CITY OF PONTIAC, MICHIGAN
POLICE & FIRE RETIREMENT SYSTEM
BOARD OF TRUSTEES
SPECIAL MEETING
MAY 9, 2008

A special meeting of the Board of Trustees was held on Thursday, May 9, 2008 at the Marriott Hotel at Centerpoint Parkway, Pontiac, Michigan. The meeting was called to order at 9:58 a.m.

TRUSTEES PRESENT	**TRUSTEES ABSENT**
Raymond Cochran, Secretary *(arrived at 10:04 a.m.)*	Mayor, Clarence Phillips
Brian Lee	
Thomas Miller, Vice Chair	
Craig Storum, Chairman	

OTHERS PRESENT
Eric S. Smith, Consulting Services Support Corporation
Maryann Foster, Consulting Services Support Corporation
Ellen Zimmermann, Retirement Systems Administrator
Jane Arndt, M-Administrative Assistant

Re: Consulting Services Support Corporation
CSSC Investment Advisory Services, Inc.
Eric Smith, Chairman & CEO
Maryann Foster, Direct Services Coordinator

Mr. Smith said that his firm has introduced a process that takes the manager selection process out of the hands of the investment consultant and the financial services industry transferring it to the fiduciary responsibility of the Board.

He said that he has been an attorney and an ERISA financial planner for twenty-three years. In the past he relied on the traditional financial community and investment consultants to provide information which did not give him or his clients better knowledge of the manager or enough meaningful information. At the end of the process they had to make an uninformed decision from the available choices and determine which manager best would return the best performance.

He said he recently presented their process to the New York City Pension System which has $120 billion in assets under management, as well as, the Pompano Beach Police and Fire Pension System which is similar in size to the City of Pontiac Police and Fire Retirement System.

He reviewed the New York City Pension System's investment portfolio and stated that Callan Associates is their investment advisor. Their current asset allocation has 73% allocated to equities with 61% of that in domestic equities equivalent to $53 billion. The Board of Education has $3 billion allocated to domestic equities which represents 48% of their asset allocation. He said that the active mid cap and small cap managers have returned 3.2% of underperformance for the past three years and 3.9% of underperformance for the past five years.

It is hard to makeup for these types of performance gaps. He said that you cannot rely on the actuarial assumption to accurately portray performance returns. The cure is better than benchmark performance.

Being advised by a professional consultant has not ensured superior or even good returns and replacing investment advisors or consultants seldom produces better returns because the process remains unchanged. He used an example of a Taft Hartley Plan that has been managed by Morgan Stanley for twenty years and has consistently underperformed stating that many plans develop long-term relationships with their consultants and find it difficult to terminate those relationships.

He reviewed a chart of the traditional investment process. It begins with the formulation of investment policies and defining the asset allocation which are not the problem areas. The last piece of the investment process being the manager/investment selection is where the fiduciaries have no real control.

He said that the problem is that there is no meaningful description of the investment consultant's due diligence process. After the consultant completes their due diligence they bring a limited number of choices to the Board. The Board does not see the due diligence process and as fiduciaries they are in the dark and are expected to pick from the managers presented.

He referred to an article from the New York Times dated March 21, 2004 that speaks to the manager selection due diligence process. It stated that state and local pension funds are being steered into high-risk investments by pension consultants who often have business dealings with the money managers they recommend.

He also referred to an article regarding how federal examiners were looking into conflicts of interest with many pension fund consultants. The SEC conducted a sweep of twenty-four pension fund consulting firms resulting in a large number being referred to the SEC's enforcement division for investigation and possible legal action due to violations and compensation from money managers.

The GAO (Government Accountability Office) Report said that undisclosed conflicts could be lowering pension fund investment returns. The report examined twenty-four consultants with thirteen failing to disclose significant conflicts of interests. These consultants produced returns 1.3% lower than the plans with the eleven consultants who disclosed their conflicts.

