MINUTES

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

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

July 19, 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 Bolger called the meeting to order at 9:00 a.m.

ROLL CALL

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

ABSENT: Given, Piombo (alternate safety), Shore

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. MANAGER ANNUAL REPORTS

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

   Jim Callahan, Executive Vice President with Callan Associates, stated today's annual portfolio reviews will be the Dimensional Fund Advisors Small Cap Value portfolio, the Parametric Emerging Markets portfolio, and the Parametric Futures Overlay Program.

2. Dimensional Fund Advisors, Small Cap Value – *John Hertzer, Ted Simpson – 9:05 a.m.*

   Ted Simpson, Dimensional Fund Advisors (DFA) Vice President, stated the goal of the small cap value strategy is to outperform the market by using evidence-based empirical research. Mr. Simpson introduced Portfolio Manager John Hertzer to present the portfolio review. For the fiscal year ending June 30, 2017, the DFA U.S. Small Cap Value Trust returned 22.7% versus 24.9% for the Russell 2000 Value Index.

   Mr. Hertzer reported the small cap value strategy has not done well relative to the overall market over the past few years. Over longer periods small cap equities outperform large cap equities and value outperforms growth, Mr. Hertzer said. The portfolio holds about 1000 securities and is highly diversified. Security selection focuses on the bottom 10% of market capitalization and emphasizes those with higher profitability. Responding to Trustee Stevens' inquiry, he said the profitability factor was added to the strategy in 2013 and has not yet shown a meaningful difference in portfolio results.

   The DFA investment team incorporates momentum when making buy and sell decisions by delaying buys and sells to enhance results. Small cap equities tend to be less liquid so the team is careful to manage implicit trading costs such as the bid-ask spread that become more important than explicit costs like exchange fees. This is accomplished each day by sending a basket of names to the traders who can determine the most beneficial execution of the trade. Mr. Hertzer reviewed portfolio characteristics as compared with the benchmark Russell 2000 Value Index. The portfolio has a $491 million median market cap as compared with $713 million median market cap for the benchmark.

   Trustee Silberstein asked whether, due to the success of the small cap value strategy, it has become too large and therefore difficult to trade in and out of. Chair Bolger added many have closed successful funds for that reason. In response, Mr. Hertzer stated they are willing to be flexible by trading a small amount on any given day and so holding relatively large positions is not a big problem. Mr. Hertzer cited metrics to prove his point that there are significant differences between the small cap value portfolio and the Russell 2000 benchmark and its implementation. For example, the index drifts through time and is rebalanced once per year, unlike the DFA small cap value portfolio. Trustee Silberstein asked whether recent underperformance may be due to the growth in the assets of the portfolio. In response, Mr. Hertzer attributed recent relative underperformance to the annual rebalancing of the benchmark.

   Trustee Silberstein inquired about DFA's proxy voting policies and whether they follow Institutional Shareholder Services (ISS) and their own proxy voting recommendations. As examples, Mr. Silberstein asked about the concept that a Chief Executive Officer should not be on more than three Boards of Directors and the policy on dilution of shares. Mr.

Hertzer responded that DFA has its own internal proxy voting policies that are similar to those of ISS and they take corporate governance very seriously.

3. Parametric, Emerging Markets – *Tim Atwill, Dan Ryan – 9:30 a.m.*

Dan Ryan, Managing Director and Relationship Manager with Parametric, presented a supplemental report including the attribution through June 2017. He stated the MCERA emerging markets portfolio was consolidated into the Commingled Investment Trust vehicle in November of 2016. Mr. Ryan introduced Timothy Atwill, Head of Investment Strategy, to present the portfolio review. For the fiscal year ending June 30, 2017, the Parametric emerging markets portfolio returned 18.9% net of fees versus 23.8% for the MSCI Emerging Markets Index.

Mr. Atwill explained how and why the emerging markets portfolio is constructed differently than the benchmark MSCI Emerging Markets Index. He pointed out that the portfolio is designed to react against the fact that China and Taiwan represent over half of the benchmark. Their solution is to move to a modified equal weight and group countries according to size. Frontier countries are included to add diversification and lower the risk. As a result, the portfolio is generally underweight large countries and overweight small countries relative to the benchmark.

Part of the strategy is to rebalance out of winners and reinvest in losers. There is relatively low turnover and the portfolio is diversified within each country. Exposure to any given country is limited, which is the reason China is underweight, although its allocation is being increased to a 15% target. Mr. Hertzer said the portfolio performs well when there is a change in leadership at a sector or region level. An example is during 2016 when China pulled back and the rebalancing paid off. He said moving into 2017 there was a sharp rally and major movers in the benchmark did well, as is common at the outset of a rally. Then historically larger countries tend to become laggards in the return pattern and therefore the large country underweight serves as downside protection. As time passes medium to small countries are expected to outperform, and recent indications are frontier markets are starting to outperform.

