MINUTES

MARIN COUNTY EMPLOYEES' RETIREMENT ASSOCIATION (MCERA)
RETIREMENT BOARD STRATEGIC WORKSHOP

Marin Community Foundation
5 Hamilton Landing, Suite 200, Novato, CA 94949
Redwood Room
March 30-31, 2011

Wednesday, March 30, 2011
8 – 9 AM
Continental Breakfast

CALL TO ORDER Chair Richardson called the meeting to order at 9:03 A.M.

ROLL CALL

PRESENT: Bolger, Brenk, Burroughs, Given (non-voting), Gladstern, Haim, McFarland, Phillips, Richardson, Webb (non-voting), Wofford

ABSENT: None

Chair Richardson called for a moment of silent prayer for Supervisor Charles F. McGlashan.

SWEARING IN OF GARY BURROUGHS

County Counsel Pat Faulkner administered the oath of office to Gary Burroughs, County Treasurer, as Ex Officio Trustee to the Retirement Board.

OPEN TIME FOR PUBLIC EXPRESSION

No public comment.

BOARD OF RETIREMENT MATTERS

Economic and Capital Market Overview
Asset Allocation Review

Investment Consultant Jim Callahan, Callan Associates Executive Vice President, provided a recent market update and introduced analyst Jay Kloepfer who presented an overview of the economy and capital markets.

Trustee Haim joined the meeting at 9:12 A.M.

Mr. Kloepfer views capital market returns as extended below the long-term mean, and the question is when the historical trend will return. Mr. Kloepfer pointed out that the investment horizon for the MCERA fund is long-term. While lower recent returns present a challenge, the portfolio modeling process is designed to cycle through different markets over a longer period of time.

Mr. Kloepfer said that the fourth quarter rebound in the capital markets signals a renewed confidence in the economic recovery. In the last two years, equity markets have shaken off financial crisis declines; however, only emerging markets have achieved prior peaks. Additionally, the bond market surprised everyone, he said, and the question is whether to make portfolio adjustments if there is certainty that interest rates will rise.

An analysis of market returns followed. Mr. Kloepfer cautioned that average equity returns will be slow to recover to the historical 10.5% level. Mr. Kloepfer feels fixed income is fully valued, and expects equity ownership to be the best avenue to achieve mean reversion of capital market returns over the long term. Trustee Haim cited a Wharton School study that expects mean reversion and confirms the case for equities.

Mr. Kloepfer presented a wide-ranging analysis of factors affecting the global economy, to assess the prospects for growth going forward. One potential risk to the future economy would be oil price spikes, which would be a drag on growth. With faith in nuclear energy derailed due to the damaged nuclear plant in Japan, pressure on oil prices is likely. Were growth to stagnate over the next ten years, he said, deflation becomes a threat.

Continued low construction activity constrains employment, and the weak job market is a concern, according to Mr. Kloepfer. Also, falling home values and increased savings have dampened consumption, which drives 70% of GDP, he said. Fiscal stimulus has bolstered state and local governments and prevented a deeper recession, but will end, and growth has yet to appear. There are continued challenges to the financial system, as evidenced by the contraction of private credit in the fourth quarter of 2010.

The sovereign debt crisis continues with ratings downgrades of Greece and Portugal, Mr. Kloepfer said. The failure of such countries to maintain debt payments weakens Germany, Britain and France, which are, therefore, unlikely to drive the next growth cycle.

Given weak global economic conditions, Mr. Kloepfer said that inflation is not widely expected by bond market experts. Mr. Callahan pointed out that low employment levels will inhibit consumption and inflation. Concern about a deflationary environment remains, which could be ignited by another downturn in housing prices. Callan Associates expects the yield curve to rise in the short end and rise in the long end at a lower rate. Mr. Kloepfer explained changes in the yield curve vis-à-vis inflation expectations.

In summary, Callan Associates forecasts bond returns to be 3.75% and is reducing expected equity returns to 8% from 8.5%. Mr. Kloepfer reviewed ten-year return expectations for all market classes. Trustee Phillips asked about the reduction in equity return expectations, and Mr. Kloepfer attributed reduced expectations to lower-than-average GDP growth.

Chair Richardson recessed the meeting for a break at 10:45 A.M., reconvening at 10:51 A.M.

Capital Market Review
Asset Allocation and Liability Modeling

Mr. Kloepfer is forecasting a target expected ten-year geometric return of 7.45% for the portfolio. In adjusting for price inflation Callan's real rate of return expectation is approximately 5%. This compares to MCERA's real return expectation of 4.25%. Mr. Callahan advised caution on increasing portfolio risk in order to increase expected return.

