

SPRINGFIELD POLICE/FIRE PENSION BOARD

2010 YEAR END REPORT

Submitted by:

Cynthia A. Rushefsky
Springfield City Council
Liaison Representative

VOTING MEMBERS OF THE BOARD:

<u>Name</u>	<u>Representing</u>	<u>Term Expires</u>
Ken Homan, Chairman	Financial	4/30/2012
John M. Bishop	Citizen at large	4/30/2012
David Carter	Fire	12/31/2010
Charles Cowherd, Esq.	Attorney	4/30/2011
Jim Edwards	Police	12/31/2011
James Gillette	Actuarial	4/30/2013
Joshua Hartman	Financial	4/30/2011
Marilyn Hill	Medical	4/30/2013
Ronald Hoffman	Retirees	12/31/2010

NON-VOTING MEMBERS OF THE BOARD:

Brady Stark	Police Alternate
Chris Thompson	Fire Alternate
James Dancy	Retirees Alternate
Mary Mannix-Decker	City Finance Director
Cynthia Rushefsky	City Council Liaison

STAFF:

Nikki White, Secretary

OVERALL FUND MANAGER: SEGAL ADVISORS, New York

Gino Reina, CFA

INVESTMENT MANAGERS:

State Street Global Advisors	All Cap Equity	4/30/07 to date
Pictet Asset Management LTD	Int'l Core	2/29/08 to date
Galliard Capital Mgmt, Inc.	Fixed Income	7/01/08 to date
Brandywine Global, LLC	Fixed Inc. Int'l	4/30/07 to date
Prudential Real Estate	Real Estate	9/30/07 to date

SUMMARY

This year continued to be a time of change and adjustment for the Board following major revisions to Board structure by City Council and the closing of the Plan to new employees. By mid-year, all Tier II employees had left the Plan and joined the LAGERS system, creating a need to re-evaluate some of the basic assumptions on which the Plan had been operating. Complicating the picture was an ongoing search for an Administrative Director for the Board and possibly a new Investment Consultant for the Fund. Throughout the year, the Board has been struggling with controversial disability issues: re-evaluating the health status of current disability recipients and adjusting pension payments as warranted by changes in income for disability check recipients.

Despite the turmoil and uncertainty, there were some major bright spots. Improving market conditions meant that the Fund saw more positive monthly and quarterly financial reports and significant increases in investment income. Infusion of additional funds from a settlement with AT&T and the first sales tax receipt checks also helped increase the net Fund balance. As a result, the funding ratio increased for the first time in several years from 47% to 49% by year's end. As of the last available report, November 30, 2010, the Fund's net balance was \$158,604,133.

Section I: FINANCIAL REVIEW

Beginning in May, 2009, the Police/Fire Pension Fund investment portfolio began a slow climb out of a dismal market depression that had left the Fund with a balance of \$89.4 million in February, 2009 and a negative return on investments. As a result of the improving market, the Fund began the 2010 calendar year with net assets of \$132,317,188 and an annual return for 2009 of 14.5%. In February, 2010 the Fund received \$7,450,000 from the City as a result of a settlement with AT&T of which \$6 million was invested with the State Street Global non-lending fund and \$1.45 million with Pictet International.

Fourth Quarter Report - 2009

Also in February, 2010, the Board received a 4th Quarter (2009) review from its Fund Investment Manager, Gino Reina, who spelled out some of the problems facing the Board. At that point, both Galliard and Brandywine were doing well compared to their benchmarks. Pictet was struggling to make up for significant losses in 2008 but were operating well ahead of their benchmarks and were still in the top 17% of international equity managers. PRISA, the Fund's real estate investment managers, had suffered unrealized losses of -34% in 2009, largely because of forward commitments. However, Segal believed that PRISA would ultimately rebound because they were aggressively writing down their portfolio and had a long history of institutional core real estate investing. The Board in

2009 had placed a redemption request for its full investment of \$6.7 million which Prudential indicated it would not satisfy in 2010.

How to maximize returns and minimize risk was clearly a major challenge that faced the Board in 2010. As Reina pointed out, closing the Plan to new employees had completely changed the dynamics of the Plan. His recommendation was Asset Liability Modeling, a six to nine month process in which Segal would model out liabilities, contributions and cash flow and design a portfolio that best suited the mix. The Modeling would cost the Fund \$60,000 in addition to the \$55,000 yearly management fee charged by Segal and would have to be updated every five years. The ultimate goal for the Board was to balance risk and return so that the Fund would be 100% funded at the time the last employee retired. As the Fund matured, because of the loss of new employees paying into the Fund and the increase in retirees drawing out of the Fund, the tolerance for risk in investments would decrease as the need for funds would increase. The Board ultimately declined to proceed with the Modeling in part because of the impending changes the Board was facing and in part because of concerns about continuing with Segal. However, the challenge of balancing the need for more conservative investment and mitigation of risk with the need for increasing income is one that dominated the discussion of the Board throughout the year.

