Agenda

ND Teachers' Fund for Retirement
Special Board Meeting

Friday, August 22, 2014
1:00 pm
Peace Garden Room
State Capitol, Bismarck, ND

1. Call to Order and Approval of Agenda – Pres. Gessner (Board action)

2. Approval of Minutes of July 24, 2014 Meeting – Pres. Gessner (Board action)

3. Discussion of Legal Analysis of IRC Guidance relating to DOMA/Windsor Decision and Effect on TFFR plan - Mary Beth Braitman, Ice Miller LLP; Jan Murtha, Attorney General's Office; and Fay Kopp (Board action)

4. Annual SIB Customer Satisfaction Survey – Mike Gessner (Board action)

5. Experience Study Planning – Fay Kopp (Information)

6. Legislative Update – Fay Kopp or Shelly Schumacher (Information)

7. Adjournment

Next Board Meeting: September 25, 2014

Any person who requires an auxiliary aid or service should contact the Deputy Executive Director of the Retirement and Investment Office at 701-328-9885 at least three (3) days before the scheduled ming.

NORTH DAKOTA TEACHERS' FUND FOR RETIREMENT
MINUTES OF THE
JULY 24, 2014, BOARD MEETING

BOARD MEMBERS PRESENT:	Mike Gessner, President Clarence Corneil, Vice Chair Kirsten Baesler, State Superintendent Kim Franz, Trustee Rob Lech, Trustee Mel Olson, Trustee Kelly Schmidt, State Treasurer
STAFF PRESENT:	David Hunter, ED/CIO Richard Nagel, Sup. of Information Systems Darlene Roppel, Retirement Assistant Shelly Schumacher, Retirement Program Manager
OTHERS PRESENT:	Janilyn Murtha, Attorney General's Office

CALL TO ORDER:

Mr. Mike Gessner, President of the Teachers' Fund for Retirement (TFFR) Board of Trustees, called the board meeting to order at 1:00 p.m. on Thursday, July 24, 2014, at the State Capitol, Peace Garden Room, Bismarck, ND.

THE FOLLOWING MEMBERS WERE PRESENT REPRESENTING A QUORUM: SUPT. BAESLER, MR. CORNEIL, MRS. FRANZ, MR. GESSNER, MR. LECH, AND MR. OLSON.

APPROVAL OF AGENDA:

The Board considered the revised meeting agenda. This included the addition of information on a member's Qualified Domestic Relations Order (QDRO) litigation and the addition of the QDRO application to the Consent Agenda.

SUPT. BAESLER MOVED AND MR. CORNEIL SECONDED TO APPROVE THE REVISED AGENDA AS PRESENTED.

AYES: MR. CORNEIL, MRS. FRANZ, SUPT. BAESLER, PRESIDENT GESSNER, MR. OLSON, AND MR. LECH.
NAYS: NONE
MOTION CARRIED.

MINUTES:

The board considered the minutes of the regular TFFR board meeting held May 15, 2014.

MRS. FRANZ MOVED AND MR. OLSON SECONDED TO APPROVE THE MINUTES OF THE REGULAR TFFR BOARD MEETING HELD MAY 15, 2014.

AYES: MR. LECH, SUPT. BAESLER, MR. OLSON, MRS. FRANZ, MR. CORNEIL, AND PRESIDENT GESSNER.
NAYS: NONE
MOTION CARRIED.

TRUSTEE RE-APPOINTMENT:

President Gessner announced Governor Dalrymple has reappointed Mrs. Kim Franz to the TFFR Board for another five year term (July 1, 2014-June 30, 2019). Mrs. Franz represents active teachers on the TFFR Board.

ELECTION OF 2014-15 OFFICERS:

President Gessner opened the floor for nominations for President of the TFFR board.

MR. CORNEIL NOMINATED MR. GESSNER FOR PRESIDENT. MRS. FRANZ SECONDED THE NOMINATION.

AYES: MR. OLSON, SUPT. BAESLER, MR. LECH, MR. CORNEIL, MRS. FRANZ, AND PRESIDENT GESSNER.
NAYS: NONE
MOTION CARRIED.

President Gessner opened the floor for nominations for Vice President of the TFFR board.

MR. OLSON NOMINATED MR. CORNEIL FOR VICE PRESIDENT. SUPT. BAESLER SECONDED THE NOMINATION.

AYES: MRS. FRANZ, MR. CORNEIL, SUPT. BAESLER, MR. LECH, MR. OLSON, AND PRESIDENT GESSNER.
NAYS: NONE
MOTION CARRIED.

MRS. FRANZ MOVED AND MR. OLSON SECONDED TO REAPPOINT PRESIDENT GESSNER, ACTIVE TEACHER, MR. CORNEIL, RETIREE, AND MR. LECH, ACTIVE ADMINISTRATOR, TO REPRESENT TFFR ON THE STATE INVESTMENT BOARD (SIB).

AYES: MR. OLSON, MR. CORNEIL, MR. LECH, MRS. FRANZ, SUPT. BAESLER, AND PRESIDENT GESSNER.
NAYS: NONE
MOTION CARRIED.

Treasurer Schmidt arrived at the meeting at 1:10 p.m.

MR. LECH MOVED AND SUPT. BAESLER SECONDED TO REAPPOINT PRESIDENT GESSNER TO THE SIB AUDIT COMMITTEE AND TO APPOINT MR. OLSON AS ALTERNATE TO THE SIB.

AYES: SUPT. BAESLER, MR. LECH, MRS. FRANZ, MR. CORNEIL, MR. OLSON, TREASURER SCHMIDT, AND PRESIDENT GESSNER.
NAYS: NONE
MOTION CARRIED.

LEGISLATIVE UPDATE:

Mrs. Shelly Schumacher, Retirement Program Manager, gave an update on the interim Legislative Committees. The Legislative Employee Benefits Programs Committee has taken jurisdiction over the bill that was submitted by TFFR (Bill No. 140). It has been sent to our actuary, Segal, for technical analysis. Future meetings of the Committee are scheduled for September 18 and October 29, 2014.

Mrs. Schumacher updated the board on the Legislative Government Finance Committee that met on July 1, 2014. Their next meeting is tentatively scheduled for August 4, 2014.

The last contribution increase to complete the implementation of the 2011 funding improvement legislation became effective July 1, 2014. The employer contribution rate increased from 10.75% to 12.75% and the employee contribution rate increased from 9.75% to 11.75%. Every TFFR employer is required to complete a new Employer Payment Plan form. To date, 214 of the 216 July 2014 Employer Payment Plan forms have been received by TFFR.

Defense of Marriage Act (DOMA) UPDATE:

Mrs. Schumacher updated the board on the process used to hire outside counsel to assist TFFR, the North Dakota Public Employees Retirement System (NDPERS), and the ND Attorney General's Office with the DOMA analysis. Ms. Mary Beth Braitman and three other attorneys from IceMiller Legal Counsel have been appointed as Special Assistant Attorney Generals. IceMiller staff is currently analyzing the pension plan's statutes, rules, policies, and procedures and will present their recommendations to the TFFR Board in August 2014.

