

DRAFT

NORTH CAROLINA SUPPLEMENTAL RETIREMENT BOARD OF TRUSTEES

MINUTES OF MEETING

June 22, 2016

Time and Location: The North Carolina Supplemental Retirement Board of Trustees (the Board) met at 9:00 a.m. on Thursday, June 22, 2016, in the Dogwood Conference Room, 3200 Atlantic Avenue, Raleigh, North Carolina.

Members Present: The following members were present: Treasurer Dale R. Folwell, CPA (Chair), Melinda Baran, Ron Copley, and Heyward McKinney. Gene Hamilton attended via telephone.

Staff Present: The following Department of State Treasurer (DST) staff were present: Steve Toole, Mary Buonfiglio, Kevin SigRist, Loren de Mey, Reid Chisholm, Maja Moseley, Catherine Jarboe, Rekha Krishnan, Patti Hall, Laura Rowe, and Fran Lawrence.

Guests Present: The following guests attended the meeting: Michael McCann and Jessica Quimby (via phone) from Prudential Retirement; Kelly Henson and Liana Magner from Mercer Investment Consulting.

AGENDA ITEM – WELCOME AND INTRODUCTIONS

The meeting was called to order at 9:00 a.m.

Dale R. Folwell, CPA, Chair, welcomed Board members, staff and guests. The Chair asked members of the public to sign in and hold the public comments until the appointed time at the end of the meeting. The Chair also noted that one position on the Board remains open and provided a brief update regarding the Board terms nearing expiration or expired.

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

The Chair asked Board 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 Chair asked if there were any comments or changes to the minutes of the March 23, 2017, Board meeting. There were no changes and Ms. Baran made a motion to approve the minutes. Mr. Hamilton seconded and the motion passed unanimously.

AGENDA ITEM – APPOINTMENT

Mr. Toole proposed the nomination of the Treasurer to be the Chair of Investment Subcommittee. He noted that the current Chair, Ms. Baran, will remain a Subcommittee member. The Treasurer will begin chairing the Subcommittee meeting beginning in August 2017.

Mr. McKinney made a motion to accept the nomination and Ms. Baran seconded. The motion passed unanimously.

Board members and staff presented Ms. Baran with a certificate in recognition of her years of service as Chair of the Investment Subcommittee.

AGENDA ITEM – RESOLUTION

The Board considered a resolution regarding Robert Orr's service on the Investment Subcommittee. Mr. Orr served as an Investment Subcommittee member from October 30, 2014, until February 15, 2017. Board members and staff expressed appreciation of Mr. Orr's service and the resolution passed by acclamation.

AGENDA ITEM – NOMINATION

Ms. Baran made a motion to nominate Mr. Copley to serve as a member of the Audit Subcommittee and Mr. McKinney seconded. The motion passed unanimously.

AGENDA ITEM – LEGAL UPDATES

The Chair recognized Mr. Chisholm who directed the members' attention to the memorandum included in the meeting materials and briefly described the proposed Policy and Procedures for Investment Transactions and Investment Manager Selections, noting that SRP policy was modeled on the Department's Investment Management Division (IMD) policy.

Mr. McKinney made a motion to adopt the policy and Mr. Hamilton seconded. The motion passed unanimously.

AGENDA ITEM – LEGISLATIVE AND REGULATORY UPDATE

The Chair recognized Mr. Toole. Mr. Toole discussed recent developments in the regulatory field, which are being monitored by the Department, as well as minor technical corrections to House Bill 176 and 115 regarding Supplemental Retirement Plans (SRP) and the NC ABLE Program. He noted the potential impact to the pension system if the Department chose to exclude charter schools from the current definition of "employer." Auto-enrollment continues to stay on the Department's agenda and the matter is revisited by the policy team annually. In light of Department of Labor's fiduciary rule, Mr. Toole emphasized the importance of proper advice to members who are considering a distribution from their accounts. Ms. Buonfiglio added that members who left the plans were surveyed and their satisfaction level regarding the plans was

high. Board members recommended that the theme of fiduciary oversight and, in particular, the Board's role in providing strong oversight of fees and investments continue to be highlighted in the quarterly participant newsletter, the *Signature Newsletter*.

