South Carolina Retirement System Investment Commission
Meeting Minutes

October 16, 2008

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

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

Others present for all or a portion of the meeting: Dunkin Allison, Geoff Berg, Robert Borden, Jonathan Boyd, Donald Brock, Dori Ditty, Brenda Gadson, Douglas Lybrand, Heather Muller, Rick Patsy, Greg Putnam, Kathy Rast, Nancy Shealy, Nicole Waites, Brian Wheeler, and Hilary Wiek from the South Carolina Retirement System Investment Commission; Mike Addy, Frank Rainwater, and Shakun Tahiliani from the State Treasurer's Office; Rhett Humphreys from New England Pension Consultants; Chris Anderson, Robin Benson, Sarah Corbett, Tammy Davis, John Page, Danielle Quattlebaum, Joni Redwine, Travis Turner, and Faith Wright from the South Carolina Retirement Systems; Kelly Rainsford from the Budget and Control Board; Tom Heflin and Greg Nordquist from Russell Implementation Services; Ernest Cruikshank and Keith Wood from Jamison, Eaton & Wood, Inc.; and Crawford Clarkson from the State Retirees' Association.

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

Chairman James Powers 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. Commissioner Blaine Ewing was unable to attend the meeting due to illness.

Chairman Powers referred to the meeting agenda and said that there were two proposed changes. He had talked with Mr. Robert Borden, Chief Investment Officer (CIO), and Dr. Travis Pritchett about the item related to the Risk Component of Employee Incentive Pay Plan and that unless there was an objection, it would be beneficial to carry the item over to the next meeting to gather additional information. He also stated that in lieu of that item, Mr. Borden wanted to present a proposal relating to the movement of collateral for the Morgan Stanley SCRSIC Strategic Partnership Fund LP. Ms. Nancy Shealy, Administrative Director and General Counsel, noted that the details of the collateral proposal originated late the day before the meeting so there was insufficient time to amend the pre-approved and posted agenda. State Treasurer Converse Chellis expressed concerns about quick and last minute items that require a Commission vote. Chairman Powers, noting and concurring with Mr. Chellis' concerns, said that he would provide additional information during the Chairman's Report. Chairman Powers called for objections or other amendments to the meeting's proposed agenda, and there being none, the proposed agenda was adopted as amended.

Chairman Powers called for objections or amendments to the minutes from the meetings on September 18 and October 3, 2008. Upon motion of Mr. Reynolds Williams and second by Mr. Chellis, the minutes from both meetings were approved.

Chairman Powers referred to information that was provided to the Commission and discussed during prior Commission meetings regarding the incentive compensation plan calculation for Mr. Borden for Fiscal Year (FY) 2008-2009. He said that the proposal was vetted by the Commission, was audited by New England Pension Consultants (NEPC), and asked for any further discussion. In response to a question by Mr. Chellis, Chairman Powers confirmed that the Commission had adopted the incentive compensation plan for the CIO over a year ago and that this information related to the calculation of the payment. Mr. Williams made a motion to approve the incentive compensation plan calculation and payment to Mr. Borden for FY 2008-2009. Mr. Allen Gillespie seconded the motion, which passed unanimously.

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

Chairman Powers noted that the current performance of the stock market required quick decision making in some areas, which also tied into concerns about adding items to the agenda and the policy project Mr. Gillespie is coordinating. Chairman Powers stated that while the CIO clearly has authority to move assets within the broad guidelines and allocation targets set by the Commission, specific guidelines are needed to more clearly define the triggers by which the Chairman, CIO, or General Counsel would be involved with the process for moving assets. He explained that as long as cash or collateral is moving from and to existing managers within the target ranges, the process would not be a change to the investment decisions of the Commission. Mr. Gillespie noted that strict guidelines for asset movement were in place when the Commission was established, but those guidelines did not specify who had the authority to sign off on any transfers for the purpose of rebalancing or posting collateral to implement the investments. He also stated that given the current market conditions, managers should have pledged collateral as soon as possible. Ms. Shealy noted that the Commission has the authority to delegate certain functions, but final authority to invest cannot be delegated. She noted further that the implementation of the Commission's investment decisions is delegated to the CIO and managers as long as the movement or implementation is within the target ranges and guidelines set by the Commission. Ms. Shealy, noting that strategic partnerships cross a broad range of asset classes, suggested that specific guidelines be considered in the policy project to address strategic partnerships.

