SCERS
SACRAMENTO COUNTY
EMPLOYEES' RETIREMENT SYSTEM



# M I N U T E S

## RETIREMENT BOARD MEETING, WEDNESDAY, SEPTEMBER 21, 2016

A regular meeting of the Retirement Board was held in the Sacramento County Employees' Retirement System Administrative Office, 980 9th Street, 19th Floor, Sacramento, California, on Wednesday, September 21, 2016, and commenced at 10:01 a.m.

## OPEN SESSION:

### PUBLIC COMMENT:

1. None heard.

### MINUTES:

2. The Minutes of the August 17, 2016 regular meeting were approved on Motion by Mr. DeVore; Seconded by Mr. Kelly. Motion carried (6-0), Ms. Gin abstained.

### CONSENT MATTERS:

Items 3-11

The Consent Matters were acted upon as one unit upon a Motion by Mr. DeVore; Seconded by Mr. Pittman carried (7-0).

3. CLEVELAND, Vera D.: Granted a nonservice-connected disability retirement.

**CONSENT MATTERS (continued):**

4. FRANK, James: Granted a nonservice-connected disability retirement.

5. LAWRENCE, Monay: Granted a reciprocal nonservice-connected disability retirement.

6. PEREZ, Lisa: Granted an interim nonservice-connected disability retirement.

7. ZIEGLER, Michael E.: Granted a nonservice-connected disability retirement.

8. SNIVELY, Eleanor: Denied a service-connected disability retirement.

9. ROBERT, Richard: Rescinded application for nonservice-connected disability retirement.

10. Received and filed the August 2016 Monthly Investment Portfolio Activity Report.

11. Received and filed the August 2016 Monthly Investment Manager Compliance Report and Watch List.

**ADMINISTRATIVE MATTERS:**

12. Chief Executive Officer Richard Stensrud provided an update on developments affecting public retirement systems and on miscellaneous system and staff activities.

    Mr. Stensrud reported that SCERS had received the qualified plan determination letter from the Internal Revenue Service (IRS). Mr. Stensrud stated that this would likely be the last time that SCERS would go through this process with the IRS for some time. General Counsel Robert Gaumer explained that going forward, SCERS would not need to re-apply every five years. Mr. Gaumer also stated that SCERS would continue to receive communication and guidance regarding maintaining compliance with federal tax law requirements through the Hanson Bridgett law firm.

    Mr. Stensrud reported that the conference hotel for the State Association of County Retirement Systems (SACRS) Fall Conference was full and that Staff was working to find alternate accommodations for those who will be attending.

    Mr. Stensrud reported that AB 1853, the bill initiated by SACRS pertaining to the operating authority of County Retirement Systems, had completely passed through both the State Senate and Assembly, and was now awaiting a decision by the Governor. Mr. Stensrud stated that the Governor has three options: veto the bill, sign the bill, or take no action. Mr. Stensrud noted that if the Governor takes no action by the bill's cutoff date of September 30, then the bill would go into law.

**ADMINISTRATIVE MATTERS (continued):**

Mr. Stensrud reported that SCERS had recently completed the sale of an apartment complex and that the proceeds will ultimately be redeployed to a core property commingled fund managed by Townsend. Deputy Chief Investment Officer Steve Davis stated that due to the timing of the sale, the proceeds will first be invested in a combination of REITS and TIPS until the Townsend fund is available for investment. Mr. Davis noted that this is consistent with previous real estate sales.

Mr. Stensrud reported on a recent court decision involving the Marin County Employees' Retirement Association (MCERA) regarding MCERA's decision that 'stand-by pay' should not be included in the pay elements considered as compensation earnable as under CalPEPRA. Mr. Stensrud stated that some labor organizations representing employees of Marin County had filed suit to include stand-by pay, but that a state appeals court had upheld the authority of MCERA to make the decision to exclude stand-by pay. Mr. Stensrud noted that the court did not conclude that stand-by pay should not be included, but rather, only approved MCERA's authority and right to make the decision. Mr. Stensrud stated that SCERS currently includes stand-by pay as compensation earnable, but that Staff would be reviewing that and other pay elements again to determine if any elements should be reconsidered by the Board.

