South Carolina Retirement System Investment Commission
Meeting Minutes

February 21, 2008
Second Floor Conference Room
202 Arbor Lake Drive
Columbia, South Carolina 29223

Commissioners Present:
Mr. Reynolds Williams, Chairman
Mr. James Powers, Vice Chairman
State Treasurer Converse Chellis
Mr. Blaine Ewing
Mr. Allen Gillespie

Others present for all or a portion of the meeting: Dunkin Allison, Robert Borden, Brenda Gadson, Heather Muller, Rick Patsy, Greg Putnam, Kathy Rast, Nancy Shealy, Nicole Waites, Brian Wheeler from the South Carolina Retirement System Investment Commission; Mike Addy, Delores Dacosta, Rick Harmon, and Shakun Tahiliani from the State Treasurer's Office; Sean Gill and Joe O'Byrne from New England Pension Consultants; Peggy Boykin, Tammy Davis, Robin Leadbitter, John Page, Danielle Quattlebaum, Kelly Rainsford, Joni Redwine, Travis Turner, and Faith Wright from the South Carolina Retirement Systems; Rena Grant from the House Ways and Means Committee; Jack Coates, Gil Caffray, Mark Vanderzwan, and Eban Cuanotta from Morgan Stanley; Sam Griswold, William Kay, Jan Angler, and Wayne Pruitt from the State Retirees' Association.

I. CALL TO ORDER AND CONSENT AGENDA

Chairman Reynolds Williams called the meeting of the South Carolina Retirement System Investment Commission (Commission) to order at 10:00 a.m. and welcomed the Commissioners and guests. Dr. Travis Pritchett was unable to attend the meeting due to an illness in his family.

Chairman Williams noted that State Treasurer Converse Chellis would need to leave the meeting prior to 2:00 p.m. to attend a State Budget and Control Board (Board) meeting, so he asked that the Chairman's Report be addressed during an appropriate point in the meeting so Mr. Chellis could participate in discussions. There being no objections or amendments, the proposed agenda was adopted as presented. The minutes from the meeting on January 17, 2008, were approved; Mr. Allen Gillespie abstained from voting as he had not had an opportunity to review the minutes prior to the meeting. The minutes from the meetings on October 18 and November 19-20, 2007, were carried over.

Chairman Williams asked Ms. Nancy Shealy to introduce the new Administrative Coordinator for the Commission, Brian Wheeler, and the Commission welcomed him to the staff.

II. INVESTMENT MATTERS

Chairman Williams recognized Mr. Robert Borden for the Chief Investment Officer's (CIO) report. Mr. Borden referred to the portfolio performance flash reports for December 31, 2007, and January 31, 2008, the Beta Overlay performance report, and the draft December 31, 2007 Quarterly Report. He discussed the investment performance of the portfolio, noting that the South Carolina Retirement Systems' (Retirement System) peer group ranking had improved significantly since the Commission began transitioning the portfolio to a more diversified asset allocation. He discussed the preliminary performance for January 2008 and highlighted contributing factors to that performance.

Mr. Borden introduced Sean Gill from New England Pension Consultants, LLC (NEPC) to review the portfolio performance for the quarter ended December 31, 2007. Mr. Gill referred to NEPC's quarterly report and discussed performance of the total portfolio, various asset classes, and the Retirement System's performance compared to peer group rankings. Mr. Ewing requested that a weighted composite benchmark be developed to measure each manager's performance relative to the total portfolio.

Mr. Borden introduced Mr. Rick Patsy to review the performance of the core fixed income portfolio. Mr. Patsy highlighted the investment strategy and provided a brief overview of the yield curve, the general economic environment, and the performance of the portfolio over various periods. Mr. Borden noted that he, Mr. Patsy, and the Commission's fixed income investment advisor, Jamison, Eaton & Wood, were working on a project to further institutionalize the core fixed income portfolio management process.

Mr. Borden referred to Callan Associates Inc.'s (Callan) Investment Measurement Service Quarterly Report for the Retirement System. He noted that Callan provided the report to the Commission at no charge in return for providing comparative data by which Callan could prepare peer group rankings. He noted further that the Commission received similar data from three other sources and that staff would develop summary reports for the Commission in the future.

