

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

GOVERNANCE COMMITTEE MEETING

March 28, 2018

9:00a.m.

MINUTES

Attendance was as follows:

Present: Shawn Dewane, Chair; Roger Hilton, Vice Chair; Chris Prevatt; and David Ball

Also Present: Steve Delaney, Chief Executive Officer; Molly Murphy, CFA, Chief Investment Officer; Gina Ratto, General Counsel; Brenda Shott; Chief Executive Officer, Internal Operations; Anthony Beltran, Visual Technician; and Sonal Sharma, Recording Secretary

The Chair called the meeting to order at 9:09 a.m.

ACTION ITEMS

NOTE: Public comment on matters listed in this agenda will be taken at the time the item is addressed, prior to the Committee's discussion of the item. Persons wishing to address items on the agenda should provide written notice to the Secretary of the Committee prior to the Committee's discussion on the item by signing in on the Public Comment Sign-In Sheet located at the back of the room.

A-1 CHIEF INVESTMENT OFFICER CHARTER

Presented by Steve Delaney, CEO and Molly Murphy, CIO

Mr. Delaney provided background commentary regarding Ms. Murphy's recommended revisions to the CIO Charter, including the recommendation of delegated authority to hire and terminate managers. He suggested this is only a slight change to current processes and procedures, but also noted this change is an important one.

Mr. Delaney reviewed and discussed OCERS' contract with OCERS' Strategic Portfolio and Risk Advisor, PCA; he stated, that "pursuant to Government Code Section 31595 and related provisions of law, the BOARD, may, in its discretion, invest, or delegate the authority to invest, the assets of the fund through the purchase, holding, or sale of any form or type of investment, ..., 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 aims." Therefore, he rationalized that the central issue for the CIO Charter discussion, and in particular, the associated risks and benefits of delegated authority, is the prudent person rule.

Ms. Murphy expressed that she understood the Committee's concerns as natural, particularly given the circumstances: she recognized that the proposed change of delegated authority in the CIO Charter arrives at the same time OCERS is building out new internal resources and hiring new external sources, TorreyCove and Townsend Group.

Ms. Murphy suggested that the new relationships are effectively substitutions. She noted that Townsend Group is replacing RVK for real estate coverage. Observing that OCERS is allocating relatively more to private equity versus hedge funds, she noted that TorreyCove is replacing Aksia.

Mr. Delaney observed that some Trustees had wanted Meketa, as OCERS' General Consultant, to opine on private market investment managers; however, he explained that this type of monitoring was not the case historically. For example, he recalled that when RVK advised on a real estate manager, NEPC, as OCERS' General Consultant, would not opine on that manager.

Mr. Ball responded that this was one of his issues with NEPC.

Mr. Delaney responded, noting the difference, as NEPC would provide color on the impact upon the overall portfolio, but would not opine on a RVK's manager recommendation.

Ms. Murphy described the differences between the prior and the proposed CIO charter. In both charters, she discussed the various levers the Committee continues to control over advice, execution, and operations, including all investment consultants and custodians.

Mr. Hilton and Ms. Ratto discussed the OCERS' past processes and the recently proposed steps for hiring/firing investment managers.

Mr. Hilton asked Ms. Ratto if the only way for the Committee to hire/fire managers was through hiring/firing consultants.

Ms. Ratto responded that if the Committee were unhappy with the CIO's manager selection, the recourse would be to direct the CIO to issue an RFP, and work with the CEO and CIO, since the CIO reports to the CEO. She also observed that if the Committee is just concerned with one manager, then the issue is with the investment manager; however, she also noted that if it's a pattern where the CIO selects underperforming managers, then the issue is with CIO, at which point the Committee would then go to the CEO.

Ms. Murphy and Mr. Prevatt duly noted that the Committee has discretion over delegated authority and therefore could pull it anytime in its entirety, and/or change parts of the structure and process anytime as well.

Mr. Prevatt and Mr. Hilton continued the discussion on the appropriate steps and procedures should the Committee have any issues with delegated authority.

Ms. Murphy discussed the role and responsibilities of each of OCERS' investment consultants, including a discussion of their fiduciary duty; she reported upon the standardized contract language surrounding fiduciary language for each consultant.

