MINUTES

FINANCE AND RISK MANAGEMENT COMMITTEE MEETING
MARIN COUNTY EMPLOYEES' RETIREMENT ASSOCIATION (MCERA)

Retirement Board Conference Room
One McInnis Parkway, 1st Floor
San Rafael, CA

November 29, 2011 – 9 A.M.

CALL TO ORDER Chair Bolger called the meeting to order at 9:06 A.M.

ROLL CALL PRESENT: Bolger, Brenk, Given, Gladstern, Richardson, Webb

ABSENT: Phillips

MINUTES

It was M/S Gladstern/Given to approve the October 4, 2011, Finance and Risk Management Committee Meeting Minutes as submitted. The motion was approved by unanimous vote.

Chair Bolger discussed elements of proposed standards for foreign currency transactions, such as setting a non-discretionary range for transactions.

A. OPEN TIME FOR PUBLIC EXPRESSION

David Ratner joined the Committee meeting as a representative of the Citizens for Sustainable Pension Plans. Mr. Ratner referred to his background as prior Dean of the University of San Francisco Law School, and experience working with the Securities and Exchange Commission.

Chair Bolger directed deliberations to **Agenda Item C.1**.

C. NEW BUSINESS

1. Fiduciary Considerations for Actuarial Funding Decisions

   Counsel Ashley Dunning briefed Committee members on their fiduciary obligations as they relate to actuarial funding decisions.

   Counsel Dunning described the Board's legal obligation to secure the services of an independent actuary in order to assure the proper actuarial funding of the retirement system. Actuarial funding methodologies should be designed in order to assure timely payment of the benefits that MCERA pays. The actuary is to make recommendations and may provide prudent ranges which are the boundaries within which the trustees may take action.

The trustees are deemed to be prudent experts, and are deemed to understand the recommendations provided. The duty of care refers to prudence required of the trustees, and requires trustees to ask sufficient questions to ensure that they do in fact understand the actuarial recommendations that are provided and upon which they are acting. The duty of loyalty refers to the relationship between the trustees and all retirement system members, new hires and retirees alike, and their beneficiaries. The duty of impartiality requires decisions that are in the overall best interest of all members and beneficiaries. The exclusive benefit rule means that funds are to be used for the exclusive benefit of members and beneficiaries. There is a secondary constitutional duty to minimize employer contributions.

Ms. Dunning received questions about the balance of interests between members and sponsors, and she indicated that the overall best interest of members and beneficiaries predominates, but not to the exclusion of sponsor interests so long as those interests can be reconciled. Pertinent considerations, according to Ms. Dunning, include sufficient liquidity to pay benefits on time, as well as potentially the plan sponsors' ability to meet future obligations with MCERA. Actuarial methods must be in accord with accepted actuarial standards of practice, and GASB rules need to be considered with regard to financial reporting.

Ms. Dunning responded to the trustees' questions to clarify their obligations with regard to the actuarial process. She also discussed other components of prudent processes including active oversight of investments with the goal of obtaining future investment returns and recovering from losses. The investment consultant's recommendations are also considered by the actuary.

Trustee Brenk discussed his understanding, based on attendance at SACRS, that the trustee's most important job is to determine actuarial methods and contributions. It is a rational balancing act, said Chair Bolger, who transitioned the discussion to Mr. Graham Schmidt's preview of the Experience Study.

Chair Bolger directed deliberations to **Agenda Item C.2**.

2. <u>Experience Study Preview</u>
   Review and discuss preliminary Experience Study

   Mr. Schmidt began the discussion by pointing out that the draft recommendations were the same as what was presented to the Board at the September 2011 Strategic Workshop. He provided background based on the preliminary Experience Study in support of EFI's recommendation to reduce the assumed rate of return from 7.75% to 7.5%. That recommendation included a 0.25% recommended reduction in the inflation assumption, from 3.5% to 3.25%. Mr. Schmidt discussed the importance of the real rate of return, which is the investment return assumption adjusted by inflation.

