

DRAFT

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

**MINUTES OF MEETING
FEBRUARY 19, 2015**

Time and Location: Investment Subcommittee (the “subcommittee”) of the North Carolina Supplemental Retirement Board of Trustees (the “board”) met at 8:30 a.m. on Thursday, February 19, 2015, in the Dawson Conference Room of the Albemarle Building, 325 North Salisbury Street, Raleigh, North Carolina.

Members Present: The following members were present: Melinda Baran, Chair; Karin Cochran and Robert Orr. Board member Ron Stell also attended the meeting.

Staff and Guests present: The following staff and guests attended the meeting: from the Department of State Treasurer, Steve Toole, Mary Buonfiglio, Mary Laurie Cece, Lisa Page, Rosita Sabrosso-Rennick, Joan Fontes, Tim Viezer, Fran Lawrence, Maja Moseley. From Mercer, Kelly Henson, Will Dillard and via phone, Liana Magner. From Prudential: Michael McCann, Jessica Quimby, Thomas Conlon, and Kathleen Neville. From TIAA-CREF, James Summerlin. From Galliard, William Weber and Erol Sonderegger. From Wellington Management, Elizabeth O’Hara, Andrew Shilling and Kevin Boreen. From Brown Advisory, Chris Berrier, Trish Carroll and George Sakellaris. Member of the public, Bob Slade (via phone).

AGENDA ITEM – WELCOME AND INTRODUCTIONS

Meeting convened at 8:30 a.m.

Ms. Baran, Subcommittee Chair, welcomed everyone and asked that the public comments be held until the end of the meeting. She also asked everyone to sign the attendance sheet.

AGENDA ITEM – ETHICS AWARENESS AND IDENTIFICATION OF CONFLICTS OR POTENTIAL CONFLICTS OF INTEREST

The chairperson 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 – APPROVAL OF MINUTES

The chairperson stated that the minutes of the Investment Subcommittee meeting from November 13, 2014, have already been approved at the Supplemental Retirement Board of Trustees meeting on December 11, 2014, and are included in the book for reference only.

AGENDA ITEM – STABLE VALUE PORTFOLIO REVIEW AND CUSTODIAN FEE INCREASE UPDATE

The chairperson recognized Billy Weber and Erol Sonderegger from Galliard.

Mr. Weber updated the subcommittee on two outstanding items. Wells Fargo will waive the proposed increase in custodian fees indefinitely. There will continue to be no custodian fee charged on Stable Value Fund assets custodied at Wells Fargo. Mr. Weber also stated that portfolio allocation to Great West Life is now at the target of 20%. Galliard expedited the re-allocation of funds out of Great West and in December 2014, approximately \$55 million of the Great West contract was redeployed to Nationwide, thus achieving the 20% allocation target for Great West. Galliard will continue to monitor these allocations.

Ms. Buonfiglio asked about Galliard's October due diligence trip to Great West. Mr. Weber stated that Galliard was looking at Great West for two different reasons. First was the negotiation of the wrap terms, and second was diligence on them as an investment manager. He stated that Great West's senior management has committed to and is showing more flexibility with regard to the wrap contract terms. Mr. Sonderegger added that Galliard continues to monitor Great West's investment management and its ability to generate alpha in the portfolio.

