MINUTES OF THE INVESTMENT ADVISORY COMMITTEE
FRIDAY, FEBRUARY 9, 2007
CENTRAL FIRE STATION, EMERGENCY OPERATIONS CENTER

I. CALL TO ORDER AND ROLL CALL

The Investment Advisory Committee Meeting was called to order on February 9, 2007 at 8:30 a.m.

On roll call, the following committee members were present:

Investment Advisory Committee
Chair Michael F. Andrews
Vice Chair Edward L. Hennessy, Jr.
Stephen L. Brown
William J. Mikus
Bernard R. Panfel

Others in Attendance
Jon Prime, Prime Buchholz & Associates
Sean Higman, Prime Buchholz & Associates

Town Staff
Jane Struder, Finance Director
Cheryl Somers, Assistant Finance Director
Betty Cotton, Recording Secretary

II. PLEDGE OF ALLEGIANCE

Chair Andrews led the pledge of allegiance.

III. APPROVAL OF AGENDA

Vice Chair Hennessy made a motion for approval, Mr. Brown seconded, motion passed unanimously.

IV. COMMUNICATIONS FROM CITIZENS (3 MINUTE LIMIT PLEASE)

No citizens attended.

V. MEETING OBJECTIVES

Chair Andrews turned the meeting over to Jon Prime and Sean Higman.

Mr. Higman thanked the committee for selecting Prime Buchholz. He referred to the draft work plan in the handout and stated it can be used to work through the objectives. He said the ultimate goal for the meeting is asset allocation endorsement. Then they will begin to gather suggestions from managers.

Mr. Prime said research has proven that the way the fund is structured is going to be the primary determinant of the long term results. Various studies have indicated that it is at least 85% of the results. They will probably spend a fair amount of time talking about managers and then looking at manager performance. Always keep in mind that the decisions made about the structure are going to be the most important. They want to get some degree of consensus about that. They are going to spend time looking at, reviewing, and talking about the various elements of that to get a broad framework. From that, they will look at what the manager candidates would be.

VI. REVIEW PROCESS/DISCUSS TIMELINE

Mr. Prime said one of the key variables in terms of timing is the extent to which the committee is going to want presentations from the managers that are selected or from a group of managers from among which the committee would make the final determination. They will provide a lot of information to the board about the managers that should be discussed in terms of the overall process. Some boards only interview the finalists in each category.

They will look at who the custodian might be for the funds. After that, it is a process of implementation which is pretty simple because it is all in marketable readily available cash and instruments. As part of this whole process, Prime will draft a Statement of Investment Policy and Objectives. They will deal with various elements in there including rebalancing because rebalancing is an important part of the overall process. The keys are going to be asset allocation and diversification. Those organizations that are most disciplined in the way they approach it on a regular basis have better performance. After that, they will move forward with the implementation, probably toward the end of March. He does not think they can make February given the fact that the attorney will need to do a legal review of the documents.

Ms. Struder said the Town Council also has to approve the investment policy.

Chair Andrews asked if a meeting is needed prior to implementation or can it be approved subject to Town Council approval?

Ms. Struder said it depends on what step in the process the board is in at that time.

Mr. Prime asked how long it takes to get on the Town Council agenda?

Ms. Struder said two weeks prior to the Town Council meeting. They meet the second Tuesday of each month. She said only the investment policy is needed.

Mr. Prime said they could target to get on the Town Council agenda for March and get that approved. Depending on the level of involvement in terms of the manager selection process, they probably could make the March meeting.

Mr. Brown asked if Mr. Prime will be meeting with the committee again next week?

Mr. Higman said they have set some time aside depending on how far they get today in the process.

Chair Andrews said today is the determinant. If enough is completed today, maybe the asset allocation can be done next week.

VII. REVIEW PLAN DYNAMICS

Mr. Higman said page 2, Framework for Setting an Asset Allocation Policy, is a slide that is worth touching base on the context and the framework for what they are trying to do. This is another type of defined benefit pension plan. Even though the Town is not regulated by ERISA, they are trying to use the principles of ERISA, including expert theory, doing everything for the sole benefit of the beneficiaries. They are always balancing the plan participants to safety of benefits, liquidity versus the Town, the taxpayers and the cost of providing that benefit. As the liability is discussed, it is important to think about risk. Risk is defined in a number of different ways. One of the primary ways is the probability of meeting the return target. The actuarial assumption assumes the rate of return on the funded plan. Start with that as a base line. If that is lowered, is an 8% rate of return a reasonable rate of return? The answer is sure, relative to the capital markets and other defined benefit pension plans. An 8.5 or a 9 like five years ago absolutely could not be done. They will show why that is true with their capital markets forecast going forward. An 8% is a good place to start. They will look at risk measures around achieving that 8% rate of return and doing it at different levels of volatility with different levels of diversification.

The assumption is made, and they have touched base with the other Town board attorneys, that the Florida 215.47, which dictates trust fund assets in Florida, would apply to this fund. Broadly, the constraints should not be too much. The fire and police boards' law prescribes that they cannot have more than 10% in any foreign securities. For the Health Insurance Trust Fund, it is now possible to have 25% in foreign securities. They think they can work reasonably within that. The other one that will be at work in the discussion is the 20% in fixed income. In looking at the asset assumptions, the forecast is expected return. 215.47 is part of the reason why there would be 20% in fixed income.

