

# North Carolina Supplemental Retirement Plans Annual Review

March 2012

# Agenda

- Overview and Recommendations
  - Inflation Sensitive Options
- Fund Structure Review
  - GoalMaker Review
  - SMID Cap Growth
- Investment Operations
- Disclaimer

# Overview and Recommendations

# Investment Structure Design

## Fund Considerations

- **Lifecycle Funds**

- **Recommendation:** Evaluate active versus passive by asset class.
- **Rationale:** Additional alpha is expected in some less efficient asset classes more than others. The Committee should evaluate each asset class to determine the most cost effective risk/reward tradeoff.

- **Inflation Sensitive Option**

- Consider adding an inflation sensitive option.

- **Small/Mid Cap Growth**

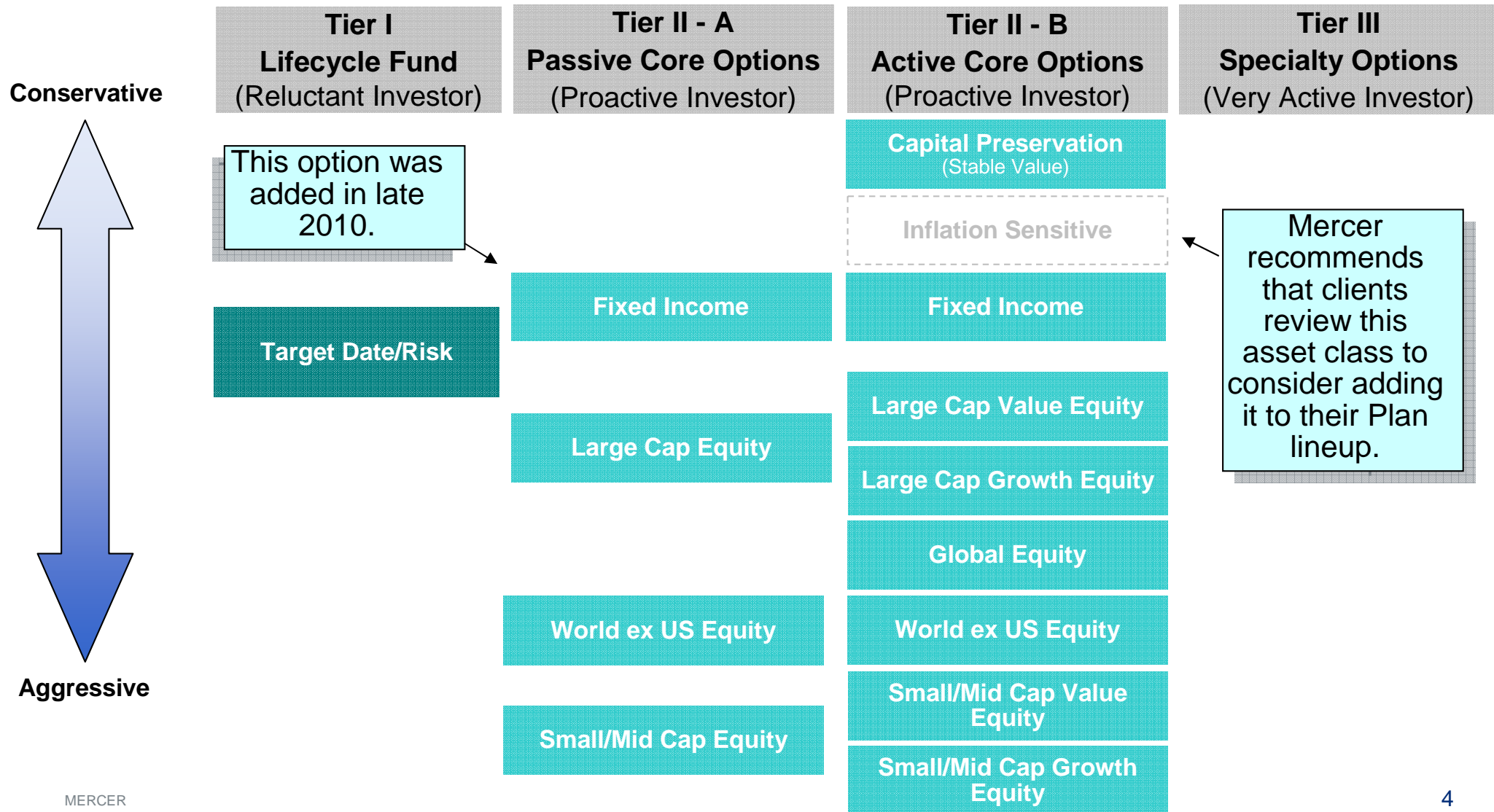
- Brown and TimesSquare offer sufficient diversification within the Fund.

