June 8, 2010
Minutes #460

Minutes of the Board of Trustees' Meeting -1-

Call to Order: Chairman, Donald Pinard called the meeting to order at 8:34 a.m.

Present: Trustees: Chairman, Donald Pinard, Jennie Angell, Richard Molan, and Paul Porter
MECRS Staff: Gerard Fleury, Sandi Aboshar and Suzanne Wilson

Absent: Trustees: Mayor Ted Gatsas, Chuck Hungler and Bill Sanders

In Attendance: Attorney John Rich of the McLane Law Firm
Mr. Kevin Leonard and 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 May 11, 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 Angell and passed unanimously by all those trustees present.

Report of the Executive Director:

Sample CD of Supporting Reports & Documents – Mr. Fleury began by reporting that some months ago, the board collectively elected to stop receiving reams of reports, charts and statements from MECRS money managers which were being provided as informational items in their monthly board packets. Much of that information was seen as redundant with summary analysis received from NEPC, and the rest was largely a combination of marketing materials or market speculation too vague or cryptic to be of value. Nevertheless, that information continues to be received, catalogued for easy retrieval, and can be supplied upon demand. The trustees did not seem to have missed the paper copies which were discontinued but just to refresh the boards' memories and to demonstrate the System's soft copy storage techniques; trustees have been provided with a CD of 2010 YTD documents. Mr. Fleury noted that everything on the CD is public information and the trustees don't need to guard it from loss. Mr. Fleury stated that after reviewing the contents, if any of the trustees find the contents valuable and would like periodic updates, staff would be happy to provide that information.

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Revision to Monthly Asset Chart – Moving on, Mr. Fleury noted that each month the trustees receive an internally generated graph of assets distributed by class for the preceding year. With the recent reallocation of asset categories and a greater focus on cash, the time seemed right to revise the composition of the monthly graph. Domestic and foreign equities which were formerly segregated are now consolidated into a general equity category. The hiring of a real asset manager has been included with real estate and timber in a real asset class, GTAA which is a meaningful percentage of the portfolio, is now tracked separately and cash has been added as its own category. Fixed income and alternative investments are still tracked but were unaffected by the changes.

MECRS Bi-Annual Pre-Retirement Seminar Scheduled – Next, Mr. Fleury noted that dates have been set for the 2010 MECRS Pre-Retirement Seminars to be held at The Executive Court on Mammoth Road on September 14th and 15th. Each of the morning sessions will run from 8:00 to noon and will feature presentations from social security, deferred comp, estate planners and financial planners. Mr. Fleury explained that Sept. 14th and 15th were chosen due to the scheduling of the Teacher Workshop on September 15th. There is no school on the 15th, therefore enabling the school paraprofessionals and School Food, Nutrition staff time to attend the seminar.

Monthly Status Report on Pension Administration System Upgrade/Replacement – Mr. Fleury then reported that RFPs for a Pension Administration System Upgrade were issued on schedule and the System has responded to written questions put forth from one interested party. An RFP analysis process will be in place before the June 25, 2010 deadline for the submittal of proposals. Analysis of proposals will parallel development of a contract agreement at which time MECRS counsel will be called upon to review the agreement.

Security Upgrade to Banking Software – In closing his report, Mr. Fleury noted that although MECRS will be upgrading the toolset provided by State Street Bank for its retiree services and lump sum processing in just a few months, a security patch needed to comply with regulatory changes scheduled to go into effect in the Commonwealth of Massachusetts needed to be installed immediately. That upgrade has been completed without difficulty and operations were unaffected. As for the pending application switch, State Street has confirmed that all of the necessary steps have been completed and the System is waiting its turn in the bank's conversion queue. The conversion is now anticipated for July or August.

New Business:

Scheduling of September Board Meeting – Chairman Pinard then moved on to New Business, regarding the scheduling of the September Board Meeting.

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Mr. Fleury stated that the MECRS board meetings are typically held the second Tuesday of each month, however, the next Bi-Annual Retirement Seminar is scheduled for September 14th, which is the second Tuesday. The options available for re-scheduling the monthly board meeting are Sept. 7th, 21st, or Monday, September 13th.. After brief discussion of available dates and trying to coordinate the trustee's schedules, the board agreed to conduct its September meeting on September 16, 2010.