Mr. Chellis questioned what proposed changes would allow Mr. Borden to move assets. Mr. Borden stated that currently, clear language exists in Commission policies setting forth the approved asset allocations and the asset manager hiring process. He also explained that the Annual Investment Plan (AIP) specifies that the rebalancing decisions within target allocations will be made by the CIO in consultation with Commission staff. Mr. Borden stated that certain ranges had been established within the AIP, and as long as allocations remain within the ranges, Commission approval is not needed to change allocations. He explained further that the steps and some of the legal documents needed to process an allocation change, even if it is within the ranges set by the Commission, are not covered by Commission documents. Mr. Chellis reiterated that changes outside of the target ranges would have to be approved by the Commission. Chairman Powers confirmed and noted that action by the Commission was not requested at this time, but he wanted to identify some of the issues Mr. Gillespie would address in the policy project.

Mr. Chellis requested that any proposed movement outside the established range be vetted by State Treasurer's Office staff. After further discussion, Mr. Gillespie noted that best practices would require notification of several parties for any allocation movement. Chairman Powers concurred with Mr. Gillespie and stated that the creation of specific guidelines is necessary. Ms. Shealy added that she would work with Mr. Borden to vet documents and that while Mr. Borden could execute certain documents as part of the implementation process, some contractual and other documents would still require the signature of the Commission Chairman.

Mr. Chellis questioned how Mr. Borden determines if movements will result in changes to the asset class weights. Mr. Borden answered that everything is measured together and targets weights vary on a daily basis. He explained that before changes are made, the Commission staff calculates what effect changes in one target would have on another target. Mr. Borden also stated that in general, the process is to sell assets from over-weighted asset classes and move funds into under-weighted asset classes. He noted that by policy, some rebalancing is within the CIO's discretion while some rebalancing is mandatory depending on the allocation levels.

II. INVESTMENT MATTERS

Chairman Powers recognized Mr. Borden for the CIO's report. Mr. Borden reported a significant amount of market sell down in September and in October and referred to the preliminary September Flash Report provided by NEPC. He indicated that the South Carolina Retirement Systems' (Retirement System) portfolio was down 8.9 percent for September and down 10.7 percent for the fiscal year to date. He said that benchmark returns were down with the Russell 3000 Index down 9.4 percent, the Russell 1000 Index down 9.5 percent, and the Russell 2000 Index down 8 percent, and internationally, the MSCI EAFE Index (EAFE) was down 14.5 percent. Mr. Borden noted issues with margin calls because the Retirement System portfolio had significant derivative positions in which there was synthetic long exposure to EAFE. He stated that investments in the S&P 500 Index should not be shorted to fund EAFE investments because they were currently performing much worse. He reported further that in general, all the world equity markets had sold off more than domestic and emerging markets.

With regard to the hedge fund program, Mr. Borden estimated that the HRFX Global Hedge Fund Index was down 7 percent, but the Retirement System's hedge fund program was down approximately 4.8 percent. Mr. Borden noted that the portfolio's hedge fund performance was outperforming the global index by 200 basis points (bps), which has preserved capital for the Retirement System, and its pool of managers performed relatively well for September.

