CITY OF PONTIAC, MICHIGAN
POLICE AND FIRE RETIREMENT MINUTES
SPECIAL MEETING
May 24, 2006

A Special meeting of the Board of Trustees was held on Wednesday, May 24, 2006 at Soaring Eagle Hotel, Mt. Pleasant, Michigan. The meeting was called to order at 11:05 a.m.

TRUSTEE PRESENT

Craig Storum, Chairman
Ray Cochran, Secretary
Brian Lee

TRUSTEES ABSENT

Mayor Clarence Phillips
Tom Miller, Vice Chairman *(excused)*

OTHERS PRESENT

Cynthia Billings, Sullivan, Ward, Asher & Patton, PC
Lawrence Gray, Gray & Company
Andrea Stewart, Gray & Company
Paul Carey, Atlantic Asset Management/Fountain
Bruce Goode, Goode Investments
Dave Fitchett, Northern Trust
Jim Deming, Montag & Caldwell
Bill Long, Montag & Caldwell
Joe Gatz, Loomis Sayles
Don Moll, Loomis Sayles
Pam Hopkins, Munder Capital
Tony Dong, Munder Capital
Cathy Colecchi, Morgan Stanley
Ellen Zimmermann, Retirement Administrator
Deborah Munson, Retirement Accountant

CONSULTANT

Overview
Mr. Gray noted that this was second year using the roundtable format for the economic overview. The roundtable will be followed by brief manager performance presentations.

It was felt that more robust discussion resulted from having the mangers' peers around the table.

The total portfolio returns for the total plan were presented ex-CAPROC as Gray & Company is not receiving CAPROC data. For the period ended March 31, 2006, the year-to-date return for the total fund was 4.5%. For the trailing one-year, the return was 11.7%; for the trailing three-year period, the return was 14% and for the trailing five years the fund returned 11.7%. The fund has exceeded the actuarial target rate for the past five years. The market goes in cycles and has been doing incredibly well. When things are going well, the consultant's job is to temper client expectations.

Domestic market returns benefited from strong profit growth and low interest rates. For the trailing year the S&P 500 returned 11.7%, the Russell 1000 returned 13.2%, the Russell 2000 Growth index returned 27.8% and the NAREIT returned 31.8%. Energy stocks remained strong returning 21.8% for the year. In the most recent quarter telecommunication services were the best performing sector returning 14.5%. Small cap stocks outperformed large cap and lower quality stocks outperformed high quality stocks during the quarter. Large value stocks outperformed large growth stocks.

There will be a slow-down: the current pace cannot continue. The S&P has had sixteen consecutive quarters of double-digit growth. Low interest rates and productivity improvements have made companies more efficient. In the normal cycle small cap leads the way, followed by mid cap and then large cap.

In the fixed income market there have been sixteen consecutive increases in interest rates and the fed funds rate now stands at 5.25%. Fixed income had positive returns and although they were not great, they were positive. The top line numbers look very good.

Trustee Cochran noted that there have been ominous signs in the market and asked if there was cause for concern and whether there is more of an inflation concern. Contrary to the conventional wisdom, bond prices increased. Mr. Gray said that concern is well-founded as the bull market continues. A correction (10% for more) is due if not well overdue and the expectation is that investors will begin to take profits.

Interest rates have been ratcheted up by Greenspan and Bernanke on the short end and the long end rates are increasing a little. Inflation is starting back and Bernanke can continue to increase rates: he can only control short term rates. Inflation in the housing market was fueled by easy money and creative money. An example of the latter is interest-only loans and other products created by the mortgage industry that stretched credit to those who cannot really afford it. Indicators of the last month or so portend inflation.

Chairman Storum asked about the status of Montag & Caldwell and Morgan Stanley. Mr. Gray said Montag has a good process overall that has worked well in most cases. They buy high quality companies; a rising tide lifts all ships. C-rated companies are doing better than A-rated companies. High quality is great, but there can be long periods when it does not perform. They have a solid process but they lag the market by 50 to 250 basis points. They are a good average manager, nothing exciting. For one year they are down 200 basis points, for the three-year period they are down 300 basis points. Another Michigan client terminated them and went to an index fund. Montag, over a market cycle, has not met the benchmark net of fees. Asset allocation drives 90% of returns. The large cap market is the most efficient part of the market. The fund would be better off in an index fund paying 8 basis points versus 40 basis points for active management. Chairman Storum noted they had good numbers when they were hired.

