

**MercedCERA INVESTMENT SUBCOMMITTEE MEETING AGENDA
THURSDAY, AUGUST 27, 2020
MERCED COUNTY EMPLOYEES' RETIREMENT ASSOCIATION
3199 M STREET, MERCED, CA 95348
TELEPHONE NUMBER: 1-310-372-7549, CONFERENCE CODE: 975839**

Important Notice Regarding SARS-COV-2

Based on guidance from the California Department of Public Health and the California Governor's Office, in order to minimize the spread of the SARS-COV-2 virus, MercedCERA's building will be closed to the public during MercedCERA Board meetings. Members of the MercedCERA Board will participate in this meeting offsite via conference call. Members of the public may listen to the meeting and offer public comment telephonically by calling into the telephone number provided above and entering the stated conference code. If you have any issues participating in the meeting telephonically or require reasonable accommodation for your participation, please contact MercedCERA staff at 209-726-2724.

CALL TO ORDER: 10:22AM

- ROLL CALL
Absent:
Present:

- APPROVAL OF MINUTES – April 29, 2020.

PUBLIC COMMENT

Members of the public may comment on any item under the Board's jurisdiction. Matters presented under this item will not be discussed or acted upon by the Board at this time. For agenda items, the public may make comments at the time the item comes up for Board consideration. Persons addressing the Board will be limited to a maximum of five (5) minutes in total. Please state your name for the record.

BOARD ACTION¹/DISCUSSION

Pursuant to Govt. Code § 31594 and MercedCERA's Investment Objectives & Policy Statement due diligence analysis requirement:

1. Review and discussion of MercedCERA's US equities sleeve – Meketa Group.

INFORMATION ONLY

These topics will be brought to the September 10, 2020 Meeting for approval if needed by the full Board of Retirement.

ADJOURNMENT:

¹ "Action" means that the Board may dispose of any item by any action, including but not limited to the following acts: approve, disapprove, authorize, modify, defer, table, take no action, or receive and file.

All supporting documentation is available for public review online at

www.co.merced.ca.us/retirement

Any material related to an item on this Agenda submitted to the Merced County Employees' Retirement Association, after distribution of the Agenda packet is available for public inspection at

www.co.merced.ca.us/retirement

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**MercedCERA SPECIAL INVESTMENT SUBCOMMITTEE MEETING AGENDA
WEDNESDAY, APRIL 29, 2020 at 9:00AM PST
MERCED COUNTY EMPLOYEES' RETIREMENT ASSOCIATION
TELEPHONE NUMBER: 1-310-372-7549, CONFERENCE CODE: 975839**

ROLL CALL: 9:00 A.M

Board Members Present: Ryan Paskin, Karen Adams and David Ness. **Staff:** Kristen Santos, Alexis Curry, Mark Harman and Ninebra Maryoonani. **Consultants:** Kathleen Barchick, Cliffwater LLC and Mika Malone and Paola Nealon, Meketa Group. **Absent:** Michael Rhodes.

APPROVAL OF MINUTES – February 27, 2020.

Motion to approve the minutes from the February 27, 2020 meeting minutes.

Adams/Ness U/A (3-0)

PUBLIC COMMENT

No Comments.

CLOSED SESSION

(Govt. Code § 54956.81)

1. Discussion and possible recommendation to full Board to review MCERA Portfolio Allocation – Meketa and Cliffwater.
The MCERA Subcommittee voted to bring this discussion to the full board on May 13, 2020.
2. Discussion and possible recommendation to full board of investment in a fund – Meketa and Cliffwater.
The MCERA Subcommittee board voted to bring this discussion to the full board on May 13, 2020.

REPORT OUT FROM CLOSED SESSION

Staff was given Direction.

ADJOURNMENT

The meeting adjourned at 9:44 A.M

Respectfully submitted,

Ryan Paskin, Chair

Date

Merced County Employees' Retirement Association

August 27, 2020

Domestic Equity Review

Introduction

- As part of Meketa's due diligence process, we completed an initial fund review (IFR) of MCERA, prioritizing segments of the portfolio for a deeper dive analysis. To date, the following structural changes have been implemented as a result:
 - Addition of a new asset class, Opportunistic Credit
 - A restructuring of the international segment of the portfolio, both developed international and emerging markets
 - An assessment and modification of the core fixed income segment
- The intent of this final component of the Initial Fund Review is to assess the structure and performance of the fund's US equity program (the final piece of the puzzle), and to offer recommendations for potential enhancements, where appropriate.
- The analysis evaluated the focus areas listed on the following page.

