

MINUTES OF THE
NEW MEXICO EDUCATIONAL RETIREMENT BOARD
INVESTMENT COMMITTEE

April 22, 2008

CALL TO ORDER

A Regular Meeting of the New Mexico Educational Retirement Board Investment Committee was called to order on this date at approximately 11:05 a.m. in Room 324, State Capitol Building, Santa Fe, New Mexico.

A quorum was present, as follows:

Members Present:

Mr. Bruce Malott, Chair [teleconference]
Mr. Gary B. Bland, Acting Chair
Ms. Jan Goodwin
Mr. James B. Lewis

Members Excused:

None.

Other ERB Members Present:

None.

Legal Counsel Present:

None.

Staff Present:

Mr. Bob Jacksha, CIO
Ms. LeAnne Larrañaga-Ruffy, Investment Officer
Mr. Steve Neel, Portfolio Manager
Mr. Jeffrey Riggs, Deputy Director
Mr. Greg Trujillo, IT Director

Others Present:

Mr. Allan Martin, New England Pension Consultants

APPROVAL OF AGENDA

Mr. Malott moved approval of the Agenda, as published. Ms. Goodwin seconded the motion, which passed by voice vote.

APPROVAL OF MINUTES: March 20, 2008

Mr. Lewis moved approval of the March 20 minutes, as submitted. Ms. Goodwin seconded the motion, which passed by voice vote.

FLASH REPORT, MARCH 2008

Mr. Jacksha reported that returns were slightly negative for the month of March, and some managers had a very bad month, although most of them do better over the longer term. He said one of them, Brandywine, was 120 basis points under the benchmark, but longer term has added about 30 basis points.

Mr. Jacksha said some EAFE shares were sold off in order to rebalance the portfolio, which caused a little bit of underperformance for the month.

Mr. Jacksha stated that, under Fixed Income, WAMCO underperformed by about 200 basis points for the three months. He said the Committee would hear from WAMCO later in this meeting.

Mr. Jacksha reported the REITs had a nice recovery, which carried on into April; they were up almost 680 basis points for March and approximately another 200 basis points for April.

APPROVE PRIVATE EQUITY INVESTMENTS

Mr. Jacksha said the Private Equity Investment Committee reviewed investment recommendations for ComVest Investment Partners III and Clayton, Dubilier & Rice Fund VIII at its April 9 meeting, and heard presentations from Aldus equity as well as the fund principals, but lacked a quorum.

Mr. Jacksha stated that staff recommends approval of both investments, and he asked the Investment Committee to approve these commitments today. He said staff reports on each investment were emailed to Investment Committee members.

1) ComVest Investment Partners, III, L.P.

Mr. Neel reported that ComVest Investment Partners III is a \$400 million fund which operates in the lower middle market, looking for distressed situations and control investments. He said their sector focus is in manufacturing, information technology, healthcare, communication and aviation.

Mr. Neel stated that the recommended commitment by staff and Aldus Equity is for \$25 million.

Mr. Bland moved that the Investment Committee approve a commitment of \$25 million, plus any notional interest, to ComVest Investment Partners III, L.P. The commitment shall not exceed 20% of the committed capital of the Fund and is subject to New Mexico state law, Educational Retirement Board policies, and negotiation of final terms and conditions and completion of appropriate paperwork.

Mr. Lewis seconded the motion, which passed by voice vote.

2) Clayton, Dubilier & Rice Fund VIII, L.P.

Mr. Neel said CD&R is a marquee name in the private equity sector, and Fund VIII is a \$7.5 billion leveraged buyout fund. He said they focus on operational turnarounds; one of their noteworthy investments was Hertz, a corporate orphan from Ford Motor Company.

Mr. Neel said CD&R has been a top quartile performer in five of their seven funds.

Mr. Neel stated that the recommended commitment by staff and Aldus Equity is for \$40 million.

