# MINUTES OF MAY 12, 2011 RETIREMENT BOARD
# CITY OF ALEXANDRIA FIREFIGHTERS AND POLICE OFFICERS PENSION PLAN
# SPECIAL MANAGER SEARCH MEETING

## PRESENT

| Members | Others |
|---|---|
| Michael Cross, Chairman [2,4] | Steven Bland, Retirement Administrator |
| Michele Evans [1] | Barry Bryant, Dahab Associates |
| Shirl Mammarella (Alternate) [2, 3] | Bladen Burns, CFA, Fiduciary Management |
| Ed Milner [1] | Randell A Cain Jr. Herndon Capital Management |
| Cheryl Orr [3,4] | Ted Kellner, CFA, Fiduciary Management |
| Morgan Routt [3] | Jack Kelly, Mount Lucas Management |
| Al Tierney [4] | Arthur Lynch, Retirement Specialist |
| Laura Triggs [2, 3] | Dean Molinaro, Prudential |
| | Theresa Nugent, Pension Communication Specialist |
| | Kathleen Ognibene, Deputy Director Human Resources |
| | Lisa Powell, Prudential |
| | Marc Sydnor, Herndon Capital Management |

Committee Membership
[1]Buyback Committee
[2]Technical Correction Committee
[3]Training Opportunities Committee
[4]Vendor & Service Provider Committee

## CALL TO ORDER

The meeting was called to order at 8:42 AM on May 12, 2011.

## MINUTES

Review of the minutes was deferred.

## DUE DILIGENCE MEETING

Dean Molinaro referred to pages fifteen through seventeen in the Prudential Quarterly review, *Investment Review, First Quarter 2011*. He discussed the multi manager matrix. Prudential selects and evaluates quarterly. The international blend manager is Artio. Their returns are found on pages 17 and 25. They have been in the fourth quartile. They have tracking error and downside risk. Their exposure to emerging markets and European banks has been a drag on performance.

Staff discussed the asset allocation of real estate and used that as a context for asking Dean about the cue to invest with PRISA. Mr. Molinaro talked about the cue, which would probably result in PRISA not accepting investments until December 31, 2011 or March 31, 2012. Mr. Tierney asked if existing customers have a shorter cue. Mr. Molinaro said “No, they do not.”

Mr. Bryant said most recent real estate activity had been centered on prime properties, the kind PRISA is centered on. This is where there were cues. Funds that were non-core had few cues.

Staff pointed out the procedures for rebalancing liquid securities such as stocks and bonds is not the same as that for illiquid partnerships such as timber, real estate, and private equity. The real estate allocation is below the target, but there is no formally adopted rebalancing range. The Board has much to do with four remaining manager searches scheduled and others not yet scheduled. This could be deferred several months. The board agreed.

Mr. Evans arrived at 8:52 AM.

Ms. Triggs arrived at 8:55 AM.

Chairman Cross asked Mr. Molinaro to discuss the investment choices available in the Defined Contribution component, especially those on watch list or otherwise not performing. These would include:

- Artio, the international manager,
- LSV, the large cap value manager, and
- Thornburg Core Growth, the aggressive midcap manager.

Times Square – another mid cap manager - has 4% of the plan’s deposits, Thornburg has .3%. The former has a quality bias, the later is more aggressive.

Thornburg is a retail mutual fund. This means it has a different contractual relationship with Prudential than others. Prudential cannot fire them. That must be done by the Board.

Mr. Bryant said the lifestyle funds did well.

Chairman Cross asked what the alternatives are to Artio. Mr. Molinaro said the Thornburg International Value Fund is a viable candidate. The fund may be more core than value. Thornburg is more concentrated with 40 – 60 holdings whereas Artio had 100.

Chairman Cross asked when Artio was placed on the watch list. Mr. Molinaro said the decision was based on December 31, 2010 data and it was placed on the watch list in February, possibly after the last quarterly report went out. Staff asked if Artio was on the watch list in a prior year. Mr. Molinaro said no, it had poor performance. It had not been on the watch list, though it had been discussed.

Ms. Mammarella asked if there was s suitable replacement. Ms. Ognibene asked if it would go off the watch list if it had a good quarter. Mr. Molinaro said the decision would be based on long term performance which is not sensitive to a single quarter's performance.

