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NORTH CAROLINA
TOTAL RETIREMENT PLANS
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INVESTMENT SERVICE MODELS

INVESTMENT ADVISORY SERVICE APPROACHES

- There is a wide range of service models from which institutional plan sponsors can choose when determining the most appropriate investment advisory service relationship.
- There is not a standard service model, as every institutional plan sponsor has different goals, resources and desire for control.
- The table on the following page differentiates between the traditional non-discretionary consultant relationship and discretionary manager (“Outsourced Chief Investment Officer“ (OCIO), “ERISA 3(38)”) model.
 - Most plan sponsors’ needs fall somewhere in the middle of the two, resulting in increased interest in “hybrid” approaches.

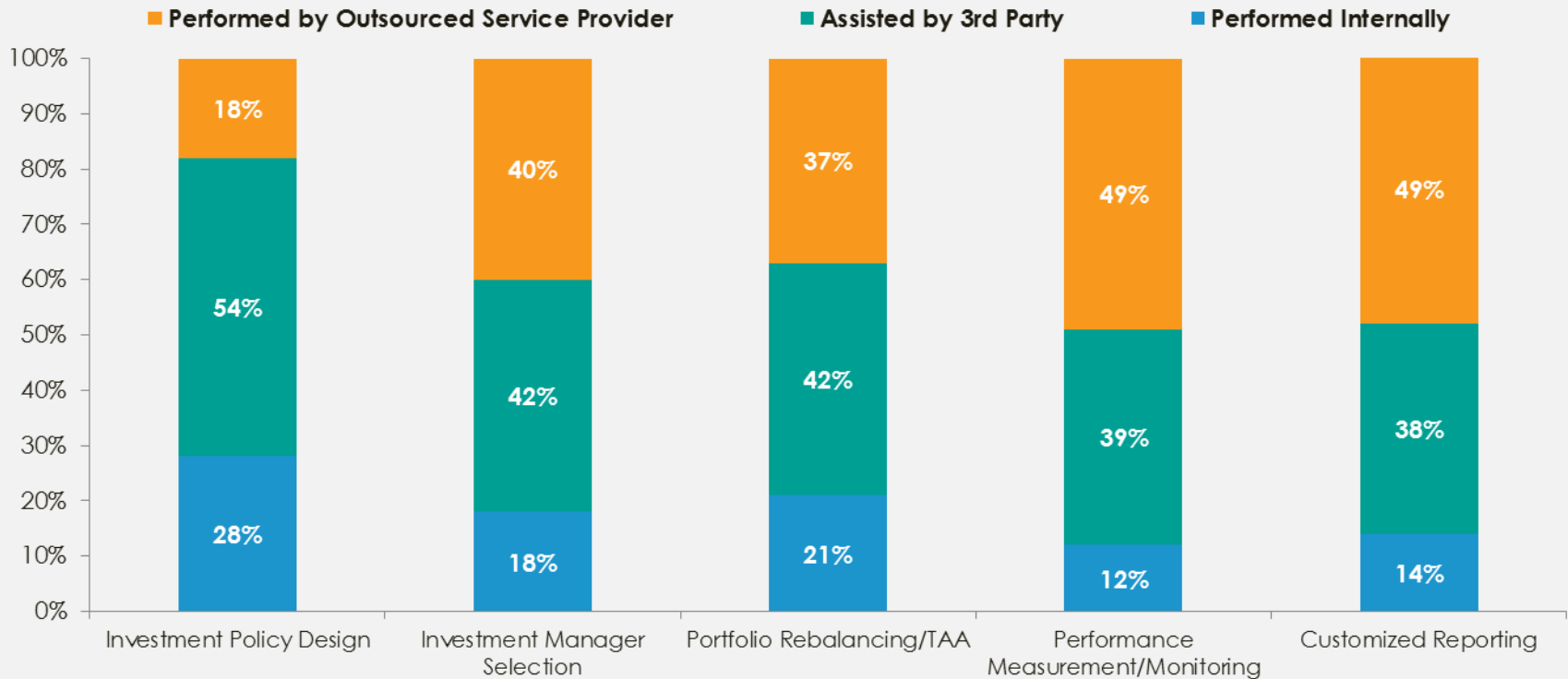
INVESTMENT ADVISORY SERVICE APPROACHES

Range of Service Models

Traditional Consulting	Needs	Outsourced CIO (“OCIO”)
Board/Consultant	Investment Policy Development including asset classes offered on DC menu	Board/Consultant
Board/Consultant	Implementation Approach (active, passive)	Board/Consultant or OCIO
