SPECIAL MEETING OF THE BOARD OF ADMINISTRATION
RETIREMENT BOARD
WATER AND POWER EMPLOYEES' RETIREMENT PLAN

MINUTES – OCTOBER 3, 2002

Present:

Javier Romero	President
Dan Mirisola	Vice-President
Lilly Calvache	Board Member
Norma Bertrand	Board Member

Absent:

David H. Wiggs	General Manager
Ron Vazquez	Chief Financial Officer
Anne E. Cho	Commissioner

Others Present:

Duamel Vellon	Retirement Plan Manager
Sangeeta Bhatia	Assistant Retirement Plan Manager
Silvia Tesseneer	Recording Secretary
Mike Wilkinson	Deputy City Attorney
Neil Rue	Pension Consulting Alliance

President Romero called the meeting to order at 10:05 a.m. after the Pledge of Allegiance.

[Pledge of Allegiance]

Mr. Vellon indicated there is quorum of the Board present. He also indicated a new Board Member, Commissioner Annie Cho, was appointed to the Retirement Board last Tuesday, October 1st. He added she confirmed her attendance to the regular Board Meeting October 16.

PUBLIC COMMENTS
President Romero inquired if there were any public comments and there were none.

Mr. Neil Rue approached the table.

1. **Consideration and implementation of Board allocation of 15% of the Plan's assets (approximately $900 million) to International Equity investments:**
   a) **Determination of Portfolio characteristics**
   b) **Selection of asset class benchmark.**
   c) **Determination of number of managers, dollars allocations, and funding sources.**
   d) **Authorization of Request for Proposal (RFP) process.**

Mr. Rue pointed out this meeting was primarily to cover the two major components of international equity investments. Mr. Vellon clarified the amount originally allocated to International Equity, approximately $900 million, was based on June 30 market values and the amount was adjusted to $784 million, based on September 27, unaudited, Bank of New York market values.

Mr. Rue continued to explain why International Equity is important. The primary reason is it provides long-term growth and offers diversification when compared to domestic equity. He pointed out the two asset classes providing big growths are domestic equity and international equity. He noted, when one takes into consideration inflation, the numbers change drastically, and what's important, from the investment viewpoint, is the plan needs growth to ensure retirement benefits will continue.

He explained when one invests in international equity; one doesn't invest in dollars, but in foreign currency, such as pound, corona and franc. He went into explaining the relationship between the currencies and the dollar and the fluctuations against one another, adding an element of volatility.

Mr. Mirisola suggested the tape of this meeting be available to the Board members who could not attend. He asked Mr. Rue to state the page number throughout his presentation so interested Board members can follow along.

Mr. Rue explained the concept of diversification and standard deviation of returns. He discussed historical risk relationships relative to global equity portfolios.

Mr. Vellon inquired if there is an anomaly in standard deviation, within a short period of time, would there be a longer time frame to provide more comfort as to the true measure of risk (standard deviation) for a particular asset class. In other words, is risk, measured by standard deviation, predicated on time? Mr. Rue responded standard deviation varies by time and that one would want to look at risks from an investment cycle standpoint, which is a 3 to 5 year timeframe. He added there are different ways to measuring risk, but the basic trend is the longer time frame one uses for investments, time will reduce the distance of outcomes; the maximum outcome and the worst outcome.

Mr. Vellon inquired about the correlation of returns between domestic equity and international equities. Mr. Rue responded correlations are not stable and, in the international equity markets, all the equity markets have been jerked around together because of all the crises in the 90's and has caused correlations to increase. He explained there is a present debate in the industry, because of globalization, whether or not correlation will stay up there and if they stay higher, then the diversification benefits go away. He noted, as correlations drop, which means that things behave more differently, then correlation is better for diversification. When asked his opinion as a consultant, Mr. Rue stated current valuations suggest a cyclical peak in correlations. He explained the correlation between domestic and international equities right now can range between –1 (moving in completely opposite direction) to +1 (moving exactly the same) and 0 (meaning there is no relationship). He added, right now the correlation is pretty high, between 0.7 and 0.8, based on monthly returns, coming from a 0.4 in the mid 90's. He expressed his opinion correlations will decline to a 0.5 to 0.6 range, which is their long-term historical average.

Mr. Vellon inquired whether the two asset classes can be considered as correlated perfectly or inversely and what would be Mr. Rue's projection relative to possible fit for the Plan's portfolio. Mr. Rue responded the numbers suggest these are going to be somewhat related, but that there are diversification benefits for going into international equity.

