

INVESTMENT POLICIES AND PROCEDURES

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POLICY

1.0 PURPOSE

The purpose of this Investment Policy and Procedures is to assist the Board of Trustees of the Houston Firefighters' Relief and Retirement Fund (Fund) in the investment management of the Fund assets. The authority to amend these policies and procedures rests solely with the Board. The Investment Committee is a committee of the whole Board and has the authority to act on all matters related to investments.

2.0 GOALS AND OBJECTIVES

The primary goal of the Fund investment program is to provide sufficient investment returns with commensurate levels of risk necessary to pay the benefits promised by the Board to the Fund participants and beneficiaries. Associated with this goal is the Board's objective to maintain a fully funded status with regards to the Fund actuarial rate.

3.0 INVESTMENT PHILOSOPHY

In developing the investment program, the Investment Committee is guided by a set of precepts from which all investment decisions are made and establishes the foundation and direction for all future activity. These precepts are applied by the Investment Committee knowing the importance of asset allocation and the benefits of diversification. These guiding precepts are as follows:

- A) Long-term Focused - The Investment Committee recognizes the long-term nature of the Fund liabilities and an appropriate investment program should have long-term assets and strategies, generally assumed to target a ten-year planning horizon.
- B) Value-Driven - The Investment Committee shows preference in buying lower-priced out-of-favor assets as a less risky approach to investment management, but will maintain an appropriate exposure to growth to enhance portfolio diversification.
- C) Relationship-Driven - The Investment Committee believes significant non-quantifiable benefits accrue to the Fund by fostering good long-term relations with the many service providers associated with the investment management program.
- D) Opportunistic - The Investment Committee can react with flexibility and agility to take advantage of investments which have a short decision time but exhibit an above-market opportunity, so long as proper due diligence is completed.
- E) Contrarian - The Investment Committee is willing to be different from other investors by considering investments which are unconventional or may not be the current consensus thinking.

The Investment Committee has adopted a predominately active manager based philosophy in the belief that over a long-term horizon active management will provide excess risk-adjusted performance over passive strategies.

4.0 PORTFOLIO PERFORMANCE MEASURES

The performance objective of the Fund is to meet or exceed the actuarial rate plus Fund expenses, currently 8.5% plus 75 basis points, over a long-term horizon. For planning purposes,

the time horizon is defined as ten years. To assess the performance of the overall Fund, the Investment Committee has established a target mix portfolio, which is reflective of the most recently approved asset allocation study. The target mix portfolio will consist of the following index weightings which are representative of the Fund's current asset allocation:

<u>Asset Class</u>	<u>Weight</u>	<u>Index</u>
Domestic Equities	20%	Russell 3000
International Equities	24%	MSCI All Country World Ex-US Index
Fixed Income	35%	Lehman Universal Index
Alternative Investments	20% 15%	Flat Rate 15%
Real Estate	5%	Flat 9.25%
Cash	1%	Merrill Lynch 90 Day Treasury Bill Index

5.0 ASSET ALLOCATION

The Investment Committee has allocated the assets of the Fund to several asset classes with the objective of optimizing the investment return of the Fund within the framework of acceptable risk and diversification. Each asset class is allowed to operate within its specific range established by the Investment Committee. In addition, a strategic allocation has been established for each asset class for the purpose of semi-annual performance evaluation and asset rebalancing. If a public, non-cash asset class reaches an endpoint of its allocation range, the Investment Committee shall complete a rebalance to within 2.5% of the Strategic Allocation within 90 days and upon completion, review a further move toward the Strategic Allocation. Current asset classes, asset class ranges, strategic allocations, and philosophical precept application are as follows:

<u>Asset Class</u>	<u>Asset Class Range</u>	<u>Strategic Allocation</u>	<u>Precepts</u>
Domestic Equities	15% - 25%	20%	Long-term, Value, Relationship, Contrarian
International Equities	20%—30% 19%-29%	24%	Long-term, Value, Relationship
Fixed Income	30% - 40%	35%	Long-term, Value, Relationship, Contrarian
Alternative Investments	15%—25% 11% - 18%	20% 15%	Long-term, Value, Relationship, Opportunistic, Contrarian

