

POLICE PENSION BOARD MEETING

APRIL 15, 2004
4:30 p.m. – Ante Room

A meeting of the Police Pension Board took place in the Downers Grove Village Hall Ante Room on Thursday, April 15, 2004.

MEMBERS PRESENT

President Greg Boltz, Trustees: Norman Sidler, Paul Lichamer, Andy Blaylock (left @ 5:50 p.m.)

MEMBERS ABSENT

Secretary Dennis Burke

VILLAGE TREASURER

Rita Trainor

OTHERS

Tim Hamann, Vice-President-Marquette Associates; Timothy Hyland, President-Boyd Watterson; Michael Bee, Executive Vice President-Boyd Watterson; Terrence McCormick, Investment & Trust Consultant-Downers Grove National Bank; Lisa Marchese- Downers Grove National Bank; Maureen Svagera – Harris Investment Management, Inc. and Laura Alter, Sr. Partner, Head of Long-Term Fixed Income-Harris Investment Management, Inc.

I. CALL TO ORDER

President Boltz called the Police Pension Board of Trustees meeting to order at 4:30 p.m.

II. MINUTES OF THE 1/15/04 MEETING

MOTION

Mr. Sidler moved to accept the minutes of the 1/15/04 meeting. Mr. Blaylock seconded. Motion passed unanimously.

Motion Carried: 4 – 0

III. INVESTMENT ADVISOR REPORT

Mr. Hamann suggested hearing representatives from Downers Grove National Bank first; therefore the order of presentation was reversed.

He said there was little volatility in the first quarter of the fixed income market. However, at the end of the quarter, all the broad indices were positive between 1 ½% and 2%. He added that it was a good year in the bond market. There was also some volatility in domestic equities, but the S&P 500 was up about 1.7%. Mid and small cap were up a bit higher. The smaller the cap, the better the return. The MSCI EAFE Index was up about 4-½%. Mr. Hamann said that both the fixed and equity markets were positive.

Mr. Hamann noted that the Executive Summary books are still not complete due to the fact that all assets are still not transferred in. He was unable to compute the composite return for this quarter. At the close of the quarter, the Pension Fund had an approximate market value of \$27,878,237, which is approximately \$629,000 greater than last quarter. This was up about 2%.

Mr. Hamann asked everyone to turn to page 3, which is a summary of investments. He said that both the American Scandia Variable Annuity and the Manu-Life Variable Annuity were fully surrendered. Also, the 10% surrenders on the remaining annuities have begun. He then referred to page 4, which indicates all investment managers being utilized by the Pension Fund. Page 5 is the market value page. He added that it's 99.9% accurate. Unfortunately, Fidelity's March statement has not been received. He said that asset allocation is a bit low in fixed income. He added that the board agreed to keep the fixed income in cash until a fixed income manager was agreed upon.

Mr. Hamann stated that he hoped this information was simplified sufficiently and not to have significant overlap in various annuities and mutual funds. The goal is to simplify and stick to the targets.

Page 7 lists the annual fee review and Mr. Hamann noted that the fees for underlying mutual funds in annuities are double the industry average. The mortality and expense fees are responsible for the high cost. He said that he would continue to do the 10% surrender on an annual basis. Within 5 years they will all be surrendered.

Mr. Hamann then asked everyone to turn to Exhibit II regarding the Intermediate Fixed Income Manager Search. This search profiled 6 firms of which 2 were chosen for presentations tonight. Those being, Boyd Watterson and Harris Investments. They were told to keep their presentations to 20 minutes and 10 minutes for questions and answers. Mr. Sidler said he is familiar with Harris Associates and Boyd Watterson and wants the board to be

aware of that. Mr. Hamann wanted to clarify something and asked the board members to turn to page 11, the credit quality breakdown. He said that information was requested on their composite. This composite is based on similar portfolios. Harris's composite included AAA corporate securities. Their performance is not a true apples-to-apples comparison because corporate securities tend to give a higher return. Therefore, when looking at the numbers, he asked everyone to keep in mind that ¼th of Harris's portfolio contains corporate securities. The same fees were conducted for the Downers Grove Fire Pension Fund and they chose Harris Investment. Harris came down to 25 bp. He suggested asking both Boyd Watterson and Harris Investment for the best and final fees. Mr. Sidler noted that neither manager would have much flexibility insofar as managing the funds because of State Statutes. So the real difference would be in their fees.

