

0001

1 Proceedings

2

3

4

5 NEW YORK CITY TEACHERS' RETIREMENT SYSTEM
6 INVESTMENT MEETING

7

8

9 Held on Wednesday, April 13, 2016, at 55 Water
10 Street, New York, New York

11

12 ATTENDEES:

13 JOHN ADLER, Chairman, Trustee

14 SANDRA MARCH, Trustee

15 THOMAS BROWN, Trustee

16 MICHAEL HADDAD, Comptroller's Office

17 SUSANNAH VICKERS, Trustee, Comptroller's Office

18 CHARLOTTE BEYER, Trustee

19 DAVID KAZANSKY, Trustee

20 RAYMOND ORLANDO, Trustee

21 MELVYN AARONSON, Teachers' Retirement System

22

23 REPORTED BY:

24 YAFFA KAPLAN

25 JOB NO. 0235926

0002

1 Proceedings

2 ATTENDEES (Continued):

3 SUSAN STANG, Teachers' Retirement System

4 MICHAEL FULVIO, Rocaton

5 ROBIN PELLISH, Rocaton

6 DAVID LEVINE, Groom Law Group

7 DAVID OLSTEIN, Groom Law Group

8 PATRICIA REILLY, Teachers' Retirement System

9 VALERIE BUDZIK, Teachers' Retirement System

10 LIZ SANCHEZ, Teachers' Retirement System

11 SAM RUMLEY, Office of the Actuary

12 PAUL RAUCCI, Teachers' Retirement System

13 DEBORAH PENNY, United Federation of Teachers

14 ANTONIO RODRIGUEZ, Mayor's Office

15 ENEASZ KADZIELA, Bureau of Asset Management

16 TATIANA POHOTSKY, Bureau of Asset Management

17 MICHAEL FLAHERMAN

18

19

20

21

22

23

24

25

0003

1 Proceedings

2 MR. ADLER: Good morning. Welcome to
3 the investment meeting of the Teachers'
4 Retirement System of the City of New York for
5 April 13, 2016.
6 Pat, will you please call the roll?
7 MS. REILLY: John Adler?
8 MR. ADLER: Here.
9 MS. REILLY: Thomas Brown?
10 MR. BROWN: Here.
11 MS. REILLY: David Kazansky?
12 MR. KAZANSKY: Here.
13 MS. REILLY: Sandra March?
14 MS. MARCH: Present.
15 MS. REILLY: Charlotte Beyer?
16 MS. BEYER: Here.
17 MS. REILLY: Susannah Vickers?
18 MS. VICKERS: Here.
19 MS. REILLY: We do have a quorum.
20 MR. ADLER: Great, thank you.
21 So the first item on our agenda today is
22 a presentation by Michael Flaherman regarding
23 private equity fees. By way of introduction.
24 Mr. Flaherman is with the UC Berkeley,
25 University of California, Goldman School of
0004

1 Proceedings
2 Public Policy. He is a former trustee and
3 chair of the investment committee of CalPERS
4 and also a former employee of a private equity
5 firm and he can tell you a little bit more.
6 So, Mike, the floor is yours.
7 MR. FLAHERMAN: Thank you. It's a
8 pleasure being here today and this is a
9 presentation I have given many times, but I
10 have never given it to so august a body.
11 I am going to start with a disclaimer.
12 The most important thing in the disclaimer is
13 that UC Berkeley didn't approve what I said.
14 And, second, I am not saying that anyone has
15 violated any law or any contracts.
16 MR. ADLER: I think you should just
17 speak up so everybody --
18 MR. FLAHERMAN: UC Berkeley didn't
19 approve what I said and I am not saying
20 anybody violated any law or any contract.
21 A little bit about who I am. As John
22 said, I am currently a visiting scholar at the
23 UC Berkeley, Goldman School of Public Policy.
24 Before that I had a fellowship at Harvard.
25 And in both of those contexts I largely
0005

1 Proceedings
2 focused on bad practices in private equity.
3 Before that I worked for a private equity

4 firm. I worked at New Mountain Capital which
5 is based here in New York and to which this
6 pension system has allocated significant funds
7 of capital. Some of those fundraisings I was
8 actually involved in, so I thank you for that.
9 I was on the board of CalPERS from 1995 to
10 2003. I was an elected beneficiary member. I
11 represented everyone who worked in local
12 government in California on the board and I
13 had a chance to chair the investment committee
14 for the last three years that I was there.
15 And I started my work career working on the
16 development of Pier 11 as a ferry pier for the
17 City of New York actually as an urban fellow
18 in 1987, '88 and it thrills me whenever I come
19 back and see all the boats pulling out,
20 especially from this vantage.

21 So my main messages. First, the most
22 important thing that I want you to take away
23 today is that, in general, private equity
24 investors who are generally known as the LPs
25 are not getting the deal they think they

0006

1 Proceedings
2 negotiated. I call that the gap. And the
3 main source of that gap is the fees that
4 private equity firms charge to the portfolio
5 companies that the funds own. It's a lot of
6 money and I think that investors could do
7 better. I am going to take you through some
8 of the different evidence for the gap. We
9 know about it from SEC statements. We know
10 about it from Enforcement actions now, public
11 filings, et cetera, et cetera. I am going to
12 show you a lot of these things.

13 So to start with SEC statements: Many
14 of you may be aware that on May 6, 2014,
15 Andrew Bowden who was at that time the head of
16 examinations for the SEC made a speech which
17 was essentially a jaw-dropping speech. He is
18 the official who is in charge of going into
19 every investment advisor who is registered
20 with the SEC and verifying that they are
21 complying with the securities laws. And
22 private equity had been outside of the SEC's
23 mandate until the Dodd-Frank Act. The
24 Dodd-Frank Act brought private equity to
25 within the SEC's supervision and they started

0007

1 Proceedings
2 doing examinations in October, 2012.
3 So 18 months later, he got up in front
4 of an audience largely of private equity firms
5 and said I need to tell the world what we have

6 found and it's not good and he said a number
7 of things, right? He said when we look at the
8 private equity business, we see risks and
9 temptations that are not present in the more
10 common advisor model where the advisor buys
11 and sells shares of publicly-traded companies.
12 So he is saying the structure of private
13 equity lends itself to essentially gifting in
14 a way that buying and selling shares on the
15 stock market doesn't. So he goes on to
16 explain some of the ways that you can exploit
17 the fact that you own entire companies. So he
18 says the advisor can instruct the portfolio
19 company it controls to hire the advisor or an
20 affiliate, instruct the company to pay certain
21 of the advisor's bills, it can instruct the
22 company to add to its payroll all of the
23 advisor's employees who manage the investment.
24 So what all of those things have in common is
25 because the private equity firm on behalf of

0008

1 Proceedings

2 the fund owns an entire company, the private
3 equity firm effectively has access to the
4 treasury of every company that it owns, right?
5 And it can basically say give me a dollar,
6 right, whenever it wants a dollar and it can
7 dress it up however it wants? It can make up,
8 you know, flimsy or more flimsy or less flimsy
9 reasons why that dollar needs to be paid, but
10 that's a power that a private equity firm has
11 which other kinds of investment strategies
12 don't have.

