MINUTES

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

Marin Community Foundation
October 16-17, 2013

October 16, 2013
8 – 9 AM
Continental Breakfast

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

ROLL CALL PRESENT: Bolger, Brenk, Cooper, Given, Gladstern, McFarland, Piombo (alternate safety), Shaw (ex officio alternate), Shore, Smith, Webb (alternate retiree)

ABSENT: Bartfeld

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

No public comment.

BOARD OF RETIREMENT MATTERS

9 AM – 12:30 PM
Investment Manager Annual Portfolio Reviews
Panel Discussion
Private Equity and Real Estate
Anne Heaphy and Jim Callahan
Gary Robertson, Private Equity
Avery Robinson, Real Estate
Callan Associates

Real Estate Overview

Retirement Administrator Jeff Wickman welcomed trustees, consultants and the public to the Retirement Board's Strategic Workshop and introduced Jim Callahan, investment consultant with Callan Associates. Mr. Callahan introduced Avery Robinson, Callan Associates real estate specialist, to present the overview of real estate. Mr. Robinson stated that the real estate compound return of 9.2% over the past 20 years is derived from income and appreciation. The real estate asset class provides diversification since assets have a relatively low correlation to stocks and bonds. Advantages include continuity of the income stream through recessions and inflation protection. Considerations include the cyclical nature of the real estate values.

MCERA's real estate portfolio consists of private investments with core and value-added strategies. The majority of the portfolio consists of core real estate, the most conservative class, with tenants in place who are paying rent that comprises the majority of the return. Properties are upgraded over time to maintain high-quality tenants.

<u>AEW Core Property Trust and AEW Partners V</u>
Dan Bradley, Senior Portfolio Manager, presented the review of the AEW Core Property Trust. Mr. Bradley stated that the strategy is to invest in liquid assets with high lease rates and stable income with the expectation of growing income to keep pace with inflation. With recent low interest rates, leverage is at the high end of the 30% limit allowed in the fund. The portfolio is developed with a research-driven, coastal focus concentrated in eight core markets with the best industries and a high percentage of educated workers. In response to Trustee Brenk's inquiry, Mr. Bradley explained that the focus is on gateway markets that have entry barriers. AEW is proactive in meeting with property managers and tenants to maintain long-term, credit-worthy tenants through different market cycles. Capital appreciation and income levels are on target so far in 2013. In response to Trustee Bolger's inquiry, Mr. Bradley explained that cash is held in an interest-bearing account and may be used to pay down credit.

Marc Davidson, Portfolio Manager for the AEW Partners V value added portfolio, stated that the 2005 opportunistic fund is in the final stages of liquidation. Due to concern about market conditions in 2008, the pace of investments slowed leaving capital that was never invested that reduced relative volatility through the financial crisis. To date the fund has returned 62% of capital and that is expected to reach 70% on the sale of four assets prior to the end of the year. Of the total 56 holdings, 46 properties will be sold by the end of this year. Mr. Davidson reviewed the status of specific properties that he expects to be valued above book value upon the next appraisal.

Trustees Shore and Smith joined the meeting at 9:45 A.M.

Mr. Davidson presented a formal request by AEW for a two-year extension of the Fund in order to maximize returns for remaining properties that would be valued at 91 cents on the dollar in the current market. He explained the process of negotiating the sale of remaining properties and the importance of timing to realize upside value. In response to Trustee Bolger's inquiry, Mr. Davidson stated that the fund initially planned to close in March 2014, explaining that the timing of certain construction projects was delayed due to the poor real estate environment during the recession in 2008. Ms. Bolger discussed the potential for a reduction of fees since they are in sell mode. In response Mr. Davidson indicated that he will discuss the matter with the CEO. The AEW Partners V Fund team will meet in a few weeks to consider responses to the extension request.

It was M/S Cooper/Smith to approve the two-year extension of the AEW Partners V Fund maturity date requested by AEW.