GASB 67/68 IMPLEMENTATION UPDATE:

Mrs. Schumacher reported TFFR, PERS, and the State Auditor's Office have continued to meet to develop a collaborative plan to implement the new GASB pension reporting standards and to educate pension plan employers, auditors, and other stakeholder groups. A working group meeting was held June 26, 2014, in Bismarck. Mr. Eric Berman, the Eide Bailly consultant hired by the pension plans, led the working group meeting. About 40 representatives from the State, school districts, political subdivisions, auditors, and staff from PERS, TFFR, and the State Auditor's office attended. Feedback and suggestions from the meeting will be incorporated into the full training session scheduled for later in 2014.

Mr. Berman's presentation is on file at the Retirement and Investment Office (RIO).

TFFR INVESTMENT UPDATE:

Mr. David Hunter, Executive Director/Chief Investment Officer, updated the board on TFFR investment performance, asset allocations, market returns, and the U.S. economy. He also reviewed the agenda for the July 25, 2014 State Investment Board (SIB) meeting.

FUNDING PROJECTIONS:

Mrs. Schumacher reported the estimated fiscal year end return for July 1, 2013 to June 30, 2014, is approximately 16%. Various funding projection scenarios assuming a 16% return for FY14 and 8% returns thereafter were reviewed.

SIB AUDIT COMMITTEE UPDATE:

President Gessner presented an update on the activities of the Audit Committee. The audit supervisor position has been reposted with a deadline of July 31, 2014, for submission of applications.

ANNUAL IT UPDATE AND TECHNOLOGY INITIATIVES DISCUSSION:

Mr. Rich Nagel, Supervisor of Information Services, gave the annual technology report. Since all 2011 legislative changes have been completed, implementing member web services is now the top priority. There was also discussion on future technology initiatives including the use of electronic documents for board meeting materials.

Mr. Nagel's report is on file at RIO.

MR. OLSON MOVED AND MR. LECH SECONDED TO ACCEPT THE ANNUAL TECHNOLOGY REPORT.

AYES: MRS. FRANZ, MR. CORNEIL, MR. LECH, MR. OLSON, TREASURER SCHMIDT, SUPT. BAESLER, AND PRESIDENT GESSNER.
NAYS: NONE
MOTION CARRIED.

The board recessed at 2:40 p.m. and reconvened at 2:55 p.m.

Supt. Baesler left the meeting at 2:40 p.m.

ANNUAL TFFR PROGRAM REVIEW:

Mrs. Schumacher reviewed the 2013-14 program monitoring summary, the 2013-14 board accomplishments, 2014-15 board education plan, and the

TFFR Program Manual. The board requested discussion of the timing of the Experience Study be put on the agenda of the next board meeting. Based on the board's review of the program manual, staff will bring suggested policy changes for the board's consideration to the next TFFR Board meeting. The board members completed the Code of Conduct affirmation that is required annually.

After board discussion,

TREASURER SCHMIDT MOVED AND MRS. FRANZ SECONDED TO APPROVE THE ANNUAL PROGRAM REVIEW.

AYES: TREASURER SCHMIDT, MR. CORNEIL, MR. LECH, MRS. FRANZ, MR. OLSON, AND PRESIDENT GESSNER.
NAYS: NONE
MOTION CARRIED.

ANNUAL TFFR CUSTOMER SATISFACTION REPORTS:

Mrs. Schumacher reviewed responses to the Customer Satisfaction Surveys received from North Dakota Council of Educational Leaders (NDCEL), North Dakota Retired Teachers Association (NDRTA), North Dakota School Board Association (NDSBA), and North Dakota Association of School Business Managers (NDASBM).

Mrs. Schumacher expressed appreciation to the RIO staff for doing an excellent job as is evidenced by the comments and evaluations that were given by members and business managers.

MR. OLSON MOVED AND MR. CORNEIL SECONDED TO APPROVE THE ANNUAL CUSTOMER SATISFACTION REPORTS.

AYES: TREASURER SCHMIDT, MRS. FRANZ, MR. OLSON, MR. CORNEIL, MR. LECH, AND PRESIDENT GESSNER.
NAYS: NONE
MOTION CARRIED.

The SIB has requested that the TFFR Board complete a Customer Satisfaction Survey. After discussion, it was decided to table the survey until a future board meeting.

TRUSTEE EDUCATION:

Mrs. Schumacher highlighted upcoming pension trustee educational opportunities.

MEMBER QDRO LITIGATION:

Ms. Murtha informed the board that the member QDRO litigation naming TFFR as a party to the lawsuit has now been dismissed.

CONSENT AGENDA:

TREASURER SCHMIDT MOVED AND MR. CORNEIL SECONDED TO APPROVE THE CONSENT AGENDA WHICH INCLUDES DISABILITY APPLICATION # 2014-3D AND QDRO # 2014-2Q.

AYES: MR. CORNEIL, MR. OLSON, TREASURER SCHMIDT, MR. LECH, MRS. FRANZ, AND PRESIDENT GESSNER
NAYS: NONE
MOTION CARRIED.

OTHER BUSINESS:

The next meeting will be held August 22, 2014, at 1:00 p.m., after the SIB meeting.

ADJOURNMENT:

With no further business to come before the Board, President Gessner adjourned the meeting at 3:35 p.m.

Respectfully Submitted:

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Mr. Mike Gessner, President
Teachers' Fund for Retirement Board

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Darlene Roppel
Reporting Secretary

MEMORANDUM

TO: TFFR Board

FROM: Fay Kopp & Shelly Schumacher

DATE: August 22, 2014

SUBJ: DOMA / Windsor Decision Update

The Ice Miller analysis and recommendations regarding the Windsor decision will be sent early next week.

IceMiller
LEGAL COUNSEL

MEMORANDUM

TO: **Fay Kopp, Shelly Schumacher, Jan Murtha**

CC: **Sparb Collins**

FROM: **Mary Beth Braitman, Tiffany A. Sharpley, and Malaika Caldwell**

DATE: **August 18, 2014**

RE: **North Dakota TFFR Compliance With Respect to *U.S. v. Windsor***

This Memorandum focuses on our analysis of the impact of the U.S. Supreme Court's *U.S. v. Windsor ("Windsor")* decision and Rev. Ruling 2013-17, subsequently issued by the Internal Revenue Service ("IRS") on the North Dakota Teachers' Fund for Retirement ("TFFR").

BACKGROUND ON *WINDSOR*

In *Windsor*, the Supreme Court ruled that section 3 of the Defense of Marriage Act ("DOMA") was unconstitutional. The holding by the Supreme Court provided that same-sex spouses who were married in a state that recognizes same-sex marriage as well as in states that do not, must receive the same treatment as opposite-sex spouses for purposes of federal law. The primary effect of this decision for TFFR is that for federal tax purposes, a same-sex spouse must be treated the same as an opposite-sex spouse. The Supreme Court did not address section 2 of DOMA, which allows a state to continue to decline to recognize the validity of same-sex marriages legally performed in other states for limited state purposes. This means that North Dakota can continue to distinguish same-sex spouses from opposite-sex spouses for certain benefit design purposes. In Rev. Ruling 2013-17, the IRS has taken the position that for federal tax purposes, the terms "husband and wife," "husband," "wife," "spouse," and "marriage," wherever used in the Internal Revenue Code ("Code") must be interpreted to include both same-sex spouses and same-sex marriages. In its ruling, the IRS adopted a "place of celebration" test for determining the validity of same-sex marriage for federal tax purposes.

