MINUTES

Marin County Employees' Retirement Association (MCERA)
Retirement Board Strategic Workshop

One McInnis Parkway, First Floor
San Rafael, CA
October 17, 2023

This meeting was held at the address listed above and, absent technological disruption, was accessible via videoconference and conducted in accordance with Government Code section 54953 and 54954.2.

Meeting Chair Todd Werby

9:00 a.m.
Call to Order/Roll Call

Chair Werby called the meeting to order at 9:03 a.m.

ROLL CALL

PRESENT: Cooper, Gladstern, Klein, Murphy, Poole, Silberstein, Vasquez, Werby, Jones (alternate retired)
ABSENT: Gullett (alternate safety), Martinovich, Shaw (ex officio alternate)

CONSIDER ANY BOARD MEMBER REQUESTS TO TELECONFERENCE FOR "JUST CAUSE" OR "EMERGENCY," AS SET FORTH ON THIS AGENDA BELOW

No Board members requested to teleconference.

Open Time for Public Expression

Open time for public expression, from three to five minutes per speaker, on items not on the Board Agenda. While members of the public are welcome to address the Board during this time on matters within the Board'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 Board concerning a non-agenda item. Members of the Board may (1) briefly respond to statements made or questions posed by persons addressing the Board, (2) ask a question for clarification, or (3) provide a reference to staff for factual information.

No members of the public provided comment.

9:00 a.m. – 10:00 a.m.

2023 Experience Study Preview – Economic Assumptions

Graham Schmidt, ASA, FCA, MAAA, EA, Consulting Actuary, Cheiron
Bill Hallmark, ASA, FCA, MAAA, EA, Consulting Actuary, Cheiron

Graham Schmidt, Actuary with Cheiron, presented preliminary Experience Study results for the actuarial economic assumptions. Mr. Schmidt explained that economic assumptions help to determine contribution rates used to fund the Plan. He also noted the more conservative the assumptions, the less contributions will be needed in the future and that ultimately the funding process is self-correcting every year when the actuarial valuation is conducted. Mr. Schmidt is not expecting dramatic changes in experience that would require changes to economic assumptions – the assumed rate of return, inflation, base wage growth, payroll growth, and the post-retirement Cost-of-Living Adjustment (COLA). Factors reviewed by the actuary when evaluating the economic assumptions include industry trends, historical data, forward-looking expectations, and the Board's risk tolerance.

Mr. Schmidt discussed MCERA's assumed rate of return/discount rate which is currently 6.75%. The average assumed rate of return for public pension plans has trended down over the last 20 years from 8% to 6.91%. With rising bond yields, public pension plans have more allocation to private asset classes, taking on more risk to achieve the same returns. Mr. Schmidt pointed out the 2022 decline in the capital markets increased projections for future returns. Callan's 10-year capital market return expectation has increased to 7.2%, based on a 2.5% inflation assumption. The average California public pension plan assumed rate of return is 6.77%, which is close to MCERA's. Mr. Schmidt noted MCERA has had more conservative assumptions over time than the average public pension plan. The actuary stated the likelihood of achieving MCERA's assumed rate of return of 6.75% is over 50%.

Mr. Schmidt discussed inflation, which he said had been low since 1992. Then last June the Consumer Price Index (CPI) peaked at over 9% and since then has trended down to under 4%. Mr. Schmidt stated MCERA's 2.5% inflation assumption is in the middle of peers and close to the economic forecasters' average and median inflation rate of 2.4%. He said market expectations for inflation can be equated to the 2.3% difference between US Treasury bond yields and Treasury Inflation-Protected Securities (TIPS) over five and 30 years. Mr. Schmidt concludes MCERA's inflation assumption is consistent with expert and market expectations.

No change is recommended for MCERA's current base wage growth assumption of 3.00%, based on 0.50% real wage growth above inflation. Reasons for a positive real wage growth assumption include productivity increases and Social Security projections. Mr. Schmidt observed that median wage growth has grown slower than the average due to top wage earners increasing wages more than lower paid employees. Trustee Silberstein noted wages are a function of political power which lately has been increasing for employees versus employers.

