INVESTMENT SUBCOMMITTEE OF THE NORTH CAROLINA SUPPLEMENTAL RETIREMENT BOARD OF TRUSTEES

MINUTES OF MEETING
February 14, 2013

Time and location: The Investment Subcommittee (the "Subcommittee") of the Supplemental Retirement Board of Trustees (the "Board") met on Thursday, February 14, 2013, 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), Melinda Baran, Mona Keech, and Chuck Leedy.

Members Absent: None. Dalip Awasthi resigned from the Board prior to this meeting.

Staff Present: The following Department of State Treasurer staff members were present: Steve Toole, Mary Buonfiglio, Rekha Krishnan, Blake Thomas, Rhonda Smith, and Kevin SigRist.

Guests Present: Tim Bryan, Rob Luciani, and Travis Swartwood from Prudential; Andy Apostol from Galliard Capital Management; John Barker, Neill Groom, and Carter Reynolds from Neuberger Berman; Jay Love from Mercer Investment Consulting; and interested member of the public Bob Slade.

AGENDA ITEM – WELCOME AND INTRODUCTIONS

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

Chairwoman Libby George recognized two new Department of State Treasurer staff members: Rekha Krishnan, Operations Analyst; and Kevin SigRist, Chief Investment Officer.

AGENDA ITEM – ETHICS AWARENESS AND CONFLICTS OF INTEREST

Chairwoman Libby George asked Subcommittee members to review the agenda for the meeting and identify any actual, implied, or potential conflicts of interest. No conflicts, implied conflicts, or potential conflicts were reported. Ms. Baran commented that at previous meetings, she had noted her employment with Wells Fargo Advisors, an affiliate of Galliard, but Ms. Baran retired from Wells Fargo as of December 31, 2012.

AGENDA ITEM – MINUTES

The Chair noted that the minutes from the November 15, 2012 Subcommittee meeting were approved at the December 5, 2012 full Board of Trustees meeting.

AGENDA ITEM – STABLE VALUE PORTFOLIO REVIEW

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

Mr. Apostol began by briefly discussing Galliard's corporate profile and the latest developments in the overall stable value fund market. Galliard has more than $85 billion in assets under management and is the second largest U.S. stable value manager, with $77.2 billion of stable value assets. Wrap capacity has recently begun to increase after declines following the financial crisis, but the effect on fees of this turnaround in capacity is likely more than one year away.

After reviewing the major actions taken by Galliard since it assumed administration of the Stable Value Fund in December 2010, Mr. Apostol turned to Galliard's three primary goals for the 2013 calendar year. First, Galliard will continue the process of implementing the strategic changes approved by the Board of Trustees in 2012. Jennison Associates will be added as an additional manager. Second, Galliard will seek to increase wrap issuer diversification by adding an additional wrap issuer. Galliard negotiated with Transamerica to provide wrap coverage for funds managed by Payden & Rygal, but Transamerica determined that it was no longer interested. Third, throughout the year, Galliard will perform on-site compliance reviews.

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

- Mr. Apostol noted that the fees, at 44-45 basis points including the 12 basis point administration fee, were very competitive.
- The Stable Value Fund's blended yield was 2.92% before fees.
- Actual return on the Stable Value Fund portfolio, net of fees, was 2.75% for the 2012 calendar year.
- The effective duration was 2.6 years.
- The market to book value ratio was 104.56 percent.

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.

Ms. Baran asked Mr. Apostol for an estimate of Stable Value Fund's return at the end of the 2013 calendar year. Mr. Apostol responded that the performance would probably trend down due to low interest rates generating low underlying yields on the Fund's contracts. The blended yield of the Stable Value Fund might be in the range of 2.25 to 2.5% by the end of 2013.

Mr. Apostol discussed the Stable Value Fund's portfolio characteristics. He noted that the portion of the Fund in money market funds, 6.5%, was somewhat high compared to the target of 3%. This is the result of planning for the transition concerning the Payden & Rygal portfolio, and the money market component will decline closer to the 3% target thereafter.