Board Changes

The changes the Board faced were significant and continued to effect decisions throughout the year. Between March and May, in keeping with ordinance changes approved by City Council, six new members joined the Board for a total of nine voting members, and the voting structure of the Board changed. Police and Fire representatives now had one voting member each (rather than two), plus a retiree representative; there would also be alternate, non-voting members for each category who voted only when a voting member was absent. Ken Homan, who had been serving as interim chairman, was elected Chairman of the Board in May. In addition, a subcommittee consisting of Homan, Hartman, Bishop and Hoffman was created to consider investment strategies.

After consideration of the options, the committee favored a more passive approach to investments with broader indexing. It also felt that the Board should look at alternative investments to buffer the Fund from future volatility.

Joint Meeting with City Council

In addition to investment strategy, the Board was concerned about the need to change the assumptions on which the Fund was operating given the fact that the Plan was now closed. In April, a joint meeting was held by the Board and City Council with Michael Zweiner of Milliman Associates, the actuarial firm for the Plan. Zweiner told the joint meeting that a thirty year amortization period was no longer reasonable. Amortization is a process of spreading funding of future payouts (unfunded liability) over time, in this case, thirty years. The Fund had been using a system based on a level percentage of payroll, spread over thirty years, which was reasonable as long as new people were coming into the Plan. It made more sense, according to Zweiner, to pay off all liabilities over the period the liabilities were being earned, roughly twenty years. He also did not feel that it was appropriate to spread out the cost over the entire payroll when only a portion of the payroll would be tied to the Plan. He presented six different alternatives to the Board for consideration. The Board, following Zweiner's recommendation, chose the 20 year closed level dollar alternative. Under that plan, the unfunded liability would be recalculated and amortized each year for twenty years in much the same way that a mortgage payment is calculated.

During the Joint Session, Zweiner also reviewed the 7.5% assumed rate of return. He noted that the investment return results over the five years covered by his study had been significantly below 7.5% primarily as a result of the poor overall markets in late 2007, 2008 and part of 2009. However, he felt that modifications that had been made to the Fund's asset allocation would be likely to support higher expected returns over the long term as compared to the prior asset allocation and he indicated that the 7.5% return rate was still a valid assumption.

First Quarter Report

In May, Segal representative Gino Reina presented the Analysis of Investment Performance for the first quarter of 2010. GDP was increasing for the third consecutive quarter, although more slowly than the previous quarter. Unemployment had declined slightly and inflation had increased slightly. Equities were still going up, particularly small cap equities, and real estate had gone up for the first time in two years. Corporations, however, were still building up cash balances and consumer credit had declined significantly. The bond market had increased dramatically, particularly Treasury bonds. On March 31, 2010, the Fund was valued at \$139,906,422, about a \$10 million increase from the last quarter. The composite return was 3.49% for the quarter, slightly above the benchmark; equities were up 6.27%. Reina suggested that the Board may want to dedicate an allocation to small cap equities and select an active manager. However, the Board favored a more passive approach and Reina recommended that the Board separate out some of its SSgA funds into S&P 500 and Russell 2000 at a rate of 30% and 10% respectively.

Second Quarter Report

By June, 2010, the first sales tax check had been received and \$1.4 million was added to the Fund's balance. The net investment income reported for April was \$2.7 million for a net Fund balance of \$144,993,441. It was the last good news for awhile, however. The second quarter was not good for the Fund or for the market as a whole. As anticipated, all Tier II employees had opted to move to LAGERS taking payouts totaling \$550,207.47 out of the Fund balance. All the equity markets were down by double digits as a result of the oil spill in the Gulf, slowing economic growth in China, and financial problems in Europe. Unemployment figures were still high although the GDP was positive again and inflation remained low. The one bright spot in the Fund this quarter was, surprisingly, PRISA which was now up 8%. Prudential had previously been criticized for decisions which now appeared to be good in the long term. Segal, which had previously expressed some concern about the quality of management

at PRISA, now recommended putting tax money into PRISA and withdrawing the request for liquidation. The Board voted to take the Fund off the queue for liquidation of its investment and put \$1 million of the September tax money into the account.

In keeping with earlier discussions with Segal about dividing the State Street Global account into two separate accounts to take advantage of small cap opportunities, the Fund opened two new accounts: the S&P 500 Index Fund and the Russell 2000 Index Fund. All of the Wilshire 5000 non-lending Index Fund monies were transferred to the new accounts: \$17 million to Russell and \$11.5 million to S&P and the remaining \$22 million to be transferred as liquidity restrictions were lifted.

