Wisconsin Coalition of Annuitants

Minutes of Meeting October 21, 2009

The meeting was held at the State of Wisconsin Investment Board, 121 East Wilson Street, Madison and was called to order by Chair Jim Palmer at 9:37am.

MEMBERS & ALTERNATES PRESENT: O. Berge, WARSDA; B. Fendel, AFSCME; E. Frank, DNR; J. Grosklaus, West Allis; R. Hoessel, DOT; A. Hubbard, WSAA; D. Kratz, CORR; A. Lee, WSAA; J. Maydak, West Allis; J. Miller, DNR; J.Munro, WARSDA; J. Palmer, WPPA; D. Rohweder, ESP, W. Rowe, ACE; B. Schaefer, SEA; J. Skiles, UW-R; T. Speranza, RPFFW; J. Stoddard, CORR; J. Vreeland, WAUWATOSA; A, Wallace, UWMRA; J. Zwadzich, SWIB.

GUESTS: K. Bozarth, S. Drew, A. Fendel, D. Garcia, K. Johnson, M. Stohr.

EXCUSED: J. Elmer, J. Egan.

MINUTES of the September meeting were approved as mailed.

GUEST: Keith Bozarth, Executive Director, SWIB

Mr. Bozarth welcomed us to the SWIB offices and thanked the WCOA for the support on the issue of deferred incentive payments. The incentive program is critical to maintaining quality staff. The Board's business decisions need to be supported in making SWIB competitive in the labor market.

Mr. Bozarth introduced Dominic Garcia, Fixed Income Fund-of-Funds Manager, who joined SWIB in September 2008 to fill the newly created position that includes overseeing fixed income external managers and leading the look at investing in Hedge Funds. Before joining SWIB he was the deputy chief investment officer of the New Mexico Public Employees Retirement Association.

GUEST: Dominic Garcia, Fixed Income Fund-of-Funds Manager's presentation was: Introduction to Hedge Funds. Three goals are: 1) Demonstrate that Hedge Funds can add value, 2) Show that SWIB will have capable resources and processes to evaluate Hedge Funds, 3) Demonstrate that SWIB will invest in "institutional quality" Hedge funds that have longevity and staying power in the market.

A Hedge Fund is a less constrained active external manager, who invests primarily in publicly traded assets and has the ability to sell short, invest in multi-assets and across geographies, with a larger opportunity set than typical long-only external managers, and typically a well diversified portfolio with over 100 positions globally. Investment objective is for absolute returns and provide equity-like returns at bond level of risk with low volatility and preserve capital in difficult environments such as 2008 where loss would be considerable less than in equities. Typically have lower correlation to stocks and other markets where the return stream does not follow stocks. Hedge Funds are a limited liability entity which limits the liability/losses of an investor to only its capital contribution and the manager/GP (general partner) typically is the largest investor "eats own cooking". The owner/manager has the most money invested.

Hedge Funds have superior performance over most asset classes. Better risk/adjusted returns, maximize Sharpe (risk/return) ratio, with low volatility. Lower correlation performance does not track to stocks or bonds. In general Hedge Funds managers have superior skill/talent due to expanded global investment options/diversifications over traditional managers and compensation is greater. Hedge Funds are a better business model with limited assets under management and a majority of a manager's compensation based on profit sharing with the investors.

Mr. Garcia utilized a graph from 1994 to the present comparing performance of Hedge Funds to the S&P 500, Barclays Aggregate Bond and Libor+3.5%, all at net of fees. A $1 invested in 1994 would be worth $4 in Hedge Funds and $2.50 in the S & P. The annual return from 1994 to July 2009 is: Hedge Funds 9.63% with a risk of 7.35%, S&P 500 6.92% with risk 15.61%, Barclays 6.32% risk 3.87% and Libor 7.69% risk 0.51%. The emphasis is the Hedge Funds had a greater return than the S&P at less than half the risk. The next graph was Risk Adjustment Performance over a ten year period ending in July 2009 again net of fees. Stocks had a return of -1.19% and risk of 15-16%. Bonds return of 6.19% and risk of 5%. A common allocation of 60% stocks and 40% bonds had a return of 1.62% and risk of 10%. Hedge Funds had a return of 7.19% and a risk of 7-8%. Other investments options were also charted. Private Equity, Commodities, and Emerging Markets exceeded Hedge Funds returns but at a risk of 8-11%. Hedge Funds add value to a portfolio with reduced risk. The previous graphs were the averages for Hedge Funds.

