

# FEDERATED CITY EMPLOYEES' RETIREMENT SYSTEM

## Committee for Investments Summary

THURSDAY

SAN JOSÉ, CALIFORNIA

JUNE 25, 2009

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### Present:

Jeff Perkins

Matt Loesch

David Busse

### ALSO PRESENT:

Russell Crosby -Secretary/Director

Carmen Racy-Choy -Staff

Ali Amiry -Staff

Ron Kumar -Staff

Ceara O'Fallon -Staff

Cristin James -Staff

Patrick Thomas -SIS

Deborah Gallegos -SIS

John Calamos, Sr. -Calamos

David Danhauer -Calamos

## RECOMMENDATIONS

1. Approval of the fiscal year 2009-10 Workplan.

## MEETING SUMMARY

### 1. Approval of Minutes:

- a. Investment Meeting, April 23, 2009.

*(M.S.C.) Motion carried 3-0*

### 2. Discussion and action regarding the onsite due diligence review of Brandywine.

Mr. Thomas stated that Deborah Gallegos from SIS visited Brandywine in April to perform a due diligence review of the firm and its small cap value strategy. SIS does not believe the changes Brandywine has made to their investment process will substantially improve performance and does not believe that the new process will cure the performance lag during times of volatility. Finally, Brandywine's new process has changed the characteristics of the product. SIS recommends a search for a new manager in this asset class to replace Brandywine.

Dr. Amiry stated that staff has already started to search for replacement managers with the help of the new eVestment software.

### **3. Recommendation to invest in convertible securities.**

- a. Recommendation to invest \$50 million with Calamos Advisors.**
- b. Authorization for the Secretary to negotiate and execute an agreement with Calamos Advisors.**

Mr. Thomas explained that the inclusion of convertibles would add diversification to the portfolio and provide an alpha opportunity without having an effect on the risk/return of the portfolio.

Dr. Amiry suggested that an investment in convertible securities could replace the existing investment with Fisher Investments.

Mr. Thomas stated that SIS and Dr. Amiry have completed a global convertible search. SIS interviewed three candidates to determine whether their strategy was suitable for San Jose. Oak Tree Capital Management was the most compelling manager; however, they currently have no capacity in their global convertible strategy. Zazove Associates has demonstrated average performance in their global securities product. Given the global scope of the mandate and the limited availability of global bond managers, Calamos presents the most attractive opportunity for this assignment.

Chair Perkins stated that the Board has not discussed or documented adding this new asset class. There has always been a process of first adding the asset class to the asset allocation to determine how it affects the overall portfolio. This process should be one of the first steps completed before a manager is brought in front of the Investment Committee.

The Secretary stated that staff will come back to the Investment Committee with the convertible recommendation and provide a revised asset allocation reflecting the addition of the convertible asset class.

Ms. Gallegos explained that convertibles are a good opportunity in the current market; however, the number of managers in the global convertible arena is limited. The managers reviewed were:

- Oak Tree International - approaches convertibles investing by analyzing the bond side of an investment first and then by analyzing the equity side. Their global funds are closed to new investors.
- Zazove Associates - focuses on trading and has only \$22 million in convertibles investment strategy.
- Calamos Advisors - starts with equity research and then reviews the fixed income investment.

Chair Perkins asked why staff and SIS are looking at global convertibles instead of investing in U.S. convertibles.

Dr. Amiry stated that global convertibles were chosen over U.S. convertibles since the exposure to global investments needs to be increased in the portfolio to move closer to the target asset allocation, especially due to the pending replacement of Fisher Investments.

Mr. Calamos stated that the goal of a convertible portfolio is to achieve equity-like returns in a conservative portfolio. Convertibles appreciate in an up market and get the benefit of the equity side; and in a down market, the bond-like characteristic creates a cushion. In a convertibles portfolio, risk remains fairly constant whether the markets go up or down. No matter how markets react going forward, volatility will continue.

Mr. Calamos explained that 55% of the portfolio is investment grade bonds or better. There is a defensive investment strategy and assets purchased are always liquid so they can be sold quickly if the market moves. Calamos performs their own credit rating since most credit agencies do not provide accurate ratings in a timely manner.

