January 8, 2013
Minutes #488

Minutes of the Board of Trustees' Meeting -1-

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

Present: Trustees: Chairman Donald Pinard, Richard Molan, Robert Lynch, William Sanders, Mike Woitkowski and Dianne Mercier (arrived at 8:40 a.m. and departed at 10:38 a.m.)

MECRS Staff: Gerard Fleury, Sandi Aboshar and Suzanne Wilson

Absent: Mayor Gatsas

In Attendance: Attorney John Rich of the McLane Law Firm, Mr. Kevin Leonard and Sebastian Grzejka of New England Pension Consultants as well as Mr. Ken Alberts of Gabriel, Roeder, Smith & Co.

Approval of the Public Hearing Minutes on addition to By-Laws, Held December 11, 2012:

A motion was made by Trustee Woitkowski to approve the public hearing minutes of December 11, 2012, seconded by Trustee Sanders and passed by all those trustees present.

Approval of the Minutes of the Previous Board Meeting:

Trustee Molan moved to approve the board minutes of December 11, 2012, seconded by Trustee Lynch and passed by all those trustees present.

Approval of the Immediate Meeting Agenda:

It was then moved by Trustee Molan to approve the immediate meeting agenda, seconded by Trustee Lynch, and passed unanimously by all those trustees present.

New Business:

Board Organization – Chairman Pinard began the meeting by opening nominations for the MECRS Board Chairman pursuant to Article II, 2.01 of the MECRS By-Laws.

Trustee Sanders nominated Donald Pinard to continue serving as Board Chairman, seconded by Trustee Molan. Chairman Pinard asked if there were any other nominations. As there were no other nominations, Trustee Sanders moved to close nominations for Board Chairman. Pursuant to Robert's Rules of Order, the Chairman cast a single vote for himself, to continue serving as MECRS, Chairman, for a two year term.

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For the benefit of the new trustee, Mr. Robert Lynch, Mr. Fleury explained that the chairman can appoint the chairs of the three sub-committees, Investment, Administration & Accounting and Benefits Committee.

The next item of board organization, pursuant to Article 5.01 of the MECRS By-Laws, was the appointment of committee chairs for the three sub-committees, Investment, Administration & Accounting, and Benefits.

Mr. Fleury noted that presently, Trustee Woitkowski is chairing the A&A Committee, Trustee Molan is chairing the Investment Committee and due to the departure of Trustee Porter, there is a vacant seat as chairperson on the Benefits Committee.

Chairman Pinard noted that Trustee Sanders, as the City Finance Director, is automatically on the Administrative & Accounting Committee, and he is also presently on the Investment Committee. Vacant seats remain on the Administration and Accounting Committee, and the Benefits Committee.

Moving on, Chairman Pinard nominated Trustee Molan to continue as Chairman of the Investment Committee and Trustee Molan indicated his acceptance of the appointment.

Chairman Pinard asked Trustee Lynch, if he would be interested in chairing the Benefits Committee. Trustee Lynch expressed his willingness to chair the committee and Chairman Pinard congratulated him on his new seat.

Chairman Pinard then nominated Trustee Woitkowski to continue chairing the Administrative & Accounting Committee, to which Trustee Woitkowski thanked Chairman Pinard.

Next, Chairman Pinard asked Trustee Lynch if he would agree to fill the vacancy on the A&A Committee. He agreed to do so and was so appointed.

Chairperson Comments:

Chairman Pinard took a moment to welcome Trustee Bob Lynch, to the MECRS Board of Trustees.

Report of the Executive Director:

Status of Funding – Commercial Real Estate - Mr. Fleury reported that as of January 1^{st}, the transition of investments from Morgan Stanley to Prudential was completed. On January 15^{th}, the first capital call by TA Associates, in the amount of $400,000, will be made. That amount equates to 20% of the commitment to that investment.

Status of Redemption with Gottex - Next, Mr. Fleury stated that pursuant to the vote taken at the December 11, 2012 meeting, a redemption notice was prepared and submitted with Gottex Funds. An acknowledgement was subsequently received and it is expected that the bulk of the proceeds will be received in the last week of June.

NEPC 2013 Client Conference - Mr. Fleury informed the board that NEPC has selected the second Tuesday in May for its annual client conference in Boston. This will cause a schedule conflict for the trustees who must attend a MECRS board meeting and who also wish to attend the NEPC Conference, unless the board is willing to move its regularly scheduled meeting date by a week, or hold the meeting on a Thursday rather than a Tuesday. Mr. Fleury asked, what is the pleasure of the board on this issue?

