TUCSON SUPPLEMENTAL RETIREMENT SYSTEM
BOARD OF TRUSTEES

Board Retreat Meeting Minutes – Thursday, November 7th, 2013
Arizona Inn (Safari Room) – 2200 East Elm Street, Tucson, AZ

Members Present:	Robert Fleming Chairman Lani Simmons, Human Resources Director John O'Hare, Elected Retiree Representative Karen Tenace, Elected Representative Silvia Amparano, Finance Director Kevin Larson, CM appointee Eric Kay, Elected Representative
Staff Present:	Michael Hermanson, Plan Administrator Allan Bentkowski, Treasury Finance Manager Silvia Navarro, Treasury Administrator Kelly Gottschalk, Assistant City Manager Michael Jesse, Lead Management Analyst Melissa Waychoff, Administrative Assistant Brandy Kadous, Human Resources Manager
Guests:	Jenefer Carlin, Retiree Representative Jean Wilkins, Retiree Representative Mariko Boswell, PIMCO Sasha Talcott, PIMCO Richard Fulford, PIMCO Cassie Langford, Yoder & Langford Leslie Thompson, Gabriel Roeder Smith & Co. Gordon Weightman, Callan Associates Paul Erlendson, Callan Associates Bill Davis, Piper Jaffray Max Rodriguez, J.P. Morgan John Faust, J.P. Morgan Lee Palmer, Retiree Cindy Jansen, Retiree

Call to order at 8:28AM by Chairman Fleming.

Introductions and Welcome to new TSRS Board Member Eric Kay
Eric Kay will be voting as a Board member and Brandy Kadous is here to provide his observations as a former Board member.

1) Consent Agenda – Approval of October 25, 2013 TSRS Meeting Minutes
Motion to approve consent agenda made by John O'Hare, 2nd by Silvia Amparano, motion approved 7-0.

2) Actuary Valuation Report for June 30, 2013 – Gabriel Roeder Smith & Assoc., - Leslie Thompson

a. June 30, 2013 TSRS valuation report and discussion
b. Cash flow discussion, policy recommendations for improving the Plan's funded ratio
c. Discussion of contribution rates, funding policy for plan year beginning July 1, 2015

The discussion of these 3 agenda sections were combined - Michael Hermanson wanted to kick this discussion off by making a few observations from this year's actuarial report and set the stage for some of the decisions that need to be considered by the Board. First, board members should note that the 6/30/2013 valuation report indicates the TSRS funded ratio has slowed its downward descent, this the actuarial funded ratio moved slightly from 63.5% to 63.3%; almost flat. As a result, the recommended contribution rates for FY15 are changing only slightly, by 6-8 basis points – so that's good news. More good news – the valuation shows a deferred gain of $40.7 million due to the plan's five year smoothing assumption. Mike sees this as evidence that the plan's funding policy recommendations implemented in prior year are starting to add stability and provides the Board with a rare opportunity; to recommend aggressive action to improve the plan's funded ratio. In years past, the TSRS Board has worked hard to adopt prudent investment policy changes; implement sustainable benefit plan designs (Tier II in 2011) and adopt sound contribution funding policies for both employees and the employer. The rare opportunity facing this Board is to articulate a funding policy designed to improve the plan's funded ratio quicker and improve the plan's health. We have a concept for consideration; and the Board will be asked to recommend a policy that will sets the stage to put the plan in a better position to accelerate paying down unfunded liabilities and make future contribution rates more stable and predictable.

Leslie Thompson: TSRS has three tiers of membership, determined by their date of hire; members hired prior to July 1, 2006 have a fixed contribution rate of 5%; Tier I members hired after June 30, 2006 and Tier II members, who were hired after June 30, 2011 have variable contribution rates subject to annual adjustment. Recall that members hired prior to July 1, 2006 have a fixed contribution rate because outside legal counsel has indicated member contribution rates cannot be increased and would be considered as an impairment to the agreement under which these employees were hired, in direct conflict with protections offered under the Arizona State Constitution. Beginning with members hired after July 1, 2006, member contribution rates are re-set annually.

