



Dale R. Folwell, CPA

INVESTMENT MANAGEMENT

To: North Carolina Supplemental Retirement Board of Trustees

From: Kris Byrd, Portfolio Manager

Date: February 22, 2024

Subject: Discussion / Action: 401k and 457b Plans: Macquarie Watch List Recommendation

Recommendation

When assessing managers for potential inclusion on the watchlist, three critical criteria are considered: consistent underperformance relative to benchmarks and peers, substantial shifts in investment philosophy, and significant organizational changes. These elements enable an evaluation of whether an investment strategy necessitates increased scrutiny due to potential risks to its success.

Staff and Callan recommend adding the Macquarie Large Cap Value Focus strategy to the watchlist, as its five-year underperformance correlates with the departure of key personnel.

The strategy has experienced over \$15 billion in net outflows over the past three years, which is meaningful. However, strategy assets under management remain sizeable at \$11.1 billion, as of year-end 2023. Callan and Staff continue to monitor assets and net flows closely as a continued decline in assets could negatively affect the firm's capacity to maintain its full team.

Portfolio Positioning

Macquarie manages 18% of the NC Large Cap Equity option. They are one of two active value managers that each manage an equal allocation and offset the two growth managers and passive portfolio. Their style exposure can be thought of as traditional value although portfolio characteristics can shift from deep value to relative value over time. As a result of quality screens, the strategy has been more consistent in offering below average portfolio volatility and more defensive characteristics.

People

The Large Cap Value Focus strategy is managed by a highly experienced team under the leadership of a senior portfolio manager who has been with the firm since 2019. This individual succeeded the original architect and long-standing portfolio manager of the strategy, who retired in 2019. The investment team includes two additional senior portfolio managers, one portfolio manager, three associate portfolio managers, an equity analyst, and an investment specialist. All team members are involved in all buy/sell decisions.

In October 2022, Macquarie Asset Management announced the retirement of one of their Senior Portfolio Managers, who had been with the firm since 2004.



INVESTMENT MANAGEMENT

Philosophy/Process

The core investment philosophy is centered around the following insights:

1. Behavioral Finance – It acknowledges that stock prices are influenced by human emotions and crowd psychology, aiming to capitalize on the resulting discrepancies between a stock's intrinsic value and its market price.
2. Selective Concentration – By developing portfolios with 30-40 holdings that are equally weighted at the time of purchase, it reflects a deep conviction in selected 'best ideas' and aims for superior performance through focused investment.
3. Mandated Diversification – The portfolio mandates diversification across all economic sectors. This means that while the portfolio may be concentrated in terms of the number of holdings, it still maintains a diversified exposure to various sectors of the economy, reducing sector-specific risk.
4. Collaborative Research Process – It involves all team members in the discussion and implementation of investment ideas, enhancing the depth and quality of analysis through diverse perspectives.

The investment process for constructing the portfolio follows a structured and comprehensive approach, integrating both qualitative and quantitative analyses:

1. Initial Universe Selection: The process begins with identifying U.S. companies with a market capitalization of at least \$2 billion, creating a starting universe of approximately 1,000 companies.
2. Proprietary Screening: A proprietary multi-factor screen narrows this universe to around 400 securities, focusing on valuation (75%) and quality (25%) factors. This screening evaluates stocks based on metrics such as price to book, cash flow, earnings, sales, dividend yield, and quality scores including the Ford quality rating and return on equity.
3. Sector Analysis and Stock Selection: Using a top-down approach, the team determines sector weightings, while bottom-up fundamental analysis drives the stock selection. The investment team, comprising of three portfolio managers and three associate portfolio managers, conducts sector-specific research. Fundamental research on companies involves detailed analysis using financial statements, direct company contact, and various valuation models (DDM, DCF, CSFB HOLT, etc.), supported by tools like FactSet, Bloomberg, and StockVal.
4. Development of Price Targets: For the narrowed down list of approximately 135 stocks, price targets are developed through financial statement analysis, proprietary valuation work, and direct contact with company management, spanning all 10 sectors.