Focus Areas

Weighting to US Small Cap and Mid Cap

The current US equity program is overweight to small cap strategies. The portfolio's 16% weight to small cap is higher than the weight of small cap stocks in the Russell 3000 index (8%). Meketa believes over the long term, an overweight to small cap can be beneficial, but private equity exposure also provides small cap exposure.

Active Management in US Equity

The US large cap core space is a relatively efficient portion of the domestic equity market. In contrast, there is compelling evidence that the small and mid cap areas are less efficient, and therefore offer attractive opportunities for active management. This aligns with the current structure of the program.

Mellon Dynamic US Equity Performance

Despite operating in a relatively efficient portion of the US market, the Mellon Dynamic US Equity strategy has achieved impressive performance both against the benchmark and against the large cap core peer group.

Current US Small Cap Managers

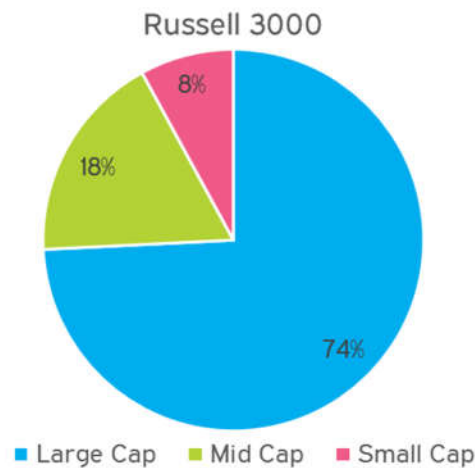
The fund currently has two active small cap managers on its roster. One of these managers, DFA, has failed to match the passive benchmark index since account inception. PanAgora has added value to the fund since its account inception. Both managers have low historical tracking errors, which can limit potential upside.

Recommendations

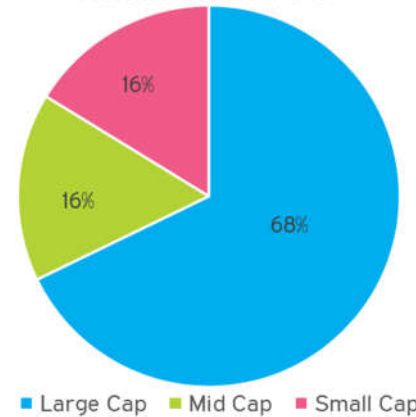
We recommend aligning the US small cap exposure with that of the Russell 3000 index. In this context, we recommend the termination of DFA. We also recommend either increasing the weight of PanAgora US Small Cap Stock Selector, or allocating to a different active small cap manager with higher tracking error, to align the portfolio's small cap exposure with that of the index. We also recommend hiring an active mid cap core manager in alignment with the weighting in the index. Despite the efficiency of the US large cap core space, the Mellon Dynamic US Equity fund has achieved attractive relative and risk-adjusted returns. We recommend retaining this strategy.

Merced County Employees' Retirement Association US Equity Portfolio¹

	Market Value (\$)	% of US Equity
US Equity	251,493,831	100.0
Mellon Dynamic US Equity	113,026,663	44.9
Mellon Large Cap	97,505,279	38.8
DFA Small Cap	25,787,713	10.3
PanAgora US SC Stock Selector	15,174,175	6.0



Current Merced County Employees' Retirement Association Portfolio



- The US equity program has a significant overweight to small capitalization strategies compared to the small cap stock exposure of the Russell 3000 index.²

¹ Data as of June 30, 2020.

² The market cap definitions for the Russell 3000 index are: large cap is greater than \$25 billion, mid cap is between \$5 billion and \$25 billion, and small cap is less than \$5 billion. Portfolio exposure is based on strategy allocation dollar amounts and not on the true underlying holdings. The portfolio exposure is thus an approximation of the actual exposure.

