South Carolina Retirement System Investment Commission
Meeting Minutes

May 20-21, 2010

Wampee Training and Conference Center
1274 Wampee Plantation Road
Pinopolis, South Carolina 29469

Commissioners Present:
Mr. James Powers, Chairman
Mr. Allen Gillespie, Vice-Chairman
State Treasurer Converse Chellis
Dr. Travis Pritchett
Mr. Reynolds Williams, Chairman *Emeritus*

Others present for all or a portion of the meeting on Thursday, May 20, 2010: Mike Addy, Dunkin Allison, Geoff Berg, Curtis Barrineau, Bob Borden, Jonathan Boyd, Donald Brock, Harris Chewning, Dori Ditty, Brenda Gadson, Hershel Harper, Dave Klauka, Cindy Lau, Sarah Lohmann, Doug Lybrand, Jared O'Connor, Kathy Rast, Nancy Shealy, Nicole Waites, Brian Wheeler, and Hilary Wiek from the South Carolina Retirement System Investment Commission; Rick Harmon and Shakun Tahiliani from the State Treasurer's Office; Ashli Aslin and Tim McCusker from New England Pension Consultants; Peggy Boykin, Tammy Nichols, John Page, and Danielle Quattlebaum from the South Carolina Retirement Systems; Jim Zelter from Apollo Capital Management; Bill Michaelcheck and Jamie Silver from Mariner Investment Group; Jeff Greenburg from Aquiline Holdings, LLC; Lewis Ranieri from Ranieri Partners Management, LLC; Eric Lane and Pat Sullivan from Goldman Sachs Investment Management; and Matt Harris and Bruce Jackson from Arnall Golden Gregory, LLP.

Others present for all or a portion of the meeting on Friday, May 21, 2010: Mike Addy, Dunkin Allison, Geoff Berg, Bob Borden, Jonathan Boyd, Donald Brock, Harris Chewning, Dori Ditty, Brenda Gadson, Hershel Harper, Dave Klauka, Doug Lybrand, Jared O'Connor, Kathy Rast, Nancy Shealy, Nicole Waites, Brian Wheeler, and Hilary Wiek from the South Carolina Retirement System Investment Commission; Shakun Tahiliani from the State Treasurer's Office; Ashli Aslin and Tim McCusker from New England Pension Consultants; Peggy Boykin, Tammy Nichols, John Page, and Danielle Quattlebaum from the South Carolina Retirement Systems; Eric Lane and Pat Sullivan from Goldman Sachs; and Torrey Rush from Ed Rush Development.

I. CALL TO ORDER AND CONSENT AGENDA

Chairman James Powers called the meeting of the South Carolina Retirement System Investment Commission (Commission) to order at 10:05 a.m. and welcomed the Commission and guests to the Strategic Planning Retreat at Wampee. Chairman Powers reported Blaine Ewing would not be attending due to an injury and that State Treasurer Converse Chellis was en route.

Chairman Powers stated that significant changes to the Commission's strategy would be discussed during the meeting. He explained that the South Carolina Retirement Systems (Retirement System) pays hefty management fees to managers not located in South Carolina and suggested additional self management. Bob Borden, Chief Executive Officer/Chief Investment Officer (CEO/CIO), indicated that a proposal he would present during the meeting could save the Retirement System approximately $500 million over the next 10 years. Chairman Powers stated that while that figure might be high, the Retirement System was already paying similar fees to external managers. He also noted that it would be beneficial to hire managers who reside, pay taxes, and contribute to South Carolina's economy. Chairman Powers indicated that the expertise needed to manage the Retirement System's total portfolio (Portfolio) would require appropriate compensation. Chairman Powers explained that over a 10-year period, the estimated total savings would be approximately $1 billion, with a net present value of approximately $500 million to the Portfolio if the Commission hired an internal manager.

II. STRATEGIC PLAN UPDATE

Mr. Borden explained that the 2010 Strategic Planning Retreat was designed to review the progress made since the June 2009 Strategic Planning Workshop. He explained that the Chairman was referring to suggestions for *Goal VII: Perform a Feasibility Study and Prepare Recommendations for Long-term Organizational Structure* (*Goal VII*) of the Commission's Strategic Plan. Mr. Borden highlighted the agenda and noted that the Commission staff would present brief updates of *Goals I-VI*. He also noted that Commissioner Travis Pritchett and Dr. David Schweiger, the *Buck Mickel/Flour Daniel Professor of International Business* at the University of South Carolina and Adjunct Professor of Strategic Management at EM Lyon in France, had assisted the Commission and staff in the development of the Strategic Plan, which was adopted by the Commission in June 2009.

Mr. Borden briefly reviewed the purpose of each goal and noted that the goals were not listed in order by importance. Mr. Borden introduced Hershel Harper, Deputy Chief Investment Officer, for a progress report on *Goal I, Initiative I.A: Centralize and Integrate Strategic Partnerships* and *Initiative I.B: Improve Strategic Partnership Economics.* Mr. Harper said that approximately $5 billion of the Portfolio was invested within Strategic Partnerships. He indicated the Commission wanted to ensure that the coordination of the investments with the Strategic Partnerships were being represented and accounted for within the overall asset allocation of the Portfolio. He also reported that Dunkin Allison, Strategic Partnership Officer, was the primary point of contact for each partnership. Mr. Harper explained that each Strategic Partnership had one contact person who communicated with Mr. Allison on a weekly or bi-weekly basis to coordinate partnership updates, potential investments, and meetings. Having one point of contact had reduced confusion and increased efficiencies in managing the Strategic Partnerships.

