POLICE & FIRE PENSION INVESTMENT BOARD

February 13, 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 and welcome Becky Ferguson as a new Investment Board member. Mrs. Ferguson over 25 years of experience working with financial institutions in Lincoln. Security Mutual Life, First Mid America/Paine Weber. BLN Investment Corp (Bankers Life of Nebraska) a Broker-Dealer, which eventually changed its name to Ameritas Investment Corp. National Bank Of Commerce, where she was the PF Pension’s contact. Mrs. Ferguson joined Union Bank in April of 2000 as an investment officer for UFS Securities. A few years later she began working in the STFIT and NPAIT Trust area. She currently is a portfolio manager for discretionary accounts and consults with high net worth clients. She holds a Certified Financial Planner Designation (CFP) and Series 7 license.

Board members and consultants introduce themselves.

Doug asks members that recently attended conferences to give a short presentation. He notes the that travel policy was recently changed to limit one person at a time to attend a conference, so that will be in place in the future. He states Steve Hubka is not present and that Steve attended an Opal Financial Investment Trends conference in September 2013.

Russ Fosler states he attended NCPERS in October. There was discussion of changing GASB rules that will make the pension funding look different from an accounting reporting perspective, but the underlying market value situation will stay the same.

Guy Pinkman states he attended the Opal Financial Public Funds Summit and we need to be pro-active with a pre-council session to educate the City Council members on the GASB changes. DC v. DB, and how much more cost effective DBs are. Detroit lost 1 million people from tax roll. Pension was 2% of their cost.

Steve Neimeyer states he also attend the same Opal conference. Pension liabilities are in the news, such as Detroit. Europe was thought to do well in the near future. Emerging markets are a mixed bag.

Doug thanks the presenters and asks Dale Connors of Watershed to present.

Dale distributes information and thanks the Board. Gary will present the analysis and I will present the recommendations.

Gary Radcliff presents the performance report:

Page 1 calendar year returns. US equities up more than 30%. Strongest return since 1997. Outperformed the rest of the world. Biggest gap was emerging markets. Allocations did matter. Fixed income rates rise and expectation of future increases. Longer term issues were hardest hit. High yield performed well. Your portfolio was positioned well.

Your portfolio starts on page 11. Asset allocation is the most important decision as the ultimate driver of your returns. You have a large number of managers. Over diversification may lead to underperformance. You have nearly 50. 15-20 is more typical. We don't believe in concentration for its own sake, but do think there are reasons for it. We need to learn more about your alternative asset classes.

Dale Connors states AMJ, Nuveen and Van Eck, Calamos, are labeled an alternatives but are equityand that he would like to discuss the Dividend Portfolio sometime.

Gary Radcliff asks if there are any questions before asset allocation. Below is a summary and highlight of comments.

Page 13 shows performance. The graph blocks show the return range of a peer group with your funds actual returns shown as an "L." The returns from an index made using your target allocations is shown as "1." Government DB plans less than $500M with any asset allocation. The actuarial target return is shown as "2." For example, for 2013 your fund returned in the 27^rd^ percentile, better than 73% of your peers. Two year return was 15.03%, in the 32^nd^ percentile, in other words the top third of the peer group. The five year return was 10.62%, a good absolute return, but in the 93rd percentile of peers. The ten year return average was 5.57% in the 99rd percentile of peers. The High return was 7.39%, the low was 5.78%. The fund derived index would have done well. The managers you selected drove your return down. (The index was based on the 12/31/13 allocation targets).

Page 15 is a risk return quadrant graph. The ideal is the upper left. You are in the lower right.

Page 17-20 look at alternative assets. If you want to protect against downside there is some work to be done.

Page 21-24 look at domestic equity managers. Dodge and Cox is very volatile and had very good returns. Perkins is low return, they have held a lot of cash. The rest are in the middle. We will watch Perkins and Baron. Baron is a micro-cap manager with $8 B, so that can make it difficult to manage. Questions?

Page 27 shows 3 year and page 28 shows 10 year return and standard deviation. The “R” for Royce Special equity fund is in the best position with high return and low SD.

Page 29 show 9 boxes with cap size and growth versus value.

Page 30 shows sector analysis. Portfolio is fairly neutral weighted to overall market, slightly over only in energy exposure.

Page 31 shows portfolio relative to the Russell 3000 total market. Portfolio significantly overweight to small cap, which was a very good last year. This year may not be the same.

Page 32 adds growth versus value to the comparison. Portfolio has a small bias to growth.

Page 33 shows style drift. The larger symbols are more recent. Your managers are staying pretty consistent.

Page 40 5% allocated to emerging markets

Page 45 developed International portfolio. Performing well. EuroPacific is very big, so we may want to look at them. With emerging markets the country matters.

Page 47-48 is risk adjusted return. Sharpe ratio higher is better.

