September 18, 2012
Minutes #485

Minutes of the Board of Trustees' Meeting -1-

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

Present: Trustees: Chairman Donald Pinard, Richard Molan, and William Sanders. Trustee Dianne Mercier arrived at 8:50 a.m. and Paul Porter

MECRS Staff: Gerard Fleury, Sandi Aboshar and Suzanne Wilson

Absent: Mayor Gatsas and Michael Woitkowski

In Attendance: Attorney John Rich of the McLane Law Firm and Kevin Leonard of New England Pension Consultants

Approval of the Minutes of the Previous Board Meeting:

A motion was made by Trustee Molan to approve the minutes of August 14, 2012, seconded by Trustee Porter and passed unanimously by all those trustees present.

Approval of the Immediate Meeting Agenda:

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

Report of the Executive Director:

Right to Know Requests: Mr. Fleury reported that earlier this year MECRS was obligated to release information associated with its retiree population to the Manchester Union Leader. This action was the result of unsuccessful attempts in the New Hampshire courts by the New Hampshire Retirement System, (NHRS) to block access to such information. The NHRS had contended that retiree pension amounts were not subject to provisions of RSA 91-A. Mr. Fleury noted that in more recent months, MECRS has responded to two additional requests, both from out of state but citing RSA 91-A. The first request came from an organization calling itself "For the Good of Illinois" asking for retiree pension information extending back for a decade. The second and most recent request came from an organization known as "Taxpayers United of America". This organization requested some information which MECRS does not even compile for itself. In both cases, the requests were referred to counsel to ensure that statutory compliance obligations were being met. Counsel had informed the System that while RSA-91-A obligates the staff to make information available upon request, it does not obligate MECRS to collect, compile or calculate information that is not require for its own needs. The board should expect that as requests of a repetitive nature are received, that staff will respond to those requests as they have in the past but in the event that requests for more personal items are received, those requests will be forwarded to counsel for advice and assistance.

Pre-Retirement Seminar Results: Next, Mr. Fleury reported that the bi-annual MECRS Pre-Retirement Seminar was conducted on Tuesday, September 11th and approximately120 people attended the half day session. In addition to a review of MECRS benefits, speakers from the Social Security Administration, The McLane Law Firm, and Wells Fargo Advisors also made presentations. The session was well received and Mr. Fleury thanked the trustees for their support in conducting the seminar.

Status Report of Investment With Prudential Real Estate: Moving on, Mr. Fleury informed the trustees that the next installment in MECRS's consolidation of commercial real estate investments from Morgan Stanley to PRISA, which began in early July, is tentatively scheduled for Friday, September 28th. The $1.4 million commitment balance will be split, with a capital call of $418,000 on the 28th and with additional capital calls later in the year. Mr. Fleury stated that the trustees will be kept informed of progress until the entire consolidation has been completed.

Conversion to VoIP: Mr. Fleury announced that in light of steadily increasing phone charges, the voice phone lines for MECRS are being converted to Voice over Internet Protocol, (VoIP) which involves almost no additional equipment, no startup fees and should result in a reduction of more than 50% in ongoing telephone expenses. He explained that MECRS is in the early stages of testing the new system and that the option exists of remaining with the old system, should tests prove disappointing.

Preliminary Work on 2013 Budget Underway**:** In closing his report, Mr. Fleury indicated that work is underway for the MECRS 2013 operating budget. He noted that there will be some costs increases, such as a possible increase in the health insurance rates for staff members. Local Government Center, the System's health insurance carrier, is holding a public hearing later this month, where the health insurance premiums will be announced. Mr. Fleury noted that there are no new initiatives planned for 2013 and the emphasis for the budget will be administrative cost control. He recommended scheduling a meeting of the Administration and Accounting Committee on October 8, 2012 at 8:00 a.m. to review the working draft of the budget and to review and discuss refinements prior to an eventual budget approval of the full board at the December meeting.

