NORTH CAROLINA

OFFICE OF THE TREASURER

JANET COWELL, TREASURER

June 17, 2013

North Carolina General Assembly
16 West Jones Street
Raleigh, NC 27601-2808

Dear Leaders of the General Assembly:

I am writing to detail some of the risks to the North Carolina Retirement Systems and consequences of not taking action to provide greater investment flexibility. I am referring to Senate Bill 558, which has already passed the Senate by a vote of 48 to one and the House Committee on State Personnel, and is now stalled in the House Committee on Rules, Calendar, and Operations.

My tenure overseeing $80 billion in pension fund investments has been characterized by quickly changing markets and heightened volatility. However, my team of investment experts and I have continued to achieve the 7.25 percent long term target rate of return, keeping the investment earnings as the largest source of income for the fund to pay promised benefits. This was in large part due to outstanding returns in the stock and bond markets over the past few years, and was supplemented by you allowing me to diversify investments via legislation approved in 2009 and 2011.

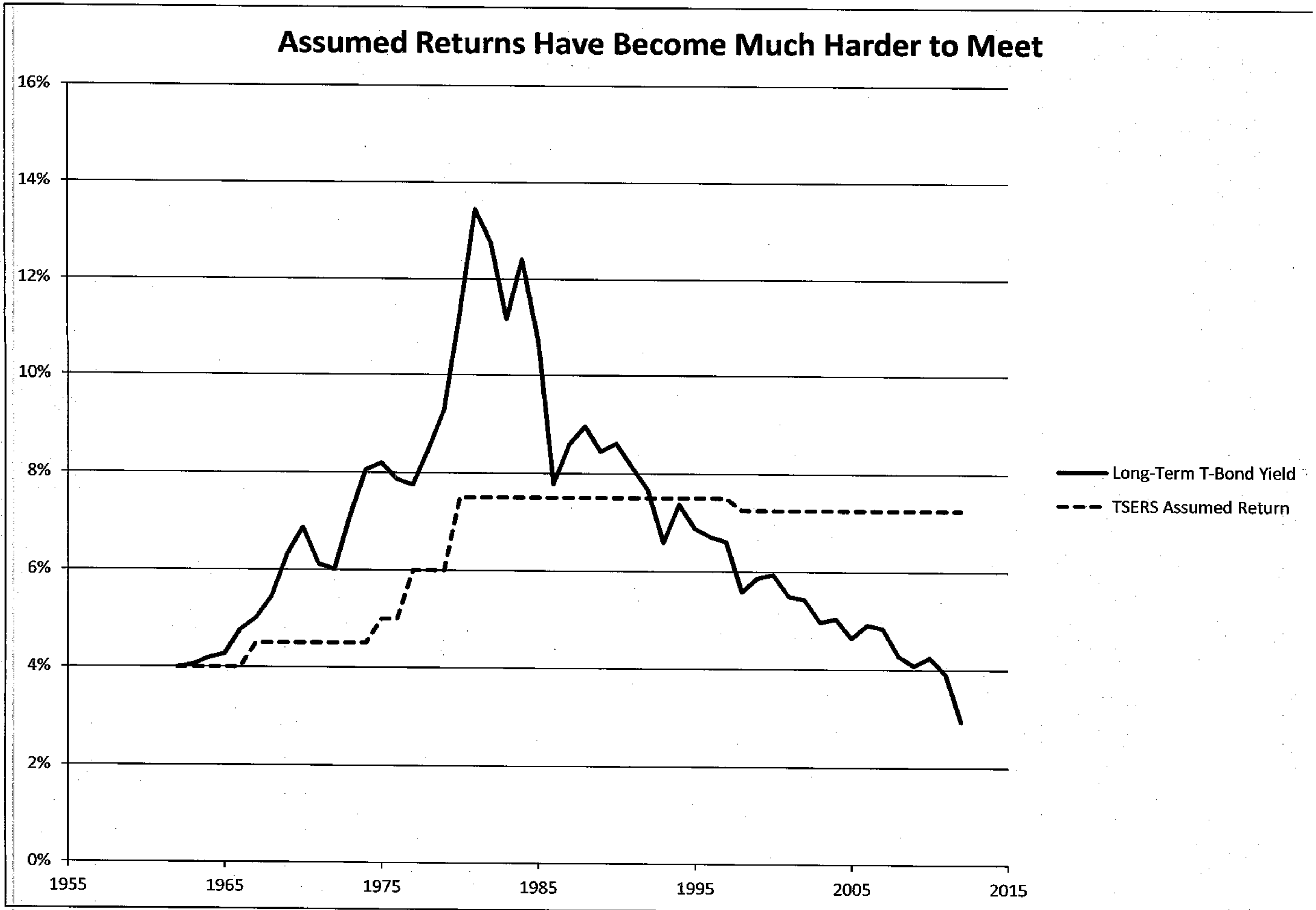
However, global stock markets are nearing all-time highs meaning we will likely not see the same strong returns that we have over the past few years. Furthermore, we may not hit the target rate of return given that our large portfolio of bonds (nearly 35 percent of the total portfolio) is expected to only earn between 2 and 4 percent for the next five years. As a result of this failure to meet the rate of return, taxpayers would have to provide greater support of our pension system. For example, lowering the target return by just 0.25 percent to 7 percent, would result in more than $280 million additional General Fund dollars needed per year to fund the pension system. As legislators, you will have the painful choice of asking taxpayers to pay or not fully funding the pension, which is contrary to our state's history. While achieving greater investment flexibility does not guarantee that we will meet the target rate of return, the current allocation structure almost ensures that we will not.

