EMPLOYEES' RETIREMENT SYSTEM OF THE COUNTY OF MILWAUKEE

MINUTES OF THE SEPTEMBER 21, 2011 PENSION BOARD MEETING

1. Call to Order

Chairman Mickey Maier called the meeting to order at 8:35 a.m. in the Green Room of the Marcus Center, 127 East State Street, Milwaukee, Wisconsin 53202.

2. Roll Call

Members Present	Member Excused
Linda Bedford (Vice Chair)	
Keith Garland	
Mickey Maier (Chairman)	
Dean Muller	
Dr. Sarah Peck	
David Sikorski	
Guy Stuller	
Rex Queen	

Others Present
Mark Grady, Deputy Corporation Counsel
Marian Ninneman, Interim ERS Manager
Matthew Hanchek, Interim Director of Employee Benefits
Dale Yerkes, ERS Fiscal Officer
Yvonne Mahoney, Retiree
Ray Caprio, Marquette Associates, Inc.
Nat Kellogg, Marquette Associates, Inc.
Tom Rosalanko, GMO
Carolyn Van Putten, GMO
William Tsotsos, Baring Asset Management
Steven Huff, Reinhart Boerner Van Deuren s.c.
Steve Schultze, *Milwaukee Journal Sentinel*

3. Chairman's Report

The Chairman thanked the Board members for attending and welcomed the two recently-elected Board members. Rex Queen, elected by employees, is the Milwaukee County Deputy Treasurer responsible for investing $300 to $450 million in County surplus funds to ensure that County bills are paid. Mr. Stuller, elected by retirees, returns to the Board to serve for a third time. The Chairman suggested that Mr. Queen would be a good addition to the Audit Committee because of his current responsibilities.

The Chairman stated that a complaint had been lodged by an employee candidate for the Board prior to the July meeting. At the July Board meeting, the Board decided to accept the election results for both offices, subject to an independent review of the elections. The Chairman noted that a thorough audit left no question about the integrity and results of the elections. Mr. Grady agreed.

The Chairman concluded by reiterating that Board meeting attendance is critical to achieving a quorum. County Executive appointments still need to be made, but the Board hopes to be fully staffed by this fall.

4. Minutes — July 20, 2011 Pension Board Meeting

The Pension Board reviewed the minutes of the July 20, 2011 Pension Board meeting.

The Pension Board unanimously approved the minutes of the July 20, 2011 Pension Board meeting. Motion by Mr. Garland, seconded by Dr. Peck.

5. Reports of ERS Manager and Fiscal Officer

(a) Introduction of Interim Benefits Director

Ms. Ninneman introduced Matt Hanchek, who joined the County in 2007 as the Life and Health Benefits Manager. Mr. Hanchek was part of the new benefits team established when Mr. Arena came to Milwaukee County, and he implemented a new contract with United Healthcare that saved the County millions of dollars. Mr. Hanchek was recently asked to serve as the interim Employee Benefits Director, and since assuming those responsibilities, is quickly becoming familiar with ERS.

Mr. Hanchek then stated that he played a role in creating the staffing model for ERS. While the majority of his career in employee benefits has been focused on health and welfare benefits, he also has experience with defined benefit pension plans and their administration. Mr. Hanchek's focus going forward will be to develop core competencies for ERS as well as to make sure that there is no regression or missed opportunities as a result of leadership changes.

Mr. Hanchek then noted that Ms. Ninneman has done an excellent job with day-to-day operations as well as working with the Pension Board. Mr. Hanchek stated that a key part of his role is to support these efforts as ERS continues to look for ways to improve operations. He will also look to improve communication between the Pension Board and County policymakers to ensure that goals and information are properly relayed.

The Chairman then stated that the Board welcomes Mr. Hanchek in his new role. Mr. Maier noted the progress made over the last couple of years under Messrs. Arena and Schroeder. He indicated that it is critical to maintain that type of leadership to keep the momentum going. The Chairman then encouraged the Board to meet with Mr. Hanchek to discuss how the parties can best help each other.

(b) Retirements Granted, July and August 2011

Ms. Ninneman presented the Retirements Granted Report for July and August 2011. Twenty-two retirements were approved in July, with a total monthly payment amount of $26,511. Of those 22 retirements, 13 were normal retirements, 5 were deferred, 3 were deferred early, and 1 was an accidental disability pension. Additionally, 14 retirees chose the maximum option, and 16 were District Council 48 members. Eleven retirees elected backDROPs in amounts totaling $1,041,868. Of these 11 backDROPs, 8 were under $100,000 and the highest was $254,300.

Ms. Ninneman continued that 54 retirements were approved in August, with a total monthly payment amount of $84,774. Of those 54 retirements, 38 were normal retirements, 13 were deferred, 2 were deferred early, and 1 was an accidental disability pension. Additionally, 26 retirees chose the maximum option. Twenty-six retirees elected backDROPs in amounts totaling $2,607,501. Of those 26 backDROPs, the smallest was $14,770.

Ms. Ninneman then stated that though the backDROP elections continue, they are recently in lower amounts. Additionally, July was one of the quieter months in terms of the number of retirements, but the August total was what ERS considers the new normal. ERS expects to see more District Council 48 retirements because it is the largest employee group.

(c) ERS Monthly Activities Report, July and August 2011

Ms. Ninneman presented the Monthly Activities Report for July and August 2011. ERS had 7,731 retirees at the end of July, with a monthly payout of $12,499,386. At the end of August, ERS had 7,710 retirees with a monthly payout of 11,891,911.

Ms. Ninneman noted that there were no surprises in the last few months of activity. There will be an expected uptick in retirements because ERS's schedule is already completely booked for individual retirement meetings in November, so the last quarter is going to be busy.

Ms. Ninneman stated that all retiree files have been converted to the new file format. ERS will review its scanning processes and procedures to determine whether there are more documents to include in an effort to reduce the large volume of paper in the files.

Ms. Ninneman then stated that ERS is developing an audit plan for the data from the County payroll system to ensure ERS is capturing the information it needs. ERS has begun making OBRA payouts, which will continue to increase with a cash-out plan in place.

Ms. Ninneman continued that the Medical Board review is experiencing a backlog because of the vendor change. ERS is currently negotiating the contract with the new vendor, so that backlog should be gone in the next several weeks.

