M I N U T E S

RETIREMENT BOARD MEETING, THURSDAY, SEPTEMBER 20, 2012

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 Thursday, September 20, 2012, and commenced at 11:02 a.m.

OPEN SESSION:

PUBLIC COMMENT:

1. None heard.

MINUTES:

2. The Minutes of the August 16, 2012 special meeting were approved on Motion by Mr. Fowler; Seconded by Ms. Wolford-Landers. Motion carried (7-0).

CONSENT MATTERS:

Items 3-6

The Consent matters were acted upon as one unit upon a Motion by Ms. Gin; Seconded by Mr. Johnson. Motion carried (7-0).

3. DAY, Gary A.: Granted a service-connected disability retirement.

CONSENT MATTERS (continued):

4. PEREZ, Albert V.: Granted a nonservice-connected disability retirement.

5. TAYLOR, Joyce A.: Granted a service-connected disability retirement.

6. Received and filed the August 2012 Monthly Investment Manager Compliance Report and Watch List.

INVESTMENT MATTERS:

7. Pete Keliuotis and Patrick Thomas of Strategic Investment Solutions, Inc. (SIS) led an educational presentation on the fixed income asset class.

Mr. Keliuotis reviewed SCERS' current fixed income structure. Mr. Keliuotis noted that even though SCERS' managers have performed well, the investment environment presents challenges for two of the primary roles of fixed income in SCERS' overall portfolio – i.e., capital preservation and income generation. Mr. Keliuotis explained that bond yields are very low in most developed markets, and if economic growth or inflation were to pick up, it would cause bonds to lose value because value is inversely related to interest rates. Mr. Keliuotis also noted that low bond yields mean income generation will be low. Mr. Keliuotis explained that reviewing the fixed income structure is important to ensure that the investment opportunity set is broadened to improve diversification and that alternative structures are considered to pursue higher-yielding strategies with attractive risk characteristics.

Mr. Keliuotis stated that there are significant markets where SCERS currently has little to no exposure, including non-US (particularly emerging markets), high yield and bank loans. Mr. Keliuotis noted that adding exposure to international fixed income, emerging market debt, high yield, and bank loans significantly increases expected return with a modest increase in expected risk.

Mr. Thomas provided commentary on these potential markets, including:

- Adding exposure to international fixed income would increase the opportunity set of available instruments, allow for exposure to maturing world corporate bond markets, and less leveraged economies.

- Adding exposure to emerging market debt would provide a natural inflation hedge and a natural hedge against US dollar weakness.

- Adding exposure to high yield would provide higher expected return exposure to lower quality corporate bonds, a better risk/return profile than very expensive government securities, and lower exposure to price volatility from higher interest rates.

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

- Adding exposure to bank loans would diversify exposure to senior (highest in the capital structure) bank loans to corporations, provide protection/participation in the event of higher interest rates through floating rate characteristics, and provide high recovery in the event of a default through a senior capital structure position.

Mr. Keliuotis stated that SCERS can pursue these opportunities with SCERS' existing fixed income managers to some extent, but not fully, even if the investment parameters for those managers are expanded. Mr. Keliuotis noted that the 'core plus' managers currently have some discretion to shift their portfolios between 'core' and 'plus' sectors but they do not necessarily have deep expertise in the 'plus' sectors. Mr. Keliuotis explained that the current managers should continue to have the ability to invest in 'plus' sectors, but it may be advisable to supplement them with specialist managers.

Mr. Keliuotis concluded by stating that possible fixed income structures will be modeled and presented to the Board in October as part of the final educational presentation on the fixed income asset class.

Discussion followed, including discussion of how a manager operating in the credit sector would manage exposure to bank loans and other elements in the portfolio when those areas were not favored by the market.

Motion by Mr. Fowler to receive and file the educational presentation on the fixed income asset class; Seconded by Ms. O'Neil. Motion carried (7-0).

8. Jamie Feidler of Cliffwater, LLC presented the Alternative Assets Investment Performance Report for the Quarter Ended June 30, 2012, including information regarding the hedge fund, private equity, real estate, and opportunities portfolios.

Mr. Feidler reported that SCERS' hedge fund portfolio was down 0.7% in the second quarter of 2012, whereas the absolute policy benchmark (90-day T-Bills + 5%) was up 1.2% in the second quarter of 2012. Mr. Feidler noted that SCERS' hedge funds significantly outperformed the HFRI Equity Hedge Index in the second quarter of 2012, where the index was down 2.3%. Mr. Feidler stated that SCERS' hedge fund portfolio was up 3.5% in 2012 and outperformed the HFRI Fund of Funds Composite Index which was up 1.8% and also outperformed the 90-day T-Bills + 5% benchmark which was up 2.9%.

