

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

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

January 23, 2019 – 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 items, please alert the Retirement Administrator to that request prior to the matter being called.

CALL TO ORDER

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

ROLL CALL

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

ABSENT: Cooper

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

Investment Committee Chair Sara Klein stated the investment manager portfolio reviews have been lengthened to give trustees more time to ask questions as an important part of the Committee's due diligence process. As a result, managers will be reporting on a three-year cycle instead of annually. Retirement Administrator Jeff Wickman noted the Committee can bring in managers any time if there are matters to discuss.

Jim Callahan, President of Callan LLC, said Wellington Management Company (Wellington) is a long-standing manager of approximately half of the Fund's fixed income allocation. Wellington has a core plus mandate to manage around the Bloomberg Barclays U.S. Aggregate Index, with flexibility to add value with positions outside of the benchmark. Referencing the Investment Policy Statement, Trustee Block asked how the Wellington portfolio duration range between 75% to 125% of the benchmark is determined. Mr. Callahan explained the range for duration is typical for an active fixed income manager, and keeps the duration from being too far outside the benchmark. Duration is part of the beta of the fixed income portfolio. Based on interest rate sensitivity, there can be opportunities to position the portfolio either short or long; sector rotation and other tactics also affect duration. Trustee Block asked if portfolio duration is designed to match liabilities, and Mr. Callahan replied no, the two are not related.

2. Wellington Management Company, Core Fixed Income – Anand Dharan, Matt McLaughlin – 9:05 a.m. – 10:35 a.m.

Matt McLaughlin, Relationship Manager with Wellington Management Company, introduced Anand Dharan, Investment Director, to review the core plus fixed income portfolio. Mr. Dharan stated when reviewing portfolio performance almost a year ago, he was surprised how positive sentiment was given some of the rising risks to economic growth. In light of that viewpoint, Mr. Dharan said markets are increasingly engaging on real risks to global growth. In the fourth quarter of 2018, there was one of the most bearish selloffs since the great financial crisis. In the midst of this uncertainty, there remain bright spots in fixed income markets. As of September 30, 2018, the Wellington fixed income portfolio returned 0.42% net of fees for the quarter (versus 0.02 % for the Bloomberg Barclays US Aggregate Index), and negative 0.54% net of fees for the year (versus negative 1.22% for the benchmark).

During 2018 the only areas of positive performance for fixed income markets were global sovereign bond markets. Mr. Dharan indicated there was a global flight to quality due to a combination of supply and demand factors. As the Fed tightened monetary policy and trade tensions rose, the broader environment became negative, with weaknesses in emerging markets followed by a selloff in the upper tier of the U.S. corporate high-yield market to close the year. In Europe, there were concerns about productivity, and in Asia, concerns about slowing growth in China. Although Mr. Dharan does not expect a recession in 2019, he stated it is reasonable to expect decelerating growth around the world. Central banks have broadcasted they would be unwinding the liquidity they provided to backstop the great financial crisis. Counterpoints to tightening financial

conditions include the fiscal stimulus from tax cuts that was enough in the short term to offset some of the risks to growth imposed by trade tensions. Mr. Dharan noted tax cuts were front-end loaded, and there could be more to come from tariffs having a negative effect. Low inflation was indicative that central banks would be able to engineer a soft landing for global economies. Finally, there was an expectation the institutional environment would be stable as far as an all-out trade war.

Mr. Dharan said that in order to experience further growth in the economy without inflation, he would expect to see an improvement in productivity. Productivity is considered a lagging indicator. He explained that rising productivity is a relief valve for inflation. There are greater costs of labor, land and materials leading to margins getting squeezed which will be passed on to consumers. This could lead to the need for the Fed to raise rates and have a harder landing. Mr. Dharan indicated that the current political paradigm is a risk to the financial markets and that old assumptions that the institutional landscape would be stable during political uncertainty may not hold true. In addition, economic policy and national security are increasingly intertwined, notably with respect to China.

Mr. Dharan presented a historical spread analysis showing investors can still be appropriately compensated for taking risk. Specifically, certain sectors like bank loans and agency mortgages look positive enough that Wellington is comfortable making investments there. As maturities outpace new issuance, investment grade credit is an area the investment team will focus on this year.

Mr. Dharan observed that consumer non-cyclicals are improving debt service metrics, and portfolio positioning in non-agency mortgage-backed securities has moved from underweight to overweight due to high-quality collateral and underwriting. As housing affordability erodes, fewer of these securities will be issued because of tighter underwriting standards. Factors that could have a negative effect on consumers include slower consumer spending patterns given the slower housing market, a turn in the labor market, or if inflation rises in a low productivity environment.

