STATE OF HAWAII
DEFERRED COMPENSATION PLAN
BOARD OF TRUSTEES

OPEN SESSION MINUTES
SEMI-ANNUAL MEETING
MEETING # 377

Date: October 16, 2013

Place: County of Kaua'i
Mo'ikeha Building, Conference Rooms 2A and B
4444 Rice Street
Lihu'e, HI 96766

Present: Wayne Chu, Chairperson
Kalbert Young, Ex-Officio Member
Barbara Krieg, Ex-Officio Member
Michael Okumoto, Employee Member
Brian Moto, Employee Member
Ken Villabrille, Employee Member

Others: Rodney J. Tam, Deputy Attorney General
Cynthia Akiyoshi, DHRD Staff
Troy Saharic, Mercer Investment Consulting
David Williams Mercer Investment Consulting
Kevin Malmud, Plan Administrator Staff Prudential Honolulu Office
Grace Baracao, Plan Administrator Staff Prudential Honolulu Office
Jeanne Kanai, Plan Administrator Staff Prudential Honolulu Office
Julie Klassen, Prudential Retirement
Gabe D'Ulisse, Prudential Retirement
Greg Hodges, Prudential Retirement
Deborah Baran, Prudential Retirement
Andrea Prokop, Prudential Retirement
Terence Geenty, MorningStar Investment Advisory Services
Bill Beardsley, MorningStar Investment Advisory Services
Steve Hunt, National Benefit Services
Cris Hernandez, Wellington Management Co.
Peter Whitlock, Century Capital Management
Tom Smythe, MainStay Investments
Vince Ortega, American Funds/Capital Group
Steve Caruthers, American Funds/Capital Group

Brendan Bowe, BlackRock
Marco Merz, BlackRock
Joan Larsen, Prudential
Cheryl Lynch, Jennison Associates
Todd Egger, INVESCO
Delia Roges, INVESCO
Yoojin Kim, JP Morgan Asset Management
Lisa Rosenthal, Victory Capital Management
Jack Scott, PIMCO
Tom Atchison, Vanguard
Robert Spector, MFS
Matt Westhoven, MFS
Karen Jordan, MFS
Carl Lutz, Life Insurance of the Southwest
Wanda Kau-Shibata, State Governor's Office-Kauaʻi
Thomas Takatsuki, County of Kauai

Absent: Neal Miyahira, Employee Member

Call to Order: There being a quorum present, Chairperson Wayne Chu called the meeting to order at 9:09 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.

Chairperson Chu welcomed everyone to the meeting, thanked everyone for participating at the Fairs over the last two (2) days, and opened with introductions of Board members (Trustee Miyahira was excused from today's meeting), Board staff, and consultants from Mercer Investment Consulting.

Agenda Item #1: Investment Performance Presentation from Mercer Investment Consulting
Presented by Troy Saharic and David Williams

Mr. Saharic provided the investment performance and economic and capital market environment snapshot report, through September 30, 2013:

- Russell 2000 Growth was up 33.6% year-to-date.
- U.S. equities have done well; emerging markets remain off.
- Fixed income has been negative because of rising interest rates.
- Commodities index has been down.

Mr. Williams provided investment manager updates:

- Wellington continues to grow the leadership group outside the U.S.;
- Winslow has had two (2) portfolio manager changes; Mercer has downgraded the strategy from A to B+ due to the leadership change; monitoring stability within the team;
- Century Capital has added an analyst and loss a portfolio manager on the SMID strategy;
- MFS announced the departure of its co-portfolio manager.

Mr. Williams reviewed the Plan highlights:

- Plan assets are just under $1.8 billion.
- There was some significant movement out of the index strategies into the active strategies.
- No concerns with the BlackRock index strategies.
- There is some performance lag with the underlying managers within the Stable Value Fund, partly due to the rise in interest rates.
- PIMCO has had a good performance.
- JP Morgan has had positive performance.
- Solid performance numbers from Vanguard Wellington fund.
- Seen a rebound in the Victory Institutional Diversified Stock Fund, as well as in the MainStay Large Cap Growth Fund.
- Harbor Small Cap Value Fund has bounced back.
- Century SMID Cap Growth Fund continues to lag during the quarter.
- MFS had a slight lag during the quarter but long term is still strong.
- EuroPacific Growth Fund lagged a bit during the quarter.