In response to a question from Mr. Grady, Ms. Ninneman stated that ERS has not yet heard back from the new vendor on the contract and that she will contact them directly.

Ms. Ninneman concluded by stating that ERS plans to revise and add different categories to the activities report for 2012. One item of note is that while ERS reports the number of deaths, there is no breakdown that indicates whether a member exited from the Plan altogether or whether there are joint and survivor options that will continue to be paid.

(d) Fiscal Officer/Cash Flow Report

Mr. Yerkes first discussed the ERS cash flow report, stating that the only real change is that infrastructure and real estate fund payment amounts are now included.

The Pension Board unanimously approved the liquidation of assets to fund cash flow of $15 million for October 2011, $15 million for November 2011, and $15 million for December 2011. The amounts should be withdrawn from investments designated by Marquette. Motion by Dr. Peck, seconded by Ms. Bedford.

Mr. Yerkes next distributed the July and August 2011 Portfolio Activity reports, noting that July and August cash flow was drawn from bond funds.

Mr. Yerkes concluded by noting that the second quarter check register shows ERS expenses from April 1 to June 30, 2011, with no unusual activity.

In response to a question from the Chairman on an item in the check register, Mr. Yerkes stated that Michael Malloy was an independent contractor who was brought in to ERS for a project that is now complete.

6. <u>Investments</u>

(a) <u>Barings</u>

Bill Tsotsos introduced himself as the Managing Director for Barings, an international investment company with a history dating back to 1762. Barings is based in Toronto and owned by MassMutual, with $52 billion in assets under management. MassMutual owns other money managers, but Barings is the global manager responsible for investing outside of the U.S. MassMutual occupies three of eight seats on the Barings Board, but has no active role in the day-to-day management of the business.

Mr. Tsotsos then addressed the Barings team changes. In terms of the international equity portfolio, the Fund has a new lead manager. Other new team members include a Japan specialist, a top-down specialist, and a newcomer in October who will add more synergy to the existing group. This is a very broad team that is compact enough to do its job well.

Mr. Tsotsos first discussed Barings' investment philosophy, which is to look for unrecognized growth; companies that are growing and that are catalysts for growth. Recent years have been challenging in the markets, so the approach has been more top-down and large-cap biased.

Mr. Tsotsos then discussed Fund performance. Since Barings was hired, the market has been very challenging. The timing of fund inception in the latter half of 2007 through the first half of 2008 determined how well it performed. This is a race won in turns and not straight-away, and Barings has been building a portfolio of quality growth companies that could withstand these turns. Barings is pleased with its overall performance. A very strong portfolio has yielded a 13.1% return for the ERS Fund versus 10.5% for the MSCI EAFE on a one-year basis. The three-year number is also good by comparison at -0.9% versus -2.5%, and Barings continues to chip away at that.

Mr. Tsotsos stated that in terms of performance attribution, Barings added the most in financials because of the underweight in European banks, which tend to move up and down very quickly. Barings does not jump in and out of companies it does not have confidence in. Technology has been a contributor and will continue to be very strong. Health care has been surprising—Barings has typically been a buyer in medical technology, which has always been too big and spread too thin, but it appears to finally have started to do well. Energy is a significant overweight; Barings still likes energy, though better performance was expected. On the country side, Japan is underweight. The U.K. is an ugly market, but the companies Barings owns, such as Rolls Royce, are real global players.

Mr. Tsotsos then stated that the number one contributor to performance has been Autonomy. Autonomy has always been a good target because of its uniqueness in services and data management. Other top contributors include Shires, SJM Holdings, Grifols, and Resolution, with products ranging from pharmaceuticals to life insurance. The primary bottom contributor is Paladin Energy, a uranium miner. This has been a positive year in uranium, but Barings is undecided about its stock given the Japanese issue with nuclear and China having no choice but to buy nuclear power prospectively. Other bottom contributors include Niko Resources, Centamin Egypt, and Hypermarcas, with products ranging from oil and gas to various retail commodities.

Mr. Tsotsos stated that the portfolio includes weightings in emerging markets at 7.6%, in the U.K. at 2.4%, and in Canada at 1.1%. Barings is moving toward neutral with Japan and believes Asia is going to struggle for a bit. Finally, there is Continental Europe, which really has no current catalyst. The Barings outlook is that, in terms of sectors, energy and technology are still favored, but industrials are struggling. The global recovery has not stopped, but it is certainly not progressing as quickly and will be a drag for some time.

Mr. Tsotsos then discussed emerging markets, a big part of Barings' business and an area it takes very seriously. While Barings is disappointed to have lost people in that area, it has a lot of bench strength and will continue to deliver for the Fund. The current head of emerging markets has a background in global emergence and Barings has a lot of confidence in him. Barings also has a strategic policy group and a quantitative research group to provide added input in risk control for the portfolio managers. The portfolio managers do not pick stocks. The stocks are picked by the analysts and presented to the portfolio managers, whose job is to understand how the process works and to synthesize that understanding into a portfolio that delivers to the client. Because the market has been so challenging, especially with emerging markets, additional team members will be added by the end of 2011. Barings is very careful when hiring employees, and the typical interview includes questions about the types of companies the potential hire is looking at as well as investment philosophy. Barings looks for people who have very similar philosophies in how they identify companies, countries, and sectors.

In response to a question from Dr. Peck, Mr. Tsotsos stated that Barings does not specifically have a target number of analysts for specific locations. There are many resources and sometimes coverage is coming from those resources in other areas of the company. While an analyst might be in charge of managing India, for example, the actual resource base is the entire company.

Mr. Tsotsos stated that 40% of Barings' assets are in emerging markets because of growth potential. There is approximately $8 billion in China and $3.8 billion in Asia, with Europe emerging stable at $5.8 billion. Performance in emerging markets has been rough in general and the manager has had a difficult time reshaping the portfolio, but it has started to show improvement. While the overall year-to-date is still struggling, Barings is hopeful the portfolio yield will meet expectations.

In response to a question from the Chairman, Mr. Tsotsos stated that the current portfolio manager is not necessarily an improvement over the portfolio managers who left. Rather, there is a difference in approach. The current manager has more of a bottom-up background and considers input from other people in the strategic policy group.

