

North Carolina Supplemental Retirement Plans Neuberger Berman Large Cap Disciplined Growth Retention Review

February 2014

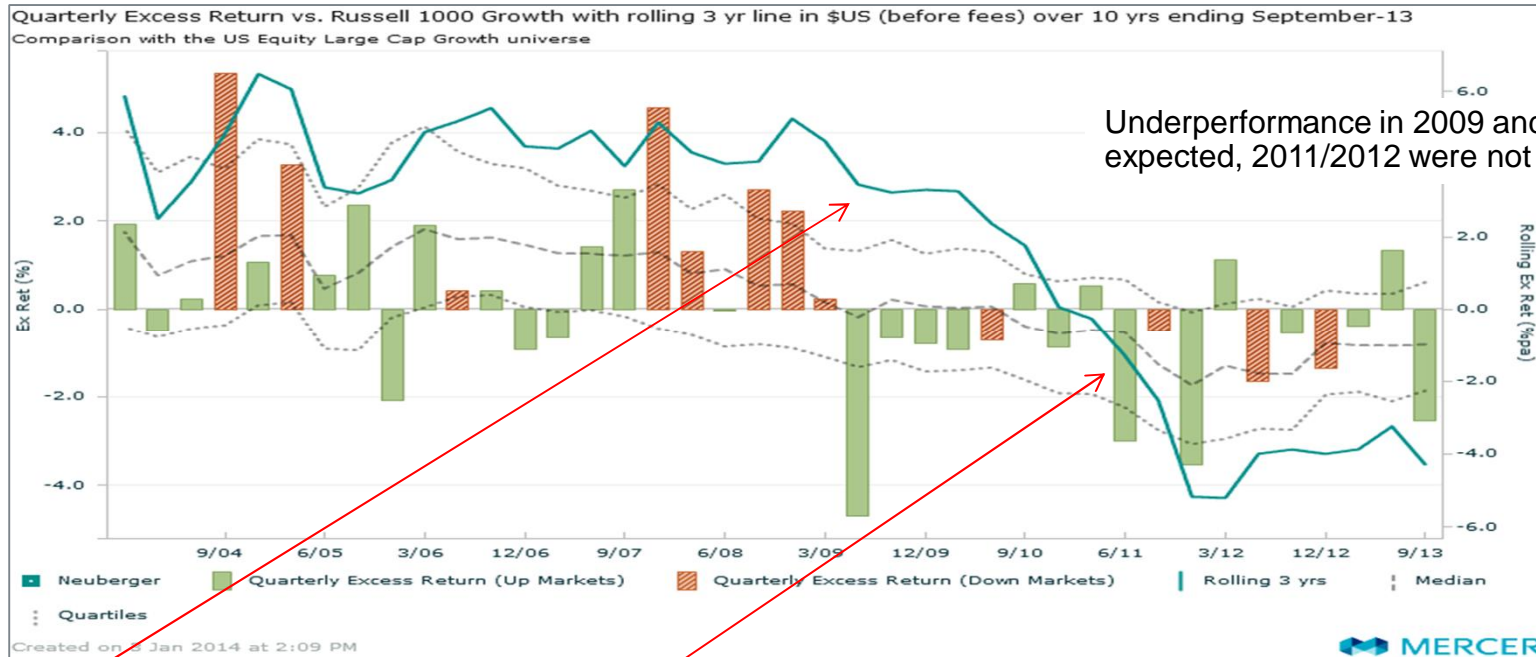
Evaluating Managers on Watch List

- Objective: Evaluate confidence in manager's ability to succeed in the future
- Watch List Manager Retention Evaluation
 - What is the manager's process and philosophy
 - When should it be effective and when should it struggle
 - Is recent performance consistent with expected pattern of performance
 - Can the team execute the strategy successfully
 - Is past performance indicative of ability or luck
 - Can the strategy succeed in the future
 - Stable Team
 - Process and Philosophy expected to work
 - Process and Philosophy can be implemented by manager

Philosophy and Process

- Growth oriented strategy seeking accelerating earnings growth driven by an identified catalyst
- Valuation discipline enhanced by requirement for attractive free cash flow yield
- Companies must have strong and conservative balances sheets, with ample liquidity to finance growth
- Experienced management teams with proven ability to execute
- This philosophy should produce a portfolio that will
 - perform well in most market environments
 - will excel in down markets
 - struggle in exuberant markets

Performance Overview



2009

2011 / 2012

2013

- Dramatic underperformance
- Biased towards quality and large cap
- Risky and small stocks led market
- New PMs added to team.
- # of stocks in portfolio begins to increase to around ~65
- turnover decreased