Ms. Bertrand inquired what the correlation was between international equities and political unrest in various countries, especially in the Far East. Mr. Rue responded this was clearly a risk and there is a lot of volatility associated with those markets, because of political unrest and that is one of the things Board members will have to consider when making the decision on whether or not to participate in those types of markets. He indicated emerging markets offer moderately higher returns but are significantly more risky. He pointed out, since the mid 90's, having a global equity portfolio is less risky than having just a U.S. or regional portfolio.

Mr. Vellon inquired if, assuming the predicted correlation returns to normal levels (of 0.5) in the future, if one would estimate domestic equities are going to make 10% over the longer period of time, what should be the expected return of international equities, if that correlation holds. Mr. Rue responded they are independent and one doesn't drive the other. He indicated one can't forecast who is going to do better, the U.S. or international, and one should be skeptical of anyone who does. He added the correlation is not perfectly related to each other and, because of that, one should get a global portfolio less risky than just holding a regional portfolio.

Ms. Bertrand inquired if Mr. Rue's modeling was based on a 3-year rolling standard, which would appear on the low side in terms of time horizon. Mr. Rue indicated the 3-year rolling highlights trends well, but he uses a 5-year rolling when developing expectations. He reiterated one would attain growth, and a less risky equity portfolio, if one includes international equities. Mr. Rue continued by elaborating on the nature of international equities including marked vales of various economies, compared with the U.S. He noted opportunities are often created by companies traded in the U.S. markets, as ADRs, which may at the same time be trading at more favorable levels in foreign markets.

Ms. Bertrand commented ADRs limit the liability, vis-à-vis, political unrest and currency exchange, because the sectors do play into the price of international equity. Mr. Rue responded ADRs are not always the best place in the world to buy certain company stock, unless one has expertise monitoring these stocks outside of the U.S. Ms. Bertrand added another item for consideration is the protection provided by the Securities and Exchange Commission (SEC). Mr. Rue agreed with Ms. Bertrand, but noted there is a current debate whether U.S. has the best standard these days, especially with the very big companies who have perpetrated fraud even under the SEC rules in place.

Mr. Rue explained where the investments tend to go when one invests in international markets. He stated the bulk of money goes to the U.K., Japan and Continental Europe and active managers, if hired, make the tactical decision on whether to be there or not. He noted funds would not be exposed to emerging markets (Middle East, Pacific Basin, Latin America) unless Board members adopt some specific choices.

Mr. Mirisola commented, according to Mr. Rue's last statement, if the Plan would have been invested in 60% domestic equity and 15% internationally, the losses would have reduced by 8%. Mr. Rue pointed out, for the last two years, international markets have been doing better than the U.S. markets, due to the weakening U.S. economy and the weakening of the dollar. More discussion ensued about the historical trends in international markets.

Mr. Vellon inquired if, looking at the emerging markets, versus the developed markets, would it be a correct statement to say the emerging markets would present more of a risk, than the developed markets. Mr. Rue responded in the affirmative adding emerging markets are 50% more risky than developed countries such as G-7, but when put together, risk is diversified to a modest amount within an international equity portfolio. He then indicated, in spite of the volatile performance, the ratio of emerging markets has stayed constant at the 10% level since 1994, so it has represented a material proportion of non-U.S. equity markets. He added, in emerging markets, return on equity and investments are typically higher, representing a better value and significant economic growth. He clarified emerging markets doesn't mean one will be investing in primitive, tiny companies, since there are huge companies such as Samsung, Taiwan Semiconductor (the largest chip manufacturer in the world), etc. and the only way to purchase these, is by hiring an emerging markets manager. He pointed out, another risk in emerging markets in the "contagion factor", which means if something happens in Russia it goes all the way over to Latin America and all those markets tend to fall as well. Mr. Rue noted many emerging countries are adopting more prudent governance standards, political reforms are taking place, improved accounting practices, and modernized market structures have been created. Mr. Mirisola added, after the September 11th event, the markets declined dramatically, but had there been a similar incident in an international market it wouldn't have caused the level of market to decline, as was the case in the U.S.

Mr. Rue described what happens when one incorporates emerging markets into a broader benchmark. He explained there is a correlation between emerging markets and the rest of international markets and if it goes a certain way it can be beneficial, but it represents a marginal benefit. He explained how benchmarks (EAFE Index, G-7 countries and ACWI ex-U.S., EAFE plus emerging markets, Canada and a couple others) all interact with one another and their volatility is a benefit, from a risk return standpoint, and the return may be about the same, but the risk is 5% less when one uses a broad benchmark.

