M I N U T E S

RETIREMENT BOARD MEETING, JULY 21, 2005

The meeting of the Retirement Board was held in the Sacramento County Employees' Retirement System Administrative Office, U.S. Bank Plaza Building, 980 9th Street, 18th Floor, Sacramento, California, on July 21, 2005 at 1:01 p.m.

OPEN SESSION:

PUBLIC COMMENT:

1. Chief Executive Officer Richard Stensrud introduced Florence Craig, his newly appointed Executive Assistant.

MINUTES:

2. The Minutes of June 16, 2005, were approved on motion by Mr. Suter; Seconded by Mr. William Johnson. Motion carried (8-0).

CLOSED SESSION:

DISABILITY MATTERS:

3. JACKSON, Betty L.: Action was taken on the Application for Disability Retirement as indicated per attached confidential memorandum dated July 15, 2005.

4. CUMMINGS, Nicholas: Action was taken on the Application for Disability Retirement as indicated per attached confidential memorandum dated July 13, 2005.

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DISABILITY MATTERS: (continued)

5. GOODMAN, Patricia F.: Action was taken on the Application for Disability Retirement as indicated per attached confidential memorandum dated July 13, 2005.

OPEN SESSION:

ADMINISTRATIVE MATTERS:

6. In accordance with Board of Retirement Bylaws providing for the election of officers at the first regular meeting in July, Board President James A. Diepenbrock turned the item over to Chief Executive Officer Richard Stensrud. A Motion was made by Mr. Hickox to re-elect the current slate of officers, i.e., Mr. Diepenbrock – President; Mr. Suter – 1st Vice-President; and Mr. Kelly, 2nd Vice-President. The motion was Seconded by Ms. Wolford-Landers. Motion carried (8-0).

7. Chief Executive Officer Richard Stensrud provided an update on pension reform legislation and other recent developments regarding public retirement systems, including continuing news coverage of events involving the San Diego City Employees' Retirement System.

   Mr. Stensrud reported that the Government Finance Officers Association (GFOA) had awarded SCERS the Certificate of Achievement for Excellence in Financial Reporting for its Comprehensive Annual Financial Report (CAFR) for the Fiscal Year Ended June 30, 2004. Mr. Stensrud and the Board commended Chief Operations Officer Kathryn Regalia and her staff for their excellent work.

8. Chief Operations Officer Kathryn Regalia presented a request by the County of Sacramento that it be permitted to pre-pay its employer retirement contributions for Fiscal Year 2005-2006. Ms. Regalia noted that SCERS' actuary, The Segal Company, had determined the requisite amount of the pre-payment to be $126,740,346 based on salary estimates for the year. Ms. Regaila further reported that the County Department of Finance and SCERS had determined the year end reconciliation amount for Fiscal Year 2004-2005 to be $1,494,995 based on actual salaries. Motion by Mr. Kelly to accept the two payments; Seconded by Mr. Woods. Motion carried (8-0).

INVESTMENT MATTERS:

9. Chief Investment Officer Jeffrey States presented a report summarizing the R.V. Kuhn & Associates Report, Public Funds Universe Analysis Report, for the year ending December 31, 2004. Discussion followed regarding how SCERS' investment performance and asset allocation model compared to the other funds in the Kuhn Report, as well as discussion of the impact of SCERS' active managers on the investment performance. Mr. Hickox noted that he continued to be interested in developing a method for the Board to assess its decision-making on investment matters. Chief Executive Officer Richard Stensrud reported that he and Mr.

<u>INVESTMENT MATTERS</u>: (continued)

States had been exploring the feasability of compiling subsequent investment performance information for the entire semi-finalist group of investment managers considered by the Board for investment assignments in the last few years, as well as subsequent investment performance information for the managers terminated. Mr. Stensrud noted that such information would help the Board guage manager selection decisions in hindsight, but cautioned that it would not necessarily be determinative of whether the hiring decision was right because such decisions are based on the information available at the time. The Board indicated that they thought such comparative information would be very interesting and requested that CIO States and Tom Lightvoet of Mercer Investment Consulting prepare such an analysis. The R.V. Kuhn & Associates Report was received and filed on a Motion by Mr. Woods; Seconded by Mr. Kelly. Motion carried (8-0).

