FEDERAL RETIREMENT THRIFT INVESTMENT BOARD
1250 H Street, NW Washington, DC 20005

MINUTES OF THE MEETING OF THE BOARD MEMBERS

February 17, 2009

Andrew M. Saul, Chairman of the Federal Retirement Thrift Investment Board, convened a meeting of the Board members on February 17, 2009, at 9:30 a.m., Eastern Time, at Serco Inc., 1818 Library Street, Suite 1000, Reston, Virginia 20190. Part of the meeting was open to the public and part of the meeting was closed to the public. In attendance were Thomas A. Fink of Alaska, member; by telephone, Alejandro M. Sanchez of Florida, member; Gordon J. Whiting of New York, member; Gregory T. Long, Executive Director; Thomas K. Emswiler, Secretary and General Counsel; Mark A. Hagerty, Chief Information Officer; Pamela-Jeanne Moran, Director, Participant Services; James B. Petrick, Chief Financial Officer; Tracey A. Ray, Chief Investment Officer; Thomas J. Trabucco, Director, External Affairs; and Renée Wilder, Director, Research and Strategic Planning.

1. Executive Session.

On a vote taken by the Secretary before the meeting, the members opened an executive session at 9:30 a.m. for a discussion of proprietary data.

At 10:20 a.m., upon completion of the executive session, Chairman Saul convened the open portion of meeting.

2. Opening Remarks.

Chairman Saul noted that he was glad to be meeting with Serco's leadership and to be partners with Serco. It is very important that Serco protect participant's assets. The Board takes that matter very seriously.

3. Approval of the minutes of the January 15, 2009 Board member meeting.

Chairman Saul entertained a motion for approval of the minutes of the January 15, 2009 Board member meeting. The following motion was made, seconded, and adopted without objection:

MOTION: That the minutes of the Board member meeting held on January 15, 2009, be approved.

4. Serco Introductions and Presentations.

Mr. Long noted that SI, International and Serco were merging. An important purpose of this meeting is to meet Serco's leadership and to understand what affect the merger will have on TSP participants and to understand the capabilities of Serco.

Ed Casey, the Serco Chief Executive Officer, introduced Ron Lewis, its Chief Technology Officer and Art Nolan, the vice-president responsible for the TSP account. He then gave an overview of Serco. Serco was once part of RCA. It became an independent company approximately 20 years ago. It has 70,000 employees in 30 countries. Ninety-nine percent of its U.S. business is with Federal agencies. Its United Kingdom parent company runs, for example, prisons, rail-roads, and atomic weapon facilities and has been voted the number one service company in the United Kingdom five years in a row. Serco has operated in the United States for about twelve years. It operates under a special security agreement that allows it to handle classified matters despite being owned by a United Kingdom company. Serco plans to continue its aggressive growth strategy in order to gain market share and economies of scale. Like SI International, Serco has a customer first culture. Serco should bring greater capabilities to the TSP and the transition should not disrupt services.

Ron Lewis stated Serco wants to ensure that its infrastructure and technology supports not only its internal operations but also provides innovative solutions to its customers. Serco has service-oriented architecture and agile network matchups. Mr. Casey added that Serco frequently uses itself as a lab, for example, adopting paperless HR and finance procedures and then delivers a proven product to its customers. Serco wants to deliver great service and have its customers look to it for solutions. In response to a question from Mr. Long, Mr. Casey discussed reach-back. Reach-back is a process by which Serco looks to other parts of its company to provide needed skills to its clients. It is not satisfied with merely using employees assigned to a given project. Instead, it seeks to leverage resources throughout Serco. Serco desires long-term relationships with its clients. It has operated a missile early-warning system contract in the UK for over 50 years.

Art Nolan then gave an overview of Serco, North America. It has approximately 11,500 employees. Reach-back allows it to quickly pull together teams to support its clients. It is a very nimble organization in terms of being able to move resources to where they are needed. With regard to the SI transition, six of Serco's top 14 people are from SI. In terms of total personnel, Serco has retained approximately 50 percent of the SI work force. SI was fully represented on the transition team.

