STATE OF HAWAII
DEFERRED COMPENSATION PLAN
BOARD OF TRUSTEES

OPEN SESSION MINUTES
MEETING # 348

Date: March 31, 2011

Place: Department of Human Resources Development
14th Floor Director's Conference Room
235 South Beretania Street
Honolulu, HI 96813

Present: Wayne Chu, Chairperson
Sunshine Topping, Ex-Officio Member
Kalbert Young, Ex-Officio Member
Scott Kami, Employee Member
Wesley Machida, Employee Member
Michael Okumoto, Employee Member

Others: Rodney J. Tam, Deputy Attorney General
Cynthia Akiyoshi and Lily Chu, DHRD Staff
Troy Saharic and John Bothwell, Mercer Investment Consulting – Via Conference Call
Carol Cann, Kristine Matthews, Plan Administrator Staff (ING)/Boston Office - Via conference call
Melody Takacs, Jeanne Kanai, and Grace Baracao, Plan Administrator Staff (ING)/Honolulu Office
Tom Smythe, MainStay Funds – Via Conference Call
Lisa (Yoshioka) Hoxha, Great West Retirement Services

Absent: Sandra Yahiro, Employee Member

Call to Order: There being a quorum present, Chairperson Wayne Chu 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 Chu welcomed and introduced members of the Board and guests.

Chairperson Chu stated that applications for reappointment for both himself and Trustee Okumoto were submitted to the Governor's Boards and Commissions Office. Ms. Akiyoshi added that the last day for the Governor to send in the nominees' names to the Senate will be April 1, 2011.

Agenda
Item # 1: Approval of Minutes No. 345 and 346

A motion was made by Trustee Machida and seconded by Trustee Kami to approve Minutes Nos. 345 and 346, as is. The motion passed unanimously.

Agenda
Item # 2: Performance Evaluation Report by Mercer for 4th Quarter 2010, Period Ending December 31, 2010

Mr. Saharic presented an overview on the 4th Quarter 2010 period and provided a brief report on the economic and capital market environment:

- GDP shows increase in economic growth for U.S.;
- Economic picture remains mixed with high unemployment, high debt levels which will hamper growth;
- Market risks include oil. With unrest in Saudi Arabia leading to increase prices may cut U.S. growth rate to zero; the other risk is events in Europe and numerous bailouts such as in Ireland. There is some concern with how Europe will deal with the fiscal crisis;
- Saw positive retail sales; demand for materials is robust;
- Saw positive corporate earnings;
- S&P rallied, up 10.8% during the quarter; small cap stocks rallied, up 16.3%;
- Russell 1000 sector weights – Energy and Materials (includes commodities and other goods) did the best;
- Trends showed growth stocks outperformed value stocks;
- Fixed income was not positive during quarter – yields rose, resulting in negative returns;
- High yields did well; yield curve shows a shift upward, an indication by the bond market that there is a concern on what they are seeing especially with the European sovereign debt;
- International Equity Market – the MSCI EAFE index was up 7% during the quarter; notable was that the non-US stocks lagged US stocks due to events in Europe;
- Japan did well; however, after quarter end with crisis they are facing, saw a 10% correction in the Japanese market after the tsunami; and
- Emerging market stocks continued to deliver solid returns, up 7.4% for the quarter and 19.2 % for the year.

Mr. Bothwell summarized some Plan performance highlights:

- Plan assets totaled $1,497 million at December 31, 2010 end, an increase of $61 million from last quarter;

- 27,516 participants in Plan, a decrease of 113 from last quarter; average account balance increased to $54,428, up from $51,996 as of February 3, 2011;
- Stable Value Fund continues to hold the majority of the Plan's assets at 52.4%, followed by the BlackRock US Large Cap Index Fund;
- Lifecycle Funds contain approximately 3.4% of the Plan's assets; and
- Transfer activities showed participants transferring out of fixed income and into equities.