We were asked to consider how the federal tax rules have changed in ways which impact TFFR. TFFR is required to follow federal tax law in order to maintain its status as a qualified governmental plan.

TFFR'S TAX QUALIFICATION

The primary advantages in TFFR retaining this status under Code Section 401(a) are that:

- Employer contributions are not taxable to members as they are made (or even vested); taxation only occurs when plan distributions occur;
- Earnings and income are not taxed to the trust of the member (until distribution);

- Certain favorable tax treatment may be available to members when they receive plan distributions, e.g., ability to rollover eligible distributions;

- Employers and members do not pay employment taxes (even if the positions are Social Security covered) when contributions are made or when benefits are paid.

- TFFR is currently exempt from many costly and cumbersome Employee Retirement Income Security Act of 1974 ("ERISA") nondiscrimination testing requirements;

- TFFR may "pick up" employee contributions so that they are pre-tax when made; and

- TFFR has favorable grandfathering and transitional rules under much IRS guidance.

<u>BASIS FOR OUR *WINDSOR* REPORT</u>

We prepared our Report and analysis using the North Dakota materials provided by Ms. Murtha on July 3, 2014. For TFFR, this included the following:

- North Dakota Constitution, Article X, Section 12(1);
- N.D.C.C. ("Century Code") Chapter 15-39.1;
- N.D.A.C. Article 82-05;
- AG Letter Opinion 2013-L-06; and
- N.D.C.C. Sections 14-03-01 through 14-03-08.

Our Report entailed an analysis of the impact of *Windsor* on the following TFFR plan provisions. Each of these provisions involved situations where North Dakota law provides for certain benefits or rights for spouses of members of TFFR. In each case, we were looking for scenarios in which the provision could remain as it is currently, versus when it was affected by federal tax law, and thus by the *Windsor* decision.

- Beneficiary Designation Rules;

- Plan Rollovers;

- Benefit Limitations under Code Section 415;

- Record Confidentiality;

- Survivor & Death Benefits;

- Qualified Domestic Relations Orders (QDROs); and

- Required Minimum Distributions (RMDs).

I. Areas of Immediate Compliance

During our review of these area, we broke our analysis down into three types of provisions – those governed by: (i) pure federal law; (ii) pure North Dakota state law; and (iii) a combination of both federal and state law. This review identified the need for TFFR to make few **immediate** compliance changes. However, as you may be aware, there are court cases pending in all circuits that raise certain issues that we will not address here, because these issues have not been decided by the U.S. Supreme Court. There are areas described in our review that may need to be revisited depending on the outcome of pending litigation cases. These are not discussed further in this memorandum. Our recommendations identify only those areas for the TFFR Board to consider for immediate action.

A. Rollovers

N.D.C.C § 15-39.1-20 – Withdraw from Fund. We recommend the last line of this provision be revised to remove the date at the end of the provision which appears to limit the reference to the Internal Revenue Code section regarding rollovers to a specific date and time, which could raise questions since that date predates the *Windsor* decision.

> A member or beneficiary of a member may elect, at the time and under rules adopted by the Board, to have any portion of an eligible rollover distribution paid in a direct rollover to an eligible retirement plan specified by the member or the beneficiary to the extent permitted by Section 401(a)(31) of the Internal Revenue Code ~~in effect on August 1, 2011.~~

Under the current language, all spouses would not have broad rollover rights. *Windsor* requires those broad rollover rights to be made available to same-sex spouses as of the effective date of the *Windsor* decision, as well as opposite-sex spouses.

B. Benefit Limitations

N.D.C.C § 15-39.1-10.6 – Benefit Limitations. We recommend a revision to the following provision to remove the date references, which appears to limit the reference to the Internal Revenue Code section to a specific date and time, which could raise questions since that date is after the effective date imposed by *Windsor*.

> Benefits with respect to a member participating under former chapter 15-39 or chapter 15-39.1 or 15-39.2 may not exceed the maximum benefits specified under section 415 of the Internal Revenue Code [26 U.S.C. 415] ~~in effect on August 1, 2013,~~ for governmental plans. The maximum dollar benefit applicable under section 415(b)(1)(A) of the Internal Revenue Code must reflect any increases in this amount provided under section 415(d) of the Internal Revenue Code ~~subsequent to August 1, 2013~~. . .

Windsor requires that the benefit limitations be administered to treat all spouses the same for purposes of applying these limits.

C. Required Minimum Distributions

N.D.C.C § 15-39.1-10 . . . We recommend a revision to the provision to remove the date reference, which appears to limit the reference to the Internal Revenue Code section to a specific date and time, which could raise questions since that date is after the effective date imposed by *Windsor*.

> (4) . . . payment of minimum distributions must be made in accordance with Section 401(a)(9) of the Internal Revenue Code ~~in effect on August 1, 2013,~~ and the regulations issued under that section as applicable to governmental plans.

The minimum distribution rules require distributions from a qualified plan to be made at certain times. Those times vary depending on whether the benefit is payable to a spouse or a non-spouse. *Windsor* requires that all spouses (both same-sex and opposite-sex) be treated the same for this timing issue.

ADDITIONAL COMMENTS

In addition to the immediate areas of compliance described above, we also identified several administrative tools that TFFR may want to consider revising. These include potential changes to 415 testing, tax notices, retirement and survivor forms, and QDRO forms.

MEMORANDUM

TO: **TFFR Board**

FROM: **Fay Kopp**

DATE: **August 15, 2014**

SUBJ: **Annual SIB Customer Satisfaction Survey**

At the July 24 meeting, the Board discussed the annual customer satisfaction survey sent by the SIB (copy attached) for the TFFR Board to complete.

The Board discussed:

- Who the survey was sent to - all SIB clients including TFFR, PERS, WSI, Job Service, Legacy Fund, etc.
- Intent of the survey - to measure service provided to all SIB clients from RIO staff, identify areas for improvement, and gather feedback from clients.
- Process used to complete survey – whether board members should complete the survey individually with results being compiled by Board president, and then collaborated by full board, or discussed and completed by board as a whole, or other means of completing the survey; should those TFFR trustees who also serve on SIB complete survey, etc.
- Survey ratings – what ratings mean in terms of specific, whether ratings should also include comments or explanation of rating.

The Board can continue discussion of this survey to decide how to complete it for the current year, and any suggestions for the future.

NORTH DAKOTA STATE INVESTMENT BOARD
CUSTOMER SATISFACTION SURVEY

Is the State Investment Board (SIB), through the Retirement and Investment Office (RIO) staff, providing you with quality service? Please help us measure our performance and identify areas for improvement by rating our service to you during fiscal year 2014. Circle the appropriate response and return the questionnaire in the courtesy envelope to the RIO office.

RATING FACTORS	EXCELLENT	ABOVE AVERAGE	AVERAGE	POOR
Handling of telephone calls promptly and professionally	X	X	X	X
Clarity and effectiveness of letters, reports, and presentations	X	X	X	X
Detail provided on reports	X	X	X	X
Delivery of high-quality service	X	X	X	X
Accessibility	X	X	X	X
Responsiveness	X	X	X	X
Efficiency	X	X	X	X
Knowledge of investments	X	X	X	X

HOW CAN THE SIB AND/OR RIO STAFF IMPROVE THEIR SERVICE TO YOU?