Board/Consultant	Fund and Glidepath Construction (single or multi-manager)	Board/Consultant or OCIO
Board/IC/Consultant	Manager Selection/Termination	OCIO
IC/Consultant	Portfolio Tilts, Rebalancing and Transition Management (within multi-manager structure)	OCIO
IC/Consultant (Quarterly)	Manager Monitoring and Policy Compliance	OCIO (Potential for daily)
Consultant	Performance Reporting	OCIO
IC/Consultant contract directly	Contracting	Single Contract with OCIO
Slowest	Implementation Speed	Fastest

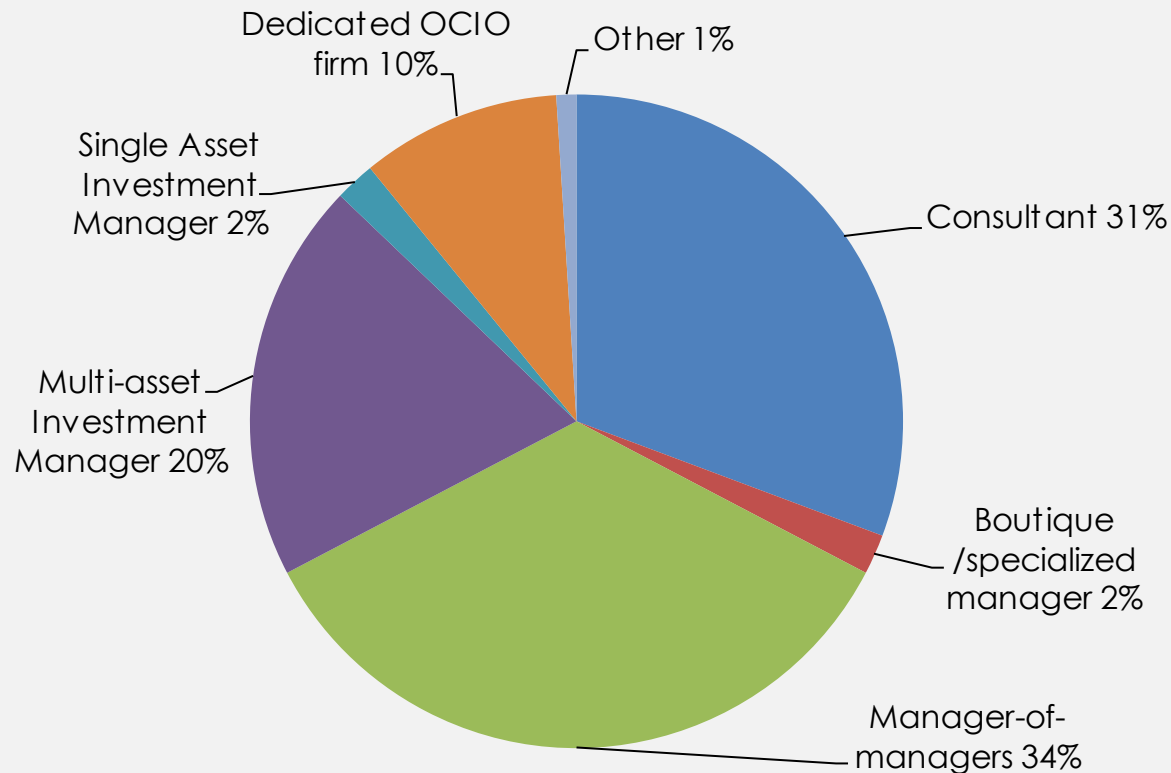
INDUSTRY TRENDS – OUTSOURCED CIO SERVICE USAGE

- With few defined contribution sponsors electing an outsourced CIO structure, much of the available survey data and trend information is based on public and corporate pensions, foundations/endowments and other types of investment pools that have been quicker to delegate investment services to outsourced providers.
- Anecdotally, we have observed defined contribution sponsors who have elected to outsource generally following a similar pattern of retaining strategic activities, such as investment policy design, while delegating investment manager selection, portfolio rebalancing and manager monitoring.



