INVESTMENT SUBCOMMITTEE OF THE NORTH CAROLINA SUPPLEMENTAL RETIREMENT BOARD OF TRUSTEES

MINUTES OF SPECIAL MEETING AUGUST 27, 2015

Time and Location: Investment Subcommittee (the "Subcommittee") of the North Carolina Supplemental Retirement Board of Trustees (the "Board") met at 2 p.m. on Thursday, August 27, 2015, in the Kitty Hawk Conference Room of the Longleaf Building, 3200 Atlantic Avenue, Raleigh, North Carolina.

Members Present: The following members were present: Melinda Baran, Chair. Karin Cochran and Robert Orr attended via telephone.

Staff and Guests present: The following staff and guests attended the meeting. From the Department of State Treasurer: Steve Toole, Mary Buonfiglio, Mary Laurie Cece, Rhonda Smith, Rekha Krishnan, Marni Schribman, Rosita Sabrosso-Rennick and Maja Moseley. From Mercer: Liana Magner and William Dillard.

AGENDA ITEM – WELCOME AND INTRODUCTIONS

The Chair called the meeting to order at 2 p.m., and welcomed the attendees.

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-RECOMMENDATION ON SWEEP OPTIONS FOR UNBUNDLED CUSTODIAN

The Chair recognized Ms. Magner. Ms. Magner presented two options that were recommended by Mercer: the EB Temporary Investment Fund and the Government Short Term Investment Fund. Cash sweep vehicles are used by investment managers to hold extra cash in a portfolio. A sweep vehicle needs to be identified and communicated to the custodian during the process of plan unbundling.

Ms. Magner noted that the BNY Mellon EB Temporary Investment Fund is used by the Investment Management Division and choosing this option would allow for a consistent approach for the department. The fund has a 9 basis points fee, which is well below the market median. Unlike some money market funds, this fund also has no fee waiver and there is not a claw back provision. The Government Short Term Investment Fund is a more conservative sweep vehicle, also with no fee waiver. Neither fund would participate in a securities lending program.

There were no questions from the Subcommittee members and the Chair entertained a motion to approve the BNY Mellon EB Temporary Investment Fund as the cash sweep vehicle for the plans with the Government Short Term Investment fund as a backup option. Mr. Orr so moved and Ms. Cochran seconded. The motion passed unanimously.

AGENDA ITEM-RECOMMENDATION ON CUSTOM PORTFOLIO

Ms. Magner introduced her colleague, William Dillard, from Mercer. She began her presentation with the evaluation of International Equity investment manager search for the NC 403(b) Program. Currently, the program features two international fund options, Allianz NFJ International Value and American EuroPacific Growth. She explained some of the manager selection process used by Mercer. Since we are dealing in the 403(b) industry, Mercer can only evaluate mutual funds for use in the Program. Firms must have been managing assets for at least five years, have a competitive fee schedule, and present a good fit with the program. She noted that many of the funds have minimums, so when they can, they try to get waivers. Ms. Magner highlighted the following four candidates:

1. GMO All Countries International Equity - This is a fund of funds run by the GMO asset management team. The team established a top-down view and implements strategies using the funds available within GMO; all underlying strategies are quantitative. This fund has the largest emerging markets exposure of all the candidates and this could increase as they have no maximum allocation to this market. The benchmark, MSCI EAFE index, features only developed markets. This manager has a value bias and clients may therefore see longer periods of underperformance. For that reason, this would not be Mercer's first choice. A more core-oriented portfolio is preferred due to volatility in today's market environment.
2. MFS International Equity - This manager is Boston-based, owned by Sun Life Financial, Inc. in Canada, but has been run independently. It is a core-oriented, international equity strategy with a slight growth bias and higher quality focus. This strategy is quite concentrated at approximately 75 securities, but still appropriate. This manager also offers the lowest fee of 72 basis points and the bottom-up strategy has been a consistent, strong performer. This fund is one of Mercer's top choices.
3. Schroder QEP Global ex US Value - This strategy displays a value bias and the manager applies a quantitative screen to stock ranking, based on price. This fund has the smallest

assets of all candidates at $981 million and has the second highest fee in the group of managers screened: 90 basis points. This is not Mercer's top choice, also due to higher allocation to emerging markets at 18% and too strong of a value bias.

4. Thompson, Siegel, and Walmsley (TS&W) International Equity - This is a core-oriented strategy with slight value tilt. The manager uses a blend of quantitative and qualitative screening to identify possible candidates. This fund has the smallest allocation to emerging markets currently at 7.5% and has been a strong performer. However, this is the most expensive strategy at 95 basis points.

