



ILLINOIS STATE BOARD OF INVESTMENT

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Date: December 21, 2015

To: Governor Bruce Rauner and the General Assembly

From: William R. Atwood, Executive Director
Johara F. Farhadieh, Portfolio Manager *JF*
Illinois State Board of Investment

Subject: Report on Emerging Money Managers (Public Act 96-0006)

In accordance with Public Act 96-0006 (the "Act"), the Illinois State Board of Investment ("ISBI" or the "Board"), which directs the investments for the General Assembly Retirement System, the Judges Retirement System of Illinois, the State Employees' Retirement System of Illinois, and the Power Agency Trust, is submitting the following report to the Governor and the Illinois General Assembly.

In furtherance of the law governing emerging and minority utilization under the Act, the Board adopted the Diversity Policy (the "Policy") encouraging emerging and minority utilization. The Policy is continuously reviewed by ISBI Staff and updated accordingly.

A copy of the Policy is attached to this report and a brief explanation is provided below:

In order to take advantage of emerging and minority organizations, the Board has adopted the Policy, which seeks to increase participation by emerging and minority investment managers, sets forth minimum goals for the utilization of minority-owned broker/dealers, pledges to use its best efforts to increase the racial, ethnic and gender diversity of its fiduciaries and sets forth goals for the utilization of businesses owned by minorities, females, and persons with a disability for all contracts and services of the Board.

The Policy was most recently amended by the Board on September 17, 2015, to comply with Public Act 98-1022. In addition, the Policy was revised to combine multiple diversity-related policies into one, all-encompassing Diversity Policy.

Currently, the Board either meets or exceeds the majority of the Policy goals with respect to emerging and minority investment managers. The two areas where which ISBI's utilization falls below the Policy goals are ISBI's investments in female-owned firms and emerging equity investment managers. As communicated in this report last year, changes in the ownership structures at the Rock Creek Group ("Rock Creek") and Rhumbline Advisers ("Rhumbline") has resulted in the Board's investment allocations in 2015 to female-owned and emerging equity investment managers to fall below previous years and current Policy goals. Rock Creek no longer qualifies for female-ownership status since selling a majority stake of the firm to Wells

Fargo Investment Group, Inc. Rhumblin no longer qualifies for female-ownership status since revising its ownership structure following the passing of the firm's founder.

Please refer to the chart below for further detail:

**Illinois State Board of Investment
Emerging and Minority Investment Manager Utilization
As of September 30, 2015**

Summary by Status (for comparison to goals identified in the Policy)

	Emerging Mgrs.	Minority Mgrs.*	Emerging Mgrs. %	Emerging Goal %	Minority Mgr. %*	Minority Goal %
Minority-Owned	1,199,755,871	1,338,633,439	8%	5-7%	9%	5-7%
Female-Owned	139,397,428	139,397,428	1%	3-5%	1%	3-5%
Disabled	7,466,236	7,466,236	0%	0-1%	0%	0-1%
	1,346,619,535	1,485,497,103	9%		10%	

Summary by Asset Class (for comparison to goals identified in the Policy)

	Emerging Mgrs.	Minority Mgrs.*	Emerging Mgrs. %	Emerging Goal %	Minority Mgr. %*	Minority Goal %
Equities	543,617,662	682,495,230	6%	8-10%	8%	8-10%
Fixed income	674,186,464	674,186,464	21%	10-12%	21%	10-12%
Alternatives**	128,815,409	128,815,409	5%	1-5%	5%	1-5%
	1,346,619,535	1,485,497,103				

* For the purposes of the Policy the term minority investment manager (minority mgrs.) includes emerging investment managers (emerging mgrs.). Minority investment managers include investment managers with over \$10B in AUM.

**Alternatives investments include allocations to real assets, real estate and private equity.

Please refer to the attachment titled, "Listing of Emerging and Minority Investment Managers," for the names, addresses and the percentage of assets under management for each of the Board's current emerging and/or minority investment managers.

