



## **MINUTES**

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

The regular quarterly meeting of the Investment Subcommittee of the North Carolina Supplemental Retirement Board of Trustee was called to order at 9:00 a.m., May 23, 2018, by the Chair, State Treasurer Dale R. Folwell, CPA. The meeting was held in the Dogwood Conference Room of the Longleaf Building at 3200 Atlantic Avenue, Raleigh, NC 27604. The Chair indicated there would be a public comment period for organizations and individuals to address the Subcommittee later in the agenda.

#### **Members Present**

The subcommittee members present were: Treasurer Dale R. Folwell, CPA, Chair, Melinda Baran, Karin Cochran and Heyward McKinney (by telephone).

#### **Members Absent**

No subcommittee members were absent.

#### **Guests Present**

The guests attending were: Nick Gage and Billy Weber from Galliard; Will Dillard and Kelly Henson from Mercer; and Michael McCann, Michael Knowling and Jessica Quimby (by telephone) from Prudential Retirement.

#### **Department of State Treasurer Staff Present**

The staff members present were: Mary Buonfiglio, Reid Chisholm, Chris Farr, Patti Hall, Sam Hayes, Catherine Jarboe, Rekha Krishnan, Loren de Mey, Maja Moseley, and Steve Toole.

#### **Ethics Awareness and Identification of Conflicts or Potential Conflicts of Interest**

The Chair asked, pursuant to the ethics rules, about conflicts of interest of subcommittee members. No conflicts of interest were identified by the subcommittee members.

#### **Minutes from February 21, 2018, Supplemental Investment Subcommittee Meeting**

The minutes were approved during the Supplemental Retirement Board meeting on March 21, 2018, and were attached for reference.

#### **NC Stable Value Portfolio Review and New Structure/Contract Update**

The Chair recognized Mr. Gage and Mr. Weber. Mr. Weber provided the company update and detailed information regarding the investment portfolio's performance, quality and cash flow for the quarter. He emphasized that the 99.13 percent market/book value ratio at the end of the first quarter does not translate to negative returns to members. Members redeeming units continue to receive the portfolio book value. Mr. Weber described Galliard's ongoing efforts to reduce the cost of underlying portfolios, resulting in fee reductions in Nationwide, American General and, beginning on June 1, 2018, MetLife contracts.

Mr. Gage discussed the upcoming asset allocation changes to GoalMaker and the impact to the NC Stable Value Fund, which is estimated to be a decrease of approximately \$365 million. He also elaborated on the "clean slate" or NC Stable Value Fund restructuring project, noting the reduced contract fees and other changes amount to a proposed total fee of 0.0330 percent, as compared to the current total fee of 0.343 percent. The estimated savings equals approximately \$1.5 million per year, and the changes become effective on June 1, 2018. Mr. Gage also described the proposed structure of each contract provider portfolio, noting the liquidity buffer size and duration.

#### **Investment Compliance Summary Report**

The Chair recognized Ms. de Mey who provided an update regarding the daily monitoring of investments, noting that all managers were adhering to their respective guidelines.

#### **Annual Review Report of the Investment Policy Statement and Plan Design**

The Chair recognized Ms. Henson. As a part of Mercer's annual review of plan design and the Investment Policy Statement for the NC 401(k) and NC 457 Plans, Ms. Henson summarized the Plans' current structure and market trends, including auto-enrollment, professionally managed accounts and retirement income products. She noted the changes to the current investment lineup, including the addition of the NC TIPS Fund, to be implemented on June 1, 2018, and the removal of the NC Global Equity Fund on June 15, 2018. She noted that, at this time, Mercer does not recommend any other investment changes. She also outlined Mercer's three top priorities for plan sponsors, noting that the Plans have already implemented several of them: Established success measures, promote overall financial wellness and diversify through white label funds. In addition, the changes made recently to the Investment Policy Statement for the Plans include updates to the GoalMaker glidepath.

Subcommittee members briefly discussed trends in the industry related to the auto-enrollment option, and Ms. Henson noted that plans tend to add this option more readily when there is no additional cost associated with doing so. Ms. Henson said that 41.3 percent of large defined compensation plans have auto-enrollment, and the members asked for a breakdown of these plans between corporate and public. Ms. Henson stated that Mercer can research this question further. Mr. McCann added that auto-enrollment, should this option be added to the Plans, can be administered by Prudential.

At Ms. Cochran's request, Ms. Henson further clarified the consideration of an Environmental, Social and Governance (ESG) option as part of the top priorities. She noted that companies are looking into ESG options as part of their Investment Policy Statement, but the trend is much larger internationally, especially where the option is mandated by governmental regulations. Nationally, younger participants seek out the socially responsible investment options. At this time, Mercer is not specifically recommending that this option become a priority for the Plans.

#### **Economic Overview and 1<sup>st</sup> Quarter 2018 Investment Performance Report for the NC 401(k) and NC 457(b) Plans**

The Chair recognized Mr. Dillard who provided a summary of on-site visits with investment managers and updates on investment managers. He noted changes to the manager Watch List and provided detailed background regarding Mercer's recommendation to remove Sands Capital and to add Mondrian, due to Sands' recovery and to Mondrian's trailing behind its benchmark and its peer group.

The Chair made a motion to remove Sands from the Watch List and to add Mondrian to the Watch List. Ms. Baran seconded and the motion passed unanimously.

