INVESTMENT ADVISORY COUNCIL
Wednesday, December 14, 2011

MEETING NO. 391

Members present:	Thomas Barnes Thomas Fiore, representing Benjamin Barnes Laurence N. Hale David (Duke) Himmelreich William Murray Denise L. Nappier, Treasurer* Joseph (Joe) D. Roxe, Chairman Carol Thomas Peter Thor
Absent:	Michael Freeman Sharon Palmer
Others present:	Jonathan Harris, Deputy Treasurer Christine Shaw, Chief of Staff Lee Ann Palladino, Chief Investment Officer Gary Carter, Interim Deputy Chief Investment Officer Joanne Dombrosky, Principal Investment Officer Gregory Franklin, Assistant Treasurer Adrian Kingshott, Principal Investment Officer Donald Kirshbaum, Investment Officer-Policy Catherine LaMarr, General Counsel Shelagh McClure, Director of Compliance David Rivera, Director of Communications Reginald Tucker, Investment Officer Linda Tudan, Executive Assistant Lawrence Wilson, Assistant Treasurer Winifred (Winnie) Scalora, Administrative Assistant
Guests:	Bradley Atkins, Franklin Park Associates Scott Booth, The Townsend Group Jeanna Cullins, Hewitt EnnisKnupp, Inc. Mary Dunleavy, State Street Bank & Trust Theo Dunoyer, AXA Real Estate Investment Manager Greg Fox, Hewitt EnnisKnupp, Inc. Will Greene, Loop Capital Markets Robin Kaplan-Cho, Connecticut Education Association Louis Laccavole, SOC Teachers' Retirement Board Kevin Norton, BNY Mellon Mike Scotto, Hewitt EnnisKnupp, Inc. Neil Sheth, NEPC Johnson Shum, State Street Bank & Trust

*In at 9:10 a.m.

Christopher Smith, Service Employees International Union
Kevin Vandolder, Hewitt EnnisKnupp, Inc.

Chairman Joseph D. Roxe called the Investment Advisory Council ("IAC") meeting to order at 9:04 a.m.

Approval of Minutes of the November 9, 2011 IAC Meeting

With a quorum present, Chairman Roxe asked for comments on the Minutes of the November 9, 2011 IAC meeting. **There being no comments, a motion was made by Peter Thor, seconded by Carol Thomas, that the Minutes of the November 9, 2011 IAC meeting be accepted as drafted. The motion was passed with the exception of Thomas Barnes who abstained due to his absence from the last meeting.**

Chief Investment Officer's Update on the Market, Connecticut Retirement Plans and Trust Funds Final Performance for the Month Ended October 31, 2011, Combined Investment Funds Review for the Quarter Ended September 30, 2011, and Connecticut Horizon Fund Review for the Quarter Ended September 30, 2011

Lee Ann Palladino, Chief Investment Officer ("CIO"), provided an update on the capital market environment, its impact on the performance of the Connecticut Retirement Plans and Trust Funds ("CRPTF") and the economic outlook. Ms. Palladino commented that the broad global macro themes that were currently affecting the capital markets continued to include the deleveraging of the developed world, low interest rates and the economic growth which was centered in the higher risk emerging markets.

Ms. Palladino next reported on the performance of the CRPTF for the month ended October 31, 2011. She said despite the unsettled macroeconomic trends, the one-year return horizon had posted positive returns of 374 basis points ("bps") for the CRPTF. Focusing on the fiscal year-to-date performance, she stated that all markets had been driven by the deterioration in Europe. Ms. Palladino commented on the prospective European policies that could possibly lead to a resolution, but added that the markets didn't reflect confidence that a sustainable solution had been reached. She commented that Standard and Poor's ("S&P") had placed 15 European countries on watch for downgrade and that Moody's was considering doing the same. Ms. Palladino said that S&P had noted that the systemic stress in the Euro zone had risen in recent weeks and that a review of all the Euro zone sovereign ratings was warranted. Finally, she said that given the macro trends there was an increased risk of recession in the Euro zone and the potential of slower growth worldwide.