Real Estate	4% - 7%	5%	Long-term, Value, Relationship, Opportunistic, Contrarian
Cash	0.5% - 1.5%	1.0%	Relationship

6.0 MANAGER SELECTION, GUIDELINES, RETENTION, AND REVIEW

To assist the Investment Committee in the investment management of the Fund assets, managers will be retained to implement the strategies selected by the Investment Committee. This policy section will address the manager selection process, the guidelines applicable to managers hired by the Fund, and the review and retention procedures for managers retained by the Investment Committee.

A) Manager Selection

The Investment Committee uses the processes listed below to select managers depending upon the asset class placement under consideration. The examples listed as sources and filters may be modified as appropriate.

- 1) Domestic and International Equities and Fixed Income
 - a) Investment Committee decides specific asset class placement.
 - b) Investment staff identifies candidate managers through databases and other sources, develops appropriate filters such as product type, risk-adjusted performance comparisons, and assets under management to narrow list, and present Request for Proposal (RFP) list to Investment Committee for approval. Once the Investment Committee has approved the RFP list of candidates, additions to the list will not be considered.
 - c) Investment staff analyzes proposals, ranks candidates through additional filters approved by the Investment Committee such as investment philosophy, manager strengths and weaknesses, personnel changes, and expense control and presents analysis to Investment Committee.
 - d) Investment Committee selects presentation finalists.
 - e) Upon completion of presentations, Investment Committee selects on-site visitation candidates. All Investment Committee members are strongly encouraged to participate in the on-site visits.
 - f) Upon completion of on-site visits, Investment Committee selects final manager for asset placement.
- 2) Alternative Investments **and Real Estates**
 - a) Investment staff reviews all incoming proposals and determines appropriateness according to investment philosophy, asset allocation ranges, and capital availability.
 - b) Investment staff and consultant due diligence is performed on candidate investments not previously receiving investment by the Fund. Consultant due diligence is not required for follow-on investments by candidates previously receiving investment in a similar strategy, although a consultant review may be requested by the Investment Committee.
 - c) A presentation is given by the candidate, if requested by the Investment Committee, regarding the proposed investment.
 - d) The Investment Committee decides whether to approve proposed investment along with commitment level.

- 3) Cash
 - a) Cash management is performed by the custodian bank or a related affiliate.
 - b) Changes to custodian and cash manager require Investment Committee approval.

B) Manager Guidelines

Manager guidelines include general guidelines applicable to all managers and specific guidelines unique to each manager. The specific guidelines for each manager will be developed cooperatively by the Investment staff, legal counsel, and manager and shall be incorporated into the Investment Management Services Contract executed by the Chair, Executive Director, and the manager consistent with the Investment Committee's direction. In case of conflict between the specific manager guidelines and the general guidelines, the specific guidelines, as approved by the Investment Committee, shall supersede. The general guidelines are as follows:

- 1) Manager investment philosophy, style, and strategy shall remain consistent and shall not change without the Investment Committee's approval. The manager shall have discretion to manage the portfolio consistent with the style presented to the Investment Committee at the time of selection and further subject to the restrictions established by the policy herein.
- 2) The following transactions are prohibited: short sales, selling on margin, put and call options, and the use of derivatives for speculation unless authorized by the Investment Committee.
- 3) Transactions that involve a broker acting as a principal, where such broker is also affiliated with the manager who is making the transaction are prohibited, unless specifically approved by the Investment Committee.
- 4) Transactions shall be executed at competitive costs, or within the parameters established for directed brokerage transactions by the Investment Committee.
- 5) Managers shall maintain cash levels consistent with their style as presented to the Investment Committee at the time of selection. Any deviation shall be allowed only after notifying the Chief Investment Officer and Executive Director and should be related to unusual market conditions. The cash level held by each manager will be addressed in the Investment Management Services Contract.

