SONOMA COUNTY EMPLOYEES' RETIREMENT ASSOCIATION

INVESTMENT COMMITTEE MEETING MINUTES

Thursday, April 19, 2018
9:02 a.m.

Presiding: Greg Jahn (Chair) presided.

Present: Trustees Neil Baker, John Pels, Christel Querijero, Joe Tambe, Brian Williams, and Bob Williamson. Chief Executive Officer Julie Wyne, Assistant Chief Executive Officer Kelly Jenkins, Chief Investment Officer Jim Failor, Investment Officer Steve Marsh, Chief Legal Counsel David Lantzer (via WebEx), and Administrative Aide Rebecca Lankford.

Also present: Executive Director Mario Maturo and Mia Dennis (of UBS Realty), Greg Korte [via Webex], Partner John Lee and Senior Consultant Shane Schurter (of Aon Hewitt), Vice President John Powell (State Street Bank and Trust), as well as members of the public Jim Scriven and David Wallace.

Absent: Trustees Michael Gossman, David Rabbitt, and Erick Roeser.

I. MINUTES APPROVAL

Approval of March 15, 2018 Minutes.

Recommendation: Approve Minutes.

Motion was made by Trustee Williamson and seconded by Trustee Williams to approve the March 15, 2018 Minutes as drafted.

The motion carried 6-0-0-3 with voting as follows:

AYES	NAYS	ABSTAIN	ABSENT
Mr. Jahn			Mr. Gossman
Mr. Pels			Mr. Rabbitt
Ms. Querijero			Mr. Roeser
Mr. Tambe			
Mr. Williams			
Mr. Williamson			

II. PRESENTATION

UBS Realty – Executive Director Mario Maturo and Director Mia Dennis presented an update on the real estate market and the Trumbull Property Fund in which SCERA invests. Staff introduced the speakers noting that with the departure of Tom Klughertz., Mia Dennis was now SCERA's main point of contact. Mr. Maturo commenced his presentation by detailing some of the organizational changes on the Trumbull Property Fund (TPF) investment team. Mr. Maturo became a portfolio manager on the team in 2017. He is based in San Francisco, whereas traditionally, all the portfolio managers were in Hartford Connecticut. Prior to his UBS appointment, he worked for thirteen years at UBS on the acquisition team covering California and the Pacific Northwest area. Kevin Crean who has been the senior portfolio manager for TPF for the last fourteen years is retiring. His replacement as senior portfolio manager is Paul Canning who will move across from his current role as the senior portfolio manager for the "Value Add" team. Timothy Walsh who is currently a portfolio manager on the TPF team will move over to the "Value Add" team. Independently of these changes, Steve Olstein (who has participated at SCERA's planning session multiple times) is retiring.

Mr. Maturo also noted that, in addition to the organizational changes, TPF was reducing its management fees for the next two years but stressed that these events were unrelated. The incentive component of the management fees is judged in relation to CPI, which over the recent period has been at an exceedingly low level compared to historic norms. In recognition, TPF will hold off applying the incentive component for the next two years. This action will be a topic at the annual Client Advisory Council for the next two years and they will solicit feedback from the Council on its merits.

Switching to performance, Mr. Maturo noted that the one year return to end December 2017 was 6.3% and that their expectation for core real estate in 2018 was a return around 6%. The since-inception net-of-fee return was 9.2% which reflects the strength of real estate post the Global Financial Crisis (GFC). When questioned about the use of leverage, Mr. Maturo confirmed that TPF operates at a lower level of leverage than its competitors do, and TPF' s leverage is at the Fund level because it allows them to get better loan terms. Real estate is a cyclical investment and the aim of TPF is to outperform the ODCE benchmark over a full market cycle, which they define as peak-to-peak. To illustrate this Mr. Maturo referred to a chart showing performance over peak-to-peak cycles from 1982 to the present for TPF and the NFI-ODCE benchmark.

