CITY OF PHILADELPHIA
SINKING FUND COMMISSION

In Re: Quarterly Meeting

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Wednesday, September 9, 2015
Philadelphia, Pennsylvania

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This Meeting of the Sinking Fund Commission, held pursuant to notice in the above mentioned cause before Anita Kerrigan, Professional Court Reporter and Notary Public in and for the Commonwealth of Pennsylvania, held at Two Penn Center, 16th Floor Conference Room, on the above date, commencing at approximately 11:05 a.m., pursuant to the State of Pennsylvania General Court Rules.

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APPEARANCES:

COMMISSION MEMBERS:

BENJAMIN GILBERT, Chairman

NANCY WINKLER, Commissioner

ALAN BUTKOVITZ, Commissioner

BILL RUBIN, Alternate for Mr. Butkovitz
First Deputy City Controller

ALSO PRESENT:

CHARLES JONES, Executive Director
MATTHEW MAZZA, Deputy Executive Director
CHRISTOPHER R. DiFUSCO, Chief Investment Officer, PGWPP
FRANK DOMEISEN, Investment Consultant
DIANE LASHLEY, PGW
DAN LEONARD, PGW
ROBERT GALDI, PGW Pension Retirees
ELLEN BERKOWITZ, City Law Department
JANET WERNER, Wells Fargo
GENE McCAULEY, City Finance Department

PRESENTERS:

MARK FARRELL, Director, Vaughan Nelson
JAMES EISENMAN, CFA, Vaughan Nelson
TODD WOLTER, ClariVest
PETER CRIVELLI, ClariVest
DAVID HOURLICHT, GAMCO
KEVIN DREYER, GAMCO
THOMAS VICENTE, AON

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MR. GILBERT: We'll call the meeting to order. The transcript of a quarterly meeting held May 13th circulated by way of email. Are there any corrections or additions to those minutes?

Hearing none, may I have a motion to accept the quarterly transcript from May 13th? Is there a motion to accept minutes from --

MS. WINKLER: Motion to accept.

MR. BUTKOVITZ: Second.

MR. GILBERT: Properly moved and seconded. Any questions on the motion?

All those in favor?

MS. WINKLER: Aye.

MR. GILBERT: Motion carries.

Special meeting on July 8th minutes were also circulated by way of email. Are there any corrections and/or additions to those minutes?

Hearing none, do I have a motion to approve those minutes?

MS. WINKLER: Motion to approve.

MR. BUTKOVITZ: Second.
MR. GILBERT: Properly moved and seconded. Any questions on the motion?
All those in favor?
MS. WINKLER: Aye.
MR. GILBERT: Motion carries.
We will now hear presentations from the --
MR. JONES: The quarterly statements.
MR. GILBERT: I'm sorry.
Quarterly Sinking Fund statements were circulated by email. They were dated June 30, 2015. Are there any questions on those statements?
Hearing none, may I have a motion to approve the Sinking Fund statementS from June 30, 2015?
MS. WINKLER: I don't have them, I don't believe, in my packet.
MR. JONES: I'm getting them. That's the Sinking Fund.
MR. BUTKOVITZ: That's the same.
MR. JONES: That's the retirement

reserve.

MS. WINKLER: Charlie, could you walk us through the Sinking Fund statements?

MR. JONES: Sure. These statements for the Sinking Fund are supposed to reflect the activity that runs through the GO Sinking Fund, which is made up of, I believe, two Sinking Fund accounts; one is for the variable rate debt for the GO, and -- for the general obligation, and the second one is the regular Sinking Fund account for the general fund. Both these accounts are housed at or trusteed at US Bank.

And you will see the quarterly and the annual activity. These are for fiscal year '15. And you will see the activity in there broken down by the way that these are classified in the financial statements, the City's financial statements.

Are there specific amounts that you may have questions on?

MS. WINKLER: It appears that you're

leaving about a million dollars in the variable rate bond account each year; is that correct?

MR. JONES: That's correct. It's -- that is the balance in the variable rate Sinking Fund account that we use on a monthly basis to the tune of, like, between right now a thousand, $5,000 --

MS. WINKLER: This is not the activity. This is just the net position.

MR. JONES: Well the million dollars is the position, but the activity that you see there is -- you see the activity there on the activity report.

MS. WINKLER: I'm sorry, which report is the activity report?

MR. JONES: If you go to Schedule B-1.

MS. WINKLER: I don't have B-1.

MR. BUTKOVITZ: Yeah.

MS. WINKLER: Oh, here it is. It's the very last one. So this is related to the variable rate bonds.

MR. JONES: Yes.

MS. WINKLER: So, sorry. This is just a summary of debt service payments that were made.

MR. JONES: And swap payments.

MS. WINKLER: And swap payments.

MR. JONES: And swap payments.

MR. BUTKOVITZ: We earned $66 in interest on one million dollars plus in deposits?

MR. JONES: That's what it says, yes.

MR. BUTKOVITZ: How is that possible?

MR. JONES: Is that six basis points? Is that even six basis points?

MS. WINKLER: It must be in a money market fund, Charlie. You must have it in a money market fund.

MR. JONES: Yes, it is. It's just not sitting in cash. It's in a money market account.

MS. WINKLER: You have a million dollars in a money market account?

MR. JONES: Yes.

MS. WINKLER: Okay. And has this been looked at by the -- is this account included in the rebate reports that the rebate agent does for the City?

MR. JONES: Yes. They -- they have -- they know the activity in this account, yes. They get it right from the trustee.

MR. BUTKOVITZ: But let me go back. That still can't be right. 10 percent of a million is a hundred thousand, one percent is a hundred thousand, a half a percent would be 50,000, right? How could you be getting $66 in interest even if you had it in a passbook account?

MS. WINKLER: Was it sitting there in the account the whole year?

MR. JONES: Well, it started out something a little bit higher, as you can see. It started out at a million one and dropped down to under a million one. That shows you the activity in the account, the amount of interest we paid over the year.

MS. WINKLER: I get 6,000 that we

should be getting if we're getting six basis points.

MR. JONES: Well, I'm -- yeah. One basis point on a million dollars is a hundred dollars.

MR. BUTKOVITZ: No.

MS. WINKLER: We should be getting 6,000, if it's six basis points.

MR. JONES: I don't know what it is. I'm just saying.

MS. WINKLER: I'm just -- yeah. Yeah, yeah. I understand.

MR. BUTKOVITZ: Well that's a problem.

MS. WINKLER: Would you please meet with the treasurer on this and report back to the Sinking Fund at its next meeting?

MR. JONES: Sure.

MS. WINKLER: Great. I mean, it's understood that we need to leave some money in that account, so we need to just be clear why we need to leave it, what -- and what's appropriate given the amount that we're leaving in that account.

And then the other account, Charlie, is the -- those are the general bond payments, and that is all activity for the GO bonds?

MR. JONES: Yes.

MS. WINKLER: Okay. And there's no interest earnings shown. Oh again, you're showing -- you're showing -- actually, what you're showing is 37 cents on the GO Sinking Fund interest lines.

MR. JONES: That's on the variable rate account.

MS. WINKLER: Are there any earnings on the -- this says $66.75 as I read it not on the variable rate account. That is the varible rate account that's earning the $66? The other account that has roughly the same amount -- I'm sorry. I'm looking at Exhibit C. Does Exhibit C include both accounts?

MR. JONES: Yes.

MS. WINKLER: How do I know that? I think I mentioned -- I think I asked at another time if you would work with the accounting department for these to be more clearly labeled.

MR. JONES: That was the pension plan accounts statements that you --

MS. WINKLER: No, I think I asked about this, too. But, I understand these are produced by the accounting department, correct?

MR. JONES: Yes. Correct.

MS. WINKLER: Okay.

MR. DIFUSCO: And on the 66.75 that Nancy was asking about, that's labeled earnings on investment as opposed to interest, so is some of that money in that account invested differently?

MR. JONES: No.

MR. BUTKOVITZ: So who is the custodian of that money?

MR. JONES: US Bank.

MR. GILBERT: Any other questions?

MR. BUTKOVITZ: Well, is there going togoing to be some action on that? Because that strikes me as a real vulnerability. So what are we going togoing to do?

MR. JONES: Excuse me. Where is the vulnerability?

MR. BUTKOVITZ: The vulnerability is we gave a bank over a million dollars in deposits for nothing, as a favor for free.

MS. WINKLER: I don't think --

MR. BUTKOVITZ: It looks to me like a potential scandal.

MS. WINKLER: I guess from my perspective it was bid out, so, and US Bank won through a bidding process, correct, to handle this?

MR. JONES: Years ago, yes.

MS. WINKLER: Yes. And the issue is why -- what's the operational requirement that we leave the million dollars there and just to understand if that's really necessary for us to leave it there. The reality is interest rates are at a -- this is -- has to be invested in a US Treasury-only money market fund, as I understand it, because it's a US Treasury money market fund and because the Fed funds target is between 0 and 25, the net earnings we can get on this is -- essentially we have to preserve principle. So it's a problem that we're experiencing with investing the City's cash right now in general, short-term cash that we're -- preservation of principle is the -- you know, sort of dictates what we can invest in.

So, I think the question is because that -- I think the question is operationally do we need to leave that money there, and is there an opportunity to slightly alter how we -- you know, what we do so that we could still preserve principle and earn more money or is there a good operational reason why we have to leave it there?

MR. BUTKOVITZ: But you could deposit that money at PNC Bank and get half a percent. I don't understand why you are obligated to get a tiny fraction of that. Why are we required to give this money away?

MS. WINKLER: This is the account

that we pay the GO bonds for the City.

MR. BUTKOVITZ: Right.

MS. WINKLER: So there's a lot of sensitivity around making sure that there's always -- we always have enough money in that account to make the debt service payments on time. Why we're leaving a balance there, I -- and operationally how that works, that's something we --

MR. BUTKOVITZ: Right. That's one issue, but the other issue is that a market rate interest. It seems to me to be a fraction of what the market rate interest is. Right?

MS. WINKLER: I don't think there are many savings accounts or short-term accounts that are collateralized that are earning net 40 basis, 50 basis points.

Are you --

MR. BUTKOVITZ: This is different from a private savings account, right?

MS. WINKLER: Well, it's not the FDIC insured. Because it's not FDIC insured, it's collateralized and there's a collateral -- well, in this instance it's not collateralized. I guess it's in a money market.

MR. JONES: Correct.

MS. WINKLER: And the money market, because we by the investment policy limit what we can invest in to money market funds, there's some other options.

Charlie, we just need to look and see if there's -- it's not a passbook savings account and for good reasons it's not a passbook savings account. But we just need to see if there's any opportunity to handle it differently.

MR. JONES: Okay.

MS. WINKLER: We can talk about that and report back at the next meeting.

MR. GILBERT: You want to approve the statements --

MS. WINKLER: Sure.

MR. GILBERT: -- and have a separate question to look at the operation?

MS. WINKLER: I'll move to approve the statements.

MR. BUTKOVITZ: Second.

MR. GILBERT: Properly moved and seconded. Any questions on the motion?

All those in favor?

MS. WINKLER: Aye.

MR. GILBERT: Motion carries.

The pension fund plan statements for June 30 also were circulated by way of email.

Are there any questions on those statements?

Hearing none, may I have a motion to accept the pension fund?

MS. WINKLER: So moved.

MR. GILBERT: Properly moved, do I hear a second?

MR. BUTKOVITZ: Second.

MR. GILBERT: Properly moved and seconded.

Any questions on the motion?

All those in favor?

MS. WINKLER: Aye.

MR. GILBERT: Motion carries. Thank you.

MS. WINKLER: I have a question, Charlie. The Sinking Fund pays all the other debt service as well other than the PGW debt service, but the Sinking Fund Commission is not obligated to review or consider that even though it's in your budget?

MR. JONES: Let's go back and examine what you just said.

MS. WINKLER: You pay the debt service.

MR. JONES: We don't pay -- I don't pay the debt service for PGW.

MS. WINKLER: That's what I just said. You pay for airport, water, all the paid --

MR. JONES: All the authorities.

MS. WINKLER: -- and all the authority debt services.

MR. JONES: And the general fund.

MS. WINKLER: And the general fund. The Sinking Fund does all that. If you could check with the Law Department and come back and report to us on why the only

Sinking Fund activity we look at is the general fund, even though the Sinking Fund activity is substantially greater than the reports shown here.

MR. JONES: Okay.

MS. WINKLER: Thank you.

MR. GILBERT: Okay. We will now have a presentation for the candidates for the Small Cap Domestic Equity Manager.

Charlie.

MR. JONES: Okay. First group of gentlemen is from Vaughan Nelson, who are the incumbent.

(At this time, Mr. Farrell and Mr. Eisenman enter the conference room.)

MR. JONES: So these are the representatives of Vaughan Nelson, our incumbent. This is Mark Farrell and Jim Eisenman.

Gentlemen, you're going to be presenting to the Sinking Fund Commission, which is made up of Ben Gilbert, Nancy Winkler and Alan Butkowitz. You'll have 25 minutes once you get settled to present your credentials, and then I'll give you a five-minute warning.

MR. FARRELL: First question is, does anybody need any books?

MR. JONES: So you brought copies? Did you bring copies?

MR. FARRELL: I did.

MR. JONES: Okay. Why don't you --

MS. WINKLER: I got one unless it's changed.

MR. JONES: Alan needs one. Ben needs one.

MR. FARRELL: Well thank you all for having us today and certainly appreciate, you know, managing these funds over the last five years; and obviously, we'd love to continue doing that. So I head up our distribution at Vaughan Nelson, and Jim Eisenman is one of our senior analysts at the firm.

I thought we'd start on tab 1, page 6 of the presentation. I know that I had about an hour conference call about a month ago, so some of this may be a little repetitive to you all, but given 25 minutes, I'll spend 10, 15 minutes on kind of a firm overview and then we can get into how we put the portfolio together.

So page 6 essentially gives a flyover of what we call why Vaughan Nelson and then what we do in a statement to you, but what we're trying to do simply is compound your capital at 15 percent on a annualized basis. But we're not going out looking for names that can give us a 15 percent return in any one year. What we're simply doing is we're going out looking for names that can give us a 50, 5-0 percent return over a three-year period but we want asymmetric facts. So we went 50 percent up, ten or 15 percent down; a hundred percent up, 20, 25 percent down.

So there's obviously, you got a big team behind the strategy, a lot of models behind it, but if you say what are these guys in Houston, Texas trying to do with my portfolio, what we're simply doing is going after the market with a measuring stick, looking for things that can give me 50 percent return over three years, but I want every name in that portfolio to be an asymetric pattern. There'll be basically 60 to 80 names in the small cap space. So that's kind of the flyover of what we're trying to do.

So what you will get for that is this very high active share which you might imagine, we're not looking to square backs against the benchmark. But if you look at page 11, it gives you some metrics.

So we run three strategies. The small cap is closed to new assets. And -- but we run a midcap, a small cap and a concentrated cap which is the other two on here.

But just concentrate on the small cap value, which is the one that you're in, it has these very sticky metrics. One is in with Vaughan Nelson portfolio. Every quarter that you look at this you're going to have an earnings growth rate which is higher than the index. And it's meaningfully higher than the index.

