CITY OF PONTIAC, MICHIGAN
GENERAL EMPLOYEES RETIREMENT SYSTEM
BOARD OF TRUSTEES
SPECIAL MEETING
NOVEMBER 17, 2017

A special meeting of the Board of Trustees was held on Friday, November 17, 2017 at the Pontiac General Employees' Retirement System Office located at 2201 Auburn Road, Suite B, Auburn Hills, MI 48326.

TRUSTEES PRESENT
Sheldon Albritton
Jane Arndt
Koné Bowman
Janice Gaffney
Robert Giddings
Walter Moore, Chairman *(by Skype)*
Billie Swazer
Deirdre Waterman, Mayor *(arrived @ 12:58 p.m.)*
Patrice Waterman, City Council President

TRUSTEES ABSENT
Nevrus Nazarko
Kevin Williams, Vice Chair

OTHERS PRESENT
Steven Roth, Dahab & Associates
Cynthia Billings-Dunn, Sullivan Ward
Deborah Munson, Executive Director
Linda Watson, Retiree

Chairman Moore called the meeting to order at 12:06 p.m.

Re: Dahab & Associates – Value-Add Real Estate Review
Mr. Roth began the meeting by explaining that the main difference between value-add real estate investments versus core real estate investments is the style difference.

Chairman Moore asked Mr. Roth to explain the reasons why the System should invest in value-add opportunistic real estate.

Mr. Roth responded that the System's current asset allocation is over-weighted in public equity and there is a desire to decrease the volatility of the System's portfolio.

Ms. Swazer questioned the term "public equity".

Mr. Roth indicated that public equity includes all equities including the various capitalizations (large-, mid- and small-cap) international and global equity that are traded on public exchanges. It does not include private equity.

He stated that the review is to give the Board a better understanding of value-add real estate investments. He continued that the Board could choose to simply allocate more to core and/or core plus or other options it is not comfortable moving forward with value-add.

Trustee Bowman inquired about the other options.

Mr. Roth responded that his firm likes timber and farmland but those investments lock up the assets for seventeen years and longer.

Trustee Bowman asked whether those are the only options.

Mr. Roth responded that those investments are less risky compared to others and reduce the short-term volatility of the portfolio. Hedge funds are another option but they prefer other options over hedge funds.

Trustee Giddings stated that it makes more sense to invest in real estate versus timber or farmland that locks up the assets for longer periods of time.

Trustee Bowman asked about REITs.

Mr. Roth responded that REITs are traded like securities and are considered public equities.

Miss Munson noted that the Board considered nine asset allocation mixes before selecting the new asset allocation based upon the consultant's recommendation.

Trustee Bowman indicated that he had been uncomfortable investing in real estate prior to attending a Wharton Conference focused on real estate. He is more comfortable with the asset class now.

Mr. Roth reviewed the pros and cons of investing in value-add real estate. One of the pros for investing in real estate is its bond-like properties which can generate higher long-term returns than bonds. Value-add has more risk than core and core plus but there should be greater appreciation and inflation protection.

Some of the cons of investing in value-add real estate are increased economic sensitivity, illiquidity and higher management fees. Value-add increases risk. There are some open-ended funds that offer quarterly or monthly liquidity but most are closed-end funds that are locked in for a seven to ten year period.

Trustee Swazer asked how much of the System's assets are currently invested are illiquid investments.

Mr. Roth told the Board that currently 2.5% of the System's assets are invested in illiquid private equity funds.

Trustee Swazer asked how long the assets will be illiquid.

Mr. Roth explained that it will be several years before the System will have access to those assets.

Trustee Swazer explained that she did not like the investment in Consequent Capital and that she did not like the fact that the System could not get out of the investment and that the entire investment may be lost.

Mr. Roth stated that value-add real estate is a similar vehicle but is not the same type of investment and should be a more reliable investment.

He explained that the fees range anywhere from 100 – 150 basis points up to 200 basis points.

Miss Munson added that these managers also participate in excess returns noting that if the manager exceeds a certain rate of return, they would receive increased fees.

Mr. Roth described real estate variations and common elements of institutional quality funds, including commingled funds, as well as the NCREIF ODCE or the NCREIF Property Index benchmarks.

