TUCSON SUPPLEMENTAL RETIREMENT SYSTEM
BOARD OF TRUSTEES

Meeting Minutes from Friday, October 27, 2006 – Arizona Inn, Tucson, AZ

Members Present:	Brian Bjorndahl, Chairman John Moore, City Manager's Appointee Cindy Bezaury, Human Resources Director Scott Douthitt, Finance Director Marie Nemerguth, Employee Representative John O'Hare, Employee Representative Paul Miner, Retiree Representative
Staff Present:	Frank Kern, Board Counsel Joe Ladenburg, Deputy Finance Director Robert Leko, Finance Administrator Joel Peterson, Risk Manager Allan Bentkowski, Investment Manager Michael Hermanson, Retirement Manager Claire Beaubien, Administrative Assistant Enid Cranshaw, Fund Accountant
Guests Present:	Jean Wilkins, CTRA Representative Wendy Gomez, City of Tucson Intern Professor Jun Peng, University of Arizona Joel Damon, JPMorgan J. D. Sitton, JPMorgan (via teleconference) Larry Kohn, JPMorgan Mark Klimek, Hewitt Investment Group Rob Van Den Brink, Hewitt Investment Group Rick Roeder, Gabriel, Roeder, Smith Scott Roney, PIMCO Ryan Korinke, PIMCO Liz Green, City of Tucson Water R. Bruce Johnson, Tucson Water Janet Garcia, Tucson Water Linda Dekker, Tucson Water, Disability Retirement Applicant

Call to Order

Chairman Brian Bjorndahl called the meeting to order at 8:30 a.m.

A. Hewitt Associates – Mark Klimek, Rob Van Den Brink
   1. TSRS Portfolio Quarterly Update
   2. Comments on Investment Manager Performance

Chairman Bjorndahl started off the meeting with a quick welcome to Mark Klimek and Rob Van Den Brink from Hewitt Investment Consultants. Mark began by mentioning that financial data needed to produce the quarterly PRIME report was unavailable for the retreat, however, the 3rd quarter financial performance has been strong. Biggest reasons relate to the Fed's relaxed attitude towards continued interest rate hikes and the slowing economy without needing further intervention. Mark also mentioned that the DOW had risen close to 11,000 by the end of the third quarter, approaching a peak not seen since 2000. The best performing segments of this recent quarter were the telecom, healthcare and energy.

Moving to commentary on individual investment managers, Mark explained that Hewitt regularly meets with these managers, to evaluate their processes; in particular those that are not performing well. Hewitt then ranks managers based on a current assessment. Recently, Hewitt met with the TCW Concentrated Core and Value Opportunities managers. Hewitt rates Concentrated Core as "moderately favorable" despite the recent performance challenges, and anticipates further volatility from them due to their concentrated portfolio approach. Historically, when this manager's portfolio significantly under performs, it also rebounds during subsequent periods, and their strong, long-term track record supports this. Mark suggests monitoring this manager closely for the next 2-3 quarters, expecting good performance in the near future.

TCW Value Opportunities, on the other hand, has had a strong third quarter. Their past under performance was due to poor stock selection, however, this has turned around and their picks have panned out well. In addition, Causeway has returned a strong third quarter, for the same reasons as TCW Value. Fixed income has trailed the benchmark a bit, but this has to do with the nature of the product and the longer bond durations in the porfolio. PIMCO posted an overall return of 8.11% year-to-date for our investment with them.

B. TSRS portfolio composition, transactions and individual investments

Allan Bentkowski reported the portfolio was valued at $625 million on 9/30/06, with all of the allocations inside our policy target ranges. A capital call from LaSalle for funding of $500k, bringing their total investment to date at $3 million, or 40% funded. As of 10/26/06, the fund hit an new high of $641 million. Equity markets continue their strong performance through October.

