STATE EMPLOYEES' RETIREMENT SYSTEM OF ILLINOIS

MINUTES OF THE REGULAR MEETING
OF THE BOARD OF TRUSTEES

July 13, 2016

A regular meeting of the Board of Trustees of the State Employees' Retirement System of Illinois convened on Wednesday, July 13, 2016, at 10:00 a.m. in the System's Springfield office located at 2101 South Veterans Parkway with a video conference location at the Bilandic Building, Room N-703, 160 North LaSalle Street, Chicago, IL.

The following trustees were in attendance:

Leslie Geissler Munger, Chairperson
David Morris, Vice-Chairperson
Alan Latoza, Retired Trustee
John Tilden, Retired Trustee
Tad Hawk, Active Trustee
Rob Fanti, Active Trustee
Thomas Allison, Appointed Trustee
Carl Jenkins, Appointed Trustee
Renee Friedman, Appointed Trustee
Danny Silverthorn, Appointed Trustee

Absent:

Yasmin Bates-Brown, Appointed Trustee
Stephen Mittons, Active Trustee

Others in attendance were:

Loren Iglarsh, Executive Committee Chairman
Timothy Blair, Executive Secretary
Jeff Houch, Assistant to Executive Secretary
Casey Evans, Chief Internal Auditor
Steve Bochenek, System Attorney
William Atwood, Director, Illinois State Board of Investment
Frank Benham, Managing Principal, Meketa Investment Group
Alli Wallace, Principal, Meketa Investment Group
Alex Rivera, Consulting Actuary, Gabriel, Roeder, Smith and Co.
Ryan Gunderson, Consulting Actuary, Gabriel, Roeder, Smith and Co.
Alan Fowler, Manager, Accounting Division
Gerry Mitchell, Chief Information System Officer
Barbara Baird, Manager, SERS Chicago Office
Jennifer Staley, Recording Secretary

Vice-Chairperson Morris presided and called the meeting to order at 10:00 a.m. with a quorum present.

PUBLIC COMMENTS

Vice-Chairperson Morris asked if there were any members of the public who wished to address the Board. There were none.

CONSIDERATION OF RETIRED TRUSTEE APPOINTMENT – JOHN TILDEN

Vice-Chairperson Morris referred the Board to a memo dated July 13, 2016 explaining the resignation of Trustee Byrd, effective July 12, 2016. Executive Secretary Blair explained that Trustee Byrd's term would have ended July 14, 2016, but she was unable to attend the Board meeting on July 13, 2016. The resignation would allow Trustee-elect John Tilden, whose five year term would begin on July 14, 2016, to represent SERS retirees at the July 13th Board meeting.

Vice-Chairperson Morris noted the unusual situation was caused when the Board meeting date was changed from July 26, 2016 to July 13, 2016. He asked for a motion to appoint John Tilden to complete the vacancy created by the resignation of Trustee Byrd. Trustee Latoza moved to appoint John Tilden to the vacancy. Trustee Hawk seconded the motion and all were in favor.

MINUTES OF THE APRIL 19, 2016 BOARD MEETING

The minutes of the Board meeting held April 19, 2016 were presented to the members by Vice-Chairperson Morris. Copies of these minutes were previously provided to each trustee for preliminary review. Secretary Blair noted there were a few clarifying changes made at the request of Trustee Allison. The changes were distributed and Trustee Allison briefly reviewed and explained the requested changes. Trustee Fanti moved to approve the minutes as amended by Trustee Allison. Trustee Silverthorn seconded the motion and it passed unanimously.

REPORT OF THE ILLINOIS STATE BOARD OF INVESTMENT (ISBI) AND MEKETA

Vice-Chairperson Morris noted that Meketa and ISBI would make presentations and Executive Secretary Blair reminded the Board that Meketa had been invited to address the Board after the discussion at the April meeting regarding the recommendation to lower the assumed rate of return from 7.25% to 7.0% annually.