Ms. Magner walked the Subcommittee members through the detailed research report provided by Mercer, noting several differences among the four funds screened candidates. MFS is the largest fund and they manage a suite of products; GMO and Schroder are the smallest in terms of vehicle assets. MFS has a substantial analytical team, dedicated to the strategy and somewhat of a higher turnover rate. TS&W team is the smallest, but highly skilled. GMO has the largest number of holdings in the group, while MFS is the most concentrated, holding 75 positions. Ms. Magner noted that among the group, MFS has the most reasonable fee. The median fee for an international equity fund is 97 basis points, compared to 72 basis points, offered by MFS. All candidates fall within median and all funds are available on the recordkeeper's platform. In consideration of fee transparency, Ms. Magner stated that Schroder does have revenue sharing and it was her understanding that it is the preference not to have revenue-sharing in the funds. With respect to the tracking error, MFS is around median and TS&W is low in comparison to the peer group. MFW has the lowest standard deviation and offers most reward for risk ratio. MFS also stands out positively in terms of consistent performance in a rolling three-year period. Mr. Orr asked whether MFS strongly under-performed in the up market and Ms. Magner confirmed this was for the year 2008 and then there was a sharp reversal in March 2009: MFS was impacted by that reversal. Both MFS and TS&W have shown consistent results in two-, five- and ten-year periods, with MFS outperforming the American EuroPacific Growth Fund, currently offered through the NC 403(b) Program. It is Mercer's recommendation to select the MFS fund: the lowest cost, core-oriented, quality-focused option, which has been a consistent performer.

Ms. Cochran asked for clarification on revenue-sharing and Ms. Magner responded that this is a practice that can be disclosed, and the revenue can be used to either offset the recordkeeping fee or refunded to members who are invested in the fund. She reiterated that Mercer did not exclude revenue-sharing managers from the search, but also understood that the Board's preference was no revenue-sharing.

The Chair entertained to motion to select MFS International Equity Fund as the option for the NC 403(b). Mr. Orr so moved and Ms. Cochran seconded. The motion passed unanimously.

Next, Ms. Magner and Mr. Dillard presented the candidates for US Equity Large Cap Growth investment managers. Mercer screened the universe of candidates in their Global Investment Manager Database. Ms. Buonfiglio asked if the fund fees have been fully negotiated and Ms. Magner responded that mutual fund fees cannot be negotiated, but a more attractive share class can potentially be obtained. Mr. Dillard highlighted the following four candidates:

1. Harbor Capital Appreciation Fund, which is sub-advised by Jennison (a subsidiary of Prudential) - This fund employs a bottom up security selection and has two portfolio managers, that are backed by a strong analytical team. The strategy can be classified between traditional and aggressive growth, and performs best in moderate growth in the markets. The fund performed well this year. The fund offers the second lowest expense ratio among screened candidates.
2. T. Rowe Price Blue Chip Growth Fund - T. Rowe Price is the largest firm in the candidate pool, and also has the largest asset size of all the funds being discussed. The fund seeks sustainable earning growth and employs the GARP discipline: growth at reasonable price. The strategy is core- to growth-oriented and has provided consistent returns in the last three rolling three-year periods.
3. Waddell&Reed Ivy Large Cap Growth Fund - This strategy focuses on quality metrics. It looks for sustainable earnings growth and this manager uses quantitative screening to identify securities with low-leverage and high-potential earnings growth rates. Mercer believes this strategy to be a solid and consistent investment approach, focused on long-term sustainability. The standard deviation for this strategy is the lowest of the group. However, this fund is not as strong a performer. This is also the most expensive option at 74 basis points.
4. Wells Fargo Large Cap Growth Fund - This manager uses the bottom-up fundamental research process and the portfolio has been divided into three separate sections, based on risk. This fund does have the lowest expense ratio, the strategy has not shown positive performance, but has some excessive risk which has not paid off in performance. For that reason, Mercer is not recommending this fund.

Ms. Henson said that Mercer is recommending one of two candidates: Jennison and T. Rowe Price. Both teams have been in the market for quite some time and the funds are solid, consistent performers. Harbor Capital Appreciation Fund is a distribution arm which selects the sub-advisors. Mercer has confidence in their equity team lead, Katherine McCarragher, who superseded Spiros Segalas in this role; Mr. Segalas now serves as the Chief Investment Officer.

Ms. Smith asked about T. Rowe's significant number of assets under management and potential concern associated with overcapacity. Ms. Magner responded that T.Rowe has several large cap strategies and that there is some concern that certain strategies may overlap; however, no capacity constrains have been observed yet, and Mercer is monitoring the asset level. In addition, the Blue Chip Growth Fund is a core offering and the goal is to map the existing program offering 100% into the new one.

