MINUTES

MARIN COUNTY EMPLOYEES’ RETIREMENT ASSOCIATION
RETIREMENT BOARD STRATEGIC WORKSHOP
Acqua Hotel, Mill Valley
March 16-17, 2010

Tuesday, March 16, 2010 -- Day 1

8 – 9 AM
Continental Breakfast

CALL TO ORDER
Education Committee Chair Gladstern called the meeting to order at 9:09 A.M.

ROLL CALL
PRESENT: Bolger, Given (non-voting), Gladstern, Haim (late arrival), Hufford, Phillips, Richardson, Smith, Sweet, Webb (non-voting), Wofford

ABSENT: Hufford

BOARD OF RETIREMENT MATTERS

Capital Market Review -- Jim Callahan and Jay Kloepfer, Callan Associates
Investment Consultant Jim Callahan of Callan Associates introduced Jay Kloepfer, head of the Callan capital markets research group, which oversees Callan’s process for setting expectations for long term asset class return, risk and correlation assumptions. Mr. Callahan stated that meaningful changes to expectations have occurred. For example, Mr. Callahan said, because the capital markets have not provided the returns necessary to meet most Plans’ actuarial assumptions over the past 10 years, currently there is a wave of reconsideration of whether standard asset allocation is the proper investment model going forward. Mr. Callahan reviewed how the various asset classes have performed relative to MCERA and the median public fund over the trailing 20- and 10-year periods. Over 20 years, U.S. Treasuries performed as well as MCERA, which met actuarial expectations, though slightly behind the peer median. The trailing 10 year period was a difficult one for stocks (domestic and developed international) while long bonds, TIPS and emerging market stocks performed much better. Due to the poor stock market performance of the decade, the portfolio return of 3.64% was considerably below the actuarial assumption.

Mr. Callahan then reviewed various models that Pension Plans were considering including the Risk Parity Model, Interest Rate Hedge (LDI) Model, “Yale Model”, Inflation Focused Model and the Total Return Model. The standard model MCERA is using is called a “Total Return” model, which has fairly standard mix of equity, bonds and core real estate, according to Mr. Callahan. Another model which many university endowments use is known as the “Yale Model”,

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which is based on the premise that increased risk in illiquid investments will yield greater returns over time than the public markets due to the illiquidity premium. MCERA partially implemented this concept by moving into private equity as well as value added real estate; in 2008, however, the illiquidity of these portfolios presented problems. The Risk Parity Model has been getting the most press recently and involves allocating risk equally to the included asset classes. Risk parity portfolios typically have much higher fixed income allocations than in a total return approach, and therefore must apply leverage to achieve returns of 8 to 9%. Other models discussed include the Inflation Hedged and LDI Models, which are best suited to DC Plans and Corporate Defined Benefit Plans respectively. For the trailing 5 years ending in 2009, none of the models would have performed up to the actuarial assumption. Notably, over the trailing 10 year period, only the “Risk Parity Levered 55%” model achieved a return in line with the actuarial assumption, which is the reason the model is enjoying attention at the present time. However, over the 10 years leading up to 1999, the “Risk Parity Levered 55%” model underperformed all models. Jay pointed out that the relatively good performance of the Risk Parity Model was dependent upon a declining interest rate environment. Any model is likely to underperform at some period of time, Mr. Callahan said. Mr. Callahan recommended maintaining the current model while making adjustments to include newer concepts.

Jay Kloepfer presented a detailed review of Callan’s capital market projections, which are used to model portfolio returns and risk on a long term forward looking basis. He stated that the financial crisis had a much deeper impact on the developed world and financial institutions in particular and will cause the recovery to be slower than otherwise would be expected. He said that the equity market has already priced in the recovery, and Callan’s equity return expectations are lower going forward. In response to a Trustee question, Mr. Kloepfer recommended not making a direct allocation to U.S. Treasuries at this time, as Callan is worried about the possibility of a bubble in the Treasury market and the current historically low interest rate environment. Furthermore, he expects fixed income to return only 4.5% over ten years, versus the 6.2% average over the past 15 years. Other expected ten-year returns going forward are: Cash, 3%; domestic equity, 8.5%; real estate, 6.8%. Even with emerging markets returning 80% in 2009, it is difficult to say whether the markets have yet to fully price in that much of global growth will be led by the emerging markets for the foreseeable future.

