MINUTES

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

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

December 5, 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 9:03 a.m.

ROLL CALL

PRESENT: Block, Cooper, Given, Gladstern, Klein, Murphy, Shaw (ex officio alternate), Silberstein, Thomas, Werby

ABSENT: Jones (alternate retired), Piombo (alternate safety)

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 LLC*

   Jim Callahan, President of Callan LLC, stated MCERA's actively managed real asset portfolios will be reviewed today. The 15% target to real assets is split 8% to private real estate and 7% to public real assets. The private real estate portfolios are managed by UBS and AEW using core strategies. The public real assets are made up of two active and two passive strategies. Commodities, managed by Invesco, and natural resource equity managed by KBI Global Investors, are the active strategies. The passive strategies are real estate investment trusts (REITs) and U.S. Treasury Inflation-Protected Securities managed by BlackRock.

2. UBS – Core Real Estate – *Mario Maturo, Mia Dennis – 9:05 a.m.*

   Mia Dennis, Director and Client Relationship Manager with UBS, stated real estate industry returns are moderating. Ms. Dennis introduced Portfolio Manager Mario Maturo, who reminded the Committee that earlier this year UBS announced that Trumbull Property Fund (TPF) Senior Portfolio Manager Kevin Crean decided to prepare for retirement. Paul Canning is replacing Mr. Crean as Portfolio Manager. Mr. Canning is focused on growing net operating income and maintaining the core strategy, seeking superior returns at the lower end of the risk spectrum. TPF uses relatively low leverage and over time 83% of returns have come from income. As of September 30, 2018, TPF returned 6.75% (versus 7.89% for the NFI-ODCE Equal Weight Net benchmark (ODCE)) for the prior 12 months.

   Mr. Maturo stated the real estate market is in a period of recovery from outsized levels of appreciation based on historical standards. He attributed underperformance to the ODCE partly to significantly lower leverage used by UBS than the benchmark and greater appreciation on the west coast. The key differentiator of the inventory model from the benchmark is diversification using a back-tested model that has a higher weighting to apartments and lower weighting in, and continued divestment from, the office sector. Mr. Maturo stated holdings are balanced on the east and west coast of the United States. He discussed the ten largest assets that are restricted to no more than 10% of the portfolio to reduce over-concentration risk.

   Acquisition activity over the previous 12 months has focused on building to core for value creation potential. Eighty-two percent of acquisitions were in apartments and the industrial sector. The most dispositions over the past 12 months were made in the office sector, including tactical sales of older properties and those with property challenges. From a debt perspective, leverage is 17.6% using mostly fixed-rate terms, and the overall loan-to-value ratio is 34%. The overall weighted average interest rate of 3.5% is below the benchmark's 3.9% rate.

   Trustee Gladstern asked about challenges with Marriott hotels and Mr. Maturo replied holdings include two Marriott hotels involved in labor issues. The Baltimore location is having ongoing negotiations about unionizing the property in a fair process for employees. In response to Trustee Silberstein's inquiry on the affect on revenue, Mr. Maturo said revenue projections for the Baltimore Marriott are declining, mostly due to the property itself and not the labor issue. Trustee Silberstein asked about holding periods, Mr. Maturo stated every asset is different and depending on the strategy will have different holding periods. A hold-sell analysis is performed every quarter and if there is no potential for growth, a sale will be recommended. Trustee Gladstern asked how climate change factors into decisions, and Mr. Maturo replied the initial acquisition evaluation considers wind, fire and flood-level risk

In conclusion, Mr. Maturo said individual opportunities in the challenging retail sector are considered. Trustee Block asked about exposure to Sears, which Mr. Maturo said is minimal.

