EMPLOYES' RETIREMENT SYSTEM OF THE CITY OF MILWAUKEE
ANNUITY AND PENSION BOARD

Minutes of the Investment Committee Meeting
held March 20, 2008

The meeting was called to order at 9:13 a.m.

Committee Members Present:	John Barmore Thomas Fischer Larry Holland Michael J. Murphy, Chair
Committee Members Not Present:	William C. Carey (excused) W. Martin Morics (John Egan arrived later in meeting) Sebastian Raclaw (excused) Ron Walter (excused)
Retirement Staff Present:	Bernard J. Allen, Executive Director Martin Matson, Deputy Director Tom Rick, Chief Investment Officer David Silber, Pension Investment Analyst Bruce Thomas, Pension Investment Analyst Suzanne Fortier, Board Stenographer

Others Present: Patty Schneider and Eric Friedman, Mercer Investment Consulting; Beth Cleary, City Attorney's Office; Rob Kochis and Tony Pietro, Townsend Group; Pam Newton and Don Anderson, Northern Trust; and Mark Egan and Todd Thompson, Reams Asset Management.

Due to the lack of a quorum, the meeting convened as a sub-committee.

Election of Vice-Chair. Mr. Murphy indicated this would be held until a quorum is present.

Investment Manager Presentations.

The Townsend Group. As a matter of information, Committee members received a presentation booklet, Real Estate Overview and Portfolio Update. Mr. Rick handed out an updated performance chart. Mr. Silber reported that Townsend has been a consultant for the Fund since 1993, and a discretionary manager since 1996. He noted the estimated preliminary year end numbers for the real estate portfolio was worth $373 million, representing 7.2 percent of the Fund's assets. There is still one separately managed property within the Portfolio, but the rest of the investments are broken out between commingled and limited partnership strategies. Mr. Silber reported that strategies include core (>60 percent), value-added and opportunistic (<40 percent), allowing for 20 percent of the 40 percent being international. He noted that the year-end estimate shows 6.9 percent of the real estate assets are in international real estate. Mr. Silber stated that the 10 year performance has been very solid, outperforming its benchmark for most time periods. In 2007 the estimate is that real estate did underperform the benchmark, but still returned a solid 15.1 percent.

Mr. Kochis said that real estate has been in the headlines, primarily due to the housing industry in the U.S. He stated that ERS has some exposure to residential investments, but by and large, ERS is not invested in housing. What ERS is invested in are office buildings, retail plazas, apartment complexes and industrial complexes. Mr. Kochis noted that Townsend feels that commercial real estate is in for a rough year in 2008, but not as badly as the U.S. housing market. Mr. Rick asked Mr. Kochis what Townsend attributes to ERS' outperformance. He said that Townsend is pleased that ERS has been firing on all cylinders, with 23 funded investment accounts with approximately 16 different managers. Mr. Kochis indicated Townsend transitioned the foundation of ERS' program to open end funds, which are large pools of properties, typically more than a 100 properties in the $4 to $10 billion range in terms of the total value of that real estate. ERS also has the ability to move money in and out of those vehicles to get immediate exposure. He said that on top of that, ERS' program has always had a small part that is targeted at more tactical strategies that are designed to take more risk, but also generate higher returns.

(Mr. Egan arrived at 9:23 a.m.)

The meeting convened as an Investment Committee meeting at 9:23 a.m.

Mr. Kochis stated the housing sub prime debacle for residential mortgages in the U.S. is in a meltdown situation and that affects broader credit markets worldwide. He indicated that commercial real estate lags the U.S. economy so it looks healthy right now, but if the overall economy slides into a recession, that is going to affect commercial real estate. Brief discussion ensued. Mr. Kochis said that looking at the markets today the capital markets are clearly signaling that we are in for a correction in the commercial real estate values, but fundamentally, commercial real estate is relatively strong. Capital markets determine pricing and pricing of risk; fundamentals relate to building occupancy and rental income. Mr. Kochis said that right now there is a disconnect between the capital markets and the fundamentals because the economy has been going relatively well for the last few years, and that has driven rents and occupancies up so owners of commercial buildings today are satisfied with their income growth. He noted that the way the capital market prices risk is changing, which will affect values. Mr. Kochis talked about public real estate securities, capitalization rates by property type; and real estate debt (U.S.). He also talked about the commercial real estate supply and demand.

Mr. Kochis discussed the commercial property performance stating that there has been one period of time in our modern history of real estate, 1991-1993, where there were negative returns in the overall market in commercial real estate. He said the challenge right now is which factors will prevail: will capital market impacts swamp fundamentals or will fundamentals, supply/demand balance and income growth, outweigh the capital market declines in value in real estate. Mr. Kochis indicated that Townsend projects overall property values to decline by 5 to 15 percent in commercial real estate, but the growth that is built into the market right now should make up for the declining values. Townsend is expecting this to be a low-single digit year in real estate, maybe zero or 1 or 2 percent negative, but low-single digit returns for 2008 are mostly likely.