Mr. Schmidt is recommending maintaining MCERA's current payroll growth assumption of 2.75%. He noted some elements of compensation for new hires are not pensionable and some pensions are capped. Trustee Silberstein noted another factor that can limit payroll growth is the tendency to contract out work.

Mr. Schmidt explained that post-retirement COLA benefits grow by the increase in the Bay Area CPI rounded to the nearest .5%, subject to a 2%, 3%, or 4% cap depending on tier. Mr. Wickman noted over 50% of retirees are in the 2% COLA cap. Any excess over the cap is banked every year. Because this year there is significant growth in COLA banks for retirees, Cheiron recommends incorporating their value directly into the liability calculations. The assumption is the retiree will receive the maximum COLA until the COLA bank is drawn down.

In summary, Mr. Schmidt stated MCERA's current economic assumptions are reasonable based on current market conditions and long-term expectations. The only change Cheiron is recommending for the June 30, 2023 Actuarial Valuation is valuing increases in retiree COLA banks.

Mr. Wickman noted that the final Experience Study report will be presented at a future meeting and will include a review of the demographic assumptions. The Board can take action to adopt the report and any recommendations from the actuary at that time.

10:00 a.m. – 11:00 a.m.
Fixed Income Allocation Strategy Review
Jim Callahan, President, Callan LLC

Jim Callahan, President of Callan LLC, discussed capital market conditions from the perspective of the fixed income allocation. Mr. Callahan stated in 2022 equities were down significantly and bonds were down to historical lows due to a dramatic rise in yields. These conditions led Callan to increase the fixed income return expectation from 1.75% to 4.25% in their latest 10-year capital market projections which were presented to the Investment Committee in March 2023. For public equities the risk premium over the bond market compressed, meaning there is less return for meaningfully more risk.

MCERA's current target allocation for public equity is 54% and 23% for fixed income, and Callan's 10-year projected return is 7.2%. Mr. Callahan indicated because the expected return is meaningfully higher than the 6.75% return assumption, a consideration is whether to de-risk the portfolio by increasing the fixed income allocation. He noted interest rates have risen meaningfully from the beginning of the year and the fixed income portfolio has a yield of 6%. Another factor to consider is MCERA's liabilities are better funded, leading to the question of how much risk is needed to achieve the goal of being fully funded. Mr. Callahan expects next year's 10-year capital market expectations for fixed income to increase from 4.25% to 5% and no meaningful change to the equity return assumption. He noted fixed income provides liquidity and downside protection and is a good diversifier, adding that from a risk perspective equity is driving. Mr. Callahan stated the argument for decreasing fixed income is the ability to absorb volatility and risk over the long term.

Trustee Silberstein proposed continuing the long-term trajectory to reduce the fixed income allocation from 23% to 20% of the Fund since it has a long time horizon. He indicated this may result in a higher return. Mr. Callahan pointed out that projections showed that reducing the fixed income allocation to 20% increased risk without significantly increasing projected returns. Trustee Vasquez asked if the recent volatility in the fixed income market would continue, and Mr. Callahan replied not over any meaningful time period. He noted bonds have been more volatile because interest rates were artificially repressed for a long period of time. Trustee Klein's view is to consider increasing the allocation to fixed income. She noted interest rates have become more reasonable and if they rise further, it will not be good for equities. Chair Werby supported this view.

Mr. Wickman said the Investment Committee Chair could choose to agendize this topic for further discussion at a future meeting.

Chair Werby recessed the meeting for a break at 10:42 a.m., reconvening at 11:00 a.m.

11:00 a.m. – 12:00 p.m.
Macroeconomic Impact of Current Real Estate Market
Kristina Hooper CFP®, CAIA, CIMA®, ChFC®, Invesco Chief Global Market Strategist
Brooks Monroe, Invesco Managing Director Portfolio Manager, North America Real Estate
Delia Roges, Invesco Managing Director

Mr. Wickman introduced Kristina Hooper, Chief Global Market Strategist with Invesco, and Brooks Monroe, Managing Director and Client Portfolio Manager with Invesco Real Estate. He thanked them and Delia Roges, Invesco Managing Director, for being available to share their insights on the macroeconomic impact of the current real estate market.

