MINUTES

Marin County Employees' Retirement Association (MCERA)
Retirement Board Strategic Workshop

One McInnis Parkway, First Floor
San Rafael, CA
October 15, 2024

This meeting was held at the address listed above and was accessible via videoconference and conducted in accordance with Government Code section 54953 and 54954.2.

Meeting Chair Daniel Vasquez

9:00 a.m.
Call to Order/Roll Call

Chair Murphy called the meeting to order at 9:02 a.m.

CONSIDER ANY BOARD MEMBER REQUESTS TO TELECONFERENCE FOR "JUST CAUSE" OR "EMERGENCY," AS SET FORTH ON THIS AGENDA BELOW

No Board members requested to teleconference.

PRESENT: Cooper, Gladstern, Martinovich, Murphy, Poole, Raabe, Silberstein, Vasquez, Werby, Jones (alternate retired), Shaw (ex officio alternate)

ABSENT: None

Open Time for Public Expression
Open time for public expression, from three to five minutes per speaker, on items not on the Board Agenda. While members of the public are welcome to address the Board during this time on matters within the Board's jurisdiction, except as otherwise permitted by the Ralph M. Brown Act (Government Code Sections 54950 et seq.), no deliberation or action may be taken by the Board concerning a non-agenda item. Members of the Board may (1) briefly respond to statements made or questions posed by persons addressing the Board, (2) ask a question for clarification, or (3) provide a reference to staff for factual information.

No members of the public provided comment.

9:00 a.m. – 10:00 a.m.
Public Real Assets – Market Structure and Investment Options
Jim Callahan, President
Callan LLC

Jim Callahan, President of Callan LLC, introduced David Zee, head of Fixed Income Global Manager Research, and Jay Kloepfer who leads Capital Market Research at Callan. Mr. Callahan discussed the market structure and investment options for the public real asset portfolio targeted to 7% of the total Fund. One component, commodities, have been in question due to not performing well but having strong diversification components. Real Estate Investment Trusts (REITs), Treasury Inflation-Protected Securities (TIPS), and Global Natural Resources comprise the remainder of the real asset portfolio.

Mr. Callahan reported that net of fees over the life of the program the real assets portfolio has added value by outperforming the median return of Callan Real Assets Mutual Funds. Even with this, returns for the real assets portfolio have been less than the assumed rate of return for the total Fund. Risk statistics are in line with the median in terms of volatility, the Sharpe Ratio (return per unit of risk) is favorable, and correlation is low. Mr. Callahan concluded the real assets portfolio has done what it was designed to do.

Mr. Callahan discussed Global Listed Infrastructure as a potential alternative for the real asset portfolio. This sector includes regulated businesses with strong purchasing power found in the transportation, utilities and communication sectors. Trustee Silberstein indicated there is overlap in this group with the Global Natural Resources portfolio. Mr. Callahan agreed there is some overlap, but not in the transportation, power generation, or communications sleeves. Trustee Werby pointed out long-term performance is unimpressive. Mr. Callahan agreed and said the strong dollar has been a headwind to performance for global infrastructure.

Trustee Vasquez asked about investing in infrastructure through private equity, and Mr. Callahan replied many institutional investors are following this path. Trustee Raabe observed that global infrastructure has the same volatility as the equity portfolio with a smaller return. Mr. Callahan replied the merits of infrastructure are to diversity the equity portfolio. He reviewed components of the Global Infrastructure Index.

Floating Rate Bank Loans are another potential option for the real assets portfolio, Mr. Callahan said. The appeal of this investment is its sensitivity to inflation. Mr. Zee explained that investors in Floating Rate Bank Loans are first in line on the list of creditors. Issuers are below-investment-grade companies that pay more in interest for the loan. There is more correlation to equities than investment-grade securities, and returns are favorable over 10 years. Mr. Zee pointed out that bank loan quality has gone up, whereas the high yield market has done the reverse.

