San Mateo County Employees' Retirement Association

Minutes of the Investment Committee

July 22, 2003 – Investment Committee Agenda

PUBLIC SESSION – The Committee met in Public Session at 10:04 A.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 Review, Revision & Reaffirmation of Investment Committee Charter
 * 6.3 Annual Investment Consultant Review – Strategic Investment Solutions
 6.4 Integrate Liability and Asset Projections and Review Results for the Asset / Liability Modeling Study
 6.5 Adoption of Due Diligence Policy & Procedures
 6.6 Approval of Topics for Investment Manager Review – Deutsche Asset Management
 6.7 Acceptance of Report on the 2003/2004 Property Value Optimization Plans
 6.8 Acceptance of INVESCO's Presentation on its Commingled - Open End – Core Real Estate Fund
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 10:10 A.M., May 27, 2003 in *SamCERA's* Board Room, Suite 125, 100 Marine Parkway, Redwood Shores, California.

2.0 Roll Call: Mr. Buffington, Mr. Bryan, Ms. Colson, and Mr. Cottle
Board Members in Attendance: Mr. McMahon (10:20) and Ms. Salas *Alternate Board Member:* Ms. Arnott *Staff:* Mr. Clifton and Mr. McCausland. *Consultant:* Mr. Gesell, Ms. Jadallah, and Mr. Thomas *Public:* none *Retirees:* One

3.0 Approval of the Minutes: The May 27, 2003 Investment Committee Minutes were unanimously approved.

Action: Motion by Mr. Buffington, seconded by Ms. Colson, carried unanimously to accept the Investment Committee Minutes.

4.0 Oral Communications From the Committee Ms. Colson noted that the Board will elect officers, which may lead to the appointment of new committee members. She asked the committee if they wished to serve for another year. All committee members indicated that they would be willing to serve for another year.

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 return is 3.86% thanks in part to the equity rally that began in late March and continued mid-way through June when it returned some of its market gain. Although real estate only represents approximately 6.0% of the portfolio's assets, its contribution should be noted. Real estate's trailing twelve month return is 15.35% versus NCREIF's 7.42%. This outperformance is responsible for the Plan's 27 basis points of excess total return**.**

Over the fiscal year SamCERA's portfolio return outperformed its policy benchmark by 27 basis points. The portfolio outperformance came from SamCERA's asset allocation weights, which contributed 74 basis points (bps) to return. Each portfolio allocation contributed to performance as follows: the overweight fixed income (25 bps), real estate (4 bps) and cash (15 bps) and the underweight equity (30 bps).

The Russell 2000 Index Fund under performed the benchmark in the first quarter. The tracking error for May and June is attributed to the Russell Reconstitution, part of which was a decision to be underweight Sirius Satellite (SIRI).

Usually deletions to the Russell 2000 underperform index additions. BGI engaged in proactive trading, selling anticipated deletions ahead of time. The deletions subsequently outperformed the index. The additions presented some liquidity challenges for BGI. They were able to purchase baskets of predicted add names prior to May 31st and June 13th. The additions did not experience the anticipated impact associated with a large volume trade due to heavy speculative activity.

Due to corporate restructuring in March SIRI price was at $0.73. This led BGI to believe that the stock would be deleted at reconstitution since Russell eliminates issues with a price under $1. Amid continued volatility, the stock began to rise through May 30th, cutoff date for inclusion into the new index. It was at $2.35 at the beginning of June, a 220% increase

Bank of Ireland had good performance for the month, but the quarter was less than expected.

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

June 30, 2003		One Month	Trailing Three Months	Trailing Six Months	Trailing Twelve Months
Equity Aggregate	$809,819,617	1.50%	17.82%	11.90%	-2.07%
Equity Composite Benchmark		1.73%	17.86%	12.92%	-0.54%
Variance		-0.23%	-0.04%	-1.02%	-1.53%
Fixed Income Aggregate	$363,085,151	-0.14%	2.73%	4.20%	10.51%
Fixed Income Composite Benchmark		-0.20%	2.50%	3.93%	10.41%
Variance		0.06%	0.23%	0.27%	0.10%
Real Estate Aggregate (1)	$65,637,716	2.45%	3.33%	8.46%	15.35%
NCREIF (one quarter lag)		1.88%	1.88%	3.80%	7.42%
Variance		0.57%	1.45%	4.66%	7.93%
Cash Aggregate	$2,058,607	0.21%	0.60%	1.01%	2.38%
91 Day Treasury Bill		0.14%	0.34%	0.64%	1.53%
Variance		0.07%	0.26%	0.37%	0.85%

