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**INVESTMENT SUBCOMMITTEE OF THE
NORTH CAROLINA SUPPLEMENTAL RETIREMENT BOARD OF TRUSTEES**

MINUTES OF MEETING

August 14, 2014

Time and Location: The Investment Subcommittee (the “Subcommittee”) of the Supplemental Retirement Board of Trustees (the “Board”) met at 9 a.m. on Thursday, August 14, 2014 in the Dawson Conference Room of the Albemarle Building, 325 North Salisbury Street, Raleigh, North Carolina.

Members Present: The following members were present: Melinda Baran, Chair, Mona Keech, and Karin Cochran.

Staff and Guests Present: The following staff and guests attended the meeting. From the Department of State Treasurer: Mary Buonfiglio, Blake Thomas, Rekha Krishnan, Jaclyn Goldsmith, Erica Hinton, Rosita Sabroso-Rennick, Tim Viezer and Mary Laurie Cece. From Prudential Retirement: Michael McCann, Ann Cashman, Kathleen Neville and Jessica Quimby. From Mercer: Liana Magner and Kelly Henson. From Galliard: Carrie Callahan and William Webber. From the Public: Robert Slade.

AGENDA ITEM – WELCOME AND INTRODUCTIONS

The meeting was called to order at 9 am. Ms. Baran welcomed everyone and introduced Liana Magner, Partner and Senior Investment Consultant for Mercer Investments. She will be working with Kelly Henson to monitor investment programs and strategies across the three NC Supplemental Retirement Plans. Ms. Baran also welcomed William Weber of Galliard who is Director of Client Portfolio Management and Service. He will replace Andy Apostol, and will be responsible for managing and monitoring the Stable Value Fund for the NC 401(k) and NC 457 Plans.

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

The Chair noted the minutes from the May 8, 2014 Investment Subcommittee were included in the Board book for reference only. The minutes were approved in the June 12, 2014 meeting of the full Board.

AGENDA ITEM – GALLIARD DUE DILIGENCE SITE VISIT

The Chair recognized Ms. Buonfiglio, who gave a report on the due diligence site visit to Galliard's offices in Minneapolis, Minnesota. Ms. Buonfiglio said the visit was at the behest of the Board in order to see Galliard's home office and meet the team working on the NC Stable Value Fund (SVF). They saw Galliard's processes from an investment management perspective, as well as from a compliance and due diligence perspective. She referred the Board to her memo in the Board book for details of the visit. She pointed out she met with David Lui, who is heading up Galliard's wrap contract review process, along with Ms. Callahan and Mr. Weber. In the stable value market, place wrap contracts can vary wildly, and Galliard believes they are at a good place in the market cycle to leverage and negotiate these contracts to get better, more consistent, and stronger terms. This review is a big job and an ongoing process. She said that, overall, she thought the trip was very worthwhile and recommended it be done on an annual basis.

Ms. Henson added that while on the trip she met with the Galliard investment team and learned their processes for selecting managers for the SVF, and said it was good to see the depth and capabilities of the team.

Ms. Cochran arrived at 9:05 a.m., and stated she had no known conflicts with the agenda.

AGENDA ITEM – STABLE VALUE PORTFOLIO REVIEW

The Chair recognized Ms. Callahan and Mr. Weber from Galliard to present a review of the Stable Value Fund ("SVF") for the NC 401(k) and NC 457 Supplemental Retirement Plans (the Plans). Ms. Keech first asked Ms. Callahan about the departure of Andy Apostol. Ms. Callahan stated he had gone back to a good opportunity with a former employer. She noted that Mr. Weber had been working on the North Carolina Plans behind the scenes for quite some time, and is now happy to be meeting with the Board.

