MINUTES

MARIN COUNTY EMPLOYEES' RETIREMENT ASSOCIATION (MCERA)
RETIREMENT BOARD STRATEGIC WORKSHOP

Marin Community Foundation
October 17-18, 2012

October 17, 2012
8 – 9 AM
Continental Breakfast

CALL TO ORDER Chair Webb called the meeting to order at 9: 05A.M.

ROLL CALL PRESENT: Bolger, Brenk, Cooper, Given, Gladstern, Haim, McFarland, Piombo (safety alternate), Richardson, Stevens, Webb (retiree alternate)

ABSENT: Shaw (ex officio alternate)

OPEN TIME FOR PUBLIC EXPRESSION Note: The public may also address the Board regarding any agenda item when the Board considers the item.

No public comment.

BOARD OF RETIREMENT MATTERS

9 – 10:30 AM
Economic and Capital Market Review
Jay Kloepfer
Jim Callahan
Callan Associates

Jim Callahan, Executive Vice President and Manager of Callan Associates Fund Sponsor Consulting group, stated that annual capital market projections represent a set of expectations for reasonable returns and risk of each asset class and their performance over a period of five to ten years. Mr. Callahan introduced associate Jay Kloepfer, Director of Capital Markets Research, who presented the economic and capital market review.

Mr. Kloepfer stated that the equity markets have performed well recently. Other economic indicators show some challenges; for example, commodities prices have fallen, yields on fixed income securities are lower than expected, and there is slack demand for new investments. Mr. Kloepfer noted that other factors affecting markets are the Federal Reserve's (the Fed) quantitative easing that has increased liquidity in the markets and the potential for recession as Europe continues to struggle with sovereign debt.

Callan Associates' ten-year capital market projections through 2021 are 3.25% for bonds, 7.75% for domestic equities, 7.9% for non-U.S. equities, and 6.4% for real estate. With GDP growth trending at 2.5% instead of 3.5%, growth expectations are lower, according to Mr. Kloepfer. Depending on the outcome of the November presidential election, potential policy changes create a degree of uncertainty in the capital markets, he said.

Mr. Kloepfer pointed to the steep decline in GDP during the 2007 financial crisis and ensuing slow recovery. Low GDP growth rates of 1.8% in 2011 followed by an estimated 2% for 2012 are a cause of concern for the Fed. Items that contribute to the low growth include continued high unemployment levels, wealth depletion, and continued deleveraging. On the plus side, Mr. Kloepfer noted the relative strength of the U.S. dollar, strong corporate cash flow, expanding capacity utilization and foreign trade, and an increase in consumption.

Mr. Kloepfer responded to trustee inquiries on the U.S. housing market decline and the deleveraging of private debt that he said reduces demand. He also discussed historical returns of the equity markets and returns of equities and bonds through August 30, 2012.

Mr. Callahan inquired about scenarios going forward that may indicate a need to change assumptions. In response, Mr. Kloepfer expects no change for equities; however, if GDP remains low, the expected return would be reduced, he said. Responding to Trustee Brenk's inquiry, Mr. Callahan explained that the low liquidity and high duration of TIPs make them less attractive as an investment in the portfolio. The Fed is likely to have a measured response to signs of inflation, Mr. Kloepfer stated in response to Trustee Richardson's inquiry. Equities and real estate, he added, serve as inflation hedges.

Mr. Callahan demonstrated how changing asset allocations drives return by reviewing expected returns over ten years for the portfolio when the real estate allocation is varied. In summary, Mr. Kloepfer reviewed reduced return expectations for all asset classes and stated that a strong orientation to equity assets, broadly defined, is indicated in order to achieve the assumed rate of return.

Chair Webb recessed the meeting for a break at 10:47 A.M., reconvening at 11:04 A.M.

