

South Carolina Retirement System Investment Commission Meeting Minutes

March 9-10, 2006

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

Commissioners Present:

Mr. Reynolds Williams, Chairman
Mr. James Powers, Vice Chairman
Treasurer Grady Patterson
Mr. Blaine Ewing
Mr. Allen Gillespie
Mr. Travis Pritchett

Others present for all or a portion of the meeting on Thursday, March 9, 2006:

Nancy Shealy and Ashli Aslin from the South Carolina Retirement System Investment Commission; Bob Borden from the Louisiana State Employees' Retirement System; Anne Macon Flynn from the Budget and Control Board Office of General Counsel; Rick Patsy, Trav Robertson, Frank Rainwater, and Shakun Tahiliani from the State Treasurer's Office; Jeff Schutes and Jay Love from Mercer Investment Consulting; Keith Wood from Jamison, Eaton & Wood, Inc.; Peggy Boykin, Faith Wright, Travis Turner, Sarah Corbett, and Tammy Davis from the South Carolina Retirement Systems; Ron Ryan from Ryan ALM, Inc; Barton Waring from Barclays Global Investors, LLC; Bluford Putnam from Bayesian Edge Technology & Solutions; Vince Lowery from VTL Associates; Paul Podolsky from Bridgewater Associates; John Huffman a retired state employee; and Brian Hussain, a member of the South Carolina public.

Others present for all or a portion of the meeting on Friday, March 10, 2006: Nancy Shealy and Ashli Aslin from the South Carolina Retirement System Investment Commission; Bob Borden from the Louisiana State Employees' Retirement System; Anne Macon Flynn from the Budget and Control Board Office of General Counsel; Rick Patsy, Trav Robertson, Frank Rainwater, and Shakun Tahiliani from the State Treasurer's Office; Jeff Schutes and Jay Love from Mercer Investment Consulting; Keith Wood from Jamison, Eaton & Wood, Inc.; Peggy Boykin, Faith Wright, Travis Turner, Sarah Corbett, and Tammy Davis from the South Carolina Retirement Systems; and John Garrett from Milliman Consultants and Actuaries.

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

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

Chairman Williams called for objections or amendments to the meeting's agenda. He asked that the adoption of the minutes from previous meetings be carried over to the following day. There being no objections, the agenda was adopted as amended.

Chairman Williams reported on the status of the search for the Chief Investment Officer (CIO). He stated that after careful consideration of all candidates, the Commission had offered the position to Mr. Robert L. Borden, who had accepted it. Treasurer Grady Patterson made a motion, which was seconded by Mr. Blaine Ewing and passed unanimously, to ratify the decision to hire Mr. Borden as the Commission's first CIO. Chairman Williams introduced Mr. Borden and stated that he would begin his duties on April 10, 2006. Mr. Borden expressed his excitement to work with the Commission and his expectation to add significant value to the South Carolina Retirement Systems' (Retirement Systems) portfolio and the to Commission over time.

II. LIABILITY BENCHMARKING: "SOLUTIONS TO THE PENSION CRISIS"

Chairman Williams introduced Mr. Ron Ryan from Ryan ALM, Inc. and recognized him for a presentation on liability benchmarking. Mr. Ryan discussed funding issues facing pension plans and suggested that creating a liability index fund could provide a partial solution. He explained the various components of a liability index fund, which would include a Beta portfolio comprised of bonds matched to the liabilities and an Alpha portfolio that would increase asset value and decrease the funding deficit. Mr. Ryan also discussed Portable Alpha and concluded that when a pension fund is 100 percent funded, the Alpha portfolio would then be comprised only of bonds that match the fund's liabilities.

Chairman Williams and the Commission thanked Mr. Ryan for his presentation.

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

III. ECONOMICS OF ASSET LIABILITY RELATIONSHIP

Mr. Ewing introduced Mr. Barton Waring of Barclays Global Investors, LLC (BGI) and recognized him for a presentation on Liability-Relative Investing: Improving the Risk/Return Tradeoff.

Mr. Waring outlined historical methods for managing pension funding risk and setting investment strategies and described the problems associated with those methods. He discussed asset return smoothing, managing both assets and liabilities, and surplus optimization. Mr. Waring also discussed setting discount rates and modern investment principles. He presented a new strategy for managing pension funding risk that included surplus optimization and duration matching, controlling surplus beta, and manager structure optimization, and he illustrated implementation of the strategy.

Chairman Williams and the Commission thanked Mr. Waring for his presentation.

