STATE OF HAWAII
DEFERRED COMPENSATION PLAN
BOARD OF TRUSTEES

OPEN SESSION MINUTES
MEETING # 347

Date: February 15, 2011

Place: Department of Human Resources Development
14th Floor Director's Conference Room
235 South Beretania Street
Honolulu, HI 96813

Present: Wayne Chu, Chairperson
Scott Kami, Employee Member
Michael Okumoto, Employee Member
Sunshine Topping, Ex-Officio Member
Sandra Yahiro, Employee Member

Others: Rodney J. Tam, Deputy Attorney General
Cynthia Akiyoshi, DHRD Staff
John Bothwell, Brian Yadao, and Troy Saharic, Mercer Investment Consulting – Via Conference Call
Brian Merrick, Carol Cann, Marilyn Mitchell, and Bernie Wong, Plan Administrator Staff (ING)/Boston Office - Via conference call
Melody Takacs, Grace Baracao, and Jeanne Kanai, Plan Administrator Staff (ING)/Honolulu Office
Todd Egger and Molly Ono, INVESCO - Via conference call
Ed McGettigan, Gerry Mullane, and Tom Atchison of Vanguard

Absent: Wesley Machida, Employee Member
Kalbert Young, Ex-Officio Member

Call to Order: There being a quorum present, Chairperson Wayne Chu called the meeting to order at 9:07 a.m.

Agenda: The agenda for this meeting was filed with the Office of the Lieutenant Governor, as required by Hawaii Revised Statutes section 92-7.

Agenda Item # 1: Welcome New Trustees

Chairperson Chu welcomed new Trustee Sunshine Topping and presented a lei. New Trustee Kalbert Young and Trustee Machida were excused. Introductions of the Board members and other attendees were made.

Agenda
Item # 2: Approval of Minutes No. 344

A motion was made by Trustee Yahiro and seconded by Trustee Kami to approve Meeting Minutes No. 344. The motion passed unanimously.

Agenda
Item # 3: Status Report on Complaint: Heckman v. Jorgensen-Weber, et al., Civil No. 10-1-0071

DAG Tam distributed the order received yesterday regarding the Plan's first lawsuit against the Plan. The lawsuit involved a participant who made his wife the primary beneficiary and his parents as the contingent beneficiaries at the time the participant signed-up with the Plan. Since then, the participant divorced his wife and did not change the beneficiary designations before he died. When the participant's ex-spouse came forth to claim the monies, the participant's estate claimed that the ex-spouse was not entitled to the money because by operation of law, divorce terminates the designation of an ex- spouse. ING, the Plan administrator, decided to pay the monies to the ex-spouse based on the beneficiary designation form on file. As a result, the estate of the deceased participant sued the State. A court hearing was held on the Big Island. Judge Hara ruled in the State's favor, citing that there were no statutes or case law that overturns the beneficiary designation for a deferred compensation plan. The plaintiff ex-spouse subsequently agreed not to appeal the decision.

DAG Tam thanked ING and Ms. Akiyoshi for their help in researching and reviewing this matter.

Chairperson Chu recognized and noted the importance of updating the beneficiary designation form and should be emphasized and featured in the Plan newsletter. DAG Tam also recommended amending the Pan Document to make it clear that the Plan will only pay according to the beneficiary designation form on file.

Agenda
Item # 4: Plan Administrator's Report

a. Discussion on American Funds' Revenue Sharing

Mr. Merrick of ING referred to a presentation handout and provided some background information on the discovery of a revenue sharing issue in 2010, when Mercer was exploring the feasibility of moving to a lower share class within the American Funds EuroPacific Growth Fund, and discovered that American Funds had not been submitting the 12b-1 fees back to the Plan.

