MINUTES

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

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

June 17, 2020 – 9:00 a.m.

This meeting will be held via teleconference pursuant to Executive Order N-25-20, issued by Governor Newsom on March 12, 2020, Executive Order N-29-20, issued by Governor Newsom on March 17, 2020, and Executive Order N-35-20, issued by Governor Newsom on March 21, 2020.

The public may listen to and observe the meeting on YouTube at: https://youtu.be/G1Crfi9UdKs.

If members of the public wish to comment, those comments may be submitted to MCERA via email at MCERABoard@marincounty.org. This account will be monitored prior to and for the duration of the meeting. If the comment pertains to a particular agenda item, please identify that item number and the comment will be read to the Committee during that discussion. Otherwise, the comment will be read under Item A, Open Time for Public Expression. All public comments submitted before or during the meeting that pertain to topics within the jurisdiction of the MCERA Board and otherwise comply with MCERA guidelines will be read in open session and kept as part of the permanent record.

The Board of Retirement encourages a respectful presentation of public views to the Committee. The Committee, 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 Committee meetings.

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, Thomas, Werby

ABSENT: None

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 REPORTS

1. Manager Overview – Jim Callahan, Callan LLC

   Jim Callahan, President of Callan LLC, said today's portfolio reviews are the Balanced-Risk Commodity Trust, managed by Invesco, and the international growth equity portfolio managed by Artisan Partners.

2. Invesco - Commodities – David Gluch, Delia Roges – 9:05 a.m.

   Delia Roges, Managing Director, Invesco, introduced David Gluch, Senior Client Portfolio Manager and a member of the global asset allocation team, who presented the Balanced-Risk Commodity Trust portfolio review. Mr. Gluch reported the Bloomberg Commodity Index (benchmark) is trading at an all-time low. This is the worst commodities bear market in modern history, he stated, noting that financial assets are trading in their top decile. In the first quarter of 2020 commodities were down 23%. It is not surprising to see a recovery since then, he said, but it has been tepid. Mr. Gluch said going forward the question is whether disinflation continues, or inflation occurs. In the quarter ending March 31, 2020, the commodities portfolio returned negative 25.55% (versus 23.29% for the Bloomberg Commodity Index.)

   Mr. Gluch explained how an economist would make the case for deflation or disinflation. The case for deflation is that the U.S. debt burden relative to the level of production is too high and has low cash flow payback. Due to demographics more people are tapping Social Security, for example, and it is necessary to borrow the money to provide these benefits. More debt suppresses inflation and economic growth and leads to low yields. Mr. Gluch stated that the only way to remove disinflation is to devalue the currency.

   The case for inflation is that inflation is the antidote to the debt burden. There are two aspects, monetary policy and the commodity markets. For monetary policy, central banks will have to buy much of the debt. Now they are buying corporate debt, including junk bonds. Mr. Gluch said they have to keep interest rates low to maintain the debt service. The commodities aspect is that most commodities in the world are priced in U.S. dollars. Mr. Gluch pointed out that periods of low production take a long time to recover. Also, COVID-19 could lead to deglobalization which increases the risk of supply shock.

   Mr. Gluch stated that inflation is the only practical solution to managing the debt. An inflation indicator is the price of gold relative to the money supply. The key is the confidence in the U.S. dollar, he said, as to what happens with commodities. The dollar is trading in the middle of a long-term range and the market is trying to determine whether it will be inflation or deflation.

Mr. Gluch explained that commodities are diversifiers and their diversification value is dependent on the economic environment. If inflation is rising and a concern, then commodities benefit, which is why MCERA should maintain the commodity hedge in the portfolio. He added that bonds no longer would be a safe haven. Mr. Gluch emphasized the scarcity function in commodities makes the forward-looking opportunities look promising. The investment team will continue to make tactical adjustments to match the portfolio to the environment at hand.