Mr. Monroe stated Invesco has been active in real estate transactions over the past five years. He said the pandemic compressed a decade of evolution in the real estate market into two years of disruption, resulting in dislocation in the Office sector. The steep rise in interest rates has had significant implications for real estate and is expected to remain for the foreseeable future. The consequences have been higher borrowing costs, slowing growth, and declining real estate values, with 15% write-downs over the last year and more to come. Mr. Monroe expects the Office sector to become a smaller part of the overall real estate sector. He noted there is near zero debt to finance buying an office building and liquidation values are lower than carry values.

Mr. Monroe said the rest of the U.S. real estate market is in a healthy place from a supply-demand standpoint. Apartments and Industrials have had strong performance since the end of 2020. Apartments are now coming into some stress due to a wave of supply causing rent growth to decline. He noted high borrowing costs and floating rate debt coming due in a much higher interest rate environment will create some challenges. Of $1.9 trillion in commercial real estate loans maturing in the next 3 years, he estimates one-third could be troubled. Banks are the largest holders of these loans comprised mostly of office and multi-family properties. Remedies for troubled loans include extension, adding equity, selling the property to pay off the debt, or foreclosure. He indicated the resulting distressed sales may provide opportunities to invest in high-return strategies, excluding Office.

Ms. Hooper addressed the impact of the downturn in real estate on the overall economy. She said real estate downturns have led to weaker real estate investment and a severe downturn would reduce GDP. This downturn is centered on commercial, non-residential properties. She indicated the wealth effect, how wealthy households feel about investment portfolios and real estate, tends to be more about residential properties. While historically tightening credit conditions have led to recessions, low unemployment and a healthy jobs market indicate a recession would not be significant. Ms. Hooper cautioned credit conditions could tighten further, making it one of the most important metrics to follow.

In conclusion, Ms. Hooper stated her expectation is that interest rate reduction by the Federal Reserve may begin in 2024. She and Mr. Monroe distinguished the severity of current real estate issues from those in the past due to tighter bank regulations. Citing recent improvements in bank lending and new home sales, she said the U.S. consumer is carrying this economy. Trustee Vasquez asked if there are demographic tailwinds from millennials and Ms. Hooper replied that millennial household formation has been delayed and their economic activity may moderate with the resumption of student loan payments.

Chair Werby recessed the meeting for lunch at 12:10 p.m., reconvening at 1:16 p.m.

12:00 p.m. – 1:15 p.m.
Lunch Break

1:15 p.m. – 2:15 p.m.
What Key Factors Drive Inflation
Mike Bazdarich, Senior Economist, Western Asset
Frances Coombes, Client Service Executive, Western Asset

Frances Coombes, Client Service Executive with Western Asset Management Company, LLC, introduced Dr. Michael Bazdarich, Senior Economist, to discuss the key factors driving rising inflation. Dr. Bazdarich began by explaining the mandate of the Federal Reserve (the Fed) is to quell U.S. price increases to a 2% rate. He observed that in early 2022 inflation peaked at 9% and has been declining since then.

Discussing inflation dynamics, Dr. Bazdarich said inflation is a macro phenomenon of prices rising across the economy. For inflation to continue, the nominal spending growth needs to continue to rise. Since rising prices reduce purchasing power, inflation comes down unless there is more fuel (spending) to add to the fire. Dr. Bazdarich noted there is a consistent relationship between inflation and interest rates. When inflation comes down, interest rates will follow.

Turning to the economic backdrop, Dr. Bazdarich said in 2020 Covid changed everything by shutting down what was a healthy U.S. economy. The U.S. is still dealing with the effects of that shutdown and subsequent reopening. Initially, there was deflation for a brief period when the shutdown occurred and there was a surplus of goods. Then, inflation took off in 2021 and 2022. He said the primary driver of inflation is monetary policy that increases the money supply. The Fed distributed trillions of dollars to banks that many blame inflation on.

Discussing current conditions, Dr. Bazdarich made the point that for the last 18 months the Fed has been reducing the money supply. In fiscal policy, the aid the government provided to individuals who lost money during the shutdown ended two years ago. As a result, there is deceleration of spending growth in both monetary and fiscal policy. Currently, the trend in inflation is clearly down and has been low for the past year. As examples he cited home prices declining since peaking in May of 2022, stabilizing rents, food prices decelerating sharply, and energy prices coming down.

