City of Hartford Pension Commission
City Conference Room
260 Constitution Plaza
Hartford, Connecticut
Friday, December 19, 2014
9:00 a.m.

AGENDA

INVESTMENT PROGRAM

I. Review of Minutes
- Meeting of November 21, 2014

II. Status of the MERF Portfolio
- Inventory of Assets as of November 30, 2014
- MERF's Overall Performance

III. Update from MERF's General Investment Consultant-NEPC
- Education-Currency Hedging

IV. Deferred Compensation Plan Recommendation

V. Report on Annual Performance Review Meeting
- SouthernSun Asset Management

VI. Other Business
- SW Pelham Fund III Update

INVESTMENTS:
AGENDA ITEM I

CITY OF HARTFORD

PENSION COMMISSION

MEMORANDUM

To: Pension Commission

From: Adam M. Cloud, Secretary

Date: December 12, 2014

Subject: **Review of Minutes from the Meeting of November 21, 2014**

Enclosed for your review are the minutes of the investment portion of the Pension Commission meeting of Friday, November 21, 2014.

City of Hartford Pension Commission
City of Hartford Conference Room
260 Constitution Plaza
Hartford, CT 06103
Friday, November 21, 2014
9:00 a.m.

MINUTES

INVESTMENT PROGRAM

MEMBERS PRESENT: Peter Stevens, Chairman; Frank Lord, Commissioner; Gene Goldman, Commissioner; Adam M. Cloud, Secretary and Carmen I. Sierra, Assistant Secretary

MEMBER EXCUSED: Marc Nelson, Employee Representative

STAFF PRESENT: Gary B. Draghi, Director of Investments; P. Wayne Moore, Assistant Director of Investments; Terry Williams, Senior Administrative Assistant, Chelsea Mott, Accountant

STAFF EXCUSED: J. Sean Antoine, Principal Administrative Analyst

OTHERS PRESENT: Kristin Finney-Cooke, Senior Consultant, William Forde, Senior Analyst, and Matt Ritter, Consultant, all of NEPC, the MERF's general consultant, Tad Fergusson, PCA, the MERF's Private Equity consultant

I. Review of Minutes:

Meeting of September 26, 2014
Chairman Stevens introduced the item and asked for questions, comments or corrections. There were none.

A motion was made, seconded and adopted to accept the minutes as presented.

Special Meeting of October 7, 2014

Chairman Stevens introduced the item and asked for questions, comments or corrections. Commissioner Lord requested that the minutes be revised to include that the Landmark Partners Real Estate Fund VII presentation took place on October 7, 2014.

A motion was made, seconded and adopted to accept the minutes as amended.

II. Status of the MERF Portfolio as of September 30, 2014 and October 31, 2014

Chairman Stevens introduced the item and asked the Investment Unit to report. P. Wayne Moore, the MERF's Assistant Director of Investments, reported that, as of September 30, 2014, the MERF's portfolio had a market value of approximately $1.03 billion and had generated a -2.0% net of fees return for the month, outperforming the MERF benchmark by 50 basis points. Mr. Moore introduced a new report format for the Commission's review and reported that the report could be produced in the future on a monthly basis. Discussion ensued.

Mr. Moore then reported that, as of October 31, 2014, the MERF's portfolio value was $1.04 billion and had generated a 0.7% net of fees return for the month, underperforming the MERF policy benchmark return of 0.8%, by 10 basis points.

The Commission accepted the reports for advice.

III. Update from MERF's General Investment Consultant--NEPC

Quarterly Performance ended September 30, 2014

Acting Chairman Lord introduced the item. Secretary Cloud asked Ms. Kristin Finney-Cooke of NEPC, the MERF's general consultant, to report to the Commission. Ms. Finney-Cooke reported on the MERF's investment performance for the periods ended September 30, 2014. After recapping the MERF's goals and objectives and recent activities, Ms. Finney-Cooke reviewed the MERF's performance results, reporting that the MERF had generated a -1.1% return for the quarter ended September 30, ranking in the 33rd percentile of its peer group universe (the IFDB Public Fund Universe). She went on to state that the MERF portfolio generated returns of 8.7% and 10.4%, respectively, for the annualized three and five year periods ending September 30. Discussion ensued.

Matt Ritter of NEPC reported on the MERF's real estate portfolio for the quarter ended June 30, 2014. He reported that the portfolio experienced a positive quarter, earning an internal rate of return ("IRR") of 2.58% and that the annualized IRR since inception was 3.97%. He added that, since inception, the total value to paid in capital (TVPI) multiple (current valuation plus cumulative distributions / total capital calls) was 1.07. In addition to performance, Mr. Ritter reviewed the portfolio in terms of vintage year and investment pacing. He also reviewed the MERF's 2015 Real Estate implementation plan, which calls for the MERF to commit $4 million, in 2015, to a value-add fund, and details additional investments of $9 million through 2017.

Ms. Finney-Cooke presented the MERF's private debt portfolio performance report through June 30, 2014 noting the format and highlighting that the performance was positive for the quarter, earning a 1.53% IRR and a TVPI multiple of 1.11.

Ms. Finney-Cooke closed by reviewing the MERF's updated Road Map, noting the significant number of completed items since 2011. She then highlighted the proposed new order of searches and other action items.

The Commission accepted the reports for advice.

IV. Private Equity Quarterly Performance Report

Acting Chairman Lord introduced the item. Secretary Cloud asked Tad Fergusson of Pension Consulting Alliance ("PCA"), the MERF's private equity consultant, to address the Commission. Mr. Fergusson began by reviewing the highlights of the portfolio, noting its mature status and that it has continued to increase its IRR as the harvesting of investments picks up pace. He reported that the net since inception IRR had grown to 12.3% with an investment multiple of 1.4x. He noted the portfolio's double digit absolute returns and stated that the portfolio had underperformed its public equity-based policy benchmark (Russell 3000 plus 300 basis points) in recent years due to the strong performance of the public equity markets but that it had exceeded its benchmark for the trailing ten year and since inception periods. Other highlights noted were the facts that the portfolio was cash flow positive in recent years and that it was well diversified by vintage year, sector and industry exposure.

Mr. Fergusson continued by reporting on several industry trends, including the increased risk metrics in the buyout market, as both purchase price multiples and debt multiples rose. He noted that private equity fundraising was strong across sectors, including venture capital.

Mr. Fergusson closed by discussing investment pacing. He stated that, while still within its asset class range, the MERF remained over-allocated to private equity at 7%, compared to the 5% target established in 2012. He reminded the Commission that PCA recommended a scheduled annual commitment pacing of $10 million to $15 million per year - observing that, at a $10 million per year pacing level, the MERF's private equity allocation would be projected to decline towards the 5% long-term target by 2018. Discussion ensued.

The Commission accepted the report for advice.

V. Proxy Voting Services Search

Acting Chairman Lord introduced the item. Mr. Moore reviewed the MERF's process for issuing a request for information ("RFI") for proxy voting services. He then reported that staff had received two RFI responses and that, based on its review, both of the respondents (Institutional Shareholder Services ("ISS"), the incumbent provider, and Glass, Lewis and Co.) were qualified to provide proxy voting services to the MERF. The Commission authorized Secretary Cloud and staff to review these candidates and, upon completion, make a recommendation to the Commission.

