MAPERS

Pension Scope

Winter 2015

A Newsletter by the Michigan Association of Public Employee Retirement Systems

President's Report

By James Haddad

I hope you are all surviving this long, cold, snowy Winter, think Spring, it's almost here! I often struggle thinking of what would be an important topic to cover in my Pension Scope articles. This spring article is a little different; I did not have to think too hard to select a topic. It has to do with a "grandfather" of MAPERS who will be missed but never forgotten.

When I was a young fireman, a senior officer announced at one of our union meetings that he would be retiring. He was the fire union's "Pension rep". At the time, I really did not know what that position was and, believe it or not, I did not even know (or care) that I was getting a pension! I was hooked on the adrenalin rush of running into burning buildings. With all that said, the union asked if anyone would be interested in replacing the retiring fireman as "Pension rep". Most of my family and friends think I have a "problem" with volunteering, although I don't see it myself. You won't be surprised then that I guess I must have raised my hand, and in a split second a wood gavel came down on the table and the president said "SOLD!"-- I thought I was at an auction. Looking around the room, everyone was chuckling as though I just bought a lemon of a car. What did I get myself into now? The retiring pension rep congratulated me on a Thursday night and told me that next weekend was an educational conference up north at a place called Grand Traverse, the group's name was MAPERS and I needed to attend and my wife was welcome. So I talked my wife into going, although both of us still had no idea what we were in for. On the first day of the conference, we were invited to an event that was called the

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Vice President's Report

By Michael Grodi

Let me start by saying that I am honored to serve as MAPERS Vice President for 2015. I look forward to helping with challenges that lie ahead for our organization. I would also like to take this opportunity to let all of you know a little bit about myself.

I began my career at the Monroe County Sheriff's Office on June 16, 1998. I graduated from the Washtenaw County Corrections Academy in 2000. I have held several positions throughout the Correctional Division during my tenure. In 2007 I was appointed as the Correctional Training Coordinator, a position which I still currently hold. In that same year I was appointed to the Michigan Sheriffs Coordinating and Training Council (MSCTC), and its' Advisory Board, which sets the training and education standards for over 4,700 local correctional officers in the State of Michigan. I am currently the Chairman of the Advisory Board, and Vice-Chairman of the MSCTC. I am a Certified Correctional Officer through the American Jail Association. I was also

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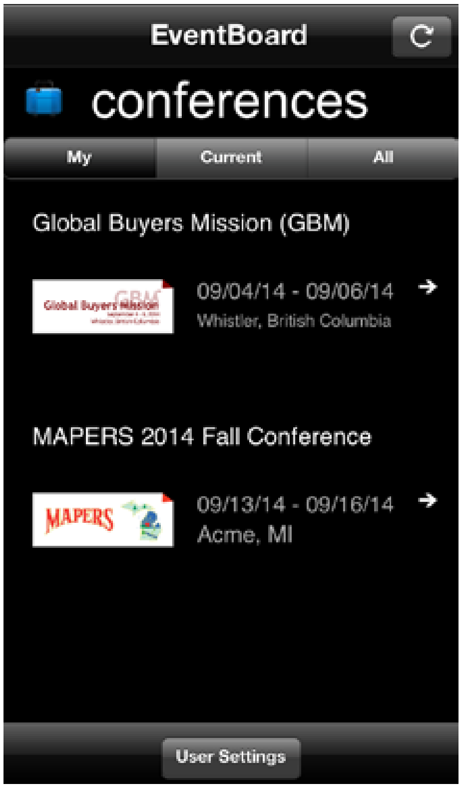
Secretary/Treasurer's Report - The App Made This a Snap!

By Lauri Siskind, MAPERS Secretary/Treasurer

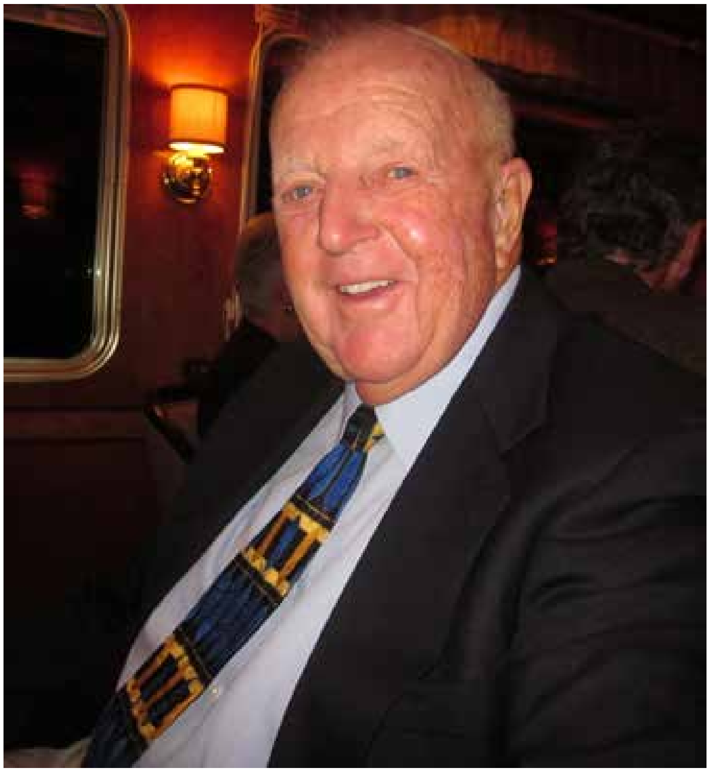
I've been reading and re-reading the evaluation results from the Fall 2014 MAPERS conference, trying as I usually do to detect a theme, general complaint, or definable issue to address in this column. I typically try to research the "why and wherefore" of the matter that caused such widespread duress or displeasure, and assure the MAPERS membership that we have successfully ferreted out the offensive (fill in the blank….."cold food", "hot rooms", "inefficient registration", "boring speaker", "lack of appreciation for non-coffee drinkers", you get the drift), and have taken steps to prevent these concerns in the future.

However, the Fall 2014 Conference Evaluations were OVERWHELMINGLY positive. For every "food not so great" that we received were ten "best conference EVER" replies. The Overall Comments produced repeated comments of "Excellent" , "Awesome", and "Great!" The individual speakers (for the most part) received high marks for presentation and relevance. And as one of the members of the committee that sets the Conference Agenda, I was delighted to read numerous comments that the sessions were important, provocative, useful, and informative.

One series of comments, however, did appear and deserves some discussion. Several members commented that they were new/newer Trustees, and appreciated the several sessions that were specifically geared to the presentation of basic pension-related topics. There were also several comments in other sessions that the material was "too advanced", "high level", "too fast for me", etc. When the Agenda is put together, the committee is careful to mix in both "basic" and "advanced" topics throughout the conference, to address the full spectrum of our members' educational needs. In the session description, we will identify sessions that are basic or beneficial to new Trustees. Feel free, however, to attend any session you wish—basic or advanced—as repeated exposure to lectures on GASB requirements, UAAL, and the Yield Curve will gradually increase your knowledge and comfort level with a variety of topics. And won't you just be the talk of the next cocktail party when you can confidently expound on the economic benchmarks that show recent Michigan outperformance (thank you, Mr. Sowerby)? I want to again mention the success of the Event Board smartphone app for evaluating the MAPERS sessions. I hope more and more of you take the time to use this technology to report your assessment of each session and the overall conference performance. The numbers using the app at the FALL Conference were fairly small compared to the previous paper evaluations, but the ability to collect and analyze your responses was noticeably enhanced. Please remember to use the app—it's really "a snap"!! We will again hold mini "training sessions" for app use at the next several conferences, and we will continue to have paper forms available if needed. You can also pull up the speaker bios and presentation materials on the app for quick reference. To save valuable resources of money and time, we will be moving away from providing printed presentation books to all system members. You will be able to print out your session materials before or after the conference, or view on-line from the app or the MAPERS website. Just think of all the pension knowledge you will now be able to have (literally) in your back pocket!