AYES:	*Bolger, Brenk, Cooper, Gladstern, McFarland, Shaw, Shore, Smith*
NOES:	*None*
ABSTAIN:	*None*
ABSENT:	*Bartfeld, Given*

UBS Trumbull Property Fund

David Lawson, Executive Director of the UBS Trumbull Property Fund, presented the review of the new core open-end real estate portfolio. Mr. Lawson stated that MCERA invested $15 million in the Fund on April 1 and has an additional commitment of $50 million waiting to be called. The conservative portfolio with low leverage of 17% has returned 7.85% annualized over the past 10 years, putting it in the top quartile of its benchmark.

In response to Trustee Smith's inquiry, Mr. Lawson compared the portfolio with the benchmark. He noted that properties are allocated according to the model investable universe which, research shows, outperforms over time with more stable returns. Mr. Lawson reviewed the purchasing strategy for apartments, retail and industrial space and explained that low leverage is a competitive advantage by allowing for the assumption of loans at a lower price. The current lease rate is 94% with minimal lease expirations through the remainder of the year. In response to Trustee Gladstern's inquiry about whether climate change is considered, Mr. Lawson stated that they focus on "green" properties that save energy. In summary, Mr. Lawson emphasized the Fund's consistent core strategy in the investable universe, performance-based fees, and team continuity and experience.

Real Estate Panel Discussion

In response to Trustee Brenk's inquiry, Mr. Lawson explained that low leverage is the better place to be over the long term for core real estate as it is difficult to sell assets with leverage during declining real estate cycles. During a rising cycle, low leverage is likely to result in underperformance to more highly leveraged portfolios. In response to Trustee Shore's inquiry, Mr. Bradley indicated that with the continued economic recovery he does not see an end to higher capitalization rates. Mr. Callahan discussed capitalization rates with Mr. Bradley who indicated that real estate values should improve. According to Mr. Davidson, in major markets with multiple drivers of economic growth capitalization rates are as expected. Trustee McFarland inquired about the timing of real estate investments and Mr. Callahan explained the value of diversification over time versus trying to time the market.

In conclusion, Mr. Robinson referred to the importance of industry diversification. According to Mr. Bradley an industry focus carries more weight than property type or region. For Mr. Davidson, energy, technology, and the housing recovery are key themes for growth.

Chair Piombo recessed the meeting for a break at 10:50 A.M., reconvening at 11 A.M.

Private Equity Overview

Gary Robertson of Callan Associates presented the overview of private equity investing. Private equity is expected to provide a return stream that exceeds public equity returns. The process involves fund managers taking full control of companies, typically through limited partnerships, and using leverage to achieve faster growth, with the challenge being finding the best managers to accomplish this goal. The normal eight-year cycle to achieve results has been longer due to the slow economy. Mr. Robertson reviewed the five major private equity strategies of buyouts, special situations, venture capital, subordinated debt, and distressed debt. Special situation funds and venture capital typically invest in medical and technology industries. Subordinated debt is high yield involving turnaround companies. A baseline portfolio structure would have 40% in buyouts and 50% divided between special situations and venture capital. The MCERA portfolio was reviewed showing good balance in strategy allocations with similar benchmark performance and diversification for the two private equity managers.

<u>Abbott Capital Management</u>

Charlie van Horne of Abbott Capital presented the review of the two Abbott private equity funds. Mr. van Horne stated that portfolios are constructed with best-of-breed general partners using a high-conviction approach to produce strong companies. The firm invests 1 1/4 % alongside the investors and emphasizes accountability. Jonathan Roth of Abbott Capital noted the wide dispersion of results in the asset class makes avoiding the lower performers important. Active monitoring includes participating on advisory boards of partnerships.

In 2008 MCERA committed $100 million to the ACE VI fund of which $36 million in capital has been called with the June 30, 2013 value at $37.6 million. In addition, MCERA has committed $35 million to the ACE VII fund. Mr. Roth reviewed strategic allocations, explaining that capital flows to high conviction managers, resulting in a 35% allocation to the special situations category. Mr. Roth provided an example of a successful company returning capital after having gone public. According to Mr. Roth several strategies are out of the J-curve, producing positive results.

