



INVESTMENT MANAGEMENT

To: North Carolina Supplemental Retirement Board of Trustees

From: Loren de Mey, Assistant Investment Director

Date: August 22, 2018

Subject: Discussion / Action: 401k, 457b, 403b Plans: Recommend Termination of the PIMCO Inflation Response Multi Asset Fund

Staff is recommending to terminate the PIMCO Inflation Response Multi-Asset Fund due to the following reasons:

1. Increase in the net expense ratio
2. Mutual fund structure may provide less control over and insight into investment costs and expenses
3. The Fund's underlying investment strategies, such as the financing strategy within the TIPS portfolio, may be too complex for a defined contribution plan

PIMCO Inflation Response Multi Asset Fund – Increase in Net Expense Ratio

While conducting the quarterly performance and expense review of the PIMCO Inflation Response Multi-Asset Fund (IRMAF), Staff determined that the Fund's net expense ratio, as reported in the Fund's most recent prospectus, issued on July 30, 2018, had increased.

PIMCO's process for reflecting changes in costs or expenses in the Fund's net expense ratio is based on actual fund expenses incurred in the Fund's reporting year prior to the release of the prospectus. In this case, the increase in the net expense ratio was based on the average of the actual fund expenses incurred from March 31, 2017, through March 31, 2018. The actual increase in expenses were then reflected in the Fund's updated prospectus released on July 30, 2018.

The following chart breaks down the net expense ratio of the Fund.

	Current Net Expense Ratio	New Net Expense Ratio	Increase
Investment Management Fee	0.69%	0.69%	0.0%
Interest Expense	0.14%	0.53%	0.39%
Other Fund Fees	0.23%	0.29%	0.06%
Fee Waiver	-0.23%	-0.29%	-0.06%
Total Net Expense Ratio	0.83%	1.22%	0.39%



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Increase in Interest Expense

The net expense ratio is increasing from 0.83% to 1.22% due to an increase in interest expense from 0.14% to 0.53%. The Fund had experienced an increase in interest expense during the March 31, 2017, through March 31, 2018, reporting period given the increase in interest rates over the year.

PIMCO utilizes a strategy within its TIPS (Treasury Inflation Protected Securities) portfolio where they own a portion of their TIPS exposure through forward instruments. PIMCO finances these forward purchases paying a rate slightly less than LIBOR. When PIMCO finances this TIPS exposure, this creates interest expense from an accounting standard. This then frees up the Fund's cash whereby PIMCO seeks to add incremental return by investing in enhanced cash instruments that pay a yield advantage over their borrowing rate by approximately 40-50 basis points. Representatives from PIMCO have stated that while the interest expense is required to be reported within the net expense ratio, the additional yield or income advantage to investors, is not also required to be reported. However, this income will be included as part of the Fund's net return.

Interest Rates Likely to Continue to Increase

The interest expense increase is based on actual expenses incurred ending March 31, 2018. The Fed has increased rates an additional 25 basis points since the end of March and market expectations are for two additional increases by the end of this year. Therefore, interest expense will likely continue to increase within the Fund throughout 2018 given the Fed has and will likely continue to raise rates.

Mutual Fund Structure

Mutual fund structures in general provide fewer opportunities to negotiate the monitoring and management of expenses and costs relative to separately managed accounts and collective investment trusts. Although we are limited to mutual funds in the 403b Program, in the 401k and 457 Plans where the assets are much greater, Staff believes it is preferable, if possible, to increase our opportunities to monitor and manage costs and expenses by investing through collective investment trusts or separate accounts.

Underlying Investment Strategies

The PIMCO Inflation Response Multi-Asset Fund (IRMAF) is a real return asset allocation strategy that was designed to hedge global inflation risks while targeting enhanced return opportunities that inflation dynamics may present. The Fund invests in TIPS, commodities, emerging market currencies, REITs, and gold. The Fund may also pursue tactical use of floating rate securities. The Fund utilizes options, swaps, futures, forwards, derivatives and may pursue both long and short investment strategies.

Although the strategies the PIMCO Fund pursues have shown to provide alpha overtime, many of its strategies may be too complex for a defined contribution plan. For example, explaining the Fund's financing strategy within the TIPS portfolio is an example of this type of complexity. If we cannot break down the net expense ratio for our participants in a simple explanation, the Fund may not be the best fit for participants in a defined contribution plan.

North Carolina Supplemental Retirement Plan's Investments

PIMCO's IRMAF Fund is held in the North Carolina Supplemental Retirement 401k and 457 Plans and the 403b Program. Below are the assets within each Plan as of 7/31/18:

401k/457: \$374.2 million (\$349.8 million of which is in GoalMaker)

403b: \$607,814 (\$459,004 of which is in GoalMaker)



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Total assets within PIMCO IRMAF: \$1.13 billion (total assets within the mutual fund)

North Carolina Supplemental Retirement Plan's assets represent approximately 33.2% of the total PIMCO IRMAF assets.

Net Fund Returns, ending June 30 2018

	Quarter	YTD	One-Year	Three-Year	Since Inception *
PIMCO	-0.06%	-0.18%	5.90%	3.56%	2.3%
Benchmark	-0.02%	-0.72%	3.04%	1.30%	0.1%

Benchmark: 45% Bloomberg Barclays US TIPS, 20% Bloomberg Commodity Index, 15% JPMorgan Emerging Markets Index Plus (Unhedged), 10% Dow Jones US Select REIT Total Return Index, 10% Bloomberg Gold Subindex

**initial inception date of PIMCO account within NC SRP: October 2013 – initially the PIMCO account was funded as a separate account, and then moved to the mutual fund in December 2015.*

Recommendation

Given the reasons stated above, Staff recommends termination of the PIMCO Inflation Response Multi-Asset Fund within the 401k & 457 Plans and 403b Program. Staff will recommend replacement Fund options at the Supplemental Retirement Board of Trustees meeting on September 20, 2018.