

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

**OPEN SESSION MINUTES
SEMI-ANNUAL MEETING
MEETING # 397**

Date: November 2, 2015

Place: King Kamehameha Golf Club
Ho'oheno Room
2500 Honoapiilani Hwy.
Wailuku, HI 96793

Present: James Nishimoto, Ex-Officio Member
Michael Okumoto, Employee Member
Kanoë Margol, Employee Member
Brian Moto, Employee Member
Kenneth Villabrille, Employee Member

Others: Rodney J. Tam, Deputy Attorney General
Cynthia Akiyoshi, DHRD Staff
Glenn Ezard, Segal Rogerscasey
Wendy Young Carter, Segal Rogerscasey
Leah Belmonte, Office of the Governor/Maui Office
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
Deborah Baran, Prudential Retirement
Carol Blumenthal, Prudential Retirement
Rich Gagne, Prudential Retirement
Mark Bojanowski, Prudential Retirement
Jim Diskin, Prudential Retirement
Joan Larsen, Prudential
Paul Dowd, MorningStar Investment Advisory Services
Cheryl Lynch, Jennison Associates
Itai Lourie, Jennison Associates
Todd Egger, INVESCO
James Carville, BlackRock
Brendan Bowe, BlackRock
Aimee Hirata, BlackRock
Robert Atwell, Harbor

Joel Damon, J.P. Morgan
Patrick Carter, J.P. Morgan
Cliff Kalish, William Blair & Co.
Stephen Weeks, William Blair & Co.
Michael Bowman, Capital Research (EuroPacific)
Steve Caruthers, Capital Research (EuroPacific)
Matt Westhoven, MFS
Peter Loncto, MFS
Michael Chandra., PIMCO
Lisa Rosenthal, Victory
Tom Smythe, New York Life (Mainstay Investments)
Ed McGettigan, Vanguard
Sue Bonfeld, Wellington Management
Alexander Zurflueh, Wellington Management
Allan Duckett, Schrodgers
Tom Kalili, Prudential Retirement
Al Lee, Prudential Retirement
Peter Eddy, Prudential Retirement
Kapena Kim, Prudential Retirement
Ata Azarshahi, LSW
Nathan Glassey, NBS
John Thorne, NBS

Absent: Wesley Machida, Ex-Officio Member
Roderick Becker, Employee Member

Call to Order: There being a quorum present, Interim Chairperson Okumoto called the meeting to order at 9:15 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.

Interim Chairperson Okumoto opened the meeting with all trustees except for Trustees Machida and Becker. He welcomed all attendees and opened with introductions from the Board and Prudential Retirement. Interim Chairperson Okumoto also welcomed Ms. Leah Belmonte from the Governor's Office. Interim Chairperson Okumoto briefly covered some housekeeping items.

Agenda
Item # 1: Semi-Annual Report from Prudential Retirement

Presenting from Prudential Retirement are Ms. Julie Klassen, Ms. Deborah Baran, Mr. Kevin Malmud, and Mr. Paul Dowd from MorningStar.

Ms. Klassen opened with an introduction of Rich Gagne who leads the retirement counseling team and comments on the IRS' annual limits, and the 2015 NAGDCA (National Association of Defined Contribution Administrators) conference at which the State was presented with a Leadership Award, key messages announced on the National Retirement Security Week with emphasis on retirement security, and presentations on sustainable withdrawal strategies and plan leakage. Ms. Klassen stated that they are looking to improve participant outcomes through the use of tactical messaging. She noted that the Plan audit was underway by N&K CPAs, and Prudential is looking to update the Plan document to address the Windsor decision. Ms. Klassen provided other commentaries:

- Number of active participants totals 16,743.
- Overall participation rate is at 29%.
- 93% of assets held by participants over age 45+ years. Prudential will look at more education for the younger ages.
- 44% of the Plan's assets held in the Stable Value Fund; 4.7% in the Lifecycle Portfolios, 4% in GoalMaker.

Ms. Baran provided highlights of the communication and education activities:

- The activity on the Plan website provides various self-service opportunities such as on-demand videos and reflects that the site is well utilized after the statements have been generated.
- They will be looking to add videos for more on-demand opportunities to make education more available on the website, and are seeing how participants access the website, which has reflected a 21% increase through mobile mediums (such as smartphones and tablets).
- They are planning to do a total refresh on the website in 2016.