Mr. Bothwell reported on the organizational announcements and updates:

- Mercer met with BlackRock, which now has about $1.25 trillion in equity assets with most arising out of index products. With the acquisition of Barclays, BlackRock is now the largest money manager in the world;
- BlackRock is completing the acquisition and moving the rest of the index teams to the San Francisco office which Mercer does not anticipate this will cause disruptions in any of the passive offerings;
- BlackRock announced departure of Blake Grossman, their Vice Chairman, whose main focus has been on the integration of the merger with Barclays. This does not change the rating of the firm and Mercer does not anticipate it affecting the index strategies;
- Changes at PIMCO include the departure/retirement of Paul McCulley. Mercer does not see this as a major concern since PIMCO has experienced senior level staff at the firm;
- PIMCO announced that they have changed its guidelines for the PIMCO Total Return Fund, allowing 10% of the total assets to be equity related securities. Mr. Saharic added that this was removed from the guidelines at one time and now PIMCO has added it back in. This would allow PIMCO to find/take advantage of opportunities in bonds that could convert to an equity. If the bond does convert, they do not want to be forced to sell the security before the proper value is realized;
- PIMCO has settled some of its lawsuits related to mortgage securities. Mercer does not feel this is a major concern and impact on the Fund;
- Announced the departure of two (2) analysts within Alliance Bernstein, but there were no changes to the investment policy group;
- Changes to the Winslow Capital Management, sub advisor to the MainStay Large Cap Growth Fund, include announcement that they are no longer accepting sub-advised mandates or additional retail SMA account sponsors in order to limit/slow the growth in the Fund; and
- MainStay announcement that the fee limitation amount will be raised from 85 basis points (.85%) to 88 basis points (.88%). During 2008-09, the market took a downturn. MainStay took a hit and ate a lot of expenses over and above the cap. Now that the Fund has grown to $8.3 billion, the actual expense ratio in the Fund is 82 basis points (.82%). Mercer discussed this with MainStay and both do not expect the expense ratio to exceed the cap. Fund assets are

growing and the change is mainly as a safeguard. If assets drop, the expense ratio could increase so having the cap is beneficial.

Mr. Saharic reported on some key observations:

- Implemented new allocations to the Lifecycle Funds lineup in January 2011;
- At the February 2011 meeting, the Board voted to add a diversified inflation option and an emerging market equity fund;
- On December 21, 2010, the American Funds EuroPacific Growth Fund converted from "A" shares that had an expense ratio of 85 basis points (.85%) to the "R6" shares with an expense ratio of 52 basis points (.52%). There was an issue earlier with the 12b-1 fee reimbursements in the "A" shares, so the move to the lower cost share class should streamline and prevent similar issues from reoccurring in the future; and
- Monumental, one of the wrap providers for the INVESCO portion of the Stable Value Fund, has increased its fees from 15 basis points to 21 basis points, effective at the end of January 2011. At the November 2010 meeting, the fee cap for the INVESCO portion of the Stable Value Fund was increased from 30 basis points to 35 basis points due to the trends with the wrap provider fees continuing to increase their fees.
- Recommendations:
    - Continue the Century SMID Growth on the watch list due to long-term underperformance;
    - Continue the Bernstein International Value Fund on the watch list due to performance issues;
    - The Harbor Small Cap Value Fund has been struggling. Recommend placing the Fund on the watch list due to its underperformance; and
    - Option of using Fund of Funds concept for certain asset classes.

Mr. Saharic reported on the performance of the Funds:

- Stable Value Fund holds about 52.4% of the Plan's assets at year-end, which is managed by 2 managers; one is Jennison, who managing 50% of the assets, and the other is INVESCO, who manages 50% of the assets. Jennison is invested in intermediate fixed income strategies and the strategy is wrapped by Prudential Insurance Company. The Jennison strategy has had a strong performance over the 1-, 3-, and 5- year periods. INVESCO has four (4) components to its portfolio: a cash component (the SSgA STIF), the INVESCO short-term bond fund, the INVESCO intermediate fund, and the INVESCO core fund. Performance results have been strong. Market value to the book value has been positive. The market value is at $847.3 million and the book value is at $788.6 million. The difference is cushion that has been built up;
- Fixed Income Options – the BlackRock U.S. Bond Index, designed to track the

broader market, did well. PIMCO had mixed performance. They outperformed the Barclays Aggregate U.S. Index and did well in security selection in underweighting treasuries, but not in the higher duration bonds, which hurt them in the overall performance standpoint;

