TUCSON SUPPLEMENTAL RETIREMENT SYSTEM
BOARD OF TRUSTEES

Regular Meeting Minutes-Thursday, August 21st, 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
Silvia Amparano, Director of Finance
Eric Kay, Elected Representative
Curry Hale, HR Director- Interim
John O'Hare, Elected Retiree Representative

Staff Present: Amanda Celaya-Brown, Administrative Assistant
Veronica Natividad, Executive Assistant
Michael Hermanson, Pension Administrator
Allan Bentkowski, Treasury Finance Manager
Silvia Navarro, Treasury Administrator
Kelly Gottschalk, Assistant City Manager
Dave Deibel, Deputy City Attorney

Guests Present: Jenefer Carlin, Retiree Representative
Judy O'Connell, Champlain
Scott Brayman, Champlain
Gordon Weightman, Callan Associates
Paul Erlendson, Callan Associates
Andy Iseri, Callan Associates
Leon Richardson, AllianceBernstein

Absent/Excused: Kevin Larson, CM Appointee

A. **Call to order**- Chairman Fleming called the meeting to order at 8:31 AM.

B. **Consent Agenda**
1. Approval of July 31st Board Meeting Minutes
2. Retirement ratifications for the month of August 2014
3. July 2014 TSRS expenses and revenue compared to budget

Motion to approve Consent Agenda from July 31st Board Meeting passed 6-0 (Kevin Larson absent).

C. **Investment Activity Report**
1. Staff and Callan Associates Questions for Champlain
2. Champlain Investment Manager Profile
3. Annual Investment Manager Review – Champlain Investment Partners – Judy O'Connell, Scott Brayman

Q 1-What is the investment philosophy of the strategy and how is it implemented?

Investing in a good business at a good price is a high probability path to wealth creation. Champlain believes buying shares of a good business with credible and sincere management at a discount to fair or intrinsic value gives investors several potential paths to wealth creation. First, the market may bid the shares to a premium over Fair Value. Second, management may grow the Fair Value over time at a faster rate than market appreciation. Third, the company may be bought by a larger company or private market investor.

2-Please describe the research process. Is it bottom up or top down or perhaps a combination of both? How does a security make it into the portfolio?

Our research process is bottom up. Our sector factors and portfolio construction guidelines determine our industry/sector positioning. However, macro-economic analysis is done by each member of the investment team during their Fair Valuation Analysis of a stock. In their effort to understand a company's Fair Value, they look carefully at the fundamentals surrounding the company's business. They consider all variables, such as macro-economic trends, that are likely to have a material impact on future earnings and cash generating power.

The S&P MidCap 400 Index is the starting universe for Champlain's mid cap strategy. We often introduce companies that are owned in our small cap product, and with which we are very familiar, and continue to own the shares as business success causes a migration into mid cap status. Other securities are found in the Russell Midcap and the S&P 500 indices.

The first step in the process is our sector factors. There are specific factors for each of the five major sectors: consumer, health care, technology, industrials and financials. For consumer we avoid fashion risk, in health care we minimize our exposure to government reimbursement risk, for technology we avoid rapid product obsolescence, for industrials we look for innovators and/or problem solvers and in financials we avoid spread businesses and focus on niche opportunities.

The next step of the process targets specific company attributes, including high or excess returns on capital, strong balance sheet, credible and sincere management, high quality earnings (e.g. strong operating cash flow), superior growth relative to other companies in the sector and a predictable business model.

The third and final step of the process is our valuation analysis to determine Fair Value. To us, Fair Value is what the stock is worth today. Here we use four different methods. We first consider relative valuation and historical M&A activity. Next, we look at discounted cash flow using a variety of models. We also consider franchise or strategic value (e.g. the secret sauce). Finally, we weigh a company's fundamentals (e.g. new product cycles, R&D spending, market conditions and competition, economic trends and corporate developments) to shade the Fair Value derived from the first three quantitative methods. FactSet and Holt are two primary analytical tools we use for our valuation analysis. Once we have identified a potential buy candidate, we then set strict target levels for purchase, and will be very patient in establishing a good entry point for the investment. We typically seek a minimum margin of safety or discount to Fair Value of 20-25%. This final step of the process is where we often will come across additional names (S&P 500 and Russell Midcap) during comparable valuations that we run through the process.

