

**ORANGE COUNTY EMPLOYEES RETIREMENT SYSTEM  
BOARD OF RETIREMENT  
2223 E. WELLINGTON AVENUE, SUITE 100  
SANTA ANA, CALIFORNIA**

**INVESTMENT MANAGER MONITORING  
SUBCOMMITTEE MEETING**

**March 2, 2017  
9:00 A.M.**

**MINUTES**

The Chair called the meeting to order at 9:06 a.m. and read the opening statement into the record. Attendance was as follows:

Present: Frank Eley, Chair; Russell Baldwin and Charles Packard

Absent: Thomas Flanigan, Vice Chair

Also present: Steve Delaney, Chief Executive Officer; Shanta Chary, Director of Investment Operations; David Beeson, Investment Officer; Adam Cheng, CFA, Investment Officer; Stina Walander-Sarkin, Investment Analyst; Javier Lara, Visual Technician; and Julius Cuaresma, Recording Secretary

**A. INDIVIDUAL MANAGER PRESENTATIONS**

Mr. Beeson introduced ASB Real Estate Investments and their Allegiance Real Estate Fund. In January 2013, OCERS originally invested \$110 million in the Allegiance Real Estate Fund. He discussed the manager's relative underperformance in 2016, and indicated it was largely a function of the manager's lower leverage levels: the portfolio is presently 14%, compared to a fund leverage limit of 40%. He also observed that the portfolio, relative to the NCREIF ODCE benchmark, is presently overweight the retail sector and underweight the industrial sector.

Mr. Eley asked if there are any concerns with the manager's overweight retail exposure.

Mr. Beeson responded that the manager's retail exposure has tended to work over the years, citing the manager's focus on high-end urban market locations versus big box mall exposure; this intentional mismatch has fared well through different market cycles.

Mr. Beeson also noted that since OCERS terminated RVK as its real estate consultant, there is no consultant Q&A report in the March 2017 Investment Manager Monitoring Subcommittee book. Should there be a presenting real estate manager at an upcoming meeting, he reported that there would be a Meketa real estate Q&A report.

**ASB REAL ESTATE INVESTMENTS**

*Presentation by David Quigley & Frank Nigro*

**The key highlights of the presentation were:**

Firm update: As of the end of 2016, the manager had \$7.2 billion in assets under management. ASB employs 43 people and has two offices, Washington D.C. and San Francisco.

Market Overview/Outlook for 2017: The manager believes that the current real estate market is behaving in a more normal fashion relative to recent years: ASB forecasts that prospective returns will likely be lower than the double-digit returns seen since the long recovery dating back to 2009. The manager observed that seven months ago, the economy was already slowing, particularly in the rent market. ASB remarked that the possible 2017 slowdown likely is delayed to 2019: they are cautiously optimistic, defensively balancing the portfolio between an acceptance that a slowdown will occur and an uncertainty regarding the timing of such a slowdown.

Portfolio Strategy: ASB is a buy-and-hold real estate investor, with a general holding period of approximately 10-12 years. The manager focuses on the following four sectors: office, industrial, multi-family assets and retail (particularly in the big city, urban market retail space). ASB avoids traditional office space investments, preferring open, flexible, mixed-use, creative office spaces. As it relates to the retail space, ASB employs a tenant centric mindset in that they analyze investments based on long-term forecasts of what tenants will likely want and need. Such properties tend to be supply constrained with heavy foot traffic (i.e., 3<sup>rd</sup> Street Promenade in Santa Monica, SoHo in New York).

Performance: Through the end of December 2016, the fund has slightly underperformed the NCREIF ODCE index over the last three years: 12.0% gross of fees versus 12.1% for the index.

Mr. Eley observed the fund's performance history and asked if recent performance, relative to historical performance is an indication of potential problems in the portfolio.

