# CITY OF MANCHESTER EMPLOYEES' CONTRIBUTORY RETIREMENT SYSTEM

# 2002 ANNUAL REPORT

## *To The Members & Beneficiaries of the Employees' Contributory Retirement System*

*Arthur J. Beaudry*
*Chairman, Board of Trustees*

As Chairman of the Board of Trustees, I am pleased to present the 2002 Annual Report for the City of Manchester Employees' Contributory Retirement System. This report includes the Financial and Actuarial Valuation summaries of the System's investment and membership activities for the plan year 2002. The report also includes management's discussion and analysis of the events of the past year. The results provided demonstrate the Board of Trustees' continuous and successful implementation of its mission to ensure financial security for the members and beneficiaries of the Retirement System.

As a matter of policy, the Board of Trustees closely monitors the System's asset allocation and investment policies and directs Board activity at maintaining the best mix of investment vehicles to achieve maximum investment return with minimum risk exposure. In order to achieve these results, the System's investments include domestic and international equities, fixed income securities, real estate, and alternative investments. Investment professionals representing sixteen management firms are hired to actively manage the System's diversified investment portfolio. The soundness of the System's investment and management decisions is intended to ensure future financial security for plan participants.

The Board of Trustees holds asset managers to a strict performance standard. For each manager, performance comparisons are made against a relevant benchmark and peer universe as specified in the System's Investment Manager Objectives. When results fall below both the benchmark and universe median in any one calendar year, the manager will be critically reviewed. A formal watch will be initiated if manager results fall below the performance criteria over any given period. A manager will be placed on probation if this performance is below both the benchmark and universe median, and, once the probationary period begins, the manager will be given four quarters to improve relative performance. If relative performance deteriorates or does not improve, the manager will be subject to termination. The magnitude of performance shortfall, longer term results and current market conditions will be considered in assessing manager performance. The Board of Trustees also reserves the right to terminate any manager at its discretion.

The Annual Report and the Management Discussion and Analysis review the results of the System's asset management and administrative operations for Plan Year 2002. The System's investment returns have not shown positive results over the last three years, but public pension plans nationally have experienced similar investment results.

On behalf of the Retirement System Board of Trustees and staff, I wish to thank the membership for its support and interest in the Board's activities. The Board is totally committed to improving membership service and communications. I also wish to thank my colleagues on the Board of Trustees and System staff for their continuing effort and dedication throughout the year.

Sincerely,

Arthur J Beaudry

Arthur J. Beaudry
Chairman, Board of Trustees
City of Manchester Employees' Contributory Retirement System

# MANAGEMENT DISCUSSION AND ANALYSIS

Our discussion and analysis of the City of Manchester Employees' Contributory Retirement System's (System) financial performance provides an overview of the System's financial activities for the fiscal year ended December 31, 2002. Please read it in conjunction with the transmittal letter from the Chairman of the Board of Trustees and the System's financial statements.

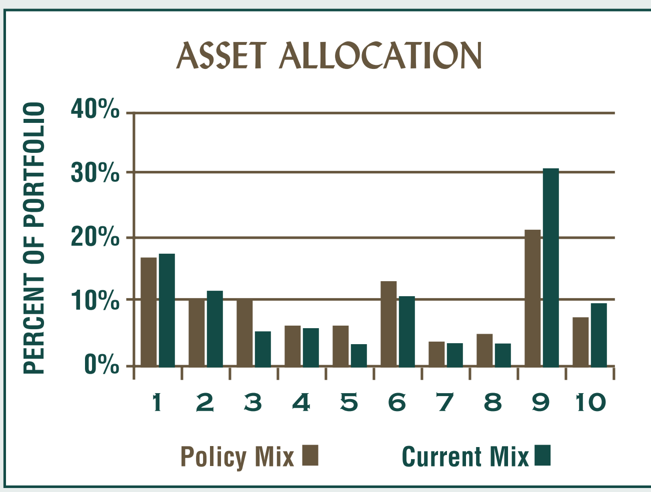
## USING THIS ANNUAL REPORT

This annual report consists of a series of financial statements. The Statement of Net Assets and the Statement of Changes in Net Assets (on page 6) provide information about the activities of the System and the net assets held in trust for pension benefits. The financial statements also contain actuarial information on the value of plan assets, accrued liability and the significant actuarial assumptions used in the actuarial valuations.