In summary, Mr. van Horne stated that capital investment has been slow but strong managers are showing early indications of success. He noted that as of June 2013 the internal rate of return (IRR) is positive. In response to Mr. Robertson's inquiry about the length of time for the portfolio to develop, Mr. Roth explained that the majority of commitments were not made until 2010 and therefore it is too early to assess results. Furthermore, he noted, vintage-year benchmark comparison is not as meaningful.

<u>Pathway Capital</u>

Jim Reinhardt and Valerie Ruddick of Pathway Capital presented the annual review of the Pathway Private Equity Fund 2008 (PPEF) and PPEF I-7. Mr. Reinhardt stated that PPEF 2008 has emerged from its J-curve with increasingly strong performance resulting in a net IRR of 3.0% as of June 30, 2013. The three core strategies of buyouts, venture capital, and special situations have net IRRs in excess of 10%. Distributions of 8% of contributed capital have been driven by several attractive initial public offerings (IPOs) and exits, he reported.

Mr. Reinhardt reported that there have been more opportunities than expected in special situations than expected. After a slow commitment, the fund is now virtually fully invested, according to Mr. Reinhardt. Ms. Ruddick emphasized the diversification of the PPEF 2008 portfolio across investment strategies, industries, and geographic region, pointing out that most companies represent less than 2 ½% of portfolio value. Buyouts represent the largest strategic category at 1/3 of the portfolio. Ms. Ruddick reported that 18 partners have significant returns with substantial progress over the past 18 months and a number of meaningful exits. The portfolio is performing as anticipated, she stated, and is in the top quartile of its peer set.

MCERA committed $35 million to Pathway's new PPEF I-7 portfolio that Mr. Reinhardt said is 25% committed with investments in eight partnerships. In response to Trustee Smith's inquiry, Mr. Reinhardt discussed the difficulty of timing investments in private equity and the importance of hiring managers with strong historic track records.

Chair Piombo recessed the meeting for lunch at 12:17 P.M., reconvening at 1:04 P.M.

Trustee Cooper was excused from the meeting at 12:30 P.M.

12:30 PM – 1:30 PM
Lunch on site

1:30 PM – 2:30 PM
Investment Manager Annual Portfolio Reviews
continued

<u>Private Equity Panel Discussion</u>
In response to Trustee Brenk's inquiry, Mr. Reinhardt stated that currently the private equity environment is balanced as to investing or exiting. Notwithstanding uncertainties as to the European economy, Mr. Reinhardt is expecting a period of long-term economic growth. Mr. Roth pointed to the fast growth rate in the evolving computer cloud revolution. He observed that exit conditions are favorable for private equity market due to the strength in the stock market.

In response to Trustee Bolger's inquiry, Mr. Roth discussed the ebb and flow of private capital and the difficulty of predicting what will be a hot market. Mr. van Horne discussed renewed activity in the energy industry in the mid-West. Mr. Roth discussed the use of technology to deliver educational services that he expects to reshape education. Mr. Reinhardt stated in response to Mr. Robertson's inquiry that there are themes in private equity that require the ability to determine which general partner is viable and what the exit strategy is. Emphasizing the importance of the skills and ability of managers, Mr. Reinhardt explained the qualitative analysis of determining the value of general partners. Mr. van Horne emphasized the need to work with proven successful partners.

Chair Piombo concluded the panel and recessed the meeting for a break at 1:40 P.M., reconvening at 1:45 P.M.

Mr. Wickman invited Mr. Callahan to comment on the morning's discussions. Mr. Callahan observed that there is considerable money competing for core real estate assets now. He noted that for the larger UBS Trumbull Property Fund, new investments are a smaller portion of the fund. It is a conservative fund, he added, in the use of leverage and is income-centered. Mr. Callahan explained that real estate properties are appraised annually and reviewed and adjusted on a quarterly basis.

