STATE OF HAWAII
DEFERRED COMPENSATION PLAN
BOARD OF TRUSTEES

OPEN SESSION MINUTES
SEMI-ANNUAL MEETING
MEETING # 345

Date: October 21, 2010

Place: Kauai County Mo'ikeha Building
4444 Rice Street, Conference Rm. 2A & 2B
Lihue, HI 96766

Present: Marie C. Laderta, Chairperson
Wayne Chu, Employee Member
Georgina Kawamura, Employee Member
Scott Kami, Employee Member
Wesley Machida, Employee Member
Michael Okumoto, Employee Member
Sandi Yahiro, Employee Member

Others: Rodney J. Tam, Deputy Attorney General
Cynthia Akiyoshi and Lily Chu, DHRD Staff
Troy Saharic and John Bothwell, Mercer Investment Consulting
Melody Takacs, Plan Administrator Staff (ING)/Honolulu Office
Grace Baracao, Plan Administrator Staff (ING)/Honolulu Office
Jeanne Kanai, Plan Administrator Staff (ING)/Honolulu Office
Ron Campana, Plan Administrator Staff (ING-Boston Office)
Brian Merrick, Plan Administrator Staff (ING-Boston Office)
Luke Poussard, Plan Administrator Staff (ING-Boston Office)
Carl Lutz, Life Insurance of the Southwest
Paul Lovell, National Benefit Services
Mark Kniesche, Alliance Bernstein
Jason Di Piazza, BlackRock
Kevin O'Donnell, BlackRock
Lily Matias, Capital Group/EuroPacific
Peter Whitlock, Century Capital
Ben Coll, Harbor Funds
Todd Egger, Invesco
John Maschoff, Mainstay
Tom Smythe, Mainstay
Gary Major, TD Ameritrade
Neil Kilbane, Victory

Lisa Rosenthal, Victory
Sue Bonfeld, Wellington
Sunita Patel, Wellington

Call to Order: There being a quorum present, Chairperson Laderta called the meeting to order at 9:00 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.

Agenda Item # 1: Welcome and Introductions

Chairperson Laderta welcomed all attendees and opened with introductions of the Board members.

a. Annual Report from ING
Presenters: Brian Merrick, Ron Campana, Jeanne Kanai

Mr. Merrick, Director of Government Operations Team, provided an updated report of the status with American Funds and the revenue sharing issue with the EuroPacific Growth Fund:

- Senior manager teams from ING and American Funds have been diligently working together in good faith to resolve this matter.
- American Funds agreed to pay back the 12b-1 fees back to the Plan.
- ING has made the initial calculations of the exact dollar amount to be refunded and American Funds will confirm the amount, and finalize it in the next couple of days.
- ING will provide an analysis and will be developing an allocation strategy and a report for the Board with recommendation on how best to distribute the funds. ING acknowledged the professionalism and cooperation of American Funds as well as the patience of the Board as they worked to resolve this matter.

DAG Tam acknowledged the efforts of ING and American Funds on this issue.

Mr. Merrick, next, presented ING's Strategic Vision:

- ING has been actively participating in the industry and at the recent NAGDCA conference, had an opportunity to interact with some of the groups there.
- ING recently started a premier client advisory council to talk about recent industry events, facilitate discussions between ING's large clients, talk to each other about best practices between government clients, and bring government market colleagues together to share ideas to better service clients.

- Based on feedback from participants, ING has made system enhancements such as a new participant home page which allows the participant to better see their account balance, has a quicker transaction capability, and has a more robust educational content with streaming videos, presentations, etc. It provides lots of opportunities for sponsors or outlying organizations to reach out to the participants. Additional enhancements forthcoming include additional charts and graph capabilities to help them understand the nuances of their plan. This reinforces ING's continual investment in technology and they look forward to getting feedback from the Board.

Mr. Campana reported on the Advice campaign:

- Big accomplishment is the Personal Evaluation Statement Kit that went out early October (distributed to the Board with samples of some other materials). These types of campaigns are effective and successful as shown yesterday when many participants walked up to the advice tables at the Benefits Fair. Many just don't know what to do and the advice capability gives them that opportunity and is doing very well. There were a number of materials put out for the National Save for Retirement Week campaign.