- **Other Considerations**

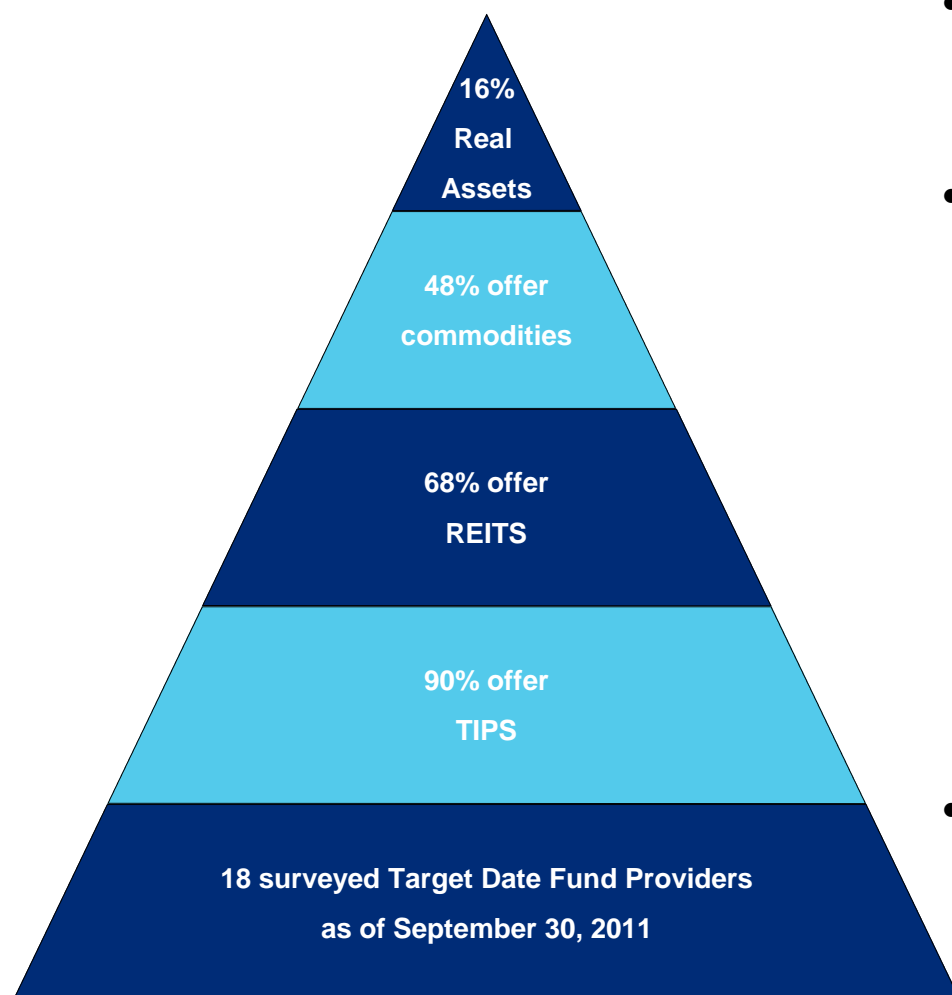
- A custody fee benchmarking study and FX review.

