MINUTES

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

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

September 17, 2020 – 9:00 a.m.

This meeting was 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.

CALL TO ORDER

Chair Klein called the meeting to order at 9:06 a.m.

ROLL CALL

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

ABSENT: Cooper, Poirier (alternate safety)

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 Debt Manager Interviews
   Conduct interviews with potential private debt managers.

a. Manager Overview – Jim Callahan, President, Callan LLC.

Jim Callahan, President of Callan LLC, stated the Investment Committee is interviewing three private debt managers today for a potential allocation. After the interviews, if the Committee chooses to go forward, there will be discussion to determine where private debt fits into the portfolio and the size of the potential allocation. The Committee is joined again by private debt specialist Catherine Beard of Callan.

b. CarVal – 9:15 a.m. – Lucas Detor, Matthew Hanson

Matthew Hanson, Managing Director of Investor Relations with CarVal, stated the firm has a 30-year approach to investing in the private and public credit markets. Due to COVID-19 a classic distress cycle has emerged providing investment opportunities. These include nonperforming loans which are a $2.2 trillion opportunity set. The U.S. default loan rate and levered loan market are increasing, and banks are responding in kind with over $50 billion of loan loss provisions in the first quarter of 2020 alone.

Mr. Hanson said CarVal employs fundamental value investing using a multi-strategy approach. The investment process includes sitting on credit committees and influencing restructuring. Fund returns have been almost always in the first quartile of peers. The commonality of CarVal Credit Value Funds II, III and IV is organic cash flows that can be distributed back to investors. Mr. Hanson introduced Lucas Detor, one of the three Managing Principals of CarVal.

Mr. Detor said CarVal invests in the best global opportunities including corporate securities, loan portfolios purchased from banks, structured credit and hard assets. He explained that structured credit involves pooling assets and selling debt against the assets. Hard assets are in the aviation and renewable energy sectors where CarVal is seeing opportunities. Portfolios are brought together by determining base cash flow for every deal. The upside and downside is analyzed to assess risk and mitigate the downside, he said, noting the investment team's loss ratio is in the low single digits. The firm does not use a lot of leverage and is patient with its investments. He emphasized the importance of sourcing ideas through CarVal's network. Mr. Detor pointed out that the Great Financial Crisis was a good pressure test for the strategy, and it performed well.

Trustee Gladstern asked about diversity on the investment team. Mr. Detor replied there is a woman at the top of the organization and the plan is to focus on hiring diversity in the investment team.

Mr. Detor discussed examples of how CarVal gets involved in organizing disorganized cash flows or loan portfolios and turns them into viable investments. CarVal made a loan based on a price reduction of a hotel and is getting paid 15% interest with an added equity interest. The hotel is expected to recover in the next three or four years. In another example partners purchased and operate a solar farm at an 8% unlevered yield to CarVal and 20-year contract. CarVal sold the debt at a 3% yield and makes additional return there. In a different scenario, CarVal purchased the debt of a bankrupt satellite firm at the 50- 60 cents on the dollar level. The firm has a good management team and is expected to come out of Chapter 11 bankruptcy with a successful business.

Mr. Hanson stated Credit Value Fund V raised over $3 billion in the initial close and capital will be capped at $3.5 to 4 billion. Over 8% of funds raised in the first close were reups from prior investors. Ms. Beard asked how the amount of capital in the fund might change the opportunity set and upside potential. Mr. Detor replied the opportunity set has expanded along with the amount of capital raised and he expects continued dislocations in selected sectors. Ms. Beard inquired about alignment of interests. Mr. Detor replied managers are heavily personally invested in the funds, own 100% of the firm, and distributed a second share class to every employee. Compensation for investors is full return of investment and compound interest before CarVal receives any fee. Ms. Beard also asked about distressed residential mortgages and Mr. Detor replied most of this is in reperformance loans. The best workout is to keep the resident in the home since in foreclosure nobody wins.