A few of the trustees expressed interest in attending the NEPC Conference and so Mr. Fleury stated that the date for the May Board meeting would be rescheduled accordingly.

Previous Business:

Continued Review of NEPC Liquidity Study and Discussion on Portfolio Rebalancing for 2013 - Chairman Pinard called upon Mr. Kevin Leonard of New England Pension Consultants, to continue the review of the Liquidity Study commissioned by the board in October and addressed in part at earlier meetings.

Mr. Leonard began by calling the trustees attention to the Total Fund Performance detail, which indicated the preliminary return for the total composite, year to date, was up 12.8%, due to positive returns in domestic and international equities. Mr. Leonard also reported positive returns for fixed income as well as the real estate composite.

Looking back at 2012, Mr. Leonard expressed the opinion that the board should be satisfied with MECRS Portfolio's overall ranking, relative to their peer groups and he noted the excellent performance of global equities on a broad basis.

Next, Mr. Leonard directed the trustees to page 7 of the 2013 Observations and Assumption booklet. He stated that the booklet is a 5 to 7 year market forecast which includes a 30 year component and general observations, by NEPC's senior asset allocation team as well. Mr. Leonard noted that the overall expectations of the 2013 assumptions, given the System's asset allocation and market forecast, is for lower returns over the next 5 to 7 years and also for the next 30 years.

Mr. Leonard then provided the trustees with NEPC's underlying thesis, explaining why they are assuming lower rates of return.

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Mr. Grzejka explained that the level of volatility, given the macroeconomic position of the entire globe, is expected to continue. He noted that one of the key factors used in building the

assumptions, is the role of bonds and bond yields. Last year at this time, bond yields had fallen further, thus providing the first building block to the assumptions.
He then elaborated further on the rest of the building block methodology utilized by NEPC.

Chairman Pinard asked Mr. Leonard to explain the fixed income projection for 2013.

Mr. Leonard explained that the MECRS bond portfolio is not just US core bonds. He turned the trustees' attention to a Geometric Expected Return chart in the booklet, which provided the expected returns for all asset classes in 2013. NEPC is not expecting a reversal of 2012, Mr. Leonard stated that the relative ability for the portfolio to outperform is still there but the absolute returns are lower.

From an actuarial standpoint, Mr. Leonard stated that his materials on rates of return and forecasting assumptions are what NEPC utilizes for their recommendation and modeling purposes. NEPC is forecasting a 6 to 6.5% return over the next 5 to 7 years, which is well below the System's current assumed rate of return of 7.5%. He noted with some importance however that due to starting at a low point in the economy, it is also assumed that over the long term, that those returns will be lower than the long term averages but that those expectations apply to performance benchmarks and not the return of managers inclusive of alpha. When the manager's ability to outperform a benchmark is taken into consideration, the System's 30 year expected return on the current target allocation of 7.5% still seems reasonable.

Trustee Sanders expressed his thoughts, regarding the trustees' consideration on lowering the investment return from 7.5% to at least 7%. He indicated that the System has only exceeded the 7.5% assumed rate of return once, during his tenure as trustee and that the losses back in 2007 and 2008 were devastating to the retirement system and the impact on the employer rate to the City had been substantial.

Trustee Sanders went on to say that the board has a unique opportunity this year, due to a 12.8% gain, and he suggested that the board use the surplus gain, to lower the System's assumed rate of return, which would provide the board with a more reasonable expectation moving forward.

In addition, Trustee Sanders stated that he believes that setting the assumed rate of return, is probably one of the most important decisions the trustees can make. Assumed rates of return in public pension plans will be criticized in the coming years and the trustees need to keep in mind that they will be held accountable in setting the rate, because of the effect it has on the funded status of the Plan.

Trustee Mercier stated that she is interested in the possibility of transitioning further into a liability driven investment strategy. She felt that the System should be out of the risk business, and should focus more on the preservation of the assets.

Mr. Leonard informed the trustees that NEPC has been observing a trend among its public fund clients. Their observation show that those clients are lowering their return assumptions. He cautioned however that municipalities will struggle with the affordability of lowering the assumed rate below 7%.