C) Manager Retention

Upon selecting a manager for placement of Fund assets, the Investment Committee's intent, according to the relationship-driven precept detailed in Section 3.0, is to retain the manager indefinitely. The Investment Committee with assistance from the investment staff shall monitor each manager's performance and adherence to style, strategy, and manager specific guidelines. It is the Investment Committee's discretion to take corrective action by replacing a manager if they deem it appropriate at any time.

- 1) Quantitative Measures - In monitoring performance of each manager, the investment staff will determine linear regressions of gross monthly time-weighted data to the appropriate benchmarks indicated in Section 7.0. From these regressions, coefficients of determination, beta, and alpha are monitored on rolling five-year periods. If the rolling alpha is less than the manager fees (in basis points), then staff will present quarterly reports to the Investment Committee and measurable improvement is required over the ensuing 12-month period. If no improvement is detected over the ensuing 12-month period, then the investment

- 2) Qualitative Measures – The Investment staff shall notify the Investment committee of changes occurring in the key portfolio management of a manager, significant account losses, significant growth of new business, a change in manager ownership, or other organizational changes. After identifying a significant event impacting a manager, the investment staff will recommend appropriate action and remedies, if any, to the Investment Committee.

D) Manager Review

All active managers shall make a presentation before the Investment Committee once per year to review the account under management. Additional manager reviews shall be made semi-annually to the Investment Committee through the Investment staff presentation of materials pertaining to manager performance and cash management practices. Passive managers and alternative investment managers shall be reviewed as requested by the Investment Committee. More frequent manager reviews may be requested by the Investment Committee as needed.

7.0 MANAGER PERFORMANCE MEASURES

The performance objective for each manager retained by the Fund is to provide a five-year rolling alpha in excess of the manager’s fees. For determining the linear regression statistics, the following benchmarks have been chosen to be the best representation of each manager’s style and strategy:

A) Domestic Equities

<u>Manager</u>	<u>Style/Strategy</u>	<u>Benchmark</u>
Gulf Investment Management	Large-Cap Value	S&P 500 Value
Mellon EB Stock Fund	Large-Cap Index	S&P 500
Sanford Bernstein	Small-Cap Value	Russell 2000 Value
State St. Research A	Small-Cap Energy	Wilshire Energy Equal Wtd.
State St. Research B	Small-Cap Energy	Wilshire Energy Equal Wtd. +500bp
The Mitchell Group	Large-Cap Energy	Dow Jones Energy

B) International Equities

<u>Manager</u>	<u>Style/Strategy</u>	<u>Benchmark</u>
Mellon Cap ICA Fund	Country Allocation	MSCI EAFE net dividends
Marvin & Palmer Associates	Emerging Markets	MSCI EM Free
Mercator Asset Management	Bottom/Up	MSCI EAFE Net
Schroder Investment Mgmt	Top/Down/Bottom/Up	MSCI EAFE Net dividends
Schroder Investment Mgmt	Emerging Markets	MSCI EM Free
Seudder Kemper	Emerging Markets	MSCI Emerging Markets Free

C) Fixed Income / Cash

<u>Manager</u>	<u>Style/Strategy</u>	<u>Benchmark</u>
GW Capital	Low Quality/Converts	Lehman Brothers Aggregate
Loomis Sayles A	Low Quality/Converts	Lehman Corp Bond 80%/Merrill Lynch High Yield 20%
Loomis Sayles B	High Yield	Merrill Lynch High Yield
STW Fixed Income	Long Duration	STW Long Bond Index
Mellon SuperSTIF	Enhanced Cash	Merrill Lynch 1-Year T-Bill

D) Alternative Investments

<u>Manager</u>	<u>Style/Strategy</u>	<u>Benchmark</u>
All Managers	All Strategies	15%

E) Real Estate

<u>Manager</u>	<u>Style/Strategy</u>	<u>Benchmark</u>
All Managers	All Strategies	9.25%

8.0 OPERATIONAL PROCEDURES

A) Stock Distributions

Distributions of stock from alternative investments with a market value less than .25% of total Fund assets may be liquidated by the Chief Investment Officer, with written approval of the Chair and the Executive Director. Since the Investment Committee views these shares as a return of capital allocated to alternative investments and does not intend to contribute these shares to the small capitalization equity allocation, these shares should be liquidated in a prudent and timely manner. The Chief Investment Officer may defer immediate liquidation if market, sector, or company specific knowledge provides a reasonable expectation of value improvement through a longer holding period. Should the Chief Investment Officer decide to hold the stock in excess of 180 days then the Investment Committee shall be advised at the next Investment Committee meeting.