Mr. Vellon inquired if, in a general sense, when one compares international equity with domestic equity, which would be more risky. Mr. Rue responded statistically they are both about the same, but in the general sense, the U.S. is more risky and the risk of both has gone up. Mr. Vellon inquired if the two equities are equally risky, what would be the reason for the Board to diversify into international, if they have the same risk/return characteristics. Mr. Rue responded these two asset classes are not correlated with one another, and a world equity portfolio is less risky than either one apart, by themselves. He stated, with respect to international, the incorporation of emerging markets (which is "by and large" the primary difference between the EAFE, the G-7 index and the ACWI ex-U.S.), lowers the risk. He reiterated if one has more things incorporated into the benchmarks, this lowers the risk of the benchmark, which represents a benefit of diversification.

Mr. Vellon, again, inquired if this is the reason why Mr. Rue thinks international equities would have less risk than domestic equities. Mr. Rue reiterated, when put together, these two classes behave differently, and their correlation is low, which is why both should be included in the Plan's portfolio.

Mr. Rue summarized the role and characteristics of international equity as follows: Real growth, international equity helps to diversify the equity component, significant exposure to large companies outside of the U.S., broader market proxies have marginally better risk-adjusted results than a G-7 type proxy, and international equity should perform well when the U.S. dollar weakens.

Mr. Vellon reiterated Ms. Betrand's point, to the effect international equity add elements of risk, such as instability of governments of the different regions, which do not exist in the domestic equities Board members are familiar with. He added the currency risk as another factor with companies trading in foreign currency. He emphasized these are factors the Board members need to understand, because the behavior of such securities in any short term, will show these risks. He pointed out, these factors, when considered together, will show a different portfolio behavior than a purely domestic equity portfolio and this is why one would try to diversify. Mr. Rue responded anything could look bad in a short period of time. He reported, in the past 18 months, international equity has been the better because of diversity of currencies, the weakening of the dollar, and because the U.S. has been called regarding governing issues that the rest of the world is not dealing with. Mr. Vellon expressed the Board needs to look at the long term, because the fact a market is doing well today doesn't mean that will always be the case. He stated there should be a long-term expectation of a certain performance that is going to benefit the Plan, and it is important, when going into this kind of asset class to have the discipline to allow it to perform.

Mr. Vellon reminded the Boardroom was scheduled for another Department meeting at 12 noon.

The President called for a 15-minute recess at 11:08 a.m.

[Recess]

The meeting reconvened at 11:23 a.m.

Mr. Rue began to outline key factors influencing investment management performance such as going active or buy an index funds (passive). Mr. Rue listed the different types of managers (broadly diversified international, European, Pacific Basin, and emerging market) and went on to state broadly diversified managers had a tough time in the early 90's, but by the mid 90's they outperformed 70% of the time. Mr. Vellon requested Mr. Rue to define "broadly diversified". Mr. Rue defined "broadly diversified" as the discretion to invest within broad parameters, across the G-7 countries, and some of the products have the discretion to invest into emerging markets, and they are benchmarked against a "developed market only" benchmark. He reported the translation of the active management trend, on average, is about 3% excess return over the benchmarks since 1995 and have very rarely under - performed the benchmark in a 3-year cycle. He indicated European managers have less success, describing them as less consistent, outperforming barely over half the time, and having a volatile trend, while Pacific basin managers outperformed less than half the time, and their added value trend is cyclical and not consistent. He indicated emerging market managers have the best track record, outperforming the benchmark 75% of the time with an excess return averaging 3% to 4%. He added, when the Board selects managers, the odds are they are going to find a manager that adds value versus the benchmark. He stated, with an account of the DWP's size, fees would not be anymore than 25 to 50 basis points for a broadly diversified international manager and between .5% and 1% a year for an active emerging markets manager, and factoring such costs, if the average manager is producing 3% to 4% over the benchmark they net out to 2.5% to 3% return. Mr. Vellon inquired about the high percentage of active managers outperforming the benchmarks. Mr. Rue responded this does not happen everywhere; it happens with the broadly diversified and emerging markets wherein managers are allowed discretion to move along the markets. He added stock selection has modestly helped, but not to the degree of significant value that market allocation has done over time. Mr. Vellon inquired if there is something highly inefficient about those markets to justify 75% of the managers outperforming the index. He inquired if the market is efficient, do these people have certain knowledge or the measures of efficiency of the indices are not based on reality. Mr. Rue responded once one starts venturing outside of the U.S. the efficiency tends to get marginally worse, allowing “opportunity” to present itself to active managers. Mr. Vellon inquired about the range of typical turnover in this type of account. Mr. Rue expressed it difficult to say, but there are low turnover mangers from 25%, which means a manager will hold a stock for four years. Mr. Vellon suggested the numbers Mr. Rue provided make a case for active managers versus passive. Mr. Rue added the evidence doesn’t look as good with European managers, whereas broadly diversified managers add value.

