MINUTES

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

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

January 22, 2020 – 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 9:00 a.m.

ROLL CALL

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

ABSENT: 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 LLC

   Jim Callahan, President of Callan LLC (Callan) stated today's portfolio reviews begin with the global sovereign bond portfolio managed by Colchester. Then UBS will provide the review of its Trumbull Property Fund and Callan will follow up with an overview of MCERA's real estate allocation and potential alternatives for the Committee to consider.

2. Colchester Global Investors – Keith Lloyd, Janhavi Kumar – 9:05 a.m.

   Janhavi Kumar, Head of Distribution at Colchester Global Investors (Colchester), introduced Keith Lloyd, Chief Executive Officer and Deputy Chief Investment Officer with Colchester and one of the founding members of the firm.

Trustee Shaw joined the meeting at 9:02 a.m.

Ms. Kumar stated that the sole focus of Colchester is on global sovereign bonds. Its portfolio consists of cash bonds and forward exchange contracts to implement currency positions, but otherwise no derivatives. Ms. Kumar stated that 80% of Colchester employees own shares of the firm and assets under management are stable. The preliminary annual return of the Colchester global bond portfolio as of December 31, 2019 is 7.6% net of fees (versus 5.9% for the FTSE World Government Bond Index (WGBI).

Mr. Lloyd reported that the first three quarters of 2019 were difficult for the bond portfolio, but in the 4th quarter most of that unwound, leading to a relatively strong quarter. Since its inception in 2000, the global sovereign bond strategy at Colchester has meaningfully outperformed the WGBI. He pointed out this has been done without using credit. Mr. Lloyd stated that the key reason to have sovereign bonds in the MCERA Fund is they are not correlated with the equity markets; only government bonds have this negative correlation. High-yield corporate bonds have a higher correlation with the U.S. equity markets. Mr. Lloyd stated the key point is the more credit you put into a bond portfolio, the more you lose that negative correlation. He also emphasized that global bond markets do not behave in the same way the U.S. government bond market behaves.

Trustee Given joined the meeting at 9:12 a.m.

The result of the negative correlation of global sovereign bonds is to generate better risk characteristics for MCERA's overall Fund, Mr. Lloyd stated. He also pointed out that any given country has better returns on average every 20 years. Performance of the Colchester global bond strategy as compared with the U.S. equity market over the past 20 years shows that at stress points, global bonds went up when equities went down. These results confirm the correlation theory, Mr. Lloyd said.

Mr. Lloyd discussed attribution to portfolio returns over the past year. During the first 3 quarters of 2019, there was a significant underweight to negative real-yielding bonds in Europe. During the 4th quarter as interest rates moved up globally, the underweight in the United Kingdom and core Europe were major positive contributors to returns. On average over time, 2/3 of excess returns come from bonds and 1/3 comes from currency, and this will vary from year to year.

Trustee Werby asked that performance net of fees be provided, and Mr. Lloyd agreed net returns can be generated over time. Trustee Block asked if currency is used to hedge bonds or for speculation. In response Mr. Lloyd explained the global bond fund is effectively two portfolios consisting of bonds and currencies. The investment strategy employs a value approach for both asset classes. Currency positions are usually held for approximately 5-year periods. Once currency valuation in real terms is determined, the highest real-returning currencies are selected, which will be the most undervalued. Trustee Gladstern asked whether the benchmark includes currency and Mr. Lloyd said it does. The bond portfolio is invested in higher real-yielding bond markets. Considerations include the strength of the government's balance sheet and adding a premium for those with strong balance sheets. The reverse is true with weaker countries like Italy. Due to its unstable debt path, Greece was screened out of the opportunity set prior to 2007. Another factor for bond valuation is a quarterly 2-year forward inflation forecast used to determine expected real yield. Based on this metric, bonds are ranked from low to high.

Mr. Lloyd discussed how the portfolio is optimized based on risk. Colchester is taking active risk against the benchmark and the magnitude is a function of the portfolio that can be built relative to the benchmark. The amount of risk taken on the bond side versus currency side depends on the amount of alpha expected from bonds. The more alpha in bonds, then the more on that side, and vice versa with currency. The investment team is looking to build a diversified bond and currency portfolio to hold for a long time by investing in undervalued assets. Mr. Lloyd stated the average turnover in the portfolio is 65% per year. Trustee Block asked if leverage is used for currency futures contracts and Mr. Lloyd stated there is no leverage in the portfolio.