Valuation is almost always lower in terms of PE than the index. It's interesting. This is one of the very few times we've been implying strategies for 15 years that the PE is actually a little bit above the index. And some of that has to do with we've been paid forward. Our performance is substantially outperforming the index year-to-date. Some of the healthcare names have run a little bit. But I think as you turn the page, next quarter you're kind of going togoing to see

activity

be below the index again, which it typically has been for 15 years or so.

Return on assets or profitability is always substantially higher than the index. And so when you put this together this kind of going out looking for these things that give us 50 percent over three years, these are the very sticky metrics that you get, the higher valuation -- or lower valuation or higher profitability, higher earnings growth, but we do it with less risk. And

so there's a metric found there that's called earnings variability on the bottom. So if you look at the small cap value and say great, you know, the index is growing at 11, the Vaughan Nelson guys are growing at 16. How much risk are they taking around on that growth rate?

So what that metric tells you, it basically pegs the index at a hundred and says relative to the index, how much variability do I have around my growth rate? Longwinded way of saying is our 16 percent growth rate is 23 percent more predictable than the growth rate in the index, which is only growing at ten percent. So more predictability in growth rate, higher growth rate and better -- a better profitability.

MR. BUTKOVITZ: How do you get the predictability and the growth rate?

MR. FARRELL: So, the way it works is literally -- I'm going to draw a picture on this because it's a lot easier.

If you take the growth rate of --

this is Vaughan Nelson's portfolio. This is -- so if I had a whiteboard I'd draw it bigger.

So we have this steeper line is Vaughan Nelson's growth rate at 16 percent. Okay? This more shallow line is the index at 10.6 percent. Okay? So then what we do is we take the variability around my growth rate of all my 60 or so names in the portfolio. How much variability do I have around that growth rate? And then I look at the index and say how much variability do I have around the growth rate? And you can see this skewness here is greater than -- essentially you take an R-square between this and this and that gets you to --

MR. BUTKOVITZ: So it's a historic threshold.

MR. FARRELL: Yes. Right. Right. And so what we're trying to do is say look, let's keep it real simple. 50 percent over three years and not get really complicated about determining -- let's, you know, buy a healthcare over an energy name right now. Healthcare just is an easier play for us. That's where we get that more predictability in earnings.

And it's -- that's been a very consistent metric for 15 years in the portfolio.

MR. BUTKOVITZ: When you have surprises such as the changes in oil prices, how is that accounted for in predictability?

MR. FARRELL: So, it's on the sell side, right? So what we do is we map out every -- everything so you get 50 percent up and then 10 or 15 percent down. The other thing, maybe it's helpful to touch on the valuation just a little bit. So we use the saying around the office, valuation is like nailing jello to the wall. It's a very imprecise science. Okay?

So we say let's go ahead and value every name in the portfolio using a standard discount rate of 20 percent. You can certainly make the argument of retail and utilities you can have a different discount. What we're saying is if I use a blunt rate of 12 percent, I get more degrees of freedom on my side. If I find something that's 50 percent under value with a 12 percent growth rate, okay. I know I'm kind of 70 to 30 percent undervalue. The stock is cheap. Let me build my downside, so if I got ten or 15 percent down on it, so when you run into an oil and start seeing things fall apart and we're selling -- we're not -- you're buying at such a deep value that -- if you look actually at energy, we owned energy. Did very very well for us, and those names outperformed. But when you look at energy over the past year relative to the index, we've done very very well in energy because it started seeing a lot of those names, just because they were too expensive.

MR. BUTKOVITZ: You mean we liquidated at the right time?

MR. FARRELL: Yes. Not saying we went to zero exactly the right time, but we started moving money out of energy at --

MR. BUTKOVITZ: So how did you make that decision?

MR. EISENMAN: Well, it was really a combination of factors. So if you look at, you know, why was oil price where it was? Part of the buildup was just institutional money, calipers and other pension funds putting money into leveraged commodity plays that kind of bumped the price up of above supply and demand dynamics. And in August they said we're kind of pulling back out of commodities. So calipers did it. A lot of other people started to follow. The price started to come down.

And then the next sort of big event we also had a stronger dollar at that point which hurt, but when the Saudis said we're not cutting production in the fall, I believe it was in October, that shocked everyone.

That's the -- really the point where we just start punching out of everything. Energy names, our industrials that were tied to energy and a lot of the industrials that said they weren't tied to energy but were probably second-tier plays on that. So over kind of October, November into December we sold out of basically all of our energy names except one, and we reduced that holding by probably 50 percent, a lot of our industrials as well.

MR. BUTKOVITZ: So what are the next big things that are going to go down and go up?

MR. FARRELL: Well, I'll tell you.

MR. JONES: We're on the record here.

MR. FARRELL: Is this being recorded?

Yeah. I can tell you where we're finding value is in healthcare now. So the portfolio is significantly overweight in healthcare. Its place where we're not finding value is REITs. R-E-I-T-S. We think they're exceedingly expensive here.

We owned REITs in '08 and '09 and did very well, but it all goes back to, look, there's no way you can fool yourself in a REIT to get you 50 percent over three years and have an asymmetric back. And maybe you get 50, but you got 50 on the downside, right? But that trades well. So let's just take 50 up and then minimal down.

And that's really more of kind of how some healthcare names, and actually the consumer names will be added. So a name we had in the portfolio for a long time is Men's Warehouse, which you wouldn't think is a -- it's certainly not a growth industry, but they're going through some things interesting with Joseph A. Banks. That's very kind of niche opportunity out there that -- it was in the Consumer's Space or Service Master, Terminex. I mean, these guys have strong end markets and -- but it's not these big -- we don't play these big sector swings in or out. It's all very stock specific.

MR. DIFUSCO: Are you looking at anything now going back into energy given how much it's dropped or are you seeing opportunities there now?

MR. EISENMAN: Yes. We've been looking at it the entire time, frequently going through all the ENPs, all the service names. Our thought until very very recently had been that the oil as a molecule is cheap at 40, $50. It costs a lot more than that to get the marginal barrel out of the ground. There wasn't really a way to play in the market. ENPs are still priced in $70 oil, obviously well below that.

So we've been kicking out a lot of those names. We actually just added a new service name last week and went in kind of small with the 60 basis point position. But, with that combined with one named Fordham Technologies, which is another service company that we already own another small position, just starting to position ourselves for the rebound which may be a 2017 event, but, you know, finding companies that have strong balance sheets, are well positioned in their spaces, and are going to be consolidators. So maybe it's not 2017, maybe it's 2018. But if that's the case, they're going to be buying up a lot of cheap assets because there's a lot of people that are going to feel the pain the longer it lasts. So for them it's kind of a win win. A nice rebound in oil, they go up. The pain lasts longer. They acquire cheap assets and have a bigger better business when it does go up. So just kind of quickly -- or excuse me, slowly levering into those names. Kind of just dipping into this at this point.

MR. DIFUSCO: And then switching back real quickly to the Men's Warehouse example. It's a name I've heard come up with some hedge funds and others that I've met with for the Muni Fund.

Could you just talk for 30 seconds about how you source it and how long you've been in it and kind of where you got that idea?

MR. EISENMAN: Sure. So that's a

name we've actually known really well. They're actually based in Houston, which is coincidental more than anything else. But we owned it years ago in our midcap portfolio, had always kind of been aware of it, kept track of it. We keep track of all of our names that we've owned. And it just came back up on our radar probably shortly before the Joseph A. Bank acquisition was announced. As new management came in, the founder had been kicked out. All his little pet projects were going to end. Wasting of capital was going to end. A lot of costs to take out. So that was the basic thesis around that.

After we bought it, they decided to acquire Joseph A. Bank, which is their biggest competitor. We reevaluated the thesis from kind of square one and said, you know, there's a lot of value there when you buy your biggest competitor, a lot of costs to take out. Decided to keep the position. Management came out and put out essentially a three-year target of 550 in earnings in 2017. That -- the guidance for this year is around 260 or 270.

So, big, big jump. Markets were really disappointed because people wanted a 12-month time horizon. Management wouldn't give it at the time. They would only give it a three-year number.

For us, a three-year number is perfect. If the stock is in the 40s and you're going to earn 550 in 2017, that looks pretty good. Right?

So we layered in the name more and more. We actually bought it in another portfolio. And as Mark said, that stock actually quartered last night, traded off today. We're actually buying more today as well. So we have confidence in that thesis.

MR. FARRELL: We had -- the name is not in the portfolio anymore. It's Rite Aid. So that was one that the hedge fund guys jumped out on. But our thought is, look, it's the three-year window that we think is this advantage. So we look at

Men's Warehouse, the small million dollar one, the growth guys are the guys who are looking for next quarter are punching this name out. I've had a three-year look. I can go ahead and add to the name. Same thing when we took Rite Aid which was a disaster at the time. I think what were we, $2 in that?

MR. EISENMAN: Yep.

MR. FARRELL: I think it was a $2 stock, and it sold at what?

MR. EISENMAN: Probably 7 or 8.

MR. FARRELL: Yeah. So, but that was the name that the hedge fund guys really started jumping on at 5 and 6 bucks. Right? But that's because they can see the catalyst over the next quarter.

We're getting in there and saying I can get this catalyst over three years at two bucks. And I'm okay if it's at two bucks for two years, as long as I get my catalyst over three. It's that kind of being patient with the market that I think is where you get the advantage there.

Does that make sense?
MS. WINKLER: So the pages that we've been looking at --
MR. FARRELL: Yes.
MS. WINKLER: -- are all predictive pages. They're not -- they aren't just saying that's what we could expect. Am I right, that page 12 actually shows the returns?
MR. FARRELL: That's your actual returns, yes.
MS. WINKLER: And that's without fees?
MR. FARRELL: Right. So if you want to take your fee, just take one percent off the top. That would be your fee.
MS. WINKLER: Okay.
MR. FARRELL: And so, the thing I would say about --
MS. WINKLER: One percent per year?
MR. FARRELL: Yeah. So if you're combining the 16.1, you're basing your 15.1 since '99, net our fees.
So the thing I would say about page

12 was this historical return is if I came here in '99 and said I'm going to compound at 15 percent and I told you I'm going to have a dotcom bubble, I'm going to have 9/11, I'm going to have two Gulf wars, and I'm going to have the biggest credit crisis we've ever had and a credit recession, can you compound at 15 percent?

MS. WINKLER: Excuse me. What were you saying to people in 1999?

MR. FARRELL: 15 percent.

MS. WINKLER: Okay. And so has anything in your strategy changed over this period of time?

MR. FARRELL: No. No. The only thing we've done is build the team out, and we've also put a good amount of work into risk analytics on the portfolio looking at factor exposures.

But when we first rolled this out and we came out, we had $20 million in small cap and one PM. And I rolled it out and said we're going to -- we've got one PM and $20 million and we're going to compound at

15 percent. People -- it took me four
years for people to talk to us, right?
Because it's a kind of an eclectic not
scoring bets against the benchmark.
It's -- we think the 15 percent return, the
reason why we have that, because it squares
better with what the client needs. Right?
You need returns in a portfolio.
And when clients make allocations, the
equities, they typically don't say, hey I'm
making allocation to equities because I
want some volatility in the portfolio.
Right?
No. They're saying I'm making an
allocation in the equity because I've got a
man -- I've got a required absolute mandate
liability I've got to offset. 8 percent, 7
percent, whatever the number is. Right?
That's part of allocating the equity.
So we say, okay, if I'm going to manage
a portfolio for you who has a mandated
liability, why am I going to square bets
against a benchmark and give you relative
return? Those two just don't square up.

So what we said is, throw out the cold kind of relative return concept. Let me see if I can get 15 percent. If you can compound a 15 percent, you basically can offset almost everybody's liability.

MR. DIFUSCO: Just to piggyback slightly on Nancy's question.

MR. FARRELL: Yes.

MR. DIFUSCO: And, you know, we had talked about it a little bit either on email or on the phone. Do you think kind of in light of the pressure that industry in terms of fees, do you feel the one percent fee is competitive, you know, appropriate? I know we asked you guys about potentially lowering it or for a fee break.

MR. FARRELL: Right.

MR. DIFUSCO: Can you just talk and make sense about that?

MR. FARRELL: I think that's certainly a fair question to ask. The way that we view it is there's alpha and there's beta. Right? And the problem that you see with a lot of alpha, it's basically high-priced data, right?

And where we see the market going is that if you're really going to generate alpha, you can command a one percent fee for that. If you're just a guy who's running 50 percent active share, yeah. Buy in for 30 basis points, right? Because he's giving half the index for free anyhow. And so -- and with our small cap we've been able to demonstrate we can earn well above that fee.

And the other thing that I will tell you with the strategy is closed to new assets now, and the clients that we have in there at your level, at the level, that's what the majority of the clients are going to pay. Now if you're talking two and $300 million mandates, there's some flexibility there, but really under 50 million I just don't have a lot. Because I need to be fair to all the other clients that are throwing in their hat.

MR. MAZZA: Because also for one

percent you'd think that you'd be paying up to -- because you guys would be taking a look at riskier names, but looking at your characteristics right now, about 59 percent is in that area of the 3 to 5 billion dollar range of companies. So not exactly the riskier names in small cap, more of that median sweet spot.

So, that's why I think the people have issues with one percent on that, because you guys aren't -- you're not looking at -- you're not entirely allocated like the benchmarks in smaller companies --

MR. FARRELL: Right.

MR. MAZZA: -- like $300 million companies, $500 million companies. You guys are looking at the guys who are established, 3 to 5 billion.

MR. FARRELL: Right. But if I allocate to there, your returns are going to go down. And I'll give you -- for 50 basis points you're going to lose 300 basis points for performance.

MR. DIFUSCO: Do you entertain -- I

don't remember. Do you entertain performance-based fees?

MR. FARRELL: We do. If that's something that's of interest to you, we would do that.

How much time do we have left?

MR. JONES: About eight minutes.

MR. FARRELL: Maybe let's jump to -- skip over the team. In terms of interest, let's skip to tab 3. I'll let Jim kind of talk about how the process works.

MS. WINKLER: Maybe I will take that Power Point so I can just follow with you.

MR. FARRELL: Yep.

MR. EISENMAN: So as Mark said, the target for everything that goes in the portfolio is 50 percent over three years. We basically look for that in sort of three categories which we called undervalue, growth, undervalued assets, and undervalued dividends. And on page 25 you can see sort of how that's trended over time.

Undervalue growth, you can think of these as basically your better businesses that have sustainable competitive advantages, usually a high market share, higher returns or improving returns. They compound capital at a high rate over time, which is how you generate value over a period of years rather than, you know, quarters or a year or two. So typically that's been the majority of the portfolio. It still is right now. Those names have done really, really well over the last 12 to 18 months especially.

Undervalued assets, those are names that are priced at a discount to the asset value. Typically, they'll be more cyclical type names. A lot of times we'll be buying those at the bottom of the cycle where the market just doesn't appreciate the cash generating ability of that company over the longer period of time. Usually all the names we buy will have some sort of self-help we'll call it, whether it's they just did an acquisition that makes it the peek earnings power more attractive than it was historically, new management in place that's going to take out costs, something like that. Nothing that's just pure cyclical. A name like that -- actually, Men's Warehouse would fall under that perfectly, which we already discussed.