Total Fund Returns	$1,240,601,092	1.06%	12.06%	9.34%	3.86%
Total Plan Policy Benchmark		1.18%	12.31%	9.81%	3.59%
Variance		-0.12%	-0.25%	-0.47%	0.27%

Asset Allocation As of 6/30/2003	Market Value	Allocation Current	Allocation Target	Percentage Off Target	Rebalance Range
BGI Russell 1000	$504,456,079	40.66%	40.00%	0.66%	±5%
BGI Russell 2000	$124,154,260	10.01%	10.00%	0.01%	±5%
BIAM	$181,209,278	14.61%	15.00%	-0.39%	±5%
Total Equity	$809,819,617	65.28%	65.00%	0.28%	
BGI US Debt	$194,855,284	15.71%	16.00%	-0.29%	±3%
DAMI	$168,229,867	13.56%	13.00%	0.56%	±3%
Total Fixed Income	$363,085,151	29.27%	29.00%	0.27%	
Real Estate	$65,637,716	5.29%	6.00%	-0.71%	±2%
Cash	$2,058,607	0.17%	0.00%	0.17%	
Total	$1,240,601,092	100.00%	100.00%		

Mr. Clifton informed the Committee that the Plan was near its target weightings on 6/30/2003 (refer to the table above). Those weightings were used to distribute the $50,943,786 in County pre-paid contributions, which came in July 11th. The contributions were deployed into the Russell 1000 ($20,00,000), Russell 2000 ($10,000,000) and US Debt Fund ($15,000,000). The BGI Indexes were utilized primarily in an attempt to limit transaction costs should those assets need to be redeployed at the completion of the Asset Liability and Manager Structure Studies.

Mr. Clifton noted that in prior reports that the NCREIF Performance is now available by the twentieth calendar day. The quarterly performance report no longer needs to lag NCREIF by one quarter. However, staff usually produces the monthly report by the ninth calendar day, and does not have the current NCREIF performance.

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

6.2 **Review, Revision & Reaffirmation of Investment Committee Charter** The Investment Committee Charter was last reviewed and amended in May 2001. That amendment to the Charter provided for Committee oversight of the Investment Consultant Structure and Performance and the Actuarial Economic Assumptions. Mr. Clifton briefly reviewed the entire Investment Committee Charter Resolution. • Ms. Colson observed that a later item, *Adoption of Due Diligence Policy & Procedures*, might impact the Charter. If a policy is adopted, it should be referenced in the Charter. • Mr. Cottle recommended that the Charter be tabled until after the due diligence policy. •

Action: The Committee unanimously accepted the Strategic Investment Solutions' Quarterly Performance Report. The report in its entirety will be presented to the Board at its afternoon meeting.

6.3 **Annual Investment Consultant Review – Strategic Investment Solutions** Mr. Clifton reported that the Board has adopted a policy of reviewing its entire professional staff. This is the second annual review for Strategic Investment Solutions. Prior to the meeting, the Trustees and Strategic Investment Solutions are asked to complete an Investment Consultant Evaluation. Staff reviewed the completed evaluations and reported that the Trustee responses and the Investment Consultant responses were very similar. • Mr. Cottle asked Mr. Clifton to elaborate on the comments regarding SIS educational presentations. The general theme to this question was that there have not been many educational presentations. The Asset Liability Study is not considered an educational presentation. Therefore, there have been only two educational presentations, maybe three if you include the first year. The Private Markets Presentation was the most direct educational event, which was well received by the Board. The other event was at January's Board Retreat, which seemed to be even by SIS's admission a little below standard. It did not flow as well nor was it as valuable as the Board expected. • Mr. Cottle offered that perhaps it was a function of time. SIS tried to cover a lot of ground in a short period.

