

MINUTES OF THE
NEW MEXICO EDUCATIONAL RETIREMENT BOARD
REGULAR MEETING

April 18, 2007

A Regular Meeting of the New Mexico Educational Retirement Board was called to order on this date at approximately 3:15 p.m. in the Educational Retirement Board Room, 6201 Uptown Boulevard, N.E., Ste. 203, Albuquerque, New Mexico. A quorum was present.

ROLL CALL – ASCERTAIN QUORUM

Members Present:

Mr. Bruce F. Malott, Chairman
Mr. Gary B. Bland, Secretary
Dr. Veronica Garcia
Mr. H. Russell Goff [sworn in during meeting]
Mr. James B. Lewis
Dr. Pauline Turner

Members Excused:

Ms. Mary Lou Cameron, Vice-chair [unable to attend telephonically because of [technical difficulties at the Albuquerque office.]

Legal Counsel Present:

Mr. Robert Shulman, Staff Attorney

Staff Present:

Ms. Jennifer Dunstan, Public Relations Director
Mr. Frank C. Foy, Deputy Chief Investment Officer
Mr. Bob Jacksha, Chief Investment Officer
Ms. LeAnne Larrañaga-Ruffy, Investment Officer
Ms. Deborah Martinez, Chief Financial Officer
Ms. Bernadette Montoya, Executive Admin. Assistant
Mr. Steve Neel, Portfolio Manager
Mr. Greg Trujillo, IT Network Specialist

Others Present:

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

a. Approval of Agenda

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

b. Approval of Minutes: February 23, 2007

Dr. Garcia moved approval of the Minutes of the February 23 meeting, as amended. Mr. Lewis seconded the motion, which passed by voice vote.

c. Introduction of Guests

Guests were introduced.

OATH OF OFFICE FOR NEW BOARD MEMBER — H. RUSSELL GOFF

Mr. Goff was sworn in as new Board member.

CONSENT AGENDA — BOARD TRAVEL

- a. Mary Lou Cameron — to attend NEA Retirement and Benefits Forum, Philadelphia, PA, June 29, 2007.**

- b. Bruce Malott — to attend Alpha Investors Forum, San Francisco, CA, March 21-22, 2007**

- c. Bruce Malott — to attend Conference on Hedge Funds, Real Estate and Other Alternative Investments, San Francisco, CA, July 9-10, 2007.**

Mr. Bland moved approval of the Consent Agenda, as published. Dr. Garcia seconded the motion, which passed by voice vote.

[The Agenda was reprioritized.]

DIRECTOR'S REPORT

c. Update — Remodel of Santa Fe Office — Willard Eastman, AIA, DWL Architects.

Mr. Eastman provided an update on Phase 2 of the renovations and additions to the ERB Philip Gonzales Building in Santa Fe. He said a contract was awarded to Michael S. Rich Contractors of Albuquerque for the construction work, with a notice to proceed issued on March 29.

Mr. Eastman stated that the contractor hopes to complete the project by November 5, which is a month ahead of schedule.

Mr. Malott said he has asked Jeff Riggs to secure an appraisal on the building in order to answer the question of whether it would have made better economic sense to simply sell the property and build offices elsewhere.

INVESTMENT REPORTS — BOB JACKSHA

a. Private Equity Investment Committee Update — Steve Neel

Mr. Neel circulated a report on action taken by the Private Equity Investment Committee on April 12, when it approved an allocation of \$10 million to Psilos Group Partners III, a venture capital fund focusing on healthcare-related industries. Mr. Neel stated that allocations awarded by the Committee to the program now total \$110 million.

Mr. Neel noted that Psilos I and II were top quartile performers. He said Psilos is headquartered in Santa Fe with offices in New York and California.

b. Selection of Real Estate Consultant — Bob Jacksha.

Mr. Jacksha reported that the Investment Committee heard presentations on April 12 from three finalists in the Real Estate Consultant search: ORG, Townsend Group and Courtland Partners. He said NEPC assisted staff with the RFI and search.