Chairman Boltz also noted that he is familiar with an employee from Harris Investment.

IV. DOWNERS GROVE NATIONAL BANK – Custodial Services

Mr. McCormick, Investment and Trust Consultant of Downers Grove National Bank introduced himself along with Lisa Marchese as representatives. They proceeded to update the board on the transition of assets and benefit payment services.

Mr. McCormick said that he and Ms. Marchese met with Ms. Trainor and Ms. Holm on Tuesday. They familiarized themselves with the communication process. He added that they lease the Northern Trust system, thereby getting a global, automatic and sophisticated system. He said that he would make the entire pension benefit payments, along with 1099R reporting, which each pensioner will receive once a year. The board members will receive a report indicating everything going into and out of the account broken down by category. It will also indicate the cash flow.

Chairman Boltz asked if there would be any need for secondary records. Ms. Trainor replied that only one journal entry would be required by the Village and added that it will be very beneficial insofar as reducing the workload. She said that the Village has to calculate the amount received by every pensioner and if any changes occur after the first of the year. Ms. Trainor stated that the Village would not have to do the pensioners checks every month, nor deal with 1099 or 1096 forms. However, the Village will still have to do 945 forms and the Department of Insurance filings, which includes statistical information.

Chairman Boltz asked what procedure is followed if a retiree has questions. Lisa replied that she would have the information. However, because of the

Privacy Act, the retiree would personally have to seek the information, as opposed to a phone conversation.

Mr. McCormick discussed Transaction Reports in which every recipient is listed, showing where the monies are disbursed. It also shows dividends and expenses. At the end of the year, a Summary Report is completed for the board's perusal. Mr. McCormick stated that all information would be current with the previous day's information and also web accessible.

Chairman Boltz queried whether the pensioners would receive a set of procedures. Lisa replied that retirees would have to fill a form out and a letter will be included with the form. She added that checks could be cut as soon as the pensioners authorize them. Chairman Boltz asked to be copied on the letter along with Ms. Trainor and the other trustees.

Mr. McCormick stated that only Ms. Trainor would have the authority to make changes to the checks.

Chairman Boltz said that the Fire Pension Board has a statutory Treasurer on their board. However, the Police Pension Board does not. He asked about the procedure to authorize Ms. Trainor. Mr. Hamann suggested that the trustees sign an authorization indicating that Downers Grove National Bank can take instructions from the Treasurer, Ms. Trainor. Mr. McCormick recommended an either/or authorization, in case Ms. Trainor was on vacation. He then suggested a resolution authorizing specific signatures.

Ms. Marchese said the letters would be sent out next week and the first checks would be sent no later than the beginning of June.

Mr. McCormick said the bulk of the bonds came in today. Various accounts have been opened according to Mr. Hamann's recommendation. The Police Pension Fund has approximately 10.9% in cash. It's in a government security mutual fund, which is managed by Northern Trust. Mr. Hamann summarized that the fixed income assets have been transferred, along with the money market funds. He added that Vanguard and Fidelity Income Funds are in process and the annuity contracts should be completed within 3 to 4 weeks. Mr. McCormick stated that this information is also web accessible. Mr. Sidler confirmed that all transactions should be complete by May 31st.

Ms. Trainor also mentioned checks needed for transcription costs. It was noted that meetings are usually on a quarterly basis.

Mr. McCormick said that he appreciates the Police Pension Board choosing his bank.

V. INTERVIEW MONEY MANAGERS

Boyd Watterson

Mr. Timothy Hyland introduced himself as President of Boyd Watterson, Asset Management and Michael Bee, Executive Vice-President. He stated that both he and Mr. Bee were fortunate enough to have worked with Mr. Sidler at Duff & Phelps.

Mr. Bee said his agenda was as follows:

- 1) Organizational overview
- 2) Fixed Philosophy
- 3) Downers Grove Fixed Income Analysis
- 4) Commitment to Client Service

He said that Boyd & Company was founded in 1928. Duff & Phelps purchased it in 1979. A management and employee buyout occurred in June 2000. It then became an affiliate of Mercantile Bank in February 2003 and formed the New England Group of Boyd Watterson Asset Management.

Their products consist of equity management, conservative value and large cap growth. They also offer various fixed income management. They have approximately \$4 billion in assets under management with a total of 938 relationships and an additional 300 institutional clients.