Mr. Roth told the Board that they are currently invested in four open-ended real estate funds. Real estate investments also consist of public REITS, direct ownership and closed-end funds. Value-add funds are mainly closed-end funds which lock up the assets for a period of seven to ten years.

Leverage is anywhere between 20% and 70% and varies by investment style with core having the least leverage. Real estate also varies by property quality which is a factor in the range of expected returns.

Miss Munson added that the returns are calculated by the fund managers using what is called an internal rate of return.

Mr. Roth described a publicly traded REIT and a private REIT. He said publicly traded REITs trade like stocks and have a high correlation to the equity markets. He would not recommend these investment vehicles because they are looking to lower the volatility of the portfolio. He also described direct ownership which would be a separate account with the System as a single investor. A commingled trust or an open or closed-end fund is structured as a Limited Partnership. Most are closed-end and liquidity is not provided until the end of the fund's life.

Core and value-add real estate managers invest in the same types of real estate including multi-family; industrial; office and retail. Some managers also have expertise in common property types like hotels; self-storage; medical office and student housing. The difference between the two is that core generally invests in new buildings and value-add invests in older buildings that they revamp or add value through refurbishing.

Value-add managers buy older buildings, invest in them and often sell them to the core managers once the building is renovated which does add an element of risk.

Mr. Roth continued described how the real estate debt managers loan money to the real estate owner but also issue bonds. This fund is a closed-end fund with a four- to five-year investment period which adds more risk than value-added.

He showed examples of multi-family; industrial; office and retail real estate investments. He indicated that core managers only invest in major cities and value-add can extend beyond the core areas.

Trustee Albritton asked how much input the Board has with regard to the manager's investment decisions.

Mr. Roth indicated that the Board would have no input.

Mr. Roth explained the associated risk and returns investing in real estate.

Miss Munson told the Board that the managers report their own performance returns for the NCREIF ODCE benchmark and questioned whether the return for funds that are no longer in existence are taken out of the benchmark.

Mr. Roth responded that those managers are not removed from the benchmark. He continued that the benchmark is currently made up of sixteen large open-ended fund managers that report their returns quarterly.

Mr. Roth explained that real estate debt fund has the same risk/reward profile as investments in real estate equity fund. Value-add real estate investments are more risky than core but the return potential is higher. He reviewed a chart showing the risk and return potential of the various real estate investment styles noting that real estate debt falls between core and core plus on the risk return scale.

He went over the specifics of the investment styles based on target returns, typical leverage and primary markets. He told the Board that they are currently invested in Invesco and Principal which are core real estate managers. Their target returns are 6% to 8% with typical leverage of up to 30%. They buy and hold stabilized properties with an emphasis on the primary real estate markets including Boston, New York, Washington, D.C., Chicago, San Francisco and Los Angeles.

The System currently has two core plus real estate investments with Intercontinental and UBS. The target returns for core plus are 7% to 9% with typical leverage of up to 55%. They buy and hold primarily stabilized properties including some value-add properties.

Mr. Roth stated that value-add real estate target returns are 10% to 12% with typical leverage up to 70%. This type of investment looks to reposition or refurbish properties in order to increase lease rates and rent. There is more risk associated with this type of real estate investment. He noted that there is even more risk associated with opportunistic real estate investments; which he is not recommending as an investment for the System at this time.

The real estate debt funds loan money to the builder and this investment style looks for target returns of 9% to 12% with moderate risk return potential.

Trustee Giddings asked if real estate debt would be classified as fixed income.

Mr. Roth indicated that it is similar to fixed income.

Miss Munson asked Ms. Billings-Dunn how a real estate debt fund would be classified under Public Act 314.

Ms. Billings-Dunn responded that she would need to look up the information and report back to the Board.

Mr. Roth reviewed the examples of value-add multi-family and office properties that were renovated and/or upgraded including new lobbies, common areas, kitchens, grounds and parking lots. The element of risk is renting the properties after they are refurbished. Value-add managers may sell the upgraded properties to a core manager.

Real estate debt managers loan money to real estate owners and/or developers. They invest in first, second or mezzanine financing. The loans are collateralized by the property. These are closed-end funds.

