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

One McInnis Parkway, San Rafael, California
March 15-16, 2016

8:00 a.m. – 9:00 a.m.
Continental Breakfast

9:00 a.m.
Call to Order

Chair Stevens called the meeting to order at 9:12 a.m.

Roll Call

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

ABSENT: None

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.

9:00 a.m. – 11:00 a.m.
Capital Market Theory and Practice
Risk, Return, Diversification, and Correlation
Measuring return and risk
Asset allocation
Role of correlations in asset allocation
How returns compound and influence asset values
Jim Callahan, Executive Vice President
Jay Kloepfer, Executive Vice President
Callan Associates

Jim Callahan, Executive Vice President with Callan Associates, introduced Executive Vice President Jay Kloepfer, an economist leading the firm's research on asset returns, risks and correlations used to develop modeling for capital market assumptions. Mr. Callahan began the presentation by discussing the key steps in the investment process. It begins with developing investment policy guidelines and setting asset allocation policy, which is the most important consideration, he said. The next steps are to implement the policy and continually monitor and evaluate progress through performance measurement and rebalancing when needed. Every five years or so an asset/liability study should be conducted, and in the interim years refreshed, to determine if anything forces the need to rethink the asset allocation.

Mr. Kloepfer presented the Callan Periodic Table of Investment Returns to demonstrate that returns vary for each asset class from year to year. He also noted that the chart demonstrates why it's important to keep a long investment horizon in mind. Mr. Kloepfer noted that the emerging markets class, also at a low price level, has performed well over the longer term and is a reason to have the class in the portfolio.

Mr. Kloepfer explained that capital market theory looks at the relationship between risk and return and how humans behave. For example, less risk is preferred for the same level of return, and to increase return, more risk is required. The questions are how to evaluate what assets are available and appropriate for MCERA, how to put the portfolio together, and then how to measure success. The change introduced by modern portfolio theory about 65 years ago was the need to look at the total perspective. Economists assume returns follow a normal distribution and can therefore infer probabilities for expected returns.

Responding to Trustee Brenk's inquiry, Mr. Kloepfer explained that standard deviations are fairly stable over longer periods of time. In periods of low volatility stocks are usually trending in one direction. Mr. Callahan emphasized that the more data points, the more statistically significant and the more confidence in the results. Chair Stevens inquired about modeling risk and return for private equity and real estate since they are not marked to market daily as with public equities. In response Mr. Kloepfer said the economic risk is embedded in the asset class and may change over time. Private equity is a reasonable allocation with the return worth the risk, he said.

Given the probability of returns and standard deviations, a range of projected returns is developed. A chart showing actual returns of the S&P 500 over 227 years shows a normal distribution pattern with most years within the one standard deviation level and the greatest number of years within a smaller range of 1 to 10% returns. Mr. Kloepfer explained that the point of diversification is to smooth the ride instead of having an entire portfolio in a single asset class.

In response to inquiries of Trustee Given and Trustee Brenk, Mr. Kloepfer discussed changes in the correlation between equities and bonds, noting that more recently there is greater correlation which indicates a smaller allocation to bonds is warranted. Mr. Callahan stated that structural changes in the global capital markets have led to increasing correlations among international markets, with the exception of emerging markets. The conclusion, according to Mr. Kloepfer, is that if you invest in only one asset class you lose out. Furthermore, he emphasized that the global investable universe is the opportunity set. Over the short term there is more volatility than in the past, Mr. Kloepfer said in response to Trustee Piombo's inquiry.

Mr. Kloepfer discussed Modern Portfolio Theory developed in the 1950's that identifies optimal portfolios using return, risk, and correlation expectations. Subsequently metrics were introduced such as Alpha indicating added manager value and Beta indicating how a portfolio moves relative to the market.

Mr. Kloepfer continued discussing capital market theory and the roles of idiosyncratic risk, systematic risk, and the promise of active management to add unsystematic return. Risk and return measures such as the Sharpe ratio, information ratio, and tracking error were discussed. Concepts such as covariance to the market and standard deviation based on regression studies are considerations in determining asset allocations. Mr. Callahan stressed the importance of asset allocation which drives 90% of the variability of portfolio returns.

