INVESTMENT SUBCOMMITTEE OF THE
NORTH CAROLINA SUPPLEMENTAL RETIREMENT BOARD OF TRUSTEES
MINUTES OF MEETING
August 15, 2013

Time and Location: The Investment Subcommittee (hereinafter, the "Subcommittee") of the Supplemental Retirement Board of Trustees (the "Board") met at 9:00 a.m. on Thursday, August 15, 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 Chuck Leedy (arrived at 9:15).

Staff and Guests Present: The following staff and guests were present:

- From Department of State Treasurer: Steve Toole, Mary Buonfiglio, Blake Thomas, Koreen Billman, Kevin SigRist, Rhonda Smith, Rekha Krishnan, Lisa Page, Jaclyn Goldsmith;
- From Prudential Retirement: Rob Luciani, Travis Swartwood and Jessica Quimby;
- From Mercer: Jay Love, Kelly Henson;
- From Galliard: Andy Apostol.

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. Chuck Leedy affirmed he had no conflicts when he entered the meeting.

AGENDA ITEM – REVIEW OF PRIOR MEETING MINUTES

Ms. George indicated that the meeting binder included the May 16, 2013 Investment Subcommittee meeting minutes, which were approved at the June 5, 2013 meeting of the full Board.

AGENDA ITEM – STABLE VALUE PORTFOLIO REVIEW

The Chair recognized Andy Apostol from Galliard for a report on the Stable Value Fund investment options for the 401(k) and 457 Supplemental Retirement Plans (the "Plans").

Mr. Apostol updated the Subcommittee regarding transitions to Stable Value Fund's wrap providers and managers.

- With the support of the Subcommittee, Galliard has approached several firms over the last year to serve as an additional wrap provider for the Stable Value Fund. Recently, Monumental Life backed out of a verbal agreement to provide wrap coverage in the portfolio. Monumental Life stated that it no longer has capacity to wrap new assets. In lieu of Monumental Life, Mr. Apostol is pursuing an agreement with American General to wrap the Payden & Rygel portfolio.
- When Jennison Associates is added as a money manager, as previously approved by the Board, assets will be allocated from Prudential. Once all of the proposed changes are in place, Prudential will manage approximately 15% of the portfolio, and Great West's portion will decline from approximately 23% to 20%. Metlife's allocation will decline slightly.
- Once the addition of the new wrap provider and the new manager are complete, individual wrap provider exposure will decline from a maximum of 38% to a maximum of 30%. Individual portfolio manager exposure will decrease from a maximum of 24% to a maximum of 20%. Mr. Apostol projected that manager fees would increase from 17 basis points to 18 basis points.

Mr. Apostol expressed Galliard's concern over the commitment to the Stable Value market for United of Omaha, a wrap provider for the Stable Value Fund. He indicated that Galliard may look at Nationwide as a new provider.[1]

Mr. Apostol then reviewed the portfolio's fees, found on pg. 9 of the Galliard report. The fees for the Stable Value portfolio are 0.44% for the 401(k) portfolio and 0.45% for the 457 portfolio. Mr. Apostol reviewed the portfolio's performance, summarized on pg. 10 of the report. The portfolio has outperformed the stated benchmark for all time periods, returning 1.17% and 2.53% (net of fees) for the year-to-date and one-year timeframes respectively.

Ms. George noted that the Stable Value Fund's benchmark stated in the Investment Policy Statement is the 91-day Treasury Bill +100 basis points, rather than the 91-day Treasury Bill +150 basis points benchmark found on page 10 of Galliard's report. Ms. George also requested the addition of a blended benchmark. Mr. Apostol indicated he would look into making these changes and would follow up.

Mr. Apostol then reported on the Stable Value Fund's performance:

- The portfolio's duration extended over the course of the quarter from 2.9 years to 3.2 years.
- The crediting rate declined to approximately 2.24%.
- The market-to-book value ratio declined from approximately 104% in March to 101.82% in June. This was due to the significant rise in interest rates and the subsequent decline in the value of

[1] At this time, Steve Toole reminded the committee that Nationwide is his former employer. Mr. Toole stated that if any recommendation involving Nationwide were presented to the Subcommittee, he would recuse himself and refrain from comment.

bonds. The increase in duration helps to preserve the market-to-book ratio by amortizing the premium over a longer time period.

Mr. Apostol explained that the crediting rate of approximately 2.2% is above the portfolio yield of 1.7%, and that over time the crediting rate will trend toward the portfolio yield. Mr. Leedy asked how the book value of the portfolio relates to the (blended) crediting rate. Mr. Apostol explained that the difference between the two numbers is the value of the wrap contracts. Mr. Apostol reported that the yield of the portfolio is projected to be 1.9% by the end of the year and 1.75% in twelve months.

