NEW YORK CITY TEACHERS' RETIREMENT SYSTEM
BOARD MEETING
held on Thursday, February 7, 2013
at
55 Water Street
New York, New York

ATTENDEES:

MELVYN AARONSON, Chairperson, Trustee, TRS
SANDRA MARCH, Trustee, TRS
MONA ROMAIN, Trustee, TRS
PATRICIA REILLY, TRS
JANICE EMERY, Trustee, Finance
RAY SAROLA, Trustee, Finance
JUSTIN HOLT, Trustee, Finance
LARRY SCHLOSS, Trustee, Comptroller's Office
JOEL GILLER, TRS
MARC KATZ, TRS
THADDEUS McTIGUE, Comptroller's Office
RENEE PEARCE, TRS
ROBERT NORTH, Actuary
LIZ SANCHEZ, TRS
MARK RAUCCI, TRS
SUSAN STANG, TRS
CAROL BANAT, Comptroller's Office
JOHN BRIGHT, Comptroller's Office
VALERIE BUDZIK, Comptroller's Office
MARTIN GANTZ, Comptroller's Office
JOHN MERSEBURG, Comptroller's Office
BARRY MILLER, Comptroller's Office
YVONNE NELSON, Comptroller's Office
INGA VAN EYSEN, Corporation Counsel
ROBERTA UFFORD, Groom Law Group
ROBIN PELLISH, Rocaton
CHRIS LYON, Rocaton
MICHAEL FULVIO, Rocaton
STEPHEN BURNS, Townsend
STEPHEN NOVICK, Courtland

P R O C E E D I N G S

(Time noted: 10:00 a.m.)

MS. REILLY: Good morning. Welcome to the February 7, 2013 Teachers' Retirement System investment meeting. I'm going to start the roll call.

Melvyn Aaronson?

CHAIRPERSON AARONSON: Here.

MS. REILLY: Justin Holt?

MR. HOLT: Here.

MS. REILLY: Kathleen Grimm?

(No response.)

No answer.

Sandra March?

She's on her way.

Frieda Foster. I just wanted to mention that Frieda Foster has submitted her resignation to the Board, so she will not be here today.

Mona Romain?

MS. ROMAIN: Present.

MS. REILLY: Thad McTigue?

MR. McTIGUE: Here.

MS. REILLY: We have a quorum.

I will turn it over to the chairman, Mel.

MR. AARONSON: Thank you very much.

It has been suggested that the order of

business today is that we do the pension funds, public part first; then we will do the Passport funds public part; and then we will do the Passport funds private; and then do the pension funds private.

So that's the format.

I'll turn it over to Larry.

MR. SCHLOSS: Thank you.

Does everybody have their monthly performance review?

If you turn to page 32, this is the calendar year just ended. We ended at $46.7 billion, which is the highest amount for the Teachers' Retirement System. The return for the year was 13.1 percent. Generally up, a problem we had in the spring, but started low and ended high. All good.

If you look at the next page, this is a ten year look.

Mel, you'll ask what is the ten year rate of return, I'm sure. For Bob North's benefit, it's 7.9 percent before fees. So good ten years, even though we had this ridiculous period that you all lived through, happily before I got here, in 2008 and 2009; but again, 7.9 percent overall.

If you look at the asset allocation on page 35, it's exactly the way it was last month.

Overallocated U.S. Equities, which has done well, underallocated Core 5.

If you jump to page 39, you can see that the month of December was a good month. The U.S. stock markets were up 2 to 3 percent; international markets were up 3 to 4 percent. The equity markets were going up. The fixed income markets backed up a little, coming off. Again, we got more equities than fixed income.

If you look at the next page, page 40, we made about a point and a half last month, bringing our fiscal year to date to 6 and a half percent. Please don't annualize that number.

But January is also good, the markets are up. My guess is we added another 2 percent or so in January. So again, we got the portfolio set up right, the markets are good, everything is pretty good.

Since it was good, there was not that much to describe, everything worked the way it's supposed to in a rising market.

Any questions?

Thad has the basket clause now.

MR. McTIGUE: Good morning, everyone.

If I can ask you to turn to page 63 in your book. We have today a presentation and a discussion on the basket clause.

As you know, we've had many conversations over the last year and a half or so about this issue, and it really goes back to when the Board, the Comptroller's Office and Rocaton worked on an asset allocation.

