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EPISODE 21:

Staying on the Fairway with Andy Spellar

CIO of Fairfax County Employees' Retirement System

Robert Morier: Welcome to the Dakota Live podcast. I am your host, Robert Morier. The goal of this podcast is to help you better know the people behind investment decisions. And we introduce you to chief investment officers, manager research professionals, sales leaders, and other important players in the industry who will help you sell in between the lines and better understand the investment sales ecosystem. If you're not familiar with Dakota and their Dakota Live content, please check out dakota.com to learn more about their services. Before we get started, I need to read a brief disclosure. This content is provided for informational purposes and should not be relied upon as recommendations or advice about investing in securities. All investments involve risk and may lose money. Dakota does not guarantee the accuracy of any of the information provided by the speaker who is not affiliated with Dakota. Not a solicitation, testimonial, or an endorsement by Dakota or its affiliates. Nothing herein is intended to indicate approval, support, or recommendation of the investment advisor or its supervised persons by Dakota. Today's episode is brought to you by Dakota Searches. Are you tired of endlessly scrolling through investment publications, trying to stay on top of the latest investment mandate opportunities? Look no further than Dakota Searches. With Dakota Searches, you'll never miss a new mandate again. Our powerful platform sends you email alerts as soon as new searches are posted so you can be one of the first to know. Subscribe today for a 30-day free trial and experience the convenience and efficiency of Dakota Searches. And for even more benefits, become a Dakota Marketplace Member for full access to Dakota Searches, our Institutional Investor Database Dakota Marketplace, and more. Sign up for Dakota Searches and stay ahead of the game. Visit our website at dakota.com/dakota-searches to learn more and start your free trial today. And I am always happy to introduce you to my partner on the desk, Chris O'Grady. Chris, welcome back to the show.

Chris O’Grady: One of your many partners, but I always enjoy coming down here. It's been a while.

Robert Morier: My most experienced partner.

Chris O’Grady: Yeah. That's right.

Robert Morier: Well, I texted you a few weeks back. I was at the Ardmore Music Hall. I know you're a big music fan.

Chris O’Grady: It was great, yeah.

Robert Morier: It was great. I saw Larry McMurtry. He was great. It was an acoustic show. If you read Lonesome Dove, he was-- it's Larry, James's son. And he had-- I like lyrics, and I listen to the lyrics on these songs a lot of the times. And one of his songs is "If It Don't Bleed," and it made me think about asset management, because

unfortunately, even when I'm at live music shows, I can't help but think about asset management.

Chris O'Grady: Can't escape it.

Robert Morier: Yeah.

Chris O'Grady: Can't escape life.

Robert Morier: Exactly. And I was also a history major, I think our guest was as well. So it's good to look back in the past to find some solutions to the present problems. He said that "there's more in the mirror than there is up ahead." So as you think about past experiences, what past experiences are you drawing parallels to as you help set the stage for current opportunities for your clients?

Chris O'Grady: Sure. Well, first of all, I've become lame in terms of hitting music shows, but my wife and daughters have demanded they go see Taylor Swift. And if they put Taylor Swift tickets in the inflation component, we're at a 27% rate of inflation. So I'm saving my money for the Taylor Swift show. It's unbelievable. Philly girl. How about a hometown discount? It's great to have - and because we used to cover Fairfax County on the bond. We were bond sales people here in the late '90s, or early '90s, in Philadelphia. And it's been a killing field for bond investors, and of the Dakota Live! shows that we host, we're talking more and more about alternatives and yield and fixed income. And I think it's going to be a gold, we're not in the prediction business, but I think it's going to be a golden era. I just remember that abrupt Fed tightening in 1994, that all chaos was created, and then obviously led to the internet bubble. But I think, and we'll dive into this with Andy, but really talk about yield is now really attractive. You can earn 5% for hanging out in cash. And people are waiting for the commercial real estate cycle to kind of fall apart and we've had the banking issues. But bottom line is all things really lead to more volatility and fixed income, and that's how I started my career in the euro dollar pits with Goldman Sachs and as a bond salesman. So I think it's going to be a really interesting time. I think people are going to make money. I don't think-- I don't think equities get killed. I don't think it spreads wide to infinity. But it's game on. And that's just my experience from earlier in my career. It's going to be really interesting and hear Andy and as we talk to other investors how they're really trying to position for potential probabilities.

Robert Morier: OK. Warning to guest. Fixed income questions are on the way.

Andy Spellar: Oh, boy. Oh, boy.

Robert Morier: Well, I am thrilled to introduce you and our audience today to Andy Spellar. Andy's the Chief Investment Officer of the Fairfax County Employees Retirement System. Andy, welcome to the show.

Andy Spellar: How are you, sir? Long time, no see.

Robert Morier: It is a long time, no see. It's great to see you. We're excited that you're here. We have a lot of questions to ask you. But before we do, I want to quickly share your background with our audience. Andy is the Chief Investment Officer for the $5 billion Fairfax County Employees Retirement System located in the suburbs of Washington, DC. Andy started with Fairfax County in June 1998 as a senior investment manager. He's been with the plan for nearly 23 years, taking a few years in the middle of his tenure to join Parametric as portfolio manager where he designed, implemented, and managed customized asset allocation and derivative overlay, as well as funded solutions for institutional investment management clients. Prior to joining Fairfax County, Andy began his career at GIT Investment Funds as an independent registered investment advisor. Andy received his MBA from Marymount University in Arlington, Virginia, and two BAs in history and European Studies from George Mason University. If you haven't visited Andy's LinkedIn profile in a while, I can tell you his background photo is of a golfer who looks like-- a lot like him, I should say. And somewhere in mid swing, either in Scotland or Ireland. Andy, where were you when that photograph was taken?