Mr. Borden said that being down 10 percent for the year to date was a new low but indicated that relative to other retirement systems, South Carolina had better performance. Mr. Chellis requested information on how much the portfolio had declined in October. Mr. Borden, stating that the market had been in a free fall, estimated that for the broad based benchmarks for the first two weeks of October, the Retirement System portfolio was down approximately 10 percent. Mr. Borden roughly estimated that other retirement system funds were down approximately 25 percent. Mr. Chellis noted that because of broad diversification within the last few years, the Retirement System's portfolio had performed better. Chairman Powers added that the domestic US equity program was currently at its lowest historical level but that the exposure was less than it was when the Commission was formed. Mr. Gillespie requested the hedge fund program's figures. Mr. Borden replied that the imbedded beta in the program was around 20-25 percent and noted that hedge fund allocations were about 4 percent of the total portfolio, which was the anticipated exposure. He also stated that despite being down in the equity portfolio, diversification of the portfolio had preserved capital that would have been lost if the Commission had not invested in other asset classes.

Mr. Borden referred to a report of the Beta Overlay Program and introduced Mr. Greg Nordquist from Russell Implementation Services, Inc. (Russell). Mr. Borden, stating that the portfolio has about a $10 billion derivative overlay program, estimated the notional amount of exposure to be about $10 billion. He said that when entering into a future or swap, a certain margin requirement is necessary to represent the possible exposure. Mr. Borden explained that the current market situation had resulted in more margin calls being requested, thus causing issues with cash accounts. He also said that within the last week, there were margin calls every day so he has had to generate redemption requests to global fixed income managers to raise funds to cover the margin calls.

Mr. Borden said that the Commission's three largest counterparties are JP Morgan, Goldman Sachs and Morgan Stanley. He noted that these companies are also strategic partners with the Commission. Mr. Borden stated that the Commission's participation in strategic partnerships has permitted the use of other collateral and other allocations to provide cash to cover margin calls, without needing to liquidate quality assets.

Mr. Borden said that Russell had an Umbrella ISDA (International Swaps and Derivatives Association, Inc.) contract agreement to enter into swaps, which gave the Commission access to counterparties. He stated that Russell's Umbrella ISDA contract agreement was one of the key points in choosing them as a multi-manager investment service. Mr. Borden added that Russell manages and negotiates collateral requirements with counterparties, monitors counterparty exposure, and reviews and studies collateral positions on the behalf of the Commission. The Commission discussed various aspects of collateral, risks, and exposures.

Chairman Powers suggested discussing the proposal relating to the Morgan Stanley SCRSIC Strategic Partnership LP (Morgan Stanley). Mr. Borden reported that Morgan Stanley, by virtue of its relationship with the Commission, had proposed allowing the Commission to substitute collateral. He stated that a pledge of a $1 billion pool of hedge funds, real estate, and other investments would be substituted as payable collateral on swap agreements. Mr. Borden said that since the Commission was a partner in the strategic partnership, the Commission would have to agree to and approve this use of collateral. Mr. Nordquist explained the status of the Beta Overlay portfolio and the effect of the Morgan Stanley proposal. Chairman Powers, noting that this would be a great opportunity for the Retirement System portfolio and that the assets were fenced by the strategic partnership, asked if pledged collateral would modify any counterparty risks. Mr. Borden replied that the only counterparty risk would be if Morgan Stanley went bankrupt, and he explained the ramifications if the Retirement System was in a net payable position to Morgan Stanley. Mr. Gillespie stated that this proposal may in fact be safer because, unlike with other firms, the collateral would not be placed into Morgan Stanley's general fund. Mr. Borden added that if Morgan Stanley owed the Retirement System's portfolio money, it could be paid in cash. However, if the portfolio owed Morgan Stanley money, the Commission could pledge an illiquid asset. Chairman Powers stated that some of the Retirement System's positions could be liquidated if the Commission does not allow the use of the strategic partnership as collateral. After further discussion, Mr. Williams made a motion to pledge the Morgan Stanley partnership interest as collateral for the Beta Overlay Program with Russell and to authorize the Chairman to negotiate and execute any necessary documents, subject to approval for legal sufficiency by General Counsel. Mr. Gillespie seconded the motion, which passed unanimously.

Chairman Powers requested data from other states regarding investment performance and a report that shows how the Retirement System portfolio would have performed if the Commission had not diversified investment of the assets.