The discussion turned to the recent public debate over using a risk-free rate discount rate. Trustee Bolger referred to a variety of publications that have recommended using a lower discount rate. Mr. Kloepfer suggested that it is unreasonable to use a U.S. Treasury return to value portfolios. He went on to argue that the main problem in not achieving expected returns is not the investment portfolio but the lack of adequate contributions. Trustee Haim stated that the Board must base its conclusions on the expert and detailed analysis of its consultants as opposed to public opinion. Retirement Administrator Jeff Wickman pointed out that the system's sponsors are required to fully fund the annual contribution. Mr. Wickman pointed out that benefit improvements, in particular improvements to service that has already been performed, increases the cost to the system. Those costs can only be recovered from a point forward. He also pointed out that the funding level does not factor in that liabilities are not due immediately, but over time. He pointed out that high funding levels are a snapshot point in time and that you must factor in the impact of smoothing in gains and losses to fully understand your current position. There was discussion about the learning curve and the need for increased education and communication among plan parties. Mr. Wickman will be participating in pension plan discussions with all of MCERA's plan sponsors.

Mr. Callahan reviewed investment return assumptions and asset allocations, which drive return and risk over time. He explained that the portfolio differs from peers due to many of the other public pension plans move into alternative investments such as private equity and hedge funds. The asset allocation and target returns are reasonable, concluded Mr. Callahan. Mr. Callahan recommended conducting an asset-liability model study in 2011.

Upon Trustee Haim's inquiry about the possibility of plan sponsors abandoning the defined benefit plan structure, Mr. Kloepfer stated that under that scenario increased bond exposure would be required as pensions would be paid out with no new contributions flowing into the plan. Mr. Wickman observed that contributions would increase in this situation because of a lower payroll base.

Chair Richardson recessed the meeting for lunch at 12:02 P.M., reconvening at 1:00 P.M.

Manager Structure Review
Active vs. Passive Management
Global Equity

Mr. Kevin Dunne from Callan Associates reviewed portfolio asset allocation targets and ranges. Final allocations reflect funding of the new emerging markets portfolio and the shift from market neutral assets to a passive index, resulting in 83% active and 17% passive management.

Domestic equity is slightly underweight to large cap and slightly overweight to small cap equity relative to the Russell 3000 Index. Mr. Callahan expressed confidence in the current portfolio structure, which he said is common to institutional pension plans. Potential modifications to the domestic equity allocations would be the balance between large cap versus small cap and the balance of active versus passive management in the large cap space. Mr. Callahan stated that Callan Associates favors a bias toward the small cap space, because the return expectation is higher over time due to value added by active management. Mr. Callahan explained that mid-cap exposure is attained via the large cap managers, since investment managers are stock pickers, and as such, do not use capitalization to drive investment decisions.

The discussion turned to expanding the investment opportunity set by increasing the allocation to global equity. Mr. Dunne said that one option would be a dedicated global equity manager. Another avenue would be Mr. Callahan's recommendation of one global value manager and one global growth manager selected from the current domestic and international managers. This change would remove the restraint on international investments for the domestic equity managers, because they are investing based on individual companies and not geographical location. Additionally, Mr. Callahan pointed out that the expected engine of growth going forward is emerging markets, and he advised increasing exposure to that region over time.

Trustee Richardson suggested that a dedicated global equity manager may add value to the fund, pointing out that such a mandate would include investment in domestic equities. Investment Committee Chair Phillips observed that the global economy demands global investment. The Trustees discussed the relative benefits and risks of international equities.

Mr. Dunne reviewed fixed income portfolio allocation and return expectations based on varying interest rate changes over time. Fixed income is all actively managed and its purpose is to protect the portfolio over time. The portfolio has some additional protection relative to the benchmark in a rising interest rate environment due to the higher yield advantage its Core and Core Plus managers currently have, according to Mr. Dunne. Mr. Callahan advised against making major changes to the fixed income portfolio.

Mr. Dunne reviewed the real estate portfolio, which is largely invested with Woodmont. Mr. Callahan recommended initiating a search for a new core real estate manager in response to ownership changes at ING Clarion. There was general agreement to this point, and Investment Committee Chair Phillips gave direction for Callan Associates to conduct the search.

Mr. Callahan offered to present alternative investment options on TIPS, commodities, agriculture, and shipping, at a future meeting.

Mr. Callahan discussed the relative merits of active versus passive management based on the efficient market hypothesis. He presented data showing there to be an active management premium for small cap managers, international equity managers, emerging markets managers, and core-plus bond managers.