Mr. Weber gave an update on the SVF manager PIMCO. He stated that Galliard is recommending that the state replace PIMCO with a new investment manager. At this point, they are recommending Dodge & Cox as the replacement. Mr. Sonderegger summarized the process that led to the decision to replace PIMCO. He noted that PIMCO was closely monitored by Galliard during the 4th quarter of 2014. PIMCO experienced another organizational change in January 2015, when Portfolio Manager Saumil Parikh departed from the firm. In addition to this change, the PIMCO fund has experienced two consecutive quarters of underperformance. Mr. Sonderegger pointed out that PIMCO would have to outperform its benchmark by approximately 200bp in the next two calendar quarters for them to outperform the benchmark. While such performance improvement is not impossible, it is highly improbable and Galliard feels that now is the time to replace PIMCO. Mr. Sonderegger stated that Galliard is very comfortable with Dodge & Cox as a replacement manager. The Dodge & Cox fees are approximately half of PIMCO fees. In addition, Mr. Sonderegger noted that Dodge & Cox is already an option in the Met Life wrap program, so the wrap contract will not need to change. He stated that there are two investment vehicle options. One option is a commingled vehicle (available only to Galliard clients) and the other is a separate account. The main difference between the two is the fee structure: separate account fee is 13bps (compared to current PIMCO fee of 20bps) while the commingled vehicle offers an aggregated-asset pricing of 11bps and the possibility of a fee decline as the relationship grows. The commingled vehicle will be available in April 2015, and the separate account could most likely be established by May. Galliard will work with Dodge & Cox to stagger the transition over a period of few months.

Mr. Sonderegger also noted that Dodge & Cox is a solid organization with stable leadership. They tend to be overweight in the corporate sector, with particular focus on banking and telecommunications. Other managers Galliard considered as replacements for PIMCO were Loomis, Babson and IR+M. Galliard reviewed a full 10-year period of the performance. All of the managers had strong performance. They believe Dodge & Cox's investment management style fits within the current structure of the NC Stable Value Fund portfolio well.

Ms. Cochran asked who absorbs the transaction costs in the transition to the commingled vehicle. Mr. Sonderegger stated that the North Carolina plans would constitute approximately 50% of the commingled vehicle and as such, it would absorb a bulk of the transaction costs. He added that while the cost is inevitable, it is also manageable and Galliard will work with Dodge & Cox to minimize it.

Ms. Baran asked for the cost translation into dollars and Mr. Sonderegger responded that it would amount to approximately several thousand dollars. He also confirmed that the transition would not be an "in-kind" transition, but Galliard will work to buy and sell opportunistically. Mr. Orr asked about the flexibility potential of the transition process and Mr. Sonderegger stated that overall, the process is very flexible; given the size of the portfolio, it may be feasible to split the process into two or three parts, depending on the market conditions.

Ms. Baran asked about interest rate risk during the transition. Mr. Sonderegger said that a rise in interest rates might be quite beneficial to the portfolio.

Ms. Buonfiglio inquired whether Galliard uses any hedging strategies during the transition. Mr. Sonderegger replied that while they could do so, the transition is almost immediate – overnight – so there is almost no exposure to being out of the market. Galliard also does not think it is necessary to hire an outside transition manager and it would add unnecessary cost. Finally, Mr. Sonderegger asked whether the subcommittee had any thoughts about the investment vehicle. Galliard recommends the commingled fund since the fees are lower.

Mr. Toole made a recommendation to the subcommittee to hold Galliard, the delegated manager, responsible and accountable for the choice of the most appropriate vehicle for the transition. Ms. Cochran made a motion to accept Galliard's recommendation of Dodge & Cox to replace PIMCO and Mr. Orr seconded. The motion passed unanimously.

AGENDA ITEM – ECONOMIC OVERVIEW AND 4TH QUARTER INVESTMENT PERFORMANCE REPORT

The chairperson recognized Ms. Kelly Henson and Ms. Liana Magner from Mercer. Ms. Henson introduced Mr. Will Dillard, who also works on the North Carolina Supplemental Plans account.

Ms. Henson gave a market overview for the 4th quarter of 2014 and for the full year. The 4th quarter was fairly strong for domestic equity overall. Small cap stocks that had been struggling had a strong quarter and returned about 5% for the year. International equity struggled in the 4th quarter, especially in the emerging markets. Emerging markets struggled because of strength in the US dollar in the 4th quarter. The drop in oil prices had a significant impact on both US and international equities. Fixed income was relatively flat for the quarter. High yield underperformed. International bonds were the worst performing. They were affected by the

strong dollar. 2014 was a strong year for REITS and this had a negative impact on the plans' active managers. Commodities suffered losses due to the oil price decline.

