**HALIFAX REGIONAL MUNICIPALITY**
**PENSION COMMITTEE**
**August 27, 2013**
**The Halifax Club, Almon Room**
**10:00 a.m. – 12:00 p.m.**

MEMBERS: Audra Abbott, NUMEA
Sheldon Harper, CUPE
Michael Lawlor, Retiree
R. Scott MacDonald (HRPA), Co-Chair
Raymond MacKenzie, ATU
Roxanne MacLaurin, Management
Jennifer Purdy, NSUPE
Gordon Roussel, Management
Mike Sampson, Management
Dan White, IAFF

ALTERNATES: Jerry Blackwood, Management
Stephen Bussey, IAFF
Gerard Cottreau, Management
Rick Dexter, NUMEA
Jack Dragatis, ATU
Nigel Field, Retiree
Melanie Gerrior, NSUPE
Sherry Hilchey, NUMEA
Dwayne Hodgson, HRPA
Peter Nixon, HRPA
Dwayne Tattrie, CUPE

STAFF: Terri Troy, CEO
Donna Bayers, Executive Assistant
Matt Leonard, Manager, Finance & Operations
Alex Longmire, Senior Investment Associate
Abbie Sui, Senior Investment Associate

OTHERS: Cathie O'Toole, Halifax Water

REGRETS: Bill Moore, Management
Britt Wilson, Management, Co-Chair

## 1. CALL TO ORDER

The meeting was called to order at 10:05 a.m. by the Co-Chair, Mr. R. Scott MacDonald.

## 2. APPROVAL OF THE AGENDA, ADDITIONS, AND DELETIONS

Mr. MacDonald added, "Update – Mortality Impact on 2013 Funded Status" by Terri Troy and "Effective Date of Creation of the Training and Education General Budget" by Audra Abbott under "Other Business."

***Moved by Dan White and Seconded by Audra Abbott to approve the agenda as amended. Motion Put and Passed.***

## 3. APPROVAL OF MINUTES – June 17, 2013

***Moved by Audra Abbott and Seconded by Gordon Roussel to approve the June 17, 2013 minutes as presented. Motion Put and Passed.***

Mr. Sampson referred to 5.3 (d) Communication and Support to the Committee regarding two alternates who have not signed the Code of Conduct. Mr. MacDonald replied that this item will be carried forward to the next meeting.

## 4. NEW BUSINESS

### 4.1 An Opportunistic Investment Strategy – Hedge Fund Secondaries

Ms. Troy introduced Mr. John Mecca, Vice President of Business Development for Morgan Stanley Alternative Investment Partners and Mr. Mark van der Zwan, Portfolio Manager.

Mr. van der Zwan presented an overview of hedge funds in order to provide context to the key part of the presentation, hedge fund secondaries. Hedge funds are actively managed pools of capital, which tend to be privately organized and only available to qualified investors. Hedge fund managers can invest across a broad range of public and private capital markets and may use a variety of investment strategies.

Mr. van der Zwan summarized the key benefits and risks of hedge funds. The benefits include higher risk adjusted returns for the portfolio as hedge funds can provide a differentiated source of returns while displaying a lower correlation to current assets. The HFRI Fund Weighted Composite Index has provided higher risk adjusted returns than both the S&P 500 and Barclays US Treasury 7-10 Yr Index since 1990. Mr. van der Zwan contrasted the benefits with the potential risks which included transparency, illiquidity, and leverage. He also provided an overview of hedge fund secondaries. A secondary transaction is when a third party buys a fund interest directly from a fund investor, rather than from the fund manager, usually at a discount to the fair market value. The HRM Master Trust has made attractive investments in private equity and infrastructure secondary transactions.

An interesting but short-term opportunity exists in hedge fund secondaries. Before 2008, some hedge funds invested in illiquid investments e.g. private equity or private debt, which is not an appropriate investment for hedge funds that are supposed to provide liquidity. Some investors are willing to sell their investments at reasonable discounts to get immediate liquidity. Pension plans have a long-term investment horizon and are better suited to invest in illiquid investments and are compensated for doing so, with an illiquidity premium.