ND Teachers' Fund for Retirement

SIGNATURE ______________________ DATE ____________

Thank you for helping us to serve you better.

MEMORANDUM

TO: **TFFR Board**

FROM: **Fay Kopp**

DATE: **August 15, 2014**

SUBJ: **Experience Study Planning**

State statutes require the Board's actuary to conduct an actuarial experience study every 5 years.

NDCC 15-39.1-05.2. Board authority - Continuing appropriation.
The board:

3. *Shall arrange for actuarial and medical consultants. The board shall cause a qualified, competent actuary to be retained on a consulting basis. The actuary shall:*
   a. *Make a valuation of the liabilities and reserves of the fund and a determination of the contributions required by the fund to discharge its liabilities and pay administrative costs;*
   b. *Recommend to the board rates of employer and employee contributions required, based upon the entry age normal cost or other accepted actuarial method, to maintain the fund on an actuarial reserve basis;*
   c. Once every five years make a general investigation of the actuarial experience under the fund, including mortality, retirement, employment turnover, and other items required by the board;
   d. *Recommend actuarial tables for use in valuations and in calculating actuarial equivalent values based on the investigation provided for in subdivision c; and*
   e. *Perform other duties assigned by the board.*

In an Experience Study, the demographic and economic assumptions used by the actuary are reviewed to see if they continue to be appropriate. The actual number of member retirements, withdrawals, disabilities, and deaths are compared to the number that was expected based on the actuary's demographic assumptions. The actual investment returns and active member compensation increases are compared to the actuary's economic assumptions. If actual experience differs from the assumptions, the assumptions may need to be modified. It is important to note, that in addition to looking at past experience, expectations about the future should also be considered.

The last Experience Study was conducted by GRS for the five fiscal years 2005-2009. That report was presented to the Board in January 2010, and assumption changes incorporated into the July 1, 2010 valuation report which was delivered in October 2010.

The next Experience Study is scheduled to be conducted by Segal and include the five fiscal years 2010-2014. The Experience Study report should be delivered to the Board in the 2014-15 fiscal year, although a specific date has not yet been determined. Should Segal make any recommendations as to changes in actuarial assumptions, the Board will need to consider such recommendations, and if approved by the Board, the new assumptions should be incorporated into the 2015 valuation report.

In 2013, the TFFR Board approved a two-year contract extension with Segal for the 2013 and 2014 annual valuation reports ($40,000 each) and the 2014 Experience Study ($33,000), plus additional consulting services (GASB, legislative, administrative, etc.) at an hourly rate.

MEMORANDUM

TO: TFFR Board

FROM: Fay Kopp

DATE: August 15, 2014

SUBJ: Legislative Update – Interim Committees

Legislative Employee Benefits Programs Committee

Future Employee Benefits Programs Committee meetings are scheduled for September 18 and October 29, 2014. At the September meeting, the Committee will receive technical comments from actuaries on bills presented to the Committee (i.e. TFFR Study Bill No. 140). At the October meeting, the Committee will receive the results of the 2014 actuarial valuation report of TFFR (and PERS). An opportunity for public comment on the bills will be held at one or both of the meetings.

Legislative Government Finance Committee

The Government Finance Committee met on August 5. The Committee received an update from Gallagher & Co. on the actuarial review being conducted for the Committee on the state employee retirement plan. The Committee also reviewed a bill draft relating to changes to the PERS plan. Their next meeting will be in September.

Overview of Asset Class Definitions (New)

There are three major asset classes:

1. **Equity**
2. **Debt**
3. **Real Assets** (or Other)

Alternative Investments are often cited as the fourth major asset class, but can frequently be re-classified into one of the other three categories with some exceptions (i.e. total return strategies using debt and equity).

Equity investments represent an ownership claim on the residual assets of a company after paying off debt.

Equities should be segregated into two major sectors, Public and Private, given major differences in liquidity:

1. Public equities are generally highly liquid and *valued on a daily basis* in the financial markets. Examples include common stock (Apple, Coca-Cola or McDonalds), options and futures.
2. Private equities are generally less liquid and often *valued on a less frequent basis* (monthly or quarterly). Major private equity firms include Apollo, Bain, Blackstone, Carlyle, KKR and TPG.

Public equity markets are often sub-classified by geographic region (U.S., International or Global), market capitalization (Large, Medium or Small), investment style (core, growth or value) and level of economic development (developed or emerging markets). The top U.S. and global equity benchmarks are discussed below.

Five major U.S. equity benchmarks include the **S&P 500, Russell 1000, 2000 and 3000,** and **Dow Jones Industrial Average ("Dow")**. The **S&P 500** is based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ. The **Russell 1000** represents the highest-ranking 1,000 stocks in the Russell 3000 Index, and represents about 90% of the total market capitalization of that index. The Russell 1000 has a weighted average market capitalization of over $100 billion with a median of approximately $8 billion. The **Russell 2000 Index** is a small-cap index and represents the bottom 2,000 stocks in the Russell 3000 Index. The Russell 2000 has a weighted average market capitalization of less than $2 billion with a median of less than $1 billion. The Russell 2000 is the most common benchmark for funds that identify themselves as "small-cap", while the **S&P 500** index is used primarily for large capitalization stocks. The **Dow** is a price-weighted measure of 30 U.S. blue-chip companies. **The Dow** covers all industries with the exception of transportation and utilities, which are covered by the Dow Jones Transportation Average and Dow Jones Utility Average. While stock selection is not governed by quantitative rules, a stock typically is added to The Dow only if the company has an excellent reputation, demonstrates sustained growth and is of interest to a large number of investors. Maintaining adequate sector representation within the indices is also a consideration in the selection process.

The **MSCI All Country World Index** (or "ACWI") measures the equity market performance of developed and emerging markets and consists of 46 country indexes comprising 23 developed and 23 emerging market country indexes. The developed market countries are: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom and the United States. The emerging market countries are listed below. The **MSCI EAFE Index (Europe, Australasia, Far East)** measures the equity market performance of the developed market countries, excluding the US & Canada. The **MSCI Emerging Markets Index** measures equity market performance of emerging markets and consists of the following 23 countries: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey, and United Arab Emirates. On June 2, 2014, Greece was moved to the Emerging Markets from the Developed Markets, while Qatar and United Arab Emirates were added to the Emerging Markets.

Public equity has historically provided **high investment returns with high volatility and high liquidity when compared to Bonds or Real Assets**. Currently, many investment consultants believe that Private Equity will provide an even higher investment return than Public Equity, albeit with higher volatility and less liquidity.

Debt represents a legal obligation between a borrower and a lender for a stated period of time and rate.

Debt or "Bonds" are classified as fixed or floating depending upon whether the interest rate is derived using a fixed rate (i.e. 5%) or a floating rate (i.e. Prime + 1.00%). Duration risk within fixed income is a major driver of investment risk and return particularly for longer term securities, including U.S. Treasury bonds.

Debt is often sub-classified into investment grade (rated BBB- or better) or non-investment grade (rated less than BBB- or non-rated) or by geographic region (U.S., International, Developed Markets or Emerging Markets). Debt can be issued by governments, agencies or companies and represent general obligations of the issuer or be backed by a specified pool of assets (i.e. mortgage backed securities). Bonds serve to diversify a portfolio by offering **lower volatility** than equities along with a **lower expected return and generally high liquidity**.

