

San Mateo County Employees' Retirement Association
Minutes of the Investment Committee

March 27, 2000 – Investment Committee Agenda

PUBLIC SESSION - The Committee will meet in Public Session upon Adjournment of the Closed Session.

- 1.0 Call to Order
- 2.0 Roll Call
- 3.0 BGI's Analysis of *SamCERA*'s Asset Allocation & Manager Structure
- 4.0 BGI's Macro Manager Services
- 5.0 Selection of Investment Consultant Finalists for Recommendation to the Board
- 6.0 Discussion on Socially Sensitive Investment Statements
- 7.0 Review the Analysis of Westport Asset Management – Style Drift
- 8.0 Discussion of a Watch List - Concept, Criteria and Procedures
- 9.0 Draft Revision of *SamCERA*'s Investment Plan
- 10.0 Approval of Amendment to Custodial Fee Agreement with State Street
- 11.0 Review of State Street Analytics – Equity Attribution
- 12.0 Other Business
- 13.0 Adjournment

MINUTES OF *SAMCERA*'s Investment Committee

1.0 Call to Order

Mr. Cottle called the Public Session of the Investment Committee to order at 3:08 p.m., March 27, 2000, in *SamCERA*'s Board Room, Suite 280, 702 Marshall Street, Redwood City.

2.0 Roll Call

Mr. Bryan, Mr. Buffington, Ms. Wills-Colson & Mr. Cottle. *Board Members in Attendance:* Mr. McMahon & Ms. Perroton-Stuart. *Staff:* Mr. McCausland, and Mr. Clifton. *Public:* Retired – 1, Public – 1.

3.0 BGI's Analysis of *SamCERA*'s Asset Allocation & Manager Structure

The Board invited Mr. Waring to expand upon his January presentation, which focused primarily on active versus passive management. Barclays Global Investors compiled a special report, which reviewed performance management issues. Some of those issues pertinent to this agenda item are establishing a policy benchmark and validation of the benchmark through reverse optimization. In addition the report utilizes style analysis to determine a manager's true benchmark and to assist in creating an optimal combination of managers.

The report provides insightful comment regarding *SamCERA*'s Asset Classes and Benchmarks. Mr. Waring reminded the Board that most of a Plans' returns could be attributed to the Strategic Asset Allocation. The Allocation also generates a natural benchmark. The Board can add value to the Strategic Asset Allocation by over or under weighting specific asset classes in an active decision making process or by hiring active managers to add alpha. In association with Watson Wyatt the Board went through the traditional methods of developing an Asset Allocation. BGI approached the development of an allocation through reverse optimization lightheartedly referred to as "grapes from wine." It is a technique developed by Markowitz originally and used heavily by Ibbotson & Sharpe. The technique uses assumptions about the expected future risk characteristics of Asset Classes, which is then worked backwards knowing some weights or Asset Allocation policies for reference mixes. The reference mixes used by BGI were the Kuhns \$1-5 Billion Public

San Mateo County Employees' Retirement Association
Minutes of the Investment Committee

Plan Mix, the Greenwich Large Corporation Plan Mix, and the World Investable Asset Mix.

The underlying assumptions for risk are the assets correlation. BGI anchored the optimization with an 11.0% return for Large Cap Equities and 7.0% for Fixed Income. They proceeded to calculate an efficient frontier using the expected returns implied by the Greenwich Large Corporation Mix. The four alternatives in the table below were then tested and the proposed policy was optimized. The optimized portfolio demonstrated that 2.2% foreign bond is optimal, but not critical at this size. It also demonstrates *SamCERA's* proposed portfolio is overweight in small cap. However, small cap would not be overweight relative to the peer group. Allocating small cap at the optimal mix would guarantee tracking error against the peer group. The conclusion is *SamCERA's* proposed policy mix is essentially equivalent to the Optimal Portfolio at the same risk level and is sensible in the context of the Greenwich reference mix.

	<i>Current Policy</i>	<i>SamCERA's Proposed</i>	<i>Alternative #1</i>	<i>Optimal at Proposed Risk</i>	<i>Alternative #1</i>
Large Cap Equity	27.00%	40.00%	41.10%	45.30%	48.80%
Small Cap Equity	10.00%	10.00%	4.30%	4.60%	4.90%
International Equity	20.00%	15.00%	14.40%	15.60%	16.90%
Domestic Bonds	22.00%	28.40%	30.40%	25.80%	21.60%
Foreign Bonds	8.00%	0.00%	3.20%	2.20%	1.20%
Real Estate	8.00%	6.00%	6.60%	6.60%	6.60%
Expected Return	9.54%	9.62%	9.41%	9.65%	9.86%
Expected Risk	9.89%	10.09%	9.42%	10.09%	10.67%

BGI's analysis validates the work of the committee and recommends establishing a solid asset allocation policy. The Allocation should be the benchmark because benchmarking against a peer group is difficult at best. Every organization has different liability benchmarks and every board has different risk tolerances. Mr. Waring advocates the mantra of Risk Control, Return Control, Cost Control. The allocation should be implemented with a low cost, risk controlled, solution. Mr. Bryan moved that the Committee recommend to the Board adoption of *SamCERA* proposed asset allocation. It was seconded by Ms. Wills-Colson and passed unanimously.

Barclays Global Investors' special report includes style analytics of *SamCERA's* Portfolio Managers. William Sharpe developed these analytics, which assist in determining a manager's true benchmark. The Manager's historic return pattern is utilized to determine the actual style exposure. Active returns are compared to a series of different indexes. The returns are then disaggregated into component pieces which is similar to saying a little of this a little of that. Returns based data is easy to get and provides excellent information to answer the question is the manager doing what he says he is doing?