Ms. Jadallah provided an overview of SIS's written responses to the Board's questions. The most interesting item in the update may be that 20% OF SIS was acquired by Frank Russell Company. That transaction was announced in January and officially closed July 16, 2003. The reasoning behind it was three-fold (i) this provides SIS with the ability to leverage its existing resources with Frank Russell's research and resource support, (ii) the affiliation provides SIS with legal support. SIS was improperly named as a defendant in a law suit, which was quickly dismissed, but to consume time and resources not usually utilized by SIS, and (iii) at Mike Beasley, one of the Managing Directors, will be easing out and retiring. • Responding to a question from Mr. Cottle, Ms. Jadallah explained there might appear to be a discrepancy in time horizon for Mr. Beasley. The fact is that he will start cutting back in year three and he should be retiring in five to seven years.

SIS reports that they are working with basically all the same clients. They have a few more project relationships such as central Bank of Chile and AAA of Southern California. San Jose Federated now uses SIS exclusively and has formalized the project relationship. SIS lost two small clients, RAG out of Denver and Hanna Boys Center. Missouri Teachers put SIS on a watch list pending additional information on the Russell relationship.

Ms. Colson noted that 100% of SIS's revenue is generated from investment consulting. However, Frank Russell has a different business model. Would it be fair to break the revenue reporting into two parts? Ms. Jadallah reiterated that Frank Russell has a 20% minority stake and currently is not impacting SIS's business model. In two years, should Frank Russell exercise its option to acquire 100%, you would see different responses. Expanding upon the response, Mr. Thomas stated that for now they go forward as SIS with a minority owner and leverage Russell's capabilities. In two years both sides will make the decision whether to go forward with a greater percentage of purchase. The intention is for SIS to be acquired by Frank Russell, but that is an open issue at this point. Russell currently has no management input in SIS.

The Committee stated that Russell has a good reputation for manager research. In an overview of

Russell's manager research capabilities Ms. Jadallah stated that Russell visits their managers about 50% of the time. They have multiple people following style groups and asset classes and often send several people at once on an on-site visit. They have great internal analytics to download portfolios and look at characteristics to insure managers are doing what they say they are doing. When making hire recommendations, Russell tracks managers via these analytics, not performance. Russell and SIS each follow about 500 Managers. In the manager search process SIS will maintain its same process, but augmenting the process with Russell research. • The Committee reminded SIS that Russell's research is important, but they should not dictate the list of firms *SamCERA* will be reviewing. • Mr. Thomas stated there are two areas of potential conflict. One is the transition services and brokerage that Russell provides. The other is fund management, which is primarily for clients with fewer than one billion dollars.• Mr. Buffington offered that there is another more common form of conflict in the investment business, which is "I'll do something for you, you do something for me." That issue pervades the investment business and there is nothing *SamCERA* can do about that. • Mr. Cottle suggested that SIS provide a more detailed review of the SIS/Frank Russell manger search process at a future meeting. He also sees value in the Committee learning more about the services Frank Russell provides. Staff should arrange for a presentation of those services.

Mr. Thomas reported that when State Street took over the Deutsche/ICC service SIS saw an improvement in the size and depths of the account universes that they use. That universe is larger than the Russell universe.

Action: By consensus the Committee approved Strategic Investment Solutions' Annual Review.

6.4 Integrate Liability and Asset Projections and Review Results for the Asset / Liability Modeling Study.

Marc Gesell, Margaret Jadallah, and Patrick Thomas presented the Asset / Liability Integration. This presentation flows from the Board's decision on May 27th to review a range of optimized portfolios along an efficient frontier with expected annual returns between 7.75% and 8.40%. Portfolios in that range of the efficient frontier will then be used to project mean asset values versus liabilities. The asset / liability modeling will then allow projections that include employer contributions and the Plan's funded status. After reviewing the decision criteria, the Board should be able to select an asset allocation that will allow it to achieve its long-term goals.

Action: Motion by Mr. Buffington seconded by Mr. Bryan carried unanimously to recommend to the Board that the Plan maintain its current asset allocation of 65% equities (40% domestic large cap, 10% domestic small cap and 15% international equities), 29% domestic fixed income and 6% real estate.

To accommodate INVESCO'S schedule the Committee heard item 6.8 out of order.