Chair Stevens recessed the meeting for a break at 10:53 a.m., reconvening at 11:10 a.m.

Mr. Kloepfer reviewed the process for setting asset allocations that begins with the asset/liability studies to match expected returns with benefit payments over time. The tolerance for risk is defined and exposure levels to the opportunity set are considered with appropriate rebalancing points defined. The goal is to build an efficient asset mix using mean variance optimization to achieve the greatest return for a given level of risk. Capital market assumptions are based on 10-year annualized projections for return, risk and correlations of asset classes. As to their accuracy, Mr. Callahan stated that the projections for multiple asset classes are tested over time, in response to Chair Stevens' inquiry. For equities typically projected returns will be 2% lower when equities perform well.

Mr. Kloepfer reviewed projected rates of return for portfolio mixes with increasing levels of risk. Responding to Trustee Brenk's inquiry, he stated that a portfolio designed to protect against another 2008-2009 scenario would be substantially different and would miss out on the subsequent gains.

In conclusion Mr. Kloepfer reviewed rolling 10 year correlations of major asset classes. Real asset correlations indicate that commodities are a good diversifier, Mr. Callahan said, and will show less correlation as 2008 rolls out.

11:15 a.m. – 12:00 p.m.
Economic and Capital Market Review
Jim Callahan, Executive Vice President
Jay Kloepfer, Executive Vice President
Callan Associates

Mr. Kloepfer reported that the capital markets went sideways in 2015, emerging markets had a difficult year, and the last two months were very negative for commodities. The first major factor was slowing growth in China. The second big event of the year was the raising of the Federal Reserve Bank's (Federal Reserve) key interest rate for the first time since 2007 following years of monetary stimulation and then tapering. Mr. Kloepfer stated that the market is discounting the belief that the Federal Reserve wants to raise rates to the long-term norm. As a result rising rates are built into the forecast and the dollar is strengthening. Low prices for oil and commodities are a source of uncertainty.

The job market has recovered after a long period of weakness, leading to an unemployment rate below 5%. Going forward Mr. Kloepfer expects GDP growth to moderate from the average of 3.2% since 1995 to between 2.5% and 3%. For this reason Callan Associates has lowered expectations for equity returns.

Chair Stevens recessed the meeting for lunch at 12:17 p.m., reconvening at 1:02 p.m.

12:00 p.m. – 1:30 p.m.
Lunch (on site)

1:30 p.m. – 2:00 p.m.
Economic and Capital Market Review Continued

Mr. Kloepfer attributed the low labor force participation rate to demographic pressures such as aging baby boomers and under-employment. Average hourly earnings are beginning to tick up, he reported. Responding to Chair Stevens' inquiry, he stated that productivity has been strong since employers are doing more with fewer people. The All Urban Consumer Price Index dropped to 0.86% because of falling energy prices, but the Core Consumer Price Index is holding steady at about 2%.

Trustees Given and Shaw joined the meeting at 1:11 p.m.

Challenges facing the recovering housing sector include fewer household formations and evidence of a shift in housing preferences to downtown locations. Corporate profits have had a remarkable run since 2010 which is why the stock market went up. In the global economy both Japan and Europe are responding to stimulus with modest growth. The prospect for emerging markets is clearly tied to commodities and growth in the developed world. The biggest risk is the potential for a trade war around the globe. In summary, Mr. Kloepfer stated that global growth is subdued and the United States is the strongest economy.

In response to Trustee Shore's inquiry, Mr. Kloepfer attributed lowered projected equity returns to slowing global growth, strength in the dollar, and relatively high equity valuations. Trustee Gladstern asked how U.S. politics affect the capital markets and Mr. Kloepfer responded that a trade war would be a negative economic factor. Currencies are expected to have a neutral effect over 10 years, Mr. Kloepfer said in response to Trustee Bolger's inquiry. The strong dollar is causing investments to flow to the United States, he said.