Mr. Malmud presented highlights of the local office initiatives:

- The local office activities for the Third Quarter 2015 included 174 group meetings, so the office is ahead of its goals.
- The local office attended the HSTA Teachers' Institute Day event for a second year, and participated for the first time in the HGEA Educational officers' event which is held with all of the principals. They have also participated for a second year at the DOE pre-retirement seminars.
- The local office is focusing on working with former Trustee, Ms. Barbara Krieg at DOE that involves producing a new hire video for DOE's website.
- The local office held a mini fair at the UH Manoa campus and are now making arrangements to replicate the mini fair at the other community college campuses and neighbor island campuses.

- Additional efforts also included making deliveries of the Benefits Fair posters at various agencies and school sites in advance of the fair on Maui.

Mr. Dowd from Morningstar described how Morningstar determines the risk/tolerance level of a participant and customizes portfolios by adjusting allocations. Mr. Dowd noted that when using the managed accounts service, they find that the spendable income increases by 40%. Managed accounts service uses two (2) methods: one through a professional manager and the other method is recommendations provided by Morningstar and the participant would make the decision.

Mr. Dowd reported that upgrades are planned for the Morningstar website and the rollout is planned by the end of next year.

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Item # 2: Investment Performance Presentation from Segal Rogerscasey

a. Economic and Capital Market Environment

Mr. Ezard provided a flash summary on market activity through the end of the Third Quarter 2015:

- World equities were down during the Third Quarter, led by Emerging Markets and China.
- Performance of the Emerging markets dropped by 18% for the Third Quarter due to concerns of global growth going forward; the EAFE (developed markets) was down by 11%.
- There is a shift in China's economy to consumption and a less of a demand on commodities as before; thereby, lowering the prices of commodities. Emerging market economies such as Brazilian markets were heavily selling commodities into China.
- There is a concern about the divergence of monetary policies globally.

Mr. Ezard provided a brief overview on the performance of the Plan's core funds and the funds on the watch list, and had no recommendations to make changes to the watch list at this time. He also reported on some organizational issues:

- Since the departure of Mr. Bill Gross, PIMCO received a Wells notice from the SEC in August 2015 related to practices in the ETF BOND. In addition, another development is a lawsuit that was filed by Mr. Bill Gross for the non-payment of claims under the employment agreement.

- INVESCO received a notice from the Department of Labor related to its Short Term Investment Fund (STIF) which is a cash sweep vehicle. During the financial crisis, many market fund companies suffered from illiquidity and falling prices and as a result weren't able to liquidate at par. In such a circumstance, INVESCO stated that they will make whole to remedy situation to demonstrate they are supporting the agreement.
- PIMCO had a difficult Third Quarter 2015.
- MainStay has seen improvement during the quarter with medium returns.
- Victory had a better quarter and recovery; however, the long term performance is still lagging.

Ms. Carter introduced herself as Segal's public sector defined contribution director, and will be looking at the design of the Plan to better serve participants. To do this, she needs to understand participants and will be in attendance at the Benefits Fair. She noted that she looks at different trends out in the industry.

- She said to look at the defined contribution plan through the eyes of a defined benefit (DB) plan. She stated that there are eight (8) features that a defined contribution plan can take advantage of:
 - Involuntary participation: Many plans are looking at auto-enrollment as a way to get participants to take action. For DB plans, there was no choice.
 - Auto-escalation option: DB plan contributions are high. 58% of corporate plans utilize this option; whereas, only 20% of defined contribution plans use auto-escalation. It is important to get the younger participants on board early.
 - No leakage in a defined benefit plan. Avoid leakage in the Plan by keeping monies consolidated and keeping monies in after retirement to take care of the low share costs.
 - Government initiatives toward retirement leakage.
 - Annual Retirement Income: Participants need to understand the risk of longevity, so to look at increasing education on this.
 - Provide defaults: For defined contribution plans, there should not be an option to get into the Plan.
 - Defined contribution plans are the likely plans to pool assets and utilize institutional share pricing to obtain the lowest cost share class, and this is an emerging trend.
 - Professional asset allocation: Provide assistance in managing assets for unique needs and invest appropriately; advisory services will continue to be a trend.

