MINUTES

INVESTMENT COMMITTEE MEETING
MARIN COUNTY EMPLOYEES' RETIREMENT ASSOCIATION

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

September 20, 2012 – 9 A.M.

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

ROLL CALL

PRESENT: Bolger, Brenk, Cooper, Gladstern, Given, Haim, McFarland, Piombo (safety alternate), Shaw (ex officio alternate), Stevens, Webb (retiree alternate)

ABSENT: Richardson

A. OPEN TIME FOR PUBLIC EXPRESSION

Note: The public may also address the Committee regarding any agenda item when the Committee considers the item.

No public comment.

Acting Chair Gladstern directed deliberations to **NEW BUSINESS**, **Agenda Item E.1**.

E. NEW BUSINESS

1. Presentation on Risk Parity – AQR Capital Management (TIME CERTAIN: 9:00 A.M.

Gregor Andrade, AQR Capital Management Client Strategies representative, provided an educational presentation on risk parity portfolios. Mr. Andrade explained that the objective is to improve risk-adjusted return over time by increasing diversification in the sources of risk, i.e., using risk as a factor to allocate assets to reduce portfolio volatility.

According to Mr. Andrade, the risk parity strategy is designed to reduce the risk associated with relatively high equity allocations. When compared to a typical institutional portfolio, the risk parity strategy would reduce dependence on the equity asset class without sacrificing return, Mr. Andrade asserted. He presented data showing that the Sharpe Ratio (a measure of risk-adjusted return) of bonds and inflation-linked assets such as commodities since 1971 compares favorably with equities.

In addition to changing asset allocations and adjusting to market conditions, risk parity necessitates the use of leverage in order to offset the reduced allocation to equity assets, which have higher absolute returns over time.

In response to Trustee Haim's observation, Mr. Andrade agreed that the higher correlation among asset classes over time blunts the effect of diversification. Since commodities and inflation-linked bonds have lower correlation to equities or bonds, they represent another bucket to balance portfolio.

In response to the inquiries of Trustees Bolger and Given, respectively, Mr. Andrade stated that bonds protect against deflation and strong equity markets result in underperformance of the risk parity approach.

Investment consultant Jim Callahan of Callan Associates asked about risk parity performance in a rising-interest rate environment, as opposed to the current declining interest rate environment where leveraged bonds have performed well. Mr. Andrade responded that bonds would underperform in a rising interest rate environment but would be balanced out by the returns of other asset classes.

In summary, Mr. Wickman stated that the risk parity presentation serves as educational background as a follow-up to discussions on the equity allocation at the March Strategic Workshop, and for consideration as a risk-management tool at the October Strategic Workshop.

Acting Chair Gladstern directed deliberations to **Agenda Item B.1**.

B. MANAGER ANNUAL REPORTS

1. State Street S&P 500 Index

Sonya Park, Senior Relationship Manager, and Brett Collins, Investment Strategist with State Street Global Advisors (SSgA), presented the review of SSgA's S&P 500 Flagship Non-Lending Fund. Ms. Park stated that the objective of the fund is to match the returns and characteristics of the S&P 500 Index as closely as practicable before expenses. As of June 30, 2012, the fund returned 5.44% net of fees for the fiscal year (versus 5.48% for the S&P 500 Index).

Mr. Collins provided an overview of the global economy. He reported that Europe is now in a shallow recession and the U.S. has shown very modest growth. Relatively low inflationary pressure allows for continued monetary easing by the Federal Reserve (the Fed) to spur economic growth. The European Central Bank is supporting the sovereign debt of Eurozone members committed to fiscal controls.

According to Mr. Collins, current quantitative signals point to potential reversal of the recent market rally. Factors to be considered include the so-called fiscal cliff, sovereign debt issues, disputes over islands in Asia, and tension in the Middle East. The presidential election may resolve uncertainty about the direction of the U.S. economy. Bearish signs in the U.S. labor market include the low participation rate, increasing numbers of one-income families, and longer duration of unemployment. On a positive note there are signs of an improved housing market.

