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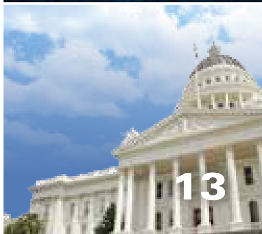

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Ready for Another *Great Year*

“With two top-of-the-line conferences to produce, it takes a lot of people to make our conference days jam-packed with relevant (and often attendee suggested) topics and speakers.”

As a SACRS Administrator, a new year means another opportunity to support the education committee and help to develop some of the best conferences in the industry! With two top-of-the-line conferences to produce, it takes a lot of people to make our conference days jam-packed with relevant (and often attendee suggested) topics and speakers. In fact, our first conference for 2017 is rapidly approaching. Hope you can join us May 16-19 at the Napa Valley Marriott Hotel & Spa in Napa, California. If you need help deciding, just take a look at the preliminary agenda on pages 14 and 15 of this issue. It's going to be another great event that you won't want to miss.

While you are thinking about SACRS' conferences, why not get your calendar out and reserve November 14-17 to join us at the Hyatt Regency San Francisco Airport in Burlingame. Keep an eye out for more details about that event as the planning unfolds, and if you have a great idea for a session or speaker, let me know!

We also welcome your ideas for this magazine. It is meant to not only be for the members, but also *by* the members. If you have ideas for a future article or would like to submit a commentary, you can contact me about that too.

Send me an email, sulema@sacrs.org, with your ideas or better yet, come to Napa in May and tell me all about it!

Sulema H. Peterson

***Sulema H. Peterson**, SACRS Administrator, State Association of County Retirement Systems*

Art Goulet
Secretary SACRS
Board of Directors

NOTIFICATION:

Retirement Board Voting Change

CRCEA was successful in gaining an amendment to the 1937 Act, which will give the Alternate Retired Member of a Retirement Board additional opportunities to vote. Under current law, the Alternate Retired Member may only vote when the Retiree Member (8th member) of the Board is absent. AB 2376, which was signed by the Governor in August, added the following new section to the 1937 Act:

31520.6.

Notwithstanding any provision to the contrary in Section 31520.3 or 31520.5, in any county in which there is an alternate retired member, if the eighth member is present, the alternate retired member may also vote as a member of the board in the event both the second and third, or both the second and seventh, or both the third and seventh members are absent for any cause.

Translated, this means that the Alternate Retired Member may vote, even when the Retired Member is present, if the Safety Member and one General Member, or both General Members are absent.

CRCEA has been interested for many years in expanding voting opportunities for the Alternate Retired Member, but previous efforts have been blocked by the Professional Firefighters Union, and SEIU apparently didn't think it was worth expending political capital on the issue. This year there was no opposition, and CRCEA achieved its goal.

***Art Goulet** has been the Retiree Member Trustee of the Ventura County Employees' Retirement Association since 2005. He is also the Immediate Past President of the Retired Employees Association of Ventura County (REAVC), after serving in that position for more than 10 years. He also serves as the Legislative Chair for the California Retired County Employees Association (CRCEA) and is SACRS Secretary, as well as a member of the SACRS Legislative and Audit Committees.*

Words *of* Wisdom

From Nationally Renowned Personalities Opens Fall Conference

I hope you had a very prosperous 2016! Before we move much deeper into the New Year, we thought it might be useful to review what happened at SACRS this past year.

The Fall SACRS Conference proved once again how valuable it is when we gather with other pension professionals and learn from each other. The credibility and quality of speakers was excellent, and many attendees urged the SACRS board to continue to grow this resource that has become vital to our members.

"The morning after" the presidential election was a real treat for conference attendees. More than 600 people were captivated by the quick, thoughtful analysis offered by the conference kick-off panel that was comprised of nationally renowned news reporter Forrest Sawyer, former *NBC Nightly News* producer Alex Wallace, and noteworthy investment advisor Gabriel Wisdom.

Voices from throughout the country gathered in Indian Wells to weigh in on what the future holds for pension systems. The majority of pension articles throughout the U.S. (including a recent series by the *Los Angeles Times*) have cast public retirement plans in a negative light. The scrutinizing press coverage underscores why events like SACRS' conferences are more important than ever in bringing stakeholders into one room to foster new ideas and approaches.

Indeed, we're entering a time where financial prudence and patience are needed. During the first panel, Gabriel Wisdom, co-founder and managing director of American Money Management, warned that every time a U.S. president has completed eight years in office, his term was followed by a recession (light or heavy). Wisdom told attendees to expect some sort of market correction with President Barack Obama's exit.

From start to finish, the panel speakers over the course of Wednesday, Thursday, and Friday impressed attendees with thought-provoking insights and ideas.

Hottest Show in Town Coming to a Napa Near You: Register Now!

Building on the success of the fall conference, the program committee, under the capable direction of SACRS Vice-President Gabe Rodrigues, has shifted into high gear and promises to deliver an even greater conference this spring. The conference in Napa promises not to be a "sleepa," so make sure you register early.

Save the dates: The 2017 SACRS Spring Conference is May 16-19. Don't miss it. Book by April 1 and save $260.

While we can work extremely hard to get the best speakers for our conferences, we want to encourage our members – especially our trustees – to attend. The combined number of trustees in all '37 Act counties is about 220. Because state law now requires trustees to fulfill 24 credit hours of continuing education every two years, why not attend SACRS conferences to fulfill this requirement?

With participation in mind, we want to send a "shout out" to all trustees to send in their ideas and let us know of great speakers or value-added programming that we could bring to future SACRS conferences.

SACRS/UC Berkeley Team Up Again in 2017 for Trustee Education

In keeping with the primary SACRS goal of education, SACRS, in concert with UC Berkeley's Center for Executive Education, has developed a wonderful and valued program for educating public pension trustees throughout California. The SACRS Public Pension Investment Management Program offers up practical and detailed education for trustees.

This year, this **certificate** program is scheduled to be held on the UC Berkeley campus from July 24 to 26. It is designed to teach trustees about modern investment theory and practice for their respective retirement systems. The program offers participants a chance to exchange thoughts with the excellent faculty at UC Berkeley and with other California public pension trustees.

SACRS Rebranding and Website Update Are Afoot

The SACRS board has made tremendous progress in its efforts to rebrand SACRS and redesign its logo, website, and materials to provide members with quicker access and better resources. The board hopes to unveil the products of these efforts this year. Look for announcements on our upcoming webinars to gain insight on pension management from your work computer.

Very best wishes for a wonderful and prosperous 2017, and on behalf of the SACRS board, thank you for supporting SACRS and its diverse program opportunities.