Mr. Feidler reported that the net investment rate of return ("IRR") of SCERS' private equity portfolio is up 2.7% since inception compared to the Venture Economics Private Equity Index up 6.4% and the multiple of total value to paid in capital ("TVPI") is 1.05x since inception. Mr. Feidler noted that SCERS' private equity portfolio shows lower relative returns due to the early phase/cycle of investments (j-curve effect) compared to the index.

Mr. Feidler reported that SCERS' real estate portfolio IRR is 6.9% compared to SCERS' real assets portfolio benchmark (CPI+5%) at 7.5% and that SCERS' TVPI is 1.2x.

INVESTMENT MATTERS (continued):

Mr. Feidler reported that SCERS' opportunistic portfolio generated a net IRR of 6.8% in the second quarter of 2012, which underperformed SCERS' long-term benchmark (SCERS' actuarial rate of return) of 7.75% and SCERS' immediate benchmark (SCERS' total portfolio policy weighted return) of 11.8%.

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

9. Chief Executive Officer Richard Stensrud stated that with the development of the direct investing platform in alternative assets, Staff will be having alternative asset managers who have been added to the platform make educational presentations regarding their investment strategy to help expand the Board's knowledge of the direct alternative assets investments. Mr. Stensrud noted that the presentation by Elliott Management Corporation would be the first of these sessions.

Chief Investment Officer Scott Chan introduced Jamie Hobbeheydar, head of business development and investor relations for Elliott Management Corporation.

Mr. Hobbeheydar provided a history of Elliott Management Corporation and reviewed the firm's investment approach. Mr. Hobbeheydar stated that Elliott's primary emphasis is on risk control and that the firm employs a substantial degree of diversification of strategies and positions. Mr. Hobbeheydar noted that Elliott uses a global investment approach that is both opportunistic and value-added.

Mr. Hobbeheydar stated that Elliott utilizes a layered approach to liquidity, with a substantial proportion of assets in trading activities with high liquidity and turnover. Mr. Hobbeheydar noted that Elliott has not had to liquidate positions prematurely, even in difficult market environments.

Mr. Hobbeheydar stated that Elliott's trading activities focused on distressed securities, performing debt, hedge/arbitrage activities, equity-oriented positions, real estate-related positions, basis trading, and portfolio volatility protection strategies.

Mr. Hobbeheydar reviewed Elliott's long-term track record of consistent returns and moderate risk. Mr. Hobbeheydar noted that Elliott had a compound annual net return to investors of 14%, compared to a compound annual net return of 10.8% for the S&P 500. Mr. Hobbeheydar also reviewed Elliott's structure and management team.

Motion by Ms. Wolford-Landers to receive and file the presentation by Elliott Management Corporation; Seconded by Mr. Johnson. Motion carried (8-0).

10. Micolyn Magee of The Townsend Group provided a presentation regarding the development of a strategic and investment implementation plan for SCERS' real estate allocation.

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

After providing an overview of The Townsend Group, Ms. Magee reviewed the real estate strategic planning process, including indentifying SCERS' strategic objectives, constructing an optimal portfolio, and conducting an annual strategic plan review.

Ms. Magee next discussed the first step in SCERS' investment planning process, which includes reviewing and analyzing SCERS' existing portfolio, collecting capital projections from underlying managers and overlaying SCERS' growth assumptions, and identifying capital available for investment. Ms. Magee then reviewed the second step in SCERS' investment planning process, which includes matching capital available with best market opportunities for SCERS.

Motion by Ms. Wolford-Landers to receive and file the presentation by The Townsend Group; Seconded by Ms. O'Neil. Motion carried (8-0).

<u>ADMINISTRATIVE MATTERS:</u>

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

Mr. Stensrud stated that the SCERS Board Member Election was approaching. Mr. Stensrud noted that three positions were up for election, including one Miscellaneous member-elected position and two Safety member-elected positions. Mr. Stensrud further noted that the voting period was from September 24 through October 5.

Mr. Stensrud provided a follow-up to the annual report on the processing of applications for disability retirement benefits that was presented at the August Board Meeting. Mr. Stensrud reported that the costs associated with processing disability retirement applications represented 21% of the SCERS administrative budget.

Mr. Stensrud noted that a recent editorial stated that public employees should not be blamed for problems with public employee pension benefits, but instead, the fault rests on public employers and retirement boards. Mr. Stensrud noted that the SCERS Board does not establish the benefit levels or set the salaries for SCERS members.