Mr. Brown asked if convertibles count as equities?

Mr. Higman said legally speaking no. Theoretically, convertibles act more like equities but legally they are bonds until conversion.

Mr. Prime said their insurance and other regulated portfolios are stock driven, so they use convertibles because they are hybrid securities. They are seen by regulation as fixed income but it is possible to get something closer to an equity like return out of convertibles.

Mr. Brown asked if the fund falls short of the 8% over a period of time, the consequence of that is that the Town may have to pay in more money. The consequence is not that the participants get their benefits reduced, is that correct?

Mr. Higman said that is an important question in terms of what Prime Buchholz is trying to accomplish here.

Mr. Prime said there are two issues. There is no way to guarantee that the fund will earn an 8% actuarial assumption every single year. Over the longer periods of time, there is a higher probability that the 8% return will be earned.

Mr. Higman said he thought it would be useful to capture a couple of statistics off the latest actuarial report. If the plan was not funded, then the return assumption was that the reserves were returned, the return reserve will earn about 5%. If the plan was funded, the return assumption would be 8%. That gives a sense of where the funded status is. The top line is actuarial accrued liability for the past service rendered. It is as if another day's service was not accrued. That is the reporting mechanism as reported under the accounting standards. He has put this down as a frame of reference, and that doesn't include all future benefits because that is a moving target. They have folks accruing benefits every year, year in, year out. He has not put the $16,000,000 in the report because they have not contributed that yet. In the actuarial report, he is just assuming for the purpose of this analysis that the Town will fund it. He has not already count affected in the $16,000,000.

Chair Andrews asked but where is the $27,000,000?

Mr. Higman said the $27,000,000 will have to be shown on the Town reports.

Ms. Struder said, yes, that is the target.

Mr. Higman said the numbers are moving. The other issue is that in the preliminary review, he has looked at the actuarial report on a preliminary basis. He has not yet tried to model or to link them to the asset allocation. His first goal was to say what is the cash flow? Does he have a net draw from the fund? He used the actuary report and then Ms. Struder provided him a spreadsheet that she generated and they check.

Before the Town makes any contributions, the fund would be drawing about 5%. But the Town makes annual contributions and the level of that contribution is dependent on what is in the budget for the Town to make in the way of contributions. The next issue to consider today is the cash flow is positive, meaning that in thinking about risk or reward, there can be a little more volatility than there might otherwise be if the funds were in that draw in the portfolio.

Another thing to think about is that the $16,000,000 doesn't cover the whole current liability. There is some gap to make up. That gap is always made up one of two ways, contributions or return. That is the same dilemma that the corporate pension plans are facing every day. The new pension act accelerated that process which is one of the reasons why the pension act is kind of a misnomer in its name, because it won't protect pensions. It will probably end defined benefit pensions on the corporate side because it is going to force people to put it on their balance sheet and run it through their income statements. It is a little different in a public fund setting. The future funded status, which is that unfunded liability, is simply whatever they calculate for the AAL less what they call an actuarial value of assets. That goes to the question before. Every year Prime is going to have to produce a return. It will not be 8%. It will average 8% over time. Statistics is that line down the middle, all of the observations will be around it, but it would be a coincidence if it landed on that expected return. The actuary is allowed to smooth that over a period of time. The difference between the return assumption and the actual return is smoothed and amortized over three years, generally speaking.

The real drivers of the funded status in the Town will be three things, and two of them are the most important. The return will have some influence unless there are some extremes one way or the other, and that is the medical trend rate, how much are the premiums going up year over year? The next is how much is being contributed, what is that portion of the portfolio? And lastly, the trust fund returns, and those are in magnitude order of how that fund status will be influenced over time.

He does not want to sound negative because the Town is so far ahead of every municipality that he knows of but these are the key mechanics. He is going through the same exercise with a municipality in Pennsylvania who has twice the liability and zero assets. What does that mean? A minimum expected return of 8% has to be a little north of 8% from a probability standpoint to get a 50% probability of succeeding or reaching the goal. There is a modest tradeoff between contributions and returns. That target could be a little higher than that, if that is comfortable, but not to any extreme. Notice in the modeling that they cannot put together a 9% return portfolio and be comfortable with the risk. Lastly, they need to seek as many opportunities as possible to reduce the volatility because the smoothing helps but the more volatility, the more volatility the Town and the taxpayers have to deal with in future contributions.

VIII. ROLE OF ASSET CLASSES

Mr. Prime said let's go on to how to start to look at investment opportunities and the alternatives for putting the fund structure together. They are interested in what the objectives are, and in terms of the modeling in which they are using expected rates of return, standard deviations, and correlation of asset classes, and what they end up with is their models.

