MINUTES

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

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

May 24, 2017 – 9:00 a.m.

The Board of Retirement for the Marin County Employees' Retirement Association encourages a respectful presentation of public views to the Board. The Board, staff and public are expected to be polite and courteous, and refrain from questioning the character or motives of others. Please help create an atmosphere of respect during Board and Committee meetings. If members of the public wish to speak on any agendized items, please alert the Retirement Administrator to that request prior to the matter being called.

CALL TO ORDER

Chair Shore called the meeting to order at 9:00 a.m.

ROLL CALL

PRESENT: Bolger, Given, Gladstern, Jones (alternate retired), Murphy, Shaw (ex officio alternate), Shore, Silberstein, Stevens

ABSENT: Cooper, Piombo (alternate safety) and Thomas

A. OPEN TIME FOR PUBLIC EXPRESSION

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

Open time for public expression, from three to five minutes per speaker, on items not on the Committee Agenda. While members of the public are welcome to address the Committee during this time on matters within the Committee's jurisdiction, except as otherwise permitted by the Ralph M. Brown Act (Government Code Sections 54950 et seq.), no deliberation or action may be taken by the Committee concerning a non-agenda item. Members of the Committee may (1) briefly respond to statements made or questions posed by persons addressing the Committee, (2) ask a question for clarification, or (3) provide a reference to staff for factual information.

B. <u>MANAGER ANNUAL REPORTS</u>

1. <u>Manager Overview – *Jim Callahan, Callan Associates*</u>

   Jim Callahan, Callan Associates Executive Vice President, introduced Cliff Fox, Portfolio Manager and Karl Anderson, Senior Managing Director of Marketing, who presented the Columbus Circle Investors small cap growth portfolio annual review.

2. <u>Columbus Circle Investors, Small Cap Growth – *Cliff Fox, Karl Anderson – 9:05 a.m.*</u>

   Mr. Anderson reported it has been a difficult time in the equity markets for active managers. Issues in the macroeconomic environment emanating from Federal Reserve (Fed) policy, fees and indexing made the discipline more difficult. Post-election, the environment has changed, he said; there is more optimism and active management is showing more value across the firm's products. Mr. Anderson believes this is an indicator of better performance ahead because good fundamental stocks are being rewarded. Chair Shore asked if the Columbus Circle name is in reference to political establishment and Mr. Anderson replied it is not.

   Mr. Fox reported underperformance has been broad across the firm's small, medium and large capitalization equity strategies. After the Fed began to raise rates in the fourth quarter of 2016, investors returned to growth stocks in the first five months of 2017. Mr. Fox explained the investment strategy for the small cap growth portfolio is a positive momentum, positive surprise discipline based on accelerating business fundamentals such as sales and economic indicators. Stocks are selected based on secular trends and company specific products and key attributes.

Trustees Shaw and Jones joined the meeting at 9:05 a.m. and 9:10 a.m., respectively.

The portfolio monitoring process involves continually reviewing expectations, including those from the business and trade press and competitors, to make sure they are in sync. Chair Shore asked if Mr. Fox was buying companies through initial public offerings (IPO's), which he said are going public at relatively high valuations. In response, Mr. Fox stated IPO's have never been a meaningful part of the discipline. Trustee Silberstein asked about turnover and holding periods. Mr. Fox replied the average turnover is 150% per year, including profit taking and then adding back to positions, and the average holding period is 1.5 years. Trustee Silberstein indicated he was concerned about possible manipulation of financial information by chief executive officers. Mr. Fox explained if that is the case or the story has changed, sometimes there is a need to sell a stock. The portfolio manager further stated that is why the investment team tracks quality measures; as an example, if receivables start to balloon, that would indicate there is a problem. Favorite stocks have supporting information that it is broad and deep, with sufficient reinforcement from different sources, Mr. Fox said. With the advent of the Sarbanes-Oxley Act CEOs are required to sign the accounting statements, resulting in much better financial reporting than in the 1990's, he explained.

Trustee Gladstern asked how climate change factors into investment decisions. In response, Mr. Fox stated he considers the regulatory impact on the energy sector of slowing business or higher costs. There are some holdings representing the shale energy secular trend.

In conclusion, Mr. Fox directed attention to the Earnings Momentum & Surprise Grid for the first quarter of 2017 and the three prior quarters. During this period, most portfolio holdings were consistently in the preferred area higher and to the right on the grid, showing stronger earnings and better surprise. The median growth rate of nearly 30% per year is very meaningful, he said, because higher earnings and growth rates support price. To support his thesis, the portfolio manager presented a First Call earnings-per-share estimate report on Columbus Circle Small/Mid Cap Holdings, which Mr. Fox believes is one of the more favorable earnings guidance reports on Wall Street.

C. NEW BUSINESS

1. Passively Managed Portfolios (**Action**)
   Consider and take possible action to consolidate passive portfolios under one manager.

