

**MINUTES OF THE REGULAR MEETING OF THE BOARD OF TRUSTEES
ARKANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM
MAY 16, 2012**

The regular quarterly meeting of the Board of Trustees of the Arkansas Public Employees Retirement System was held on Wednesday, May 16, 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
Ms. Janet Harris, Deputy State Auditor (*proxy*)
Mr. Wes Goodner, State Treasurer's Office (*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. Ryan Ball, Callan Associates, Inc.
Ms. Heather Lampkin, Bureau of Legislative Audit
Ms. Jessica Middleton-Kurylo, Bureau of Legislative Research
Ms. Erika Gee, Attorney General's Office
Mr. Danny James, Arkansas State Employee Association
Mr. Mark Watts, Arkansas State Employee Association
Mr. Matt Twyford, Arkansas State Employee Association
Mr. Nicholas Poole, Arkansas State Employee Association
Mr. Paul Young, Arkansas Municipal League
Ms. Kay Kilgore, Arkansas Parks and Tourism
Mr. Mike Wickline, *Arkansas Democrat-Gazette*

STAFF PRESENT:

Ms. Michele Williams, APERS Deputy Director
Mr. Carlos Borromeo, APERS Chief Investment Officer
Ms. Susan Bowers, APERS Associate Director of Investments
Mr. Jay Wills, APERS Attorney Specialist
Ms. Becky Walker, APERS Administrative Service Manager
Mr. Mark Herring, APERS Accounting Operations Manager
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, copies of the Minutes from the meetings of February 15 & April 11, 2012 were mailed to each APERS Board member for review. Due to a question on the voting

that had arisen after the April 11th meeting had adjourned, Mr. Gaddy asked for the Minutes to be approved individually. On a motion made by Judge Jacobs and seconded by Mr. Gaddy, the Minutes for February 15th were approved as presented.

Mr. Gaddy expressed his concern on the count of the vote on a motion to go forward with the search for a Fund-of-One manager during the April 11th meeting. He stated that at the time of the vote, there were seven Trustees present, three of whom did not cast a vote. Under the circumstances, Mr. Gaddy felt that the motion should have failed for not receiving the necessary five votes and so he wished to amend those Minutes and withdraw his motion.

Mr. Wills stated that it was not proper procedure to go back and change the previous Minutes, but the Trustees were free to revisit the issue and make a new motion that would be reflected in the current Minutes. He suggested the Board go ahead and approve the April 11th Minutes and then move on to the issue of Hedge Funds. Mr. Gaddy motioned to accept the April 11th Minutes as presented and was seconded by Ms. Wright. Motion carried.

Ms. Stone politely requested for Staff's benefit, that in the future, if any Board members wished to abstain on an issue that they do so verbally, in order for the Minutes to accurately reflect the intentions of the Trustees.

FUND-OF-FUNDS VOTE REVISITED

Mr. Gaddy attempted to withdraw his previous motion to go forward in the Fund-of Funds manager search. Judge Jacobs pointed out that Mayor Northcutt had seconded the motion and he was not in attendance to withdraw his second. Mr. Wills interjected that he and Ms. Gee, from the Attorney General's Office, agreed that the correct course of action would be for Mr. Gaddy to affirm the action or change the action in some way.

Mr. Gaddy moved for the Board to reconsider the previous action, as reflected in the Minutes and instead, consider alternative investment opportunities that had been discussed at previous meetings by Callan and Staff. Dr. Shelnut seconded the motion.

Ms. Wright commented that she felt like "this poor horse had been beaten to death." She stated that for many years simply investing in stocks and bonds had been sufficient for the System, however it was no longer "your father's investment environment" and it had gotten increasingly sophisticated. Ms. Wright admitted that for years she had avoided Hedge Funds, because she didn't understand them, but that was exactly why the Board hired smart people. She felt very strongly that the Board should listen to Staff and the Consultants when they suggested moving the portfolio in this direction.

Dr. Shelnut asked Callan what part Hedge Funds played in the recent \$2 Billion loss by JPMorgan. Mr. Ball responded that he could not state that Hedge Funds were responsible for the losses at JPMorgan. Dr. Shelnut expressed his concern that APERS could have Hedge Fund managers betting against each other with APERS' funds. Mr. Ball commented that it was possible, but not very likely and that was exactly why a Fund-of-Funds manager was employed. He emphasized that while Callan supported APERS moving into a Fund-of-Funds, he was sympathetic to the Board's wishes if they wanted to expand on investments like AQR and Newton, but the performance volatility and risk would be higher than utilizing a Fund-of-Funds.