Turning to pg. 13 of the report, Mr. Apostol reviewed the portfolio's characteristics, including portfolio distribution, credit quality and sector diversification. Turning to pg. 15, Mr. Apostol reviewed each manager's change in market-to-book ratio, duration and book value crediting rate. In response to a question from Ms. Baran, Mr. Swartwood (Prudential) indicated that there had not been a significant change in participant-directed cash flows. Ms. Baran indicated that she would like to see pg. 15 added as a permanent part of the report and asked for performance to be reported net of fees.

Mr. Apostol indicated that this quarter's bond market performance was highly unusual given the dramatic rise in interest rates. Ms. Baran asked how long a turnaround would take. Mr. Apostol indicated that interest rates dropped slightly in July and were flat thus far in August; therefore, there could be a positive return for those months. Ms. Baran then referenced page 23 and asked that projected annual income by manager be added to each similar page in Galliard's report.

Ms. George inquired about the meaning of the footnote beginning with "Disclosure" on page 31. Mr. Apostol explained that Galliard must rely on information provided by PIMCO regarding the commingled fund it manages, and that information has not been verified independently.

Mr. Apostol explained that the assets in the Stable Value portfolio fall into one of two categories: Synthetic Guaranteed Investment Contracts (bonds held in a custody account) and Insurance Company Separate Accounts (assets held on the books of the insurance company with beneficial ownership held by the plans). Mr. Leedy asked what would happen to assets held in an insurance company separate account in the event of a default. Mr. Apostol replied that he was familiar with three default situations. In each case, the assets of the company were frozen and the assets held for the benefit of participants were eventually paid to them.

The conversation then turned to fees in the portfolio. The draft American General wrap provider contract currently under negotiation is at 25 basis points. The Prudential contract it is replacing is at 17 basis points. Mr. Apostol explained that prices have risen generally in the market due to supply and demand. The Subcommittee and Mr. Apostol discussed whether the plans might utilize Monumental Insurance despite its statement that it is nearing capacity. It was agreed that Mr. Apostol should negotiate with American General to see if the plan might receive more favorable pricing. Mr. Apostol agreed to pursue a lower price either through Monumental Insurance or American General.

AGENDA ITEM – ECONOMIC OVERVIEW AND 2ND QUARTER INVESTMENT PERFORMANCE REPORT

The Chair then recognized Jay Love and Kelly Henson from Mercer, who presented a summary of market forces and the performance of the Plans' investment options over the past quarter.

Mr. Love noted:

- Domestic equities had a good second quarter and exhibited good returns on a year-to-date basis as well. International equities declined in the quarter.
- Fixed income was the big story of the quarter, with interest rates rising dramatically. During the second quarter, the Federal Reserve announced that the period of interest rate easing may be coming to an end. The market reacted strongly to this news, sending interest rates higher.
- The U.S. dollar rose in reaction to the rise in interest rates. The dollar remains undervalued, but not dramatically.
- The economy continues to experience weak growth, with improvement occurring slowly. U.S. GDP growth in the first quarter was not very strong. Expected GDP growth is in the range of 2.5% or higher, which Mercer considers the normal break-even point for economic growth.
- Within the U.S. equity markets, style did not have much influence on returns. Sector performance was mixed. During the first quarter of the year, "quality" stocks outperformed lower quality equities, but during the second quarter, the trend was quite the opposite.

For the quarter, value outperformed growth, except in the small-cap sector, where the trend was reversed. Health care was the best-performing sector of the markets, followed by consumer staples and utilities. International emerging markets were down 7% to 8% and continue to experience a slowdown in China and the "BRICs." On a valuation basis, international equities look a bit more attractive than those in the U.S., where equities are significantly more expensive and have a projected slower rate of growth.

Mr. Love then turned to the performance of each investment option (or "fund") in the Supplemental Retirement Plans' portfolio, along with the performance of the investment managers whose accounts are blended to produce those investment options for the Plans.

Commenting on the performance data found on pages 21-24 and 27-31 of Mercer's report, Mr. Love and Ms. Henson noted:

- Generally, the performance of the funds and managers was very good.
- Within the Supplemental Retirement Plans' Large Cap Value Fund, the Wellington Quality Value component has underperformed over recent time periods. The five-year composite results of Wellington Quality Value were strong.
- The Plans' Large Cap Growth fund has struggled over the 2013 calendar year, but is still in the 31st percentile in the peer group.

