EMPLOYEES' RETIREMENT SYSTEM OF THE COUNTY OF MILWAUKEE
MINUTES OF THE AUGUST 17, 2005 PENSION BOARD MEETING

1. Call to Order

   Chairman Walter Lanier called the meeting to order at 8:35 a.m. in Room 203-R of the Milwaukee County Courthouse.

2. Roll Call

Members Present:	Members Excused:
Linda Bedford	Thomas Weber
Donald Cohen	
Walter Lanier	
John Martin	
Marilyn Mayr	
Michael Ostermeyer	
John Parish	
Dean Roepke	

   Others Present:
   Charles McDowell, Director of Human Resources
   Jack Hohrein, ERS Manager
   Mark Grady, Principal Assistant Corporation Counsel
   Gordon Mueller, ERS Fiscal Officer
   Bob Shupe, ERS Retirement Administrative Specialist
   Anh To, Milwaukee County
   Steven Huff, Reinhart Boerner Van Deuren s.c.
   Leigh Riley, Foley & Lardner LLP
   Brad Blalock, Mercer Investment Consulting
   Patrick Race, Mercer Investment Consulting
   Neil Cornell, Mercer Investment Consulting
   Kristin Finney, Mercer Investment Consulting
   Dennis Skelly, Mercer Human Resource Consulting
   Ray Smith, Maximus
   Cliff Van Beek, Retiree
   Ken Loeffel, Retiree
   Michael Howden, Retiree
   Florence Ignarski, Retiree
   Virginia Schumann, Retiree
   Doug Jenkins, Deputy Director of Audits
   Dave Umhoefer, Milwaukee Journal Sentinel

The Chairman noted that Mr. Weber had not yet attended a Board meeting. Mr. Hohrein stated that he had attempted to contact Mr. Weber without success.

3. <u>Approval of Minutes of July 20, 2005 Meeting</u>

The Board reviewed the minutes of the July 20, 2005 Pension Board meeting. Mr. Martin pointed out that the meeting had adjourned at 2:50 p.m., rather than 3:50 p.m. as stated in the minutes.

The Board unanimously approved the minutes of the July 20, 2005 Pension Board meeting, as amended to reflect the correct time of adjournment. Motion by Mr. Cohen, seconded by Mr. Martin.

4. <u>Report of Retirement System Manager</u>

A. <u>Ratification of Retirements Granted</u>

Mr. Hohrein presented the schedule of Retirements Granted for the prior month's retirements and asked the Board to review them.

The Board unanimously approved the schedule of Retirements Granted. Motion by Mr. Martin, seconded by Mr. Parish.

5. <u>County Board Request that Pension Board Reconsider Contribution Request and Actuarial Assumed Rate</u>

The Board discussed the Director of Audits' report on the review of key actuarial assumptions used for the 2006 recommended pension contribution. The Chairman noted that the Board had considered a great deal of material at two of its meetings, which resulted in several hours of deliberations on the actuarial interest assumption.

Mr. Skelly indicated that in 2001, the Board established the actuarial assumed rate of return as the 10-year average investment return of ERS, with a minimum of 7.5% and a maximum of 9.0%.

Mr. Jenkins asked to address the Board regarding the report. He noted that Mercer had not specifically recommended that the Board set the assumed rate of return at 8.0%. He also explained the findings set forth in the Director of Audits' report. He agreed with the Chairman that the Pension Board had acted with appropriate due diligence and within its reasonable discretion in adopting the 8.0% rate.

Ms. Mayr asked for clarification on whether Mercer is required to make a recommendation regarding the assumed rate of return. The Chairman stated that he recalls that Mercer did not say that 8.0% was its recommendation. The Chairman also noted that the motion the Board passed stated that changing the assumed rate of return to 8.0% was Mercer's recommendation. Ms. Mayr pointed out that Mercer did not object to that characterization in the motion. Mr. Skelly responded to her question that Mercer is not required to make a recommendation.

6. Investments, Mercer Investment Consulting

A. Asset/Liability Modeling

Mr. Blalock presented the asset/liability modeling results. He noted that ERS has experienced mixed results because it has had better relative asset performance but the funded status continues to decrease. Mr. Grady stated that ERS was cash-strapped even without last year's back DROP payments. Mr. Blalock observed that ERS had been in the top half of the applicable universe for payouts without considering the back DROP payments for 12 years. He also stated that ERS pays out more than other funds because it has a greater proportion of retirees than most plans.