# Our approach NCSRP Fund Options

## *Communication of investment structure, not just options*

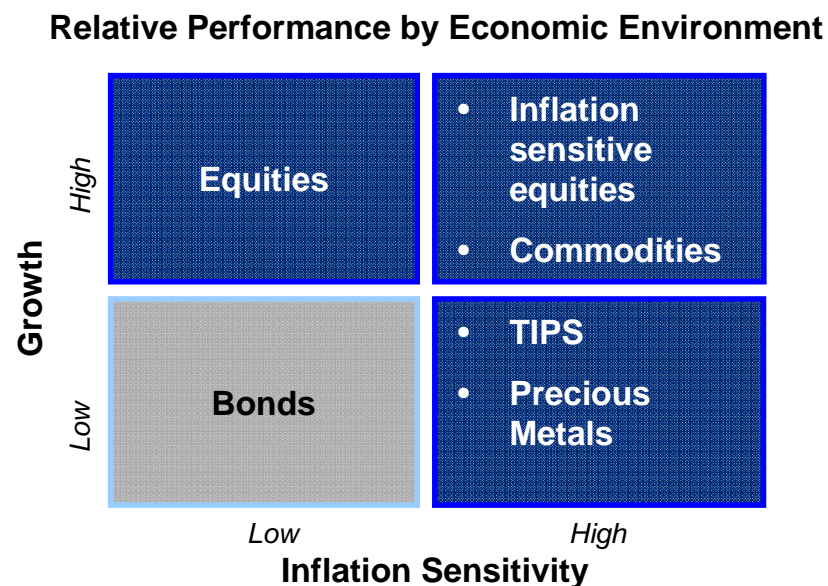


# Real Asset Exposure in Lifecycle Funds



- Participant exposure to inflation hedging and other real asset strategies is most prevalent as a component of lifecycle funds.
- 5 of the 31 major target date fund families surveyed by Mercer as of September 30, 2011 currently include exposure to a multi-asset class real return strategy:
  - Fidelity (0.1% to 4.8% allocation across series)
  - Principal (1.2% to 4.6%)
  - T. Rowe Price Funds and T. Rowe Price Trusts (1.9% to 5.0%)
  - Wellington (3.0% to 5.0%)
- 28 of the 31 surveyed target date fund families currently include exposure to a TIPS fund.

# Potential Benefits of a Diversified Approach



- There is no perfect inflation hedge which will protect a portfolio in all inflation scenarios.
- Diversification across many types of real assets ensures protection from different levels of inflation as well from different underlying drivers of inflation.
- Real assets may add volatility to the portfolio and diversifying asset exposure maximizes return per unit of risk.

