

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

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

June 20, 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 agenda item, 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, Given, Gladstern, Jones (alternate retired), Klein, Piombo (alternate safety), Shaw (ex officio alternate), Silberstein, Thomas, Werby

ABSENT: Cooper, Murphy

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.

B. MANAGER ANNUAL REPORTS

1. Manager Overview – Jim Callahan, Callan Associates

Jim Callahan, President of Callan Associates, introduced the Parametric Emerging Markets equity portfolio and the Parametric Policy Overlay Implementation Service. The emerging markets are a volatile part of the capital markets and the Parametric portfolio has lagged its benchmark. The overlay program provides liquid market exposure for residual cash in MCERA's Fund and eases the administrative burden of managing cash flows.

2. Parametric, Emerging Markets Equity – Tim Atwill, Dan Ryan – 9:05 a.m.

Dan Ryan, Relationship Manager with Parametric Portfolio Associates LLC, stated in 2017 the emerging markets equity portfolio underperformance was due to the concentrated nature of countries in the benchmark index; five countries represent 70% of the MSCI Emerging Markets index. The portfolio is designed to be more diversified than the benchmark to improve the risk-return profile over the long term. Recently markets have seen a return to volatility and more distributed participation, resulting in the portfolio outperforming in the first quarter of 2018. As of March 31, 2018, the Parametric Emerging Markets portfolio returned 1.74% net of fees for the quarter (versus 1.42% for the MSCI Emerging Markets Index), and 18.16% net of fees for the prior twelve months (versus 24.93% for the MSCI benchmark).

Trustee Silberstein asked if Parametric would consider lowering fees, in view of the move in the industry to passive investing and the portfolio's watchlist status. Mr. Ryan noted that Parametric implemented a fee reduction in the fall of 2016 and consolidated MCERA's portfolio into a commingled investment trust with a lowest fee structure. The firm has no plans for further fee reductions and is comfortable fees are now consistent with the market landscape.

Mr. Ryan introduced Dr. Tim Atwill, Head of Investment Strategy to present an overview of the investment process. Dr. Atwill pointed out emerging markets have always had a concentration issue because of China, which represents about 30% of the benchmark index. As a result, there is an overreliance to China and Taiwan for performance. Parametric uses diversification with more even country exposure to lower volatility across the portfolio. Country exposure is based on trading volume and market size. Systematic rebalancing brings countries back to target weights. Within each country, holdings are diversified across sectors and market caps. The resulting portfolio is underweight larger countries and overweight smaller countries and frontier markets.

In response to Trustee Silberstein's inquiry, Dr. Atwill said China represents about 10% of the portfolio. Trustee Silberstein noted the benchmark index is adding China A shares that would increase China's weighting in that index. In response, Dr. Atwill said exposure to mainland China has been increased. Still, he believes 40% of the benchmark would be too concentrated for one country. Over time the Parametric portfolio experiences less drawdown that is expected to add value in the extremely volatile emerging markets asset class. Trustee Gladstern asked if there is a more appropriate benchmark for the portfolio and Dr. Atwill replied the MSCI Emerging Markets Index is an appropriate comparison.

Dr. Atwill explained that a natural fallout of the diversified approach is the portfolio will lag in sharply rising markets and will outperform in downward markets. He noted during 2017 China's outperformance detracted from performance. Trustee Block asked how the portfolio is constructed and Dr. Atwill explained there are no specific security decisions. Holdings in local securities are selected in a passive approach based on country weightings and market capitalization. Trustee Block inquired if Dr. Atwill had a sense of the level of U.S. exposure in the portfolio based on revenue. In response, Dr. Atwill said the country of origin explains a significant part of the business and stock performance, more so than in developed markets. Trustee Block asked about political risk and Dr. Atwill said the focus is on market liquidity; countries experiencing negative political events will be drawn down. Trustee Werby asked whether large caps exist in the smaller countries and Dr. Atwill replied there is a small cap bias in the portfolio because large cap companies are generally found in the larger countries.

3. Parametric, Overlay Program – Justin Henne – 9:30 a.m.

Justin Henne, Managing Director, said the Policy Implementation Overlay Service (overlay) provides market exposure that alleviates inefficiencies and slippage in cash that occur in the day-to-day management of a portfolio. Because cash is a performance drag, long-term investors want to minimize cash levels. The overlay adds value by securitizing cash through exchange-traded futures contracts. Mr. Henne noted MCERA was an early adopter of the overlay program that many of its peers are now using.

