

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

MINUTES OF MEETING

November 14, 2013

Time and Location: The Investment Subcommittee (the “Subcommittee”) of the Supplemental Retirement Board of Trustees (the “Board”) met at 9:00 a.m. on Thursday, November 14, 2013 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. One position on the Subcommittee was vacant, as Charles Leedy resigned from the Board and the Subcommittee prior to the meeting.

Staff and Guests Present: The following staff and guests attended the meeting. From the Department of State Treasurer: Steve Toole, Mary Buonfiglio, Blake Thomas, Kevin SigRist, Rhonda Smith, Rekha Krishnan, Koreen Billman, Lisa Page, Jaclyn Goldsmith, Tim Viezer and Mary Laurie Cecc. From Prudential Retirement: Michael McCann, Jennifer Willis, Jessica Quimby, Travis Swartwood, and Rob Luciani. From Mercer: Jay Love and Kelly Henson. From Nationwide: John Piper.

AGENDA ITEM – WELCOME AND INTRODUCTIONS

The meeting was called to order at approximately 9:05 am. Ms. Baran welcomed everyone and introduced Tim Viezer as the new Director of Public Equity for the Investment Management Division.

AGENDA ITEM – ETHICS AWARENESS & 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 that the minutes from the August 15, 2013 Investment Subcommittee were included in the Board book for reference only. The minutes were approved in the September 18th meeting of the full Board.

AGENDA ITEM – STABLE VALUE PORTFOLIO REVIEW

The Chair recognized Andy Apostol from Galliard to present a review of the Stable Value fund (“SVF”) for the 401(k) and 457 Supplemental Retirement Plans (the Plans). Mr. Apostol began by giving an update on Galliard. He noted that Galliard’s assets under management had increased over the last year to \$85.5 billion.

Mr. Apostol gave an update on the process of adding additional wrap providers to the SVF. In October a new wrap contract was entered into with American General. He noted this was done after the end of the quarter, so information on American General’s allocation was not reflected in the written presentation. Mr. Apostol also noted that starting in January, the SVF will begin the planned gradual decrease of 3% in the allocation of assets to Great West. When the transition is complete, Great West will have a total allocation of 20%.

The SVF now has five Investment Managers with Prudential having the largest allocation. Mr. Apostol explained the allocation changes in the portfolio. The assets transitioned out of Great West have been taken on by Prudential and Jennison. Ms. Baran asked the reason for the increase in number of managers. Mr. Apostol stated that the additional managers give the fund an appropriate style diversification. Ms. Cochran asked about the ideal number of managers. Mr. Apostol stated that industry best practice is between 3 and 6 for a fund the size of the SVF.

Mr. Apostol pointed out that on the Annualized Performance Table, a blended benchmark was added as requested by former board chair Libby George. He also noted that Book Value Performance amortizes the gains and losses of the underlying assets. As of the end of the 3rd quarter, the total assets in the 401(k) fund were \$1.84 billion and the average credit quality of the underlying assets was AA+.

Mr. Apostol then presented reports on the SVF’s performance for the 3rd quarter of 2013:

- The SVF’s blended yield was 2.02% net of fees.
- The effective duration was 3.24 years.
- The market to book value ratio was 101.85%.

Mr. Apostol noted that the blended yield was now being reported net of fees, a change from the past reporting. He also stated that if interest rates fluctuated up or down by 50BPS and cash flows were unchanged, he would expect the crediting rate to be between 1.65% and 1.96% over the next year. He also noted that interest rate movements in 2013 substantially affected the market value to book value ratio.

Finally, Mr. Apostol reviewed performance of the particular investment managers in the SVF. He stated that he did not anticipate changing any of the managers at this time. With regard to wrap issuers, the fund is looking to improve the terms of the contract with Mutual of Omaha. Ms. Baran asked about the large SVF cash outflow in September of 2013. Mr. Apostol answered that this had to do with the rebalancing of GoalMaker, particularly with the introduction of the PIMCO inflation protection fund.

He commented on the performance of individual managers. Galliard had a little bit of underperformance. Prudential is performing as expected. PIMCO had a little trouble over the last year. Great West is hard to compare to a benchmark because they are heavily weighted toward mortgage backed securities, but Mr. Apostol said this is a complimentary strategy to the rest of the portfolio.

Mr. Apostol then asked if there were any questions. Mr. Toole asked if there was a slide that showed the competitiveness of all fees versus a peer group. Mr. Apostol answered that there was not one that showed competitiveness, but that all fees were shown on slide 9. Mr. Toole asked if Mercer and Galliard could work together to come up with a chart analyzing competitiveness of fees. They agreed to do so.

