State of North Carolina

Department of State Treasurer

Investment Management Division

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To: **Kevin SigRist**

From: **Rhonda Smith**

Date: **May 14, 2013**

Re: **Goalmaker/Glidepath – Summarization**

The "through retirement" asset allocation recommendation presented to the board by Mercer in March 2013 appears to be consistent with the research findings and long term capital markets assumptions provided.

The proceeds from the reductions made to passive fixed income, active and passive large cap equity as well as active and passive international equity will go towards funding more diversified investment options (Small Cap, Global and Inflation) while largely maintaining the existing manager lineup. The only new strategy addition reflected in the recommendation is the diversified inflation hedging strategy.

We offer the following comments:

1. Meaningful increases within the SMID growth and value portfolios align with Mercer's 20-year risk/return assumptions favoring US small and mid capitalization. We view these changes favorably.

2. The substantial increase within the active Global allocation incorporates the proposed initiative to consolidate participant investment options as well as broaden investment manager flexibility to navigate US/Non-US markets in a more diversified and opportunistic approach relative to cap, sector and/or regional exposures. We view these changes favorably.

3. It appears that the inflation hedge recommendation is largely based on Mercer's 20-year expected bond assumptions. As such, there is a reasonable basis for the recommended adjustments within the Glidepath. However, it is worth noting that, the diversified inflation hedging product is relatively new in the market, has a more esoteric opportunity set than most participants would be familiar with, and it is not clear how the product would impact Goalmaker funds in a deflationary environment. While we view the changes favorably, we would suggest an enhanced communication campaign to participants on the diversified inflation hedging product and enhanced monitoring of the contribution of the diversified inflation hedging product to performance should inflation trend toward deflation.

4. Though the existing manager lineup largely remains the same, the contemplated changes would require a meaningful rebalance and the cost of implementation should be evaluated and taken into consideration.

RMS