Board members discussed the possibility of creating additional options as opposed to a replacement.

There was a motion by Ms. Mammarella:

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| Add Thornburg International Value Fund to the defined contribution component and remove Artio. |

Mr. Evans seconded the motion.

Discussion: Chairman Cross asked if the motion included a mapping of Artio assets directly to Thornburg. Ms. Mammarella a said yes, it did.

The motion was unanimously approved 7 – 0).

Mr. Bryant recommended holding LSV. Its due diligence rating from Prudential is three, the lowest is four.

In the mid-cap space Chairman Cross asked about replacing Thornburg with Times Square. Times Square had beaten the benchmark for three and five years. Mr. Molinaro referred to tab C, page six.

There was a motion by Ms. Mammarella:

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| Close the Thornburg mid cap growth fund and map assets to Times Square Mid Cap Growth Fund. |

Chairman Cross seconded the motion.

Discussion: Ms. Mammarella said it had been on the watch list for a year. Prudential cannot remove it due to contractual limitations. It was up to the Board to remove it from the menu.

The motion passed (7 – 0).

Mr. Tierney asked about communication to employees. Ms. Powell outlined the transition process, key component of which is communicating the change to plan participants.

Chairman Cross asked when LSV went on the watch list. Mr. Molinaro said 2010. Chairman Cross asked if the watch list was posted on the Prudential website. Mr. Molinaro said "No," the watch list is designed for employers.

LSV has two participants. The merits of posting this were discussed. Chairman Cross might want to research the minutes.

Chairman Cross asked Ms. Powell to mention the communication efforts Prudential had made. She said they were invited to seminars several times and also to individual financial counseling sessions. There was material on websites, hard copies distributed via the Pension Administration Division, and attendance at the Benefits Fair.

Ms. Ognibene asked about the expense ratio. Mr. Tierney said it was 1.79%. Mr. Molinaro said there were fee waivers. The actual rate is 1.50%. Mr. Tierney asked if the Board wants one manager or two. Chairman Cross asked when Thornburg went on watch list. Mr. Molinero said a year ago. Staff suggested having two choices makes sense if there is a large investment in the asset class. In this case the investments are modest.

Staff reported that at the April 14, 2011 direction was given to renew the contract with Prudential but split investment and administrative services into two contracts. That requires that the Procurement division authorize a "sole source" contract. To that end staff and Ms. Triggs completed the required forms and wrote a memo to Procurement requesting the sole source status. It is in process but not complete. Following that a contract with Prudential will be pursued.

## INVESTMENT MANAGER PRESENTATIONS

FIDUCIARY MANAGEMENT

Mr. Bryant provided an overview. Mount Lucas Management is a quantitative manager. They use computer algorithms. Fiduciary Management is the largest, Mount Lucas the smallest. Herndon has 40 – 70 holdings. Others are more concentrated. Fiduciary Management's standard deviation of returns is smallest. Their alpha is low but positive. Referring to his booklet Mr. Bryant called attention to page six and returns for 2008. Fiduciary had more downside protection. Staff pointed out that Mount Lucas did poorly in the 2008 market drop but quite well in the 2000 – 2002 downturn.

Ted Kellner, CFA, introduced himself, Bladen Burns, CFA, and Fiduciary Management. They distributed a booklet, *U.S. Large Cap Value Equity Management*.

Page 2: provides an overview. The small cap fund is closed. Their fund is concentrated. They will close the fund when it reaches ten to twelve billion dollars. Interests are aligned by management owning funds in the company. Mr. Kellner learned lessons from the 1973-74 bear market when some accounts lost 70% of their value. The key is to limit downside.

Mr. Bladen said the key was to find businesses that were entrenched. Annual turnover is 16%. Wal-Mart has a 14% return on capital and a cost of capital of 6%. Disney has a 10% return on capital and 7% cost of capital. They make expensive acquisitions that do not benefit shareholders.

Fiduciary Management looks for returns on invested capital, quality management, and a business with barriers to entry. The do not hold leveraged banks.

Mr. Tierney asked what the turnover was in 2008.  It was 28%.

Mr. Kellner emphasized they have business analysts, not stock analysts, so they are qualitative.

