

Investment Basics

Presented by
Mike Charette,
Senior Investment Officer and Portfolio Manager
Mike Strader,
Regional Manager

BUILDING
RETIREMENT
SUCCESS
TOGETHER

Agenda

- Investing Basics
- Managing the Defined Benefit Portfolio
- Managing the Investment Menu for Participant Directed Accounts

What is an Asset Class?

An asset class is a group of securities that generally:

- Have similar characteristics
- Behave similarly in the marketplace
- Are subject to the same laws and regulations

Cash

Bonds

Stocks

Alternatives

Bond Investments

- Bonds are financial obligations in which the issuer agrees to pay a specified amount to the holder at a future date
- There are two types of payments:
 - Interest payment (coupon) – percentage that is paid for using the borrowed funds, typically paid quarterly or semi-annually
 - The interest rate can be a fixed amount or it can be a floating rate
 - Principal payment – return of the borrowed funds, typically paid in lump sum at maturity

Types:

U.S. Treasury Bonds

- Issued by the U.S. Treasury Department, backed by the full faith and credit of the U.S. Government (largest issuer in the world)

Corporate Bonds

- Debt issued by a corporation

High Yield

- Corporate bond with a lower credit rating than investment-grade. Investors are compensated with a higher interest rate

Stock Investments

- A type of security that signifies ownership in a corporation and represents a claim on part of the corporation's assets and earnings
- Also known as "shares" or "equity"

Categories:

Small Cap

- Stocks with relatively small market capitalization, typically between \$300 million to \$2 billion

Mid Cap

- Stocks with relatively middle market capitalization, typically between \$2 billion to \$10 billion

Large Cap

- Stocks with relatively large market capitalization, typically between \$10 billion to \$200 billion