Appreciating its ongoing success through the utilization of emerging and minority investment managers, the Board, along with its investment staff and consultants, continues to expand its efforts in seeking new opportunities to allocate to firms owned by minorities, females and persons with disabilities. During the past year, the Board has approved a commitment to the following minority-owned real estate and private equity funds: Oak Street Real Estate Capital Fund III (\$30 million), European Property Investors Special Opportunities 4, LP (\$35 million), and Clearlake Capital Partners IV, LP (\$30 million). The Board also committed to Rock Creek (\$100 million) and Appomattox Advisory, LLC (\$50 million) to invest in a portfolio of emerging hedge fund managers. In addition, during the past year, the Board allocated an additional \$65 million to Garcia Hamilton, a Latino-owned fixed income investment management firm.

As the Board continues its efforts to increase allocations to emerging and minority firms, it is worth noting that allocations to private market funds tend to be smaller commitments compared to allocations to public market investment managers. For example, an average allocation for ISBI to a public market investment manager ranges from \$150 million - \$600 million; an average allocation for ISBI to a private market fund, through a private equity and real estate vehicle, for example, ranges from \$30 million - \$50 million. However, investment management fees plus incentive fees paid by ISBI to private market funds are significantly higher than fees paid by ISBI to public market investment managers. As such, while continued commitments to private market funds may marginally move the needle in terms of ISBI's Policy goals, fees paid to emerging and minority managers and funds as a whole continue to significantly increase.

In addition, the Policy sets forth minimum goals for the utilization of minority-owned broker/dealers by the Board's equity and fixed income investment managers, which ISBI regularly monitors. Each manager that reports less than the directed utilization goal is required to submit a written explanation to the Board, outlining the shortfall; in addition, the manager may be brought before the Board as outlined in the Policy. Consistent with the Policy, ISBI does not allow its investment managers to utilize step outs or correspondents.

ISBI's investment managers, as a whole, currently meet or exceed the minority brokerage utilization goals within all asset classes outlined in the Policy. Please refer to the chart below for minority brokerage utilization as of September 30, 2015:

Asset Class	Minority Utilization (%)	Goal
Domestic Equity	43.0%	30%
International Equity	47.0%	20%
Fixed Income	42.0%	20%
International Fixed Income	<1%	0 - 5%
Emerging Markets Small Cap Equity	<1%	0 - 5%

Finally, the Policy sets forth goals for the utilization of Illinois-based broker/dealers by the Board's equity and fixed income investment managers. Please refer to the chart below for the Illinois-based brokerage utilization as of September 30, 2015:

Asset Class	Illinois Brokerage (%)	Goal
Domestic Equity	27.0%	25%
International Equity	42.0%	25%
Domestic Fixed Income	28.0%	25%

Within the Policy, the Board has also pledged to use its best efforts to increase the racial, ethnic and gender diversity of its fiduciaries, including consultants and senior investment staff. Among the staff employed by ISBI, approximately 73% are female and 36% are African-American.

In line with the Policy, ISBI, on a quarterly basis, requests its consultants to report racial, ethnic and gender diversity of their respective firms and to annually provide a copy of the respective firm's diversity plan.

Aside from the Policy, and in furtherance of Public Act 98-1022, ISBI requires the following disclosures from investment advisors, consultants and private market funds (collectively, the "Vendor") prior to contracting with or receiving a commitment from the Board:

- The number of the Vendor's investment and senior staff and the percentage of its investment and senior staff who are a (i) minority person, (ii) female, or (iii) person with a disability;
- The number of contracts, oral or written, that the Vendor has in place for investment services, consulting services, and professional and artistic services that constitute a (i) minority owned business, (ii) female owned business, or (iii) business owned by a person with a disability; and
- The number of contracts, oral or written, that the Vendor has in place for investment services, consulting services, and professional and artistic services where more than 50% of services performed pursuant to contract are performed by a (i) minority person, (ii) female, or (iii) person with a disability but do not constitute a business owned by a minority, female, or person with a disability.

Lastly, the Policy sets forth goals for the utilization of businesses owned by minorities, females, and persons with a disability for all contracts and services of the Board. Staff annually reviews these goals and surveys the list of vendors currently servicing ISBI to determine areas for potential utilization of businesses owned by minorities, females, and persons with a disability.

ISBI will continue to comply with and improve upon its policies pertaining to emerging and minority utilization and will review such on an annual basis.