AGENDA ITEM – 2016 RETIREMENT READINESS UPDATE

Mr. Toole directed the members' attention to the Annual Benefit Statement report included in the meeting materials and noted that the retirement goal of 66% of members on track to replace 80% of income by the age of 62 was not achieved; the actual retirement readiness score, overall, was 58.04%. Salary increases and market fluctuation had the most significant impact on this retirement readiness score.

A discussion regarding the Plans' participation, contribution levels and asset allocation followed. Mr. Toole noted some of the tools assisting the members in achieving their individual retirement readiness goals, such as GoalMaker and Retirement Income Calculator. Ms. Baran asked whether the replacement of 80% of income should be higher. Mr. Toole responded that he believes the industry is headed toward using a percentage set by each participant. Mr. Toole and Ms. Buonfiglio noted that the Retirement Income Calculator, available on the Plans' website, allows participants to set their own percentages.

AGENDA ITEM – 2017-19 BUDGET PROPOSAL

The Chair recognized Ms. Buonfiglio who first thanked Ms. Krishnan and the Financial Operations Division (FOD) for their assistance in budget preparation. She then directed the members' attention to the budget summary included in the meeting materials, highlighting the cash-on-hand status, projected revenue, and projected expenses. Ms. Buonfiglio noted the proposed budget increase is needed due to recent adjustments in personnel cost allocations. The Plans have an opportunity every two years to adjust these allocations to more accurately reflect the percentage of salaried time spent on the Plans, which, given the exclusive benefit rule, is an extremely important step in the budget review process. In addition, the 2016 unbundling process, which resulted in significant improvements in transparency for the Department and participants, also added a significant number of complex responsibilities to SRP and FOD staff. The proposed budget also includes a new, dedicated full-time FOD accountant position to support SRP in managing these new responsibilities. She added that a minimum of one year's worth of expenses is kept in the administrative account in order to provide the plans with financial cushion.

The Chair entertained a motion to approve the budget. Ms. Baran so moved and Mr. McKinney seconded. The motion passed unanimously.

AGENDA ITEM – COMPLIANCE UPDATE

Ms. Buonfiglio introduced the *Compliance at a Glance* document included in the meeting materials. She noted that the document provides the members a more detailed view into the work SRP staff is doing behind the scenes. She highlighted contract management, performance standards and the creation of SRP's procedures manual.

AGENDA ITEM – APPROVAL OF MINUTES

The Investment Subcommittee Chair moved to approve the minutes of the May 17, 2017 meeting with no changes. Mr. Hamilton seconded and the motion passed unanimously.

Mr. Copley addressed the Subcommittee members, noting the importance of the nature of Subcommittee's work. He cited a report recently published by the *Wall Street Journal* that compares active and passive investment options' performance; the report's findings show that 88% of active managers underperform their benchmark. Mr. Copley stated that he would like the Subcommittee to consider a more significant shift toward passive investment options for Plan assets.

AGENDA ITEM – PLAN DESIGN RECOMMENDATION

The Chair recognized Mr. SigRist and Ms. de Mey. Ms. de Mey summarized the staff's recommendation regarding the elimination of the Plans' four actively managed growth and value funds in the U.S. Large Cap and U.S. S/Mid Cap sub-asset categories and their replacement with a core fund for U.S. Large Cap and a core fund for U.S. S/Mid Cap. The new core funds would include growth and value components, as well as passive allocations – 25% for U.S. Large Cap and 5% for U.S. S/Mid Cap. Also, two of the current U.S. Large Cap managers would be terminated. Ms. de Mey discussed the implications of the plan design changes for GoalMaker. She also noted the estimated investment management fee reductions in both portfolios.

Next, Ms. de Mey turned the floor over to Ms. Magner and Ms. Henson. Ms. Magner described Mercer's methodology regarding the research and various GoalMaker allocations, and emphasized the variety of scenarios tested. She added that the analysis was conducted in collaboration with the IMD staff. Ms. Magner also highlighted several sections of Mercer's presentation.

