Memorandum

To: Audit Committee of the ISO Board of Governors

From: Ryan Seghesio, CFO & Treasurer

Date: March 13, 2013

Re: **Decision on Investment Strategy of the Retirees Medical Plan Assets**

This memorandum requires Committee action.

EXECUTIVE SUMMARY

At its September 2012 meeting, the Board approved the new corporate investment policy related to the investment guidelines of ISO funds. One of the changes approved was the removal from the scope of the corporate investment policy funds currently held in trust on behalf of the ISO Retirees Medical Plan and those funds designated to be transferred to the trust. Management indicated at the time that those assets would continue to be invested in a manner consistent with the policy, but that we intended to bring a new proposed investment strategy, specific to those assets, to the Board for approval.

The new proposed investment strategy will better align the management of assets versus the growing liabilities of the Retirees Medical Plan. To date, these assets have primarily been invested in short-term (maturities within five years) fixed income securities. A policy change in 2010 allowed investments in fixed income securities with maturities up to 30 years; however, given the low-yield environment, the bulk of the investments have remained within 10 years. This strategy has produced returns averaging 1.87% over the past three years; although liabilities, driven by rising health care costs, are growing by approximately 5-8% annually.

Management proposes to change the investment strategy of these designated assets to align with the asset allocation of the Moderate Portfolio in the ISO's Pre-Mixed Portfolio Allocations defined in the 401(k) Plan (Attachment 1, pages 1-2). The Moderate Portfolio invests approximately 55% in equities and 45% in fixed income. This structure would have yielded an 8.1% average annual return over the past three years and 8.8% annual return over the past 10 years (Attachment 1, page 3). Furthermore, the assets will benefit from the oversight of the ISO's internal Employee Pension Benefits Committee, which will govern the specific investment policy language, perform quarterly due diligence on the selected investments and recommend further changes to the investment strategy.

> ***Moved, that the Audit Committee of the ISO Board of Governors approves the new investment strategy, as outlined in the memorandum dated March 13, 2013, pertaining to the assets associated with the present value of the liabilities, defined as the Accumulated Postretirement Benefit Obligation of the ISO Retirees Medical Plan; and***
>
> ***Moved, that the Audit Committee of the ISO Board of Governors authorizes the ISO Employee Pension Benefits Committee to approve the specific language of the investment policy and to monitor the investment strategy of the assets.***

Management will submit and brief the Committee on the final policy language, and will return to the Audit Committee with any changes to the strategy for their approval.

BACKGROUND

Retirees Medical Plan

The ISO maintains a Retirees Medical Plan designed to help retirees with ongoing medical benefit costs. Every year, the plan is analyzed by an actuary to determine the total liabilities and expenses associated with the plan. These liabilities and a description of the plan are included in the ISO financial statements annually. Strict accounting rules dictate the annual expenses of the plan that must be included in the financial statements and these are collected as part of the benefit burden in the ISO budget. The present value of the total liabilities related to the plan is approximately $20 million.

The assets held to offset this liability are held in two separate accounts. Approximately $6.5 million is held in a VEBA (Voluntary Employees Beneficiary Association) Trust. The ISO elects to contribute the liabilities associated with current retirees and employees who have reached the eligibility requirements of the Retirees Medical Plan into this trust. This act separates those assets from the ISO assets and is not reflected on the ISO balance sheet, with the exception of reducing the amount of total liabilities associated with the plan. The remaining assets, approximately $14 million, are held within the corporate reserves and are reflected in the ISO balance sheet. These designated assets represent the present value of the liabilities, as determined by the actuary, associated with employees who have not yet met the eligibility requirements of the plan, and are transferred to the trust according to the funding policy described above.

Employee Pension Benefits Committee

The Employee Pension Benefits Committee, which is comprised of certain executive officers of the ISO, the CFO & Treasurer, and a third-party fiduciary consultant, oversees the Retirement Savings Benefits Plan (the 401(k) Plan), the Retiree Medical Plan, and the VEBA Trust. The Employee Pension Benefits Committee meets on a quarterly basis to review the structure and policies of the plans and to perform due diligence on the investments offered within the 401(k) Plan. The committee offers employees five pre-mixed portfolio allocation models which are designed to give employees guidance on sample portfolios to meet specific risk tolerance levels. Suggested portfolio allocations cover risk targets from conservative to aggressive (Attachment 1, pages 1-2). The sample portfolio suggests percentage allocations to various approved mutual funds contained within the 401(k) Plan. The historical returns of these suggested allocations are on Page 3 of Attachment 1.

PROPOSED STRATEGY

Management is proposing that the designated assets described in this memorandum be invested in a style consistent with the moderate portfolio allocation. Specifically, those assets are defined annually in the actuary report and represent the amount held in the trust and the net liability amount held in the corporate reserves. By using the approved mutual funds within the 401(k) Plan, the assets will benefit from the low fees of the institutional class of funds as a result of the overall size of the relationship. Furthermore, the investment strategy will benefit from the due diligence that is performed on a quarterly basis by the Employee Pension Benefits Committee. In certain circumstances, where a mutual fund is not eligible to be purchased outside of a 401(k) plan, a similar fund will be recommended by the third-party fiduciary consultant to achieve the suggested percentage allocation.

The Employee Pension Benefits Committee will approve the specific language of the investment policy, currently being developed by the third-party consultant, and review the quarterly performance of the investment strategy. The investment performance of the assets will continue to be delivered to the Audit Committee as part of the annual investment report.

CONCLUSION

A new investment strategy for the designated assets described in this memorandum will allow for a better matching to the liabilities associated with the Retirees Medical Plan. The plan represents long-term defined benefits that can be earned by all employees and has an actuarial life of approximately 20 to 30 years. With healthcare costs forecasted to increase by 5-8% annually, a short-term fixed-income investment strategy will not keep pace. The annual shortfall increases the ISO's liabilities and, therefore, the annual expenses that flow through to the revenue requirement. The new investment strategy will expand the allocation of assets across several asset classes and better position the funds to keep pace with the growing liabilities.