Trustee Bolger initiated a discussion of how to manage cash and income from real estate investments. For real estate, income is reinvested, according to Mr. Wickman. Mr. Callahan indicated the disposition of income depends on whether you want to grow the real estate portfolio, or whether there is another need for cash.

Turning to private equity, Mr. Callahan views June 2013 private equity returns as a sign of improvement. He indicated in response to Mr. Brenk's inquiry that 3% is an appropriate premium over public equity returns to expect from private equity. Mr. Callahan discussed economic factors that raise the cost of doing business for the capital markets.

Chair Piombo inquired about the status of the Woodmont agreement and Mr. Wickman reported that contract discussions are in progress. At the November Investment Committee meeting there will be a presentation addressing discretion and non-discretionary manager approaches.

In conclusion, Mr. Callahan stated that in addition to selecting a global fixed income manager, the composition of the remaining 75% of the fixed income portfolio should be considered. Otherwise there are no further changes recommended for the overall Fund, he stated.

Chair Piombo recessed the meeting for a break at 2:30 p.m., reconvening at 2:36 p.m.

2:30 PM – 4 PM
Presentation on Municipal Bankruptcy Filings in the United States
Ashley Dunning
Ileana Hernandez
Manatt Phelps and Phillips

Mr. Wickman introduced Counsel Ashley Dunning of Manatt, Phelps & Phillips and her colleague Ileana Hernandez who specializes in bankruptcy law. Ms. Dunning stated that the overview of Chapter 9 bankruptcy filings will cover bankruptcy proceedings in Detroit, the City of San Bernardino, and the City of Stockton. In Ms. Dunning's view there is a potential collision of the rules that are typically applicable in bankruptcy proceedings and the law applicable to public pension plans in California.

Ms. Hernadez began the presentation by explaining that federal bankruptcy law provides a temporary freeze on creditors' actions and offers the debtor the opportunity to restructure assets and debts. To file for Chapter 9 bankruptcy, a municipality must be insolvent, desire to implement a plan of adjustment, and be at an impasse with respect to negotiations with creditors and unions. The Bankruptcy Code requires State adoption of Chapter 9 before a municipal entity can file for bankruptcy protection under those provisions. Once a petition is filed, there is a distinct line between pre and post bankruptcy filing debt, an automatic stay of collection proceedings against the municipality, and a continuation of municipal operations without court supervision.

Ms. Hernandez noted the role of the bankruptcy court is to oversee the Plan of Adjustment. In Chapter 9 proceedings, only the municipality (debtor) submits a Plan of Adjustment as opposed to Chapter 11 where both the debtor and creditor submit plans to the Bankruptcy Court. The Bankruptcy Court has no authority to liquidate assets of the municipality or adjust its revenues. The Plan must be timely filed and explain how classes of individuals or creditors will be treated. Creditors have the opportunity to negotiate Plan provisions, react to them, or approve the Plan. The Bankruptcy Court attempts to determine the fairest and most feasible Plan of Adjustment for creditors.

In response to Trustee Brenk's inquiry, Ms. Hernandez explained that Chapter 9 provisions evolved from the Depression era and are the result of a Supreme Court decision regarding the powers of the federal government. The constitutionality of Chapter 9 is still being challenged in pending court actions, she noted.

Ms. Hernandez explained that the City of Detroit filed for bankruptcy in July 2013. At $18 billion, it is now the largest Chapter 9 bankruptcy filing. The City's active and retired pension system members have filed objections arguing that accrued pension benefits cannot be modified through Chapter 9 proceedings. The Bankruptcy Court is in the process of determining whether the City is eligible for the Chapter 9 filing.

Ms. Hernandez discussed features of the City of Stockton bankruptcy filed in June 2012. The Stockton City Council adopted a budget for the Fiscal Year commencing July 1, 2012, that, by state law, must be balanced. The required balance was achieved by cutting costs, including unilaterally reducing retiree health benefits. City retirees filed a lawsuit asserting that benefits were protected under federal and state law. A published decision denied temporary relief on the grounds that the assertion conflicts with bankruptcy law.