Acting Chair Gladstern recessed the meeting for a break at 10:26 A.M., reconvening at 10:34 A.M. and directing deliberations to **NEW BUSINESS**, **Agenda Item E.2**.

2. Wellington Emerging Markets – Sue Bonfeld
   Discussion of emerging markets investments in Wellington portfolio.

   Sue Bonfeld, Relationship Manager with Wellington Management, presented an overview of the core plus fixed income portfolio. Due to the transition from the core to core plus strategy in April 2012, portfolio returns do not reflect outperformance of the high-yield sector in the first quarter of 2012. As of June 30, 2012, the portfolio returned 8.17% net of fees for the fiscal year (versus 7.47% for the Barclays Aggregate).

   Ms. Bonfeld explained that the portfolio has no below-investment-grade holdings in emerging market debt at this time as portfolio manager Campe Goodman is finding more favorable risk/reward profiles in high yield and mortgage-backed securities.

   In responding to trustee inquiries, Ms. Bonfeld stated that quantitative easing measures have been a positive factor to date, although Mr. Goodman is currently risk-neutral due to uncertainties regarding the structural nature of the weak labor market, the eventual unwinding of favorable monetary policies, sovereign debt, and the potential impending fiscal cliff. The use of currency forwards is dependent on completion of counter-party agreements, according to Ms. Bonfeld.

Acting Chair Gladstern directed deliberations to **Agenda Item E.5**.

5. Discuss and Consider RCM Performance and consider possible termination of program and transition of assets (**Action**)
   Mr. Callahan introduced Scott Migliori, RCM Select Growth Portfolio Manager, who addressed performance of the portfolio. Mr. Migliori attributed the portfolio's underperformance over the past two years to the market's move to dividend-paying stocks. Referring to the portfolio's outperformance in 2005 to 2009 time frame, he explained that performance is not expected to be linear. Mr. Migliori sees signs that the market is broadening out and performance is stabilizing.

   Trustee Haim questioned Mr. Migliori about recent staff turnover (the firing of two underperforming analysts and the hiring of two new analysts to replace them. In response, Mr. Migliori stated that since 2004 staff turnover has stabilized to anticipated levels. Trustee Stevens pointed out the relatively high cash level and that stock selection is not adding to performance. In response Mr. Migliori characterized the cash level as prudent considering market conditions and pointed to subsectors as a focus instead of individual securities.

Mr. Callahan pointed out that only a quarter of large-cap-growth managers have outperformed the Russell 1000 Growth Index over the past three years. He explained that in that time frame domestic equities have struggled in a volatile, macro-driven market. Callan Associates consultant Uvan Tseng stated that upon conducting an on-site meeting with RCM, Callan remains confident that communications and staff performance issues will be addressed.

Ms. Gladstern stated that there is general concern on the Board about relative underperformance of the portfolio in view of fees paid. Over time there have numerous discussions on the matter, observed Mr. Haim. Mr. Brenk questioned the investment strategy. In response to the trustees' remarks, Mr. Callahan cautioned about placing too much emphasis on the last three years of RCM's underperformance, since over time active managers tend to outperform the benchmark. Mr. Callahan remains comfortable with a combined approach to active versus passive management and the current managers.

It was M/S Stevens/Bolger to terminate RCM as manager of the select growth portfolio.

Discussion on the motion included Trustee Haim's request to determine the investment alternative. Trustee Stevens suggested the Russell 1000 growth index as an interim vehicle. Mr. Callahan recommended against that approach due to the unnecessary transaction costs that would be incurred if the Board decided to hire a new active large cap growth manager thereafter. Trustee Bolger recommended utilizing State Street's transition management services. Trustee Brenk agreed with Mr. Callahan's advice to determine the investment alternative prior to taking action.