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

IV. ECONOMIC REVIEW

Mr. Ewing introduced Mr. Bluford Putnam from Bayesian Edge Technology & Solutions and recognized him for an economic review. Mr. Putnam discussed global demographics; market sources of volatility, including geopolitical risk and natural disasters; the United States government budget and governmental revenues; and the foreign purchase of US bonds. Mr. Putnam also discussed past and present Federal Reserve Board (FED) policy. He noted the differences between Mr. Alan Greenspan, former FED Chairman, and Mr. Ben Bernanke, current FED Chairman, and discussed how those differences might affect FED policy. Mr. Putnam outlined investing implications in the context of current global and domestic economies, noting that excellent risk-adjusted returns could be earned from illiquid markets.

Chairman Williams and the Commission thanked Mr. Putnam for his presentation.

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

V. CAPITAL MARKET THEORY

Chairman Williams recognized Mr. Jay Love of Mercer Investment Consulting (Mercer) for a presentation on modern portfolio theory and capitalization weighted indices.

Mr. Love discussed the history of market indices, and explained there was no formalized method for calculating investment performance until the 1980s. He stated that the Nifty-Fifty craze and the market crash of the late 1960s proved the need for more rigorous treatment of investment results, risks, and management. In addition, the passage of the Employee Retirement Income Security Act of 1974 (ERISA) and technological developments that permitted greater computational power spurred modern performance evaluation methods.

Mr. Love explained Modern Portfolio Theory and the Capital Asset Pricing Model (CAPM), outlined the major criticisms of CAPM, and stated that while it was accepted as less than perfect, it provided the only unified theory of asset pricing.

Mr. Love discussed CAPM and market capitalization weighted indices. He outlined the positive and negative attributes for using capitalization-weighted indices as a passive investment vehicle.

Mr. Love concluded that approximately 95 percent of an investment portfolio's volatility was determined by asset allocation and noted that asset class allocation was critical to investment portfolio performance. He stated that approximately 95 percent of the return of the Retirement Systems' portfolio was determined by broad exposure to the asset classes.

Chairman Williams and the Commission thanked Mr. Love for his presentation.

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

VI. FUNDAMENTAL INDICES

Mr. Ewing introduced Mr. Vince Lowery from VTL Associates and recognized him for a presentation on Fundamental Indices. Mr. Lowery reviewed work completed by Dr. Jeremy Siegel, Professor of Finance at the Wharton School at the University of Pennsylvania, and Mr. Robert Arnott, President and Chief Investment Officer of First Quadrant. Mr. Lowery said he believed that capitalization weighted indices were inefficient and suboptimal to fundamental weighted indices. Mr. Lowery also discussed the ideology, merits, performance, and variances to the S&P 500 of the VTL Revenue Weighted Large Cap Index.

Chairman Williams and the Commission thanked Mr. Lowery for his presentation.

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

VII. TACTICAL ASSET ALLOCATION

Mr. Rick Patsy from the State Treasurer's Office (STO) introduced Mr. Paul Podolsky of Bridgewater Associates and recognized him for a presentation on tactical asset allocation.

Mr. Podolsky stated that there were two major ways to add value to a portfolio: (1) holding assets (passive investing), or (2) trading assets (active investing). He outlined considerations for constructing Alpha and Beta portfolios. He stated that while many believed mistakenly that most of the risk in a portfolio was caused by active management, most portfolio risk was caused by holding particular asset classes in reality.

Mr. Podolsky defined what he considered to be the six major components of a Beta portfolio: nominal bonds, inflation linked bonds, commodities, equities, spreads, and real estate. He also discussed the trading strategy at Bridgewater Associates, which was comprised of analyzing cause and effect relationships in markets and systematically applying that logic to current conditions to determine trades.

Mr. Podolsky concluded that it was important to understand the distinction between portfolio Alpha, which he defined as trading skill, and Beta, an asset class. He reiterated the importance of maintaining highly diversified Alpha and Beta portfolios.

Chairman Williams and the Commission thanked Mr. Podolsky for his presentation.

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

VIII. STRATEGIC PLANNING PREVIEW

Chairman Williams stated that the Commission had reached a stage in its growth to develop strategic planning. He explained the stages of the strategic planning process and noted that he intended to solicit observations from each Commissioner and then categorize those observations as strengths, weaknesses, problems, or opportunities. Chairman Williams encouraged each Commissioner to carefully consider notable observations for the strategic planning session scheduled for the following day. Chairman Williams also distributed a draft mission statement for the Commissioners' review.

Chairman Williams recessed the meeting at 6:00 p.m.

Chairman Williams reconvened the meeting at 8:15 on Friday, March 9, 2006 and welcomed Commissioners and guests.

IX. ACTUARIAL PRESENTATION AND DISCUSSION

Chairman Williams introduced Mr. John Garrett from Milliman Consultants and Actuaries (Milliman), the actuary for the Retirement Systems and State Budget and Control Board (Board), and recognized him for an actuarial presentation and discussion.