Mr. Bland noted that the SIC approved a commitment in CD&R earlier today after expressing a concern about the increase in size of this fund. He recalled that the ERB Private Equity Investment Committee discussed this, as well.

Mr. Neel responded that, while the Fund has increased significantly in size, so has CD&R's bandwidth.

Mr. Bland moved that the Investment Committee approve a commitment of \$40 million, plus any notional interest, to Clayton, Dubilier & Rice Fund VIII, L.P. The commitment shall not exceed 20% of the committed capital of the Fund and is subject to New Mexico state law, Educational Retirement Board

policies, and negotiation of final terms and conditions and completion of appropriate paperwork.

Mr. Lewis seconded the motion, which passed by voice vote.

WAMCO Performance Review— WAMCO

Mr. Jacksha stated that the ERB has discussed WAMCO's performance before, and has placed them on watch. He said staff has met with WAMCO as required by policy, and thought WAMCO should make a presentation to the Investment Committee.

Joe Carieri appeared before the Committee, distributed presentation materials, and stated that he has been head of client services for public funds at WAMCO for 13 years. He apologized for WAMCO's "fairly dismal performance" for the past nine months.

Mr. Carieri said he would discuss organizational issues and then performance issues.

Mr. Carieri explained that the client service executive who was covering ERB's account since its inception, Andre Cuerington, left a few months ago and joined another investment management firm in Los Angeles, and WAMCO is actively seeking his replacement. Mr. Carieri said he has been assuming responsibility for Mr. Cuerington's account in the interim.

Mr. Carieri said the second organizational item is that WAMCO announced last week that their CIO, Ken Leech, is taking a medical leave of absence to deal with a longstanding throat ailment. Mr. Carieri stated that Mr. Leech will remain as CIO, will be chairing their investment strategy committee meetings, and will continue to provide the macro top-down perspective and outlook he has maintained for the last 18 years. Mr. Carieri said their deputy CIO, Steve Walsh, who has been with WAMCO for 17 years, will assume Mr. Leech's responsibilities in the interim.

Mr. Carieri reviewed a chart of investment results for the past two years. He said almost all of their underperformance has occurred in the last nine months, which has also been very challenging for the fixed income markets as a whole. He said WAMCO's style has always been to overweight spread sectors and to underweight the Treasury sector of the portfolio—and those have been the most adversely affected sectors of the market. He said these include AAA rated government agency guaranteed mortgages, investment grade corporate bonds and agency and non-agency securities.

Mr. Carieri added that performance started to come back in April, however, and there seems to be a sentiment in the market that the worst is over.

Mr. Carieri reviewed a performance attribution chart pinpointing where the underperformance has come over the last quarter. He noted that WAMCO underperformed by 448 basis points. He stated that, while one or two strategies posted very modest positive returns, the meaningful underperformance came in the mortgage-backed allocation, which represented AAA-rated government agency guaranteed mortgages and non-agency mortgages. He commented that WAMCO had a lot of strategies going on in the portfolio to avoid the prospect of having an overwhelming theme impact overall performance; but in this particular case, it was the spread products—investment grade corporates, mortgage and asset backed securities, high yield and non U.S.—that were all negative for this time period.

In reviewing a pie chart of sector allocation in the ERB March portfolio versus that of the Lehman Aggregate Index, Mr. Carieri said the most meaningful in terms of the ERB portfolio are: 1) the overweight to mortgages at 59% versus 44% in the benchmark, and 2) no allocation to Treasuries versus 22% in the Index. Given where interest rates have been lately, with ten years currently trading at 3.71%, he said WAMCO felt there were better chances to add more yield to the portfolio by overweighting some of the spread sectors.

Mr. Carieri assured the Committee that the portfolio has not lost any money; the pricings are mark to markets. He said there is tremendous illiquidity in the portfolio and in the market as a whole, and WAMCO has to rely on pricing sources that are pricing securities in portfolios on a daily basis. He said WAMCO believes that, once transparency and liquidity returns to the market, this portfolio will snap back very nicely; in the meantime, the ERB portfolio is yielding 450 basis points over the Index. He said the ERB has a very high quality, AA-rated portfolio yielding close to 9% in this environment, which is very attractive—it has just been “beaten up a little bit” because of the effects of illiquidity on pricing.