See you in the SPRING!



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Friendship Hour. The retiring rep and his wife were saying good byes to other trustees for his impending retirement and introduced us to other trustees and what they called "corporates" or money managers. As you can imagine, it was pretty overwhelming.

I know that was a long intro, but what this article is really about is a beautiful person and his wife who dropped into my life that night. At Friendship Hour, we were introduced to a couple by the name of Don and Julie Moll. The minute we shook hands, I was put at ease and he immediately erased my fear of a large room filled with people I did not know. When I said this article was about a "grandfather", that's the way I felt about Don; it felt as if he was the grandfather of this group called MAPERS. He knew everyone in the room and everyone made a point to say hi to Don. He always remembered everyone's name and a little bit about their lives to weave into the conversation. He gave the impression that he had known each one of us forever. Don was a snappy dresser, quick with a joke and always had a big smile. I think Don made it his mission to make all the new trustees feel welcomed. I could tell that Don loved people, and he and his wife Julie loved this organization. I'll never forget Don and Julie riding around the golf course offering the golfers a cup of coffee and a brown bag with a little something "extra" in it to warm you up. I also remember that Don always went to church when he was at the conference, and I would ask in passing "Don, you and Julie going to church?" and he'd always give the quick comeback with something like "You bet, Julie really needs a lots of praying living with me".

People come and go in an organization, and most of the time they make small footprints. Don was a big man and he left big footprints on this organization. Don and Julie, you will be missed but never forgotten.

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appointed to the Deputy Sheriffs Association of Michigan in 2006. I have been the President of the Monroe County Corrections Officers Association since 2000. In 2011, I was elected as a Trustee to the Monroe County Employees Retirement System, and in January 2013 was elected Chairman. Additionally, in 2011 I was elected to the Michigan Association of Public Employees Retirement Systems (MAPERS) as a board member. This past Fall I was elected by the MAPERS Board of Directors to serve as Vice President for 2015. In this roll I am responsible for activities related to the MAPERS PAC, monitoring legislation as it relates to Michigan's Public Pensions, including testifying in Lansing on behalf of our members, and I oversee our biannual newsletter, PensionScope.

I am active in my home community of Erie Township serving as an elected Trustee since 2006, and I also serve on the South County Water Board and Erie Township Planning Commission. I have been married to my fantastic wife Jodi for over 16 years and together they have three children, Michael (15), Chloe (11), and Rylee (8).

Many challenges lie ahead for our organization and the general state of public employee pension systems throughout Michigan and the country. I will do my best to represent the concerns and mission of MAPERS at every level, and look forward to working closely with both our system and corporate members.

Legislative Update

By Noah Smith Capitol Services, Inc.

The End of Session

The legislature's first official day of session was January 14, 2015, but that is largely a ceremonial day whereby new lawmakers are sworn-in. The first real day of session wasvJanuary 20, 2015, which is also the Governor's State of the State Address.

Election and Legislative Leadership Update

The 98th Legislature:
Senate Majority Leader: Arlan Meekhof
(R – West Olive)
Senate Majority Floor Leader: Mike Kowall
(R – White Lake Twp)
Senate Appropriations Chair: Dave Hildenbrand (R – Lowell)
Senate Minority Leader: Jim Ananich (D – Flint)
Senate Minority Floor Leader: Morris Hood III
(D – Detroit)

Speaker of the House: Kevin Cotter
(R – Mt Pleasant)
Speaker Pro Tem: Tom Leonard (R – DeWitt)
Majority Floor Leader: Aric Nesbitt (R – Lawton)
Appropriations Chair: Al Pscholka (R – Stevensville)
House Minority Leader: Tim Greimel
(D – Auburn Hills)
Minority Floor Leader: Sam Singh (D – East Lansing)

Committees and Committee Chairs are in place now as well, as business has started since mid-January. Below are a few of the committees common to MAPERS activity (note: the Detroit Reinvention committee from last session, built to deal with the Detroit bankruptcy "grand bargain" no longer exists):

Senate Local Government:
Senator Dale Zorn, Chair (R – Monroe)
Senator John Proos, Vice Chair (R – St. Joseph)
Senator Coleman Young, III, Minority Vice Chair
(D – Detroit)
Senator Jack Brandenburg (R – Harrison Twp)
Senator Tory Rocca (R – Sterling Heights)

Michigan Competitiveness:
Senator Mike Shirkey (R – Clark Lake), Chair
Senator Jim Stamas (R – Midland) Vice Chair
Senator David Robertson (R – Grand Blanc)
Senator John Proos (R – St Joseph)
Senator Rebekah Warren (D – Ann Arbor)
Minority Vice Chair

Elections and Government Reform:
Senator David Robertson (R – Grand Blanc), Chair
Senator Patrick Colbeck (R – Canton), Vice Chair
Senator Judy K Emmons (R – Sheridan)
Senator Mike Shirkey (R – Clark Lake)
Senator Morris W Hood III (D – Detroit),
Minority Vice Chair

House Financial Liability Reform:
Representative Pat Somerville (R – New Boston), Chair
Representative Eric Leutheuser (R – Hillsdale),
Vice Chair
Representative Robert Wittenberg (D – Oak Park), Minority Vice Chair
Representative Jeff Farrington (R – Utica)
Representative Andrea LaFontaine (R – Richmond)
Representative Lisa Lyons (R – Alto)

House Local Government:
Representative Lee Chatfield (R – Levering), Chair
Representative Amanda Price (R – Holland),
Vice-Chair
Representative Kurt Heise (R – Plymouth)
Representative David Maturen (R – Portage)
Representative Jim Runestad (R – White Lake)
Representative Jason Sheppard (R – Temperance)
Representative Lana Theis (R – Brighton)
Representative Jeremy Moss (D – Southfield),
Minority Vice-Chair
Representative Charles Brunner (D – Bay City)
Representative David Rutledge (D – Ypsilanti)
Representative Sheldon Neeley (D – Flint)

House Commerce and Trade:
Representative Joe Graves (R – Linden), Chair
Representative Jason Sheppard (R – Temperance), Vice Chair
Representative Tom Barrett (R – Potterville)
Representative Mike Callton (R – Nashville)
Representative Daniela Garcia (R – Holland)
Representative Andy Schor (D – Lansing),
Minority Vice Chair

This is not to say that bills won't go to other committees like Finance, Appropriations, and the like; these are just the most common places for local/pension issues to go. With Republicans having increased their majority in each Chamber from this past election, they have also increased their lead on each committee; in a few cases there is a single Democratic member on a committee. Practically for MAPERS, this increases the need to develop relationships with the Chairs of the various committees and explain local pension issues. Though each committee has members that served in local government, largely the Chairs did not.

Practical Implications for MAPERS

MAPERS has certainly "survived" the 2013-14 legislation session thus far, in no small part to the work involved in keeping former county commissioners, CVT officials and pension board members/trustees close to MAPERS issues. Though philosophically the legislature is "more conservative," practically, nothing much changes with MAPERS' approach to working on pension-related issues. Attached to this report is a list on the newly-elected members of the legislature. Many of them have a background in local government, which is a key constituency for MAPERS issues. Further, when new legislative committees are chosen, the Chairs (especially on the most relevant committees like Finical Liability – if that still exists in 2015-16 – and Local Government) will again be important for MAPERS relationship-building.

No candidate ran for office specifically on pensions or pension "reform," but that doesn't mean it won't come up, and the few Representatives notorious for discussing those issues are returning for another term in office. Additionally, Detroit continues to emerge from bankruptcy and many elected officials see that as a huge victory for the Governor and vindication for the policies enacted during the bankruptcy process. This means we will have to watch closely for similar policies being enacted for similarly-situated local governments.

Are Electoral College Changes on the Horizon?