What is important is the selection process and it is expected that SWIB will do better than the average in quality selection by looking at the best of the best that are SEC and FSA (European Financial Services Authority) registered. Of roughly 6,000 hedge funds worldwide ($1.4 trillion in assets), only 300-500 ($700 billion in assets) are considered institutional quality with asset level, management and infrastructure necessary to sustain performance. Of the institutional quality universe, Cliffwater (SWIB consultant hired in July) has identified roughly 60 ($200 billion in assets) select funds.

Today investors in Hedge Funds have assets exceeding $1.4 trillion. Some of the largest pension funds have Hedge Funds investments. For example Pennsylvania Employees has 26.8% of assets in Hedge Funds, South Carolina 22.1%, New Jersey 5.6%, New York 2.7%, Texas 3.6%, Calpers 3.3%, Verizon 5.8% and GE 4.3%. The 200 largest investment funds have $81B or 1.7% of their total assets in Hedge Funds.

SWIB is at the beginning stage in the development for a hedge fund program and process details are still being defined. SWIB has hired consultant Cliffwater to conduct due diligence, fund recommendations and monitoring. Cliffwater is experienced in Hedge Funds and have many institutional investors and will be an extension to the SWIB staff. SWIB staff will review and analyze recommendations from Cliffwater followed by the SWIB CIO/Managing Directors review and approvals. There will be internal and external legal review of investment documents.

Once the portfolio is started there will be consultant and staff monthly monitoring along with Board and Investment Committee oversight. The potential governance structure begins with Board oversight and policy approval, portfolio construction by consultant and funds management, manager selection/due diligence process by consultant and staff, portfolio monitoring by consultant and funds management, and performance/risk reporting to Investment Committee and Board.

The operational review process by Cliffwater has a team that reviews the Hedge Funds on its philosophy, performance and process and a team to review the Hedge Funds back office accounting and operations to avoid a Madoff type situation. Before investing in the funds Cliffwater will conduct on-site due diligence by interviewing senior operations, legal, compliance and IT staff and review functional departments of trade, accounting, risk management and others. A best practice analysis evaluates fund operations and identifies variances, associated risks and mitigating factors. Another Cliffwater team will provide monthly monitor, provide reports, same day email any exceptions, provide a watch list which may recommend that SWIB redeem, and assist with early exit of redemption and secondary sales.

The Hedge Fund plan is to have 4-5% of assets invested over a three year period with the actual dollar exposure to an individual fund of less that 0.2% of assets which will minimize risk. The portfolio will have multiple 20-25 managers across strategies and styles and broader expectations with the maximum allocation per manager of $100M. Example mentioned was $40B in stocks with a 5% loss is $2B or the amount in the proposed Hedge Fund portfolio.

WCOA members mentioned the importance of keeping losses at a minimum and "transparency" and questioned if Hedge Funds managers pay is based on performance and other managers have their incentives deferred, as they were this year, does this set up conflicts? Mr. Bozarth stated that is happening now with SWIB managers deferred and external managers of SWIB dollars receiving much large bonuses than SWIB staff. SWIB Hedge Fund managers will not receive incentive until they reach and exceed a determined "high water" mark.

Hedge Funds have had a negative image and that image is getting better with the institutional quality of the best funds. The SWIB Board at the October retreat agreed to begin the Hedge Fund process and it is anticipated to start early next year.

Cliffwater was selected as the consultant after SWIB staff interviewed, visited and evaluated several others. Unlike a Fund-to-Funds manager, with Cliffwater, SWIB has retained the individual fund analysis and decision making which is now possible with the added section headed by Mr. Garcia.

Mr. Garcia concluded that Hedge Funds have achieved attractive risk adjusted, net of fees returns; SWIB will have a through process and capable resources in evaluating Hedge Funds and exposure will be thoughtful and incremental with an eye towards minimizing risk.

WCOA thanked Mr. Garcia for his presentation.