Summarizing economic expectations, Mr. Kloepfer believes interest rates have hit bottom and the federal funds rate will be 3.5% over the long term. If the Federal Reserve does not raise rates, the risk is that spreads would narrow and fixed income's low yields could continue for some time. Equities are richly valued after moving sideways and growth in corporate earnings is projected to be about 10%.

Mr. Kloepfer reviewed 10-year projected returns for alternative mixes for asset allocations. Projections do not include expectations for active management of the asset class. The 10-year expected return for the MCERA Policy Target Mix is 6.87% with nearly 50% probability of achieving the 7.25% assumed rate of return. In addition, the real return embedded in the valuation (7.25% - 2.75% inflation – 0.25% wage growth = 4.25%) is actually lower than Callan's expected real return (6.87% - 2.25% inflation = 4.62%). Since last year the biggest change in the portfolio has been to recast real estate into broader classes and include diversified real assets.

Mr. Kloepfer stated that further diversification of the Fund through multi-asset class strategies is worth considering. He discussed one relatively inexpensive, liquid vehicle developed as a method of managing a portfolio with less risk. The active strategy has a long bias and models a 60-40 (equity/bond) portfolio across multiple asset classes. Benefits of the strategy include outperformance to its benchmark, reduced risk and lower correlation to the rest of the portfolio. Mr. Callahan noted that a hedge strategy is the one strategy not represented in the Fund. In response to Chair Stevens' inquiry, Mr. Kloepfer said that the vehicle had a positive return in the market downturn of 2008.

Callan Associates' ten-year capital market expectations are 7.35% for stocks, 3% for bonds, and 2.25% for inflation. Over 30 years the expectations are 9.5% for equities, 5% for bonds, and 3% for inflation.

Chair Stevens recessed the meeting for a break at 2:10 p.m., reconvening at 2:28 p.m.

2:00 p.m. – 3:30 p.m.
Utilizing Active versus Passive Management

What are the reasons for spending more on certain asset classes
What are the fee comparisons
What are the correct benchmarks
Are there ETF alternatives

Jim Callahan, Executive Vice President
Anne Heaphy, Vice President

Mr. Callahan explained that evidence-based investing is the same as traditional cap-weighted indexing in response to Trustee Bolger's inquiry. The investment consultant stated that asset allocation is the biggest driver of risk and return for a portfolio. Most institutional investors use a blend of passive or active approaches that cover a full array of strategies. Generally certain areas are more efficient for passive management and large cap U.S. equities are the prime example. Domestic small cap equities and international equities offer more opportunities for active managers to add value.

Mr. Callahan explained the version of the Efficient Market Hypothesis concluding that there is information that is not currently in the price and therefore it is possible to beat the market. Research on the topic differs but Mr. Callahan stated that some asset classes with active management outperform.

Reasonable strategic uses of passive management in the investment consultant's view are for efficient markets such as U.S. large cap core equities or to gain inexpensive exposure to a certain asset class or to an asset class with high transaction costs where the fund's liquidity requirements are high. Considerations include the size of the commitment, cost differentials, and the efficiency and liquidity of the market.

Trustee Bolger quoted a statistic that 18% of active managers consistently outperform. In response Mr. Callahan said while it is not likely that an active manager can consistently outperform an index, the numbers support the outperformance over time of active managers in the small cap space. The investment consultant observed that adequate time is needed to gauge performance results; when the manager is skilled and interests are aligned with the client, there is a good probability of future success.

Mr. Callahan reviewed the performance of the Callan Universe of active managers for rolling three-year periods going back 20 years. Results show that active management is worth the fee for small cap managers, international equity managers, and core plus fixed income managers, among others. In conclusion, Mr. Callahan explained that the distinctly different strategies of active managers in the MCERA portfolio lend diversification to the Fund. Mr. Callahan believes there is value in Callan Associates' ability to focus on the universe of managers with reasonable qualities to consider.

