Gallagher Fiduciary Advisors, LLC
a Subsidiary of Gallagher Benefit Services, Inc.

SUPPLEMENTAL RESPONSES FOR THE FELRA PENSION FUND

- October 31, 2012

Segal Rogerscasey

1. Please provide any comments or concerns your firm may have with the current Investment Policy Statement and if so, what amendments/changes would you propose?

The fund's Investment Policy Statement is more or less typical of other Policy Statements of the clients we inherit from other consulting firms. There are some relatively minor edits we would make to allow for easier understanding of the various components of the Policy, but also some fairly substantial ones.

For starters, we would want to relax the derivatives guidelines and the use of leverage to reflect the overlay approach to GAA/Risk Parity that we describe in question 2.a. below. Specifically, we would want to substantially relax the restrictions placed on private investments and other alternative strategies listed in Section V.2. and also V.9. Many of these currently prohibited securities and transactions are already being used by the fund's hedge fund of funds managers, and consistent with our views spelled out later in this supplemental questionnaire response, we would want to be able to use these (prudently, of course), in order to improve the Fund's odds of meeting its significant return requirements.

A substantial change Segal Rogerscasey would be to the table is eliminating the distinction between long-only and long-short strategies within equity and fixed income allocations. We believe that long-short strategies are a natural extension of long-only approaches, and that the entire equity and fixed income allocations (including those that use long-short portfolios) should reflect the desired beta characteristics defined in each year's Asset Liability Study. Currently, the policy is written in such a way that makes this commingling of long-only and long-short portfolios problematic. While we were not provided with Attachment C of the policy (the section that describes individual manager guidelines and restrictions), our familiarity with NEPC-derived policy statements suggests that the hedge fund allocation allows for long-short and other alternative strategies to be employed (naturally), while the rest of the allocation does not.

We would want to allow, where liquidity constraints permit, investments in private market opportunities, including private debt, secondary opportunities and other strategies designed to generate as much yield and overall return as possible. Infrastructure, natural resources (including Master Limited Partnerships) and high yielding real estate are all attractive examples of this.

Related to the GAA/Risk Parity portion of the existing portfolio, we are concerned that the equity and fixed income beta exposures within the GAA/Risk Parity portfolios are effectively ignored when it comes to measuring the fund's total allocation to each. As we describe in 2.a. below, our approach is to use an overlay method for making tactical portfolio shifts, including ones that employ Risk Parity techniques, effectively allowing the fund to have higher target allocations to equity and fixed income, and appropriately reflecting the beta exposures that will exist across the total fund. This is a much more capital efficient way of achieving tactical portfolio shifts, although it does necessarily translate into using modest amount of leverage, and equitized cash collateral will be held to allow the overlay managers to use futures (primarily) and other derivative instruments (such as options and ETFs) to make tactical beta shifts across the entire portfolio.

We would also want the policy to focus more on downside volatility, short-fall risk, funding status risk, contribution risk and other measures of losses as opposed to relying on standard deviation, which also captures upside volatility, which is something we *want* to take advantage of within the investment program. Indeed, we would structure the portfolio to have an asymmetric return profile, effectively maximizing the fund's chances of participating in positive return environments, while minimizing exposure to losses.

There are a variety of small edits we would make, as well. For example, we would specifically mention the fund's required compliance with all applicable regulations and laws, and not just federal statutes. We would also add language that spelled out how one goal of the ongoing management of the fund is to be appropriately sensitive to the ability of the sponsoring entities to make unexpected contributions into the fund. Stated differently, we would not want to design an asset allocation that required additional, unexpected contributions during a period of economic distress that impaired the sponsors' ability to contribute; rather, we'd design the program so that there was effectively a negative correlation between the fund's ongoing contribution needs and the financial health of the sponsors.

Another change we would suggest is adding more language to reflect what happens in the event of a major market dislocation where either the fund or the underlying managers would suddenly be out of guideline compliance, and getting back into compliance would impair the portfolios' long-term potential. Stated differently, we do not want to be in a situation where the fund is forced into selling into a declining market in order to be in compliance with these investment guidelines. The guidelines should be just that: a road map for how to invest the assets. They should not be an overly rigid set of documents that tie the fund's hands during periods of severe market stress. To be clear, in ordinary circumstances these guidelines are important and should be adhered to; but there also needs to be some measure of flexibility in periods where such flexibility is beneficial. There is some language that allows for this, but we think it needs to be clarified.