10:30 – 12 Noon
Review Economic Assumptions
California Actuarial Advisory Panel Model Funding Policies
Graham Schmidt
EFI Actuaries

Review Economic Assumptions

Consulting actuary Graham Schmidt of EFI Actuaries presented an analysis of MCERA's current economic assumptions, stating that the goal is to set reasonable values for the interrelated assumptions of inflation, wage growth, cost of living adjustments (COLA), and expected return on assets. Mr. Schmidt recommends retaining current assumptions for the upcoming annual actuarial valuation which are: for inflation and base wage growth, 3.25%; for nominal expected return, 7.5%; and for real return, 4.25%. In response to trustee inquiries Mr. Schmidt explained

the derivation of the inflation assumption and presented data on the views on inflation of the Fed and a survey of professional forecasters.

Trustee Piombo joined the meeting at 11:17 A.M.

Mr. Schmidt does not expect overall wage growth to exceed the inflation rate given the current economic and political environment. He noted, however, that Safety members' wages have been growing faster than other employer groups. In addition, the average COLA is expected to be less than the cap for several years.

According to Mr. Schmidt, the process of calculating the expected return begins with collecting assumptions of returns, risk, and asset-class correlations from the investment consultant. After adjusting for expenses and differences in inflation assumptions, simulations of the target portfolio are created. Administrative and investment expenses are then applied based on the most recent (2011) experience study.

In summary, Mr. Schmidt emphasized the longer time horizon used by the actuary as compared to the investment consultant's capital projection using 5 and 10 year periods. He explained that the actuarial process is self-correcting by amortizing gains/losses and adjusting to periodic experience studies.

In his response to Trustee Bolger's reference to Warren Buffet's opinion that return assumptions are too high, Mr. Schmidt noted that the real rate of return (discount rate less inflation), should be the key factor so that differences in the inflation assumption, which vary widely, do not distort comparisons of projected assumed rates of return.

Mr. Wickman requested the direction of the Board on the actuary's recommendation of no change to current economic assumptions for the June 30, 2012 valuation. Discussion and consideration of the assumed rate of return followed.

Trustees expressing a preference for lowering the assumed rate of return included Trustees Bolger and Stevens. Trustees Richardson and Piombo expressed confidence in the actuary's recommendation and process. Mr. Schmidt responded to Trustee Gladstern's suggestion to phase in modifications to the return assumption by noting that it adds some complications to administering such a process.

Board Counsel Dunning noted the next experience study is also an appropriate time to consider changes. As a reminder she reviewed the goals of minimizing volatility and determining what is reasonable and prudent. Based on discussions the trustees agreed with the recommendations of the actuary to retain current economic assumptions.

Chair Webb recessed the meeting for lunch at 12:37 P.M., reconvening at 1:22 P.M.

12 Noon – 1:30 PM
Lunch on site

California Actuarial Advisory Panel (CAAP) Model Funding Policies

Mr. Schmidt discussed the draft CAAP Model Funding Policies ("policies"). According to Mr. Schmidt, the policies – classified into four categories ranging from acceptable to unacceptable – are advisory in nature. They remain under consideration by the panel which is soliciting input on its content.

Mr. Schmidt compared current MCERA practices with respect to the model policies in the areas of actuarial cost methods and amortization policy. The CAAP is recommending layering closed amortization periods with the length of the period depending on the source of the Unfunded Actuarial Accrued Liability (UAAL). One value to layering amortization is increased transparency. According to Mr. Schmidt amortizing over a longer period than 16 years can create negative amortization which is not desirable since in that case the interest on the unfunded liability is not covered. MCERA's amortization policy is 17 years, declining ultimately to a period of 10 years. MCERA's current amortization policies would fall into the "acceptable" category within a few years.

Mr. Schmidt stated that MCERA policies are fully disclosed in the annual valuation and no action is required at this time. Ms. Dunning commented that any potential changes to current practice should be implemented prospectively. Mr. Schmidt stated that the Board's considering a change as a result of the model policies should include developing a transition strategy.

1:30 – 3 PM
Active/Passive Management
Index Funds vs. Exchange Traded Funds (ETFs)
Alternative Indices – Equal Weighted, Fundamental
Allocation of Assets (Action)

Consider and take possible action on allocation of assets among active and passive strategies, including without limitation, setting timing and re-allocation of assets from RCM
Jim Callahan
Callan Associates

Active/Passive Management

Mr. Callahan introduced the topic of active versus passive investment management. Currently, according to Mr. Callahan, 80% of the portfolio is comprised of actively traded stocks and bonds that could be managed with passive investments.