Mr. Tsotsos then stated that in terms of country attribution to performance, Taiwan was the biggest detractor in 2010 and the reason why Barings struggled last year. The portfolio is underweight in Taiwan and South Korea largely because Barings believes the global economy is going to slow down. China is still performing well, but Egypt has been a detractor. Overall, stock selection has been the primary cause of underperformance year-to-date. Going forward, more emphasis will be placed on stock picking, with the ultimate goal of a very risk-managed portfolio.

In response to a question from the Chairman, Mr. Tsotsos explained that equity analysts are reviewed monthly. An internal rating sheet is published that shows how each analyst performed over the last month, quarter, year, and three years. The analysts are compensated entirely on how well their picks perform versus their respective benchmark. This helps Barings identify which analysts are struggling and those that could benefit from guidance from either the sector head or the head of equities. Additionally, it helps ensure the analysts are doing their jobs. They are not just responsible for picking winning stocks—they also need to avoid the losing stocks. Barings wants to make sure the analysts understand how Barings look at companies, Barings' philosophy, the valuation for its respective sectors, and the growth and value creation catalysts.

Mr. Tsotsos then stated it would be of value to bring a portfolio manager to an Investment Committee meeting. Barings wants to provide the Board with the highest level of confidence because the Board must be confident that Barings can deliver what was promised irrespective of any changes to the team or ownership, or any other event.

Mr. Tsotsos then discussed Barings' investment outlook. The global economy has been improving in general, but imbalance and risk remain; very little has been done to resolve these imbalances. The western recovery is weak because of high indebtedness and withdrawal of fiscal stimulus. Eastern and emerging economies are becoming inflationary, which is worrisome because the answer to that is generally for banks to tighten up and raise the interest rate and monetary policy. Japan is increasingly offering attractive investment opportunities, and one item of note is that some of these Japanese companies are small-to-mid size with about 70% to 80% market share, and they are relatively unknown. Barings' focus is to find the growth segments and under-appreciated opportunities within the recovery.

In response to a question from Ms. Bedford, Mr. Tsotsos stated that Barings is changing stocks less often now. The markets have been so volatile that the previous turnover rate of 80% has decreased to 50% or 60%. While Barings wants companies that are going to deliver, it also does not want to incur trading costs when trading one bad stock for another potentially bad stock.

In response to a question from the Chairman regarding the impact of the current European debt crisis on the ERS portfolio, Mr. Tsotsos stated that Barings has been trying to sidestep this impact by finding companies with strong balance sheets and growth niches to minimize the potential crisis. Barings is not confident in the European banking system and when this type of uncertainty exists, Barings prefers to own other companies. There are ways to make money in Europe; there are factors that Barings looks for when it cannot find any secular trend in areas in which money was traditionally made.

(b) GMO

Carolyn Van Putten introduced herself as a member of the client services team and Tom Rosalanko as a member of the equity team that manages both ERS international portfolios.

Ms. Van Putten then provided background on GMO, a private firm committed to remaining a private firm owned by its 46 partners. Many of the founders are still active with the firm, either in the day-to-day operations or through positions on the Board. Across the various investment solutions, most teams that manage the portfolios take a team approach to investing. Initially formed using a fundamental approach, the firm has become a quantitative investing firm in the international markets.

Ms. Van Putten stated that GMO's investment strategy is a value-oriented style that tends to be contrarian. The intrinsic value portfolio is purely developed markets in which GMO does not have exposure to emerging equities. International small-cap is capacity-constrained, given the nature of the small-cap market place.

In response to questions from the Chairman, Ms. Van Putten stated that the size of the portfolio for small-cap is $450 million. Mr. Rosalanko then stated that GMO could target a hard close at around $1 billion, as in the past, but it is open to the asset allocation team. For existing clients, GMO tries to maintain some capacity in order to increase. Mr. Rosalanko is unsure whether there will really be a hard close, but stated that GMO does not want the portfolio to get too large, or too far past the $1 billion.

Mr. Rosalanko then discussed Fund performance. The last year has produced some interesting numbers because of the fluctuations in the market. August was a very difficult month. Investors were scared, so markets were down quite a bit. In that environment, depending on the portfolio, GMO was able to keep its head above water or at least close to the surface. Year-to-date performance in both ERS international portfolios has outperformed the market indices, so though August may have been bad, it did not hurt relative performance. The one-year numbers look much better because of the up markets of late last year, plus year-to-date, including the downdraft in August. Overall, the international intrinsic value is up 12% for the year. International small-cap, up 23%, is a great place to be right now, performing much better than the international value portfolio. Small-cap performed well for ERS, not just because ERS was in small-cap, but because the portfolio itself outperformed.

In response to a question from the Chairman, Mr. Rosalanko stated that GMO has one client in the portfolio that is larger than ERS, at approximately $100+ million. In small-cap stocks in particular, liquidity is somewhat more constrained than it would be in larger cap, more liquid companies. If a client were to liquidate everything very quickly, GMO would need to establish a schedule with the client that works with the stocks in the portfolio. This could also be handled through transfers over time so that stocks would go out without actually having to sell them, and then the liquidation could be managed as appropriate. Mr. Caprio added that there would be some transactional cost associated with it, but a client could get in and out if a change needed to be made.

Mr. Rosalanko then discussed GMO's investment philosophy. This philosophy includes four basic and unchanging points. One, that fundamental value matters. If undervalued opportunities are picked over time, they are worth more than they are priced. Two, that quality is worth a premium. GMO focuses on high-quality stocks with a competitive advantage over any other company. Three, that momentum complements value. Momentum tends to pick stocks to help insulate and diversify value price. Four, quantitative, not qualitative. GMO tries to avoid having analysts go out and visit companies because that can get in the way of being objective. Instead, GMO looks at big picture characteristics—what it can see of a company based on the numbers that show how it will perform.

In response to a question from Dr. Peck, Mr. Rosalanko stated that GMO does not directly look at management compensation in its quantitative analysis because it tends to come through in the bottom line.

