SONOMA COUNTY EMPLOYEES' RETIREMENT ASSOCIATION
RETIREMENT BOARD EDUCATIONAL FORUM MINUTES

DoubleTree Resort
One Doubletree Drive, Rohnert Park, CA 94928

Wednesday, October 9, 2024
9:31 a.m.

Presiding: Chair Brian Williams, presided

Present: Trustees Neil Baker (Retiree Alternate) Travis Balzarini, Chris Coursey (left at 3:30 p.m.), Amos Eaton, Greg Jahn, Mark Walsh (left at 3:30 p.m.), and Bob Williamson; Chief Executive Officer Julie Wyne, Assistant CEO/Chief Legal Counsel Cristina Hess, Chief Investment Officer Jim Failor, Investment Officer Mickey Nguyen, Finance and Retiree Services Manager Cheryl Enold, Retirement Analyst Rebecca Gay, Administrative Aide Julia Smith, and Accountant II Stacy Vasquez

Also Present: Nick Klein (of the Sonoma County CAO Office); Chris Behrns and Tim Pflugradt (of Aon); Amy Brown (of Arc Strategies); Jon Simon (of Arrowstreet Capital); Dominic Chalifoux and Anne-Sophie Roy (of Axium); Kevin Johnson (of Dodge & Cox); Christine Chun (of Double Line); Antoine Bisson McLernon and Jeff Zweig (of Fiera Comox); Brian McAuliff and Margaret Schorgl (of Guggenheim); Gary Harrison and Timothy Dobney (of IFM Investors); Erik Olsen (of Jacobs Levy); Tom Klugherz, Jason Curran, and Akash Patel (of JP Morgan); Felix Boyeaux and Rohan Bhargava (of KKR); Macki Anderson (of Parametric); David Altshuler and Wil VanLoh (of Quantum Capital Group); Sonya Park (of State Street); Steve Shaw and Ken Burgess (of Systematic); Jim McCandless, Tom O'Shea, Husayn Hasan, and Dan Murray (of UBS); Kathy Young (of SCARE); David Wallace - interested member of the public

Absent: Trustees Erick Roeser and Joe Tambe

I. WELCOME AND INTRODUCTIONS

Chair Brian Williams and Chief Executive Officer Julie Wyne welcomed attendees and provided a brief overview of the planned presentations.

II. INVESTMENT MANAGER PANEL – REAL ESTATE

Participants on the panel were Jason Curran of JP Morgan and Husayn Hasan of UBS Realty. The first topic covered the outlook for Office properties. The participants recognized the depressed valuations, in some cases reflecting a discount to recovery cost, and signaling the potential for a good recovery ahead. The timing of a trough though could be delayed as current leases roll off. A promising sign was that the most recent quarter's transactions were 5-8% above where JP Morgan was carrying those properties, so the market could be reflecting fair value today. With expectations of a lower 10 yr Treasury yield, real estate returns look more attractive relatively. JP Morgan's underwritten rate of returns indicate investors are being well compensated on a level not seen since the Great Financial Crisis. The discussion then focused on the management of large redemption queues. Mr. Curran noted the new contributions and recissions had significantly reduced the balance of redemptions as investors begin to recognize the attractive going-forward opportunities. Mr. Hasan also viewed positively the year-to-date level of recissions at UBS Trumbull Property Fund. Regarding how demographic changes will affect real estate sectors, multifamily assets have had good demand even with supply coming online because renting has been a good option for families. Other areas of opportunity mentioned include data centers, self-storage, manufactured housing, and life sciences. Mr. Hasan believes the NCREIF ODCE benchmark sector changes is a good development allowing for larger exposures to attractive alternative sub-types.

Questions from the audience raised a concern about the social and political ramifications of build-for-rent communities, but it was noted that the percentage of stock in that category is very small, and the new housing that is being built would not exist otherwise given developers' limitations. The panelists concluded that climbing interest rates, war, and deteriorating consumer finances could be negative developments, while rapidly declining construction activity, continuous evolution of artificial intelligence, and falling rates would support upside moves.

III. INVESTMENT MANAGER PANEL – FARMLAND

Jim McCandless and Dan Murray represented UBS AgriVest on the panel and Antoine Bisson-McLernon represented Fiera Comox. The panelists were asked about the macroeconomic trend toward deglobalization and supply chain disruptions. In response, it was noted that this has not taken place in farmland products because they are considered essentials. In fact, the trend for the export of agricultural products has been growing for years. In addition, tariffs on agricultural products have generally been short in duration but it is still important to diversify to protect against these kinds of short-term risks. Sustainability was also discussed. It was noted that sustainability is in the investors interest as there is value in the land that needs to be retained and can be enhanced. UBS discussed Leading Harvest, which has developed farmland sustainability standards for institutional farmland investors. Mr. McCandless was instrumental in developing these standards and UBS has nearly all of their properties already enrolled in Leading Harvest. Fiera Comox is in the process of enrolling their properties in countries, like the US, where it is offered. Changes in weather were also addressed and it was noted that diversification is important to protect against weather-related risks. Both firms also attempt to obtain multiple water rights, both surface and subsurface, when underwriting properties to mitigate water risks.