Leslie indicated the TSRS valuation shows recommended FY15 contribution rates for Tier I at 6.67%, down from 6.72% for FY14, Tier II at 5.14%, up from 5.06% for FY14. Blending the employee contribution rate across all Tiers for FY15 gives a rate of 5.27% and for the employer, it is 26.95% for a total ARC rate of 32.22%.

However, as Mike alluded to previously, a recommendation that would fund a little more than minimum requirements would put accelerate paying down liabilities, and Leslie concurs with a staff recommendation to consider an administrative policy using a "rounding-up" approach to accompany contribution rate recommendations for FY15. The employee approach recommends variable employee rates indicated in the annual valuation be rounded up to the next higher 25 basis point value. For example, Tier I variable member rate would be 6.75% and Tier II would be 5.25%. The round-up approach to the Employer rate should use a higher round-up value to make it meaningful (since the ratio of employer contributions is much higher), so a round-up moves it to the next higher 50 point value, pushes it to 27.50%. Articulating this policy will need to indicate a consistent approach.

(Note: a form of this strategy was stated earlier this year when the TSRS Board recommended funding policies that were adopted by Mayor and Council effective July 1, 2013. The communication to Mayor and Council actually stated "staff and the actuary were evaluating strategies to improve the Plan for the benefit of current and future members"; at the time, the Board was considering a level funding approach. This funding policy to round-up recommended contribution rates follows through on the promise we had in mind).

From today's discussion, the tone of the rounding up policy will benefit the plan in many different ways: it sends a message to the Public that the City wants to protect benefits promised by improving the funding of the plan; the argument that the City is underfunding will be eliminated; it offers visible assurance to members that the City is interested in offering more stability that will minimize annual rate changes ; it provides a method for employees to have skin in the game and participate in protecting the plan, and would have only a minimal effect on their paycheck (A 25 basis point increase on a $50K salary would be approx. $125/yr or $4.80/pay period). If employee rates from the June 30, 2014 valuation change by less than 13 basis points for employees, or less than 26 basis points for the blended employer rate, no change to thee rate would occur.

Kelly Gottschalk thinks this might be a good idea, but she would like to understand how the funding strategy to increase Employer contributions would impact budget planning. Mike indicated he had calculated that an increase of a full 1% to the City contribution rate using FY13 salary levels would add $1.25M to the FY15 budget, but this round up recommendation only changes ER rates by about half of that, or around $5-600,000.

<u>Review of statistics from the 6/30/2013 valuation</u>: the City contribution rate has decreased from FY13 at 30.03% to 27.09%; the blended rate for FY15 is 26.95%. The amortization period was increased from 15 to 20 years and that is how contribution rates were reduced. The TSRS accrued liability increased from $941M to $949M. The aggregate normal cost for the plan is 12.08% and the ARC based on percent of pay is 32.22%, down from 32.32%. Payroll increased from $125M to $126M. Tier I and Old Hire Tiers can only shrink and Tier II can only grow.

In 2013 the Market Value of Assets was $641,046 versus the Actuarial Value of Assets of $600,330 and that's good news because we have a $40 million deferred gain. However, asset returns are smoothed to keep the contribution rates from large swings from one year to the next.

It is always important to do an experience study because we want assumptions to stay as current as possible. This will help normal costs and employee contribution rates to be stable. There has been no salary increase so it shows as a gain. The blended normal cost will be coming down over time. The plan is becoming heavy; retirees are now 64% of the total accrued liabilities, 10 years ago it was only 46%. Light discussion of amortization periods, private industry amortizes over 30 years, but in the corporate world a health funding ratio target is considered to be 80%, but public plans are different. Karen Tenace thinks the chart (TSRS Historical and Projected Funding Results) on page 43 is great to hang onto for moving forward and making policy decisions. The chart on page 40 shows there are enough assets in the plan to cover 100% of contribution refunds to employees and 75% of retiree payments and 0% of future retirement benefits.

d. Acceptance of valuation report, adoption of funding policies, adoption of FY15 contribution rates