Trustee Block asked if the risk-reward environment was favorable for bank loans. In response, Mr. Dharan noted that the rally in bank loans in 2017 and 2018 was not as pronounced as other sectors. Also, more deals are being turned down by bank loan managers. Therefore, Wellington is avoiding bank loans given their lower quality. Trustee Silberstein asked if Mr. Dharan expects interest rates to rise and for his view of duration. Mr. Dharan replied the market environment has not been what they expected given fundamentals. He stated the short answer is yes, he is expecting interest rates to rise in the front end of the curve. He expected the 10-year U.S. Treasury to yield over 3%, but currently it is not sustaining this level, and increased demand will keep the yield range bound. Mr. Dharan said the strategy is to keep risk low because the markets are affected by global uncertainty. Trustee Silberstein asked about the correlation of fixed income with the equity markets. Mr. Dharan replied that in the fourth quarter of 2018 when equities retreated, the fixed income benchmark was up because of the fall in yields. He also pointed out that agency securities are not correlated with equities.

Mr. Dharan reported the portfolio underperformed the Bloomberg Barclays Aggregate in 2018, mostly due to the fourth quarter. The most positive contributor to performance was positioning in securitized multifamily commercial mortgage-backed securities. Detractors from performance were allocations to high yield corporates and bank loans in the fourth quarter of 2018, which sold off in sympathy with everything else. Duration positioning was also a detractor since the portfolio was positioned for rising rates, and rates fell. In 2019 market conditions have normalized and the portfolio is ahead of the Bloomberg Barclays Aggregate.

Trustee Silberstein asked if the Fund was rebalanced into bonds as equity markets rose in the first half of 2018. Mr. Callahan said no physical rebalancing occurred during the quarter. He explained what would happen when these market conditions occur is that adjustments are made through the futures overlay program to maintain target ranges by taking long bond and short equity futures positions. Anne Heaphy, Senior Vice President with Callan, reported in July there was a physical rebalancing into fixed income. At the end of 2018 the Fund was short \$35 million in equity futures and long \$61 million in fixed income futures. Trustee Silberstein asked if the fixed income portfolio dampens the volatility in equity markets, and Mr. Callahan replied affirmatively that has always been the role of bonds in the Fund.

Trustee Block asked about the convexity of the portfolio. In response, Mr. Dharan said the portfolio is more negatively convex due to having more agency mortgage-backed securities, which are the primary source of convexity. Convexity matters in a high volatility environment, he said, which occurred in the fourth quarter of 2018. Mr. Dharan explained that convexity measures the rate of change of duration in relation to bond price and yield. With positive convexity, as rates fall, prices rise, and duration rises. With agency mortgage bonds, there is negative convexity since as rates fall, more holders want to refinance, so the duration falls with faster prepayments. Asked by Trustee Block if the curve is symmetrical, Mr. Dharan said it is not because prepayments only happen on one side and not the other.

Trustee Gladstern asked how the investment team functions as to market opinions. Mr. Dharan stated Portfolio Manager Campe Goodman is ultimately responsible for the investment decisions. Four lead portfolio managers determine sector allocations. Then, inside those areas, sector specialists give important input on how to design the portfolio. Chair Klein asked why PG&E is in the portfolio, and Mr. Dharan replied Wellington's investment thesis was PG&E had robust cash flow and was trading at a discount. The view was PG&E would avoid bankruptcy. The rationale for continuing to hold PG&E is an expectation for bankruptcy recovery. In this event, the existing capital structure would be re-instated and senior bond holders would have their investments returned.

C. NEW BUSINESS

1. TimesSquare International Small Cap Investment Vehicle (Action)

Consider and take possible action to select vehicle for international small cap portfolio

Mr. Callahan stated at its September 2018 meeting the Investment Committee selected TimesSquare to manage the international small cap allocation. The only funded

investment vehicle at that time was the mutual fund. Since then a lower cost Collective Investment Trust (CIT) has been funded and MCERA should consider whether to use the CIT since the mandate has not been funded. Trustee Silberstein asked about negotiating the fee, and Mr. Wickman said this is part of negotiating the agreement. Trustee Silberstein asked about the anti-dilution fee, which Mr. Callahan said protects investors in the fund from the behavior of others; for example, an investor that liquidated a large position can negatively affect the price.

It was M/S Gladstern/Piombo to select the TimesSquare Collective Investment Trust as the vehicle for the international small cap portfolio, subject to successful contract negotiations.

Trustee Werby asked if there is a more efficient way of investing in the benchmark. In response, Mr. Callahan explained that international small cap is a good place for active management and will give broad, diversified exposure to the index. In response to Trustee Block's inquiry, Mr. Wickman said it is always the case that the Committee's decisions are subject to successful contract negotiations.