3- Please discuss the current positioning of the portfolio.

The portfolio will benefit from a rising rate environment due to the lack of exposure to REITS and exposure to asset sensitive banks. The portfolio is overweight healthcare – medical device and diagnostics, but no exposure to biotechnology due to the binary nature of the industry. We believe that demographics we be a powerful driver of demand within the healthcare sector. We remain underweight consumer discretionary and overweight consumer staples, focusing on brand loyalty.

4-In what type of market environment would you expect the strategy to outperform/underperform?

We expect to underperform during periods of speculation, momentum, and periods where low quality and highly cyclical companies are favored. Champlain's mid cap strategy is expected to meaningfully outperform the mid cap market when there is a flight to quality. Trendless overall market conditions when individual stocks fluctuate widely around Fair Value should also enable Champlain's mid cap strategy to outperform.

5-When will you sell a security?

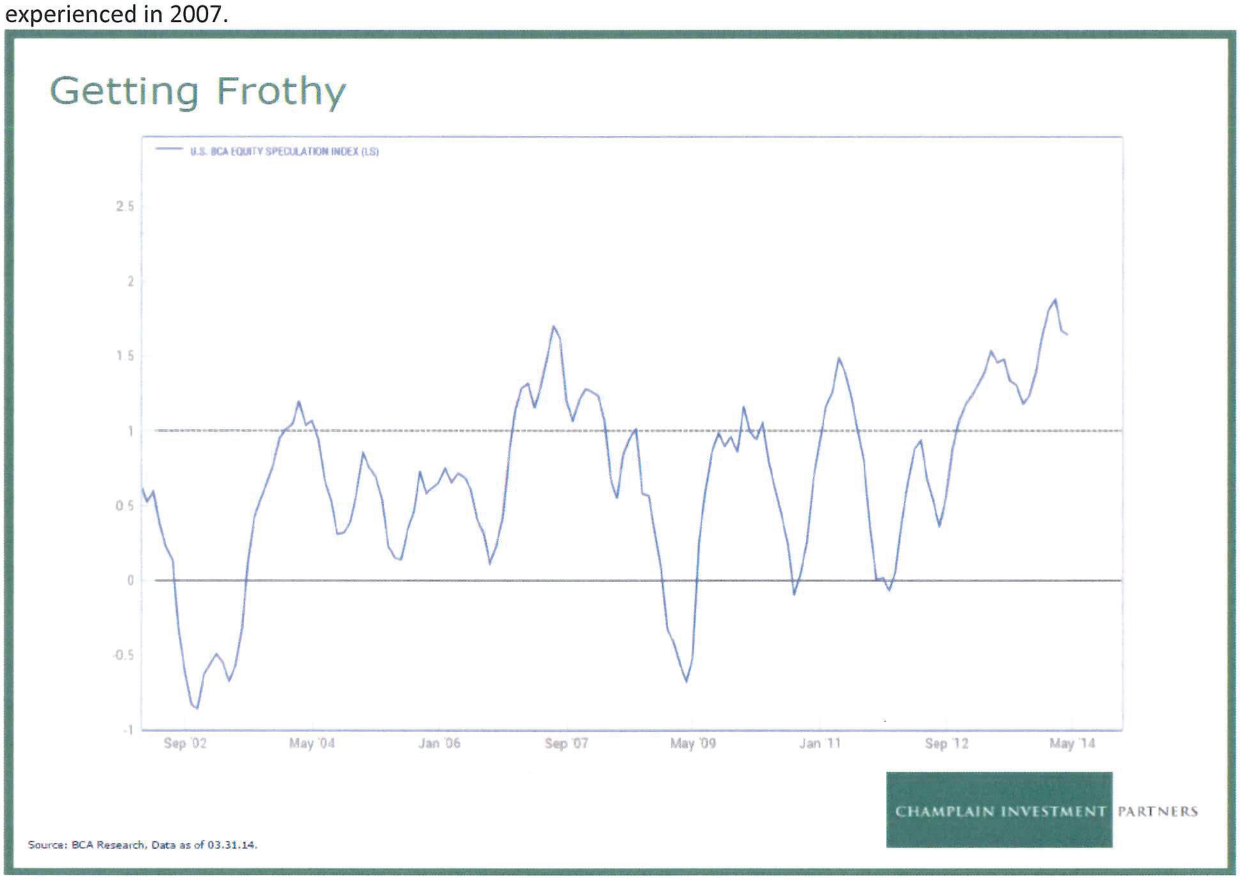
We begin to sell stocks when they reach our estimate of Fair Value. We eliminate holdings that substantially exceed our Fair Value estimate. We also sell holdings when information invalidates our original investment premise. We will trim positions exceeding 5 percent of the portfolio and when sectors exceed the established sector weight rules. We will reevaluate a holding when the price declines 25 percent below cost.