Real Assets represent an ownership interest in physical assets such as real estate, infrastructure (airports, toll roads), timberland and commodities (gold, oil, wheat). Real assets are expected to provide inflation hedging characteristics in periods of unanticipated inflation and diversify a portfolio consisting of debt and equity.

Alternative Investments can include precious metals, art, antiques, and financial assets such as derivatives, commodities, private equity, distressed debt and hedge funds. Real estate and forestry are also often termed alternative. Alternatives are sometimes used as a tool to reduce overall investment risk through diversification and may offer lower correlation with traditional financial investments such as stocks and bonds, although it may be difficult to determine the current market value of the asset, may be illiquid, purchase and sales costs may be high, and there may be limited historical risk and return data, all of which makes analysis complex.

Callan's 2014 Capital Markets Expectations for Return and Risk by major asset class and sector are summarized below and helpful when comparing the projected benefits and risks of each investment class.

2014 Capital Market Expectations—Return and Risk

Summary of Callan's Long-Term Capital Market Projections (2014 – 2023)

		PROJECTED RETURN		PROJECTED RISK	
Asset Class	Index	1-Year Arithmetic	10-Year Geometric*	Standard Deviation	Projected Yield
Equities					
Broad Domestic Equity	Russell 3000	9.15%	7.60%	19.00%	2.00%
Large Cap	S&P 500	8.90%	7.50%	18.30%	2.20%
Small/Mid Cap	Russell 2500	10.15%	7.85%	22.95%	1.40%
International Equity	MSCI World ex USA	9.25%	7.50%	20.20%	3.00%
Emerging Markets Equity	MSCI Emerging Markets	11.45%	7.90%	27.95%	2.50%
Global ex-US Equity	MSCI ACWI ex USA	9.80%	7.80%	21.45%	2.90%
Fixed Income					
Defensive	Barclays Govt 1-3	2.75%	2.75%	2.25%	2.80%
Domestic Fixed	Barclays Aggregate	3.05%	3.00%	3.75%	4.00%
Long Duration	Barclays Long G/C	4.70%	4.10%	11.40%	5.50%
TIPS	Barclays TIPS	3.10%	3.00%	5.30%	4.00%
High Yield	Barclays High Yield	5.60%	5.05%	11.45%	7.00%
Non-US Fixed	Citi Non-USD World Govt	3.15%	2.75%	9.40%	3.80%
Emerging Market Debt	JMP EMBI Global Diversifiec	5.40%	4.90%	10.65%	6.40%
Other					
Real Estate	Callan Real Estate	7.35%	6.15%	16.50%	5.00%
Infrastructure	S&P Global Infrastructure	8.90%	7.35%	19.00%	3.00%
Private Equity	TR Post Venture Cap	13.55%	8.50%	33.05%	0.00%
Hedge Funds	Callan Hedge FoF	5.40%	5.10%	8.85%	0.00%
Commodities	DJ-UBS Commodity	4.65%	3.05%	18.25%	2.00%
Cash Equivalents	90-Day T-Bill	2.00%	2.00%	0.90%	2.00%
Inflation	CPI-U	2.25%	2.25%	1.50%	

Geometric returns are derived from arithmetic returns and associated risk (standard deviation).
Source: Callan Associates

The Callan Periodic Table of Investment Returns

Annual Returns for Key Indices Ranked in Order of Performance (1994–2013)

1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
MSCI EAFE 7.78%	S&P 500 Growth 38.13%	S&P 500 Growth 23.97%	S&P 500 Growth 36.52%	S&P 500 Growth 42.16%	MSCI Emerging Markets 66.42%	Russell 2000 Value 22.83%	Russell 2000 Value 14.02%	Barclays Agg 10.26%	MSCI Emerging Markets 56.28%	MSCI Emerging Markets 25.95%	MSCI Emerging Markets 34.54%	MSCI Emerging Markets 32.59%	MSCI Emerging Markets 39.78%	Barclays Agg 5.24%	MSCI Emerging Markets 79.02%	Russell 2000 Growth 29.09%	Barclays Agg 7.84%	MSCI Emerging Markets 18.63%	Russell 2000 Growth 43.30%
S&P 500 Growth 3.13%	S&P 500 37.58%	S&P 500 22.96%	S&P 500 33.36%	S&P 500 28.58%	Russell 2000 Growth 43.09%	Barclays Agg 11.63%	Barclays Agg 8.43%	Barclays Corp High Yield -1.41%	Russell 2000 Growth 48.54%	Russell 2000 Value 22.25%	MSCI EAFE 13.54%	MSCI EAFE 26.34%	MSCI EAFE 11.17%	Barclays Corp High Yield -26.16%	Barclays Corp High Yield 58.21%	Russell 2000 26.85%	Barclays Corp High Yield 4.98%	Russell 2000 Value 18.05%	Russell 2000 38.82%
S&P 500 1.32%	S&P 500 Value 36.99%	S&P 500 Value 22.00%	Russell 2000 Value 31.78%	MSCI EAFE 20.00%	S&P 500 Growth 28.24%	S&P 500 Value 6.08%	Barclays Corp High Yield 5.28%	MSCI Emerging Markets -6.00%	Russell 2000 47.25%	MSCI EAFE 20.25%	S&P 500 Value 5.82%	Russell 2000 Value 23.48%	S&P 500 Growth 9.13%	Russell 2000 Value -28.92%	Russell 2000 Growth 34.47%	Russell 2000 Value 24.50%	S&P 500 Growth 4.65%	S&P 500 Value 17.68%	Russell 2000 Value 34.52%
S&P 500 Value -0.64%	Russell 2000 Growth 31.04%	Russell 2000 Value 21.37%	S&P 500 Value 29.98%	S&P 500 Value 14.69%	MSCI EAFE 26.96%	Russell 2000 -3.02%	Russell 2000 2.49%	Russell 2000 Value -11.43%	Russell 2000 Value 46.03%	Russell 2000 18.33%	S&P 500 4.91%	S&P 500 Value 20.81%	Russell 2000 Growth 7.05%	Russell 2000 -33.79%	MSCI EAFE 31.78%	MSCI Emerging Markets 19.20%	S&P 500 2.11%	MSCI EAFE 17.32%	S&P 500 Growth 32.75%
Barclays Corp High Yield -1.03%	Russell 2000 28.45%	Russell 2000 16.49%	Russell 2000 22.36%	Barclays Agg 8.70%	Russell 2000 21.26%	Barclays Corp High Yield -5.86%	MSCI Emerging Markets -2.37%	MSCI EAFE -15.94%	MSCI EAFE 38.59%	S&P 500 Value 15.71%	Russell 2000 Value 4.71%	Russell 2000 18.37%	Barclays Agg 6.97%	S&P 500 Growth -34.92%	S&P 500 Growth 31.57%	Barclays Corp High Yield 15.12%	S&P 500 Value -0.48%	Russell 2000 16.35%	S&P 500 32.39%
Russell 2000 Value -1.54%	Russell 2000 Value 25.75%	Barclays Corp High Yield 11.35%	Russell 2000 Growth 12.95%	Barclays Corp High Yield 1.87%	S&P 500 21.04%	S&P 500 -9.11%	Russell 2000 Growth -9.23%	Russell 2000 -20.48%	S&P 500 Value 31.79%	Russell 2000 Growth 14.31%	Russell 2000 4.55%	S&P 500 15.79%	S&P 500 5.49%	S&P 500 -37.00%	Russell 2000 27.17%	S&P 500 Value 15.10%	Russell 2000 Growth -2.91%	S&P 500 16.00%	S&P 500 Value 31.99%
Russell 2000 -1.82%	Barclays Corp High Yield 19.18%	Russell 2000 Growth 11.26%	Barclays Corp High Yield 12.76%	Russell 2000 Growth 1.23%	S&P 500 Value 12.73%	MSCI EAFE -14.17%	S&P 500 Value -11.71%	S&P 500 Value -20.85%	Barclays Corp High Yield 28.97%	Barclays Corp High Yield 11.13%	Russell 2000 Growth 4.15%	Russell 2000 Growth 13.35%	S&P 500 Value 1.99%	Russell 2000 Growth -38.54%	S&P 500 26.47%	S&P 500 15.06%	Russell 2000 -4.18%	Barclays Corp High Yield 15.81%	MSCI EAFE 22.78%
Russell 2000 Growth -2.43%	Barclays Agg 18.46%	MSCI EAFE 6.05%	Barclays Agg 9.64%	Russell 2000 -2.55%	Barclays Corp High Yield 2.39%	S&P 500 Growth -22.08%	S&P 500 -11.89%	S&P 500 -22.10%	S&P 500 28.68%	S&P 500 10.88%	S&P 500 Growth 4.00%	Barclays Corp High Yield 11.85%	Barclays Corp High Yield 1.87%	S&P 500 Value -39.22%	S&P 500 Value 21.17%	S&P 500 Growth 15.05%	Russell 2000 Value -5.50%	S&P 500 Growth 14.61%	Barclays Corp High Yield 7.44%
Barclays Agg -2.92%	MSCI EAFE 11.21%	MSCI Emerging Markets 6.03%	MSCI EAFE 1.78%	Russell 2000 Value -6.45%	Barclays Agg -0.82%	Russell 2000 Growth -22.43%	S&P 500 Growth -12.73%	S&P 500 Growth -23.59%	S&P 500 Growth 25.66%	S&P 500 Growth 6.13%	Barclays Corp High Yield 2.74%	S&P 500 Growth 11.01%	Russell 2000 -1.57%	MSCI EAFE -43.38%	Russell 2000 Value 20.58%	MSCI EAFE 7.75%	MSCI EAFE -12.14%	Russell 2000 Growth 14.59%	Barclays Agg -2.02%
MSCI Emerging Markets -7.32%	MSCI Emerging Markets -5.21%	Barclays Agg 3.64%	MSCI Emerging Markets -11.59%	MSCI Emerging Markets -25.34%	Russell 2000 Value -1.49%	MSCI Emerging Markets -30.61%	MSCI EAFE -21.44%	Russell 2000 Growth -30.26%	Barclays Agg 4.10%	Barclays Agg 4.34%	Barclays Agg 2.43%	Barclays Agg 4.33%	Russell 2000 Value -9.78%	MSCI Emerging Markets -53.18%	Barclays Agg 5.93%	Barclays Agg 6.54%	MSCI Emerging Markets -18.17%	Barclays Agg 4.21%	MSCI Emerging Markets -2.27%

