

ACTION SUMMARY
NEW MEXICO EDUCATIONAL RETIREMENT BOARD

SPECIAL MEETING

January 11, 2010

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MINUTES OF THE
NEW MEXICO EDUCATIONAL RETIREMENT BOARD

SPECIAL MEETING

January 11, 2010

A Special Meeting of the New Mexico Educational Retirement Board was called to order on this date at approximately 2:00 p.m. in the Educational Retirement Board Room, 6201 Uptown Boulevard, N.E., Ste. 203, Albuquerque, New Mexico.

ROLL CALL – QUORUM PRESENT:

Members Present:

Mr. Bruce F. Malott, Chairman
Ms. Mary Lou Cameron, Vice-chair
Mr. H. Russell Goff, Secretary
Mr. James B. Lewis
Dr. Gautam Vora
Dr. Beulah Woodfin

Members Excused:

Dr. Veronica Garcia

Legal Counsel Present:

Mr. Chris Schatzman, General Counsel

Staff Present:

Mr. Mark Canavan, Portfolio Manager
Ms. Jan Goodwin, Executive Director
Ms. Linda Kissko, Executive Assistant
Mr. Steve Neel, Portfolio Manager
Mr. Jeff Riggs, Deputy Director
Mr. Boris Wessely, CIO

Others Present:

[See sign-in sheet]

APPROVAL OF AGENDA

Mr. Lewis moved approval of the Agenda, as published. Mr. Goff seconded the motion, which passed by voice vote.

ADMINISTRATIVE AUDIT REPORT: ENNIS KNUPP

Raúl Burciaga, Assistant Director of the Legislative Council Service, said this review was requested by the Legislative Council and was funded by the Legislative Council and the State Board of Finance. He said Ennis Knupp & Associates (“EnnisKnupp”) was selected as contractor, represented today by Jeanna Cullins, Mike Sebastian and Nancy Williams. He said Ms. Cullins and Ms. Williams, attorneys with more than 25 years of experience, head up a 12-member fiduciary team and are the co-leaders of this project; and Mr. Sebastian is the leader of the investment policy practice at EnnisKnupp and is a peer reviewer of the analyses and recommendations of the report. He said the team has experience with state investment boards in several states.

Mr. Burciaga said he realized ERB members would have preferred receiving copies of the report prior to this morning. He added, however, that Ms. Goodwin and her staff received copies of the draft reports earlier for review and fact checking.

Ms. Cullins thanked staff for the quick turnaround of requested documents and for their cooperation.

Ms. Cullins said today’s presentation would provide a “Cliff Notes version” of their report and would highlight some of the recurring themes identified in the report. She said they would also discuss key recommendations that EnnisKnupp feels the ERB should focus on first.

Ms. Williams discussed the framework and scope of the review.

Ms. Williams stated that EnnisKnupp compared the ERB’s Board Policies and Procedures with what they consider to be a very good checklist for a board governance manual, “and we were very favorably impressed. It was better than most that we see.”

Ms. Cullins and Ms. Williams highlighted the findings and recommendations identified in the review.

The need for more clarification regarding roles and responsibilities.

Ms. Cullins said contracts should be amended to reflect that consultants to the ERB—even though they work with and interact with staff—work for the Board.

Ms. Cullins said statute should be amended to include a definition of who is a fiduciary. She noted that the Constitution refers to the fact that board members are fiduciaries and have fiduciary duties and responsibilities, but there is no definition

that extends to others, i.e., if someone has discretionary authority and control over the assets or administration of a fund, they are also deemed a fiduciary.

Ms. Cullins said the ERB should develop a responsibility matrix. She said the report Appendix sets forth several duties and responsibilities that are related to the administration of a fund.

Ms. Cullins said EnnisKnupp recommends that the ERB develop a committee chart setting out the duties and responsibilities of the Audit Committee, Investment Committee and Evaluation Committee vis-à-vis the Board and staff.

On that note, Ms. Williams suggested beefing up the information already included in the Board Policies and Procedures, so the committees would understand exactly what their authority is, e.g., do they have the right to engage outside service providers themselves, and who would they report to, etc.

Ms. Cullins stated that the current position descriptions of the Executive Director and CIO should be enhanced.