Their philosophy is to try to determine which way interest rates are headed over a 12 to 18 month period. Within that framework, they identify undervalued areas of the fixed income market. Longer maturity bonds are limited to Treasuries, Federal Agencies and High Quality Corporate bonds. The United States Government would guarantee all securities in the Police Pension Fund and are AAA rated.

It is their belief to go outside the benchmark +/-20%. They feel that enough value can be realized within the 20% band. Another portfolio feature is sector and maturity allocation to improve diversification. They focus on a liquid portfolio, especially for State funds.

Mr. Bee said they have a five member Strategy Committee. He added that he is a member of the team, which averages 26 years of experience. Mr. Hyland said the team is a nice blend of age and youth, looking at the market from both perspectives. Mr. Bee continued that their strategy focuses on moderate duration shifts to take advantage of changes in interest rates, sector allocation and issue selection. Mr. Bee added that model implementation is utilized. He said that all clients with similar benchmarks are managed the same way.

Mr. Bee stated that interest rate sensitivity is realized through an analysis of domestic and international economic conditions. They have three proprietary interest rate models, one of which was developed by the University of Chicago. The other two models were developed in-house. They identify distribution among maturities to maximize anticipated changes in the shape of the yield curve. They will then be +/-20% of the benchmark or remain neutral for a while.

Mr. Bee said they try to identify undervalued sectors in the market. They take the current and past trends and try to identify future trends. They will then allocate assets to the undervalued sectors. They have both internal and external resources and focus on a top-down and bottom-up analysis.

He then referred to the government only AAA rated portfolio, which indicates the results as of March 31, 2004. He said that his clients have benefited by about 50bp. Mr. Hyland said their results are very attractive and they have been achieved by taking less risk. He likened it to buying coach air tickets, but having first class seats. Consistency and predictability of terms relative to the market is most important for the fixed income portion of assets. He said their job is to provide consistency and stability. He added that it's called the SWAN approach (sleep well at night). Risk is taken on the equity side, while fixed income is the anchor.

Mr. Bee then proposed several changes to the existing portfolio. Yield will be added through mortgages, callable agencies, agency subordinated debt and other government sponsored securities. He said if they had managed the Police Pension Fund a few weeks ago, they would have been at 82% duration of their benchmark. He said the value added in the portfolio would be much more liquid and provide more income to reinvest in a rising rate environment with less duration.

Mr. Bee referred to several scenarios whereby a bearish portfolio versus a bullish portfolio and the end results. He said that each manager has their own bias relative to the markets. Currently, their firm has been somewhat bearish on bonds and has decided to be a bit more defensive. Mr. Bee said his firm's goal is to protect the portfolio and capture value throughout the year.

Mr. Hyland stated that a team of investment professionals is assigned to each account. Their objective is to ensure continuous dialogue. He added that they enjoy meeting with their clients. His firm manages over \$1 billion in assets of public funds. Mr. Hyland said that fees are never an issue. If they do a good job, they will receive more assets to manage. He quoted 20bp on the first \$20 million and 15 bp above the \$20 million mark. He added that if the pension fund is doing well, he is doing well. It's a partnership approach.

Mr. Bee said he enjoys getting back to Chicago as much as possible and would be happy to be working with the Police Pension Fund. Mr. Hyland said his brother-in-law resides in Chicago and would also enjoy his visits.

Mr. Sidler questioned the benchmark position. Mr. Bee replied that it averages 10% and changes are usually modest. It is rarely at extremes. He added that 2 to 3 changes might occur throughout the year.

Mr. Hamann asked what Mr. Bee anticipates for Treasuries in the next year. Mr. Bee replied that he believes rates will probably move a little higher. What he doesn't like to see is extreme volatility, such as last year. He said the shock to the market was that last month 308,000 jobs were created. However, he would like to see a trend. Mr. Hyland said they foresee a nominal increase in rates. They are currently in a defensive mode as opposed to the offensive mode during the last decade.

Mr. Sidler noted that their firm must follow fairly rigid guidelines. However, he asked for suggestions for additional yields. Mr. Bee said the mortgage area could yield approximately 100 to 110bp additional income. Other areas are in subordinated agency debt, yielding 70bp's. In addition, they'll buy Tennessee Valley Utility Bonds and also bonds issued by the US Mint that are backed by the US Government. Mr. Bee added that with government portfolios, the goal is to maximize the income as much as possible.