In conclusion, Mr. Gluch reviewed sectors and performance. In the first quarter of 2020, energy and industrial metals were the worst performers as they are most sensitive to the economy. In that period the VIX (CBOE Volatility Index) was four times higher than during the Financial Crisis, and the energy space and other sectors were overleveraged After underperforming in March, in recent months the commodities portfolio has been outperforming the benchmark. Mr. Gluch attributed this to the portfolio being positioned correctly.

3. Artisan Partners – International Growth Equity – Sean Howley, Andrew Euretig – 9:25 a.m.

Sean Howley, a Managing Director with Artisan Partners, stated stock market performance in the first quarter of 2020 shows the impact of COVID-19. Through May 2020 markets have an improved tone, he said. The Artisan international growth portfolio is still outperforming the benchmark and added alpha in the first and second quarters. The performance driver has been stock selection. For the quarter ending March 31, 2020 the Artisan international growth portfolio returned negative 21.42% (versus negative 22.83% for the MSCI EAFE Index.)

Mr. Howley introduced Andrew Euretig, a Managing Director with Artisan Partners and a Portfolio Manager on the Global Equity team. Mr. Euretig said the investment strategy includes looking for secular growth opportunities and underappreciated quality. He observed that 2020 has been the most challenging time to balance those factors, with equity markets at all-time highs and then the economic lockdown. He noted that the firm is supporting staff working from home. Key growth factors are still intact, and themes are still working. Trade war issues with China are still front and center, so the investment team is balancing that situation.

Mr. Euretig reviewed new additions to the portfolio that have high growth and benefit from the staying at home environment. An example is a business improving indoor air quality. Other opportunities are in the 5G buildout and in health care. Four out of five contributors to performance in the first quarter of 2020 were health care companies. The industrial sector is being reduced given current uncertainties. Environmental trends are accelerating further, notably the Green New Deal in Europe that is being discussed. Companies expected to benefit include wind and solar generation companies. He noted they exited positions in European banks due to regulatory concerns. The team continues to seek secular growth opportunities.

Trustee Silberstein asked about Petrobras which used to be one of the portfolio's larger holdings. He said Petrobras has been subject to scandals and asked why Artisan included them in the portfolio. In response Mr. Euretig explained that the idea was the Petrobras governance was improving. If the level of corruption could be corrected, it would be a good opportunity. The analysis was that gasoline will be needed for a long time and deep-water oil is the cleanest and lowest cost. Mr. Euretig acknowledged the analysis was a mistake and Artisan exited the position. Chair Klein asked when the exit occurred, and Mr. Euretig replied it was two or three months ago. Mr. Euretig pointed out that historically Artisan has strong environmental-social-governance (ESG) credentials. He further stated that the portfolio as a whole has half the carbon emission of the benchmark. Trustee Silberstein asked whether Artisan will receive any of the $3 billion Petrobras settlement. Mr. Euretig replied no, adding that a lot of that was already priced into the stock. Mr. Euretig stated Artisan has a track record of engaging with companies that are turning governance around. The concept is to reward companies trying to do the right thing.

Trustee Werby said he noticed many S&P 500 stocks in the portfolio. Mr. Euretig explained that Artisan invests in category leaders with strong overseas business. The reason is that there is no European equivalent to Amazon, for example.

C. <u>NEW BUSINESS</u>

1. <u>Capital Market Projections and Asset Allocation Review – Jay Kloepfer, Callan LLC – 10:00 a.m.</u>

   Jay Kloepfer, Executive Vice President with Callan LLC, stated the purpose of developing capital market projections is to set long term investment goals and to build portfolios. The projections set reasonable return and risk expectations for the next ten years. Callan takes a conservative approach to looking at capital markets, based on the belief in taking risk to get return and ultimately markets will clear and are rational. Building blocks for the projections include determining the path for inflation and future interest rates, which will be a challenge, and the economic outlook that knits everything together. Also, projections look at how asset classes interact. Once developed, projections are examined to determine if the results are reasonable.