Mr. Gray said 13.4% is in large cap growth. The asset allocation drives returns. A manager should meet or exceed the benchmark net of fees. In an efficient market, 80% of managers cannot beat the benchmark net of fees. One thing active managers do is to give better downside protection than an index. One might not want to get rid of them if a correction is expected however, the system is a long-term investor. Montag & Caldwell has decent downside protection but he cannot say an index would not be better. In an article from April 13, 2006 by John Vogel of Vanguard he indicates that of mutual funds with expected stock returns of 8% and fees of 2.5% (net 5.5%), almost half of the investment went away in fees even with compounding. Mr. Gray intends to extrapolate this out for institutional plans.

There are still major problems with Morgan Stanley. Their dialing back on the telecom exposure was a change done due to client losses. They are behind the benchmark and still have 10% in telecom: that was half of their recent underperformance. Caldecott gave plenty of notice. There has been corporate in-fighting. Mr. Gray attended a conference call in New York and it was not very genteel. Part of the problem is that they buy mega-cap stocks and do not dip down into mid cap or small cap. In the global equities market a manager that has the ability to dip down opportunistically will do better than one who cannot. Morgan Stanley does not have that ability. The fund would be better served with some exposure to small and mid cap international equity.

Chairman Storum expressed interest in adding some emerging market exposure. Mr. Gray indicated that the board could have a small allocation to emerging markets or could get a strong manager who can opportunistically go into the emerging markets. Oppenheimer Capital has a solid international manager.

Discussion followed regarding the potential market correction and the likely flight to quality and globalization.

Break at noon.

Economic Roundtable

Mr. Gray said that ten years ago hedge funds were the province of high net worth individuals, foundations and endowments. To day there are about 8,000 hedge funds totaling $1trillion. He asked why there has been so much growth and what should trustees expect in terms of risk and return.

Mr. Dong said there is nothing wrong with hedge funds; they are not that different from what money managers do. They are not superior to long funds, just different. He opined that the average hedge fund manager is not very good. It is not easy to identify good ones which explains the growth. There are low returns as investors are chasing returns. The first question one must ask is how much risk one will tolerate; then accept the returns. Expectations for returns were good for the early managers but must be much lower now than in the past.

Mr. Gray indicated retail investors are now going into the asset class and asked whether it is too late. Mr. Gatz said that it was formerly the asset class of wealthy individuals. Now there are too few funds chasing too many dollars since there are so many funds. It is not practical for individuals. Mr. Dong said that dollars are flowing into alternatives: Wall Street delivers products where the dollars are going. Mr. Deming stated that as a long investor, hedge funds have changed the environment and have had an impact on all markets. Mr. Deming agreed stating that it is hard to quantify the impact due to limited disclosure but hedge funds have certainly increased volatility in the markets.

Mr. Gray asked whether trustees understand enough or how much confidence they should put in a consultant if they do not understand. Mr. McDaniel concurred that there is increased volatility in the markets and it has impacted the fixed income markets. He felt it was much the same as money going into high yield, international or emerging markets. He felt trustees should rely on consultants but should also understand the investment and assess the risk. He opined that the risk of a hedge fund is probably more like equity than before. Ms. Guice added that consultants now have teams focused just on alternative asset classes and that is the current trend. More due diligence is required and is being done by consultants.

Mr. McDaniel said this is a new asset class and interest will wane. As a contrarian, he feels it best to look at what is not in favor. He also felt that expectations for returns are too high after the 1980's and 1990's; people want to maintain higher returns and it will unwind. Mr. Dong agreed and opined a correction will occur after something bad happens with hedge funds. Mr. Long said hedge funds need to be able to articulate their strategy in a couple sentence to lay persons. Consultants should be sure that trustees understand the manager. Mr. Gray said the range of returns is so broad as to be meaningless. We are in the educating phase now – it has been overblown and far too exploited. With a $10,000 minimum investment, he felt a major blow-up is coming. He also discussed the John Vogel article stating that if you add up the fees, especially in hedge funds, the fees are excessive and he is unsure they can keep up.

