MINUTES

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

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

December 4, 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 9:10 a.m.

ROLL CALL

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

ABSENT: Cooper, Poirier, 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. NEW BUSINESS

1. Private Equity Allocation, Strategy and Fees – Callan LLC – Jim Callahan, Jay Nayak

Jim Callahan, President of Callan LLC, stated MCERA's private equity program was initiated about 10 years ago. Mr. Callahan indicated that, in conjunction with the day's other agenda item regarding the private equity pacing plan, this was a good time to review how MCERA implemented its private equity program in 2009 and discuss other ways private equity could be implemented.

Jay Nayak, Callan Private Equity Consultant, said he investigated different ways of implementing private equity programs to understand what shaped the plans and how that impacted performance. His research shows implementation is the most important decision made in a private equity program. Mr. Nayak summarized the current private equity program and shared what is important to think about and what the mechanics are for private equity implementation options.

When Abbott Capital Management and Pathway Capital Management were selected as MCERA's private equity managers in the fall of 2008, the global financial crisis had significantly repriced the market. This provided a good foundation for the program that has become more diversified over time. Mr. Nayak said MCERA is well-positioned to think about other implementation options. The allocation is above target at 11% of total assets but below the 12% upper range. The program can converge over time to the 8% target allocation by enabling the investments to get distributions with no strategic change. He directed attention to older vehicles with healthy distributions and other vehicles that are starting to deploy capital.

Chair Klein asked for a comparison of 10-year returns of the private equity program with the S&P 500. Mr. Nayak replied that private equity performance has lagged the S&P 500 due to its strong run in that time period. Mr. Callahan added that the Fund portfolio is growth oriented and the main reason to invest in private equity is for a diversification benefit and to get a better return than the public markets. He cautioned that relatively short-term performance is not a good comparison to go by. Trustee Silberstein asked how our target allocation of 8% compares with other pension systems. Mr. Nayak replied it is broadly in line and there is a pattern of real estate and private equity allocations balancing each other out. Mr. Wickman observed that other factors like liabilities and funded ratio's drive asset allocation, making it difficult to get an apples-to-apples comparison to other '37 Act Systems. Mr. Callahan noted that cash flow is another factor. Most public pension funds have negative cash flow, the investment consultant said, and liquidity is a factor creating a ceiling on what is a reasonable private equity allocation. He said the conclusion to date is MCERA's liquidity needs are manageable and could absorb a market dislocation. At some point, the allocation will be brushing up against that ceiling, Mr. Callahan said.

Mr. Nayak assessed investments in the private equity program. The majority of the private equity holdings are in the developed markets. He discussed investments within the technology sector that are elevated at 40% of holdings. There is rampant activity in software company investments, the majority being business-to-business software services, many of which are vertically oriented and specialized for specific purposes. Chair Klein asked if these are money losing companies, and Mr. Nayak replied there are a little bit of both, including well-established software companies with good growth rates. He stated there is a lot of potential to drive further business. He noted there is a lot of buyout exposure and also venture capital holdings that may not be profitable today. Chair Klein requested the percentages for these strategies and Mr. Nayak indicated he would follow up with that information. Trustee Block asked whether these characterizations are Mr. Nayak's or provided by managers, and Mr. Nayak replied they are both and are verified by their research. Trustee Block noticed distressed holdings are high as compared with normal, and Mr. Nayak explained that managers took advantage of a pocket of opportunity in energy special situations. In summary, Mr. Nayak stated that the private equity portfolio developed favorably in the last market cycle and no course correction is needed.

Mr. Nayak discussed different private equity implementation approaches in three broad categories: 1) outsourced model; 2) direct model; and 3) hybrid model. In the outsourced model which MCERA uses, a fund-of-fund manager is hired to make fund investments. In the direct model, the investor makes investments in funds directly. In the hybrid model, the investor makes targeted fund investments next to the outsourced portfolio. The models used by SACRS peers were listed.

