

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

**OPEN SESSION MINUTES  
MEETING # 387**

Date: November 7, 2014

Place: Department of Human Resources Development  
14<sup>th</sup> Floor Merit Appeals Board Conference Room  
235 South Beretania Street  
Honolulu, HI 96813

Present: Wayne Chu, Chairperson  
Kalbert Young, Ex-Officio Member (arrived at 9:22 a.m.)  
Cindy Inouye, Ex-Officio Member  
Michael Okumoto, Employee Member  
Brian Moto, Employee Member  
Kenneth Villabrille, Employee Member

Others: Rodney J. Tam, Deputy Attorney General  
Cynthia Akiyoshi, DHRD Staff  
Troy Saharic and David Williams, Alex Williams, Mercer Investment  
Consulting – via conference call  
Julie Klassen, Carol Blumenthal, Prudential Retirement –  
via conference call  
Taylor Alan-Lee, Jeff Helsing, PIMCO (via conference call)  
Kevin Malmud, Jeanne Kanai, Grace Baracao, Prudential Honolulu Office  
Michael Chandra, John Miller, PIMCO  
Brian Isobe, Patrice Sumikawa-Inouye, N&K CPAs  
Dan Purcell, Public

Absent: Kanoe Margol, Employee Member

Call to Order: There being a quorum present, Chairperson 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.

Chairperson Chu indicated that there is quorum for the meeting; one Trustee is

excused. He welcomed the Trustees and attendees present and those attendees via conference phone. Chairperson Chu opened the meeting with introductions.

Agenda

Item # 1: Approval of Minutes No. 385

Chairperson Chu stated that Minutes no. 385 is presented for the Board's review and action. DAG Tam confirmed that Trustee Inouye is able to vote on this item despite not being present at the September 4, 2014 Board meeting.

**A motion was made by Trustee Villabrille and seconded by Trustee Moto to accept Minutes no. 385, as presented. The motion passed unanimously.**

Agenda

Item # 2: Report by N&K CPAs on Plan Audit

Mr. Isobe, a principal at N&K CPAs, presented its report to the Board on the Plan audit report covering the period ending June 30, 2013, the final year of ING's contract. Mr. Isobe stated that two (2) reports are provided. One is the Report on Internal Controls and Compliance. The other report is the Report on the Financial Statement.

The Report on Internal Control provides the explanation on the scope of testing of the internal controls in place to determine that the procedures are appropriate, and a status of compliance findings with respect to the laws, regulations, and agreements. Mr. Isobe noted that the comments address revisions to the language when making future amendments to the Hawaii State Administrative Rules ("Rules") and the Plan Document. These notes to amend the Rules and Plan Document were reflected in the last Plan audit report. Mr. Isobe recognized that the revisions are time and labor intensive, so suggested that when the Board conducts a major, thorough review of the Plan Document to ensure it is in compliance with legislative and IRS Code changes, it would be a good time to amend the Rules and make revisions to the wording as provided in the report.

Mr. Isobe provided an overview and some details of the Report on Financial Statements:

- In the audit, looked at testing the controls covering contributions, especially the elections of their salary deferrals, and distributions by eligible participants. The demographics of the participants showed that 80% were within the State, and about 20% within the county jurisdictions.
- At this point, ING was the Third Party Administrator working with the employer agencies, so they looked at those controls in place.
- They looked at payments being made. There were \$76 million in distributions. The test sample coverage totaled about 20%, and there were

144 total distributions.