Mr. Long said that he has been very favorably impressed by the transition and by the capability of Serco's personnel. Mr. Hagerty added that the requirement to move the TSP's data center arose unexpectedly. The first phase of the move has been very successful, in large part, due to Serco.

5. System Modernization Update.

Mr. Hagerty reported that the modernization started over a year ago with significant upgrades to the data center. These upgrades included mainframes, storage, communication equipment, and servers. They had planned to relocate the data center last weekend. However, at the last minute, they decided to move only the storage area network and some servers because a vendor could not provide them with the confidence movement of the remaining components would go smoothly. The partial move was very successful, and it was prudent not to take unnecessary risks.

Mr. Friend extended his thanks to Serco for assisting with the move. He reminded the Board that the move was necessary because the existing data center lacked the power and cooling capacity to support the TSP modernization effort. The TSP will have a three-fold increase in such capacity when the move is complete. The collocation provider (Switch & Data) will provide the TSP with monthly updates on its capacity to ensure the TSP always has adequate power and cooling for future enhancements. The move has been a phased approach. It started in January and is expected to be complete by September. To ensure the safety of the move, we are using loaner equipment and moving services from each manufacturer. Chairman Saul confirmed that the plan was to shut down the current data center by September and that this move was necessary to implement the modernization plan the Board had approved. Mr. Friend added that they are standing-up new equipment in the new data center instead of initializing it first and then moving it. The physical move will

be complete in September, but some efforts, such as setting-up a full-sized test bed will take about six months longer. Mr. Long stated that the modernization efforts are not just about hardware, but also include software.

Susan Smith discussed the software development plan. The plan has three goals: meet critical project needs; ensure business and mission continuity; and plan and coordinate application projects. She then discussed the number of pending projects under each goal and how the Office of Automated Systems sets priorities. For example, first tier mission critical projects are those that have statutory or regulatory required completion dates. Chairman Saul thanked Mr. Hagerty, Mr. Hagerty's staff, and Serco for all the hard work that went into the partial move of the data center. He added that the modernization plan and its implementation has been handled in a very professional manner and is very impressive. It is a very good system that will provide safety and security to our participants.

6. Discussion of Audit Reports.

James Petrick discussed the February 6, 2009 memorandum entitled "Report on Audit Recommendations 2003-2008." Attached. The report shows the number of audit recommendations that have been closed on the Agency's books and the 16 recommendations that are still open. Fourteen of these recommendations are from KPMG and two are from Deloitte & Touche. He thanked Anne Beemer for her invaluable work on the audits. He also thanked Mark Hagerty, Roy Friend, and Susan Smith for their hard work because the recommendations pertained almost exclusively to IT (which was the focus of the most recent audits). Mr. Petrick also referred to the Department of Labor documents entitled "EBSA Performance Audit of the Service Continuity Controls over the Thrift Savings Plan" and "EBSA Performance Audit of the System Enhancements and Development Lifecycle and Software Change Controls over the Thrift Savings Plan System." Attached. He stated that a large part of these reports relate to the system modernization project. He asked whether the Board had any particular questions on either document. Hearing none, he asked Michael Auerbach and William Bailey from the Department of Labor to comment on the reports.

Mr. Bailey thanked Mr. Petrick and Ms. Beemer for making the work on the audits run so smoothly. He also thanked Chairman Saul for inviting the Labor Department to the meeting. Mr. Bailey reviewed the PowerPoint presentation entitled "Fiscal Year 2009 Thrift Savings Plan Fiduciary Oversight Program." At-

tached. He pointed out that the audit found "no instances of material non-compliance with FERSA." The Labor Department was pleased with the progress it has seen in the area of automated systems. They have three significant issues yet to review: system security, system enhancements and lifecycle/software change controls, and service continuity.