Undervalued dividend, only one of those names right now, which is TCP Capital, which is a business development corp that lends to small and medium-size businesses, kind of replacing what's sort of come out of the bank channel, if you will. We targeted ten percent dividend when we go into the name. They need to be covering that with a high degree of certainty, and then a little bit of earnings growth and dividend increases on top of that. So, you can see on page 25 of how that's kind of trended over time.

Coming out of the credit crisis, you know, a lot of the cyclical names were very cheap. We traded into those. Over time those become overvalued. We've sort of sold those off and have continued to go into higher and higher quality names, which the market has rewarded over time.

MR. FARRELL: Let me touch on that just for a minute, because I think if you don't remember kind of anything about what we talked about here, if you remember these two pages is probably the most important thing because it keeps you away from mean reversion. So when we put the process together in '99, we said we want 15 percent. And we did a lot of work and looked at other small cap managers and said, what are the good ones, what are the bad ones? The mean reversion is the biggest issue. Right?

You come in here and my guess is everybody out there probably has top core tile numbers, right? Because you're not going to get in the finals presentation without top core tile numbers.

But the issue is you go top core tile, now your bottom core tile mid, and then you're looking at your consultants saying, why are we hiring these guys to begin with? And typically the response is, well, they're out of favor and you got to wait for them to come back in. So we've sat back and said, can I take some of that ride off. Right?

So you sit back and say mathematically, how does an investor get a return? Let's figure that out, and let's say that's how we're going to allocate assets.

So mathematically there's really three ways to get a return. Jim went through them. Undervalue growth, that means you buy companies that are growing but you don't pay forward for it.

Warren Buffett's philosophy, deep value, that's the second --

MR. JONES: Five minutes.

MR. FARRELL: Okay. The second bucket is looking for dollar bills selling at 50 cents, and the third is some type of cash flow.

So if those are three ways to allocate and make money, let's say we're going to be agnostic as to what bucket it goes in and let's just look for those types of names.

So what you see here, and you look at the historical performance of this, particularly in downmarkets we were protected significantly during the credit crisis point-to-point. We actually had positive returns during the three-year credit crisis when most managers were negative about cumulatively 18 percent over that time period.

And if you look at even today's market, the market is down nine percent. We're up three percent. Look at 2011, we were down about half. The market was down I think six, we were down two.

I think if I go back -- let me see 2011.

MR. DIFUSCO: Since you reference -- I'm sorry.

MR. FARRELL: Yes.

MR. DIFUSCO: Since you referenced the peer rankings of the quartile performance --

MR. FARRELL: Yeah.

MR. DIFUSCO: -- do you tend to do -- is your quartile peer performance tend to be better when there's more dispersion between the top and the middle or when it's, like, everyone's kind of bunched up together?

MR. FARRELL: You know, that's a good question. I haven't looked at it. I will tell you that if you run -- I know the core tyler ratings, if you run them one, three, five, seven, ten and 15, I don't think there's one period there that we're below the 30th percentile. And that gets back just ability to rotate between those two. So I don't know. My sense is maybe probably when there's more dispersion, I would think.

But the point with this is, in -- in 2006, if you look at how much we had in that first category, if you had a deep value guy, he had a very difficult -- if you hired a deep value guy, he probably did very well in '04. In '06 he wasn't doing well. And you got to sit with him, right?

And wait until things blow up. Things blow up, you can rotate back in and buy kind of the deep value stuff.

We said look, if the deep value trade isn't there, let's not make it. Right now private equity is very active. Credit spreads are very tight. Deep value is kind of expensive. You go with the first category. You just kind of take some of those peeks and valleys.

One more minute?

MR. JONES: Yeah.

MR. FARRELL: The last -- do you have anything else you want to --

MR. EISENMAN: I think that's my points.

MR. FARRELL: Yeah. So the only -- the last thing I'll leave you with is page 10, which is the credit crisis. I think it's back to your point if we're buying kind of -- we're putting a lot less risk in this portfolio than -- and I think you're getting something for the one percent even though you're getting a lot of the upside.

But if you look at this during the credit crisis, this is the clip-out of the left-hand side. So during the credit crisis we had a cumulative draw down this portfolio of 16 percent. The index was down 36 percent. And we had well over a hundred percent of the upside coming out of it. So you had positive returns point to point.

And that's just not during the credit crisis. In 2000 and -- as I said, 2011 the index was down six, we were down three. And then -- and then 2002 the index was down 11, we were down 6.8. So a lot of downside protections portfolio. So you get kind of -- you're paying something for the premium if you want like an insurance.

That's a historical return. Obviously, you can't guarantee anything going forward, but the objective is to compound at 15. But the -- and the reason why I think the strategy works is because you'd never compromise off the 50. So if you don't compromise off the 50, it's forced you to kind of go to the low areas of the market. And when things blow up, you know, the market is down nine percent and we're up at three percent today, it's because six months ago we weren't willing to pay up. Just don't pay up for it. And when they come back to you superior like yesterday comes back to us, start buying. Or Men's Warehouse.

MR. JONES: Anything else?

MS. WINKLER: I have one question. How much cash do you keep in the portfolio so you can take advantage of these opportunties?

MR. FARRELL: It's zero. Typically --

MS. WINKLER: So you're going to liquidate something to buy?

MR. FARRELL: No. It's typically one to two percent kind of cash. Cash is residual. Maximum cash is five percent.

MS. WINKLER: Okay.

MR. FARRELL: And so as we liquidate stuff, we -- like right now we're running four percent or something.

MR. EISENMAN: Maybe between three and four.

MR. JONES: 818 thousand.

MR. FARRELL: Yeah. Okay. So there's always some kind of frictional cash. And we look at cash as an option. So like Men's Warehouse opens up down, hey, I can add to it. Right? But we won't go over five percent in cash.

MS. WINKLER: How long have you been there?

MR. FARRELL: Since '99. So.

MR. EISENMAN: 2005.

MR. FARRELL: And Chris Wallace is a lead PM. He's been here since '99 as well. So he's -- the entire track record is he's the one you're looking at and he's the lead PM.

MR. GILBERT: Any other questions?

MR. FARRELL: Okay. We appreciate it. Thanks for your time.

MS. WINKLER: Thank you very much.

(At this time, Mr. Farrell and

Mr. Eisenman leave the conference room.)

MR. JONES: Okay. These gentlemen are from ClariVest. These are Peter Crivelli and Todd Wolter. Todd Wolter, he came all the way from San Diego.

You're presenting to, the Sinking Funds Commission: Ben Gilbert is the chairman, Nancy Winkler and Alan Butkovitz.

MR. CRIVELLI: And we have presentations.

MR. JONES: If you would, please.

MR. CRIVELLI: So we'll make a very short introduction, if that's okay. I'm Peter.

MR. JONES: So Peter, we'll give you 25 minutes to present to the Commission, and I'll give you a five-minute warning. So when you get started, the clock will start.

MR. CRIVELLI: Thanks, Charlie.

Well, thank you so much for having us here today. My name is Peter Crivelli. I'm responsible for marketing and client service. If you appoint us, I'll be your client service representative. Actually, I already have a role as client representative for you. Todd is our portfolio manager, Todd Wolter. Todd Walter is founder and owner of a little more than nine percent of ClariVest, and so Todd is one of the founders who developed the philosophy in the process.

Todd is going to do all the talking today. I'll just make a quick couple quick comments. First comment is that we are small cap and we are value. Small cap, other average market cap is even with the benchmark, a little bit lower and value, our PE is lower than the benchmark, 15 versus 16. And we think that's an important trait, for a small cap value manager.

So, first point small cap. Value, our second -- and our second point --

MR. DIFUSCO: The second point is?

MR. FARRELL: We are unique. We do something a little bit different. Our portfolio management team combines quantitative tools, qualitative -- qualitative research and behavioral elements. And Todd will talk to you about that difference.

The other thing is that we are actually a good fit with your growth manager. We've done the research against your small cap growth manager, and there's virtually no overlap, just two stocks. And that's really important when you're building a portfolio that your small cap and your growth and your value match don't have any overlap.

And the last point is about risk. Risk is really important to us, and Todd's background is in risk. And we talk about it a little bit in the bio, that Todd studied risk management as a graduate student and then started his career in risk management and then became a portfolio manager. So, small cap in value, doing something a little unique, we're a good fit in terms of building the portfolio between your small growth and your small volume and your portfolio.

MR. WOLTER: Thank you for the opportunity to present our small cap value product. As Peter mentioned, just sort of by way of background, started my career focusing on risk management. Full-time as tech classes fixed index, derivatives at Price in New York, and then moved into economy portfolio management, joined the equity team at Nicholas-Applegate in San Diego, came back to San Diego and have been really kind of focused on portfolio construction and stocks selection ever since that time.

It think it's a somewhat unique background. A lot of portfolio managers start out as equity analysis and then kind of raise through the ranks and become portfolio managers. I think starting with a risk background really is helpful and it helps know how to construct portfolios that are really well-diversified and sort of subject to unintended risk that might be leaking in a portfolio.

So with that, Peter has kind of covered the bios. If we move to page -- let's see, page 3: Why ClariVest? I think this is really important. Why ClariVest? We have a really seasoned team at ClariVest. We've been together -- most of the team has been together since 2000. So we've been together for 15 years. We founded ClariVest in 2006. And the continuity in this business is, in our opinion, critical but rare. I don't think, you know, in normal times when equity markets are pretty good and performance is good, that's thought really as critical. It's really when you get a '07, '08 time frame you hit a regression, equity markets are down and you know that you're all in the same boat together, and we're all equity owners, we are all about the mission in finance. So really understanding that is critical. It's rare in this business.

I've been in this business a long time and seen teams come and go and firm's stability, but having equity ownership and seasoned teams is really important in our team.

Secondly, ClariVest we have a unique philosophy. Why is that a benefit to you? We'll talk more in depth about that, but really it gives you diversification of process. Our return stream is going to be unique, and as Peter mentioned, complementary when you have a growth manager on the other side. A lot of cases people look at us for multi-manager type structures because we fit really well because you have our unique philosophy.

MR. DIFUSCO: How would you -- this is a hypothetical question. How would your philosophy pair up if the manager on the other side was an index strategy?

MR. WOLTER: If they were a growth manager?

MR. DIFUSCO: If there was an index growth manager. I know you said you would work with our current manager. How would you look at that?

MR. WOLTER: We look, arguably, probably even better. Because you'd have a lot of biotech and things like that on the growth side. We really play our position. We stay in our sandbox, in our yard, and manage the value benchmark. We don't drift into core, we don't drift into Smith. We stay in that style box. So we pair very well with the growth manager. And I'll talk about kind of some of those reasons as we get to the characteristics, things like that.

Lastly, we use an integrated approach. We use both quantitative and qualitative. We really have the best of the best. Peter mentions if you look at equity, things like that, we really in this product limited our capacity. So you're not going to see us running two, three, five, six billion dollars in this product. We're going to close this a billion, a billion five in capacity. You want to make sure we continue to generate health for our clients. So we're very conservative as a boutique employee-owned firm.

MR. BUTKOVITZ: That's great business for us, so.

MR. WOLTER: So moving on to the next page, the season team. This is I think the big takeaway. This is a group that loves to work together. Ten of the eleven investment professionals are equity owners. We just expanded to four more people this spring. So it was -- it was six, now we have ten of the eleven. The one individual who's only been there one year I would fully expect down the road he would also become equity owner.

Since founding ClariVest, we've only had one analyst leave the team. So we've had tremendous stability, people enjoy working there. We bring them up through the ranks and eventually they're working on their own product. So it's kind of the ultimate goal. So the takeaway is the team that you hire today will be the team that you'll be speaking with five years, ten years, 15 years down the road. We have low turnover and really pride ourselves on continuing team aspect.

So why is ClariVest unique? When investors make decisions about -- page five -- investors make decisions based on publicly availability of information. All the facts are out there on the public domain. Where we really think the big difference lies is how those facts, those fundamentals are interpreted by investors, you know, positively, negatively, sort of in a different light. And we find that stocks become mispriced most, the most mispriced when companies are going through some sort of a change. And so we use a disciplined approach to target those companies and seek out those companies where there's a disconnect between the fundamentals and their pricing. Okay? And I'll talk a little bit more about that on the next page.

So, you'll see, this is kind of on page 6 what I would call kind of a stylized version of a company. It could be in a economy, it could be a sector. All companies go through growth and contraction cycles. Okay? And they all pass through that behavioral lens that you see on the error page.

So the type of company that we're looking for is a company that has the surprising growth, that that growth is going to be persistent and it's underappreciated by the marketplace.

So if you look on this graph, you'll see our target entry zone, you'll see the realized fundamentals as the blue line and the red line are the expectations that the prices that investors have afforded that company. So, the typical company that we'll buy will be something -- some company that's coming out of a contraction cycle but growth is starting to accelerate.

We're not a deep value manager. We don't buy companies and wait for the fundamentals to turn around. We're looking for a catalyst. But at the same time those companies tend to be mispriced by investors.

And if you see these characteristics, kind of like I call our proof statement here, five-year historical growth rate 7.5 versus 7.7 for the index, we're kind of in line with that. Companies are, you know, it's sort of average. But if you look at the one-year historical EPS growth, 16.7 versus 3.2. So these are companies where fundamentals are accelerating dramatically. But then you look down at the price earnings multiple, these companies are still trading as a discount. Okay, 14 versus 16.6. So we're cheaper than the index but we have a faster growth profile from earnings standpoint.

So if you think where our excess return comes from, if you were to freeze the portfolio one year, didn't touch it, if you were to look at it a year from now, those same companies would continue to grow at a well-above average rate relative to the index, but at that time investors would come around to the idea that, in fact, that growth is sustainable. So then you get a evaluation stance as investors kind of revalue those fundamentals and realize that those fundamentals are, in fact, sustainable.

So before I turn to the next page, is it pretty clear how we kind of have a unique philosophy there?

So, how does the stock get into the portfolio? Well we start with ten to 15 different dimensions that we look at from a reward profile. I'll talk more specifically about those. And at a high level we start to look at risk very early in the process. We want to put risk and reward on the same plank early in the process. And I think that's -- that's actually a really unique aspect, because we only want to see potential trade opportunities that fit within the existing portfolio already. We're not -- we don't want to find, fall in love with a stock and then try and make room in the portfolio for it. We think that bringing risk in early and having a strong sense of fit early on is critically important.

So, after we do that, we look -- look at the liquidity profile and see if we can trade both the buy and the sell position. That is the Risk-Aware Idea Generation. And then below that we have the -- we want to tighten our focus and really develop to make sure that there's a forward-looking steering to along with the backward-looking story. The kind of data that we're seeing, the ideas that are being presented, but we want to make sure they're all the false positives. Things are cheap for a reason.

Does that make sense?

MR. DIFUSCO: How much cash do you generally keep?

MR. WOLTER: Typically, about one percent we target, so it probably balances between zero and two percent, but we keep our cash very tight.