10. Nick Gallucio, Group Managing Director for US Equities and Delia Roges, Senior Vice President, Client Relations of the TCW Group, Inc presented a performance report on the US equity small cap value portfolio managed for SCERS. They offered explanations for the weak performance of the portfolio and provided an outlook for performance for the remainder of 2005 and 2006. The Board expressed its disappointment with the performance and its expectation that portfolio performance will improve as described over the next few quarters. The portfolio report was received and filed on a Motion by Mr. Woods; Seconded by Ms. Wolford-Landers. Motion carried (8-0).

11. Mr. John Lui, Managing Director and Robert Prusiewicz, Vice President, Institutional Client Development of BNY Asset Management presented a performance report for the US equity small cap growth portfolio managed for SCERS. Mr. Lui explained the past performance of the portfolio and gave an outlook for performance for the remainder of 2005 and 2006. The portfolio report was received and filed on a Motion by Mr. Kelly; Seconded by Ms. Wolford-Landers. Motion carried (8-0).

12. Tom Lightvoet of Mercer Investment Consulting presented an analysis and recommendations for amending SCERS real estate investment strategy and portfolio construction. The primary recommendations were that SCERS diversify its real estate investment strategy to include: (1) Investment in open-ended and closed end commingled real estate funds; (2) Placing 20% of the real estate alloction in public REIT securities; and (3) Placing 20% of the real estate allocation in value-added funds. Mr. Lightvoet and Chief Investment Officer Jeffrey States noted that the recommendations were designed to allow SCERS to fully invest the real estate allocation more quickly, while diversifying the real estate holdings and improving returns. Mr. Lightvoet and Mr. States recommended that the revised strategy be implemented in stages over the next three to five years in order spread out portfolio risk by dollar cost averaging the changes over time. As the first step in implementing the strategy, Mr. Lightvoet and Mr. States recommended that SCERS conduct a search for a REIT manager or managers. Mr. Lightvoet and Mr. States noted that SCERS had gained exposure to commingled funds through its recent investments in the Cornerstone Property Fund and the BlackRock Tower Fund. Mr. Lightvoet and Mr. States further explained that a REIT manager search could be done more quickly and easily than a search for a value-added manager.

<u>INVESTMENT MATTERS</u>: (continued)

Extensive discussion followed regarding the recommended changes in strategy and portfolio construction, including: (1) Whether SCERS should consider engaging a specialist real estate consultant; (2) The size of SCERS' real estate allocation relative to the allocation at other funds; (3) Whether the real estate market was due for a correction; (4) The proposed implementation strategy for the recommended changes; (5) Whether the REIT investments should be designed to achieve exposure to the broad REIT market or to provide exposure to those types of properties SCERS does not get exposure to through its other real estate investments; and (6) The appropriate performance benchmark for the REIT allocation. After much discussion, the Board determined that it was not necessary to reconsider the real estate allocation or the broader asset allocation model at this time. With respect to the appropriate focus of the REIT investments, Mr. Lightvoet and Mr. States noted that the recommendation was premised on the assumption that the REIT investments would be designed to achieve exposure to the REIT market as a whole, but that they would explore the issue further and report back to the Board on the workability of a more targeted exposure.

Mr. DeVore moved that the recommended changes in the real estate strategy and portfolio construction be approved, and a search for a REIT manager or managers be undertaken; Seconded by Mr. Woods. Motion carried (8-0).

13. As follow-up to a presentation and discussion at the June Board Meeting, Chief Investment Officer Jeffrey States recommended that the Board authorize a search for a synthetic index overlay program manager as a value-added strategy for eliminating cash drag on performance and to improve the efficiency of portfolio rebalancing and reduce transaction costs. Discussion followed regarding how the search should be conducted and the Board determined that the CIO and Mercer Investment Consulting should conduct the search and present the Board with a recommended manager or managers for the engagement. The Board also determined that a description of the search process, the criteria used to evaluate the firms, and an explanation as to why the recommended manager was selected be included as part of the report and recommendation to the Board. Motion by Mr. Woods authorizing the CIO and Mercer Investment Consulting to conduct the search for a synthetic overaly manager in accordance with the described process; Seconded by Mr. Hickox. Motion carried (8-0).

14. The Asset Allocation and Portfolio Rebalancing Report for the Quarter ending June 30, 2005, as prepared by the Chief Investment Officer, was received and filed on a Motion by Mr. Suter; Seconded by Mr. Woods. Motion carried (8-0).