In addition, Mr. Fleury noted that he received notification from the actuarial firm, Gabriel, Roeder, Smith & Co. on the cost of the valuation for 2013, which will increase by $1,200, due to the transition from GASB 25 & 27 to GASB 67 & 68 standards. Mr. Fleury requested that the trustees' approve the GRS contract and grant permission to sign the engagement letter for 2013.

Trustee Sanders stated that he had no complaints with GRS's past services and that they have done a good job for the System. Trustee Sanders then moved to accept the increase with GRS, seconded by Chairman Pinard and passed by all those trustees present.

Minutes of the Board of Trustees' Meeting -3-

Chairman Pinard called upon Mr. Kevin Leonard of New England Pension Consultants to brief the board on recent financial events and to deliver the presentation on the Asset Liability Study commissioned by the board.

Mr. Leonard began by distributing the July 31, 2012 Flash Report as well as a weekly market update. He noted that the Fed will continue to maintain low short- term interest rates thru mid 2015, in order to further stimulate the economy which he cited as positive. Another piece of good news, Mr. Leonard reported was that the equity market indices were up year to date from earlier lows.

Referring to the Flash Report, Mr. Leonard noted the new format of the report which resulted from switching from the old performance platform to a new platform with better analytics and color. Mr. Leonard further noted that the overall composite on a year-to-date basis is up about 6.7%, thus outperforming the policy index.

Moving on to the Asset Liability Study, Mr. Leonard explained that the goal of this study was to assess the appropriateness of the current asset allocation relative to the expected progress of liabilities and cash flow, as well as to review the current and projected financial status of the pension plan over the next 5-10 years. He noted that the "recommended" asset allocation mixes within the study are not drastic and are for discussion purposes only and that the study does not include health care assets, just the pension assets. In addition Mr. Leonard stated, the study examines the assumed rate of return and considers whether that rate is a reasonable for the current economy.

Mr. Leonard acknowledged that Mr. Ken Alberts from Gabriel, Roeder, Smith & Co., was very helpful in providing information from the 2011 valuation, for NEPC's study.

Mr. Leonard summarized the findings of the study which indicate that if the trustees are willing allocate funds presently assigned to publicly traded equities, and put those funds into alternative investments, that NEPC believes that over the long term, MECRS would receive a better risk adjusted return.

Mr. Leonard identified the key considerations of the study which included; a low return environment, low funded status and cash flow requires which would eventually require income from investments at a higher level than is currently experienced. He stated that over the next 5-7 years, NEPC is predicting the returns to be positive but lower than long-term historical averages and that the board should consider opportunities to maintain similar returns while reducing equity risk concentration.

Mr. Leonard noted that the MECRS funded status currently sits at 62% and it is projected to increase over the next 10 years. He provided the trustees with data which predicted that percentage to be in line with the average for other public pension funds.

Mr. Leonard reported that the cash flow will become a concern as outgoing annual benefit payments become greater than annual contributions. Such a condition will require that any shortfall be made up through investment returns or other cash outlays and he suggested that MECRS' liquidity profile should be adjusted accordingly.

Mr. Fleury asked Mr. Leonard how comfortable he is with the valuation of the alternative asset classes.

Mr. Leonard replied that NEPC performs their operational due diligence of the alternative asset classes and the investment firms go through a vigorous valuation and that NEPC is comfortable in recommending this asset class.

Mr. Fleury cautioned that commitment to an asset class does not ensure performance associated with that class and he noted how both Benchmark and Gottex were hired on the same day for exactly the same cost, with the similar investment philosophy. Their returns since inception show that Gottex has lost 2.4% while Benchmark has a return of 4.1%. He questioned whether manager selection might be more crucial than simply identifying the correct allocation mix.

Chairman Pinard asked Mr. Leonard if the MECRS portfolio has a target for cash, which is currently at 7% of the portfolio.

Mr. Leonard responded that that target allocation for cash is currently high and that the MECRS's Investment Policy states a 2% target allocation for cash.

