SONOMA COUNTY EMPLOYEES' RETIREMENT ASSOCIATION
INVESTMENT COMMITTEE MEETING MINUTES

Thursday, May 16, 2019
9:02 a.m.

Presiding: Brian Williams, Vice Chair

Present: Trustees Neil Baker (Alternate Retiree), Susan Gorin (left at 11:25 a.m.), Michael Gossman, John Pels, Erick Roeser, Joe Tambe, and Bob Williamson; Assistant Chief Executive Officer Kelly Jenkins, Chief Investment Officer James Failor, Retirement Analyst Rebecca Gay, and Administrative Aide Julia Smith

Also Present: Tom Hauser and Leigh Poggio (from Guggenheim); Shane Schurter and Chris Behrns (from Aon); Mike Pollard and Neil Collins (from Aon and via video conference); and Jim Scriven (a member of the public)

Absent: Trustees Greg Jahn and Christel Querijero

I. MINUTES APPROVAL

Approval of April 18, 2019 Minutes

Recommendation: Approve Minutes.

A motion was made by Trustee Williamson, seconded by Trustee Gossman to approve the April 18, 2019 Investment Committee Minutes. The motion carried 7-0-0-2 with voting as follows:

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

II. PRESENTATION

Guggenheim – Senior Managing Director Tom Hauser and Managing Director Leigh Poggio presented. Ms. Poggio began by thanking SCERA for the business and the opportunity to speak. She reviewed the health of Guggenheim's business which continues to be strong. The firm's bank loan management business, in particular, continues to be robust with $16.6 billion in assets under management as of March 31st. Mr. Hauser then discussed performance noting that their portfolio outperformed in the fourth quarter of 2018 as investors fled risk and the benchmark (the Credit Suisse Leverage Loan Index) turned down. While the portfolio is generally more defensively positioned it was lighter in higher quality BB rated securities which helped relative performance. Mutual fund outflows across the industry put downward pressure on the more liquid higher quality BBs, leading to their poor performance in the fourth quarter. In the first quarter of 2019 the market snapped back with strong absolute returns for the benchmark. The portfolio trailed in this environment due to its lower exposure to the more liquid higher quality BBs which now outperformed. In response to a question regarding default rates, Mr. Hauser commented that bank loan defaults had not increased and were less than 1%. However, Guggenheim believes they could turn up going forward. The firm sees the possibility of recession in 2020 and leverage among businesses is higher today putting more risk on lower quality credits. It was also stated that more leveraged companies with weaker cash flow are issuing loans and, as a result of this and the increasing chance of an economic downturn, Guggenheim has gotten pickier in evaluating loans. As evidence, last year they participated in only 20% of new loans issued where typically they participate in around 30% of new issues.

In discussing attribution Mr. Hauser noted that they expect their alpha in the long run to be sourced from security selection. The attribution model for the first quarter suggested that underperformance was primarily sourced from security selection (most notably in the Technology sector) and secondarily due to holding 4.6% in cash. The cash exposure is higher than normal (2-3%) and was largely due to the firm's passing on more new issuances. It was also noted that for the past two years they have been moving toward less cyclical exposure, reducing exposures to Industrials, Energy and Building Products. In discussing loans that evolved into restructuring issues they discussed their holding in American Tire (AT). Guggenheim likes to have a large enough position to guide the restructuring process to obtain more attractive outcomes. AT was an example of this as they ended up with a higher yielding and more valuable loan in the end. In discussing portfolio characteristics, comment was made that the Yield to Maturity (YTM) was lower for the portfolio than the benchmark (6.5% vs 7.1%). Mr. Hauser commented that the lower YTM was due to the lower exposure to lower quality credits (such as CCCs) and other stressed issues in the benchmark. In response to a question about loan life, he stated that most new loans are issued today with a 7-year maturity but they are typically called early. Consequently, they generally expect a 3-4 year life on new loans. The firm's typical position size is a half percent. In reviewing the asset class breakdown it was stated that the portfolio had a couple High Yield bonds and that these were legacy securities from the origination of the separately-managed account when it was split off from the firm's commingled fund. They went on to discuss credit quality, effective duration and sector weightings.

The last topic addressed was the economic outlook. Guggenheim believes that growth is set to cool in 2019, that the Fed will raise rates one more time and that this will be followed by recession in 2020. They are of the opinion that "easy money" has caused an excess in the credit markets. As a result, they are positioning the portfolio to have less market "beta" and to be less cyclically exposed and they are tightening their underwriting standards. In response to a question about the potential impact on the portfolio from the trade war with China, Mr. Hauser commented that a handful of names could be impacted but that they have talked with these firms and they believe they have offsets to largely mitigate the potential impact.