So in terms of idea generation, I talked about the reward profile. So again, the takeaway here is we're looking for three things are the companies fundamental actuaries: Are they persistent and underappreciated, and is it starting to be recognized by the market; are the shorts, for instance, starting to give up on the name; are the shorts starting to cover their position? Maybe that's a good sign the fundamentals are turning. So we view this reward profile as a likely fishing pond where that behavioral bias, that mispricing is most likely present.

And again, then we bring in a risk budget, transaction costs, and that will give us kind of a preliminary trade list where I can go look for ideas and kind of go through a qualitative vetting process. And again, bringing in risk liquidity early ensures that we're not drifting from our style. We're not moving into the sort of aura or gross sandbox, if you will.

So with that I can tell you, lead into the next page more about qualitative process. So there that I mentioned an initial idea generation.

(Brief interruption.)

MR. WOLTER: So, after the Risk-Aware Idea Generation phase, we want to go through and tighten up the information and make sure what we're being presented with the trade idea really makes sense. Again, we want to avoid things that are cheap for a reason, valued correct. Effectively removing kind of the worst ideas and really kind of hone in on what really are the best ideas.

So, I'm going to move through on the next page, unless there are any questions.

A specific stock example in our portfolio today show you both kind of the idea generation and the qualitative existence element stage. So this is currently a company that we own in the portfolio, and so what you'll see here on the reward profile, you'll see each of the metrics that we had listed on the prior box, kind of stored on a plus to minus three basis. So minus three being the worst, plus three being the best. And I think the takeaway here is you'll see a lot of green and a lot of positive numbers. There are two points where the company is not -- not perfect on our scoring. So -- and that's valuation. Okay?

So the company, I would say, is probably a little bit further up that wave curve. The behavioral gap might be a little bit tighter, but it's a little bit further up that wave curve. But you'll see that we already own 51 basis points on the right-hand side. So this is actually a suggested add to the position. So it's suggesting that we add the position. Something we've done, done well with already.

In this middle box you'll see, and this is a good way that we like to visualize -- I'm sorry. It's kind of small.

MS. WINKLER: I forgot to put my contacts in today. So I'm just visually challenged today.

MR. WOLTER: I'll try to explain it.
MS. WINKLER: I can see it. I just need to be close up.
MR. WOLTER: So you'll see reward on the vertical, so the up and down; so higher is better. And on the left to right is risk. So that's the risk of those names. Each one of those gray dots is an existing name in our portfolio. So we can see from a risk/reward perspective what fits and what doesn't. The blue/green dot is this position, Resource Actions is the name of the company. So you'll see that from a reward perspective it has a pretty high reward profile. And that vertical line you see in the middle is kind of the risk addage, and on the risk it would be risk diversified. So it doesn't add, but you get a lot of return benefit from adding to this position. It's sort of what it comes down to.
Ideally, if you can find companies that earn the far top left-hand side, left-hand quadrant, that would be your

ideal company. We often say those are unicorns in a lot of cases. They don't exist. But if we could find them, that would be ideal.

So --

MR. DIFUSCO: How long do companies -- when you have these kind of aggregate scores but then you see a fair number of companies, you know, certainly not the majority, but a fair number kind of hovering around the zero or some cases a few sizable positions even below the line --

MR. WOLTER: Sure.

MR. DIFUSCO: -- how long do they generally stay in the portfolio when they're down there? Is there a reason -- are they done to diverse some sort of diversification? Can you talk about that?

MR. WOLTER: Sure. In this case you'll see the two dots just to the right of the line or below kind of a reward. Those would be pretty good reasonable sell candidates. Okay? If it were way over on the left-hand side, we're really diversifying a negative profile. We might let that stay in the portfolio a little bit longer because it's truly diversifying especially if we're kind of flustered. And risk and relationship we're kind of more companies in the right-hand side. So we may -- the one that you see that's a minus one here, we may very well hang onto that for a period of time and see how the fundamentals play out.

MR. DIFUSCO: What's the turnover?

MR. WOLTER: Year-to-date we're actually running lower than typical. I think we're in the 60 percent range year-to-date. More typically we're in the low hundreds.

MR. DIFUSCO: The low -- I'm sorry?

MR. WOLTER: Low hundreds. Yeah, it really is somewhat dependent on the market environment. Right now things have been, until August, relatively stable from a fundamental standpoint. So our turnover is down a little bit, if things started to move around a little bit.

MS. WINKLER: Are you expecting a lot more volatility in the market going forward?

MR. WOLTER: I think, you know, much like when we started to see QE -- sorry, taper if you will, happen, you saw some volatility ahead of that and then things really settled down when people weren't as scared. I think once you get that first Fed rate increase, I think things will settle down a little bit. I think Europe's arguably on the mend. China is kind of its own animal that everybody is afraid of. My opinion, China is something to be a little bit worried about at the margin, but I think the fears are really overblown.

MR. MAZZA: Todd, how often do you pay into short interest?

MR. WOLTER: How often?

MR. MAZZA: How often do you pay into -- you buy stocks that are underappreciated? Is short interest one of the main drivers in that?

MR. WOLTER: Right. Yeah. So we favor companies that are not heavily shorted, try and avoid companies that are heavily shorted. In a lot of cases the shorts -- and this bears out empirically -- the shorts have done their homework and they're usually pretty good at identifying the short candidates. So we pay a lot of attention with the short interest. The short interest decreasing, we view that favorably. Maybe the shorts are giving up and this negative fundamentally is playing out.

So, that's a pretty important part of our process. And we get both monthly and daily updates on that one in the exchange, but also from our prime broker as well, so.

Great question, though.

Again, this previous page was more on the idea generation, giving a concrete example. This is a concrete example how we build out that thesis. This is an actual framework of a note that we built out when we added to this position. Highlighting the rewards, resource connections and things that a professional services company that caters primarily to financial services companies. So when Dodd-Frank and a lot of those things came around, that was a big boost to their fundamentals. The risk to this one, Europe has been a little bit slow. So we build this note when we buy our add to the position.

We can go back and revisit the thesis as it plays out. How is Europe doing? How is the Dodd-Frank implementation going? So this is just kind of an example of a note that we write when we buy a position.

MR. JONES: Five minutes time.

MR. WOLTER: Okay. Thank you. Moving into risk management I talk a lot about how we bring in risk early in the process, but it's also an ongoing part of the process. It's really important that people often ask, you know, the magic question is, when will you underperform?

When people want to know what your weaknesses is, what your Kryptonite is. For us it's really when there's a fall in earnings growth. So like a recession, it gets really difficult to find companies with accelerated fundamentals. Right? We joke that the only companies that had accelerated fundamentals in '07 and '08 were salt and toilet paper companies. But there really -- where there's a fall in earnings, that's a challenge for us.

And so, we want to be able to identify and quantify those risks when those environments develop and play more defense in those times. So, it's really important that we know what our weaknesses are and are able to quantify those weaknesses. And lastly, we want to minimize risk from unintended bets that might arise in the portfolio.

In terms of risk oversight, really transparency is the key here. All of our risk reports are run and generated internally daily for us to look at. The first thing that I look at when I come in in the morning are the top ten risk contributors to the portfolio. I want to know at a name level if this is my number two risk position in the portfolio, does this position still make sense and at this weight. We're always challenging ourselves on that. So it's important that it's transparent and it's important that it's timely.

And then lastly, our chief investment officer, general counsel and chief operating officer will go through on a minimal quarterly basis but on a rolling basis to evaluate the products and ensure that we're delivering to you the product that we've committed to delivering.

MR. DIFUSCO: How do you handle stocks that are screened out for social reasons? Do you do a pro rata or --

MR. WOLTER: It's pro rata.

MR. DIFUSCO: It's pro rata.

MR. WOLTER: Yeah. And we do get that. We have some European clients that have some issues, and so they're pro rata.

I talked a little bit about the profile on the previous page or in the previous part of the presentation, but as Peter mentioned on the characteristics, the weight average market cap, we're a small cap manager. We're 1.67 billion weight average cap, which is 1.237 billion for the index. So we're right in line for the index.

And as I mentioned, our signature profile five year in line growth rate, one year very high growth rate, and cheap valuation for the index.

MS. WINKLER: Did you say how long you hold, you tend to hold --

MR. WOLTER: Yeah, I mentioned our over over is running 60 percent year-to-date. That's a little bit on the low end of historical. It's more on, you know, low one hundreds is more predictable. So, valuation in line with the index.

So we're really -- you know, this is a small cap value portfolio. One of the challenges I think a lot of managers struggling with is financials are 42 percent of the benchmark. And I think, you know, we're, in my opinion, relative to a lot of peers, fairly tight on financials. We don't want to take huge sector bets. We're five percent under. I've seen managers that are 20 percent under of financials and they call themselves a small cap value manager.

I think, you know, if the Fed does start to raise rates, you're going to see -- and that interest margin starts to expand for some of these smaller regional banks, we're going to see pretty quickly who has that bet against financials.

So, I think from our standpoint we're -- we want to stay fairly close on financials, and are finding some value particularly in small regional banks at this point. So in terms of performance, you know, I'm proud of our track record. I think that the big takeaway here is that we win and we outperform by being consistent.

You know, we're not likely to have a thousand or 1500 basis points above the index year. We want to be consistent year in and year out. Knocking out 300 basis points, 400 basis points a year ahead of the index.

So, just to kind of summarize why ClariVest. I mentioned seasoned team, unique philosophy that we have, and the diversification that we provide and fit with other managers and our integrated approach that takes best of breed tools to really get out and identify those unique companies.

MR. FARRELL: We appreciate your time today. We'd love the opportunity to work for you in small cap value. And if there's anything we can provide in terms of additional information about us, we'd love to do that. But please, consider us.

MS. WINKLER: When was the fund founded?

MR. WOLTER: ClariVest was founded in 2006.

MS. WINKLER: 2006. So the ITD is 2006?

MR. WOLTER: That's correct. March of 2006.

MR. DIFUSCO: How did the portfolio hold up the last 45 days or so? Can you give us the benchmark?

MR. WOLTER: Good question. I wrote down those numbers. I anticipated -- you know, August was a pretty rough month for people. So, particularly in August, the small cap value benchmark was .4 -- 4.91 percent. We were down 4.1. So that was the basis in August; and year-to-date, I think the index is down 6.83, and we're about two percent better than that.

MR. DIFUSCO: Thank you.

MR. GILBERT: Any other questions? Thank you.

MR. JONES: Thank you, gentlemen.

(At this time, Mr. Crivelli and Mr. Wolter leave the room.)

MR. JONES: So these are representatives from GAMCO. This is David

Ourlicht and Kevin Dreyer.

You're going togoing to be presenting to the Sinking Fund Commission. It's made up of Ben Gilbert, Nancy Winkler and Alan Butkovitz.

MR. DREYER: Hi. How are you?

MR. OURLICHT: Hi.

MR. JONES: You will have 25 minutes once you get started, and I'll give you a five-minute warning.

MR. OURLICHT: Okay. Great.

MR. JONES: And the floor is yours. You have 25 minutes.

MR. OURLICHT: Okay. Thank you. I'll give introductions again, and then hopefully the goal is to give you a better understanding of GAMCO, what we do, how we do it.

Kevin Dreyer is the co-CIO and portfolio manager, and that's a relatively new development. I'll give it to him a little later, but.

You know, our -- we hope that once you get through, we get through this presentation you'll feel more comfortable with us and trusting us with some of the assets that you have, trusting with some of the assets, as well as letting us work on your behalf.

GAMCO is a value equity shop. We have a unique approach to value equities. It's a private market value with a catalyst. It's something that was developed by Mario, recognized by Mario. We're a 37-year-old firm, so we've got a long history of doing this. You'll also see that we are a intense research-driven culture. Starts every morning at eight o'clock with a investment call, all hands on deck. It's led by Mario, our CIO, and Kevin and Chris.

We have a long track record. This particular product, small cap value, it was established in 1989. You'll see that we have superior long-term risk adjustor returns in that the process has been consistently applied since the founding of the firm.

If you turn to page 3, you'll see that -- it will give you a little better understand of the firm. Profile, we were founded in 1977 by Mario Gabelli. We went public in 1999. We currently have 245 people globally. Our headquarters is in Rye, New York. We have offices in Tokyo, Hong Kong and London.

Firm assets, we're at $45.4 billion. And that's broken out in that we have about 24 and a half billion in our mutual fund complex, which are a combination of closed-end and open-end mutual funds. We have almost 20 billion in separately managed accounts, and about a little over a billion in alternatives, which are primarily a number of different hedge fund products.

As you can see, we're represented in most -- in all the institutional segments. I'd add to this the outsource CIO segment, which is a growing segment. And as far as by mandates, most of our -- we have -- our all cap is our flagship product, and we're certainly well-represented in small cap.

The portfolio team's on four. So Mario on the right was the founder of Gabelli. Just last month in recognition of their role and contribution to the firm and -- Kevin and Chris were named co-CIOs along with Mario, which is -- one is a recognition of the value to the firm; two, it's also a recognition not subtly of succession planning, which is -- which is I think is an important statement. And for -- from a practical standpoint, I think Kevin will tell you, it doesn't really change much. You know, they've been doing and serving that capacity for quite some time. But it is a recognition of their contribution.

And then you see the other members of the portfolio management team. A lot of them are portfolio managers on a variety of different mutual funds that we have, like Lillian Lord, who managing the Mighty Mites, which is a micro-cap fund.

And so, the next slide, we do have a

growth side of the house of which Howard is the CIO, and Caesar is a portfolio manager on international growth. And then below the partnership situations, special situations, those are our hedge fund products of which the largest and oldest is our merger arm hedge fund, and then you see the other ones that we have.

You'll hear this a lot. You'll hear it from me, you'll hear it from Kevin, and you'll see it in our performance. We're a long only, un-leveraged, and unhedged value manager steeped in Graham and Dodd Security Analysis that was I don't want to say improved on, but it was changed and recognized by what Mario did with private market value with a catalyst.

I'm sure you hear catalyst a lot with value investors, but there is -- this is the sort of the birthplace of it in GAMCO. Repeatable superior returns and an experienced portfolio management team. Those are all sort of topics that we touch on.

I'll turn over to Kevin to talk about research, philosophy, process, and then he'll turn back to me and I can go over performance.

MR. DREYER: Great. Thank you, David.

First of all, it's wonderful to be in Philadelphia. I'm actually from Wayne, Pennsylvania, just outside the city. Went to UPenn for undergraduate. So, you know, I'm very happy to be back here and very much hope to do business with you going forward.

So, just a second on myself. So I've been with the firm for just over ten years, joined as a research analyst finding consumer sector. I did Columbia Business School. We hire a lot of our analysts out of Columbia. They have a value and vesting program there that dovetails very nicely with our unique style of investing.

I started managing money in mutual funds in '07 and then joined Mario along with Christopher Marangi in a separate account team in 2011. So, that would essentially be the team managing the portfolio.

This is the research team here. We have about 40 analysts covering industries on a global basis. They are all cap focused. So they'll follow everything from micro-cap companies up to large cap ones. We think that that cross-rolization of knowledge of different capitalization companies really helps us especially in the small to mid-cap area that we can leverage our work on industries with the larger companies, with those smaller companies that we can go and visit with that don't have the Wall Street analyst coverage or as many other potential investors out there knocking on their door and looking at them.