The overlay is implemented at the Fund level and by peering through to each portfolio's cash level. The aim is to keep the portfolio fully invested day to day. This includes assisting with cash transfers during manager transitions if requested. The overlay program is also used to rebalance the Fund to reflect risk-return objectives in an efficient manner. This is achieved by selling overweight assets and buying underweight assets when defined triggers away from long-term policy targets are reached.

Mr. Henne said the average cash holding for MCERA's Fund is over \$40 million, which is consistent with Parametric's other clients. He pointed out that over time this can be a significant cash drag. Mr. Wickman noted the cash level includes cash held for retiree payroll within the custodial short-term investment fund and manager cash. Since inception in August of 2001, the overlay program has added just under \$28 million in incremental value, or 11 basis points annually on a net basis.

Mr. Henne presented a chart of incremental gains and losses for the overlay program since inception illustrating that the capital markets do not always add value, but the overlay has added value over the long term. Tracking error metrics were presented that support the overlay program as a risk mitigation tool to get closer to policy targets.

Trustee Block asked about counterparty risk and quality of collateral. In response, Mr. Henne explained that counterparty risk is functionally zero since only exchange-traded futures contracts are used; due to safeguards, there has never been a default. The overlay program is implemented in a very efficient, risk-controlled process, he said. Trustee Block asked what keeps us from having to sell securities with respect to derivatives and cash calls. Mr. Henne responded down markets may create a call for cash to support futures

positions. In general, there is adequate cash at hand. Trustee Block asked whether a 2-standard deviation market event would result in the need to sell securities. Mr. Henne replied the rebalancing program would kick in and transfer assets from a physical state into a futures state. Mr. Wickman observed there have been two requests to raise cash in the past seven years. Mr. Henne said this is a qualitative aspect of the overlay program that is a partnership with MCERA. Mr. Callahan stated without the overlay it would be much more difficult to manage the portfolio.

Trustee Werby asked about the reason for the loss over \$800,000 in April 2018. In response Mr. Henne explained part of the challenge as equities rallied was reducing equity exposure to rebalance the Fund. When policy triggers were reached, equities were sold short to bring them down to policy targets. Mr. Callahan explained bonds were negative in April and we had exposure to bond futures in that month. Trustee Klein asked which futures were used. Mr. Callahan replied they were U.S. Treasury bond futures in multiple maturities to give passive exposure with duration across the yield curve. Trustee Silberstein asked about margin which Mr. Wickman said is for the futures contracts. Mr. Callahan explained that dedicated margin cash is used to get the futures exposure. Dr. Atwill noted there is no leverage at the Plan level; for futures contracts, \$1 million is needed to get exposure for \$10 million in cash.

C. NEW BUSINESS

1. Domestic Equity Allocation (Action)

Consider and take possible action regarding vehicle and manager for large cap equity allocation

Mr. Callahan said the Investment Committee decided to retain the 70%/30% split between large cap and small cap equity. For domestic small cap equity, the decision was to consolidate the two small cap portfolios into the Dimensional Fund Advisors small cap core strategy. Remaining considerations are whether to consider the Russell 1000 Index for large cap equity and whether to retain State Street Global Advisors or consider a new manager and determine whether to use separately managed accounts or use securities lending vehicles. In addition, the method of voting proxies is a consideration for each portfolio. Mr. Callahan explained in commingled funds the Committee is accepting how proxies are voted. When using separate accounts, the manager can vote proxies on MCERA's behalf or MCERA can vote the proxies or hire a third-party provider to do so.

Mr. Callahan presented fee information for different managers of large cap equities for commingled funds, non-lending and lending, and separately managed accounts. He noted that custody fees would be incremental in a separate account and securities lending vehicles would be a credit back to offset expenses. In separate accounts, there would be a cost to have a third party vote proxies.

The Committee focused on the small cap domestic equity portfolio based on Trustee Silberstein's suggestion. Trustee Gladstern asked Mr. Callahan how proxy voting would work. In response, he said for a separate account we can change our position on when to take over proxy voting. He explained in response to Trustee Block's inquiry that the fee would not be reduced if MCERA took over proxy voting at a future date because it is

considered a service across clients. Trustee Silberstein noted the question of how to handle proxy voting depends on how DFA responds to the questions we have asked. He recalled the estimate for MCERA to take on proxy voting is about \$20,000 per year.