Currently inflation has returned to average levels, and Mr. Kloepfer expects inflation to remain a modest 2.75% over the next ten years. The reality is that the world is in a very weak economic condition with plenty of excess capacity. The job market is weak with no wage pressures. We are importing deflation. Interest rates may rise as the result of the removal of economic stimulus. Inflation may also rise as a result of a possible commodity supply disruption. What is notable is the volatility in commodity prices over the past two years. Deflation is a risk, as deleveraging is still working through the economy. A W-shaped path is not out of the cards. He said the bigger risk is to the downside, rather than the upside. The U.S. economy experienced 3 quarters of unprecedented declines in consumer spending in 2008 and 2009. Since consumption is 70% of GDP, expectations are low for GDP, as wealth has been depleted.

Chair Gladstern recessed the meeting at 11:10 A.M., reconvening at 11:20 A.M.
Asset Allocation Review -- Jim Callahan and Jay Kloepfer, Callan Associates

Mr. Kloepfer emphasized international equity investment opportunities. Mr. Callahan followed by recommending increasing the international equity (including emerging markets) allocation from the current 30% of total equity. Mr. Callahan said that what is missing from the equity portfolio is a global equity manager who invests regardless of political borders. He noted that the MCERA already has global exposure and a transition to this approach could add higher fees and result in overlap with current exposures, he added. Trustee Smith noted that uncorrelated asset classes are desirable. Trustee Given asked whether sufficient diversification is being achieved, and Consultant Callahan said that the portfolios were carefully designed and are monitored closely to assure that there is appropriate diversification.

Mr. Callahan reviewed asset classes available for different strategies. He emphasized that commodities are non-correlated but highly volatile. Hedge funds could be considered, he said. Over the short term Mr. Kloepfer said that no asset class is directly correlated to inflation. Mr. Callahan said that Callan considers equities an inflation hedge over the long term. Trustee Webb commented that timing an inflation hedge is important. There is a volatility capture premium involved in investing in commodities, according to Mr. Kloepfer, which involves selling at price peaks and adding at price declines. Mr. Kloepfer explained an inflation-hedge investment class known as “real-return” which is comprised of several asset classes and is designed to be an inflation hedge. Trustee Wofford reflected that the fund has performed well over time and she would be concerned about over-reacting to the unusual market declines in 2008. Mr. Callahan noted that there is an opportunity cost associated with adding inflation hedged asset classes similar to paying an insurance premium.

Investment Policy Statement Review -- Jim Callahan and Jay Kloepfer, Callan Associates

No discussion.

Chair Gladstern recessed the meeting for lunch at 12 noon, reconvening at 1:35 P.M.

12 – 1:30 PM
Lunch – Robata Grill

Manager Structure Review

Market Neutral/Portable Alpha Review
Jim Callahan, Callan Associates

Market Neutral Portfolio - Consultant Callahan reviewed the Plan’s market neutral strategy. He outlined why the decision was made to get into the strategy and how the strategy works, is designed and performance. He stated that the objective of the market neutral strategy is to eliminate market exposure by making pair trades of one long position and one short position and to utilize manager skill to outperform cash. The target return is the Treasury bill rate plus 3%, while the return over five and a half years is a disappointing 3.6%. Fundamental manager Pyramis is the most successful of the group, while the quantitative market neutral managers have not performed as well. The Numeric portfolio is the most credible manager in the quantitative group, according to Mr. Callahan.
Mr. Callahan stated the question is whether the strategy is worthwhile going forward, especially since separate accounts require retaining an expensive prime broker. Consultant Callahan advised against eliminating the strategy at this time, recommending instead reducing the allocation as well as consolidating to three managers. He also stated that the Board may want to consider whether the portfolio had the right mix of managers in the portfolio. Mr. Kloepfer also cautioned against terminating all of the quantitative managers as these strategies provide diversification benefits because they have a low-correlation with the fundamental approach.

Trustee Phillips requested the Board’s opinion on whether to change the market neutral managers. He pointed out that the market neutral portfolios are not truly market neutral, stating he would prefer to eliminate the group, and Trustee Richardson agreed. Trustee Richardson suggested making a decision on market neutral investments in light of other investment opportunities. Trustee Webb commented that in high volatility market environments, the quantitative model did not perform well. Trustee Gladstern posed the option of retaining Pyramis and letting the others go. Trustee Bolger agreed with Trustee Gladstern’s approach, and also stated the group could be eliminated as too complex and costly. Trustee Smith said he preferred to transfer all the market neutral portfolios to large cap equity. Trustee Wofford expressed a preference to stay with the strategy, although with reallocation within the group.

Trustee Haim joined the meeting at 2:55 pm.

