South Carolina Retirement System Investment Commission
Meeting Minutes

May 11, 2006

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

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

Others present for all or a portion of the meeting: Robert Borden, Nancy Shealy, Ashli Aslin, Tomas Jokl, and Justin Young from the South Carolina Retirement System Investment Commission; Frank Rainwater, Rick Patsy, 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, Tammy Davis, and Joni Redwine from the South Carolina Retirement Systems; Anne Macon Flynn from the Budget and Control Board Office of General Counsel; John Huffman, a retired state employee; Wayne Pruitt, Kent Phillips, Sam Griswold, and Bob Sealy from the State Retirees Association; and Charley McDonald from the South Carolina Trooper's 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. Mr. Travis Pritchett was unable to attend due to a family emergency.

Chairman Williams called for objections or amendments to the meeting's proposed agenda and requested the discretion to vary from the proposed agenda as required by time constraints. There being no objections, the agenda was adopted.

Chairman Williams called for objections or amendments to the minutes from the Commission meeting on March 9-10, 2006, as amended. There being none, the minutes were adopted as amended. Chairman Williams called for objections or amendments to the minutes from the Commission meeting on April 13, 2006. There being none, the minutes were adopted.

II. REPORTS

Chairman Williams reported that Senate Bill 1094 (S.1094) had been signed by the Governor. He stated that the statutory amendments added several types of investments in the representative investment list, amended provisions relating to fiduciaries' standards of conduct, provided for indemnification of the Commission and staff as provided for the State Budget and Control Board (Board) and State Retirement Systems Investment Panel (Panel), and made technical changes relating to the National Guard Retirement System.

Chairman Williams reported that, based on the preliminary staffing plans for the upcoming fiscal year, the South Carolina State Senate approved eight additional full-time employees (FTEs) in the Commission's budget authorization for Fiscal Year 2007. The budget authorization was pending before the South Carolina House of Representatives. He noted that a proviso was added to require the Commission to evaluate and approve the positions prior to hiring additional staff, but the positions could be filled as the Commission deems appropriate.

Chairman Williams addressed the Commission's public relations strategy regarding the proposed constitutional amendment that would allow further diversification of the portfolio of the South Carolina Retirement Systems (Retirement System). Chairman Williams stated that he asked Ms. Nancy Shealy to ascertain to what extent the Commission could expend funds to address the ballot measure. Ms. Shealy stated that generally the Commission could use funds to prepare informational materials, conduct public meetings, or respond to news media or citizens' inquiries concerning a ballot measure affecting the Commission and/or Retirement System, but the Commission would be prohibited from using funds, state property, or staff time in an attempt to influence the outcome of a ballot measure. Chairman Williams stated that the Commissioners and staff could use their own time and funds to the maximum extent possible.

Chairman Williams stated his intent to invite a retired public relations executive to the June Commission meeting. Chairman Williams stated that the executive offered to lend his expertise to the Commission's public relations efforts to provide information relating to the proposed amendment free of charge.

Mr. Robert Borden stated that he met with Mr. Hunter Howard, who is a member of the Panel and President and Chief Executive Officer of the South Carolina Chamber of Commerce (Chamber). Mr. Borden said Mr. Howard expressed his support of the Commission's effort and the proposed constitutional amendment and offered the Chamber's aid in informing the public as to the meaning and effect of the proposed amendment.

Chairman Williams stated that the individual Commissioners were allowed to form a committee to influence the outcome of an election if no state funds, property, or time were used. Mr. Blaine Ewing suggested that the Commission provide the state's newspapers and other media outlets with pertinent information about the amendment and Retirement System. Mr. Allen Gillespie requested an informational packet be drafted to aid with discussions. Ms. Shealy reiterated that a public relations strategy to inform and educate the public about the investment program, the Commission, the Commission's role, and the impact of asset allocation on the Retirement System's portfolio would be beneficial and in the public interest, and the expenditure of funds to do so should be acceptable as approved by the Commission.

Chairman Williams noted that a draft of the Statement of Investment Objectives (SIO) had been included in the Commissioners' meeting materials. He stated that a draft of the Statement of Policies (SIP) and Annual Investment Plan (AIP) would be forwarded to the Commissioners upon completion. Chairman Williams requested that each Commissioner carefully consider each document and submit suggestions and/or comments to him or Mr. James Powers. Chairman Williams expressed his intent to submit the documents for approval during the Commission's June meeting.

