MINUTES

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

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

January 24, 2018 – 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 Given called the meeting to order at 9:00 a.m.

ROLL CALL

PRESENT: Block, Cooper, Given, Gladstern, Jones (alternate retired), Klein, Murphy, Piombo (alternate safety), Shaw (ex officio alternate), Werby

ABSENT: Silberstein, 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.

No members of the public provided comment.

MANAGER ANNUAL REPORTS

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

   Jim Callahan, Executive Vice President of Callan Associates, discussed MCERA's three fixed income managers presenting annual portfolio reviews. Mr. Callahan stated that several years ago MCERA's fixed income portfolio was restructured. The Colchester Global Bond Fund vehicle was added and the Western Asset Management Company core plus portfolio was changed to intermediate credit to focus on corporate bonds and other credit, with latitude to invest in high-yield bonds. Wellington Management Company retained their core plus mandate, meaning they have some latitude to invest in securities like high yield bonds that are outside of the benchmark Barclays Aggregate universe. Mr. Callahan explained the concept at the time was that interest rates were historically low and may rise and the portfolio was concentrated in U.S. Treasurys. Since the restructuring the fixed income portfolio has performed quite well relative to the Barclays Aggregate and individual managers are performing well. Mr. Callahan said one of the topics we will address later is the implications of tax reform legislation that is likely to have a significant impact on the corporate bond market. Repatriation may mean the supply of corporate debt may shrink as debt is paid down. There is demand on the long end of the yield curve, especially as pension plans de-risk and hedge their liabilities.

2. Colchester Global Investors, Global Fixed Income – *Mamak Shahbazi – 9:05 a.m.*

   Mamak Shahbazi, President and one of the founders of Colchester, stated the firm only invests in sovereign bonds. The investment philosophy is value oriented in inflation-adjusted terms. Projections for inflation for the next few years are subtracted from yields to determine expected real returns; then markets with higher expected returns are overweighted in the portfolio. The value philosophy is carried into currencies that are considered a separate market. Bonds and currencies are combined to make up the final portfolio. As of December 31, 2017, the Colchester global sovereign debt portfolio returned 8.7% for the calendar year (versus 7.5% for the Citigroup World Government Bond Index).

   For 2017, overweights to positions in Brazil, New Zealand and Singapore were the top three contributors to relative returns. For currencies, the top three contributors to relative returns were overweight positions in the British Pound, Malaysian Ringgit, and the Polish Zloty. Detractors from performance in 2017 were underweight positions in Europe, the United States, and Japan in the bond portfolio; in currencies, underweight positions in the Euro, Australian Dollar and Canadian Dollar detracted from performance.

   Ms. Shahbazi reviewed expectations for real bond yields showing where value is at the moment. The portfolio is overweight bond positions in Brazil, Mexico and Singapore that have higher real yields. Countries in Europe, Great Britain and the United States with relatively lower real returns are underweighted. In currencies, the New Zealand Dollar and Australian Dollar are relatively expensive. The portfolio is overweight in the British Pound and Japanese Yen that are relatively inexpensive compared to the rest of the world and relative to their history.

Ms. Shahbazi reported the portfolio consists of high-quality sovereign bonds with an average credit rating of AA-. Duration is 5.9 years which continues to be at the shorter end of the range relative to the benchmark where there is better value. The macroeconomic outlook is for a modest rise in inflation and relatively tight credit that is causing slow velocity of money. The $1.3 trillion tax cuts are just under 1% of Gross Domestic Product (GDP) and therefore smaller than the Reagan tax cuts as a percentage of GDP. Most corporations do not pay 35% but will be going from a 26% tax rate to 21%. The impact of repatriation of capital is fairly limited on currency since most of the capital is already valued in the U.S. Dollar. Pressure on wages due to the U.S. recovery will have an inflationary impact but not substantial. Ms. Shahbazi does not see the same impact of the increase in yields outside of the U.S. bond markets.

Trustee Klein inquired about the impact of the unwinding of global quantitative easing. Ms. Shahbazi indicated Colchester does not forecast what central banks will do but expects that some tightening as markets recover will have a marginal effect on where yields are going to be. Credit is tight and capital growth is not substantial, so Ms. Shahbazi is not concerned about rising rates in the extreme.