   Mr. Kloepfer pointed out that a crisis is the worst time to change assumptions. He discussed a chart comparing six episodes of severe drawdowns in the equity market. It shows the pandemic event in the first quarter of 2020 which was the fastest market drop in recent history, declining 33.4% after 23 days. Currently, the equity market is close to recovering to the level prior to the March, but uncertainty prevails. The pandemic was a natural disaster we have never seen, he said. Chair Klein asked for a comparison of the monetary responses to prior market declines and the current crisis. Mr. Kloepfer noted the monetary response was very fast because the Fed had a playbook as compared with prior market drawdowns. This stabilized the financial markets. An example is the CARES Act passed by Congress. The best we can do is treat the symptoms, he said. He said that until there is a solution on the health side, there will be hiccups as to how we pull out of this.

The 40% drop in GDP in the second quarter of 2020 has never been seen before, he said. The initial spike in the volatility index was unusual through March and has settled back, but not to its long-term average.

Mr. Kloepfer discussed current economic and fiscal conditions. The U.S. Treasury yield curve has shifted down over the last six months, especially on the short end of the curve. It is back to zero interest rate policy for the federal funds rate, he said, and the Fed (Federal Reserve Board) is not expecting to raise rates in the near future. He noted that tax revenue will be hit hard at the state and local government level. Some of the biggest declines in employment were related to health care areas that were displaced by COVID-19. Since consumption is 70% of GDP, unemployment is an issue for the economy.

Mr. Kloepfer said a V-shaped recovery in the economy seems to be a smaller probability, as is typical of most natural disasters. The expectation is for a U-shaped recovery which suggests a strong bounce-back a year or two from now. Discussing aspects of monetary policy, Mr. Kloepfer said the stimulus prevented a worse economic outcome, but sustainability of the larger debt level is a question. He noted loan facilities are cost-neutral and low interest rates ease the debt service burden. Loss of tax revenue is a big problem, he said. Borrowing at low interest rates to invest in infrastructure could help the economy grow faster.

Chair Klein asked about yield caps being considered by the Fed, and if the Fed's balance sheet is unlimited. Mr. Kloepfer replied it is unlimited. He said the Fed holds securities until maturity and may end up not making a real return. Trustee Werby asked if there could be high inflation and low interest rates. Mr. Kloepfer replied it is hard to see how unless it were a direct policy move by the Fed. Chair Klein asked if there been talk about lowering Callan's inflation forecast. Mr. Kloepfer said inflation is discussed every year. A slightly overstated inflation is more beneficial than not, and he would be reluctant to set inflation below 2%.

Callan's capital market assumptions for this year are:

Broad Domestic Equity	7.15%
Global Ex-U.S. Equity	7.25%
Domestic Fixed Income	2.75%
Private Equity	8.50%
Real Assets	6.05%
Cash Equivalents	2.25%

Callan lowered the fixed income expectation at the start of the year due to the change in Fed policy in 2019. Trustee Silberstein asked about commodities that has one of the lowest expected returns. Mr. Kloepfer said commodities are a hedge against inflation and a diversifier with volatility similar to small cap equities. Trustee Block asked whether it is realistic to be using the baseline projections in view of various economic recovery scenarios. In response, Mr. Kloepfer indicated that the 10-year return could be less than the projected 6.7%, but he pointed out that there are a range of potential outcomes in the capital market projections.

Mr. Kloepfer stated the current portfolio roughly aligns with Mix 3 asset allocations presented in the report. Chair Klein asked if correlations among asset classes were changed and Mr. Kloepfer said not since January. Trustee Silberstein proposed eliminating commodities from the portfolio, and Mr. Callahan said we can have that discussion. Chair Klein said commodities can be considered at the next Committee meeting and Mr. Wickman will add it to the agenda.

