MINUTES

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

Sheraton – Four Points
1010 Northgate Drive, San Rafael, CA 94903
Sonoma Room
March 21-22, 2012

Wednesday, March 21, 2012
8 – 9 AM
Continental Breakfast

CALL TO ORDER Education Committee Chair Webb called the meeting to order at 9:00 A.M.

ROLL CALL PRESENT: Bolger, Gladstern, Haim, McFarland, Piombo (safety alternate), Richardson, Stevens, Webb (retiree alternate)

ABSENT: Brenk, Cooper, Given

OPEN TIME FOR PUBLIC EXPRESSION Note: The public may also address the Board regarding any agenda item when the Board considers the item.

BOARD OF RETIREMENT MATTERS
Retirement Administrator Jeff Wickman welcomed members of the Board, consultants, and the public to the Strategic Workshop. The workshops provide the opportunity for an in-depth review and discussion of subjects relative to MCERA's role in administering the system.

9 – 11 AM
Economic and Capital Market Review
Jay Kloepfer
Callan Associates

Mr. Wickman introduced investment consultant Jim Callahan, Executive Vice President of Callan Associates. Mr. Callahan introduced Jay Kloepfer, Director of Capital Markets Research, who presented the economic and capital market review. Mr. Kloepfer stated that capital market projections are developed in order to plan for the future. The process includes modeling, data evaluation, referring to industry experts, and finally peer review. Economic factors that affected projections include historically lower-than-expected fixed income yields over the past several years. Based on reduced expectations for GDP growth, projected returns for riskier assets are lower. There is uncertainty about when these measures will revert to the mean, with potential economic scenarios including slow and steady growth, an ignited recovery with inflation, or stagnating economy.

Emotion and politics influenced the capital markets in 2011, as economic stimulus and payroll tax cuts were used to defend the economy against weakness in financial institutions, housing markets, the European debt crisis, and U.S. budget issues. A so-called "risk-off" trade resulted in a flight to U.S. Treasurys and lower equity returns. Trustee Bolger inquired about the effect of high frequency trading, and Mr. Kloepfer said it is a factor in increased volatility in the capital markets.

Mr. Kloepfer pointed out that the deepest recession since the Depression occurred in 2008. Weakness in the housing market affected the health of the entire economy, he explained. Positive economic signs include corporate cash flows, equipment purchases, and exports. Other economic data reviewed included employment levels, property taxes, and sentiment indicators.

There is a lack of inflationary pressure in the economy, according to Mr. Kloepfer, who identified factors that balance otherwise inflationary economic stimulus, such as lower prices over time for computers and automobiles, and low wage growth. Mr. Callahan discussed the potential for a change in the equilibrium between CPI and core CPI due to structural changes in the demand-supply equation for food. He indicated that the long-term global theme of decreasing natural resources offers an opportunity to target investment options. MCERA's Actuary Graham Schmidt pointed out that the CPI and wages affect the Plan's liabilities.

Mr. Kloepfer reviewed the history of U.S. Stock Market returns and the historical yield curve of U.S. Treasurys. Current market weakness has resulted in 15-year equity returns that are lower than longer term averages. Future capital market expectations are lower across all asset classes, according to Mr. Kloepfer, with bond market returns expected to be 3.25%, equities under 8%, and real estate at 6.4%. Risk factors include a geopolitical event resulting in a substantial increase in oil prices, continued weakness in the housing market, or economic stagnation.

In his response to Trustee Stevens' inquiry about hedging fixed income holdings against a potential rise in interest rates, Mr. Callahan indicated that the timing and execution risks of alternative investments should be carefully measured, and encouraged an analysis of the the total portfolio in the context of a long-term time horizon. Mr. Kloepfer stated that U.S. Treasurys continue to be the most significant flight to quality. Trustee Richardson inquired about the potential for rapidly rising interest rates, and Mr. Kloepfer responded that the effect on fixed income would be capital loss and increased yield.

Chair Webb recess the meeting for a break at 11:10 A.M., reconvening at 11:19 A.M.