Ms. Magner discussed the fund fees, comparing Jennison at 66 basis points and T. Rowe at 72 basis points, and also noting that T. Rowe has a revenue-sharing of 15 basis points. The universe median is 80 basis points; the expense ratio of the current option in the program is 69 basis points. In terms of performance, both Jennison and T. Rowe have the strongest consistent results and both rank in the top half of the peer universe with regards to manager ranking.

Mr. Orr asked whether the charts and graphs presented by Mercer are a standard issue per manager search and whether they were based on the peer universe. Ms. Magner confirmed that Mercer based them on the peer universe and although more data is available, the charts presented are what Mercer presents for every search it does. She stated that including all data would create an extremely long report; but there was no picking or choosing of charts for the presentation. Ms. Smith also added that very similar search procedure is followed by the Investment Management Division.

Ms. Magner stated that Mercer recommends both Jennison and T. Rowe equally, and believes that the plans cannot go wrong by choosing either option. Historically, Jennison has been offering more downside protection, is cheaper, and there is no revenue-sharing. T. Rowe is the only fund to out-perform its benchmark for the last quarter. Ms. Smith asked whether a correlation analysis has been performed, and Ms. Magner confirmed that both funds are negatively correlated to Vanguard fund, T. Rowe more so than Jennison. Mr. Orr inquired whether T. Rowe presented a "key man risk" and Ms. Magner replied that both leaders: Larry Puglia and Katherine McCarragher are team-oriented. While Mr. Puglia is the flagship person, T. Rowe also has other growth fund teams and they all communicate with each other. For Jennison, Katherine assigns several portfolio managers to different accounts and they also collaborate. Ms. Smith asked which of the two managers complemented the value strategy better and Ms. Magner replied that Jennison was a better match on correlation, but that it is not a clear-cut winner. She also replied to Ms. Buonfiglio's revenue-sharing question, noting that this option is not likely to go away. Both Mr. Toole and Mr. Orr agreed that lower fees are the more attractive choice.

Ms. Cece checked the current recordkeeper contract and informed the attendees that TIAA was able to take the revenue share and credit is back to the specific participants in the fund.

The Chair asked the Subcommittee members whether they had a final recommendation. Mr. Orr made a motion to replace T. Rowe Price Growth and Income Fund with T. Rowe Price Blue Chip Growth Fund. Ms. Cochran seconded and the motion passed unanimously.

Next, Ms. Magner and Mr. Dillard presented the candidates to manage US Equity Small/SMID Cap Core investment option. The following four were presented by Mercer:

1. Boston Trust & Investment Management - The team is led by Ken Scott, primary driver of the bottom up fundamental strategy. The team believes in finding companies with above average financial metrics and the strategy is quality-biased. However, the fund performance has suffered and therefore, it would be hard for Mercer to justify this choice.
2. Luther King Capital Management - This small firm is in Texas and has the primary owner is the main pm. He uses both a bottom up and top down approach to locate growth opportunities. This manager's research process focuses on improved financial results and strong balance sheets. This is the most expensive option at a 1% expense ratio.
3. Rothschild Asset Management - This strategy is slightly value biased and expects undervalued stocks to out-perform over time. The stock selection is the driver behind the performance. Fee of this fund is also at 1%.
4. Dimensional Fund Advisors (DFA) - This is a completely quantitative-focused strategy based on investment theory which has proven to work well. The goal is to invest in broadly diversified cross-section of small companies while reducing transaction costs through a robust trading platform. DFA has had a consistent performance and offers the lowest fee of 37 basis points.

Ms. Magner noted that Mercer finds capacity constraints in the SMID cap investment manager space: the candidates tend to change frequently, there is a certain level of volatility, and Mercer must try to find new and upcoming candidates. In addition, the small cap team managers tend to have very small teams. For example, Luther lists no investment professionals dedicated to the strategy, and Rothschild lists seven. DFA stands out with 45 dedicated analysts, and has also won quite a bit of new business over the past three years. DFA has no maximum with regards to market cap range but will not hold anything mid-cap. Luther is the most concentrated and all candidates have a low turnover and are quality biased: Boston and Luther tend to be more core-oriented, while DFA and Rothschild are more value focused. With respect to style characteristics, all candidates are above market beta of 1, with DFA being the highest at 1.21 – in comparison, Russell 2000 benchmark is at 1.18. Ms. Magner re-stated the expense ratios for respective managers: Boston 0.75%, Luther 1%, Rothschild 1% and DFA 0.37%, noting that Rothschild is not currently on TIAA-CREF's platform and the implementation could take up to two months if this manager were to be selected. Mercer has also analyzed the past performance and Rothschild and DFA have consistently out-performed in the past 3 to 7 years trailing periods. Performance shown for Boston, Luther and Rothschild is their composite account net of investment manager fess while DFA shows the Small Cap Portfolio Institutional Share Class performance data. With respect to return and standard deviation, Rothschild stands out positively as less risky than its benchmark, and DFA is still favorable when compared to Russell 2000; Luther has the highest tracking error. Rothschild and DFA also show the favorable reward to risk ratio. DFA has been a consistent in their results, tends to perform better in the rising market. Mr. Dillard added that Rothschild hit a rough patch in the 2009 reversal but has since performed better and in some instances, outperformed the benchmark, and tends to protect well on the downside.