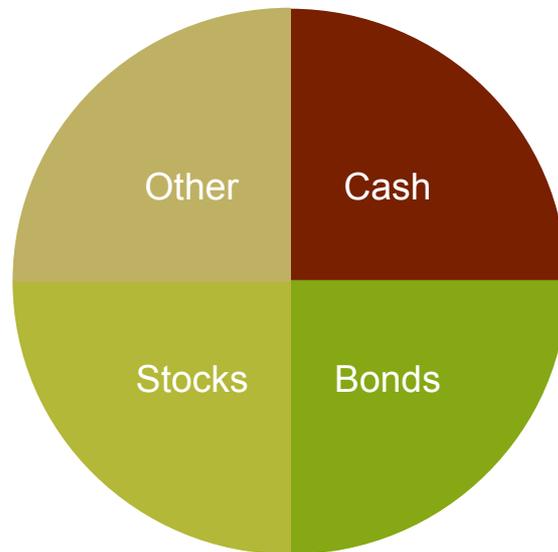
Alternatives

- Real Estate
- Commodities
- Private Equity
- Hedge Funds



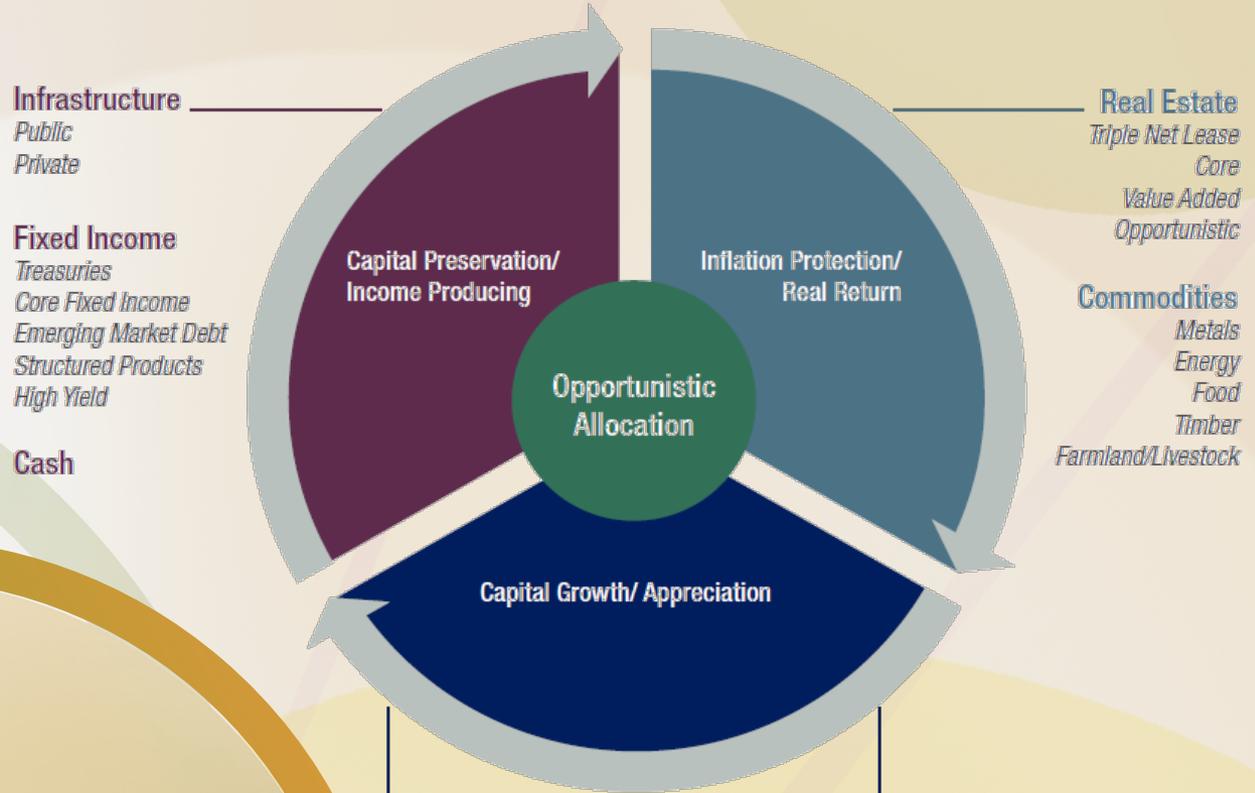
Diversification

Reduces portfolio risk by using a variety of asset classes in one portfolio



Active Management vs. Passive Management

- Active management – An investing strategy that seeks returns in excess of a specified benchmark
- Passive management – An investing strategy that mirrors a market index and does not attempt to beat the market
 - Also known as “passive strategy” or “passive investing”



Managing the Defined Benefit Portfolio

Portfolio Foundation

Optimizing Potential Returns while Minimizing Risk

Diversification

Long-Term Investors

Economies of Scale

Strategic Asset Allocation

Tactical Decision Making

Investment Policy Statement

- The Investment Policy Statement outlines the investment goals, objectives, and policies
- Assists the Board, Investment Committee, and Staff in effectively monitoring MERS' investments and offers a map to assist in making prudent and informed investment decisions
- Addresses:
 - Goals
 - Policies
 - Performance objectives and evaluation
 - Investment processes and procedures
- Designed to provide sufficient flexibility in the management and oversight process to reflect the dynamic nature of the capital markets

Governance Philosophy

- Regulatory compliance and robust governance structures
- MERS has a long history of having appropriate separation of investment policy and investment management decision making
- Fiduciary Duty
 - The MERS Retirement Board (Board), as “investment fiduciary” under the Public Employee Retirement System Investment Act (PERSIA)
 - Board must follow the state law and prudent person standards of diligence consistent with “discharging their duties for the exclusive benefit of plan participants”
 - The prudent person standard requires that the Board “exercise the same judgment, care, skill, prudence, and diligence under the circumstances which persons acting in a like capacity and familiar with such matters would use in the conduct of a similar enterprise with similar aims”

Roles and Responsibilities

Retirement Board

- The Board appoints public members to serve on the Investment Committee
- Acts as a sole fiduciary and sets general investment policy

Investment Committee

- Three voting Board members
- Serves as the Board's investment policy development arm
- Monitors investment management activity and policy development recommendations
- Approves recommendations to hire/fire managers with exception of the Emerging Manager Program

Portfolio Review Committee

- Decision making body
- Final say on selection of managers for the Emerging Manager Program
- Determines tactical shifts to make within the portfolio
- Reports decisions to the Investment Committee

Office of Investments

- Carries out all investment activity on behalf of the fund
- Provides a monthly report on the fund's activities and performance
- Report any material changes within the Fund to Investment Committee and Board
- Facilitates the Emerging Manager Program
- Internal Fixed Income and Equity Management
- Monitors external investment managers

Philosophy

- Investing in today's financial markets is becoming increasingly complex
- Core beliefs:
 - Capital preservation is paramount; avoiding losses is more important than achieving gains
 - Markets are shockingly inefficient; they are driven by human emotion which can often be exploited by taking a contrarian, long-term perspective
 - Keep it simple; if you do not understand it, do not invest in it
 - Volatility is not a true measure of risk, permanent impairment of capital or shortfall is risk

Philosophy, Cont'd.

