

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

**MINUTES OF MEETING
November 15, 2012**

Time and location: The Investment Subcommittee (the "Subcommittee") of the Supplemental Retirement Board of Trustees (the "Board") met on Thursday, November 15, 2012, in the Dawson Conference Room of the Albemarle Building, 325 North Salisbury Street, Raleigh, North Carolina.

Members Present: The following members were present: Libby George (Chair), Mona Keech, and Melinda Baran.

Members Absent: Chuck Leedy. Mr. Leedy granted Ms. George his proxy for the meeting.

Staff Present: The following Department of State Treasurer staff members were present: Steve Toole, Mary Buonfiglio, Blake Thomas, Joan Fontes, William Hockett, and Tina Simpson.

Guests Present: Board member Dalip Awasthi was in attendance. Prudential representatives attending were Tim Bryan and Rob Luciani. Also in attendance were Andy Apostol from Galliard, Elizabeth O'Hara and Andrew Shilling from Wellington, Jay Love from Mercer Investment Consulting, and interested member of the public Bob Slade. Travis Swartwood (Prudential) and Kelly Henson (Mercer Investment Consultants) joined by phone.

Form of Meeting: Mr. Awasthi is a newly appointed member of the Supplemental Retirement Board of Trustees, but Mr. Awasthi has not yet been appointed to the Investment Subcommittee. All parties agreed that Mr. Awasthi would take part in the Subcommittee session and provide comments as he saw fit, but would not vote upon Subcommittee motions.

AGENDA ITEM – INTRODUCTION

The meeting was called to order at approximately 9:00 a.m.

AGENDA ITEM – ETHICS AWARENESS AND CONFLICTS OF INTEREST

Chairwoman Libby George read the Ethics Awareness and Identification of Conflicts or Potential Conflicts of Interest Statement. No conflicts, potential conflicts or appearances of conflicts being reported, the Chair moved to the next agenda item.

As required by N.C.G.S. § 138A-15(c), we note in the minutes that the State Ethics Commission cited the potential for a conflict of interest concerning Ms. Baran. This potential for a conflict of interest arises because Ms. Baran is the Assistant Vice President of Investments with Wells Fargo Advisors. The Ethics Commission concluded in its August 24, 2012 letter, "The potential conflict identified does not prohibit service on this entity."

AGENDA ITEM – APPROVAL OF MINUTES

The minutes from the August 15, 2012 Subcommittee meeting were reviewed. Melinda Baran moved to accept the minutes as written. This motion was seconded by Mona Keech and passed unanimously.

AGENDA ITEM – STABLE VALUE PORTFOLIO REVIEW AND RECOMMENDATION

The Chair recognized Andy Apostol with Galliard to report on the performance of the Stable Value Fund and offer recommendations for any changes to the Stable Value Fund that would be advantageous.

Mr. Apostol began by noting that the Stable Value Fund has performed very well this past quarter. Whereas a Stable Value Fund will typically perform 100-200 basis points above money-market accounts, the Plans' Stable Value Fund has recently performed 300 basis points above money-market accounts.

Mr. Apostol noted that the securities within the Plans' Stable Value Fund have unusually long durations. This has benefitted the Plans to date, as it has meant our Stable Value Fund has had one of the highest market value to book value ratios in the market. However, Galliard now expects that the duration of these securities will decline in anticipation of the eventual rise of interest rates.

Ms. Keech questioned Mr. Apostol on how rising interest rates would impact the price of wrap contracts. Mr. Apostol responded that the primary driving factor in the pricing of these contracts is supply and demand. Prior to the 2008 financial crisis there were eight to 10 issuers of these agreements offered at 7 to 8 basis points. That market has now tightened and wrap fees are from 18 to 25 basis points. Wrap providers use underlying plan profiles to determine risks and set fees. Mr. Apostol observed that our Plans' profile is relatively favorable, both in terms of age and the ratio between terminated and active participants. Ms. Keech asked what percentage of participants are 65+, to which Mr. Apostol answered 19.9. Ms. Keech requested further information on the 70+ demographic.