The Callan Periodic Table of Investment Returns conveys the strong ***case for diversification*** across asset classes (stocks vs. bonds), investment styles (growth vs. value), capitalizations (large vs. small), and equity markets (U.S. vs. international). The Table highlights the uncertainty inherent in all capital markets. Rankings change every year. Also noteworthy is the difference between absolute and relative performance, as returns for the top-performing asset class span a wide range over the past 20 years.

A printable copy of The Callan Periodic Table of Investment Returns is available on our website at ***www.callan.com***.

Callan | **Knowledge. Experience. Integrity.**

The Callan Periodic Table of Investment Returns 1994–2013

Callan's Periodic Table of Investment Returns depicts annual returns for 10 asset classes, ranked from best to worst performance for each calendar year. The asset classes are color-coded to enable easy tracking over time. We describe the well-known, industry-standard market indices that we use as proxies for each asset class in the text below.

Barclays Aggregate Bond Index (formerly the Lehman Brothers Aggregate Bond Index) includes U.S. government, corporate, and mortgage-backed securities with maturities of at least one year.

Barclays High Yield Bond Index measures the market of USD-denominated, non-investment grade, fixed-rate, taxable corporate bonds. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below, excluding emerging market debt.

MSCI EAFE is a Morgan Stanley Capital International Index that is designed to measure the performance of the developed stock markets of Europe, Australasia, and the Far East.

MSCI Emerging Markets is a Morgan Stanley Capital International Index that is designed to measure the performance of equity markets in 21 emerging countries around the world.

Russell 2000 measures the performance of small capitalization U.S. stocks. The Russell 2000 is a market-value-weighted index of the 2,000 smallest stocks in the broad-market Russell 3000 Index. These securities are traded on the NYSE, AMEX, and NASDAQ.

Russell 2000 Value and **Russell 2000 Growth** measure the performance of the growth and value styles of investing in small cap U.S. stocks. The indices are constructed by dividing the market capitalization of the Russell 2000 Index into Growth and Value indices, using style "factors" to make the assignment. The Value Index contains those Russell 2000 securities with a greater-than-average value orientation, while the Growth Index contains those securities with a greater-than-average growth orientation. Securities in the Value Index generally have lower price-to-book and price-earnings ratios than those in the Growth Index. The indices are market-capitalization-weighted. The constituent securities are not mutually exclusive.

S&P 500 measures the performance of large capitalization U.S. stocks. The S&P 500 is a market-value-weighted index of 500 stocks that are traded on the NYSE, AMEX, and NASDAQ. The weightings make each company's influence on the Index performance directly proportional to that company's market value.

S&P 500 Growth and **S&P 500 Value** measure the performance of the growth and value styles of investing in large cap U.S. stocks. The indices are constructed by dividing the market capitalization of the S&P 500 Index into Growth and Value indices, using style "factors" to make the assignment. The Value Index contains those S&P 500 securities with a greater-than-average value orientation, while the Growth Index contains those securities with a greater-than-average growth orientation. The indices are market-capitalization-weighted. The constituent securities are not mutually exclusive.

Callan

Callan was founded as an employee-owned investment consulting firm in 1973. Ever since, we have empowered institutional clients with creative, customized investment solutions that are uniquely backed by proprietary research, exclusive data, ongoing education and decision support. Today, Callan advises on more than $1.8 trillion in total assets, which makes us among the largest independently owned investment consulting firms in the U.S. We use a client-focused consulting model to serve public and private pension plan sponsors, endowments, foundations, operating funds, smaller investment consulting firms, investment managers, and financial intermediaries. For more information, please visit www.callan.com.

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Asset Class Definitions **(previously distributed to PERS Investment Subcommittee)**

Global Equity

Definition
Investment represents an ownership claim on the residual assets of a company after the discharge of all senior claims such as secured and unsecured debt.

