

May 21, 2013

MEMORANDUM TO THE TRUSTEES

FROM THE PRESIDENT and CHIEF EXECUTIVE OFFICER

**SUBJECT: Selection of Investment Managers for the Authority's
Other Post-Employment Benefits Trust Fund**

SUMMARY

The Trustees are requested to approve the award of multiyear investment management service contracts to replace expiring agreements for professional investment management services in connection with the Authority's Other Post-Employment Benefits Trust Fund to the following firms: State Street Global Advisors ("SSgA"), GAMCO Asset Management Inc. ("GAMCO"), WCM Investment Management ("WCM"), Urdang Securities Management Inc. ("Urdang"), and Wells Capital Management, Inc. ("WellsCap").

Due to the need to commence services, interim contract awards were issued to three of these firms, GAMCO, Urdang and WellsCap earlier in May 2013, in accordance with the Authority's Guidelines for Procurement Contracts and Expenditure Authorization Procedures, subject to the Trustees' approvals.

BACKGROUND

Section 2879 of the Public Authorities Law and the Authority's Guidelines for Procurement Contracts require the Trustees' approval for procurement contracts involving services to be rendered for a period in excess of one year. Moreover, the Authority's Expenditure Authorization Procedures require the Trustees' approval for the award of personal services contracts in excess of \$1 million if low bidder, or \$500,000 if sole-source or non-low bidder. The terms of the contracts considered herein are for more than one year and, in some cases estimated to exceed the dollar thresholds over the term of the agreement, therefore, the Trustees' approval is required.

Certain Governmental Accounting Standards Board ("GASB") standards¹ issued in 2004 require governmental employers to account for other post-employment benefit ("OPEB") liabilities on an "accrual" basis (i.e., as the benefits are earned during the working career of the employee) rather than on a "pay-as-you-go" basis, where costs are recorded as the benefits are paid during the employee's retirement years. OPEBs may include medical, prescription drug, dental, vision, life and other long-term care benefits for retirees and eligible beneficiaries. Similar GASB standards for pensions have existed since 1994. The Authority began reporting its OPEB obligations in this manner in 2002.

¹ These standards include Statement No. 43 – Financial Reporting for Post-employment Benefit Plans Other Than Pension Plans and Statement No.45 – Accounting and Financial Reporting by Employers for Post-employment Benefits Other than Pensions.

The GASB rules do not mandate funding of the accrued OPEB obligations, only a recognition of the accrued OPEB liability on the employer's financial statements. If left unfunded, however, the amount of the unfunded liability could significantly impact the

employer's overall financial condition and its credit rating with an attendant impact on the cost of debt financing.

After an assessment by staff, it was determined that the establishment of a separately managed trust fund would be fiscally prudent. Authority staff, with the support of its financial advisor, PFM Advisors ("PFM"), then evaluated various portfolio strategies designed to meet the investment objectives of the Authority. Reviews of different strategies were conducted based on projected assets class returns, correlations and risk tolerances to determine the optimal allocations. The portfolio design considered to be most aligned with the Authority's overall return objectives and risk tolerances was a diversified approach employing domestic and international equity assets, fixed income assets, as well as real estate investment trust asset classes to further enhance diversification.

At their July 31, 2007 meeting, the Trustees: (1) approved the creation of the Power Authority of the State of New York Other Post-Employment Benefits Trust (the "Trust"); (2) adopted the Trust Investment Policy Statement; (3) appointed a Trustee Custodian and (4) approved an initial \$225 million funding plan. Subsequently, in October 2011, the Trustees approved an on-going annual funding plan for the OPEB Trust and certain amendments to the Investment Policy Statement clarifying diversification and credit quality standards.

As of March 31, 2013, the market value of assets held in the OPEB Trust Fund totaled \$361 million, of which \$230 million were invested in equities, \$110 million were invested in fixed income securities, and \$21 million were invested in real estate investment trust securities. When compared to the actuarial accrued liability of \$544 million (as of December 31, 2012), this represents a funding level of 66%.

DISCUSSION

In September 2012, as the Authority prepared to issue a Request for Proposal to rebid six expiring investment management agreements, staff and PFM evaluated the current portfolio construction for potential improvements in risks and returns. Based on this evaluation, an overall change is the allocation of assets amongst equities; fixed income and real estate is not being recommended; however, staff will be implementing the following strategies for the OPEB Trust:

1) Portfolio Strategy

At the inception of the Trust in 2007, it was recognized that equity markets typically exhibit cycles of relative outperformance by value and growth stocks versus a core approach. These cycles can last varying time periods from two years to much longer periods. Since the timing of which style will be in favor is nearly impossible to predict, a way to capitalize on those periods of style outperformance is to allocate equal portions of the assets to both a value and growth oriented strategy. Based on historical performance analysis over multiple trailing time periods, staff and PFM determined that returns for a balanced value/growth style allocation compared to returns for a full all cap core allocation was generally indistinguishable; however, the all cap core strategy exhibited lower risk. As such, staff will be reallocating the value/growth assets to an all cap core manager to reduce future portfolio volatility and expected increased risk adjusted returns.

2) Diversification Strategy

- a) In accordance with the OPEB Investment Policy Statement dated October 25, 2011, the Trust may expand investments into international fixed income securities. Staff will be allocating the intermediate fixed income assets to a core “plus” (i.e. emerging markets, higher yield) strategy. As a result in the shift from the Intermediate U.S. Government/Credit exposure to an Aggregate exposure, and the flexibility to invest in “plus” sectors, additional diversification benefits and an increase in expected returns will be realized. The overall rating of the fixed income assets in the Trust will remain at least an “A” in accordance with the Investment Policy Statement.
- b) While the U.S. Real Estate Investment Trust (“REIT”) strategy has performed well for the Authority in the past, assets are being re-allocated to a global REIT strategy. A globally diversified portfolio is better positioned to benefit from a larger universe of potential investments, more attractive relative value of non-domestic REITs and greater prospects for future growth.