We ran the asset allocation with, as you're aware, the New York State law, the retirement Social Security law, limits certain investments, which we'll get to in a few minutes, to a 25 percent basket limitation.

We also ran an analysis at a 35 percent basket. Part of the process was, as BAM, Rocaton and the Board ramped up the asset allocation and implemented its plan, we would need that additional head room.

So as we went and did those investments and worked closely with the Board, we're now coming to you with what we think is a prudent time for a number of reasons, to pursue the 35 percent basket so that we can continue to implement our asset allocation.

So on page 65, page 2 of the presentation, is a history of the basket clause, which is a statute that all retirement systems in the State operate under. Essentially what the basket clause sort of says is that the statute talks about legal investments the Board can invest in. And those investments that don't meet the legal list go into what we term the basket.

So if I can ask you to turn to page 3 of the presentation. The left-hand side of the page talks about the legal investments. It's fairly straightforward. The one item I would draw you to as a legal investment, for example, international equity up to 10 percent.

And then the right-hand side of the page is a longer list, items and our investments that go into this 25 percent basket constraint that we have. And you can see it's quite a long list. And as the Board diversifies its assets, the competition for the basket space has become much keener in a sense.

And this Board, for instance, doesn't do hedge funds, but we do many other things such as bank loans, high yield, U.S. Equities above 10, non-U.S. Equity above 10 percent, private equity. So the competition, as I mentioned, as we try to diversify the portfolio and reduce our volatility is there.

On page 4 of the presentation, we have the basket clause summary as of December 31 of this year. And I think there's a couple of interesting numbers on this page.

I think that what I would draw your attention to is on page 4 on the right-hand side of the page, is the number we have the remaining capacity, which is just about 7.6 percent, akin to the items on page 3. When you look at where we are in terms of private equity, for example, we make commitments to private equity and draw those down, and that will have an impact on what our actual head room is.

There's also denominator effect issues. When the market does go down, the amount you have regarding 25 percent also becomes less, and in terms of private equity and real estate, these are commitments you made and are legally obligated, as the Board knows to keep.

The following page is a list of some of our top funds, our peers, and their performance. I think what is interesting on this page is that some of the funds have basket clause restrictions, some do not. I think the takeaway for me is also on the following page.

When you look at restrictions or basket clause type statutory frameworks that other states have, their framework seems to be much more limited in terms of what they define as sort of a basket or what we might define as a legal investment.

So I would draw your attention again to page 3 of our presentation. Our list of basket investments is quite extensive as compared to our peers.

So, as we had numerous conversations at the Board, and I think consistent with what this Board has discussed in the past, it is our view that we would like to give all the boards this presentation, to some of the boards in the city, to ask board support to pursue an increase in the basket and amending the retirement Social Security law so that the basket can be increased to 35 percent from its current 25 percent.

And I think in furtherance of this presentation, Rocaton has put an analysis together of some of the items we talked about when we did our presentation on the asset allocation and looked at the 35 percent basket clause.

I'll turn it over to Chris or Robin for some of the analysis they provided today.

MR. LYON: Thank you.

The analysis we put together here looks at the current targets and an alternative portfolio which is not necessarily a recommendation, but rather a way to illustrate a portfolio that in a way reflects where we've been, but try to show a higher allocation to the basket clause component.

And basically we're talking about roughly an 8 percent increase in this illustration to the basket clause. The main point here is that this does not necessarily change in a meaningful way the downside case that we would project, if markets did terribly, for the current portfolio versus this alternative portfolio that makes very extensive use of increased basket clause.

So similarly, you can see that while the total volatility increase is a modestly commensurate increase in the return. So this may slightly change the expected risk-return profile, but the point here is that we're recommending a new target, building in flexibility so that over time, in calibrating the right level of risk that you're trying to target, you have the flexibility to both move to the left and the right of where you are today, as opposed to only having the flexibility to stay where you are and move to the portfolio with less expensive risk.

So it's all about the flexibility. If you take it in this direction eventually, our projections are that it doesn't change the downside significantly, and that there are expected returns to compensate for the modest increase in expected risk.

That's really the overall conclusion, and the other pages really show the assumptions that were embedded in coming up with the numbers in the Board book, page 71.

CHAIRPERSON AARONSON: Thank you.

Questions?

MR. HOLT: Mr. Chairman, more of a statement, to bring everybody else up to speed. Thad's office and ours have been in some side discussions on this topic, and at the moment we are not ready to vote in favor of this.