Heather Flanagan, from KPMG, reviewed the scope of the audits from 2005 through 2008 and the projected scope of the 2009 audit (pages 9-13). She then reviewed the open recommendations and noted that many may actually be completed, but KPMG cannot formally close them until it completes a new audit. She noted that the number of open recommendations has increased by five and Mr. Whiting asked what led to the increase. Ms. Flanagan said that there are seven new open recommendations. Five came from areas they hadn't audited in several years. Two came from areas they had only lightly examined several years ago. They also closed to prior year recommendations. Mr. Munster added that the audit also involved new areas of inquiry, for example protecting participant privacy. Mr. Whiting asked why the Agency had not identified these areas of concern. Mr. Munster stated that, while the auditors follow the same guidelines used by Agency employees, the context and scope of the audit environment can lead to different results. Mr. Hagerty added that the guidelines, which can be onerous, apply to large executive branch departments as well as to small agencies like the FRTIB that have less than 25 people in its IT department. These guidelines apply to both policy and process. About three years ago the Agency moved from having the National Finance Center as its principal contractor to having multiple contractors. This required the Agency to "build the airplane in-flight." We invested a lot in security in 2008 but have yet to see the fruits of that investment. Our emphasis is on ensuring that our processes are protected, with development of written policies documenting these procedures following as resources allow. Mr. Long added that we are adding more staff to ensure we satisfy all requirements.

Chairman Saul commented on the positive working relationship that has been established between the FRTIB and the Department of Labor since this Board was seated.

Mr. Bailey concluded the report by saying that this year's audit would focus on TSP system modernization and the other areas the Agency was addressing in the IT area.

7. Thrift Savings Plan activity report by the Executive Director.

a. Monthly Participation Activity.

Ms. Wilder reviewed the report on TSP statistics. See "Thrift Savings Fund Statistics." Attached. She noted that the participation rate seems to be stabilizing at around 84.3%. The TSP had $197 billion in assets under management at the end of January. Loan activity and withdrawal activity was stable. The active duty participation rate was stable at 36.3% and the reserve participation rate showed its traditional fluctuations.

Mr. Long noted that the press recently reported that the TSP is the largest plan in the United States. He noted that he is less concerned with the TSP's size relative to other plans and more concerned with how many participants we serve and how many we help retire with dignity. Mr. Fink stated that CALPERS had been around $260 to $270 billion and asked was it now under $200 billion. Mr. Long replied that CALPERS was now under $200 billion and the decrease was due to its having a different investment philosophy than the TSP. Chairman Saul stated that the adverse markets have caused the TSP to decrease too. Mr. Trabucco agreed, but added that we have lost a smaller percentage of assets under management than CALPERS.

Mr. Long stated that a member of Mr. Trabucco's staff, Dave Toro had returned to the United States after performing a tour of duty with the Navy in Iraq. He commended Mr. Toro for his service to our country.

b. Legislative Report.

Mr. Trabucco reported that Agency staff had recently met with the Employee Thrift Advisory Council (ETAC) and discussed seven potential legislative items for the new Congress. Five of the items, adding a Roth feature to the TSP, adding a mutual fund window, providing for immediate employer contributions, establishing survivor accounts, and obtaining authority to issue administrative subpoenas had the unanimous support of ETAC. The proposal to automatically enroll new employees and to set the L Funds as the default option (rather than the G Fund) did raise some concern. We had proposed the L Fund default because our analysis found that many younger employees failed to exercise any investment choice for many years after being defaulted into the G Fund. This would also align the TSP

with what Congress and the Department of Labor have authorized for private sector plans. Some ETAC members, however, favored retaining the G Fund default because the G Fund presents no investment risk. Additionally, the uniformed services had previously expressed concern over automatic enrollment. Department of Defense leadership is changing with the new administration and the DOD ETAC representative is waiting to see whether the new leadership will have the same concern. He added that some concern was also expressed regarding how much of their accounts that participants could invest through a mutual fund window (as did a number of union representatives).

