**Subject:** INVESTMENT POLICY-EMPLOYEE RETIREMENT SYSTEM **No. 20.4**

**Date:** April 27, 1998 

## PURPOSE:

The purpose of this revised policy is to comply with the recent amendments to Michigan Public Act 55, which regulates Michigan public retirement systems.

## SCOPE:

The Employee Retirement System's objective is to accumulate a pool of assets sufficient to meet the obligation of the City of Kalamazoo Employees' Retirement System at the lowest total cost to the City of Kalamazoo in a manner consistent with the fiduciary responsibilities of the Fund and solely in the interest of the participants and beneficiaries, all pursuant to Act 485 of Michigan Public Act of 1996 and all other applicable laws and regulations. The System's assets will be invested to achieve the maximum long-term, risk adjusted (three to four market cycles) cumulative return possible under the laws and regulations under which these assets can be invested.

## POLICY:

The System will maintain the following disciplined asset mix:

1. A target of sixty-five percent (65%) of the portfolio's market value will be invested in common stock with the balance invested in notes, bonds, equity real estate and short-term securities.

    a. A target of no more than five percent (5%) of the portfolio's market value will be invested in equity real estate.

    b. Variations from this target asset mix based on market value will be remedied in a prudent manner through the allocation of annual contributions, liquidations to meet System's needs, and or the transfer of assets between fund managers.

2. The City of Kalamazoo will seek to achieve and maintain a target-funded ratio (market value of assets as a percent of the present value of total accrued liabilities on a plan termination basis) of not less than 100%.

3. The Employees' Retirement System's Investment Committee is responsible for recommending to the City Commission the investment policies/strategies and monitoring the systems serving as controls over the managers, trustees, advisors, actuaries and other fiduciaries.

4. The City Commission is responsible for approving the recommendations of the Employees' Retirement System's Investment Committee.

5. The Investment Committee of the Employees' Retirement System is responsible for the execution of the policies, strategies and the retaining of managers, advisors, trustees and other fiduciaries, as well as other necessary services pursuant to all City policies and procedures and will consult City staff when appropriate.

6. The Employees' Retirement System's Investment Committee will annually prepare a budget. The budget will be prepared in conjunction with the City's budget process and procedures and will be approved by the City Commission. Once approved, the Investment Committee, along with staff, will have responsibility for managing the expenses within the budget in accordance with all applicable City policies and procedures.

7. Minutes of all meetings will be recorded by the Secretary to the Investment Committee and distributed to all pertinent parties.

9. The Employees' Retirement System's Investment Committee will report in writing to the City Commission all findings.

9. Investment Objectives, Strategies, and Performance Measurement and Review

   c. Long-Term Common Stock Objectives (three to four market cycles)

      - To realize a long-term cumulative total rate of return (defined as income plus realized and unrealized gains and losses) equal to the average annual rate of return on U.D. Treasury Bills plus six hundred (600) basis points net of all fees and expenses.

   d. Short-Term Common Stock Objectives (one to five years)

      - Active managers must realize a cumulative annual rate of return equal to the performance of the S&P 500 plus twenty-five (25) basis points. Fees and expenses will be negotiated separately.

   e. Passive managers must realize a cumulative annual rate of return equal to the Index for which they were hired, less no more than fifteen (15) basis points. Fees and expenses will be negotiated separately.

   f. Active managers must realize a total rate of return equal to or better than each manager's commingled equity fund ("a showcase fund") where appropriate.

10. Bonds and Short-Term Securities

a. Long-term (three to four Market Cycles) Objective

- Realize a long-term cumulative annual rate of return (defined as income plus realized and unrealized gains and losses) equal to the average annual rate of return on U.S. Treasury Bills plus two hundred seventy-five (275) basis points.

b. Short-term (one to five years) Objective

- Active managers must realize a cumulative annual total rate of return equal to the appropriate bond index plus ten (10) basis points net of all fees and expense.

- Passive managers must realize a cumulative annual rate of return equal to the Index for which they were hired to manage of not less than ten (10) basis points of the Index's performance. Fees and expenses will be negotiated separately.