TYPES OF OUTSOURCED INVESTMENT PROVIDERS

- The chart below details the different types of investment firms employed by Plan Sponsors that are using outsourced investment services. In general, the majority of plans surveyed are using firms such as consultants or managers-of-managers.



INDUSTRY TRENDS – OUTSOURCING FEE STRUCTURE

- Performance fees tend to be the least common of the various fee structures.

Fee Structure Trends		
	<u>2013</u>	<u>2014</u>
Flat Fee	41%	54%
Performance Fee	11%	12%
Sliding Asset-Based Fee	53%	38%
Other	7%	10%

Mercer has been chosen as the Investment Consultant to the Board. At the Board's discretion, Mercer may serve in the capacity of a 3(21), 3(38) or a hybrid of the two.

Mercer has proposed a sliding asset-based fee for their services.

REASONS FOR OUTSOURCING

- The most important reason noted for moving to an outsourced approach is a lack of internal resources.

Top Seven Reasons for Outsourcing

Lack of Internal Resources

Additional Fiduciary Oversight

Better Risk Management

Need to Increase Returns

Faster Implementation/Decisions

Cost Savings

Desire for Strategic Partnership

Interestingly, the ability to make faster implementation decisions is considered less important by the majority of plan sponsors surveyed, though we would argue it is one of the more important advantages.

PERCEIVED ADVANTAGES OF OUTSOURCED CIO APPROACH

- Some of the perceived advantages of an OCIO approach relative to a traditional consulting approach include:
 - **Reduced opportunity costs due to faster implementation of new investment ideas or strategies**
 - May be more meaningful in a portfolio (i.e. pension) context and less applicable to DC plans where new asset classes will likely still be vetted by the Board.
 - **Enhanced fiduciary oversight given continuous monitoring of the investment portfolio and the rapidly changing regulatory environment**
 - Ability to move to more “real-time” portfolio monitoring vs. lagged reporting to satisfy the quarterly Committee cycle.
 - **Ability to focus more Board and internal resources on the core areas of the organization’s business**
 - Shift focus to strategic plan oversight and operational continuity during times of turnover.
 - **Potential for cost compression through bundled managed contracts**
 - Beneficial for smaller plans; less so for large State Plans.
 - **Sustainability**
 - Ability to create consistent processes and procedures within organizations that experience turnover that is detrimental to decision making

INDUSTRY TRENDS – CRITERIA FOR SELECTING AN OCIO

- Experience and breadth of services tend to be the key factors when selecting an OCIO provider.