- Upcoming initiatives include:
  - Asset retention;
  - Campaign to target retirees or those nearing
  - Creating the Association for Public Sector Retirees as an avenue for retirees to interact amongst themselves. The Participant Connection is a user friendly, transactional website for participants.
  - Conducting market survey on government workers. Highlights of the survey found that a lot of government workers are paid a lot less than the corporate side and that affects a number of decisions as they save for retirement. Government workers depend on their spouse for decision-making and retirement, so need a campaign to include spouses in the process. Another finding is a need for train the trainer programs to empower participants with information to help others. ING plans to start a campaign to make it easier for participants to respond such as sending postcards so participants can write their questions and easily send it back.

Ms. Kanai provided the Executive Summary report:

- The total asset growth as of June 30, 2009 was $1.385 billion, the same as June 30, 2010 because the ERS Hybrid Upgrade took over $150 million (10% of the Plan's assets);
- The Hybrid closed as of September 30, 2010 with an increase of $3.66 million. The Local office: processed just under 3,000 of the Hybrid

purchases;
- Processed 586 early and post vacation rollovers for a total of $8.9 million;
- Added the 2055 Fund on July 2, 2010;
- Set up 47 new participant accounts (a little under $3 million) in the Brokerage Window;
- Merged a dual pay process for UH of lag and non lag payrolls, so as of August 19, 2010, we have just lag paydates;
- Worked with the County of Maui to convert their payroll processing to ADP (Automatic Processing Inc) in August 2010; and processed 218 Unforeseeable Emergency Withdrawals (UEWs) for a total of $2.7 million since ING took over in December of 2009; and
- Finally, the upcoming initiative is the National Save for Retirement Campaign.

b. Annual report from Life Insurance Company of the Southwest (LSW)
Presenters: Carl Lutz, Executive Vice President of LSW and Paul Lovell, President of National Benefit Services

Mr. Lutz provided the 2009 to 2010 Plan Year report:

- Plan assets total $78,286,911 and for the first time contributions dropped by $1.5 million. This probably meant that the State hired less part-time, seasonal, casual workers, which is consistent with the economy.
- The State saved $6.4 million this year, funds that would have been paid to Social Security, and to date the PTS Plan has saved the Plan $85 million.
- The number of active participants decreased this year and the bulk of the participants still are from the Department of Education and the University of Hawaii system.
- Credited rate is 4.37%
- For the new contract in 2006; an escrow account was setup as collateral for the plan. It had $82 million as of June 30, 2010, which is over-funded.
- The Board requested an audit for the plan year of 2009 – 2010 (the twelve month period ending June 30, 2010). The audit was completed and the preliminary report had no major findings, everything balanced. Along with the report is a management letter provided for internal control purposes identifying three control items. The first item is ineligible participants. The audit found one employee who worked full time at one department and was teaching part-time at night, resulting in contributions to both the regular and part-time plans. Corrections were made. The second item related to Charter School employees and whether Charter Schools should be included in the PTS plan. They

have their own private payroll system through Ceridian and currently their part-time, seasonal employees are not in the plan. HRD is researching whether they need to be in the Plan. The final item is regarding the approval of distributions on the distribution list. The auditor found discrepancies between the number of distributions and the actual list amount. There are two reasons for that; 1) sometimes there are people who change their mind, and 2) sometimes there are problems with the bank or company where they want to setup the fund and the company can't accept the monies so there's really nothing wrong there except that the mechanics of the transfer gets delayed. The auditor found two months where there were more checks cut than signed for on the list, due to the period when there was an acceleration of transfers to the Hybrid Upgrade plan at the end of the month. LSW has taken steps to correct it whenever they need to expedite payments by sending an amended list for signature.

Trustee Yahiro asked for a status on the problem of locating participants with account amounts less than $10 still exists and believes that if problem exists, these accounts have been inactive for more than 10 years. Mr. Lutz said that in the past they discussed what methods can be used to locate these participants with no current mailing address, but have not done anything new at this time. DAG Tam stated that he would check with ING's legal section on what can be done about this. Mr. Lutz stated that he would find out and provide a report of the accounts by size and amount.