Mr. Prime said their long term assumptions are shown on page 3. Generally, they focus on ten years. It can be anywhere between five and ten years. It is easier to forecast what is going to happen in the next ten years than in the next twelve months. No one really knows for sure what's going to happen short term so they always defer to the longer term. These are reviewed and updated annually. Generally speaking, there are not enormous changes year to year unless something dramatic occurs but there are some certain trends. They start with inflation. They are assuming long term inflation is about 3.1%. Inflation last year was around 2.5% and they are continuing to think that inflation is going to be lower than it has been in the long term. They are saying 2.5% and it is not so important really whether they are right in terms of the forecast for all of the individual asset classes. They are more interested in the relationship between inflation and what the asset class expectations are.

In the middle column are the inflation premiums by investing in some of the asset classes. For example, they are forecasting 6.5% inflation premium for domestic equity, the best of real rate of return. Historically, stocks have provided a little better than that at about 7%. They are saying that because of valuations and where they think the markets are, over the next ten years, the real return will be a little less than the 7%. Then there is the expected standard deviation which is the level of volatility. Two thirds of all the occurrences are going to be plus or minus one standard deviation. Two standard deviations is 95% of all, and three standard deviations is 99% or virtually all. Sometimes the press will talk about a three sigma event, which is an unusual event because three sigma is beyond three standard deviations. Whether it is a hurricane or whatever, a three sigma is one in one hundred. That is the one that attracts the attention. The importance here is in looking at the model, these are the inputs, "what you put in relates to what you get out". These are the assumptions upon which the model is based. The correlations use historical correlations mainly because it is very difficult to anticipate any change in that basic relationship. They are using the long term relationships between the components of the market.

IX. MODELS

Mr. Prime said their Model Portfolios are to help focus the discussion. They have listed six models. The closer they get to the right side to model six is the closer they think they are getting to where they want to end up within the structure. The expected returns, standard deviations, and the Sharpe ratio, which is kind of the risk adjusted standard, are shown at the bottom.

Chair Andrews asked why a risk free return was used in the Sharpe ratio?

Mr. Higman said it is not listed here but generally speaking it is 3.5%, 30 day treasury bills. The Sharpe Ratio is trying to measure the return per unit of risk taken. There is always the interaction of, "I can get more return but what is my risk tradeoff to get that return?" This attempts to measure that, the higher the number the better.

Mr. Prime said all of the models will produce an expected return over time of 8%.

Mr. Higman said they have categorized this now in the new paradigm, in two areas. It is even different than what they showed in their presentation. One area is the growth or return engine for the portfolio versus those asset allocations that they are making in the way of risk reducing**.** Notice, any amount of core bonds that returns 5.5%, is going to pull down the 8% goal. The question is, why bonds in a portfolio besides the regulatory requirement? The bonds protect against inflation risk, likewise, some other asset classes would be included here that protect against other sorts of risk.

The first model is a typical defined benefit, the Florida League of Cities asset allocation. As they talked about in their presentation, an 8% return is their target, with 13.3% standard deviation. Again, to review, that means that in any given observation 66% of the time, it is going to be plus 21.3 or -5 so there is still a fair amount of volatility year to year. In order to get the 8%, there has to be some volatility. Moving to the right, the first thing they do is to reconfigure the equity component to have a much larger proportion of international than 10%. 10% is kind of a historic range that corporates in defined benefit plans had, but today clients are being pushed, and even the Florida laws are reflecting the fact that the world equity market is a global market.

Next, the model is moved up to the limit of the Florida 250.47 at 25%. Then, as mentioned before, convertibles are bonds, fixed income is on the accounting statements until converted. They have taken a portion of the fixed income asset allocation from a typical plan and put it into convertibles. The result being that they have moved up their return a bit. That is primarily driven out by the internationals by the use of the convertibles and they have also moved up the expected standard deviation so really that portfolio is only modestly better than the traditional one. So they have to do something different in the portfolio.

In model 3, they start that process just by taking about 10% or a third of the assets that would have been devoted to the fixed income and putting them in absolute return spreads. One of the things they did was include some education materials because they were not sure how familiar the committee was with those kinds of strategies. By adding that component of an asset class, it continued to get additional rate return but the risk reward tradeoff was better. They obviously moved it up again. As they go to the next stage, they are just continually adding diversifications to the portfolio.

Mr. Prime said with Models 4, 5, and 6, they have also added 10% to long/short hedge. Absolute return and long/short are all hedge funds. Practically speaking from an implementation perspective, given the nature of this fund, it is the same thing they do with some of their other public funds because they use the fund to funds approach. These are funds of hedge funds. A hedge fund will include 20 or 25 to 30 individual hedge funds. The hedge fund is broadly stated between the long/short and the absolute return. Absolute return is primarily funds that are arbitrage related so these would be arbitrage and market neutrals. They would be long/short portfolios where the longs and shorts are the same percent so that is kind of a market neutral portfolio. They are statistical equity arbitrage where two stocks have high correlations. For example, GM and Ford, if a client likes GM, and doesn't like Ford, they are long GM and short Ford. It is all based on the historical statistical relationship between convertible arbitrage within the debt structure, fixed income arbitrage. These are all arbitrage related and in some cases distressed.