Mr. Lloyd observed that most of the European bond market offers negative real yields, in contrast with the U.S. bond market. He reported that real yields are drifting up on a global basis, and there are significant positive real yields in some of the emerging markets. For this reason, there is a slight overweight to Japanese government bonds, and large holdings in Mexico and Singapore. Mr. Lloyd pointed out that what is considered emerging markets has changed. In the currency markets, at the end of 2019 the U.S. dollar jumps out in real terms as overvalued against a diversified basket of global currencies, so the portfolio is under-weight there. He said it is interesting that G-5 or G-7 market currencies are 20% undervalued relative to the U.S. dollar about 4 years into the average 5-year cycle.

Looking forward, Mr. Lloyd said the Colchester team thinks the world is in a better state than generally indicated. Due to record low unemployment levels around the world, the average consumer household is in a good space. There is certainty about income, one of the key drivers of spending and consumer confidence underpinning world economic growth. Nominal wages are trending higher and most countries are getting to 3% wage growth. Due to higher money growth, the expectation for inflation is a consistent drift up globally to 2.3% or 2.4% in the next two years.

3. <u>UBS Realty Investors – Core Real Estate – Mario Maturo, Mia Dennis – 9:50 a.m.</u>

Mario Maturo, Portfolio Manager with UBS Realty Investors, reported that 2019 was a challenging year for the Trumbull Property Fund (TPF). Mr. Maturo stated there was significant downward pressure on the TPF returns because of existing retail portfolio assets that had write-downs of about 20% in value. These significant valuation changes were followed later in the 4th quarter with additional write-downs in the retail portfolio on five mall properties. There is a significant risk premium placed on retail properties in TPF. The preliminary annual return as of December 31, 2019 for the Trumbull Property Fund was negative 2.0% (versus 5.1% for the NFI-ODCE index).

Mr. Maturo said the NFI-ODCE retail benchmark has not seen the same changes to its valuation metrics as had been expected. It is an industry-wide change, so other comparable funds should see some sort of adjustment. Investors are asking if this is over as to value changes and how UBS is changing the TPF portfolio to perform better. Mr. Maturo said TPF is a large, diversified portfolio that had valuation changes in 2019 but has stabilized. He said the challenge is with five large mall assets that make up the majority of the write-downs. In what is not a robust market, UBS plans to sell two of those malls this year. The other three assets will be changed into more mixed-use properties that include creative office, multi-tenant, and a broader choice for consumers, such as fitness.

Mr. Maturo discussed portfolio positioning for TPF going forward. He noted that the strategy should be appropriate for a core investment vehicle. The core strategy is to operate a lower risk fund through lower leverage and broad geographic diversification. This means changes in asset allocations and quality that are more in line with the original strategy. As an example, steps have been taken to transition from the office sector into the apartment sector using a build-to-core program. The idea is less volatility and more income, because office has significant volatility with periods of low occupancy. Another change is deemphasizing full-service hotels that enhanced returns in the past but are capital intensive.

Lastly, to align more with the core strategy, UBS has taken a more specific stance on a broad inventory model. New investments are in areas in TPF that are underweight, and dispositions are in overweight areas. Going forward work is not complete with transitioning retail assets, Mr. Maturo said, and this is the most important thing the team will focus on during 2020.

The first goal for TPF is to outperform the benchmark over a full market cycle. The current market cycle started in 2008 and has been longer than normal, Mr. Maturo said. The second goal is to provide a real rate of return of 5% or more before fees. Historically, the majority of returns comes from income. Mr. Maturo reviewed asset allocations as compared with the benchmark. TPF is geographically similar to the benchmark in focusing on the U.S. east and west coasts. The 3-year plan is to increase the west coast allocation.

