

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

**MINUTES OF MEETING**

**February 18, 2016**

**Time and Location:** The Investment Subcommittee (the “Subcommittee”) of the North Carolina Supplemental Retirement Board of Trustees (the “Board”) met at 8:30 a.m. on Thursday, February 18, 2016, in the Dogwood Conference Room of the Longleaf Building, 3200 Atlantic Avenue, Raleigh, North Carolina.

**Members Present:** The following members were present in person: Karin Cochran. Robert Orr attended via phone.

**Staff and Guests present:** The following staff and guests attended the meeting. From the Department of State Treasurer: Steve Toole, Mary Laurie Cece, Mary Buonfiglio, Lisa Page, Kevin SigRist, Rhonda Smith, Sondra Vitols, Casey High, Rekha Krishnan, Catherine Jarboe, Maja Moseley. From Mercer: Kelly Henson and Liana Magner. From Prudential: Michael McCann, Aaron Koval, Kathleen Neville and Jessica Quimby. From Galliard: William Weber.

**AGENDA ITEM – WELCOME AND INTRODUCTIONS**

The Meeting convened at 8:33 a.m. Ms. Cochran chaired the meeting in Ms. Baran’s absence. She welcomed the staff and guests.

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

Ms. Cochran 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 – MINUTES FROM NOVEMBER 12, 2015 INVESTMENT SUBCOMMITTEE MEETING**

The Chair stated that the minutes have already been approved and are included for reference only; no action is needed.

## **AGENDA ITEM – STABLE VALUE PORTFOLIO REVIEW**

Ms. Cochran recognized Mr. Weber. Mr. Weber noted that the merger of the Stable Value Funds for the NC 401(k) and NC 457(b) Plans into one Stable Value Fund was completed and thanked all parties involved in the transition project.

As for the Stable Value Fund, there were no notable changes in the quarter in the market or the firm. Galliard continues to negotiate lower contract fees and most recently, Nationwide's fee was lowered to 21 basis points (from 23 basis points). The net of fees performance of the Fund remains at a competitive rate of 48 basis points as of the quarter end, and performance was strong over the book value and benchmark. There were no changes in contract issuers or quality. Contracts reset during the quarter, which had an impact of 6 basis points at the Fund level. The Stable Value Fund's underlying duration was just shy of three years, and the yield curve shifted higher. Overall, the Fund is performing as designed to deliver competitive results over time with limited volatility. Mr. Weber reflected that if interest rates continue to rise, the market value may drop below par. There were no material changes to the portfolio's structure, but corporate fixed income assets increased by 3 percent. The portfolio continued to experience positive cash flow. The performance summary for each manager shows negative returns in fixed income due to higher interest rates, however the managers outperformed their respective benchmarks.

Mr. Weber added that there was also a change to Prudential's mandate, modifying the fixed income component from enhanced index strategy. Mr. Weber provided the Subcommittee members with additional meeting materials concerning Prudential's enhanced index strategy. On February 1, 2016, assets were transferred in-kind into a separate account custodied by Wells Fargo. The Plans did not incur any administrative costs due to this transition. Mr. Weber emphasized that this strategy adds value to the plan at an additional cost of 6 basis points and an expected pick up in yield of 40 basis points.

Ms. Buonfiglio informed the Subcommittee members that Galliard has been named in a lawsuit and that more details will be forthcoming. It is known that the lawsuit has no direct impact to the Plans. Staff will be monitoring the issue.

## **AGENDA ITEM – ECONOMIC OVERVIEW AND 4<sup>th</sup> QUARTER INVESTMENT PERFORMANCE REPORT**

Ms. Cochran recognized Ms. Magner. Ms. Magner emphasized the continuing theme of volatility for the quarter. The results shown in the report reflect the rebound in both U.S. and foreign equity markets, and the economy was stronger in the quarter: 2.5 percent GDP growth, unemployment decline to 5 percent, average of 284,000 jobs added, and an increase in retail sales and loan demand increased. Equities posted gains, and large cap growth fared better than large cap value and US stocks outperformed foreign stocks. Materials, technology and health sectors were stronger performers, while consumer discretionary, energy and utilities were the weak performers. Loomis Large Cap Growth and Sands Capital Large Cap Growth both

benefited from their concentration in technology, and Brown Advisory SMID Growth rebounded due to concentration in technology and biotechnology as well as lack of energy equities. Large Cap Value strategies lagged the benchmarks and growth funds, and Hotchkis and Wiley struggled due to deeper value bias and large focus on energy.