As background, Mr. Blalock discussed ERS's investment policy and observed that ERS has historically been a relatively conservative fund. He stated that, for the past few years, ERS has held a significant proportion of the assets in fixed income, which has served ERS well. The Chairman asked whether ERS had to be more aggressive to pay benefits. Mr. Blalock responded that ERS has historically relied in part on the cash flow from higher yield fixed income investments to pay benefits. This has delivered a higher level of credit risk but has been successful in terms of returns over recent years. Going forward, past performance should not necessarily be relied on to drive the new long-term strategy for the future. He stated that the alternative to the higher yielding fixed income approach to fulfilling cash flow needs would be to sell assets each month.

Mr. Blalock also addressed asset allocation. Ms. Bedford asked whether Mercer had looked at manager structure and Mr. Blalock responded that it had, but the overarching goal at this stage was strategic asset allocation. The Chairman pointed out that the Board did not control benefit structure, which was listed as one of the considerations in asset allocation. Mr. Blalock also discussed the influence of liability on the investment policy and noted that there was a substantial mismatch between the duration of ERS investments and anticipated liabilities. He stated that they could not be equalized without significantly accelerating the need for contributions, and that and appropriate approach was for ERS to continue to take an equity risk. He further discussed Treasury Inflation Protection Securities ("TIPS"), global markets and international investments as potential areas of change in the investment policy.

Mr. Blalock also addressed the ERS objectives to pay benefits as they become due and to fund benefits through a combination of risk-controlled investment return and contributions. He noted that funding status and contributions need to be controlled to ensure that the plan remains affordable. He stated that the desired funding percentage drives risk tolerance and that the ultimate funding goal should be 100%. He noted that funding need not always be over 100% on a long-term basis, but that ERS should avoid 50-60% funding. He also discussed the trend towards implementing defined contribution plans.

Mr. Blalock reviewed a chart showing the economic scenarios that resulted from changes in economic growth and inflation, which are the most important factors in building assumptions. He also reviewed charts showing the required contribution calculation using the 10-year Treasury securities as a risk-free investment for comparison. He stated that with exception of Ideal Growth, all economic scenarios generate higher contributions and explained that if ERS fails to earn 8.5% (the background assumption against which the analysis was carried out each year), the shortfall gets larger each year and requires a larger contribution. The Board reviewed a similar chart regarding funding status, which showed that, except for Ideal Growth, the funded status will decrease despite contribution increases.

The Board reviewed simulation results for contributions and funded status of the current allocation and alternative allocations, including a chart showing expected returns for each alternative. Mr. Blalock presented analyses of the alternatives that looked at contribution volatility in 2010, annual investment return volatility and funded status in recession and stagflation.

The Pension Board discussed the risk tolerance of ERS. Mr. Ostermeyer stated that it is not the Board's job to chase investment returns, but to set the risk level and tailor investments to achieve it. Mr. Blalock agreed that the Board must decide what it can live with on the down side and then build an efficient portfolio to try to achieve the necessary return, and minimize the probability of breaching the worst case conditions. The Chairman indicated that establishing an investment policy for a mature fund such as ERS is difficult because of its cash flow needs. Mr. Grady indicated that volatility is difficult for a government to plan for. Ms. Bedford recognized that it is difficult for investment managers to do their jobs if the Board has to keep withdrawing money to pay benefits.

The Chairman asked whether there is a model that captures the political risk of the government not contributing. Mr. Blalock responded that theoretically, the employer must contribute now or later and that he could calculate the present value of the contributions needed. Mr. McDowell asked how the County Board and Pension Board could work together better to establish a predictable level of contributions. Mr. Blalock indicated that the County would have to overfund ERS to compensate for variances and that investments will not solve the funding problem. Mr. Grady suggested that benefit changes could be a solution to the problem.

Dr. Roepke and Ms. Bedford suggested that the current ERS asset allocation depended too heavily on fixed income. Mr. Ostermeyer indicated his view that the Board's commitment to fixed income was a conservative approach and that significantly changing the risk tolerance of ERS to chase returns at the risk of increased volatility, was not practical under current circumstances, or prudent.

