February 9, 2010
Minutes #456

Minutes of the Board of Trustees' Meeting -1-

Call to Order: Chairman, Donald Pinard called the meeting to order at 8:36 a.m.

Present: Trustees: Chairman, Donald Pinard, Jennie Angell, Chuck Hungler and Richard Molan
MECRS Staff: Gerard Fleury and Suzanne Wilson

Absent: Trustees: Mayor Ted Gatsas, William Sanders and Paul Porter

In Attendance: Attorney John Rich of McLane Law Firm
Mr. Kevin Leonard and Mr. Sebastian Grzejka 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 January 12, 2010 board meeting, seconded by Trustee Molan and passed unanimously by all those trustees present.

Approval of the Immediate Meeting Agenda:

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

Report of the Executive Director:

Security Test - Mr. Fleury reported that the MECRS web site now uses encrypted communications when it is accessed. In a previous report, he had noted that clients needed to specify the URL for the secure socket in order to ensure encrypted sessions. This is no longer true as all sessions are now encrypted by default.

On a related matter, Mr. Fleury informed the trustees that there has been a delay in hiring a firm to test the MECRS's internet security by attempting to hack both the local area network and the web site. The delay resulted from the System's inability to obtain clean references from the states in which the proposed vendor does business and to confirm that the company was indeed adequately qualified to conduct such tests. Mr. Fleury stated the he is seeking other firms to carry out security tests but has not yet located a company that he feels is trustworthy and will do the tests without seeking a major engagement.

Regarding internet security, Mr. Fleury referred to an informational article entitled "A Defensive Posture" which was distributed to the trustees before the meeting. Because of the importance of these tests, he asked the Chairman of the Administrative & Accounting Committee to convene a meeting of that committee next month to formally discuss the issue in detail.

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Committee Chairman Angell agreed to do so.

Social Security Number Suppression - Mr. Fleury further reported that concerns had been voiced by the membership following the mailing of annual statements that certain characters in the social security numbers were not suppressed or omitted. This issue has been visited before without an effective resolution, but this time the vendor responsible for the application has been told that this matter is a high priority and that the issue must be resolved. Less effective measures can be taken if the vendor cannot accommodate our demands, but should that happen, the contract to replace the pension administration software which is presently up for consideration will most likely be awarded to a different vendor.

Change of Payroll Provider – Next, Mr. Fleury reported that due to processing problems which the previous vendor was unwilling or unable to rectify, that MECRS has switched payroll vendors for administrative payroll processing. There is essentially no costs difference between the current provider, PayChex, and the new vendor, Automatic Data Processing. Paychex required the use of paper forms and other procedures which were prone to data entry errors made by the service provider and failed to take advantage of newer technology. The online toolset inherent in ADP's application will allow secure updating of payrolls directly by MERCS personnel thereby eliminating middle man errors.

Progress Report – Pension Administration System Upgrade - In closing his report, Mr. Fleury stated that work continues at a slow pace, on the project to replace the existing pension administration software. The existing application borders on obsolescence and so the System has been planning its replacement for the past two years. Delays have resulted because of the lack of confidence in the original vendor's ability to deliver the promised upgrade in an acceptable manner. Site visits to other public retirement plans which have contracted with our historic vendor revealed conversion efforts which were seriously behind schedule, where the delivered product could not perform as promised and where client vendor relationships were strained. He stated that while the vendor appears to know how the deliverable should be handled, they appear unable to implement an effective delivery plan and have yet to provide a reference which demonstrates their success.

Mr. Fleury further noted that MECRS has therefore elected to reexamine competing firms and has located a promising alternative. There are very fundamental differences in the way in which the most promising alternative delivers their product. Those differences should not be taken lightly, and the board should comprehend and definitively concur with the philosophical change in how administrative software is obtained, paid for, and how it is maintained before pursuing a business relationship with the alternative firm.

Previous Business:

Mezzanine Private Equity Fund of Funds Manager Selection: Representative from New England Pension Consultants, Mr. Kevin Leonard and Mr. Sebastian Grzejka were present to conduct a series of 10-minute telephone conferences calls with the mezzanine managers, interviewed at the September, 2009 meeting of the full board. Those calls were designed to satisfy concerns by members of the board which have postponed the selection process for a manager in this asset class.

Back up information on the three Mezzanine Mangers was provided to the trustees and the first conference call was made to Peter Gummeson of Audax Mezzanine Fund III.

Mr. Fleury placed the call and introduced those in attendance at the MECRS end.

Mr. Leonard then asked to hear Audax's reasons why then should be chosen over competitive firms and asked that they describe the "secret sauce" which made their formula successful.