Mr. Fink reminded Mr. Trabucco that the Board has not yet taken a formal position on whether to recommend adding a Roth feature. Mr. Trabucco and Mr. Long replied that they were not trying to sell this proposal to the ETAC, but were, instead, ascertaining the ETAC's position so that the Board could be aware of it in making its decision. Mr. Long added that we have concerns regarding the cost and complexity of a Roth feature. Mr. Fink said that we should have substantial demand from our participants before we recommend adding either a Roth feature or a mutual fund window. Both Mr. Trabucco and Mr. Long noted that Congress had previously expressed interest in adding a Roth feature and might again do so even without a Board recommendation. Chairman Saul asked whether there was a chance the TSP legislation might be added to one of the pending stimulus bills and was told that it is not in the bill that recently passed the Congress. Legislation including a Roth feature had passed the previous Congress, but, since a new Congress has been convened, any such proposal would need to be reintroduced. Chairman Saul then asked whether we had scheduled a meeting with our Congressional committees to discuss proposed legislation and was told that, while he had been talking with staff, we believed it prudent to wait for a recommendation from the Board before formally meeting to discuss legislation.

Mr. Trabucco completed his report by stating that he had been contacted by a member of the White House Office of Presidential Personnel and had advised him that all five board members were in a hold-over status and that seating an entirely new Board would be unprecedented and potentially disruptive to the smooth operation of the TSP. The staff member said that this was exactly the type of information he was seeking and that he would be evaluating these concerns over the next few weeks.

c. Participant Survey Report.

Before the report began, Mr. Fink questioned the validity of the participant survey. Attached. He noted that 45 percent of the respondents were members of the uniformed services and 28 percent were covered by the CSRS retirement system. However, as a percentage of TSP participants, uniformed service members represent only 16 percent of TSP participants and CSRS employees represent only 8 percent of TSP participants. Employees covered by the FERS retirement system represent 46 percent of TSP participants but constituted only 26 percent of the survey's respondents. Each group has different interests but was either grossly over-represented or under-represented in the survey.

Mr. Wilder replied that the groups are different and that the surveys were mailed in proportion to each group's representation. Even though the response rate was different, our consultant, Watson Wyatt, concluded that the survey was valid. Mr. Fink stated that a pollster would re-work a survey with such disproportionate responses. Chairman Saul and Mr. Whiting also questioned the survey's validity. Mr. Long agreed that the response rates were different, but pointed out that the survey breaks-out response rates for each group. Watson Wyatt confirmed that the response rate for each group was large enough to be statistically significant. This break-out allows us to compare results by each group. Mr. Fink said, absent unanimity among the groups, he still questioned the survey's validity.

Ms. Wilder added that we also broke the responses down by age-group and income-level. Mr. Whiting asked why the survey showed different satisfaction levels by age. Ms. Wilder said that, older participants, who have participated in the TSP the longest, may have a sense of ownership in the TSP. Mr. Long added that this presents a challenge for the Agency as older participants separate and new participants continue to serve. Ms. Moran stated that the dissatisfaction may be attributable to the downturn in the economy. Younger participants are likely more heavily invested in equity and, therefore, have been more adversely affected by the downturn than older participants. Additionally, younger participants likely are not looking to take loans or withdrawals and have different service expectations than older participants.

Ms. Wilder then turned to the survey. See memorandum entitled, "Summary of 2008/2009 TSP Participant Survey" (attached). We sent out 35,000 surveys in November and received 4,900 responses (1,300 on-line). The economic turbulence at

that time may have hurt the response rate. Despite this, eight-one percent gave a favorable rating to the TSP and seventy-five percent gave a favorable rating to the quality of service. This is approximately five percent lower than the 2006 survey, but is still much better than private sector plans (private-sector plans have a top-end satisfaction rating of around sixty-eight percent).

Most participants use the TSP website to obtain TSP information and only four-percent responded that they used the Thriftline. Chairman Saul asked when the web redesign project would be completed and was told we will have the beta site up in September and feedback from that site will determine how soon we implement. We will give the Board an update at the May Board member meeting. We will, however, be implementing website enhancements throughout the summer.

Ms. Wilder noted that fifty-six percent of participants would like to have a Roth feature added to the plan and forty-two percent of participants stated they would contribute to a Roth feature. Thirty-nine percent of participants thought their tax rate would be lower when they retired and twenty percent expected to have a higher rate. Surprisingly, seventy-seven percent of those who expected to have a lower rate said they would contribute to a Roth feature; this reflects a lack of understanding about the benefits of a Roth feature. Fifty-one percent of participants thought they would need tax advice if the TSP added a Roth feature but only thirty-five percent would be willing to pay for such advice.