Andy Spellar: That's Turnberry in Scotland, yeah. And it was a duck hook to the left, but it looked really good in terms of a picture.

Robert Morier: It's good. I've got a feeling it's going to stay there for a while. It is a good one. So well, we're excited you're here. Thank you for joining us, and congratulations on all your success.

Andy Spellar: Thank you.

Robert Morier: You're welcome. Well, I always find it inspiring to speak to people in our industry who have been with the same organization for many years. We recently interviewed Mark Steed from Arizona Public Safety, Ryan Hickey of SCI. They both grew up at their respective firms. And you didn't start your career at Fairfax, but you've spent the lion's share of it with them. So what initially drew you to the plan and the allocator role?

Andy Spellar: Well, it's kind of an interesting story. So my wife got pregnant. How about that? So at the time, I'd been at GIT Investment Funds for about five years. That had worked out really well, and got a real good grounding on just about every aspect of the investment management business on the back side of a mutual fund

company. So that was great. That company got bought, and myself and another gentleman that was there, we set up a registered investment advisor. And we sort of flied by the seat of our pants for a while. But one day, my wife came to me and said, guess what? We're pregnant. And didn't have insurance and really needed sort of a stable - more stable job. So it was really luck that I just sort of found in The Washington Post an advertisement for an investment analyst and applied. I Interviewed with - I think you'll remember these names, but Larry Swartz and Jeff Wilson, and was lucky enough to be hired. To be honest with you, I was somewhat naive to sort of the institutional investment management business. I'd been more on the retail side. So back then, I think the Employees Retirement System was about $1.6 billion. And so started in with Fairfax in '98. And then shortly after I was hired, I had the good fortune to get to work with a guy named Tom Weaver, who you may remember as well or know. But Tom was really a very insightful and forward-thinking guy. And that's really - I always say the two best days of my career was when Tom walked in the door and when Tom walked out the door because he gave me a great grounding in his thought process, and I've just carried that forward ever since. So that's how I ended up in Fairfax.

Robert Morier: That's exciting. Congratulations. So by accident you ended up in Fairfax. A happy accident.

Andy Spellar: Quite literally. Yeah. Yeah. But it's been great. A great experience and really opened my eyes to just really being able to think about constructing portfolios for the long term. And so it's been great.

Robert Morier: We look forward to hearing how you do construct those portfolios. But you took a little bit of a sabbatical. You left in 2011. You came back in 2013, as I mentioned during the introduction. What took you away, and then what brought you back?

Andy Spellar: Well, I had the opportunity to go work with Parametric. As you probably know, we use them quite extensively to do some of the derivative overlays that we use at Fairfax. So we gain a lot of exposure to markets that we think we can't really add a lot of value to, but are valuable to our portfolio. So most of our, talking about fixed income, most of our Treasury exposure is through futures. Obviously, commodities is through futures, so we gain that diversification. And then efficient asset classes like the S&P. And then also, we run a gold overlay as well to add diversification. So Parametric has done a lot of that for us over the years. And we also want a risk balance-type strategy, very akin to sort of the Bridgewater All Weather construct. And so just in talking to Parametric, they were looking for somebody to go out and talk to people about using their overlay services for more things in line with what we were doing. So completion portfolios, and then also developing a risk parity strategy. So that was an interesting opportunity. Did that for

three years. I traveled a lot. A lot of travel. You know how that works. We had some success. And then in 2000, I think 2012, '13, Eaton Vance actually bought, because it was The Clifton Group back then, bought The Clifton Group and merged them into Parametric. I had a change of control clause in my contract, and it gave me the opportunity to think about what I was doing relative to what I had been doing. I had always stayed in touch with my board chairman at Fairfax, and he said, if you ever want to come back, we'd love to have you back. So when I sort of looked at some of the things I was doing, just traveling all the time and working on a single portfolio as opposed to sort of the exposure to all the different parts of a big institutional portfolio, it was just much more intellectually stimulating to me to manage that type of an asset pool. And so I had the opportunity to go back, and so I went back in late 2013. So I was gone for about three years. Great experience. I got to travel around and certainly meet and sit down across the table from a lot of CIOs. And that was great because I came away from a lot of those meetings feeling like I knew a lot, and could see how the people thought about some of the same issues and some of the same concepts. And anyway, it was a great experience. But I've loved being back, and I've been back for, it'll be 10 years in September. And believe it or not, I'm eligible to retire next year.

Robert Morier: Have you filled out the paperwork yet?

Andy Spellar: No, not yet. Not yet. Still thinking about how that process is going to work, and I'm not ready to quit.

Robert Morier: Thank you for that. That's helpful. As you think about your role now as a public pension plan CIO, there's often this pull between the achievement of ROA, Return On Assets, and the securing of promised benefits. So what do you believe is the primary objective in managing a public pension system as you sit in the CIO role now?

