

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

MINUTES OF MEETING

May 21, 2015

Time and Location: Investment Subcommittee (the “subcommittee”) of the North Carolina Supplemental Retirement Board of Trustees (the “board”) met at 8:30 a.m. on Thursday, May 21, 2015, 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; Karin Cochran and Robert Orr¹.

Staff and Guests present: The following staff and guests attended the meeting. From the Department of State Treasurer: Steve Toole, Mary Buonfiglio, Blake Thomas, Lisa Page, Rosita Sabrosso-Rennick, Joan Fontes, Tim Viezer, Rhonda Smith, Kevin SigRist, Rekha Krishnan, Maja Moseley. From Mercer: Kelly Henson and Liana Magner. From Prudential: Michael McCann, Jessica Quimby, and Kathleen Neville. From TIAA-CREF: James Simone. From Galliard: William Weber. Member of the public: Robert Slade.

AGENDA ITEM – WELCOME AND INTRODUCTIONS

Meeting convened at 8:30 a.m.

Ms. Baran, Subcommittee Chair, welcomed everyone and asked that the public comments be held until the end of the meeting.

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 – REVIEW OF MINUTES

¹ Mr. Orr joined the meeting at approximately 8:50 a.m., during the Stable Value portfolio review.

The Chair stated that the minutes from the Investment Subcommittee meeting of February 19, 2015, were approved by the board and are included in the book for reference only; therefore, no action needs to be taken.

AGENDA ITEM – STABLE VALUE PORTFOLIO REVIEW

The Chair recognized William Weber from Galliard to present the Stable Value report.

Mr. Weber reiterated that the report covers the first quarter of the current year and the portfolio has experienced a few notable changes in April and May, due to the replacement of PIMCO by Dodge&Cox. Mr. Weber presented the 2014 book value investment performance (net of all performance fees) which was 180 bps. The portfolio shows consistent, positive performance and provided a blended yield of 1.83 percent. There has been no change in quality of the portfolio, which remains at AA+. Weber provided an additional chart that shows a snapshot of the current portfolio state and several scenario analyses in the event of adverse rate shocks at 25, 50 and 100 bps. Mr. Weber reiterated that the scenarios consider only one variable: the interest rate, and that an increase of 25 bps is the most likely one. Rates are predicted to rise as early as June or September, due to overall stagnant economy and slow decline of crediting rates. Mr. Weber noted that the manager distribution in Dodge&Cox was 12.9 percent, effective as of May 1, 2015, after the transition of \$125 million out of PIMCO to Dodge&Cox was completed. The transition was seamless and took advantage of the existing yield in the units of commingled funds: 1.85 percent for Dodge&Cox and 1.7 percent for PIMCO, respectively. In addition, Dodge&Cox manager fees amount to approximately 50 percent of PIMCO manager fees. Mr. Weber added that formal reporting on this event will be provided in the second quarter of this year.

Mr. Weber noted that portfolio underlying fixed income credit quality is 75 percent “AAA” and Galliard aims to be well-diversified in all sectors; there has been a slight increase in U.S. Treasury assets due to the addition of Dodge&Cox to the portfolio.

Mr. Weber also pointed out that the Stable Value Fund has experienced only positive or flat cash flows, which indicates contributions to the fund. In most other Stable Value Funds observed by Galliard, a negative cash flow trend is seen. Ms. Baran remarked that the size of the positive cash flow has been declining, even though it is still positive, and she inquired about possibly defending the portfolio against the negative flow. Mr. Weber responded that cash flows are managed on monthly basis to ensure liquidity; approximately 10 percent of investments are trading as cash.

Mr. Weber summarized the issuers’ ratings, noting that there has been no change in credit quality. One of the issuers, Metropolitan Life Insurance Company, has been declared a “non-bank SIFI” by the Financial Stability Oversight Council and Ms. Buonfiglio inquired about the significance of this declaration. Mr. Weber committed to providing more detail on this decision, adding that it would involve higher regulatory oversight for the institution in question.

Ms. Baran asked about Nationwide's significant variable annuity hedging, which resulted in volatile investment earnings. Mr. Weber explained that while the annuity is separate from the insurance business, Galliard continually monitors the credit of the entity and its affiliates, and this particular investment does not pose a cause for concern. Mr. Toole clarified that this is in fact the same company, but a separate account, and the company is strong.

