MENDOCINO COUNTY EMPLOYEES RETIREMENT ASSOCIATION

Date: March 20, 2024
To: Board of Retirement
From: F. Robert Reveles, Retirement Financial Investment Officer
Subject: Domestic Equity Structure Recommendation – SMID Option

Recommended Action:

Receive and file. No action required.

Fiscal and Financial Impacts:

There are no immediate financial impacts from receiving this report.

Strategic Plan Importance:

The review of the domestic equity structure aligns with Strategic Plan Goal 1, protect the plan's long-term financial health, Objective C – Explore scenarios to further protect member benefits.

Background and Discussion:

During the August 16, 2023, Board of Retirement meeting Trustees considered alternate structures of the domestic equity composite. The Board directed a review of the current domestic equity manager lineup and further consideration of the possibility to simplify the composite by decreasing the manager lineup.

At the October 18, 2023, Board of Retirement meeting Trustees reviewed the current domestic equity structure and the current small/mid-cap managers. The review showed the total domestic equity composite compared favorably vs the benchmark over longer periods and vs peers, with net of fee performance falling within the top quartile on longer time periods. The Board directed Callan to review the SMID Cap manager universe to determine the merit, if any, of changing the current domestic equity structure with new managers to remove the Small/Mid Cap tilt in the domestic equity portfolio.

In November 2023 Callan initiated a search by creating a broad client/candidate profile which described the requirements for desired strategies. The MCERA profile outlines, among other things, the rationale for the search, total size of the MCERA portfolio, estimated strategy funding, number of candidates for each mandate, and plan type. The candidate profiles required only qualified investment organizations registered under the Investment Advisers Act of 1940, potential strategies which have a complementary strategy type compared to the current manager line-up, at least 5 billion in assets under management in the strategy, a commingled or mutual fund structure, a team investment approach with at least 8 year investment management experience among professional staff, a lack of excess staff turnover, and at least 3 years of investment performance, among other basic requirements. The equity structures considered were: (1) one value, one growth, one core; (2) one value and one growth; and (3) three core managers.

In January 2024 staff and Callan met twice to review the strategies. We identified four to seven strategies within each style type (growth, core, value) for a more thorough due diligence review. The due diligence review included total firm assets under management (AUM), vehicle structure and AUM, key investment professional review, strategy style, sector allocation, dividend yield, historical weighted market capitalization, multiple period performance, calendar year performance, rolling three-year performance, rising/declining period performance, excess return correlations, standard deviations, and other major risk statistics. (Both current and historical statistics)

There are several considerations for Trustees when thinking about changing the current domestic equity structure. First, is the MCERA on track to meet our current funding goals? Both the Segal ASOP 51 Risk report and annual valuation reports indicate this to be the case. Segal estimates the UAAL will be paid down by 2034, only a decade away. In fact, the Board took action in December 2021 to lower the 2012 UAAL restart layer, the single biggest contributor to the UAAL, from 18 years to 15 years (on June 30, 2021). The Callan Asset Liability study also shows MCERA is on track to meet our funding goals with an estimated 94% funded ratio within 10 years.

Has the MCERA changed our overall strategy to reach our funding goals? During the most recent asset liability review Trustees eventually determined to retain (what was then) the current asset allocation. During this discussion Trustees passed on the addition of the Private Equity asset class because of the belief that the MCERA can meet our investment return requirements without it. Specifically, investment returns are expected to be higher over the next decade due to the increase in return expectations on "risk-free" fixed income.

Have we changed our investment beliefs? The MCERA beliefs are: focus on the long-run, diversification adds value, understand and manage risk, simple is often better, public markets are largely efficient, investment costs matter, and strong governance is vital. At the October 18, 2023, meeting Trustees approved these beliefs as part of the Investment Policy Statement.

Does the behavior of the domestic equity structure match our expectations? Staff and Callan believe it does. At the October 18, 2023, meeting Mark Wood of Callan presented an overview of each domestic equity manager, stating his belief that the domestic equity managers have meet expectations. Each manager has a unique strategy, and each are expected to do well in different market environments. This provides the composite with built in economic diversification.

How has the long-term performance been vs composite benchmarks and vs peer groups? At June 30, 2023, the total domestic equity composite outperformed the Russell 3000 index by 9 basis points net of fees over the last 15 years and ranks in the 24th percentile compared to peers. At December 31, 2023, the total domestic equity composite outperformed the Russell 3000 index by 33 basis points net of fees over the last 15 years and ranks in the 11th percentile compared to peers.

Has the management of the funds changed dramatically, or has the investment style changed over time? While there have been some major management changes at the Fidelity and Alliance Bernstein strategies (Joel Tillinghast of Fidelity and Bruce Aronow of Alliance Bernstein retired at the end of 2023), both funds remain in the capable hands of Morgen Peck, Sam Chamovitz (both of Fidelity) and Samantha Lau (Alliance Bernstein). While style exposure can drift over time (Size, Yield, Liquidity, Volatility, Momentum, Quality, and Style) because of market sentiment and business cycles, the funds have stayed true to their stated mandates. Staff will be bringing another risk review like the one provided at the August 16, 2023, meeting in the upcoming quarter.

For these reasons, staff recommend retaining the current domestic equity structure.