

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

**OPEN SESSION MINUTES
SEMI-ANNUAL MEETING
MEETING # 337**

Date: November 10, 2009

Place: Maui Tropical Plantation and Country Store
1670 Honoapiilani Highway
Wailuku, HI 96793

Present: Georgina Kawamura, Employee Member
Scott Kami, Employee Member
Wesley Machida, Employee Member
Ryan Ushijima, Member
Ken Taira, Member

Others: Rodney J. Tam, Deputy Attorney General
Cynthia Akiyoshi and Lily Chu, DHRD Staff
Troy Saharic, Mercer Investment Consulting
Carol Cann, Kristine Matthews and Kim Alger - ING-Boston Office
Jeanne Kanai, Melody Takacs, and Grace Baracao - ING – Honolulu Office
Sheila Fried, ING - Maui Office
Carl Lutz, Life Insurance Company of the Southwest
Mark Kneische, Alliance Bernstein
Lily Matias, Capital Research (EuroPacific)
Peter Whitlock, Century Capital Management
Robert Atwell, HCA Securities (Harbor Funds)
Molly Newcomb Ono and Todd Egger, Invesco
John Maschoff and Tom Smythe, New York Life (Mainstay)
Gregory Grabar, Sr., PIMCO
Joan Larsen and Frank Terpenning, Prudential
Sue Bonfeld, Wellington
Brad Norton, Victory Connect

Absent: Marie Laderta, Chairperson
Sandi Yahiro, Employee Member

Call to Order: There being a quorum present, Trustee Kawamura called meeting to order at 9:00a.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 and Introductions

Trustee Kawamura welcomed everyone in attendance at the meeting and asked that each person in attendance to introduce themselves.

a. Annual Report from ING

Kim Alger of ING stated that in a recent announcement, ING made a decision to separate the banking and insurance divisions of their company globally. Retirement services and corporate operations will be under the insurance umbrella. What happens under the insurance umbrella still needs to be determined. ING's re-structuring and re-organization is a getting Back to Basics program that is looking at synergy, reducing risks, and re-evaluating all companies to ensure that the right core companies are there. ING will continue to improve on customer needs and promises to service customers at the highest level. ING is not cutting costs, but re-investing in the company to provide top-notch level of customer service.

Ms. Cann referred everyone to Section 2 the Executive Summary of ING's Board Report. Comparing the Third Quarter Assets of 2008 to 2009, there was an increase of \$59.182 million. The average balance for the Plan increased by a little over \$2,000 from the Third Quarter 2008 to Third Quarter 2009. In accomplishments year-to-date, ING processed over 300 Hybrid Plan Trustee to Trustee Transfers since October 1, 2009. The local ING office spent a lot of time ensuring the accuracy and timeliness of the transfers. Trustee Machida stated that 95% of the Hybrid Plan Upgrade Program fund transfers came from ING and commended ING for being extremely accommodating to participants.

Other ING initiatives were the Going Green Initiative, conversion of the AXWAY Transmission Server for the State of Hawaii payroll files, and replacement of the Wells Fargo Large Cap Growth Fund with the Mainstay Large Cap Growth Fund. Upcoming initiatives include the addition of a brokerage window option with TD Ameritrade and adding index funds to the Plan's investment options. Ms. Cann reviewed Section 3 – Local Office Support statistics. For Section 4 Advisor Service Usage, there was a significant increase of 13%. Local office representatives are now advisors too. There were 840 participants using the Professional Account Manager, which is also a significant number.

Ms. Matthews reported on Section 9, ING's Communication Accomplishments. Upcoming initiatives include seeking Board support

for the launch of the Brokerage Option, announcement of the index funds, and educational topics for Unforeseen Emergency Withdrawals (UEW), and spotlight on the Plan's investments.

b. Annual Performance Report on the Part-Time, Temporary, and Seasonal Employees (PTS) Plan by Life Insurance Company of the Southwest

Mr. Carl Lutz reported that the Plan assets up to June 30, 2009 were \$72,795,045 and contributions to date were \$95,414,163. The State's savings amounted to \$7,534,433 and a total of \$78,875,708 since inception in 1997. These savings are realized by not having to pay the employer portion of Social Security tax. The average number of active participants per month is 10,717. Participants from the Department of Education make up the majority or 89.1% of the enrollments and the average account is a little more than \$1,000. The Hawaii PTS website had almost 4,800 hits for the period July 1, 2008 to August 30, 2009; whereas, the year before that, there was very minimal usage. As a result, telephone inquiries decreased. A Hawaii escrow account set up by LSW contains almost \$81 million as of October 31, 2009 to protect the assets in the Plan. All in all, it was a good year with no bumps.