11 – 12 Noon
Portfolio Risk Measures
Jim Callahan/Jay Kloepfer
Callan Associates

In response to questions from attendees about how risk and volatility are measured, Mr. Callahan explained that the least amount of risk to achieve the target return is the guiding principle. In response to a question regarding fiduciary and other legal obligations of the Board, Counsel Dunning advised that the California Constitution requires the Board to diversify the portfolio to maximize return and minimize risk unless it is not prudent to do so. Further, benefits must be timely paid when they are due based on an actuarially sound system, she stated. Ms. Dunning also noted there is a constitutional secondary duty to minimize employer contributions, assuming the primary duty to members and beneficiaries is met. Ms. Dunning explained that if the Board determined that increased funding were appropriate, then it could make related adjustments.

Ms. Gladstern requested a discussion of risk-reduced strategies such as Liability Driven Investment (LDI). In response Mr. Kloepfer pointed out that a reduction in the expected return would necessitate increased contributions. He indicated that challenges occur when plan sponsors either cannot pay contributions or costly benefit improvements are implemented. Trustee Piombo pointed out that plan sponsors should make decisions on benefits based on long-term funding conditions. Trustee Richardson suggested smoothing assets when there is a surplus in order to build larger reserves. According to Mr. Wickman the funding level at any given point in time needs to be considered with regard to the whole picture.

Mr. Callahan stated that diversification is a central tool to control risk, both across and within asset classes. The level of risk is based on expectations for volatility from asset classes over time and is a key component of asset allocation. The concept of risk budgeting measures conviction levels to increase efficiency. For example, the passive S&P 500 index controls risk, with active management providing balance to increase return.

Risk policy, according to Mr. Callahan, rests on a well-constructed Investment Policy Statement that provides a rebalancing guide as a risk-control discipline to adjust to target allocations. Risk control includes a governance structure with clearly defined responsibilities for staff, consultants, and the actuary.

Chair Webb recessed the meeting for lunch at 12:20 P.M., reconvening at 1:15 P.M.

12 – 1:30 PM
Lunch on site

In summary, Mr. Callahan spoke to increasing diversification and the industry trend toward reducing the fixed income allocation. Alternatives for portfolio diversification that are in demand include goal-based strategies that have low correlation with asset classes, hedge funds, and risk parity strategies, and Tactical Asset Allocation strategies that implement equities and fixed income with tactical trading.

1:30 – 2:30 PM
Fixed Income Education Session
Jim Callahan
Callan Associates

Mr. Callahan presented an overview of the fixed income portfolio, which has historically served as a low risk, diversifying anchor against riskier investment. He noted that there is an asymmetry to the fixed income return pattern since the upside is capped to interest and principal, and the downside is to zero. If and when interest rates rise from current historically low levels, a loss of principal will occur. Over time the allocation to fixed income has been reduced, and the question, he said, is whether to go further.

Alternative considerations for the fixed income portfolio were reviewed by the consultant. The first of these is to stay the course and accept potential price depreciation, which is offset by higher coupons. A second option would be to reduce the fixed income Beta by reducing the allocation and duration. Third, Alpha expectations can be increased for fixed income managers, strategically and tactically. This goal has been met as both fixed income portfolios have a core plus strategy. A fourth option is to change fixed income exposure by using specialty mandates for various assets such as high yield and bank loans.

The final option posed by the investment consultant is to invest in a new asset class of purpose-driven allocations that are based on economic scenarios or risk exposures.

Mr. Callahan reviewed the current core plus fixed income portfolios. The managers manage portfolios to the broad Barclay's Aggregate Index. They operate within constraints for duration and have latitude for adding value with yield curve strategies, sector rotation, security selection, and the use of non-index sectors such as emerging market bonds, high yield bonds, and non-dollar denominated bonds. Mr. Callahan recommended retaining the fixed income benchmark but indicated that the Barclay's Universal Index would be a reasonable index for individual portfolios.

Mr. Callahan suggested that the most immediate question is whether the broader asset allocation is still appropriate. He pointed out that it is difficult for core bond managers to add value net of fees and the average excess return for core plus fixed income is 0.57%. He referred to an unconstrained fixed income strategy that would allow managers to flow among a broader opportunity set. He also referenced the underperformance of equities over the past ten years that has led to a degree of underperformance to peers. Trustee Richardson stated that so long as the long-term goal indicates the equity allocation is correct, then volatility can be endured.