So, we don't follow every company or every subsector in the index. In fact, we call ourselves index agnostic when it comes to investing. We really built the portfolios from the bottoms up basis starting with liking the industry, liking individual companies first and foremost, and then filtering it through our POV with a catalyst style.

So historically, we've had kind of three pillars of areas of our focus that we believe are within our core competence. We rebuilt accumulated compounded knowledge over time. I'd say the industrial area where Mario himself started as a research analyst, me in the entertainment area, and then my sector, the consumer sector and branded food/beverage companies and consumer product companies.

We're always building out. Started investing in utilities probably 20 years ago. Maybe health and wellness about ten years ago or so. But, you know, we will be, as you'll see in our numbers, overweight in sectors that we like best, and underweight some others that don't fit our style as well.

MR. DIFUSCO: So not to jump ahead, but I'm going to jump ahead.

MR. DREYER: Please.

MR. DIFUSCO: And because it's so much different from at least one of the other groups we've talked to today. One of the sectors you guys are, you know, really, really underweight is financials.

MR. DREYER: Correct. Yeah.

MR. DIFUSCO: Could you talk about what you're seeing there or maybe not seeing there and why that's not kind of playing in your --

MR. DREYER: Yeah. So -- that's a perfect example. So that's not per se a sector call on financials. It's not that we're bearish on financials. It's just that there are a lot of small regional banks within, you know, the index in that -- in that bucket. They tend not to fit as well within our style of investing just in that, you know, historically haven't been as comfortable with what's in the balance sheet.

Of some of those banks, et cetera, we have, you know, picked certain pockets that we've invested in, not so much for the small cap portfolio, but trust banks. To an extent we've invested in all-cap portfolios, some of the asset managers, hopefully a business we understand pretty well, where we do see consolidation coming, as well as an area that we've invested in some credit card companies as well. And we've picked, you know, certain banks that we've invested in. But again, not a bearish view, but that happens to comprise a significant portion of, you know, the value index, you know, whereas that's always historically been an area that we've been underweight.

You know, consequently, an area like industrials where we have a lot of focus on, say, pump, valve and motor companies, companies that are suppliers to the aerospace industry. We're actually hosting an aerospace supplier conference in New York today. Companies like Command that both make structures as well as fuses and certain other things. A company like Aerojet Rocketdyne that makes rocket

propulsion systems. They were in the news
today that they might be buying a certain
business from Lockheed and Boeing as well.
So we'll have a whole host of these
companies that we followed institutionally
for over 35 years that would be in this
bucket that we'd be following.

So, you know, long-winded way of
putting it, but these aren't sector calls
per se, but more just what falls out of our
bottoms up process of what we know best in
understanding.

MR. DIFUSCO: So even with kind of
the change in regulations, the increased
scrutiny, the increased regulations of the
community of regional banks are under
coming out of Dodd-Frank and other things
still you don't feel even still after that
comfortable with the balance sheets and
things like that.

MR. DREYER: It's just -- it's not
been -- it's not been an area that we've
seen the most opportunity in and, you know,
relative to other areas I think is just,

you know, the best way of putting it.
MR. DIFUSCO: Okay.
MR. DREYER: And please, jump in at any time with questions.
MR. MAZZA: My quick question was, you know, small gap value you hear a lot from the same managers, right? I always hear about you talking about private market valuations --
MR. DREYER: Yep.
MR. MAZZA: -- and paying attention to the company's value within the private marketplace and some takeovers. Can you just explain --
MR. DREYER: Yeah.
MR. MAZZA: -- what you guys are utilizing the private market values of the company?
MR. DREYER: Absolutely. So that dovetails perfectly to I will jump right to slide nine, to private market value, the catalyst. So what that means is when we analyze a company, we're not trying to figure out precisely what they're going to

earn next quarter or next year. What we're trying to do is figure out what would an informed industrialist pay to own a whole business. One screen from that would be what would a financial buyer like a private equity firm pay, and what would a strategic buyer pay, and then looking for some sort of a catalyst to surface value over time.

So as far as the financial buyer, my background would be for business school I was in investment banking, as is my partner Chris Marangi, who is as well. The firm years ago had a small private equity owner who, historical footnote, one of our early holdings, a company called Houdaille Industry was the first takeout by KKR back in the late '70s.

So that's been there. And we specialized in we know how they model companies, we look at cash flows. We'll look at the amount of leverage one can put on those cash flows. What's the cost of that leverage? What's the potential exit multiple and try to back into what price can we pay to take a company private and get, say, a 20 to 30 percent on our investment. So that would be the financial buyer analysis.

We then look at what a strategic buyer would pay, which I describe as part art and part science. We'll keep deep data basis of multiples paid within industries. We're typically looking at multiples of cash flow or proxies for cash flow, but of course there's judgment. How good is this business? How good is the industry? How unique is the asset? That's all going to go into factor when we're looking at a company.

Again, just hitchhiking on the aerospace as well as pump, valve and motor area of industrials comment, Prevision Cast Parts, which is not a small cap stock, it's a large cap stock, they're in the process right now of being taken over by Berkshire Hathaway for cash. $235 per share. That's about 13 times their trailing twelve months EBITDA, earnings before interest, taxes, depreciation and amortization.

So we would look at that multiple page and say, do we have other businesses that either are similar to Precision Cast Parts or play to the same themes of 19,000 planes today around the world going to 40,000 over 20 years, a long-term cyclical trend, which granted we're going to have a little bit of variability around it quarter to quarter, but that is a long-term trend that we think are attractive relative to that evaluation. And I would say in the small cap portfolio, we do.

A company like Command which has both an aerospace division as well as an industrial distribution business where they distribute bearings and some other products, we think that company could be split apart potentially and each piece sold. Right now it's trading at something around seven or eight times EBITDA in its entirety. Stocks have been at 35. We think it's probably worth 65 or more. They're a takeout scenario. So that would be one example there of private market value.

I think the other component is the catalyst. So, when we buy a company, we're not just buying a cheap company because we think it will be less cheap. We're not starting with just a screen of low PEO or low price-to-book stocks like certain other value managers do. And the catalyst is a very important component of this because as Mario likes to say, it's not an economic exercise. So we need to pay the bills and we need to generate returns for our clients. And having the catalyst or a potential catalyst in place is one way to do that.

So one of our favorite catalysts is a takeover of the entire business, and it fits very well with the way we look at stocks. We have seen this wave of takeovers continue, expect that continue given where interest rates are even if they move up quite a bit.

Another catalyst, a hard catalyst,

is what we call financial engineering, split-ups, spin-offs, split-offs, other sorts of restructurings. For instance, Murphy USA, which is a top position in the strategy was a spin-off for Murphy Oil. They're a convenience store operator. We think they could be a takeover candidate. In fact, that whole industry has -- there have been spin-offs.

CST Brands, that's another sort of operator that we think can be takeover candidates and are going to be beneficiaries of the decreased price of oil just because as gasoline goes down, people have more money in their pocket. They might buy a sandwich or a soda or something else that's a higher margin item in the convenience store in addition to filling up with gasoline.

So, and then there can be softer catalysts, things like new management in terms of cash low allocation or regulatory change, et cetera. You know, that's the framework with which we're looking at all of our investments.

MR. OURLICHT: Why don't you add to that just -- you know, speak to the margin of safety, because that's the other part to this private market value with the catalyst.

MR. DREYER: Yeah.

MR. OURLICHT: And it's a key component, so.

MR. DREYER: Yeah. Absolutely. So, whenever we're investing, we're demanding, you know, what we believe is an adequate margin of safety. Usually it's 30 percent or greater discount over a two to three-year time horizon. It's not a hard and fast number. It will depend a little on the situation.

Prime market value, it's not a static number. So we're biased towards really great businesses that generate a lot of cash flow, have recurring revenue, have pricing power. So that private market value per share as they pay down debt, buy back shares, do productive things with their cash flow, that's going to increase ideally over time.

So, you know, for a company in that situation versus, say, another company where the private market value is, let's say, derived from a hidden asset like land that we wouldn't project to increase even though it may, you know, we might allow a slightly lesser margin of safety or lesser discount, you know, in that situation where we think a catalyst is imminent versus we might demand a greater one if you, say, have a family-controlled company with a more static kind of thing. So that's the philosophy.

Just to backtrack one slide to go through the process on slide 8, it's really bottoms up fundamental research. We call it GAPIC: Gather, array, project, interpret and communicate the data. So nothing terribly fancy here. We're reading the ten Ks, the ten Qs. We're combing through the footnotes. We're reading trade journals. We are taking the industry conferences and very importantly we spend a lot of time on the road meeting with management. So all of our analysts and portfolio managers are doing hands-on research meeting with companies. And we like to visit them where they live as opposed to waiting until they come to New York to market.

We install all this data into our proprietary models. We tend to look out five years when we're modeling a company, which roughly bears our holding period, which is usually over five years. Actually, our turnover tends to be under 20 percent per year. A lot of people talk about being long-term investors. We really are long-term investors.

We have our morning meeting everyday at 8:00 a.m. that David mentioned where everybody goes over everything in their sector. We also write up our ideas and reports. And then we hold certain investor conferences and symposiums like the one in aerospace going on today in New York.

With that I'll flip to just briefly on slide 10 as far as the portfolio construction. Again, we are bottoms up stock pickers. We are not managing to the index. You are getting active management. Our active share is quite high. And it's really starting with that universe of over 2,000 companies that we follow and actively track, whittling it down based on those quantitative and qualitative factors. What's our private product value? How good is our discount or margin of safety? What's the likelihood we think we'll realize a catalyst and how good is this business and do we want to own it for the next, you know, ten years or longer? And based on that, we build a diversified portfolio.

We don't go over five percent of cost of any one security, and we're happy to be overweight but do pay attention to our sector weighting. You know, you're not going to see us go 70 percent in one sector for instance.

Maybe with that, I'll turn it back to you --

MR. OURLICHT: Okay.

MR. DREYER: -- with the slide -- or actually, you know what? I can just do slide 11 and 12.

MR. OURLICHT: Yeah, right. So the sector and then highlight the turnover here.

MR. DREYER: Yeah. So slide 11 just shows some of the portfolio characteristics. Again, this falls out of our process so as opposed to it being something it's managed to. You'll see certain areas that we are overweight. Again, industrials, consumer discretionary, some of the media/telecom names are in that bucket as well as stables. Some of those food beverage companies.

We're underweight in certain other areas, pure commodity businesses like energy, you know, have been historically underweight, as well as I guess we're about equal weight now in healthcare and financials as was pointed out.

MR. JONES: You've got five minutes, guys.

MR. DREYER: Okay. Top ten, I'll just mention briefly, holdings. This has a number of -- you known, Command I've mentioned already, as well as Aerojet Rocketdyne, two of our aerospace plays. Ryman Hospitality is the former Gaylord. They own the Ryman Auditorium in Nashville, the Grand Ole Opry. It's a REIT. We think it could be a takeover candidate.

Murphy USA was the spin-off from Murphy Oil. Pharaoh Corp is a specialty chemicals company; it's going through an operational restructuring. So we've got, you know, a diversified top ten. And it would be typical that that would make up approximately 20 to 30 percent of the portfolio.

MR. OURLICHT: All right. So if you turn to slide 13, we can -- this is sort of the prove the thesis. Prove the thesis and look at the performance. So we've got, you know, annualized performance. You see we've consistently outperformed the Russell 2000 Value Index. I'm assuming that's the same index we'd be benchmarked to here.

We've added, because I think this is probably more indicative of how one should look at performance which is in two-year rolling periods, and here you have, because we've got so much data points, the three-year rolling period is dating back to 2006. And there is -- again, you can see this sort of -- this graph of consistent outperformance on net-of-fee basis.

As importantly, sort of on downside upmarket capture ratio, I think that's -- that's -- the downmarket capture ratio is proof of the value of the margin of safety, if you will.

And then that's followed, you can see on slide 16, just annual -- you know, annual performance going back to in 1989, which is the inception of this product.

And I guess I'll close, or I guess we've been open for questions, with --

leave you with the point that this -- Mario has pioneered this market value with a catalyst approach. And I know it's not the first time you've heard it, but this is the pioneering firm that did it.

We've heard Kevin talk about we do focus on our areas of core competency as we pick stocks and it reflects itself in what -- as you pointed out, in the differences in the sector weightings. We have a strong, long track record. We have a intense research-driven culture, and we overlay that with a global perspective on industries and companies, and this has been a consistently-applied investment process, and --

MR. DREYER: And I just add, these last two slides I think are something that are very important to us that, you know, providing, you know, value on the downside as well as the upside is something that's very important to us. So, you know, we're not going to be all things in all markets. Sometimes when you have raging bull markets led by, you know, tech let's say or certain other speculative areas of the market, we might underperform. We do tend to outperform in downmarkets. And to the extent that we're in a choppier area now, we think that we will benefit and also we see, you know, in the next couple of years this trend of increasing M and A activity, as well as all the financial engineering that's taking place over the last couple of years we think bodes very well with our style going forward.

MR. MAZZA: Doug, I know it was distributed in the materials.

MR. DREYER: Dave.

MR. MAZZA: I'm sorry, Dave. I know when you joined Gabelli five years ago you were still the New York City Insurance Fund lord.

MR. OURLICHT: Yeah.

MR. MAZZA: Are you -- can you just explain your responsibility in the New York City Insurance Fund?

MR. OURLICHT: Yeah. So I -- I

don't know if it's -- I serve as a public fund trustee. I was on the NYCERS Board, I was -- which is the largest municipal pension plan in the United States. I was then public output Bill de Blasio's designee. Before that I was appointed by Governor Patterson to the New York State Insurance Fund Board where I'm still on that board, and I chair the investment committee. It's a -- I think there's one in Pennsylvania. So it's Workman's Comp. It's a Workman's Comp provider. And I'm a trustee as well.

So, it's just public sector service unrelated to GAMCO. Unrelated in that I'll never give myself money because I promised my wife.

MR. RUBIN: When you look at like the '91, '92 and then 2000 where you underperform in a major way or overperform in a major way, what caused those big swings and what has changed?

MR. DREYER: You know, I can't speak to '91, because I think I was at Saint

Katherine of Siena in grade school at the time back in Wayne.

MR. RUBIN: Yeah, all right.

MR. DREYER: But I can -- you know, I can speak a little bit to the late '90s and early 2000s.

MR. RUBIN: And then '9 and '10 when you swung way out and overperformed, is there something that caused each of those kind of things?

MR. DREYER: Yeah. I mean, you know, it's -- you know, generally speaking, we had avoided the -- you know, we didn't invest in a lot of tech stocks on the way up. We had invested it in different securities. We did have an allocation to TMT.

I think oftentimes looking at, say, a rolling average is very useful that if there -- we have one year of incredible outperformance those stocks, we don't turn over the whole portfolio yearly. We are long-term guys. So they might take a pause. And conversely, we've always if we've ever underperformed then done very well in the subsequent period after that. We can look back at what the sector or stock breakdowns were back then, unfortunately, I just don't have the --

MR. RUBIN: The '9 and '10, it wasn't style-driven? You weren't chasing after it and then came back?

MR. DREYER: No, no. If you -- if you looked at our breakdowns sector-wise, you know, statistics-wise, it's going to be very similar to today. In fact, we probably own a lot of the same stocks still today that we owned back in 1991. We've, you know, literally been owners of businesses for sometimes 20 or 30 years.