Gary Draghi, the MERF's Director of Investments, then discussed the Secretary's recommendation that the Commission authorize the Secretary to extend the existing contract with ISS to March 31, 2015 from December 31, 2014 in order to allow adequate time to evaluate the candidates and to execute a new contract.

A motion was made, seconded and unanimously adopted to authorize the Secretary to extend the Institutional Shareholders Services contract to March 31, 2015.

VI. Recommendation-Transition Manager Services

Secretary Cloud introduced the item and asked Mr. Draghi to report to the Commission. Mr. Draghi described the MERF's need to have multiple transition managers and staff due diligence on the transition management firms recommended to the MERF by NEPC. He then reviewed the recommendation to authorize the hiring of Northern Trust, Penserra (an emerging firm) and BlackRock to provide transition management services to the MERF. Discussion ensued.

A motion was made, seconded and unanimously adopted to authorize the Secretary to complete the necessary documents to retain the three firms identified in the recommendation as transition managers for the MERF.

VII. Reports on Annual Performance Review Meeting: HIMCO

Acting Chairman Lord introduced the item and asked Mr. Draghi to report. Mr. Draghi stated that the report was self-explanatory and asked if there were any questions. There were none.

The Commission accepted the report for advice.

VIII. Manager Information

Acting Chairman Lord introduced the item. Mr. Draghi reported that, at each of the six named MERF portfolio managers, there had been recent changes, including portfolio manager departures, key person departures and in the cases of Conning and TA Associates, changes in the ownership of the firm. Mr. Draghi reported that staff had engaged with NEPC in each case to obtain NEPC's written input on how the change might affect the MERF's portfolio. He reported that, at present, NEPC had not indicated a need to take any action on these matters but that certain of these would be considered when the MERF reviews its equity and fixed income portfolios in early 2015. Discussion ensued.

The Commission accepted the report for advice.

IX. Other Business

BNY Mellon Private Equity Support Services

Mr. Draghi reported that staff reviewed the capabilities of BNY Mellon with regard to providing private equity support services to the MERF. He reviewed the potential benefits relating to internal controls, improved reporting and investment analysis. He then reviewed the Secretary's recommendation that the MERF amend its custody contract with BNY Mellon to add capital call and data management services for the MERF private investments at a projected annual cost of $17,000 per year. Secretary Cloud then highlighted the potential efficiency of this action. Discussion ensued.

A motion was made, seconded and unanimously adopted to authorize the Secretary to execute an amendment to the current custody contract with BNY Mellon to add capital call and data management services.

Other Business (continued)

Lumber Liquidators – Potential Shareholder Litigation
Treasurer Cloud introduced the item. He then introduced Motley Rice, a law firm that monitors the MERF's portfolio for potential shareholder action. Messrs. Marlon Kimpson and Gregg Levin, partners at Motley Rice, provided information, by telephone, on a potential shareholder litigation matter involving Lumber Liquidators Holding, Inc. ("LLHI"), an equity portfolio holding of the MERF. Motley Rice recommended that the MERF consider leading a derivative action lawsuit against LLHI. Discussion ensued.

The Commission accepted the recommendation for advice.

There being no further business, Acting Chairman Lord adjourned the meeting.

ATTEST: Adam M. Cloud
Adam M. Cloud, Secretary

INVESTMENTS:
AGENDA ITEM II

CITY OF HARTFORD

PENSION COMMISSION

MEMORANDUM

To: Pension Commission

From: Adam M. Cloud, Secretary

Date: December 12, 2014

Subject: **Status of MERF Portfolio as of November 30, 2014 Performance Report**

The portfolio report for the month of November 2014 will be distributed at the meeting.

INVESTMENTS:
AGENDA ITEM III

CITY OF HARTFORD

PENSION COMMISSION

MEMORANDUM

To: Pension Commission

From: Adam M. Cloud, Secretary

Date: December 12, 2014

Subject: **Currency Hedging Education**

As part of the education process relating to currency hedging, representatives from NEPC will present the enclosed materials at the meeting.

Executive Summary

Executive Summary

- **The City of Hartford Municipal Employees' Retirement Fund ("MERF") is exposed to currency risk as a result of it's policy targets to non U.S. investments**
  - International Developed and Emerging Market Equities
  - Global Fixed Income and Emerging Market Debt

- **Currencies are volatile and most U.S. institutional investors have traditionally ignored this volatility in their portfolios, leaving a meaningful risk exposure unhedged**

Asset Class	Current Target
Cash	2%
Large Cap Equities	9%
Small/Mid Cap Equities	4%
Int'l Equities (Unhedged)	10%
Emerging Int'l Equities	9%
Total Equity	**32%**
Core Bonds	5%
High-Yield Bonds	4%
Global Bonds (Unhedged)	3%
EMD (External)	6%
TIPS	4%
Long Govt/Credit	9%
Total Fixed Income	**31%**
Private Equity	5%
Private Debt	3%
Real Estate (Core)	8%
Hedge Funds	10%
Total Alternatives	**26%**
Global Asset Allocation	7%
Commodities	3%
Total Other	**10%**

Executive Summary (cont.)

- **As part of our 2015 Actions and Assumptions, NEPC recommends that clients take a proactive approach to *managing* currency risk**
  - While NEPC recommends that developed-market currency risk should be actively hedged, we view emerging market currencies to have a positive expected return and should remain unhedged

- **How would MERF go about implementing a currency-hedging program?**
  - 1. Hire a dedicated overlay manager
  - 2. Currency-hedged commingled product
  - 3. Hire foreign equity/bond strategies benchmarked to a currency-hedged index
  - 4. Change the mandate of existing foreign equity/bond managers to hedge currency exposure

- **Despite the potential sub-optimal results of not hedging, practical challenges exist in implementing solutions**
  - There will be several trade-offs in addressing currency risk:
    - Explicit /implicit costs of implementation, strain on internal resources, the ability or willingness to hire a new manager or change an existing mandate

- **Investors who find that foreign currency exposure has minimal impact on its total portfolio risk may instead choose to focus on higher value-add decisions**

Currency Education

Developed Market Currency, A Strong Candidate For Hedging

- **Foreign currency exposure adds volatility to a portfolio**
  - Currency exposure is most often additive to risk, not diversifying
  - It is reasonable to expect a return for bearing this risk

- **Developed market currency risk has gone uncompensated over the last 25 years supporting the theory that such risk should be hedged**
  - MSCI EAFE's annualized currency impact has been -0.17% since January 1988
  - BarCap Global Aggregate's annualized currency impact has been -0.07% since January 1990

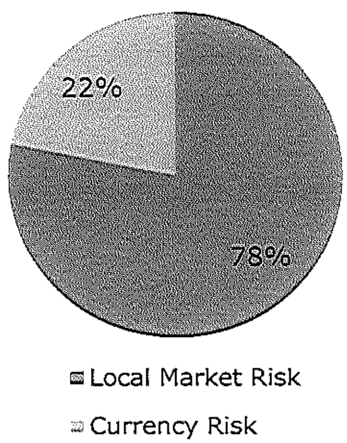
- **Emerging market currencies hold a positive expected return, indicating the currency should remain unhedged**
  - Stronger fiscal position of emerging currencies drive long-term value
  - High level of short term interest rates and lower liquidity makes hedging expensive