Dan McAllister*, President of SACRS & SDCERA Trustee*

CONTRIBUTORS

ART GOULET

Secretary SACRS Board of Directors

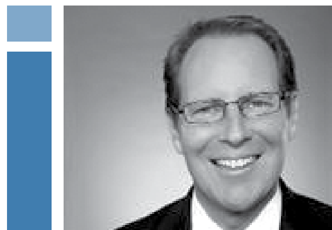
Art Goulet has been the Retiree Member Trustee of the Ventura County Employees' Retirement Association since 2005. He is also the Immediate Past President of the Retired Employees Association of Ventura County (REAVC), after serving as President for more than 10 years. He also serves as the Legislative Chair for the California Retired County Employees Association (CRCEA) and is SACRS Secretary, as well as a member of the SACRS Legislative and Audit Committees.

He has Bachelor of Civil Engineering and Master of Public Administration Degrees, and lengthy public service at the state, city, and county levels. He retired from the position of Director of the Public Works Agency of Ventura County in 2000, after 22 ½ years in that position.

EDWARD HOFFMAN, CFA, FRM

Managing Director & Senior Consultant, Verus

Edward Hoffman brings over 20 years of experience to his clients, providing strategic investment advice to ensure that clients meet their long-term investment objectives. He serves as lead consultant to both public and Taft-Hartley benefits plans. Before joining Verus in 2011, Mr. Hoffman served institutional clients at Legg Mason and Prudential. In addition to his client service responsibilities at Legg Mason, he served on the asset management division operating committee and Legg Mason Funds valuation committee, led corporate development initiatives including several related to the 2005 acquisition of Citigroup's asset management division, and managed a variety of product development initiatives. Today, his work in risk-based advisory services provides an additional and valuable perspective to his non-discretionary clients.



CHRISTOPHER MACKE

Managing Director, Research and Strategy, American Realty Advisors

Christopher Macke is American Realty Advisors' Managing Director, Research and Strategy, responsible for leading the firm's research efforts and working closely with the firm's Investment and Portfolio Management Teams in developing investment analysis to support acquisitions and strategy implementation for its commingled funds. Mr. Macke also serves as a member of the firm's Investment Committee. Prior to joining ARA, Mr. Macke was a Senior Research Strategist with CB Richard Ellis Global Research & Consulting as part of the firm's macroeconomic, property market, and capital market outlook and strategy effort. Mr. Macke's previous real estate experience includes working for large institutional investors such as G.E. Real Estate, providing investment strategy consulting services to large institutional investors such as CalPERS, and advising regulatory agencies, including the U.S. Federal Reserve and the U.S. Treasury Department. He is currently a contributor to the Federal Reserve's Beige Book and a member of the PREA Research Advisory Council.

DAN MCALLISTER

SACRS President and San Diego County Treasurer-Tax Collector

Dan McAllister was elected San Diego County's Treasurer- Tax Collector in November 2002 and re-elected to his fourth term in June 2014 by an overwhelming 99% majority of the vote. Not only is he responsible for the collection of more than $5.5 billion in property taxes each year, but his office also manages the Investment Pool, which reached an all- time high of $10.1 billion in April of 2016, ensuring that these funds are wisely invested and safeguarded for entities such as the school districts and cities in the County.

Mr. McAllister also serves as a member of the San Diego County Employees Retirement Association, which manages more than $10 billion of investments. Additionally, he is a former chairman of the Board of Directors of the internationally recognized San Diego Convention Center Corporation. Prior to his election as San Diego County Treasurer-Tax Collector, Mr. McAllister was a successful financial consultant and investment broker.

JEFFREY R. RIEGER

Counsel, Reed Smith, LLP

Jeffrey R. Rieger graduated from U.C. Berkeley School of Law in 2001 and has been practicing law continuously in the San Francisco Bay Area ever since. Mr. Rieger began his career as a general litigator and has handled employment claims, trust and estate claims, securities arbitrations and complex contract disputes. In 2003, he began working in the representation of California public retirement systems. Since then, Mr. Rieger has represented CalPERS, CalSTRS and over a dozen City and County retirement systems throughout California.

MICHAEL ROBSON

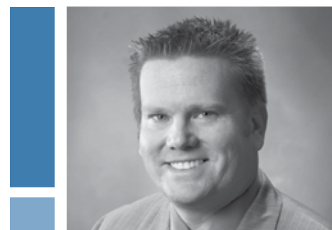
Edelstein, Gilbert, Robson & Smith llc

Michael R. Robson has worked since 1990 in California politics and has been lobbying since 2001 when he joined the firm. Prior to joining the firm, he began a successful career with Senator Dede Alpert as a legislative aide soon after she was elected to the Assembly in 1990. He became staff director/chief of staff in 1998, while the Senator served in the position of Chair of the Senate Appropriations Committee. He is experienced in all public policy areas with particular expertise in environmental safety, utilities, revenue and taxation, local government finance, education, and the budget.

GABRIEL RODRIGUES

SACRS Vice President and Program Committee Chairperson and a Deputy Sheriff with the Contra Costa County Office of the Sheriff

Gabriel Rodrigues is a Deputy Sheriff with the Contra Costa County Office of the Sheriff. Mr.Rodrigues spent over two decades in the Food and Drug Industry prior to entering Law Enforcement. His titles included Financial Analyst, Database Analyst, Marketing Manager, and Account Executive. At the age of 48, Mr.Rodrigues followed his lifelong dream of becoming a Peace Officer. His work in Law Enforcement provides him with the satisfaction of helping the community that he is sworn to protect. Mr.Rodrigues earned his BA in Management from Saint Mary's College at Moraga, California and his MBA in Marketing Management from California State University, Hayward.



TRENT E. SMITH

Edelstein, Gilbert, Robson & Smith llc

Trent E. Smith worked for over 12 years in the State Capitol prior to joining the firm. He started his career in 1990 working for the well-respected late Senate Republican Leader Ken Maddy. He was later awarded one of 16 positions in the prestigious Senate Fellowship Program. Upon completion, he started working in various positions in the State Assembly. He worked as a Chief of Staff to Assembly Member Tom Woods of Redding and later to Orange County Assembly Member, Patricia Bates, who served as Vice Chair of the Assembly Appropriations Committee. In this position, he gained a unique and valuable knowledge of the State budget and related fiscal policy matters. In addition, he has extensive experience in numerous policy areas.

Adding Value to MEMBERSHIP

How can we improve our communication with SACRS members and better serve you?

I hope that 2017 is turning out to be a healthy and enjoyable year for you and your loved ones. For those of you that have read SACRS President's message, Dan McAllister did a great job of summing up what a good year 2016 was for our SACRS organization and what our goals are for 2017.

The SACRS Board of Directors met in December for our annual mid-year review of the priorities and action items we are currently working on. The meeting was positive and productive, and the Board has much to be proud of, as we have made great progress on accomplishing many of our goals set in 2016.

Our Communication and Outreach effort is under way. We will be reaching out to all Trustees and retirement staff members in an effort to glean more insight on how SACRS can better serve you. In the coming months, your SACRS Board of Directors and SACRS staff will be contacting you by either attending your Board of Trustees' meetings or asking you to participate in a survey. Again, our goal is to learn how we can improve our communication with SACRS members and add value to your membership.

