

**TOBACCO SETTLEMENT PERMANENT TRUST ACCOUNT INVESTMENT  
ADVISORY COMMITTEE  
Wednesday, March 21, 2014  
Minutes**

The Tobacco Settlement Permanent Trust Account Investment Advisory Committee (the “**Committee**”) met on Friday, March 21, 2014 at 10:00 a.m. in Room 320, Rusk State Office Building, 208 E. 10<sup>th</sup> Street, Austin, Texas.

**Committee Members Present**

Stuart Ford, Chairman; Judge David Silva; Roy Browning; Commissioner Neil Fritsch; Judge Wayne Gent; Fred Greene; Noe Hinojosa; and Chuck Norris.

**Committee Members Absent**

Judge Mike Brown; Judge Dan Gattis; and Peggy Deming.

**Texas Treasury Safekeeping Trust Company (“Trust Company”) Staff Members Present**

Paul Ballard, Chief Executive Officer and Chief Investment Officer; Danny Sachnowitz, Deputy Chief Investment Officer; Frank Zahn, Chief Financial Officer; Marianne S. Dwight, General Counsel; John Wright, Deputy General Counsel; Michael Leifeste, Real Estate Portfolio Manager; J Germenis, Public Markets Manager; Victor Scott, Director of Financial Reporting; Michael Anderson, Compliance Officer; Gena Minjares, Director of General Ledger Accounting; Nora Arredondo, Special Projects Coordinator; and Corrine Hall, CAPCO Administrator; .

**Additional Participants Present**

Mike O’Brien, Padgett, Stratemann & Co.; Tom Janisch, Asset Consulting Group (“ACG”); and Pam Sliman, State Street.

**Call to Order**

Chairman Stuart Ford declared that a quorum was present and called the meeting to order at 10:05 a.m.

**Approval of Minutes (Tab 1)**

*A motion was made by Mr. Chuck Norris to approve the October 25, 2013 meeting minutes. The motion was seconded by Mr. Fred Greene and unanimously approved.*

**Presentation of Annual Audit (Handout)**

Mr. Mike O’Brien reported that Padgett, Stratemann & Co. issued an unqualified audit opinion with respect to the Tobacco Settlement Permanent Trust Account (“Account”) for the year ending December 31, 2013. He reported that net assets held in trust were approximately \$2.29 billion as of December 31, 2013 versus \$2.13 billion in 2012. There was an approximate 16% increase over a three year period in the net value. The Distribution Stabilization Account (“DSA”) balance as of December 31, 2012 was approximately \$26.13 million. If the Committee votes to use a portion of the DSA for distribution then the balance for 2013 in the DSA will be adjusted accordingly. Mr. O’Brien affirmed that the account had been managed in

compliance with the Investment Policy and the Distribution Policy. No audit adjustments were recorded during the audit engagement, nor was a management letter issued.

Mr. O'Brien reviewed the distribution calculation process as described in the distribution attestation report. He explained that the audit attests to the calculation process not the decided distribution amount since it has yet to be determined.

### **Capital Markets Outlook and Discussion (Tab 2)**

Mr. Tom Janisch of ACG reported that in January, members of the Trust Company met with ACG in St. Louis, Missouri, as they do annually, to review the portfolio's construction and current positioning, investment themes, targets and in general, the portfolio's objective. He explained that the portfolio is a risk-managed portfolio, it is globally diversified and it is positioned to exceed the 8% return hurdle over a long term investment horizon. He presented an economic snapshot for 2013 which showed negative returns across the bond and commodities markets. Equity markets were positive in the U.S. and developed markets, but not in emerging markets. He explained that emerging markets and commodities are highly correlated with each other because many commodities are produced in emerging markets. Mr. Janisch explained that market volatility had increased in 2014. Globally, he reported, there was tension between the West and Russia; Chinese exports were down 18% in February; and Japanese economic growth had stalled and, for the first time in seventeen years, they will have a significant sales tax increase. Initially, in the U.S., economic data was impacted by the severe winter but ACG expects a second quarter rebound. Mr. Janisch reported that Federal Reserve Chair Janet Yellen had her first Fed meeting and essentially indicated no rate increase until the middle of 2015 or longer if the inflation stays below 2%.