Mr. Long said page fifty-two of the survey shows that different participant groups favor adding a Roth feature to varying degrees. Tables like those on page fifty-two show that the survey does reflect interest in various features by group and that the unbalanced survey response rate does not invalidate the survey. Mr. Fink pointed out that, when you break the survey down by age and pay, the survey is still skewed toward the uniformed services. Mr. Whiting asked whether the total pay numbers reflected untaxed benefits received by uniformed service members such as housing, food (some of which may be received in-kind rather than in-cash). Ms. Wilder responded that we did not inquire to that level of specificity. Instead, we asked the respondents to self-report income levels. Mr. Whiting said that he did not see how the survey could be valid based on age and pay, particularly since the uniformed service members constituted such a high percentage of the respondents. Ms. Wilder agreed that some segments may be too small and stated that she

would determine how many were required to constitute a valid sample. Mr. Long added that the survey results were most helpful when it came to comparing among retirement coverage groups (FERS, CSRS, uniformed services).

The 2006 survey reflected that most participants wanted more investment options. Twenty-four percent of current respondents indicated they would use a mutual bund window. This number drops to ten-percent if using a mutual fund window might require an annual fee of up to $100.00.

Ms. Wilder stated that the survey makes clear that participants recognize the value of education. Mr. Whiting pointed out that the responsibility for educating Federal employees on retirement planning lies with the Office of Personnel management and not with the Agency. Mr. Long replied that Ms. Wilder was referring to TSP-specific education. Where this job starts and ends is not, however, clearly drawn. Nevertheless, educating on the merits of using a Roth feature would fall within those boundaries.

Ms. Wilder summarized her report by stating our participant satisfaction numbers are good. We still have some challenges with our younger participants. The website redesign project should be a significant step toward meeting that challenge. Chairman Saul asked whether younger participants dislike the TSP's website. Ms. Wilder replied that it provides them the information they need, but that they may be accustomed to websites with a more modern look. Chairman Saul added that a more modern site should improve the attitude of our younger participants toward the TSP. Mr. Long cautioned that the new site would likely cause satisfaction levels to fall initially until participants became used to it. At that point, attitudes should start to improve. Ms. Wilder concluded that we are looking at providing multiple ways for participants to access information on the new website to ensure participant satisfaction.

d. Monthly Investment Performance Report.

Ms. Ray reviewed the February 6, 2009 memorandum entitled "January 2009 Performance Review - G, F, C, S, I, and L Funds." Attached.

She noted that the December stock market rally did not continue into January. The S Fund had a tracking error of 68 basis points for the month due to sampling. The I Fund

had a tracking error of 213 basis points due to fair value adjustments on December 31st and January 30th.

I Fund volatility resulted in a 24 basis point trading cost credit. Trading volumes are down substantially compared to January of last year ($2.7 billion compared to $7.6 billion) which was before the interfund transfer restrictions were implemented. Mr. Long added that this is a massive reduction in volume.

Page three of the report shows that all funds, except the G Fund, posted negative returns in January. I Fund losses were partially attributable to the six-percent strengthening of the dollar. The S Fund lost eight-percent in January but has recovered 1.5 percent in February. Bonds have had a good month in February and credit seems to be improving. Mortgage-backed securities have improved by 60 basis points this month. Three-month Treasuries are back up to .13 percent—which is a good sign that people are willing to take a little risk again. The L Funds outperformed all equity funds in January and have also done so since their inception. The number of participants with amounts in the L Funds has risen every month since inception except November 2008.

8. Real Estate Investment Trust (REIT) Report.

Ms. Ray reviewed the January 2009 Ennis Knupp report entitled: "Review of the Appropriateness of a REIT Index Fund Allocation in the L Funds for the Federal Thrift Savings Plan." Attached. The report was prompted by a suggestion from the National Association for Real Estate Investment Trusts that the TSP should add REITs to the L Funds and that REITs could serve as a proxy for real estate.