# Fund Structure Review



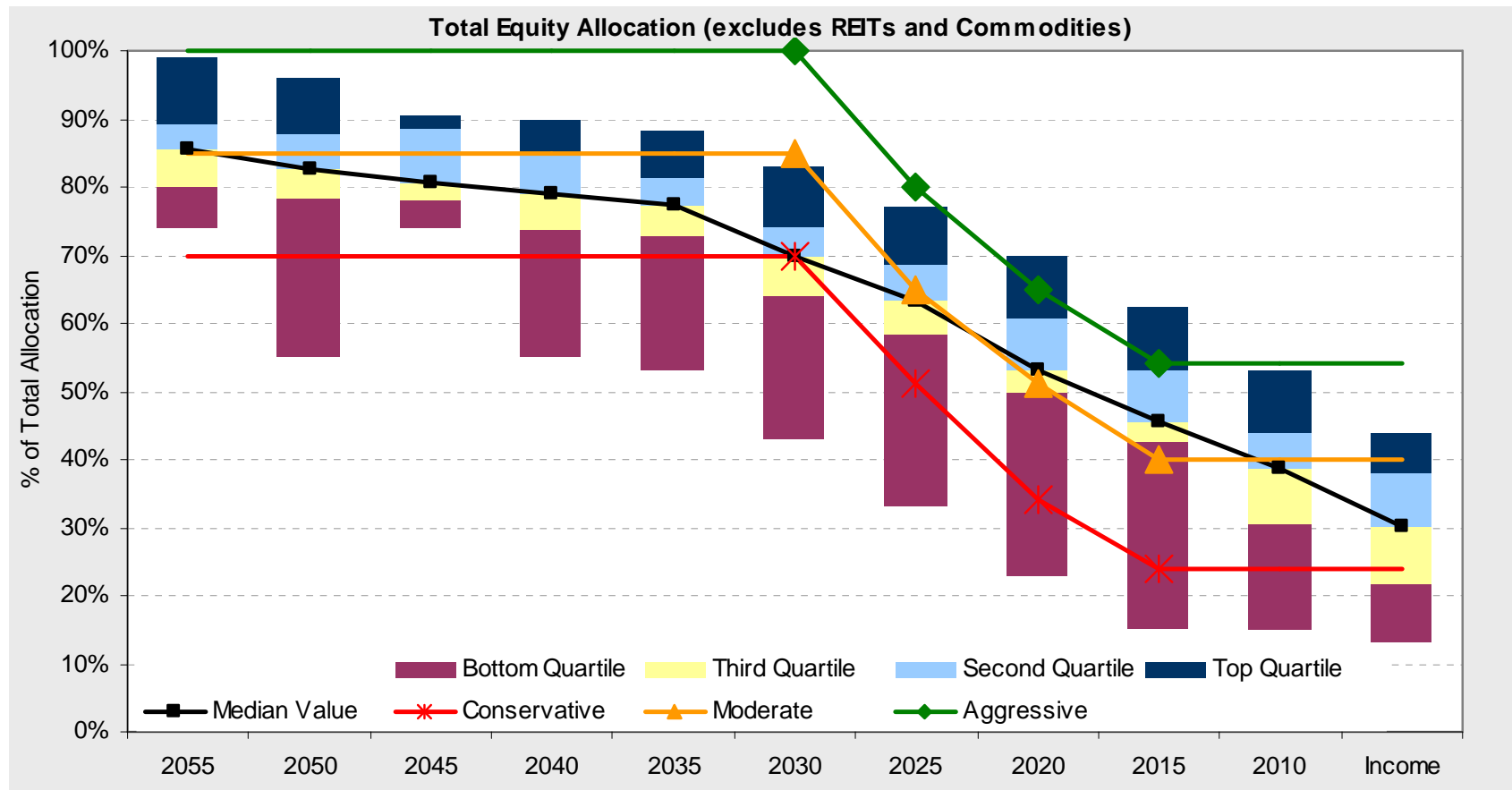
## GoalMaker Funds

### Active/Passive Selection

- The GoalMaker portfolios currently use both active and passive underlying funds in every asset class
- Mercer's opinion is that the Plan sponsor should choose between utilizing active or passive by asset class when constructing custom target date funds.
  - **Active Management** – Active management is used in hopes of exploiting inefficiencies in the market and adding incremental returns above passive management.
  - **Passive Management** – Passive management is employed to lower management fees and eliminate manager risk.