15. The Monthly Investment Compliance and Activity Report for June 2005 was received and filed on a Motion by Mr. Suter; Seconded by Mr. Woods. Motion carried (8-0).

ADMINISTRATIVE MATTERS:

16. Chief Executive Officer Richard Stensrud presented a recommendation from SCERS' actuary (The Segal Company) that interest be credited on SCERS reserve accounts at the rate of 1.66%, effective June 30, 2005. Mr. Stensrud noted that this recommendation had been developed in accordance with SCERS Excess Earnings and Interest Crediting Policy and recent Board decisions regarding interest crediting. Mr. Stensrud also noted that the recommended interest crediting rate fell short of the target crediting rate of 4% for the period, and that the overall interest rate of 3.93% for the fiscal year fell short of the target annual crediting rate of 8%. Mr. Stensrud explained that the below-target interest crediting was due to the ongoing phase-in of investment losses from previous years through the five-year asset smoothing technique utilized by SCERS, which negated the strong investment performance of approximately 10% for the year. Mr. Stensrud further noted that the recommended interest crediting rate did not take into account the possible supplemental interest that would be credited if the Board approved his recommendation in a subsequent Agenda item to draw upon the funds in the Contingency Reserve. Motion by Mr. Woods to approve the recommended 1.66% interest crediting rate for SCERS reserves effective June 30, 2005; Seconded by Mr. Suter. Motion carried (6-0).

17. As a follow-up to the educational presentation and discussion on interest crediting and excess earnings at the June Board Meeting, Chief Executive Officer Richard Stensrud presented an outline of the possible components of an interest crediting and excess earnings policy, including the ramifications of the various policy positions the Board might choose to incorporate in such a document.

    Mr. Stensrud noted that an interest crediting and excess earnings policy was a statement of the Board's goals and priorities in funding the retirement system. Mr. Stensrud explained that although the 1937 Act placed limitations on the Board's decisions in that regard, the law also gave the Board substantial discretion. In exercising that discretion, however, Mr. Stensrud noted the Board must act as prudent fiduciaries. Mr. Stensrud explained that this meant that the Board's decisions could take into account the individual interests of the various stakeholders in the retirement system, but ultimately the policies must be grounded in what was in the best interest of the retirement system as a whole.

    Among the issues presented for consideration were: (1) Whether the active member contribution accounts should receive interest at a different crediting rate than the other benefit reserves; (2) Whether certain threshold funding status requirements must be met before funds are allocated to non-vested, supplemental benefits; (3) Whether SCERS should credit interest based only on the funds actually available for interest crediting or whether SCERS should credit interest at the full target crediting rate and account for any funding shortfall through a 'contra-account'; (4) The appropriate definition of 'excess earnings'; (5) Whether, and under what circumstances, SCERS could subsidize retiree health care costs; and (6) The appropriate level of contingency reserves that should be maintained and how the funding of such reserves should be prioritized relative to other possible uses of available funds.

ADMINISTRATIVE MATTERS: (continued)

Extensive discussion took place, including consideraton of the relative advantages and disadvantages of the possible positions that could be taken on the various issues.

Mr. Stensrud stated that, based on the discussion, he would develop and bring to the Board a draft interest crediting and excess earnings policy reflecting the preliminary views expressed by the Board. No other action was taken.

18. Chief Executive Officer Richard Stensrud presented a recommendation that the Board draw upon the funds in the Contingency Reserve to provide supplemental interest crediting to SCERS benefit reserves in the amount of 1.2%, effective June 30, 2005.

Mr. Stensrud noted that historically SCERS had maintained a balance in the Contingency Reserve equal to at least 1% of plan assets. Mr. Stensrud explained that under the 1937 Act, the primary purpose of the Contingency Reserve was to serve as a source of funds in those periods when: (1) Investment earnings were insufficient to meet the interest crediting target of the retirement system (i.e., the assumed earnings rate); (2) There were losses on investments; and (3) It was necessary to address other contingencies, such as litigation awards. Mr. Stensrud noted that currently, the balance in the Contingency Reserve was approximately $52.11 million.

Mr. Stensrud explained that since contingency reserves are established to address a shortfall in assets, such funds are placed outside the actuarial asset base for purposes of the actuarial valuation. Mr. Stensrud noted that this meant that they are not included when the plan's funded status is determined or when contribution rates are set, however, as the need arose, funds are drawn from such reserves into the actuarial assets.