There can be merger arbitrage. When a fund to fund structure is used, the fund to fund provider is going to blend a lot of different strategies. They will have managers that will focus on convertible arbitrage, some that do merger, or an event which would be recapitalization, restructuring, distress, so those are all absolute return. Look at the expectations for absolute return, the expected returns are around 8.5% but more importantly the standard deviation is 5%. Those are going to do a little less than expectations for allowing only equity but the 5% standard deviation, the US core bonds, the standard deviation of those types of strategies is less than the bond market. That is close to an equity like return for less volatility, not less risk but less volatility. Volatility is a metric of risk. It is a lower standard deviation than in the core bond portfolio so from that perspective, they are less volatile, but they are not necessarily less risky than bonds.

Mr. Mikus asked are these return numbers adjusted for the higher internal management costs?

Mr. Prime said yes. That is an excellent point because on an implementation basis, they use a fund to funds. Generally speaking, a hedge fund on a direct basis, historically, is a 1 and 20. The problem is now some of the better ones are getting higher than that. They are getting to 1.5 or 2 but then when a fund to funds vehicle is used, another management fee and in some cases another participation fee is paid, which can be getting up to paying 2, 2.5% and 20 or 25% of profits. All of the performance is done net of fees. The expected returns and the assumptions are all net of fees.

Mr. Brown said the expected returns are net of fees, but they would not be net of that extra layer of fees for the fund to funds.

Mr. Prime said yes they are.

Mr. Higman said because the assumption is made for the most part, clients are going to access the market with fund to funds.

Mr. Prime said it is kind of an insurance wrap. The client is paying a 1% insurance fee that does a couple of things. One is it provides an extra layer of due diligence. Their research group spends a lot of time doing research on hedge funds, fund to funds, and directs, because clients do use some directs. Also for diversification, if you have 20 or 25 or 30 individual funds, it is not as easy to get out on a timely basis. A lot of hedge funds are annually, some are quarterly and some are annually with ninety days notice. There will be an initial lock up period depending on whether the fund is SEC registered. If it is not registered, the fund will have an initial two year lock up effective as of February 2006. There will be a period where it is locked in at least one year and sometimes two years. Obviously that is another consideration.

Chair Andrews asked to get a comparable rate of return, if the committee were to look at hedge funds versus fund to funds, the committee would have 25 funds that they would have to look at and review as a committee versus one fund to funds?

Mr. Higman said they do some of those but there is a practical impossibility for the committee to do that because they generally have a $1,000,000 minimum. The Health Insurance Trust does not have enough funds to build a direct portfolio. One of the reasons why Prime doesn't do a lot of directs is because most of their clients are in the $100,000,000 to $400,000,000 range so if they have a 20% allocation to hedge funds, for the most part, they are still accessing through fund to funds. The other thing about fund to funds is that it is a preferred distribution point for a lot of the hedge funds because instead of having $20,000,000 accounts, they have one $20,000,000 account. The additional benefit of fund to funds is why a client would pay an extra layer of fees on top of the due diligence, diversification and access to funds that otherwise they probably would not have access to.

Mr. Prime said when they look at fund to funds providers, they are looking at who are the directs that they are using and the individual partnerships that they are using within that because they know most of them and are interested in those fund to funds that can access the higher quality directs. So the committee will only be looking at this in terms of Prime's recommendation. The committee would only be looking at the fund to funds.

He said the long/shorts are directional. They are not arbitrage related. In terms of gross exposure, add the longs and the shorts. If a fund is 125% long and 50% short, the gross exposure is 125 + 50 and the net exposure is 125 less 50 so that is only 75%. The long/short funds tend to have a little higher volatility. The hedged equity would give the same return as a long equity only portfolio on a net basis for a 12% standard deviation versus a 19%. It is a little bit like having a free lunch, the same return for less volatility.

Mr. Higman said if the committee took their assumptions and let the model run itself, without placing constraints and judgments upon it, and said, "give me the asset allocation that gives the lowest volatility for an 8% portfolio", that would likely be a portfolio that is dominated by absolute return, but would that earn 8.5%? Because of the correlation benefit, it would have a little bit of international equities, a fairly large portion in real assets, and it would ignore almost every other category. Now, are there any portfolios that look like that? No, not in the DB world. In the endowment foundation world, that would be Yale or Harvard. But in a DB world, they add not only the constraints of Florida but the constraints of the prudent expert. That is why they have capped off the amount of hedge funds to about 20% of the portfolio. Allowing the statistics to run wild, it would all be put in.

Mr. Mikus said as valuations between asset classes change, the expected rates of return change, how often does the model change?

Mr. Higman said because their horizons are ten years, they do not change. They do not try to make an interim forecast of those so they would have to be for a ten year time horizon for valuations to really enter into. Inflation has to change.

Mr. Mikus asked if future expectations increase, would the model pick that up?

Mr. Higman said it probably would not fundamentally change the returns for the S&P. These are built up primarily from an inflation forecast and risk premium. They build up from the bottom so asset classes change from time to time. This year, the domestic equity came down a bit but it is very rarely going to be driven by short term.

Mr. Mikus asked if they would add more equities to rebalance to bring it up to 22.5%?

Mr. Higman said they would always be rebalancing and that would take care of the valuations.