- Balanced Funds – the Vanguard Wellington Fund has about 7% of the Plan's assets; slightly underperformed the S&P 500 60%/40% Barclays Aggregate Index for the period; however, the 3- and 5- year periods are still positive; Vanguard did well in overweighting the equity portion compared to fixed income;
- Lifecycle Funds – Funds are slightly behind the underlying benchmark for the 3-month period, for the year matched the underlying indices. One factor that drove the results down for the quarter was due to the underperformance of funds by the 2 international equity fund managers;
- Domestic Equity Strategies – Wellington Research Value Fund, Large Cap Value Fund, did well in the quarter. The Fund had an overweight in financial stocks which did well within the consumer discretionary and materials sectors; the BlackRock U.S. Large Cap Index tracked the benchmark closely; Victory, the large cap core manager, came back for the quarter, and stock selection in oil helped them during the quarter resulting in positive performance; MainStay's performance, managed by Winslow Capital Management, dragged a little but holdings in Oracle and Schlumberger helped their performance. The underweight in energy and materials sectors contributed to the lagging performance. Long term performance continues to be positive;
- Harbor Small Cap Value Fund showed a lagged performance for quarter-end, as well as for the 1-year period. Concern that although there were times that it looked like the Fund was on the rebound, there were times when the Fund was trending down unexpectedly. Mr. Saharic recommended placing the Fund on the "watch" list. Also, wanted to introduce other funds to possibly counter balance some of the underperformance;
- BlackRock U.S. Small Cap Index Fund did well during the quarter.
- Century SMID Growth Fund is moving in a positive direction in terms of performance. Allocation to health care and industrials helped them. Mercer will monitor them for another quarter or two to determine whether to remove them from the "watch" list;
- International Equity Funds – Bernstein International Value Fund did well relative to the MSCI EAFE Value during the period, but lagged the universe median; BlackRock Non-US Equity Index Fund tracked its underlying benchmark; the EuroPacific Growth Fund lagged for the period but the Fund did well over the long term. They were underweight in materials and industrials, and got hurt by stock picks such as Anheuser-Busch and a high allocation to cash; and
- Investment Management Fees – For the mutual funds, paying less than the median institutional expense ratio. Weighted fees average 34 basis points, so participants will benefit from the low fees in the Plan.

Trustee Okumoto asked about the strategy that AllianceBernstein expressed in regard to their exposure in Japan. Mr. Saharic stated that they have been talking with the international fund managers about their exposure to Japan and reaction by the managers is their surprise that the market opened up quickly despite the 10% decline. The biggest issue appears to be the short-term disruption in the supply chain rather than the recovery side. Example is that Japan produces a lot of components, and managers worry about the ability of Japan to continue to provide that to the various markets. May see shifts occur where other countries taking on the production of those supply chains. Japan was seen as the number two (2) economy in the world has shifted to number three (3), surpassed by China.

Mr. Saharic presented Mercer's recommendation before the Board to place the Harbor Small Cap Value Fund on the watch list.

A motion was made by Trustee Machida and seconded by Trustee Topping to place the Harbor Small Cap Value Fund on the watch list. The motion passed unanimously.

Mr. Saharic addressed the Board's concerns on the appropriate time to remove or replace underperforming fund managers. He stated that they look both quantitative (in which performance is lagging over the rolling 3- and 5- year periods relative to the standards in the Investment Policy) and qualitative standards (where Mercer has lost confidence in the manager's capabilities) as factors that drive the recommendation to remove a manager.

For the Harbor Fund, the underlying manager is Ernest Partners. Mercer has downgraded their rating a little, but not to the point where they would recommend selling the strategy. Mr. Saharic would recommend monitoring the Fund for 1 to 2 quarters.

Mr. Saharic presented information on considering another alternative structure, a Fund of Funds structure. Mr. Saharic referred to the handout on the Addition of New Asset Classes.

- At the last meeting, Mercer discussed adding two (2) new asset classes: the Emerging Market category and the Diversified Inflation Option in the Lifecycle Funds and as stand-alone options.
- In light of what has happened in relation to the crisis in Japan and the Middle East, Mercer reaffirmed its recommendation to move ahead with adding the new asset classes, and the need for additional diversification.