MR. RUBIN: All right. I'm more worried about '9 and '10 where you outperformed.

MR. DREYER: Oh, 2009 and 2010.

MR. RUBIN: Yeah. Were you chasing?

MR. DREYER: Oh yeah. Basically, no, we didn't change everything. What happened was in 2008 there was nowhere to hide. Everything was done Q4 of '08 after Lehman went bust. And it was really those same stocks and sectors, many of our holdings happened to be owned also by hedge funds that were getting redemptions, being sold down. So that was really unwinding itself on the way back up. You know, our stocks recovered much better.

But it was -- we did not plow into financials or some other sector that outperformed. In fact, I think we had some head winds from the sector standpoint at that point. It was a lot of our industrial names I know led the way, which certainly had a cyclical component to them, but we did not make major changes to the portfolio. It was just tweaking at the end. We probably owned more of those cyclical industrials, we might have bought them at the margins, but nothing major.

MR. RUBIN: Okay.

MR. GILBERT: Any other questions?

All right. Thank you.

MR. DREYER: Thank you very much.

MR. OURLICHT: Thank you.
(At this time, Mr. Ourlicht and Mr. Dryer leave the room.)
MR. JONES: I'll tell Tom just to wait a minute so you guys can discuss this.
MR. GILBERT: Okay. Do you want to make the selection?
MS. WINKLER: So I just have a question. These guys have -- are they the highest -- the strongest performers?
MR. MAZZA: No. Vaughan Nelson would be the strongest --
MS. WINKLER: Vaughan Nelson is the incumbent who has the highest fees.
MR. MAZZA: Highest fees but --
MS. WINKLER: Right. But net of fees, they're still the highest?
MR. MAZZA: Still the highest. Still the best performers net of fees, yes.
MS. WINKLER: Are we on the record?
MR. GILBERT: Yes.
MR. MAZZA: Yeah, net of fees, Vaughan Nelson is still the highest performer, and they are the incumbent.

MS. WINKLER: And is there any issue about Vaughan Nelson that we -- that you want to raise, whether these issues -- the issue -- I think there was a suggestion, implied suggestion by one of the other firms that Vaughan -- that the, you know, portfolio that they would have would overlap with another portfolio managed by another manager.

MR. MAZZA: I think that the thing that we've seen, based on our research, is that -- my question asking they earn higher quality names --

MS. WINKLER: Uh-huh.

MR. MAZZA: -- that the market has rewarded higher quality names for the past five years. So that's been a good part on their decision-making process.

My question, my problem is with the higher fee, they're not taking as much risk as other managers. They're not looking at companies in the 300 million to $3 billion market cap, which is typically what you're paying for when you have a small cap.

Right?

You know, you're paying a manager a higher fee for a small cap because they're digging deeper into more liquid names, companies that aren't as prevalent.

MS. WINKLER: Right.

MR. MAZZA: But Vaughan Nelson has not. They're stuck in that 3 to $5 million market cap area. But their returns are there. So we can't complain about the returns, even if the fee is high, which is my argument. Especially with the plan the way it is, we have to look for great returns.

MS. WINKLER: Charlie, what are you thinking?

MR. JONES: I was trying to look at how each of these managers adhere to the benchmark. And GAMCO other than -- GAMCO is probably the furthest away from the benchmark. If we go to an index fund for the other half of this mandate --

MS. WINKLER: Uh-huh.

MR. JONES: -- we might want to

consider somebody, you know, an investment manager who isn't tied to the benchmark. I think ClariVest --

MS. WINKLER: So that ties to that point --

MR. JONES: Yeah. I think ClariVest is very tightly wound up with the benchmark, as far as I can tell.

MR. DIFUSCO: Yeah.

MR. JONES: I mean, whereas these other two, Vaughan Nelson and GAMCO, do have some dispersion from the benchmark.

MR. MAZZA: Just want the Commission to know as well, we let the three managers know of we were selecting them, Vaughan Nelson did not change their fee, they kept it at one percent. ClariVest dropped 20 basis points, and GAMCO drops 20 basis points. So GAMCO is about 80 basis points.

MS. WINKLER: Okay.

MR. MAZZA: ClariVest is 65 basis points.

MS. WINKLER: Okay. And then I have a question. What did you think, recommend, Frank?

MR. JONES: Can we look at this? What Chris has here is ClariVest at 60 and GAMCO at 85; is that right?

MR. MAZZA: 60 and 85.

MR. DIFUSCO: That's right.

MR. JONES: Okay. And Vaughan Nelson at --

MR. DIFUSCO: Vaughan Nelson is at a hundred. That's right.

MS. WINKLER: Thank you.

MR. DOMEISEN: We think that the alpha, the higher alpha does, which you see from Vaughan Nelson which I think is the highest of the group, so the value added beyond just buying the beta which is the index, warrants the higher fee. And it's shown out in the results, so they clearly --

MS. WINKLER: So what about the point Charlie raised?

MR. JONES: About being tied to the benchmark.

MR. DOMEISEN: Oh. Well, we look at

the R-squared, the correlation metric if you will. And certainly I think you said that Vaughan Nelson doesn't look like the index. There's more tracking error to the index and it has a lower correlation. The other two actually are fairly high.

MS. WINKLER: Yeah. Charlie mentioned that already.

MR. DOMEISEN: Yeah.

MS. WINKLER: I was really asking you how does that affect your recommendation.

MR. RUBIN: Wait. Nancy, I thought Charlie said the opposite, that GAMCO was not --

MR. JONES: GAMCO and Vaughan Nelson are not tied to the benchmark. ClariVest is.

MR. RUBIN: And you say GAMCO was the one furthest away.

MR. DOMEISEN: We would agree if you had a complement to an index, which I think is what you were mentioning --

MR. RUBIN: Frank, hold on. Charlie

is saying GAMCO is furthest away from the benchmark, and you're saying that Vaughan Nelson is. Which one is?

MR. DOMEISEN: I think Vaughan Nelson from an R-squared correlation coefficient is.

MR. JONES: And that's probably a more scientific way of looking at it.

MS. WINKLER: Oh, okay.

MR. RUBIN: I just want to square those two issues. Okay.

MS. WINKLER: Thank you.

MR. JONES: I think the one thing that -- one number that jumps out at me on Frank's little report here is the downmarket capture, the three-year downmarket capture. Vaughan Nelson is at 56, and that's where you want them to be, isn't it, Frank? You want that to be as low as possible. Whereas the other two are in the 80s. So they're capturing 80 percent of the downmarket, and Vaughan Nelson's only capturing 56. And I would say that's probably one of the keys to their performance over the last few years. Whereas the upmarket capture, you want that to be as much as possible; all three managers are at 103 percent. So that's like --

MS. WINKLER: That's interesting.

MR. JONES: -- that's like a non-factor.

MR. DIFUSCO: And you also have to consider if we've kind of pushed let's just say for ClariVest to the side for the moment --

MR. JONES: Uh-huh.

MR. DIFUSCO: -- that there's a transactional, there's a frictional cost between, you know, changing between two active managers. And if you're only talking at that point about a 15 basis point split, then you're going to eat up some of those fees --

MS. WINKLER: Okay. Thank you.

MR. DIFUSCO: -- or that difference.

MR. DOMEISEN: Right.

MR. GILBERT: All right. Is there a

motion?

MR. BUTKOVITZ: Yeah. I nominate the incumbent, Vaughan Nelson.

MS. WINKLER: I second.

MR. GILBERT: Properly moved and seconded.

Any questions on the motion?

All those in favor?

MS. WINKLER: Aye.

MR. BUTKOVITZ: Aye.

MR. GILBERT: Motion carries.

MR. JONES: Thank you.

MR. GILBERT: Thank you.

MS. WINKLER: Thank you, guys.

MR. GILBERT: There has been a request to modify the agenda. Is there anything that we can move?

MR. MAZZA: I think that we were going to go over, due to time constraints on Nancy's part, the pension plan cash flows before the pension policy review. Just go over the -- switch six and seven, if that's okay, Mr. Chairman?

MR. GILBERT: Okay.

MS. WINKLER: Well, six and seven I thought I'd be through both of those, so it doesn't matter. Switching -- I mean, if we can -- I just need to leave in an hour.

MR. MAZZA: Yeah. Ms. Treasurer, I think that the cash flow aspect is more important than the policy.

MS. WINKLER: Okay. Well hopefully we're not going to spend too much time on that.

MR. MAZZA: No. But I think that's a more pressing matter.

MS. WINKLER: Well, we're going to get through both of those. So we don't need to switch them. Tom is sitting out there, right? How long has Tom been out there?

MR. JONES: He's been out there at least for an hour.

MS. WINKLER: Yeah. Let's let Tom come in.

(Mr. Vicente now enters the room.)

MR. JONES: I don't think this man needs any introduction, but this is Tom Vicente from AON Hewitt, and he's here today to talk about the pension funding policy review.

And you're going to be talking to the Commission: Ben Gilbert, Nancy Winkler and Alan Butkovitz.

MR. VICENTE: And does everybody have a copy of the presentation? Does anybody need a copy?

MR. JONES: It was delivered the other day.

MS. WINKLER: Thank you, Tom.

MR. VICENTE: How much time do we have in the agenda? Five minutes?

MR. JONES: I would say the next two topics should take -- let's try to get done them in an hour. So, if you could take a half an hour to go over this presentation?

MR. VICENTE: Okay. Sure. Sure.

So what this presentation is is a set of analyses we did at the request of a working group for PGW to try to look at different ways of funding the pension plan.

Just as background before digging

into all the pages, what PGW has done historically is they've paid for the cost of benefits being earned on a year-to-year basis, the normal cost, plus then if the plan is underfunded, they paid according to a schedule that would be a 20-year paydown of that unfunded liability. Part of that funding policy was that the 20-year was always refreshed every year. So, we were always 20 years out from finalizing the payment of the plan.

So we looked at a couple of different ideas in the actual evaluation before we presented earlier in the year, and one was to switch to a 30-year amortization or a 30-year paydown of the liabilities but do it on a fixed basis so that the 30 years counted down and eventually you would reach a point there.

If you look on page 2 of the presentation, you'll see a summary of some of these results in numerical fashion. Around the middle of the page you'll see the contribution page range. The 20-year contribution was $26,475,000 and a 30-year contribution about two and a half million dollars less that at $24,019,000.

And so what we went into with this presentation was to look at two different options: One -- and not that they're exclusive options, but two different things to think about. One was to switch from the 20 years to the 30 years. The main advantage being that the 20 years right how is what we call open; that is, it continues to go out into the future and always 20 years out, versus 30 years being closed where we count down, which is what the City does.

And the other was to look at whether we should do any smoothing of investment returns. In the past, PGW has always just used the market value of assets in determining these liabilities and the funded liabilities. And the question was, should they do some smoothing of that, thereby averaging some of the ups and downs and taking some of the volatility out. So those were the two points we looked at.

Looking ahead to page 7, we have just a summary there of the amortization policy and analysis and what we looked at. Really just in words what I just expressed to you about what we were trying to determine here, the 20-year open versus the 30 years closed approach.

And if you actually turn to page 8, you can see what the difference is. Essentially, as you would expect, initially the 20 year more open approach requires a higher contribution. So the plan is becoming funded. But over time as you wind down that 30-year period and 20-year period always stays at 20 years, the 30-year approach starts to have a higher contribution. And so you have this point where the blue bars on page 8 are higher initially representing the 20-year amortizations, and the red bars become higher later on with the 30 years.

We had a discussion with the working group about this, and where we really came out was, there was a suggestion made that why don't we actually blend the two approaches together. Not that those are the only two approaches we can take, but blend these two together and say, let's use the larger of the two. So actually take a 20-year approach but always have this 30-year amortization. Close the amortization as a floor, so to speak. So if we did get into a situation, we always would be actually on a schedule to fully defies the pension, unfunded pension liabilities over a defined period of time, as opposed to an open period of time.

I don't have that in this book, but essentially what you would see would be a chart that looks very similar to what you see here when you look at the higher of the blue or the red bars at any point in time. It actually is a little bit not exactly the same because you're funding faster and by the time the 30 year kicks in, you've already funded more of the plan.

MR. DIFUSCO: I'm sorry, Tom.

When's the expected crossover?
MR. VICENTE: Expected crossover is around 2023, 2024. Right around there then is when the contributions cross over. The two essentially get you to the same point as far as being funded about 20 years out. And if you look at page 9, you can see that.
The red line, this represents the funded ratio and the funded percentage of the plan, starting where it is today about 73 percent funded and moving all the way up to 20 years from now. They essentially cross over at about 2032 when the two become essentially the same funding ratio, then the 30 years starts to exceed it. So you can see what happens.
MS. WINKLER: I'd like to ask you a question.
MR. VICENTE: Sure.
MS. WINKLER: Why, if I look at page 8 --
MR. VICENTE: Yes.
MS. WINKLER: -- it looks to me that

the -- under the open amortization we are making a higher contribution up through 2021.

MR. VICENTE: Yes.

MS. WINKLER: And then our contribution goes down below -- I mean, if we keep the 20 open amortization, the contribution is then below the 30-year closed.

MR. VICENTE: Correct. Right.

MS. WINKLER: So what I don't understand is why is the funded status still higher out till 2033? Is there a different definition of funded status of the exact same dollars?

MR. VICENTE: Well it's not the same dollars.

MS. WINKLER: Oh, okay. So we have more dollars --

MR. VICENTE: You've funded more dollars over the first ten years. So you've raced ahead, so to speak, in terms of the fund status.

MS. WINKLER: Okay. So we have more

dollars, okay.
MR. VICENTE: And then it takes the next ten years to catch up.
MS. WINKLER: It takes the next ten years to catch up.
MR. VICENTE: So you get ahead by ten years and then they basically come together.
MS. WINKLER: Okay. Great. Thank you.
MR. VICENTE: So that's what's happening.
So that's what the funding policy that's being considered right now or is proposed right now, is to actually merge these two together and take the flexibility the 20-year open approach provides but also combining with the definitiveness of we're going to actually fully fund the plan over a 30-year period, all assumptions being met. And so you have that combination of the two.
In terms of the dollars and cents, we've shown this projection to PGW, and it

seemed acceptable to them. You know, when you -- unfortunately, as much as we actuaries like to look at this stuff and say we've got this great 20 years projection for you, we do know that by the time we get ten years out or five years out or two years out that the world can be markedly different, as we've seen in the investment market turmoil over the last several weeks. So, but this is the best we can do as far as an approach to say, we think this is a sound approach. It would be a reasonable approach to move the plan toward a sounder funding footing.

Questions on that?

Okay. The rest of the pages in this section just go through the same analysis but looking at what would it look like if we had stronger investment returns or what if we had weaker investment returns. You'll see the same pattern represented just the dollar amounts change. If you have better investment returns, then we're going to have to put less money in. Worse investment returns, we'll have to put more money in. But they didn't really show a pattern that was particularly different from what this initial assumption showed.

