February 21, 2012
Minutes #477

Minutes of the Board of Trustees' Meeting -1-

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

Present: Trustees: Chairman Pinard, Richard Molan, Bill Sanders, Michael Woitkowski, and Mayor Gatsas

MECRS Staff: Gerard Fleury, Sandi Aboshar and Suzanne Wilson

Absent: Paul Porter, Dianne Mercier

In Attendance: Representatives, Kevin Leonard and Sebastian Grzejka of NEPC, Attorney John Rich of the McLane Law Firm

Approval of the Minutes of the Previous Board Meeting:

Trustee Molan moved to approve the minutes of the meeting of January 10, 2012, seconded by Trustee Woitkowski and passed unanimously by all trustees present.

Approval of the Immediate Meeting Agenda:

A motion was made by Trustee Sanders to approve the immediate meeting agenda, seconded by Trustee Molan, and passed unanimously by all those trustees present.

Report of the Executive Director:

Webcast – Re-Defining Defined Benefits – A Modern Day Solution for Defined Benefit Plans – Mr. Fleury reported that Cafaro Greenleaf , Advisors to Corporate, Institutional and Public Retirement Programs conducted a webcast entitled "Re-Defining Defined Benefits" on Thursday, January 19th. Registration was free and participation offered an opportunity to review the challenges facing defined benefits plans as well as solutions being employed by many plans. He noted that there may be a web replay available for a limited time for anyone interested but in summary, the MECRS already appears to have a good handle on the larger issues identified in the webcast. Specifically, managing risk, and adopting a disciplined approach to asset allocation and underlying investments are two of the areas where MECRS appears to be in good strategic shape. He also mentioned that these webcasts are repeated periodically and trustees will be notified of the next event so that they may participate if so inclined.

Insurance Presentation Confirmed for April Meeting - Mr. Fleury informed the trustees that pursuant to their interest when queried on the subject at their January meeting, Mr. Grady Crews of Cross Insurance, (formerly Ferdinando) will be present at their April meeting to deliver a short summary on insurance coverage currently purchased by MECRS for various purposes.

Confirmation of Valuation for March Meeting – Mr. Fleury reminded the trustees that as is customary each year, Mr. Ken Alberts of Gabriel, Roeder, Smith & Company will be present at the March 13th meeting to deliver the results of the actuarial valuation. He went on to explain that at the time this report was written, it was very clear that MECRS did not meet its earnings assumption for 2011 and the impact of those disappointing results will become known when Mr. Alberts delivers the valuation report.

Meeting with Auditors - Mr. Fleury stated that a meeting was conducted with auditors from Berry, Dunn, McNeil & Parker regarding the upcoming audit of MECRS for the period ending December 31, 2011. A list of disclosure items was reviewed at that meeting and plans for expanding disclosure of investment performance was also discussed. While such a level of disclosure is not mandatory, Mr. Fleury noted, adopting best practices in situations where compliance poses little difficulty has been the rule for a number of years and will likely continue.

NEPC Client Conference Dates Announced – In closing his report, Mr. Fleury mentioned that NEPC has announced the dates for their annual client conference in Boston on May 15th & 16th. The conference is being held at the Boston Convention & Exhibition Center, 415 Summer Street in Boston. Mr. Fleury requested permission to attend the conference for one day and he strongly recommended that trustees also consider attending at least one of the days.

Budget Line Item Transfer – Referring to a hand-out distributed at the start of the board meeting, Chairman Pinard asked Mr. Fleury to explain the Request for a Motion.

Mr. Fleury explained that as part of the wrap up of 2011that he is requesting a transfer, in the amount of $1,198.95, of previously approved and budgeted amounts from an area of surplus to areas where expenses have exceeded expected and budgeted amounts.

Mr. Fleury provided details of the transfer, referring to account line items of total lines decreased and total lines increased and requested a motion moving a total of $1,978.95 between the identified lines.

It was then moved by Trustee Sanders to approve the Executive Directors request to transfer of $1.978.95, seconded by Trustee Woitkowski and passed by all those trustees present.

New Business:

Investment Performance Review for 2011 - Representatives, Mr. Kevin Leonard and Mr. Sebastian Grzejka were present to review investment performance for 2011 as well as providing a re-cap of the Core Real Estate Overview for the trustee's consideration.

First, Mr. Fleury asked Mr. Leonard to explain to the full board the opportunistic component of the real estate portfolio that NEPC was recommending and the risk tolerance threshold. Also, Mr. Fleury informed the trustees that he had met with Mr. Art Solomon, Chairman, of DSF Capital Partners IV, LP Real Estate in the previous week and that he had explained to Mr. Solomon that the System deals solely with managers that have been vetted by NEPC. He noted that Mr. Solomon's fund was not as diversified as the products being recommended by NEPC. Mr. Fleury stated that NEPC had been notified of the meeting and he asked Mr. Leonard to briefly address the sector and geographic distribution of the DSF Group compared to firms on the NEPC recommended list.