Enclosures.

ILLINOIS STATE BOARD OF INVESTMENT DIVERSITY POLICY

Objective

The Illinois State Board of Investment (“ISBI” or the “Board”) has adopted this Diversity Policy (the “Policy”) to increase access and opportunities for emerging managers, brokers, minorities, women and persons with a disability as those terms are defined in the Business Enterprise for Minorities, Females, and Persons with Disabilities Act¹ and the Illinois Pension Code².

A. Emerging and Minority Investment Manager

It is the primary goal of ISBI to develop and maintain an investment program that will help secure the retirement benefits of the participating retirement plans. In order to achieve this objective, investment advisers are selected based on their long-term records of performance, depth of investment staff and consistency of approach among other characteristics.

However, the Board recognizes that even large, experienced and successful investment organizations were once small, start-up firms with few assets under management. Today many such firms are owned by minorities, women and persons with a disability. These firms are often started by experienced investment professionals, who show great promise, but find it difficult to compete with large majority owned organizations. The firms typically do not meet the minimum standards set for investment advisers by large investment programs such as ISBI. Consequently, they are not considered.

In order to take advantage of these emerging organizations, the Board has established an aspirational goal³ to use emerging investment managers⁴ for no less than 20% of the total portfolio funds under management within ISBI’s investment program.

Furthermore, the Board goes beyond the utilization of emerging managers and has adopted goals for the utilization of minority investment managers⁵. The Board has

¹ 30 ILCS 575

² 40 ILCS 5

³ Effective January 1, 2016, Senate Bill 1334 requires the Board to establish certain aspirational goals for the utilization of Minority Investment Managers.

⁴ Effective April 3, 2009, Public Act 96-0006 revised the definition of “emerging investment manager.” As a result, the current definition applicable to ISBI is found in 40 Ill. Comp. Stat. § 5/1-109(4) and is defined as “a qualified investment adviser that manages an investment portfolio of at least \$10,000,000 but less than \$10,000,000,000 and is a ‘minority owned business’, ‘female owned business’ or ‘business owned by a person with a disability’ as those terms are defined in the Business Enterprise for Minorities, Females, and Persons with Disabilities Act.”

⁵ For purposes of this Policy, the term “Minority Investment Manager” includes emerging investment managers and/or minority owned business, female owned business, or business owned by a person with a disability as those terms are defined in the Business Enterprise for Minorities, Females, and Persons with Disabilities Act.

established an aspirational goal to have no less than 20% of its investment advisors be minorities, females, and persons with a disability.

Goals for Utilization of Minority-Owned Businesses, Female-Owned Businesses, and Businesses Owned by Persons with a Disability

It is the goal of the Board that, subject to its fiduciary responsibility, the use of emerging investment managers shall be significant in each of the broad asset classes in which ISBI is invested and not concentrated in any particular asset class.

The Board has adopted the following minimum goals for the utilization of emerging and minority investment managers⁶:

**Goals for Utilization of Emerging and Minority Investment Managers
By Investment Manager Classification**

Classification	Percent of Total Portfolio	
	Emerging	Minority
Minority-Owned	5% - 7%	5%-7%
Female-Owned	3% - 5%	3% - 5%
Disabled	0% - 1%	0% - 1%

**Goals for the Utilization of Emerging and Minority Investment Managers
By Asset Class**

Asset Class	Percent of Asset Class	
	Emerging	Minority
Equities	8% - 10%	8% - 10%
Fixed Income	10% - 12%	10% - 12%
Alternatives*	1% - 5%	1% - 5%

* Alternative investments are not subject to the requirements set forth in Public Act 96-0006.

These goals will be reviewed annually by Investment Staff.

For purposes of this Policy, in order to be considered an emerging and/or minority investment manager by the Board, documentation of a current State of Illinois

⁶ Public Act 96-0006 requires the establishment of “3 separate goals for (i) emerging investment managers that are minority owned businesses; (ii) emerging investment managers that are female owned businesses; and (iii) emerging investment managers that are businesses owned by a person with a disability.”

certification⁷ must be provided to the Board before any asset allocation is received. In the event an emerging and/or minority investment manager is unable to obtain a State of Illinois certification due to the annual gross sales threshold requirement, such manager may appeal to the Board for recognition. Minority investment managers may represent any asset class within ISBI's asset allocation. Allocations of the Board's assets to minority investment managers will be made in accordance with the fiduciary standards under which all ISBI investment advisers operate.

