TUCSON SUPPLEMENTAL RETIREMENT SYSTEM
BOARD OF TRUSTEES

Regular Meeting Minutes-Thursday, July 31st, 2014
Finance Department Conference Room, 5th floor East
City Hall, 255 West Alameda
Tucson, Arizona 85701

Members Present:	Robert Fleming, Chairman Karen Tenace, Elected Representative Eric Kay, Elected Representative John O'Hare, Elected Retiree Representative
Staff Present:	Amanda Celaya-Brown, Administrative Assistant Michael Hermanson, Pension Administrator Allan Bentkowski, Treasury Finance Manager Silvia Navarro, Treasury Administrator Michael Jesse, Lead Management Analyst Veronica Natividad, Executive Assistant
Absent/Excused:	Kevin Larson, CM Appointee Curry Hale, HR Director Kelly Gottschalk, Assistant City Manager Silvia Amparano, Director of Finance Dave Deibel, Deputy City Attorney

A. **Call to order**- Chairman Fleming called the meeting to order at 8:33AM.

B. **Consent Agenda**
1. Approval of June 26th Board Meeting Minutes
2. Retirement ratifications for the month of July 2014
3. TSRS Budget vs. Actual expenses June 30, 2014

Motion to approve Consent Agenda from June 26th Board Meeting passed 4-0 (Kevin Larson, Curry Hale, Silvia Amparano absent).

C. **Investment Activity Report**
1. Staff and Callan Associates Questions for BlackRock [1]
2. BlackRock Investment Manager Profile
3. Annual Investment Manager Review – BlackRock Value (Equity Account)
4. Annual Investment Manager Review – BlackRock US Debt (Fixed Income Account)

On conference call: Roshani Pandey with BlackRock and Gordon Weightman with Callan Associates.

1. *What is the methodology used to track the index for both strategies, is it full replication, stratified sampling, or some other portfolio management strategy?*
   - For the Russell 1000 Value Index fund, the methodology is full replication of the index.
   - BlackRock's US Debt index fund investment process does not attempt to explicitly match the benchmark's *average* statistics - rather it matches the *distribution* of its statistics. By matching the distribution of each statistic, we ensure that portfolio performance will track the index regardless of how the relationships among the various factors change. If the distribution of each benchmark statistic is correctly replicated, by definition the *average* of that statistic will also be correctly replicated. In this sense, the funds' *average* characteristics serve as control checks on the quality of our portfolio construction process. In short, our sampling approach gives us confidence that our funds will tightly replicate their indices under varying market conditions. The stratified sampling process is used to construct the majority of index fixed income portfolios. This is essentially a top-down disaggregation of the custom benchmark index into smaller units or cells. The risk dimensions used to disaggregate an index vary by sector. For example, the key dimensions used to create the cells in credit funds are sector, maturity, quality, and

optionality - the key risk characteristics of each bond in the credit index. This process divides the index into numerous small cells, each of which represents a "sub-index." When completed, all bonds in the index will have been assigned a cell and all bonds within a cell will have similar characteristics. Next, we begin to construct the portfolio by selecting representative bonds from each cells. We ensure that each cell's weight (market value) and duration in our portfolio match the respective weight and duration in the index. Finally, we require that each cell in the portfolio be well diversified in terms of issuer.

2. *What is the targeted tracking error for each portfolio and what was it as of 6/30/14 (please define tracking error for the benefit of Board members who may not be familiar)?*
    - The predicted tracking error for the Russell 1000 Value index fund is 0-5 bps
    - The expected tracking error for the US Debt index is 5bps over a full investment cycle
    - Tracking error is a measure of how closely a portfolio follows the index to which it is benchmarked. For an index fund, tracking error is typically pretty low.

3. *Please describe securities lending and BlackRock's process to lend securities. How is the collateral invested? From a return perspective has securities lending benefited the portfolios?*

Here are the securities lending processes:

- A large financial institution asks to borrow a stock or bond from a fund or account. The fund or account asks for cash collateral to secure the loan.
- Once it receives collateral, the fund or account lends the stock or bond to the financial institution (the borrower).
- The fund or account invests cash collateral in low-risk, short-term investment funds, which generates a return to satisfy rebates due to the borrower and generate incremental return to the fund or account.
- The fund or account receives the economic equivalent, paid by the borrower, of any dividends while securities are on loan.
- At the end of the loan (or when the fund or account requests), the borrower must return the security.
- The fund or account then releases the collateral back to the borrower to close out the process.
- By lending securities, the fund or account generates additional income for fund or account investors.
- Securities lending has produced returns for both the index funds that Tucson Supplemental Retirement System is invested in.

