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STATE OF VERMONT
OFFICE OF THE STATE TREASURER

Proposal to

UNITIZE THE ASSETS FOR PURPOSES OF INVESTMENT OF THE VERMONT STATE TEACHERS' RETIREMENT SYSTEM VERMONT STATE EMPLOYEES' RETIREMENT SYSTEM VERMONT MUNICIPAL EMPLOYEES' RETIREMENT SYSTEM

12/10/03

Purpose

- To invest the assets of the Vermont State Teachers' Retirement System (VSTRS), the Vermont State Employees' Retirement System (VSERS) and the Vermont Municipal Employees' Retirement System (VMERS) in a manner that is more cost and resource efficient than under current practice and that improves the oversight and management of the three systems' assets.

- To maintain the actuarial, accounting and asset allocation integrity of each System.

- To respond to Act 66, Section 40 (a), of 2003: *The state treasurer, in consultation with the retirement boards referenced in 3 V.S.A. § 471, 16 V.S.A. § 1942 and 24 V.S.A. § 5062, shall develop a proposal to unitize the assets of the pension funds for the Vermont employees' retirement system, the state teachers' retirement system of Vermont, and the municipal employees' retirement system of Vermont. The proposal should include an estimate of projected cost savings and a plan for administration and governance of the unitized fund, as well as a schedule for implementation of the proposal. The proposal shall be submitted to the house and senate committees on appropriations and government operations by January 15, 2004.*

Objectives

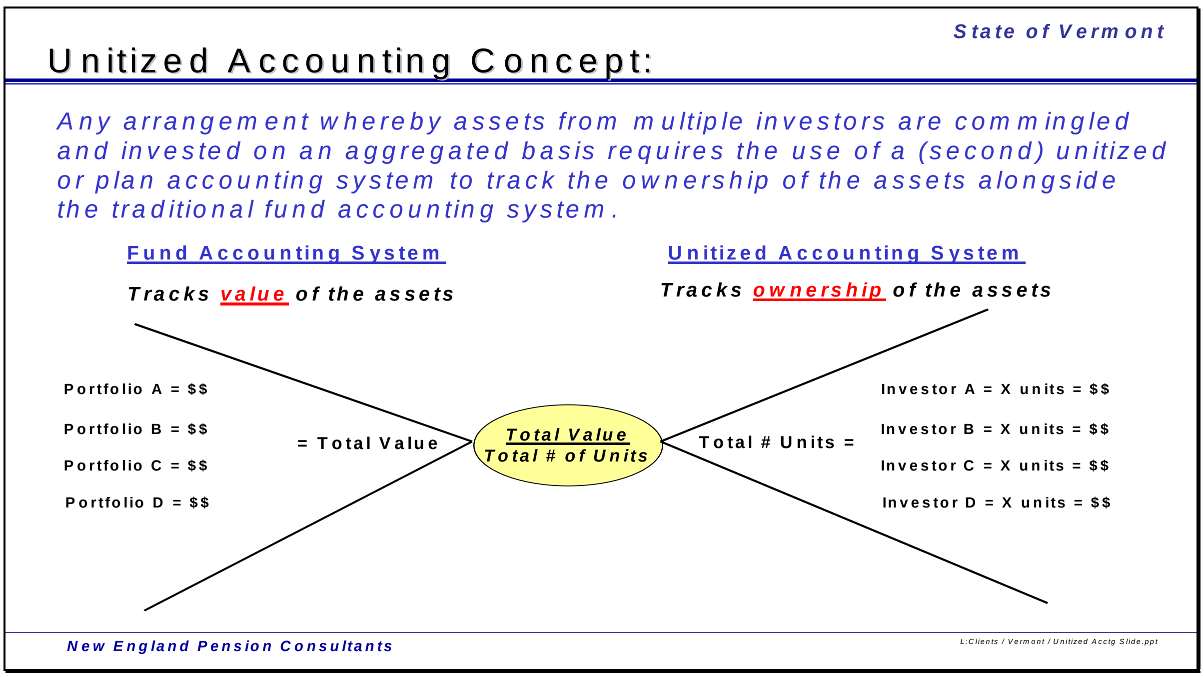
- To reduce management, advisory and custodial fees by combining investments in common asset classes (e.g., Large Capitalization Value, Global Fixed Income). Estimated savings are in excess of $900,000 per year.