Mr. Rosalanko then discussed the small-cap portfolio and strategy. GMO starts with the developed markets in the world and emerging markets in the U.S. and by each region takes the smallest companies with well-fixed stock based on their value and on their momentum in order to diversify. Country and currency allocations are made, and then the rest of the portfolio is reviewed for the final portfolio. GMO updates its information every month, reassesses what it owns and what it should own, and then rebalances the portfolio.

Mr. Rosalanko continued that when GMO picks stocks, it uses three different processes; two based on value and one on momentum. These disciplines are well-balanced at 35%, 35%, and 30% respectively. Quality-adjusted value is a way of incorporating how cheap stocks are by favoring those that are higher quality. Momentum-adjusted value is similar, except it factors in companies that are showing signs of turning around. The third process, momentum, factors in companies that have done well for the last twelve months with that trend likely to continue. Once the trend is visible, GMO will buy into these companies to see how they will perform. The momentum-adjusted value and momentum processes each performed above the small-cap index. However, the quality-adjusted value process performed below the small-cap index. The small-cap idea of quality is relative. Most of these companies have not been around forever and in some cases do not have a good track record in terms of profitability. In September 2010, when the Federal Reserve agreed to stimulate the economy and keep interest rates low, it sent the market a strong signal that stocks and companies should perform better. This helped to drive a strong outperformance at the end of 2010 that since has continued. Despite fears, the market has not fallen off to a great degree and the momentum in this portfolio in particular is helping to carry the market from a stock selection perspective.

Mr. Rosalanko then discussed performance attribution. Many companies have done well in the ERS small-cap portfolio; for example, K's Holding, Hugo Boss, and Rhodia. These are the kind of companies that drive the outperformance. What hurt in the portfolio were some of the Irish holdings. Ireland has been an amazingly cheap market but with debt prices and other financial issues it was difficult for the economy to proceed at the pace it did a few years ago when it was robust. While investment mistakes were made, there are more winners than losers, and the winners have essentially overwhelmed the losers; portfolio performance has not been severely impacted. Bottom line, the country selection and stock selection really helped outperformance. Country selection because of an overweight to Japan and an underweight to Switzerland. Stock selection because of companies in Australia.

The portfolio is very diversified with positive impact from many areas. The top 15 stocks make up 15% of the holdings.

In response to a question from the Chairman, Mr. Rosalanko stated that there are approximately 400 stocks in the portfolio, many more than with Barings.

Mr. Rosalanko then addressed international small-cap country and currency allocations. There is an underweight from Australia because GMO reduced positions, but Australia is a market that has performed well over time. GMO prefers to buy into a cheaper and undervalued market than into an expensive market. Japan is a significant overweight, and France and Germany are also overweight because they have a lot more growth in smaller cap companies. In terms of currency, there are no big positions. GMO invests in emerging in this portfolio, working among small-cap stocks in that part of the world. Current allocation is 2.9%, but in a month or two that should rise to about 5%. Emerging markets will be attractive and increases should start occurring here as well. When looked at by sector, there is a large allocation to consumer discretionary, and some are practically priced and have shown strong momentum.

Mr. Rosalanko then discussed portfolio forecast and annual real rate of return over 7 years. For international large-cap, GMO expects 4.3%. For international small-cap, GMO is less optimistic at 1.4%. Emerging markets is the most attractive at 5.5%. The indication is that, because these numbers are lower than the 6.5% long-term historical U.S. equity return, these large-cap, small-cap, and emerging markets are somewhat overvalued. Additionally, these numbers should all be slightly higher because the markets were down approximately 10% in August. Small-cap is a good place to be, but is not as attractive as large-cap right now.

In response to a question from the Chairman, Mr. Rosalanko stated that GMO anticipates increasing exposure to emerging markets in the small-cap portfolio. Emerging still looks somewhat attractive and has gotten a lot cheaper in approximately the past month, which makes it a good time to increase exposure. GMO tries to be well-diversified and almost always has exposures to most of the developed markets.

Mr. Rosalanko concluded by stating that the international intrinsic value portfolio performed well because of its high-quality stocks. Market fears tend to drive people toward companies like Sanofi, GlaxoSmithKline, and AstroZeneca that are higher quality.

In response to a comment from Ms. Van Putten about the GMO breakfast meeting the following week, the Chairman confirmed that the invitation had been forwarded to the Board.

(c) Marquette Associates Report

Ray Caprio of Marquette Associates, Inc. distributed the monthly report, along with Nat Kellogg, head of private equity and hedge fund research, also from Marquette.

Mr. Caprio first provided an overview of the quarterly report, specifically the Milwaukee County Pension Fund compared to the average public pension fund. The composite includes 175 funds ranging from $1 million to $8 billion, and the ERS Fund has taken a different approach relative to its peers. The Pension Fund has an allocation of 23% in U.S. stocks. The average public pension fund is at 25%, so the Fund is slightly underweight to the average. In fixed income, the Fund is in line with the peer group. There is a significant underweight to the average in international, which is approaching 25%. In real estate, the Fund is slightly overweight to the median, but in line with the average. In special investments, which would be anything included in private equity infrastructure, the Fund is overweight. In hedge funds, where there is not a lot of representation in the public fund, there is also an overweight. Marquette's position is to reduce exposure to some markets and increase exposure to alternatives, reduce volatility, and still achieve the 8% rate of return. For the last two years, the absolute returns on the pension fund have looked very good. Ranks have not been as good because the Fund essentially has a 7% to 8% total underweight in equities to peer, and as the markets have gone up over the last two years that has been a detractor.

Mr. Caprio then addressed total Fund performance through June. On a return basis, marginal returns are at 1.6%. The Fund is in the 12th percentile of the roughly 175 funds, which is a big change over the last two years because alternative investments paid off. If the funds greater than a billion are segregated, the ERS Fund is in the top quartile. While the listed markets do not do as well as interest rates drop to low levels, the Fund is benefitting from that. Total fixed income is 2.2%, ranking in the 41st percentile, and it performed in line with the benchmark. The U.S.-only portfolio performed in line with the Wilshire 5000. The Fund benefitted from having underweight stocks, so the takeaway is that as the volatility in the stock market and bond market continues, the portfolio should start to perform in ways that are a little contrary. Overall, the portfolio is well-positioned.

