STATE OF HAWAII
DEFERRED COMPENSATION PLAN
BOARD OF TRUSTEES

OPEN SESSION MINUTES
SEMI-ANNUAL MEETING
MEETING # 423

Date: May 24, 2018

Place: Hawaii Prince Hotel
100 Sails Restaurant, Naio Room
100 Holomoana Street
Honolulu, HI 96815

Present: Brian Moto, Chairperson
Ryker Wada, Ex-Officio Member
Ken Kitamura, Ex-Officio Member
Roderick Becker, Employee Member
Kanoe Margol, Employee Member
Kalei Rapoza, Employee Member

Others: Krishna Jayaram, Deputy Attorney General
Cynthia Akiyoshi, DHRD Staff
Glenn Ezard, Segal Rogerscasey
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
Gabe D'Ulisse, Prudential Retirement
Ken Zlotnick, Prudential Retirement
James Headley, MorningStar Investment Advisory Services
Stephen Weeks, William Blair & Co.
Todd Egger, INVESCO
Vince Ortega, Capital Group/American Funds
Robert Atwell, Harbor Funds
Matt Westhoven, MFS
Jeff Budd, New York Life (Mainstay Investments)
Megan Anderson, Winslow Capital
Alexander Zurflueh, Wellington Management Co.
Ed McGettigan, Vanguard
Mike Manfre, Vanguard

Scott Donaldson, Vanguard
Allan Duckett, Schroders
John Mensack, Schroders
Erin Lloyd, BlackRock
Jeremy Kish, BlackRock
Sonya Park, State Street Global Advisors
Tom Smythe (formerly with New York Life/MainStay Investments)

Via Conference Phone: Cara Lafond, Wellington Management Company

Absent: Kenneth Villabrille, Employee Member

Call to Order: There being a quorum present, Chairperson Moto called the meeting to order at 9:03 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 Moto opened the meeting noting that all trustees present, except for Trustee Villabrille who is excused from today's meeting. He welcomed all attendees and opened with introductions of the Board members, guests, including those participating via conference call. He stated that there are no public attendees present to testify, and briefly covered some housekeeping items.

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

Presenting from Prudential Retirement are Mr. Gabe D'Ulisse, Ms. Julie Klassen, Ms. Deborah Baran, and Mr. Kevin Malmud; and Mr. James Headley from MorningStar.

Mr. D'Ulisse opened with introductions and opening remarks on the relationship that Prudential has had over the 35+ years with the State's Plan, and Prudential's continued partnership and mission with the State to ensure participants have a secure retirement. He extended thoughts for those residing on the Big Island and who may be affected by effects of the volcanic activity.

Ms. Klassen provided remarks on observations while at the Benefits Fair, and a summary overview and commentary on Asset Allocation and Education.

- The audit of the Plan by N&K CPAs is in progress. Prudential has completed all of the requests by the auditor for Plan information and data. N&K is working on finalizing their report.

- Prudential is working on the replacement and transition of the Victory Institutional Diversified Stock Fund to the AMCAP Fund with a trade date of June 14, 2018, with the new fund being available on June 15, 2018.
- Prudential is preparing an educational presentation for the Board on the asset retention efforts and the availability of a new service for a future meeting.

Mr. Malmud reported that Prudential has launched a new service, the Prudential concierge service:

- The purpose is to address the heavy concentration of assets with the older population. The concierge service is a dedicated team that will contact separating employees to educate them of: (1) the ability to stay in the Plan and that they do not need to move their assets out of the Plan; and (2) the benefits of staying in the Plan. Prudential would do a comparison amongst other options that may be available. The concierge service has had a good success rate. Based on results, of the individuals contacted by the concierge services, 45% of those individuals decided to keep their assets in the Plan. A formal presentation can be made available.
- Cash flow within the Plan:
    - In 2016, the Plan saw a positive cash flow;
    - In 2017, the Plan saw a reversal, but noted factors in 2017 such as the one-time event of the transition of the HHSC out of the State jurisdiction that was a contributing driver for the negative cash flows.

Ms. Klassen reported on the Plan statistics:

- Website usage after the launch of the redesigned website generated 80,000 log-ins versus the prior quarter of 69,000 log-ins. With the web refresh, the website had increased usage.
- A number of reasons for calls to the call center were centered around disbursements which is a reason for considering a dedicated concierge service.

