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

**MINUTES OF MEETING**
**February 13, 2014**

**Time and Location:** The Investment Subcommittee (the "Subcommittee") of the Supplemental Retirement Board of Trustees (the "Board") met at 9 a.m. on Thursday, February 13, 2014 via a teleconference that originated in the Dawson Conference Room of the Albemarle Building, 325 North Salisbury Street, Raleigh, North Carolina.[1]

**Members Present:** The following members were present on the telephone: Melinda Baran (Chair), Mona Keech, and Karin Cochran.

**Staff and Guests Present:** The following staff and guests attended the meeting. From the Department of State Treasurer: Mary Buonfiglio, Blake Thomas, Rekha Krishnan, Jacquelyn Goldsmith, Tim Viezer, Rhonda Smith and Mary Laurie Cece. From Galliard: Andy Apostol and Carrie Callahan and Ellen Shay. From Prudential Retirement: Michael McCann, Jessica Quimby and Travis Swartwood. From Mercer: Jay Love, Kelly Henson and Sabrina Bailey. From Wellington Management: Elizabeth O'Hara, Matthew Baker. Member of the public: Robert Slade.

## AGENDA ITEM – WELCOME AND INTRODUCTIONS

The meeting was called to order at approximately 9:05 am. The Subcommittee Chair (the "Chair") Ms. Baran welcomed everyone. She then welcomed Mary Laurie Cece, noting she is the new attorney in the Retirement Division who will handle legal issues for the Supplemental Plans.

## AGENDA ITEM – ETHICS AWARENESS & 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.

## AGENDA ITEM – MINUTES

The Chair noted that the minutes from the November 14, 2013, Investment Subcommittee was included in the Board book for reference only. The minutes were approved in the December 18 meeting of the full Board.

[1] Due to heavy snow and ice which made travel hazardous in the Raleigh area, all meeting attendees joined the meeting by telephone. A staff member for the Plans held the phone line open in the originally scheduled conference room, in case anyone appeared in person to attend the meeting. No one appeared.

**AGENDA ITEM – STABLE VALUE PORTFOLIO REVIEW**

Mr. Apostol stated that Galliard's assets under management had remained about the same this quarter with approximately $84 billion assets under management of which $78 was in Stable Value. He stated that Galliard was fully staffed to service its clients.

In response to a question from Ms. Keech about members taking distributions from the Supplemental Retirement Plans' (the "Plans") Stable Value fund, Mr. Apostol said that the general trend is that distributions from the Stable Value fund are around a 50/50 split of assets being taken out for retirement and assets being taken out to switch investment options.

Mr. Apostol then gave an update on the wrap market in general. A majority of the banks in the business have scaled back or left the market, but insurance companies continue to be in the wrap business. Mr. Apostol commented that JP Morgan is looking to get back into the business, and this is a good indication of the health of the wrap market. In general, wrap fees remain in the 20-25 basis points range. He believes fees they will probably remain at this level for the next 2-3 years. He stated that the Plans' new agreement with Nationwide should be finalized by the end of February.

He then turned to the 2014 objectives for the Plan. Galliard is replacing United of Omaha with Nationwide once the contract is in place. Nationwide's fees are slightly lower. He continues to scale back the Great West Life exposure slightly to about 20% of portfolio. This process will probably occur over an 18-24-month period. Ms. Buonfiglio asked whether Galliard will be diverting inflows to the new managers. Mr. Apostol responded yes, most likely. He noted that at the moment the inflows were not causing significant reallocations.

Mr. Apostol then discussed a new fee table on page 8 of the Subcommittee materials. The table breaks out Galliard's management fee, the subadvisor fees, the investment contract fees, etc. He noted that the administrative fee declined to 10.4 basis points. Galliard worked with Mercer to prepare the fee analysis table.

