

**MINUTES OF THE REGULAR MEETING OF THE BOARD OF TRUSTEES
ARKANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM
FEBRUARY 15, 2012**

The regular quarterly meeting of the Board of Trustees of the Arkansas Public Employees Retirement System was held on Wednesday, February 15, 2012 at 9:00 a.m., in the Conference Room, 124 West Capitol, Little Rock, Arkansas. Mr. Artee Williams presided.

QUORUM PRESENT:

Mr. Williams recognized the presence of a quorum.

BOARD MEMBERS PRESENT:

Mr. Artee Williams (State Employee Member), *Chair*, Director, Dept. of Workforce Services
Ms. Ouida Wright (State Employee Member), Conway, AR
Judge Mike Jacobs (County Employee), Clarksville, AR
Mr. Bill Gaddy (State Employee Member), Little Rock, AR
Ms. Carol Bevis, (Other, Non-State Employee), Little Rock, AR (*left during lunch*)
Ms. Janet Harris, Deputy State Auditor (*proxy*)
Dr. John Shelnett, Dept. of Finance and Administration (*proxy*)
Ms. Gail H. Stone (Executive Director), APERS

BOARD MEMBERS ABSENT:

Hon. Richard Weiss (Ex-Officio Member), Dept. of Finance and Administration
Hon. Charlie Daniels (Ex-Officio Member), State Auditor
Hon. Martha Shoffner (Ex-Officio Member), State Treasurer
Mayor Steve Northcutt (City Employee), Malvern, AR

VISITORS PRESENT:

Mr. Kevin Dolsen, Callan Associates, Inc.
Mr. Ryan Ball, Callan Associates, Inc.
Mr. Michael Travaglini – Grosvenor Capital Management
Mr. David Richter – Grosvenor Capital Management
Ms. Jennifer Stack – Grosvenor Capital Management
Ms. Chris Burk, National Timber Partners
Ms. Josie Hart, National Timber Partners
Mr. Marc Watts, Arkansas State Employee Association
Mr. Chris Klapse, Arkansas State Employee Association
Mr. Matt Twyford, Arkansas State Employee Association
Ms. Kim Mullen, Office of the Governor
Mr. Scott Perkins, Association of Arkansas Counties
Ms. Karen Holliday, Bureau of Legislative Research
Mr. Paul Young, Arkansas Municipal League
Ms. Kay Killgore, Arkansas Parks and Tourism (*left during lunch*)
Mr. Mike Creekmore, State Treasurer's Office (*arrived after lunch*)
Hon. Roger Smith, F.O.P/ District Judge Lobbyist (*arrived after lunch*)

STAFF PRESENT:

Ms. Michele Williams, APERS Deputy Director
Mr. Carlos Borromeo, APERS Chief Investment Officer
Mr. Jay Wills, APERS Attorney Specialist
Mr. Craig Blackard, APERS Internal Auditor
Ms. Becky Walker, APERS Administrative Service Manager
Mr. Bill Dull, APERS Chief Fiscal Officer
Ms. Jacobia Twiggs, APERS Retirement Section Manager
Ms. Linda McGrath, APERS Administrative Specialist

NEWS MEDIA NOTIFIED:

A letter of notification of the Arkansas Public Employees Retirement System Board meeting was sent to the Arkansas Democrat-Gazette, the Associated Press, Television Station KLRT/FOX16, Radio Station KARN, and Radio Station KAAY. This letter of notification is pursuant to A.C.A 25-19-101 (Act 93 of 1967) as amended-The Freedom of Information Act.

MINUTES:

Prior to the Board meeting, a copy of the Minutes from the meeting of October 24, 2011 were mailed to each APERS Board member for review. On a motion made by Judge Jacobs and seconded by Mr. Gaddy, the October Minutes were approved as presented.

CAROL BEVIS APPOINTMENT:

Mr. Williams stated that Ms. Bevis' term would officially expire on March 9, 2012. Ms. Bevis was filling the unexpired term of Mr. Maurice Henry. Mr. Gaddy motioned for Staff to send a letter to the Governor requesting that Ms. Bevis be reappointed to the APERS' Board. He was seconded by Ms. Wright and the motion passed unanimously.