Agenda Item # 2: Investment Performance Presentation from Mercer Investment Consulting
Presenters: Troy Saharic and John Bothwell

Mr. Troy Saharic presented Mercer's Third Quarter 2010 Investment Review:

- Economic activity remains muted.
- GDP numbers are estimated at 2.3% and Mercer thinks it will come in lower than that.
- In terms of the government stimulus, there is very little activity. There is increasing speculation of double dipping in terms of a recession. The civilian unemployment rate is ticking up to 9.6%. There is a view of pessimism with the markets and inflation remains rather muted.
- Looking at the domestic equity markets, the market snaps back in the quarter and the S&P 500 was up to 11.3%. Growth outperformed value across all market caps and benefited strategies that had a growth tilt associated with them.
- Small cap and mid cap stocks outperformed large cap stocks; indicating investor's ability to take on some risks.
- The performance of the non-US developed market index showed a 16.5% increase during the quarter for MSCI EAFE. Local currency

terms went up 7.2%, representing the depreciation of the dollar against most Asian currencies. There is a lot of speculation of how far the dollar may decline relative to those Asian currencies, particularly Japan, as their currency appreciates from an export standpoint.

- Emerging markets had third quarter returns of 18.2%, and it is the 8th consecutive quarter that emerging markets outperformed developing markets. There is talk that emerging markets are overheated and a lot of interesting things are happening in emerging markets. There is local consumerism; they are developing their own economies; they are resource rich; a lot of them have been through their own economic crisis a long time ago; they are educated at some of the most prestigious universities around the world. It will be interesting to watch the performance of emerging markets relative to other sectors in the equity market in the next five years.
- On the Fixed Income side, the Aggregate Index had some respectable returns at 2.5% for the quarter and 7.9% for the year-to-date. The opportunistic sectors outside of the Barclays Aggregate did the best in the third quarter. Fixed Income managers who over-weighted the opportunistic sector and underweighted the mortgages and treasuries did pretty well. At the beginning of the year, there was a spike in interest rates and at the end of the year there was a decrease in rates. There is a lot of speculation within the fixed income market and bond managers are all over the map in terms of viewpoints.

Mr. John Bothwell reported on the Plan Investment Review for the third quarter:

- Plan assets were at $1.4 billion, an increase of $50.7 million;
- There are 27,629 participants in the Plan with an average balance of $51,996;
- Assets decreased 3.1% over the one-year period, and it was partially due to the transfers to the Hybrid Plan.
- 54.9% of Plan investments were in the Stable Value Fund.
- Lifecycle Funds are 3.4% of Plan assets versus 2.3% last quarter.
- Consistent with last quarter, there were a lot of contribution transfers into the Stable Value Fund and PIMCO. Participants were more risk adverse and transferred funds out of EuroPacific Growth Fund.

- Mr. Saharic noted the transfer activity into the TD Ameritrade SDB Window indicated that participants were looking to diversify beyond the array of options. Mr. Major of TD Ameritrade added that there were 71 participants and about $3 million in the accounts, which is a small number and consistent with government accounts. It would be surprising to see more than 3% of participants in the SDB, but the percentage of assets in the SDB money market accounts is 25%, a little higher than usual but may be due to individuals waiting to decide on the options.

Mr. Bothwell continued and reported:

- The American Funds showed fund expense ratio of 0.85% and noted that Mercer will be proposing a move to the R6 share class, which is currently at 52 basis points. The 12b-1 fee revenue sharing amounts would be eliminated.
- The 3 and 5 year performance of funds against their benchmarks was discussed and Century and Bernstein continue to be on watch. Those two funds did outperform their benchmarks in the third quarter.

