South Carolina Retirement System Investment Commission
Meeting Minutes

Thursday, October 13, 2005

Second Floor Conference Room
202 Arbor Lake Drive
Columbia, South Carolina 29223

Commissioners Present:
Mr. Reynolds Williams, Chairman
Mr. James Powers, Vice Chairman
Treasurer Grady Patterson
Mr. Blaine Ewing
Mr. Allen Gillespie

Others present for all or a portion of the meeting: Nancy Shealy and Ashli Aslin from the South Carolina Retirement System Investment Commission; Frank Fusco and Steve Osborne from the South Carolina Budget and Control Board, Office of the Executive Director; Anne Macon Flynn from the Budget and Control Board Office of General Counsel; Sam Wilkins and Chris Byrd from the Budget and Control Board Office of Human Resources; Rick Patsy, Frank Rainwater, Trav Robertson, Paige Parsons, and Shakun Tahiliani from the State Treasurer's Office; Jeff Schutes and Jay Love from Mercer Investment Consulting; Peggy Boykin, Dianne Poston, Faith Wright, Tammy Davis, Travis Turner, Sarah Corbett, Danielle Quattlebaum, Joni Redwine, and Melissa Carter from the South Carolina Retirement Systems; Lil Hayes from the House Ways and Means Committee; Sam Griswold and Wayne Pruitt from the State Retirees Association; and Charley McDonald from the South Carolina Trooper's Association.

I. CALL TO ORDER, CONSENT AGENDA, AND CHAIRMAN'S REPORT

Chairman Reynolds Williams called the meeting of the South Carolina Retirement System Investment Commission (Commission) to order at 10:05 a.m.

Chairman Williams called for objections or amendments to the proposed agenda. There being none, the agenda was approved as proposed.

Chairman Williams called for objections or amendments to the minutes from the Commission meetings on September 8, 2005, and September 20, 2005. There being none, the minutes were approved as presented.

Chairman Williams stated that the level of responsibility and accountability with which the Commissioners had been entrusted was not exceeded by anyone in state government. He noted that as fiduciaries, Commissioners would be subject to removal from office and could be held personally liable for a breach of fiduciary responsibility relating to investing the assets of the South Carolina Retirement Systems (Retirement Systems). He stated that it was an extraordinary testament to the courage of the

Commissioners to be willing to serve under those circumstances. He expressed pride in his association with people who are willing to undertake that level of public scrutiny, accountability, and sacrifice in order to serve.

Chairman Williams discussed decisions he had made on behalf of the Commission concerning Commission letterhead, office space, and insurance. Mr. Blaine Ewing made a motion to ratify the letterhead, office space, and insurance decisions made by Chairman Williams. Mr. Allen Gillespie seconded the motion, which carried unanimously.

Chairman Williams stated that he spoke with the actuaries and was concerned that the actuarial assumptions assume Cost of Living Adjustments (COLAs) of only one percent each year in the future, while historically retirees had received higher COLAs. Chairman Williams stated the Commission should be aware of the implications of the actuarial assumptions such as rates of return and liabilities, and he recommended that the Commission engage an Asset and Liability Modeling (ALM) study along the lines of Mr. Gillespie's suggestion at the last meeting. Chairman Williams said he thought the Commission could consider proposals from both the actuary and Mercer regarding the costs for conducting an ALM and could negotiate with them as current service providers for the Commission and the Retirement Systems. He said that such services appeared to be within the scope of their general responsibilities and that the Commission had a responsibility to consider the liabilities in managing the investments.

Chairman Williams stated that the fee structure for The Bank of New York's (BoNY) securities lending program was 15 percent, with 85 percent going to the Retirement Systems' portfolio. He noted that the dollar amounts associated with this program last year totaled approximately $1.9 million in fees to BoNY and $7.6 million in returns to the Retirement Systems. Mr. Ewing asked about the risk involved in the securities lending program. Mr. Williams stated that the risk was not addressed in the contract, and Ms. Nancy Shealy agreed to review the matter when she received a copy of the contract between the State Treasurer's Office (STO) and BoNY. Mr. Patsy from the STO explained that when securities were lent, they were collateralized to 102 percent. He noted that in his experience, securities lending risk was substantially lower than equity risk. Mr. Ewing reiterated that his concern was from a fiduciary perspective, and Chairman Williams added that as fiduciaries, the Commission needed to insure that it's done correctly.