Chairman Williams recognized Ms. Shealy for the Administrative Director's report. Ms. Shealy provided the Commission with an update on the fiduciary liability insurance policy. She stated that the current policy would expire on July 1, 2006, and an application for renewal had been submitted. She explained that the policy would cover the Board, Commission, Panel, and staff for their respective responsibilities for the Retirement System. Ms. Shealy recommended that the Commission renew the policy if the premium resulting from the application was reasonable and consistent with the premium history for the current policy. Ms. Shealy expressed interest in exploring the issuance of a Request for Proposal for brokers specializing in fiduciary insurance during the next fiscal year. She added that insurance was not exempt from the SC Consolidated Procurement Code generally and that she understood the Board's Materials Management Office obtained and managed those contracts.

In response to a question from Mr. Gillespie, Ms. Shealy said that while S.1094 provided indemnification for the Commission and staff, fiduciary liability insurance provided additional benefits. She said she understood that the Board would maintain fiduciary liability insurance and suggested that the Commission carry it as well. Mr. Gillespie asked a question relating to payment of the policy's premium. Ms. Shealy explained that the entire policy premium was paid from the Panel's budget previously, but she had had conversations with several Board representatives who agreed that the premium should be prorated in the future for budgetary purposes. Mr. Gillespie asked why the Retirement System should not be responsible for the insurance, and Ms. Shealy explained that while the Commission's administrative expenses were paid from the same source as the Retirement System's administrative expenses, each entity maintained a separate budget. She said that she discussed the issues with Mrs. Peggy Boykin, and they agreed that the cost for the insurance should be allocated proportionately between the Commission and Retirement System. Mrs. Boykin explained further that the Commission had included the projected insurance costs in its budget authorization request for Fiscal Year 2007, but the costs were not included in the Retirement System's request, so if the premium for the insurance renewal exceeded the amount the Commission had budgeted for fiduciary liability insurance, the Retirement System would pay the difference for next fiscal year. Mr. Ewing made a motion to approve the fiduciary liability insurance policy renewal so long as the premium was determined reasonable by both the Commission's Administrative Director and the

Director of the Retirement System. State Treasurer Grady Patterson seconded the motion, which passed unanimously.

Chairman Williams recognized Mr. Borden for the Chief Investment Officer's (CIO) report. Mr. Borden introduced and discussed the qualifications of the Commission's two new interns, Messrs. Tomas Jokl and Justin Young. Mr. Borden explained that technically he had requested only one position be approved at the last meeting, although he had discussed hiring two interns. After evaluating pending projects and time frames for hiring permanent staff, he asked for a second intern, which was approved by the Chairman on an interim basis. Mr. Gillespie made a motion to ratify the hiring of an additional intern, which was seconded by Mr. Ewing and passed unanimously. The Commission welcomed Messrs. Young and Jokl.

Mr. Borden discussed investment policy development and provided an overview of his recommended approach. He stated that in terms of evaluating whether to include additional asset classes, legal authority for the asset class should be determined first, followed by a documented process for the Commission to decide whether to add that asset class to the portfolio. Mr. Borden stated that this exercise should include developing an expected rate of return, analyzing expected risk, determining the expected correlation for that asset class compared to other asset classes in the portfolio, and setting limits for the allocation of that particular asset class. Mr. Borden stated that after the exercise was completed, an implementation strategy should be determined. He noted that the last step of the process would be to initiate an investment manager search.

Mr. Borden discussed staff recruitment and development and stated that effective July 1, 2006, eight additional FTE positions would be authorized for the Commission's consideration. He stated that within the Investment Division, he anticipated these positions to include a Director of Equity Investments, Senior Equity Portfolio Manager, Equity Analyst, Director of Research, Research Analyst, and Performance and Analytics Analyst for the fixed income portfolio. Mr. Borden noted that staffing requirements would depend on the complexity of the portfolio and the amount of assets that would be internally managed. Mr. Borden stated that additional facilities to implement these operations would be necessary.

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

III. INVESTMENT MATTERS

Chairman Williams recognized Mr. Borden for a summary of the portfolio's performance. Mr. Borden stated that as of March 31, 2006, the total portfolio had increased 2.7 percent, compared to a median return of 4.8 percent for large public funds. He explained that the relatively inferior performance was due to the structural limitations placed on the portfolio. Mr. Borden briefly discussed the performance of the equity and fixed income portfolios and noted that the fixed income portfolio's performance was in the top quartile compared to similar portfolios.