Reviewing valuation changes through the third quarter of 2019, Mr. Maturo pointed out the strong allocation to the mall side and the disparity in valuation of TPF versus the benchmark. He explained that after the initial asset write-downs, a significant move up in the discount rate used by independent appraisers had a negative impact on TPF asset values. Jonny Gould of the Callan Real Assets Consulting group inquired about bids on malls that are on the market. In response, Mr. Maturo said the bids received on one mall on the market are lower than the appraised value by about 10%. He explained this mall is a redevelopment property for the next buyer.

During 2019 there were $430 million in new investments and $2 billion of assets sold across sectors including hotels and older apartment communities. Going forward the 3-year plan is to increase the apartment allocation to 37% of the fund, increase industrial to 20% and decrease office exposure. Retail will be reduced to a 16% allocation through two mall sales. In response to Chair Klein's inquiry about acquisition transactions, Mr. Maturo explained it is standard practice for UBS to bring 95% of the equity investment with a developer as a fixed investment. Once there is a stable valuation point, developers like to exit with a put option. Then, UBS decides whether to purchase the developer's interest based on a negotiated price for the property. Trustee Werby asked about the premium in these developments and Mr. Maturo replied the premium has come down from 36% to 15 to 20% as the market has matured. The risk for TPF is in the lease-up period, he explained.

Trustee Silberstein noted the TPF $20 billion fund value has over $5 billion in the redemption queue and the new fee program will result in less revenue to support ongoing operations. Given less revenue, he asked "are you or anyone you know looking for another job." Mr. Maturo replied no, he is not looking for another job. He agreed fees will be lower and income is dropping, but said it is still a profitable business. Mr. Maturo further stated there are always people looking for other employment, especially in a low unemployment market, but in the San Francisco and Hartford offices there is a core group of people who believe in the culture and what the fund is doing who have no plans of leaving UBS. Chair Klein questioned making any acquisitions, given the redemption queue. Mr. Maturo replied there is a mechanism to provide liquidity that is balanced by new investments that are expected to be accretive to TPF. In order to reduce the redemption pool, performance needs to be improved. Mr. Maturo said the team is expecting some recisions from the redemption pool. He further stated that the portfolio manager is moving to more active management by cycling the portfolio more often to capture returns.

Trustee Given asked how many other properties in TPF are overvalued and Mr. Maturo said 60% of the portfolio that he termed power centers have had stable values for two quarters and have sold at that valuation. Values may still be off in the large mall properties, he said, as the buyer market is not very deep. He pointed out that the valuation of TPF is 100 basis points less than the benchmark and this is an industry-wide issue. Trustee Given asked how UBS adjusts for investors in the redemption queue who are exiting at higher values. In response, Mr. Maturo said unfortunately, there is a level of value that is higher for those exiting if those values continue to decline. During 2020 there may be readjustments lower as the two malls on the market are sold.

Mia Dennis of UBS Portfolio and Client Services stated there have not been enough sales to set the value of large malls. Ms. Dennis discussed fee programs offered for election until January of 2021. The first is a 15% or 25% fee discount for 3- or 4-year commitments, respectively. The second incentive is for new money at zero fee up to the amount currently invested. She reported UBS has had good interest in the fee incentives from existing clients. Ms. Dennis reported that net redemptions began in 2016 and by the second quarter of 2018, more people wanted to redeem. UBS is waiting to see if TPF performance picks up in the next few quarters. Mr. Callahan clarified that the loyalty incentives are not hard lockups and investors can designate part of their investment to go into the redemption pool.

Chair Klein recessed the meeting for a break at 10:54 a.m., reconvening at 11:07 a.m.

C. NEW BUSINESS

1. Core Real Estate Allocation Strategy Review – Callan LLC – Jim Callahan, Jonny Gould

   Mr. Callahan introduced Jonny Gould of the Callan Real Assets Consulting group to present the core real estate allocation strategy review. Mr. Callahan stated the bigger issues are how to interpret what is going on at UBS and what are the alternatives as to what the Committee wants to do with its core real estate portfolio.