Ms. Henson continued on to the executive summary and stated that the plans' investment structure remains unchanged, with a full suite of options available. She noted that overall during the 4th quarter; the plans' funds experienced a strong performance against their respective benchmarks.

Ms. Henson gave a few manager updates. During the quarter, Mercer's research group met with Wellington Management to discuss the Opportunistic Growth strategy and, as a result of the meeting, maintains Mercer's "A" rating. She noted that Wedge hired a new portfolio manager of which Mercer thinks highly. She stated that there was a high-level change within J.P. Morgan Asset Management, a retirement of Co-Head of Risk Management, Rene Noel. This change, however, does not affect Mercer's current rating. Mercer also continues to closely monitor the organizational developments at PIMCO and it continues on the watch list, with respect to Inflation-Responsive Multi-Asset exposure and additional exposure in the NC 403(b) Program.

Ms. Henson also pointed out that PIMCO fees are higher and that Mercer is in the process of negotiating lower fees. PIMCO is open to the reduction, but multiple approvals are needed to implement it. She noted that PIMCO asked whether the plan would be open to a commingled vehicle, but she said in Mercer's opinion, the maintenance of a separate account is preferable. Ms. Cochran asked when PIMCO would let the plans know about a fee reduction. Ms. Henson said any day now. Ms. Buonfiglio asked whether managers were hesitant to give fee discounts to North Carolina because it would open them up to requests for discounts by all of Mercer's clients. Ms. Henson said no. Fee discounts are really based on who the client is and the demand for the fund. Ms. Henson reiterated that overall, the plan fees are lower in comparison to the peer group.

Mr. Dillard discussed the fund performance scorecard. The scorecard highlights that the Wellington Quality Value and Brown Advisory strategies have struggled throughout the year. Brown has experienced a wide margin underperformance due to securities selection in the retail sector. Ms. Henson pointed out that, due to the strong performance of the other managers participating in the fund, participants are still receiving the benefit from the NC Large Cap Value Fund.

Mr. Toole requested that Mercer add a page showing the criteria for putting a manager on the watch list and from removing them from the watch list in order to assist the board in the review process.

Mr. Dillard continued on to describe fund level performance. He noted that six funds outperformed their respective benchmarks. The energy sector experienced a 19% decline and this impacted the managers within that sector. The Mid and Small Cap Value fund has been a good performer over time. This quarter's outperformance is attributed to Wedge. Mr. Dillard noted that NC Mid/Small Cap Growth underperformed the benchmark by 30 bps and active managers have struggled to be the index within this time period.. The underperformance of this fund is attributed to Brown Advisory

Ms. Baran asked if Mercer had ever created a report to show how active managers have performed compared to passive funds within the same sectors. Ms. Buonfiglio pointed out that this has been done and, over time, this showed that the active managers did outperform the benchmark. Ms. Henson pointed out that it is important to have both active and passive managers in a DC plan. Mr. Dillard went on to describe the International Equity Fund. Its performance was largely driven by manager Baillie Gifford. With regards to fixed income, Mr. Dillard noted corporate spreads have widened and this has posed difficulties for active managers; however, the NC Fixed Income Fund remains strong overall.

AGENDA ITEM – TRANSITION UPDATE: PIMCO TO PRUDENTIAL – NORTH CAROLINA FIXED INCOME FUND

Ms. Henson gave a brief update on the completed manager transition in the Fixed Income Fund from PIMCO to Prudential. Prudential managed the transition and it went smoothly. She noted that there was a minimal cost and it was dispersed over the entire fund. Mercer will have the performance data from the 1st quarter of 2015 available for the Investment Subcommittee meeting in May 2015.