III. INVESTMENT CONSULTANT & STAFF

A. Review of GMO's Global Asset Allocation Mandate (Aon participation via WebEx).

Chief Investment Officer Jim Failor introduced the topic and Mike Pollard of Aon consulting who participated via WebEx video conference. The topic was turned over to Mr. Pollard to review Aon's "Buy" ranking of GMO's asset allocation strategy. He noted that they find the mean-reversion asset allocation approach sound and, while they have had turnover within their investment team, the senior members such as Ben Inker are experienced and capable. He added that they "stick to their guns", which is important, even when the market is going against them as asset classes can be over/underpriced for extended periods of times.

Mr. Failor then addressed the recommendation by staff and consultant to place the manager on "Watch". (While Aon continues to rank the manager a "Buy", the Aon consulting staff is supportive of the "Watch" recommendation given SCERA's specific investment program and experience with GMO.) He began by reviewing the history of the 14 year old account. Over the first nearly 8 years when it was a global equity account the manager outperformed in three years, two of which were bear market years. Since conversion to a global asset allocation (GAA) strategy the manager has underperformed in every one of the six calendar years. Since inception the account modestly trails its benchmark after fees. The account was placed on "Watch" in 2016 due to concerns regarding performance and organizational turnover. GMO was taken off "Watch" in 2017 as the firm appeared to be stabilizing.

SCERA has always been skeptical of market timing and, as a result, active asset allocation. However, the GMO approach seemed well thought out and credible and the team very capable. The view was that if anyone could execute active asset allocation, it would be GMO. On the other hand, successful implementation of the mean reversion approach requires that the manager has a good idea of what the future "mean" (rather than the historical mean) is. In addition, if you have no idea regarding the timing of the reversion (which GMO does not claim to forecast), it makes it that much harder to add value with the strategy. The long consistent period of underperformance has caused SCERA to question GMO's mean reversion approach. SCERA was persuaded, however, that their largest active position (a significant underweight to US equities) is approaching a "fat pitch" opportunity as US equities are priced at an historic high relative to non-US equities. A secondary large active position in the portfolio is an overweight to Value which has underperformed Growth for an extended period and is now, arguably, also positioned to outperform. Consequently, it was deemed to be prudent to give the manager more time to turn their performance record around.

Considerations for potential termination were also discussed. Comment was made that if the account were eventually terminated, the fixed income portion of the mandate could provide most of the funding for Axium Infrastructure as the Board has expressed the desire for this 2% policy weight expansion in infrastructure to be sourced from fixed income. (As a global asset allocation manager with a 5% allocation, GMO's benchmark and "neutral" position is 35% fixed income which translates to 1.75% of total Plan assets.)

Recommendation: Place the manager's account on "Watch".

A motion was made by Trustee Tambe, seconded by Trustee Pels to place the manager's account on "Watch". The motion carried 7-0-0-2 with voting as follows:

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

B. Templeton Update – Aon Flash Report

Mr. Failor introduced the topic noting that Aon had recently downgraded the Franklin Templeton global and non-US equity strategies to "Qualified". He commented that Templeton is now the third of the Plan's 18 managers not rated a "Buy". Neil Collins of Aon consulting was introduced. He participated via WebEx video conference. Templeton had been a "Buy" but was moved to "In Review" in February of this year on concerns surrounding the changes being implemented by the new Chairman of the Templeton Global Equity Group. Mr. Collins explained that after an on-site visit in March they were not comfortable with a "Buy" rating as they were concerned about the slow pace at which the new Chairman was evolving the team and what they viewed to be a suboptimal investment and risk management process. They are not concerned about the quality of the individual stock research which they consider strong but are, rather, concerned about portfolio construction and the process of getting "good" ideas into the portfolio. As a result, they downgraded both the subcategories of Process and Performance from a 3 (above average) to a 2 (average).

Templeton has been a non-US equity manager for SCERA for approximately 14 years. They have underperformed over 1, 3 and 5 years and are approximately equal to the benchmark since inception (before fees). Staff did not make a recommendation to change Templeton's standing with SCERA at this time but that could be considered at a future meeting. After questions and answers the discussion was concluded.

C. First Quarter 2019 Investment Performance Report – Aon presenting

Chris Behrns reviewed first quarter performance beginning with the markets. He noted that the concerns of the fourth quarter in 2018 eased in the first quarter and equities rose. Along with the easing of trade concerns the markets were supported by the "easy money" policies of central banks. In this environment the S&P 500, the Russell 2000, the MSCI EAFE and the MSCI Emerging Markets Index returned 13.6%, 14.6%, 10.0% and 9.9%, respectively. Interest rates dropped during the quarter contributing to the Bloomberg Barclays US Aggregate return of 2.9%. Within US equities Growth beat Value across the capitalization range and leading sectors included Technology, Producer Durables and Energy while trailing sectors included Healthcare and Consumer Staples. Within fixed income Corporate Bonds were the best performing sector and Asset Backed Bonds were the poorest. High Yield and lower quality credits outperformed in this environment. In reviewing the Real Estate market it was noted that returns are moderating and that, while there has been healthy capital appreciation over the last several years, going forward they expect most of the return to be sourced from yield.