13 Then another really important thing that
14 he said, that was he said finally and most
15 importantly we see that most limited
16 partnership agreements -- that's the contract
17 that you enter into when you sign up with a
18 private equity fund, most limited partner
19 agreements do not provide limited partners
20 with sufficient information rights to be able
21 to adequately monitor not only their
22 investments, but also the operations of the
23 their managers. This is something that the
24 SEC has reiterated on a number of occasions
25 since then, which is that they were really

0009

1 Proceedings

2 surprised to discover that the investors don't
3 actually have legal rights in the contract to
4 enough information to know whether the private
5 equity firm is actually complying with the
6 contracts, right? That's something that sort
7 of legal theory says is not supposed to

8 happen, right, because under the legal
9 doctrines that govern this there is this idea
10 that you and other pension funds and
11 institutional investors are sophisticated
12 investors. And what that means, there is a
13 phrase that's used in law which means that you
14 can fend for yourself. That means in theory
15 you don't require the SEC to come in and sort
16 of rescue you. You are supposed to be able to
17 negotiate contracts that give you all of the
18 rights that you need in terms of information
19 to be able to ensure that the contract is
20 being adhered to. But the SEC is actually
21 saying, well, now we discovered that's
22 actually not even true, right?

23 And then this was really the kicker in
24 his speech, which is that he says the most
25 common observation is the -- it relates to the

0010

1 Proceedings
2 collection of fees and expenses. When we have
3 examined how fees and expenses are handled by
4 advisors to private equity funds, we have
5 identified what we believe are violations of
6 law or material weaknesses in controls over 50
7 percent of the time. So that was really a
8 shock. It was a shock to the LP community; it
9 was a shock to the SEC. The SEC gave a lot of
10 commentary at the time that they had never
11 actually gone into a new area of the
12 investment business and found the level of
13 compliance to be so low. And one of other
14 things they actually commented privately to
15 many people about was that typically when they
16 go into a new area, they find the compliance
17 to be the worst at the smallest firms. The
18 most marginal players are the ones that have
19 the worst compliance, but they were very
20 surprised to find actually that a lot of the
21 worst compliance was with the biggest firms.

22 And I want to show you this, actually,
23 because this is sort of a recapitulation of a
24 lot of those same statements, but it's not
25 from the SEC. It's actually from The Carlyle

0011

1 Proceedings
2 Group 2015 annual report and I will help you
3 decode this a little bit. They are actually
4 explaining in the annual report that they are
5 under SEC investigation, right? And to help
6 kind of make it sound a little bit better they
7 say, well, to this end many firms have
8 received inquiries. And, by the way,
9 inquiries in SEC-filing speak, that means

10 investigation. Okay, so many firms have
11 received inquiries, which means under
12 investigation, directly from the SEC Division
13 of Enforcement regarding various
14 transparency-related topics including the
15 acceleration of monitoring fees, allocation of
16 broker-dealer expenses, disclosure of
17 operating partner or operating executive
18 compensation, outside business activities of
19 the firm, group purchasing, et cetera, et
20 cetera, et cetera. So you can see even the
21 private equity firms at this point are
22 actually saying, yes, this is a widespread
23 problem, many firms are under investigation.

24 I would like to talk just in general
25 terms for a moment about portfolio company

0012

1 Proceedings

2 fees and how they work. Right, so when a
3 private equity firm buys a company on behalf
4 of the fund that it's managing, it's very,
5 very common -- it's not universal, but it's
6 very common to require the company to execute
7 an agreement with the private equity firm
8 which says the private equity firm will be
9 paid certain sums of money for providing
10 certain services on an ongoing basis. And
11 there are different kind of fees that are
12 usually laid out. One is an investment
13 banking fee for advising the company on being
14 bought by the PE firm. So this is sort of the
15 going-in fee, so this can be a lot of money.
16 In a bigger deal you can see an \$80 million
17 fee that are sort of the going-in fee, then on
18 top of that an annual monitoring fee for the
19 private equity firm to supervise them. Again,
20 these are all fees being taken from the
21 portfolio company.

22 Now, for a big deal like I think for
23 example -- just to give you an example, TBG
24 owns J. Crew, the clothing. I think their
25 monitoring fee is 8 million a year. So that's

0013

1 Proceedings

2 a biggish fee because that's a biggish
3 company. It's an advisory fee whenever a
4 company issues securities or borrows money.
5 So that means if a company borrows half a
6 billion dollars, typically the private equity
7 firm says you owe us 1 percent fee so give us
8 \$5 million for that. Often it's what's known
9 as a success fee on exit, so that's when the
10 company is sold. And then there is the now
11 infamous termination of monitoring fee on

12 exit. So you may have heard of a termination
13 of monitoring fee. It's a really interesting
14 concept which is that these annual monitoring
15 fees typically -- typically the way the
16 agreement works is it says you are going to
17 pay us say \$5 million every year for the next
18 10 years, so it's a total of \$50 million if we
19 sell you after three years, right? So there
20 is seven years left on the meter, that \$35
21 million that we would have gotten if we owned
22 you all ten years, pay us that anyway. So you
23 are going to pay us that for the privilege of
24 essentially stopping the monitoring.

25 And one of the really interesting and
0014

1 Proceedings
2 troubling aspects is that if you look at the
3 actual fee agreements, they almost always say
4 that no work is required for the PE firms that
5 earn the fee. Now, that's problematic for a
6 lot of reasons. First, you are telling
7 investors you are charging the portfolio
8 company a fee for doing work for them for
9 adding value, but actually the agreement says
10 we don't have to do any work.

11 It's also very problematic in terms of
12 what you are telling the IRS because you are
13 telling the portfolio company is taking a tax
14 deduction for those fees and saying we are
15 paying for professional services, but if no
16 work is required then it starts to look a lot
17 like a dividend. A dividend is a payment to
18 owners and it's not tax deductible. So
19 investors traditionally have been very
20 skeptical of these fees and thought they were
21 essentially dividends and so the perspective
22 was why should the PE firm get the dividend
23 since we are the owner and so they came up
24 with this demand that the fees be rebated to
25 them. And for tax reasons, the PE firms came

0015

1 Proceedings
2 back to the LPs and investors and said we
3 can't give you the money directly, but what we
4 will do is we will credit the management fee
5 that you would have otherwise paid. So if you
6 are paying us 2 percent a year in management
7 fee, we will reduce that as a way of giving
8 you the benefits of these fees. And it has
9 evolved over time. At one point in time they
10 would give you the benefits of half the fees,
11 then it was 80 percent of the fees. Very
12 often today it's 100 percent of the fees, but
13 the biggest mistake you would make is to think

14 that 100 percent of the fees means you are
15 getting back 100 percent of the fees.
16 The rest of our presentation is about
17 how you are not getting 100 percent of the
18 fees of the offset. And critically for tax
19 reasons, there has to be uncertainty about
20 whether you will actually get the full benefit
21 of the fees because this sort of subterfuge of
22 actually not paying the fund directly but
23 instead giving this credit, we could can talk
24 about why, what the tax issue is, it kind of
25 takes a while. But in order to satisfy the

0016

1

Proceedings

2 IRS, there has to be uncertainty about it.
3 But the investors kind of lost track of that
4 over time that there had to be uncertainty
5 about it. So I don't want to really dwell on
6 this slide, but the main point of how the fee
7 offset works is that the amount that is earned
8 in fees from a portfolio company is
9 essentially a shifting of what you would have
10 paid in management fees out of pocket to
11 instead actually having the manager
12 compensated from the portfolio company for
13 that management fee. And what that has the
14 effect of is if you pay the fee out of pocket,
15 you would know how much you were paying,
16 right? But since the fee is instead being
17 collected from the portfolio companies, you
18 don't know what the fee, what's actually being
19 collected.

20 MS. VICKERS: May I ask a question just
21 on that point. With regard to the tax
22 applications for that, the tax benefit is
23 going to the management company because they
24 are not paying it as income like the
25 management fee? Is that --

0017

1

Proceedings

2 MR. FLAHERMAN: Well, the tax issue I
3 was referring to actually, which I presume
4 that you would take the position that your
5 retirement system is not subject to UBTI
6 or -- well, not subject to UBTI. For anyone
7 who is a UBTI investor, those fees are UBTI
8 income so that's why the fees can't be paid
9 directly to the investors. So it ends
10 up, that ends up driving the structuring of
11 private equity even though you happen to be
12 not affected by it. So many people are
13 affected by it, that it ends up driving how
14 private equity has evolved.