Mr. Harper explained that Mr. Allison chaired the Co-investment Committee. Commissioner Allen Gillespie requested that Mr. Borden explain partnerships with regard to buy-side and sell-side organizations. Mr. Borden explained that the five Strategic Partnerships were designed to source quality deals with highly experienced partners that would be able to close investments in a timely manner. He said that on the very large sell-side, the outcome had not met the Commission's expectations, which resulted in a "product cram down" that required filtering to select investments that would be most beneficial to the Portfolio. Mr. Borden indicated that a strategic plan for each partnership was created to address the needs of the Commission. He also stated that the large bandwidth of the Strategic Partners that were investment banks prevented the partnerships' investment committees from reviewing each and every silo that was available. Mr. Borden explained how federal regulations that changed investment banks into commercial banks created additional issues, including problems with continuity and employee turnover. He described how the buy-side Strategic Partnerships had excellent bandwidth and how they had been able to move more quickly on potential investments. In conclusion, Mr. Borden said that the size, structure, and make-up of a potential partner should be considered before investing.

Chairman Powers noted that discussions regarding *Goal VII* would not result in any actionable motion during the Strategic Planning Retreat. Mr. Borden indicated that a June 10, 2010, Commission meeting was scheduled.

As an aside, Mr. Borden explained how each of the Commission's goals contained very detailed and granular steps in action plans that were tied to each Commission employee's Employee Performance Managing System (EPMS) yearly performance review. He also explained that each goal had a cross-functional work team responsible for the goal's success. Mr. Borden noted that each work team and committee had agendas and minutes for their meetings. Mr. Chellis asked if information regarding the meetings were stored in a paperless imaging system. Mr. Borden explained that each decision had corresponding documentation that was kept electronically. Chairman Powers reiterated that everything that the Commission had done was transparent and that the Commission had approved all investments in public session. Mr. Borden noted that there were certain elements of prospective deals that could not be disclosed while under consideration because it could jeopardize the Portfolio performance or implementation of the investment plan. Chairman Powers added that occasionally manager terminations were discussed in executive session to protect the Portfolio; however, the actions were deemed public when there was no longer risk to the Portfolio from public disclosure.

Mr. Harper continued discussions regarding Strategic Partnerships. He reported that the Commission saved approximately $27 million between management fees and carried interest per year through the Strategic Partnership structures. Chairman Powers requested that Mr. Harper explain carried interest. Mr. Harper stated that in its simplest form, carried interest was a performance based fee. He provided the following example: if a manager sets a 10 percent return target, once the manager achieves that 10 percent return target, the additional performance beyond the 10 percent would be split between the manager and the investor – usually an 80/20 split. Mr. Harper explained that in this example, 80 percent of the returns over the target would be paid to the investor and the 20 percent or "carried interest" would be paid to the manager. He further explained the benefits of Strategic Partnerships and indicated that most co-investment activity had been obtained at zero fees and zero carry because the Commission was able to assume a small portion of the risk. Mr. Allison stated that one of the Commission's current co-investments had a return of 96 percent. Mr. Borden described the purchase of two defaulted secondary partnership interests that had resulted in 700 percent and 1200 percent returns. Mr. Harper explained how Strategic Partnerships provided training and knowledge sharing that would not be possible without the partners.

Mr. Harper highlighted activities relating to *Goal I, Initiative I.C.1: Real Estate Plan* and explained that there was a plan level target of $1.25 billion with a current exposure of $138 million. He also noted that there was a future commitment through a Strategic Partnership. Additionally, Dave Klauka, Senior Alternatives Officer, and Mr. Chellis were conducting due diligence on opportunistic/distressed real estate investment managers. Mr. Harper referred to *Goal I, Initiative I.C.2: Real Asset Plan* and said the plan had a target of 5 percent that would be split 50/50 to commodities and inflation linked bonds. Mr. Borden added that it would be very hard to discern the direction of commodities based on where the economy was heading.

Mr. Harper presented a progress report of *Goal I, Initiative I.C.3: Hedge Fund Transition* Plan. He referred to the transition timeline chart and noted that creating a legal structure, finalizing service level agreements with partners, developing business and operational procedures, and instituting compliance oversight and monitoring had been delayed. Mr. Harper and the Commission discussed outsourcing, functions, and function responsibility. Mr. Borden explained that the transition plan for hedge funds would reduce fees, limit strategies, secure better control of the liquidity, and result in separately managed accounts whereby the Commission would control the underlining interest. He also noted that staff had explored the concept of purchasing an equity interest in a firm and allowing it to create a fund of funds structure for the Commission.

Mr. Chellis requested information regarding total investment fees paid by the Retirement System, including any embedded fees. Mr. Borden estimated that $150 million in fees were paid in 2009, not including carried interest, which could be an additional $200-800 million depending on the economy. Chairman Powers indicated that embedded fees were not unusual and were necessary to invest prudently. Mr. Gillespie added that although some pretend that embedded fees do not exist because they are not a line item in an operations budget, embedded fees certainly exist. Mr. Borden stated that during the early stages of the Commission's development, the estimated cost or fees were close to $200 million based on industry averages. Chairman Powers reiterated that the Retirement System had gone from one of the worst performing plans in the country to the being named the best performing large public pension plan of the year.

Mr. Harper indicated that a joint-venture platform with similar pension fund investors was under consideration and would be beneficial to all parties. Mr. Borden opined that platform ownership could provide the Commission with additional income if other large pension funds were interested in hiring the platform service provider.

