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## Memorandum

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To: The North Carolina Supplemental Retirement Board of Trustees

From: Loren de Mey, Assistant Investment Director

Date: January 20, 2017

Subject: Investment Guideline Compliance Reporting – 4<sup>th</sup> Quarter of 2016

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The compliance monitoring system has been fully operational since April 2016. As of the end of the year, all investment managers were in compliance with their respective investment guidelines.

Although there were no significant compliance breaches during the quarter, Supplemental Retirement Plans staff had identified several minor issues. Staff, in collaboration with the custodian (BNY Mellon) and the managers, resolved all issues:

- Staff determined that two managers' guidelines were not captured in the custodial system in their entirety, which impacted two portfolios and produced two false-positive exceptions. The guidelines have been updated within the BNY Mellon compliance system to precisely reflect the language included in the investment management agreements.
- During the months of November and December, cash positions in several portfolios were trending above the investment guideline limit of 5%. In most instances, the positions were swiftly adjusted by the managers. In two cases, satisfactory explanations were obtained from the managers.

The Department has published an updated Iran Divestment List that now also includes, in addition to parent companies, their subsidiaries and affiliates. The expanded list has been uploaded to the custodial system. The investment monitoring goals for 2017 include continued compliance with the Iran Divestment Act and providing the custodian, as well as the investment managers, with an expanded holdings list every quarter. Staff will continue to work with BNY Mellon to identify any guidelines that were not captured correctly in order to reduce the occurrences of false-positive exceptions.



To: Supplemental Retirement Board of Trustees  
From: Loren de Mey, Assistant Investment Director  
Date: February 2, 2017  
Subject: Fixed Income Manager Transition Update

### **Background**

The Supplemental Board of Trustees approved replacing JP Morgan with TCW to manage a Core Plus strategy within the NC 401(k) and NC 457 Fixed Income white label fund on November 29, 2016. After approval, Staff moved forward to implement the transition from JP Morgan to TCW.

### **Transition Update**

The transition of the separate account to TCW occurred on January 3, 2017 in order to avoid any illiquidity associated with the Federal Reserve meeting and various holidays during the month of December.

In order to evaluate the best approach for transitioning the account, Staff reviewed proposals from two potential transition managers. Each transition manager provided a proposal on how they would transition the account along with expected costs and risks. Given TCW's investment style, which invests in "spread product" such as corporate bonds and mortgage-backed securities, many of the fixed income securities within the target portfolio would be difficult to purchase for the transition managers. The transition managers' proposals suggested purchasing U.S. Treasuries and bond futures as a substitute for certain spread product in order to bring the duration in line with the target portfolio. Then TCW would sell the U.S. Treasuries over time and purchase the target securities TCW had identified as components of their strategy within the new account. This approach would have increased costs given there would have been two sets of trades. Given the additional transaction costs with this approach, Staff determined it would be more cost-effective to have TCW take control of the legacy securities and directly transition the portfolio.

To date, TCW has completed about 90-95% of the transition and expects to be 100% complete within the next two weeks. TCW has sold approximately 59% of the original portfolio. Over time there may be additional turnover depending on individual security price levels and general market conditions. The estimated transaction costs of the transition is 6 basis points, or approximately \$197,000. This estimate is based on the implicit costs of trading within the fixed income market which are determined by the bid ask spreads within the various sectors. The three-month fee holiday offered by TCW will help to offset the costs of transition (i.e., the fee holiday results in a savings of approximately \$183,000).



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The portfolio remained invested throughout the transition. Preliminary performance for the month of January shows the TCW separate account remained in line with the benchmark (Bloomberg Barclays Aggregate Index): 0.17% versus 0.20% for the benchmark. The investment guidelines have been coded into BNY's compliance system and Staff has started to receive daily reporting on the account.