Andy Spellar: Yeah. So in the public space, we don't mark our liabilities to market like you do in the corporate space. So sort of that asset liability matching really is not the issue. What the issue is, is volatility in the contribution rate that the sponsor pays to the system, right? And currently, that's 6.75%. That's down from around 8%. So we brought that down somewhat over time. That actuarial assumed rate of return has no volatility to it. So it's the same year in, year out, right? So the way that we've sort of thought about it is to engineer it backwards. Well, how much risk do we need to take in order to achieve that 6.75% return? And then do that with as little volatility as we can, which is obviously the hard part, right? And that's really where the diversification concept comes in of the All Weather-type construct, the risk balancing of making sure that you've got assets that perform in different environments and you have equal risk contributions from those assets so that sort of through the business cycle you're just a little less volatile than everybody else. And you know in

terms of geometric returns, your volatility's actually a component of your return, right? So if you have two assets or two asset pools and they have the same average return month in and month out, so let's just say 50 basis points, but one is more volatile than the other, the more volatile one will end up with less money over time. And that's just simply because the negative compounding, if you go negative, you have a negative period. You have a drawdown. You have a dollar and you lose 50%, and now you've got $0.50. Well, now you have to earn 100% to get back to even, right? So the math gets really tough if you have drawdowns, so that's why you want to have slightly less volatility than everybody else. You don't go down as much. You might not go up as much, but you don't have to work as hard on the upside. So that's really the way that we've thought about it is try to be as diversified as we can, make sure we're earning the right amount of risk premium over time, and just sort of stick to that strategy, which has really worked out well for us in terms of helping us maintain what's really been sort of top quartile performance over the long term. And what I say is we try to just be average a lot. And so what actually happens on a quarterly basis, we end up being either in the first percentile or the bottom percentile, depending on what equities did that quarter. But over the long term, we're just much more diversified. We're a shade less volatile than everybody else, and just compound at a slightly higher rate. And so over the long term, that really has added up.

Robert Morier: Yeah, when you listed that, Andy, it's how we should all manage our own money. I mean, you could shoot lights out and said, but what's the point? I mean, at the opening comments at the top of this, I made comments about fixed income. I'll hearken back to 1994 when good old Orange County blew themselves up by just mismanaging their risk. And it's, what's the point of shooting lights out when the downside's there? Andy, you've got three retirement systems within your group. Can you walk the listeners through how to think about all those pools of capital?

Andy Spellar: Yeah, sure. It's a little unique. It's a little bit more like New York City, which I think has six or eight different pension funds. But we have three in our office. The Employees Retirement System, which I oversee, is about $5 billion. And I manage that exclusively and just report to that board. So there's a separate board for all three. And I do not work with an outside consultant. My colleague who I work actually very closely with, Katherine Molnar, manages our Police Officers Retirement System. It's about $2 billion. That is just strictly for sworn police officers. We have about six, I guess 1,600 police officers in Fairfax County. And she also does not work with a consultant, so her and I end up working quite closely together on a lot of ideas, and our skills are very complementary. And then we have a third system. It's the Uniform Retirement System that's for everybody else in public safety that is not a sworn police officer. So I think we have something like 1,800 police officers, or I'm sorry, firefighters and medics. About 500 sheriffs, dog catchers and helicopter pilots and things like that. So our colleague, Brian Morales, runs that system, reports to

that board. So there are three distinct boards with very little overlap. There's one person that sits on all three. And you can say that it's not perhaps the most efficient structure. I think it just works for everybody involved. And there's some politics involved in some of that too. I think everybody likes to have their own pool of assets managed by folks that they think represent them.

Chris O'Grady: I mean you were at Parametric, so you know what it's like to be on the sales side. So from a sales professional, not working with a consultant, there's not those two layers of talking to the field consultants. What inspires you not to work with a consultant? Because I wish more were that way.

Robert Morier: Because that's changed as I remember it. It's been a long time since we've worked together, Andy. But what was the evolution of that relationship like in terms of having a consultant and today not having one?

Andy Spellar: Yeah, so the employee system has not had one for quite a long time. Really, I think since 1995, shortly before I got there. So my board chairman is a guy named Bob Carlson. He's been great. He's been the chair the whole time that I've been here and predates me. But he looked at the consulting model which has lots of different options for people, but it just wasn't for him. You have a consultant that's busy. Might have 10 to 12 clients. And his time is limited. And you get sort of approved lists of managers, which is fine. But generally, they also have to have a lot of capacity. And so if you want to do sort of niche-y, different things, that might not necessarily play out well with working with a consultant. So in '95, he made the decision to not work with a consultant and hire a dedicated internal staff. And so that was Jeff Wilson for a while, and then Tom Weaver came in, and then I replaced Tom when he left to go to WARF, the Wisconsin Alumni Research Foundation. So that's been the case there. We did used to have Mercer as a consultant on the police plan. And I don't know if you remember, but I think it was 2009 or so, 2010, Mercer fired all their public fund clients. And at the time, the police board had gotten comfortable with watching what we were doing with the employee system, and so they decided to opt to not work with a consultant, but again, have that dedicated internal resource just focused on one plan. But the uniform system has always decided that they like working with a consultant. It gives them a certain level of comfort. And you know, and I think Brian just individually likes working with a consultant and the resources that brings to bear. So there's different models for everybody, but I think just from my seat, we have a lot more degrees of freedom to do things. I think that really is a key to having a stable board, which has been great. So there's been some turnover and a little bit more recently, but there's still a core of people on the board that really understand what we're doing, so that's great. And like you said, it doesn't remove a layer of, between us and the opportunity, the investment opportunities that are out there. And so we really try to work hard and beat the bushes. We don't have somebody providing us with approved lists, so we

work with databases to sort of pick through traditional asset classes. And then we've developed processes to try and reach out and see what else is out there in terms of alternatives like hedge funds and real assets and privates, which we've really expanded in the last couple years.