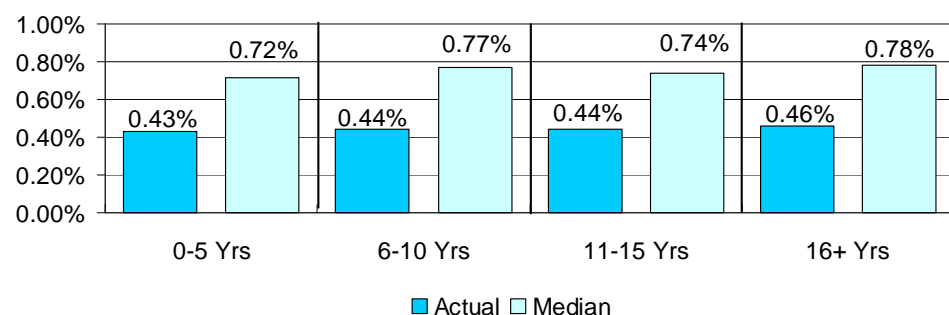
# GoalMaker Funds

## Glidepath Comparison – Difference in Asset Allocation Range

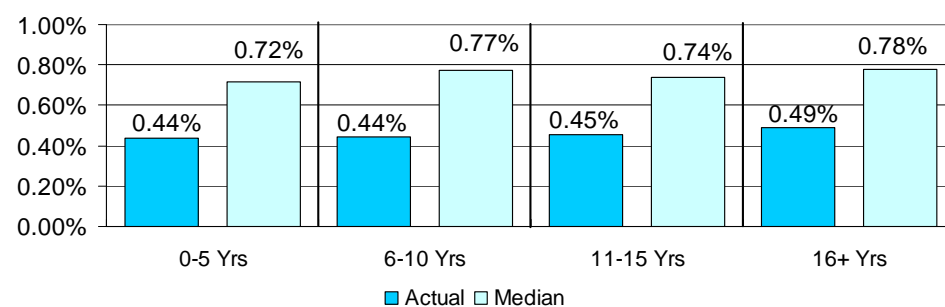


# GoalMaker Funds Fee Comparison

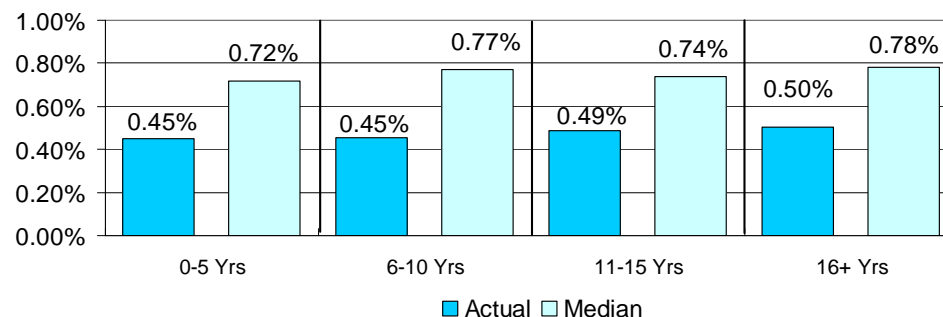
**Conservative**



**Moderate**



**Aggressive**



\* Actual fees represent the weighted average fee of the underlying funds given the target allocation. The median fee is the Mercer Mutual Fund Target Date Fund Median Fee based on years to retirement.

## SMID Cap Growth

Manager	TimesSquare	Brown	SMID Growth Fund
NCSRP Assets	\$56.5	\$59.2	\$115.7
Process Type	Fundamental	Fundamental	Ok
Style Bias	Traditional Growth	GARP	Ok
Size Bias	Slightly higher	Lower	Slightly lower
# of Holdings	97	59	146
Turnover	75%	60%	N/A
Tracking Error (10 Yr)	4.8%	7.7%	4.2%
Style Beta	0.8	1.1	1.0
Mercer Rating	A	R*	N/A
Benchmark	2500 Growth	2500 Growth	2500 Growth

- This fund has performed well versus the Russell 2500 Growth and well or in line with its peer group universe over longer periods.
  - Most of the Fund's outperformance has come from TimesSquare.
- TimesSquare and Brown offer sufficient diversification both by historical returns and also by philosophy and process.

