

# New Jersey State Investment Council

## March 23, 2016 Regular Meeting

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### **Minutes of the Regular Meeting**

Held March 23, 2016 at the Trenton War Memorial, George Washington Ballroom, 1 Memorial Drive, Trenton, New Jersey.

#### **Council Members in Attendance:**

Brendan T. Byrne, Jr., Chair  
Adam Liebttag, Vice Chair  
Marty Barrett  
Thomas Bruno Jr.  
Michael Cleary  
Charles Dolan (via telephone)  
Michael Greaney  
James Hanson  
Guy Haselmann  
James Joyner  
Jeffrey Oram  
Mitchell Shivers (via telephone)

Timothy McGuckin was not in attendance.

#### **Roll Call and Meeting Notice**

The Regular Meeting was called to order by Brendan T. Byrne, Jr., Council Chair, at 10:06 a.m. Ernestine Jones-Booker, Council Secretary, performed roll call and reported that a quorum of the State Investment Council (Council) was present. Ms. Jones-Booker reported that notice of the Regular Meeting, scheduled for March 23, 2016, was posted on the website of the Division of Investment (Division), faxed to the Times of Trenton, the Bergen Record, and the Courier Post, and e-mailed to the Secretary of State on February 16, 2016. A copy of the notice was posted at the Division and is on file.

#### **Opening Remarks by Chair**

Mr. Byrne made some brief opening remarks, discussing the process of adopting an asset allocation plan and emphasizing the need for specialized categories of investment to smooth volatility and enhance returns, especially given the lackluster performance of traditional asset classes. He welcomed a full discussion of the fund's allocation to alternative investments and other assets later in the meeting.

#### **Minutes of the Annual Meeting held January 27, 2016**

Mr. Byrne presented for adoption the minutes for the annual meeting held January 27, 2016. Mitchell Shivers made a motion to approve the minutes, with Michael Cleary seconding the motion. All Council Members present voted in favor, except that Charles Dolan, James Hanson and Jeffrey Oram, abstained since they were not in attendance at that meeting and Thomas Bruno abstained as he was not a Member of Council at the time of that meeting.

#### **Minutes of the Regular Meeting held January 27, 2016**

Mr. Byrne presented for adoption the minutes for the regular meeting held January 27, 2016. Guy Haselmann made a motion to approve the minutes, with Mr. Cleary seconding the motion. All Council Members present voted in favor, except

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that Messrs. Dolan, Hanson and Oram abstained since they were not in attendance at that meeting and Mr. Bruno abstained as he was not a Member of Council at the time of that Meeting.

### **Audit Committee Verbal Report on Fiscal Year 2015 Audit**

Michael Greaney reported that the Audit Committee met on March 4, 21016 with the auditor, KPMG, who completed the audit of the financial statements of the Division of Pensions and Benefits and the pension funds with an unmodified opinion and no issues reported. Mr. Byrne stated that John Megariotis of the Division of Pensions and Benefits was out of town and unable to attend, but that he would invite him to a future meeting to answer any questions.

### **Director's Report/Updates**

Director Christopher McDonough welcomed Mr. Bruno to the NJ State Investment Council as the new representative for the Public Employees' Retirement System. Mr. McDonough presented the Director's Report, providing an update on capital markets, absolute and relative performance of the portfolio and each asset class, and changes in asset allocation. Mr. McDonough cited a report issued by the Private Equity Growth Capital Council, which ranked the pension fund's private equity portfolio return first among 22 public pension funds over a three-year period, and second over a five-year period. Mr. Bruno noted that members of the Private Equity Growth Capital Council included large private equity firms like Blackstone, with which the Division has an investment relationship, to which Mr. McDonough responded that the returns of pension funds described in the report are based on publicly available statistics.

### **Alternative Investment Notifications**

Pursuant to the Council's Alternative Investment Modification Procedures, Mr. McDonough notified the Council of two hedge fund redemptions, including a partial redemption from Brevan Howard, LP, and a full redemption from Protégé Partners QP Fund and Protégé Partners LP, in order to rebalance the portfolio and to reduce fund to fund exposure within the hedge fund portfolio.

