Discretionary Investment Solutions for Gallagher Fiduciary Advisors' Client

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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?

We propose a complete overhaul of the Fund's Statement of Investment Policy (IPS) to incorporate best practices for good governance. We believe it is imperative the Trustees clearly articulate the Fund's objectives and risk tolerances, and there should be no ambiguity regarding authorities, responsibilities, and accountability.

Wurts & Associates Policy	Current Policy	Comments
I. Introduction/Purpose	I. Introduction	▪ Minor changes in language.
II. Investment Philosophy		▪ We will articulate an investment philosophy per Trustee approval.
III. Mission	II. Statement of Goals of the Fund	▪ We will utilize some of the language from Section II "Statement of Goals of the Fund" in the current policy.
IV. Objectives A. Return B. Trustees C. Chief Investment Officer (CIO) D. Third Party Managers	II. Statement of Goals of the Fund + IV. Role of Investment Managers	▪ We will explicitly state the return objective. ▪ We will establish objectives for the Trustees, CIO, and third party managers. ▪ The current policy mandates diversification for third party managers, but does not define any related metrics, nor address diversification when positions are aggregated across managers.
V. Time Horizon		▪ The time horizon will be clearly defined and based on the Actuary's wind up estimate.
VI. Risk Tolerances	II. Statement of Goals of the Fund	▪ Current policy statements are ambiguous, e.g., "Conserve the capital value of the Fund's assets." ▪ There should be explicit ex-ante volatility limits, drawdown limits, and liquidity limits.
VII. Asset Allocation	Appendix A: Asset Allocation + III. Asset Allocation Policy	▪ Within the current policy, the permissible ranges are wide enough to significantly alter the risk profile of the Fund, which may be an unintended consequence. On the other hand, the Policy is too granular with bifurcation of Domestic Equity. ▪ The current policy incorrectly treats Hedge Funds and GAA as asset classes. ▪ Our recommended Asset Allocation will be accompanied with a Risk Benchmark as a tool to govern the risk profile of the portfolio. ▪ The current policy is vague in terms of adding a new asset class when defining whether the "…Funds position will or will not be improved…"

VIII. Risk Guidelines A. Risk Benchmark B. Risk Limits a. Dollar allocations to asset classes and/or strategies b. Ex-ante Volatility c. Ex-ante Drawdown d. Relative Value-at-Risk e. Liquidity f. Private Assets g. Credit h. Leverage i. Active Risk j. Etc. C. Rebalancing Guidelines	V. General Investment Guidelines	▪ This section is inadequate for the portfolio's level of complexity and the current global investment environment. ▪ The Risk Benchmark is similar to the Asset Allocation, except the composition is established using only liquid market indexes.
IX. General Investment Guidelines	V. General Investment Guidelines	▪ There are several general investment guidelines we will recommend to retain, e.g., proxy voting. ▪ We will add new sub-sections; Securities Lending, and Authorized Investments.
X. Derivatives A. Objectives B. Authorized Investments	Appendix B: Derivatives Policy	▪ We propose more clarity in this section with explicit limits and authorized derivative instruments.
XI. Reports and Communication A. Risk Dashboard B. Performance C. Fees & Expenses D. Communication Protocol	VI. Reports and Communication	▪ We will deliver daily risk and performance reports via our secure website, as well as comprehensive risk and performance reports monthly. ▪ Reports will ensure Trustees have superior oversight into the Fund versus the current policy and practices.
XII. Third Party Managers A. Search & Selection Process B. Manager Contracts and Investment Vehicles C. Performance & Risk Monitoring D. Manager Terminations E. Manager Transitions F. Manager Reporting	IV. Role of Investment Managers	▪ Similar to prior comments, we will increase clarity and set expectations in the Policy to which the CIO and Third Party Managers must follow.
Appendix I: Glossary		▪ We believe that it is important to define technical terms found within the document, such that a lay person could decipher the Policy objectives and constraints.

As there will be a new fund (Mid Atlantic Fund) created, the IPS shall clearly define the fundamental difference in the investment objectives and management of this new fund and define separate risk and return objectives.

A sample of our investment policy work is available on Alaska Permanent Fund's website, www.apfc.org. We do not mean to imply, however, that FELRA's IPS will be identical to the APFC IPS. This recommendation is merely a sample of our work.