At this point in the presentation, Ms. Henson from Mercer was asked to walk the Board through the Stable Value fund fee analysis. She noted that fee analysis is a little trickier to do with a customized Stable Value fund. Mercer looked at other large public funds similar to the Supplemental Plans and compared expense ratios. Mercer looked at the wrap fees of 37 funds, finding that the average expense ratio is 21% and North Carolina's is 16%. Ms. Henson noted that this is very good for North Carolina. Ms. Cochran asked if this is the case, why the Plan's overall expense ratio was higher than some of the other plans in the fee analysis. Mr. Henson said that this has to do with the use of internal versus external management. For example, Maryland has all external managers, so their expense ratio is higher. Mr. Apostol pointed out that there are a couple of components unique to North Carolina that play into this expense ratio. Mr. Love pointed out that the use of managers for intermediate term assets leads to a higher yield. While these managers receive probably an extra 5 basis points in fees, the performance is far outweighing the extra costs.

Mr. Apostol walked the Board through the performance of the Stable Value fund ("SVF") for the 4$^{th}$ quarter of 2013. He pointed out that the SVF is outperforming all of the bench marks.

- The SVF's blended yield was 1.83% net of fees.
- The effective duration was 3.16 years.
- The market to book value ratio was 101.28%.

He noted when you strip away the wrap, you can see that some of the SVF's sub-managers had negative returns. He noted that 2013 was a challenging year for mortgage-backed securities. The other thing that impacted Stable Value portfolios was that higher quality debt did not perform as well as lower quality, and the SVF has a bias to higher quality. He asked if there were any questions. There were none.

## AGENDA ITEM – ECONOMIC OVERVIEW AND 3RD QUARTER INVESTMENT PERFORMANCE REPORT

The Chair then recognized Jay Love and Kelly Henson from Mercer who presented a summary report of general market conditions and a report on the performance of the Plans' investment funds.

Mr. Love pointed out that it was a strong fourth quarter and a strong year for stocks. Growth stocks surpassed value stocks. The cyclical stocks and consumer discretionary did better and the worst performing sectors were utilities and telecom. The top performers were the small to midcap growth stocks and the worst performers were in the more defensive areas. International equities were doing better, but the developed markets are a little behind the U.S. market. He noted that while U.S. interest rates have hurt the emerging market and the slowing Chinese economy has had a contagion effect, this area was up for the quarter. With regard to fixed income, Mr. Love noted that the U.S. yield curve did rise over the quarter as the Federal Reserve decided to start tapering.

Mr. Love then turned to the specific performance of the funds and fund managers. He pointed out specifically that Neuberger, Sands and Wellington have had some changes in their management. Mercer is comfortable with these changes. In fixed income, PIMCO is putting in new management and a new leader of the firm. Mr. Love stated that he didn't think there would be major changes, but they are going to watch this.

He turned to the Performance Score Card for the managers. Again, Mr. Love pointed out Mercer's emphasis on evaluation under a rolling three year period. He noted red checks for Wellington and Neuberger. He said they have more defensive strategies and we should expect them to have this kind of performance. With that said, he noted that Wellington was just put on the watch list at the last Subcommittee meeting and Neuberger has been on the watch list.

He then directed the Board to the fee page for the various managers. He noted that for Blackrock there will soon be a fee change. Ms. Buonfiglio pointed out that the agreement is under legal review and she is hoping for a March 1 implementation for the new fee.

With regard to performance, Mr. Love said that it has been a great quarter and a great year overall. He said, though, that when the stock market goes up as much as it has and gets overvalued it is hard for managers to beat the benchmark, but he thinks the fund managers have kept up pretty well. He noted in particular Hotchkis & Wiley. He said they are the fund's most aggressive manager and they did the best. He also noted that Wellington is down, but as he said this is expected. As for large cap growth, he noted that Sands is the most aggressive manager in this strategy and they were the closest to the benchmark. Neuberger, our more defensive manager, is expected to trail. With regard to midcap value, Hotchkis & Wiley and Earnest Partners are still doing okay. He pointed out that Wedge, a relatively recent addition to the Plans' managers, had strong results for the quarter and year. Finally, he noted that in international equity, the Plans outperformed the benchmark.

At this point in the meeting the phone line became very inaudible and all participants hung up and redialed.

