Minutes of the meeting held on September 10, 2014

Present: Francis Murphy – Chair, James Monagle, Michael Gardner, John Shinkwin, Ellen Philbin, Louis Depasquale, Rafik Ghazarian and Chris Burns.

Left Early: Nadia Chamblin-Foster (left following UBS presentation)

The meeting was called to order at 9:12 AM. The meeting was digitally recorded.

Agenda Item # 1 – Manager Reviews

Ghazarian submitted a written analysis of investment performance for the period ending June 30, 2014. The last quarter saw strong returns across all asset classes. The system remains overallocated to equities and fixed income and underallocated to real estate and alternative investments. Gardner stated that he was concerned with the underallocation in the real estate segment, noting that even if the Rockwood commitment were fully funded, the system would still be short of the target allocation. Gardner stated that he was also concerned that include the Cambridge Bancorp stock in the alternatives portfolio obscures the funding shortfall in that category, and he suggested that the holding might be assigned to the equity category. Chamblin-Foster requested that Segal include the Asset Allocation Comparison pages from the report of 12 months prior in each new report.

Overall, the Total Fund was valued at $1.078 billion, representing a gain of 3.57% during the quarter. The fund underperformed the policy index return of 3.86%. The domestic equity segment of the portfolio returned 4.03%, which underperformed the Russell 3000 Index return of 4.87%. MFS was the largest detractor from performance in this sector, returning 3.42% vs. the Russell 1000 index at 5.1%. Ghazarian noted that a number of funds were moving to index their equity holdings, particularly in the large cap segment.

Jonathan Cordo represented Brandywine. A written portfolio report was submitted to the Board. Cordo stated that Patrick Bradley has moved into a new role on the investment team. Brian Hess, one of the Associate Portfolio Managers, opted to leave the firm in January. The firm is likely to add people to the research department over the next year. Over the last year, the fund has underperformed the benchmark, returning 8.08% (net of fees) vs. the Citigroup WGBI Ex-US at 8.88%. Since March, the fund has moved to buy opportunistically and extend durations. The portfolio maintains the strategy of having zero holdings of Japanese bonds, as it has for the last several years, and also maintains a significant underweight to the Euro. Over the last year, Japanese bonds in the benchmark performed well. The portfolio is overweight to Australian and Mexican bonds, noting that both countries are offering high real rates. Cordo stated that the firm does not always hedge against currency fluctuations, when a strengthening currency might be able to add additional performance. Approximately one-third of the portfolio returns come from favorable currency fluctuations.

Mark Davidson represented AEW. A written overview of the portfolio was presented to the Board. Davidson stated that he anticipates that the fund will be fully liquidated by the end of 2015. There are ten properties remaining in the portfolio, six of which are currently being marketed for sale. There are two substantial properties left in the portfolio. One is Menkes Gibson Sqaure, a Toronto condominium complex which is in the final stages of construction. The other is the W Hotel in Atlanta. The condominiums are 96% pre-sold. Davidson states that he anticipates bringing the hotel to market in January 2015. The firm is closing their fund VII in November, with $550 million committed. Davidson reviewed the geographic distribution of the portfolio, noting that the firm invests in major cities with high quality of life. The largest holdings are in Atlanta, San Francisco, New York and Toronto. The firm currently forecasts an IRR of between 2% and 2.9% for the portfolio. This will result in a gain of approximately $500,000 on $5 million invested. Davidson stated that he anticipated that his would be one of the top-performing funds in his vintage year. He reminded the Board that the firm had stopped investments in 2007. He stated that some firms had been able to make investments post-crash and saw gains from them, but he felt that the assets that were offered for sale in 2008 and 2009 were of lesser quality and represented poor investments.

Maria Bascetta represented UBS. A written overview of the portfolio was presented to the Board. The fund has underperformed the index over the last five years. Bascetta stated this was primarily due to the higher level of leverage in the ODCE index. The fund has about 12% leverage, vs. the ODCE at approximately 22%. Over the longer term, the fund has generated higher returns than the index. She noted that the fund has maintained a strategy of low leverage and higher exposure to apartment properties. There have been no significant changes to the management team, and Bascetta stated that succession plans are in place should any senior managers opt to retire. The majority of the properties are located on the east and west coasts, with smaller holdings in the south and Midwest. In the last year, the fund acquired Water Tower Place, a shopping mall in Chicago. The fund has also made several purchases in Los Angeles. The firm has added new value-added properties, and these now constitute 9.4% of the portfolio. Bascetta stated that interest in the portfolio remains strong, with a queue for new investors, currently four quarters for entry. Bascetta noted that the firm has been challenged in putting this money to use, as prices continue to rise and the firm has been outbid on several properties. Over the last year, the firm has moved to refinance debt. The average interest rate is now 4.08%, a reduction of nearly one hundred basis points since 2013. Bascetta described the property management process. The properties are appraised at least once per year, and the maintenance functions are usually contracted out.