Mr. Kloepfer stated the COVID-19 crisis has created imbalances and noted the solution to the health crisis is still unresolved. Trustee Block said the scenario chart reflects we will not return to the mean over ten years and asked if this occurred after the financial crisis. It depends on the start date, Mr. Kloepfer said, adding that the peak-to-peak comparison is close. Mr. Kloepfer noted the projections were adjusted after the first quarter and reviewed the recovery scenarios, including W-shaped and swoosh-shaped recoveries. Trustee Block said there will be more visibility at the end of the year. Mr. Kloepfer noted the difficulty of projecting when air travel and unemployment, for example, will recover.

Mr. Wickman said actuary Graham Schmidt will be doing an Experience Study this summer and will collect capital market projection data from Callan and other investment advisors. The Experience Study will be brought to the Board to discuss economic factors and consider changes it may want to make.

Chair Klein recessed the meeting for a break at 11:15 a.m., reconvening at 11:25 a.m.

2. Investment Opportunities – Distressed Investments – Catherine Beard, Senior Vice President, Alternatives Consulting Group, Callan LLC – 10:45 a.m.

   Mr. Callahan introduced Catherine Beard from the Callan Alternatives Consulting Group to discuss investment opportunities in distressed debt. Ms. Beard said distressed debt is an emerging investment opportunity that has evolved as a result of current market volatility and corporate distress due to the COVID-19 dislocation. Ms. Beard said the high-yield loan index is experiencing an impact due to downgrades and potential stress situations. She reviewed expected default frequencies in response to Chair Klein's inquiry. Chair Klein asked about data on high-yield spreads. Ms. Beard said prior to the dislocation spreads were close to historical highs relative to U.S. Treasurys. Since then spreads have come in and Ms. Beard expects continued volatility in those spreads.

   Corporate default rates in U.S. high-yield market were around 20% but with quantitative easing default rates came down significantly from their peak. Many companies were able to access the capital markets and find solutions to maturing debt. The expectation is that default rates will climb to prior peaks. Also, there are investment grade companies that are expected to be downgraded to high-yield levels.

   Private credit is an emerging asset class due to banks stepping away from traditional financing areas driven by tightening regulations. There are significant private credit areas in finance lending, special situations, and distressed debt. The underlying structures are drawdown in nature, similar to a private equity structure, with a 3-year investment and 3-year harvesting period. She outlined three phases of distressed debt opportunities. The first phase may include high-quality securities purchased at significant discounts. Other opportunities are providing rescue finance and bridge loans to get firms through the COVID-19 shutdown. In Phase 2 that is starting to emerge, more technically driven opportunities start to wind down. This phase involves stressed business that need short-term liquidity. The third phase is over the next two to three years involving leading companies through restructuring. Distressed debt managers may work across all opportunities or fewer.

Distressed debt managers Callan is looking at have generated significant internal rates of return in the double digits. Callan is examining their expertise in different areas, including managers who can take an opportunistic approach to direct lending. This can be for distressed companies for bridge financing and advising on turnaround situations.

In conclusion, Ms. Beard stated Callan is working with a number of clients in executing these opportunities. Some clients set a 10% bucket, and some replace fixed income assets. Ms. Beard offered to go into more detail on Callan's top manager picks at a future meeting and responded to further trustee inquiries.

Trustee Gladstern asked if this is a short-term investment. Ms. Beard said the outsized investment opportunity is expected to unfold in the next two years. There is typically a 3-year investment period and 3-year harvesting period. In that time capital can be recycled more quickly than 3 years into new opportunities. Trustee Werby asked if our private equity managers are in this space and Mr. Callahan said Pathway may have a small amount of distressed debt. Chair Klein asked how much leverage is employed by these funds. Ms. Beard replied leverage is 20 to 30% in the typical amount. Trustee Block noted Oak Tree is not included in Callan's top group. Ms. Beard said Callan is moderately positive on Oak Tree in that it has a relatively large portfolio that has led to challenges in driving performance.