- To improve the effectiveness of the Systems' investment decision and oversight processes by focusing staff, advisory and board resources through an appropriately sized and balanced joint Vermont Pension Investment Committee.

Unitization of Assets Defined

Unitization is a form of investment accounting that allows one pension fund's assets to be pooled with the assets from other pension funds for investment purposes, while maintaining its own separate identity for actuarial, accounting and asset allocation purposes. Each pension fund in a unitized system essentially owns shares in a pool. Investment growth and income are allocated to the individual funds based on the number of shares owned.

The pension funds will not be combined into a one-size-fits-all structure. Rather, each asset class will be a separate investment sleeve and each system will be able to invest in a particular sleeve, depending upon the system's unique asset allocation.



Estimated Cost Savings

While each system will retain its unique asset allocation, significant savings will be achieved through increased efficiencies and economies of scale.

Since investment manager fees are based on a tiered fee schedule, with the size of the portfolio under management ultimately determining the average (%) fee paid for each account, by consolidating assets in principal asset classes, management fees will be reduced considerably by this proposal. For example, at present there are five separate large cap managers for the three pension funds: Fidelity, Baring, Alliance, Delaware and

SSGA. These five managers collectively manage eight individual equity portfolios, which under a unitized system could be combined into three to four portfolios held in one unitized large cap equity sleeve. This same process can be applied to small cap, international, fixed income, real estate and alternative asset classes.

Immediate cost savings will be achieved at State Street, our custodian bank, because the total number of individual accounts and portfolio transactions will be decreased. In addition, some commingled funds will be able to be eliminated, allowing for greater securities lending exposure and additional revenue. Additional savings will come from the investment consultant, NEPC.

Staff and administrative expenses in the Vermont Treasurer's Office will be reduced and available for reallocation with the creation of the Vermont Pension Investment Committee. At present, in addition to administering an unusually large number of contracts for pension assets the size of Vermont's, several staff members of the Treasurer's Office prepare for, attend and support quarterly investment meetings for each of the three boards.

NEPC has estimated savings, not including savings in the Office of the Treasurer, to be in excess of $900,000 per year. The following chart details an example of how the fee savings could be realized given the tiered fee schedule:

State of Vermont

Example: Consolidate Two Large Growth Accounts

- Baring – Large Growth: Employees

  Separate
  - First $30 m – 0.625% ($187.5k)
  - Next $20 m – 0.40% ($80k)
  - Over $50 m – 0.25%

  Annual Fee

  Employees - $91.4 m = $371,000

- Fidelity – Large Growth: Teachers

  Separate
  - First $25 m – 0.80% ($200k)
  - Next $25 m – 0.60% ($150k)
  - Next $50 m – 0.40% ($200k)
  - Next $100 m – 0.30%

  Annual Fee

  Teachers - $145.6 m = $686,800

Combined into 1 account* - $237 m = $735,000

Savings = $322,800 (without renegotiating fees)

** Assuming Baring's existing fee schedule*

NEPC

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Unitized Investments Schedule

Initially, the following investment categories are expected to be available for allocation of investment funds by each retirement system; other categories may be added as needed (each system will not necessarily use all of these investment categories):

Equities

Large Cap Value

Large Cap Core/Index

Large Cap Growth

Small/Mid Cap Value

Small/Mid Cap Growth

International Large Cap Value

International Large Cap Growth

Fixed Income

Core Domestic

International

High Yield

Global

Real Estate

(2-3 R.E. managers)

Alternatives

Venture Capital

Other Direct Investments/Funds

Administration and Governance

The three existing retirement boards will continue to oversee the operations of each system in such areas as actuarial valuation, medical disability, benefit revisions, State contribution levels and general administration, as specified in Vermont Statutes.

In addition, statutes will be amended to provide for a new joint investment committee, Vermont Pension Investment Committee (VPIC), to oversee and administer the investment assets of each of the three Vermont Retirement Systems.

The capacity for effective investment oversight and administration will be significantly enhanced by this proposal. Given the small size of the individual funds, it is difficult to justify the expenditures necessary to provide the optimal level of investment education and support to three boards. Over time, the VPIC can be expected to gain an improved capability that is likely to improve the investment performance for all three funds.