SACRS Board would like to encourage all Trustees and Staff to get involved in joining committees and taking on various roles at our conferences. This could include being a speaker or a moderator at one of the many conference breakout sessions.

If you would like to inquire about volunteering to serve on a committee or participate at a conference as a speaker or moderator, please contact one of the following SACRS' volunteers:

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- **Michael Keough** – michael.keough@db.com

AUDIT COMMITTEE:
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PROGRAM COMMITTEE:
- **Gabe Rodrigues** – gabrielrodrigues777@gmail.com

CONFERENCE SPEAKER OR MODERATOR:
- **Sulema Peterson** – sulema@sacrs.org

Thank you for your continuing support and ongoing commitment to SACRS!

Gabriel Rodrigues, *is a Deputy Sheriff with the Contra Costa County Office of the Sheriff and SACRS Vice President and Program Committee Chairperson. Gabe chose to become a Retirement Board Trustee, allowing him the opportunity to use his business experience to protect and grow the assets of the pension plan that his fellow Contra Costa County employees depend on for their retirement.*

The Cost of Not Hedging Foreign Currency Exposure

The recent broad strength of the U.S. dollar has hurt unhedged international equity investors. Currency losses can erode and negate positive returns found overseas. In 2016, for example, the MSCI EAFE index returned 6.2% on a hedged basis, but only 1.0% on an unhedged basis. Does this mean you should reconsider your international equity exposure?

This article examines the currency risks potentially involved in investing in international equities and the historical experiences of unhedged versus hedged exposure. It also looks at what hedging means for the total portfolio and how investors can take advantage of factors in the currency market. We believe that currency management programs are important to the overall portfolio construction process and can be beneficial to institutional investors, if implemented smartly.

FRAMING THE CURRENCY PROBLEM

There are two major types of currency risk when investing in international equities: internal corporate currency risk and denomination currency risk. Internal corporate currency risk occurs because many corporations, especially larger ones, have operations in multiple foreign countries and exposure to a wide range of currencies. The company itself is responsible for managing this currency risk and an equity investor should assess the competency of the firm's ability to do so.

As institutional investors and allocators of capital, our focus is on the second flavor: denomination risk. Denomination risk captures the exchange rate impact between an investor's domestic currency and the currency in which a foreign asset is denominated during the time of the investment. This type of risk is the focus of extensive investment literature regarding hedging and what is normally meant by currency risk.

Unhedged international equity investments can be disaggregated into two distinct components: ownership of the foreign security in local currency combined with a long position in the foreign currency. Both components drive an investor's realized risk and return. For example, U.S. investors in Nestlé, a stock traded in Swiss francs, need to buy Swiss francs with U.S. dollars and then buy shares of Nestlé with the Swiss francs. To exit this investment, U.S. investors need to unwind both trades by selling the Nestlé shares for Swiss francs and then exchanging the francs for dollars. A key point here is that the size of the resulting exposure to currency risk is the same as the exposure to equity risk— a 1% move in the exchange rate will have the same impact on the portfolio as a 1% move in the underlying asset.

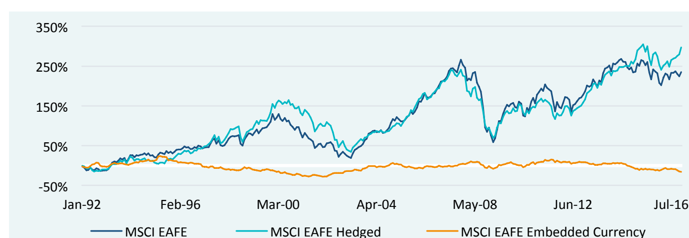
HISTORICAL IMPLICATIONS OF THE CURRENCY HEDGING DECISION

To help us determine the impact of currency hedging, we can easily analyze the realized experience of hedged versus unhedged international equity benchmarks in terms of return, volatility, and correlations. The difference between the hedged and unhedged benchmarks is attributed to the embedded foreign currency portfolio. We will use the MSCI EAFE index partly because it is a widely-used benchmark for international developed equity exposure and partly because hedging programs typically encompass only developed currencies.

1. RETURNS

The long-term returns of hedged and unhedged international equity investors based in the U.S. have been rather similar. From 1992 through the end of 2016, the MSCI EAFE index had an annualized return of 5.7% on a hedged basis and 5.0% on an unhedged basis. Over this period, the embedded foreign currency portfolio lowered a U.S. investor's return by 0.7% per year. The embedded currency exposure can be thought of as an unmanaged active portfolio in which a naïve basket of currencies is completely funded by a short position in only the investor's domestic currency. There has been no prior economic or academic evidence that suggests such a portfolio of currencies should receive consistent positive returns over long time horizons. While there is support that, much like the equity market, the currency market has a risk premium to compensate investors, the embedded currency exposure is not representative of the overall market. Therefore, while it is impossible to forecast, it is reasonable to expect the embedded currency portfolio should deliver a return of zero over the long term.

Cumulative Equity Returns of International Developed Markets and Currency



Sources: Morningstar, Verus, as of December 31, 2016

2. VOLATILITY

Unlike returns, volatility has been significant and remarkably stable. Over the long-term, the embedded foreign currency portfolio included in an unhedged EAFE exposure has experienced an annualized standard deviation of 7.6% and, other than during the 2008 financial crisis, volatility has been within a relatively stable range between 6 and 8%. Currency has caused the unhedged exposure to have a higher overall volatility than its hedged counterpart. This relative difference was exacerbated during the financial crisis when currency volatility rose above historical norms.

In addition to increasing overall volatility, exposure to the unmanaged embedded currency portfolio has resulted in

greater downside risk for unhedged investors. Over the period examined, the maximum drawdown from peak for both hedged and unhedged international equities occurred from November 2007 to February 2009. Currency exposure for unhedged investors led to a drawdown of 56.7%, whereas hedged investors lost 50.4%. The table below summarizes important statistics of the MSCI EAFE index on a hedged and unhedged basis.

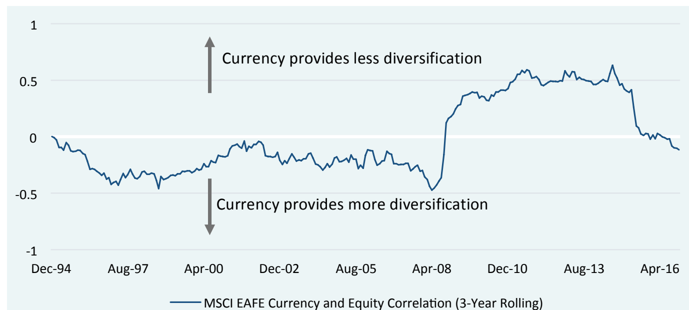
	Annualized		Sharpe	Max Drawdown	
	Return	Stnd. Dev.	Ratio	1-Year	From Peak
Fully Hedged	5.7%	14.4%	0.3	-41.3%	-50.4%
Unhedged	5.0%	16.3%	0.2	-50.2%	-56.7%

Sources: MPI, Verus, as of December 31, 2016

3. CORRELATIONS

Correlations are the third dynamic worth examining for portfolio construction. While low and even negative correlations between foreign currencies and international equities in local currency has certainly provided some diversification benefits, they have rarely been low enough to reduce volatility to that of a hedged portfolio. The 3-year rolling correlation between the MSCI EAFE currency exposure and the MSCI EAFE index in terms of local currency shown below demonstrates this. The correlation between foreign currency and equities has also increased dramatically during times of financial stress – the diversification benefit, therefore, is weakened when it is likely needed the most.