Ms. Callahan pointed out that behind Tab 1 of Galliard's presentation was an update on the statistics of the firm. She then turned the presentation over to Mr. Weber to discuss the performance of the SVF. He directed the Board to page 9 of his report. He stated the Book Value Performance for the quarter was 0.45%, and year-to date was 0.88%. He noted that bond yields had been shifting lower across the term, and that is consistent with the book value levels of the SVF. Page 10 of the report gave the portfolio characteristics of the SVF. He noted there had been no change in wrap fee providers. As of the end of the 2nd quarter, the total assets in the SVF were \$1.89 billion, and the average credit quality of the underlying assets was AA+.

SVF's performance for the 2nd quarter of 2014:

- The SVF's blended yield was 1.82% net of fees.
- The effective duration was 3.04 years.
- The market-to-book value ratio was 102.34%.

Mr. Weber noted the SVF is fully invested. He stated that, currently, the crediting rate is 1.82% for the second quarter, but market trends indicate that a year from now we could be seeing a 2.01% crediting rate. Mr. Weber pointed out that on page 12 of his presentation is a breakdown of the portfolio distribution and manager distribution. He noted the SVF is a high-quality portfolio. He said Galliard, as a firm, does not make any big bets on companies or interest rates. He said the top five holdings in the Galliard portfolio are household names. Ms. Cochran asked about the credit ratings of individual holdings. Ms. Callahan noted the fund has a weighted average of AA+.

Mr. Weber noted that cash flows for the SVF have been consistent and neutral since inception. He said there had been a few chunky periods, but, overtime, they are relatively stable.

Mr. Weber discussed that one area of underperformance was PIMCO. He noted they are underperforming the benchmark because of their defensive position, and this is what the fund would want to see in terms of diversification. Mr. Weber noted they continue the reduction of Great West's allocation by 2-3% over the next quarter to get them to the target of 20% of the fund.

Ms. Callahan noted that Galliard does a great deal of oversight on SVF's external managers. There is a scheduled visit to Great West, and they plan to have some additional contract negotiations with them as well. She noted this is a legacy contract, and there needs to be some changes and updates. After the onsite visit, she will provide the Board with a summary of the review. In addition, she noted that after Galliard did an audit from the transition in 2009, they discovered an open receivable at Great West. Galliard is doing more research, and will come back to the Board with the resolution of this open item.

Mr. Weber reported that Galliard is also reviewing the new SEC money market fund regulations. He said that as a government money market fund, there should be no impact on the SVF. However, they are following these regulations as the OCC may follow the SEC in a few years. Ms. Magner asked if Galliard had seen new business as a result of the regulations. Ms. Callahan said she does not see this causing a massive rush out of money markets at this time.

There were no more questions or comments.

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

The Chair then recognized Ms. Magner and Ms. Henson who presented a summary report of general market conditions, as well as a report on the performance of the funds in the Plans.

Ms. Magner first gave an overview of her background. She has been with Mercer for 16 years, consulting to large defined contribution plans. She listed some of the other plans she works with, and some of their interesting Board members, such as professors from MIT. She noted that she works with the Kroger DC plan, which is a \$6 billion plan with a broad, diverse participant base. She said she also sits on the DC Strategy Committee within Mercer, and will be bringing the Board information from that committee on a regular basis.

Ms. Magner gave a view of the market environment for the quarter. Highlights of the quarter: 1) after downward revision to GDP, growth in the global economy started gaining in the quarter; 2) there was a similar trend of gains in employment, but not one of the economy's key strengths; 3) corporate profits are still high, even a few surprises in this; 4) the Fed is on track to end QE 3; and 5) there are positive gains in domestic equities. Ms. Magner noted that small cap stocks did not do quite as well as large cap and mid cap, but since the overall portfolio has a bias toward large cap, that helped performance. She noted the uptick in utilities during the quarter hurt some of the fund's managers. She said valuations in equities still remain relatively high, but given what is happening in the economy, they still prefer stocks over bonds. Ms. Magner noted the quarter saw equal gains in US and non-US equities. There was a rebound in emerging markets in the quarter. Latin America is leading the way, with the Middle East and Russia not performing quite as well. In fixed income, rates dropped and the yield curve flattened. She noted that TIPS outperformed treasuries. She said we should continue to see long-term bonds outperform short-term bonds because of the drop in interest rates. With regard to alternatives, RETS did pretty well in the quarter, benefiting from a rally in yields. She noted the fund's domestic equity managers tend to be underweight to REITS, so this impacted the active manager's relative performance. Commodities have been volatile because of turmoil in the Middle East. Finally, Ms. Magner noted that August, thus far, has been relatively flat, but there are still gains year-to-date.