- **Institutional investors could benefit from hedging a portion of developed country foreign currency exposure**
  - Reduces some potential tail risk associated with euro or other currencies
  - A partial approach enables active managers to express views within their mandates

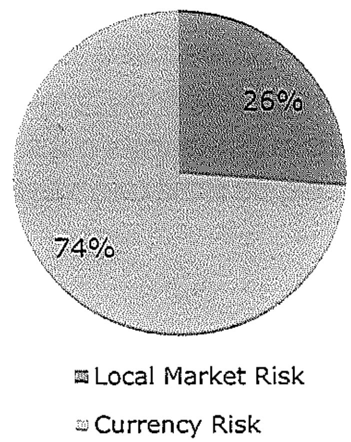
International Investing Provides Varying Degrees Of Currency Risk

- **MERF has exposure to developed market currencies through Policy Index allocations to MSCI EAFE and the BC Global Aggregate Bond Indices (Citi WGBI Index is used as a proxy for non US fixed Income)**
  - This represents 10% and 3%, respectively
  - Hedge fund currency exposures are tactical and therefore not considered for hedging
- **Estimated currency risk contribution to the total risk of each of these markets on a forward basis is depicted below**
  - Note the expected volatility for unhedged Citi WGBI is ~74% which is more than 3x that of the MSCI EAFE

MSCI EAFE



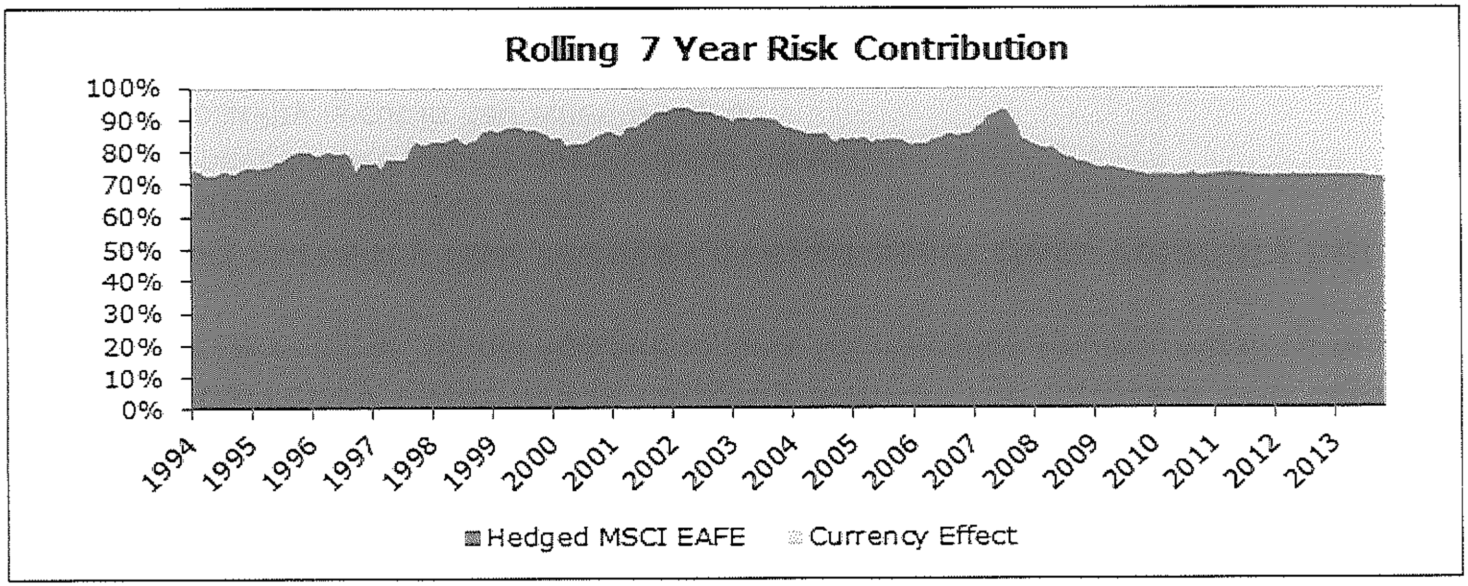
Citi WGBI



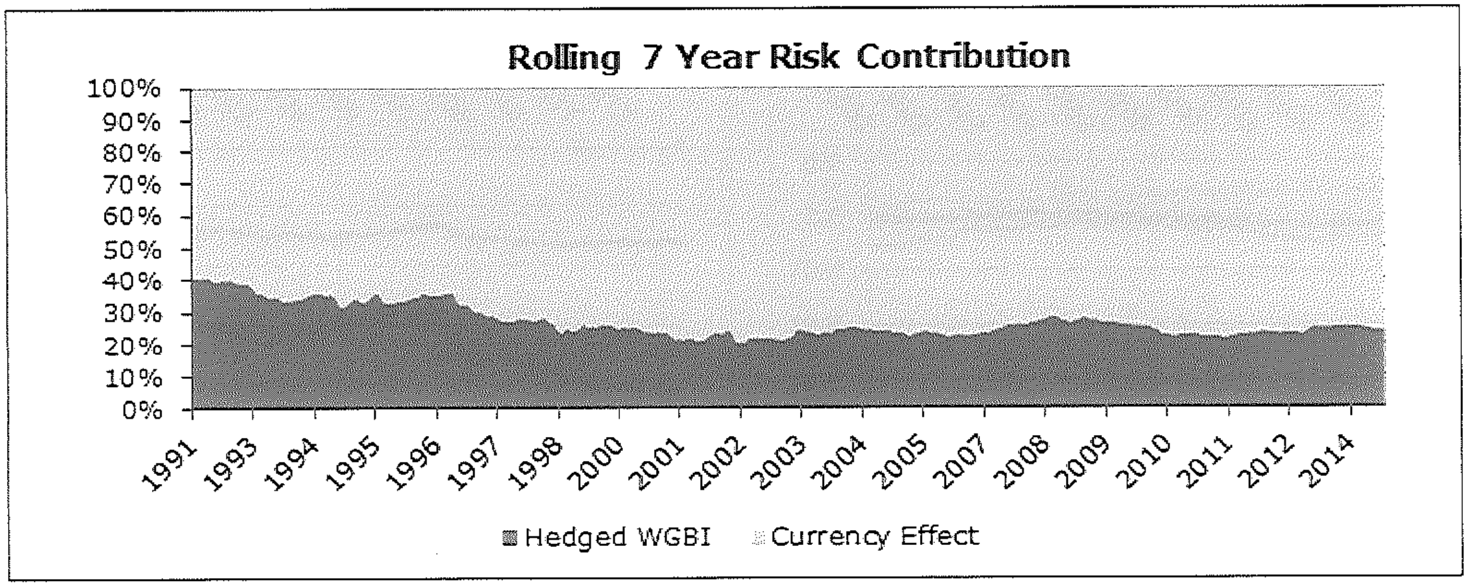
Source: Barra

Historical Risk Contribution Is Relatively Stable Over Time Supporting Strategic Hedge