Mr. SigRist emphasized the contingent nature of the recommendation, as noted on page two of IMD's recommendation memo, and emphasized the importance of staying committed to the product and the need for patience during potential underperformance periods. He noted the difficulty of finding managers who consistently outperform their benchmarks in the large cap space and underscored the Plans' mission to provide a variety of diverse investment choices to participants and potential participants in the Plans.

Ms. Magner added that while different philosophies on retirement plan investment structure exist, statistics show that participants tend to gravitate to the most popular option: large cap.

Both IMD and Mercer agreed that there is still a compelling opportunity for active management within the S/Mid cap space. Ms. Magner added that the vast majority of plans have an active option and that fiduciary responsibility involves offering portfolio building blocks for participants.

Further, Board members and staff discussed the industry terms of “passive” and “active” with respect to the Plan participants’ perception thereof. Ms. de Mey commented that participants do not necessarily understand passive versus active management, including the difference and impact of fees. The Board members and staff also compared the pension fund equity management to the defined contribution management, as the NC pension fund is headed towards almost entirely passive management in U.S. Large Cap. Ms. Baran remarked that the passive options outperform the active ones, by the virtue of fees, but that she endorses the use of active options for long-term investing.

Mr. Hamilton commented that providing participants choice in investment options is important. He asked whether the defined benefit plans have active or passive management. Mr. SigRist responded that the defined benefit plans are headed toward entirely passive investment for U.S. Large Cap but largely use active management for U.S. SMid Cap.

Ms. Jarboe noted the Plans’ commitment in helping members be proactive and providing education surrounding the importance of proper asset allocation. Mr. Toole added that he views the Plans from a perspective that members, to some extent, lean on the Board’s decisions to help them make their choices. He noted that his focus is on a long-term approach, with a decision by the Board that is capable of withstanding a potential criticism. However, Mr. Chisholm noted that a number of lawsuits involving defined contribution plans are related to fees and retail funds, while some concern self-dealing and offering too many (versus too few) investment choices. Mr. Chisholm emphasized that fiduciary responsibility is a process, such as the robust discussion in which the Board engaged.

The Chair entertained a motion to consolidate the NC Large Cap Value Fund and the NC Large Cap Growth Fund into the NC Large Cap Core Fund. Ms. Baran so moved and Mr. Hamilton seconded. Mr. Copley voted against the motion, and the remaining members voted for the motion. The motion carried by majority vote.

The Chair entertained a motion to terminate Boston Partners in the NC Large Cap Value Fund and Wellington in the NC Large Cap Growth Fund concurrent with the Large Cap fund closures. Ms. Baran so moved and Mr. McKinney seconded. Mr. Copley voted against the motion, and the remaining members voted for the motion. The motion carried by majority vote.

The Chair entertained a motion to consolidate the NC Small/Mid Cap Value Fund and the NC Small/Mid Cap Growth Fund into the NC Small/Mid Cap Core Fund. Ms. Baran so moved and Mr. McKinney seconded. Mr. Copley voted against the motion, and the remaining members voted for the motion. The motion carried by majority vote.

Lastly, the Chair entertained a motion to approve the GoalMaker allocation changes in IMD's recommendation memo. Mr. Hamilton so moved and Mr. McKinney seconded. The motion passed.

A break took place from 11:15 a.m. until 11:25 a.m.

AGENDA ITEM – NC 401(k)/457(b) PLANS 2nd QUARTER INVESTMENT PERFORMANCE REPORT

The Chair recognized Ms. Henson who presented the investment performance summary for the second quarter. She noted very strong three-month results for all except one fund and noted that overall, small cap outperformed large cap and value performed better than growth. She then directed the members' attention to the performance scorecard where a "red flag" symbol was added to denote funds on watch. Three funds were added to the watchlist due to a difficult fourth quarter of 2016 for active managers.