Mr. Prime said, the rebalancing mechanism typically is with a portfolio structure, the fees would be in the mid point of the range, on each side of the mid point, at about a plus or minus 15 percentage points. With an allocation of 10, the range would be 15 to 20, so that would be 8 to 12. They are not going to have much in the way of flows here except maybe on an annual basis. They look at it every quarter and if they get closer to the upper or lower boundary of a range for each of the asset classes, they rebalance back against the market allocation. If there was a dramatic downturn in the equity markets, which can prove valuations in the large cap, they could because they review these, they don't think it makes sense to look at them more than once a year. But they could raise the domestic equity because the long term nominal returns of domestic equity is about 10% or 7% real with an inflation of 3%. They could get closer to a long term assumption on the equity. They have actually been trending down.

Mr. Higman said it is very easy to determine a forecast up to two years but they do not think they can add any value.

Chair Andrews asked Ms. Struder, when the Town releases money through the budget period process for next year's contribution, do they do it all at one time or on a quarterly basis? How are the monies put into investment vehicles?

Ms. Struder said for the general employees and the pension funds, they do the transfers quarterly.

Chair Andrews said let's just say the Town gave this fund $5,000,000, would you get that in one lump sum?

Ms. Struder said quarterly or monthly.

Mr. Prime said whenever the fund gets the contribution, Prime works with Ms. Struder or the Town because they are getting monthly values on these from the custodian. They would look at where the values are and would add that contribution in a way that moves back toward the target allocation.

Mr. Higman said it is not perfect to the extent that they have the alternatives in there and they are semi-liquid. They would not be continuously monthly making deposits into the alternatives. It would create too much of an administrative burden and it is just not practical.

Mr. Prime said continuing on with models 4, 5, and 6, notice that the international equity comes down some. The reason is even though the aggregate is 25%, they do pick up some foreign in the long/short hedge and in the absolute return. Of course, the percentage is at cost. Given what has happened in the international markets over the last several years, they could be at 25% at cost but on a market value basis, they could be at 30 or wherever the upper boundary is. So it is usually on the cost basis. They are picking up some contributions to international in the other strategies. Then the bigger change in the risk reduction is the introduction of real assets which includes a number of different segments in that. It is not just real estate, it is natural resources, commodities, treasury inflation, protected bonds, so they are picking up a broad range of real assets and as seen in model 5, they pick up 10%, and what happens is, now, they start to give up a little in return but the big tradeoff is in terms of expected volatility.

In model 6, the expected standard deviation is at 10% versus the peak received in model 1 which is the plain vanilla. That is a 30% reduction in volatility and again the Sharpe ratio, which is that unit of return per unit of risk, is up 0.53 which is the most attractive on the page because they are going to get at least an expectation, they are going to earn more than 8%. These are using indices or averages. The extent to which they move into some of the less efficient asset classes, which would be long/short, absolute return, international, and real assets, should get additional return from the manager contribution because less efficient means more value added from. They also should get a contribution to volatility because they are focusing not only on what the return is but on the net return which is also the volatility.

Mr. Brown asked, "on the real assets, you say marketable real assets". He assumes that the vehicles used are things like REITs and mutual funds?

Mr. Higman said one of the things there is a particular product that they have in mind on the asset allocation but this particular product is a passive approach which combines REITs index with TIPs with natural resource stocks with commodities futures and it is a daily liquidity fund. Because these asset classes are uncorrelated, it has terrific diversification method, as will be seen in the portfolio. Once they get to more size and as the market evolves, there are some more active approaches to those asset classes that can be applied. But right now, in the market place, there is not a lot out there. SSgA, State Street Global, has a real assets product. It has a minimum fee. Given all the other SSgA business within the Town, Prime would expect them to negotiate that and reduce minimum or something. That is what they are contemplating.

Mr. Brown asked if some of the other pension funds are using this vehicle now?

Mr. Higman replied yes. The pension funds in Town are able to access the more active because of their size.

Chair Andrews asked Mr. Higman if he were to have to guess on the other two Town funds, what model are they closest to?

Mr. Higman said because they are constrained, it probably does not work because of the international but they have 20% in hedge and 10% in real.

Mr. Prime said the international is constrained, real assets are 10%.

Mr. Higman said the fixed income component is 25% which includes convertibles of 10%, 15% in alternatives in the hedge, and 10% is in international.

Mr. Mikus asked what is the main asset allocation if compared to return enhancement risk reduction, 60/40 or is it more like 55/45?

Mr. Higman said it is a 50/50 split almost. Again, part of the issue is because of the constraints on the international. They are up to 15% in hedge. Part of that challenge with both boards is that because of globalization of the hedge funds, 10% is causing this problem so he is moving the hedge funds up.

Mr. Prime said if they do get relief on the international side, they can raise the hedge and absolute return some because they pick up international as some of those funds.

Mr. Higman said if they lower the total return enhancement like the way it is in there, the 25% is not as constrained. Over time, upwardly sloping returns, the cost versus market basis will allow a lot more maneuverability. Starting off, there is less maneuverability. If the committee asked where they would be, they would be in model 6. The question is how to get comfortable with that? That conversation centers largely around risk measurements. There are a number of ways to measure risk. Page 5, the second grouping from the bottom, shows the probability of exceeding 8% over various time horizons. That shows the interaction of the expected return and that standard deviation. Moving out to the right, the probability of beating the 8% return keeps improving. It never becomes 60 unless the committee does what Yale does.