Mr. Maturo then gave a detailed account of portfolio positioning. Before delving into the detail, he stressed that when considering real estate allocations from a property type and geographic perspective, they are guided by their own proprietary research model. TPF does not seek to replicate NFI-ODCE rather they use a proprietary inventory model that seeks to capture the broader US real estate market which they estimate at $5 trillion or about twenty times larger than the ODCE universe.

In terms of property type, they have been at the midpoint of target exposure to Apartments and this allocation will likely increase over the near term. In the Office sector, they have been derisking and expect the current allocation to drop down to the midpoint of the TPF target range. Relative to the ODCE benchmark, this means they will have more in Apartments and less in Office. By geography, they expect to maintain their coastal focus striking a balance between east and west. The portfolio maintains a diversified approach to risk management with a low property concentration risk. The largest individual properties account for no more than

3% of the portfolio and the largest metropolitan area exposures are New York (14%), Chicago (11%), Los Angeles (10%) and San Francisco (8%).

With regard to dispositions, they have been selling older properties with increasing capital requirements. In 2017, they closed on $1 billion of sales from 29 individual transactions. On the acquisition side, they continue to use a mix of straight acquisitions and build-to-core. In 2017, they undertook $376 million in 32 transactions, half of this build-to-core being in Industrial properties. On the financing side, they have been positioning TPF for a rising rate environment. TPF now has a greater percentage in fixed rate debt with an average duration of 5.5 years, with only 4% of the 17% overall leverage ratio being in floating rate debt. The average interest rate for TPF is 3.4%, which is below the ODCE average of 3.9%.

Mr. Maturo concluded his presentation with some commentary on net operating income (NOI) forecasts. He noted that the average for all property types including value add has an NOI growth forecast of 7.6% over the next three years. Pulling out value add, the forecast for stabilized (occupied and leased) assets is 4.7% over the next three years.

III. INVESTMENT CONSULTANT & STAFF

A. Securities Lending Program.

Mr. Failor noted that there were two topics related to the securities lending program. The first was that SCERA's auditors (Brown Armstrong) discovered a technical violation of a guideline. It concerned an overseas subsidiary of a US firm that was collateralized at 102% and not the 105% stipulated in the Investment Policy Statement (IPS) for a non-dollar bond. The 102% collateral is consistent with current market practice and with the securities lending agreement between SCERA and State Street. The recommendation is to bring the IPS into line with current market conventions and harmonize with the State Street lending agreement, which is 102%. The draft IPS changes reflected this harmonization.

The second topic related to securities lending with non-cash (most notably equity) collateral. Mr. Failor commented that it was a technical topic, which is why staff had asked Mr. Powell (a securities lending practitioner from the Global Markets division of State Street) to provide an overview of the topic. Mr. Powell introduced the topic by describing the regulatory changes to the financial markets noting that the result of such change has institutions increasingly saying, "Pledging cash is not working for me but I have plenty of securities I am willing to pledge as collateral". This regulatory pressure has led to a significant growth in non-cash collateral lending. Mr. Powell highlighted that in 2014 non-cash collateral represented an average of 33% of all loans but by 2017 it had grown to 55% of all loans. As State Street provides indemnification for borrower default, they have enhanced risk mitigation for non-cash collateral. One aspect of this is the monitoring and scrutiny of counterparties by the credit and enterprise risk management teams. In addition, the level of collateral demanded will vary depending on the type of collateral and market conditions. Currently minimum initial collateral requirements vary from 102% to 108%, with collateral marked to market on a daily basis.

The guidelines for collateral levels in the draft IPS specified a minimum of 106% for equity collateral while current market convention is for 108%. This was set below the current collateral level for equities to provide flexibility since market practice for equity collateral has been dynamic. Other collateral levels have been more stable and the IPS guidelines for these are set based on current market convention. In any event, arguably the greatest risk reduction is provided not by the collateral but by the indemnification by State Street for non-performance by the borrowers. If market convention changes and State Street would like to lend with collateral levels below those specified in the IPS they would first need to talk with SCERA staff to obtain permission. After a thorough discussion the consensus was that as State Street bank was continuing to provide borrower indemnification, it made sense to capture the potential for increased revenue offered by non-cash collateral lending.