Asset Management

1. Investment Staff will review the statistical requirements for investment adviser searches as needed to provide better access to minority investment managers that have appropriate products.
2. Investment Staff will seek to include at least one minority investment manager in final Investment Staff interviews. Investment Staff will inform the Board of all minority investment manager candidates.
3. Investment Staff will regularly meet with Illinois-based minority investment managers on-site, and learn more about the Illinois-based minority investment manager community.
4. ISBI will make best efforts to include a meaningful representation of minority investment managers in the State Deferred Compensation Plan.
5. Investment Staff will encourage ISBI Consultants to be proactive and use creative approaches in achieving the Board's objectives with respect to the use of minority investment managers.

B. Minority and Illinois Brokerage

The Board seeks to increase access and business with state certified, minority-owned broker/dealers and Illinois-based broker/dealers; therefore, the Board, as a part of this Policy, has adopted minimum expectations for the use of minority-owned broker/dealers⁸ by the Board's investment advisers. The minimum expectations are established based on the asset class in which the investment adviser invests. In addition, the Board will

⁷ A "State of Illinois certification" is a certification granted by the Illinois Department of Central Management Services to a Minority Business Enterprise, a Female Business Enterprise or a Person with Disabilities Enterprise under the Business Enterprise Program for Minorities, Females, and Persons with Disabilities.

⁸ In accordance with Public Act 96-0006, "minority-owned broker dealer" means "a qualified broker-dealer who meets the definition of 'minority owned business', 'female owned business', or 'business owned by a person with a disability', as those terms are defined in the Business Enterprise for Minorities, Females, and Persons with Disabilities Act."

encourage its investment advisers to direct 25% of their trades to Illinois-based⁹ broker/dealers. It is further the policy objective of the Board to encourage its investment advisers to seek to obtain best price execution at the Chicago Stock Exchange, which can be achieved by utilizing the Institutional Brokers of the Chicago Stock Exchange.

For purposes of this Policy, in order to be considered a minority-owned broker/dealer by the Board, documentation of a current state certification must be provided to the Board.

Transactions completed with minority-owned broker/dealers on behalf of the Board must be completed at rates fully competitive with the market. Subject to best execution, investment advisers for the Board's separately managed investment portfolios are strongly encouraged to direct the below percentages of total eligible commission dollars or eligible trading volume to minority-owned broker/dealers.

Asset Class	Minimum Goal as a Percentage
U.S. Equity	30%
International Equity	20%
Fixed Income	20%
International Fixed Income	0 – 5%

These goals will be reviewed annually by Investment Staff.

Brokerage

1. Investment Staff will strongly encourage verbally and in writing the Board's domestic and international equity and fixed income investment advisers to directly utilize minority-owned brokers/dealers. Investment staff will add additional asset classes when appropriate.
2. Investment Staff will strongly encourage verbally and in writing investment advisers to direct 25% of their trades to Illinois-based broker/dealers.
3. Investment Staff will strongly encourage verbally and in writing investment advisers to obtain best price execution at the Chicago Stock Exchange ("CHX"), which may be achieved by utilizing the list of Institutional Brokers of the CHX. For purposes of this Policy, the most current list of Institutional Brokers of the CHX can be accessed via the CHX website.⁷
4. Investment Staff will provide verbally and in writing to minority-owned broker/dealers the contact information for the Board's domestic and international equity and fixed income investment advisers.

⁹ The definition of an "Illinois-based" firm is consistent with the Illinois Pension Code which defines "Illinois business" as "a business, including an investment adviser, that is headquartered in Illinois." 40 Ill. Comp. Stat. § 5/1A-108.5(a).