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

Mr. Borden referred to information relating to recommendations for changes to the policy target asset allocations. He noted that based on information discussed during the Commission's November meeting, NEPC had updated their assumptions used in developing the recommended policy target asset allocation or mix. Mr. Borden stated that based on NEPC's updated assumptions, the valuation opportunities in the capital markets, the improvement to the risk/reward profile, and the practical structural limitations on asset redeployment, they recommended shifting some of the asset allocations and conducting additional manager searches in 2008. He asked Mr. Gill to review the recommendations and rationale.

Mr. Gill referred to NEPC's 2008 Asset Allocation Analysis (Analysis) for the Retirement System and provided an overview of NEPC's assumptions and analyses, which included information about the current asset allocation mix, the impact of various shifts in allocations, historical performance from 2003 through 2007, and risk and return correlation forecasts. Mr. Borden noted that the asset allocation recommendations were related to the recommendations for manager searches during 2008, which included conducting searches for strategic partnerships, opportunistic credit, high yield, emerging market debt, and real estate. He outlined the recommendations for the changes to the asset allocation mix, which were presented as "Mix 2" in NEPC's Analysis, and the proposed 2008 searches.

Upon question by Mr. Allen Gillespie, Messrs. Borden and Gill provided additional information about the asset allocation mix recommendations and risk management. After further discussion, Mr. Chellis made a motion to adopt the recommendation to shift the long-term asset allocation to Mix 2 and to authorize staff to amend the Annual Investment Plan, Statement of

Investment Policies, and Statement of Investment Objectives as applicable. Mr. Gillespie seconded the motion, which passed unanimously.

Upon motion by Mr. Chellis and second by Mr. Gillespie, the Commission unanimously approved the recommended searches as outlined in Mr. Borden's memorandum, which had been submitted to the Commission prior to the meeting. After further discussion, Commissioners were assigned to the search teams as follows: Chairman Williams for strategic partnerships, Mr. Gillespie for opportunistic credit, Mr. Ewing for high yield, Mr. James Powers for emerging market debt, Mr. Chellis for real estate, and Dr. Travis Pritchett for continued searches for private equity.

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

Mr. Borden introduced Dr. Jack Coates and Messrs. Gil Caffray, Mark Vanderzwan, and Eban Cuanotta from Morgan Stanley Investment Management to review the FrontPoint Multi-Strategy Fund (FrontPoint) and to discuss risk management and reporting.

Mr. Caffray reviewed the FrontPoint investment strategy and discussed the fourth quarter market environment and the impact on performance of absolute return strategies. He reviewed FrontPoint's performance and the contributing factors for that performance. He provided an overview of the outlook for 2008, including opportunities, positioning and new strategies, and risk review. Mr. Borden discussed the due diligence process the search teams used in evaluating managers and the portfolio and risk analyses that had been conducted. The Commission and Mr. Caffray discussed the economic environment and opportunities further.

Dr. Coates reviewed the Morgan Stanley Completion Fund (MS Fund) and explained its role in the Retirement System's portfolio and the general investment strategy. He introduced Mr. Vanderzwan, Senior Portfolio Manager for Morgan Stanley's hedge fund of funds. Mr. Vanderzwan reviewed the portfolio performance and the contributing factors for that performance. He reviewed asset and geographic allocations within the MS Fund and portfolio holdings. Mr. Vanderzwan provided a strategy outlook and discussed fixed income arbitrage, risk factors, and opportunities for the portfolio.

Mr. Cuanotta, Head of Quantitative Research for Morgan Stanley, discussed risk reporting and profiles relating to hedge fund portfolios and the total alternative portfolio. He referred to reports that had been prepared relating to the Retirement System's hedge fund investment portfolio to demonstrate the analyses Morgan Stanley used to evaluate portfolio risk. He explained the different components of the reports, which included performance, exposures, strategy allocations, leverage, and other portfolio statistics. Mr. Borden noted that while the risk profile might be greater for one manager, the focus was on the risk exposure for the total portfolio and the correlation between the asset classes. He noted also that there would be multiple types of risk reports as the risk management program continued to evolve.