With respect to non-U.S. equities, Ms. Magner noted the MSCI EAFE index rose approximately 5 percent and international small cap equities rose by 7 percent. The U.S. dollar appreciated in this environment, while commodities prices, oil in particular, fell and this impacted the PIMCO IRMAF mandate. Additional volatility in the market came from diverging global monetary policies. The Federal Reserve increased interest rates by 25 basis points in October, and rates have now stabilized. U.S. bonds were mostly negative due to the rate increase; the yield curve flattened; corporate debts outperformed Treasuries; and high-yield bonds exhibited volatility, especially in the energy sector. Ms. Magner noted that the Prudential Core Plus portfolio has exposure to the energy sector, as well as emerging market debt. Overall, market returns were muted for the quarter.

Ms. Magner stated that Mercer believes in staying the course and using the volatile conditions to the Plans' advantage, rebalancing to equities over fixed income.

Ms. Cochran asked about the frequency of GoalMaker rebalancing. Ms. Buonfiglio replied that it is performed quarterly, and there is also an "age adjustment" feature available. Ms. Neville added that Prudential's Call Service Center received few phone calls regarding the volatility in the market and Prudential's staff is educating members about the benefits of staying the course and using GoalMaker. Mr. Orr inquired whether an action plan regarding increased periods of volatility and appropriate guidance should be communicated to the members and Mr. Toole replied that it can be included in the overall communication plan.

Ms. Magner noted that there were no changes to portfolio managers and informed the members of organizational changes within Sands Capital Management and Delaware Investments. Thomas Ricketts, Sands' executive managing director will leave the firm this June and his company ownership will be repurchased by Sands within the next 2-3 years. This departure does not change Mercer's rating for the manager and appropriate personnel coverage for the strategy is already in place. Mercer is monitoring the situation and will conduct an on-site visit.

Delaware Investments Senior Portfolio Manager Anthony Lombardi has left the firm and this was a surprising departure. Mercer received little information with regards to the reason for the departure. It was confirmed, however, that no trade violations were linked to this event. Mr. Lombardi's 30 percent oversight of the portfolio translates to approximately \$293 million dollars and Mercer is confident the firm provided ample coverage of Mr. Lombardi's duties and will be monitoring the situation closely. Ms. Cece reminded the attendees that the manager is under contractual obligation to notify the Plans of personnel changes, and both Ms. Buonfiglio and Ms.

Smith confirmed such notice was received. Investment Subcommittee can convene a special meeting at any time regarding this matter, should any unfavorable news materialize.

Both Ms. Henson and Ms. Magner reminded members that no changes to the investment structure of Plans have been made in quite some time and that this subject was discussed in 2014 and it was agreed it would be revisited at a later time. Mercer believes it would be prudent to revisit the investment structure later this year and specifically, evaluate the decisions of members not enrolled in GoalMaker and strategic data, provided by Prudential.

With respect to the fee chart, Ms. Henson noted that this chart reflects the 4<sup>th</sup> Quarter of 2015 and the fee structure and will change considerably when reviewed in May when the new, unbundled fee structure is presented. The Recordkeeping Fee column will be removed and the "Other Investment Expenses" column will reflect the cost of custody. She also highlighted several funds on the performance scorecard, noting great overall performance of the NC Large Cap Value Fund and the NC SMID Cap Value Fund. Both the NC International Equity Fund and the NC Inflation Responsive Fund followed a trend of outperforming their respective benchmark but underperforming their peer groups. Fixed income funds were solid performers and two managers are still on watch: Brown Small Cap Growth and PIMCO Inflation-Responsive Multi-Asset. Ms. Cochran asked about Mercer's view of PIMCO's current environment and Ms. Henson replied that assets are growing slowly in the fund and Ms. Magner added that the drop in assets is stabilizing now but the organization remains in the news due to Bill Gross' lawsuit. Ms. Henson noted that PIMCO continues to hire respected business people.

Brown has come back strongly from underperformance and the plan laid out by the portfolio manager worked exactly as designed. Mercer believes this to be a good sign and trend, and the firm continues to grow assist and add strategies. In November, 2016 the manager will have been on watch for the whole year and can be re-evaluated. Ms. Smith agreed that Brown's rapid pace of growth and expansion to the high net worth area should be watched carefully.

#### **AGENDA – INVESTMENT COMPLIANCE REPORT REVIEW**

Ms. Henson continued on to the compliance report, noting that this is also the last time the report is presented in the pre-unbundling format. The main focus was the repapering of all Investment Management Agreements and tying them back to the Investment Policy Statement, ensuring that the managers have the necessary level of flexibility in portfolio managing. Ms. Henson noted that the Plans' staff is receiving more frequent compliance updates from the custodial platform and those will replace the compliance report, traditionally prepared by Mercer. Ms. Buonfiglio noted that Ms. Smith and Mr. High have also been very helpful in the process and that the staff will prepare the report for the next Subcommittee meeting.