## FINANCIAL HIGHLIGHTS

- The System's total net assets held in trust for pension benefits was $74.8 million at December 31, 2002.
- The System's net assets decreased by $11 million which is primarily due to a market decline in the fair value of plan investments.
- Employer and employee contributions to the plan were $3.3 million which represents a $1.5 million increase over the preceding year.
- Benefits paid to plan participants were $4.6 million. At December 31, 2002, there were 499 retirees and beneficiaries currently receiving benefits.

## INVESTMENT POLICY




| | | POLICY MIX | CURRENT MIX |
|---|---|---|---|
| 1. | TAA | 17.00% | 17.60% |
| 2. | Large Cap Value | 10.00% | 11.20% |
| 3. | Large Cap Growth | 10.00% | 5.20% |
| 4. | Mid Cap Value | 6.30% | 6.00% |
| 5. | Mid Cap Growth | 6.30% | 3.20% |
| 6. | International Equity | 12.90% | 10.20% |
| 7. | Emerging Markets | 3.90% | 3.60% |
| 8. | Alternative Equity | 5.00% | 3.30% |
| 9. | Domestic Fixed | 21.10% | 30.30% |
| 10. | Cash/Other | 7.50% | 9.50% |

The Board's investment policy permits fund assets to be invested in U.S. and non-U.S. equities, U.S. and non-U.S. fixed income securities and equity real estate commingled funds. Asset allocations among various asset classes are shown in the box above.

The Board of Trustees' investment objectives and risk tolerance are to achieve a maximum total return with emphasis on preservation of capital in real terms. The investment mix is designed to participate in rising markets, with defensive action expected to an even greater degree in declining markets. Total return includes interest, dividends, and realized/unrealized gains or losses from investments.

# REPORTING ON THE SYSTEM'S FINANCES

The Statement of Net Assets and the Statement of Changes in Net Assets report information about the System as a whole and about its activities in a way that helps answer the question of whether or not the System is better off as a result of the year's activities. These statements include all assets and liabilities using the accrual basis of accounting, which is similar to the accounting used by private-sector retirement plans. All of the current year's revenues and expenses are taken into account regardless of when cash is received or paid.

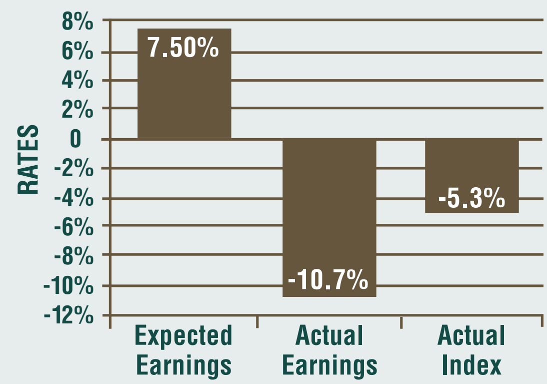
These two statements report the System's net assets and their changes. The System's net assets – the difference between assets and liabilities – represent a measurement of the System's financial health, or financial position. Over time, increases or decreases in the System's net assets are one indicator of whether its financial health is improving or deteriorating. The actuarial liability or surplus as determined at the first day of each plan year must also be considered.

