TUCSON SUPPLEMENTAL RETIREMENT SYSTEM
BOARD OF TRUSTEES

Regular Meeting Minutes-Thursday, February 27th, 2014
Finance Department Conference Room, 5th floor East
City Hall, 255 West Alameda
Tucson, Arizona 85701

Members Present: John O'Hare, Elected Retiree Representative
Silvia Amparano, Director of Finance (late)
Karen Tenace, Elected Representative
Eric Kay, Elected Representative
Lani Simmons, Human Resources Director
Kevin Larson, CM appointee

Staff Present: Melissa Waychoff, Administrative Assistant
Michael Hermanson, Pension Administrator
Silvia Navarro, Treasury Administrator
Michael Jesse, Lead Management Analyst
Dave Deibel, Deputy City Attorney
Allan Bentkowski, Treasury Finance Manager
Kelly Gottschalk, Assistant City Manager

Guests Present: Jenefer Carlin, Retiree Representative
Reed Palmer, Retiree
Leslie Thompson, GRS Actuary
Ed Hubert, Independent Audit & Performance Commission
Gordon Weightman, Callan Associates
Paul Erlendson, Callan Associates

Absent/Excused: Robert Fleming, Chairman

A. Call to order – Acting Chair Karen Tenace called the meeting to order at 8:30AM.

B. **Consent Agenda**
1. Approval of January 30th Board Meeting Minutes
2. Retirement ratifications for the month of January 2014
3. January 2014 TSRS expenses

Motion to approve consent agenda **made by John O'Hare, 2nd by Eric Kay,** motion approved 5-0 (Chairman Fleming absent, Silvia Amparano late).

C. **Investment Activity Report**
1. Asset Liability Study Discussion – Callan Associates

Michael Hermanson reviewed the Actuary's responses to the Board's follow-up questions posed during last month's discussion of the Actuarial Experience (Draft). Implementing the Actuary's proposed changes to the Draft report for updating the salary scale by eliminating any productivity related increases, and decreasing the expected merit rates and promotion by another 25 basis points has the following effects on the plan's calculated contributions (CC):

Discount Rate	Total CC%	Blended EE Rate	Net Employer Rate	Total CC (in dollars)
7.75% (current)	31.52%	5.07%	26.45%	$41.48
7.50%	33.05%	5.14%	27.91%	$43.48
7.25%	34.62%	5.23%	29.39%	$45.55

In summary, every quarter point change to the Plan's earnings or discount rate adds about $2 million to the calculated contributions, or about 1.5% of payroll. Implementing every recommended change will move the Plan's unfunded liability from $348.23M to $396.99M. The main recommendation from the study indicates a reduction to the plan's earnings rate by .50%, moving it from 7.75% to 7.25%, accounting for $43M in unfunded liability, or if it's reduced to 7.50%, unfunded liabilities rise by $28M. However, Callan Associates is conducting their asset liability study and weigh in on the question of what our investment return should be, based on analysis of the Plan's investment policy. Callan's review of this study is scheduled to be presented on June 5th.

Next, Callan began discussions about the asset liability study they will be conducting in the coming months, beginning with observations on our current investment policy: 61% of asset allocations are to equities, 8% Real Estate, 5% Infrastructure and 26% fixed income. The actuary is recommending a reduction in the rate, but history indicates that 7.75% has been achievable. That said; Paul indicated there are very few government pension plans with an investment policy showing more in equities than TSRS. Over the last 5 years, TSRS has posted a compound investment return of 13.4% (gross of fees), with a relatively risky allocation to equities. John O'Hare thinks we should be looking at a longer range for averages of returns since the average person is in the pension fund for 20 years active and 20 years retired, maybe we should be looking at a 40 year average. Paul Erlendson responded the effective timeline in theory is when an employee first contributes to the fund until that person passes away. But realistically, a shorter period is used because policies of running investments should be shorter duration, for example, only 10 years. The real time horizon is a critical decision. An investment policy can be in place only for so long without recognizing changes in the financial markets, certainly not 40 years.

An asset-liability study evaluates the actuarial assumption for investment returns. A lower return assumption means less risk, but it will raise the unfunded amount. A lower return assumption is a priority in the long-term, but the unfunded liability is a priority in the short-term. Kevin Larson would like to know the implication of having a larger unfunded liability from the City's perspective. Michael Hermanson responded that our Bond underwriters are acknowledging they are aware that this is likely to happen, but the basic issue is, it will drive up our calculated contribution rates. Kevin Larson believes it is okay if the City contributes more, because we do not get sufficient funding to cover the unfunded liability over time and that is one reason why the Board accepts higher risks with so much invested in Equities.

Paul Erlendson indicated, in pension math, benefits payments plus expenses must equal contributions plus investment returns. If the benefit payments in the future are higher than expected and the plan needs more contributions or investment returns, that means the plan is taking on more risk. However, the investment return assumptions need to match up with the real experience of the plan. The plan needs to meet fiduciary requirements to demonstrate a prudent process when selecting or changing an investment strategy. The median return is only a mid-point. Callan will look at outcomes around the median. One possible outcome could be confirming our current policy is as good as it can be.