Vice-Chairperson Morris noted that Chairperson Munger had arrived at the Chicago location. He asked that she be added to the roll call and then turned the meeting over to her. William Atwood, ISBI Director, distributed copies of and briefly reviewed the minority utilization report. He also distributed the Quarterly Review for the period ended March 31, 2016 and a report detailing performance through May 31, 2016, and introduced Frank Benham, Meketa Managing Principal and Alli Wallace, Meketa Principal, to the Board.

Alli Wallace began the Meketa presentation by noting the value of the ISBI portfolio totaled slightly more than $15.6 billion at May 31, 2016 and reviewed the asset allocation policy adopted by ISBI in January 2016. She continued her report by informing the Board the entire portfolio returned 2.5% (net of fees) for the five months ended May 31, 2016, and noted the June return is expected to be 1.5%, increasing the total portfolio return for the first six months of calendar year 2016 to an estimated 4% and the expected FY 2016 return to -0.6% net of fees.

Ms. Wallace began her review of the individual asset classes with the Fixed Income portfolio, which returned 3.7% net of fees over the five months ended May 31, 2016, and the U.S. Equity portfolio, excluding Hedge Funds, returned 3.3%, while their benchmarks returned 3.9% and 3.4%, respectively. Trustee Allison pointed out the Fixed Income and U.S. Equity portfolios both underperformed over the prior one, three, five and ten year periods ended May

31, 2016. Chairperson Munger answered there had been a lot of rebalancing in the portfolio over the last eighteen months and several manager changes. Director Atwood added that the U.S. Equity portfolio was heavily weighted in Value stocks and Small-Cap stocks, which both underperformed relative to other equity classes. He added that exposure to high yield bank loans and non-U.S. debt instruments hurt the return of the Fixed Income portfolio when compared to the relevant benchmarks.

Chairperson Munger continued that since she has been a member of ISBI, the many changes include rebalancing the portfolio, changing several investment managers, reducing fees and hiring Meketa to provide a new perspective on the portfolio, and that she is optimistic about the significant long term impact of these changes on the portfolio. Ms. Wallace added these changes are projected to save the portfolio $37 million in fees during the next year.

Ms. Wallace continued her report by asking if anyone had any other questions about specific asset class performance or if the preference was to focus on asset allocation. Director Atwood asked Ms. Wallace to update the Board on the changes to the Hedge Fund portfolio. She told the Board of the recent reduction in the Hedge Fund allocation from 10% of the portfolio to 3% of the portfolio and the consolidation of assets under fewer managers. Mr. Benham added that it would take several years to reduce the allocation to 3% due to the illiquid nature of the investment.

Mr. Benham referred the Board to the next section of the Meketa report and noted that portfolio return is influenced more by asset allocation than whether individual managers under or over perform. He suggested the changes in asset allocation adopted by ISBI at the January 2016 Board meeting will produce the same or better returns with much less risk than the prior asset allocation model and that Meketa expects the portfolio to return an average of 7.7% annually over 20 years.

Mr. Benham reported that Meketa developed their portfolio return expectation based on the long-term return expectations for the various asset classes, risk as measured by the standard deviation, and the correlation of returns between the various asset classes. These factors were used to develop a 10 year forecast model for each asset class, considering the major factors that affect the return of 8 different asset classes. Based on a question from Trustee Allison, Mr. Benham reviewed for the Board the portion of the Meketa report detailing examples of the development of capital market assumptions. Mr. Benham noted that based on a peer review of capital market assumptions, Meketa tends to be near the average.

Chairperson Munger asked Mr. Benham about the probability of meeting return expectations. He answered that the portfolio is expected to average a return of 7.7% annually over the next 20 years, meaning there is a 50% probability of achieving that return. Trustee Jenkins asked about Meketa's near-term assumptions for the U.S economy. Mr. Benham referred to the World Economic Outlook prepared by the IMF and World Bank, which projects 2.5% growth for the U.S economy. Ms. Wallace then added that based on the asset allocation model and the Meketa assumptions, there is a 56% probability of achieving a 7.25% return over the next 20 years.