On November 21, 2012, the Authority solicited proposals for professional equity, fixed-income, and alternative investment management services by notice to a number of firms providing such services and advertisement in the *New York State Contract Reporter* in order to determine qualified investment managers for the OPEB Trust Fund. On or before December 20, 2012, the Authority received a total of 54 proposals from thirty-eight bidders. After evaluating the 54 proposals, staff determined that the Authority received insufficient high quality responses for the REIT strategy and the All Cap strategies. For the REIT rebid, staff solicited proposals on January 24, 2013, and received a total of 19 proposals from thirteen bidders on or before February 14, 2013. For the All Cap equity strategy, staff solicited proposals on February 12, 2013, and received a total of 14 proposals from thirteen bidders on or before March 5, 2013.

Authority staff, with the support of PFM, evaluated each proposal taking into consideration quantitative and qualitative criteria. From a quantitative standpoint, staff evaluated historical performance, various risk metrics and the schedule of fees. From a qualitative standpoint, firms were evaluated based on team duration and experience, investment style and research capabilities. After conducting extensive reviews and analysis of each proposal, a total weighted score combining the quantitative and qualitative criteria assessed by PFM was calculated and examined by Authority staff. The Authority, with the recommendation of PFM, invited sixteen firms with the highest relative rankings to give oral presentations. Based on the above criteria and oral presentations, the following firms were identified to have the highest overall rankings to manage each of the respective asset classes in the OPEB Trust Fund: SSgA for Equity All Cap Core Passive; GAMCO for Equity All Cap Core Active; WCM for International Equity; Urdang for REIT; and WellsCap for Fixed Income Core Plus. A summary of the rationale for each selection follows:

SSgA was the passive Russell 3000 index fund manager that the Authority selected in 2008. Due to its excellent customer support, being a product leader, and low fee structure, it is recommended that State Street continue to serve as a passive equity index fund manager of the OPEB Trust managing **\$86 million** in assets. Complementing the passive equity index strategy with an active overlay, staff is recommending that **GAMCO**, an all cap core manager with a unique investment process, rigorous approach in risk management, and perceived superior security selection expertise, be selected to manage **\$58 million** in assets. For the international large cap growth strategy, **WCM**, with a high conviction portfolio approach, a focus on higher quality companies and strong track record is recommended to manage **\$24 million** in assets.

In respect to the REIT allocations, **Urdang**'s global strategy with a distinguished security valuation process, strong risk controls and depth of its research teams is recommended to serve as the global REIT portfolio manager of the OPEB Trust with **\$21 million** in assets. For the fixed income core plus strategy, the firm **Wells Capital Management** adopts a conservative investing approach in the high yield credit sectors. While taking less risk, WellsCap has shown the ability to deliver strong performances, historically, through security selection from domestic and international markets. It is recommended that Wells Capital Management manage this fund with **\$44 million** in assets.

The recommended firms will be awarded five-year contracts, with asset allocations as noted below, subject, however, to early termination at any time by the Authority on 60 days' notice. The allocation amounts are based on the assets ending market value as of March 31, 2013 and will be adjusted proportionally for the actual asset value on the transition date of the assets.

	<u>Asset Allocations</u> <u>(in \$millions)</u>
State Street	86.0
GAMCO	58.0
WCM	24.0
Urdang	21.0
Wells Capital Management	<u>44.0</u>
Total	<u>233.0</u>

FISCAL INFORMATION

The fees for the five recommended investment managers, which will be paid from OPEB Trust assets, are expected to average approximately 39 basis points per annum (a basis point is equal to 1/100th of 1%, or 0.01%). The fees should equal about \$970,000 for the first year, growing in conjunction with the Fund's growth. Over the course of the recommended five-year term of the investment manager contracts, fees are estimated to total about \$6.1 million assuming a normal growth rate in the Fund's Assets.

RECOMMENDATION

The Deputy Treasurer recommends the Trustees' approval of the award of multiyear service contracts to State Street Global Advisors, GAMCO Asset Management Inc., WCM Investment Management, Urdang Securities Management Inc., and Wells Capital Management, Inc., for professional investment management services in connection with the Authority's Other Post-Employment Benefits Trust Fund.

For the reasons stated, I recommend the approval of the above-requested action by adoption of a resolution in the form of the attached draft resolution.

Gil C. Quiniones
President and Chief Executive Officer

Att.
Selection of Investment Manager

RESOLUTION

RESOLVED, That pursuant to the Guidelines for Procurement Contracts adopted by the Authority, the award of the multiyear investment management service contracts to State Street Global Advisors, GAMCO Asset Management Inc., WCM Investment Management, Urdang Securities Management Inc., and Wells Capital Management, Inc., for professional investment management services in connection with the Authority's Other Post-Employment Benefits Trust Fund, as recommended in the attached memorandum of the President and Chief Executive Officer, is hereby approved and the execution of such contracts by the Executive Vice President and Chief Financial Officer or the Treasurer, subject to the approval of the form thereof by the Executive Vice President and General Counsel, on behalf of the Authority is approved; and be it further

RESOLVED, That the Chairman, the Vice Chairman, the President and Chief Executive Officer, the Chief Operating Officer, the Executive Vice President and Chief Financial Officer and all other officers of the Authority are, and each of them hereby is, authorized on behalf of the Authority to do any and all things and take any and all actions and execute and deliver any and all agreements, certificates and other documents to effectuate the foregoing resolution, subject to the approval of the form thereof by the Executive Vice President and General Counsel.