Active Management Performance in the US Equity Markets¹

		Active Manager Outperformance (%)	
	Manager Rank	5 Yr.	10 Yr.
	25th Percentile	0.42	0.44
US Large Cap Core	50th Percentile	-0.81	-0.41
	75th Percentile	-2.29	-1.08
	25th Percentile	2.56	1.78
US Mid Cap Core	50th Percentile	0.96	0.14
	75th Percentile	-2.64	-0.81
	25th Percentile	2.25	2.30
US Small Cap Core	50th Percentile	0.73	0.88
	75th Percentile	-1.42	-0.08

- Over the trailing 5 and 10-year periods, the median US large cap core manager has failed to outperform the Russell 1000 index, gross of fees, by a significant margin. In contrast, both the median US small and mid cap core manager has outperformed their respective indices, gross of fees, over the trailing 5 and 10-year periods. The 10 year mid cap returns are only marginally better than the index, causing pause in considering active management in this space.
- In the US large cap core peer group, a manager at the margin of the top quartile has generated modest excess returns above the benchmark, gross of fees. In contrast, top quartile small cap core and mid cap core managers have generated substantial excess returns against their respective benchmarks.

¹ Source: eVestment Alliance. Data as of June 30, 2020.

Active Management Performance in US Equity¹

Index	Peer Group Rank	
	5 Yr.	10 Yr.
Russell 1000	33	39
Russell Midcap	54	52
Russell 2000	61	72

- In order to outperform the Russell 1000 index on a gross-of-fee basis, a US large cap core manager must have ranked near the top third of all managers in the peer group over the trailing 5 and 10-year periods. In contrast, the median US small cap core and mid cap more manager have outperformed their respective index, gross of fees.
- This data suggests that the mid cap and small cap areas of the domestic equity market are less efficient than large cap. Active management is therefore appealing in small cap and mid cap due to the potential payoff.

¹ Source: eVestment Alliance. Data as of June 30, 2020.

Mellon Dynamic US Equity¹

	YTD	1 Yr.	3 Yr.	5 Yr.	7 Yr.	SI ²
Performance						
Returns (%)	-1.1	11.1	13.6	13.8	15.1	16.5
S&P 500 (%)	-3.1	7.5	10.7	10.7	12.1	13.2
Excess Returns (%)	1.9	3.6	2.8	3.0	3.0	3.3
Percentile Rank ³	18	10	5	1	1	1
Risk Measures⁴						
Tracking Error (%)	2.6	2.1	2.3	2.6	2.5	2.5
Beta	1.0	0.9	1.0	1.0	1.1	1.1
Upside Capture (%)	93.3	96.6	108.9	112.8	114.7	116.2
Downside Capture (%)	91.2	87.0	98.1	99.5	101.7	102.4
Risk-Adjusted Performance						
Information Ratio	1.5	1.7	1.2	1.2	1.2	1.3
Percentile Rank ³	15	4	3	1	1	1
Jensen's Alpha	3.5	3.6	2.4	2.4	2.2	2.3
Percentile Rank ³	18	11	8	5	4	2

- The Mellon Dynamic US Equity strategy has generated attractive relative and risk-adjusted returns that rank in the first (or second) percentile of the peer group since account inception in December 2012.

¹ Data is net of fees, as of June 30, 2020.

² The strategy was incepted in December 2012.

³ The peer group is the eVestment US Large Cap Core Equity Universe.

⁴ The benchmark is the S&P 500 index.

Merced County Employees' Retirement Association Active Small Cap Managers¹

	Market Value	% of US Equity	YTD (%)	1 Yr. (%)	3 Yrs. (%)	5 Yrs. (%)	SI ² (%)
PanAgora US SC Stock Selector	\$15,174,175	6.0%	-13.3	-7.3	2.3	4.4	6.6
<i>Russell 2000</i>			-13.0	-6.6	2.0	4.3	5.9
Excess Returns			-0.3	-0.7	0.3	0.1	0.6
<i>Percentile Rank¹</i>			46	46	41	48	37

