

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

MINUTES OF MEETING

May 8, 2014

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, May 8, 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: Steve Toole, Mary Buonfiglio, Blake Thomas, Rekha Krishnan, Erica Hinton, Lisa Page, Jaclyn Goldsmith, Joan Fontes, Arlene Jones-McCalla and Mary Laurie Cece. From Prudential Retirement: Michael McCann, Kathleen Neville, Ann Cashman and Jessica Quimby. From Mercer: Jay Love and Kelly Henson. From Galliard: Andy Apostol. From BlackRock: Tim Richman and Marco Merz.

AGENDA ITEM – WELCOME AND INTRODUCTIONS

The meeting was called to order at approximately 9:05 am. Ms. Baran welcomed everyone and introduced Erica Hinton the new communications officer for the Supplemental Retirement Plans. Ms. Hinton said she is excited to be at the Department of State Treasurer and looks forward to doing good work. Ms. Baran also welcomed Tim Richman from BlackRock.

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. Ms. Cochran noted that she used to work at BlackRock. Ms. Baran noted there was a sign-up sheet if any member of the public wanted to speak at the end of the meeting.

AGENDA ITEM – MINUTES

The Chair said the minutes from the February 13, 2014 and February 20, 2014 Investment Subcommittee meetings were included in the Board book for reference only. The minutes were approved in the March 19th 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 gave a brief update on Galliard. He noted that Galliard had a good quarter and added another \$2 billion in assets. They anticipate adding another \$1.5 billion in the second quarter.

Mr. Apostol gave an update on the wrap market. Galliard is doing business with four new issuers. He anticipates that wrap fees however will remain at about 20-25 basis points. He said that there are still about 18 wrap providers in the market. Galliard is going through a process of doing a deep drill down on all its wrap contracts hoping to result in better contracts and lower fees. He said that over the long term he hopes to see wrap fees come down to about 18-20 basis points. Ms. Buonfiglio asked what elements of the contract they are looking at in this drill down. Mr. Apostol stated that they are looking at the book value coverage as well as fees. He said they are also evaluating how Galliard monitors crediting rate resets. Ms. Baran asked Mr. Apostol to provide the Subcommittee with a memorandum on the things Galliard is looking at in this drill down. Mr. Apostol agreed to do so. Ms. Henson asked if they are looking at investment guidelines. Mr. Apostol said they are always looking at this. He thinks tight guidelines are good for the industry.

Mr. Apostol then reviewed some of the changes in the SVF since 2010. He noted that Mutual of Omaha had been terminated. The new contract with Nationwide has been approved and they hope to be funding this account in the next few weeks. Galliard is still working on further diversifying the portfolio by reducing Great West's portfolio to 20% of the total portfolio. They had slowed this process a little because cash flows have been good in the past couple of quarters, but now they are getting a little flat, so Galliard will start picking up on this transition. It will probably be completed over the next 18-24 months.

Mr. Apostol then discussed a chart which compared the portfolio characteristics at the time Galliard took over managing the fund versus the current characteristics. There has been a slight change in durations because of the mortgage securities in the portfolio, but this is still within the guidelines. Ms. Cochran asked what changes Galliard intends to make in the future. Mr. Apostol stated that he did not want to see durations get any longer. Next he pointed out the fee table and stated that nothing has changed on this. Galliard's fee is still 7 basis points. Sub-advisory fees are close to 6 basis points with the investment contract fees being 16 basis points. All total the SVF's annual operating expense is 44 basis points. Ms. Baran stated that she would like to see another column showing what these fees are in dollars amounts. Ms. Baran made a motion to request Galliard to put the fees in dollar amounts and Ms. Keech seconded. The motion passed unanimously.

Mr. Apostol then gave a performance review of the SVF. He noted that the 401(k) portfolio is outperforming the benchmarks. He stated that in general short term fluctuations in interest rates generate fluctuations in short term performance. Longer term performance numbers are therefore more meaningful indicators of performance because that takes out the fluctuation caused by an immediate change in interest rates. Ms. Cochran asked about the one month performance. Mr. Apostol said that is the effect of change in interest rates. He pointed out the line on the chart that shows the SVF is outperforming inflation. Ms. Baran suggested that Ms. Buonfiglio may want to do an article explaining that the SVF is performing ahead of inflation. Ms. Buonfiglio agreed to do this.

At the end of 1st quarter the total assets in the fund were \$1.877 Billion and the average credit quality of the underlying assets was AA+.

The SVF's performance for the 1st quarter of 2014:

- The SVF's blended yield was 1.76% net of fees.
- The effective duration was 3.12 years.
- The market to book value ratio was 101.70%.

