MINUTES
INVESTMENT SUBCOMMITTEE OF THE BOARD OF TRUSTEES
OF THE NORTH CAROLINA SUPPLEMENTAL RETIREMENT PLANS
August 15, 2012, 9:00 a.m.
Dawson Conference Room
Albemarle Building, 325 N. Salisbury Street
Raleigh, NC

The meeting of the Investment Subcommittee of the Board of Trustees for the Supplemental Retirement Plans was called to order at 9:00 a.m. by the Acting Chair, Steve Toole.

Members Present

Libby George and Mona Keech attended in person.

Members Absent

Chuck Leedy was not in attendance.

DST Staff Present

Staff members present were: Steve Toole, Mary Buonfiglio, Timothy Dale, Bryan Lewis, Blake Thomas, and Jaclyn Goldsmith.

Guests Present

Board member Melinda Baran was in attendance. Prudential representatives attending were Travis Swartwood, Tim Bryan, and Rob Luciani. Also in attendance were Jay Love and Kelly Henson from Mercer Investment Consulting, Andy Apostol from Galliard Capital Management, and Scott Dauenhauer from SST Benefits Consulting. Mr. Apostol and Mr. Dauenhauer joined by telephone.

Form of Meeting

Because the previous Chair of the Investment Subcommittee, Dexter Perry, was not reappointed to the Supplemental Retirement Board of Trustees, Mr. Toole acted as Chair for this meeting.

The Subcommittee briefly discussed with Mr. Thomas, legal counsel to the Board, whether Ms. Baran should vote at this Subcommittee meeting. Ms. Baran is a newly appointed member of the Supplemental Retirement Board of Trustees, but Ms. Baran has not yet been appointed to the Investment Subcommittee. All parties agreed that Ms. Baran would take part in the Subcommittee session and provide comments as she saw fit, but would not vote upon Subcommittee motions.

Conflicts

The Chair asked the Subcommittee if there were any actual conflicts, potential conflicts, or appearances of a conflict concerning any item on the meeting agenda. No conflicts were reported.

Approval of Minutes

It was moved by Libby George and seconded by Mona Keech to approve the minutes from the Investment Subcommittee meeting held on May 16, 2012. The motion passed unanimously.

At this time Ms. Keech expressed concern regarding the proposed cuts to the Great West allocation in the Stable Value Fund, as presented at previous meetings of the Investment Subcommittee. Mr. Toole noted that the proposed changes were based on a strategic recommendation from Galliard, which the Board could discuss with Galliard during the next item on the meeting agenda.

Stable Value Fund Portfolio Review

The Chair recognized Andy Apostol with Galliard to report on the Stable Value Fund.

Mr. Apostol began by describing the market for wrap providers, noting that new providers and new capacity had recently appeared in the market.

Mr. Apostol then provided a transition update. Based on earlier direction from the Board to limit exposure to the Eurozone, Galliard changed the short term investment fund used for accounts custodied at Wells Fargo to a government money market short term investment fund. This transition is now complete.

Mr. Apostol turned to the subject of overall portfolio allocation, including the topic raised by Ms. Keech earlier in the meeting. Galliard had not yet completed its revised recommendation for adjustments to Stable Value Fund wrap providers and investment managers. The revised recommendation, to be provided at the next Subcommittee meeting, will take into account the feedback received by Galliard at the previous Investment Subcommittee meeting. Mr. Apostol stated that Galliard was currently in discussions with Transamerica to further diversify the wrap coverage provided in the fund. Once Transamerica has finished its underwriting proposal, Galliard will perform quantitative analysis to demonstrate whether the proposed change adds value to the portfolio. In addition, the Chair asked Galliard to summarize in a single document the best industry practices for a fund of the Plans' size.

Mr. Apostol reported on the second quarter performance of the Stable Value Fund:

- The average duration was 2.6 years;
- Market to Book value was 104.77 percent;
- The Fund's blended yield was 3.05 percent;
- Actual return on the portfolio was approximately 1.4 percent for the YTD.

