

3Q2019 IAC Meeting Materials

IAC Meeting – November 18, 2019

Revised Tab E Handout

**Proposed Statutory Amendments
to Investment Authority**

DATE: November 12, 2019

TO: Members, Investment Advisory Council

FROM: SBI Staff

SUBJECT: Proposed Statutory Amendments to Investment Authority

Staff is recommending that the Investment Advisory Council (IAC) endorse a legislative amendment which would authorize investments in co-investments and separate accounts through the SBI's Private Markets program, bank loans through the SBI's Public Markets program, and exempts liquid alternatives from the 35% market capitalization restriction.

Co-investments and Separate Accounts

Each quarter, the Private Markets team considers numerous investment opportunities for the State Board of Investment. Most of this deal flow represents the traditional commingled limited partnership fund structures. Over the past decade, large institutional investors have negotiated new investment arrangements in the form of co-investments and separate accounts with more favorable economic terms. In most cases, these situations represent investment opportunities similar to traditional fund structures but with lower fees and lower carried interest. The main difference between traditional structures and co-investments/separate accounts is that the latter may be customized by the general partner for larger limited partners such as the SBI. Investing in co-investments or separate accounts will result in significant investment savings versus being limited to investing in the traditional fund structures only.

Staff is recommending proposed legislation which permits investments in separate accounts and co-investment opportunities and exempts these investments from certain restrictions. These investments can benefit the portfolio in the following ways:

- (i) Provide access to the same type of underlying investments as a commingled vehicle, but at lower cost;
- (ii) Generate attractive risk-adjusted returns through investments that cannot easily be made via a commingled vehicle; and
- (iii) Allow for the SBI to impose investment restrictions and/or guidelines that protect the interests of the plan, or allow for the SBI to construct a unique portfolio specific to the SBI's needs.

For instance, a General Partner may be unwilling to grant significant fee concessions on a commitment to a main commingled fund, but may instead be willing to manage a separate pool of

capital for the SBI alongside the SBI's commitment to the main fund on a lower-fee or no-fee basis, and without carried interest. In this hypothetical example, by committing \$70 million to the main fund and \$30 million to the separate pool, rather than \$100 million to the comingled fund, the SBI would substantially lower both the management fees charged on the total amount of capital, as well as the carried interest shared with the General Partner. Depending on the structure of the separate pool, the SBI may be the only limited partner in the fund or may participate in a co-investment opportunity with one or more additional limited partners.

If these investment opportunities are prudent and provide economic benefits that would accrue to plan participants, it is within the Executive Director's fiduciary duty to consider them. Currently, however, Minn. Stat. § 11A.24, subd. 6(b) forecloses the ability to participate in separate accounts and most co-investment opportunities because the SBI would hold up to a 100% interest in the investment vehicle and the vehicle may not have four other participants. To address this issue, the proposed amendment exempts these investments from the requirements that the SBI's participation in the investment vehicle be limited to 20% and that the investment have four unrelated owners. Importantly, the amendment preserves the requirement that the SBI participate in investment vehicles that have limited liability, which would limit the SBI's co-investment opportunities to indirect ownership through appropriate investment vehicles. Finally, any investments in separate accounts or co-investment opportunities would count against the 35% portfolio limitation for alternative investments.

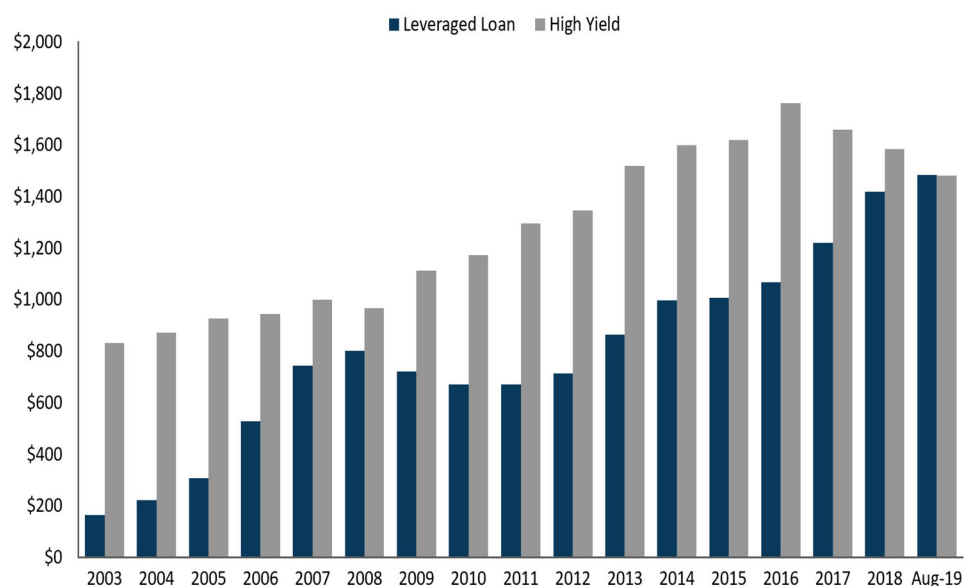
Bank Loans

Staff is seeking the authority to invest in bank loans to further diversify the SBI's portfolio by allowing investment in companies and structures that cannot be accessed in either the high yield or investment grade corporate market. Because bank loans (also referred to as leveraged loans) are not considered securities, the SBI does not currently have statutory authority to invest the asset class. With additional authority the SBI could invest in bank loans via both the primary and secondary market.

Bank loans are a unique asset class with both offensive and defensive characteristics. Staff believes that an allocation to bank loans – either on a stand-alone basis or as part of a fixed income asset allocation product such as Multi-asset Credit or Core Plus – would provide an opportunity for enhanced yields and broader diversification within the SBI's fixed income investment program.