After each Board member gave their thoughts on the market neutral strategy, Acting Administrator Ford summarized by stating the consensus was to reduce the number of managers from five to three with equal allocations and to reduce the overall allocation to market neutral from $125 million to $75 million. Consultant Callahan said that the equity overlay is more appropriate than the bondized overlay due to the ability to better replicate the benchmark with futures on the equity side and that if the allocation is to be reduced it should come from the bondized allocation. Trustee Haim expressed a preference for simpler investment approaches.

**Domestic Equity Portfolio** – Mr. Callahan reported the large cap core sector allocation to be above target but within the defined range, a slight underweight to the mid-cap sector, and a slight overweight to the small-cap sector. Consultant Kloepfer recommended maintaining the 50-50 value vs. growth balance. He emphasized the lack of a passive management vehicle for equities. Trustee Given asked whether there was a significant difference in returns between active and passive investment for the large cap sector. Trustee Phillips stated that maintaining diversification is critical to long-term performance, and Trustee Haim agreed. Trustee Phillips confirmed that the 80%-20% large cap to small cap weighting protects against high volatility.

Trustees Haim and Given recommended hiring a mid-cap manager to replace the market neutral investments. Investment Consultant Callahan stated that the number of managers should be constrained.

According to Mr. Dunne, international equities are also 100% actively managed, with a 50-50 growth-to-value allocation. He stressed that low exposure to emerging markets dampened performance. There was general agreement by the Trustees to increase investments in emerging...
markets. Trustee Richardson inquired as to the advisability of going with a dedicated emerging markets manager. Consultant Callahan stated that he would support such a decision, along with increasing international exposure and using a broader benchmark. Trustee Phillips advised discussing options for increasing emerging markets investments at the next Investment Committee meeting. Mr. Callahan agreed to begin the process of searching for a manager.

Trustee Richardson recommended removing Western Asset from the watch list and there was general agreement to do so.

**Private Equity**

Gary Robertson reviewed the relatively new Private Equity portfolio. He explained that it provides for a different style of equity with a different return stream, which should exceed that of public equities over time. The portfolio is illiquid by nature, with a period of negative returns at the beginning, referred to as the “J-curve.” The five types of Private Equity strategies include venture capital, acquisitions/buyouts, special situations, subordinated debt, and distressed debt/restructuring. Private Equity is self-liquidating and heaviest distributions are expected to be between years seven and twelve of a 15 year investment time horizon. He stated that fund-of-fund managers select the underlying limited partnership investments. Complicating the picture is the fact that currently merger and acquisition activity is low, he stated. Furthermore, there is little lending to fund leveraged buyouts.

Mr. Robertson reviewed the search and due diligence process that Callan and the Board went through to select MCERA’s current private equity fund-of-fund managers. Gary discussed that both portfolios are diversified by private equity strategy. He highlighted that Abbott Capital and Pathway Capital Management are complementary in getting MCERA full market coverage because Abbott invests in mezzanine debt as part of the broad portfolio, but not distressed debt, and Pathway invests in distressed debt, but not mezzanine debt. Gary noted that both Abbott and Pathway invest most of their portfolios in venture capital, buyouts and special situations, which are the largest private equity strategy categories. Trustee Phillips stated that both firms have superior reputations.

**Due Diligence – Investment Manager Site Visits Report** – Trustee Phillips

*Abbott Capital, Columbus Circle, Morgan Stanley*

Trustee Phillips provided his written due diligence report.

**Open Session**

No public comment.

Chair Gladstern adjourned the meeting at 5:00 P.M.

*6:30 – 9:30 PM*

*Dinner – Piatti*
Wednesday March 17, 2010 – Day 2

8 – 9 A.M.
Continental Breakfast

CALL TO ORDER

Education Committee Chair Gladstern called the meeting to order at 9:10 A.M.

ROLL CALL

PRESENT: Bolger, Given (non-voting), Gladstern, Haim, Phillips, Richardson (early departure), Smith, Sweet, Webb (non-voting), Wofford

ABSENT: Hufford

Educational Presentation

Fiduciary Fundamentals - Ethics
Ashley Dunning, Manatt, Phelps and Phillips
Patrick Faulkner, Marin County Counsel

Counsel Ashley Dunning provided a report on Fiduciary Fundamentals and Ethics for Public Officials.

Ms. Dunning explained the following Fiduciary Duties of Trustees:

- Fiduciary Duty of Care
  - Prudent Expert Rule
  - Duty to Assure Competency of Retirement System Assets
  - Duty to Monitor
  - Duty to Consult with Experts

- Fiduciary Duty of Loyalty
  - Exclusive Benefit Rule
  - Primary Duty Rule
  - Potentially conflicting interests among members and beneficiaries

- Processes to establish fiduciary compliance

Ms. Dunning next discussed ethical rules that apply to public officials and focused primarily on rules pertaining to conflicts of interest.

