December 14, 2010
Minutes #466

Minutes of the Board of Trustees' Meeting -1-

Call to Order: Chairman, Donald Pinard called the meeting to order at 8:30 a.m.

Present: Trustees: Chairman, Donald Pinard, Richard Molan, Chuck Hungler, Paul Porter, Jenny Angell and Bill Sanders arrived at 8:44 a.m.
MECRS Staff: Gerard Fleury, Sandi Aboshar and Suzanne Wilson

Absent: Trustees: Mayor Ted Gatsas

In Attendance: Attorney John Rich of the McLane Law Firm
Ken Alberts of Gabriel, Roeder, Smith and Company,
Sebastian Grzejka and Doug Mosley of New England Pension Consultants

Approval of the Minutes of the Previous Board Meeting:

A motion was made by Trustee Angell to approve the minutes of the November 18, 2010 board meeting, seconded by Trustee Hungler and passed unanimously by all those trustees present.

Approval of the Sealed, Non-Public Session held November 18, 2010:

A motion was made by Trustee Angell to approve the sealed, non-public session meeting minutes, held November 18, 2010, seconded by Trustee Molan and passed unanimously by all those trustees present.

The trustees then handed in their copies of the approved sealed minutes of the non-public session of November 18, 2010 for proper disposal.

Approval of the Immediate Meeting Agenda:

Trustee Molan made a motion to accept the immediate meeting agenda, seconded by Trustee Hungler and passed unanimously by all those trustees present.

Report of the Executive Director:

State of Legislation for 2011 – Mr. Fleury reported that he had appeared before the Manchester Board of Mayor and Aldermen, the previous week, asking for their support of the MECRS legislative initiative to streamline language relative to death benefit entitlements. After asking relevant questions, the BMA unanimously gave their support to the measure. Mr. Fleury went on to say that he has since been contacted by legislative services and has provided them with a draft of the legislation along with a copy of the fiscal impact statement from the System's actuary and a copy of the BMA's vote. The next step will be to provide testimony before the house and senate committees when they convene hearings on the bill. Mr. Fleury speculated that the hearing would not occur before mid January but that he would be there to offer testimony when the time came.

Trustee Angell noted that when the BMA acted upon MECRS' request for support, Mayor Gatsas had requested that the legislation be given a retroactive effective date if it would result in a positive effect on the recent death of the city employee from Highway who died prior to their effective date of retirement.

Chairman Pinard added that he had discussed the particulars of the case with Mr. Fleury following the BMA meeting and ascertained that the legislative amendments being proposed would not affect the party in question.

Preparation for Audit and Valuation for 2010 - Next, Mr. Fleury reported that the agreement for the audit engagement for 2010 has been accomplished. The scope of the audit is expected to mirror that of 2009 and will follow the same approximate timelines except that final reports have been targeted for June instead of July. He also noted that MECRS is on track to provide demographic data to Gabriel, Roeder Smith & Co. for the 2010 actuarial valuation shortly after the first of the year and that the valuation itself should be completed for March 8, 2011 meeting of the MECRS board.

Status of Funding – Private Equity Investments- Mr. Fleury informed the board that MECRS has funded its first capital call with Newstone Partners amounting to $196,309 or slightly more than 13% or the total commitment. He reminded the board that the funded percentage of commitments to private equity is internally tracked, integrated into cash flow management, and reconciled with the custodian and investment advisors reports. In aggregate, $3.5 million in total commitments to private equity have been 17.59% funded to date.

Investigations by the FBI Into Alleged Insider Trading by Hedge Fund Managers - In concluding his report, Mr. Fleury stated that there have been recent press articles regarding investigations by the FBI into alleged insider trading by hedge fund managers. Mr. Fleury noted that while it does not appear that any of the MECRS managers are under investigation, some have been contacted requesting information about their dealings with suspect firms and one portable alpha manager reported ridding itself of one hedge fund manager within its fund of funds for involvement in the matter. He went on to say that the System does not anticipate any material impact from the limited involvement which was reported, will continue to track this situation, but will only report further on it if issues of materiality are found to exist.