3. Wellington Management, Core Fixed Income – *Anand Dharan, Matt McLaughlin – 9:30 a.m.*

Matt McLaughlin, Relationship Manager with Wellington Management Company (Wellington), introduced Anand Dharan, Core Bond Specialist, to present the portfolio review. Mr. Dharan reported 2017 was another strong year for credit and for the Barclays Aggregate. The Wellington core fixed income portfolio returned 5.1% for the 2017 calendar year (versus 3.5% for the Bloomberg Barclays U.S. Aggregate Index). The outlook remains moderately procyclical and the current strategy is to reduce risk. For example, as valuations have tightened the investment team reduced high-yield corporates. The base case is that inflation is under control and therefore the portfolio is overweight credit such as bank loans that contributed to performance. Portfolio holdings are at the top of the capital structure. In addition, securitized positions express a positive view on American consumers with better balance sheets; these include residential mortgages and student loans that are expected to be an important part of the opportunity set over the next year. Mr. Dharan stated the outlook for commodity countries like Russia is particularly positive going forward.

Trustee Block asked whether consumer debt, outside of mortgages, is at pre-crisis levels. In response, Mr. Dharan said credit card debt is high and therefore not an area of focus. He does not see signs of a return to the 2008 financial crisis. Brick-and-mortar consumer finance is benefiting from deregulation, he explained, and private label student loans for educated, well-paid professionals are an attractive opportunity.

Going forward the strategy is to look for income-generating investments and selective areas that include local opportunities in emerging markets and in European financials. Mr. Dharan said in looking for potential risks to hedge, the biggest would be an upside surprise to inflation. An aggressive response through more rate hikes by the Federal Open Market Committee (FOMC) would suggest an increase in interest rate volatility. Therefore, portfolio holdings include TIPS to hedge potential inflation.

Mr. Dharan discussed the potential effects of tax reform legislation. Tax cuts affect each company on a case-by-case basis. The stimulus is front-end loaded and skews inflation risk to the upside. The demand for long-term debt is a strong technical factor compressing long-terms spreads relative to short-term spreads. If tax cuts do not pay for themselves, there may be a recession and the FOMC would have fewer tools to fight it.

In response to Trustee Klein's inquiry, Mr. Dharan said a steepening yield curve alone is not a concern because 30-year Treasury yields could stay low. His expectation is that 2- and 10-year Treasurys could rise and, if so, the focus would be what this means for the U.S. Dollar, how the FOMC would react to an inflation challenge, and potential interest rate volatility.

Trustee Cooper joined the meeting at 9:48 a.m.

Trustee Werby asked about the effect of a potential increase in the federal budget deficit. In response, Mr. Dharan said U.S. Treasury Inflation-Protected Securities (TIPS) would gain value relative to nominal U.S. Treasurys.

4. Western Asset Management Company, Intermediate Credit Fixed Income – *James So, Frances Coombes – 9:55 a.m.*

Frances Coombes, Client Service Executive with Western Asset Management Company (Western), stated the portfolio transitioned to the intermediate credit mandate from a core plus mandate in 2014. Ms. Coombes reported there has been a positive fundamental backdrop for investment grade credit. During 2017 credit spreads became tighter and she emphasized the importance of avoiding losers which is how Western differentiates itself. For the 2017 calendar year the Western Asset intermediate credit fixed income portfolio returned 4.4% (versus 3.7% for the Bloomberg Barclays U.S. Intermediate Credit Index). Ms. Coombes introduced James So, Product Specialist, to present the portfolio review.

Mr. So stated the investment philosophy is based on long-term fundamental value and implementing a diversified portfolio. Value means whether the price of a bond reflects its true value for the long term. Two themes during 2017 were very little market volatility and fading of the inflation trade as yields went sideways with 5 FOMC rate hikes in the last two years. Mr. So said the firm does not believe labor markets are that tight and does not see inflation taking off. He emphasized the importance of selecting the right bonds when valuations are high and spreads are tight. Positions in the banking, metals and mining sectors contributed most to performance during 2017. Trustee Gladstern asked about risk in subprime auto loans and Mr. So said there are none held in the portfolio. He said portfolio exposure to consumer cyclicals has been reduced.

