MINUTES

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

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

March 20, 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 agendized 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 9:03 a.m.

ROLL CALL

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

ABSENT: Gladstern, 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.

B. MANAGER ANNUAL REPORTS

1. Manager Overview – *Jim Callahan, Callan*

   MCERA Investment Consultant Jim Callahan, President of Callan LLP, stated today's annual portfolio reviews are for the long-standing Morgan Stanley international equity portfolio for developed markets, and the State Street Global Advisors securities lending program.

2. Morgan Stanley, International Equity – Bruno Paulson – 9:05 a.m.

   Bruno Paulson, Managing Director with Morgan Stanley, stated the focus of the international equity strategy is to generate long-term outperformance to the MSCI EAFE Index. Portfolio holdings are a mix of high-quality compounders that are resilient in tough times and value opportunities where returns are expected to improve. The approach is conducting bottom up analysis resulting in steady holdings with a margin of comfort. Compounders, whose revenues and margins do not go away in weak economic environments, provide downside protection in tough times for the portfolio. When markets do well, such as for the last three years, the portfolio may lag. The view towards very high-quality companies means the downside capture is lower, Mr. Paulson explained.

   As of December 31, 2018, the Morgan Stanley international equity portfolio returned negative 13.46% for the year (versus negative 13.79% for the MSCI EAFE Index).

Trustee Shaw joined the meeting at 9:08 a.m.

Portfolio managers operate in a flat structure as sector specialists who engage in shared discussions and redundancies to lessen the effect of one person leaving. Keeping the absolute risk of losing money in mind, the investment team focuses on cash flow and earnings to assess investments and avoid the value trap. In addition, holdings have higher returns in operating capital and gross margins than the market. Sustainable compounders are characterized by low volatility and reasonable returns with very good management. These holdings tend to be in the consumer staples and health care sectors, which currently make up close to half the portfolio.

Mr. Paulson stated Environmental, Social and Governance (ESG) matters are central to the investment process and an important part of long-term investing and returns. The portfolio is underweight energy and auto sectors because the team is worried about trapped assets. Also, there is the potential for regulators to affect certain sectors such as social media. To address potential ESG risks, Morgan Stanley dedicated one portfolio manager to be in charge of ESG matters. Meeting with companies and engaging is an important part of this process.

Mr. Paulson discussed the developed international equity market in 2018. The MSCI EAFE Index was down double digits with little variation across geographic locations. During the year earnings were up, but stocks were rerated. For the Morgan Stanley portfolio, stock selection was a marginally negative contributor to performance. A few stocks negatively impacted performance, with British American Tobacco (BAT) being the largest of detractors, followed by Bayer which was hit by a surprise legal verdict. As a long-term main core holding due to its pricing power and steady compounding, BAT was close to 4 to 5% of the portfolio. Mr. Paulson said things started to go wrong in late 2016 when leverage was used acquire Reynolds American. In addition, in 2018 the U.S. regulatory environment became less favorable and the rise of JUUL vaping products threatened the profit pool. Subsequently, there was a major derating of the stock's price/earnings ratio. Morgan Stanley has subsequently trimmed the BAT position this year. Another detractor was Fresenius which makes a generic injectable drug and provides medical care services. After a period of steadily compounding earnings, earnings growth slowed, and the stock was de-rated. Mr. Paulson considers the stock's headwinds to be short-term bumps and has added to the position.

To illustrate how the investment team thinks about companies, Mr. Paulson gave examples of successful stock selections. Shiseido is a Japanese beauty company which was added to the portfolio in July 2016. The initial 150 basis point position reached 400 basis points, largely through appreciation, when it was trimmed back to a 2.5% position. This was a value opportunity with forward earnings and margins expected to improve radically with a new manager, and the turnaround happened. Another positive story was Safran, an aeronautics company with predictable long-term recurring revenue. Safran transitioned successfully to a new engine and benefited from a strong year in the civil aftermarket.

Mr. Paulson explained how the portfolio is positioned with respect to sectors. Detractors included energy holdings in oil-sensitive stocks, and holdings in larger diversified health care companies that were outperformed by smaller biotech companies. Underweights in consumer discretionary and financials are slightly less than in the past. Within consumer staples, the plan is to be in branded beverage and beauty firms. In the technology sector, holdings focus on software and services rather than hardware, which is cyclical and volatile. In financials the portfolio is overweight in insurance because the business is more predictable than banking. Mr. Paulson highlighted the fact that, based on revenue, nominal U.K. holdings have more emerging markets exposure than U.K. exposure.

On a macro level, going forward Mr. Paulson worries about corporate debt, observing there is now more BBB corporate debt than the entire U.S. corporate debt market 10 years ago. This puts the U.S. in a vulnerable position in a downturn. Positive factors include tax reform which has helped the economy. Given the global economic slowdown, the risk is that more cyclical companies will have earnings disappointments, Mr. Paulson said. He thinks there is too much optimism, with trade, Brexit, and politics being potential negative factors.