Mr. Rue compared growth vs. value managers, but stated, regardless of the behavior going on at the time, both types of managers can outperform the benchmark at the same time, and this doesn’t happen in the U.S. Ms. Bertrand inquired about the meaning of PMI. Mr. Rue defined the term as principal markets index by Solomon Smith Barney (who breaks it up into value/growth indexes), which is ahead of Morgan Stanley Capital International (MSCI) (who produces the EAFE index).

Mr. Rue advised if Board members elect to go into emerging markets, there are choices of giving the manager a broad mandate to go into every market they so desire, or a collection of dedicated emerging market managers where that’s all they do. He indicated when giving a broadly diversified manager extension into the market, they hold less emerging market securities than a dedicated manager and their portfolio ends up being less diversified, resulting in the same return but with huge volatility. He outlined the considerations for portfolio management as follows: The pacific basin as the diversification driver in non U.S. markets, potential for consistent added value when managers are given a broad mandate, managers add value by country and regional allocation, growth and value both outperform the benchmark, and dedicated emerging market managers being a better approach, instead of diversified managers with extended mandates.

Mr. Vellon inquired how many managers are recommended. Mr. Rue indicated what geographical peers (CalPERS, CalSTRS, LACERS, LA F & P, and SFERS) are doing at this time. He stated all of them have exposure to emerging markets to varying degrees. He noted, the bigger funds tend to have more passive, given the scale of assignments would call for 30 or more managers, and in turn end up with average results, while the smaller funds (similar in size with DWP) tend to be active. Mr. Wilkinsons questioned if the average fund exposure to emerging markets is relatively neutral at 10% of the portfolio versus the index. Mr. Rue indicated the three city funds have more of a tilt to emerging funds, but he is not advocating that. Mr. Wilkinson further inquired if the average fund is roughly neutral and the 10% is about what the market weight is. Mr. Rue agreed and stated this average is based on the five geographical peers.

Mr. Rue suggested the first decision would be to adopt an asset class benchmark, deciding whether or not to participate in emerging markets. He indicated this would allocate 10% of the International Equity portfolio to emerging markets. Mr. Vellon suggested Board members focus on making this decision first. Board members agreed to consider each decision individually. Mr. Rue reminded Board members PCA's recommendations were summarized all together, but the Board may take them one at a time. Mr. Vellon suggested considering the first decision of including emerging markets, which would be done by the Board's adoption of the proposed index. Mr. Rue suggested doing this by recommending Board adoption of the "MSCI All Country ex-U.S." Free index as the benchmark. Mr. Vellon noted the implication of this action would be the exposure to emerging markets. Mr. Rue concurred and added one could also adopt the MSCI EAFE Free index, which is primarily G-7 countries, but this was not his recommendation. Mr. Rue suggested if LADWP was uncomfortable with emerging markets, to get additional education or exclude them and wait for the next policy review (two to four years later) and reconsider at that point.

Mr. Vellon asked if PCA was recommending the Board consider emerging markets at the onset or two to four years from now. Mr. Rue responded he recommended a decision now. Mr. Vellon stated if this item can be resolved it would easier to move on to other issues.

Mr. Romero indicated he had recently been to a conference and most of the Plans already had emerging markets in their portfolios and were considering increasing their international as well as emerging markets. He added, being that DWP does not possess any at all, and this is the trend of other pensions, and the hired consultant (PCA) is recommending this, he feels the necessary education is there to make a decision. He noted he personally feels comfortable with the recommendation.

Ms. Calvache stated, since being walked through the information, she has a better understanding and asked how much would be the emerging market exposure. Mr. Rue suggested the Board adopting a benchmark and clarified the benchmark has about 10% exposure. Mr. Vellon noted the implication of adopting the index is the Board adoption a 10% (of a the International portfolio) exposure to emerging markets.

Mr. Vellon clarified notes were being taken and Board resolutions would eventually be drafted for formal Board approval at the next meeting, once the appropriate motion was in place.

Mr. Mirisola inquired if anyone had any input and if everyone was ready to vote on accepting the recommendations by PCA. Ms. Bertrand expressed her reservations regarding emerging markets, stating she would rather see the MSCI EAFE index, which allows entry into international, minus the emerging markets, because of its safety throughout lower volatility. Mr. Rue expressed there was nothing wrong with doing that and it depends on the collective comfort level of the Board. Mr. Vellon commented there has to be some sort of decision in order to give PCA direction. Mr. Mirisola indicated he did not see a reason not to include emerging markets based on the presentation. Mr. Vellon commented a consensus was the ideal scenario. He added there was nothing wrong with having one approach, with emerging markets or without, because the bigger decision would be whether to diversify to international equity, which is a major decision for this Plan. He stated whether or not to get into emerging markets at this point is a secondary concern.