We're working with Thad's office to clarify a couple questions we have, such as why is the move from 25 percent to 35 percent the best recommendation, to consider some alternative scenarios and to clear up a couple other matters. So at some point our principal might come on board for this proposal, but at this point we're going to still need to clarify with Thad and the Comptroller's Office.

CHAIRPERSON AARONSON: This board has been for a long time discussing even changing the whole thing and throwing out the legal and the basket clause and coming under the prudent man rule. That's been our goal.

This is another step in that direction, and it's going to take legislation up in Albany to do this, and I think it would be an excellent idea to go ahead and propose this legislation. And I think that we should -- if you are prepared to recommend this and ask for our consensus of whether to do this or not.

MR. SCHLOSS: Can I ask Justin a question? I'm confused. What is the issue? Is it 35 should be 45 or 32 and a half or some other number? Or you think that the 25 percent basket clause is good enough, and leave it alone? I'll break it up in two pieces. Should we leave it alone?

MR. HOLT: We haven't seen to date a case that satisfies our principal, that is, a need to increase the basket clause.

MR. SCHLOSS: You think the 25 percent is sufficient?

MR. HOLT: Me personally, my opinion doesn't matter.

MR. SCHLOSS: Yours is the seat you sit in. So you, that seat --

MR. HOLT: There's no case for what needs to go up, based on what has been submitted to date.

MR. SCHLOSS: Really? I find that astounding, that there's no case you have seen to date means saying 25 percent is fine. Astounding.

MR. HOLT: I have seen conjecture.

MR. SCHLOSS: The facts. There is unfunded commitments that currently exist that I truly have shown scenario analysis, to show that under certain circumstances if the stock market go down, so you get the denominator effect, and some of the things are drawn down, you might go through the 25 percent; right? You've seen those cases.

MR. HOLT: We haven't seen any scenarios what it would take to promote that. We're working under the assumption you gave us that the asset allocation, the new policy mix that we're migrating to was this basket clause 25 percent limit was more than sufficient to accommodate that.

So, we haven't heard any proposal on what sorts of staffing, reporting, systems, risk management capabilities would need to be in place in order to adopt more investment flexibility.

So, as I said, our office has requested further analysis on those topics before it's willing to sign off.

MR. SCHLOSS: I wanted to understand the problem. Thanks.

CHAIRPERSON AARONSON: Let the record show Ms. March has entered.

(Ms. March entered the meeting.)

MS. ROMAIN: I don't know what your real concerns are, and I'm sure they could be further clarified as to what Larry just said. But this is a continuing situation of a process that this board has started.

I don't know who you are referring to when you say that your principal -- you're sitting here -- I don't understand the question you have. But I think what we need to do is --

MR. SCHLOSS: One last thing.

Justin, you might benefit from reading the minutes before you sat in that seat, where the person who sat in that seat insisted we expand the basket clause. So I remain confounded that seat doesn't want to do this now.

(Talking over each other.)

MR. SCHLOSS: Read the minutes. It wasn't all conditional. It was point blank and it was from that seat that said you, the Comptroller's Office, should hurry and do this as soon as possible.

MR. HOLT: I can clarify. We're not here to object or to create friction in this. We could well come on board. We just need to -- having side discussions to clarify a few points, and perhaps we can return to this at a later date.

MR. SCHLOSS: Okay.

CHAIRPERSON AARONSON: Larry, I have a question. Does this 35 percent require we go to 35 percent?

MR. SCHLOSS: No. We just have to go to Albany, once a year to get a change -- then a conversation that will take us a lot of time to figure out another asset allocation.

MS. MARCH: I know I just walked in the room, but history counts. And this city and our boards, all of them -- and I believe one of the trustees may have already said something in regard to this -- we have always wanted prudent man.

So moving from 25 percent to 35 percent is a baby step. And I will say it again. I really want to pick up what Larry said. You really have to know what's going on. You can't just drop yourself in to a position and believe you have the solution or you have the problem solved.

You have to read the minutes. And maybe you need to read 20 years of minutes to understand what has gone on here and why we're at a point. And those of us sitting here for so long clearly understand that in terms of our being able to invest in certain assets, we can't do it, because we had a relatively small basket clause.

If I'm correct, at one point it was 15 percent?

MR. McTIGUE: Correct.