Summing up, Mr. Failor stated that it was staff's recommendation to expand the existing securities lending program to include non-cash collateral lending subject to the collateral provisions in the draft IPS and that, if approved, staff would work with State Street to implement such a program.

Recommendation: Expand the securities lending program to include non-cash collateral lending and approve changes to the Investment Policy Statement as drafted.

Motion was made by Trustee Tambe and seconded by Trustee Pels to approve the recommendation.

The motion carried 6-0-0-3 with voting as follows:

AYES	NAYS	ABSTAIN	ABSENT
Mr. Jahn			Mr. Gossman
Mr. Pels			Mr. Rabbitt
Ms. Querijero			Mr. Roeser
Mr. Tambe			
Mr. Williams			
Mr. Williamson			

B. Brokerage Commission Recapture Program.

Mr. Failor gave a thumbnail sketch of the broker commission recapture program (BCRP) noting that such programs were significant twenty years ago, but have since declined as the market structure has changed and trading costs have come down. Today SCERA has only two managers using the program and it only generates a very small level of rebates. Even the small savings are not actual net savings because the up-front brokerage fees are often higher, further diminishing the value of the program. Perhaps more important than the fiscal considerations, is the philosophical position of not wanting to insert SCERA into the manager's process of choosing brokers/trade venues. It was stressed that SCERA measures its managers net of all costs and that staff monitors trade costs using the service provided by Global Trading Analytics. Staff's recommendation is that the program be discontinued and the Investment Policy Statement (IPS) modified to reflect this as outlined in the draft IPS. The Board felt that that the dollar amount involved was negligible and they endorsed staff's wish not to be seen as involved in broker selection.

Recommendation: Discontinue the commission recapture program and approve related changes to the Investment Policy Statement as drafted.

Motion was made by Trustee Tambe and seconded by Trustee Williamson to approve the recommendation.

The motion carried 6-0-0-3 with voting as follows:

AYES	NAYS	ABSTAIN	ABSENT
Mr. Jahn			Mr. Gossman
Mr. Pels			Mr. Rabbitt
Ms. Querijero			Mr. Roeser
Mr. Tambe			
Mr. Williams			
Mr. Williamson			

C. Guggenheim Work-Out Security

Staff provided a summary of the case history of the investment in ExGen, a Texas power company. The original investment was a loan but through the bankruptcy proceedings the company creditors will emerge as the new equity owners of the company. The new shareholding will not be listed on a national exchange, which triggers a provision in the IPS that prohibits holding such securities without Board approval. As time was of the essence in making the decision to try to cash out or convert to equity, staff held discussions with the Plan's investment consultant and the Investment Committee Chair. The consensus of this discussion was to participate in the conversion and hold the new equity security but seek Board confirmation at the next Investment Committee. When discussed with the Committee it was agreed that Guggenheim has the expertise to manage a work-out such as this and, consistent with the recommendation of the manager and staff, permission was given to continue holding the new equity position.

Recommendation: Approve continued holding of position detailed.

Motion was made by Trustee Tambe and seconded by Trustee Williamson to approve the recommendation.