13. Chief Executive Officer Richard Stensrud reported on the proposed remediation plan for member enrollment errors made by the Mission Oaks Recreation and Park District (Mission Oaks).

Mr. Stensrud explained that Mission Oaks had advised SCERS that in the course of conducting its annual external audit, the auditor had identified several instances where Mission Oaks had failed to enroll employees in SCERS that should have become SCERS members under the rules under which Mission Oaks operates. Mr. Stensrud stated that since that time, SCERS Staff has been working with Mission Oaks to assess the scope of and develop a plan to remedy the problem.

Mr. Stensrud stated that the failure to properly enroll an eligible employee in SCERS means that the employee has not obtained the SCERS service credit he/she should have received and it also means that SCERS did not receive the employer and employee contributions that should have been submitted for that service. Mr. Stensrud noted that because SCERS operates as a tax qualified retirement plan, the question of how to address such situations is largely controlled by federal tax law. Mr. Stensrud stated that the IRS views problems like this as an operational failure to follow the terms of the retirement plan and the errors must be corrected in accordance with IRS rules and procedures in order to reduce the risk of the IRS challenging the plan's qualified status in a potential IRS audit. Mr. Stensrud noted that Staff has sought and obtained guidance from tax counsel on the remedial measures that will be required and/or permitted under federal tax law.

**ADMINISTRATIVE MATTERS (continued):**

Mr. Stensrud stated that given the tax law requirement that both the plan and the impacted employees must be 'made whole,' SCERS Staff has worked with Mission Oaks to identify the employees who should have become SCERS members; when the membership should have started; the salary experience for those employees; the service credit they should have accrued; and the employer and employee contributions, and accrued interest, that SCERS should have received. Mr. Stensrud noted that this analysis has been partly completed but additional audit work will need to be performed to ensure that all impacted employees are identified (including past employees) and all the relevant information is incorporated in the determination of the pension liability and cost to establish the missing service credit for those employees. Mr. Stensrud stated that this information will be provided to the Board when the analysis is finalized.

Mr. Stensrud stated that the proposed remediation plan is designed to achieve the dual goals of making the plan and the employees whole. Mr. Stensrud noted that under federal tax law, the ultimate responsibility for the funding necessary to meet these goals rests with the employer (i.e., Mission Oaks) because it was their error that led to the operational failure. Mr. Stensrud stated that within certain legal limits, however, the employer may seek to obtain funding from the employees to help redress the operating error.

Mr. Stensrud stated that Mission Oaks will provide the funding for the vast majority of the additional pension liability and associated cost related to the operating error, but that Mission Oaks has elected to ask the current employees who should have become SCERS members to provide the missing employee contribution component for the service credit they accrued in the 36 months prior to when they will begin making regular, ongoing contributions as SCERS members. Mr. Stensrud noted that the regular, ongoing contributions will start this month (September, 2016), meaning that the employees will be responsible for providing the employee contributions for the service they earned from September 2013 to September 2016. Mr. Stensrud stated that Mission Oaks will provide both the employer and employee contributions, plus the necessary interest, for any service credit accrued by these current employees prior to September 2013.

Mr. Stensrud stated that former employees who should have become SCERS members will not have to make any employee contributions for the service they accrued prior to terminating employment with Mission Oaks. Mr. Stensrud stated that Mission Oaks will provide both the employer and employee contributions, plus necessary interest, for those former employees.

Mr. Stensrud outlined: (1) The options for impacted Mission Oaks employees to provide funding for their portion of the three year contribution requirement and the result if an employee is unwilling or unable to do so; (2) The contributions that will be refunded if an employee subsequently terminates employment with Mission Oaks and elects to withdraw his/her contributions; (3) The two primary procedures under federal tax law for addressing and correcting operational errors and the differences between those procedures; (4) The

**ADMINISTRATIVE MATTERS (continued):**

correction procedure contemplated in this case and the limitations and requirements for using that procedure; and (5) The process for addressing any challenge brought by Mission Oaks or an impacted employee to an aspect of the remediation plan.