3-Year Rolling Correlations Between MSCI EAFE Currency and the MSCI EAFE Index

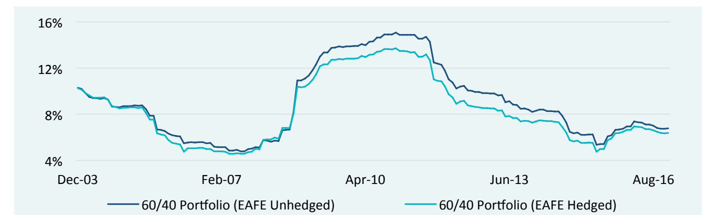


Sources: Morningstar, MPI, as of December 31, 2016

CURRENCY HEDGING AND THE TOTAL PORTFOLIO

Now that we have examined the impact of currency hedging on an international equity portfolio, it is helpful to look at it from the standpoint of a total portfolio. We use a simple hypothetical balanced portfolio using a passive approach that contains 60% global equity and 40% domestic fixed income. We then compare two identical portfolios, with the only difference being that one includes the MSCI EAFE unhedged index and the other includes the MSCI EAFE hedged index. The results are comparable to that of a standalone international equity portfolio: the long-term returns are similar, but the volatility of the portfolio that includes the unhedged international equity exposure is higher. Even in a balanced portfolio, the diversification benefit the foreign currency exposure provides is not enough to offset the additional volatility it contributes. The following chart shows the rolling 3-year volatility of these two portfolios since 2001.

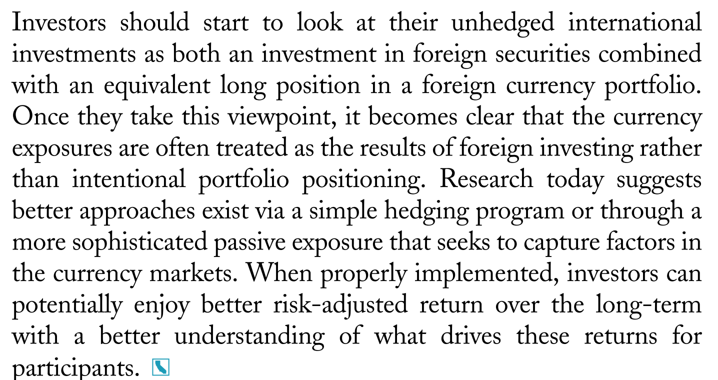
Rolling 3-Year Standard Deviations of Hedge and Unhedged 60/40 Portfolios



Sources: MPI, Verus as of December 31, 2016

CURRENCY BETA REPLACEMENT

While a basket of foreign currencies, like that embedded in the MSCI EAFE index, has an expected long-term return of zero, not all currency exposure is a zero-sum game. There has been strong academic support that suggests certain factors exist in the currency market, which can be taken advantage of using a passive rules-based approach. When used together, three factors: carry, value, and trend have been shown to have positive, uncorrelated returns with moderate volatility. The carry factor invests in higher yielding currencies and sells lower yielding currency, the value factor invests in lower valued currencies and sells higher valued currencies as determined by purchasing power parity, and the trend factor invests in currencies with an upward trend and sells currencies with a downward trend. Products have been created, such as the Russell Conscious Currency Index (RCCI), that can give investors exposure to these currency factors at a relatively low cost. Hedging currency exposure embedded in international equity investments, and overlaying a passive currency factor approach can provide diversification to a balanced portfolio without creating additional volatility. The table below shows important performance and risk statistics for the two hedged and unhedged portfolios mentioned in the previous section, in addition to a hedged portfolio that includes an unfunded position in the RCCI.



	Annualized		Sharpe	Max Drawdown	
	Return	Stnd. Dev.	Ratio	1-Year	From Peak
Fully Hedged	5.1%	8.8%	0.41	-28.1%	-33.3%
Fully Hedged w/ RCCI	5.9%	9.1%	0.48	-28.0%	-33.4%
Unhedged	5.3%	9.4%	0.39	-30.5%	-35.0%

Sources: MPI, Verus, January 1, 2001 – December 31, 2016

CONCLUSION

Investors should start to look at their unhedged international investments as both an investment in foreign securities combined with an equivalent long position in a foreign currency portfolio. Once they take this viewpoint, it becomes clear that the currency exposures are often treated as the results of foreign investing rather than intentional portfolio positioning. Research today suggests better approaches exist via a simple hedging program or through a more sophisticated passive exposure that seeks to capture factors in the currency markets. When properly implemented, investors can potentially enjoy better risk-adjusted return over the long-term with a better understanding of what drives these returns for participants.

Edward Hoffman, CFA, FRM, *is Managing Director and Senior Consultant at Verus. For additional information on this and other research, please visit www.verusinvestments.com/insights*

Rising Rates & Commercial Real Estate: A Glass Half Full or Half Empty?

The brief period following the Presidential election has been the best of times for equities and the worst of times for fixed income. The Dow Jones Industrial Average has risen more than 12% above its pre-election level, at one point increasing from 18,260 the day before the election to more than 20,620 as of mid-February.

Conversely, yields on 10-year U.S. Treasury rate increased more than 40%, at one point moving from 1.83% the day before the Presidential election to a high of 2.60% afterward.

	DAY BEFORE ELECTION	POST ELECTION HIGH	2/16/17
DJIA	18,260	20,101	20,620
10-Year Treasuries	1.83%	2.60%	2.44%

Source: Federal Reserve Bank of St. Louis, Yahoo Finance

While these two benchmarks went in different directions subsequent to the election, both are being driven by market expectations of significantly rising rates and expectations of expansionary fiscal, regulatory, and trade policies. But is this scenario a certainty, and, if so, how should commercial real estate investors react?

Great Expectations, Great Uncertainty

As we wrote in our research piece, "Will 1600 Pennsylvania Avenue Return to Economic Relevance, or Is It Merely Rhetoric?", a robust economic expansion is not a current certainty. There are many steps between here and the booming economy necessary to generate the earnings growth and rapidly rising rates that seem to be baked into current market pricing. First, we have little but speculation regarding the new administration's proposed fiscal initiatives. Second, while the President does have a majority in both chambers of Congress, he may not have many powerful allies within his own party – he will have to contend with a staunch group of deficit hawks that are unnerved by the prospects of yawning deficits over the next ten years. It remains to be seen whether Congressional Republicans will wholeheartedly sign off on both a substantial increase in government spending and a reduction in taxes.