Trustee Gladstern asked if CarVal provides ILPA disclosures and Mr. Hanson replied yes and they will provide the disclosures on a regular basis. Trustee Block asked if the Brice (the former President of CarVal) litigation is over and Mr. Detor replied it was settled several years ago. Trustee Werby asked about the special servicing sector and Mr. Detor said CarVal does not provide special services but may work with special service providers.

c. Fortress – 10:15 a.m. – Drew McKnight, Danny Kayne

Managing Director Danny Kayne, Global Head of Consultant Coverage, stated Fortress manages highly diversified investments and targets cash flows. The firm has successfully managed private debt over the last 18 years. In late 2007 and 2008, the investment team anticipated volatility and launched the first of six Credit Opportunities Funds supported by the same investment team. Target returns for Funds I through V have been achieved or exceeded and the Fund V targeted return is 18% or higher. The Fund V Expansion will have 4 years to invest and six years to mature and has a 20% target return. Final funding is in October and the firm has made room for MCERA to invest. Mr. Kayne introduced Drew McKnight, co-Chief Investment Officer and one of the four Managing Partners for Fortress Credit.

Mr. McKnight stated the Fortress Credit Opportunities Fund V Expansion is a top decile credit opportunity set. He said COVID-19 has changed the investing landscape. The first of four credit phases was forced liquidation which is over. Now there is an illiquidity phase with more private transactions and bilateral negotiations. Mr. McKnight said the firm has an active pipeline and its sourcing network is broad. Complex transactions are structured with downside protection. The next cycle will be the reconstruction phase and the need for capital in this phase is expected to be immense, he said.

Mr. McKnight discussed the opportunistic credit investment spectrum and noted all investment ideas are assessed on a relative basis by their Investment Committee. Sectors are lending, corporate debt and securities, portfolios and orphaned assets, real estate, and structured finance. Existing investments are closely managed by a separate asset management function to prevent distraction, he said, calling this a distinguishing characteristic of Fortress. He highlighted patience in recovering investments when things go wrong and investing in countries with Western rule of law to be able enforce contracts.

Trustee Gladstern asked about diversity in the investment committee. Mr. McKnight replied there is one woman and Indian and Muslim members on their Investment Committee. He stated that they were faced with challenges for hiring diversity candidates into their business. Chair Klein asked how Fortress is finding illiquid investment opportunities since capital markets seem liquid now. Mr. McKnight agreed the Federal Reserve Bank (Fed) has improved market liquidity but is not investing in the private markets. He added the opportunities in March and April of 2020 are not around anymore. A recent investment was the purchase in June of a Sur La Table Senior Secured Loan at approximately 30 cents on the dollar with a view to the asset value of the firm. The assumption was Fortress would have to fund the business until it recovered. Some shopping centers offered no-rent opportunities to keep Sur La Table in its space. Ultimately in a bankruptcy auction a bidder offered to pay Fortress at par for the debt. The result was in two months Fortress made 2 ½ times its investment.

Mr. McKnight said Fortress owns a special servicer in Europe which lends insight and has broad servicing relationships across multiple industries. Investment committee members specialize in different asset classes, and the investment pipeline shows Fortress is active across a number of asset classes. Fortress is cautious about commercial real estate space. He discussed the legal asset business which is unique and involves financing the general counsel's business. It does not depend on market exits and is a good diversifier, he said. Chair Klein asked if they are assuming litigation risk and how damages are valued. Mr. McKnight replied technically the company holds the risk. In one investment Fortress calculated the damages, which can triple if there is a judgment, to assess the value of the investment. In this price-fixing case the valuation was based on a price differential of pharmaceutical drugs. Fortress received its investment back with a 10% return and also began sharing in the upside.

Mr. McKnight discussed the triple net lease portfolio, explaining that the real estate underneath a retailer needing liquidity is purchased and leased back to the counterparty. The counterparty is obligated to pay Fortress unless it files for bankruptcy. Trustee Werby asked how Fortress can target a 20% return on net leases. In response, Mr. McKnight said it is financial markets engineering. He gave the example of Amazon paying Fortress a 6% cap rate to lease distribution centers back to Amazon. Fortress then entered into back-to-back financing for 60% investment of the investment which resulted in earning a 3% incremental yield times 1.5. This resulted in a 13% cash-on-cash yield. Finally, Fortress closed a securitization taking the financing 60% to 90% on a cash flow basis, resulting in a return of two times the invested capital. In another example when Amazon bought Whole Foods the public stocks of other grocers went down. Fortress underwrote the Kroger credit risk and real estate at a 7.5% cap rate and financed it in the same way described above. Fortress also bought 70 stores and then sold them at about a 5% cap rate. Mr. McKnight said these examples highlight the depth of Fortress' team, which is a competitive advantage.