MR. MAURICE HENRY RESOLUTION:

Mr. Williams noted that the Board needed to send a resolution to Mr. Henry recognizing his years of dedicated service to APERS. Mr. Gaddy motioned for such a resolution to be crafted and sent to Mr. Henry and was seconded by Ms. Wright seconded. The motion was passed unanimously.

DROP INTEREST RATE FOR FISCAL YEAR 2013:

Ms Stone asked if the discussion for the DROP interest rate could be moved up on the agenda as Ms. Bevis had to leave early. She reminded the Board that during the previous year, the Board had adopted a regulation to set the DROP interest rate at each February Board meeting as per §24-4-803(c) *The interest on contributions to the member's deferred option account shall be credited to the individual account balance of the member on an annual basis at the end of each fiscal year. The board shall determine the rate of interest to be credited to each member's deferred option account.* Any changes the Board voted on would take effect on July 1, 2012.

She distributed a graph that showed the rates of return on 10-year Treasury Notes for the last 15 years. Ms. Stone pointed out that in 1997 the prevailing rate was 7%; however the current rate of return is 1.926%. Currently, APERS members in the DROP earn 3%, which is significantly above market rate. Staff recommended the Board maintain that rate.

Judge Jacobs motioned to maintain the 3% DROP Interest rate for Fiscal Year 2013 and Ms. Wright seconded. Mr. Gaddy noted that when the Board had set the DROP Interest Rate to 3%, 10-year Treasury Notes were paying 3% and asked why APERS would want to be above the Market Rate. Dr. Shelnutt stated that the Federal Reserve had pledged to keep interest rates low until 2014 and that APERS investment had only earned 0.68% for Calendar Year 2011. Mr. Gaddy stated that in light of lack of increases in salaries for Elected Officials and Public Employees he wanted to proceed cautiously. He felt that with a 2.2% Consumer Price Index for 2011, that a 2.5% DROP Interest Rate was more reasonable. Dr. Shelnutt agreed that 2.5% was appropriate in light of the current economics and expected drift upwards in the employer contribution rate.

Judge Jacobs withdrew his motion and Ms. Wright withdrew her second.

When asked, Ms. Stone stated that Teachers (ATRS) was still paying out 6% on their DROP accounts, Local Police & Fire (LOPFI) was statutorily set at 6%, State Police (ASPRS) is at 3.25% and Highway (ASHERS) was either 5 or 6%. Ms Wright pointed out that APERS members enjoyed a 6% rate for a number of years and many members accepted it as a given. When the rate was lowered to 3%, it came as a big shock to many people. She recalled 15 years previously, when she was given her 7-year DROP estimate and how that number was fixed in her mind. Ms. Wright wanted to make sure that all members going into the DROP were made aware that the "estimate" they were given, might not be the amount they actually received if the interest rate changed. She stated that dropping the interest rate from 6% to 3% last year had knocked the legs out from many members, and felt strongly it should not be lowered at this time.

Mr. Gaddy acknowledged there was a tendency towards "selective hearing" when people attended pre-retirement counseling, but believed Staff never represented it as a guaranteed rate. He felt it was important for the Board to be realistic and conservative when setting the DROP Interest and thought someone should take the lead among the state retirement systems. Mr. Gaddy motioned to set the DROP Interest Rate at 2.5% and was seconded by Dr. Shelnutt. Motion carried. (5:1 – Ms. Wright)

QUARTERLY REPORT FOR THE PERIOD ENDING SEPTEMBER 30, 2011 - Presented by Mr. Kevin Dolsen and Mr. Ryan Ball of Callan Associates, Inc.

Mr. Dolsen noted that 2011 was a year of significant global events. Political upheaval in the Middle East; a terrible earthquake and tsunami in Japan; a debt crisis that threatens the world's largest economic union; US political gridlock that seems to drown out most reasonable voices; S&P downgrades on the sovereign debt of nine developed countries and warnings on five others. Additionally, the blowup of investment bank MF Global, blamed on 40-1 leverage utilizing client capital invested in European sovereign debt, resulted in the 7th largest bankruptcy in US history. With that as a backdrop, the US stock market went exactly nowhere and closed with the smallest annual price change since 1947 (0.04%).