## – SYSTEM'S ACTIVITIES –

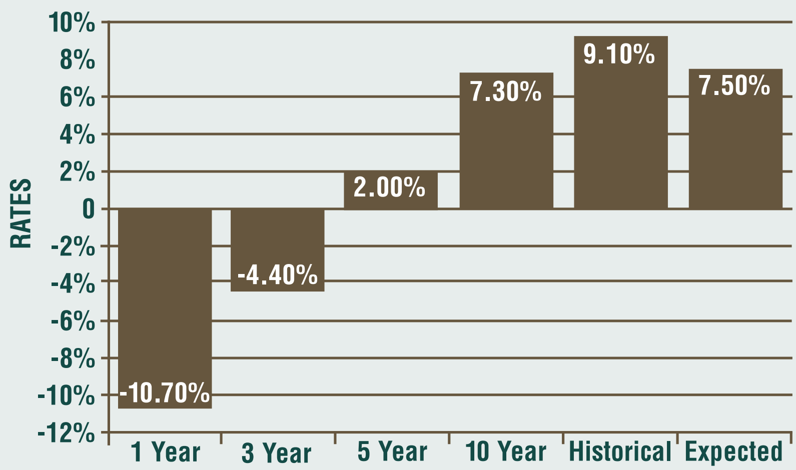
Operationally, Plan expenses for the period ended December 31, 2002 were $5,449,074. This total includes $578,213 in administrative expenses, $301,901 in refund of employee contributions and $4,568,960 in benefits paid to retired members and beneficiaries. A total of 1893 City employees were participants or beneficiaries at year-end.

The value of plan assets, after subtracting liabilities of the plan was $74,796,544 and $85,786,154 as of December 31, 2002 and December 31, 2001, respectively. For the year 2002, the plan experienced a decrease in its net assets in the amount of $10,989,610 and an investment rate of return of -10.7%. Total fund earnings did not meet expectations for the third straight year.

### TOTAL FUND EARNINGS 2002

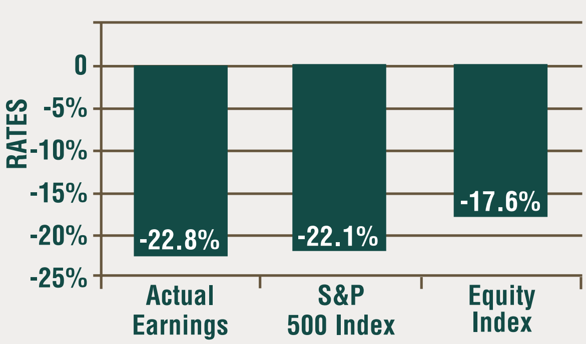



### PERIOD RATES OF RETURN 2002




For the plan year ended December 31, 2002, the System's rate of return for the one, three, five and ten year periods fell below its assumed earnings of 7.5% at -10.7%, -4.40%, 2.00%, and 7.3%, respectively. The historical return rate of 9.10% exceeded the assumed rate of 7.5%.

### TOTAL EQUITY EARNINGS 2002



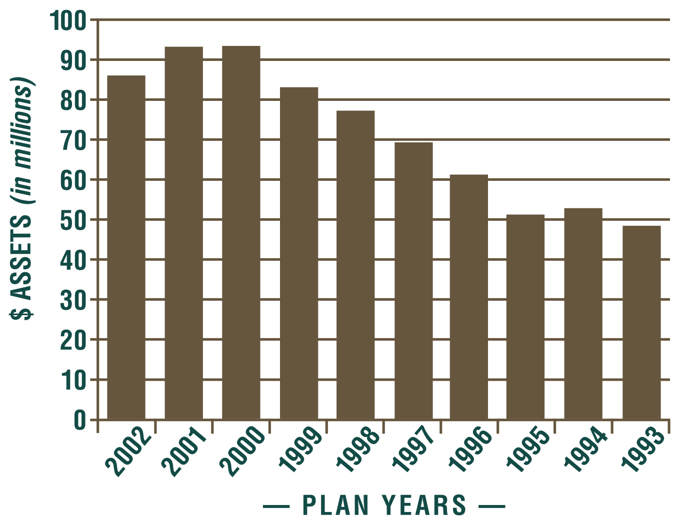

Total plan equities ended the year with a loss of 22.8% and underperformed the -22.1% rate of return of the S&P 500 Index and the Equity Index of -17.6%.

The year 2002 marked the third consecutive year U.S. equities declined in value. The last time the U.S. experienced back-to-back market declines was the recession of 1973-1974. The System's total portfolio declined by 12.9% during 2002, ending the year with $75.0 million in total assets.

