Wisconsin Coalition of Annuitants

Minutes of Meeting February 17, 2010

The meeting was held at the Wisconsin Professional Police Association Building, 304 Coyier Lane Madison and was called to order by Chair Jim Palmer at 9:32am.

MEMBERS & ALTERNATES PRESENT: R. Alesch, ACE; V. Cutler, UWMRFA; E. Frank, DNR; B. Frantz, DOT; R. Hoessel, DOT; C. Howard, WEAC-R; D. Klimpel, UWMRA; D. Kratz, CORR; A. Lee, WSAA; J. Maydak, West Allis; J. Miller, DNR; J. Palmer, WPPA; D. Rohweder, ESP, B. Schaefer, SEA; T. Speranza, RPFFW; J. Stoddard, CORR; J. Vreeland, WAUWATOSA; Zwadzich, SWIB.

GUESTS: K. Bozarth, S. Drew, R. Mensink, D. Schmidt, M. Stohr, R. Wojciak.
EXCUSED: J. Elmer, B. Fendel, J. Grosklaus, A. Wallace. \

MINUTES of the January meeting were approved as mailed.

GUESTS: Keith Bozarth, Executive Director, SWIB
Ron Mensink, Managing Director Analytics & Fund Management, SWIB

Mr. Mensink is responsible for the funds management of External Managers, which includes selection and monitoring of external managers.

For 2009 the Core Fund was up 22.2% and the Variable was up 33.7%, both above benchmarks.

The overall returns were a result of the total portfolio exceeding benchmarks. January has made adjustments and on 1/31/10 the Core was -2.1% and the Variable was -3.8%.

Mr. Bozarth and Mr. Mensink's topic was <u>Risk Balancing Initiatives</u> which has been a topic of discussion before the Board for over the past two years. A handout was provided.

BACKGROUND A reconstructed long trend in stock market value begins in 1871and goes to June 2009 showing an annual gain of 6.7% above inflation. However, since 1926 there have been three periods where the equity risk premium (equity risk premium is the value-weighted return on all stocks minus the one-month Treasury bill rate) was flat or negative and we are in one now. The first one was through 1930-40's and lasted 16 years, the second was the 1970-80's and lasted 17 years, and the latest began around 2000 and has lasted 11 years. Over the long term there is a good return with periods where the stock market does not produce positively and with the WRS smoothing over a five year period there are disproportionate impacts on the system. SWIB and most investment fund portfolios have the approximate 60/40 asset allocation and then mix to get the best ratio for return and risk. Fluctuation in the fund value is driven by the equities exposure of 60% and as a result the 60% has a greater impact on the total fund which means the fund is driven by the stock markets. This is the area that SWIB has been addressing with the Board.

CONVENTIONAL ASSET RETURN/RISK High returns means high risk, low returns means low risk. The goal is to find a way to maintain the 7.8% return and have less risk/volatility or reliance on equities and create a more even annual return over time. Cash has a return of 3.5-4% and no risk, bonds have a return of 4.5-5% with risk of 5%, fixed income has a of return of 5%

and a risk of 5%, US equities and emerging markets debt have a return of about 9% and risk of 18% and private equity/venture capital have a return of about 17% with a risk of 35%. To maintain the 7.8% return and have a healthy system SWIB uses the conventional allocation and the best mixture of returns and risk ratios to reach the 7.8% goal. SWIB is now considering making adjustments internally to maintain an acceptable return and risk ratio for a sustained period. For example what if fixed income had return and risk increased and then a better mixture of stock and bonds were created. This concept using leverage creates concerns. Mr. Mensink stated: "What if we were able to find a way to get all the assets to approach the volatility of equities and at the same time amplifying their rates of return?" Then the assets would all have an expected rate of return of about 5%. Using leverage at the lower level volatility (fixed income) the return would approach that of US equities. This also creates another opportunity for asset mixture. Before implementation of leverage the movement of interest rates, movement of inflation and the cost of the leverage payments need to observed and compatible. Answer to a question: Commodities are not being considered.

THREE CONSIDERATIONS FOR 2010

1) Increasing allocation to active risk strategies, this is not leverage. There will be focus on traditional strategies with higher alpha (excess return over benchmarks) sources such as the small cap stocks and others. Tactical multi-asset strategies of about 4% of the fund will be used to enhance excess returns. There also will be a small allocation in hedge funds, if the components come together, to add active returns that are not available with the present structure. Hedge funds are not related to leverage and there is no borrowing in hedge funds. The active risk strategies will prepare the portfolio to perform consistently across market environments.