APERS portfolio did fairly well over the most recent quarter returning 7.76%, well ahead of the benchmark's 6.93%. This return ranks the Fund in the top 5% of its peers. All three managers in the Fixed Income portfolio outperformed the BC Aggregate. Their relatively low exposure to Treasuries was the primary contributor to their outperformance; this was a complete reversal of the third quarter. High yield exposure was the biggest positive in each of the portfolios. While the 2011 calendar year was disappointing, the longer time periods show the APERS fixed income portfolio leading the BC Aggregate.

International Equity underperformed domestic equities during the fourth quarter and is trailing by over 13% for the one-year period. Artisan again posted the strongest performance among international equity managers with a 7.70% return. The APERS International equity composite has outperformed the benchmark in every time period.

Mr. Dolsen directed the Board's attention to the newly reorganized Asset Allocation that was approved at the November meeting.

Domestic Equity: Actual Allocation 46.4%

CastleArk
Golden Capital
Horrell Capital – Passive
Horrell Capital – Active
INTECH
INVESCO
Lazard Asset Mgmt.
Lombardia Capital
Mellon S&P 500 Index Fund
SSgA Index Plus
SSI Investment Mgmt.
Stephens Investment Mgmt.
Wellington Equity
Westwood

Diversified Strategies: Actual Allocation 1.85%

AQR Capital
Newton Capital

Domestic Fixed Income: Actual Allocation 21.56%

MacKay Shields
Pareto Partners
Prudential Global

International Equity: Actual Allocation 15.47%

Artisan Partners
Lazard Asset
Manning & Napier Advisors
Pyramis Global Advisors
UBS Global AM

Real Assets: Actual Allocation 14.6%

CastleArk AR Energy Fund
CastleArk Global Energy Fund
INVESCO Real Estate
INVESCO Global REITS
National Timber
Pinnacle

The Actual Asset Allocation is very close to the Target Allocation; no rebalancing is necessary.

- **UBS Global (All Cap):** strategy outperformed the MSCI EAFE Index by almost 1.4 basis points and ranked at the 19th percentile of Callan's Core Growth International Equity Style Group. Performance is worse over the one- and two-year time periods, where the portfolio trails the benchmark and median manager. This is the portfolio's most aggressive International manager and subsequently, the most volatile. Economics in Europe and Japan are pretty challenged right now, so Callan is keeping track if it is a problem with the manager or the market.
- **INVESCO (Domestic Equity):** third quarter return of 12.64% above the S&P 500 Index by 82 basis points. Relative returns and rankings have been volatile over longer time periods. Mr. Dolsen outlined more organizational changes to the organization that had taken place and reminded the Trustees that when Golden had been added to the portfolio (through the ASPRS portfolio), the Board had suggested to let the two managers go head to head. Callan felt that Golden had proven itself to be the superior product and now would be a good time in the market cycle to let INVESCO go and distribute their assets pro rata.

Mr. Gaddy motioned to terminate INVESCO (Domestic Equity) and spread the assets across APERS underweight managers. Judge Jacobs seconded and the motion passed.

- AQR and Newton Capital: APERS' newest managers have both been performing well and are off to a good start. Currently, Callan is very pleased with their steady, upwards progress.

Dr. Shelnett asked how much the SSi portfolio lost on the bankrupt MF Global investment and Ms. Stone estimated that through the two convertible notes the amount was just shy of \$1 million, but she noted they had both been sold before the bankruptcy so APERS was not stuck with a defaulted security. Ms. Stone noted that this manager had been added to the domestic equity portfolio as "ballast", as well as offering protection during down markets.

- INTECH: announced that Jennifer Young, President and Co-CEO, and Adrian Banner, Co-CIO, will succeed Robert Garvy and Robert Fernholz as Chairman and CEO, and CIO, respectively, effective December 31, 2011. Garvy and Fernholz have signed consulting agreements with INTECH through December 31, 2014.

Real Estate Search Update

After careful evaluation, Callan had winnowed the potential candidates down from fifteen to four Value-Added Real Estate managers. It was their recommendation that APERS select two managers and give each an initial funding of \$30 million. The four semi-finalists were:

- AEW Capital
- CBRE Global
- LaSalle Investment
- TA Realty

Mr. Ball discussed how these managers differed from the other Real Estate managers that APERS was familiar with and how they utilized entrance and exit queues for their investors. After a short discussion on how the Board wished to proceed, Ms Wright commented that traditionally all the semi-finalists would present before the Trustees and the Board would make their final selection. Mr. Ball cautioned that Value-added real Estate tended to be rather technical and he wanted to make sure the Board was very comfortable with their choices. Ms. Stone noted that a special meeting would need to be scheduled to hear the presentations and she would contact everyone later to find a mutually agreeable date in April.

