

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

MINUTES OF MEETING

May 16, 2013

Time and Location: The Investment Subcommittee (the “Subcommittee”) of the Supplemental Retirement Board of Trustees (the “Board”) met at 9:00 a.m. on Thursday, May 16, 2013 in the Dawson Conference Room of the Albemarle Building, 325 North Salisbury Street, Raleigh, North Carolina.

Members Present: The following members were present: Elizabeth “Libby” George, Chair, Melinda Baran, Mona Keech, and (by telephone) Chuck Leedy.

Staff and Guests Present: The following staff and guests attended the meeting. From the Department of State Treasurer: Steve Toole, Mary Buonfiglio, Blake Thomas, Kevin SigRist, Rhonda Smith, Rekha Krishnan, Lisa Page, and Sam Watts. From Prudential Retirement: Tim Bryan, Travis Swartwood, and Rob Luciani. From Mercer: Jay Love and Kelly Henson. From the North Carolina Attorney General’s Office: Robert Curran. Member of the Public: Robert Slade.

AGENDA ITEM – WELCOME AND INTRODUCTIONS

The meeting was called to order at approximately 9:05 am.

AGENDA ITEM – ETHICS AWARENESS & IDENTIFICATION OF CONFLICTS OR POTENTIAL CONFLICTS OF INTEREST

Ms. George asked Board 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 – APPROVAL OF MINUTES

Motion was made by Ms. Baran, seconded by Ms. Keech, to approve the minutes from the February 14, 2013 Investment Subcommittee Meeting. The motion was unanimously approved.

AGENDA ITEM – STABLE VALUE PORTFOLIO REVIEW

Andy Apostol from Galliard presented the review of the Stable Value Fund (“SVF”) for the 401(k) and 457 Supplemental Retirement Plans. Mr. Apostol began by noting that the universe of wrap issuers was largest it had been in last decade, with 13 firms on the approved wrap issuer list. Most of the new wrap capacity is at or slightly below the 25 basis point range. Galliard expects wrap fees will stay at this level for at least the next couple of years. Additional wrap

capacity is entering the market, with orderly liquidations from the market by JP Morgan, Bank of America and Natixis. (Mr. Leedy joined the meeting at this time.)

Mr. Apostol reviewed transition of the SVF from 2010 to the present, including changes to the portfolio allocations, numbers of managers and wrap providers, and the goals for 2013, which are to continue implementation of approved changes to portfolio management strategy, secure wrap coverage for Payden & Rygal, and perform on-site compliance reviews of managers.

Ms. Baran inquired about limits on wrap contracts and the appropriate number of managers. Mr. Apostol stated that multiple investment managers are customary in this market – 3 or 6 or 8 – and that Galliard tries to keep any particular manager below 20% where possible.

Mr. Apostol reviewed progress on the previously approved SVF reallocation, including increasing the number of wrap issuers from 4 to 5 and the number of managers from 5 to 6, while decreasing the maximum wrap exposure from 38% to 30% and the maximum manager exposure from 24% to 20%. Reductions are anticipated in the allocation to Wells Fargo STIF buffer and intermediate duration funds managed by Prudential, Great West, and MetLife. The weighted average wrap fee would increase by one basis point, but Galliard expects better performance and lower risk from greater manager and wrap issuer diversification.

Mr. Apostol then presented reports on the SVF's fees and performance for the 1st quarter of 2013:

- The SVF's blended yield was 2.73% before fees.
- The effective duration was 2.88 years.
- The market to book value ratio was 103.97%.
- Total all-in fees were 44 basis points for the 401(k) and 45 basis points for the 457 Plan.
- Actual return on the SVF portfolio, net of fees, was 2.67% for the previous 12 months.

Although there is no exact benchmark, over all time periods the Fund outperformed inflation and two measures of performance: three-year constant maturity Treasuries and 91-day T-bills + 150 basis points. Mr. Apostol noted that the Stable Value Fund was one of the strongest-performing stable value funds on Galliard's books.

The 401(k) and 457 plans had effectively identical performance and portfolios. Mr. Apostol observed that the crediting rate is moving down toward current market interest rates, which is what would be expected. In response to Subcommittee questions as to future expectations, Mr.

Apostol stated that if interest rates and cash flows were unchanged, he would expect the crediting rate to drop from current 2.6-2.7% range to about 1.3% at the end of the next three years. This is because the underlying yield on bond portfolio is about 1.3%. A credit rate expectation of approximately 2.25% at end of year seems logical.

Mr. Leedy asked what would happen if interest rates were to go up by 3% or if members began to withdraw heavily from their accounts. Mr. Apostol stated that in a rising interest rate scenario, a fund such as the SVF can operate at a loss in the portfolio and it would be just as healthy from a crediting rate perspective, because the market value deficit relative to book value will be offset by the increasing yield on the underlying portfolio. A greater worry is actual security defaults. All bond managers experienced the widest gaps between book and market seen in history in 2008 and early 2009. Once markets normalized, parity returned because there were few actual defaults on the underlying securities. Stable value funds have countercyclical cash flows. The underlying factors that would create a rising interest rate environment would be expected to cause investors to seek lower-volatility investments such as a stable value fund.