Callan Associates investment consultant Anne Heaphy discussed the efficient market hypothesis that serves as a model for determining asset allocation. According to a historical study, active management through technical and fundamental analysis provides a performance premium over passive. These include U.S. small and mid cap and international equities. Mr. Callahan noted that for large cap equities, MCERA's existing S&P 500 Index fund may be a suitable vehicle.

Index Funds vs. Exchange Traded Funds (ETFs)
Alternative Indices – Equal Weighted, Fundamental
Allocation of Assets (Action)

Addressing asset allocation, Mr. Callahan reviewed MCERA's domestic equity style matrix compared to the Russell 3000. He noted that the portfolio has reasonable exposure to mid-caps and more exposure to small caps than the Russell 3000. The market is weighted 80/20 toward

large cap, he said. Over the long term, small caps outperform other equity classes. He also commented on the balance between growth and value, observing that many institutions have a value bias to reduce volatility.

Most institutional use of exchange-traded funds (ETFs), according to Mr. Callahan, is for transitions, rebalancing, tactical adjustments, and cash equitization. As these investment vehicles are relatively expensive, however, they unsuitable as core investment. An additional concern is that ETFs were subject to short-term trading anomalies that occurred during the 2008 financial crisis.

Mr. Callahan also discussed three types of alternative indices and the advantages and disadvantages of each. These indices are grouped into market cap weighted, equal weighted, and fundamentally weighted. For example, in market cap weighted indices stocks with the highest market cap have the largest impact on the performance and volatility of the index. In an equal weighted index, an advantage is that smaller and mid-sized companies are more represented than in a market cap weighted index. In response to Trustee Bolger's inquiry, Mr. Callahan and Mr. Kloepfer recommended caution with regard to newer alternative passive indices.

It was M/S Gladstern/Piombo to terminate Dodge & Cox and invest its and the RCM portfolio proceeds in the SSgA S&P 500 Index Fund. Disappointing performance, the challenge for active large cap managers to add value, and fees associated with active management of the large cap portfolios were the reason for the motion. The motion was approved by unanimous vote, with Trustee Haim absent.

Callan Associates will provide transition information at the November Investment Committee meeting.

3 – 4 PM
Real Asset Strategies
Jim Callahan
Callan Associates

In considering real asset strategies, Mr. Callahan emphasized the importance of the variation in fees and the degree of liquidity. He introduced Jamie Shen, who heads the real assets group, and Brett Cornwell, a member of the fixed income team who specializes in Master Limited Partnerships (MLPs), to present an educational overview of real asset strategies.

Ms. Shen stated that returns from agricultural real assets are derived from income and appreciation, with an expected total return of 7 to 9%. Implementation is hindered by the relatively small market that is generating increasing interest by institutional investors.

Other real assets discussed by Ms. Shen included infrastructure in the form of leveraged, financially engineered vehicles similar to long-term fixed income that are subject to the effects of political policy and have high fees relative to returns. Timber, which is subject to supply shocks, is a highly cyclical asset with returns generated by growth, price, land appreciation, and hunting and fishing licenses and fees.

As an asset class water is highly correlated to the S&P 500, according to Mr. Tseng. Water consumption has trended higher recently, most notably in Asia where demographics-based demand is greater than supply.

According to Mr. Cornwell, master limited partnerships (MLPs) are natural-resource-based, publicly traded limited partnerships investing in the transportation, such as pipelines and barges, of energy commodities. Revenue from fee-based long-term contracts is stable with a growth component that has outpaced inflation.

In summary, from a strategy perspective Mr. Callahan discussed restructuring the real asset portfolio, currently 100% invested in real estate, as a reasonable approach. Trustee Brenk expressed interest in MLPs. Mr. Cornwell recommended MLPs as a cornerstone of an energy-independent political strategy that supports job growth.

Trustee Webb adjourned the meeting for evening recess at 4:27 P.M.

Trustee Haim joined the meeting for the Thursday, October 18, session.

EVENING RECESS
5:30 PM
Dinner at Wild Fox
225 Alameda Del Prado
Novato, CA

October 18, 2012
8 – 9 AM
Continental Breakfast

Chair Sean Webb reconvened the meeting at 9:00 A.M.

