THE BOARD OF PENSIONS AND RETIREMENT
INVESTMENT COMMITTEE MEETING
JUNE 27, 2012

MEETING MINUTES

There being a quorum, Rob Dubow, Board Chair, opened the Investment Committee Meeting at 9:50 a.m., 16th Floor, Board Conference Room, Two Penn Center Plaza.

Present:

Rob Dubow, Finance Director
Paula Weiss, Esquire, Alternate Board Chair
Harvey Rice, Esquire, Alternate, First Deputy City Controller
Brian Albert, Alternate
James Leonard, Esquire, Alternate
Celia O'Leary, Alternate, Deputy Director of Human Resources
Ronald Stagliano, Employee Trustee
John A. Reilly, Employee Trustee
Carol G. Stukes, Employee Trustee
Veronica M. Pankey, Employee Trustee
Anne Kelly-King, Non-Voting Board Member

Executive Director:	Francis X. Bielli, Esquire
Deputy Executive Director:	Mark J. Murphy
Chief Investment Officer:	Sumit Handa, Esquire
Deputy Chief Investment Officer:	Rhonda McNavish
Investment Officer:	John Foulkes, Esquire
Investment Officer:	Brad Woolworth
Investment Officer:	Daniel Falkowski
Investment Associate:	Dominique A. Cherry

Also Attending:

Robert O'Donnell, O'Donnell Associates
Benjamin Hinerfeld, Esquire, Law Department
Jacob Walthour, Cliffwater
Ashley Cooke, Cliffwater
Gabrielle Zadra, Cliffwater
Christopher Rice-Shepherd, Cliffwater
Jose Ortega, JP Morgan
Scott Dahs, JP Morgan
Brian Hyde, JP Morgan
Taugh Lynch, JP Morgan
John Dunfee, Greentree
Andrew Thomas, Local #22 – Firefighter
Chester Skaziak, Retiree, Firefighter
Arlene Sawyer, Investments

Donna Darby, Investments
Carmen Heyward, Investments

<u>Agenda Item #1 – Approval of Minutes – May 24, 2012</u>

Ms. McNavish advised about several substantive changes to the Minutes of May 24, 2012. Page five, bottom, last paragraph, the amount should be $168.0 million in investments. The last sentence on page eight should read "The majority of the new capital that was committed was "to" (not from) existing funds, including (remove "the approval") $10 million more to JP Morgan that was funded in the 4th quarter. The top of page nine should be changed to "to" previously allocated as opposed to "from" previously allocated.

Mr. Dubow requested a motion to approve the Minutes of May 24, 2012 with the integration of the substantive changes as discussed. Mr. Stagliano made the motion. Mr. Albert seconded. The motion passed.

<u>Agenda Item #2 – JP Morgan Update</u>

Mr. Ortega, who is an Executive Director for Worldwide Securities Services and responsible for the engagement process with the City in selecting the new custodian, thanked the Board for selecting JP Morgan as their new custodian. He introduced Mr. Hyde, Executive for JP Morgan's Pension Business, Mr. Dahs, Vice President and Relationship Manager and Mr. Lynch, Vice President for Securities Lending.

Mr. Ortega said that JP Morgan was invited to address any Board questions related to the firm or the custody transition, and their purpose was to provide commentary about the recent media reports regarding JP Morgan's CIO office and to also present the progress made as the City's new custodian bank and to discuss the results of JP Morgan's Securities Lending program. The representatives provided an update on the status of their progress as the Fund's service provider and responded to Board questions.

Mr. Hyde provided a brief update from May 10, 2012, when they disclosed to Staff about the significant losses incurred by JP Morgan related to their CIO office. Some of the losses were offset by gains. The intent of the activity in the CIO office was to hedge their risk exposure, but something went wrong with the analysis, and the opposite happened, making things more risky and less effective. In response, they have teams across the firm looking into what was going on, what they could learn from the process and the steps that they need to take to make sure that they will not make the same mistake in the future. He said that they have spoken to all their custody clients to reassure them that none of their clients were impacted by what was going on or experienced any loss. He apologized for what happened and assured that it would not distract them from serving their clients well. He described JP Morgan as a strong firm with solid risk capital, earning $19 billion in 2011 and $5 billion in the 1st Quarter.