Trustee Sanders again mentioned his grave concerns over the need to lower the assumed rate of return as well as the need for continued discussion regarding market expectations and the fiduciary duty of the Board of Trustees.

Referring to Trustee Mercier's comment, Mr. Leonard cautioned that LDI investing provides for the preservation of capital but with lower expected returns

At that point in the discussion, Mr. Ken Alberts, Actuarial Representative, of Gabriel, Roeder, Smith & Co. commented on Trustee Sanders' statement, regarding the trustee's fiduciary liability and called attention to the risks associated with setting the assumed interest rate, too high or too low.

Mr. Alberts stated that GRS is comfortable with the trustees lowering the assumed rate of return as low a 7%, but not lower. He noted that state wide funds, larger than MECRS, justifiably have a higher rate of return, therefore the MECRS should be below the published average and smaller funds should be on a more conservative basis.

Mr. Alberts informed the trustees that there is more than one way to utilize the opportunity of the 12.8% gain. He suggested the trustees think about taking a portion of the gain as a reserve fund.

Chairman Pinard asked if that would entail a separate asset allocation for the reserve fund.

Mr. Alberts replied that it would simply be a different accounting entry which would have to be disclosed.

Trustee Mercier noted that while reserve fund is an interesting idea, she felt that the trustee's responsibility is primarily toward the fund and its adequacy for retirees, with a lesser responsibility toward the city's contribution rate.

Mr. Alberts agreed with Trustee Mercier, but he questioned whether it would be in the best interests of the fund and its members, if the contribution rate were to be volatile?

Chairman Pinard responded that he believed that if the city's contribution rate is too volatile then there could be pressure to change the Plan.

The trustees continued to discuss the pros and cons of a reserve fund.

Mr. Alberts provided the trustees with historical examples of how other municipalities had set their assumed rates of return over the past years and of how it had impacted their funds.

Mr. Alberts explained another risk element that the trustees should keep in mind. He noted that the better funded the System is, the greater the impact of market volatility on such a mature plan.

Returning to the topic of LDI investing, Mr. Grzejka stated that under the LDI approach, as the funded status increases, the asset allocation of the portfolio also evolves, no longer taking on as much risk.

Attorney Rich asked Mr. Grzejka to elaborate on risk volatility to which Mr. Grzejka spoke to the formula and its results.

Trustee Mercier asked how the trustees begin the process of an LDI strategy. Mr. Leonard stated investing 100% in LDI, would result in low rates of return and increases in the contribution and protection for the fund from a down market.

The trustees continued to discuss aspects of Liability Driven Investing.

Mr. Fleury expressed his concern that if the earnings assumption is reduced, in turn elevating the City's expense, that there could be political backlash including recommendations to replace the defined benefit plan with a defined contribution plan.

Trustee Mercier stated that she agrees with Trustee Sanders in taking a more conservative approach to funding the Plan.

Trustee Sanders reiterated his primary desire to lower the assumed rate of return.

Mr. Alberts noted that the current valuation assumption of 7.5% is not the same as the assumed rate because the valuation assumption includes the administrative expenses and the assumed rate of return, does not. One recommendation within the valuation under all the alternatives is to start factoring in the cost for administrative expenses. All of the alternatives within the GRS Experience Study are reflective of this change.

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Mr. Leonard concluded his presentation by emphasizing the trustees' need for continued discussion and research on how NEPC builds the assumptions. Such an understanding could result in re-balancing of the System's portfolio in order to adopt a more conservative approach.

Before departing Mr. Leonard suggested scheduling an Investment Committee Meeting whereby the committee would have continued discussion on re-balancing the MECRS portfolio, mainly to address the more immediate need to conclude discussion on the allocation to portable alpha.

Mr. Fleury stated that he would coordinate the scheduling for an Investment Committee meeting during the month of March.

<u>Selection of Experience Study Results for Use in the 2013 Valuation</u> - Mr. Alberts reviewed the range of options identified in the 2012 Five-Year Experience Study so that the board could choose the exact factors to be used in the upcoming valuation.

Mr. Alberts explained that the assumptions were broken down into two categories, demographic and economic. Demographic assumptions are basically, different scenarios which may occur regarding the participants, such as termination of employment, retirement, disabilities, etc. Economic assumptions are based on the investments, inflation and the value of money.