Ms. Magner noted a new table that Mercer is providing in their report. Page 17 shows an outline of Plan options, and is included to help the Board think about the investment lineup going forward. She stated the trend in the marketplace is toward streamlining investment options, especially for funds which are large enough to utilize institutional managers. This can drive down fees. She stated that Mercer likes the structure the Plans are in today, but they see that participants don't tend to change their allocations once they are made, so rebalancing does not

occur. Mercer is planning to take a look at participant data for those who are not using GoalMaker and are perhaps not allocated correctly. This will help inform Mercer and the Board as to whether there need to be “core” based options. She noted the Board could still have all the current options “beneath the hood”. Ms. Henson pointed out that Mercer has done a great deal of work with the managers’ strategies so they offset each other well. Ms. Cochran asked whether this meant the diversification would be behind the scenes, and with core options does the Board takes away more of the risk that the participant won’t re-adjust? Ms. Henson said the mechanics of the current funds can be built into the core. She noted that perhaps there would not be six managers in an asset class; maybe the Board would determine it needed fewer. Ms. Magner said the Board and staff would have to see how they fit together because the Plans don’t want to end up having an index-type fund when the Board is paying active management fees. Ms. Buonfiglio asked if the Board could get the same help to participants who are not properly allocated through a communications strategy. Ms. Magner said yes, but the marketplace is going toward simplification. She noted she has some clients who have combined all their US active managers, and have done this with their global equity too. She said the majority of plans are eliminating separate style-specific funds, and rather separating them out according to US versus non-US. Ms. Buonfiglio said Board and staff should think about this over the next 18 months as the Plans go through the unbundling process. Ms. Cochran said she thought the Plans should be thinking about these decisions and their policy component, a logistics component, and communications component based on outcomes versus costs. Ms. Magner pointed out that GoalMaker would still utilize these underlying funds. Ms. Cochran stated she thought the goal is to try to get participants to use GoalMaker. Ms. Buonfiglio pointed out that new hires do this, but the Plans still have 50% who don’t use GoalMaker, and this new approach could be targeted to the non-GoalMaker participants. Ms. Buonfiglio sees these as complimentary strategies.

Ms. Cochran then asked about next steps. Ms. Buonfiglio said if the committee has interest, there should be an offline dialogue to see what the components and timing might be. Ms. Cochran stated she would like to see the costs involved and how many people are really being negatively impacted by not being properly allocated. Ms. Magner stated the first step is to take a deep look at participant behaviors and use this data to see if this makes sense to switch to core options. Ms. Cochran again stated it might be better to just educate participants to use GoalMaker. Ms. Buonfiglio said staff currently does this with the quarterly newsletter, webinars, etc. She said the Plans have a great deal of communication around GoalMaker and other asset allocation issues, but that should not prohibit the Board for looking at other strategies. Ms. Magner noted that if it turns out that a larger core strategy is appropriate, it might not be a large cost, because the Board might use the current managers. Mr. McCann from Prudential stated that since there has been a big communications strategy around GoalMaker, the Plans have seen participation go up. Ms. Cochran agreed the next step should be to get more information. Ms. Keech pointed out that some participants may be reluctant to go into proper allocation of funds because they do not want

to have to choose the funds, and others are in Stable Value because they don't want to lose their money. Mr. McCann pointed out that it is true many of the participants not in Goal Maker are in the Stable Value fund. Ms. Magner noted that page 18 of the presentation shows how participants are currently allocated. Finally, she pointed out that, as of next quarter, Wellington will be on the watch list for one year. Neuberger Berman was also on the watch list and has been replaced as of July 31, 2014. She stated that page 24 of the Mercer presentation show fees, and they continue to be very favorable. Recent, negotiations have resulted in lower fees in passive strategies that are not reflected in the Mercer chart. Ms. Cochran asked Ms. Magner if she had any concerns with the fees being charged. She said she did not. Ms. Buonfiglio pointed out that as of April 1, 2014, a significant reduction went into effect for the strategies managed by Blackrock.

