

Date: April 17, 2024
To: Board of Retirement
From: F. Robert Reveles, Retirement Financial Investment Officer
Subject: Overview of Callan's Due Diligence Process for Manager Search

Recommended Action:

Receive and file.

Fiscal and Financial Impacts:

There is no financial impact to receiving this report.

Strategic Plan Importance and Risk Assessment:

This due diligence update relates to the Board's strategic goal to protect the Plan's long-term financial health and strengthening risk oversight. Due diligence of investment managers, when considering a new manager and ongoing review for existing managers, is a fiduciary requirement of the Board. Callan provided an overview of their process in March 2022. MCERA participated in the review process of potential SMID managers earlier this year. This report outlines Callan's process in more detail to illustrate the depth of their process.

Background and Discussion:

This memo provides an overview of Callan's investment manager search process in anticipation of a formal update on due diligence by Callan at next month's meeting.

Callan, MCERA's investment consultant, is an SEC-registered investment adviser with more than \$4.5 trillion of assets under advisement and over 200 employees. They provide advice to institutional investors like MCERA across the country through proprietary research, an in-depth investment manager database, and ongoing fiduciary education (available to trustees).

Just over half of Callan's employees hold an advanced degree, a Chartered Financial Analyst (CFA) designation, or a Chartered Alternative Investment Analyst (CAIA) designation. There are separate research teams, covering both public and private markets, for U.S equity, non-U.S. equity, fixed income, real estate, and other real assets (other real assets include commodities, Master Limited Partnerships (MPLs), Real Estate Investment Trusts (REITS), agriculture, timberland, and infrastructure). The teams focus solely on original research and due diligence support for client manager searches. We've had several different research team members speak on performance and education over the years. Recently Mark Wood on domestic equity/Environmental, Social and Governance (ESG) and, a few years ago, Jan Mende on infrastructure.

Callan's search process is client-driven and customized to each client. Investment manager searches combine numerous qualitative and quantitative factors, and are reviewed by Callan's Manager Search

Committee, a 13-member committee of senior consultants, who verify the accuracy, completeness and objectivity of all methods used in the manager screening process.

The search process begins with a client profile. The client profile outlines the type of plan doing the search, the rationale for any search, total size of the plan, dollar assets to be allocated, the plan custodian, a search timeline, and provides a current portfolio snapshot. The client profile sets the foundation for investment manager and strategy expectations that will be reviewed over the course of the search.

Next, an investment manager profile is compiled. The manager profile sets expectations for the investment manager type, style, managed asset minimums, professional staff, manager structure and experience, investment vehicle type, historical performance and risk characteristics, and any qualities specifically sought or to be avoided.

In our recent manager search only qualified investment organizations, registered under the Investment Advisers Act of 1940, were considered. Potential managers needed to have at least \$5 billion in assets under management with a stable well diversified client base. To mitigate key person risk, a team approach was preferred, and key professionals needed to have at least eight years of investment experience and have worked as a team for at least three years. A commingled fund or mutual fund structure was required. A three-year track record was also required. Additional qualities specifically sought were that the firm be a viable, ongoing business, with an organizational structure to support an institutional client base, a disciplined investment process, low turnover of key personnel, low dispersion of returns (within appropriate composite), a commitment to client service that includes the ability to effectively articulate the investment process, and a willingness to visit MCERA as needed. Qualities specifically avoided were managers currently involved in a merger, acquisitions, recent transactions impacting the firm's senior executives, and excessive recent personnel turnover.

Once the client and manager profiles are complete Callan's research teams compile and review firm and strategy information, portfolio characteristics, and historical performance of managers which meet the profile requirements.

Firm information includes location of headquarters, ownership structure, total firm assets, Global Investment Performance Standards (GIPS) compliance, disaster recovery plans, firm wide ESG policies (including publishing annual sustainability information and United Nations Principles for Responsible Investment signatory).

Strategy information includes proposed vehicle type, benchmark, product Assets Under Management (AUM), number of holdings, issue diversification, annual turnover (holdings), combined z-score, weighted median market cap, non-US exposure, and strategy inception date. Product level (strategy) investment professional information is also compiled and includes the number of portfolio managers, research analysts, fundamental analysts, key investment professionals, asset turnover, and asset concentration (largest account).

Portfolio characteristics reviewed are sector allocations, sector allocations vs. benchmarks, dividend yields, combined z-scores (how growthy or value-y the strategy is over time), historical weighted median market capitalization, historical issuer diversification, and historical number of holdings.

Performance review includes multiple period trailing period performance (quarter, year, 3-years, 5-year, 7-year, 10-year), calendar year performance (past 10 years), rolling 3-year periods, performance in rising/declining periods, up/down market capture, 5-year excess correlation vs benchmarks, 5-year risk/reward, 5-year excess return vs tracking error, 5-year risk characteristics (alpha, beta, information ratio, Sharpe ratio, standard deviation, downside risk, correlation vs peer group), 10-year risk characteristics (rolling single year returns vs peers, rolling 3-year returns vs peers, rolling 3-year standard deviations vs peers, rolling 5-year standard deviations vs peers, rolling 3-year Sharpe ratio vs peers, and rolling 3-year excess return ratio vs peers).

Callan's U.S. Equity Market Research team dug through over 2500 strategies (different products and vehicles) eventually settling on 31 strategies the team had the most conviction in based on our investment requirements. In January, staff went to the Callan office in San Francisco to review the strategies identified, discuss options with the consulting team and the market research team, and to determine 15 strategies that could be finalists of the search. These 15 strategies were then reviewed by Callan's Manager Search Committee as the final step in the manager screening process.