Chairman Williams stated that he was aware of two nominations for the retiree Commissioner. He noted that the deadline for nominations would be the end of October 2005. Chairman Williams asked Treasurer Grady Patterson to forward all nominations he received through General Counsel to ensure that they meet the statutory qualifications to serve. Treasurer Patterson agreed to provide Ms. Shealy with the information he received for nominees.

Chairman Williams stated that he had reviewed the investment manager contract template as well as the contract with Mercer Investment Consulting, Inc. (Mercer). He noted that Commission staff was in the process of making technical changes to the contracts so that they were properly transitioned to the Commission.

Chairman Williams noted that the Commission received two memorandums, one from Ms. Anne Macon Flynn from the Budget and Control Board (Board) Office of General Counsel and one from Ms. Peggy Boykin from the Retirement Systems, providing a status report and outlining the administrative services that would continue to be provided by the Board and the Retirement Systems during the Commission's transition.

(Information relating to this matter has been retained in the Commission's files and is identified as Exhibit A.)

II. INVESTMENT MATTERS

Chairman Williams recognized Mr. Jeff Schutes and Mr. Jay Love from Mercer for an overview of the equity portfolio. Messrs. Schutes and Love reported on the portfolio's guidelines and objectives as outlined in the Annual Investment Plan (AIP). Mr. Love stated that the main objectives of the equity portfolio included: complementing the fixed income portfolio; providing a broad market exposure; getting cost effective exposure to the equity markets; and avoiding any excessive risk. Mr. Schutes discussed the general objectives of the equity portfolio, the history of equity portfolio, significant events, the growth of equity assets since inception compared to the Standard & Poors 500 Index (S&P 500), and the continual due diligence and oversight processes. Treasurer Patterson asked if the equity program had added any value to the Retirement Systems' portfolio, to which Mr. Love answered it had added approximately $2 billion since inception.

Messrs. Schutes and Love discussed the portfolio's total allocation structure in terms of active versus passive management, style biases, and market capitalization. Mr. Schutes explained that an area of concern as assets grow would be finding appropriate active management in the Small Cap strategy given manager constraints.

Mr. Love stated that after extensive analysis to determine the most risk-efficient way to maximize the performance of the portfolio, the rebalancing policy outlined in the AIP was established. Messrs. Schutes and Love discussed the rebalancing policies and explained that such policies encompass how exposure to each asset class was monitored, the process followed when the portfolio was off target, how transfers between the fixed income portfolio and the equity portfolio were managed, and the allocation among asset classes and investment managers.

Mr. Schutes discussed the manager selection process outlined in the AIP. He reiterated that the search process was completely independent and included all investment managers in Mercer's database. Ms. Shealy asked if Mercer received any compensation, either directly or indirectly, from managers to be included in the search process or Mercer's database. Mr. Schutes replied that Mercer's database was the largest database of investment managers and there was no fee for managers to be included. In addition, Mercer does not receive any finders-fees or commissions for including managers in a manager search or on the database. Mr. Schutes stated that the only fees Mercer received were the hard-dollar fees from consulting clients. Mr. Schutes explained that at one time Mercer had several ancillary businesses that had relationships with managers, but those had since been exited. He also stated that some data was, at one time, sold to managers, but to avoid any potential conflicts of interest, all forms of revenue generation from the investment management community had been dissolved. Mr. Schutes stated that, at one time, Mercer hosted educational seminars, but individual consultants, such as he and Mr. Love, received nothing of value and only participated in the conference as presenters from an educational perspective. Mr. Schutes stated that investment managers paid to attend those conferences and clients were also invited to attend, but the group that was responsible for the educational conferences was a separate business unit outside of Mercer Investment Consulting.

Mr. Ewing noted that the State Retirement Systems Investment Panel (Panel) and Board referred managers who wanted to do business with the Retirement Systems to Mercer as the primary "gatekeeper" in the search process. He said that Mercer screened candidates based on quantitative and qualitative analysis and then recommended the most qualified candidates for further consideration. Mr. Ewing said that in his opinion, using Mercer as the "gatekeeper" maintained the integrity of the process, and he intended to continue referring managers to Mercer to screen based on qualifications and appropriateness for the portfolio.

Mr. Schutes stated that currently the portfolio was reasonably balanced between active and passive management, well diversified by style, capitalization, types of active management, and risk, and should add a substantial amount of alpha going forward.

(Information relating to this matter has been retained in the Commission's files and is identified as Exhibit B.)

