

**STATE OF HAWAII
DEFERRED COMPENSATION PLAN
BOARD OF TRUSTEES**

**OPEN SESSION MINUTES
MEETING # 340**

Date: March 9, 2010

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

Present: Marie C. Laderta, Chairperson
Georgina Kawamura, Ex-Officio Member
Sandi Yahiro, Employee Member
Scott Kami, Employee Member
Wesley Machida, Employee Member
Kenneth Taira, At-Large Member
Ryan Ushijima, At-Large Member

Others: Rodney J. Tam, Deputy Attorney General
Cynthia Akiyoshi and Lily Chu, DHRD Staff
Troy Saharic and John Bothwell, Mercer Investment Consulting –
Via Conference Call
Melody Takacs, Plan Administrator Staff (ING)/Honolulu Office
Grace Baracao, Plan Administrator Staff (ING)/Honolulu Office
Jeanne Kanai, Plan Administrator Staff (ING)/Honolulu Office
Kristine Matthews, Plan Administrator Staff (ING-Boston Office) –
Via conference call
Todd Egger, INVESCO – Via Conference Call

Call to Order: There being a quorum present, Chairperson Laderta called the meeting to order at 9:01 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: 2010 Legislative Session

- a. Status of Bills: S.B. No. 2394 (H.B. No. 2259), Relating to the Board of Trustees of the Deferred Compensation Plan. Ms. Akiyoshi reported that this bill was introduced by Senator Dwight Takamine, and proposes to change the composition of the Board by increasing the number of members who must be public employees from three to five, and requires these five members to be elected annually by participants.

Ms. Akiyoshi stated that Chairperson Laderta and Trustee Yahiro tried unsuccessfully to meet with Senator Takamine and had to cancel the meeting with Senator Carol Fukunaga because the hearing on the bill came up before the scheduled meeting. However, Trustees Yahiro and Machida were able to follow-up and meet with Senator Norman Sakamoto. The Trustees relayed the concerns of the Board and Senator Sakamoto was provided additional information in summary format upon request. The Board members were unsuccessful in scheduling a meeting with Representative Karl Rhoads yesterday. This Bill passed in the Senate and crossed over to the House.

The hearing on the House Labor Committee side is scheduled for today, March 9, 2010 at 9:30 a.m. A copy of the written testimony submitted to the House Committee was provided to the Board. The Board asked if Trustee Machida could attend the hearing on behalf of the Board. There was a House companion bill, H.B. No. 2259, which did not move in the House.

DAG Tam reviewed the points in the testimony which includes the Board's opposition to the bill because this bill would incur an additional expense to participants to cover the cost of the elections and the Board has a fiduciary responsibility to keep participant costs down, and cited the Board's numerous prior accomplishments.

Ms. Akiyoshi added that staff was finding ways to get the information on the legislative updates out to participants; however, since the Plan newsletter is not scheduled to be out until mid-April, a notice was considered and drafted for possibly posting on ING's website or distributed at ING's information workshops to inform participants of what is going on regarding legislation that affects the Plan. A draft document entitled "2010 Legislative Updates", to be posted on ING's website, summarizes the significance of this legislative bill was presented to the Board for review. The Board accepted the draft notice with minor changes to the wording and posting of the document on the Plan website, on the quarterly statements, and handouts at ING's informational workshops. Trustee Kawamura noted that the information should go out to participants

through whatever means possible since it would impact participants' accounts.

b. Report on Other Legislative Initiatives:

Ms. Akiyoshi reported on the following bills:

H.B. No. 2665, Relating to Deferred Compensation Plans

This Bill allows withdrawal of funds upon demonstration of financial hardship. There was no companion bill in the Senate. There has been no movement out of the House side so this bill is probably dead.

H.B. No. 2133, H.D. 1, Relating to Procurement

This Bill was being monitored because it sets time frames on awards, which impacts the RFP process for contract awards. This bill establishes that the award must be made 45 days from the initial request of the proposal. The concern is how the Board would meet the timeframe since there is an evaluation period, best and final offer period, and interview period before a contract is awarded. It takes a significant amount of time from the time the contract proposal is received to the time the contract is awarded. Thus, it would not be possible to award a contract within a 45 day timeframe. This bill was transmitted to the Senate Economic Development Committee which heard the bill and the Senate committee deferred the measure as of yesterday. If the bill moves forward, the Board indicated a concern with the time frame on the contract award which should be relayed to the committees.