Representative Pete Lund (R) has recently introduced a bill, HB 5974, that would change the way the Electoral College votes are distributed to presidential candidates in Michigan. Under the current system, it is "winner takes all." In other words, whoever gets the most statewide popular votes in Michigan gets all 16 electors. HB 5974 would change that to a considerably more complicated system where the 16 electoral votes are divided among the top two candidates receiving the most statewide popular votes. The candidate who received the most statewide votes would get 9 electors plus one additional elector for every 1.5% of the popular vote the candidate receives over 50%. The second place candidate would receive the remaining electors. Under this system, Obama would have received 12 of Michigan's electoral votes to Romney's 4.

Michigan is among 48 states that have a "winner take all" system and it has been in place since 1836. Proponents argue that our current system is broken and needs to be fixed. Proponents further argue that our current system does not incentivize Presidential candidates to conduct campaigns "on the ground" in Michigan (meaning: spend lots of campaign money here), and essentially makes Michigan a fly-over state (something easily disproven in quick Google search for newspaper articles detailing how often candidates Romney and Obama visited the state).

Opponents argue that changing the system to the proposed one would actually weaken Michigan's importance in the Presidential campaign by putting fewer electors up for grabs. Additionally, opponents showed how much money was spent by the Presidential candidate committees, and supporting organizations, in the last several elections specifically because Michigan has 16 electoral votes. Opponents also argue that a change as important as this should be decided by the citizens. If passed the law would likely be challenged based on the Equal Protection Clause.

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Opponents of the law agreed with proponents: the current Electoral College system itself is antiquated and serves to disenfranchise voters. However, the two sides differ in tactics. Proponents of laws like this would like to see this or a much more onerous system in place where Electoral College votes are decided by Congressional districts (meaning Romney would have won Michigan despite the popular vote in which Obama won). Opponents would like to see something more along the lines of the National Popular Vote movement – a movement which guarantees the most popular-vote getter ascends to the Presidency – or similar movements that are closer to one-person-one-vote.

Two hearings on the bill had failed to move it from committee; a broad and diverse group of organizations have dismissed the measure as right-sentiment-wrong-idea. Though the bill was a hot topic for the Lame Duck session, with proponents pushing hard to pass this bill in the 7 remaining days of legislative session, the measure did not pass before session ended for the year and thus the bill is "dead."

HB 4804: DB to DC Ordinances

Before the election season started, MAPERS Board Member Mike Grodi testified in opposition to HB 4804 – prohibiting DB plans from collective bargaining discussions via local ordinance – along with individuals from POAM, the Chiefs of Police, and MPFFU. The House Local Government Committee met last week in one more attempt to dislodge the legislation to no avail. Opposition groups, especially and including MAPERS, were successful not only in holding-off a vote but also in getting the bill off the committee agenda.

The bill failed to move before session adjourned for the year, and thus the measure is dead. There is always a chance it will be reintroduced next session.

SB 1105; Waste Disposal Investment

Senator Hoon-Yung Hopgood (D – Taylor) introduced SB 1105, which prohibits the Detroit Police and Fire pension system from investing in a "hazardous waste deep disposal well facility." The system can not make additional investments in that facility, and has to sell, divest, or withdraw all investments in that facility under the following circumstances:

- The operator of the facility files for bankruptcy;
- A controlling interest in the operator of the facility was sold, transferred, purchased, or acquired;
- There is an EPA action for a violation at the facility;
- The EPA revokes the operator's license; or,
- The EPA or the MDEQ ordered operations at the facility to terminate.

This measure has been introduced every session for at least the past 7 sessions (14 years); it is one of the most important issues for every State Representative and Senator from Taylor, where this well operates.

Late (literally) during the Lame Duck portion of session, the opportunity opened for Senator Hopgood to move the measure. It will head to the Governor's desk for signature.

Balanced Budget

Senate Joint Resolution V, a resolution requiring a balanced federal budget, cleared the final hurdle and became "official." The resolution signals Michigan's "vote" to require a constitutional convention around the question of a balanced federal budget. The significance is that if 34 total states pass "substantially similar" resolutions, then the question is called; a "con-con" (constitutional convention) happens. Michigan by some counts is the 19th state, and by others the 23rd.

Opponents of a balanced federal budget – MAPERS included – point out that more than 40% of the state's budget is federal; in fact, Michigan – which has a constitutional balanced budget requirement – balances its budget on federal money. Much hay was made, of course, over the "expense" of pensions to the federal system.

The Governor need not sign a Joint Resolution. It is an expression of legislative will.

HB 4001: FOIA

Another attempt is expected to be made on HB 4001 during Lame Duck. Some time ago, the measure was referred to the Senate Government Operations committee when it was voted from the House some time ago. A new substitute bill was shared with stakeholders, including MAPERS, late last week. The Government Operations Committee, Chaired by outgoing Majority Leader Randy Richarvdille, may meet this week to vote this and several other measures (including Medical Marijuana) to the Senate floor.

MML, MAC, the Townships Association, and various school management organizations remain opposed to the measure. Despite this and much other opposition, HB 4001 became one of those issues that moves at the end of session during Lame Duck, and passed the legislature. The Governor is expected to sign the measure.

Detroit Bankruptcy

HB 5961 (Rep. Ken Yonker – R, Caledonia) was introduced recently and has already been voted out of the Detroit's Recovery and Michigan's Future committee; this was the committee that heard the entire 10-bill Detroit bankruptcy package.

The bill changes "qualified system" to "LARGE SPONSORED" system, and "chief financial officer" to "chief INVESTMENT officer."

The bill was voted out of the committee and the House, but failed to see any action in the Senate before session ended for the year.

Lame Duck Wrap-Up

Roads

The legislature completed work on a package of legislation that would raise over $1 billion for transportation infrastructure. In addition, the package would raise $300 million in new revenues for public education and nearly $100 million for local governments. All of the changes will be placed on a statewide ballot question in May of 2015. If voters reject the plan, only the legislation regarding internet sales tax (known as the Main Street Fairness Plan) will remain in place. The plan is made up of the following parts:

- The sales tax on gasoline will be eliminated (tax reduction of approx. $700 million)
- Michigan sales tax would be increased from 6 to 7% (tax increase of $1.34 billion)
- Increased driver registration fees and overweight truck fees (tax increase of $95 million)
- 'Main Street Fairness' legislation included in plan: companies with a 'nexus' in Michigan must collect sales tax revenue for online sales (tax increase of $40 million)
- Earned Income Tax Credit would be restored to 20% of the federal level (tax reduction of $260 million)
- Transform current per gallon motor fuel tax to a wholesale tax and increase the rate to raise $1.2 billion for transportation infrastructure

When factoring in the various tax increases and tax reductions, the plan would raise overall revenues by approximately $1.8 billion. The new money, when fully phased in, would primarily be divided between roads and bridges ($1.3 billion); public education ($300 million); local government ($94 million); and public transportation ($112 million). Other pieces of the agreement include:

- The School Aid Fund will be used only for k-12 and community colleges, not universities. This reverses a trend started several years ago where up to $200 million was removed from the SAF to pay for university operations. Commitments were made by the governor and legislative leaders to restore the lost funds for universities through the general fund• The creation of a study to examine the true cost of education with the goal of providing a better indication of k-12 spending needs
- While the House and Senate have been debating a final road package for weeks, in the end the ballot proposal passed overwhelmingly in the House but barely made it through the Senate. Many Senators expressed concern that voters may shy away from such a complicated proposal. Over the next few months backers and detractors of the plan will have the opportunity to sway voters one way or the other.

Religious Freedom Restoration Act Dies

Earlier last week, the House passed HB 5958- the Religious Freedom Restoration Act (RFRA). As the last day of lame duck session approached, several Senators signed a letter urging Majority Leader Randy Richardville (R-Monroe) to take up the house passed version of the bill after he had told local media he felt there was no 'fervor' in his chamber for the issue. The letter was signed by the letter's author Senator Tom Casperson (R-Escanaba), Senate Minority Floor Leader Tupac Hunter (D-Detroit), and 13 other Republicans.