Ms. Cullins said there is also a need for enhancement with respect to asset management. She said this doesn't mean the ERB isn't doing a good job in numerous areas, and those areas are noted in the report; for example, the process the ERB uses to set its asset allocation is consistent with best practices. She said EnnisKnupp highlights some areas where they feel the ERB could enhance its investment operation; for example, one recommendation is that the ERB conduct an asset liability study.

Mr. Sebastian said he understood the ERB does asset liability studies every three to five years, and they recommend that the next one be done in 2010.

Ms. Cullins said EnnisKnupp recommends that the ERB complete a review of its equity and fixed income structure.

Ms. Cullins said EnnisKnupp recommends periodically evaluating the cost benefit of internal management—while there is a benefit through cost savings, the ERB should determine whether it is getting the type of performance it needs, what the savings are, and whether it is being done as effectively and efficiently as it could be as opposed to using outside management.

Ms. Cullins noted that staff has authority with respect to tactical asset allocation, which is an area of potential risk. She said EnnisKnupp therefore recommends revisiting the discretion that has been given to staff in that area.

With respect to the rebalancing process, Ms. Cullins said the ERB currently has very wide ranges around its asset classes, and EnnisKnupp believes these ranges should be tightened.

The need for ongoing trustee education and training.

Ms. Cullins noted that the ERB currently participates in trustee education and training, and EnnisKnupp feels there should be a statutory requirement for new trustee orientation, as well as to increase the number of required hours for ongoing training. She said an amendment was recently passed that would require eight hours of training.

Ms. Williams said EnnisKnupp realizes the ERB Board is “far beyond that.” She said the recommendations are meant to nudge the ERB toward either putting it in policy or statute and requiring this so that future boards keep up with this as well as the current Board does. She remarked that the existing ERB Board is unusual in this respect, with Board members taking the time and trouble to take CAPP program classes.

Ms. Williams stated that EnnisKnupp continually stresses new board member orientation because, under the law, a Board member becomes a fiduciary the moment they join the Board. She said there is a very high prudent expert standard from day one, and best practices now are for orientations that last a day and a half to two days.

Ms. Cullins said having it in policy and statute makes it much easier to respond to the need for trustee expertise. She said legislators also need to understand the intent behind the Prudent Investor Act, where Board members themselves don't have to be an expert, but if they are not experts, it is incumbent upon them to hire experts to facilitate decision-making.

The need for added authority for the members.

Ms. Cullins said EnnisKnupp believes the Board should have the authority to hire and fire its own custodial bank, which function is currently performed by the State Board of Finance. She commented this can create serious problems when the Board is forced to change custodians when it doesn't want to change custodians.

Ms. Cullins also stated that the Board should have the authority to establish its own budget, decide what and how many staff it should have, as well as procure its own goods and services without having to go through the governmental process. She said the appropriations process can be extremely helpful, but non-fiduciaries are controlling the decisions of fiduciaries, and the assets are coming out of trust fund assets and not from the general fund. She said the fiduciaries should make the decisions regarding how those assets are spent.

This concluded Ms. Cullins's presentation of EnnisKnupp's "higher level" recommendations.

Mr. Burciaga said these recommendations about budget autonomy are not expected to go over well with the Legislature. He stated that he asked Ms. Williams and Ms. Cullins early in the process to report on what other states do this successfully, and they have provided a supplemental report on how that can be done while still giving the Legislature the oversight and accountability it would want.

Mr. Malott asked if the Legislature might be amenable to giving the Board authority to hire and fire its own custodial bank, and Mr. Burciaga said he didn't know how the Legislature would feel about that, but legislative members of the Investments Oversight Committee would probably have questions. He said he suspected the Board of Finance would have a bigger problem with it than the Legislature. He stated that it might make sense to have a separate standalone authority body without fiduciary responsibility but with the ability to provide advice to the ERB Board, PERA and SIC. He said such a body, in addition to the oversight body, would provide the balance that the Legislature would probably want.

Mr. Malott asked for comment from EnnisKnupp on the ERB's placement agent/third party marketer policy.

Ms. Williams responded that this is a big issue for everybody. She said their position as a firm is that disclosure cures 90 percent of the conflicts of interest. She said they do not recommend a ban.

Ms. Cullins said third party marketers, with the appropriate qualifications and appropriate oversight and appropriate disclosure, can provide a very useful function. She stated that EnnisKnupp includes a recommendation that the ERB might want to use an external independent third party to do those evaluations, rather than having the Board or staff do them. She said it helps to mitigate claims of conflict or the appearance of conflict by having an external party do them, provided the external party doesn't have conflicts.