Mr. Ewing asked Dr. Coates to discuss his experiences with the Weyerhaeuser Pension Fund (Weyerhaeuser), and Mr. Gillespie asked him to address his team's move to Morgan Stanley. Dr. Coates explained that they had flexibility and resources to search for alpha when he developed the strategy at Weyerhaeuser in 1985. He said that Weyerhaeuser had been the highest performing fund in the United States consistently, which resulted in overfunding. As the program grew, benefits escalated while contributions decreased, so there was less opportunity for the investment strategy. He said his team went to Morgan Stanley because of the available resources and the opportunity to develop other resources to conduct additional research. He noted that Weyerhaeuser had partnered with Morgan Stanley for the first five years and there had been strict agreements to maintain confidential information about clients and investments between the two entities. Mr. Ewing asked if there were similar assurances that the Retirement System's proprietary information would remain confidential, and Dr. Coates reaffirmed. Dr. Coates reiterated that Morgan Stanley had developed a large staff to complete extensive due diligence and that they would not invest unless they had a full understanding of and confidence in the funds. He said that the hedge fund universe was extremely large, and while Morgan Stanley could increase its size, they chose to maintain a manageable number of relationships so they could focus on the most opportunistic strategies and remain dynamic.

Chairman Williams thanked Morgan Stanley for their presentations, and the Commission received the reports and materials as information.

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

III. CHAIRMAN'S REPORT

Chairman Williams noted that his report was moved on the agenda so Mr. Chellis could participate, and the Commission would return to the remainder of the investment items after conclusion of the discussion about the actuarial return assumption.

Chairman Williams referred to information and a draft letter that had been provided to the Commissioners relating to the actuarial return assumption for the Retirement System. He explained that he had received a request from two members of the Board for the Commission's input on the 30-year actuarial assumed rate of return. He noted that he had testified before the S.C. House of Representatives' Ways and Means Subcommittee relating to the Commission's requested budget for Fiscal Year 2009 and that the subcommittee members and several senators had asked him about the issue. He noted that it had been discussed briefly at the Retreat in November and the draft letter was his proposed response to the inquiry.

The Commission reviewed the "2008 Asset Allocation Analysis: An Evaluation of Portfolio Characteristics for the Near-Term, the Long-Term, and Historically", which had been prepared by NEPC upon request. Mr. Gill explained the differences between the shorter and longer period normalized projections, forecast adjustments that were made for the longer periods, and other assumptions used for the projections in the analysis. Mr. Borden noted that a different method had been used for the long-term historical analysis of the hypothetical asset mix because some of the strategies had been developed more recently. The Commission discussed the probabilities of achieving the returns during various periods and the standard deviation over a 50-year period. Chellis asked whether the information considered the impact of actual performance on the probabilities to which Messrs. Borden and Gill explained that the statistical data was based on historical benchmark performance assuming no alpha. Mr. Gillespie asked for further clarification of the projected probabilities of achieving the various return rates over a 30-year period.

Mr. Powers stated that he continued to oppose providing a letter projecting returns. He noted that he had not spoken to anyone on the Board about the issue and that while personally he felt that it may not be unreasonable for the Board to increase the discount rate, he did not feel as a Commissioner that the Commission should suggest an actuarial rate of return. He said that he interpreted the draft letter as suggesting a projected rate of return to the Board and that a short letter with factual information by which the Board could reach its own conclusions would suffice.

He stated further that if the Board relied on a recommendation from the Commission, then he felt the Commission may be held accountable for the Board's actions. He said he was concerned about potential fiduciary liability for making such a recommendation.

Mr. Ewing stated that while he thought it acceptable for the Commission to discuss ranges for assumed rates of return, he opposed sending a letter recommending a range for an actuarial assumed rate of return. He said he understood the Board's dilemma in addressing funding issues but that the Board had to make the decision as to the actuarial assumed rate of return. Mr. Chellis noted that the Commission's discussions would be reflected in the minutes. Mr. Chellis said he agreed with Mr. Powers in that he did not feel that the Commission needed to send a lengthy response, and the letter could be redrafted so that it did not appear that the Commission recommended an assumed rate of return. He added that the letter related to an assumption, not a guaranteed return rate. Mr. Powers stated that while the draft letter may not be intended to recommend a guaranteed or assumed rate of return, it would be interpreted as such. Mr. Chellis agreed, but reiterated that the Commission would not intend for such a letter to be a recommendation.