Mr. Leonard began by recapping NEPC's recommendation to the MECRS's which included further diversification of the real estate allocation. He noted the System's current core real estate allocation is an open end structure with Morgan Stanley and Prudential but real estate offers different investment strategies and investment vehicles which could be added to the allocation to improve the yield.

Mr. Leonard noted that MECRS' current allocation includes RMK Timber and that NEPC does not consider Timber as real estate but a real asset instead. He went on to explain the proposed addition to real estate which includes value-add real investment in a closed end structure which is structured like private equity investments.

Chairman Pinard noted the finite lifespan of the proposed structure and he asked Mr. Leonard, how the System is protected from adverse market timing with an allocation to a closed end fund.

Mr. Leonard replied that at the end of the life of a closed end structure, which is typically set at a 10-year life with two one-year options, the two one -year options would provide the manager the ability to work whatever the distress property might be. He elaborated further providing the trustees with different exit strategy scenarios.

Trustee Sanders voiced his concerns with the way real estate assets might be valued. He stated that for such an asset class, he is interested in the valuation process, the quality of the management, the types of funds that the System is selecting and the overall fiduciary standards employed by potential managers.

Trustee Molan concurred with Trustee Sanders sentiments.

Mr. Fleury asked Mr. Leonard to explain the rationale for terminating a fund after a decade for an organization with a real estate class that is returning more than the earnings assumption.

Mr. Leonard called attention to a chart on page 3 of the presentation booklet and replied that it is a way to provide an incremental higher rate of return, without a significant increase in fundamental volatility. An increase in risk would be associated with the closed end structure, because it can provide higher leverage as well as a higher rate of return.

Mr. Grzejka reminded everyone that it is NEPC's recommendation that MECRS adopt a new target sub- allocation to real estate focusing on 60% Core and 40% Non Core and that the overall portfolio target of 5% would not change. Mr. Grzejka also noted that the recommendation included the consolidation of the two existing core real estate portfolio managers down to one, preferring Prudential over Morgan Stanley.

Mr. Fleury noted that no official action had yet been taken on the matter of manager consolidation and he requested that a motion be made to authorize that action and also stating which manager was to be eliminated if the Board was so disposed. Mr. Fleury also expressed concern over the timing of consolidating action because neither manager presently has an exit queue but notification of withdrawal requires a few weeks notice in advance of the end of a quarter for receipt of proceeds at the end of the upcoming quarter and entry queues do exist which can extend entry for more than two quarters. He cautioned that a liquidation and corresponding funding strategy would be in order to avoid cash flow problems.

A motion was offered by Trustee Molan and seconded by Trustee Sanders to consolidate the existing core real estate managers by closing out the position with Morgan Stanley and reinvesting the proceeds with Prudential to represent the portfolios' core real estate allocation of 3% and to further explore committing 2% to non core real estate in a manner yet to be determined. The vote was taken and the motion passed unanimously by all those trustees present.

Mr. Leonard stated that they would work with Mr. Fleury on a liquidity time horizon with Morgan Stanley.

Mayor Gatsas asked Mr. Leonard, if NEPC receives a fee for the hiring of a new manager.

Mr. Leonard replied that NEPC is an independent consulting firm whose sole revenue comes from quarterly consultation fees from clients. He further explained that NEPC's recommendations are made in recognition of their fiduciary responsibility to better the MECRS Fund.

Returning to the subject of commercial real estate options, Mr. Leonard stated that NEPC will evaluate the DSF Group at the board's request and will schedule value-add manager presentations for the Investment Committee Meeting on March 12, 2012 if it meets with the pleasure of the Board.

Trustee Molan noted that a meeting of the Investment Committee was tentatively scheduled for that date and he asked that Mr. Fleury see to the agenda. Mr. Fleury stated that it would be done and he reminded the group that the new real estate allocation would also involve an amendment to the Investment Policy Guidelines.

Moving on, Mr. Leonard referred to the Investment Performance Analysis as of December 31, 2011. In recognition of disappointing 2011 results, he noted that what hurt the absolute performance last year is helping the absolute performance so far this year. The riskier asset class as defined by equities and non-US equities underperformed last year but are driving the market upward in 2012.

Mr. Leonard informed the board that for the month of January, the overall composite was up 4.8% gross of fees, which constitutes a significant one-month return. He went on to note annualized returns for the last 3 years, 5 years and 10 years respectively.

Mr. Leonard addressed the performance of active managers for the month of January. He noted that Benchmark and Gottex have outperformed the S&P 500 and are up 4.5% whereas last year, portable alpha hurt returns due to underperformance by hedge fund of funds.

He reported that active large cap value manager Pzena was up 6.9%, significantly outperforming the Russell 1000 Value benchmark. Sands Capital was up 8.5% versus their benchmark of 6%, while Rothschild, although up 5.5% in January underperforming its benchmark of 6.6%.

Moving on to the international equity composite, Mr. Leonard reported that active international managers underperformed their benchmarks last year. City of London was the worst performing asset class last year and now it is the best performance asset class for the month of January.