	Market Value	% of US Equity	YTD (%)	1 Yr. (%)	3 Yrs. (%)	5 Yrs. (%)	SI ³ (%)
DFA US Small Cap Core	\$28,787,713	10.3%	-16.9	-11.5	-0.9	2.9	3.6
<i>Russell 2000</i>			-13.0	-6.6	2.0	4.3	4.7
Excess Returns			-3.9	-4.9	-2.9	-1.4	-1.1
<i>Percentile Rank¹</i>			71	72	68	66	68

- PanAgora has achieved approximately 60 basis points (bps) of annualized excess returns, net of fees, versus the Russell 2000 index since account inception in 2013, which ranks near the top third of the peer group.
- DFA has failed to generate excess returns, net of fees, since account inception in 2014. The strategy has trailed the Russell 2000 index by an annualized 108 bps, which ranks in the bottom third of the peer group.

¹ Data as of June 30, 2020. The peer group is the eVestment US Small Cap Core Equity Universe.

² The PanAgora US Small Cap Core Stock Selector account was inceptioned in October 2013.

³ The DFA US Small Cap Core account was inceptioned in July 2014.

Merced County Employees' Retirement Association Active Small Cap Managers¹

	PanAgora US SC Stock Selector					DFA US Small Cap Core				
	YTD (%)	1 Yr. (%)	3 Yrs. (%)	5 Yrs. (%)	SI ² (%)	YTD (%)	1 Yr. (%)	3 Yrs. (%)	5 Yrs. (%)	SI ³ (%)
Tracking Error	2.2	1.9	2.7	2.7	2.7	1.9	2.8	2.4	2.8	2.7
<i>Peer Group Median</i>	7.1	6.0	5.0	4.9	4.8	7.1	6.0	5.0	4.9	4.8
<i>Percentile Rank</i>	98	99	97	99	98	99	94	99	97	99
Information Ratio	-0.2	-0.4	0.1	0.0	0.2	-3.5	-1.8	-1.2	-0.5	-0.4
<i>Peer Group Median</i>	-0.3	-0.3	-0.1	0.0	0.0	-0.3	-0.3	-0.1	0.0	0.0
<i>Percentile Rank</i>	50	52	40	47	21	96	93	89	73	75

- The tracking errors of both small cap strategies are consistently low and rank toward the bottom of the peer group over all trailing periods. A manager with persistently low tracking error generally has less potential to outperform (and underperform) meaningfully relative to the benchmark.
- The information ratio (IR) reflects the strategy's risk-adjusted performance using tracking error as the measure of risk. PanAgora has generated a positive IR since account inception, and ranks near the top quintile of the peer group. DFA has failed to generate a positive IR since account inception, and ranks in bottom quartile of the peer group.

¹ Data is net of fees, as of June 30, 2020. The peer group is the eVestment US Small Cap Core Equity Universe.

² The PanAgora US Small Cap Core Stock Selector account was inceptioned in October 2013.

³ The DFA US Small Cap Core account was inceptioned in July 2014.

Recommendation

- We recommend retaining the Mellon Dynamic US Equity strategy. The investment team has executed well, and the strategy has outperformed the S&P 500 index by 330 bps since account inception in December 2012, which ranks in the top percentile of the large cap core peer group. The strategy's risk-adjusted returns are also attractive.
- We recommend the termination of the DFA US Small Cap Core strategy. DFA has failed to generate excess returns since account inception and ranks in the bottom third of the peer group. The strategy's low exposure to risk, as measured by tracking error, limits upside potential.
- We recommend that the fund reduce the portfolio's exposure to US small cap in order to align with the Russell 3000 index. The fund should reallocate assets from the DFA US Small Cap Core strategy to a combination of large cap (to better align overall program exposure) and either the PanAgora US Small Cap Stock Selector strategy or to a different higher tracking error small cap manager with a potentially higher payoff.
- The US Mid Cap Core space can be an attractive area for active management. In the future, it may be worth considering hiring an active US Mid Cap Core manager, If MCERA was to consider this, we would recommend using proceeds from the passive Mellon Large Cap Core index fund and the remaining funds from the DFA US Small Cap Core strategy. The fund should align the mid cap exposure with that of the Russell 3000 index, which is approximately 18% as of June 30, 2020.