H.B. No. 1104, H.D. 1 and S.B. No. 922

These bills were introduced last year and involves automatic enrollment into the Plan. These bills were carried over to this year and there has been no movement.

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Item # 2: Review of Stable Value Fund

a. Status Report by INVESCO

Ms. Akiyoshi referred the Board to a December 31, 2009 report provided by Invesco and also distributed was a handout of Todd Eggers's presentation for today. Mr. Eggers will be presenting the end-of the year activities in the Stable Value Fund, how the ERS Hybrid Upgrade Program affected the Stable Value, and what INVESCO sees happening with the

Stable Value Fund going from this point forward.

Mr. Egger reported that INVESCO was prepared for the ERS Hybrid Upgrade and there was a lot of cash activity from the State ERS Hybrid Upgrade Program in the 4th quarter which was illustrated by the graph of cash flows on page 3 of the March 9, 2010 report. This graph shows the historical cash flows on by month. The last three months of last year's cash outflow for the Hybrid Upgrade represented less than half of the elections that were paid out. Slide 4 shows the contract issuer position and INVESCO was able to raise cash allocation to about 10% in December even though the issuers ING, Pacific Life, and Monumental had not agreed to pay the Hybrid related cash flow out at book value. Invesco has a good buffer built up to cover cash flows. The market value to book value is really strong. The Fund has a market value greater than book value to cover participant accounts.

Slide 5 is a recap of how INVESCO is managing. Essentially, they were able to neutralize the event of cash flows to a great extent. The goal is to avoid accessing any liquidity from the contract when market value is below book. The volatility of the market will cause market value to go below book at times. With the Hybrid Upgrade program going on for another six months, they are closely monitoring the market to book ratio and their cash positions. Where the cash position in December was at 10%, it is at 7.4% today compared to the normal cash position of 1-3%. One of the assumptions they are using is the worst case scenario where another 10% of the Stable Value Fund is paid out due to the Hybrid Upgrade. So the plan of action is to monitor the market to book ratio on any one contract and giving the Fund a 1% buffer to get more liquidity to get it covered. There will be a slight drag on the crediting rate for the coming quarter due to the higher cash balance. In conclusion, there is a lot of uncertainty as to the level of potential cash flows and potential liquidity needs. Invesco will continue to closely monitor outflows, portfolio cash, and contract market value to book value ratios. INVESCO would like to remind the Board that any plan changes will be under heavy scrutiny by contract issuers. Heavy cash outflows will dilute the market and put a drag on future crediting rates. This causes a weaker Fund and lower interest rates for the participants. INVESCO recommends that they be included early on in any discussions of potential Plan changes to mitigate risk to wrap contracts.

Mr. Saharic of Mercer inquired about the wrap provider updates and what the capacity to seek additional wrap providers is. Mr. Egger responded that there were no new wrap capacity and until contract negotiations are finalized, they have access to three separate accounts. Right now, they

have the best line up of three wrap files, but if necessary they have specialized ones in the bull pen.

Trustee Yahiro inquired whether the Hybrid withdrawals caused INVESCO to reach their cap. Mr. Egger responded that the cap maybe on the Prudential side. INVESCO has a 100% draw which means that the issuers have no cap. Mr. Saharic stated that there maybe a 10-20% on the Prudential side but need to check the contract. There is a certain amount of leeway that wrap providers are still going to look at the event that is sponsor driving and that could jeopardize or create more risks. There are a number of tools on the provider's back pocket to help with liquidity. INVESCO is in a very good position than most funds right now.

b. Overview by Mercer Investment Consulting by Troy Saharic

Mr. Saharic clarified that the wrap providers are looking at their own risks. So when the market to book value ratio is over 100%, then there is some leeway in such situations. Wrap providers look at sponsor-driven activities that could jeopardize or pose risks. We just need to monitor situations.

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Item # 3:

Performance Evaluation Report by Mercer for 4th Quarter 2009, period ending December 31, 2009 and 1st Quarter 2010.