The Board selected American Funds' EuroPacific Growth Class A Fund (AEPGX) in 1996 as an investment option. This Fund provides 12b-1 service fees of 25 basis points of the Plan's assets in the Fund and revenue sharing of $3 per participant, back to the Plan. In 2003, when ING (then CitiStreet) became the Plan's new TPA, ING continued to receive the $3 per participant revenue sharing amount which was allocated back to participant accounts, but never received the 12b-1 fees of 25 basis points. In October 2010, American Funds agreed to pay back about $1.385 million (for period 2003 to 2010) back to the Plan. American Funds provided ING with a quarterly breakdown of accrued revenues for both EuroPacific and life cycle funds. ING determined which participants possessed balances in each fund for each month since 2003 and further calculated the proportion of accrued revenue sharing due to each participant. The allocated revenue sharing was broken into allocation categories and then ING identified the participants for each category in the "Stand Alone" EuroPacific Growth Fund and Lifestyle Portfolios. Page 7 of the handout provided a comprehensive overview of the 14,440 participants that are due a total of $1,180.554.00. Trustee Kami asked about the difference between the initial allocation amount of $1.385 million and the $1.18 million reported on page 7. Mr. Merrick indicated that the $1.385 includes the total value of the revenue sharing up to October 2010 and participants don't get paid that until after one year. The gap between the $1.385 million and $1.18 million represents that one-year lag. The next step is to allocate the monies back to the participants.

Mr. Merrick recommended to the Board to:

1) Allocate monies back to into their accounts for participants with existing balances.
2) Hold calculated amounts in a single account for them to claim for participants whose accounts were closed.
3) Hold a massive educational campaign to communicate the return of 12b-1 fees through special communication and mailings.

Board members discussed the mechanism or strategy of distributing the monies to the participants, and whether it is possible to turn over unclaimed monies over to the State's Unclaimed Property program.

A motion was made by Trustee Kami and seconded by Trustee Topping to allocate revenue sharing funds back to participants by depositing the funds into a single account for participants who have closed their accounts to claim, utilize various recommended communication methods to notify participants, and to have staff work with ING to draft and issue appropriate communications and advertisements to current and former participants. The motion passed unanimously.

Mr. Merrick said that ING will proceed with the allocation and target it for this quarter ending March 2011.

b. Overview on Plan Activities

Before preceding with the next item, introduction of guests from Vanguard were made. They were Ed McGettigan, relationship manager, Gerry Mullane, senior manager of Vanguard Retirement Plan Business, and Tom Atchison, relationship and sales for the State of Hawaii.

Jeanne Kanai of ING began with the executive summary of activities in the 4th quarter of 2010.

- October 20, 2010 Benefits Fair on Kauai was held with over 230 attendees.
- Advice campaign: Many attendees brought their personal evaluation statements to the Fair to speak with ING advisors there. The advice campaign in the 4th quarter generated 728 new Professional Advice Management accounts that amounted to $36.7 million in assets.
- First Webinar was held on October 22, 2010 and generated over 125 listeners. Due to the overwhelming response, a recording of the webinar was posted on the Plan's website and a second webinar was held on November 24, 2010.
- American Funds EuroPacific Growth Fund changed from Class "A" to "R6" which reduced the fees from 85 basis points to 52 basis points.

Plan Administration updates included:

- Rollovers into the Plan for the 4th Quarter: 27 rollovers in ($1,097,191.05); 16 ERS rollovers in ($178,523.37); 32 PTS transfers ($66,375.25); 86 vacation rollovers ($1,259,273.76 excludes 12/31/10 retirees because they get paid in February 2011). Total rollovers in were $2.6 million.
- Unforeseen Emergency Withdrawals: 309 UEW applications with 283 approved and processed for 2010 (total paid out $3,920,217.56). 4th Quarter 2010 had 93 applications with 88 approved for $1,485,666.09.
- SDBA (TD Ameritrade) for the 4th quarter 2010 had 36 new setups for $833,802.57.