House Bill 5958, sponsored by Speaker Jase Bolger (R-Marshall), would limit Michigan government's ability to infringe on one's "sincerely held religious beliefs." Opponents of the bill, several of whom protested outside of the state capitol building this week, believe that the bill is essentially a license to discriminate, and will violate the civil rights of gay individuals, women, and others. Supporting the bill, Ari Adler, spokesperson for Speaker Bolger, maintained that that it only requires that state or local government have sufficient justification for its action when infringing on someone's religious beliefs. The bill failed to move before the end of lame duck.

Medical Marijuana Legislation Goes Up in Smoke

Legislation that deals with Michigan's medical marijuana dispensaries was recently discharged from Senate committee after lying dormant for months. Michigan law enforcement held a press conference this week to voice their strong concerns with the legislation. The Michigan Sheriffs Association, the Michigan Chiefs were joined by the Michigan Association for Local Public Health, who announced that they had formed a list of 19 new issues with the latest version of House Bill 4271. One of the main components of the bill is to allow state-issued medical marijuana growers, or caretakers, to sell their excess marijuana. Law enforcement has a major issue with the financial incentive aspect of the bill, and sees this as a loophole, with nothing stopping authorized growers from selling 100% of their marijuana,

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rather than using any for themselves. The issue was ultimately not taken up.

Wayne County Pension

The brand new Wayne County Executive is facing a $70 million deficit, saying the county, if it continues the way it is now, will "run out of cash" in 15 months.

Further, Mr. Evans indicated that he will look at big budget cuts and "significant changes to legacy liabilities." Specifically, the pension fund is only at about 45% funded, about twice as low as had been claimed in the past. Mr. Evans has stated that he believes he can pull the county out of this without declaring bankruptcy, but he ominously hasn't taken the option off the table.

Since this news was just revealed Friday, the legislature hasn't talked about it yet. The legislature is certain to talk about this, and probably introduce legislation or hold special committee hearings on it. It will certainly spur another round of EVIP requirements in the budget again this year (which had ended last year finally), and more pension-control legislation. MAPERS lobbyists are meeting in the next few weeks with the DMB Director and will discuss this with him to determine the Governor's disposition.

Many of Mr. Evans' statements and solutions could very well be to self-manage and take state/legislative action off the table.

Republicans Release 2015-16 Plan

As they did two years ago, the House Republicans again released their two-year action plan, ostensibly to Strengthen Michigan. Some highlights of the plan:

- Repeal Prevailing Wage
- Repeal Community Benefit Agreements
- Repeal "sick pay ordinances," which govern local employers providing paid sick leave
- Institute savings accounts for family leave (for long-term care and extended leave)
- Reducing long-term financial obligations by "reforming" a municipality's ability to incur long-term debt
- Increase TIF transparency
- Move all new teachers to a 401(k)
- Cut the income tax from $.25% back down to 3.9%
- Modernize public notice requirements and give the ability to post online
- Property tax "relief"
- Review and update the Civil Service Commission and its laws (including state employee benefits).

The plan itself, found at http://gophouse.org/focusonmich/, is much lengthier.

New Legislation

SB 30
PENSION TAX (Knezek) Eliminate limitations and restrictions on deduction of individual income tax for retirement and pension benefits. A bill to amend 1967 PA 281 by amending section 30 (MCL 206.30), as amended by 2012 PA 597.

HB 4052
MANDATORY LEAVE TIME (Poleski) Prohibits local units of government from establishing mandatory wage, benefit and leave time requirements.

HB 4044
LOCAL GOVERNMENT (Johnson, J.) Allows 2-year audit under certain conditions.
Introduced (1/21/2015; To Local Government)

SB 21
POLICE RETIREMENT (Nofs) Provide one-time increase of monthly retirement allowance for certain retirants to provide cost-of-living adjustment.
Introduced (1/21/2015; To Appropriations)

SB 22
POLICE RETIREMENT (Casperson) Provide one-time increase in monthly retirement allowance for certain retirants to provide cost-of-living adjustment.
Introduced (1/21/2015; To Appropriations)

SB 23
PENSION TAX (Jones) Eliminate limitations and restrictions for deduction for retirement and pension benefits.
Introduced (1/21/2015; To Finance)

SB 24
HOMESTEAD EXEMPTIONS (Nofs) Continue principal residence homestead exemption upon death of homeowner under certain circumstances.
Introduced (1/21/2015; To Finance)

From the MAPERS Office

Thank you to the following sponsors of the 2014 Fall Conference held September 14-16 at the Grand Traverse Resort & Spa in Acme, MI:

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Efficiently Exercising Your Fiduciary Responsibility

By Aaron L. Castle, VanOverbeke, Michaud & Timmony, PC

According to popular belief an effective exercise routine only takes 15 minutes a day, but is it possible to exercise your fiduciary responsibility as trustees in the same amount of time? In an effort to increase the effectiveness (and lessen the pain of) lengthy meetings, many retirement boards have implemented a practice of setting time limits on presentations from professional service providers; usually 15 – 20 minutes for prepared comments with 5 – 10 minutes reserved for questions. Accordingly, proper preparation and execution by all those involved is crucial to making the most of the limited amount of time set aside for such matters.

It is apparent that the presentation process is most beneficial and efficient when those involved have a firm grasp and understanding of the process itself and the various roles involved in that process. For purposes of professional service provider presentations the participants in the process can generally be narrowed to those of: (1) Presenting professionals; (2) Other (i.e., non-presenting) professional advisor(s); and (3) the Board of Trustees. In light of the foregoing, the following four-step routine is suggested to help maximize the benefits of the presentation process.

Step 1 – Do Your Warm-Ups

Professional athletes and fitness experts don't go into a game or their work-out routine without first warming-up. The same rational applies in this context; proper preparation by all reduces the risk of injury to the plan.

"Before anything else, preparation is the key to success." – Alexander Graham Bell

Trustees: In fulfilling your fiduciary responsibility as Trustees preparation should be your primary concern in advance of presentations. A general understanding of the particular topic of presentation along with a preliminary review of any informational materials provided in advance will be helpful. Rely on your Professional Advisors to provide you with some basic background info with respect to the Presenter(s) and/or service(s) being presented to the Board. Set goals in advance with respect to what you want to achieve from the presentation process.

"By failing to prepare you are preparing to fail." – Benjamin Franklin

Presenters: Presenters must rely on the Board's Professional Advisors to provide them with a basic presentation routine, as well as sufficient information to prepare presentation materials and get an idea of a Board's goals and expectations. Advance copies of any presentation materials will be valuable to Trustees' ability to prepare.

"Chance favors only the prepared mind." – Louis Pastuer

Professional Advisors: Professional Advisors play a key role early on as they will have a familiarity with all parties involved and are in a position to assist both the Board and the Presenter(s) with preparation for the presentation. Think of yourself as each participant's own personal trainer. Depending on the type of presentation, it may be helpful for the Professional Advisor to provide the Board with an "advance screening" detailing background information, historical data, personnel, etc., on the particular Presenter(s). Likewise, a preliminary discussion with Presenters about the makeup and dynamic of the board will assist with their preparation. In the spirit of objectivity it may also prove helpful to lay some ground rules in advance to establish a level of cohesiveness between presentations.

Step 2 – Lose the Weight

I had a rather colorful law professor who used to tell his classes during exam preparation to follow the K.I.S.S. ("Keep It Super Simple") rule when writing exam responses. A similar approach seems to work for the presentation process. Overly complex and convoluted presentations quickly lose the interest of the audience resulting in an unhealthy situation for everyone involved.

Trustees: A Trustee's job is easy at this point in the process; all you need to do is listen. If Trustees have done their homework in advance, they should have an idea of what they want to hear from the presentation(s). If you aren't getting what you would expect out of the process then ultimately is the Trustees' responsibility to dig deeper and expand the extent of the exercise.