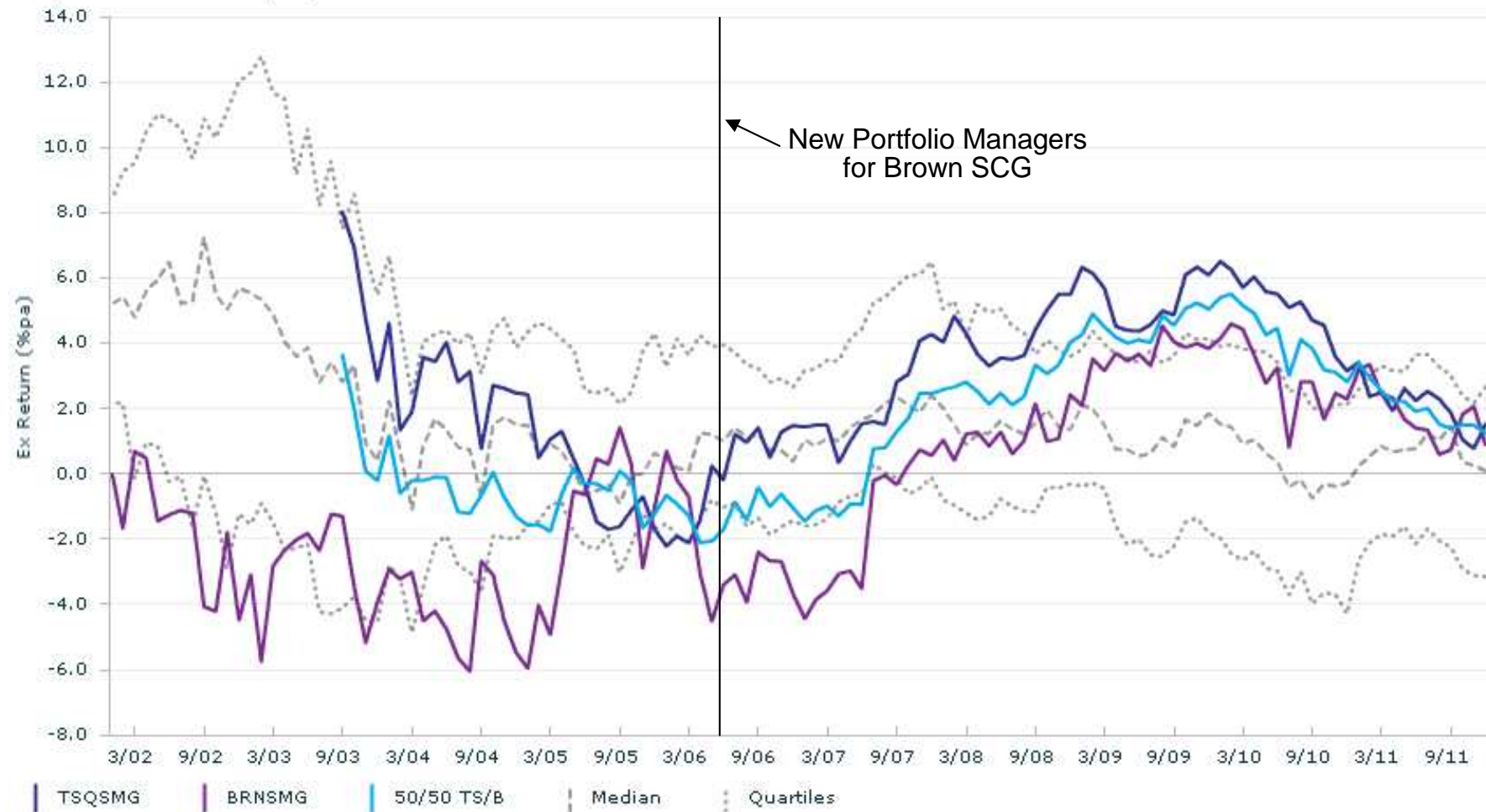
\* At this time, Mercer's equity research team has no plans to conduct further research but seek to reflect their understanding of the product through an R rating, which denotes that Mercer has carried out some research but has not completed its full investment strategy research process.

# SMID Cap Growth

**TimesSquare - Small/Mid Cap, Brown - Small Cap Equity, 50/50 TS/Brown**

Rolling 3 yr Excess Return vs. Russell 2500 Growth in \$US over 10 yrs ending December-11

Comparison with the US Equity SMID Growth universe



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# Investment Operations



# Understanding operational and execution costs and risks

## Investment managers, transition managers, custodians, administrators, etc



<b>Visible</b>	<b>Explicit Costs:</b> <ul style="list-style-type: none"><li>• Known / observable costs</li></ul>	<b>Examples:</b> <ul style="list-style-type: none"><li>• Fees</li><li>• Commissions</li><li>• Taxes</li></ul>
<b>Not Visible</b>	<b>Implicit Costs/Risks:</b> <ul style="list-style-type: none"><li>• Operational inefficiencies and errors</li><li>• Control failures</li><li>• Inefficient or poor execution</li></ul>	<b>Examples:</b> <ul style="list-style-type: none"><li>• Bid/ask spreads</li><li>• Market impact</li><li>• Opportunity costs</li><li>• Trade errors</li><li>• Fraud / theft</li></ul>

# Mercer Sentinel

## Custodian Benchmarking

### Commercial terms:

- Fee Benchmarking
- Cash Management
- Securities Lending splits

### Asset Safety / Risk minimization:

- Review of Custody & Securities Lending contracts
- Review of Current Operating model
- Service capabilities

## Custodian Selection “Mercer Sentinel Custody Database”

- 19 Categories and additional sub categories
- Over 350 evaluation criteria
- Established Guiding Principles for Best Market Practice
- Updated annually
- Regular on-site due diligence and surveillance of custodians
- Customized RFP for client