MSCI EAFE

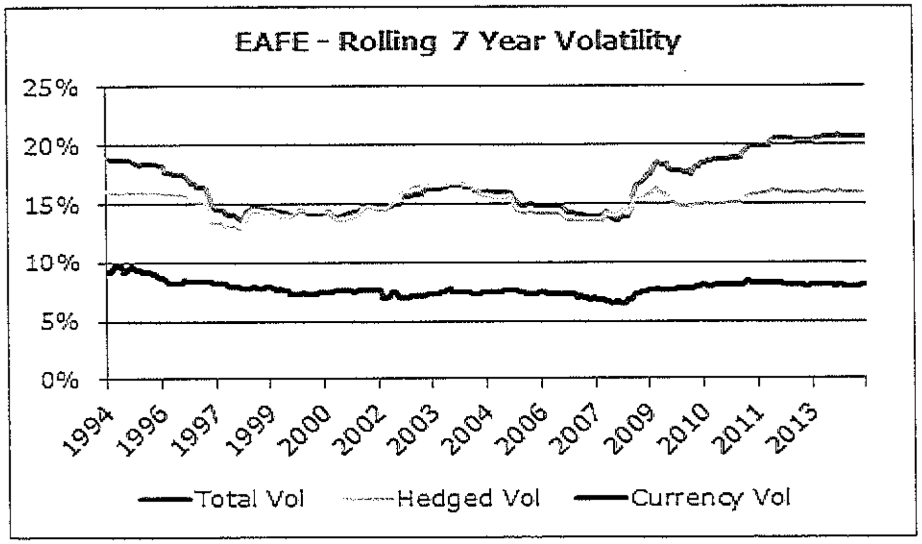


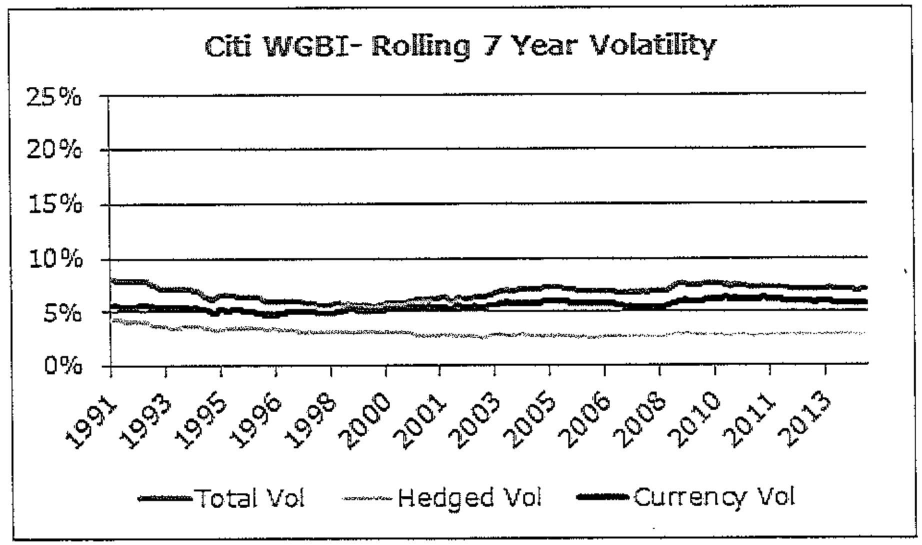
Citi WGBI



Source: Bloomberg, NEPC

Relative Risk of Stocks & Bonds

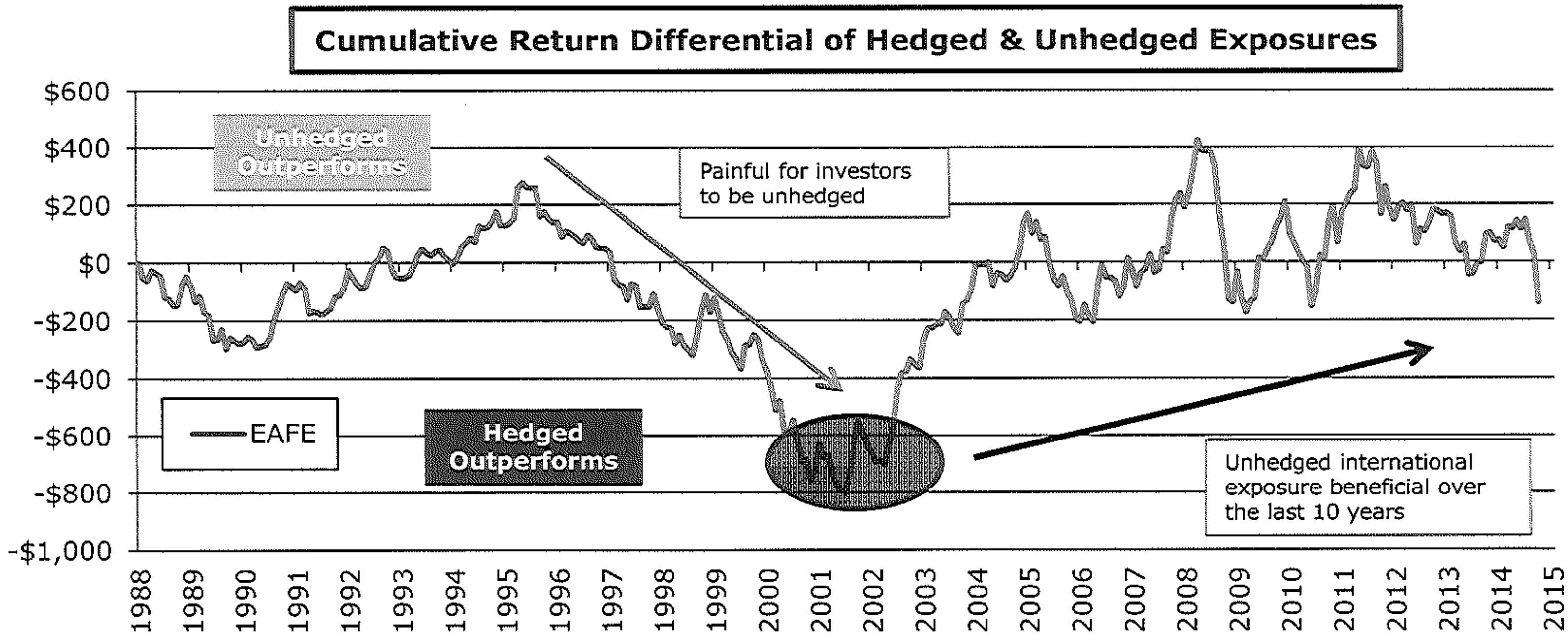




- **Currency risk is additive to non-dollar asset classes**
- **Absolute currency volatility is roughly similar for equities and bonds**
  - Slightly lower for BC Global Agg due to large US allocation (mutes overall currency volatility)
- **Eliminating currency risk reduces overall asset class volatility but with different magnitude for each**
  - Stocks have limited impact due to higher volatility
  - Bond volatility is cut in half when hedged