Mr. Stensrud reported that with the signing into law of Assembly Bill 340, the pension reform measure, the State Association of California Retirement Systems (SACRS) would be having a symposium to discuss and seek agreement on the interpretation of the bill. Mr. Stensrud noted that he would be setting up meetings with employers and bargaining units to discuss how the bill affects those groups.

ADMINISTRATIVE MATTERS (continued):

Mr. Stensrud noted the recent announcement from the European Central Bank about their stabilization plan for the Eurozone and the Federal Reserve's announcement of plans for a third round of quantitative easing, and invited SCERS' investment consultants and investment staff to offer comments on what these actions will mean for investments in general and SCERS specifically. Chief Investment Officer Scott Chan, Deputy Chief Investment Officer Steve Davis, Patrick Thomas and Pete Keliuotis of SIS, and Jamie Feidler of Cliffwater all provided their views on the recent announcements. In particular, Staff and consultants agreed that the new quantitative easing limits downside risk, but would likely lead to continued volatility.

12. Chief Executive Officer Richard Stensrud introduced Andy Yeung of The Segal Company (Segal) who presented the Review of Economic Actuarial Assumptions for the June 30, 2012 Actuarial Valuation.

Mr. Stensrud noted that one component of the actuarial funding policy which is expected to be proposed to the Board in the next few months will be a recommendation to transition from a one-year to a three-year cycle for reviewing the economic actuarial assumptions. Mr. Stensrud noted that this was also being recommended by Segal. Mr. Stensrud stated that a significant reason for the proposed change would be to reflect the fact that the economic actuarial assumptions are long-term assumptions and not elements that need to be adjusted annually. Mr. Stensrud noted, however, that if there were to be a material change in SCERS' investment program (e.g., adoption of a new asset allocation model) or consensus that there had been a material and sustained change in the investment markets, the economic actuarial assumptions could be reviewed sooner.

Mr. Yeung reported that Segal is recommending that: (1) The inflation assumption be reduced from 3.50% to 3.25%; (2) The investment return assumption be reduced from 7.75% to 7.50% due to the recommended reduction in the inflation assumption; (3) The real 'across the board' component of the salary increase assumption be increased from 0.25% to 0.50%; (4) The combined inflation and real 'across the board' assumption remain at 3.75% since the increase in the real 'across the board' salary increase assumption will offset the decrease in the inflation assumption; (5) The active member payroll growth assumption remain at 3.75% for the same reasons; and (6) The retirement benefit cost-of-living adjustment (COLA) assumption for Tier 1 retirees be reduced from 3.40% to 3.25% to make it consistent with the recommended inflation assumption.

Mr. Yeung noted that the inflation assumption plays multiple roles in that it is a component of the investment return assumption and a component of the salary increase and payroll growth assumptions. Mr. Yeung noted that while the 3.25% inflation assumption recommended by Segal may seem high in light of the current interest rate environment and/or current and near term budgetary challenges, it is important to remember that the inflation assumption is long term in nature, and over time inflationary impact will be felt in both the investment and labor markets.

ADMINISTRATIVE MATTERS (continued):

Mr. Yeung noted that the recommended inflation assumption would bring SCERS in line with the median retirement system inflation assumption nationally, and would bring it more in line with other inflation projections. Mr. Yeung also noted that lowering the inflation assumption was one of the recommendations in the actuarial audit recently conducted by EFI Associates.

Mr. Yeung noted that the investment return assumption is comprised of two primary components – inflation and real rate of return – with adjustments for risk and expenses. Mr. Yeung explained that Segal's recommendation to lower the investment return assumption from 7.75% to 7.50% is driven by the recommended reduction in the inflation assumption and not by the actuary's or the investment community's belief that the real rate of return on SCERS' assets is expected to be materially lower than what was expected over the last few years. Mr. Yeung also noted that the reduction was not driven by higher expected expenses, which remain unchanged from past years.

Mr. Yeung noted that the asset allocation model approved by the SCERS Board last year is expected to yield a higher real return than the previous asset allocation model, with virtually the same standard deviation as the previous model. Mr. Yeung explained that for purposes of developing the investment return assumption, Segal determines the projected real rate of return for the next 15+ years by taking SCERS' asset allocation model and plugging in the various asset class return projections from SCERS' general investment consultant, Strategic Investment Solutions, and the investment consultants advising eight other California public retirement systems. In determining SCERS' specific real rate of return, Segal then uses the average of the expected real rates of return as it reflects a broader range of capital market information.

Mr. Yeung reported that based on this process, Segal is recommending that a 5.97% real rate of return be utilized in developing the overall investment return assumption. Mr. Yeung noted that this real rate of return is only slightly lower (0.12%) than the projected real rate of return used in the June 30, 2011 valuation.