Mr. Gaddy admitted that he did not have an open mind regarding Hedge Funds and he resented that Hedge Funds manager's income was taxed at a different level from the average taxpayer. He was still concerned about the level of transparency and information that Staff would receive, as well as the timing of that information. He noted these were tough times and felt if the idea was to mitigate risk, then the portfolio should move to Index Funds.

Ms. Harris inquired about the "alternatives to Hedge Funds" that had been mentioned several times and Ms. Stone replied that two of these were currently on the books, having been implemented last fall; these managers are AQR and Newton Capital. Mr. Ball explained that after those two managers were hired, the Board looked at two or three other options for fill the remaining allocation to diversified strategies before focusing on Fund-of-Funds. If the Board was still uncomfortable with investing in Hedge Funds, then Callan could find managers similar to AQR and Newton Capital to fill the allocation, but this would probably be more volatile and hold a greater risk than utilizing a Fund-of-Funds manager.

Ms. Bevis stated that while she had not been on the Board for very long, she firmly believed in the Staff and Callan to show them what was best for the fund and thought that their suggestions should be given the utmost consideration during the discussions. Although she had not been in attendance during many of the prior decisions regarding Fund-of-Funds, she had no qualms voting for it based on Staff and Callan's research and recommendations.

Mr. Williams called for a vote on Mr. Gaddy's motion revisit the other options to Hedge Funds before going forward with the Fund-of-Fund manager interviews. A show of hands was requested for an accurate count. There were 3 votes For (Gaddy, Shelnutt and Goodner) and 5 votes Against (Jacobs, Bevis, Harris, Wright and Williams). Motion failed.

QUARTERLY REPORT FOR THE PERIOD ENDING MARCH 31, 2012 - Presented by Mr. Ryan Ball of Callan Associates, Inc.

Mr. Ball began by noting that the recently adopted asset allocation was an attempt to limit APERS' exposure to the volatile equity markets. In early March, several transactions were performed which moved roughly \$500 million out of Fixed Income and Domestic Equities into the Fund's new Diversified Strategies and International Equities. Starting next quarter, Mr. Ball stated that the new target asset allocations would be employed through-out the quarterly reports.

For the quarter, the fund returned an 8.9% due to the strong returns across APERS' Equity and Fixed Income managers. The fund managers added value in their selection, as did the fund's asset allocation. Over the past twelve months, the fund trailed its policy target, due mainly to the poor investing environment during the first quarter of Fiscal Year 2012. Mr. Ball noted that APERS is very impacted, both positively and negatively, by swings in the stock market.

- Stephens: outperformed the Russell 2000 Growth Index by 275 basis points and ranked at the 25th percentile of Callan's Small Cap Growth Style Group. Performance remains strong across the board as relative rankings over all time periods remain above benchmark and median.
- Wellington: returned 14.39%, which was ahead of the Russell 1000 Value Index by 327 basis points. Over the ten-year period, the portfolio has outperformed the benchmark by 0.70% and ranked at 45th percentile of Callan's Large Cap Value Style Group.
- Lazard Asset Management: underperformed the Russell 3000 Index by 199 basis points for the first quarter. Near term performance has trailed the benchmark. However, since the portfolio's inception (June 30, 2005); it has outpaced the benchmark by 27 basis points and ranked above median.
- INTECH: returned 12.58%, which was 211 basis points below the Russell 1000 Growth Index and ranked in 97th percentile of Callan's Large Cap Growth Style Group. Over the last one-, three-, and five-year periods ended March 31, 2012 the portfolio has trailed the benchmark.
- CastleArk AR Energy: outperformed the CAI S&P Energy Sector Index. Since inception, the portfolio ranked in the 45th percentile of Callan's Natural Resources Mutual Fund Style Group.
- Pareto Partners: outperformed the return of the BC Aggregate Index by over 3% during the quarter and ranked at the 7th percentile of Callan's Core Bond Plus Style Group. The 62% allocation to corporate debt, coupled with 17% of the total portfolio invested in below investment grade bonds, kept performance above the benchmark.
- Manning & Napier: outperformed the MSCI EAFE Index by 459 basis points and ranked at the 5th percentile for the quarter. Since inception, the portfolio outpaced the Index by over 3% and ranked at the 8th percentile of the style group.
- UBS Global AM: outperformed the MSCI EAFE Index by over 3% and ranked at the 31st percentile of Callan's Core Growth International Equity Style Group. Performance over the one- and two-year time periods trails the benchmark and ranks in the bottom quartile.