In Mercer's opinion, the two candidates that stand out the most are DFA and Rothschild. DFA has a low fee and is a pure small cap approach, and ultimately, this candidate is preferred by Mercer, also noting that Rothschild in not on TIAA-CREF's platform, which would considerably slow down the transition process. All Subcommittee members were of the opinion that DFA was the most attractive option. However, Mr. Orr inquired whether DFA could also be considered a potential outlier in the program lineup. Ms. Smith agreed that while this manager has a unique look and feel they have performed incredibly well and Ms. Magner added that choosing them would be a good way to obtain a low-cost, small cap option and their strategy is constant which makes it easier to predict possible underperformance.

Ms. Cochran made a motion to select Dimensional Fund Advisors as the US Equity Small/SMID Cap Core investment manager and Mr. Orr seconded; the motion passed unanimously.

Ms. Magner presented the last agenda item, Passive Small-Mid Cap US Equity and Core Fixed Income search, noting that desired outcome is to combine SMID cap strategy into one index and change core bond from short term to aggregate. Mercer's search criteria mandate that in order to be considered for the NC 403(b) Program, the strategy must be rated "Preferred Provider," the manager must have a mutual fund vehicle open to new investors, must be willing to accept minimal initial assets and be added to TIAA-CREF's recordkeeping platform. Only one manager met the criteria: Vanguard Extended Market Index, which offers investors a low-cost option to gain broad exposure to the US mid- and small cap stocks. Mercer recommends the selection of this passive option, as the manager is well known for indexing, had no liquidity issues in 2008 and although they engage in securities lending, they do so very conservatively. All revenue from securities lending is passed to investors. Ms. Magner reiterated that an index product must have a tight tracking error and a low expense ratio is preferred: Vanguard's fee is 10 basis points.

Subcommittee members agreed with Mercer's recommendation and Ms. Cochran make a motion to select Vanguard Extended Market Index. Mr. Orr seconded and the motion passed unanimously.

Mercer presented two candidates for the Passive Core Fixed Income:

1. Vanguard Total Bond Market Index Fund, Admiral share class
2. BlackRock US total Bond Index Fund, K class share

These funds are designed to provide broad exposure to US investment grade bonds denominated in US dollars and invest in Treasury, Agency, corporate and mortgage-backed, as well as asset backed securities. Ms. Magner stated that BlackRock offers a slightly more advantageous fee of 6 basis points but if consistency is what the program is looking for, and then Vanguard is also an option at 7 basis points.

Ms. Smith noted that Investment Management Division has a substantial relationship with BlackRock and even if mutual fund fees are non-negotiable, there may be an opportunity to reduce them elsewhere.

Mr. Toole reiterated that TIAA-CREF and Vanguard partnered in offering the program to North Carolina and stressed that TIAA-CREF should be notified that BlackRock is being considered as possible replacement candidate, as this may potentially impact the vendor relationship. Ms. Magner believed that Vanguard might eliminate the minimum on Admiral class shares, and Mr. Dillard added that Mercer would communicate with TIAA-CREF, also noting that the fee difference is quite small already and either option is a suitable one. Ms. Buonfiglio added that the members are familiar with Vanguard and from the member perspective, it makes sense to have consistency in the fund family.

Subcommittee members agreed that the recommendation should be postponed until such time as a fee reduction was discussed and decided upon. A telephone meeting will take place in the near future to discuss the results of fee negotiation.

AGENDA ITEM - SUBCOMMITTEE MEMBERS QUESTIONS/COMMENTS

No further comments were offered.

AGENDA ITEM – PUBLIC COMMENT

No public comments were offered.

Ms. Cochran made a motion to adjourn and Mr. Orr seconded. The motion passed unanimously and the meeting adjourned at 4:08 p.m.

Mary Buonfiglio

Secretary