Trustee Block discussed where the money would come from to invest in this area. Mr. Callahan said equity would make the most sense due to the similar risk-return aspect. The range of the bucket may by 0% to 5 or 8%. Or, it could be included in the private equity portfolio by expanding the definition of private investments. Another option could be a new asset class for an absolute return allocation. Trustee Block asked how the risk profile compares with equity. Mr. Kloepfer said distressed debt is more risky than high yield, not as risky as equities, and more risky than fixed income. Mr. Callahan noted the funds are targeting low- to high-teen internal rates of return, so the risk should reflect that relative to lower equity returns. Ms. Beard added that value creation and average recovery periods are important factors being considered. Trustee Werby asked if the allocation should consider our global allocation. Ms. Beard said a global approach broadens the opportunity set. Mr. Callahan said the effect on the allocations at the portfolio level would be minimal. Trustee Block asked if the fund-of-fund structure is used. Ms. Beard replied this is available, but you are paying fees on top of fees, so direct investments are the preferred structure. Mr. Callahan indicated hiring two or three private debt manager would be a reasonable approach. Trustee Silberstein noted there is likely to be overlap so having too many managers may not add to diversification.

Mr. Callahan asked for direction on the matter. Trustee Werby said we should be considering private debt and Trustees Silberstein and Murphy agreed. Chair Klein requested that Callan bring information on private debt managers for consideration by the Committee.

3. Investment Manager Update – Parametric Emerging Markets, Anne Heaphy, Callan LLC

   Anne Heaphy, Vice President with Callan LLC, reported that Parametric updated its investment process for the emerging markets strategy. The strategy differs from the benchmark; for example, frontier markets are included, and China is relatively underweighted to the benchmark. The modification is to the "Super-Tier" rule to increase the weighting of China from 12% to 19% of the portfolio. Other modifications will be made to achieve balance in sector weights relative to the total portfolio. Weights for financials and information technology will be optimized. Ms. Heaphy stated that these adjustments are in line with changes across the asset class over time and Callan is comfortable with them.

4. Investment Manager Update - UBS Trumbull Property Fund, Anne Heaphy, Callan LLC

   Ms. Heaphy reported that the Head of UBS Realty and the UBS Head of Realty Acquisitions at UBS were replaced. Matt Johnson is now the head of UBS Realty and portfolio managers for the Trumbull Property Fund (TPF) report to him. This is a potentially positive change, Ms. Heaphy said, and Callan will continue to monitor how TPF progresses.

5. Investment Manager Update – AEW Core Property Trust, Anne Heaphy, Callan LLC

   Last week AEW announced that Mike Byrne, Senior Portfolio Manager, will be moving up to Chief Investment Officer for AEW. Portfolio Managers Sara Cassidy and Lily Kao were promoted to Senior Portfolio Managers of the Core Property Trust. Callan sees this as positive and the result of planned succession.

6. Disposition of Dividends in Real Estate Portfolio – Anne Heaphy, Callan LLC
   Consider and take possible action on disposition of dividends received in AEW and UBS real estate portfolios

   Ms. Heaphy said currently MCERA receives real estate portfolio dividends on a quarterly basis that are reinvested. The Committee can determine to receive the payouts rather than reinvest them.

Trustee Silberstein made a motion to receive dividend payouts from the AEW and UBS real estate portfolios.

Mr. Wickman said the option to receive dividends is already in place and the Committee could direct the Administrator to do so. Trustee Silberstein said the dividends would be used for cash flow, noting it is an easier way to withdraw money from the real estate funds sooner. Trustee Block agreed for the UBS portfolio but asked Mr. Callahan for his opinion on the AEW portfolio. Mr. Callahan said it seems reasonable to harvest the dividends. Chair Klein and Trustee Given agreed, and Counsel Dunning affirmed the process outlined by the Administrator. Trustee Silberstein withdrew his motion and the Chair directed the Administrator to set up receiving dividends from the AEW and UBS real estate portfolios.