Mr. Gillespie provided the Commissioners with a handout and discussed the relationship between assets and liabilities and real rates of returns. He reviewed excerpts from the Retirement System's Comprehensive Financial Annual Reports and compared the accounting reports to the actuarial assumed rate of return. He discussed problems with focusing on an assumed rate of return without considering the actual rates of return relative to more current assets, liabilities, and economic forces. Mr. Gillespie said that he did not feel that the Commission should suggest an actuarial assumed rate of return because it was outside of their purview, but that it was appropriate to provide the Board with investment data in context.

Chairman Williams said that he received the inquiry and felt that a response was in order, whether they opined differently, sent a shorter response, or sent a letter that made it clearer that the Commission's response should not be considered a specific recommendation. Mr. Gillespie suggested sending a cover letter with factual data attached. Mr. Chellis reiterated that the Board sought information regarding a reasonable range so that the Board could make a determination. Mr. Powers said that he opposed suggesting a range but that the Commission could send the Board a variety of information regarding investments. He said that he understood the Board was responsible for setting the actuarial assumed rate of return and that it should be clear that the Board was making an independent decision without the Commission having suggested or created an expectation for a rate of return. Mr. Chellis noted that the actuary would calculate the funded status and the returns would be smoothed over a period for actuarial purposes. He noted further that the Commission had adopted a target policy asset allocation mix based on probabilities of achieving certain returns, and the Board was seeking similar projections.

After further discussion, Chairman Williams referred to the investment statute relating to actuarial assumptions and explained that it required the Commission to provide the CIO with a statement of actuarial assumptions developed by the Retirement System's actuary and approved by the Board, upon which the CIO would develop the annual investment plan for adoption by the Commission. Mr. Gillespie asked whether the actuary had been consulted. Ms. Peggy Boykin, Director of the Retirement System, stated that part of the process required the actuary to inquire about the investments, and that accordingly, the actuary contacted NEPC for information. She said that the feedback from the Commission would drive the actuary's report to the Board. She said that the actuary would provide the report, but it would be based on information from the Commission, which the Commission was charged to provide.

The Commission discussed various ways to respond to the inquiry, and after further discussion, Chairman Williams asked Mr. Borden to opine. Mr. Borden said that the Commission could provide facts and statistical information upon which a determination could be made by the Board.

In response to several questions by Commissioners, Mr. Chellis provided additional information about the actuarial assumed rate of return. He said that the issue of funding a cost-of-living adjustment (COLA) for retirees had been posed for a number of years and was before the General Assembly. He noted that a COLA Task Force had been formed, had met over the past six months, and had discussed ways to address funding issues. He said that part of the COLA Task Force's proposal involved guaranteeing a COLA based on the funded status of the Retirement System, which in turn was affected by the actuarial assumed rate of return. He said that the Commission had been asked to provide a reasonable expectation for projected returns over the next 30 to 60 years. He noted further that if the expectation was not met, it would be the General Assembly's responsibility to provide funding. He said that the actuary had opined about various ranges and benefit/cost analyses. He said that he did not understand the Commission's reluctance to commit to a range of return expectations after having adopted an asset allocation based on projections. Mr. Gillespie explained that the pattern of the unfunded liabilities was not due to the rate of return solely, but it was due to other factors such as benefit enhancements and COLAs which were beyond the Commission's control. Mr. Chellis reviewed the legislative history of the benefit enhancements that had been granted and explained the COLA Task Force's proposal, which he said was planned to reduce the unfunded liability to zero over the next 15 years.

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

After further discussion, Chairman Williams asked if there was a motion to convene in executive session for the purpose of receiving legal advice, which related to matters covered by the attorney-client privilege. Upon motion by Mr. Chellis and second by Mr. Powers, Chairman Williams announced that the Commission would meet in executive session for that purpose and asked that Mr. Borden remain in executive session.

IV. INVESTMENT MATTERS CONTINUED

The Commission reconvened in open session. Mr. Chellis was excused from the meeting to attend a meeting of the Board. Chairman Williams advised that Mr. Ewing also needed to leave the meeting, so he asked Mr. Borden to address the issues that required Commission action while a quorum was still present.

