

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

March 25, 2003 – Investment Committee Agenda

PUBLIC SESSION – The Committee met in Public Session at 10:15 P.M.

- 1.0 Call to Order
- 2.0 Roll Call
- 3.0 Approval of the Minutes for the Investment Committee Meeting
- 4.0 Oral Communications From the Committee
- 5.0 Oral Communications From the Public
- 6.0 Investment Management Services of the Investment Committee
 - 6.1 Acceptance of Monthly Portfolio Performance Report
 - * 6.2 Approval of Assumptions and Parameters for Asset / Liability Modeling Study
 - 6.3 Acceptance of the 2003/2004 Strategic Plan
 - 6.4 Approval of extension to Bank of Ireland Asset Management's Contract
 - 6.5 Approval of Written Consents of Sole Stockholder/Shareholder in Lieu of Annual Meeting
 - 6.6 Acceptance of INVESCO Realty Management's Compliance Certification Statement
 - 6.7 Approval of Topics for Global Custodian Review – State Street Bank & Trust Company
- 7.0 Other Business
- 8.0 Adjournment

**The Committee will briefly discuss this topic. The Agenda Item in its entirety will be heard at the Board.*

MINUTES OF SAMCERA'S Investment Committee

- 1.0 Call to Order:** Mr. Cottle called the Public Session of the Investment Committee of the Board of Retirement to order at 10:15 A.M., March 25, 2003 in *SamCERA's* Board Room, Suite 125, 100 Marine Parkway, Redwood Shores, California.
- 2.0 Roll Call:** Mr. Buffington (10:50), Mr. Bryan, Ms. Colson and Mr. Cottle
Board Members in Attendance: Ms. Salas *Staff:* Mr. Clifton and Mr. McCausland. *Consultant:* Ms. Jadallah
Public: none *Retirees:* One
- 3.0 Approval of the Minutes:** Mr. Cottle provided editing changes, which were adopted without objection. Mr. Buffington later provided Ms. Arnott's edits to the February 19, 2003 Investment Committee Minutes. Those edits were also accepted without objection.

Action: Motion by Mr. Bryan, seconded by Ms. Colson, carried unanimously to accept the Investment Committee Minutes as amended.
- 4.0 Oral Communications From the Committee** None
- 5.0 Oral Communications From the Public** None
- 6.1 Acceptance of Monthly Portfolio Performance.** Staff provided the following review of the portfolio performance.

SamCERA's fiscal year to date yield of -7.76% is well below the actuarial interest rate of 8.25%. Without a sustained market rally it is very likely that *SamCERA* will experience its third year of negative returns (FYE2002 -5.92%, FYE2001 -4.25%). In fact, for the past three months, beginning with the 12/31/2002 report, *SamCERA's* four-year return is slightly negative (-0.28% as of 2/28/03).

Total portfolio returns slightly underperformed the policy benchmark over the trailing one, three and six month periods (refer to page six). In each period the portfolio was underweight equity and overweight fixed income,

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which had a positive effect on returns. However, it was overshadowed by the negative impact of the security selections. Specifically for the trailing six-months, security selections were detractors in *SamCERA's* international equity, domestic equity, and domestic fixed income portfolios.

The Manager/Custodian Variance Report shows a six-month variance between Deutsche Asset Management (DAMI) and State Street (SSB) of 61 basis points. Performance variances are reconciled monthly. This particular variance is traced to pricing differences on several issues. Staff notes that pricing variances between DAMI & SSB appear periodically and are generally resolved in a couple of months when the issues are sold at market value. If price variances are significant or persistent, staff will work with the manager and custodian to resolve the differences.

Below is a table with the composite returns followed by portfolio market values and target versus actual allocations.