Ms. Calvache stated, after the presentation, she now feels comfortable and Board members needed to move forward. Mr. Romero inquired if everyone agreed on the international being MSCI EAFE. Mr. Rue clarified the decision would be MSCI EAFE if the Board did not want emerging markets in the portfolio. Mr. Romero asked if emerging markets were desired at a later time, what would be the process. Mr. Rue responded if the Board adopted the EAFE, this would be setting the asset class and the Board would have to come back sometime in the future and redefine the asset class. Ms. Bertrand stated that is just a matter of a resolution. Mr. Vellon commented it would only take meeting, doing the resolution and deciding whether to go ahead with emerging markets. He emphasized a full Board consensus is important, because this is a major decision for the Plan. Mr. Mirisola indicated he was in favor of taking the excellent advice of the consultant of adopting the "MSCI ACWI ex-U.S." index for the reasons of keeping up with DWP's peers and doing it once, rather than revamping it later. Mr. Romero agreed.

Mr. Rue clarified there are risk-adjusted benefits going into emerging markets and it is very volatile by itself, but when added with the other asset classes it adds benefits. Ms. Calvache expressed her comfort, considering everything she had heard in the presentation and asked if the Board wanted to take it to a vote. Ms. Bertrand indicated there was no point in voting because four votes were needed. Mr. Mirisola suggested voting anyway to see where they stood.

Vice President Mirisola moved approval of PCA recommendation. Seconded by Ms. Calvache and carried by majority after the following vote:

Ayes: Romero, Mirisola, and Calvache
Nays: Bertrand

Mr. Romero questioned Mr. Wilkinson on where the Board stood at that point. Mr. Wilikinson responded there was a requirement of four votes. Mr. Mirisola interjected that was already decided and the Plan didn't require four votes and the Board already ruled on it. An argument ensued between Mr. Mirisola and Mr. Wilkinson on what the Plan states in regards to how many votes are required as far as investment decisions is concerned.

Mr. Vellon suggested, in the interest of time, the Board continue with the decision making process and come with the resolution at the next Board meeting at which time a Board vote will be required. Mr. Rue requested the Board come to a decision on the active/passive structure. He advised opportunity for better returns existed in the market, and thus, PCA's recommendation is 100% active portfolio. He provided another option of 80% active and 20% passive, which would provide rebalancing among the asset classes, and maintain liquidity in the portfolio, but 100% active is still recommended.

Vice President Mirisola moved approval of PCA recommendation. Seconded by Ms. Calvache and carried unanimously after the following vote:

Ayes: Romero, Mirisola, Calvache, and Bertrand
Nays: None

Mr. Rue discussed the PCA recommendation of a structural design consisting of three active mangers if the Board decided on developed markets and two more active managers if and when the Board decided on emerging markets.

Ms. Calvache moved approval of PCA recommendation. Seconded by Vice President Mirisola and carried unanimously after the following vote:

Ayes: Romero, Mirisola, Calvache, and Bertrand
Nays: None

Mr. Rue suggested action steps to be taken for the structural option just adopted by the Board. He inquired if advertisement of proposals was required and indicated RFPs (Requests for Proposals) needed to be issued for the different types of managers. Mr. Vellon recommended everything be kept within DWP's standards. He reported the Board of Commissioners favor competition and documentation of RFP's. He added the Board was scheduled for a meeting on October 9, which Mr. Rue was to attend, wherein the Board would bring all the resolutions into place and subsequently there could be written directions to PCA to avoid misunderstandings through verbal directions. Mr. Rue continued by stating RFP's would be issued, the managers would be given a three-week timeframe to complete the RFPs, and a week to score them. Mr. Vellon requested when PCA received the proper written instructions, they proceed with the action steps, submit a report to the Board stating what was received, the criteria for the RFPs, responses, people included for consideration, and so on. Mr. Mirisola agreed, stating that was the standard procedure. Mr. Rue explained the final result would be the Board interviewing between 6 to 12 managers in a day and making a decision with the participation of PCA.

Mr. Vellon expressed an important factor of deciding the source of funding, whether giving all cash to the new managers or instructing the managers to build cash. Ms. Bertrand commented this could be included in the RFP and in a resolution of the Board.

The Board meeting was adjourned at 12:07 PM.

JAVIER ROMERO President	DUAMEL VELLON Secretary

SILVIA TESSENEER
Recording Secretary