

CITY EMPLOYEES RETIREMENT FUND BOARD

MINUTES

DRAFT

February 19, 2009

PLACE: City Hall
200 Orange Street
Dept. of Finance Conference Room
New Haven, Connecticut 06510

PRESENT: Jerry Sagnella, Chairman
Thomas Cama
John Varrone, Members' Representative
Mark Pietrosimone, Secretary
Anthony Acri

ABSENT: Mayor John DeStefano, Jr.
David Slifka

ALSO PRESENT: Joann Giri, Benefits Auditor
Tim Ryor, Hooker and Holcombe
Art Assantes, Hooker and Holcombe
Derek Ciampini, Merrill Lynch
John Beirne, Merrill Lynch
Chris Coppola, Merrill Lynch
Wendy Coppola, Merrill Lynch
Patricia Solomon, Local 3144 Rep.
Harland Abraham, Northern Trust
Walter Weisenburger, Northern Trust
Chris Doell, Northern Trust
Neill Groom, Neuberger Berman
Charlie Diccianni, Neuberger Berman

Mr. Sagnella convened the meeting at 10:03 a.m.

1. APPROVAL OF MINUTES

Mr. Varrone moved the approval of the minutes from the meeting of January 15, 2009;
Mr. Cama seconded, and the vote was unanimous.

2. NEW PARTICIPANTS - INFORMATION ONLY

The Board reviewed the information under Item 2.

3. DEATH AFTER RETIREMENT – INFORMATION ONLY

- a) Catania, Michael
- b) Langella, Anna

4. WITHDRAWAL – INFORMATION ONLY

The Board reviewed the information under Item 4.

5. AGE RETIREMENTS – INFORMATION ONLY

Mr. Sagnella stated one of the retirements is a product of an agreement negotiated between Labor Relations and the union providing an enhanced retirement.

The Board reviewed the information under Item 5.

6. PAYMENT OF BILLS

Mr. Cama made a motion to approve payment of the bills in Item 6; Mr. Varrone seconded and the vote was unanimous.

7. ADMINISTRATIVE MATTERS

- a) CERF – Union Trustees Election Results

Mr. Sagnella stated the results have been received regarding the union trustees election and were mailed to the trustees. Mr. Sagnella and Mr. Varrone were re-elected.

- b) Northern Trust Presentation – Securities Lending Agreements

Mr. Abraham has been the relationship manager for City of New Haven since 2002. He stated Northern Trust is the Fund's global custodian; they are doing accounting, safekeeping some of trades associated with your managers and also work with Jerry's office on monthly benefit payments for both CERF and P&F. Walter Weisenburger is senior vice president and is the public funds division manager in Chicago; also Chris Doell is senior vice president and the head of securities lending on the client service end.

Mr. Weisenburger thanked the board for the opportunity to speak with them. He stated they have had an exceptional financial year under extraordinary times. Over the course of the last year Northern Trust had a net income of \$640 million which was down about 20%. In the 3rd quarter they had their first loss in better than 5 years; it is a direct result of some of the things they did to support their clients during these turbulent times. For example they contributed \$160 million of their capital for their clients that are in securities lending. In addition they changed the securities lending split so that all of their clients get a 20% increase in the revenue that they will earn through September 2009. They put almost \$500 million to support their money market funds. They have been able

to do this is because we are a strong financial position and have a very strong liquid balance sheet. Unlike some of their competitors 90% of the assets they hold AAA rated, which reflects their conservative nature. They are one of the few financial services firms that enjoy such a high rating. They believe they are well positioned to help their clients as they go through this process but it is going to take time.

Mr. Doell stated he is part of the client relations team for securities lending.

As a review, Mr. Doell stated securities lending is a very common investment practice. They are holding assets in custody for clients like CERF. There is a demand in the marketplace to borrow those securities for short term purposes; on the lending side are all the institutions that are long term institutional investment programs that have significant pools of assets. They engage in securities lending to earn an incremental return on those assets that are otherwise sitting in a custody account in a risk control framework. The idea of this is to earn a little over a period of time on a fairly regular basis and avoid any serious losses from realizing the sale of securities at a declining price.

The largest providers in this business tend to be the major custodians like Northern Trust, State Street, and Bank of New York. Northern Trust has about 660 plans that are participating in their securities lending program that amounts to about \$.5 trillion in assets that are eligible to be lent out at any time; currently they have about \$110 billion of those assets out on loan to different borrowers.

Northern Trust serves as the middleman to facilitate the transfer of assets to those borrowers for short term purposes. They step in as lending agent, initiate a loan with the borrower and negotiate terms such as what securities they want to borrow and what sort of collateral they are going to give in return; usually it is cash collateral. They transfer the security to them temporarily and the cash goes into a collateral pool of assets with other lenders' assets. The idea is to manage that pool of assets and generate a yield that can, at the end of the loan, be shared with the client; Northern Trust takes a cut of that yield as their fee. If you send the borrower \$100 worth of AT&T common stock you get \$102 worth of cash in return and every day that is market to market. That is a way to mitigate the risk that borrower could default on the loan. At the end of the loan term they return the security to Northern Trust, it goes back in the custody account and they return the cash collateral (with interest) and that is the income that has been generated.