In response to Trustee questions, the impact of the recent dock workers strike was discussed and the eventual move away from traditional plastic packaging of food products toward paper and cardboard and potentially biodegradable plastics was also discussed. The impact of technology was reviewed, the historical impact, including the move toward horses and then to tractors, and the anticipated impact on future productivity with emerging technologies. Last, the panelist responded to a question about potential unexpected events that could be positive or negative. In response, the recent high number of California nut tree farm bankruptcies was mentioned as well as the potential impact of regulations. It was also noted that, because agriculture products are considered essential, they are a good inflation hedge as rising input costs can usually be passed on to consumers.

IV. THE STATE OF GLOBAL ENERGY MARKETS

Wil VanLoh, founder and CEO of Quantum Capital Group, presented on energy security and the practical realities of the energy transition. He spoke about the challenges of providing abundant, affordable, and reliable energy while also recognizing the impacts of climate change. He noted that over the coming decades, all sources of energy production will be necessary to meet the enormous global demand and that the shale revolution enabled the U.S. to gain energy independence and created a geopolitical advantage that saved the country trillions in energy costs. Additionally, oil and natural gas produced in the U.S. and Canada have been shown to be more ESG-friendly compared to countries of origin that have much lower standards. He stated that to reach NetZero goals by 2025, $5-7 trillion of public and private capital will be needed annually versus the $1.8 trillion invested in the energy transition globally in 2023 and that green technology (e.g. solar/wind power, electric vehicles, batteries) requires vast amounts of minerals that are mined and processed predominantly in the China-Russia bloc. He further noted that structural challenges in mining such as underinvestment, long cycle times, and degrading ore quality are obstacles to obtaining the supply of critical minerals necessary to keep up with projected demand. Finally, he indicated that several themes support a favorable investment case in oil and natural gas: potential major supply/demand imbalance, a long-term secular inflationary cycle, cheap relative industry sector valuation, public vs private valuation disconnect, limited competition and unprecedented buying opportunities.

V. INVESTMENT MANAGER PANEL - INFRASTRUCTURE

Participants on the panel were Dominic Chalifoux of Axium, Timothy Dobney of IFM, and Felix Boyeaux of KKR. Mr. Dobney addressed the question in regard to mitigating risks associated with potential changes in government incentives and regulations impacting infrastructure. Axium takes a long-term view so there are always expectations that regulations will change; avoiding placing undue weight on government incentives is important. Generally, any changes are phased out in an orderly fashion so that there is time to adapt. Panelists also added that support for infrastructure is non-partisan, and a laser focus on downside protection is key. Capital flows have been healthy in core strategies as investors seek out resilient asset classes, and M&A activity has rebounded recently since rates have declined. In digital infrastructure, the panelists recognized the elevated AI hype that can lead to the risk of poorly allocated capital. Axium, which is a NetZero signatory, does not invest in data centers but is exposed to power industries that will benefit from growing demand. Mr. Dobney emphasized the strong demand for renewable power from data centers utilized by Big Tech companies that have NetZero goals.

Mr. Chalifoux discussed the complex issues in relation to nuclear power plants from the cost of building, length of construction over 5-10 years with no yield, an unknown exit strategy to the possibility of shutdowns. Infrastructure managers are very good at project financing and nuclear simply doesn't fit in that category. The panelists described characteristics of portfolio assets including Axium's Texas transmission lines and Toronto toll road, and IFM's Indiana toll road. Mr. Dobney answered a question about high insurance costs using an example of hailstorm insurance quotes for solar farms that was much higher than assumed, suggesting that going forward pricing will reflect increased rates. Mr. Chalifoux added that insurers are raising premiums to cover increased costs for reconstruction and business interruption as well, but this may have plateaued since insurers are better at assessing catastrophic risk. Panelists reviewed their processes to ensure adequate diversification from using multiple project partners, analyzing underlying revenue sources, and active hedging to reduce cash flow variability.

VI. LEGISLATIVE UPDATE

Amy Brown, Partner at Arc Strategies, provided a legislative update focusing on California pension legislation that affects county and state retirement systems, noting that several bills were signed by the Governor. Ms. Brown discussed bills relating to overpayments, disability presumptions, compensation earnable definitions, and closed session exceptions to the open meeting law. She also provided a high-level overview of the state of the economy through the legislative lens touching on legislation that impacts gas production, affordable housing wildfire prevention and reducing homelessness.