Robert Morier: It sounds like that freedom and continuity has, I guess in some ways, spurred innovation. And you guys have always been known as being quite innovative as it relates to manager selection and your views on risk allocation. So I guess in thinking about your years at Fairfax, where did that spirit of innovation come from, and how are you carrying it forward in the role now as CIO?

Andy Spellar: I mean, there's two people that were really responsible for that. One was Larry Swartz hiring a guy like Tom Weaver, and then letting Tom actually do his thing. And Tom deserves a ton of credit for that. So one of the first things he did when he came in was hire The Clifton Group, Parametric, to start running an overlay in terms of just securitizing their cash and then using - so we weren't having a cash drag. That's a pretty simple thing to do, but a lot of people don't do it. And then using futures to do rebalancings as well. So instead of creating transactions within, say, equities or fixed income portfolios, we would just rebalance using futures. And then that sort of expanded. And I think I've mentioned this to you before, but Tom and I went up and spent some time with Bridgewater to understand their All Weather strategy and spent a lot of time with Bob Prince. And I've got to be honest with you, that conversation, I can still remember it. It's almost like a light bulb went off in my head because prior to that I'd sort of been a traditional guy of stocks and bonds. And the equity managers would come in, and we'd talk about the stock stories and things like that. But at the end of the day, that's really not your bread and butter. It's the asset classes, right? And how you allocate that. And then just this concept of most asset classes or almost all asset classes when you have that capital market line have similar Sharpe ratios over time, which makes total sense, right? Because if any one asset class is more efficient at delivering risk premium than another, then it would be arbitraged away. And so over time, most asset classes do display something similar in terms of Sharpe ratios. So it's a function of, how much risk do you want to take in order to capture that risk premium? And then if you can balance the risk between two different asset classes, that's when you get the true diversification benefit, the full diversification benefit of owning those two assets. And so that conversation, Tom and I went back and we talked about it a lot. And then we started to try and think about our own portfolio that way, not just on sort of one account level, but on the whole thing. And so that's really the genesis of it. That was about 2002 when we started implementing that. Tom left in 2004. And Larry said, well, Andy, you're in charge until we figure out who's next. And so I walked into the next board meeting. And I knew what Tom's plan was and I said, this is where we're going to go and this is what we're going to do. And six months later, I was given the job, and that's what we built over time, which is very unique. We're much more

diversified than anybody else out there. We have much more exposure to fixed income, particularly like tips, which has been a great diversifier. And we've added commodities and we've been working over the last probably eight years to bring privates in that we really hadn't had, but fit that into that framework as well. And then some of the things that we've done in sort of the venture capital space recently has certainly created some buzz. But I think those were all good moves and very innovative, and we're really trying to bring an innovation theme into the portfolio. But everything is done within this sort of broader risk allocation process. So we look at a dollar and say, well, how much risk do we need to take to achieve that 6.7%? And then how do we make each dollar effective in creating that? So again, we get Treasury exposure through futures. We don't tie up capital in Treasury bonds that were yielding whatever, 1 and a half for quite a while there, right? So when we get that exposure and diversification through the futures, and then that allows us to go off and do other things.

Chris O'Grady: Portable alpha. Yeah. I mean, it's beautiful. It's a beautiful thing with short rates offering 4% or 5% yield so the cash collaterals can really earn stuff right now. And that's just something that people haven't really been thinking about for 15 years.

Robert Morier: Yeah, and I like what you said about the Sharpe ratio. I read something that your colleague Katherine Molnar said, that she said, "I can't pay benefits with a high Sharpe ratio." So I thought that was telling based on what you were thinking of. So I'm skipping ahead a little bit, but it does beg the question as whether low-vol strategies should have a place in your portfolio. I'm asking as if, I guess in a way, I'm asking as if you were speaking to one of your public pension market peers. You know, how do you think about volatility in light of some of the comments that you had mentioned about where innovation can come from?

Andy Spellar: Yeah, I mean that is a little bit of a conundrum. Generally, we want higher vol strategies because we can allocate less money to them and still get the diversification benefit. If they're truly diversifying then we can get that, right? So generally in hedge fund strategies, we have opted for higher vol. And I'd say about 60% of our hedge funds are even higher than that, but probably 2/3 are global macro in some way, shape, or form. So either trend following systematic. We have one discretionary. We've never been a huge fan of discretionary, but we do have one discretionary manager. But then we also have a bucket of relative value, and that tends to be a lot lower vol, but higher Sharpe ratio. And so I think if we're using sort of the portable alpha construct that we do, we can sit something like that on top of, say, a Treasury bond. And you're getting good returns, just not high vol. I think that works out great. I don't know that if we weren't using sort of the leverage in that way, the lower vol might not work unless maybe used as a fixed income replacement. I think some

people do that. But we've been, I think, pretty lucky to work with some pretty good firms. And we've had high-Sharpe, low-vol, high-return strategies. That's worked out really well for Citadel clients. I think we're one of the only public funds that are Citadel clients. And so those things have worked out well for us. So all things being equal, we'd like higher vol share classes of everything, but there are managers that can really provide those higher Sharpe ratios and we've got a few, and it works out fine. So especially in the portable alpha construct.