Trustee McFarland's call for the question was sustained on a vote of 6-2, with Trustees Brenk and Haim opposed. The vote on the original motion follows:

AYES: Bolger, Cooper, Given, Gladstern, McFarland, Stevens

NOES: Brenk, Haim

ABSTAIN: None

ABSENT: Richardson

Upon discussion the Committee determined that the timing of the RCM termination and transition of assets will be considered at the October Board meeting.

Acting Chair Gladstern recessed the meeting for a working lunch at 12:09 P.M., reconvening at 12:26 P.M. and directing deliberations to **Agenda Item E.3**.

3. System Risk Presentation – SF Sentry
Preliminary system risk quarterly analysis discussion

David Hansen of SF Sentry presented the system risk quarterly analysis as of June 30, 2012, in addition to a July update. The quarterly analysis includes a review of macro headlines, a study of cash levels, and private equity and securities lending reviews. Also included are a discussion of the volatility index (VIX), stress tests, a qualitative history, and exposure report updated as of July 31, 2012.

Mr. Hansen reviewed the macro themes for the quarter reporting that the market retreated and the VIX rose. He also reported on MCERA's private equity investments stating that since the private equity portfolio is only 30% deployed, analysis will become more meaningful as it approaches full funding.

Regarding the securities lending program, Tim Holmes of SF Sentry reported that State Street has confidence in the eventual unwinding of the Quality D Pool which has been frozen for new collateral since 2010. The Quality Duration pool for new collateral holds diversified investment-grade securities, he said.

Mr. Hansen presented background on the VIX which he said measures near-term volatility of the market based on S&P 500 Index options. He pointed out the spike in the VIX in 2008 during the financial crisis and commented that the incremental change in the VIX is a useful indicator.

The stress test quantifies the impact to the portfolio of historical market events. According to Scott White of SF Sentry, stress test values are stable across quarters. He also presented the value-at-risk (VaR) analysis, which projects risk of loss at various confidence intervals. He emphasized the importance of considering the level of volatility the Board is comfortable with, noting that risk exposure is dominated by equities. Mr. White reviewed contributors to VaR values and remarked on the potential for elevated risk if and when the Fed's quantitative easing measures come to an end.

Mr. Hansen reviewed the qualitative summary for equities, including exposure by manager, asset class, sectors and capitalization. Assets remain within targeted ranges and the relative value of top ten holdings has increased to 7%. In a similar review of fixed income holdings, Mr. Holmes stated that holdings are well-diversified with intermediate durations. U.S. Treasurys are underweight and mortgages and corporates are overweight compared to the Barclays Aggregate Index.

In conclusion, Mr. Hansen reviewed capital flows and responded to trustee inquiries. The effect on the Fund of implementing a risk parity strategy could be modeled, he said, in response to Trustee Steven's inquiry.

4. SF Sentry Contract Renewal (**Action**)
   Consider and take possible action on Finance Committee's recommendation regarding renewal of contract with SF Sentry

   Mr. Wickman stated that the current one-year contract with SF Sentry expires October 12, 2012. The Finance and Risk Management Committee, which has received quarterly presentations for the past year, recommended that the Investment Committee consider whether to renew the contract after receiving the most recent quarterly analysis from SF Sentry. Renewal of the contract would be contingent upon SF Sentry becoming a Registered Investment Adviser and signing a fiduciary acknowledgement.

Trustee Haim commented that there may be unnecessary overlap with Callan Associates' current services. Trustees Gladstern, Brenk, and Stevens have become convinced of the value in the SF Sentry studies. Trustee Given expressed a preference for contract details.

It was M/S Bolger/Brenk to engage with SF Sentry in a multi-year contract for system risk studies, subject to its Registered Investment Advisor status, a fiduciary acknowledgement, and a reasonable fee.

AYES:	Bolger, Brenk, Cooper, Gladstern, Haim, McFarland, Stevens
NOES:	Given
ABSTAIN:	None
ABSENT:	Richardson

Acting Chair Gladstern directed deliberations to **Agenda Item E.6**.

