

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

**OPEN SESSION MINUTES
SEMI-ANNUAL MEETING
MEETING # 386**

Date: October 27, 2014

Place: Hilo Hawaiian Hotel
Mokuola I Room
71 Banyan Drive
Hilo, HI 96720

Present: Wayne Chu, Chairperson
Kalbert Young, Ex-Officio Member
Kanoë Margol, Employee 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, Mercer Investment Consulting
David Williams, Mercer Investment Consulting
Alex Williams, Mercer Investment Consulting – via conference call
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 – via conference call
Deborah Baran, Prudential Retirement
Paul Dowd, MorningStar Investment Advisory Services
Todd Egger, INVESCO
Robert Atwell, Harbor
Vince Ortega, Capital Group (American Funds)
Steve Caruthers, Capital Group (American Funds)
Lisa Rosenthal, Victory
James Carville, BlackRock
Marco Merz, BlackRock
Tom Smythe, New York Life (Mainstay Investments)
Cheryl Lynch, Jennison Associates

Joan Larsen, Prudential
Cris Hernandez, Wellington Management Co.
Taylor Alan-Lee, PIMCO
Matt Westhoven, MFS
Gamaliel Blanco, Schroders
Carl Lutz, Life Insurance Company of the Southwest
Ata Azarshahi, Life Insurance Company of the Southwest
Dave Smith, National Benefit Services

Absent: Cindy Inouye, Ex-Officio 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 welcomed the Trustees and all attendees and thanked everyone for attending today's meeting. Chairperson Chu asked for introductions from the Board, guests in attendance, and attendees participating via the conference line. Trustee Inouye was excused from today's meeting.

Agenda

Item # 1: Semi-Annual Report from Prudential Retirement

Presenting from Prudential Retirement are Ms. Julie Klassen via conference call, Mr. Kevin Malmud, Ms. Jeanne Kanai, Deb Baran, and Mr. Paul Dowd.

Ms. Klassen opened with an introduction and provided the following highlights:

a. Contribution Monitoring Project:

Prudential is looking at ways to enhance monitoring and more automation in terms of payroll deductions and changes that participants make throughout the year. Anticipate scheduling of a future meeting with DAGS, primary payroll system in the State.

b. Strategic Business Plan

Overall participation in the Plan is at 26%, based on all active eligible employees. Some departments and sub-plans do have a higher participation rate.

c. Local Staff Strategic Developments

There have been strategic efforts by Local team to conduct outreach through Hawaii State Teachers' Association and Teacher's Institute Day events.

d. Asset Allocation Initiatives

The Stable Value Fund has 44% of the Plan's assets. Prudential is looking at ways to increase diversification. Within the Plan, the average number of funds per participants is 4, compared to Prudential's book of business at 5.6.

e. Asset Retention Efforts

Asset retention is always a major topic among large governmental plans. The last 3 quarters have shown the amounts of the inflows is about the same as the amounts of the outflows. They are looking at the broker dealers who are receiving the rollouts, because they have observed that 64% of the monies are being rolled out.

Ms. Klassen stated that the total assets in the Plan (as of September 30, 2014) are over \$1.9 billion; and further provided a summary of the demographics within the Plan, explained the asset allocation by funds, education tools available, and the number of participants including the distribution by participants, types of participant transactions, and some behavior statistics.

Mr. Malmud reported on the Local Office activities:

- The Local Office staff has been participating in DOE's Teacher Institute Day events held last week across the islands, and plan to participate in next year's events. Also participated in the second new teacher's orientation with over 100 in attendance, in the HGEA stewards meeting with over 300 stewards in attendance which led to a principals' meeting, and they are working with University of Hawaii to hold mini fairs on campus.

Ms. Baran provided communication highlights:

- Ms. Baran reviewed the website activities and noted that there was a 35% increase on new visitors to the website.
- Have observed a number of visits that have generated more traffic as a result of the log-ins.

Mr. Dowd introduced himself and presented information on Morningstar. He noted that participants have access to various tools and access to help. Participants can build a customized individual portfolio, based on a strategic process.

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Item # 2: Investment Performance Evaluation Report from Mercer

a. Economic and Capital Market Environment

Mr. Saharic provided an overview of the economic and capital market environment for the 3rd Quarter 2014:

- In 2014, the markets had a phenomenal year.
- U.S. Domestic equity sector was volatile and was not a particularly good quarter. Large cap stocks did well, small and mid cap equities were down.
- Non U.S. equity stocks declined incrementally more than the broader U.S. equity markets.
- Barclays U.S. Aggregate index (fixed income) was up incrementally only by 20 basis points.
- REITS and commodities were down incrementally more than the broader market.