2) Leveraging fixed income and reducing stocks. Leveraging is not borrowing to boast the entire trust fund to a higher return. Without leverage SWIB could earn the expected 7.8% return on the conventional model. However, with leverage the attempt is to reduce risk and with reduced risk there is also reduced return. If fixed income with low risk were leveraged to increase return with more risk then some equities risk could be removed. It is balancing the risk from equities by replacing it with fixed income at a higher risk and return or diversifying risk away from equities. This portfolio would perform more consistently across different market environments which as we have seen are tough on equities.

3) Increasing allocation to TIPS (Treasury Inflation Protection Securities). With interest and inflation movement there is consideration of increasing exposure to TIPS issued by the US government. As inflation increases TIPS value increases. By leveraging from bonds into TIPS there would be protection from inflation rather than additional interest rate exposure. Leverage would be focused in fixed income and today nominal bonds are the area of emphasis for protection through TIPS.

The Board has endorsed the above three strategies subject to timing and implementation. Implementation plans will be shared and discussed this year.

LEVERAGE Understanding Explicit and Implicit Leverage - An example of explicit leverage is buying a company that costs $200M. You have $100M in assets and you borrow $100M and now have assets of $200M and liabilities of $100M. Implicit leverage is a company costs $200M and you borrow $100M and buy stock and the Company borrows $100M, you now have assets of $100M and $0 Liabilities. In both the cash invested is the same.

Every stock owned is in a company that has debt and there is implicit leverage in ownership of the stock. The implicit leverage on current SWIB assets is 3.9 to1. US equities are the highest at 5.7 to 1. Example: If you buy a house with 20% down and borrow 80% the leverage is 5 to 1. TIPS and fixed income are the lowest at 1.0 to1 (no leverage). The concept is reducing implicit leverage in stocks for some explicit leverage in fixed income which presently has no leverage.

This strategy applied appropriately will reduce the volatility of the trust fund. Leverage is only half of the strategy with reduced stock exposure being the other half. Selling 2% US equities at 17% volatility (17% standard deviation means 2 out of 3 years stocks could move up or down by 17%), buying 6% fixed income at 5% volatility and using 4% leverage (2% selling US equities plus 4% leverage equals buying 6% fixed income) gives a 7.8% fund return. The benefit is a reduced volatility from equity to fixed income of 12.3% to 12.0%.

Leverage example: SWIB could use the futures market to free up cash to purchase the additional 4% fixed income. By selling $100M treasury bonds and purchasing $100M futures treasury bonds at $5M the exposure would still be $100M but in futures and leaving $95M to purchase fixed income or TIPS. There is an implicit loan in the futures agreement but there is no need to take a loan outside the trust fund. SWIB is at the front end for this type of investment in pension funds. It is common in foundations and personal high worth accounts. Some pension funds have hired money managers and done a commingled leverage and paying high management fees which are commonly 2% plus a percentage of profits. SWIB has the expertise and experience in house and can save on management fees.

These strategies are designed to cover all economic environments; the one environment where it would lag would be if equities growth were strong. With fewer equities the returns would not be as much because of less exposure. But in other environments performance would be steady and not as harsh as in past down times.

The maximum amount leveraged when SWIB's proposal is fully implemented by 2012 is 20% or 1.2 to 1. The 2010 proposal is a 1.04 to 1. Last year the leverage of many banks was up to 30 to 1 or higher and with a small movement in asset value it caused them to fail.

The above is SWIB's plan and goal of risk balancing and diversifying risk, not dramatically increasing returns or taking on more risk. SWIB tries to do better in a down market than the market itself and therefore will have asset classes that return negative numbers but over the long term market returns will produce and preserve the fund. Leverage is a tool that will help the fund during down markets especially when equities decline. With the 4% goal for this year it does not fulfill the overall goal but gives SWIB an opportunity to gain internal experience and show results.