Mr. Saharic added that Mercer participates in the NAGDCA conference, and pointed out some trends in the marketplace that impacts the defined contribution plans. There is a movement towards multi-manager structures (hiring more than one manager in an asset class). There is an attraction of this structure in the private area.

<u>Agenda</u>
<u>Item # 2</u>: <u>Semi-Annual Report from Prudential Retirement</u>
Presented by Julie Klassen, Kevin Malmud, Deborah Baran

Ms. Klassen provided opening remarks and overview of the Plan, and noted that the Benefits Fairs over the last two (2) days were very successful Benefits Fair and very well attended.

Ms. Klassen provided an Executive Summary Overview:

- Prudential will be preparing a Business Plan to identify activities and efforts to address areas such as asset retention.
- Information is provided on participation within departments which has been good; see room for improvement within the Department of Education.
- Some documents for consideration are the Plan Document and the Summary Plan Description to explain details of the Plan.
- Prudential has produced an Investments Brochure to explain the options and tools and provide distinctions among the options such as LifeCycle Portfolios and the Goalmaker tools.
- Prudential is working on a number of administrative projects including utilizing the catch-up provisions, excess deferrals, and Hawaii tax withholding.
- Plan assets carried over on July 29, 2013 and on September 30, 2013 were almost $1.8 billion.
- Data shows a greater concentration of assets among the more mature age category.
- The average deferral rate is at 10.9% which compares very well.
- New enrollees into the Plan are going into the LifeCycle Portfolios.
- Utilization by fund shows Stable Value Fund representing 47% of the Plan assets.
- Data on investment utilization shows about 8,800 participants using one investment option; the Stable Value Fund shows 6,500 in one option.
- Field representatives are working with participants using the Retirement Income Calculator which shows the gap in savings.
- Plan participation is about 26%; are working with various entities in gathering data to provide breakout of the participation among the agencies.
- There were 2,075 participants enrolled in Managed accounts service at conversion.

The Board complimented Prudential on its report to capture the various data elements and what areas that needs to be focused on going forward and which target groups still need educational outreach.

Ms. Klassen addressed some questions from Trustee Krieg that were raised by participants at the Fair:

- Ms. Klassen stated that information initially published stated that there was a 50% maximum limit on the assets that can go into the Self Directed Brokerage account; however, that was subsequently corrected to show a 99% maximum limit.
- There was a participant who raised a concern in working with Morningstar about her investment risk style which she feels is

conservative. Trustee Krieg explained that the participant stated that Morningstar categorized her portfolio as moderately aggressive and that Morningstar explained that the characterization of the risk comes from the information provided on her profile. She wanted the monies invested in a conservative manner but was told that it could not be changed unless she goes in to change some of the profile information so that it can be conservative.

Ms. Klassen mentioned that they have been exploring the contrasts between the Morningstar service and the allocations under the Financial Engines service. They are looking at the assumption methodologies that are being used and are in discussions with Morningstar.

Mr. Terence Geenty and Mr. Bill Beardsley provided additional explanations on the methodology that Morningstar uses in comparison to Financial Engines model Morningstar focuses on risk capacity which looks at the amount of risk a participant can take on based on the participant's information profile. Morningstar will be working with Prudential on expanding the communications and with its investment team. Although the risk preference component is not in the model today, Morningstar is internally evaluating its methodology and to what extent to allow participants to express their risk preference since Morningstar does not have the risk preference level in its model. Mr. Geenty added that with some portfolios under the Financial Engines service model there was a heavy utilization of index funds which resulted in a portfolio of four to five investment options. Morningstar tends to diversify among the investment options and use active management where it makes sense. So some allocations in individual portfolios were increased to ten to twelve investment options.

Mr. Malmud reported on activity within the Local Office since the transition on July 29, 2013. Group meetings, including the transition meetings, totaled 166. They are focusing on expanding the topics for the group meetings and continue with the one-on-one meetings.