Michael Hermanson would like the Board to consider adopting the rates on page 8. Old Hire Tier is set at 5% no matter what. Tier I will be 6.67% for FY15 and Tier II will be 5.14% for FY15. The blended contribution rate for FY 15 is 5.27%. Leslie Thompsen recommends a rounding up policy of 25 basis points for member contributions. That would make Tier I at 6.75% and Tier II would be at 5.25%. Michael Hermanson is recommending the City contribution rate go up 50 basis points to 27.5%. Kelly Gottschalk stated it will be a challenge to ask the City contribute more than is required. **Motion to adopt funding policies (including the employee increase by 25 basis points) and FY15 contribution rates made by John O'Hare, 2nd by Kelly Gottschalk, motion approved 7-0.**

3) PIMCO – Rick Fulford, Mariko Boswell, Sasha Talcott
- **Annual Investment Manager Review for StocksPlus, Custom Fixed Income Fund**

<u>Diversified Income Portfolio:</u> This diversified income strategy targets 100-150 basis points of alpha over the index. It has been a volatile year and a dominant driver has been the Fed's QE policies. One of the key events that caused the volatility was an indication that the Fed was going to pull back or taper. They are still purchasing, but purchasing less which does still add liquidity to the market. Retail oriented investors absolutely reacted to the Fed, but institutional oriented investors (such as us); it was still business as usual. On September 18, 2013 the Feds surprised the markets by deciding not to taper. Treasury yields continue to rise on uncertainty over the Fed's potential for tapering quantitative easing policy.

This strategy has outperformed the benchmark by about 1% with absolute returns at 6.6%; returning 6.9% average since inception outperforming the benchmark by 75 basis points. At this time, the investment is overweight in Investment Grade, underweight in High Yield, and underweight Emerging Markets, yield of 5.23% vs. the benchmark at 4.93%. The Fed is not expected to raise the base rate until 2016. This means longer end yields could increase, but the front end could stay where it is.

<u>Equity Portfolio (StocksPLUS):</u> This portfolio reduces risk and favors high quality sources of income. YTD returns of 21.8% vs. 19.8% for the benchmark. This portfolio is conservatively positioned and structured to be cognizant of what the Fed is doing. Interest rate risk has come down during the year, which is less risk than you would expect for the amount of return received. There is a diversification in the structure of the mandate. The yield on this portfolio is 2.25%. Buy and hold stock index futures and/or swaps to provide stock market exposure. The portfolio attempts to enhance returns with active management of risk-managed fixed income portfolio backing the equity index derivatives. The portfolio has structurally based excess return potential and potentially noteworthy

diversification benefits. This portfolio is flexible to adapt to different portfolio needs. The portfolio has one source of alpha (actively managed fixed income value add versus money market rate) and a second source can be added (enhanced RAFI value add versus cap weighting).

- **Current Economic Overview and Forecast**

Current Overview: The fixed income landscape is changing. Core bond portfolios are unlikely to deliver historic characteristics and returns requiring investors to adopt a more tactical "unconstrained" approach. There is a very strong correlation between starting yield and future 10-year total return. The compensation we are receiving for taking risk in bond markets has gone down dramatically over the last 20 years. Themes for optimizing fixed income allocation and implementing an unconstrained approach:
Theme #1 Increase duration flexibility: higher discretion promotes more active positions to hedge against rising rates or potentially capitalize on them; Theme #2 Employ tactical spread exposure: maintain an attractive yield premium relative to government bonds in an effort to avoid financial recession; Theme #3 Embrace global diversification: global approach may help minimize exposure to countries with high levels of indebtedness.

Economic Outlook: The new normal has morphed into a three-speed world: 1. Above new normal growth, 2. New normal growth, 3. Below normal growth. Emerging markets have higher levels of growth and healthier balance sheets and a younger population. Volatility creates more opportunities. Not everyone does better in a volatile market. Rate sensitive sectors lead the recovery. Low supply and pent up demand fuel housing. Consumer balance sheets are improving, improving U.S. economy justifies cautious cyclical optimism, but secular headwinds impede progress towards escape velocity. Real wage growth has been stagnant. Corporations are key for household spending. Demographics challenge long-term growth.