6. Cornerstone Patriot Fund – Change of Portfolio Manager (**Action**)
Consider and take possible action regarding resignation of portfolio manager

In August, MCERA and Callan Associates received notification that Cornerstone Senior Portfolio Manager Brian Murdy had elected to leave the company. Previous to Mr. Murdy's departure the president of the real estate group, Mark Higgins, also left Cornerstone due to family health issues. Since Mr. Murdy was key to the Board's decision to invest with Cornerstone, Callan Associate's position is that his departure is a material event that calls into question continuing with the Patriot Fund. Furthermore, he stated, the relative inexperience of the individual replacing Mr. Murdy is another concern for the future of the portfolio.

Mr. Callahan presented two courses of action: maintain the status quo or exit the fund. If the Board chose to exit the fund, there would be three main paths to choose from. The Board could choose to move the Cornerstone assets to the Fund's other core real estate manager, UBS, whereby the assets would go to the back of the entry queue (currently at 18 months). The Board could also choose to evaluate the core offering from the Fund's opportunistic real estate manager, AEW, where there is currently no entry queue (though they do have approximately $300 million in commitments). Lastly, the Board could refresh the search and find a new manager altogether.

Mr. Callahan recommended determining the investment alternative and taking action to be able to exit Cornerstone by the end of the year, which is the first opportunity that MCERA would have to be able to exit.

It was M/S Haim/Stevens to terminate Cornerstone subject to contract provisions.

Discussion of the motion followed. Mr. Wickman reviewed the process for notification of termination and receiving a distribution that could fund a new mandate. Mr. Callahan stated that either considering AEW or searching for a new manager are reasonable options. Upon discussion it was agreed that Callan Associates would search for a new manager to be considered at the November Investment Committee meeting.

The motion was approved by unanimous vote.

Acting Chair Gladstern directed deliberations to **Agenda Item C**.

C. INVESTMENT CONSULTANT QUARTERLY REPORT AND PERFORMANCE UPDATE

For period ending June 30, 2012

Anne Heaphy, Callan Associates investment consultant, presented the quarterly report and performance update. She reported that over the past fiscal year market volatility has been a headwind to performance. The Fund's return for the quarter ending June 30, 2012, was negative 1.79% (versus negative 2.21% for the Composite Benchmark), and for the fiscal year ending June 30, 2012, 2.08% gross of fees (versus 2.02% for the Composite Benchmark). The fiscal year-end June 30, 2012 net-of-fees return was 1.49%. Within the CAI Public Fund Sponsor Database group, the Fund performed in the 44th percentile for the quarter and in the 29th percentile for the prior 12 months.

Contributors to performance included international equity, fixed income, real estate, and private equity managers. Domestic equities are slightly above their target allocation and were challenged with respect to benchmarks, she said. Ms. Heaphy discussed macro-economic factors and reviewed historical returns as well as metrics on asset allocations and sector weightings for the portfolios.

Trustee Given initiated a discussion of the relative underperformance of domestic equity managers. Ms. Heaphy and Mr. Callahan reviewed market conditions over the past five years that have made it difficult for active managers in the asset class to outperform benchmarks. Mr. Callahan also explained that quantifying returns for the real estate and private equity portfolios is more qualitative than other asset classes.

At the request of Ms. Stevens and Gladstern, additional net-of-fee performance results will be presented in Callan Associates reports.

In response to Mr. Brenk's inquiry about cash flow, Mr. Wickman explained that employee and employer contributions fund the majority of benefits, with income and investment returns making up most of the difference between inflows and outflows.

Based on the upcoming retirement of Walter Riddell, who covers the technology sector at Morgan Stanley, at the end of the year, Callan will be monitoring the team more closely.

D. OLD BUSINESS

None.

There being no further business, Acting Chair Gladstern adjourned the meeting at 2:42 P.M.

Maya Gladstern, Acting Chair

Attest: Jeff Wickman
Retirement Administrator