John Bothwell of Mercer Investment referred everyone to page 1 of the Defined Contribution Performance Evaluation 4th Quarter Report. The Gross Domestic Product (GDP) was at 5.9%. The economy and unemployment rate seemed to have stabilized; however, consumer confidence remains weak. Last month, the Fed raised the interest rate to 25 basis points. Last month's core Consumer Price Index (CPI), excluding food and energy, declined 1% due to housing increases and lower rental prices. Mr. Saharic added that in terms of the overall health of the economy, the last 2 GDP numbers revealed a lot of consternation and as long as unemployment remains high (currently hovering around 10%), consumers are sitting on the sidelines. This means a muted economic growth through the remainder of the year.

Mr. Bothwell referred to Page 2 which shows that equity markets continued to outperform in the 4th quarter. Information technology and healthcare stocks were the strongest performers and financials were the worst performers in the 4th quarter of 2009. On page 3, the bond market cooled off for the 4th quarter but finished at a 5.9% gain for 2009. Page 4 on International Equity Market Performance shows emerging markets delivered the best results at 8.6% for the quarter and 73% for the year. This was led by Russia and Brazil. In general,

investors had a greater appetite for risks. Page 5, the only change in this Theoretical Return and Risk Chart is the addition of Mainstay Large Cap Growth managed by Clark Winslow and no turnovers in the firm were reported. Assets in the Plan on December 31, 2009 were at \$1430 million. During the quarter, withdrawals totaled \$108.7 million, contributions totaled \$21.3 million, and 28,555 participants had an average account balance of \$50,094. The Stable Value Fund retained the majority of Plan assets of 55.5% of total assets. Participants moved out of the riskier asset classes and into the riskier asset funds, including the EuroPacific Growth Fund and the Bernstein International Value Fund, which was a reversal of last year. This shows that people are reacting to the economy, not the market. Page 12, Hawaii Stable Value Fund holds the most at 55.5% of the Plan. This Fund is being split between two providers: Prudential/Jennison and the other is Invesco. INVESCO retains about 50.7% of those assets and 49.3% with Jennison for a split strategy of exposure. This diversification strategy has paid off really well. The Plan has 50% invested in the Jennison Intermediate Fixed Income Strategy which has done very well. Based on the performance results, Mr. Saharic recommended to the Board to take INVESCO off the watch list.

A motion was made by Trustee Ushijima and seconded by Trustee Kawamura to amend the agenda to add the Review of INVESCO's Watch List Status. The motion passed unanimously.

A motion was made by Trustee Kami and seconded by Trustee Taira to remove INVESCO from the watch/probation list. The motion passed unanimously.

Mr. Saharic referred to Page 13 which shows that PIMCO Total Return Fund outperformed the Barclays Capital US Aggregate by a considerable margin. PIMCO has been very concerned with the market environment and with the risks. They have de-risked the portfolio by pulling back on some of the financials and that had hurt them a little bit in the 4th quarter. However, PIMCO has always been a little bit earlier and there is a little bit of flight to risk which has helped the portfolio. Vanguard Wellington Fund had a strong performance partly due to the overweight they had in equities relative to the benchmark. They also did well in some of the stocks they held in the portfolio, particularly in healthcare stocks in Pfizer. Page 14, the Lifecycle funds are doing well relative to the benchmarks in every quarter. Glide path is customized and doing better than off the shelf funds.

Trustee Ushijima inquired whether the Lifecycle fund mix is sufficient or whether there were any other funds that need to be added because there is a lot of controversy now on whether the lifecycle funds are meeting customer needs. Page 26 shows how the funds are build and later this year we would need to discuss diversification of funds. Trustee Ushijima inquired whether ETF (Exchange Traded Funds) can be used or must it be mutual funds. Mr. Saharic replied that

generally ETF funds are not used for defined contribution plans. ETFs use hedge funds that could cause tracking errors. Because of the many obstacles to using ETF funds, there are better vehicles to do that.