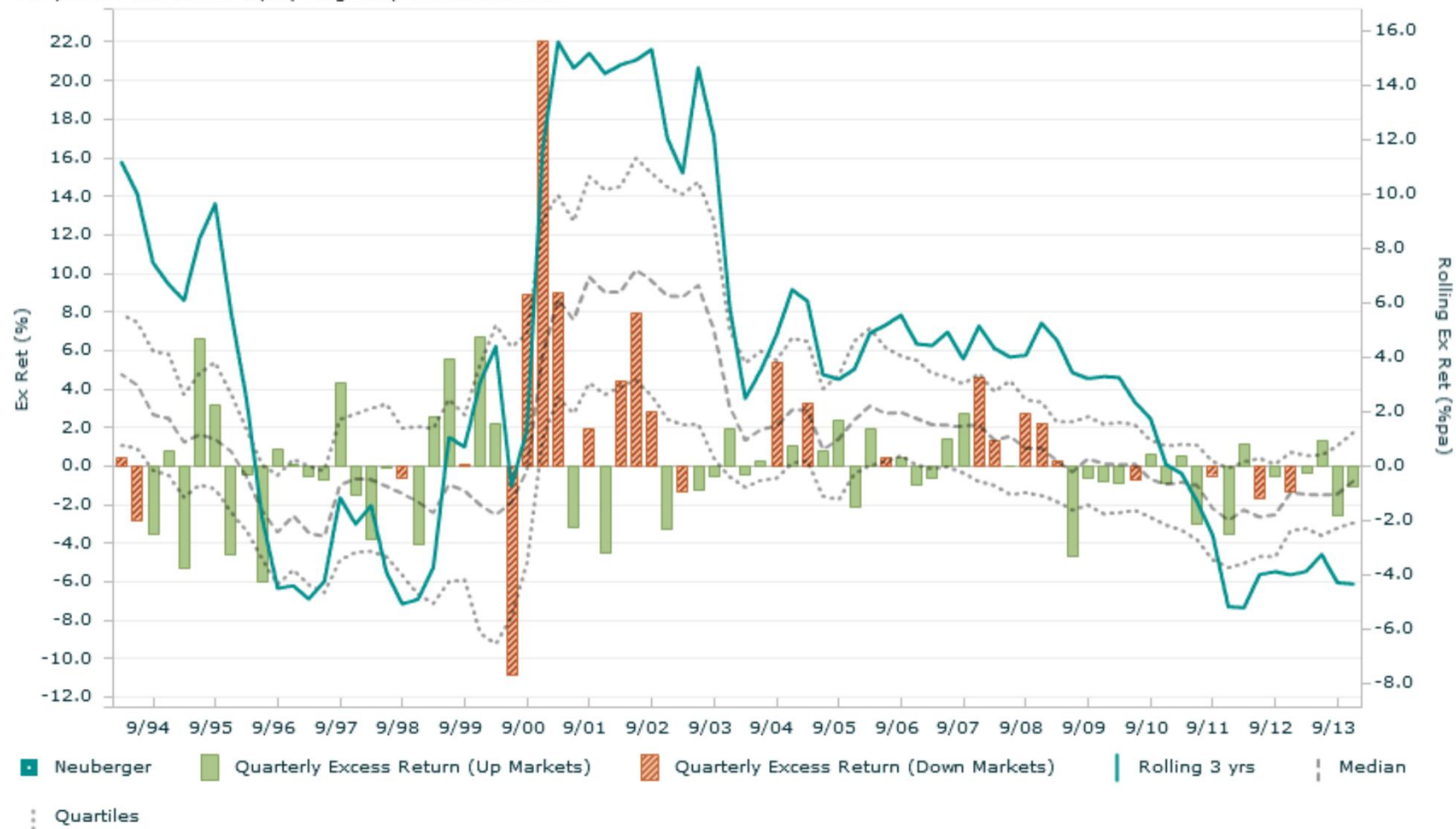
- Lagged index by 6.3%
- Poor stock selection
- Underperformed significantly in 2Q11 and 3Q11 when quality was *in favor*,
- Netflix and Illumina were major detractors.
- 2012 underperformance was smaller and in line with process in a rising market
- PM team reduced to original 2 members in 2012

- 2013 underperformance expected in sharply rising market
- # stocks back down to <55, decision process streamlining

Long Term Performance Cycle

Quarterly Excess Return vs. Russell 1000 Growth with rolling 3 yr line in \$US (before fees) over 20 yrs ending December-13

Comparison with the US Equity Large Cap Growth universe



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Team and Resources

KEY TEAM MEMBERS

| Name | Title | Location | Joined Firm | Joined Industry |
|-------------------------|---|--------------|---------------------------|-----------------|
| John J. Barker | Managing Director, Portfolio Manager | New York, NY | 1994 | 1980 |
| Daniel H. Rosenblatt | Managing Director, Portfolio Manager | New York, NY | 1990 | 1981 |
| Neil Groom | Managing Director, Portfolio Risk Manager | New York, NY | 2004 | 1999 |
| Dedicated Research Team | 5 Team Members | New York, NY | > 16 Years Avg Experience | |



1997-2007

2009

2012

2012

Strategy headed by co-portfolio managers, John Barker and Daniel Rosenblatt.