Chris O'Grady: Andy, with all the three plans, what is the funding status? I know that's becoming a hot topic with rates going higher so future liabilities get discounted a little bit less. Where are we on a funding status?

Andy Spellar: Yeah, so the employee system is around 72%, 73%. That's down. Last year I think we were in the low 80%s. And so I think pretty much everybody took a hit last year. And then the Police Officer Retirement System is in that sort of low 80%s. It had been back up to about 92%, so everybody took about a 10% haircut last year. And then the Uniform Retirement System is about 73% as well. They have a lot more sort of equity risk than we do, and so they had a tough year last year, and that really sort of knocked them down a little bit. Historically, the Police and the Uniform systems have been better funded over time. And that's not because of the contribution rates or anything. It was more the actuarial makeup of the systems. So those two systems are much more homogeneous - a police officer is a police officer is a police officer, whereas an employee system, we actually have two pools of employees. We have the regular county employees and then we have school board employees that are not teachers. And so when you're looking at, say, somebody like me or a county, some county manager or something like that versus a food service worker that is only working four hours a day and things like that, that pool of assets is really from an actuarial basis hard to value. And so we had a lot of actuarial losses back in sort of the 2000s. But we've worked that out. We've sort of broken those two pools into, and defined them and then rolled it back up. And so we've had a lot more success on the actuarial front in that regard because the employee system has always had the higher returns, but it could never quite overcome some of the actuarial losses that we had just in terms of valuing those liabilities. But in general, we're pretty well funded in terms of a relative basis to a lot of our peers. And then the county's also made it a commitment to continue to, they actually over-fund every year to try and get us back to 100% funded. I think it's in 2032 I think is the date that they're looking at. So we're very lucky in that regard. And Fairfax County's, I don't want to put this all on the taxpayer, but it's a rich county, and it's one of the wealthier counties in the country. And we're very fortunate in that regard to have a plan sponsor that's committed to keeping the systems healthy.

Robert Morier: Thanks for that, Andy. Well, many years ago, you told me that a 60/40 allocation doesn't add up to 60/40 risk. So as you touched on risk buckets,

what do those risk buckets look like for the plan? And how should a potential asset manager be thinking about where you consider certain asset classes as it relates to your respective risk buckets?

Andy Spellar: Yeah, I mean, the math is pretty simple, right? If you have 6% of your assets in equities and that's 15 vol, and you've got 40% of your assets in, let's call it a Lehman ag or a Barclays ag, intermediate-type bond strategy with five vol and you're looking for the bonds to diversify your equity risk, if you get in a drawdown, just get that correlation perfectly right but your stocks are still going to go down three times more than your bond's going to go up. And so the risk of that 60/40 is actually more like 90/10. And so what we're trying to do is just even that out across a number of different asset classes. So the asset classes include equities, credit, real assets, inflation-linked bonds, nominal bonds. We consider gold to be sort of a separate type of asset. And then obviously, currency is also sort of an uncompensated risk that's in the portfolio that you need to manage and then we break our manager returns out into two buckets. One is funded, which would be hedge funds. So we literally put capital into an account and then we expect a return out of that. And then the other part is just the active component of having managers that are benchmarked to an index, right? So that tracking error. We roll all of that up and measure it. And every line item in our portfolio has one or more risk estimates to the different components of it. So let's just take an international equity portfolio. There's equity risk, and there's currency risk, and then there's active risk. And so we know what all of those are. We come up with an estimate and how much we expect to get paid for that in terms of our relative expectations. A high-yield portfolio would have credit risk in it, would have nominal bond risk in it, and would also have active risk. And so we break every piece out and then roll all of that up. And then what we also do is then take it a step further and try to identify how those will do in certain environments, and then how that plays out in the business cycle. And we have developed a model internally here that we used for attribution, sort of looking backwards for a long time that we would say, OK. Well, we've been in what we would consider a peak environment, which would be above average inflation, above average growth. And then when we look back at the asset classes, if you equalize the volatility of them, you can compare how they've done in an environment like that. And it's always worked quite well that we can identify what the period looked like and then which asset classes would have, or did do well. And so that's how we manage the portfolio. You want to have risk that will provide positive risk premium to us in a number of different environments. And we just want to be efficient in collecting risk premium through the business cycle and not give up a ton of, again, we don't want to go down, we don't want to be down 10. We want to be down five. And we're happy to be up 20 and everybody else is up 25.

Chris O'Grady: That's good education for somebody calling on you to show an idea, and we'll get into the manager research process later. But obviously, know what your

contribution of volatility is to the bucket you're talking about. So everybody obviously wants to talk about the process returns, things like that. But really understand, and what's the classic response from a lot of allocators? Hey, this is a really interesting strategy. I just don't know where I'm going to put it. So if you can really slot it and from understanding it from the vol perspective and how you're looking at it as an overall portfolio is super helpful.

Andy Spellar: Yeah, and we really want to look for things that are truly diversifying, right? So we've come across a lot of really cool ideas and good opportunities. And if we can identify how we might think about it in that construct, we'll find a place for it.

