TUCSON SUPPLEMENTAL RETIREMENT SYSTEM
BOARD OF TRUSTEES
Meeting Minutes from October 23, 2008, 4:00 p.m.

Members Present: Brian Bjorndhahl, Chairman
Kevin Larson, City Manager's Appointee
Frank Abeyta, Finance Director
Cindy Bezaury, Human Resources Director
John O'Hare, Employee Representative
Gage Andrews, Employee Representative
Paul Miner, Retiree Representative

Staff Present: Jacinta Figueroa, Board Counsel
Joel Peterson, Risk Management Administrator
Allan Bentkowski, Investment Manager
John Behrens, Investment Analyst
Mike Hermanson, Retirement Manager
Doris Rentschler, Finance Analyst
Claire Beaubien, Board Administrative Assistant

Guests Present: Jean Wilkins, CTRA Representative
Frank Abeyta, Executive Financial Consultant
Brandy Kadous, Employee Represtative-Elect
Mark Klimek, Hewitt Investment Group
Rob Van Den Brink, Hewitt Investment Group
Jean Wilkins, City of Tucson Retirees Association Representative
Carli Brosseau, Tucson Citizen

A. Call to order
Chairman Bjorndahl called the meeting to order at 4:08 p.m.

B. Review of TSRS Investment Policy and Objectives
1. Elements of Risk for TSRS - Chairman Bjorndahl turned the meeting over to Rob Van den Brink to begin the discussion on the TSRS Investment Policy and Objectives. Rob acknowledged that this topic is probably a review to some in attendance but new to other board members. He said that the Investment Policy and Objectives is an important tool used in the management of the TSRS portfolio. The policy statement is an important document that discusses why the Board is investing the way it is. It is a roadmap of where the Board has been, where the Board is planning on going and how to get there. The asset allocation policy is how the assets are being invested in order to pay off liabilities over time. The policy statement outlines investment policies and guidelines for investment managers. It also proposes specific responsibilities for the Board, the investment managers and investment consultants. Rob defined risk posture as a combination of the fund's risk tolerance and the fund's risk preference. Risk tolerance is the ability the fund has to take risk and risk preference is the willingness of the Board to take risk in the pension investment program. There are three important areas that affect the Board's overall pension risk tolerance: demographic characteristics, actuarial characteristics and funded status. Through analysis of these factors, the risk tolerance of TSRS has been determined by the Board to be slightly above average relative to other U.S. public pension funds.

Items considered for the characteristics of the Risk Tolerance for TSRS include average age of participants, average service of participants and ratio of retirees to total participants. Rob explained that if there was a relatively new workforce in place, there would be little or few benefits promised. If there were more participants closer to retirement, more benefits would be promised. TSRS is somewhere in between, as was the case in the last asset/liability study conducted in the 2002-2003 time frame. John O'Hare asked Rob to define risk for the Board. Rob replied that risk is part art and part science. Unfortunately, there is no magic formula that says if you have this age and this amount of service, you can take on this amount of equity type risk. Rather, it is assumed that, as a whole, the entire pension population is probably the correct way to look at things. Rob said that when they talk about risk they are talking about volatility of return, using standard deviation as a measure of that volatility. Do the characteristics of TSRS suggest that more risk could be taken? Allan commented that the type of plan also dictates the type of risk that can be taken. For example, TSRS is a defined benefit plan that has liabilities that have to be met whereas an endowment plan does not have those obligations. Mike commented that over the past few years, the retiree population has been steadily increasing while the active employee population has not been increasing at the same rate. Therefore, there are fewer participants paying into the plan but more retirees receiving benefits from the plan, causing a negative cash flow.

The actuarial assumptions for TSRS are slightly conservative, using a lower assumed target rate of return at 7.75%. Other public plans employ much higher assumed rates of return, which can produce funding shortfalls when targets are not met. Rob commented that TSRS has been about the same as other plans in regards to a reasonably well-funded plan. Some years, the plan has been slightly negative, while other years have been slightly positive. There are only two ways for the plan to become fully funded: earn more or contribute more. Neither the City nor the participants want to pay more into the plan.