7. Investment Policy Statement Updates (**Action**)
   Consider and take possible action on recommended amendments to Investment Policy Statement regarding Appendix B-8, Western Asset Management, Statement of Objectives, Guidelines & Procedures: Update guidelines to reflect increased limitations to contingent convertible securities and preferred stock and below investment grade securities.

   Ms. Heaphy said the only change to the Investment Policy Statement is the slight modification approved at the last Committee meeting. The revision is to allow Western Asset to invest up to 10% in contingent convertibles and preferred stock and increase the investment level of below investment-grade securities.

It was M/S Gladstern/Given to approve updates to the Investment Policy Statement as presented.

Trustee Silberstein noted in the Investment Policy Statement there are inconsistencies with the Proxy Voting and Governance Policy in the way the proxy voting policy is expressed. The Administrator noted the inconsistency and said he will bring a revision to a future meeting for approval.

The motion was approved by a unanimous vote of 9-0 as follows:

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

D. INVESTMENT CONSULTANT QUARTERLY REPORT

1. Quarterly Report as of March 31, 2020
   a. Summary Report

Mr. Callahan presented the summary performance report for the first quarter of 2020. Asset allocations as of March 31, 2020 were reviewed that show domestic equity at the low end of its range and private equity at the high end of its range. Mr. Callahan highlighted the portfolio return and rebalancing in late February by selling equity and adding to the fixed income portfolio. He pointed out that the rebalancing was good timing due to the subsequent decline in equities in March. Some of the funds were used to defer expenses for MCERA. The Fund was down 13.5% in the first quarter of 2020 and is down about 5% over the past year. Returns over longer time frames look better.

Morgan Stanley no longer qualifies for the Watchlist, and the Invesco Commodities fund qualifies for addition to the Watchlist. The Committee reviews the Watchlist once per year in December. Mr. Callahan referenced performance of open-ended core real estate funds managed by AEW and UBS. He stated that AEW wrote down a quantity of their retail portfolio. Rent collections for April and May remain strong. Returns by property type for the quarter were provided, as were weights of the funds to retail. Transaction activity in commercial real estate is almost at a halt, he said. This makes it harder for appraisers to make adjustments to property valuations. Addressing the valuation time lag, Mr. Callahan noted after the financial crisis real estate valuations were written down in the following year.

b. Flash Performance Report – May 31, 2020

April and May saw sharp rebounds in the equity markets. Domestic equity portfolio trails due to the overweight to small cap and DFA has underperformed the benchmark over the period. DFA is tilted toward value which has underperformed growth. International equities outperformed the benchmark with both Artisan and Morgan Stanley performing well. TimeSquare underweight to China explains its underperformance. Portfolio outperforming in May fixed income with all. Tips and REITs are passively invested. Invesco Commodities improved in April and May. KBI Natural Resources portfolio protected well in the calendar year to date period. Trustee Block asked when there would be more updated returns from private equity. Private equity valuations are typically six months old, Mr. Callahan said. He said appraisal-based valuations take time and there are no comparison sales to work with.

Trustee Klein asked if we should be expecting more distributions from the older funds. Mr. Callahan said the distribution activity had been starting to pick up before the first quarter. These are appraisal-based valuations and will take time to funnel through.

In summary, Mr. Callahan said Callan will follow up on the public real asset structure, and distressed debt manager options. Chair Klein asked if Callan could consider putting it into equity and reduce exposure to small cap equities. Ms. Beard stated funding could come from equity but not be classified in that asset class. Trustee Block proposed a presentation on our overall derivatives exposure, including with respect to Colchester. Mr. Wickman indicated this topic can be presented at a future meeting.

There being no further business, Chair Klein adjourned the meeting at 12:50 p.m.

Jeff Wickman	Michelle Hardesty
Retirement Administrator	Assistant Retirement Administrator
On Behalf of:	On Behalf of:
Sara Klein, Committee Chair	Jeff Wickman, Retirement Administrator