The relationship between the existing boards and the new VPIC has been carefully considered. Actuarial valuation will remain the responsibility of the individual pension system boards. Subsequent to actuarial valuation and liability studies being completed and approved by system boards, VPIC will then have the responsibility of maintaining investment asset allocation for each system and investment of funds. Prior to final approval or subsequent revision by VPIC of investment asset allocation for a particular system, a report shall be delivered to the pension system board explaining the asset allocation recommendation. That board, within 30 days, shall have the power to approve or reject the proposed asset allocation, but shall not have the power to make revisions. If no response is made within 30 days, the asset allocation proposal shall be deemed approved. The VPIC would then be responsible for implementing the new asset allocation, including the selection of outside investment managers when necessary. The existing asset allocation in place at the time of the creation of the VPIC shall remain in place until approval or revision pursuant to the above process.

The primary objective of the VPIC will be maximization of investment returns within acceptable levels of risk through a broadly diversified investment portfolio. Specific responsibilities will include:

- Asset allocation, subject to the approval process referenced above
- Selection and oversight of a pension consultant and custodian bank
- Selection and oversight of investment managers
- Establishment of appropriate investment policies and guidelines
- Maintaining a high level of investment knowledge through educational offerings
- Communication with the Treasurer's office regarding all matters relating to investment of the systems' assets.

Composition of Vermont Pension Investment Committee

The Vermont Pension Investment Committee (VPIC) will be comprised of nine members, as follows:

2 – VSEA or VRSEA members from the VSERS Board
2 – Teacher, active or retired, members from the VSTRS Board
1 - VMERS Board Member
1 – Governor or Designee
1 - Gubernatorial appointee with investment experience
1 – Treasurer or Designee
1 - Treasurer appointee with investment experience
9 - Total

The VSEA and VRSEA members of the VSERS Board shall elect two members and one alternate to the VPIC. The active and retired teacher members of the VSTRS boards shall elect two members and one alternate to the VPIC. The employee and employer members of the VMERS Board shall elect one member and one alternate member of the Board to the VPIC. Members of the VPIC shall serve at the pleasure of the appointing authority and shall annually elect a Chair and Vice Chair.

Implementation Plan & Schedule

March 2004 – Bill passes and is signed by Governor
June 2004 – New board members appointed
June 2004 – Managers and custodians notified of new investment process
July 2004 - Initial meeting of the VPIC – discussion of implementation issues
Aug. / Sept. 2004 – Interview all existing managers by asset class
Oct. 2004 – Meeting with custodian to discuss reporting issues

a) Report format
b) Sleeve structure
c) Accrual of management fees and expenses

Nov. 2004 – Meeting to review final proposed manager structure and discuss transition
December 31, 2004 – Unitized accounting system initiated
Jan. / Feb. 2005 – Manager transitions conducted

After three years of implementation, a thorough evaluation of the unitized investment system will be conducted by an independent entity to document realized savings and effectiveness of the VPIC, or lack thereof. The evaluation will be delivered to the relevant legislative committees and all retirement boards.

Unitization Q&As

Will there still be a need for Individual Retirement Boards?

Yes, the existing boards will still have important roles. Examples of the kinds of responsibilities they will maintain include:

- Engagement of the actuarial consultant and approval of all actuarial studies and reports
- Periodic review of benefit and contribution levels for members of the system
- Review and approval of budget requests to Legislature, including funding adequate to cover benefit payouts
- Oversight of the provision of services and dissemination of information to members
- Investigation and voting on all disability retirement allowances
- Initiation of statutory and regulatory changes deemed necessary for the fair and effective functioning of each system
- All matters of a non-investment nature including, but not limited to, hearings of petitions from System members.

What will be the major responsibilities of the Vermont Pension Investment Committee?

- Maximization of investment returns within acceptable levels of risk though broadly diversified investment portfolios

- Allocation of assets, subject to approval by the relevant retirement board
- Selection and oversight of pension consultant and custodian bank
- Selection and oversight of investment managers
- Establishment of appropriate investment policies and guidelines
- Communication with the Treasurer's office regarding all matters relating to investment of Systems' assets.

Realizing that the performances of the three systems have been different in the past, should we feel comfortable combining investment decisions into one investment committee?

The investment performances of the three systems have been slightly different, but keep in mind that results (relative performances) depend on the time period examined.

Because each retirement system has its own asset allocation, based on actuarially derived target rates of return, much of the small investment variance is caused by differing asset class weights.

A well-balanced investment committee with adequate staff and consulting support should be able to improve the performance of all three funds, while reducing management fees.

Will a smaller number of managers be detrimental in terms of diversification and risk management?