Robert Morier: Well, why don't we move into the manager research process? Andy, could you talk a little bit about the team? How are responsibilities allocated amongst you all? And what's the staff look like these days?

Andy Spellar: Oh, it's pretty slim. So you know, I think you remember the days when it was just myself and Jeff Wilson and then probably Damien. You probably dealt with Damien. He's doing well, by the way. He's moved on, but he's doing well. So really, again, there's a chief investment officer for each one of the three systems and because each board wants a dedicated resource. And obviously, the three boards are separate. And so we have monthly board meetings, so it's quite a pretty rigorous schedule. So it's the three of us. And Brian works with any PC who's his consultant there, so he sources a lot of ideas there. We have some access to that, which is great, and we've done some different things together. Katherine and I tend to work very closely together, so our skills are very complementary. So she comes out of the hedge fund, the funds world. She has just a tremendous background of knowing the managers, and she's just a fabulous professional when it comes to having a manager meeting. So I'll be honest with you. Over the years now, I've just really deferred to her. I'm just like, she can handle this because there's nobody in my mind that can do a better job of handling a manager meeting than her. And then my skills have always been sort of the portfolio construction, sort of top-down piece of it all, right? How do you put all the pieces together and think about that? And so the two of us have really sort of formed a pretty good partnership over the last few years. And we've actually got to the point where we've converged our portfolios to be pretty much identical. So some nuances to that. So we work on a lot of ideas together and sourcing those. Katherine's been great in terms of understanding how to navigate the cap intro business out there that, frankly, I didn't even know existed. I would never have gone to a conference to do the speed dating-type thing where you meet with six managers in a day. Luckily, I'm not the guy that takes notes. She takes all of the notes. But it's a great way for us without a consultant to canvas what's out there. And then we've also done, I think, a really good job of just conveying that we're looking for idiosyncratic-type things. So a lot of people out there know that and will come to us. If they know us, then they know that's what we're looking for, and we'll get pretty

interesting ideas that way. We're sort of not looking for them the off-the-shelf thing. We customize strategies too. We're pretty aggressive about fees, and so we will often seed new strategies or work with a manager to customize a solution for us that they may then go on and sell, and we'll obviously get some preferential treatment that way. We've done revenue shares, so we've done a lot in that regard to just be as innovative and creative as we can. And we're always trying to beat the bushes on what's out there.

Chris O'Grady: Yeah, that's more music to a salesperson's ear because you're a willing listener to ideas. You're accessible. My current theory from talking to a lot of folks like you is everybody seems to be taking meetings. Everybody seems to be looking at ideas. There's really no urgency because we've been talking about high cash rates. But is there any near-term opportunities right now that you'd sit here and say, you know what? I'm probably close to figuring out I want that exposure and I've just got to find the right managers to express that. Anything near-term over the next couple quarters? You still waiting for things to shake up?

Andy Spellar: Yeah, not really. I mean, we've done a lot in adding private exposure over the last few years, and we sort of finished that up last summer. And so that was really the biggest sort of thing, biggest project we've been working on for a while in terms of building out. We'd had private credit for a while. We've added a bunch of different interesting stuff in real asset space. So we have cattle feedlots. We have grain elevators up and down the Mississippi. Railcars, shipping containers. So we have a very - musical royalties. We have a very eclectic mix in sort of the real asset bucket. And then we've added, private equity is really the latest addition. For a while, we sort of barbelled it a little bit. So we started out buying private equity firms that the GP stakes. So like the Dials of the world where they're buying stakes in private equity firms where you get participation. You get the management fee and you get participation in the carry, and then you also get participation in the funds via balance sheet investments. And we'd want to own the really big asset aggregators in that space. But then on the other side, we've put this innovation theme in that has blockchain. It's artificial intelligence, machine learning, deep tech as well. National and cyber security and then life sciences. And so those are the four innovation themes we've really targeted. And then we're working with much smaller managers, much more concentrated in those defined buckets. And those funds tend to be smaller. And let's say it's a $100 million fund. We walk in with a $30 million check. We can really get good economics as well to go along with that. So we're getting the exposure we want. We're getting at a price we want. And so that's where we've really been concentrating. Sort of looking forward, I think we're pretty done. But it's a very challenging environment right now. I mean, I think you've all heard about the denominator effect, right? So all those privates have really sort of maintained on a relative basis. Some value versus the public markets, which all have dropped, right? Including bonds. And so you've got this crazy sort of dynamic right now where

everything that's illiquid is overweight, and it's still calling capital. And then everything that's underweight right now is your public portfolios. And so from sort of a portfolio management perspective, it's really actually a bit of a logjam. It really sort of ties your hands a little bit because you might not be as nimble as what I know we would certainly like to be. Because historically, we've been very active in sort of downturns in terms of pivoting and making really good moves. But in this environment, we've just been a little bit more handcuffed, and that's a very big determining factor in terms of, we don't really feel like we can do a whole lot right now because of just the way that the portfolio structure is just by happenstance.

Robert Morier: Expanding a little bit on venture capital, it sounds like you do the early stage. And I also know that you had invested in some managers that do GP staking as well in businesses. Could you just talk a little bit more about, you mentioned privates being an area that was of a recent opportunity. But as you think about, maybe thinking about that alpha classification. So a little bit less privates, a little bit more on the hedge fund side. You had mentioned hedge fund alpha and then the other being manager alpha. So when you roll those up, how do they interact with each other from a performance and allocation perspective?