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:

- 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)
- your proposed fee, assuming that type of portfolio
- 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

Please refer to the RFP response for our investment philosophy and portfolio construction where we describe the following in detail:

1. Risk framework
2. Risk allocation
3. Risk management
4. Use of Alpha and Beta exposures and the relevant investment vehicles
5. Use of Public vs. Private assets
6. Use of Active vs. Passive managers

Based on the above and the requirements of the legacy Fund, we propose the following structure for this Fund:

Risk Allocation	Weights	Active vs. Passive		Type of Account	Number of Managers	External Manager Fees (bps)	Weighted Fee (bps)
		Active	Passive				
US Equities	4%	0%	100%	Mutual Fund	1	6	0.3
Developed Equities (ex-US)	6%	0%	100%	Mutual Fund	1	9	0.5
EM Equities	10%	0%	100%	ETF	1	20	2
Total Equity	**20%**	**0%**	**20%**				
Developed Sovereign Bonds	5%	0%	100%	Internally Managed	0	0	0
EMD ($ & LC)	10%	100%	0%	Mutual Fund	1	83	8
Total Rates	**15%**	**10%**	**5%**				
Global IG Corporate	10%	50%	50%	ETF, Mutual Fund	2	30	3
Global High Yield Bonds	10%	50%	50%	Mutual Fund	2	39	4
Bank Loans	10%	100%	0%	Mutual Fund	1	75	8
Total Credit	**30%**	**20%**	**10%**				
Commodities	5%	0%	100%	Internally Managed	0	0	0
Total Inflation	**5%**	**0%**	**5%**				
Hedge Fund Beta	15%	0%	100%	Commingled Fund	2	100	15
GAA/Risk Parity	15%	100%	0%	Commingled Fund	3	50	8
Total Other	**30%**	**15%**	**15%**				
Total	**100%**	**45%**	**55%**		14	Weighted Average Fee	**48**
						Wurts Fee (bps)	36
						Total Fees (bps)	**84**

The above portfolio was designed based on the factors and risk philosophy mentioned in our RFP response while keeping the existing Fund holdings in mind. Wurts' fees are from the staggered fee schedule based on AUM we shared in our RFP response. The bulk of the management fees are coming from the hedge fund allocation. We believe these could be brought down further by looking into lower cost GAA mandates currently in the legacy Fund, which may contribute positively to the overall target risk factors in the portfolio.

The risk allocation for the new fund (Mid-Atlantic Fund) is based on the positive cashflows and the Fund's small size in the initial years. An additional consideration is the ability to transition into a more effective asset allocation with investment vehicles where larger size and private market is required.

Risk Allocation	Weights	Active vs. Passive		Type of Account	Number of Managers	External Manager Fees (bps)	Weighted Fee (bps)
		Active	Passive				
US Equities	4%	0%	100%	Mutual Fund	1	6	0.3
Developed Equities (ex-US)	6%	0%	100%	Mutual Fund	1	12	0.7
EM Equities	10%	0%	100%	ETF	1	20	2
Total Equity	**20%**	**0%**	**20%**				
Developed Sovereign Bonds	5%	0%	100%	Internally Managed		0	0.0
EMD ($ & LC)	10%	100%	0%	Mutual Fund	1	83	8
Total Rates	**15%**	**10%**	**5%**				
Global IG Corporate	15%	0%	100%	ETF, Mutual Fund	2	30	5
Global High Yield Bonds	15%	100%	0%	Mutual Fund	1	66	10
Total Credit	**30%**	**15%**	**15%**				
Commodities	10%	0%	100%	Internally Managed		0	0
Real Estate	10%	100%	0%	ETF	1	10	1
Total Inflation	**20%**	**10%**	**10%**				
Hedge Fund Beta	15%	0%	100%	Commingled Fund	1	100	15
Total Other	**15%**	**0%**	**15%**				
Total	**100%**	**35%**	**65%**		9	Weighted Average Fee	**42**
						Wurts Fee* (bps)	0
						Total Fees (bps)	**42**

*No Wurts fee for first 3 years

Due to the Fund's smaller size and possible additional overhead costs related to investment size, we are proposing no Wurts fee for the first 3 years of the new Fund. After 3 years, Wurts' fee would move to the staggered AUM based fee schedule.