Mr. Fleury explained that the current overweight in cash amount is attributed to excess proceeds from Morgan Stanley the liquidation of the Morgan Stanley portfolio which has been committed to but not been fully called by PRISA. In addition, cash reserves are maintained to satisfy periodic capital calls on commitments of $2 million for commercial real estate with TA Associates and another few million in pending calls from Private Equity Managers, Newstone and Lexington Partners.

Referring back to the Mr. Fleury's comments regarding Benchmark and Gottex, Trustee Mercier asked Mr. Leonard how the negative 2.4% return listed on the Flash Report was calculated, noting that there were no recorded losses in any of the displayed columns.

Mr. Leonard explained that that return is calculated from inception, referring to 2008, and that the whole loss just following inception such that it does not appear in the 1, 2 or 3year return averages because it precede them.

Returned to his presentation, Mr. Leonard gave a brief overview of charts within the presentation booklet entitled, Summary of Total Assets and Liabilities. The charts indicate a smaller active membership in 2011 and a greater number of retirees in the Projection of the Funded Ratio chart which was covered in detail by the System's Actuary, GRS during last month's board meeting.

Trustee Molan asked Mr. Leonard what the impact on the Plan might be if, in 2013, the City were to eliminate 200 positions.

Mr. Leonard replied that there would be a negative impact to the Plan, because of the fewer number of people contributing.

Mr. Fleury explained that the accrued liability is expressed as a percentage of payroll and therefore, if the number of employees declines, the accrued liability is simply divided into a remaining smaller number but the total dollar cost remains static.

It was noted that the employer required contribution as a percentage of payroll as shown in the Five Years Experience Study is expected to gradually increase over the next 10 years.

Trustee Sanders expressed concern that the ability to consistently achieve the assumed rate of return is in jeopardy. The MECRS Plan has $160 million dollars in assets and cannot afford a repeat of 2008 which saw a negative return in excess of 20%. He stated that he believes the plan is paying out more than it is taking in and that the City is not in a position to sustain such a situation. As a trustee of the MECRS, Trustee Sanders stated that he is very concerned about the size of the Plan and its ability to withstand extreme return volatility.

The second premise which Trustee Sanders questioned is the idea that higher returns can be achieved with higher risk and volatile assets. As we approach the end of the year, he stated that he is concerned whether the objective of the portfolio is to earn the assumed rate of return or to preserve the capital of the pension plan and not having put the Plan at risk.

Trustee Mercier asked if MECRS has the authority to offer any retirees or beneficiaries a buyout of their pension.

Mr. Fleury provided statistics to the trustees that currently, within the active membership, there are about 13% who could request immediate retirement under normal retirement provisions. In addition, there is another 12% who qualify for early retirement based upon a combination of age and service. The statistic which Mr. Fleury stated he could only speculate about was what motivates those percentages to remain in the workforce rather than exercising their ability to retire.

Attorney Rich explained that Trustee Mercier was probably referring to activity in the private corporate setting for lump summing out both terminated vested employees as well as vested employees. He further explained that the IRS has issued a ruling, favorable to exercising that option.

Attorney Rich informed the board that the MECRS provides retirement benefits to city employees and does not possess the needed statutory structure to offer a retiree a lump sum in exchange for his/her stream of payments. He explained that MECRS provides a guaranteed retirement where the member never outlives the benefit. As a result, the investment risk is on the employer and the fund. The trustees continued to discuss the impact of the buyout structure, acknowledging that it would require a legislative change in order to create such an option. There was no decision to pursue such an option in the immediate future.

Mr. Leonard posed a rhetorical question for the trustees' consideration; "Is the current MECRS portfolio structured for preservation of capital?" He then answered the question by responding, "No it's not. The current portfolio is built for growth; it's built to meet an assumed rate of return of 7.5%."