Chair Perkins asked if there is a discipline that is followed if an asset falls to a junk bond status.

Mr. Calamos explained that if Calamos rates a bond as lower than investment grade and the bond then declines, a sale would be triggered.

Chair Perkins asked why Calamos is able to invest in global markets when other managers cannot.

Mr. Calamos explained that Calamos started investing in global securities in the late 1980's. Calamos recognizes that industries line up across the world. The global world market does not allow you to look at a U.S. industry without also looking at the other countries that are involved in the same industry. Calamos sends analysts all over the world to conferences to keep up with global events.

Chair Perkins requested that staff present this item at the next investment meeting with an explanation of how the new asset class would affect the overall portfolio.

#### **4. Discussion and presentation by SIS relating to third-party marketers.**

Mr. Thomas stated that SIS believes that third party marketing and placement agents perform legitimate and valuable services for asset managers that choose to outsource these functions. The key issues for investors to address are transparency and disclosure. SIS has provided some sample questions that can be used in the form of a questionnaire for all managers to provide full disclosure of their activities to the System. In addition, SIS suggests that the Board add language to the Statement of Investment Policy to address disclosure of third party marketing and placement agent arrangements.

Member Loesch suggested that staff require each manager to complete a questionnaire disclosing any third party marketing activity as part of the initial due diligence performed on a manager and then at least annually.

Ms. Racy-Choy explained that the Board should require all managers to complete a questionnaire quarterly to assure that they are complying with the Statement of Investment Policy and their contract.

Member Loesch added that the Board needs to have a formal discussion to determine the policy regarding Trustees' interaction with managers and ask legal counsel to provide an opinion as to what activities cross the line.

*(M.S.C.) Motion carried 3-0*

## **5. Discussion and approval of the fiscal year 2009-10 Workplan.**

Ms. Racy-Choy stated that the Asset Liability Study and the RFP for the Investment Consultant are the top priorities for staff. The timeline for the top priority projects are:

- Hire Investment Consultant – third quarter 2009.
- Complete ALM Study – fourth quarter 2009.
- Restructure asset allocation – fourth quarter 2009 through first quarter 2010.
- Complete searches for new managers – fourth quarter 2009 through second quarter 2010.

Ms. Racy-Choy added that the choice of Investment Consultant drives the timeline. The longer it takes to hire a new consultant, the farther in the future the rest of the projects will be completed.

*(M.S.C.) Motion carried 3-0*

## **6. Discussion and action regarding the Investment Consultant RFP finalists.**

Ms. Racy-Choy explained that there were nine responses to the Investment Consultant RFP. Macquarie Funds Management and Stepstone Group are not general consultants so they were eliminated. The two top candidates are NEPC and Watson Wyatt.

The Secretary stated that the Investment Committee should perform due diligence with staff on the top two Investment Consultants: NEPC (Boston) and Watson Wyatt (New York).

The Secretary added that staff has asked Hanson Bridgett to prepare a sample contract that includes liability provisions for the finalists to review and to make sure they would agree to the City's terms if they were selected.

## **7. Oral update on the Plan's Securities Lending Program.**

Dr. Amiry stated that the System had approximately \$170 million in the securities lending program in January 2009. At this time the System's exposure has been reduced to \$25 million, which will decrease each week until the System is fully withdrawn from the program. The value of the

collateral has rebounded due to market appreciation and the unrealized loss continues to decrease. Securities are being held until maturity and sold at par.

## **8. Informational Item: Index Volatility Futures in Asset Allocation – A Hedging Framework.**

Dr. Amiry stated that the hedging framework, Index Volatility, proposed in this research paper is relevant to active risk-takers in financial markets, because it could allow portfolio managers to mitigate risk more precisely, by taking into account the anticipated magnitude and time horizon of market corrections.

Dr. Amiry added that Index Volatility investing helps to reduce volatility. As the System is a few years away from implementing this type of strategy, this article is being presented for educational purposes.

**Approved:**

  
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**RUSSELL U. CROSBY, RETIREMENT DIRECTOR**  
**BOARD OF ADMINISTRATION**