Ms. Cullins and Ms. Williams agreed to review the ERB's placement agent policy and provide comments later.

Mr. Lewis expressed concern about the ability of the Board to appropriately delegate responsibilities while maintaining its fiduciary duties, to enhance its authority and meet all of the other responsibilities as recommended by EnnisKnupp, given that it meets only every two months.

Ms. Cullins said the matrix provided in the report will facilitate the process. She said board micromanagement is not something EnnisKnupp endorses, but they still

feel the Board has to be engaged in an oversight process. She stated that Board members should receive the types of documents that allow the Board to know whether or not the authority it has delegated is being prudently carried out. Once the Board sets the policy, she said it is then important that the Board periodically review it. With respect to functions, she said people often think they know who is responsible for what function, but authority sometimes gets delegated in a de facto manner, so staff will take on a responsibility but the Board may not know about it. She said using the accountability matrix in the report helps facilitate an open discussion and heightens awareness of who is doing what.

Mr. Goff asked if the increasing complexity of investments warrants more frequent Board meetings, or is it sufficient for the Board to continue meeting every two months.

Ms. Williams responded that it is common to see boards meet eight to twelve times a year. She said some boards are required to meet twice a month, which EnnisKnupp sees as serious micromanagement.

Dr. Woodfin said legislation is being proposed that would alter the size and composition of the ERB Board, and would reduce the proportion of constituent-selected members and increase the number of appointed members. She asked how EnnisKnupp sees this as fitting in with best practices.

Ms. Williams responded that this type of legislation has been proposed all around the country ever since the stock market began having problems, because legislators and policymakers think that changing the composition of a board will somehow fix bad performance. She said there is no study showing that an appointed board gets a higher rate of return with less risk. She stated that orientation, ongoing education and a solid understanding of fiduciary duty leads to better performance.

Dr. Vora asked if EnnisKnupp has a list of best practices followed by funds of a similar size to the ERB, and Ms. Cullins responded yes. She added that she and Ms. Williams are very aware of the practices of pension funds, retirement systems, investment boards and corporate boards across the country, and recognize that a best practice for one organization may not be a best practice for another organization.

Referring to a chart of budget amounts requested and approved (page 23), Dr. Vora asked if there is comparable data for similar size funds, whether state, city or corporate.

Ms. Williams responded that EnnisKnupp uses the CEM (Cost Effectiveness Measures) database. She said CEM looks at the complexity of a program and does it with more precision than anyone else. She added that there was nothing in the level of ERB's budget that was of any concern to EnnisKnupp.

Ms. Goodwin added that the ERB used CEM to do a report for the June 30, 2008, year, and everything was very much in line.

Dr. Vora referred to the list of references in the footnote on page 1 and suggested requiring that all of the trustees obtain Fiduciary 360 AIF certification.

Ms. Williams said that was fine, although the CAPPP program is more extensive. She said EnnisKnupp would add the Fiduciary 360 certification to the list.

Mr. Malott commented that the Board has unofficially adopted the CAPPP program, and many of the existing Board members have taken it.

Mr. Malott asked EnnisKnupp how the ERB compares to other funds of a similar size, and Ms. Cullins responded that they found no smoking guns or anything they thought presented a lot of risk, with the exception of the wide ranges around its asset class targets and its use of tactical asset allocation by the staff.

Mr. Sebastian added that they would advise the ERB to take a look at how its internally-managed index funds are being managed, and whether the tracking error that exists in those funds might be expected to persist in the future for adding significant additional assets to it.

RESCHEDULING OF JUNE 11, 2010, BOARD MEETING

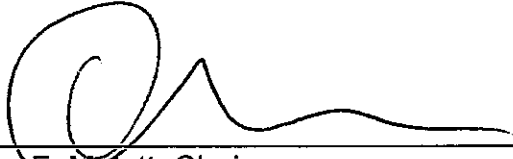
A revised Board meeting schedule was distributed.

EXECUTIVE SESSION

None.

ADJOURN

Its business completed, the Educational Retirement Board adjourned the meeting at approximately 3:10 p.m.

A handwritten signature in black ink, consisting of a large, stylized 'B' followed by a series of connected loops and a long horizontal tail.

Bruce F. Malott, Chairman

ATTEST:

Dr. Beulah M. Woodfin, Secretary