In response to a question from Ms. Baran, Mr. Apostol noted that 31 percent of all 401(k) assets were invested in the Stable Value Fund, which constitutes a slightly higher allocation to the Stable Value Fund than average.

Mr. Apostol discussed the Stable Value Fund's allocation between intermediate duration, short duration, and liquidity buffer strategies. Mr. Apostol did not recommend any changes to the allocation benchmarks at this time.

Mr. Apostol did recommend adding another manager to the Fund to raise the number to six. The purpose here is to add greater diversification across managers; Mr. Apostol noted that such an addition would be in keeping with the general practices of similarly situated larger funds, which typically have between four and six managers.

In response to questions from Ms. Baran and Mr. Awasthi, Mr. Apostol provided detail about the minimum required credit quality rating for a wrap issuer. A minimum rating of A- is required in order to participate.

Mr. Apostol provided Galliard's overall goals for the Stable Value Fund: first, to increase manager diversification by adding an additional manager; and second, to increase wrap issuer diversification by adding an additional wrap issuer.

As to Galliard's second goal, Galliard is currently working with Transamerica to provide a quote under which it would provide wrap services to the Stable Value Fund. That effort is not yet complete, and it will be presented to the Subcommittee and the Board at a later meeting.

As to Galliard's first goal, Galliard recommended adding Jennison Associates, a subsidiary of Prudential, as an additional manager. Mr. Apostol stated that Jennison will provide diversity in both its management and investment style, as it is characterized by a more bottom-up style of management and focused on value-oriented security investments. Jennison manages as a large \$2 billion fixed income pool with Galliard. Galliard anticipates that this existing relationship will enable them to bring the firm in at a lower fee level.

Mr. Love commented that, while Jennison is not expected to "blow performance out of the water," Mercer is very comfortable with their addition to the portfolio.

Mr. Apostol then recommended allocating to Jennison 15 percent of fund assets, but as much as 24 percent of the intermediate-duration component of the Stable Value Fund.

Mr. Apostol addressed the impact of adding Jennison on fees and performance. Mr. Apostol explained that Galliard expects to see a slight increase in wrap fees of approximately 1 basis point. He directed the Subcommittee to the analysis supplied in Galliard's materials for the meeting. These materials compared the current and projected fees, allocation, and performance of the Stable Value Fund with and without Galliard's proposed transition to Jennison. The proposed altered portfolio, including Jennison, would have outperformed the current Stable Value Fund over five of the last eight years. Mr. Apostol commented that this amount of outperformance makes it prudent to change strategy.

Mr. Awasthi noted that over the last four years, the markets had exhibited many unusual characteristics. He asked Mr. Apostol whether the previous eight years' performance could be expected to be representative of future market behavior. Mr. Apostol responded that Galliard could not say that the Jennison transition would in fact increase performance over the next eight-year period. The transition's overall goal is to improve consistency of investment returns.

Jennison's additional return over the last few years has come in part from being relatively overweight in corporate securities, but also from selecting a superior set of securities.

Ms. Baran asked, if the recommendations are approved, how quickly they will be implemented and how, in the interim, performance would be differentiated and measured. Mr. Apostol estimated that such an agreement would be finalized by the third quarter of 2013. He explained that while that may seem like a long timeline, Galliard wants to allow time for a gradual migration and to allow complete underwriting from Transamerica.

Ms. Keech made a motion to adopt Galliard's recommendations to present to the full Board at the next meeting. Ms. Baran seconded this motion, which passed unanimously.

Mr. Apostol then presented reports on performance by the Stable Value Fund's individual managers and on the Stable Value Fund's fees.