15 MS. VICKERS: But are there implications

16 for the income tax?
17 MS. MARCH: It's not your income tax.
18 MS. VICKERS: But for the management
19 company because if it was a management fee --
20 MR. FLAHERMAN: It would be ordinary
21 income to them.
22 MS. VICKERS: In either scenario it's
23 ordinary income?
24 MR. FLAHERMAN: Yes.
25 MS. VICKERS: Thank you.

0018

1 Proceedings

2 MR. FLAHERMAN: So if you look at the
3 partnership agreements, one of the big changes
4 in private equity actually in the last several
5 years is that every partnership agreement in
6 the world used to be under lock and key and
7 actually that's not true anymore. There are
8 actually a number of them in the public domain
9 which you can look at. So if you actually
10 look at the language in partnership
11 agreements, you can see actually these are the
12 portfolio company fees and it says the fees
13 shall be paid solely to the management company
14 and shall not be received by the partnership
15 and, similarly, the fees shall be paid
16 directly to the advisor. Again, this is being
17 done because if that money ever hit the fund,
18 it would have all these terrible tax
19 implications for UBTI investors.

20 And the problem though is that because
21 the money never goes to the fund, you have
22 audit rights over the fund. You do not have
23 audit rights over money that is paid to the PE
24 firm in general. And in fact historically if
25 LPs, the investors, asked a PE firm for a

0019

1 Proceedings

2 schedule of the portfolio company fees that
3 they were receiving, a very common answer was
4 really none of your business, that's our
5 business, that's a separate line of business
6 that's not really any of your business. And
7 you can see because of Dodd-Frank, private
8 equity firms started to have to make these
9 annual disclosures statements to the SEC
10 called Form ADV and this is a very helpful
11 statement that is fairly common.

12 This is from T. H. Lee, a pretty big
13 Boston private equity firm. So the advisor
14 determines the amount of these fees at its own
15 discretion, blah, blah, blah. So these are
16 the portfolio company fees and the amount of
17 such fees and reimbursements may

18 not -- except in connection with the
19 reductions described below, the reduction
20 described below is the management fee offset,
21 the credit in the management fee be disclosed
22 to investors and the clients. The clients are
23 the funds. So T.H. Lee is telling you, we are
24 not even telling you all of the fees. I mean,
25 they were very careful to go on record with

0020

1 Proceedings

2 the SEC about that. We don't even necessarily
3 tell our investors all of these.

4 MR. ADLER: So if the LPA provides for
5 100 percent of the fees to go
6 to --

7 MR. FLAHERMAN: It actually never
8 provides for that.

9 MR. ADLER: -- Warburg Pincus
10 supposedly --

11 MR. FLAHERMAN: Even -- let's go through
12 some examples. We will get right to that
13 right now.

14 So let's look at KKR. KKR is a terrific
15 example to study in this respect because KKR
16 is a publicly-traded company, number one, so
17 they are filing annual reports and quarterly
18 reports with the SEC.

19 But the second reason why they are
20 actually better than say Blackstone, which is
21 also a publicly-traded company, is KKR is
22 actually pretty transparent. And they
23 actually break out their fee income by
24 business segment, where Blackstone and Apollo
25 and others are mushing their real estate

0021

1 Proceedings

2 activities and private equity activities and
3 other activities all together. KKR shows just
4 the private equity unit by itself. So this is
5 their fee income, monitoring fees, and
6 transaction fees, and then these are the
7 management fee offsets. Now, there is a note
8 in every 10-K of KKR which is their funds all
9 have a 80 percent offset, 80 percent/80
10 percent. So in theory you would say that the
11 fee credits should equal 80 percent of the sum
12 of these two, but if you look over history as
13 recently as 2009 it was 34 percent. So the
14 nominal fee offset is 80 percent, but the
15 actual fee offset that year was 34 percent, 28
16 percent, 43 percent, and it's gone up a bit
17 over 50 at this point. But there is still a
18 very significant lag between the nominal and
19 the actual offset amount and you can see it

20 actually averages about \$90 million a year.
21 So that raises the question of where -- how
22 can we have an 80 percent offset in the LPA,
23 but in fact it's actually really only between
24 28 percent and 56 percent. That's sort of the
25 question and the concept that I really want to

0022

1 Proceedings

2 draw, introduce here is the idea that you
3 should think about the partnership offset
4 percentage as a nominal percentage and then
5 there is usually a much lower percentage which
6 is the effective percentage.

7 And one other example. So TPG case
8 study, this is a report that TPG gave out to
9 its investors for TPG VI for a particular
10 quarter and they showed that the transaction
11 fees that were subject to offset for this
12 particular quarter was \$6.0 million. Then
13 they had a 65 percent management offset which
14 resulted in 3.9 million deduction, so net 2.1.
15 Okay, so \$6 million they say was their fee
16 income. Now, I went through actually the
17 records of what did TPG VI own at this time
18 and this is a little bit approximate, but I
19 think it's pretty accurate. And these are all
20 the companies that were actually
21 publicly-traded somewhere in the world where I
22 could actually go into their filings and see
23 what did they pay TPG in that quarter.
24 So -- and then I adjusted for the number of
25 shares owned by the fund and I came up with

0023

1 Proceedings

2 \$5.8 million that these seven companies paid
3 in that quarter which I think is a coincidence
4 that it's so close to the \$6.0 shown here, but
5 where it gets really interesting is TPG owns
6 68 other companies at this time, right, the
7 vast majority of whom certainly one would
8 assume were paying some kind of monitoring fee
9 to TPG. So there can be a very
10 substantial -- here is another example of a
11 very substantial gulf between the nominal and
12 the actual -- and this is the rest of the list
13 of 68 other companies.

14 So let's talk about some of the ways
15 that you go from an 80 percent to 100 percent
16 nominal offset to a much lower effective
17 offset. So one of the details of every
18 partnership agreement which is the contract
19 that, you know, really sort of nobody was
20 paying attention to for decades was that
21 it -- that it always said that the offset was

22 applied to the fee income net of out-of-pocket
23 expenses. Now, I don't know if any of you
24 ever heard stories about Hollywood accounting.
25 In Hollywood, a movie can gross half a billion
0024

1 Proceedings
2 dollars and if you have an interest in the net
3 income of the movie, at the end they may tell
4 you it didn't actually earn any money, right,
5 because they apply all kinds of things against
6 the gross before getting to -- the goal is to
7 get to a net that's zero. And so there is a
8 little bit of that as well. In general, these
9 out-of-pocket expenses are not -- are not
10 disclosed actually in public company filings.
11 It's a kind of a hole in the SEC regulations
12 where they are actually excluded from having
13 to be disclosed, but a stock phrase that's
14 actually used in the disclosure statement of
15 the private equity firms is that the fees, the
16 out-of-pocket reimbursements, may be
17 substantial. So they are putting you on
18 notice that it can be a lot of money.

19 There are a few examples where it has
20 been disclosed even though it's not required
21 to be. This was Sabre Corporation which is a
22 TPG Silver Lake deal. Reimbursed expenses
23 were -- for these two years, 2013 and 2012,
24 were 2 million and 1 million respectively.
25 So, again, these were just the reimbursed
0025

1 Proceedings
2 expenses. This is another deal, Aurora
3 Capital, 2.9 million, .4 million and .2
4 million. So you can see, especially for these
5 big deals where you have 2 million and 1
6 million a year if you are Silver Lake and you
7 are getting a million dollars a year per
8 company in expense reimbursements, you have
9 the opportunity to put significant portions of
10 the total cost structure of your firm against
11 these reimbursements.