Mr. Weber asked if the discussion regarding the Great West account receivable issue was called for. Ms. Buonfiglio, as well as Mr. Thomas, replied that this matter will most likely be discussed in a closed session, during the board meeting in June. Mr. Weber reiterated that with respect to closing the accounts receivable position, Galliard will act as a delegated manager, consulting with the plan and the auditor.

Ms. Buonfiglio inquired whether lower wrap fee negotiations can be entertained with respect to some issuers, such as American General Life Insurance Company. Mr. Weber confirmed that such discussion with AGL has been on-going for several months and Galliard believes it will ultimately lead to a lower fee agreement.

Mr. Toole asked for a confirmation that the portfolio is working as designed after the changes have been made and Mr. Weber confirmed, adding that Galliard is working with good providers and managers, as well as conducting ongoing reviews of contracts, paying particular attention to Great West's contract.

AGENDA ITEM – ECONOMIC OVERVIEW AND 1ST QUARTER INVESTMENT PERFORMANCE REPORT

The Chair recognized Kelly Henson and Liana Magner from Mercer.

Ms. Magner provided the market and current events summary, focusing on their impact to the plan investment managers in particular. The U.S. economy has experienced a slower than predicted rate of growth, while data from the Eurozone exceeded expectations; the U.S. dollar, however, remains strong. The unemployment rate fell to 5.4 percent in the first quarter. The strike at west coast ports, as well as weather events, had negative impact on imports. Worldwide, Japan's outlook has improved, and China, as well as India, were strong performers; the Brazilian economy was down 14 percent, while Russia rebounded at 19 percent. Emerging markets were negatively impacted by currency declines. Small cap stocks surged in the first quarter and there was a wide dispersion in the sector returns, with healthcare stocks delivering 7.4 percent and energy stocks, as well as utilities, declining. Earnest Partners benefited from their strong growth bias, but Sands Capital Management was negatively impacted by being overweight in the energy sector. Times Square was also hindered by being underweight in healthcare sector. Brown Advisory outperformed slightly due to small cap bias.

In the fixed income environment, the yield curve shifted down and somewhat flattened in the first quarter. Long duration bonds have out-performed short-term bonds; global bonds were hurt

due to the strong U.S. dollar. With respect to alternatives, commodities declined by 6 percent and REITs went up by 4 percent. TIPS have outperformed Treasuries.

Ms. Magner then summarized the investment structure, noting that there have been no changes other than a manager change in the Stable Value Fund. She added that the update on transition from Wellington to Delaware will be provided in the next meeting. Ms. Henson noted that the transition is moving along as planned. Prudential and State Street stay in regular contact and the completion date remains as planned, for June 1, 2015.

Next, Ms. Henson presented the fee overview for each of the funds, starting with investment management fee, followed by additional fees wrapped into the investment fee — an “all in” comparison. She added that while the Mercer median expense fee does not include all added -on expenses, the fee for each fund is below Mercer’s median expense fee, which means that fees are competitive overall. Ms. Henson noted that the fee for PIMCO reflects the recently negotiated, lower rate in the NC Inflation Responsive Fund. With regard to the NC Large Cap Value Fund, upon transition to the new manager, Wellington’s current fee of 29 bps will be replaced with Delaware’s new fee of 30 bps (negotiated from 36 bps), under a tiered fee structure.

Mr. Orr remarked that the fee page is of utmost importance to board members and inquired about the possibility of page restructuring, to show a better “apples to apples” fee comparison. Mr. Orr felt that two columns of the fee table, the recordkeeping fee and the NC budget fee, may not be adding much value. Ms. Buonfiglio suggested that Ms. Henson present the overview table column-by-column to the board members in order to fully explain the numbers; Ms. Henson walked the members through each column and row. Ms. Magner also added that the institutional median is an “all in” expense and that the comparison bar has been set higher, as the recordkeeping fee and budget expense is wrapped up in the median. Mr. Orr questioned whether the approach of “setting the bar higher” is the most practical one. Mr. Toole stated that investment management expenses should be compared straight on, to illustrate how competitive they are for the plans; he added that the board’s primary focus is on investment manager fees, including the recordkeeping fee. Ms. Buonfiglio noted that members pose the question, “What are my fees?,” frequently and Mercer’s fee review table is used to answer these individual questions. Ms. Henson and Ms. Magner summarized the presentation by stating that having fee transparency is a good practice and fees should be reasonable, not just the lowest in the peer universe. Ms. Magner added that Mercer will add an explanation of content as a note to the Mercer median expense fee column.

