SC House Executive Subcommittee of the Legislative Oversight Committee

Michael Hitchcock, Chief Executive Officer
Geoff Berg, Acting Chief Investment Officer
July 12, 2016
Investment Background

• Although the Retirement Systems Investment Portfolio existed since 1945, the assets of the Retirement System were historically invested in domestic fixed income investments only until 1997.
• The Investment Panel was created in the late 90’s to advise the Budget and Control Board on the domestic equity portfolio, which was limited to 40%.
• Effective October 1, 2005, the State Retirement System Preservation and Investment Reform Act established the Investment Commission.
History up to Commission

- 1997: Amendment allowing SC Retirement Systems to invest in equities
- 1999: Retirement Systems begins investing in equities
- 2005: Act 153 creates Investment Commission – allows up to 70% of plan to be put in equities
- 2007: Constitutional amendment ratified allowing RSIC to invest across all asset classes
- 2009: Transition from fixed income is complete
Purpose & Duties

- The assets of the five defined-benefit plans are held collectively in a group trust referred to as the “South Carolina Retirement Systems Group Trust” or “Systems”.

- RSIC is responsible for investing and managing assets held in trust for the five systems.

- As of March 2016, Systems totaled approximately $27.7 billion in assets.
Who Do We Work For?

OVER 500,000
Plan Participants and Beneficiaries

*About 1 in every 9 South Carolinians*
Why do We Exist?

We exist to help provide a secure future for our beneficiaries.

“Beneficiaries First: Their Future. Our Mission.”
The Commission

The RSIC is a seven member commission:

- **Rebecca Gunnaugsson, PhD**, Chair (Appointed by: Comptroller General Richard Eckstrom)
- **Ron Wilder, PhD**, Vice Chair (Retiree Representative to the Commission)
- **Reynolds Williams, J.D., CFP** (Appointed by: Senate Finance Committee Chairman, Hugh Leatherman)
- **Peggy Boykin, CPA** (Ex-Officio as PEBA Executive Director)
- **Allen R. Gillespie, CFA** (Appointed by: Ways and Means Committee Chairman Brian White)
- **Edward N. Giobbe, MBA** (Appointed by: Governor Nikki Haley)
- **Curtis M. Loftis, Jr.** (State Treasurer)
RSIC Staff Qualifications

RSIC staff and Commission includes:

- Seven Juris Doctors
- Three Certified Public Accountants
- Nine Chartered Financial Analysts
- Nineteen Masters Degrees
- Three PhDs
- Five Chartered Alternative Investment Analysts
- Three Claritas Investment Certification

Chartered Financial Analyst (CFA) is a professional credential that measures the competence and integrity of financial analysts.

- Required to pass 3 exams.
- A minimum of 4 years of investment/financial experience and a bachelor’s degree.
- One of the most respected designations in finance and considered the gold standard in the field of investment analysis.
RSIC Organizational Chart
Aon Hewitt Background – Consultant

• Aon is RSIC’s investment consulting firm.
• Aon is a fiduciary.
• Aon has $4.3 trillion in assets under advisement worldwide.
• Aon has over thirty years of experience working with public funds.
What Can We Invest In?

Includes, but not limited to, the following:

(1) bonds of this State, other states of the United States, the United States, or any political subdivisions or agencies thereof;
(2) banks and savings and loan institutions;
(3) top-rated commercial paper;
(4) funds of funds;
(5) foreign certificates of deposit;
(6) short-term debt;
(7) investment trust securities;
(8) real estate securities;
(9) foreign fixed-income obligations;
(10) futures and options regulated by the United States Securities and Exchange Commission;
(11) private equity;
(12) domestic and foreign group trusts;
(13) investment vehicles of Federal Deposit Insurance Corporation approved institutions;
(14) bonds of foreign countries designated industrialized by the International Monetary Fund;
(15) collateralized mortgage obligations;
(16) World Bank bonds;
(17) debt of the United States or Canadian corporations;
(18) equipment trust debt;
(19)(a) purchase money mortgages received for real estate;
   (b) real property;
   (c) exchange traded funds;
   (d) American Depository Receipts;
(20) real estate investment trusts; and
(21) investments allowed pursuant to Section 11-9-660 and equity investments as allowed pursuant to Section 16, Article X of the Constitution of this State.
The Commission must determine asset allocation – the biggest driver of return, risk, and complexity.