We would also more clearly define a market cycle to reflect a peak to trough to peak, rather than an arbitrary 3- to 5-year time horizon. It should reflect the entire cycle, and not just a calendar time period.

Again, since we didn't receive Appendix 3 of the policy statement, we cannot be sure of what language applies to the GAA/Risk Parity allocation. But we note that certain guidelines in the main document, such as those that relate to cash positions, don't apply to these strategies. Since our approach will be to use an overlay approach, this doesn't require a change in the language for our purposes, but for the way the fund is currently structured, the language seems inconsistent.

As it relates to the active managers, we note that there is a checklist that managers of commingled portfolios are required to submit as it relates to their compliance with their own investment policies, but we do not see similar language that relates to separate account managers doing the same with respect to the fund's policies. We think this is important, in that it helps provide an additional tool for determining overall guideline compliance, in addition to the tools we would expect the fund's custodian bank to provide, as well as our own compliance monitoring efforts.

We would also want to see a much more detailed explanation of the risk factors the fund seeks to avoid, and mechanisms to avoid them. Segal Rogerscasey has worked to introduce to our clients' portfolios a set of tools which allow us to aggregate underlying portfolio risks across the entire portfolio, across all asset classes and managers. These exposures include not only the traditional "asset" buckets, but also specific market factors that permeate most if not all portfolios, such as macro-economic factors, interest rates, sector exposures and even client-specific factors that could influence a sponsor's ability to make contributions during periods of stress on the sponsor's cash flows.

These tools also allow us to measure the fund's total portfolio allocation to these various portfolio buckets, relative to a baseline allocation that's been established. Additionally, we can measure the relative valuation of these betas, both relative to each beta's own history, as well as to the other betas present in the portfolio. We can also measure liquidity flows across beta exposures, as well. This allows us to help determine when overweight beta exposures are relatively expensive, and also if underweight beta exposures are relatively cheap. Having this insight allows for more optimal tactical rebalancing procedures, so that we can maximize the potential return enhancement coming from rebalancing. Having the policy statement reflect these tools and efforts is critical.

Finally, as it relates to our desire to more efficiently rebalance the fund's total portfolio using overlay managers, we would revise the language currently provided to allow for such an approach. We think timely, efficient and effective rebalancing is critical to help close the gap between the fund's significant return needs and future liabilities. We think the annual review provided for in the current policy is far too restrictive to be able to accomplish this.

2. After reviewing the enclosed info, please set forth how you would propose to structure the portfolio for each Fund (legacy and new). This explanation should include:

a. asset allocation (including asset classes and asset subclasses), portfolio structure (number of managers, use of active vs. passive strategies), types of accounts (separately managed, limited partnership vehicles, commingled funds, etc)

We have already described some of our philosophical approaches to asset allocation in Question 1 above, but to elaborate, we strongly believe in having a tactical component within a fund's asset allocation structure, much like the fund currently has. The notable difference in the Segal Rogerscasey approach is that we would use an overlay approach on the entire fund, rather than carving out a portion of the assets to fund the GAA/Risk Parity managers directly. In our approach, the overlay GAA/Risk Parity managers would be funded by an equitized collateral pool, which allows the fund to be fully invested, while also allowing efficient strategic and tactical shifts across the entire fund.

This approach necessarily involves modest amounts of leverage to be employed, and therefore requiring a rewriting of the guidelines as they pertain to leverage and derivatives use.

In the end, we would seek to create what we call a "2 Bucket" asset allocation structure, reflecting the points made above.

Bucket #1

Cash/Collateral reserves for making ongoing benefit payments, as well as providing necessary cash collateral for the overlay approach to GAA/Risk Parity described earlier.

Bucket #2

An alpha pool consisting of high alpha-seeking, conviction driven managers with low correlation to one another, and avoiding, where possible, equity beta risk. Within the Alpha generating pool, we would re-purpose fixed income investments away from Barclay's Aggregate-type mandates, and instead towards opportunistic fixed income investing including emerging market debt, high yield fixed income, structured credit and collateralized obligations. Unless used for interest rate hedging, government credit (U.S. and non-U.S. established markets) should be strongly de-emphasized.