Mr. Borden introduced Jim Zelter, Chief Investment Officer of Apollo Capital Management, Bill Michaelcheck, Chairman and Chief Investment Officer of Mariner Investment Group, and Jeff Greenburg, Managing Partner of Aquiline Holdings, LLC. He also reported that Lew Ranieri, Chief Investment Officer of Ranieri Partners Management, LLC was en route to the meeting. Chairman Powers reported that Aquiline Holdings, LLC (Aquiline) was the Commission's first private equity investment manager and that Aquiline's investment advisory committee had grown from 15 members to over 100 members. He also stated that Larry Fink and Mr. Ranieri essentially created the mortgage backed security business. He added that the Commission's guests were extremely talented and respected in their areas of expertise.

Mr. Harper presented a progress report on *Goal I, Initiative I.C.4: Public Equity Portfolio Structure.* He discussed large cap manager contract renewals, EME (emerging market equity) manager searches, and potential EAFE (Europe, Australasia, Far East) searches. Mr. Harper noted that Commissioner Reynolds Williams and Hilary Wiek, Director of Public and Private Equities, had completed the first phase of due diligence for the EME manager search.

Mr. Harper presented a progress report on *Goal I, Initiative I.C.5: Fixed Income Plan.* He explained that one of the goals from the previous year was to outsource the internal fixed income portfolio. Mr. Harper indicated that outsourcing had been completed and due to excess cash, the Commission approved managing an internal short duration strategy, which currently held approximately $600 million invested in 43 positions. He also reported that a plan was under review to expand internal management to include cash and core bond strategies. In closing, Mr. Harper suggested reducing the Global Fixed Income allocation from 4% to 3% and rebalancing the portfolio with respect to credit managers.

Mr. Harper presented a progress report on *Goal I, Initiative I.C.6: Opportunistic Credit* and noted that this initiative was added to the Strategic Plan after the 2009 Strategic Planning Workshop. He stated that the Commission had received positive returns on an opportunistic credit strategy despite the manager's internal key man risk issues. Mr. Borden requested that Mr. Zelter and Mr. Michaelcheck provide the Commission with insight regarding opportunistic credit markets.

Mr. Zelter opined that the dislocation of the last few years would continue for the next 5 years and explained that there were many asset classes that had the ability to take advantage of distressed credit. Mr. Michaelcheck indicated that he believed that the economy was in the second stage of opportunistic credit opportunities and despite some risk, attractive returns were possible through active management. Mr. Greenburg concurred with Messrs. Zelter and Michaelcheck and said that there was still dislocation in parts of the market when moving away from securities to originations. He opined that middle market asset-based lending still offered favorable returns.

Mr. Borden said that there were still opportunities in opportunistic credit, but it would require harvesting and redeploying certain areas. He also noted that the Portfolio was ranked in the top 15 percent of pension funds last year due in part to the Portfolio having significantly lower equity risk compared to its peers' portfolios.

Mr. Harper presented a progress report on *Goal I, Initiative I.C.7: Private Equity & South Carolina Co-Investment Plan.* He stated that the original plan was to hire a gatekeeper manager, but elements of *Goal VII* may change the plan if approved. Mr. Harper reported that the Commission continued to monitor 24 private equity fund relationships with 20 advisory board seats. He also reported that due diligence was completed and 4 additional private equity funds had been approved by the Commission within the last year. Mr. Harper said he estimated that the Commission would conduct due diligence on 4-6 new funds within the next year.

Mr. Harper presented a progress report on *Goal I, Initiative I.C.8: Beta Overlay Plan.* He explained that the transition implementation phase was complete and that the current focus was on maintaining and modifying risk exposures. Mr. Harper also reported that flexible rebalancing ranges were developed to accommodate tactical shifts. He suggested moving overlay implementation to internal management by the Commission. He said that he expected a reduction of synthetics when new EME and EAFE managers were funded. Mr. Borden noted that there may be issues with swaps and the Federal Financial Services Reform Bill.

Mr. Harper presented a progress report on *Goal I, Initiative I.C.9: Custody Services Assessment.* He explained that Mike Addy, Senior Fixed Income Officer, and members of the State Treasurer's Office were developing investment guidelines for the collateral pool for the securities lending program. Mr. Harper also reported on the status of initiating an offset of non-custody, investment related services through securities lending review.

Mr. Harper presented a progress report on *Goal I, Initiative I.C.10: Global Tactical Asset Allocation (GTAA/ Risk Parity)* and reported that this initiative was added to the Strategic Plan after the 2009 Strategic Planning Workshop. He indicated that one GTAA manager had been terminated, and he expected to conduct a replacement manager search before the end of the calendar year. Mr. Harper said the current plan level allocation was approximately 7 percent with a target allocation of 10 percent.

Mr. Harper presented a progress report on *Goal I, Initiative I.D: Develop and Implement Risk Management Processes.* He reported that Doug Lybrand, Compliance and Risk Management Officer, was in charge of developing and issuing a risk assessment request for proposals, incorporating risk methodologies into the asset allocation process, developing plan-wide counterparty risk reports and liquidity analyses, and completing the International Fiduciary

Standards (IFS) corrective action plan. Chairman Powers noted that Mr. Lybrand's extensively detailed action plans were close to completion.