Source: Bloomberg, NEPC

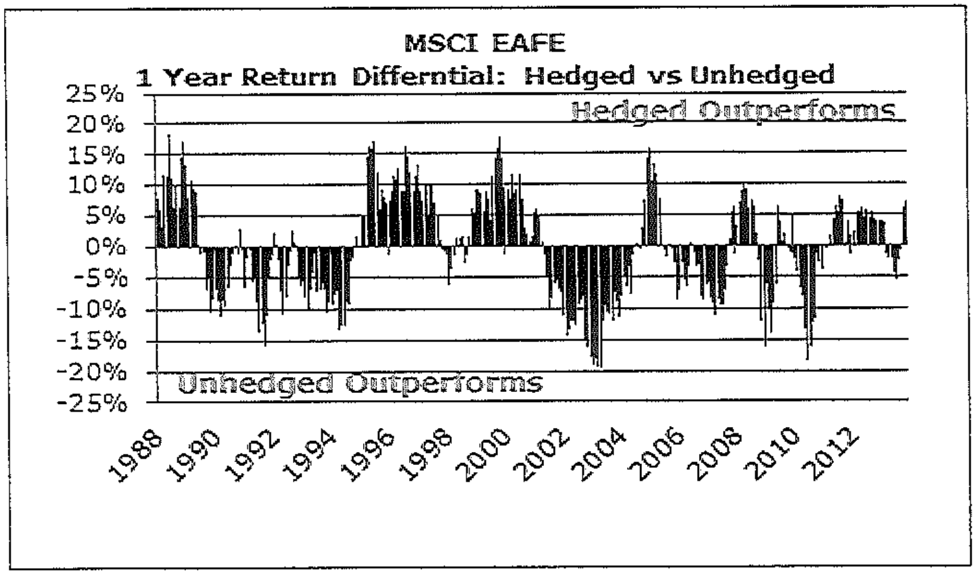
Return Impact of Currency Exposure

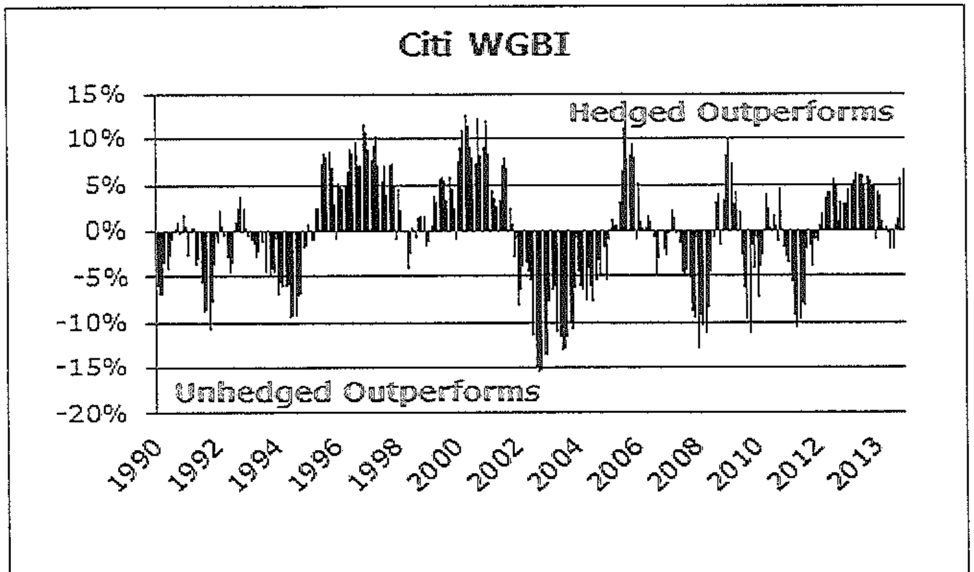


- **Basket of developed currencies has annualized volatility of ~8%, but cumulative impact can be much more severe**
- **By 2002, an investor in EAFE on January 1, 1988 would have 80% less cumulative total value by leaving the exposure unhedged**
- **Over 26 years, currency returns did in fact balance out – but what a bumpy ride to get to the same cumulative return**

Source: Bloomberg, Ibbotson, NEPC

Currency Returns Are Volatile In The Short-Term



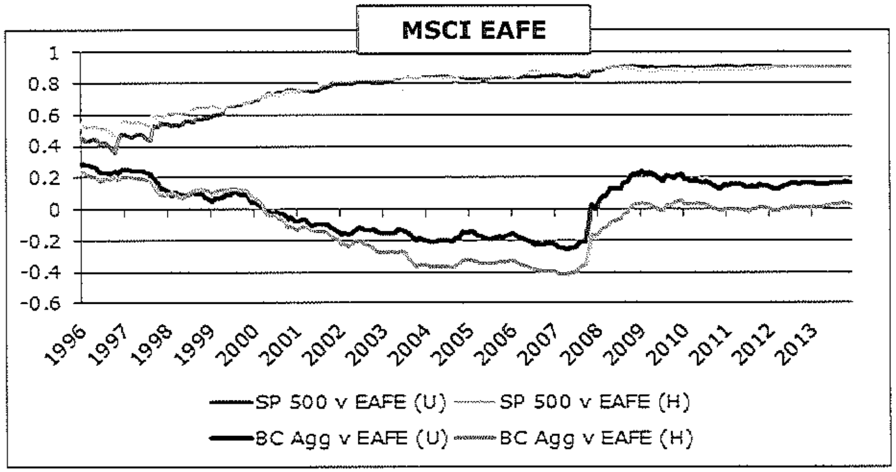


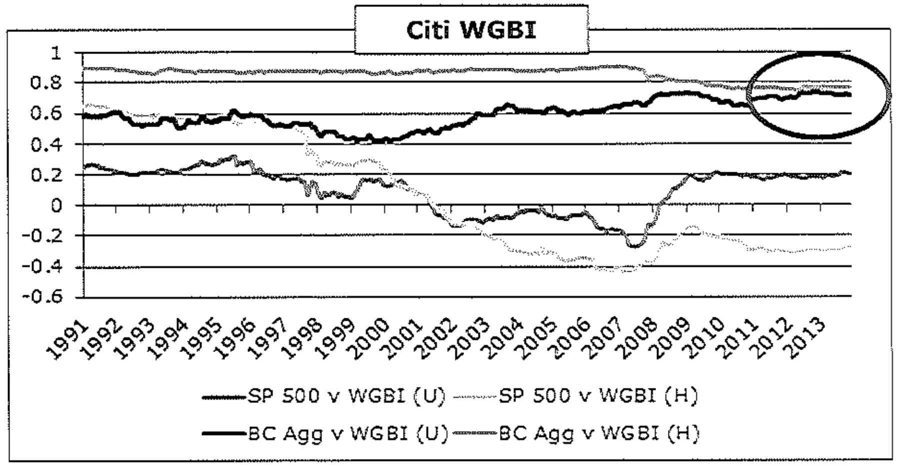
- **Currency returns are much more than a rounding error**
  - At times adding or subtracting upwards of 20% from the annual returns of international asset classes
  - For a portfolio with just 10% allocated to foreign assets, this creates up to a 2 percentage point impact in performance
- **Volatility contribution from currencies is relatively high**
  - EAFE's FX volatility is roughly 8% which is a large portion of total index volatility (18%)
  - Citi WGBI's FX volatility is 5.9% which is nearly all of the total index volatility (7.1%)
- **Return has averaged close to 0% per month over the long run, despite the significant contribution to portfolio volatility**