Finally, Mr. Apostol reported on the performance of the Stable Value Fund's individual managers. A discussion followed concerning the performance of the Great West portfolio, which appeared to have underperformed its benchmark by four basis points. Mr. Apostol noted that Great West's mortgage-based strategy did not precisely match the benchmark. Galliard had debated whether it wanted Great West to manage to the benchmark, but had ultimately concluded that Great West was a great mortgage manager, and it would not want to put Great West into a different box. Galliard expected to resolve the matter within the next three or four weeks. Mr. Toole asked whether the Stable Value Fund as a whole might be overallocated to mortgage strategies. Mr. Apostol responded that the plan was to scale Great West back by 3% as part of the Jennison transition, but regardless, there was no concern about Great West's fit in the overall portfolio.

AGENDA ITEM – ECONOMIC OVERVIEW AND 4TH QUARTER INVESTMENT PERFORMANCE REPORT

The Chair then recognized Jay Love from Mercer, who presented a summary of market forces over the past quarter and the Plans' performance. Mr. Leedy joined the meeting at this time.

Mr. Love opened by observing that 2012 was a great year for equities. Domestic equities were relatively flat in the fourth quarter, but international equities performed strongly.

Mr. Love noted:

- The third quarter featured strong economic growth, estimated at approximately 3%, but this figure was near zero for the fourth quarter.
- The dollar continues to be slightly undervalued relative to other currencies.
- Value stocks outperformed growth stocks during the fourth quarter. Cyclical sectors rallied, while defense sectors lagged in performance.

Mr. Love discussed the Supplemental Retirement Plans' overall allocation between funds, selected by participants. Approximately 32% of assets are invested in the Stable Value Fund; 35% in the Plans' large cap funds; 10% in the Plans' mid/small cap funds; 10% in the Plans' international funds; 2% in the Plans' global equity fund; and 11% in the Plans' fixed income funds. This pattern roughly follows GoalMaker's moderate asset allocation.

Mr. Love then turned to the performance of the Plans' individual investment managers and the performance of the Plans' fund options for participants. Mr. Love commented that overall, the Plans' investment performance was extraordinarily good. Mr. Love noted, however, that a few components underperformed benchmarks:

- Although the Plans' Large Cap Value Fund outperformed benchmarks and the universe median over most of the time periods measured, its Wellington Quality Value component underperformed. Mr. Love explained that Wellington Quality Value was a more defensive manager, and its risk-averse positioning diminished returns in this environment.
- The Plans' Large Cap Growth Fund outperformed benchmarks and the universe median over all time periods measured. The most aggressive manager in this fund, Sands

Capital, has performed very well. The most defensive component, Neuberger Large Cap Growth, has underperformed.

- The Plans' International Equity Fund underperformed over the last quarter and last year. The Mondrian ACWI ex US Value component has underperformed the index and universe median over the last quarter, last year, and last three years. Turbulence in Europe and in the financial sector has negatively impacted Mondrian's results. Mr. Love recommended that the Investment Subcommittee request a presentation from Mondrian at a future meeting.

In response to a question from Chairwoman George, Mr. Love discussed the factors that led to Sands Capital's outperformance. Mr. Love stated that the Sands Capital fund would be expected to provide good long-term results, but would be volatile at times.

Mr. Love commented that Neuberger's performance is a little worse than would be expected for their strategy in the recent market environment. Performance at Neuberger Large Cap Growth began to decline in 2010, after two additional portfolio managers were added to the management structure. The pre-2010 management structure has now been restored. In response to a question from Mr. Leedy, Mr. Love stated that the portfolio managers who have been restored are not close to retirement. Mr. Toole asked whether Neuberger's fund was on Mercer's watch list. Mr. Love responded that Mercer had not placed Neuberger on watch, as Mercer believed Neuberger's changes were an appropriate response to the decline in performance. As to whether the Supplemental Retirement Plans should put Neuberger on watch, Mr. Love noted that Neuberger Large Cap Growth was beneath the Plans' performance criteria. Neuberger would make a presentation to the Investment Subcommittee later in the meeting.