Mr. Brown said he finds the numbers surprising. It is very fascinating that it is only a little over 50% at best. What he finds surprising is the 53% probability in five years, add another five years, that adds another 1.3% probability, add another five years, that only adds another 1% probability. It seems that the probability should be going up faster, just instinctively. Doesn't that seem a little odd?

Mr. Higman said it is fairly typical because the improvement is not that great and the standard deviation is still 10%.

Mr. Brown said sure but enough time should cure that.

Mr. Higman said the shape of the distribution is still pretty wide.

Mr. Mikus said also there might be an argument that the expected rates of return are used versus historic rates of return. If historic rates of return numbers were used, it might be different.

Mr. Higman said the third line down shows what happens if actual historic rates of return are used.

Mr. Mikus said that would be 12.3% versus 8.3% which is really making a huge difference.

Mr. Brown said it may also be true that if you go out to 15 years that the possible returns narrow so the risk of getting down to 6% during this period must be a lot less.

Mr. Higman said when they look at that correlation, they go out 30 years.

He said another measure they always have to keep an eye on is liquidity. .They do not think they have given too much in liquidity so in the sense by putting the last 20% in semi-liquid, there is no need to worry about making benefit payments.

Chair Andrews asked Ms. Struder if these liquidity percentages on the higher models bother her at all?

Ms. Struder said it shouldn't at all especially with the initial deposit, the funds coming in and going out.

Chair Andrews said the committee wants to make sure they are working within her constraints.

Mr. Brown said this is going to be cash positive for a long time.

Mr.Higman said they do not have to worry about liquidity and they can actually take a little more. These are ways to think about it. The next couple of pages, 6 and 7, for the mathematicians, are the efficient frontier pages that get a little mathematically statistically intense. Page 7, which they want to do over time, is to move to the upper left as seen in model 6 there. The exploded view shows the one that is farthest to the left in the northwest quadrant. These are a bit of statistical gamesmanship because the inputs and a constrained model influence it.

Page 8, Forward Looking Projections, is really just an illustration. Let's take these numbers and try to link them to the actual liability which is seen moving from model 1 to model 6. On the upside, asset growth gives up some but some expected return is picked up. The range of outcomes gets substantially narrower. Their goal is to increase the expected return over time and the expected growth of the assets and try to do that with the least amount of bad outcomes.

Chair Andrews asked Mr. Higman what information he needed at this time from the committee?

Mr. Higman said they need the committee to be comfortable with an asset allocation.

Chair Andrews asked if they have to specifically choose one of the models presented, is the committee allowed to tweak the model?

Mr. Higman said they can tweak the model if they would like.

Chair Andrews said the committee does not want to be over sophisticated to the point that they cannot get anything done. He asked the committee for opinions.

Mr. Mikus said because he is an investment advisor, it is amazing how close model 6 is to his optimal long term asset allocation. He stated the presentation was fantastic. If he had to vote, it would really be model 6 with no changes that he can really see. For long term, he is very comfortable with it.

Mr. Panfel said his expertise is actually after the fact as a CPA, auditing the numbers and finding out why they didn't match up to model 6. He passes except to say that if these gentlemen believe that model 6 is the one, he is all for it. He is relying on the expertise of the other committee members on this.

Chair Andrews said let's hold Mr. Panfel's pass for now.

Mr. Brown said he is not an investment advisor, but he has chaired the investment committee for a large foundation for quite a few years in New York City. Their mix has developed into something somewhere between model 5 and model 6. He thinks that is absolutely the right direction to go. He would be happy with either model 5 or model 6. If he had to pick, he would take model 6.

Mr. Hennessy said he had the privilege of just going through two reviews with J P Morgan and Goldman Sachs and model 6 is exactly as he remembers theirs.

Mr. Panfel said model 3 seemed to be a better rate.

Mr. Higman said it is a better rate of return but there is always the tradeoff between the risk and return and that is what the Sharpe ratio is. That is why they prefer, as long as the general premise is being met of at least an 8% rate of return over time, to pick the one with the comfortable level of risk and the desired level of return. In this case, get a little bit north of 8% to get the probability up and then make the best tradeoff.

Mr. Prime said they have really seen a change in philosophy on the part of most organizations in the past fifteen years. The focus was if the volatility of the markets was 20% and volatility was only 15% that was good. The problem is everyone is happy when the volatility is on the upside but the downside volatility causes problems. It really started to change dramatically with the bursting of the technology bubble in the end of the first quarter of 2000. Then the pendulum always goes to extremes. With technology and the market doing well, everybody was happy and they were focused on return. Who cares about a risk, everything was on the upside. Then what happened when the technology bubble burst? The pendulum went completely the other way. Now everybody is concerned with how much risk they have in their portfolio because the market is down 40% cumulatively and "we are only down 30% but you can't spend relative results".

Mr. Higman said the human behavior of finance is to tend to put more emphasis on recent experiences. They have started to hear that same conversation again about it is impossible to be both a relative return investor and an asset return investor at the same time. So a portfolio that is set up for long term absolute return on short periods of time will not compare well.

Mr. Prime said the focus for the last few years has been good because it has gotten investors to focus on the return and risk which is always where the focus should have been.