4) Pension Obligation Bond Discussion – Bill Davis, Piper Jaffray

Pension Obligation Bonds transfer a current pension obligation into a long-term, fixed rate obligation of the City. They can be sold with a fixed or variable rate and must be issued as taxable bonds. They have been issued as General Obligation Bonds, Excise Tax Revenue Bonds, and as annually appropriated Certificates of Participation. Pension Obligation Bonds have the potential to be a useful to if issued with the right structure at the right time. The City of Tucson would need voter authorization to issue Pension Obligation Bonds. General obligation bonds sold with a 20 year period would issue with a coupon rate of around 5 to 5.5%.

The primary benefit is in the short term; it would reduce the UAAL and can provide resources to meet future benefit payments. The primary risk to the City is that the actual return on plan assets will be lower than the borrowing cost over the life of the Pension Obligation Bonds; accordingly, the issuance timing and the interest rate on the bonds are important. POB's have the effect of converting a soft liability owed to beneficiaries over time to a hard liability that must be paid periodically.

One Board member commented that despite the risks indicated, from a fiduciary standpoint it's really all about finding a way to improve the funded ratio for this Plan. The fundamental problem is the Plan has a funded ratio of 63%, and future projections are flat, changing only slightly in the 30 year projections. It will be a tough sell to educate the public, but we need to seriously consider something that will solve this issue and it's one way to help the plan; maybe not for the full amount of unfunded liability, maybe 50 to 100 million dollars. Kelly Gottschalk expressed concerns over how successful she would be in asking the current and future City Council members for a long term funding commitment from POB's.

5) JP Morgan – Strategic Properties Fund, Income & Growth Fund – Max Rodriguez, John Faust

Ann Pfeiffer retired and has been replaced by two seasoned professionals at the firm. JP Morgan believes in promoting from within, plus, the two employees experienced a down market and they believe you learn the most in a down market.

The two TSRS real estate strategies are U.S. only. Headlines are: the fundamentals are a tailwind, construction remains historically low outside apartments, and we think core pricing is broadly fair, but full, and underwriting

IRRs are stabilizing. Job growth and commercial development are positively correlated. High tech jobs have increased since 2007; these employees are spending money. We are at a 30 year historic low of new office construction; and that is unprecedented. Retail power centers have gone negative. All other real estate sections have increased adding reasons why investing in real estate is positive. High rise apartments have increased the most. New office space net absorption is increasing faster than new buildings are being built. 50% of U.S. private offices go unoccupied. The amount of square footage people are using today is dropping 30-40%.

The Strategic Property Fund invests in Office, Industrial, Residential, and Retail. This is a core fund. Investment characteristics include excellent location, stronger growth demographics, high quality income stream, minimal new development, focus on stabilized investments with high quality physical improvements. They want to make sure the tenant will be able to pay. The operating cash target is 3% to 5% of total net asset value. Current leverage is about 23%. All debt is held at the asset level only. Lenders are banks and insurance companies and JP Morgan does not lend to itself. They own large assets that outperform. Since inception, this portfolio has beaten the index at 9.3% versus 8.4%.

U.S. Real Estate Income and Growth Fund invests in stabilized core real estate, targets moderate amounts of leverage, and the primary objective is income. It is an open-end structure with a quarterly liquidity feature and multiple feeder entities offering flexibility to investors with different tax profiles. The target net annualized IRR is 8-10% (gross of taxes). This fund generates current cash.

6) Fiduciary Responsibility Review – Cassie Langford

We go through fiduciary training each year. This past year has been tough facing the Ballot Initiative and the employee contribution change. The Fiduciary role is to administer the plan and to invest the plan assets all with the same care, skill and diligence under the circumstances, then prevailing which a prudent person acting in a like capacity and familiar with those matters would use in the conduct of an activity of like character and purpose. A "settllor" is a person who establishes a trust and includes establishing, designing, amending, and terminating the pension plan. A Fiduciary is the person who is entrusted with the management of the Settlor's trust and fiduciary functions are administration and investment. Fiduciaries have no control over Settlor functions and vice versa. All Board members are fiduciaries. Other individuals can become fiduciaries by assuming certain TSRS responsibilities or by accepting fiduciary responsibilities in a contract. Tools for the fiduciary include periodic training, qualified service providers, and financial protection options. Principal fiduciary duties include: duty of prudence and duty to exercise due care, duty of loyalty and duty to act impartially, in good faith, duty to comply with applicable law. Laws governing fiduciary actions include: Tucson City Code, Arizona common law of trusts, Internal Revenue Code, and courts may consider: Uniform Management of Public Employee Retirement Systems Act, ERISA (Employee Retirement Income Security Act of 1974) and Uniform Prudent Investor Act.