C. Pacific Investment Management Company (PIMCO) – Scott Roney, Ryan Korinke

1. Fixed Income Account
2. StocksPlus Account

1. Scott Roney thanked the Board for the opportunity to provide this year's annual report, noting that his colleague Bransby Whitton had been reassigned to Thailand. Bransby's replacement Ryan Korinke gave a report on PIMCO's recent performance for TSRS. The first two quarters of 2006 showed very weak performance, but the third quarter has rebounded extremely well with a year-to-date return up 100 basis points. In the economic forecast, the economy has slowed due to the housing slowdown. PIMCO's portfolio benchmark weights 70% mortgages, 15% high yield bonds and 15% in investment grade credit.

2. The StocksPlus portfolio employs an enhanced equity strategy investing in equity futures contracts. This approach has outperformed the S&P 500 by 40 basis points. Recent performance history of this strategy has struggled a bit because of the rate increases imposed by the Federal Reserve, and the bets PIMCO made that they would stop sooner. Nevertheless, this portfolio should be well positioned to recover now that the Fed has begun halting rate increases.

D. TSRS Actuary Report – Rick Roeder - Gabriel, Roeder, Smith & Associates

1. Results of Valuation Analysis for plan year ended June 30, 2006
   a. Normal Cost Considerations, Actuary's Review of Funding Assumptions
   b. Recommended contribution rate for plan year beginning July 1, 2007
2. 5 year forecast of retirement system funding requirements
3. Analysis of TSRS Unfunded Actuarial Accrued Liability
4. Actuarial Insights/comments/observations
   a. Benefit Increases
   b. Pension Protection Act
   c. Retiree medical / Other Post Employment Benefits
   d. Public sector valuations

Our system actuary Rick Roeder started his annual valuation report, indicating there is only a slight change to the recommended FY 08 funding rates of .17% (from 20.04% to 20.21%). Notably, our new rate will only increase slightly even with projected annual contributions decreasing due to the exodus of 250 library employees to the County. Other good news from this year's valuation is the plan's funded ratio increasing to 79.9% from 77.6% last year. Without our newest ad hoc COLA granted August 2006, the funded ratio would have been 80.1%. This is the third consecutive year in which the market based funded ratio has increased for our plan – and we are now into positive territory with our portfolio returns, because our four year smoothing has gone beyond the poor returns that resulted from FY 2001 and '02. There are $27.1 million in deferred gains, which may translate into somewhat lower contributions over the next several years, if nothing else changes.

Rob Van Den Brink asked Rick how funded ratios of other similarly sized pension funds compare to TSRS. Rick answered that it would be dangerous to compare our system to others simply based on funded ratios, because significant internal differences exist in many areas, such as plan demographics, age and maturity of the plan, as well as the plans actuarial methods and assumptions employed. Rick then mentioned that the End of Service Program could be a source of a slight actuarial loss if the average age and years of service from these new retirees are significantly different from what the plan has experienced from new retirees in the past.

Another point Rick discussed was the Non-Investment Net Cash Flow which is currently a minus $1,315,509. Negative cash flow is a symptom of the plan's maturity and will continue to grow as our fund matures further, i.e., as the ratio of pension recipients to plan participant's increases. Rick stated that less than seven years ago the City had two active employees for every retirant. Eight years ago, there were three active employees for every retirant. Rob asked Rick if the assumed inflation was in line with the CPI. Rick replied the assumed inflation rate was in line with the CPI.

Rick was asked to estimate how our funded ratio and liabilities have been affected by the ad hoc benefit increases that have been granted to our retirees during the past five years (note: there have been 14 ad hoc benefit increases granted during the past 20 years). The annual funding rate required from ad hoc benefit increases granted during only the past five years has been raised by .50% and the plans funded ratio has diminished by 1.1% as a result. Considering all impacts to the system for benefit changes to our system during the last seven years, the system has incurred an estimated increase 1.48% to the funding rate and a 3.3% lower funded ratio (includes two additional years of ad hoc benefit increases granted during 2001 and 2002, plus the enhancements made to retirement benefit calculations by including sick leave and by reducing the final average pay from 4 to 3 years). Rick remarked that there aren't many systems in the country that have automatic COLA increases, but those that have it, have been unable provide this type of increase for the past few years. Other systems based retirement benefit increases on an excess investments earnings pool, such as ASRS, which has been depleted and will not allow a resumption until the excess earnings pool is rebuilt. Mike Hermanson stated that ASRS has formally announced that their pension benefit increases will not resume for at least 3-4 more years as the fund will need to re-establish a pool of excess investment earnings to pay for future increases. In the meantime, member contribution rates have increased from 7.4% to 9.3% on July 1st, taking a bite of active member paychecks and employer sponsor budgets. Rick completed his presentation by stating that the TSRS ad hoc increases are more financially sound for the fund and it gives the Board more flexibility in managing the fund's liabilities.

