

MINUTES
INVESTMENT SUBCOMMITTEE OF THE BOARD OF TRUSTEES
OF THE NORTH CAROLINA SUPPLEMENTAL RETIREMENT PLANS

May 16, 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 Chair, Dexter Perry.

Members Present

Members present were: Dexter Perry. Libby George joined by phone.

Members Absent

Chuck Leedy was not in attendance.

DST Staff Present

Staff members present were: Steve Toole, Timothy Dale, Rhonda Smith, Bryan Lewis, William Hockett, Joan Fontes, Blake Thomas, and Jaclyn Goldsmith.

Guests Present

Prudential representatives attending were Travis Swartwood, Tim Bryan, Tammy Lewert, Jennifer Willis, and Bill Walsh. Also in attendance were Jay Love and Kelly Henson from Mercer Investment Consulting, Andy Apostol and Carrie Callahan from Galliard Capital Management, and interested public members Robert Slade and Mary Buonfiglio.

Form of Meeting

The Chair noted at the beginning of the meeting that a quorum was not established. As a result, no formal actions were taken by the Subcommittee at this meeting. The Subcommittee members would report to the full Board at the subsequent June 6, 2012 meeting, which would take action after hearing the Subcommittee members' recommendations.

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

Due to the lack of quorum, the Subcommittee postponed the vote to approve minutes from the previous Subcommittee meeting.

Stable Value Fund Performance Report

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

Mr. Apostol began by presenting Galliard's revised recommended portfolio adjustments scheduled to begin in 2012. The adjustments were recommended to further diversify the Plans' assets between multiple wrap providers and investment managers. Galliard proposed the following:

- Reduce the PIMCO allocation by \$100 million;
- Replace the Prudential wrap coverage of the Payden and Rygel portfolio with Metlife wrap coverage;
- Reduce the Great West portfolio allocation by approximately \$185 million;
- Reduce the Prudential portfolio allocation by approximately \$100 million;
- Fund a new Jennison managed portfolio;
- Add Prudential wrap coverage on the Jennison portfolio;
- Fund a new Babson managed portfolio; and
- Wrap the new Babson portfolio with Mass Mutual wrap coverage.

Mr. Apostol noted at the previous Subcommittee meeting Galliard had recommended eliminating PIMCO as a manager and moving all of its assets to other managers. In this recommendation, PIMCO would remain an investment manager but would receive a reduced allocation. Mr. Apostol also noted that the allocation changes and funding of new managers would be a gradual process that would take approximately 12-24 months to complete.

Ms. Callahan stated that the changes would provide additional diversification and reduced risk by shifting allocations across multiple fixed income sectors. She noted that some managers maintain sector biases in their allocations and Galliard was comfortable with that approach as long as other managers in the Fund allocated to other sectors. Ms. Callahan gave the example of Great West, which maintained a bias toward mortgage-backed securities that had benefitted the Fund over the past few years. However, she stated that the Fund would also benefit from the additional diversification provided by Jennison that maintains a bias toward corporate bonds.

Mr. Perry asked what the total assets under management were for Babson compared to PIMCO. Ms. Callahan responded that Babson currently has approximately \$150 billion under management compared to PIMCO which has over \$1 trillion under management. Mr. Perry noted that the changes would slightly increase the overall Fund expense and asked if the proposed changes would provide an overall benefit in relation to the additional expense. Mr. Apostol stated that performance would likely remain similar when compared to the current structure, but the changes would add diversification and reduce duration volatility in the Stable Value Fund.

Mr. Perry and Mr. Apostol discussed the ratings applicable to the Great West and new proposed portfolios. Mr. Apostol commented that the proposed investments would have similar ratings, listed as either AAA or U.S. government debt.

Mr. Perry stated that, before implementing the proposed changes, the Subcommittee would like to further review projected Fund performance, fees, and risk levels, comparing the current structure to the proposed structure.

Mr. Apostol then reported on the first quarter performance of the Stable Value Fund and noted the following:

- The crediting rate for the quarter was approximately 3 percent;
- Overall effective duration was approximately 2.75 years;
- The Market Value/Book Value ratio was 104.4 percent; and,
- The actual return of the Fund without amortized gains was 1.5 percent.

Stable Value Fund participants examining their statements will see a 3% rate, slightly declining from the crediting rates in previous quarters.

The Subcommittee discussed potential performance of the Stable Value Fund in rising interest rate environments. Galliard representatives noted that if the rates made gradual shifts, the Stable Value Fund would be expected to outperform even in a rising interest rate environment.

The Chair thanked Galliard for its presentation.