Chairman Williams recognized Mr. Rick Patsy from the State Treasurer's Office (STO) for a presentation on the fixed income investments of the Retirement System. Mr. Patsy provided a brief overview of the yield curve and the interest rate environment for the past 12-month period. He noted that in February 2006 the Federal Reserve Board (Fed) reissued 30-year Treasury Bonds for the first time since 2001. Mr. Patsy explained the impact of the reissue of the 30-year Treasury Bond on the yield curve.

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

Mr. Patsy and the Commission reviewed the fixed income portfolio's characteristics, including the average maturity, coupon, duration, and ratings. Mr. Patsy also discussed asset allocations within the fixed income portion of the portfolio, the changes that occurred over the previous 12-month period, and the changes the STO expected to make in the coming months. He also provided the Commission with a summary of the STO's economic forecast.

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

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

Chairman Williams recognized Messrs. Jay Love and Jeff Schutes of Mercer Investment Consulting (Mercer) to review the equity portfolio Quarterly Investment Performance for Periods Ending March 31, 2006. Mr. Love reviewed economic factors and broad market performance. Mr. Love provided an overview of market performance on an industry and sector basis, discussed market returns, and provided an overview of the largest positive and negative contributors to the S&P 500 for the first quarter of 2006.

The Commission and Mercer discussed the Retirement System's equity portfolio performance. Mr. Love reported that the equity portfolio totaled approximately $14.02 billion, which was consistent with the targets and ranges set forth in the AIP. He said that for the three- and five-year periods ended March 31, 2006, the equity portfolio returned 19.6 percent and 5.4 percent, outperforming the S&P 500 by 240 basis points (bps) and 140 bps, respectively. He noted that for the quarter, the equity portfolio underperformed the Total Equity Index (a weighted average of the benchmarks of all the Retirement System's equity investment managers) by 30 bps, which was largely attributable to the active Large Cap portfolio. The Commission and Mr. Love reviewed the performance of the asset classes relative to the applicable indices. They also reviewed the performance of the individual managers and compared them to the applicable indices and rankings within their respective peer groups. Mr. Love discussed the equity portfolio's allocation by sector and noted that the overall equity portfolio was aligned with the broad market in terms of sector allocations.

Mr. Love updated the Commission on several individual investment managers. He noted that J.L. Kaplan Associates (Kaplan) underperformed its benchmark by 8 percent for the trailing one-year period. Mr. Love attributed this underperformance to analyst turnover and firm transition issues. Mr. Borden stated that Kaplan's performance continued to worsen over recent months, and he anticipated the pattern to persist. He recommended that the Commission either consider initiating a search for a Small Cap Value investment manager to replace Kaplan, or based on the current asset allocation, eliminate the Kaplan Small Cap Value allocation and invest that allocation in the Passive Large Cap strategy. Treasurer Patterson made a motion to terminate the contract with Kaplan, authorize the Chairman of the Commission or his designee to negotiate and execute a contract with a transition manager as recommended by the CIO and Mercer, and to transition the assets to the Passive Large Cap strategy. After thorough discussion, Mr. Ewing seconded the motion, which passed unanimously.

The Commission received the Quarterly Investment Performance for Periods Ending March 31, 2006, and the Executive Summary as information. No amendments to the Interim Annual Investment Plan were proposed.

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

Chairman Williams recognized Mr. Shealy and Mr. Borden for a discussion on the contract renewal with AllianceBernstein L.P. (AllianceBernstein) for the Large Cap Growth strategy. Ms. Shealy stated that the contract would expire on June 22, 2006. Mr. Borden and Mercer recommended that the Commission renew the contract with AllianceBernstein. After further discussion, Mr. Ewing made a motion to authorize the Chairman of the Commission or his designee to negotiate and execute a contract with AllianceBernstein in the Large Cap Growth strategy upon approval for legal sufficiency by General Counsel. The motion was seconded by Treasurer Patterson and passed unanimously.

Chairman Williams recognized Mr. Borden for an update on the investment consultant selection process. Mr. Borden outlined a proposed schedule for each aspect of the search process, concluding with the selection of an investment consultant at the Commission meeting scheduled for August 10, 2006. In addition, Mr. Borden discussed the scope of services sought and the minimum qualifications required of the candidates. The Commission discussed the cost of an advertisement in Pensions and Investments Magazine (P&I). Mr. Gillespie made a motion to adopt the consultant search timeline, minimum qualifications, and scope of services as proposed and authorize payment for an advertisement in P&I. Mr. Ewing seconded the motion, which passed unanimously.