Mr. Lynch reported that the first month of the Philadelphia securities lending program at JP Morgan earned over $300,000 That was contrasted with 2011 May earnings, which was a little over $200,000, outperforming significantly the former provider. They worked with the City's Investment Staff during the Custody and the Securities Lending transition to create a customized and individualized program for what the City did and the risk that they wanted as part of the program. A new cash collateral investment account was established for the City's Fund, and was doing well and was profitable.

Mr. Dahs advised that they were in the governance phase of the conversion, where they were working with Investment Staff to identify key metrics, and they would be meeting on a monthly basis to advise them of the issues about which they needed to know.

Board discussion followed the presentation that addressed their concerns, with input from Cliffwater, about the media coverage related to JP Morgan CIO losses and the impact on the City's Fund, and Mr. Ortega assured them that the City's assets were completely separate from the equity in the firm.

Agenda Item #3 – Cliffwater Review of Real Estate Portfolio

Mr. Walthour said that Cliffwater's report was designed to respond to the Board and Staff's request to look at the Fund's Real Estate allocation exposure and other areas of the portfolio. In response, Cliffwater looked at the Hedge Fund, Private Equity, as well as in the traditional Fixed Income and Equity portfolios. The presenters went into specifics of the Fund's exposure to Real Estate, with opportunity to look at the recommended changes, followed by a brief description of Cliffwater's process for management of Real Estate investments.

Ms. Zadra (slide 2) provided Cliffwater's division of Real Estate into three categories. The first was REITs or Core which represented the most liquid. Whether through an open-end fund (JP Morgan and Invesco) or a Public REIT, the underlying real estate was the same. Looking at REIT performance over 25 years, they performed in line with Public Equities and generated higher performance than Core funds, which tracked Fixed Income. Current yield was calculated on the REIT or Core funds as 3.4%, and target return at 8% to 10%. All targeted returns quoted are net.

The second category that was higher in the risk and return spectrum was Private Real Estate Debt, either as Performing Debt (Mesa West) or a Distressed Debt fund (Lone Star) and the Fund had one of each in the portfolio. This category is not liquid. The investment has an income -a current yield-component and long-term capital appreciation. The targeted return is between 9% and 16%. Cliffwater advised that this was a prime opportunity to invest in performing or distressed real estate funds.

The last was the Private Real Estate Equity, with a targeted return expectation of a 12% to 20% net return, leveraged to 70%, with less current income and more long-term appreciation. This category is not liquid.

Mr. Rice-Shepherd (slide 3) looked at the historical returns of the major indices both Private and Public. He offered Cliffwater's historical preference for REITs as a substitute for Private Core vehicles.

He noted the short-term valuations in the portfolio and recommended redemption of shares in the JP Morgan and Invesco funds within four to eight Quarters of $10.0 million per Quarter for a total of $80.0 million.

Ms. Zadra (slide 5) highlighted the three categories of dedicated real estate in the Fund's portfolio: (1) Open-end Core funds, (2) the pre-2008 Opportunistic funds, or the Opportunistic Private Real Estate Equity funds that underperformed, and (3) the post-2008 Debt-oriented funds. The pre-2008 funds were performing poorly, and their recommendation was to sell them on the secondary market. Replace the open-end Core Funds with one or two REITs. Cliffwater recommended that the Board hold on to Mesa West and Lone Star.

Mr. Walthour (slide 5) noted the Fund's exposure in various Hedge Funds to the RMBS and CMBS Fixed Income sectors, as well as to some REITs, advising that the traditional Equity and Debt managers were large users of Real Estate-related products.

Ms. Zadra (slide 6) provided the suggested breakdown of the Real Estate 5% bucket, with REITs at 1%, Private Real Estate Debt at 2% and Private Real Estate Equity at 2%.

Mr. Rice-Shepherd (slide 7) highlighted 2011 and 2012 Real Estate market performance, advising that the investment climate currently favored Real Estate as an investment.

Ms. Zadra closed by talking about Cliffwater's process for management of Real Estate investments related to mapping out the best funds by strategy, performing due diligence, providing Quarterly updates, and their legal and operational due diligence.