Mr. Stensrud noted that during robust investment earnings periods SCERS had established contingency reserves at levels greater than 1% of assets. Mr. Stensrud noted that over the years SCERS had drawn upon those reserves to address various events affecting the financial condition of the system, such as the Ventura settlement and the recent protracted period of poor investment performance. Mr. Stensrud explained that as a result of such transfers, the only funds remaining to address funding shortfalls were the funds in the Contingency Reserve.

Mr. Stensrud noted that although the 1937 Act did not require maintenance of a 1% Contingency Reserve, a reserve equal to that amount was required if a 1937 Act system wanted to provide supplemental non-vested benefits such as support for retiree health care costs. Accordingly, Mr. Stensrud noted that if the Board approved transferring the funds in the Contingency Reserve to the actuarial assets, SCERS would not be able to provide such benefits until such time as a 1% reserve was re-established. Mr. Stensrud further noted, however, that even if funds were not drawn from the Contingency Reserve, SCERS would not be able to provide such benefits until it had excess earnings, and it did not appear that SCERS would have such earnings in the forseeable future.

<u>ADMINISTRATIVE MATTERS</u>: (continued)

Mr. Stensrud noted that while caution was warranted regarding depletion of the Contingency Reserve, he believed there were compelling reasons to draw upon those funds at this time. Among other things, Mr. Stensrud submitted: (1) The current circumstances were exactly the type of situation for which the Contingency Reserve was established; and (2) Use of the funds in the Contingency Reserve would have a meaningful, positive impact on the financial condition of the system.

With respect to this latter point, Mr. Stensrud noted that transferring the funds in the Contingency Reserve to the benefit reserves would result in supplemental interest crediting in the amount of 1.2%, which would increase the interest credited for the fiscal year from 3.93% to 5.13%. Mr. Stensrud further noted that increasing the actuarial assets by $52 million would result in a reduction of .39% in the County's contribution rate, which translated into a $2.9 million annual cost saving beginning in the 2006-2007 fiscal year.

Extensive discussion followed, including consideration of whether it was advisable to retain the reserve in case there was a more substantial need for such funds in the future, and how long it might take to re-establish a contingency reserve equal to at least 1% of assets.

Mr. Hickox moved that the funds in the Contingency Reserve be applied to the benefit reserves in the form of supplemental interest crediting in the amount of 1.2% effective June 30, 2005; Seconded by Mr. Suter. Motion carried (5-1), with Ms. Wolford-Landers dissenting.

The meeting was adjourned at 4:31 p.m.

<u>MEMBERS PRESENT:</u> James A. Diepenbrock, President; Ronald Suter, 1st Vice-President; John B. Kelly, 2nd Vice President (departed at 3:37 p.m.); Members Robert Woods; William D. Johnson; Keith DeVore (departed at 3:35 p.m.); Winton Hickox; Nancy Wolford-Landers; and William Cox.

<u>MEMBERS ABSENT:</u> Mark Norris and Steven Soto

ADMINISTRATIVE MATTERS: (continued)

OTHERS PRESENT: Richard Stensrud, Chief Executive Officer; Jeffrey States, Chief Investment Officer; Kathryn Regalia, Chief Operations Officer; John Gobel, Sr., Chief Benefits Officer; Suzanne Likarich, Retirement Services Manager; Michele Bach, Supervising Deputy County Counsel; Diana Ruiz, Deputy County Counsel; Nicholas Gallucio and Delia Roges, Trust Company of the West; John Lui and Robert Prusiewicz, BNY Asset Management; Tom Lightvoet, Mercer Investment Consulting, Inc.; Michele Raymond, Senior Office Assistant; and Florence Craig, Executive Assistant.

Respectfully submitted,

SACRAMENTO COUNTY EMPLOYEES'
RETIREMENT SYSTEM

Richard Stensrud,
Chief Executive Officer

APPROVED: ________________________________
James A. Diepenbrock, President

DATE: ________________________

cc: Retirement Board (11); Clerk, Board of Supervisors (6); County Counsel (2); County Executive; Employee Organizations (21); Sacramento County Retired Employees' Association; SCERS Member Districts (11); and The Sacramento Bee.