According to Ms. Hernandez, the Bankruptcy Court ruled that in the interim period between filing for bankruptcy and the Plan of Adjustment, there is a limitation on the Bankruptcy Court's authority to order the city to make payments that it has chosen not to make. The Court further stated that while the Contracts Clause of the United States Constitution bans states from impairing contract obligations, it does not so restrain the federal government, i.e., the bankruptcy court. Thus, according to that Court's decision, the shield of the Contracts Clause "crumbles" in the bankruptcy arena.

Ms. Hernandez reviewed provisions in the Plan of Adjustment filed by the City of Stockton. These include an agreement with retirees making earlier medical benefit cuts permanent and paying retirees a one-time payment of $5.1 million. The City's Plan of Adjustment left pension benefits untouched. The City has continued to make its regular contributions to CalPERS. The City negotiated settlements with the majority of other creditors conditioned on the passage of a measure by Stockton voters that will increase taxes.

Ms. Hernandez reviewed circumstances of the City of San Bernardino Chapter 9 bankruptcy filed in August 2012 claiming unsustainable pension costs and other financial hardships that led to a budget shortfall of $46 million. The California Public Employees' Retirement System (CalPERS), to which the City temporarily halted pension contributions, objected to the City's filing stating the City didn't qualify as a debtor for bankruptcy under Chapter 9 nor did it negotiate with creditors prior to filing for bankruptcy as required by Assembly Bill 506. The court disagreed and said the City was eligible to file for bankruptcy. Subject to any potential appeal of the eligibility decision, the next procedural steps will be for the City to submit a draft plan to the Court and negotiate with creditors and CalPERS on its approach and method to meet its existing obligations.

In summary, Ms. Hernandez reviewed constitutional questions raised by recent bankruptcy filings. These include: 1) whether public pension plans have sovereign immunity in a municipal bankruptcy proceeding; 2) whether a federal bankruptcy court handling a municipal bankruptcy case has authority to diminish a contractual right provided by a state constitution; 3) whether a state constitution effectively prohibits a Chapter 9 filing in which the municipality may modify pension obligations; 4) whether a bankruptcy court can confirm a Plan of Adjustment under Chapter 9 that would impair certain employer contributions to or employee benefits from the plan.

Ms. Hernandez stated that there is a conflict between federal bankruptcy and state law that goes to the balance of power between the two. In Michigan for example, there is an explicit constitutional provision protecting public employees' "accrued" pension rights, and California courts have determined that accrued and future pension benefits are protected. To date none of the plans of adjustment have addressed accrued pension benefits. Whether a bankruptcy court will permit existing pension benefits to be adjusted as a method for a municipality to reach financial solvency is yet to be seen, according to Ms. Hernandez.

In response to Trustee Smith's inquiry regarding whether a retirement system could appear in a bankruptcy proceeding on behalf of its retirees, Ms. Dunning advised that MCERA's duty of impartiality among its members means that it could not advocate only for retirees in that manner. However, she noted that retirement systems would have a stake in any bankruptcy proceeding that implicated plan sponsor payments to the retirement system or potentially to benefits owed to its members, just as CalPERS has demonstrated its stake in the California proceedings that were discussed. Thus, the retirement system that could potentially be impacted by the bankruptcy would likely be involved in some manner in the proceedings.

Chair Piombo recessed the meeting at 4 P.M.

EVENING RECESS

October 17, 2013
8 – 9 AM
Continental Breakfast

9 – 12 Noon
Economic and Capital Market Review
Jay Kloepfer
Anne Heaphy
Callan Associates

Trustee Given joined the meeting at 9 A.M.

