

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

**OPEN SESSION MINUTES
SEMI-ANNUAL MEETING
MEETING # 417**

Date: October 26, 2017

Place: Grand Nanihoa Hotel Hilo
Ho'omalimali Ballroom
93 Banyan Drive
Hilo, HI 96766

Present: Brian Moto, Chairperson
Wesley Machida, Ex-Officio Member
Roderick Becker, Employee Member
Kanoë Margol, Employee Member
Kalei Rapoza, Employee Member

Others: Krishna Jayaram, Deputy Attorney General
Cynthia Akiyoshi, DHRD Staff
Glenn Ezard, Segal Marco Advisors
Wendy Carter, Segal Marco Advisors
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
Afua Brefo, Prudential Retirement
Mark Bojanowski, Prudential Retirement
James Headley, MorningStar Investment Advisory Services
Brendan Bowe, BlackRock
Sean Lewis, BlackRock
Matt McLaughlin, William Blair & Co.
Todd Egger, INVESCO
Sam Kaplan, Jennison
Michael Bowman, Capital Group (EuroPacific)
Steve Caruthers, Capital Group (EuroPacific)
Chris Rooney, MFS
Peter Loncto, MFS

Jeff Budd, New York Life (Mainstay Investments)
Sunita Patel, Wellington Management Co.
Ed McGettigan, Vanguard
Mike Manfre, Vanguard
Shawn Parris, Schroders
Nathan Glassey, National Benefits Services
Ata Azarshahi, National Life Group/LSW
Peter Eddy, Prudential
Tom Kalili, Prudential

Absent: James Nishimoto, Ex-Officio Member
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 Trustees Nishimoto and Villabrille who are excused. He welcomed all attendees and opened with introductions of guests who were in attendance. 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 Ms. Julie Klassen, Ms. Deborah Baran, and Mr. Kevin Malmud; and Mr. James Headley from MorningStar.

Ms. Klassen opened with remarks, and a summary overview and Plan highlights:

The Benefits Fair in Hilo was held yesterday which attracted 309+ attendees. The feedback was overall positive and attendees were appreciative of having the Benefits Fair in Hilo.

Commentary on Asset Allocation and Education:

- As of September 30, 2017, the Plan assets totaled \$2.2 billion.
- The LifeCycle funds comprised 5% of the Plan's assets. Ms. Klassen commented on the contributions, and the outflows which a portion was due to employer events such as the transfer of the Maui hospitals to Kaiser

during the year.

- The Goalmaker asset allocation comprised 7.4% of the Plan's assets.
- The annual contribution limit will increase in 2018 by \$500, to \$18,500. Age 50 catch-up remains the same.
- NAGDCA released a benchmark survey of 52 plans representing 37 plan sponsors, and in comparison, the Plan is in the jumbo plan sponsor category: The survey shows:
 - An average participation rate of 40% for competing plans where participants have more than one plan as an option. If the DOE and UH is extracted, the Plan participation rate is at 48%.
 - The average participation rate for non-competing plans is 57%, compared to the Plan's participation rate of 28%.
 - The average deferral is \$4,800, compared to the Plan's average deferral of \$6,200.
 - The survey shows 20% of the responding plans offer automatic enrollment; the Plan does not offer automatic enrollment.
- Fund changes were implemented during 2017: the PIMCO Total Return Fund was removed and replaced by BlackRock Total Return Bond Fund. Prudential is working on implementing the retroactive fee reductions for the BlackRock index funds which is effective from January 1, 2017.
- The independent auditing project that is being conducted by N&K CPAs is in progress.
- Prudential is monitoring the anticipated closure of the J.P. Morgan fund and the changes that are needed as the end of the year approaches.

Mr. Malmud presented an overview of the local office activities:

- Worked with DOE personnel to coordinate an EZ enrollment card campaign to heighten awareness on the Plan and to increase enrollment among the approximately 20,000 DOE employees. The campaign distributed Plan information via emails to both current participants and non-participating employees in September 2017.
- Held meetings with Maui hospital employees, who were transitioning to Kaiser hospital, to inform them of their separation options, such as vacation and severance pay elections.
- Have been in partnership with UPW to participate in the UPW section 8 meetings to counsel and present information on the options and benefits of deferring the upcoming lump sum amount being issued as a part of the UPW agreement.
- Held mini fairs on UH campus in September 2017 which attracted over one hundred attendees.
- Held meeting during this past week with Hawaii County payroll and human resources staff to strengthen relationships.

