



1526 K Street, Suite 420
Lincoln, NE 68508
Phone: 402-471-2043
Fax: 402-471-2498
www.nic.nebraska.gov

TO: Council Members
FROM: Joe Spitznagel, Portfolio Manager
DATE: December 13, 2018
SUBJ: Benchmark Change for Operating Investment Pool and K928 (Health Care)

Recommendation:

That the Nebraska Investment Council adopt the recommended benchmark changes for the Operating Investment Pool and Health Care Endowment Fund as listed on the following pages.

The Bloomberg Barclays indices we are recommending for use on a go forward basis align very closely with the indices they would be replacing in terms of both characteristics (yield, duration, credit quality, etc.) and historical performance. These benchmark changes will not impact how the portfolios are managed.

Background:

Bloomberg has been updating its portfolio analytics system over the past few years. It can be used as a replacement to our current analytics system BondEdge with no added costs. In order to keep the service free we will need to move the Benchmarks over to a Bloomberg Barclays index.

cc: Council Investment Team

OPERATING INVESTMENT POOL INVESTMENT POLICY STATEMENT

STATUTORY REFERENCES

- Nebraska State Funds Investment Act Neb. Rev. Stat. §§ 72-1237 - 72-1260
- Nebraska Capital Expansion Act Neb. Rev. Stat. §§ 72-1261 - 72-1269

In addition, statutes relating to each of the various entities listed above give the Nebraska Investment Council (the Council) the authority to invest the funds of that entity.

INVESTMENT OBJECTIVES:

The primary objectives are as follows (in order of priority):

Safety. Investments will be undertaken in a manner that seeks to ensure preservation of capital.

Liquidity. The Operating Investment Pool (OIP) will remain sufficiently liquid to meet the daily cash flow needs of the State and other entities participating in the Pool.

Return on Investment. The objective is to attain a competitive income rate of return given the risk constraints and cash flow characteristics of the portfolio.

INVESTMENT STRATEGY

The OIP is to be managed primarily as a buy and hold ladder portfolio of high quality investment grade fixed income securities that also provide the necessary liquidity.

From time to time, it is possible that market conditions or other outside events that are out of the Internal Manager's control may cause the portfolio(s) to fall out of compliance with this policy. Should this occur, it is expected that the Internal Manager will provide written communication to the State Investment Officer (SIO) outlining a course of action as well as a time frame to bring the portfolio(s) back into compliance.

While the assets of the TDOA program are included in the OIP, it has a separate Investment Policy Statement because it has different statutory requirements and objectives.

ASSET ALLOCATION

Short-term Liquidity Portfolio – 15% target allocation of Total OIP Portfolio

Investment Constraints:

Allowable investments: U.S. Treasuries, U.S. Agency Notes & Debentures, Euro Time Deposits, Commercial Paper, and Government Money Market Funds, all with the highest quality rating by 2 nationally recognized statistical rating organizations (NRSRO).

Maturity:

Maximum maturity of one year.

Diversification (limits are in reference to the short-term liquidity portfolio)

Government Money Market Funds – maximum 100%, no more than 50% to any single Government Money Market Fund

Commercial Paper - 5% maximum per issuer

Intermediate/Government Corporate Portfolio – 85% target allocation of Total OIP Portfolio

Investment Constraints: Allowable investments: U.S. Treasuries and U.S. Agency Notes and Debentures, Euro Time Deposits and Government Money Market Funds, all with the highest quality rating by 2 nationally recognized rating service organizations (NRSRO). Corporate bonds, notes and debentures and Yankee bonds with a rating of A-/A3 or better by 2 NRSROs. Structured notes, reverse repos or any other strategies that introduce leverage are not allowed.

Maturity:

Maximum maturity of any single bond is 10 years from time of purchase.

Duration:

The effective duration of the portfolio will be maintained within +/- 10% of the benchmark

Diversification: (minimum and maximum limits refer to the Intermediate/Government Corporate Portfolio)

U.S. Treasuries	15% minimum
U.S. Agency Notes & Debentures	50% maximum in total, 20% maximum per agency issuer
Government Money Market Funds	5% maximum
Corporate Bonds	50% maximum for the total corporate sector
AAA and AA rated corporate issues	3% maximum per issuer
A rated corporate issues	30% maximum in total, 2% maximum per issuer
Industry	5% maximum per industry

If an issuer is downgraded below an A-/A3 rating by 2 NRSROs, the issue may be held at the discretion of the internal manager, subject to a maximum of 5% of the corporate portfolio in issues below A-/A3

Quality: All securities will be rated A-/A3 or better by at least two NRSROs at the time of purchase. At all times, the weighted average quality of the portfolio will be at least A.