Karen Tenace stated it sounds like we are an outlier as far as the amount of risk the fund is taking on given that only 16% of other plans have higher investments in Equities. Karen added it is not our fiduciary role to look at the City's liabilities; it is to look at a realistic return and meet the obligations in a sustainable fashion. Karen wonders if it is an ideal time to lower the risk of return because of the deferred gains we currently have; this might be a short window of opportunity. Allan Bentkowski reminded that Board also have to be mindful of liquidity issues, since the Plan pays out more in benefits than collects in contributions.

Capital market projections are updated every year with a ten year forward look and the most important thing is that entry point matters. Fixed income yields are very low at this time. Callan stated we need to accommodate where we are, starting with these projections. In terms of new asset class options to improve the investment returns for the plan, alternatives involve anything other than the liquid markets and are higher manager skill oriented and typically private and possibly more risky. If alternatives do make sense, we need to look at what kind of alternatives they are. Asset allocation has subcategories and some classes are not highly correlated to one another. Fixed income return assumptions have been raised compared to a year ago, real estate returns have been reduced, domestic equity is 7.6% and Nondomestic is 7.8%, and hedge funds are at a return of about 5%. We are assuming inflation at 2.25%, which is less than the actuarial assumption.

Callan needs to know if there are any asset classes the Board would not want to use. If a new asset class is added, there needs to be a meaningful exposure to an asset class in order to make using it worthwhile. Kevin Larson would be willing to put more in Emerging Markets for Equities. There are very few single asset classes that get to 7.75%, so it would be difficult to get there on a median case and the probability of achieving it would be less than 50%. The ones that do get to 7.75% have some liquidity issues. The current cash flow out of the investment portfolio pays out about $2M per month to meet requirements for retiree benefit payments. Kevin Larson is not a fan of private equity or hedge funds. John O'Hare asked if Callan ever goes back to see what Callan's record is for projecting 10 year allocations, for example 1998 or 1999's projections for predicting what happened in the following decade. John O'Hare requested Callan send the record to Board staff so that he can review it.

The probability of achieving a 7.75% return is about 48% over one year, which is not inconceivable. Every asset class lost money in 2008 and 2009 except for Treasuries. The probability of achieving 7.75% over a 10 year period is about 41%. Anytime there is a bad outcome, you need a much higher rate of return just to get back to your starting point. Asset classes typically used are Capital Accumulation, Diversification/Expand Opportunity Set, Lower Volatility, Flight to Quality, Alpha Generation, and Inflation Hedge. Best option is to achieve target rate of return and minimize risk in liability. Callan stated that investing in Private Equities has some things to overcome, such as fees. Callan would like to come back May 29th with the final study. Michael Hermanson stated the May meeting will need to be pushed to June 5 to accommodate schedules for all staff/board members that should be in attendance.

2. 12/31/13 Investment Performance – Executive Summary Review – Callan Associates

4th Quarter Market Review - Fundamentals have been improving in the U.S economy. Inflation does not seem to be much of a threat in the short-term, but longer-term projections are uncertain. There needs to be more jobs and wage growth for inflation to heat up. Unemployment has been falling due to job gains exceeding 100,000 over the last three years, but this may be misleading since we know some people have just quit looking for a job, which reduces the labor force participation rate. If labor force participation was 66%, unemployment would be 14%. But the labor force participation rate is 62.8%, so unemployment *appears* to have decreased to 6.5%. An unemployment rate 62.8% may not be the best time to start quantitative easing.

Developed Equity markets are performing well, but currency exchanges added some headwind as the Yuan depreciates against the U.S. Dollar. Emerging markets are a country by country decision. The fragile five (Brazil, India, Indonesia, South Africa and Turkey), are countries with deficits and their currencies have been depreciating. Riskier assets have continued to perform well. Equities have performed well with the exception of Emerging Markets and bonds have had positive outcomes. March 2009 was the market bottom and Equities have run up since then, but are still fairly valued despite the run up in 2013. Non-U.S. Equities have trailed U.S. Equities, but Europe did have a strong quarter. In the midst of strong overseas equity markets, emerging markets fell 2.3% for all of 2013. Gold and commodities fell. Telecom was up in this quarter. The Treasury yield curve shifted up, which hurt returns, especially for bonds with longer maturities. 10-year Treasury yield increased 40 basis points from last quarter ending at 3.04%. The Aggregate was down 14 basis points while some of the riskier assets had positive returns.

The Fed reiterated its intention to maintain a zero interest rate policy for the immediate future and is expected to continue easy monetary policy at least in the short-term. A rise in domestic equities means the stock market is no longer cheap. While volatile, consumer sentiment is on an upward trend since 2008.

Investment Measurement Service Quarterly Review
The CEO and co-CIO Mohamed A. El-Erian is leaving PIMCO in mid-March. This will have no direct affect on the management of our PIMCO accounts. Aberdeen is very close to meeting the Watchlist criteria for the One-year provision, but does not quite qualify. As of 12/31/13, the one year return for the

portfolio was 9.79% vs. 15.29%. LaSalle does meet the criteria for the Watchlist on the Three-year provision.