Ms. Baran provided a summary of initiatives during the year:

- A new interactive awareness activity has been launched for the Fall Employees' Benefits Fairs which involves an aging booth with the purpose of getting employees to think and see their future selves. Saw employees taking actions to meet with the Plan counselors.
- Plan Website Updates:
 - Updates to the Plan website were launched in May 2017.
 - Saw a decrease in desk top computer access; and seeing about 20% more mobile access (e.g., laptops, tablets, mobile phone access, etc.). Since the launch, there are about 25% new users and the website usage has increased with users spending more time on the site.
- The DOE Email Campaign:
 - Emails sent to 22,000+ DOE employees with a target audience of employees who were enrolled and not enrolled.
 - Approximately 4,500 employees opened the email, resulting in 144 actions in total to enroll and make deferral increase changes.
 - Will discuss follow-up actions after the results of the Benefits Fairs.

Trustee Rapoza asked if Prudential was participating in the HSTA Institute Day conference event, as he thought there was one scheduled for today on Oahu. Mr. Malmud stated that Prudential was invited to one that is coming in next February 2018.

Mr. Headley presented general observations and review on the Managed by Morningstar services:

- He observed at the Benefits Fairs that the engagement by employees has increased.
- Seeing a steady trend in retirement plans that are adopting the Morningstar solutions.
- There have been no changes in the methodology of determining allocations, continue to follow a human capital approach, and identifying risk levels to create individual portfolios.
- Take into considerations participant demographics in order to come up with the most appropriate allocations.
- Within the Plan:
 - There are 1,500 enrolled users; half of the participants are changing their retirement ages; default is 65 years of age.
 - In reviewing a chart that illustrates the trend line of participants with custom portfolios, there are 165 users who are using unique portfolios.

Agenda

Item # 2: Performance Evaluation Report for the Third Quarter 2017 by Segal Marco Advisors, including but not limited to:

Ms. Carter opened with general observations of the Benefits Fair and other comments. She stated that she plans to present the annual deep dive on the Plan next year. She noted that some Boards are asking to cover areas such as cyber security, fiduciary liabilities, Roth option, economic and social governance, and proxy voting issues.

a. Economic and Capital Market Environment

Mr. Ezard provided comments on the Third Quarter 2017:

- GDP growth was up 3.1% in the Second Quarter 2017 from 1.2% in the First Quarter, which is in line with the Federal Reserve expectations. Third Quarter 2017 experienced some disruptions such as hurricanes. Growth rate for the first 3 quarters is 2 to 2.5% range.
- Short term interest rates are expected to go up; there is uncertainty around the Federal Reserve Board due to possible changes.
- Unemployment is low at 4.2%; however, disaster events such as hurricanes did result in job losses.
- 10-year Treasuries has declined over the year, but showing signs, it is going up and is staying steady.
- Equity markets have been strong; strong returns in U.S. equities, and non-U.S. equities have been strong due to the improved growth outlook in Europe.
- Bonds have shown positive returns; the year-to-date is up at 3%, and may see modest returns in bonds.

b. Review of Investment Strategy and Option Performance

Mr. Ezard continued with an overview on the investment funds:

- As of the end of the Third Quarter 2017, the Plan's assets totaled \$2.3 billion.
- 40% of the assets are in the Stable Value Fund.
- The equity index is the next largest asset group.
- The expense fee ratios for all of the funds are comparable to the peer group; the LifeCycle portfolios have slightly higher fees due to the glidepath allocation and underlying funds.
- The scorecard for the investment options:
 - PIMCO was transferred to the BlackRock Total Return Fund;

PIMCO closed out on a high note. The change was due to organizational concerns with PIMCO.

- Victory is seeing better returns, but long-term performance continues to decrease relative to peers.
- The MainStay Large Cap Growth fund has slightly weak returns but the long-term performance is still good.
- Bond funds are showing moderate returns.
- The Vanguard fund is performing well.
- The BlackRock Large Cap Index has done well.
- Wellington Research Value has been trailing but the value sector has been a difficult space; Segal is monitoring.
- The small cap strategies are showing strong results; Harbor fund was up 25% for the 1-year.
- The non-U.S. equities:
 - BlackRock Non-U.S. Index saw a 20% increase over the 1 year; some due to the weakness in the U.S. dollar.
 - Emerging markets have shown strong results; the Schroders Emerging market saw an increase of 32% year-to-date.
 - EuroPacific Growth Fund had an increase of 6.9% during the Third Quarter, with a 26% year-to-date.
- LifeCycle Funds saw solid returns across all funds, relative to its peer group.