Source: Bloomberg, NEPC

Including Currency Exposure Does Little to Change Correlations

Rolling 7-year Correlations





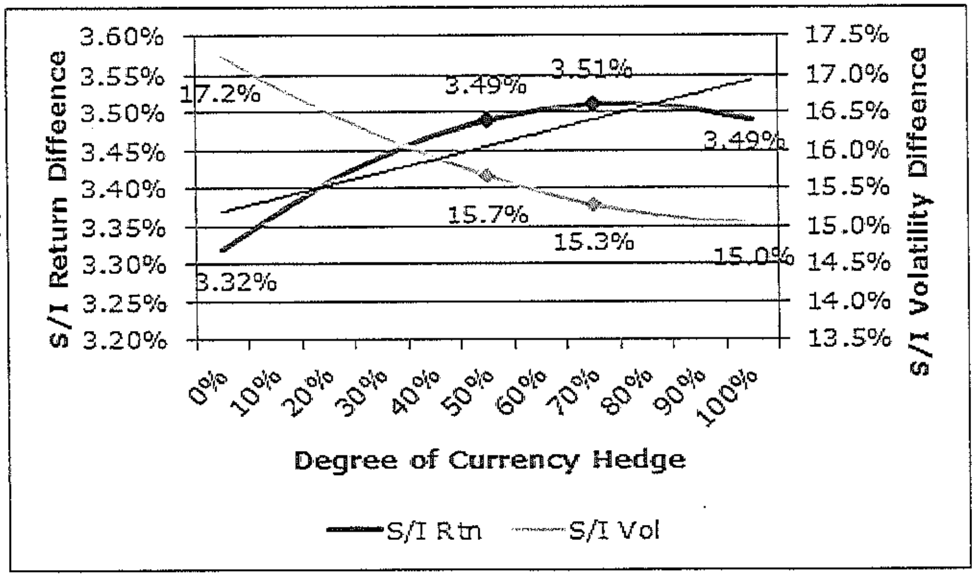
- **Correlations of foreign asset classes are generally unchanged or lower when hedged**
  - True across most risky asset classes
  - The impact of currency exposure on an underlying asset must be negatively correlated to reduce overall correlations and risk of the asset class

- **In fixed income there is an exception, the relationship between the US Markets (BC Aggregate) and global sovereign markets (Citi WGBI) is significantly different when hedged vs. unhedged**
  - Shorter term correlations indicate the recent convergence will reverse
  - Note that both correlations were high already which is not resounding evidence to change the hedging thesis on this metric alone

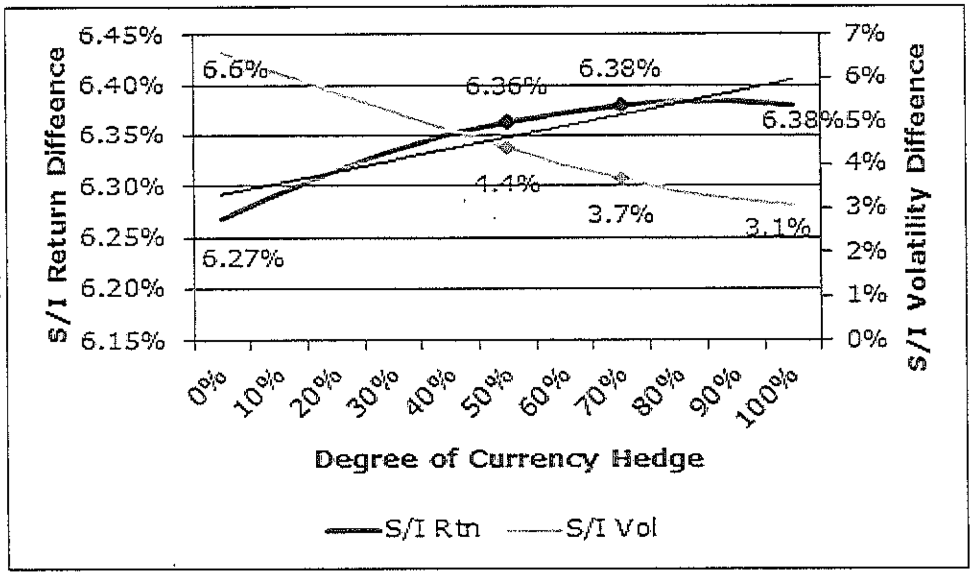
Source: Bloomberg, NEPC

Evaluating the efficiency of hedge ratios over the last 25 years

MSCI EAFE



Citi WGBI



- **70% hedge level appears most attractive historically for equities & bonds**
  - Near the apex of the data set
- **50% level may be more appropriate**
  - Ease of implementation
  - In the up slope of the data (or less likely to provide diminishing returns)
- **Volatility reductions are meaningful for both markets**

Source: Bloomberg, NEPC; MSCI EAFE from January 1988–October 2014; Citi WGBI from January 1990–October 2014

Emerging Currencies Are An Exception

- **Secular view argues for unhedged emerging currency exposure**
  - Emerging countries with surpluses expected to experience wealth increases through currency appreciation relative to developed currencies
- **Trading costs are still meaningfully higher for emerging currencies**
  - Emerging currency markets have improved dramatically but still not as deep and liquid as developed foreign exchange
  - Higher level of interest rates makes hedging less practical (more expensive)
- **Emerging currencies should be unhedged in order to experience positive expected return from currency appreciation**
  - Long term fiscal strength and low debt supportive of currency appreciation
  - Strong active management is required as this is not a homogenous asset class
- **As emerging currencies revalue, cost of hedging compresses, and size in portfolios grows – hedging decision could be readdressed**

Emerging Markets hedging costs are high

- **EM Local Currency bonds offer a yield advantage vs developed market sovereigns**
  - Removing the currency exposure also removes the yield advantage

- **Example – 10 year Turkish local currency bond yields 8.63%**
  - Hedging Turkish Lira can be accomplished by entering into a 3-month long USD/short TRY currency forward
    - Currency forwards are based on interest rate differentials between the risk-free rates of the US and Turkey
  - In this example the forward implied yield is 8.51%
    - This short currency forward position can be considered as a "cost" of hedging
  - Net position is roughly 0.14% after accounting for the Long position in 3 month US T Bills (0.02%)
    - Such a neutralized risk position would defeat the original purpose of the allocation
  - Note the same cost would apply to hedging the Turkish Lira out of an equity position

