June 14, 2016
Minutes #524

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: Donald Pinard, Mike Woitkowski, Dick Molan and William Sanders
MECRS Staff: Gerard Fleury and Sandi Aboshar and Suzanne Wilson

Absent: Bob Lynch, Dianne Mercier and Mayor Gatsas

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

Approval of the Minutes of the Previous Board Meeting:

Chairman Pinard entertained a motion to approve the previous board minutes of May 17.

Trustee Molan moved to approve the board minutes of May 17, 2016, seconded by Trustee Sanders and passed unanimously by all those trustees present.

Approval of the Immediate Meeting Agenda:

Trustee Woitkowski moved to approve the immediate meeting agenda, seconded by Trustee Sanders and passed unanimously by all those trustees present.

Report of the Executive Director:

GASB 67 & 68 Related Accounting Changes: Mr. Fleury reported on changes required to the MECRS chart of accounts, necessitated by GASB 68 reporting requirements and the needs of the System's actuary, Gabriel, Roeder, Smith & Co, for contribution details, not previously compiled. After making preliminary changes to the pension fund accounting procedures toward the vision of what compliance would require, a meeting with the System's Auditor, Berry Dunn and the System's actuary, Gabriel, Roeder, Smith & Co., was conducted to review the proposed changes. In summary, it was agreed that the changes would be beneficial and sufficiently effective as drafted. Mr. Fleury stated that steps are being taken to implement the new procedures and that Berry, Dunn and GRS & Co. are being advised on MECRS implementation progress.

Audit Report for 2015 - Scheduled for July 12, 2016 Meeting: Next, Mr. Fleury informed the board that the auditors will be ready to deliver the MECRS 2015 Audit results, at the July, Board of Trustees meeting. Mr. Fleury also noted that except for the audit letter the CAFR for the plan year ending December 31, 2015 is ready for printing.

Report of the Investment Committee – Although the Investment Committee did not formally meet**,** Mr. Fleury informed the board that the first capital call with the real estate manager, DSF Group, is scheduled for the coming week.

Consent Agenda:

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

Before proceeding with the day's agenda, Chairman Pinard recessed the meeting at 8:41 a.m. to await the arrival of NEPC representatives.

Chairman Pinard reconvened the meeting at 8:48 a.m.

New Business:

Presentation and Recommendation by NEPC – Representatives, Kevin Leonard and Sebastian Grzejka were in attendance to continue discussion on two pieces of the System's asset allocation, the review of Hedge Funds as a whole, and consideration of MECRS' investment opportunities in "Liquid Alternatives".

Mr. Grzejka began by directing the trustees to turn to page one of the Hedge Fund Discussion booklets, and he provided the trustees with a history of MECRS allocation to Hedge Funds as well as the outlook for Hedge Funds. He stated that MECRS has maintained an allocation to hedge funds for over a decade, exclusively through Fund of Funds, initially through Archstone Partners and Attalus Capital. In 2011, however, Permal replaced Attalus as the second manager. The result created a broad based portfolio, combining both equity and fixed income exposure in the Hedge Fund space.

Mr. Grzejka explained that Hedge Funds are a vehicle, not an asset class, and not a single investment. It's a vehicle in which the manager has latitude to invest across a lot of different strategies and in different ways. He stated that MECRS has maintained a 10% allocation within the Hedge Fund space and NEPC is now recommending, that moving forward, MECRS reduce their exposure to 5% and to review the hedge fund approach in total.

Mr. Grzejka stated that the thesis behind investing in hedge funds still remains intact. The objective is to provide a differentiated and uncorrelated return stream, which is in between stocks and bonds, with bond like volatility. Hedge funds also have access to non-traditional strategies not available to traditional investment vehicles, such as the use of shorting and leverage through the use of derivatives.

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Mr. Leonard stated that many factors have impacted hedge fund performance over recent years, however, they have maintained their low volatility profile throughout.

Working through the presentation booklet, Mr. Grzejka listed the three main reasons for investing in hedge funds as, diversification, risk-adjusted returns and access to non-traditional strategies.

Over the long-term, he stated, hedge funds have demonstrated a low correlation to traditional asset classes.

Mr. Fleury stated that after comparing the flash report in the agenda packet to a more recent flash report, and in light of Mr. Grzejka' s earlier comment, regarding a broad group of Hedge Funds positive return over a certain period, he expressed his concern regarding MECRS' investment in Hedge Funds, and the report indicating returns for the same period which failed to positively contribute toward achieving the fund's earnings assumption.

Mr. Grzejka explained that the report shows performance through April and since inception with trailing returns, which is end point sensitive, therefore, the trailing performance looks lack luster, whereas calendar returns will show the Hedge Fund volatility has achieved its goal of being more bonds like. He elaborated further on the history of hedge funds and stated that incorporating hedge funds into an investment portfolio has historically aided in reducing volatility while preserving and or improving return.

