



Board of Retirement Regular Meeting

Sacramento County Employees' Retirement System

Agenda Item 7

MEETING DATE: September 19, 2018

SUBJECT: Investment Management Agreement for Public Equity Manager Dalton, Greiner, Hartman, Maher & Co.

SUBMITTED FOR: X Consent Deliberation and Action Receive and File

RECOMMENDATION

Staff recommends that the Board approve an amendment to the Investment Management Agreement (IMA) with public equity manager Dalton, Greiner, Hartman, Maher & Co. (DGHM), and provides Staff authority to approve future amendments that are technical in nature, reduce management fees, or revise investment guidelines, but remain in compliance with the Board approved Investment Policy Statement (IPS) for the Public Equity asset class.

PURPOSE

This agenda item does not specifically support the 2018-19 Strategic Management Plan, but complies with SCERS' Public Equity IPS requirement of Board approval for entering into contracts with investment managers. This item contributes to the effective management and oversight of investment activities.

BACKGROUND

SCERS recently completed restructuring the Domestic Equity asset class to conform to SCERS' Strategic Asset Allocation. As part of the June 2018 restructuring, SCERS evaluated the investment managers included in the structure, including the target allocation and fee structure for each manager. The restructuring process resulted in SCERS consolidating its domestic small cap value manager lineup down to one existing manager, Dalton, Greiner, Hartman, Maher & Co. (DGHM). SCERS has maintained a strong relationship with DGHM over many years, dating back to 2000.

Fee Structure

DGHM manages a small cap value mandate within SCERS Domestic Equity asset class. Since the original IMA was executed in 2000, there have been few changes or amendments to the agreement. Given the changing market conditions and legal standards, including applicable

investment guidelines, Staff felt it was in the best interest of both parties to complete a new IMA with DGHM (versus completing an amendment to selective parts of the existing contract). The starting point for a new IMA was SCERS' current IMA template for equity managers, with modifications needed to customize the agreement with DGHM.

In addition to updating the IMA to current legal standards, SCERS and DGHM also updated the fee agreement. As part of the domestic equity restructuring, SCERS increased the target allocation to DGHM by approximately \$17 million. Given the increased allocation and long-term relationship with DGHM, Staff and Verus were able to negotiate a significant reduction in the investment management fee schedule payable to DGHM.

DGHM is one of several public equity managers that incorporates a performance incentive fee (PIF) into the overall fee agreement with SCERS. These fee agreements typically include a base fee and performance incentive fee, which rewards the manager for delivering excess performance, net of the base fee, above their benchmark. Depending on the fee schedule offered by the manager, Staff and Verus believe that a performance based fee schedule can properly align the interests of SCERS and the investment manager. The fee arrangement also includes a cap on the maximum fee that can be earned by the manager, to limit the overall management fees paid on the account. The following table details the reduction in the base fee, performance incentive fee, and maximum fee under the new fee agreement with DGHM:

	<u>Prior Fee Schedule</u>	<u>New Fee Schedule</u>
Base Fee (bps)	55	45
PIF Participation Rate	15%	11%
Max Total Fee (bps)	115	90

As detailed in the table, the base fee was reduced by 10 basis points (-18%), the PIF participation rate decreased from 15% to 11% (-27%), and the max fee was reduced by 25 basis points (-22%). The PIF is based on a rolling 12-quarter measurement period and is payable at the end of each quarter. However, the short-term performance for DGHM has been below its benchmark and therefore SCERS has only been paying the base fee. As of June 30, 2018, the one- and three-year gross of fee returns for DGHM were 9.3% and 9.1%, compared to the Russell 2000 Value benchmark returns of 13.1% and 11.2%, respectively. However, given the active small cap strategy employed by DGHM, excess returns can vary significantly and it is possible for DGHM to quickly recover from the recent underperformance. For example, if DGHM were to generate outperformance of 200 basis points under the increased mandate size, the overall effective management fee on the account would decline from 77 basis points to 62 basis points (-19%). Under these assumptions and an estimated account size of \$100 million, compared to the prior account size of approximately \$83 million, the estimated total fee (including base and performance fee) would decrease from \$637,000 to \$620,000. Given the timing of the restructuring and negotiations, DGHM agreed to mark the effective date of the new fee schedule as the beginning of the second quarter, April 1, 2018.

Future IMA Amendments

Upon Board approval to hire a public equity investment manager, the Board resolution typically contains language authorizing the *“President or Chief Executive Officer to execute an Investment Management Agreement and any other documents which may be reasonably*

necessary” to complete the agreement. Recently, Staff has encountered situations where minor technical contractual amendments (i.e. fee reductions, permitting use of SCERS name for marketing purposes, amending market capitalization ranges) would improve our relationships between SCERS and its public equity managers. However, the language in the current enabling resolutions does not provide Staff the ability to execute future documents, such as minor amendments to the IMA, including changes to investment guidelines and/or reduction in management fees, without Board approval or consent.

Staff is seeking Board approval to allow the Chief Executive Officer to execute documents necessary to approve future amendments to Investment Management Agreements that are technical in nature, reduce management fees, or adjust investment guidelines to better suit the manager or current market conditions, but remain in compliance with the Board approved Public Equity IPS. The proposed changes will improve the process and make it more efficient to execute minor modifications to equity manager IMAs, but not change the overall nature or scope of the agreement with the investment manager. The following sentence will be added to resolutions pertaining to new or amended IMAs with public equity managers, including DGHM, going forward:

The President or the Chief Executive Officer is authorized to execute an amendment to the Investment Management Agreement and any other documents that may be reasonably necessary. These documents may include future amendments to the Agreement that are technical in nature, reduce management fees (Exhibit B), or amend investment guidelines (Exhibit A) in conformity with the Investment Policy Statement for the Public Equity asset class.

ATTACHMENT

None

Prepared by:

/S/

Brian Miller
Investment Officer

Reviewed by:

/S/

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Chief Investment Officer

/S/

Eric Stern
Chief Executive Officer