MINUTES OF THE MEETING OF THE BOARD MEMBERS

November 19, 2007

Thomas A. Fink of Alaska, member of the Federal Retirement Thrift Investment Board, convened a meeting of the Board members on November 19, 2007, at 9:03 a.m., Eastern Time. The meeting was open to the public at the Board’s offices at 1250 H Street, N.W., Washington, D.C. In attendance were, by telephone, Andrew M. Saul of New York, Chairman; Alejandro M. Sanchez of Florida, member; by telephone, 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; and Thomas J. Trabucco, Director, External Affairs.

1. Approval of the minutes of the October 15, 2007 Board member meeting.

Chairman Saul entertained a motion for approval of the minutes of the October 15, 2007 Board member meeting. The following motion was made, seconded, and adopted without objection:

MOTION: That the minutes of the Board member meeting held on October 15, 2007, be approved.

2. Executive Director’s Report.


Mr. Long reviewed the report on TSP statistics. See "Thrift Savings Fund Statistics" (attached). He noted that the TSP fund balances had increased to $235 billion, an increase of $4.6 billion. He noted that $3 billion of the increase was attributable to good fund performance and that remaining $1.6 billion was attributable to new cash flow. The total number of participants increased by 12,000 (to 3,813,000). The number of outstanding loans increased slightly; this is consistent with the increase in the participant base. The number of CSRS participants continued its steady decline. Active duty partici-
pants increased by 2,000 and ready reserve participants increased by 1,300 (reversing the downward trend from prior months).


She noted that the Small-Mid cap Fund again had some tracking error. It underperformed by 14 basis points due to the optimization process used by Barclays. The International Fund outperformed the index by 56 basis points for the month and by 86 basis points for the year due to fair value adjustments.

In October, $1.1 billion was traded in the F Fund, which compares to $2.8 billion in September. For the year, $8 billion has been traded in the F Fund, versus $2.4 billion in all of 2006. In October, $4 billion was traded in the S Fund. For the year, $11 billion has been traded in the S Fund, versus $6 billion in all of 2006. In October, $4.3 billion was traded in the I Fund (costing participants $1.3 million), versus $4.6 billion in September. For the year, $23 billion has been traded in the I Fund (costing participants $13.5 million), versus $12 billion in all of 2006.

TSP Fund performance was very good in October with the I Fund leading the way at 4.5 percent, bringing it to 18 percent for the year. For the year, strong equity performance aided L Fund performance. L Fund balances grew by $1 billion in October. Year-to-date, all L Funds have outperformed the G and the F Funds and the 2030 and 2040 Funds are outperforming the C Fund. L Fund participation rates rose to 15 percent for FERS participants and to 11 percent for CSRS participants.

c. Legislative Report.

Mr. Trabucco reported that we are still talking with Congress concerning the pricing the Agency’s proposals to automatically enroll new employees and members of the uniformed services in the TSP and to set an age-appropriate L Fund as the default fund. The issue is now the indirect cost. That is, since the proposals would increase tax-deferred contributions, they are examining how much implementing them would reduce the tax base. We are addressing this issue with the Joint Committee
on Taxation, the Congressional Budget Office, and our authorizing committee.

Mr. Sanchez noted that he had served on a committee that evaluated candidates for the military academies; the committee included active duty service members. The active duty members commented that they loved the L Funds and were pleased with the TSP’s security enhancements (such as the switch from Social Security numbers to account numbers). He added that he was pleased they knew about these features; Mr. Long then congratulated Ms. Moran for her work in communicating these features to participants.

3. **Trade Pattern Analysis.**

Ms. Ray then gave a [power point presentation](#) (attached) and reviewed her [November 6, 2007 memorandum](#) (attached), on “frequent trading” and the [November 9, 2007 memorandum](#) (attached) from the Executive Director to the Board members on “frequent trading.”

She noted that trade volume is up as are transaction costs (which are borne by all TSP participants). The majority of this activity is attributable to less than 3,000 TSP participants who engage in frequent trading.

Annual trading in the F, S, and I Funds has increased significantly over the last three years with the I Fund showing the largest increase (from $6.7 billion in 2005, to $12.3 billion in 2006, and to $23.5 billion through October 2007). These increases have been significantly disproportionate to assets invested in the Funds.

We’re also experiencing large trades on a daily basis. The F Fund had no trade days greater than $100 million in 2005 or 2006, but has had eighteen this year. The S Fund had one trade day greater than $100 million in 2005, seven in 2006, and twenty-three this year. The I Fund had three trade days greater than $100 million in 2005, twenty-seven in 2006, and sixty-four this year.