3. <u>AEW – Core Real Estate – *Lily Kao, Candida Hoeberichts – 9:30 a.m.*</u>

Candida Hoeberichts, Director, Investor Relations, with AEW, reported MCERA's total investment of $65 million in the AEW Core Property Trust (CPT) as of the second quarter of 2013 is now valued at $98.3 million. Ms. Hoeberichts introduced Lily Kao, Portfolio Manager, who stated that full employment and tax cuts leading to stronger economic growth and wage growth are positive for real estate. Across the country supply is matching demand, and occupancies and rent are at historical highs. Recent trends include moderating rents and delayed home purchases by millennials. After several years of atypical returns with appreciation equal to or exceeding income, Ms. Kao expects 6.5% to 7% returns going forward for real estate, with more from the income side. As of September 30, 2018, CPT returned 7.05% (versus 7.89% for the NFI-ODCE Equal Weight Net benchmark (ODCE)) for the prior 12 months.

The open-ended CPT fund core real estate strategy focuses on income and high occupancy with moderate risk. The CPT fund has one of the highest occupancy rates in the ODCE Index at 96%, which drives strong income returns. Investments are best-in-class assets in liquid markets in the United States in the office, industrial, multifamily and retail sectors. Geographically, the focus is on constrained coastal markets with job growth. Hotels are not included in the portfolio to reduce risk, and leverage is no more than 30% leverage at the fund level. Trustee Block asked about the percentage of mezzanine debt, which Ms. Kao said is 2%, to offset development costs over shorter time frames.

Trustee Gladstern asked how climate change affects the investment process. Ms. Kao replied an investment will not be made unless there is manageable risk with respect to natural disasters such as flooding, earthquakes, or fire. Trustee Silberstein asked about property in San Francisco Block 9, which Ms. Kao said is a non-core building project in a dynamic high-rise office development in downtown San Francisco. In response to Trustee Klein's inquiry about development costs, Ms. Kao said the project is on time and on budget due to a locked-in construction contract with a guaranteed maximum price.

Trustee Silberstein inquired about the cost of acquisitions and dispositions relative to holding properties long term. Ms. Kao replied the strategy is to hold for the long term. Properties are sold opportunistically if the value is considered high or if non-strategic assets are not expected to keep pace with expectations. Generally, more properties are being acquired than disposed, as evidenced by the $1.3 billion in acquisitions compared with $0.3 billion in dispositions during 2018.

4. <u>KBI Global Investors – Global Natural Resources – *Simon Padley – 9:55 a.m.*</u>

Simon Padley, Senior Vice President of Business Development and Client Services at KBI Global Investors (KBI), reported assets in the global natural resources strategy continue to increase as investors look for credible assets. The firm is committed to responsible investing in companies offering solutions to supply and demand for natural resources. Companies favored have considerable intellectual capital and strong governance that KBI quantifies according to United Nations sustainable investing goals. KBI actively votes proxies in a sustainable manner that considers climate change and board diversity. As of September 30, 2018, the KBI Global Investors Global Resources Fund returned an annualized 12.71% over the prior 3 years (versus 18.99% for the S&P Global Natural Resources Index).

Mr. Padley stated holdings differ from traditional natural resources portfolios. The key differences from the benchmark are the focus on water, clean energy, a broader agricultural solution set, and no mining or fossil fuel exposure. As a result, the portfolio will underperform when oil prices rise. Areas of focus are water desalination and reuse, the energy grid infrastructure including smart energy meters and smart grid, and satellite technology used to increase agricultural efficiencies for arable land.

KBI believes the outlook is for substantial spending on infrastructure including the electrical grid, water, and emerging markets agriculture. Mr. Padley said these areas will develop over longer time frames and therefore make the portfolio less cyclical. The expectation is that merger and acquisition activity will benefit the portfolio. Mr. Padley said based on earnings growth and reasonable valuations, the firm is confident companies can deliver expected returns over time.