Ms. Baran compared the manager fees in the NC Fixed Income Fund and inquired as to why JP Morgan’s fee is higher than Prudential’s for a more conservative management approach. Ms. Magner responded that an extremely attractive fee was negotiated with Prudential and it was a very good deal for the plan; however, the “pure core” portfolio is slightly more expensive to manage for JP Morgan in comparison to Prudential’s “core plus” portfolio. Ms. Magner stated

that JP Morgan's fee is still a reasonable one within the peer universe. Ms. Baran stated that she respectfully disagreed.

Ms. Cochran asked about the timing of fee renegotiation. Ms. Buonfiglio reiterated that as the unbundling project progresses, the plan will be re-papering all of the investment management contracts, which will potentially lead to fee negotiations. Ms. Smith advised to compare the assets under management at the contract starting point to the current situation and determine the asset percentage ratio, as this could be a potential negotiation point, particularly in light of the engagement with another manager with a slightly lower fee.

Ms. Baran discussed the recently filed criminal charges against JP Morgan in connection with foreign exchange rate manipulation. She stated that the plan could do better with regards to the fee management, as well as service, and asked that serious consideration be given to restructuring and not just re-papering the contract. Ms. Baran confirmed that she would like to have a review and comparison conducted, comparing JP Morgan to other potential investment managers. Ms. Buonfiglio asked Ms. Baran whether her concerns included the manager's performance. Ms. Baran replied that weakness in JP Morgan's organizational structure resembles that of PIMCO's: there is a significant concern around key man risk.

The Chair then made a motion to review possible JP Morgan replacement options. Discussion followed.

Mr. Orr asked whether Mercer predicts significant organizational changes in JP Morgan. Ms. Henson replied in the negative, adding that JP Morgan's operation in Columbus, OH, will not be impacted by the parent company's legal problems. The unit is conducting business as usual, able to recruit, promote and pay the employees. In Mercer's opinion, it is very common to have a key man in the equity space and this area can certainly be explored further; however, the cost to the plan is still at median.

Mr. Orr stated that based on Mercer's review and the cost — as well as effort to perform a formal review and comparison search — there was not a compelling reason to embark on the search and replacement process. Ms. Cochran noted that Mercer, at the request of the Investment Subcommittee, performed a general review of JP Morgan and, while she understands the concerns, the Columbus, OH, arm is independent from the parent company. The motion failed due to a lack of a second. The Chair requested that her concerns surrounding JP Morgan, and the need to monitor the legal charges, be reflected in the meeting minutes.

Mr. Thomas briefly summarized the impact of guilty pleas from JP Morgan, Citibank, RBS, UBS and Barclays, calling them "the new normal," which replaces the old deferred prosecution agreement practice. It is likely, but not yet certain, that the SEC and Federal Reserve will provide waivers to the banks, allowing them to continue to operate. This risk will be monitored closely by the DST legal counsel.

Ms. Buonfiglio also noted that the plan is in the middle of proxy voting season and it has just voted proxies for JP Morgan on May 18, 2015. The plan did not support the proposed executive compensation package and voted in favor of an independent board chairman. Ms. Baran noted that the executive compensation package vote passed anyway, with a narrow support margin of 64 percent.

Ms. Henson returned to the executive summary to discuss the watch list, which features Wellington Asset Management, in the process of being replaced with Delaware, and PIMCO. There have been two recent departures from PIMCO: Paul McCulley resigned from his role as Chief Economist and Managing Director; the position of Chief Investment Officer Global Equities, filled by Virginie Maisonneuve, will be made redundant due to PIMCO's decision not to pursue increased exposure to active equities. That PIMCO program has not been successful.

Ms. Cochran asked about PIMCO's selling point in the context of the plan business. Ms. Henson replied that the firm still stands with an impressive pool of very talented people, but acknowledged that it is going through a difficult time. Ms. Buonfiglio added that the plan has already slimmed down PIMCO strategies from three to one.

Next, Ms. Henson directed the subcommittee members' attention to the Stable Value Fund performance and noted that two new charts have been added to the overview: market to book value and crediting rate. The Fund has placed in the top half of both charts. There have been some changes in the wrap fees, but no material changes on the fund level.

Ms. Baran asked when the overall asset allocation will be reviewed. Mr. Toole confirmed that this task will take place in the next 12-18 months, and be accompanied by Mercer's recommendation regarding the Glidepath. The timeline for the allocation and Glidepath is to continue to and beyond retirement.

There was a break from 9:55 a.m. until 10:05 a.m.