Ms. Baran reported on the communication activities. Some of the website levels for September have leveled off a little so would like to develop a strategy to continue to drive participants to the site. Based on participant feedback and interest, there will be enhancements to some of the content on the website pages. The website will have more education to clarify some of the options and services like the managed accounts. At the Fairs, it was noticed that there was significant activity on the website demonstration and learning to navigate the website. There was positive feedback on the website. Some highlights of the Benefits Fairs were the interactive banner for participants to write their retirement goals and the interactive Aloha bingo card that engaged the participants with the investment fund managers. Ms. Baran added that they would like to explore electronic communication methods to do more outreach.

Agenda
Item # 3: Annual Report from Life Insurance Company of the Southwest
Presented by Mr. Carl Lutz.

Mr. Lutz provide a summary of the Plan highlights as of June 30, 2013:

- Plan assets totaled approximately $98 million.
- There are just under 80,000 participants; the number of active participants during any one month are approximately 10,000.
- Contributions during the year were about $9 million.
- Benefits paid out totaled about $64 million.
- The State savings totaled $7.5 million, to date the savings has been about $107 million.
- The vast number of employees are from the DOE.
- The rate as of July 1, 2013 was 2.98%; as of October 1, 2013 the rate is at 2.90%.
- As of June 30, 2013, the amount in the escrow account is about $91,000,000.
- The call volume has been down about 20%; access to the Plan website is up at 45%.
- Out of the 80,000 annual statements that are mailed out, LSW still receives a large volume of returned mail. Because this Plan is comprised of part-time and temporary employees who move around, bad addresses are a common occurrence in these types of plans.

Mr. Lutz explained how the escrow account is utilized in the event that LSW cannot perform, so it offers protection to the Plan. The escrow account holds investment grade securities that are removed when the securities mature.

Chairperson Chu called a short break at 10:20 a.m. The meeting resumed at 10:40 a.m.

Agenda
Item # 6: Panel Presentation by Prudential Retirement/Jennison and INVESCO on the Fixed Income Market and Impact on the Stable Value Fund
Presented by Joan Larsen, Cheryl Lynch, and Todd Egger

Mr. Williams provided a brief introduction on the panel of Stable Value Fund providers who will be talking on what is happening in the stable value fund environment and a general overview of the bond market and how the movement of the bond market is impacting the stable value investment. Because the interest rates have been rising, investors are seeing market value losses in the stable value funds.

Mr. Egger explained that when interest rates rise, the bond market falls which does impact the market value side:

- Expectation that market to book value will fall below par for certain periods of time as it fluctuates.
- Described scenario when rates rise, bond prices will fall but the crediting rate remains stable. Longer duration will amortize those falling market values.
- When calculating forward performance, over full market cycles stable value fund will still have an attractive performance.
- In general, stable value crediting rate will track market interest rates with a lag and cash flows can impact how fast the fund responds to changes in the interest rates.

Ms. Lynch described what Jennison is doing to temper rising interest rates and effects that it potentially has in the stable value portfolio:

- With the Federal monitoring policies, it is difficult to forecast when interest rates will dramatically rise so Jennison maintains a conservative approach with a high quality bias.
- Main focus to minimize downside risk and maintain a duration neutral portfolio.
- Explained how Jennison adds value through analyzing yield curves and how add value outside the benchmark through mortgages.

Ms. Larsen provided information on the current state of the wrap provider market:

- The Fund is composed of wrap providers and portfolio managers.
- Portfolio is split 50/50 between Prudential and INVESCO.
- During the financial crisis, banks became aware that there was a need to hold capital for the stable value fund which wasn't the direction they intended to take. Prudential is committed to the stable value market and does not have any capacity limit.
- As the wrap fees started to rise, Prudential has kept its wrap fees low at 16 basis points for the Stable Value Fund compared to 20 to 25 basis points.

Trustee Krieg was excused from the meeting at 11:00 a.m.