Trade frequency is also up significantly, with participants buying one day, selling the next, buying again, and so on. For example, on October 19th, $371 million was transferred into the L Fund. On October 24th, $391 million was transferred out of the L Fund. Two thousand of the participants who redeemed on the 24th, had purchased on the 19th and these two thou-
sand accounted for $295 million of the trade volume. Three hundred and twenty-three of these participants traded accounts of $250,000 or more, and, in the previous sixty days, completed 5,804 exchanges in the I Fund for a total trade amount of $1.9 billion (that is, 323 participants averaged 18 trades over 60 calendar days). Mr. Long noted that this shows that a small group of participants are engaging in multiple transactions and thereby are disrupting the Agency’s ability to manage the Funds and are generating expenses.

Ms. Ray explained that frequent trading activity has (1) increased fund transaction costs and (2) increased the likelihood that a Fund’s performance will deviate from its benchmark.

(1) Transaction costs, which are in addition to the TSP administrative expense for each fund, can be double or triple the cost of administering the fund. Transaction costs are the costs comprising commissions paid to brokers, transfer taxes, and market impact (the difference between where the stock is bought or sold versus the stock price used to value the fund). For example, BGI receives the I Fund trades after the international markets have closed; however, the participants get that day’s closing price. If $330 million were sold after the market had fallen by 10 percent when the trade was completed, it would cost the Fund $33 million. All participants in the I Fund absorb this cost. Transaction costs reduced the I Fund’s performance by 8 basis points in 2006.

(2) Further, because of the very large dollar amounts being traded, particularly in the I Fund, BGI has had to increase its cash/futures pool to ensure that the Funds can meet their daily redemption requirements. As a result, the possibility that the funds’ performance will differ from the performance of the index each fund tracks has increased.

Mr. Sanchez asked Ms. Ray why these participants are trading so frequently. Ms. Ray explained that they were acting on the advice of financial advisers or were following their own trading strategies. Chairman Saul added that the Board had anticipated this and discussed it in-depth when the TSP transitioned to balancing accounts on a daily basis. Mr. Long noted that many mutual funds have experienced similar patterns of frequent trading and that Ms. Ray’s memorandum details the responses of the mutual funds.
Ms. Ray explained that, in order to reduce these costs, we are proposing to limit participants to two interfund transfers per month (with unlimited transfers into the G Fund thereafter) and that this policy is much more liberal than the policies of many large, well-regarded, mutual fund companies. The response of the mutual fund industry to control frequent trading has been: (1) to impose fees and (2) to impose trading restrictions. Our proposal allows more trades than those of many of the largest mutual fund providers. Mr. Fink asked if we had decided against fees because it would be difficult to determine an appropriate fee. Ms. Ray said that was the reason and added that we also wanted to give participants the opportunity to occasionally rebalance their portfolios (for example, if they needed to correct a mistake). The only way to reduce the magnitude of these trades is to impose trading restrictions.

Mr. Sanchez asked for clarification on the proposed policy. For example, he asked, suppose a participant moved $100,000 into the G fund and then moved it into the I Fund, could he still move it to the G Fund? Ms. Ray said that was correct. Even though the participant had executed his allowed transfers for the month when he moved to the I Fund, we decided that we would always make the G Fund available as a safe harbor in times of market volatility. Ms. Ray added that we plan to announce this policy when we mail the annual statement next year. In the interim, we propose notifying the frequent traders and asking them to stop. If they refuse to do so, they will only be allowed to make interfund transfers requests by mail. Mr. Fink then stated that this means we will just require them to mail their requests but will not limit the number of requests. Ms. Ray said that that is correct; we need to stop market timing; this will accomplish that because the participant cannot know when we will receive and process the request. Mr. Long said that he agreed and that he had prepared a motion for the Board's consideration.

Mr. Sanchez asked whether there was any downside to this proposal? Mr. Long said that the 3,000 participants who have their ability to make interfund transfers restricted will likely complain, but that we must focus on what is best for the TSP's 3.8 million participants.

Chairman Saul asked whether the statutes that established the TSP provided that it is a retirement plan and not a trading plan? Mr. Trabucco said that the legislative scheme of requiring indexed funds and the initial limits which only allowed transfers during open seasons was completely consistent
with this proposal. Mr. Long added that the requirement in 5
U.S.C. § 8475 that directs the Board “to develop investment
policies ... which provide for ... low administrative costs” is
also consistent with this proposal.