Mr. Borden presented a progress report on *Goal II: Develop and Implement Specific Governance Policies.* He said that 6 of the 9 governance polices had been approved by the Commission and that 2 of the remaining 3 policies would be discussed during the meeting the following day. Chairman Powers stated that he wanted all governance policies completed before the end of his term on June 30, 2010. Mr. Borden noted that the policies could be reviewed and amended by the Commission at any time. He also indicated that as part of the Commission and CEO/CIO Evaluations policy, Commission self-evaluation forms would be distributed to the Commissioners during the meeting the following day.

Mr. Borden introduced Jared O'Connor, Research Officer, for a progress report of *Goal III, Improve and Standardize Due Diligence Processes.* Mr. O'Connor stated that the Commission's Strategic Partners and NEPC were assisting staff with the development of new due diligence processes. He reported that the internal Co-Investment Committee was developing a similar due diligence framework for co-investments. Mr. O'Connor also explained the three phases of the new investment manager due diligence process: Information Sourcing and Analysis, Onsite Due Diligence, and Approval and On-boarding. Mr. Borden added that the formation of the internal investment committee had generated greater staff understanding of the Portfolio. He reported that standardized due diligence processes would improve recordkeeping relating to decisions and ensure thorough verification of representations made by managers during the process.

Mr. Borden explained the creation of a data library structure and file tree for organizing reports and integrating data more efficiently. He said that future and current Commission documents were located on an extranet website accessible to all Commissioners. Chairman Powers asked if all information would be transparent and public, to which Mr. Borden replied that public information would be available in accordance with state law.

Mr. Borden introduced Geoff Berg, Director of Research and Analytics, for a progress report of *Goal IV: Improve Reporting Processes.* Mr. Berg noted that within the last 13 months, various consolidated reports had been created to bridge most of the gaps that were present in individual reports. He said that market dashboards had been developed and noted that customizable reports were also being created. Mr. Berg reported that in conjunction with Mr. Lybrand, a portfolio data warehouse was being designed that would ensure compliance with the Commission's future risk management platform.

Mr. Gillespie stated that the significant progress made by Commission staff throughout the prior year was exceptional, and suggested discussing *Goal VII* after lunch. Mr. Williams and Chairman Powers concurred.

The Commission recessed for lunch at 12:30 p.m., and Chairman Powers reconvened the meeting at 1:30 p.m.

Chairman Powers explained that Mr. Borden's proposal for *Goal VII: Perform a Feasibility Study and Prepare Recommendations for Long-term Organizational Structure* (*Goal VII*) was innovative and had been successfully executed by several European and Canadian pension plans.

Mr. Borden proposed the creation of an investment organization that would be structured to have more flexibility and would be more able attract the best investment personnel available than the Commission. For purposes of his presentation, he gave the organization the generic name of “NewCo”.

Mr. Borden described the challenges of earning 8 percent return annually and consistently at a prudent level of risk. Mr. Borden also opined that meeting the actuarial assumed rate of return would require significant alpha. He indicated that there were excellent opportunities for alpha generation due to credit dislocation and economic recession. Currently, Mr. Borden suggested that the Commission was unable to staff an appropriate enterprise to improve the sourcing, evaluation and management of potential alpha opportunities. He said that the Commission could follow the very expensive, traditional solution by outsourcing or it could create an investment organization. Mr. Borden indicated that his proposed NewCo solution would be a unique outsourcing arrangement that would provide special benefits and economic advantages to the Retirement System and the State of South Carolina. He opined that NewCo could increase the probability of producing alpha and meet the actuarial assumed rate of return.

Mr. Borden said that the Commission’s current budget was wholly inadequate for a $25 billion multi-asset class investment management enterprise. He stated that a comparable investment organization with a $25 billion portfolio would have a $125 million operating budget. Mr. Borden opined that the Commission was significantly constrained with only a $5 million operating budget. In addition to budgetary constraints and limited resources, Mr. Borden outlined other constraints including inability to recruit/retain top tier talent in a public fund setting, inefficient due diligence processes, inability to close deals in a timely manner subsequent to approval, and limited strategic vehicle capabilities that created opportunity costs.

Mr. Borden said that his goal was to build a “best of breed” investment management firm with clear and distinct alignment of interests with the Retirement System through dynamically and efficiently allocating capital to take advantage of shifting market opportunities; focusing on improving overall utility of the portfolio; increasing the utility of the Commission’s balance sheet; and by quickly executing investment opportunities. He stated that this would be possible by the creation of a South Carolina based professional investment management firm that would benefit the Portfolio through a revenue sharing agreement, in addition to private market, co-investment, opportunistic, and advisory services management. Mr. Borden explained that NewCo would be overseen and held to the same standards as would any of the Commission’s managers.

Mr. Borden indicated that Messrs. Michaelcheck, Ranieri, Greenburg, and Zelter were willing to serve as advisory board members of NewCo. He said that the advisory board would guide the firm’s strategic plan, deal flow, and business planning and operations. Mr. Borden reported that these potential board members understood how the Commission operated, had good chemistry among them, and understood the proposed business model.

Mr. Borden briefly discussed the four silos of NewCo: Fund Management, Co-Investment Management, South Carolina Opportunistic Initiatives, and Advisory Services. He also indicated that, pursuant to state law, if a potential investment had the ability to affect South Carolina secondarily, that potential could not be the sole reason for investment. He explained that all investments would be considered on their own merit, not as they related to South Carolina. Mr. Borden opined that there were many opportunities in South Carolina that were not being matched to adequate capital. He also indicated that neighboring states might want NewCo to provide capital for companies in their state and manage state-specific customized mandates, which would create third party revenue.