Mr. Love provided a chart outlining the performance of each GoalMaker target date fund relative to its benchmark. All the GoalMaker funds outperformed their benchmarks over the fourth quarter, the 2012 calendar year, and the 2010-12 calendar years.

AGENDA ITEM – INVESTMENT POLICY STATEMENT MONITORING

Mr. Love presented a report detailing compliance with the Supplemental Retirement Plans' Investment Policy Statement and manager guidelines. All of the funds offered to participants by the Plans were in compliance.[1] Then, Mr. Love turned to the topic of compliance measured at the manager level. Four investment managers' portfolios, taken individually, would have been out of compliance with the guidelines applicable to the Supplemental Retirement Plan funds in which those managers' portfolios are components. Each of these managers was in compliance with the guidelines in its contract.

AGENDA ITEM – ANNUAL REVIEW OF PLANS

[1] On December 5, 2012, the Board of Trustees recognized a technical violation of the Investment Policy Statement by the Plans' Global Equity Fund concerning the maximum allocation to any country. The Board approved a six-month temporary exception to the rule, setting the maximum allocation at 60% rather than 50%.

STREAMLINING

Mr. Love presented the Plans' annual review of investment options. At the outset, Mr. Love noted an industry trend. In general, plans are reducing the number of options they provide; for example, instead of separate small cap value and small cap growth portfolios, a plan might simply offer a small cap investment option to its participants. Research indicates that limited participant understanding is a challenge for plan sponsors. There are concerns that participants do not respond well to market changes. Mr. Love offered two streamlining options for discussion. First, the Plans' Large Cap Value and Large Cap Growth Funds could be merged into a single active large cap equity fund. Second, the Plans' Small/Mid Cap Value and Small/Mid Cap Growth Funds could be merged into a single active small/mid cap equity fund. Mr. Love noted that Mercer presented these ideas as a best-in-class structure that is, in Mercer's view, more effective for participants overall; Mercer did not believe that the Supplemental Retirement Plans were problematic in their present form.

Mr. Leedy commented that with this participant population, one did not want to simplify the investment options too much. Large numbers of participants are currently invested in the Plans' Large Cap Growth and Large Cap Value Funds. Chairwoman George noted that from her perspective, the key was determining whether these active managers were providing the active alpha that the Board of Trustees wants. In response to this remark and a question from Mr. Leedy, Mr. Love commented that the Supplemental Retirement Plans' managers had done very well in providing alpha, with extremely strong results.

In response to a question from Mr. Toole, Mr. Love stated that it could have an effect on fees if merging the Large Cap Value and Large Cap Growth Funds resulted in the Plans reducing their number of investment managers. Ms. Baran requested that Mr. Love translate this information into actual dollar amounts; Mr. Love promised to calculate and provide the figures.

Ms. Keech noted the importance of the large cap segment to older participants in the Supplemental Retirement Plans. Chairwoman George asked Mr. Love for a reminder of the percentage of the Plans' participants that elect to manage their investments using GoalMaker. Mr. Love, Mr. Bryan, and Mr. Luciani responded that approximately 50% of the Plans' members and 85% of new members used GoalMaker. Mr. Bryan and Mr. Luciani commented that blending the Large Cap Value and Large Cap Growth Funds would have some negative impact upon their marketing efforts for the Plans; blending excludes some part of the population with a strong preference for growth or value, and competitors would cite the merger of the Value and Growth funds as an example of limited choice.

Ms. Baran requested that Mercer draft a white paper detailing the pros and cons of the Plans' current system and a blended system. She requested details on past performance, projected future performance, and fee cost. The members of the Investment Subcommittee agreed. The topic will be discussed as an agenda item at the next quarterly Investment Subcommittee meeting, with the expectation that action will be taken at the June 5, 2013 meeting of the Supplemental Retirement Board of Trustees.