Mr. Saharic highlighted the Hawaii Stable Value Fund:

- It is the largest option within the Plan and is basically split 50% between Jennison/Prudential and 50% with INVESCO. There are sub-components with the performance of the underlying managers and wrap contract issuers, which help amortize the gains and losses.
- There was a really good performance across the board for the 3-month period in the underlying fixed income strategies. Jennison, along with such PIMCO, Blackrock, and Goldman, have all benefited off the trends.
- The crediting rate was 4.59% for the quarter. The market to book value ratio showed the ratio at over 109%, which is one of the higher ones seen amongst Mercer's clients.
- There is still the ability to find new contracts in the wrap market, but need to do it creatively. Mercer will watch the wrap market environment very closely, especially, if the fixed income starts to go up because of the uncertainty of the wrap markets being able to take the hit. Mercer has been talking to some financial institutions. As wrap costs go up, because of supply and demand, it will attract new entrants into the market. At 20 basis points, it is such a good fee that banks are thinking of entering the market as wrap providers. Mercer will be monitoring that very closely.
- Mr. Egger stated that the wrap provider fees are going up and has submitted a letter to request to increase their fee cap. This issue will be taken up by the Board at a future meeting.

Mr. Bothwell continued to report:

- The BlackRock US Bond Index has approximately $9 million in the plan. That fund tracked the index with 2.5% versus the mean average outside the Barclay Capital US Aggregate.
- PIMCO Total Return Fund did better at 3.8%.
- On the balanced side, the Vanguard Wellington Fund Admiral

outperformed its index on both benchmarks.

- All Lifecycle Funds met their benchmarks. The short dated funds were helped by the PIMCO Fund and Stable Value Fund. The longer dated funds were helped by the Mainstay Fund and Century Fund.
- The Wellington Research Value Fund was helped by outpatient financials with stocks in the healthcare industry.
- The BlackRock US Large Cap Index finished at 11.4% and 11.3% at the S&P 500.
- Victory Institutional Diversified Stock Fund outperformed its benchmark and was helped by technology stocks and the acquisition of McAfee by Intel.
- The Mainstay Large Cap Growth Fund outperformed its index by quite a bit due to stocks in information technology and was hurt by stocks hit in the healthcare industry.
- Harbor Small Cap value stood out with its under performance by quite a bit in its benchmark due to its overweight in healthcare and its stocks sludge in the information technology sector.
- BlackRock US Small/Mid Cap Index passed its index, beating it by one basis point, 12.6% to 12.5%.
- Century SMID Growth Fund, which Mercer recommended to remain on watch, beat its index heavily with 16.4% to the Russell 2500's 13.2%. Mercer reported that recently Century lost one analyst who covered consumer stocks, an area where the funds were lagging or causing a lag in their benchmark. So, Mercer will continue to watch this fund and see if it improves in the three-year and five-year periods, but they are now outperforming for the three-month, year-to-date, and one-year period.
- Bernstein International Value Fund also remains on watch. It was helped by energy and telecom and was at 17.9% for the three months and 16.4% for the quarter.
- BlackRock Non-US Equity Fund beat its index at 17.7% versus 16.6% of the index.
- The American Funds EuroPacific Growth Fund was helped by stock selection in Germany and Mexico and including the insurance and automobile industry.
- All funds in the Plan, except for Harbor, had a great quarter.
- Mercer reported to the Board that Wellington Management Company and the Vanguard Wellington Fund lost one person, who was a member of the Corporate Bond Strategy team. However, as he was not a direct decision maker, Mercer did not view his departure as a major event.
- The Small Business Jobs Act of 2010 passed by President Obama contained two provisions affecting Roth 457 options. It provides more flexibility for the participants than the traditional Roths, and provides a hedge for high paying participants. But on the downside, there is not much utilization. Mr. Saharic added that while Roths have been around the 401Ks and 403b side for a while, now a lot of corporate plan

sponsors are getting some really good feedback from participants who are worried about taxes and want to put some money into an after tax bucket and be able to withdraw that tax-free. Mercer recommends that the Board consider adding a Roth feature to the plan. From administrative and payroll standpoints, there are lots of things to consider and so it will require more analysis and input from the providers and ING, to determine whether that is the path the Board wants to take.

Trustee Machida asked how fast this could be implemented if the Board adopts this measure starting January 1st. Mr. Bothwell stated that ING has experience on the 401(k) side doing this and have plans to go live on January 11, 2011.