On a parting thought, Mr. Fleury also informed the board that medical subsidy rate change notices have been prepared for each recipient and that those custom notices will be mailed to the subsidy recipients prior to the January increase.

Report of the Administrative & Accounting Committee:

Committee Chair Angell reported that there had been a scheduled Administrative & Accounting Committee Meeting earlier that morning and that Mr. Fleury had presented MECRS Operating Budget for 2011. She stated that A&A Committee Members voted to recommend the budget as presented with the addition of a one step increase on the Condrey Salary Scale for MECRS staff. Committee Chair Angell also noted that the budget included funds for replacement pension administration software, and that the total amount of the recommended budget came to $1,054.767.

It was then moved by Trustee Molan to accept the MECRS Operating Budget for 2011 as recommended by the A&A Committee, in the amount of $1,054,767, seconded by Trustee Angell and passed unanimously by all those trustees present.

Consent Agenda:

Trustee Hungler moved to accept the Consent Agenda, seconded by Trustee Molan and passed unanimously by all those trustees present.

It being the final board meeting for Trustee Angell and Trustee Hungler, Chairman Pinard took the opportunity to thank them both for their years of dedication and presented each with a plaque for their service as trustees on the MECRS Board. The plaque for Trustee Hungler cited the completion of part of the unexpired term of his predecessor plus to full three year terms during which he also chaired the Investment Committee of the MECRS board. The plaque for Trustee Angell cited her three year elected term plus her chairmanship of the Benefits Committee and the Administration & Accounting Committees of the MECRS board.

New Business:

Discussion with MECRS Actuary and Investment Advisor Regarding Adequacy of the Present Earning Assumption - Mr. Fleury open the discussion by introducing Mr. Doug Mosley, Partner at New England Pension Consultants, (NEPC) accompanied by Mr. Sebastian Grzejka, Analyst, for NEPC. Mr. Mosley explained that he was filling in for Mr. Kevin Leonard who was unable to attend the meeting because of an inability to return to the region in time following assignments to other parts of the country.

Trustee Sanders briefly stated his concern for the importance of the earning assumption and the implications on the funded status of the pension plan and hence the annual cost that the City if the assumptions were too optimistic. In light of the unpredictable nature of the stock market and bond markets over the last two years, Trustee Sanders felt it would be in the best interest of the board to obtain an assessment from NEPC that the board could rely on and ponder whether the present 7.5% assumption is still appropriate.

Mr. Mosley stated that concern over the earnings assumption is a common discussion for NEPC internally as well as with its clients. On an annual basis, NEPC goes through a process beginning in October during which an asset allocation team updates the asset class assumptions. Mr. Mosley noted that in October of 2010, MECRS received an assessment from NEPC of the expected return of its current policy. That level, he went on to say, was around 7.6% using five to seven year projections.

Mr. Mosley explained that of the two sets of projections NEPC utilizes, the five to seven year projection is the basis for most of their asset allocation studies. That is true because they want to express their opinion about asset classes over a shorter term time horizon than an actuary would consider when they prepare a valuation. In using the 30-year assumption, the expected return would be higher than 8%. The shorter period does reflect the dip seen in interest rates and also the lowering of the equity assumptions over the last two years.

Mr. Mosley explained in detail, different factors which can drive the lowering or raising of the assumption rates and the process employed by NEPC in setting their assumptions. The question then becomes how the System will react to the new rate over a long term cycle and work with the actuary to fund the Plan. NEPC believes that the Plan should take data from the actuary and from the investment consultant into consideration and make only small changes over time to the assumptions. He stressed the importance of not over reacting to 7.6% rate. He further noted that NEPC's timeline for assumptions tends to be shorter because they seek to move the portfolio slowly, year to year, to better position it.

Trustee Porter noted that lowering the assumption rate would increase the City's liability and he inquired how much incremental changes would impact the City's contribution obligation.

Mr. Ken Alberts of Gabriel, Roeder, Smith & Co., the System's actuarial firm, offered to take the question and he began by explaining that they look at the annual obligations that are paid out of the Retirement System and the cash flow. A benefit that is going to be paid out ten years from now has the opportunity to earn invested income on that money. That benefit is discounted back with the expected earnings to come up with the present value today. There are three sources of funds to pay for the benefits, employer contributions, member contributions and investment return. If less of the obligation comes from the investment return, more has to come from the other two, however member contributions are determined by statutory benefit design, which leaves the employer contribution.