Ms. Dunning also provided a summary of the California Supreme Court’s decision in Lexin v. Superior Court and responded to questions from Trustees. In response to a question about the governmental salary exception, Dunning noted that if a Board decision directly involves a Trustee’s own department but does not impact the Trustee’s own salary or other financial interests, the Trustee should nevertheless disclose that relationship and recuse himself or herself from the discussion.

The Chair deferred the Ethics discussion, directing deliberations to the time-certain Actuarial Report.
Actuarial Report
Bob McCrory and Graham Schmidt – EFI Actuaries

Actuary Graham Schmidt of EFI Actuaries presented actuarial valuations as of June 30, 2009, noting that this is the first year in which data has been available ahead of the fiscal year. Mr. Schmidt stated that there were significant increases in contribution rates due to recent investment losses to the fund. He reviewed employer contribution rates; liabilities, actuarial value of assets, and funding ratios. Funding ratios are declining, he said, based on actual asset value.

The payment on the unfunded liability is driving the increase in contribution rates, he said. Mr. Schmidt stated that studies show investment returns generally provide 2/3 of benefits. He provided a gain/loss analysis showing reasons for rate increases, which include: investment losses; decreased inflation assumption; reduced interest rates; and an increase in mortality assumptions. The methodology used to calculate COLAs also affected employee contribution rates, according to Mr. Schmidt. The new assumed rate of return rate is 7.75%; the assumed CPI is 3.5%, the actuary stated.

Mr. Schmidt said that GASB rules will be changing to tighten amortization requirements so that there will no longer be 30 year amortization available. The reduced amortization is based on the principle of generational equity, he explained. According to Acting Retirement Administrator Ford, there is controversy over these new regulations coming at the most inopportune time. For the County the target amortization period is 10 years, and Mr. Schmidt said that would provide for each generation to pay for benefit costs. Leveling the amortization period for 5 years prior to declining to 10 years is under consideration, he said.

Mr. Schmidt discussed that some systems are recognizing 50% of the extraordinary investment losses incurred during 2009 over a period of 30 years; in this circumstance, unusual gains would also have to be amortized over 30 years, he said. Trustee Haim emphasized the cyclical nature of investment gains and losses and the importance of recognizing that current trends in either direction are not likely to continue. Counsel Dunning asked whether such an increased amortization period applied to MCERA would compromise the actuarial soundness of the system. Mr. Schmidt stated that he did not believe it would.

Counsel Faulkner asked the actuary how declining payroll would impact contribution rates, and Mr. Schmidt said that there would be a reduction in the normal cost as well as increased rate volatility.

For Novato Fire, Mr. Schmidt recommended ten-year amortization as a goal in order to provide for generational equity. A reasonable method would be to adopt the 5-year policy and then decline to 10 years, he stated. He reviewed contribution values and rates for the City of San Rafael. It was noted that San Rafael City Council is initiating procedures to issue bonds. Acting Retirement Administrator Ford stated that he will be requesting that plan sponsors move to increase funding for unfunded liabilities. Mr. Ford added that policy decisions are pending to address issues such as excess earnings and interest rates. Mr. Ford thanked Mr. Schmidt for his expertise and efforts to improve actuarial calculations for the system.
The Chair returned deliberations to **Fiduciary Fundamentals – Ethics**, with Counsel Ashley Dunning presenting.

Counsel Dunning completed her summary of the *Lexin* ruling. County Counsel Pat Faulkner observed that there currently is discussion regarding the ability of employees to be involved in employment contract discussions on behalf of the County in light of *Lexin*.

Ms. Dunning next provided detailed information on conflict of interest laws in the following areas: campaign contributions; investments; gifts; honoraria. Ms. Dunning also discussed recent legislation tightening further the prohibitions on board member activities, both during and following their time on a retirement board. The meeting was recessed at approximately noon for lunch.

12 – 1:30 PM

*Lunch – Robata Grill*

Trustee Richardson was excused from the meeting after lunch.

The meeting was reconvened at approximately 1:30 pm.

Counsel Dunning continued her discussion of gift reporting requirements and provided examples. Advising that the law is the floor for ethical behavior, Counsel Dunning encouraged the Board members to go beyond the law to avoid even the appearance of a conflict of interest, and to seek advice early. Multiple resources were provided by Counsel Dunning to guide the Trustees.

Acting Administrator Ford provided a handout instructing the Trustees on required online ethics training, requested completion of the certificates by the end of April.