MS. MARCH: Mel says it was even less. So that we've taken a giant step. And if the people in Albany don't want to do prudent man, we are very prudent in that we believe we should be increasing it, since there are new asset classes over the last, it's almost 30 years that I'm sitting here.

MS. ROMAIN: So the recommendation is to pursue --

MR. HOLT: Mr. Chairman, one thing. I'm familiar enough with the minutes to know our office has supported prudent expert standards, which I think you mix that one point up there. But there hasn't been a case made for this here, and there hasn't been any action plan provided in this proposal to increase the legal limit 10 percent.

So it's kind of hard for us, our vote, to sign off when we don't know how it's going to be deployed. And we are perfectly open. We could return to this and provide our support. We need to clarify a couple of things.

MS. MARCH: In a democratic process, since this board is governed by law, I'd like us to move on and make a decision as to where we're going with this issue.

MS. ROMAIN: For clarification here. We are seeking approval to pursue legislation that would expand the basket clause. And this is not just for Teachers, it's for all of the systems in New York State.

MR. McTIGUE: Yes.

MS. ROMAIN: Thank you.

CHAIRPERSON AARONSON: This recommendation has been made. Is there consensus to go ahead with this?

MS. MARCH: Yes.

MR. SCHLOSS: Yes.

MS. MARCH: Move forward, please.

MR. SCHLOSS: Thank you.

The next agenda item is discussion of risk.

John Bright, who you all know.

MR. BRIGHT: From a risk management point of view, the optimum basket clause would be 100 percent, where we would be governed by prudence. Any artificial restraint, in my mind, increases your risk.

This presentation is going to be a little different from what I've shown you all in the past. There's no colored charts, not all that many numbers. Sort of a minimalist Bauhaus school presentation.

And the reason for that is, it's easy to get lost in the weeds of lots of numbers and in all the statistics, and sometimes that gets in the way of inside and what's really going on in the portfolio.

And also, I view the job of the risk manager as identifying what are the things most likely to go wrong in a portfolio. Sometimes that has to do with statistics and sometimes it doesn't. And right now I think our biggest risks are not statistical risk, so I want to get away from that and give a little insight into the portfolio.

So the first thing is, what do we mean by risk? We frequently talk about bar and standard deviations. But the real risk is that we don't earn enough money to fund our liabilities. I apologize.

MR. SCHLOSS: Amen, Bob North.

(Laughter.)

MR. BRIGHT: I should apologize to Bob because he told me he prefers the word "obligations" to "liabilities," but he told me after I'd gone to the printer.

(Laughter.)

MR. NORTH: Same thing.

MR. BRIGHT: I would end up saying "liabilities," lifetime of habit. And what I want to contrast for you is, in normal times what risk looks like. And in normal times I mean when you got interest rates, government bonds 5 percent, corporate bonds 6 percent, junk bonds 8 percent, you're within spitting distance of your actuarial target from fixed income investments.

So then it's good to look at diversification and to look at all the statistical paraphernalia one can bring in, because you are pretty close to meeting your bogey anyway, and you can take a little risk, not too much risk.

And for me, it's not all clear that short term volatility actually has a profound effect on the ability to pay our liabilities; but nonetheless it's very disconcerting to lose a whole lot of money in a hurry, so we can control that.

So, in normal times we look at our big risk as being the markets just fall apart a la 2008, we lose a whole lot of money in a hurry and we have to struggle to get it back. And we love having the fixed income portfolio, in part because when the equity markets tank, you typically get a flight to quality rally in fixed income and you get some of the money back there.

And we can look at correlations 'til the cows come home and all the statistics. I would argue that this is not a time where that is particularly relevant. We have extraordinarily low interest rates.

And the biggest risk to our fund, in my

opinion, is that the Fed continues to keep rates this low -- you no longer have the luxury of corporate bonds and Treasuries will get us close to our return assumptions. Yields are pathetic. And they may stay pathetic for a long time. I don't know that they will, but that's the biggest risk, that the Fed keeps rates low. Low rates make it much harder to fund our liabilities.

So in this environment I think we shouldn't look so much at short term volatility, but we should look at the long term, what happens if rates stay low in the long term? How do we make enough money?

So, the Fed has -- next page -- our risk is that the Fed continues to keep rates low for a long time. And when we look at the fixed income part of our portfolio, we have a sizable chunk of our portfolio lending to the federal government and corporations at yields less than 2 percent.

Now, let me just add a digression on interest rates. Because the short term effect of the change in interest rates and long term effect actually move in opposite directions for a fund like ours.