Mr. Quigley responded that they were a bit early in defensively positioning the portfolio. He noted that ASB is generally less aggressive relative to the index: 1) portfolio leverage and; 2) non-core allocation is only 6%, whereas the index is roughly 10%. Further, the manager has cash on the balance sheet; ASB saw peers experience exit queues. This underperformance resembles their underperformance in the previous rallying markets leading up to the 2008 collapse. As such, he noted they are better positioned for the next downturn.

Mr. Delaney, Ms. Chary, and Mr. Nigro discussed OCERS' investment management fees and dividends.

Mr. Baldwin discussed recent institutional real estate surveys that suggested technological innovation as possibly the biggest threat to the industry and asked about the manager's thoughts on zero net energy (ZNE) and environmental, social and governance (ESG) investing. Additionally, he asked about ASB's investment holding period as it relates to environmental sustainability.

Mr. Nigro discussed their emphasis on sustainable investments or are building towards ZNE. He described property investments that are LEED certified, including data centers. He noted ASB's attention to ESG has been successful: ASB's underlying tenants care about ESG as these tenants resell and market their environmental conscientiousness and sustainability focus to their own end customers. Mr. Nigro observed that ASB's approximate 10+ year holding period involves environmental sustainability, ASB however does not necessarily look beyond 20+ years for properties that could sustain, for example, rising sea levels. Further, he explained that active

selling, particularly prior to the economic downturn in 2006-7, alleviates this potential duration mismatch between a 10+ year and 20+ year holding period.

Mr. Packard discussed the possibility of recession and asked what could happen to ASB's portfolio between their typical 10+ year time horizon.

Mr. Nigro responded that ASB focuses on downside protection, analyzing a potential asset's: 1) likely performance in a downturn; 2) liquidity; and 3) exit strategy. ASB prioritizes properties that are less economically sensitive such that in a down market, their asset rents go down less than the market. Further, ASB caps their downside by using less leverage. They create an all-weather portfolio by continuously exiting out of profitable properties during good markets. Mr. Packard, Mr. Nigro and Mr. Quigley discussed ASB's leverage levels, particularly as it relates to their underlying floating versus fixed rate.

***The Committee recessed at 10:07 a.m.***

***The Committee reconvened at 10:20 a.m.***

#### **LOOMIS, SAYLES & COMPANY**

##### ***Presentation by Stephanie S. Lord, CFA***

Mr. Beeson introduced Loomis, Sayles & Company, and discussed OCERS' investments in High Yield Conservative (present NAV approximately \$380 million with an original investment inception date of October 1987), and Strategic Alpha (present NAV approximately \$220 million with an original investment inception date of September 2013).

Mr. Beeson discussed Dan Fuss (portfolio manager at Loomis, Sayles & Company, including portfolio manager of the fund's high yield strategy) and his presentation to the Investment Committee at the beginning of 2016. He discussed Mr. Fuss' successful market call to be overweight high yield.

Mr. Beeson and Ms. Chary also remarked on Meketa's recommendation to simplify OCERS' fixed income portfolio, which includes the redemption of unconstrained funds, versus a measured rebalancing effort, specifically in the context of various interest rate environments.

##### **The key highlights of the presentation were:**

Firm update: As of the end of December 2016, Loomis, Sayles & Company managed approximately \$240 billion.

##### ***High Yield Conservative:***

Market Overview/Outlook for 2017: The manager believes this is a late-cycle high yield market, as the manager does not see much further upside: they are taking less risk, reducing equity convertibles received in conversion, as well as names in the energy complex. They likely would have sold more energy exposure; however, the relative opportunity set has much richer

valuations. Thus, the manager still has single digit exposure (versus peak levels in the mid-teens). The manager has rotated profits from exited names into reserves, specifically liquid, high quality paper and asset backed securities. The manager is concerned with the potential for a U.S. trade war, particularly with China (and less so with Mexico and Canada).

**Portfolio Strategy:** Given market conditions and the manager's perceived opportunity set, the conservative high yield strategy can dynamically dial up or down the portfolio's high yield exposure. Accordingly, this fund has a custom benchmark of 50% Merrill Lynch High Yield/50% Barclays Aggregate. Should the manager perceive the high yield market is increasingly risky, such as the current one, the manager has the flexibility to trade in reserve-like instruments, i.e., Treasuries.