Ms. Abbott asked why is this considered a temporary opportunity? Wouldn't there always be someone wanting to get out? Mr. van der Zwan replied before 2008, hedge funds were given far more latitude. After 2008, as investing in hedge funds changed so dramatically, much of the new dollar is focusing on liquid securities. Therefore, more liquidity exists in funds raised after 2008. Investors in these funds do not need to sell at a significant discount to redeem their funds.

Ms. Abbott asked Mr. van der Zwan if it was his role to invest on behalf of the client? Mr. van der Zwan replied that Morgan Stanley is part of the investment management. They have large institutions that they invest on behalf of and they have worked with some large US pension funds and high net worth individuals. They are coming to market now with a fund to invest in this opportunity and are seeking investment capital to invest along with Morgan Stanley.

Ms. O'Toole asked if he had some examples of Canadian Public Sector Pension Plans who would currently be clients? Mr. van der Zwan replied that presently they do not have a Canadian client. The investment has been satisfied with a relatively small number of investors and there has been sufficient capital over the past couple of years without speaking with Canadian investors. Some of the large Ontario and Quebec pension funds are considering this strategy. However, it is challenging to do this strategy on your own because of the complexities involved. Currently, there are only a few players in the market with experience and Morgan Stanley is the pioneer in the space and has invested $1.9 billion since 2009.

Ms. O'Toole asked Ms. Troy if she has seen a summary of reporting for clients? Ms. Troy replied, no, this would be covered in due diligence. Mr. van der Zwan added that as an investor, you would be provided with full transparency.

Ms. MacLaurin asked if transparency was the main issue with the Madoff investment scandal and how has transparency changed? Mr. van der Zwan replied that Madoff was definitely an issue of transparency as well as segregation of duties. Madoff owed its own broker and created false entries. Also, Madoff used a one man auditing firm which should have raised red flags for potential investors. As an investor, Morgan Stanley did not invest in that fund. Morgan Stanley has a 10 person due diligence team that evaluates hedge funds purely from the perspective of operational risk and this team has veto power over any investment.

Mr. Sampson asked how is the fund valued, for example, if the only asset is a legal claim? How would this be shown in the financial statements? Mr. van der Zwan replied that the hedge fund has always been a mark-to-market business. If it is more difficult to value, the manager will attempt to fair value and have the fund audited every year. Every fund that Morgan Stanley invests in has to be valued by Morgan's Stanley's independent fair value committee. In hedge funds that are publicly traded, there is less ambiguity since there is a known value on the exchanges.

Mr. White asked, related to the above, on a day to day basis, how difficult is this to monitor? Mr. van der Zwan replied on a day to day basis, Morgan Stanley has an advantage in monitoring because of their knowledge of so many of the funds.

Mr. White asked if their management fee is typical of hedge fund management fees or more like a pooled fund? Mr. van der Zwan replied that the fee structure would be much more typical of a private equity structure, with a base management fee and an incentive fee. In terms of their incentive base fee structure, they only get paid once cash is returned, a realization base fee structure.

Ms. MacLaurin asked if we are investing in a fund that invests in hedge funds, what is the advantage of doing that as opposed to investing directly in hedge funds? Mr. van der Zwan replied that this Morgan Stanley fund is not a typical fund of funds. It is not investing in plain vanilla funds but is looking for opportunistic situations that are not being followed by many other firms.

Ms. Troy added to Ms. MacLaurin's point that this is investing in illiquid private investments that just happen to be in hedge funds.

