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INVESTMENT SUBCOMMITTEE OF THE NORTH CAROLINA SUPPLEMENTAL RETIREMENT BOARD OF TRUSTEES

MINUTES OF SPECIAL MEETING OCTOBER 30, 2014

Time and Location: The Investment Subcommittee (the "Subcommittee") of the North Carolina Supplemental Retirement Board of Trustees (the "Board") met at 10:00 a.m. on Thursday, October 30, 2014 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 attended via telephone.

Staff and Guests present: The following staff and guests attended the meeting. From the Department of State Treasurer: Steve Toole, Mary Buonfiglio, Blake Thomas, Rekha Krishnan, Lisa Page, Rosita Sabrosso-Rennick, Erica Hinton and Maja Moseley. From the Investment Management Division: Kevin SigRist and Rhonda Smith. From Mercer: Kelly Henson. Liana Magner attended via telephone. From Prudential: Michael McCann. Jessica Quimby and Thomas Conlon attended via telephone. From TIAA-CREF: Jamie Summerlin attended via telephone.

AGENDA ITEM – WELCOME AND INTRODUCTIONS

Meeting convened at approximately 10:02 a.m.

Ms. Baran welcomed everyone.

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

The Chair 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 – PIMCO MANAGER REVIEW

The Chair recognized Ms. Henson and Ms. Magner of Mercer.

Ms. Henson explained that Mercer had been asked to assist in the evaluation and selection of a new manager for the North Carolina Fixed Income Fund (the "Fund") in the NC 401(k) and NC 457 Plans. The manager is to be a potential replacement for PIMCO that is currently managing a portion of the Fund. Ms. Henson explained that the strategy to be replaced is an active core bond option that complements the existing core bond strategy, managed by J.P. Morgan. Mercer's opinion is that a manager who has a top-down investment approach and incorporates credit and "plus" sectors ("plus" sectors being non-dollar, high yield and some emerging market debt) would be a good fit.

Ms. Henson stated that Mercer has ranked the list of suitable investment managers:

1. Pacific Investment Management Company (PIMCO): Listed because they are the current manager.
2. Loomis, Sayles & Company (Loomis): Mercer's first choice. Loomis possesses a good exposure in "plus" sectors and focuses a little more on credit. It has a low correlation when compared against J.P. Morgan.
3. Prudential Fixed Income (Prudential): A close second to Loomis. Strong in fixed income, high yield and non-dollar. Their focus is a little more in the credit space.
4. TCW Group (TCW): TWC has large allocation to mortgages, so not as good a complement to J.P. Morgan
5. Goldman Sachs Asset Management (GSAM): Mercer determined that GSAM, although very strong and a potential good fit, have been in the median of their peer group for the past 3 and 5 year rolling periods. Therefore, a manager who takes more risk would be more desirable.
6. Western Asset Management (Western): Western recently became "A" rated; and in Mercer's opinion, this particular manager has improved a great deal recently.

Ms. Magner reiterated that two managers offer the best fit to NC Plans: Loomis and Prudential. She noted that J.P. Morgan is purely a core manager so a more opportunistic manager is desired to generate more alpha in the portfolio. She said that that both Loomis and Prudential have that capability and Mercer holds both managers in high regard.

Ms. Henson went on to describe other characteristics of the firms included in the report, as well as their staff. All firms researched have a large number of assets under management and offer multiple products lines. With regards to assets in particular, GSAM is the smallest operation with approximately $5 billion under management and PIMCO is the manager with the highest account losses (exits out) of approximately $19 billion. With regards to the personnel, PIMCO has the largest number of professionals backing up their strategy. However, all firms are adequately staffed: TCW staff is the smallest group, comprised of professionals from Metropolitan West Asset Management – a company recently acquired by TCW.

Ms. Henson next described the drivers behind the performance of the managers as compared to JP Morgan. She noted that GSAM takes more of a top down view on duration. It has the largest duration range. J.P. Morgan focuses on security selection and does not make interest rate bets. All the managers have some international exposure and will move in and out of sectors. Loomis has the most concentrated portfolio. Ms. Buonfiglio asked if the data as of June 30, 2014 is just a snapshot or if it represents the usual portfolio management style. Ms. Henson confirmed the data is a snapshot, but stated that it also represents how the portfolio has typically been managed. Ms. Henson noted that while it is difficult to find a manager who replicates what PIMCO does, Mercer thinks they have identified several managers who all compliment J.P. Morgan.

