

MINUTES OF THE
NEW MEXICO EDUCATIONAL RETIREMENT BOARD

SPECIAL MEETING

January 12, 2007

A Special Meeting of the New Mexico Educational Retirement Board was called to order on this date at approximately 9:00 a.m. in the Educational Retirement Board Room, 6201 Uptown Boulevard, N.E., Ste. 203, Albuquerque, New Mexico. A quorum was present.

1. ROLL CALL – ASCERTAIN QUORUM

Members Present:

Mr. Bruce F. Malott, Chairman
Mr. Gary B. Bland, Secretary
Ms. Mary Lou Cameron, Vice- chair
Dr. Veronica Garcia
Mr. James B. Lewis
Dr. Pauline H. Turner

Members Excused:

Mr. Delman Shirley

Legal Counsel Present:

Mr. Robert Shulman, Staff Attorney

Staff Present:

Mr. Jeffrey M. Riggs, Deputy Executive Director
Ms. Jennifer Dunstan, Public Relations Director
Mr. Frank C. Foy, Deputy Chief Investment Officer
Ms. Shari LaCome, Executive Admin. Assistant
Ms. LeAnne Larrañaga-Ruffy, Investment Officer
Mr. José Martinez, IT Director
Mr. Steve Moreno, Director, Member Services
Mr. Steve Neel, Portfolio Manager
Mr. Greg Trujillo, IT Network Specialist

Others Present:

Mr. Bob Jacksha
Mr. Allan Martin, New England Pension Consultants
Ms. Judith Beatty, Recorder
[Also see sign-in sheet]

[The agenda was reprioritized.]

**2. OATH OF OFFICE FOR NEW *EX OFFICIO* BOARD MEMBER:
STATE TREASURER JAMES B. LEWIS.**

Mr. Lewis was sworn in by Secretary of State Mary Herrera.

a. Approval of Agenda

Dr. Turner asked why there was nothing on the agenda regarding the search for a new Executive Director, and Chairman Malott responded that he thought that was contemplated in Appointment of Acting Executive Director.

Dr. Turner requested that this item include discussion on the search for a new Director.

[Action on Approval of Agenda was deferred pending the arrival of Dr. Garcia and Mr. Bland.]

3. INVESTMENT COMMITTEE APPOINTMENT — CHAIRMAN MALOTT

Responding to questioning from Mr. Malott, Mr. Shulman stated that, according to Investment Committee rules, the chair is elected and not appointed.

Mr. Malott recommended the appointments of the following members to the Investment Committee:

Gary Bland
James Lewis
Bruce Malott
Acting Executive Director

Ms. Cameron moved these appointments. Mr. Lewis seconded the motion, which passed by voice vote. [Mr. Bland and Dr. Garcia were not present during this action.]

4. APPOINTMENT OF ACTING EXECUTIVE DIRECTOR — CHAIRMAN MALOTT

Mr. Malott noted that Dr. Hunemuller took retirement effective January 5, that Mr. Riggs has been acting Executive Director since then, and following discussion

with counsel, he thought it advisable to appoint an Acting Executive Director to officially fulfill those duties.

Ms. Cameron moved the appointment of Jeffrey Riggs as Acting Executive Director. Mr. Lewis seconded the motion.

In response to questioning from Dr. Turner, Mr. Shulman clarified that there was actually no requirement for the Executive Director to be an ERA member, although that has been the practice for a while.

The motion passed by voice vote. [Mr. Bland and Dr. Garcia were not present during this action.]

Presentation of plaque honoring service of Dr. Evalynne Hunemuller

Ms. Cameron read the inscription on a plaque to be presented to Dr. Hunemuller, who could not be present to receive it. Ms. Cameron said Dr. Hunemuller was involved in professional development which prevented her attendance.

[Dr. Garcia and Mr. Bland joined the proceedings.]

a. Approval of Agenda (Cont'd)

Ms. Cameron moved approval of the agenda, as amended. Dr. Garcia seconded the motion, which passed by voice vote.

b. Approval of Minutes: December 8, 2006

Mr. Lewis moved approval of the minutes of the December 8 minutes, as submitted. Dr. Turner seconded the motion, which passed by voice vote.

c. Introduction of Guests

Mr. Riggs introduced guests.

5. GOVERNANCE AND ORGANIZATIONAL STRUCTURE DISCUSSION — CHAIRMAN MALOTT

Mr. Malott distributed a “Proposed Educational Retirement Board Reporting Structure” organizational chart. He said he developed this chart following discussion with NEPC advisor Allan Martin and later with auditors Deloitte & Touche.

Mr. Malott stated that, for at least the last ten years, the Executive Director has been very involved in the investment function of the Board, so much so that the CIO has reported to the Executive Director, and he believed that was an inefficient and ineffective way to run the organization.