Trustee Gladstern pointed out that a Chief Investment Officer would be needed to implement the direct model. Mr. Nayak spoke to the need to calibrate correctly so that staffing, procedures and processes are in place to support implementing a private equity program. The idea of several systems investing in private equity together proposed by Trustee Werby was discussed. Counsel Dunning indicated that is happening from a practical standpoint when new agreements are being developed that result in fee reductions.

Mr. Nayak discussed factors to consider when deciding how to implement private equity. These include who hires a manager, develops the strategy, screens investments, and is responsible for managing and administering the portfolio. In the current program, MCERA is responsible for hiring the manager and remaining functions flow from there. He pointed out there is some ability to carve out special strategies.

There was discussion of the mechanics of different implementation methods, including use of a separate account which Mr. Callahan said typically is only used by much larger pension plans that can absorb some of the administrative duties. Mr. Nayak said the hybrid model is a multi-manager approach that could be used by pension systems that are migrating to a direct investment approach. Trustee Gladstern asked if Abbott and Pathway provide this process. Mr. Callahan said with Abbott there is a model portfolio, but you can opt in or out of co-investments, for example. We have accepted the basic model for both Abbott and Pathway, he said, but the structure is in place to customize the model.

Trustee Silberstein asked if retirement systems have done better or worse with different implementation methods. Mr. Nayak replied generally a number of plans found fees suboptimal for the fund-of-funds approach and therefore migrated to a hybrid model. From a performance standpoint there is no data, but meaningful fee savings are the justification. Mr. Callahan discussed situations that went wrong in going toward a direct approach due to a tendency to overcommit to opportunities with detrimental results. He emphasized the need to take a measured approach and have someone overseeing the whole private equity portfolio. Trustee Silberstein asked if university endowments use direct private equity investing. In response, Mr. Nayak said there is a migration of universities of sufficient scale to the direct approach, with the tendency toward a very tactical approach. Mr. Callahan pointed out that large endowments have historically long relationships with private equity funds, giving them more access and credible expertise to do direct investing. Replicating that is very difficult, he said.

Mr. Nayak presented fee structures for private equity implementation methods. Chair Klein noted the data indicates there would be a 12 basis point fee savings by moving to a fund of one, and Mr. Nayak noted there would be differences depending on negotiations.

Data was presented showing private equity implementation for SACRS plans relative to the size of the program. Trustee Block said what you want to know is to compare liquidity needs across the different plans. Mr. Callahan said risk posture is important and peers have different needs and risk tolerances.

Chair Klein recessed the meeting for a break at 10:22 a.m., reconvening at 10:34 a.m.

2. <u>Private Equity Pacing Plan and Commitment (**Action**) – Callan LLC – Jim Callahan</u>
Consider and take possible action on new commitments to private equity program

Mr. Nayak presented Callan's proposed private equity pacing plan to guide and recalibrate the private equity program. He said the pacing plan is a risk mitigating tool enabling good vintage year diversification to make sure the private equity program is moving in a well-structured direction. The goal is to converge the private equity allocation of over 11% back to its 8% target. He explained how data is used on an annual basis that results in projections for commitments to provide exposure to vintage years as the allocation converges back to target. The pacing plan calls for a $20 million commitment to 2020 private equity fund vehicles. Mr. Wickman explained that assumptions used in the pacing plan are based on the actuary's Experience Study conducted every three years that will be presented to the Board next year. Mr. Callahan noted the assumptions are needed in order to develop the private equity pacing model.

In response to Trustee Block's question on whether a credit crunch such as occurred during the financial crisis could happen now, Mr. Nayak stated this is difficult to know, but that idiosyncratic factors require toggling up or down and the overarching goal is to stick with the strategic plan and avoid over concentration. Mr. Callahan added that the objective is to smooth out the pacing plan.

Trustee Block proposed moving to a fund of one approach for future commitments due to fee savings. Mr. Callahan indicated for any commitment made today, the path would be the model and managers MCERA currently uses. He said future commitments could go into a different model. Mr. Nayak sees accelerated distributions for mature 2008 vintage year private equity vehicles. He expects favorable outcomes with the conservative $20 million commitment as returns may be higher than projected in this pacing plan. Chair Klein proposed not making a new commitment to the private equity program this year and making a bigger commitment to a fund of one next year and see how the distributions come in. Mr. Nayak indicated this would be a reasonable approach as there would still be some exposure to those years.