Trustee Silberstein noted securities lending would add about 20 basis points in revenue. Mr. Callahan and Mr. Wickman explained custodian State Street administers securities lending, so the benefit will be there holistically at no additional cost to MCERA. Trustee Block stated that if MCERA issues a Request for Proposal for custodial services there should be an analysis of any collateral pools used for securities lending. Mr. Callahan noted that Callan continually evaluates State Street's services. Mr. Wickman said some of the custodial credit risk is not necessarily in securities lending.

It was M/S Block/Gladstern to move the Dimensional Fund Advisors small cap core portfolio into a separate account to include securities lending.

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

It was M/S Silberstein/Gladstern to have Dimensional Fund Advisors (DFA) vote proxies for the DFA small cap core portfolio.

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

Trustee Thomas was excused from the meeting at 10:15 a.m.

The discussion turned to the domestic large cap equity portfolio. Mr. Callahan clarified that the options presented are the least expensive available proposals for funds and separate accounts in both the S&P 500 and the Russell 1000 indices. Trustee Silberstein indicated he preferred a vehicle with securities lending that is a separately managed account in order hold our options open regarding proxy voting. He views Mellon's proxy voting policy favorably and Trustee Block noted Mellon's low fee. Mr. Callahan said the Mellon vehicle is not tied to a custodial account and there would be a negotiation with them for securities lending. He further stated that State Street's fees may be affected if MCERA moved the S&P 500 portfolio to a different manager, and Mr. Wickman agreed with his view. In response to Trustee Block's inquiry, Mr. Wickman said MCERA pays a flat fee of \$400,000 per year for State Street's services in a year-to-year contract expiring in January of each year. Mr. Callahan said the simplest move would be to move the State Street S&P 500 Index Fund to a separate account with State Street.

It was M/S Silberstein/Gladstern to move the State Street Global Advisors S&P 500 Non-lending Index Fund to a separate State Street S&P 500 account with securities lending.

Chair Given voiced his objection to moving the S&P 500 Index Fund to a separate account that would be more expensive. He noted the Mellon proposal is less expensive and more

in alignment with MCERA's proxy voting policy. His preference is to change the S&P 500 portfolio to a securities lending vehicle until the matter is more fully vetted. Mr. Wickman said we are already engaging the managers on how they vote proxies; we will have greater flexibility and can voice our opinion on proxy voting through a separate account. Trustee Gladstern supported the idea of moving to the separate account while MCERA is expanding how it engages with managers.

In response to Trustee Piombo's inquiry, Mr. Callahan reviewed the least expensive options with variables of proxy voting and securities lending. He noted expenses do not consider third party proxy voting. Trustee Piombo prefers to save cost and leave the proxy voting decision for another time. In summary, Mr. Callahan stated a securities lending fund is the cheapest option; a separate account with securities lending is a little more expensive and gives the ability to vote proxies.

Trustee Gladstern called for the question and the Committee voted as follows:

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

The Committee voted on the above motion by Trustee Silberstein and seconded by Trustee Gladstern regarding repositioning the S&P 500 portfolio as follows:

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

Chair Given recessed the meeting at 10:48 a.m. for a break, reconvening at 11:05 a.m.

2. International Small Cap Portfolio (Action)

Consider and take possible action regarding manager for international small cap equity portfolio

Mr. Callahan stated because of the recent announced changes in the portfolio management team at the Fidelity Institutional Asset Management international small cap portfolio, MCERA should consider making a change to a new manager. At the direction of the Committee, Callan Associates conducted a manager search that includes passive options for the portfolio. Mr. Callahan stated his belief that active management, especially globally, can add significant value, which has been the case for MCERA's Fund.

In response to Trustee Gladstern's inquiry, Mr. Callahan said Blackrock and State Street Global Advisors are clients of Callan Associates. Responding to Trustee Silberstein's inquiry, Mr. Callahan said DFA's international small cap fund was not included because Callan Associates has more conviction with the three managers presented. He explained in response to Trustee Klein's inquiry that the managers presented have different strategies

to provide some choice for the Committee. Mr. Callahan introduced Senior Vice President Andy Iseri.