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Item # 3: Annual Report from Life Insurance Company of the Southwest (LSW)

Mr. Azarshahi opened with introductions of himself, and Mr. Glassey and Mr. Thorne from National Benefit Services (NBS), and on the transition of the PTS Plan to himself from Mr. Carl Lutz who retired earlier this year.

Mr. Azarshahi reviewed the history of the Plan since its implementation in 1997, and provided some summary points:

- The Plan's assets total approximately \$109,470,186.
- The State saved \$7.6 million this year; and overall, has saved \$122 million since the Plan's inception.
- The average number of active participants for this year totaled 9,631.
- The escrow account maintains a balance of \$113 million.
- LSW maintains a spread of 1.95%; the current effective crediting rate is 2.88%.
- NBS provides the record keeping for the Plan.

Mr. Azarshahi also provided the history of the National Life Group which is the parent company of LSW, and the services provided by LSW which includes annuity services.

Interim Chairperson Okumoto called a break at 10:35 a.m. The meeting resumed at 10:50 a.m.

Interim Chairperson Okumoto acknowledged the sponsors for today's meeting and lunch. The Board thanked Ms. Julie Klassen and the Prudential Retirement Team, Mr. Cliff Kalish and Mr. Stephen Weeks of William Blair & Company, Mr. Tom Smythe of MainStay/New York Life, Mr. Allan Duckett of Schroders, Ms. Sue Bonfeld and Mr. Alexander Zurflueh of Wellington Management, Mr. Michael Chandra of PIMCO, Mr. Matt Westhoven of MFS Investments, Mr. Michael Bowman and Mr. Steve Caruthers of Capital Group, and Mr. Todd Egger and Ms. Delia Roges of Invesco.

Mr. Ezard opened the panel discussions for today's meeting and commented that the panels will address broader investment alternatives strategies in defined contribution plans, global interest rates and outlook, and the volatility in global equity markets.

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Item # 4: Panel Presentation # 1 on Alternatives in Defined Contribution Plans: by BlackRock and Prudential Financial

Presenters: James Carville and Aimee Hirata from BlackRock; Julie Klassen and Mark Bojanowski from Prudential.

Highlights of the discussion by the presenters focused on information related to alternatives in defined contribution plans, and on responses to the Board's questions.

Mr. Carville and Ms. Hirata opened with the following commentary:

- Alternatives are an all-encompassing asset class, like real estate commodities and real assets, which is unlike the traditional asset class of stocks and bonds. Alternatives can be stand-alone or within custom Lifecycle portfolios. One reason for consideration is diversification; in particular, during down markets. Defined contribution plans have limited exposure to alternatives, unlike defined benefit plans which have a large adoption of alternatives that have allocations generally in excess of 25%, including real estate, private equity, etc. The utilization of alternatives in Endowments is higher. Alternatives have unique return benefits.
- There are different types of alternatives: Liquid alternatives such as commodities and REITs; Marketable alternatives which are the traditional hedge funds which provide broader opportunities; and Illiquid alternatives such as private equity and real estate.

Mr. Bojanowski and Ms. Klassen discussed implementation considerations:

- Described two (2) types of alternatives: Alternatives Life strategies such as real assets and Pure Alternatives strategies.
- The focus has been on real assets. The vast majority is in real returns, with a smaller percentage invested in hedge-type strategies. The most common implementation is in a diversified fund. Investors have not forgotten the crisis in 2008, so more considerations are being given to these types of strategies.
- Discussed implementation of alternatives in the Plan, the strategies and cost to implement, the related trading and management agreements that would need to be executed, and the communication for participants.

The Board asked Ms. Hirata and Mr. Carville to explain how the alternative strategies are made up and how fees are handled and utilization of private equity within defined contribution plans. Alternatives are a broad mix of strategies with sub strategies that may include long/short equities as an example. Fees are typically higher for alternative strategies for defined contribution plans. Main

adoption is in target date funds. Less than 5% usage of private equity is seen in institutional plans; but BlackRock is fostering conversions with some clients to configure similar strategies within custom Lifecycle funds. They forecast that there will be a higher usage of alternatives within defined contribution plans within 5 to 10 years.