Mr. Apostol pointed out the sector distribution of the portfolio at the bottom of page 10 of his presentation. He then described how the net crediting rate would change if interest rates were to change. Ms. Baran asked about overall demand for bonds. Mr. Apostol said he thinks that the demand for bonds changes as the situation with interest rates changes. He said it will really depend on what the Federal Reserve does with regard to interest rates.

Mr. Apostol then described the portfolio allocation and manager allocation, noting again the largest allocation is with Great West. Ms. Cochran asked which manager will receive a higher allocation. Mr. Apostol said probably into securities that are a little shorter in term. He noted that 76 % of portfolio is AAA rated.

He pointed out the chart with the historical cash flows, saying that these are where Galliard wants to see them. Mr. Apostol discussed the performance of individual managers. He noted that PIMCO is not technically on a watch list, but Galliard is looking at them a little closer. Ms. Keech asked him about his thoughts on PIMCO. He said that they are the premier bond manager but they are being watched a little closer because of recent management changes. He said Galliard has the ability to be very nimble if they see any problems. He thinks PIMCO is going through a stressful period, but they have a good track record over a long period of time.

Mr. Apostle then asked if there were any other questions. Mr. Toole said that the Board and staff need to come up with an annual review process for Galliard. Mr. Apostol suggested site visit to Galliard could be very helpful for the staff to see its processes. Mr. Henson noted that Mercer also does a deep review of Galliard and is about to do an onsite with them as well. Mr. Toole suggests that DST staff should perhaps do this at the same time as Mercer. This was agreed upon.

AGENDA ITEM – ECONOMIC OVERVIEW AND 1ST 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 investment performance of the various funds in the Plans.

Mr. Love stated that the 1st quarter was fairly strong overall. Domestic equities were up about 1.5-2 %, but he noted there was a fair amount of volatility that these numbers don't reflect. During the quarter there was a slowdown in China that put some fear in the market and Argentina devalued its currency. US earnings, however, calmed some of the market fears. The same type of volatility can be seen in the international market. He pointed out that this volatility affects manager performance. He said that fixed income returns were up slightly. As far as one year performance, equities have been strong and fixed income flat. Overall, there are no signs that the economy is strongly accelerating. The expectation is growth of a little over 2% in the US economy in the coming year. Europe has had very modest 1% growth and not a strong recovery. Emerging markets continue to be a challenge. The performance of foreign currencies has been mixed.

In looking at the equity markets in depth. Value stocks outperformed growth stocks. Large cap outperformed small cap a bit. Utilities had the strongest performance. Some of the best performing sectors from last year had slower performance this quarter. US markets remain fully valued.

International markets had a mixed quarter. Mr. Love noted that Japan is bit of a story this quarter. Ms. Cochran asked about Hong Kong. Mr. Love said he was unsure how Hong Kong performed last year. He also noted that high yield performed well in the quarter and hedge funds had a bit of a challenge during the quarter. Ms. Baran asked could there be a chart of where market performance stands now since the quarter ended six weeks ago. Mr. Love agreed to do a monthly flash report for the Subcommittee.

As for the actual results of the NC funds, Mr. Love stated that overall the quarter was pretty good but there were a few managers that had challenges.

Ms. Henson gave the manager updates. First she pointed out that Wedge in the SMID Cap Value Fund was downgraded by Mercer from an A to a B+ because a management team member left. She feels it is still a good solid team and they are not in a rush to hire someone. The team member who left was asked to leave because of personal job performance issues. Ms. Henson feels like the firm made the best decision. Mr. Love said they will be on heightened watch. Ms. Buonfiglio pointed out Wedge reached out to the staff and she agreed with Mercer that a heightened watch is appropriate. Ms. Henson pointed out that Arrowstreet also has had a departure. They have a large team and she just wanted to note that it happened but it does not cause concern. She also noted that Wellington has closed their global opportunities strategies, but existing clients can still add money.

And finally Ms. Henson reiterated what Galliard said about PIMCO and it has been added to their watch list. They agree with Galliard that there are lots of talented people in the group at PIMCO, so it is just a heighten watch. Ms. Henson then discussed the Performance Score card. She noted this performance is based on a rolling three year time frame. She pointed out that Wellington Quality Value was put on watch a few quarters ago. She recommends keeping them on watch, but this quarter their underperformance is very small. She noted that SMID Value and SMID Growth had strong performance overall. In the Mid Cap Growth fund there are two managers and in the prior period they were both outperforming, but now they are being looked at because they are both underperforming. Ms. Buonfiglio asked if they are looking at adding a third manager. Ms. Henson said Mercer is thinking about it. Turning to the international markets, Ms. Henson explained that the international funds have been underperforming because the benchmark for international is made up of mostly developed markets, but the fund's managers have a good bit of exposure to emerging markets.