Although there is no precisely analogous benchmark to the Stable Value Fund, the Fund outperformed inflation and two measures of performance: three-year constant maturity Treasuries and 91-day T-bills + 150 basis points. There were no fee changes in the quarter.

Mr. Apostol discussed with the Subcommittee the topic of Stable Value Fund portfolio duration. Longer-duration portfolios take longer to track changes in interest rates, and therefore have larger differences between book and market value. In a falling interest rate environment, longer duration is helpful. However, in the present environment, with interest rates unlikely to decline further, a lower duration becomes desirable. In response to a question from Ms. Buonfiglio about whether the Plans should reduce duration still further, Mr. Apostol noted that Galliard was comfortable with the present situation, for two reasons. First, underlying managers are likely to shorten up their durations. Second, the Plans' positive cash flows allow easier investment when interest rates rise, which increases potential return for the Plans in a rising interest rate environment. Mr. Apostol reminded the Subcommittee that the Stable Value Fund is designed to smooth out market volatility over the duration of the portfolio.

The Chair thanked Galliard for its presentation. At this time, Mr. Apostol left the meeting.

<u>Economic Overview and Quarterly Investment Performance Report</u>

The Chair then recognized Jay Love and Kelly Henson from Mercer.

Mr. Love noted the following:

- GDP estimates were a modest 1.5 percent annualized rate;
- The dollar strengthened against other currencies;
- Treasuries continued to be attractive;
- Economic data measuring job growth was surprisingly disappointing;
- Mondrian, an investment manager in the international fund, had a portfolio manager leave;
- Investment management fees remain low when compared to competitors;
- The Plans' Large Cap managers struggled compared to their respective benchmarks for the quarter;
- The Eurozone is in a recession and short-term growth prospects are poor; and
- There are no concerns or performance issues identified with any of the options or fund managers.

Ms. Henson discussed with the Subcommittee a chart comparing the fees and expenses paid by the Plans to the median fees and expenses tracked by Mercer. The Plans feature lower fees for most funds, and in many cases the Plans' funds have significantly lower fees. Fees were slightly above the median for certain index funds and active managers.

In response to a question from Ms. George, Mr. Love noted that approximately $2 billion of the Plans' assets were invested through Goalmaker. The remainder is invested at the direction of participants, distributed among various asset classes and the Stable Value Fund.

Ms. George asked Mr. Love whether there were any investment options that the Plans should consider in addition to the present choices. Mr. Love indicated the inflation sensitive investment option that would be discussed next on the agenda.

The Chair thanked Mercer for its report.

Inflation Sensitive Investment Option

Mr. Love then presented Mercer's recommendations regarding the proposed inflation sensitive investment option. The fundamental idea behind an inflation sensitive option is to provide a structure that will do well in a high-inflation environment. Mr. Love discussed options in terms of two criteria: first, hedging against high inflation; and second, beta, or sensitivity to volatility.

Mercer's report presented five possible diversified inflation sensitive investment funds that Mercer believed to be the best suited for the Plans. Mercer analyzed these options based on each fund's investment allocations, fees, assets under management, and inception date.

Mercer further grouped the funds into high-beta or low-beta options. Mr. Love stated that the high-beta funds, compared to the low-beta candidates, have the possibility of providing additional return over longer periods of time but expose participants to additional downside risk during market downturns. Mr. Love stated that both beta options would provide inflation protection, but the choice between the low-beta and high-beta options is a policy decision for the Subcommittee to consider.

Based on the analysis in Mercer's report, Mr. Love suggested the PIMCO Inflation Response Multi-Asset Fund as the best low-beta option and the Wellington Balanced Real Assets Collective Investment Trust as the best high-beta option for the Plans.

Both the PIMCO and Wellington funds invest a large portion of their assets in TIPS and inflation managed funds. Both funds also invest in commodities. The PIMCO fund also invests in non-dollar funds and currencies, real estate, and gold; the Wellington fund makes equity investments based on natural resources. Mr. Love noted the existence of underlying derivatives in the PIMCO fund. The Subcommittee discussed the need to ensure that the Investment Policy Statement correctly describes and authorizes this strategy if the Board chooses to utilize the PIMCO fund.