Mr. Jacksha said the Investment Committee unanimously recommended the selection of ORG as ERB's retained Real Estate Advisor and Courtland Partners as an Infrastructure Advisor. He said ORG's mandate will include a 4.5% Real Estate allocation, while Courtland's \$50 million mandate will be for infrastructure investments.

Mr. Jacksha stated that staff would proceed with contract negotiations following Board approval of the Investment Committee's recommendations.

Dr. Turner asked what the fees would be, and Mr. Jacksha responded that ORG's fee would be approximately \$225,000 a year. He said Courtland's fee will be somewhat less than that, but will be negotiated because they have been given a much smaller piece than before in this mandate.

Dr. Garcia moved the Investment Committee's recommendations. Mr. Bland seconded the motion, which passed by voice vote.

**c. Investment Committee Recommendation of Allocation to
Gottex Market Neutral Plus Fund — Bob Jacksha.**

Mr. Jacksha noted discussion at a previous meeting about the need to rebalance the portfolio by moving some money out of equities. He said the decision was subsequently made to take the ERB's hedge fund-of-funds allocation up to the maximum policy weight of approximately 8% with the remainder going into the bond portfolio.

Mr. Jacksha referred to a memorandum from ERB staff to Board members describing how the reallocation would be accomplished, with a list of managers, the amount of the original allocation, the amount of the new allocation, and the dates of these allocations. He stated that some of these allocations have already occurred, with the remainder scheduled for May 1.

Mr. Jacksha noted that, while Board approval is not required on reallocations to existing funds, in this case the single exception is Gottex; and on April 12, the Investment Committee heard a presentation by Gottex and unanimously recommended that the Board invest \$115 million in Gottex Market Neutral Plus fund. He stated that the ERB currently has \$100 million with Gottex in their Market Neutral Fund, which is being closed to new investments because they are concerned about running out of capacity. He said the new fund will be almost exactly the same, where they will use 70% of the same managers and will have a slightly more restrictive liquidity feature than the existing fund — while the existing fund allows the ERB to withdraw money monthly, the next one will be quarterly. He stated that this does not represent any major disadvantage to the ERB.

Mr. Jacksha said Gottex expects the new fund to have better performance than the old fund, as does staff. He added that Gottex has offered to reduce its list price fees by 40% if the ERB allocates this money on May 1.

Dr. Turner asked when the maximum policy weight in hedge funds increased to 8% from 5%.

Mr. Jacksha responded that the target in the ERB policy is 5%, and the maximum range on hedge fund-of-funds is 8%. He said this is still within policy and therefore does not require a policy change.

Dr. Turner asked what this meant for the total 15% that the ERB allocated in alternatives, and Mr. Jacksha responded that the target on private equity remains at 5%, although the ERB is well below that because it takes a long time to get the money invested.

Mr. Neel added that about \$40 million is currently deployed in private equity out of the \$450+ million target.

Mr. Jacksha stated that, including real estate (REITS), about 12.25% is in alternatives at the current time, which is below the 15% overall target.

[Mr. Jacksha clarified in later discussion that the ranges on all alternatives are the same as hedge funds, with an envelope maximum of 8% for each category, a minimum of 2%, and a target of 5%.]

Mr. Malott asked how the hedge funds have performed in the first quarter, and Mr. Neel responded that returns were very close to 4% for the period January through March, which would be about 16% annualized, representing very good returns.

Mr. Bland moved to approve a \$115 million allocation to Gottex Market Neutral Plus Fund. Mr. Lewis seconded the motion, which passed by voice vote, with Dr. Turner dissenting.

d. Selection of International Equity Managers — Bob Jacksha

Mr. Jacksha stated that the Investment Committee met from 8:15 until 3:15 today to hear presentations from finalists responding to an RFP for international equity managers. He said the search was for people to manage in the international value space and the international growth space, while previously all of the ERB's managers were in the middle (core). He stated that goal is to put managers to the right and left of core, which aggregated together should outperform the core benchmark (EAFE).

Mr. Jacksha said there were 38 responses to the RFP, and 10 were eliminated because they failed to meet minimum qualifications. He stated that staff and NEPC then went through the remainder and selected six finalists, all of whom were

interviewed today, with three in the value space, two in the growth space, and one in portable alpha.