Report of the Investment Committee: On behalf of Committee Chairman Hungler and because of the Committee Chairman's absence, Mr. Fleury delivered the Investment Committee Report.

Due to concerns regarding the performance of the recently hired SMID cap manager, Rothschild Investment Management, Mr. Fleury stated that a conference call was held on May 18, 2010 consisting of NEPC Research Consultant, Stephen Gargano, NEPC Senior Consultant, Kevin Leonard, Senior Analyst, Sebastian Grzejka, Investment Committee Chairman, Chuck Hungler and himself.

Mr. Fleury first explained that more than a year had passed since the board elected to hire Rothschild to manage a SMID Cap portfolio of MECRS. Although Rothschild's investment return for the one year period ending March 21, 2010 of 42.2% (gross) would seem exceptional, when compared against its Russell 2500 benchmark which returned 65.7%, the actual result can only be viewed as a significant failure by Rothschild to meet its benchmark. Mr. Fleury stated it would seem appropriate for the trustees to inquire of Rothschild for an explanation of why the exceptional underperformance had occurred. In addition, Mr. Fleury noted that the one year track record of PENN Capital Management, another SMID firm interviewed, but not hired in March of 2009, was 85.79% for the same period.

Mr. Fleury noted that while the MECRS Investment Committee and the full board had discussed Rothschild's under performance at meetings on more than one occasion, NEPC Advisors have been steadfast in their support for Rothschild. Mr. Leonard was asked to comment on the discovery by MECRS that at least one public plan, which is also an NEPC client, had terminated Rothschild for performance. Mr. Leonard stated that the plan had acted on its own and contrary to NEPC's recommendation.

During the conference call, many of Rothschild's characteristics were revisited and identified as having been prominent in the 2009 manager interviews which helped to influence the decision to hire Rothschild. The decision to hire Rothschild was made following the steep market declines of 2008 when the competing firms had seen comparatively larger losses. When comparing Rothschild with Penn Capital, it is also important to recall that Rothschild tends to be less volatile because its portfolio contains approximately twice the number of stocks and that the investment philosophy is considerably different for the two firms.

Mr. Fleury reminded the trustees that Rothschild uses a quantitative model to reduce the 2500 stocks in the Russell 2500 index to a lesser number consisting of what they deem to be "well ranked stocks" and then applies a portfolio construction model to pare that number down to about 150. Penn Capital on the other hand, uses its research of each company's debt obligations to identify likely survivors and focuses on a lesser number of companies which results in big wins when predictions go their way. In that manner, PENN Capital does not invest in speculative companies but rather debt laden ones which might be considered junk quality by the lesser informed. The length of the track record for Rothschild is also considerably longer than that of PENN Capital which could have helped to influence the decision early in 2009 to prefer Rothchild over Penn Captial and the other SMID finalists.

Mr. Fleury went on to report that due to the significant monetary difference in the one year return between these two managers, it seemed logical in the wake of the May 18th conference call to have Rothschild come before the full board to discuss their underperformance and their investment philosophy defend their position and forecast their expected returns for the coming quarter. It would also afford them the opportunity to explain whether they had found it necessary to tweak their quantitative model in light of the prolonged positive run of what they call "low quality" stocks. Mr. Fleury noted that, a manager review would also demonstrate the board's proactive response to a manager struggling to perform up to its benchmark without lending the appearance of market timing or chasing returns.

Mr. Fleury noted that Rothschild is scheduled to come before the full board at its July 13th meeting to review their performance as discussed.

Mr. Kevin Leonard of NEPC reiterated Mr. Fleury's comments, then stating that NEPC continues to recommend to their clients that Rothschild has the ability to outperform the benchmark.

Next, Mr. Fleury informed the trustees that the System received a message from Lexington Capital Partners VII, on accessing reporting features via the internet. Although it was not an easy feat to access the reporting feature, Mr. Fleury reported that he was successful in doing so. After reviewing the reports, he noted significant declines in the carrying value of the investment and he surmised that start up costs resulted in the loss observed within the portfolio. Mr. Fleury reported that he had alerted NEPC to review the Lexington Portfolio further.

Mr. Kevin Leonard confirmed that fees on committed capital are paid up front and common place in private equity investments and are the result of drop in capital. In summary, the decline in market value, while significant, was not unexpected or a sign of trouble.