3:30 p.m. – 4:00 p.m.
Manager Reporting Format

Mr. Wickman stated that the Manager Reporting Format discussion is based on Board members' interest in receiving key information from the quarterly investment report in a more easily accessible summary report. In response to this request Callan Associates developed a proposal for consideration. Upon request the trustees commented on preferred data around performance metrics, volatility measures, comparison to internal managers and to peers, and fiscal year returns. The proposed summary report was well received and Mr. Callahan offered to incorporate selected suggestions into the format.

Mr. Wickman emphasized the importance of focusing on investments, observing that one of the challenges is holding Investment Committee meetings the day immediately following Board meetings. Ideas considered included reducing the number of annual manager reviews, returning to six Investment Committee meetings per year rather than five, spacing Board and Investment Committee meetings in two-week intervals, and holding special meetings as needed. Trustee Bolger observed that Board members have a wide variety of experience in investments. Mr. Wickman noted that in 2015 the Governance Committee discussed changing the composition of the Committee during a review of the Investment Committee Charter.

Based on discussions Chair Stevens directed that the summary report presented by Callan Associates is suitable and may incorporate new ideas as appropriate. The Chair also indicated a preference for limiting annual manager reviews, spending more time reviewing the quarterly investment report as the investment consultant advised, adding a sixth Investment Committee meeting, and separating Board and Investment Committee meetings in 2017.

Trustee Cooper was excused from the meeting at 4:31 p.m.

4:00 p.m. – 4:30 p.m.
Closing and Follow-up Items from Today's Agenda

Mr. Wickman and Mr. Callahan agreed with the Chair to limit annual reviews for managers unless otherwise indicated. This would optimize time to address the most important topic which is asset allocation, according to Mr. Callahan.

Trustee Shore was excused from the meeting at 4:35 p.m.

Chair Stevens recessed the meeting at 4:35 p.m.

5:00 PM
Dinner at Wild Fox
225 Alameda Del Prado
Novato, CA

Day 2
March 16, 2016

8:00 a.m. – 9:00 a.m.
Continental Breakfast

Chair Stevens reconvened the meeting at 9:00 a.m.

Trustee Thomas joined the meeting at 9:00 a.m.

Open Time for Public Expression Note: The public may also address the Board regarding any agenda item when the Board considers the item.

9:00 a.m. – 10:00 a.m.
Class Action Securities Litigation Monitoring
Blair A. Nicholas, Partner
Bernstein Litowitz Berger & Grossmann LLP

Mr. Wickman introduced Mr. Nicholas stating that the topic of class action securities litigation monitoring is a follow-up to the Finance and Risk Management Committee's review of its current service providers at its December 2015 meeting. The Committee recommended that the full Board review the services providing for portfolio monitoring at a regularly scheduled workshop. Blair Nicholas is managing partner of Bernstein Litowitz Berger & Grossman LLP (Bernstein Litowitz), one of MCERA's service providers.

Mr. Nicholas stated that his primary role at Bernstein Litowitz is to prosecute securities fraud actions. Clients include the institutional investor community and large private investment firms. Class action securities litigation monitoring is provided to MCERA at no cost. Compensation would only be involved when clients suffer major damages and decide to pursue litigation. As an example he referred to a major class action case involving the misrepresentation by Volkswagen of its vehicle's emission system. Mr. Nicholas highlighted the firm's depth of experience in litigation, expertise in conducting due diligence to increase the likelihood of recovery, and focus on customer service.

The monitoring process involves looking for securities fraud that could cause damages. Mr. Nicholas emphasized the importance of being able to make an informed decision to make sure the Plan is protected. He explained in response to Trustee Gladstern's inquiry that there may be multiple cases involving one corporation and different legal firms. For example investors may opt out of a class action to pursue individual separate actions.

Mr. Nicholas stated that securities litigation is a powerful tool based on federal laws allowing any investor or member of a class to bring a cause of action. Private firms have been driving securities fraud actions with $100 billion recovered since 1995 when the Private Securities Litigation Reform Act (PSLRA) was enacted. The PSLRA encourages individuals to come forward and requires a public notice giving 60 days to file an action. Typically an institutional investor will step forward as lead plaintiff leading to settlements that are 20% higher, as is the case for 91% of the top 100 settlements.

