POLICE & FIRE PENSION INVESTMENT BOARD

May 8, 2014

Summary Minutes

The information in these meeting minutes is intended to assist Police and Fire Pension members in understanding the activities of the Investment Board. The information is not intended to provide investment or financial advice to any individual or organization and should not be relied upon for that purpose. While we attempt to keep the content accurate we cannot guarantee that all information is current, accurate or complete.

Members present: Doug McDaniel – Human Resources Director (Board Chairman)
Becky Ferguson – Mayoral/Council Appointment
Mark Westphalen – Mayoral/Council Appointment
Gerry Finnegan – Mayoral/Council Appointment
Russell Fosler – Police Electee (Board Secretary)
Steve Niemeyer – Police Electee
Jeremy Gegg – Fire Electee
Guy Pinkman – Fire Electee

Members absent: Steve Hubka – Finance Director

Human Resources.
Resource Staff: Paul Lutomski – Police and Fire Pension Officer

Others present: Dale Connors – Watershed Investment Consulting
Gary Radcliff - Watershed Investment Consulting

Doug McDaniel calls the meeting to order.

Doug asks members that recently attended conferences to give a short presentation.

Paul Lutomski states he attended NCPERS in April. There was discussion of 1) in-house hedge funds or private equity for large funds $5B+ 2) equal weight portfolio outperformed cap weighted portfolios, Implications of Healthcare Reform:

Coverage expanding 6 million newly insured
24% of median family income spent on health premiums
Debt as % of GDP highest since WWII
US Healthcare spending will rise and taxes will rise.
Other countries have an even larger % of age 65+ citizens
Healthcare spending increases dramatically after age 65.

Invest in healthcare companies

Regarding coming GASB 67/68 implementation; it is recommended to refer to 20 year average returns to justify actuarially assumed rates. If 80% or less funded instead of the assumed rate, a blended rate incorporating the 10 year treasury rate, will have to be used. That will lower the rate and increase unfunded status.

Dale Connors states He will review performance report and Gary Radcliffe will speak about asset allocation. He has heard for GASB 67/68 the blended rate is not used if amortization period is closed.

Page 1 most returns were positive. Emerging markets up. Bond up with stocks. Rates keep falling.

Page 9 shows returns for various classes for last 10 years. 7.5% has been hard to earn. You really had to have been all in basic stocks to earn it. The difference between 5 year and 10 years are amazing., because of 2008. The last decade was worse than the 1930s because of 2008.

Page 11-12 lists investments. Eliminated 13 added 1. We will work on structure of equities at the next meeting. We will talk asset allocation today.

Page 13-14 show returns. Recent 0-3 year returns have been what you need. 2008 and 2011 returns show the portfolio's downside volatility compared to peers.

Page 15-16 show risk reward chart for 5 and 10 years. You are somewhat volatile compared to peers. Active managers have not added value over last 5 years. You are pretty much optimal in efficient frontier. We will talk more later.

Page 17-20 shows returns.

Gerry Finnegan: What is our risk adjusted return best performer?

Dale Connors: First Eagle is risk adjusted best performer with Sharpe ratio of 0.91. Ivy captures 137 of upside and 237 of downside. That is the opposite of what you want in these types of portfolios.

Page 28 shows equity returns. We will want to look at if we want active managers in all these categories. The Vanguard is listed first. The Board managed Dividend Portfolio came into style in March. The portfolio was created and is to be left alone for 4 years. We will need to look at that as a fiduciary.

Page 33-42 show details of funds. Page 43 is an equity style map, Royce is on the next page. Page 47 shows balanced managers. Page 56 shows international managers. Oakmark and Europacific work well together. Cap Gaurdian not doing that well. Oppenheimer not bad. Page 65 shows fixed. Less interest rate exposure, more credit exposure, as that is good. We will watch Pioneer.

We will add the hedge funds and Tenaska private equity. I like how your real estate is structured now, not 5 years ago. Overall good quarter up 1.6%, but need to pick up the pace to make 7.5%.

Questions?

Paul Lutomski asked for the addition of a description at the top of the pages that state the asset class.

Gary Radcliff presents the asset allocation study.

Which classes to invest in and how they will be combined. Portfolio optimization. Quantitative and qualitative. Optimizer does not tell you what the right portfolio is, you must decide. It is a tool. Constraints add subjectivity. Long term process. Driven by investment policy, statistical analysis looking at hundreds of portfolios. Maximize return for given risk – standard deviation or vis versa. Need three inputs, expected returns, SD, correlation between the classes. Decide if we should constrain: exclude some classes, maximum percent allowed. We have found if you do not constrain the optimizer you will have highly concentrated portfolios. Delivers numbers that look precise, but are just starting points.

Gerry Finnegan: Should we have a risk maximum that goes with our 7.5% return target?

Dale Connors: At certain times you have to take more volatility to earn the target. Experience has shown about a 2X relationship, 7.5% return will require about 15% SD. We plan on looking at this every year.