9 – 11:30 AM
Next Steps to Implement AB 340/AB 197
Jeff Wickman
MCERA
Ashley Dunning
Manatt Phelps and Phillips
Graham Schmidt
EFI Actuaries

Mr. Wickman introduced the topic of implementing AB 340, the Public Employees' Pension Reform Act of 2013 (PEPRA) and AB 197 by stating that counsel and staff have analyzed provisions of the legislation that will require changes for MCERA. Mr. Wickman discussed the challenges of determining which new employees hired after January 1, 2013 will become members of the PEPRA tier. In addition to Ms. Dunning's presentation, supporting documents for the discussion include the MCERA Policy Regarding Reciprocal Members' Final Compensation Determinations and MCERA Procedures for Hearings on Non-Disability Retirement Related Matters. Mr. Wickman introduced Board Counsel Ashley Dunning for the presentation.

Key elements presented by Ms. Dunning include the following:

- Who is a "New Member" Under PEPRA
- Contribution Rates for New Members under PEPRA
- "Compensation Earnable" Definition for Current Members
- "Pensionable Compensation" Definition for New Members
- Retirement Board Policies and Procedures

Who is a "New Member Under PEPRA

In general, new employees with no reciprocity hired on and after January 1, 2013, are considered "new members" under PEPRA. Members not considered "new members" under PEPRA include deferred, returning deferred, and redepositing members who return to the same employer in MCERA. Members with reciprocity with another public retirement system who left their contributions on deposit and joined MCERA within six months are likewise not considered PEPRA members.

Mr. Wickman noted that employers will need to at the time of hire seek additional information from the employee in order to determine if they become members of the PEPRA tier or join a previously open tier with the employer.

Contribution Rates for New Members under PEPRA

PEPRA requires members and employers to share equally in the normal cost of the plan. New members after January 1, 2013 will pay at least 50% of normal cost contributions. In addition employers are prohibited from paying contributions on behalf of the employee.

Ms. Dunning discussed an exception to the 50/50 cost sharing referred to as the "MOU Savings Clause." This provision in the law provides if an employer has a memorandum of understanding (MOU) that provides for a different cost sharing arrangement with a group of employees the new PEPRA member will pay contributions as defined in the MOU for the life of the agreement or until amended, whereupon the new rules will be applicable.

Ms. Dunning reviewed the four new PEPRA Tiers: for Miscellaneous members, formulas are 2% at 62 with either a 2 or 4% COLA; for Safety, 2.7% at 57 and either a 2 or 4% COLA. The COLA element remains the same as currently provided by the employer.

Pertinent questions on contributions that remain include whether the normal cost should be based on age at entry into membership, as is MCERA's current practice, or a single uniform rate applicable to all members in a benefit tier. According to Mr. Schmidt since the benefit structure under PEPRA are more uniform, simplifying the normal cost calculation is appropriate, with the added benefit of reduced volatility.

These and other matters subject to interpretation are expected to be addressed during the November SACRS conference. Ms. Dunning discussed the potential for emergency legislation to address certain technical issues in the new law.

"Compensation Earnable" Definition for Current Members

Under AB 197 there are additional clarifications applicable to '37 Act systems regarding what should be included as compensation earnable for the purpose of calculating retirement benefits. Staff and counsel will present recommendations to harmonize the provisions of AB 197 with current administration as provided in the Ventura decision.

"Pensionable Compensation" Definition for New PEPRA Members

PEPRA defines pensionable compensation as base pay, paid to similarly situated individuals based on publicly available salary schedules.. The interpretation of what may be considered a base pay is expected to be a topic of discussion at the SACRS conference. The goal is to achieve consistency among '37 Act systems as well as CALPERS.

Final determinations by the Board on items to be excluded from pensionable compensation will be made by the Board in December.

Chair Webb recessed the meeting for a break at 10:30 A.M., reconvening at 10:45 A.M.