Trustee Allison asked if the ISBI asset allocation model is affected by the return assumption adoption by the SERS Board, specifically if a change in the SERS return assumption would cause a change in the ISBI asset allocation model. Director Atwood answered that if SERS would change the return assumption, ISBI would discuss the change with Meketa, but that a small change in the assumption would probably not merit a change in the asset allocation model. Chairperson Munger then asked whether there should be a change in asset allocation due to a return assumption change or whether the goal is to maximize return for a given risk level. Director Atwood answered that ISBI manages to the return assumption.

Following additional discussion on the old asset allocation model and the new asset allocation model, Chairperson Munger noted ISBI considered several asset allocation models before choosing the current model, based on the preferences of the diverse Board. Director Atwood noted the ISBI vote on the new asset allocation was unanimous. He continued by pointing out that increased investment returns generally mean living with higher levels of volatility. Further, as the cash needs of SERS and the other systems are unknown, and increased cash needs of the Systems tend to increase during market downturns, high levels of volatility can be very costly for the portfolio.

Trustee Friedman asked Mr. Benham if the 56% probably of hitting the return assumption was common with other public fund Meketa clients. He answered that it is common and the probability of hitting a particular return assumption has decreased over the last several decades as the return assumptions of retirement systems have decreased during that time. Chairperson Munger reiterated the significant changes made by ISBI and the positive impact those changes will have on the actual portfolio returns.

Chairperson Munger asked if there were any additional questions for Mr. Atwood or the Meketa representatives. Trustee Friedman asked if Meketa worked with any retirement systems that actuarial assumptions are different than the portfolio's expected return. Mr. Benham answered that the actuarial assumption may be different than expected returns, but they generally are pretty similar. He added the expected rate of return is generally slightly higher than the actuarially assumed rate of return and the expected return should never be lower than the actuarially assumed rate of return.

Copies of the Meketa reports are maintained at the ISBI office and made a part of these minutes as Exhibit A. Chairperson Munger thanked Ms. Wallace, Mr. Benham and Director Atwood for their reports and excused them from the remainder of the meeting.

<u>REPORT OF CONSULTING ACTUARIES – EXPERIENCE REVIEW</u>

Alex Rivera and Ryan Gunderson of Gabriel, Roeder, Smith & Company (GRS), Consulting Actuaries, distributed an updated experience review report containing the recommended SERS actuarial assumptions. Mr. Rivera began the report by reminding the Board of the April presentation but noted the updated report provided projections of the impact of the assumption changes beginning in FY 2018, rather than the pro forma projections provided at the April meeting. He noted the actual recommendations are unchanged from the April meeting.

Mr. Rivera reviewed the results, noting that adopting the recommended mortality table would increase the required FY 2018 State contribution by about $190 million and adopting the other recommended demographic assumptions would increase the FY 2018 State contribution by an additional $55 million. He concluded the fiscal impact review by telling the Board the recommendation to reduce the investment return assumption from 7.25% annually to 7.0% annually would increase the required FY 2018 State contribution by $77 million.

Mr. Rivera reminded the Board that the role of the actuary and the purpose of the actuarial valuation is to measure the current and projected funded status of a retirement system and to determine the required statutory contribution. Two important considerations are the discounting of future benefit payments and the return on invested assets. He continued that if a plan is relatively well funded, the return on invested assets in the near term, 10 years or so, is very important as those returns are used to pay benefits. For poorly funded plans, the assumed return on invested assets is not as critical.

Trustee Friedman noted the 34% funded ratio of SERS is low and Mr. Rivera concurred. Trustee Allison added the statutory funding plan is not actuarially sound and Mr. Rivera again concurred and noted the Board's recent adoption of an actuarially sound funding policy. Trustee Friedman then asked if GRS' actuarial projections assume the full payment of the State's annual contributions and Mr. Rivera answered in the affirmative.

Chairperson Munger reminded the Board of the delayed November 2015 contribution but that the payment was actually made prior to the end of FY 2016. She then noted the ongoing budget problems and that it was probable that State payments would again be delayed. Chairperson Munger then cited the $116 billion shortfall in all of the State-funded retirement systems and added that decreasing the return assumption will not bring additional money to SERS due to the finances of the State. She added the State contributed $7 billion to the retirement systems in FY 2016 and will contribute $7.9 billion in FY 2017. Trustee Friedman answered the condition of the State finances should not be considered when setting actuarial assumptions, but acknowledged it was a concern for Chairperson Munger in her position as State Comptroller.