Agenda Item #4 – Lee Munder Small Cap Value Recommendation

Mr. Falkowski recalled the Board's May 24, 2012, decision to retain Fisher as the Fund's Small Cap Value manager. The Subcommittee had also requested Staff to evaluate replacing Lee Munder with New South Capital Management. He provided a report on both managers.

Lee Munder was funded in November of 2009, replacing Robeco Capital Management. The performance, to date, had not met Staff expectations, underperforming by 40 basis points. They were placed on Watch -1 Status.

New South Capital Management's portfolio is more concentrated than Lee Munder. In highlighting their strong performance, the returns on a trailing three, five and seven-year basis, were in the top percentile. They also looked good on a risk-reward basis via the Sharpe Ratio.

Mr. Falkowski said that Staff agreed with the Subcommittee's recommendation to hire New South Capital Management.

Mr. Dubow requested a motion. Mr. Stagliano made the motion to hire New South Capital Management to replace Lee Munder in the Small Cap Value space. Ms. O'Leary seconded. The motion passed.

Agenda Item #5- JP Morgan Currency Alpha Recommendation

Mr. Falkowski provided background on the Fund's currency managers, noting that A.G. Bissett was terminated in 2011.

Mr. Handa said JP Morgan's performance was -.06% annualized net of fees since inception, below their benchmark of 2% and well below the Fund's cost of capital of 8%. From Staff's perspective, it was hard to justify continuing the investment at this time, and their recommendation was to exit.

Mr. Stagliano made the motion to terminate the relationship with JP Morgan. Mr. Albert seconded. Mr. Dubow requested a Board vote. The motion passed.

Agenda Item #6- Flash Report for the Period Ended May 31, 2012

Mr. Handa provided a brief Fund summary from 2011 to 2012 before Cliffwater's report.

He said that the Pension Plan turnover was, over, $400.0 million of assets, meaning buys and sells. There were $700.0 million in outflows, with approximately $400.0 million in inflows and the performance was flat in a volatile environment. In changing the portfolio, fees were reduced from between 20% to 40% across the board, including Equity, Fixed Income, as well as Hedge Funds. The reductions had a meaningful impact on the Fund, saving the fund, approximately, $10.0 million.

He informed that the Fund's new manager partnerships with KKR, LEM, Beach Point, Almanac, as well as a new view in Emerging Markets, starting with ESG, would pay dividends for years to come. The Fund changed custodians in 2012. There was more to be done. Finding yield in a low-interest rate environment was not easy and created risk. Staff and the consultants continued to look for the most attractive, risk-adjusted return, so that Pension assets generated the cost of capital and provided a safeguard at the same time.

Mr. Walthour provided a brief market commentary that 1st Quarter gains were reversed in May, and the flight-to-quality was evidenced in the performance of the Pension Plan, with investment-grade fixed income continuing to perform with historically low rates and riskier areas - like HighYield and Equity selling off significantly.

The Equity markets (page 3) and Hedge Funds did not hold up in the environment in May. The markets that were close to the issues were less safe and sold off the most. The U.S. market sold off 6%. MSCI EAFE was off in the double-digits. Commodities were down, with no place to hide.

The Fund is underweight its target in International Equity.

Fixed Income was the bright spot in the portfolio. High Yield sold off significantly. For Fixed Income, declining interest rates can not be relied upon to generate the same types of fixed income returns that have been generated by the respective fixed income indices over the last three years.

In talking about the performance of Fixed Income over the last year, Cliffwater would be looking for ways to alter the portfolio. They had in mind putting in place some long-short Fixed Income managers, so that they could deliver more steady performance as the markets sold off, to profit from the Shorts, but selectively picking the Longs.

The Alternative segment delivered negative results, but less negative than Equity markets, and the Board would want to see less volatility with some down-side protection. Credit managers sold off. Long-Short Equity managers were down 4%. The U.S. markets were down 6, and the international markets were down in double-digits. Event Driven managers, Credit and Equities were down 1.35%. Commodities were down 9% in May and were down over 20% since the bear market in Commodities started. This should be addressed in the portfolio. Real Assets are underweighted.