The report divided the consultants into two groups with Group A including the consultants who did not disclose conflicts and Group B which included those who disclosed conflicts. The consultants in Group A managed 983 plans with average computed returns of 3.2% while the consultants in Group B managed 39 plans with average computed returns of 4.5%.

He stated that another conflict is that many investment consulting firms are responsible for manager selection for conferences and organizing conference agendas. You will find sessions at these conferences for asset allocation but not for manager selection.

Recently, investment consultants have began to recommend unregulated investments to pension funds like private equity and alternative investments whose performance cannot be tracked. These types of investments have the potential to provide higher returns but carry more risk than traditional stocks and bonds.

He said that the investment manager size, experience, years in business and assets under management is not a guarantee of manager performance.

Their method uses a fundamentally different process unlike the traditional investment industry or advisory firms. The patent is pending on their method which was developed to remedy the fundamental flaws in the standard manager selection process. They utilize unique formulations.

They have universal market access to all available money managers. Their process makes it possible to evaluate the 5,000 to 6,000 managers that would be impossible for most consultants who reduce the number to a more manageable size. On the surface it sounds reasonable.

Investment advisors would then conduct their due diligence to reduce the number further and would then perform their quantitative analysis. He said that their process runs a quantitative analysis on the entire manager universe and from those they feel are quantified they run due diligence combined with no compromising relationships to corrupt the process.

He said there is an exception to the rule when they do take money from a manager. However, they would disclose this to the client and it would be credited to the client's fee pricing structure. He said it is in the marketing pricing structure.

There are times when they would recommend a mutual fund to a large plan. He discussed the share classes and how they determine whether to invest in institutional shares versus retail shares. Institutional shares are a class of mutual fund shares that are available for sale to investing institutions on a load or no-load basis. With a minimum investment of $1 million these funds will typically waive any fees.

There are 23,000 mutual funds and a plethora of money managers.

They use Decision Assistance Technology. With this technology they can attain and position available choices that best fit the fiduciary needs of the client. They can compare performance of active managers using weighted schemes as proof of performance parameters. This technology will display managers that are maximizing their returns with no real risk premium.

They take the composite score of the manager and plot it against a numerical distribution curve. He described the slope of mediocrity, the slope of exceptional returns and the crossover point. He said their process is as transparent as it gets. It filters out the gunk that deters portfolio performance.

There was discussion detailing the chart relating to due diligence, accuracy of the numbers, and indicators whether the manger will continue to produce these numbers or performance.

He discussed whether index funds are the answer. Index funds typically outperform ordinary and average managers. He said that they use an artificially constrained universe to select managers. They also use a flawed or compromised selection process. There is no way to track performance because index funds are measured against themselves.

By investing in index funds, you have no way of knowing what type of performance you could be getting.

<u>Challenging the Process</u>
He said that their process utilizes historical data with past performance not being an indicator of future performance. In hindsight they cannot guarantee current high performance scores will outperform the current ones. However, past performance does suggest some degree of positive correlation between past and future performance.

With this process you would be getting the same analysis from scratch every quarter. It would check the manager’s correlation and look for any positional drift or any weakness in performance. It is equivalent to having a new manager search each quarter.

He said that investors have no method to verify the information they receive from an investment manager. They rely on their investment consultant.

<u>Performance Monitoring</u>
Chairman Storum said that the problem is not how the current managers are performing. The problem is how the fund’s current managers are performing relative to every other manager they could have chosen.

Mr. Smith said that the manager replacement criteria in the Investment Policy Statement is based on beating the benchmark which is no measure of volatility or whether the manager is ranked in the top 50th percentile of managers. This is one of the least understood conflicts of interest within the IPS where the bar is set too low.

Momentum factors into performance being strong and consistent. This data allows for an actionable decision making a cash call from manager on watch putting the money into a consistent performing manager.

Traditionally funds trade out one or two managers per year. This also helps to cure another fundamental flaw which is the tendency to hold a manager too long.

This process reviews all manager performance in summary against the asset class. It blends three and five year performance returns and volatility into one chart. The Board could use this chart to evaluate performance relative to all other managers which in turn defends the Board's manager decision.