Responding to Trustee Brenk's inquiry, Mr. Nicholas stated there are fewer incidences of fraud since the financial crisis when securities litigation activity tripled. Other federal regulations such as the Dodd-Frank Act may have had an effect on behavior also, he said.

Mr. Nicholas discussed his firm's PortfolioWATCH services allowing client access to real-time news and analysis of new and settled cases. The system is used to monitor MCERA's trading through downloads from the custodian that are cross-referenced against cases where MCERA may be impacted. Data provided includes potential losses and key information to assist with claim filings for settled cases. Services include communications with the claims administrator to ensure claim forms are received and are being paid. Responding to Chair Stevens' inquiry, Mr.

Wickman said there are a number of settlements outstanding and MCERA's policy sets $1 million as the minimum loss for requesting lead plaintiff status.

Mr. Nicholas discussed the *Morrison* decision which bars investors from pursuing claims in the United States for securities traded on a foreign exchange. From a due diligence perspective Mr. Nicholas advised caution with respect to international securities litigation due to the lack of well-defined securities laws, the loser-pays rule, and the risk of dealing with aggregators, or firms that get several institutional investors to fund litigation. Bernstein Litowitz limits international securities litigation to complimentary advice for clients. Trustee Gladstern noted that the Council of Institutional Investors (CII) lobbied Congress to override the Morrison decision. In response to Trustee Haim's inquiry, Mr. Nicholas stated that some countries will not recognize the settlement of class action securities cases, meaning the laws are effectively unenforceable.

Bernstein Litowitz' litigation services include shareholder derivative cases where action is brought against boards of directors, for example to disclose political contributions. In addition the firm litigates transaction deal cases to determine whether there was an arms-length transaction or a breach of fiduciary duty. Mr. Nicholas discussed a successful case in which one security in a merger was considered undervalued that was subsequently valued 27% higher.

In conclusion Mr. Nicholas stated that Bernstein Litowitz maintains a conservative litigation philosophy that focuses on high-impact cases. The firm is successful in settling over 68% of cases. Responding to trustee inquiries, he explained that opting out of class action lawsuits to pursue direct action would not be cost effective for MCERA. Trustee Bolger noted that Mr. Nicholas assisted with a recovery related to securities lending on behalf of MCERA.

Chair Stevens recessed the meeting for a break at 10:02 a.m., reconvening at 10:11 a.m.

10:15 a.m. – 12:00 p.m.
Disability Retirement Processing

Role of the Board Counsel and MCERA's Counsel
Role of the Medical Advisor
How do MCERA Disability Retirement standards differ from Workers Compensation
Format of consultant memo

Ashley K. Dunning, Partner
Nossaman LLP
Jeff Wickman
Retirement Administrator

Mr. Wickman stated the presentation was developed to review the roles and processes for disability retirement applications. The staff will also be presenting a proposed format for the communications and the request for information with the Medical Advisor.

Board Counsel Ashley Dunning of Nossaman LLP reviewed the roles of the parties involved in disability retirement processing and related legal standards. As General Counsel Ms. Dunning serves as the advisor to the Board, whereas County Counsel Pat Richardson is the advocate for MCERA. The reason for the separation of these roles is to provide the disability retirement applicant with due process in connection with the administrative hearing to which he/she is entitled, upon request, in accordance with state and federal constitutions.

Due process is the right to be heard and to be provided with a fair hearing. A fair hearing means having an impartial adjudicator and since the Board is the adjudicator, Board members and the Board's consulting attorney have to be impartial. For this reason each Board member needs to consider whether he/she can be fair and impartial if they know the applicant and, if not, recuse themselves from the deliberations.

Mr. Richardson communicates separately with the Retirement Administrator and does not communicate to the Board or the Board's counsel, expect when the applicant or applicant's attorney if any, is present. The Retirement Administrator only discusses disability retirement process with Ms. Dunning, and not facts of any particular application, because of her role as Board counsel. The Medical Advisor summarizes and analyzes medical records regarding the applicant and advises as to whether there is a permanent incapacity and if it is related to employment. The use of a professional medical advisor serves to fulfill the need for the Board to operate as a prudent expert on the matter.