Mr. Caprio next discussed the monthly update for August. The market has been very challenging for the last few months, so the month of August is negative. In fixed income, the Fund is slightly underweight to the target of 32%. Marquette has been drawing down fixed income investments over the last few months as yields have gone down. The price on bonds had gone above par, and Marquette felt it could naturally rebalance the plan by taking benefits from different areas of the portfolio. U.S. equities is also slightly underweight to its target of 23%. Year-to-date that has been a detractor as large-cap growth and small-cap value have traded in different patterns. International has a 1% overweight to its target of 18%. Aggregate is in line with equities so there is no need to rebalance to target. Hedged equity did well relative to the long-only stock market, but did not meet expectation. In real estate, Marquette is 90% complete with the re-allocation, moving from a REIT-only structure to a commercial-only structure. Marquette is still waiting to fund UBS, but the allocation will not be large. Marquette is comfortable with Morgan Stanley as anchor to the portfolio because they have a good blend of both core properties and value-added properties, as well as a very geographically-diverse portfolio. Infrastructure has been, from a timing perspective, one of the Fund's best asset classes. Funded in May of 2010, there has been significant appreciation on the value. On all alternative investments with the exception of hedged equities, there is a strong income component that is very significant, especially as it relates to bonds. Marquette tries to draw that out of the portfolio to pay down benefits. Private equities is an area where improvements can be made, at least an allocation increase. Over the years, Marquette has made additional but not meaningful allocations to this asset class. The funds in aggregate have done well on an internal rate of return basis since inception, especially as it relates to the public market equivalents. However, private equities currently has a significant underweight of 1.5% to its small target of 3%. Marquette thinks there is good opportunity in that sector from a pricing perspective. At the end of August, the Fund was just over $1.7 billion, so the total asset base is down for the month.

Mr. Caprio next discussed Fund performance for August, which was negative 3.3%. Year-to-date, the Fund is down to positive .8% from the positive 4.5% in June. The bond portfolio performed well at 5.6% year-to-date, close to its benchmark of 5.9%. In equity, there is more exposure to value stocks than growth stocks. Small-cap has not done as well as large-cap, so overexposure to small-cap has detracted year-to-date. However, small-cap tends to perform better over full market cycles. On the international side, relative outperformance is starting to occur, which is a reversal of recent trends. The overweight to the GMO small-cap has helped. The Fund outperformed for the month, year-to-date, and for the one-year. On hedged equity, the stock market was down and so was hedged equity, but to a much lesser extent. On real estate, Marquette is still working into the commercial portfolio, but year-to-date it is the best performing asset class next to infrastructure.

Mr. Caprio then discussed the Fund managers. With mid-cap growth, a strong performing asset class for the Fund long term, the only positive long-only manager is Artisan, up 2% for August. Reinhart Partners continues to trail the benchmark. Their style is currently out of favor, so that should be reevaluated by the Investment Committee. In international, relative outperformance has been strong, at least in the near term. In emerging markets, it is too early to assess, but Marquette still has a lot of conviction in those managers. With hedged equity, ABS and K2 have both outperformed. In real estate, there is less monthly recording because it is a quarterly valued investment, so the focus should be on year-to-date. Morgan Stanley and American Realty have done well on an absolute basis at an 8% return year-to-date. Commercial real estate is on the upswing from an economic perspective. The cap rates are still very low and there are positive trends. For infrastructure, IFM is up 7.9% year-to-date and JPMorgan is up 6.4%. Overall, there are a number of managers beating the benchmarks, with only a few exceptions, in a very tough market.

In response to a question from the Chairman, Mr. Caprio stated that Reinhart Partners should be invited to an Investment Committee meeting to address underperformance and their plans to rectify that over the next few quarters and into the next year. While they may protect assets well on the downside, the August numbers are worrisome to Marquette.

In response to a question from Mr. Muller, Mr. Caprio stated that there are multiple mid-cap managers for diversification of style and philosophy. For example, AQR and FMA are two completely different managers. AQR is a highly quantitative manager with a lot of well-diversified stocks. FMA is more fundamental and owns approximately 50 to 60 stocks. In mid-cap, Artisan is much more growth-oriented and aggressive. A lot of their stocks have direct and indirect exposure to emerging markets and non-U.S. earnings. Reinhart Partners, however, is a very domestic and home-based manager with a private market capitalization style.

In response to a question from the Chairman, Mr. Caprio stated that Marquette recommends that Reinhart Partners be placed on alert. This would not hurt their portfolio; it would simply allow the Board to officially take action on the underperformance. Generally, an alert status moves to an on notice status if performance does not improve over the upcoming quarters. If performance still lags, an administrative process can begin to replace a manager or determine another solution.

In response to a question from Dr. Peck, Mr. Caprio stated that Reinhart Partners is not already on alert; the Board had previously decided to wait on that decision.

The Pension Board unanimously approved placing Reinhart Partners on alert. Motion by Dr. Peck, seconded by Mr. Sikorski.

Mr. Caprio then addressed Marquette's rebalancing recommendation to reduce allocation based on the August 30, 2011 market values. The Fund is slightly overweight to hedge funds and slightly overweight to infrastructure. Marquette wants to reduce hedge funds by .5%, from 10.5% to 10%, or $4 million from ABS and $4 million from K2. Additionally, Marquette wants to take 2.5% of the IFM portfolio, which would leave it at 2.5%. Marquette has a two-year hard lockup on that fund where 2.5% can be taken out of the investment each quarter until the two-year period is over, which is May of 2012. By the second quarter of next year, anything can be taken out. Since the fund is overweight, it is a good time to trim a little bit off to pay benefits in December. All redemptions will be sent to the Fund on a quarterly basis, and the next quarter is the end of December, so this redemption is approximately 85% to 90% of the December benefit payments.

In response to a question from Dr. Peck, Mr. Caprio stated that ING will stay in the Fund until Marquette has a contract executed by UBS. Marquette has a write-up available and will bring it to the next Pension Board meeting.

The Pension Board unanimously approved liquidating a portion of the portfolio by moving $4 million from ABS Hedged Equity and $4 million from K2 Hedged Equity and 2.5% from IFM Infrastructure into cash. Motion by Dr. Peck, seconded by Ms. Bedford.

Mr. Grady stated that this is not really a rebalancing because the funds are actually being removed. It is more of a liquidation. Mr. Caprio agreed.