5. <u>Invesco – Commodities – *Dave Gluch, Mike Baran – 10:20 a.m.*</u>

Mike Baran, Relationship Manager and Director, Invesco, reported that Invesco plans to purchase OppenheimerFunds, Inc. Mr. Baran introduced Dave Gluch, Client Portfolio Manager and member of the Global Asset Allocation team. Mr. Gluch acknowledged that commodities can be a difficult and opaque asset class. To illustrate the current negative environment, he presented performance returns of 23 commodity subsectors for the third quarter and year to date for 2018 showing more price depreciation than appreciation. Two major factors affecting commodity prices this year are the trade war and central bank intervention. Rising interest rates and quantitative tightening have resulted in a strong dollar. The shortage of the U.S. dollar has caused shock waves in emerging markets, leading to dislocation and overselling of assets. For the twelve months ending September 30, 2018, the Invesco Commodity Fund returned 3.16% (versus 2.59% for the Bloomberg Commodity Index).

Mr. Gluch explained that the balanced-risk commodity strategy has little bearing to the index and therefore returns will be either above or below the index. For example, the portfolio is underweight energy, the most volatile subsector, and will trail the benchmark when energy prices rise. The strategy has broader diversification than the benchmark and is biased to commodities that have a scarcity function. In addition, the strategy combines low correlation with high volatility to rebalance frequently. This results in a source of return not available with the index that only rebalances annually. There is latitude to overweight or underweight in bull or bear markets through tactical allocations. In conclusion, Mr. Gluch presented data showing the strategy outperforms the benchmark over most 3 and 5-year rolling periods.

Chair Given recessed the meeting for a break at 10:49 a.m., reconvening at 11:04 a.m.

C. NEW BUSINESS

1. Private Equity Pacing Plan – *Jim Callahan, Callan LLC*

Gary Robertson, Private Equity Consultant with Callan LLC, introduced private equity team member Ashley DeLuce who gave a general overview of private equity. MCERA's private equity target is 8% with an allowable range up to 12% of the Fund. As of March 31, 2018, the total Net Asset Value (NAV) of the MCERA private equity program was $250,266,000, or 10% of the Fund. Mr. Robertson presented the revised private equity pacing plan for the next 10 years. Callan recommends no new commitments for 2019. There are uncalled commitments to the program of $135,552,000 that Mr. Robertson said will drive the portfolio forward. Pausing new commitments this year will help taper the NAV toward the 8% target through a moderate reduction in uncalled capital and accelerating distributions, if capital markets remain liquid.

The private equity program is managed by Abbott Capital Management and Pathway Capital Management who were funded in equal portions in 2008. Mr. Robertson reviewed performance metrics for each manager, both of which have Internal Rates of Return of 12.2%. Including distributions back to MCERA, the ratio of the Total Value to Paid-In Capital is 1.44 for the private equity program, which is in the second quartile of the Cambridge Private Equity Database.

Mr. Robertson presented a one-year change analysis as of March 31, 2018, highlighting the 19% increase in paid-in capital. Distributions increased by over $58 million, resulting in a net $15 million positive cash flow back to MCERA for the period. Based on being almost 2/3 invested, performance going forward is expected to improve, Mr. Robertson said.

In response to Trustee Klein's inquiry, Mr. Robertson explained that uncalled capital for international partnerships in the Pathway Private Equity Fund 2008 (PPEF 2008) fluctuate due to the strong U.S. dollar. Mr. Callahan said PPEF 2008 has about one-third in international investments in response to Trustee Gladstern's inquiry. Trustee Block asked when the $135 million in uncalled capital for the private equity program will be invested, and whether ideally there would be a level of constancy in investments. Mr. Robertson noted the uncalled capital is already associated with vintage years and it is likely more capital will be committed next year. MCERA is not losing anything by not making new commitments now, he said, because existing commitments will cover this vintage year. Mr. Callahan added we need to recognize getting to the 8% target is based on assumptions for the total private equity plan growth rate, which will not be exact every year.

Trustee Cooper was excused from the meeting at 11:50 a.m.

2. Annual Alternative Investment Fee Report

Mr. Robertson presented the annual alternative investment fee report that is based on a template developed by the Institutional Limited Partners Association (ILPA). This is the second year of the required disclosures, and MCERA worked with the managers to standardize calendar year information and provide uniformity to the degree practicable. Mr. Wickman noted the report will be posted on MCERA's website is in accordance with California Government Code Section 7514.7 that became effective in January of 2017.