  Trustee Okumoto noted that he agreed on adding the emerging market class but rose a concern that this is one of the more riskier options, so there needs to be adequate disclosure on the risks involved.

- Mr. Saharic explained the Fund of Funds strategy:

  - Current level includes Tier 1 (Lifecycle Funds); Tier II (the Core Option Array of Passively Managed Funds); and Tier III (the Core Option Array of Actively Managed Funds); and Tier IV (the Self-Directed Brokerage Account)
  - Explore ways to mitigate the underperforming Funds such as through a Fund of Funds structure. This would be a significant change for participants who are used to investing in single investment option categories.

  - Some reasons for doing this are:

    - Benefits: Helping participants invest in well-diversified investment options that will help minimize volatility; by combining multiple managers, can reduce down the expected standard deviation from each one of those managers; and introducing more diversification to the extent that if want to swap a manager out it would be easy to do so and represent a minimal change for participants.
    - Others: Move to a generic naming convention, example: Hawaii U.S. Large Cap Equity Fund, and would move away from brand name recognition. The focus would be on asset allocation and would collapse the line-up of investment options. There has been a trend to reduce down the line-up, resulting in minimizing participant paralysis when investing.
    - Concerns: The Board will need to approve the underlying managers, the underlying allocations, and the underlying evaluations and complexities of reviewing the portfolio structure. This may result in greater fiduciary accountability because the Board is in essence establishing the weights and investment mix in each investment option category, and additional costs for custodial services to create a daily NAV pricing and customized communications. If the stand-alone investment options are closed to participants, there may be some backlash because some participants like to invest in individual mutual funds and track them daily.

The Board requested information on other plans that utilize this structure and issues that arose and positive impacts, and the number of plans that have adopted this structure. The Board asked whether ING has administered other plans with this structure.

Mr. Saharic noted that he will present some survey data at the next meeting, and some cost estimates to develop the NAV, including any defined contributions plans that do offer a combination on the level of options.

Ms. Takacs shared that in meeting with participants, a number of participants have strongly favored name brand funds.

Agenda
Item # 3: Plan Administrator's Report

a. Plan Updates

Ms. Kanai stated that the 1st Quarter 2011 Plan report will be presented at the next meeting since the quarter ends today, and continued with a report on the status of the American Funds' revenue sharing allocation.

b. Status of American Funds' Revenue Sharing Allocation

Ms. Kanai presented a draft of the communication to participants for the Board's review and comments. The draft letter covers an explanation and the handling of the allocation to participants with accounts in the Plan and participants without accounts and who are no longer in the Plan. Ms. Kanai indicated that the monies would be deposited into the Stable Value Fund investment option since it is the only investment option that would guarantee a return rate, and from there participants can move the monies over to a different option. For participants who no longer have an account in the Plan, ING is checking the addresses on record, will reopen the individual's Plan account, and deposit the monies into the Stable Value Fund investment option. Ms. Kanai recapped by saying that the allocation of 12b-1 fees that are owed would be to participants who were in the EuroPacific Growth Fund between 2003 and 2010. The Board provided comments to the draft letter.

Ms. Akiyoshi added that the allocation to participants is targeted for sometime in April, so ING would like to have a final letter completed and distributed before the allocation. An announcement will be placed in the Plan's newsletter. The Board agreed to wait and see whether how well the distribution is to participants before deciding on other outreach methods.

c. Discussion on Direct Rollover Distributions Between Institutions

Ms. Kanai summarized that in response to the previous participant inquiry on allowing a direct rollover to the participant's financial institution without issuing a check direct to the participant, ING contacted the participant to inform him of his options and exceptions made on a case-by-case basis. Ms. Kanai also reported that ING is reviewing and creating generic rollover-in and rollover-out forms with instructions, and noted that they cannot change the

Special Tax Notice. The forms and procedures are still in discussion internally and plan to have draft forms ready for the next meeting. ING will be discussing further whether ING is capable of issuing and sending checks directly to the contra firms since some of the work flow processes are automated and some are manual. For all other plans that ING currently administers, ING sends the checks directly to the participants to bring to the receiving institution. This is for auditing purposes and in accordance with its compliance team.