11. Real Estate

a. Long-term (three to four Market Cycles) Objective

- Realize a long-term cumulative rate of return (defined as income plus realized and unrealized gains and losses) equal to the average annual rate of return on U.S. Treasury Bills plus three hundred seventy-five (375) basis point net of all fees and expenses.

b. Short-term (one to five years) Objective

- Realize a cumulative annual total rate of return equal to or greater than that achieved by the median real estate fund as reported by the major performance measurement services.

12. Performance Measurement and Reviews – All Managers

(The following criteria will be used to evaluate each manager's performance):

a. Achievement of the Funds objectives.

b. Comparisons with other managers, indexes, etc.

c. Subjective observations regarding the manager's organization, professionalism, administrative skills, etc.

d. Members of the Employees' Retirement System's Investment Committee will meet with each manager not less than two (2) times each year. Normally, once at the managers' office and once in Kalamazoo.

13. Strategy for All Assets

a. The Kalamazoo City Commission expects each of its managers, trustees and fiduciaries to be familiar with the laws and regulations governing the investment of its assets, particularly Act 485 of Public Act of 1996, and as it may be amended from time to time, and to invest the System's assets accordingly. Should there be any conflict or variance between the Kalamazoo City Commission's policy and said laws and regulations, then said laws and regulations will prevail.

b. The Kalamazoo City Commission expects each of its investment managers to maintain or advise the City as to any changes from style, philosophy and strategy for which it was originally selected.

c. The Kalamazoo City Commission expects each of its investment managers to maintain a fully invested position. However, the City Commission recognizes its managers may have any amount of cash or cash equivalent from time to time.

d. Common stock managers may not invest in letter stock or make foreign investments (excluding U.S. listed foreign corporations).

14. Bonds and Short Term Securities Managers

a. May invest up to one hundred percent (100%) of the managers' portfolio in U.S. Government and Agency issues. However, the investments should be diversified among a number of issues and only up to fifty percent (50%) of the manager's portfolio in Government Agencies.

b. May invest up to thirty percent (30%) of the managers' portfolio, valued at cost, in such issues as utilities, oils, industrial and direct placements.

c. Bonds must be graded in the top four major grades as determined by two (2) national rating agencies approved by the State Treasurer of Michigan.

d. Commercial Paper must be, at the time of purchase, within the two highest classifications established by not less than two (2) national rating services as determined by the State Treasurer of Michigan and mature within two hundred seventy (270) days.

15. Use of Derivatives

Explanation: Derivatives consist of those financial instruments that derive their value from an external source. E.g., an interest rate benchmark, commodity benchmark, underlying mortgage pools, etc. Derivatives can be used prudently to reduce portfolio risk and enhance return, and they can also increase portfolio risk if used inappropriately.

a. Derivatives of Moderate Risk

1) Floating rate notes.

2) Planned Amortization Class (PAC) on Collateralized Mortgage Obligations (CMO)

3) Asset backed securities

4) Repurchase agreements

b. Derivatives of Extraordinary Risk

1) Inverse and range floating rate notes

2) Interest Only (IO) and Principal Only (PO) strips

3) Support traunche CMO's

4) Structured notes

5) Issues that have potentially high sensitivity to interest rate changes or are not understood by the Investment Committee.

16. Requirements for Usage of Derivatives

b. A majority of the members of the Investment Committee must have familiarity and confidence in the overall abilities of any professional money manager before the manager is hired for the City of Kalamazoo Employees' Retirement System.

c. The key to successful use of derivatives rests with

   1) Rigorous modeling of the security or derivative's potential price movement in changing market conditions. From this modeling, the effective duration of the instrument can be estimated and embodied in the overall portfolio's duration.

   2) Continual monitoring of such securities and daily pricing using a reliable source.

   3) Derivatives with unusually high potential price volatility should be limited to a modest percentage of the portfolio.

   4) Derivatives whose value is derived from non-fixed income sources, e.g., currencies or commodities, will be limited to applications which hedge an exposure to the portfolio.

   5) Managers investing the City's portfolios must submit a quarterly report profiling all derivative positions, the effective durations, and the impact on total portfolio duration. This report will allow the Investment Committee to see the extent of the portfolio's exposure to various types of derivatives and the potential impact on portfolio performance.

This policy reviewed and adopted by the City of Kalamazoo City Commission at a business meeting of April 27, 1998.

Robert B. Jones, Mayor