Ms. Murphy discussed the process that the Committee undertakes prior to manager selection, i.e., the Asset Allocation, which includes asset and sub-asset class targets and ranges. She observed that there are many guidelines around Manager Search and Selection, as the Committee, through Asset Allocation policy, signals the investable areas to staff and consultants. She stated that if it is not defined in the asset allocation, then staff cannot invest without going back to the Committee for an approved mandate.

Ms. Murphy presented a slide on public peers with and without delegated authority, stating she also discussed the slide from a prior Investment Committee meeting. She reported upon peer exceptions, while also reporting those exceptions are evolving towards some form of delegated authority. She also observed that plans of OCERS' similar size have some form of delegated authority.

Ms. Murphy presented her slide on OCERS' Manager Hiring Process, which includes the following steps: (1) Asset Allocation; (2) Ongoing Due Diligence; (3) Manager Search and Selection; and (4) Manager Approval. She opined that the Ongoing Due Diligence process of staff and consultants is not discussed sufficiently enough in the Committee setting, and therefore she suggested the discipline of this process may not be clear or apparent to the Committee.

Ms. Murphy stated that OCERS' Asset Allocation is explicit direction from the Committee on what staff and the consultants can and cannot invest in.

Ms. Murphy discussed that where there is a gap in Asset Allocation, i.e., underperformance, or when the structure of an investment is not ideal, staff will assess the industry for peer group improvements. She also discussed the idea of "white space" i.e., gaps not already addressed or approved in the asset allocation, or structural inefficiencies that OCERS may want to exploit. She reported that it is incumbent of staff to bring such gaps to the Committee, and accordingly provide the needed educational presentations to the Committee. She observed that this is the time and place for input from the Committee to vet whether the investment idea is prudent and palatable such that the staff and consultants can proceed with Manager Search and Selection, and thus implement the Asset Allocation.

Mr. Ball opined upon the hiring of consultants and their respective duties to the Committee and to staff. He discussed the legal responsibility, fiduciary duty of each and every consultant, as well as their practical duty. He opined that Meketa, due to their day-to-day relationship with staff, would report to staff; further, he suggested that PCA, upon their hiring, would be both a Risk consultant, as well as a general consultant that acts as an independent source and voice to the Board.

Mr. Ball further observed that manager approval does not belong to the Committee, as the issue is the process by which the CIO educates and communicates to the Committee how OCERS' Asset Allocation is going to be distributed and implemented, with discussion on ranges and targets. He stated that during the Asset Allocation and Ongoing Due Diligence stages are the only stages where the Committee should get into the discussion and pose issues and questions. He noted that the Committee should step away and empower staff and consultants once staff and consultants are in the Manager Search and Selection stage.

Ms. Murphy expressed agreement with Mr. Ball, and reported that, given her experience, as well as OCERS' prior experience with RVK, OCERS should perform an annual strategic review and plan for each asset class. She expressed one concern with Mr. Ball's comments, specifying that not every manager search would go through a RFI/RFP process. She reported the Manager Search and Selection stage could go through a shortlist process. However, she noted that she would frequently communicate staff's due diligence process to the Committee, otherwise she would not even be doing the CIO's bare job requirements. She also described that another good way to provide transparency and frequent communication would be through providing a running pipeline of potential investments to the Committee on a monthly basis.

Mr. Ball noted that he is not necessarily concerned about the RFP/RFI process; rather, he expressed his concern that as the process is currently drafted, there is a possibility for zero communication

between the Committee and the CIO. He voiced his desire for the Committee to be strategically involved, with frequent communication as to who and what potential manager hires are.

Mr. Prevatt, Mr. Ball, and Ms. Murphy discussed the need for more precise explicit language during the Ongoing Due Diligence process.

Mr. Prevatt reported that one of the Committee's concerns is that a manager could be hired without the Committee even knowing or understanding the manager's strategy.

Mr. Prevatt discussed that the process must explicitly state that new strategies or an underperforming existing strategy be discussed and presented to the Committee. He opined on the need for explicit controls that require a new idea or strategy to come before the Committee prior to additional steps are undertaken by staff and consultants.

Ms. Murphy expressed agreement that a new idea or strategy needs to be first vetted by the Committee.

Mr. Prevatt further explained that it is his understanding that this step would need to be hardcoded into the process for the Committee to get comfortable and agreeable with delegated authority.