401(h) Administration

Retirement Administrator Wickman stated that the Board previously took action to allow for administration of 401(h) accounts within the MCERA trust. He presented a draft 401(h) agreement between MCERA and Marin County Courts. The agreement was developed in compliance with IRS code which identifies the roles and responsibilities of the parties. Key points will be presented with the goal of presenting the agreement formally to the Board at a later date.

Counsel Ashley Dunning reviewed features of the proposed agreement. The Court determines eligibility for the medical plan and establishes the level and amount of benefits. The 401(h) account would be tracked separately by MCERA, but funds would be comingled for investment purposes. MCERA would make payments to insurance carriers designated by the Courts based on assets available in the account after investment gains and losses and administrative expenses. Mr. Wickman stated that the account is considered a part of the MCERA plan and MCERA is expected to implement it within state and federal laws.

The question of whether MCERA should take on the additional fiduciary and administrative responsibility for managing such a plan was discussed. Mr. Wickman stated that MCERA would have to assess the staffing impact. This could lead to adding staff to help manage the 401(h) account. Several Trustees expressed concern about the additional work load and also potential dilution of attention to the essential mission of the system. Mr. Burroughs observed that if the goal were to expand and provide the service to other sponsors, then it would make more sense to proceed with the 401(h) plan.

Based on discussions, Mr. Wickman said that he will meet with sponsors to determine the level of interest in the 401(h) plan, and recommend that the court research potential alternative providers for such a service.

Chair Richardson adjourned the meeting at 5:12 P.M.

Chair Richardson called the meeting to order at 9:05 A.M.

Actuarial Report

MCERA Actuary Graham Schmidt of EFI Actuaries presented the draft actuarial valuation report as of June 30, 2010. The report presents employer contribution rates for the fiscal year beginning July 1, 2011. Factors contributing to an increase in employer contribution rates include a decline in the payroll base over which the unfunded liability is amortized, and recognition of prior year investment losses under asset smoothing methods. Sponsors with smaller work forces should expect greater volatility in contribution rates, he said.

Mr. Schmidt reviewed Plan assumptions which have not changed. He stated that the real return rate of 4.25% is somewhat conservative, and is the most important factor in the cost calculation.

In response to a question posed by Trustee Haim, Counsel Dunning advised the Board members of their legal responsibilities with respect to the actuary's report. First, she noted the Board's obligation to make sure that sufficient contributions are collected to maintain an actuarially sound retirement system. Second, counsel noted that the trustees' fiduciary duty is to make decisions that serve the overall best interest of the plan members and their beneficiaries. She noted that the Board also has a secondary constitutional duty to plan sponsors not to require more contributions than are necessary, as determined by the Board. Finally, she stated that the trustees' decisions with respect to the report are to be based on the advice and recommendations of the actuary, while exercising reasonable independent judgment.

Mr. Schmidt reviewed projected contribution rates for employers over time. He also reviewed funded ratio projections, which decline initially as losses are amortized, and then rise. Mr. Schmidt discussed actuarial gains and losses, the actuarial value compared to market value of assets, and non-valuation reserves.

Mr. Wickman stated that he has been working with the actuary to update reserve balances in accordance with Board policies. Other potential refinements to the analysis were discussed, such as the allocation of assets between different groups once the CPAS system is completed.

Trustee Bolger questioned the assumed rate of return, based on several studies which recommend using a lower assumed rate of return. Ms. Bolger pointed out that the City of San Rafael was once funded at 100%, and she asked if a reduced assumption rate could have prevented the funding-level decline. Mr. Schmidt responded by explaining the market-value-of-liabilities concept whereby the risk-free rate is used to discount liabilities. The theory of this concept is that benefits should be valued using what would be earned on a government-backed bond, such as a U.S. Treasury. Mr. Schmidt advised, however, that most investment experts believe returns over time will be higher than the risk-free rate of return. Mr. Schmidt said that if risk is taken, it is reasonable to expect to be paid more than inflation and more than the risk-free rate of return. Furthermore, he pointed out that using the lower rate of return would increase contribution costs, and the disadvantages of such a path were discussed. Counsel Dunning pointed out that there could be a legal issue if MCERA set an unreasonably low assumption rate that would increase costs substantially in the near term. Moreover, Ms. Dunning observed that the portfolio is mandated by the California Constitution to be diversified so that it would not be possible to invest only in U.S. Treasuries. Counsel Faulkner pointed out that an undesirable consequence of too low a rate may be over-funding, which is not a desirable condition. Mr. Schmidt advised that the time to consider reducing portfolio risk would be under conditions of 100% funding.

Mr. Wickman pointed to the nature of the system's financing plan. Trustee Haim added that historical data supports the current assumption rate for the long term.