They are not optimistic about markets.  They have underweighted commodities.  Cash holdings are currently 5%, which is typical.  They have gone as high as 8%.

Ms. Ognibene asked about diversity of employees.  They have fifteen male employees and eight females, one African American.

Mr. Kellner said the annual bonus is based on long term qualitative value.  They have ten stocks per analyst.

Mr. Tierney asked about Microsoft.  Mr. Kellner said they just paid $8.5 billion for Skype.

Staff asked if the ten companies the analysts reviewed were the same companies year after year or if they were new companies.  Mr. Kellner said they were pretty much the same companies. Staff said that even if the firm did not buy the companies they would get to know them very well.

Ms. Triggs asked why they had opened up an international value fund.  Domestic firms do so much business internationally they pretty much were already reviewing things internationally.

HERNDON CAPITAL AMANAGEMENT

Marc Sydnor introduced himself, Randell A Cain Jr., and his firm.  He provided a history of the firm.  Staff asked about the role of the holding company.  The insurance company had less than $20 million of assets under management by Herndon.

Ms. Ognibene asked about the diversity of the company's workforce.

Mr. Cain mentioned his experience and credentials.

Portfolio turnover is 63% annually.

Page 5: Assets under management have grown very quickly.

Page 12: The screening process begins with the Russell 10000.  They seek firms with higher returns on equity than the market average.  They seek firms whose return on equity is higher than reflected in their price to earnings ratio.

They have an upside capture of 120% and downside capture of 80%.

Page 13: They seek to avoid value traps, companies that appear cheap on a fundamental basis that have no future.  An example is the U.S. airline industry.  These are trading opportunities, not partnerships.

Page 14: these fundamentals are used to further screen stocks.

Page 15: this is the last of their four steps. This occupies 80% to 90% of their time. They review the strengths, weaknesses, opportunities, and threats to companies. They do these repetitively in four areas: Strategy, Operations, Management, and Finances.

They gave examples of three companies doing business in Japan, AFLAC, Coach, and Babcock & Wilcox. Most of AFLAC'S business is in southern Japan, far from the disaster site. Exposure was limited. In fact, people increased their insurance after the incident. Deliveries and access to some malls was interrupted, but on line orders picked up. Babcock & Wilcox has nuclear contracts, but none in Japan. Herndon did not panic and sell any of these companies.

They have learned not to extrapolate.

They initially make a 1% position. They may increase it later. They get 80% of their alpha from stock selection and 20% from sector selection.

Ms. Mammarella asked about the role of the insurance company and majority owner.

Chairman Cross asked about style drift and placing as much as 60% in midcap equities. Mr. Bryant said that the limits of large cap vs. mid cap had changed since the last reconstituting the index. Some large caps went down in price, some mid caps went up in price, and this blurs the limits.

Staff asked about the forty percent return on equity indicated as being their portfolio average. Mr. Cain said they overweighted consumer staples which had very high returns.

Mr. Tierney asked if they owned Microsoft. Yes, they do. The $8.5 billion purchase of Skype makes sense from two perspectives: 1) diversifying their holdings, and 2) earning more than they were when invested in cash. However, they do doubt it will have a meaningful impact.

Ms. Ognibene asked if they owned Apple Computer. They do not.

Ms. Triggs asked if they would buy more Microsoft. Yes, they might buy a little more.

Mr. Tierney asked about fees. They are negotiable.

## MOUNT LUCAS MANAGEMENT

Timothy Rudderow introduced himself and his firm. Mount Lucas has $1.9 billion assets under management. Their largest product is their global macro strategy. Their retail fund uses the ticker symbol BMLEX. They have $150 million of the owners personal wealth invested alongside customers' money in the various funds.

Unlike other money managers they began with a hedge fund and then moved to equities. They invest in deep value because they believe this reflects people's fears gone too far and momentum, because momentum persists and it reflects other investor's greed. This may go against human tendency, so they apply quantitative models to this.

Their cash level is zero.

Mr. Rudderow asks the question, why they have a quantitative approach. The reason is to fight human tendencies and to remove discretion. The holding period is one year. Being Capitalization weighted hurts returns.

Page 8: They have a laddered approach, buying half the portfolio every six months. They have a backward looking data. They look at price to sales ratios, price to earnings ratios, dividend yields, etc.