Ms. Henson next highlighted a few things on the fee table on page 24 of the presentation. She noted that the record keeping fee is .079% which is a reduction from last year. And starting April 1st, there will be a reduction in the BlackRock fee. Ms. Baran asked if there would be communication to participants around these fee reductions. Ms. Buonfiglio said yes and commended BlackRock for working with the Department to lower fees.

Ms. Henson pointed out a few other items of note: Wellington's performance was below the benchmark, but they outperformed their peers. Sands underperformed this quarter in the Large Cap Growth fund, but Wellington Opportunistic Growth had strong performance. Mr. Love said that Neuberger continued to underperform this quarter and the thought was that they should have performed better in the market environment of the first quarter. Ms. Baran asked if the average annual return of all the funds is able to meet the projected needs of participants. Ms. Buonfiglio noted that for the defined benefit plan the projected return is 7% but for the defined contribution plans it is an individual's projected income at retirement listed on the annual benefits statement.

that is material to the participant. Ms. Baran asked if an analysis had been done to see what GoalMaker's over all returns has done for participants. Mr. Love stated that they are doing this now. He said that there has also been an analysis of how GoalMaker is doing compared to its peer group and it is doing well.

Ms. Henson then went on to state that there have been no material issues with managers and the investment policy guidelines. The only thing that has been flagged is PIMCO has a slight deviation from the guidelines. They are underweight in corporates. Ms. Buonfiglio asked where they are overweight. Ms. Henson said in governmental and municipals bonds. Mr. Love stated this does not really lower their level of risk. Ms. Cochran asked what Mercer is doing regarding PIMCO and its recent management changes. Mr. Love stated that they are on a watch, not a formal watch list, but Mercer has a heightened awareness.

The next issue on Mercer's agenda is the Large Cap Manager review. Brian Clark from Mercer joined the meeting via the phone. Mr. Love gave an overview of the NC Large Cap Growth Fund and its investment objective. Mr. Love referenced a chart in his presentation that showed the benefits of having multi manager funds. The objective of Mercer is to pair managers who have complimentary styles and strategies. He noted that in this fund Neuberger has been the defensive manager. A discussion ensued about other managers in the proprietary data basis of Mercer and potential candidates to replace Neuberger.

AGENDA ITEM – PORTFOLIO MANAGER PRESENTATION

Ms. Baran tuned the meeting over to the BlackRock team to make its presentation. Tim Richman, from the BlackRock's Atlanta office introduced himself and his colleague Marco Merz. Mr. Richman gave an overview of BlackRock and the assets it manages. He noted that the firm has \$4.4 trillion in assets under management. He stated that this is particularly relevant because in the index business size matters very much. He said that there is a dedicated research staff on the defined contribution retirement side. The firm also has a dedicated communication staff for the defined contribution business and sees this as a strategic area of growth.

Mr. Richman then gave an overview of BlackRock's performance. He explained that what BlackRock is hired to do is to track the benchmark. Ms. Baran asked about fees. Mr. Richman stated that BlackRock's fees are among the lowest in the industry. Mr. Merz explained the importance of index funds for participants. He then described BlackRock's advantage in the industry. First, the firm is represented on the boards of many of the organization that set the benchmark index. Over the past 40 years they have grown into the largest index fund company. Because of their size they are able to net client flows, thus saving on execution costs. In

addition, there is a strong geographical breakout in the portfolio management team, which gives them a great deal of expertise in different markets. They have an advantage with a dedicated fixed income team that is geographically diverse. BlackRock has offices in 60 countries. He said they take their fiduciary responsibility very seriously. They offer straightforward pricing and are always looking to get the best execution. He noted BlackRock has no other ancillary businesses. They are only an investment firm.

Ms. Baran asked about how BlackRock is protecting the fund from frontrunning. Mr. Merz noted that this is important when the fund is having to rebalance. He said that they are protected somewhat in that they can do internal cross trading and he also noted that they do not have to trade on the index re-balance date.

There was a discussion regarding securities lending. Ms. Cochran noted that she liked the disciplined approach of BlackRock. She asked are other index fund companies on the benchmarking board's Mr. Merz stated that some are, but not all of them. Mr. Toole asked about Black Rock's biggest challenge going forward. Mr. Merz said pricing pressure. He said the erosion of fees is a challenge. Mr. Toole asked who is their biggest competitor. Mr. Merz answered State Street. Ms. Baran asked what makes them the best in the industry. He stated their longevity. Ms. Baran then thanked Mr. Richman and Mr. Merz for an excellent presentation.

AGENDA ITEM – SUBCOMMITTEE MEMBERS QUESTIONS / COMMENTS

Mr. Toole noted that staff is moving forward with the Mercer contract and would come back to the Board in June.

AGENDA ITEM – PUBLIC COMMENT

No public comments were offered.

A motion to adjourn was made by Ms. Baran, seconded by Ms. Cochran, and unanimously passed. The Subcommittee adjourned at 12:00 p.m.


Secretary