Ms. Baran provided an overview and comments:

- Acknowledged the sub-committee who worked on the website redesign project. The website featured enhanced tools and marketing for users.
- The Benefits Fair attracted 1,000 attendees and was very successful. There were a lot of activities such as standing-room crowds attending the various workshops which included rolling out a new workshop for millennials; and an aging booth was set-up to get employees to think about

preparing for retirement. Activities generated enthusiasm at the Fair. Launched a millennial campaign to focus on the younger employee population. The active participating millennials represent 26% of the active participants in the Plan. A specific article focusing on millennials was also included in the 1Q 2018 Plan newsletter.

- A submission to NAGDCA was also completed for the 2018 NAGDCA Leadership Awards.
- 2018 Marketing initiatives and strategies that are being planned:
  - Hold Lunch-n-learn workshops during the summer on how the Island $avings Plan ties in to social security and the ERS, and on understanding the value of the Plan.
  - Send out Pre-retiree mailings to address outflows.

  Mr. Malmud added that the pre-retiree mailings would highlight awareness that they do not need to make any elections or take any actions to move assets out of the Plan upon retirement. Their money is just made available.
  - One option is direct mailing campaigns to pre-retirees which will target age 55+ years.
  - Summary of initiatives:
    - Target millennials and new participants;
    - Target pre-retirees; and
    - Provide concierge services.

  Mr. Malmud also reported that other initiatives that the local office is working on which include:
  - Working with HGEA to inform employees who will be receiving a special lump sum payout and the July 1, 2018 pay increases about deferring and setting aside through the Plan; and with UPW towards the end of the year for the anticipated lump sum payout;
  - Scheduling of quarterly meetings with the UH-Manoa campus and with the other college campuses.

Mr. Headley provided a review and commentary on the Morningstar Investment Advice Services:

- Observations at the Fair that it was one of the better attended Fairs. He felt that participants were very engaged and brought their questions and interest for solutions around the Morningstar service.
- Through the overall service by Morningstar, they have seen great growth within plans; and he is seeing more interest by employees in saving.
- The methodology utilized by Morningstar has not made changes and follows a human capital approach in managing individual profiles.
- For employees coming up on retirement, the service brings customized

solutions including using service after separation from service.

- Observation on general demographic and usage trends:
  - 65% of individuals using the advice services are females.
  - The Morningstar tool creates 589 portfolios built for the plan and 169 of those portfolios are being used by participants.

Mr. D'Ulisse provided closing remarks to summarize that many other states are struggling with similar issues. Plans are looking for the TPA providers to provide solutions, especially the mature plans. Expectations for the future by Prudential are to focus on financial holistic wellness because they see a need for individuals to prepare for life events.

Chairperson Moto noted that since data illustrates that 65% utilization with Morningstar are by the female population, are there differences in the marketing strategies for women versus men, especially since there is a longer life expectancy among women. Ms. Klassen stated that there are presentations that are not gender-specific but are tailored for women that focus on dealing with stresses. Ms. Baran added that the presentations can be more topic specific for women, and will look at the data analysis to see if there are any changes in gender. Mr. Headley agreed that having some marketing initiatives that focus on women could be a very effective campaign.

<u>Agenda Item # 2</u>: <u>Performance Evaluation Report for the First Quarter 2018 by Segal Marco Advisors, including but not limited to:</u>

a. Economic and Capital Market Environment
b. Review of Investment Strategy and Option Performance

Economic and Capital Market Environment

Mr. Ezard provided a flash summary update on market activity during the First Quarter 2018:

- The market was down a little during the First Quarter 2018 which is reflective in the performance of the funds.
- The overall economy revealed that most investments were down during the quarter.
- The GDP growth rate was at 2.3% which matches the growth rate for 2017.
- The unemployment rate is improving and decreased to 4.5% at the end of the First Quarter 2017.
- Unemployment fell to 3.9%; this puts pressure on wages.
- The Federal Reserve has been raising rates; there is an expectation that

rates will increase; however, thereafter it is uncertain.

- Volatility within the equities has been picking up and see a weaker return in equities.
- The fixed income market was down 1.5% during the First Quarter 2018; and yields on 10-year Treasuries were up but have fallen again to below 3%. We may not expect to see a more aggressive policy stance as previously stated.