Merced County Employees' Retirement Association US Equity Portfolio

Current US Equity Portfolio		
	Market Value (\$)	% of US Equity
US Equity	251,493,831	100.0
Mellon Dynamic US Equity	113,026,663	44.9
Mellon Large Cap	97,505,279	38.8
DFA Small Cap	25,787,713	10.3
PanAgora US SC Stock Selector	15,174,175	6.0

Alternative Option 1		
	Market Value (\$)	% of US Equity
US Equity	251,493,831	100.0
Mellon Dynamic US Equity	128,839,168	51.2
Mellon Large Cap	97,505,279	38.8
PanAgora US SC Stock Selector	25,149,384	10.0
DFA Small Cap	0	0.0

Alternative Option 2		
	Market Value (\$)	% of US Equity
US Equity	251,493,831	100.0
Mellon Dynamic US Equity	113,026,663	44.9
Mellon Large Cap	68,048,894	27.1
<i>Active Mid Cap Core Strategy</i>	45,268,890	18.0
PanAgora US SC Stock Selector	25,149,384	10.0
DFA Small Cap	0	0.0

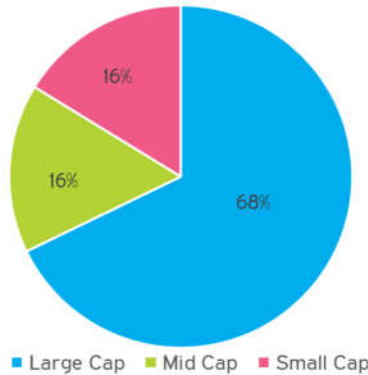
- Alternative Option 1: Allocate DFA funds to PanAgora (up to 10%) and the remainder to Mellon Dynamic.
- Alternative Option 2: Allocate DFA funds to PanAgora (up to 10%). Hire a mid cap core manager at 18% using the remaining funds from DFA and the balance from Mellon Large Cap.

Additional Alternative Options

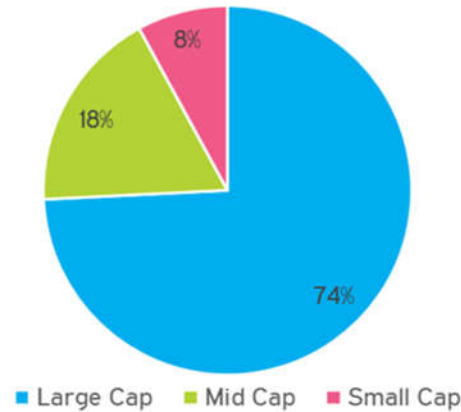
- Allocate DFA funds to a higher tracking error small cap core manager to bring the total active small cap exposure up to 10%. Retain PanAgora at current weight. Allocate the remaining funds to Mellon Dynamic.
- Terminate both DFA and PanAgora, hire a higher small tracking error small cap core manager at 10% of the portfolio, and allocate the remaining funds to Mellon Dynamic.

Merced County Employees' Retirement Association US Equity Portfolio¹

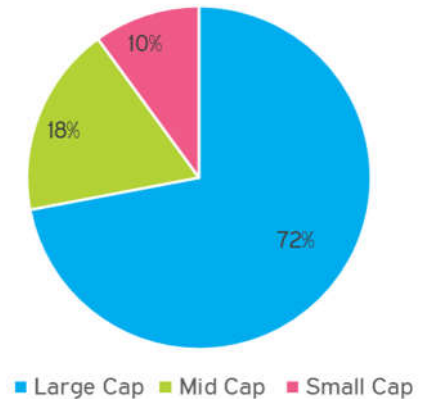
Current Merced County Employees' Retirement Association Portfolio



Russell 3000



Target Merced County Employees' Retirement Association Portfolio



- If the recommended changes to the US equity portfolio are implemented, the portfolio will have exposure to the large, mid, and small cap sectors that is consistent with the Russell 3000 index. These allocations are reflected in the chart on the right above.

¹ The portfolio weights are based on strategy allocation dollar amounts and not on the true underlying holdings. The portfolio exposure is thus an approximation of the actual exposure.