Trustee Miller said he is concerned that by having this information someone could constantly challenge the Board's manager selection decisions.

Mr. Smith asked how this is different than relying on the recommendation of your investment consultant. You would have more knowledge and information to defend you decision.

Trustee Miller said there are those who could question how much the Board has cost the system choosing a specific manager. Mr. Smith stated that the fund could be missing performance by keeping under performing managers. Performance relative to all other mangers could have been used. How much does this cost?

He asked if the Board is meeting the actuarial targets plus costs. Their goal is to optimize the manager selection to minimize under performance. Their process would be a change in methodology, not an all or nothing proposal. The Board could carve out a portion of the portfolio to run the process against and see what happens.

He described the pricing mechanisms. There is fixed percentage pricing and performance based pricing. Fixed percentage pricing is 2.25% to 2.5%

There is a $25,000.00 one-time setup fee.

Actual Size (Millions)	**Participation Ratio**
$10 to $24.9	25%
$25 to $49.9	20%
$50 to $99.9	15%
$100 to $249.9	12.5%
$250 to $999.9	10%
$1 billion +	Negotiable

Average over performance is 300 basis points to 400 basis points. They allow Boards to elect the pricing structure annually.

They could work for a whole year and not get paid if they do not outperform the blended benchmark indices. There is a $10 million minimum investment of assets.

He discussed cost adjusted performance. He said that manager performance would be reported on a cost composite basis. The largest out-of-pocket costs are the performance gaps you miss.

This process is prudent and produces greater defendability and improved investment performance. By changing your process you can change the results.

Chairman Storum confirmed that this process evaluates the managers quarter by quarter to make sure they are hitting the benchmark and allows the Board to perform due diligence on the manager each quarter.

Mr. Smith said that the Board could adopt a protocol that if the manager drops three straight quarters or are under the 85^{th} percentile they are put on watch. These triggers could be incorporated into the IPS.

He said that they would also look to compare managers to mutual funds. They are more liquid, government controlled but charge higher fees.

Ms. Zimmermann asked if the total universe includes mutual funds and whether they are GIPS reporting compliant. Mr. Smith confirmed that mutual funds are included and that filters could be set to screen for compliant managers.

Chairman Storum asked about the City of Jacksonville's performance since changing to the new investment consulting model. Mr. Smith said that it is not applicable at this time since they have not been using the process for an adequate amount of time. He did say that they outperformed the index by 145 basis points during the fourth quarter of 2007.

Trustee Miller asked how many funds they currently manage. Mr. Smith said that the model was pioneered by a wealthy individual. They currently have 750 clients and out of those 34 are institutional clients. He said that the New York City pension fund is the third largest fund in the country.

Trustee Miller asked what the length of the contract would be if the Board carved out a portion of the portfolio for CSSC to manage. Mr. Smith said that if the Board chose the performance based pricing structure they would manage it for one year. They could consolidate the public information piece of their model with Gray & Company but there is a piece that is a trade secret that has to be protected under the open record law.

He described how the City of Ann Arbor Employees Retirement System has a $500 million pension fund and was looking for a manager for their $30 million VEBA fund. He said that Gray & Company brought four managers to the Board for consideration. All of the four managers brought for consideration scored below the manager that was currently managing this asset class in their retirement system.

Trustee Lee asked how many employees are in the company. Mr. Smith said that the company was founded on January 2, 1998 and they have thirty employees.

He said that the next logical step would be for him to ask for the IPS and the latest quarterly performance review for analysis without a commitment.

Trustee Miller said that he looks at this model as an early warning system.

RESOLUTION 08-035 By Miller, Supported by Lee
Resolved, That the Board authorize to send information to Consulting Services Support Corporation for analysis.

Yeas: 4 – Nays: 0

RESOLUTION 08-036 By Lee, Supported by Cochran
Resolved, That the meeting was adjourned at 12:05 p.m.

Yeas: 4 – Nays: 0