Mr. Apostol observed that the 401(k) and 457 Stable Value Fund portfolios have moved "almost in lockstep," and both have outperformed their benchmark indices over all time periods. The average quality of securities is AA+ and the average quality of the wrap agreements is A/AA-. The blended yield is 2.88 percent and the market to book value ratio is 105.24 percent, one of the best in the industry. The Stable Value Fund's 2.88 percent crediting rate compares very favorably to money markets' performance, which is currently in a range of 0.2 percent or less, and the five-year Treasury, which is on the order of 0.65 percent. Galliard expects that the Stable Value Fund's crediting rate will continue to decline to reflect current interest rates.

Ms. George asked what would be the expected scenario should participants suddenly withdraw money en masse in response to a catastrophic event, such as the threatened fiscal cliff. Mr. Apostol responded that such a drain would have to be very significant and sustained before Galliard would recommend any changes. This would require a drain of as much as \$40-50 million over a quarter.

Ms. Baran asked Mr. Apostol to explain what would happen in the reverse scenario, if the fund had a massive influx of money. In that event, Mr. Apostol responded, the fund would have to invest in lower interest rate securities, which would accelerate the reduction of the crediting rate. While this would not create a change in overall asset allocation, Galliard might then recommend adjusting to support a larger cash allocation.

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 of market forces over the past quarter and the Plans' performance.

Mr. Love opened by observing that the Portfolio's performance has been strong this past quarter. He further noted that plan assets are increasingly allocated in accordance with GoalMaker directives.

Mr. Love described the past quarter as a macro-driven relief rally. Aggressive stimulus actions, including the anticipated third round of quantitative easing by the Federal Reserve and the European Central Banks undertaking to purchase member-funded bonds under its new policy of Outright Monetary Transaction, have had calming effects on the markets, improving valuations. Despite this rally, the uncertain economic environment will cause the financial markets to continue to be subject to volatility.

Mr. Love noted:

- The global equity markets have exhibited strong gains. The US equity market has gained 14-17 percent over the year to date.
- Value stocks outperformed growth stocks over all capitalization segments this past quarter.
- For the second consecutive quarter, the best performing asset class was Large Cap Value, with a return of 6.5 percent.
- The energy sector had the most robust gains. Telecom stocks were the top performer with a 25.9 percent return.
- The US dollar continues to function as a financial "safe haven" globally.
- Monetary easing, in addition to reduced macro tensions, contributed to the depreciation of the dollar over the past quarter by 2.9 percent.
- Over the past quarter, international markets outperformed slightly, but have underperformed over the year-to-date.
- Over the past year, emerging markets have outperformed, but not by as great a margin as expected.
- Global REIT underperformed broad equity markets for the quarter.
- The management of the fiscal cliff and changes to US tax policy will play a significant role in future market performance.

Ms. Keech questioned Mr. Love on the outlook of the US housing market and its projected impact on the national economy. Mr. Love, acknowledging the significant indirect impact that market has on the economy, responded that Mercer believes that this market's decline has stopped and that we will soon see it start to contribute to the economy.

Mr. Love then turned to report on the performance of individual fund managers. Mr. Love first commented on the performance of the Large Cap Value Fund, which as a whole performed beneath the one-year and three-year benchmarks. Mr. Love stated that he is not concerned by the underperformance of the Hotchkiss & Wiley Large Cap Value and Wellington Quality Value funds, as he believes the reasons for this underperformance have been addressed. Secondly, Mr. Love asserted that he derives reassurance from seeing some of the Supplemental Retirement Plans' funds and managers underperforming in any particular quarter, as this indicates

diversification. In this segment, Robeco BP Large Cap Value fund outperformed very significantly, which outweighed the underperformance of the other two managers.

Ms. George asked Mr. Love to elaborate further on why Mercer downgraded its rating for Neuberger from "A" to "B+". Mr. Love explained that changes in internal leadership, including the departure of two senior project managers, indicated that there are some internal organizational issues that remain.