Actuarial Valuation Report

By September the picture was looking much better. As of July 31st, the fund balance was \$146,810,394. The net investment income was \$7 million and the fund managers had outperformed the index. At its October meeting, the Board received the Actuarial Valuation Report which analyzed the Fund as of June 30, 2010 for the purpose of determining the recommended level of employer contributions for the 2011-2012 fiscal year and assessing the relative funded position of the Plan through a comparison of plan assets and projected plan liabilities. The report reflected the change of active membership from 481 to 406 and a decrease of \$3 million in covered payroll as a result of the transfer of Tier II employees. It also reflected an increase in retirees and beneficiaries from 477 to 485. However, it did not reflect the sales tax which had been implemented in April but had not impacted the Plan in time for the Report.

For fiscal year July 1, 2011 through June 30, 2012, Milliman recommended a decrease in the member contribution rate to 13.35% from 15.34%. This rate included a flat 8.5% plus 4.85% to cover the cost of the Additional Funding Contribution (AFC). City Council had approved a one-time City contribution of \$4.75 million to pay for a portion of the increase in the AFC, resulting in a temporary decline in the AFC rate from 7.52% to 4.85%. The City contribution rate jumped from 57.7% to 93.02%, a result of actuarial losses from previous years,

the new amortization method and transfer of the Tier II employees out of the Plan. The Actuarial Report also indicated that the net market rate of return for the fiscal year 2009 was 8.7%. However, because of the smoothing technique used to amortize losses, the net actuarial rate of return was -2.3%. Chairman Homan reminded the Board that the Investment Consultant's report which takes into account the actual timing of contributions rather than actuarial assumptions, reported an investment return of 11.1% for the fiscal year and is probably a more accurate indicator of performance.

In presenting his report to the Board, Zweiner explained that as additional sales tax monies were added, they could cover the recommended contributions, decrease the unfunded liability and increase the funded ratio. It appeared that five years would be insufficient to complete the task, although an additional five years would probably not be necessary. He indicated that the Fund was currently not sufficiently funded to justify completely de-risking the plan although a decreasing rate of return might become tolerable as the funding ratio increased.

Audit Report

In November the Audit Report from Davis, Lynn & Moots was presented to the Board by John Cummings and was similarly positive. The Audit Report did include the inflow of \$5.6 million in sales tax revenue to the Fund, resulting in net assets of \$140,634,188, an increase for the fiscal year of \$28 million. The funded ratio was 49% and the unfunded accrued liability (UAL) showed its first decline since 1999.

Third Quarter Report

Although Segal's contract had expired in July, 2010, they had agreed to an extension of their contract pending selection of a permanent investment consultant firm. The Third Quarter Report was submitted in November and showed an investment return of 9.9% for the quarter. Market value of assets at the end of the third quarter was \$154,208,799.

Fourth Quarter

Although the Fourth Quarter report will not be available until early 2011, the monthly reports for that period were mixed. The final report will depend on the investment market picture as it emerged in December. As of October 31, 2010, the Fund balance was reported at \$160,074,922. Investment income had increased by \$36 million over last year and total net assets had increased by \$28 million. By the end of November, however, investment income had declined by \$2.3 million, leaving the Fund with a net balance of \$158,604,133, still a substantial increase in Fund assets over November 2009 (\$132 million) despite the many uncertainties the Plan had endured.

Section II: Personnel

Administrative Director

In addition to the changes in Board membership, City Council had voted to allow the addition of an Administrative Director for the Board. This independent contractor would assist the Board in working with the investment consultant and the actuary and coordinating the efforts of the Finance Department which handled the monies for the Fund. It was felt that although the position would be part-time and without benefits, it required someone with pension administration experience, preferably public pensions. By August the Board had developed a job description but locating a suitable candidate with public pension and defined benefit plan experience proved more difficult than expected. A local recruiter was enlisted to assist in the process and the position will be advertised as appropriate. The search is still on-going.

Investment Consultant

The Board is also in the process of selecting an investment consultant who will be open to using a passive management approach for the core investments (75% of the portfolio) and active management for the satellite investments (25% of the portfolio). Segal's contract expired in July, 2010 and they have continued to

manage the investments on a temporary basis pending selection of the permanent manager. RFP's were issued for the position and three finalists were interviewed by a selection committee of the Board. The unanimous selection of the Board was Hammond Associates and the Board voted to approve. However, the firm was subsequently sold and Hammond was no longer available to manage the Fund. This search also remains on-going.

Section III: DISABILITY

The good news this year is that there were no new disability claims. However, the Board continued to deal with knotty issues involving existing disability recipients including income verification and medical re-examination of claimants.

