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INVESTMENT SUBCOMMITTEE OF THE NORTH CAROLINA SUPPLEMENTAL RETIREMENT BOARD OF TRUSTEES

MINUTES OF MEETING

August 13, 2015

Time and Location: Investment Subcommittee (the Subcommittee) of the North Carolina Supplemental Retirement Board of Trustees (the Board) met at 8:30 a.m. on Thursday, August 13, 2015, in the Dogwood Conference Room of the Longleaf Building, 3200 Atlantic Avenue, Raleigh, North Carolina.

Members Present: The following members were present: Melinda Baran (Chair) and Karin Cochran. Robert Orr attended via phone.

Staff and Guests present: The following staff and guests attended the meeting. From the Department of State Treasurer: Steve Toole, Mary Laurie Cece, Mary Buonfiglio, Blake Thomas, Lisa Page, Marni Schribman, Fran Lawrence, Rhonda Smith, Rekha Krishnan, Maja Moseley; Kevin SigRist attended via phone. From Mercer: Kelly Henson and Liana Magner. From Prudential: Rob Luciani, Michael McCann, Ann Cashman, Jessica Quimby, and Kathleen Neville. From TIAA-CREF: James Simone. From Galliard: William Weber. Member of the public, Robert Slade, attended via phone.

AGENDA ITEM – WELCOME AND INTRODUCTIONS

Meeting convened at 8:30 a.m.

Ms. Baran, Subcommittee Chair, welcomed everyone and asked that the public comments be held until the end of the meeting.

AGENDA ITEM – ETHICS AWARENESS AND IDENTIFICATION OF CONFLICTS OR POTENTIAL CONFLICTS OF INTEREST

The Chair asked Subcommittee members to review the agenda for the meeting and identify any actual, implied or potential conflicts of interest. There were no conflicts identified.

AGENDA ITEM – MINUTES FROM MAY 21, 2015 INVESTMENT SUBCOMMITTEE MEETING

The Chair stated that the minutes reflect a correction noted at the June 18, 2015, Board meeting and are included for reference only. No action is needed.

AGENDA ITEM – INVESTMENT GOVERNANCE AND OVERSIGHT UPDATE

The Chair recognized Mr. Toole to give a description of the new, proposed investment position for the plans. This position would report to Kevin SigRist and Mary Buonfiglio. Mr. Toole noted that the addition of this role will further strengthen the plans and create an environment where the Board can manage existing processes efficiently, and enhance the fiduciary oversight. He stated that the NC 403(b) Program is still in the early phases and this new employee would also oversee the 403(b) funds. At a previous Board meeting the budget was approved for this position. It is expected that the position will work closely with Mercer in the areas of investment manager selection and fund review, and also leverage the internal knowledge and experience of the Investment Management Division staff. Mr. Toole stated that while it is unlikely that a difference of opinion would arise between the investment consultant and the new staff member, if it were to happen, such an issue would be brought before the Investment Subcommittee for a final decision.

Ms. Cochran asked for clarification with regards to the new employee interactions with Board members. Mr. Toole stated that while Mercer will continue in their current role, the new position, as a dedicated resource to the plans, will report out to the Board directly and will partner with Mercer in the investment decision-making process.

Mr. Orr stated that the relationship between Mercer and the new position could be a significant challenge from management perspective and Mr. Toole agreed, stating that Mr. SigRist will oversee the management from the investment perspective, while he and Ms. Buonfiglio will oversee from the Board perspective. Mr. Toole added that this position will be an enhancement to the Board's fiduciary oversight responsibility and allow for better risk management.

AGENDA ITEM – STABLE VALUE PORTFOLIO REVIEW

The Chair recognized Mr. Weber. Mr. Weber first presented a market update, noting that there were hardly any changes in the market environment since the last quarter update. He pointed out that the total expenses for the fund remain at around 44 basis points. Portfolio assets have increased slightly and the portfolio maintains its AA rating; there have been no changes to the contracts with providers. The effective duration is 2.87 years with a blended yield of 1.90% net of fees. Market to book value ratio is at 101.62% and was directly impacted by a steepening yield curve. The portfolio is also fully invested and is working exactly as designed, with very low volatility. Galliard anticipates entering a slowly rising rate environment. In terms of portfolio distribution, there is still a small percentage in cash. The SVF participates in all sectors at all times and Galliard does not look to make large bets on interest rate movements or sectors. Mr. Weber noted that there are still cash inflows into the portfolio, albeit modest, and this was expected. Participants are transferring out in search of a higher yield. With regards to performance, Payden&Rygel returned 16 basis points over the quarter, while Galliard was managing to neutral; longer term bonds were near their peak returns for the quarter. Mr. Weber noted that PIMCO was replaced with Dodge&Cox, which will be reflected in the materials for next quarter. The cost of this transition had no direct impact in selling bonds. Great West was down 0.41 %, but exceeded the benchmark by 22 basis points. The annualized return to plan participants was just shy of 10 basis points. There has been no change in rating for the issuers and the portfolio is well-diversified.