4. *Annually, Russell reconstitutes their indices, which may result in securities being added or removed from a particular index. For the Russell 1000 Value index fund, please address how BlackRock buys and sells stocks around the reconstitution date. Do you focus on minimizing tracking error, or do you use the rebalancing event as an opportunity to marginally enhance the index fund's pre-fee return?*

When trading index changes for our funds, we have a number of objectives including:

- Remaining within tracking risk tolerance levels;
- Minimizing pricing distortions around the index change point; and
- Adding value to funds.

These objectives are potentially conflicting; for instance, selling index deletions early might maximize the potential for adding value, but unexpected relative price movements could lead to an unacceptable level of risk and potentially underperformance.

As we are managing index and not active funds, the first two objectives must take precedence. When handling major index changes, our index equity strategy and portfolio management teams employ a number of techniques based on in-depth research and analysis of each security and the behavior of similar changes in the past.

Our research into major index rebalances involves additions and deletions to the benchmark and begins sometime ahead of the announcement by the index provider. At this point, BlackRock looks to identify the stocks most likely to enter/exit the index as part of the review. This enables us to search for potential trading issues as early as possible and carefully monitor the liquidity and price movements of the stocks. In formulating a trading strategy, we consider the extent to which supply of stock will meet demand from all indexers. As with all trades of this nature, we weigh up the potential absolute price impact of trading around the index close against the risk of trading away from the benchmark. We monitor trading conditions - particularly liquidity and volatility - in the affected stocks, several days or weeks ahead of the date on which the change occurs. This analysis is combined with the risk/return profile of each fund to develop trading strategies for all affected portfolios. Our trading strategies are structured so that we access the optimal points of liquidity and can exploit any opportunity to add value.

5. *On June 25, 2014, the Securities and Exchange Commission (SEC) announced rule changes for money market funds to be effective in approximately two years. How do you expect the SEC's rule change to affect cash management within the two index accounts?*

The securities lending cash collateral for our collective trust funds is reinvested in OCC-regulated STIFs (short-term investment funds) and not in SEC-registered money market mutual funds. As such, the reforms to the SEC's rule 2a-7 and money market mutual funds do not have a direct impact on these funds.

5. TSRS Portfolio composition, transactions and performance review

Allan Bentkowski reported the composition allocations compared with policy levels as of June 30, 2014. Total Fund Net Asset Value balance is $733.3M. We hit the all-time historical high on the last day of the fiscal year. It compares with the low of 644.2M which we hit on July 2nd of 2013. These values indicate the portfolio has steadily increased almost the entire fiscal year.

Value at 6/30/13: $638.3M, an increase of $95 million during the fiscal year. Total cash transfers out for retirement benefits: $24.9M for an average of $2,075,000/month. All managers and asset classes are within asset allocation policy ranges as of 6/30/14. For the month of June, the Total Fund returned 1.8% vs. 1.51% for the Custom Plan Index.

Calendar YTD – (through June 30, 2014) Total Fund Returned 5.65% vs. 5.49% for Custom Plan Index. Total Fixed Income returned 5.47% vs. 3.92% for the Barclays Aggregate benchmark. Total Equities returned 5.52% vs. 6.52% for the Equity Composite Benchmark. Real Estate returned 5.31% (NCREIF-ODCE benchmark not available yet for 6/30). Total Infrastructure returned 8.79% vs. 4.29% for the CPI+4% benchmark.

Fiscal YTD – (through June 30, 2014) For the fiscal year that ended 6/30/14, the Total Fund returned 19.07% net of fees vs. 16.71% for the Custom Plan Index. Fixed income returned 7.27% vs. 4.38% for the Barclays Aggregate benchmark. During the fiscal year, all equity managers performed exceedingly well on an absolute basis, however, 4 of 8 managers failed to beat their respective benchmarks. For the fiscal year, Total Equities returned 24.93% vs. 24.55% for the Equity Composite Index. T. Rowe Price (large cap, U.S. Equity) lead the way with a return of 32.03% vs. 26.93% for the Russell 1000 Growth Benchmark Index. Total Real Estate returned 12.03% vs. the latest comparison for the NCREIF-ODCE Index of 9.48% as of 3/31/14 (June 30, 2014 benchmark not posted yet). Total Infrastructure returned 15.34% vs. 6.15% for the CPI+4% benchmark.