Ms. Henson and the Board members also discussed the Plans' fees; Mercer confirmed the fees are already extremely competitive, and, recently, the Department renegotiated fees for 10 active managers. Ms. de Mey noted that the renegotiated fees have led to approximately \$2 million dollars in savings. Mr. SigRist added that the passive funds manager, BlackRock, also lowered its fees two years ago. Mr. Copley contrasted the fees charged for active versus passive management.

AGENDA ITEM – NC 403(b) PROGRAM INVESTMENT POLICY STATEMENT AMENDMENT

Ms. de Mey directed the members' attention to the legal memorandum included in the meeting materials that summarizes the significant revisions to the NC 403(b) Program's Investment Policy Statement (IPS), including roles and responsibilities, investment options and objectives, manager termination process, and GoalMaker model allocations. She added that the revisions make the NC 403(b) Program IPS consistent with the NC 401(k) and NC 457 Plans' IPS and reduce complexity.

Mr. Copley made a motion to approve the NC 403(b) Program's IPS as amended and Mr. Hamilton seconded. The motion passed unanimously.

AGENDA ITEM – NC 403(b) PROGRAM 2ND QUARTER INVESTMENT PERFORMANCE REPORT

Ms. de Mey summarized the Program's asset allocation and investment performance; all active funds, except DFA U.S. Small Cap, showed strong performance for the quarter. She also noted the upcoming change to the report – the performance of funds that were eliminated from the Program with the record keeper transition on February 22, 2017, is being featured in the report for the final time.

AGENDA ITEM – NC 401(k)/457(b) PLANS AND NC 403(b) PROGRAM 2ND QUARTER 2017 ADMINISTRATIVE REPORT

The Chair recognized Mr. McCann who noted an organizational change within Prudential Retirement: Phil Waldeck succeeded Christine Marks as CEO on June 5. No disruptions in the firm's operations are expected due to the transition.

Next, Mr. McCann highlighted several sections of the administrative report: the vendor's compliance disclosure, the summary of each plan and their respective subgoals and the snapshot of asset allocation. A brief discussion regarding asset allocation, specifically the percentage allocated to Stable Value Fund (SVF), followed. Mr. Copley commented that too much money is in the SVF, and he asked why. Mr. McCann responded that Plans' percentage of assets in stable value is actually lower than the governmental plan average of approximately 35%-40%. Mr. McCann also noted that GoalMaker usage has helped to decrease the amount of assets in the SVF. Ms. Buonfiglio also noted that GoalMaker addresses this concern and that GoalMaker is the default investment for the Plans. She added that the Plans have consistently emphasized the importance of the proper allocation of assets, inclusive of the assistance provided by GoalMaker. Ms. Quimby commented that the Department communicates with participants regarding longevity, market, and inflation risk. Ms. Jarboe added that the newsletter for the second quarter included an article on inflation.

The Chair inquired about the strategy to address the asset outflows from the Plans. Mr. McCann noted that many distributions coincide with a member having a long-standing relationship with another financial services provider, such as a bank or a credit union. He noted that a more robust strategy needs to be put in place and that Prudential will continue its work on narrowing the gap. Mr. Toole added that the Department is working toward providing the members with better income options in retirement by expanding the variety of plan services. Ms. Baran suggested calling members who are near retirement. Ms. Buonfiglio and Ms. Jarboe remarked that the Plans already possess viable data regarding this issue and an email outreach effort has been implemented to inform the retirees they do not have to leave the Plans. The member communication, begun this year, is generated upon the filing of retirement paperwork. Ms. Jarboe noted that the open rate for the email is 90%.

AGENDA ITEM – BOARD QUESTIONS/COMMENTS

Mr. Copley asked whether the possibility of managing the investment options in-house can be explored and Mr. SigRist affirmed, provided the Board has interest in the project. He also noted the existing fixed income management capabilities within the Department. The Treasurer also noted that the Department is exploring in-house asset management.

AGENDA ITEM – PUBLIC COMMENTS

No public comments were offered.

The meeting adjourned at 12:17 p.m. by acclamation.

Secretary