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INVESTMENT SUBCOMMITTEE OF THE NC SUPPLEMENTAL RETIREMENT BOARD OF TRUSTEES

MINUTES OF SPECIAL MEETING OCTOBER 3, 2014

Time and Location: Investment Subcommittee (the "Subcommittee") of the NC Supplemental Retirement Board of Trustees (the "Board") met at 2 pm on Friday, October 3, 2014 in the Dawson Conference Room of the Albemarle Building, 325 North Salisbury Street, Raleigh, North Carolina.

Members Present: The following members were present: Melinda Baran, Chair. Karin Cochran and Robert Orr attended via tele-conference.

Staff and Guests present: The following staff and guests attended the meeting. From the Department of State Treasurer: Steve Toole, Mary Buonfiglio, Blake Thomas, Rekha Krishnan, Erica Hinton, Lisa Page, and Maja Moseley. From Mercer: Kelly Henson and Liana Magner attended via telephone.

AGENDA ITEM – WELCOME AND INTRODUCTIONS:

Meeting convened at approximately 2:01 p.m.

Ms. Baran welcomed everyone.

AGENDA ITEM – ETHICS AWARENESS AND IDENTIFICATION OF CONFLICTS OR POTENTIAL CONFLICTS OF INTEREST:

The Chair asked Subcommittee members to review the agenda for the meeting and identify any actual, implied, or potential conflicts of interest. There were no conflicts identified.

The Chair asked to hold public comments until the end of the meeting and to sign the attendance sheet.

AGENDA ITEM – PIMCO MANAGER REVIEW:

Ms. Baran reviewed the SRP mandates for the NC 401(k) and NC 457(b) (the "Plans"): Stable Value Intermediate Duration Fund (a $228 million separate account of the Plans); Core Fixed Income Fund (a $288 million fund of the Plans in a commingled pool with Prudential) and the Inflation Responsive Fund (a $325 million separate account of the Plans). For the 403(b), which is a new program with few assets at this time, there are two mandates to be discussed: the Inflation Responsive Multi-Asset Institutional Fund, and Pimco All-Asset Institutional Fund.

The Chair then recognized Liana Manger and Kelly Henson of Mercer.

Ms. Magner stated that she would discuss Mercer's view on PIMCO, given the Plan's exposure, as well as recommend next steps. She directed the attendees' attention to a news item prepared by Mercer. She stated that it is Mercer's view that Bill Gross, the founder and main portfolio manager for PIMCO Total Return Fund, left the firm abruptly because it was speculated he was about to be fired. Mr. Gross's departure caused several organizational changes.

Mercer is impressed with current PIMCO staff overall. The main concern remains the fund outflows from PIMCO, and what impact the outflows have on the organization and the investors. PIMCO has a secular investment outlook set by their investment committee, and that outlook has permeated the rest of the organization. Mercer is concerned that large fund outflows may impact other PIMCO products' performance. Because of this, Mercer has downgraded PIMCO Total Return Fund from its A ranking to a B ranking.

Other reasons to downgrade are that Bill Gross's successor has been named and there are now more responsibilities placed on already busy PIMCO staff, which could cause some employees to leave.

Ms. Magner stated the net asset outflows are as follows: in September, 2014 $25 billion outflow, with $10 billion in one day after Gross left the firm. Outflows have slowed down since then. However, this does not change the fact that a $25 billion outflow is still a drastic one. The markets can potentially anticipate PIMCO outflows and position trades accordingly.

Ms. Magner stated that Mercer's recommendation is for the Plans to conduct an immediate search for a replacement for the PIMCO Total Return Fund. This change should be implemented as soon as administratively feasible. Ms. Magner noted that within the 401(k) and 457(b) Plans a commingled Prudential product is utilized, and Prudential has the ability to replace the manager of that product on their own.

The recommendation from Mercer on the separate accounts is to perform due diligence first, and to then identify a replacement. The Inflation Responsive strategy remains at its current grade of B+.

Ms. Magner noted that another area of concern is the exposure in Stable Value portfolio to PIMCO where Galliard serves as the 3(38) delegated manager. Ultimately, the decision to change PIMCO will be made by Galliard. Galliard has placed PIMCO on a watch list, and downgraded it from "superior" to "good;" in addition, no further allocations are being made with PIMCO. The underlying funds in the Stable Value Fund have much more specific guidelines, and it is a much more conservative portfolio to manage. For that reason, Mercer is not making a specific replacement recommendation.

Ms. Baran asked if Mr. Orr had any questions. Mr. Orr wanted to know how quickly we could evaluate the outflows and respond to it, should the outflows become an issue in October. Ms. Magner stated that PIMCO Total Return can be replaced as soon as possible since participants do not need to be notified of the change in advance. She stated that Mercer is fast-tracking the search across the entire client base, and that this would be done fairly quickly. Ms. Buonfiglio commented that in addition to search and replacement, the Investment Subcommittee might propose to the Board to engage a transition manager. The whole process of making a manager change can take quite a while, but a transition manager gives an opportunity to expedite it. Both Ms.

Magner and Ms. Henson recommended against moving too quickly with a manger change in the Plans, as they believe the PIMCO investment committee is an experienced, strong group and a fast change could be costly.