### **Presentation on behalf of NJ Public Employee Union Coalition by Jeff Hooke**

Adam Liebtag asked Eric Richard, Legislative Political Director of the New Jersey AFL-CIO, to provide brief remarks and introduce Jeff Hooke, an investment consultant working with a number of public employee unions on the subject of investing pension funds. Mr. Richard commended the State Investment Council and Division for their transparency and disclosure of fees, and stated that his purpose was to discuss whether the sale of alternative investments and the internal management of the proceeds in traditional assets such as publicly traded stocks and bonds would provide the same or a better level of risk-adjusted investment returns. Mr. Richard noted the acceleration of alternative investments under Governor Christie's administration, and expressed disappointment that neither the Council nor the Division had contracted with an independent contractor to conduct a cost-benefit analysis and forensic audit of the alternative investment program. Mr. Richard stated that the analysis of the alternative investment program done by the Division's consultant Aon Hewitt produced results that were notably different from those produced by the analysis done by the union's consultant, Mr. Hooke. He concluded by stating his opinion that the managers of alternative investment funds are overpaid for their investment performance relative to the Division's internally managed public portfolios and posed the question of whether selling the alternative investments would truly threaten the overall portfolio.

Mr. Byrne acknowledged Mr. Richard's comments regarding the Council's and Division's transparency, and noted that the growth of the alternative investment program is consistent with a long-term plan approved by the administrations of both

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Governor Christie and his Democratic predecessors. He also expressed the Council's desire to be responsive to the concerns of its union representatives, including by inviting Mr. Hooke to speak before the Council at this meeting.

Mr. Richard introduced Mr. Hooke, who stated that he was asked by a coalition of unions to review the pension fund's performance and to review the alternative investment program from a cost-benefit point of view. Mr. Hooke presented an executive summary of his report. He reported that New Jersey performed in line with its peer group over the past 10 years, and that compared to two composite mixes of publicly-traded securities, the New Jersey portfolio, including alternative investments, did indeed outperform the composites, but in his view not significantly. Mr. Hooke stated that the alternative investment portfolio appeared to reduce volatility, but noted that the reduction could be considered statistically insignificant and further suggested that some of this reduced volatility could have resulted from his sense that private equity firms might smooth their quarterly valuations. He further opined that the benefit of reduced volatility in private equity should be weighed against the benefits of liquidity and transparency in the public markets. Mr. Hooke noted that private equity investments appeared less volatile than investments in public equities because they were only valued quarterly, but Mr. Byrne noted that the volatility comparisons used only quarterly data from public equities as well. Mr. Hooke also questioned the proper calibration of the fund's internal benchmarks, based on the fund's outperformance in 8 out of 10 years, which he deemed statistically unlikely. He advocated the use of a public composite benchmark instead. Mr. Byrne remarked that it was possible that the fund's outperformance was not mere coincidence, but rather a reflection of superior investment decisions being made by Division staff. Comparing public asset class performance against their respective public benchmarks, Mr. Hooke noted that the fund did poorly in international equities, outperformed in bonds and performed in line with the benchmark in other asset classes.

Mr. Hooke stated his opinion that the benefits of hedge funds and private equity seemed to have decreased over the most recent ten years, and surmised that such a decrease was likely a result of the increased flow of assets into these asset classes and a resulting "competing away" of returns. Mr. Liebttag asked Mr. Hooke whether his conclusions were based on the asset classes as a whole, or whether they were tailored to New Jersey's portfolio, which is primarily comprised of top quartile funds. Mr. Hooke responded that his conclusions were not based on top quartile funds, which outperform other funds, but cautioned that it is very difficult to select top quartile firms. In response to Mr. Byrne's inquiry about whether he saw any premium for investing in illiquid private holdings, Mr. Hooke responded that he did not see a liquidity premium in private equity, at least over the past five years, because the inflows to private equity have caused any advantages to be "competed away". Mr. Byrne further asked Mr. Hooke if the Council should be assigning value to operational improvements made by private equity firms. Mr. Hooke responded that there are certainly top quartile firms such as Blackstone that have demonstrated an ability to increase a company's profits, and that investments in such firms, including Blackstone, are indeed legitimate. He expressed his view however that only top quartile private equity firms have outperformed the S&P 500 over the last 10 years, and repeated that it is very difficult to identify top quartile firms. Mr. Bruno expressed a concern that the fees being charged appeared to be disproportionately high, to which Mr. Hooke responded that the fees are consistent with those in the marketplace and tend to increase as markets (both public and private) improve. Mr. Bruno asked if the alternative portfolio achieved the goal of decreasing risk. Mr. Hooke responded that, in the case of equity-oriented hedge funds, there is still risk due to the underlying equity holdings of the hedge funds. He repeated his earlier comments that the alternative investments appeared to reduce risk, but not significantly and perhaps artificially.