Presenters: Avoid an information overload. Presenting information that is relevant, relatable and understandable should be a Presenter's primary responsibility. A long-winded discussion of your company's corporate structure, client list or other products/services may ultimately be an exercise in futility. Likewise, discussion of standard deviation, sharpe ratio, sector rotation, etc., is likely too complex an exercise for the limited amount of time. A brief introductory history of the company and the individuals who will be assigned to the client's account, followed by an explanation of the specific service(s) being considered should be addressed. Be sure to work into the discussion any unique characteristics of the company, its representatives, and the services that you feel are especially tailored to the Board's needs and goals. Don't forget about fees. Save the board the time and discomfort of having to raise the question of fees and briefly address the topic during your presentation.

Professional Advisors: The role of a Professional Advisor throughout a presentation should be similar to that of a referee. If you've provid-

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Zombie Directors and Board Accountability

Submitted By Robbins Geller Rudman & Dowd, LLP

After a decade-long campaign by investors, nearly 93% of companies in the S&P 500 now either provide for the election of directors by a simple majority vote or require directors to submit a resignation if they fail to win a majority of votes cast. In conjunction with the decline of classified boards – about three-quarters of the S&P 500 now provide for the annual election of directors – shareholders can now hold directors accountable and remove them from the board if they fail to properly represent shareholder interests.

Or at least that's the theory. In practice, it is much, much harder for shareholders to remove directors in an uncontested election. Since 2011, at least 121 directors have failed to gain a majority of votes cast by shareholders at 75 different companies and yet remain on their boards. Some of them have failed multiple times, such as at Healthcare Services Group, Inc., where nine different directors have failed to receive a majority since 2011, including one director, Theodore Wahl, who has lost three out of the last four elections. All remain active members of the board. In this case, Healthcare Services Group has a plurality election standard, where a single vote in an uncontested election is sufficient to return a director to the board.

More disturbingly, a significant portion of these directors who remain on boards after losing their vote serve at companies with either a majority vote standard or a plurality vote standard where the director is required to submit a resignation when he or she fails to receive a majority. At Nabors Industries, which has a director resignation policy, the board refused to accept the resignations of the three directors who failed to receive a majority in 2014 (after doing the same in 2013). Similarly, at Big Lots in 2013, Russell Solt was opposed by a majority and tendered his resignation, yet he remains on the board of directors (and was re-elected in 2014).

Even at companies where directors are no longer serving after losing their elections, there is often a significant delay before they leave the board. Of 47 cases of directors who no longer serve after failing to receive majority support in the past three years, in only 18 cases did the director leave within a year. For instance, after Morris Goldfarb at Christopher & Banks received 47% support at the 2011 annual meeting, he did not leave until June 2013. Few and far between are cases where a director departs directly after the annual meeting, such as at Sterling Construction, where director Robert Eckels received only 42% support and immediately tendered his resignation, which was accepted by the board.

The willingness of companies to maintain plurality voting (where one vote suffices for re-election), to reject resignations from directors who fail to receive majority support, and to re-nominate these directors to the board in following years, reflects a fundamental rupture in the chain of board accountability. This rupture is, unfortunately, abetted in part by shareholders, who have shown themselves willing to reject a director one year and re-elect him or her the next, and who have not typically held nominating committees or the broader board accountable for keeping these zombie directors on boards. One possible path forward: broader access to the proxy for shareholders, to help make more elections contested, eliminate the plurality vote loophole, and provide an affirmative alternative for shareholders. Without a choice, especially in these cases where shareholders are expressing significant discontent, accountability is weakened.

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ed the Presenter(s) with a format/routine for the presentation, make sure that they are following the format and addressing any specific information you feel is of particular importance. Similarly, try to keep the Trustees involved in the process by encouraging questions and dialogue with the Presenter. Try to avoid an overly "fit" Trustee from monopolizing the conversation or taking over the presentation process.

Step 3 – Less Cardio (Prepared Comments), More Heavy Lifting (Answers)

Oftentimes a well orchestrated Q&A session is more beneficial than any amount of prepared comments. The question and answer process gives Board members and Presenters the ability to have some direct interaction and, to an extent, provides the Board with an opportunity to control the "workout" of information for a short time. It provides Board members with an opportunity to get a better sense for the Presenters on both a professional and personal level. Presenters that are able to provide thorough, on the spot and responsive answers to questions tend to stand out from the crowd.

Trustees: Don't let a Presenter off the hook if you think they've left something on the field. Ask the Presenter to briefly touch on the subject if you feel it was omitted or to explain in more detail if any part of a presentation wasn't clear. Don't be afraid to ask questions about fees, fiduciary responsibility, and performance.

Presenters: Stick to the program. Answers to Board questions should be simple, clear, concise, and most importantly responsive to the question presented. Inconclusive answers will only raise more questions that may go unasked. Refer Board members to relevant portions of any presentation materials that may provide responsive information. Finally, don't be afraid to provide Trustees with a more detailed and responsive answer subsequent to the meeting if information of data isn't readily available at the time of the presentation.

Professional Advisors: Professional Advisors should also be involved in the question and answer process. As previously suggested it may become necessary for the Professional Advisors to act as a referee if a line of questioning gets everyone off the program. Furthermore, if a presentation seemed lackluster, it may fall to the Professional Advisors to motivate the Presenter and/or the Board with more in depth Q&A.

Step 4 – The Cool Down

Just like a lengthy workout session shouldn't come to an abrupt end, the end of a well organized presentation should never come as a surprise to those involved. A presentation's conclusion should do much more than simply tell the audience that your presentation is over. It's that last impression that can linger the longest.

Trustees: Efficient meetings are beneficial for everyone involved. Nevertheless, it is important for Trustees to remember that efficiency is secondary to your fiduciary responsibility to act in the best interest of plan members and beneficiaries. Thus, if you feel for any reason that a presentation or report was insufficient, please speak up. If necessary, ask the Board to waive/extend any time limitations or restrictions with respect to one or more Presenters. Ask the Presenter(s) to elaborate or address any specific information or issue that you feel may have been omitted or lacking from the discussion. Ultimately, the Board has the authority to determine how to conduct its meetings and how to conduct its presentation routine.

Presenters: Maximize the limited amount of time you have. Don't get so far off the subject that you don't have time to conclude your presentation. Try to address questions in a way that brings you back to your presentation materials, or defer providing an immediate response if your prepared comments will subsequently answer the question.

Professional Advisors: To use another sports analogy here, Professional Advisors should act as the timekeeper during the presentation process. In a situation in which the Board may be hearing multiple presentation(s), the timekeeping and procedure should be as objective as possible from one presentation to the next. A five (5) minute warning proves helpful in providing Presenters ample time to conclude presentations. Additionally, if a Presenter is cut off in the midst of discussion due to time constraints, don't hesitate to ask the Presenter to briefly conclude their comments. While maintaining efficient meetings is a priority, an assembly line like approach may not be beneficial if it creates the appearance of running someone out the door for taking too much time.

By design, Boards are comprised of various individuals of various backgrounds representing various interests and ideas. The natural result of this variety is some level of conflict and chaos. To overcome the inherent chaotic nature of meetings, there must be a method of control that does not stifle the meeting process, especially its creative and interactive character. A presentation process that is well-organized will increase the chances of a smooth, effective decision-making process thereby making it easier for Board members to feel a commitment towards both the process as well as whatever outcomes result. While all Board decisions ultimately derive from a vote, it is often the fiduciary exercise preceding a vote that leads to a positive result, and positive results make for a healthier plan.

IMPORTANT NOTE: This summary is intended to be informational only and is intended to provide a general overview. Reference should be made to relevant laws and regulations in addressing specific questions. This information should not be considered the rendering of legal advice or other professional services and Trustees should consult with their plan professionals regarding the implications of the matters contemplated herein.

Glancing Back, Looking Forward

Submitted By Goldman Sachs Asset Management

Funded levels of US public defined benefit (DB) plans may have troughed, as a five-plus-year bull market in equities has been additive to plan asset values. With some equity markets near historic highs and interest rates in the US poised to rise, achieving returns going forward may be more challenging than the past few years. In addition, public DB plan sponsors will need to consider a number of other important topics as they contemplate investment strategy and asset allocation in 2015 and beyond.

