South Carolina Retirement System Investment Commission
Meeting Minutes

Thursday, December 8, 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; Anne Macon Flynn from the Budget and Control Board Office of General Counsel; Sam Wilkins and Joye Lang from the Budget and Control Board Office of Human Resources; Rick Patsy, Trav Robertson, Frank Rainwater, and Shakun Tahiliani from the State Treasurer's Office; Jay Love from Mercer Investment Consulting; Ernie Cruikshank from Jamison, Eaton & Wood, Inc.; Peggy Boykin, Dianne Poston, Alice Copeland, Faith Wright, Tammy Davis, Travis Turner, Sarah Corbett, Danielle Quattlebaum, and Joni Redwine from the South Carolina Retirement Systems; Lisa Nichols from the Senate Finance Committee; David Lissek from Barclays Global Investors; Travis Pritchett, Henry Addy, Crawford Clarkson, Sam Griswold, Kent Phillips, and Wayne Pruitt from the State Retirees Association; Charley McDonald from the South Carolina Trooper's Association; and Horace Jackson and Cletus Powell, state retirees.

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 10:00 a.m. Due to a scheduling conflict, Treasurer Grady Patterson left the meeting at 12:00 p.m.

Treasurer Grady Patterson requested that the Commission consider moving the Executive Session items to the beginning of the meeting agenda. Upon a motion by Treasurer Patterson, which was seconded and passed unanimously, the proposed agenda was adopted as amended.

Chairman Williams called for objections or amendments to the minutes from the Commission meeting on November 3, 2005. There being none, the minutes were adopted as presented.

Chairman Williams stated that based on conversations with the Commission and staff, he had considered proposing several amendments to the State Retirement System

Preservation and Investment Reform Act (Act 153) that would be helpful to the Commission's operations. Chairman Williams said he would conduct additional research and provide the Commission with further information.

Chairman Williams stated that he executed several contracts per the Commission's prior authorization and monitored issues related to the transition of the additional 2.5 percent allocation to equity investments. He advised that the transition was nearly completed.

II. EXECUTIVE SESSION

Chairman Williams stated that the agenda item for the election of the retiree representative to the Commission was scheduled to occur in open session, but after reviewing Freedom of Information Act (FOIA) requirements, it was determined that the item could be discussed in executive session prior to taking a vote in open session. After discussion, it was determined that the Commission would discuss the qualifications of the candidates for the retiree representative in executive session.

Mr. Blaine Ewing made a motion, which was seconded by Mr. Allen Gillespie and passed, that the Commission enter into executive session to discuss the qualifications of the candidates for the retiree representative to the Commission, a contractual matter relating to the Asset Liability Modeling Study (ALM), and a personnel matter. Chairman Williams announced that the Commission would meet in executive session for those purposes. Treasurer Patterson noted his standing objection to any matters being discussed in executive session.

The Panel reconvened in open session. Chairman Williams noted that the Commission would address the items in the order in which they were discussed in executive session.

Chairman Williams said that first, the Commission discussed a contractual matter relating to the ALM. Mr. Ewing made a motion that the Commission solicit a proposed contract or agreement from Mercer Investment Consulting, Inc. (Mercer), to prepare an ALM and that upon receipt of the proposed agreement, the chairman negotiate the terms and bring it back before the Commission for ratification. The motion was seconded by Mr. Gillespie and passed unanimously.

Chairman Williams said that the second matter discussed in executive session involved the position of General Counsel to the Commission and the Administrative Director. Mr. Ewing made a motion to appoint Ms. Shealy, who was currently functioning as the "Acting" General Counsel to the Commission and "Acting" Administrative Director for the Commission, to the position of General Counsel to the Commission and Administrative Director of the Commission and for Chairman Williams to negotiate a salary with Ms. Shealy consistent with the Commission's discussions in executive session. The motion was seconded by Mr. Powers and passed unanimously.

Chairman Williams said that the third and final matter discussed in executive session involved the merits and qualifications of the two candidates for retiree representative for the Commission. He noted that Act 153 required the retiree representative to be elected by unanimous vote of the Commission. After thorough discussion, the Commission unanimously elected Dr. S. Travis Pritchett as the retiree representative to the Commission. Chairman Williams and the Commission congratulated Dr. Pritchett and asked Ms. Shealy to ensure that the necessary documentation was prepared to complete his appointment and qualification process.