Ms. Palladino cited some good news as the U.S. economy posted stronger than expected economic indicators for the past quarter with stronger consumer spending, a lower unemployment rate and a bit firmer housing picture. She added that a moderate pace of growth was expected, but a potential downside risk for the economy remained. For November 2011, Ms. Palladino estimated a decline of about 5.6% for the CRPTF fiscal year-to-date. Looking at the three-year performance horizon for the CRPTF, Ms. Palladino stated that the rate of return ("ROR") was 10.10%, which is above the 8.5% and 8.25% actuarially required ROR.

Ms. Palladino introduced Michael Scotto and Kevin Vandolder, Principals of Hewitt EnnisKnupp, Inc., who provided comments on the overall investment results for the Combined Investment Funds ("CIF") for the quarter ended September 30, 2011. Mr. Vandolder provided market highlights and noted that Barclays Capital Long Government rallied and returned 23.9% for the quarter even though the S&P had downgraded the U.S. credit rating during that period.

Mr. Scotto spoke about the range of returns for the CIF and highlighted three events that were essentially driving the markets: 1) the S&P downgrade of U.S. debt; 2) the worsening of the Euro zone credit crises; and 3) a perceived slowdown in China; all of which caused pressures and declines for the global economy. Next, Mr. Scotto commented on the dollar versus other currencies, and he noted that the managers that held a higher proportion of emerging markets securities denominated in U.S. dollars did better than those denominated in local currencies.

Chairman Roxe posed a question regarding the seven-year returns for the CRPTF relative to peers' performance. Mr. Vandolder responded that relative to its peers, the CRPTF ranked from the 40^{th} to the 55^{th} percentile, depending on the time period; and he noted that a lower percentile meant better performance versus peers and the 50^{th} percentile represented median performance. He further responded that generally across all time periods, the CRPTF would be considered second quartile. Chairman Roxe stated that during the asset allocation study, it would be beneficial for the IAC to know how the CRPTF compares among the universe of similar portfolios. Treasurer Nappier discussed the difficulties of comparing the CRPTF with peers because the relevant comparisons for the CRPTF would need to include plans containing similar funding, demographics, and other plan features. She added that she has never been able to identify a plan that would meet criteria necessary for a reasonable comparison. David Himmelreich stated that the peer group analysis had been a consistent challenge over the years.

Real Estate Fund Review as of June 30, 2011

Scott Booth, Principal of The Townsend Group, reported on the Real Estate Fund ("REF") for the quarter ended June 30, 2011. Mr. Booth commented on the real estate allocation within the portfolio and highlighted the fact that the market value increased by 4.5%, and that unfunded commitments were being called more rapidly than they were in prior years. Next, Mr. Booth reported the quarterly return for the portfolio at a 2.8% net return, the sixth consecutive quarterly gain, and equating to a 15.4% net return on a one-year basis. He said that the real estate market was recovering in gateway and first tier markets and less so in secondary and tertiary markets, but he added that the European market has been a growing problem. Mr. Booth said that while the CRPTF has European exposure, it had only invested on an opportunistic basis, which would capitalize on the stress, and that there were no core holdings in the portfolio.

In terms of risk, Mr. Booth stated that the REF investments were split almost evenly - with about a third invested in Core, Value Add and in Opportunistic - and that all three had positive returns for the quarter ended June 30, 2011.

In response to Ms. Thomas, Mr. Booth said that the principal cash flow was still negative because real estate purchase transactions were increasing. In response to Chairman Roxe's question regarding areas of stress within the REF, Mr. Booth said that problematic refinancings with particularly high leveraged managers remained an issue. He noted that these refinancings were ongoing, with the 2005 and 2006 vintage year projects of particular concern.

In closing, Mr. Booth stated that given the macro picture, the recovery would continue with interruptions but investments made in 2009, 2010 and 2011 had been capitalizing on the market opportunities.

Private Investment Fund Review as of June 30, 2011

Bradley Atkins, Chief Executive Officer of Franklin Park Associates, LLC, reported on the Private Investment Fund ("PIF") for the quarter ended June 30, 2011. Mr. Atkins first discussed the private market industry and noted that fundraising had been challenging over the last few years with fund sizes smaller and managers taking longer to raise funds compared to 2007. He stated that he did expect fund raising in 2011 to outpace 2010 by 50%. Mr. Atkins expanded his remarks to discuss investment activity, transaction pricing, improved earnings growth and increased exit activity.