Chair Klein asked about current private equity valuations. Mr. Nayak replied we are in a high-priced environment and there is concern in the industry about valuations. He indicated there may be a concern about private equity strategy migration because some managers will be tested to execute well in this market. His concern is that many deals being made are not reasonable as far as the expected return in what is a hyper-competitive market. Chair Klein indicated she is concerned about strategy drift and the valuation MCERA is getting in some of these investments. Mr. Nayak replied the advice is to make the bar of conviction higher today for investments. Trustee Silberstein said the question is how our fund managers think in the choices that they make. Mr. Nayak stated the opportunity to have control means going to a fund of one. He advised asking questions of the managers on how they underwrite strategy, whether there is strategy drift, and how they rationalize it if there is strategy drift. Our managers have done a good job sticking to their strategies, he said, but it is good to ask these questions. He added that there are vehicles that may enable navigating around that.

Trustee Gladstern expressed discomfort with buyouts and the effect of high leverage, including what happens to employees in buyout situations. Mr. Nayak said there are managers who are sensitive to this that would require MCERA to have a separate account strategy or a hybrid approach. He discussed an institutional program that has all growth-oriented investments and is one of the top-performing private equity programs for institutions. MCERA could take steps on the margin to transition to a hybrid approach and overweight the growth strategy. Chair Klein shares concerns about governance for private equity managers and requested that the topic be addressed by the Governance Committee. Mr. Nayak said there is an emergence of Environmental, Social and Governance (ESG) expanding into the private equity markets and tangible metrics are needed to get visibility on the true implications of the strategy. There was general agreement on the Committee to further study the different private equity investment models and hold off on new commitments in 2020.

3. <u>Watch Period Review – Callan LLC – Jim Callahan, Anne Heaphy</u>

Administrator Wickman stated MCERA's Investment Policy Statement defines criteria for managers on or to be added to the Watchlist that is reviewed on an annual basis. Mr. Callahan reported managers on the Watchlist are the Parametric Emerging Markets Portfolio, Artisan International Growth Equity portfolio, and Morgan Stanley International Equity portfolio. The Colchester Global Bond portfolio recently qualified for Watchlist status. Callan recommends keeping the three existing managers on the Watchlist and reviewing their status again in 2020 as well as adding Colchester to the Watchlist.

Trustee Block indicated he is more concerned about the UBS Trumbull Property Fund than any portfolio on the Watchlist and requested that related criteria be developed for the Watchlist. Upon discussion, Chair Klein directed that the matter be considered by the Governance Committee and Mr. Wickman will follow up to coordinate with Callan.

Trustee Murphy questioned retaining the Parametric Emerging Markets portfolio in the Fund since it has been on the Watchlist so long. Mr. Callahan explained that Parametric has done what they were hired to do in constructing a much more diversified and less volatile portfolio than the index for emerging markets. He said the reasonable question is whether this is the desired approach, and that is a philosophical question that the Committee would have to discuss. Mr. Callahan thinks there is wisdom in the diversified approach, but it requires being able to tolerate the ebbs and the flows.

It was M/S to Block/Gladstern to retain the Parametric, Artisan, and Morgan Stanley portfolios listed as Items B.3.a – c below on the Watchlist.

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

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

b. Artisan International Growth Equity (**Action**)
   Consider and take possible action regarding Watchlist status

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

d. Colchester Global Fixed Income (**Action**)
   Consider and take possible action regarding Watchlist status

It was M/S Block/Gladstern to add the Colchester Global Fixed Income portfolio to the Watchlist.

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

Trustee Werby was excused from the meeting at 11:35 a.m.