Trustee Giddings asked if this investment style pays a quarterly cash flow.

Mr. Roth indicated that the investments may provide cash flows.

Miss Munson noted that any distributions would be at the discretion of the General Partner so they are not guaranteed.

Mr. Roth added that the manager may not provide cash flow during the investment period.

Trustee Giddings asked Mr. Roth whether - in his experience - this type of real estate investment provides cash flows.

Mr. Roth responded that that has been his experience.

Trustee Swazer asked about the default risk by manager.

Mr. Roth indicated that they look at the default risk by manager.

Trustee Giddings stated this in this type of investment it is not likely the investment will be written down to zero.

Mr. Roth reviewed an example of a real estate debt investment in a multi-family property in Houston, Texas. The property was acquired by financing 80% of the purchase price. At the time the property rents were 25% below the average rental rates in the area. The manager had experience with the developer and the developer's plan was to acquire the property, renovate the units and bring rent in line with the market rates. The loan was originated in September 2013 with a rate of LIBOR plus 660 basis points. The loan was paid off in September 2015 with a net internal rate of return of 9.6%.

Mr. Roth explained that LIBOR is the London Interbank Offered Rate which is the average risk-free lending rate among banks that is used in commercial real estate transactions.

Mr. Roth described and compared the historical returns for private real estate, the stock market and long-term treasuries from 1934 through 2016. Private real estate has had 77 up years versus the stock market at 62 years and long-term treasuries at 62 years. Private real estate has had 5 down years compared to 20 down years for both the stock market and long-term treasuries. The worst performing year for real estate had returns of -16.8% versus -36.9% for the stock market and -14.9% for long-term treasuries.

Trustee Swazer asked about the down years.

Mr. Roth indicated that real estate values fluctuate up and down.

Trustee Giddings explained that down years could affect the funding level of the System similar to or the same as underperforming or down years in the equities market.

Mr. Roth reviewed the return correlation between real estate and the other investment classes. He explained that return correlation is a statistic that measure the degree to which two securities move in relation to each other. The less correlation the better because of the risk reduction benefits of diversification. He noted that 17% of the time the real estate market is in correlation with the S&P 500. He also indicated that the twenty-year historical return average for real estate is 9.34% and noted that the revised asset allocation is reallocating assets from public equities to real estate in order to decrease volatility of the portfolio.

He reviewed the types of risk associated with investing in real estate. He noted that location is very important which is why most real estate managers invest in the "smile" location philosophy which runs along the coasts. Some managers will invest in secondary markets in major cities such as Raleigh and Durham, North Carolina.

He also indicated that there could be added risk in value-add investments based on finishing a partially completed property and obtaining the necessary permits.

There is also illiquidity risk if the investment is a closed-end vehicle similar to private equity with a lock up of capital for a period of five to ten years. He reminded the Board that they have approximately $20 million to commit to value-add real estate or could choose to allocate these funds to the System's four current real estate managers.

Trustee Swazer asked about the Board interviewing and hearing presentations from the value-add real estate managers.

Trustee Albritton confirmed that the assets could be added to the investments in core and core plus real estate.

Chairman Moore referred to the twenty year performance for real estate at 9.34%. He also asked about the current allocation to private equity in the portfolio of 2.5%. He asked if the consultant would be looking to recommend the allocation of more assets to private equity.

Mr. Roth indicated that the allocation to private equity will be on the agenda as we move forward due to the updated asset allocation.

Mr. Roth confirmed that the current allocation to public equities is 71.2%. They will recommend liquidating between $5 million and $6 million of public equities in December in order to pay for benefits and System expenses.

Chairman Moore confirmed that the System is heavily weighted to public equities and that approximately $82 million of the public equities portfolio needs to be reallocated in order to bring the portfolio in line with the target allocation.

Chairman Moore asked what the options are to reach the target allocation.

Mr. Roth responded that the allocation to fixed income is underweighted and the emerging markets investment needs to be funded.

Chairman Moore stated that real estate investments are a logical choice.

Trustee Gaffney stated that that does not necessarily mean the System should invest in value-add real estate. However, given how the market has been she would be comfortable with value-add real estate but she will never be comfortable investing in private equity again.