Public Equity
Public equity is traded on a national exchange. Includes common stock, preferred stock, convertible to stock, options, warrants, futures and other derivatives on equities or composites of equities, exchange-traded funds and equity-linked notes, units and partnership shares representing ownership interests in an underlying equity investment.

Private Equity
Private equity represents equity or equity linked securities in operating companies that are not publicly traded on a stock exchange.

Types of investment strategies
- *Leveraged buyout (LBO*) – Acquisition of a company with the use of financial leverage
- *Growth capital* – Investment in mature companies looking for capital to expand, restructure, enter new markets
- *Venture capital* – Investment in typically less mature companies, for launch, early development, or expansion
- *Mezzanine* – Subordinated debt/preferred equity used to reduce amount of equity capital required to finance LBOs
- *Distressed* – Equity securities of financially stressed companies
- *Secondaries* – Investment in existing private equity assets

Types of structures
- *Direct investment* – Direct purchase of equity securities of a private company
- *Co-investments* – Investments in equity securities of a private company alongside
- the manager of a direct fund
- *Direct fund* – Pool of capital formed to make direct investments
- *Fund-of-funds* – Pool of capital formed to make investments in direct funds

Strategic Role
- High long-term real returns
- Hedge against active (pre-retirement) liabilities
- Private equity enhances total portfolio return as a tradeoff for illiquidity

Characteristics

Public Developed Markets

- Relatively high returns (long-term) as compared to fixed income and real assets
- Relatively high volatility (standard deviation of returns) as compared to fixed income and real assets
- Relatively high liquidity
- Diversification
- Historically, public developed equities exhibit high correlation with private equity and high yield bonds, moderate correlation with investment grade corporate bonds and real assets, and negative correlation with sovereign debt.
- Currency adds to volatility but can be hedged, which mutes the diversification benefits

Public Emerging Markets

- Higher expected returns due to economic growth potential
- Liquidity risk is significant, particularly in frontier markets
- High volatility, particularly in frontier markets
- Historically, public emerging equities exhibit high correlation with high yield bonds, moderate correlation with investment grade corporate bonds and real assets, and negative correlation with sovereign debt.
- FX markets not sufficiently developed to hedge currency risk
- Limited access to markets
- Market information less abundant than for developed markets
- Counterparty risk and settlement delays pronounced in frontier markets

Private Equity

- Illiquid, long-term time horizon (7-12 year closed-end partnerships)
- Quality of the managers selected is the key determinant of success
- High volatility of returns compensated by higher expected returns
- Historically, public emerging equities exhibit high correlation with high yield bonds, moderate correlation with investment grade corporate bonds and real assets, and negative correlation with sovereign debt.
- Encompasses three stages: fundraising, portfolio construction and investment, exit and return realization

Risks

Public Equity

- *Absolute risk* – Possible magnitude of price decline
- *Liability hedging risk* – Risk that assets will not increase when liabilities increase
- *Regulatory risk* – Changes may adversely affect markets
- *Tax risk* – Changes may adversely affect markets
- *Liquidity risk* – Difficulty trading securities under adverse market conditions
- *Firm specific risk* – Unique risks associated with a specific firm

- *Tracking risk* – Magnitude of performance deterioration from a benchmark
- *Time horizon* – Horizon too short to weather cycles
- *Benchmark risk* – Benchmark not appropriate proxy
- *Market risks* – Price decline
- *Currency risk* – Unanticipated changes in exchange rate between two currencies
- *Counterparty risk* – Counterparty does not live up to its contractual obligations

Private Equity

- *Liquidity risk* – Absence of liquidity and appropriate exits could significantly increase time horizon
- *Firm specific risk* – Unique risks associated with a specific firm
- *Leverage risk* – Historical excess use of leverage and current inability to secure financing may adversely affect LBOs
- *Manager selection risk* – Selecting managers that fail to deliver top performance results
- *Diversification risk* – Inability to properly diversify the portfolio by vintage year, industry groups, geography
- *Tax risk* – Changes may adversely affect markets
- *Regulatory risk* – Changes may adversely affect markets
- *Strategy risk* – Continuing applicability of investment strategy in context of capital flows
- *Market risks* – Price decline

<u>Global Fixed Income</u>

Definition

Investment represents a legal obligation between a borrower and the lender with a maturity in excess of one year. Evidence of indebtedness and securities that evidence an ownership interest in debt obligations that are issued, insured, guaranteed by, or based on the credit of the following: companies, governmental entities or agencies, banks and insurance companies. Includes agency and non-agency mortgage-backed securities, collateralized mortgage obligations, commercial mortgage-backed securities, asset-backed securities, private placements, and options, futures or other derivatives on fixed income securities or components of fixed income.

Strategic Role

- Diversification within a multi-asset class, total return portfolio
- Hedge against a long duration accrued liability
- Current income
- Non-U.S. provides hedge against unanticipated domestic inflation and diversification to U.S. assets

Characteristics

- Medium volatility asset class
- Relatively high liquidity
- Broadly diversified by market sector, quality, and maturity

- Historically, developed sovereign debt exhibits low to negative correlation with real assets and negative correlation with equities; investment grade corporate bonds exhibit moderate correlation with equities and low correlation with real assets; high yield exhibits high correlation with equities and moderate correlation with real assets.
- A large currency component exists within international fixed income returns
- Developed markets are extremely liquid. Many issues of less developed markets are also relatively liquid.

Risks
- *Duration risk* – Price volatility from a change in overall interest rates
- *Convexity risk* – Negative convexity is the risk of price declines being greater than the price increase due to interest rates moving equally up versus down
- *Default or credit risk* – The uncertainty surrounding the borrower's ability to repay its obligations
- *Structure risk* – Risk that arises from the options implicit in bonds (like call ability and sinking funds) or the rules that govern cash flow differ from expectations
- *Sector risk* – Risk of holding sectors that are in different proportions than the benchmark
- *Liquidity risk* – Cost of trading in a security which is reflected in the bid-ask spread or the cost of selling due to cash flow needs
- *Reinvestment risk* – The uncertainty surrounding future yield opportunities to invest funds which come available due to call, maturities, or coupon payments
- *Benchmark risk* – Risk of the benchmark being inappropriate
- *Yield curve risk* – Price changes induced by changes in the slope of the yield curve
- *Currency risk* – The risk of currency movements vs. the dollar for each market. Currency may contribute greatly to return and lower correlation.

Global Real Assets

Definition

Investment represents an ownership interest in real return assets that provide inflation hedging characteristics in periods of unanticipated inflation. Includes inflation-linked securities, private or public real estate equity or equity-linked investments, private or public real estate debt, infrastructure, timber, real asset mezzanine debt or equity, non-fixed assets and other opportunistic investments in real assets.