   Anne Heaphy, Vice President with Callan Associates, stated that there are three passively managed portfolios in MCERA's fund, S&P 500, Treasury Inflation Protected Securities (TIPS) and Real Estate Investment Trusts (REITs), each managed by a different company. Callan Associates prepared a presentation that showed options for streamlining by bundling passive portfolios under one of the two current passive managers, State Street Global Advisors or BlackRock. Ms. Heaphy presented four options, two for each manager reflecting lending or non-lending S&P 500 vehicles. Chair Shore asked about risk in securities lending and Mr. Callahan explained since the financial crisis, cash collateral pools are more conservative, resulting in more modest returns with lower fees.

   Mr. Callahan summarized the four options and expects fees savings to range from $60,000 to $90,000 per year. Trustee Silberstein said he is not ready to vote because he wants to factor in whether SSgA and BlackRock are responsive to MCERA's corporate governance policies. Mr. Callahan pointed out that MCERA cannot impose its governance policies on pooled funds and there are very few firms big enough to do a good job indexing large equity markets. Trustees Bolger, Given and Stevens believe the fee savings were important enough to move forward.

It was M/S Stevens/Murphy to move the State Street S&P 500 and Vanguard REIT portfolios to BlackRock's S&P 500 Lending Index Fund and DJ US REIT Lending Index Fund, respectively – BlackRock Option 2 in Callan's presentation.

AYES:	Bolger, Given, Gladstern, Murphy, Shore, Stevens
NOES:	Silberstein
ABSTAIN:	Jones
ABSENT:	Cooper, Piombo, Thomas

2. Artisan International Fund (**Action**)
   Consider and take possible action to move Artisan's vehicle from a mutual fund to a commingled investment trust.

Ms. Heaphy explained that in the past the Committee has considered potential avenues to reduce fees for the Artisan International Equity portfolio. It was determined that moving to a separate account would introduce additional administrative issues and costs associated with the need to open individual country accounts. Recently, Artisan has launched a bank-sponsored commingled investment trust vehicle (CIT) with a Tier 3 option with a $150 million account minimum. MCERA currently has $155 million in the Artisan mutual fund. The management fee would be reduced from 95 to 80 basis points, saving approximately $233,000 per year. By remaining in a fund structure, MCERA will still share operating costs and additional expenses with other fund participants.

It was M/S Gladstern/Bolger to move the Artisan International Equity Institutional Class Mutual Fund to the Tier 3 Artisan International Growth Trust.

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

3. Public Real Assets Portfolio Rebalancing (**Action**)
Consider and take possible action to reduce the allowable range for each allocation.

Ms. Heaphy stated the public real assets portfolio consists of four equally weighted strategies: BlackRock TIPS Index Fund, Vanguard REIT Index Fund, Invesco Commodities Fund, and the KBI Global Resources Fund. At the Total Fund level, the strategies each have a 1.75% target allocation with an allowable range of +/-0.75%. Ranges have not been pierced and have proven to be fairly wide for portfolios of this size. Callan recommends reducing the range to +/- 0.25% in order to prevent the actual asset allocation from being meaningfully different from the long-term target allocation and benchmark. Trustee Gladstern asked the Administrator for his comments and Mr. Wickman said rebalancing would not create a staff time issue.

It was M/S Gladstern/Stevens to reduce the allowable target range for each allocation to public real assets to 1.5% – 2.0%.

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

Mr. Wickman will discuss with Mr. Callahan including in the Investment Policy Statement language that will streamline rebalancing authorized by the Investment Committee.

Mr. Wickman announced this will be Counsel Renee Brewer's last Investment Committee meeting. He and Trustee Bolger thanked Ms. Brewer for serving as a valuable resource for MCERA. Ms. Brewer said MCERA is in good hands and thanked Committee members for their time and dedication.

Chair Shore recessed the meeting for a break at 10:16 a.m., reconvening at 10:33 a.m.

4. Education on Investment Performance Measurement – *Jim Callahan, Callan Associates*

Mr. Callahan stated that Callan Associates uses the most commonly accepted way to calculate investment returns, the Time Weighted Rate of Return methodology. With this method, every time period has the same weighting, which for Callan Associates is daily, he said in response to Chair Shore's inquiry. The Time Weighted Rate of Return measures the compound growth rate of an investment over a period of time and the effects of external cash flows are removed. This methodology best reflects a manager's ability to manage portfolios according to standard practices, a specified mandate or strategy, and forms the basis for performance evaluation practices globally. Mr. Callahan explained that part of the reason the Time Weighted Rate of Return is the most commonly accepted method is there is limited control over cash flow that affects beginning and ending values. Another commonly accepted methodology is Dollar Weighted Rate of Return, or Internal Rate of Return, used for private equity managers because they do have control over the timing of cash flows. Mr. Callahan stated that Global Investment Performance Standards (GIPS) require the application of a Time Weighted Rate of Return calculation methodology to evaluate investment performance. Callan Associates is a member of GIPS and looks closely at investment managers to make sure they are GIPS compliant.

Two widely used methods to calculate average investment returns over multiple holding periods are: Arithmetic average return and Geometric average return, which compounds the returns over multiple periods. Mr. Callahan explained that volatility matters in the return pattern, because for the same compound return, more volatility means less money at the end.