AGENDA ITEM – INVESTMENT COMPLIANCE REPORT REVIEW

Ms. Henson noted that on the fund level, only the NC Large Cap Growth Fund is out of compliance with Investment Policy Statement, due to the foreign equities exposure. She added that this type of exposure will be re-evaluated during the contract re-papering process as guidelines for the funds do not necessarily tie back to contract terms. With respect to fixed income, the mandate is 15 percent 144A maximum, but upon the transition to Prudential Investment Management, this percentage increased the past compliance guidelines as Prudential had a larger allocation to 144As. Mr. Orr asked if this was a fact known prior to transition and Ms. Magner answered "no, it was not known", noting that it was not advisable for the IPS to be quite so granular on the fund level. Mr. Toole inquired if this could be added to the compliance report, and Ms. Henson replied that once the new IPS is adopted, this will no longer be an issue.

AGENDA ITEM – 403(b) PROGRAM 1ST QUARTER INVESTMENT PERFORMANCE REVIEW

Firstly, Ms. Henson highlighted the program's investment structure and investment types. There have been no changes to the structure in the past quarter. Secondly, she summarized Mercer's recommended changes to the existing structure, in order to align the program offering with the plans' investment options and philosophy. Mercer has reviewed the fund ratings, as well as the number of options offered in active core tier, and recommends reducing international stock investments to one, which also includes emerging markets. The program lacks an active small/midcap core fund, and Mercer recommended that one should be added; replacement of T. Rowe Price in large cap growth space with a higher rated manager is also advisable. To help streamline the options for participants, eliminating the specialty funds may be considered. Lastly, Mercer recommends moving to lower-cost target-date funds or utilizing TIAA-CREF's asset allocation, similar to GoalMaker and its glidepath.

Mr. Toole remarked that the recently developed glidepath has been discussed with TIAA-CREF. Mr. Toole stated that creation of a glidepath, similar to that of qualified plans, is a fiduciary best practice, covering the investment stages in and beyond retirement. Mr. Toole also asked if there are any options similar to the Stable Value Fund available for the program, and Ms. Henson replied in the negative. Mr. Simone stated that participants trust the existing investment lineup which enables them to build diversified portfolios without making their own selections. He also noted that the participants have shown interest in the specialty funds, such as the TIAA-CREF Real Estate, which is a unique option. Ms. Henson confirmed that this fund has a good reputation in the marketplace and it is in fact a core real estate fund, unlike a REIT. However, such an option is not offered in the qualified plans and, therefore, Mercer recommends removing it from the lineup. Ms. Henson also added that a specialty fund could be included in a custom glidepath. According to Mr. Simone, the glidepath will become available in the fourth quarter of 2015. Mr. Orr inquired if the program or its members have any unique investment needs, and Ms. Buonfiglio stated that there are no discernible differences between public educators' investment styles vs. other investor groups. Ms. Magner added that members' investment choices can be reviewed in-depth to ensure that they are making suitable decisions based on the program offering. She also added that, in general, socially responsible funds do not garner substantial assets. Mr. Simone reiterated that due to 403(b) plans' funding structure, any given plan may offer multiple investment providers; TIAA-CREF's goal is to educate every member with regard to building a long-term investment strategy and suitable asset allocation.

Mr. Viezer noted that the Department's pension fund is currently focusing on long-term value as the core principle of ESG (environmental, social and governance) integration and Ms. Magner confirmed that this is also consistent with Mercer's approach; ESG ratings have been added to manager strategies.

Ms. Cochran inquired about choosing the Vanguard strategy over the T. Rowe price strategy and Ms. Magner clarified that Mercer recommends replacing T. Rowe with a higher rated manager. Vanguard is value-oriented, whereas T. Rowe is growth-oriented. Ms. Cochran stressed that it should be made clear to members that the choice is between growth and value strategies. Ms. Magner also added that Vanguard Windsor fund has an extremely competitive fee.

Mr. Toole summarized all potential changes discussed and stated that Mercer and TIAA-CREF should collaborate and build a proposal for the asset allocation service, potential glidepath for the board to review, as well as a two-year project management timeline. Mercer and TIAA-CREF should also recommend the frequency of changes, as the glidepath timing is crucial to investment lineup implementation.

AGENDA ITEM - SUBCOMMITTEE MEMBERS QUESTIONS/COMMENTS

No further comments were offered.

AGENDA ITEM – PUBLIC COMMENT

No public comments were offered.

The Chair asked for a motion to adjourn. Ms. Cochran so moved and Mr. Orr seconded. The meeting adjourned at 10:42 a.m.



Secretary