6-What is the current level of assets under management in the strategy? At what asset level will the strategy close to new investors?

As of 07.31.14 Champlain's mid cap strategy had $2,314,697,258 in assets under management. We plan to stop accepting new searches once the mid cap strategy assets, taking into account all vehicles (mutual fund, commingled fund, collective investment trust and separate accounts), reach $4.5 billion. We arrived at this asset level based on the following formula: 60 names x 1.5% of equity market capitalization x $5 billion weighted average market capitalization = $4.5 billion assets in strategy.

7-What is your outlook for US equity markets in 2014?

We continue to worry about the long-term implications of the Federal deficit (particularly about the impact higher interest rates would have on the budget) and other imbalances that have been enabled by the Federal Reserve in recent years. At some point in the future, higher rates of interest and/or inflation would not surprise us. Indeed, it seems that policy makers world-wide are trying to create "a little" inflation to produce higher nominal GDP and lessen the burden of the current levels of debt. Based on the Bank Credit Analyst research below, we are also concerned that the current speculative nature of the market may be comparable to what we experienced in 2007.



Overall corporate profit margins also look vulnerable to us, particularly for the macro-dependent companies that have benefitted disproportionately from deficit spending and cheap credit. Although there does not appear to be a definitive direction for market earnings, we believe high quality companies will become appealing to investors. Small and mid-cap companies that consistently earn above average returns (or are on a credible path to high returns), grow faster than the overall economy, invest capital wisely, and trade below their Fair Value still represent a reasonably attractive risk/reward profile relative to other assets. As such, based on these market factors, if we see disproportionate pressure on mid cap companies we would expect Champlain's mid cap strategy to outperform on a relative basis.

4. Callan Associates Quarterly Performance Review for June 30, 2014 – Paul Erlendson, Gordon Weightman

   a. Executive Summary for the Board
   b. Full Summary Report (not in board packet)

Gordon Weightman began by stating that they wanted to devote more of today's time talking about the investment structure recommendations from the recent asset liability study, so the performance review will be abbreviated today. Referring to page 2 of the Investment Measurement Service Quarterly Review, Gordon indicated the TSRS portfolio finished with a 3.73% return (net of fees) for the quarter ended June 30, 2014 and returned 19.11% (net of fees) for the fiscal year ended June 30, 2014. The Federal Open Market Committee (the "Fed") continues to taper its Treasury bond refinancing program, which is now down to $35 billion a month and is expected to end by the end of 2014. There is also indication that the Fed may increase short-term interest rates by the middle of next year. Unemployment is perhaps the brightest spot in the US economy down to 6.1%. Just a year ago, it was 7.6% so there have been meaningful additions of jobs in the US. So far this year, the economy has added about 230,000 jobs monthly. He briefly discussed page 3, Non-U.S. Equity and U.S. Fixed Income.

On pages 10 thru 18, Gordon and Paul talk about Investment Manager asset allocation, returns and overall performance. On pages 14 and 15, Mr. Weightman focuses on strong fiscal year returns. For the Fiscal Year ending June 30, 2014, the total TSRS portfolio returned 19.64%, outpacing the total fund benchmark return at 16.97%. Active managers have added a lot of value. Gordon gives an overview of benchmarks back to FY 2010.

Allan Bentkowski, asks Callan Associates for their assessment of Champlain to which Gordon answers Callan has no concerns about Champlain. He believes they are sticking to their philosophy and strategy and doing what they said they would do. Paul refers to page 13 to highlight Champlain's performance since Fiscal Year 2010. On an absolute basis they're average return over the last couple of years is in the teens. They're an equity manager which is one of the riskier asset classes, but they are one of the firms that are going to protect capital "when the market heads south." From Callan's perspective, Champlain is a great firm that will accomplish their investment strategy objectives.