Lastly, Mr. Dillard provided market and performance data for the quarter, offering a detailed overview of sector movements, interest rate changes and Mercer's views on dynamic asset allocation.

#### **NC SMID Cap Core Fund Recommendation**

To assist the Investment Subcommittee in fulfilling its fiduciary duties, Mr. Toole offered opening remarks regarding the process for recommending a replacement for TimesSquare in the NC Small/Mid (SMID) Cap Core Fund. Mr. Toole noted the background of the Board's 2017 decision to simplify the structure of the Plans' actively managed small/mid cap offerings by creating the NC SMID Cap Core Fund. This new fund balanced the value and growth components, added a liquidity sleeve, and retained active management (except for the liquidity sleeve). The NC SMID Cap Core Fund's structure recognized the opportunities for active management in the small/mid cap market. Mr. Toole then listed several criteria for the Subcommittee to consider when evaluating the options during its discussion: (1) Any changes in the small/mid cap market; (2) expected returns; (3) expected risk; (4) costs; (5) any other characteristics; and (6) fit within the current Plan design.

At its February 21, 2018, meeting, the Investment Subcommittee tasked the Supplemental Retirement Plan staff and the investment consultant with the evaluation of passive and active replacement options for the TimesSquare SMID Cap Growth strategy. This work was completed, and Ms. Henson presented the subcommittee with the following three options that resulted from this work:

1. Replace the TimesSquare SMID Cap Growth strategy with the Russell 2500 Index Fund;
2. Replace the TimesSquare SMID Cap Growth strategy with the Russell 2500 Index Fund and reweight the existing managers in order to adjust for any style bias (value versus growth) that may be created; or
3. Replace the TimesSquare with another active manager for the SMID Cap Growth strategy, within the NC SMID Cap Core Fund.

Ms. Henson provided an overview of the current structure of the NC SMID Cap Core Fund and the characteristics of its investment managers and their underlying portfolio strategies. She offered an in-depth look at each of the three options under consideration, adding detailed information regarding the potential impact to participants, cost, style, and fit considerations. Mercer's analysis also included comparisons of returns and risk for each of the three options. Mercer and staff also recommended Loomis Sayles to replace TimesSquare if the Subcommittee supported option three.

The Chair and Mr. Toole inquired about the length of the track record shown for the three options. Ms. Henson noted that Loomis Sayles began the SMID Cap Growth strategy in 2012; therefore, a six-year period was used in option three. Mr. Toole noted that using longer time periods may be of value, and Mr. Dillard replied that Mercer can provide the data but that output will remain similar to the output being presented. Both Ms. Henson and Mr. Dillard emphasized that Mercer does not benefit from any of the three options under consideration, and the ability of participants to have funds in retirement is the priority when presenting options for consideration and during any recommendation process. The Chair commented on the strength of the equity market in the 2012-2018 period used in the analysis, versus considering a longer time period.

Mr. Chisholm commented that the additional passive allocation in options one and two would raise the passive allocation of the NC SMID Cap Core Fund above the passive allocation for the

NC Large Cap Core Fund. Mr. Chisholm asked whether this increase in passive allocation, in the context of the board's fiduciary responsibility, should mandate a review of plan design more generally. Ms. Henson replied in the negative, also noting that the NC SMID Cap Core Fund is currently provided to the Plan participants as an "active" option and members' choices have to be considered. The Chair added that in his opinion, the liquidity sleeve in the fund should be excluded from the "passive" definition.

Lastly, Ms. Henson reviewed transition steps in terms of updates to the Investment Policy Statements necessary communication to members and estimated transition costs. She noted that option three has the highest estimated transition cost (\$737,266) and Ms. de Mey added that cost for option two would actually be slightly higher than shown in the meeting materials, totaling approximately \$360,000.

Following the presentation, the Chair made a motion to recommend option one "Replace the TimesSquare SMID Cap Growth strategy with the Russell 2500 Index Fund." Ms. Baran seconded the motion.

Subcommittee members discussed the motion and the three proposed options in depth. Ms. Cochran favored option three due to the ability of active managers to capture excess return in the SMID market segment. Ms. Baran preferred active management for the small/mid cap market and passive management for the large cap market, however she expressed concern about the transition cost. The members requested that Ms. Henson remind them of all current fees within the NC SMID Cap Core Fund and of the "all-in" participant fund expense. The fees were discussed in detail. The Chair stated that he was of the opinion that focus should be only on the portion of the NC SMID Cap Core Fund being replaced, however Ms. Cochran emphasized the need to look at the fund in its entirety in order to best determine overall impact to the Plans and to participants. Mr. McKinney had no comments.

The Chair entertained the earlier motion, which he presented. The Chair, Ms. Baran, and Mr. McKinney voted in favor of option one, and Ms. Cochran voted against. The motion passed by majority vote.

#### **1<sup>st</sup> Quarter 2018 Investment Performance Review of the NC 403(b) Program**

The Chair recognized Ms. de Mey who reviewed the Program's investment performance, asset balances and allocation for the quarter based on mutual funds data provided by Morningstar. None of the Program's funds are currently on Watch List.

#### **Investment Subcommittee Comments**

No comments were offered.

#### **Public Comments**

No comments were offered.

#### **Adjournment**

There being no further business before the Board, the Chair moved to adjourn, which was seconded by Melinda Baran, and the meeting was unanimously adjourned at 10:56 a.m.

Chair

Secretary