12 And one example which is -- you know,
13 it's kind of a fun example to talk about and
14 so that's part of why I talk about it, but
15 it's -- also a meaningful portion of this
16 expense reimbursement issue is private jets.
17 So Leonard Green which is a pretty significant
18 L.A.-based private equity firm, they -- in
19 their SEC disclosures they say that they may
20 be reimbursed for certain expenses such as
21 travel expenses incurred in connection with a
22 portfolio company by the portfolio companies.
23 So the portfolio company is going to pay them

24 for travelling to come see them, right? And
25 it turns out Leonard Green which -- has three
0026

1 Proceedings

2 jets actually registered in their name, right?
3 And it's interesting because if you look
4 at -- if you look at who Leonard Green is,
5 this is just their Who We Are web page, it's a
6 firm of only about 30 people and they have
7 three jets. If you look at -- Leonard Green
8 actually does not in their SEC ADV disclosure
9 statement say that they are charging private
10 jet travel to their portfolio companies. But
11 many, many private equity firms at this point
12 actually are very open about it, which is the
13 investors bear the cost of chartered aircraft
14 as an expense reimbursement. So you are
15 paying -- you are paying presumably very
16 substantial amounts every year.

17 MR. ADLER: Just so, you know, Leonard
18 Green just presented to us and they said that
19 they are not going to in the new fund.

20 MR. FLAHERMAN: Well, I have harassed
21 them substantially on this issue.

22 MS. MARCH: Keep harassing them.

23 MR. FLAHERMAN: I am thrilled to hear
24 that.

25 So co-investments. Right, so everybody
0027

1 Proceedings

2 loves co-investment because they sort of see
3 co-investments as free -- this is where in
4 addition to being an investor in the fund you
5 say, you know, I would love to have an
6 opportunity to put a hundred million dollars
7 into a particular deal and not have to pay a
8 management fee or carried interest on that
9 deal. It turns out actually a big part of the
10 reason why the private equity firms like
11 offering co-investments is they don't share
12 typically the fee income attributable to your
13 co-investment with you as the co-investor,
14 they keep that. Right, so if a private equity
15 firm buys a company for \$500 million of equity
16 and 300 million comes from the fund and 200
17 million comes from co-investors,
18 they will -- 60 percent of the fees will go
19 through the allocation process to be rebated
20 back to the investors in the fund. The other
21 40 percent of the fees that are attributable
22 to the co-investment capital, they will just
23 keep that. So that's I think a significant
24 misalignment of interests because that
25 incentivizes them to transact in order to get

0028

1 Proceedings

2 the benefit of the fees.

3 So another way that the offset amount is
4 substantially reduced is that there is this
5 concept in private equity known as a
6 management fee waiver. It's become very
7 controversial because the IRS is cracking down
8 on it. The idea here is that the private
9 equity firm says, you know, the investors are
10 going to owe us \$50 million in management fees
11 next year, don't pay us the 50 million, pay us
12 15 million and say the other 35 million, use
13 that money to make our capital contribution,
14 our -- the GP's capital contribution to buy
15 the companies that will be bought over the
16 next year. And what they then do is actually
17 they assert that when those companies are
18 sold, not only the gains in those companies
19 would then be taxed as capital gain which is
20 half the tax rate of ordinary income, but the
21 actual \$35 million that they declined to
22 receive from you and that you invested on
23 their behalf would be charged as a capital
24 gain as well. I actually always joke it's
25 like telling your boss don't give me a raise,

0029

1 Proceedings

2 buy me season's tickets to the Yankees
3 instead, and then telling the IRS that it
4 never happened because you never got the cash.
5 The IRS is in the process of issuing
6 regulations to effectively put that out of
7 business. But in the meantime the effect of
8 that, of that waiving activity, has had a
9 consequence that I think people didn't
10 generally appreciate which is if you reduce
11 the dollars that are labelled management fees
12 that are received by the private equity firm,
13 then you reduce the amount of management fees
14 that are available to be offset. And so a big
15 part of the name of the game for the private
16 equity firm is to find ways to strand offsets,
17 to create -- to create offsets where there
18 will never be a management fee for it to be
19 credited against. Right, so if you waive
20 management fees, you can strand offsets and
21 that can be a very significant driver.

22 Similarly, another way to strand offsets
23 is that suppose you sell a company in year 13
24 of a fund life and the fund is no longer
25 paying a management fee. Right, so in that

0030

1 Proceedings

2 situation if there is a termination of
3 monitoring fee or other exit fee at that time,
4 there will never be a management fee to credit
5 that against. Right, so that would be another
6 stranded fee. By the way, the stranded
7 fee -- just a small bit of good news to share
8 with you today. The stranded fee issue is a
9 much, much bigger issue for UBTI investors
10 than it is for you. And the reason is because
11 it's not uncommon for funds to actually say
12 have a provision that says at the end of the
13 fund life if there are stranded offsets, you
14 can get them in cash, you can get a rebate
15 back, just a check, right, which clearly runs
16 afoul of the UBTI issues. And -- but for
17 somebody like you to the extent that you are
18 solid on the position that you are not subject
19 to UBTI, you can just take the check. For
20 somebody like a university endowment, they are
21 really up the creek there because they can't
22 take the check, they have to decline the
23 check.

24 MR. ADLER: Mike, don't they -- and this
25 is probably irrelevant for this discussion,

0031

1 Proceedings

2 but don't they often use Cayman Islands
3 blockers in order to eliminate the UBTI issue
4 for UBTI investors? Like I used to be on the
5 board of a Taft-Hartley and there would be
6 Cayman Island blockers I was always told for
7 that purpose, so I was basically told don't
8 look askance at it.

9 MR. FLAHERMAN: Yes, that can help. But
10 it's not going to get you all the way there in
11 every situation.

12 I thought, actually, you were going to
13 raise another issue, which is -- and this is
14 very subtle but it's incredibly important,
15 which is that often it's not uncommon for a
16 fund when it's making an investment to set up
17 what's known as a parallel fund, which is a
18 side fund that exists only to hold that one
19 investment. And so if you read the provisions
20 of how parallel funds work very closely what
21 you realize actually is that if that
22 investment is sold cleanly in one day all at
23 once, that fund will go up in smoke at that
24 moment, the parallel fund. And so there are
25 actually management fees being allocated to

0032

1 Proceedings

2 that side fund, to the parallel fund and
3 so -- but they will never be -- you know, the

4 offset that's generated by the exit fee will
5 never have a chance to be applied to anything
6 because there are no more management fees.
7 That's I think one of the trickiest, in
8 a sense more subtle things that the SEC was
9 really alarmed about and was really a main
10 driver of why they were actually so concerned
11 about the termination of monitoring fee issue.
12 Because since the termination of monitoring
13 fee issue happens at the exit, it's the fee
14 that is most likely to end up stranded. And I
15 think what happened was the SEC looked at it
16 and said, well, from a technical
17 perspective in terms of clients with the LPA,
18 they didn't -- the private equity firms didn't
19 necessarily break the LPA. But they never
20 told the investors about the existence of the
21 termination of monitoring fee, so we will get
22 them. We are just not disclosing the
23 termination of monitoring fee. So, again,
24 there is also a provision in some LPAs that
25 basically says if there are excess offset at

0033

1 Proceedings
2 the -- of a fund life, even if you are not a
3 UBTI investor you can't get a check. Right,
4 and this is actually the language from Apollo
5 VIII where it actually says, "To the extent
6 that the excess of offsetable amounts exceeds
7 the amounts of management fees due for all
8 future periods, the final excess offsetable
9 amount upon liquidation of the
10 partnership, the final excess offsetable
11 amount shall be for the benefit of general
12 partner and its affiliates." So you can see
13 this is all one gigantic sentence. For those
14 of you who are teachers, it offends every rule
15 of construction.