Mr. Merrick clarified that this legislation also allows participants that are eligible to take a pre-tax distribution, to convert it to a Roth. There are a lot of unanswered questions but, generally if a participant is eligible to take a distribution of some sort, they have the ability to convert that pre-tax money into a Roth, which becomes a non-taxable event. But it starts with a timer on that Roth money where that money must be in the Roth account for five years before they can get that tax break. Mercer will obtain more statistics and get more information on what other public plans are doing.

Mr. Saharic reviewed the Lifecycle allocations:

- Lifecycle portfolios are a fund-of funds based on underlying funds;
- Each year evaluate the asset allocations in each of the Lifecycle Funds. Time to evaluate the allocations to determine the targets for 2011 and if there are other asset classes that can be added for diversification. Mercer feels that there are assets classes that can be added, but more discussion needs to occur if there is interest and also address the procurement process. Mr. Saharic provided some recommendations for the 2011 target allocations without the addition of new asset classes.

  Mr. Saharic presented two prominent asset classes dedicated to emerging market piece and an inflation hedge piece (basically a combination of TIPS, commodities, and global REITS). Mercer has a number of clients who have already adopted this and it provides good diversification. Mercer is proposing to add this to the Lifecycle Funds, but not adding it to the Plan, as a stand-alone option; sort of like target date funds version 3. Mercer is finding that these target classes are providing the benefits and will continue to provide benefits. The process of adding these funds would involve going through the procurement process and securing managers.

Mr. Saharic provided an explanation on the glide path and what the Board needs to look at. He will also provide some additional information for further discussions on the factor scores, a one-page report showing investment glides. Mercer will also provide information on what the off-the-shelf funds are doing and what the alternatives are.

Chairperson Laderta called for a recess at 10:23 a.m. The meeting resumed at 10:45 a.m.

Agenda Item # 3: Panel Presentation # 1 by Wellington Management; Victory Captial Management; and New York Life Investments/MainStay Funds
Topic: Inflation, Deflation, & the US Equity Markets

Presenters:
Sue Bonfeld, Relationship Manager, Wellington Management Company
Neil Kilbane, Senior Portfolio Manager, Victory Capital Management
John Maschoff, Director, Winslow Capital Management (sub-advisor for Mainstay Large Cap Growth Funds)

Ms. Bonfeld began the presentation with definitions of inflation, disinflation, deflation, and stagflation. The economy is not revisiting dramatic levels of inflation, but now we are right inside of rising inflation. Stocks and bonds are doing very well during falling and stable inflation. In periods of rising inflation, metals, stocks, and precious metals commodities have better returns.

Mr. Kilbane concentrated on inflation, what it is, its indicators and how it is predicted, the impact of inflation on the markets, and on what the predictions will be regarding inflation. There were two positive environments discussed. The absolute low inflation environment with the intersection of falling inflation and low current inflation is the ideal environment for stocks. These indicators are being watched very closely because while there are no problems now caused by inflation, there may be inflation problems down the road.

Mr. Maschoff focused on deflation and mentioned that there are a lot of different views on deflation and inflation in the investment management world, the Federal Reserve, policy makers, and economists talking about what kind of environment might be expected. Investment strategies for inflation as a manager and personal investor is to own stocks outside of the economy that is experiencing inflation by increasing allocations in emerging market international stocks; own high quality stocks with strong balance sheets and free cash flows, high dividend stocks, capital investments that will generate an income, and cash producing investments such as bonds and stable value funds. The Federal Reserve is watching closely to prevent a very severe spiral like in the Great Depression. With the huge amount of fiscal stimulus seen through the Federal government, in the longer term, there is a higher risk of being in the inflationary rather than deflationary environment.

Agenda
Item # 4: Panel Presentation # 2 by Harbor Funds and Century Capital Management
Topic: Consumers & Small Businesses: Ongoing Credit Challenges and Implications

Presenters:
Ben Coll, CFA, Harbor Funds Distributors, Inc.
Peter Whitlock, Director of Institutional Business Client Services/Marketing, Century Capital Management, LLC

Mr. Coll presented what was happening to small to mid-sized businesses with changes in the economy. Basically, during bad times, small to midcap businesses have held up better than large businesses historically. However, during the most recent downturn in the second half of 2007, the numbers reversed where small to midcap businesses had 62% of job losses to 38% for large businesses. Mr. Coll stated that this is an unprecedented event and that Mr. Whitlock will be providing some possible explanations for this.

