MINUTES

INVESTMENT COMMITTEE MEETING
MARIN COUNTY EMPLOYEES' RETIREMENT ASSOCIATION (MCERA)

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

January 14, 2016 – 9:00 a.m.

CALL TO ORDER Chair Brenk called the meeting to order at 9:05 a.m.

ROLL CALL

PRESENT: Bolger, Brenk, Given, Haim (alternate retired), Murphy, Piombo, Shaw (ex officio alternate), Shore, Stevens, Thomas

ABSENT: Cooper (alternate safety), Gladstern

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.

B. MANAGER ANNUAL REPORTS

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

Jim Callahan, Callan Associates Executive Vice President, stated that the 23% target to fixed income plays an important role to diversify the Fund and provide downside protection and liquidity. In view of a potential rise in interest rates, the fixed income portfolio was restructured eighteen months ago to preserve its high quality and liquidity. One of the factors for making the change, Mr. Callahan said, was the potential interest rate risk in the Barclays Aggregate Bond Index (Barclays Aggregate) due to its concentration in U.S. Government securities and long duration. As a result the fixed income portfolio was modified to add a global bond manager, Colchester Global Investors, and change the Western Asset Management core bond portfolio to an intermediate corporate bond mandate.

Mr. Callahan introduced Brett Cornwell, Callan Associates Senior Vice President, who is head of fixed income research and also commodities. Responding to Trustee Stevens' inquiry, Mr. Callahan attributed the fixed income portfolio's underperformance against the Barclays Aggregate to exposure to non-U.S. bonds and currencies because the dollar has been strong relative to foreign currencies. For the intermediate credit portfolio, Mr. Callahan explained that the shorter duration relative to the Barclays Aggregate reduces interest rate risk.

2. <u>Colchester Global Investors – Global Fixed Income – *Mamak Shahbazi* – 9:05 a.m.</u>

Mamak Shahbazi, co-founder and President of Colchester Global Investors, presented the annual review of the Global Fixed Income portfolio. In response to Trustee Shore's inquiry on the portfolio's outperformance to the unhedged benchmark, Ms. Shahbazi explained that Colchester is active in currencies. Their approach is value focused looking at inflation over the next two years, comparing current yield, and deriving a real rate of return. In the bond market the approach is to search for higher expected rates of return within investment grade or higher bonds. Trustee Stevens inquired about analytics and Ms. Shahbazi explained in the currency markets managers look at long-term exchange rates and rank currencies based on their cost. As an example Ms. Shahbazi pointed to the rise in the U.S. dollar to the third most expensive in the world since it was considered undervalued, and therefore overweighted, three years ago.

In response to Trustee Shore's question Ms. Shahbazi indicated that currency added 3 to 5% in overall value. Managers implement value by separating bonds and currencies, with the currency portfolio based on the valuation of the currency alone. An important factor in bond analysis is fundamental analysis of how countries deal with their finances.

An early move into non-U.S. currencies caused the lag to the benchmark in the current period. Since the portfolio was initiated in March 2014 bonds have performed well, Ms. Shahbazi said, and the currency markets have been affected by the strength of the U.S. dollar. The portfolio has kept up with the benchmark and compares favorably with peers, she said.

In conclusion Ms. Shahbazi stated that average credit quality is always AA and duration that has been shorter than the benchmark is increasing due to 4 to 4.5% in real yield. Mr. Callahan asked about the short duration and Ms. Shahbazi explained they look at real yields along the yield curve and when real yields are less attractive, duration is reduced.

3. <u>Western Asset Management – Intermediate Credit Fixed Income – *Frances Coombes, Ryan Brist* – 9:30 a.m.</u>

Frances Coombes, Western Asset Management client services representative, introduced Ryan Brist, who heads the intermediate credit mandate. Mr. Brist believes we are in the back half of the credit cycle where it is important to avoid losses in the credit markets. The portfolio is managed to a low volatility model, Mr. Brist said, with AA rather than BBB holdings. The financial sector is overweighted and has been a good investment since firms have deleveraged their balance sheets. In addition to having more capital, banks are engaging in less risky loans, he said.

In addition to making selective investments, the strategy underweights sectors that have been growing fast, with prices at all-time highs and a lot of debt being issued, such as the energy sector early in 2015. Another sector Mr. Brist believes is showing similar characteristics currently is the health care sector.

Mr. Brist increased duration which was a minor detractor to performance. There is a drift to wider credit spreads due to the energy sector and increased use of debt due to low interest rates. Mr. Callahan asked, given the need for higher yields on corporate bonds to be compensated for the added risk relative to U.S. Government securities, whether we are getting paid for that risk given tight credit spreads. In response Mr. Brist pointed to the additional 40 basis points generated from investing in the right sectors and being selective on bond issues. In the high yield space the portfolio outperformed the index by investing in high quality bonds with high revenues and good earnings, such as Ford and General Motors, and avoiding energy bonds. The portfolio is underweight the energy sector, with selective investments being made in the highest quality issuers to increase the weighting.