Ms. Melody Takacs provided a report for the local office:

- Local Office Educational Meetings: Held 179 educational group meetings held with an attendance of 1,078 participants. Conducted 1,545 one on one consultations with State and neighbor island county employees.
- Local Office Support: 192 walk-ins serviced and 1,197 calls received to the local office; enrolled 122 state and county employees into the Plan; conducted custom live webinars in conjunction with National Save for Retirement Week and the local office plans to hold more webinars; and implemented a successful Benefits Fair on Kauai.

Ms. Marilyn Mitchell, of the Advisor Service Team in Quincy, Massachusetts, provided the ING Advisor Service Highlights for the 4th Quarter 2010:

- Personal Evaluation campaign was launched in October 2010 of the 4th quarter, which increased usage of the Advisor Service by 4% (from 9.53% to 13.46%)
- 1,140 New Users (371 calls were made to investment advisor representatives on recommended actions, which is half of what is usually seen in one year; there were 67 first time online advice users; and 702 participants took advantage of the free trial offer for managed accounts).

  Trustee Yahiro inquired what percentage of participants that took advantage of the free trial offer for managed accounts stayed beyond the trial offer period. Ms. Mitchell will research and report back to the Board.

- Number of participants with a balance that have used the ING Advisor Service was 3,669 which equates to 13.46%; 673 total advisor calls; total PAM members were 1,607 for $85,182,862 in total member assets.

Trustee Kami inquired about UEWs and whether there were documented procedures for approving or denying UEW applications. DAG Tam explained that there were guidelines established at the Board's November 2009 meeting when the responsibility of reviewing UEW requests was delegated to ING, subject to specific guidelines adopted by the Board. UEW case 2125 was found to be a duplicate entry and will be deleted.

c. Status on American Funds EuroPacific Growth Fund A-Share Class Change

Ms. Carol Cann reported that the A-Share Class to R6 Class change transaction was completed on 12/21/10.

d. Status on Reallocations within the Lifecycle Funds for 2011

Lifecycle Funds reallocations based on Mercer's recommendation was completed on January 16, 2011.

<u>Agenda Item # 5</u>: <u>Mercer's Performance Overview on Funds on the Watch List</u>

a. Report on Century SMID Growth Fund and
b. Report on Bernstein International Value Fund

Mr. Saharic noted using the same prior report for these items and reported:

- 4th quarter was pretty good in terms of results;

- The fixed income market had a little bit of negative return, but finished the year strong being up by over 8.9%.
- The Lifecycle Funds were behind their benchmark by 1 or 2 basis points, but he was not concerned about that.
- Mercer was happy on the domestic equity side with the investment options, with the exception of the small cap managers. Century came up in terms of their performance and Bernstein did produce a decent return in terms of MSCI EAFE, but is behind in the 1, 3 and 5 years period.
- There is concern with performance in the international equity category and the small cap category. There was also an underperformance by the Harbor Small Cap Value Fund, sub advised by Ernest Partners, who has not delivered very strong results.
- Page 8 of Mercer's report shows a rolling period of return for Century SMID. Rebound in Century has not been significant enough to recommend to the Board to take them off probation. Mercer recommends to the Board to keep Century on probation.
- Page 9 shows Alliance Bernstein international value fund also struggles and has been hurt by the overweight in emerging markets. Mercer feels that Alliance Bernstein has capabilities where they can add value, but have not seen performance at where they should be. Yet, there were stunning results at year-end where they were up 4.1% versus the EAFE index that was up only 2.4%.
- Mercer recommended keeping both on probation and hope they recover in terms of overall results.