Mr. Yeung explained that Segal then adjusts the real rate of return to reflect the potential risk of shortfall in the returns analysis. Mr. Yeung said Segal does this by taking the variability of returns for the various asset classes (i.e., the standard deviation, which is unchanged from last year) and applying a risk adjustment to increase the likelihood of achieving the investment return assumption over a 15+ year period. Mr. Yeung explained that Segal presents the result in the form of a 'confidence level' that the actual average return will equal or exceed the investment return assumption over the extended period.

Mr. Yeung said that based on this process, and factoring in the reduction in the inflation assumption (which should reduce the overall risk of failing to meet the investment return assumption), Segal is recommending a 7.50% investment return assumption. Mr. Yeung stated that this assumption will have a 64% confidence level, which is at the high end of the range of 50% to 65% seen by Segal with respect to its California public retirement system clients.

ADMINISTRATIVE MATTERS (continued):

Mr. Yeung reported that there is a clear trend nationally to reduce the investment return assumption, with a 7.50% assumption becoming more and more prevalent, including the recent adoption of a 7.50% investment return assumption by two of the largest California systems (CalPERS and LACERA).

With respect to the salary growth assumptions, Mr. Yeung explained that salary increases impact plan costs in two ways: (1) By increasing members' benefits (since benefits are a function of highest average pay) and future 'normal cost' contribution rates; and (2) By increasing total active member payroll, which impacts the calculation of unfunded liability contribution rates.

Mr. Yeung noted that as an employee moves through his/her career, increase in pay is expected to come from three sources: (1) Inflationary adjustments (i.e., to compensate for increases in the cost-of-living); (2) Real 'across the board' pay increases (i.e., pay increases derived from the ability of an organization to be more productive); and (3) Merit and promotional increases (i.e., based on career advancement).

Mr. Yeung noted that the review of merit and promotional pay increase assumptions was conducted as part of the triennial experience study last year, and no change is being recommended in the current Segal report.

Mr. Yeung noted that the lower inflation assumption would normally lead to a lower overall salary increase assumption, but Mr. Yeung explained that in this case, Segal is recommending an increase in the real 'across the board' component from 0.25% to 0.50%. Mr. Yeung noted that this recommendation would offset the reduced inflation assumption and thus cause the overall salary increase assumption to remain the same.

With respect to retiree cost-of-living adjustment assumptions, Mr. Yeung noted that with the recommended reduction in the inflation assumption to 3.25%, Segal is recommending the Tier 1 COLA assumption also be reduced to 3.25%. Mr. Yeung reported that Segal is recommending that the current 2.0% COLA assumption for Miscellaneous Tiers 3 and 4 and Safety Tiers 2 and 3 be maintained.

Mr. Stensrud noted that while Segal presented data in support of its recommendation to increase the real 'across the board' assumption, he believed the data is skewed by the downsizing in the County workforce over the last few years. Mr. Stensrud explained that the 'actual average increase' in salary Segal cites is based on a comparison of the average salary for members in the system at the start of the fiscal year versus the average salary for members in the system at the end of the fiscal year. Mr. Stensrud noted that typically, when a workforce is downsized, more people at the lower salary ranges leave the system than people at the higher salary ranges. Mr. Stensrud noted that as a result, the average salary of the workforce left at the end of the year is likely to be higher than for the workforce that started the year.

ADMINISTRATIVE MATTERS (continued):

Mr. Stensrud noted that Segal made a similar recommendation for the June 30, 2010 valuation but that the Board decided not to adopt the Segal recommendation until the workforce situation had stabilized. Mr. Stensrud suggested that the situation is still sufficiently unsettled and recommended that the current assumption be maintained for at least one more year. Mr. Stensrud noted that this does not mean that larger than expected salary growth will be ignored for funding purposes in the meantime. Mr. Stensrud explained that to the extent it occurs, it will be picked up in the annual experience cost adjustment that is made as part of each actuarial valuation.

Mr. Stensrud suggested that if the Board concurs with this recommendation, he would further recommend that the Board adopt a 3.50% combined inflationary and real 'across the board' salary increase assumption for the June 30, 2012 valuation. Mr. Stensrud noted that since the active member payroll growth assumption is based on the same two components, he would also recommend that the Board adopt a 3.50% assumption for that purpose.

Mr. Stensrud explained that the proposed assumption changes are expected to impact contribution rates as follows: (1) The lower investment return assumption will push upward on contribution rates; (2) If the Board concurred with his recommendation that the real 'across the board' assumption should remain the same, the lower salary increase assumption and active member salary growth assumption will push downward on contribution rates, but will not fully offset the increase from the change in the investment return assumption; and (3) The lower Tier 1 retiree COLA assumption will push downward slightly on contribution rates.

