MINUTES

INVESTMENT COMMITTEE MEETING
MARIN COUNTY EMPLOYEES' RETIREMENT ASSOCIATION

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

December 11, 2014 – 9 a.m.

CALL TO ORDER Chair Brenk called the meeting to order at 9:04 a.m.

ROLL CALL PRESENT: Bartfeld, Brenk, Given, Gladstern, Haim (alternate retired), Piombo, Shore

ABSENT: Bolger, Cooper (alternate safety), Shaw (ex officio alternate), Thomas and Webb

A. OPEN TIME FOR PUBLIC EXPRESSION

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

Retirement Administrator Jeff Wickman recommended addressing comments about MCERA's investments in the S&P 500 Non-Lending fund made during open public comment at the December 10, 2014 Board meeting during the quarterly report and performance update, Agenda Item D.

B. MANAGER ANNUAL REPORTS

1. Manager Overview – *Jim Callahan, Callan Associates*

Mr. Callahan reviewed the securities lending program that has generated approximately $3 million in revenue for the Fund since inception in 2008. Mr. Callahan began by noting that securities lending is a common function in the capital markets. Securities, typically United States (U.S.), stocks and bonds, are loaned to settle a trade or enable funds to take short positions, for example. MCERA's custodian State Street lends the securities and receives collateral of a slightly higher value that is invested in cash equivalents. There is a negotiated rebate split 70% to MCERA and 30% to State Street. As a result of the changes in the MCERA portfolio over the years, the number of lendable securities has contracted significantly.

Mr. Callahan reviewed the history that led to State Street separating the Quality D pool into two pools, the Liquidity Pool and the less liquid Duration Pool where there is still some unrealized loss and extension of maturities. Pricing has recovered to close to par value, according to Mr. Callahan, and he recommends accepting State Street's proposal to liquidate the Duration Pool on a group basis.

Mr. Callahan said that in addressing the question of whether securities lending is worth the risk, so far the decision has been to keep the program going. Trustee Given asked whether State Street can avoid another liquidity issue should there be another financial crisis. In response Mr. Callahan advised the risk has been dramatically reduced as a result of changes in the management of the program. Trustee Given encouraged continued updates by State Street on the status of cash collateral for the securities lending program.

2. State Street – Securities Lending Program Review – *Henry Disano, Jeffrey St. Peters, Jeffrey Trencher* – 9:05 a.m.

   Jeff Trencher, State Street Account Manager, confirmed Mr. Callahan's analysis of the status of the cash collateral in the securities lending program, noting that since 2010 cash collateral for securities on loan has been invested only in the Liquidity Pool. Mr. Trencher explained that when securities are loaned State Street indemnifies MCERA from borrower default.

   Mr. Trencher discussed regulatory changes having a major impact on hedge fund and prime brokerage demand: 1) interconnectedness where all parties are exposed to the risk of one; 2) tightened risk capital controls on banks; 3) conflicting goals of having issuers use longer duration and investors being as liquid as possible. There may be unintended consequences to regulations that need to be worked out, according to Mr. Trencher. Along with small spreads in government securities and low rebate rates, he said, there is downward pressure on securities lending activity overall.

   In response to Chair Brenk and Trustee Haim's inquiries, Mr. Trencher stated that if the Federal Reserve ("Fed") increases interest rates the market will adjust accordingly.

3. Securities Lending Duration Pool (**Action**)
   Consider the liquidation of Duration Pool Assets

   Mr. Trencher introduced Senior Portfolio Manager Jeff St. Peters who reviewed the status of the securities lending Duration Pool. Mr. St. Peters observed that strong economic data over the last several months means we are closer to a tightening interest rate environment. Since ending monetary easing in October of 2014 the Fed is expected to focus on keeping inflation near its 2% target.

   Mr. St. Peters reported that there have been significant paydowns and pricing recovery in the Duration Pool. Since its inception December 6, 2010, MCERA's balance has been reduced by 91.2% to 2.8 million units (NAV of 0.9698) as of October 31, 2014. For comparison, as of that date the balance in the Liquidity Pool was 58.2 units (NAV of 1.0001).

   Mr. St. Peters advised that State Street sent a letter to investors to determine interest in liquidating the commingled Duration Pool in the first quarter of 2015. The result for MCERA would be recognition of the current unrecognized loss of approximately $85,000. According to Mr. Trencher better pricing is more likely if investors in the Duration Pool group together to sell their positions. In response to Mr. Callahan's inquiry, Mr. Trencher stated that MCERA would make payment for the recognized loss, retain its position in the Liquidity Pool and securities will remain on loan.