- The Sands Capital Large Cap Growth account (part of the Plans' Large Cap Growth Fund) underperformed over the last year. The account's three-year and five-year results, however, are best in class.
- The Neuberger Berman Large Cap Growth account, which is on the Subcommittee's watch list, showed improving performance over the year-to-date and second quarter time periods. In these time periods, the manager outperformed the benchmark index and the universe median. Stock selection was strong.
- The Earnest Partners SMID Cap Value account, which would be the subject of a discussion later in the Subcommittee meeting, showed the most challenging pattern of performance on the scorecard.
- The Hotchkis & Wiley SMID Cap Value account showed strong stock selection. It performed at top of the manager universe.
- The Supplemental Retirement Plans' Global Equity Fund[2] has outperformed particularly well.
- The performance of PIMCO Total Return has lagged during calendar year 2013.
- The Supplemental Retirement Plans' International Equity Fund, by design, overweights emerging markets relative to the universe. This led to underperformance during the quarter.
- The second quarter was the exact type of period in which a plan fiduciary wants to have a Stable Value fund. Otherwise, due to the rise in interest rates, our participants would have been at significant risk of negative returns.

Ms. George questioned what action Mr. Love would recommend, as the Plans approach the five-year performance mark, for those funds or money managers that were underperforming. Mr. Love indicated that he would evaluate performance more at the fund level than at the manager level. Mr. Love commented that generally, five-year performance should almost always be above the index. It is possible to have cyclical factors impact five-year performance, and it is important to recognize what type of market cycle we are experiencing. When evaluating individual money managers, Mr. Love recommended examining whether a manager is performing in a manner consistent with their process or if we are experiencing performance or behavior that will not change or improve. Rhonda Smith (DST) noted that it is also important to recognize when there has been a change in the target benchmark over the time period listed.

Ms. George asked whether a measure of portfolio volatility could be added to enhance Mercer's report. Mr. Love indicated he would do so. Ms. Baran thanked Mr. Love for adding dollar amounts to the fee percentages found in the report and requested that this change be adopted on a permanent basis.

Mr. Love reviewed the performance of the GoalMaker portfolios, shown on pg. 32-33 of Mercer's report, and said they were meeting expectations.

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[2] A note on terminology: the International Equity Fund excludes U.S. investments, while the Global Equity Fund makes investments on a global basis regardless of nation.

The Subcommittee discussed the Earnest Partners SMID Cap Value account. Mr. Love stated that Earnest's was, in his view, the right kind of portfolio to serve as a complement to the Hotchkis & Wiley and Wedge accounts that, along with Earnest, comprise the Supplemental Retirement Plans' Small/Mid Cap Value Fund. Earnest occupies a core value space, while Hotchkis & Wiley is a deep value strategy and Wedge is more of a high-quality play in the small/mid cap value sector. A core role in the portfolio is needed to offset the deep value characteristics of Hotchkis & Wiley. Ms. George asked Mr. Love whether he was still satisfied with the construction of the Supplemental Retirement Plans' Small/Mid Cap Value Fund. Mr. Love responded that he was satisfied with the construction of the fund.

Ms. Smith and Mr. Love noted that the benchmarks and strategies for the Earnest fund had shifted over its lifetime as a component of the Supplemental Retirement Plans' portfolios. This created divergence between actual results and what the Plans would have experienced had there been no change in strategy.

Mr. Love turned to the detailed performance data for Earnest Partners found on pg. 123 to 126 of the Mercer report. Mr. Love, Ms. Henson, and Mr. Toole commented that the rolling quarter performance found on pg. 124 may be more relevant than the more simple scorecard found on pg. 21-24. Mr. Toole noted that Earnest had some periods where it hit the ball out of the ballpark and some periods where its performance lagged.

The Subcommittee, Mr. Love, and Ms. Henson discussed the use of Mercer's scorecard, which begins on pg. 21 of Mercer's report. While the scorecard is helpful in identifying performance trends, it has two significant shortcomings: the report's tolerance level and consistency with the Plans' Investment Policy Statement. The scorecard report represents underperformance of even 1 basis point with a "red x". Therefore, from a visual perspective there is no differentiation between a manager with median performance and a manager with bottom decile performance. In addition, the Investment Policy Statement establishes a rolling 3 year and 5 year period as the timeframes by which managers will be judged. Users of the scorecard report may have a tendency to focus more heavily on 1 quarter, YTD and 1 year performance numbers rather than the time periods established in the Investment Policy Statement. Mr. Love will modify the report to address the issues raised regarding the scorecard.

<u>AGENDA ITEM – JP MORGAN IPO / NEW DEBT ISSUANCE</u>

Ms. Buonfiglio updated the committee regarding JP Morgan's new debt issuance activity. Recently, JP Morgan inquired about permission to participate in new debt offerings underwritten by the Investment Banking division of JP Morgan. Currently, our Manager Guidelines do not speak to this activity nor does our Investment Policy Statement. Historically, if bonds underwritten by JP Morgan were purchased in the NC portfolio the trade was reviewed by the JP Morgan compliance team and the purchase was made through a third-party independent broker-dealer. While the manager's process is intended to avoid conflicts of interest, there may still exist an appearance of a conflict. JP Morgan has indicated that the performance impact to the portfolio should a prohibition be put in place would be minimal. Mr. Love indicated that more information can be gathered and a formal proposal made to the Board in September.