Mr. Malott said his proposed structure would have the Investment Committee on the asset side of the organization (reporting to the ERB), with the CIO reporting directly to the Committee, the Deputy CIO under that, and then the traditional investment people in the organization under that.

Mr. Malott stated that the Executive Director and Deputy Executive Director would report to the Board, and under those functions there would be Member Services, Financial Services, Legal Services and IT. He said these offices would be managing the liability side of the organization through relationships with the actuary, Legislature, benefits, etc. — in other words, anything that would increase the liabilities of the Fund would be the responsibility of the Executive Director.

Mr. Malott said the Executive Director would also be responsible for constituent satisfaction. He pointed out that, during his years as a member of this Board, he has never seen a survey of constituency satisfaction with the Fund’s performance on the service side. He said he would like to see a survey done annually with people just coming into the system — how they were treated in the application process, etc. — as well as with the existing constituency.

Mr. Martin stated that Mr. Malott forwarded this proposed structure to him last week and asked him to prepare comments. He said he would address this in three contexts: what is common practice among teachers’ retirement systems in public funds in general; what is best industry practice, and where should the Board divide responsibilities from a managerial design perspective?

Mr. Martin said that, while it is common industry practice in public funds to have an executive director to whom a chief investment officer reports, those public funds that have been moving most rapidly into alternatives and expanding the scope of their investment activities have adopted systems that are much more oriented toward a separation of the duties between the executive director and CIO.

Mr. Martin noted that South Carolina recently set up a separate commission headed by their state treasurer; an appointee of the governor, and one appointee each from the house and senate side of their legislature, all of whom are required to have definitive educational and experience requirements in terms of investment knowledge. He said the Teacher Retirement System of Texas has just hired Britt Harris, former CIO at both GTE and Verizon, as their chief investment officer.

Mr. Martin reiterated that those funds that are among the best-managed have been moving toward this separation of duty between an administrative head who is focused on the issues of business management, actuarial and payment management, and a chief investment officer who focuses exclusively on investment matters.

Mr. Martin stated that endowment funds over the last 5-10 years, particularly Harvard, Yale, Stanford and UTIMCO (University of Texas Investment Management Company), have moved to structures where there is an oversight investment committee and a chief investment officer who reports to that committee.

Mr. Martin commented that at the end of the day, the teacher getting their check on time, knowing about their benefits and being able to access that information, and knowing that the monies are accounted for and processed to the penny, is a hugely important function which is very different from that on the investment side.

Addressing managerial design, Mr. Martin stated that the Board is no longer dealing with just domestic equities, domestic bonds and international stocks; now it is in real estate, hedge funds and private equity, and it will soon be confronted with infrastructure investing, commodity investing and other new instruments that are being created to take advantage of new markets. He commented that it would be a very rare individual indeed who would be able to focus on these complex and evolving investment strategies and at the same time oversee the managerial functions of the organization.

Mr. Bland noted that, in corporate America, the CIO ordinarily reports directly to the board through the CFO or chairman, and the management/human resources side is handled by a vice president as a separate function.

Dr. Turner spoke against this proposed structure. She pointed out that the Educational Retirement Fund is not an endowment fund, a bank, or a corporation, and she found it impossible to imagine serving on a board where the executive director had no knowledge about the investment side of the organization. She said she also couldn't imagine working in an agency where one's supervisor is a committee whose members have nothing to do with the day-to-day function of the agency or its workers.

Dr. Garcia suggested that the structural chart be redesigned so it would accurately reflect, as intended, that the Investment Committee would report directly to the Board.

Dr. Garcia said she thought the next five years would be tumultuous ones for the new Executive Director. She pointed out that there is increasing debate about the issue of retirement benefits in this country's various educational systems, and the new Executive Director will probably have to spend a lot of time in focus groups, working with political processes, and dealing with changing benefit scenarios. She said trend analyses reflect that, in the future, the ERB will not be able to afford the same kind of retirement system that is now in place; and while the Board has done a little tweaking to make the system sound, it hasn't talked about the benefits side and the changes that will be necessary.

Dr. Garcia stated that, if this proposed structure were to be adopted by the Board, the Board would have to be very clear in terms of job description, reporting and accountability so there would be no confusion later on down the road.

Mr. Lewis stated that he recently attended an orientation for newly elected treasurers where there was extensive discussion about the liability side of pension funds and what may be required. He said they also had an entire panel from the rating agencies. He commented that there would obviously be continued discussion on this topic in the future.

Mr. Lewis also stated that he recently sat before the legislative oversight committee that deals with investments and pension funds, and they are talking about requiring membership on the boards to have at least five years of financial experience.

Mr. Lewis commented that the world is changing, and he thought it very timely for the Board to look at the organizational structure while conducting its search for an Executive Director and developing a job description that would fit that. He suggested that the Board not rush into anything but take the time to look at the structure comprehensively and solicit input on it.