Trustee Porter then asked, if the assumption rate of 7.5% is too high and only 6.5% is achieved, wouldn't that increase the City's liability?

Mr. Alberts replied, yes, and he went on to explain the affects of that scenario and the steps the actuary would take in the future valuation process.

Trustee Sanders asked Mr. Alberts, if the Retirement System was to reduce its assumed rate to 7%, what would the annual cost increase be for the City?

Mr. Alberts responded that it would increase the City's contribution rate by about 2% of payroll.

Trustee Sanders noted that the funded status of the Plan is currently 60%. If the assumed rate was 7.25%, what would be the impact on the funded status?

After running a mental calculation, Mr. Alberts replied, that the funded status would be somewhere around 55%. He also mentioned that he wanted the trustees to keep in mind that the difference in the funded status would be just the impact of the assumption change and that booked losses would have to be recognized as well.

Drawing upon investment results he had compiled, Trustee Hungler stated that, over the last 17 years, the Retirement System has not met the earnings assumption of 7.5%, five times.

Mr. Alberts asked the trustees to think of overall portfolio in terms of its relationship to the maturity of Plan. For example, if the Plan is immature, the earnings assumption on the portfolio is 8%, but you have no retirees, is it reasonable to keep that rate once the Plan has matured and 2/3 of the liabilities are related to retirees collecting.

Trustee Sanders interjected that the City is actually experiencing that scenario. He elaborated and provided the board with the history of the Old Plan and the commencement of the MECRS in 1974. City employees were given the option to join the MECRS, which many did. Today, Trustee Sanders indicated, there are still 134 retirees in the pre-1974 Plan that are collecting benefits and there are approximately 13 active employees that continue to participate in the Old Pension Plan. The old Pension Plan today has actuarial liabilities at $16 million, and assets invested of $12.5 million resulting in $3.5 million underfunded on the City's Old Pension Plan.

Minutes of the Board of Trustees' Meeting -6

Trustee Sanders emphasized how important the assumption can be toward understanding and managing the MECRS liability. The eventual payouts that will be required can be staggering he noted.

Mr. Alberts reinforced the importance of re-visiting the investment assumption with an experience study on a regular basis and he encouraged the trustees to begin thinking about separating the investment return for active employees and retirees. The result of such an exercise would be the raising of the assumption for active members and lowering of it for retirees. He predicted that the two would offset each other, given the current population. He explained that over time as the retired population grows; there is a self changing mechanism that builds in conservatism. Ironically, when a fund experiences a down turn, it hits well funded plans harder than poorly funded plans. If MECRS had been 100% funded in 2008, the System would have lost 25% to accrued liabilities, but if the System had only been 50% funded, it would have only lost 12.5% to accrued liabilities.

Trustee Sanders asked Mr. Mosley for confirmation of his statement regarding the 7.6% assumption rate which would be appropriate for the next five to seven years.

Mr. Mosley explained that that was based on the investment assumptions for this year, however, they are going down so the next time the rate is updated it will be even lower, somewhere between the 7.6% and 7%.

Mr. Mosley explained that the trend is going down, however one could argue that the time horizon that the investment consultant is using is shorter, which is a discussion that System needs to have with its actuary.

Mr. Mosley also recommended that for the next actuarial valuation, that the trustees request that GRS look not only at the 7.5% earnings assumption that the System is currently using but at 7.25% and 7% to determine the impact of all three rates so that they might be compared to the returns in another years time.

The trustees continued to discuss the demographics of the Plan and the unfunded accrued liability, the System's investment performance and the ongoing strategy of the portfolio.

Attorney Rich noted that while 2008 had negatively impacted the funded status of the Plan, that the types of alternative investments that have been included in the fund were designed to reduce volatility. He asked Mr. Mosley to address that fact and inquired whether these alternative investments had been taken into account when looking at the investment returns.