5. TSRS Portfolio composition, transactions and performance review

Allan Bentkowski gave a brief activity report for the month of July. As of July 31 the total fund balance was almost $720.9M that compared with the fund balance at the end of June which was $733.3M. As of August 20, 2014, our balance was $728.4M.

<u>Calendar returns for July, 2014</u> – Total Fund returned -1.37% vs. the custom plan Index benchmark posting a -1.19% return. Five managers met or beat their benchmarks even though they were on the negative side. Total equities were down -1.78% vs -1.99% for the Equity Composite. Total Fixed Income for July returned -0.77% vs. the benchmark at -0.25%; Total Real Estate returned 0.18%; and Total Infrastructure posted a -1.24% loss vs. the CPI at 0.29%.

On a calendar YTD basis, the Total Fund returned 4.2% vs. the Custom Plan Index benchmark at 4.48%; Total Fixed Income was up 4.66% vs. the Barclay's Aggregate at 3.66%; Total Equities posted a 3.65% return vs. 4.4% for the Equity Composite, Total Real Estate returned 5.5% through July compared with the NCREIF-ODCE Index returning 5.47% (as of most recent data thru 6/30/2014). Total Infrastructure returned 7.45% vs. 4.60% for the CPI+4% benchmark.

D. **Callan Associates Discussion of Portfolio revision recommended from 2014 Asset Liability Study**

1. International Small Cap and Global Equity – with Andy Iseri, Sr. Vice President, Callan Assoc.
2. Non-US Equity Structure Discussion - with Andy Iseri, Sr. Vice President, Callan Assoc.

Paul Erlendson addresses the board to discuss asset allocation and manager structure. He states Callan is not looking for a decision today, but just wants to offer the board a few different scenarios to consider. Asks where do we want to be positioned, do we want to add new managers, do we want to remove managers or do we want to remain with the existing managers. Once Callan has that blueprint, then we can start talking about how we can meet that target. Paul starts on page 3 and explains the difference between asset allocation and manager structure. A way to think about it is to think of asset allocation as a game plan or strategy and managers as the roster. He mentions Callan wants to focus on diversifying within one component of the asset allocation that's Non-U.S. Equity. At the moment we have two managers that tend to be very large cap and tend to have lower weightings to emerging markets. The question is, are you giving anything up by being light on emerging and heavy in large cap stocks. Is that the best way going forward? On page 4, Paul goes over considerations for manager structure. The starting point is the benchmarks. Callan's view is you can do better if you get the right managers. Our goal is to increase the financial health of the pension fund. The starting point is after-fees have to do better than the ACWI ex-US index or we are wasting time and money. At the moment TSRS has two managers the question might be will adding two or more new managers really add that much more value? Paul refers to page 7 to go over the Regions and Style of TSRS International Equity Program for the last decade. Three notable biases compared to the ACWI ex-US and the "typical" international manager. He mentions we are meaningfully overweight in Europe 65% vs the benchmark of 48.5%. In the Pacific Basin, we have been underweight 19% vs 25% and significantly underweight in Emerging Markets 11% vs 19%. Also note that the average Non-U.S. Manager is even lower than that, 7%. Those are the observations that Callan has made over the last 10 years. Take a look at slide 8; what does that mean in terms of performance. Is there room for improvement? Paul continues to compare returns and Standard Deviation for the last 10 years using the graph provided on page 8. Continuing with manager structure, Callan provides four scenarios on page 10 that covers pros and cons. He starts off with a scenario not on the list, which is to leave everything as it is. The first scenario consists of keeping our existing two managers and doing a search for one more ACWI ex-US Small Cap manager. Scenario two consists of searching for two new managers (One Emerging Markets manager and one ACWI ex-US Small Cap manager), while keeping our two current managers. In scenario three, he suggests replacing the two active managers with one EAFE Passive, one Emerging Markets manager and one ACWI ex-US Small Cap manager. The final scenario consists of retaining our two current managers and searching for one new EM manager and one new EAFE plus Small Cap manager.