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

2. Investment Manager Reporting for 2019 (Action)

Mr. Wickman presented the schedule for investment manager reporting based on his discussions with Mr. Callahan and Investment Committee Chair Klein. The portfolio reviews are scheduled on a 3-year cycle instead of annually. Trustee Gladstern supported the new structure for manager reporting.

It was M/S Werby/Gladstern to approve the Investment Manager Reporting Schedule as submitted.

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

3. Due Diligence (Action)

Consider and take possible action on investment manager due diligence site visit schedule for 2019

Mr. Wickman presented the recommended investment manager Due Diligence Site Visit schedule for 2019. The due diligence site visit teams typically consist of the Retirement Administrator, the Chair of the Investment Committee, the investment consultant, and a fund specialist from the consultant.

It was M/S Werby/Murphy to approve the Investment Manager Due Diligence Site Visit schedule for 2019 as submitted.

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

Chair Klein recessed the meeting for a break at 10:48 a.m., reconvening at 11:02 a.m.

4. Investment Policy Statement Updates (Action)

Consider and take possible action on recommended amendments to Investment Policy Statement re:

Mr. Wickman presented updates to the Investment Policy Statement (IPS) that reflect previously approved actions of the Investment Committee (Committee). Ms. Heaphy highlighted changes which include moving the domestic small cap equity allocation to a core strategy that is also reflected in Dimensional Fund Advisor's Statement of Objectives, Guidelines & Procedures. She noted the U.S. Equity Allowable Range needed to be adjusted to reflect a 2% move from the small cap target in both directions. Some managers are being removed from the IPS as they no longer manage portfolios in the Fund. Trustee Silberstein asked if it would be better to have smaller or larger rebalancing ranges. Mr. Callahan replied by explaining the rebalancing target ranges are generally effective in allowing general market activity and controlling costs. The target ranges are designed to minimize transaction activity because it is expensive. The rebalancing targets should be reflective of the volatility of each asset class and its liquidity profile.

Trustee Gladstern asked about the change from the MSCI REIT Index to the Dow Jones U.S. Select Real Estate Securities Index. Ms. Heaphy replied BlackRock is managing the REIT portfolio to the new benchmark. Trustee Werby asked why language on commission recapture was removed, and Mr. Wickman explained that the Board ended the commission recapture program in 2012. Mr. Callahan noted opportunities for commission recapture shrank when the domestic large cap portfolio was moved to the S&P 500 Index.

Trustee Block sought assurance that the IPS provided guidelines with respect to managers reporting a change in personnel or a merger, for example. Counsel Dunning advised a change in control would require notice to MCERA, and Mr. Callahan referenced the section on duties of investment managers in the IPS that captures the requirement. Mr. Wickman added the IPS is part of our agreement with managers.

It was M/S Given/Thomas to adopt updates to the Investment Policy Statement in Items C.4.a - t as amended per discussions above.

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

- a. Investment Goal Statement: Remove Commission Recapture Provision
- b. General Investment Objectives and Guidelines, Real Estate Portfolios: Remove benchmarks and provisions for Separately Managed and Value-Added Real Estate

- c. General Investment Objectives and Guidelines, Real Assets Portfolio: Change REIT benchmark to Dow Jones US Select Real Estate Securities Index
- d. General Investment Objectives and Guidelines, Policy Implementation Overlay: Remove provision for portable alpha program
- e. Duties of Responsible Parties, Duties of the MCERA Board of Retirement: Update links to Trustee Due Diligence Policy and Trustee Education Policy
- f. Appendix A, MCERA's Long-Term Strategic Asset Allocation Targets and Ranges: Remove US Equity Small Cap Value and Small Cap Growth asset classes
- g. Appendix A, MCERA's Long-Term Strategic Asset Allocation Targets and Ranges: Reduce ranges for real assets
- h. Appendix B-1, State Street Global Advisors, S&P 500 Index Fund, Statement of Objectives, Guidelines & Procedures: Change Lead Portfolio Manager to representative regarding availability to meet with MCERA
- i. Appendix B-2, Dimensional Fund Advisors, Statement of Objectives, Guidelines & Procedures: Remove Domestic Small Cap Value Equity statement and replace with Domestic Small Cap Equity statement
- j. Appendix B-3, Columbus Circle Investors, Domestic Small Cap Growth Equity, Statement of Objectives, Guidelines & Procedures: Remove
- k. Appendix B-5, Artisan International Fund, Statement of Objectives, Guidelines & Procedures: Change title to Artisan Partners, and remove all references to the International Fund
- l. Appendix B-7, Eaton Vance/Parametric, Emerging Markets Equity, Statement of Objectives, Guidelines & Procedures: Change Eaton Vance/Parametric to Parametric
- m. Appendix B-14, Vanguard, REIT Index Fund, Statement of Objectives, Guidelines & Procedures: Remove
- n. Appendix B-14, BlackRock, REIT Index Fund, Statement of Objectives, Guidelines & Procedures: Add
- o. Appendix B-15, Woodmont Realty Advisors, Inc., Real Estate Portfolio, Statement of Objectives, Guidelines & Procedures: Remove
- p. Appendix B-18, AEW Capital Management, Value-Added Real Estate, Statement of Objectives, Guidelines & Procedures: Remove
- q. Appendix B-19, RREEF, Value-Added Real Estate, Statement of Objectives, Guidelines & Procedures: Remove
- r. Appendix C-1, Pathway Capital Management, Statement of Objectives, Guidelines & Procedures: Add Pathway Private Equity Fund Investors 9 (PPEF I-9)