Chairperson Munger then asked if there was a good reason to lower the return assumption given Meketa's expected return of 7.7% annually for the ISBI portfolio. Trustee Allison answered that Meketa is relatively new and their expected portfolio return is higher than the previous expected portfolio return. He then pointed out the ISBI portfolio had returned 5.1% annually over the 10 years ended May 31, 2016, and accurate actuarial assumptions should be adopted to ensure that SERS has the funds to pay benefits that have been promised.

Trustee Allison asked if the recommended assumptions must be considered together. Secretary Blair answered that the assumptions could be considered any way the Board wished, and noted the adoption of the recommended mortality table had a much bigger financial impact than reducing the return assumption to 7%. Chairperson Munger agreed the recommended mortality table and other demographic assumptions should be considered and adopted. Secretary Blair suggested the Board could consider all recommended assumptions, excluding the investment return assumption, which could then be considered separately.

Vice-Chairperson Morris asked if the consideration of the recommended assumptions could be considered at any other time of the year. Secretary Blair responded that work on the FY 2016 actuarial valuation had to begin soon in order to be completed by the October Board meeting and to meet the statutory certification deadline of November 15th. He added this would be the final opportunity to consider assumption changes that affect the required FY 2018 State contribution.

Chairperson Munger continued by stating that she felt confident in the achievement of the 7.25% annual return number, citing the recent changes made to the ISBI portfolio and added there is a need to adopt the recommended mortality tables. Trustee Hawk followed up by opining that given the condition of the fund he supported conservative assumptions, including the 7% annual investment return assumption. Vice-Chairperson Morris added that adopting the recommended assumptions, excluding the recommended investment return assumption, would increase the required FY 2018 State contribution by $245 million, while the decrease in the return assumption would have a much smaller impact on the FY 2016 state contribution. Chairperson Munger agreed but stated she would prefer to consider all demographic assumptions, including the recommended mortality tables, but wait on the adoption of the lower investment return assumption.

Trustee Allison referred to the minutes of the April meeting, noting specifically that GRS projects only a 44% chance of of earning 7% annually over the next 20 years, given the asset allocation of the ISBI portfolio and the expectations of eight investment firms and Meketa. He then noted that the same analysis provided the assumption would have to be 6.60% annually in order to provide a 51% chance of achieving the return assumption over 20 years. Chairperson Munger asked if the investment return recommendation was based on the revised asset allocation policy and Mr. Rivera responded that it was.

Trustee Friedman moved to adopt all recommended assumptions, excluding the 7% investment return assumption. Trustee Allison seconded the motion and it passed unanimously. Trustee Allison then moved to adopt the 7% investment return assumption and Trustee Fanti seconded the motion. The motion prevailed on a vote of 9-1, with Chairperson Munger voting against the motion and all other Trustees voting in the affirmative.

<u>REPORT OF CHAIRPERSON MUNGER</u>

Chairperson Munger noted the passage of the stopgap budget and estimated there will be $10 billion to $11 billion in unpaid bills at the end of calendar year 2016, with payment delays of up to 6 months. She concluded her report by stating the need for a balanced State budget and noted the ongoing struggle to make the State contributions to the retirement systems in a timely manner and the possibility of one or two delayed payments in FY 2017.

<u>REPORT OF ANY TRUSTEE</u>

Chairperson Munger asked if any other trustees would like to offer a report. No reports were offered.

<u>REPORT OF AUDIT AND COMPLIANCE COMMITTEE.</u>

Vice-Chairperson Morris, Chairperson of the Audit and Compliance Committee, reported the Committee had met prior to the Board meeting and introduced Chief Internal Auditor Casey Evans to provide the report. Mr. Evans noted the discussion of internal audits and the commencement of the external audit, being conducted for the first time by RSM. He then noted the completion of the GAAP process audit and the personnel and payroll audit, noting one finding regarding delays in completing employee performance evaluations.