Mr. Gummeson began with an overview of the 110 professionals associated with the group and also the history behind the firm. He pointed out the reasons why the MECRS Trustees should be interested in the Audax Group, such as recognized market leadership, a proven and cohesive team, disciplined lending approach, diverse transaction sources and superior investment performance on realized transactions.

Mr. Gummeson went on to address the investment strategy which is the same that they have employed since inception, having a middle market focus and an average investment size of $20 million. He stated that the Audax firm covers over 190 equity sponsor relationships and 80% of deal flow is sourced directly from Audax. He also spoke about capital preservation and attractive returns.

Mr. Gummeson noted that value added for this mezzanine strategy stems from in depth credit analysis and deal selection. Deal selection is enhanced by a focused marketing effort on middle market sponsors and leveraging relationships in the middle market. He also noted that an in depth credit analysis with a focus on minimizing losses is the key source of added value for this mezzanine strategy.

Mr. Gummeson summarized the Audax Fund I and Fund II Portfolios reviewing fund details, transaction metrics and portfolio construction. He stated that Audax began investing in Fund II in July 2006.

Mr. Leonard asked Mr. Gummeson to provide the trustees with an example of the types of clients that have committed to the Audax Group thus far.

Mr Gummeson replied that their clients consist of a combination of Public Funds, Fund of Funds, Endowments and Sovereign Funds.

Mr. Leonard then asked, whether Audax had changed any of the terms contained in the original version of their contract while negotiating agreements with any of their investors.
Mr. Gummeson responded that there was an original post investment fee of 1.5%, that changed to 1.0% and also a fee split in the original contract which was amended from 50/50 to 100/0. He

stated that Audax has fairly significant participation by public pension funds which requested those changes and so Audax has moved in that direction.

There being no further question from the board or NEPC, the session concluded.

Mr. Gummeson thanked the board for the opportunity to review their fund and for the trustees to feel free to call him with any further questions.

Next, Mr. Fleury placed a conference call to Mr. John Rocchio of Newstone Capital.

Once again, there was a round of introductions followed by a request from Mr. Leonard for the manager to make their best case.

Mr. Rocchio, began by stating that Newstone's investment thesis is about maintaining the investment discipline. Newstone is very credit focused and conducts bottoms-up fundamental research on each investment opportunity presented.

Mr. Rocchio provided the trustees with description of the firm, stating that Newstone Partners, LLC was founded in 2006 by Timothy Costello and himself, and that they are recognized as leading participants in the mezzanine industry having raised over $3.3 billion in four mezzanine funds. The partnership targets investments in mezzanine securities of profitable, larger middle-market companies involved in leveraged transactions. The objective of the partnership is to provide investors with attractive risk-adjusted returns by generating substantial current income in addition to long-term capital appreciation from a diversified portfolio of mezzanine securities.

Mr. Rocchio went on to state that Newstone has a sponsor driven strategy. Every investment and every company that Newstone invests in is owned by a Private Equity Sponsor. The Fund intends to invest in mezzanine debt security issues consisting of leveraged buyouts, recapitalizations and later stage growth financing controlled by private equity sponsors. The Partnership will typically act as the lead mezzanine investor in larger middle-market companies with revenues ranging from $100 million to $5 billion. Investments will be between $25 million to $75 million per transaction. Company investments will typically be structured as 85% mezzanine debt and 15% equity while some transactions may have different structures which include higher or lower levels of equity and may occasionally include senior debt securities or equity warrants.

Mr. Rocchio further stated that the Partnership investment process will include a comprehensive, risked-based investment valuation analysis and an intensive due diligence process. The strategy will seek to minimize losses through vigorous in-depth, bottom-up research prior to making an investment.

Mr. Rocchio noted that Newstone feels differentiated from their competitors in a few areas, mainly by their relationships with the Private Equity Sponsors' and the fact the Newstone is structured as an independent firm. The other area Mr. Rocchio mentioned is in Newstone's performance for which he highlighted past performance results.

In closing, Mr. Rocchio stated that Newstone charges a manager fee on the fund. Any other fee that comes into Newstone, whether it be a closing fee or a commitment fee goes to reduce the management fees to the LP's.

Mr. Rocchio asked the board, to think about the proven strategy, discipline and philosophy that is employed by Newstone when they are deciding on a manager and he noted that those attributes have been associated with Newstone for a very long time.

Mr. Leonard of NEPC asked Mr. Rocchio what types of investors had currently made commitments with Newstone.

Mr. Rocchio replied that Newstone's client base consists of a very diverse mix of public pension plans, financial institutions, Taft Hartley Plans, corporate retirement funds, and fund of funds.

In closing, Mr. Rocchio stated that Newstone appreciates the board's interest in their firm and that they will be looking forward to hearing from the MECRS. That statement concluded the phone interview.