**4.2 Canadian Equity Long/Short**

Ms. Troy introduced Mr. Reza Satchu, Managing Partner, and Mr. Tim Hodgson, Managing Partner, Alignvest Management Corporation. Ms. Troy explained that Alignvest will be speaking on the more public types of hedge funds, equity long/short strategies. Alignvest is presently part of the HRM Master Trust's private equity portfolio but has not invested in any of the underlying individual platforms. However, Ms. Troy is close to finalizing two private debt deals with Alignvest. The SIP&P does not currently allow investment in hedge funds. The SIP & P would have to be changed to do any type of investment in hedge funds either private or liquid type strategies.

Mr. Hodgson and Mr. Sachu gave a brief overview of the firm. Portfolio Managers, Reno Giancola and Jeff Hales next presented how a long/short equity hedge fund functions from a practical basis. They discussed the market mechanics of this particular type of hedge fund, as well as how extra returns could be generated while lowering the risk.

Ms. Troy asked what happens if a stock gets delisted? Mr. Giancola replied that they would still have their short position. If the stock ends up going to 0 and you make profit, you never actually buy it back but you would still have the entire mark-to-market gain.

Ms. O'Toole asked if they have any examples of Canadian Public Pension Plans who are hedge fund clients at this time? Mr. Hales replied that currently they do not as they recently launched the fund at Alignvest and are testing the systems before going out to institutions.

Ms. Troy added that she has been working with Alignvest looking at a separate account so there would be full transparency of the holdings. Ms. Troy is presently on the board and does not have any issues with transparency. There would be no lock up for HRM Master Trust and Alignvest has offered a fee discount. The two prime brokers are TD and Scotiabank.

Mr. Sampson asked what the terms “long term lock up” and “full fee” mean? Mr. Hales explained that lock up means they have restrictions on their ability to take out their capital. Alignvest cannot take out capital for 3 years from the initial launch. A lot of managers do not charge employees fees but Alignvest investors including staff are paying the same fees as investors.

Mr. Roussel asked about the mechanics of short selling and how money is made? Mr. Giancola explained that any security that is held in a margin account anywhere in the world is available to be borrowed by short sellers. For a fee, they would borrow the shares and short sell them. If the shares were sold at $20.00 and bought back at 10 cents, a profit would be gained. The shares would be paying a dividend so the short seller is responsible for funding the dividend.

**4.3 Recommendation to Approve Revised DB SIP&P**

Ms. Troy explained that the Statement of Investment Policies & Procedures (SIPP) would need to be revised if the Committee wished to invest in hedge funds, including the two types of strategies presented today.

On a more timely note, Ms. Troy recommended changing the SIPP to allow more discretion to invest in shorter duration bonds with a goal to preserving capital. Ms. Troy referred to the chart included with Agenda Item 4.3 on the Change in Canadian Government Bond Yield in 2013. The chart shows that bond yields have been increasing with significant increases in interest rates of approximately 85 bp year to date. The DEX long term government bond index returned -8.7% as at August 16 2013 and the DEX Universe Index returned -2.8% over the same period. In order to get a +6.25% on the Master Trust in 2013, you would have to get approximately 13% on equities and private investments, assuming no further increase in bond yields. While the solvency funded status has improved by approximately 10 percent, potential contribution increases are now triggered by the Going Concern Deficit. The HRM Master Trust needs to earn approximately 2.46% in 2013 to prevent further contribution increases in 2015. However, negative returns on bonds need to be minimized as much as possible in order to improve going concern and solvency funded ratios.

Mr. Sampson asked if this would improve going concern? Ms. Troy replied by making this change, the going concern funded status would improve because capital would be preserved in a rising interest rate environment.