When we had the spectacular rally it was great. We got a capital gain. But we continued to hold the stuff, and it's now accruing interest at a very low rate.

And so, my example is, to flip it around, suppose tomorrow rates went up 500 basis points. Yes, we take a mark to market hit. But over time we get it back. Because now, instead of accruing at 2 percent, our fixed income portfolio accrues at 7 percent. And to totally belabor the point there's a chart, to show I can give you numbers.

(Laughter.)

Where, if rates stay where they are at 2 percent, we've got roughly $15 billion in fixed income, it grows 2 percent every year compounded. If overnight rates went up 500 basis points, we drop a lot, a capital loss. But now we accrue at 7 percent. Within 6 years you're back from the hole and beyond that it is great.

So high interest rates are good for a pension fund, they're good for savers. Low interest rates are bad for pension funds, they're bad for savers.

And the flip of this, of course, the wonderful rally we got in fixed income in 2008, we've given back virtually all that money in a very real sense, from accruing at a very low rate. Because that's what happens when you have a rally, the rates come down.

So, what happens to us if rates stay low? We need to earn 7 percent after expenses, that's Bob's new actuarial risk. We have a third of the portfolio earning less than 2 percent in fixed income.

That means the rest of the portfolio has got to earn 10 percent. That's possible, but it is requiring an awful lot of heavy lifting on the part of the portfolio doing all the work. That is historically a pretty high premium over fixed income for equities and other investments.

What happens, is there any way we can lessen the burden on the part of the portfolio that does all the work? Can we mitigate this risk? I think we can.

In a low rate environment you want to be a borrower, not a lender. So, what can we do? We can accelerate the reduction. We think cutting back on Core+5, but we should dramatically accelerate it. There's no sense investing money at 2 percent that costs 7 percent. Expand the rebalancing ranges to give more flexibility to do these sorts of things, and increase our exposure to the bottom of the capital structure.

So, private equity, those people are borrowing at historically low rates. We want more exposure to them, not less. We want more exposure to junk bonds, we want more exposure to mezzanine debt, and more exposure to futures. Use leverage.

Now that comes with risk, as the next page would show. Let's say if we earn 10 percent on the part of the portfolio that's doing all the work, equities and alternatives; and at our current two-thirds/one-third proportion, we have a current bar of $2.4 billion. Then we need our bogey.

Let's go down to suppose over the long term equities only make 7 percent. A handsome yield, but not enough with the drag of the fixed income portfolio on us. Then we need to put all the money in equities and alternatives and have nothing in fixed income.

Then the bar goes up, the volatility goes up, but at least we have a fighting chance now of earning the yields we need.

If we have middling returns, 5 percent, we're in an area of low growth, that could easily happen, we would need to lever up the portfolio. Go into futures, go into alternatives that actually increase our exposure. Yes, it increases the short term volatility, but it gives us a chance to earn enough.

So, conclusions are that if we have middling growth and middling returns going forward, we need to lever in order to earn enough money. And it's scary in the short term, yes, because you increase volatility. But in the long term it's the only way to get enough to eat. We can't have money sitting around earning 2 percent.

We can do it directly by actually borrowing money or by using futures; or indirectly, by investing more in private equity and other people at the bottom of the capital structure.

The constraints on this are, the basket clause is an impediment, hopefully it gets up higher, and we need to accept more volatility in the short run in order to have a chance.

Bob, I'm told in the past it's said we have to ride the wild tiger.

(Laughter.)

I'm proposing you may need to ride two wild tigers. One may not be enough. If the Fed keeps rates this low, we simply cannot afford the luxury of keeping this much money earning pitiful yields.

MS. MARCH: Maybe we should increase the basket clause 50 percent.

MR. BRIGHT: A hundred is my optimal; I'll compromise at 50.

MS. MARCH: You are the expert in risk; am I correct?

MR. BRIGHT: I won't use the definite article.

(Laughter.)

MS. MARCH: You are the expert in risk for the New York City Teachers' Retirement System.

MR. SCHLOSS: He's our expert.

MS. MARCH: That's right.

MR. HOLT: A couple questions on this. First off, I think this is great, thank you for bringing this thoughtful analysis to the Board and for your assisting BAM with risk management items.

With regards to levering up, I know we have spent a fair amount of time in past board meetings talking about how the portfolios need to reduce their equity risk, and this seems to, on the face of it, be a reversal of that shift over the last several years, to reduce equity concentration.