Attorney Rich asked Mr. Leonard what the management fee would be for Newstone.

Mr. Leonard replied that it is 1.5% of committed capital and 1% thereafter.

After brief discussion and comparison of the first two phone conferences, Mr. Fleury placed the last conference call to Mr. Ed Cerny of Kayne Anderson Mezzanine Partners, L.P.

As with the first two conference calls, Mr. Fleury introduced everyone in attendance at the MECRS end to Mr. Cerny. Mr. David Petrucco and Mr. Kevin Walsh, both with Kayne Anderson joined in the call in progress.

Mr. Leonard again instructed the manager to make their best case.

Mr. Petrucco began by recapping the September board meeting and stating that historically, Kayne Anderson focuses on businesses that are simple to understand and not in the most competitive situations. He also noted that Kayne Anderson structures deals quickly and without taking big equity positions. Kayne Anderson also prides their firm on their credit knowledge and tends to focus on deals which can generate fixed income.

Mr. Petrucco provided the trustees with a strategy description of Kayne Anderson Mezzanine Partners, LP, (KAMP). He noted that KAMP is a non-captive private equity fund providing mezzanine debt financing and junior capital to equity sponsors and private companies in the middle market. The fund seeks to provide investors with an attractive current yield combined with equity upside, while attempting to limit principal risk. KAMP is targeting a 20% gross internal rate of return, (IRR) (15% net). The fund managers will employ a strategy similar to their prior funds by investing in an industry diversified portfolio, generally no more than 15% in one industry, and in companies that can generate predictable levels of cash flow.

Mr. Petrucco went on to state that the fund will invest in a diversified portfolio in terms of industry sector, with a specific focus on middle market companies involved in both non-sponsored and private equity-sponsored leveraged buyouts, recapitalizations, refinancing, acquisition and structured financings. The fund's investments typically will have an interest paying subordinated debt position and an equity component in the form of warrants, co-investments, and/or options. Generally, the fund will seek to invest in companies with revenues between $100 and $500 million and earnings before interest, taxes, depreciation and amortization,(EBITDA) between $10 million and $50 million.

Mr. Petrucco noted that the fund targets portfolio companies with strong financial fundamentals.

Mr. Leonard asked Mr. Peturcco what type of client base was investing with KAMP.

Mr. Petrucco replied that schools such as UCLA are committed to the fund, small private pension funds, family offices, and multi-family offices. Interest on the part of institutional investors and public pension plans like MECRS is just beginning now, in part because of affiliation with advisors like NEPC.

Mr. Walsh interjected that currently another consulting firm is presenting the KAMP fund to its board and will be profiling it for all their clients in April. Also, one of the top ten foundations in the U.S. is scheduled to meet with Kayne, Anderson for their third round of due diligence in a couple of weeks.

There being no further questions for Kayne Anderson, Mr. Petrucco thanked the board for their time and ended the conference call.

Mr. Leonard began a recap of the interview calls and reiterated NEPC's past recommendation regarding private equity mezzanine fund of funds. He stated that NEPC feels the opportunity still exists for MECRS to add a mezzanine asset class to their private equity portfolio.

The trustees discussed the distinguishing characteristics of each of the three mezzanine managers which had been interviewed and all agreed that Newstone Capital would be the best fit for the MECRS portfolio.

Trustee Hungler introduced a motion to invest $1.5 million with Newstone Capital Partners II and also to grant Mr. Fleury the authority to work with legal counsel in reviewing the mezzanine contract as a prelude to signature. The motion was seconded by Trustee Molan and passed by all those trustees present.

Previous Business:

"Real Asset" Manager Interviews – At its January meeting, the board opted to delay a decision on the hiring of a Real Asset manager. Mr. Leonard suggested that the board conclude deliberations on the adoption of a draft amendment to the asset allocation model to include "Real Assets". If that draft were to be adopted, the board could then decide upon a manager from candidates interviewed in January to satisfy the role of a "Real Asset" Manager and also determine where the assets allocated to that manager are to be obtained.

Mr. Leonard reiterated NEPC's recommendation to allocate funds to a "Real Assets" strategy consisting of multi-sector products. He explained that NEPC is recommending that their clients take this step in order to further diversify their risk exposure by providing better protection against possible inflationary trends. Referring to the Asset Allocation Review booklet distributed to the trustees at last month's board meeting, Mr. Leonard explained the Current Asset Allocation chart, the potential allocation mixes, and he forecasted different scenarios.

He stressed again that "Real Assets" plays two roles. It provides non-correlated diversification and also the ability to provide significant return in a inflationary period.