Mr. Jacksha pointed out that there was virtually no spread in the spread sector in late 2007 and early 2007, which created the perception of low risk. He asked Mr. Carieri if it wouldn't make sense, should a similar environment appear in the future, to hold some Treasuries because the risk return ratio might be skewed because there spreads would be low.

Mr. Carieri responded that WAMCO did anticipate a slowdown in the economy going into 2007 and didn't think inflation would be a problem. He said the risk premium associated with that was very tight—people did not anticipate problems on the horizon. Instead of holding Treasuries, he said WAMCO thought it could pick up a little more yield by owning AAA-rated government guaranteed mortgages; and while in hindsight they probably would hold more Treasuries in that situation, they thought they were holding the same risk of a Treasury and would pick up 100 basis

points. He said they didn't really think the housing market was going to blow up the way it did.

Mr. Carieri commented that WAMCO has enough dry powder to make shifts in the portfolio if they think it will be necessary. He said the high yield market right now appears to have the most promise.

Mr. Martin noted that the 59% allocation to mortgage-backed securities in the ERB allocation is after they were crushed, so presumably it would have been even higher had they not been crushed. He expressed concern about risk control with that much invested in a single sector.

Mr. Carieri responded that the 59% represents a combination of agency and non-agency mortgages. He said about 14% is in non-agency mortgages. He agreed that this is heavily weighted, but WAMCO underweighted credit, didn't think emerging markets offered any opportunity, and had a small weighting to non-U.S. and bank loans. He said they were looking for a "safe haven" when they thought AAA-rated mortgages would be the place to be.

In reviewing the ERB's credit allocation, Mr. Carieri noted that WAMCO has a bias toward autos, finance and energy. He said the largest single holding is in Ford Motor Credit (finance arm, not operating arm).

In reviewing non-agency mortgage sub-sector allocations, Mr. Carieri said the ERB is in the senior-most tranche of the capital structure of a deal: it is in the first pay position and is last to realize any losses. He said the securities in the ERB portfolio have not realized any losses or defaults and are all generally AAA-rated high quality deals and include mortgages underwritten before 2006.

Mr. Bland asked if the bids for these securities are starting to firm up, and Mr. Carieri responded that WAMCO is seeing a bit more flow starting at the senior tranches down into subordinate tranches, but they are still trading anywhere from 95 cents to 70 cents on the dollar.

Mr. Bland asked when WAMCO thinks pricing will firm up, barring any natural disasters, and Mr. Carieri responded that things should return to where they were in the next 12 to 18 months. He added that WAMCO is launching a levered distressed mortgage fund for some of its more aggressive clients who see some opportunity going forward. Addressing lessons learned, he said there will be less inventory coming into the market because of tightened credit criteria.

Mr. Lewis asked Mr. Carieri if the Investment Committee should have some hope that WAMCO will be able to turn things around, and Mr. Carieri asked the Committee to bear with WAMCO and let things work themselves out. He

commented that WAMCO believes the portfolio was built on sound risk controls and good value fundamentals.

Mr. Lewis asked what period of time WAMCO is talking about, and Mr. Carieri responded that they hope to see the portfolio start to turn around by the end of the year, and in the next 12 to 18 months they expect to start producing returns the ERB is used to seeing.

Mr. Jacksha noted that, as of yesterday, WAMCO was about 120 basis points over the Index for April.

Mr. Carieri responded that, annualized, that is meaningful outperformance including the 450 basis points in excess yield that the ERB is currently earning over the Lehman Aggregate.

Mr. Carieri said WAMCO is “sticking to its knitting” and its research team is on top of what is happening.