In conclusion Mr. Brist stated that the intermediate credit portfolio duration of 4 years with a 3.62% yield compares favorably with the core plus mandate. Responding to Chair Brenk's inquiry, Mr. Brist stated that the portfolio is expected to outperform the benchmark by 50 basis points over the long term.

Chair Brenk recessed the meeting for a break at 10:24 a.m., reconvening at 10:38 a.m.

4. Artisan Partners – International Growth Equities – *Sean Howley* – 9:55 a.m.

Sean Howley, Global Equity Relationship Manager with Artisan Partners, stated that the investment team is organized into sector specialists who use a bottom-up approach to select stocks. Investments are made in companies with long term sustainable growth around changing themes, being careful about valuation. Performance as of September 30, 2015 was the low point for the year with markets declining, currency depreciation and weakness in Europe. Mr. Howley attributed underperformance against the index to volatility in China as investors became nervous about a slowing economy. Artisan believes the true economic test for China is the state of the industrial manufacturing economy as indicated by changing electricity consumption. Mr. Howley reported that the portfolio trailed the index for 2015 but outperformed in the final quarter of the year. Over the long term the portfolio is outperforming the index.

Reviewing stock selections and attribution, Mr. Howley emphasized the plan is to stay with good quality companies with strong management and good structural growth in large population areas, including emerging markets. Mr. Howley discussed holdings in growth sectors where faster internet demand is leading to strong cash flows that allow firms to pay down increasing debt levels. In conclusion, Mr. Howley stated that core holdings are expected to lead to outperformance over the long term.

Trustee Stevens inquired about the low weighting to the financial sector which Mr. Howley attributed to the lack of quality banks in Europe and low return on equity. China is still classified as an emerging market due to the GDP per capita metric, he said in response to Trustee Haim's inquiry. In response to Trustee Bolger's query, Mr. Howley said they do not take views on currencies and have been underweight in euro zone companies. Chair Brenk asked about the health care sector which Mr. Howley said is overweight due strong margins and attractive growth in equipment providers and large cap pharmaceuticals. Other investment themes include cloud computing, ecommerce and payment processing.

As to the economy, Mr. Howley said they look for pockets of secular growth and are aware of macroeconomic themes in response to Trustee Shore's inquiry. The portfolio is always underweight the energy sector, Mr. Howley said, because there is no pricing power. The underweight to Europe and Japan is a long-term bias because there are better growth opportunities elsewhere, he said, such as in the emerging markets.

C. NEW BUSINESS

1. Real Assets Manager Selection (**Action**)
   Consider and take possible action to select active managers to interview for Natural Resources equity and Commodity portfolios

   Mr. Callahan reviewed the Committee's 2015 decision to diversify the real asset portfolio from 100% private real estate to include a 7% allocation to a diversified portfolio of public real assets. The real asset portfolio was implemented with equal weightings to passive strategies for Commodities, U.S. Treasury Inflation Protected Securities (TIPS), Natural Resource Equities and REITs. At the time Callan Associates recommended considering at a future date active management for Commodities and Natural Resource equities and the Investment Committee indicated an interest in that discussion.

   Responding to Trustee Bolger's inquiry, Mr. Callahan explained that there is systemic risk in owning commodities. In his view, a way to add value and help avoid risk over time is through active management because of the structure of the Commodities index. Callan Associates has a strong conviction for active managers for Commodities and Natural Resource equities, Mr. Callahan said. As yet there are no Callan public sector clients who have only an index strategy for commodities, according to Mr. Callahan in response to Chair Brenk's inquiry.

   Mr. Cornwell explained that the shortfalls of passive management and opportunity for the active manager are the spot return, the slope of the forward curve, and the return from collateral. For example, active management allows for discretion to manage the collateral and the contract timing, using the slope of the forward curve that is most advantageous.

Trustee Piombo was excused from the meeting at 11:25 a.m.

Mr. Callahan grouped commodities managers into those with active or enhanced approaches. Active management offers the opportunity to manage forward curves and collateral and over or underweight based on the opinion of the spot price. This process allows for efficient exposure to commodities using the futures market. Mr. Cornwell pointed out that active managers use TIPS to enhance return on collateral while the index invests collateral in a 3 month U.S. Treasury bill. He further stated that active management is a risk-protection measure for commodities based on tracking error.

