that other pension plans do not have because they invest in commingled funds. This partnership structure also increases staff’s ability to deploy more capital with the same manager without striking a new partnership agreement or investing in a new fund. This particular structure gives the ASRS a unique, competitive edge over other large investors by locking up competitive investment opportunities. Next, Mr. Alaimo updated the trustees about the portfolio’s holdings in distressed debt, which are currently in European distressed funds, specifically comprised of nonperforming loan pools sold by banks. Mr. Alaimo finished his presentation with house views of the Interest Rate Sensitive asset class. Briefly describing the quantitative easing currently enacted by the Federal Reserve and the resulting low yields, Mr. Alaimo explained that in the future, staff does not expect attractive returns in this asset class relative to the total Fund's target return. Meaningful investment in this asset class will be maintained to be used as a source of diversification and liquidity.

Mr. Taylor Mammen, Sr. Managing Director, RCLCO, provided an outlook of the current economic climate and anticipated impacts on the real estate asset class. The first quarter of 2021 (Q1 2021) indicates that 2021 promises to be one of the strongest economies on record. In Q1 2021, the rise in GDP was propelled by stimulus-assisted consumer spending and housing activity. Job growth rose throughout the quarter, and the increase in inflation in March rose to 0.6% (vs. February) and 2.6% for the past year. The house view expects that increase to be temporary. In the outlook on property markets, multifamily has been remarkably resilient throughout the pandemic, and as renters return to the metro areas, it will continue to strengthen. Because of leases, office demand stayed steady during the pandemic, but occupancy and rents are starting to decrease. Retail is still struggling but is expected to enjoy a post-pandemic boost as shoppers return. The shift to e-commerce during the pandemic will probably endure and further erode retail performance. As warehouse demand continues to increase, industrial remains the most robust asset class in Q1 2021. Finally, as travel restrictions have lifted across the nation, hotel fundamentals improved notably in Q1 2021.

Mr. Lofton acknowledged the efforts of the staff, citing the consistently high quality of explanations given about the investment strategy of the ASRS. Mr. Lofton suggested that stakeholders in the ASRS would benefit from the detailed reports being presented.

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

Mr. Ghaddar initially presented the estimated total Fund returns as of May 31, 2021, for the fiscal year-to-date, 24.12%, and the estimated three-month returns, 7.18%, outperforming the benchmark by 1.72%. Three-year risk statistics show that the portfolio standard deviation for volatility is 8.07%, reflecting less risk than the benchmark standard deviation of 8.56%.

Mr. Ghaddar next presented investment performance for periods ending March 31, 2021. For the three months, total fund returns of 4.01% underperformed the benchmark by 0.42%. Total Equity overweight was at about 4%, with total Equity comprising 54% of the Fund. Roughly 21% of the Fund was in Credit, 15% in Real Estate, 8% in Interest Rate Sensitive, and 2% in cash. Highlights of ASRS performance as of March 31, 2021, are as follows:

- Fiscal year-to-date total fund returns through March 31, 2021, are approximately 18.4% against the benchmark of 21.28%.
- Total equity returns for the period ending March 31, 2021, of 33.45 outperformed the benchmark by 0.28%. Staff feels that this performance improvement directly reflected the restructuring of the equity portfolio in 2020.
- Fixed income (Interest Rate Sensitive) is underweight by about 2.5% and underperforming by 0.01%.
- The credit asset class shows a valuation of about $9.96 billion. The preliminary fiscal year-to-date returns of 10.10% show an underweight of 10.71%, but this continues to change as results are still being reported and better returns are anticipated.
- Private equity fiscal year-to-date performance is 27.05%, and Mr. Ghaddar noted that on June 22, 2021, private equity performance is at 39.40%.
- Real estate fiscal year-to-date performance is 4.04%, exceeding its benchmark by 4.45%.

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

Mr. Paul Matson gave the Committee a brief introduction of Mr. Chris Levell, Partner, NEPC, who presented the NEPC oversight report for the first quarter of 2021. Mr. Levell, an actuary focused on investment consulting since the late 90s, has been with NEPC since 2005. Although currently working in asset allocation research, he has served in various roles at NEPC but focuses on pensions. Mr. Levell has presented to the ASRS in the past, most recently with GRS on the actuarial return for the Experience Study. Mr. Levell 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. Mr. Viteri briefly addressed standard deviations shown in the universe comparisons section, mentioning that these results illustrate the nature of the diversified portfolio currently in place. From a standard deviation/volatility perspective, the portfolio has been top quartile for the last one-, three-, five-, and ten-year reporting periods, demonstrating great returns combined with lower standard deviation and volatility. Mr. Levell agreed, noting that the position of risk and diversification is something that staff has the highest degree of control over. Sufficient cash is maintained to meet all payment requirements, and the Fund complies with the SAA policy.

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

Mr. Ghaddar presented the risk report, beginning with an illustration of how ASRS assets and risk sources are diversified across different asset classes. He also noted the smaller measurement of standard deviation and how the diversification of the total portfolio is nearing 50%, echoing earlier observations of the portfolio's levels of volatility and diversification. Mr. Ghaddar noted that because current asset markets are increasingly correlated, it is difficult to achieve high levels of diversification, and staff has worked diligently toward that goal. Next, Mr. Ghaddar described currency exposure to risk by region. Approximately 84% of the Fund's total risk exposure is in the US and about 9% in Europe. The remaining 7% of the Fund's total risk exposure is divided between Asia, Africa, the Middle East, Australia, and others. Total portfolio Value-At-Risk (VaR) was approximately 25%. MSCI estimate of value at risk decreased to 24.70% as the quarter ended March 31, 2021. Mr. Matson briefly commented on the VaR measurement and the senior investment division staff's collaborative focus on perspectives of risk, risk management, and risk oversight. Mr. Viteri briefly reviewed the visual illustration of the historical risk contribution of the major asset classes and the impact of equities on overall portfolio risk.

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 March 2021 – May 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 total fund level investments for February 2021 – April 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 Private Markets Investment Compliance Program includes reviews by two investment consultants for the ASRS.
  - RCLCO, Real Estate Separate Account Investment Compliance Review – RCLCO is currently working on the compliance reviews for the 2020 review period.
  - Meketa Investment Group, Commingled Funds, and Non-Real Estate Separate Accounts Investment Compliance Review – Meketa is currently working on the compliance reviews for the 2020 review period.

8. Request for Future Agenda Items

No requests for future agenda items were made.

9. Call to the Public

No members of the public requested to speak.

10. The next ASRS Investment Committee Meeting is scheduled for Monday, September 20, 2021, at 1:30 p.m.

Mr. Lofton noted the next IC meeting is scheduled for Monday, September 20, 2021, at 1:30 p.m.

11. Adjournment of the ASRS IC Meeting.

Mr. Michael Lofton adjourned the meeting at 11:02 a.m.

Respectfully submitted by:

Joyce Williams
Investment Committee Administrator
ARIZONA STATE RETIREMENT SYSTEM