Ms. Akiyoshi brought another participant request that was just received to the Board for review and consideration that would enable a direct rollover or trustee-to-trustee transfer from the Plan to the receiving institution. The Board asked ING to check if there is any flexibility to adopt a trustee-to-trustee transfer or direct rollover to the receiving institution as oppose to its current process of issuing checks to the participant. The Board recognized that the trustee-to-trustee transfer and direct rollovers are subject to different Internal Revenue Code provisions. For the ERS Hybrid Upgrade Plan, checks were issued and the transfers were done on a trustee-to-trustee transfer arrangement. Each plan had to adopt the ability to transfer and accept the transfer.

d. Other Plan Issues

DAG Tam stated that an article is being considered for the upcoming Plan newsletter to remind participants about updating their beneficiary designations, especially due to changes like divorce where one cannot assume that a divorce will automatically nullify the prior designation of an ex-spouse. The Heckman case will being cited to inform participants that the judge ruled that the Plan has no alternative but to follow the last known beneficiary designation on file.

Agenda
Item # 4: PTS Plan

a. New Quarterly Rate on April 1, 2011

Ms. Akiyoshi reported that beginning April 1, 2011, the 2nd Quarter 2011 interest rate for the PTS Plan is at 4.22%. The 1st Quarter 2011 rate was 4.29%.

b. Follow-up on Questions Regarding the Quarterly Management Report for the 3rd Quarter Ending September 30, 2010.

c. Follow-up on Inactive Accounts with Small Balances.

Ms. Akiyoshi reported that there were two (2) items that the Board requested some follow-up information.

One question was related to the 3rd Quarter 2010 Management Report under the Plan statistics, and why the new participants and the continuing actives (those participants who had a contribution the prior month) numbers appear to increase between August and September. In checking with ING, the numbers are correct, but was not captured in the report was the total number of ongoing active participants, so this will be included in future reports.

The other item was related to the issue of inactive accounts with small balances. LSW was asked whether they are aware of any other plans where the money is turned over to the State. LSW responded that they were not aware of any other state plans that do that. There are over 31,000 participants that have inactive accounts and bad addresses. So, the question is how to reach these participants. Staff looked into an option of asking the state agencies to provide some updated demographic information, but due to confidentiality concerns originating from recent privacy laws, there were some reservations about providing it to the State who in turn will turn over the information to an outside party. LSW explored other another option of having an outside firm conduct an independent database search to try and find the people. But the search would be at a cost of approximately $5,500. The firm charges based on the inputting the participant's information and based on a tiered average success rate of between 65% and 75%. The Plan's reimbursable account has a remaining balance of $14,053.72 as of January 2011.

The Board discussed various ways that participants can be notified about the inactive accounts, such as turning it over to the State Unclaimed Property program or by placing a notice in the newspaper with the names rather than spending the monies for an independent search. The notice could be done periodically over the years until the inactive account numbers decrease. Because of the volume of the names to print in the newspaper, it could result in a significant cost, so the Board agreed that a notice could be placed in the local newspapers directing individuals to check the DHRD website, which would have a list of names that one could search. Trustee Young stated that this was done at the County of Maui for the delinquent taxpayers. Trustee Machida also added that an announcement could be included in the ERS newsletter.

The Board asked for a draft notice for the newspaper for review at the next meeting. The notice would direct readers to the DHRD website with names and instructions.

Agenda Item # 5: Other Business/Announcements:

a. 2011 Legislation

Ms. Akiyoshi reported on two (2) bills related to Public Agency meetings that are being monitored: H.B. No. 549, H.D.1 and H.B. No. 640, H.D. 1. Both bills are moving through the committees.

b. Scheduling of Next Board Meeting(s)

Ms. Akiyoshi reminded the Board of the upcoming meetings that have been scheduled and confirmed. The next Board meeting is on April 26, 2011, and the semi-annual meeting follows on May 26, 2011. May 27, 2011 is the Employees' Benefits Fair, which will be held at the State Capitol building on the Chamber level.

Motion to Adjourn: **A motion was made by Trustee Machida and seconded by Trustee Young to adjourn the meeting at 11:14 a.m. The motion passed unanimously.**

(NOTE: Signed copy on file.)