Since peaking early in 2016, the U.S. Credit Index spread has tightened to 85 right now. The top three sector overweights are metals, subordinated bank paper, and mining. Mr. So stated the broad outlook for U.S investment-grade credit is fundamentals are mixed with no turn yet in the credit cycle, but debt levels have gone up. U.S. bonds look cheaper relative to low and negative yields worldwide. Since valuations are high, the portfolio manager is starting to de-risk the portfolio as compared with the index. For example, the average credit quality has moved from A- to A and exposure to high-yield securities is lower. The strategy is to maintain the overweight to banking and metals and mining sectors, and underweight communications and technology.

Tax reform legislation including full expensing of capital expenditures and repatriation of cash is expected to have a positive effect on corporate credit. The measure is expected to lead to lower debt levels going forward, which would be positive for this portfolio.

Trustee Werby observed that fixed income returns are lower than the expected return for the Fund. Mr. Callahan explained the fixed income portfolio has a low correlation to growth assets (equities) and is there to diversify the Fund when equities do not perform well. Trustee Klein asked about the effect of global quantitative tightening with respect to volatility. Mr. So replied they are not expecting a disruption in yields because the FOMC will move very slowly to tighten interest rates; volatility is not the base case for the fixed income markets, he said. Mr. So said if Federal Reserve Chair Janet Yellen is replaced, the firm expects FOMC policies to continue with a lighter touch on the regulatory side.

Chair Given recessed the meeting for a break at 10:19 a.m., reconvening at 10:35 a.m.

B. OLD BUSINESS

1. Education on Small Cap Equity Allocation Vehicles (**Action**)
   Consider, discuss and take possible action regarding small cap equity vehicles

   Based on discussions during the November 2017 Investment Committee meeting, Chair Given directed the investment consultant to discuss alternatives for moving the domestic small cap portfolio to a small cap core allocation. Mr. Callahan said currently 30% of the domestic equity portfolio is dedicated in equal portions to the DFA small cap value and Columbus Circle Investors small cap growth portfolios. There is a structural overweight to small cap relative to the Russell 3000. The reason for this is over the long term small cap is expected to outperform large cap and active management is expected to outperform passive management in the small cap space.

   Potential passive approaches to implementing the domestic equity portfolio include indexing by investing in the Russell 3000 Index. Another option would be to overweight small cap by moving it to the Russell 2000 index. Another potential solution is to condense the domestic small cap portfolio to a single small cap core strategy. The advantage would be to eliminate the value/growth cycle and reduce fees from 62.5 basis points to 37 basis points, in the case of the DFA small cap core strategy presented below.

   Trustee Block asked why we are not considering firms showing better excess returns and lower tracking error on the risk analysis chart in Callan's presentation. In response Mr. Callahan said Callan could do a search for small cap core managers but he cautioned that the search criteria included other factors that may not be captured in the risk analysis chart. Trustee Gladstern observed that the Columbus Circle small cap growth portfolio has the best return from any manager on the preliminary December 31, 2017 performance report. Chair Given recalled at the November Committee meeting the reasons leading to selecting the small cap core option were to move away from volatility and to save on fees. Trustees Gladstern and Block indicated they preferred more information and discussion on how the domestic small cap portfolio should be allocated. Mr. Callahan said it is an option to do a manager search and it also makes a lot of sense to go with DFA's small cap core vehicle. Mr. Wickman indicated DFA is scheduled to present their small cap core product later in the agenda. Mr. Callahan stated fees for passive management of the small cap core strategy would be 2 to 3 basis points. In response to Trustee Block's inquiry, Mr. Callahan said fees for passively managed separate accounts are higher because providers say it is more work for separate accounts and the manager would have to manage our proxy votes. Securities lending revenue is meaningful and is split between the manager and MCERA.

a. Small Cap Core Strategy
   Presentation on small cap core strategies

   1. Dimensional Fund Advisors – U.S. Small Cap Core Portfolio

      Ted Simpson, Vice President with Dimensional Fund Advisors (DFA), stated small cap equities were the original focus for DFA. Mr. Simpson stated the firm's investment strategy is based on academic research showing different securities have different expected returns. Long-term outperformance is achieved by investing in securities with higher expected returns and lowering the cost of ownership by using patience in executing trades.