VII. END OF DAY ONE

Thursday, October 12, 2023
9:31 a.m.

Presiding: Chair Brian Williams presided

Present: Trustees Neil Baker (Retiree Alternate); Travis Balzarini, Chris Coursey, Amos Eaton, Greg Jahn, Mark Walsh (left at 1:00 p.m.), and Bob Williamson; Chief Executive Officer Julie Wyne, Assistant CEO/Chief Legal Counsel Cristina Hess, Chief Investment Officer Jim Failor, Investment Officer Mickey Nguyen, Finance and Retiree Services Manager Cheryl Enold, Retirement Analyst Rebecca Gay, Administrative Aide Julia Smith, Accountant II Stacy Vasquez, and Accountant I Katelyn Groman

Also Present: Nick Klein (of the Sonoma County CAO Office); Chris Behrns and Tim Pflugradt (of Aon); Jon Simon (of Arrowstreet Capital); Kevin Johnson (of Dodge & Cox); Andrew Hsu and Christine Chun (of Double Line); Brian McAuliff and Margaret Schorgl (of Guggenheim); Erik Olsen (of Jacobs Levy); Jason Curran and Tom Klugherz (of JP Morgan); Macki Anderson (of Parametric); Marc Seidner and Matt Clark (of PIMCO); Neil Aggarwal (of Reams); Emily Klare and Todd Tauzer (of Segal); Gordon Clark, presenting via Zoom (of Smith School/Oxford), Steve Shaw and Ken Burgess (of Systematic); Husayn Hasan (of UBS); Phyris Tobler (of SCARE); David Wallace and Tom Ford – interested members of the public

Absent: Trustees Erick Roeser and Joe Tambe

VIII. INVESTMENT MANAGER PANEL – FIXED INCOME

Participants on the panel were Neil Aggarwal of Reams, Marc Seidner of PIMCO, and Andrew Hsu of DoubleLine. Mr. Aggarwal stated that expectations of Federal Reserve actions does not influence Reams' decision making due to the difficulty in predicting what will transpire in markets; a focus on what spreads look like relative to what may happen is preferred. Mr. Seidner pointed out the 10-year Treasury yield has hardly changed in two years while the narrative has been highly volatile and short term interest rates will likely fall below 3%. He further noted that because central bank policies have moved in symmetrical paths, first up in yields and now lower, investors can trade a range in the U.S. and globally to add value. Mr. Hsu stated that the Fed has continued to be behind the curve even with the recent rate cut. On the long end of the curve, DoubleLine does not expect rates to fall sharply due to deficit spending. Panelists were in agreement that the budget deficit will continue to grow no matter the outcome of the election, leading to higher yields due to more supply. Mr. Aggarwal believes real rates are very attractive across the curve, especially the 7 and 10 yr, and also expects a curve steepening.

Regarding the widespread favorable positioning in mortgage-backed securities (MBS), PIMCO is quite overweight agency mortgages that are offering attractive spreads versus investment-grade corporates. Mr. Hsu agreed that mean reversion should result in MBS outperforming corporate bonds, delivering excess return with lower volatility, as the spread relationship normalizes. MBS spreads widened beginning in 2022 because the Fed stopped buying agency MBS and drastically hiked rates in conjunction with quantitative tightening measures. So Reams began heavily investing in mortgages, both agency and select non-agency where there is no credit risk at the AAA level.

Mr. Hsu described the more difficult environment for sourcing opportunities in the private credit space that is materially different from the public markets. As the economy cooled, he believed more work out/recovery situations would arise, but the availability of private credit willing to take on the risk keeps these companies moving forward. This development clearly raises concerns from a risk-adjusted perspective. Mr. Aggarwal pointed out spreads are tightening because of the strong flows/demand in private credit, and therefore credit deterioration may continue due to the ease of borrowing. Mr. Seidner quipped that private credit funds are brilliant at marketing because they take an asset that has risk but no mark-to-market and proclaim returns are great. In fact, the yield differential between public and private floating rate debt is near a six year low of 2.15%. If economy weakens, private credit could potentially see great losses. With 4.5-5% yields plus the MBS spread opportunity plus tactical curve positioning, a fixed income total return of 6% is enough to rival equity portfolios. The panelists also discussed low coupon mortgages and collateralized mortgage obligations (CMOs).