Andy Spellar: Yeah, I mean, I've looked at that and how those behave generally through the business cycle. And just generally, they will act not quite as much. You do get alpha in sort of crisis situations from a lot of managers, some managers, and we try to look for those that will protect you on the downside. But we also look to try and diversify our alpha streams as much as possible. So we'll look at the correlations of alphas when we're looking at active managers in a bucket. That's one of the places we'll start when we're looking for managers. So what are the alphas that we have? And then let's try and identify something that is differentiated from that right from the start. So a little less performance-oriented and more looking at the alpha and how that might fit into the portfolio because we're always looking for just further diversification. But generally, alphas as a whole, and this is true for hedge funds and sort of active management, tends to do a little better when things are good and not quite as good when things are bad. So you sort of set yourself up to be a little disappointed, but you can work on that pretty hard. But just I think in general, it's sort of like a 60/40 rule is the way that we think about it is that 60% of the time the manager's going to do well when things are going well. And then 40% of the time, you're going to get managers that outperform on the downside. So you've just got to try and get the right mix. Obviously, 50/50 would be great, but it's hard to get to. I think a lot of people just have processes that lend themselves to doing sort of well when things are going well. They ride that wave, right? But that's one of the reasons we don't have a traditional fixed income bucket. So a long time ago, you sort of blew up the core fixed income process. We had, I think, three or four core fixed income managers. They all had tracking errors of about 1.5%. You paid them 40 basis points and they earned you 30. And the "alpha," quote, unquote, was 90% correlated to

credit. And so everything worked great until credit didn't, and then you'd suffer the consequences. And so we looked at that and just said, that works for somebody, but it doesn't work for us. And what we tried to do is come up with some sort of ratio where we'd get to keep 70% of the profits and the manager gets 30%. And that's kind of the way that we've sort of thought about it. And that structure didn't work. So a long time ago, what we did is we sort of blew up fixed income. We took just different segments of the fixed income arena. So corporate credit. We only do high yield because it is, we get bang for our buck there and we can manage that as a separate exposure. We have a mortgage manager. We have a duration manager. We have a structured credit manager. And so we have specialists in each one of these sectors as opposed to trying to hire somebody to do a core fixed income portfolio. So all those things have a lot more tracking error, but they are diversifying in and of themselves. And so when you put that together, I think we've had Lehman ag by probably like 300 basis points. And that's a combination of just having higher returning assets and then the value added that those managers have added because they all have relatively high tracking errors. And so our fixed income portfolio has really done extremely well over probably, that was probably 2006 I think we did that. So, 2005. So it's been a long track record of doing well in that space. Again, we're just trying to make sure that every dollar is earning that cost of capital, right? That's 6.75. And you just can't do that by sitting on, well, you couldn't do it. It's gotten better.

Chris O'Grady: Having said trying to exceed 6.75 and really building on the venture comment, let's talk about what you said earlier in the call about some digital assets. Obviously, there's not a lot of pension, public pension funds. More and more invested in digital assets. Obviously, it's been a great comeback for certain crypto firms. I think there's been probably destruction of some capital, so it's creating more opportunities on the private equity side. But you know, Jim Grant, I've been a follower of Jim Grant for years, and Jim Grant always said, you should allocate something to your portfolio that you might not be super familiar with, but in time get familiar, and that really speaks to digitization. So Andy, you just talked about how you at Fairfax are being one of the leaders and being willing to put up capital in this growth area, which I've done five or six podcasts on digitization, all the way back seven, eight years. I'd love to hear your opinion. It's just wonderful to see somebody willing to embrace a new asset class and obviously suffer the ups and downs, because it's not definitely a frictionless, straight line.

Andy Spellar: Yeah. No, we're either famous or infamous. It depends on your perspective on it. But yeah, we really, so we started this process in 2018 because we had talked to a lot of different folks and really thought about, well, we need to add an innovation bucket to our portfolio. It's equity risk to us, but nevertheless, very concentrated in innovation. And we just happened to be fortunate to get invited to a really good conference called the FTSE Russell World Investment Forum, which is actually more of a, sort of a retreat for a lot of the financial, academic luminaries out