Top Five Reasons for Selecting an OCIO

Breadth of Capabilities/Services

Reputation/Recommendation of Peers

Experience of Top Management

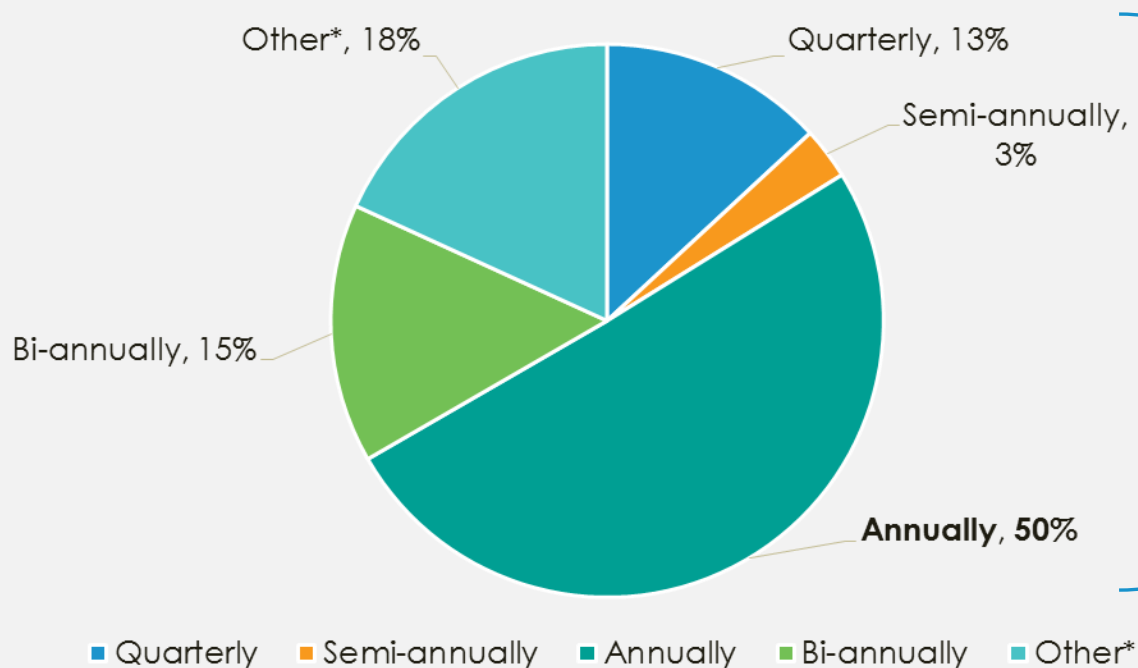
Client Service

Price

Within a Defined Contribution Plan environment, manager selection, implementation and daily portfolio oversight are critical areas for candidate assessment.

FREQUENCY OF OCIO EVALUATION

- Hiring an OCIO may require an additional layer of review on a periodic basis to ensure that the provider is meeting expectations.
- Outlined below is an excerpt from the Chatham Partners 2014 outsourcing survey on the frequency with which plan sponsors evaluate their OCIO provider.



Establishing a process for monitoring the OCIO manager is critical, particularly in the areas of policy compliance, policy implementation, daily oversight, performance, and fees.

*Other includes as needed, 3-5 years , or not available.