#### **AGENDA ITEM – UNBUNDLING - FUND TRANSITION UPDATE**

Ms. Henson noted the transition was completed smoothly and will yield overall improvement going forward. However, the NC SMID Cap Equity Index Fund remains in the securities lending vehicle with BlackRock who now offers a non-lending vehicle. The Plans' staff will be overseeing the transition from a lending to non-lending vehicle, which will be an "in-kind" transition and with virtually no cost to the Plans' other than the cost to change securities name. There will be no impact to members during this transition. Ms. Buonfiglio noted that the staff will begin work on the transition timeline.

#### **AGENDA – NC 403(b) PROGRAM 4<sup>TH</sup> QUARTER INVESTMENT PERFORMANCE REVIEW**

Ms. Cochran recognized Ms. Smith who noted that this is a new stage of oversight and reporting for the Program, and that the contents of the report may continue to evolve. She also added that currently the report may seem somewhat limited, however access to the mutual fund universe database, which occurred mid-January 2016 has been helpful. This type of access enables additional analytics for both the defined benefit and the defined contribution plans, and will enhance the performance and asset allocation reporting.

Ms. Buonfiglio noted that the Program performance reporting has just transitioned from Mercer to the IMD team and thanked Ms. Smith and Mr. High for their work on the project. She also highlighted the ongoing Custom Portfolios project, noting the "go live" date of May 9 and the funds mapping date of May 11. The Plans' staff is working closely with TIAA staff on participant communication, including the executive summary letters and transition guide, to be received by all participants at least 30 days prior to the mapping. The participants can find out more transition detail in the guide, as well as by calling the service center.

Ms. Smith remarked that the current report reflects the existing investment structure and much of it will change after the fund mapping is complete. Ms. Cochran inquired about the purchase of Morningstar's database and Ms. Smith replied it was acquired by the defined benefit plan and is being used for access to the mutual fund universe, as well as for optimization. Mr. SigRist added that the pension is already utilizing services redundant to Morningstar and it is expected that both systems will be used for a period of one year.

Ms. Smith continued on to the summary of asset allocation, noting that only marginal increases occurred since the prior quarter and the majority of Program assets resides in the Tier I target-date funds. She also stated that IMD staff will begin reaching out to and interacting directly with the investment managers, to better understand their processes and philosophy. On-site visits are planned, as well, and the overall goal is to set up reports and performance monitoring process, similar to that used currently by the pension group. There is also a need for establishing more consistent benchmark utilization. Ms. Smith highlighted individual performance of several funds, indicating that three are currently on watch from the prior quarter: PIMCO IRMAF, Vanguard Windsor and AllianzGI NFI International Value. Several funds, including the Allianz GI NFI

International Value, TIAA Real Estate Account and PIMCO All-Asset will be mapped and removed. With respect to expense analysis, Ms. Smith noted that the last three columns of the summary: Fund Net Investment Management Expense Ratio, Median Net Expense Ratio and the Net Expense Difference look somewhat different to the prior quarter report due to the index strategies which reflect larger expense differences. IMD staff is working on identifying better universe comparison. Ms. Cochran asked about IMD staff being as proactive as Mercer was in negotiating lower fees and Ms. Smith replied that a more aggressive approach will require getting to know the managers better first. Ms. Wagner added that because this is the mutual fund universe, the only means for obtaining a lower cost is to invest in a different share class. Ms. Henson noted that typically, a specific monetary threshold must be met in order to obtain the lower cost shares. Ms. Cochran asked about possible benefit due to mutual relationship with pension and Ms. Wagner confirmed that if the Program, for example, utilized the Vanguard index funds then those could be leveraged.

In closing, Ms. Smith and Mr. SigRist introduced Mr. High who has recently joined the pension's public equity team. Mr. High was previously employed with CAPTRUST Investment Advisors and provided consulting services to corporate pension plans. He has also worked for the NC DST IMD previously, in the fixed income area. His primary role will be working closely with Ms. Smith on in-house passive management of investments in index strategies.

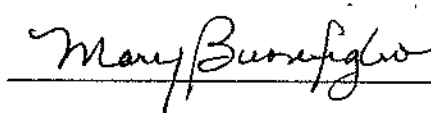
#### **AGENDA ITEM - SUBCOMMITTEE MEMBERS QUESTIONS/COMMENTS**

No further comments were offered.

#### **AGENDA ITEM - PUBLIC COMMENT**

No public comments were offered.

Mr. Orr moved to adjourn the meeting and Ms. Cochran seconded. The meeting adjourned at 10:01 a.m.



Secretary