Due to the difficulty of liquidating odd lots, Mr. Callahan recommended joining other investors to liquidate the Duration Pool.

It was M/S Haim/Piombo to liquidate the Duration Pool as provided in State Street's memo and recommended by Callan Associates.

AYES:	Bartfeld, Brenk, Given, Gladstern, Haim, Piombo, Shore
NOES:	None
ABSTAIN:	None
ABSENT:	Bolger, Thomas, Webb

Discussion followed on whether to consider ending the securities lending program. Mr. Callahan indicated that it would be reasonable either to retain the program or end it. He pointed to the incremental revenue that helps offsets expenses and noted that risk is more manageable. Trustee Given expressed concern about risk but also noted that securities lending will look like a more reasonable investment in a higher interest rate environment.

Noting that securities lending is a recurring theme, Trustee Piombo encouraged a focus on overall investments and asset allocation. Chair Brenk and the Retirement Administrator supported prioritizing investment matters noting that the Committee can consider the securities lending program again if and when it so chooses.

Chair Brenk recessed the meeting for a break at 10:24 a.m., reconvening at 10:33 a.m.

4. Columbus Circle – Small Cap Growth Equity – *Stephen Weeks, Cliff Fox* – 9:50 a.m.

Stephen Weeks, Client Services Officer of Columbus Circle Investors, stated that MCERA's small cap portfolio has been a good asset class since inception in November of 2009. As of September 30, 2014 the portfolio has grown in value to $110 million and provided a three-year annualized net return of 18.71% (versus 21.26% for the benchmark Russell 2000 Growth Index). In the fourth quarter the portfolio is outperforming its benchmark. The year to date return as of November 30, 2014, is 3.2% (versus 2.6% for the benchmark). Mr. Weeks reported that 25% of the firm that was owned by Portfolio Manager Cliff Fox and other partners has been sold to Principal Global Investors. Mr. Fox has a five year contract going forward with Principal.

Trustee Given was excused from the meeting at 10:42 a.m.

Mr. Fox stated that the investment strategy is to look for fundamentals that are better than anticipated by the market for sustainable reasons – in essence, what makes a company's business tick. Opportunities are identified based on secular trends that gain share in the economy, industry dynamics, supply and demand, and changes in competitive dynamics. Also good execution can drive profits, according to Mr. Fox.

The expectation is that investments will outperform over time as the market recognizes fundamental value in positive surprises. Factors considered in the stock selection process include expectations of buyers and sellers, information gathered from business and press journals, and finally the real information on business performance and whether that information reflects favorably on the business. The idea is to exit the position before outperformance wanes. Stocks that perform in line with expectations or disappoint are avoided. Portfolios are diversified to avoid reliance on one area of the economy.

Mr. Fox believes that the monetary easing program initiated by the Fed at the end of 2012 created an environment of speculation in the capital markets. As a result there was a bull market in small cap stocks leading to overvaluation. This was a difficult period to invest in growth stocks that Mr. Fox expects to improve when the Fed stops easing in 2015.

In response to Trustee Brenk's inquiry, Mr. Fox stated that the small cap growth portfolio remains closed to new investors. The portfolio manager reviewed specific portfolio holdings, noting that the energy sector is underweight in view of declining oil prices that reflect weakness in major economies outside the U.S. There is an overweight to the consumer discretionary sector that reflects relative strength in the U.S. economy.

In conclusion Mr. Fox stated that economic metrics such as employment levels and retail sales indicating the U.S economy is working hard relative to the rest of the world. Going forward he expressed a note of caution, explaining that with real inflation close to zero, the Fed is worried about the potential for a deflationary period with economic weakness and heavy debt levels leading to a debt spiral.

5. Pathway Capital Management – Private Equity – *Valerie Ruddick, Jim Reinhardt* – 10:35 a.m.

Jim Reinhardt, Senior Managing Director of Pathway Capital Management (Pathway), stated that both private equity funds (PPEF 2008 and PPEF I-7) are performing well. The PPEF 2008 fund is fully committed and two-thirds fulfilled. Investment activity is expected to remain strong through the remainder of 2014 and 2015 as the underlying partnerships deploy the balance of their capital. Mr. Reinhardt reported that 27 partnerships have made distributions, with a total of $43 million distributed as of September 30, 2014. Portfolio allocations are within targets and were reviewed by strategy and geographic region.