Previous Business:

Report on Potential Sales of Seix Advisors - Mr. Leonard reported that there was some press on the potential sale of Seix Advisors, the System's credit opportunity manager, hired last year. He then read communication received from Joe Pollock, Research Analyst on fixed income at NEPC. His comments are as follows.

Reporting on the potential sale of Ridgeworth, one of the owners of Seix, it is very evident that Seix is unhappy with SunTrust (an owner of Seix) and that they would like to be spun out or sold. An MBO would be the best course of action but seems unlikely at this point. Seix is 75% of RidgeWorth's value. Joe Pollock stated that he would view the sale of Seix from SunTrust as a positive event for the firm.

Mr. Leonard stated that NEPC feels that the sale will not have a material impact on the ability for Seix to manage their portfolio but NEPC will continue to monitor the situation and report back to the MECRS Board.

Morgan Stanley Presentation - At 9:15 a.m. Mr. Fleury placed a conference call to Mr. Joe Finnigan of Morgan Stanley to review presentation material held over from the MECRS board meeting last month.

Mr. Fleury introduced the trustees and staff members present to Mr. Finnigan as well as System Legal Counsel, Mr. John Rich Jr. from the McLane Law Firm and NEPC representatives.

Mr. Finnigan began by providing a brief self-introduction and informing the Board that he has been employed with Morgan Stanley for about four years and that he just joined the Prime Property Fund, full time, about 4 months ago. Prior to that, he was involved in real estate acquisitions and asset management.

Beginning on page 5 of the presentation booklet, Mr. Finnigan described Prime as a core strategy, fully specified, open-end commingled equity real estate fund with a moderate risk diversified by property type and location designed to provide a stable, income-driven rate of return over the long term with potential for growth of net investment income and appreciation of value.

Mr. Finnigan turned the trustees' attention to page 8, Organizational Chart, listing the management team of Scott Brown, Co-Head, employed for 7 1/2 years, David Morrison, Co-Head, employed for 3 years and CFO, Candice Todd, employed for 9 years. Also, Mr. Finnigan noted a recent addition to the real estate group, Mr. John Klopp from Capital Trust, the head of American Real Estate Investing & Global Real Estate Debt Investing.

Mr. Finnigan briefed the trustees' on the U.S. Property Fundamentals. While things seem to be better in the real estate market, Mr. Finnigan commented that Prime believes property fundamentals are reaching cyclical lows and that rising vacancies and falling rents will persist in 2010, leading to falling income growth over the short-term with positive growth to resume in 2012 or 2013.

Mr. Finnigan then referred to a chart on page 13 of the presentation regarding the Capital Markets Improving and provided the trustees with an extensive Real Estate Risk Pricing Analysis. He commented that private real estate is undervalued and that now, is a good time to buy real estate.

Moving on, Mr. Finnigan focused on real estate debt markets and transaction volumes stating that there is an estimated $3.1 trillion of commercial real estate debt. He provided the trustees with sector strategies of March 31, 2010 and noted that Morgan Stanley Real Estate targets large, high quality assets that generally attract better credit quality tenants committing to longer-terms. He reported that 66%, of Prime's holdings (on a gross basis) are concentrated in 7 preferred markets. These markets historically provided a number of characteristics that make them attractive for investors.

Next, Mr. Finnigan provided the trustees with a brief overview of the fund profile as of March 31, 2010, stating the gross real estate assets of $7 billion, $3 billion of debt, 133 investors, over 200 assets, 90% leased as a portfolio, and return since inception of 8.1%, one of the highest among their peer group.

Continuing his report, Mr. Finnigan summarized the leasing status of Prime and provided a debt profile as well as an investor profile.

Mr. Leonard asked Mr. Finnigan about the status of the queue for money going out.

Mr. Finnigan replied that there is $607 million in the queue at present. As of December 31, 2009, it was $639 million, and it is continuing to trend down.

In closing his report, Mr. Finnigan reiterated Prime's performance as of March 31, 2010, which has produced an average since inception gross total return of 8.1%. He further noted that Prime's total return turned positive in the first quarter, 2010.

Trustee Molan noted that nearly 1/5 of Prime's debt matures next year and asked Mr. Finnigan, if, in this current environment, he anticipates any problems relating to this issue.

Mr. Finnigan answered that Prime has the ability to issue unsecure debt, enabling them to go out into the market and issue unsecure bonds should the need arise.