Keri Hepburn and Brooks Monroe represented Invesco. A written review of the portfolio was presented to the Board. The firm is now offering a new product, an open-ended US income fund. This fund has a greater focus on income-generating properties and more exposure to secondary markets than the core fund. The core fund generates about two thirds of returns from income and one third from appreciation. The income product aims to generate 90% of returns from income. There have been no changes to the investment strategy or portfolio team. Monroe reviewed the firm’s investment philosophy, described their use of leverage in the portfolio and stated that the firm performs external valuations of each property on a quarterly basis. Monroe described the current real estate environment. He noted that properties are now priced very aggressively. He does not believe that they are necessarily overpriced, but that it has been more difficult to acquire new properties at reasonable prices. The portfolio is now 94.9% leased, which is the highest leasing rate since the 2008 downturn. At that time, the leasing rate fell as low as 89%. Over the last two years, the firm has had higher-than-normal sales activity, selling between 7% and 10% of the portfolio each year. In general, the firm is redeploying the proceeds from these sales into new purchases. The fund has been shifting the apartment strategy over the last several years, moving from suburban properties, and into more central, urban areas. The portfolio has somewhat underperformed the ODCE index over the last three years. Monroe attributed this to lower leverage and less exposure to value-add properties than the index. The core fund strategy invests exclusively in and around large, developed cities. Ghazarian stated that there was little significant difference in the strategies between UBS and Invesco. He reminded the Board that UBS was unable to accept more money due to their entry queue, which resulted in a search for a new core manager in 2010.

Tyson Skillings and Walter Schmidt represented Rockwood Capital. A written review of the portfolio was submitted to the Board. In the last year, the firm opened a new office in Seoul, South Korea. Ed Kavounas, the Chairman of Rockwood, retired in May 2014. The retirement had been anticipated, and the succession plan was executed smoothly, with Skillings, Schmidt, Peter Falco, and Peter Kaye forming a management committee to run the firm. The portfolio is now in the middle of the investment cycle. The fund closed in November 2013 with $678 million in capital commitments. The fund has closed on 14 investments, committing $334 million. There are three additional investments under contract which will close before the end of the year. The fund invests primarily in major cities, with the largest investments in Seattle, Portland, Southern California, Boston, New York, Washington DC and South Florida. The investment period is projected to run through 2016, and the fund will close in 2021. Skillings reviewed the investment strategy and risk management. The majority of the targeted properties are planned to generate income within 12 to 18 months. A number of properties generate income immediately. The firm attempts to control risk by holding longer renovations (24-36 months) to between 15-30% of the fund. The firm generally uses floating-rate debt for the value added properties. The firm attempts to match the capitalization strategy to the business plan. The interest rate is typically fixed for three years, which is often enough time to complete any renovations and start the sale process.

Jonathan Aggett and Logan Roise represented Hancock Timber. A written overview of the portfolio was presented to the Board. Roise has replaced Amy Haynes as the portfolio analyst. The COO, Bruce McKnight, retired in March. His role is now being split between two people. Aggett stated that the ForesTree V portfolio is now completely liquidated. He noted that under the terms of the sale contract, Hancock is required to hold back a percentage of the proceeds for one year. The final distribution should be paid in November 2014. The portfolio generated inflation-adjusted returns of 9.1% annually over its life. This substantially outperformed the NCREIF index.
The Hancock Timberland X portfolio is now fully invested, and in the holding period. The fund is likely to terminate around 2024. The properties are located in the Pacific Northwest, Louisana and Queensland, Australia. The total portfolio consists of over 500,000 acres of timberland. Year to date, the portfolio has seen appreciation of 4%. This resulted from an appraisal gain in the Queensland plantation, as well as currency gains in the Australian Dollar. The firm does not make currency hedges, although Aggett noted that some investors make such hedges on their own. Aggett reviewed the economic outlook for timber products. He noted that US housing starts continue to trend upward. He also stated that China has reduced domestic timber harvests, and there is optimism that this will result in higher imports. At present, the firm is not actively raising money for any new funds. Aggett noted that the firm is having difficulty investing committed capital for the two prior funds. The firm is now in the preliminary stages of creating a fund to invest in Brazilian timberlands.

