



NORTH CAROLINA
DEPARTMENT OF STATE TREASURER
INVESTMENT MANAGEMENT DIVISION

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To: Supplemental Retirement Board of Trustees

From: Loren de Mey, Assistant Investment Director

Date: October 28, 2016

Subject: Discussion/Action: NC 403(b) Program- JP Morgan Core Bond Fund Replacement

Staff Recommendation

Staff recommends removing the JP Morgan Core Bond Fund from the NC 403(b) Fund line-up and replacing the fund with the Metropolitan West Total Return Bond Fund, managed by Trust Company of the West (TCW).

Background

During the first quarter 2016 Investment Subcommittee meeting, Mercer recommended a search be initiated to find a replacement manager for the JP Morgan Core Bond Fund within the NC 401(k) and NC 457 Plans. The search also included finding a replacement for the JP Morgan Core Bond mutual fund within the NC 403(b) Program. The search was initiated given concerns regarding senior level portfolio management turnover within the JP Morgan fixed income team. Mercer worked with the Department's Investment Management Division (IMD) to analyze the universe of more than 120 fixed income managers. Managers were evaluated on a number of factors including Mercer rating, assets under management, firm stability, and strength of team.

IMD staff conducted onsite due diligence meetings with two finalists. In addition to the onsite meetings, IMD reviewed firm materials including ADVs, due diligence questionnaires, manager presentations, consultant reports, and performance and risk statistics of the strategies. After reviewing all materials and conducting the onsite meetings, staff recommends replacing the JP Morgan Core Bond Fund with the Metropolitan West Total Return Bond Fund (Ticker: MWTSX), managed by TCW. Staff is concurrently recommending TCW to manage a Core Plus separate account mandate to replace JP Morgan within North Carolina's Fixed Income Fund for the 401(k) and 457(b) Plans.

The Metropolitan West Total Return Bond Fund, managed by TCW, was ultimately selected given the strength of the organization and depth of resources, not only within investment management, but also within the firm's back office, trading, legal and compliance groups. Additionally, the generalist portfolio managers and other senior team members have worked together for more than two decades (albeit at a predecessor firm) and are further supported by a strong team of sector experts, which focus on mortgages, credit, and rates.

The current Morningstar rating on the mutual fund is five stars, with an analyst rating of Gold. The Metropolitan West Total Return Bond Fund was the winner of 2016 Lipper Fund Award for its 10-year performance among core plus bond funds and was named one of The Kiplinger 25, an annual list of Kiplinger's favorite no-load mutual funds in 2016.

Organization

TCW, founded in 1971, is an investment management firm based in Los Angeles, with total assets under management of \$197.3 billion (as of September 30, 2016). The firm manages \$173.5 billion in fixed income assets, representing 87.7% of total firm assets. This includes \$121.3 billion in Core and Core Plus strategies. TCW has three mutual fund complexes including the TCW Funds, the MetWest Funds, and the TCW Alternative Funds.

Most of the senior level fixed income investment professionals have worked together since the early 1990's, while they worked for Metropolitan West (MetWest), a fixed income firm based in Los Angeles. TCW purchased MetWest in 2009 to replace the firm's fixed income team that had left the company to start a new firm. The MetWest mutual funds, including the MetWest Total Return Bond Fund, originated with the fixed income team at MetWest and continue today under the TCW organization.

Investment Strategy

TCW applies a value-oriented approach and recognizes the mean-reverting nature of fixed income securities. The team believes that significant alpha can be generated by applying fundamental research to identify the securities whose market prices do not reflect fair value. This alleviates pressure to take undue risk related to macroeconomic forecasts, which TCW believes are more efficiently priced with less alpha opportunities. TCW believes that the structural inefficiencies in the bond market will appear most profoundly at the issue and sector levels of the market. Therefore, TCW prefers to add alpha from the bottom up as the distortions observed from fair value pricing will be greatest at the idiosyncratic level of the market where limited research and lower liquidity will amplify market dislocations and sponsorship effects. TCW's philosophy is anchored in a belief that the fixed income markets have a strong mean-reversion tendency.

The portfolio's duration is determined by the TWC team's fundamental economic outlook. The team constrains portfolio duration to within one year of a portfolio's benchmark duration and will move duration in a gradual disciplined fashion over the business cycle. Over the last 15 years, the strategy's duration has ranged from 3.1 to five years, always within one-year of the benchmark's duration. The current duration of the fund is 4.9 years, compared to 5.5 years for the benchmark. The yield curve positioning is driven by the team's consensus on business cycle conditions and prospective Federal Reserve policy. TCW applies proprietary models to determine the maturities which represent the best risk/return based on their fundamental outlook. The team begins the sector allocation process by comparing relative value across all sectors of the bond market, including governments, agencies, corporates, mortgages, and asset-backed securities. TCW's sector rotation decision begins with their economic outlook in order to assess the level of risk in various sectors versus the yield premia being paid.

The fund seeks to maximize long-term total return and invests at least 80 percent of its net assets in investment grade fixed income securities or unrated securities that are determined by the manager to be of similar quality. Up to 20 percent of the Fund's net assets may be invested in

securities that are rated below investment grade. As of 9/30/16, the fund had only five percent invested in below investment grade securities.

Performance (net, as of 9/30/16)

The Metropolitan West Total Return Bond Fund outperformed the Barclays Aggregate Index in the three, five and ten year time periods and has outperformed the index in 3 out of the 5 most recent calendar years. The Fund provides downside protection relative the benchmark participating in 114% of the benchmark's return in up markets, and only 60 percent of the market's return in down markets.

	Quarter	One-Year	Three-Year	Five-Year	Ten-Year
MetWest Total Return	0.77	4.87	4.07	4.78	6.35
Barclays Aggregate	0.46	5.19	4.03	3.08	4.79
<i>Over/Underperformance</i>	<i>-0.31</i>	<i>-0.32</i>	<i>0.04</i>	<i>1.7</i>	<i>1.56</i>

	2011	2012	2013	2014	2015	2016 YTD
MetWest Total Return	4.92	11.54	0.45	6.16	0.25	5.33
Barclays Aggregate	7.84	4.21	-2.02	5.97	0.55	5.80
<i>Over/Underperformance</i>	<i>-2.92</i>	<i>7.33</i>	<i>2.47</i>	<i>0.19</i>	<i>-0.3</i>	<i>-0.47</i>

Fund Statistics	
Average Effective Duration	4.82 years
Average Credit Quality	BBB
Average Weighted Coupon	2.77%
Standard Deviation (over 5 yrs)	2.64%
Up/Downside Capture (over 5 yrs)	114.7/60.5

Fund Expense:

The lowest fee share class available on Prudential's menu is the MWTSX share class with a 0.38 percent expense ratio. This will be a slightly higher expense ratio compared to the current JP Morgan Core Bond Fund of 0.34 percent. However, the Metropolitan West Total Return Bond Fund is a Core Plus strategy which typically has a higher fee compared to Core.

Staff Recommendation

Staff recommends removing the JP Morgan Core Bond Fund from the NC 403(b) Fund line-up and replacing the fund with the Metropolitan West Total Return Bond Fund. If approved, the fund mapping will occur along with the record keeper transition from TIAA to Prudential, currently scheduled for February 22, 2017.