Chairman Williams asked Messrs. Schutes and Love to discuss Mercer's frequency and format of reporting to the Commission. Mr. Schutes stated that in the past, Mercer provided a monthly "flash" report and detailed quarterly reports about the equity portfolio and capital markets. Mr. Schutes recommended that this practice be continued. Mr. Schutes expressed concern in the practicality of completing quarterly reports in time for meetings held the first Thursday after a quarter's end. Chairman Williams stated that in addition to the reports mentioned, Mercer should report on various components and issues about the portfolio during each meeting until the Commission was updated thoroughly. Messrs. Schutes and Love agreed, and in light of requests made by Commissioners, they agreed to report on current market trends and benchmarking issues in upcoming meetings.

Chairman Williams asked about Mercer's access to data about the portfolio. Mr. Love stated that Mercer receives paper statements and a tape feed of the portfolio's holdings from BoNY approximately three weeks after the month's end. Mr. Love stated that the lack of direct access to the information from BoNY does not allow Mercer to monitor holdings or risk of the portfolio on a real-time basis. Chairman Williams asked what could be done to remedy the problem. Mr. Love stated that since the STO maintains the relationship with BoNY, the STO should request access on Mercer's behalf. Mr. Patsy stated that the STO would not allow Mercer to receive real-time data or access to BoNY because giving someone who does not work for the state of South Carolina access to the state's banking information or accounting system would be a security violation. In addition, Mr. Patsy stressed that data before the third week of the month would not be audited. Mr. Schutes explained that Mercer would not request unlimited access to the state's banking information and accounting system, and noted that BoNY had a system that would allow third party providers limited access to certain tools and data. Mr. Patsy stated that Mercer could request the information from the STO or directly from the investment managers, but reaffirmed that the STO would not give Mercer direct access. Chairman Williams stated that to whom and in what manner the portfolio data would be distributed would be the Commission's decision ultimately, and asked that Messrs. Schutes, Love, and Patsy determine a security-conscious way for Mercer to receive immediate online access to Retirement Systems' portfolio data.

Chairman Williams asked about the broker selection process and whether a commission recapture program would be appropriate. Mr. Schutes explained that brokers for the portfolio were selected by the investment managers currently, and stated that considering the available technology and the sophistication of the process, a commission recapture program would be appropriate from a fiduciary perspective. Chairman Williams asked if there would be any negative impact in participating in commission recapture, and Mr. Love replied that there would not be negative impact if the program were properly structured. Mr. Schutes stated that some managers would not participate in a commission recapture program or would restrict participation based on investment strategies, but the Commission would evaluate individual managers to determine the appropriate level of participation, and Mr. Love concurred. Mr. Schutes reiterated that with increasing transparency in the industry, some of the previous concerns had been negated. Mr. Ewing made a motion to authorize Mercer to issue a Request for Proposals (RFP) for commission recapture providers. After discussion, the motion was seconded by Mr. James Powers and passed unanimously.

Mr. Powers asked whether the Commission had a comprehensive disaster recovery plan. Ms. Shealy explained that Commission staff maintained the paper records from the Panel, the Board, and now the Commission. In addition, many records were archived electronically, and the electronic archival process would be an ongoing project. Ms. Shealy noted that the electronic documents were stored on a secure drive that was backed-up nightly and retained off-site for a period of time.

Mr. Schutes explained that the Boston Company Asset Management (TBC) had been terminated due to changes in the portfolio's investment process made by a new portfolio manager. Mr. Schutes stated when TBC was terminated, the funds were transitioned into the Passive Smaller Cap fund until the Commission determined the long-term strategy for those assets. Mr. Schutes explained that while TBC was hired as a value manager for the Retirement Systems' portfolio originally, the portfolio became more core oriented over time and had continued to be appropriate for the Retirement

Systems' overall investment strategy. Mr. Schutes stated that since this was a unique manager who played such a flexible role, it was improbable that the same kind of manager could be found. Mr. Love stated that the Commission should focus on the entire asset allocation to determine the appropriate strategy in which to place the funds.

Chairman Williams asked that Messrs. Schutes and Love complete an analysis of the portfolio and provide a recommendation for allocation of the funds. In the interim, the funds should remain invested in the Passive Smaller Cap fund. Mr. Schutes agreed and stated that the analysis could be provided in conjunction with the discussion of indices, benchmarks, and overall market trends. Mr. Love emphasized that given the portfolio's objectives and structure, there was no concern about leaving the funds invested in the Passive Smaller Cap fund until completion of an analysis because exposure to the smaller cap markets would be maintained.