Chairman Fleming asks board members for a consensus on where they stand so far regarding the options presented by Callan. Mr. Bentkowski, Mr.Hale and Mr. O'Hare like scenario one, the chairman indicated leaning toward scenarios one or three. Overall, Board consensus pointed toward pursuing Scenario One. With this direction, Callan will begin work on providing additional details and information on the strategies involved with this scenario.

E. **Administrative Discussions**

1. Preliminary Results - Salary Survey Information

Michael Hermanson provided an update on last month's discussions concerning the Lead analyst vacancy, and information received from a survey of pay ranges paid positions comparable to our retirement office staff positions. Mike informed the board he had contacted offices at the Arizona State Retirement System, the Arizona Public Safety Personnel Retirement System and the City of Phoenix Employees Retirement System to obtain job descriptions and pay levels for the other programs in the State of Arizona. Mike asked direction from the board because current pay levels for retirement staff have lead to the departure of 2 lead analysts over the past 3 years to another City organization offering higher pay. Ms. Gottschalk asks why this conversation is being directed to the TSRS Board. Mike responded that the plan's ability to attract and retain qualified staff is an administrative concern the board needs to be informed of, and since the administrative budget is set by the board, this would be an issue for them to consider. Current recruitment efforts underway to replace the Lead Pension Analyst may fail to attract qualified candidates unless we are willing to match the pay scales indicated in the survey information. Mrs. Tenace proposes that the board recommend a salary range that goes up to the midpoint of the pay scale determined by HR. Mr. Hale interjects that the full range of the scale could be used depending on candidate experience. If the position calls for higher pay, it will require sign off from HR Director and City Manager. Chairman Fleming raises a concern that if we can't hire a Lead Pension Analyst because our offered salary is too low then that is a problem that the board needs to resolve or ask somebody to do something if it's something the board can't take care of. Mr. Fleming is troubled by the number of TSRS staff compared to ASRS, PSPRS and City of Phoenix Retirement System; there is a significant difference. Mr. Hermanson added that the four staff positions for TSRS will soon change to operating with only two because Amanda will be taking her leave in early October. Finance Director, Silvia Amparano added the Finance Department is here to offer support to TSRS. Mr. O'Hare asks if the recruitment process will take the full six months estimated, or is it something HR can expedite. Mr. Hale answers that someone can be brought into the organization in less than six months based on existing hiring classifications. Mike indicated that he and Ms. Tenace had met with the HR Analyst for Finance to get recruitment efforts underway, but it will probably take until November to fill the Lead position. TSRS will use a full color flyer to solicit qualified candidates. Board member Karen Tenace reminds staff that there may need to be an interim budget change request the next time the board is setting the budget to accommodate retention of TSRS staff.

F. **TSRS Board Membership Terms**

1. Board Member Terms expiring January 2015
2. Draft of letter to TSRS members for active employee solicitation
3. Election timeline

Plan Administrator, Michael Hermanson informs the board that Mrs. Tenace's term will expire in January 2015. He has updated the Solicitation Notice providing information for candidates interested in serving on the TSRS Board and asks for feedback from staff and board. John O'Hare asks if management can "stack" board seats and would double department representation allowed. Mr. Hermanson answers that no more than one elected employee from the same department can be on the board, however, an employee that's not appointed from the same department can have a seat on the board as well. He also states that ultimately the committee recommends qualified candidates and the board approves. Chairman has a concern that we may not meet the deadline on the notice, to which Mr. Hermanson says he plans to edit the dates and requested language changes, before mailing. A revised copy will be included in next month board packet and board members will be provided a copy of the rules applicable to this issue, for clarification.

G. **Articles for Board Member Education / Discussion**
   1. Chief of Arizona's Firefighters' Group Pushes for Cut in Pensions (New York Times, Aug. 11, 2014)
   2. GASB Update – Toward Transparency (Callan Investments Institute, July 2013)

H. **Call to Audience – None heard.**

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

J. **Adjournment - Chairman adjourned meeting at 11:12AM.**

Approved:

[signature]	9/25/14	*[signature]*	09-25-14
Robert Fleming Chairman of the Board	Date	Michael Hermanson Plan Administrator	Date