While fiscal policy remains an uncertainty, what is becoming increasingly certain is the President's willingness to aggressively engage the world, especially Mexico and China, in trade policy disputes. The potential impact of this stance should not be taken lightly, as it can have material implications for economic growth, trade, and inflation. Net exports reduced 4Q16 GDP by 170 basis points.

Absent this headwind, GDP would have grown 3.6% instead of the less than robust 1.9%. Given the Administration's desire for more restrictive policies the potential magnitude of trade's near-term negative impact on GDP should give equity markets pause. Reduced trade and falling imports would place upward pressure on inflation, and the economic implications of this are very different from inflation resulting from robust economic activity, employment, and wage growth. Rising costs of goods without commensurate increases in wages and employment impairs consumer purchasing power and places downward pressure on personal consumption, the largest component of GDP. Thus, even if the President proposes and Congress approves an increase in federal spending and tax cuts, economic growth could be somewhat offset by a combination of reduced export activity and rising costs.

Fed Governors Face Interest Rate Governors

Even if the market's belief that the President will implement a expansionary fiscal policy while not following through on his aggressive trade rhetoric becomes reality, there are factors limiting future movements in interest rates.

First, the dollar is already ascending on the mere prospects of an expanding economy, so much so that the President attempted to "tweet" it down while the Treasury Secretary nominee voiced concern that an excessively strong dollar could hurt economic growth. A rising dollar could lead to the Federal Reserve being more sensitive to the impact its interest rate policies may have on the dollar and exports.

Second, global growth trends in Europe, Japan, and China are very different than in the U.S., resulting in different monetary policy outlooks. With one-third of the world's GDP already operating under negative rates, aggressive monetary policy by foreign central banks would only further strengthen the dollar.

Third, U.S. government and corporate debt levels are high and rapidly rising rates would compound the economic drag of U.S. debt levels, while corporate profits would come under pressure from increased financing costs. Additionally, rapidly rising rates could create refinancing issues for corporations.

Fourth, rapidly rising rates could create financial instability in emerging markets through negative impacts on capital flows.

Fifth, the already depreciating Chinese yuan would face additional downward pressure, forcing it to liquidate more Treasuries, and in turn, reducing demand for Treasuries and placing upward pressure on rates.

Last, if protectionist trade policies are implemented, it would exacerbate the negative effects of a rising dollar on exports limiting Fed action further.

Absent a spike in inflation, these factors collectively will likely result in a manageable increase in rates. This contrasts with the exponential rise in rates that some feared based on the initial increase in rates after the Presidential election. This is not to say that Treasury rates couldn't increase in the event of passage of a highly expansionary fiscal policy, but there will be limits to the subsequent path of rates. This conclusion is based on the assumption that inflation will continue to increase at a manageable pace. If inflation spikes in response to highly expansionary fiscal policy, the Fed would be compelled to react quickly, at which point the major macroeconomic concern wouldn't be rising rates, but rather the possibility of a Fed induced recession. In that scenario, equities would go from today's darlings to tomorrow's discarded.

Commercial Real Estate: Fish or Foul?

So how should investors view the prospects for commercial real estate in the current environment? While retail investors are borderline giddy regarding the prospects for equities and downright dour regarding the prospects for fixed income, opinions on commercial real estate are only cautiously optimistic and mixed, with some fearing a bond-like reaction to changes in short-term rates. We think it is a mistake to lump commercial real estate into the same bucket as fixed income.

> *"An expanding economy results in increased demand for office space, warehouses, shopping center locations, and housing."*

Commercial real estate is a hybrid offering characteristics found in both equities and fixed income. Like fixed income, it provides a higher current income than equities. However, commercial real estate income is dynamic and generally grows over time. This is an important distinction that alone should separate the outlook for real estate from the market's dour prospects for fixed income. How significant is the difference? In periods of rising interest rates from 2002 through 2016, while fixed income levels were just that, fixed, real estate income grew 3.9% annually on average, providing a »

significant tailwind to both income returns and valuations. Why is this? An expanding economy results in increased demand for office space, warehouses, shopping center locations, and housing. In the property sectors and markets where manageable construction activity is occurring, landlords have the ability to adjust rents upward, having a positive effect on income.

Real estate values can also benefit from an expanding economy. As real estate income levels increase, this exerts upward pressure on real estate values, reflecting real estate's equity-like component, where valuations benefit from expanding economic growth similar to stocks reacting to expanding earnings.

Commercial Real Estate Performance During Periods of Rising Rates

What does history tell us? Employment growth during periods of rising rates on average was nearly triple the rate seen during periods when rates were not rising. Growth in GDP, especially its business investment component, was significantly greater during periods of rising rates. Growth in business investment during periods of rising rates was nearly twice that of growth during periods when rates were stable or falling. As the economy grows, higher employment requires additional workspace, provided by office buildings, higher consumption drives demand for retail, and higher levels of business investment result in an increasing need for warehouse space to store the goods being produced and consumed.

Q3 1993 - Q3 2016	RISING	NON-RISING	RISING VS. NON
Average Quarterly Job Growth (ths.)	720	270	2.6
Quarterly GPD Growth (%)	3.0	2.4	1.3
Quarterly Consumption Growth (%)	3.4	2.7	1.3
Quarterly Business Investment Growth (%)	6.8	3.3	2.1

Source: NCREIF

> “Investors seem to be underestimating the positive effects an expanding economy has on demand for real estate space and the resulting real estate income growth.”

Not surprisingly, robust employment growth and business investment during periods of rising rates results in greater real estate income growth during periods of rising rates than periods of non-increasing rates. As shown in the following table, net operating income growth during periods of rising rates was more than three-and-a-half times greater than during periods when rates were not increasing. Investors seem to be underestimating the positive effects an expanding economy has on demand for real estate space and the resulting real estate income growth.

Q2 2002 - Q3 2016	RISING RATES	NON-INCREASING RATES
ODCE, YOY, NOI Growth	3.7%	1.1%

Source: NCREIF

That's the income side of the return equation. Regarding the appreciation component of real estate return, data related to average quarterly appreciation during different interest rate regimes in the table below show that appreciation rates during periods of increasing interest rates outpaced value increases during periods of non-rising rates.