Mr. Murphy indicated that we were going to lose the quorum shortly and there were action items that needed to be taken up at this time. He stated the Committee would then go back to Townsend's presentation.

Election of Vice-Chair. Mr. Murphy asked for nominations for Vice-Chair. It was moved by Mr. Fisher and seconded by Mr. Holland, to nominate Mr. Barmore. Mr. Murphy asked three more times if there were any further nomination. There being no further nominations, nominations were closed and a unanimous vote was cast for Mr. Barmore as Vice-Chair.

Approval of GTA Transaction Cost Analysis Contract. As a matter of information, Committee members received copies of a Memorandum from Mr. Silber, dated March 12, 2008; a copy of the Contract for Services; a Statement of Work and Estimate, Exhibit A; and a Trading Cost Analysis Vendor Questions. Mr. Silber briefly talked about the contract, which was reviewed by the City Attorney's Office. It was moved by Mr. Fischer, seconded by Mr. Barmore, and unanimously carried, to approve the contract contingent on GTA providing the required Certificates of Insurance.

Approval of William Blair Guideline Change. As a matter of information, Committee members received copies of a memorandum from Mr. Thomas, dated March 13, 2008; a letter from Mercer, dated March 20, 2008 and a letter from William Blair, dated February 6, 2008. Mr. Rick reported that William Blair has requested modification of their guidelines, specifically relating to their exposures to emerging markets. He indicated that staff and Mercer are recommending that the exposure be increased from a 25 percent limit up to 35 percent. William Blair originally requested 35 percent or twice the benchmark weighting, but staff believes that the benchmark weight could increase to the point where the portfolio risk/return profile is substantially affected. Mr. Rick noted that when ERS originally hired Blair, they were hired as an International All Cap Growth manager, with the ability to look at emerging markets on an opportunistic basis, and ERS believes that 35 percent gives Blair that opportunity. He said that on behalf of Mercer and ERS staff, we recommend the increase to 35 percent of emerging market opportunities. Mr. Barmore said he felt that ERS should replace the 35 percent to 1.50 times the market weighting, which would currently be 30 percent. He explained his concerns about a 35 percent limit. After discussion, it was moved by Mr. Barmore, seconded by Mr. Fischer, and unanimously carried, to approve a change to Blair's guidelines for 1.5 times the benchmark weighting, not to exceed 35 percent.

(Mr. Fischer and Mr. Egan left the meeting at 10:20 a.m.)

The meeting convened as a sub-committee meeting at 10:20 a.m.

Mr. Murphy apologized to Townsend for the interruption and directed them to continue their presentation. Looking at page 21, Mr. Pietro talked about continued opportunities such as putting ERS in a debt fund. Another opportunity is value added and development which would capture growth in the rents and occupancies. He also indicated that the apartment sector looks pretty promising right now with people moving out of houses due to foreclosures. Mr. Pietro stated that these are the ideas that Townsend is going to focus on, as well as global opportunities as they become available. He briefly talked about ERS' portfolio composition and target allocation. Mr. Kochis indicated that ERS has almost $71 million of unfunded commitments that have not yet been invested. He said managers are ready to pursue opportunities they see due to the distress in the market. Townsend believes this is a good position to be in. He noted they are watching it carefully, but Townsend thinks there is probably room to make one or two more investments this year. Mr. Kochis indicated that for the first six months of 2008, Townsend is basically holding steady for now as the market is too volatile. Discussion ensued throughout the presentation.

Northern Trust Securities Lending Educational Session. As a matter of information, Committee members received a presentation booklet, dated March 20, 2008. Mr. Rick indicated that the Committee previously requested an educational session regarding Securities Lending. Ms. Newton and Mr. Anderson are present from Northern Trust. Ms. Newton stated that Mr. Anderson works in the public fund arena with Securities Lending and that is his sole focus. She said that despite negative media reports about the banking industry, Northern has avoided controversy, which is their goal. She stated that Northern is a conservative organization, and Mr. Anderson's presentation will confirm this applies to Securities Lending. Ms. Newton said Northern looks at Securities Lending as a value added product, and something that consistently earns ERS additional revenue.