Chairman Boltz asked Mr. Hyland and Mr. Bee if they would lower their fee. Mr. Hyland said he would like to work for the Police Pension Fund. Mr. Bee suggested 17½ bp. Mr. Hyland said the fee is not an overriding issue. His belief is if they do a good job, there will be more assets to manage. If they don't, they'll be terminated. He is sensitive to budget constraints. Mr. Hyland said the fee for anything over \$20 million would be 14bp's.

Chairman Boltz complimented Mr. Hyland and Mr. Bee on their presentation.

Mr. Sidler commented that the fees were extremely competitive.

Mr. Blaylock left at this point.

Harris Investment Management, Inc.

Ms. Maureen Svagera, introduced herself as Senior Partner, Portfolio Manager and Laura Alter as Senior Partner, Head of Long-Term Fixed Income. Ms. Alter said in addition, they both are bond traders and have worked together for 10 years. They manage corporate bond funds.

Ms. Alter said her firm is an autonomous subsidiary of Harris Bank, which is headquartered in Chicago. They currently manage \$21 billion in assets. Their

clients include corporations, endowments, foundations and public funds. Their philosophy is quantitatively driven. All the professionals at their firm have advanced degrees and the head of their group, Dr. Patel, is a resident of Downers Grove. She then referred to a chart depicting their investment profile.

Ms. Alter noted that the Downers Grove Fire Pension Fund just hired them.

Ms. Svagera said they obtained a copy of the Police Pension portfolio and ran it through their modeling system, which is used to analyze all the portfolios. It measures where risks lie and what overexposures exist relative to the index. The average coupon in the portfolio is a bit lower because of zero coupon bonds. She asked everyone to notice the duration of the bonds. She explained that duration is a way to measure the risk of the portfolio to changes in interest rates. Also, the portfolio has a larger exposure to agency securities. This normally suggest a higher yield, however, the Police Pension's portfolio yield is lower. Therefore, they are not getting compensated in their security selection.

Ms. Svagera referred to page 8, *portfolio analysis, a closer look*. She said there are a few bonds in the portfolio having some unique performance characteristics. 6% of the portfolio is in a Freddie Mac security. She added that it matures in 2028, but is callable semi-annually. At today's prices, it's likely to be called. If rates rise, there could be a substantial decline in price, possibly yielding a -40% return rate. She added that while callable securities can be decent, if you're compensated enough for them, it's obvious that the Police Pension portfolio is not being compensated enough.

Ms. Svagera said if Harris has the opportunity to manage the portfolio, they would keep the interest rate exposure the same. She would purchase highly volatile securities. She added that their specialty is issue selection. They try to buy cheap bonds, meaning different types of bonds that will pay a bit more yield than Treasuries, but don't have the same interest rate risk as some of the current agency bonds. She would focus on purchasing securities with more yield and less volatility. She suggested adding more mortgages. She added that mortgages tend to do better in a rising rate environment. Their philosophy is to try to hit singles and doubles as opposed to home runs. Over time, getting a little extra yield, avoiding volatility and taking smaller interest rate movement will insure a steady performance.

Ms. Alter stated the bond process focuses on 3 main strategies including interest rate risk management, sector/quality weightings and security selection. She added that these should be balanced. Ms. Alter said that different markets lend themselves to different strategies.

Ms. Alter said that they are professional money managers. Their clients are institutions and have access to all the tools that they have. They have the ability to access markets that a retail investor can't. She added that if there is a need for cash flow or have a particular targeted maturity, she will meet those particular needs. She added that she welcomes calls and enjoys working with their clients.

Ms. Alter said the fee for managing the account would be 20bp's. Normally, it would be 30bp's. They are delighted they were invited to attend this meeting. They are honored that the Fire Pension Fund chose them to manage their portfolio and they would appreciate having the same opportunity to manage the Police Pension Fund.

Mr. Sidler asked what their parameters would be and also for any recommendations. Ms. Alter replied that it would be +/-10%. She said they are pretty much at neutral right now. It will probably be a bearish posture. She said the Police Pension's portfolio is at the 95% benchmark duration. She suggested keeping it there for now and recommended mortgage backed bonds or muni bonds. She also suggested HUD bonds, pepco, and Fannie Mae DUS bonds or ACES. She said that the DUS bonds are commercial mortgages that don't have the ability to refinance when rates change. They are locked out for 5 years, plus a penalty.