- The test sample was also conducted for the administrative fees that go to the Plan Administrator. From the participant data, they looked at the fees coming out of the individual participant accounts.
- The audit was conducted in accordance with the Government Auditing Standards and U.S. Audit Standards, and does not cover the Management Discussion and Analysis (“MD&A”). The MD&A is required to be a part of the report in accordance with the Government Auditing Standards, but is not a part of the audit scope.
- The MD&A provides a general overview and is information already contained in the financial statements (e.g., net assets, composition of the Plan assets, etc.).
- The Plan’s net position was provided comparatively for the fiscal year ending June 30, 2013 and the prior fiscal year ending June 30, 2012. It was noted that a large portion of the assets are in the Stable Value Fund.
- During the fiscal year, contribution additions totaled \$204 million; total deductions totaled \$80 million. The net increase was approximately \$123 million.
- The notes to the financial statements were provided to explain the background of the Plan and the description of the Plan.
- A description of the investment options offered in the Plan was provided.
- Notes were provided to explain the investment risks that the Plan’s investments are exposed to.
- With respect to the investment fund managers, the testing looked at the internal controls by the custodian.

**A motion was made by Trustee Okumoto and seconded by Trustee Inouye to accept the Plan audit report for the period ending June 30, 2013, by N&K CPAs, as presented. The motion passed unanimously.**

Agenda

Item # 3:

Presentation by PIMCO re: Request to Reconsider the Board’s Decision to Terminate the PIMCO Total Return Bond Fund

Mr. Chandra provided opening remarks and background, and introduced Mr. John Miller, managing director and head of U.S. Retirement Practices, and Mr. Jeff Helsing who is the credit specialist and is available to explain liquidity and transaction costs. He stated that they appreciate the time given to speak to the Board on the nature of Mr. Bill Gross’ departure that has led to many questions.

Mr. Miller gave an update and overview on the outflows from the PIMCO Total Return Bond Fund (Fund) and the resources available to continue managing the Fund and the stability of the team. He noted that they disagree with Mercer’s position on the short-term concerns and resources that PIMCO has available to manage the Fund.

The press release on the October 2014 redemptions within the Fund provided that there were outflows of \$27.5 billion in October; however, Mr. Miller stated that you need to look at the size of a fund as well as the trend of the outflows. The trend has decreased and the pace of the flows is significantly slower. Despite the large outflows, the Fund's NAV was up and the Fund is in the middle of its peer universe in terms of performance. Six (6) weeks into the transition (since Mr. Gross' departure), the data reflects that the transition was managed well.

In response to Trustee Okumoto's question on whether Mr. Gross' departure was an unplanned event and whether PIMCO provided for any additional liquidity prior to his departure, Mr. Miller confirmed that the departure on September 26, 2014 was unplanned. He further explained that it is the investment strategy that puts the Fund in a liquid position so that they are able to meet liquidity demands. When there were liquidity demands on September 26, 2014, PIMCO was able to meet those demands without any additional liquidity. This Fund operates in the most liquid sectors of the bond market. The investment strategy is the factor that drives performance, not redemptions. In addition, with exceptions of the additional redemptions, PIMCO does not anticipate any large redemptions over the next few months. Timing will be over the course of months versus days or weeks. Therefore, PIMCO will still be able to manage the Fund and meet redemptions in accordance with its objectives.

Mr. Chandra stated that the Fund is used by 25,000 plan sponsors across the U.S., and noted that the press generally reports on the plans that have stopped using the Fund (not on the positives, timelines, and the vast majority who have stayed with the Fund).

In response to Mr. Williams' question on the processes that are being developed, coordinating with record keepers on the timing of the potential outflows and how PIMCO is managing the Fund with respect to maintaining the philosophy and process of the Fund, Mr. Miller stated that:

- They look at and evaluate trends and identify likely redemptions.
- They have conversations with larger clients and dates that redemptions would likely will happen.
- They have conversations with record keepers to understand what their que is for redemptions.
- The initial media reports that the bond market will freeze and that PIMCO will not be able to meet the liquidity demands is not true.
- They are cognizant of liquidity needs and feel they are in a good position to meet the liquidity demands of their clients.
- They believe it will continue to be a core flagship strategy and to forecast expected outflows is difficult. This speaks to the stability of the team.
- Of the \$27.5 billion in outflows, the vast percentage is associated with wealth

management involving individual decisions, and a smaller percentage is associated with retirement plans.