B) Securities Lending

The Investment Committee has authorized the custodian bank, through a securities lending agreement, to engage in the lending of the Fund securities for the purpose of generating income from the investment of the related collateral. The income is divided between the Fund and the custodian bank according to the Custodial Bank Contract. The Investment Committee has elected to participate in the securities lending program of the

custodian bank because of the more stringent broker/dealer controls provided by the bank. This approach offers a more secure lending program though less profitable than other programs with less rigid broker standards.

C) Directed Brokerage

The Investment Committee has implemented a directed brokerage commission recapture program for the purpose of lowering the Fund's transactions cost. Brokers have been selected by the Investment Committee who are capable of providing quality transaction service to the Fund managers and have a designated history of delivering recaptured commission income to plan sponsors. The investment staff monitors the program and ensures that the recaptured income is directed into the manager's account according to the commissions generated and the recapture rate negotiated with the brokers used by the manager.

D) Cash Management

The Chief Investment Officer is allowed the discretion to use the S&P500 passive equity index to manage the cash level within the 0.5-1.5% asset class range. If cash rises/falls above/below the asset class limit, the S&P500 will be bought/sold to bring the cash within the range and staff will provide monthly activity reports to the Investment Committee. The Chief Investment Officer may not reduce the S&P500 index below \$75 million without approval from the Investment Committee.

9.0 MINORITY AND/OR WOMAN OWNED INVESTMENT MANAGEMENT COMPANY POLICY

In keeping with the Board's commitment to equal opportunity for all people and firms, without regard to the race, color, national origin, religion, sex, age or disability of the person or the firm's principals, employees or associates, the Investment Committee has approved the following Guidelines.

Guideline 1: The Committee shall determine whether a firm is minority, women or disabled owned (MWDBE) by using the then-current City of Houston guidelines.

Guideline 2: A firm shall be considered "local" if: (1) the firm's principal place of business or corporate headquarters is located in the greater Houston metropolitan area, without regard to the firm's state of incorporation or registration; or (2) the person(s) having a controlling interest (51% or more of the firm's ownership) in the firm live in the greater Houston metropolitan area.

Guideline 3: A firm shall be considered "small" if it had less than \$250 million in assets under management.

Guideline 4: In order to qualify for consideration for initial placement of Fund assets, a MWDBE, local or small firm shall generally be evaluated under section 10.00 of the *Policy and Procedures Manual: Investments*. However, MWDBE, local and small firms may be considered under alternative qualification standards in the following areas: (1) the firm must demonstrate that it has existed as a business entity under stable management

for at least two years with sufficient assets under management to allow adequate review by the Committee, or in the case of private equity, that its key investment professionals have worked together and the offering represents the principals' only income source and the principals' equity investment in the offering represents a significant percentage of their net worth; (2) at least three years verifiable history of performance attributable to the team proposed to manage the Fund's assets, or in the case of private equity, that the principals have a superior track record attributable to each individual and as a team; and (3) management of the firm must have control of the investment and business decision-making process.

Guideline 5: Any MWDBE, local or small firm awarded an investment contract under the alternative standards set forth above must be directly responsible for the management of Fund assets placed under its control, but it may use outside resources in the investment process in accord with guidelines established by the Committee.

Guideline 6: Once a firm or person that qualifies as MWDBE, local or small has Fund assets placed with it for management, it shall be evaluated by the same performance objectives, performance benchmarks and evaluation procedures as all other similar investment managers.