GUEST: Sandy Drew, Legislative and Beneficiary Liaison, SWIB
Preliminary returns as of September 30 - CORE 18.1% benchmark 16%, VARIABLE 26.9% benchmark 25.4%. SWIB is recruiting for two analysts and one corporate governance and a half time external management position. Six other positions are unfilled, four due to vacancies and two new positions. The Board's October workshop booklet is available for review. SWIB has been giving numerous presentations along with contacts from Legislators on bonuses and furloughs. An audit is being conducted on best practices for the IT and Operations section. Handed out was a Dave Stella and Keith Bozarth paper Pension Sustainability - The Wisconsin Example which explains our defined benefit plan and contribution rate history. Also provided was an updated SWIB staff compensation plan summary. Depending on the measurement the WRS is funded at 85-99.5%.

GUEST: Matt Stohr, Director Legislation, Communications & Planning, ETF.
Legislation related to ETF. AB126 Military Service Credit had an April hearing and is in committee and ETF states it should have an actuary study. AB337 Municipal employee new hires must pay first 3% of retirement and is in committee. AB199 Adds several classifications to protective status and has not had a hearing. SB320 Variable fund closure as of 1/1/11 and is awaiting a hearing. The actuary analysis for police officers formula cap has been completed and we will receive an update in November from Dan Schmidt, Legislative Council. A bill to have ETF collect dues from labor organizations and have ETF provide addresses to the organizations is circulating for sponsorship. This bill was in the budget and pulled out in the Assembly version. Several health insurance issues from the budget are being changed for implementation in January. Posted today on the ETF website is a Core Fund summary with SWIB returns of 5% to

25%. At a 15% return the Core will be -2.3 to -2.7%. Also in the same link is active employee information on the question of retiring in 2009 or 2010. Local government contribution rates are being questioned by the media and articles written in local newspapers.

CORRESPONDENCE: None

OLD BUSINESS: WCOA Elections: The Chair, Vice Chair and Secretary have agreed to be nominated. John Maydak stepped forward and agreed to be nominated as Treasurer.
MSC WCOA Officers: Jim Palmer, Chair; Ed Frank, Vice Chair; John Maydak, Treasurer; Dick Kratz, Secretary.

Annual Conference committee will meet and set up the date at the American Family Headquarters. Any suggestions for a guest speaker, contact Jack Stoddard or the Secretary. (Date has been confirmed - Monday May 10, 2010)

NEW BUSINESS: We have discussed the incentive compensation plan the past few months and the SWIB Board decisions. We need to recognize the Board's independent authority in compensation decisions and in addressing and not implementing the furloughs.
MSC The WCOA issue the following RESOLUTION: The board of directors of the Wisconsin Coalition of Annuitants supports the State of Wisconsin Investment Board's independent authority to award merit-based bonuses to its investment personnel, to not implement furloughs, and to otherwise manage its affairs in the best interest of the board's funds and those who rely upon its continued health.
Adopted unanimously this 21st day of October, 2009.

NABE - John Zwadzich attended the National Association of Business Economics and reports that because the last two years recession was a result of financial breakdown, rather than federal credit drop and reinstatement, that the outlook is for a slow growth of 2.5-3% which will be the slowest since WWII.. This quarter should be positive because of the markets discounting ahead. Corporate earning next year will be about 11% with the stock market returns 7-8%. Inflation will rise from a negative this year to 1.5-2% next year. Bond yields will go up, ten year treasure which mortgages are tied to will go from 3.5-4.5%. Unemployment will hit 10% and will drop slow with about 9-9.5% the end of next year. Consumers will continue to save more until unemployment drops. The Federal deficit and how to pay it is a big concern. The dollar continues to slip and with TARP funds terminating the question is will the economy be able to take over. One of the speakers was Tommy Thompson who mentioned to watch the NJ and VA governor elections. In 1993 Democratic Governors in both states were defeated and the health bill in Congress also was defeated.

The SWIB annual reception held at the Monona Terrance is considering relocating to the University Fluno Center to reduce costs. The WCOA agrees and supports the change.

NEXT MEETING: November 18, 2009 9:30 am, WI. Professional Police Association Building.
The meeting adjourned at 11:45am
Respectfully submitted – Dick Kratz