Page 49-50 compares your portfolio to a benchmark. Int’l equity is 37% exposed to emerging markets and that is higher than the benchmark.

Tab on fixed income shows many different types of managers. We believe the run high yield has been on is coming to an end. We like bank loans, or senior secured debt. We are very concerned about emerging markets debt.

Last tab is alternatives. We are working on gathering data, but do have real estate listed. Portfolio real estate performance is good. Core has been the right place to be. We are starting to look at value added. As the US economy recovers real estate is a good place to be.

Dale Connors states the portfolio real estate mix is interesting. JPMorgan Strategic Property is probably the best fund and you liquidated a lot of it recently. Rreef REIT2 is pretty good. PRISA3 value added is a good place to be going forward. Typically Watershed does not like public REITS. They are highly correlated to 10 year treasuries.

Mr. Connors moves to recommendations. He states the Custody RFP responses are due back to the City by March 20 and that will move the portfolio forward.

Gerry Finnegan asks if the Board's inability to ask questions of the RFP respondents a holdover from when it was only advisory.

Paul Lutomski answers, no. Per the City's Purchasing regulations prior to the RFP submission only the Purchasing Manager can speak to the potential RFP respondents, after receipt only the RFP Selection Committee Members are allowed to speak to the RFP respondents.

Gerry Finnegan states he was asking in terms of the Investment Advisor selection. We have fiduciary responsibilities and did not get much of a hand in the selection process.

Paul D. Lutomski: Per Lincoln Municipal Code the Personnel Director selects the plan's Investment Advisor.

Gerry Finnegan: The process went well, but under some future administration the process might not go as well.

Doug McDaniel asks Dale to discuss Recommendations for Immediate Action

Dale explains the list below:

1) Convert all mutual fund shares to lowest expense ratio version available to qualified governmental defined benefit plans where available (up to 10 funds).

2) Transition all iShares U.S. equity holdings to the Vanguard Total Stock Market Index fund – Institutional shares, ticker VITSX.

    a) This recommendation consolidates seven investments into one.
    b) Plan currently has an overweight to small and mid cap stocks which worked well during 2013 but are now expensive relative to large cap U.S. stocks. Small cap stocks have not been this overvalued for a long time.
    c) All are underperforming their target indexes.
    d) The iShares expense ratios range from 0.20% to 0.36% while the Vanguard fund expense ratio is 0.04%. This should save about $75,000 in expense fees.

3) Liquidate Calamos Growth & Income fund, ticker CGIIX and move proceeds to Loomis Sayles Bond fund, ticker LSBDX.

a) Calamos fund invests in both U.S. growth stocks and convertible securities.

b) The firm recently went through major investment professional change with Nick Calamos, former CIO, leaving the firm and Gary Black, new CIO, taking over after resigning from Janus.

c) The overall Plan exposure to fixed income is below the Policy target.

d) Loomis is very adept at being in the right place at the right time.

4) Liquidate Van Eck Global Hard Assets fund, ticker GHAYX, and move proceeds to Vanguard Total Stock Market Index fund, ticker VITSX.

a) Fund has performed poorly since untimely death of former portfolio manager in 2010.

b) Implementation of such as strategy via a mutual fund vehicle does not provide the same diversifying exposure available through direct, private equity vehicles.

c) The move to Vanguard should be viewed as temporary until Watershed presents a full structure analysis.

d) Long term we would like to move this money to private equity

5) Liquidate Invesco Balanced Risk Allocation fund, ticker ABRYX, and move proceeds to the Vanguard Total Stock Market Index fund, ticker VITSX.

a) Invesco fund utilizes a risk parity approach with levers up fixed income exposure while reducing equity exposure, the theory being to “balance” the risk drivers in the portfolio.

Gerry Finnegan: How much are your planning to leave in an index.

Dale: 15-20%.

b) Watershed views the risk of rising interest rates as highly probably over the next one to three years.

c) A leveraged fixed income position would exacerbate the negative effects of rising rates on bond valuations, hence being detrimental to the fund’s returns.

d) Move to U.S. stock exposure from a flexible mandate will improve the Plan’s longer term potential to achieve the actuarial assumed rate of return.

6) Liquidate MFS Emerging Markets Debt fund, ticker MEDIX, and move proceeds to the Templeton Global Bond fund – Institutional share class, ticker FBNRX which should be converted from current Advisor share class, ticker TGBAX.

a) Emerging markets economies are highly sensitive to U.S. interest rates, which are rising.

b) Additionally, the expectation of continued volatile emerging markets currencies lead to this recommendation.

Emerging markets are very disparate. Need understanding of how each market works. Dirty Five are India, Indonesia, South Africa, Turkey and Brazil. Over leveraged, currencies float , long term needs financed with short term debt. We think it best to let let the Templeton managers decide where to invest.