Mr. Orr asked as to how quickly Mercer would be able to obtain information on others leaving PIMCO so that the committee could guide our process appropriately. Ms. Magner noted that PIMCO fund information is public, and the fund is valued once daily. She also pointed at that many other DC plans are invested in mutual fund vehicles, and they will need to wait due to transition out of PIMCO due to Sarbanes-Oxley requirement of 30-day advance notice. This could mean a period of 60-90 days before other clients are exiting. Mr. Orr asked whether more drastic action would be called for should there be a full-fledged run on PIMCO. Ms. Magner explained the PIMCO fund is about 40-50 percent liquid, and that Mercer is watching the outflows with that in mind. She remarked that some other clients were considering utilizing an index strategy until replacement of PIMCO. However, the Total Return mutual fund is a bit more protected, as it is in a commingled fund with Prudential. Ms. Buonfiglio confirmed that, per Michael McCann, Prudential is likely to have a decision whether to keep PIMCO as the sub-adviser or replace them by mid- to end of next week. Ms. Magner reiterated that Mercer's position is to perform due diligence first, and have an action plan lined up to enable quick change should the need arise. Mr. Orr agreed, but also stressed the importance of planning for an emergency "Plan B," and watching the outflow on a daily basis to ensure that we are able to respond immediately.

Ms. Cochran asked about the Core Fixed Income fund and the other two strategies in which the Plans are invested. Ms. Magner responded that the recommendation is to replace the PIMCO Total Return fund. Mercer will perform a replacement search for the Inflation Responsive Fund, but indicated a change in this fund may be problematic as there are not a lot of providers in this segment of the market. Mercer is watching the firm to see what direction PIMCO will go in. Ms. Magner stressed that not just the outflow, but also the firm strategy, should be the focus. Ms. Cochran then inquired about the amount of time involved in identifying possible alternatives and cost evaluation. Ms. Magner confirmed that the search can start right away, and can be completed within a two-week period, but that cost evaluation would be very hard to estimate and also depends on whether the assets would transition in-kind or be liquidated. Ms. Henson added that Prudential would be notifying clients so transition would be at least 60 days from the notification. Mercer is expediting the process and taking into account that J.P. Morgan is also involved.

Ms. Baran commented on the fees the Plans have been paying PIMCO and J.P. Morgan, and quoted the 6/30/2014 performance figures. She stated this was a great time to address the entire bond investment strategy and review it to see if we are going in the right direction. In Ms. Baran's opinion, PIMCO is too expensive in relation to J. P. Morgan, which is 18.8 bps. Ms. Magner responded that Mercer looks at fees overall, and that 25 basis points is not that high with 20 bps being the average. Ms. Baran stressed the importance of focusing on the PIMCO problem and finding solutions. Both Mr. Toole and Ms. Cochran agreed that we needed to reconfirm our direction. Mr. Toole seconded Mr. Orr's idea to establish a threshold for the emergency plan and procedure to commence it. Both Mr. Toole and Mr. Orr agreed while the emergency plan has a low probability, it is nevertheless good practice to have one from the Board perspective.

The Chair noted that a motion was in order.

Mr. Thomas described the motion and options:

First motion proposed: to begin a search for a change in manager for all PIMCO mandates for the Plans. Ms. Baran asked if 403(b) should also be included. This was affirmed by Mr. Thomas.

Mr. Thomas went on to describe a backup insurance plan to either hold the meeting either of the full Board as emergency meeting or a special meeting with a 48 hour notice; another option would be to or pre-authorize (with full Board approval) a specific action to take place, such as moving to index fund at a pre-arranged outflow threshold. Mercer could assist us in drafting such scenario. Ms. Magner mentioned that contributions now go directly to managers, so some paperwork could be involved in setting up a fixed-income index fund sleeve. She remarked that we may want to look at the existing contract with Blackrock to see if there is any flexibility within the contract itself. Ms. Buonfiglio added that we are interested in a liquidity buffer within Prudential's commingled fund, and Prudential may have an index vehicle which could help expedite the process. Ms. Magner explained they could not move the assets in there, as they account for 9 percent of the commingled fund. Ms. Baran suggested that a meeting be held with Prudential and Mercer by Ms. Buonfiglio and Mr. Toole to identify the immediate action. Investment Subcommittee should be notified immediately after the meeting with regards to the action plan.

Both Mr. Orr and Ms. Cochran were comfortable with that approach.

Two motions were agreed on:

Motion 1:

Initiate an investment manager search concerning a potential replacement for each PIMCO strategy in the NC 401(k), NC 457(b), and NC 403(b) plans.

Ms. Cochran moved to approve; Mr. Orr seconded and motion was approved unanimously.

Motion 2:

Evaluate overall structure of investments for North Carolina Fixed Income Fund in the NC 401(k) and NC 457(b) plans.

Ms. Cochran moved to approve; Mr. Orr seconded and motion was approved unanimously.

Ms. Henson advised that the timeframe to contact all managers would be at least two weeks.

The Chair asked Mercer to work closely with Mr. Toole and Ms. Buonfiglio in order to have something concrete to discuss by the end of October.

Ms. Henson asked whether the search for Stable Value Fund should be conducted as well.

The Investment Subcommittee wanted to do a search for the Stable Value mandate. However, Galliard should conduct search.

Ms. Buonfiglio inquired about possible consequences of Galliard affirming PIMCO.

Mr. Toole's opinion was that Galliard should first conduct the research and, if indeed, they find in favor of PIMCO, Galliard will need to present their arguments to the Investment Subcommittee.

<u>AGENDA ITEM - SUBCOMMITTEE MEMBERS QUESTIONS/COMMENTS:</u>

No additional comments were offered.

<u>AGENDA ITEM – PUBLIC COMMENT:</u>

No public comments were offered.

Mr. Orr moved to adjourn, and this was seconded by Ms. Cochran. The Subcommittee adjourned at 2:48 pm.

Secretary