Mr. Borden estimated that 40 highly talented professionals would be needed to successfully operate NewCo. He also noted that NewCo could increase the Commission's allocation to private equity and debt. He estimated that NewCo would reduce management fees by 50% resulting in structural value added and less loss of revenue to carried interest. He explained that over a 10-year period, current estimates indicated that the Retirement System would pay $2.2 billion in fees, but under the proposed firm structure, estimated fees would be $1.3 billion.

Mr. Borden noted additional benefits to the NewCo structure including: a significant financial management presence in South Carolina, a platform that could assist other South Carolina entities in investing their capital, reduction of taxpayer contributions required to fund the Retirement System, improvement of the funded status of the Retirement System, increased deal flow, matching excess cash with future funding needs to produce increased yields and superior liquidity management, increased information flow and intelligence gathering, increased ability to execute deals in a timely manner, superior risk adjusted returns and alpha generation, approximately $400 million of added value over 5 years for the Portfolio through reduced fees and revenue sharing, production of 200-370 basis points (bps) of structural alpha per year, providing a resourced facility for direct investments in South Carolina companies, and generating multiple ancillary benefits to the State of South Carolina. He explained that the creation of NewCo would not have been successful in 2005-2006, but because of changes in market conditions, now would be an ideal time to act on the opportunity.

Mr. Michaelcheck said that the next part of the economic cycle should provide an excellent opportunity for ancillary investment organizations to generate quality returns. Mr. Greenburg opined that financial institutions that were created during more benign times would not survive in their current form and with any type of dislocation, there would be winners and losers. He also said that banks were selling many different assets and having access to the balance sheet as a natural holder would provide an enormous advantage to create flow and origination. Mr. Greenburg said he had never seen the widespread changes that were occurring currently. Mr. Ranieri stated that the mortgage crisis was centered on 11 states and for the most part, other states seemed to be faring better. He added further that it would be almost impossible to obtain a construction loan, and within the next five years, if someone was able to obtain a loan, the terms and conditions would be significantly different than before. Mr. Ranieri said that the new housing and commercial real estate production system would have to be redesigned, restructured, and removed from the balance sheets of banks. He indicated that this would create new opportunities for investments. Mr. Zelter opined that Mr. Borden's proposed NewCo plan was a logical progression that could take advantage of opportunities that other investment organizations were unable to implement. Mr. Michaelchek said that most investment organizations were currently taking advantage of transparent Treasury bonds and ignoring private opportunities. Mr. Ranieri indicated that opportunities were present currently for both long and short term investing. Mr. Zelter said that many other long term investment organizations would agree that the NewCo proposal was viable. Mr. Borden concurred with Mr. Zelter and opined that only 5 other public pension funds would be able to replicate and execute a similar proposed investment management firm strategy. Mr. Greenburg stated that there were no similar investment organizations that could take advantage of many of the opportunities that currently exist, and Mr. Michaelcheck added that even outsourcing a similar proposal would be daunting.

Chairman Powers reiterated his earlier comments by stating that it would be better to pay fees to someone in South Carolina than to pay fees to a New York or California firm. Mr. Borden said that there were opportunities to not only hire high quality individuals, but to hire entire teams of professionals. He added that under the NewCo proposal, fees would be reduced significantly, and the reduced fees would be paid in the State of South Carolina. Mr. Borden said that any third party opportunities would be structured so NewCo would not grow too fast.

Mr. Borden introduced Harris Chewning, Alternatives Officer, for a presentation regarding venture capital. Mr. Chewning stated that in 2008, South Carolina received 1 percent of the total venture capital investments in the United States and by comparison, Georgia and North Carolina received 8 percent. He outlined several research institutions in South Carolina that were underserved currently. Mr. Chewning also noted that companies may need alternate sources of capital. Mr. Borden said that matching deal flow to capital would allow NewCo to serve an underserved market.

Mr. Chellis expressed concerns that political pressure may be placed upon NewCo to invest in specific industries. Mr. Borden replied that NewCo could co-invest with a national partner and perform specialized due diligence that would screen out those types of deals. Mr. Zelter replied that in this example, a national company's investment would not be contingent on NewCo's investment, but NewCo's investment could be contingent on the national company's decision to invest.

Mr. Gillespie stated that South Carolina was somewhat removed from the marketplace and that he received calls asking for contacts for additional information and capital investment requests. He indicated that under the NewCo structure, at least South Carolina companies would have more exposure to the marketplace. Mr. Gillespie also noted that NewCo would create a centralized point of contact. Mr. Zelter said that other entrepreneurs would be attracted to South Carolina because the centralized point of contact would significantly reduce lead-time and the presence of deal flow. Mr. Borden said that having a structure to move quickly on deals was not present currently. The Commission and Mr. Borden discussed key risks and mitigating factors of the NewCo proposal.

Chairman Powers opined that the NewCo proposal needed an additional board member. He also asked if NewCo would be a taxable entity. Mr. Borden replied that NewCo would have a revenue sharing agreement and if the Retirement System or a tax-exempt entity took ownership of NewCo, several tax issues would arise. He also said that NewCo would be a private, for profit entity. Mr. Borden indicated that if NewCo was successful and sold in the future, the revenue sharing agreement could be designed to transfer any Retirement System interest into warrants that would become monetized.