Agenda
Item # 7: Panel Presentation by Vanguard, BlackRock, American Funds and MFS on the Rally and Sustainability in U.S. Stock Market
Presented by Steve Caruthers, Tom Atchison, Robert Spector, and Marco Merz

Mr. Saharic provided a brief introduction of the panel which will describe the overall rally and global equities.

Mr. Caruthers explained the backdrop of the macro markets and how American Funds is operating in that environment. Mr. Caruthers presented insights on sustainability within the U.S. markets, Europe, Japan, and the Emerging Markets.

U.S. markets are at high levels and reaching a point where companies need to prove that earnings can come through. Given the weakness in emerging markets, U.S. companies have a lot of exposure and revenue in those emerging markets so will need to determine what those earnings will look like and still remains to be seen. There is optimism built into the U.S. markets today because of the auto and housing markets, and the energy revolution.

Coming out of the debt crisis, a lot of the markets in Europe have been slow growers and expect that to continue. Some of the companies in Northern Europe, in particular Germany, have been successful and have helped with the rally for the remainder of Europe.

There have been a lot of political changes in Japan resulting in structural changes. American Funds have focused mainly on the Japanese exposure on exporters like Toyota and Honda. They are increasing their exposure in the domestic companies like banks and trading companies.

Emerging markets have not done well over the year because U.S. has tapered the quantitative easing in place since the crisis and the countries have relied on that funding to sustain themselves. American Funds does see value in the emerging markets and feels that the highest growth lies in these emerging markets. Many companies are global in nature, so American Funds is looking at where companies are doing business as opposed to where the companies are domiciled.

Mr. Atchison provided Vanguard's views on the world. Revenue will be the driver in the next stage. Some views noted:

- See continued strength in the housing markets driven by Federal intervention.
- Noted that until employment comes down, they do not see inflationary pressures building.
- See a continuing of low yield bonds, but has a strong position in portfolio

and provides diversification.

Mr. Spector discussed the outlook of the equity markets by questioning whether the conditions for a sustained bear market are out there. In the history of bull markets, find a theme that markets tend to go up when there are three (3) things in place: (1) the economy is not in recession and there is growth; (2) the growth is not an inflationary growth or not in deflation; and (3) the banking system is in good health. He stated that they feel these conditions are in place and will likely remain in place. The low growth environment that we are in right now means that it will take a while for those inflationary pressures to develop and it will be some time before interest rates start to head up and lead to bear markets. The charts described support the position.

Mr. Spector provided two points:

- That in the past year while advanced economies seem to have put a bottom on growth, the emerging world has continued to slow. They are monitoring to see and watch whether emerging markets are bottoming out.
- When liquidity was flowing, emerging markets were treated as one big asset class with strong growth potential. When liquidity tide started to turn out, separated the countries with the weakest market and currency performance. The market created a distinction between stronger and weaker markets and will need to go back to the basics of fundamental investing rather than treating as one big asset class.

Mr. Merz discussed the state of the U.S. economy and provided comments:

- There are fundamental underlying metrics are in place for a slowed continued growth globally.
- There are three (3) risks that could derail this point:
    - What is happening in Washington D.C. with respect to the default situation. While trying to avoid the default, at some point in time the delays would have some impact down the road.
    - In Greece, there is a north – south divide. In the southern hemisphere like Spain and Italy, there are severe recessions. Germany will have to realize that they will have to lend a hand in the south, otherwise could result in massive problems on the euro crisis again.
    - The potential continued slowing emerging market growth and the further decline in emerging market growth rate.

Mr. Merz described the BlackRock philosophy on emerging markets and the cautions on the volatility within the emerging markets, and ways to get better exposure to emerging markets..

Chairperson Chu noted there are no other announcements and acknowledged the investment managers who sponsored the meeting and luncheon to follow. Chairperson Chu expressed appreciation to the investment managers for attending the Benefits Fair and to the presenters for their time in preparing the presentations for the Board which helps the Board members to understand. The Board appreciates the efforts in providing the valuable information at these meetings.

Chairperson Chu adjourned the meeting at 11:46 a.m.

(Note: Signed copy on file.)