<u>Transition of the Legacy Fund to New Risk Allocation:</u>

It is necessary to facilitate an orderly and efficient transition of the fund to the proposed risk allocation. This needs to be efficient on both a cost and operational basis in order to reap the intended benefits of the risk factor allocation. The prime objective is to attain the proposed aggregate risk factor allocation for the Fund over a medium term, while aligning the Fund as close as possible to the proposed risk factor allocation in the short term without compromising on costs and potential operational issues. We will adopt a portfolio and investment manager rationalization approach which would depend on a number of factors and issues including, but not limited to:

1. *Investment mandate risk factor*: Contribution by risk factors of the existing investment managers to the overall proposed target risk factors in aggregate for the legacy Fund.
2. *Asset class type*: Liquidity and bid/ask spreads in each of the asset class and sub-asset classes.
3. *Active vs. passive mandate*: The ability of investment manager to create alpha.
4. *Management fees*: Fees being paid to the manager for the respective mandate and their ability to consistently generate alpha against the fee being paid for the service.
5. *Type of investment vehicle*: Whether the mandate is under a separately managed account, commingled fund, or mutual fund, would determine how liquid the investment is and the resulting costs associated with liquidating individual positions vs. getting an end of the day NAV. Separately managed accounts may need to be managed through a transition manager so that there are no unnecessary turnover costs associated with the rebalancing.
6. *Legal*: Any lock-ups with the investment managers may determine how much flexibility there is to decrease the exposure or alternatively change the investment mandate for that account.

In addition to the above, based on the asset allocation shared, we will adopt the following rebalancing strategy in each of the asset classes:

Equities

We will rationalize the number of active managers and focus on reducing costs by using mostly passive mandates. As 90% of the returns are determined by the asset allocation mix for the funds, we will be selective in the use of active managers in this space. Using a dedicated team in our Manager Research Group, we will conduct a thorough due diligence on the existing equity managers and determine their likelihood of generating alpha given their fee structure. If the active management justifies their fees, we may retain them partially. If there is a need to cut down the equity exposure as per the new risk allocation mentioned above, the number of managers would be smaller.

Fixed Income

Since only 12% is currently allocated to this asset class versus a much higher allocation in the proposed risk allocation, the current exposures in High Yield and Barclays Aggregate could substitute for High Yield bonds and Investment Grade bonds. However, a manager analysis would be conducted by the Manager Research Group to ascertain the value add by each manager for the fees being paid.

Global Asset Allocation

Due to the nature and size (35%) of these mandates, it is necessary to look at the underlying risk factors that each of the investment managers is exposing the Fund to, and then map them against the required risk factors as per the proposed risk allocation. Our proposed allocation already includes 15% to the GAA/Risk Parity mandates, therefore, some of the managers may be retained under the existing mandates. Some of the GAA mandates may be more flexible than others if the investment vehicle gives flexibility to increase or decrease the exposures (separately managed account with lock-ups vs. commingled funds with liquidity). Depending upon the strategy of these managers, some managers may even qualify for the "Hedge Fund Beta" bucket in our risk allocation. Rationalization in this category shall require a combination of retention of existing managers, swap with Hedge Fund Beta, possibly a reduction in mandate size, and changes to the investment mandate in the short term before the exposures in this bucket are explicitly mapped to the proposed risk allocation.

Hedge Funds

Since our target asset allocation to hedge funds is 15% versus the existing 10%, we may not have to change this in the short term, however, we will conduct a thorough review of the existing hedge fund managers and evaluate them on the basis of alpha generation versus the fees being paid. Our target is to have 15% Hedge Fund Beta exposure and look into the possibility of having some Hedge Fund Alpha if justified.

3. 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.

Legacy Fund

Liquidity of the fund is an extremely important factor to be considered for the legacy fund. As the cashflow projections shared, net cash outflows progressively grow from 12% of the total assets in 2012 to 23% of the total assets in 2016, ultimately consuming all assets by year 2021. It is important to construct a portfolio that has much smaller drawdown than a typical 60/40 portfolio. A major draw down on the portfolio can have a significant effect on the solvency time horizon of the legacy Fund.

It is equally important that most efficient investment vehicles and exposures are used to construct the portfolio. Given a large percentage of the portfolio that would be liquidated each year, there is a need to rebalance the portfolio exposures in addition to making sure that cash is available. The cash yield of the portfolio will be one source of generating cash and our portfolio construction makes sure that the cash yield on the portfolio is much higher than a typical 60/40 portfolio.

Since the net cash outflows are mostly known at the beginning of each year, it is important to conduct cashflow forecasting. This exercise would entail the sources and use along with timing of cash and the resulting rebalancing required at different dates within each year. The forecast shall also include a normal and stressed market scenario to make sure that the cash obligations are met in either of the market scenarios.

New Fund

Just like the legacy fund, the new fund has a liquidity need, but for a different reason. The size of the fund is very small in the initial years and it builds up over time due to net positive cash inflows. This means that the portfolio needs to be structured carefully in liquid low cost strategies. It is relatively easier to change allocations later when the size allows it to be invested in more illiquid assets and low cost investment vehicles.

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

A standard investment consulting agreement has been included under Tab II for your conveience.