Chair Andrews said his opinion is never to take that last model to the right. If there was a model 7, he would take model 6. He understands Mr. Brown being between model 5 and model 6. He asked Mr. Panfel for his vote.

Mr. Panfel said he would tend to go with model 6.

Chair Andrews asked for a motion from the committee on which model portfolio they preferred.

Mr. Brown made a motion to choose model 6. Mr. Hennessy seconded. Motion passed unanimously.

X. IMPLEMENTATION/STRUCTURAL ISSUES

Mr. Higman said there are a couple of items on implementation that are worth discussing that Mr. Brown brought up about the sense of the committee on the use of indexes. He will introduce Prime Buchholz's thoughts on it and then ask the committee to comment or express their personal thoughts.

When they build this portfolio out, they would probably, in the large cap domestic portfolio, use a significant portion of that to an index product. The reason is, while they believe strongly in active management and devote an enormous amount of their company capital to researching active managers in large cap space, and that is literally the most difficult, the statistics and the probabilities do not work. The premium from getting the top core active manager is times the expected return, the expectation is kind of a push. They can use the expense dollars that they would pay for active management essentially to reduce the cost of the portfolio a little. Mr. Prime mentioned the fund to funds hedge funds. Why not reduce the cost of the portfolio with that? Think about active risk management as finite dollars to spend. How much risk does the committee want to take from active managers? "Let's budget the dollars where we are most likely to succeed". They would probably do that. Maybe real assets is the place to do it just because of the size of the SBA. That SSgA product is primarily asset.

Mr. Brown asked if Prime got their way on the fee, what would the fee be?

Mr. Higman said the fee absent the minimum is about 30 basis points but it is a $10,000 minimum. Their goal is to fight on behalf of the Town for the best terms. Since there isn't enough money to put it in SSgA, they have to use the Town of Palm Beach's relationship basis to fight for the best terms, the best of everything.

Mr. Prime said they would like to get the large cap index and it certainly should be below 10 basis points. Their goal is to get below 10 basis points, depending on where they end up, they might even get 5 basis points.

Mr. Brown asked how much of the invested equity would the large cap be?

Mr. Higman said if they use the all cap, Russell's 3000 Universe Large Cap is going to between 70 and 80%.

Mr. Brown asked if their intention would be to index a major portion?

Mr. Higman said they might not index 70%. They will probably look at a combination of index and two managers who either do all cap to get the conditional active return where they typically are combining with the index and see how it looks relative to the Russell 3000.

Mr. Prime said the US Market today is about 68% large cap so they would probably be around two thirds.

Mr. Mikus asked if they would do the Russell 1000?

Mr. Higman said yes, they all carve up the capitalization slices a little differently. The approach would be to take a basic index and get their bases tracking to the Russell 3000 out of the index and then build around it with either all cap value and all cap growth or a mid cap value with a small mid growth to get that. They will look to their Research Team to give their best thoughts. Part of the issue is the small and mid cap managers base has gotten a little difficult product wise because of the recent performance. They urge active managers to close at certain size because their alpha evaporates when they get involved with certain size funds. They prefer to close right after they get clients in but they are not always that lucky, particularly in the small end.

Mr. Prime said and in the mid cap, probably $4,000,000 domestic managers, probably $2,000,000 or $3,000,000 international managers, one long/short fund to funds, one absolute return funds, one multi strategy, one convertible, and probably one real asset. Then probably what they would do with the international is they might have three managers there, one would be developing markets, one would be a small cap international manager, and one would be a merging market manager.

Mr. Higman said they have the research teams working on it already. The idea is to see where the dollars break out and see what makes the most sense. Sometimes it does not make sense to do a dedicated merging market just because it ends up below an institutional pricing. It makes the hurdle too big.

Mr. Prime said for the convertibles they would probably like to use the same firm used in the other Town of Palm Beach accounts. It is a Boston based bond manager. It is fairly unique because it is a bond manager that manages convertible portfolios. Consequently, it is conservatively less volatile usually a Merrill investment grade or better portfolio.

Mr. Higman said the vast majority of the convertible market in the past has been high yield. They do not want to do that. They don't want to take a lot of high yield risks.

Mr. Brown asked what is the name of the manager?

Mr. Prime said it is Income Research and Management, IR&M. They came out of Putnam and Goldman twenty plus years ago. They have done a great job and they manage the other two Town portfolios.

Mr. Higman said the other thing before they conclude is to understand process wise how well the committee wants to interview the finalists. They bring in two for each class. They are going to be Prime's A list. Prime would be able to endorse either one and allow the committee to have a discussion. With nine managers, that would be eighteen interviews.

Chair Andrews said if the Town had about $20,000,000 to invest, what percentage would the largest manager have?

Mr. Higman said absent the index, the real assets would be 15%.

Mr. Prime said if they had one manager that had 15%, that would be a multiple index so that would be $3,000,000.

Mr. Brown asked would it make sense for Prime to give written recommendations and rationale as to why they think these are the best? Then if the committee feels like saying they would really like to talk to one, they can do that.

Mr. Prime said it is not going to be productive to talk to the bond manager. It is probably not going to be productive to talk to the convertible bond manager. Prime provides all the information, qualitative and quantitative. Focus on the hedge funds. They would be more difficult.