      Portfolio Manager Gavin Crabb discussed how the DFA investment team focuses on the markets. Given prices are generally fair, research has shown the following signals lead to higher returns: 1) small cap equities over large cap equities; 2) profitability; and 3) relative price. Mr. Crabb stated these factors hold true across the globe. The strategy needs to have an economic rationale and be sensible, backed by data, and cost-effective. In implementing portfolios, the goal is to reduce excess trading costs and invest for the long term to capture returns. Keys to lower trading costs are low turnover (about 20% per year) and trading only electronically which allows for controlling the trade from start to finish. In addition, by allowing for flexibility on what stocks to trade and when, DFA does not have to be a price-taker. Mr. Crabb pointed out that normal index funds have more turnover and a study from 1990-2015 showed that rebalancing on one day causes a 1.1% drag on the Russell 2000. In conclusion, Mr. Crabb stated for the reasons discussed above the DFA U.S. Small Cap Trust has an advantage over the Russell 2000 Index and since inception has outperformed that benchmark by close to 2% on a gross-of-fee basis as of December 31, 2017.

Trustee Cooper was excused from the meeting at 11:40 a.m.

Responding to Chair Given's inquiry, Mr. Crabb said the small cap core strategy expands the universe as compared with the small cap value strategy. Trustee Werby asked about the net-of-fee return and Mr. Crabb will provide that data. Trustee Piombo supported moving the domestic small cap equity portfolio to the DFA U.S. Small Cap Trust given its better track record than the current allocation. Trustee Klein agreed, noting active management adds value in the small cap space. Trustee Block, supported by Trustee Gladstern, suggested deciding on active or passive management and then opening the discussion as to what manager to select. Trustee Werby said it makes sense to go 50-50 active and passive and include securities lending. Chair Given supports active management using the DFA small cap core strategy.

It was M/S Block/Gladstern to allocate the domestic small cap portfolio to an actively managed small core cap allocation.

Mr. Callahan pointed out that if the decision is for active management, small cap core is not the only option that can be considered. The domestic small cap portfolio could be designed by replacing the Columbus Circle portfolio with a small cap vehicle that has a more attractive profile. The DFA small cap core option is a compromise to use a known manager at an attractive price.

Trustee Block amended his motion to allocate the domestic small cap portfolio to an actively managed small cap portfolio and Trustee Gladstern seconded the amended motion.

AYES:	Block, Given, Gladstern, Jones, Klein, Murphy, Piombo, Werby
NOES:	None
ABSTAIN:	None
ABSENT:	Cooper, Silberstein, Thomas

It was M/S Piombo/Murphy to allocate the domestic small cap portfolio to the Dimensional Fund Advisors U.S. Small Cap Core strategy.

In response to Trustee Block's inquiry, Mr. Callahan said a search process including interviews may take from six to nine months. Trustee Block indicated an interest in considering a broader range of candidates to include managers in the upper left quadrant of the risk/return analysis on page 43 of Callan's presentation. Mr. Callahan responded that in selecting managers, Callan uses a more complex process with more factors considered. Trustee Block proposed limiting the number of managers in the search and said there is a fiduciary responsibility to consider more than one manager. In response to Trustee Block's inquiry, Mr. Simpson stated DFA would offer the separate account at the same 37 basis point fee; MCERA would take on a custodian, proxy voting and securities lending for the separate account. Trustee Gladstern views going through a manager search as valuable, particularly for new trustees. Trustee Werby inquired about securities lending and Mr. Simpson estimated the commingled account receives about 15-20 basis points from securities lending.

AYES:	Given, Jones, Klein, Murphy, Piombo, Werby
NOES:	Block, Gladstern
ABSTAIN:	None
ABSENT:	Cooper, Silberstein, Thomas

Mr. Wickman asked if the Committee wants to invest in DFA's commingled small cap core vehicle or in a separate account. Mr. Callahan noted there is a meaningful difference in transaction costs. Trustee Jones asked the investment consultant for his recommendation and Mr. Callahan said being in the commingled fund is a more efficient structure; for example, custodial costs are absorbed by the fund. Trustee

Block asked whether, assuming we do not invest in a separate account now, there would be an added expense later to do so, and Mr. Simpson said there would be no further expense to make that change.