5. Investment Staff will monitor the use of Illinois-based broker/dealers and minority-owned broker/dealers by the Board's investment advisers, and report results to the Board on a quarterly basis. If an investment adviser reports less than their encouraged percentage of minority-owned broker/dealer utilization, Investment Staff will require the adviser to report in writing the reason for the shortfall, at which time the Board will decide if the adviser's practices are in accordance with this Policy.
6. Investment Staff will consider the use of Illinois-based broker/dealers and minority-owned broker/dealers when evaluating existing investment advisers.
7. Step outs and correspondence are prohibited. With regard to the emerging market asset class, best efforts by ISBI's investment advisers shall be applied.

Consequences of Non-Compliance

The Board continuously monitors investment advisers' compliance with this Policy and has established a series of consequences for those advisers who continually fail to meet the Board's expectations. The investment advisers are expected to achieve the desired levels of brokerage usage over a fiscal year period. The following steps will occur if the investment adviser continues to fall short of expectations:

1. A follow-up letter will be distributed to the investment advisers not achieving the minimum level of minority-owned broker/dealer usage. The investment advisers will be reminded of the brokerage usage expected by the Board.
2. Not achieving the desired level of minority-owned broker/dealer usage will be noted in the annual investment adviser review presented to the Board.
3. Investment Staff will conduct a meeting with the investment adviser to discuss the reasons for not achieving the desired level of brokerage usage.
4. Investment advisers not achieving the expected levels of minority-owned broker/dealer usage may be subject to a moratorium on additional funding.
5. If an investment adviser fails to comply with the request, they may be invited to appear before the Board to explain why they are unable to achieve the desired level of brokerage usage.
6. The investment adviser may be placed on the Investment Advisers Watch List.

C. Minority Contract and Service Utilization

Public Act 96-0006 ("PA 96-6") states that the Board shall adopt a policy which sets forth goals for the utilization of businesses owned by minorities, females, and persons with disabilities for all contracts and services. According to PA 96-6, "The goals shall be based on the percentage of total dollar amount of all contracts let to minority owned businesses, female owned businesses, and businesses owned by a person with a disability,

as those terms are defined in the Business Enterprise for Minorities, Females, and Persons with Disabilities Act.”

In furtherance of the Act, the Board, subject to its fiduciary responsibility, has set forth a minimum goal of 0-1% of the total dollar amount for all contracts for the utilization of businesses owned by minorities, females, and persons with disabilities.

In addition, pursuant to Public Act 099-0462 ISBI has set an aspirational goal to have no less than 20% of the total service contracts awarded for information technology, accounting, insurance brokerage, and legal services to be let to businesses owned by minorities, females, and persons with a disability, as those terms are defined in the Business Enterprise for Minorities, Females and Persons with Disabilities Act.

D. Fiduciary Diversification

The Board acts as fiduciary for the General Assembly Retirement System, the Judges' Retirement System of Illinois and the State Employees' Retirement System of Illinois. As a fiduciary, the Board is responsible for managing, investing, reinvesting, preserving and protecting fund assets.¹⁰

It is the policy objective of the Board to comply with all federal and state statutes, rules and regulations pertaining to the Board's investments. PA 96-6 encourages the Board to increase the racial, ethnic, and gender diversity of its fiduciaries, to the greatest extent feasible within the bounds of financial and fiduciary prudence.¹¹

In furtherance of the Act, it is the goal of the Board to use its best efforts to increase the racial, ethnic, and gender diversity of its fiduciaries, including its consultants and senior staff, within the bounds of financial and fiduciary prudence.

Due to the small size of the staff and the number of individuals in these categories during the past fiscal year, there is no underutilization. As vacancies occur, the Board will make every effort to increase the racial, ethnic, and gender diversity of its consultants and senior staff in accordance with this Policy and within the bounds of financial and fiduciary prudence.

In accordance with its Affirmative Action Plan, the Board submits quarterly Workforce Analysis and Workforce Transaction Reports to the Department of Human Rights. The Board will continue to report to the Department of Human Rights on both a quarterly and an annual basis.

This goal will be monitored and reviewed annually in conjunction with the annual Affirmative Action Plan.