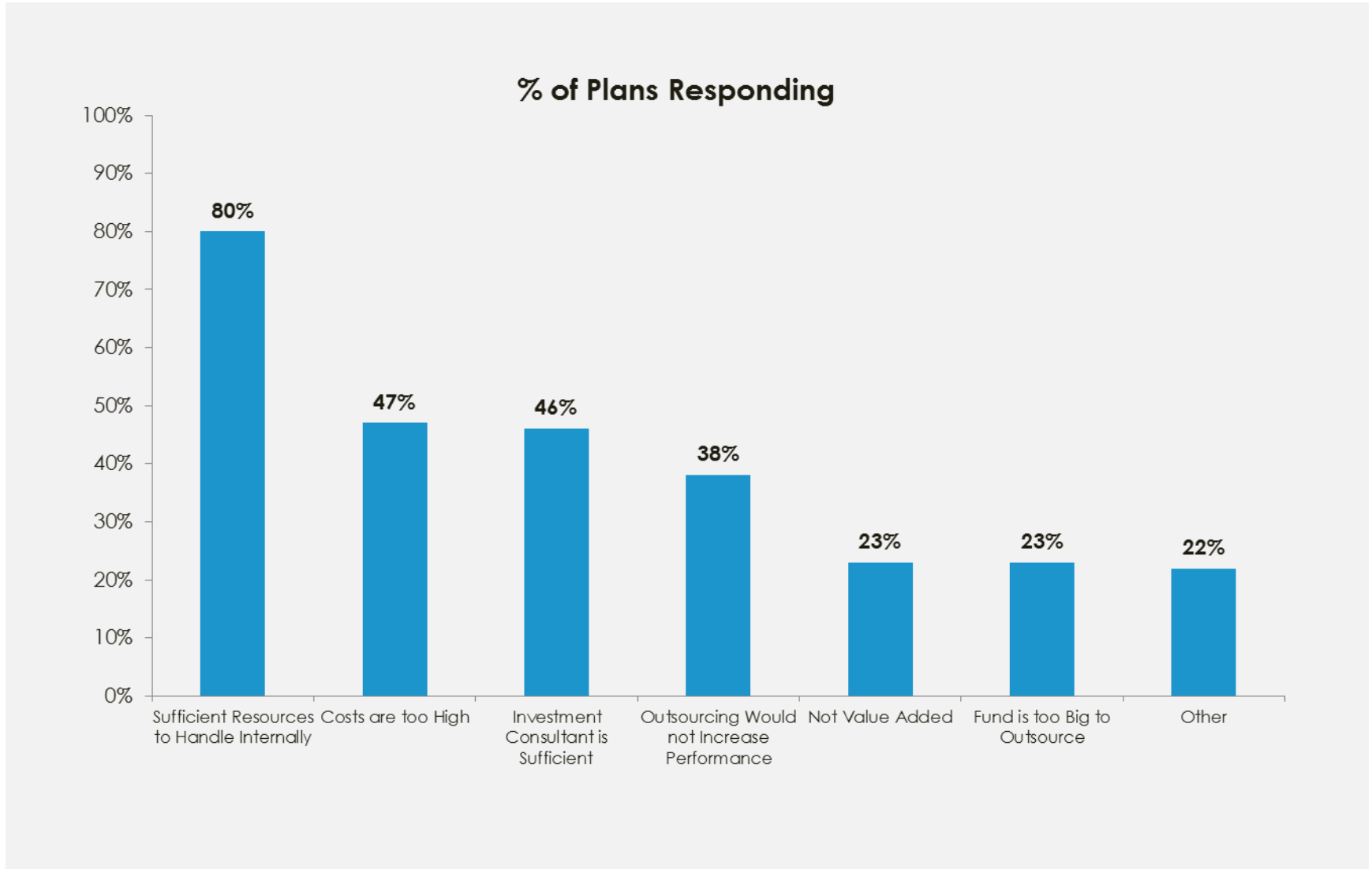
MARKET DYNAMICS

- Despite general sentiment that outsourced investment management is on the rise, a recent industry survey by Chatham Partners indicates that the current market dynamics are less clear. Some of the findings of the study include:
 - **Moderate to low satisfaction levels with CIO/investment outsourcing providers** — Institutional buyers' decision to outsource and their evaluation of partners is primarily based on their ability to generate investment returns, and satisfaction in that regard is muted. Only 23% of organizations that outsource are very satisfied with investment performance.
 - **Moderate up-sell potential within organizations that outsource** — Of the respondents that currently outsource, only 23% indicate that they are likely to increase the percentage of assets under management that are outsourced. Additionally, only 17% of these respondents are looking to add additional services.
 - **Entrenched bias among organizations that do not outsource** — Only 6% of organizations that do not currently outsource are likely to consider utilizing an outsourced provider in the next 24 months. Their rationale is clear; they do not believe that outsourcing will produce better results than they can achieve on their own. Additionally, they believe that outsourcing is expensive and fails to mitigate the risks that trustees face as fiduciaries.

PERCEIVED DISADVANTAGES OF AN OCIO APPROACH

- Some of the perceived disadvantages of an OCIO approach relative to a traditional consulting approach include:
 - Lack of control
 - May require use of OCIO manager's proprietary investments, resulting in reduced opportunity set or conflicts of interest
 - Potentially higher costs than could be achieved through a traditional consulting or “hybrid” approach
 - Reduced development of internal investment knowledge
 - Potential for additional layer of review over the OCIO on a periodic basis

INDUSTRY TRENDS – REASONS FOR NOT OUTSOURCING



INVESTMENT MANAGEMENT LIMITATIONS

OPEN ARCHITECTURE VS. USE OF PROPRIETARY FUNDS

- **One of the more important considerations when implementing an Outsourced CIO Structure is the underlying management of the assets.**
 - An open architecture approach allows the OCIO to select the best underlying investment managers regardless of firm affiliation.
 - Other OCIO's rely on a mix of their own proprietary investment strategies and outside investments. In general, the open architecture approach is more widely accepted as there are few investment firms that can be considered "best in class" across all asset classes.

For North Carolina, Mercer proposes an open architecture, fully customized solution that allows for manager flexibility with no proprietary requirements.

EFFECTS OF ACTIVE VERSUS PASSIVE MANAGEMENT

- A key driver of investment-related fees in an outsourced investment relationship is the amount of assets that are invested passively versus actively.
 - Greater use of active strategies should result in higher expected outperformance, higher tracking error, and correspondingly higher fees.
 - The addition of passive investment strategies should limit tracking error, reduce potential outperformance, and ultimately result in lower fees.
- The responsibility for determining whether to invest actively or passively can be maintained by the Board/Investment Committee, or delegated to the outsourced manager.
 - Current lineup is structured to offer both passive and active options.
 - North Carolina can provide direction on the use of passive strategies (outside of liquidity management) in the multi-manager funds.