Considering the current capital market environment, Mr. Callahan discussed moving to absolute return strategies in order to diversify the portfolio and provide higher returns. He discussed a 5% allocation for a diversifier bucket that would include, for example, strategies like covered calls, risk parity, and GTAA that may be considered a total fund diversifier. A presentation to the Investment Committee on possible options for the total fund was recommended by Mr. Callahan

Trustees Haim and Stevens expressed their preference to follow up the discussion with the Investment Committee. Three broad decision categories of reducing fixed income and/or equities and considering absolute return options were outlined by Mr. Wickman for future discussion.

Chair Webb recessed the meeting for a break at 3:01 P.M., reconvening at 3:14 P.M.

2:30 – 4 PM

Asset Allocation and Liability Modeling

Callan Associates – Jay Kloepfer

Mr. Kloepfer stated that asset allocation is the prudent process for a pension plan that determines the optimal allocation of a portfolio among broad asset classes. The analysis involves simulation of financial conditions based on capital markets assumptions and asset mix alternatives, in concert with the actuary's liability assumptions and liability model that were presented to the Board at last fall's Strategic Workshop. Risk tolerance is defined, and then the appropriate asset allocation is considered.

The studies show that the Plan is diversified and lies on the efficient frontier of risk and return. Improved funding levels are expected over the next ten years and liquidity needs do not constrain asset allocation. Given the long-term time horizon linked to duration of liabilities, risk tolerance and the assumed rate of return are reasonable. Mr. Callahan indicated that since return expectations are lower for the near term, an orientation toward higher risk assets may be required in order to achieve the Plans' assumed investment return. Orienting more assets to equities would require the implementation of new strategies to mitigate risk.

Mr. Kloepfer reviewed an array of potential asset classes and strategies, and discussed the idea of moving part of the real estate allocation into real assets. Private real assets such as timber, energy, infrastructure and mining were discussed by Mr. Callahan as potential income-generating vehicles, although exit strategies need to be considered and they are typically highly leveraged and illiquid. In response to Trustee Stevens' inquiry, Mr. Callahan stated that commodities have high volatility and uncertain returns.

In summary, Mr. Callahan recommended the Investment Committee consider reducing the equity allocation and diversifying into other alternate asset classes. Trustee Gladstern recommended exploration of investment alternatives, and Mr. Wickman will bring an action item to the Investment Committee for further consideration of asset allocation.

Trustee Richardson was excused from the meeting.

Chair Webb recessed the meeting for evening recess at 4:10 P.M., reconvening at 9 A.M., March 22.

EVENING RECESS

5:30 PM
Dinner at Wild Fox
225 Alameda Del Prado
Novato, CA

Thursday, March 22, 2012
8 – 9 AM
Continental Breakfast

9 – 10:30 AM
Corporate Governance – Proxy Voting
Grant & Eisenhofer
Marc Weinberg

Marc Weinberg of Grant & Eisenhofer introduced Michael Barry as the firm's expert in the relationship between fiduciary responsibilities and good corporate governance. In presenting his overview, Mr. Barry discussed its relevance, shareholder options, current issues, and litigation.

According to Mr. Barry, corporate governance provides a control mechanism over corporate behavior in the interest of shareholders. Transparency and accountability, he said, lead to improved management performance. He noted that pension plans and hedge funds own a third of the equity of all publicly traded companies in the U.S. He also pointed out that the Dodd-Frank Act has increased federal oversite of public institutions requiring, among other things, the CEO and CIO to release signed financial statements.

Mr. Barry discussed the State of Delaware model, which is relevant as the majority of companies are incorporated in that state. He said recent trends include voting, communications with Directors, short slate elections, "Vote No" campaigns, shareholder proposals, joint coordination, and inspection of corporate records. He encouraged the use of Institutional Shareholder Services (ISS) and Glass Lewis, & Co. voting policy recommendations. Counsel Dunning noted that MCERA has policies on corporate governance and proxy voting.