Mr. Dewane and Ms. Murphy discussed an extreme example of Large Cap Growth, Private Equity, and Chinese Real Estate to emphasize the necessary steps and discussions required for the CIO to allocate capital across those strategies. The discussions and steps required would include a vetting of the change to the asset class, as well as vetting of the changes to the sub-asset class targets and ranges.

Mr. Ball described two boundaries for the delegated authority process: 1. Asset allocation; and 2. the Investment Committee has the right to be informed prior to the hiring of the manager, whereby a number of items are discussed, including but not limited to returns, risk, and timeframe.

Ms. Murphy and Mr. Ball discussed a hypothetical delegated authority example where Ms. Murphy sought to directly allocate to private equity buyout managers. They discussed the required discussions and communication between the CIO and the Committee, including the structure to fulfill that allocation, returns, risk, timeframe, fee structure, parameters, etc.

Ms. Murphy explained that this type of structural discussion has been lacking, even for less complex assets such as equities. She stated her goal is to have annual asset class reviews, where the Committee, staff, and consultants discuss, for example, goals and target tracking error parameters for each manager. Ms. Murphy commented that these types of discussions should be ongoing regardless of whether or not OCERS is hiring a manager or not.

Mr. Ball agreed, but noted the need for explicit parameters and guidelines.

Ms. Murphy and Mr. Hilton discussed the proper process in providing the information to the Committee.

Mr. Hilton expressed his preference for an executive summary that included the following: manager source (e.g., RFI, RFP); number of applicants; fees; and how the manager fits in the mandate. He explained that many conference attendees generally ask about OCERS' hiring process.

Mr. Hilton explained his concerns stem from the private equity consultant hiring as the background hiring information was limited to the information given to him the day of the ICM.

Ms. Murphy agreed and explained that the hiring process will be transparent. She explained that with the updated agenda format, the Trustees are free to pull items, discuss, and ask questions to the staff about the hiring of the managers.

Mr. Dewane, Ms. Ratto, and Ms. Murphy discussed the prudent person rule and prudent expert rule, particularly as it pertains to delegated authority.

Ms. Ratto explained that as members of the Investment Committee, Trustees would be bound by the prudent expert rule; that said, she continued to explain, that if a Trustee does not believe they are an expert, they are bound by fiduciary duty that they hire experts and rely on that expertise accordingly.

Ms. Murphy further explained and applied the prudent expert rule to her responsibilities as CIO, particularly as it relates to delegated authority; she discussed certain capacities that did warrant her to delegate authority, i.e., delegating authority to a custodian, such as State Street to value the portfolio. She explained that she does not have to serve as a prudent expert in every single capacity.

Mr. Dewane stated for the record that there are good academics supporting delegated authority.

Mr. Dewane asked if there were any comments from the public.

Mr. Eley, Regular Board and Investment Committee Member, addressed the Committee and asked for every '37 act pension to be listed with whether or not they have delegated authority.

Ms. Murphy explained that she reached out to every system but not every system responded.

Mr. Eley and Ms. Murphy discussed the costs and benefits of manager presentations during the manager hiring process.

Mr. Eley addressed the Committee, suggesting that manager materials and information could be added to the agenda under "Information Items", noting the importance of manager presentations as educational tools for the Committee.

Ms. Murphy stated that the termination process is similar to the hiring process, explaining that the process similarly starts with Asset Allocation, as the Asset Allocation will have changed over time from the manager's initial hiring.

Ms. Murphy expressed her preference to increasing the frequency of the quarterly compliance report to monthly, as compliance issues can occur monthly and not squarely on a quarterly basis.

Ms. Murphy described the Watch List process; she provided commentary on the importance of this step in the termination process to be in the public domain and in the domain of the Committee. She discussed the need for transparency, suggesting that a termination could be telegraphed for months through the Watch List step.

Ms. Murphy explained that with the proposed recommendation of delegated authority, the Committee would not necessarily bring a termination to a vote. She explained that in more emergency situations, the CIO has the ability to terminate for cause, with the approval of the CEO, and in conference of the Chair and Vice Chair of the Investment Committee.

Mr. Hilton and Ms. Murphy discussed the appropriate process regarding executive summary memos for termination, including how Board Members could arrive at a different interpretation of the rationale for termination without an executive summary.

