SONOMA COUNTY EMPLOYEES' RETIREMENT BOARD
INVESTMENT COMMITTEE MINUTES

Thursday, September 13, 2018
9:01 a.m.

Presiding: Chair Greg Jahn.

Present: Trustees Neil Baker (Alternate Retiree), Michael Gossman, John Pels, Erick Roeser, Joe Tambe, Brian Williams, and Bob Williamson; Chief Executive Officer Julie Wyne, Assistant Chief Executive Officer Kelly Jenkins, Chief Retirement Counsel David Lantzer, Senior Investment Officer Steve Marsh and Administrative Aide Rebecca Lankford.

Also present: Portfolio Manager Ken Shinoda and Senior Product Specialist Aaron Prince (of DoubleLine), Partner Chae Hong [Townsend Group], John Lee and Chris Behrens (of Aon Hewitt), as well as member of the public David Wallace.

Absent: Trustees Christel Querijero and David Rabbitt

I. MINUTES APPROVAL

Approval of the August 16, 2018 Minutes

Recommendation: Approve Minutes.

Motion was made by Trustee Pels, seconded by Trustee Williamson to approve the August 16, 2018 Investment Committee Meeting Minutes. The motion carried 7-0-0-2 with voting as follows:

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

II. PRESENTATION

A. DoubleLine

Portfolio Manager Ken Shinoda and Senior Product Specialist Aaron Prince presented an update on the firm, the markets and the fixed income portfolio they manage for SCERA. Staff noted that the portfolio was incepted four years ago and at the time, it was believed that DoubleLine's investment strategy with its focus on the mortgages market had the investment characteristic for a core plus fixed income mandate and would be complimentary to SCERA's existing core plus managers. The presenters were asked if they thought the investment thesis still stood and whether there were any perceived headwinds for a mortgage focused portfolio. Secondly, they were asked if there were any problems anticipated with the strong growth in assets under management. Responding to the second question, Mr. Prince noted that DoubleLine had built up its client support personnel to match the growth of the business. Mr. Shinoda further noted that although DoubleLine had increased its assets under management to around $100 billion, this was not significant given the size of the bond market, and they have no issues in implementing their various investment strategies.

Turning back to the first question, Mr. Shinoda opined that the thesis still stood. Primarily he cited competitive performance. Taking the period to end July 2018, he noted that for the year-to-date period the portfolio had outperformed the Bloomberg Barclays U.S. Aggregate Index by 1.6%. At end August he estimated that the net outperformance had edged up to around 1.7%. Taking the longer from inception (6/23/2014) to end July 2018 period he noted that the portfolio net return was 3.0% per annum compared to the benchmark return of 1.8% per annum, resulting in an excess return of 1.2%. Staff noted that this portfolio is monitored against dual benchmarks and that the portfolio had outperformed the secondary benchmark, a mortgage backed security index, as well.

Mr. Shinoda then addressed the investment characteristics of core plus bond investing. He highlighted what he thought were the two key drivers of relative performance, which he described as credit and rates. His contention was that the strategy adopted by DoubleLine with its mortgage focus was less risky from a credit standpoint than most core plus managers because the majority of the mortgage securities held by DoubleLine are Agency mortgages that are guaranteed by the Government. In contrast, he argued that typical core plus managers strive for benchmark excess returns by taking on credit risk in corporate and high yield bonds. Switching to rates, the second driver noted earlier, Mr. Shinoda extolled the virtues of managing convexity in the mortgage market such that declines in value due to interest rate rises were more muted and do not offset the benefit of the extra yield earned on mortgage securities.

Mr. Shinoda then proceeded to give an overview of portfolio positioning. Covering some of the high-level statistics, he noted that the coupon on the portfolio was 4.0%, which is higher than the 3.1% offered by the benchmark. He also noted that they continue to have a lower duration at 4.2 years for the portfolio compared to 6.0 years for the benchmark. Commenting on the sector breakdown, he pointed out that half of the portfolio had the benefit of Agency guarantees, which when combined with the cash holding meant that 60% of the portfolio has in theory no credit risk. He pointed out that the cash is not held as an investment in its own right, rather it is a tool used in "barbell" strategies where the cash is used to tone down the properties of the investment on the other side of the barbell (duration management for example).

Mr. Shinoda concluded his presentation with some commentary on the overall market place. He noted that the non-Agency side of the mortgage market has shrunk dramatically. In 2007, it was roughly the size of the corporate investment grade market at around $3 trillion. The non-Agency market has now shrunk to around $0.5 trillion whereas the corporate side has more than doubled to $8 trillion. While their preference is for hard asset backed credits, they have invested in some collateralized loan obligations (CLO's) which are corporate credit. Where they have done so they have only placed money at the top of the capital structure. One of the reasons they are not so keen on higher risk corporates is that their correlation to the equity market is quite high at around 0.6%, with similar numbers shared by Bank Loans, Emerging Market Debt and High Yield bonds. By contrast, Mortgage Backed Securities (MBS) have only a 0.2% correlation with the equity market.

Returning to the question regarding headwinds for a mortgage focused portfolio, he thought that a scenario of adverse inflation surprise coupled with aggressive rate hikes by the Federal Reserve would be such a case. He did think that the world had become used to low interest rates and that coming off such a "drug" will have some unforeseen side effects. On an optimistic note, as a mortgage investor he was pleased to see that "Millennials" are finally getting around to buying homes.