16 The one thing is, how did this happen
17 over a period? These are agreements. I mean,
18 it's fair to say these are agreements that are
19 not meant to be understood, they are not. So
20 if you ever looked at one and said I didn't
21 really know what it meant, don't feel badly.
22 So there are also all kinds of carve-outs from
23 the offset that are either in the LPA that
24 says if we get a fee for this, it doesn't
25 count, we don't have to share it with you and

0034

1 Proceedings
2 then there are also all kinds of carve-outs
3 from the offset where the private equity firms
4 just decided they were carving it out from the
5 offset, but they didn't tell you it's not in

6 the LPA. And some of them are going to have
7 Enforcement action taken against them for
8 that. So the carve-outs that are clearly
9 allowed in various agreements is if you have a
10 broker/dealer. Right, so Blackstone has a
11 broker/dealer. Blackstone can assign any
12 portfolio company to do business with its
13 broker/dealer when they are doing securities
14 transaction and to pay their broker/dealer a
15 fee for it, but it's in the LPA you don't get
16 that fee. That raises an interesting question
17 because it says you do get the, quote/unquote,
18 investment banking fees, but what's the
19 difference between that fee and the investment
20 banking fee? It's really kind of curious, but
21 it's in the LPA.

22 And then we will talk about these other
23 things, senior advisor, internal purchasing
24 advisors. So what is a senior advisor? So
25 many, many private equity firms have different

0035

1 Proceedings

2 kind of categories of people who are part of
3 the team. Right, so the senior people usually
4 have a title like managing director and then
5 you have the more junior people, but then you
6 also have these people with the title senior
7 advisor. Usually those tend to be older, they
8 are almost all men.

9 MS. MARCH: Don't leave out white.

10 MR. FLAHERMAN: They are almost all
11 white men who worked not in finance their
12 whole career, but very often worked in
13 industry. So they are there to help the
14 private equity firm deal with the portfolio
15 companies.

16 And where you get into trouble is that
17 many private equity funds when they are
18 selling the fund they say, yes, the reason why
19 we need this management fee is that this is
20 the roster of people who it supports, right,
21 including the senior advisors. Right, but
22 then once the fund closed they went to the
23 portfolio companies and said, you know, Joe
24 over here, he is an expert in IT, we would
25 like you to hire Joe, Joe our senior advisor

0036

1 Proceedings

2 and -- you know, because he is just somebody
3 we know who is good at IT. And so Joe's
4 compensation -- Joe is not being paid by the
5 private equity firm. He is not being paid by
6 the management fee that you are paying. You
7 know, that management fee which you thought

8 was being divided among many other people is
9 actually being divided among a much smaller
10 number of people because the portfolio
11 companies are paying Joe. And of course it
12 goes without saying to the extent that the
13 portfolio companies are paying Joe, really you
14 are paying Joe again? You are paying him.
15 You thought you were paying him with the
16 management fee, but then you are actually
17 paying him out of the portfolio company
18 treasury. Really what this hangs on, to a
19 large extent, is almost all LPAs say any
20 payment to affiliates of private equity firm
21 are subject to this management fee offset. So
22 the question becomes, does it really fly to
23 claim these people are not affiliates?
24 So give one example -- actually, this is
25 the KKR example. So KKR in their 2006 fund,

0037

1 Proceedings
2 they define what an affiliate is and it's kind
3 of a standard corporate law definition which
4 is an entity that control or is controlled or
5 is under common control with KKR. And then
6 they define what a monitoring fee is because a
7 monitoring fee is what's subject to sharing
8 and it's a payment for consulting services
9 rendered by the any KKR affiliate. So if you
10 are a KKR affiliate and you render consulting
11 services, it's a monitoring fee. So in KKR's
12 2011 10-K, their annual report, KKR has a
13 consulting entity. If you go on their
14 website, it's on the KKR website called KKR
15 Capstone. And KKR has disclosed that the
16 employees of KKR Capstone share office space
17 with KKR, they are in the KKR 401(k) plan,
18 they get carried interest in KKR deals, and
19 even in 2011 they listed Capstone consulting
20 as a subsidiary of KKR, okay? They later
21 decide that was a mistake. They told the SEC
22 that was a mistake. It was an error and by
23 being -- the reason why it had to be a mistake
24 is because a subsidiary is an affiliate. So
25 by definition, you know, that's the legal

0038

1 Proceedings
2 definition.
3 So these are the kinds of things that
4 are going on on a very widespread basis. The
5 SEC, actually my understanding, has actually
6 passed on this as an issue and I think
7 actually the reason why they passed on it was
8 because -- not because they thought that KKR
9 had a winning argument, but because they

10 thought the LPs are sophisticated and can fend
11 for themselves. So many, many private equity
12 firms use this "disclosure" phrase, which is
13 that they deem their senior advisors
14 independent. "Deem" in my opinion is a code
15 word actually which is that when you actually
16 have contractual authority for something in
17 your disclosure statement, you always say
18 pursuant to the contract they are independent.
19 When you don't have contractual authority, you
20 just deem something. And of course we don't
21 actually know because we don't have the
22 contract, but that's my conjecture. So I just
23 want to be clear that it is a conjecture, but
24 the point is all these people say that the
25 senior advisor payments to the senior advisors
0039

1 Proceedings
2 are not subject to offset.
3 This is actually a page from the website
4 of Silver Lake which is a pretty large private
5 equity firm as it existed in February, 2012
6 and you can see they had all of their
7 employees listed and they had the senior
8 advisors just mixed in with everybody else in
9 a way that certainly gave you the impression
10 that they worked for Silver Lake. Right, but
11 once the SEC started clearing its throat on
12 this issue, then suddenly they were segregated
13 and there was this important footnote, you
14 know, not employees, not members or personnel
15 or affiliates of Silver Lake. Right,
16 so -- but it sure looked like for a long time
17 they were saying that they were.
18 This is actually a deficiency letter.
19 This is what the SEC sends out after they have
20 done an audit on a private equity firm where
21 they want to tell you what they think you have
22 done wrong. It's to Freeman Spogli which is
23 an L.A.- based private equity firm. So what
24 the SEC is alarmed over here is the
25 registrant, which is Freeman Spogli has a team
0040

1 Proceedings
2 of affiliated executives. Guess what, seems
3 to be a poor choice of words in their title.
4 So it appears that Freeman Spogli took the
5 position with the SEC that the affiliated
6 executives were unaffiliated. And the SEC is,
7 if you read the full text of this, basically
8 saying we don't buy it and you should refund
9 all the money that those people have that you
10 should have offset.
11 So third-party fees. This is one of my

12 favorite topics because I think it's so
13 indefensible. So there is this entity called
14 CoreTrust which is actually a division of
15 another company called HealthTrust, which is
16 actually a division of HCA which is a big
17 hospital management company based in
18 Tennessee. And so CoreTrust is a middleman in
19 the procurement world. So what they do is if
20 you join CoreTrust, what they can do is they
21 can get you better prices on all the standard
22 things that a business has to buy, whether
23 it's pencils, copy machines, a FedEx contract.
24 And that they do it by -- since they have
25 thousands of businesses or at least many, many
0041