With expected low bond returns, we need the ability to better diversify the pension system investments over time. North Carolina's allocation to alternatives, such as real estate, private credit, private equity, and infrastructure, is significantly lower than other large pension funds. A Fidelity Investments survey found that 109 public funds identified private market alternatives as the top strategy to address low returns. By allocating broadly across different asset classes, our investment experts can navigate dynamic markets more successfully and take advantage of available opportunities.

Granting this additional investment flexibility is the right thing to do. Not only for the long-term fiscal stability of our pension system and the state, but also for the 875,000 active and retired teachers, police officers, firefighters, and, state and local public employees that are part of our pension system, as well as our taxpayers. With the near unanimous vote in the Senate and House committee, you have demonstrated that you agree with me. I urge you to make sure that Senate Bill 558 does not get lost in the legislative shuffle and is enacted into law this session.

Sincerely,

Janet Cowell



Assumed Returns Have Become Much Harder to Meet
16%
14%
12%
10%
8%
6%
4%
2%
0%
1955
1965
1975
1985
1995
2005
2015
Long-Term T-Bond Yield
TSERS Assumed Return

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Senate Bill 558
Treasurer's Investments

Sponsor: Senator Hise

Relevant Statutes:
G.S. 147-69.2; G.S. 147-69.7

Goal

With this legislation, the Department of State Treasurer seeks limited additional flexibility in allocating assets in the State's investment portfolio. The Department is seeking this flexibility for the following reasons:

1. The portfolio currently has a higher than desirable allocation to publicly traded stocks which is a problem given the danger of large equity market declines.
2. Expected high interest rate environments mean that the North Carolina Retirement System's traditional reliance upon fixed income assets (bonds) will result in serious underperformance of the overall portfolio, making the target rate of return of 7.25% difficult to achieve. NC has a much higher allocation to fixed income assets than its peers.
3. Access to attractive risk-adjusted investment opportunities can change substantially and quickly over time according to capital availability, pricing of risk capital, global economic growth sectors, regulations, etc. – particularly across different non-public market asset classes, strategies, and vehicles.
4. A thoughtful, prudent and methodical program to build non-public asset class allocations can take a significant period of time. In the intervening periods the NCRS should have the ability to allocate broadly across different alternatives without the impediments of sub-sector allocation limits.

Brief summary of suggested changes:

I. Changes to Asset Allocation

§ 147-69.2(b)(10). In the proposed bill, new subdivision (b)(10) establishes a 40% aggregate limit for all the five "alternative" investment asset classes, replacing the existing asset limits shown below.

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	Current Statute	Proposal
Credit Strategies Portfolio – (b)(6c)	5%	40% combined
Real Estate Portfolio – (b)(7)	10%	
Hedge funds or other nonpublic investment vehicles trading primarily in public equity securities – (b)(8)(b.)	6.5%	
Alternatives Portfolio – (b)(9)	7.5%	
Inflation Protection Portfolio – (b)(9a)	5%	
Total	**34%**	**40%**

As shown above, the proposal also raises the combined limit for these classes by six percent.