The report shows private equity fees paid for the last calendar year including management fees, incentives, and expenses charged back to the funds. Abbott Capital Management reported a total of $1.4 million in Fund-of-Funds Managers Fees and Expenses and $9 million in total underlying partnerships net fees, expenses and incentive allocations. Pathway Capital Management reported a total of $1.5 million in Fund-of-Funds Managers Fees and Expenses and $8.2 million in total underlying partnerships net fees, expenses and incentive allocations. Mr. Robertson stated in response to Trustee Block's inquiry that accounting firms and the Securities and Exchange Commission (SEC) provide checks and balances to make sure the carry fee is correct.

Chair Given recessed the meeting for lunch at 11:59 p.m. and reconvened the meeting at 12:15 p.m.

3. Watch Period Review – *Jim Callahan and Anne Heaphy, Callan LLC*

Mr. Wickman stated managers on the Watchlist are reviewed annually in accordance with MCERA policy.

a. Columbus Circle Growth Equity (**Action**)
Consider and take possible action regarding Watchlist status

Mr. Callahan reported the Columbus Circle small cap growth portfolio was transferred out of the Fund into the new DFA small cap core strategy on November 6, 2018 and therefore the recommendation is to remove it from the Watchlist.

It was M/S Werby/Block to remove the Columbus Circle growth equity portfolio from the Watchlist.

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

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

Mr. Callahan stated the Parametric Emerging Markets Equity portfolio was placed on the Watchlist for performance reasons and the recommendation is to keep the portfolio on watch. He explained the Parametric portfolio is structured differently from the MSCI Emerging Markets Index. In response to Trustee Werby's inquiry, Mr. Callahan explained that Jack Hansen's departure from Parametric will not affect the emerging markets strategy.

It was M/S Gladstern/Silberstein to retain the Parametric Emerging Markets Equity portfolio on the Watchlist.

Trustee Block asked if there has been significant change in the level of assets under management in Parametric's emerging markets strategy. Mr. Callahan responded he is not aware of a change in the asset level which he will include as part of the analysis moving forward. In response to Trustee Werby's inquiry, Mr. Callahan explained that the emerging markets portfolio is structurally underweight to China, which drives performance as compared with the benchmark. Callan is comfortable with this strategy which produces relatively lower volatility over time. The question is if we are getting the type of exposure we want, Mr. Callahan said, adding China will likely become a bigger and meaningful part of the global market. Trustee Gladstern encouraged further education on the topic.

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

c. <u>Dimensional Fund Advisors Small Cap Value Equity (**Action**)</u>
Consider and take possible action regarding Watchlist status

Mr. Callahan stated the Dimensional Fund Advisors (DFA) small cap value portfolio was transitioned to the DFA small cap core strategy and therefore the recommendation is to remove it from the Watchlist.

It was M/S Gladstern/Silberstein to remove the Dimensional Fund Advisors Small Cap Value equity portfolio from the Watchlist.

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

d. <u>Artisan International Growth Equity (**Action**)</u>
Consider and take possible action regarding Watchlist status

Mr. Callahan stated the Artisan International Growth Equity portfolio was placed on the Watchlist due to underperformance attributable to 2016 and recommended it be retained on watch for another year.

It was M/S Werby/Silberstein to retain the Artisan International Growth equity portfolio on the Watchlist.

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

e. Morgan Stanley International Equity (**Action**)
Consider and take possible action regarding Watchlist status

Mr. Callahan stated the Morgan Stanley International Equity portfolio represents a value and quality strategy to complement the Artisan international growth strategy. Due to performance and some personnel matters, Callan recommends retaining the Morgan Stanley portfolio on watch.

It was M/S Gladstern/Werby to retain the Morgan Stanley International Equity portfolio on the Watchlist.