Once information on a disability retirement application is complete, staff makes a recommendation, without input from Board Counsel on the substance of the application, who makes sure the Board receives the information they need.

With the exception of applications that are on the consent agenda, the MCERA Board generally considers disability retirement applications in Closed Session as allowed for in an opinion issued by the Attorney General of the State of California, unless the applicant requests to be heard in Open Session. Responding to Trustee Thomas' inquiry, the Administrator explained that the medical advisor determines what records are needed for evaluation of the disability claim. There can be delays in the process if, once the record including the medical advisor report is complete, the applicant wants to obtain more evidence for the Board to consider. Ms. Dunning advised that the Board has an obligation to grant the disability retirement if the applicant has met his or her burden of proof, as determined by the Board, no matter how vigorously the advocate counsel argues against the application. The Board uses a Disability Consent Agenda to consider disability retirement applications where staff and MCERA's consultants agree as to the requested outcome. Mr. Wickman observed that typically cases are not referred straight to the ALJ. Ms. Dunning views the Board's process for considering disability retirement applications as a good service to applicants since the Board may grant disability retirement without the need to go through the ALJ process, should sufficient uncontradicted competent evidence of permanent incapacity and, if applicable, service-connection be presented to the Board with the application at the outset.

Ms. Dunning discussed the differences in disability retirement under the County Employees Retirement Law of 1937 (CERL) from Workers' Compensation provisions. The CERL provides that for disability retirement a permanent incapacity from the performance of usual duties is required, whereas for Workers' Compensation there may be a partial, temporary, or permanent disability. Under the CERL there may be disability retirement that is not service-connected; this is not the case for Workers' Compensation which must be job-related.

Other conditions are applicable under the CERL, such as whether an employer is able to provide reasonable accommodation within the employee's job position or classification. Ms. Dunning discussed examples of reasonable accommodation and what are considered usual duties under the applicable case law. For a permanently incapacitating condition to be considered substantially caused by employment there must be a real and measureable connection with the job and the injury, with exceptions for statutory presumptions. Statutory presumptions apply to certain safety members with at least 5 years of service: heart trouble, cancer if exposed to a known carcinogen on the job, and with limitations blood-borne infectious disease, a specific skin infection, and bio-chemical substance exposures. With the presumptions the burden of proof shifts from the applicant to MCERA to disprove that the incapacity was caused by work.

Chair Stevens inquired about trustees applying for disability retirement. Mr. Wickman explained that MCERA has an agreement with the Sonoma County Employees' Retirement Association to process any disability applications for MCERA Board members or staff. Sonoma would collect the medical information and responses from the IME and Medical Advisor and provide that information to the MCERA Board for consideration. Ms. Dunning noted that the CERL requires the MCERA Board to hear applications for disability retirement that would be provided by MCERA; however, the information regarding the application can be developed by an outside party. In response to Trustee Piombo's question Ms. Dunning said that under the CERL MCERA may require annual medical examinations if a disability retiree is under the age of 55.

Trustee Bolger was excused from the meeting at 11:43 a.m.

Mr. Wickman indicated that staff has a good idea of cases that should be followed up on for the limited number where the applicant is under 55 years old.

Mr. Wickman presented a model letter formatted for the Medical Advisor to report the results of his analysis of medical records for consideration. The letter is based on a format developed by a consultant engaged by MCERA a few years ago. Trustee Given responded positively to the consolidation of medical evidence into a standardized format. The Chair agreed, noting that the information flows well and allows for quick access to the data, and directed staff to implement the letter.

12:00 p.m. – 12:30 p.m.
Closing and Follow-up Items from Today's Agenda

There being no further business, Chair Stevens adjourned the meeting at 12 noon.

Kim Stevens, Chair

Attest: Jeff Wickman
Retirement Administrator