6.8 Acceptance of INVESCO's Presentation on its Commingled - Open End - Core Real Estate Fund. Most Trustees are concerned that dollar constraints ultimately hinder *SamCERA's* ability to diversify its real estate allocation. The Board of Retirement has discussed an open-end core real estate fund as one alternative to diversify its portfolio. INVESCO has engaged in several conversations with *SamCERA's* Trustees and Ventura County Employees' Retirement Association Trustees regarding the development of a core fund.

INVESCO's **Max Swango and Steve Walker** presented an update on the status of the "Core Commingled Fund". Steve Walker recently joined INVESCO and provided a brief review of his background. He spent twenty-two years with Lend Lease, previously known as Equitable Real Estate. He started out in operations moved to marketing and then spent a number of years as a portfolio manager. He would be the lead portfolio manager on this product. Mr. Walker is located in Atlanta, but will work with Dallas staff on the portfolio. Mr. Swango stated Sally Kittles would remain involved in the core fund portfolio.

The fund would initially have a market value of $119 million with San Mateo and Ventura being the only shareholders. Both Associations will have the options of obtaining shares for cash or by contributing assets. The original portfolio is expected to include nine investments from both Associations with a market value of $91.9 million and a $27 million cash allocation from Ventura. The report did not account for a cash contribution of approximately $20 million from *SamCERA's* underweight to real estate. The portfolio would subsequently be marketed to other clients with INVESCO projecting portfolio growth of $200 million per year • Mr. Swango reminded the Board that INVESCO closed its door to separate accounts in 1999. INVESCO intends to grow its business through funds. This fund will take a very high priority at INVESCO and long term will become its flagship product. It is a product they have been missing.

If *SamCERA* contributed its properties, INVESCO would look for a guarantee that it will keep its money in the fund for a minimum of eighteen months. That should be sufficient time to fully diversify the fund. After that there would be quarterly liquidity. Typically market standards require a 90 day notice for draws. INVESCO would allow *SamCERA*'s real estate attorney to view any plan documents before they are published. The Fee for the overall fund would be approximately 1% of net assets. A cash management fee would be charged separate from the asset management fee.

Responding to a question from Mr. Bryan, Mr. Swango provided some pros and cons regarding investing in a core fund. Advantages of the Core fund are to dramatically improve diversification, limit volatility, provide a more predictable income stream, allow for the acquisition to larger properties, better liquidity, a fee break over market fees, and the comfort of staying with a known quantity (INVESCO as manager). The major disadvantage is loss of ultimate portfolio control.

Mr. Bryan asked Mr. Walker to provide some assurances that the fund would provide proper diversification. He stated that all of the core funds compete against the benchmark, which is diversified. He would envision 30%-35% Office Building, 25% Multi-family, 20%-25% Industrial and 20%-25% Retail.

Ventura has tentatively accepted INVESCO's fund proposal and its consultant, Ennis Knupp and Associates supports it.

Action: Motion by Bryan second by Colson passed unanimously to direct staff to bring back to the Investment Committee a recommendation regarding INVESCO's proposal for an open-end commingled core fund.

The Committee returned to the agenda order at item 6.5

6.5 **Adoption of Due Diligence Policy & Procedures** Mr. Clifton provided a brief review of SamCERA's governance and current due diligence process. Article XVI, Section 17(c) of the California Constitution provides that "the members of the retirement board of a public pension or retirement system shall discharge their duties with respect to the system with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of a like character and with like aim."

Based on that governance, *SamCERA* put together an extensive program of professional services oversight. The program begins with provider selection and continues with staff monitoring and provider presentations. To date, *SamCERA's* due diligence relies upon information received in the form of reports from other parties, such as the ADV Part II and Statement of Auditing Standards 70. It also depends on provider's presentations, which are often given by a marketing person and a portfolio manager. Staff was directed to prepare a comprehensive due diligence policy representing *SamCERA's* review process and present it to the Committee for consideration. That policy was presented as Appendix F to *SamCERA's Investment Plan*.