Diversification is not normally thought of as a function of multiple managers. Barron's Dictionary of Finance and Investment terms defines diversification as, "spreading of risk by putting assets in several categories of investments – stocks, bonds, money market instruments, and precious metals, for instance, or several industries, or a mutual funds, with its broad range of stocks in one portfolio." By focusing on asset allocation and choosing the best managers for each asset class, there is every reason to believe that the return available per unit of risk will be excellent for all three systems.

Will the members of each system be losing control of investment decisions with the creation of VPIC?

While it is true that, in raw numbers, there will be fewer teachers, state employees, or municipal employees on the VPIC than the current three boards, this proposal may actually increase the board weighting of employee members to a majority status -- five employee members and four non-employee members. Currently, the VERS Board has four employee members and four non-employee members. The VSTRS has three teacher members and three non-teacher members. The VMERS Board has two employee members and three non-employee members. So, assuming the employee and employer members of the VMERS Board elect an employee member to the VPIC, employee board members, as a group, will have more say over investments on VPIC than under the current board structures.

Pension Investment Committee Structures in Other States

No other state in New England has a pension investment system similar to Vermont's current system. The VPIC proposal will move Vermont more into line with these states, which all have unified boards or committees to manage pension funds for multiple systems, except in Connecticut, where the Treasurer serves as the fiduciary/trustee for the funds with advice from an investment advisory council.

Connecticut

The State retirement system includes six retirement plans for teachers, state employees, and participating municipalities.

While there are separate retirement boards for the different groups, with some 12 to 14 members, they do not handle the investments. The State Treasurer is the principal fiduciary for the system and is responsible for the management of the pension funds. The state employees' retirement system and board are housed in the State comptroller's office. The state teachers' retirement board is a separate administrative division of the State.

There is one statutorily created 12-member Investment Advisory Council to *advise* the Treasurer regarding investments.

Twelve members –
- State Treasurer
- Secretary of the Office of Policy and Management
- Three representatives of the teachers' unions
- Two representatives of the state employees' unions
- Five gubernatorial appointments with experience in investments

Maine

The Maine State Retirement System is an independent instrumentality of the State and administers retirement plans that cover State employees, public school teachers (including school administrators and other licensed/certified staff), employees of municipalities and other public entities called participating local districts (PLDs), legislators, and judges.

The responsibility for the Maine State Retirement System is vested in the eight-member MSRS Board of Trustees, all of whom are supposed to have a working knowledge of retirement issues and policy, as well as a general knowledge of finance and investments.

Eight members –
- State Treasurer

One member elected by the Maine State Employees’ Association
One member elected by the Maine Education Association
One system member proposed by Maine Municipal Association
Four gubernatorial appointments:
  One from list submitted by Maine Retired Teachers’ Association
  One MSRS retiree submitted by state and/or municipal retirees
  Two experts in investments, accounting, banking on actuarial science

Massachusetts

The Pension Reserves Investment Trust ("PRIT") Fund is a pooled investment fund established to invest the assets of the Massachusetts State Teachers’ and Employees’ Retirement Systems, and the assets of county, authority, district, and municipal retirement systems that choose to invest in the Fund. There are separate boards charged with administering the system for teachers, state employees, and municipal employees.

The nine-member PRIM Board acts as Trustee for all retirement system investments in the PRIT Fund and is responsible for the control and management of the Fund. There is also a six-member investment advisory committee to the PRIM Board, created by the PRIM Board.

PRIM Board - Nine Members–
State Treasurer, Chair
Governor, or designee
One of the elected members of the State Teachers' Retirement Board
One of the elected members of the State Employees' Retirement Board
One elected by the retirees of the State Teachers’ Retirement System
One elected by the retirees of the State Employees’ Retirement System
Two Gubernatorial appointments
One Treasurer appointment

Investment Advisory Committee – Six members – Appointed by PRIM Board
David Grain, Treasurer’s appointment, is Chair – experienced in investments/finance
Doug Rubin, First Deputy Treasurer
Glenn Strehle, Treasurer Emeritus, MIT
Herman Daley, Deutsche Asset Management
Peter Brooke, Private Equity Investment Professional
Ralph White, Board member (state employee member)

New Hampshire

The New Hampshire Retirement System is an independent instrumentality of the State and includes 47,000 active and 16,000 retired State employees, teachers, and police/firefighters.

The responsibility administration of the system and management funds is vested with a 13-member Board of Trustees.