Aon conducts an Asset Liability Modeling Study at least every 5 years. Annually, Aon recommends asset allocation that best balances risk and return.

The Commission reviews and discusses recommended asset allocation and has the opportunity to present alternative Asset Allocation Strategies.

Vote goes to the Commission.

RSIC Staff and Aon recommend individual managers to fulfill asset allocation mandates.

Commission votes to hire individual managers.
## Asset Allocation

<table>
<thead>
<tr>
<th>Asset Type</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity</td>
<td>47%</td>
</tr>
<tr>
<td>Conservative Fixed Income</td>
<td>12%</td>
</tr>
<tr>
<td>Diversified Credit</td>
<td>18%</td>
</tr>
<tr>
<td>Opportunistic</td>
<td>12%</td>
</tr>
<tr>
<td>Real Assets</td>
<td>11%</td>
</tr>
</tbody>
</table>
Section 9-16-335 Assumed Rate of Return

Effective July 1, 2012, the assumed annual rate of return on retirement system investments is:

7.5%
Understanding Securities Lending
Securities Lending

SCRS Trust Funds (RSIC)

<table>
<thead>
<tr>
<th>Interest Earned On Cash Collateral</th>
</tr>
</thead>
</table>

Lending Agent (BNY Mellon)

<table>
<thead>
<tr>
<th>Securities Loaned</th>
</tr>
</thead>
</table>

Collateral Reinvestment Pool

<table>
<thead>
<tr>
<th>Cash Collateral</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Rebate Paid To/From Borrower</th>
</tr>
</thead>
</table>

Borrowers (Broker/ Dealers)

15
The Lending Transaction

SCRS Trust Funds (RSIC) → Lending Agent → Securities Loaned → Borrowers (Broker/Dealers)

Cash Collateral
Collateral Reinvestment Transaction

- SCRS Trust Funds (RSIC)
- Lending Agent (BNY Mellon)
- Interest Earned On Cash Collateral
- Collateral Reinvestment Pool
Collateral Reinvestment Transaction

- SCRS Trust Funds (RSIC)
- Interest Earned On Cash Collateral
- Lending Agent (BNY Mellon)
- Collateral Reinvestment Pool
- Rebate Paid To/From Borrower
- Borrowers (Broker/Dealers)
## Securities Lending Risks

<table>
<thead>
<tr>
<th>Risk</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Borrower Risk</strong></td>
<td>Borrower becomes insolvent and is unable to return securities to the lender</td>
</tr>
<tr>
<td><strong>Collateral Risk</strong></td>
<td>Value of collateral falls below the replacement cost of the lent securities</td>
</tr>
<tr>
<td><strong>Intraday Settlement Risk</strong></td>
<td>Securities being lent are delivered to the borrower before collateral is received</td>
</tr>
<tr>
<td><strong>Operational Risk</strong></td>
<td>Late recall of securities, failure to claim dividends, etc.</td>
</tr>
<tr>
<td><strong>Legal Risk</strong></td>
<td>Lender's legal agreement does not provide full protection against borrower default or for Cash Collateral Risk</td>
</tr>
<tr>
<td><strong>Cash Collateral Risk</strong></td>
<td>Lender suffers loss on the re-investment of the cash collateral</td>
</tr>
</tbody>
</table>

*Source: International Securities Lending Association (www.isla.co.uk)*
Key Events

• Lending Agent invested in Lehman Brothers and asset-backed securities (backed by mortgages), resulting in losses
  • FYE 2009 CAFR showed losses of $223 million (unrealized)
  • Actual realized losses totaled $165 million (September 2012)
• RSIC funded $75 million loss in order to remove the asset-backed securities from the collateral reinvestment pool (“CRP”)
• The STO filed suit against the Lending Agent (2011)
• The STO settlement included a cash payment of $20 million for the Trust fund (May 2013)
Removal of ABS Securities From CRP

• Asset-backed securities removed from the pool
  – RSIC hired external firm to manage these distressed securities
  – Removing securities from the CRP required funding the losses attributed to these securities ($75 million)
  – As of 2013 analysis, outcome had improved $28 million vs. taking no action
Conclusion

Questions?
Beneficiaries First: Their Future, Our Mission.