Chairman Williams thanked Messrs. Schutes and Love for their report.

III. ADMINISTRATIVE MATTERS

Chairman Williams expressed thanks to Mr. Patsy and STO staff for providing the fixed income flash report and asked Mr. Patsy to prepare a report concerning benchmarks for the fixed income portfolio. The Commission discussed various issues relating to customized benchmarks versus market indices for evaluating the portfolio. Messrs. Gillespie and Powers suggested exploring customized benchmarks that would include consideration of the liabilities of the Retirement Systems, and the Commission concurred. Mr. Ewing noted that a portion of the fixed income investments could be tailored relative to liabilities and said he would like to see the impact of various types of investments on the assets and liabilities, and the Commission concurred. Chairman Williams asked if information relating to appropriate benchmarks and various asset allocations would be incorporated in an ALM study, and Messrs. Schutes and Love responded that it would be included. Chairman Williams reiterated that he would request proposals from the actuary and Mercer for the cost of conducting an ALM study.

Chairman Williams explained that based on the motions made and carried at the last meeting, staff prepared technical amendments to the Statement of Investment Objectives and Policies (SIP) and the AIP to conform to current law and other changes made by the Commission. He noted that he vetted both documents very carefully so the documents were the result of a collaborative effort.

The Commission received proposed changes to the documents from Mr. Gillespie, Mr. Patsy, and STO staff relating to various provisions in the investment objectives and the annual reporting requirements for the total portfolio. After discussions, Mr. Gillespie moved that the term "high yield investments" be stricken from both the AIP and the SIP in the fixed income investment guidelines. Mr. Ewing seconded the motion, which carried unanimously. Mr. Ewing made a motion to ratify the SIP as amended. Mr. Powers seconded the motion, which carried unanimously. Mr. Ewing made a motion to ratify the AIP as amended. Treasurer Patterson seconded the motion, which carried unanimously.

(Information relating to this matter has been retained in the Commission's files and is identified as Exhibit C.)

Chairman Williams recognized Mr. Powers to lead the discussion of the Chief Investment Officer's (CIO) job description. The Commission received working documents outlining possible duties, responsibilities, and qualifications of the CIO. Mr. Powers suggested that at this point the job description and qualifications be kept as broad as possible. The Commission discussed, in detail, the position of the CIO and scripted a preliminary job description and list of required qualifications.

Mr. Ewing suggested that the Commission consider hiring a compliance officer for purposes of a separation of duties. Mr. Powers stated that since Ms. Shealy reports directly to the Commission, she is acting in that capacity currently.

Chairman Williams recognized Mr. Sam Wilkins from the South Carolina Budget and Control Board Office of Human Resources (OHR). Mr. Wilkins explained OHR offers Executive Search Services to state agencies, which provides professional recruitment and selection services for agency heads and senior level management positions. Mr. Wilkins described the recruiting services that OHR could provide through the Executive Search Services program, noting that the Commission could select the level of services they deemed appropriate. Mr. Wilkins and the Commission discussed fees for the recruiting services. The Commission determined that a focused group specializing in facilitating the search should be retained and that the fees charged by OHR would be significantly less than engaging a private recruiting office. Mr. Wilkins agreed to draft a proposal for the Commission. Chairman Williams thanked Mr. Wilkins for his presentation.

Mr. Powers moved that the job description and qualifications for the CIO be adopted as outlined and amended by the Commission. Mr. Ewing seconded the motion, which passed unanimously after thorough discussion.

Mr. Powers made a motion that the Commission engage OHR's Executive Search Services to facilitate and to coordinate with Chairman Williams and Mr. Powers in the CIO search. The motion was seconded by Mr. Ewing and passed unanimously.

(Information relating to this matter has been retained in the Commission's files and is identified as Exhibit D.)

Ms. Shealy informed the Commissioners of several upcoming educational seminars. She asked that the Commissioners advise staff if anyone was interested in attending so arrangements could be made.

Ms. Shealy stated that the Commission's travel reimbursements would be subject to the guidelines established by state law and regulations of the Comptroller General's (CG) office. Ms. Shealy outlined those guidelines, and at the request of Mr. Powers, agreed to provide the Commissioners with a copy of the guidelines. She informed the Commissioners that conferences for continuing education would be allowable expenses and covered by the agency. After discussion, it was decided that Commissioners traveling for the purpose of continuing education would be reimbursed by the agency if such conferences are held within the continental United States, the expenses are reasonable and appropriate given the Commission's responsibilities, and the arrangements are made using the most economic means available. Chairman Williams stated that attendees would be expected to provide a report to the Commission about any conferences upon their return. All travel by Commission staff would be approved by the Chairman prior to arrangements being made.