MR. BRIGHT: Yes. I don't think we have the luxury of worrying about Sharpe ratios and correlations and diversification. We have a bogey that's 500 basis points north of fixed income yields. You get it from equity or you get it from fixed income. The Fed is recapitalizing banks by keeping short term rates zero, essentially.

All right. If they want to do that, act like a bank. Buy long bond futures. Lever up fixed income so that you get some yields, but we've got to do something. We can't just sit slowly and bleed to death.

MR. HOLT: To what extent has your synopsis in the fixed income taken into account rolldown return from the bond curve and further actions that the Fed stimulus -- related bond moves?

MR. BRIGHT: Supposed the Fed buys every long bond out there and brings the ten year yield down to 1 percent. We get capital gains, but we accrue at 1 percent. We at some point have to say the capital -- if you take the capital gain and then you cash in the bonds and put it in something else, then you captured it.

If we stay in Core+5, all we do is rob from the future. All you're doing by taking out mark to market gain on a fixed income portfolio which you hold forever, is to take money that you would have gotten in the future and recognize it now and get less money in the future. And for a pension fund that doesn't seem wise to me.

MR. HOLT: Raising the question to a policy level, since the basket clause is under consideration, raising it in order to incorporate this into a basket clause, increase what sort of risk monitoring systems, staffing needs, et cetera would you imagine would need to come on board?

MR. BRIGHT: I don't think you need a whole lot. We'd get outside managers. If we do futures we would not do it internally, we'd get a CTA fund. And we would have to look at them, look at their results. It's pretty straightforward if all they're doing is buying long bond futures, to estimate the risk and how that correlates.

Again, for the foreseeable future, I would consider the short term volatility estimates largely irrelevant to the problem. The problem we face is how do we get enough yield?

Look, if we want to keep a third of the portfolio earning 2 percent, we're saying that we think over the long run equities and alternatives aren't even going to earn 2 percent. That's all they have to outperform to be better off.

And if we think that's the case, what are we doing here? If equities and alternatives don't even make 2 percent, where are we?

MR. McTIGUE: I know you work alone, but to follow-up on Justin's notion of these risk systems -- 35 percent.

As a risk expert, I would think that, as done in the past, Sandy indicated about the history of when we move the basket clause, from 7 and a half to 15 to 25, something that's gotten through incrementally. It suggests that we need a risk system to somehow change the whole paradigm, I don't think is accurate.

Would you agree?

MR. BRIGHT: Yes. Also, we're not saying we're going to do the weirdest derivatives out there anyone can find. We're talking about fairly straight -- the basket is not something that eliminates you from doing screwy stuff, or from perfectly normal stuff you didn't happen to think of when they wrote the enabling legislation.

So it's a straightforward exercise.

CHAIRPERSON AARONSON: I'd like to hear from the Actuary.

MS. MARCH: He is smiling.

(Laughter.)

MR. NORTH: Thank you. One of the things I liked about this presentation is the observation between the normal and the abnormal. I'm not always sure whether any year is abnormal, but I do admit, and Chairman Bernanke has made the point that the interest rates are low because he doesn't want money kept where it isn't going into other things that in theory produce productive growth or into assets for risk on trade. That's what the Fed wants. How long it will last, who knows?

From the Board's point of view, you have a couple of issues here. Getting back to the basic goals and objectives, as John pointed out, one of the desires is not to have employer contributions rise relative to the current expectations. And under the current funding mechanics, that would require 7 percent over the long run.

Now, long run could be a really long time, especially from this environment a short run, it may be difficult to achieve that.

It then boils down to a couple of choices. For the better part of 15, 20 years since the Board decided to go into equities as a riskier asset class with higher expected returns, the goal has been to produce those extra expected returns to hold down contributions.

But, find a balance where the overall relationship between the volatility created and the extra expected returns was something that was comfortable. It may require being more risky to get greater expected returns.

And then the question is, do you really -- once you get past the legal question, can you expand into those classes -- if you could, are you comfortable with the implications thereof?

Because, it may be -- and this is a

hypothetical exercise -- if you could only get the return you need by being all in equities or all in private equities or all in something that's very risky, and that short term volatility is very high, there are then the questions of headline risk and other things not quite as bad as the Atlantic City roll the dice approach; but you would have to accept the wild tiger, or now two.