After this discussion, the members made, seconded, and
adopted the following resolution by unanimous vote:

RESOLUTION

WHEREAS the Federal Employees’ Retirement System Act
of 1986, as amended (5 U.S.C. § 8401 et seq.), pro-
vides that the Board members shall establish policies
for the investment and management of the Thrift Sav-
ings Fund (5 U.S.C. § 8472(f)(1)); and

WHEREAS frequent trading has been shown to have a det-
rimental effect on fund performance because of the re-
sulting increase in transaction costs; and

WHEREAS the TSP was designed as a cost-effective, long-term
investment vehicle, to generate retirement savings.

NOW THEREFORE BE IT RESOLVED that, subject to advice
from the Employee Thrift Advisory Council, the Board
adopts a policy of placing trading restrictions on all
of the funds in the Thrift Savings Plan. Initially,
this policy shall be to advise excessive traders that
they must stop this activity or face being restricted
to requesting interfund transfers via mail. Eventu-
ally, with changes in automation, this policy shall be
to allow participants two interfund transfers per cal-
endar month with additional transfers allowed only
into the G Fund.

4. Internal Controls.

Mr. Petrick then gave a PowerPoint presentation on the
FRTIB Internal Control Plan under OMB Circular A-123 (attached).
He stated that in 2006, the Board decided to voluntarily comply
with A-123 and to establish a control plan for the Thrift Sav-
ings Plan. He pointed out that we already have controls in
place: controls are built into the automated system, we have ex-
tensive external audits, we review the financial status of our
vendors on a quarterly basis, and the Contracting Officer Tech-
nical Representatives exercise control over Agency contractors.
Other controls include our budget, daily accounting reconcilia-
tion, and the SAS-70s that we receive from our vendors. A-123 brings all of these together so that they can be tested and audited. A-123, in essence, documents existing controls. He then reviewed where we were originally, where we are today, and where we want to go in the future. This involved a discussion of eight steps: step 1: establish a senior assessment team (completed); step 2: train managers (completed); step 3: establish high-level document control framework for the Agency (completed); step 4: identify and document critical processes and subprocesses (completed); step 5: complete a risk assessment for each critical subprocess (completed); step 6: identify existing internal controls for each critical subprocess (completed); step 7: document existing internal controls (in process); and, step 8: test and update internal controls (to be accomplished).

At the conclusion of the presentation, Mr. Sanchez commented that this was very well thought out. Mr. Petrick noted that two of his staff members had done a great job in preparing it, Anne Beemer and Carla Steiger. He added that he hoped to be able to show how this process adds value next year. Mr. Long noted that this reflected a lot of very important work.

Mr. Petrick then asked whether we should do an external audit of our internal controls (noting that it would cost approximately $500,000). Mr. Long pointed out that the Board did not need to decide now. It could wait until steps 7 (document existing internal controls) and 8 (test and update internal controls) are implemented. Chairman Saul stated that this matter should be raised again, next spring, prior to soliciting proposals from vendors to conduct the Agency’s audits. Chairman Saul added that this was a very good report; it reassured the Board that the Agency’s key staff is engaged and thinking about how best to run the Agency.

5. End of Year Checklist.

Ms. Moran showed the Board a poster her staff had prepared and would distribute to agencies later this year. The poster is entitled “end-of-year checklist.” Its purpose is to remind employees to review their plans for retirement, to review their TSP election for 2008, and to review their TSP investment mix. It asks them to look at the L Funds and refers them to the TSP website. It will help agencies with their financial education efforts. Mr. Fink wanted to make sure that employees would understand what was meant by reviewing the 2008 TSP election and was assured that they would.
Whereupon, there being no further business, the following motion was made, seconded, and adopted without objection and Chairman Saul adjourned the meeting at 10:25 a.m.

MOTION: That this meeting be adjourned.

NOTE: Ace-Federal Reporters, Inc. made a verbatim transcript of this meeting.

Attachments

1. Thrift Savings Fund Statistics
3. PowerPoint Presentation on FRTIB Frequent Trading
4. November 6, 2007 memorandum on “Frequent Trading”
5. November 9, 2007 memorandum on “Frequent Trading”
6. PowerPoint presentation on the FRTIB Internal Control Plan under OMB Circular A-123

After the meeting concluded, Messrs. Fink, Whiting, Sanchez, and Long received annual ethics training.