Mr. Blalock presented Mercer's conclusion that the current strategy is shown to carry marginally more upside than downside and that the three alternatives presented so far with slightly greater upside are increasing equities, increasing bond duration and increasing proportion of international equities. He also said that the next steps the Board should take are to make decisions regarding equity/bond allocations, U.S./international allocations, other asset classes, alternative assets and tactical asset allocation including active currency management. He explained that once the Board has set its strategy, the portfolio structure can be assessed and then the monitoring process will return to manager issues.

Mercer was asked to consider a range of alternative asset allocations in terms of the difference they made to expected contributions. Specifically, an option to deliver the assumed 8% rate of return was to be investigated, along with portfolios with a greater allocation to real estate, international equity and a new allocation to hedge funds.

7. Presentation Regarding Possible Claims Against Third Parties

The Chairman stated that the Pension Board may enter closed session to confer with the Pension Board's legal counsel regarding strategy to be adopted with respect to litigation in which it is or is likely to become involved. Mr. Loeffel asked for clarification regarding the third parties to be discussed. The Chairman responded that the Board would be meeting with its legal counsel regarding a resolution that the Board had previously passed.

The Board unanimously agreed by roll call vote to enter closed session for a presentation by Mr. Domina and additional legal counsel regarding possible claims against third parties. Motion by Mr. Cohen, seconded by Dr. Roepke.

Mr. Ostermeyer and Mr. Huff recused themselves from the presentation. Mr. Martin was excused from the meeting during the presentation to attend another meeting.

8. Investments, Mercer Consulting (Continued)

B. Investment Policy

Mr. Blalock presented an updated draft investment policy. He indicated that the policy had been sent to all ERS investment managers and that the benchmarks had been communicated.

The Board reviewed the purposes of the investment policy, which are to provide a written document of the Board's expectations regarding investments, establish objectives and guidelines for investing, outline criteria and procedures for evaluation of the investment program and provide a communication method for the investment managers. Mr. Blalock noted that the statement is intended to be dynamic and will be updated and revised on an annual basis to reflect the Board's current investment goals.

The Board also discussed the asset allocation policy and noted that the current policy had been created by evaluating the fund's actuarial methods and assumptions, key elements of investment theory, historical and prospective risk and return characteristics associated with various asset classes and investment management styles and diversification benefits derived from combining disparate asset classes.

The Board reviewed the investment management structure and noted that it uses a multiple manager structure in order to diversify effectively by asset class and management organization and to limit the impact of any single manager. Mr. Blalock also noted that the precise dollar allocation among managers in a particular category will be determined by the Board and may be modified at its discretion. The Board also discussed the responsibilities of the investment managers.

The Board next discussed investment objectives and guidelines, along with information regarding liquidity requirements, prohibited transactions and the review policy for investment mangers that underperform their benchmarks. Mr. Blalock noted that markets tend to be cyclical, so the Board does not fire managers quickly due to the transaction cost. Ms. Mayr inquired about the purpose of the many exceptions to the prohibited transaction policy. Mr. Blalock explained that the managers need to be allowed to buy non-registered securities and that Adams Street Partners and Progress Investment do not buy public securities so they must be allowed to buy private stock. The Board noted that it reserves the right to terminate its relationship with any investment manager or remove assets from any investment manager at any time it is appropriate.

The Board also reviewed its procedures for evaluating and reviewing the performance of the investment managers. The Board observed that each manager will be expected to meet with the Board at least annually and to provide a verbal and written review of their investment performance and portfolio structure, a synopsis of their key investment decisions and an organizational update. The Board reviewed the responsibilities of the investment consultant as well.

Mr. Blalock pointed out that investment managers should be familiar with Ordinance sections 201.24 and 203 and that they should be provided with any amendments to these sections.

The Board examined the nondiscrimination policy, the policy and guidelines for brokerage services and the proxy voting guidelines. The Chairman requested that the performance guidelines be turned into a compliance matrix. Mr. Blalock indicated that Mercer could create a yes/no checklist to be included in the quarterly reports. Mr. Ostermeyer inquired whether the Board should be monitoring proxy voting. Mr. Blalock responded that the Board could hire an audit firm such as ISS to monitor proxy voting but that there is insufficient internal staff to do so. Mr. Blalock stated that the Board should adopt the investment policy in the near future to send to the investment managers.