Discussion followed.

Motion by Mr. Baird to approve the elements of the proposed remediation plan for member enrollment errors at the Mission Oaks Recreation and Park District; Seconded by Mr. Pittman. Motion carried (7-0).

14. Chief Executive Officer Richard Stensrud led a discussion regarding whether funding from SCERS' Contingency Reserve should utilized in the actuarial valuation as of June 30, 2016.

Mr. Stensrud noted that SCERS has historically sought to maintain a Contingency Reserve as a source of funding to mitigate future investment return shortfalls, unexpected expenses, or other factors leading to material cost increases. Mr. Stensrud noted that the Contingency Reserve is 'outside' of the various reserves used by the actuary in the annual actuarial valuation to determine SCERS' funded status and the next year's contribution rates. Mr. Stensrud explained that funds are placed in the Contingency Reserve in years when the investment returns, after smoothing, are greater than the level necessary to meet the interest crediting rate that represents SCERS' growth target, and that when the funds in the Contingency Reserve are needed, they are 'transferred' back into the actuarial reserves and are included in the actuarial calculations. Mr. Stensrud provided examples of how the Contingency Reserve has been used in the past to mitigate employer costs.

Mr. Stensrud stated that as a result of several strong years of investment performance following the Global Financial Crisis (GFC), the smoothing process moved to a net positive status (i.e., the deferred gains being smoothed in exceeded the deferred losses), and it was possible to replenish the Contingency Reserve. Mr. Stensrud noted that as of June 30, 2015, the balance in the Contingency Reserve had grown to $81.1 million. Mr. Stensrud stated that over the past few years, however, the investment market performance has been poor with the result that the smoothing process is now in a net negative status (i.e., the deferred losses being smoothed in exceed the deferred gains). Mr. Stensrud explained that this means that unless and until there is investment experience that exceeds the investment return assumption, the deferred investment experience being smoothed in will put upward pressure on employer cost. Mr. Stensrud stated this leads to the question of whether funding should be drawn from the Contingency Reserve to help mitigate the expected cost increases, and if so, when, and in what amount.

Mr. Stensrud stated that it appears that after smoothing, as of June 30, 2015, SCERS will be approximately $60 million short of meeting the target interest crediting rate of 7.50%. Mr. Stensrud noted that this shortfall projects to an increase in the employer contribution

**ADMINISTRATIVE MATTERS (continued):**

rate of approximately 0.48% of pay. Mr. Stensrud stated that if the Board were to apply $60 million from the Contingency Reserve, the cost impact of the negative investment experience would be zero, leaving a balance in the Contingency Reserve of $21.1 million. Mr. Stensrud further stated that if the Board were to apply all $81.1 million from the Contingency Reserve, the employer contribution rate would decrease by 0.65% of pay, more than fully offsetting the impact of the negative investment performance, but leaving the balance in the Contingency Reserve at zero. Mr. Stensrud noted that in that case, there would be nothing in the Contingency Reserve to help mitigate the increasing upward pressure on cost over the next few years.

Mr. Stensrud noted that there are other factors that affect the employer cost besides the investment performance. Mr. Stensrud described several of those factors, including the shift toward employees paying higher contributions, and potential changes to future actuarial assumptions, and the impact of such factors on employer cost. Mr. Stensrud explained that such factors were expected to put upward pressure on employer cost in future actuarial valuations.

Mr. Stensrud noted that the factors for the Board to consider in deciding whether, when, and how to utilize the Contingency Reserve are similar in many respects to the factors faced by the Board in 2011 and 2012. Mr. Stensrud stated that at that time, the Board decided that the best course of action was to defer utilizing funds in the Contingency Reserve in order to deploy them to offset more substantial expected cost increases in the near future.