Commodities – Active Strategies

Mr. Cornwell reviewed characteristics of four active managers. Cohen & Steers Capital Management, Inc., (Cohen & Steers) represents the most traditional, fundamentally oriented strategy and is the most unique because they consider valuation and do onsite analysis of commodities. A dynamic strategy is used to take a view on the commodity cycle by over or underweighting commodities.

Gresham Investment Management LLC (Gresham) is a more conservative commodities manager with less dramatic allocation swings, no short positions, a lower expected return and less risk relative to the benchmark. Sector exposure is set annually and the portfolio is more broadly diversified. Collateral is invested in high quality U.S. Government short-term securities.

Invesco and Wellington Capital Management LLP (Wellington) are non-traditional commodities managers. Invesco takes a risk-balanced approach by making sure each of the sectors are contributing to the risk budget of the portfolio. Allocations reconstruct benchmark weightings, with some over or underweight positions to achieve a better risk-adjusted return. For example energy dominates the index and Invesco minimizes the impact of energy. Chair Brenk asked about the timing of the commodities cycle which Mr. Cornwell said is long term with episodes in between. Trustee Stevens added that the important factors are supply and demand, noting the distinction between oil which depletes and gold which does not. Trustee Given pointed out that Invesco's downside risk is lower than others, and Mr. Cornwell affirmed that the Sharpe ratios show less risk for the Invesco portfolio than the index.

Wellington Management Company's (Wellington) approach is more conservative than Invesco's, with more equally weighted allocations to each commodity sector and more modest under or overweights relative to the benchmark. In addition Wellington's portfolio is more concentrated and will also be long-short. Collateral management is conservative using U.S. Government securities.

In response to Trustee Haim's observation, Mr. Callahan agreed commodities have performed poorly over the past five years. Referencing rebalancing processes of investing as pricing comes down and taking profits when prices are high, Mr. Callahan stated that commodities are expected to be a good diversifier for the Fund due to the low correlation to other asset classes.

Chair Brenk recessed the meeting for a break at 12:15 p.m. for lunch, reconvening at 12:37 p.m.

Trustee Shaw was excused from the meeting at 12:15 p.m.

<u>Commodities – Enhanced Strategies</u>

Mr. Cornwell reviewed characteristics of the three enhanced strategy candidates BlackRock, Credit Suisse Asset Management (Credit Suisse) and Dimensional Fund Advisors Inc. (DFA). All three enhanced strategy candidates have the same sectors and weightings as the benchmark. They are differentiated in the timing of rebalancing through contract roll. DFA represents the most distinctive approach by investing the collateral pool further out the forward curve, with durations extending up to three-year maturities. The credit grade may be as low as BBB. The approach is quantitative based on academic statistics around the yield curve. DFA performance has been good in a declining rate environment, according to Mr. Cornwell, who indicated the expectation would be the strategy would be adjusted depending on the outlook for interest rates.

BlackRock and Credit Suisse have similar approaches in looking at commodities' seasonality to manage roll return. There is no value added in collateral return for these managers.

Chair Brenk inquired about a comparison of absolute returns and Mr. Callahan offered to follow up on a return comparison for the enhanced and active managers. Active managers are expected to outperform the index and will track less closely to the index than enhanced managers, he said. Trustee Bolger indicated that long term performance numbers over 7 years would be useful.

Discussion followed on whether to interview both active and enhanced managers or one or the other. Trustees Shore, Given and Haim indicated a preference for the active management approach and Trustee Bolger indicated a preference for staying with passive management for commodities. In response to Trustee Steven's concern about risk, Mr. Callahan explained that active management always adds risk which leads to a risk-adjusted return. Mr. Callahan further stated that investing in a passive commodities index would be a suboptimal way of running a commodities portfolio.

It was M/S Haim/Shore to select Dimensional Fund Advisors, BlackRock, Invesco and Cohen & Steers as candidates to interview as manager of the Commodities portfolio.

In response to Trustee Bolger's inquiry Mr. Callahan referenced return patterns showing median active manager returns above benchmark returns over longer time frames. Trustee Given stated that the decision between active and enhanced strategies should be made prior to selecting managers to interview.

AYES:	Brenk, Haim, Murphy, Shore, Stevens, Thomas
NOES:	Bolger, Given
ABSTAIN:	None
ABSENT:	Cooper, Gladstern, Piombo

Global Natural Resources Equity

Mr. Callahan introduced Andy Iseri, Callan Associates Senior Vice President from the global and international equity team, to review potential candidates to manage the natural resources equity portfolio. Mr. Iseri explained that managers of global natural resources invest in firms that are public equities as opposed to the commodities themselves. Natural resources firms have capital expenditures to extract commodities and are assessed based on the cost of capital, return of the projects, dividend payout ratio and debt-to-equity ratio.