- There is only one structural change over the past six (6) weeks and that is Dan Ivascyn replaced Mr. Gross as the new Chief Investment Officer. There is no change to the investment philosophy or investment process in which they manage the Fund's assets. Mr. Miller noted that even though it is difficult to forecast, they have confidence in managing the assets and the liquidity, as they reach a new norm.

Mr. Helsing added that in case of a large draw down, it would be unlikely that there will be a performance impact other than negligible.

Mr. Purcell commented that the bond market is not as liquid, so feel items would need to be discounted in order to sell. Also, PIMCO may have to keep a lot of cash to accommodate the transfers out which could hurt the bottom line. Whatever decision is made, participant investors can choose among the other options.

**A motion was made by Trustee Villabrille and seconded by Trustee Inouye to move into Executive Session at 10:20 a.m., to confer with the Plan's legal counsel. The motion passed unanimously.**

All guests were excused from the meeting.

#### EXECUTIVE SESSION

Chairperson Chu called for a short break at 11:14 a.m.. Executive Session resumed at 11:22 a.m..

#### Meeting

**Reconvened: A motion was made by Trustee Villabrille and seconded by Trustee Okumoto to move out of Executive Session at 11:36 a.m. The motion passed unanimously.**

PIMCO, Prudential representatives, and Mercer consultants rejoined the meeting in person and via conference call.

**A motion was made by Trustee Young and seconded by Trustee Inouye to reconsider the Board's decision made at the October 27, 2014 meeting, to terminate PIMCO, move the assets from the PIMCO Total Return Bond Fund to the BlackRock U.S. Bond Index Fund, and the conduct a search to replace the PIMCO Total Return Bond Fund.**

Trustee Moto noted that he stands on the prior motion and decision by the Board to terminate the PIMCO Total Return Bond Fund, based upon the advice by the

Plan's consultant and that the concerns still exist as we may see further withdrawals from the Fund.

Trustee Young noted that he recognizes the concerns and trends over past 45 days but feels that the decision should consider the longer view of past performance and a longer term performance possibilities of the Fund. The exit is an extraordinary event; however, one fund manager does not make the total performance of the Fund. There are other fund managers, and despite the decline of assets PIMCO still has a large amount of Assets Under Management, and the assets that have moved out did not follow Mr. Gross to his new firm, Janus.

Trustee Young clarified that the motion would reconsider the Board's prior decision and therefore, a search would not be initiated to replace the PIMCO Total Return Bond Fund and would not terminate PIMCO from the Plan. A "No" vote represents standing on the prior Board decision.

**The motion failed to pass, with three (3) "yes" votes and three (3) "no" votes. Because the motion failed to pass and no new motion was made thereafter, the Board's prior decision at its October 27, 2014 meeting stands.**

Mr. Chandra thanked the Board for its time and consideration for allowing PIMCO to attend today's Board meeting. He added that PIMCO respects the decision made by the Board.

#### Agenda

Item # 4: Performance Evaluation Report by Mercer for 3<sup>rd</sup> Quarter 2014, Period Ending September 30, 2014, including but not limited to:

- a. Performance Overview on Funds Currently on the Watch List: Century SMID Growth Fund, Harbor Small Cap Value Fund, and MainStay Large Cap Growth Fund

Mr. Williams provided an overview for the quarter ending September 30, 2014, and noted that much of the report for the 3<sup>rd</sup> Quarter was presented at the October 27, 2014 meeting; therefore, a brief overview and performance snapshot will be covered today:

- Performance of the Lifecycle Portfolios did outperform their custom indices despite the negative performance for the quarter, and has good long term performance.
  - The MFS and EuroPacific Growth funds contributed to the performance; the Wellington, PIMCO and the JP Morgan funds contributed to the drag in the performance.
- The BlackRock funds were in line with respective indices.
- The Stable Value Fund had a solid long term performance. The Fund

continues to deliver strong results. There are no recommendations for changes to this strategy.