SPEND DOWN

Continuing with the annual review of investment options, Mr. Love highlighted the topic of "spend down," the process by which defined contribution plan participants draw down their assets in order to provide income and meet expenses in retirement. Some defined contribution plans address spend down through annuity products, managed payout or installment plans, or hybrid products. In North Carolina, the ability to transfer assets to the State pension plan provides a spend down option today, but this option is relatively rigid.

This topic remained open for discussion at future meetings.

FEES

Mr. Love turned to the topic of the Supplemental Retirement Plans' fees. Mercer believes the Plans' BlackRock fees could be reduced by half, with a potential savings of three to six basis points. The Plans may be able to leverage the pension plan's relationship with BlackRock to lower fees; if not, Mercer will talk to other managers as an alternative to BlackRock.

Mr. Love noted that securities lending is frequently used to reduce fees by two to three basis points, but this was not allowed under the Supplemental Retirement Plans' investment policy. Mr. Leedy requested a discussion of this point at a future Investment Subcommittee meeting.

OTHER FUND LINEUP OPTIONS

Mr. Love stated that some defined contribution plans offer standalone investment options for emerging markets and real estate investment trusts (REITs). Mercer does not recommend standalone funds, instead recommending that these types of investments be incorporated as part of the global equity and inflation hedge investment options.

Chairwoman George thanked Mr. Love for his presentation.

AGENDA ITEM – PORTFOLIO MANAGER PRESENTATION (NEUBERGER BERMAN)

The Chair recognized John Barker, Neill Groom, and Carter Reynolds of Neuberger Berman. Mr. Barker and Dan Rosenblatt are the heads and managers of the Neuberger Large Cap Disciplined Growth Portfolio, a component of the Supplemental Retirement Plans' Large Cap Growth fund.

Mr. Barker and Mr. Rosenblatt have made decisions on the Neuberger Disciplined Growth Portfolio since 1994. At the end of the last decade, Mr. Barker and Mr. Rosenblatt made the decision to add two additional portfolio managers to the team. Mr. Barker commented that although he had expected this would add to the portfolio's resources, having four portfolio managers led to "too many cooks in the kitchen." The Neuberger portfolio's results became less favorable after the management transition. Neuberger analyzed the situation and determined that decision-making was being delayed because of the new portfolio management structure. In early 2011, Neuberger made the decision to return to the prior decision-making method.

Mr. Barker presented the portfolio's philosophy and expectations. In general, Neuberger expects that the Disciplined Growth Portfolio will underperform when the Russell 1000 Growth index gains more than 15%, but will outperform in other conditions. (Neuberger commented that the portfolio's results in 2011, when the Russell 1000 Growth rose slightly but the Neuberger fund declined slightly, were anomalous.) Generally, the portfolio seeks stocks which exhibit an acceleration in a company's key growth metric, driven by some identifiable catalyst; a business model demonstrated by a high EBIT and FCF yield; potential upside to consensus estimates; and a valuation that passes Neuberger's "reality check." Neuberger seeks to process potential investment ideas in under two weeks.

After a brief discussion of Neuberger's methodology and the lessons learned from the changes in Neuberger's decision-making structure, Neuberger completed its presentation. Chairwoman George suggested a motion to put the Neuberger Disciplined Growth Portfolio on the Plans' watch list for the next year in order to determine the impact of the changes that Neuberger had made. Ms. George requested quarterly reporting to the Investment Subcommittee. Mr. Leedy made this motion, and Ms. Baran seconded the motion. The motion passed unanimously.