AGENDA ITEM – INVESTMENT MONITORING

Mr. Love then reviewed the Investment Policy Statement compliance report. There was a high level of compliance reflected in the report. However, at the end of the quarter, the North Carolina Global Equity Fund was not in compliance with the Investment Policy Statement provision limiting holdings in any single issuer to the greater of 5% or the benchmark plus 2.5%, not to exceed 10%. This breach was due to an overweight position in Google taken recently by ArrowStreet. After the end of the quarter, Sands sold its position in Google and the Global Equity Fund thereby came into compliance.

Mr. Love suggested that a modification be made to the Investment Policy Statement and to ArrowStreet's manager guidelines to better align with the composition of the MSCI ACW index. Mr. Love also noted that the Plans' guidelines do not currently prohibit investment in "frontier market" stocks. This may cause misalignment if a benchmark does prohibit "frontier market" investments.

Mr. Leedy made a motion that Mr. Love should bring these proposed Investment Policy Statement changes to the Board of Trustee meeting for review and action. Ms. Baran seconded the motion, which unanimously passed.

The Chair adjourned for a short BREAK at 11:05 a.m. The Subcommittee reconvened at 11:15 a.m.

AGENDA ITEM – INVESTMENT MANAGER PRESENTATION

The Chair recognized Paul Viera and Chris Hovis of Earnest Partners. Earnest is one of three investment managers in the Supplemental Retirement Plans' Small/Mid Cap Value Fund. Mr. Viera discussed the long term performance of the portfolio and the fact that on an absolute basis the fund had performed well and that the portfolio had grown considerably. He also noted the high quality of the stocks that had been purchased and held in the portfolio. As a value manager, Earnest believes in paying less for earnings; Mr. Viera stated that the P/E statistics for the Value Strategy portfolio bear this out.

Mr. Viera also pointed out that, compared to the June 30, 2013 figures discussed earlier in the Subcommittee meeting, the performance of the portfolio had since rebounded.

Mr. Viera discussed the process by which Earnest manages the portfolio. This system starts with a screening process, then analyzes acceptable risk and discusses ideas with firm analysts. Mr. Viera said that his team has a fundamental perspective on picking stocks, and the hallmark of their process is good risk-adjusted return.

Following the conclusion of Earnest's presentation, the Subcommittee discussed the presentation and performance of the Earnest Value Strategy portfolio. Ms. George referenced the Investment Policy Statement and the criteria for placing a manager on the watch list.

Ms. George and Mr. Leedy stated that they did not believe it consistent with the plan's IPS to place Earnest on the watch list. Ms. George and Mr. Leedy noted that the Earnest portfolio's performance had improved in July 2013, bringing three-year performance in line with the benchmark. Ms. George stated that she advocated continuing to closely monitor the Earnest portfolio's performance. Subcommittee members noted that the portfolio's strategy had been changed from mid cap to small/mid cap during the portfolio's time as a manager for the Plans.

Ms. Baran provided a dissenting opinion at the meeting, stating that she would place Earnest on the watch list. With the consent of the Subcommittee as a whole, Ms. Baran submitted an e-mail after the meeting which stated the reasons for Ms. Baran's desire to place Earnest on the watch list. In her email, Ms. Baran stated, "This is supported by the Mercer scorecard report indicating underperformance of the fund in every time period." In addition, Ms. Baran stated she was "uncomfortable with the manager's presentation. It was lacking much basic information, was shallow, and lacked clarity of investment opinion."

The Subcommittee did not take a formal vote on the issue, as the issue would be raised again at the next meeting of the full Board of Trustees and it was clear there was not a majority of Subcommittee members in favor of placing Earnest on the Plans' watch list.

AGENDA ITEM – PUBLIC COMMENTS

No public comments were offered.

AGENDA ITEM – SUBCOMMITTEE MEMBERS QUESTIONS/COMMENTS

Ms. Baran circulated a Financial Times article concerning the use of low-cost index funds by public pension funds. Ms. Baran asked staff to research the article and report to the Subcommittee. Ms. Baran noted that each Board member, as fiduciaries, needed to be sure that the Plans' managed accounts are providing a good return on investment.

Mr. Love responded that the Plans' fees were cheaper than the typical defined contribution plan. Mr. Love cited pg. 26 of the Mercer report, which compares the Plans' fees to its peers. Mr. Love also commented that the need to examine return on fees is the reason why Mercer's report, at pgs. 34-37, shows the net-of-fees performance for the Plans' investment options and component managers. These tables compare net-of-fees performance to the index benchmark.

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

Melinda Baran

CHAIR