Mr. Ezard said that the next panel will talk about fixed income and address issues such as variable interest rates and outlook for this asset class and any challenges with possible rising rates.

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Item # 5:

Panel Presentation # 2 on the Bond Market: by Prudential, Jennison Associates, and INVESCO

Presenters: Joan Larsen and Jim Diskin from Prudential, Itai Lourie and Cheryl Lynch from Jennison Associates, and Todd Egger from INVESCO.

Highlights of the discussion by the presenters focused on global divergence, money market reforms, the stable value funds, and on responses to the Board's questions.

Mr. Lourie opened with the following commentary on global divergence and monetary policies:

- External risks like the slowing growth in China and Australia causing the central bank easing on policies to increase liquidity and commodities to weaken.
- With policy divergence, the dollar appreciates versus the rest of global economies and exports become less advantageous and profits shrink.
- Discussed the U.S. 30-year spreads and rates against the rest of the world and the Germany 30-year government yields, resulting in a higher U.S. dollar.

Mr. Egger highlighted the following:

- Historical events leading to money market reforms.
- Next October 2016, structural changes and new concepts are being considered within money market funds that involve liquidity gates, and fees for government and retail accounts.
- Other options are collective trust funds that will gain traction and not be subject to norms and without having to deal with floating NAV issue, gates and fees.
- Hawaii's Stable Value fund will not be impacted as it uses a State Street bank collective trust fund.

Mr. Diskin presented the following:

- Discussed how Stable value funds are built for safety, it is principal preservation with money market benefits.
- The stable value funds represent about 40% of section 457 plans.
- He noted that with more restrictions to money market, it makes Stable value more attractive.

Mr. Ezard remarked that the third panel will cover global equities and concerns such as slowing growth and impact on global economy.

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Item # 6:

Panel Presentation # 3 on Global Equity: by Harbor, Capital Group, William Blair & Co., and MFS

Presenters: Robert Atwell from Harbor; Steve Caruthers from Capital Group; Cliff Kalish and Stephen Weeks from William Blair & Co., and Peter Loncto from MFS.

Mr. Atwell discussed the following:

- The historical perspectives of China's GDP leading to the maturing of economies.
- China's population is large and the shifting of China's economy from capital intensive economy to a focus on the consumer.
- Retail sales in China are a larger part of China's GDP; areas of opportunities that are present and stemming from rising technology as it relates to biotech, robotics, and to the consumer (example: smartphones).

Mr. Caruthers discussed global equities:

- Discussed the evolving of companies and where companies are domiciled; you can see that corporations have become more global.
- Tourists are moving around the world and buying companies leading to the evolving of markets. Exports have become important to economies.
- Get best exposure by owning companies based on their products and not where they are located to get optimal benefits.

Mr. Kalish and Mr. Weeks provided the following comments:

- They discussed the slow growth environment and continued trend for slowed growth. Managers may need to look at companies that are hitting earnings expectations and have worthwhile projects.
- Managers should still consider opportunities in China despite the slow growth;

what matters will be looking at what people are spending their money on.

Mr. Loncto presented some thoughts, as follows:

- He discussed the impact of China's slowdown on global economy, running from 10% to about 5%.
- Exports to China have been low; overall impact on major developed economies from export perspective will be limited, and the impact will be greater on smaller Asian companies that export heavily to China and commodity producing nations.
- China's slowdown and its government's attempt to intervene in the markets have led to the spike in volatility.
- Investing in a low growth environment, you see that investors put a premium on companies with strong earnings and there are more mergers and acquisitions.

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Item # 7:

Other Business/Announcements

- a. Approval of Minutes No. 396

A motion was made by Trustee Villabrille and seconded by Trustee Nishimoto to approve Minutes No. 396. The motion passed unanimously.

There being no other business or announcements, Interim Chairperson Okumoto closed the meeting by thanking the TPAs for their reports, the fund managers for their presentations, and Mr. Ezard for arranging the panels. He invited everyone to join the Board for lunch. Interim Chairperson Okumoto adjourned the meeting at 12:31 p.m.

(NOTE: Signed copy on file.)