Discussion followed.

Motion by Mr. DeVore to not utilize funds from the Contingency Reserve in the actuarial valuation as of June 30, 2016; Seconded by Mr. Kelly. Motion carried (7-0).

**INVESTMENT MATTERS:**

Items 15 – 18 were taken up out of order to accommodate scheduling constraints with SCERS' investment consultants.

17. Jamie Feidler of Cliffwater, LLC presented the Alternative Assets Investment Performance Report for periods ending March 31, 2016 and June 30, 2016, including information regarding the absolute return, private equity, real assets, and opportunities portfolios.

Mr. Feidler reported that SCERS' absolute return portfolio was up 1.19% in the second quarter of 2016, which was slightly below the absolute policy benchmark (90-day T-Bills + 5%) which was up 1.29%, and above the HFRI Fund of Funds Composite Index which was up 0.75%.

## INVESTMENT MATTERS (continued):

Mr. Feidler stated that the SC Absolute Return Fund, LLC ("SCARF") was up 1.68% in the quarter, and outperformed both the HFRI Fund of Funds Composite Index and the 90-day T-Bills + 5%.

Mr. Feidler stated that for the quarter, SCARF B returned 0.56%, which underperformed the HFRI Fund of Funds Composite Index and the 90-day T-Bills + 5%.

Mr. Feidler reported that SCERS' direct absolute return program was up 1.14% during the second quarter, which outperformed both the HFRI Fund of Funds Composite Index, but underperforms the 90-day T-Bills + 5%.

Mr. Feidler stated that third quarter to date, through August 30, 2016, SCERS' total absolute return program is up 1.88%, the direct absolute return program is up 1.84%, and the SCARF portfolios are up 1.90%. Mr. Feidler noted that these numbers compare to the HFRI Fund of Funds Composite Index and the 90-day T-Bills +5%, which are up 1.73% and up 0.85%, respectively.

Mr. Feidler reported that for the concluded fiscal year ending June 30, 2016, SCERS' absolute return program was down 4.31%, with the direct absolute return program down 1.01%, and the SCARF portfolios down 6.96%. Mr. Feidler noted that these numbers compare to the HFRI Fund of Funds Composite Index and the 90-day T-Bills +5%, which are down 5.23% and up 5.19%, respectively.

Mr. Feidler reported that the net investment rate of return ("IRR") of SCERS' private equity portfolio was up 9.67% since inception compared to the Cambridge Associates Private Equity Index up 9.74% and the multiple of total value to paid in capital ("TVPI") is 1.22x since inception. Mr. Feidler noted that SCERS' private equity portfolio shows lower relative returns due to the early phase/cycle of investments (j-curve affect) compared to the index.

Mr. Feidler reported that, through March 31, 2016, SCERS' real assets portfolio IRR was 5.07% compared to SCERS' real assets portfolio benchmark (CPI + 5%) IRR of 7.16% and SCERS' TVPI was 1.14x.

Mr. Feidler reported that SCERS' opportunities portfolio generated a net IRR of 8.73% as of March 31, 2016 which has outperformed SCERS' long-term benchmark (SCERS' actuarial rate of return) of 7.5%.

Motion by Mr. Kelly to receive and file the quarterly performance report; Seconded by Mr. Pittman. Motion carried (7-0).

16. Deputy Chief Investment Officer Steve Davis introduced the educational presentation on approaches to the development of asset classes in SCERS' investment portfolio.

**INVESTMENT MATTERS (continued):**

Mr. Davis reviewed the methods for constructing institutional investment portfolios, including traditional and more modern approaches. Mr. Davis discussed the traditional analysis achieved through mean variance optimization, measuring risk through standard deviation, and asset correlations, and the limitations of such approaches. Mr. Davis noted that more contemporary approaches view a portfolio as comprised of an amalgamation of risk factors that are impacted differently in differing economic environments, and that the key is identifying and understanding the portfolio's relative risk factor exposure and how that portfolio will perform in different economic environments.