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

Mr. Borden referred to materials that were presented to the Commission during the September meeting and a new report from NEPC regarding the Fixed Income and Cash Program. He reported that Commission staff is currently managing a $6 billion portfolio with a long-term target of 15% of total assets or approximately $3.5 billion. Mr. Borden stated that concentration in corporate bond exposure and reducing the portfolio to fund other strategies had created more liquidity pressure. Mr. Borden, echoing his comments from last month's meeting, stated that the Commission is faced with a "buy" vs. "build" decision. He further noted that historical performance of the fixed income and cash portfolio had been very competitive and explained that the transition of assets to other investments had created issues within the program.

Mr. Borden stated that it is important to have the same internal processes and controls that the Commission would expect from any external manager. He also said that the recent problems with credit rating agencies had generated a need to internally generate credit ratings for the Commission's managers. Mr. Borden suggested the creation of an internal credit program. Mr. Borden stated that the internal fixed income and cash processes were antiquated, manual labor intensive, and could be negatively affected by human error. He also said that new software would reduce the possibility of human error. Mr. Borden suggested that structural changes and additional resources devoted to internal controls would be necessary to improve the fixed income and cash portfolio if managed internally. He also stated that current limited human resources and physical office space lends itself to outsourcing the back office accounting functions of the program.

Mr. Borden recommended that the Commission approve outsourcing management of the fixed income and cash portfolio by allocating $1 billion to $1.5 billion to Blackrock, Inc., in a core plus fixed income portfolio, $1 billion to $1.5 billion to Pacific Investment Management Company LLC (PIMCO) in a core plus fixed income portfolio, and reserving $750 million to $1.25 billion to invest in a Core Plus strategy product-launch with Mariner Investment Partners (Mariner) with equity participation by the Retirement System, and to allocate $750 million to $1.5 billion to cash to be managed in Bank of New York Mellon and Russell sweep vehicles.

Mr. Borden also stated that Jamison, Eaton & Wood, Inc. (Jamison) expressed interest in partnering with the Commission for management of assets within the fixed income and cash allocations. Dr. Travis Pritchett mentioned that when considering the risk return comparisons, both Jamison and the Retirement System looked very attractive and asked how many employees would be needed to continue the program internally. Mr. Borden estimated at least three people would be needed. Mr. Gillespie added that if an outside organization was examining the current program as a potential investment vehicle, it would most likely decide not to invest. Mr. Gillespie also expressed concerns about how the current market situation had altered fixed income programs and structure. He was also concerned about the quantity of bond issues and line items in the current fixed income and cash portfolios. Mr. Rick Patsy estimated at least 400 bond issues in the portfolio and indicated that no credit agencies were used. He further stated that research, Jamison's third party analysis system, and working experience contributed greatly to the fixed income and cash portfolio's success.

Chairman Powers expressed concerns about the time and resources needed to change the internal program and stated that he was in favor of outsourcing management of the fixed income and cash portfolios. Mr. Borden concurred with Chairman Powers and said that there were many current portfolios that could be more closely monitored by external resources.

Mr. Chellis expressed concerns with outsourcing given the performance of the portfolio with Jamison during the past thirty years. Chairman Powers replied that he did not think that the Commission would invest in a similar strategy for the current portfolio. Mr. Gillespie replied that performance was only one aspect of due diligence. Mr. Borden said that process, philosophy, people, and price were other criteria for manager selection. Chairman Powers added that environment was also given consideration and that future investments may not be similar to previous investments. Mr. Gillespie stated that there were many ways to generate returns through asset allocation and said that given the market environment and the size and scope of the fixed income and cash portfolios, operating the program from the bottom up would be limited by current expertise. He added that with knowledge transfer from outsourcing partners, the program would operate more efficiently. Mr. Gillespie said that the underlying issue was implementation. He further discussed the difficulties involved with moving cash through liquidating assets over many line items. Chairman Powers stated that Mariner and PIMCO were asked to examine the legacy portfolio and that they said the portfolio's quantity of corporate bonds hampered the ability to raise $750 million quickly. Chairman Powers added that Jamison's performance was very good and suggested that with additional due diligence, the Commission may possibly select them as a manager.