- Core beliefs:
 - Diversification is critical because the future is unknown
 - Mean reversion drives everything; it is helpful to remind ourselves that most investments go through cycles, and cycles imply reversion
 - The focus should be on risk-adjusted returns; returns cannot be evaluated without considering the risk taken to achieve those returns
 - We believe that constantly reminding ourselves of and framing our discussions around these central tenets will help achieve the stated investment goals and increase the probability of long-term investing success



Managing MERS Investment Menu

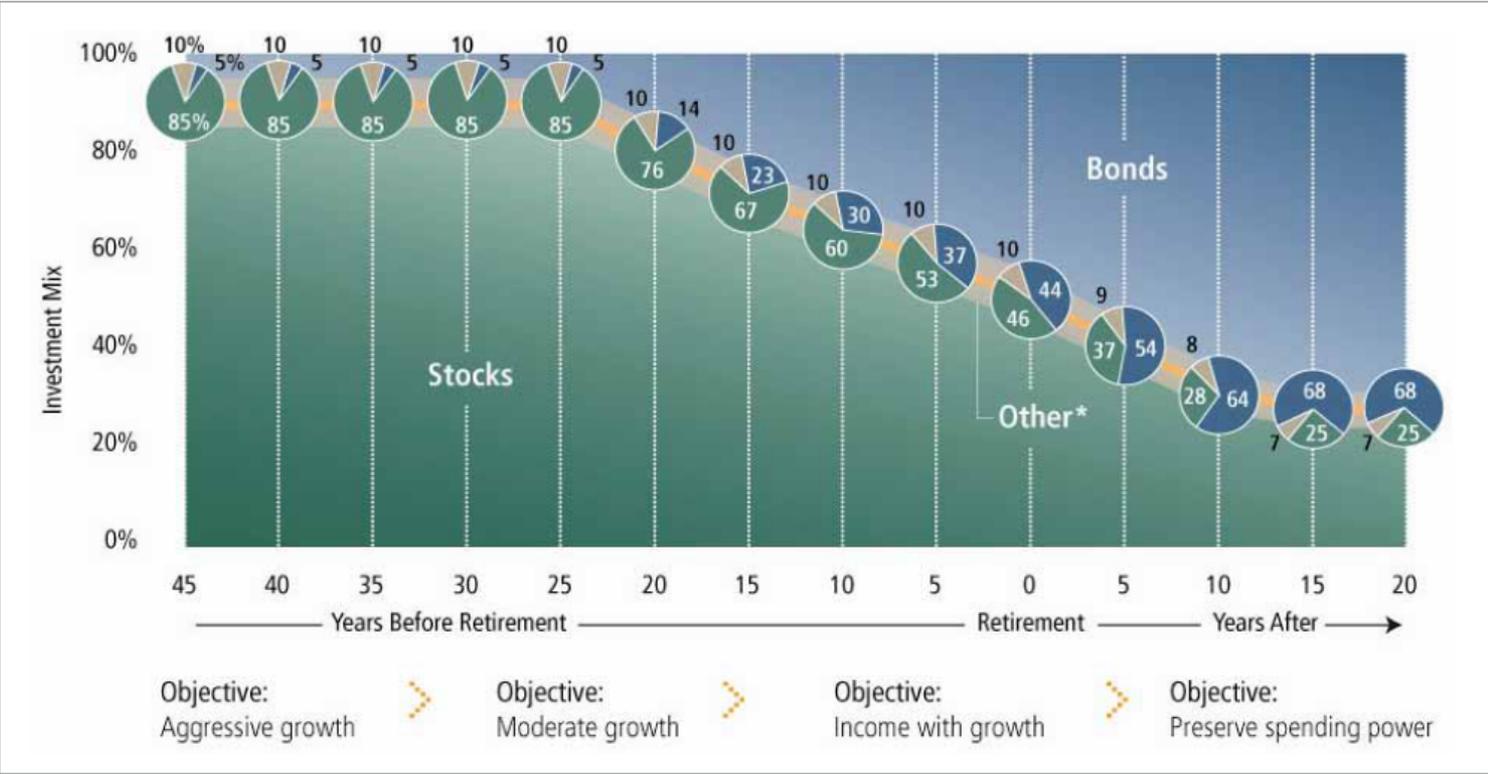
1

Retirement Strategies Target Date Funds

- Retirement Strategies are the default investment selection, and are based on your projected retirement date
 - For example, “MERS 2040 Retirement Strategy” is for someone retiring near the year 2040
- MERS Retirement Strategies are designed especially for MERS with a custom “glide path,” gradually moving from a more aggressive allocation to a more conservative allocation