Trustee Block asked about BNP Paribas, and Mr. Paulson replied it is a medium-risk bank that is reasonably well capitalized and has a stream of income. Trustee Block asked about corporate debt, and Mr. Paulson replied the increase in leverage is a potential problem if companies are downgraded into junk, because investors may flee. Trustee Silberstein asked whether the position in British American Tobacco would be unwound. He specifically asked about Morgan Stanley's vote against one of the directors. In response, Mr. Paulson indicated the position will remain since earnings are not likely to fall off a cliff. Regarding the proxy vote, he said there is a fundamental problem with the remuneration system having to do with currency. Currently, he is comfortable with the risk/return on the holding; in retrospect, the position had been too high. Trustee Silberstein said he appreciated that proxy voting was accessible on Morgan Stanley's website and requested that the reason for proxy votes be added.

Trustee Klein asked if L'Oreal is a value trap since smaller firms are taking market share from older firms. In response, Mr. Paulson explained that many new brands are controlled by L'Oreal. The good companies are exploiting the new merchandizing, he said. Further, L'Oreal is growing faster than the market and has a data base that may become a new barrier to entry into the industry. It also goes to competence and ability, he said.

Trustee Klein asked about Mr. Paulson's view of Brexit. In response, Mr. Paulson said the referendum in 2016 for Britain to leave the European Union (EU) could mean a whole continuum of things, the ultimate being just to leave. In his view, the Prime Minister prioritized freedom of movement and there has been no grown-up discussion about economic access. The Prime Minister is asking for an extension until the end of June and there is significant risk of no deal. He said the EU needs to know what the Prime Minister wants. Trustee Klein asked how the portfolio should be hedged with respect to Brexit. Mr. Paulson replied he does not think a U.K. Brexit would have a major impact on the portfolio. For one reason, the portfolio revenue from the U.K. is very low, and for another, Morgan Stanley has avoided the U.K. banks. Trustee Block asked Mr. Paulson to describe a scenario of a very bad global reaction to Brexit. Mr. Paulson replied this is unlikely because no one will be caught by surprise.

Chair Klein recessed the meeting for a break at 10:24 a.m., reconvening at 10:36 a.m.

Trustee Cooper was excused from the meeting at 10:24 a.m.

3. <u>State Street Global Advisors, Securities Lending – John Powell – 10:35 a.m.</u>

   John Powell of State Street Global Advisors (SSGA) explained that securities lending involves the lending of MCERA's domestic assets, including equities and fixed income securities. Revenue is split 70-30 to MCERA and SSGA, respectively. Since its inception in 2007, the securities lending program has generated over $4 million for the MCERA trust. Historically, 2008 was the best year for securities lending due to demand and volatility.

   Loan duration is typically 21 days, except for U.S. Treasurys which have a shorter time frame. Mr. Powell highlighted short selling in Revlon and Visa as popular securities on loan. Top earnings generally come from small cap equities, such as pharmaceutical companies that are thinly traded. Mr. Powell said securities lending tends to be seasonal, as many hedge funds close from mid-November through the end of the year. As a result, there is more activity in the spring. Mr. Powell characterized the securities lending program as a consistent, plain vanilla program with no problems. He noted the top 10 buyers generate 80% of the revenue for the program and are all highly rated counterparties. If any counterparty were to go bankrupt, MCERA is indemnified by State Street against the loss. He discussed global stay protocols where governments are all in agreement that if there are issues with any counterparty, a 2-day stay will be established. After meeting with management, it will be determined whether to put the company in receivership to prevent a panic.

Cash collateral from securities on loan is invested in State Street's Quality D investment fund consisting of high credit-quality positions. The Quality D fund is similar to a money market fund and has 22% liquidity on a 7-day basis. The one-day yield at the end of January was 2.76% net, which is above the overnight rate.

Trustee Silberstein asked what the effect will be on securities lending due to moving to the separately managed account for the S&P 500 Index fund. Mr. Powell replied he expects the level to remain the same, noting most of the securities on loan come from the small cap portfolios. Trustee Block asked about the net spread value for the current fiscal year to date and Mr. Powell thinks there is a rounding error. Trustee Block also inquired about declining margins based on net investment income from 2017 to 2018. Mr. Powell said margins have dropped from 2017 because the amount SSGA is paying back to the borrower has increased.

Trustee Werby asked what the risk is in securities lending. In response, Mr. Powell said the risk is in investing the cash collateral. For this reason, the cash investment is more conservative than it was in the past. A concern would be a macro event setting in contagion, but new regulations have created less risk in global banks. SSGA has a strong firewall and knows what it is facing regarding cyber security, Mr. Powell said. The firm also participates in banking consortiums to be aware of what is going on. Chair Klein asked about collateral for repurchase agreements. Mr. Powell explained there is a menu of repurchase collateral that is primarily agency securities and U.S. Treasurys. There is a definitive trend of equities used as collateral because of their liquidity, but not within MCERA's program.