Agenda
Item # 2:

Semi-Performance Evaluation Report from Mercer Investment Consulting

Mr. Troy Saharic directed the Board to his Third Quarter 2009 Investment Review report and began his presentation with a review of the macroeconomic and capital market environment on page 4 of the report. The third quarter showed a GDP estimated increase of 2.4% which was actually caused by the Stimulus Package. This means that the consumers are sitting on the sidelines and just watching. The 10% unemployment rate on page 5 shows a disconnect between the U.S. capital markets and the economic conditions which makes Mercer very nervous about where the economy is heading. The domestic equity charts on page 11 revealed strong returns with double digit returns in every sector of the market and the small caps outperforming the large caps. The non-U.S. equities market on page 16 outperformed the broader U.S. equities market with the emerging markets up 21% for a 64.9% year-to-date total. On page 17, emerging markets in all countries shown posted positive gains year-to-date. On the fixed income side, page 18, the Barclays Aggregate Index finished strong, up 3.7% for the quarter as credit spreads narrowed.

The Plan finished at almost \$1.5 billion at quarter-end (see, page 24), which is a 6.9% increase from the previous quarter-end. Assets increased by \$59.6 million for the year ending September 30, 2009. The historical asset growth chart (page 25) shows that the Plan for the 3rd quarter is back to its 2007 4th quarter levels. The top 5 funds on page 26 dominate the total Plan assets. The transfer activity chart on page 27 shows where participants are moving their assets. Mr. Saharic indicated that they are not seeing the level of activity expected from participants

reacting to the economy. Activity actually decreased. The international options looked fairly attractive to participants.

An analysis of the investment option estimated fees (page 29) shows that investment management fees are very low. The fund expense ratio for the Hawaii Stable Value Fund is 25 basis points. For the Bernstein International Value Fund, management fees are currently at 91 basis point and participants will be seeing a fee reduction due to switching of shares. In regards to the Stable Value Fund (page 31), the majority of the numbers are green, indicating that the Fund outperformed both benchmarks. The credit ratings are high and managers are doing well. On page 32, the PIMCO Total Return Fund is showing very strong returns. However with the economy, PIMCO is positioning for lower growth rates and taking some risks to be much more allocated. Vanguard Wellington, a balanced fund, showed a decent performance for the 3rd quarter with the help of non-U.S. funds. The LifeCycle Funds showed a bit of a lag and although the rankings do not look as strong as the other options, not to worry because these funds are more conservative. Wellington Research Value Fund (page 34) had very nice rebound figures. The Wells Fargo Fund option went way and left on a high note with new stocks that they added to their portfolio. However, Mercer believes that the switch to Mainstay is a much better alternative.

Mr. Saharic stated that he would like to see better performance with Harbor and Century Small Cap funds. In the International Equity area (page 35), the EuroPacific Growth fund has continued to do very well with 34.5% year to date and similarly for AllianceBernstein. However, some organizational changes in AllianceBernstein have Mercer concerned.

The Stable Value credit rating is 4.47% for the 3rd quarter and Mercer hopes it continues to grow. Prudential will be increasing their wrap fees for the Hawaii Stable Value Fund (page 38). The fee increases are due to higher perceived risk of doing business in the current economic environment and in order to stay competitive. This is consistent with what is happening in the market. The changes result in a 5 basis points increase on the first \$100M, 8 basis points increase on the next \$400M, and 8 basis points on the excess of \$500M. The increase will take effect on January 1, 2010. In October, Mercer was informed of Morgan Stanley's (MS) decision to sell its retail asset management business to INVESCO. This decision is part of MS's restructuring plans to focus on the institutional space, and to further its commitment to institutional clients globally.

PIMCO recently hired Marc Seidner on August 17, 2009 as an Executive Vice President (page 40), which is the highest title outside of a Managing Partner. With this hire, it appears PIMCO is adding quality depth to its team of generalist portfolio managers (PMs) to help bolster the bench strength of senior members of the investment team. Mercer views the hiring of Seidner as a positive gain for the firm unless the news of his hiring is accompanied by the announcement of generalist PM departures.

Former Bernstein CEO, Lew Sanders, formed his own asset management firm called Sanders Capital Management and as a result, some investment professionals left Bernstein to join him. This jeopardizes our confidence level as Lew Sanders is a well respected figure head amongst investment teams. Mercer will continue to monitor the firm closely and report to the Board as necessary.

Capital Guardian (page 42) announced on October 1, 2009 that the firm will be making a series of changes to the line-up of portfolio managers running the global and non-U.S. equity products. The changes outlined will go into effect during the 4th quarter of 2009, but Mercer does not expect to see any negative impact on the growth rate of the fund.