there. And we get to sort of be a fly on the wall. And so one of the things that we did at one of those conferences was attend a session by Cam Harvey who teaches a digital and blockchain technology class at Duke. And up to that point, I'd sort of heard of cryptocurrencies, so to speak, which I think is a terrible misnomer, by the way. So that's the first thing that needs to be fixed is the word currency needs to just go away. But so we thought, I just thought it was fascinating. And you could just sort of see the promise of blockchain technology and the allocation, but in lots of different things. And then when you start to think about, what's the future hold five, 10, 15 years from now? Will more things be digitized than less? And you just think about the arc we've been on already, right? So our thought process is just that everything is going to be digitized at some point in the future. Even traditional stocks and bonds will be digital. Real estate will be digital in terms of the ownership, representation of the ownership of that asset. And blockchain is sort of ideally set up for that. And it looks like it's, to us, it looks like it's very disruptive to sort of the status quo, which we're long in lots of places, right? So we looked at this as sort of a hedge against that. And so we went to this one session by Cam. And then just sort of out of the blue about a couple of months later, I got a call from a manager that, again, knows we're always looking for different, off-the-wall kind of things and said, would you be interested in taking a meeting about a blockchain opportunity fund? And so we were like, yeah, sure. Sat down. Had a really good meeting. Was probably about a two, two-and-a-half-hour meeting. And what came across there was, look, you just really need to think about this as technology. That's what it is. Bitcoin is a database. That's what it is. All of these blockchains are databases. They're secure blockchain or, Bitcoin is sort of the proof of concept of that. We don't view it as digital gold or anything like that. But it's also very clunky and not very useful in lots of other different types of applications. So where the innovation now is moving beyond Bitcoin and developing blockchains that can handle size and scale and sort of the applications that we think will happen in the future. And so that's where we started to invest in. So we've invested in a number of different venture capital funds. Those funds have varying levels to which they could actually invest in liquid tokens or coins, whatever you want to call them. And we've gotten very comfortable that as long as you have the right governance structure in place, those tokens and those coins represent the equity value of that enterprise. And so generally, the way that it works out is we're about 85% invested in private equity of businesses that are working in the blockchain space, and then 15% of it is liquid tokens of varying kinds. I would say about half of that 15% is Bitcoin and Ethereum, and then the other half is a number of different other types of tokens that are liquid or illiquid. And then we've made six different investments in venture capital funds. We did have a hedge fund for a while and we ended up, so really, when FTX sort of went down, you could just tell, and we're very close to the eco space. Everybody knows who we are. And so we just, the feedback was and the obvious statement was that the ecosystem had become very fragile back in sort of November of last year. So we had a hedge fund for a while. We

redeemed that at the end of last year, just because we thought that that space was going to be very tricky for a while in terms of just the ecosystem. And we also had some yield forming that we've pulled back on a little bit as well. But in general, our investments have been up. We're profitable over the four or five years that we've made the investments. The timing on the first couple of funds has been great. And so it's interesting. We've actually made, in the time that we've invested in the digital space, we've made money in our digital asset portfolio and we've lost money in our core bond portfolio, right? So if you're looking at the riskless asset versus the risky asset, we've actually done better in the risky asset. So it generated a lot of publicity, some of it good, some of it bad. Unfortunately, we've had a couple people out there that really have made some outrageous comments about the size and the scope and how we're thinking about this and what we're actually invested in, and that's been a little unfortunate. So we've done a number of town halls with employees and retirees. We actually have retirees thinking that the system was going to go bankrupt because we'd lost all of our money in crypto, right? Which is, that's irresponsible of the people that were out there spreading that.

Chris O'Grady: Misinformation's always the bugaboo for these new ideas. I mean, I think coin volatility and this Bitcoin volatility was less than S&P volatility for a good chunk of last year. And I mean, like anything, we talked about Orange County. We could talk about Silicon Valley Bank. We could talk about FTX. At the end of the day, it's leverage. It doesn't destroy the theme. It doesn't destroy the trends. But you get some bad actors that are just super over-levered, and it just kind of, then you get those comments in the press, which I think are quite foolish. But I mean, it's only going to be growing. I mean, the St. Regis in Aspen that probably people have stayed there, that's digitized. Student housing's digitized. It's more and more, I mean, we're not going to have to worry about where the deed of our house is or our insurance policy. It just makes so much sense. But with change comes friction, comes misinformation. But kudos to you for having the willingness to, I mean, an innovation bucket. There's nothing more innovative.

Robert Morier: What's amazing to me is that 20 years ago, Fairfax was innovating because they were investing in an international equity strategy that included emerging markets. And now 20 years later, here we are talking about digital assets. So it's amazing and a testament, Andy, to you and the innovation that you and your colleagues have incorporated into the plan. So we wish you nothing but the best of luck going forward, and we are very happy for all of the success that you've had in your career. So congratulations.

Andy Spellar: Well, thank you. Appreciate it. It's been a long journey, and at this point, you shaved your beard. I was really looking forward to giving you a hard time about that.

Robert Morier: I was afraid of that.

Andy Spellar: How gray your beard was.

Chris O'Grady: He was, yeah, he looked less venture and less millennial teaching a venture class with your beard. You need a hoodie. And you've got the coat and tie. I feel under-dressed, so I apologize for not dressing up.

Robert Morier: This is counterculture in academia.

Chris O'Grady: And by the way, Andy, just so you know, we've had a bunch of guests just, I mean, obviously, you get a lot of sales people that call on you. But it's just so great to sit here and listen, ask one question and listen. So thank you for the tutelage and the insight because we all need to get better in understanding how investors are thinking. So your wisdom and transparency is well appreciated.

Andy Spellar: I appreciate that. So I've had great mentors along the way, so I've got to give them a lot of credit. But yeah, I think I'm very proud of what we've built here.

Robert Morier: Well, congratulations. If you want to learn more about Andy and Fairfax County's retirement systems, please visit their website at www.fairfaxcounty.gov. You can find this episode and past episodes on Spotify, Apple, Google, or your favorite podcast platform. We are also available on YouTube if you prefer to watch while you listen. If you would like to catch up on past episodes, check us out on our website at dakota.com. And finally, if you like what you're seeing, hearing, please be sure to like, follow, and share these episodes. We welcome your feedback as well. Andy, thank you again. Chris, as always-.

Chris O'Grady: Robert, thank you.

Robert Morier: Pleasure.

Chris O'Grady: Thanks for having me.

Robert Morier: And we'll see you soon, Andy.