Agenda

Item # 3:

Annual Report from Life Insurance Company of the Southwest

Mr. Azarshahi and Mr. Glassey presented highlights for the PTS Plan:

- Plan assets are over \$122.2 million, as of June 30, 2017.
- \$167 million in contributions; paid out \$90 million in benefits.
- The State savings totaled \$8.2 million; and inception-to-date totaled \$138 million.
- The average number of actives in a one-month period is about 9,846; total accounts of 90,746 of which approximately 13,000 are active and the remaining is inactive.
- The crediting rate as of July 1, 2017 is 2.64%.
- Escrow account information has been included. The total escrow assets are at \$123 million as of August 31, 2017. LSW will evaluate the account twice a year.
- The county of Kauai joined the Plan on September 1, 2017; initial payments into the Plan on September 30, 2017.
- LSW is part of the National Life Group family of companies; and National Benefit Services (NBS) provides the recordkeeping services.

Chair Moto called a break at 10:13 a.m. The meeting resumed at 10:37 a.m.

Chair Moto acknowledged Prudential and our investment fund partners coming together to participate in the Benefits Fairs, and acknowledged the sponsors for sponsoring the Board meeting and luncheon.

Agenda

Item # 4: Panel Presentation # 1 on Active versus Passive U.S. Equity: by BlackRock, Prudential, and William Blair

Presenters: Sean Lewis, from BlackRock; Mark Bojanowski, from Prudential; and Matt McLaughlin, from William Blair.

Mr. Bojanowski opened with explaining that active fund managers – identify stocks, and passive fund managers hand the monies to managers. He provided some comments:

- 81% of active large cap value managers have been beating the benchmark.
- There is a decent number of equity managers who have been able to go out and find companies.
- Index funds have done better over the last 10 years than the average equity manager.
- Active investing rationally makes sense; and fees have dropped among the active managers.
- Passive investing have seen low fees; and has had broad exposures to the marketplace so large amounts have inflowed to passive strategies.

Mr. McLaughlin presented his perspectives on how active management adds value and why it works:

- Some inefficiencies in active management could be due to looking at short term factors, or informational reasons where not understanding the companies.
- 25% of the index are in companies that don't make money.
- As an active manager, tend to underweight those types of companies.
- William Blair looks for quality companies. There are good companies which may underperform, but when quality shines, active investors pick up alpha and can add value.
- Interest rates in the last 8 years has been low; companies were lifted with the low rates. Active managers do well when interest rates are rising. See a good outlook going forward.

Mr. Lewis presented his perspectives on passive equity strategies:

- Passive equity exposure has worked; participants have benefited from the price gains. Price to earnings ratio is above the long run average that we have experienced.
- Interest rates have been at historically low levels; if there is an increase, may see a disruption in price of global equities. Interest rates will be defining the shape of the macro-economic environment going forward.
- A solution is to provide participants with simplified solutions. Rather than add options, provide multi-manager solutions:
 - Have 3 portfolio managers covering active.
 - Look at selection criteria with focus on fees, alpha generation, alpha correlation, and style exposure (factor based investing or smart beta).
 - Alpha is generated by manager skills.
- Having a partnership in active and passive is good based on factor based investing.
- Factors used in securities selection to reduce risk and enhance returns, such as diversification away from market cap based to macro based weight factors to get different returns; optimizing one white label approach is a balanced solution to get risk-adjusted returns.

Agenda

Item # 5:

Panel Presentation # 2 on Forward Path for Federal Funds and A Primer on Book Value Pricing: by Jennison Associates, Prudential and INVESCO

Presenters: Sam Kaplan from Jennison Associates, Afua Brefo from Prudential Retirement, and Todd Egger from INVESCO.