AGENDA ITEM – ECONOMIC OVERVIEW AND 3RD QUARTER INVESTMENT PERFORMANCE REPORT

The Chair then recognized Jay Love and Kelly Henson from Mercer, who presented a summary report of general market conditions and a report on the performance of the funds offered as investment options under the Plans.

General Market Conditions

Mr. Love described the third quarter as very strong overall for the markets. Domestic equities did well, with smaller cap stocks rising even more than large cap. Mr. Love noted this same theme could be seen in the performance of the Plans' funds; the riskier areas of the markets saw better performance relative to less risky areas. In looking at performance of US equities by sector, he said it appears that for the full year most every sector will be up over 10%. Emerging markets also did better this quarter, but it is still a challenging environment for emerging markets. Fixed income was flat for the quarter and negative year to date.

Mr. Love noted that for the third quarter, the top performing sectors were materials, industrials, consumer discretionary. Telecom, utilities and consumer staples trailed. Ms. Baran asked if Mercer thought the challenges surrounding the rollout of the Affordable Care Act would affect the health care sector. Mr. Love said that they thought it would, but it was difficult to say how.

Ms. Cochran stated that she thought health care insurers could be running into headwinds, but they had not seen a decline yet. Ms. Smith noted that the investment manager Brown Advisory, who was presenting to the Board later in the meeting, might be able to answer these questions. Ms. Keech asked Mercer what they thought the effect of Janet Yellen's appointment to be Chair of the Federal Reserve would be. Mr. Love said that it was the general opinion that Ms. Yellen may be more willing to keep interest rates down than Mr. Bernanke.

Mr. Love went on to say that the U.S. equity market appears slightly overvalued. He believes earnings need to rise to justify current valuations, but that equities are still more attractive than bonds. European equities appear to be cheap compared to the US and valuations of emerging markets are above developed markets. Fixed income has been volatile but the quarter ended slightly the same as it started. The yield curve has steepened a little bit. Corporate yields declined a bit during the quarter, but they are still more attractive than treasuries. High yield is the best performing area of fixed income for the quarter. Mr. Love reviewed performance of various asset classes, with most doing well except for emerging markets, which declined during the quarter.

Performance of Particular Managers and Participant Investment Options

Mr. Love turned to the specific performance of the each of the funds and fund managers that are in the Plans. He noted that the Performance Scorecard found in the Subcommittee materials has been modified a bit from past reports, since the industry tends to evaluate based on a more rolling environment. The Scorecard now presents performance on a rolling three year basis as of the third quarter and the previous two quarters. Mercer thinks this should aid in providing an early warning system for underperforming funds.

Moving to a specific example, Mr. Love gave the example of Wellington Quality Value Fund, which featured "X" marks (meaning performance beneath the benchmark) across the time periods. Mr. Love stated this pattern would require looking into, but cautioned that this sort of performance would not necessarily suggest replacement of a manager like Wellington, since that particular Wellington fund is playing a defensive role in the portfolio and would expected down in an up market.

Mr. Love pointed out that Neuberger also has more red X's than other funds. They also play the same defensive role in the growth area; however, Mercer is still watching them closely because of the changes in their management structure. Ms. Henson pointed out that this type of performance from defensive funds is typical. Ms. Baran asked if there were other fund manager who could play the same portfolio role as Wellington and Neuberger, but do it better. Mr. Love stated that Mercer is always looking at other managers, but he thinks the answer is no. He said what makes the Plans do so well overall is that there are complementary managers and a

diversified structure. Ms. Cochran asked about Mercer's communication with Neuberger. Mr. Love said that communication is good, but Neuberger is feeling pressure, so they need to be watched closely. Mr. Viezer added that defensive strategies are necessary in the portfolio because you don't know the future.

Mr. Love pointed out that there would be a recommendation to put Wellington on a watch list later in the presentation. Ms. Baran asked how long a fund would stay on the watch list before a decision is made whether to keep them. Mr. Love said it is important to see how they perform in different markets. Ms. Smith said that on the defined benefit side, they like to see how a manager performs through a market cycle. Ms. Baran noted that it would be helpful for the committee to have clearer standards for underperforming funds. Mr. Toole added that he thinks putting underperforming managers on a watch list is appropriate. Mr. Thomas suggested that a thorough evaluation should take place after a year when the fund is on a watch list. Mr. SigRist agreed. At this time, Ms. Baran requested that Mercer present a retention review memorandum after a fund has been on a watch list for four quarters. Ms. Billman asked if this retention review memorandum would provide alternate managers. Mr. Love stated they could do that.