They have to generate a decent yield on that cash collateral because they owe it back to the borrower at the end of the term along with a rebate rate. They take some risk generating yield that satisfies an amount high enough to repay that rebate rate and have something for their clients. These are small incremental earnings so you have to have volume to make it worthwhile.

Mr. Ciampini asked if they peg to the libor. Mr. Doell stated it is typically pegged to the federal funds rate minus some variable. Mr. Cama asked who determines the interest rate. They are the lending agent so they have to negotiate a favorable rebate rate with that borrower. The more business they do with them the more leverage they have to negotiate good terms with our clients. He asked what is the percentage split for the interest earned? Northern Trust takes 40% as their lending agency fee and 60% goes to CERF. Currently they are operating at a 68-32 split through September 2009.

This has been an attractive business in terms of the amount of earnings available; what is unattractive is what happens to the assets when we take in that cash collateral and the assets that are being purchased with that cash collateral are suffering from a great deal of illiquidity.

You have had some significant earnings from this activity but there is always risk. They have been scaling back the amount of risk they have been taking in the cash collateral since August 2007. We have not purchased any longer dated asset backed securities to preserve liquidity. There have always been four risks with this business: Borrower risk, Collateral Investment Risk, Interest Rate Risk and Trade Settlement Risk. Collateral Investment risk is currently the biggest risk. Each of their clients sign an agreement to invest under certain guidelines.

They have the ability to be selective about initiating new loans. Mr. Weisenburger stated they do believe in the long term viability of securities lending.

Mr. Doell stated in September 2009 the securities lending collateral committee declared a collateral deficiency. They are still able to accommodate normal course activity like managers trading, allocation rebalancing. But if a client needs to exit they are going to have a payable posted to their account representing the difference in the market to book ratio of the collateral pool. Instead of returning cash the client would have to take assets out of the pool in kind. This has been a very unpopular decision but it was done to allow the equitable treatment of clients.

Mr. Ciampini asked if there was any talk of implementing a higher demand on cash collateral postage for new loans. Mr. Doell stated they do occasionally; they did that with Lehmann and they have some excess cash from the Lehmann trade. They do that in circumstances where they are concerned about the health of the bond. Mr. Doell stated all the investment activity that took place in this pool is easily within the guidelines. Mr. Ciampini asked if they have had a lot of requests to terminate agreements. Mr. Doell stated there is interest in lowering or controlling the amount of securities lending exposure. He stated the amount of lending activity for the plan was \$25 million back in September. Currently the value of assets on loan is about \$13 million. A big chunk of that is because of the market and also because the demand has fallen from the borrowers. They also have been more selective their loans.

Mr. Ciampini asked how much of the \$160 million contributed by Northern Trust was dedicated to CERF's collateral pool. Mr. Doell stated about \$5 million.

Attorney Carolyn Kone asked how CERF got into this particular collateral pool. Mr. Doell stated CERF chose this collateral pool when they subscribed to securities lending.

Mr. Acri stated Northern Trust addressed the current situation by putting \$160 million in and by changing the split from 60/40 to 68/32. Going forward, what is the strategy? Mr. Doell responded back in August 2007, their portfolio managers began to horde liquidity. When something matures they are buying treasuries and agencies and overnight repurchase agreement instruments. Overtime more of those illiquid assets mature and they are off the books and the health of the program will continue to improve. Soon they

may formally and permanently change the investment guidelines to make their collateral pools more conservative.

Attorney Kone asked them to describe the 12 week program to exit securities lending. Mr. Doell stated they introduced a staged withdrawal concept for their clients from October - December. This allowed clients to opt into a program where they committed to reducing their lending volume by 35-60%. They put caps on their lending activity and gently reduced those caps. About 20-25% of their clients opted into that arrangement. The vast majority continues to lend, and some have put some caps on their lending activity. The cap can be set at the higher of the 9/18/08 level or today's level.

Mr. Coppola asked how long has securities lending been around and how long has Northern Trust been involved with it; also, what percentage of Northern Trust's revenue is due to securities lending. Mr. Doell stated securities lending became an industry about 30 years ago and Northern Trust has been lending securities for about 30 years. Looking at their institutional business it amounts to about 5-10% of their revenue stream.

Mr. Sagnella stated securities lending is not an unusual practice for clients. The City entered into it so the earnings could help cover the cost of custody fees. It was functioning well until now.

Northern Trust left at 11:15 a.m.

8. INVESTMENT REVIEW

a) Neuberger Berman – Review

Charlie Dicciani and Neill Groom entered the meeting 11:20. Henry Ramallo was participating by telephone.

Mr. Ciampini asked why they moved away from healthcare. Mr. Ramallos stated losses due to generics replacing name brands. They do have CVS which has national distribution but they stay away from pill manufacturers. Mr. Ciampini asked when they expect to see signs of inflation. Mr. Ramallo stated you may see 3% inflation rate in the fourth quarter. He does not see an impact on the consumer this year.