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

Chairman Williams recognized Mr. Borden for an update on the global fixed income search process. Mr. Borden provided the Commission with an overview of the global bond market and discussed its short and long-term performance. He explained that global bonds act as a potential return enhancer over U.S. Core Fixed Income and, because of the low correlation to other asset classes, they offer a strong diversifying strategy, particularly during U.S. market downturns. Mr. Borden described some of the risks in global bond investing including changes in interest rates, currency swings, issuer credit downgrades and defaults, economic and political instability, and bond-specific risk. Mr. Borden opined that global investments should be part of an institutional investment program and concluded that economic conditions made global investments attractive.

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

Mr. Ewing made a motion, which was seconded by Mr. Powers, that the Commission meet in executive session to receive legal advice and to discuss proposed contractual matters. After discussion, the Chairman called for the question, and the motion passed. Chairman Williams and Messrs. Powers, Ewing, and Gillespie voted for the motion. Treasurer Patterson voted against the motion. Chairman Williams announced that the Commission would meet in executive session to receive legal advice and discuss proposed contractual matters. Treasurer Patterson asked for additional information as to the contractual matters, and Chairman Williams responded that the Commission would discuss issues relating to investment management contracts.

The Commission reconvened in open session and Chairman Williams reported that after going into executive session and discussing the issues, the Commission determined that public disclosure would jeopardize the Commission's ability to achieve investment objectives and the portfolio, so the Commission's executive session was held pursuant to S.C. Code Ann. §9-16-80. He stated that the Commission did not take any action reportable at this time, but if any action were to be taken as a result of the executive session, information would be publicized as soon as the risk arising from disclosure dissipates.

IV. ADMINISTRATIVE MATTERS

Chairman Williams and Ms. Shealy provided the Commission with an update on office facilities. Ms. Shealy reported that there was insufficient space at the Retirement System's facility to staff and implement the Commission's investment and agency operations. Ms. Shealy stated that adequate facilities were imperative for effective and efficient management, although the Commission must also consider minimizing costs and the duplication of services, where feasible.

Ms. Shealy outlined the general process for procuring office space set forth by state law and noted that the Board's Office of General Services (OGS) was the central leasing agent for all state agencies. Ms. Shealy explained that the OGS solicitation process was required unless an agency was exempted based on specific needs. Ms. Shealy stated that she and Mr. Borden had begun identifying issues relating to office space, staffing, and equipment needs of the Commission. After further discussion, Mr. Ewing made a motion to authorize the Chairman of the Commission or his designee to begin the process with OGS to obtain adequate office space and facilities. Mr. Powers seconded the motion, which passed unanimously. Chairman Williams designated Ms. Shealy and Mr. Borden to act on his behalf for this matter.

V. OTHER BUSINESS

Chairman Williams recognized Mr. Schutes for an update on the Asset Liability Modeling Study (ALM). Mr. Schutes stated that the objective of the discussion was to establish the parameters, assumptions, and output that would be used in conducting the ALM for the portfolio. He stated that Mercer and Milliman Consultants and Actuaries (Milliman), the actuary for the Retirement System, would work together to perform the analysis. Mr. Schutes discussed three main objectives of the ALM: develop the most effective asset allocation mix, evaluate the implications of changes in liabilities in the future such as Cost-of-Living-Adjustments, and evaluate the economic view of the assets and liabilities.

Mr. Schutes discussed the merits of analyzing a public pension plan on an economic basis which involved using a rate derived from market bond rates to discount liabilities. Mr. Schutes stated that while an economic analysis provided a more realistic view of the liabilities and funding status of the plan, it was standard for public pension plans to discount liabilities with the actuarial assumed rate of return. Mr. Gillespie stated that he strongly believed that the Commission should be aware of the plan's economic reality, as the information could be used to make important decisions about the portfolio and the Retirement System. The Commission concurred with Mr. Gillespie's view.

Mr. Schutes discussed the assumptions on which the analysis would be based and received direction from the Commission. Mr. Schutes assured the Commission that the process would be very interactive, and after performing an initial analysis, Mercer would submit a draft report to the Commission for preliminary review.

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

VI. ADJOURNMENT

Chairman Williams thanked everyone for attending the meeting. Treasurer Patterson made a motion to adjourn. Mr. Powers seconded the motion, and the meeting adjourned at 2:20 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 May 8, 2006.]