GUEST: Dan Schmidt, Senior Analyst, Legislative Council

Mr. Schmidt reviewed the report he completed in December, 2008 Comparative Study of Major Public Employee Retirement Systems. Part 1 - Description of Retirement Systems in Report, the study compares features of the major state, local and public employee retirement systems and includes general and teachers but excludes protective and elected officials. It has been prepared every two years since 1982, except 1998. This report added two systems following a split, Kentucky CERS and Nebraska CEPP, making a total of 87 systems. At least one plan from each state is represented. The study includes over 12M active employees and over 6M retirees. Active employees decreased by 0.5% and retirees increased by 6.3%. Ratio of actives to retirees is down to 2.0. The WRS has 263,186 actives and 144,033 retirees, ratio of 1.83. Part 2 - Normal and Early Retirement Provisions are mainly a combination of years of service and age 55 with some having an "actuarial discount" for early retirement. Seven plans reduced their early retirement provisions. WRS has normal retirement at age 65 and at age 57 with 30 years and age 55 with the "discount". All but four of the systems have defined benefit plans. Part 3 - Contribution Rates and Vesting Requirements have found contributions are increasing for employees with a majority over 5%. Employer contributions have also increased to cover prior pension liabilities. Vesting periods remained the same with most at five years. Several years ago the WRS eliminated the 5 year vesting period because ETF found it was not cost effective. Part 4 - Retirement Benefit Calculations are mainly based on years of service times formula multiplier times average salary. Of the 17 plans not covered by social security the formula multiplier is 2 - 3.3%. With social security the formula multiplier is 1.3 - 2%. The average of the plans with social security is 1.94%. WRS is at 1.6% with Act 11 adding 0.165 for service prior to 1/1/2000. Part 5 - Post Retirement Annuity Increases and Taxes have remained the same. Increases are tied to the CPI, to an automatic increase by legislature or the executive branch. Twenty seven of the plans have state tax exemption and 23 have state income tax. The remainder has no income tax or a portion of the retirement annuity is exempt. We should all be are aware of the WRS annual annuity adjustment procedure. Beginning with 2009 a $5,000 retirement exemption is available with an adjusted gross income of $15,000 individual or $30,000 married. Part 6 - Actuarial and Accounting Information shows earning assumption of 5% to over 8%. A majority, 56 plans, fall in the 7 - 8% range. Funding ratios fell from 2000 to 2008 and if we were to project to 2009 the ratio continued to fall. In 2008 funding of 71 of the 87 systems was at 70% or more with the average at 81%. The WRS funding ratio for 2008 was 99.7%.

The report is available at: http://www.legis.state.wi.us/lc/publications/crs/2008_retirement.pdf

LEGISLATIVE REPORT: Matt Stohr, Director Legislation, Communication, Planning, ETF

SB 390 Deduction of retiree membership dues and mailings to WRS members. Bill is a concern for ETF and the ETF Board by outsiders using ETF mailing lists and also if this would be proper use of ETF resources. Bill is in committee.

SB 320 Closing the variable on Jan.1, 2011 has been moving slow and may not see passage.

SB 439 and AB 648 - Twin bills on Roth IRA to comply with the Federal IRC guidelines. The bill has been amended, approved by Joint Finance and both houses appear to be interested in passage.

There are other bills that will affect health insurance.

Communication: Last week a press release reported the effective rate of Core 4.2% and Variable of 33%. The annuity adjustment will be announced in early March.

The IRS passed a regulation to have retirement ages in public pension systems to be consistent within a given trade or industry. It is unclear what the impact or changes would have on retirement systems. Initially set to be effective in 2011 the date has been moved to 2013. Trust Fund News has additional information:

The study for an actuarial analysis to increase the cap from 65 to 70% for specific protective classifications has been completed. The analysis resulted in a cost of about $44M to the system and an increase in contributions for employers. The disparity in the cap is recognized but is a cost factor.

It is expected that employer contribution rates will have another increase this year.

Mr. Stohr was thanked for including the annual conference in the Trust Fund News.

GUEST: Sandy Drew, Legislative and Beneficiary Liaison, SWIB
Preliminary returns under management as of January 31 were provided. Core and Variable total $71B and total fund is $77.6B. Both funds are negative with core matching benchmark at -2.1% and variable exceeding benchmark at -3.8%. SWIB website has added features and is user friendly.

CORRESPONDENCE: None
The WCOA was saddened by the death of our member Lenny Hand.

GUEST: Richard Wojacik aka Ranger Rick
Rick was contacted by Jim Miller and agreed to share his expertise in developing a website for the WCOA. Rick has developed several websites including one for a DNR retiree organization. We would use a website as an information provider and receiver. We would need to secure a domain name, determine amount of content (pages) we would need from a share hosting site and then provide update maintenance listing for member organization events or info we want everyone to know. If Rick were to develop a site for us the domain name would be $20-30 per year, monthly maintenance $20-30 per month and initial develop of $300-500. If we are interested Rick will provide a proposal.

OLD BUSINESS: Annual Conference, Monday May 10, is taking shape. Registration and handout material will be available at the March meeting.

TREASURER'S REPORT: An income/expense summary was provided. Also provided was information on the closing of the account at M & I and the opening including an EIN at Summit Credit Union. Account balance is $5681.88.

Ed Kehl took care of banking as well as serving as Chair for many years and it has been appreciated. He also assisted in closing the M & I account.
<u>MSC</u> The WCOA provide a $150 honorarium to Ed Kehl.

NEW BUSINESS: None

The SWIB Board will be meeting on Wednesday March 17th and it was agreed that we would move our meeting one week later on the 24th.

NEXT MEETING: *<u>NOTE</u>*: March 24, 2010 9:30 am, (4th Wednesday)WI. Professional Police Association Building.

The meeting adjourned at 11:45am
Respectfully submitted – Dick Kratz