February 28, 2003		One Month	Trailing Three Months	Trailing Six Months	Trailing Twelve Months
Equity Aggregate	\$684,299,400	-2.31%	-10.43%	-8.97%	-21.93%
Equity Composite Benchmark		-1.88%	-9.41%	-7.76%	-20.74%
Variance		-0.43%	-1.02%	-1.21%	-1.19%
Fixed Income Aggregate	\$357,814,047	1.41%	3.45%	4.22%	9.73%
Fixed Income Composite Benchmark		1.38%	3.58%	4.74%	9.93%
Variance		0.03%	-0.13%	-0.52%	-0.20%
Real Estate Aggregate (1)	\$63,128,039	0.71%	4.07%	6.12%	3.21%
NCREIF (one quarter lag)		0.00%	1.79%	3.43%	5.69%
Variance		0.71%	2.28%	2.69%	-2.48%
Cash Aggregate	\$10,648,479	0.12%	0.43%	1.01%	1.62%
91 Day Treasury Bill		0.09%	0.31%	0.78%	1.07%
Variance		0.03%	0.12%	0.23%	0.55%
Total Fund Returns	\$1,115,889,965	-0.95%	-5.40%	-3.73%	-10.68%
Total Plan Policy Benchmark		-0.82%	-5.09%	-3.30%	-10.78%
Variance		-0.13%	-0.31%	-0.43%	0.10%

Asset Allocation As of 2/28/2003	Market Value	Allocation		Percentage Off Target	Rebalance Range
		Current	Target		
BGI Russell 1000	\$431,377,964	38.66%	40.00%	-1.34%	±5%
BGI Russell 2000	\$99,647,890	8.93%	10.00%	-1.07%	±5%
BIAM	\$153,273,546	13.74%	15.00%	-1.26%	±5%
Total Equity	\$684,299,400	61.32%	65.00%	-3.68%	
BGI US Debt	\$190,126,211	17.04%	16.00%	1.04%	±3%
DAMI	\$167,687,836	15.03%	13.00%	2.03%	±3%
Total Fixed Income	\$357,814,047	32.07%	29.00%	3.07%	
Real Estate	\$63,128,039	5.66%	6.00%	-0.34%	±2%
Cash	\$10,648,479	0.95%	0.00%	0.95%	
Total	\$1,115,889,965	100.00%	100.00%		

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Mr. Cottle noted that the performance of other Deutsche Asset Management Portfolios were well above the commingled portfolio they manage for *SamCERA* over the quarter ending 12/31/2002. • DAMI addressed this concern in their December Monthly Commentary. *“The account (SamCERA) has lagged the performance of our composite primarily as a result of holding the following Bonds: Green Tree Financial 1998 Series 4 Class B1; Green Tree Financial 1998 Series 4 Class B1; Conseco Finance 1999 Series 6 Class B1; Oakwood Mortgage Investors 2000 Series A Class M1; and Oakwood Mortgage Investors 2000 Series A Class M2. These bonds, collectively, have negatively impacted the account by approximately 90bp in 2002. . . . Due to the non-ERISA status of these bonds, they were not held in all of our portfolios, thus explaining the difference between San Mateo’s performance and that of our composite.”* The “non-ERISA status” refers to bonds issued prior to 2002 at which time Plans governed by ERISA were allowed to only invest in the senior tranches of asset-backed securities. Investment in mezzanine and subordinate tranches were approved for the ERISA Plans in 2002.

In regards to the manager variance between State Street and Deutsche Asset Management, Mr. Cottle informed the Committee that State Street recently changed one of their bond-pricing sources from Merrill Lynch to Bear Sterns. It resulted in fairly significant pricing differences on another portfolio that he reviews.

Mr. Cottle believes total return versus benchmark return is a good measurement of *SamCERA* investment performance. He directed the Committee’s attention to the past six months where total return, lags the benchmark. Whether the variance is positive, or in this case negative, the Committee should be aware of the drivers behind the variance. • The Committee and staff offered pricing issues, active manager underperformance and actual versus target allocation as contributing factors to the current lagging performance. • The Committee expressed concern regarding Bank of Ireland Asset Management’s (BIAM) underperformance relative to the benchmark. The Committee recommends that as part of an ongoing due diligence process, BIAM should be invited to attend the April Board/Committee meeting. The Board instructed staff to invite BIAM to attend the April Board Meeting.