Team moves towards a four portfolio manager structure, promoting Larry Fisher and Daniel Fletcher. Portfolio decisions had to be unanimous among portfolio managers. Client service was one of the reasons for the team expansion.

The team moved back to the co-portfolio manager structure as a result of poor performance and a less efficient decision making process. Fisher and Fletcher retained their previous associate portfolio manager positions.

Larry Fisher and Neuberger Berman mutually agreed to part ways. The team felt that Fisher did not react quickly enough when ideas were brought to him by analysts and was too risk averse.

Asset & Rating History

| Date | Assets (\$B) | Clients | Mercer Rating | Comment |
|----------------------------|--------------|---------|---------------|---|
| May 2009 ¹ | \$6.5 | 649 | B+ | Mercer initially rated the Disciplined Growth Strategy |
| November 2010 ² | \$11.6 | 641 | A | Mercer upgraded rating to “A” based on the impressive team and investment process |
| September 2012 | \$10.5 | 530 | B+ | Mercer downgraded the fund to a “B+” due to the personnel changes within the team as well as structure change that took place in 2011 |
| September 2013 | \$6.6 | 422 | B+ | Mercer reaffirmed the “B+” rating on the strategy |

¹ Assets and clients as of June 30th 2009

² Assets and clients as of December 31, 2010

Strategy Profile

Key Decision Makers: The core investment team consists of co-portfolio managers Dan Rosenblatt and John Barker who are the final decision makers. The investment team is supported by four research analysts, one portfolio risk manager, and one portfolio specialist. Additionally, the team has access to Neuberger's centralized buy-side analysts.

Investment Style/Philosophy: The Large Cap Disciplined Growth team invests in companies with prospective accelerating growth metrics (earnings per share, cash flow, or number of subscribers) driven by an identifiable catalyst. The team seeks companies that have an experienced and accessible management team, ample liquidity, manageable leverage, and/or the ability to generate both free cash flow and operating income growth over time. The team believes companies with these qualities have the potential for price appreciation through earnings growth and an expanding valuation brought about by improved investor perception.

Investment Process: The initial step in the investment process is a simple quantitative screen to identify stocks with market-capitalizations above \$3 billion and daily dollar trading volume greater than \$100 million. Additionally, debt as a percent of total capitalization and price-to-earnings ratios for each respective industry group is considered. These screens typically yield approximately 400 companies. Fundamental analysis is then performed to identify potential catalysts that could accelerate growth at particular companies. This typically reduces the field to approximately 150 names. Examples of identifiable catalysts include: new product development, regulatory change, management changes, mergers, acquisitions, demographic shifts and corporate reorganizations. Next, the team analyzes the significance of the catalyst and quantifies its impact on a company's growth. As a final step, the team will often meet with company management. The investment process typically produces five or six companies at any given time that meet the team's criteria. While the dedicated team maintains ownership of the process, its research is supplemented with the firm's centralized analyst team throughout the entire process.

The team will sell a stock if one of the following occurs: full accretion of catalyst into relevant metrics or stock price, or failure of initial catalyst. A stock will be reviewed if it declines 10% from cost or 15% from its 52-week high.

The portfolio consists of 50 to 70 holdings with no one single position exceeding the maximum of 5% or 1.5x the index weight at cost. Sector weights are restricted to fall between 50% and 150% relative to the benchmark sector (up to +/- 10% for smaller sectors). Cash is limited to 5%, ADRs are capped at 15%, and portfolio turnover averages 80%-100%.