C. INVESTMENT CONSULTANT QUARTERLY REPORT

1. Quarterly Report as of September 30, 2019
   a. Summary Report

Mr. Callahan discussed capital market conditions in the third quarter of 2019, pointing to the divergence between the United States (U.S.) economy doing well with low unemployment and the rest of the world that is taking a turn for the worse. Factors include the Brexit situation, Japan slipping into recession, and emerging markets slowing. In addition, global negative yielding debt means that modest interest rates in the U.S. will attract capital, leading to a strong dollar that impacts international returns. Returns for the calendar year 2019 are extraordinary, given the concerns about higher interest rates at the end of 2018. Growth is outperforming value in domestic and global equity markets. Small cap underperformance is a headwind as the Fund is overweight small cap. Bonds are providing high returns, private real estate returns are moderating, private equity is good, and commodities are negative. Leverage in private equity markets is continuing to grow. The Callan periodic table for historical investment returns by market sectors shows that diversification over time pays off, Mr. Callahan said, because sector performance is different every year.

Anne Heaphy, Senior Vice President of Callan, reported all asset allocations are within target ranges and there were no changes to the portfolio during the quarter. The Plan was valued just below $2.6 billion as of September 30, 2019. As of that date, the Fund returned 3.33% net of fees for the prior twelve months and net of fee returns exceed the assumed rate of return of 7.00% over longer periods up to fifteen years. The Fund's fiscal year return as of June 30, 2019 was 5.88% net of fees and includes updated private equity returns for that date.

MCERA's domestic equity portfolio is invested in the S&P 500 and in the Dimensional Fund Advisors (DFA) small cap core strategy that has a slight value bias. In the international equity portfolio, the return was slightly negative for the quarter but modestly positive for the prior twelve months. The Artisan portfolio's growth orientation has been a tailwind and, along with good stock selection, is easily outperforming the benchmark over the past few years. Other international equity portfolios are managed by Morgan Stanley, Parametric for emerging markets, and TimesSquare for small cap equities. The fixed income portfolio underperformed the target in the third quarter. The Wellington core plus fixed income portfolio benefited from good corporate credit positioning, and the Colchester sovereign debt portfolio performance was impacted by the lowering of global interest rates.

Trustee Silberstein asked about considering investing in private credit due to low interest rates. In response, Mr. Callahan explained that he does not consider private credit as fixed income because it has a different set of risks. He stated the purpose of MCERA's fixed income allocation is to diversify the Fund. Trustee Silberstein asked if we should reduce the fixed income allocation and the investment consultant said it can be reviewed. Mr. Callahan said fixed income is there to provide liquidity and for downside protection, noting the allocation has been brought down lower than it was and is in line with funds with similar objectives. Mr. Wickman said in his research he found peer systems had private credit in the growth bucket and there were concerns there. In response to Trustee Gladstern's inquiry, the Administrator explained that CalPERS' fiscal year performance was boosted by its high-yield bond investments.

Real estate portfolio returns are modestly positive for the past quarter and twelve-month period. The allocation consists of two core open end funds managed by AEW and UBS. The AEW portfolio benefits from the industrial allocation and by reducing the retail sector. UBS performance was affected by a decline in appreciation due to debt mark-to-market adjustments from declining interest rates. The UBS portfolio will be reviewed at the Investment Committee meeting in January 2020. Mr. Callahan observed that as the real estate market has slowed down, current income is very high. He said this is a good thing going forward because then most of the return will come from that component.

The real assets portfolio net return exceeded its target return for the quarter and twelve-month period. Commodities were impacted by trade tariffs affecting agricultural prices. In the private equity program, MCERA has committed $400 million and $320 million is paid in. $208 million has been distributed as of June 30, 2019, and the total value to paid in capital ratio is 1.54x. The private equity portfolio net internal rate of return (IRR) is almost 13%.

2. Flash Performance Update

The flash performance update by asset class was presented as of October 31, 2019, showing the Fund value of slightly above $2.6 billion. The total Fund calendar year-to-date return net of fees is 14.4% and the fiscal year to date return net of fees is 2.1%.

There being no further business, Chair Klein adjourned the meeting at 12:18 p.m.

Sara Klein, Chair

Attest: Jeff Wickman
Retirement Administrator