GOVERNANCE TRENDS

SUMMARY

- All organizations are different. Dynamics between the Board, an internal Investment Management Division, Staff, and Consultant are different. In the end, the goal is to ensure that the limited time all three parties are together is effectively used towards strategy and overall direction of the investment portfolios.
- Ultimately, an organization aims to create a governance process and philosophy that maximizes the efficiencies and skills of each group, effectively makes timely decisions, and maximizes each group's time and efforts.
- With that said, there are a few activities that Slocum believes are vitally important for a governing body with fiduciary oversight:
 - ✓ Organizing an effective Board – clearly define roles and responsibilities
 - ✓ Structuring effective use of the Investment Committee – focus on strategy and top level results
 - ✓ Maintaining proper oversight – review risk, returns, and compliance (Fiduciary Duty)
 - ✓ Avoiding conflicts of interest

ORGANIZING A COMMITTEE

- The chart below shows the Traditional make-up of a committee vs. those deemed to be “Best Practices”, as noted by Yoder.

	Traditional	Best Practices
Board Role	Makes all final decisions. Very hands-on.	Delegates much. Focused largely on big-picture/policy issues
Investment Oversight Role	Filled by Committee/Consultant/ Treasurer	Strong role, filled by CIO/team with authority to implement policy
Roles, Board tenure, composition, & conflicts of interest	Undefined	Well-defined

STRUCTURING EFFECTIVE USE OF TIME

- Boards are typically responsible for strategic decisions and initiatives, relying on the due diligence of service providers and staff to make informed decisions.
- Investment Committees usually meet quarterly to discuss strategic and tactical plan issues.
- With this in mind, tasks involving the implementation of the strategic decisions should be delegated to Management/Staff and the Investment Consultant/OCIO.
- Investment Committee members often have a sense of “losing control” of decisions.
 - This is especially evident in the selection and oversight of investment managers.
 - There is a “Fiduciary gray area” with this sense of lost control.

NORTH CAROLINA CONSIDERATIONS

BUILDING BLOCKS FOR DECISION MAKING PROCESSES

- The desired outcome of this process will provide clarity around roles and responsibilities for managing various aspects of the Supplemental Retirement Plans.
- North Carolina has the flexibility to own, share or completely delegate responsibilities to Mercer. For areas that North Carolina owns, Mercer can be leaned upon for consulting support.



HIGH LEVEL OVERVIEW OF MERCER'S SPECTRUM OF SOLUTIONS

- Mercer's solution for defined contribution plans with significant scale is a customized approach rather than a pooled manager-of-managers solution.
- Portfolios are constructed based on existing manager lineups and client-specific preferences.
 - Flexibility to use existing managers
 - Managers sourced by the IMD may be included in the DC plan following normal due diligence process and provided that they meet an A or B+ rating
- North Carolina can influence the level of control and timing of changes.
- Mercer has the ability to structure daily compliance monitoring under both approaches, however, the OCIO structure allows for more timely resolution of issues.
- Mercer's ability to contract directly with managers can save North Carolina staff time and resources.
- Mercer's OCIO structure allows for dynamic asset allocation rather than the current approach of equal weighting managers; however, North Carolina could take a more dynamic approach if control is retained.

CURRENT STRUCTURE – GOVERNANCE, PLAN DESIGN & ADMINISTRATIVE

Key Responsibilities:

Develop (D) = Create materials and obtain information

Advise (A) = Use information to provide insight and analysis

Endorse (E) = Provide recommendation for proper course of action

Informed (I) = Provided information related to that step. Action may or may not be required

Responsible (R) = Final approval or responsible for completion

	Board	Investment Committee	Counsel	SRP	IMD	Mercer	Galliard	Prudential
Governance								
Investment Policy Statement	R	E	A	D	A	A	-	-
Governance/Fiduciary Education	I	I	R / D	I	-	-	-	-
Regulatory/Compliance Updates	I	I	R	I	-	-	-	D / A
Service Provider Retention and Termination	R	E	A	D	-	-	-	-

	Board	Investment Committee	Counsel	SRP	IMD	Mercer	Galliard	Prudential
Plan Design								
Plan Design Review and Benchmarking	I	I	I	D	-	A	-	-
Plan Design Changes	R	E	A	D	-	A	-	A
DC Trends and Thought Leadership	I	I	I	D	-	A	-	-
Retirement Income Adequacy Analysis	I	I	-	D	-	A	-	D