Ms. Cochran asked about the transition from Neuberger Berman to Loomis Sayles. Ms. Henson said the transition is complete. As transition manager, Blackrock took over the portfolio as of July 31, 2014, and Loomis took control as of August 11, 2014. Ms. Buonfiglio stated that a complete update will be provided at the September Board meeting. She noted the importance of a transition manager, as the week of the transition was very volatile in the stock market. She also stated that with the new manager, the fee in this fund will go up slightly, from .555% to .598%. Ms. Magner turned the presentation over to Ms. Henson to discuss performance. Ms. Henson noted that Wellington has been on the watch list. Their underperformance in the last quarter was not dramatic. They were flat in July, which is what you would want to see. Their style has been out of favor in this market. Ms. Henson said they will present to the Board later in this meeting, and it will be good to hear what they say to see if the Board still has confidence in them. Ms. Cochran asked when a decision should be made about Wellington. Ms. Magner pointed out that all managers have cycles of underperformance, but the Board needs to look to see if this is what we expect with their strategy.

In the SMID area, Ms. Henson noted it was nice to see good performance from Earnest Partners because, previously, there had been some concern about them. Brown is down more than 6% to the benchmark. The most recent quarter they are down 5%. This is caused by stock selection in consumer discretionary and healthcare. They will continue to be watched. Ms. Cochran asked Mercer to keep the Board informed if they see any major changes going on with investment managers. Ms. Henson agreed.

Ms. Henson discussed the international and global funds. She pointed out there was volatility in the emerging markets. The funds' managers have done well versus benchmarks, but not among peers, because of manager exposure to emerging markets.

The Inflation Responsive Fund has done well. Year-to-date, they returned 8.7%. Ms. Henson noted the fixed income fund is doing well. Ms. Buonfiglio wanted to discuss PIMCO and their asset outflows. Ms. Henson said they have rehired Paul McCully who retired in September of 2010. He is their economist, and will not be in a PR role. Mercer thinks it shows well for PIMCO that they were been able to hire him. Ms. Buonfiglio asked how the new executive team structure is working. Ms. Henson said, from her knowledge, it seems to be working out well. She said PIMCO has a very deep talent bench, but this fact doesn't make the headlines. Ms. Magner said PIMCO had reached out to Mercer to discuss what was going on. Mercer did an analysis on outflows. It does seem like a lot when you look at dollar value, but as a percentage of assets, it was consistent with what other bond funds saw during the same period.

Ms. Baran asked what would happen if Bill Gross left the firm. Ms. Magner said Mercer would have to evaluate that in the context of the broader market. Ms. Henson said Mercer would be able to re-evaluate quickly and make a decision. Ms. Henson pointed out the Plans do have the Inflation Responsive and Stable Value funds managed by PIMCO, as well as the Core Bond portfolio.. Ms. Baran said she just wants to make sure the Board has a strategy in place should there be changes within PIMCO.

Ms. Henson stated that nothing in the compliance summary had changed quarter-to-quarter. She noted, as she has mentioned on a number of occasions, that fixed income is out of compliance because certain sectors are overweight. The Board and staff have acknowledged this fact, and determined it did not represent a significant risk to the portfolios. However, this issue will be addressed in the investment policy statement review. Ms. Henson then stated that part of the unbundling project will be to renegotiate all of the contracts with investment managers and, at that time, staff will make the manager's guidelines consistent with the updated IPS.