Strategy Profile

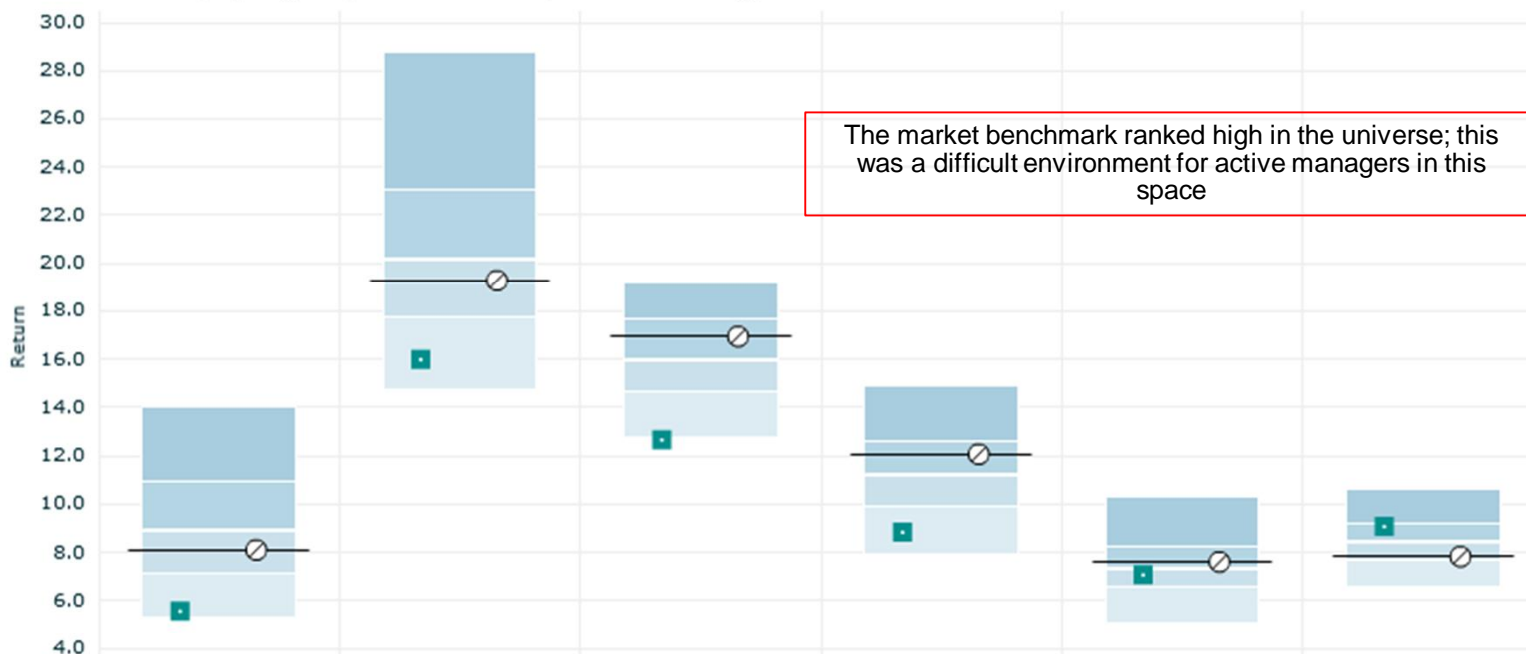
Mercer Evaluation Summary

| Factor | Rating (-, =, + or ++) | Comments |
|---|---------------------------|--|
| Idea Generation | + | The generation of ideas is the responsibility of each team member, but ideas are approved by Rosenblatt and Barker. This growth oriented investment team seeks stocks with accelerating growth metrics, as opposed to those that meet certain high growth hurdle rates, and very specific quality metrics. This 'second derivative' approach to growth investing, while reflective of a forward looking, non-consensus oriented investment philosophy, does not necessarily translate into a defensive investment strategy on a consistent basis. Neuberger has restructured its large cap growth team over the last several years to generate more investment ideas for Rosenblatt and Barker to consider and lessen its reliance on the firm's centralized buy-side analysts (used primarily for industry overviews), but has encountered some personnel issues in doing so. On the positive side, the investment process is considered sound and research is focused on developing a non-consensus edge. We think idea generation benefits from the team being specifically dedicated to this one strategy and from the insulation of key team members from most non-investment distractions. |
| Portfolio Construction | + | The portfolio is well diversified but is subject to the sector tilts of the growth benchmark (Neuberger generally refrains from taking large sector bets relative to the index). Positions are weighted based on index weight plus (or minus) conviction. Neill Groom, as portfolio risk manager, is responsible for tracking the portfolio's risk exposures on a daily basis. BARRA is used to analyze ex-ante tracking error and the portfolio's Active Share is explicitly managed but not particularly high. Groom's daily dashboard review monitors multiple exposures versus the benchmark and he works very closely with the portfolio managers. A quarterly portfolio review is conducted which focuses on strategy, style, performance attribution, and risk analysis, mostly for the benefit of the firm's head of portfolio analysis and equities CIO. |
| Implementation | + | Trading resources are sophisticated and capacity/liquidity issues are not a concern at this time. |
| Business Management | + | In December 2008, following the bankruptcy of Lehman, a group of senior investment and management professionals agreed to acquire a majority interest in Lehman's Investment Management Division. We viewed this as a positive development for investors in Neuberger Berman and Lehman Brothers funds as the alignment of interests and the longer-term direction of the business was made more stable and clear. Since then, the firm has demonstrated its ability to operate as a stand alone entity while retaining talent within the firm and is moving toward 100% employee ownership over the next three years. The firm remains in a strong financial position with revenues from approximately \$214 billion in assets under management. Neuberger's compensation scheme includes a deferred element of up to 25% that, for the Disciplined Large Cap Growth investment team, is invested in either Neuberger shares or this strategy. |
| Overall Rating (A, B+, B or C) B+ | | The insistence on both free cash flow yield and operating income growth ensure some portfolio emphasis on quality over time, but the strategy is by its nature somewhat chameleonic (i.e., not always defensive) as the team seeks companies with acceleration of a key business metric that can differ from company to company. Growth and seasoning of the team over the years has added depth to Neuberger's research capabilities. Personnel and structural changes have been somewhat disruptive, albeit beneficial. While the team leverages the Neuberger's centralized buy-side analyst team to supplement its research, this group is not utilized for idea generation. The team is knowledgeable and Rosenblatt and Barker provide solid but not necessarily passionate leadership. Moreover, the support provided by the organization allows the team the luxury of singularity of focus and a minimization of distractions within the context of a firm with an expanding product lineup. |
| Additional Observations | | The strategy is considered to be traditional growth and has the potential to perform well in most market environments. Those favoring lower quality or smaller cap names within the Russell 1000 Growth Index may present performance headwinds for Neuberger. |