Fixed Income was 4% underweight, which is beneficial. Technically the plan is within all allowable ranges in the policy. Fixed Income is close to median. The U.S is 75% and 25% Non-U.S. and that indicates a home country bias. The globe is closer to a 50-50 split. There was $26M increase in the plan assets, $44M in investment return, and outflows were about $8.1M. T. Rowe Price has really been getting it right; they are 2% above the benchmark before fees on an annualized basis. Aberdeen is a manager to be concerned about. They try to pick high quality stocks at reasonable prices and have the ability to invest in Emerging markets and the plan has had money with them for six quarters. During this period, their performance has been down and it was 5.49% below the benchmark over the last year. Callan believes in their process and would argue they are still a qualified manager; just that they have disappointing investment results. Six quarters is not a long enough period to consider, so probably another 6 quarters would be a sufficient time period to consider letting this manager go (if their performance continues to lag). Callan will definitely let the Board know if they believe it is time to let this manager go.

3. TSRS Portfolio composition, transactions and performance review

In the month of January, a total of $1.8M was transferred out from T. Rowe Price into the pooled account to pay retiree benefits. The total value of assets in the portfolio was $690.4M for January compared to $705.8M for December. As of 2/26, the value is back up to $705.1M. For January CYTD, Total Fixed Income was positive, but slightly underperformed the benchmark and you can see all the negatives on the Equity side due to the Fed's taper talk. Total fund return was -1.92% vs. -1.73% for the total benchmark.

Fiscal Year to Date:

The Total Fund return was 10.54% vs. Custom Plan Index at 8.72%; Six of eight managers were above or at benchmarks. Aberdeen was 2.67% vs. MSCI All Country at 10.1%; T. Rowe Price was 26.4% vs. the Russell 1000 Growth at15.99%; Total Equities returned 14.41% vs. 12.95% for the Equity Composite; Total Real Estate returned 7.58% vs. 6.84% for the NCREIF-ODCE (through 12/31/13); Total Infrastructure was 4.69% vs. 2.49% for CPI+4% benchmark. During the past 10 plus years to date, from FY2004-2014 a total of $180M has been moved out of the portfolio to meet the retiree payment requirements.

D. **Administrative Discussions**

1. Updated Actuarial Projections from Historical Experience Study
2. Review and approval of FY15 TSRS Budget

Mike Hermanson asked the Board to approve the FY15 budget, emphasizing that the real decisions here are about the administrative expenses, which are lower by about $1,000 for FY15. **Motion to approve** FY15 TSRS Budget made by Kevin Larson, **2nd by Acting Chair Karen Tenace, motion approved 6-0 (Chairman Fleming absent).**

3. Review and approval of the 2013 Summary of Major TSRS Board Actions

This is a summary of what the Board did and this is a first draft of the actions. Kevin Larson thinks the summary looks good. Michael Hermanson would like to field any recommended changes over the next few days and incorporate this summary in the retiree quarterly mailing as well as provide this in the annual contribution summary mailed out in March and post this to the TSRS web site.

4. 2014 TSRS Board meetings – projected schedule of events

The investment manager review for Pyramis and Causeway are coming up in March. Michael Hermanson would like to still hold the May 29 Board Meeting to ratify the retirements and consent agenda, but move the rest of the meeting to June 5. There are scheduling conflicts with Board and staff availability and since this is an important meeting, all Board members should be present. The Board agreed to the June 5 meeting.

5. Briefing on Fields Case - Arizona Supreme Court Decision

Dave Deibel stated this was a good case. It is consistent with Cassie Langford's advice over the last few years. The Employers participating in PSPRS will see an increase to contribution rates in FY16 to replenish the trust fund and the pay back benefits owed to retirees.

E. **Articles for Board Member Education / Discussion**
   1. Arizona's Pensions: On Track to Financial Sustainability with Retirement Security (Grand Canyon Institute Policy Paper Jan. 27, 2014)
   2. Arizona Supreme Court ruling; Fields vs. Elected Officials Retirement Plan and it's Board of Trustees (Feb. 20, 2014 – Arizona Supreme Court)

F. **Call to Audience** – Reed Palmer asked if there was a group fighting against this amendment and Dave Deibel was not aware of any.

G. **Future Agenda Items**
   1. 3/27/2014 meeting: Investment Manager Reviews for Pyramis & Causeway
   2. Philosophy of contribution rates discussion – Board retreat item
   3. Actuarial Historical Experience Study & Asset Liability Study Results – May meeting
   4. Update on posting Board materials accessible via web and an update on the ESS system

H. **Adjournment – Motion to adjourn made by Kevin Larson, 2nd by John O'Hare, motion approved 6-0.**

Approved:

[signature]	3/28/14	[signature]	03-27-14
Robert Fleming Chairman of the Board	Date	Michael Hermanson Plan Administrator	Date