Mr. Caprio then discussed various asset allocation portfolio options prepared by Mr. Caprio, Mr. Christenson, and a Marquette actuary. The options do not completely revamp the existing portfolio; they slightly shift asset allocation in fixed income to another asset class. Current low interest rates will eventually increase and hurt the bond portfolio. Because of this, a move away from bonds over a long period of time is necessary. Marquette created several scenarios that show how slowly increasing allocations to different alternative investments by taking it away from fixed income and still achieving the 8% rate of return will affect the portfolio. Additionally, Marquette looked at multiple forms of risk and the structural impact of changing the portfolio in terms of how it would look versus its peers. Finally, Marquette took into account asset liquidity. The focus is on alternatives; those investments often take longer to invest in and they are locked up longer, which means there is less access to capital. Therefore, current cash flow needs of the pension fund using the current actuarial assumptions must be taken into account in determining the amounts of potential increased illiquidity if allocation to real estate, hedge funds, real estate, infrastructure, or private equity is increased.

In response to a question from Mr. Muller, Mr. Caprio stated that Marquette did not model mid-cap value because Marquette's philosophy on equity portfolio construction has been that mid-cap growth is a better place to be. The Chairman also stated that with the asset allocation study a few years ago, the Board chose to shift out of mid-cap value and small-cap growth and stay with small-cap value and mid-cap growth.

In response to a question from Mr. Muller, Mr. Caprio stated that all changes are reflected in the analysis summary. Moving from portfolio option to portfolio option, the underlying asset allocation of the pension fund changes, and those changes are reflected in the capital market assumptions.

Mr. Caprio continued his discussion with portfolio A. Fixed income is decreased by 3% and that 3% is reallocated to core real estate. Return expectations and risk factors then need to be considered. With this option, the average annualized ten-year return is 7.97%, which is similar to the long-term expectation of this option and to the current portfolio. However, portfolio A takes on slightly more illiquidity, so essentially moving more core real estate is not the best option right now despite that it is a good asset class that will do well long-term.

Mr. Caprio next discussed portfolio B. Fixed income is decreased by 3% and that 3% is reallocated to hedge funds. The impact again is relatively minor. The average annualized ten-year return is 7.96%. However, portfolio B takes on slightly more volatility, which could conflict with the 8% rate of return that must be achieved.

Mr. Caprio then outlined portfolio C, which focuses on reallocating to real estate opportunistic. This portfolio models the illiquid structure to simulate the impact of creating a fund and ultimately looking at the cash flows there. This adds a very high average annualized ten-year return expectation at 9.17% and a slightly lower volatility.

Mr. Caprio then stated that portfolio D increases the infrastructure from 7% to 10%, which results in a slightly higher average annualized ten-year return at over 8%. Again, though, 10% is a fairly large allocation to add to any one asset class and more of a balanced approach is needed.

Mr. Caprio then discussed portfolio E. Fixed income is decreased by 3% and that 3% is reallocated to private equity, yielding an average annualized ten-year return of 8.41% with slightly more volatility than the current portfolio and with a slight increase in illiquidity. Additionally, the percentage of the portfolio in illiquid assets increases from 10% in the current portfolio to 13%. This is acceptable because the current projected benefit payments in net cash flows can handle it over long periods of time. In just the last two and a half years, there have been some changes to the actuarial assumptions and to the backDROP payments, and so for these reasons the asset allocation portfolios are run every three years. Additionally, the 3% allocation currently in private equity is not really doing much for the portfolio. It is a legacy portfolio. While there are a few new funds, they are calling capital very slowly and it is a waste of time and fees. It is time to either exit the asset class or increase the allocation to make it meaningful. Another manager to compliment Adams Street can be searched for, or the money can be moved into infrastructure or some other asset class that is not so correlated to public markets and stock markets or the fixed income bond market. Those components right now are extremely volatile and moving to an alternative is a better option. While the ERS portfolio statistically leans toward portfolio C, the underlying components of real estate indicate that it is not a good option. Real estate is a very illiquid asset class long term. Opportunistic real estate would be closed-end, meaning that it would be similar to private equity where capital is called for over a certain period of time and then each investment is exited. This is much easier to do in private equity with public markets and an IPO than in real estate with distressed property or some sort of office building or apartment complex. Long-term private equity is a better option.

In response to a question from Dr. Peck, Mr. Caprio stated that the number of discrete assets in opportunistic real estate is most likely different from conventional private equity. It would be a fund of funds situation so capital would be allocated to a manager who would invest that capital with other managers within the asset class.

In response to a question from Mr. Muller, Mr. Caprio stated the portfolio option model is an average that is annualized over ten years and runs to June 2011. The model is based on a long-term perspective of the likelihood of achieving a specific rate of return.

In response to a question from Mr. Muller, Mr. Caprio stated that 92% of the 8% return comes from asset allocation. Academic studies indicate that active management over long periods of time achieves little value. Managers do well or they do not; at the end of the day, allocations are most important.

Dr. Peck then stated that a study showed that ERS's active management net of fees has added value. Mr. Caprio agreed, but then stated the takeaway is that this puts pressure on to always find top profile managers to beat the benchmark, and that is difficult to do.

In response to a question from Mr. Muller, Mr. Caprio stated that Marquette does not feel constrained by the marketplace when determining whether to allocate more to alternatives. Marquette only places client money in illiquid asset classes to the extent that the client can handle the illiquidity.

Mr. Caprio then discussed growth projections for the current portfolio. With the projected net cash flow from the actuary on a smoothing basis translated into a market value basis, Marquette is able to show the impact of a portfolio based on liquid and illiquid amounts and the projected returns in the portfolio. Predicted earnings are roughly 8% over the next ten years. Approximately 6% to 7% is paid out per year in negative cash flow. If there are earnings, if the portfolio is in the 50th percentile of that 8%, earnings will be at $1.8 billion over the next ten years. The focus is that projected net cash flow not exceed the growth rate, even with the draw downs. Portfolio E is similar in that the net cash flow is not going to be moved too much by only increasing illiquidity by 3%. It is critical that the Fund is able to handle additional illiquid assets, and that there is a cushion available if there is a large draw on the assets.