Gary: slide 3 inputs expected returns, SD, correlation between the classes. Eligible five classes: global equity, fixed income, real estate, private equity, hedge funds. Looked at 30-40 year history for assumptions.

Slide 4 is the efficient frontier. The lower line is the current portfolio with hedge funds and private equity constrained to be zero. Your portfolio is a red circle. It is hidden by the green box which is the 7.5% portfolio with lowest risk. So your portfolio is optimized. Our issue is with structure and manager selection. 13.5% SD. The second line, orange, the upper line includes hedge funds and private equity constrained to 5% each.

Slide 5 shows exact percent. The pie chart on the right constrains real estate to 10%, and the full 10% is used.

Gerry Finnegan: With hedge fund and private equity reporting quarterly and not monthly, how helpful are including those numbers. Is there really a reduction in volatility?

Dale Connors: When Harry Markowitz invested optimization he used annual risk and return. There are not enough inputs for some asset classes using annual. We use quarterly to match stocks and hedge funds etc. reporting and enough inputs. It is not a true look, and that is why we constrain it.

Becky Ferguson: If you optimize to attain 7.5%, the Standard Deviation is what it is.

Gary Radcliffe: We adjusted the volatility of Private Equity up to 20% because we thought the calculated SD was lower than it should be because of quarterly reporting.

Dale Connors: For example private real estate had a volatility of 26% and private real estate had a volatility of 3.2%. Private real estate prices are set by appraisers and accountants. The real SD is somewhere between those two.

Gary Radcliffe: Slide 7, adding alternatives you can attain 7.5% and reduce volatility from 13.5% to 12%. That is the bulk of what we are looking at. Mean variance is a very exact toll solving an equation. Slide 8 (conversely) uses Monte Carlo simulation which generates hundreds or thousands of portfolios and makes probabilities of future occurrences. Three probabilities are shown for three portfolios. The probability of exceeding 0%, exceeding 7.5%, and exceeding 10%. The portfolio of 7.5% with alternative shows the highest probability of exceeding the 7.5% target over time. Slide 9 shows the corresponding numbers. Alternatives reduce volatility and offer downside protection.

CONCLUSIONS

- The current mix is basically "optimal" in that it achieves the 7.5% assumed rate of return at a reasonable risk level, as measured by standard deviation of returns.
- Risk-adjusted returns for the portfolio could be improved by renewing allocations to alternative investments (private equity and hedge funds), which add diversification and additional sources of return. Under this scenario, allocations to long-only equity would be reduced in favor of 5% allocation to both private equity and hedge funds. Also, the target allocation to real estate is increased slightly to 10%.
- Alpha generation and risk mitigation could be improved with changes to portfolio structure and investment manager/product implementation.
- Portfolio structure refers to the allocation to sectors and styles within an asset class. After asset allocation, investment structure is the most influential decision in determining a portfolio's return. Generally, the portfolio structure decisions made by investors are more important than the choice of managers selected.
- The emphasis on portfolio structure is to ensure cost-conscious and risk-controlled implementation of the strategic asset allocation.

We would like to leave here today with approval of an asset allocation.

In the future we look forward to :

- Completion of the custodian search and transition portfolio.
- Conduct equity portfolio structure analysis.
- Review Investment Policy Statement.

Our Near term Recommendations will be:

- Reduce allocation to interest-rate sensitive fixed income sectors.

- Comparative potential senior-secured debt managers.
- Add a 5% position to senior-secured debt/bank loans.
- Sell positions in Wells Fargo Note and iShares Interim Government/Credit Bond ETF. Partially liquidate positions with core-plus managers.
- Discuss investment objectives and execution process for the board managed dividend equity account.

Gerry Finnegan states that the Board had viewed the Dividend Portfolio as a fixed unit trust and asks what fiduciary issues Watershed is referring to.

Dale Connors states that if it is unmanaged that is a problem. If it is managed he would like to know the plan if there is a problem with one of the stocks, for example that might lead to bankruptcy. How to vote the proxies for the stocks.

Gerry Finnegan states that this is only a problem if the Board has actionable information that the security is mispriced.

Paul D. Lutomski states the Board discussed proxy voting and decided that he would vote with the Directors unless there was a shareholder issued item. Then Paul is authorized to vote as he sees fit.

Dale Connors states a written proxy policy would be a good idea.

Gary Radcliffe states that for the asset allocation vote he is asking the Board to select one of the portfolios we discussed. 1) Current policy mix, 2) Current with changes to 7.5% optimized that have 10% real estate max, or 3) Current with changes to 7.5% optimized with change to 10% real estate max and with 5% hedge funds and 5% private equity.

The Board asks for more information on hedge funds and private equity before deciding on the asset allocation selection.

Gerry Finnegan states that the Board has seen that active managers using selection and timing cannot consistently add alpha, we do not have information on why hedge funds or private equity can add alpha.

Dale Connors states that hedge funds can do things our current managers cannot do, such as arbitrage. We will do the education.

Gerry Finnegan states Watershed has expertise that the Board has not had access to before.

Doug McDaniel asks if there are any other questions or new business. There being none he adjourns the meeting at 3:45.