Mr. Fleury questioned Prime's appraisal process.

Mr. Finnigan replied that Prime has implemented a rigorous and "best in class" appraisal process and stated that every asset is independently appraised quarterly. A nationally recognized accounting firm is engaged to manage the process with the third party appraisal firms providing the appraisals. He also noted that individual appraisal assignments are rotated every three years.

At 9:47 a.m. Mr. Finnigan concluded his presentation and there being no further questions, he thanked the trustees for the opportunity to address the board and ended the conference call.

Mr. Leonard reiterated NEPC's recommendation that the board begin the process of exploring the expansion of their real estate portfolio. Issues to get to the next step include identifying sources of cash available and fortifying fiduciary education on the subject. NEPC would still like the board to proceed with the due diligence by examining available investment options with "value added" components.

Mr. Leonard listed potential manager candidates to help build out and diversify the MECRS Real Estate program in keeping with NEPC's recommendation to review non-core value as a compliment to this allocation. He identified three top close-end fund-of-funds which the board might review and provided a brief overview of each manager, along with their potential advantages and issues. The managers were Metropolitan Real Estate Partners Global III, Flag Capital Management and Sigular Guff Distressed Real Estate Opportunities Fund.

Referring to NEPC's Flash Report distributed at the start of the meeting, Attorney Rich noted that the report indicates a target range of 10 % to real estate and real assets. The minutes from last month however indicate that NEPC had a 5% target to real estate with a decrease in timber. Attorney Rich asked Mr. Leonard if Morgan Stanley and Prudential were liquid, and on the subject of new allocations, whether NEPC would be proposing half to the core fund and half to the value added fund.

Mr. Leonard replied that a conservative mix might be 70% to core with 30% to value added, a medium mix might be 60/40 and an aggressive might be 50/50. Clients need to make the determination, however it all depends on which manager is chosen after the trustees' interview process.

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The trustees and the investment advisors continued to discuss the asset allocation and possible liquidity from which to fund the value added manager chosen.

Mr. Fleury recommended that fiduciary education regarding the asset class would best be addressed before decision time. He suggested scheduling the interviews of the value added managers in October which would put them closer to the end of the year. That timeframe would allow the board to be better informed on what was happening in the market place and to know more about the likelihood of RMK coming forward and requesting another extension on the liquidation of the timber portfolio. That knowledge would give the trustees the ability to map their objectives with the liquidity sources.

Chairman Pinard suggested eliminating one of the recommended three managers.

NEPC then recommended Flag Partnership and Metropolitan Investment for consideration and also agreed to facilitate the interview of the managers in October. There was no objection from board members and so it was agreed that Mr. Fleury and Mr. Leonard would see to the schedule.

At 10:10 Chairman Pinard recessed the board meeting.

At 10:30 Chairman Pinard reconvened the board meeting.

Previous Business:

Results of 2009 Audit and Delivery of Draft Audited Financial Statements for 2009 - Chairman Pinard introduced Principal, Mr. Mark LaPrade, of Berry, Dunn, McNeil & Parker who delivered the draft audited financial statements for 2009.

Mr. LaPrade began by referring to the draft Required Auditor Communications and the draft Financial Statements included in the trustees agenda packets. Referring to the Financial Statements, Independent Auditors Report, Mr. LaPrade explained that the MECRS Audit was conducted in accordance with U.S. generally accepted auditing standards. Those standards require that the audit obtain reasonable assurance, not absolute assurance, about whether the financial statements are free of material misstatement. Mr. LaPrade explained that the audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements and also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

Next, Mr. LaPrade reported that it is the opinion of Berry, Dunn, McNeil & Parker that the financial statements present fairly, in all material respects, the net assets available for benefits of the Retirement System as of December 31, 2009 and 2008, and the changes in its net assets available for benefits for the years then ended, in conformity with U.S. generally accepted accounting principles.

Moving on, Mr. LaPrade stated that in planning and performing the audit, BDM&P considered the Retirement System's internal control over financial reporting as a basis for designing auditing procedures for the purpose of expressing an opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Retirement System's internal control over financial reporting. Accordingly, BDM&P does not express an opinion on the effectiveness of the Retirement System's internal control over financial reporting. He informed the trustees that the audit did not identify any deficiencies in internal controls that they consider to be a material weakness.