Mr. Gillespie opined that $40-$150 million would be necessary to create NewCo. Mr. Borden said that seed capital could come from fees. Chairman Powers reiterated that the Commission paid fees anyway, so NewCo could provide an opportunity to create something of value. Mr. Gillespie said that there were opportunities for deals to be made and noted that NewCo would have the ability to proactively create deals. Mr. Chellis asked whether the Commission would be liable if NewCo was sued by a third party. Mr. Borden replied one of the reasons that the Commission would not be a direct owner of NewCo would be to prevent such a scenario. Mr. Gillespie said that the Commission would only be an investor in the company. Chairman Powers noted that the proposed NewCo board of advisors would be assuming more risk than the Commission. Mr. Williams added that the relationship with NewCo would be similar to any of the Commission's managers.

Mr. Gillespie said that the NewCo entity must be entirely independent of the Commission to prevent any future issues. Mr. Zelter opined that as a potential advisory board member, he would not want NewCo to start any third party funds until it was successful with Retirement System investments. After further discussion about third party funds, Mr. Zelter said that if NewCo reached the point where third parties wanted to invest, then NewCo would be performing well with quality returns.

Chairman Powers noted that although there would be complaints about the salaries needed to attract quality professionals, the University of South Carolina had hired a Defensive Coordinator for $750,000. He stated that if an assistant coach's salary is $750,000, a company should pay quality professionals to manage $25 billion accordingly. Dr. Pritchett asked if Mr. Borden had created pro-forma statements for NewCo and suggested conducting due diligence on NewCo. Mr. Borden replied positively, and indicated that NewCo staff would have to be paid by NewCo's revenue stream with no notion of carry.

Mr. Borden opined that most Retirement System stakeholders did not understand carried interest, even though it was an expense of hundreds of millions of dollars every year that came off of returns. He also suggested that the contractual expense of $200 million in management fees did not peak stakeholder interest, however, everyone knew the definition of a salary, and requested an explanation or justification for these budget line items. Mr. Borden said that the business model was designed to remove the Retirement System and Commission from NewCo ownership, while benefiting from NewCo's economics.

Mr. Borden opined that the NewCo proposal would run a governmental entity like a private business, an ideal that many constituents share. Mr. Williams said that during Mr. Borden's interview, he stated he wanted to create a first class investment organization. He said that NewCo was the first step in fulfilling that vision. Chairman Powers reiterated that the Commission would not vote on the NewCo proposal during the Wampee Retreat and opined that the Commission may not vote during the next Commission meeting. He noted, however, that because of market opportunities, decisions could not be delayed for a year. Mr. Chellis requested that additional risk metrics be presented at the June 10, 2010 Commission meeting. Mr. Michaelcheck opined that the Commission's current situation was unsustainable.

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

Chairman Powers thanked the Commission's staff and the State Treasurer's staff for all of their hard work and noted that throughout his term on the Commission, both agencies had worked together harmoniously. He also said that the Retirement System's staff had been extremely helpful and he appreciated all of their hard work. Chairman Powers also said that only two people in the room knew how hard Nancy Shealy worked, and he thanked her for her work.

Mr. Chellis made a motion, which was seconded by Mr. Gillespie and passed unanimously, to recess the meeting at 5:00 p.m. on Thursday May 20, 2010, and to carry over unfinished agenda items until 8:30 a.m. on Friday, May 21, 2010.

I. CALL TO ORDER

Chairman James Powers reconvened the meeting of the Commission at 8:30 a.m. on May 21, 2010, and noted that a quorum was present. He indicated that Messrs. Ewing and Chellis would not be able to attend the meeting.

Chairman Powers noted that staff received new information about pending investments with Aquiline Holdings, LLC, after the agenda had been posted, and he requested that the agenda be amended to include those matters. There being no objection, the proposed agenda was adopted as amended. The minutes from the March 18, 2010 meeting were carried over.

Mr. Borden presented the proposed 2010 and 2011 meeting schedules to the Commission and stated that the proposed schedules were consistent with current Commission practice except for the addition of the meeting on June 10, 2010. He said he hoped the September 23, 2010 meeting would be held in the Commission's new facility in the Capitol Center. Mr. Gillespie suggested adding Audit Committee meetings to the schedules as it is a standing committee of the Commission. Mr. Gillespie made a motion, which was seconded by Mr. Williams and passed unanimously, to approve the 2010 and 2011 Commission meeting schedules, and that Mr. Borden contact Mr. Chellis and add a listing of Audit Committee meeting dates to the schedules when available.

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

II. ADMINISTRATIVE ITEMS

Mr. Borden referred to the draft Committees Policy, which had been presented initially during the March 2010 Commission meeting. He introduced Dori Ditty to provide an overview of changes since the last draft of the policy was circulated. After further discussion, Mr. Gillespie made a motion, which was seconded by Mr. Williams and passed unanimously, to approve the Committees Policy.

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

Mr. Borden presented the Communications Policy to the Commission and noted that it had been presented initially during the March 2010 Commission meeting. Chairman Powers added that the draft policy had been on the Commission's extranet website for some time also. Mr. Gillespie noted that often investment professionals are required to notify compliance departments of communications with the media, and he suggested adding text to the policy to provide that a Commission member would inform the other members of the Commission after speaking to the media so they could be prepared to respond to any additional inquiries. Chairman Powers concurred with Mr. Gillespie. Mr. Borden noted that the policy did not prohibit communicating with the media, but that the amendment would merely provide notice to the other Commissioners after the communications. Mr. Gillespie agreed and also suggested that the Commission maintain a log of communications with the media. Chairman Powers indicated that the Chairman would keep the log. After further discussion, Mr. Borden suggested the communications log be posted on the Commission's extranet website so the information could be viewed by Commissioners at any time. Ms. Shealy suggested adding text in the policy to notify the Compliance Officer and the Chairman. After further discussion, the Commission amended the Communications Policy to provide that in their external communications under the policy, Commissioners would be obligated to notify the Chairman and other Commissioners of the date, time and content of the communications. Mr. Gillespie made a motion, which was seconded by Mr. Williams and passed unanimously, to approve the Communications Policy as amended.