Chair Vasquez asked about the average duration being less than one year. In response, Mr. Zee said the short duration is due to readjusting the coupons every quarter. Chair Vasquez said he has seen loosening of covenants in the past and asked if this is going on today. Mr. Zee replied the covenant-light aspect of Floating Rate Bank Loans continues because the issuer is looking to see what terms it can get. Mr. Callahan added this is a characteristic the manager needs to be aware of. Trustee Raabe observed bank loans have a higher yield relative to volatility. Trustee Silberstein asked how Floating Rate Bank Loans compare with MCERA's Opportunistic portfolio and Mr. Zee explained the Opportunistic portfolio has less liquidity.

In conclusion, Mr. Callahan said due to a concern about performance of the commodities portfolio, Callan is presenting alternative public real assets mixes that eliminate commodities. Floating Rate Bank Loans and Global Listed Infrastructure are added with varying weights. Trustee Raabe noted the performance of TIPS has been very low with material volatility. Mr. Callahan replied there is a diversification benefit with TIPS. Trustee Silberstein indicated a preference for the KBI natural resources portfolio. Trustee Raabe indicated Floating Rate Bank

Loans performance is compelling, adding he is not impressed with Global Listed Infrastructure. Based on discussions, the Chair directed staff to present alternative mixes for the public real assets portfolio using the current three real asset allocations and adding Floating Rate Bank Loans at a future Investment Committee meeting.

10:00 a.m. – 11:00 a.m.
How U.S. Financial Market History Informs Future Markets & Investment Decisions
Mark J. Higgins, CFA, CFP®, Senior Vice President, Institutional Advisor
Index Fund Advisors, Inc.

Chair Vasquez introduced Mark Higgins, Senior Vice President and Institutional Advisor with Index Fund Advisors, Inc., and author of *Investing in U.S. Financial History: Understanding the Past to Forecast the Future*. Chair Vasquez noted the purpose of this presentation was to help inform the Board's decision-making process. The Chair pointed out historical examples of how money has been lost due to group think, for example.

Mr. Higgins started by quoting a famous investor as saying there is no better teacher than history in determining the future. As an example, he condensed the history of the U.S. Navy pension which began in 1800 by investing in U.S. bonds. Subsequently, banks were added and when money came in from the War of 1812, benefits were increased. Then, the panic of 1819 hit and benefit expansions were removed when banks failed. In the 1820's the economy grew only to fall apart in 1837 with the depression and benefits again became unworkable. Mr. Higgins cautioned there is a danger when political influence affects investments.

Mr. Higgins pointed to governance issues that can affect investment decisions. These include committee member turnover, infrequent meetings, and limited meeting time. In addition, decision-makers have variable levels of investment experience and may hold biases to certain asset classes.

Continuing with the broad history of U.S. capital markets, Mr. Higgins said in 1835 an investor cornered the market in one stock and traded on insider information. This became the norm for about 100 years, until the crash of 1929 led to the Securities Act of 1933 outlawing market manipulation and trading on insider information. This led to the need for securities analysis.

Mr. Higgins said in 1963 index investing became popular, followed by a trend over the last 25 years to move into alternative asset classes. The venture capital funding model was validated in 1966 when a successful Initial Public Offering was issued. In 1979 the big challenge for venture capital was being limited by the Employee Retirement Income Security Act (ERISA) prudent investor rule. Following the reinterpretation of this rule, a flood of money came into venture capital. By the year 2000, alternative asset classes were considered a cornerstone of investing. Mr. Higgins cautioned that when the herd comes in, unless there is a really good opportunity, it is not worth being in the flood stage. He presented data showing the average public pension plan allocation to alternative investments has risen to 34%.

Trustee Raabe asked what MCERA's allocation is to alternative investments and Mr. Callahan said the Fund has about 10% exposure. Chair Vasquez asked what the inflection point is when the economic benefit is not there. Mr. Higgins replied it can be faster than would be expected. He added we are well into the flood stage for alternative investments. As evidence, he presented the rolling 10-year return for alternative investments showing outperformance followed by underperformance relative to a passive index.

Trustee Raabe said the bigger issue historically is asset allocation. Mr. Higgins agreed and advocates implementation with index funds, adding it is not common for active managers to outperform passive indexes. He gave the example of a state pension plan portfolio with 80% allocated to passive investments that outperformed 89% of peers over the past 20 years gross of fees.