Thirteen Members –
Treasurer
Two gubernatorial appointments – not members of system/business experience
Two state employees, nominated by NHSEA and appointed by Governor
Two teachers, nominated by NHEA and appointed by Governor
Two policemen, nominated by police association and appointed by Governor
Two firefighters, nominated by firefighters' association and appointed by Governor
One State Senator
One Representative

Rhode Island

The Employees' Retirement System of Rhode Island serves state employees and teachers, as well as cities and towns that choose to participate, and is administered through the State Treasurer's Office.

There is both a Retirement Board and a State Investment Commission.

ERS Retirement Board – 15 members

- Treasurer
- Director of Administration
- Budget Officer
- Fiscal Advisor to House Finance Committee
- President of League of Cities and Towns
- Two active state employees or union officials elected by active state employees
- Two active teachers or union officials elected by active teachers
- One active municipal employee or union official elected by active employees
- One retired member of ERS elected by retired members of the system
- Chair of House Finance Committee
- Chair of Senate Finance Committee
- Two gubernatorial appointments, one of whom is a C.L.U.

State Investment Commission - Nine voting members/one non-voting member

- Treasurer
- Director of Administration
- Chair of Senate Finance Committee
- Chair of House Finance Committee
- Chair of the Higher Education Assistance Authority
- One teacher, state employee, or municipal employee appointed by the Treasurer
- Executive Director of the State Retirement Board (nonvoting member)
- Three members appointed by the Governor – experienced in investments/finance

In addition to the New England States, the investment governance systems of Michigan and Pennsylvania were examined.

Michigan

Michigan operates separate systems for state employees and teachers, as well as a separate system for State police, judges, and legislators. The Michigan Municipal Employees' Retirement System is an independently operated entity. They are all housed administratively within the Department of Management and Budget, Office of Retirement Services.

The State Employees' System has two plans, a defined benefit plan and a defined contribution plan. According to their Web site, State employees hired on or after March 31, 1997, are enrolled in the defined contribution plan.

The net asset value of the defined benefit plan was $8.4 billion as of 9/30/02.

The State Employees' Retirement System Board is the investment authority for the fund and has nine members:

The Insurance Commissioner
The Attorney General
The State Treasurer
The Deputy Legislative Auditor General
The State Personnel Director
Two employee members, appointed by the Governor
Two retired system members, appointed by the Governor

The Public School Employees' Retirement System as an eleven-member board, but the State Treasurer is the investment authority for the pension fund, which had a market value of $29.9 billion as of 9/30/02.

There is a statutorily created five-member "Investment Advisory Committee" to the State Treasurer, which has limited powers to require certain actions by the Treasurer:

Three public members appointed by the Governor with senate confirmation
The Director of Consumer and Industry Services
The Director of Management and Budget

The Michigan Municipal Employees' Retirement System is an independent public nonprofit organization, which is an instrumentality of MERS participating municipalities.

The system had approximately $3.5 billion in investment assets as of June 30, 2002. The investment authority and responsibility is vested in a nine-member board:

Three officer members
Three employee members
One Retiree member
Two public members

Pennsylvania

Pennsylvania maintains separately administered state systems for teachers, state employees, and municipal employees.

The State Employees' Retirement System administers both a defined benefit and defined contribution system, with total fund assets of approximately $21 billion in 2002.
Investment authority is vested in an eleven-member board:

- Six members appointed by the Governor
- Two state representatives
- Two state senators
- State Treasurer (elected Chair)

The PA Public School Employees' Retirement System has pension fund assets of approximately $42 billion, as of 6/30/03.

Investment authority and responsibility is vested in a 15-member board:

- Secretary of Education
- State Treasurer (elected Chair)
- Executive Director of PA School Boards' Association
- Two members appointed by the Governor
- One member of the Annuitant Group elected among their number
- Three members elected from among the certified contributors
- One member elected from among non-certified contributors
- One member elected by members of the PA school boards
- Two State representatives
- Two State Senators

The Pennsylvania Municipal Retirement System had assets of $887 million as of March 30, 2003.

Investment Authority and responsibility is vested in an eleven-member board. The State Treasurer and the Secretary of the Commonwealth serve on the Board by virtue of their position. Another eight board members are appointed by the Governor after being nominated by their respective organizations or associations (municipalities, police, firefighters, etc.). In addition, one board position is filled by a retired member of the Pennsylvania Municipal Retirement System, whom the Governor appoints from a pool of interested applicants.