Mr. Williams provided the following report on the Plan's investment structure:

- The major assets are covered and do not have recommendations at this time.
- Manager updates: On September 26, 2014, Bill Gross left PIMCO (which was on the heels of the departure of Mohammed El-Erian). PIMCO named Dan Ivascyn as successor. At MFS, Michael Roberge was named co-Chief Executive Officer. Mercer does not anticipate any significant impacts to the investment teams at this time.

Mr. Williams provide Plan highlights:

- No significant changes to the fund expense ratio and average 31 basis points.
- The Lifecycle Portfolios outperformed its benchmarks.
- The BlackRock Index passive strategies were performing in line with its indices. Mr. Saharic added that post 2008, participants have experienced a number of different cycles between active and

passive management which is the reason for a balance of both options. Post 2008, active managers lagged as macro trends were in favor, and in 2013, active managers did better.

- The Stable Value Fund continues to be the largest single option in the Plan with about 44% of the Plan's assets. Performance has been very strong. A lower yield environment has kept the rates down a bit.
- Both the INVESCO and Jennison strategies have worked well.
- PIMCO Total Return performance is a bit behind the benchmark on year-to-date. Long term continues to be favorable.
- JP Morgan strategy performance is slightly behind for the quarter.
- Vanguard Wellington's long term performance continues to be favorable.
- Wellington Research Value has been slightly behind the benchmark on a year-to-date but favorable relative to peers.
- Victory Diversified Stock fund is behind its benchmark on a year-to-date.
- MainStay Large Cap Growth Fund performance bounced back during the 3rd quarter. Performance has been positive quarter-to-date compared to its benchmark.
- Monitoring Harbor's long term performance; not recommending any further changes.
- Century SMID cap strategy is a bit behind on a year-to-date; long term performance is still trailing its benchmark.
- MFS International value strategy and the EuroPacific Growth strategy are down on absolute basis but ahead on a relative basis.
- Schrodgers' long term performance is favorable but a little behind on a year-to-date basis.

Agenda

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

Presentations by Carl Lutz, Ata Azarshahi, and Dave Smith:

Mr. Lutz introduced Mr. Azarshahi who is also assigned to the Plan, and Mr. Smith who is with National Benefit Services, the record keeper for the Plan.

Mr. Lutz provided an overview of the history of the Plan and current statistics of the Plan. The Plan assets currently total \$104 million. The State has saved \$7.8 million last year. The bulk of the participants are still in the DOE. The current crediting rate is 2.87% as of July 1, 2014.

Chairperson Chu called for a break at 9:55 a.m. The meeting resumed at 10:13 a.m.

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Item # 4: Panel Presentation # 1 on Stable Value Market Update: by Prudential, Jennison Associates, and INVESCO.

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

Mr. Williams explained that the presenters will talk about the state of the Stable Value fund market and provide an update since the financial crisis, and also how things have changed with respect to wrap providers, guidelines, and fees.

Ms. Larsen talked about the arrangement of the Stable Value Fund, with the Fund split 50% between Prudential/Jennison and INVESCO.

Mr. Egger provided an overview of the historical arrangement (e.g., track record and objectives) and the arrangement before the 2008 crisis and after the crisis. By design, the Stable Value Fund smoothes the gains and losses over time so as not to see the extreme volatility as seen during a crisis. They are keeping an eye on legislation on whether wrap contracts would be considered swaps. There is indication that this will not be the case and that anything currently in place will be grandfathered. But they are monitoring the situation. Before the crisis, wrap contracts were readily available. Post crisis, managers saw challenges with wrap capacity and are now trying to adapt to new constraints and changes.

Ms. Larsen stated that banks have been staying away from wrap contracts. The universe has expanded to a number of contract issuers and seeing new entrants; several issuers may start to open up capacity. Prices have declined but competitive pressures impact the fees. The investment guidelines have gotten tighter and vary by issuer.