11:00 a.m. – 12:00 p.m.
Risk of Passive Investment Concentration in Financial Market Structure & Performance
Michael Green, Managing Director, Chief Strategist and Portfolio Manager
Simplify Asset Management

Michael Green, Managing Director, Chief Strategist and Portfolio Manager at Simplify Asset Management, stated the vast majority of the new money in the capital markets is flowing into passive indices. Other areas of passive investing include futures and many forms of separate accounts and derivatives. Since 2014 active management has experienced net redemptions, and now less than 10% of investments represent fundamental analysis used by active managers.

Mr. Green explained ways in which passive investment vehicles change the underlying structure of markets. He stated there is an increase in correlation between securities, and an increase in security valuations regardless of fundamentals. Reduced market elasticity raises risks of extraordinary price movements. In addition, there is an increase in market concentration as momentum bias leads to the largest companies becoming larger. Mr. Green pointed out that the momentum in large cap equities is the reason for underperformance of small caps over the past decade. Moreover, there is a reduced ability for new companies to become public since less money is flowing to active managers. The result of passive systematic algorithmic investing is to shift the market away from mean reversion to mean expansion, rising valuations over time, and ultimately much higher volatility. He stated the awareness of this problem is growing.

Mr. Green invited comments from the trustees. Trustee Raabe noted the Fidelity Contra Fund that is actively managed has substantially outperformed the S&P 500 Index over any time frame. In response, Mr. Green pointed out that the Contra Fund has experienced net outflows driven by liability avoidance. Chair Vasquez asked how the evolution of market structure into perverse outcomes can be mitigated. Mr. Green replied there has been a move to shift the responsibility to the individual investor by going from defined benefit plans to defined contribution plans. Secondly, the investment giants are determining investment options for retirement plans. Due to lack of regulation, he said, in this scenario the risks of a systemic event grow.

Mr. Wickman pointed out that MCERA's Fund is different from target date funds and 401K plans in that it is a defined benefit plan. Counsel Dunning added that MCERA is not subject to ERISA and has assurances with the retirement law that require employers to pay contributions to the plan. Mr. Green agreed MCERA's pension plan structure has an advantage.

Chair Vasquez recessed the meeting for lunch at 12:13 p.m., reconvening at 1:32 p.m.

12:00 p.m. – 1:15 p.m.
Lunch Break

1:15 p.m. – 2:15 p.m.
Fixed Income Manager Replacement Search Candidates (Action)
Jim Callahan, President
Callan LLC

Mr. Callahan stated at the direction of the Investment Committee Callan conducted a search for candidates to replace Western Asset Management as a core plus fixed income manager. Callan's concerns about Western Asset were discussed with the Committee at its September 18, 2024 meeting. Mr. Callahan recommended identifying three firms to interview as replacement managers.

Mr. Zee pointed out the six potential candidates for fixed income manager are institutional firms with long track records and public pension fund clients. The Candidate Product Summary reflects that BlackRock has a top down perspective and Dodge & Cox focuses on bottom up analysis to find issuers that may be mispriced in the market. Fidelity Institutional Asset Management (FIAM), Loomis, Sayles & Company, L.P., and PGIM Fixed Income use a blend of both top-down and bottom-up analysis. Pacific Investment Management Company (PIMCO) is a more top down-focused manager. Mr. Zee reviewed assets under management and key investment professionals for each of the firms.

Mr. Zee noted that historically Dodge & Cox had shorter duration than the benchmark, but this has come more in line in 2024. Effective yields for all managers are greater than the benchmark by different degrees. Mr. Zee presented relative positioning based on credit quality and sector allocation for the firms. Next, he reviewed up market capture and down market capture for each firm.

Mr. Callahan discussed proposed vehicles for each manager. BlackRock, PGIM and PIMCO are proposing Collective Investment Trusts, and Dodge & Cox, FIAM and Loomis are proposing separate accounts. Trustee Gladstern asked if fees would be lower with BlackRock or FIAM since they manage other portfolios for MCERA. In response, Mr. Callahan said it is possible but he pointed out the fees are already reasonable. Trustee Poole asked if it is beneficial for MCERA to have a separate account, and Mr. Callahan replied there are tradeoffs. The concern is anytime MCERA funds are pooled with other investors whether inflows or outflows will have an adverse effect. The upside of a pooled fund is more diversification due to the additional funds available. A separate account requires MCERA to provide for custody, for example, but also provides for the ability to modify provisions as preferred when market conditions change.