For the month of May, Alternative managers ESG and Caspian contributed 40 basis points and 56 basis points of positive performance. However, Mr. Handa added that the numbers for ESG and Caspian reflected April's numbers. The point was that for May's performance, very few did well. Mr. Walthour said, on the other side, the Fund had managers that were down in dramatic fashion in the double-digits.

Regarding select manager contributions year-to-date, Mr. Walthour reported that Emerald Advisors continued to make a positive contribution to the portfolio. On the negative side, the year to date performance of Real Asset managers FAMCO and Harvest were negative, but both were long-only strategies.

Mr. Walthour reported that asset allocation by underweighting Non-U.S. Equity was good for the month. Fixed Income was good for the month, being underweighted in Hedge Funds was even. The Real Assets underweight was good, as commodities sold off, and having a heavy cash position helped the portfolio.

Despite the negative numbers, it was a good month relative to the index, outperforming the policy index by 91 basis points during the month. The trailing three months was up 1.6% relative to the benchmark. Fiscal-year-to-date, the Fund was up about 65 basis points relative to the index.

Agenda Item #7- Flash Reports for Opportunity Fund Managers for the Period Ended May 2012

Mr. Handa requested that a Subcommittee be formed to consider changes to the Opportunity Fund Policy. Mr. Dubow requested volunteers, and the members of the Diversity Subcommittee, Mr. Rice, Ms. Stukes, Mr. Stagliano and Ms. Weiss volunteered.

Ms. Cherry said all sectors reported negative returns and all market cap segments were down for the month of May. Large Cap performed slightly less worse than Small Cap. She highlighted the managers that were currently on FIS' and PFM's Watch list.

For FIS, Moody Aldrich outperformed in the 1st Quarter. Three names detracted, almost 300 basis points for the month. The manager has a high concentration in high beta securities that performed poorly in May. Victoria 1522, since inception, from 2009 to 2011, outperformed in every calendar year. The manager underperformed in the first quarter and the month of May, attributed to weak stock selection in information technology and materials. Staff discussed outlook for this manager with FIS. The manager will be evaluated at the end of the second quarter.

For PFM, three managers were on their Watch list, and two of the three underperformed for the month of May, Palisades and Profit. During PFM's first quarter presentation, they noted they would extend their evaluation period for both managers and had a favorable outlook for both. PFM noted that they were considering a replacement for Profit, but the stocks that were detracting from performance were beginning to help their performance. They were suggesting waiting for another month or two before considering a replacement for Profit. For Palisades, sector allocation was the primary detractor of performance in the month of May, and for Profit, stock selection across all sectors detracted most from relative performance in the month.

Mr. Dubow asked Ms. Cherry's recommendation. She said that she expressed concern for both Palisades and Profit. Both of the managers had been on board for at least three years. It was her opinion that the manager should continue in their search for potential replacements.

Per Board request, Staff will invite both PFM and FIS to provide a status update to the Board at the next meeting.

Agenda Item #8 – Chief Investment Officer's Report

Mr. Handa reported for Securities Lending that JP Morgan, earlier, discussed the $300,000 in income earned. The positive aspect of Securities Lending was from the team of JP Morgan quickly getting securities out on loan during a traditionally high earning month of May. It did not offset the losses in the rest of the portfolio, but it was notable.

He said that as the Board was requesting a breakout of the local and minority, as well as the diversity managers, Mr. Woolworth was providing the information and trying to make it as comprehensive as possible.

Ms. McNavish referenced at the May 24, 2012 Investment Committee Meeting, Staff noted a discrepancy in the performance as reported by the custodian and Stone Harbor for the first quarter of 2012. The custodian reported a return of 10.39%, and Stone Harbor reported a return of 8.19%. In quarterly reporting to the Board, Staff uses the custodian's performance numbers; however, in this case, Ms. McNavish stated that she used the manager's return of 8.19%, as it was more conservative. Ms. McNavish requested that Stone Harbor go back and reconcile performance to the performance that State Street reported and to indicate where there were differences versus State Street and the reason for those differences. Stone Harbor noted that the custodial monthly return in December 2011 was - 3.36% versus a -1.24% reported by Stone Harbor. For the quarter ended December 2011, State Street was reporting -1.05% versus Stone Harbor's 2.02%. Therefore, State Street's performance was approximately 300 basis points less than that reported by Stone Harbor for the 4th Quarter of 2011; however, State Street's reported performance was approximately 220 basis points greater than that reported by Stone Harbor for the first quarter of 2012. In January of 2012, the custodian reported a return of 10.32% versus 7.56% reported by Stone Harbor, a difference of close to 300 basis points.