The Chairman then stated that in 2008 when that did happen to ERS, ERS exercised its discretion not to automatically rebalance out of those illiquid asset classes because of the potential upturn the market could take.

The Chairman stated that private equity was addressed in the Investment Committee meeting and the general outcome was that increasing the existing allocation was preferable to getting out of the asset class completely.

Mr. Kellogg then provided an overview of the Fund's long term private equity performance. The academic research and the research that Marquette has done shows significantly that over longer periods of time, private equity generates outperformance over the public markets. In the Marquette exhibit, page one, the first table looks at the return of the two mature ERS investments in 1998 and 2001. The second table looks at the same investments, only from a public equity investment standpoint rather than private equity. It takes the cash flow normally placed in the ERS investments and instead assumes it was invested in the S&P 500. The last table looks at the relative performance or the outperformance of the private equity investment versus the public market. The outperformance is what is really most relevant. Typically, investors should expect a 4% to 6% outperformance of the public equity equivalents in a private equity investment to pay for illiquidity. Since inception, the 1998 fund generated a 3% compound annual outperformance over the public equity benchmarks, and the 2001 fund generated a 4.3% compound annual outperformance. The 1998 fund, then, was a bit below expectations, but both investments generated strong outperformance over the public equity equivalents. The 3% or 4% is compounded over multiple years so the real effect on the Fund has also been compounded over multiple years. On average, most private equity dollars are invested for 6 to 7 years. The 3% compounded over six to seven years will yield 15% to 20% more capital in a private equity investment than in a public equity equivalent. The ERS Fund has already benefitted from the fact that there is a real illiquidity premium for those who are willing to make a private equity investment. The Fund, through these two Adams Street funds, has realized that outperformance.

Mr. Kellogg continued with the exhibit, page two, which shows the 2005 and 2009 investments. The outperformance is not yet there, which is very typical of private equity investments. The fees and the early stage of the fund make the performance look less attractive and then, as the fund matures, the relative outperformance starts to appear. While the 1998 and 2001 funds are most relevant, the last table shows the 2005 fund basically about to break even with a public equity investment. The 2005 fund over the next 3 to 4 years should start to outperform the public equity markets. The 2009 fund does not look very attractive right now, again very typical of the first year or two of a private equity investment. In the next year or two, that should catch up and eventually some strong outperformance will occur as more capital gets invested. The point is to show that there had been some real benefit in making the private equity investments for the Fund.

Mr. Kellogg concluded by discussing pages 3 and 4 of the exhibit, which show how cash flow is drawn down, invested, and then returned over time. The gray bars show actual cash flow and below the axis are cash payments to Adams Street. Above the axis are payments back to the Pension Fund. The red bar is the net total investment over time. During the first few years, the bar dips to the negative as cash is drawn down and invested. For the 1998 fund, all the capital paid in plus additional money was paid back, which is the desired return. The 2001 fund is not quite as mature, so it is getting close to but has not quite returned all the capital paid in. There is still approximately $10 million invested in this fund, so over the next few years the rest of that capital will continue to grow. The point of these two funds is to show that private equity is a long-term asset. It can take a number of years to draw down the capital and a number of years for the capital to come back. There has been some real benefit to the Fund by taking on these illiquid investments. Before increasing the private equity exposure from 3% to 6%, it is worth confirming that experience to date has been meaningful.

Mr. Caprio then stated that the investments were made from a number of different buckets. There is good, healthy diversification of all the different subcomponents in private equity, and that also contributes to the performance. The 1998 fund is very heavily invested in venture, more so than some of the other funds, and that paid off well. Also, Adams Street is a marquee manager, though they have been a little slow to call money recently. If the allocation to private equity is increased, the Investment Committee can review how to do it, with whom, and what buckets would provide the proper diversification.

Mr. Caprio then stated that Marquette recommends the adoption of portfolio E.

In response to a request from Mr. Grady, Mr. Caprio agreed that the asset allocation change is a change to the actual investment policy and assuming a motion is proposed and adopted, Mr. Caprio will provide a revised policy statement.

The Pension Board unanimously approved the adoption of Portfolio E of Marquette Associates' recommendations. Motion by Dr. Peck, seconded by Ms. Bedford.

In response to a question from Mr. Muller, Mr. Caprio stated that Marquette recommends that a portfolio analysis be performed every three years, or more often if extreme market conditions require it.

Mr. Grady then noted for the new Board members that Marquette came on in 2008 as a consultant. One of the first tasks was an asset allocation analysis, and Marquette made a series of recommendations. Real estate was the last piece—moving funds into new allocations and new asset classes and hiring new managers—but it has really been a massive undertaking. It is fair to say that the first asset allocation study is still in process, so this most recent analysis is really just a tweak of the first.

The Chairman then recommended that at a future Board meeting, Messrs. Caprio and Christenson discuss the initial research that Marquette had done on value versus growth as well as the basis for Marquette's recommendations.

In response to a question from Mr. Queen, Mr. Caprio stated that the last time the investment policy was changed was in 2010 to update asset allocation and other structural changes. It needs to be changed again to take 3% out of fixed income and allocate it to private equity. The Investment Committee will need to work on that.

7. <u>Investment Committee Report</u>

Dr. Peck reported on the September 6, 2011 Investment Committee meeting.

Dr. Peck noted that the committee discussed the various options and risk factors in Marquette's asset allocation analysis. The consensus of the

Committee was that the committee wanted to increase the private equity portion of the allocation.

8. Audit Committee Report

The Chairman reported on the September 1, 2011 Audit Committee meeting.

The Audit Committee discussed the ERS enrollment forms, which are in the process of being updated based on rule changes, as well as changes to the backDROP election form.

The Audit Committee also discussed the Pension Board election results. Specifically, concerns regarding potential conflict of interest if employees from certain departments were elected to serve on the Pension Board. Any changes to the current election process would require an Ordinance change. Mr. Grady then stated that Ms. Ninneman and Mr. Hanchek requested that he draft an Ordinance amendment reflecting this change in order for them to present it to County administration and the County Board. The amendment will most likely name specific ERS departments.