Trustee Raabe stated Dodge & Cox is the most attractive candidate, and PGIM is competitive. Trustees Murphy and Silberstein supported Dodge & Cox, and Trustees Werby and Chair Vasquez recommended adding Fidelity and Loomis. Mr. Callahan indicated PGIM has a better platform than Loomis, and said Dodge & Cox and Fidelity are fine. Trustee Cooper supported Mr. Callahan's view.

It was M/S Werby/Vasquez to select Dodge & Cox, Fidelity Institutional Asset Management, Loomis, Sayles & Company, and PGIM to interview as manager of the core plus fixed income portfolio. The motion passed by a vote of 9-0 as follows:

AYES: Cooper, Gladstern, Martinovich, Murphy, Poole, Raabe, Silberstein, Vasquez, Werby
NOES: None
ABSTAIN: None
ABSENT: None

2:15 p.m. – 3:15 p.m.
Modern Monetary Theory
Jay V. Kloepfer, Executive Vice President and Director of Capital Markets Research
Callan LLC

Jay Kloepfer, Executive Vice President and Director of Capital Markets Research for Callan LLC, discussed Modern Monetary Theory (MMT) at the request of the Ad Hoc Strategic Workshop Education Committee as a matter of interest and education. Mr. Kloepfer pointed out that the theory is not modern because it has been around since the 1930's. Currently, MMT is popular within some circles, he said, but the theory is not popular with mainstream economists.

Mr. Kloepfer stated the essence of MMT is that countries controlling their own currency are not constrained by revenues. The idea is they can print money and spend when needed to get through difficult times without being concerned about rising debt. Mr. Kloepfer explained that under MMT if a country has no limit to how much money it creates, full employment is necessary to make MMT work. This would mean implementing government guaranteed jobs for all.

Mr. Kloepfer pointed out that one challenge of MMT is that when monetary stimulus is implemented during tough economic times, inflation increases. An example is inflation rising to 9% in 2022 following trillions of monetary stimuli. Another challenge is MMT's tenet to use fiscal policy rather than monetary policy to control inflation and unemployment because taxes take time to implement. He pointed out that currently the Federal Reserve Open Market Committee has the dual purpose of managing inflation and the labor market, and controls demand by increasing the cost of borrowing.

Mr. Kloepfer presented a chart showing the growing U.S. federal deficit is becoming a greater percentage of GDP. Comparing policies on how to fund the deficit, he said traditional policies include future tax liability, bond issuance, and increased fiscal responsibility. MMT policies include continue spending, printing currency when necessary, and using future change in taxes to combat inflation.

In conclusion, Mr. Kloepfer stated the criticism from the academic economic establishment is there are assertions but no modeling or new insight to back up the claims of MMT. Chair Vasquez noted there are two premises that put MMT on the map: 1) the U.S. reserve currency status; and 2) settling global trade payments in U.S. currency. He asked, given episodes in history of failed countries promising more than they could deliver, what makes today's U.S. debt different from the past. In response, Mr. Kloepfer said there are similarities with the past. Mr. Kloepfer said none of the MMT tenets are implementable in the current environment.

3:15 p.m. – 3:30 p.m.
Closing and Follow-up Items from Today's Agenda

Chair Vasquez summarized today's presentations and relayed one trustee's suggestion to have regular reporting on correlations of asset classes, including public real assets. Chair Vasquez is interested in having Callan expand the excess return matrix from the fixed income presentation to the Fund level and being able to vary inputs. Trustee Jones said the Workshop topics were interesting and informative.

Mr. Wickman invited comments on topics that trustees would like to discuss further. Chair Vasquez is interested in the budding global infrastructure opportunity set. Trustee Murphy requested that one mix to consider for the public real assets portfolio be the three preferred current real assets in equal portions. Trustee Gladstern indicated real estate performance is a challenging topic that needs more analysis. The dynamics behind housing issues, such as a perceived shortage, are of interest to Trustee Silberstein.

There being no further business, Chair Vasquez adjourned the meeting at 3:09 p.m.

Daniel Vasquez, Meeting Chair

Kelsey Poole, Secretary