Income Verification

Following the resolution of a court case last year, the Board had begun a process of verifying income for all current disability recipients. Section 2-477 of the Plan's charter requires a reduction in disability pension when the recipient's earnings from employment together with the pension benefit exceed the salary that was paid for the job the recipient held at the time the disability began. In order to determine whether an off-set is appropriate, the Board had required all recipients of disability payments to submit verification of income in the form of W-2 forms submitted to the IRS. A number of recipients objected to the disclosure of spousal income which was not relevant to the Board's determination. As an alternative, the Board elected to accept either a CPA's letter or a wage and income transcript (IRS Form 4506T) as alternatives. While all disability recipients have complied with the income verification, one legal challenge to the income verification process and income limitations remains pending and is scheduled for trial in 2011. This year, eleven disability claimants had pension amounts reduced for a total reduction of \$156,507.

Disability Re-examination

Section 2-475 of the Plan charter provides that the Board may require annual re-examination of any person under the age of fifty receiving a disability pension. Although the Board had not taken this course in the past, it was felt advisable by the previous board to do a re-examination of recipients on a regular basis to eliminate any public perception of fraud or deception. As a result, a nurse consultant was hired by the Board to coordinate and facilitate the re-examination process and all eligible applicants were required to have a medical examination by an appropriate physician as directed. A specific form had been created and approved by the Board for this purpose. Almost immediately, a number of questions arose which has made this issue difficult in terms of both process and policy. One question has been whether a person who was found to be disabled as a result of a particular injury, which has subsequently healed, but is found to be “still disabled” as a result of a follow-up examination, must be returned to work or would still qualify for the disability pension. That question was ultimately answered by examination of the legal history of the Plan. An old court decision, which remains unchanged, had determined that “disabled” meant, in the context of our Plan, that the recipient of the pension had to be able to perform all of the tasks for which he had qualified at the time of the disability. It has long been the policy of both the Police Department and the Fire Department, because of certification requirements and the necessities of budget management, that every police or fire officer had to be physically qualified to do all aspects of the job. Therefore, it did not matter whether the disability recipient was found to be disabled because of the original injury or subsequent medical issues. As noted by Dr. Thomas Corsolini who has performed many of the examinations for the Board, most of the injuries in these employment fields are muscular/skeletal injuries which do not improve with age. Along with the original injury comes the usual deterioration that comes with age. Even those former officers and firefighters who could do some of the job some of the time are unlikely to be able to perform the job as required.

The matter is further complicated when the recipient of the pension is close to fifty years old at the time of the re-examination, as several were this year. If returned to work, they would qualify almost immediately for standard retirement benefits at a higher rate. Several members of the Board have questioned the wisdom of requiring re-examination in those cases. As a matter of reasonable fiscal management of the Fund, the cost of the process versus the benefit to the Fund has been a real concern. Part of that concern has been trying to determine who should be re-examined, how much re-examination was required in each case and by whom it should be performed. Because this is the first time re-examination has been performed, the Board has decided that all members should undergo at least one medical re-examination for baseline purposes. Developing a reasonable, workable and consistent policy for the future, however, remains an ongoing process.

SECTION IV: FINAL WORDS

This year the Board has struggled with a number of important issues, striving to set consistent policies and processes that will carry the Plan through the remaining years of its life following major changes in structure and composition. Clearly that struggle has not ended and promises to continue for some months to come. Financially, it has taken considerable, but necessary, time and effort to rebuild and regroup after the devastating losses of fiscal years 2008 and 2009. That redevelopment has been assisted greatly by the infusion of new money, in the form of the AT&T settlement and the sales tax checks that began in April, 2010. The market remains erratic, but without the extreme volatility of previous years.

However, the lessons of fiscal year 2008 and fiscal year 2009 were harsh and well-learned. It is obvious that the market must be approached cautiously and cannot be solely depended on to carry the Plan. The Board is looking for experienced, permanent leadership that will monitor the Fund's investments and assist in developing a long-term strategy for financial soundness. The challenge to maintain a necessary level of return while reducing risk to the Fund as it winds down is not underestimated by anyone on the Board. It is abundantly clear to the

Board and reiterated by the Board's actuary on more than one occasion, that the Fund cannot maintain itself for the duration of its life without at least one renewal of the sales tax, although probably not for an additional five year period. Ironically, the better returns made by the Fund and the more the unfunded liability is reduced, the more difficult it will be to persuade the voters of this basic truth. That, too, will be a major challenge for the Board and for Council in the coming months and years. It is essential that the Board and Council continue to educate the public about the Fund and its requirements, without bias and without rhetoric, if we are to keep faith with our employees and with the people of the City of Springfield.

Submitted by:

Cynthia Rushefsky

City Council Representative, Zone 2

December 30, 2010