Ms. Kecch made a motion, seconded by Ms. Cochran, that Mercer provide a retention review memorandum and recommendation to the Subcommittee after a firm has been on the watch list for four quarters. The motion was unanimously adopted.

Mr. Love reported:

- The Mid/Small Cap Value fund slightly underperformed because Earnest Partners is running a little behind.
- The Large Cap Passive fund is tracking relative to the benchmark.
- The Large Cap Value fund is outperforming the benchmark.
- The Large Cap Growth fund is doing well. Large Cap Growth fund component Sands Capital is one of the top performing large cap growth funds in Mercer's universe.
- International Equity has been one of the weaker areas. Baillie Gifford has done pretty well, but Mondrian's slightly more defensive tilt has hurt the strategy.
- Global Equity is performing well and is 7% above benchmark.
- Active Fixed Income is above benchmark.
- The Mid/Small Cap Growth fund has had mixed performance. Brown Advisory has beaten the benchmark over all time periods.
- Stable Value is performing well relative to other stable value funds.

There was discussion as to whether Earnest Partners should be put on a watch list. Ms. Baran said she was willing to re-evaluate the issue at the end of the year and see their fourth quarter results.

Ms. Keech made a motion to put Wellington Quality Value on a watch list seconded by Ms. Cochran. The motion was unanimously approved.

Fee Discussion

There was a discussion of the recent fee review. Ms. Smith stated that she continues to work with Mercer to get fee reductions. Hotchkis has agreed to a fee reduction at the end of the year. Sands said they are working on giving the lowest possible fee. Ms. Baran asked if it might be good to see a chart of exact dollars going to managers on an annualized basis. Mr. Toole pointed out that the administrative fee of the Funds is being reduced by two basis points starting in calendar year 2014. Cochran asked how the Stable Value fund compared to cash. Ms. Henson answered that the alternative would be a money market fund and Mercer feels Stable Value will outperform a money market.

The Chair adjourned for a short **BREAK** at 10:30 a.m. The Subcommittee reconvened at 10:40.

AGENDA ITEM – INVESTMENT MANAGER PRESENTATION

Ms. Henson commented that Brown Advisory had been asked to come before the Board to make a presentation because Brown Advisory was in the process of changing its portfolio management structure for its small cap fund from two decision makers to one. At this time Chris Berrier, portfolio manager for the Small Cap Growth Fund and Trish Carroll, Client Service Manager of Brown Advisory were asked to join the meeting. The Brown Advisory Small Cap Growth Fund is a component of the Supplemental Retirement Plans' Mid/Small Growth investment option.

Ms. Carroll gave some background on Brown Advisory. She noted that it was founded in 1993 and that all full time employees had an equity ownership in the firm. Brown holds \$42 Billion in assets under management, with half private client money and half institutional. Small Cap Growth is Brown's third largest strategy in terms of assets. The Plans are the only public funds client in the Small Cap Growth strategy. The fund currently manages \$1.725 billion; there will be a soft closing of the strategy when it reaches \$2 billion.

Ms. Carroll went on to describe the shift in portfolio management responsibilities. Tim Hathaway has been managing the strategy since 2004, and Mr. Berrier and Mr. Hathaway have been co-managers for the strategy since 2006. Mr. Hathaway is assuming new responsibilities as

Head of Research for Brown. This transition will take place over time. Mr. Berrier will be the lead portfolio manager, with Mr. Hathaway as a sounding board.

Mr. Berrier stated that he and Mr. Hathaway developed the small cap growth strategy and core principles for the fund in 2006; this transition would not change that. Ms. Smith asked if Brown was adequately staffed, given the growth in assets it has experienced. Mr. Berrier noted that the firm has added four analysts in the last year and are expected to add one to two per year after that. He noted that the firm wants to keep an intimate and very collaborative atmosphere. Ms. Smith asked for the number of other strategies for which his team of analysts were responsible. Mr. Berrier answered that the analysts cover six other strategies, but they are divided up by sector.

Mr. Toole asked why Brown hired from within by promoting Mr. Hathaway. Mr. Berrier said that Mr. Hathaway was the best person for the job. It was also decided that a person from the outside might bring in too big a shift to the firm's culture. Mr. Toole asked how this change from two to one portfolio managers would benefit the State of North Carolina. Mr. Berrier said that the firm would be able to generate more investment ideas because he has a closely aligned partner in research. Mr. Toole asked how many analysts worked with the fund and what was their tenure. Mr. Berrier stated that there were three or four new analysts in the past several years, with all coming from industry sectors rather than the finance sector.