John Nicolini of Verus Advisory provided an overview on evaluating a portfolio through a risk factor lens. Mr. Nicolini explained why asset allocation does not equal risk allocation, and how apparent diversification does not necessarily produce true diversification. Mr. Nicolini reviewed the different economic environment profiles and how they impacted different types of assets. Mr. Nicolini also discussed the roles that the various asset classes play in a portfolio.

Mr. Davis reviewed SCERS' current portfolio under the current traditional asset class structure and labels, then how the portfolio looks when broken down by risk factors, and ultimately, what the portfolio would look like when restructured by risk factors and the function being performed by different assets.

Mr. Davis and Barry Dennis of Verus discussed the next steps SCERS and Verus will be taking going forward. Chief Executive Officer Richard Stensrud noted that the overarching goal of the asset/liability analysis was not to design a portfolio that meets a certain investment return target, but instead, to design a portfolio that meets the outcomes the Board wants to achieve, and that the target return would then flow from that portfolio.

Motion by Mr. Kelly to receive and file the educational presentation on approaches to the development of asset classes in SCERS' investment portfolio; Seconded by Mr. DeVore. Motion carried (7-0).

18. Jennifer Young-Stevens of The Townsend Group presented the quarterly performance report on real estate investments for the quarter ended June 30, 2016.

Ms. Young-Stevens provided a summary of the real estate market for the quarter. Ms. Young-Stevens also provided an overview of SCERS' real estate portfolio, including the portfolio's funding status and composition.

Ms. Young-Stevens reported that SCERS' total real estate portfolio returned 2.7% during the second quarter of 2016, which outperformed SCERS' blended benchmark of 2.3%. Ms. Young-Stevens stated that for the 12-month period ending June 30, 2016, SCERS' real estate portfolio return was 9.5% and that in the same period, the benchmark returned 11.4%.

**<u>INVESTMENT MATTERS (continued):</u>**

Ms. Young-Stevens reported that SCERS' core real estate portfolio returned 2.1% during the second quarter, outperforming the benchmark of 1.9%. Ms. Young-Stevens stated that for the 12-month period ending June 30, 2016, SCERS' core real estate portfolio return was 6.8% and that in the same period, the benchmark returned 10.8%. Ms. Young-Stevens further stated that the core separate accounts and the core commingled fund returned 2.4% and 1.8%, respectively, for the quarter.

Ms. Young-Stevens reported that SCERS' non-core real estate portfolio returned 2.1% for the quarter, slightly underperforming Townsend's benchmark of the NFI-ODCE plus 100 bps benchmark, which returned 2.2%. Ms. Young-Stevens stated that SCERS' non-core real estate portfolio returned 13.4% for the 12-month period ending June 30, 2016, outperforming the benchmark return of 11.9%.

Ms. Young-Stevens reported that SCERS' domestic public REIT portfolio returned 7.4%, compared to a second quarter return of 5.4% for the FTSE NAREIT (domestic) REIT Index. Ms. Young-Stevens stated that for the 12-months ending June 30, 2016, SCERS' domestic public REIT portfolio earned 26.2% return, beating the benchmark return of 18.8%.

Ms. Young-Stevens reported that SCERS' international REIT portfolio returned 0.8%, compared to the second quarter return of 0.7% for the FTSE EPRA/NAREIT Global ex-US REIT Index. Ms. Young-Stevens stated that for the 12-months ending June 30, 2016, SCERS' international REIT portfolio earned a -0.5% return, trailing the benchmark return of 1.4%.

Motion by Mr. DeVore to receive and file the quarterly performance report; Seconded by Ms. Gin. Motion carried (7-0).

**<u>ADMINISTRATIVE MATTERS:</u>**

15. Chief Benefits Officer John Gobel and General Counsel Robert Gaumer presented the annual report on the processing of applications for disability retirement benefits.