So from the Board's point of view, I think stepping back, looking at your goals on the implications of policy, whether or not you might have to accept that in the short run achieving the long term expected return objectives might be extremely difficult or impossible; but maintaining the current volatility level, whether that's better or whether you really want to tactically, in this period of time, think about making a shift to something that appears on the surface more risky, but to the extent interest rates are expected to rise in the future, the definition of risk matters a lot.

It might be the only thing that will pay off. And if the expectations are met, then in the long run you are better off. But it's that you, what you are comfortable with on the risk scale, short term versus long term, that I think should be important to guiding this decision. That's my two cents.

MR. BRIGHT: I'm the risk guy. So advocating more risk makes me uncomfortable in some ways, too. But the argument simply is that it's a luxury to feel comfortable and have reduced volatility and also expect to meet the bogey. I don't think both can happen.

MR. SCHLOSS: One of the keys is, it's a long term bogey, therefore it's an average bogey. Therefore, you can exceed it sometimes and underperform sometimes. And when you have the Fed with a ten year Treasury at 2 percent, put your risk premiums on, it's mathematically very hard for everything else to settle, as you correctly point out.

The real operational question is, all right, is the short term year or two years or ten years? If it's ten years, it's a problem. If it's two years, it is an aberration, you shouldn't worry about it.

If you look at what we've done, we have, because of new asset allocation, we pushed diversification as a way to ameliorate risk in things that have higher expected returns. So we've gotten a little bit off the tiger; but we've sort of got a tiger cub kind of thing.

So we have a little more high yield, a little more private equity; those are tiger cubbies.

And private equity is a real tiger in and of itself, levered equities. We've got this fixed income thing, all of which are trying to get you more return. And you put the gumbo together and you get more diversification out of it.

I think the part of the takeaway from what you are saying is, "Keep going."

MR. BRIGHT: Yes. At an accelerated pace, if I have my druthers.

MR. SCHLOSS: We're going as fast as we can.

(Laughter.)

With what we have for pools, inside the government.

Any more questions for John?

Thought provoking.

MS. MARCH: Thank you very, very much, John.

MR. SCHLOSS: That ends the public agenda for the pension funds.

Mr. Chairman?

CHAIRPERSON AARONSON: Thank you very much.

We'll move on to the public agenda for the Passport funds.

MR. LYON: I will start with the diversified equity Passport funds. It was sent around in advance and distributed today, as well. Through year end, we'll have more detailed review of year end at the next meeting. But the short version is here today.

The first page, you can see the allocation of assets from the diversified equity fund, $9.661 billion at the end of the year. All the major targets were inside rebalancing ranges relative to their targets.

And also, in the active management composite U.S. Equity we previously discussed, one manager was removed from the program, and that was completed during December.

If you skip ahead to page 3, you can see the performance information; all the numbers I will present are net of fees. And for the month of December this option was up in the 1.4 percent range. That compared favorably to the two benchmarks, the Russell 3000 and the hybrid benchmark.

For the one year period, this option was up 16.2 percent. And that was in between the two benchmarks; so somewhat favorable comparison, again, on a net of fees basis.

And for both the month and the year the exposure to non-U.S. Equities was particularly helpful to the return. And given that 2012 was a strong year for the equity markets in general, we still managed to exceed the -- diversified defensive strategy composite, but 11.7 percent. But nonetheless -- broader equity market is not as equity sensitive. That's intentional, for all elements downside protection over the long term.

MS. PELLISH: I want to call the Board's attention to another item within this report. For the year, Chris mentioned that it's been a while coming, but having the exposure was of significant benefit during 2012.

And also, the active domestic equity manager composite added almost 150 basis points during the course of the year. We will be back to the Board next month with some more ideas for enhancing this composite. So it's gratifying that all the work done on the active manager composite has paid off.

MR. LYON: Any questions?

The next handout is the Passport fund normally known as variable B, C, D and E, shorthand. And the bond fund shown on page 1 is the asset levels, almost $376 million at the end of the year. Performance for the option for the months was down 3 basis points. .03 percent, and the benchmark was flat.

The one year period returns from this conservative fixed income option was 2.2 percent, which is net of fees and within a handful of basis points of the benchmark.

If you flip to page 2, you can see the other remaining Passport fund options, international equity, inflation protection, socially responsive equity fund. And we had $79 million, $33 million and $39 in assets at year end respectively.