Mr. Iseri explained that global natural resources are best managed through an active rather than passive approach because there is no good index for a diversified natural resource strategy. The primary benchmark, the S&P Global Natural Resource Index, is concentrated in materials and energy, he explained.

Jennison Associates LLC (Jennison) and Van Eck Global (Van Eck) are the closest to a pure play on global natural resources, with sector allocations close to the benchmark. The firms conduct on site basic fundamental research with respect to return on capital versus the cost of capital, Mr. Iseri said. They have similar return patterns and Van Eck has experienced some personnel changes.

T. Rowe Price Associates, Inc. (T. Rowe Price) expands the natural resource universe by investing in the customer chain, thereby leading to less correlation to commodities. An example of a typical investment is a commodities user such as a trucking company. Thus, there is less energy exposure and more protection during a negative commodity cycle. Mr. Iseri advised that T. Rowe Price represents an investment thesis that makes sense as a step away from a pure commodity exposure.

Kleinwort Benson Investors International Ltd. (Kleinwort Benson) expands the universe of natural resources further to include water, agriculture, and renewable energy. These are conservation themes from an environmental scarcity standpoint. In response to Chair Brenk's inquiry, Mr. Iseri stated their holdings are fossil-free. He noted there is a direct correlation between energy and alternative energy assets, which is a small nascent industry. In Mr. Callahan's view Kleinwort Benson has some appeal from the energy aspect but has merit based on the natural resources thesis alone. Chair Brenk asked if other clients were invested with Kleinwort Benson and Mr. Callahan said there are none.

Trustee Given asked whether asset size can affect returns and Mr. Iseri and Mr. Callahan indicated asset size is a factor due to capacity constraints. Trustee Stevens indicated a smaller fund may be able to achieve more of an impact on return.

Trustee Bolger was excused from the meeting at 1:44 p.m.

It was M/S Haim/Shore to select Jennison Associates, Kleinwort Benson Investors International, and T. Rowe Price as candidates to interview as manager of the Global Natural Resources portfolio.

AYES:	Brenk, Given, Murphy, Shore, Stevens, Thomas
NOES:	None
ABSTAIN:	None
ABSENT:	Bolger, Cooper, Gladstern, Piombo

2. Portfolio Rebalancing (**Action**)
   Consider and take possible action on additional funding for Parametric Emerging Markets portfolio

   Mr. Wickman stated that in September 2015 funds that were targeted for Parametric Emerging Markets portfolio were instead overlayed in emerging market futures because the Investment Policy Statement (IPS) did not allow investing additional assets with a manager on the Watchlist. Subsequently the IPS was revised to modify this restriction. The question is whether additional funding of $20 million consistent with MCERA's rebalancing policy is appropriate for the Parametric Emerging Markets portfolio.

It was M/S Shore/Given to move $20 million from emerging market futures to the Parametric Emerging Markets portfolio based on Callan Associate's rebalancing recommendation at the September 2015 Investment Committee meeting.

AYES:	Brenk, Given, Murphy, Shore, Stevens, Thomas
NOES:	None
ABSTAIN:	None
ABSENT:	Bolger, Cooper, Gladstern, Piombo

3. <u>Investment Manager Reporting for 2016 (**Action**)</u>
   Consider and take possible action to schedule annual portfolio reviews by investment managers

   Based on Mr. Wickman's recommendation, Chair Brenk directed that the schedule for investment manager reporting will be considered at the next Committee meeting. The schedule will be adjusted to allow time to interview active real asset managers in March and June.

4. <u>Due Diligence (**Action**)</u>
   Consider and take possible action on investment manager due diligence site visit schedule for 2016

   Mr. Wickman presented a schedule for due diligence site visits for 2016 in line with MCERA's Due Diligence Policy that is carried over from last year.

It was M/S Given/Haim to approve the due diligence site visit schedule for 2016 as presented.

AYES:	Brenk, Given, Murphy, Shore, Stevens, Thomas
NOES:	None
ABSTAIN:	None
ABSENT:	Bolger, Cooper, Gladstern, Piombo

D. <u>INVESTMENT CONSULTANT PERFORMANCE UPDATE</u>

Mr. Callahan reported that as of December 31, 2015 the portfolio slightly underperformed the custom benchmark for the calendar year. For the first half of the fiscal year the return was modestly negative. For the calendar year domestic equity was flat, underperforming due to the overweight to small caps. The international portfolio performed well, outperforming the index by 4%, with Pyramis (now Fidelity) producing notable relative strength. The fixed income portfolio slightly underperformed the benchmark and will continue to be monitored in view of restructuring.

There being no further business, Chair Brenk adjourned the meeting at 2:02 p.m.

Greg Brenk, Chair

Attest: Jeff Wickman
Retirement Administrator