Review of Investment Strategy and Fund Performance

Mr. Ezard provided comments on the funds on the watch list and an overview of the investments funds:

- Plan assets were at $2.36 billion in March 2018.
- The largest concentration of assets still remains in the Stable Value Fund; represents 39% of the total assets.
- The BlackRock Index funds have not done as well as the actively managed strategies. In a weaker market, the low cost index funds can offset the decline in values
- The LifeCycle funds and Goalmaker program represent 13% of the overall Plan assets. The multi-asset class diversified options enables participants to manage the long-term savings without having to make changes and not likely to react to short term movements in the market. The Board has decided to replace the LifeCycle Funds due to the relatively higher fees, versus its peer group, and which has been primarily due to the function of the asset mix in the individual portfolios.
- The funds that have on the watch list are:
  - The underperforming Victory Institutional Diversified Stock Fund will be replaced, and the transition is scheduled for June 14, 2018.
  - MainStay Large Cap Growth Fund has been removed from the watch list, as of August 2017. Performance has been good across a number of periods.
- The crediting rate of the Stable Value Fund has remained strong.
- Since beginning of this year, the trend of the Stable Value Fund crediting rate has shown the rate rising, but it is not expected to get above 5%.
  - With the falloff in the market value, rising interest rates may affect the market-to-book ratio. The difference between the market and book value has narrowed, and means a less of a surplus. If the market ratio falls below the book ratio, this may cause some to go out sooner than later. Segal will continue to monitor as the rates increase.

Chairperson Moto called a networking break at 10:10 a.m. Trustee Becker was excused. The meeting resumed at 10:50 a.m.

Chairperson Moto announced acknowledgements to the Board's partners – the Plan's investment fund managers for participating in this past Tuesday's Benefits Fair, and to Prudential Retirement for coordinating the Benefits Fair and today's meeting site arrangements.

Agenda Item # 3: Panel Presentation # 1 on How will U.S. Equities React to Tighter Monetary Policy by Vanguard and Wellington Management Company

Presenters: Alexander Zurflueh, Wellington Management, with Cara Lafond via conference call, and Scott Donaldson and Ed McGettigan, Vanguard.

Mr. Zurfleuh opened with remarks on the history between Wellington Management Company and Vanguard. Vanguard was born out of Wellington Management and has been a sub advisory partner ever since the 1970s.

Mr. Donaldson presented commentary on the expectations of the monetary policy:

- U.S. Federal Reserve Bank has been raising the interest rates. There is market implied expectation that the rates will rise to the year 2020, with an expected rate of 2.75%. There may be 3 rate hikes in 2019.
- The impetus for the rising rates: the rising GDP rate, rising inflation, and seeing equities performing well. There is an expectation that inflation will hover at the 2% level over the next 10 years. Over the long term, it will be difficult to maintain a 2% inflation target. Globalization will keep a lid on prices. In the short term, there may be an uptick in the inflation and the market may not be completely appreciating which may be due to the tight labor market. During the rising rate environment, data scenarios show a higher p/e at the start of the hiking environment and ending with a lower p/e once rates rose. It is an indication of p/e contraction and investors have expectation of higher rates. Earnings are being discounted and earnings cannot compensate for the contraction in the overall prices.
- The equity forecast over the 10 years demonstrates a median range of 4-6% return on an annual basis. It is below what it has been historically but is still higher since the global financial crisis.
- Possible types of strategies to take on to increase return on the equity market are: a global 60/40 asset allocation mix could result in 4% return over 10 years; Vanguard expects that global diversification over the next 10 years outside of the U.S. will be vital component in construction of portfolios.

Mr. Zurflueh introduced Ms. Lafond who provided insights within the equity sector:

- Insights into some areas of opportunity, see:
  - financial companies have been profiting due to rates normalizing. Rollback from the Trump administration relative to 5 years ago has made it easier for financial companies to do business.
  - Using technology for business models. Bank of America has been going direct to mobile devices which is away from the brick and mortar methods. It is an important driver for long-term success.
  - In the consumer discretionary sector, consumer confidence is strong and feel there is more cashflow and seeing wages grow; at Wellington, they look at factors when picking companies such as how innovative are the companies in doing business.
  - In the industrial sector, see strong growth and fiscal stimulus through tax reform; companies are benefiting from this and are looking to reinvest in their facilities. See that there is a demand for automation, a strong interest in robotics; and an interest and demand in air travel.
- Rising rates are a headwind for businesses and a tailwind for others.