Trustee Sanders expressed his dissatisfaction with MECRS hedge fund manager fees, as well as with the hedge fund strategy as a whole. Mr. Leonard stated that he is in agreement with Trustee Sanders and that investors need to closely monitor the value they are getting for their fees and that NEPC does try to negotiate the current fee structure. Management fees should be reflective of the cost of operation, not an element of profit maximization. Mr. Leonard reviewed the fees associated with Archstone and Permal referring to page 12 of the presentation booklet. He acknowledged Archstone's high management fees of over 3%. With respect to Archstone, he stated that NEPC has less conviction going forward that it will be able to achieve its stated performance and diversification objectives. He also noted that it is no longer an NEPC preferred manager. As a result, NEPC is recommending that the Board terminate Archstone. The trustees discussed the NEPC recommendation and the time frames required to receive capital from Archstone.

Mr. Leonard then addressed the organizational change and new entity of, Fund of Funds Manager, Entrust/Permal, and he recommended that the board cautiously observe the merger of the two distinct cultures.

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Mr. Fleury asked the NEPC representatives if Entrust/Permal has made any indications that they are willing to make concessions on fees to which Mr. Leonard replied, Entrust/Permal can lower fees at the underlying fund level, but not at the top line. He also noted that NEPC will continue to monitor the integration of Entrust/Permal.

Moving on, Mr. Grzejka directed the trustees to turn to page 4, providing them with a summary of the diversification benefits of hedge funds, downside protections afforded by the strategy, and the risk adjusted return considerations.

On a go forward basis, Mr. Grzejka stated that hedge funds represent the purest form of active management across a number of strategies and asset classes and those sub-strategies can perform better or worse during different market environments.

In conclusion, Mr. Grzejka stated that hedge funds have historically been seen as diversifying investment strategies, offering the potential for attractive risk-adjusted returns. Recent underperformance has mostly been on a composite basis, and individual sub-strategies have delivered varying performance.

NEPC believes that as a vehicle, hedge funds will continue to perform well in the current environment and that they should continue to be part of the MECRS portfolio, albeit reduced from a 10% allocation to a 5% allocation.

Mr. Grzejka reiterated NEPC's earlier intention to review Entrust/Permal, to schedule interviews with three private equity energy-related managers, and to terminate Hedge Fund Manager, Archstone Partners.

Mr. Leonard stated that there is an opportunity set to add risk adjusted returns to the MECRS portfolio. The board continued to discuss the pros and cons of reducing the MECRS hedge fund allocation and moving towards liquid alternatives.

Executive Director Fleury expressed concerns that in light of implications of volatility and diversification within the hedge fund vehicle that Mr. Leonard spoke of, he does not believe that hedge fund investments are contributing toward the effort of reaching MECRS' assumed rate of return.

In response to Mr. Fleury's comments, Mr. Leonard asked the trustees to turn to page 21 of the presentation booklet, which provided the board with a 5-to-7 year forecasts.

Trustees Sanders concurred with Mr. Fleury's concerns and noted the importance of the board exercising due diligence in making investment decisions.

Mr. Grzejka then began the second part of his presentation on MECRS investment opportunity in Liquid Alternatives. He explained in detail that liquid alternatives have transparency and full liquidity, low fees and constitute a new strategy.

Mr. Leonard stated that Liquid Alternatives is the industry response to indexing hedge funds.

Mr. Fleury asked the NEPC representatives why they predict the liquid alternatives return to be superior to the hedge funds return, to which Mr. Grzejka responded, liquid alternatives have no underlying manager fees as well as a liquid beta type strategy, therefore a probability of having a higher return. Liquid alternatives are similar to hedge funds, but in a less expensive manner.

Mr. Grzejka stated that liquid alternatives are meant to manage the volatility so risk can be taken elsewhere, namely private equity and private real assets.

Mr. Fleury summarized NEPC's recommendations to terminate Archstone Partners, to schedule interviews with three liquid alternative managers, to replace Archstone's current 5% allocation within the MECRS portfolio.

Mr. Grzejka informed the board that they will receive a private equity energy-opportunity manager's search booklet in the coming weeks in order to choose the next installment in private equity placements.

It was moved by Trustee Sanders to terminate Archstone Partners from the MECRS portfolio, seconded by Trustee Woitkowski and passed by all those trustees present.

The board also agreed to have NEPC submit a short list of liquid alternative managers to fill the space of Archstone Partners.

Mr. Fleury asked the NEPC representative for the status on the MECRS' real estate commitment, to which Mr. Grzejka referred to the recommendation at the last Board meeting to raise cash and have cash on hand. At the next Board of Trustees meeting, the NEPC Flash Report will identify a portion of the cash to be used to fund PRISA and keep the real estate allocation closer to target.

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Motion to Adjourn:

Having conducted all the business of the day, Trustee Sanders moved to adjourn the meeting at 10:00 a.m. seconded by Trustee Woitkowski and passed unanimously by all those trustees present.

Respectfully Submitted,

Gerard E. Fleury
Executive Director