After discussing the different scenarios presented by NEPC and recapping the "Real Asset" interviews held at last month's meeting, Chairman Pinard moved to accept the draft amendment to the MECRS policy target, specifically selecting Mix A, which incorporates a 5% allocation of "Real Assets". The motion was seconded by Trustee Molan and passed unanimously by all those trustees present.

Mr. Leonard noted for the record, that the new policy mix would result in funding for Real Assets consisting of 2% being taken from diversified fixed income and 3% out of small to mid cap equities for a total of 5% to be allocated to "Real Assets".

Next, Trustee Molan moved to adopt the draft Investment Policy presented at last month's meeting, seconded by Trustee Hungler and passed unanimously by all those trustees present.

Trustee Hungler then moved to invest up to 5% of the Plan assets in Wellington Capital Management's diversified inflation hedges product, seconded by Trustee Angell and passed unanimously by all those trustees present.

Rothschild Management Performance – Although Rothschild has provided a positive return on its portfolio from inception to date, the portfolio's performance has been short of its benchmark for the same period. As part of the board's due diligence, NEPC was instructed to review the matter and explain whether this issue merited further concern.

Mr. Leonard was called upon to report his findings and he referred to a handout distributed at the beginning of the meeting, providing the trustees with a composite track record for Rothschild dating back to 1997.

Looking at the calendar year returns, Mr. Leonard explained that from 2004 through 2008, it revealed that Rothschild had added significant alpha with the exception of 2007 where they mirrored the benchmark. It was in 2009 where Rothschild significantly underperformed. That underperformance was attributed to lower quality stocks in the Russell 2500 benchmark outperforming higher quality stocks which generally compose the Rothschild portfolio.

Mr. Grzejka directed the trustee's attention to the second to the last page of the handout, which compared the returns of the low quality stocks against the high quality issues and revealed double digit outperformance by the low quality stocks.

Mr. Leonard explained that Rothschild is a higher quality, value oriented core manager, and that NEPC would expect them to underperform given market conditions last year. Those events should not be a cause for undue concern however and it is the recommendation of NEPC that the System continue with Rothschild as the next market cycle is more apt to be quality related which would result in outperformance by a portfolio such as Rothschild's.

Moving on, Mr. Leonard presented the MECRS Fourth Quarter 2009 Investment Review booklet and reviewed the 2010 capital market observations and expectations. He listed general actions which should be taken by clients such as reviewing the role of fixed income, building strategic exposure to real assets and retaining focus on diversification in a time of uncertainty.

Mr. Grzejka called the trustees' attention to the MECRS, Total Fund Performance, for the period ending December 31, 2009. He noted the transition within the portfolio at the end of December, resulting from the liquidation of Cadence Capital Management and State Street Global Advisors, and he reported on how funds were used to gain some exposure to the markets during the transition.

Mr. Grzejka stated that the composite (gross) return for last year was 20.3% which he described as a very solid return, ranking MECRS in upper 37% of the public fund universe. The three year ranking, which include the disappointing results from 2008, ranks in the 63rd percentile, down 1.5%. However, the ten year 4.2% return ranks in the 34 percentile, so he expressed his opinion that long term, the MECRS portfolio is performing well.

Moving on, Mr. Grzejka reported that Mellon Global Alpha returned 31.3%, ranking in the 22 percentile. The two portable alpha managers, Gottex and Benchmark, had returns were well above their benchmark of the S&P 500 Fund. City of London, the MECRS emerging market manager had an 80% return last year. Fixed income manager, Income Research Management returned 14% for the last year, ranking in the 36 percentile while Loomis Sayles with its credit exposure, returned 36.7% which was well above their benchmark.

Mr. Grzejka noted that Seix Credit Dislocation Fund II which as only been in the portfolio since last summer, has a 2.4% return for the quarter, ranking in the 24th percentile. He further explained that he did not have the "since inception" number but that he will forward it to the trustees when he receives it.

Mr. Grzejka informed the trustees that hedge fund managers, Archstone and Attalus, had returns of 19.5% and 13% respectively, outperforming their benchmarks while achieving returns in between stocks and bonds with bond like volatility.

In closing his report, Mr. Grzejka noted that both Real Estate Mangers were lower because of market conditions. The returns for Morgan Stanley and Prudential are down 33% and 34% respectively, which is on a par with most managers in the market place over the last year.

Having concluded their report and there being no further question from the board, Mr. Grzejka and Mr. Leonard thanked the board for their time and departed.

Consent Agenda:

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

Motion to Adjourn:

Having concluded all of the items of business for the day, Chairman Pinard entertained a motion to adjourn. Trustee Angell moved to adjourn at10:39 a.m., seconded by Trustee Hungler and passed unanimously by all those trustees present.

Respectfully Submitted,

Gerard E. Fleury
Executive Director