

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

DRAFT 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.

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 Cece. From Prudential Retirement: Michael McCann, Jennifer Willis, Jessica Quimby, Travis Swartwood, and Rob Luciani. From Mercer: Jay Love and Kelly Henson. 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 Gaillard. He noted that Gaillard's assets under management had increased over the last year to \$85.5 billion. He stated that seven new clients had brought an additional \$1 billion in assets to the firm. Even with the inflow of assets, he believes Gaillard will stay at its current staffing levels.

Mr. Apostol gave an update on the 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 their allocation is not reflected in the written presentation. He also noted that starting in January there will be an additional 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 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. Apostle said this is a complimentary strategy to the rest of the portfolio.

Mr. Apostle then asked if there were any questions. Mr. Toole asked if there was a slide that showed the competitiveness of all the fees versus a peer group. He answered that there was not one that showed competitiveness, but that all fees were shown on slide 9. Mr. Toole asked if Mercer and Gaillard 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.

Mr. Love described the third quarter as very strong overall for the markets. Domestic equities did well, with smaller cap stocks being up even more than large cap. He noted this same theme could be seen in the performance of the Plan's 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 Obama care 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 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 even Mr. Bernanke.

Mr. Love went on to say that 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 as 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.

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 has been modified a bit from past reports since the industry tends to evaluate based on a more rolling environment. The charts presented now look at 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. He gave the example of Wellington Quality Value Fund, which has X's all the way across the time periods. He noted this needs looking into. He said that Wellington should not necessarily be fired based on this because they are playing a defensive role in the portfolio and we would expect them to be down in an up market. He 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 do the same thing 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 they are 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 will 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 pointed out 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 pointed at that

perhaps 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 a retention review memorandum be presented after a fund has been on a watch list for four quarters. Ms. Billman asked if a report would provide alternate managers. Mr. Love stated they could do that.

Ms. Keech made a motion, seconded by Ms. Cochran that Mercer provides a 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 because Sands is one of the top performing large cap growth funds in their 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.

There was a discussion of the recent fee review. Ms. Smith stated that she continues to work with Mercer to get fee reductions. Hotchkiss 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 Stable Value compared to cash. Ms. Hensen 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. The Chair noted that Ms. Cochran needed to leave by 12:00

AGENDA ITEM – INVESTMENT MANAGER PRESENTATION

Ms. Henson commented that Brown Advisory had been asked to come before the Board to do a presentation because it 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.

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. This resulted in low turnover in the firm. Brown had \$42 Billion in assets under management, with half private client money and half institutional. Brown's portfolios attempt to preserve capital in down markets. They have a diversification across strategies. Large Cap growth is the largest strategy with small cap growth being the third largest in terms of assets. The Plans are the only public funds client in the small cap strategy. The fund currently manages \$1.725 billion and there is going to be a soft closing of the strategy when the fund reached \$2 billion.

Ms. Carroll went on to describe the shift in portfolio management responsibilities. Tim Hathaway has been managing the strategy since 2004. But as Brown has grown its asset to \$30 billion Mr. Hathaway is assuming new responsibilities as Head of Research for Brown. This transition will be taking place over time, but Chris Berrier who has been co-managing since 2006 will be the lead portfolio manager with Mr. Hathaway as a sounding board.

Mr. Berrier stated that Brown thought it made sense to have one person be the overall head of research. He noted that he and Mr. Hathaway developed the small cap growth strategy and core principles for the fund in 2006 and with this current transition nothing is going to change in 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 how many other strategies his team of analyst responsible is for. Mr. Berrier answered that the analyst cover six other strategies, but they are divided up by sector.

Mr. Viezer questioned if they had the co-portfolio managers to start, why are you changing now. Mr. Berrier answered that when they started the entire team was much smaller. Now there are many analysts who support the portfolio manager. He also noted that every other strategy has only one portfolio manager. Ms. Smith asked if there was a key man problem. Mr. Berrier stated that there were several analysts who would be well positioned to take over the portfolio. Ms. Carroll noted that there is a disciplined process to managing the portfolio.

Mr. Toole asked why Brown hired from within rather than get the best manager from the market. Mr. Berrier said that a great deal of thought was put in to this and 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. Under this structure with the analyst taking the role of looking at companies, the portfolio manager can look at a higher level. 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 ones in the past several years and they come from the industry sectors rather than the finance sector.

Ms. Baran asked how they thought health care would be affected by Obamacare. Mr. Berrier said it 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 and that only the last ½% is based on technical. Ms. Cochran then asked how much time he spends on client service. He said because of the soft close, very little.

Mr. Berrier then went on to describe investment process/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 that in the 100 year history, small cap stocks outperformed large cap stocks.

Ms. Baran thanked Mr. Berrier and Ms. Carroll for their presentation. And, they 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 they 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 put Brown Advisory on enhance monitoring for the next 12 months. The Board unanimously approved.

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 under 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 left the meeting.

AGENDA ITEM –DETAILED INVESTMENT MANAGER FEE ANALYSIS

Ms. Baran note that this analysis will go 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 and then ranked them as compared to other managers. On the charts provided it is possible to see what funds outperform. Overall it looks as though the Plans are getting very good value for its fees. Ms. Buonfiglio pointed out that CEM is looking at this from a different perspective. 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. Bared noted t Mr. Leedy’s resignation from the board and that he was missed at the board meeting and 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