The bank loan market has grown steadily since the mid-1990s, and outstanding loans now exceed \$1.4 trillion, making the bank loan market as large as the high yield bond market (see Figure 1).

Figure 1. Bank loan vs. high yield market size, \$ billions: 1999-2019



Note: As of 08/2019. Includes US and European High Yield Bonds and Leveraged Loans
Source: JPM

Bank loans are loans provided by lenders to companies in order to support mergers and acquisitions, recapitalization of the balance sheet, and other activities within the company. Bank loans are typically the senior-most debt in a company’s capital structure and in most cases are secured by collateral and have covenants which require the borrower to maintain certain financial metrics.

The term to maturity for a bank loan will vary by borrower but is usually five to seven years. Bank loans typically pay a floating rate coupon based on short-term reference rate, such as 3-month LIBOR, plus a spread. The spread on a particular bank loan will vary based on credit quality of the company and conditions in the market at the time of issuance. Bank loans are typically repayable at par at any time by the borrower without penalty.

While the typical borrower has a leveraged capital structure and tends to be smaller in size than an average investment grade issuer, bank loans’ senior placement in the capital structure, collateral security and (commonly) covenants can make loans attractive compared to high yield bonds, which are largely unsecured. In addition, the floating rate nature of bank loans reduces interest rate risk and can provide inflation protection.

As bank investment products, the bank loan market is overseen by banking regulators, including the Office of the Comptroller of the Currency (OCC), the FDIC and the Federal Reserve. New issue bank loans are marketed via an offering memorandum (versus a prospectus for SEC-registered securities) and may be offered only to institutional investors. There is a robust secondary market for trading bank loans between institutional investors, with investors usually trading through dealer desks at the large underwriting banks.

Liquid Alternatives

SBI staff and the IAC have discussed options for further diversifying the Combined Funds portfolio beyond public equities, fixed income, and private markets. Specifically, we have discussed the potential use of liquid alternative strategies. These assets can include more common assets such as real estate investment trusts (REITs) or master limited partnerships (MLPs). However, many investors like the SBI are focusing more complex strategies in this area.

These strategies can be benchmark unconstrained, aim to generate an absolute return and have the ability to take both long and short positions. These investments provide access to unique strategies which may utilize non-traditional asset classes such as commodities, currencies, or options/derivatives. Additionally, they may implement traditional “alternative” investment strategies such as equity long-short, market-neutral relative value, trend-following or value, momentum, carry, or quality strategies. Similar to investments in private markets, liquid alternatives may be structured as limited liability companies, limited partnerships, or separate accounts. Importantly, however, the strategies will typically invest in marketable securities and other liquid instruments.

While Minn. Stat. §11A.24, subd. 6(a) currently authorizes investments in these types of vehicles, staff believe it is appropriate to provide a separate authorization for liquid alternatives because, unlike private market investments, they invest in marketable securities and provide for periodic liquidity. The proposed amendment contains a separate authorization for liquid alternatives and exempts these investments from the 35% statutory market capitalization restriction. The exemption is appropriate because the concentration limit protects the portfolio from illiquidity, a concern mitigated with respect to liquid alternatives due to their periodic liquidity features.

Attachment A includes sample language for a proposed amendment to Minn. Stat. § 11A.24, subd. 6(a) and (b).

RECOMMENDATION:

Staff is requesting that the Investment Advisory Council concur with Staff’s recommendation to pursue proposed legislation permitting Private Market investments in separate accounts and co-investment opportunities, while exempting these investments from restrictions which currently prohibit separate accounts and co-investment; permitting investments in bank loans; exempting liquid alternatives from the statutory 35% market capitalization restriction currently applicable to investments in the Private Markets portfolio; and any corresponding administrative or conforming changes consistent with the foregoing.

ATTACHMENT A
SAMPLE AMENDMENT

Minn. Stat. § 11A.24, subd. 6(a) and (b)

(a) In addition to the investments authorized in subdivisions 1 to 5, and subject to the provisions in paragraph (b), the state board is authorized to invest funds in:

(1) equity and debt investment businesses through participation in limited partnerships, trusts, private placements, limited liability corporations, limited liability companies, limited liability partnerships, and corporations;

(2) real estate ownership interests or loans secured by mortgages or deeds of trust or shares of real estate investment trusts through investment in limited partnerships, bank-sponsored collective funds, trusts, mortgage participation agreements, and insurance company commingled accounts, ~~including separate accounts~~;

(3) resource investments through limited partnerships, trusts, private placements, limited liability corporations, limited liability companies, limited liability partnerships, and corporations; ~~and~~

(4) investment vehicles that are co-investments or separate accounts;

(5) liquid alternatives;

(6) bank loans; and

~~(4) (7) international securities.~~

(b) The investments authorized in paragraph (a) must conform to the following provisions:

(1) the aggregate value of all investments made under paragraph (a), clauses (1) to ~~(3)~~ **(4)**, may not exceed 35 percent of the market value of the fund for which the state board is investing;

(2) there must be at least four unrelated owners of the investment other than the state board for investments made under paragraph (a), clause (1), (2), or (3);

(3) state board participation in an investment vehicle is limited to 20 percent thereof for investments made under paragraph (a), clause (1), (2), or (3); and

(4) state board participation ~~in a limited partnership~~ **in an investment vehicle** does not include a general partnership interest or other interest involving general liability. The state board may ~~not engage in any activity as a limited partner~~ **not participate in any investment vehicle in a manner** which creates general liability.

* This amendment will also include conforming changes to other sections, including appropriate cross references.