Trustee Gladstern asked if Fortress has ILPA disclosures and Mr. Kayne replied he will get back to the Committee on this question. In response to Chair Klein's inquiry, Mr. McKnight said Fortress does not finance the private equity side of Fortress. Fortress will sometimes partner with companies buying assets. Ms. Beard asked about alignment of interests. In response Mr. McKnight said all members of the investment team invest across the capital structure and managers are invested in the Fortress funds. Trustee Werby requested an example of an investment that was not recovered. In response Mr. McKnight said Fortress made a loan to a person who through fraud had not signed the agreement. Fortress litigated and is at about 70% recovery of the investment so far.

Chair Klein recessed the meeting for a break at 11:25 a.m. and reconvened the meeting at 11:35 a.m.

d. Varde – 11:30 a.m. – George Hicks, Brad Bauer, Andrew Knapp

Andrew Knapp, Director and Relationship Manager on Varde's Business Development Team, said Varde developed the Varde Dislocation Fund in response to the stress created by the COVID-19 pandemic. The Dislocation Fund has been active since June 2020 and has deployed over $500 million in capital to date. Mr. Knapp introduced George Hicks, co-Chief Executive Officer who is one of the co-founders and partners of the firm, and Brad Bauer who is a partner and serves as Deputy Chief Investment Officer.

Mr. Hicks gave an overview of the firm, emphasizing its expansive global platform, investment team and culture built up over time. He stressed relationships give the firm the ability to put capital to work in both public and private markets across the globe. Investments are mostly in developed markets in the Corporate and Traded Credit segments. Varde is a value investor looking at 50 cents on the dollar debt opportunities. Mr. Hicks stated default rates are at 6% now and we are at the tail end of the dislocation phase. Moving into the middle cycle, debt markets have stabilized and Varde is beginning to look at bankruptcies in the late stage cycle.

Mr. Bauer said the investment grade market has been the focus of the Dislocation Fund. An example is a triple-net lease REIT in high-quality tenant space. Mr. Bauer said in the emerging mid-cycle the investment focus is on large corporate stress, capital structure dislocation, structured credit, rescue lending, and performing loan portfolios. Going forward, Mr. Bauer is expecting opportunities to emerge in hotels and rescue lending because the level of dislocation is just beginning to be recognized. Rescue lending is centered on primary lending in real estate and financial services. The manager is looking for a return of 1.2 or 1.3 times the investment over about 12 months and then Varde will reinvest. The firm has not done much on the distressed corporate arena, he said. Debt in quality companies may be purchased at 60 cents on the dollar and sold when the company recovers. He noted private equity firms are looking to solve their capital needs due to extended investment periods so Varde sees opportunities there.

Ms. Beard asked about the philosophy around the 18-month investment period and Mr. Bauer replied this was in response to client requests. Ms. Beard asked if the investment opportunity set is sufficient. Mr. Hicks noted they have not seen the snapback in travel and leisure sectors yet and the economic damage is still there. The investment grade opportunity set has largely retraced. They still have a view that distress takes time to play out and they expect to launch a fund to take advantage when the conviction is there.

Trustee Gladstern asked if Varde provides ILPA fee disclosures. Mr. Knapp replied fee disclosure is addressed in side-letter negotiations and they are flexible on that. Trustee Werby asked what percentage of the fund is invested in loan portfolios. Mr. Bauer said it is all corporate traded credit and there are no loan portfolios as of today. He expects minor exposure to loan portfolios going forward. Trustee Murphy asked what expectations are for Fed policy in the mid-cycle phase. Mr. Hicks replied interest rates are expected to continue to be low and therefore financial firms that depend on interest margins will be more challenged.