And you can see the performance starting with the international equity fund in the middle of the page, the bolded row, 2.74 percent return net of fees, a little bit behind the EAFE for the month. But for the one year period, within 5 basis points of EAFE 17.9 percent returns.

The inflation protection fund, 1.76 return for the month, more than 2 percent ahead of the benchmark. So it's good, but I'd like to regularly mention that the benchmark can't be expected to closely track, particularly over the short time period, but rather endeavors over the long hall.

You can see that for the one year period, not quite long haul, but nonetheless, that beat the benchmark by 10 percent, 15 percent return from this option, an option which is fairly fixed income heavy but not necessarily in traditional kind of Treasury type strategies. Of course, it invests in a whole mix of other strategies, as well.

Lastly, the socially responsive equity fund, point 9 percent return, right in line with the benchmark. And you can see the one year period, we discussed that this particular time period had some performance challenges in some concentrated actively managed portfolios. We expect that to be the case for certain points in time.

And so for the year this fund returned 10.5 percent, and although a reasonable absolute return, that was behind the 16 percent return of the benchmark.

Any questions on that?

And then lastly, we have a handout. We changed it a little bit from what you have seen in the past, besides it's slightly prettier. We changed the components, which is more important. And this is the preview of January's performance as brought to you by the benchmark and underlying mutual funds and the Passport options.

And what was different, to cover briefly now and you will see the next time you get the monthly report, the actual performance results, we previously discussed a change to the composite benchmark for the defensive strategy composite, where we moved, based on the targets, a blend of the underlying managers benchmarks, as we feel the for system the most appropriate way going forward is to benchmark this composite, a diverse mix of strategies. And so, as a cutover to that benchmark, at year end.

Of course, this is hot off the press. That row is blank, but the return we want to quote for the month was 3.96 percent, which differs from the strategies benchmark.

What you can see in general, as mentioned earlier, for equities all across the markets in the U.S. and internationally, 5 percent returns for the month. So a strong start for the calendar year. Fixed income has by these benchmarks been in very modest negative territory for the month.

Any questions?

I guess I'll point out some things. We talked about the 2012 performance. The underlying manager in the socially responsive fund gained almost 2 percent relative to the benchmark in January, which made up for a good portion of the underperformance from last year. We still have a way to go.

That's everything for the Passport funds for the public session.

CHAIRPERSON AARONSON: Thank you very much.

And now we need a motion to go into executive session.

MS. MARCH: I move that, pursuant to Public Officer Law 105, we go into executive session to discuss the proposed acquisitions, sales or exchange of securities held by the Teachers' Retirement System; and to discuss proposed pending or current litigation.

CHAIRPERSON AARONSON: Do I hear a second?

MR. SCHLOSS: Second.

CHAIRPERSON AARONSON: Any opposed?

Motion carries.

We are now in executive session.

(Whereupon, the meeting went into Executive Session.)

CHAIRPERSON AARONSON: That finishes our business in executive session.

Do I hear a motion?

MS. MARCH: I move that we go out of executive session.

CHAIRPERSON AARONSON: Second?

MS. ROMAIN: Second.

CHAIRPERSON AARONSON: All those in favor?

(A chorus of "Ayes.")

Anybody opposed?

We're now out of executive session.

Can Susan review what we did?

MS. STANG: In the executive session of the pension fund there was discussion of pension fund and variable fund investment in the industry sector.

There was a discussion of an increased commitment to an investment in the opportunistic fixed income space. Consensus was reached, which will be announced at the appropriate time.

There was also a presentation and discussion of two real estate investments. Consensus was reached, which will be announced at the appropriate time.

CHAIRPERSON AARONSON: Does that cover everything?

MS. ROMAIN: Motion to adjourn.

MR. SCHLOSS: Second.

CHAIRPERSON AARONSON: Anybody opposed?

We are adjourned. Thank you very much.

(Time noted: 1:13 p.m.)

C E R T I F I C A T I O N

I, Jeffrey Shapiro, a Shorthand Reporter and Notary Public, within and for the State of New York, do hereby certify that I reported the proceedings in the within-entitled matter, on Thursday, February 7, 2013, at the offices of the NYC TEACHERS' RETIREMENT SYSTEM, 55 Water Street, New York, New York, and that this is an accurate transcription of these proceedings.

IN WITNESS WHEREOF, I have hereunto set my hand this _____ day of _____________, 2013.

____

JEFFREY SHAPIRO