Mr. Leonard used his rhetorical question to transition the presentation on to Liability Driven Investing, (LDI) which he explained is meant to lower the volatility of a portfolio. The problem with LDI is that the mechanisms invested in, are typically fixed income structures and like fixed income investments are currently returning practically nothing and are projected to have unimpressive returns for some time. Mr. Leonard explained that if the System were to practice LDI, with an emphasis on preservation of capital, the return assumption should be lowered, and the MECRS asset allocation adjusted accordingly.

Trustee Sanders explained that his concerns were not associated with the limited return expectations of LDI but rather with present lack of allocation to alternative asset classes which could improve the long term earnings potential of the fund and he cited the role of the board as one of chasing the return assumption.

Mr. Leonard agreed with Trustee Sanders' interpretation of the situation which he was prepared to discuss in some greater detail.

Before concluding his presentation, Mr. Leonard referred to page 8 if the handout which listed Potential Asset Mixes. He explained that column one was the current target allocation with the 2012 risk return assumptions applied. For discussion purposes, mixes A and B were provided. The current target asset allocation using NEPC's assumptions, which are beta only, result in an assumed rate of return over the next 5 to 7 years of 7.1%. The chart also showed results for the next 30 years. Mr. Leonard went on to explain that in column two, Mix A, that 5% was taken out of the equity portfolio and was allocated to private debt, which would be a new asset class in the portfolio, the expected return resulting from that change would go from 7.1% to 7.4% and the standard deviation would actually be reduced from 12.0% to 11.6%. Mix B results in a 7.6% expected return with a standard deviation of only 11.7%.

Chairman Pinard quickly concluded that the System could switch to Mix B and increase the expected rate of return and still lower the volatility.

Mr. Leonard confirmed that the Chairman's conclusions were correct.

In order to get a higher risk adjusted rate of return, taking money out of equities and putting it into illiquid asset classes will be required. Mr. Leonard went on to say that NEPC is comfortable with MECRS' current target asset allocation which he described as a well built portfolio taking advantage of what's in the market. Relative to the peer groups, Mr. Leonard stated that MECRS is right in line.

Chairman Pinard asked M. Leonard what the effect of a Mix A and Mix B would be on the operation of the Plan.

Mr. Leonard responded that NEPC would model the options and run projections.

The trustees thanked Mr. Leonard for his presentation and they agreed to continue discussion regarding the study and options for the Plan at future meetings.

<u>Review of Work In Progress - Proposed By-Law Creating an Indemnification Policy –</u> Attorney Rich began by reviewing the chronology of event beginning back in April which resulted work to date on the formulation of a new By-Law which would create and indemnification policy for the organization. Back in April, the board met with the System's insurance broker to go over the Fiduciary Liability Policy as well as the Director's and Officers' Policy. During that review, a number of questions were raised. It was requested that Attorney Rich research issues which had been discussed and report back on matters of trustee liabilities and statutory indemnification.

At the May BOT meeting, Attorney Rich reported that there were seven identifiable issues which could be examined in greater depth in connection with the Board's earlier request. Subsequent to that meeting, it was suggested that any indemnification policy resulting from this work should provide a mechanism for an orderly review of circumstances whenever a case involving trustee indemnification under the current statute occurred. Attorney Rich explained that Chapter 218 provides two types of protections for trustees. The first is for payment of defense costs as well those expenses associated with a trustee who becomes involved in litigation. The second is that the statute provides for financial indemnification should the trustee be found liable when acting upon the advice of counsel for the Plan. The exception to indemnification exists in instances of fraud, willful or deliberate misconduct, or gross negligence.

Attorney Rich then went on to review the draft Indemnification Policy developed to date and he highlighted the updated provisions. He noted that the policy was designed to work with both the current and future insurance policies as well as with the current statutory structure. Attorney Rich noted that indemnification exists in the statute in order to attract and retain qualified individuals to serve as trustees while minimizing risk to their personal assets.