Ms. Troy referred to the recommended changes in the SIPP. These changes are recommended to preserve capital in a rising interest rate environment. Administration changes were made in 3.5 and 3.6 on Page 6 changing the discount rate from 6.75% to 6.25% to reflect the Committee’s decision to change the going concern discount rate from 6.75% to 6.25% earlier in the year. Changes were also made in section 3.15 of page 7 and section 3.17 of page 8 to remove “net of fees” from “Current Going Concern Discount Rate net of fees”. On page 7, 3.12, Ms. Troy recommended changes in the bond category. The Dex Long Government Index allowable range was 40-100% and the recommended change is 0-100%. The Dex Universe Index allowable range was 0-60% and the recommended change is 0-100%. US Bank Loan Index (specific benchmark to be determined) was added with an allowable range of 0-25%. This is floating rate bank loans. The SIPP currently allows for the investment in bank loans but a reference to investment ranges and the flexibility to set the appropriate benchmark are needed when the investment is made. Ms. Troy also added the change in the 3-month Canadian Banker Acceptances allowable range from 0-25% to 0-100%. These changes are recommended to preserve capital in a rising interest rate environment.

Mr. MacDonald asked how the US Bank Loan Index compares to other bonds? Ms. Troy replied that this is a benchmark that reflects a universe of floating rate bank loans instead of fixed rate bonds, which are reflected in the DEX Long Government Index and the DEX Universe Index.

Mr. White asked if this works like a real return bond? Ms. Troy replied that real return is inflation indexed and floating rate debt would adjust higher or lower as the base rate changes, similar to variable mortgages. Mr. Sampson asked if the return would be lower? Ms. Troy replied that the return will be higher in a rising interest rate environment. Mr. Sampson asked if we have any now? Ms. Troy replied, no, this is currently under review.

Ms. Troy referred to Page 8, with the addition of 3.19 which asks the Committee to approve the inclusion of a US Bank Loan Index for a US Bank Loan component of the Fixed Income allocation if applicable.

Ms. Troy referred to Page 9 with the addition of 4.3 (h) Hedge funds up to 5% of the Fund's market value.

Ms. O'Toole commented that she is not aware of any Canadian Public Sector Pension Plans that are investing in hedge funds. She asked Ms. Troy if she was aware of any that have amended their SIP & P's in order to do this? Ms. Troy referred to her knowledge of the use of hedge funds by Canadian Pension Plans. This type of information is found in PIAC's annual asset mix survey. Most pension plans that use hedge funds have an allocation of around 5%, but some are higher and some are lower. Ms. O'Toole asked who would primarily be the hedge fund managers they are using? Ms. Troy replied that these vary because the number and types of strategies vary. For example, a common strategy is managed futures where you hire a manager to take directional bets on stocks versus bonds versus commodities. Ms. O'Toole asked if the addition of 4.3 (h), investing in hedge funds, changes any of the due diligence check lists currently being used? Ms. Troy replied, no, this would not change, regardless of the size.

Mr. MacDonald asked if the 6% risk factor relating to volatility identified in the presentations was correct? Ms. Troy replied, yes, this is correct.

Mr. Bussey referred to the word, "leverage" which was referred to in the presentations and asked if we could be exposed 2 to 3 times so that the losses are compounded? Ms. Troy replied that for the shorting, they are borrowing to get the securities from the prime broker so there is leverage. For the Alignvest strategy, leverage would be under 2 times since the manager typically maintains a net long position. Mr. Bussey asked why wouldn't we use Credit Suisse to source the hedge fund secondaries if we use them to source other types of secondaries for us? Ms. Troy replied that there are only a handful of mangers that source hedge fund secondaries and Credit Suisse is not one of them. If we decide this is an attractive opportunity, Ms. Troy would hire a leader in this area. Mr. Bussey asked if the proposed wording in the SIPP would permit any type of hedge fund strategies? Ms. Troy replied, yes.

Mr. Roussel asked if the long term equities give the best returns, why are we not switching from bonds and buying more equities? Ms. Troy explained that if we were to go with 70% equities and 30% bonds, there would be a lot of volatility. Because we need to file an annual valuation while the solvency ratio is under 85%, a portfolio with a significant exposure to equities would increase the probability for contribution rate increases year to year. Hedge funds have half the volatility of equities.

Mr. Sampson commented that if hedge funds require less regulatory oversight, would this require more in house staff to monitor? Ms. Troy replied, no. We would partner with a firm such as Morgan Stanley that monitors hedge funds. Ms. Troy also noted that hedge funds have the same regulatory oversight as the private equity and infrastructure investments that we currently invest in.