Kathy Riley and Bill Connolly presented the Actuarial Valuation and Review as of January 1, 2014. She stated that over the last two years, the system saw a decrease of 5.6% in the number of active participants, primarily from the Hospital. The system saw a small gain from lower-than-expected salary growth. Riley stated that in setting the salary growth assumption, she tends to add between 1% and 1.5% over the expected COLA increase in the short term. She also stated that if the system opts to change the assumption that she felt it would be more prudent to only change the next two years, as she felt that 4.75% wage growth was still a more reasonable long-term assumption.
Riley reviewed the process of calculating the actuarial value of assets, and described the smoothing process, which has resulted in significant unrecognized gains from the strong investment returns over the last two years. She discussed the challenges that pension systems can face as they approach full funding. Systems may choose to take risk off the table, which reduces their likely returns, and can then result in systems falling behind in their funding ratio. She stated that if the system intends to further reduce the assumed rate of return, that it would be prudent to do so gradually, and that it is always easiest to make reductions in years when the system has an actuarial gain.
Riley reviewed the assumption changes, noting that the valuation reflects benefit changes for employees hired after April 2, 2012, as well as an increase in the Section 101 allowance to $9,000 annually. The system has not seen any significant gains from the 2012 pension reform, but will see further gains as more employees are hired who are subject to the new law.

The proposed funding schedule uses an investment return assumption of 7.875%, and assumes that the City's contributions will increase by 5.85% each year. Under this schedule, the unfunded liability will be paid off in 2026.
Riley stated that she was comfortable retaining the current mortality table, although she might recommend a switch to a generational table in 2016. She noted that, given the fact that the system experienced a gain from higher-than-expected mortality, there was no immediate need for a change. Without objection, the Board agreed to adopt the valuation and funding schedule.

Ghazarian stated that after reclassifying certain investments in the alternatives sleeve as belonging in real estate, the real estate investments should be in line with the allocation target. He stated that the Board would need to determine if new private equity investments would be made through PRIT, and would also need to search for a new timber manager. He also recommended that the Board consider an immediate allocation of $40 million to a private equity secondaries fund. He noted that the PRIT private equity fund has little exposure to secondaries, and that buying into a secondaries fund would give the fund exposure to prior vintage year funds.

Motion by Gardner, seconded by Monagle to adopt a new asset allocation strategy, described in Segal's report as model #5. The motion carried on a 4-0 vote, with Chamblin-Foster absent. The model would allocate assets as follows:

- 10% Core Fixed Income
- 5% High Yield
- 3% Emerging Markets Debt
- 5% Global Fixed Income
- 25% US Equities
- 9% Developed International Equities
- 10% Emerging Markets Equities
- 9% Private Equity
- 9% Hedge Fund of Funds
- 10% Real Estate
- 2.5% Timber
- 2.5% Infrastructure

Gardner requested that he would favor moving the Cambridge Bancorp stock into the equity sleeve. He also stated that he was concerned that it would be challenging to locate a strong timber manager. He requested that Ghazarian review if the system would be better served to consider moving part of the timber allocation into farmland.
Motion by Gardner, seconded by Monagle to request that Segal issue an RFP for a private equity secondary fund, with a mandate up to $40 million. The motion carried on a 4-0 vote, with Chamblin-Foster absent. Ghazarian stated that he hoped the RFP could be published within the week, and he would report back in October with a timetable for how soon the new manager could be hired and funded.
Ghazarian stated that he was working with the Director to prepare a schedule for issuing RFPs for the managers subject to periodic reviews. He requested that the Board provide guidance if the Board wishes to consolidate certain managers, or move to an index strategy in certain asset classes. Gardner stated that he felt the entire large cap space should be indexed, and he suggested that when issuing a RFP, the Board state that a passive manager would be considered.

Monagle moved to adjourn at 1:25 PM.