Retirement Board Policies and Procedures

PEPRA adds a requirement for '37 Act systems to establish a procedure for the determination of items to be excluded or included in pensionable compensation. To this end, Ms. Dunning presented proposed revisions to the Procedures for Hearings on Non-Disability Retirement Related Matters that provide members with a procedure should they wish to challenge whether an item may be included in their pension calculation. The procedure is structured for the orderly presentation of witnesses and evidence that is supportive in the event of appeal. The Governance Committee will address the revised procedures at its meeting next week.

11:30 AM – 12 Noon
Fall MCERA Newsletter (Action)
Consider and take possible action to approve Fall newsletter copy
Jeff Wickman

The Fall Newsletter focuses on the new PEPRA legislation. The goal is to ensure that information is presented to members and beneficiaries in sufficient detail with a balanced, neutral approach according to Mr. Wickman. The following discussions were incorporated into newsletter copy revisions.

Topics of discussion included sharing of employer and employee contributions. In response to Trustee Cooper's inquiry, Mr. Wickman explained the interpretation of 50/50 cost sharing provision. For certain employees subject to existing MOUs, the agreements will require analysis by the employer to determine what the impact will be of the new PEPRA provisions.

Other topics considered including changes in provisions for retirees who return to work and related exemptions for safety employees.

Mr. Wickman stated that since there are substantive changes to the newsletter it will be reconsidered by the Board at the November Board meeting.

Chair Webb recessed the meeting for lunch at 12:22 P.M., reconvening at 1:30 P.M.

12 Noon – 1:30 PM
Lunch on site

1:30 – 3:30 PM
Discuss Long-term Structure of MCERA's Investment
Management and Finance Capabilities
Jeff Wickman
MCERA

Mr. Wickman provided an analysis of MCERA's investment management and finance resources. For its size, he stated, the MCERA structure of one Retirement Administrator supported by a senior accountant is not uncommon. He provided the data developed by staff showing a list of '37 Act systems with a Chief Investment Officer (CIO) according to asset size. Mr. Wickman noted that to hire a CIO would require establishing a position description and appropriate salary ranges in concert with Marin County Human Resources.

Mr. Haim suggested comparing the investment returns of systems with CIOs to those without, observing that the investment expertise of Board members varies. Trustee Richardson observed that MCERA's current asset level would not support a CIO. Trustee Stevens suggested merging the fund with similar retirement systems. in order to achieve efficiencies in fees. Ms. Stevens also commented that a CIO could analyze performance data and investigate strategies to improve returns. In response to Trustee Given's inquiry, Mr. Wickman stated that the functions of a CIO would include monitoring investment managers, considering portfolio changes, and communicating with managers on a daily basis. Mr. Wickman felt the challenges of recruiting a CIO based on the cost of the position did not warrant pursing this course of action.

Mr. Wickman felt it maybe more valuable to MCERA to look at hiring a CFO to enhance MCERA's financial capabilities. As an example, he referred to the development of new Notes to Financial Statements that required diverting staff from normal operations and expanding the existing knowledge base. Several trustees supported the general concept of expanding MCERA's financial expertise.

In summary, Mr. Wickman emphasized the need for consistency and prioritization of investment management with a long-term view. The challenge for small systems, he said, is focusing on strategic and tactical matters while keeping pace with regularly recurring meetings. Mr. Wickman suggested following through on Ms. Bolger's approach of determining the functions of CIO's in similar-sized systems.

3:30 – 4 PM
Items for Future Agendas

Topics presented for consideration at future Board meetings included recommendations for new investments such as real assets and Master Limited Partnerships. Trustee Richardson recommended new commitments to the private equity. There was discussion about adjusting to the slower-than-expected funding of current commitments to private equity.

The structure of both Board and Investment Committee meetings was presented as a topic of discussion to improve efficiency and add structure to the decision-making process. Alternatives to the current Board meeting structure suggested by Trustee Piombo included streamlining the disability retirement process by using the Consent Calendar for suitable cases. For the Investment Committee, he proposed reducing both its size and the number of topics at each meeting. Mr. Wickman proposed refining the process of annual reporting by investment managers to add focus to strategic matters.

There being no further business, Chair Webb adjourned the meeting at 3:41 P.M.

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Sean Webb, Chair	Attest: Jeff Wickman Retirement Administrator