   Trustee Silberstein asked if UBS marked Trumbull Property Fund assets down more or less than a peer fund would do. Secondly, he asked about the potential for mark-downs in other investments in the future. In response, Mr. Gould stated the TPF asset quality compared to other regional malls was poor and this led to vacancy challenges. Since bids are still lower, Mr. Gould expects write-downs will continue but he is not sure to what extent, other than they would not be as severe as last year's write-downs in regional malls. Trustee Block asked whether write-downs correlated with new management coming in, and Mr. Gould said yes as the new portfolio manager wanted to reposition the portfolio. Since bids were much below valuations, UBS did not sell but did write-downs instead.

   Chair Klein asked about the valuation process in the industry as to who makes the decision and what is the standard. Mr. Gould replied that the NFI Open End Diversified Core Index (ODCE) is the benchmark and all assets are valued once per year. He pointed out that different assets trade with different frequency, and large malls sales are limited so valuations tend to be more off. Valuation is determined by a third party on a quarterly basis for each asset group. Mr. Callahan added the ODCE represents 21 funds like UBS and the valuation is done around the year on a rotating basis. There is a valuation index that is updated quarterly.

   Trustee Given noted the $5.4 billion redemption queue is a lot on a $20 billion vehicle. He asked where MCERA stands as compared with funds similar to TPF, and how will the redemption queue affect returns when UBS sells TFP property. Mr. Gould replied there is a universe of open-end core real estate funds of varying values. The more comparable larger funds include the J.P. Morgan fund, and Morgan Stanley's fund, for example. Mr. Gould pointed out that smaller funds can be more nimble. Trustee Given asked if other funds are requesting full redemptions and what is the rest of the market doing. Mr. Gould replied that UBS by far has the most challenges that are fairly unique to UBS. Mr. Callahan indicated there are a number of considerations, including a risk in deciding to pivot. He stated the universe has many different types of funds with different retail exposure. What the impact on this universe is unknown. Some funds have written down properties more quickly than others. It is known the changes going on in retail, he said, and generally Callan would expect some impact on the retail allocation. If MCERA goes into the TPF redemption queue it will take several years to get the funds, Mr. Callahan said, and then the question is where to invest it.

Trustee Block said that based on Callan's presentation, the chart of spreads of several real estate-related indicators, it may not be so bad to get the cash back now. Mr. Callahan noted these funds once had entry queues due to low interest rates. Since then cap rates have come down and real estate has appreciated significantly. Mr. Callahan observed that the return chart for real estate looks similar for other asset classes, so the question is where to allocate any redemption from TPF. Real estate returns now are more from income, he said, which is what you would expect long-term from a core real estate fund. Mr. Callahan said it is not clear how this will settle out.

Trustee Silberstein noted MCERA is a long-term investor and the Committee should not get too upset in short-term situations. Even if MCERA went into the redemption queue, it would be years to redeem MCERA's investment in TPF. He suggested not following the crowd by jumping into the queue, saying the wise thing to do is to take the 25% fee reduction offered in the TPF 4-year loyalty incentive and keep UBS on the watchlist. Mr. Gould said several Callan clients have considered this approach and added the 4-year term is not a hard lock up. Mr. Callahan pointed out the MCERA's real estate allocation is all core and this structure can be revisited.

Trustee Block asked how much more pressure redemptions will put on TPF, when does UBS become cash constrained, how would that affect asset values, and is there a secondary market for MCERA's position. In response, Mr. Gould explained that UBS is under no obligation to sell assets to satisfy TPF redemption requests. With new money they can try to reverse the redemption requests, he said, and protections are in place to try to reposition TPF to improve its performance. Mr. Callahan pointed out that some in the redemption queue are requesting only a portion of their investment in the TPF. When Trustee Block noted the redemption queue is increasing, Mr. Gould observed the flow is decelerating since the 3rd quarter of 2019. There are secondary markets, he said, but the valuation would be much lower.

Trustee Werby said he believes the managers did a poor job not realizing big retail malls would be a problem. Noting that it is expensive to move real estate assets around, he asked for Mr. Callahan's recommendation. Mr. Callahan replied there are a number of reasonable approaches and moving to a different asset class would take time to consider. Mr. Callahan stated his recommendation is to rebalance the real estate allocation back to 50-50 with UBS and AEW by issuing a small redemption request and then taking the TPF 4-year loyalty program on the balance to reduce the fee. Mr. Callahan said this makes the most sense as a long-term investor to stay the course.