Mr. Borden referred to materials relating to a proposed transfer of interest in the TCW Special Mortgage Credits Fund that had been provided to the Commission prior to the meeting. He explained that an opportunity had arisen to accept an assignment of an additional $40 million interest in the Fund from another limited partner. He said that closing was targeted for the end of February provided legal review was completed. After discussion, Mr. Powers made a motion to approve the recommendation to accept an assignment of an additional $40 million interest in the TCW special Mortgage Credits Fund and to authorize the Chairman or his designee to negotiate and execute any necessary documents to complete the investment upon approval for legal sufficiency by General Counsel. Mr. Gillespie seconded the motion, which passed unanimously.

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

Mr. Borden reviewed the private equity recommendations and referred to the materials that had been provided to the Commission prior to the meeting. He explained that the Commission had approved investments in the Bridgepoint Europe IV (Bridgepoint), Apax Europe VII (Apax), and CVC V (CVC) Funds, subject to completion of satisfactory due diligence reviews by NEPC. He said that NEPC had completed satisfactory due diligence reviews of Bridgepoint and Apax, and that the recommendation was to reaffirm the Commission's prior action. He said that NEPC was continuing its due diligence review of CVC, so the recommendation was to continue with legal review of the CVC documents pending further review by the Commission at the next meeting. After further discussion, Mr. Powers made a motion to reaffirm the Commission's decisions to invest in Bridgepoint and Apax as approved during the January 17th meeting. Mr. Ewing seconded the motion, which passed unanimously.

(Information relating to these matters has been retained in the Commission's files and is identified as Exhibit F).

Messrs. Borden and Gill noted that additional information relating to the Private Equity Third Quarter Performance Review had been included in the Commission's materials and that they would answer any questions after the Commission had an opportunity to review the report.

(Information relating to these matters has been retained in the Commission's files and is identified as Exhibit G).

Mr. Gill introduced Joe O'Byrne with NEPC who had conducted the due diligence meetings in London with Bridgepoint, Apax and CVC. He provided a brief overview of his meetings and offered to answer any questions. There being none, Mr. Borden concluded his report on investment matters.

V. ADMINISTRATIVE MATTERS

Mr. Ewing was excused from the meeting, and Chairman Williams recognized Ms. Nancy Shealy for the Administrative Director/General Counsel's report.

Ms. Shealy provided a report on the private equity investments that the Commission had been granted contractual rights to appoint a member to the advisory boards or committees. Mr. Powers requested that an item be added to the next meeting agenda to discuss the role that the Commission might take with regard to those positions. Mr. Gillespie added that he would like to discuss corporate governance issues and policies at a meeting in the near future, to which the Commission concurred.

Ms. Shealy advised that she had been working on projects with the Retirement System's Accounting Department, which included converting and providing electronic copies of contractual documents, assistance in developing procedures for verifying and processing management fee invoices, etc.

Ms. Shealy reported that approximately 28 alternative investment contracts, the BGI international index contract, the Beta Overlay contracts, and several domestic equity contracts had been completed. She advised that ten private equity contracts were pending and that she was waiting for approval from the Attorney General to retain associate counsel for the new European investments and the TCW Special Mortgage Credit Fund assignment. Mr. Borden asked about the status of the Morgan Stanley Strategic Partnership, and Ms. Shealy advised that contractual issues were close to resolution.

Ms. Shealy provided a brief report on several administrative projects, including staff cross-training, archiving Commission documents, and developing processes to streamline report distribution for consistency and compliance purposes. She noted that the Commission had approved the Compliance Officer position and salary range previously. She added that the Compliance Officer would report some matters directly to the Commission, so she requested input from the Commissioners as to any specific job responsibilities and qualifications for the position.

Ms. Shealy provided a budget status report, which had been prepared by Ms. Kathy Rast, the Administrative Manager. She said that Ms. Rast and she would be available to answer any questions. Ms. Shealy reviewed the basic structure of the budget and reiterated that the subcategories were internal targets for budgeting purposes.

Ms. Shealy referred to materials relating to changes to the Investment Division's Organizational Chart and staffing plan. Chairman Williams carried the matter over as a quorum as not present.

Ms. Shealy referred to the draft Continuing Education Policy that she had vetted with Ms. Hilary Wiek, Ms. Rast, and Mr. Wheeler. She provided a brief summary of the draft policy, and the Commission discussed several general areas for consideration.

VI. ADJOURNMENT

Chairman Williams asked if there was any further business, and there being none, he thanked everyone for attending, and the meeting adjourned at 2:40 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 February 19, 2008.]