Ms. Henson picked up with a discussion of an investment guidelines amendment requested by Brown Advisory. Brown would like to change the number of holdings allowed in the portfolio from 40-60 to 50-80, to change the weight of its top 10 holdings from 35-40% to 20-40% and to change its top 20 holdings' weight from 50-60% to 40-60%. Brown is requesting this change as it would allow them to have more diversification and not let their top holdings become quite so big. Ms. Henson said Mercer does not see this as a huge change, and Mercer understands Brown's rationale. She also noted that this does not impact the Plans' investment policy. Ms. Baran asked Ms. Keech and Ms. Cochran if they have any objections. Ms. Cochran moved to accept the proposal, Ms. Keech seconded and the motion passed. Ms. Buonfiglio pointed out that since this change doesn't impact the investment policy statement, it does not need full board approval. Ms. Baran stated she would advise the full Board.

Next, Mr. Love turned to the review of Neuberger. He pointed out that Neuberger has been on watch for a year and he said that once a manager has been on the watch list for a year and nothing has changed in their performance, then Mercer does a deeper dive analysis. He described Mercer's review process. They are not just looking at a manager's past performance, but more importantly, they look at the manager process and see if the pattern of performance is consistent is with that process. Mr. Love described Neuberger's growth oriented strategy. Mr. Love said Neuberger looks for companies with consistent growth. They look at the experience of the management teams and they also look at the free cash flow of the company. Mr. Love said that based on this strategy, we should see a portfolio that performs well in most markets, but does not do as well in exuberant markets. Mr. Love pointed out page three of his report as showing what we should expect from Neuberger. This chart shows a long period of outperformance, but challenges starting in 2008-2009. In 2009 and 2013, we would not have expected Neuberger to do well, but Neuberger should have done better in 2011-2012. Apparent contributors to these performance problems were some poor stock selection and a slowdown in the decision-making process after Neuberger added two new portfolio managers.

Ms. Baran thanked Mr. Love for this retention review, but she noted that the memorandum presented did not address alternative managers as the Subcommittee had requested. Ms. Cochran stated that she would also want to know the transition costs of transferring to a new manager. Mr. Love said that the effective transition costs could be expected to be in the 50 basis point ball park. He noted that he could present alternative managers to the Board with better past performance over the last three years, but the real question is would they have better performance going forward. Mr. Love said the bottom line of the review is that over the long term, the performance of Neuberger has been good. There were two years of errors, but Mercer thinks that they have taken actions to correct this. Mr. Love commented that in Mercer's view, Neuberger does not have a long leash, but Mercer would give Neuberger a couple more quarters to show good performance.

Ms. Baran stated that she had concerns with the note in the retention review that described outflows in assets. She stated that she has a confidence problem with Neuberger's management. Mr. Love stated that at this point, Mercer still has confidence in Neuberger, giving Neuberger a B+ score. Ms. Smith pointed out that the outflows may be for other reasons. It is typical for funds in this strategy to take outflows because of the underperformance. Ms. Smith stated that in her view, now may not be the right time to move assets. Mr. Viezer agreed that investors tend to chase return and noted that he agreed with Mr. Love that Neuberger's recent underperformance is expected.

Ms. Cochran noted that she could not make a decision on whether to keep Neuberger because the retention memorandum did not provide costs of change or comparisons to other managers in the same strategy. Ms. Baran asked Mr. Love to return to the Subcommittee in a special Subcommittee meeting with more information on alternative managers and costs associated with changing managers. With this additional information, the Subcommittee could make a decision on Neuberger. Ms. Cochran stated that she would also like more declarative information as to why Neuberger should be kept. Mr. Love agreed to do this.

Next, Mr. Love presented the Plans' Annual Review. He stated that annually, Mercer takes a broader look at the plan to see if it is accomplishing everything it should be. In this annual review they are partially looking at the past and partially looking at the future. He introduced Sabrina Bailey of Mercer who has a great deal of experience with defined contribution plans. She looked at the Supplemental Retirement Plans from a retirement readiness perspective and gave the Board a description of her review. Ms. Cochran paused Ms. Bailey to ask if looking at the issue of retirement readiness was broadening the scope beyond what Board members were supposed to be looking into. Ms. Buonfiglio stated that all the trustees are looking at retirement readiness, and Ms. Buonfiglio stated she hoped Ms. Bailey would be a great resource for the Subcommittee and Board. Ms. Baran asked whether the presentation on retirement readiness should go to the full Board. Mr. Love said that they would be happy to do so, and the staff agreed this would be helpful.