The Audit Committee then discussed the Retirement Granted form. The form includes date of birth and some members and retirees are concerned that these dates are public record. Pension Board Rule 1040 mandates this information be included and would need to be amended if that were changed. Mr. Grady stated that the question is whether the Board wants this information on the form. If not, the rule can easily be amended.

In response to a suggestion from Dr. Peck that the date of birth be removed and only the Rule of 75 information be included, and after general Board discussion, Mr. Grady stated that he would draft an amendment to the Rule and present it at the next Audit Committee meeting.

The Audit Committee then discussed the member handbooks. ERS is still working on the handbooks; they are very complicated because of the different benefit structures.

The Audit Committee next discussed the small accounts in OBRA that need to be cashed out, but for which many of the participants cannot be located. The Committee is looking for an IRA custodian that could place the money into an IRA for that participant and hold it until the participant is found. Only one response to the RFI was received, but it was expensive. Another potential vendor was found and an RFI provided.

The Audit Committee concluded with a decision to select Columbia St. Mary's to serve as the Medical Board going forward, subject to an acceptable contract.

The Chairman then invited the Board members to participate in the Audit Committee, particularly if the members want to influence the policy of the Board on any issue.

9. Proposed Ordinance Amendments

Mr. Grady provided the background on the proposed Ordinance amendment, which will be in front of the various committees and then the County Board over the next week.

Mr. Grady noted that the Ordinance amendment does not change the benefits of any current employee. It states that if an employee is eligible for the Rule 75 as of September 29, 2011, that eligibility is retained. Going forward, employees will never gain that eligibility. The primary impetus behind the amendment is the potential for a union to decertify. In this case, those members would become non-represented members and eligible for the Rule of 75. District Council 48 and the smaller unions gave up the Rule of 75 on various dates throughout the 1990s. However, non-represented employees did not lose that benefit until 2006. Therefore, if an employee was hired after the Rule of 75 was bargained away but before 2006, and that employee became non-represented through a decertification process, the employees could become eligible for the Rule of 75. This Ordinance amendment is to essentially prevent that from happening.

Mr. Grady stated that the Ordinance amendment is expected to be passed and adopted. There is no actuarial cost to it because it does not change current benefits. Additionally, if unions stay certified, this would not affect members unless members made job changes. The County Board passed similar amendments in the past for specific promotional categories. This amendment is just on a larger scale.

In response to a question from the Chairman, Ms. Ninneman stated that there are no implementation costs relating to this amendment.

The Chairman then noted that the Board's responsibility is not to comment on policy but to provide comments on any impact to ERS operations. There is a requirement in a County Ordinance that states every change in the Pension System will be referred to the Pension Board for comment. The Pension Board is then given 30 days to comment if it chooses to do so. Typically, the Board adopts a resolution making no formal comment.

The Pension Board voted 7-1, with Mr. Stuller dissenting, to approve the adoption of the following resolution:

> **The Pension Board offers no formal comment regarding the proposed Ordinance amendments to sections 201.24(4.1) of the Milwaukee County Code of General Ordinances codifying pension provisions for collectively bargained employees, and waives the balance of its 30 day comment period provided for under section 201.24(8.17) of the Milwaukee County Code of General Ordinances. The Employees' Retirement System ("ERS") Manager estimates that implementation of the proposed Ordinance amendments would not result in additional cost to the System. The Pension Board believes that it is in the best interests of ERS for the County Board to adopt Ordinance amendments which clarify the intended operation of the Ordinances.**

Motion by Ms. Bedford, seconded by Dr. Peck.

10. Administrative Matters

The Pension Board discussed additions and deletions to the Pension Board, Audit Committee, and Investment Committee agendas. The Chairman asked that anyone with future topic suggestions should voice them. Those topics will be discussed at the next agenda planning meeting.

No action was taken on educational opportunities for the Pension Board members because all proposed opportunities are approved.

Ms. Bedford moved that the Pension Board adjourn into closed session under the provisions of Wisconsin Statutes section 19.85(1)(e), with regard to item 11 for considering the investing of public funds, or conducting other specified public business, whenever competitive or bargaining reasons require a closed session, and that the Pension Board adjourn into closed session under the provisions of Wisconsin Statutes section 19.85(1)(f), with regard to item 12 for considering the financial, medical, social, or personal histories of specific persons which, if discussed in public, would be likely to have a substantial adverse effect upon the reputation of any person referred to in such histories, and that the Pension Board adjourn into closed session under the provisions of Wisconsin Statutes section 19.85(1)(g), with regard to items 12, 13, and 14 for the purpose of the Board receiving oral or written advice from legal counsel concerning strategy to be adopted with respect to pending or possible litigation. At the conclusion of the closed session, the Board may reconvene in open session to take whatever actions it may deem necessary concerning these matters.

The Pension Board voted by roll call vote 8-0 to enter into closed session to discuss agenda items 11, 12, 13, and 14. Motion by Ms. Bedford, seconded by Dr. Peck.

11. Actuarial Services Request for Proposal

In open session, the Pension Board voted 7-1, with Mr. Stuller dissenting, to approve the recommendation of the actuarial services RFP panel to award the contract to Buck Consultants. Motion by Dr. Peck, seconded by Ms. Bedford.

12. Disability Matters

(a) Applications

(i) Karen Mickelson, ADR

The Pension Board discussed Ms. Mickelson's accidental disability pension. The Medical Board stated that Ms. Mickelson is permanently unable to perform the job functions of her position as a result of service-related injury. The disability standard for the position is one which requires the member to be able to perform her own job.

In open session, the Pension Board unanimously granted the accidental disability pension application based on the Medical Board's determination. Motion by Dr. Peck, seconded by Mr. Stuller.

13. Pending Litigation

(a) *Mark Ryan, et al. v. Pension Board*

The Pension Board took no action on this item.

(b) *Travelers Casualty v. ERS & Mercer*

The Pension Board took no action on this item.

(c) *ERS v. Lynne Marks*

The Pension Board took no action on this item.

(d) *Christine Mielcarek v. ERS*

The Pension Board took no action on this item.

(e) *Lucky Crowley v. ERS*

The Pension Board took no action on this item.

14. Report on Compliance Review

The Pension Board took no action on this item.

15. Adjournment

The meeting adjourned at 12:45 p.m.

Submitted by Steven D. Huff,
Secretary of the Pension Board