Economic Overview and Quarterly Investment Performance Report

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

Mr. Love noted the following:

- GDP estimates were a modest 1.7 percent annualized rate;
- Equities provided strong returns for the quarter;
- Fixed income performance was less favorable as investors rushed to equities;
- Investment management fees remain low when compared to competitors;
- Rabobank was trying to sell Robeco Investment Management;
- Arrowstreet was added as the second manager in the Global Equity fund; and
- There are no concerns or performance issues identified with any of the options or fund managers.

Mr. Perry noted that Robeco was one of the new managers added in 2011 after the manager search performed by Mercer. He asked whether the pending sale of Robeco posed a risk to the Plans and whether the Board should be considering another search in the future. Mr. Love stated that the pending sale was a result of Rabobank's judgment that, in light of European concerns, it would be wise to obtain additional capital, not a result of issues with Robeco Investment Management. Robeco plans to retain its current staff and investment process after integrating with any prospective buyer.

Mr. Perry noted the continued growth of Apple Inc. as a percentage of plan holdings and its concentration in the Large Cap Growth fund. Because of Apple's outstanding stock appreciation, Apple now makes up an unusually large percentage of many benchmarks; for instance, Apple was 7.5% of the Russell 1000 Growth index. Mr. Love stated that all three manager portfolios in the Large Cap Growth fund contained allocations between 8 percent and 9 percent in Apple securities. Mr. Perry raised concerns that these portfolio weightings exceeded the permitted allocation listed in the Investment Policy Statement. Mr. Love noted that, while the allocation to Apple was in excess of the permitted allocation, it remained close to the benchmark allocation to the company. Mr. Love recommended modifying the Investment Policy Statement to permit managers to invest, in any one company, the greater of 5 percent of the total account or the weight of the security in the assigned benchmark plus 2.5 percent, up to an absolute limit of 10.0 percent at market value.

The Subcommittee expressed interest in making the recommended modifications to the Investment Policy Statement at the next meeting of the Board of Trustees.

Mr. Perry reminded attendees that the Board had taken action to reduce the Eurozone risk associated with the short term investment funds (STIF) utilized by the Plans. Mr. Perry asked the Galliard representatives if Plan assets invested in the Wells Fargo STIF had been moved to Wells Fargo's government-backed STIF. Mr. Apostol stated that Galliard would change the Stable Value STIF account to mirror the STIF used for the separate accounts.

Active vs. Passive GoalMaker Allocations

Mr. Love then presented Mercer's recommendations regarding the GoalMaker allocations toward active and passive management.

Mr. Love noted the following:

- Currently, GoalMaker maintains a 50 percent/50 percent split between active and passive management across all asset classes;
- Passive management provides lower fees for returns that should match their stated benchmark;
- Active management requires a higher fee for returns that attempt to beat the benchmark over time;
- Some asset classes benefit more from active management than others;
- Active management has outperformed passive management in all asset classes over time in the Plans; and,
- Net performance differences, after fees, between active and passive management were most noticeable in the SMid Cap and International equity asset classes.

Based on these findings, Mr. Love recommended maintaining the current 50 percent/50 percent split between active and passive management in the Fixed Income and Large Cap asset classes. However, due to the larger benefit provided by active management in the SMid Cap and International equity asset classes, Mercer recommends moving the allocation to 100 percent active management in these asset classes.

Mr. Perry asked if there would be any capacity issues with the existing active managers upon receiving the transfers from passively managed portfolios. Mr. Love responded that the existing managers were capable of managing the additional funds.

The members of the Subcommittee were supportive and recommended presenting the proposal to the full Board for approval.

The Subcommittee and Mr. Love discussed the distributions of investment choices produced under the GoalMaker program's current glidepath allocations. The Subcommittee members agreed to raise at the next Subcommittee meeting whether these distributions should be adjusted, after a comparison of the glidepath allocations with those of other similar programs.

Inflation-Sensitive Investment Option

Mr. Love then presented the proposed inflation-sensitive investment option to be added to the fund lineup offered by the Plans. In general, inflation-sensitive options seek to provide participants approaching retirement with greater certainty about the real value of their retirement funds, after inflation.

Mr. Love said that inflation-sensitive investment options were not as prevalent in the marketplace as other investment strategies. As a result, there are few managers with considerable experience in the strategy. Mercer presented to the Subcommittee a list of inflation-sensitive investment options. Some options would provide lower expected returns with less volatility over time; other options would provide greater expected returns with greater volatility over time.

Mr. Love continued by providing a breakdown of typical asset class weightings for inflation-sensitive portfolios and the asset classes held by each prospective manager. Mr. Love also explained how each manager attempts to hedge against inflation risk while providing returns in excess of Treasury Inflation Protected Securities.

The Subcommittee members asked that Mercer revisit the inflation-sensitive option at the next Investment Subcommittee meeting to allow further review and analysis.

Adjournment

There being no further business, the meeting was adjourned at 11:55 a.m.

CHAIR