Prudence encompasses Investment and Administration. Prudent investments maximize return without incurring undue or inappropriate levels of risk, evaluating performance on a portfolio basis and on an individual investment basis, because investment returns directly impact required contributions. Prudent administration includes annual review of funded status and future projections; prudence in setting actuarial and valuation factors is required; prudent hiring of actuaries and administrators is required; ongoing monitoring and adjustment of administrative policies and procedures is required as circumstances evolve; and documentation of decision, policies and procedures.

Break for lunch at 12:30 PM and Reconvened at 1:30 PM – Fiduciary Responsibility discussion continued

The Board owes duty of loyalty to TSRS members and beneficiaries. Fiduciary loyalty is complete and unwavering, and must overcome all other loyalties owed by Board member. Loyalty requires acting on behalf of TSRS (the Plan), not the City.

Board members may have conflicts of interest and if so, should abstain from voting and/or recuse self from deliberations. The Board cannot do the daily work and has to relay on the Administrator and Staff to do the work. Financial protection includes fiduciary liability insurance and indemnification by the City.

Current issues include politics and pension reform, conflicts of interest, and governance policies. The City recently implemented a conflict policy and put it into City Code. Cassie Langford thinks a conflict policy would be a good provision to adopt, but not exactly the same as the City's policy. Cassie Langford is asking for permission to put together something for the Board.

Motion to request Cassie Langford put together a conflict policy for the TSRS Board made by Brandy Kadous, 2nd by Karen Tenace, motion approved 6-0 (Kevin Larson left early). Motion to have Cassie Langford and Leslie Thompson develop a general funding document for the Board to be considered at a later date, 2nd by Lani Simmons, motion approved 6-0 (Kevin Larson left early).

7) **Investment Activity / Status Report**
   a. TSRS portfolio composition, transactions and individual investments, securities lending summary and performance by manager for the quarter ending 9/30/13
   b. Comments on investment manager performance

We were at $669.8M at the end of September 2013, $649.6M at the end of August 2013, estimated $683.9M at the end of October, and estimated $685.2M as of 11/6/13. For September we moved $2M out of T. Rowe Price and $1M out of Pyramis to fund retirement benefits. In October we moved $1.6M out of T. Rowe Price and $500K out of Pyramis and $500K out of Champlain for retirement benefits.

<u>CYTD Estimated returns through October 31, 2013 were:</u>
Total 15.86% vs. 14.66% for Custom. Fixed Income was -0.57% vs. -1.09% for Barclays Aggregate. Equity was 25.43% vs. 24.26% for Equity Composite. Real Estate was 11.88% vs. 10.44% for NCREIF (through 9/30/13). Infrastructure was -0.57% vs. 5.5% for CPI+4%.

<u>FYTD estimated returns though October 31, 2013 were:</u>
Total 8.48% vs. 7.71% for Custom. Fixed Income was 2.32% vs. 1.39% for Barclays Aggregate. Equity was 12.04% vs. 11.78% for Equity Composite. Real Estate was 2.94% vs. 3.56% for NCREIF (through 9/30/13). infrastructure was 3.29% vs. 1.72% for CPI+4%.

8) **Integrating the TSRS Asset Liability Study with the Actuarial Historical Experience Study - Callan Associates / GRS Presentation – Leslie Thompson, Paul Erlendson, Gordon Weightman**

Paul Erlendson: This process is similar to planning for travel: we need to know where we are going, what we need to bring to get there, and what the path is to get there. Asset Allocation is the primary determinant of investment return and asset volatility; how much money in which asset class will dictate the return on the fund. We need to consider what assets classes to include, liquidity requirements, and rebalancing discipline. If you are going to add something new, it needs to improve the outcome. In general, asset classes should be at least 5% of the plan, if not, it won't make a meaningful difference.