Mr. Gray said the Federal Reserve has increased interest rates sixteen times. He raised the question of whether inflation is under control. Mr. McDaniel said he is contrarian on long rates. The Fed could raise rates in June to 5.5%. Inflation remains under control although oil is at $70 per barrel. Housing is slowing and it could create problems with a lag. Fuel prices tend to have a one year lag in slowing the economy. We are starting to see that now. The economy will start to slow. If it does, interest rates are too high, especially long rates. The yield on a 10-year security, each time it has peaked, has peaked at a lower point. He felt it will continue to trend down and make the current 5% rate an attractive return.

Mr. Fitchett said their chief economist thinks the Fed has overdone it and expects them to lower it by the end of the year. Mr. Goode opined there may be a couple of increases before the end of the year. Mr. Long said that CCC bonds' risk premium is very small; as the economy slows the risk premium on lower quality issues has to increase. Part of that is hedge fund activity. The risk premium is expected to increase as the economy slows and they are taking a defensive position. Mr. Deming felt profits will be under pressure. Mr. Goode said the spread on GIC's is less than the spreads on lower quality issues.

Mr. Gray noted the overall increase in commodity and housing prices and felt we will see a slowing economy and the lag will make it appear at the start of next year. Mr. McDaniel felt fuel prices have a big impact on people. Mr. Dong said that the futures contracts are the best indication of what oil companies expect fuel to sell at five years out. The price is $68 to $70 a barrel. Mr. McDaniel said there is still some hedge fund speculation. Mr. Deming said there is no additional supply now. Mr. Dong said that oil companies' exploration and production companies can lock in at $70 a barrel now and that suggests they expect they can get more than that then.

Mr. Gatz said that regarding the futures, the companies know and make those assessments and the prices include $2 to $3 a barrel for uncertainty. He expects prices to remain high but it will not be a problem as there are offsets in other areas due to globalization. Ms. Colecchi said consumer spending which is 71% of GDP is expected to slow. She expects the U.S. economy to slow and rates will tighten. The global economy will slow and the U.S. will factor into that. GDP growth of 3.5% to 4% like that in the fourth quarter is extraordinary and there will be a reversion to the norm.

Chairman Storum noted that the Midwest and Michigan have a slow economy now and asked about the impact of cheap labor in India and outsourcing. Discussion followed regarding jobs lost to India and China and Newcor (steel) asking for protection. We have seen it in the auto and raw materials sectors and it is affecting Michigan. We may see it bleeding into other areas. Mr. Gatz said that China and Brazil have cheap labor and Michigan is exposed in several of these areas. Mr. McDaniel said that the dollar has been weak and wondered how much that impacted foreign results.

Ms. Colecchi confirmed that the dollar has been weak especially in 2003 and 2004. The weaker dollar has given some bang to the buck. Mr. McDaniel noted that China has no pollution restrictions and the U.S. does. That puts U.S. companies at a tremendous disadvantage. We also have different work rules. Mr. Gray said automotive companies went to Mexico, China and are now back in Alabama and Georgia. Mr. Deming opined that unionized labor will be a disadvantage because consumers will buy the cheaper product of similar quality. The difference is $1,800 versus $800 per car in labor cost per unit. Discussion followed that union legacy costs cannot all be passed on to the consumer.

Manager Performance

Oppenheimer Capital

Ms. Guice said Oppenheimer out performed for the fiscal year to date. They were overweight in mortgage backed bonds. It is a high quality portfolio. They are overweight in treasuries, financials and pass-throughs. There was very little reward for taking more risk; spreads are narrower due to liquidity chasing.

Mr. McDaniel said they were bar-belled last year. Since then they have gotten shorter in duration and higher in quality with treasuries, agencies and AA bonds. There are now narrow spreads. The overweight in corporates has not done well so far but will do well long-term. They are skewed toward corporates. Foreign ownership is increasing in U.S. bonds including corporates. They are short of the index on duration. He is positive on fixed income. As a country we tend to always find a way out: it is dangerous to bet against the dollar. We find innovative ways of coping with things over time. Fixed income will have a stronger return over the next year.