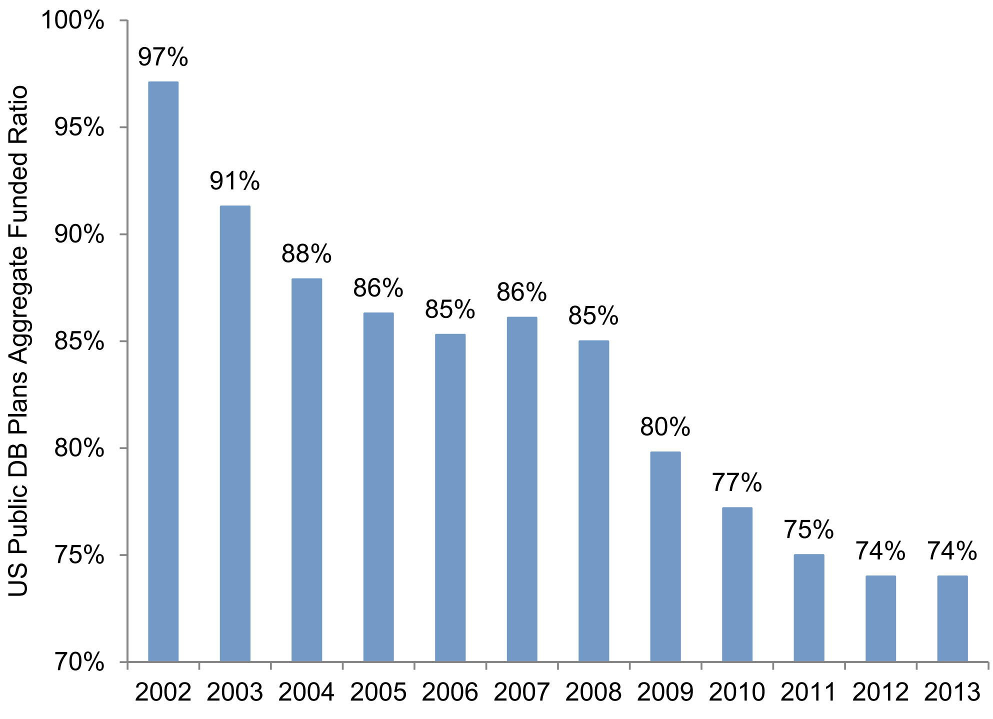
Funded Status Trajectory is Up, But Work Remains

Public DB pension plans had previously suffered through a multi-year period of steadily declining funded ratios. However, this has not just been the case since the financial crisis of 2008. Instead, it dates all the way back to the bursting of the technology bubble at the turn of the century. Now, the tide may finally be turning. This five-plus-year equity bull market has contributed to notable increases in the asset values of these plans.

At the same time, changes in the calculation of funded ratios, as dictated by the Governmental Accounting Standards Board (GASB), will move the valuation of assets from an actuarially smoothed methodology to a market value framework.[1] Consequently, the increase in asset values of recent years will be reflected immediately, whereas previous years saw fluctuations in asset values slowly eased into the actuarially calculated value. Funded status based on asset market values now exceeds funded ratios calculated based on actuarially calculated asset values for the first time since before the financial crisis.

Despite this, some plans still face daunting deficits. In addition, further changes by the GASB could require some plans to use a lower discount rate when valuing their pension obligations. This could place upward pressure on liability values and downward pressure on reported funded ratios for some plans. Despite the asset gains in recent periods, some plans still face challenging funding deficits which, combined with ongoing accruals for new benefits, mean the need for return generation in portfolios is still strong (Exhibit).

Exhibit 1 – Reported Public DB funded ratios may have troughed



Source: National Association of State Retirement Administrators Public Fund Survey; Goldman Sachs Asset Management; company reports; as of 2012.

Longer Lives, New Challenges

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[1] *For additional information please December 2012 report "A 'Sea Change' in Public Pension Reporting on the Horizon"*

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Potential changes to mortality tables could also place even further downward pressure on funded status for some plans. Please see further discussion on the topic of mortality rates and the effects on population in (Demographics *title*) on page (XX).Earlier this year, the Society of Actuaries (Society) issued proposals to update mortality tables. In short, increases in life expectancy and expected future improvements in mortality mean that expected benefit payments for some plans may have to be made over a longer period of time than what is currently baked into liability calculations.

Based on conversations with those in the actuarial community, it appears many of the largest state and local plans develop their own mortality assumptions based on the actual experience of their participants. Indeed, the Society's project actually excluded public plan data from its analysis on the basis that mortality for public sector employees differs from private sector participants.

Consequently, the changes proposed by the Society may not have any impact on some public plans. But for others that do rely on the Society's mortality tables, these proposed changes could place downward pressure on funded levels, although perhaps implemented more slowly than what is likely in the US corporate DB universe.

Changing The Scorecard

At the same time, revised approaches to evaluating pension exposures by credit rating agencies, combined with the GASB changes to pension accounting and reporting, begin to place more of an emphasis on the liability side of the funded status equation. As touched on earlier in this article, the GASB has instituted several notable changes to public pension accounting and financial reporting: (i) the funded status of plans will now be on the sponsor's balance sheet, similar to the treatment in the corporate universe. (ii) Discount rates for some plans may need to be lowered, resulting in higher liability values and lower funded ratios. (iii) And asset values for reported funded status calculations will now be based on market values, as opposed to smoothed actuarial values, potentially leading to increased volatility of that measure.

At the same time, credit rating agencies have made their own adjustments to pension metrics that in some cases go even beyond the GASB changes, such as using municipal bond rates to value pension obligations. These changes begin to place a greater emphasis in the public DB universe on plan liabilities and the volatility of funded status. As such, it may lead to questions such as…

Follow The Glide Path?

Establishing a strategy to adjust risk as funded status fluctuates has become fairly mainstream in the corporate DB community. Under this type of framework, when funded status rises the focus turns towards reducing the volatility of that measure by aligning the characteristics of plan assets with plan liabilities. Since corporate DB pension obligations are valued based upon market interest rates of high quality, long-duration bonds (for accounting and reporting purposes), their glide paths typically call for higher allocations to long duration fixed income with lower allocations to equities or other "return-seeking" assets.

Since public DB liabilities, in general, are not valued based on market interest rates, implementing such a strategy would not hedge their reported funded status. Such a shift in asset allocation would likely hurt their reported funded status since it could result in a lowering of its expected return on asset assumption, which would increase the present value of its pension obligations. Nonetheless, a strategy that, in some ways, reduces risk as funded status improves to prevent large drawdowns, such as those experienced in the 2000–2002 and 2008–2009 time periods, likely makes sense for some public DB sponsors.

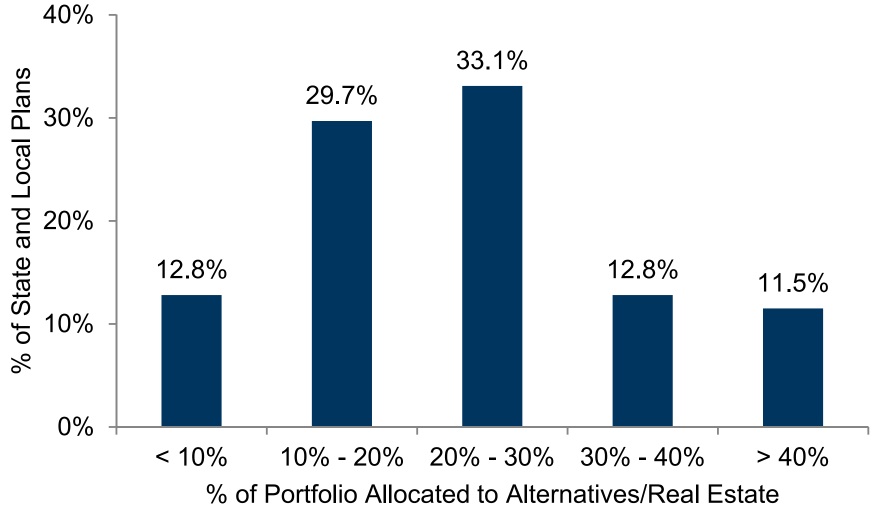
Considering The Alternatives

Taken together—a potentially challenging investing environment, deficits that in some cases still need to be reduced and which potentially face new headwinds and changes to the reporting of public DB plans—it is easy to see that public plan sponsors have their plates full. A key question is what does all of this mean from an asset allocation and investment strategy perspective?