Ms. Henson gave the portion of the presentation regarding the annual review of the Plans' fund line up. Ms. Henson pointed out that the current fund line up can be broken down into three tiers. The first tier encompasses GoalMaker. Tier 2-A has passive core options and Tier 2-B is for the active core options. Most of the Plans' participants are in GoalMaker, and Ms. Henson commented that this is a good thing. Ms. Henson suggested that the Board to think about whether the investment option line up should be more streamlined so that participants are not intimidated or confused. The slides in the presentation showed a few ways to potentially consolidate. Ms. Cochran agreed with Ms. Bailey that the decisions new investors have to make could be confusing. Ms. Buonfiglio pointed out that before we begin streamlining, the staff needs to do some research around why 48% of participants are not in GoalMaker. She noted that 90% of new participants do pick GoalMaker. Ms. Baran also pointed out that 32% of assets are in Stable Value.

Mr. Love continued his presentation with a review of GoalMaker. Mercer looked at the GoalMaker glide path. He thinks that more modeling should be done to see if GoalMaker is meeting the needs of participants. Ms. Buonfiglio pointed out that the age adjustment project is going to start in the 2nd quarter. Staff would implement it in June-July.

Mr. Love continued with the performance and fee review section of the Annual Plan Review. As part of this review, Mercer went back and reviewed the Plan's investment policy statement. Mr. Love commented that it is apparent that that the funds are doing very well. Of the fund managers, there were two that Mercer was watching. There was further discussion around fees and manager performance. Ms. Cochran asked, based on the Plan review, what issues Mercer thought thinking it needed to be proactive about. Mr. Love said they were looking at whether to consolidate some funds. Ms. Baran said she would like for Mercer to be looking at other managers and to let current managers know we are doing this all the time.

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**AGENDA ITEM – INVESTMENT MANAGER PRESENTATION**

At this time, the Chair asked recognized the representatives from Wellington Management. Elizabeth O'Hara introduced herself and Matt Baker who is the portfolio manager for Wellington's quality value fund. She also introduced Ellen Shay, product manager. She noted that things are very stable at Wellington and then turned the presentation over to Mr. Baker.

Mr. Baker noted that the portfolio management team for the Quality Value fund is made up of six members who have been together a long time and have the same philosophy, which is to focus on high quality companies with high quality management and invest in the right time of the cycle. They look for management teams that generate lots of cash and that manage the businesses for the long term. They like companies that give cash back to shareholders as dividends. They are not dividend yield focused, but rather they focus on the company's ability to grow the dividend. The Wellington fund is designed to help give market downside protection. In regular market conditions, the fund should keep up but in a market like 2013, the fund is going to perform less well. They sell off stocks at a certain price target and don't invest in leveraged stocks. Mr. Baker noted that in 2013, they would have expected the fund's underperformance, but the fund did worse than expected because of some specific stocks. Ms. Buonfiglio asked about underperformance in 2012. Mr. Baker responded that 2012 was unique because some of the industries that did well were utilities, telecom and REITs, but the Wellington strategy had sold out of these overvalued stocks because they did not see a huge risk reward. He said he is now seeing that the markets' buying into overvalued stocks is abating. This group of stocks is now cheaper, so he thinks the fund is poised to do really well. Ms. Cochran asked about discipline around selling a stock. Mr. Baker said as the stock gets to upper top of price range, they will sell regardless of good management. He noted that Hormel is an example of that. Ms.

Baran asked if there were any more questions. There were none. Ms. O'Hara thanked the board for their business.

**AGENDA ITEM –STAFF REPORT**

Mr. Buonfiglio gave an update on investment consultant RFP process. She said it is moving along according to plan. She noted that the staff had finished the first phase of its evaluation and had invited three candidates to visit next Friday.

**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 12:20 p.m.

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