Chair Klein asked how the overallocation to TPF occurred. In response, Anne Heaphy, Senior Vice President with Callan, explained that when MCERA got out of another real estate fund the proceeds went into UBS because of the availability. Mr. Wickman noted we also reinvest distributions back into UBS. Mr. Callahan indicated rebalancing would mean moving $20 million. Trustee Block suggested redeeming 100%, seeing how much we get during the year the TPF loyalty incentive deal is still available, and then putting the rest in the deal that is offered. Trustee Silberstein stated that any redemption would be very small over the next year, but if we take the fee reduction, we know we get immediate savings.

Trustee Block moved to request immediately the redemption of 100% of MCERA's investment in the UBS Trumbull Property Fund. The motion failed due to the lack of a second.

It was M/S Silberstein/Gladstern to accept the UBS loyalty incentive of a 25% fee discount on MCERA's investment in TPF that will be committed for 4 years and to keep UBS on the watchlist.

Trustee Block expressed his view that with the current motion we are not buying low because he believes TPF asset values are likely to have more write-downs; as they happen, redemptions are more valuable earlier rather than later. He is against trying to make up write-downs with reduced fees. In response, Trustee Silberstein said this is all speculation; the Fund is a diversified portfolio and the Committee needs to look more carefully at its TPF holding rather than just moving out of the fund. Trustee Gladstern observed that it took years to get into the TPF vehicle and it would be nice to get a fee reduction. There is no hurry, she added. The motion failed on the following 4-5 vote:

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

It was M/S Block/Werby to issue a $50 million redemption request from the UBS Trumbull Property Fund and accept the UBS loyalty incentive of a 25% fee discount on MCERA's remaining investment that will be committed for 4 years.

Trustee Cooper expressed a preference to redeem a lower amount.

Trustee Cooper made a substitute motion to issue a $20 million redemption request and accept the UBS loyalty incentive of a 25% fee discount on MCERA's remaining investment that will be committed for 4 years. This motion was seconded by Trustee Silberstein.

Trustee Block stated he prefers getting out of TPF since management is not where it should have been.

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

Mr. Callahan asked if the Committee wants to see additional information on UBS. Trustee Block requested updates on the UBS redemption queue and Callan will include this in its quarterly report. Callan will update the Committee on UBS peer funds and its plans going forward for TPF based on requests by Chair Klein and Trustee Given, respectively.

2. <u>Parametric Portfolio Associates Personnel Update</u>

Anne Heaphy, Senior Vice President with Callan, reported the announcement by Parametric Portfolio Associates that the Head of Global Equities Portfolio Management, Jodi Wong, will depart the firm for personal reasons. Ms. Heaphy said that the emerging markets strategy is systematically managed on a team basis in a quantitative process, meaning there is not a key portfolio manager. Of the five other members of the Global Equities team, two are senior members. Ms. Heaphy said that Parametric has grown to become larger institution and Callan is not concerned about one person leaving. Experienced staff remain at the firm and there is no disruption to the portfolio management process. Trustee Werby asked if there is concern about two high-level women leaving the firm. In response, Ms. Heaphy indicated she recently visited the firm and she believes the departure of Ms. Wong was amicable and did not represent a broader concern. As a sign of this Ms. Wong continues to work with Parametric during the transition.

D. INVESTMENT CONSULTANT PERFORMANCE UPDATE

Mr. Callahan presented Callan's preliminary flash performance report net of fees through December of 2019. He reported there are many good numbers on the report, such as the 27% calendar year 2019 return for the Fund's domestic equity portfolio. The DFA domestic small cap equity portfolio underperformed its benchmark in that period. The international equity and public real assets portfolios outperformed respective benchmarks for the calendar year. For the total Fund, the preliminary return for the 2019 calendar year is 18.3% and 5.5% for the mid-way point of the 2019-20 fiscal year ending June 30, 2020.

There being no further business, Chair Klein adjourned the meeting at 12:27 p.m.

Sara Klein, Chair

Attest: Jeff Wickman
Retirement Administrator