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Mr. Hooke described his analysis of select buyout funds in the private equity portfolio and concluded that the funds selected by New Jersey were only slightly above average. He opined that one reason for this is that many of the best performing managers revert to the mean in their subsequent funds. Mr. Byrne recognized that past performance is not always indicative of future performance, but noted that the Division does additional quantitative and qualitative analysis as well. Mr. Hooke next summarized the hedge fund portfolio, and concluded that although equity-oriented hedge funds provided some protection against market downturns, it was not a huge difference, and he wondered whether it would be possible to obtain similar results at a lower price using a better mix of stocks and bonds. Similarly, with respect to bond-oriented hedge funds, he concluded that a straight bond portfolio outperformed bond-oriented hedge funds over the past 10 years, and therefore suggested that there may be publicly traded strategies that could provide similar benefits to the hedge funds at a lower price. Mr. Byrne pointed out that given the sharp decline in bond yields in recent years, one would be locking in extremely low yields to maturity by investing more heavily in long-dated bonds and that in turn would only increase the unfunded liability of the funds over time unless stock returns greatly exceeded what most analysts expect.

Mr. Liebttag noted the dissonance between the long term capital market assumption for absolute return and credit-oriented hedge funds, the recent and three-year performance of the asset classes, and the benchmarks for those asset classes. Mr. McDonough commented that the focus should be on actual returns, which for credit-oriented hedge funds was 4.15% over the past three years versus returns of 2.21% and 1.91% for investment grade and high yield bonds, respectively, over the same time period. Mr. Byrne concluded that the overall allocation to fixed income, as well as the allocations within fixed income, are an important part of the asset allocation discussion that the Council will be undertaking. With respect to real estate, Mr. Hooke stated that there appeared to be a benefit from the state's investments in private equity real estate over publicly-traded REITS. Even so, Mr. Hooke suggested that shifting out of alternatives would not appear to have a significant negative effect on the funds' performance and that there might be an upside due to fee savings. However, Mr. Hooke noted that he lacked the software to estimate annualized returns for his proposed asset allocation. He suggested that it would be interesting to have the Division's consultants do so utilizing JP Morgan's capital market assumptions as an alternative to Aon Hewitt's. Mr. Byrne thanked Mr. Hooke for his presentation, and said that Division staff has already evaluated asset mixes as requested by Mr. Liebttag. One conclusion was that the existing New Jersey portfolio outperformed a 70% Global Stocks / 30% Fixed Income mix by approximately \$4 billion over the past five years. Staff will continue to run various scenarios in order to maximize the fund's risk-adjusted returns.

Mr. Richard responded to Mr. Byrne's earlier remarks, stating that he was not questioning whether alternative investments have a place in the fund's portfolio, but expressing concern about the current percentage of the portfolio that is comprised of such investments. He further stated that the Division should attempt to achieve similar investment results in a more cost-effective manner by bringing a larger percentage of investments in-house. Mr. Byrne said that determining the proper allocation to each type of alternative investment is a legitimate question that is part of the annual process. He noted that the Division attempts to minimize costs through aggressively negotiating below-market fees and above-market hurdle rates. Mr. Oram stated that, as a fiduciary, he is willing to pay higher fees in order to receive superior net returns. Mr. Hooke responded that, in some cases, funds receive fees even in the case of inferior relative performance and suggested that the Division negotiate fees that subtract out returns that merely reflect overall growth in the public markets. Mr. Byrne stated that the idea was a creative one, but that the fund at the same time needed to be wary of the adverse selection risk associated with requesting non-market fee arrangements. Mr. Byrne and Mr. Richard agreed to work together with the Division to address certain inaccuracies in Mr. Hooke's report.