Ms. Baran asked how they thought health care would be affected by the Affordable Care Act. Mr. Berrier said that health care sector investment was challenging because the rules of the game keep changing. He thinks the sector will continue to grow, but an investor has to be cautious. Ms. Cochran asked whether the portfolio uses just fundamental analysis or also technical analysis. Mr. Berrier stated only fundamental; technical analysis is a consideration only at the very end of the process. Ms. Cochran then asked Mr. Berrier how much time he spends on client service. Mr. Berrier responded that because of the soft close, very little.

Mr. Berrier then went on to describe the investment process and philosophy of the fund. The fund focuses on smaller companies and looks for inefficiencies that can be exploited. They do concentrated investments. There are only 50 companies in the portfolio, but they have diversification to manage risk. The portfolio is benchmark agnostic. Ms. Buonfiglio asked if Mr. Berrier is the person making the ultimate determination on an investment. He said yes, but he does this with a great deal of analyst input. At this point, Mr. Berrier walked the Subcommittee through a specific example of his investment process with a company. Then, he described the portfolio's historical performance. He summed up his remarks by noting his enthusiasm for small cap investing, noting that over a 100 year history, small cap stocks outperformed large cap stocks.

Ms. Baran thanked Mr. Berrier and Ms. Carroll for their presentation. Mr. Berrier and Ms. Carroll left the meeting.

Mr. Toole asked Mr. Love and Mr. SigRist if there were any steps that should be taken. Mr. Love stated that he did not believe Brown Advisory needed to be added to a watch list, but should be monitored closely. Mr. SigRist agreed. Ms. Cochran pointed out that it appears the portfolio has a clear process and therefore is less likely to have significant change under new structure.

A motion was made by Ms. Cochran, seconded by Ms. Keech, to conduct enhanced monitoring for Brown Advisory over the next 12 months. The Board unanimously approved the motion.

AGENDA ITEM – INVESTMENT POLICY STATEMENT PROPOSED MODIFICATIONS

The Chair recognized Ms. Henson, who explained the need for the proposed change in the Large Cap Growth fund guideline for individual security limits. The change would be in the guideline concerning individual securities limits. The overall fund would still have a limit of a 10% maximum of any one security, Ms. Buonfiglio stated that procedurally this is coming to the Subcommittee so that they can discuss and then make a recommendation to the full board. The Subcommittee then had a discussion regarding the proposed change.

Ms. Keech made a motion, seconded by Ms. Cochran, to approve this recommendation, as stated in the materials presented to the Board. Unanimously approved.

AGENDA ITEM – INVESTMENT MONITORING

Mr. Love presented the quarterly investment monitoring report, prepared by the Plans' staff, Mercer, Prudential and Galliard. Mr. Love noted that there were no technical violations at either the fund-level guidelines or manager-level guidelines. There were a few instances in which the manager would be in violation of the fund-level guidelines where those guidelines to apply to the manager individually. Mercer had no concerns with these instances.

Mr. Love did point out that with regard to PIMCO, their exposure to industrials could be too low, but they think this could be temporary and are monitoring it.

At this point, Ms. Cochran had another engagement and left the meeting.

AGENDA ITEM –DETAILED INVESTMENT MANAGER FEE ANALYSIS

Ms. Baran noted that Mercer's detailed fee analysis would be presented to the full Board at the next meeting. Mr. Love explained that Mercer looked at each manager, taking into consideration the size of account and fees being paid. Mercer then ranked them as compared to other managers. Mr. Love stated that overall, it looks as though the Plans are getting very good value for its fees. Ms. Buonfiglio noted the difference in scope of analysis between this report and the CEM report. Ms. Baran asked if Mercer could provide an analytical memorandum be prepared regarding the meaning of this report when sending it to the full Board for a recommendation.

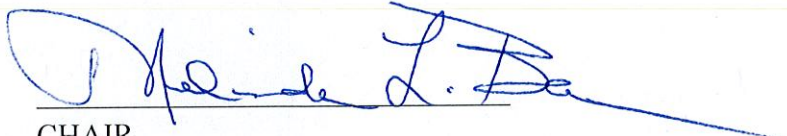
AGENDA ITEM – SUBCOMMITTEE MEMBERS QUESTIONS / COMMENTS

Ms. Baran noted Mr. Leedy's resignation from the board and that he was missed at the board meeting. Ms. Baran asked that this be put in a resolution for the full board meeting. There were no additional questions or comments from members of the Subcommittee.

AGENDA ITEM – PUBLIC COMMENT

No public comments were offered.

A motion to adjourn was made by Ms. Baran, seconded by Ms. Keech, and unanimously passed. The Subcommittee adjourned at 12:10 p.m.



CHAIR