2. Private Debt Manager Selection (**Action**)
   Consider and take possible action to select manager(s) for private debt allocation

Ms. Beard gave her analysis of the three private debt managers. She stated all are high conviction in their ability to capture dislocation in the private debt markets. They also have broad multi-strategy platforms and have the same 1.5% management fee and 20% carry fee. Returns in the mid to high teens are expected from all three managers.

Distinctive characteristics of the three managers include the following:

- The CarVal Credit Value Fund V has a duration of 6 years with a 3-year investment period which is in the middle of the three managers. CarVal has particular strength in Europe and an area of focus in the renewable energy space. The firm is culturally conservative and a disciplined credit investor.

- Fortress has the broadest and deepest platform with a history of leaning toward complex transactions. Its funds have a slightly stronger historical performance track record and strong loss recovery. The term of the Credit Opportunities Fund V Expansion is 10 years with a 4-year investment period.

- The Varde Dislocation Fund has a shorter term of 4 years and an 18-month investment period. The firm will probably come to market with a longer-term distressed debt fund to capture Phase 3 of the distressed debt credit cycle. The focus is on liquid corporate securities, so exposure is not as broad.

Mr. Wickman paused the discussion because the public could not hear Ms. Beard's analysis above. Mr. Callahan summarized Ms. Beard's comments recorded above and noted Fortress stands out because of the depth of their platform.

Mr. Callahan indicated an allocation with a 0% target and 5% range would be reasonable if the Committee is interested in private debt. The question then is how much to commit, and he suggested between $50 to $100 million could be invested assuming a $2.5 billion Fund value. Fortress is oversubscribed and offered $30 million which would be $23 million for MCERA.

Trustee Gladstern asked which firms have a relationship with Callan and Mr. Callahan said none. Chair Klein asked about Softbank's acquisition of Fortress and how that impacts employee retention. Ms. Beard replied key senior members of the credit team have employment contracts, and Trustee Given added the contracts are through 2022. Mr. Callahan said the risk of losing key members is low. Ms. Beard added the more likely outcome is for key members to take the firm private again which would be a positive.

Administrator Wickman requested a short break while meeting participants reconnect and reconvened the meeting at 12:59 p.m.

Trustee Werby requested a comparison of track records for the three firms. Ms. Beard replied Fortress has the most consistent top quartile performance in both net Internal Rate of Return (IRR) and Total Value to Paid-In Capital (TVPI) multiples. In 2008 Fortress outperformed the other two managers. From 2008 through 2020 Fortress had the lowest level of portfolio losses among the three managers and had a fairly high recovery rate. In general, the multiples are very similar across the three funds, Ms. Beard said.

Trustee Block expressed concern with CarVal's potential allocation of 15% to distressed Chinese debt and asked why they would do that. Ms. Beard said she would check with CarVal on this question. Mr. Callahan noted the 15% potential exposure to China is a limit and the other funds do not have those levels of allocation to China. Trustee Block asked if we could preclude Chinese investments, and Ms. Beard indicated this would be difficult. Trustee Werby pointed out a loss for CarVal which Ms. Beard said was due to a misstep in a shipping investment.

Mr. Wickman requested that Ms. Beard repeat her review of the three managers for the benefit of the public who were not able to hear her earlier. Ms. Beard said all three have strong track records with a few distinguishing characteristics:

- CarVal is employee owned, and its Credit Value Fund V can invest in public and private assets throughout the three phases of the distressed credit cycle.
- Fortress has more niche capabilities to invest in litigation finance and intellectual property lending. Fortress takes on more complexity and invests across all three phases. The Fortress Credit Opportunities Fund V Expansion has the longest term with a 4-year investment period and 10-year maturity.

- Varde is a multi-strategy global credit platform whose Dislocation Fund has a shorter tenure of 4.5 years and 18-month investment period. Most investments are in liquid corporate credit dislocation opportunities.

Trustee Werby asked about the value of TVPI versus IRR multiples and Mr. Callahan said TVPI is the more important measure. Trustee Werby proposed investing in all three managers since the Fortress opportunity is limited. He emphasized the importance of skill when investing in the private markets. Trustee Gladstern asked if the time needed to negotiate contracts would result in losing investment opportunities. Ms. Dunning said her partner has successfully negotiated with two of the three managers and they will do their best to close the deals on time.