Investment Risk Analytics

David Hansen, principal for SF Sentry, introduced Tim Holmes and Scott White. Mr. Holmes reviewed the firm's risk analysis process, which is based on the need to study portfolio risk from different perspectives. The goal is to consolidate and analyze asset manager data to assure that there are no inadvertent investments which would serve to minimize the most efficient risk-return profile. Through this analysis, systematic market risk such as duplicative investments in the same company across investment managers can be revealed. Mr. Hansen pointed out that the increasing frequency of portfolio shocks makes risk management a key issue.

Mr. Holmes explained that the risk assessment provides for an informed dialogue on which to base decisions, and that regular analysis allows for perspective into the portfolio's characteristics.

Mr. Hansen summarized the benefits to MCERA as the objective evaluation of risk across multiple investment managers, awareness of volatility, maximizing return based on risk, increasing transparency, and improving the decision making process. The discussion focused on measuring risk-return over the portfolio as a first step. A potential result is to reduce volatility while maintaining the same return, for example.

Mr. Wickman stated that several peer systems have indicated an interest in risk management. He stated that the Board had approved a three month contract with SF Sentry to review what can be learned from their risk product. The reports will be presented to the Ad Hoc Investment Risk Committee who will in turn present the information to the full board.

Trustee Phillips observed that the risk management analysis will provide more detailed information on which to base investment decisions. Trustee Richardson agreed, adding that over time the risk analysis will become more meaningful and accurate.

Chair Richardson recessed the meeting for lunch at 12:11 P.M., reconvening at 1:30 P.M.

Sustainable Investing

Tony Arnerich of Arnerich Massena, Inc., presented their analysis that sustainable industries are poised at the edge of growth. He introduced David Chen of Equilibrium Capital Group, LLC, which is a private equity investor of investment managers. Mr. Chen said that the strategy is to build a platform of the best asset managers who invest in key assets such as water and energy. Classic investment fundamentals are based on macro trends of resource constraint, for example. The emergence of a middle class in India and China is a major theme. Mr. Chen gave examples of resource efficiencies which are expected to increase net profit and suggested investing in firms using that strategy. Mr. Chen asserted that in-demand commodities such as cotton will rise in price and create additional demand for water. Thus, the trend is for sustainable assets to have more economic value.

Mr. Arnerich defines "sustainability" as "meeting economic, environmental and social needs of the present without compromising the ability of future generations to meet their own needs." Mr. Arnerich introduced Ejnar Knudsen of Passport Capital, LLC.

Mr. Knudsen is portfolio manager of the Passport Capital, LLC, Agriculture Fund, which is a global equity, long/short fund comprised of 550 companies in 40 subsectors. Mr. Knudsen used the metaphor of a tsunami happening in slow motion to visualize the rising population and higher demand for grain consumption. Investments are focused on firms solving similar problems. The portfolio is evenly invested in developed and undeveloped markets. Mr. Knudsen presented population estimates and commodity price studies to support his investment thesis.

Matt Diserio co-founder and co-portfolio manager of Water Asset Management, LLC, outlined the basis for water investment opportunities in companies engaged in the business of ensuring water quality and supply. The thesis is that water is essential and poorly understood, thereby creating investment opportunity. The need for water is also driven by alternative energy production, according to Mr. Diserio. He stated that an inadequate amount of capital has been invested to assure an adequate water supply, which creates opportunity for private companies.

Disability Process Review

Mr. Wickman presented proposed ideas targeted at streamlining and improving the disability application process. The Disability Retirement Application and Determination guidelines propose formation of an MCERA Disability Review Group which would review documentation and make recommendations to the Board. Counsel Dunning commented that in certain cases it may be easily determinable that the case needs to go to an administrative hearing and can proceed there prior to being presented to the Board in the interest of using the Board's time to make meaningful decisions on disability retirement applications. All powers of the Board are retained in this process, she added.

The Trustees discussed the process in terms of transparency versus privacy, and considered the advantages and disadvantages of such a procedure. The Trustees deliberated whether due process for the applicant would be served under such a process, and whether it would be appropriate to use staff time for such decisions. Based on discussions, there was general agreement to retain the current process, while allowing for the use of a staff summary and recommendation regarding disability applicants. Once the Board is accustomed to the staff recommendations, then the proposed process may be reconsidered by the Board.

4 – 4:30 PM
Items for Future Agendas

No discussion.

There being no further business, Chair Richardson adjourned the meeting at 4:45 P.M.

Gerald Richardson, Chair

Attest: Jeff Wickman
Retirement Administrator