Scott Douthitt **motioned** to accept the recommended actuarial funding rate of 20.21% for the fiscal year that begins on July 1, 2007, **seconded** by Cindy Bezaury. **Motion passed 7-0.**

E. JP Morgan – Joel Damon, J.D. Sitton, Larry Kohn
1. Strategic Property Fund
2. Income and Growth Fund

1. Joel Damon briefly overviewed the team members and their areas of expertise that are responsible for managing JP Morgan's Strategic Property Fund. Then he contacted J.D. Sitton to participate in this discussion via teleconference (arrival by air was cancelled due to weather). The current market value (for TSRS) of the Strategic Property Fund is $37.1 million. Since inception, this fund is doing well (average return of 12.5% gross of fees over 5 ¾ years). As a side-note, the Income & Growth Fund investment

for TSRS has a current market value of $9.1 million and the fund has returned **15.55**% (less than one year since TSRS invested in it). The targeted minimum performance for the Strategic Property Fund is NCREIF plus 100 basis points versus Income and Growth's target of 10-13% returns, net of fees. JP Morgan believes that the real estate in their portfolio is priced correctly relative to other assets in those market segments. Commercial real estate has done well, in addition to keeping pace with inflation, it has not been adversely affected by the residential market slow down.

There are four main segments of commercial real estate found in this fund: office buildings, apartments, retail and industrial buildings. This fund does not develop properties, but specializes in high quality real estate that is purchased or managed. The fund manager looks for physical structures with high quality physical improvement, prime location and high occupancy potential. Joel advised the Board that the manager of this portfolio is adjusting their leverage guidelines from 30% from 35% and the single property investment guideline 50% from 65%, offering further flexibility. Their target is NCREIF plus 100 basis points which they try to obtain through superior asset selection, active management and moderate use of debt. Annualized returns through September 30, 2006 have been realized in the amount of 6% from income streams and 11.2% from appreciation of the property itself.

2. Joel reported on the Income and Growth Fund. This fund invests in levered direct real estate, which is the same type of property in which the Strategic Property Fund invests. However, this fund can use more leverage than the Strategic Property Fund, up to 65% leverage. However, Income & Growth does other things to enhance the potential return and mitigate risk such as offering mezzanine loans, investments in high yield commercial mortgage backed securities and ability to invest in REIT's. Overall fund performance has exceeded the 10-13% return target with 15.8% year-to-date and 25% for a year over year period thru 8/31/06.

Chairman Bjorndahl thanked Joel and J.D. for their informative report. The meeting was then adjourned for lunch at 11:58 a.m.

F. JP Morgan – Infrastructure Investing (Investment Education) – Larry Kohn

Chairman Bjorndahl reconvened the meeting at 1:33 p.m. by welcoming Larry Kohn from JPMorgan to lead a discussion of Infrastructure Investing. Larry presented an interesting review of the skepticism and cynicism associated with infrastructure investments. During his discussion, he presented compelling examples of why this approach could be considered in a marketplace; where a single fallen tree recently caused First Energy to have an electrical blackout of the entire eastern coast for several days. He also discussed how an infrastructure investment was successfully utilized by the City of Chicago to grant price-setting autonomy to the private sector with authorized toll limits stipulated in the 99-year Skyway Concession agreement while obtaining a $1.83 billion concession price and operating risk assumption. Aging infrastructure and deferred maintenance across the continental US will continue to pressure the demand for the unique solutions provided with this investment which combines lower operating risks and inelastic demand. This type of investing typically uses TIPS + 300 basis points for their benchmark and is usually an open-ended investment with no performance fees and no fees on committed capital. Chairman Bjorndahl thanked Larry for his informative presentation, stating that he thought the Board might like to hear more information about infrastructure investments in the future.