AGENDA ITEM – INVESTMENT COMPLIANCE REPORT REVIEW

Ms. Henson stated that only NC Large Cap Growth Fund was out of compliance at the fund level with IPS guidelines. This is due to ADR exposure. However, the individual underlying managers are not breaking their contractual guidelines. Ms. Henson reiterated that IPS is currently under review and the managers' contracts will be re-papered within the next six months. Ms. Buonfiglio added that the compliance monitoring process will greatly improve once the plans have unbundled and asked whether the breach was significant enough to pose a risk to the portfolio. Ms. Henson replied that she was not concerned about the risk due to this breach. In the meantime, all compliance/investment manager issues are being addressed promptly.

AGENDA ITEM – INVESTMENT POLICY STATEMENT PROJECT REVIEW – J.P. MORGAN BUSINESS PRACTICES REVIEW

At the request of the subcommittee in a prior meeting, Ms. Henson reported on the plans' exposure to J.P. Morgan Core Bond. Currently, it is 3.2% of total assets for the NC 401(k) and NC 457(b), combined and 7.3% of Program assets for the NC 403(b). In Mercer's opinion, J.P. Morgan's recent headline risk involves the other areas of the firm and not the asset management arm in particular. As of the present, there is no direct negative impact to the NC portfolio.

Mr. Orr asked whether J.P. Morgan was being considered for a formal review, and Ms. Henson responded that the presentation was prepared in order to address the chairperson's concerns regarding this investment manager, outlining the impact of their governance and management culture on the plans. Mercer believes that if the subcommittee wanted to monitor and evaluate corporate governance, then this should be set forth in the investment policy statement. She stated that the board would need to make that decision.

Mr. Viezer pointed out that there is a Corporate Governance Committee on the pension side. He stated that the pension side has previously visited J.P. Morgan's offices in Columbus, OH, and suggested the same for the supplemental plans.

Ms. Buonfiglio acknowledged the suggestion, but stated that while this type of review committee is common for defined benefit plans the approach for the defined contribution plans is somewhat different. The plans' sole objective is to maximize the economic value of the accounts and must make decisions based on what is in the best interest of participants. Ms. Henson added that Mercer already considers the impact of business culture and business management as one of five evaluation factors they look into when reviewing managers. Mr. Orr stated that he did not think an investigation of J.P. Morgan Asset Management was justified. Ms. Cochran inquired whether the pension due diligence could be leveraged and Ms. Buonfiglio reminded the members that the plans do not vote proxy issues in lockstep with the pension, as our goals can be different. Mr. Toole stated that the corporate governance discussion should continue at the next meeting. Mr. Toole suggested that Mercer follow up with J.P. Morgan on the headline/high profile issues and conduct a visit to their Columbus, OH headquarters.

A break was announced by the chairperson from 10:18 a.m. until 10:28 a.m.

AGENDA ITEM – MERCER REVIEW OF WELLINGTON QUALITY VALUE

Ms. Henson listed three investment managers currently managing the NC Large Cap Value Fund: Hotchkis & Wiley, Robeco, and Wellington. The purpose of the research was to find a manager to replace Wellington Management and one who complements Robeco and Hotchkis & Wiley. Ms. Henson stated that Mercer's top candidate is Delaware Investments. The only negative with this manager is that they did not perform well in 2008. Wellington provides downside protection for the fund, but has been underperforming in up markets. In contrast, Delaware has a good record of performance in up markets.

Brandywine Global Investment Management was a close second candidate, but was not quite as good on downside protection and not as good a fit with Robeco.

Wellington Value Equity was also looked at. This is a very large manager with a large global research team. This manager has an approach different from the existing Wellington strategy.

Another candidate reviewed by Mercer is AJO, which favors a purely quantitative approach of investing in the market. They have a robust team. AJO can offer lower costs due to their approach. Ms. Magner added that while AJO does not conduct meetings with the management, they still base their analysis on fundamentals.

Dodge & Cox Investment Managers would be Mercer's last choice.

Next, Ms. Henson focused on a detailed overview of Delaware Investments. Delaware is owned by Macquarie Group Limited of Australia, but is located in Philadelphia. Their firm culture is one that is independent of Macquarie's. Delaware leverages Macquarie as a resource for distribution, but it functions independently. Ms. Baran requested more information regarding Macquarie from Mercer. Mr. Viezer also added that the DB side has looked at Delaware's growth strategy.