AGENDA ITEM – 403(B) IMPLEMENTATION

Chairwoman George recognized Ms. Buonfiglio to discuss implementation of the Supplemental Retirement Plans' 403(b) program. Department of State Treasurer staff and the Board of Trustees' selected vendor, TIAA-CREF, are targeting an April 1, 2013 date for making the 403(b) program available to school districts. Ms. Buonfiglio presented the Investment Subcommittee with a proposed 403(b) Investment Policy Statement. Staff sought to keep this document consistent, as much as possible, with the existing Investment Policy Statement for the 401(k) and 457 plans. Within the next 12 to 18 months, the Plans expect to do a simultaneous review and revision of both sets of Investment Policy Statements. In response to a question from Mr. Leedy, Ms. Buonfiglio noted that staff had relied upon the assistance of Scott Dauenhauer of SST Benefits Consulting.

Ms. Buonfiglio stated that the default option under this 403(b) Investment Policy Statement would be a target date fund, as TIAA-CREF's equivalent of the GoalMaker program will not be available until the first quarter of 2014.

Ms. Baran commented that the proposed 403(b) Investment Policy Statement was easy to understand and flowed nicely, but the proposed 403(b) investment structure and philosophy seemed somewhat different from the State's 401(k) and 457 plans. Ms. Baran pointed to the existence of emerging markets in the core index investment options under the 403(b) plan; Ms. Baran commented that she would like to see an emerging market option in the 401(k) and 457 plans. Ms. Buonfiglio noted that emerging market investments were indirectly available in the 401(k) and 457 through the Plans' international funds.

Ms. Baran requested a motion to modify the proposed Investment Policy Statement to add emerging markets to page 11, section 2. With this modification, she would recommend the Investment Policy Statement be adopted by the full Board. Chairwoman George made a motion to modify, then recommend the Investment Policy Statement as stated. Mr. Leedy seconded the motion, which passed unanimously.

Ms. Buonfiglio also provided a draft 403(b) program investment lineup developed by the 403(b) Subcommittee, along with a summary of the criteria utilized to prepare that lineup. The Subcommittee would continue to work on the investment lineup with the expectation that it would be presented for comment or approval at the March meeting of the full Board.

AGENDA ITEM – INVESTMENT CONSULTANT RFP UPDATE

Ms. Buonfiglio provided an informational update on staff's efforts to determine the ideal role for the Board's investment consultant. Staff hope to issue an RFP in the first quarter of 2013. At the next full Board of Trustees meeting, staff will offer for discussion whether the investment consultant should be a typical 3(21) fiduciary providing advice only, a typical 3(38) fiduciary with power and discretion to make investment decisions, or some mixture of those two sets of responsibilities.

AGENDA ITEM – GLIDEPATH UPDATE

The Chair recognized Ms. Buonfiglio and Mr. Love for the Supplemental Retirement Plans' periodic review of the "GoalMaker" branded glide path available to participants in the 401(k) and 457 Plans. In January 2013, Mercer had prepared a draft presentation on this topic that was presented to a working group made up of staff and Board members.

Mr. Love stated that one key question was whether GoalMaker would be designed to take members "to retirement" or "through retirement." Should one design the glide path on the assumption that retirees will withdraw their funds and place them in an annuity at retirement, or instead should one design the glide path to generate income through the rest of the retiree's life? Mercer recommends that plan sponsors target a "through retirement" glide path. Mr. Luciani commented that in the first year following retirement, 40% of the Supplemental Retirement Plans' members take out their funds, while 60% leave their funds in the Plans. After the first year, most members keep their funds invested in the Plans; 96% of all remaining members leave their funds in the Plans after three years.

Mr. Love provided a series of slides showing GoalMaker's levels of equity allocation compared to the universe of all target date funds tracked by Mercer. In general, GoalMaker's default "moderate" option is in line with the universe of target date funds. Because there is a smaller number of year-to-retirement fund options in North Carolina's GoalMaker plan (0-5 years, 6-10 years, 11-15 years, and 16+ years) compared to some other defined contribution plans, the funds at the ends of North Carolina's GoalMaker range (0-5 years and 16+ years) resemble features not only of their particular five-year range, but also "through retirement" income funds and 20+ year target date funds, respectively. Mr. Love noted that GoalMaker's present structure was the most appropriate allocation at the point of retirement, but it does not continue to reduce risk as a true "through retirement" income fund would do.