In response to Chair Brenk's inquiry Mr. Reinhardt stated that comparison of returns with public equities will be more meaningful as the funds mature in a few more years.

Pathway Director Valerie Ruddick reviewed portfolio specifics that reflect broad diversification of PPEF 2008 across managers, partnerships, vintage years, and active companies. The largest market value for any individual company is 4.6% and top ten holdings represent 13.5% of the fund. Buyouts or acquisitions represent two-thirds of the portfolio. The fund is well diversified across industries, with none overweight.

Ms. Ruddick stated that PPEF 2008 is emerging from the J-curve and has generated significant outperformance by vintage year over industry benchmarks. In response to Trustee Shore's inquiry, Ms. Ruddick attributed the fund's success to date to manager selection and adjusting strategy to the economic environment. She discussed the monitoring process through participation on advisory boards, meeting with managers, and managing cash flows. Ms. Ruddick expressed optimism about the strength and eventual success of the underlying partnerships in PPEF 2008.

Mr. Reinhardt reported that the PPEF I-7 private equity fund has demonstrated a healthy investment pace to date with a strong pipeline. As there are more investments available PPEF I-7 will be funded sooner and exhibit a shorter and shallower J-curve than the PPEF 2008 fund. PPEF I-7 diversification characteristics are similar to the 2008 fund.

A new fund, PPEF I-8 will be available in 2015 for potential follow-on investment. Mr. Callahan said cash flow projections will be reviewed next year to determine the potential for reinvestment of distributions. In response to Trustee Gladstern's inquiry, Mr. Reinhardt said fees will be lower for the PPEF I-8 fund and repeat investors will be rewarded.

In response to Chair Brenk's inquiry, Ms. Ruddick discussed activity in the private equity markets and stated that leverage is reasonable and is closely monitored as part of the due diligence model in accordance with federal lending guidelines. Mr. Reinhardt added that borrowers and lenders are working together to work out lending issues.

Mr. Wickman recommended moving to action items due to time constraints. The Chair directed deliberations to **Agenda Item C.2**.

C. <u>NEW BUSINESS</u>

2. <u>Portfolio Rebalancing (**Action**) – *Parametric Clifton, Jack Hansen*</u>
   Consider and take possible action to implement futures overlay portfolio rebalancing

   Portfolio Manager Jack Hansen of Parametric Clifton reviewed the Policy Implementation Overlay Service that is currently implemented to keep cash working in an efficient manner by eliminating excess cash exposures in the Fund on a daily basis. The overlay process allows for the orderly transition to new policies and helps to manage liquidity needs and manager cash. Rebalancing overweight and underweight positions is termed "mini-rebalancing" has also been implemented.

   Mr. Hansen stated that threshold-based rebalancing can be implemented harmoniously with the cash overlay program. Threshold rebalancing allows for timely and efficient rebalancing of the portfolio by selling as markets rise and buying as markets go down that would otherwise be lost opportunities. Synthetic derivatives are employed to lower transaction cost and maintain overall market exposure in accordance with policy benchmarks.

The potential advantages of automatic rebalancing are that given a set policy the portfolio is rebalanced quickly and relatively cheaply when the market pushes the portfolio out of bounds. There is no need for subjective intervention or additional staff time. The result is that the desired market exposure for the portfolio is maintained over time with a favorable risk-adjusted return depending on market behavior. Mr. Hansen noted that considerations include potential liquidity needs to support futures positions if markets fall dramatically.

Mr. Hansen presented a simulated rebalance analysis (back test) over a 20 year period ending October 31, 2014. Results demonstrate that the more frequently rebalancing occurs, the lower the tracking error versus the fund policy mix. There is a tradeoff between trade frequency based on the width of the rebalancing band and tracking error. The conclusion is that rebalancing helps to manage tracking error and liquidity needs.

Mr. Callahan recommended implementing the Clifton automatic portfolio rebalancing as an efficient way to manage policy bands and as a risk control measure. This program would have been beneficial in 2008 when the portfolio pierced the band, he said.

It was M/S Gladstern/Piombo to adopt the investment consultant's recommendation to implement the Clifton futures overlay rebalancing program.