	Board	Investment Committee	Counsel	SRP	IMD	Mercer	Galliard	Prudential
Administrative								
Recordkeeper Service and Fee Evaluation	I	I	-	R	-	D	-	-
Procurement of Vendor Services	R	I	A	D / A	-	-	-	-
Oversight of Vendor Relationships and Performance Guarantees	I	I	A	R	-	D	-	-
Day-to-Day Plan Management	-	-	A	R	-	-	-	-

CURRENT STRUCTURE – INVESTMENTS EXCLUDING GALLIARD

Key Responsibilities:

Develop (D) = Create materials and obtain information

Advise (A) = Use information to provide insight and analysis

Endorse (E) = Provide recommendation for proper course of action

Informed (I) = Provided information related to that step. Action may or may not be required

Responsible (R) = Final approval or responsible for completion

	Board	Investment Committee	Counsel	SRP	IMD	Mercer	Galliard	Prudential
Investments Excluding Galliard 3(38) Portfolio								
Plan Investment Structure	R	E	A	D	A	D	-	-
Manager Compliance	R	E	-	A	-	D	-	-
Performance Reporting	I	I	-	I	-	D	-	-
Manager Selection/Termination	R	E	-	A	A	D	-	-
Manager Search	I	I	-	I	A	D	-	-
Manager Monitoring/Evaluation	R	E	-	E	A	D	-	-
Manager Due Diligence	I	I	-	R	D	D	-	-
Transition Management	I	I	-	R	A	D	-	A
Investment Manager Agreements/Guidelines	I	I	D	D	-	A	-	D
Fee Negotiations	I	-	-	A	A	A	-	-
Custom Fund Portfolio Construction	R	E	-	A	A	D	-	D
Proxy Voting	I	I	-	R	A	A	-	-

CURRENT STRUCTURE – GALLIARD STABLE VALUE INVESTMENTS

Key Responsibilities:

Develop (D) = Create materials and obtain information

Advise (A) = Use information to provide insight and analysis

Endorse (E) = Provide recommendation for proper course of action

Informed (I) = Provided information related to that step. Action may or may not be required

Responsible (R) = Final approval or responsible for completion

	Board	Investment Committee	Counsel	SRP	IMD	Mercer	Galliard	Prudential
Stable Value Investments Controlled by Galliard*								
Manager Compliance			-		-	-	R	-
Performance Reporting			-		-	-	R	-
Manager Selection/Termination			-		-	-	R	-
Manager Search			-		-	-	R	-
Manager Monitoring/Evaluation			-		-	-	R	-
Manager Due Diligence			-		-	-	R	-
Transition Management			-		-	-	R	-
Investment Manager Agreements/Guidelines			-		-	-	R	-
Fee Negotiations			-		-	-	R	-

*Galliard serves as a delegated 3(38) manager over North Carolina's stable value portfolio. The Board, Investment Committee and SRP are still responsible for monitoring Galliard on an ongoing basis.

CRITICAL AREAS FOR DISCUSSION

▪ **North Carolina staffing and resources**

- Investment Implementation and Oversight: add staff, rearrange priorities, or expand relationship with Mercer
- Retirement Plan Expertise: specialized administrative and defined contribution experience retained by SRP staff and supplemented by Mercer
- Legal: add staff, rearrange priorities, or delegate investment contract management and execution to Mercer (note: if Mercer retains responsibilities for managing and executing contracts, North Carolina may not have flexibility to retain control over investment decisions)

▪ **Cost tradeoffs between insourcing vs. outsourcing and hybrid models**

- Incremental costs of adding staff and building out systems to run the retirement program vs. delegating responsibilities to third parties (Mercer, recordkeepers, etc.)
- Potential risk mitigation or sharing of risks through delegation or hybrid models

▪ **Execution of investment decisions, monitoring and compliance**

- Investment policy review and monitoring
- Manager compliance monitoring process (including daily oversight of investment manager guidelines)
- Fund compliance monitoring process (including daily oversight of policy guidelines)
- Custom fund construction process and implementation
- Target date fund construction process, implementation and oversight
- Manager selection and termination process
- Transition manager selection and execution
- Fund audit support and oversight

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