III. INVESTMENT MATTERS

Chairman Williams recognized Mr. Jay Love of Mercer to review the equity portfolio Quarterly Investment Performance for Periods Ending September 30, 2005.

Mr. Love reviewed economic factors and broad market performance. He explained that, in general, the economy was robust during the quarter despite the impact of increased energy prices resulting from hurricanes Katrina and Rita. He noted that the Standard & Poors 500 Index (S&P 500) increased 3.6 percent. Mr. Love provided an overview of market performance on an industry and sector basis, discussed market returns, and provided an overview of the largest positive and negative contributors to the S&P 500 for the third quarter of 2005.

The Commission and Mercer discussed the South Carolina Retirement Systems' (Retirement Systems) equity portfolio performance. Mr. Love reported that the equity portfolio totaled approximately $12.3 billion dollars, which was consistent with the targets in the Annual Investment Plan (AIP). Mr. Love explained that the equity portfolio outperformed the Total Equity Index (a weighted average of the benchmarks of all the investment managers for the Retirement Systems' equity portfolio) by 60 basis points (bps), which signified the alpha generated by the equity portfolio. For the three- and five-year periods ended September 30, 2005, the portfolio returned 17.9 percent and 0.7 percent, outperforming the S&P 500 by 120 bps and 220 bps, respectively.

The Commission and Mr. Love reviewed the performance of the asset classes relative to the applicable indices. They also reviewed the performance of the individual managers and compared them to the applicable indices and rankings within their respective peer groups. Mr. Love discussed the total portfolio's allocation by sector and noted that the overall equity portfolio was aligned with the broad market in terms of sector allocations.

Mr. Love advised the Commission that Mercer recently downgraded Flippin, Bruce, & Porter, Inc. (FBP), one of four Large Cap Value managers for the equity portfolio. Mr. Love explained that Mercer's internal downgrade was primarily due to FBP's contrarian investment process and portfolio construction, which made the strategy unsuitable for a majority of Mercer's clients. Mr. Love stated, however, that Mercer had not recommended that any clients terminate FBP. Mr. Love explained that given the large number of assets in the Retirement Systems' equity portfolio, there was more flexibility than the typical client, and while FBP might not be suitable for Mercer's typical client, Mercer felt that FBP remained suitable for the Retirement Systems' equity portfolio.

The Commission received the Quarterly Investment Performance for Periods Ended September 30, 2005, and the Executive Summary as information. No amendments to the Interim Annual Investment Plan were proposed.

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

Mr. Love provided the Commission with a summary and update on the transition of the additional 2.5 percent allocation to the equity portfolio and noted that the additional cash contribution to the equity portfolio totaled approximately $650 million. He explained the benefits of using a transition manager in instances when a large amount was being transitioned and noted that using the transition manager resulted in a savings of approximately $500,000. Mr. Love noted that using a transition manager did not impact the managers' investment processes.

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

Chairman Williams recognized Rick Patsy from the State Treasurer's Office (STO) and Ernie Cruikshank from Jamison, Eaton & Wood, Inc. (Jamison) for a presentation on the fixed income investments of the Retirement Systems.

Mr. Patsy gave a brief overview of the yield curve and the interest rate environment for the past 12-month period. Mr. Patsy noted that the Federal Reserve raised rates twice during the third quarter of 2005 to 3.75 percent with the expectation that they would continue to raise rates at a measured pace. Mr. Patsy explained that the economy still faced a relatively low interest rate environment.

Mr. Patsy reviewed the general performance of the total portfolio, fixed income portfolio, and equity portfolio for the previous month, quarter, one-year, three-year, and five-year periods. He discussed the performance of the fixed income portfolio relative to its benchmark, the Lehman Aggregate, as well as the performance attribution analysis using the Wilshire Axiom during the same periods.