Ms. MacLaurin asked if Ms. Troy's position on the Board of Directors at Alignvest was a conflict of interest? Ms. Troy replied, no, because her role on the board is as a representative of the HRM Master Trust.

Mr. Sampson asked if a target return was given for the hedge funds? Ms. Troy replied that hedge funds are not an asset class but individual strategies. The Alignvest Long/Short strategy is targeting 10-12% net of fees and expenses over a business cycle and Morgan Stanley is targeting approximately 13-18% net of fees and expenses. The higher return includes the illiquidity premium.

Ms. MacLaurin asked if the Committee could consider a lesser percentage of investment in hedge funds than 5%? Ms. Troy replied, yes.

Mr. Sampson asked if changing the Dex Universe long term was signaling the belief that interest rates were going to increase? Ms. Troy replied, yes. The consensus view of Canadian economists is that Government of Canada 30 year bonds are expected to increase to 3.12% by the end of 2013 and 3.6% by the end of 2014.

Mr. Dexter asked how long is the term of these funds? When could we get our money back? Ms. Troy replied that the illiquid fund with Morgan Stanley is 5-7 years and the long/short with Alignvest would be month to month. If a separate account can be implemented with Alignvest, then the funds would be available daily. Alignvest is offering a discounted fee schedule if we implement by October 1st.

***Motion: To approve the proposed revisions made to the SIPP as presented with the amendment to an investment in Hedge Funds of up to 3% of the Fund's market value restricted to those Hedge Funds with illiquidity characteristics and/or Long/Short Equities and to add the change of the allowable range of the 3-month Canadian Banker Acceptances bond category from 0-25% to 0-100%. Moved by Gordon Roussel and Seconded by Roxanne MacLaurin. Motion Put and Passed.***

## 5. OTHER BUSINESS

### 5.1 Update – Mortality Impact on 2013 Funded Status

Ms. Troy referred to the handout distributed at the meeting regarding considerations for the December 31, 2013 Actuarial Valuation. The actuary profession has updated the mortality tables and is concluding that on average, pension liabilities have been understated by 5-10%. This is a one-time adjustment to reflect 20 years of low assumptions. From 2004-2012, the HRM Pension Plan has experienced a net gain from mortality experience of $9.2 million. The recent $1.25 million experience loss per year is modest and equates to 0.09% of the going concern liabilities.

Due to the recent mortality loss, the Committee may wish to monitor the situation or start to strengthen mortality assumptions over a period of time, or tactically strengthen assumptions when investment performance permits in order to maintain current contributions rates. Ms. Troy did not recommend strengthening the mortality assumption in 2013 as this could require an increase in contribution rates commencing January 1, 2015.

Ms. O'Toole commented that it is her understanding that the mortality tables are still in draft and not yet approved. If they were approved by the Fall of 2013, would we need to use them? Ms. Troy replied that the actuary advised that we would not have to make an adjustment in the 2013 valuation.

### 5.2 Effective Date of Creation of the Training and Education General Budget

Ms. Abbott on behalf of the Training and Education Committee recommended the general budget be created retroactive to January 1, 2013. This will move costs from individual budgets to the general budget for anyone who, in 2013, attended FTMS, TDP and/or one (1) introductory course outlined in the advanced financial education section for all members and/or one (1) advanced course outlined in the advanced financial education section for voting members. If approved, this will provide those affected time to register for other training coming up in the calendar year should they wish to do so.

***Moved by Audra Abbott and seconded by Raymond MacKenzie to approve the general budget be created retroactive to January 1, 2013. Motion Put and Passed.***

## 6. <u>DATE OF NEXT MEETING</u> – October 3, 2013

## 7. <u>ADJOURNMENT</u>

The meeting adjourned at 12:30 p.m.

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R. Scott MacDonald, Co-Chair