Ms. Henson continued that Delaware is focused on the long-term and their personnel include 346 investment professionals. Delaware also offers the most concentrated portfolio of all managers reviewed; Mercer believes this to be advantageous, since Delaware is able to show the conviction and research behind the concentration. Delaware also has a high tracking error vs.

benchmark and this is desirable, as long as their strategy complements the other two strategies. At Mr. Orr's request, Ms. Henson confirmed that Delaware's sector allocation is driven by bottom up stock selection.

Ms. Cochran asked whether the error tracking was the main driver for the decision to choose Delaware. Ms. Henson said no, but reiterated that while deviation from benchmark is desirable for Delaware, it is not desirable in the fund overall; the down side protection was the main driver. In Mercer's opinion, Delaware would not be suitable for a defined contribution plan as a stand-alone manager, but will complement the part of current manager group, with Robeco and Hotchkis & Wiley.

Mr. Orr made a motion to approve Delaware Investments as a replacement for Wellington Management in the NC Large Cap Value Fund. The motion was seconded by Ms. Cochran and passed unanimously. The recommendation will be presented to the Supplemental Retirement Plan Board of Trustees on March 19, 2015.

AGENDA ITEM – 403(b) PROGRAM 4TH QUARTER INVESTMENT PERFORMANCE REVIEW

Ms. Henson noted that the 403(b) Program investments and their performance are now presented in a format that is standard for a defined contribution mutual fund report. She described Tier I to Tier IV investment options, beginning with Wells Fargo Target Date Funds, which are the equivalent of GoalMaker product. She noted that the program offers a socially responsible fund in the large cap space: TIAA-CREF Social Choice Equity Fund, as well as two specialty funds: PIMCO All Asset Fund and TIAA-CREF Real Estate, which is a unique fund investing directly in real estate rather than REITs. These two funds are not available in the NC 401(k) and NC 457(b) Plans.

Mercer continues to watch the PIMCO All Asset Fund, as well as the PIMCO Inflation Response Multi-Asset Fund and recommends no change in strategy at this time.

Over \$900K has been allocated among the program's mutual funds as of the end of 4th quarter of 2014.

Ms. Henson noted the Manager Summary Compliance and discussed the status of the PIMCO All Asset Fund, which has been trailing the benchmark for the periods 1, 3, and 5 years. She pointed out the unique, much diversified structure of the fund which invests across all asset classes. The fund strategy is focused on long-term and therefore it is hard to evaluate it based upon short-term performance alone.

Mr. Orr asked about the purpose of offering such a fund within the program and Ms. Henson replied that such a fund may be seen as hedge fund, a diversifier against the typical equity portfolio.

Ms. Buonfiglio and Ms. Baran also added that SST Benefits Consulting was engaged in the investment selection process for the program and the investments were chosen with the public educator client in mind. Mr. Orr and Mr. Toole agreed that this particular investment choice should be discussed in depth at the next Investment Subcommittee meeting.

With regards to program fees, Ms. Henson noted that expenses are higher than its peer universe median expenses. This is not uncommon for a new plan during start-up phase and as the program grows, fee reductions can be negotiated.

AGENDA ITEM – WELLINGTON MANAGEMENT COMPANY, LLC
OPPORTUNISTIC GROWTH LARGE CAP GROWTH FUND

The chairperson introduced Elizabeth O'Hara, Managing Director; Andrew Shilling, Portfolio Manager and Kevin Boreen, Investment Director from Wellington Management.