Mr. Clifton informed the Committee that he and Mr. Bryan are attending the Government Finance Officers Association (GFOA) Conference in May, which will be held in New York City. They wish to take that opportunity to perform a due diligence site visit at Deutsche Asset Management’s Philadelphia Office. • Ms. Colson suggested that *SamCERA*’s Investment Consultants, Ms. Jadallah or Mr. Thomas, would add value to that visit. The Committee agreed and requested that one of the Consultants schedule time to participate in the site visit. • Absent a formal due diligence policy, the Committee instructed the Investment Consultants to prepare written reports for the Board concerning due diligence visits. The Investment Consultants’ reports will be included in the materials handed out under the Investment & Finance Managers Report (Agenda Item 8.3). The Investment Committee will hear the reports under Agenda Item 6.1, Monthly Performance. • The Committee instructed staff to prepare a due diligence policy for presentation at the May Investment Committee and Board meetings. • Ms. Colson suggested the policy should designate a due diligence committee. The Investment Committee agreed. A certain skill set is desirable for a due diligence committee. Consistency of committee membership should assist in developing the required due diligence skill set.

Action: The Committee unanimously accepted the Monthly Performance Report. The Committee will recommend to the Board of Retirement that it accepts the report.

6.2 Approval of Assumptions and Parameters for Asset / Liability Modeling Study

Mr. Clifton reviewed last month’s discussion and explained why this item was before the Committee again this month. Strategic Investment Solutions presented the Asset/Liability Study - Phase I to the Investment Committee on February 19, 2003 and to the Board on February 25, 2003. The objective for those meetings was to determine suitable asset classes, constraints and weighting schemes for integration of sub-classes. Working with SIS the Investment Committee arrived at levels they felt

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appropriate for the *Capital Markets and Allocation Assumptions* along with *Asset Correlations* that should be utilized in the study. The Board accepted all recommendations from the Investment Committee with the exception of an acceptable range for the real estate asset class. The Board sent the item back to Committee with the task of recommending an alternative real estate allocation that would be acceptable to the Board.

The Committee reviewed the real estate issues, which include lack of diversification, uncertainty of investment vehicle, and performance (manager and portfolio). • Ms. Colson suggested that the committee should review the real estate vehicles, such as separate property, open or closed commingled funds, or REITS choosing the ones they deemed appropriate. • Ms. Jadallah commented that the Real Estate Managers and Consultants she speaks with suggest that proper separate property diversification is best achieved with a portfolio in excess of \$100 million and 10 properties. • The committee dismissed investment in closed end real estate funds because they would not be able to meet *SamCERA's* liquidity objectives. • REITS were also dismissed because they do not have the real estate characteristics desired by the Committee. • The committee noted that INVESCO has been exploring the possibility of establishing an open-end core fund. INVESCO is currently discussing this possibility with Ventura County. Ventura would be allowed to bring their current properties into the fund, if one is established. • The Committee found some merit in this concept of an open-end core fund. The Committee was undecided whether an INVESCO developed Fund would be acceptable or if one allowing properties in lieu of cash would be in *SamCERA's* best interest. • (Mr. Buffington joined the meeting at 10:50. The Chair, Mr. Cottle, brought him up to date on this mornings meeting.) The Committee spent additional time reviewing the real estate issue. The Committee's consensus was that their discussion on real estate vehicles, managers and performance was informative. However, the task before them is to recommend a real estate allocation for the Asset Liability Study. Their recommendation will be a range from 5% to 10%.

Before reviewing the other recommendations, the Committee briefly discussed Alternative Investments. While that asset class provides diversification and possibly improved returns, the consensus of the Committee is that the asset class contains more volatility than is currently acceptable to *SamCERA*.

Below is a summary of the Committees recommendation for the Asset Liability inputs:

US Equities – We will run asset allocation mixes using an 80% Russell 1000/20% Russell 2000 custom benchmark, reflecting *SamCERA's* current overweight to small cap stocks. US Equities will range between 30% and 60% of the portfolio. This range is in line with asset allocation mixes of institutional portfolios, and allows for more conservative and more aggressive mixes around *SamCERA's* current target.

Fixed Income – We will use the Lehman Aggregate as the benchmark proxy for bonds. After some discussion, the Investment Committee decided that a Core Plus benchmark, incorporating High Yield and Non-US Fixed Income exposure on a strategic basis, is inappropriate for the Plan. But the Committee is interested in addressing Core Plus assignments at the manager structure level. Fixed Income will be constrained to a range of 20% to 50% in the modeling.