<u>Agenda</u>
<u>Item # 6</u>: <u>Discussion on INVESCO Stable Value Portfolio</u>

Mr. Egger provided a background and summarized the developments:

- Last fall, the Board agreed to increase Invesco's fee cap;
- However, currently, what has happened in the stable value industry is that the wrap providers have been increasing fees because of their concerns about increased risk.
- Wrap providers provided guidelines in reaction to the risks and Invesco is well within those guidelines.
- What Invesco is running up against is duration. Issuers are putting a much lower cap on the length of maturity on the funds that they are willing to wrap and that happened to Monumental recently.
- Currently, this portfolio's duration is 4.3 and we need to get that number down to less than 4 years in order to get Monumental as a wrap provider. Shortening the duration of their fees shortens the duration of their fund and most importantly, the impact will be a downward affect on the crediting rate which amounts to about 7 basis points to participants that will be worked into the crediting rate when it is reset.
- Sub-advisor fees will decrease by 1.2 basis points, as the Short term Bond Trust has no such associated fees. Invesco does anticipate the wrap fees of ING to

increase from 12 to 20 basis points, the reduction in sub-advisor fees will maintain expenses below the 35 basis point cap.

Mr. Troy Saharic pointed out on page 12 the discussion on the current allocation to the anticipated allocation for Invesco. This represents 50% of the total Hawaii Stable Value Fund.

Mr. Saharic provided a brief summary of what a wrap is and how the wraps work:

- This applies to investing in underlying fixed income strategies. On page 12, the pie chart on the left shows the Invesco intermediate fund, short-term bond fund, core and Short Term Investment Fund or STIF (which is like cash).
- A wrap is like an insurance policy, which amortizes gains and losses within the fixed income portfolio. That is what creates stable value funds because it smoothes out the gains and losses so the ups and downs of the market are not seen.
- The wraps also guarantee investments at book value. The book value represents the original principal plus any credited rate.
- The bottom of page 12 lists the three (3) wrap providers used: ING, Monumental, and Pacific Life. 50% of Hawaii's Stable Value Fund is with Invesco and the other half is with Jennison & Associates. Prudential, which owns Jennison, provides the single wrap contract for that portion of the portfolio.
- Before Mercer was involved, 100% of the portfolio was managed by Jennison. Mercer felt that a single wrap provider was a risky position for participants and recommended to the Board that the portfolio be diversified.

Agenda Item # 7: Follow-up Information on the Lifecycle Portfolio Allocations

Mr. Saharic provided an illustration of the current manager targets for 2011, and stated that participants invest in these glide path allocations and it is sort of like a free fall option where the rebalancing is done for you and the fund is diversified across asset categories. He further explained how the Plan is diversified across categories and the allocations for each of the underlying managers. Trends seen with Lifecycle portfolios are additional asset classes, specifically inflation hedging options, and then also emerging market equity options being added to the Lifecycle funds to provide further diversification.

The emerging markets equity option invests in equity securities of companies, which have their headquarters in countries such as China, India, and other developing countries. Emerging markets are good in the near and long term because of the significant shift occurring within the capital market where from an economic standpoint, emerging markets have their shops put together.

The inflation hedging option is more complex. It is basically the amount of debt that the

US has racked up in underdeveloped countries, the demand seen around the world, and many expect to see inflation increase over time. The overall hedge against inflation is equity. During inflation, economies are doing well and the stock market is rallying. Equities are comprised of three (3) components: treasury inflation protected bond component which moves with inflation; equity which tends to be real estate, trusts, energy, and infrastructure funds; and commodities based such as gold, silver, precious metals, and agriculture, etc. A diversified inflation hedge option is preferred over the treasury inflation protected securities ("TIPS") option because supply and demand factors can impact the pricing of TIPS.

Mr. Saharic discussed the benefits of an inflation hedge portfolio. The main reason for adding an inflation hedging option is the diversification benefits that it brings to other asset classes. Mercer would like to discuss with the Board about the interest of adding an emerging market option and an inflation hedging fund to the customized Lifecycle portfolio with the understanding that it will take some time to go through the State's procurement process to obtain the new funds.

Mr. Saharic explained off the shelf Lifecycle funds versus creating one out of our own funds. The Board chose to go down the customize fund route because of significant economies of scale that could be achieved through the underlying investment options. There are more complexities with managing custom funds where the drawbacks include producing your own fund fact sheets, so the Board would need to make decisions on how to allocate the funds, and what are the underlying managers that you want to utilize. The bottom line is philosophically, where the Board wants to go. Target date funds are preferred in any defined contribution plan.