Page 15, domestic equity funds had a good year with all funds outperforming their benchmark for the one year period. The Mainstay Large Cap Growth Fund outperformed the Wells Fargo fund that it replaced by over 300 basis points for the one year period. Page 16, small Cap funds had mixed performances with decent quarter performances but a bit of a struggle for the one year. Mercer is going to be watching the Century Small Cap very closely for the next quarter or two because they were so far off the benchmark and they expect them to get back on track. The EuroPacific Growth Fund had a very strong performance and would have had a better performance if they reduced their cash position. Even then, they were able to overweigh the gross stock and there is continued confidence in this fund. The Bernstein International Value Fund had a decent one year, but Mercer is watching the organization very closely since Lou Sanders left and started his own company. A lot of people have left the company due to right-sizing. Mercer is watching their extra-curricular activities from an organizational standpoint to make sure they are spending enough time on their portfolios to align them with the interests of the investors. Page 17, the Investment Expense Analysis shows that the Board has been very proactive in getting low cost funds for participants.

Trustee Yahiro inquired whether we should be concerned about the Century SMID Growth Fund's performance. Mr. Saharic replied that they have concerns and will be monitoring the fund for the next quarter and may recommend putting the fund on probation. If so, the Board should consider issuing an RFP to see what else is out there. The addition of the brokerage window will allow participants to look at small to mid cap index funds if they do not like what they see in the mutual funds.

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Item # 1: 2010 Legislative Session

Trustee Machida provided a recap of today's hearing on S.B. No. 2394 and stated that he provided oral testimony on this bill. The bill was passed with amendments to make the Director of Human Resources Development one of two ex officio members and to delete the requirement for the Director to serve as the Chairperson of the Board of Trustees. This amended bill also requires the Board to have five employee members be appointed instead of elected.

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Item # 4: Status Report on Contract Award for RFP No. DCP-FY-09-2, Request for Proposals for Passively Managed Investment Options

Ms. Akiyoshi informed the Board that the contract was just finalized today and the new options are set to go live on April 1, 2010. Ms. Akiyoshi asked for a formal motion to replace the Vanguard Institutional Index Fund with the BlackRock U.S. Large Cap Equity Index, that resulted from the search and the Board's selection of BlackRock because of its lower cost structure compared to Vanguard.

A motion was made by Trustee Kawamura and seconded by Trustee Taira to replace the Vanguard Institutional Index Fund with the BlackRock U.S. Large Cap Equity Index Fund. The motion passed unanimously.

Communications regarding the BlackRock Funds and the brokerage window will be coming out shortly.

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Item # 5: Approval of Meeting Minutes No. 336 – September 1, 2009

A motion was made by Trustee Taira and seconded by Trustee Ushijima to approve Meeting Minutes No. 336, as is. The motion passed unanimously.

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Item # 6: 2010 Employees' Benefits Fair Schedule and Semi-Annual Meeting

Ms. Akiyoshi informed the Board that the sites for the Benefits Fairs will be at Koolau Golf Course Ballroom on May 17, 2010, and the Hawaii Okinawa Center on May 19, 2010. The Semi-Annual Meeting will be held on Tuesday, May 18, 2010, at the Willows Restaurant.

Trustee Ushijima suggested that invitations be sent to Senator Takamine and all union heads about the Benefits Fairs and the Board's Semi-Annual meeting. The benefits of inviting members of the Legislature and unions were discussed. The Board agreed it would be a good idea. Staff is to prepare invitation letters.

Ms. Akiyoshi asked that the Board plan for the last Semi-Annual meeting for the week of October 18, 2010, so that the last regular Board meeting can be held in November. It would a good time as there will be some outgoing board members this year.

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Item # 7: Plan Administrator's Report

Ms. Takacs of ING reported on the local office activity. 442 group meetings were held for the period July 1, 2009 to February 28, 2010 with 3,479 attendees. The local office conducted 3,644 one-on-one meetings, received 4,588 calls, 1,068

walk-ins, and had 286 new enrollments. The advisor program has been well received and therefore, ING would like approval from the Board to use the Island Savings Plan logo in an ING video to promote the enhanced Advisor services. Melody Takacs referred to the handout of Representative Sponsors and explained that it would mean flashing the Island Savings Plan logo to show participation.

A motion made by Trustee Kami and seconded by Trustee Kawamura to allow ING to use the Island Saving Plan logo in the ING video. The motion passed unanimously.