Regarding compliance and other matters, Mr. LaPrade reported that as part of obtaining reasonable assurance about whether the Retirement System's financial statements are free of material misstatement, tests were performed of its compliance with certain provisions of laws, regulations, contracts and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. The results of the tests disclosed no instances of noncompliance or other matters that are required to be reported under Government Auditing Standards.

Mr. LaPrade asked Chairman Pinard if he was currently aware of any instances, of any changes in the Retirement Systems' compliance from his perspective.

Chairman Pinard replied, no.

Next Mr. LaPrade asked Chairman Pinard whether or not he was aware of any instances of fraud or any concerns relative to fraud.

Chairman Pinard replied, no.

Reporting on the status of a material weakness identified in 2008, Mr. LaPrade commented that that issue has been corrected.

Mr. LaPrade then addressed the Required Auditor Communication for December 31, 2009, stating that Part I is a reiteration of what is in the audit report. Qualitative Aspects of Accounting Practices is BDM&P interpretation of anything that is significant within the financial statements. He noted that there were no new accounting policies that were adopted and the application of existing policies was not changed during 2009. He also noted that there were no transactions entered into by the Retirement System during the year for which there is a lack of authoritative guidance or consensus.

Continuing, Mr. LaPrade reported that the fair value of the alternative investments on a basis other than at quoted market prices in an active market is considered a sensitive estimate. As of December 31, 2009, the Retirement System held approximately $22.3 million in alternative investments. The basis for the estimate of fair value of alternative investments is disclosed in Note 2 of the financial statements.

Part II of the DRAFT Audit referenced Internal Control Matters. Mr. LaPrade reported that BDM&P did not identify any deficiencies in internal control that is considered to be material weaknesses.

It was moved by Trustee Porter to accept the DRAFT audit 2009, seconded by Trustee Molan and passed by all those trustees present.

Follow-up Report by the Executive Director on the GRS Estimator Tool – Mr. Fleury recapped the March meeting of the Board of Trustees when the System's Actuary, Gabriel, Roeder, Smith & Co., delivered the valuation for 2009. At that time, GRS had offered to provide an estimator tool that would allow the trustees to estimate the impact on the employer contribution rate on market changes and assets, for a fee. After a review of the cost and what the projection tool would provide, the trustees had additional questions. Those questions were posed to the actuary and the responses were documented and included in the trustees packets.

Mr. Fleury reminded the trustees that if the board was interested in obtaining the tool, that there would have to be additional appropriations to the budget in order to pay the cost of the estimator.

The board discussed the costs of the projection tool at length and the potential value that it would provide to the System.

It was moved by Trustee Porter to receive and place on file the response from GRS, seconded by Trustee Angell and passed by all those trustees present.

Consent Agenda:

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

Other Business:

Statutory Amendment:

Mr. Fleury commented that the board had granted him permission to work with counsel to streamline existing language and clarify the intent of in service death benefit entitlements. A pair of flowcharts which depict the existing entitlements for job related and non-job related death benefits had been included in the trustee's agenda packets. Also included was the proposed amended language to the statutes to make entitlements and options clearer.

Mr. Fleury explained the existence of different scenarios which may occur and the potential flaws in the structure of the law which serve only to create difficulties for the board should certain circumstances materialize. He expressed concern that the scope of the amendments needed exceed the original authority granted by the board to amend simple language issues and that he was returning to obtain authority to fully address deeper concerns which had been discovered.

Mr. Fleury also noted that from the stand point of the Systems actuary, there is no funding implication and that the amendment proposed will not affect the funding ratio or employer obligation.

After the board's lengthy discussion and effort to understand the possible implications of the current statute, they agreed to grant Mr. Fleury permission to continue work on amendments to the death benefits as stated.

Approval of Administrative Rule Changes: It was then moved by Trustee Molan to accept the amended, Administrative Rule, Part 6, Additional Employee Contributions, seconded by Trustee Angell and passed unanimously by all those trustees present.

Chairman Pinard informed the trustees that the next meeting of the Board of Trustees is scheduled for July 13, 2010, at 8:30 a.m.

Motion to Adjourn:

Having concluded all of the items of business for the day, Chairman Pinard entertained a motion to adjourn. Trustee Molan moved to adjourn at 11:10 a.m. seconded by Trustee Porter and passed unanimously by all those trustees present.

Respectfully Submitted,

Gerard E. Fleury
Executive Director