The customized glide path was designed around the State's demographics. Managers that have done well from an off the shelf basis, like T. Rowe Price, have very strong returns and is a highly rated off the shelf manager by Mercer. They have got a much greater equity allocation. Trustee Yahiro had the concern of going through so many RFPs.

Trustee Okumoto asked Mercer whether they foresee a correction of equities in the emerging markets in the next year. Overwhelmingly, the MSCI EME has been one of the dominant performers for ten plus years. Mercer recommends adding the two features: an emerging market search and inflation hedging option with three components built into one another.

A motion was made by Trustee Chu to accept Mercer's recommendation to authorize staff to start the procurement process to add an emerging markets and inflation hedging funds as new stand-alone investment options in the Plan, and include them in the Lifecycle Funds. The motion was second by Trustee Okumoto. The motion passed unanimously.

Agenda
Item # 8: PTS Plan

a. New Quarterly Rate on January 1, 2011

Ms. Akiyoshi reported that the PTS Plan administrator, Life Insurance Company of the Southwest, declared a quarterly rate on January 1, 2011 at 4.29%, a slight increase from 4.22% in the fourth quarter of 2010.

b. Approval of Report on Funds Not Deposited in the State/County Treasuries

A motion was made by Trustee Yahiro to accept the report on Funds Not Deposited in the State/County Treasuries and was second by Trustee Kami. The motion passed unanimously.

c. Life Insurance Company of the Southwest (LSW) Report on Available Funds for Reimbursement

Ms. Akiyoshi reported that LSW provided their annual letter and report to disclose what is available for reimbursement. By contract, LSW sets aside three basis points (i.e., 0.03%) of contributions received and at the ending of last year, the balance is $14, 053.73. That figure also included the cost of the financial audit last year.

Agenda
Item # 9: Other Business/Announcements

a. Vanguard Vision Symposium in Honolulu

Vanguard representatives are present today and they have invited the Board to attend their Annual Vision Symposium on Thursday, February 17, 2011.

b. 2011 Legislation

Ms. Akiyoshi reported that the Plan did not pursue the legislation on automatic enrollment and there were no bills that directly impact the Plan. However, she mentioned some bills of interest to the Board.

c. Scheduling of the Next Board Meeting

Ms. Akiyoshi noted plans for scheduling meetings for March and April. The semi-annual Board meeting is scheduled for May 26, 2011 at the Hawaii Prince Hotel, Captain's Room and the Benefits Fair on May 27, 2011. Staff researched several possible locations in downtown Honolulu. Discussion was held on deciding the location for the Benefits Fair.

d. Letter from Island Savings Plan participant regarding Rollover

The Board discussed an issue raised by a participant who lives in Japan and had a concern about the current rollover process. He was informed that ING would issue a check in the name of his financial institution (Fidelity Investments) that will be receiving his Plan proceeds and mail that check to him in Japan. He would then have to turn around and mail the check back to Fidelity Investments in the United States. He was unhappy that he had to do this, especially since he is now residing in a foreign country. Thus, he asked if ING could transfer his Plan proceeds directly to Fidelity Investments.

Due to liability reasons, ING instructed the participant to obtain the routing number and banking information from Fidelity Investments and ING will then make an exception to do a wire transfer, or if the participant provides the overnight address of Fidelity Investments, ING would overnight the check to Fidelity.

The Board discussed the drafted response to the participant, made revisions, and also requested that ING revise their rollover form so that it is clear to anyone requesting a rollover what ING's procedures are.

<u>Motion to Adjourn</u>: **A motion was made by Trustee Machida and seconded by Trustee Kami to adjourn the meeting at 11:27 a.m. The motion passed unanimously.**

(NOTE: Signed copy on file.)