Ms. O'Hara stated the purpose of the presentation was to address the concerns regarding the fund performance in 2014. Mr. Shilling noted that the investment team is very strong and experienced; he has been employed with Wellington for more than 20 years. The team is comprised of 56 research analysts. The team believes in investing in high-quality growth companies and adding value over time by identifying their ability to maintain a specific competitive position. Mr. Shilling gave examples of such companies; Amazon and its unmatched distribution network or a pharmaceutical company, holding a new drug patent which enables growth without incoming competition for a period of time. Wellington finds these companies by researching the rate of growth of a typical company and locates value opportunities. Keurig is a good example of a lower valuation buy; when purchased by Wellington, it held approx. 10% of its market; now, the market share is estimated at 16-17%. Mr. Shilling confirmed that selling Keurig shares in 2015 was consistent with Wellington's sell discipline to exit when risk-to-reward ratio is considered by them to be no longer favorable. Mr. Shilling gave several other examples of companies owned by Wellington to illustrate the opportunistic growth investment approach (e.g., Google, Bristol-Myers Squibb and Home Depot).

With respect to the fund's 2014 performance, Mr. Shilling noted that it was not as good as the team had hoped. However, he noted that periods of underperformance are not uncommon and Wellington has always managed through them. The firm is confident that the 2014 performance was no exception and that Wellington will be able to bounce back from the underperformance.

Ms. Cochran asked what lessons specifically has the firm learned from the 2014 performance. Mr. Shilling replied that they isolated three factors involved in the underperformance. He noted that their investment strategy had a small cap bias in relation to index, they had a bad year of stock picking, and they were underweight in Apple and Microsoft.

Ms. Cochran inquired if the firm will be making any changes to their investment philosophy based on the 2014 performance. Mr. Shilling replied that no changes will be made. He believed that they have the key resources in place and will continue to execute on their philosophy and approach.

AGENDA ITEM – BROWN ADVISORY MID/SMALL CAP GROWTH FUND

The chairperson introduced Chris Berrier, Portfolio Manager; Trish Carroll, Relationship Manager and George Sakellaris, Analyst from Brown Advisory. Mr. Sakellaris is a recent addition to the firm and serves on two small cap research teams.

Ms. Carroll began with a company update. The organization continues to be employee-owned and experiences low turnover. Brown Advisory has \$51 billion assets under management, and

institutional assets represent approximately half of this figure. She noted that when the fund reaches \$2 billion it will be closed to new investors. (It is now at \$1.7 billion.) Ms. Carroll noted that the portfolio's process is based on fundamental research. Absolute returns on the fund have been good; however, 2014 performance was disappointing due to market conditions and specific stock selection.

Mr. Berrier stated that the quality of the team is a foundation of the firm investment process. The portfolio continues to look for high-quality business, run by dedicated people focused on multi-year investment horizon. The team does not managed to the benchmark, but rather constructs its portfolio by performing due diligence research and focuses on finding young, smaller companies with the ability to scale into large organizations. In general, the fund avoids companies with a commodity orientation, capital intensive or difficult to profitably scale. This approach has yielded solid long-term results; however, performance suffered in 2014 due to disappointing stock selection. For example, the firm did not sell the shares of Quicksilver, Inc., aggressively enough. He also attributed the 2014 underperformance to the fact that they were relatively underweight in biotech. He noted that the low interest rate environment also caused some anomalies in valuations. Mid cap stocks are the most expensive within the equity category.

Mr. Berrier reiterated that the firm believes their process and philosophy to be sound and the investment team to be committed to its execution. Brown expects heightened volatility in 2015 — which tends to benefit their strategy — and is working hard on improving the stock selection process.

In response to Ms. Cochran's question, Mr. Sakellaris stated that he made a transition from the sell-to-buy side four years ago and Mr. Berrier added that his was an opportunistic hiring.

AGENDA ITEM – STAFF REPORTS

No staff reports were discussed.

AGENDA ITEM - SUBCOMMITTEE MEMBERS QUESTIONS/COMMENTS

No further comments were offered.

AGENDA ITEM – PUBLIC COMMENT

No public comments were offered.

Ms. Cochran made a motion to adjourn and Mr. Orr seconded. The subcommittee adjourned at 12:32 p.m.

Secretary