Mr. Saharic reviewed with the Board key issues and recommendations for the 3rd quarter. They are: (1) Wells Fargo Advantage Large Company Growth Fund was replaced by the MainStay Large Cap Growth Fund and assets were transferred on October 16, 2009, (2) INVESCO was put on the watch list on August 15, 2007 and has been doing better. Mercer may take INVESCO off the watch list, but will continue to gather and review for now, (3) the Board approved the change from the Bernstein International Value H share class to P share class and may run that with the brokerage window, (4) the Board is in the process of adding Passively Managed investment options to the Plan's line-up, and (5) the Board moved from annual to monthly LifeCycle rebalancing, with rebalancing last occurring on September 15, 2009.

Trustee Machida asked, "Where does Mercer see the market heading in 2010?" Mr. Saharic's response was that Mercer is very nervous with the equity markets right now. He foresees a correction in the equity markets. They are watching this very closely as there are a lot of things happening in Congress, such as Healthcare Reform bill. That could drive where we go in 2010. Mr. Saharic stated that he is very nervous in the short term equity market.

A handout of the updated performance of investment options was distributed to the Board.

Trustee Kawamura called for a break at 10:05 a.m. The meeting reconvened at 10:24 a.m.

Added to

Agenda:

A motion was made by Trustee Machida and seconded by Trustee Kami to add to the end of the agenda an item on the Board's approval of PTS Plan Report on Funds not deposited in the State and County Treasuries for July 1, 2009 to September 30, 2009. The motion passed unanimously.

Agenda

Item # 3:

Panel Presentation # 1 by Wellington Management Company, Victory Capital

Management; and New York Life Investment Management

Topic: Indicators to Watch

Mr. Brad Norton of Victory Capital Management started the presentation with the definition of Gross Domestic Product (GDP). Gross Domestic Product is the market value of goods and services produced by labor and property in the United States, regardless of nationality. The largest component of GDP is Personal Consumption Expenditures which makes up almost 70% of GDP. What to look for in GDP is when the rate of decline becomes smaller (less bad) the market views this as a positive signal. Page 4 of the handout looks at how the unemployment rate affects the real GDP. The unemployment rate is defined as the number of unemployed persons divided by the labor force, where the labor force is the number of unemployed persons plus the number of employed persons. Persons are classified as unemployed if they do not have a job, have actively looked for work in the prior 4 weeks, and are currently available for work. What is important to look for is a decrease in the number of unemployment claims and an decrease in the unemployment rate. The earnings expectations (page 7) is a forecast of future earnings determined by the consensus of investment professionals. If earnings improve, the market is positive.

Ms. Sue Bonfeld of Wellington Management Company spoke on inflation indicators. Gold and oil are two commodities that pretty much speak for themselves and follow the supply and demand for them in the market. The next indicator, Output Gap, measures the actual output with installed capacity versus potential output which could be produced if capacity was fully used. This index is released monthly by the Federal Reserve but there is a couple of months lag. ISM Prices Paid is the Institute for Supply Management and gives an overall manufacturing sector trend. An index of above or below 50 indicates whether the manufacturing sector is expanding or contracting. PPI (or Producer Price Index) is a business to business index that looks at future price changes as an inflation indicator in the U.S. only. CPI or the Consumer Price Index is issued by the Bureau of Labor Statistics and measures the average change in prices paid for a market basket of goods and services. There are many problems with using the CPI. For one, it does not account for substitutions and does not calculate changes that incorporate quality and desirability. It also does not include the cost of housing in terms of pollution. It includes rental income. The CPI is calculated by telephone or personal visits (i.e., the person comes knocking on your door).

Mr. John Maschoff of New York Life (Mainstay) spoke on the impact of energy and housing on consumers and the economy. In 2006, money was free. The spending, investors, individuals, traders, homebuyers, etc. were all at the expense and the discipline of risk. That was the problem at that time. The brick economies (i.e., Brazil, Russia, India, China- developing markets) were all on fire from an economic standpoint. Equity markets were doing well. In the spring of 2007, there was an erosion of housing prices and oil prices. This was a deadly combination. In the summer of 2008, energy prices peaked at \$145 a barrel and

the housing prices had started to decline. Consumers played a very important and powerful factor in the U.S. economy. Consumers continue to face headwinds from the lower home values and the cyclical rise in energy prices. There is a tremendous growth in the emerging markets in India and China. In the housing market, the reality is catching up and there is a new wave of homebuyers losing their homes to foreclosures. This pushes the inventory up and keeps the pressure on housing prices. New York Life is concerned about the consumer.