Mr. Evans concluded his report by noting the completion of the annual internal control assessment required by the Fiscal Control and Internal Auditing Act and the approval of the updated two year internal audit plan. He offered to answer any questions. There were none.

<u>REPORT OF CHIEF INFORMATION SYSTEMS OFFICER (CISO)</u>

<u>Ethics.</u> Gerry Mitchell, CISO and Ethics Officer, reminded the Board the annual ethics training is due and should be turned in as soon as possible.

Systems Modernization. Mr. Mitchell informed the Board that progress continues on the re-engineering of the active member system with quality assurance testing of the benefit setup pending system. In addition, new disability letters have been implemented and several system changes are underway to accommodate CMS' new benefits administration system scheduled to be implemented in September.

Computer Security. Mr. Mitchell noted the annual security awareness had been completed by all employees and security administration functions have been implemented for the employer website. In addition, all operating systems have been updated to reduce security vulnerabilities.

Member Services Website. Mr. Mitchell stated that 20,200 active members and 16,875 retirees have registered for the member services website, with more than 9,000 members logging into the system within the last 30 days. Chairperson Munger asked if there were any questions for Mr. Mitchell. Seeing none she thanked Mr. Mitchell for his informative report.

THIRD QUARTER FINANCIAL STATEMENTS

Alan Fowler, Accounting Division Manager, presented the financial statements for the third quarter of FY 16. Mr. Fowler noted that in comparison to the third quarter of FY 15, there was an increase in employer contributions of $70.2 million, due to the timing of the receipt of the GRF portion of the employer contribution. He noted retirement annuities increased by $38.6 million when compared with the previous quarter. This is the result of the statutory 3% January COLAs and an increase in the number of retirees.

Chairperson Munger asked if there were any questions for Mr. Fowler. Seeing none she thanked Mr. Fowler for his report. Trustee Silverthorn moved to accept the third quarter financial statements. Trustee Latoza seconded the motion and all present were in favor. Copies of these financial statements are made a part of these minutes as Exhibit B.

REPORT OF THE EXECUTIVE SECRETARY

Final Review of FY 2017 Operations Budget. Secretary Blair noted the final FY 2017 operations budget request amounted to $18,217,681, a decrease of $4,163, or 0.02%, from the FY 2016 operations budget. He noted the budget request includes the establishment of a call center, with a supervisor expected to be hired on December 1, 2016. Three call center representatives would then be hired on January 1, 2017 and an additional representative hired on April 1, 2017. The budget request includes $60,000 for a full scope actuarial audit, as recommended by the State Actuary, and an internal auditor to report to the Chief Internal Auditor.

The budget request eliminates the funding of a position in the Administrative Services Division and a position in the Services and Refunds Division, and reduces the funding for 75 day employees by $100,000 from the FY 2016 budget level. Trustee Silverthorn moved to approve the final budget as requested and Trustee Latoza seconded the motion, which passed unanimously.

Elected Trustee Vacancy Policies. Secretary Blair referred the Board to a recommended change to the Active and Retired Elected Trustee Vacancy Policies. The recommended change allows the Board to appoint a qualified candidate to fill an elected trustee vacancy through the end of the vacant term, rather than until the next election. Trustee Latoza moved to approve the change to the policy. Trustee Allison seconded the motion and all present voted in the affirmative.

APPROVAL OF EXECUTIVE COMMITTEE MINUTES

The trustees had previously been furnished with copies of the April and May 2016 Executive Committee minutes for review. There being no changes to these minutes, Trustee Friedman moved to approve. Trustee Jenkins seconded the motion, which prevailed by a unanimous vote.

OLD BUSINESS

Chairperson Munger asked if anyone had old business to discuss. None was offered.

NEW BUSINESS

Chairperson Munger asked if anyone had new business to discuss. None was offered.

ADJOURNMENT

There being no further business to be brought before the Board, the meeting adjourned at 12:05 p.m. Chairperson Munger reminded the Board the next meeting is scheduled for October 27, 2016, at 10 a.m.

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Leslie Geissler Munger, Chairperson

Date: _________________________

ATTEST:

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Timothy Blair, Executive Secretary

Date: _____________________________