**Performance:** Through the end of December 2016, Loomis Sayles returned 5.7% net of fees over the trailing three years versus 4.4% for its custom benchmark – this was largely generated from a strong 2016, where the fund, on a net basis, returned 24.0% versus 10.4% for its custom benchmark.

Mr. Baldwin and Ms. Lord discussed the energy market, including the energy renewable space.

***Strategic Alpha:***

**Market Overview/Outlook for 2017:** The manager observed that the world is in different stages of their respective credit cycle: the U.S. is in a late-cycle expansion stage, whereas Europe is still in a recovery stage. The manager describes late-cycle as a market that is experiencing a tightening central bank, with rising inflation. The recovery stage, which precedes the expansion to late-cycle stage, is characterized by a central bank policy that is starting to tighten, with moderate to rising inflation.

**Portfolio Strategy:** With a focus on limiting drawdowns and growth risks in a portfolio, Strategic Alpha aims to be an all-weather type of strategy. This is done through a combination of a traditional bond portfolio with an alternative portfolio that dynamically invests, long and short (for alpha and beta-hedging purposes), across the global fixed income market. The result is an absolute and uncorrelated return stream. As such, Strategic Alpha is benchmark unconstrained. In addition, this strategy can have negative duration as it is intended to have zero to low interest rate risk, which is ideal for a rising interest rate environment.

**Performance:** Since OCERS' initial investment, Strategic Alpha has generated a net return of 2.9% versus 0.4% for 3-month LIBOR. The manager reported on the strategy's recent performance, particularly since the U.S. election: Strategic Alpha has generated an absolute and relative return that has outperformed the Barclays Aggregate, approximately 4.0% vs 0.5%.

Mr. Baldwin discussed ESG as a potential investment overlay and asked about ESG's role within Loomis, Sayles & Company's portfolio construction.

Ms. Lord indicated that Loomis, Sayles & Company has clients with ESG investment constraints, as well as a number of other client specific mandates (i.e., country limitations).

Mr. Packard and Ms. Lord discussed the eurozone, particularly the manager's thoughts on European financials in the context of divergent European rates and currencies.

Mr. Eley and Ms. Lord remarked on the manager's returns, fees, and the alpha generated since OCERS' original investment.

Mr. Eley commented on Meketa's recent asset allocation discussion with the Investment Committee. These discussions included Meketa's recommendation to simplify OCERS' portfolio, which aimed at eliminating the unconstrained portfolio – this includes the Strategic Alpha Fund (and the PIMCO Unconstrained Bond Fund).

A **motion** was made by Mr. Packard and **seconded** by Mr. Baldwin to receive and file the manager presentations. The **motion carried unanimously.**

**PUBLIC COMMENTS:**

None

**COMMITTEE MEMBER COMMENTS:**

Mr. Eley again discussed Meketa's recommendation to simplify the fixed income allocation and stated his aversion to redeeming from Strategic Alpha, managed by Loomis, Sayles. He stated this recommendation will be discussed at the Investment Committee meeting.

**CHIEF EXECUTIVE OFFICER/STAFF COMMENTS:**

None

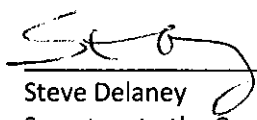
**COUNSEL COMMENTS:**

None

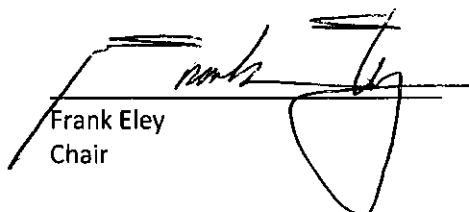
**ADJOURNMENT:**

The Chair adjourned the meeting at 11:35 a.m.

Submitted by:

  
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Steve Delaney  
Secretary to the Committee

Approved by:

  
\_\_\_\_\_  
Frank Eley  
Chair