So what we would want to do, if we could change to page 15 of the presentation, page 15, that addresses the question of should we adopt a policy that uses actuarial asset calculations. So, I think everybody here is familiar with the market value of the plan assets are. It's what's reported by the Sinking Fund, the sell value of the different funds. We're on page 15.

The actuarial value, and this can be calculated in a number of different ways, but essentially what it tries to do is average out or smooth out investment returns or the best returns that differ from our actuarial expectation. So we assume 7.65 percent. To the extent we have a strong year or a weak year compared to that 7.65, currently as soon as that stronger or weak year occurs, we factor that entire investment gain or loss into the calculations for the following year. Add some volatility to the contribution rates.

However, if we use the smoothing method, we would average out those higher and low years with the idea that over a market cycle, if you average them out you'd be right where you would otherwise be at the end of the market cycle but without the ups and downs in the cash contributions. So provides some stability for the cash contributions.

MR. BUTKOVITZ: Although that policy could be changed at any time by a vote in Sinking Fund though.

MR. VICENTE: The policy could be changed, yeah. As far as putting it in, you could put it in. It can be put in after the fact. It can be put in in advance. So there's a lot of things you can do. You know, the long and short of using an actuarial smoothing method is it just helps to manage the cash flow of the

PGW, as far as contributions to the plan. It does not change the funding status of the plan.

MS. WINKLER: Pardon me. But technically, I think we should seek guidance from the law department regarding how that could be changed.

MR. VICENTE: Okay.

MS. WINKLER: It's my understanding that the finance director is charged with setting the -- these policy issues. Is that correct? Is that incorrect or correct?

(Discussion held off the record.)

MS. WINKLER: Okay. Yeah. Okay. Never mind. It's okay.

So Tom, I have a question for you.

MR. VICENTE: Sure.

MS. WINKLER: I know we've discussed, I mean, the various options now, it's just troubling to see a scenario where while we're looking to get to a long term that we -- that we get to a fully-funded plan, close to a fully-funded plan, do each year do you need a new amortization for any unfunded -- I mean any variances from the plan? So how do you deal with the --

MR. VICENTE: Under the 30-year approach?

MS. WINKLER: Yeah. Over the 30-year approach, how do you deal with any increase in the unfunded from the date you start -- start the amortization of the current unfunded liability?

MR. VICENTE: So typically what you would do is just what you said; that if we start this new 30-year policy, for example, we're going to take the entire unfunded and start an amortization schedule for that pot, that number over 30 years. A year from then we get the census data and we find out that, oh, pay increases, that's a lot of overtime, something, liabilities are a little bit higher than we otherwise would have expected them to have been, or maybe the investments performed better or worse. But now the unfunded liability doesn't match what it would have been if we expected -- if everything were to have been exactly as we expected. We have a differential. That differential we take and typically in a closed amortization approach you take that differential which is small and you give it its own 30-years schedule of amortizations. Some organizations will say, well, it depends where that came from. Some will say if it's a plan amendment, we want to do that over, say, 15 years. If it's an assumption change, we'll do it over ten years. It depends how complicated you want to make it.

MS. WINKLER: And how -- what have you drafted here?

MR. VICENTE: Here we just used 30 years. So every incremental difference year to year --

MS. WINKLER: Gets its own separate --

MR. VICENTE: -- has its own 30-year schedule.

MS. WINKLER: -- schedule?

So no matter what type of --
MR. VICENTE: Exactly.
MS. WINKLER: -- factor is driving the performance away from the assumptions that were used at the time it was established the initial --
MR. VICENTE: Exactly.
MS. WINKLER: -- unfunded liability.
MR. VICENTE: Right.
So that's what we did here in the examples.
MS. WINKLER: So that means it's, you know, over time if there's underperformance, it means that while we would get closer to full funding there was still -- than we would if we had 20-year open --
MR. VICENTE: Correct.
MS. WINKLER: -- it's also understandable that it's also possible that we would not get the full funding in 30 years.
MR. VICENTE: Right.
MS. WINKLER: We would still have an

accommodation 30 years of, you know,
underperformance of something.
MR. VICENTE: Right.
MR. JONES: Underfunding.
MR. VICENTE: Well, underperformance in terms of versus the assumptions made. So just --
MS. WINKLER: And that would lead to the underfunding. Yes.
MR. VICENTE: The underfunding would never really catch up or not catch up as fast as this chart shows.
MS. WINKLER: Right.
MR. VICENTE: Because the assumptions are too aggressive in some component of or a combination of.
MR. MAZZA: Bottom line, Tom. We need returns to be there in the investment.
MR. VICENTE: For this plan the way its structured, yes. Investment returns are a important, very important component of this. Not the only component, but they are one of the important components.
MS. WINKLER: So, in that regard, is

there any consideration that we would -- or I would like us to discuss, like your feedback on a modification of this which would be to provide that as long as we were -- as long as the 20-year provides for a larger contribution, that we would continue to fund -- we'd measure today the unfunded liability and track from today both, and that the contribution would be at the higher level up until the time there's that crossover point at which --

MR. VICENTE: Right.

MS. WINKLER: -- and I don't know how you would define that, but we'd have to find a way to define it. And then at that point we would switch to the 30-year closed.

MR. VICENTE: Right. I mean, we can do it. The how is more mechanical. We've already, you know, after meeting with the work group --

MS. WINKLER: Because I don't know why we would want to do a -- we have a fund that's been having its funded status decline. Why we would prudently take any action that would further --

MR. VICENTE: Right.

MS. WINKLER: -- slow --

MR. VICENTE: Right.

MS. WINKLER: -- the return to full funded status?

MR. VICENTE: And that was one the working group worked out, that the idea of taking the -- using the -- as far as like a funding policy, the number to fund every year would be the larger of what came out of the existing approach versus establishing a 30-year schedule today and comparing them in an ongoing fashion year to year. And then, you know, assuming various variances, you would probably cross over in that ten to twelve-year period is when the crossover would occur, but we'd be tracking it on a mathematical basis every year.

So there wouldn't be a need for any sort of a change in ten years to now it's time for a new policy. The policy would be defined today that would say this is what we would want to do, and then mathematically we can do that analysis year to year.

MR. MAZZA: Judging by the financial condition of PGW, too, a higher contribution should not be an issue.

MS. WINKLER: It's not a higher contribution. It's continuing at the contribution that we're already budgeting at.

MR. VICENTE: Are there questions about that?

But there are -- as Nancy points out, there are a lot of ways to amortize. If you look at what they're doing in the GASB these days, they're saying amortize it over the future working lifetime of the group, which gives you a much shorter amortization period; which is probably too short for cash funding purposes, because it really puts a lot of volatility into the cash flow.

MS. WINKLER: I'm sorry. GASB is

saying that --

MR. VICENTE: GASB 68, which is the new pension standard, is saying you're going to amortize the -- amortize any unfunded liabilities that occur year to year over the average future working lifetime of the group.

MS. WINKLER: What is the average future working lifetime of the PGW group?

MR. VICENTE: Of PGW? Let me see. I might have it in my bag here. I don't have it. No, wrong one.

MR. JONES: Come on. Make something up, Tom.

MR. VICENTE: I'd have to get back to you. But the thing --

MR. JONES: 20 years, 30 years?

MR. VICENTE: Much less than that, because what they do for GASB is they say, well, the future working lifetime includes the working lifetime of your retired and terminated people, who are zeros. So you're going to average --

MS. WINKLER: Oh.

MR. VICENTE: -- a working lifetime of 1200 actives over 3800 lives. So you get a very short period. So that's probably not a good approach to take, but that's sort of like the extreme end.

MS. WINKLER: But what would that mean for PGW's balance sheet? Would there then be a different liability?

MR. VICENTE: Well the balance sheet isn't effected. It's the expense year to year.

MS. WINKLER: Okay. It's the expense.

MR. VICENTE: So that's -- so when they have gains or losses amortized over that period of time.

MS. WINKLER: I'm sorry. Let me ask the question again, because I don't understand your question.

MR. VICENTE: Okay.

MS. WINKLER: So GASB is saying -- GASB 68 says that's how you do it. And we don't do it that way, what impact does it have on PGW's financial statements?

MR. VICENTE: Well, so the funded level, so the balance sheet which will show assets and liabilities, those assets and liabilities are the same regardless of any of these amortization periods. It's going to say what are your -- what's your --

MS. WINKLER: Because it's at market.

MR. VICENTE: Because that's at market. They're both basically set to market. What you'll have is your annual expense, which is an accrual accounting expense, not a cash requirement, that will differ. So that will be larger than it had been in the past.

MS. WINKLER: So they will have cash. I mean they'll have accrual losses on --

MR. VICENTE: Accrual losses.

MS. WINKLER: -- non-cash losses.

MR. VICENTE: Exactly.

MR. LEONARD: I'm sorry, I didn't hear you.

MS. WINKLER: You'll have non-cash

losses, but that's already driven by the
current provisions of GASB 68.
MR. LEONARD: That's correct.
MR. VICENTE: And the way that GASB
68 is set up is everybody is going to have
these losses being driven.
MS. WINKLER: Okay.
MR. VICENTE: So it shouldn't really
affect the cash.
MS. WINKLER: So whatever we decide
here has nothing -- won't have that effect
anyway.
MR. VICENTE: Exactly. Yeah.
That's not going to really affect it. I was
using that as an example for how short an
amortization period could be.
MR. LEONARD: If I may, I think it
will have an impact to our, to PGW's P and
L to whatever the extent it changes, but in
terms of PGW's debt service coverage, it
should have no impact and it should be
considered a non-cash item.
MR. RUBIN: They were really the two
items, right, Tom?

MR. VICENTE: Yes.
MR. RUBIN: And that's really all we needed to consider.
MR. VICENTE: Yep.
MS. WINKLER: Yeah. Thank you.
(At this time, Mr. Vicente leaves the room.)
MR. GILBERT: So item 7 is moved to executive session. So we'll hear from Frank Domeisen?
MR. DIFUSCO: No. Item 7 is law department, Commissioners, staff. Frank is in 8.
MR. GILBERT: Okay.
MR. DIFUSCO: So we're doing the cash flows and the --
MS. WINKLER: We're staying in order.
MR. GILBERT: Okay.
MR. RUBIN: Before we do that, do you need a motion to put through what we just talked about there, to accept that as the 20 to 30?
MR. GILBERT: I think we said --

MR. DIFUSCO: No. Hang on. Billy is asking a different question. Go ahead.

MR. RUBIN: Right. We just talked about going to the 20 and the 30 and a five-year smooth. So if you're going to do that before we move off that item, do you need to get confirmation from the panel?

MR. DIFUSCO: Not as I understand it, if that's under the purview of the finance director solely as I -- and if I'm mistaken, correct me.

MR. RUBIN: Okay.

MR. DIFUSCO: But my understanding is it's purview of the --

MR. RUBIN: That's fine. So that's going to be the way that it goes moving forward?

MR. DIFUSCO: And my understanding is the finance director will send a letter to PGW memorializing that -- those selections, which the Commission will receive a copy.

MS. WINKLER: Can we ask the PGW staff to prepare a draft letter?

MR. DIFUSCO: Sure.

MS. WINKLER: With --

MR. RUBIN: However --

MS. WINKLER: That's what we want. If that's how -- right? We want to see a letter.

MR. DIFUSCO: That's fine.

MS. WINKLER: Yeah.

MR. RUBIN: Yeah.

MS. WINKLER: And this will be effective when? It should be effective the next contribution date.

MR. RUBIN: Correct.

MR. MAZZA: As of October 9th is the next contribution date, is the next pension --

MS. WINKLER: Well, I think -- or budget year. Maybe that would be better, I think.

MR. LEONARD: Our fiscal year begins on September 1st.

MS. WINKLER: Right. So you currently are budgeting at the 7.65 percent contribution, correct?

MR. LEONARD: That's correct.
MS. WINKLER: Okay. So that's been -- that was an action taken last year.
MR. LEONARD: Yes.
MS. WINKLER: And that's now in your budget for this year.
MR. LEONARD: That's included in our budget, yes.
MS. WINKLER: And then this action will affect the budget beginning in fiscal '17?
MR. LEONARD: That's what I understand you're saying.
MS. WINKLER: I'm asking. Is that what --
MR. LEONARD: I was under the impression that this was all going togoing to be effective this fiscal year.
MS. WINKLER: Oh good. Okay.
MR. LEONARD: The changes that we were implementing were going to be effective this fiscal year.
MS. WINKLER: Okay. That would be --

MR. LEONARD: And there would be -- whatever variance there is compared to budget, we can explain that in change in policy.

MS. WINKLER: Are there any concerns?

MR. LEONARD: Not at the current moment. It closely resembles what our expectations were, at least for this fiscal year.

MS. WINKLER: I understand.

MR. GILBERT: Okay. So we're going togoing to
move to executive session to hear the pension plan cash flows.

MS. WINKLER: And who is staying in that meeting?

MR. DIFUSCO: It would be law, Commissioners and staff.

MS. WINKLER: Okay.

(At this time, Executive Session takes place off the stenographic record.)

MR. GILBERT: Frank Domeisen is going to give the pension investment report.

MR. DOMEISEN: Okay. You have two

booklets that were passed out. One was through June 30th. I'll be fairly quick. I'll try to touch on things that are relevant to the full quarter report, and then you do have a flash report that brings us through the end of August that I'll touch on later.

I'll skip the market background from the second quarter. I think we all at this point have a good sense that the markets were fairly flat in the second quarter but have declined especially in the equity markets post June 30th. So with that I'll jump to page 9. The page numbers are in the lower left.

Page 9 we start by looking at the positioning of the portfolio. And again, as of June 30th, the market value shown in the upper left of this chart, $514,034,563.

MR. JONES: As of this morning, that number was $489 million, just so you know.

MR. DOMEISEN: Okay. And what we show is the three major asset classes and their specific allocations. And domestic equities, diversified domestic equities represent about 54 percent of the portfolio, and the benchmark is 50 percent. So there's a slight overweight to equities. Offsetting that is a slight underweight in fixed income bond segment of the market. 32 percent weighting versus a target of 50 percent.

We have been tactically underweighted fixed income and slightly overweight equities within the ranges, within the policy ranges that are established. One part of that is due to the low interest rate environment and potential risk of rising interest rates later in 2015 and beyond. Otherwise, your allocations are close to targets in all components here.

MR. DIFUSCO: Not to interrupt Frank, but just on Charlie's point, the drop, there was also about six and a half million dollars, though, that was in outflows for benefit payments. So it's not all -- I just want to point out it's not all market-driven. Some of it obviously is, but there also was significant --

MR. RUBIN: What was the outflow?

MR. DIFUSCO: Seven. Excuse me. Five and a half million --

MR. JONES: Five and a half, and $7 million. $7 million of that -- of the $25 million decline --

MR. DIFUSCO: Was for outflows.

MR. JONES: -- was cash to PGW.

MR. DIFUSCO: I just wanted to make clear that was not all market-driven.

MR. DOMEISEN: Yeah. On page 10 and 11 we did an overview of all the managers, and we look at absolute and relative performance. And what I can say in review of this on page 10, which covers the equity managers, that on a three-year basis they're either exceeding their relative target and/or exceeding the peer group median. There's one expectation to that, and I'll get to that in a moment.