Mr. Atkins provided a summary of the PIF returns and noted that there were approximately $1.27 billion in unfunded commitments and about $2.175 billion in remaining value or about 8.6% of total plan assets. He reported earnings of 8.5% net return for the PIF since 1987. Regarding cash flow activity, Mr. Atkins reported that since inception there was an increase in distributions back to the plan from the PIF, which had been positive for the last few years. Finally, he reported that the relative returns prior to 2000 were typically below the median and dragged down the portfolio, but since that time period the returns were typically near or in the top quartile. With respect to the aggregate return, Mr. Atkins reported that the PIF earned 8.5% versus the 8% benchmark. Chairman Roxe commented on the PIF's fund performance and noted that comparing the relative returns for the investments made pre- and post-2000 were distinctly different.

Alternative Investment Fund Review as of September 30, 2011

Neil Sheth, Director of Hedge Fund Research, NEPC, reported on the performance of the Alternative Investment Fund ("AIF") for the quarter ended September 30, 2011. Mr. Sheth provided an overview of the AIF assets, noting that the absolute returns hedge fund-of-funds mandate returned negative 4.76% for the quarter, outperforming the Dow Jones Credit Suisse Hedge Fund Composite by 4 bps and the S&P 500, which declined by 13.90%. He noted that most strategies did not do well in the quarter, with the exception of the short-biased and short-term trading strategies. Mr. Sheth commented that the event-driven and multi-strategies were detractors due to a flight to liquidity during the quarter. With respect to the year-to-date earnings, he reported that the AIF composite declined a little over 4%, but noted the outperformance compared to the equity markets and that the fund was preserving capital. Mr. Sheth stated that the goal of the AIF portfolio was being met by limiting leverage, keeping a relatively liquid portfolio and by diversifying and managing risk. He next provided performance statistics and stated that the portfolio had been allocated as follows: 80% to developed markets, 15% to Europe and the remainder to Asia. Mr. Sheth further commented on the hedge fund-of-fund portfolio, which included 136 total managers, and noted that 84% of the portfolio had unique exposure.

Discussion ensued regarding the need to monitor the hedge fund-of-fund portfolio to ensure that it meets its objective of added protection during difficult markets, but with a cost of limiting upside potential.

Securities Lending Review as of October 31, 2011

Johnson Shum, Vice President of State Street Bank, provided a review of securities lending activity for the quarter ended September 30 and the month ended October 31, 2011, and compared earnings and performance for Fiscal Year 2011 versus Fiscal Year 2012. He reported that earnings increased nearly 21% on a year-to-year basis. Finally, he reported on the CRPTF's separate account, collateral portfolio fund, which was at $2.8 billion and had a one-day yield of 43 bps as of October 31, 2011 with an average expected maturity life of 161days. Finally, he discussed the CRPTF's holdings in Europe which held short maturity periods.

Chairman Roxe posed questions about the maturity periods, to which Mr. Shum stated that 18% of the portfolio had maturity dates beyond one year. Chairman Roxe commented that securities lending was now a critical area of investing due to the global uncertainties.

Short-Term Investment Fund Review as of September 30, 2011

Lawrence Wilson, Assistant Treasurer, reported on the performance of the Short-Term Investment Fund ("STIF") for the quarter ended September 30, 2011. Mr. Wilson stated that the STIF had an average annualized yield of 18 bps, 15 bps above similar money market mutual funds, thereby earning an additional $1.8 million for state and local governments investing in the STIF. For the fiscal year ended that same period, he reported that the STIF had an annual return of 21 bps, again 15 bps above the benchmark, thereby earning an additional $7.4 million in interest for the STIF's investors. Mr. Wilson stated that S&P reaffirmed STIF's AAA rating, the highest rating available for money funds or government investment pools. He said the STIF had maintained its conservative investment posture with one-day liquidity of approximately 67% of assets and that the weighted-average maturity was 28 days. He reported that 62% of the portfolio was invested in securities which were issued, guaranteed or insured by the U.S. government or federal agencies, or in repurchase agreements backed by such securities. He concluded his presentation by noting that the STIF's reserves totaled $44.9 million. Chairman Roxe provided positive feedback on the report.

Other Business

Chairman Roxe presented the IAC budget for the fiscal year ended September 30, 2011. He invited IAC members to submit agenda items for the January 11, 2012 IAC meeting.