Over the past several years, the trend of public DB plans increasing their allocations to alternative assets has been well documented. However, while some plans have shifted their investment strategy more towards private equity, hedge funds and real estate in recent periods, others have maintained little or no exposure to these asset classes. Debates have continued in certain areas of the public DB universe as to the role of alternatives in some portfolios, and CalPERS' recent announcement that it will exit its hedge fund investments garnered much attention across the entire investment landscape.

While the overall allocation to alternatives in the public DB space has risen over the past decade, the use of alternatives varies widely between plans. As seen (exhibit 2), while about 12% of public DB plans have more than 40% of their portfolios dedicated to alternatives, almost 13% have less than a 10% allocation. It is likely that more plans will at least explore increasing the allocation to alternatives in their plans given: (i) equity valuations are, in some markets, at historically high levels; (ii) an expectation of rising interest rates (iii) funding gaps still need to be closed; and (iv) a potential desire by some plans to minimize the volatility of asset values due to the aforementioned change by the GASB to move to more of a mark-to-market type of framework for calculating funded status.

Exhibit 2: Wide dispersion in use of alternative asset classes



Source: Center for Retirement Research at Boston College and Center for State and Local Government Excellence Public Plans Database; data as of fiscal year 2012.

Focus On ESG Issues On The Rise (Yet Again)

Finally, the attention to environmental, social and governance (ESG) topics by public DB plans appears to be increasing. In the past, interest in ESG-related topics has ebbed and flowed. Tragic events over the past decade, such as Hurricane Katrina in 2005 and the Newtown, CT school shooting in 2012, had raised the profile of ESG-related issues for many portfolio managers and investors. Over time, that interest sometimes seems to dissipate as asset allocators focus on other issues or question the efficacy of implementing such strategies as part of their investment strategy. At the risk of falling into a trap, it does feel as if this time it is different.

Investors seem to be increasingly coming to the conclusion that ESG is not just about “doing the right thing,” but rather recognizing that these issues are fundamental factors that can have a material impact on investment performance. Several public DB plans, such as the Florida State Board of Administration and the New York State Common Retirement Fund, have announced ESG-related initiatives in recent years and it is likely public plans will increasingly move in this direction.

Like many investors, public DB plans have benefited from the tailwind of rising financial asset prices in recent years. Funded ratios may have fallen to a nadir, and continued improvement in the US economy may be beneficial not only for the value of plan assets, but also the economic activity and tax receipts of sponsoring state and local governments. Nonetheless, a number of important issues, even outside of a plan’s view of the relative attractiveness of various asset classes, will likely contribute to discussions in the public DB universe over the next year.

Hitting The ARC

GASB regulations have no direct impact on funding requirements for public DB plans. Nonetheless, many plans had previously used the Annual Required Contribution (ARC), as defined by GASB, as the de facto funding policy for a plan. The revised GASB rules eliminate the ARC, although it is replaced with an actuarially determined contribution disclosure.

Contributing the ARC in full each year has been a good indicator of a sponsor’s diligence in working towards reducing any deficit. Indeed, many of the worst-funded state plans failed to pay 100% of their ARC in recent years. Establishing actuarially-driven funding policies, and contributing in line with them, has proven to be a key to maintaining a well-funded plan. As seen (Exhibit 3), almost a third of public pension plans determine contributions by statue rather than by actuarial methods. The disconnect between accounting and funding due to the GASB changes may need to be addressed by some public DB plan sponsors through the establishment of revised funding policies.

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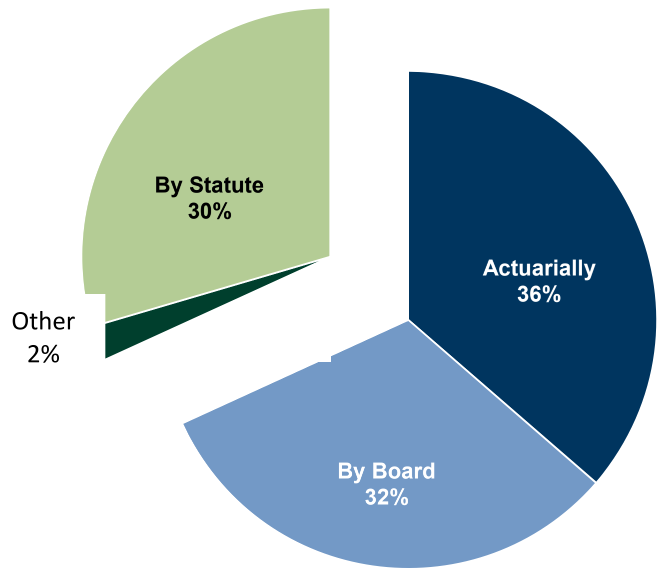
Exhibit 3 – Actuarially-driven funding policies are a key to maintaining a well-funded plan



Source: Center for Retirement Research at Boston College Public Plan Database, as of 2012.
Note: In the "By Board" category the Board's decision is often enlightened by the recommendation of the actuary. Consequently, these could be considered to be (generally speaking) actuarially-driven as well.

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Hedge Funds Go Mainstream

Submitted By UBS Global Asset Management

Over the past decade, many institutional investors' views of hedge funds have evolved from a paradigm where hedge funds were detached from their core portfolio and treated as a separate asset class, to a more nuanced and intricate view that recognizes that hedge funds come in different flavors, and can play quite different roles in multiple areas of a portfolio. For example, some strategies can potentially dampen long equity volatility while also adding equity alpha, while other hedge funds seek to replace traditional fixed income exposures that no longer offer significant yield, or which may lose value when interest rates rise. As a result, many institutions are increasing their overall allocations to hedge funds, with some placing more directional strategies directly alongside their traditional long-only equity and fixed income managers, as shown in Exhibit 1.

Within equities, it is fairly commonplace to see cost-conscious pension plans allocate to passive beta strategies, employ newer "smart beta" approaches with the potential to offer better risk-adjusted returns and use derivatives to express tactical views within their equity portfolios. Institutions often pair this relatively inexpensive equity beta with high-conviction, high-alpha long-only managers, and increasingly with long/short equity managers. Within this framework, a primary benefit of adding long/short managers is the potential for downside protection, though not necessarily delivered in a market-neutral style. Some institutions prefer long/short managers that can still participate somewhat during equity market rallies (such as those with a beta of 0.3 to 0.6 relative to the MSCI World Index), but that can also serve as valuable "shock absorbers" when equity markets drop.
Within fixed income, institutional investors have been integrating higher-beta, higher return-generating distressed credit and private debt strategies, often managed by private equity and hedge fund managers in less liquid vehicles. This trend picked up considerable steam after the financial crisis of 2008. Responding to new regulations, banks pared back commercial lending, reduced capital dedicated to market making and shrank their proprietary trading desks. As some capital markets became fairly choppy and inefficient as a result, this translated into more opportunities for private equity and hedge fund managers. By providing much needed liquidity to the markets, these managers can receive an attractive premium in exchange for taking on market risks. Other pension plans are also integrating more liquid and uncorrelated long/short fixed income managers that have the flexibility to invest anywhere across the global fixed income landscape. Using the same tools and trading techniques that hedge funds use, these unconstrained managers seek to deliver modest positive returns in all market environments.