Jay Kloepfer, Director of Capital Markets Research at Callan Associates, presented an economic and capital market review. Mr. Kloepfer stated that the process supports strategic planning through adjusting expectations for ten-year projections for asset class returns with defensible results. Mr. Kloepfer pointed out that interest rates are rising in the bond market. Last year, he stated, we were in uncharted waters with a recovering housing market and low interest rates. Whether growth for GDP of 3 to 3.5% is more likely to be in the 2.5 to 3% range is a consideration, he said. Inflation is currently very low, he stated, and the Fed is concerned about potential deflation. He indicated that the capital markets have priced in the expectation that the Fed will cease its purchase of U.S. Treasurys. In response to Trustee Bolger's inquiry, Mr. Kloepfer discussed the relationship between sentiment and interest rate moves.

Geopolitical concerns include the fading of the Arab Spring, the potential for reverting to a deflationary mode, and economic stagnation, according to Mr. Kloepfer. In 2011 uncertainty regarding tax policy caused small businesses to slow. Mr. Kloepfer expects increasing demand for long-term debt as pension plans look to match duration of assets with liabilities.

Mr. Kloepfer presented projected capital market returns for a variety of asset classes. For domestic equities the ten-year projected return was reduced to 7.7% and for non-U.S. equities, reduced to 7.85% as earnings are expected to follow GDP. Mr. Kloepfer stated that he remains comfortable with the current 7.5% assumed rate of return for the Fund. The trendy projection of a 4% return for equities, he stated, is unreasonable and opinions about the unknowable future should be tempered. Callan Associates projects inflation over the next 10 years to be 2.5%.

Trustee Brenk inquired about the expected return for hedge funds. Mr. Kloepfer indicated hedge funds are expected to underperform equities due to their role of hedging risk. In response to Trustee Shore's inquiry on whether inflation expectations should be higher, Mr. Kloepfer explained that dramatically lower prices in assets such as computers and clothing lower the inflation rate even as other costs rise.

Mr. Kloepfer continued his analysis of the capital markets and the economy. Since the beginning of the year, he stated, the economy has been doing well, the stock market has risen, and the housing market seems to have found a bottom and in some market is recovering. In the labor markets the quality of jobs being created is a concern, and there is a "discouraged worker" effect, including unemployment for younger workers. Mr. Kloepfer struck a note of caution for equities that have returned 160% since the 2009 bottom. Expectations for the developed markets overseas, particularly the European equity sector, are lower due to the slowing economy in Europe and concerns about the management and value of the Euro.

Chair Piombo recessed the meeting for a break at 10:20 A.M., reconvening at 10:41 A.M.

Mr. Kloepfer discussed details of the housing market that has been a drag on the economy and the renewed domestic energy sector, noting that prices for crude oil and natural gas have diverged. A move by institutional investors toward international assets includes exposure to foreign currency, he said.

Mr. Kloepfer responded to Trustee Gladstern's question about how climate change is factored into the economic forecast. He noted that climate change is not explicitly considered in economic forecasts but is showing up in higher agricultural values. Water and food shortages are considered in the economic analysis, he said in response to Trustee Brenk's inquiry.

Mr. Kloepfer presented data on GDP projections, the yield curve at exceptionally low levels that he said has been in a steep decline for several years, trailing price-earnings ratios for the market, and the rolling ten-year return for the S&P 500.

Mr. Kloepfer concluded the presentation by reviewing projected 10 year returns for varying asset mix alternatives. He noted that projected returns for fixed income are substantially lower, which reduces the overall expected return to closer to 7%, with a real return of 4.5%. Ranges of expected returns for efficient mixes of assets were reviewed over different time frames. Over a 30 year time frame, according to Mr. Kloepfer, the assumptions for inflation and asset returns would be higher.

Dave Brown inquired whether low returns for several years could result in a low funding ratio from which the Fund would not be able to recover. In response, Mr. Kloepfer explained that over the long term the Fund would be expected to recover from such a scenario. In the interim plan sponsors would be required to make additional contributions, according to Graham Schmidt. Mr. McCrory explained that the impact of such increases on employer would be mitigated through smoothing mechanisms and so long as there are resources periods of low funding ratios can be managed.