Ms. Buonfiglio asked Mr. Love to further clarify Mercer's rating system, what it means, and at what point any particular rating would trigger action on the part of Mercer. Mr. Love explained that a rating of "A" means that Mercer has most confidence in the organization; a "B+" indicates that Mercer still expects that the fund will outperform; a "B" is a 'neutral' rating, meaning that Mercer expects the fund will have an average performance; and a rating of "C" means that Mercer expects the fund to underperform compared to the index. At the point of a "C" rating, action is needed. Where a fund is downgraded to "B", Mercer recommends some action, although that action may not necessarily be termination. Mr. Love further explained the Mercer ratings' citations indicating when a manager or fund is tracked ("T") and/or watched ("W"). A citation of "T" indicates a manager-tracked benchmark that could be volatile over the short term, while a "W" citation indicates a long-term, continuing event. For example, Robeco is marked with a "W" rating because of team shifts and concerns regarding its internal organization.

Mr. Toole asked how Mercer's performance scorecard relates to the Plan's Investment Policy Statement ("IPS"), and whether action is needed under the IPS where Mercer has noted "red" on its scorecard. Mr. Love asserted that no action is needed, as the IPS always references a rolling three year period. When looking at fund performance in the context of the IPS, Mercer is looking for patterns in order to understand why a given fund or manager is underperforming.

Mr. Love then turned to discuss Mondrian ACWI ex US Value, noting that the underperformance of this fund over the past years is not a concern. Instead, the Mondrian fund is acting as expected given its exposure and allocation. It performs a diversifying role within the International Equity Fund.

Ms. George expressed concern regarding the payment of fees to managers who are not outperforming indices. Mr. Love responded that for large-cap equities, there may not be a significant advantage to active, rather than passive, managers, but noted that in general, the Plan had some of the best results across Mercer's client base.

Mr. Love discussed the diversification of the portfolio, taking Sands and Neuberger as an example of such diversification. Mr. Love does not expect both to outperform, as each of these managers utilize different styles and investment directions. The objective, for a quarter like this one, is to have Sands outperform by more than Neuberger trails.

Ms. George asked Mr. Love to incorporate the GoalMaker C01 (conservative 0-5 year maturity) and R02 (aggressive 6-10 year maturity) benchmarks into Mercer's quarterly reports.

Mr. Love concluded his presentation, noting that the plan is structured quite well and that no changes are recommended at this time.

AGENDA ITEM – INVESTMENT POLICY STATEMENT MONITORING

The Chair led a discussion on the Plans' compliance with the current Investment Policy Statement, noting that Prudential, Mercer and Galliard have joined together in a collective effort to monitor various areas. The Chair then recognized Mr. Love, who provided a chart showing compliance with the IPS and manager guidelines.

First, Mr. Love gave an account of compliance measured at the fund level, measuring each fund's compliance with the Plans' Investment Policy Statement. Mr. Love reported that all funds were in compliance with the promulgated IPS, with the exception of the Plans' Global Equity Fund. The Plans' IPS calls for a maximum allocation to any one country of twice that country's weight in the MSCI AC World Index.* Mr. Love stated that he believed this provision should not always be a hard-and-fast rule for an international fund. Mr. Love noted that he preferred to keep the ability to overweight smaller countries. Mr. Love recommended that, on this point, the full Board of Trustees should recognize a technical violation of the Plans' IPS, but should grant an exception to the IPS rule.

Then, Mr. Love turned to the topic of compliance measured at the manager level. Here, each manager's performance was measured against the guidelines in the manager's contract and against the Plans' Investment Policy Statement. Mr. Love noted that some managers' contractual guidelines did not match the Plans' Investment Policy Statement. The Chair asked why that was. Mr. Love stated that no one gave the managers the IPS – that the linkage “was not made.” No violations of the managers' contractual guidelines were found. However, there were four managers whose portfolios were in technical violation of the Plans' Investment Policy Statement. These managers were Hotchkiss and Wiley, Wellington, Pimco, and Mondrian. The Chair and Ms. Buonfiglio noted that this was an identified issue and stated that the Subcommittee, Board and staff would work to reconcile the IPS and contractual guidelines.