Comments by the Treasurer

Treasurer Denise L. Nappier formally announced her decision to appoint Lee Ann Palladino to the position of CIO and noted that her recommendation for the appointment was presented to and unanimously approved by the IAC at the November 9, 2011 meeting. Treasurer Nappier said that she had asked Lee Ann to serve as the Interim Chief Investment Officer with the departure of Tim Corbett in May 2011. She then extended her congratulations.

Treasurer Nappier next commented on the ongoing issues surrounding the unfunded liabilities of the State Employees' Retirement Fund ("SERF") and Teachers' Retirement Fund ("TERF"). She first reiterated her position to the IAC that she had been an advocate since the beginning of her administration to improve the financial footings of both the SERF and TERF through strategies that addressed the unfunded liabilities and by seeking to educate State policy makers through testimony and other communications. Treasurer Nappier further commented that during every year of her nearly 13-year tenure as State Treasurer, she had advocated consistently and aggressively for 100% funding of the actuarially recommended contributions ("ARC") for each of the pension plans. Upon being elected into office in January of 1999, she noted that she inherited both the SERF and TERF, which had not been fully funded on a regular basis for many years. Treasurer Nappier stated that she had argued that taxpayers would ultimately have to compensate for years of chronic underfunding, and that over the years she had spoken across tables, at lecterns, and into bullhorns in fierce attempts to convey to the Governor and General Assembly, over several administrations, the urgency of the underfunded position of the public pension plans. She also noted that she was frequently at odds with other policy makers simply because too often the most expedient suggestion was the one implemented at the expense of the long-term health and viability of the pension funds. Treasurer Nappier cautioned that she was not suggesting that there were not any successes, because there were – just not nearly enough – and the impact of the unfunded liability continued to be felt, particularly as it related to how Connecticut's creditworthiness was evaluated.

In early 2000, Treasurer Nappier noted that she went on record saying that based on the actuarial data as of June 30, 1998, the SERF had an unfunded liability of $3.9 billion and the TERF had an unfunded liability of $3.3, billion totaling over $7.2 billion, which indicated that the funding ratios of SERF and TERF were 59% and 73%, respectively. Treasurer Nappier further commented that nearly 12 years ago, she had stated that under the State's funding plan at that time, the unfunded liabilities were projected to double to $15 billion in less than 20 years. With the latest SERF and TERF valuations at 44% and 61% funded, respectively, she said that the funds have lost ground, and the total unfunded liability stands at approximately $21.8 billion as of June 30, 2010.

Treasurer Nappier stated that she testified before the General Assembly, and delivered a caveat regarding what she referred to as: "The most important issue affecting the financial health of the State." In speaking about the unfunded liabilities of the State pension fund, she noted that she had cautioned the Legislature that unless action was taken to increase the annual contributions to 100% of the ARC, the unfunded pension liability would wreak havoc with the State's budget;

and impose a staggering burden on Connecticut's taxpayers and threaten the future financial security of the Plan participants and retirees, the funds' beneficiaries. Treasurer Nappier said the warning she sent was not heeded.

Treasurer Nappier further commented that despite the fact that the Office of the Treasurer ("OTT") led the charge in 2007 to issue a $2 billion pension obligation bond ("POB") for the TERF, the present funded level of the TERF remained below the 1998 level of 73% and is currently at 61%. She said that the silver lining of the POB issue was the covenant that committed the State to fully fund the ARC, which guided the State in the right direction toward ensuring the future financial stability and viability of the TERF, and holds a high probability of saving billions of dollars in taxpayer money over the life of the bonds because the total interest cost of the POB, at roughly 5.6%, is far less than the cost of carrying the unfunded liability at the actuarially-assumed rate of return of 8.5%. Treasurer Nappier noted that the 5.6% interest cost was an important figure because from January 1999 to November 30, 2011, the CRPTF's average return was 5.6% due to the recent market downturns.

With respect to the SERF, Treasurer Nappier said that the State was contractually obligated to fully fund the ARC by virtue of its 1996 agreement with the State Employees Bargaining Agent Coalition ("SEBAC"). However, she added that in 2008 there was a contribution suspension of $200 million by mutual agreement of Governor M. Jodi Rell and SEBAC. Currently, Treasurer Nappier said that the unfunded liabilities of both plans are in the midst of a 40-year amortization period, with less than 25 years remaining for each plan. At this point, she stated that both the SERF and TERF were bound to fully fund the ARC, and were on schedule to amortize the remaining unfunded liability by about 2031, which should ultimately lead to fully-funded pension plans. Treasurer Nappier commented that the challenge for the State budget going forward will be the costs of paying the full ARC for both plans, and that State policy makers will face multiple financial priorities, including the continued funding of the pension plans. She added that this funding priority will stand alongside many other important programs and obligations, all of which will be vying for scarce resources.