PERFORMANCE BENCHMARKS

Total Portfolio ~~15% ICE BAML 91 Day T-Bill Index + 85% Blend of Bank of America Index (60% Bank of America/ML 1-10 Year US Treasury & Agency Index; 40% Bank of America/ML 1-10 Year AAA-A Corporate Index)~~

15% BB Barclays US Treasury Bellwethers: 3 Month TR Index + 85% Blend of BB Barclays Index (60% BB Barclays US Govt Intermediate TR Index; 40% BB Barclays Intermediate Corp Ex Baa TR Index)

Short-term Liquidity Fund ~~ICE BofAML 91-Day T-Bill Index~~

BB Barclays US Treasury Bellwethers: 3 Month TR Index

Intermediate Govt/Corp. ~~60% Bank of America (ML) 1-10 Year US Treasury & Agency Index;
40% Bank of America (ML) 1-10 Year AAA-A Corporate Index~~

60% BB Barclays US Govt Intermediate TR Index;
40% BB Barclays Intermediate Corp Ex Baa TR Index

RESPONSIBILITIES FOR THE OPERATING INVESTMENT POOL:

The Council:

- Determines the investment strategy for the OIP.
- Defines the investment constraints.
- Sets the performance benchmarks.

The State Investment Officer:

- Administers and supervises the Council-approved Investment Policy Statement for the OIP.
- Evaluates and reports on the assets and investment performance in the Pool.
- Maintains a current written Policy approved by the Council
- Establishes written procedures for implementation of the Policy.
- Obtains Council approved Policy exceptions as needed.

The Internal Manager:

- Manages the assigned assets within the OIP in accordance with the manager allocations and investment constraints set out above.
- Evaluates and reports on the assigned internal portfolios and the total OIP.

ADMINISTRATIVE AND GOVERNANCE POLICIES

Council Administrative and Governance Policies are contained in two additional documents.

Revised March 25, 2014

Revised September 15, 2016

Revised February 8, 2018

Revised May 24, 2018

HEALTH CARE ENDOWMENT FUND INVESTMENT POLICY STATEMENT

PURPOSE

The purpose of this Investment Policy Statement (IPS) is to set forth the asset allocations, investment strategy, guidelines, and responsibilities for the Health Care Endowment Fund. The Health Care Endowment Fund is comprised of funds from the Nebraska Medicaid Intergovernmental Trust and the Nebraska Tobacco Settlement Trust. The Nebraska Medicaid Intergovernmental Trust is funded through an intergovernmental transfer which provides funding for health care expenditures determined by the legislature. The Nebraska Tobacco Settlement Trust is funded through revenues received from tobacco-related litigation to which the State is a party.

ENTITIES

Health Care Endowment Fund

- Nebraska Medicaid Intergovernmental Trust Fund
- Nebraska Tobacco Settlement Fund

STATUTORY REFERENCES

- | | |
|---|---|
| <ul style="list-style-type: none"> • The Nebraska Health Care Funding Act • Medical Assistance Program • Nebraska Capital Expansion Act • Nebraska State Funds Investment Act | <p>Neb. Rev. Stat. §§ 71-7605 - 71-7614</p> <p>Neb. Rev. Stat. §68-1018</p> <p>Neb. Rev. Stat. §§72-1261 - 71-1269</p> <p>Neb. Rev. Stat. §§72-1237 - 72-1259</p> |
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INVESTMENT OBJECTIVES

As an endowment, there are two primary investment objectives. One is to meet the current year income needs. The other is to grow the endowment to meet future needs. The annual income distribution is determined by the Nebraska Legislature.

ASSET ALLOCATION

In accordance with the investment objectives, the asset allocation adopted by the Nebraska Investment Council (“Council”) is as follows:

<u>Asset Class</u>	<u>Target Allocation</u>	<u>Acceptable Range</u>	<u>Benchmark</u>
U.S. Equities	30.5%	25.5% - 35.5%	DJ US Total Stock Market Index
International Equities	13.0%	8.0% - 18.0%	MSCI All Country World Index ex-U.S. IMI
Global Equities	21.5%	16.5% - 26.5%	MSCI All Country World IMI
Fixed Income	25.0%	20.0% - 30.0%	10% Citigroup 30-day CD Index + 90% Bloomberg Barclays Intermediate Govt./Cr Index

		10% BB Barclays US Treasury Bellwethers: 3 Month TR Index + 90% Blend of BB Barclays Index (60% BB Barclays US Govt Intermediate TR Index; 40% BB Barclays Intermediate Corp Ex Baa TR Index)
Real Estate	5.0%	NFI-ODCE Index
Private Equity	5.0%	DJ US Total Stock Market Index + 3% net

The allowable range for individual managers is $\pm 3\%$ of the target allocation established by the Council.

Any uncalled private equity or real estate capital will be invested in the public U.S. equity markets.

The Total portfolio will be benchmarked to a weighted average of the asset class benchmarks outlined above, based on the long-term target allocation. Interim targets may be used for Real Estate and Private Equity as long-term target allocations are phased-in. The difference between interim target weightings and long-term target weightings to Real Estate and Private Equity will be added to the long-term target weighting to U.S. Equity for the purpose of calculating total portfolio benchmark returns.

The strategy for the domestic fixed income sector is to be managed primarily as a buy and hold, laddered portfolio of high quality fixed income securities, with a maximum maturity of ten years, and that also provides the necessary liquidity.