Performance Analysis

Return in \$US (before fees) over 3 mths, 1 yr, 3 yrs, 5 yrs, 7 yrs, 10 yrs ending September-13

Comparison with the US Equity Large Cap Growth universe (Percentile Ranking)



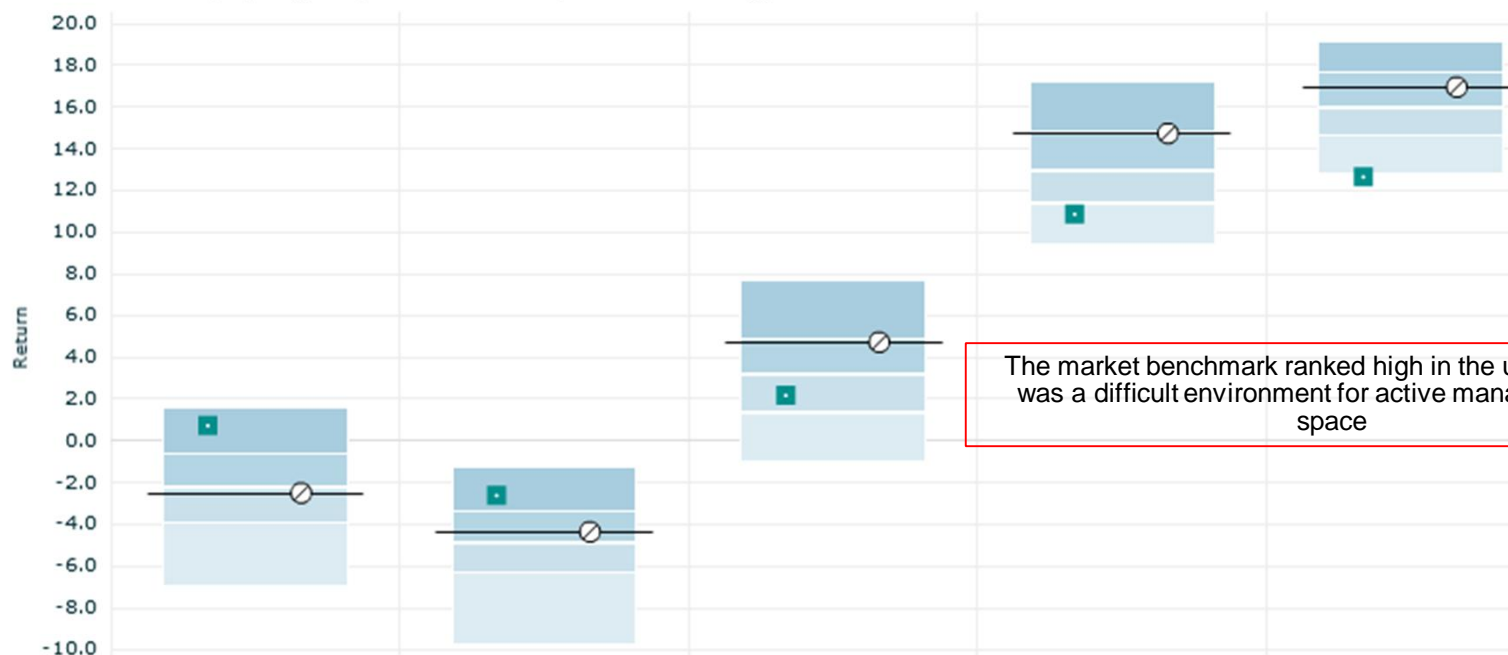
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Performance Analysis

Return in \$US (before fees) over 5 annual rolling periods ending September-13

Comparison with the US Equity Large Cap Growth universe (Percentile Ranking)