Treasurer Nappier stated that the OTT would play a role in the ongoing financial support of the pension plans through investment returns and proper allocation of assets, but added that at this point in time the heavy lifting associated with the unfunded liability was beyond the OTT. She added that as a long-term investor, the OTT had navigated the CRPTF through a very difficult decade where the S&P 500 returns had a cumulative appreciation of 1.44% from January 1, 1999 to November 30, 2011, and an annual rate of return of just 11 basis points. Treasurer Nappier said that typical public pension plan portfolio allocations had been weighted toward equities to produce upside returns to meet the actuarially required rate of return. Since January 1, 1999, she reported that the CRPTF had returned 5.68% on an annual basis, outperforming its benchmark from a relative perspective. Treasurer Nappier clarified that to the extent the CRPTF invested in the capital markets, it had been successful at taking all, and then some, of the return that the markets were able to generate. Without a doubt, she commented, the historic market downturns during the periods of fiscal year ("FY") 2001 through FY 2002 and FY 2008 through FY 2009 exacerbated the State's unfunded liabilities. Going forward, she said that it was quite clear that the lost ground could not be recovered by investing our way out of the situation and that increased contributions by the State were required in order to more quickly improve the SERF's funded ratio.

In closing, Treasurer Nappier said that this message had been sent to legislators and other interested parties since the beginning of her administration, and she would continue to offer support and any assistance in order to promote the improvement of the financial strength of these plans going forward. She stated that the OTT would continue to work in concert with the Governor's administration, through the Office of Policy and Management, to examine options in order for accelerating the improvement in the funded ratio of SERF in order to reach the goal of being fully funded by 2031. Finally, Treasurer Nappier said that the CRPTF's investment income was the single major source for financing the pension benefits.

In response to William Murray, Treasurer Nappier stated that there was currently no relief overall for these unfunded liability projections and noted that the 2008 through 2009 negative investment performance will affect the valuations for the TERF and SERF. Discussion continued regarding the current actuarial valuations for the SERF and TERF. Thomas Fiore noted that the 2011 positive returns would be included in an updated valuation and would deflect some of the negative impact caused by the historic economic downturn during the prior two years. Treasurer Nappier said that this would delay the impact but the State would ultimately face the burden. Mr. Fiore noted that due to the 2011 SEBAC Agreement, changes to the Plans made them less beneficial to the remaining State employees and that there were now 3,000 fewer State employees with the rehire rate at about one-third by October 2011. Peter Thor provided another perspective in citing that the Tier I Pension Fund within the SERF was never funded, instead was a pay-as-you-go plan, and added that it had been closed for about 25 years and this Fund was slowly disappearing with the aging of the Tier I recipients, just as the earlier investments that underperformed would disappear over time. He also elaborated on the additional burden on the pension plans caused by the early retirement incentive programs, which were extended to State employees, despite SEBAC's disapproval. In agreement with Treasurer Nappier, Mr. Thor stated that it was important for all elected officials to make the point that a defined benefit pension plan was actually a good value for the taxpayers because the payout is only about twenty-six cents on the dollar to the taxpayer when it is properly funded. He also agreed with Mr. Fiore that there had been various modifications to the structure of the SERF that would also have a direct positive affect on the cost to fund the Plan. Treasurer Nappier agreed, but also added that the underfunding must stop and given the outlook for the investment horizon, the State's contribution needed to be increased beyond the ARC.

Comments by the Chairman

Chairman Roxe stated that Treasurer Nappier's comments were very insightful. He added that she covered a great deal of information that needed to be kept in mind when reviewing the asset allocations and other matters.

There being no further business, the meeting was adjourned at 11:00 a.m.

This meeting was recorded on audio tape.

Respectfully submitted,

DENISE L. NAPPIER
SECRETARY

Reviewed by

JOSEPH D. ROXE
CHAIRMAN