Closing Thoughts

- **Developed market currency exposure from non-US stock and bond portfolios is an additive risk**
- **Incremental risks should offer a return premium**
- **Currency risk is a large component of non-US indices**
- **Over 25+ years there is no evidence of persistent return from developed market FX**
- **Removing currency risk does not dramatically impact the diversification elements of non-US asset classes**
- **Hedging emerging market FX is not recommended due to expectations for positive return premia, high cost of hedging, and low liquidity**
- **Recommend a half hedged approach to hedging developed market foreign currency exposures within the equity & debt portfolios**

Appendix: Additional Considerations

The below provides a list of MERF's non U.S. equity and fixed income managers

	Market Value ($)	% of Portfolio	1 Mo (%)	3 Mo (%)	YTD (%)	Fiscal YTD (%)	1 Yr (%)	3 Yrs (%)	5 Yrs (%)	Return (%)	Since
International Developed Markets Equity	**110,930,979**	**10.7**	**-1.0**	**-4.4**	**-1.0**	**-5.5**	**-0.5**	**7.8**	**--**	**--**	**Sep-97**
MSCI EAFE			*-1.5*	*-5.4*	*-2.8*	*-7.2*	*-0.6*	*9.7*	*6.5*	*4.7*	*Sep-97*
Walter Scott Large Growth	55,549,621	5.4	-0.5	-3.7	-2.2	-4.5	-2.0	7.5	6.9	3.9	May-06
MSCI EAFE			*-1.5*	*-5.4*	*-2.8*	*-7.2*	*-0.6*	*9.7*	*6.5*	*2.3*	*May-06*
First Eagle All Cap Value	46,767,947	4.5	-1.6	-4.9	0.7	-6.6	1.5	8.2	8.7	13.5	Oct-02
MSCI EAFE			*-1.5*	*-5.4*	*-2.8*	*-7.2*	*-0.6*	*9.7*	*6.5*	*8.9*	*Oct-02*
SSgA EAFE Index	8,613,411	0.8	-1.6	-5.5	--	-5.5	--	--	--	-5.5	Jul-14
MSCI EAFE			*-1.5*	*-5.4*	*-2.8*	*-7.2*	*-0.6*	*9.7*	*6.5*	*-5.4*	*Jul-14*
International Emerging Markets Equity	**101,151,536**	**9.8**	**1.1**	**-2.8**	**4.9**	**-2.3**	**2.3**	**--**	**--**	**--**	**Sep-97**
MSCI Emerging Markets			*1.2*	*-4.2*	*3.6*	*-2.4*	*0.6*	*3.2*	*4.6*	*6.8*	*Sep-97*
Parametric Emerging Markets	54,302,870	5.2	-0.3	-3.2	3.9	-2.5	2.3	--	--	7.6	Jun-12
MSCI Emerging Markets			*1.2*	*-4.2*	*3.6*	*-2.4*	*0.6*	*3.2*	*4.6*	*6.1*	*Jun-12*
Mondrian Emerging Markets	38,080,121	3.7	3.0	-2.0	6.6	-1.8	2.5	--	--	4.9	Jun-12
MSCI Emerging Markets			*1.2*	*-4.2*	*3.6*	*-2.4*	*0.6*	*3.2*	*4.6*	*6.1*	*Jun-12*
SSgA Daily MSCI EM Index	8,768,545	0.8	1.0	-3.8	--	--	--	--	--	-3.8	Aug-14
MSCI Emerging Markets			*1.2*	*-4.2*	*3.6*	*-2.4*	*0.6*	*3.2*	*4.6*	*-4.2*	*Aug-14*
International Fixed Income Composite	**112,589,460**	**10.9**	**1.5**	**0.1**	**7.8**	**0.0**	**6.4**	**5.1**	**--**	**5.3**	**Sep-10**
International Fixed Income Allocation Index			*1.1*	*-1.0*	*6.5*	*-1.2*	*4.8*	*4.0*	*--*	*4.9*	*Sep-10*
Barclays Global Aggregate			*0.0*	*-2.2*	*1.7*	*-3.1*	*0.2*	*0.7*	*2.6*	*2.4*	*Sep-10*
Prudential Emerging Mkt Debt	71,346,389	6.9	1.8	0.6	10.9	0.9	9.2	9.0	9.7	9.7	Aug-05
JP Morgan EMBI Global Diversified			*1.7*	*0.7*	*9.9*	*1.1*	*8.5*	*7.0*	*8.4*	*8.2*	*Aug-05*
Mondrian Global Fixed Income	32,339,347	3.1	0.3	-0.7	2.0	-1.5	1.1	-0.2	2.5	6.5	Oct-99
Barclays Global Aggregate			*0.0*	*-2.2*	*1.7*	*-3.1*	*0.2*	*0.7*	*2.6*	*5.1*	*Oct-99*
SSgA Passive World Gov't	3,785,505	0.4	-0.7	-4.9	-5.1	-5.1	-5.1	--	--	--	Jun-00
Citi WGBI ex US			*-0.8*	*-4.9*	*-0.5*	*-6.1*	*-2.9*	*-1.7*	*0.8*	*5.3*	*Jun-00*
SSgA Passive EM Local Currency	5,118,218	0.5	6.5	1.5	--	1.5	--	--	--	1.5	Jul-14
JP Morgan GBI - EM			*1.3*	*-3.6*	*1.5*	*-5.4*	*-1.6*	*2.8*	*4.4*	*-3.6*	*Jul-14*

Recognition of Practical Challenges

- **Academic perspective**
  - The case for hedging currency exposure, a risk that is not compensated with a positive return, is dramatically clear
- **Practical reality**
  - Challenges exist in implementing solutions, each deserving appropriate consideration
    - Liability characteristics – currency denomination of liabilities or spending requirements should be the starting point for portfolio currency exposure
    - Liquidity – an overlay portfolio of currency forwards can be cash intensive
    - Implementation – investigation, implementation, and monitoring of currency hedging solutions requires significant resources
    - Opportunities for active management – foreign exchange markets are relatively inefficient and can offer an opportunity to add alpha to a portfolio
    - Behavioral considerations – the "long-term" required to justify the risk reduction and portfolio efficiency improvements can stretch beyond the patience of many investors
      - Most US investors leave currency exposure unhedged – choosing to hedge introduces maverick risk

Liquidity Considerations

- **An overlay program of currency forwards requires cash for regular collateral posting of gains and losses**
  - Short position to foreign currency means the investor is long USD and short foreign currency
  - Will require collateral posting when USD is depreciating/foreign currency is appreciating
  - Foreign asset class exposure is long foreign currency/short USD
    - Will have opposite experience of currency forwards
    - Can regularly rebalance gains of one to offset losses of the other

- **This approach can create a liquidity mismatch**
  - Overlay program – daily liquidity needs
  - Commingled international investment – monthly redemptions?