Strategic Role
- Reduces risk of composite multi-asset portfolios through diversification
- Relatively low correlations to traditional asset classes
- Can serve as a possible inflation hedge during periods of high inflation
- Provides an attractive return relative to fixed income asset class in periods of low to moderate inflation
- Infrastructure provides inflation protection as he revenues of the underlying assets are typically linked to CPI
- Potential for high returns in niche opportunities

Characteristics

Real Estate
- *Risk* – Volatility of private real estate falls between publicly-traded debt and publicly-traded equities
- *Returns* – Nominal returns are expected to fall between equities and fixed income

- *Correlation* – Expected to exhibit low to no correlation with government and investment grade corporate bonds, and moderate correlation with high yield and equities.
- *Illiquidity* – Transactions require a significantly longer period to execute than other asset classes
- *Inefficient Market* – Information affecting real estate asset valuation and market trading is not rapidly, accurately, or efficiently reflected or interpreted in its pricing

Infrastructure

- *Long life assets* – Capital intensive assets with 25 to 99 year concessions, match for liability duration
- *Inflation protection* – Revenues typically linked to CPI
- *Monopoly or quasi monopoly* – High barriers to entry due to scale and capital cost
- *Steady and predictable cash flow* – Produce strong and predictable yields
- *Low correlation* – Provides portfolio diversification, low beta; expected to exhibit low to no correlation with fixed income and equities
- *Inelastic demand* – Predictable demand with little volatility, less susceptibility to economic downturns
- *Limited commodity risk* – Not subject to commodity pricing
- *Insensitive to changes in technology* – Low risk of redundancy or technology obsolescence
- Investments are usually illiquid and involve a long (10 to 20 year) holding period

Timberland

- *Return* – Low correlation with other asset classes, returns stem from four distinct sources: biological growth, timber prices, land values and management strategy
- *Income* – Driven almost entirely by the sale of harvested mature trees
- *Correlation* – Expected to exhibit low to no correlation with government and investment grade corporate bonds, and moderate correlation with high yield and equities.
- *Appreciation* – Driven by increased volume and value on timber and appreciation of underlying land
- Categorized by type of land (e.g. plantation, natural forest), type of tree (e.g., hardwood, softwood), country and region

Commodities

- *Real assets* – Raw materials that are the physical inputs of production, relatively homogenous in nature, lending itself to be traded via contracts with standardized terms
- *Inflation protection* – Storable commodities (such as energy) directly related to the intensity of economic activity exhibit positive correlation with unexpected inflation
- *Insurance risk premium* – Commodity futures prices tend to be priced at a discount to spot prices in order to induce speculators to bear volatile commodity price risk that inventory holders and producers wish to lay off
- *Positive event risk* – Surprises that occur in the commodities markets tend to be those that unexpectedly reduce the supply of the commodity to the market, resulting in price spikes
- *Negatively correlated with financial assets* – Unlike stocks and bonds, commodities are not as directly impacted by changes in discount rates as they are by the current supply and demand of the underlying commodity, thus they should be expected to have little or even negative correlation with capital assets.

Risks

Real Estate

- *Property type risks* – Negative changes in demand/supply conditions by property type (e.g., office, industrial, retail, lodging, mixed-use, multi-family)
- *Location risks* – Local market condition relative to the adverse changes surrounding a property, or in discovery of hazardous underlying conditions, such as toxic waste
- *Tenant credit risks* – Failure by a tenant to pay what is contractually owed
- *Physical/functional obsolescence* – Negative influences on buildings due to technological changes, outdated layout and design features, and physical depreciation
- *Interest rate risk* – Higher rates can negatively impact both sales strategies and leveraged properties at refinancing
- *Reinvestment risk* – In a declining rental rate market, cash flow received may not be reinvested at the same level
- *Business cycle risk* – As economies slow down, there may be less demand for space
- *Inflationary risk* – Rent levels may not always keep up with rising operating expense levels
- *Illiquidity* – Inability to effectively liquidate a property into cash
- *Natural disaster risk* – Weather, floods, earthquake
- Regulatory concerns are critical, especially in emerging markets
- Capital and managerial intensive

Infrastructure

- *Leverage* – Deals with leverage between 40% and 80% can transform low risk assets into risky investments. Changes in the credit environment alter refinancing risk.
- *Market inefficiencies* – Competitive auctions lead to overpaying. There is a limited history and track record in the U.S. infrastructure space.
- *Political and headline risk* – Public acceptance and understanding of infrastructure needs to expand. In addition, the political landscape in every state and municipality differs.
- *Regulatory risk* – Regulated assets are subject to government changes
- *Construction and development* – Project overruns and delays should be shared with construction partners. Volume/demand risk for new developments can vary.
- *Labor issues* – Greenfield projects could generate new jobs while the privatization of brownfield assets could eliminate skilled labor members
- *Asset control* – Stipulations via concession agreements limit some management control (pricing, growth, decision approvals, etc.). Asset control needs to be appropriately priced.
- *Firm specific risk* – Unique risks are associated with specific firm

Timberland

- *Liquidity risk* – Liquidity is thin, marketplace characterized by few buyers and sellers, transactions are complicated and can take many months to execute
- *Valuation risk* – Annual appraisal process can lead to disparities between carrying value and realized sales prices during downturns
- *Physical risk* – Subject to losses from natural and human-caused events such as fire, insect and vermin infestations, disease, inclement weather, and theft

- *Political and regulatory risk* – Environmental regulations can restrain or prohibit timberland management activities
- *Leverage* – Can amplify volatility and potentially lead to an inability to refinance properties or lead to a distressed sale, requires a minimum level of generated income
- *Location risks* – Real estate dispositions may also be impacted by weakness in local residential real estate markets

Commodities

- *Price risk – C*ommodities with difficult or non-existent storage situations (heating oil, live cattle, live hogs, copper) coupled with a long-lead time between the production decision and the actual production of the commodity can lead to very volatile spot prices
- *Negative futures roll* – When the future contract's price is at a premium to the spot price, the cost to roll contracts forward is negative: an investor continuously locks in losses from the futures contracts converging to a lower spot price
- *Regulatory risk* – Concerns about the role played by investors in commodity markets could lead to new regulations impacting available investment opportunities, ultimately affecting investors' "license to invest".
- *Leverage* – A commodity futures program that is not fully collateralized (for every desired $1 in commodity futures exposure, an investor sets aside $1 in cash) can amplify volatility and potentially lead to greater losses
- *Implementation* – Because futures contracts are levered, cash management for the collateral is an important consideration due to the value

Global Alternatives

Definition

Investment has a distinct return/risk factor profile as compared to other specified broad asset class groupings. Examples: Low market exposure/absolute return strategies such as market neutral, and other niche strategies with low asset class beta such as insurance-linked investments, volatility, intellectual property, healthcare royalty, shipping, litigation finance and fine art.

Strategic Role

- More robust diversification achieved through the introduction of non-traditional return drivers/risk factors
- Low or negative correlations to other asset classes
- Return profile less dependent on economic growth and interest rates
- Potential for attractive risk-adjusted returns

Characteristics

- *Returns* – Exhibits lower correlations to broader equity and credit markets in periods of market distress
- *Illiquidity* – Transactions may require a longer period to execute than other asset classes
- *Inefficient Market* – Information affecting asset valuation and market trading may not be accurately or efficiently reflected or interpreted in its pricing

Risks

- *Market risk* – Cost of carry on being long volatility
- *Natural disaster risk* – Weather, floods, earthquake affect natural catastrophe-based insurance-linked products
- *Due diligence* – Complicated to evaluate and monitor

- *Illiquidity* – Transactions may require a longer period to execute than other asset classes
- *Implementation* – Complexity of implementation may be an impediment