- PIMCO for the quarter had a slight underperformance compared to a positive benchmark. Long term performance is favorable. Allocation to TIPS and exposure to Mexican and Brazilian bonds were contributors to the underperformance.
- JP Morgan Diversified Real Return strategy had a negative performance due to commodities, natural resources, and REITs during the quarter.
- Vanguard Wellington fund had a slight underperformance compared to the index; long term performance is favorable.
- Wellington Research Value fund underperformed for quarter; long term performance is favorable.
- Victory Diversified Stock Fund underperformed for quarter due to stock selection in the healthcare, industrials and energy sectors.
- MainStay had a positive quarter and outperformed the benchmark. Mercer continues to recommend keeping the fund on the watch list.
- Harbor Small Cap Value outperformed for the quarter; long term performance is in line with the benchmark.
- Century SMID Cap fund continues to behind.
- Schroder fund had long term performance in line with the benchmark.

Mercer does not have any other recommendations at this time.

#### Agenda

#### Item # 5:

#### Old Business

##### a. Follow-up on Early Vacation Payout (EVP) Issue

DAG Tam referred to Minutes No. 385 and provided a summary of the EVP issue. A request was made at the September 4, 2014 Board meeting to research whether there would be any legal impact that would jeopardize the tax exempt status of the Plan. DAG Tam stated that the decision at the meeting was to allow the department to reverse the EVP deferral in question. Based on the provision in the Code and Treasury Regulations, the deferral is considered “includible compensation” and appears to meet the requirements of the IRS and the Treasury Regulations. Thus, reversing the deferral would probably not jeopardize the Plan’s tax exempt status.

The department would need to determine other impacts to Employer obligations such as collective bargaining issues.

Trustee Moto opined that it does not seem necessary to rescind the Board’s motion done at the September 4, 2014 meeting, as the Board only granted the department’s request. He noted that the Board did state that

the department to determination to reverse is up to the department.

The decision on whether the deferral should be reversed or not is up to the department and/or the employee.

- b. Follow-up on Participant Issue Involving Erroneous Vacation Payout Deferral Amount and Recovery of any resulting Gain/Loss

Ms. Akiyoshi summarized the issue that was presented at the September 4, 2014 Board meeting, and reported that the reimbursement request (to cover the loss incurred by the participant) was presented to the department; however, it was relayed that the fiscal officer felt that the department should not have to reimburse the Plan. Further discussions will be scheduled with the department. Chairperson Chu suggested that a written memo be issued to the department.

- c. Status on Contract Award fir RFP No. DCP-FY-14-1, For a Small/Mid Cap Growth Equity Investment Option (in Executive Session Pursuant to HRS sections 92-5, 103D-105, and 103D-303)

Agenda

Item # 6: Review and Discussion on Request for Proposals for Investment Consultant Services (in Executive Session Pursuant to HRS sections 92-5, 103D-105, and 103D-303)

**A motion was made by Trustee Inouye and seconded by Trustee Villabrille to move into Executive Session at 12:44 p.m., to discuss procurement items (Agenda items # 5.c. and # 6) and to confer with the Plan's legal counsel. The motion passed unanimously.**

Chairperson Chu called for a break at 12:44 p.m.. All guests were excused from the meeting.

EXECUTIVE SESSION

Meeting

Reconvened: **A motion was made by Trustee Inouye and seconded by Trustee Villabrille to move out of Executive Session at 12:54 p.m. The motion passed unanimously.**

Agenda

Item # 7: Other Business/Announcements

Ms. Akiyoshi stated that a meeting is not anticipated for the remainder of the year,



and will resume the regular meetings for next year. There were no other business or announcements.

Chairperson Chu adjourned the meeting at 1:01 p.m.

**(NOTE: Signed copy on file.)**