D. Administrative Discussions

1. TSRS Staffing Issues

Michael Hermanson, Plan Administrator, addressed the board to inform them of staffing issues affecting the Plan's ability to retain qualified retirement office staff. Recently, our lead analyst Michael Jesse accepted an offer from the City's PSPRS office for additional pay. The loss of a fully trained analyst experienced with our pension system and the City's payroll system will require additional effort from remaining staff to carry out that position's functions and may take as long as 18 months to hire and train a replacement.

This makes the second time in the past 3 years the retirement office has lost experienced staff to an agency within our own organization because they offered higher pay than we are authorized to offer. Mike Hermanson explained that both members of the retirement office staff were hired because they possessed prior experience in Defined Benefit and Defined Contribution plan administration and had additional skills relevant to retirement plan administration. For example, when Michael Jesse was hired 5 years ago, he was the only candidate meeting all criteria and was offered pay consistent with the City's pay practices. Meanwhile, the City's compensation policy lags average pay in this particular industry, coupled with the absence of merit pay increase for the past 6 years and mandated furlough hours, we are seeing the impact of that on staff. Without authorization to adjust our pay levels to match them to a comparable level of pay being offered by other employers in this industry, it will be very difficult to attract any candidates with similar levels of skill and experience. In short, we have two significant obstacles to clear; appropriate pay levels for staff and the probability there is only a narrow pool of candidates that will be hard to locate.

It will take approximately 4-6 months to solicit, interview and hire a replacement for the Lead Analyst position. Mr. Hermanson stated, based on past experience, hiring efforts will need to go beyond the local Tucson geographical area to be noticed by a candidate with relevant experience. Board Member, John O'Hare, asks if we can keep this as an item in the coming months to keep the board updated on what needs to be done.

Mr. Hermanson states his first objective is establishing what the pay range should be to post an advertisement for the Lead Analyst position, and determine what the pay range should be for all other staff levels, so that we know where things stand. Mike asks the Board for direction or if they might support establishing a sub-committee task force to oversee the operation of approving or proposing a higher range in pay. Allan Bentkowski asked Mr. Hermanson if it might be better to pursue a third party Market Value Compensation Study. Mike indicated that involving the services of a compensation consultant with a narrow focused on positions found in the Retirement office would certainly provide an independent determination of what the market values of these positions are and he would welcome the opportunity to hire a consultant. Mike also indicated he had contacted a compensation consulting firm to ask them for a ballpark fee quote, but they had not provided this information as of the time of today's Board meeting.

Mr. O'Hare asks if we have reached out to PSPRS in Phoenix to compare what they are paying staff. Mr. Hermanson stated that it is well known what that office pays their administrator, but that is only part of the equation, we need to know what comparable staff positions are paid.

Chairman Fleming asks that by next month's meeting, Mr. Hermanson can present at least 3 or 4 informal assessments of likely candidates such as ASRS and the Phoenix Retirement office and also a price for the cost of a market study. He further asked if the City would allow a study to be considered, first; or if these efforts would not matter to the City and make any difference. Mr. Hermanson explains that the City's pay increase practices for staff already hired are difficult to change; typically requiring a reclassification request which would take an extended period of time, and may not help changing the pay range set for an offer to solicit for the Lead Analyst position.

Mike also mentioned that the Board approves the TSRS administrative expense budget, and the Board should be aware that this issue may impact the current year's Budget require the Board's approval to change. Karen Tenace points out that Mr. Jesse's current position is a civil service position within the compensation program with the City as opposed to PSPRS, which are appointed positions that fall outside of the civil service rules. That gives PSPRS more flexibility on salary ranges when making job offers.

E. **Call to Audience – None heard**

F. **Future Agenda Items**
   1. Philosophy of contribution rates discussion – Board retreat item

G. **Adjournment – Chairman adjourned meeting at 9:26AM.**

Approved:

Robert Fleming — Date
Chairman of the Board

Michael Hermanson — Date: 9-10-15
Plan Administrator