Mr. Janisch reviewed the Capital Markets presentation behind Tab 2. He reported that currently the U.S. small cap equity market was up 3%, small cap growth was up 4% but emerging markets were down -4.9%. Because of such a divergence between countries, ACG and the Trust Company believe active management of emerging markets equities is appropriate. ACG continues to be bullish on emerging markets and believes they present the largest opportunity for growth. Mr. Janisch reviewed the performance of various market sectors and stated that the healthcare sector was the biggest driver of performance. He stated that the Trust Company and ACG were actively seeking another healthcare long/short equity manager to replace HealthCor.

Mr. Janisch reviewed a new summary chart that was added to the asset class relative rankings section. He summarized the asset class relative rankings as of the first quarter of 2014 and reported that there were no changes to the tactical outlook for the quarter.

### **Presentation and Discussion of Investment Performance for the Period Ending 12/31/13 (Tab 4)**

Ms. Pam Sliman of State Street reviewed the investment performance of the endowment funds for the period ending December 31, 2013. The portfolio return was approximately 3.37% for the quarter, which was slightly behind the benchmark of 3.38%; however, longer term results demonstrated that the portfolio had outperformed its benchmark. From inception to date, the portfolio's return is approximately 5.72%, outperforming its benchmark by approximately 31 basis points. Ms. Sliman reviewed each asset class. The portfolio realized a lower level of volatility than its peers. Preliminary numbers for the portfolio's performance through February were estimated at 1.6% which outperformed the benchmark by 20 basis points.

### **Endowment Portfolio Update and Related Matters (Tab 3)**

Mr. Paul Ballard presented an overview of the endowment portfolio and reported that it was in compliance with the investment policy. As of December 31, 2013 the portfolio value was approximately \$2.67 billion.

He reviewed the asset allocation evolution graph and explained that the portfolio was in alignment with its asset allocation targets. He compared the actual vs. the target allocations for the 4<sup>th</sup> quarter of 2013 for the various asset classes. Mr. Ballard explained the cautious economic outlook the Trust Company had in relation to the portfolio positioning. He reviewed the portfolio characteristics and stated that the portfolio was very liquid, is positioned opportunistically and is extremely diversified. Its objective is consistency of performance with downside protection. Mr. Sachnowitz and Mr. Ballard explained the various strategies within each asset class and the types of managers within each asset class. They reviewed the performance of the investment managers and discussed the managers that have been added or redeemed from the portfolio. Mr. Ballard explained that the Value at Risk (VaR) for the portfolio was 3.4% and in line with expectations. In conclusion, Mr. Ballard reported that the portfolio was performing in line with expectations, given the current economic conditions.

### **Discussion and Approval of Annual Trust Distribution (Tab 5)**

Mr. Stuart Ford led the discussion by stating that the Trust value was greater than calculated corpus for the first time since 2007. He reviewed the distributions since 2008 noting that the DSA balance had been drawn down significantly since 2009 and stated that the Committee's intent was to rebuild the DSA. Mr. Ford asked the Committee to review three options for the 2014 distribution that are being considered. Option 1 would allow a maximum distribution of \$79 million. This option would represent the maximum allowable distribution and take current 2013 earnings of \$49.5 million, plus positive net earnings of \$16.4 million and deplete the DSA by 50% (\$13.1 million). Option 2 would allow the Committee to match the 2013 distribution of approximately \$50 million and add \$16 million to the DSA. Option 3 would be to distribute less than either option 1 or 2. When determining the distribution amount, Mr. Ballard reminded the Committee that the investment objective is to provide a predictable, stable stream of distributions, ensure that the inflation adjusted value of the distributions are maintained over the long term, and also ensure that the inflation adjusted value of the corpus (after distributions and fund expenses) is maintained over the long run. The Committee discussed the options and suggested the distribution should match the 2013 distribution of approximately \$50 million (Option 2). Chairman Stuart Ford was asked to send a cautionary letter to the trust beneficiaries explaining the circumstances and advising them of the Committee's intent to maintain stable distributions in the future given the economic uncertainty, and focus on rebuilding the DSA.

*A motion was made by Chuck Norris to distribute approximately \$50 million to the beneficiaries of the Tobacco Settlement Permanent Trust Account and to contribute approximately \$15,905,911 to the DSA. The motion was seconded by Judge Wayne Gent and unanimously approved by the Committee.*

### **Discussion of Next Meeting and Agenda Items**

Committee members will be contacted to determine the best date for the next meeting in October 2014.

### **Public Comment**

None.

### **Adjourn**

*Chairman Stuart Ford adjourned the meeting at 12:06pm.*