Glide Path

The “glide path” is simply the path your investment will follow as you age and become a more conservative investor”



*Other includes Global Real Estate Investment Trusts (REITs) and Commodities



2

Diversified Portfolios *MERS-managed portfolios*

- The Diversified Portfolios are professionally managed by MERS Investment Department
- When you invest in these funds, you invest alongside MERS Defined Benefit Portfolio
- Any changes in your age or financial situation could mean a different investment mix may be appropriate
 - With this in mind, it's always a good idea to review your investment choices regularly to make sure they are still appropriate

3

Expanded Funds

building and fine-tuning your own portfolio

- The Expanded Funds give experienced investors a wide variety of available funds to choose from
- These funds can be a great complement to the Diversified Portfolios or Retirement Strategies, giving you the ability to further diversify your investment portfolio and fine-tune your strategy

4

Self-Directed Brokerage Window *more choices*

- For experienced investors MERS also offers the additional services of a brokerage window
- From individual securities to mutual funds in a variety of share classes, the brokerage window gives savvy investors access to more than 1,000 additional investments.
- While the brokerage window offers you greater investment choice and control, there are several requirements you must meet to be eligible

Investment Policy Statement

- Investment Policy Statement has been adopted by the Retirement Board as the fiduciary and trustee of the retirement system, to provide guidelines for the investment options offered to participants with the Defined Contribution Plan, Health Care Savings Program, and Supplement 457 Program
- These plans are intended to provide eligible participants with long-term accumulation of retirement savings through a combination of employee and employer contributions to individual participant accounts
- All transactions undertaken on behalf of the Plans shall be for the sole interest of the Plans' participants and beneficiaries
- Participants will be provided the opportunity to obtain sufficient information to make informed decisions with regard to investment alternatives under the Plans

Responsibilities

Board

- Investment Policy Statement
- Establish and maintain guidelines
- Approve any material changes to the Plans

Office of Investments

- Determine the overall number and types of options offered to participants
- Establish due diligence procedures for selecting, monitoring, and eliminating investment choices
- Provide the Board with adequate information to carry out their fiduciary duty

Participants

- Read investment education and communication materials
- Determine their individual risk tolerance
- Manage their own investments

Investment Objective

- Accommodate the varying needs of participants by providing appropriate and diversified investment options
- Options will include several different asset classes, including stocks, bonds, and cash
- Accommodate the different risk tolerances of participants and will offer competitive risk-adjusted returns at a reasonable cost
- Encourage participants to take an active role in saving and selecting among investment options for their retirement by providing education and information so they can make informed investment decisions

Selection

Proprietary Funds

- MERS creates proprietary portfolios to offer participants the ability to benefit from economies of scale created by the defined benefit portfolio
- It is expected that the proprietary funds will offer attractive risk-adjusted returns at a below market fee
- The Office of Investments manages MERS proprietary portfolios pursuant to the MERS Defined Benefit Investment Guidelines and Investment Policy Statement

Selection

External Investment Options

- The Office of Investments selects externally managed investment options based upon the following minimum criteria:
 - Investment style
 - Performance exceeding the 50th percentile of its peer group universe over a variety of time periods
 - Lower risk compared to its peers if similar returns are achieved
 - Expense Ratio lower than peer average
 - Relatively consistent investment performance over time
 - Consistent investment style over time
 - Stability of the investment management team
 - Reputation of the fund company

Monitoring

- Investment options that drift from their investment style, experience management or organizational changes, or have relative declines in either their performance or risk rankings, may be recommended for removal
- Alternatively, an investment option could be placed on a “Watch List” until a final decision is made

Monitoring

- The Office of Investments may place an investment option on a “Watch List” if any of the following occurs:
 - The investment option’s net performance has underperformed its benchmark over the trailing five-year period
 - The investment option’s rolling three year returns underperform its benchmark for three of the most recent four calendar quarters
 - The investment option’s investment strategy and/or portfolio characteristics have materially shifted from its designated style
 - An adverse change in the investment option’s management team
 - A downgrade in the investment option’s Morningstar rating
 - Material legal or regulatory allegations or findings

Contact Us

MUNICIPAL EMPLOYEES' RETIREMENT SYSTEM

1134 Municipal Way

Lansing, MI 48917

800.767.2308

Fax: 517.703.9707

www.mersofmich.com

www.mymers.mersofmich.com

This presentation contains a summary description of MERS benefits, policies or procedures. MERS has made every effort to ensure that the information provided is accurate and up to date. Where the publication conflicts with the relevant Plan Document, the Plan Document controls.