HISTORICAL ASSET VALUES FOR THE PAST TEN YEARS ARE SHOWN HERE:

| | |
|---|---|
| 2002 | $75,035,448 |
| 2001 | $86,187,284 |
| 2000 | $93,034,852 |
| 1999 | $93,075,859 |
| 1998 | $83,222,903 |
| 1997 | $77,944,473 |
| 1996 | $69,295,742 |
| 1995 | $61,183,155 |
| 1994 | $51,251,920 |
| 1993 | $53,156,530 |

TEN YEAR ASSET VALUES AS OF 12/31/02




# ADMINISTRATIVE BUDGET

Administrative expenses for 2002 were $115,878, a 5.31% increase from the previous year. Human Resource expenses increased in 2002 to $193,884 from $171,113 in plan year 2001. Professional Services expenses in 2002 were $218,315, a reduction of 5.18% from $230,230 in the previous year.

Capital Expenditures totaled $138,427 which included $128,850 for the new pension administration system scheduled to go on line January 1, 2003.

Special Projects expenses in 2002 were reduced from the previous year from $45,430 to $31,473. And, overall, operational expenses were reduced by 7.35% from the previous year.

# ECONOMIC ENVIRONMENT

The absence of a visible rise in business spending coupled with an increasing unemployment rate continued to plague the U.S. economy. However, auto and new home sales remained brisk due to low interest rates. In an effort to improve the current environment, the White House revamped its economic team and proposed a substantial fiscal stimulus plan for 2003. The New York Attorney General's office announced a settlement in its investment banking/securities research conflict of interest investigation that will cost major Wall Street brokerage firms $1.4 billion. On the geopolitical front, a cloud of violence and diplomatic posturing continued to overshadow worldwide financial markets. Instability in Iraq, the Middle East, Northern Korea, and Venezuela in particular threatened to disrupt an already weak global economic foundation. Despite a decent fourth quarter rally led by Technology and related issues, U.S. equity markets experienced their third consecutive calendar year decrease. The bear market, at 33 months, has been the longest in the post WWII era. Meanwhile, a rally in December capped another solid year in the bond market, with most investment-grade portfolios posting double-digit annual gains. Declining interest rates to near historic lows and investors' wariness of the stock market drove prices up and yields down, especially in the U.S. Treasury market.

*—Prime, Buchholz & Associates*

# STATEMENTS | BENEFITS

## NET ASSETS AVAILABLE FOR BENEFITS

| Year Ending December 31 | 2002 | 2001 |
|---|---|---|
| **ASSETS** | | |
| Cash | **$ 804,485** | $ 292,923 |
| Investments | **74,099,597** | 85,669,869 |
| Receivable for investment sold | **135,193** | 233,827 |
| Accrued interest | **165,872** | 174,487 |
| Employee Contributions Receivable | **42,197** | 46,224 |
| Property, plant and equipment, net of accumulated depreciation | **240,975** | 121,211 |
| Other Assets | **8,927** | 3,333 |
| TOTAL ASSETS | **$75,497,246** | $86,541,874 |
| **LIABILITIES AND NET ASSETS** | | |
| Payable for investment purchases | **$ 161,423** | $ 266,536 |
| Accounts payable & accrued expenses | **$ 137,940** | $ 112,031 |
| Pension benefits payable | **401,339** | 377,153 |
| TOTAL LIABILITIES | **700,702** | 755,720 |
| Net assets held in trust for pension benefits | **$74,796,544** | $85,786,154 |
| TOTAL LIABILITIES & NET ASSETS | **$75,497,246** | $86,541,874 |