Mr. Sidler referred to page 5 and questioned the Lehman Government Bond Index. Ms. Alter clarified that this particular bond is a longer duration than the intermediate government bond. Mr. Hamann stated that the Fire Pension Fund is going to be using the core, while the Police Pension will use the intermediate. Ms. Alter said that the portfolio they used is a blended index, utilizing 50% intermediate and 50% government.

Chairman Boltz said he appreciates Harris reducing their fee from 30bp to 20bp and asked if there was room for negotiation. Ms. Alter replied that she cannot negotiate the fee and suggested Mr. Hamann speak to someone at their organization who can negotiate. Both Ms. Alter and Ms. Svagera thanked the board for inviting them and said they would do a good job, if chosen.

Mr. Lichamer asked for the difference between the intermediate government bond and the core bond. Mr. Sidler replied that it's approximately a 2% difference. Mr. Hamann explained that Harris presumed the funds would utilize the same bonds. Therefore, the comparison between Boyd Watterson and Harris Investment Management would be inconclusive. He said that Boyd Watterson was dead-on to their benchmark while Harris added a little more value. Again, because of core bonds versus intermediate bonds, the comparison is somewhat skewed.

At this point, Ms. Alter and Ms. Svagera left.

Mr. Hamann stated that both managers' hands are tied in the State of Illinois insofar as investment options. He said they were looking at two quality managers. Boyd appears to be more of a market timer, as far as their way to add value with a +/- 20% benchmark. Harris is +/-10% of the benchmark, demonstrating that they are more constrained insofar as interest rate timing. Boyd's way of increasing value is with interest rate timing. Harris focuses more on the security selection. Mr. Hamann said the Fire Department interviewed three different managers; Harris, J.P. Morgan and M.D. Sass. Ultimately, Harris had the lowest fees and they liked the local presence. Ms. Trainor stated that the Fire Pension Trustees also commented that Harris customized their presentation. However, it was noted that both managers customized today's presentation. Mr. Hamann said that sometimes it's a gut instinct as to who to choose. He added that Mr. Sidler's previous affiliation might be advantageous insofar as quick responses from Boyd Watterson. Mr. Sidler said that both would perform with full faith and credit; however, Harris appears to have a little more risk. He also said there is a comfort level with Boyd Watterson.

Mr. Hamann said that no decision is permanent. The manager will submit quarterly reports and if they aren't performing a sufficient job, they will be terminated. Chairman Boltz asked if there is a duration period on their contract. Mr. Hamann replied there was not. Mr. Lichamer said that he prefers Harris insofar as their location in Chicago and not Ohio. He queried also as to the possibility of Mr. Sidler resigning from the board. The connection would no longer exist.

Mr. Hamann commented that both firms are professional and if Mr. Sidler was no longer a trustee, they would still perform with a high level of service. He added that if any manager is not performing a good job as far as customer service, it's reason enough to fire them.

Chairman Boltz asked for the possibility of Harris lowering their fee. Mr. Hamann said he would speak to someone at Harris. He also said that he was surprised that Harris proposed a fee of 20bp rather than 25bp's. Both Mr. Hamann and Mr. Sidler agreed that Boyd Watterson's quote at 17 ½ bp's was excellent. Mr. Hamann felt that they are trying to form a relationship with Marquette Associates. Mr. Sidler stated that he has seen the way Boyd Watterson works and there is a comfort level. Mr. Hamann said that both Harris and Boyd Watterson were interviewed by his firm and found to have excellent credentials. He added that he would not have asked them to make presentations, if he found otherwise.

MOTION

Mr. Lichamer moved to utilize Boyd Watterson as the Intermediate Government Fixed Income Manager with additional negotiations regarding the lowering of fees. Mr. Sidler seconded. Motion passed unanimously.

Motion Carried: 4 - 0

V. NEW BUSINESS – Election

MOTION

Mr. Blaylock moved to table New Business. Mr. Sidler seconded. Motion passed unanimously.

Motion Carried: 4 - 0

VI. OLD BUSINESS

There was none.

VII. ADJOURNMENT

MOTION

Mr. Lichamer moved to adjourn the meeting at 6:40 p.m. Mr. Sidler seconded. Motion passed unanimously.

Motion Carried: 4 - 0