One of the most important things to consider is risk preference – the amount of risk the Board is willing to take. The Board believes that the goals of increasing long-term expected returns and reducing ultimate contributions and expense to the plan should be balanced against its short-term concerns regarding increases in pension expense resulting from short-term investment volatility. Allan asked Rob if there was a bias towards trying to grab more risk and going out of the spectrum of riskier assets because the fund is underfunded. Rob replied that other plans are taking a wait and see posture on this. John O'Hare asked Rob if it was smarter to take less risk when the markets are high and more risk when the markets are down. Rob replied that in theory that would be the way to go but only in theory. Unfortunately, that isn't the way the market works, most plans tend to do exactly the opposite.

2. Target Asset Allocation Policy - to achieve the 7.75% rate of return, a very broad asset base is required. Having said that, caution is needed because the more assumptions made, the more margin of errors will be possible. TSRS reviews its asset mix at least quarterly and rebalances the portfolio when a primary asset class, secondary asset class, portfolio style or manager reaches the minimum or maximum target allocation specified in the policy. In rebalancing, TSRS allocates assets back to the target mix over a reasonable period of time, considering the volatility of the market. Separate target ranges are also set for each investment manager. This portfolio is equity biased because of the assumed rate of return necessary to meet the fund's obligation. Gage Andrews asked Rob if there was any degree at which illiquidity of an investment is an advantage in this market. Is this a point that the Board should be looking for when interviewing managers being considered for the portfolio. Rob answered that yes, but the liquidity needs have to be weighed against illiquidity.

Rob reminded the Board that the asset allocation policy is the main driver of returns and ultimate driver of volatility. There is no asset allocation study done for infrastructure because it hasn't been around for 80 years like the S&P has been. Kevin Larson asked Rob if the City's targets were similar to other public plans. Rob answered that, in general, they were. Historically, the equity allocation has been a bit higher but that has been adjusted over time due to diversification moves. Mark pointed out that the City's 61% Equity target is comparable to the 59% Equity target of other plans.

3. Investment Guideline Issues for Investment Managers in today's markets - Rob pointed out the investment manager guidelines that cover several pages in the Investment Policy. Kevin asked if there are individual contracts for each money manager. Rob replied that there are contracts in place for each manager. They are flexible enough so as not to "handcuff" the manager but the contracts do have

restrictions, as outlined in the statement. John O'Hare asked if the managers are audited for style drift. Rob replied that they do, indeed, check their portfolio and returns to be certain that the manager doesn't drift too far from their asset class. To date, no manager has been charted out of their asset class.

Rob reminded the Board that the managers are always being evaluated to ensure that they are outperforming their index and how they compare to their peers. John commented that some of the managers interviewed suggest that, based on their history, they could outperform their index by 2%. He suggested that we should put this in the investment policy. Rob disagreed, because adding to the policy would be detrimental both to the fund and to the manager. He asked John if a manager outperformed the index by only 1%, would he fire the manager, just because the said they would outperform by 2%. John replied that if the manager said they could outperform by 2%, they should be held to that. Mark replied that by putting such a restriction in the policy statement, the Board could be held responsible if the manager is not terminated. Brandy Kadous asked how many managers were terminated over the past five to ten years. Mike replied that about three managers have been terminated and replaced over the past five years. Brandy asked if Hewitt handles the hiring of new managers or how do the names come to the Board. Rob replied that Hewitt sifts through the possible candidates and tries to bring the best three to the Board for their review. An interview of these candidates ensues and usually one is hired from those interviews. Mark added that he and Rob typically interview the current managers on a quarterly basis and include those reviews in the PRIME report.

4. Evaluation and Review Process - Rob explained that the watch list is the tool used to monitor manager performance against benchmarks for quantitative and qualitative issues. The watch list is included in the policy but is overseen by Hewitt. Rob reminded that a manager can be put on the watch list only if they underperform the benchmark by 2% and are in the bottom quartile in their peer group for two consecutive quarters.