Mr. Kloepfer explained that the longer the time horizon, the more likely asset returns will move to the historical mean, i.e., recover from low returns. As a result, the long term expectations are higher across asset classes, he observed. Furthermore, he explained, expectations are evolutionary and will look different across time periods according to goals and opportunity sets. A reasonable return assumption for the Fund over a 30 year horizon would be 8%, he stated in response to Trustee Bolger's inquiry.

Trustee Shore asked about methods to mitigate tail risk. According to Mr. Kloepfer options to mitigate tail risk would depend on what part of the portfolio you want to hedge, the level of risk, and the opportunity cost. Methods would include the purchase of insurance for a credit risk event, hedge funds, put and call options, diversification, giving more flexibility to managers, reducing equities, or risk parity strategies. Mr. Kloepfer pointed out that according to a PIMCO study, elaborate tail risk hedging can cost almost 100 basis points per year.

Chair Piombo recessed the meeting for lunch at 12:06 P.M., reconvening at 1:30 P.M.

12 Noon – 1:30 PM
Lunch on site

1:30 – 4 PM
Review Economic Assumptions
Review Amortization Policy (Action)
Graham Schmidt
Cheiron-EFI Actuaries

Review Economic Assumptions

Mr. Wickman introduced actuaries Graham Schmidt and Bob McCrory of Cheiron EFI to present the review of economic assumptions and amortization policy. Mr. McCrory stated that economic assumptions are determined from a range of possibilities that result in a reasonable basis for funding the Plan. When assumptions vary, he explained, the funding mechanism is self-correcting. When investment returns do not meet expectations amortization policies stabilize the cost of resulting unfunded liabilities. If the investment return assumption is reduced, then employer cost will rise. He explained that the legal, regulatory, and economic environments for public pension plans are different from private pension plans that are being capped or terminated. In responding to Trustee Shore's inquiry about the effect on cost of a pension obligation bond, Mr. McCrory pointed out that bonds have a fixed payment schedule that adds to risk for the employer.

Mr. McCrory stated that economic assumptions for inflation, real return, and wage growth must be reasonable individually and in aggregate. There is no compelling reason to change the current inflation assumption of 3.25%, according to Mr. McCrory, noting that investment consultant Callan Associates projects inflation of 3% over a 30 year horizon. As median wage growth has been close to inflation, no change is indicated for the current wage growth assumption. Given the current inflation assumption, no change is indicated for Cost of Living Adjustment (COLA) assumptions, according to Mr. Schmidt.

Steps for calculation of the expected rate of return were reviewed by Mr. McCrory. These include collection of returns, risk, and asset correlations from Callan Associates' 10-year capital markets projections. The target portfolio is then simulated using 10,000 trials and compound annual returns computed. The result was an average compound return of 7.69%, which Mr. McCrory said agrees with Callan's 6.98% plus 0.75% adjustment for the difference in the inflation expectation. Mr. McCrory, observing that assumptions are not a prediction, reviewed the distribution and probability of returns. Trustee Bolger inquired whether 52% is a reasonable probability for a public pension plan to achieve its return assumption. In response Mr. McCrory demonstrated that odds are only slightly better with each 0.25% reduction in the assumed rate of return. Based on the analysis Mr. McCrory recommended retaining the 3.25% inflation and 4.25% real rate of return as a reasonable set of assumptions with the total return assumption remaining 7.5%. A more conservative assumption of 7.25% would also be considered reasonable, he said.

Two approaches to administrative expenses were reviewed by Mr. McCrory. Traditionally for '37 Act systems, administrative expenses are subtracted from the net return of the fund. For accounting purposes, the Government Accounting Standards Board requires that administrative expenses not be subtracted from returns and instead should be listed on the accounting statements as a separate line item. Mr. Schmidt discussed how using this same line item approach would allow MCERA to use the current discount rate of 7.5% for both accounting and funding requirements. However, according to Counsel Dunning, this approach may not align with the requirements of the '37 Act. Ms. Dunning indicated that she and the counsel for other '37 Act systems will be discussing this question next week. Mr. Schmidt noted that if it is not possible to use the line item a lowering of the discount rate to 7.25% would be reasonable. He also noted that there may be other approaches to addressing this topic so as to comply with the '37 Act and not necessarily use the line item approach.