Chair Bolger recessed the meeting for a break at 9:51 a.m., reconvening at 10:06 a.m.

4. Parametric, Futures Overlay Program – *Jay Strohmaier – 9:55 a.m.*

Jay Strohmaier, Managing Director and Senior Portfolio Manager with Parametric, explained that the Parametric futures overlay helps to prevent performance drag due to cash in the Fund. He said large investors face challenges with the practical day-to-day need for cash and active managers holding cash. Futures contracts are used to overlay cash to provide market exposure. Responding to Trustee Silberstein's inquiry, Mr. Strohmaier said an S&P 500 futures contract is purchased by putting up 5% without leveraging the Fund. Futures contracts are used as a bridge for transactions to manage risk until the spot price converges with the futures price at the expiration of the contract. Futures are a perfect way to track an index, he said.

Mr. Strohmaier said the goal is to be able to have cash on demand without the performance penalty since the return from cash is not good over the long term. Since inception in 2001 the overlay program has added over $33 million dollars gross of fees to the Fund, which is better than the 10 basis points goal. Mr. Callahan asked for a review of the other element to the program which is rebalancing. In response Mr. Strohmaier explained that if the Fund is overweight equities, one way to correct the overweight is to sell futures contracts to rebalance for the short term.

Mr. Callahan explained the value of futures contracts equals the amount of cash in the Fund so there is no leverage within the portfolio. He said the futures market is efficient and rebalancing occurs only when policy exposure thresholds are pierced, not every day. In summary, Mr. Strohmaier said the futures overlay makes the Fund more efficient by reducing unneeded cash and improves the policy mix by rebalancing.

C. OLD BUSINESS

1. Investment Policy Statement (**Action**)
   Consider and take possible action on Governance Committee's recommended changes to the Watchlist provisions.

   Mr. Wickman said at its May 24, 2017 meeting the Investment Committee discussed two sets of proposed changes to Watchlist provisions in the Investment Policy Statement (IPS). The first set included technical changes Callan proposed for how managers get on the Watchlist that there was general agreement on. There was concern expressed about the second set which was language added to the Guideline Violations section that could potentially put a manager on the Watchlist for violating Proxy Voting and Corporate Governance Policy provisions. The direction to staff was to restore the Guideline Violations and create a new section, which in the proposed draft in front of the Committee is titled "Deviation from Proxy Voting and Corporate Governance Policy." This new provision captures the intent of the Governance Committee and is presented for consideration, along with the technical changes.

It was M/S Gladstern/Cooper to adopt the Governance Committee's recommended changes to the Watchlist provisions as submitted with one administrative edit.

Trustee Silberstein requested clarification of gross and net-of-fee provisions. Mr. Callahan explained the net-of-fee metric is used when comparing a manager's performance to its benchmark. When a manager's performance is compared relative to peers, then it is necessary to use gross of fees as a measure since fees vary across systems.

Trustee Shaw indicated she and Trustee Given had reservations about the scope of the task regarding proxy voting and putting the onus of collecting and evaluating information on the Administrator. Chair Bolger agreed that tasking the Administrator with assessing all the proxy votes is far beyond what we should be asking. Chair Bolger proposed continuing the discussion at the Strategic Workshop in October rather than voting to adopt the new section in the IPS at this time. Trustee Gladstern stated that she would expect MCERA to get assistance from proxy voting specialists like Institutional Shareholder Services (ISS) to assist MCERA. Trustee Silberstein believes companies have sufficient resources to self-report and the Governance Committee would look at the reports to get some information. Trustee Stevens observed there are complexities to proxy voting, issues are not always clear, and special knowledge is required. She advised figuring out the process before revising the IPS.

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

The motion having failed, the Chair directed that the matter be considered further at a Strategic Workshop. Trustee Cooper suggested looking at what other systems are doing on the proxy issue.

Mr. Wickman requested that the Committee consider the technical changes to the Watchlist provisions without the Deviation from Proxy Voting and Corporate Governance Policy section.

It was M/S Gladstern/Cooper to adopt the Governance Committee's recommended changes to the Watchlist provisions as amended to exclude the Deviation from Proxy Voting and Corporate Governance Policy section.

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

D. <u>NEW BUSINESS</u>

1. <u>Watch Period Review</u>

   a. <u>Columbus Circle Small Cap Growth (**Action**)</u>
   Consider and take possible action regarding Watchlist status

   Mr. Callahan stated Columbus Circle is still on the Watchlist based on the new parameters that were just approved as they have three consecutive years of underperformance. He recommends keeping the manager on the Watchlist for one year absent some other change in the organization regarding qualitative matters. Mr. Callahan stated Columbus Circle has been consistent in applying the portfolio strategy and remains strong in continuing to compensate their staff while having lost assets.

It was M/S Stevens/Murphy to adopt the investment consultant's recommendation to retain Columbus Circle on the Watchlist for one year.