G. Consent Agenda

1. Approval of September 28, 2006 TSRS Board meeting minutes
2. Service & Disability retirement facts and figures report for October 2006
3. June 30, 2006 TSRS Financials
4. End of Service Program – Review of Participant Statistics (as of October 26th)

Scott Douthitt **motioned, seconded** by Cindy Bezaury, to approve the consent agenda as presented. **Motioned passed 7-0.**

H. Disability Retirement Applications*

1. Linda Decker

Doris Rentschler review Ms. Dekker's application for the Board. Motions to move into executive session were made by John O'Hare**, seconded** by Scott Douthitt and affirmed by Board member vote. At the close of the Executive session, Scott Douthitt **motioned, seconded** by John Moore to return to regular session, which was unanimously affirmed by a Board member vote. Scott Douthitt **motioned, seconded** by Paul Miner to approve the Disability Retirement for Ms. Dekker. **Motion passed 6-1,** (Brian Bjorndahl voted nay).

I. Hewitt Associates – Hedge Funds (Investment Education) - Rob Van Den Brink

Rob Van Den Brink gave a presentation on the pros and cons of Hedge Funds. He explained that Hedge Funds can be almost any asset class, not just a few. They usually have ongoing management fees of at least 2% and an incentive fee of 20% of any profits over zero, making them quite expensive over what this Board would normally see. There are directional (participate when markets move), non-directional which are lower risk, equity long/short, equity long only, equity arbitrage, distressed debt and fixed income arbitrage types of hedge funds. Hewitt recommends a hedge fund that is a fund of funds type approach for hedge funds. John Moore asked Rob if smaller municipal pensions used hedge funds. Rob replied not usually, hedge funds are typically used by large endowment funds. Chairman Bjorndahl remarked that this is another subject he would like more education on and learn more about the different kinds of hedge fund to fund managers at some point in the future.

J. Nominations Committee / Election Report – John O'Hare - A chairman of the committee, John O'Hare reported that he has asked two people to serve on this committee, but he has not confirmed that both are willing to serve. He will report at the next meeting on who the members of the nominations committee will be.

K. Pension Software Update - Mike Hermanson reported that a contract with Gabriel Roeder and Smith had just been signed to development and implement a new pension administration software that will be used to eliminate our furrent software. A vendor has been identified and selected, Gabriel, Roeder, Smith. A gap analysis meeting will occur in November, 2006 and the entire process should take approximately 6-8 months with an initial cost of $190,000.

L. Highlights of Pension Protection Act of 2006 - Mike also provided some highlights of the Pension Protection Act of 2006, including a $3000 tax-free distributions for long-term healthcare insurance of Public Safety Officers, clarification of purchase of permissive service credit allowing "air-time" purchases, automatic enrollment will be allowed. EGTRRA provisions on the annual deferral limits and other rules have now been made permanent and rules affecting emergency hardship withdrawals for 457 plans have been amended to allow requests to benefit non-participant family members such as a grandchild, parent or domestic partner.

M. Securities Litigation Discussion - Scott Douthitt reported that the information contained in the Board packet was distributed for the purposes of information only. The information concerns a firm who specializes in software database services on litigation. They are class action lawsuit attorneys who are interested in working with the City of Tucson. Scott informed the Board that our custodial agreement with Mellon already provides processing services that include initiating class action lawsuits and remitting claim settlements to TSRS as part of their overall service agreement. No further action recommended.

N. Call to Audience - none heard.

O. Future Agenda Items – Additional Hedge Fund Education and Infrastructure Education, Post Retirement Benefits Committee Report

P. Adjournment - Marie Nemerguth **motioned, seconded** by Scott Douthitt to adjourn the meeting. **Motion passed 7-0.** Meeting adjourned at 4:06 p.m.

Approved:

Brian Bjorndahl, Chairman Date Michael A. Hermanson, Retirement Mgr. Date