Fund-of-Funds Search Update

Mr. Ball led the Trustees through the search procedure that Callan had used to evaluate 41 different Absolute Return and Diversified Hedge Fund-of-Funds in their database and select the six semi-finalists to present for the APERS' Trustees consideration. He assured the Board that any of these managers would be capable of providing the Fund-of-One that APERS desired. Mr. Ball reviewed fees, performance during various market cycles, risk, lock-up period and manager turnover. He reiterated that this search is for one manager who would be initially funded with approximately \$100 million for a Fund-of One. The six semi-finalists (in alphabetical order) were:

- Blackstone Alternative Asset Management
- Crestline Investors, Inc.
- Grosvenor Capital Management, L.P.
- Lazard Alternatives, LLC
- Mesirov Advanced Strategies Inc.
- Prisma Capital Partners, LP

Judge Jacobs asked Mr. Ball which managers he would recommend and Mr. Ball picked out Blackstone, Grosvenor and possibly Lazard, for contrast. After a short discussion on these three managers, Judge Jacobs motioned to follow Callan's suggestion and interview them at the August 15th meeting. He was seconded by Ms. Beavis. Motion carried.

SUMMARY OF RETIREES FOR MARCH, APRIL & MAY 2012 :

Ms. Stone noted that APERS was on target to exceed more than 1400 new retirees this year, surpassing last year's total.

MEDICAL REVIEW BOARD RECOMMENDATIONS:

The Medical Review Board met at 10:00 a.m. on Tuesday, May 8, 2012 in the APERS Library to discuss the four cases of Ms. Patricia Jewell, Mr. Dewey Grissom, Ms. Carla Royal and Mr. Jeffery Jones.

- After review and discussion, the Medical Review Board found that Ms. Patricia Jewell was suffering from an illness or injury at the time of the member's termination in May 2007, which subsequently led to the disability determination.
- After review and discussion, the Medical Review Board found that Mr. Dewey Grissom was suffering from an illness or injury at the time of the member's termination in December 2009, which subsequently led to the disability determination.
- After review and discussion, the Medical Review Board found that Ms. Carla Royal was suffering from an illness or injury at the time of the member's termination in September 2010, which subsequently led to the disability determination.
- After review and discussion, the Medical Review Board found that Mr. Jeffery Jones was suffering from an illness or injury at the time of the member's termination in December 2010, which subsequently led to the disability determination.

With APERS Board approval, in accordance with ACA 24-4-511(e)(3) benefits for all four members will be effective June 1, 2012. On a motion made by Ms. Wright and seconded by Judge Jacobs, the Trustees approved the Medical Board Reviews' recommendations.

FINANCIAL STATEMENTS FOR THE QUARTER ENDING MARCH 31, 2012:

Ms. Stone noted that new this quarter Staff was transferring the accounting from "cash" to the "modified accrual" method. This will bring the retirement system more in line with how others report their numbers and gives a more accurate account of the fund's commitments. It will also allow for a smoother "breakout" of the State Police portion of the investments. She also pointed out that for the first nine months of fiscal year 2012 the fund has paid out over \$272 million in

benefits to members and their beneficiaries. She calculated that by the end of the fiscal year, the fund is in line to pay out over \$350 million; a record high for the system.

OTHER BUSINESS:

2014-2015 Biennial Budget Presentation

Ms. Stone distributed a single-page budget request for the 2014-2015 Biennium and commented there was not much to it except for her request of one, big-ticket item. She explained that the current computerized member record system “MARSS” (Membership Administration and Retirement Support System), has been in use since 1997 and is on its last legs. Staff is researching replacing it with a more comprehensive system that will integrate with other systems currently in use, as well as imaging/workflow technology and a new telephone system. APERS Budget Analyst has estimated the cost to be \$10 million and has recommended that Staff ask for the full amount, split \$5 million per year, towards construction of this new online system. Ms. Stone added that there will be special language included in the request that require both Judicial Retirement and State Police Retirement will pay a portion of the system’s cost.