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

Mr. Gillespie suggested that a master calendar be developed to track documents and pertinent dates. Chairman Powers noted that Mr. Borden was already responsible for that task, and Mr. Borden stated that staff could develop a calendar for the extranet website to capture the information. Doug Lybrand, Compliance and Risk Management Officer, noted that an operational calendar had been included on the extranet website for the Commission's use prior to the meeting.
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Mr. Borden presented the first draft of the Service Provider Selection Policy. Chairman Powers noted that of the initial list of governance policies identified for adoption, this was the last pending policy, and it would be scheduled for approval during the June 10, 2010 Commission meeting. Mr. Borden indicated that the policy identified 4 types of service providers that would require Commission selection and/or approval. These included: investment managers, investment consultants, other consultants for non-investment matters pertaining to staff, and auditors/financial consultants. He also said that the policy outlined service providers that could be selected by the Commission staff, such as administrative and technical vendors. Mr. Gillespie asked if the policy covered approvals by the Attorney General for engagement of external legal counsel. Ms. Shealy replied that external legal counsel selection should be independent of the Service Provider Selection Policy as the state legal requirements differed significantly. Mr. Borden referred to text in the policy relating to the South Carolina Consolidated Procurement Code and suggested that the Commission obtain an exemption for all service provider selections. He also reiterated that the Commission could amend the governance policies at any time. The Commission received the draft Service Provider Selection Policy as information.

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

III. INVESTMENT ITEMS

Mr. Borden introduced Tim McCusker, Director of Traditional Research from NEPC, for discussion of NEPC's Asset Allocation Analysis. Mr. McCusker provided an overview of the analysis and then reviewed NEPC's capital market observations and expectations for 2010. He stated that 2009 had provided strong market returns, but cautioned against higher return expectations for 2010. He said that the risk of long-term inflation was at its highest level in 30 years, that the dollar was expected to continue a long-term weakening trend along with other developed currencies, and that forward-looking expected returns had declined. Mr. McCusker suggested that the Commission continue to assess the future from a risk management perspective, review the role of fixed income, build strategic exposure to real assets, consider illiquid investments for increased expected returns, overweight emerging market investments to protect from dollar losses, and maintain focus on diversification in a time of uncertainty.

Mr. McCusker explained the process NEPC used to develop its asset class assumptions and its 5- to 7-year return, risk and correlation forecasts for various asset classes, including cash, bonds, domestic equities, international developed equity, emerging market equity, fixed income, hedge funds, private equity, and real estate. He reviewed NEPC's analysis of the Portfolio, explaining the projected returns, asset class standard deviations, current target allocations, and NEPC's recommended target allocation changes. Mr. Gillespie asked several questions regarding treating commodities as an asset class and commodity exposure in hedge funds. He noted that historically, institutional hedge funds did not put weight on global macro funds, so he asked how NEPC modeled commodity exposure. Mr. McCusker explained that the return for commodities was not attractive from the Sharpe ratio perspective. However, he said that despite having risk in the alternative environment, commodities could become the most attractive asset class, and he explained several factors that would affect the impact of commodities on a portfolio. Mr. Borden suggested viewing commodities in two separate and distinct allocations: as a long position, inflation hedging property and as part of the absolute return portfolio. After further discussion, Mr. Borden said that more clarity regarding commodities trading would be seen as the Hedge Fund Transition Plan progressed.

Mr. Borden noted that NEPC's annual asset allocation analysis was intended for discussion purposes at the Retreat, and he suggested waiting until completion of the Strategic Plan discussions to adopt any major asset allocation changes to insure that all of the target allocations were consistent.

Mr. McCusker explained the risk budgeting standard deviation calculations for annualized volatility. He opined that the Commission's sophisticated and diverse portfolio structure had lower risk when compared to its peers. Mr. Borden noted that 4 years ago when the Commission assumed the responsibility for the Portfolio, 90 percent of risk was a result of the equity markets. He said that within the past 4 years, the Commission had systematically reduced that risk to 55 percent while producing higher returns. Mr. McCusker opined that the Portfolio's total active risk allocation was efficiently constructed and that the traditional equity structure was balanced across strategies. He also said that the active fixed income structure was dominated by alpha volatility in global strategies and indicated that the portable alpha pool had very low beta exposure. The Commission and Messrs. McCusker and Borden discussed different risk strategies and their impact on asset allocations and investment strategies for the Portfolio.

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

Mr. Berg referred to the Portfolio Level Dashboard and noted that within the last several days, the Portfolio was underweight in equities. He reported that at the beginning of April 2010, the Euro was in an adjustment period, and the Commission decided to remove $220 million of exposure paired with EAFE (developed markets). Mr. Borden indicated that the move resulted in a 10 percent return. Mr. Berg reported that the Portfolio was overweight in fixed income and actions had been taken to reduce the global fixed income allocation. He also explained that the Portfolio was currently underweight in real estate, but it would be addressed before the end of the year.