5. Responsibilities of Board, Investment Managers, Investment Consultant - Rob remarked that the major responsibilities of the Board are putting these policies in place, evaluating the policies and making changes when necessary all for the benefit for the retirees and participants of the fund. Responsibilities of the investment managers include but are not limited to investing the assets of TSRS pension fund with care, skill and prudence, adhering to the investment policies and guidelines, informing TSRS regarding all significant matters pertaining to the investing of the fund assets. Rob reminded the Board that this (government) plan is not subject to ERISA regulations. Responsibilities of the investment consultant (Hewitt) include assisting TSRS in the development and review of asset allocation policies, including periodic reexamination of asset mix strategy, assist in the review of new asset classes, assist in the development and review of investment manager structure and assist in the development and review of the "Statement of Pension Investment Policies and Objectives".

In summary, Rob reviewed for the Board the objectives: determine what the Board is trying to achieve, how they are going to achieve it and evaluate whether or not their goals have been met. John O'Hare asked if Hewitt considers themselves as fiduciaries to the Board. Rob replied that they have fiduciary responsibility for the investment advice given to the Board. However, they are not fiduciaries for the Plan, the Board has fiduciary responsibility for the Plan. Gage asked what percentage Hewitt serves defined contribution plans versus defined benefit plans. Rob replied that the defined contribution is about 1/3 of Hewitt's business. The defined benefit plans have been reduced to about 1/3 to 40% of Hewitt's business and the not-for-profit plans constitute the rest of the business.

C. Review of TSRS Asset Liability Analysis

1. Role of Investment Consultant - Rob explained that the process for the asset-liability study begins with determining the capital required by the actuary, combine that with assets returns to see what the pattern looks like. The main objective is to determine the contributions needed to reach the objectives. Rob reminded the Board that the last time the asset allocation study was done, the implications of a cost of living adjustment were not built into the considerations. Allan remarked that, based on this study, the allocations could be tweaked or could be left alone, depending on the results of the study. Mike noted that

the actuarial liability assumptions and investment returns are only significant at plan year end, because that's when everything is measured. However, this year at June 30, 2008 the market was just beginning to head south and has continued falling for the past 4 months. He suggested that current information be incorporated in both the actuarial experience study and the asset allocation study to be more reflective of the current situation. Gage asked what the participation of the Board might be in this process. Rob replied that the Board could participate as much or as little as it wants. Rob summarized the desired outcomes of the asset liability study to understand the risks inherent in the plan, design the most appropriate investment strategy and to keep goals and objectives in mind throughout process. This process should take six – eight weeks to complete, once started.

Rob pointed out to the Board that TSRS's total equity manager target was similar to other public plans although a bit higher than most public plans. As a result, TSRS has lower total fixed income targets than most public plans.

Kevin asked Rob how the Plan is funded, how much the City is contributing, how much the participants contribute. Cindy replied that the various contributions are determined by ordinance. Employees hired before July 1, 2006, pay a flat rate of 5% of their base salary, while employees hired after July 1, 2006 pay 40% of the actuarial recommended contribution rate with a cap. Mike remarked that the actuarial numbers provided in the Board packet are recommendations for fiscal year 2010 beginning July 1, 2009 (a year in advance).

2. Role of Actuary - the actuary provides characteristics associated with a higher degree of risk tolerance that includes assets that substantially exceed accumulated benefits, small plan contributions relative to total assets and an asset valuation method that smoothes the effect of market volatility.

3. Role of TSRS Staff and Board - Rob then tasked the Board to complete a short survey to determine the risk preference of the Board. Some of the items on the survey include the objective of pension assets, the pension risk profile, the importance of volatility of cost, the importance of level of cost and the investment time horizon of the pension plan (in years). Based on the combined answers of the Board of these questions, the asset allocation study can be conducted utilizing the Board's preferences.

Rob went over the historical timeline that included education and implementation over the past eight years. Some of the highlights include the Board chose to enter into diversity by investing in core real estate in 2000, discussed equity structure including enhanced indexing in 2001, discussed of private equity and hedge funds in 2002, discussed additional real estate diversification, rebalancing education in 2004, small cap diversification, value added real estate managers hired in 2005, discussed adding infrastructure to the portfolio in 2007, and hired infrastructure managers in 2008.

D. Call to Audience
None heard.

E. Dinner Break - Barrio Grill – 135 South 6th Avenue, Tucson, AZ 85701

F. Adjournment
Meeting adjourned at 6:02 p.m.

Approved:

Brian Bjorndahl, Chairman	Date	Michael Hermanson, Retirement Manager	Date