The Plan's liabilities are an interaction of three key policies: Investment Policy, Contribution Policy, and Benefits/Spending Policy. Benefits plus expenses must equal investment earnings and contributions. If you make changes in one, there will be changes in others to make it balance. An asset liability study should be conducted every 3-5 years. Investor or sponsor liabilities are a key driver of the asset allocation process. Liabilities may include retirement benefits, survivor benefits, death benefits, disability benefits, and other plan-specific benefits. Liabilities and assets are evaluated and tested separately, then integrated into a single model. The purpose of projections is to guide strategic planning and projections should be thought of as representing the path of the global economy and capital markets over a long time horizon; not as a one year forecast. Equities are richer than they were four years ago. Callan does not believe they will perform like they have recently. 6.8% is the projected rate of return as we have it funded right now. The trend is important to consider for funding status: improvement, decline, or remaining the same. The probability of better outcomes is greater than the probability of negative outcome of staying where you are. Cumulative contribution measures the cumulative contributions that would be required. Leslie Thompson would like the asset mixes to show contribution rates. Callan responded they can certainly do that.

Factors for making a decision on the investment return assumption and resulting liabilities, include:
Return objective, time horizon, liquidity needs, liability growth, financial situation, contribution risk, peer group risk, risk tolerance, and actuarial methodology. A criterion could be achieving 7.75% for the assumption. Callan's

equity projections right now are 7.7%. A proposed timeline includes the Board's final approval of a new allocation policy by May 2014. John O'Hare suggested Michael Hermanson provide copies of the last two asset allocations for the Board. Chairman Fleming stated Callan did a good job on their presentation.

9) Discussion of Pension Education Committee Activities, efforts

Karen Tenace reported - in September, an Education Committee was put together in response to retirees asking what was happening with this education to the public; at the same time, CTRA provided a list of questions to the administrator to be answered. The education committee consists of Michael Hermanson, Doris Rentschler, Marie Nemerguth, and Karen Tenace. Accomplishments by the committee thus far have been: answering the list of questions; which has been posted to the TSRS web site. A town hall meeting was held October 23rd and another meeting is scheduled at the Main Library December 17, 2013 from 9:00 AM – 10:30 AM. There will be an email announcement going out to City employees ahead of time.

Karen Tenace would like to use Leslie Thompson's chart showing how the Board will get to 100% funding. John O'Hare thinks the pension issue will come back on the Ballot and he is not sure how proactive we need to be about going out and speaking to the public about the TSRS plan and the work the Board is doing; everyone seems to feel we are not doing anything. Michael Hermanson responded we can be as proactive and outreaching as we are allowed to be with the community. The community may not be able to overcome the idea that we have a pension plan and they do not, so they might think it would be better to shut it down and save money.

Chairman Fleming does not think it is very productive for us to try to convince the general public that our pension plan is worth keeping, it will be more effective to educate the general public on how much it will cost the City (in the short term) to close the pension plan. Chairman Fleming stated that speaking with City staff, the message should be about how well the plan is managed and that benefits from the plan are secure. But for speaking with the general public, it should be about how much it will cost the City to close the plan. Cassie Langford commented that the Board's education of the public should be focused on plan members and retirees first, and then Council members who are willing to listen, but politics have to be left to the politicians.

10) Articles for Board Member Education / Discussion

a. Comparing Public Pension Accounting and Funding Measures (GRS Insight, October 2013)
b. Cities Borrow to Strengthen Pension Funds (USA Today, October 17, 2013)
c.

11) Thank you to departing TSRS Board Member Brandy Kadous

Michael Hermanson formally thanked Brandy Kadous for his service with a gift. Brandy Kadous responded that the Board has been one of the most rewarding ones and he has valued his time on the Board.

12) Call to Audience –

Cindy Jansen thanked the Board and CTRA and the Education Committee. Cindy Jansen asked to be notified about the town hall meeting more than a week ahead of time.

13) Future Agenda Items

14) Adjournment – Chairman Fleming stated we are adjourned at 3:55PM.

Approved:

Robert Fleming Chairman of the Board	12/18/13 Date	Michael Hermanson, Plan Administrator	12-18-13 Date