Chair Brenk asked if rebalancing could work against us given the overweight to equities. Mr. Callahan noted this is a risk control measure that embraces buy low and sell high and has significant advantages. The Chair inquired about policy bands that Mr. Callahan will present in detail for consideration at the January 2015 Investment Committee meeting.

AYES:	Bartfeld, Brenk, Gladstern, Haim, Piombo, Shore
NOES:	None
ABSTAIN:	None
ABSENT:	Bolger, Given, Thomas, Webb

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

3. Real Asset Allocation Alternatives (**Action**)
   Consider and take possible action regarding real asset allocations

   Mr. Callahan prefaced the real assets discussion by explaining that due to a capital call in the amount of $50 million expected from AEW on December 31, 2014, a decision needs to be made on the composition of the real assets portfolio. The capital call can be rescinded or the amount reduced depending on how real assets will be allocated.

   At the October 2014 Strategic Workshop the Board directed Callan Associates to create options for devoting 7% of the 15% real assets allocation (currently allocated 100% to real estate) to a broader real return public real assets portfolio. Mr. Callahan presented three hypothetical model real asset portfolios consisting of TIPS, commodities, REITs, and natural resource equities that are considered key elements and the most practical to implement. The risk and return characteristics range from conservative to aggressive according to how each asset is weighted. When folded into the total portfolio, the aggressive model resulted in the most favorable projected return while reducing total risk as compared with a 100% real estate profile. Mr. Callahan concluded that the diversification benefit of adding the aggressive real assets model was a compelling argument for the Fund.

Implementation options for a real assets portfolio were reviewed by Mr. Callahan including passive off-the-shelf products, single firm solutions, and custom build-your-own portfolios. Advantages and disadvantages of each approach were discussed. Mr. Callahan advised formalizing the overall allocation to real assets and determining specifics on implementation at a later date.

Trustee Piombo made a motion to allocate 8% to private real estate and 7% to public real assets, reduce the AEW capital call from $50 to $20 million, and implement a build-your-own real asset portfolio.

Mr. Wickman recommended reducing the AEW capital call to zero. Mr. Callahan noted that capital calls offer a window to move cash into private real estate. He also noted that the real estate target is expected to be below target for a period of time due to winding down the Woodmont portfolio.

Trustee Gladstern called for the question.

Trustee Piombo withdrew his motion and made a new motion to allocate 8% to private real estate and 7% to real assets, rescind the $50 million AEW capital call in its entirety, and implement a build-your-own real asset portfolio. The motion was seconded by Trustee Shore.

AYES:	Bartfeld, Brenk, Gladstern, Haim, Piombo, Shore
NOES:	None
ABSTAIN:	None
ABSENT:	Bolger, Given, Thomas, Webb

Trustee Piombo was excused from the meeting at 12:32 a.m.

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

1. <u>Report on Sale of Century Plaza and Deposit of Proceeds from Sale – *Jeff Wickman*</u>

Mr. Wickman reported that Century Plaza was sold for $39.55 million, which is above the minimum sales price. Net proceeds of slightly under $38.5 million were wired to the custodial bank for deposit, initially into the short term investment fund that is invested in low-risk government securities (GSTIF).

Trustee Given rejoined the meeting at 12:34 p.m.

Mr. Wickman reported that the question arose as to whether the proceeds should be part of the Clifton cash overlay program. After consulting with Callan Associates the proceeds were made available to Clifton so that the futures overlay could be applied. Mr. Wickman stated that the overlay was thoughtfully applied by Clifton, with $29 million in U.S. Treasury futures and $9 million in S&P 500 futures. In response to the Chair Brenk's inquiry, Mr. Callahan explained how the overlay percentages are determined.

Mr. Wickman requested direction with respect to handling similar cash transactions in the Fund, explaining that Clifton requires direction with respect to cash that is specifically in the GSTIF account. Upon discussion there was consensus with Mr. Callahan's observation that it would be an exception not to overlay cash received as a result of transitioning Fund assets.

Based on Trustee Given's recommendation and a unanimous show of hands, Chair Brenk directed the Administrator to follow the policy regarding cash.

Chair Brenk recessed the meeting for a working lunch at 12:42 a.m., reconvening at 1:08 p.m. and directing deliberations to **Agenda Item D**.

Trustee Shore was excused from the meeting at 1:01 p.m.