C. <u>NEW BUSINESS</u>

1. <u>Parametric Organizational Update – *Jim Callahan, Callan*</u>

Mr. Callahan said Parametric manages MCERA's emerging markets equity portfolio and the futures overlay program run by Jack Hansen. He reported that Mr. Hansen plans to retire later in 2019. Callan is comfortable that the strategy on the futures overlay team is well resourced. In addition, the co-Chief Investment Officer for the emerging markets portfolio, Tim Atwell, announced he would step away for personal reasons. Mr. Callahan views these personnel movements as isolated incidents. He sees no resulting issues or significant changes in assets under management, and therefore no changes are recommended. Trustee Block observed that assets under management are lower than the prior year, which Mr. Callahan attributed to emerging markets being down in 2018. He does not see outflow that would cause any alarm. Callan will continue to monitor Parametric and bring back any concerns that arise.

D. INVESTMENT CONSULTANT QUARTERLY REPORT and PERFORMANCE UPDATE

1. Quarterly Report as of December 31, 2018

   a. Summary Report

Mr. Callahan pointed to negative capital market returns for the fourth quarter of 2018 due to the market downturn in December. Concerns about slowing global economic growth and the Fed pushing interest rates higher all weighed on the markets. Small cap equities were worse, and the Fund is overweight to small caps. Emerging markets slightly underperformed developed markets. Not surprisingly, there was a flight to quality into bonds, which rallied during the quarter and were flat for the year. Private equity was up and is one of the benefits of private assets. Mr. Callahan said the takeaway is diversification is key and rebalancing leads to discipline in terms of risk management. Year to date, markets have risen 13% and are close to recovering the December 2018 downturn. Small cap has outperformed, benefiting the Fund. International markets are trailing domestic markets, and bonds are up as rates have come back down. Commodities and natural resources are showing good returns.

Anne Heaphy, Senior Vice President with Callan, reported that the total Fund value as of December 31, 2018 was $2.358 billion. Total Fund allocations during the fourth quarter of 2018 were close to targets, and therefore no rebalancing was needed. In the summary report, a new column shows Net New Investments, which is the sum of contributions before asset transfers minus any transfers out. It shows fund flows out of the DFA small cap value and Columbus Circle small cap growth portfolios into the new DFA small cap core vehicle.

Ms. Heaphy presented a chart showing quarterly changes in Parametric futures overlay positions for fixed income, domestic equities, and international equities. Trustee Block noted a widening spread between fixed income and equity positions since the second quarter of 2016, asking if it would be more efficient to rebalance the portfolio. Mr. Callahan replied rebalancing can be done but at a higher fee. Further, the primary function of the overlay program is to securitize cash. There is also a rebalancing function that allows Parametric to use futures to go short and has an influence. Mr. Callahan concluded the spread Trustee Block is referring to is not wide enough to have a big influence on the portfolio.

Ms. Heaphy reviewed total Fund annualized performance as of December 31, 2018 compared with the Callan Public Fund Sponsor Database. The results show that the MCERA Fund has very strong peer rankings over annualized calendar years. Other metrics presented included rolling 3-year standard deviations and Sharpe ratios. Risk-return measures show the Fund has relatively higher returns due to its higher equity exposure.

Domestic equities consist of the DFA small cap core portfolio and the S&P 500 Index portfolios. There is an overweight to small cap, with remaining characteristics, including sector allocations, fairly in line with the benchmark. International equity portfolio characteristics include a slightly lower market cap as compared with the benchmark, and a slight underweight to emerging markets. The international equity portfolio performed in line for the quarter and outperformed for the year. All international managers outperformed benchmarks for the calendar year. The Parametric emerging markets portfolio had a beneficial underweight to China, which did not perform well during 2018.

The fixed income portfolio underperformed for the quarter and year, but is outperforming over longer time frames. Ms. Heaphy attributed the short-term underperformance to underweights in U.S. Treasurys in the Wellington and Western Asset portfolios, and the strength of the U.S. dollar and overweight to the British pound in the Colchester global bond portfolio. The MCERA real estate portfolio outperformed for the quarter. As compared with the NFI-ODCE Equal Weight Net Index, the real estate portfolio has slight underweights to office and industrial sectors and overweights to multi-family and retail.

The private equity program returns lag one quarter. Of a total of $400 million committed, there remains about $116 million in uncalled capital. MCERA has received $168.6 million in distributions and the Net Asset Value is $269.4 million. The Total Value to Paid-In (TVPI) of 1.5x ranks MCERA in the second quartile of the Thomson-Cambridge Private Equity Database. Information on the private equity program strategy mix, geographic mix, and industry mix was presented. In conclusion, Ms. Heaphy referenced detailed performance information for each portfolio manager in the Fund. Chair Klein expressed her appreciation for the summary investment report.

2. Flash Performance Update

As of February 28, 2019, the Total Fund value is $2.5 billion, reflecting a year-to-date return of 7.1%, and a fiscal year-to-date return of 1.3%.

There being no further business, Chair Klein adjourned the meeting at 11:52 a.m.

Sara Klein, Chair

Attest: Jeff Wickman
Retirement Administrator