Ms. Lynch described the portfolio characteristics: that the portfolio is position competitively and there is an overweight to longer credits and underweight on the shorter end of the curb. They see a potential for global central banks to maintain fiscal stimulus which would keep yield steep, so to offset that they will maintain a neutral credit exposure while underweighting riskier assets, focus on higher quality assets, avoid higher beta credits as sovereigns, and optimize along the yield curb and add positions in the intermediate yield curb. They will continue to monitor the spreads and adjust the portfolio accordingly.

Mr. Egger summarized some points on the rising interest rate environment and the expectations for the portfolio. He explained the historical perspective and the pace of the stable value market versus the other fixed income indices. Stable value

has performed short to medium term (intermediate bond fund level returns). In a 5-year look forward, market expectation is for rates to increase. Stable value will continue to provide positive returns and outpace money market. In a rising rate environment, market-to-book value may drop but fund would still perform well.

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Item # 5: Panel Presentation # 2 on Active versus Passive Management: by Capital Group, MFS, and BlackRock

Presenters: Steve Caruthers from Capital Group, Matt Westhoven from MFS, and Marco Merz from BlackRock.

Mr. Williams commented that the market has seen the passive management outperform active management on a year-to-date basis, and the market is cyclical. So, the panel will be presenting on both types of options.

Mr. Westhoven presented on active management and when it works and when it does not work. Research conducted on active managers' performance at end of 2008 and between 2009 and 2011, found that there was not a consistent theme among the median active managers and so investors may have had better results in index funds during the period the market was up and down. What to look for in a top quartile active manager are to look if they capitalize particular market efficiencies (e.g., unique investment process/research platform, etc.), how they focus on macro events and identify speculative changes. Market noise (e.g., social media, etc.) is causing short-term investing. He concluded that active managers stay focused with long-term objectives.

Mr. Caruthers presented on some common misperceptions:

- Active managers cannot beat the index. The average active manager cannot beat the index; however, you can identify things within the active managers that can help.
- It is impossible to identify managers who can consistently beat the index. He pointed out that their funds have demonstrated that they have been able to outperform the benchmark across a number of time horizons.
- Index investing is a safer choice. Active management has shown that you can protect some of the downside. Compounded returns enable an investor to move above and beyond the benchmark.
- Low fees are available only through index investing. There can be active managers that can be among the lowest in their peers.

Mr. Caruthers concluded by pointing out that over the last rolling 10 year periods the EuroPacific Growth fund has outperformed its benchmark 98% of the time.

Mr. Merz presented on passive management. Trends have shown a large flow into index funds and an increased allocation to index funds within the defined benefit and in defined contribution plans. From around 2006 through today, there was a 170% increase in index funds. He noted that the average industry fee for active management is 90 basis points whereas with the Plan's S&P index fund the average fee is 4 basis points. The place where an investor should use active management is where you cannot get beta exposure.

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Item # 6: Other Business/Announcements

Chairperson Chu announced the departure of Trustee Barbara Krieg and read a resolution that has been prepared which will be presented to her at a later date. Chairperson Chu invited attendees for lunch which is being sponsored by Prudential and MorningStar.

Chairperson Chu stated that for the agenda item related to the updates on PIMCO and possible action on the PIMCO Total Return Bond Fund, he asked that the Board move into Executive Session to confer with the Plan's legal counsel.

A motion was made by Trustee Okumoto and seconded by Trustee Villabrille to move into Executive Session at 11:16 a.m. The motion passed unanimously.

All guests were excused with the exception of Mercer.

EXECUTIVE SESSION

Chairperson Chu called for a recess from the Executive Session portion of the meeting at 12:04 p.m.

The meeting resumed at 1:15 p.m. PIMCO joined the meeting.

Meeting

Reconvened: **A motion was made by Trustee Young and seconded by Trustee Okumoto to move out of Executive Session at 2:19 p.m. The motion passed unanimously.**

All guests rejoined the meeting.

A motion was made by Trustee Moto and seconded by Trustee Villabrille to terminate the PIMCO Total Return Fund; liquidate and transfer the remaining assets to the BlackRock U.S. Bond Index Fund as soon as administratively possible; and immediately initiate a search for a replacement active bond strategy. The motion is made based on Mercer's

recommendations and report, and the Board intends to give participants a 30-day period to move their money out of the PIMCO Fund into another investment option in the Plan. The motion passed with five (5) votes in favor and one (1) vote by Trustee Young in opposition.

Mr. Taylor Alan-Lee thanked the Board for its consideration and partnership.

The meeting was adjourned at 2:24 p.m.

(NOTE: Signed copy on file.)