Referring to the agenda packet materials, Mr. Alberts stated that GRS is recommending a package of hard recommendations for changes to the demographic assumptions and he presented four economic assumptions with a recommendation for alternative 3.

Mr. Alberts began to address demographic changes within the board packet when Trustee Sanders indicated a comfort level with the board's comprehension of the materials provided and he moved to accept the changes, seconded by Trustee Lynch and passed unanimously by all those trustees present.

Moving right along, Mr. Alberts turned the trustee's attention to the Contribution Calculation Comparison Chart, which illustrated the economic assumptions and how they would impact the contribution rate and funded status of the Plan.

Referring to alternative 4, with an assumed rate of return of 7.00% Trustee Sanders asked Mr. Alberts what the employer contribution result would be with the 12% gain for 2012, to which Mr. Albers replied, 22.71%.

Mr. Alberts reminded the board that when GRS began servicing the MECRS, there was no COLA assumption built into the valuation. Basically the System was understating the liability; because COLAs that were granted were not reflected until they were approved. It was GRS's recommendation to reflect the long term average COLAs in the liabilities. Ultimately, this resulted in a 1.75% COLA assumption.

Trustee Sanders stated that he would like to see the employer contribution rate between 20% and 21%.

Mr. Alberts provided the trustees with a detailed explanation of the history of pension gains and losses. He explained that the market value of assets and the actuarial value of assets are not the same, which means that there are losses from the past that have not been recognized. One of the potential actuarial changes discussed was to reset the market value, which would actually raise the contribution rate.

Mr. Alberts also stated that he is not sure that he would recommend lowering the COLA assumption to 1%. Mr. Alberts and the trustees discussed various changes to the actuarial assumptions and in some cases Mr. Alberts entered the requested variables into a proprietary GRS application loaded on his notebook computer to determine how they would affect the results of the valuation. Part of those results revealed that the shorter the amortization period is, the greater the increase in the funded ratio.

Mr. Alberts explained that ultimately the goal is to achieve a full funded status for the plan.

During the discussion, Mr. Alberts noted that he would be able to run a 2012 preliminary valuation with alternative variables for the assumed rate of return and the COLA which could be presented at the March BOT meeting.

At the conclusion of the discussion, the trustees requested Mr. Alberts to conduct a preliminary 2012 valuation inclusive of a change to the demographic of a 7.25% assumed rate, 3.25% wage inflation and 1.25% COLA assumption and also with a 7.00% assumed rate, 3.25% wage inflation and a 1.25% COLA assumption.

Chairman Pinard asked what the actual wage growth has been to which Mr. Alberts responded that while the assumption has been 3.50%, the actual has been closer to the 3.00% over the five year period.

Chairman Pinard felt that the 3.25% wage inflation assumption was too high and Trustee Sanders agreed with the Chairman.

The trustees continued to discuss the wage inflation component.

Mr. Alberts noted that in light of lowering the COLA assumption, it would make sense to also lower the wage inflation to 3.00%.

Again, Mr. Alberts recapped the trustee's request to work up the 2012 valuation with the adopted demographic assumptions including the .50% load for administrative expenses, also utilizing the requested economic assumptions as stated in the earlier request and changing the wage inflation to 3.00%.

Trustee Sanders moved to approve the request of the preliminary valuation request, as stated by Mr. Alberts, seconded by Trustee Mercier and passed by all those trustees present.

Preliminary changes to the valuation and investment performance processes which might be required as a result of GASB pronouncements 67 and 68 - Mr. Fleury reported that he took part in a 90 minute web seminar on the projected impact of the new GASB pronouncements which was sponsored by GRS. Mr. Fleury stated that he wanted the board to be aware of the changes and from the City's point of view, they will be looking to the pension fund for a greater degree of information than they currently receive. It may also impact NEPC's reporting requirement, requiring a separate earnings expectation for each asset class.

Mr. Alberts stated that all the information needed for reporting is in the annual valuation, however GRS is moving toward the development of a separate report which will encompass the new and expanded requirements.

Consent Agenda:

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

Chairman Pinard announced the next Board of Trustees meeting for February 12, 2013.

Motion to Adjourn:

Having completed all of the items of business for the day, Chairman Pinard entertained a motion to adjourn. Trustee Lynch moved to adjourn at 10:46 a.m., seconded by Chairman Pinard, and passed unanimously by all those trustees present.

Respectfully Submitted,

Gerard E. Fleury
Executive Director