Q2 2002 - Q3 2016	RISING RATES	NON-INCREASING RATES
Average Quarterly Appreciation Returns	2.1%	0.4%

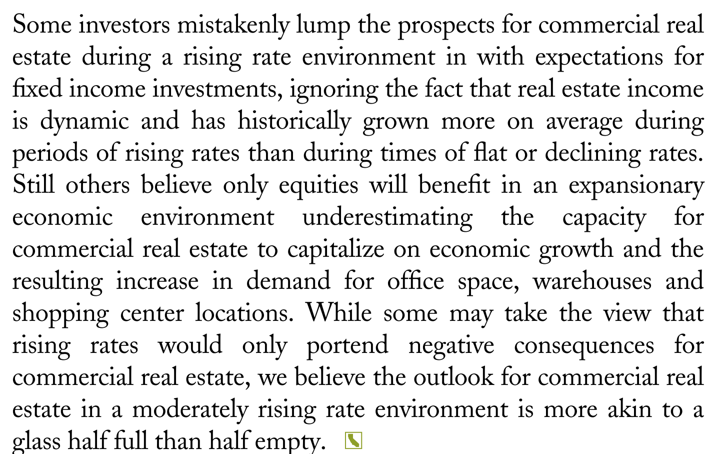
Source: NCREIF

This may appear counterintuitive, but considering the significantly higher NOI growth during periods of rising rates, higher appreciation during periods of rising rates becomes reasonable.

Where does this leave total returns during periods of rising rates versus periods of non-rising rates? Given superior NOI growth and appreciation returns, it should not be surprising that average returns during periods of rising rates were greater than returns during periods of non-rising rates.

Q2 2002 - Q3 2016	RISING RATES	NON-INCREASING RATES
Average Quarterly Appreciation Returns	3.4%	1.8%

Source: NCREIF



Glass Half Full or Half Empty?

Some investors mistakenly lump the prospects for commercial real estate during a rising rate environment in with expectations for fixed income investments, ignoring the fact that real estate income is dynamic and has historically grown more on average during periods of rising rates than during times of flat or declining rates. Still others believe only equities will benefit in an expansionary economic environment underestimating the capacity for commercial real estate to capitalize on economic growth and the resulting increase in demand for office space, warehouses and shopping center locations. While some may take the view that rising rates would only portend negative consequences for commercial real estate, we believe the outlook for commercial real estate in a moderately rising rate environment is more akin to a glass half full than half empty.

Christopher Macke, *is American Realty Advisors' Managing Director, Research and Strategy, responsible for leading the firm's research efforts and working closely with the firm's Investment and Portfolio Management Teams.*

State Association of County Retirement Systems

★ ★ ★ LEGISLATIVE REPORT ★ ★ ★

The 2017-2018 Legislature was sworn into office on December 5 with seven new Senators and 22 new Assembly Members. Upon being sworn in, the Legislature immediately began introducing legislation for the 2017 Legislative Session and then left town for the holidays. The Legislature returned on January 4, bills resumed being introduced until February 17 and committee hearings will commence around March. Most importantly, the Governor released his proposed State Budget on January 10, which outlines his spending and policy priorities for the coming year.

Outlook on Public Employee Retirement in the Legislature

We expect the 2017 Legislative Session to be a busy one as it pertains to Public Employee Retirement. There are several reasons for this speculation:

1. The media is acutely focused on the story of long-term unfunded public employee retirement obligations, especially as it relates to municipalities that contract with the California Public Employee Retirement System (CalPERS).
2. Before the year ended, CalPERS reduced its expected rate of return from 7.5 percent to 7 percent to be phased in by 2019. The lower rate of return will require the state and municipalities to contribute more general fund money to make up for the lower returns. However, contracting agencies increased contributions will be phased in over a longer period of time (2024) in order to shield those agencies from larger contributions right away.
3. Pension reform advocates, including former San Jose Mayor Chuck Reed and Carl DeMaio, shelved their ballot measure in 2016 and we expect their efforts to ramp up again in 2017.
4. There has been early legislation introduced in the 2017 Legislative Session.

Early Bill Introductions

At the time of this writing, Republican Senator John Moorlach of Orange County has introduced SB 32, which states intent to build upon the Governor's Public Employee Pension Reform Act of 2013.

An additional bill, AB 20, by Democrat Assemblyman Ash Kalra of San Jose continues a trend of legislators attempting to use the state retirement systems to achieve unrelated public policy goals. This bill would prohibit PERS and STRS from investing in the Dakota Access Pipeline. As noted earlier, the Legislature can introduce bills up until February 17.

New Committee Chairs and Changes

With the new session comes new committee Chairs. Assemblyman Freddie Rodriguez from San Bernardino County will chair the Assembly PERSS Committee and Senator Richard Pan from Sacramento will once again chair the Senate PERSS Committee.

While there is no SACRS sponsored legislation being introduced in 2017, we nevertheless still expect to find a full and busy year for SACRS in the Legislature.

Michael Robson and Trent Smith *of Edelstein, Gilbert, Robson & Smith LLC*

May 16-19, 2017

2017 SACRS SPRING CONFERENCE

NAPA VALLEY MARRIOTT HOTEL & SPA • NAPA, CA

Tuesday, May 16, 2017

Time	Event
10:00AM - 6:30PM	SACRS Registration
11:00AM - 1:00PM	Lobbyist' Ethics Orientation Course

For more information and to register, please visit the SACRS website.

Deadline to register for the Lobbyist' Ethics course is May 9th at noon with the Secretary of State Office.

Speaker: Secretary of State Office and FPPC representative

Time	Event
3:00PM - 5:00PM	Disability Investigations **Speakers:** Tamara Caldwell and Hernan Barrientos, Los Angeles CERA; Suzanne Jenike, Orange CERS and Jackie Purter, Sonoma CERA
3:00PM - 5:00PM	AB 1234 Ethics Certification for Trustees and Staff **Speaker:** Ashley Dunning, Nossaman
5:30PM – 6:30PM	SACRS Reception

Wednesday, May 17, 2017

Time	Event
6:45AM - 7:45AM	SACRS Yoga
7:30AM - 8:30AM	SACRS Breakfast
7:30AM - 5:00PM	SACRS Registration
8:30AM - 9:00AM	General Session **Welcome Remarks** **Speaker:** Dan McAllister, SACRS President

Wednesday, May 17, 2017 *continued*

Time	Event
9:00AM - 10:00AM	General Session **First 100 Days – Panel Discussion** **Speakers:** Christopher Probyn, State Street Global Advisors; Maria Contreras and Matt Miller, Front Right and Center
10:00AM - 10:30AM	Networking Break
10:30AM - 11:30AM	General Session **Global / Macro** **Speaker:** Kevin Klowden, Milken Institute
11:40AM - 12:40PM	General Session **Economic Overview / Impact New Administration**
12:40PM - 1:50PM	SACRS Lunch
2:00PM - 5:30PM	Breakout Sessions

- Ops/Benefits Breakout AND Disability Breakout (Consolidated Session)
- Affiliate Breakout
- Attorney Breakout
  Speaker: Steven Glass, Zenocg
- Internal Auditors Breakout
- Administrators Breakout
- Investment Breakout
- Trustee Breakout
- Safety Breakout

Time	Event
6:30PM – 10:30PM	Wednesday Night Event Castello di Amorosa

FEATURED SPEAKERS

Frank Mottek
Broadcast journalist,
CBS stations KNX 1070 Newsradio and KCAL-TV Channel 9