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

b. Parametric Emerging Markets (**Action**)
Consider and take possible action regarding Watchlist status

Mr. Callahan reported Parametric is consistently applying their emerging markets strategy. Deviation from the MSCI Emerging Markets Index (benchmark) performance is expected since the portfolio is constructed differently than the benchmark. The appeal of the strategy is that the portfolio is more diversified and less volatile than the benchmark, and it is cost effective. These qualities remain, he said, and recommended retaining Parametric on the Watchlist for one year.

It was M/S Stevens/Murphy to adopt the investment consultant's recommendation to retain Parametric on the Watchlist for one year.

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

2. Small Cap Equity Allocation (**Action**)
Consider, discuss and take possible action regarding small cap equity investment vehicle

Mr. Wickman said this is the first time the Committee has discussed in detail options for potentially changing the small cap portfolio allocation. The Administrator invited a full discussion to be sure we have captured any ideas on implementing the U.S. equity portfolio. Mr. Callahan said MCERA has a 32% allocation to U.S. equities benchmarked to the Russell 3000 Index. The question is the implementation of the U.S. equity portfolio. The decision was to index large cap equities, as it is an efficient area of the market, in the S&P 500 Index managed by State Street Global Advisors. Small cap equities are a less efficient part of the market so there can be performance advantages over time through active management. The other premise was that over many years small caps outperform large caps. As a result, the Fund is overweight to small cap equities relative to the Russell 3000 Index. The small cap equity portfolio consists of the DFA small cap value strategy and the Columbus Circle small cap growth strategy to diversify the small cap space with different styles lending different performance profiles. Mr. Callahan stated the Columbus Circle small cap portfolio has been volatile and the style has been out of favor in the past four years, which is a factor leading to the discussion today.

In reconsidering the small cap equity allocation, options are to retain the current structure, replace Columbus Circle as the manager of the small cap growth strategy, split the small cap growth strategy with one more manager to add diversity to that component of the portfolio, or move to one core small cap manager or index to cover the small cap equity universe. For the last option, there is a Dimensional Fund Advisors core U.S. small cap strategy that has done well over time and is less expensive than the small cap value strategy. A secondary consideration is whether to retain the overweight to small cap equities, reduce it, or go to the overall domestic equity market small cap weight. Mr. Callahan recommended reducing the U.S. small cap equity allocation from 30% to 20 - 25% of the domestic equity portfolio.

Trustee Silberstein suggested looking at a broad menu of options to consider, including an index fund or smart beta, with particular attention to fees. Mr. Callahan said the strategy needs to be determined before considering what index to use. He offered to provide education on smart beta, which is similar to what DFA does, can involve dozens of factors, and has more expensive fees.

Trustee Stevens stated her preference for a single core small cap portfolio. Trustees Gladstern, Stevens and Cooper indicated a preference to move forward with the investment consultant's recommendation to reduce the domestic small cap equity allocation. Trustees Silberstein, Murphy, and Thomas preferred additional information on the effect of changing asset allocations. Mr. Callahan said it is not a timing decision but a long-term strategy to reduce the risk that is coming from the overweight to small cap equities. Based on discussions, Mr. Wickman stated that it would be reasonable to get more information on the topic and Mr. Callahan supported this view.

The Chair invited further discussion and there was none. Mr. Wickman said he has direction to present the topic for further discussion at the October Strategic Workshop. Trustee Silberstein suggested considering proxy voting when comparing managers for the small cap allocation. In response, Mr. Callahan indicated the small cap equity allocation discussion would be limited to manager strategies and there was agreement on this point.

E. INVESTMENT CONSULTANT PERFORMANCE UPDATE

Mr. Callahan reported a preliminary return of 12.1% for the Fund for the fiscal year ending June 30, 2017. He expects the return to be higher once final valuations for private equity and real estate portfolios are included. The overweight to small cap equities helped as the sector rebounded. Fixed income managers had good outperformance to their benchmarks, and the real assets portfolio was slightly behind the benchmark.

Mr. Callahan clarified reporting of the futures overlay program that securitizes cash and rebalances the portfolio. In this process Parametric rebalances by shorting futures when equities are overweight, and the short positions show up as negative numbers, which do not indicate there is a loss. When all futures positions are netted, they add up to the cash position. He explained there is no target allocation to cash and therefore the futures overlay reduces the performance drag of cash. The overlay program also adds efficiency to operations in not having to manage cash flows. In response to Trustee Gladstern's inquiry, Mr. Callahan said daily rebalancing is unnecessary and, moreover, ranges allow you to capture upside.

Mr. Wickman reported that Trustee Shore is resigning from the Board after the September Board meeting.

There being no further business, Chair Bolger adjourned the meeting at 12:04 p.m.

D N Shore

Dave Shore, Chair

Attest: Jeff Wickman
Retirement Administrator