The report concluded that real estate has low volatility whereas REITs have high volatility. For the trailing three years, REITs were down 12 percent whereas the NCREIF property index was up 8 percent. Of even greater importance, the standard deviation for REITs was 41 percent for the trailing year. With a standard deviation of 41 percent and an expected return of 10 percent, your actual return could vary from minus 31 percent to positive 51 percent. This volatility is due to illiquidity in the REIT index. This illiquidity manifested itself when REITs fell 39 percent in the last quarter of 2008 while the S&P 500 fell 39 percent for the year. Another example would be the stock of General Growth Properties. It was trading at $45 per share in May and now is trading at under $1 per share. The

underlying properties in the REIT did not experience similar losses. The loss in the REIT was due to the REITs use of leverage and concerns over whether the company can obtain financing when those bonds come due. As a consequence, Ennis Knupp concluded that REITs are not a proxy for real estate and that putting REITs in the L fund would not add value for the participants.

Chairman Saul stated that the main argument for not adding REITs to the TSP was that it would add complexity. For many reasons, it is beneficial to keep this plan simple and broad-based. We do not want to add small-based funds like REITs to the TSP. Mr. Long added that the Congressional mandate for the TSP is to invest in broad indices, which is exactly what we do. Ms. Ray added that the market capitalization of the REIT index is below the value of the entire TSP. Mr. Long pointed out that another reason for not investing in REITs is that we could influence the market if TSP participants invested heavily in the REIT index.

Chairman Saul disagreed with one conclusion and stated that he believes REITs are a proxy for real estate over a period of time. REITs correct first because they are liquid and you can get in and out. Real estate, on the other hand, is illiquid and does not trade. The real value of real estate will follow the REITs unless the REITs are undervalued. Mr. Whiting stated that the problem is several of the large REITs have portfolio leverage. Individual real estate holdings are generally not cross-collateralized. As a consequence, if one holding fails, it does not pull down the others. Chairman Saul asked Mr. Whiting whether he believed that eventually private real estate would demonstrate the same trends as the REITs and yield similar returns. Mr. Whiting stated that is hard to say. Private real estate is not required to mark-to-market; so it is not as affected by the markets. It is different than REITs. Mr. Whiting stated that it was an excellent report. It considered the right points and he agreed with its conclusions. Ms. Ray added that REITs can trade above or below book value. Real estate sells for whatever the market will bear. Mr. Long made clear that owning a shopping mall is materially different than owning a REIT that owns shopping malls. Chairman Saul concluded by stating, similar to real estate or not, the TSP was not designed to and would not benefit from investing in small sector funds like REITs.

Before the meeting concluded, Mr. Fink stated that a year or two ago, the Agency decided that having real-time back-

up data center was critical. As a consequence, we got one. He then asked whether we have a back-up for Penny Moran, the Director, Office of Participant Services. He stated that he believed the agency would have significant problems if something happened to Ms. Moran. Mr. Long stated that the Agency has an emergency succession plan and that the Agency is doing strategic planning to see how the Agency should look in one, two, or three years. Part of this planning involves ensuring we are grooming the right employees for leadership positions. Chairman Saul asked that this be a Board meeting agenda item and Mr. Long agreed, stating that it might be possible to present it in March.

Whereupon, there being no further business, the following motion was made, seconded, and adopted without objection and Chairman Saul adjourned the meeting at 1:47 p.m.

MOTION: That this meeting be adjourned.

Thomas K. Emswiler
Secretary

Attachments

1. Report on Audit Recommendations 2003-2008
2. EBSA Performance Audit of the Service Continuity Controls over the Thrift Savings Plan
3. EBSA Performance Audit of the System Enhancements and Development Lifecycle and Software Change Controls over the Thrift Savings Plan System
4. Fiscal Year 2009 Thrift Savings Plan Fiduciary Oversight Program
5. Thrift Savings Fund Statistics
6. Participant Survey
7. Summary of 2008/2009 TSP Participant Survey
8. January 2009 Performance Review - G, F, C, S, I, and L Funds
9. Review of the Appropriateness of a REIT Index Fund Allocation in the L Funds for the Federal Thrift Savings Plan