Within the alpha pool, our natural starting point is to look at the fund's current managers. As a general rule, we do not wish to replace any more legacy managers than is absolutely necessary, in part to keep transition costs to a minimum.

That said, Segal Rogerscasey's approach to asset allocation calls for significant changes within the legacy portfolio, and these new approaches should be reflected in the new portfolio to be funded in 2013, as well.

It should be noted that we are unable to offer a precise asset allocation recommendation for either plan until we complete our own Asset Liability analysis. While we have reviewed the Actuarial Valuation Report prepared by Cheiron produced in November, 2011, we feel a complete review of the fund's liability structure combined with our soon-to-be released asset assumptions for 2012 offers the best starting point.

Our study would focus on the following:

1. A high frequency modeling approach for weekly asset returns and monthly liability valuations

2. A Stochastic volatility approach to model:

   a. Fat-tails

   b. Time-varying Sharpe ratios,

   c. Skewed return distributions to accommodate the fact that equity volatility tends to increase when equity prices fall and vice versa, volatility clusters and its mean reversion

   d. Time varying correlations (as equity market correlations increase toward 1.0 in down markets)

   e. Volatility from option strategies (where we'll measure both the market exposure and volatility exposure)

3. Asset class rebalancing over varying time periods (weekly to annually)

   a. Rebalancing across different asset classes

   b. Varying rebalancing based on liquidity

   c. Replicating Illiquid asset class capital call/distribution patterns

   d. Dynamic portfolio strategies – contingent of funded ratio, rate levels, etc.

4. Multi-factor interest rate and credit models underlie returns and liability valuations

    a. Borrowing cost implicit in leverage strategies

    b. Replicating the liabilities' true economics

Despite not having done this formal analysis, we can offer several comments on how we think the asset allocation would be altered.

First, we would move away from U.S. focused large cap equity managers, and instead towards actively managed, globally focused managers, and in particular, those with an orientation towards yield and low volatility.

We would also call for relatively more exposure to micro and small cap equity exposure, both in the U.S. and in the established international markets. And we would have a separate, discrete allocation to both emerging markets where we allow the manager to gain exposure to certain “frontier” markets on a tactical basis.

On the fixed income side, we would move away from a Barclay’s Aggregate focused approach, and in particular, de-emphasis exposure to government bonds, and instead use a more opportunistic approach to gain exposure to more credit sensitive sectors and securities, both domestically and internationally. We would want to see strategies such as Collateralized Loan Obligations and other types of structured approaches to fixed income. And we would want to see an allocation to emerging markets fixed income.

On the hedge fund side, we would move away from the current fund of funds approach, and instead move some portion of the current assets into direct portfolios, in part to reduce the double layer of fees the fund is currently paying. We would also seek out a combination of low volatility, diversifying strategies in addition to higher alpha seeking specialty funds, and opportunistically where possible. As an example, several funds have been created in the last several quarters to take advantage of the severe dislocations happening within the Euro-zone. Where there is an appealing risk/return tradeoff, we would want to use some combination of these funds where possible.

And finally, we would want to introduce, where the fund’s liquidity profile allows, certain illiquid strategies, particularly those that offer a high current yield. As but one example, there are funds investing in mature infrastructure portfolios currently owned by European banks which are seeking to offload some of their long-term holdings so that they are better able to meet the Basel 3 capital requirements. But we would also consider more traditional private equity and private debt portfolios, again within the limits that the fund's current liquidity and cash flow needs impose on us.

Wherever possible, and certainly for traditional portfolios, we would seek out separate accounts. But for non-U.S. strategies, and those in the alternatives/illiquid space, commingled vehicles will usually be most appropriate. We would certain pursue vehicles with a limited liability structure where leverage was employed, and we would also seek out offshore vehicles where UBTI was a concern.