To avoid a value trap they introduce a momentum factor into their selection process.

Staff asked how they arrived at the 80/20 weighting of their two approaches. Value has more weight because value is quite liquid; the value approach has more return potential, and lower beta.

They have no sector constraints.

Mr. Rudderow mentioned a study by a Yale professor. It is called "Active Share." It reflects the degree to which a portfolio takes sector bets. An index fund would have an Active share of zero. The most actively traded, highest concentrated portfolio can have an Active share of one hundred. The study showed active share leads to excess returns. Volatility will be somewhat higher.

Page 10: Chairman Cross asked from what period were the statistics. Mr. Rudderow said from portfolio inception.

They have run their model on other countries and it works as well in developed countries and emerging. They have conviction in their model so they do not vary it over time.

Chairman Cross asked about selections in the midcap space. Mr. Rudderow said they invest only in stocks in the S&P 500.

Ms. Ognibene asked about the diversity of their employees. They have 27 employees.

The meeting went into recess at 11:45 AM.

There was a motion by Ms. Triggs:

> Mister Chairman, I move that the Fire Fighters and Police Pension Plan Board convene in closed executive session at this time, pursuant to Section 2.2-3711(A)(7) of the Code of Virginia, for the purpose of consulting with legal counsel and briefing by staff with respect to specific legal matters regarding a potential claim arising out of the administration of the pension plan.

Mr. Evans seconded the motion. The motion was unanimously approved 5 – 0.

The Board exited from executive session at 12:30 PM.

There was a motion by Ms. Triggs:

> Mister Chairman, I move that the Fire Fighters and Police Pension Board reconvene in open session.

Mr. Evans seconded the motion.

All members read the following language and agreed:

> WHEREAS, the Alexandria City Fire Fighters and Police Pension Plan Board has this 13th day of June, 2005, recessed into closed executive session pursuant to a motion made and adopted in accordance with the Virginia Freedom of Information Act; and
>
> WHEREAS, § 2.2-3712 of the Code of Virginia requires a certification by the Board that such closed executive session was conducted in accordance with Virginia law;
>
> NOW, THEREFORE, BE IT RESOLVED that the Board does hereby certify that, to the best of each member's knowledge, only public business matters that were identified in the motion by which the closed executive session was convened, and that are lawfully exempted by the Freedom of Information Act from the Act's open meeting requirements, were heard, discussed or considered by the board during the closed executive session.

The motion was unanimously approved 5 – 0.

Chairman Cross asked Mr. Bryant to provide a summary of the three presentations.

There was a motion by Ms. Triggs:

> Contract with Herndon Capital Management for large cap value subject to Mr. Bryant's fee negotiations

Mr. Evans seconded the motion. The motion was unanimously approved 5 – 0.

The meeting went into recess.

The meeting reconvened at 1:15 P.M. There was not a quorum so information was presented but no business conducted.

## PIMCO:

Mr. Bryant provided a rapid overview of his handout, *Bond Alternatives II*. He then introduced Rushant Sanathara of PIMCO. Mr. Sanathara provided PIMCO'S long term view of the markets.

Page 4: The Barclays Aggregate has returned 9% annually for the last 30 years. This U.S. based index is the traditional benchmark for fixed income. Its chief components are roughly forty percent treasuries and agencies and forty percent mortgage backed securities.

Page 6: PIMCO has two outlooks, one for three to five years and the other shorter term for six to twelve months. They believe a continued focus on the Barclay's Aggregate will lead to poorer returns than otherwise possible. They believe there will be ten to twenty years of higher growth in developing countries and lesser growth in developed countries.

Seventy percent of the American economy is consumer driven. U.S. homes have been a cash machine via borrowing. Currently twenty eight percent of homes have negative net worth. One seventh of the homes are delinquent on payments. Unemployment is at nine percent. Unemployment plus involuntarily under-employed rates total sixteen percent. Increased regulation and taxes may dampen economic growth. Emerging markets have a different story.

Page 8: Mr. Sanathara said Mexico, Brazil, and others have very low Debt to GDP ratios. Emerging markets do rely on the U.S. to some extent. Ms. Mammarella asked about the U.S. dollar. Mr. Sanathara said it was in a long term secular decline. Mr. Tierney asked if entitlement programs had to be changed. Mr. Sanathara said that they would. Ultimately the dollar would be replaced as the standard for the world's currency. It would be replaced by a basket of currency, probably from Asian countries.

