

State of Michigan Retirement Systems

INTERNATIONAL EQUITY REVIEW

Investment Advisory Committee Meeting

March 9, 2017



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EXECUTIVE SUMMARY

Performance

MPSERS Plan, Gross	1-Year	3-Years	5-Years	7-Years	10-Years
Annualized Returns	4.3%	0.0%	6.5%	4.2%	1.0%
Benchmark Return	4.5%	-1.7%	5.3%	3.0%	0.0%
Peer Return (> \$1 B)	3.8%	-0.8%	6.7%	4.3%	1.7%
Rank vs. Peers	37	23	59	52	87

- In the fourth quarter of 2016, the International Equity Division portfolio returned -1.1% versus the MSCI ACWI Ex-US Index return of -1.3%, bringing year-to-date performance to 4.3% compared to the index return of 4.5%. Solid outperformance from the Stock Plus portion of the portfolio wasn't enough to offset the underperformance of the division's active investments, thereby causing the International Equity Division's 2016 returns to lag the benchmark.
- During the quarter, there was a sharp contrast in returns between the developed markets and the emerging markets. Prior to election-day in the U.S., developed market returns were down -2.6% quarter to date. Post-election, developed markets rallied to finish the quarter at -0.4%. In contrast, emerging markets were approximately flat quarter-to-date going into the election and then fell over 4.0% to finish the quarter at -4.2%.
- The active investments comprise approximately 37% of the international equity portfolio and delivered a return of -1.5% for the fourth quarter and 1.7% for 2016. While the exposure to small caps and emerging markets hurt performance during the fourth quarter, these areas aided the division's returns for the year. The International Equity Division remains focused on evaluating active managers over the medium to long-term return horizon. The three year returns across all of the active investment categories, e.g. developed markets small-cap, remained ahead of the division's benchmark.
- The stock plus investments in international equity represents approximately 33.0% of the total international portfolio. Returns for the fourth quarter and 2016 were 0.2% and 7.3%, both outpacing the MSCI ACWI Ex-US for the quarter and year to date. The internally managed swap portfolio targeting the developed large-cap market was a relative contributor to performance during the quarter and the year. Whereas the internal and external emerging markets swap portfolios exhibited mid-teens performance for 2016.
- The indexed investments, which account for approximately 30% of international equity, returned -2.2% for the fourth quarter and 4.3% for the year. Emerging markets investments were a drag on performance during the quarter, however, they contributed strongly to the year's returns with performance in the low double digits.

Market Environment and Outlook

- International equity markets continue to represent relative value investment opportunities versus domestic equity markets.
- Emerging markets appear to offer better long-term value even with higher associated risks than developed markets. This emerging market outlook remains despite the strong market-by-market performance in 2016. Eight of the top ten best return countries for 2016, in U.S. dollars, were emerging market countries.
- Uncertainty around changes to global trade policies may create global economic headwinds potentially leading to higher market volatility in countries with low growth and high debt to gross domestic product ratios.
- The U.S. dollar continued to strengthen into the close of 2016. A continuation of this trend in 2017 potentially presents a headwind to international investment returns.

Conclusion

- Move towards long-term asset allocation objectives while remaining aware of potential medium-term investment opportunities.
- Prepare for derivative market regulatory and structural changes, and focus on further development of counterparty relationships as a strategic advantage.