International Equity – *SamCERA* has decided to stick with the MSCI ACWI ex-US benchmark which is the equivalent of 90% MSCI EAFE (Developed Markets) and 10% MSCI Emerging Markets. We will

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use a 10% to 20% allowable range for non-US exposure in our modeling.

Real Estate - The Investment Committee determined that it wants to have at least as much exposure to the real estate asset class as it does now. After some discussion, the Committee decided upon a range of 5% to 10% for modeling purposes. SIS' capital markets assumptions for real estate have NAREIT-oriented quantitative inputs because the index offers daily pricing and a reliable volatility history (versus the infrequently repriced NCREIF Index which minimizes standard deviation). SIS' real estate expectation also incorporates a qualitative, NCREIF-oriented overlay looking at current appraisal cap rates.

Private Markets - The Investment Committee decided that Private Markets is an inappropriate asset class for *SamCERA*

Action: The Committee unanimously adopted, for modeling purposes, the above constraints to be utilized in the Asset Liability Study. The Committee will recommend that the Board adopt those constraints.

- 6.3 Acceptance of the 2003/2004 Strategic Plan.** Mr. Clifton reminded the Committee that it reviewed the Strategic Plan last month and there were no amendments. • Mr. Cottle inquired whether due diligence visits had been scheduled as part of the Committee's Strategic Work Plan. Mr. Clifton reported that the due diligence visits will be scheduled after their approval by the Board. • The Committee directed staff to schedule presentation of a due diligence policy. After a due diligence policy has been adopted, the Investment Committee will schedule implementation.

Action: By consensus the Committee accepts the Investment Committee's fiscal year 2002-2003 Strategic Plan (work plan).

- 6.4 Approval of extension to Bank of Ireland Asset Management's Contract.** Mr. Clifton reminded the Committee that the Investment Management Agreement between *SamCERA* and the Bank of Ireland Asset Management is scheduled to expire on June 30, 2003. In all probability the Asset Liability and Manager Structure Reviews currently under way will not conclude until July or August. Staff recommends that the Board put off consideration of all Investment Manager Agreements until the Asset Liability and Manager Structure Reviews are complete.

Staff recommends that the Board adopt an amendment to the BIAM Agreement. The pertinent portion of the amendment reads,

“. . . NOW, THEREFORE, IT IS HEREBY AGREED between the parties that the Original Agreement is amended as follows:

Section 11 AMENDMENT AND TERMINATION (b), is hereby amended to read as follows:

" Section 11 AMENDMENT AND TERMINATION

- (b) This Agreement shall terminate on October 31, 2003 unless extended by mutual agreement or unless terminated by either party by giving written notice to the other party at least thirty (30) business days prior to the date of termination. The parties agree that the fiduciary duty and standard of care provisions set forth in Section 1 (b) shall survive the expiration or termination of this Agreement."*

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NOW, THEREFORE, IT IS AGREED BY THE PARTIES that:

1. *The amendment is hereby incorporated and made a part of the Original Agreement and subject to all provisions therein.*
2. *All provisions of the Original Agreement shall be binding on all the parties hereto.*

NOW, THEREFORE, IT IS AGREED BY THE PARTIES that the Agreement of June 30, 2000 be amended accordingly. . . .”

Action: By consensus the Committee approved a recommendation to the Board that would authorize the Board Chair to execute an amendment to the BIAM Agreement, which amends the maturity date from 6/30/2003 until 10/31/2003.

6.5 Approval of Written Consents of Sole Stockholder/Shareholder in Lieu of Annual Meeting .

Mr. Clifton reported to the Committee that pursuant to provisions of the California General Corporation Law *SamCERA*, being a sole shareholder, has certain responsibilities. Those responsibilities include, but are not limited to, convening an annual meeting and maintaining a corporate minute book. To comply with those responsibilities the Board Chair is asked to execute a *Written Consent of Sole Shareholder in Lieu of Annual Meeting*. That consent specifies actions that shall constitute valid corporate action on behalf of *SamCERA* and shall have the same force and effect as if such action had been authorized and taken at a formal meeting.