The market benchmark ranked high in the universe; this was a difficult environment for active managers in this space

| | 3 yrs to 9/2009 (%pa) | 3 yrs to 9/2010 (%pa) | 3 yrs to 9/2011 (%pa) | 3 yrs to 9/2012 (%pa) | 3 yrs to 9/2013 (%pa) |
|-----------------|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|
| ■ Neuberger | 0.7 (9) | -2.6 (17) | 2.2 (64) | 10.9 (85) | 12.7 (96) |
| ○ RU1000G | -2.5 (56) | -4.4 (40) | 4.7 (28) | 14.7 (25) | 16.9 (38) |
| 5th Percentile | 1.6 | -1.2 | 7.7 | 17.2 | 19.2 |
| Upper Quartile | -0.6 | -3.4 | 4.9 | 14.8 | 17.7 |
| Median | -2.2 | -4.8 | 3.2 | 12.9 | 16.0 |
| Lower Quartile | -3.9 | -6.3 | 1.3 | 11.4 | 14.7 |
| 95th Percentile | -6.9 | -9.8 | -1.0 | 9.4 | 12.8 |
| Number | 266 | 257 | 239 | 228 | 211 |

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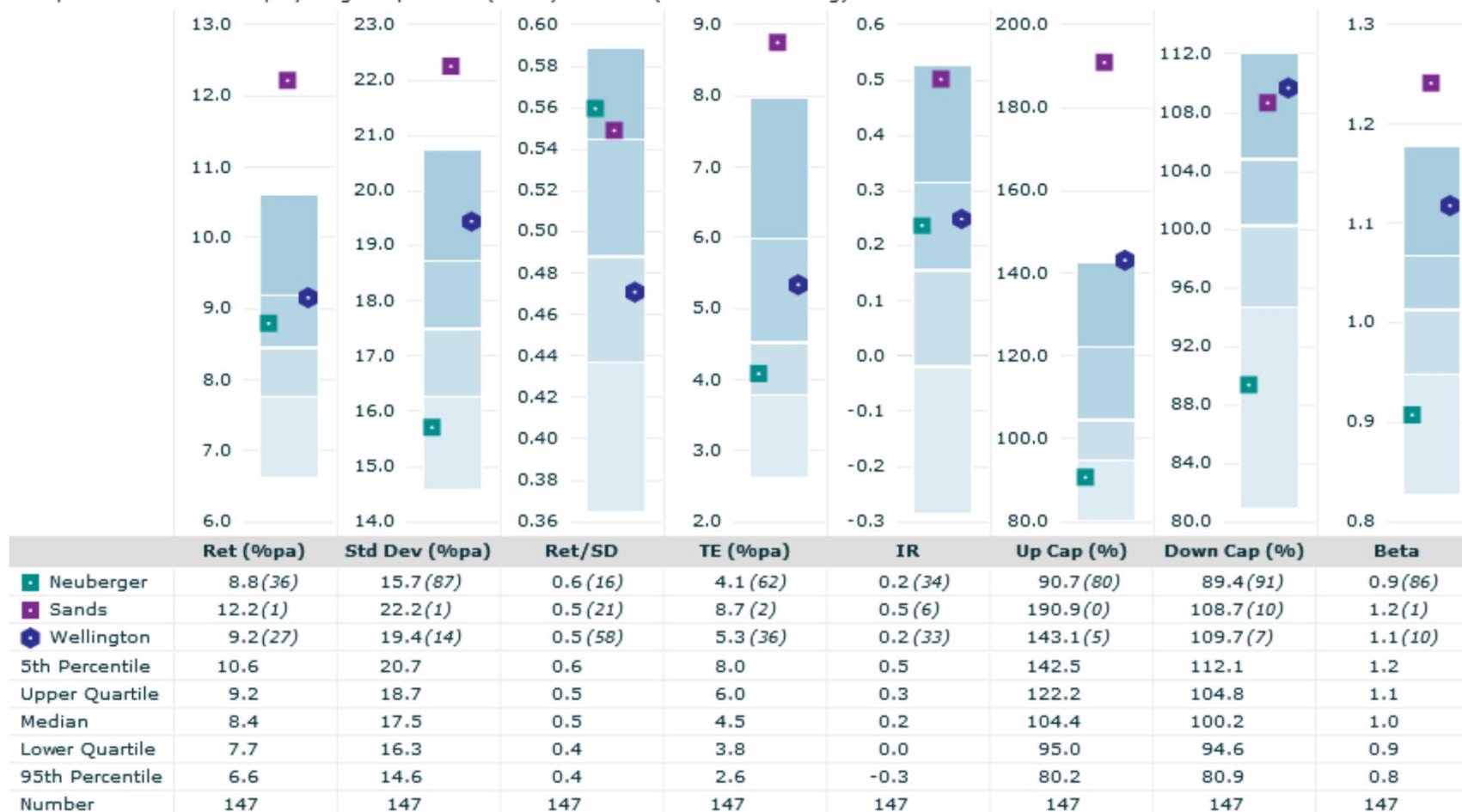
Performance Analysis

Risk-adjusted return as expected.
Strategy exhibited lower risk,
though with lower return.