The Subcommittee asked for input from the Investment Management Division staff. Bryan Lewis, interim chief investment officer, stated that this investment option would be most commonly used to diversify members' accounts from traditional equity and fixed income investment options. Members electing this option would most often be using the option as a hedge against inflation risk associated with projected rising inflationary environments. Based on that assessment, Mr. Lewis noted that the low-beta option may be the best fit for the Plans.

Mr. Love stated that he agreed with Mr. Lewis' assessment, and the PIMCO low-beta option was Mercer's top inflation sensitive choice overall for the Plans. In response to a question from Ms. George, Mr. Love noted that the volatility of the Wellington option would be problematic for participants close to retirement.

Mr. Love noted that higher fees were an expected drawback for any inflation sensitive investment option, and he presented a table prepared by Mercer that set out the fees for each of the five candidate funds.

Ms. Baran noted that many of the investment options in the Plans had multiple managers supporting each fund. She asked if both strategies could be added to the investment option. Mr. Love indicated that it was possible to have two managers under the inflation sensitive investment option, but speculated that it would not produce any additional benefit over a one manager approach, especially with the limited funding mandate provided by the Plans. Mr. Lewis noted that if a second manager were being provided for the sake of diversification, the Subcommittee would want to check to make sure that there was minimal overlap in the underlying investments.

It was moved by Libby George and seconded by Mona Keech to recommend PIMCO to the full Board for consideration, with an allocation yet to be determined. The motion passed unanimously.

The Subcommittee took a five-minute recess, then resumed the meeting.

403(b) Vendor Selection Update and 403(b) Investment Fund Selection

The Chair encouraged, but did not require, parties interested in bidding on the 403(b) program to leave that portion of the meeting, in order to create a level playing field for all potential bidders. The Chair then turned the meeting over to Ms. Buonfiglio.

Ms. Buonfiglio indicated that staff had decided to reissue the Invitation to Bid (ITB) for the record keeper for the North Carolina 403(b) program. Judging from the responses received, Ms. Buonfiglio stated that there may have been some confusion about ITB questions and requirements. Staff wanted to clarify the ITB so that vendors would have the opportunity to provide their best response. She stated that staff hoped to reissue the ITB as soon as possible so that the Board could select a vendor at the December meeting.

Ms. Buonfiglio then recognized Scott Dauenhauer from SST Benefits Consulting to discuss the prospective investment lineup for the NC 403(b) program.

Mr. Dauenhauer began by providing background information about the investment choices of typical retirement plan participants. He noted that the vast majority of participants preferred to delegate control and management of their retirement account to professionals. A much smaller portion of the population preferred more action and control of their investments.

Mr. Dauenhauer explained that the 403(b) program would require a different investment lineup than the Board's existing 401(k) and 457 plans, as a 403(b) plan cannot be structured as separate accounts. Annuities and mutual funds with a custodial account are the only option. Mr. Dauenhauer then presented multiple fund lineups that were structured according to the various populations the 403(b) program would serve, with varying levels of investment flexibility and automatic delegation of management.

The Subcommittee determined that the fund selection would be delayed until a future meeting to evaluate a specific proposal. The Chair thanked Mr. Dauenhauer for his presentation.

At this time, Mr. Dauenhauer exited the meeting.

Investment Policy Statement Review Project

At approximately 12:05 p.m., the Subcommittee voted to close the meeting pursuant to N.C.G.S. § 143-318.11(a)(3) to allow the Subcommittee to receive privileged legal counsel concerning the handling or settlement of a potential claim. The claim discussed in the session is not the subject of any outstanding lawsuit.

The meeting was reopened to guests at 12:49 p.m. Due to time constraints, the Subcommittee determined that agenda item nine, the discussion of money manager presentations, would be delayed until a future meeting.

Adjournment

There being no further business, it was moved by Libby George and seconded by Mona Keech to adjourn the meeting at 12:50 p.m.

Libby George

CHAIR