1 Proceedings
2 businesses who joined them, they have enormous
3 purchasing power. CoreTrust focuses, though,
4 on the portfolio companies of private equity
5 firms. And this is actually not my slide;
6 this is actually a marketing slide from
7 CoreTrust that actually shows various private
8 equity firms and when they joined. And the
9 reason why it's so troubling is because it
10 turns out that at least some private equity
11 firms -- now some private equity firms deny
12 this is true in their case, but it appears
13 that this is true in many private equity
14 firms -- get a kickback for referring their
15 portfolio companies to CoreTrust.
16 So Blackstone -- in consideration for
17 Blackstone facilitating our participation in
18 CoreTrust purchasing group and monitoring the
19 services that CoreTrust purchasing group
20 provides to us, CoreTrust purchasing group
21 remits a portion of the commissions received
22 from vendors in respect of our purchasers
23 under the participation agreement to an
24 affiliate of Blackstone. So the way CoreTrust
25 makes money is they charge kind of an
0042

1 Proceedings
2 administrative fee on -- of what they buy you.
3 And in theory it's still supposed to end up
4 cheaper than if you bought it on your own, but
5 it turns out actually that Blackstone gets
6 part of that fee and they don't share that
7 with you. I mean, they are quite clear about
8 that, they don't share. And I also want to be
9 clear in the case of Blackstone, Blackstone is
10 to my awareness the only private equity firm
11 that has explicit -- well, I shouldn't say
12 that, has a plausible argument for the way the
13 LPA is written allowing them to not sharing

14 the fee. And this is actually another
15 agreement where you can see that actually the
16 fee can be 50 percent, it can be 60 percent of
17 the fee. So a large portion of the fee goes
18 to Blackstone.

19 These annual disclosure statements that
20 private equity firms have to file with the
21 SEC, the deadline for that was March 30th. So
22 I have been spending a lot of time in the last
23 week reading everyone's update and a very,
24 very large portion of private equity firms
25 actually are making disclosures about

0043

1 Proceedings

2 receiving fees for purchasing activities at
3 this point, so it's definitely something
4 that's worth asking anybody who you are
5 contemplating doing business with.

6 Similarly another form of vendor
7 discount actually or vendor kickback is law
8 firm discounts. You may have heard this
9 because Blackstone just had an SEC Enforcement
10 action taken against it. This is actually an
11 a disclosure by Apollo. I love their phrase,
12 which is they first say that Apollo gets a
13 discount, but then they say legal services
14 rendered for investment transactions, that's
15 what you pay, however are typically charged to
16 the Apollo private equity managers, their
17 affiliates, and clients against on -- that's
18 you, on a full freight basis or at a premium.
19 I just love the "full freight." I didn't know
20 that was a legal term of art. Apollo has
21 actually disclosed that they are under SEC
22 investigation for this exact issue, so
23 probably there will be an Enforcement action
24 on this against Apollo as well.

25 So some conclusions. This is a lot of

0044

1 Proceedings

2 money, that's my first conclusion. It's not
3 an around-the-edges issue. It really is a lot
4 of money. And the reason why it matters in my
5 opinion is that it really goes to the core of
6 the whole alignment of interests issue. If
7 there are a thousand ways to collect a fee
8 from the portfolio companies that are
9 unrelated to the performance, if your whole
10 lifestyle in terms of a private jet can be put
11 on to the portfolio companies and it's not
12 dependent on performance, then how motivated
13 is a manager to perform? I mean, that's how I
14 would frame it.

15 And my next point is that the existing

16 process that I think almost all investors have
17 in terms of trying to look for tricky issues
18 is really a legal review process and I don't
19 think it really is set up to catch these kind
20 of issues. And the reason is because the
21 lawyers don't -- it's not their job and they
22 don't consider it their job to understand how
23 private equity works in the real world. I
24 mean, they really are looking at a document
25 kind of within the four corners of the

0045

1 Proceedings

2 document. Right, and it really doesn't answer
3 questions about, well, whose job is it to look
4 at that?

5 MS. PELLISH: So has any of this been
6 addressed by any of the ILPA discussions?

7 MR. FLAHERMAN: So ILPA released early
8 this year a fee template which is intended
9 actually, if someone fills it out correctly,
10 to capture from a disclosure perspective all
11 of this stuff. And I am certainly very glad
12 that they did it. They were kind of slow to
13 the party. I think it was only when it really
14 hit the press that they started to have to
15 scramble. But then I think the main reason
16 why I would just caution you to not rest on
17 that is that there have been conferences of
18 private equity CFOs that occurred since the
19 ILPA template was released and the -- sort of
20 the main commentary that you heard at
21 conference like that is sort of an intention
22 of massive resistance to the ILPA template.
23 And that's very plausible even just looking
24 at -- for example, ILPA has this just very
25 generic statement of principles that it

0046

1 Proceedings

2 promulgated in 2008 which it has asked private
3 equity firms to endorse. And as of today,
4 only something like thirty of the hundred
5 largest private equity even endorsed that
6 very, very vague set of principles. So the
7 adherence to ILPA's promulgation hasn't been
8 that high, unfortunately.

9 MS. PELLISH: And you think that's
10 because the large LPs haven't forced the issue
11 or why do you think? Is there any leverage?

12 MR. FLAHERMAN: I think that really is,
13 in a nutshell, is that I think LPs view it as
14 sort of a form of the prisoner's dilemma which
15 is if you can act in concert you can all be
16 better off, but if you act individually the
17 perception is you will be worse off because

18 you will be punished by the private equity
19 firms. My personal perspective, I think there
20 is a lot of misperception in that in the sense
21 that I think people way overestimate the cost
22 of acting and way underestimate the benefit.
23 And like people say well, you know, private
24 equity firms won't want to do business with us
25 anymore, but my thought is the first ones who
0047

1 Proceedings

2 will head for the door will be the ones who
3 are cheating. And so I think I feel like it's
4 almost a sort of separate conversation about
5 what is to be done.

6 I have a lot of ideas about what is to
7 be done and my hour is almost up. And I
8 just -- some other points that I think are
9 important.

10 From a fiduciary perspective -- I mean,
11 this is the question that I really like to
12 raise with people who are fiduciaries, how
13 does -- how does one become comfortable
14 investing in products where the investment
15 managers are telling you they are not going to
16 disclose all the fees to you? Under
17 California law the fiduciary standard says
18 that CalPERS and CalSTRS and the other
19 retirement systems can only defer reasonable
20 expenses of the retirement system, so
21 how -- the question I have for them, how do
22 you know the expenses are reasonable if you
23 don't even know what they are? And there is a
24 related fiduciary issue, right, which is the
25 private equity firms in the contracts also are
0048

1 Proceedings

2 disclaiming elements of fiduciary duty that
3 you are trying to impose on them. So they are
4 not full fiduciaries to you either.

5 Right, so they are real -- I
6 think -- and an observation with that also is
7 that when I first went on the board of CalPERS
8 in 1995, I remember I would go to the CII and
9 I would meet a lot of people who still didn't
10 invest in private equity at that point. And I
11 remember talking to various kind of old-time
12 lawyers who represented public pension funds
13 at that point who would use the phrase that
14 they, quote, couldn't get comfortable with
15 private equity. And at the time I didn't
16 really understand what they were talking
17 about, but I realize now this is what they
18 were talking about. They saw these problems.
19 How can you advise a fiduciary to invest in

20 something where they are not told all the
21 fees, how can you advise a fiduciary to invest
22 in something where the manager is not a
23 fiduciary to you? But what happened was that
24 the party got going so strong, that those sort
25 of old-time lawyers just got run over. And

0049

1 Proceedings

2 everybody got a new lawyer who, quote, could
3 get comfortable with private equity.