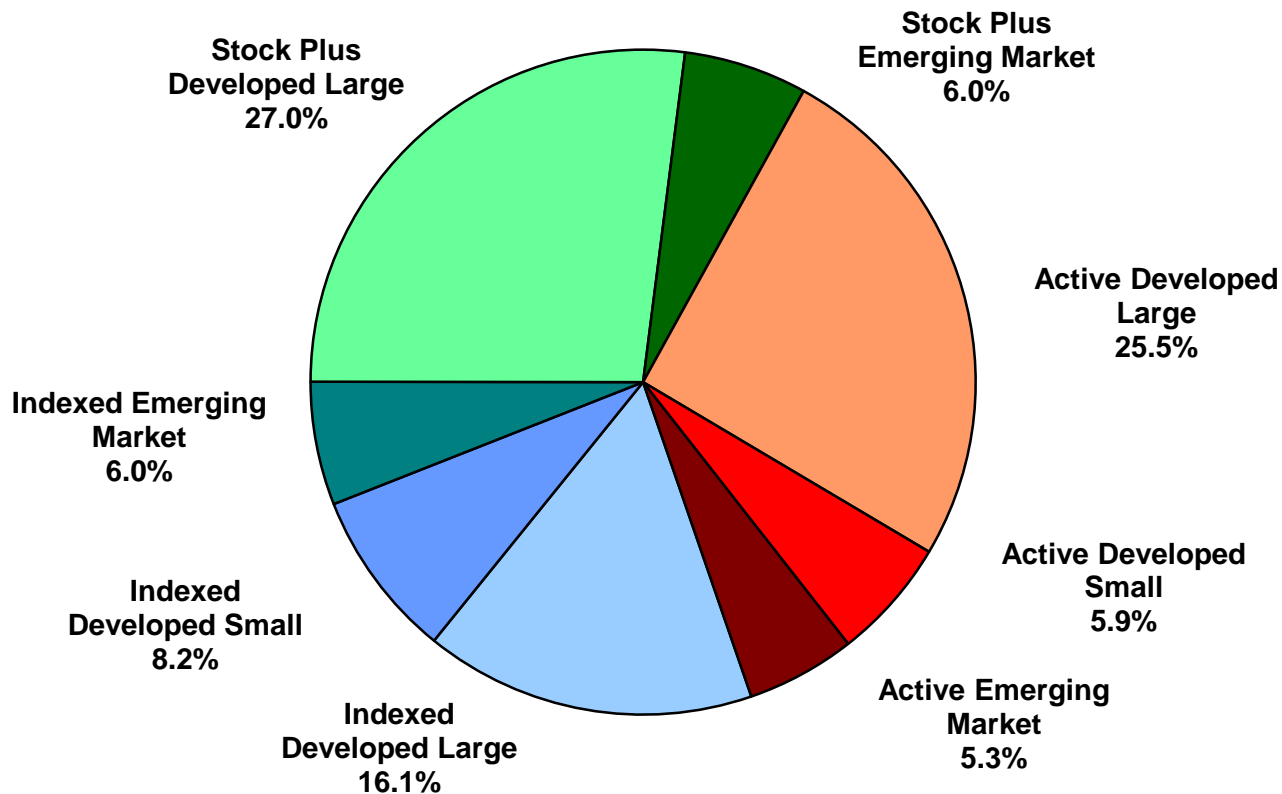
SMRS
International Equities
12/31/16

Markets	Amount	Total	% of Total
Indexed (in millions)			
SSgA	\$1,801		
Vanguard	1,135		
Total Indexed		\$2,936	30.3%
Stock Plus			
Internal Swaps	\$1,791		
PIMCO	1,406		
Total Stock Plus		\$3,197	33.0%
Active			
Los Angeles Capital	\$1,119		
Wellington	788		
Marathon London	605		
SSgA	573		
Effissimo	264		
Lazard	205		
Total Active		\$3,554	36.7%
TOTAL		<u>\$9,687</u>	<u>100.0%</u>

SMRS

International Equity Exposure By Category

12/31/16



Market Value in Millions					
	<u>12/31/16</u>		<u>9/30/16</u>		
Indexed					
Developed Large	\$1,559	16.1%	\$1,575	16.1%	
Developed Small	798	8.2%	826	8.4%	
Emerging Market	579	6.0%	602	6.1%	
Total Indexed Equity	\$2,936	30.3%	\$3,003	30.6%	
Stock Plus					
Developed Large	\$2,617	27.0%	\$2,591	26.5%	
Emerging Market	580	6.0%	599	6.1%	
Total Stock Plus Equity	\$3,197	33.0%	\$3,190	32.6%	
Active					
Developed Large	\$2,467	25.5%	\$2,484	25.3%	
Developed Small	573	5.9%	584	6.0%	
Emerging Market	514	5.3%	541	5.5%	
Total Active Equity	\$3,554	36.7%	\$3,609	36.8%	
Total International Equity	\$9,687	100.0%	\$9,802	100.0%	

Michigan Department of Treasury, Bureau of Investments

SMRS

Active International Equities

12/31/16

Date:	<u>12/31/16</u>	<u>9/30/16</u>	<u>6/30/16</u>	<u>3/31/16</u>
Assets (\$million):	\$3,554	\$3,609	\$3,348	\$3,242
Number of Securities:	1,487	1,506	1,522	1,558
Active Share:	65%	63%	62%	63%

Benchmark: MSCI ACWI ex USA

Description: The Active International Equities Composite represents cumulative investments by active international managers with developed market large and small cap, and emerging market mandates. The manager returns are well diversified and reflect a combination of fundamental analysis driven and quantitative management approaches. The cumulative exposure is constructed to produce a positive, long-term alpha while controlling risk.