Mr. Iseri presented three potential managers of international small cap portfolios for consideration: AQR Capital Management (AQR) employing a multifactor quantitative core strategy; TimesSquare Capital Management, LLC focusing on fundamentals, stewardship and growth; and Victory Capital Management, Inc., a blend of the other two strategies. For international small cap portfolios, Mr. Iseri said style is less of a driver than idiosyncratic factors such as company-specific risk.

AQR's investment approach is well-diversified and has succeeded in adding incremental value over time. The strategy keeps up with good markets and protects in down markets. Allocations are close to the index with bets made on individual stocks. The portfolio is overweight cheap securities with good momentum and underweight expensive securities with poor momentum.

TimesSquare uses a fundamental growth strategy focusing on management quality. The investment strategy is fairly new and has a successful and stable performance pattern. The portfolio exhibits one of the most attractive up/down captures in the space. Regional allocations focus on developed markets. There are some sector deviations from the index; for example, the portfolio is overweight financials that is driven by bottom-up stock selection. Market capitalization is a little larger than the index. Mr. Callahan observed of the three candidates TimesSquare has the highest tracking error, giving it a more volatile performance pattern.

The Victory Capital investment team and processes have remained consistent over the years. The strategy is an efficient blend of quantitative and fundamental analysis; the interaction of the two is the strength of the approach, Mr. Iseri said. Performance is consistent with balanced up/down capture. Country and sector allocations are risk-controlled. This is a core strategy with a market capitalization close to the index that is exhibiting better growth than the index.

Mr. Iseri reviewed fees for the three portfolio managers that he characterized as middle-of-the-road. He reviewed comparative performance supporting active management for international small cap equities. All three portfolios have benchmark-like volatility or less and have outperformed the benchmark over time. The track record for the TimesSquare portfolio is only five years, Mr. Iseri pointed out. Mr. Iseri reviewed risk and performance metrics. On a rolling three-year basis, TimesSquare was the best performer.

Mr. Callahan recommended interviewing the three candidates presented as the next step. Trustee Block asked how a passive approach using derivatives to protect from downside risk would compare to the active, quantitative approach. Mr. Iseri responded that the quantitative strategy is trying to get over-exposure to good factors, and vice versa, to achieve outperformance. Mr. Callahan added that the price of hedging downside risk would be too expensive to make the passive approach worthwhile. In response to Trustee Klein's question of which of the three managers would be least correlated to the rest of the

portfolio, Mr. Iseri said this is difficult to quantify across different benchmarks. Mr. Callahan explained that the bigger driver is that they are all international small cap portfolios.

In response to Trustee Silberstein's inquiry, Mr. Callahan explained that there is no structure in place to have a separate account for international investments that to date are in pooled vehicles. Mr. Wickman said it is a significant consideration to establish accounts overseas based on staff's prior experience.

It was M/S Gladstern/Block to interview active international small cap managers AQR Capital Management, TimesSquare Capital Management, and Victory Capital Management.

Mr. Wickman noted the Committee may also determine to make no change in the management of the international small cap portfolio.

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

3. UBS Portfolio Manager Transition Update

Investment consultant update on personnel changes for the UBS Trumbull Property Fund

Mr. Callahan reported UBS has announced that long-standing Senior Portfolio Manager of the Trumbull Property Fund, Kevin Crean, will be retiring and other team members will be moving to different roles. Callan Associates views the transition as a plus since Paul Canning, the new Portfolio Manager, has been doing very well with his fund. The Trumbull Property Fund has lagged its benchmark as it has the least amount of leverage in the NFI-ODCE universe. The movement of some investors out of the fund is being handled in an orderly fashion. Callan will continue monitoring the situation but has no concerns.

D. INVESTMENT CONSULTANT QUARTERLY REPORT and PERFORMANCE UPDATE

As of March 31, 2018

Mr. Callahan reported the market value of the Fund as of March 31, 2018 is \$2,473 million, modestly higher since the prior quarter. In the capital markets, equities and bonds were both down in the first quarter of 2018 and the biggest takeaway was the return of volatility that is a return to normal. There is tension between the underlying economy doing well, with low unemployment and strong corporate profitability, offset by a capital market environment that is highly valued with interest rates starting to go up. A third component is geopolitical tensions. Through June 15, 2018, the Russell 1000 Index is up almost 5% year to date, small cap stocks are up 10.25%, and bonds are still down. International equity and real asset returns are mixed.