Mr. Weber noted that there may be some changes coming with respect to wrap fees, due to the plans commingling funds in a group trust. He also pointed out that the portfolio managers have quite a bit of leverage with the wrap providers, who want to grow business. Mr. Weber believes that there is a potential for favorable negotiations with MetLife and American General. Ms. Cece added that commingling would involve combining the two separate Stable Value Fund accounts from each of the NC 401(k) and the NC 457(b) plans into one account under the group trust. Mr. Weber added that currently, those two funds trade separately and more information regarding possible commingling will be provided to the Board. Galliard does not anticipate that the commingling would be an issue to the contract providers, as both portfolios are almost identical and in a very good position to merge. In response to Ms. Cochran's question, Ms. Buonfiglio confirmed that such a merger and moving to group trust structure in general would mean potential cost savings. Ms. Henson also pointed out that two separate Net Asset Values (NAVs) would not need to be struck which would mean operational savings as well. Mr. Weber stated that there is a great deal more capacity in the wrap market now, thus giving more leverage on fees. Mr. Weber also confirmed for Ms. Buonfiglio that the diversification goal is for each manager to represent no more than 20 % or less of the total fund. He noted that Galliard's share is now 21.2 percent, but this is because of a liquidity issue, and Galliard is still within the guidelines.

AGENDA ITEM – ECONOMIC OVERVIEW AND 2ND QUARTER INVESTMENT PERFORMANCE REPORT

The Chair recognized Ms. Magner and Ms. Henson to give the 2nd quarter investment performance report. Ms. Magner began with the market overview and noted the muted returns, as GDP growth stalled in the U.S. during the quarter. There was noted volatility in emerging markets, some of it due to Greece's government debt crisis. The Eurozone and Japanese economies have improved. U.S. stocks have out-performed the non-U.S. stocks, which has been a pattern for some time; S&P 500 Index returned 0.3 %. Growth equities out-performed value, which was more pronounced in the small cap space: Russell 2000 Growth Index was up 2% for the quarter. There was certain disparity in sector returns: healthcare and telecomm services posted the best results, while utilities and energy were lagging. Small and midcap growth strategies were the best performers, which benefited Brown, as this manager has a small cap bias. Sands was impacted negatively in the large cap space, due to being overweight in energy. Mercer also expects the international volatility to continue; however, the emerging markets gained 70 basis points for the quarter. In the fixed income space, short-term bonds performed better than long-term, and TIPS outperformed Treasuries; REITs also fell due to increased interest rates. Passive fixed income was the worst performer of the quarter.

Ms. Henson reviewed the current investment structure of the plans, noting that there have been two changes: Delaware replaced Wellington in the Large Cap Value Fund, and Galliard removed PIMCO and replaced it with Dodge&Cox in the Stable Value Fund. Ms. Henson noted that Mercer's research group met with BlackRock, Arrowstreet and JP Morgan during the quarter and informed the Board that Mercer maintains the "preferred provider" rating for BlackRock and the "A" rating for Arrowstreet and JP Morgan Core Bond. Ms. Henson also noted that there were organizational changes within Delaware's senior management, but stated that will have no impact on the plans. Additionally, JP Morgan has been found guilty of U.S. law violation, but is expected to receive an exemption from the Department of Labor in order to continue to manage funds. Mercer also maintains the "B+(W)" rating for PIMCO's Inflation Responsive Fund. There have been two personnel changes at PIMCO: Ben Bernanke was hired as a senior advisor, and Virginie Maisonneuve, CIO of equity strategies, departed from the firm.

Ms. Henson informed that Board that Wellington Management Company has received a data request from the Securities Exchange Commission. The request was for firm-wide trading activity over the past three years, but very little is known with regards to the reason for the request. Therefore, Mercer does not recommend taking any action at this time. This is the third data request Wellington has received and the two previous ones were closed without any action from the SEC. The Chair thanked the Mercer team for their thorough analysis of the situation at JP Morgan Core Bond, Columbus branch, and requested that they continue to monitor the situation closely.