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

D. INVESTMENT CONSULTANT QUARTERLY REPORT and PERFORMANCE UPDATE

As of September 30, 2018

Mr. Callahan reported that the U.S. equity market performed well over the quarter ending September 30, 2018. International markets were mixed over the period and bonds were flat. There has been narrow leadership in technology, with the FAANG (Facebook, Apple, Amazon, Netflix and Google) group driving market performance until the recent selloff. Mr. Callahan noted part of the yield curve from 3-year U.S. Treasurys to 5-year U.S. Treasurys is inverted, meaning the longer-term rate is lower. If the yield curve becomes totally inverted where cash yields more than growth, that would be a recession indicator.

Anne Heaphy, Senior Vice President with Callan LLC, reported during the quarter ending September 30, 2018 the total Fund increased to $2.56 billion from $2.5 billion in the prior quarter. In the fourth quarter, the domestic small cap equity portfolios were moved to the Dimensional Fund Advisors (DFA) core small cap strategy. The total Fund returned 2.4% net of fees for the quarter ending September 30, 2018, and 8.32% net of fees for the prior twelve months. Fund performance is in the top quartile of the Callan Public Fund Sponsor Database. The Fund's fiscal year return as of June 30, 2018 was revised up to 9.72% net of fees based on final private equity valuations.

Mr. Callahan highlighted positive aspects of MCERA's portfolio. Risk-adjusted returns compared to peers over rolling 3-year periods show Fund volatility has come down sharply to around 5%, which he said is abnormally low. Mr. Callahan noted portfolio volatility was higher than peers in 2013 and 2014. As time has moved on, private equity has matured and with more diversification, the Fund has become less volatile than the peer group. In addition, the Fund's risk-adjusted return, as measured by the Sharpe ratio, is meaningfully better than the peer group over the last five years. This indicates we are not taking too much risk for the return, Mr. Callahan said.

Ms. Heaphy reviewed returns for asset classes and managers, pointing out the divergence in performance of growth and value. The DFA small cap value portfolio trailed during the quarter but outperformed on an annual basis. The Columbus Circle small cap growth portfolio has performed well recently. Mr. Callahan noted that for domestic equity the meaningful overweight to small cap was a premium from active management, even though small cap equities were a headwind for the markets.

In the international equity portfolio, developed market managers Morgan Stanley, Artisan, and Fidelity Institutional Asset Management outperformed respective benchmarks for the year. Emerging markets manager Parametric outperformed its benchmark for the quarter, but the underweight to China and overweight to Mexico detracted from performance for the year.

MCERA's fixed income portfolio outperformed the benchmark for the one-year period. Western Asset Management manages the intermediate credit strategy, and Wellington Capital Management manages the core plus strategy that had beneficial exposure to credit and high yield. The global fixed income portfolio managed by Colchester had negative returns that were impacted by the strong U.S. dollar.

Ms. Heaphy presented the Flash report showing performance through October 31, 2018 that reflects challenging recent market conditions. Mr. Callahan said one takeaway is that in a negative market, MCERA's active managers are doing better than benchmarks, providing a degree of protection for the Fund.

Trustee Block asked if the divergence in performance of real estate investment trusts (REITs) from private real estate is a long-term, structural matter. Mr. Callahan replied REITs are publicly traded real estate and as stocks are more volatile than private real estate. Private real estate markets are more stable and provide diversification for the portfolio. Trustee Klein noticed the increase in assets for the S&P 500 portfolio during the third quarter that Ms. Heaphy said was due to rebalancing. Trustee Given asked if there would be more rebalancing given increased market volatility. In response, Ms. Heaphy said we look at it regularly and are not out of range. Mr. Callahan explained that the Parametric futures overlay program rebalances the Fund according to rules we have established. The triggers for rebalancing are ranges for asset classes that are designed for a level of volatility. Mr. Callahan observed that the fixed income portfolio was close to the low end of the rebalancing range in September and has since self-corrected as equities have pulled back.

There being no further business, Chair Given adjourned the meeting at 1:14 p.m.

Roy Given, Chair

Attest: Jeff Wickman
Retirement Administrator