AGENDA ITEM – INVESTMENT POLICY STATEMENT PROJECT

Ms. Henson turned this part of the discussion over to Ms. Manger. Ms. Manger explained that with regard to a Plan's investment policy, there are two trains of thought in the marketplace. Some plans have a brief investment policy statement, and other plans have more detailed statements. She said regardless of the type of investment policy statement, the Board should strive to document their process. She said Mercer's IPS's are a little more detailed than most, and the North Carolina Plans have a highly-detailed policy. Ms. Magner believes some items in the current policy statement are not necessary and could lead to confusion.

Ms. Magner went through typical components of an IPS. Her view is that investment guidelines do not need to be in the policy. These are items such as benchmarks and roles and responsibilities are typically defined in the manager's investment guidelines, not in the investment policy statement. The Board might want to consider removing these items and have them defined separately in the manager's guidelines. Ms. Cochran said it would be nice to see the IPS at the beginning of the Board

materials. Ms. Baran agreed this would be helpful. Ms. Magner said she would like to have a high-level focus in the Mercer Board report. Ms. Cochran stated the Board needs to remember the Plans' vision, mission, and goals. Ms. Buonfiglio agreed.

Ms. Henson said Mercer would bring a revised draft IPS to the Board in November of 2014, and seek to finalize the project by August 2015.

Break 11:00-11:15

AGENDA ITEM – INVESTMENT MANAGER PRESENTATION

Ms. Baran welcomed Wellington Management and thanked them for coming to make a presentation to the Board.

Elizabeth O'Hara, Relationship Manager for North Carolina, introduced herself, along with Matt Baker Partner and Portfolio Manager of the Large Cap Value Fund, and Ellen Chae, VP and Investment Director, Equity Product Management.

Ms. O'Hara explained that Wellington manages three portfolios for the Supplemental Retirement Plans, but the focus for today is on the Quality Value portfolio. In addition, Wellington has managed a portfolio for the state's pension for a long time. She said she understands the Board's concerns with the performance of the Quality Value portfolio, but she said nothing has changed in this portfolio except the market environment, and she stated how much Wellington values its relationship with North Carolina. She gave a brief update on the firm. She noted that it is a partnership structure, and there are about to some personnel changes at the highest level of the firm, as several retirements are about to take place. The firm has been preparing for this turnover in advance. She stated Wellington is not only a money management firm, but a research firm, as well, and the portfolio managers rely on these deep specialist researchers. She then turned the presentation over to Mr. Baker.

Mr. Baker stated that, regardless of the market environment, his team of portfolio managers sticks to their philosophy and process. They believe that over a cycle, wealth creation is more effective when you take risk out of the portfolio. This gives protection on the downside. They minimize risk by thinking about the quality of the companies in which they choose to invest. They look at companies that create value over a long term; companies that can weather any type of environment. The team likes companies that are innovative, have good management, and generate a lot of cash flow. They also look to consistent performance. A lot of time is spent evaluating management teams and their 3- to 5-year strategy. Also they judge a management team by how they distribute the value they make: cash should be disseminated in dividends and

stock buy backs, not necessarily put back in to the business if that capital doesn't offer a high rate of return. They favor companies that pay dividends.

Mr. Baker stated another way his managers take risk out of the portfolio is to look at what happens over a complete economic cycle. They like to invest in companies when they see a price trough. Their strategy is to take advantage of the price run up between a trough and normal "pricing." There are two different investment theories at work. The first is to look at a highly-levered company or the second invest in companies with a high-quality balance sheet. Mr. Baker gave the example of one of their portfolio investments: Ralph Lauren, which has missed some trends, and now spending a lot of money to bring everything under one platform. This stock has sold off, but Wellington thinks it is a good long-term brand.

Again, Mr. Baker pointed out that Wellington takes the long-term view. It can take management teams 3 to 5 years to make long-term changes. He noted his team has been with Wellington since 2000. Microsoft, J&J, and Pfizer are examples of companies that have been in portfolio for a long time. The team creates risk / reward ranges as part of their sale discipline.