A summary of *SamCERA's* domestic equity style exposures shows that value and growth are evenly divided. The biggest style issue is the nearly 40% exposure to small cap, which is 20% overweight to *SamCERA's* own benchmark. This misfit can result in underperformance relative to the proposed benchmark (asset allocation). However it can be corrected by adjusting manager allocations and style exposures.

A summary of the international equity style exposures is broken down along regional lines.

San Mateo County Employees' Retirement Association
Minutes of the Investment Committee

In aggregate the plan is overweight Europe and underweight Japan. It is also under weight emerging markets. The weightings are relative to the All Country World Index (ACWI). This index seamlessly integrates emerging markets and Canada at cap weight with developed markets. Large funds are migrating toward benchmarking against the AWCI.

The goal of manager structure optimization is to maximize alpha across managers, while controlling risk. The inputs are manager expected returns and risks, manager and plan styles and capital market assumptions. Utilizing the three inputs can create out-performance over the benchmark (maximize alpha) while minimizing the chance of under-performance (controlling residual risk). The next step is to establish a risk tolerance or risk budget. The risk budget governs the active/passive mix. A more aggressive risk budget employs a greater percentage of active management. When enhanced indexing is thrown into the mix, they provide for clean style implementation while demonstrating similar risk-reducing properties of standard indexes. The advantages of indexing are dependable performance, substantially reduced workloads and substantial cost savings. A manager structure combining indexed and enhanced portfolios would cost ~25 basis points while an all indexed structure would be ~12 basis points. In summary a disciplined approach at manager structure controls plan misfit and risk while increasing the potential for benchmark out-performance.

4.0 BGI's Macro Manager Services

This agenda Item was combined with 3.0 above. In summary the benefits of a MacroManager relationship is to reduce oversight requirements, improve performance, reduce risk, and reduce costs and consolidation as assets under one reporting entity. A manager structure combining indexed and enhanced portfolios would cost ~25 basis points while an all indexed structure would be ~12 basis points.

5.0 Selection of Investment Consultant Finalists for Recommendation to the Board

The Committee discussed the eight responses received to the Consultant RFI Respondents were BARRA RogersCasey, Alan D. Biller & Associates, Gray & Company, Pension Consulting Alliance, R.V. Kuhns, Strategic Investment Solutions, Summit Strategies Group and Wurts & Associates. The Committee began to refine its evolving consensus on how to merge the tools available through its custodian and its manager of passive assets. The group of respondents was reduced to five through the selection of Gray & Company, Pension Consulting Alliance, Strategic Investment Solutions, Summit Strategies Group, and Wurts & Associates. Staff was directed to correspond with this group alerting them of the range of the services. The body of the correspondence will state: 1. There is no question that the Board wants its Investment Consultant to provide quarterly investment performance analyses, including attribution analyses and peer group comparisons.

2. There is no question that the Board wants its Investment Consultant to provide manager search services. However, there is a reasonable probability that the Board will scale back on its use of active managers, thereby making it difficult to predict the number of potential searches.

3. There is no question that the Board wants its Investment Consultant to provide special studies/projects as requested, though there is no list of potential projects at this time.

4. There is some question about the direction the Board is heading in regards to Asset Liability Modeling Studies. There is some sentiment for using one of the firms that provides both actuarial and investment consulting services. This issue is still under discussion.

Staff was instructed to send a letter asking if the firm is willing to be considered under these

San Mateo County Employees' Retirement Association
Minutes of the Investment Committee

circumstances, please let us know at your earliest convenience.
Interviews will be scheduled for May 23rd.

6.0 Discussion on Socially Sensitive Investment Statements

The Board packet contained the Corporate Governance Program of the California State Teachers' Retirement System (CalSTRS) and the Social Investment Procedures of the City and County of San Francisco Employees' Retirement System. Discussion of this topic is rescheduled for the next Committee Meeting.

7.0 Review the Analysis of Westport Asset Management – Style Drift

The Board solicited a response from Westport concerning style drift and a possible Investment Plan violation. The concern regarding style drift centers on two holdings, Texas Instruments and Conexant. These securities should not be considered small cap equities. Westport's response stated in part "we are small cap value managers who look for value in all market segments. As we told your committee, we do not sell stocks simply because they move to a larger cap size through appreciation . . ." Conexant moved out of small cap through appreciation. "The Texas Instruments position is the result of TI's acquisition of Unitrode." Because of strong demand for TI's products and the market's growing interest in technology companies, Westport made the decision to hold the shares. "We believe that was the correct decision as Texas Instrument's price has doubled since October." The Policy violation results by holding an equity in excess of 10.0% of the portfolio. Westport's response is, "We are acutely aware of the 10% limitation and have been selling both Conexant and Texas Instruments to keep in compliance with the contract's terms."

8.0 Discussion of a Watch List – Concept, Criteria and Procedures

This item is heldover. It has not been assigned to a specific future date.

9.0 Draft Revision of *SamCERA*'s Investment Plan

This item is heldover. It has not been assigned to a specific future date.

10.0 Approval of Amendment to Custodial Fee Agreement with State Street

Discussion of this will occur before the Board on March 28, 2000.

11.0 Review of State Street Analytics – Equity Attribution

Mr. Cottle and Mr. Clifton briefly reported on their review of the monthly performance and quarterly attribution reports. State Street will be requested to make various amendments to the report, which should appear beginning 3/31/2000. Staff will coordinate with State Street in an attempt to speed production and delivery of the reports.

12.0 Other Business

There was no other business suggested for discussion.

13.0 Adjournment

There being no further business Mr. Cottle adjourned the meeting at 5:30 p.m.

WILLIAM R. COTTLE, Chair
SamCERA Investment Committee

San Mateo County Employees' Retirement Association
Minutes of the Investment Committee