Trustee Mercier referred to the sentence in the draft which states, This Indemnification Policy is intended to enhance and supplement the fiduciary liability insurance policy, "if any", of the System, and nothing herein is intended or should be construed to replace, supplant or reduce any coverage provided by such insurance policy. Trustee Mercier interpreted the words, "if any", to mean that there may not be a fiduciary liability policy at some point, and she asked Attorney Rich if the words, "if any", were to be struck from the draft, if it would weaken the policy.

Attorney Rich noted Trustee Mercier's concern and indicated that those words will be struck from the draft.

Attorney Rich informed the board that the Retirement System Staff was now included in the policy on indemnification, having been omitted from the preliminary draft. He noted that the policy is designed as framework for future trustees and that it would provide guidelines for operation and a standard on how to handle indemnification in a manner similar to many of the other policies and by-laws.

Trustee Sanders expressed his interest in limiting to the extent possible, as much voting by the trustees in the way in which indemnification is administered.

Attorney Rich responded to Trustee Sanders concerns by stating that the policy will describe the mechanism for how a claim should be defended.

The trustees continue to discuss the draft policy as well as scenarios of how the policy and future boards would protect the past, current and future trustees.

Attorney Rich stated that the board should also consider statutory changes regarding the Indemnification Policy.

Trustee Sanders requested that Attorney Rich draft a statutory amendment in time for the next board meeting, referencing RSA33:104 which regulates the indemnification of municipal officials.

Mr. Fleury suggested a more expedient and effective route in addressing the proposed statutory amendment may be in drafting a letter to the attorney general requesting an opinion on whether the existing statute RSA33:104 applies to these circumstances arising from Chapter 218:6.

Trustee Sanders referred to Section 3 of the policy where it states, "only if a majority of the Trustees' vote in favor of such indemnification". He suggested alternate language, unless the majority of the board votes not to indemnify.

Attorney Rich responded that the trustees may not want indemnification in a criminal proceeding against one of their peers.

As Attorney Rich explained the revisions in different sections of the policy, the board continued to discuss different scenarios where individual trustees as well as the board as a whole were being sued and the policies in place which would protect them.

In closing his report, Attorney Rich informed the trustees that he will go back and make further revisions to the policy for the October board meeting. In addition he stated that he will have a recommended legislative game plan to address a possible amendment to RSA33:104.

Consent Agenda:

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

New Business:

Request for a Motion – Chairman Pinard explained that the Executive Director is requesting a transfer of appropriated funds from two budget lines with a surplus balance to two lines which are running a deficit in order to balance the budget.

It was moved by Trustee Porter to approve the transfer of funds, seconded by Trustee Sanders and passed by all those trustees present.

Trustee Molan referenced the recent activity on LIBOR amongst the legal fraternity. The major firms that bring the suits are looking at institutional investors and Trustee Molan asked if the System has been contacted by any of these firms.

Mr. Fleury responded that as of this date, the System has not been contacted.

Previous Business:

Non-Public Session Pursuant to RSA 91-A:3 II(d) For Discussion of Contract Negotiations - Chairman Pinard then entertained a motion to go into Executive Session pursuant to RSA 91-A:3 II(d) at 10:56 a.m.(Consideration of the acquisition, sale, or lease of real or personal property which, if discussed in public, would likely benefit a party or parties whose interests are adverse to those of the general community.)

Roll Call Vote:

Ayes: Messrs. Sanders, Pinard, Porter, Molan and Mercier

Nays: None

Following the conclusion of the Non-Public Session, Chairman Pinard then entertained a motion to seal the minutes of executive session pursuant to RSA 91-A:3, III.

Minutes of the Board of Trustees' Meeting -10-

Trustee Molan moved to seal the minutes of executive session, seconded by Trustee Porter and passed unanimously 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 Sanders moved to adjourn at 11:11 a.m., seconded by Trustee Molan, and passed unanimously by all those trustees present.

Respectfully Submitted,

Gerard E. Fleury
Executive Director