The motion carried 6-0-0-3 with voting as follows:

AYES	NAYS	ABSTAIN	ABSENT
Mr. Jahn			Mr. Gossman
Mr. Pels			Mr. Rabbitt
Ms. Querijero			Mr. Roeser
Mr. Tambe			
Mr. Williams			
Mr. Williamson			

D. Equity Portfolio Structure Review – follow-up by staff and consultant.

Mr. Failor introduced the topic and Mr. Schurter went on to note that in March the Board had discussed potential implementation of Aon's best thinking in terms of equity portfolio construction. The notable recommendation was to further expand the allocation to non-US equity at the expense of US equity with the end goal of being closer to a 50/50 allocation. Staff and consultant developed a transition plan to achieve the aim that had four key parameters. First, the plan would be accomplished without hiring an additional investment manager. Second, we would attempt to even out some of the differences in manager allocations. Third, we would minimize unintended style biases such as capitalization or style over-weights. Fourth and last we would work to effect the reorganization while minimizing transaction costs. The roadmap presented the option of having a two-step implementation or undertaking the whole change at once.

There was a debate on the cost benefits of the equity reorganization where the estimated $250,000 transition costs and slightly higher portfolio manager fees have to be balanced against the expected improved efficiency of the portfolio and the expected risk and diversification benefits based on Aon's long-term capital market assumptions. The Board sentiment was that while this was a big move relative to past moves, it was all contained within the equity bucket, and given staff's preference to avoid two transitions within a close period of time they were comfortable with implementing the reorganization all as one transition. When considering the timetable, staff felt that it was too ambitious to complete by end June given current commitments and that we should aim for implementation at end September.

A key component of the plan presented was migrating Dodge & Cox from a domestic to a global equity portfolio. Their global equity product is "Buy" rated by Aon but SCERA's positive experience is limited to the domestic mandate. It was resolved that staff would organize a due diligence trip to Dodge & Cox to get comfortable with their global equity product. Aon would also undertake to refine the transaction cost estimates noted earlier and investigate the potential for savings using a transition manager. The reorganization would also necessitate changes to the investment policy statement and staff undertook to produce a draft of the changes to bring back to the Board for approval.

E. Volatility as a Measure of Risk – educational presentation.

This presentation was postponed until the May meeting.

F. Annual Planning Session – discussion regarding investment content.

Staff noted that last year there was no Real Assets panel so the planned rotation would be to include three panels at the 2018 Planning Session – Equities, Fixed Income and Real Assets. This would leave two speaking slots for investment topics. Staff suggested inviting Steve Woods, Professor of Economics, to speak again this year. This would leave one speaking slot which staff will work to fill. The Board endorsed the plan to include three investment panels and to invite Steve Wood for an economic overview.

G. Guggenheim on "Watch" – update.

Staff reported that there was nothing noteworthy to report on Guggenheim.

IV. COMMUNICATIONS

A. Investment Benchmark Summary – March 2018.

Staff reported that the March Policy return was approximately -1.0%, which when added to the previous monthly returns gives a year-to-date return of 0.5%.

B. UBS Realty News Flash, "TPF and TPG Fund Updates", April 2018.

C. State Street On-Site Due Diligence Meeting Review Letter, April 6, 2018.

D. CIO, "Rocky Road Ahead for China's $1 Trillion Overseas Building Plan", March 19, 2018.

E. P&I, "Asset owners, managers trying new ways to take direct approach", March 5, 2018.

V. GENERAL DISCUSSION MATTERS

Opportunity to advise the Investment Committee of new matters and for Committee members to ask questions for clarification, provide information to staff, request staff to report back on a matter, or to direct staff to place a matter on a subsequent agenda.

VI. PUBLIC COMMENT

Opportunity for public comment on non-agenda items within the jurisdiction of the Investment Committee.

VII. NEXT MEETING

Currently scheduled for Thursday, May 10, 2018 at 9:00 a.m. in the SCERA Board Room located at 433 Aviation Boulevard, Suite 100, Santa Rosa, CA. Planned presentations for this meeting include a review by Jacobs Levy.

VIII. ADJOURNMENT

With no further business to conduct the meeting concluded at 12:13 p.m.

IX. APPROVAL

The above minutes for the Investment Committee meeting on April 19, 2018 were approved at the Investment Committee meeting on May 10, 2018.

/S/ Greg Jahn

Greg Jahn, CHAIR