Ms. Henson continued with the plans' fee review and remarked that the 65 basis points fee for PIMCO Inflation Sensitive Fund is below the peer median. She also noted that fees for four managers have been more than the median but that fund-level fee is different than the manager-level fee; thus, fund-level fees are still lower across the board for the participants. One example is Delaware's fee of 30 basis points, which is slightly higher than Wellington's, the previous manager. However, there is virtually no impact at the fund level. Ms. Henson noted that the fee review page in Board materials was also re-organized to add a column that displayed the equations behind the final numbers. Ms. Henson went on to review the manager performance scorecard and noted the good performance of the Large Cap Value Fund. The Large Cap Growth

Fund is struggling a bit, as the current environment has been difficult for our active managers who take a defensive stance and do not buy into rising stocks. In the small/mid cap space, Brown has been one of the more volatile managers, but also posted good performance recently. The international and global funds outperformed their respective benchmarks but underperformed within the peer group. Both managers in these strategies, Baillie Gifford and Mondrian, are equity managers with 20% allocations to emerging markets, where volatility prevailed for the quarter. With regards to PIMCO's Inflation-Response Multi Asset strategy, the Inflation Responsive Fund underperformed the peer median, outperformed the benchmark, but noted that the universe is small and the peer group contains more equities. For PIMCO, the next quarter will be the 4th consecutive quarter on the watch. Mercer went ahead and did a review against potential other candidates and will not recommend a change. PIMCO is expecting inflows and no major changes in the organization. Therefore, they may be potentially removed from the watch next quarter. Ms. Buonfiglio noted that typically, after four quarters on watch, a letter of conviction is presented to the Board. Ms. Toole and Ms. Cochran were interested in a recommendation and a list of potential candidates, as well as the cost of a potential transition. Ms. Magner and Ms. Henson both agreed to provide such a memo. The Chair proposed the addition of Brown Advisory small/mid cap strategy to the watch list. Ms. Cochran so moved and Mr. Orr seconded. The motion passed unanimously.

Ms. Henson then gave a discussion of the plans' asset allocation, which is mainly driven by GoalMaker. She noted that two new charts have also been added to the Stable Value Fund performance review, comparing crediting rate to the universe of stable value funds. Ms. Henson stated that the investment management fee is below the universe median, and does not include the wrap fee or recordkeeping fee. She stated that Galliard charges 7 basis points to manage the SVF. Mercer compared that to other separate accounts, worth $1 billion or more. Mr. Toole asked if the universe data can be added to the chart, and Ms. Magner responded that this data is not typically calculated quarterly by Mercer, and that the stable value fund survey does not break out all of these components. However, Mercer will look into adding the data. Mr. Toole stated that monitoring a delegated manager is important and Ms. Henson noted that Mercer does evaluate Galliard's performance (including the fees, such as the custody fee) and this is an "all in" review. She stated that annually they do a deep dive of the Galliard management of the SVF. Ms. Henson went on to say that all of the funds, with the exception of the Inflation Responsive fund, have outperformed their benchmark for the quarter. All funds, except the SMID Cap Growth, have also out-performed the benchmarks in year-to-date comparison.

AGENDA ITEM - INVESTMENT COMPLIANCE REPORT REVIEW

Ms. Henson noted that one fund – the Large Cap Growth – was not in compliance with the Investment Policy Statement, due to the concentration of ADRs and foreign equities. There are some managers that are outside of the IPS guidelines, but not outside of their own guidelines. For example, in the fixed income space, the larger allocation to 144As was driven by Prudential

Investment Management. However, the fund guidelines do not have the same limitations that the Investment Policy Statement has.

AGENDA ITEM – PRUDENTIAL INVESTMENT MANAGEMENT PORTFOLIO STRUCTURE IN UNBUNDLED ENVIRONMENT

Ms. Magner discussed the task of determining the appropriate vehicle for the Prudential Investment Management Core Plus portfolio in the unbundling project. Prudential Investment Management replaced PIMCO as one of the managers in the Fixed Income fund and the plans utilized the variable annuity product offered for the portfolio. Due to the unbundling process, the annuity product is no longer an option. Mercer identified three possible options:

1. A separately managed account, with estimated fee of 23 basis points. The advantages are that the individual investment management agreement would be between the state and PIM and the fee is not dependent on other assets within the fund. There is no commingling of assets, and the cash flow is separate. However, this is not the lowest cost option.
2. Prudential collective investment trust. This option is the most expensive of the three and also commingled, so it does not allow for customization.
3. Prudential commingled fund offered to Mercer clients only. This option offers a favorable fee schedule on a sliding scale, fees are recalculated, reconfirmed, and reset every quarter. If the Board decides to select this vehicle, the current fee would be lowered from 18 to 16 basis points (these are negotiated fees). This is the lowest cost option but some volatility may be present, subject to outflows from other clients.