Mr. Grzejka pointed out that City of London and emerging markets as a whole have been the best performing asset class during the last 3 years, even given 2011. Another analysis was to look back at the last 10 years, when 2011 was a shock to the System as well as 2008, 2003, 2002 and 2001. During that same time, emerging markets still managed to return double digits and high double digits, to increase 17% when annualized over the last 10 years.

Trustee Sanders inquired about the Mellon Expanded Global Alpha investment, which has outperformed for the month of January. He asked Mr. Grzejka if, in his view, the outperformance is solidifying or does NEPC have concerns about the manager.

Mr. Grzejka responded that NEPC is very comfortable with Mellon and they have reaffirmed their conviction regarding the firm.

After some discussion regarding the global alpha composite, Mr. Leonard noted that NEPC recommends the GAA in the MECRS portfolio in order to provide a greater degree of equity diversification in the System's portfolio.

Mr. Fleury noted NEPC's past concerns in having a 10% allocation to GAA with only one manager.

Mr. Leonard responded that GAA will be reviewed in the coming months with a possible investment policy change being brought forward. That change would increase the target allocation percentage to 15% from the current 10% and increase the target range percentages accordingly. Any consideration for a second GAA manager to assume some of the role could be discussed at that time.

Mr. Leonard continued to report on the fixed income side, noting the best performing asset class was treasuries and he also addressed alternative investments and hedge funds.

Mr. Grzejka provided the trustees with a more detailed explanation of the last year's market experience referring to charts in the booklet regarding market events and the S&P 500 Total Return for 2011. The NEPC Representatives concluded their presentation and there were no further question from the board

Before departing, Mr. Leonard informed the board on upcoming changes to the format of the performance package booklets. He stated that NEPC had recognized that some of their attribution is limited in their performance reporting, so they are switching to a new platform, called Investor Force. By September 30th the board will have a new reporting booklet that is designed to provide the client with better attribution, specifically in non-US Investments. NEPC will also be unveiling a new client internet site, which will allow clients to download reports.

Having concluded their presentation, the NEPC representatives thanked the board for their time and departed the meeting.

Consent Agenda:

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

Previous Business:

Presentation of the final draft of Admin Rule 7, Cost of Living Adjustments - Attorney Rich began by noting that at last month's meeting of the Administration & Accounting Committee, several significant changes had been contemplated to the existing version of Administrative Rule

7. Those changes were designed to add structure to the process whereby the determination is made on whether there are sufficient earnings to fund a COLA. He asked whether there were any specific question about the draft which had been included in the agenda packet for consideration.

Trustee Sanders requested confirmation from Attorney Rich that amended Rule 7 still leaves the determination on whether COLA is granted to the board, regardless of whether guidelines have been met, and requires an affirmative majority vote of the board to approve a COLA.

Attorney Rich responded that it is the board's fiduciary decision on whether to grant a COLA. The prior rule as well as the amended Rule 7 are intended to provide the board with guidelines on determining whether in fact inflation has occurred as well as whether or not there are sufficient earnings to award COLA and how to measure those earnings. Attorney Rich stated that the reasons for the review of Admin Rule 7, were the decision to add the 1.75% pre-funded COLA which had occurred after Rule 7 had been adopted, the change in the System's actuary and decline in the funded ratio.

When the Admin Rule 7 was work shopped at the A&A Committee meeting in January, it was agreed that COLA guidelines should be different when the fund was less than 80% funded which is the point at which the actuary considers the System well funded. Another assumption was made that there would not be COLA's granted above the pre-funded amount unless there were gains available to pay for them and therefore a gain sharing mechanism was instituted, that limited gains available for COLA to 20% of certain gains.

The trustees tried to speculate what affect the proposed rule might have had on COLA increases had it been in effect compared to the existing rules but the complexity of the formula and the need for background materials prevented swift conclusions from being reached.

Trustee Sanders therefore requested a fiscal analysis on the results of the proposed rule compared to the current rule which would allow for an easy comparison of the fiscal implications.

Mr. Fleury elaborated on the concept of gain sharing which had been suggested by the System's actuary and he noted that in using the proposed method the actuary looks at the increase of funds derived from earnings and determines how much of those funds were attributed to the retiree assets. Only a percentage of the amount that was attributed to the retirees would be available for a COLA under the new rule.

Trustee Molan reiterated Trustee Sanders' request by asking Mr. Fleury to prepare a comparative analysis which includes the effects of gain sharing applied retroactively.

Mr. Fleury responded that he would perform comparisons and forward them to the trustees as soon as possible.

The trustees continued to discuss the different scenarios of the gain sharing concept with Attorney Rich and considered tabling the release and public hearing until a comparative review could be completed by Mr. Fleury.

It was then moved by Trustee Molan to table the release of the draft rule for a 30-day period for public comment, seconded by Trustee Woitkowski and passed by all those trustees present.

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 10:00 a.m. seconded by Trustee Sanders and passed unanimously by all those trustees present.

Respectfully Submitted,

Gerard E. Fleury
Executive Director