Kevin Klowden
Executive Director, California Center and Managing Economist
California, Entertainment & Sports, Global Economy, Regional Economics, Technology

Mark R. Wood
Vice President and U.S. Equity Investment Consultant,
Callan's Global Manager Research Group

Anne Sheehan
Director Corporate Governance,
California State Teachers' Retirement System

Christopher J. Ailman, FSA
Chief Investment Officer,
California State Teachers' Retirement System

Veronica Gray
Attorney,
Nossaman, LLP

PRELIMINARY AGENDA

Thursday, May 18, 2017

6:45AM - 7:45AM	SACRS 5K Fun Run/Walk
7:30AM - 8:30AM	SACRS Breakfast
7:30AM - 5:00PM	SACRS Registration
8:30AM - 9:00AM	General Session **Welcome & Awards** **Speaker:** Dan McAllister, SACRS President
9:00AM - 10:00AM	General Session **Motivational** **Speaker:** Jon Fussell, Wellington Management
10:00AM - 10:30AM	Networking Break
10:30AM - 11:30AM	General Session **Future of California; A Local and State Perspective** **Speaker:** TBD
11:40AM - 12:40PM	General Session **Geopolitical; New President – New Policy** **Speaker:** Dave Bridges, Fidelity
12:40PM - 1:50PM	SACRS Lunch
2:00PM - 3:00PM	Concurrent Sessions

- Concurrent Session A
  Investment Committee Best Practices
  Speakers: Mark Higgins, RVK; Edward Hoffman, Verus and Allan Martin, NEPC
- Concurrent Session B
  It's App-tastic: 60 Apps in 60 Minutes
  Speaker: James Spellos, Meeting U
- Concurrent Session C
  Sexual Harassment Prevention Training
  Part 1. This is a 2-hour session; must attend Part 1 and 2 to receive certificate.
  Speakers: Veronica Gray and John Kennedy, Nossaman

3:00PM - 3:30PM	Networking Break

Thursday, May 18, 2017 *continued*

3:30PM - 4:30PM	Concurrent Sessions

- Concurrent Session A
  Legislative Update 2017
  Speakers: Richard Stensrud, Trent Smith, Mike Robson
- Concurrent Session B
  PEPRA Best Practices Revealed
  Speakers: Harsh Jadhav, Alameda CERA; Michael Calabrese, San Bernardino CERA; and Michelle Hardesty, Marin CERA
- Concurrent Session C
  Who says you can't add value in U.S. large cap equity? Just add options!
  Speakers: Jeff Sheran, Allianz Global Investors; Jay Strohmaier, Parametric; Mark Wood, Callan Associates
- Concurrent Session D
  Sexual Harassment Prevention Training
  Part 2. This is a 2-hour session; must attend Part 1 and 2 to receive certificate.
  Speakers: Veronica Gray and John Kennedy, Nossaman

4:30PM - 5:30PM	Education Committee Meeting **Speaker**: Christie Porter, Ed Cmte Chair, San Bernardino CERA
5:30PM - 6:30PM	SACRS Reception

Friday, May 19, 2017

7:00AM - 8:00AM	SACRS Breakfast
8:30AM - 8:45AM	General Session **Welcome** **Speaker:** Dan McAllister, SACRS President
8:45AM - 9:45AM	General Session **Speakers:** Anne Sheehan, CalSTRS and Christopher Ailman, CalSTRS
9:45AM - 10:00AM	Break
10:00AM - ADJ	SACRS Business Meeting
UPON ADJ	SACRS Post Con

PLEASE CHECK SACRS.ORG FOR UPDATES

COMMENTARY:

Laws of Unintended Consequences: Pension Reform Gone Awry

"Don't throw out the baby with the bathwater!" Sage advice for those with small children. For the rest of us, this cartoonish idiom should remind us of the dangers of overcorrection.

Good public policy emerges when targeted solutions solve clearly identified problems. Bad public policy emerges when generalizations ("Public employee pensions are too generous!") and adversarial thinking ("No private employers provide benefits like that!") drive the debate.

Here, I wish to analyze two recent and related overcorrection trends in California public retirement law: One that has already occurred in the Legislature and one that may be unfolding now in the courts.

PEPRA

The Great Recession rocked retirement funds across the state and the nation. As plan sponsor contributions were skyrocketing, their revenues were plummeting. This perfect storm was causing state and local agencies to cut services, cut jobs and cut pay, bringing heightened attention to the proportion of their budgets that unfunded pension liabilities would consume for the foreseeable future. The Public Employees' Pension Reform Act ("PEPRA"), effective January 1, 2013, was passed to rein in pension costs that were viewed as unsustainable.

In the years leading up to PEPRA, there was no shortage of media coverage of "pension abuse." Extreme cases of pension "spiking" understandably enraged the public and politicians. Ire was directed at more than just the worst spiking offenders, because some systemic flaws also had arisen in California's pension laws during the flush years of the late 1990s and early 2000s.

Over-inclusive definitions of "compensation earnable" and a one-year "final compensation" period were invitations for pension spiking. Upgrading a retirement formula for service that had already been rendered resulted in windfalls for some lucky members. Allowing members to purchase "air time" service credit at the "full actuarial cost" was virtually guaranteed to result in systemic losses, due to self-selection (healthy members buy "air time" more often than unhealthy members) and lengthening lifespans.

> *"PEPRA's changes had little impact on public employees who were hired before January 1, 2013, so most applications of the practices that PEPRA was supposed to reform were left untouched."*

Contrast these systemic flaws with what was often described as "overly-generous" benefit formulae, such as 3% at 50 that became the standard for safety members in the early 2000s. So long as compensation earnable is not subject to manipulation, the projected value of a year of service credit under 3% at 50 can be determined with reasonable accuracy. Governments and their bargaining units can then account for that value when negotiating a comprehensive compensation package. Thus, 3% at 50 appears "overly-generous" only if one ignores the fact that employees would simply demand higher salaries if they earned pension benefits under a less generous formula.

PEPRA addressed many of the systemic flaws of California pension law by, among other things, requiring a 3-year final compensation period, narrowing the definition of "pensionable compensation," eliminating retroactive benefit formula enhancements and eliminating the right to purchase "air time." But, PEPRA went way beyond just resolving these systemic flaws. It also dramatically diminished the fundamental benefit formulae, increased member contributions and imposed caps on pensionable compensation. These changes did not address any systemic flaws; they just slashed benefits for new employees.

PEPRA's changes had little impact on public employees who were hired before January 1, 2013, so most applications of the practices that PEPRA was supposed to reform were left untouched. This has created two classes of public employees, with consequent recruiting and morale problems. It also has complicated collective bargaining, because the baseline benefits for otherwise similarly-situated public employees differ greatly based on an arbitrary hiring date.