Turning to the performance of SCERA's portfolio, Mr. Behrns commented that from a broad view, active management detracted from the Plan's return as did the allocation to the Opportunistic bucket. Active management was quite challenged in the first quarter. While there were some individual managers that outperformed their benchmarks, there were more that did not and active management in every asset class (US Equities, Non-US Equities, Global Equities, Fixed Income, Global Asset Allocation and Real Assets) delivered negative alpha. Some of the reasons for benchmark relative underperformance were discussed. One of the common themes that ran through the relative performance of a number of managers was defensive positioning during a quarter with strong absolute returns.

D. Currency Hedging Discussion – deferred from prior month

Mr. Shane Schurter of Aon consulting reviewed this topic. He commented that hedging the currency exposure of the Plan's non-dollar allocation was last discussed in 2016. In the third quarter of 2018 SCERA increased its non-US equity allocation from 40% to

50% and, as a result, the staff and consultant felt it was a topic worth reviewing again given the increased size of the non-dollar exposure. Aon's recommended strategic currency hedge for "globally-oriented" equity portfolios, like SCERA's, is a 50% hedge. They note that the impetus for this is expected risk reduction and not to generate excess return. They also observe that the cost and complexity of a 50% hedging program may prove prohibitive for some clients. Mr. Schurter walked the Board through the analysis that showed, based on their modeling, that the most "bang for the buck" in volatility reduction was a 50% hedge. There were a number of questions from the trustees regarding the practical implications of a hedging program, including the cost and administrative burden. The implications of the crystallization of gains/losses and the additional effort in managing the Plan's cash to replace margin cash when losses are crystallized were of particular interest. The frequent trending nature of currencies was discussed and the resulting argument that a position of "regret minimization" may very well be with a 50% hedge. In response to a question Mr. Failor stated that, while he appreciated the analysis, he was not convinced that the reduction of volatility was the likely outcome of a 50% hedge. He noted that the analysis was predicated on volatilities of asset classes and currencies as well as cross correlations and those correlations have historically not been very stable. If the correlations are not stable then the conclusion that some hedging will reduce total portfolio volatility may not be supported.

The consensus was that, given the cost (though it is relatively modest), the additional burden on staff regarding cash management, and the question as to whether the hedge would actually lower total Plan volatility, there was not enough interest by the Board to pursue the concept further at this time. They did however appreciate the presentation and commented that it was worthwhile given the substantial size of the Plan's non-dollar exposure. They thanked Mr. Schurter for his analysis and presentation.

E. Framework for Alpha Expectations – deferred from prior month

Mr. Schurter of Aon consulting reviewed the firm's forward-looking alpha expectations by asset classes. He also explained the method used in developing these estimates which considers historical average excess returns, Aon's historical experience with "Buy" rated investment product, Aon's outlook and typical manager excess return objectives.

F. Axium Infrastructure – update

Mr. Failor provided a verbal update on the review and negotiation of contractual terms for the Axium Infrastructure North America fund in which SCERA intends to invest. There is a "vintage" expected to close in late May and another in July. After the Plan enters a "vintage" Axium estimates 12 to 18 months before commitments are called.

G. April Cash Raise – report out

Mr. Failor reviewed the $40 million cash raise and which managers experienced withdrawals to assemble the funds which will be used primarily for retiree payroll.

H. 2019 Planning Session Agenda Discussion

The content of this year's Planning Session was discussed briefly. It was decided that three investment manager panels (Equities, Fixed Income and Real Assets) was preferred. The Real Assets panel has been utilized only every other year in the past due to the smaller allocation and the slower moving nature of the asset class. This was to be a year in which a Real Assets panel would not be included. However, with a new manager (Axium) in this asset class and the growing allocation to it, the trustees preferred to include it this year. Trustees also expressed an interest in hearing from a macro economist as well as compelling topical speakers we don't typically hear from such as Dr. Baumbacher who spoke on PTSD in 2018 and Dr. Olshansky, the demographer who spoke at the 2017 Planning Session.

IV. COMMUNICATIONS

A. Investment Benchmark Summary – April 2019.

B. Jacobs Levy Due Diligence Meeting Report, May 16, 2019.

C. Guggenheim Due Diligence Meeting Report, May 16, 2019.

D. Systematic Due Diligence Meeting Report, May 16, 2019.

E. UBS Realty & Farmland Due Diligence Report, May 16, 2019.

F. Financial Times, "Equivalent of doping?", April 16, 2019.

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.

There were no general discussion matters.

VI. PUBLIC COMMENT

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

There was no public comment.

VII. NEXT MEETING

Currently scheduled for Thursday, July 18, 2019 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 Parametric. Please note that there is no June Investment Committee meeting.

VIII. ADJOURNMENT

With no further matters to discuss, the meeting was adjourned at 12:00 p.m.

IX. APPROVAL

The above minutes for the Investment Committee meeting on May 16, 2019 were approved at the Investment Committee meeting on July 18, 2019.

GREG JAHN, CHAIR