D. <u>INVESTMENT CONSULTANT QUARTERLY REPORT AND PERFORMANCE UPDATE</u>

For period ending September 30, 2014

Trustee Bartfeld inquired about public comments at yesterday's Board meeting with respect to Fund performance. In response Mr. Wickman reminded the Committee that a statement was made that there has been a 30 or 40% loss since Marin350 began addressing the Board in July 2014. Mr. Wickman noted that individual holdings within the portfolio including the oil companies in the S&P 500 index may have negative performance over the last year but that neither the total Fund nor the S&P 500 Non-Lending fund lost 30-40% since July.

Mr. Wickman noted that the Board sets their investment policy through asset allocation and hires managers to execute in that category. The Board relies on the expertise of the manager to select securities that will perform well in different economic environments.

Anne Heaphy, Callan Associates Vice President, presented the quarterly report and performance update. Ms. Heaphy reported that the original commitments to core real estate managers AEW and UBS have been fulfilled, with the last capital call of $50 million from UBS sourced from the State Street Global Advisors S&P 500 fund. Asset allocations were reviewed that are within target ranges, which for real estate and private equity are interim targets as funding progresses.

Ms. Heaphy reported that the Fund return for the fiscal year ending June 30, 2014 was adjusted upward to 19.22% to include updated private equity valuations. For the quarter ending September 30, 2014 the Fund returned negative 1.22% net of fees (versus negative

0.94% for the composite benchmark). The year-to-date return as of September 30, 2014 is 10.79% net of fees (versus the benchmark return of 10.85%), ranking the Fund in the 17th percentile of the Callan Public Fund Universe. The Fund's performance has improved relative to its benchmark over the intermediate timeframe and the track record now outpaces the index in all time periods. Ms. Heaphy noted that the overweight to equities has contributed to past performance.

Large cap equity and real estate contributed positively to the returns for the quarter ending September 30, 2014. Ms. Heaphy explained the slightly negative manager effect is a result of the overweight in domestic equities to small cap versus the benchmark Russell 3000. Mr. Callahan observed that the structural bias to small cap in the attribution model has been beneficial for the long term.

Mr. Callahan reported that the fixed income portfolio is in line with the benchmark Barclays Aggregate. The benchmark will be adjusted to reflect the diversification of fixed income portfolios away from the standard benchmark. Mr. Callahan advised continuing to monitor fixed income performance to the Barclays for comparison purposes.

Ms. Heaphy explained that challenges in international economies during the quarter led to a flight to safety into large cap U.S. equities, specifically health care and technology. As a result there is a large divergence in large and small cap returns. The resulting higher dollar value put pressure on returns for international equities, and less so for emerging markets. In the Fund international portfolios are underweight Japan, thus outperforming the benchmark. The real estate portfolio returned 3.77% net of fees. AEW and UBS core real estate portfolios provided positive returns that slightly underperformed their benchmark. The smaller value-added portfolios continue to wind down through distributions.

The private equity portfolio was initiated in 2008 with two managers, Abbott Capital Management and Pathway Capital Management. Ms. Heaphy reported that total private equity commitments are 43% paid in and distributions reflect that currently the portfolio is emerging from the J-curve. Performance according to the ratio of total value to the amount paid in is 1.21, ranking the portfolio in the second quartile of its benchmark Thomson/Cambridge institutional universe, which is a more rigorous model than its predecessor issued by Thomson-Reuters. Total private equity portfolio diversification was reviewed across strategy, geography, and industry. The Pathway portfolio is more weighted to buyouts, reflecting its adjustment to the stressed debt market scenario. Mr. Callahan expects the newer issues to take less time to build out than the original funds.

Trustee Given expressed an interest in comparing investment fees and performance with funds of similar size and structure. In response Mr. Callahan compared the structure of the Fund with public funds valued over $1 billion. The Fund has been relatively higher than peers in domestic equity and real estate, is similar in fixed income, and lower in alternative investments. Mr. Callahan stated that given the Fund structure fees would not be considered to be high. There is a service available that provides a normalized analysis of fees for public pension funds.

6. *Parametric Clifton – Futures Overlay – Jack Hansen – 11:20 a.m.*

This agenda item was discussed during the course of Mr. Hansen's presentation of Agenda Item C.2 above.

There being no further business, Chair Brenk adjourned the meeting at 2:12 p.m.

Greg Brenk, Chair

Attest: Jeff Wickman
Retirement Administrator