Mr. Stensrud noted that Segal estimates that if the assumptions it has recommended were to be adopted, the aggregate average employer contribution rate would increase from 22.5% to 24.6% of pay, and the aggregate employee contribution rate would increase from 6.2% to 6.5% of pay.

Mr. Stensrud noted that Segal estimates that if the assumptions he recommended are adopted, the aggregate average employer contribution rate would increase from 22.5% to 23.9% of pay, and the aggregate employee contribution rate would increase from 6.2% to 6.4% of pay.

Mr. Stensrud noted, however, that the projected contribution rate increase does not take into account the impact on contribution rates from actuarial experience (both demographic and investment). Mr. Stensrud noted the investment experience is likely to push upward on contribution rates as negative investment experience from the 2007-2009 market crisis, combined with the weak performance in 2011-2012, could add another 2.0%+ of pay to the employer contribution rates.

Mr. Stensrud noted there are two steps SCERS can take to help mitigate the contribution rate impact outlined above.

ADMINISTRATIVE MATTERS (continued):

Mr. Stensrud explained that the first measure would be to use the $77 million in the Contingency Reserve to help offset the expected contribution rate increase. Mr. Stensrud noted that managing cost increases is the principal reason SCERS has the Contingency Reserve, and it has been used for this purpose in the past. Mr. Stensrud also noted that when last year's actuarial valuation was being prepared it was contemplated that the Contingency Reserve would be utilized in the June 30, 2012 valuation.

Mr. Stensrud explained that the second measure would be to phase-in the contribution rate change attributable to the lower investment return assumption over a two year period, rather than implement it all at once. Mr. Stensrud noted that the investment return assumption itself would be changed to 7.50% as recommended, however the contribution rate change attributable to the new assumption that would be phased-in in two stages. Mr. Stensrud noted that SCERS has taken a similar step in the past when lowering the investment return assumption.

Mr. Stensrud explained that if the Contingency Reserve is applied in the June 30, 2012 valuation, Segal estimates that it will lower the employer contribution rate by approximately 0.56%. Mr. Stensrud noted that if the integration of past poor investment experience is expected to add 2.0%+ to the employer contribution rate, the application of the Contingency Reserve would reduce that cost increase to approximately 1.6% - 1.7%.

Mr. Stensrud explained that if the contribution rate change attributable to the lower investment return assumption is phased-in over two years, the employer contribution rate would increase each year by approximately 0.70% rather than increase by approximately 1.40% next year. Mr. Stensrud explained that the cited contribution rates are premised on the Board adopting the alternative economic assumptions he recommended and not the assumptions recommended by Segal. Mr. Stensrud noted that if the Board chose to adopt the Segal recommendations, a two year phase-in would increase cost by approximately 1.05% each of the next two years, versus a 2.1% increase next year.

Discussion followed. During that discussion, Mr. Yeung was asked if Segal would be comfortable with the alternative assumptions suggested by Mr. Stensrud. Mr. Yeung replied that Segal was comfortable using those assumptions. It was also noted that phasing in the contribution rate change attributable to the new investment return assumption will require that a footnote be placed on the financial statements of participating employers.

Motion by Mr. DeVore to receive and file the Review of Economic Actuarial Assumptions and to adopt the actuarial assumptions and actuarial valuation implementation methods recommended by the Chief Executive Officer; Seconded by Mr. Fowler. Motion carried (8-0).

The meeting was adjourned at 3:11 p.m.

MEMBERS PRESENT: James A. Diepenbrock, William D. Johnson, Keith DeVore, Richard B. Fowler II, Diana Gin, Kathy O'Neil (arrived at 11:26 a.m.), Julie Valverde (arrived at 12:45 p.m.), Nancy Wolford-Landers, John Conneally, and Michael DeBord.

MEMBERS ABSENT: John B. Kelly.

OTHERS PRESENT: Richard Stensrud, Chief Executive Officer; Scott Chan, Chief Investment Officer; 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, Accounting Manager; John Lindley, IT Administrator; Lance Kjeldgaard, Outside Counsel; Pete Keliuotis and Patrick Thomas, Strategic Investment Solutions, Inc; Jamie Feidler, Cliffwater, LLC, Micolyn Magee, The Townsend Group; Jamie Hobbeheydar, Elliott Management Corporation; and Andy Yeung, The Segal Company.

Respectfully submitted,

Richard Stensrud
Chief Executive Officer and
Secretary of the Retirement Board

APPROVED: ______________________________
James A. Diepenbrock, 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.