Shareholder proposals have limitations, according to Mr. Barry, and may not constrain the fiduciary duty of the Directors to manage the corporation, but may be used to propose bylaws changes, for example. Mr. Barry stated that Delaware law includes the right to inspect corporate documents, if there is a proper purpose.

Mr. Barry reviewed shareholder actions that have improved corporate governance, such as splitting the roles of CEO and Chairman, which is the case for 41% of corporations as of 2011 and provides for check and balance in the roles of oversight and management. Majority voting is used by 77% of S&P 500 corporations and smaller companies are expected to follow the lead.

"Say on Pay" reform, an issue for a decade and now mandated by the Dodd-Frank Act, allows voting on executive compensation including stock options and pension benefits.

Proxy access, the ability of shareholders to nominate directors, is considered the pinnacle of good corporate governance and is supported by the Dodd-Frank Act. Mr. Barry recommended monitoring of several shareholder votes on proxy access in the near future. Other areas of shareholder interest include social and environmental proposals and political donations and policies.

The benefits of class action litigation, which allows all shareholders to participate in rewards, include control over the litigation and timing of settlement, and the opportunity to assume the lead plaintiff role. Mr. Barry responded to questions from the trustees on the presentation.

10:30 – 12 Noon
Investment Policy Statement Review
Callan Associates
Jim Callahan

Mr. Callahan reviewed the Investment Policy Statement and discussed with the Board and staff potential revisions that were in the nature of refining phrasing as opposed to making significant policy changes. The trustees and staff considered and discussed refining terminology for investment vehicles and adjusting language for the investment goal statement with regard to investment returns over time. Discussions included language with respect to the fiduciary role of investment managers. Changes to the Investment Policy Statement were referred to the Governance Committee which will complete the review and recommend to the Board for consideration and potential approval.

Chair Webb recessed the meeting for lunch at 12:13 P.M., reconvening at 1:35 P.M.

12 – 1:30 PM
Lunch on site

1:30 – 2:30 PM
Portfolio Rebalancing
Callan Associates
Jim Callahan

Mr. Callahan discussed briefly the purpose and goal of rebalancing the portfolio. He noted that MCERA's historical practice has been to rebalance back to 50% of target when market conditions or manager changes make that prudent. He discussed the automatic rebalancing service that could be provided by MCERA's capital overlay manager, The Clifton Group. Mr. Callahan recommend the Board invite Clifton to a future investment committee meeting to discuss their tools and approach for automatic rebalancing. Mr. Wickman indicated he would contact Jack Hansen from Clifton and invite him to make a presentation at the May Investment Committee meeting.

2:30 – 3:30 PM
Fiduciary Fundamentals and Ethics for Public Officials
Manatt Phelps Phillips
Ashley Dunning

MCERA Board Counsel Ashley Dunning presented a review of fiduciary fundamentals and ethics for public officials. Topics included fiduciary duties and ethics with regard to personal financial gain, claiming perquisites of office, and use and gift provisions for public funds.

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
  - Loyalties of Board members
  - Collateral interests of Board members
  - Conflicting interests among members and beneficiaries
- Processes to establish fiduciary compliance

Ethical rules that apply to public officials were reviewed next, with Ms. Dunning focusing primarily on rules pertaining to conflicts of interest. Ms. Dunning discussed the *Lexin v. Superior Court* decision and responded to questions from trustees. She referred to instances in which trustees should recuse and provided examples of gift reporting requirements. 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.

To guide the Trustees, Ms. Dunning provided multiple resources. The Retirement Administrator reminded the trustees of the biannual ethics certification requirement.

3:30 – 4 PM
Items for Future Agendas

Topics of discussion at the next Investment Committee meeting include the securities lending program and a presentation by Clifton on rebalancing with the futures overlay program. Asset allocation will also be considered. A standard review of the IPS will be considered for all Strategic Workshops.

There being no further business, Chair Webb adjourned the meeting at 3:55 P.M.

Sean Webb, Chair

Attest: Jeff Wickman
Retirement Administrator