   Mr. Schmidt reviewed the history of inflation including the rolling 30-year average, which has declined since 1995. He also presented data on the inflation yield curve and the Fed's inflation assumption which is below 2% for the long term. The survey of professional forecasters shows a 2.5% factor over the next 10 years. MCERA's Investment Consultant, Callan Associates, ten-year inflation assumption is 2.5%. Based on the data, Mr. Schmidt felt the recommended reduction was appropriate.

In response to Trustee Brenk's question, Mr. Schmidt stated that assumptions are based on 100 years of data. Trustee Brenk observed that studies show the population level will not be sustained, and Mr. Schmidt noted that worldwide birth rates have dropped but that immigration neutralizes the effect. The actuary uses research as a directional indicator to gauge the appropriate inflation rate. Because signals change over time and there is no certainty, dramatic changes to inflation assumptions may not be prudent, according to Mr. Schmidt.

Chair Bolger posed the question of whether current conditions warrant a greater reduction in the inflation assumption rate. She noted that TIPS have a lower yield than the inflation assumption. Mr. Schmidt explained that bond yields are affected not only by expectations for inflation, but other market influences. Mr. Schmidt also pointed out that the inflation assumption has been significantly reduced over the last three years. Trustee Bolger inquired about the CalPERS inflation rate of 3%. Mr. Schmidt commented that it has remained stable for some time. Mr. Schmidt emphasized the long-term nature of the economic assumptions and cautioned against overreacting to extreme events that may change over the short term.

Mr. Schmidt reviewed the history of investment return assumptions. Mr. Schmidt discussed the process of developing the investment real rate of return which is based on assumptions for each asset class. The current 4.25% real rate of return is reasonable, he stated, and is in line with the investment manager's expectation.

Mr. Ratner commented that since fixed income investments are less volatile than the stock market, they should be used to fund defined pensions. He stated that plan sponsors do not have the ability to pay increased contribution rates. In response, Mr. Schmidt stated that asset smoothing is the primary tool for dealing with volatility, and counsel pointed to the constitutional mandate to diversify Plan investments.

Trustee Brenk expressed concern that the assumed return for the fixed income class may be too high because of the good performance of the class recently. Mr. Schmidt explained that bond return assumptions would not be straight-lined but more likely would be expected to come back in line.

Mr. Schmidt discussed wage growth expectations and COLA growth. COLA growth is likely not to grow as much as inflation and therefore it is recommended to assume a number that is less than the COLA cap. Mr. Ratner asked about wage growth assumptions, and Mr. Schmidt stated that due to the weak economy wage growth is not expected to be high, though wages for Safety members' wages have increased.

Mr. Schmidt presented a summary of proposed assumptions, and reviewed the actual versus expected demographic assumptions such as the number of service retirements. Most showed close correlation to expectations.

Mr. Schmidt presented a chart showing the net change as a percentage of payroll if all the recommended assumption changes were adopted by the Board. Mr. Wickman observed that the changes listed do not factor in recent investment returns that will be included in the final presentation.

Trustee Brenk stated that it may be prudent to consider different assumptions and discuss what the impacts would be on plan sponsor contribution rates. Counsel Dunning stated that that the Board may inquire about EFI's other reasonable approaches. Mr. Schmidt presented combinations of selected reasonable lower real return and inflation assumptions, with an assessment of the related increase in the County's contribution rate.

Chair Bolger directed deliberations to **Agenda Item C.3**.

3. System Risk Quarterly Review – SF Sentry
   Presentation and discussion of preliminary system risk analysis

   SF Sentry representatives David Hansen, Tim Holmes, and Scott White presented the quarterly system risk report for the period ending September 30, 2011. Mr. Hansen noted that on a macro level the markets produced one of the worst quarters since 2009. The portfolio was buffered by the fixed income class during this period, he said, in reviewing portfolio exposure by manager and asset class.

   An equity sector analysis showed an increase of 2.32% for consumer staples. According to the report, the portfolio remained large-cap weighted and highly liquid. Top equity holdings from quarter-to-quarter showed little change. Mr. White indicated that the Committee may want to discuss the use of a custom benchmark for conducting sector analysis.

   Tim Holmes reviewed quarterly changes in fixed income holdings by sector. Top ten fixed income holdings have not changed other than relative positions. The private equity allocation increased due to capital calls. Real estate has a valuation lag, so while it showed outperformance, risk is difficult to properly gauge. Mr. Holmes also noted that the Eaton Vance and private equity investments increased the overall risk profile of the portfolio.