Classic uncorrelated hedge funds, multi-strategy funds and FoHFs that seek alpha without significant beta exposure, or alpha from tactical beta exposures, still have a home by serving as a counterweight to a pension plan's more volatile return-generating assets. Here, one typically sees hedge fund strategies such as Global Macro, Managed Futures (i.e., CTA), Relative Value and recently, quant-oriented Risk Premia strategies that offer rules-based "hedge fund beta" at lower costs. Other institutions make room for Global Tactical Asset Allocation (GTAA), typically called Diversified Growth Funds in Europe, and Risk Parity strategies. While the return-generating capacity of some of these strategies can seem relatively muted, that is largely on purpose. Their true value lies as a potential volatility buffer during challenging environments, and also as a portfolio diversifier by remaining uncorrelated with a pension plan's core return-generating assets.

Exhibit 1 Hedge Fund Mainstreaming

Portfolio categories		
Return-Generating Assets	Equity	Private equity
		Passive
		Smart beta
		High-alpha long only
		Long/short
	Fixed Income	**Distressed credit**
		Private debt
		Emerging market debt
		Structured credit
		Unconstrained long/short
		Investment grade credit
		Sovereigns
Portfolio Diversification/ Stable Value		**Global macro**
		Managed futures
		Relative value
		GTAA/risk parity
Inflation-Sensitive Real Assets		TIPS
		Real estate
		Infrastructure/MLPs
		Agriculture
		Timber
		Commodities
Liquidity		Money markets
		Enhanced cash
		Short duration
Liability Hedging*		Long-duration credit
		Interest rate futures
		Swap overlays

*For corporate pension plans that are derisking their pension liabilities, their return-generating, stable value and inflation-sensitive assets coexist alongside a steadily growing liability-hedging bucket. This bucket is typically comprised of long-duration credit, plus interest rate futures and swap overlays that help reduce a pension plan's funding ratio volatility.

Source: UBS Global Asset Management.

The Grand Illusion *Submitted By Garcia Hamilton & Associates, LP*

My sons and I were watching TV when a recent concert by the 80's rock band Styx came on. The band played songs from two popular albums including "The Grand Illusion." That night, the hit song "The Grand Illusion" was stuck in my head. The song shatters the myth behind the glamour of being a rock star as it proclaims, "don't be fooled by the radio, the TV or the magazines," and ends the verse with the line "and deep inside we're all the same."

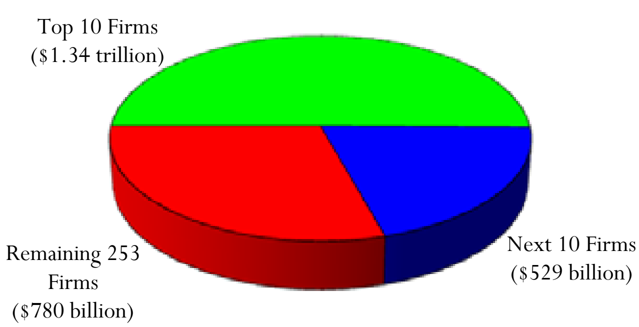
The money management industry has its own illusions, some which are now being shattered. Many practitioners have held the view that only big firms can outperform the market. This myth has existed despite several white papers that have demonstrated otherwise. Regardless, some of the key professionals at large firms, like rock stars, have taken on a larger than life image with today's instant media and 24/7 news channels.

This year, one premier bond firm has been in the news constantly, sometimes unfairly. All firms, big and small, have interpersonal challenges among senior management from time to time, particularly during succession planning and performance struggles.

Rather than focusing on "personal issues," the market should be asking at what point are firms too big to effectively manage money the old-fashioned way. At what point do they "become the market" and lose some of the magic?

According to *P & I Magazine* the universe of active, domestic fixed income managers contains 273 firms managing $2.65 trillion in assets. The top 20 firms represent a staggering 70.5% of the market share with $1.87 trillion in active, domestic fixed income assets under management. Thus, each top 20 firm ("T20 firm") on average manages almost $100 billion. Even more incredible, the top 10 firms alone represent 50.5% of the market share with $1.34 trillion.

Active Domestic Fixed Income Manager Universe (273 Firms/$2.65 Trillion)



So is $100 billion too big? Let's examine a corporate bond example. A typical global issue might be $2 billion in size. If a T20 firm wanted exposure to the credit and bought the entire issue, it would only represent a 2% position across its portfolios. Keep in mind that the typical float (tradable supply) is closer to 10% of the deal size. In this example, the float would be only $200 million. Realistically, if the T20 firm wanted exposure to the issue it would be limited to owning the float, a miniscule .20% position across its portfolios. So, the T20 firm is often forced to own multiple small bond positions, diluting many of their best ideas. It is no wonder that many of these firms are forced to utilize derivatives, primarily Credit Default Swaps (CDS), to gain exposure to the credit markets. (The CDS market is unregulated and introduces counter party risk, the risk that the other side of the trade defaults on the transaction.)

Over the past few years, some of the best fixed income opportunities have been in smaller markets. At one point we owned over 40% in agency-guaranteed mortgage balloons for all clients. They performed brilliantly. But, the entire balloon market at that time was barely $18 billion in size, making it impossible for large firms to exploit.

Another incredible opportunity was floating rate notes. The duration of floaters is close to cash because the coupon resets periodically. But after Lehman, many floaters became severely impaired because of wide credit spreads. Some floater prices declined to the mid-50's. Now, as markets have stabilized, floaters are trading much closer to par. But again, at only $348 billion in size, this market is too small for most large firms.

Adding fuel to the fire, a favorite tool of large firms is being curtailed. Many firms routinely use mortgage Dollar Rolls to add alpha. A Dollar Roll is when a manager sells a mortgage forward and agrees to purchase it back at a later date. As the purchase settlement date approaches, the manager sells it again and buys it back, further into the future. Thus, the manager "rolls" the bonds forward. The transaction allows the manager to have exposure to the mortgage market while having use of their cash. Dollar Rolls are leverage and have recently come under scrutiny by the Treasury Market Practices Group. To minimize the systemic risk to the markets, Dollar Rolls now require margin collateral.

Too big often means too slow. To make a portfolio change, some large firms require a labyrinth of investment committee meetings. In times of crisis, markets move fast and the slightest delay can be costly. For example, the Friday before Lehman failed, Lehman debt was rated "A-"and traded in the mid-70's. By Monday morning, the price of their debt opened in the mid-30's. By day's close, prices had plummeted to the low teens. No time for committee meetings!

As for intangibles, you can't top boutiques for access. Everybody in the firm is available. And boutiques often have large internal ownership which usually leads to a healthy entrepreneurial environment. Such an environment brings greater intensity to how a firm approaches the markets, client service and their business management practices. As for "bigger is always better," we think that's one of the greatest Grand Illusions of all.

Gilbert Andrew Garcia, CFA
Managing Partner

A copy of our Form ADV, Part II is available upon request.
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Future Event Sites

2015 Spring Conference
May 17-19
Soaring Eagle Resort
Mt. Pleasant, MI

2015 Fall Conference
September 27-29
Grand Traverse Resort & Spa
Acme, MI

2016 Spring Conference
May 22-24
Soaring Eagle Resort
Mt. Pleasant, MI

2016 Fall Conference
September 18-20
Grand Hotel
Mackinac Island, MI

2017 Spring Conference
May 21 - 23
Grand Traverse Resort & Spa
Acme, MI

2017 Fall Conference
September 17 - 19
Shanty Creek Resort
Bellaire, MI

2018 Spring Conference
May 20-22
Soaring Eagle Resort
Mt. Pleasant, MI

2018 Fall Conference
September 23-25
Amway Grand Plaza Hotel
Grand Rapids, MI

2019 Spring Conference
June 1-3
Radisson Hotel
Kalamazoo, MI

2019 Fall Conference
September 22-24
Shanty Creek Resort
Bellaire, MI

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