Staff is currently working with the Office of Procurement at DF&A in evaluating the four bids they had received from their RFP for a project manager. After going through a comprehensive business process review with us, this manager will construct an RFP, which will again go through Procurement, to select the actual system engineer.

Ms. Harris motioned at approve the 2014-2015 Biennial Budget and was seconded by Ms. Beavis. Motion passed unanimously.

Arkansas State Employees Association – Presented by Mr. Danny James

Mr. James thanked the Board for allowing him to speak on behalf of the 16,664 members of ASEA and all state employees. He stated that ASEA was concerned over the Board’s decision to reduce the DROP Interest Rate for FY 2013 from 3% to 2.5% without a written policy or criteria in place to determine when and how much the interest rate should be changed. He indicated that many members had been hurt financially over the abrupt change and asked that APERS develop a written policy for adjusting the DROP Interest Rate. He also asked that until such a policy was put into place that the Board reconsiders putting the interest rate back to 3%. Mr. James noted that ATRS (AR Teacher Retirement) still gave 6% interest on their DROP accounts and that APERS had enjoyed significant gains over the past year, which was inconsistent with their move to reduce the interest rate. He observed that while it was true that 10-year Treasury Notes were at an all-time low, they made up a very small portion of the APERS portfolio and it was not where the fund generated most of its revenue. APERS is strong and solvent, and Mr. James hoped that the Board would reconsider their position on this matter. Chairman Williams thanks Mr. James for his comments

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

Mr. Wills notified the Board that he had just attended the Rules and Regs Committee earlier that morning and they had reviewed and approved the changes to APERS Regulation 214 so it conforms to the new statute eliminating any additional service credit after member had been in the DROP. It had passed with no comment.

On Monday (May 14th), the APERS Brief had been filed with the Court of Appeals and Mr. Wills explained that Ms. Jo West-Taylor’s lawyer has thirty days to respond to the Brief. He reminded the Trustees that Judge Fox had generated two orders on the same day. The first order was the handling of the Administrative Appeal in which Judge Fox affirmed that Ms. Taylor had not terminated her employment and thus did not retire. He remanded it back to the Board with the suggestion that Ms. Taylor get credit for those two additional years; that was the principal reason Staff was appealing. The second order issued on December 2, 2011 concerned the “personal damages claim,” which was dismissed the same day and APERS did not appeal from that order. However, on the last day it was possible to do so, the four “double-dipping” officials filled a notice of cross- appeal on that order. Mr. Wills expressed doubt that anything would come of the cross-appeal, but promised to keep the Trustees apprised of any action.

Judge Jacobs asked Mr. Wills is he has any information on the issue with Montgomery County Nursing Home and Mr. Wills responded that he’d recently spoken to one of the lawyers representing the nursing staff. The lawyer indicated that they had agreed to settle, but were requesting that APERS sign off on that settlement. At this point in time, Mr. Wills stated he’d

seen nothing in writing, but indicated that it seemed that Montgomery County was planning on setting up a private retirement system for the Nursing Home employees that would eliminate any involvement on APERS' part. However Mr. Wills cautioned that the same attorney was eyeing other counties to see if they required similar "assistance".

APERS Annual Educational Seminar

Ms. Stone noted it was time to start lining up the time and topics for the annual educational seminar. Current available dates are October 15 and 22 (both Mondays). This one day seminar will be replacing the annual Investment Retreat and will still allow Trustees time to discuss issues with individual managers as well as investigate current investment topics. After comparing schedules, it was decided to reserve October 15, 2012 as the date.

Staff Travel Report

The report was noted with no comments from the Board.

County Lines Magazine

Chairman Williams congratulated Judge Jacobs on his wonderful picture on the front cover of the Spring 2012 edition of *County Lines*, published by the Association of Arkansas Counties. Inside were more photographs and wonderful article highlighting Johnson County.

NEXT QUARTERLY BOARD MEETING:

The next quarterly meeting of the APERS Board of Trustees is scheduled for Wednesday, August 15, 2012 at 9:00 a.m. This will be an all-day meeting with lunch provided.

ADJOURNMENT:

There being no further business, the meeting was adjourned.

MR. ARTEE WILLIAMS, CHAIR

MS. GAIL STONE, EXECUTIVE DIRECTOR