Finally, Mr. Apostol reviewed performance of the particular investment managers in the SVF; all were doing well. Mr. Apostol noted that these managers' returns, reported on slides 15 *et seq.* in the Subcommittee's materials, were gross of fees. Great West previously was reporting returns that were net of fees, not gross of fees.

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

Jay Love from Mercer presented this report. It was a very strong quarter for equities. U.S. GDP growth in first quarter was not very strong. Expected GDP growth was in the range of 2.5% or higher, which Mercer considers the normal break-even point for economic growth. Investments in foreign currencies were mostly negative. Mercer noted that the U.S. Dollar appears to be slightly undervalued over the long-term.

For the quarter, value outperformed growth, except in the small-cap sector, where that was reversed. Health care was the best-performing sector of the markets, followed by consumer staples and utilities. Stocks in tech sectors in value indexes – often, stocks that had been down – outperformed, while riskier (previously outperforming) stocks underperformed. U.S. equity market appears slightly overvalued, but nothing that indicates a reversal. What drove strong performance this quarter was not earnings growth, but valuation increases.

Mr. Love reviewed performance of various asset classes, with most doing well except for emerging markets, which declined during the quarter. Ms. George inquired as to Sands Capital's

performance. Mr. Love stated that was largely due to its investments in Apple and other tech stocks, but that the long-term outlook was good.

Mr. Love turned to the performance of the Plans' funds available to members as investment choices. He noted that on the Subcommittee materials at pages 29 *et seq.*, the Plans' funds in which members can invest (for example, the Large Cap Value fund) have performance reported net of fees, while the underlying investment managers within those funds (for example, the Wellington Value Composite) have performance reported gross of fees. Mr. Love reported:

- The Large Cap Passive fund is tracking relative to the benchmark.
- The Large Cap Value fund performed beneath the index for 3-month, 1-year, and 3-year periods. Nevertheless, the Large Cap Value fund is still in the top quartile compared to other large-cap value actively managed funds tracked in Mercer's comparable universe.
 - This fund's Robeco Large Cap Value component was discussed, in light of the sale of the investment manager group by the parent company, Rabobank. Because the investment group was sold as a whole, team members are expected to stay together. Mercer does not expect major change, but will closely monitor.
- The Large Cap Growth fund trailed the index for 3-month and 1-year periods.
 - This fund's Neuberger Large Cap Growth component underperformed relative to benchmark for all time periods tracked. The Subcommittee placed this investment manager on the watch list at the February meeting. Mr. Love reviewed management and strategy changes at Neuberger over the past several years which appear to have led to underperformance, along with how those patterns are changing. The Subcommittee discussed its desire to keep Neuberger on watch list for rest of year, along with what steps would need to be taken if a change were deemed necessary. Mercer's recommendation was to continue to closely monitor the Neuberger Large Cap Growth fund.
- The Mid/Small Cap Value fund outperformed benchmarks.
 - This performance was driven primarily by the Hotchkis & Wiley Value component.
 - The Earnest Partners Value component underperformed. Earnest Partners is positioned for a market turnaround, and that led to their underperformance.
- The Mid/Small Cap Growth fund slightly underperformed, stemming from underperformance of the Brown Advisory Growth component.

AGENDA ITEM – INVESTMENT MONITORING

Mr. Love presented the quarterly investment monitoring report, prepared by the Plans' staff, Mercer, Prudential and Galliard. Mr. Love noted that there were no technical violations at either

the fund-level guidelines or manager-level guidelines. There were a few instances in which the manager would be in violation of the fund-level guidelines were those guidelines to apply to the manager individually. Mercer had no concerns with these instances.

The Chair took two items out of order on the agenda in order to vote on those items before Mr. Leedy would need to exit the meeting.

AGENDA ITEM – 403(b) IMPLEMENTATION UPDATE

Ms. Buonfiglio discussed the stable value component for the 403(b) fund, adding additional information for an issue discussed at the last meeting of the full Board.

A workgroup of Investment Subcommittee members and staff worked on analyzing options for this component. The workgroup's choice of TIAA-CREF Stable Value was based on flexibility around the unwind period should a change have to be made; holdings and duration; fees and costs; quality; and payout period. The TIAA-CREF option offered no surrender charge, and the liquidation period was significantly less. TIAA waived its recordkeeping fee for that product, which made it more attractive.

Ms. Baran made a motion, seconded by Ms. Keech, to recommend to the full Board the inclusion of the TIAA-CREF stable value separate account option. The motion unanimously passed.

Ms. Buonfiglio discussed the Vanguard Emerging Markets Index Fund, which was included in the 403(b) investment lineup approved by the Board at its last meeting. Ms. Buonfiglio noted that concerns were raised about the volatility of emerging markets funds. An emerging markets fund is not provided as a separate option for the 401(k) and 457 plans' members. If an emerging markets fund is made available to 403(b) members, 403(b) participants may invest directly in emerging markets, which inherently feature increased risk. Ms. Baran concurred with these concern and supported removal of the emerging markets fund as a stand-alone option.