## CHANGES IN NET ASSETS AVAILABLE FOR BENEFITS

| Year Ending December 31 | 2002 | 2001 |
|---|---|---|
| **ADDITIONS TO NET ASSETS ATTRIBUTED TO** | | |
| **Investment income** | | |
| Interest | **$ 720,912** | $ 871,471 |
| Dividends | **1,067,951** | 1,334,213 |
| Net realized and unrealized appreciation in fair value of investments | **—** | — |
| Less investment expense | **(380,435)** | (342,118) |
| **Net investment income** | **1,408,428** | 1,863,566 |
| **Contributions** | | |
| Employer | **1,794,576** | 1,135,820 |
| Employee | **1,531,458** | 1,473,606 |
| **Total contributions** | **3,326,034** | 2,609,426 |
| TOTAL ADDITIONS | **4,734,462** | 4,472,992 |
| **DEDUCTIONS** | | |
| Benefits paid directly to participants | **4,568,960** | 4,239,493 |
| Net realized & unrealized depreciation in fair value of investments | **10,274,998** | 6,649,976 |
| Refunds of employee contributions | **301,901** | 234,255 |
| Administrative expenses | **578,213** | 597,966 |
| TOTAL DEDUCTIONS | **15,724,072** | 11,721,690 |
| NET DECREASE IN NET ASSETS | **(10,989,610)** | (7,248,698) |
| NET ASSETS, BEGINNING OF YEAR | **85,786,154** | 93,034,852 |
| NET ASSETS, END OF YEAR | **$74,796,544** | $85,786,154 |

NOTE: Audited Financial Statements, certified by Berry, Dunn, McNeil & Parker, Certified Public Accountants, are available from the City of Manchester Employees' Contributory Retirement System upon request.

## PENSION BENEFIT OBLIGATION

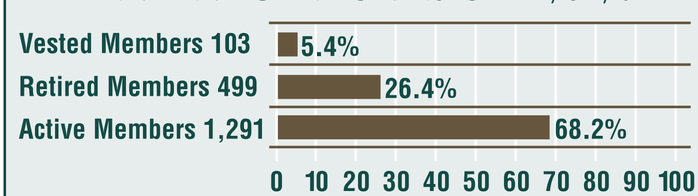
| Year Ending December 31 | 2002 | 2001 |
|---|---|---|
| Members currently receiving benefits | **$40,186,747** | $38,339,560 |
| Terminated vested members | **2,129,208** | 1,328,570 |
| Active Members: | | |
| Accumulated employee contributions, including allocated investment earnings | **13,050,940** | 11,536,020 |
| Employer-financed | **40,664,951** | 34,708,527 |
| Total pension benefit obligation | **96,031,846** | 85,912,677 |
| PBO Service Cost | **$ 4,074,600** | $ (126,523) |

## INVESTMENTS

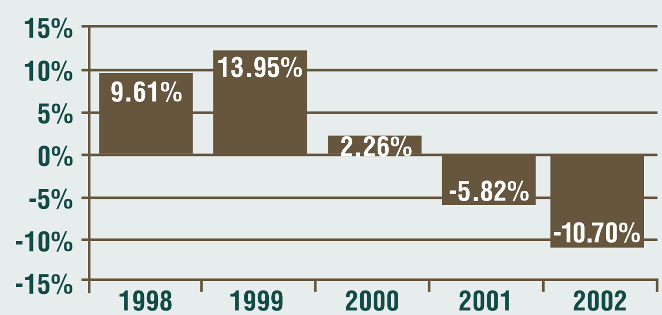
*Investment managers have discretionary investment powers within guidelines developed by the Board of Trustees. The Retirement System's investments are held by a custodian bank. The following tables present the fair market values of the Retirement System's investments and the net unrealized appreciation in fair value at December 31, 2002 and 2001.*

| Year Ending December 31 | 2002 | 2001 |
|---|---|---|
| Equity funds | **$60,582,597** | $70,965,824 |
| Fixed income | **11,247,364** | 11,529,276 |
| Emerging market funds | **1,869,155** | 1,767,466 |
| Charles B. Manning, Inc. (related party) | **—** | 613,615 |
| Cash and equivalents | **400,481** | 793,688 |
| Total | **$74,099,597** | $85,669,869 |
| Net unrealized appreciation (depreciation) | **$(7,458,799)** | $(6,663,742) |