Mr. Rhett Humphreys of NEPC said that generating alpha in core fixed income portfolios was difficult. He also stated that it must be actively managed to generate desired performance. Mr. Humphreys suggested that additional expertise from outsourcing would contribute to higher performance in the fixed income portfolio.

Mr. Williams questioned the allocations of the proposed outsourcing plan. Ms. Shealy stated that by statute, up to a certain amount of cash had to be available for the payment of benefits. Mr. Borden suggested that $750 million to $1 billion should be reserved as cash. He also believes that dividing the fixed income and cash portfolio over multiple mangers would minimize risk.

After further discussion, Mr. Chellis questioned that given the current market conditions whether outsourcing would be appropriate at this time. Mr. Gillespie replied that the total portfolio was around $16 billion with approximately $6 billion in the fixed income and cash portfolio that three Commission staff is managing, and approximately $10 billion in outside managers that need to be monitored. Mr. Chellis expressed concerns that the proposed allocations to external firms would not obtain the expertise and devotion needed due to the small size of the allocations when compared to the firms' total investment by all clients. Mr. Williams stated that the Commission has allocated $7 billion to one manager currently, which is the internal fixed income portfolio. He stated further that managing the fixed income and cash portfolio internally was inconsistent with the goals of the Commission.

After further discussion, Mr. Chellis made a motion to engage external firms to manage the fixed income and cash portfolios as recommended by Mr. Borden and to conduct due diligence meetings with Jamison relating to portfolio management. Mr. Williams seconded the motion, which passed unanimously.

Mr. Williams made a motion to invest an amount not to exceed $1.5 billion to Blackrock, Inc. in a core plus fixed income portfolio, and to invest an amount not to exceed $1.5 billion to Pacific Investment Management Company LLC (PIMCO) in a core plus fixed income portfolio, to authorize the Chairman or his designee to negotiate fees not to exceed those presented to the Commission, and to authorize the Chairman to negotiate and execute any necessary documents to invest in the funds, subject to approval for legal sufficiency by General Counsel. Dr. Pritchett seconded the motion, which passed unanimously.

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

Mr. Borden presented information regarding his proposal for the salary range for the position of Deputy Chief Investment Officer, which had been approved at the previous meeting. He recommended an annual salary range of $150,000 to $250,000. Ms. Shealy inquired if the salary range was comparable to similar positions in government pension funds, and Mr. Borden responded positively. Mr. Chellis expressed concerns regarding funding this position given the recent across the board state government budget cuts. Mr. Williams made a motion to approve an annual salary range of $150,000 to $250,000 for the Deputy Chief Investment Officer position. Dr. Pritchett seconded the motion, which passed with Chairman Powers and Messrs. Gillespie and Williams voting for the motion and Mr. Chellis voting against the motion.

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

Chairman Powers reported that he and Dr. Pritchett and Mr. Borden met with and conducted due diligence discussions with the Mariner Investment Group (Mariner) regarding a possible Core Plus strategy product-launch with equity participation by the Retirement System. Dr. Pritchett said that the partnership organization of the proposed strategy was very attractive and would be of benefit to the Retirement System portfolio. Mr. Borden estimated initial income from the investment to be at least $7 million with the potential to earn more in the future.

III. ADMINISTRATIVE MATTERS

Chairman Powers introduced Ms. Shealy for an update regarding administrative matters, including the Compliance Officer position. Ms. Shealy asked Mr. Chellis to update the Commission on the search for the Compliance Officer position. Mr. Chellis stated that initial phone interviews had been conducted with several candidates and questioned how many candidates should be invited to meet with the Commission. Mr. Gillespie indicated that he felt that meeting with at least five candidates would be appropriate. After further discussion, the general consensus of the Commission was to meet with at least two qualified candidates but no more than five.