Mr. Love commented that there is a total market ACWI option available as a possible alternative. Ms. Buonfiglio stated that staff would gather information on that and other alternatives to present at a later Subcommittee meeting.

Ms. Baran made a motion, seconded by Ms. Keech, to forward the investment lineup with this recommendation (removal of emerging markets fund) to the full Board. The motion was unanimously adopted.

AGENDA ITEM – INVESTMENT POLICY STATEMENT PROPOSED MODIFICATIONS

The Chair recognized Ms. Buonfiglio concerning draft amendments to the 401(k) and 457 plans' Investment Policy Statement. Ms. Buonfiglio presented the text of these modifications to the Board, discussing each change. The proposal would increase the maximum country weight in the Global Equity Fund from 50% to 60%, to allow for an increase in U.S. weight above 50%. The proposal would also add an Inflation Sensitive Fund, to be managed by PIMCO, to the list of investment options.

Ms. Baran made a motion, seconded by Ms. Keech, to approve these two recommendations, as stated in the materials presented to the Board. Unanimously approved.

AGENDA ITEM – INVESTMENT CONSULTANT RFP

Ms. Buonfiglio and Mr. Toole reported that staff has crafted a draft document that they are reviewing and revising. In response to questions as to a target date for implementation of the new structure discussed at the Board's March 6 and March 28 meetings, Mr. Toole stated that the change is a good two-year process, aiming to coincide with the expiration of the current record-keeping contract expiring in Dec. 2015. Staff will provide quarterly updates.

Mr. Toole noted pending legislation which contemplates the Department of State Treasurer offering a defined contribution plan as a voluntary choice for employees in lieu of the current defined benefit plan. Under the pending legislation, this defined contribution plan would be available to new state employees (not local employees) beginning August 2016. Mr. Toole noted that such a plan would most likely be a 401(a) plan, and the General Assembly could give this Board oversight. It is not yet determined whether this defined contribution choice plan would leverage the Supplemental Retirement Plans' existing investment structure.

AGENDA ITEM – BLACKROCK FEE UPDATE

Ms. Buonfiglio stated that the BlackRock fee concession negotiation is ongoing, and staff will have an update shortly.

The Chair adjourned for a short break at 11:05 a.m. Mr. Leedy exited the meeting at this time. The Subcommittee reconvened at 11:15 a.m.

AGENDA ITEM – INVESTMENT MANAGER PRESENTATION (Tab IR4)

The Chair recognized Patricia Karolyi, Executive Vice President, and Elizabeth Desmond, Director and Chief Investment Officer, of Mondrian Investment Partners. Mondrian is the investment manager for the ACWI ex-US Value strategy fund in the Supplemental Retirement Plans' International Equity fund. Ms. Smith noted that Mondrian also manages three strategies for the State's defined benefit plans.

Ms. Karolyi reviewed Mondrian's organizational structure. The International Equities team is based in London, responsible for all final decisions with respect to our portfolio; the client services unit is in Philadelphia.

Ms. Desmond then presented Mondrian's investment philosophy and style, as a value-oriented, defensive manager, reviewing how Mondrian assesses value. Value is the present value of the cash flows received from the investment, taking into consideration future real growth. Dividends play an important role in that process. The principal form of cash flows is dividends. The company looks at price parity world-wide.

Within the equity universe, Mondrian's approach is to achieve as low volatility as possible. Mondrian seeks investments that will generate a meaningfully high real return, which Mondrian views as at least 5% real. The objective is to exceed that 5% by 1% to 2% over the long-term. Mondrian's portfolios tend to be long-term, holding positions for five to ten years, with an average turnover rate of 10-20% per year. Mr. Love noted that the Mondrian fund was in the lowest-volatility quartile.

In a bull market, Mondrian expects to lag somewhat and not capture the highest gains. Conversely, the market decline in 2008 was a period in which Mondrian did relatively well, experiencing much smaller losses.

Approximately half the portfolio is in Europe, with approximately one-quarter in the Asia-Pacific region and one-quarter in emerging markets. Emerging markets offer marginally higher real returns than developed markets.

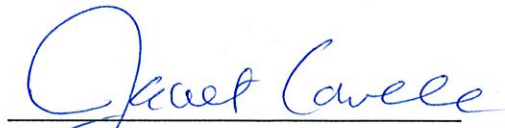
AGENDA ITEM – SUBCOMMITTEE MEMBERS QUESTIONS / COMMENTS

There were no additional questions or comments from members of the Subcommittee.

AGENDA ITEM – PUBLIC COMMENT

No public comments were offered.

A motion to adjourn was made by Ms. Baran, seconded by Ms. Keech, and unanimously passed. The Subcommittee adjourned at 12:00 p.m.



CHAIR