II. Technical Corrections

§ 147-69.2(b), introductory paragraph. Additional language was added to further clarify that changes subsequent to the Treasurer's investment or contractual commitment to make an investment with respect to market values, ratings and other investment qualifications do not affect the statutory authorization of such investment nor force any disposition of such investment. Other language was added to clarify the date of the data that should be used when calculating the percentage limitations in the statute.

§ 147-69.2(b)(6c) The Credit Strategies Portfolio investment authority, which currently allows investment in "obligations and other debt securities," was revised to clarify that asset-backed securities are permitted investments whether considered debt or equity.

§ 147-69.2(b)(7) The Real Estate investment authority was revised to allow contractual arrangements with investment managers. This form of investment management is available in other portfolios within the statute. Also, this authority was revised to clarify that asset-backed securities are not considered "related debt financing." Such securities are included in subdivision (b)(6) or (b)(6c).

§ 147-69.2(b)(8) The second paragraph of this subdivision currently allows the Treasurer to invest directly in equity securities to approximate the movement of a published benchmark index. The statute currently does not specify a parameter for how closely the Treasurer should attempt to approximate a benchmark. We propose adding the language "within 0.50% per annum" to set this parameter.

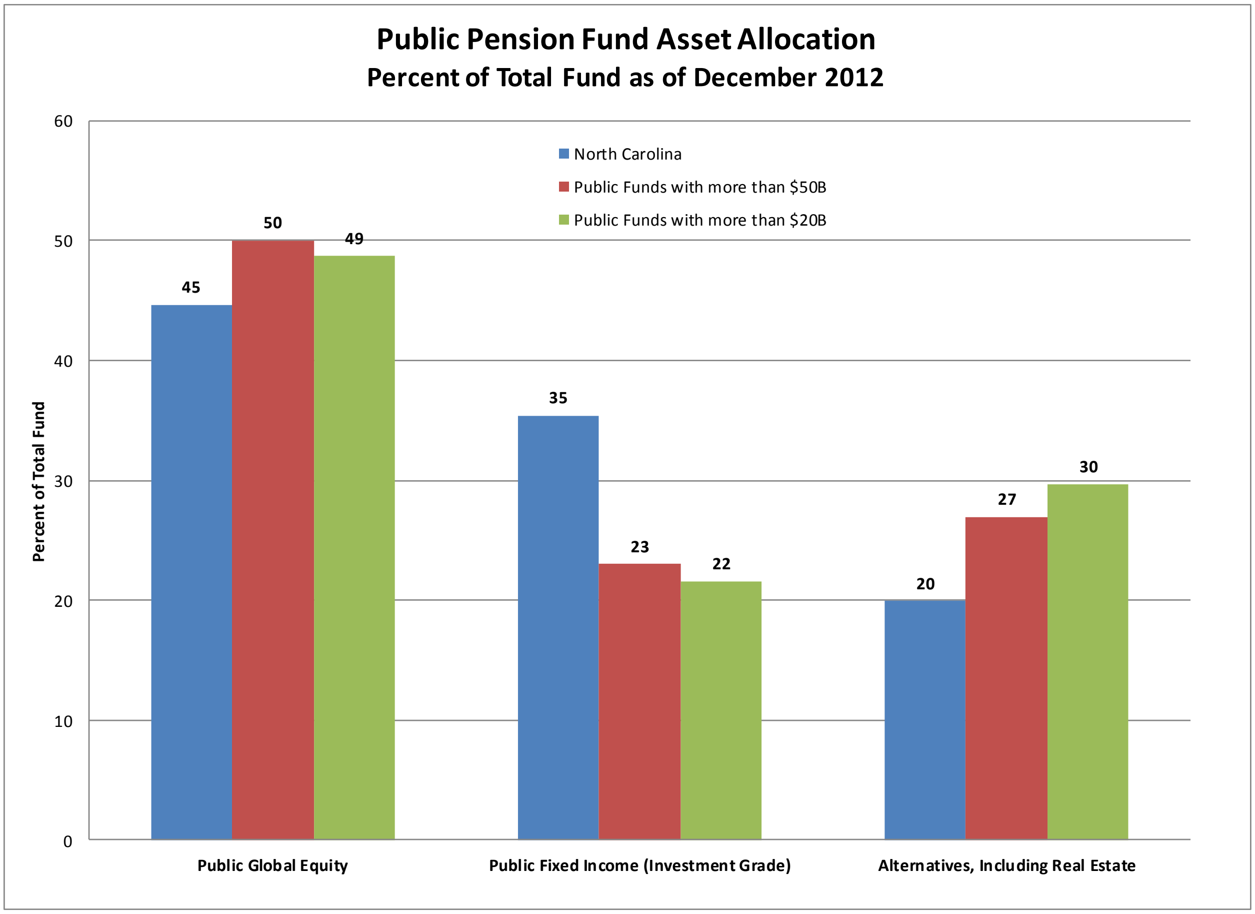
The existing statute specifies that should the Treasurer invest directly in equity securities under this subdivision, no more than 1.5% of such directly invested funds can be invested in the stock of a single corporation. Standard benchmarks may on occasion, however, be more weighted than 1.5% towards a stock of a single corporation. For instance, as of January 9, 2013, Apple Inc. constituted 3.7% of the S&P 500 index. Therefore, we propose deleting the 1.5% percentage limitation in this paragraph.