Mr. Lewis stated that he recently separated duties in the State Treasurer's Office so there is a chief investment officer who deals with investments and a cash manager who works with the state agencies to make sure cash is coming in.

Ms. Cameron said she thought this discussion a good start, but there were a number of questions to be answered, and she hoped the Board would not hurry into a decision.

Ms. Cameron wondered, for instance, how differences between the Executive Director and CIO would be resolved under the new structure. She also asked

whether it would create a conflict in the future to have the Board and Investment Committee chaired by the same person.

Addressing Dr. Turner's earlier remarks that the Executive Director would not know what was happening on the investment side of the organization, Mr. Malott clarified that the Executive Director would be on the Investment Committee.

Mr. Malott said obviously a search for Executive Director could not begin until the new structure was agreed to, and he would welcome further input.

Mr. Malott stated that it would be unrealistic to ask an Executive Director to have expertise in an increasingly complex world of investments while focusing on the infrastructure of the ERB organization. He said the auditors told him yesterday that the ERB organization has internal control problems as it relates to investments because there is not a sufficient level of sophistication on the investment side.

Mr. Bland stated that retiree health will become a huge issue in the very near future, and the ERB's Executive Director will have to become involved in that. He said the ERB's actuarial and funding issues are not resolved, either, and this individual will not have time to attend every seminar on whatever new investment structure or equity investment is out there.

Mr. Bland said the ERB Fund will increase in ten years to \$20-\$25 billion without increased funding, and the Board has the choice of continuing with an increasingly antiquated system or else deciding to move forward into a cleaner and tidier structure.

Dr. Turner stated that she didn't disagree with any of the discussion about thinking this through very carefully, and what the organizational structure should look like. She said clearly it was time to do that, now that she had listened to the points raised. She added, though, that there are other organizational structures that might be just as efficient or better, and she hoped the Board would consider them.

Mr. Lewis stated that compensation would be a very important component of any national search for the Executive Director and would have to be high enough to motivate someone to relocate here.

Mr. Malott said the next agenda would not preclude the opportunity for the Board to take action on beginning the search for Executive Director. He said the Board would then have the choice to act or not to act at that time.

6. INVESTMENT REPORTS

a. Absolute Return Funding Update — Frank Foy

Mr. Foy reported that the ERB funded three hedge fund-of-funds in November for \$250 million, and had three more to fund in December. He said staff was successful in closing those deals as follows:

Benchmark Plus \$100 million (12/29)
HFV & TAG \$ 25 million each (12/28)

Mr. Foy said there was now a total of \$400 million invested in the absolute return strategy.

b. Commission Recapture RFP Update — Frank Foy and LeAnne Larrañaga-Ruffy

Mr. Foy stated that Ms. Larrañaga-Ruffy is now working full-time in the Investment Department and will be running the index funds (S&P 500 Index and REIT Fund), now that Margie Homko has retired. He said Ms. Larrañaga-Ruffy and Ms. Homko both managed the commission recapture RFP, and a memo has been circulated to the Board members today outlining the procedures that were followed and the finalists who were reviewed.

Ms. Larrañaga-Ruffy presented an overview and stated that there were six respondents to the RFP that staff and NEPC narrowed down to two submissions: State Street Global Markets and CAPIS.

Ms. Larrañaga-Ruffy reported that State Street was selected because they offered the highest rebate of 90%, returning the highest income to the ERB.

Ms. Larrañaga-Ruffy stated that, based on current commissions, ERB staff estimates that this program, which will begin February 1, 2007, could bring in \$225,000 annually to the ERB.

c. **Private Equity Investment Committee Recommendations — Steve Neel**

Mr. Neel reported that the Committee heard presentations from Aldus Equity on two investments, and the general partners from each fund also gave presentations.

i) **Perseus Partners VII, L.P.**

Mr. Neel stated that Perseus Partners is a \$1 billion middle market buyout fund focusing on consumer products, business services, energy and biotech. He said that, while Aldus was the primary driver of the due diligence process, staff also reviewed investment memoranda and offering documents and conducted conference calls with the GPs.

Mr. Neel said the consultant, staff and Committee recommended a \$15 million investment in Perseus Partners VII.

ii) **Levine Leichtman Capital Partners Deep Value Fund**

Mr. Neel stated that LLC Deep Value Fund is a \$500 million distressed debt fund, focusing on middle market. He said Aldus did most of the due diligence, although staff also reviewed offering documents and investment memoranda, and had considerable discussion with the GPs via conference calls.

Mr. Neel stated that, notably, LLC Deep Value Fund will generate current income and help mitigate the J-curve effect, which was discussed by the Investment Committee. He said LLC has \$43 million already deployed at 70 cents on the dollar, and the Investment Committee recommended an investment of \$20 million in this Fund.