State of North Carolina Retirement System - Neuberger Berman - Large Cap Disciplined Growth, Sands C

Performance characteristics vs. Russell 1000 Growth in \$US (before fees) over 10 yrs ending December-13 (quarterly calculations)

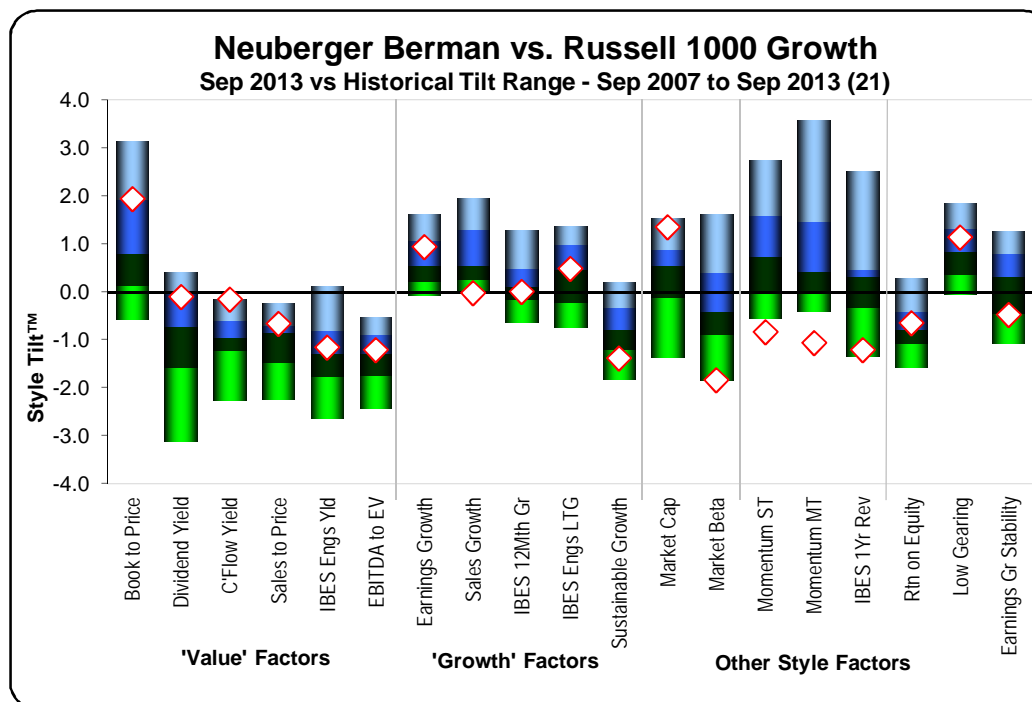
Comparison with the US Equity Large Cap Growth (Active) universe (Percentile Ranking)



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Holdings Based Style Analysis