Mr. Garrett discussed the actuary's role in the management of the Retirement Systems' portfolio and the process for developing the annual valuations. Mr. Garrett explained that in addition to performing annual valuations, Milliman provided experience studies every five years and performed impact analyses of proposed benefit changes.

Mr. Garrett noted that, in general, actuaries "smooth" the assets used for the valuation in order to spread investment gains and losses over a five-year period. He stated that this allows for future experience to offset a portion of current gains or losses in order to reduce the impact of market value volatility.

Mr. Garrett provided a summary of the Retirement Systems' 2004 Actuarial Valuation, noting that the 2004 funded ratio equaled 80.3 percent.

Chairman Williams and the Commission thanked Mr. Garrett for his presentation.

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

X. RECAP AND DISCUSSION OF ASSET ALLOCATION STRATEGIES

Chairman Williams recognized Messrs. Ewing and Mr. Allen Gillespie for a discussion of asset allocation strategies.

Mr. Gillespie stated that there were three major levers in pension fund management: benefit policy, contribution policy, and asset management policy. He noted that each lever was critical, but the Commission was only charged with asset management. Mr.

Gillespie expressed his concern about Cost of Living Adjustments (COLAs) and stated that their ad hoc nature led to unclear investment objectives.

Mr. Gillespie stated that the Commission should recognize or define the risks attributed to each of the investments in the Retirement Systems' portfolio and determine which of those risks were acceptable. He also expressed his concerns with asset smoothing and suggested that the Commission's reports clearly outline all aspects of the portfolio. Chairman Williams agreed that the Commission should strive for as much transparency as possible.

Mr. Ewing explained that long-term planning was essential and stated that the Commission should keep in mind that investment returns revert to the mean in the long-term. Mr. Ewing also outlined several strategic and tactical investment considerations and provided an overview of current market conditions.

Chairman Williams thanked Messrs. Ewing and Gillespie for their presentation.

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

XI. STRATEGIC PLANS

Chairman Williams encouraged each Commissioner, staff, and guests to offer observations of the Commission's current status and potential changes that could enhance productivity. After the observations were made, each was categorized as a strength, weakness, and/or investment theory and practice. Chairman Williams thanked the Commission and guests for their participation in the strategic planning session and stated that the observations would prove helpful as the Commission continued to grow.

XII. NEW BUSINESS

Chairman Williams stated that several Board members had asked for input from the Commission regarding the actuarial rate of return assumptions the Board might consider for thirty-year periods. Mr. Borden noted that based on his research, the average assumed rate of return for public pension plans in the United States is 8.06 percent. He said that the Retirement Systems should only expect to achieve a rate of return similar to that average if investment in additional asset classes were allowed. After a broad and thorough discussion, Chairman Williams agreed to write a letter to the Board stating that while the consensus of the Commission was that an actuarial assumption of a 7.5 percent return would be reasonable, the Commission's confidence level would be greatly increased when pending legislation and the constitutional amendment passed to allow opportunities to enhance performance and reduce risk in the portfolio.

Chairman Williams reported that the contract with Mercer for the Asset Liability Modeling Study (ALM) had been negotiated within the parameters the Commission discussed previously. Mr. James Powers made a motion that the Commission engage Mercer to perform the ALM, which was seconded by Mr. Gillespie and passed

unanimously. The Commission directed Mercer to discuss all assumptions involved in the study with Mr. Borden.

At Mr. Ewing's request, Mr. Borden agreed to submit his expected budget for the investment division to the Commission at its next meeting.

Chairman Williams called for objections or amendments to the minutes from the Commission meeting on February 9, 16, and 24, 2006. There being none, the minutes were adopted as presented.

XIII. EXECUTIVE SESSION

Mr. Powers made a motion, which was seconded and passed unanimously, that the Commission meet in executive session to receive legal advice and discuss a proposed contractual matter. Chairman Williams announced that the Commission would meet in executive session to receive legal advice and discuss a proposed contractual matter.

The Commission reconvened in open session and Chairman Williams reported that the Commission did not take any action while in executive session.

Treasurer Patterson made a motion to conduct a search for small cap growth managers, adopt the search criteria used in the previous small cap growth search, and to allow exceptions in the search for managers with similar backgrounds and experience as the current small cap growth managers. Mr. Ewing seconded the motion, which carried unanimously.

XIV. ADJOURNMENT

Chairman Williams thanked everyone for attending the meeting, and noted that the Commission should consider conducting an annual retreat beginning November 2006. Mr. Gillespie made a motion to adjourn. The motion was seconded, and the meeting adjourned at 12:05 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 on March 3, 2006, were posted at the entrance, in the lobbies, and near the 2nd Floor Conference Room at 202 Arbor Lake Drive, Columbia, SC, on March 6, 2006, and were posted at the Wampee Training and Conference Center at 1274 Wampee Plantation Road, Pinopolis, SC on March 7, 2006.]