B. Real Asset Portfolio Review

Chae Hong, a Partner with the Townsend Group, reviewed the structure of SCERA's Real Assets portfolio and commented on opportunities in the asset class. Before addressing the Sonoma real asset portfolio directly, Mr. Hong provided a brief update on the Townsend Aon integration. He noted that he had now fully moved over to the Townsend team on the consulting side and all told about a dozen Aon staff who were heavily involved in real estate or other real assets have transferred over. The Townsend team now has over sixty investment professionals and thirty operations staff, which makes it a significant part of Aon. In addition to offices in the United States and Canada, Townsend has offices in Hong Kong and London.

Mr. Hong commenced his presentation by recapping the role of real assets in the portfolio and SCERA's real assets policy. He noted that the industry is still waiting for a better infrastructure benchmark and hopefully as the asset class evolves it will follow a similar path to real estate and create industry standard benchmarks. Before commenting on the current structure, Mr. Hong presented a historical review of how the real assets portfolio had evolved at SCERA and provided a quick market update for real estate, farmland and infrastructure.

Mr. Hong presented a snapshot of the real assets portfolio exposure by individual manager at June 30, 2018. He noted that all four of the funds were open-ended and were "Buy" rated. He commented that since 99% of the rating system harmonization had been completed, he thought it unlikely that at the end of the process Townsend would have a different view.

Delving into the investment characteristics, Mr. Hong presented an analysis of the return correlations between the four funds that make up the real assets portfolio. He noted that the two real estate funds had a 90% correlation with each other, but the infrastructure and agriculture funds had very low correlations with the real estate funds. Further, the returns from the agriculture and infrastructure funds were uncorrelated. Mr. Hong commented that while the two real estate funds have shown a high correlation in terms of past return there were distinct differences in property type exposures. For example, JP Morgan has a much lower level of exposure to Industrial properties, Hotels and Apartments relative to UBS. Mr. Hong noted that both funds are very large and both have a lower-than-benchmark exposure to industrial properties, an area where big funds have difficulty in deploying large amounts of capital because of the smaller size of the assets.

Mr. Hong went on to describe the portfolio as solidly core. In terms of their current high conviction strategies that could be potentially considered by SCERA, he noted real estate debt and real estate secondaries. He did add the caveat that this was from the standpoint of risk mitigation within the real estate portfolio only, not from a top-down Plan perspective. In addition, the implementation of such strategies is typically through closed-ended funds with 8-10 year lockups that may not be appealing to SCERA. Mr. Hong thought that if SCERA were to expand its real assets portfolio, core plus infrastructure would complement the portfolio. In addition to the open-ended route, at this stage of the business cycle, Mr. Hong thought infrastructure secondaries could be considered, but once again, it would require commitments to closed-ended funds with lockups.

Mr. Hong concluded with a brief discussion on using listed infrastructure as the enhanced liquidity offered more flexibility when rebalancing. Staff confirmed they were interested in exploring this possibility and have had conversations with some large plans that do this.

III. INVESTMENT CONSULTANT & STAFF

A. Equity Portfolio Restructuring Plan – update

Staff provided an update on the portfolio restructure planned for September. It was noted that staff would arrange the funding of Arrowstreet from current cash balances, which are healthy due to the receipt of a second tranche of County pension contributions. Dodge & Cox and SSGA will be responsible for restructuring their own portfolios but for the remaining assets SCERA is engaging Blackrock who is one of three transition managers on SCERA's bench.

Staff presented an analysis of the monetary flows that will occur in September. It was noted that where a portfolio has to be restructured, the opportunity would be taken to align the target portfolio to the policy asset allocation. (This is a slight departure from the rebalancing strategy outlined in the IPS. The IPS suggests moving the physical assets to the edge of the stated band with the overlay manager using derivatives to get to the target weighting.)

B. Private Credit Opportunities – current assessment

Staff presented a summary of the firms that they had met with and those they had not met with but had reviewed their private credit offerings. While some of the investment strategies were in and of themselves interesting, when the high fee structures are factored in, they became less than compelling in the view of staff.

C. JP Morgan Due Diligence Meeting

Staff commented on the JP due diligence meeting noting JP Morgan's ambition to aggressively expand its real estate platform beyond the current set of US pension plans. While the benefits to JP Morgan are obvious, those accruing to existing clients are not. The manager argues investors will benefit from more stable assets resulting from a more diversified investor base.

IV. COMMUNICATIONS

A. Investment Benchmark Summary – August 2018.

Staff noted that the policy benchmark return for August was 0.98% and 3.81% year-to-date.

B. Hexavest, "A few thoughts on Turkey", August 15, 2018.

C. Davidson Kempner SOF IV Investment Memo, "Italian Loan Servicing Company", August 2018.

D. IFM Investor Update, "IFM Investors announces fee rebate", September 4, 2018.

Mr. Marsh commented on the disposition of an asset in Germany where IFM received an offer they could not refuse. IFM is sensitive about selling assets when there is a large investment queue, so the recent fee discount could be considered a sharing of the windfall profit from this sale.

E. AllAboutAlpha, "Making Sense of Private Credit Funds", August 28, 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.

Chief Counsel David Lantzer commented on the current status of the case brought by George Luke.

VI. PUBLIC COMMENT

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

There was no public comment.

VII. NOTICE OF NEXT MEETING

The next scheduled meeting is for Thursday, November 29, 2018 at 9:30 a.m. in the SCERA Board Room located at 433 Aviation Boulevard, Suite 100 in Santa Rosa, CA. Planned presentations for this meeting include a review by PIMCO.

VIII. ADJOURNMENT

With no further business to conduct the meeting was adjourned at 11:14 a.m.

IX. The above minutes for the Investment Committee meeting on September 13, 2018 were approved at the Investment Committee meeting on November 29, 2018.

GREG JAHN, CHAIR