The only circumstance where we would use passive strategies was where we needed a temporary "place holder" in the event that an active portfolio was not at that time available to us, for example, as part of a transition away from a manager where we lost confidence in their ability to outperform going forward. Otherwise we would be strongly biased towards actively managed strategies, and in particular, those that were very much conviction driven. Semi-passive or "benchmark hugging" portfolios are not appealing to us. We believe we should get the maximum possible benefit from active management, and not overly constrain these portfolios, apart from ensuring that we have appropriate levels of diversification and downside risk protection.

In terms of the number of managers, we would err on the side of having too few before having too many. We are strong believers in conviction driven investing, and we do not want to risk over-diversifying the portfolio and risk diluting the fund's alpha generating potential. Of course, we would have enough managers in place to make sure that we were appropriately diversified as defined by the funds' investment policy statements.

We would expect that for the GAA/Risk Parity portfolio, we would see fewer managers than are in place today. We fear that having so many managers making tactical shifts would dilute the benefit of having such managers in the first place.

b. your proposed fee, assuming that type of portfolio

Segal Rogerscasey's proposed fee will be 0.15% on all assets for a fully discretionary portfolio. Our fee is not influenced in any way by the type of asset allocation or manager combination we implement. We feel to do otherwise introduces a significant, unavoidable and unacceptable conflict of interest. Underlying manager fees are passed straight through to the sponsor, although Segal Rogerscasey will make every effort to negotiate competitive fees with the fund's underlying managers, and in a way that achieves the maximum possible alignment of interest between the fund and the underlying managers. Segal Rogerscasey is highly sensitive to achieving the highest possible risk-adjusted returns, *net of all fees and expenses.*

c. how you would envision transitioning the existing portfolio of the legacy Fund into the structure you propose and the associated costs and issues you anticipate

Once the overall structure of the two funds was determined following the completion and approval of our Asset Liability Study, we would undertake a formal review of each of the legacy asset managers to determine whether their existing portfolios were still appropriate, and if not, whether they could be modified to accommodate any new mandates. If they could not, they would be replaced by a new manager or combination of managers, and either via one or more of our 27 proprietary MasterManager^{SM} funds (at no additional charge to the plan sponsor), or if these funds would not satisfy our requirements, a manager or combination of managers with a buy rating from our in-house manager research group.

A preliminary review of the current asset allocation structure suggests that several managers will need to be replaced or see their portfolio mandates adjusted, but there are managers that are currently used that we could envision remaining in the fund, but this is only a preliminary assessment. A more formal review of each manager and their potentially revised role in the fund is required before we can say anything with certainty.

We make every effort to minimize transaction costs when either terminating, hiring or rebalancing manager portfolios. Our natural starting point would be to use the fund's custodian bank to assist in the transition, but external transition managers can be used where appropriate. To repeat an earlier point, we are extremely sensitive to keeping costs in check so that we can maximize the fund's net of fee risk adjusted performance.

d. Discuss how you would address both the negative cash flows from the legacy plan as well as the incoming cash flows for the new plan and describe how cash flows for both would impact the portfolio structure both at the outset of the relationship and over time.

Given the fund's low funding status of 43% (market value of assets to the present value of accumulated benefits), and high cash outflows relative to the market value of assets (18%), liquidity management will be of paramount concern in any asset allocation.

As it relates to the fund's asset allocation, we would (as described above), divide the portfolio into two broad buckets, each with a specific purpose. The first is a cash pool of sufficient size to cover ongoing benefit payments as well as cash collateral for overlay and any prudent use of leverage, in additional to funding opportunistic investments that may present themselves. We believe strongly (as the fund's current Investment Policy Statement also makes clear) in avoiding at all possible costs being in a position to make forced sales of illiquid assets, either to make benefit payments or because of major market dislocations impairing the funds' cash flows.

Having a liquidity pool of sufficient size will then allow us to construct an alpha seeking portfolio that can better capture illiquidity premiums and other opportunities, both strategic and tactical.

As for cash inflows, we would expect that both the new fund and the legacy fund would need to "pay their own way" in terms of satisfying benefit payments, so we would fund both in a way that did not impair either's ability to satisfy any required liquidity needs. Otherwise, we would ratably distribute these assets across their respective asset allocation mixes consistent with the policy that was developed upon completion and approval of our own Asset Liability Study.

3. Please provide a copy of the contractual agreement you propose.

See attached