   Mr. Hansen reviewed portfolio exposure which listed values and percentages of assets by manager and sector. Portfolio holdings were also defined by country. Mr. Holmes discussed the difficulty of analyzing pooled holdings. Mr. White discussed the long duration of mortgage securities and suggested MCERA consider confirming the durations with the fixed income managers.

Mr. White discussed value at risk (VaR), which increased over the third quarter. Mr. White indicated that the risk assessment assigns greater weight to recent events. He reviewed top VaR contributors, showing Woodmont as the largest and Artisan as having the highest per unit risk profile. The risk profile of each manager against the whole portfolio was reviewed.

Chair Bolger directed deliberations to **Agenda Item C.4**.

4. Commission Recapture
   Review and discuss MCERA's existing commission recapture program

   Mr. Wickman's research indicated that MCERA has maintained a commission recapture program since 1994. Mr. Wickman indicated that only one MCERA manager, RCM, continues to participate in the program and revenue from commission recapture has dramatically decreased over the past couple of years. Chair Bolger questioned the prudence of continuing the program.

   Based on discussions, the Committee determined that staff should consider eliminating the program, after discussing the matter with RCM to determine whether it would be more beneficial than not for MCERA to do so. Mr. Wickman will report to the Board on the matter in the Administrator's Report.

Chair Bolger directed deliberations to **Agenda Item C.5**.

5. Notes to Financial Statements Update
   Consider and discuss updates to financial statement notes

   Mr. Wickman discussed potential updates to notes to financial statements regarding credit risk, derivatives and other topics. There was a discussion as to the best way of incorporating all the comments into the future financial statements. Mr. Wickman recommended formation of an ad hoc committee that would review the draft statements once they are ready and provide changes.

Chair Bolger directed deliberations to **Agenda Item B.1**.

B. OLD BUSINESS

1. Administrative Budget FY 2011/12 Quarterly Review
   Consider and review budget for quarter ending September 30, 2011

   The Committee considered the administrative budget and found the expenses to date were reasonable. Matters of discussion follow.

2. Quarterly Checklist
   Consider, review and updates on the following:
   a. MCERA travel and event related expenses

The Committee found travel expenses to be reasonable.

b. Other expenses per Checklist guidelines

Trustee Gladstern discussed expenses for items such as insurance and County of Marin printing. Trustee Given explained the debt service for the County Pension Obligation Bond. Journal subscriptions will be examined to ensure accurate billings.

c. Variances in the MCERA administrative budget in excess of 10%

The Committee found no concerns regarding budget variances.

d. Reconciliation of MCERA administrative accounts

Trustee Given indicated that administrative accounts will be reviewed after the CPAS implementation.

e. Vendor services provided to MCERA

Upon the request of Chair Bolger, legal expenses will be further delineated by provider.

f. MCERA staffing status

Mr. Wickman continues to work on the staffing plan as outlined in the fiscal year 2011/12 budget. This included the conversion of certain extra hires and the reclassification positions. Chair Bolger indicated that caution regarding the staffing level is appropriate until the efficiency of the CPAS system becomes apparent.

g. Internal controls, compliance activities and capital calls

The development of a cash flow analysis was considered based on the level of capital call outflows to fund the private equity portfolios to target levels.

h. Audits, examinations, investigations or inquiries from governmental agencies

Trustee Given discussed the pending employee status of trustees. Counsel Dunning is discussing the matter of competing mandates with MCERA's tax counsel and will report to the Board expeditiously.

i. Other items from the Retirement Administrator related to risk and finance

Mr. Wickman reported that the Argent bond issue appears to be close to resolution.

Trustee Gladstern discussed the possibility of joining the Los Angeles County Employees Retirement Association (LACERA) in proposing legislation regarding errors and omissions. The proposed legislation addresses statutes of limitation and is based on existing regulations for other entities, she stated.

There being no further business, Chair Bolger adjourned the meeting at 2:40 P.M.

Bernadette Bolger, Chair	Attest: Jeff Wickman, Retirement Administrator