Ms. Shealy indicated that for the budget for FY 2007-2008, approximately $519,000 of the total allocation of approximately $4.77 million was not spent due to conservative fiscal management and delays in implementation of budgeted allocations. She also said that $30,000 set aside last year for implementation of the South Carolina Enterprise Information System (SCEIS) would be paid from the current year's budget due to processing issues at the end of the last fiscal year. Ms. Shealy reported that the current year's spending is in line with last year at this time.

With regard to the FY 2009-2010 budget, Ms. Shealy also reported that Mr. Borden had advised that due to fewer securities in the securities lending program, income will decrease which will eventually require negotiation of a new contract with Bank of New York Mellon (BONY) for banking and custody services. She explained that currently, in lieu of custodial fees, BONY is compensated for their services through profits on lending income. With a significant reduction in the securities lending program, BONY may begin to charge for banking and custodial fees. In addition, Ms. Shealy indicated that new software products and potential compliance review costs have been included in next year's proposed budget. Mr. Chellis questioned contract negotiations with BONY to pay for services directly, given their past performance, and suggested that the Commission consider conducting a search for custodial services. Mr. Gillespie concurred with Mr. Chellis that all contracts should be reviewed and renegotiated periodically. Dr. Pritchett questioned the risk of securities lending. Mr. Gillespie indicated that counterparty and other exposure risks are involved with securities lending.

Ms. Shealy stated that a significant aspect of any budget is intellectual resources, including information technology and personnel. She also stated that the Commission was able to direct less spending to some of these functions than other state agencies. Chairman Powers reported that there are no new full time equivalent positions proposed for the FY 2009-2010 budget and stated that the current budget is functioning near maximum staffing levels. Ms. Shealy estimated the Fiscal Year 2010 budget to be a total of $6.3 to $6.4 million. She stated that figure was based on current assumptions provided by the CIO and analysis of current and projected expenses. Chairman Powers noted that while legal fees are costly, the complex and multi-faceted nature of the Retirement System portfolio's investments require significant research and review. He also said that as current contracts and partnerships are closed, less funding may be needed for future legal review. Mr. Chellis asked about the process for selecting outside counsel, and Ms. Shealy explained that the Commission issued a Request for Information from law firms and evaluates counsel based on a number of factors, including experience with the particular type of investment, complexity of the issues, etc. Ms. Shealy noted that the TCW/Palmetto State Partnership had closed, and she anticipated closing on two more investments within the next few days.

IV. OTHER BUSINESS

Chairman Powers discussed the Investment Retreat at Wampee. Mr. Borden suggested fewer speakers at the Retreat this year because their quantity during the previous Retreat hampered in-depth discussions of the most important topics. Mr. Borden reiterated his suggestion of having the Commission's strategic partners examine the total portfolio and offer suggestions at the Retreat. He also suggested additional risk management discussions and presentations. In addition to general discussion, Mr. Borden requested proposals for additional ideas for future planning. He suggested having an economist conduct a presentation and discussion. Mr. Borden stated he would like to have 4-6 unanimous themes come out of the discussion at the Retreat that would help to create a roadmap for the Commission's future planning. Ms. Shealy suggested a presentation on fiduciary responsibility. Mr. Chellis questioned that since economists have different perspectives, perhaps a panel discussion would be more beneficial to the Commission. Chairman Powers stated he would discuss these suggestions with Mr. Ewing.

V. ADJOURNMENT

There being no further business, Chairman Powers thanked everyone for attending, and the meeting adjourned at 12:40 p.m.

[Staff Note: In compliance with S.C. Code Ann. §30-4-80, public notice of and the agenda for this meeting were delivered to the press and to parties who requested notice and were posted at the Commission's Office and at the entrance, in the lobbies, and near the 2nd Floor Conference Room at 202 Arbor Lake Drive, Columbia, SC, on October 14, 2008.]