Mr. Whitlock stated that there were two things that need to happen for small businesses to get going again. Small businesses are very important in getting people employed. Employment brings in tax revenues and that helps the economy. Access to credit for small businesses has come in significantly and the consumers that small businesses rely on to buy their products have gone down significantly. Small community banks play a large role in lending to small businesses because of their knowledge of local conditions and the larger banks rely on a lot of quantitative models. For the period between 1952 and 2008, people were spending more than they were making. That trend is slowly reversing. As consumers are using more of their income towards paying their debt, less consumer monies are used to spend on discretionary things. So, businesses are fighting fiercely for that incremental dollar that consumers might spend which results in small businesses are keeping their prices and margins low. The demand for consumer loans has decreased as consumers a paying down their loans to improve their financial situation. Banks are loosening their standards so that businesses can access the money. In conclusion, Mr. Whitlock provided three main thoughts:

- High unemployment and a sharp rise in savings rate have had profound consequences for small businesses;
- Their most significant challenge is first, lack of sales and second, limited access to credit;
- The environment may be improving modestly as consumer and small businesses seek credit and find banks increasingly willing to extend it; and this is the trick for small businesses to re-invest in businesses.

Agenda
Item # 5: Panel Presentation # 3 by BlackRock
Topic: Institutional Trends in Equity Indexing and the Evolution of Global Benchmarks and Emerging Markets

Presenters:
Jason DiPiazza, Account Manager for Hawaii, BlackRock
Scott Williamson, Managing Director, BlackRock

BlackRock was added to the Plan at the end of the first quarter this year and the BlackRock US Large Cap Index Fund replaced the Vanguard Institutional Index Fund. Mr. Di Piazza complimented the ING team for making it a smooth transition for participants with Vanguard funds and for introducing the other three BlackRock investment funds.

Mr. Williamson presented the significance of the world equation in global markets and why investors are making the move, what it means, and how to define that move towards international exposures. The consideration today is whether to add emerging markets to international small cap to globalize benchmarks further and have the benefit of diversification due to the conditional lower correlation of these types of assets to amassing debt. In conclusion, the institutional investment class has been forced to deal with a number of trends, including active versus passive asset allocations and recognize evolving global benchmarks.

Trustee Okumoto asked what were the political risks and availability and integrity of the information and data. Mr. Williamson replied that the increased risks will pay higher returns and growth prospects are real and we should not avoid it.

Agenda
Item # 6: Other Business:

Presentations were made to Board Chairperson Laderta and Trustee Kawamura for their years of dedicated service and contributions to the Board as their terms will end on December 6, 2010 with the change in gubernatorial administration.

Chairperson Laderta stated that the recent law that was passed this past legislative session prompted the Board to elect a Chairperson. So, the Board needs to consider who the next chair will be. Chairperson Laderta called for nominations.

A motion was made by Trustee Machida and was seconded by Trustee Kami to nominate Trustee Chu as the next chairperson for the coming year 2011 or upon the expiration of Chairperson Laderta's term, whichever is sooner. A motion was made by Trustee Kawamura and seconded by Trustee Kami to close the nomination.

Trustee Kawamura noted that because of Trustee Chu's knowledge and past experience on the Board, it is with good timing that he returned to serve on the Board with the enactment of the new law, and felt comfortable that Trustee Chu will be able to lead this Board into the future.

The motion to close the nomination passed unanimously. The motion to elect Trustee Chu as the next Chairperson passed unanimously.

The Board agreed that there would be no changes to the Vice-Chairperson assignment.

Motion to Adjourn: **A motion was made by Trustee Kawamura and seconded by Trustee Machida to adjourn the meeting at 12:20 p.m. The motion passed unanimously.**

(NOTE: Signed copy on file.)