INVESTMENT MANAGEMENT

5. **Portfolio Construction:** The portfolio is constructed to include 30-40 equally-weighted holdings, considered as "best ideas," with exposure to all 10 GICS sectors within a +/- 50% band of the S&P 500 Index sector weights. This ensures a focused yet diversified portfolio. The maximum size for any individual position is capped at 5%, and cash, a residual of the stock selection process, typically makes up 1-2% of the portfolio.
6. **Monitoring and Selling Strategy:** Stocks may be sold for various reasons, including achieving price targets, changes in relative valuation, fundamentals, sector weights, or if a position exceeds the 5% maximum weight. The average annual portfolio turnover is generally less than 30%.

The combined investment philosophy and process of this strategy is designed to outperform in markets that value company fundamentals over speculative trading and lag in speculative markets that favor lower quality names.

Performance

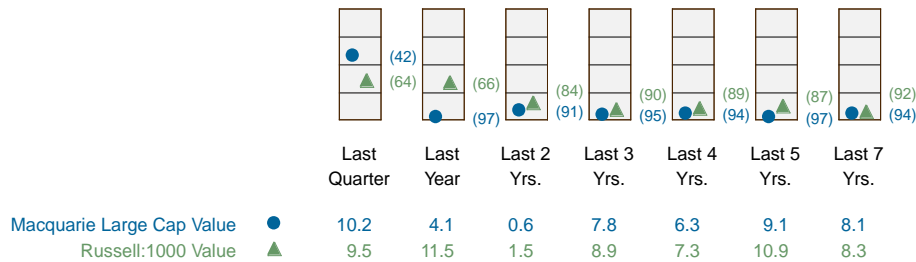
Performance has struggled over the last four years, largely since the senior portfolio manager who leads the team assumed primary responsibility for the strategy in 2019. While all team members are involved in buy/sell decisions and no portfolio manager has veto power, performance has been disappointing under the new 2019 leadership.



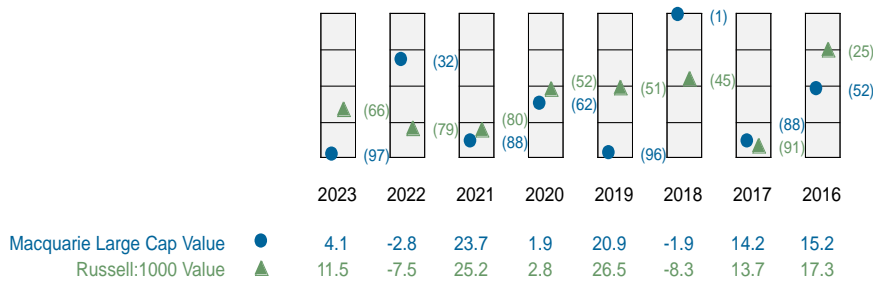
INVESTMENT MANAGEMENT

Performance as of 12/31/23

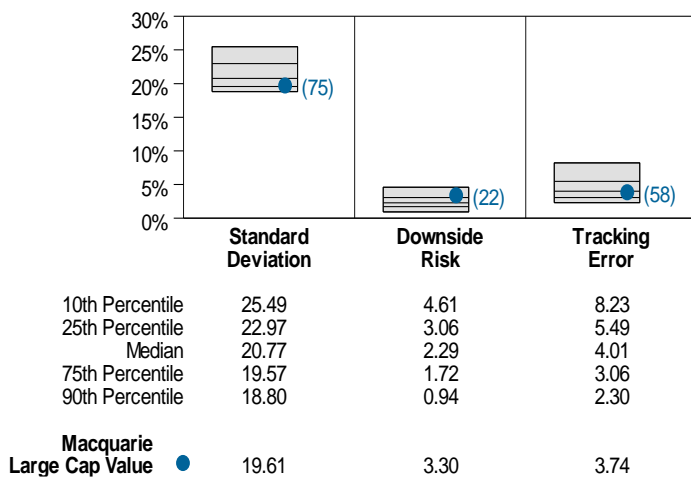
Returns vs. Callan Large Cap Value



Calendar Year Returns



Risk Statistics Rankings vs Russell 1000 Value Index Rankings Against Callan Large Cap Value (Gross) Five Years Ended December 31, 2023



Callan Large Cap Value (Gross) Annualized Five Year Risk vs Return