The *California Corporation Written Consent of Shareholders* elects David Ridley and David Farmer as Directors of the Corporation and directs the appropriate officer of the “Company” to file the Written Consent in the minute book of the Company.

The California Corporation Written Consent of Directors is executed by David A. Riley and David N. Farmer as Directors of the Corporation and filed with the corporate minutes. The Directors Written Consent adopts resolutions, which elect Officers of the Corporation and notes “that all actions taken for and on behalf of the Corporation by the Officers of the Corporation prior to the date of this Consent be, and such actions are, in all respects ratified, confirmed and approved.”

SamCERA is the single shareholder of six corporations. The Chair should be authorized to execute Shareholder Written Consents for each corporation.

Action: By consensus the Committee approved a recommendation to the Board that would authorize the Board Chair to execute the Written Consent of Sole Shareholders in Lieu of Annual Meeting for each of *SamCERA*'s Properties.

6.6 Acceptance of INVESCO Realty Management's Compliance Certification Statement. *SamCERA's Investment Plan* mandates that each Investment Manager completes and submits a semi-annual Compliance Certification Statement. *SamCERA's* Strategic Plan scheduled INVESCO Realty Advisors to submit a Compliance Certification Statement for the period ending March 31, 2003.

Staff provided the following overview of the Manager: • INVESCO manages a portfolio of six separate properties benchmarked against the NCREIF Property Index. • The December 10, 2002 disposition of Tyson's Office Center yielded a 16.82% total net return since inception and brought the portfolio under its target allocation of 6.0%. • As of February 28, 2003, INVESCO had ~\$63.1 million under management, representing 5.66% of *SamCERA's* Plan Assets. • Hunter's Creek Shopping Center is currently being marketed for disposition. A decision to reinvest the proceeds in real estate will be withheld until completion of the Asset Liability Study. • The Association's contractual agreement with INVESCO stipulates that they receive a performance-based fee in addition to a management fee. The management fee is 7% of Net Operating Assets (NOI).

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The February 28, 2003 property performance, as calculated by INVESCO, appears in table below.

	Property Fair Value	Gross Returns			Since Inception
		3 Month Rolling Return	6 Month Rolling Return	12 Month Rolling Return	
Matthews Festival	\$15,106,569	2.243%	4.529%	12.765%	
Campus Circle	7,475,000	2.686%	5.198%	3.722%	
Boca Colony Apartments	12,686,058	1.845%	4.163%	13.169%	
Highland Bank Building	5,812,351	2.767%	5.582%	4.121%	
Pacific Corporate Center	13,537,556	4.080%	7.703%	-38.926%	
Hunter's Creek Plaza	\$ 7,053,436	1.961%	4.324%	8.492%	
SamCERA Portfolio - Property Level		2.183%	5.673%	2.486%	10.854%

Action: By consensus the Committee will recommend that the Board accept INVESCO's Semi-Annual Compliance Certification Statement for the period ending march 31, 2003.

- 6.7 Approval of Topics for Global Custodian Review – State Street Bank & Trust Company.** *SamCERA's* current practice for Professional Services mandates that the Association's Custodian appear before the Board for annual reviews of their performance. *SamCERA's* Strategic Plan scheduled the Custodian, State Street Bank & Trust (SSB), to appear before the Board on April 22, 2003. In anticipation of the meeting the Custodian is required to submit a semi-annual Compliance Certification Statement and provide written response to a series of due diligence questions. The Investment Committee/Board reviews and amends as necessary that list of questions.

Mr. Cottle wishes to include questions regarding fixed income pricing. His questions include when the pricing source changed, why it changed, and were clients informed. • It seems that State Street's business strategy may be changing and a question should be included to capture that concern. • A question will be included to capture the possible fee changes when the *SamCERA/SSB* Agreement expires in 2004. State Street will be asked to price the relationship using *SamCERA's* current manager configuration then one with an addition active management. • Ms. Jadallah would like SSB to respond to questions regarding corporate changes resulting from acquisition of Deutsche Bank's Custodial Book of Business.

Action: By consensus the Committee approved the topics for Global Custodian Review.

- 7.0 Other Business: None**

- 8.0 Adjournment:** There being no further business Mr. Cottle adjourned the Committee at 11:17 P.M.