Characteristics:	<u>SMRS</u>	<u>MSCI ACWI ex USA</u>
Weighted Average Capitalization (\$billion):	\$17.6	\$40.6
Trailing 12-month P/E:	18.0x	18.4x
Forecast P/E:	16.5x	15.7x
Price/Book:	1.5x	1.6x
Beta:	0.95	1.00
Dividend Yield:	2.7%	3.0%
Tracking Error:	3.5%	NA

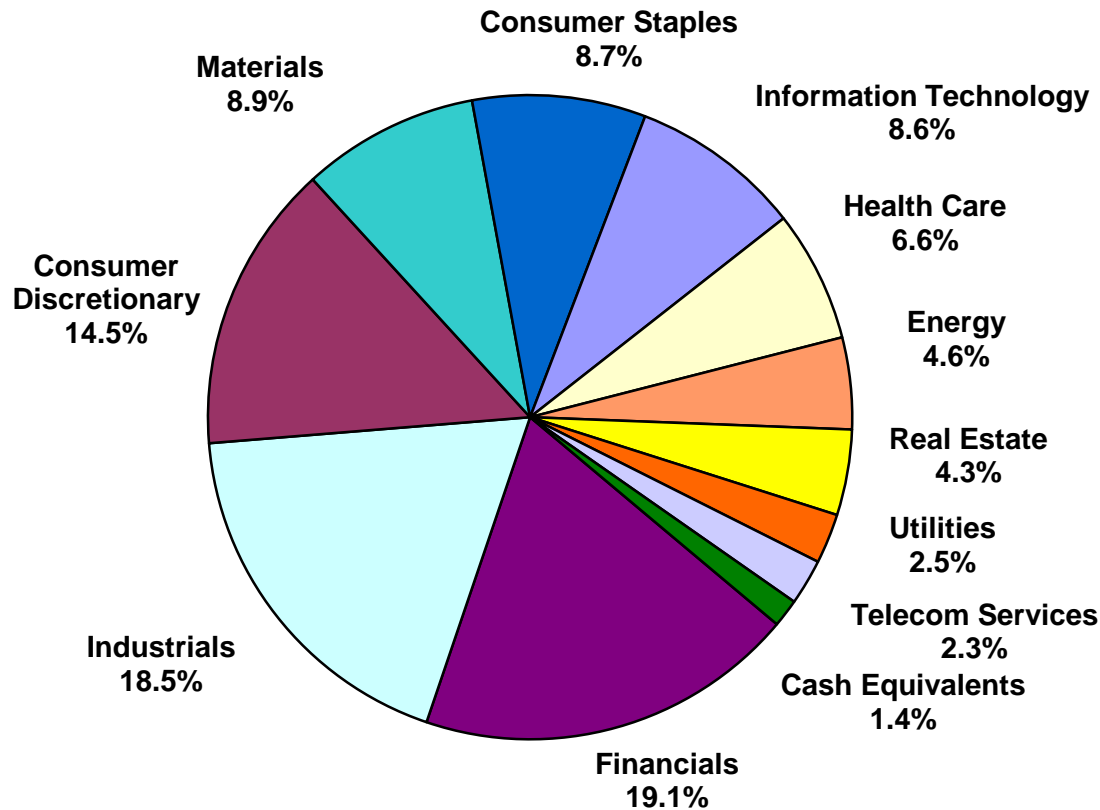
TOP TEN HOLDINGS – Active International Equities 12/31/16

	<u>Portfolio Weight</u>	<u>Market Value</u>
Dai-ichi Life Insurance Co Ltd/The	2.6%	\$93.5
Kawasaki Kisen Kaisha Ltd Ordinary JPY	1.2%	\$42.0
Ricoh Co Ltd	1.2%	\$41.0
Yamada Denki Co Ltd	1.1%	\$39.1
Lonza Group AG	0.7%	\$24.7
Adecco Group AG	0.7%	\$23.9
Atos SE	0.7%	\$23.8
Novartis AG	0.7%	\$23.3
Tencent Holdings Ltd	0.5%	\$18.4
British American Tobacco	<u>0.5%</u>	<u>\$18.4</u>
TOTAL	<u>10.1%</u>	<u>\$348.1</u>