MorningStar provides to Prudential a standard glide path, upon which Mercer provides comments for the Supplemental Retirement Board of Trustees. Previously, upon Mercer's recommendation, North Carolina had increased GoalMaker's allocation to international equity beyond MorningStar's standard recommendation. MorningStar has now essentially matched that comment, so North Carolina and MorningStar now are in agreement.

Mr. Love turned to the GoalMaker allocation to be given to the PIMCO Inflation Response Multi-Asset Fund, the inflation-sensitive investment option approved by the Board of Trustees at its December 5, 2012 meeting. MorningStar's recommendations for inflation-sensitive portfolios place the highest allocation in the longer-to-retirement target date funds. Mercer recommends, however, that the same inflation-sensitive allocation be given in the nearer-to-retirement target date funds, as inflation protection is needed most when members are in or near retirement.

Ms. Buonfiglio proposed that the Board's evaluation of the GoalMaker program have two steps. In Phase I, at the March 6 Board of Trustees meeting, the Board would incorporate the PIMCO Inflation Response fund into GoalMaker and make any other changes to GoalMaker allocations as it deems prudent. In Phase II, later in 2013, the Board would evaluate whether to expand the existing GoalMaker program to incorporate a "through retirement" fund or add other additional target date funds to the existing four-tier lineup. Prudential is performing a feasibility study to determine whether it has the technical capability to add additional target date funds to the GoalMaker program. The Subcommittee received this two-phase proposal favorably. The Subcommittee moved to present Mercer's proposed GoalMaker glide path to the full Board of Trustees at the March 2013 meeting. The motion was seconded, and the motion passed unanimously.

Mr. Love then turned to the topic of GoalMaker allocations between passive and active strategies. At the May 16, 2012 Investment Subcommittee meeting, Mercer presented recommendations to:

- Maintain the current 50% active / 50% passive split in the Supplemental Retirement Plans' fixed income and large cap asset classes; and
- Move the allocation to 100% active management in the small / mid cap and international equity asset classes, due to the larger benefit provided by active management in these areas.

The Subcommittee was supportive of this proposal, but it has not yet been adopted into GoalMaker's asset allocations.

- Maintain the current 50% active / 50% passive split in the Supplemental Retirement Plans' fixed income and large cap asset classes; and
- Move the allocation to 100% active management in the small / mid cap and international equity asset classes, due to the larger benefit provided by active management in these areas.

The Subcommittee was supportive of this proposal, but it has not yet been adopted into GoalMaker's asset allocations.

Mercer recommended making these changes to the active / passive allocation as part of the 2013 GoalMaker review. The Plans' Small / Mid Cap Passive Fund and International Passive Fund would have their GoalMaker allocation reduced to zero. The allocation shares for these funds would be transferred to the Small / Mid Cap Value and Growth Funds and the International Equity Fund, respectively.

Mercer also recommended increasing the GoalMaker allocation to the Global Equity Fund relative to the International Equity Fund. Markets and sectors are increasingly connected in a global context, and a purely non-U.S. international mandate, like a domestic U.S. mandate, prevents managers from being able to choose the best stock in global industries.

Mr. Love presented a chart showing revised GoalMaker allocations by fund. The Subcommittee moved to approve this allocation model and present it to the full Board of Trustees at the next meeting. The motion was seconded, and the motion passed unanimously.

AGENDA ITEM – QUESTIONS AND COMMENTS

Mr. Bob Slade provided a public comment. Mr. Slade wished to correct the record concerning his request to make GoalMaker portfolio performances available on the website administered by Prudential for the Plans.

A motion to adjourn was made and seconded. The motion passed unanimously. The meeting adjourned at approximately 12:45 p.m.

CHAIR