Ms. Magner also added that with the third option, there is the ability to create a separate account through an in-kind transfer of assets and fees would be capped at 23 basis points.

Ms. Cochran asked about the main drivers of the decision and Ms. Buonfiglio responded, stating that it is both the fee and the desired level of flexibility, as well as a consideration to liquidity should be part of the decision-making process. Mr. Orr added that being able to have custom-tailored guidelines is also important. Ms. Cochran inquired about other risks associated with not having a separate account. Ms. Smith noted that in this type of strategy, the guidelines are more standardized and it is not likely that many changes would be necessary. Mr. Orr asked if the option to transfer in-kind could be documented and Ms. Henson replied that it is an industry standard to do the transfer this way, and could probably be documented in the contract. Ms. Magner also pointed out that transfer in-kind makes sense from a cost perspective.

Ms. Cochran made a motion to select the Prudential commingled trust vehicle, Mercer share class, contingent upon successful negotiation of the contract and the option to transfer in-kind to a separate account if desired. Mr. Orr seconded, and the motion passed unanimously.

Ms. Magner also confirmed that no incentive for Mercer is involved in this decision, as Mercer does not receive any revenue from Prudential or the clients.

A scheduled break took place from 10:17 a.m. until 10:29 a.m.

AGENDA ITEM – NC 403(b) PROGRAM 2ND QUARTER INVESTMENT PERFORMANCE REVIEW

Ms. Henson summarized the current, diversified investment structure of the NC 403(b) Program, which is similar to the structure of the NC 401(k) and 457 Plans and also includes a few specialty options. The goal that Mercer was tasked with is to restructure the investment line-up to match the Plans' line-up more closely since there is no difference in participant base that would justify a different investment philosophy. Mercer provided the following detailed recommendations regarding the changes:

- Replace Wells Fargo Target Date Funds with a higher rated manager within the target date space and consider offering target date funds in five-year increments as an additional service
- Maintain the Vanguard passive options to give participants a low-cost option for asset class exposure
- Consolidate the mid- and small-cap index offerings into a SMID cap index
- Replace T. Rowe Price Growth and Income Fund with a higher rated manager in the Large Cap Growth space
- Add an active SMID Cap Core Fund to give participants access to active management in this area of the market
- Map the Allianz Fund into the EuroPacific Growth Fund and eliminate the DFA International Small Cap option
- Eliminate all specialty funds

Mercer also prepared an action plan, which features the changes timeline to ensure a cohesive rollout to the members. TIAA-CREF custom funds are required to notify the participants 90 day prior to transition. Mr. Orr asked about the costs associated with making significant changes to a still small program, as well as the possible undesirable impact to the small number of educators already participating. Ms. Magner stated that there are no costs to members or an additional fee to Mercer to conduct the searches. The Program would be selling out of mutual funds and those do not incur a transaction cost. Ms. Henson added that the cost associated with the transition is the cost of communication to the members.

AGENDA ITEM – CUSTOM PORTFOLIO IMPLEMENTATION UPDATE

The Chair recognized Mr. Simone to discuss the Custom Portfolios for the Program. Mr. Simone stated that the goal is to align the investment options more closely with existing options in the NC

401(k) and 457 Plans and therefore to provide something similar to GoalMaker. Mr. Simone stated the Custom Portfolios are useful to help participants with proper asset allocation and a custom glidepath which will be created by Mercer. TIAA's open architecture is used for the creation of the product, and there is a capability within the architecture to create lifetime income later on. The benefit of the Custom Portfolios is the same as in the Plans' GoalMaker product and enables an overall improvement in participant outcomes. TIAA-CREF will continue to act as the recordkeeper for the Program, and once an agreement is reached, the glidepath will be built and communications will begin to be sent out to participants.

Mr. Toole reiterated that the plans are very supportive of this improvement.

The Chair proposed a motion to approve the new investment structure for the Program, including the replacement of Wells Fargo Target Date Funds, commencement of a search for SMID and international options, as well as the implementation of Custom Portfolios.

Ms. Cochran made the motion, and Mr. Orr seconded. The motion passed unanimously.

AGENDA ITEM - SUBCOMMITTEE MEMBERS QUESTIONS/COMMENTS

No further comments were offered.

AGENDA ITEM – PUBLIC COMMENT

No public comments were offered.

The Chair asked for a motion to adjourn. Ms. Cochran so moved and Mr. Orr seconded. The meeting adjourned at 10:52 a.m.

Secretary