Mr. Gaddy asked for a timeline on investing in the Value-Added Real Estate and if there was a need to decide before the regular May meeting. Mr. Dolsen pointed out that as the timber portfolio is harvested, it was important to have another investment lined up to reinvest those monies so as to stay fully vested in the Real Assets portion of the portfolio. He felt this required for the Board to begin to moving in that direction sooner rather than later. Also if the Board waited too long, some of these funds might be closed to new investors.

Draft Guideline Approval – Lombardia

Each APERS money manager is given a set of guidelines that details how they would be measured and what the Board expects from them in regards to reporting. Ms. Stone distributed three copies of the investment guidelines to the Trustees for their approval. She noted that since Newton and AQR were co-mingled funds, so the Board had little say in most of their reporting, however Lombardia, as a separately managed account, needed a ratifying vote from the Board before Staff could implement their guidelines. As a side note, Ms. Stone noted that Lombardia had been originally funded with \$90 million back in September 2011 and the portfolio was currently valued at \$115 million, so they were doing quite well.

Judge Jacobs motioned to adopt the guidelines and was seconded by Ms. Harris. Motion passed.

Renewal of Professional Service Contracts

Ms. Stone distributed a page with the proposed contract limits and explained the formula, which uses generous Capital Market assumptions to project asset growth, for calculating the projected fees for each manager. After a short discussion, Ms. Wright motioned to ratify the estimated

manager fees (with the just terminated INVESCO deleted) and professional service contracts through Fiscal Year 2013. She was seconded by Ms. Bevis and the motion carried unanimously.

Quarterly Report Distribution

Ms. Stone confirmed with each Trustee that they were currently getting an electronic version of the Callan Quarterly Report. She queried everyone on if and how they wanted to receive the quarterly reports from the various individual managers.

HEDGE FUND OF FUND DISCUSSION WITH MR. MICHAEL TRAVAGLINI, MR. DAVID RICHTER & MS. JENNIFER STACK:

Mr. Ball and Ms. Stone gave a brief background of Mr. Travaglini highlighting his history on both sides of the pension board table, before turning the presentation over to the three speakers from Grosvenor Capital Management. The colleagues provided an in-depth educational discussion on Hedge Funds, specifically Fund-of-Funds and how they could be utilized by APERS. Walking the Board through the provided booklet, they detailed such areas as: the history of Hedge Funds, Strategies, the Hedge Fund Myth vs. Reality, Fund of Funds, Absolute Returns, Why Hedge Funds Now and the historical returns of various Hedge Fund categories.

The Grosvenor people answered a variety of questions from the Board ranging from transparency, due-diligence and fees to unintentional sector overweighting (i.e. energy).

(Ms. Bevis left at this time.)

LUNCH:

HEDGE FUND OF FUND DISCUSSION continued:

Ms. Stone explained that by investing in a Fund-of-Funds it actually helps mitigate some of the risk in the APERS portfolio. Currently, the portfolio is subject to huge swings in the market due to its large equity portion, coupled with the historically low Fixed Income returns, which makes it imperative for the Board to seek ways to take risk off the table. Hedge Funds, in general, have a 7.1 standard deviation while at the same time stocks have a 15.1 standard deviation. She noted that this diversification would mitigate much of the volatility currently found in the APERS portfolio without adding any risk.

Ms. Stone opined if APERS planned to get into a Fund of Funds by the end of the calendar year 2012, the Board would need to continue with its research and recommended they think about utilizing a "Fund-of-One" to avoid excessive energy exposure. Dr. Shelnett asked where the money to fund this allocation might come from and Ms. Stone re-distributed a handout showing the asset migration the Board had previously approved with approximately \$180 million (~3% of the APERS portfolio) being moved into Diversified Strategies portfolio. At the present time, approximately half of the state PERS utilize some sort of Hedge Fund investment. After further discussion on fees and the Board's comfort level, she suggested that the Trustees might be interested in hearing another presentation featuring the downside of Hedge Funds from a Callan representative, this could be done the same day as the Value-added Real Estate presentations. The Board agreed this was a good plan of action.