Adopted: September 21, 2001

Amended: October 24, 2003

¹⁰ See 40 ILCS 5/1-101.2

¹¹ See 40 Ill. Comp. Stat. § 5/1-109.1

Amended: June 22, 2005
Amended: March 20, 2009
Amended: December 18, 2009
Amended: March 19, 2010
Amended: December 16, 2011
Amended: June 21, 2013
Amended: September 26, 2014
Amended: September 17, 2015

Listing of Emerging and Minority Investment Managers

Asset Class	Investment Manager	Addresses	Market Values as of 09/30/15	% of Total Fund
Fixed Income	L.M Capital	401 B Street, Suite 950 San Diego, CA 92101	\$407,871,039	2.7%
Fixed Income	Garcia Hamilton	5 Houston Center, 1401 McKinney St, Suite 1600 Houston, TX	\$266,315,425	1.8%
Fixed Income			\$674,186,464	4.5%
Large-Cap Value Equity	Herndon Capital	100 Auburn Avenue, NE Atlanta, GA 30303	\$107,254,805	0.7%
Large-Cap Core Equity	Decatur Capital	250 E. Ponce De Leon Ave., Ste. 325 Decatur, GA 30030	\$19,040,527	0.1%
Large-Cap Core Equity			\$126,295,332	0.8%
Small-Cap Value Equity	Channing Capital	10 S. LaSalle St., Ste. 2650, Chicago, IL 60603	\$126,724,867	0.8%
Small-Cap Value Equity	Fiduciary Mgmt	55 W. Monroe St., Ste. 2550, Chicago, IL 60603	\$77,606,792	0.5%
Small-Cap Equity			\$204,331,659	1.4%
Micro-Cap Value Equity	Ariel Investments	200 E. Randolph Dr., Ste. 2900, Chicago, IL	\$18,659,769	0.1%
Micro-Cap Equity			\$18,659,769	0.1%
International Equity	Ariel Investments	200 E. Randolph Dr., Ste. 2900 Chicago, IL	\$120,217,799	0.8%
International Equity	Lombardia Capital	55 S. Lake Ave., Ste. 750 Pasadena, CA	\$64,883,351	0.4%
International Equity			\$185,101,150	1.2%
Hedge Fund of Funds	Appamattox Advisory	623 Fifth Avenue, 28th Floor, New York, NY	\$50,011,784	0.3%
Hedge Fund of Funds	Rock Creek Group	1133 Connecticut Avenue, NW, Washington DC, 20023	\$98,095,536	0.7%
Hedge Fund of Funds			\$148,107,320	1.0%
Private Equity	Castile Ventures III, L.P.	930 Winter Street, Suite 500 Waltham, MA 02451	\$5,363,010	0.0%
Private Equity	Clearlake Capital Partners III	233 Wilshire Blvd, Suite 800, Santa Monica, CA 90401	\$20,026,914	0.1%
Private Equity	Clearlake Capital Partners IV	233 Wilshire Blvd, Suite 800, Santa Monica, CA 90401	\$825,804	0.0%
Private Equity	Levine Leichtman V	335 North Maple Dr, Suite 130, Beverly Hills, CA 90210	\$15,660,278	0.1%
Private Equity	Valor Fund II	200 S. Michigan Ave., Ste. 1020 Chicago, IL 60601	\$38,127,815	0.3%
Private Equity	Valor Fund III	200 S. Michigan Ave., Ste. 1020 Chicago, IL 60601	\$11,047,606	0.1%
Private Equity	Vista Equity Partners V	401 Congress Ave., Ste. 3100, Austin, TX 78701	\$20,078,076	0.1%
Private Equity			\$111,129,503	0.7%
Real Estate	MacFarlane Urban Real Estate Fund II	201 Spear Street, 14th Floor, San Francisco, CA 94105	\$4,843,240	0.0%
Real Estate	Avanath Affordable Housing II	17901 Von Karman Ave., Ste. 150, Irvine, CA 92614	\$12,842,666	0.1%
Real Estate	Oak Street Capital III	125 S. Wacker Dr., Suite 1220, Chicago, IL 60606	\$0	0.0%
Real Estate	Tristan Capital IV	3 Bethesda Metro Center, Ste. 1000, Bethesda, MD 20814	\$0	0.0%
Real Estate			\$17,685,906	0.1%
Total Emerging and Minority Managers			\$1,485,497,103	9.9%
Total Portfolio			\$14,968,985,667	