In conclusion, Dr. Bazdarich stated as its inflation metric, the Fed targets the Personal Consumption Expenditure Price (CPE) Index. In particular, the Core CPE has been around 2% for the last 3 months. In response to Trustee Vasquez's inquiry, Dr. Bazdarich said the weights of pricing in the PCE are revised every month. Dr. Bazdarich pointed out while the Fed is not ready to declare victory over inflation yet, inflation is very close to the Fed's mandate and does not need to be ratcheted down further. For this reason, he believes the Fed is finished with raising interest rates.

Chair Werby recessed the meeting for a break, reconvening 2:21 p.m.

2:15 p.m. – 3:15 p.m.
Investment Consultant Request for Proposal Overview
Jeff Wickman, MCERA Retirement Administrator

Mr. Wickman provided an overview of the Investment Consultant Request for Proposal (RFP) process. He stated the goal is to issue the RFP to as broad a group of companies as possible so the Board will be able to evaluate all the qualified bidders. This will include direct mailing to firms, posting the RFP to MCERA's website, and submitting the document to national publications where it can be picked up by firms who may be qualified to provide the requested services. The Administrator indicated a critical success factor when conducting RFP's is to adhere to the timelines and evaluation process outlined in the RFP. He discussed the importance of providing the criteria by which RFP responses would be evaluated which includes the weighting of each category of responses. This helps to provide as close to an apples-to-apples comparison between firms as possible.

Mr. Wickman then reviewed the timeline for previous MCERA investment consultant searches. In 1999 MCERA conducted a search for an investment consultant and hired Callan LLC in 2000. In 2014 MCERA again went out for bid for an investment consultant. Nine firms responded to that RFP. After completing the initial evaluation six firms were selected for interviews. After the completion of the interviews and conducting a site visit, the Ad Hoc Investment Consultant RFP Committee recommended to the Board that Callan be hired as the investment consultant. The Board adopted the Ad Hoc Committee's recommendation. Mr. Wickman noted that the ad hoc committee was composed of four trustees and one staff member.

Mr. Wickman explained that the RFP is organized into the following sections: general information including the RFP timeline; background and nature of services being requested; proposal procedures; information to be provided, including specific questions for bidders to respond to; fees; and a model contract. He discussed question topics that include the firm's services, revenues, and institutional clients among others. In response to Chair Werby's inquiry, and Trustee Vasquez's comment, Mr. Wickman indicated there could be a methodology inquiry about whether candidate firms have an emerging manager program. The Administrator explained that minimum requirements for candidate firms include aggregate revenue of $5 million, 7 years of experience for the primary consultant, being in business for at least 10 years as of the RFP date and having at least three public sector clients.

Trustee Gladstern noted that Callan has paid relationships with investment managers and asked how that fits into the RFP process. Mr. Wickman replied each consultant will be asked if they receive revenue from sources other than investment consultant and, if so, to break down those revenues. Trustee Silberstein asked about the nature of fees, and Mr. Wickman said the contract is typically a flat annual dollar amount.

Trustee Klein was excused from the meeting at 2:54 p.m.

Trustee Poole inquired how the ad hoc committee is formed and the Administrator said the Board Chair makes that decision typically after consulting with the Retirement Administrator.

Noting it is a lot of work to issue and evaluate RFP responses, Trustee Silberstein asked if there is that much difference between investment consultants for other CERL systems. Mr. Wickman replied he hears good things about all of them, adding MCERA receives a high level of service from the current investment consultant. Trustee Silberstein said he has no concerns about Callan and does not see the need to issue an RFP.

3:15 p.m. – 3:30 p.m.
Closing and Follow-up Items from Today's Agenda

Mr. Wickman said the Investment Consultant RFP could be agendized for discussion at the November Board meeting. The Board expressed an interest in having the RFP agendized for the November meeting so the Board could have further discussion.

There being no further business, Chair Werby adjourned the meeting at 3:14 p.m.

Todd Werby, Meeting Chair

Maya Gladstern, Secretary