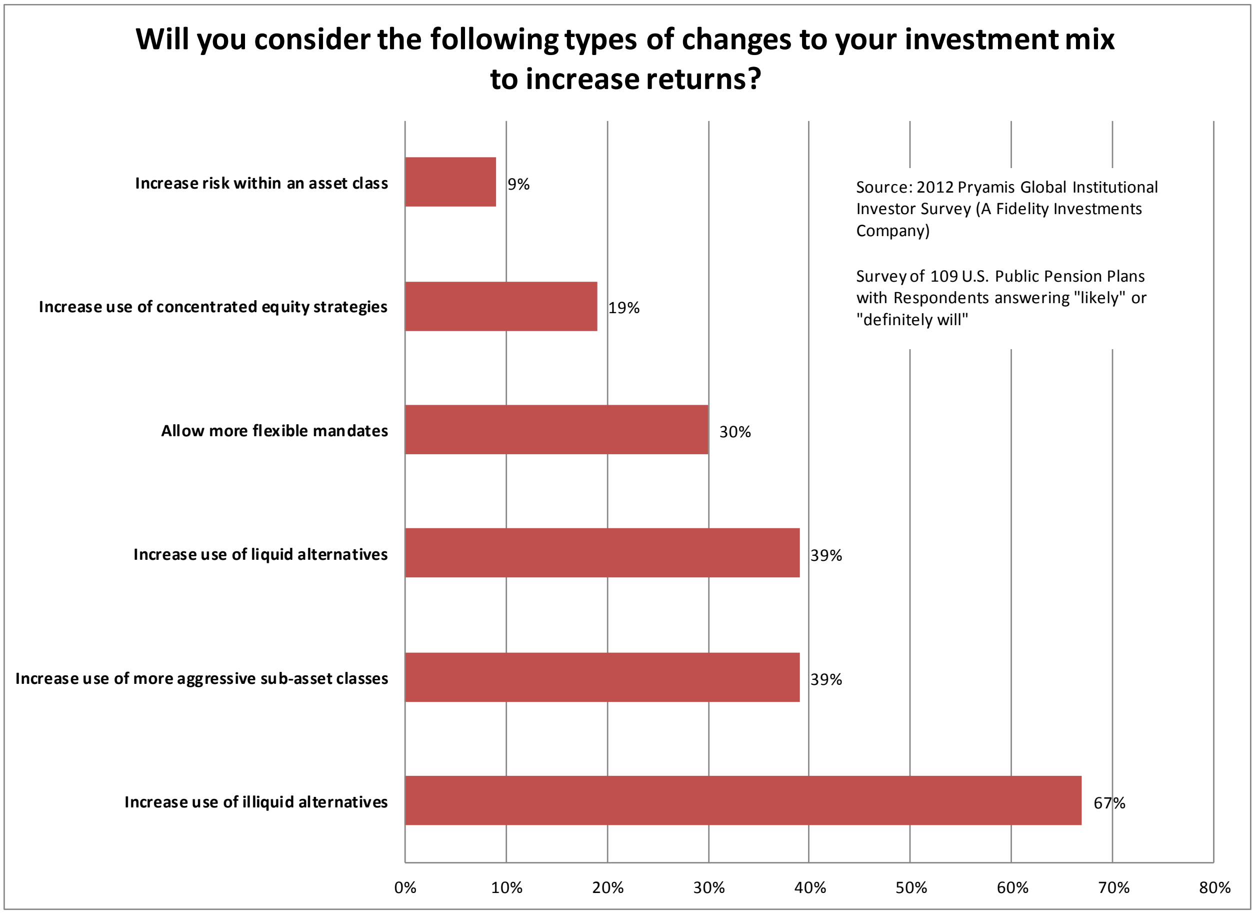
Sub-subdivision a. has been modified to clarify that all permitted investment vehicles are subject to the qualification that the vehicle must "invest primarily in investments authorized by this subdivision."