Which begs the question: Could the PEPRA benefit formulae for new employees have been more equitable if the systemic flaws had not been perceived to be locked in for legacy (pre-PEPRA) employees under California's vested rights doctrine? That question leads me to the second overcorrection that may be unfolding in the courts.

Vested Rights

For decades, California's judiciary has

protected the vested contractual rights of public employees not only to receive the benefits they were promised for past service, but also to continue earning benefits under the same or better terms for future service. See *Legislature v. Eu* (1991) 54 Cal.3d 492. The protection of benefits already earned is intuitive for most observers, but the guarantee that benefits will never be diminished for future service is less so. Along with pension spiking, that guarantee to continue earning the same level of benefits for future service has driven the so-called "pension reform movement" in California.

Similar to how the Legislature took a blunderbuss rather than a surgical approach to pension reform in PEPRA, some courts have launched comprehensive, rather than targeted, attacks on the "vested rights" doctrine. In recent months, their rulings have started to gain momentum.

In *Marin Assn. of Public Employees v. Marin County Employees' Retirement Assn.* (2016) 2 Cal.App.5th 674 ("*MAPE*"), the First District Court of Appeal in San Francisco held that the Legislature could take away a vested pension right without providing any comparable offsetting advantage, so long as the affected employees were left with a "reasonable" pension. The Court reached this conclusion by finding that, in *Allen v. Board of Administration* (1983) 34 Cal.3d 114, the California Supreme Court did not intend to use the word "must" when it said: "With respect to active employees, we have held that any modification of vested pension rights … when resulting in disadvantage to employees, **must** be accompanied by comparable new advantages." The *MAPE* court noted that most Supreme Court and other appellate decisions both before and after *Allen* used the word "should" rather than "must." The court found it "unlikely that the Supreme Court's use of 'must' in the *Allen* decision was intended to herald a fundamental doctrinal shift" away from what the *MAPE* panel believed was always intended as merely a suggestion that disadvantages "should" be accompanied by comparable new advantages.

The MAPE ruling flies in the face of over a half century of jurisprudence. In many earlier cases, the challenged plan amendments left members with what could surely have been described as a "reasonable" pension, but the courts struck down the amendments anyway, because no corresponding advantages were provided to offset the newly-imposed disadvantages. As one of many examples, in *Legislature v. Eu*, then-current legislators retained the full value of all service credit they had earned. They were merely subject to the new rules for future service credit earned after being re-elected to a new term. Those new rules were the very same ("reasonable") rules that applied to the service of all newly elected legislators. But no corresponding advantage was provided to the then-current legislators, so that amendments could not be applied to them.

Months after the First District announced its *MAPE* ruling, a different panel of justices in the same District continued MAPE's assault on vested rights. At issue in *Cal Fire Local 2881 v. CalPERS* (2016) 7 Cal.App.5th 115, was the elimination of the right of CalPERS members to purchase "air time." The *Cal Fire* panel stated: "We agree with this conclusion [regarding "should" v. "must"] reached by our colleagues and, as such, reject plaintiffs' claim that, absent proof that CalPERS members were granted a comparable advantage, the Legislature's elimination of the airtime service credit must be deemed unconstitutional." The panel in *Cal Fire* also flipped decades of pension law on its head by finding that a constitutionally vested right exists only when there is a "demonstration of intent" by the Legislature to create a vested pension right. This contradicts repeated California Supreme Court precedent holding that such an intent is presumed unless the terms of the retirement plan indicate that they are subject to change. *See, e.g., Int'l Ass'n of Firefighters v. City of San Diego* (1983) 34 Cal.3d 292.

A Targeted Solution

The Supreme Court has granted review of the *MAPE* decision. The question now is whether the High Court will throw the baby (vested rights) out with the bathwater (perceived pension spiking). The Supreme Court could cement the most protective view of vested rights, by reaffirming *Legislature v. Eu*, without providing any further clarification. Or it could adopt the First District's logic in *MAPE* and *Cal Fire*, essentially eviscerating the vested rights doctrine in California. Then still, it might take a third path, by sensibly clarifying existing precedent.

The practices at issue in *Marin* and *Cal Fire* were arguably easy pickings for the Legislature if its goal was, indeed, to hasten the demise of the vested rights doctrine. In *Marin*, the law at issue was essentially an anti-spiking law; the service credit at issue *Cal Fire* was "cost neutral" only in theory. The First District's blessings of these specific plan amendments were not necessarily unreasonable, but its overreaching rationale cannot be reconciled with decades of judicial precedent.

But there is a principle within the existing precedent that could provide a more sensible alternative to the First District's approach. In *Allen v. Bd. of Admin*. (1983) 34 Cal.3d 114, the California Supreme Court explained: "Laws which restrict a party to those gains reasonably to be expected from the contract are not subject to attack under the Contract Clause, notwithstanding that they technically alter an obligation of a contract." Similarly, in *Walsh v. Board of Administration* (1992) 4 Cal.App.4th 682, the court of appeal explained: "Constitutional decisions have never given a law which imposes unforeseen advantages or burdens on a contracting party constitutional immunity against change."

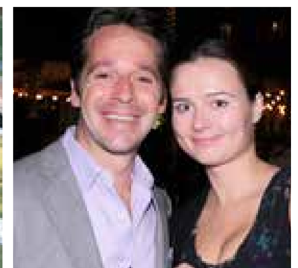
Is it fair to say that the Legislature foresaw that members might manipulate the timing of when they receive certain pay items to enhance their benefits? Is the ability to engage in that kind of manipulation part of the immutable employment contract, or may the Legislature fine-tune the definition of "compensation earnable" to limit such manipulation when it comes to light? Do members have a vested right to purchase service credit that was intended to be cost neutral, but which actually leads to unfunded liabilities that the plan sponsors must pay?

Californians would be well-served if the Supreme Court focuses on the reasonable, common sense expectations of the parties and finds a way to separate the baby from the bathwater.

Jeffrey R. Rieger *is Counsel to Reed Smith, LLP, and a senior member of its Fiduciary Practice Group. The comments made in this article are exclusively the views of the author and not necessarily those of the firm or its clients.*

2016 SACRS FALL CONFERENCE

The SACRS 2016 Fall Conference took place in Indian Wells, California November 8-11 and included presentations, training sessions, breakout sessions, and concurrent sessions covering a variety of topics. Here's a fond photographic look back at a few of the activities and events.



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SPRING 2017

May 16-19, 2017
Napa Valley Marriott Hotel & Spa
Napa, CA

SPRING 2018

May 15-19, 2018
Anaheim Marriott
Anaheim, CA

SPRING 2019

May 7-10, 2019
Resort at Squaw Creek
Lake Tahoe, CA

FALL 2017

November 14-17, 2017
Hyatt Regency
San Francisco Airport
Burlingame, CA

FALL 2018

November 13-16, 2018
Renaissance Esmeralda
Resort & Spa
Indian Wells, CA

FALL 2019

November 12-15, 2019
Hyatt Regency Monterey
Hotel & Spa
Monterey, CA