IX. DEMOGRAPHICS & ECONOMIC IMPLICATIONS

Gordon Clark, PhD, is a Professor and Director Emeritus at Oxford University, UK, and a Trustee of the Oxford Staff Pension Scheme. Professor Clark presented on demographic challenges and opportunities with a focus on Organisation for Economic Co-operation and Development (OECD), China and developing economies' prospects. Implications for global investment were also considered. World population growth, fertility rates, migration patterns, historical impacts that had positive and negative effects on life expectancy were discussed. Particularly the growth in agricultural output from the 1800s on had a significant impact on average life expectancy. Professor Clark noted that the combination of higher life expectancy and dramatically lower fertility rates below the 2.2 replacement rate has led to the percentage of the population over 70 projected to nearly triple by 2050 in the U.S. while the working age population will decline. He suggested that solutions to circumvent future challenges include government tax incentives, increased immigration, and investing in technologies that improve productivity/lessen the demand for labor. In addition, Artificial Intelligence and energy revolutions are entwined and represent significant investment themes. Professor Clark also discussed risks associated with disease and pandemics as well as climate change, on not only population, but also economic growth, productivity and geopolitical stability in part from emigration out of climate-risk regions.

X. INVESTMENT MANAGER PANEL - EQUITY

Kevin Johnson represented Dodge & Cox on the panel and Ken Burgess represented Systematic. The initial question for the panelists addressed Value versus Growth stocks and the relative opportunities in the managers' respective universes. In large cap stocks, Mr. Johnson commented that Growth had significantly outperformed Value over the last couple years and that Growth stocks now looked expensive. Mr. Burgess noted that it looked different in his universe with Small Cap Value outperforming Small Cap Growth over the last couple of years. Having said that, relative valuations for US Small Cap Value and Growth are now close to their long-term average. The excitement over AI (Artificial Intelligence) stocks was also debated. The panelists did not believe we are currently in an AI stock market bubble yet and that, while AI stocks are expensive, they do have real earnings unlike many of the overvalued stocks during the TMT (Technology, Media, Telecomm.) bubble of the late 1990s. There are no Small Cap AI stocks, but Mr. Burgess detailed some of the stocks he owns that are benefitting from the growth in AI, including companies that do electrical and HVAC work for data centers. Mr. Johnson commented that, unlike the TMT bubble, the Magnificent 7 stocks have real earnings and strong cashflow and that they would love to own them at the right price. In response to a Trustee question, both panelists commented that they believe AI will be revolutionary, as the Internet has been, but that it will take time to be broadly adopted and it wasn't clear who the ultimate winners would be. As an example, NVIDIA has benefitted greatly, thus far, and has net margins in the 50% range but this will attract competition. The panelists discussed both direct and indirect exposure to the growth in AI.

The panel reviewed the upcoming election and potential impacts on policy. While there could be some changes impacting the energy and health care industries, the one constant with either administration was the expectation of continued deficit spending which should, over the long-term, push interest rates up. In response to a question regarding a possible recession, both panelists noted they are bottom-up "stock pickers" and this possibility has had little impact on their portfolios. They discussed their positions in banks which are particularly sensitive to rates. Systematic has marginally increased their Small Cap bank exposure as a recession seems less likely and Dodge & Cox noted that they have a "barbell" exposure with large US and European banks at one end and Emerging Markets (most notably Indian) banks at the other end. In response to a Trustee question, the panelists discussed some stocks they hold that benefit from IPOs (Initial Public Offerings) as companies "go public." In response to a question about best ideas, Mr. Burgess reviewed companies they hold that should benefit from an AI upgrade cycle. Mr. Johnson discussed the large (65%) overweight to the US in their global equity benchmark and stated that they have been reducing their US due to valuations. Dodge & Cox has 51% today in the US which is their lowest exposure in years. Last, in response to a question about potential unexpected impacts on their portfolios, the panelists examined interest rate volatility, the potential for inflation and geopolitical risks.

XI. ACTUARIAL EXPERIENCE STUDY

Vice President and Actuary Todd Tauzer and Senior Actuary Emily Klare presented the December 31, 2023, Triennial Actuarial Experience Study noting that the assumption change recommendations focused largely on the demographic assumptions. Mr. Tauzer explained a methodology change in the way the investment assumption is calculated using an expected geometric return to produce a median result instead of an expected arithmetic return, which produces a mean result. He noted that using an arithmetic return calculation creates the possibility that outsized returns, either high or low, could skew the mean result, and that using a geometric calculation produces a median result, which tempers the effect. Ms. Klare presented the demographic assumption change recommendations which cover merit and promotion, mortality, disability retirements, cashouts and other assumptions reliant on the behavior of plan participants. Trustees discussed the limitation on setting mortality assumptions because SCERA does not yet have the number of deaths to ensure our data is statistically significant. Mr. Tauzer indicated that Segal accounts for this in their recommendations.

XII. PLANNING SESSION WRAP-UP

Chair Brian Williams and CEO Julie Wyne thanked the attendees for their participation and the staff for their efforts in making the Educational Forum a success.

XIII. ADJOURNMENT

The meeting was adjourned at 4:16 p.m.

XIV. APPROVAL

The above minutes for the Educational Forum on October 9 and 10, 2024, were approved at the Investment Committee meeting on November 21, 2024.

GREG JAHN, CHAIR