5. Investment Policy Statement (**Action**)

Consider and take possible action on Governance Committee's recommended changes to the Watchlist provisions.

Mr. Wickman said the Governance Committee reviewed Watchlist provisions as a result of several managers being placed on the Watchlist as a result of poor short-term performance. Callan Associates developed modified Watchlist guidelines that lengthened the periods used to assess whether underperformance should place a manager on the Watchlist. The Governance Committee modified the Callan recommendations slightly and added new language that would place a manager on the Watchlist for violations of MCERA"s Proxy Voting and Corporate Governance Policy.

Discussion ensued on the specifics of implementing, monitoring, and acting upon the proposed provisions. Trustee Bolger asked how we are going to monitor managers' alignment with the Proxy Voting and Corporate Governance Policy. Without investment staff as some systems have, Ms. Bolger is concerned about using administrative staff to do more than monitoring proxy voting without additional clerical help. She explained the issue arose in the 1980's when managers were not voting their proxies.

Trustee Given stated it will be difficult to know what we are going to do and requested a more clear understanding of what we are looking for. Mr. Wickman said the Committee felt that if a manager acted contrary to the guidelines in the Proxy Voting and Corporate Governance Policy the Administrator could recommend that they be placed on the

Watchlist The Administrator said the Governance Committee will be reviewing proxy voting reports.

Trustee Silberstein expressed his view that proxy voting is an asset that needs to be monitored. By asking managers to analyze differences in policies, he said, staff time will be minimized. Responding to Trustee Given's inquiries, he listed examples of governance issues, including that chief executive officer (CEO) pay should not be excessive and should be linked to performance. Observing there are cases of universal agreement that a CEO is receiving excessive pay, Mr. Silberstein stated investment managers should have a reason if they are not following Institutional Shareholder Services (ISS) guidance on proxy votes. Other examples are MCERA governance policy provisions favor transparency and some managers always vote with management, which is not aligned with MCERA policy. Trustee Gladstern added the example of two managers voting differently on the same company proposal.

Chair Shore directed Mr. Wickman to rework provisions to distinguish proxy voting guidelines from investment guidelines and take a look at what we care about and how we would implement it and report back to the Committee. Mr. Callahan observed there is one separately managed equity portfolio for which proxy voting provisions are applicable, because MCERA policies cannot be imposed on commingled funds, so it is just a monitoring function. Trustee Silberstein believes we can have a discussion with the managers and ask if they might change their policy. Chair Shore indicated the Committee should focus on a mechanism that aligns with our policy and can reasonably be followed.

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

For period ending March 31, 2017

Trustee Bolger asked if Columbus Circle is still on the Watchlist. Mr. Callahan replied that it is and the plan is to address its status at the July Investment Committee meeting. He said over shorter periods there has been poor performance on a relative basis but the manager has made money over the long term. Year to date through April, the Columbus Circle small cap growth portfolio is 700 basis points ahead of the benchmark, he said, and the question is if they are the right manager for this Board.

Ms. Heaphy reported the Total Fund value increased to $2.238 billion as of March 31, 2017, up $92 million from the prior quarter. As of March 31, 2017 the Total Fund returned 4.13% net of fees for the quarter and 10.3% net of fees for the past 12 months. The Fund is outperforming its composite benchmark and in the second quartile of its peer group. All properties have been sold in the RREEF and AEW value add portfolios and there will be final payouts by the end of this year. Asset allocations are within target ranges. Mr. Callahan pointed out on policy ranges we are underweight in public real assets and overweight in total real assets due to real estate, which cannot be rebalanced quickly.

Ms. Heaphy reported domestic equities have rallied in response to stronger economic growth and consumer confidence, returning 5.3% for the quarter, with large caps outperforming small caps. There are positive returns in the international equity markets that had been struggling lately. The Dimensional Fund Advisors value portfolio underperformed the benchmark for the quarter and has a negative return. The Columbus Circle small cap portfolio rebounded during the quarter and is flat for the past 12 months. In international equities, the Morgan Stanley and Artisan portfolios outperformed benchmarks for the quarter as the U.S. dollar weakened. The Parametric emerging markets portfolio had strong returns for the quarter and the year as currencies strengthened, returning 9.9% for the quarter and 15% net of fees for the year ending March 31, 2017.

The fixed income portfolio and all three managers outperformed benchmarks for the quarter and prior twelve months. Total real assets returned 1.49% net of fees for the quarter and 6.8% net of fees for the prior twelve months. In the core real estate portfolio, UBS trailed the index due to low leverage but has strong income generation. AEW continues to do well with a high occupancy rate. Public real assets were up 2% net of fees for the quarter and 7.6% net of fees for the prior twelve months. The public real assets portfolio consists of TIPS, REITs, commodities and natural resources portfolios.

Mr. Callahan observed the fixed income managers are beating the Barclays Aggregate benchmark, meaning the fixed income structure is working.

There being no further business, Chair Shore adjourned the meeting at 11:50 a.m.

D N Shore
Dave Shore, Chair

Attest: Jeff Wickman
Retirement Administrator