Chair Andrews asked in a hedge fund that it is roughly 10% of the portfolio, would that be broken up into three?

Mr. Prime said no, they are going to have one absolute return and one long/short. That is going to be approximately 1.6 million each.

Mr. Brown said what they really would be finding out from fund to fund managers is how they construct their portfolio and whether they move things around, etc.

Mr. Higman said that is exactly it. The committee can have two come in. Prime is willing to pick their recommendation to save the committee time. He said if there is a place for the board to ever be criticized, it would be the non traditional never in the index fund or bond fund.

Chair Andrews asked Mr. Higman to tell him again how they recommend two hedge funds?

Mr. Prime said one long/short and one absolute return. Within the fund to funds, there will be anywhere from twenty to thirty individual hedge funds. Take the 1.6 million and divide it by 20.

XI. NEXT STEPS

Chair Andrews asked if the committee chooses two fund to fund managers and interviews them? How does the process work? Is the investment delayed if they do not bring in a fund to funds manager?

Mr. Higman said what will happen next is Prime will produce a package, based on this conversation, that gives their single recommendation by showing a lot of funds that they considered and give their rationale. Then the board would have to endorse their recommendation that they agree with the whole structure, and they will make the record show that the committee approved every one. They will arrange for a custodian probably State Street since they already have them in the other funds. Once those decisions are made, the Town Attorney would get all the agreements, the committee does not get caught up in that at all.

Chair Andrews asked Mr. Prime how much time they need for the recommendations?

Mr. Prime said they are working on it right now. They do not know if they can make it for the February 16th meeting.

Ms. Struder said that is a tentative meeting date that was set up. If they can't make next Friday for the money managers, it would be helpful if the investment policy could be approved by this board next Friday so she can get it ready to take to Council for March.

Mr. Prime said they can go over the investment policy next Friday. Then the question is how much they can get done on the manager side.

Mr. Brown said there are also a couple of non investment items that are going to be brought forward next Friday. One is the indemnification discussion. On that issue, he has had some legal help with developing a proposed ordinance for the Town of Palm Beach. That is being discussed with Mr. Randolph. He does not know yet what will happen as a result of that. He also raised some questions with Ms. Struder about some of the answers received last time on the insurance policy. Specifically the question that was asked about whether there are any exceptions or exclusions where the committee was told there were not. He does not know of any insurance policies that do not have exceptions and exclusions. He asked them to go back and review that.

Chair Andrews said the committee is currently under the investment policy for the investment advisory committee for the Town's surplus funds. How much different in structure would it be from the new Health Insurance Trust Fund?

Mr. Higman said the outline of it is probably similar but the asset allocation is substantially different.

Ms. Struder said there is rebalancing that isn't in there.

Mr. Higman said the section about rebalancing just talks about processes. Structurally it is not a lot different but in substance, the asset allocation is a lot. He said they can have a draft available Monday or Tuesday of next week. It has already been sent and looked at by a number of Town attorneys.

Chair Andrews asked is there any chance to get a draft that would have the changes highlighted?

Mr. Higman said it is not going to look enough like the old one. It is going to look mostly like the other pension plans.

XII. NEXT MEETING DATE

Mr. Prime asked if they could focus on another meeting date in addition to February 16?

Ms. Struder said there will be a meeting on the 16th to discuss the investment policy and other issues. She does not think the investment report will be ready for next Friday. They don't usually get the numbers until around the 20th of the month. She asked if the custodial issue will be resolved by next Friday?

Mr. Prime said he thinks it can be.

Mr. Higman said there are two separate ones, one is the custodial and the other one is the asset.

Mr. Prime said the custody works against the minimum fee. One helps the other.

Mr. Higman said they want to make sure that State Street does not treat this as a separate entity.

Ms. Struder said she would prefer State Street. The Town is very happy with their performance.

Mr. Prime said they have had great experience with State Street so it really doesn't make any sense to go anywhere else. He said they can do the investment policy and finalize the custody at the next meeting

XIII. ANY OTHER MATTERS

Chair Andrews asked Mr. Mikus to give an overview of the handout he passed out to the committee.

Mr. Mikus said it is an article regarding conflicts of interest with pension consultants and how certain pension consultants are compensated by both the client, one client who is asking for them to consult on their pension assets, and also on the money managers, so they get two sources of revenue. This is an issue that was brought up and the SEC looked into it. He believes there are still some issues that have not been resolved.

Mr. Higman said it has not come out of enforcement.

Chair Andrews said he remembers that a lot of funds have addressed this issue. There is a lot of pressure to separate those.

Mr. Higman said in response to that investigation, the DOA and the SEC jointly put out a questionnaire on conflicts of interest and they urge all the pension plans across the country to request that their consultants are responsive.

Mr. Prime said just for the record, Prime Buchholz has never had any conflicts. All of their revenues come from their clients. They get no referral fees, no attribution from managers. They work completely free from it.

Chair Andrews said the committee likes to hear that.

XIV. ADJOURNMENT

Chair Andrews called for a motion for adjournment. Vice Chair Hennessy made the motion. Mr. Brown seconded. Motion passed unanimously.