Mr. Mosley replied that the volatility of the Plan had declined as a result of shifts made over the last four or five years out of traditional equities which have a high volatility to alternative asset classes with a lower correlation to equities.

In closing on the subject, Trustee Sanders stated that he was pleased with the discussion between the actuary and investment advisor and he encouraged continued due diligence by the trustees regarding the MECRS earnings assumption and its impact on the Plan.

Chairman Pinard then called upon Sebastian Grzejka of NEPC to review the MECRS October Flash Report. Mr. Grzejka began by citing the total portfolio performance of 10.3% year to date and he noted that most of the return came resulted from gains in the domestic and international equity markets. Breaking out some of the returns by manager, he noted that Mellon was up 12.9% year-to-date and that both of the Portable Alpha Managers, Gottex and Benchmark Plus had returns exceeding the S&P 500's performance of 7.8%. SMID Cap Manager Rothschild continued to do well with a return of 17.0% versus 14.6% for its benchmark.

Mr. Grzejka reported positive returns for the emerging markets and also noted that through October, bond portfolios and credit markets continued to provide added value.

Mr. Grzejka was not able to report the year-to-date return for Wellington, but stated that it is up 5% for the month of October and continues to do well since its inception with MECRS earlier in the year.

In wrapping up his cursory overview, Mr. Grzejka briefly touched on the November Market Update distributed to the trustees at the beginning of the meeting. US markets, specifically growth and small cap had a positive month. Overall however, November's performance for the entire composite was expected to be flat or slightly negative once all of the numbers were received.

Mr. Fleury asked Mr. Grzejka for confirmation on the planned presentation by Mellon Capital to educate the board at its January meeting on an alternate product that would allow Mellon to include a commodity component in the GTAA portfolio.

Mr. Grzejka responded that NEPC was still completing the arrangements and that he would be in touch with Mr. Fleury as soon as details were known.

Previous Business:

Status Report on RMK Timber Contract - Attorney Rich began by recapping the last meeting of the Board of Trustees when authorization had been given to Mr. Fleury and legal counsel to pursue a more financially attractive liquidation process and contract with RMK, which is scheduled to expire December 17, 2010. There had been no correspondence received from RMK since their last letter in which they said that they were not interested in decreasing their fee. In that letter however, they were still seeking an extension of their contract, but would only reduce their fee beginning in 2011 if certain conditions were to exist.

Minutes of the Board of Trustees' Meeting -8-

Attorney Rich referred to a letter addressed to Ms. Niggley, Senior Vice President of RMK, dated December 9, 2010, which was drafted by Mr. Fleury and refined by counsel identifying MECRS' expectations and requesting details on RMK's portfolio liquidation methodology. The letter also requested periodic progress reports retroactive to the pending expiration of the original agreement to be updated prospective until the fund is closed.

Attorney Rich indicated that the letter was drafted after consulting with the other two investors, University of Alabama and Wells Fargo, who verbally concurred with MECRS' position and shared concerns about issues whose resolution was being sought from RMK in writing.

Attorney Rich reported that RMK has yet to respond to Mr. Fleury's request and he asked NEPC representatives if it is realistic to expect RMK liquidate 3 timber holdings in the southeast in one years' time.

Mr. Mosley was unable to say if it is a realistic expectation for the value of the properties, but that it is realistic to request liquidation over a one year span.

After lengthy discussion, the trustees agreed to wait for a response and in the mean time NEPC was asked to provide a list of possible managers who might be called upon to assume management and liquidation of the EFG Evergreen Fund currently operated by RMK if negotiations proved less than fruitful.

Trustee Sanders asked exactly what would be happening on December 17, 2010 when the RMK contract expires.

Attorney Rich responded that it will be RMK's obligation to liquidate the portfolio in 180 days or one year if market conditions dictate. Mr. Fleury and legal counsel will continue to monitor the situation and keep the board informed of any new developments.

Motion to Adjourn:

Having completed all of the items of business for the day, Chairman Pinard entertained a motion to adjourn. Trustee Molan moved to adjourn at 10:13 a.m. seconded by Trustee Hungler and passed unanimously by all those trustees present.

Respectfully Submitted,

Gerard E. Fleury
Executive Director