Ms. Buonfiglio restated her thanks to all service providers during this period in addressing this challenge.

The subcommittee recessed for a five minute break at the motion of Ms. Keech.

AGENDA ITEM – PORTFOLIO MANAGER PRESENTATION

The subcommittee reconvened at 11:02 a.m. The Chair recognized Andrew Shilling and Elizabeth O'Hara from Wellington. Mr. Shilling led the presentation, taking the opportunity to

* The Plans' IPS also provides that for countries whose allocation is less than 5 percent, the maximum allocation will be 10 percent. In addition, the maximum allocation to any one country shall be 50 percent, regardless of the index weight.

provide the subcommittee with Wellington's background, investment philosophies, structural organization, and history with the North Carolina Retirement Systems.

Mr. Shilling then discussed the Wellington Opportunistic Growth Portfolio in further detail. He noted that the portfolio is aligned towards opportunistic growth, which he characterized as a conglomeration of the firm's "best ideas." Although the Opportunistic Growth fund is primarily modeled on Wellington's large cap growth strategy, it also includes some other (i.e., small and medium cap) strategies. Mr. Shilling noted that 2011 was a difficult year because growth was so much out of favor. 2011 was an extremely defensive market with a focus on safety investments beginning in the third quarter. While 2011 was a difficult year, Mr. Shilling stated that the growth oriented approach has had very favorable long term results.

In 2012, Wellington has found that its selected stocks have begun being valued more highly. The growing realization appears to be that we are no longer in a global recession and can expect some real estate market improvement.

Mr. Shilling then took the opportunity to comment on the performance of specific investment selections within the portfolio as a means of illustrating Wellington's method of selection and valuation. In particular, Mr. Shilling discussed Family Dollar, Hologic and Edwards Life Sciences. Mr. Shilling then discussed investment choices not made, noting that Wellington assessed "safety stocks" as currently being very expensive, with little opportunity for growth.

In response to questions from Ms. Keech and Mr. Love, Mr. Shilling discussed the Opportunistic Growth Portfolio's weighting in Lowe's and Apple.

Ms. O'Hara then concluded Wellington's presentation with a brief overview of Wellington's Quality Value Portfolio and Global Opportunities Portfolio, the other two Wellington funds available to participants in the Supplemental Retirement Plans.

AGENDA ITEM – STAFF REPORT ON 403(b) VENDOR SELECTION

The Chair recognized Mary Buonfiglio who reported that selection of a 403(b) recordkeeping vendor is on track, with a finalist selection meeting held last week. The selection committee will make recommendations to the Board at the December 5 Board meeting.

AGENDA ITEM – STAFF REPORT ON INVESTMENT CONSULTANT RFP

Mary Buonfiglio continued to report on progress in the recruitment of an investment consultant for the Board. Department staff have spoken with three or four firms, including Mercer, regarding this consulting service. The core questions are, first, what the Board and Department want the relationship to look like, and second, how to specifically craft clear responsibilities for each party. Staff hope to issue the RFP in the first quarter of 2013.

AGENDA ITEM – QUESTIONS AND COMMENTS

During Mr. Love's presentation, member of the public Bob Slade commented upon participant requests to make GoalMaker portfolio year-to-year performances available on the website administered by Prudential for the Plans. A discussion followed. Rob Luciani with Prudential cautioned that inclusion of such information may not be helpful or wise, noting that it is important that the Plans not be made to look like a Fund. Mr. Love commented that, while these reports are hypothetical assessments, the Plan could "put them out there." Mr. Luciani again expressed concern, noting that any time you provide participants with any level of performance review, certain rules apply.

At the end of the Subcommittee meeting, the Chair opened the floor to any further questions or comments. There being none, Melinda Baran made a motion to adjourn, which was seconded by Mona Keech and approved unanimously. The meeting adjourned at 11:50 a.m.