Ms. Kanai continued with the ING Plan Administration report with statistics on the ERS Hybrid Upgrade on page 3. As of February 28, 2010, ING processes 1,769 Hybrid Remittance requests with \$101,791,530.99 transferred to date. This accounted for 68% of the total dollar amount of Hybrid Plan Upgrade requests transferred to ERS and only 20% of eligible employees. Statistics provided by Karl Kaneshiro of ERS showed a total amount of \$149 million was transferred from all sources. In 2010 so far, ING received 177 Hybrid Upgrade requests. There were 395 vacation rollovers totaling \$6,632,848 into the Plan between October 2009 and February 2010. Other rollovers were 40 from other sources, 19 from ERS, 43 from PTS for a total of 494 in totaling \$9,208,069.

Since ING took over the processing of Unforeseen Emergency Withdrawals (UEWs) in December of 2009, there were 64 new claims. 46 were approved and processed and there were no outstanding cases prior to the takeover. Ms. Kanai provided the Board a summary of the UEW cases which provided information of what the reasons were for applying for UEW and what the results were.

Ms. Matthews provided the Board with the following updates: 1) information regarding the closing of the Vanguard Institutional Index Fund and replacing it with the BlackRock fund; and 2) for the launch of the brokerage window, ING is working on a communications campaign and should have materials for the Board to review by the next meeting.

Trustee Ushijima inquired whether the Plan has all the features necessary to bring it up to date with other plans in the country. DAG Tam responded that except for the auto-enrollment feature, the Plan appears to have all the up-to-date features.

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Item # 7:

Other Business/Announcements

Ms. Akiyoshi reported on the following:

- a. Advisory Letter from the University of Hawaii

A letter was received from Ms. Brenna Hashimoto, Director of Human Resources at the University of Hawaii, informing the Board of processing errors that occurred for deferrals on 6 occasions for 5 UH employees. The purpose of their letter was to make the Board aware of their concerns. Ms. Akiyoshi informed the Board that deferrals involve a lot of manual processing relative to the vacation payouts and other payouts being deferred into the Plan. Within the manual processing of deferral payouts, there were a lot of accommodations ING made on the department side when departments have internal issues and cannot process, which results in exceptions being made to the payroll. So, the amount of issues UH has is relatively small compared to the bigger picture involving all other state agencies.

Ms. Kanai further clarified that the movement of money within ING amounts to about \$32 million worth of regular contributions along with \$4.2 million from counties for the period October 1, 2009 to February 28, 2010. Additionally, during this time, there were a little over 4,000 deferral changes (3,555 for the State and 484 for all counties) which maybe range from assignments or cancellations to changes in deferrals. Of the 4,000 deferral changes, there were 369 vacation payouts. Each vacation payout is a manual process which is doubled because one manual process is required to make the assignment up to the maximum and then a second process is required to bring it back down to zero again. Thus, there are about 1,000 manual changes out of the 4,000 deferral changes. ING works with not only UH, but all other state agencies on these changes. To further break it down, if you look at the number of errors, whether it was an error report or manual processing, there were 35 errors made on the ING side. There were 30 on the State and County side combined. The errors range from multiple sources such as when deferrals are paid out too early or too late, or personnel was not notified by the participants who requested payouts, etc.

Trustee Kawamura inquired whether ING has met with UH since receiving this letter. Ms. Kanai affirmed that she did meet with Clifford Shinchichi and he agreed that the errors were a culmination of communication breakdown and the end of the year changes such as people on furloughs, RIFs, ERS Hybrid upgrades, retirements, etc. Trustee Kawamura felt that the Board should respond by acknowledging UH's letter, state that the third party met with her staff and highlight the specific actions that were agreed upon to resolve the issues as discussed at their meeting. DAG Tam will work with Ms. Akiyoshi on a response and send it over to ING for review.

- b. Plan Budget Report

A copy of the plan budget report on expense accounts as of December 31, 2009 was presented to the Board for review. There are sufficient funds to cover current expenses.

c. Lifecycle Funds

Information on the new 2055 LifeCycle Fund will be coming out in the newsletter shortly once the new index funds and brokerage window go live on April 1, 2010.

Motion to

Adjourn:

A motion was made by Trustee Kawamura and seconded by Trustee Machida to adjourn the meeting at 10:55 a.m. The motion passed unanimously.

(Note: Signed copy on file)