## Execution Analysis

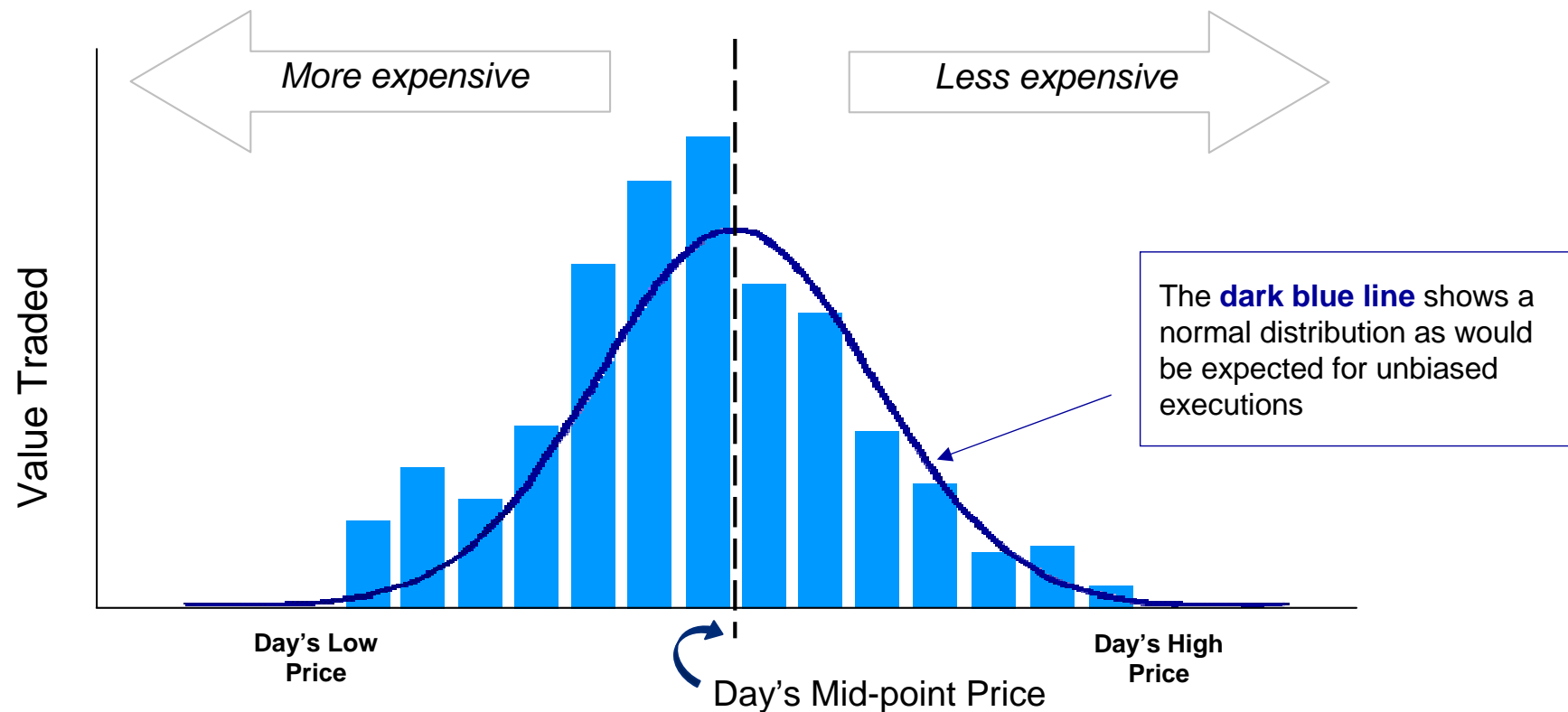
- FX Benchmarking
- Transition Management
- Transaction Cost Analysis
- Securities Lending performance benchmarking



# Foreign Exchange (FX) Cost Analysis

## Inefficient FX executions mean hidden costs

Chart showing distribution of FX executions by price\*



For this client, the **excess costs** were 6 basis points of the value traded.

■ = Custodian FX Execution

\*Source: Mercer study

# Good governance practices extend beyond investment oversight

- Effective Committee oversight and structure
  - Committee Charter, timing of meetings, record retention
- Plan design
  - Competitiveness, available features
- Vendor management
  - Ongoing oversight, fees collected, services available
- Participant communications
  - Type, timing, delivery method

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Returns for periods greater than one year are annualized. Returns are calculated gross of investment management fees, unless noted as net of fees.

Style analysis graph time periods may differ reflecting the length of performance history available.

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