- s. Appendix C-1, Abbott Capital Management, Statement of Objectives, Guidelines & Procedures: Add Abbott Annual Program 2017, LP (AP2017)
- t. Appendix D, Resolution 2010/11-03, Placement Agent Payment Disclosure Resolution and Policy: Update policy to latest reviewed version

D. INVESTMENT CONSULTANT PERFORMANCE UPDATE

1. Third Quarter Summary Investment Presentation

Consider and discuss summary presentation

Mr. Callahan presented a new Summary Investment Presentation for the third quarter of 2018. The intent is to repurpose the quarterly performance report into a condensed format that gives key points and is user friendly. To give context for what to expect from the MCERA portfolio, the report begins with key points on Callan's capital markets update presented every year at the spring Strategic Workshop. An overview of Total Fund asset allocations, performance and portfolio characteristics is followed by a look into the structure of each asset class. Callan also provides research updates for reference and matters that may be of interest to the Committee.

Mr. Silberstein observed that emerging markets are either at the bottom or the top of performance. Mr. Callahan replied the takeaway is that emerging markets are volatile and cyclical, and diversification matters since you do not know which asset class will perform in a given year. The rebalancing policy automatically captures asset class volatility by buying low and harvesting at the top, which may not always be advantageous. The emerging markets allocation is sized according to its place in the global opportunity set.

At the Chair's request, Callan will include detail on changes in portfolio value from one quarter to the next to distinguish cash flows from gains and losses. Cumulative returns are presented as of the quarter and MCERA's fiscal year. Risk-adjusted performance metrics include how the Fund's rolling volatility compares with the public markets. Mr. Callahan noted the abnormally low volatility over the past five years is unlikely to continue. The other interesting observation is the Fund has become diversified away from exposure to public equities, thus looking more like the peer group. Mr. Callahan noted the domestic equity portfolio characteristics are similar to the Russell 3000 but with a small cap bias. Performance metrics include manager net returns and ranking versus peer group. Finally, each individual manager has a one-page summary.

Mr. Callahan said the quarterly Summary Investment Presentation tells the story of the Fund on a higher level to more effectively understand how asset classes and managers are contributing or detracting from performance. Mr. Wickman invited comments on the presentation, and Trustee Gladstern said it is an easy way for the Committee members to be on the same page.

2. Flash Performance Report

Mr. Callahan discussed the flash performance report for periods ending December 31, 2018. The equity markets sold off in December 2018, making it the worst month since February of 2009. The Fund's small cap bias was a headwind, and since the DFA strategy

transition took place during the fourth quarter, the full quarter for the small cap managers coming and going is not available. Trustee Werby asked how the Fund's short positions worked out, and Mr. Callahan stated for that quarter the overlay short positions were additive for the Fund. Trustee Block asked if the overlay positions are reflected in the domestic equity value and Mr. Callahan affirmed this is the case. Mr. Callahan explained Parametric manages the overlay program on daily basis to overlay cash flows, adjust futures positions, and monitor policy ranges. The futures market is liquid and provides an efficient way of managing cash in the portfolio, Mr. Callahan said.

For the fourth quarter, the international portfolio had better performance than domestic equities. Both of the international developed managers slightly outperformed the index. The Parametric emerging markets portfolio outperformed during the quarter, resulting in a good calendar year for Parametric in relative terms. The dollar strengthened during the year, which hurts non-U.S. investments. The fixed income portfolio was a positive in the face of the selloff in equities, with modest underperformance by the two fixed income managers. Mr. Callahan observed that the fixed income portfolio is fulfilling its role by protecting the Fund in a market downturn. The real assets portfolio also protected the Fund with outperformance during the quarter. Mr. Callahan is expecting positive returns from the private real estate and private equity portfolios for the December quarter. Valuations for these asset classes lag the public markets. So far, January has been a good month for equities as the markets bounced back from the December selloff.

There being no further business, Chair Klein adjourned the meeting at 11:58 a.m.



Sara Klein, Chair



Attest: Jeff Wickman
Retirement Administrator