Counsel Faulkner stated that Counsel Dunning’s *Lexin* case argument before the Supreme Court is to be commended.

**Excess Earnings and Reserves Policy**
Bob McCrory and Graham Schmidt – EFI Actuaries

Actuary Graham Schmidt provided a presentation on the development of the MCERA Reserve Policy, stating that the intent is to define reserves for current funds available. EFI Executive Vice President Robert McCrory commented that many systems’ reserve accounts are antiquated or obsolete and therefore do not provide good examples to follow.

The actuaries presented and explained a flow diagram they prepared describing the reserves process. Definitions for the following terms were discussed: Employee reserve; retiree reserve; employer reserve; basic reserves; non-valuation reserves; contra account; contingency reserve; and undistributed reserve. Messrs. McCrory and Schmidt both recommended that the retiree reserves be trued up by equalizing them to match the retiree liability (including COLA). Mr.
McCrory emphasized that reserve accounts must align with reality so that contribution rates are calculated correctly. Mr. McCrory emphasized that these calculations are based on the market value of assets. He also said that a contra account may be useful to track whether excess earnings are available.

Mr. Schmidt cautioned that retiree reserves as currently described do not meet the expected liability. He stated further that, given that basic reserve accounts are insufficiently funded, there is a question as to whether the fund will have any excess earnings once the retiree reserve is trued up. Mr. Schmidt reviewed a possible reserve policy, once the basic reserve accounts are properly funded, that includes maintaining a contra account to track interest deficiencies as well as a non-valuation contingency reserve in which to hold surpluses.

It was noted that systems all over California are experiencing difficulties with their reserve policies. Counsel Dunning emphasized at least two legal issues that need to be resolved prior to finalizing a reserve policy: 1) The first is how to address the actuary’s recommended “true up” in light of the trust law principle that funds should not be moved out of the dedicated retiree reserve into the employer reserve; 2) The second is whether crediting interest at the full actuarial rate when funds are not available to do so is appropriate. In addition, Counsel Dunning stated that the 1937 Act requires provision for a 1% contingency reserve account before various actions may be taken with respect to “excess earnings”. Such an account could cushion the impact of some investment losses, she said, if the reserve is maintained as a non-valuation reserve, as has been recommended for the policy that will be developed. It was noted that currently the only account in the non-valuation reserve account is the 401(h) account.

Trustee Haim requested a discussion on the ad hoc COLA and the conditions under which it may be granted. Acting Administrator Ford explained that this was a summary overview and that further discussions and presentations would ensue.

Chair Gladstern recessed the meeting at 3:05 P.M., reconvening in Closed Session at 3:15 P.M. The meeting was reconvened in Open Session at 4 P.M.

Public Employee Dismissal/Release (Closed Session)
Board of Retirement Chair Jim Phillips announced that the Board took action by a vote of 7-0 to sever its employment relationship with Charnel Benner. The Board thanked Ms. Benner for her service to MCERA and its membership.

Mr. Phillips provided the following statement following Closed Session: I would like to clarify statements that were attributed to me in a Marin Independent Journal (IJ) article posted on March 5. In my comments to the IJ, I was responding to a question regarding the basis upon which the Board takes action generally and was not referring to any Board action with regard to Ms. Benner. My comments were certainly not intended as a criticism of Ms. Benner or her management of the retirement system.
2010/11 Work Plan/System Update
Acting Retirement Administrator Ford reviewed the administrative 2010/11 Work Plan. He reported plans for the CPAS system to go parallel July 1 and live September 1. The system will issue its own retiree checks, with two separate bank accounts to accommodate health benefits. Efforts are under way to implement a general accounting system to interface between SAP and CPAS. Our consultant Linea and selected staff members will visit Toronto to meet with the CPAS team. He said he has notified plan sponsors that we will be going from blended rates to actual rates for future contribution amounts.

Mr. Ford stated that interviews for the new Retirement Administrator are scheduled for May; in July, interviews for the Assistant Administrator will begin. A tentative budget will be available in May and finalized in August; Benefits Department staffing changes will be recommended in the next budget, he said. Praising staff member Rachel Williams for her assistance, he reported that the calculations buyback backlog has been reduced to 20. Mr. Ford announced the intent to provide educational disability seminars for members. In response to Trustee Smith’s inquiry as to the status of the member who spoke to in public session, Mr. Ford stated that communications with her were ongoing. Trustee Gladstern explained that when employees work in several different jobs, record-keeping becomes complicated and therefore time-consuming.

There being no further business, the meeting was adjourned at 4:25 P.M.

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Maya Gladstern, Chairperson

Michael Smith, Secretary