

# Graystone Consulting

August 8, 2014

Board of Trustees  
City of Ormond Beach General, Police Officers',  
& Firefighters' Pension Plans  
22 South Beach Street  
Ormond Beach, FL 32174

Dear Trustee,

As your investment consultant, Graystone Consulting has a fiduciary obligation to provide investment advice to help enable the City of Ormond Beach Pension Plans to meet their current and future obligations to the participants of each plan. The equity markets have performed strongly over the past 5 years and are currently near all-time highs. During this time, interest rates have remained at historical lows despite some short-term rate spikes over the past year and a half. It is expected that interest rates will rise in the future and this may have a negative impact on the value of your bond portfolio. Therefore, we believe it is imperative to identify other investment vehicles that can provide stability and income similar to fixed, but with reduced exposure to inflation risk.

Graystone Consulting Tampa's view (supported by our Global Investment Committee) is that past returns of traditional asset classes will not be representative of their expected future return. Therefore, we believe it is important to review alternative asset classes in today's environment. We believe the global economy will experience slower growth due to: lower consumption as a result of persistent unemployment and deleveraging; lower capital investment due to uncertainty and deleveraging; and reduced government spending due to higher debt. At the same time, fixed income investments offer lower yields and with interest rates the lowest they have been in decades, there is little expectation of capital gains. Over the past few years, we have sought to incorporate alternative asset classes into the asset allocation policy for many of our clients in an effort to dampen the negative impact of a rise in interest rates on the value of our clients' portfolios and to further diversify. We still believe that fixed income is a necessary part of a diversified portfolio; however, with interest rates at historical lows, we believe there is a risk in having too much allocated to fixed income at this time. For many clients, we have diversified a portion of the fixed income allocation to more conservative alternative asset classes such as core private real estate and lower volatility funds of hedge funds.

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### Core Private Real Estate

Core private real estate investments are expected to improve total portfolio diversification and provide income and opportunities for higher incremental returns in the long-term. Core private real estate is intended to invest in properties with higher occupancies and utilize lower leverage. The cash flow derived from an investment in a core private real estate fund is expected to increase and be higher than many fixed income asset classes in today's environment.

### Lower Volatility Funds of Hedge Funds

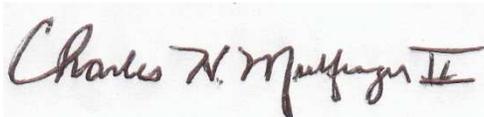
Funds of Hedge Funds are private investment funds investing primarily in the global equity and fixed income markets typically employing sophisticated trading strategies using leverage and derivative instruments. Funds of Hedge Funds invest in multiple single manager hedge funds. The strategy uses a diversified portfolio of managers with the objective of significantly lowering the risk (volatility) of investing with one manager. The Fund of Hedge Funds manager has discretion in choosing which strategy to invest in for the portfolio. A manager may allocate funds to numerous managers within a single strategy or with numerous managers in multiple strategies. The investor has the advantage of diversification among managers and styles with significantly less capital than investing with separate managers. Lower Volatility Funds of Hedge Funds tend to have return and volatility measures similar to fixed income, but may have a reduced exposure to interest rate risk.

### Due Diligence on Alternative Investment Strategies

Our firm employs a team of over 60 analysts that conduct ongoing due diligence on investment managers. This team not only reviews traditional equity and fixed income strategies, but also alternative investment strategies. The Investment Advisor Research team utilizes a stringent research process which focuses on quantitative (performance) factors along with qualitative (personnel, process, research capabilities, business stability) factors on traditional and alternative investment managers and funds. Our analysts examine a range of issues they believe are indicative of potential investment manager quality – such as investment philosophy, buy and sell disciplines, research capabilities, business operations and the qualifications of key personnel.

In conclusion, we recommend the City Ordinance be amended to permit the inclusion of core private real estate and funds of hedge funds into the plan's portfolio. We believe these asset classes can be used effectively in improving the risk/return dynamic of each of the three pensions portfolios for City of Ormond Beach.

Sincerely,



Charles H. Mulfinger, II, CIMA  
Managing Director/Institutional Consulting Director

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