Judge Jacobs motioned to hear the a Callan representative at the same time at the same time in April as the Real Estate Managers presentation and if the Trustees still wanted to go ahead with the Fund of Fund manager interviews, they could be held during the regular May meeting. He was seconded by Ms. Harris and the motion carried.

SUMMARY OF RETIREES FOR DECEMBER 2011, JANUARY & FEBRUARY 2012 :

Ms. Stone noted that APERS was retiring an average of 1200-1300 people annually and that number was steadily increasing. She expected that number to reach 1400 for the upcoming year.

MEDICAL REVIEW BOARD RECOMMENDATIONS:

The Medical Review Board met at 10:00 a.m. on Tuesday, February 7, 2012 in the APERS Library to discuss the case of Ms. Cleo M. Abernathy.

- After review and discussion, the Medical Review Board recommended the denial of disability retirement for Ms. Cleo Abernathy at this time, pending further information.

On a motion made by Mr. Gaddy and seconded by Ms. Wright, the Trustees to table the request until further information could be provided to the Medical Review Board. Motion carried

FINANCIAL STATEMENTS FOR THE QUARTER ENDING DECEMBER 31, 2011:

Ms. Stone noted that the assets were growing slowly, and as of February 14, 2012 the fund had a market value of \$5.96 billion. This was very close to the peak the portfolio had previously attained before the markets fell in 2008. In the first 6 months of the Fiscal Year, APERS has paid out \$182.8 million to its members and is on track to distribute \$395 million for FY 2012. This will be an all-time high payout for one year.

OTHER BUSINESS:

Annual Approval for Board Travel Reimbursements

Ms. Stone explained that according to ACA §25-16-902 during the first meeting of each calendar year, the Board will establish travel reimbursement rates for Trustees performing official Board duties for the calendar year of 2012. This is currently set at 42 cents per mile. Judge Jacobs motioned to approve reimbursement for travel under the state's guidelines. Ms. Harris seconded the motion and it passed unanimously.

Litigation Update – Presented by Mr. Jay Wills, APERS Attorney Specialist

Mr. Wills noted that the Board still had two outstanding cases and no new ones on the horizon. The first case was regarding the “Double-dippers” and these individuals have appealed to the Supreme Court and the clerk is currently preparing the records and has a March 29th deadline. The briefing schedule has already been established and there is nothing remarkable to note.

The litigation matter is concerning Ms. Judy Danniell regarding Public Safety Service Credit. She has filed an appeal with the Garland County Circuit Court, APERS has responded and it is now in the Judge's hands.

As an additional note, Ms. Stone noted that she had heard from several sources that Mr. Skippy Leek was resigning his office in March 2012. Mr. Wills stated that the County Clerk had called him specifically to find out what steps she should take file it with APERS. Also Mr. Wills noted that Mr. Leek's lawyer had asked for APERS to hold off filing the appeal of the Board's decision until the Supreme Court case is resolved, as it covers the same issue. One way or the other, the “Double-dippers” case will resolve Mr. Leek's case.

Audit Results

Judge Jacobs noted that he had received his Audit Report and wished to congratulate Staff on no negative comments or findings.

Statement by Mr. Marc Watts, ASEA

Mr. Watts from ASEA wanted to go on record as thanking Ms. Stone for standing up for state workers by suggesting the DROP Interest Rate be held at 3% and his disappointment in the Board by voting to lower the rate to 2.5%.

NEXT QUARTERLY BOARD MEETING:

The next quarterly meeting of the APERS Board of Trustees is scheduled for Wednesday, May 16, 2012 at 9:00 a.m.

Ms. Stone will be polling the Board members for an agreeable date in mid-April to hold a special Board meeting to interview Value-Added Real Estate Managers and hear an opposing view on Hedge Funds/Fund of Funds investment.

ADJOURNMENT:

There being no further business, the meeting was adjourned.

MR. ARTEE WILLIAMS, CHAIR

MS. GAIL STONE, EXECUTIVE DIRECTOR