Mr. Gobel reviewed the statistics for the year regarding disability retirement applications resolved via staff recommendation, decision by referees, or voluntary withdrawals by applicants. Mr. Gobel noted that given the significant increase in hearings and proposed decisions during the fiscal year ended June 30, 2016, the level of application resolution is now back in line with recent norms. Mr. Gobel noted that although disability retirement counsel should be commended for conducting more hearings during the fiscal year ended June 30, 2016, some of these gains occurred because SCERS decided to retain additional outside attorneys experienced in disability retirement matters.

Mr. Gobel noted that in the fiscal year new Disability Retirement Procedures (DRPs) had been developed that should improve multiple aspects of disability retirement processing,

**ADMINISTRATIVE MATTERS (continued):**

including the time and expense currently required to resolve applications. Mr. Gobel further noted that he and Mr. Gaumer had initiated several administrative changes during the second half of the fiscal year, which "set the table" for process changes authorized by the DRPs, including: (1) Addressing the backlog in record reviews by assigning those tasks directly to Independent Medical Examiners or an outside law firm; (2) Secured approval from the SCERS Board to retain a contract Medical Advisor to perform record reviews for future applications and schedule Independent Medical Examinations as needed; (3) Piloted a project with the Workers' Compensation office in order to reduce time and cost required to extract records of interest to new Medical Advisor. Mr. Gobel noted that in the current fiscal year, he and Mr. Gaumer anticipate submitting the final version of new DRPs to the Board of Supervisors later this Fall and releasing a corresponding Disability Retirement Handbook within the following 60 days.

Mr. Gobel stated that as a complement to large-scale process changes addressed by the DRPs, Staff continues to look for ways to reach benefit determinations quicker in order to reduce processing times for applicants and mitigate the impact of disability claims on the employer's staffing and overall operations.

Chief Executive Officer Richard Stensrud noted that SCERS commits substantial resources to the disability retirement determination process. Mr. Stensrud stated that hiring additional staff will not necessarily improve the processing of disability applications, but rather, such improvements would center on achieving greater productivity from existing resources.

Discussion followed.

Motion by Mr. Kelly to receive and file the annual report on the processing of applications for disability retirement benefits; Seconded by Mr. DeVore. Motion carried (7-0).

The meeting was adjourned at 1:16 p.m.

MEMBERS PRESENT: Rick Fowler, John B. Kelly, Keith DeVore, Steven L. Baird, Diana Gin, Chris Pittman, and John Conneally

MEMBERS ABSENT: Michael DeBord, James A. Diepenbrock, Ben Lamera, and Martha J. Hoover

OTHERS PRESENT: Richard Stensrud, Chief Executive Officer; Robert L. Gaumer, General Counsel; Kathryn T. Regalia, Chief Operations Officer; John W. Gobel, Sr., Chief Benefits Officer; Steve Davis, Deputy Chief Investment Officer; Suzanne Likarich, Retirement Services Manager; Thuyet Dang, Senior Accounting Manager; JR Pearce, Investment Officer; John Lindley, IT Administrator; Barry Dennis, John Nicolini, and Joe Abdon, Verus Advisory, Inc; Jamie Feidler, Cliffwater LLC; Jennifer Young, The Townsend Group; John Kennedy, Nossaman LLP; Debra Tierney, Daniel Barton, and Barry Ross, Mission Oaks Recreation and Park District

Respectfully submitted,

Richard Stensrud
Chief Executive Officer and
Secretary of the Retirement Board

APPROVED: ____________________________________
Rick Fowler, President

DATE: ____________________________________

cc: Retirement Board (11); Board of Supervisors (6); County Counsel; County Executive (2); Internal Services Agency (2); County Labor Relations; Employee Organizations (20); Sacramento County Retired Employees' Association; SCERS Member Districts (10); Elected Officials (3); Superior Court of California, County of Sacramento; Amervest Company, Inc.; Mark Merin; John R. Descamp; and The Sacramento Bee.