Mr. Sanathara said there has been too much treasury issuance. Once the second round of quantitative easing is complete who will buy? The combined result of inflation and commodity prices will drive up the ten year treasury yield.

Page 12: The dotted sectors of the pie chart represent the government backed securities.

Page 15: there are forty trillion dollars in developed debt and thirteen trillion in emerging markets.

Page 18: Duration is sensitivity to interest rates. The duration of the Barclays Aggregate is five years.

Investment possibilities include:

- Fundamental indexation in the bond space,
- Very broad diversification income across corporate, emerging markets, and emerging sovereigns
- Unconstrained bond that would remove Barclay's aggregate as the benchmark

Page 20: The Global Advantage Strategy gets away from a government dominated index and away from a debt related index.  It is income oriented vs. debt weighted.

Page 21: The goal of the Global Advantage Strategy is to earn 100 – 150 basis points over a three to five year period.  The unconstrained bond fund has a goal of five percent incremental return.  Staff asked for the attribution of this projected out performance.  Mr. Sanathara said emerging markets would provide 150 basis points, currency another 150 basis points, and foreign governments would outperform U.S. by 50 to 100 basis points.  The fund current has three billion in assets.  It also has the ability to go into high yield bonds.

Page 22: Unconstrained Bond Fund.  The duration may be from negative three to positive eight.  Mr. Tierney asked how they got duration of negative three.  Mr. Sanathara said they use futures.

Mr. Tierney asked how they check credit ratings.  Mr. Sanathara said they use credit rating agencies as well as internal review.

The return expectation is LIBOR plus 300 basis points over a twelve month period.

Page 24:  They like Build America Bonds.  Mr. Bryant asked if they bought sovereign debt.  Mr. Sanathara said they have the right to, but usually do not.  Their allocations would be roughly equal proportions of:

- Emerging market debt
- Global high yield
- Global high quality credit

The annual investment management fee is seventy five basis points.  They have $4.2 billion assets under management.

They believe future flight to quality will be less than the past.  As frontier markets recently went into panic silver and gold rallied a lot more than did the U.S. dollar.

## DUE DILIGENCE MEETING CONTINUED:

## COMMITTEE REPORTS

BUYBACK COMMITTEE

City Council recently passed the purchase of service credit plan amendments.  Staff will begin work on this as soon as possible.

TRAINING OPPORTUNITIES COMMITTEE

Ms. Mammarella mentioned the International Foundation of Employee Benefit Plans was specifically mentioned as the preferred conference for Board member education.  She questioned that one should be emphasized when there were many good programs available. Also, she had sent an email to members of the Training Opportunities Committee for comment and was waiting for replies. She believes guidelines will facilitate utilization and that the existing guidelines are too vague.

## NEXT MEETING

The next meeting is Thursday, June 9, 2011. This is a special meeting for manager searches for international mandates.

## ADJOURNMENT

The meeting was adjourned.

## HANDOUTS

Distributed in advance to Board members

1) Agenda
2) Minutes April 14, 2011 [4(a)]
3) Minutes May 4, 2011 [4(b)]
4) Follow-up Items [4(i)]
5) Investment Performance Review [5]
6) Summary of Activity Report [6 (a) (ii)]
7) Plan Investments, Asset Allocation, April 30, 2011 [6 (a) (ii) (1)]
8) Private Equity Cash Flow Report, Hamilton Lane VII – Series B [6 (a) (iv)(1)]
9) Private Equity Cash Flow Report, Hamilton Lane Secondary [6 (a) (iv)(2)]
10) Follow Up Memo [6 (c)]
11) *Large Cap Value Manager Search*, Dahab Associates
12) Performance Review, Dahab Associates
13) Retirement Plan Strategies, Prudential

Distributed during the meeting:

14) *U.S. Large Cap Value Equity Management*, Fiduciary Management

15) Build an Index? [4(i)(1)]

16) *Herndon Capital Management*, Herndon Capital

17) Mount Lucas Management

18) Investment Solutions for a Volatile Interest Rate Environment, PIMCO

19) *Bond Alternatives II,* Dahab Associates