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Mr. Liebtag thanked Mr. Richard and Mr. Hooke for addressing the costs and benefits of the portfolio's alternative investment program, and stated that he hoped that the information presented added a different perspective leading to an open discussion on the portfolio's asset allocation over the next couple months. Mr. Haselmann concluded by cautioning that any cost benefit analysis of the alternative investment portfolio should recognize that alternative investments include a wide variety of asset classes, including real assets, real estate, private equity and hundreds of types of hedge funds. He further noted that any cost analysis should distinguish management fees, which should be minimized, from incentive fees with hurdle rates and high water marks, which are beneficial to investors, and that any benefit analysis should place an emphasis on reducing risk, using Sortino ratios and information ratios, and should have as its ultimate goal the maximization of the efficient investment frontier. He strongly cautioned against basing asset allocations on historical analysis, noting that 10-year results may vary dramatically in the future and that any comparison to public markets over this period is unhelpful, given that these returns are based on central bank interventions and growth conditions in China and other emerging countries that are unlikely to recur.

Mr. Hooke acknowledged Mr. Haselmann's comments and responded that the question remained whether it is possible to design a publicly traded composite portfolio that might have similar risk return attributes to the alternative investment portfolio. Mr. Byrne thanked Mr. Hooke for his testimony, and stated that the Council welcomed feedback from many sources so that the Council may best serve the beneficiaries of the pension fund.

### **Fiscal Year 2017 Annual Investment Plan Discussion**

Kristen Doyle of Aon Hewitt referenced Aon Hewitt's presentation regarding alternative investments during January's SIC Meeting, stating that the presentation was intended to provide an objective view of the pros and cons of various types of alternative investments, and the proper role of each of the alternative asset classes in the portfolio. Ms. Doyle described the best practices followed by Aon in determining its proposed asset allocation mix, and the various factors taken into account. Mr. Haselmann commented that the analysis performed by Aon was in fact a form of independent cost-benefit analysis as recommended by Mr. Richard earlier. With respect to independence, Mr. Oram further noted that Aon had been hired relatively recently and had the opportunity to review the prior consultant's recommended asset allocation.

Mr. McDonough referenced a supplemental report prepared by Division staff in response to Mr. Hooke's analysis, and assured the Council that the actions of Division staff were undertaken in their role as fiduciaries and solely in the interest of plan beneficiaries. Mr. McDonough discussed the process for adopting the asset allocation plan, including the solicitation of input from various Council members. Mr. McDonough stressed the fund's need for liquidity due to its expected negative cash flow over the next several years, based on benefit payment and contribution projections. In response to Mr. Liebtag's question about the basis for the Division's contribution projections, Mr. McDonough stated that the information was provided by the Division of Pensions and Benefits, and was based on the Governor's recent budget announcements regarding pension payments through FY2020. Mr. McDonough agreed to provide the projections to Mr. Liebtag, to the extent the numbers were publicly available.

Mr. McDonough provided an analysis of historical drawdowns of various asset classes, discussed the pacing of private equity investments, and reviewed the proposed allocations to commodities, U.S. equity, and emerging and developed non-U.S. equity. Mr. Byrne and Mr. Haselmann commented on the importance of hedge funds in managing downside risk in the portfolio. Mr. Haselmann also emphasized the risk in purchasing fixed income, citing the negative interest rates on sovereign debt and the impact of lower oil prices on various types of corporate debt, and the risk in purchasing foreign

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equity, the value of which may be artificially inflated due to aggressive monetary policies. Mr. McDonough concluded by presenting various proposed asset mixes for Fiscal Year 2017. Mr. Byrne invited each of the Council members to review the proposed allocations and to direct questions or requests to Division staff prior to the investment plan's adoption at the May Council meeting. Marty Barrett reiterated the statutory mandate that the Division invest pension fund assets solely in the interest of the pension plan beneficiaries.