Mr. Anderson said that Northern Trust acts as ERS' agent to work with borrowers as ERS has securities available that someone else wants. He said the reason ERS lends is the opportunity to increase yield and add additional income. As far as why borrowers want to borrow, Mr. Anderson stated this would help borrowers in a settlement process, help cover short sales, and perhaps some arbitrage opportunities, mainly dividend arbitrage with international equities. He noted ERS is subject to a withholding tax on certain international equities. However, the borrowers do not have to pay that withholding tax, so they are willing to pay up to borrow ERS' securities. He gave an example that if there is a 15 percent withholding tax, the borrower might be willing to pay 14 percent of that to Northern and ERS just for the benefit that one percent. Mr. Anderson explained the securities lending process with the lender and gave an example of how revenue is generated. He indicated Northern's Securities Lending program has 664 participating clients, $1.1 trillion in lendable securities, and has $260 billion in loans outstanding. Mr. Anderson also mentioned this program has a distribution network in 49 worldwide markets, 24-hour trading, and work with 46 approved counterparties with electronic links to all major borrowers. Northern manages $269.5 billion in cash and non-cash collateral, with about $380 billion in the short duration group. He briefly talked about industry topics; the risk management framework; the current profile of borrowers; and provided a historical earnings and earnings performance comparing 2007 versus 2006. Mr. Anderson reported that from 2000 to 2007 ERS earned about $9.2 million through securities lending. Discussion ensued throughout the presentation.

Mr. Murphy called for a short break at 11:00 a.m. The sub-committee reconvened at 11:10 a.m.

Reams Asset Management CDS Presentation: Consideration and Approval of a Change to Investment Guidelines. As a matter of information, Committee members received a presentation booklet, Credit Derivatives Overview. Mr. Egan indicated that Reams met with the Committee previously and talked about a few things Reams would like included in their guidelines, one of which is to make ERS' portfolio look like the rest of the portfolios they manage. He stated the three things talked about were increasing the amount of mortgages to be held in the portfolio from 60 percent to 80 percent; use of the Columbus Extended Market Fund, and the use of credit derivatives. He said credit derivatives are an increasingly large part of the market. Reams finds it to be a very cost effective, efficient way to do the things they do in a cash portfolio, and they have been using and having great success with these products within their portfolios for about four years.

Mr. Thompson talked about what he calls the first generation instrument, which is a single name CDS, or credit default swap, on a single name entity, example IBM. He explained that credit default swaps originated in European markets which are much more developed than the U.S. in regard to the whole concept of swaps. Also that a CDS is tantamount to writing an insurance contract. Discussion ensued. Mr. Egan said over the next several years it is going to be increasingly difficult for investors in the fixed income universe to not utilize these products. Right now about 75 percent of Reams' client base allows the use of these products, which is not an abnormally high number. Mr. Thompson said these products came out in the late 1990s, and have become more standardized in the last six years.

Mr. Murphy asked about measuring risk, how confident is Reams in being able to measure that? Mr. Egan said the confidence is very high because there is no difference between $1 million of credit exposure, using an example of GM in a CDS contract, or $1 million of buying GM long bonds. He indicated it is more efficient to use the cash bonds. What Reams uses CDS for is primarily market baskets where they can buy index products, assemble a portfolio of 100 or 200 names, or use an index product based on CDS to replicate a basket of 100 or 125 names. This permits insignificant single issue exposure, which Reams likes because the risk/reward tradeoff is enhanced. Also the transaction costs of doing that are nearly treasury like, even in the difficult markets we are seeing now. Mr. Egan stated that you get incredible execution costs, incredible diversification, and lack of idiosyncratic risk. Mr. Thompson said as part of the standardization process the dealer community has come together and said that every six months they are going to reset these indexes. Mr. Egan said for example, yesterday the investment grade market has been extremely volatile, we are at all time highs just a week ago with a big rally because of what the Feds have done. So for Reams, and other portfolios that can do it, they had put on the S&P 500 of the investment grade universe at spread levels that were much wider than today and after getting together and looking at the risk of the portfolio, they liquidated $200 million of exposure across portfolios for virtually no cost and it was done instantaneously. He said to do that across a basket of bonds would have been almost impossible. Taking their corporate exposure down 2 percent across the board can be done in an incredibly efficient way. Lengthy Discussion ensued throughout the presentation.

Mercer Asset Liability Study. As a matter of information, Committee members received a copy of a presentation booklet, "Asset Liability Modeling Study", dated March 20, 2008. Ms. Schneider began the presentation discussing the Bear Stearns issue and how that impacts Mercer client's portfolios. Mr. Friedman proceeded to walk the sub-committee through the presentation giving a brief overview of the investment strategy process.

Due to a technical malfunction, the recording of the sub-committee meeting was incomplete. Please note the Mercer Asset Liability Study will be taken up at a Special Investment Committee meeting.

The meeting adjourned at 12:38 p.m.

Bernard J. Allen
Secretary and Executive Director

(**NOTE:** All proceedings of the Annuity and Pension Board Meetings and related Committee Meetings are recorded. All recordings and material mentioned herein are on file in the office of the Employes' Retirement System, 789 N. Water Street, Suite 300.)