Mr. Ciampini asked where was the protection for this downside. Mr. Ramallo stated their guidelines do not allow more than 10% position in cash. Until June of last year they were outperforming the market. They stayed fully invested and this philosophy worked up until last year. They probably would have raised 20% cash if they could have. Mr. Ciampini asked what they are doing this year to make some money for the trustees. Mr. Ramallo stated they are relying on the consumer to do more with less people. They aim to be more conservatively invested and focus on their stocks and hope that they can limit the downside.

Ms. Solomine noted that Mr. Ramallo stated they were only allowed to be 10% invested in cash; did he reach out to Merrill Lynch to ask to loosen this restriction? Mr. Ciampini

stated they are equity managers and are paid to be fully invested. He added they moved \$10 million into fixed to reduce energy and equity exposure.

Mr. Groom stated the big bets in the portfolio are consumer staples and healthcare. Both traditionally held up very well in difficult market environments. They were overweighted in energy until July of this year. Currently they prefer to remain defensive. They would rather than play catch up than try to predict the market. Mr. Diccianni stated as of last night the Large Cap Growth account is down 6.4%, the Russell 1000 growth is down 6% and the and the S&P 500 is down 12.4%. The Large Cap Value account down 15.4%, the Russell 1000 Value is down 17.9% and the S&P 500 is down 12.3%.

Mr. Groom and Mr. Diccianni left the meeting at 11:45 a.m.

b) Discussion of Possible Litigation (Executive Session)

Mr. Cama made a motion to go into executive session to discuss pending litigation at 11:47; Mr. Varrone seconded and the vote was unanimous. Mr. Sagnella asked Derek Ciampini, John Beirne, Chris Coppola, Wendy Coppola, Tim Ryor and Art Assantes to remain.

Mr. Pietrosimone made a motion to come out of executive session at 12:22; Mr. Varrone seconded, and the vote was unanimous. Mr. Pietrosimone made a motion to authorize Attorney Kone to draft the demand letter discussed in executive session; Mr. Varrone seconded, and the vote was unanimous.

Mr. Ciampini stated they had a meeting yesterday and interviewed three high yield fixed income managers. They are considering an allocation of 10% of the fund which is about \$14-15 million. They may have to revise the guidelines. Mr. Sagnella thought Penn Capital was a good candidate. Ideally we want a higher rate of return for less risk. Penn Capital Defensive did a tremendous job according to their graph; Penn Capital Opportunity is taking on more risk and the reward is not substantial. Beachpoint is an alternative asset manager; they did not interview yesterday. They can do a lot of different strategies in the alternative space that you cannot do with a traditional manager. May want to bring them in at a future date; the good point is they only have a \$2 million minimum. We look at the bulk of the money earmarked for a manager and then consider satellites. The two best candidates were Penn Capital Defensive High Yield and EDGE which is only available in the form of a mutual fund. Lord Abbot Institutional High Yield has a \$15 million minimum for a separate account but they do offer a mutual fund; Penn Capital will do a separate account for \$10 million. They have talked about going as low as \$5 million.

Mr. Acri made a motion to approve Penn Capital Defensive High Yield for \$10 million; Mr. Pietrosimone seconded, and the vote was unanimous.

Mr. Ciampini stated the fund was down 3.6% for the month of January versus the index down 4.4%. Aletheia Large Cap Value was down 7.5% versus the index down 11.5%; Neuberger Berman Large Cap Value was down 10.9% versus the index down 11.5%. Aletheia Large Cap Growth was down 5.5% versus -4.8 for the index; Neuberger Berman

Large Cap Growth was down 4.9% versus the index down 4.8%; S&P was down 8.4%; Munder Capital was down 5% versus the index down 4.5%; NCM Capital was down 5.8% versus -7.4% for the index; Paradigm was down 9.% versus the index down 11.1%; SPDR Metals & Mining was down 5.4% versus the index down 7.8%; Powershares Agriculture was down 3.6% versus the index down 3.7%; SPDR Energy was down 2.2% versus the index down 2.2%; Artio Global Investors was down 11.4% versus the index down 8.8%; Wentworth, Hauser & Violich was down 3.2% versus the index down 8.8%; Pimco Funds was .6% versus the index down .9%; TIPs up 1.9% versus the index up 1.7%; Israel Bonds up 4.2%; our money market which is flat. Down 3.6% for the month

Mr. Ciampini stated to fund this manager we are taking this out of the equity portion of the portfolio so we are going to treat it like an equity-like investment; get equity return with bond like risk.

Mr. Pietrosimone stated we have \$13 million in the Northern Trust securities lending and would probably have the same performance wherever it is; what is the difference if Northern Trust is holding it or it is with one of the managers losing value. On the other hand, if another manager could provide earnings on this money the investments in Northern Trust will eventually turn around and provide a return.

The meeting adjourned at 12:35 a.m. on a motion by Mr. Pietrosimone and seconded by Mr. Varrone and the vote was unanimous.

The next meeting is scheduled for Thursday, March 19, 2009 at 10:00 a.m.

ATTEST:

Secretary