#### **Private Equity Overview**

Michelle Davidson of TorreyCove Capital Partners presented an analysis of the Division's private equity portfolio, describing cash flow, uncalled commitments and asset appreciation. Ms. Davidson also discussed the portfolio's outperformance of the private and public market-equivalent benchmarks, and discussed the quartile rankings of the funds in the portfolio. Matthew Coyne of TorreyCove discussed the resources that would be required to invest directly in private equity, rather than through private equity funds, and discussed the liability concerns that would result from such investment. Mr. Haselmann stated his opinion that it would be practically impossible for the Division to obtain the manpower and resources required to directly invest in private equity. Mr. Bruno pointed out that fewer resources would be required if the allocation to private equity were substantially reduced. Mr. Coyne noted, on the other hand, that private equity in general significantly outperformed public equity over the past 10 years. Mr. Cleary asked whether the same level of resources would be required to directly invest in credit instruments, to which Ms. Davidson stated that would generally be the case, but that it would depend in large part on investment strategy. Mr. Byrne emphasized the specialized expertise required in evaluating credit opportunities.

In response to a question from Mr. Byrne regarding whether the fund receives a premium in return for the reduced liquidity of private equity, Ms. Davidson said that studies have shown that there is an illiquidity premium of approximately 300 basis points. As a final comment, with respect to management fees paid to private equity firms, Ms. Davidson pointed out that, for funds that reach their hurdle rate benchmark, fees are returned to the investor and therefore are effectively zero.

#### **Private Equity Investments**

##### ***Vista Equity Partners Fund VI, L.P.; Vista Foundation Fund III, L.P. ; and Co-Investment Separate Account***

Jason MacDonald of the Division and Ms. Davidson presented investments of \$200 million in Vista Equity Partners Fund VI, \$100 million in Vista Foundation Fund III, L.P., and \$200 million for a related co-investment separate account. Mr. MacDonald noted that the Division had invested in five prior funds across the Vista platform, and has received superior returns from the older funds. Mr. MacDonald described Vista's resources and experience, the funds' strategies, the terms of the investments, and the Division's investment rationale. Chair Byrne reported that the IPC had reviewed the investment and was satisfied that appropriate and adequate due diligence had been performed.

#### **Real Estate Investments**

##### ***Wheelock Street Real Estate Fund V, L.P.***

Kevin Higgins of the Division presented an investment of \$100 million in Wheelock Street Real Estate Fund V, L.P. Mr. Higgins noted the Division's commitment to two prior Wheelock funds and a co-investment vehicle. Mr. Higgins reviewed the prior funds' performance, described the qualifications of the fund's investment professionals, summarized the fund's investment strategy, and described the terms of the investment. Chair Byrne reported that the IPC had reviewed the

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investment and was satisfied that appropriate and adequate due diligence had been performed. *(Mr. Oram had recused himself from discussion of this investment at the IPC meeting.)*

### ***Exeter Core Industrial Club Fund II***

*(Mr. Hanson recused himself from discussion of this investment and departed the meeting at this time.)*

Mr. Higgins presented an investment of \$100 million in Exeter Core Industrial Club Fund II, a real estate fund focusing on bulk distribution and logistics properties. The Division committed \$200 million to a predecessor fund in 2012. Mr. Higgins reported the performance of the prior fund, the qualifications of the investment team and the terms of the investment. Chair Byrne reported that the IPC had reviewed the investment and was satisfied that appropriate and adequate due diligence was performed. *(Mr. Oram had recused himself from discussion of this investment at the IPC meeting.)*

### **Directors Report to the Legislature on the Iran Divestment Statute**

Ms. Sarnowski reported that the Division is required by law to provide an annual update to the Legislature on its implementation of the Iran divestment statute. Ms. Sarnowski reported that no new divestments were required since the last annual report. Ms. Sarnowski noted that in July 2015 certain sanctions were lifted by the U.S. government and other countries causing certain international companies to consider reestablishing business activities in Iran. Ms. Sarnowski stated that the Division expects that the list of prohibited companies will grow as a result.

### **Treasurer's Report**

There was no report from the Office of the Treasurer.

### **Public Comment**

Gregg Sgambati spoke to the Council regarding environmental, social and governance (ESG) metrics.

### **Adjournment**

Mr. Byrne made a motion to adjourn the meeting, with Mr. Oram seconding the motion. All Council Members present voted in favor. The meeting was adjourned at 1:50 p.m.