Mr. Kaplan opened with commentary on the candidates for the Federal Reserve chairperson, path of interest rates and the yield curve:

- The federal rate hike projections differ from what the futures market is pricing.
- Significant changes are anticipated, with new members.
- The FOMC Dot plot reveals 25 basis points hikes through year 2020.
- The FOMC Dot plot is not in agreement with the market expectations.
- Reasons that the market pricing does not agree with the Fed path expectations going forward:
 - FOMC Dot projections have been shifting projections downward; long term projections have come down.
 - After financial crisis, neutral Fed rate has stayed persistently low near zero, and a reason for the 100 basis points tightening between Fed and the market.
- Changes are coming to the FOMC. There are 3 Board vacancies plus the Chairperson. Overview of the candidates that may keep rate hikes low or those candidates that want higher rates sooner. The President can shape the

way the committee is formed and their views.

Mr. Egger and Ms. Brefo discussed the Stable Value fund environment:

- The Stable Value fund is a low risk capital preservation option that offers daily liquidity.
- There are 2 types of investors: savers and investors. Savers are generally near retirement; investors use as fixed income alternative.
- Long term performance is comparable to intermediate bond returns and meets money market price characteristics.
- The fund operates above the efficient frontier which is a reason why investors like the fund.
- The wrap contracts protect the fund from volatility risks and provide consistent rates of returns.
- In a rising interest rate environment, market value asset goes down but because of the guarantee, the principal and earnings will be okay.
- As rate falls, market value increases, but when rates rise, there is a potential to dip below the book value creating a market value deficit. The wrap contracts are designed to smooth the ups and downs. The market value funds trading in and out of the Plan. The crediting rate formula spreads out the difference between the ratio of the market and book value to press back to equality.
- Cash flows have an impact on the Stable Value crediting rate, in particular, the magnitude could determine the significance of the impact. So, Plan Sponsor directed events are important to communicate back to wrap contract providers so to avoid a detrimental impact to remaining investors in the fund.

Agenda

Item # 6:

Panel Presentation # 3 on Perspective on Non-U.S. Equity: by MFS and Capital Group

Presenters: Michael Bowman and Steve Caruthers from Capital Group and Peter Loncto from MFS.

Mr. Bowman, Mr. Caruthers, and Mr. Loncto shared their observations within the marketplace and seeing the international markets rebound:

- Reasons for the value of international investing are because the U.S. dollar strength has turned around and weakened, and is plateauing; international markets are rebounding.
- Seeing a reversal of U.S. and non-U.S. markets, and a potential for non-U.S. performance going forward.
- Optimistic for positive earnings growth from European companies.

Europe seems to be coming out of a crisis and the political environment is looking better. The market seems to feel that Brexit is a non-issue.

- Other issues of concern is the North Korean situation and a concern that the Chinese government potentially playing a more active role with some technology companies and having a say in management decisions.
- Most companies are global and many companies are exporting out of the country of domicile, and so when reporting they look at companies' revenue and where companies are doing business.
- EuroPacific Growth Fund has a high conviction in emerging markets and has a 30% allocation to emerging markets and 44% of revenue is from emerging markets.
- Closing remarks on the perspective that going forward there is value in investing in international markets, as the international market has evolved and political risks are more managed today than before.

Chair Moto thanked the fund managers for their presentations and thanked the managers for their support at the Benefits Fairs, and called a recess at 12:18 p.m. The Board members excused themselves to another room to continue the discussion on the remaining items in Executive Session.

Agenda

Item # 6:

Other Business/Announcements

- a. Board evaluation of Proposals and Award of Contract in connection with the replacement of the J.P. Morgan Diversified Real Return Fund.
- b. Board discussion regarding status of Contract Award for RFP No. DCP-16-2, for an Active U.S. Large Cap Core Equity Investment Option.

A motion was made by Trustee Machida and seconded by Trustee Rapoza to move into Executive Session at 12:28 p.m. to confer with the Plan's legal counsel on Agenda items 6.a. and 6.b., and to deliberate or make a decision upon a matter that requires the consideration of information that must be kept confidential pursuant to a state or federal law, pursuant to HRS §§ 92-5(a)(4), 92-5(a)(8), 103D-105, and 103D-303. The motion passed unanimously.

EXECUTIVE SESSION

All guests were excused except for Segal Marco Advisors.

Meeting

Reconvened: A motion was made by Trustee Machida and seconded by Trustee Rapoza to move out of Executive Session at 1:09 p.m. The motion passed unanimously.

A motion was made by Trustee Rapoza and seconded by Trustee Machida to adjourn the meeting at 1:09 p.m. The motion passed unanimously.

(NOTE: Signed copy on file.)