Reviewing actual asset allocations relative to targets, Mr. Callahan reported the Fund is a little overweight in public equities and underweight fixed income. The fixed income allocation is

being kept at the lower end of the range on purpose; the Fund will be rebalanced closer to targets soon. Real assets are in line and private equity is overweight. In response to Trustee Block's inquiry, Mr. Callahan said there is a lag in real assets as to inflation and there are technical factors as well over the short term. Inflation is a broad metric, the biggest part being wages.

The Fund had a relatively good quarter, ranking in the 21st percentile of the Callan Public Fund Sponsor - Large universe as of March 31, 2018, and ranking in the 16th percentile for the prior twelve months. Diversification and active management are adding value. Longer-term returns compare favorably to the peer group and reflect strong performance. Mr. Callahan reviewed calendar and fiscal year returns.

Mr. Callahan presented relative attribution metrics over various time frames that reflect the sources of excess returns. In the twelve months ending March 31, 2018, domestic equity outperformance came from active small cap managers that did better than large cap. The Columbus Circle small cap growth portfolio outperformed, as did the DFA small cap value portfolio. The international benchmark was down, and MCERA's international equity portfolio outperformed the benchmark. There was a significant difference in returns from growth and value equities as growth stocks outperformed both in domestic and international equity portfolios.

Trustee Gladstern asked about having a separate sleeve for China. Mr. Callahan replied that is a good question as with the emergence of the China A shares the country may become 40% to 50% of the benchmark index. This forces Callan Associates to rethink the design of MCERA's emerging markets portfolio. The question is, he said, are you getting diversified exposure in an index that is cap weighted? During a selloff, Parametric's diversified emerging markets portfolio that is underweight to China will benefit the Fund.

During the first quarter the fixed income portfolio added value over the benchmark and the appreciation of foreign currencies led to outperformance by the Colchester global bond portfolio. Over the past three years the fixed income portfolio is benefiting from the restructuring away from U.S. Government securities because of duration risk. The fixed income portfolio was diversified by introducing intermediate credit and global fixed income strategies and the active managers have added value. Real assets were flat and public real assets were down. The KBI global resources portfolio will lag when the energy sector does well; the portfolio added value against its own benchmark. Invesco did a good job as an active manager of the commodity portfolio. Private equity returns for the period are not yet available.

The total Fund returned 11.67% net of fees for the twelve months ending March 31, 2018 as compared with the target return of 10.9% and the public plan median return of 10.2%.

Trustee Silberstein requested that private equity fees be listed in the quarterly performance report. Mr. Callahan noted all private equity results are net of fees and the private equity managers would need to be relied on to get the underlying fees. Mr. Wickman noted the private equity fees are presented annually to the Investment Committee.

Mr. Callahan reported the private equity program is doing well and distributions are picking up. The private equity portfolio is diversified over time (12 years) and across several funds. MCERA has paid in \$266.3 million and the total realized and unrealized value is \$376.6 million. MCERA has received \$132.8 million in distributions and the net asset value of the portfolio is \$243.8 million. MCERA committed a total of \$400 million to the program and \$142 million in uncalled capital remains. The Total Value to Paid-In Capital (TVPI) is 1.41x, the net asset value or Residual Value to Paid-In Capital (RVPI) is 0.92x, and the Total Value to Paid-In Capital (TVPI) is 1.41x. Mr. Callahan stated as time goes the performance metrics will go up. The private equity portfolio ranks in the second quartile of the All Private Equity, All Regions Thomson/Cambridge Database.

Managers on the Watchlist are there for performance reasons and do not warrant any decisions at this point. Chair Given asked how United States trade policies affect the markets. Mr. Callahan replied the markets are concerned about the potential for a trade war and it is uncertain what the magnitude would be. The tariff discussions add to uncertainty among several considerations for the capital markets. Mr. Wickman said in terms of improving the investment process he came across what CalPERS has done on the question of corporate board diversity. Their process for engagement is similar to what MCERA has begun to do regarding proxy voting. He stated that the Governance Committee may want to implement a similar process that would be scalable to MCERA's size and capacity.

There being no further business, Chair Given adjourned the meeting at 12:50 p.m.



Roy Given, Chair



Attest: Jeff Wickman
Retirement Administrator