SMRS

Active International Equity By Sector

12/31/16



Market Value in Millions				
12/31/16				
	Assets	Percent	Benchmark	Difference
Financials	\$677	19.1%	23.4%	-4.3%
Industrials	659	18.5%	11.6%	6.9%
Consumer Discretionary	514	14.5%	11.5%	3.0%
Materials	316	8.9%	7.9%	1.0%
Consumer Staples	311	8.7%	9.8%	-1.1%
Information Technology	306	8.6%	9.3%	-0.7%
Health Care	235	6.6%	8.1%	-1.5%
Energy	164	4.6%	7.3%	-2.7%
Real Estate	154	4.3%	3.3%	1.0%
Utilities	90	2.5%	3.2%	-0.7%
Telecom Services	80	2.3%	4.6%	-2.3%
Total Investments	<u>\$3,506</u>	<u>98.6%</u>	<u>100.0%</u>	
Cash Equivalents	48	1.4%	0.0%	1.4%
Total	<u>\$3,554</u>	<u>100.0%</u>	<u>100.0%</u>	

Benchmark: MSCI ACWI ex USA

International Active Manager Performance - Net of Fees
12/31/16

<u>Fund Name</u>	<u>Market Value</u>	<u>1-Year</u>	<u>3-Years</u>	<u>5-Years</u>	<u>7-Years</u>	<u>Inception Date</u>
PIMCO Intl StocksPlus TR Strategy MSCI EAFE Net Div Index (unhedged)	\$977,053,417	3.8% 1.0%	-1.8% -1.6%	8.0% 6.5%	-- --	10/1/10
LA Capital World MSCI ACWI Ex-US	821,006,197	0.6% 5.0%	-- --	-- --	-- --	10/30/15
Marathon-London Intl Fund MSCI EAFE Index	604,808,423	1.2% 1.0%	1.0% -1.6%	-- --	-- --	2/1/12
SSGA Small Cap Intl Alpha Strategy S&P Developed Ex-US Small Cap	573,302,422	0.8% 3.4%	1.9% 1.6%	11.2% 9.2%	8.8% 7.0%	5/1/07
Wellington Intl Research Equity S&P BMI World Ex-US Index	571,582,969	-0.6% 3.0%	-1.3% -1.0%	6.8% 6.5%	4.2% 4.2%	12/1/05
Pimco EM Stock Plus MSCI Emerging Market Index	428,579,799	14.8% 11.2%	-- --	-- --	-- --	3/31/15
LA Capital Emerging Market MSCI Emerging Market Index	297,687,881	11.3% 11.2%	-2.0% -2.6%	1.5% 1.3%	-- --	12/8/09
Effissimo Capital Management Japan MSCI EAFE Net Div Index (unhedged)	264,289,380	5.7% 1.0%	-- --	-- --	-- --	12/1/15
Wellington Emerging Local Equity MSCI EAFE Net Div Index (unhedged)	215,721,456	4.6% 11.2%	-0.7% -2.6%	-- --	-- --	10/30/15
Lazard Wilmington Intl Equity Portfolio MSCI EAFE Net Div Index (unhedged)	204,750,000	-4.1% 1.0%	-- --	-- --	-- --	5/1/14

International Indexed Manager Performance, Net of Fees
12/31/16

<u>Fund Name</u>	<u>Market Value</u>	<u>1-Year</u>	<u>3-Years</u>	<u>5-Years</u>	<u>7-Years</u>	<u>Inception Date</u>
SSgA PMI Fund S&P Developed Ex-US Large/Midcap	\$1,003,483,632	3.3% 2.9%	-1.2% -1.6%	6.2% 6.0%	-- --	4/1/10
SSgA EMI Fund - Europe/Pacific S&P EPAC Small Cap	797,733,309	1.6% 1.8%	2.3% 2.1%	10.5% 10.3%	-- --	4/1/10
Vanguard Emerging Market Spliced Emerging Market Index **	578,929,698	11.8% 11.8%	-1.6% -1.0%	1.5% 1.6%	-- --	7/1/09
Vanguard Developed Mkts Fund Spliced Developed Ex-US Index *	555,769,530	2.5% 2.3%	-1.2% 1.1%	7.0% 6.9%	-- --	4/1/10

* Spliced Developed Ex-US Index: MSCI EAFE Index through May 29, 2013; FTSE Developed Ex North America Index through December 20, 2015; FTSE Developed All-Cap Ex-US Transition Index thereafter. Benchmark returns are adjusted for withholding taxes.

** Spliced Emerging Market Index: Select Emerging Markets Index through August 23, 2006; MSCI Emerging Markets Index through January 9, 2013; FTSE Emerging Transition Index through June 27, 2013; FTSE Emerging Index through November 1, 2015; and FTSE Emerging Markets All-Cap China A Transition Index thereafter. Benchmark returns are adjusted for withholding taxes.