In response to a question from Mr. Ewing, Ms. Shealy stated that under the new statutes, Commissioners could not accept anything of value from managers, even if receipt was disclosed. Chairman Williams stated that he was uncertain about the policy and would give it more attention before a final determination was made.

Mr. Ewing stated that he attended the Beyond Conventional Investment Wisdom conference hosted by Barclays Global Investors (BGI) in New York, New York. Mr. Ewing reported on relevant topics discussed at the conference and suggested that the Commission invite Mr. Barton Waring of BGI to a Commission meeting to discuss the impact increased equity exposure has on a plan's liabilities. Mr. Schutes agreed to invite Mr. Waring to the December Commission meeting.

Chairman Williams stated that the Commission would be required to submit a budget detail for fiscal year 2007, on October 14, 2005. Chairman Williams discussed the Commission's current budget for fiscal year 2006 and proposed items that should be increased in consideration of the Commission's plan to fill the CIO position. He noted that there would be expenses relating to the position in addition to certain across-the-board inflationary assumptions. In response to a question posed by Mr. Powers, Ms. Shealy outlined the budget process. Ms. Shealy noted that the Commission's budget would not be appropriated from the State's General Fund, but would be an authorization to expend trust funds for Commission operations. She also noted that given the newness of the agency, they would probably be allowed some flexibility in terms of authorizations.

Chairman Williams asked when the Commission should look at the individual line items of the budget in order to generate a more sophisticated figure. Mr. Steve Osborne from the South Carolina Budget and Control Board, Office of the Executive Director (OED) indicated that the Commission would have time before a line-item budget would be required, but he stressed that it must be done before the fiscal year begins. He noted that if the Commission feels that another employee would be necessary, they should request an additional Full-Time Employee (FTE) and include potential salary considerations in the budget figure.

Mr. Gillespie asked if there would be a fee involved in using the office space at the Retirement Systems. Ms. Boykin stated that since the Commission's operations would be drawn from the trust funds, it would not be a violation of the trust for the Commission to use the space in the Retirement Systems' building without paying rent.

Chairman Williams stated that since the CIO position was required by statute and the Commission fully intends to fill it in the near future, salary considerations for that position should be included in the budget. After thorough discussion, a motion was made by Mr. Powers, seconded by Mr. Ewing, and unanimously passed that the Commission request a total increase of $225,000 in the proposed budget detail for the purpose of "other personal services" and "state employer contributions", to be allocated as appropriate.

Ms. Shealy noted that all increases over the budget for the previous year might require justification to the Governor's Office, the House Ways and Means Committee, and/or the Senate Finance Committee.

(Information relating to this matter has been retained in the Commission's files and is identified as Exhibit E.)

Mr. Ewing asked whether the current level of fiduciary liability insurance was adequate. Chairman Williams stated that he did not believe the current level was adequate, but he would explore additional insurance quotations and a possible change in the statutory provision to provide adequate coverage for the Commission and the Retirement Systems. Ms. Shealy stated that regardless of a statutory change, the Commission and Board still should maintain some level of fiduciary liability insurance. She also noted that the level of fiduciary insurance currently maintained was consistent with information she had regarding comparable systems within the last few years. Ms. Shealy reiterated the need to develop processes and agreed to explore additional insurance options.

IV. OTHER BUSINESS

Ms. Boykin offered to organize an actuarial education presentation for a subsequent meeting. The Commission thanked Ms. Boykin and asked her to coordinate a presentation with the Retirement Systems' actuary.

At the consent of the Commission, Chairman Williams stated that due to accounting and reporting issues, starting in December, regular Commission meetings would be held on the second Thursday of every month.

V. ADJOURNMENT

Chairman Williams thanked everyone for attending the meeting. Treasurer Patterson made a motion to adjourn. Mr. Ewing seconded the motion, and the meeting adjourned at 2:15 p.m.

[Staff Note: In compliance with S.C. Code Ann. §30-4-80, public notice of and the agenda for this meeting were delivered to the press and to parties who requested notice and were posted at the entrance, in the lobbies, and near the 2nd Floor Conference Room at 202 Arbor Lake Drive, Columbia, SC, on October 11, 2005.]