### PLAN PARTICIPATION AS OF 12/31/02




### INVESTMENT RESULTS



# SUMMARY

## COMPARATIVE SUMMARY OF THE PRINCIPAL RESULTS OF THE VALUATION

| | 2002 | 2001 |
|---|---|---|
| **1. System Cost** | | |
| a. Employer normal cost | **$ 2,252,492** | $ 2,173,489 |
| b. Employer normal cost as a percentage of annualized compensation (during prior year) | **5.78%** | 5.62% |
| c. Customary employer contribution, if paid beginning of year | **3,305,451** | 1,794,576 |
| d. Customary employer contribution as a percentage of annualized compensation (during prior year) | **8.49%** | 4.64% |
| **2. System Liabilities** | | |
| a. Actuarial present value of benefits earned to date | **79,540,787** | 68,180,848 |
| b. Actuarial accrued liability | **106,120,710** | 96,270,479 |
| c. Unfunded actuarial accrued liability | **16,364,857** | 1,457,848 |
| **3. System Assets** | | |
| a. Market value | **74,796,544** | 85,818,863 |
| b. Actuarial asset value | **89,755,853** | 94,812,631 |
| c. Estimated total rate of return on market value basis during preceding year | **(10.7%)** | (5.82%) |
| **4. Benefit Security Ratio** | | |
| Market value of System assets as a percentage of liability for benefits earned to date for all System members (including retirees) = (3.a) \ (2.a) | **94.04%** | 125.87% |
| **5. Information on System Members** | | |
| a. Number of System Members | | |
| (i) Active | **1,291** | 1,330 |
| (ii) Retired | **499** | 484 |
| (iii) Terminated with deferred vested benefits | **103** | 66 |
| (iv) Total | **1,893** | 1,880 |
| b. Data on active System Members | | |
| (i) Total annualized compensation | | |
| — during prior year | **38,940,104** | 38,692,738 |
| — estimated current year | **40,791,970** | 40,598,645 |
| (ii) Average reported compensation (prior years) | **30,139** | 29,092 |
| (iii) Average attained age | **45.7 yrs.** | 45.1 yrs. |
| (iv) Average length of service to date | **9.6 yrs.** | 9.0 yrs. |
| c. Data on Inactive Participants | | |
| (i) Average annual benefit for retirees/beneficiaries | **8,978** | 9,080 |
| (ii) Average annual benefit for terminated vested | **3,351** | 3,844 |
| (iii) Average attained age for retirees/beneficiaries | **72.4 yrs.** | 72.0 yrs. |
| (iv) Average attained age for terminated vested | **52.1 yrs.** | 52.2 yrs. |

The customary employer contribution increased from $1,794,576 for 2002 to $3,305,451 for 2003 (representing an 84% increase).

### *Factors impacting the contribution:*

**ACTUARIAL EXPERIENCE:**

Overall system experience during year ending December 31, 2002 was less favorable than expected. *Specifically:*

1. The estimated total return on system assets during 2002 was *negative* 10.7% on a market value basis and *negative* 3.74% on an actuarial basis. Since the assumed rate was 7.5%, this resulted in an actuarial (asset) loss.
2. Other demographic experience was approximately as assumed.

The result of these experience factors was a net actuarial loss of $10.2 million, which represents an annual increase in cash contributions of $1.1 million over the next fifteen years.

## *Plan Amendments*

The System reduced the normal age of retirement from 62 to 60 and provided for a two-percent annual subsidy on early retirement for participants aged 55 with at least 20 years of service or participants whose age plus years of service equal at least 80 (including previously terminated participants). This amendment was granted during 2002 and became effective November 5, 2002. The increase in plan liabilities was $3 million, which reflects the impact of the plan amendment as well as a change in assumed retirement rates. The amortization of this change increases the customary contribution by $200,000 for the first 20 years and $500,000 for the subsequent 10 years.

Effective June 1, 2002, the System adopted a 3% COLA to participants in payment status as of December 31, 2001. The effect of this COLA was to increase liabilities by $1.2 million. This increase is funded over ten years. For 2003, the impact on the customary contribution is a charge of approximately $165,000.

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