Ms. Henson then reviewed the managers' fee information and stated that most managers' fees are negotiable. Ms. Magner explained a new fee structure proposed by Prudential. She noted that Prudential has selected their own fixed income fund to replace PIMCO in the existing commingled fund that the Plans currently utilize. Ms. Magner explained that as a result of this selection, Prudential will become the manager of the fund as of December 15, 2014 and the fee would be 17 bps. As an alternative approach, Prudential is setting up a commingled fund for Mercer clients, which has a favorable tiered fee structure. This vehicle would offer a fee of 18 bps to begin with and the fee could drop to 11 bps overtime as assets grow. Ms. Henson noted that 11 bps would be the minimum fee. Ms. Buonfiglio asked if there are other commingled fund structures available to Mercer clients. Ms. Magner explained that this is a new arrangement offered by Prudential to Mercer's eligible clients, due to the large size of Mercer's client base. Mr. Toole requested a clarification regarding the tiered fee structure. Ms. Henson stated that as assets go up fees go down and Ms. Magner listed the fee schedule:

When assets total between $300-$500 million: 24 bps; $500-750 million: 18 bps; $750 million - $1 billion: 16 bps; $1-$2 billion: 14bps; $2-$3 billion: 12 bps and for assets of above $3 billion: 11 bps. Operating expenses are a fixed fee of 1.7 bps.

Mr. Toole inquired whether we could choose the 17 bps fee structure and still be a part of Mercer's tiered pricing. Both Ms. Henson and Ms. Buonfiglio replied that this strategy would not be possible.

Mr. McCann of Prudential explained further that 17 bps in the Prudential commingled fund is all inclusive. The current fee structure for other investment fees, record-keeping and the administrative fee would remain the same. Mr. Toole asked if the fee of 1.7 bps would only be added to the Mercer version of the tiered fee structure and Ms. Henson affirmed. Mr. Toole also inquired if there was any insight available with regards to the speed of the fund growth or when it might surpass the 17 bps threshold. Ms. Henson replied that while Prudential is in a majority of searches Mercer is conducting they could not predict the growth of the fund. Mr. Orr stated that the Plans should not rely on the manager's ability to gather assets; rather, the Plans should take a more conservative approach of taking a good deal on the table. Ms. Smith wanted to find out if more favorable terms would be offered to early subscribers. Ms. Henson and Ms. Magner replied in the negative, with Ms. Magner stating that a fee of 17 bps already represents a discount. Ms. Henson stated that she thought a manager should be selected first and the decision regarding vehicle selection should come afterwards.

Ms. Henson then moved next to discuss the performance of each manager. She reiterated that each manager's performance was quite good compared to their respective peer groups. Loomis had the best recent quarter performance at 3.1 percent. She also remarked that overall the year 2008 was extremely challenging for the fixed income managers and noted that Western had a negative return of 9.9 percent for that year. Mr. Orr inquired if Loomis was as heavily positioned in the high-yield sector in 2008 as they are in the current year. Ms. Henson did not believe Loomis was, but would double-check. She also noted that many managers went out of business in 2008 and this might be one reason why PIMCO was viewed so favorably; PIMCO returned 3.8 percent in 2008. Loomis also had a positive return of 1.8 percent for 2008. Ms. Henson stressed the importance of assessing the manager's performance during extreme market conditions, such as in the year 2008 and 2009 as this is the time when clients look for added security. Ms. Henson noted that Loomis's extremely good 5 year performance stood out, while GSAM's performance put them in the middle of the group. With regards to the absolute and relative manager volatility, Western and Loomis are the more volatile managers, while GSAM and TCW are more conservative. Ms. Henson also stated that with regards to excess returns, all managers considered have a low correlation to J.P. Morgan. In a 50/50 performance evaluation between J.P. Morgan and another manager, Loomis had the best results and Prudential was close second. In Mercer's opinion, both managers are a good fit and each one would make a good replacement for PIMCO.

Ms. Henson asked committee members if they had any questions and /or strong leanings at this time. Mr. Orr stated that he did not currently like the high-yield markets and therefore he would lean more toward Prudential. Mr. Toole stated that Mr. SigRist is the expert in the credit field and asked his opinion. Mr. SigRist agreed with Mr. Orr's opinion particularly considering where we are in the credit cycle. He thinks the funds should be de-risking. Mr. SigRist is familiar with Prudential and in his opinion this is a strong team which offers a strong product of low risk and low tracking error. Ms. Cochran also agreed with Mr. Orr's opinion.

No further questions and comments were offered with regards to the Fixed Income report and the Chair recommended the discussion move to the Real Asset-Diversified Inflation Hedge Manager Search Report.