Messrs. Patsy and Cruikshank and the Commission reviewed the fixed income portfolio's characteristics, including the average maturity, coupon, duration, and ratings. Mr. Patsy also discussed asset allocations within the fixed income portion of the portfolio, the changes that occurred over the previous 12-month period, and the changes that the STO expected to make in the coming months. He also provided the Commission with a summary of the STO's economic forecast. Mr. Patsy noted that the fixed income flash report for October showed a continued trend of good performance versus the Lehman Aggregate.

Mr. Cruikshank provided a summary of the target strategy for the fixed income portfolio. In response to a question by Mr. Ewing, Mr. Cruikshank stated that the fixed income portfolio had momentum going into 2006, but Jamison and the STO were concerned about performance for the end of 2006 due to uncertainty about the federal funds rate.

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

Chairman Williams stated that the Commission recognized the inherent difficulty determining transaction costs in a fixed income environment, but Act 153 required the Commission to issue an annual report, which included transaction costs for both the equity and fixed income portfolios. Messrs. Patsy and Cruikshank and Commission discussed issues and possible solutions for computing transaction costs in the fixed income environment.

In response to a question by the Commission, Messrs. Patsy and Cruikshank explained the relationship between the STO and Jamison as well as the fixed income trading process. Messrs. Patsy and Cruikshank said that the STO and Jamison worked as a very close team. The STO and Jamison worked together to determine an investment strategy, and the STO was responsible for executing the strategy. Mr. Patsy stated that Jamison was responsible for approximately 90 percent of the investment results of the fixed income portfolio.

Chairman Williams recognized Mr. Love to discuss the Transaction Cost Analysis for the equity portfolio. Mr. Love noted that equity transaction costs were easily measured, and Mercer conducted an annual transaction cost analysis for the equity portfolio. Mr. Love explained that transaction costs were comprised of commission costs, which were the explicit fees paid to brokers, and execution costs, which were the implicit costs or market impact. He stated that the institutional average commission cost was about 4.25 cents per share while the average commission cost for the Retirement Systems' equity portfolio was 3.11 cents per share. Mr. Love explained the execution costs were more difficult to quantify. He said the execution costs for the Retirement Systems were within acceptable ranges, so Mercer did not recommend further investigation of any of the managers. He noted, however, that all costs and the managers' trading would continue to be monitored closely.

Mr. Love noted that the transaction report included data for three transitions, one completed by Frank Russell Securities, Inc., and two completed by State Street Bank and Trust. He stated that the transaction costs were quite good in all three transitions.

The Commission and Mr. Love discussed concerns over transaction costs of Alliance Capital Management, LP (Alliance), for the Large Cap Value portfolio. Mr. Love stated that Mercer discussed these concerns with Alliance previously, and Mercer felt comfortable with the changes that were being made. Mr. Love explained that in the past, Alliance's high transaction costs were partially attributed to above average commissions for internal trades, but those commissions had since decreased to approximately four cents per share. He stated that the amount of Alliance trades that could be executed through the AllianceBernstein brokerage arm had been limited to 25 percent. Mr. Love stated that Mercer was not concerned with Alliance's transaction costs at this time, although they would continue to explore ways to further reduce the costs.

Mr. Gillespie asked about Alliance's high transaction costs for the Large Cap Growth portfolio, particularly the above-average execution costs. Mr. Love stated that Mercer had had numerous discussions with Alliance regarding the issue and noted that Alliance's transaction costs were improving. Mr. Love noted that in the case of Alliance, a commission recapture program would help lower the transaction costs.

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

Chairman Williams asked Mr. Love to discuss options for the Mid-cap asset subclass. Mr. Love explained that the Retirement Systems' contract with The Boston Company (TBC) was terminated in August/September due to a change in the portfolio manager and impending modifications to TBC's investment strategy. TBC was a very eclectic Small to Mid-Cap Core manager, and they managed approximately 2.7 percent of the Retirement Systems' total equity portfolio. Mr. Love explained that the assets previously invested with TBC were temporarily transitioned to the Russell 2000 Index Fund (Russell 2000) pending further discussion and portfolio analysis. TBC's termination resulted in 2.7 percent of the Smaller Cap portfolio being invested in the Russell 2000, a purely small cap index. Mr. Love stated that the Commission should decide whether the assets should remain invested in the Russell 2000 temporarily or if other alternatives such as conducting a search for a mid-cap index fund or active manager should be initiated. Mr. Love stated that Mercer recommended the Commission leave the funds invested in the Russell 2000 temporarily and conduct an active manager search to replace TBC after the chief investment officer (CIO) is hired. He said that leaving the funds invested in the Russell 2000 on a temporary basis should not negatively impact the portfolio based on the market environment and timeframes. Mr. James Powers recommended that an item related to the active manager search be placed on the agenda for the retreat at Wampee in March. After discussion, the Commission determined that the funds should remain invested in the Russell 2000 temporarily.