Ms. Baran asked about the average yield and average growth rates of the portfolio. Mr. Baker stated the yield is 2.5% versus the Russell 1000 at 2.3%. Again, he noted the portfolio is dividend-focused, not yield focused. He thinks value managers who look at yield as a factor can get themselves into trouble. Ms. Keech asked about Pfizer. Mr. Baker stated the portfolio is fairly overweight in healthcare, and he explains his views around cancer drugs and the upsides in the pharmaceutical industry.

Ms. Cochran asked about the investment philosophy – if value creation is in the future will Wellington have to wait to realize positive performance. Mr. Baker gave the example of Ralph Lauren. The team wanted to see if the SAP rollout was going to be okay. They view Ralph Lauren not as a retailer, but as a wholesale manufacturer. Ralph Lauren is adding additional flagships store as a marketing strategy. Ms. Cochran asked about Wellington's sell discipline. Mr. Baker stated that once the risk/reward factors are negative, the sell strategy is triggered. He said Wellington never sells all at once, but that they sell over time. On rare occasions, they would sell all at once if something significant occurred. Mr. Baker gave the example of Mattel. Last year, the company made some missteps. Ms. Cochran asked Mr. Baker how he believes companies create value. He said his team measures investment and innovation. He said they look at capital intensity and look to see if spending makes sense. Ms. Buonfiglio said the factor analysis was interesting. Behind Tab 5 of the presentation was a historical active factor exposure analysis. Mr. Baker stated this chart highlights that they deliver a philosophy and a process that puts that philosophy in place. This shows that in down markets, Wellington Quality Value will

outperform, but in speculative markets, the portfolio is likely to underperform. In a normal market, the portfolio should match the market.

Ms. Chae noted she has a different reporting line than Mr. Baker, and is an independent voice in the firm. One of her primary responsibilities is to look at the performance of the fund. Ms. Chae explained the factor analysis chart and highlighted that the portfolio is structured in a manner consistent with the philosophy and process of the portfolio. Ms. Chae noted that leverage and volatility have been performing well, as of late. This portfolio is safely-oriented and safety today is not cheap. Ms. Cochran asked what drives the upside in the portfolio. Ms. Chae said rotation to a normal market. Ms. Cochran asked Mr. Baker what his goals are for performance. Mr. Baker stated that the last three years have been awful. He said his hope for the portfolio is that it gets to show it is a very well thought-out investment philosophy overtime. He said he wants to see the market normalize. He says the excessive risk taking in the market can't keep going.

Ms. Keech asked when a market correction might take place. Mr. Baker stated there has not been a correction in three years, and that is not sustainable, but he doesn't know what is going to trigger it. He said it is encouraging the US economy is doing reasonably well. Energy prices are coming down. Some of the other emerging markets seem to be stabilizing. Mr. Baker stated he thinks we could be in a period of steadily improving markets because the US consumer balance sheet is good. He thinks the risk has to come out of the market, and that typically happens over a period of time. Unwinding the liquidity that has been added to the market might trigger a correction.

Ms. Baran asked for any more questions. Mr. Baker ended by saying the Board should be concerned if we go into a period of a down market and this portfolio did not do what it was supposed to do.

Ms. Baran told them that the Board's process is that after four quarters of underperformance, the Board asks Mercer to evaluate alternative managers and determine if a change in the portfolio should be recommended. Ms. Keech agreed with this. Ms. Baran thanked the Wellington team for their presentation.

AGENDA ITEM – SUBCOMMITTEE MEMBERS QUESTIONS

Ms. Baran personally thanked Ms. Keech for her service. She is term-limited, and now has to be replaced. The rest of the committee thanked Ms. Keech for her years of service and contributions to the Board of Trustees.

AGENDA ITEM – PUBLIC COMMENT

No public comments were offered.

A motion to adjourn was made by Ms. Cochran, seconded by Ms. Keech, and unanimously passed. The Subcommittee adjourned at 12:25 p.m.

CHAIR