C. Flash Report/Liquidity Request

Mr. Race presented the flash report for July 2005. He observed that ERS had an aggregate market value of approximately $1.52 billion on July 31, 2005 and had a 2.5% return during July, leading the Composite Market Index by 10 basis points.

Mr. Race stated that the appointment documentation for Banc One is now complete and funding can be completed, assuming the fixed income allocations are signed off as part of the asset liability discussions. He reported that Capital Guardian's EAFE performance continues to recover and that its rating remains favorable despite the medium-term underperformance. Mr. Race noted that due diligence meetings have been scheduled with EARNEST Partners and Reinhart & Mahoney for September, but that these could sensibly be deferred given the further work required on the asset liability model.

Mr. Race also presented Mercer's report on the second quarter of 2005. He first reviewed the second quarter 2005 market environment, including the economic profile, interest rates and inflation and performance of the various markets. He also noted that ERS was valued at $1,480.6 million on June 30, 2005, which was an increase of $13.5 million since the end of the first quarter 2005. ERS had a 2.8% return for the second quarter, which led the Public Fund Universe Median by 30 basis points but trailed the Reference Index by 20 basis points. In addition, the Board reviewed the performance of investment managers for the quarter.

The Board also discussed the cash flow needs for August. Mr. Race stated that Mercer recommended that the cash needed be taken from Capital Guardian in the international small cap equity asset class, which has an overweight of 1.4%.

The Board unanimously agreed to withdraw $10 million from Capital Guardian to satisfy ERS's liquidity needs for August 2005. Motion by Dr. Roepke, seconded by Mr. Cohen.

D. Adams Street Partners Amendment

Ms. Riley presented an amendment to the Adams Street Partners investment agreement. She indicated that the amendment changed references to U.S. investments to North American investments in order to provide for investments in Canada.

The Board unanimously agreed to approve the amendment to the Adams Street Partners agreement. Motion by Mr. Cohen, seconded by Dr. Roepke.

9. Maximus Technology Update and Recommendation of Vendor

The Chairman stated that the Board may enter closed session for deliberating or negotiating the purchase of public properties, the investing of public funds or conducting other specified business, whenever the discussion will directly and substantially affect negotiations with a third party. The Board unanimously agreed by roll call vote to enter closed session. Motion by Ms. Bedford, seconded by Mr. Parish.

Upon returning to open session, the Board unanimously agreed to enter into a contract with Vitech for computer technology services at a cost not to exceed $8,010,097 and to authorize the Chairman to sign the contract, subject to review by Corporation Counsel. Motion by Mr. Parish, seconded by Dr. Roepke.

10. Fiduciary Insurance RFP Process Approval for Risk Management

Mr. Hohrein presented to the Board Risk Management's proposed RFP Process for fiduciary insurance for the Pension Board. He indicated that the Board's fiduciary insurance coverage will expire in January 2006 and that the process should be started soon to obtain proposals before the current policies expire. Dr. Roepke suggested that the RFP include costs of coverage with deductibles at various levels. The Chairman noted that the Board can review the status of the RFP process at its September and October meetings.

The Board unanimously agreed to authorize Risk Management to prepare and complete the RFP process. Motion by Dr. Roepke, seconded by Mr. Cohen.

11. Concluding Remarks

The Chairman noted that the Board did not deviate from its policy in setting the actuarial assumed rate of return for 2006 at 8.0%.

Dr. Roepke proposed that the Chairman, Mr. Hohrein or Mr. Grady ask County Board Chairman Holloway whether Mr. Weber intends to serve as a member of the Board. The Chairman asked Mr. Hohrein to follow up and report on the requirements of Board members.

Mr. Ostermeyer stated that he planned to attend the Pension Real Estate Association Annual Conference. He indicated that he will pay for the registration but wants to register as a Board member in order to be eligible for reduced fees. The Board did not object to Mr. Ostermeyer's proposal.

12. Adjournment

The meeting adjourned at 1:45 p.m.

Submitted by Steven D. Huff,
Assistant Secretary to the Pension Board