In addition, within the domestic fixed income portfolio is an allocation in high quality, short-term securities to specifically provide for the mandated current year cash withdrawals. These highly liquid securities are held in the Health Care Endowment-Fixed Income portfolio but are independent of the asset allocation. From the October cash inflow, funds are invested for nine months to July of the following year. From the April cash inflow, funds are invested in 90-day investments to July of the current year. The combined total of the investments provides the funding for the annual July distribution.

INVESTMENT MANAGER GUIDELINES

The separate account investment portfolios are managed according to written investment guidelines that are approved by the State Investment Officer (SIO) and reported to the Council. These guidelines are intended to ensure that each manager operates in the manner and style consistent with the approach it represented and for which it was retained, and within acceptable risk parameters. The guidelines for each manager are included in their written, signed Investment Manager Agreement. While it is not expected that commingled fund guidelines will align perfectly with this investment policy, it is expected that commingled funds will be vetted to ensure a reasonably high degree of consistency with this investment policy before an investment is made.

The guidelines and restrictions for the internally-managed U.S. fixed income portfolio are as follows:

Allowable investments: U.S. Treasuries and U.S. Agencies. Commercial Paper, Euro Time Deposits and Money Market Funds, all with the highest quality rating by 2 nationally recognized rating service

organization (NRSO). Corporate Bonds with a rating of A or better by 2 NRSO's. Structured notes, reverse repos, or any other strategies that introduce leverage are not allowed.

Maturity: Maximum maturity of any single bond is 10 years.

Diversification: U.S. Treasuries – minimum 15%; U.S. Agencies – maximum 15% per agency issuer and a maximum of 50% in total; Commercial Paper – 5% per issuer; Money Market Funds – 15% in total; Corporate Bonds – 10% per industry, 50% maximum for the total corporate sector, for A rated bonds – 1% per issuer and maximum 5% in total, for AA rated bonds – 2% per issuer and maximum 20% in total, for AAA rated bonds – 5% per issuer and maximum 30% in total; and Misc. – 5% on an as needed basis with the approval of the SIO.

Private Equity Specifics

The endowments' private equity investments will be executed through fund of funds, which by their nature will provide diversification. While it is not expected that the fund-of-fund guidelines will align perfectly with the DB private equity portfolio guidelines (copied below), it is expected that the fund-of-funds will be vetted to ensure a reasonably high degree of consistency with this structure.

Sub Sector Allocations and Ranges

Buyouts/Corporate Finance	40.0-50.0%
Venture Capital	up to 25.0%
Special Situations	25.0-40.0%

Investment Type

Allocation required across the spectrum of sub sectors.

Geography

Allocation required across the geographic spectrum. No more than 35% outside of the United States.

Manager Concentration

Allocation to a single manager is limited to 20% of the private equity portfolio.

Industry

No more than 30% of the private equity portfolio may be invested in any single industry.

Real Estate Specifics

Style Allocations

Core	50% - 80%
Value-Added	10% - 30%
Opportunistic	10% - 30%

Property Type

Allocation across the spectrum of property types:

Office	10-50%
Industrial	10-40%
Retail	10-40%

Multifamily (apartment)	10-40%
Lodging (hotel)	0-20%
Other	0-15%

Geography

Allocation across the geographic spectrum. No more than 25% of the real estate portfolio may be invested outside of the United States.

Within the United States:

West	NPI +/- 50%
East	NPI +/- 50%
Midwest	NPI +/- 50%
South	NPI +/- 50%

Individual Investment

Direct investment into properties is prohibited as are fund investments that have the sole purpose of acquiring or developing one property.

Manager Concentration

The net asset value exposure to a single real estate manager is limited to 20% of the real estate portfolio. Exposure to a single Core fund manager is limited to 35%. Fund-of-funds manager concentration is limited to 50% of the private market real estate portfolio.

RESPONSIBILITIES FOR THE HEALTH CARE ENDOWMENT FUND

The Council:

- Approves the IPS for the Portfolio. The IPS includes the investment objectives, asset allocation, investment strategy and manager benchmarks.
- Approves exceptions to the IPS as requested by the SIO.
- Approves investment managers upon recommendation by the SIO.

The State Investment Officer:

- Makes recommendations to the Council regarding components of the IPS, such as asset allocation, investment managers utilized, and manager benchmarks.
- Implements the Council-approved IPS for the Portfolio.
- Rebalances the investments when necessary halfway back to target allocation and looks for efficient and opportunistic ways to get back to target.
- Evaluates and reports investment performance and other investment-related issues of the Portfolio.
- Maintains a current written IPS approved by the Council.
- Establishes written procedures for internal implementation of the IPS as needed.
- Obtains Council-approved IPS exceptions as needed.

ADMINISTRATIVE AND GOVERNANCE POLICIES

Council Administrative and Governance Policies are contained in two additional documents.

Revised September 29, 2009
Revised August 18, 2010
Revised May 25, 2011
Revised September 27, 2012
Revised August 26, 2014
Revised February 8, 2018
Revised July 19, 2018