Mr. Dewane summarized and confirmed that the Watch List would be regularly given to the Committee. He noted that possible terminations would be telegraphed for months. Further, he confirmed that only under extraordinary situations could there be a surprise to the entire Committee, explaining that under such a scenario, there would necessarily be communication between the CIO, CEO, as well as the IC Chair and Vice Chair.

Ms. Murphy further explained that staff has already been operating under this standard.

Mr. Ball and Ms. Murphy discussed bringing managers on the Watch List to the Investment Manager Monitoring Subcommittee (IMMS).

Ms. Murphy further explained that the IMMS will focus on Watch List managers.

Mr. Dewane asked for public comment.

Mr. Eley, Tustin, addressed the Committee about OCERS' prior manager termination history, including a discussion about OCERS' cash overlay program several years ago, as well as the benefits of manager presentations prior to manager terminations. He also discussed the possibility of an accompanying memo each from PCA, Meketa, and the staff to confirm/deny the manager termination, particularly should there be a disagreement between staff and the CIO. Given the relatively recent hiring of the CIO and consultants, he also stated that they are in their probationary period; in light of this, he suggested that Committee retain investment authority for some strategies, e.g., private equity, while applying the proposed delegated authority process for other strategies.

Mr. Prevatt addressed and responded to Mr. Eley's issues. Regarding the cash overlay program issue, he explained that would be a change in Asset Allocation rather than a manager change, so that would need to come before the Committee. Regarding terminated manager presentations, he discussed the risks of relying upon professional presenters versus relying on OCERS' prudent experts. Regarding possible disagreements between the CIO and staff, he expressed that the CIO is in charge of staff, and for the Investment Committee to get involved here would not prudently manage the investment process.

Mr. Ball expressed agreement with Mr. Prevatt's comments.

Mr. Ball also expressed that only under unusual circumstances would a manager not go through the typical Watch List process. He considered the Watch List as an early warning system. If the Committee has issues or questions with the Asset Allocation or the Watch List, he expressed then and only then could the Committee raise those issues or questions at that respective step, and not after the decisions has already been made. He discussed his issues with manager presentations, reiterating that it is not a matter of time spent with the manager, but rather that the manager will only talk their book up.

Mr. Eley discussed the need to keep managers in check and accountable, particularly as it relates to manager presentations to the Committee.

Mr. Hilton observed Mr. Eley's tenure and service as an OCERS Trustee. He also reported that the vote has already passed and Trustees must get in line with the approval; he also noted that with prior CIOs, the mere idea of delegated authority would likely not have even gotten to this step in discussions.

Mr. Dewane discussed the difficulty in measuring the investment acumen of a manager based upon the manager's ability to present to the Committee. Given his own expertise, he opined upon the persuasive ability of presenters, who are highly trained, and are by definition not objective.

Mr. Dewane opined upon the importance of Committee meetings, while also noting that time at meetings also equates to time spent for OCERS' staff away from their manager due diligence process.

Mr. Dewane expressed that while OCERS' consultants, TorreyCove and Townsend Group, as well as Ms. Murphy are relatively new to OCERS, the idea of delegated authority is not. He stated that delegated authority is well-documented and well-researched, noting that across the industry, delegated authority is considered best practice. He observed that Ms. Murphy is asking for the responsibility and for the accountability of the portfolio and asking to be measured by the performance of the fund itself. He continued to observe that she has skin in the game and opined that she has no incentive to invest improperly. Ultimately, he stated that the Committee always holds full recourse and can recall delegated authority. He opined that this change of delegated authority in the CIO Charter is a small conversion that will help elevate the Committee's discussion to more worthwhile topics and concerns, i.e., OCERS' performance, which he reported has been bottom decile over a number of time-periods.

Mr. Prevatt discussed the manager termination for cause process; he also discussed the Watch List for underperforming managers.

Mr. Prevatt discussed managers where there is a change in strategy, i.e., style drift, and thus, he stated that this would be in contradiction to OCERS' asset allocation, and consequently, he rationalized that the Committee has already made a decision and that would obviate the need for manager presentations. He also noted that if the Chair rationalizes, either due to underperformance or a change in organization structure, that the manager should be able to present during the Watch List process at the IMMS.