Atlantic / Fountain

Mr. Murphy said that the high yield portfolio had returns that beat the benchmark for 2005. For the year to date, they are slightly behind. He noted that the riskiest assets have performed best the past few years. The portfolio is comprised of high quality high yield securities focusing on BB and B. It is a commingled account with $72 M in assets under management. The PFRS has $5 million invested. Since inception returns have been good. The high quality of the portfolio has kept volatility low.

Goode Stable Value

Mr. Goode said he has been managing for PFRS since August of 2004. The total portfolio is $188 million of assets under management. Year to date the return was 1.14%. For the one-year period, the return was 4.66% and for the three-year period, the return was 5%. This places them in the top quartile. The benchmark to the Heuler universe. The product composition is 62% AAA and 19% AA. 35% of the portfolio is invested in constant duration synthetics, 24% is in fixed maturity synthetics and 19% is in a pooled vehicle, the Magic fund. There is less is GIC's due to tightening spreads. It is a yield enhanced strategy that returned 5.47% versus the benchmark of 5.194%. The new FASB ruling does not allow defined benefit plans to make additional investment in the commingled fund: they are developing a new product to allow additional investment in stable value.

Northern Trust

Mr. Fitchett stated that Northern Trust has $3.1 billion in custody assets and $650 billion in assets under management. The firm has scale, breadth of products, people and process; they aim to be a market leader. Theirs is a global operation that allows them to trade 24 hours a day and provides for disaster recovery. He reviewed the organizational chart. He reviewed the performance of the index funds noting they had slightly outperformed the benchmark for the one-year period for both the international government credit bond index and for the Russell 1000 Value equity index. The fixed income fund is a high quality fund above Baa. They occupy the short to medium end of the curve. The equity fund focuses on large cap stocks. The trailing P/E is 15.6. - Financials make up one-third of the index.

Montag & Caldwell

Mr. Deming reported that the Chairman of the firm retired in the first quarter which was their only personnel change. Assets under management are $22.4 billion. They are in compliance with portfolio guidelines and have achieved a 55% commission recapture rate. For the one-year period the returns were 11.2% versus 13.1% for the benchmark. For the three-year period returns were 11.3% versus 14.8% for the benchmark. For the five-year period returns were 2.0% versus 1.7% for the benchmark. He reviewed the top ten holdings and said they are overweight to energy, consumer staples and health care. Mr. Long said that growth and value ran in tandem to the end of the 1990's; since the bubble, there has been disparity. They think large cap growth is undervalued and expect the gap to close; it will be an opportunity for large cap growth. He discussed the energy sector's impact on the S&P index.

There has been price/earnings compression. Large cap has done poorly the last five years. Large cap looks extremely cheap right now. He said after-tax profits as a percentage of GDP will fall; when profits are at this level, competition comes in. Mr. Deming said the economy is at an inflection point and he expects those with good solid earnings growth to return to the mean. Large companies have less debt on the balance sheet and are not as affected by rising interest rates as are small companies. Profit margins are at an all time high.

Mr. Gray said they are a high quality buyer. Confidence in the market shows people are buying lower quality. Net of fees, he asked, relative to ETF's, why an investor should stay with active management. Mr. Deming replied that active managers tend to protect better on the down side. Mr. Long added that with an index comes risk and if a slowdown is expected active management protects where an index will not. They protect well.

Loomis Sayles

Mr. Gatz said this has been a good small cap market and small cap has outperformed large cap for the past six years; the rally continued to 2006. In 2005 small companies had faster earnings growth for many quarters and while it slowed in 2005, it returned in 2006. It has generally been a lower quality market. Returns for the one-year period were 14.3% versus the Russell 2000 value index at 13.5%. For the three-year period the portfolio returned 31.6% versus the benchmark at 30.8%. For the five-year period returns were 18.4% versus 16.2% for the index. Stock selection was the key contributor to out-performance: 248 basis points out of 316 of out-performance were due to stock picking. Sector allocation was a modest positive contributing 68 basis points of out performance. The portfolio was underweight to financials and overweight to industrials: the quality focus has yet to make a strong contribution. Higher interest rates impact lower quality stocks. International investors may disinvest in U.S. companies.