7) Liquidate Principal High Yield Bond fund, ticker PYHPX, and Wells Fargo Short Term Hi-Yld Bond fund, ticker STHBX, and split proceeds between Loomis Sayles Bond fund, ticker LSBDX and Pioneer Strategic Income fund, ticker STRYX.

a) The low interest rate environment has driven bond investors to seek higher yields in more risky investments, such as high yield bonds.

b) The added demand for high yield bonds has moved yields on these securities to tight spreads relative to U.S. Treasuries, meaning that they are expensive and leave little cushion for a correction.

c) The Loomis Sayles and Pioneer funds opportunistically invest in high yield bonds and adjust the allocation based on their assessments of attractiveness.

Doug: I'd like to take the recommendations one by one for vote. Recommendation one and two?
Gerry Finnegan: So moved.
Jeremy Gegg: Second.
Doug: Discussion?
All members: Aye.

Doug: Recommendation three?
Gerry Finnegan: So moved.
Guy Pinkman: Second.
Doug: Discussion?

Becky Ferguson asks for clarification on how this change affects duration and the dollar amount involved.

Dale Connors answers that it shortens duration and affects $3.8M.

All members: Aye.

Doug: Recommendation four?
Jeremy Gegg: So moved.
Gerry Finnegan: Second.
Doug: Discussion?
All members: Aye.

Doug: Recommendation five?
Guy Pinkman: So moved.
Gerry Finnegan: Second.
Doug: Discussion?
All members: Aye.

Doug: Recommendation six?
Guy Pinkman: So moved.

Steve Niemeyer: Second.
Doug: Discussion?
All members: Aye.

Doug: Recommendation five?
Russ Fosler: So moved.
Becky Ferguson: Second.
Doug: Discussion?
All members: Aye.

Doug McDaniel asks Dale to go through the near –term recommendations.

Dale Connors states that when they recommend investment changes they understand they are co-fiducaries. Near-term recommendations are related to the timing of the custodian coming on board. A custodian makes sure you are involved in any lawsuits, so that minimizes the need to outside council as was discussed.

Near Term – Next 3 to 6 months
1) Retain the services of an independent third party bank custodian.
 a) Allows for consolidated tracking and independent pricing of the Plan's investments.
 b) Best practices method for institutional pools of investments, especially for governmental defined benefit pension plans.
 c) Allows for the implementation of separately managed institutional accounts that typically are less expensive than mutual funds and also allows for a broader range of investments and managers.

Gerry Finnegan asks Dale to explain his enthusiasm for separate accounts.

Dale Connors states there are a couple things. 1) For a minimum of $10 million for domestic equities fees are usually half a mutual fund. 2) All trades flow through the custodian, so we can analyze everything that goes on. 3) The manager has one duty, to manage your plan's assets, whereas a mutual fund manager has many masters. 4) Mutual funds, EFTs, MLP funds, take certain taxes into consideration, whereas they do not matter to us because we are tax qualified.

Continuing with near term recommendations:

2) Replace JPMorgan Alerian MLP Index ETN with an actively managed separate account of MLPs. We love AMJ to measure against, as it is widely followed and transparent, however:
 a) Indexing MLPs is expensive relative to actively managed investing.
 b) The Alerian index consists of only 50 MLPs while the universe has almost twice as many securities available.
 c) Most managers can bet this index.

3) Analyze remaining equity investment structure with bias towards elimination of:
 a) Underperforming investments,

b) Redundant investments, and
c) Expensive investments.

Watershed clients are public DB with $170 to $400 Million assets and no one has 50 different managers.   We want to go to best-in-class, and not every style box covered, so eventually we will have many less managers.

4) Present and potentially select a manager for a senior secured loan mandate. The Board was introduced to senior secured loans or "Bank Loans" in 2011. You currently have bonds. These are loans, not bonds. We will talk more about benefit and cons, but quickly a benefit is that these are floating rate debt, so in an increasing rate environment the rate will rise, because of that they have very short duration – only 3 months until the rate resets. The detriment is that investment grade companies do not issue these because they are not cheap to issue (compared to a bond with a fixed lower rate) so default risk is higher. That means maybe 5%, but compared to a bond in a rising rate that could earn 0%, 5% is good. It is a big market, about $1 trillion.

a) Senior secured loans are floating rate debt with minimal duration risk.
b) Loans are at the top of the capital stack should the issuing company develop financial difficulties.
c) Loans are to non-investment grade companies, so this is a good replacement for duration sensitive, expensive current investments in high yield bonds.

Intermediate Term – Second half of 2014

1) Asset allocation and investment structure analysis.

We are not timers, but there are better time to buy and sell certain investment classes than others. Now is good to buy senior loans and value add real estate.

2) Review of Statement of Investment Policy.

Doug McDaniel asks for general comments or questions.

Paul Lutomski compliments Watershed on the transition to them.

Guy Pinkman notes that he gave Paul Lutomski information on securities litigation if we want that for the future.

Doug McDaniel adjourns the meeting at 3:38 p.m.