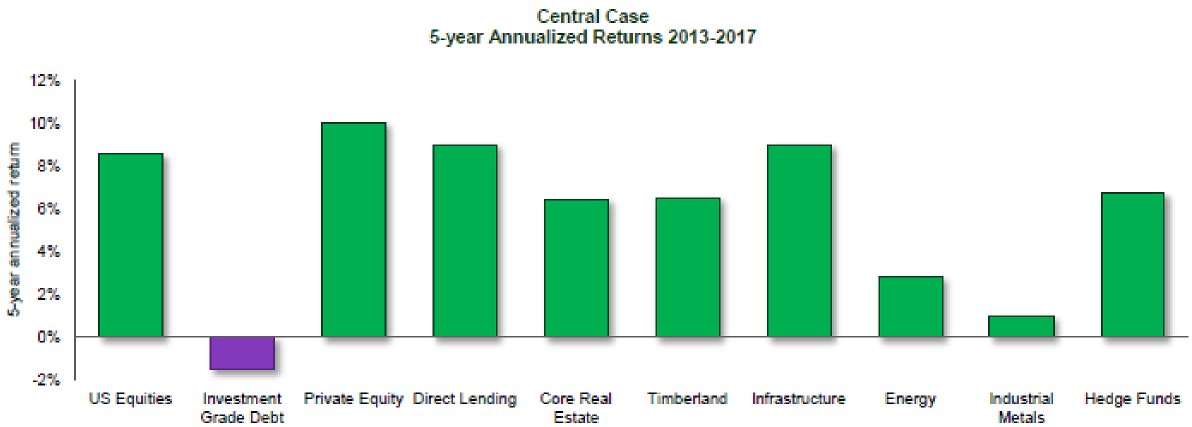
§ 147-69.2(b)(9a) This correction clarifies that in the statute, the text "primary purpose" refers to the Treasurer's purpose in making the investment in the vehicle, not any outside manager's purpose in making investments in assets on behalf of the vehicle.

§ 147-69.2(b)(12) At the time the Treasurer was given authority to form the Credit Strategies and Inflation Protection Portfolios for the Retirement Systems, this parallel subdivision governing Escheat Fund alternative investments was not updated. This proposed change would correct the subdivision to include the credit and inflation investments authorized by subdivisions (b)(6c) and (b)(9a). Twenty percent of the Escheat Fund may be placed in alternative investments under this subdivision.

§ 147-69.7(a), introductory paragraph. When the definition of "Retirement Systems" in G.S. § 147-69.2(b)(8) was updated to include the Retiree Health Benefit Fund, this parallel definition of the same term in G.S. § 147-69.7 was not updated. We propose creating a cross-reference to correct this omission and avoid future omissions.


Public Pension Fund Asset Allocation
Percent of Total Fund as of December 2012
North Carolina
Public Funds with more than $50B
Public Funds with more than $20B
Percent of Total Fund
60
50
40
30
20
10
0
45
50
49
35
23
22
20
27
30
Public Global Equity
Public Fixed Income (Investment Grade)
Alternatives, Including Real Estate


Will you consider the following types of changes to your investment mix to increase returns?
Increase risk within an asset class
9%
Increase use of concentrated equity strategies
19%
Allow more flexible mandates
30%
Increase use of liquid alternatives
39%
Increase use of more aggressive sub-asset classes
39%
Increase use of illiquid alternatives
67%
0%
10%
20%
30%
40%
50%
60%
70%
80%
Source: 2012 Pryamis Global Institutional Investor Survey (A Fidelity Investments Company)
Survey of 109 U.S. Public Pension Plans with Respondents answering "likely" or "definitely will"



Source: Albourne Partners, 2013