Ms. Murphy agreed, expressing that is how it is currently described in the current policy.

Mr. Prevatt further opined that information gap is being filled when the staff brings strategy education to the Committee. He explained strategy education and discussion tends to be less biased than the historical process, where the investment manager would present a new strategy to the Committee through marketing their own funds and firms.

Ms. Murphy, in an effort to discuss associated risks and oversight between selecting managers and selecting underlying securities, initiated a discussion on pension plans managing in excess of \$40 – 50 billion.

Mr. Ball repeatedly voiced his confusion as to why such a discussion is relevant to the day's discussion.

Ms. Murphy responded that the goal of these slides was to explain what OCERS is and is not.

The Committee and Ms. Murphy discussed her CIO Charter memo, which discussed 3 options for the Committee to decide upon, with option 1 stating that the Committee "Maintain the delegated authority as outlined in the CIO Charter approved in January 2018.

Mr. Prevatt explained that Ms. Murphy's option 2, which includes limits, arose due to concerns from the members of the Committee who were concerned that there were no limits in the proposed delegated authority.

Mr. Ball expressed that no dollar limits are needed because the CIO has no authority unless the CIO goes to the Committee first for approval, specifically an executive summary memo that describes the asset and sub-asset category, the targeted size of investment, as well as the implications of the potential investment upon the Asset Allocation targets and ranges.

Mr. Delaney asked and confirmed that Mr. Ball did not care about the "who" the Committee would be allocating capital to, but rather is concerned about the why, in terms of the investment rationale and benefit to OCERS' portfolio

Mr. Ball stated that, to be clear, in no way is the Committee giving blanket authority to staff to allocate capital without first going through the process, expressing that capital could not be invested without the Committee ever knowing.

Mr. Dewane summarized and confirmed that through this process, the Committee, through option 1, would reaffirm the Asset Allocation, and then the CIO would execute the Asset Allocation through Manager Search and Selection.

Mr. Dewane asked if Mr. Ball is advocating option 1 and observed that Mr. Ball seems to be indicating that option 2 and 3 be eliminated because the concern has been previously addressed.

Mr. Prevatt stated that he would like to address again the concerns of half of the Committee regarding the CIO's limits, noting that without option 2, there are no limits within the proposed delegated authority, and thus those concerns would arise again.

Mr. Ball opined that today's discussion obviated the need for limits, because through option 1, the CIO would still need to seek the Committee's approval prior to proceeding with an allocation.

Mr. Dewane asked for public comments.

Ms. Freidenrich, Regular Board and Investment Committee Member, addressed the Committee about option 1, and expressed her concern that there were no limits within the proposed delegated authority.

Mr. Ball responded, and noted that earlier in the meeting, the Committee reviewed the Manager Hiring Process and modified it such that the CIO, for the Committee's review and approval, would present to the Committee a complete description of the proposed investment managers' strategies, including the asset category and the potential capital allocation. He explained further that the CIO then, with the Committee's approval, would implement within those guidelines.

Ms. Freidenrich thanked Mr. Ball for the clarification, and for her understanding, confirmed and summarized that at that point, the CIO would not bring managers to present, but rather select the manager within the approved limits. She further summarized that though option 1 was approved at the prior Investment Committee meeting, the Governance Committee modified option 1 such that no additional allowance or limit would be required because the Investment Committee would have already identified limits through the pre-approval process.

Mr. Ball agreed, and confirmed that the Governance Committee made the limit effectively zero for discretion, again explaining that without the explicit approval from the Committee, there is no authority to proceed with manager selection and investment.

Mr. Dewane observing that Ms. Freidenrich was not present earlier in the day, provided an investment example for Ms. Freidenrich's benefit; he described the steps the CIO could and could not do regarding the Large Cap Growth Equity allocation, Private Equity, and Chinese Real Estate. He particularly explained that the Asset Allocation would limit the CIO from reallocating such proceeds to Chinese Real Estate since that asset class is not within the strategic Asset Allocation.

Mr. Delaney observed that Ms. Murphy move the presentation back to slide 9 to illustrate the process for Ms. Freidenrich's benefit.

Mr. Ball continued Mr. Dewane's example and further explained the necessary steps, including a discussion of the required CIO memo that would describe the proposed investments' risk profile. He also stated that at that point Meketa and the risk consultant would add their input. With the Committee's approval, the CIO would select manager(s) that would fit the approved criteria.