Long-term they have a consistent application of their process and valuation discipline and an attractive risk profile. They try to find undervalued, under-followed small companies. The portfolio is overweight to late cycle companies like industrials and producer durables. Corporate balance sheets are strong now, profit margins are high. They are underweight in consumer and healthcare. They are fully invested and quality prevails. He reviewed the portfolio characteristics, the top ten holdings and sectors noting they have no major sector bets. Relative valuation levels between small and large cap stocks are near long-term averages.

He reviewed their outlook on the current market saying the fundamental character of the small cap market is still strong. Access to capital for small companies is still high. The dollar is weak and that tends to benefit large cap more than small. Higher interest rates or steep earnings deceleration could be a concern.

Munder Capital
Ms. Hopkins said they were hired in April of 2005 for the mid cap mandate. This is their first report to the Board. Mr. Dong reported that the returns for the quarter were 11.2% versus 8.6% for the benchmark. Since inception returns were 30.95% versus 26.54% for the benchmark. Assets total $21.7 million as of March 31, 2006. Theirs is a stock picking process with robust risk controls.

He reviewed the portfolio characteristics. They concentrate on growth names with less debt to capital than the index. The ROE is 19% versus 14% for the index reflecting better management. The companies sell at a 10% premium to the market but are better quality companies than average. They control sector bets and are fairly comparable to the benchmark. Their capitalization rate is also comparable to the benchmark; 20% bigger than the average benchmark stock. Stock selection is the primary source of value added.

Mr. Dong said that the market has appreciated a lot; the S&P400 over the last three years has increased in size 70% without Munder adjusting. They have increased the capitalization by 50% to become more comparable to the market. The minimum size is $750 million and the maximum is $15 billion. The change is immediately effective.

It is easy to become accustomed to recent returns (30%) but investors cannot reasonably expect 30% returns and 400 basis points of out performance to continue. It is reasonable to assume the economy will slow and they are placing more emphasis on companies that will deliver on earnings. It is a good environment for growth and especially for cyclicals. When the economy is weaker, those who deliver earnings growth will be more highly valued.

Morgan Stanley
Ms. Collechi reported that Dominic Caldecott retired; this month Christian Derold was hired. It was an opportunistic hire. Mr. Derold is from Austria and has been working as a consultant. He has worked with Peter Wright.

At Morgan Stanley they are value investors investing in high quality. High quality and large cap have lagged for over three years. They look for high free cash flow large cap and focus on absolute returns and risks. For the quarter the portfolio returned 7.4% versus the benchmark at 9.4%. For the one-year period, returns were 14.9% versus the 24.4% for the benchmark. For the three-year period returns were 14.9% versus 24.4% for the index. For the five-year period, returns were 13% versus 9.36% for the index. They have lagged on a relative basis although absolute returns were strong. They have preserved capital in down markets and the compounding effect is very compelling.

What went wrong in 2005 was the underweight to Japan and the overweight to telecom. All the underperformance came in the last half of the year. They were not buying cyclicals due to valuation issues. The underweight to Japan turned around this year. They have trimmed the telecom exposure. They have a contrarian view. These are still generating free cash flow and are paying more dividends. They are looking for M&A. The position has been cut and there have been some profit warnings. It is an unloved sector but they still have double the index weight in Japan. Ms. Colecchi reviewed the annualized returns for the international markets and stated that they expect a return to the mean. The positioning going forward is an overweight to consumer staples and telecom; they are underweight to financials, a sector that includes banks and insurance as banks are highly leveraged and so are more risky.

Corporate profitability worldwide is at a peak. It is all greed and no fear. They tend to perform well in down or slowly upward-trending markets. In such markets, defensive, high quality, price aware issues tend to do well.

Ms. Stewart reminded the managers of the commission recapture policy with CAPIS and LJR and they should be participating.

The meeting adjourned at 5:03 p.m.