In summary Mr. Wickman stated that there will need to be an analysis regarding the line item and other approaches for administrative expenses. Once the analysis is complete the question will come to a future Board meeting for discussion and consideration.

Chair Piombo recessed the meeting for a break at 2:58 P.M., reconvening at 3:15 P.M.

<u>Review Amortization Policy</u>
Mr. Schmidt reviewed funding policy objectives of securing the benefit promise, providing predictable plan cost, and promoting intergenerational equity. Traditional funding policy uses the actuarial cost method, asset smoothing method, and amortization policy to balance these objectives. As an example, smoothing of deferred gains and losses over time stabilizes the contribution rate.

Mr. Schmidt introduced the concept of layered amortization that is based on when a liability occurs or what its source is – for example changes in market value or plan changes. This would be an alternative approach to amortizing the cumulative Unfunded Actuarial Accrued Liability (UAAL) as a whole. Each layer could have different time periods, for example. Advantages of this approach listed by Mr. Schmidt include the ability to track how each piece is amortized over time; disadvantages include complexity and potential contribution rate volatility that would occur when a large element is paid off. According to Mr. McCrory there is an emerging consensus among actuaries to use the layered approach for amortization.

Another consideration for amortization policy is the time period and whether it remains the same each year (open, or rolling) or declines over time (closed). Mr. Schmidt presented a chart demonstrating how a liability would be paid down over time using different amortization methods.

Mr. Schmidt reviewed guidance on amortization policy provided by the California Actuarial Advisory Panel (CAAP) and Government Finance Officers Association (GFOA) that includes a preference for closed asset smoothing and layered, closed amortization policies. For example, Mr. Schmidt advised, the current policy of rolling the entire UAAL after it declines (from 17 years currently) to 10 years is not recommended by the CAAP. The recommended maximum time period for amortizing the UAAL has been reduced to 25 years from 30 years.

Mr. Schmidt discussed potential changes to MCERA's current amortization policies. He suggested that closing the current 17 year amortization period for the UAAL would accomplish several objectives, including satisfying CAAP and GFOA recommendations. For the extraordinary losses in 2008, he explained, the 26 years remaining results in negative amortization overall for the next one to two years. Reducing the time period to 22 years would result in avoiding overall negative amortization and increase employer contribution rates by 0.5 to 1.5% of pay. Mr. Schmidt responded to trustee inquiries on how changes to amortization policy would work. In response to Trustee Gladstern's inquiry, Mr. Schmidt stated that the layered approach with a 15 to 20 year time period is recommended.

Mr. McCrory summarized the recommendations of the actuary as follows:

- Maintain 7.5% return assumption, 3.25% inflation and wage growth
- Set administrative expenses as a separate line item (return no longer net of administrative expenses) subject to further legal review
- Maintain current Actuarial Cost Method (Entry Age Normal) and Asset Smoothing Method (5 years, 80/120% corridor)
- Consider closing current amortization periods (no current impact) and implementing separate layers for future changes in Unfunded Liability
- Consider changes to amortization period for "Extraordinary Loss" layer from 2008
- Consider studying alternative funding approaches (i.e., direct rate smoothing) with next experience study

It was M/S Gladstern/Shore to close the current amortization period for the Unfunded Actuarial Accrued Liability (UAAL) at 17 years and reduce to 25 years the closed special amortization of a portion of the 2008 investment loss.

AYES:	*Bolger, Cooper, Given, Gladstern, McFarland, Shore, Smith*
NOES:	*Brenk*
ABSTAIN:	*None*
ABSENT:	*Bartfeld*

4 PM – 4:30 PM
Items for Future Agendas

No discussion.

There being no further business, Chair Piombo adjourned the meeting at 4:16 P.M.

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Alan Piombo, Chair   Attest: Jeff Wickman
Retirement Administrator