IV. ADMINISTRATIVE MATTERS

Chairman Williams recognized Mr. Sam Wilkins and Ms. Joye Lang from the South Carolina Budget and Control Board Office of Human Resources (OHR) for an update on the Chief Investment Officer (CIO) recruitment process. Mr. Wilkins stated that a large and diverse group of candidates responded to the posting for the CIO position. He stated that the Commission should decide the timeframe and format for the CIO Screening Committee (Committee), which was comprised of Chairman Williams and Vice Chairman Powers, to receive the applications for review. After thorough discussion, it was decided that OHR would group the applications by various qualifications and present the applications to the Committee. The Committee would review the applications and cull the group to approximately 10-20 candidates for further screening. After the Committee identified the most appropriate candidates, the information would be provided to the Commission for further screening. Mr. Wilkins reminded the Commission that candidates would likely inquire as to the organizational structure of the Commission and salary range for the position and asked that the Commission be prepared to answer such questions. Chairman Williams noted that the Committee was not intended to be exclusive, but that with the volume of applications, there needed to be a mechanism to cull the candidates to a more manageable group for the Commission to review. He said that the Committee would advise the Commission of its meeting schedule so any member of the Commission could review the applications.

Chairman Williams stated that Act 153 required the Commission provide investment reports at least quarterly to various officials and entities. Chairman Williams stated that there were no specific requirements for the information to be included in the quarterly reports and asked for the Commission's input. After thorough discussion, the Commission decided that the quarterly report should include a current flash report for both the equity and fixed income portfolios and a list of pertinent actions taken during the quarter. At Chairman Williams' request, Ms. Shealy agreed to create a draft of the quarterly report for his review.

Chairman Williams recognized Sarah Corbett from the Retirement Systems for a report on the integration of the National Guard Retirement System (NGRS) with the Retirement Systems. Ms. Corbett stated that the Retirement Systems would assume administration of NGRS, which was previously administered by the Adjutant General's Office, on January 1, 2006. Ms. Corbett explained the benefit structure, administrative implications, and the funding status of NGRS. She explained that NGRS was only 28.69 percent funded, had a 30-year amortization period, and had an unfunded liability of approximately $34 million. Ms. Corbett stated that, although equity investments were allowed pursuant to Act 155 of 2005, all NGRS assets were invested currently in fixed income securities managed by the STO. Ms. Corbett stated that the actuarial rate of return for NGRS investments was 7.25 percent; however, a pension study completed in December of 2001, stated that a 7.25 percent return was unlikely unless the assets of NGRS were at least partially invested in equities. Ms. Corbett noted that while the NGRS was closed to new members after 1993, a bill had been introduced which would open NGRS retroactively to 1993 and going forward.

Chairman Williams noted that all fixed income investments for NGRS were currently invested in the name of the NGRS and questioned the feasibility of integrating those fixed income investments with those of the other systems and transitioning the appropriate assets to the equity portfolio. Mr. Patsy and Ms. Tahilani stated that the fixed income assets were not currently pooled and discussed several implications of pooling fixed income investments. Chairman Williams requested that the STO and Retirement Systems coordinate efforts regarding the pooling of the fixed income investments of the various retirement systems, including the integration of the assets of NGRS. Chairman Williams requested that Treasurer Patterson and Peggy Boykin, Director of the Retirement Systems, appoint representatives from their respective offices to identify issues, recommend solutions, and to provide timeframes relating to pooling the fixed income investments. Mr. Gillespie made a motion that the liaisons report the implications of pooling assets for investment purposes, including any issues relating to timing, reporting, transition, accounting, or operational concerns, to the Commission at the February 2006 meeting. The motion was seconded and passed unanimously.