Mr. Ball also explained what the CIO could not do without the Committee's approval, explaining that the CIO must fulfill the pre-approved criteria. For example purposes, he explained that the CIO could not terminate the cash overlay program as that would be a complete change in the Asset Allocation. He stated that the Committee retains 100% control of the direction and timing of the capital; the only thing the Committee is relinquishing is the individual interviewing and selection process of the managers.

Ms. Freidenrich expressed appreciation for the tighter Ongoing Due Diligence process and sufficient checks and balances within the proposed delegated authority.

Ms. Freidenrich, Mr. Ball, and Ms. Murphy discussed TorreyCove and their investment recommendation. They discussed the steps required of the CIO to proceed with an investment, including the initial CIO memo seeking pre-approval, and an executive summary that followed the pre-approval memo, that would remind the Committee of the approved mandate and what the CIO is proposing. They particularly discussed this alleviate Ms. Freidenrich's concerns regarding the need for frequent communication and transparency, which the original proposed recommendation for delegated authority lacked.

Mr. Dewane, sensing consensus amongst the Committee and the Trustees present in the public suggested that: (1) option 2 and 3 are both off the table and (2) option 1 is preferred, pursuant to the Governance Committee's discussions and modifications that occurred at the day's meeting.

Ms. Murphy expressed agreement, explaining that some of today's agreed upon language, steps and processes may end up in the Investment Policy Statement, while others would fall within the purview of the CIO Charter.

Mr. Prevatt asked that Ms. Murphy, in clarifying and confirming option 1 for the approval of the Committee, needs to specify the role and responsibilities of OCERS' consultants, Meketa, PCA, TorreyCove, and Townsend Group.

Mr. Prevatt and Mr. Ball cautioned against PCA providing a second opinion on a specific real estate manager selection, which could pose a conflict of interests; they agreed that PCA, as OCERS' risk consultant, should only opine on the broader risk allocation.

Mr. Dewane expressed agreement and stated the need for OCERS' consultants to provide a written investment recommendation, rather than a verbal one, that confirms or denies staff's proposed recommendation.

Ms. Murphy, also expressed agreement, further explaining that her recommendation would likely not progress to that stage without the expressed agreement from the appropriate OCERS' consultant, i.e., general consultant or specialty consultant.

A **motion** was made by Mr. Ball, **seconded** by Mr. Prevatt to maintain the delegated authority as outlined in the CIO Charter approved at the January 2018 Investment Committee meeting, subject to the two changes discussed at today's Governance Committee meeting: (1) alteration of the due diligence process defining the potential allocation's strategy, pricing, and risk profile identified first to the Committee prior to manager selection and hiring; (2) manager termination process goes through the Watch List process, where the Committee has the right to vote whether or not the manager goes on the Watch List, and the manager cannot be fired without extenuating circumstances. The **motion carried unanimously.**

Mr. Hilton and Ms. Murphy discussed the timing of delegated authority, particularly as it relates to a live example that would require approval at the April Investment Committee meeting.

The Committee further discussed the timing of the finalized delegated authority. They agreed and Mr. Prevatt confirmed that the policy would come back at the April Investment Committee meeting.

* * * * *END OF INDIVIDUAL ITEMS AGENDA * * * * *

COMMITTEE MEMBER/CEO/CIO/STAFF/CONSULTANT COMMENTS

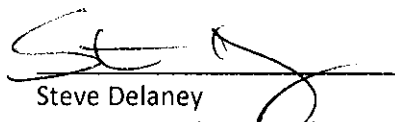
None

COUNSEL COMMENTS

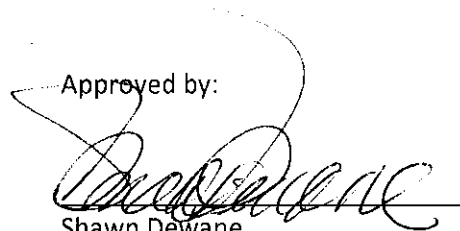
None

ADJOURNMENT: The Chair adjourned the meeting at 10:15 a.m.

Submitted by:


Steve Delaney
Secretary to the Committee

Approved by:


Shawn Dewane
Chair