Eagle was on this page, and it says recommendation watch. That's been due to, since inception, underperformance. However, that was concentrated in 2013. The performance is now in the top half of the peer group over all trailing time periods. So there's some improvement, and we'll see that specifically with their numbers.

On the next page we look at the fixed income managers, page 11. And here all the fixed income managers are exceeding their benchmark and/or exceeding the peer group median over a three-year time period. One manager that we're watching on this page is Harding Loevner. They're the international growth manager. While they've been exceeding the overall develop non-US market, relative to growth mandates they have been lagging. Part of that has been due to some merging market exposure, but more recently the performance has moved to be more consistent with the benchmarks, so.

MR. DIFUSCO: Should we consider -- I'm sorry, Frank. I mean just looking back -- I think I mentioned this probably to Charlie and maybe some others -- would it be reasonable for the Commission and staff to be looking for at least one of the three international slots to be an index? And I ask, you know, mainly because, you know, over -- just, you know, looking at the performance going back ten years, there's been, you know, significant underperformance over a ten-year period relative to the benchmark. And I'm just wondering if at least, you know, part of that underperformance or whatever could be made up by saving, you know, some significant dollars on fees.

I mean, is that a reasonable thing for us to be considering?

MR. DOMEISEN: That is reasonable. But on the value side you've been outperforming, which is Mondrian.

MR. DIFUSCO: Yep.

MR. DOMEISEN: That however long run that has been outperforming. And you did put a core mandate in, Dimensional Fund

Advisors, as a third manager a little bit more anchored to the index, a little closer correlation to the benchmark. But you could continue with that and maybe add a component that would be an index only in that space.

MR. DIFUSCO: Thank you.

MR. DOMEISEN: On page 12 I'll look at the domestic side of the equity managers, and as you scan down the quarter, if I look at the combined large cap, you were up .3 percent and the benchmark was up .1 for the quarter. So outperformance. Same on the year-to-date basis, as well as a one-year basis. Over three years the performance annualized of the large cap managers has been just behind the benchmark.

MR. JONES: Excuse me. When you say large cap, is that just the active managers?

MR. DOMEISEN: No, that's the combined.

MR. JONES: That's including -- does

that number include Rhumbline and Northern Trust?

MR. DOMEISEN: Correct. So within that large cap component, two-thirds of it is indexed, Rhumbline and Northern Trust. The other third of that, those assess, are active. So the majority of them are indexed.

MR. JONES: Yeah. Okay.

MR. DOMEISEN: And for the quarter, your outperformed came from Fred Alger, the large cap growth manager, that outperformed.

Small cap, the bottom of the page, 12, for the quarter you were up 3.2 percent and the benchmark was up .4. You got outperformance by both managers, the Eagle small cap growth was up four and a half percent versus a benchmark of two percent, and also Vaughan Nelson. So on a year-to-date basis both the managers within small cap have been outperforming. And that also is the case when you look back over three, five and the ten-year period annualized net of fees.

Page 13, the international grouping, here Mondrian was overweighted Europe and over the quarter, and then actually over the last year Europe underperformed Pacific Rim. They tend to have an overweighting to Europe; but nevertheless, the performance in a downmarket did protect when you look at the one-year column, which we would expect them to do.

In the three-year number, even though it's behind the index, it's in the top third of the peer group. So on a relative basis, the benchmark international value benchmark has been tough to beat. And that's the case for the growth side as well.

The growth manager, Harding and Loevner, over the -- for the quarter underperformed but when, you know, looking at the one-year period, they're a hundred basis points ahead of the benchmark. So we've seen some improvement there.

And DFA is a core mandate, and

having performed more or less in line with the benchmark on a one-year, but since inception is ahead of it, which has been about three years now, three-year number ahead of the benchmark.

MR. JONES: Excuse me. I mean, I'm looking at the ten-year number for this international equity benchmark. It's 5.54 percent. Why do we have any money in there at all? I mean, if their long-term return is five and a half percent, I think we have to do better than that.

MR. DOMEISEN: I would agree. And that's why we did recommend. We think we can put in a portion of that to be indexed. Your value manager is outperformed by almost a hundred during that time period. So the trick is that we need -- we should complement that with a -- either an index growth international manager or -- Harding and Loevner has not been in place for that whole time period. A manager that --

MR. JONES: I mean even if we were making a hundred basis points more, we're at 554. That's not getting us where we need to be. This should be -- this is what, 15 percent of our assets?

I guess I'd like to consider, you know, do we reduce the allocation to international because of that -- that total underperformance over a long period of time?

I guess that's a question to you, Chris.

MR. DIFUSCO: Yeah, I don't know that I would agree with that for a couple reasons; one, I'm not sure that we can expect the same -- you know, that that's based solely on the idea that what happened the last ten years is likely to repeat itself. I mean, under that scenario then we also shouldn't have any exposure to bonds, because none of the bonds have done better than four and a half percent over the last ten-year period. And even going back historically, the best -- the best index, which is a combined index, is 6.4, which is significantly below our target.

So I'm looking to having an international exposure as a diversifying tool and it's also to get exposure just beyond --

MR. MAZZA: There's some upside as well.

MR. DIFUSCO: -- beyond the United States. Whether or not to your -- a smaller subset of your question, whether or not we should have a smaller amount of money, I think that's a reasonable question and I think, you know, relative -- I can tell you that relative to some other pension plans I think we probably already are somewhat underweighted international. I think it's one of the things, quite frankly, that protected this plan.

As much as it hurts to lose the $18 million that we did in August, roughly, I think it's one of the reasons why we didn't lose more, because we were more concentrated in the US. While the US got hit, it didn't get hit as hard as China, and it didn't get hit as hard as Europe.

And I think that's why the -- we were down I think I had four and a half percent in August. A lot of other pension funds were down significantly more than that, in part because the international exposure was higher.

And if -- Frank may have, you know, more to say on that looking at other clients or other plans, but that's what I'm seeing.

MR. DOMEISEN: Your international exposure as a percent of the equity model is about 23 percent. And that is, as Chris pointed out, on the lower end of the spectrum. Keep in mind the overall global capitalization of the markets globally is closer to 50/50. So 50 percent non-US, 50 percent US. So, to Chris' point -- echoing Chris' point.

MR. MAZZA: Yeah, I agree with Chris. I think we need to keep it right where it's at. I think we saw the downmarket recently over the past three to five years, I think we got to at least participate when the upmarket comes back. You can see in Europe and Asia going through a rough couple of years, especially the equity markets in Europe. Why would we take all the downturns of the market over the past three to five years and not stay and see what the upside is? Especially when it's only 23 percent of our equity holds. You know?

I think the one thing we should start to figure out, though, is fixed income and the rising grade environment, what we need to do there. We have a number of managers seeing a lot of cash. Where that cash can be used elsewhere, you know, especially when we're making contributions towards pension benefits from the Sinking Fund. I think that, you know, the equity markets should stay the course. But I think with fixing margins we need to make some serious changes.

MR. DOMEISEN: Yeah, and we can address that. We do have some, you know, outlooks on that. Going more to a core plus type strategy on the fixed income as opposed to core, that extra yield provides some protection if interest rates rise --

MR. MAZZA: Wherever we can get yield is what we need.

MR. DOMEISEN: -- and that sometimes you exchange interest rate risk for credit risk, but nevertheless, in a prudent manner there are ways that we can hedge potential rising interest rates whether they be in September, maybe this September or throughout, you know, by the end of the year or early next year. But they're definitely high yield focus. Yield focus can help protect in rising rates, not so much just shortening maturities. That will protect you for a break rise, but the give-up right now is expensive because the yield curve is steep.

MR. MAZZA: Yeah.

MR. DOMEISEN: And if the yield curve flattens out, meaning that the Fed raises the short end, they don't control the long end of interest rates, but if the economy is soft globally and there's low inflation, the long end may come down yields. So therefore, you want to be keeping some of your longer duration bonds to get price appreciation. So there are things we can look at and fix.

Going back to international, you are underweighted, like we just -- like was just mentioned, versus the global markets in terms of US or non-US. The other item we can look at here, and we had actually presented it internally in the past, looking at a global mandate. And the reason for global is that you get the best of both worlds. Try to get domestic manager and an international manager. Not slotting it as either/or. And that provides value added over time. So that's a tactic that can work, that has shown to work effectively to add value.

Got a little sidetracked there, but if I may, I'll come back to the fixed income. Basically, for the fixed income managers for the quarter you were in line with the benchmark which was down 1.1 percent. Interest rates rose during the quarter. Interest rates raise, bond prices fall. That led to the negative performance for fixed income for the quarter.

The two plus managers, Logan Circle and Lazard, actually faired a little bit better on the quarter in the year-to-date period than Barksdale and Garcia Hamilton. That's due to the nature of that high yield. So again, when interest rates rose, those two plus managers, core plus type managers, had a little yield to protect and offset the price declines.

MR. MAZZA: Part of the yield you have in the portfolio, it doesn't matter that there were raised interest rates 25 to 50 basis points to get those higher yielding assets there to protect it, so.

MR. DOMEISEN: So bottom line, all in the performance for the quarter was up .1, and the benchmark was down .2. So it outperformed by 30 basis points for the quarter. You see the one-year number up

4.6 versus the benchmark of 3.6 outperformed by a hundred basis points net of fees on the trailing one year. And the three-year up 11.3 percent versus a benchmark of 10.8.

Where did this value added over the trailing one year come from? If we look at page 15, the upper right -- you know, the upper panel here, we're looking at value added of one percent over the benchmark on the trailing one year. And if you look to the right, the value added came primarily from manager value added. Which managers?

Well, if you look right below that in the lower right panel on page 15, it did come from large cap equity. Actually, both managers over the last year outperformed both Cooke and Bieler and Fred Alger contributing to that, as well as small cap. And over the last year small cap primarily value added came from Vaughan Nelson, the small cap value manager. Eagle was equal to the benchmark. And then international had a slight outperformance as well. So it came from a broad breath of manager value added.

Page 16, what we show here is the peer group rankings for public plans below a billion dollars. And the numbers in parentheses show the ranking. So if I'm looking at the lower panel where it says return, the total fund on the one, three and five years was above the 50th percentile. So on a relative basis, outperforming the median public plan below a billion dollars.

The other element to that is we look at the Sharpe ratio to say is the plan being compensated for the risk that it's taking? And that's measured by the Sharpe ratio. You want a higher number, suggesting that you're getting more return per unit of risk. That Sharpe ratio also was in the top half of the peer group. It's a way you're getting above-median returns, you're getting above-median Sharpe ratio or risk adjusted returns.

Page 17, the top panel looks at not

just a snapshot of how the fund is done over the trailing three-year period, but on a rolling basis for every time period that we measure, quarter ends, the PGW pension plan is the blue square and you can see that ending to the right chart -- part of the chart ending June 30th. Again, it was in the top, basically, third or 30 percent of the peer group and ahead of the benchmark and it's improving.

Finally, page 20 is the valuations. Again, we already talked on the numbers on June 30th. You can see the column titled net flows, there was approximately 5.1 million that came out. Most of the outflows were from the equity side of the table. So that actually protected a little bit and you used that for funding sources from the equity side.

That's all I had for June.

MR. JONES: That's April, May -- just so you know, four and a half million dollars of net outflows were funding the pension plan.

MR. GILBERT: Any questions for Frank?

Motion to accept the report?

MR. BUTKOVITZ: So move to accept the report.

MR. GILBERT: Properly moved and seconded.

Any questions on the motion?

All in favor? Aye.

MR. BUTKOVITZ: Aye.

MR. GILBERT: Motion carries. Thank you, Frank.

Next we have the flash report.

MR. DOMEISEN: Okay. I'll go to page 3. I think we all know that, you know, August was a tough month. But if look on page 3 down the column titled month, you can see the total plan was off about four and a half percent, and the benchmark was down 4.2 percent.

The managers outperformed consistent with prior time periods. Large cap was pretty much in line with the overall benchmark, small cap protected versus the benchmark, and the international mandate was weak in the month of August. And fixed income was slightly behind the benchmark.

So all in, down 4.5 percent versus the target of 4.2. On a year-to-date basis down 1.3 percent versus the target of 1.5. I think most importantly since that would finish the fiscal year, the one-year number for the fiscal year-to-date off .9 versus the benchmark of down one percent.

Valuations are shown on page 4 in terms of the percent weightings. Basically, the weightings are 67 percent equities, 33 percent bonds, versus a target of 65 percent equities and 35 percent bonds. So still a little underweighted fixed income.

MR. DIFUSCO: Is your snapshot or where you're drawing data from -- like, I know there's more cash there than $92. I know there is. There's, like, two and a half million dollars.

MR. DOMEISEN: Oh, that may not include the --

MR. DIFUSCO: The custody account?
I'm just wondering where you're drawing the data from, because I know last I looked there was about a 60 --
MR. JONES: That looks like the -- that is the employee contributions.
MR. DIFUSCO: Only. It does not include the --
MR. JONES: Correct.
MR. DIFUSCO: Okay. Just so everyone knows.
MR. JONES: I recognize that $300,000 number.
MR. DIFUSCO: Well I'm even just looking at the bottom where it says cash and cash equivalents and it says 92.
MR. DOMEISEN: That doesn't count the managers.
MR. DIFUSCO: And it doesn't count what Charlie and I are just holding in -- like, we have about two and a half million dollars in cash exclusive of what the managers are holding.
MR. DOMEISEN: Correct.

MR. JONES: And I think you
should -- I think you have to make it clear
to the Commission what's going to happen
there with the new funding process. We're
going to be holding four and a half million
dollars in cash in reserve. Normally it's
in two to two and a half million dollar
range, just for general purposes just for
risk management. But now because of this
new funding process, we're going togoing to keep at
least one month's cash in reserve in our --
what we call our custody account. In case
we have to fund the pension plan, the
payroll, and there's a market interruption
or maybe Chris doesn't want to go to the
market at that point in time, we're going togoing
to
keep four and a half million dollars in
cash in the custody account. Just so you
know. It's still within policy.

MR. DIFUSCO: Yeah. Well within
policy.

MR. JONES: The policy is zero
percent with a range of zero to ten
percent. And we'll be at, like, one

percent cash.

MR. GILBERT: Okay. We'll take the flash report as information. Thank you.

Impact of interest rates was deferred to the next meeting.

MR. DIFUSCO: Next meeting. Yes.

MR. GILBERT: Contract matters, Charlie Jones.

MR. JONES: There are two listed here. They are contracts that are expiring for our auditor, which is currently WithumSmith and Brown, and for our large cap growth manager which is Fred Alger. Both of those are expiring in the first part of next year. So I'd like to get an approval from the Commission to -- to float some RFPs out there for those two mandates.

MR. BUTKOVITZ: So moved.

MR. GILBERT: I'll second.

Any questions on the motion?

All those in favor?

MR. BUTKOVITZ: Aye.

MR. GILBERT: Motion carries.

MR. JONES: And for your

information, Chris wanted me to mention to you, we are going to try to float a small cap index RFP. We don't have that right now, and you've already approved it. You approved it last year. So I'm just letting you know that we're going to start that process very soon.

MR. GILBERT: Okay. Any other business? Any other business? Any other business?

We are adjourned.

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(Meeting concluded at 2:21 p.m.)

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