Dr. Turner observed that the Private Equity Investment Committee agenda included discussion on private equity investment procedures; however, the Board has not seen them in order to consider them for adoption. Given that, she asked why the Committee was recommending investments in two funds at this point.

Mr. Malott responded that, because those policies and procedures have not yet been adopted, the PEIC recommended these two investments to the full Board. He said the Committee would continue with this practice until the policies and procedures were adopted, at which point the Board would be delegating that authority to the PEIC.

Mr. Neel and Mr. Bland pointed out that precedent for this was set when two private equity investments were previously recommended for approval to the Board and then were adopted by the Board.

Mr. Bland moved approval of a commitment of \$20 million to Levine Leichtman Capital Partners Deep Value Fund and \$15 million to Perseus Partners VII, L.P. subject to and contingent upon New Mexico state law, New Mexico Educational Retirement Board policies, and negotiation of final terms and conditions and completion of appropriate paperwork.

Dr. Garcia seconded the motion, which passed on the following roll call vote:

For: Mr. Malott; Ms. Cameron; Mr. Bland; Dr. Garcia; Mr. Lewis.

Against: Dr. Turner.

Mr. Malott commended Mr. Neel and staff for doing an excellent job with these two investment recommendations.

d) Aldus Representations — Steve Neel

Mr. Neel stated that, in the course of the ERB's due diligence visit to Aldus Equity's offices in Dallas, Aldus had represented a couple of things regarding veto authority that individual funds have. He said Dr. Garcia had expressed concerns about this and asked for follow up.

Mr. Neel stated that he followed up with Aldus Equity after the meeting, and they indicated that this was correct, but they were not willing to place a representation forward because currently they have a confidentiality clause within the contract. He said that, once the contract is executed, there is a possibility that the ERB can get a representation from Aldus.

7. BOARD POLICIES AND PROCEDURES — STANDARDS AND CONDUCT:

ROBERT SHULMAN

- a. Financial Disclosures
- b. Gifts, Contributions Disclosure

Mr. Shulman distributed Financial Disclosure Statements and a Gift Reporting Forms to Board members.

Board members were asked to complete these forms and turn them in at the next meeting.

8. DIRECTOR'S REPORT

Mr. Riggs stated that, in response to requests for more comfortable chairs, three samples have been provided across the hall.

Mr. Riggs stated that mail directed to members would now be included in the Board packets.

Mr. Riggs said staff has been in touch with Gabriel Roeder Smith on several proposals for the FY 2008 budget, one of which was the Governor's proposal of a 7.4% salary increase for teachers. He distributed copies of GRS's response to staff's questions on what additional contribution the ERB should try to obtain to accommodate that.

Mr. Riggs stated that there are also two proposals pending, one an LESC proposal, and staff has asked GRS to provide information that would allow staff to be more responsive to the decision-makers as this moves through the legislative process.

Mr. Riggs referred to a three-page document detailing the Governor's recommendation for the ERB's FY 2008 budget.

Mr. Riggs asked the Board to recall that there were four expansion items requested: two alternative investment staff people, a general counsel, and an internal auditor. He said the Executive is recommending one alternative investment position and a general counsel.

Mr. Riggs stated that the LFC recommendation would not be available until noon on January 16.

Mr. Riggs noted that, on the base budget, the ERB was essentially given everything it asked for, which was a very substantial increase. He said the bulk of it was investment management consultant fees at about \$8 million.

Mr. Riggs stated that the ERB is almost at the point of accepting phase two of the IRIS implementation, which is the biggest part of this system implementation. He said the third phase will follow, which will allow members access to the system via the web site.

Mr. Riggs stated that staff has seen the draft LFC-DFA quarterly report, and it appears that ERB has the distinction of having the highest five-year return on investments of the State's three investment entities.

Dr. Turner asked why today's agenda did not include an actuarial report, as discussed at the December meeting.

Mr. Riggs responded that some data issues came up with the IRIS system that have since been corrected.

Mr. Malott asked that the next meeting's agenda include discussion on hiring someone to do a post-implementation review of the new IRIS system.

Mr. Riggs reported that the new Web site is up and running.

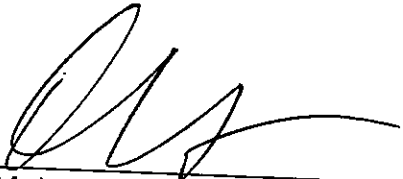
9. NEXT MEETING FEBRUARY 23, 2007 — ALBUQUERQUE

10. EXECUTIVE SESSION

None.

11. ADJOURN

Its business completed, the Educational Retirement Board adjourned the meeting at approximately 10:35 a.m.



Bruce Malott, Chairman

ATTEST:



Gary B. Bland, Secretary