Mr. Martin reiterated that he was somewhat disappointed that the mortgage investment was the “best and almost risk free” opportunity WAMCO had in the portfolio, and then the degree to which WAMCO allowed it to grow was also troubling to him. He added, though, that he recognized that WAMCO has stuck to its style and that this is more of a liquidity issue than an asset return issue.

Mr. Martin said the issue of Andre Cuerington’s departure is of some concern—could he be the so-called canary in the coalmine. He commented that WAMCO has been through a very bad period performance-wise. He asked if this is having an impact on bonuses and morale, and might WAMCO face some loss of investment personnel.

Mr. Carieri responded that there have not been any departures either on the client service marketing or portfolio management team side. He stated that morale is surprisingly good—a number of people in the firm have been there for many years and experienced similar downturns in the market in 1998, 2001 and 2004 and recognize that there can be good years and bad years.

Bonus-wise, Mr. Carieri said they are paid based on a three-legged stool: how the firm did overall; how the staff did with respective performance; and how they did as individuals. He commented that WAMCO is “managing expectations” in terms of paying bonuses.

Mr. Jacksha asked Mr. Carieri what the effect has been on WAMCO’s assets under management, and Mr. Carieri responded that they were down just \$2 billion quarter over quarter, but that was from performance and not from any terminations.

Mr. Bland commented that he saw this kind of market in the early 1980s and again in 1987, and was guessing that bids on average would be up 20% by the end of this summer.

Mr. Jacksha said he agreed with WAMCO's premise that spreads will rally back in 12 to 18 months and the ERB's portfolio performance will rally along with it.

Mr. Jacksha added that, longer term, the ERB needs to think about the overall composition of its fixed income portfolio,

Mr. Jacksha recommended no further action regarding WAMCO at this time.

Mr. Martin concurred with Mr. Jacksha.

OTHER INVESTMENT REPORTS

Mr. Jacksha reported that the top two people on the Barings international team have left the firm. He said one of them found an opportunity in Thailand, where he owns a home. He said Barings takes a team approach, and no action is recommended at this time. He noted that their April performance was very good.

Mr. Martin stated that, of the 60 analysts around the world who generate the ideas, these were the two who assembled it all. He commented that they have a replacement individual, and NEPC is disappointed. He said it is costly, however, to terminate someone in the international markets and find someone else. For all of these reasons, he said, NEPC recommends watching them carefully and not terminating them.

Mr. Jacksha reported that, in the new asset allocation, Emerging Markets is being moved from 3% to 10%, and an RFP will be issued this Friday for a core emerging markets manager. He said staff plans to put 4% of the 10% with the core manager and increase both value and growth to 3% each. To fund it, he stated that International EAFE will be reduced by 5 points down to 10%, and about 2 points will come from Domestic.

Mr. Jacksha stated that Goldman Sachs' contract is coming up June 30, and staff will recommend extending it at tomorrow's Board meeting.

OTHER INVESTMENT REPORTS

Mr. Martin reported that, through February for one year, the Lehman Aggregate was up 7.3%, so bonds have done well because interest rates have come down. He said 90 Day T-Bills +2 would bring that to 6.94%, so strategy-wise the allocation to absolute return has been about even with bonds in a period that has favored bonds.

From an execution standpoint, Mr. Martin said the portfolio is at 4.37%, lagging the index, which can be traced to two managers: 1) HFV, which is down 8.23% on the year, and Mr. Neel has put in a redemption order; and 2) Gottex, which is down 60 basis points on the year.

Mr. Martin said February was a positive month with the exception of HFV.

Mr. Jacksha commented that, in general, the absolute return strategies have done well; they are one of the best sectors in the portfolio.

Mr. Jacksha reported that the ERB will be selling about \$175 million of the EAFE portfolio in order to rebalance the portfolio to the policy asset allocations.

ADJOURN

Its business completed, the Investment Committee adjourned the meeting at approximately 2:50 p.m.

Accepted by:



Mr. Gary Bland, Acting Chair