Trustee Given asked about the source of funds. Chair Klein asked about the decision process and Mr. Wickman recommended making the manager selection first, then deciding on the allocation. Mr. Callahan reviewed allocation options for the three managers.

It was M/S Gladstern/Thomas to invest $100 million using Option 3 in the Callan presentation with a 40-40-20 allocation to CarVal, Varde, and Fortress, respectively.

Trustees Werby, Murphy and Given indicated a preference not to limit the Fortress investment. Trustee Gladstern supported this idea and restated her motion:

It was M/S Gladstern/Thomas to select Fortress, CarVal and Varde to manage the private debt portfolio with an initial investment of $100 million, maximizing Fortress up to an equal share and dividing the remainder between the other two managers.

Trustee Block indicated a preference for hiring two managers, Fortress and CarVal, to lower the expense. Chair Klein supported the motion and was impressed with the CarVal and Fortress presentations as well as Fortress' skill at pricing. She noted both managers were buying during the March 2020 market dislocation. Upon discussion, the consensus was to use all three managers for the diversification benefit.

The motion was approved by a vote of 8-0 as follows:

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

Mr. Callahan stated there is a need to create an opportunistic allocation with a 0% target allocation and 5% maximum allocation. He explained there will be capital calls over time for these funds and the Administrator will consider where to source the funds based on allocations at that time. Mr. Wickman stated staff will look to equities first as a source of funding. Ms. Dunning stated the agenda item gives sufficient notice for the Committee to establish what the allocation will be. She added the Committee can amend the Investment Policy Statement and bring it back to the next Committee meeting.

It was M/S Block/Given to add a private debt opportunistic allocation with a 0% target and a range of 0% to 5%. The motion was approved by a vote of 8-0 as follows:

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

3. Investment Manager Update – Wellington Management Co., LLP – Anne Heaphy, Callan LLC

   Anne Heaphy, Senior Vice President with Callan, reported that Wellington Management Company announced its Chief Executive Officer (CEO) Brendan Swords will be retiring effective June 30, 2020. Jean Hynes will succeed Mr. Swords as CEO, and Steve Klar has been appointed President effective January 1, 2021. Ms. Heaphy said succession planning is well thought out and the officer transitions are not expected to impact the MCERA fixed income portfolio managed by Wellington.

C. INVESTMENT CONSULTANT QUARTERLY REPORT

1. Quarterly Report as of June 30, 2020
   a. Summary Report

      Mr. Callahan stated the quarter ending June 30, 2020 had a strong comeback in the U.S. equity markets marked by the leadership of large cap stocks. He reviewed the performance of equity indices, highlighting the 27.8% rise in the Russell 1000 Growth Index for the quarter. Mr. Callahan pointed to the leadership of U.S. markets over other markets, noting the U.S. Dollar has been strong. Fixed income performance has been extraordinary, he said, due to low interest rates. The question is the role of fixed income in the portfolio as performance is not likely to continue. Other economic fundamentals have not recovered as much.

      Total Fund assets as of June 30, 2020 were slightly less than $2.6 billion and the Total Fund was up over 12% for the quarter, underperforming the peer median. Mr. Callahan attributed this to the overweight to small cap that has been a headwind and to the write-down in the real estate portfolio.

      Ms. Heaphy reported no new managers were added to the watchlist for the quarter. The Committee will review the watchlist at its December meeting. The UBS Trumbull Property Fund queue is at $8.3 billion and UBS is at the bottom of a peer group performance list for NFI- ODCE Funds. There are modest improvements as economies are reopening, with continued weakness in Apartments and slower leasing activity in the Office sector. Domestic equities show strong performance for the quarter, and international managers and fixed income managers outperformed their benchmarks.

   b. Flash Performance Update

      Ms. Heaphy presented the Flash Performance update. As of August 31, 2020 the fiscal year return of the Fund is 6.5% and the Fund market value is $2.74 billion.

There being no further business, Chair Klein adjourned the meeting at 2:31 p.m.

Jeff Wickman	Michelle Hardesty
Retirement Administrator	Assistant Retirement Administrator
On behalf of:	On behalf of:
Sara Klein	Jeff Wickman
Investment Committee Chair	Retirement Administrator