Chairperson Moto thanked the panelists for their presentations.

<u>Agenda</u>
<u>Item # 4</u>: <u>Panel Presentation # 2 on Tariffs, Trade Barriers and Equity Portfolio Risk: by New York Life/MainStay Funds and Schroders</u>

Presenters: Jeff Budd from New York Life/Winslow Capital and Megan Anderson, from Winslow Capital; and Allan Duckett and John Mensack from Schroders

Mr. Budd introduced Ms. Anderson from Winslow Capital who is the subadvisor for the MainStay Funds. Ms. Anderson provided an overview:

- President Trump's populist agenda was focused on local jobs and re-doing trade agreements.
  - He has withdrawn from TPP (Trans Pacific Partership) which was an agreement between 12 countries signed back in February 2016 that was not ratified. It was thought to boost trade volumes.
  - TTIP (Trans-Atlantic Trade and Investment Partnership) halted post the election and would have impacted the economic outlook.
  - NAFTA (North American Free Trade Agreement), was signed in 1994 and it was a goal of eliminating barriers to trade across U.S., Canada, and Mexico. Although President Trump has been considering the renegotiation or withdrawal of NAFTA, the numbers reflect impacts and consequences of less than 1% of world GDP.
- With the threat of China's trade tensions in 2018, the percent of world

GDP has not changed numbers significantly. The announcements by President Trump to impose tariffs on steel and aluminum was a big policy shift. Canada is the most vulnerable, and China is not even a top 10 importer, but the price impact would still be through the global economy.

- U.S. exports to China are only about .7% of the U.S. GDP and is concentrated in the Red State areas, which account for 10% agriculture and transport. Those companies in the sector likely lobbied the government to refrain from a trade conflict.
- Potential impacts of the trade war with China would see the prices rise in U.S., but a 25% tariff on imports from China may raise the only by one-half percent.
- During the Reagan administration, there weren't any tariffs but restrictions on imports. Despite the measures, the U.S. and the world economies did well.
- The current path has concerns and could lead to more contentious negotiations.
- Overall, the short-term risks seem overstated.

Mr. Duckett introduced Mr. Mensack who presented an overview:

- The four major trade partners are China, Germany, Japan, and South Korea. The households in these countries do not have the resources to absorb all of what is created in the countries so they become exporters.
- U.S. role absorbs about ½ of global excess savings, and our capital markets are deep and broad.
- The dynamics between China and the U.S. is a driver in each country.
- The driver in China is Made in China 2025 initiative. China is looking to be a world leader, but they have a long way to go.
- Headwind is the State-owned enterprises with accumulated debt that need modern technology, such as mills, health clinics, central services. The government cannot go out of business and China has to keep nurturing it along to see if they can become competitive again on the world stage. They need to become economic again and trying to avoid a middle-income trap.
- The U.S. is seeing towns going so there is an appeal to bring back manufacturing back.
- China has a lot of reserves. The Chinese consumers become desirable, so companies are looking to see how to attract that market.
- With the political dynamics in the U.S., different administrations may not be as aggressive in enforcing trade and things could change. The overall trade deficit in 2017 between U.S. and China was about $566 billion, with a difference between the U.S. exports to China versus the amount of imports from China.

- Even if the U.S. raised tariffs on China's exports, China can survive without the U.S. market but they do need access to U.S. technology to become the high valued manufacturer.
- Some potential safe harbors are: the emerging exporting countries benefit more from U.S. tariffs on Chinese goods; developed exporting countries benefit more from Chinese tariffs on U.S. goods; oil exporters are unlikely to be hit by tariffs so Malaysia, Mexico and Russia would benefit; and in Hungary and Poland which predominantly sells to the EU markets, there are no tariffs so this is helpful.
- Within the 3 parties of NAFTA, one may think the tension lies with the U.S. and Mexico because of the wall; but tension may lie with the U.S. and Canada because they are most alike and may be more competitive. If there is a NAFTA 2.0, the weakest player may be Canada and in which case they may go along with any deal in the negotiations.

Chairperson Moto thanked the panelists for their presentations.

Agenda
Item # 5: Announcements

There being no other announcements, Chairperson Moto closed the meeting by expressing thanks to the providers for their reports and the fund managers for their presentations and for their participation in this week's Benefits Fair.

There being no other business, Chairperson Moto adjourned the meeting at 11:58 a.m.

(NOTE: Signed copy on file.)