- **Requires total portfolio liquidity analysis to gain comfort in ability to withstand liquidity challenges**
  - Appropriate cash levels
  - Secondary liquidity

Program Implementation

- **Two general approaches**
  - Overlay Program
  - Currency-hedged commingled product

- **Overlay program**
  - Implemented through an overlay manager (likely approach for most investors)
    - Clifton Group, Russell, custody banks, etc.
    - Requires appropriate due diligence of manager's capabilities
    - Requires some element of "look-through" to underlying currency exposures
      - Though could be implemented on an index basis, ignoring active manager's over/underweights to countries
    - Requires cash to manage program
      - Could use futures to maintain exposure over cash
  - Run internally by investment staff
    - Requires skill and experience to understand and monitor derivatives
      - Collateral posting
      - Counterparty management

- **Currency-hedged commingled product**
  - Limited market right now for EAFE (but reasonable amount of preferred product for WGBI mandates)
  - Would integrate currency management and underlying asset management in one portfolio
  - Outsourcing currency management to investment manager
    - Requires additional due diligence step – determining manager's currency hedging capabilities
    - Likely that many of these managers run hedged product for non-US investors

Opportunities for Active Management

- **Expressing views on the direction of currencies can be a source of alpha**
  - Foreign exchange markets are comprised of many non-economic players
    - Central banks
    - Corporate hedgers
  - Leads to opportunities to exploit inefficiencies and generate alpha

- **Many investors access currency alpha through GTAA and global macro strategies**
  - Long-short currency strategy is one element of a diversified set of alpha sources

- **Incorporating active management into overall currency management may be both additive to overall portfolio returns and behaviorally appealing**

- **Active management of currencies can and should be implemented relative to a hedged currency baseline**
  - Active manager can implement hedging overlay and then adjust positions based on currency views

Behavioral Considerations

- **Reducing uncompensated currency risk improves the efficiency of an asset allocation**
  - Similar to experience with many corporate clients implementing LDI
- **The decision to hedge should be:**
  - Based on strategic risk management
    - Reducing exposure to an uncompensated risk
  - Focused on long-term risk allocation
    - Allowing time to observe the benefits of reduced volatility
  - Based on clear education and documentation
    - To understand logic and minimize regret
  - Independent of a directional view on the US dollar
    - Strategic hedging is a risk management exercise, not a value-add decision
- **Most US investors have unhedged exposure to non-US investments**
  - Hedging even a portion of this exposure will make the investor different from peers
  - Creates maverick risk
  - Returns will be meaningfully better or worse than peers based on the path of currencies relative to the US dollar
  - Investors should allow appropriate time to recognize the risk-reduction benefits
- **A clear plan with sound reasoning for the chosen approach to currency management is the best risk control against regret**

INVESTMENTS:
AGENDA ITEM IV

CITY OF HARTFORD

PENSION COMMISSION

MEMORANDUM

To: Pension Commission

From: Adam M. Cloud, Secretary

Date: December 12, 2014

Subject: **457 Deferred Compensation Plan Recommendation**

The Deferred Compensation Committee's recommendation regarding the investment alternatives in the City's deferred compensation plan will be presented.

INVESTMENTS:
AGENDA ITEM V

CITY OF HARTFORD

PENSION COMMISSION

MEMORANDUM

To: Pension Commission

From: Adam M. Cloud, Secretary

Date: December 12, 2014

Subject: **Report on Annual Performance Review Meeting**

Attached for your review is the report on our recent annual performance review meeting with the following investment manager:

- **SouthernSun Asset Management**

CITY TREASURER'S OFFICE
INTERNAL MEMORANDUM

To: Adam M. Cloud, Secretary
Carmen I. Sierra, Assistant Secretary

From: Gary B. Draghi, Director of Investments
P. Wayne Moore, Assistant Director of Investments
J. Sean Antoine, Principal Administrative Analyst

Date: November 25, 2014

Re: **Report on Annual Performance Review Meeting with SouthernSun Asset Management**

The Pension Commission held an annual performance review meeting on Thursday, November 20, 2014, with SouthernSun Asset Management ("SouthernSun"), a small to mid-cap value equity manager for the MERF. Present for SouthernSun was Peter W. Matthews, CFA, CPA, Principal and Senior Analyst and R. Bailey Martz, CPA, Senior Associate.

Ms. Martz began the meeting by introducing herself and her colleague Peter Matthews. She then discussed the transaction under which Affiliated Management Group ("AMG") purchased a majority interest in SouthernSun. Ms. Martz stated that, while AMG had purchased a majority stake in SouthernSun in March 2014, SouthernSun will continue to have autonomy over the day-to-day operations of SouthernSun and will retain control over the firm's investment philosophy and process. She noted that the SouthernSun investment was structured as a share of SouthernSun's topline revenues, rather than a share of bottom-line profits. She added that the transaction also involved the signing of long-term contracts for SouthernSun's management team, ensuring continuity. Michael Cook, the firm's founder, will continue to own the largest percentage of the internally held shares of the company.

In response to a question regarding the in and out flows of the small cap product, Ms. Martz stated that the product was closed to new investors and that existing investors have not been adding new assets recently due to the current high valuations.

Ms. Martz then described SouthernSun's investment process and philosophy. She stated that SouthernSun is a bottom-up, research-driven firm which invests in the stocks issued by niche-dominant, attractively-valued companies with financial flexibility and strong management teams. She stated that SouthernSun also relies on careful, in-depth analysis of a company's financial strength, market position and human capital, as the most comprehensive method of determining proper valuations, identifying catalysts and reducing the risk of making an investment.

In response to a question regarding the portfolio's perceived style drift, Ms. Martz stated that SouthernSun believes its U.S. SMID Cap strategy is best classified as a core product with a value tilt. She added that SouthernSun searches for niche dominant companies with a modest level of organic growth, which are undervalued. Additionally, SouthernSun seeks companies with financial flexibility and management teams with a proven track record.

Ms. Martz also noted that the concentrated nature of the portfolio also can cause the standard deviation of the portfolio's returns to be higher than the benchmark's, either because of outperformance or underperformance. Overall, Ms. Martz stated that they believe SouthernSun's investment philosophy and process have remained constant since the founding of the firm in 1989.

Mr. Matthews reported that the overall performance of the portfolio managed by SouthernSun remained strong, despite recent weakness. Specifically, he stated that the portfolio returned 5.9%, gross of fees, for the one year period ending October 31, 2014, underperforming the Russell 2500 Value Index return of 10.2%, by 430 basis points. Mr. Matthews stated that while security selection was positive for the period, sector allocation decisions detracted from the portfolio's relative performance. Discussion ensued.

In response to a question regarding the risk controls in the portfolio and firm, Mr. Matthews stated that SouthernSun involves every management team member in the process. He noted that broad team involvement creates an environment of trust amongst the group as they perform due diligence checks on their investments.

In response to a question regarding the influence that company founder Michael Cook has on the portfolio and the depth of the investment team, Ms. Martz responded that investment/portfolio decisions are made collectively. She also added that Mr. Cook still has the final say on any changes to the portfolio.

In closing, Ms. Martz thanked the Commission for its continued business.

INVESTMENTS:
AGENDA ITEM VI

CITY OF HARTFORD

PENSION COMMISSION

MEMORANDUM

To: Pension Commission

From: Adam M. Cloud, Secretary

Date: December 12, 2014

Subject: **Other Business**

We will discuss the following items at the meeting.

- **SW Pelham Fund III Update**