AGENDA ITEM – PIMCO ALLOCATION IN THE NORTH CAROLINA INFLATION RESPONSIVEVALUE

Ms. Henson noted that the Real-Asset/Diversified Inflation fund was added to the Plans in 2013. The fund is rated "B+" and on watch by Mercer. She stated that Mercer had not downgraded this strategy because Bill Gross was not involved in the management of this fund and this structure like a fund of funds where special teams within PIMCO manage individual components of the fund. Mercer does not recommend a replacement at this time but the outflows will be closely monitored – especially any staff departures. Based upon these observations, a second choice may need to be considered. Ms. Henson noted that this fund is a stand-alone fund for the participants as well as part of GoalMaker. She noted that when the committee was selecting this fund for the line-up, they chose PIMCO as the more conservative option. The second choice, J.P. Morgan has a different risk and return profile. Ms. Buonfiglio inquired about the impact on the glide path. Ms. Henson affirmed that the impact would need to be evaluated if a change takes place and that right now, the glide path is modeled on a more conservative risk and return profile.

Ms. Henson moved on to the analysis of the possible candidates:

1. BlackRock
2. J.P. Morgan
3. PIMCO
4. Principal
5. Wellington

Ms. Henson noted that this is a much smaller universe of managers and this product type is new to the marketplace and they are complex. She noted that Blackrock is a passive version of this strategy. Ms. Henson said that the biggest change in PIMCO since the initial search a year ago is that the assets under management now amount to over $1 billion. She noted that one of the largest clients in this strategy has already left PIMCO, but they were in a separate account so the Plans were not impacted by this departure. Ms. Buonfiglio asked why that client left. Ms. Henson said that the client got rid of all their PIMCO exposure.

Ms. Henson pointed out the target asset allocation and tactical ranges of the various managers, starting with their inflation sensitive allocations such as TIPS and non-dollar allocations. She remarked that while Wellington seems conservative from this perspective, they are also invested in natural resources which increases the beta. Mercer approves of PIMCO's diversification as it offers a broad exposure.

Ms. Buonfiglio asked for a time check and whether the discussion should go back to the North Carolina Fixed Income Fund. The Chair asked the members about their recommendation. Mr. Toole suggested a motion be made. Mr. Orr reiterated that he has already given his bias and prefers Prudential. Ms. Cochran was also comfortable with Prudential as a replacement. Ms. Henson stressed that the line between Loomis and Prudential is very thin.

Mr. Orr made a motion that the Investment Subcommittee recommend to the Board to replace PIMCO with Prudential as the core opportunistic manager for the North Carolina Fixed Income Fund. Ms. Cochran seconded and the motion was approved unanimously.

There was discussion around fees and which investment vehicle the fund should utilize. Mr. Orr stated that he did not think the Subcommittee should be making a decision based on a manager's ability to accumulate assets. Mr. Toole and Mr. SigRist agreed.

Mr. Orr made a motion that the Investment Subcommittee recommend to the Board that the fund invest in the vehicle that offers the plans a 17 bps fee structure. Ms. Cochran seconded and the motion was approved unanimously.

Ms. Buonfiglio, Mr. Toole, Ms. Baran, Ms. Cochran and Mr. Thomas agreed that a special Board meeting should be called so the Board can take action on the Investment Subcommittee recommendations as soon as possible.

Ms. Henson asked if the Subcommittee was comfortable waiting to decide whether to make a change to the PIMCO Inflation Responsive Fund. Mercer is not recommending a change. Ms. Buonfiglio pointed out that the NC 403(b) Plan is also in PIMCO strategies and that any action should be taken in tandem to ensure consistency. Mr. Summerlin confirmed that TIAA-CREF would make sure to offer a consistent fund within the NC 403(b) Plan. The Chair recommended the plans retain the PIMCO Inflation Responsive Fund and place it on watch list for a period of one year.

Motion 3:

Ms. Cochran made a motion to retain the PIMCO Inflation Responsive Fund and keep it on a watch list for one year and to continue the discussions with regard to a possible back-up if needed during the four quarters of the watch period. Mr. Orr seconded and the motion was approved unanimously.

Ms. Buonfiglio stated that the next item on the agenda, the Stable Value portfolio memorandum, would be deferred to the November 13, 2014 Investment Subcommittee meeting.

AGENDA ITEM - SUBCOMMITTEE MEMBERS QUESTIONS/COMMENTS:

No additional 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 11:23 a.m.

Secretary