Stone Harbor indicated that one of the reasons for the difference in the fourth quarter was a miscellaneous cash adjustment that State Street made in the 4th Quarter of 2011 that reversed in the 1st Quarter of 2012. State Street had not responded back to Ms. McNavish regarding the miscellaneous cash adjustment.

The bottom line was that since inception, the custodial return (which includes one month of JP Morgan reporting) reported for Stone Harbor is 7.61% compared to a return of 7.90% as reported by Stone Harbor. These are in line. Furthermore, Stone Harbor agreed to notify Staff when there was a 25 basis points difference in the monthly performance it calculates compared to that of the custodian, and the source of the difference.

Mr. Handa advised that Tortoise, in 2012, one of the Fund's MLP managers, changed ownership after the Board funded them. They were 50.5% Native-American owned at the time of investment,but recently lowered their minority ownership to 45% Native-American owned. He indicated that the 5% change was the result of an ownership transfer to existing employees which actually helps to better align the firm's interest with investors. the firm was funded in February of 2012 and performance has been impacted due to the challenging investment environment. Due to these changes, Staff was able to negotiate a 25% reduction in management fees, lowering the fees by 25 basis points, to 75 basis points. This fee structure is usually only available for accounts of $100 million or more, but Staff negotiated, and the new lower fee will be retroactive to since inception of funding the manager.

Mr. Woolworth informed about the events that led to a meeting held, Wednesday, June 26, 2012, in New York City, with the Limited Partner investors of Relativity Capital, L.P. and the firm's General Partners to inquire about the manager's underperformance compared to their peers. He advised that during the meeting, an executive session was called with just the Limited Partners, extending the meeting from two to four hours. Staff's concerns were outlined in their memorandum, and the Limited Partners reguested that the General Partners provide a new business plan to address the investor's questions. He advised that another conference call was scheduled in July to discuss the General Partner's response to the Limited Partner investors.

Mr. Walthour and Mr. Woolworth talked about their due diligence efforts related to the background of the key principals, their track records and internal relationships regarding the funds. Mr. Woolworth said that Staff's hope was that the other Limited Partners would continue to listen to the City's concerns and eventually agree on a course of action to improve the performance of the partnership.

Mr. Handa reported that the Independence Fund started investing on May 1, 2012, and the results could be found in the Flash Report. Of the $43.0 million allocated, $30.0 million was currently invested, with $13.0 million in cash set up in a traditional Long-Short strategy. JP Morgan was acting as the Fund's Risk Manager, as was outlined in the guidelines. He reported that the Independence Fund was down last month at, about, -84 basis points.

At 11:35 a.m., Mr. Dubow requested a motion to adjourn the Investment Committee Meeting. Mr. Albert made the motion. Mr. Stagliano seconded. The motion passed.

At 11:35 a.m., Mr. Dubow reconvened the Board of Pensions and Retirement Meeting to affirm the actions taken at the Deferred Compensation Plan Committee

Meeting and the Investment Committee Meeting. Mr. Stagliano made the motion. Mr. Reilly seconded. The motion passed.

At 11:35 a.m., Mr. Dubow announced that the Board would go into Executive Session. At 12:55 p.m., Ms. Weiss said that the Board of Pensions and Retirement was back in session, after discussion of legal issues and litigation matters.

New Business

Mr. Stagliano recalled the issues of the medical panel back to the Board and made a motion that they table the action that was taken regarding the incumbent co-chair Dr. McCoy. Mr. Rice seconded. Ms. Weiss requested a Board vote. Ms. Pankey opposed. The motion passed.

At 12:55 p.m., Ms. Weiss requested a motion to adjourn the Investment Committee Meeting. Mr. Albert made the motion. Ms. O'Leary seconded. The motion passed.

The Investment Committee of the Board of Pensions and Retirement approved the Minutes on ____ .

____
Paula Weiss, Esquire
Alternate Board Chair