4 And then, you know, my last two points.

5 Again, don't count on the SEC. The SEC
6 is not going to be your savior and they are
7 really trying to make that very clear. They
8 consider you sophisticated. They consider you
9 able to, quote, fend for yourself. Right, and
10 fend for yourself means something specific,
11 right, in securities law. That means sue
12 people who are stealing from you. Right, the
13 SEC assumes that you would take legal action
14 to enforce your contracts.

15 Right, and my -- and the ultimate
16 question that I like to leave people with,
17 which is that: It seems to me having had many
18 conversations with many private equity LPs
19 like yourselves at this point, that there is a
20 basically a pervasive perspective that it's
21 effectively impossible to sue private equity
22 firms because, you know, you will be punished
23 and won't get, quote, into the good deals if
24 you do that. So what does it mean for a whole
25 asset class if you -- if you are willing to

0050

1 Proceedings

2 acknowledge what I think you know is true in
3 many cases, which is that there is this whole
4 category of managers who are effectively
5 legally untouchable, right? I -- you know,
6 our -- if they are going to be legally
7 untouchable, I think investors should at least
8 be honest in their own hearts about that fact
9 and make decisions based on that. Or you
10 should actually say, you know something, we
11 don't think they are legally untouchable, not
12 that you should go sue somebody now but you
13 should have a posture if something comes to
14 your attention you would be willing to.

15 So those are my observations. I would
16 love to talk to you about if I were you what I
17 would think about doing next, but that's sort
18 of another hour.

19 MR. ADLER: So what's the pleasure of
20 the board, do we want to continue this
21 conversation for a little while?

22 MR. KAZANSKY: I definitely want
23 something maybe in executive session.
24 MS. MARCH: You are welcome to stay.
25 MR. ADLER: So should we go through our

0051

1 Proceedings
2 public agenda and then Michael can stay for a
3 little while?
4 I ask you to stay for executive session.
5 MR. FLAHERMAN: I am free until 2:00.
6 MR. ADLER: So thank you very much. You
7 can stay because it's public. You can take a
8 seat.
9 So I think we then move to the Passport
10 Funds report. Rocaton.
11 MR. FULVIO: Good morning, everyone.
12 MS. MARCH: Good morning.
13 MR. FULVIO: So I will begin with just a
14 quick recap.
15 You might recall January was a
16 particularly weak month for equity markets in
17 the U.S. By comparison February we saw not
18 necessarily a recovery, but markets were flat.
19 I will make comments later about March, but
20 since then March was a pretty strong month.
21 We have seen the year-to-date numbers turn
22 positive, but you won't see that in the
23 February report today. The Diversified Equity
24 Fund at the end of February had about \$9.6
25 billion in assets. As I mentioned, the

0052

1 Proceedings
2 Russell 3000 was flat about negative 3 basis
3 points and the Diversified Equity Fund as a
4 whole was returned to negative 4 basis points.
5 During that time period the hybrid benchmark
6 was down about 20 basis points, so contributed
7 to the performance during February and thus
8 far year to date. So we saw more negative
9 performance by international equity markets
10 relative to the U.S. during February and so
11 that did on the margin detract from the
12 yearend performance.
13 That's the chime to turn the page. We
14 did see a little bit of modest outperformance
15 by active management, so that did contribute
16 to the overall relative performance. We did
17 see some outperformance on an absolute basis
18 by the defensive strategies composite, even
19 though equity markets were modestly negative.
20 So all told year to date, the fund through
21 February is down about 5.6 percent, basically
22 in line with the hybrid benchmark and the
23 Russell 3000 Index. The bond fund during

24 February returned positive 20 basis points
25 bringing the year to date for that fund to
0053

1 Proceedings
2 positive 1 percent, also in line with its
3 benchmark. I mentioned some positive relative
4 performance thus far for the international
5 equity composite. That's the same as well for
6 the International Equity Fund, which is about
7 a hundred million dollars in assets was down
8 about 1 percent. Like I said, slightly ahead
9 of the international composite benchmark. The
10 Inflation Protection Fund during the month of
11 February returned about negative 25 basis
12 points, right between its custom benchmark and
13 CPI. Year to date, that fund is down 1.3
14 percent. And the Socially Responsive Fund,
15 which has about \$113 million in assets,
16 outperformed the S&P 500 with a return of 80
17 basis points versus negative 13 basis points
18 for the S&P. So year to date there the fund
19 is still trailing, but we saw a modestly
20 positive relative results again in March for
21 that fund. The next -- are there any
22 questions on the Passport Funds?

23 I started alluding to the March
24 performance and the next handout provides some
25 information on that. You can see the U.S.
0054

1 Proceedings
2 equity market in March was up about 7 percent.
3 That brought the calendar year-to-date return
4 to positive territory to the tune of about 1
5 percent. It's international composite
6 benchmark, which again now includes not only
7 developed markets but also emerging markets,
8 returned positive 8 percent during March. The
9 year-to-date return, there was negative 33
10 basis points. The defensive strategies
11 benchmark was up about 5.25 percent for the
12 month and year to date. That brought the
13 return to also about positive 1 percent, so
14 keeping pace with the Russell 3 for the first
15 three months of this year. And the
16 Diversified Equity Fund's hybrid benchmark
17 also all told was up about 7 percent, bringing
18 the year-to-date return there to -- calendar
19 year to date that is, to positive 80 basis
20 points. I did make a comment earlier, you can
21 see towards the middle of the page the
22 developed non-U.S. equity markets, the EAFE
23 Index positive by about 6.6 percent in March.
24 The custom Emerging Market index was up about
25 32.6 percent. And then below that the

0055

1 Proceedings
2 strategies that underlie the Inflation
3 Protection Fund, that was positive by about
4 3.8 percent, outperforming both proxies below
5 that. And the underlying strategy for the
6 Socially Responsive Fund was a positive return
7 of 6.58 percent, modestly ahead of the S&P.
8 Are there any questions on the markets
9 or the funds?

10 MR. ADLER: Thank you, Michael.

11 MR. FULVIO: That concluded the Passport
12 Funds.

13 MR. ADLER: So I think the next item on
14 the agenda is verbal update from Rocaton on
15 the asset allocation study for the QPP.

16 MS. PELLISH: Right. So -- well, I
17 think what this item was intended to focus on
18 was followup to the discussion at the last
19 investment meeting where we mentioned that
20 we -- Scott mentioned that there was going to
21 be a discussion about use of long bonds and
22 the trustees had been invited, but they
23 weren't able to attend. There was a request
24 that we update this board on any results or
25 conclusions drawn from that discussion. So

0056

1 Proceedings
2 that discussion took place a couple of weeks
3 ago. It was really focused on the use of core
4 plus 5 bonds within the pension fund versus
5 the use of long government bonds. And, as you
6 know, we have been proponents of the board
7 considering the allocation to long government
8 bonds as a diversifier and also as a source of
9 downside protection when equity markets are
10 particularly negative.

11 And so that was the focus of the
12 discussion and I don't know if you would like
13 to comment on conclusions from the
14 comptroller's office, if any.

15 MR. HADDAD: Thanks.

16 I think the meeting was fantastic.
17 Every consultant was invited, the board
18 members were invited. And, as Robin said,
19 Rocaton has one point of view on extreme and
20 Cowan has a different view, kind of teed them
21 up to address one another. They both prepared
22 a multipage paper in advance of it and I
23 thought that the debate between the two of
24 them that everyone joined in was excellent.