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

Chairman Williams noted that the provisions of Act 155 relating to the NGRS would become effective January 1, 2006. While further analysis would be needed prior to implementing an investment plan for the NGRS assets, the Commission should consider amending the Interim Annual Investment Plan (AIP) and Statement of Investment Objectives and Policies (SIP) to include references to the NGRS. Mr. Ewing made a motion, which was seconded by Mr. Gillespie, that the AIP and SIP be amended to include a provision that effective January 1, 2006, S.C. Code §§9-16-10 *et seq*., would govern the investment of the assets of the NGRS and that after analyses of the portfolios are completed, the appropriate investment strategy would be determined and implemented. The motion carried, and the AIP and SIP were amended to conform.

Chairman Williams stated that the Commission's office would be open Monday through Friday from 8:15 a.m. to 5:00 p.m. except for South Carolina state holidays. He stated that since the Retirement Systems' doors locked at 4:45 p.m., Commission staff would be available by phone or by appointment between 4:45 p.m. and 5:00 p.m.

Chairman Williams asked if there were any objections to the 2006 Commission regular meeting schedule, and there being none, the schedule was adopted.

Chairman Williams explained the agenda item relating to policies for conference attendance. He said that under the SC Freedom of Information Act (FOIA), a meeting of the Commission convened anytime a quorum of members was present and Commission business was discussed, which required posting notice of the meeting and an agenda. He noted further, however, that a quorum could be present for a purely social function without a meeting being convened so long as Commission business was not discussed. Given that four members were going to attend a conference in January 2006, he asked whether the Commission should consider establishing a policy limiting the number of Commissioners who could attend an educational conference. In the alternative, he said the Commission could establish that if a quorum of Commissioners attended a conference, the members would agree that no business would be discussed. After thorough discussion, the Commission determined that a specific policy was not necessary as this would be a rare occurrence and individual instances could be addressed as needed. The Commission agreed that if a quorum were present, the members would refrain from discussing Commission business unless the meeting was posted pursuant to the FOIA.

Chairman Williams briefly discussed a proposed FOIA Request policy and outlined the process for answering requests for information pursuant to the FOIA. He stated that all requests for information from the Commission should be answered in accordance with FOIA, including, but not limited to, timeframes, definitions of releasable information, and exemptions. He explained that matters not subject to disclosure under the FOIA would not be released without prior approval of the Chairman of the Commission, and in matters where disclosure was questionable, the advice of the Chairman should be sought prior to releasing records under the FOIA. Chairman Williams stated that if information requested under the FOIA was determined to be non-releasable, the Chairman and/or his designee would provide written notification of that determination and the reasons thereof within the timeframes required by the FOIA. Consideration of the proposed FOIA Request policy was carried over until the next meeting.

Chairman Williams requested that Mr. Ewing lead the Commission in determining the format and agenda items for the retreat at Wampee scheduled in March 2006. Mr. Ewing agreed and asked that Commissioners submit ideas and discussion topics. Ms. Shealy discussed possible format options and noted that Mr. Barton Waring from Barclays Global Investors (BGI) had confirmed that he would present at the retreat.

The Commission discussed the organizational structure of the agency and the level of investment authority the CIO should have within that structure. Mr. Powers stated that the Commission should be prepared to invest in every asset class allowable by law and should collaborate with the CIO in making investment decisions with the CIO being responsible for implementation and timing decisions. Mr. Powers also stated that the Commission should employ, separate from the CIO, an Administrative Director who is responsible for compliance, budgeting, legal issues, and other operational matters. At Chairman Williams' request, Ms. Shealy agreed to compile an outline of allowable asset classes and the Commission agreed to compile questions for the candidates for the CIO position.

V. ADJOURNMENT

Chairman Williams thanked everyone for attending the meeting. Mr. Ewing made a motion to adjourn. Mr. Powers seconded the motion, and the meeting adjourned at 3:05 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 December 6, 2005.]