Agenda

Item # 4: Panel Presentation # 2 by Century Capital Management and Harbor Funds Distributors, Inc.

Topic: Implications of the Low Quality Rally in Small Caps

Mr. Peter Whitlock of Century Capital Management started off his presentation by talking about the changes going on in the marketplace. Last year, the Dow had been continuing to fall and then started moving up again. What is a “high quality” small cap business? Quality as defined differs from firm to firm. Basically, it is a company that has consistent earnings or profitability, high and recurring free cash flows, and strong balance sheets with low financial leverage. Qualitatively, they have a dominant industry positioning because of their strong management team. Power quality companies tend to lead where we are coming out of tough environments. Factors contributing to the current low quality rally are: (1) many companies left for dead in the downturn have benefited from an improved credit environment and lowered earnings expectations from 2009 and (2) the year-to-date statistics up to October 31, 2009 for small cap mutual fund inflows (over \$7 billion) and small cap ETF inflows (over \$1 billion) have been strong, potentially helping boost the smaller small caps.

Mr. Robert Atwell of Harbor Funds Distributors, Inc. reviewed the Russell 2000 Index and the historical context of leadership rotation in small caps. The Russell 2000 Index jumped 77% during the period of March 9, 2009 to September 30, 2009, which is much stronger than the 70% jump during the period of October 9, 2002 to December 30, 2003. Looking ahead, the 2010 market could resemble the 2004 market where the largest market cap beat the Russell 2000 by over 90%. Small/mid cap investors believe that rotation where “high quality” stocks start outperforming has occurred this year and into the first quarter of 2010. October of 2009 was the first month where the rotation of leadership occurred and the lower quality stocks were hit the hardest (see, page 12). There is still over \$3 trillion sitting in money market mutual funds. The current low-quality rally is longer and more pronounced than usual. This trend may have begun to show signs of reversing. Century Capital Management and Harbor Funds Distributors could benefit from this reversal when it materializes.

Agenda

Item # 5: Other Business

DAG Tam reviewed with the Board members the definition of “unforeseeable emergencies” and the criteria for Unforeseeable Emergency Withdrawals.

a. Ratification of UEW Case Nos. 220A (Revised) and 226

UEW Case No. 220A was reviewed and discussed.

A motion was made by Trustee Kami and seconded by Trustee Ushijima to ratify the UEW subcommittee's decision to approve UEW Case No. 220A. The motion passed unanimously.

UEW Case No. 226 was reviewed and discussed.

A motion was made by Trustee Ushijima and seconded by Trustee Taira to ratify the UEW subcommittee's decision to approve UEW Case No. 226; provided that the participant provides copies of the past due bills. The motion passed unanimously.

b. Review and Action on UEW Case Nos. 255, 263, 269, and 278

UEW Case No. 255 was reviewed and discussed.

A motion was made by Trustee Ushijima and seconded by Trustee Machida to approve the UEW request, and to address events such as a divorce as a qualifying, triggering event for an unforeseen emergency on a case-by-case basis. The motion passed unanimously.

UEW Case No. 263 was reviewed and discussed.

A motion was made by Trustee Ushijima and seconded by Trustee Taira to approve the UEW request in the amount of \$8,000 as requested. The motion passed unanimously.

UEW Case No. 269 was reviewed and discussed.

A motion was made by Trustee Machida and seconded by Trustee Kawamura to approve the amount requested. The motion passed unanimously.

UEW Case No. 278 was reviewed and discussed.

A motion was made by Trustee Machida and seconded by Trustee Kami to approve the cost of the funeral expenses only upon reconsideration based on the participant's appeal. The motion passed unanimously.

DAG Tam mentioned that there were 7 new cases and an additional 28 cases to be reviewed. He recommended that a separate Board meeting be held to go over the UEW process and the UEW policy with regards to furloughs. He anticipates that more and more employees will be requesting UEWs when financial hardship arises due to being furloughed.

The Board agreed to convene a meeting on November 20, 2009, Friday, at 8:30a.m. The location will be determined later. Trustee Ushijima suggested that the Board should consider delegating the authority of deciding on UEW cases to ING because the subcommittee is not always able to meet.

c. Approval of PTS Plan Report on Funds not Deposited

A motion was made by Trustee Ushijima to approve the PTS Plan Report on Funds not deposited in the State/County Treasuries for the Period July 1, 2009 to September 30, 2009 and seconded by Trustee Machida. The motion passed unanimously.

A motion was made by Trustee Ushijima and seconded by Trustee Kawamura to adjourn the meeting at 11:45 a.m. The motion passed unanimously.

(Note: Signed copy on file)