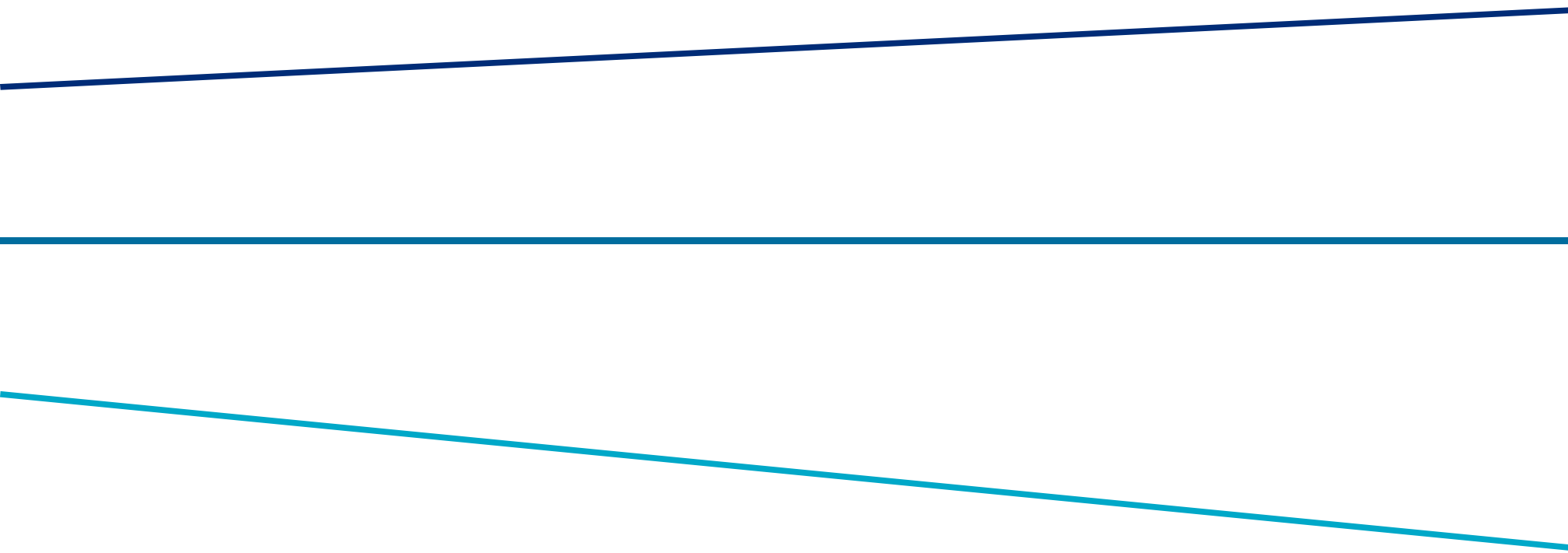


- Portfolio exposures generally in line with philosophy
- Low Gearing (financial leverage) indicates conservative balance sheet
- Low Sustainable Growth and RoE indicate portfolio holds stocks whose financial results have not been strong (and may be poised for an improvement)
- Moderate exposure to forecast earnings growth consistent with buying stocks where market does not recognize future growth
- Low Cash Flow yield is out of character, but most recent period shows this metric increasing

Summary and Observations

- Recent performance challenges mostly consistent with their philosophy and process
 - 2011 and 2012 somewhat out of character
 - Team changes an issue, may be resolved
 - Macro environment not favorable to strategy
 - Little differentiation among quality and fundamentals
 - High quality balance sheets not benefited by low rates
- Very long track record that is strong, indicating more skill than luck
- Deep team and firm resources support the strategy

Appendix



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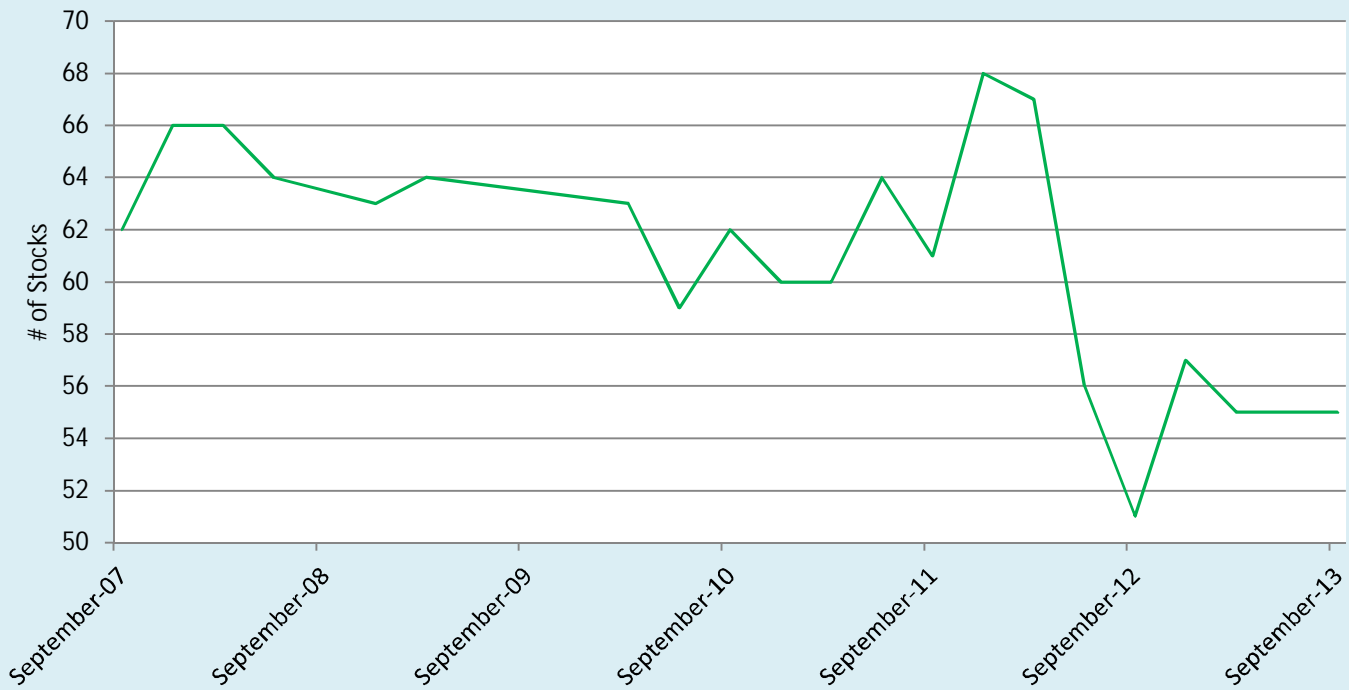
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Neuberger Berman History of Stock Holdings in Portfolio



Performance Analysis

The market benchmark ranked high in the universe; this was a difficult environment for active managers in this space