The Committee discussed the policy, focusing on section **F.12 – Limitation on Board Due Diligence**, which states "The Board of Retirement will not participate in any due diligence trip being conducted on any new service provider, investment manager, or others." The consensus of the Committee is that the most crucial time for due diligence is prior to hiring an investment manager and the trustees should not be willing to delegate that due diligence exclusively to staff. It was noted that traditionally public entities employ a quiet time when an RFP was issued to safeguard against the impression of impropriety. However, during manager selection visits, trustees could employ extra caution to guard against managers attempts to influence the selection process. • Mr. Buffington strongly believes that the time for due diligence is at the time of hiring. After a contract is signed you can judge their performance relative to compliance with the contract. He stated that *SamCERA* pays the Investment Consultant, who has a much better capacity to evaluate the managers; to keep the Board informed after the contract is signed. • Ms. Colson thought the policy was too broad and generally agreed with Mr. Buffington's comments. During the selection process only the top one or possibly two finalist should be visited. An existing manager would only be visited if they were underperforming or went on a watch list or other specific instances where the Board needed more due diligence. • Mr. Cottle believes when trustees attend an on-site due diligence it allows the Board to make better decisions through a better understanding of the investment processes. The more due diligence a plan performs the better off they are. Due Diligence is part of the Board's fiduciary responsibility. • Mr. Thomas agrees with Mr. Buffington that the investment consultant should keep the board informed. He believes it is also true that trustees need to be personally informed themselves in order to make difficult calls on complex issues. • As chair of the Committee, Mr. Cottle suggested that any thoughts the committee has on the policy should be funneled to Mr. Clifton. He will redraft the policy for the next meeting.

Action: By consensus the Committee directed staff to solicit opinions from the Committee and bring an amended due diligence policy back to the Investment Committee in August.

6.6 **Approval of Topics for Investment Manager Review – Deutsche Asset Management.** The Committee reviewed a list of questions prepared for Deutsche Asset Management's response prior to their annual review. Mr. Cottle provided a few minor modifications to the list that he passed on to Mr.

Clifton. He noted that at a previous meeting Ms. Colson raised some interesting questions regarding an SEC deficiency letter and its resolution in 2000. Those questions should be included and forwarded to Deutsche Asset Management. Ms. Colson noted that Mr. Clifton had responded to the questions but they could be asked again.

Action: By consensus the Committee approved the amended list of questions and directed staff to forward the questions to Deutsche Asset Management for their response.

6.7 **Acceptance of Report on the 2003/2004 Property Value Optimization Plans.** A Value Optimization Plan is a property specific business plan prepared by INVESCO Realty Advisors' Asset Management department. The VOP is prepared within 90 days of the completion of an acquisition and then annually thereafter. The Value Optimization Plan includes an exit/disposition strategy, current year operating budget, current and five-year capital expenditure plan, marketing/leasing plan and market position analysis. The VOP is evaluated regularly and any significant event affecting a property would result in an amended Plan.

Since 1997, a Committee of the Board has reviewed the annual Value Optimization Plans for SamCERA's institutional grade properties. In 1999 the Investment Committee opined that the VOP's provided more financial and budgetary data than investment analysis. It recommended that this review be transferred to the Audit Committee. Last year the Audit Committee agreed that it does not have the resources to perform a comprehensive review of the property budgets and operational plans.

Mr. Clifton recommended that staff provide an executive summary of all property Value Optimization Plans and present that summary to the Investment Committee. The Investment Committee may be most interested in the hold/sell analysis.

Mr. Buffington noted that the Pacific Corporate Center carries a loan at 7.87% and matures 9/1/2006. He questioned whether the loan could be refinanced. Mr. Clifton explained that the loan provisions include a large prepayment penalty, which prohibits refinancing.

Action: By consensus the Committee approved staff's recommendation that staff prepare an executive summary of the Value Optimization Plans and present it to the Investment Committee.

6.8 **Acceptance of INVESCO's Presentation on its Commingled - Open End - Core Real Estate Fund.**

This item was heard out of order. It appears after item 6.4. Action on the item is provided below

Action: Motion by Bryan second by Colson passed unanimously to direct staff to bring back to the Investment Committee a recommendation regarding INVESCO's proposal for an open-end commingled core fund.

7.0 **Other Business: None**

8.0 **Adjournment:** There being no further business Mr. Cottle adjourned the Committee at 12:55 P.M.