Trustee Deirdre Waterman arrived at 12:58 p.m.

Miss Munson questioned whether the Trustees are comfortable in their understanding of the limited partnership agreements and the terms thereof.

Trustee Patrice Waterman asked what managers the Board is considering.

Mr. Roth stated that the System is currently looking at open-ended value-added managers American Realty Advisors and J.P. Morgan; closed-end value-added real estate managers Alidade and Greenoak and real estate debt manager Barings Real Estate Advisors.

Chairman Moore noted that the finance committee has not made their recommendation but they did want to make sure all the Trustees understood the investment before the committee was ready to move forward.

Trustee Bowman left at 1:00 p.m.

Re: Investment Policy Statement Revisions
Chairman Moore asked Mr. Roth to explain why the revisions to the IPS were being reviewed today.

Mr. Roth indicated that there have been a number of revisions to the IPS and – over the course of times - things get added and may no longer be relevant or necessary. There was a need to reorganize the IPS as well as include the language relevant to the new asset allocation.

A number of the investment styles were removed from the investment guidelines because they are no longer part of the target asset allocation including high yield, global equity, global fixed income and non-U.S. equity managers.

Trustee Gaffney felt that it made sense to shorten the IPS and make it more consistent.

Trustee Albritton asked about the placement agents policy disclosure.

Mr. Roth indicated that placement agents do not work directly for the manager but are hired by the manager. The primary reason for the placement agent policy is to ensure that System investments are made solely based on the merits of the investment opportunity.

Trustee Gaffney asked what happened to the permissible investment section.

Mr. Roth responded that the language has been moved to the individual asset class sections and along with non-permissible investments and restrictions.

Mr. Roth continued to explain the reorganization of the IPS and its structure.

Trustee Deirdre Waterman pointed out that the bullet point under prohibited securities indicating that managers are prohibited from investments in their own securities, affiliates or subsidiaries was missing in the fixed income table.

Mr. Roth noted that the funding commitment of up to 150% to private equity managers was removed.

Trustee Giddings referred to the last paragraph on page two that indicated the separation of NOMC from the City and it no longer being a contributing employer to the System. He questioned whether that also applies to the Stadium Authority and whether the language should be revised.

Trustee Gaffney felt that the paragraph could be removed from the IPS since the Hospital and the Stadium Authority are no longer contributing employers.

Re: City of Pontiac Investment Options
Miss Munson was asked to begin the discussion. She noted that the Trustees have recently been discussing whether investing in Pontiac is feasible and permissible under PA 314 and this session was designed for the Trustees to discuss their thoughts and inquire of the consultant. She

summarized Dahab's response to the question which was asked at the September manager review meeting: per the IPS, the System's equity managers invest in publicly traded securities; the bond managers can only invest in issues that have an investment-grade bond rating and the private equity and real estate managers invest in funds that have specific criteria. There have not been any investments in Pontiac that have been identified that would fall into any of these categories.

Trustee Deirdre Waterman indicated that the Board has appointed a relocation committee tasked with identifying an office to house the System's staff and operations that would be located in the City of Pontiac. However, it does not appear that the property currently under consideration would qualify as an investment as described in the IPS. She inquired of the search and review process used by the committee. She suggested that the needs analysis and other criteria to be used in selecting the property be documented and brought to the Board.

Trustee Gaffney stated that - when considering investments - there are currently no opportunities in Pontiac that would be permissible under the IPS and noted that investment decisions must be driven by the Board's fiduciary standard: Trustees must take their hearts out of it and use their heads. She believes that it is important to have the attorney available to provide that guidance to the Board.

Trustee Albritton encouraged the Trustees to look outside of the box. He stated that managers give so much to charity and that it may be possible to see if they would sponsor a golf outing for charity and donate it to the schools. He believes that it would be nice if they had some type of visibility and impact in the community.

Trustee Patrice Waterman left at 1:53 p.m.

There was additional discussion.

It was determined that there are currently no opportunities for the System to invest in Pontiac.

RESOLUTION 17-133 By Gaffney, Supported by Swazer
Resolved, That the meeting of the Board of Trustees of the Pontiac General Employees' Retirement System be adjourned at 1:58 p.m.

Yeas: 7 – Nays: 0