25 To summarize, what's happening in our

0057

1 Proceedings

2 group is I don't think we have come to a
3 conclusion. I don't think there is a right
4 answer. I think there is three variables that
5 drive the decision or drive the input and that
6 is projected, so these are projected rates of
7 return, risk measures, and most importantly
8 correlation. And the difference, when you
9 tease out what Rocaton has versus what Cowan,
10 is the correlation of long duration fixed
11 income to the equity market. I think your
12 guys' correlation is a minus .4 or .34.

13 MS. PELLISH: Yes, so we -- yes, and
14 that leads to a much larger digression. But
15 yes, so our view, our model doesn't say that
16 long bonds are always negatively correlated to
17 equity markets because they are not. What our
18 model includes is this tendency for long bonds
19 to perform well when equity -- most notably
20 when equity markets perform significantly
21 negatively and so that drives how the
22 correlation. It's sort of the output of
23 various factor correlations. But, anyway, so
24 our view and our model's recognition is that
25 tends to happen frequently -- not always, but

0058

1 Proceedings
2 frequently over time lead to our support of
3 the long bonds.
4 MR. HADDAD: I think the opposing view
5 was centered on a few different things: The
6 importance of quantitative easing on that
7 relationship over the past few years. The
8 relative what's called valuation of long
9 duration treasuries at this point in time.
10 And if you move more of your assets into long
11 duration treasuries, you are reducing your
12 investments into higher-yielding bond and you
13 are losing current income. And that was kind
14 of the crux of the argument. I think both
15 arguments carry a lot of weight and I don't
16 think a conclusion can be drawn. Again it's
17 all based on at least ten-year projections for
18 which are projections, not something I think
19 anyone has a lot of confidence in.

20 MS. MARCH: So would you say since we
21 have individual consultants, the boards can
22 make individual decisions?

23 MR. HADDAD: 100 percent.

24 MS. MARCH: Good.

25 MR. ADLER: Charlotte?

0059

1 Proceedings
2 MS. BEYER: I just want to share two
3 take-aways I took from that meeting that are

4 in layman's language for me.

5 First was that so often fixed income is
6 thought of as insurance against downdrafts
7 and, actually, this was a different argument
8 that Rocaton was making.

9 The second take-away was not to confuse
10 the implementation and the timing of the asset
11 allocation, but view it as a strategic asset
12 allocation decision that then has to be spoken
13 through to figure out the timing and
14 implementation.

15 And, lastly, what was most appealing to
16 me was by slowly cutting the fixed income
17 allocation, it's currently at 18 percent,
18 conceivably we can cut that back in half over
19 time so that we have extra capital to deploy
20 to perhaps higher-returning assets.

21 So those were the compelling take-aways
22 that I heard. But I thought the big one was
23 that we are not talking about doing this right
24 away, but it's a strategic allocation decision
25 that certainly the data seemed pretty

0060

1 Proceedings

2 compelling.

3 MR. ADLER: I would just like to follow
4 up as well. You know, one of the points which
5 Charlotte mentioned was this notion that with
6 long duration bonds, you get more bang for the
7 buck, right, that's the term you used?

8 MS. PELLISH: Yes, it's a very technical
9 term.

10 MR. ADLER: More protection for equity
11 volatility. And so what I am interested in
12 is -- because, you know, the scenarios that
13 you have given us so far don't reflect that;
14 they reflect essentially a flat allocation to
15 fixed income. And so I would be interested to
16 see if in fact you think that we can get more,
17 you know, protection per dollar invested in
18 long duration bonds, what an asset allocation
19 would look like with that principle. And you
20 know, I think it's agreed that in fact given
21 the consultant's different points of view,
22 that the asset allocations are likely to look
23 very different across the multiple New York
24 City funds. So I feel like it's time to, you
25 know, get to the point where we are ready to

0061

1 Proceedings

2 look at some real proposals and make a
3 decision about, you know, where we want to go
4 with our assets allocation.

5 MS. PELLISH: Thank you. We will follow

6 up on that.

7 MR. ADLER: Any other comments or
8 questions for Robin?

9 Okay, that does it for your guys'
10 presentation?

11 MS. PELLISH: Yes.

12 MR. ADLER: Okay. So if I am not
13 mistaken, that concludes our public agenda for
14 today. So I think we can use a motion to go
15 into executive session.

16 MR. FLAHERMAN: Just before you do, I'm
17 sorry, I apologize, I was just reflecting on
18 some of the things I said and I think you can
19 appreciate my caution here. I would just like
20 to say something for the record here.

21 I spoke about KKR and this KKR Capstone
22 thing and I said that I believed that the SEC
23 just passed on Enforcement action on it not
24 because it was lacking in merit. And I just
25 want to say I actually don't know why the SEC

0062

1 Proceedings

2 passed on it and I just want that to be in on
3 the record.

4 MR. ADLER: Sure.

5 MS. MARCH: I would like us to go into
6 executive session for the purposes of
7 discussing personnel matters and so I believe
8 that's not the same as going into executive
9 session for the purpose of discussing
10 investors.

11 MR. ADLER: Can't we do it all together?

12 MS. BUDZIK: We can do it all together.

13 MS. MARCH: Okay.

14 MR. ADLER: In executive session we can
15 distinguish, right?

16 MS. BUDZIK: Right.

17 MR. ADLER: Can you make a motion?

18 MS. MARCH: Yes, I urge that we go into
19 executive session under Public Officer Law 105
20 for the purpose of discussing sales and
21 securities.

22 MR. ADLER: And you can say and
23 personnel issues.

24 MS. MARCH: And personnel issues.

25 MR. ADLER: Perfect.

0063

1 Proceedings

2 Is there a second?

3 MR. KAZANSKY: Second.

4 MR. ADLER: So motion is made and
5 seconded. Any discussion?

6 Okay, all in favor of the motion, please
7 say aye. Aye.

8 MR. BROWN: Aye.
9 MR. KAZANSKY: Aye.
10 MS. MARCH: Aye.
11 MS. BEYER: Aye.
12 MS. VICKERS: Aye.
13 MR. ORLANDO: Aye.
14 MR. ADLER: All opposed, nay? Any
15 abstentions? Okay, motion carries.
16 (Whereupon, they went into Executive Session.)
17 MR. ADLER: Okay, we are back in public session.
18 Susan?
19 MS. STANG: In executive session one
20 manager update was presented, an update to a
21 presentation on emerging markets manager was
22 received and discussed, consensus was reached
23 which will be announced at the appropriate
24 time, an investment personnel matter was
25 discussed.
0064
1 MR. ADLER: Very good, thank you.
2 So I think we are ready to adjourn the
3 meeting. Is there a motion to adjourn?
4 MS. MARCH: So moved.
5 MR. ADLER: Is there a second?
6 MS. VICKERS: Seconded.
7 MR. ADLER: Motion made and seconded.
8 All in favor of the motion to adjourn, please
9 say aye. Aye.
10 MR. BROWN: Aye.
11 MR. KAZANSKY: Aye.
12 MS. MARCH: Aye.
13 MS. VICKERS: Aye.
14 MR. ORLANDO: Aye.
15 MR. ADLER: Abstentions?
16 The meeting is adjourned. Thank you
17 Proceedings
18 very much.
19 [Time noted: 12:11 p.m.]
20
21
22
23
24
25

0065

1 Proceedings
2 C E R T I F I C A T E
3 STATE OF NEW YORK)
4 : ss.
5 COUNTY OF QUEENS)
6
7 I, YAFFA KAPLAN, a Notary Public
8 within and for the State of New York, do
9 hereby certify that the foregoing record of

10 proceedings is a full and correct
11 transcript of the stenographic notes taken
12 by me therein.

13 IN WITNESS WHEREOF, I have hereunto
14 set my hand this 26th day of April, 2016.

15
16
17
18

YAFFA KAPLAN
19
20
21
22
23
24
25