Mr. Harper noted that the plan for the large cap equity allocation was to invest it through the portable alpha program. He also reported that $1 billion was allocated directly to equity managers. Mr. Harper indicated that within the past year, the Commission had authorized Mr. Borden to use large cap equity allocations as a source for cash or reduce allocations to those managers at the appropriate time. He noted further that allocations to those managers would be used to fund the new EME managers when they are engaged. Mr. Harper also briefly discussed internal changes at Credit Agricole and distributed a memo to the Commissioners. He said that while staff was not recommending termination at this time, staff had considered reducing Credit Agricole's allocation by taking profits from that portfolio at the appropriate time. Mr. Berg added that Credit Agricole had a good track record with the Commission and Portfolio.

Mr. Berg reported that for the month of April, the Portfolio was up 1 percent and the month-to-date estimate for May was down 2.6 percent. He estimated the fiscal year-to-date performance was up 16.14 percent.

Mr. Berg referred to the Market Dashboard and reported that Jonathan Boyd, Investment Officer, had developed a report to track current and historical data for all asset classes. He said that this report would be generated on a regular basis and would be available to the Commission. Mr. Borden reported for Calendar Year 2009, the Portfolio performed in the top 15 percent amongst its peers.

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

The Commission received as information NEPC's Investment Performance Review of the Portfolio for quarters ended March 31, 2010, which included information about the market environments, Portfolio performance summary and risk reports, a flash report, and information about asset classes and individual managers.

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

Ms. Wiek referred to the Square 1 Venture 1, L.P. (Square 1) memorandum that was distributed to the Commission prior to the meeting. She noted that Square 1 had been granted a one year extension to raise additional funds. Ms. Wiek advised that Square 1 had offered the Commission favorable economic concessions and the potential to gain additional exposure to 9 investments. After further discussion, Mr. Gillespie made a motion, which was seconded by Mr. Williams and passed unanimously, to waive the 25 percent of the total fund allocation restriction set forth in the Annual Investment Plan for the investment with Square 1, to invest an additional $7.96 million in Square 1 Venture 1, L.P. under the terms negotiated and recommended by staff, and to authorize the Chairman or his designee to negotiate and execute any necessary documents to implement the investment subject to approval for legal sufficiency by General Counsel.

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

Chairman Powers indicated that the Commission's first private equity investment, Aquiline Financial Services Fund L.P. (Fund I), had provided excellent returns. He asked Mr. Borden to explain the issues relating to Aquiline. Mr. Borden explained that the Retirement System committed $100 million to Fund I, and Fund I had completed a majority of its investments. In addition, he said that the Commission previously approved allocating up to $50 million to Aquiline Financial Services Fund II, L.P. (Fund II) and allocating up to $50 million to a co-investment sidecar for Fund II. He advised that Aquiline had been amenable to providing the Retirement System with the opportunity to participate in additional co-investment opportunities relating to its funds. In order to affect the favorable terms of no fee and no carry on co-investments and to attain most favored nations status (MFN) with Aquiline, Mr. Borden recommended that the commitment to Fund II be increased to $100 million and that the co-investment fund not be limited to either fund or to a specific amount to take advantage of some excellent opportunities and extremely favorable economic concessions. He noted that participation in any co-investments would be at the Commission's discretion. After further discussion, Mr. Gillespie made a motion, which was seconded by Mr. Williams and passed unanimously, to increase the commitment to Aquiline Financial Service Fund II, L.P. from $50 million to an amount not to exceed $100 million, to establish a co-investment sidecar fund to invest in any co-investment opportunities with Aquiline under the terms and conditions as presented and recommended by Mr. Borden, and to authorize the Chairman or his designee to negotiate and execute any necessary documents to implement the investments subject to approval for legal sufficiency by General Counsel.

Mr. Borden requested Commission approval to retain external legal counsel to review the proposal for *Goal VII.* After discussion, Mr. Williams made a motion, which was seconded by Mr. Gillespie and passed unanimously, to authorize Ms. Shealy to negotiate with the firm of Arnall Golden Gregory, LLP, to provide legal review and services related to the proposal for *Goal VII* of the Strategic Plan, and to authorize engagement of the firm upon approval by the Attorney General.

Dr. Pritchett questioned whether the Commission should obtain permission from the South Carolina Budget and Control Board (B&C Board) or guidance from the State Ethics Commission before proceeding with further discussions relating to *Goal VII*. Mr. Borden said that the legal opinion may address some of the ethical considerations. Mr. Williams stated that depending on the final structure, an opinion from the State Ethics Commission may be desirable for certain actions, but additional research and vetting would be necessary prior to requesting any opinion. He stated further that the B&C Board should be informed, but that permission would not be required. Chairman Powers said that some of B&C Board members had been informed of preliminary discussions regarding *Goal VII*, but he reiterated that no decisions had been made by the Commission and many details needed to be developed and fully vetted. Mr. Gillespie concurred.

Mr. Borden distributed the Commission Evaluation Discussion Guide to Commissioners, and the Commission briefly discussed issues with pending legal matters related to Lehman Brothers Holdings, Inc.

IV. ADJOURNMENT

There being no further business, Chairman Powers thanked everyone for attending, and the meeting adjourned at 10:45 a.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 of the South Carolina Retirement System at 202 Arbor Lake Drive, Columbia, South Carolina, at the office of the Commission and at the Wampee Training and Conference Center at 1274 Wampee Plantation Road, Pinopolis, South Carolina prior to 9:00 a.m. on May 19, 2010]