It was M/S Block/Gladstern to move the domestic small cap portfolio to the Dimensional Fund Advisors U.S. Small Cap Trust.

Trustee Werby expressed his preference to invest in a separate account now. Chair Given indicated more information on cost would be useful and Mr. Wickman advised the easiest method is to move to the commingled account.

AYES:	Block, Given, Gladstern, Jones, Klein, Murphy, Piombo
NOES:	Werby
ABSTAIN:	None
ABSENT:	Cooper, Silberstein, Thomas

C. NEW BUSINESS

1. Discussion on Impact of Tax Reform Legislation on the Markets – *Jim Callahan, Callan Associates*

Mr. Callahan stated Callan Associates believes tax reform legislation does not require any adjustment to MCERA's investment portfolio. Discussing potential implications of the tax reform legislation, he said that economically tax reform may have a positive effect depending on how corporations use the additional money or how they repatriate money from overseas. Domestic companies may benefit from capital expenditures. Mr. Callahan further stated that the main reason for tax reform was to create jobs; there is historically low unemployment anyway and companies are having a hard time finding qualified people to hire. He added that headline unemployment may not reflect underemployed people. There may be a modest impact on GDP growth that is expected to benefit earnings.

Mr. Callahan said there is tension for investors in the market because while the overall economy looks good, inflation is benign, and data supports the global growth story, the flip side is asset prices are high compared to historical levels. Asset prices matter, Mr. Callahan said, and when these conditions exist risk management is critical. Diversification is important and we have done that at the policy level and we rebalance as targets drift. These are the pillars of how to manage in this environment, he stated. In the fixed income markets, the long-term implications may be less debt issuance that would put downward pressure on yields. Responding to Trustee Klein's inquiry on how the deductibility of interest will affect private equity managers, Mr. Callahan said private equity may become less competitive relative to strategic buyers. In the near term, prices would be bid up; it is unclear what the ultimate effect on private equity would be.

2. Investment Manager Reporting for 2018 (**Action**)

Mr. Wickman presented the proposed manager reporting schedule for 2018. He recommended removing Columbus Circle Investors from the list.

It was M/S Piombo/Werby to approve the Investment Manager Reporting schedule for 2018 as amended to remove Columbus Circle Investors.

AYES:	Block, Given, Gladstern, Jones, Klein, Murphy, Piombo, Werby
NOES:	None
ABSTAIN:	None
ABSENT:	Cooper, Silberstein, Thomas

3. Due Diligence (**Action**)
   Consider and take possible action on investment manager due diligence site visit schedule for 2018

   Mr. Wickman recommended adopting the proposed due diligence schedule amended to exclude Columbus Circle Investors. The Administrator will work with Mr. Callahan to determine the time frame and who will participate.

It was M/S Gladstern/Murphy to approve the investment manager due diligence site visit schedule for 2018 amended to remove Columbus Circle Investors.

AYES:	Block, Given, Gladstern, Jones, Klein, Murphy, Piombo, Werby
NOES:	None
ABSTAIN:	None
ABSENT:	Cooper, Silberstein, Thomas

4. Future Meetings

   No discussion.

D. INVESTMENT CONSULTANT PERFORMANCE UPDATE
As of December 31, 2017

Mr. Callahan reported the performance update for the Fund as of December 31, 2017 is exceptional in both absolute and relative terms. The preliminary return for the 2017 calendar year is 17%, and the fiscal year-to-date return exceeds the 7% expected return. Domestic equities are in line with the Russell 30000 Index as actively managed portfolios made up for the small cap overweight. International equities bounced back; the emerging markets portfolio underperformed due to its underweight to China. MCERA's three bond managers and the public real assets portfolio are all doing well. The real estate portfolio is managed conservatively and slightly underperformed its benchmark.

There being no further business, Chair Given adjourned the meeting at 12:38 p.m.

Roy Given, Chair

Attest: Jeff Wickman
Retirement Administrator