Mr. Martin stated that, when they did this search, they allowed managers who employed other strategies besides just choosing international stocks to buy and sell to create the alpha.

Mr. Martin distributed copies of a presentation on portable alpha given to Board members at the ERB October retreat.

Mr. Martin stated that portable alpha was, put simply:

- Using futures or swaps to gain market exposure with limited capital commitment;
- Investing the remaining capital you have available in something targeted to achieve a return greater than cash.

Mr. Martin said this has become attractive because, in general, despite the fact that has been a bull market for equities, most people feel that the market is subdued for returns going forward — that is, equities in the traditional 8%-9% range and bonds in the 4%-5% range. He commented that, if the Board is trying to consistently achieve 8% to fund its actuarial liabilities, 8% in equities and 4% in bonds, no matter the combination, will not do it.

Mr. Martin stated that, above and beyond that, in areas like large cap and in bonds, an active manager is basically providing the return of the large cap index plus their ability to choose undervalued stocks. He noted that there are 100+ money management and research firms in big cap markets that follow each of those large cap stocks; so for the ability of a manager to choose to overweight a large cap stock (GE, IBM, GM, Ford, etc.), "someone else is doing worse, because it is a zero sum gain at the end of the day."

In reviewing a graph of median manager performance versus index for the five-year period through 3/31/2005, Mr. Martin noted that there is very little value added in the median manager vs. the index in areas like large cap and core fixed. He said these numbers are also gross of fees, so ultimately performance is not as good as the index.

Mr. Martin stated that Mellon, which gave a presentation to the Investment Committee earlier today on portable alpha, trades equities in the U.S. versus equities in foreign countries, bonds in the U.S. as a class against stocks in the U.S. as a class, and currencies around the world against one another. He said they do this both long and short.

Mr. Martin said the key points of portable alpha are: 1) that cash should be invested in something with little or no beta/market risk; and 2) to seek investments that are less volatile and have a higher probability of success than traditional long-only managers.

Mr. Martin stated that the goal is to find portable alpha solutions that have a higher probability of generating excess returns than traditional products. He stated that the managers hired last December in the hedge fund allocations have all very consistently outperformed cash. He noted that February was a very difficult month for stock managers and bond managers because of the subprime mortgage crisis; and while the ERB's equity managers didn't do as well that month, the ERB's hedge fund managers generated a premium, as expected.

Dr. Turner asked Mr. Martin if there were managers that might decide to stop selling long only and move into portable alpha, so then many people might be doing portable alpha instead of just a few.

Mr. Martin said that was quite possible. He said the challenge in all of investing is "good ideas don't last forever," so it is necessary to constantly look for new ideas, recognize that new ideas have risk, and intelligently choose those that work. He commented that the concept is a good one, however, and not everyone is in portable alpha because the educational hurdles are great.

Responding to questioning from Dr. Turner, Mr. Martin said it is true that, for the last 3-4 years, value style has done better than growth style in a very persistent trend, but there has almost never been a period in history where that over- or underperformance has persisted for more than 5 or 6 years. He said he wasn't advocating the idea of putting everything in growth or everything in value, but to put an equal amount in each in order to create offset.

In discussion on Mellon, Mr. Jacksha said they have been involved in portable alpha for 30 years.

Mr. Bland moved to approve a \$100 million allocation and that Mellon Capital be selected to work with this allocation in portable alpha in the international market, subject to and contingent upon 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. [Dr. Garcia was not present during this action.]

Mr. Malott stated that the Investment Committee also interviewed three value managers (Alliance Bernstein, JP Morgan Asset Management and Thornburg Investment Management) and two growth managers (Baring Asset Management

Limited and Principal Global Investors), and selected Alliance Bernstein and Baring with allocations of \$325 million to each.

Mr. Bland moved these recommendations. Mr. Lewis seconded the motion.

Mr. Jacksha stated that Baring was founded in 1967 and is headquartered in London with offices around the world, with about \$42 billion under management. He said their parent company is MassMutual and their product is focused international plus equity style, which was started in 2000. He said Baring, like all of the managers being recommended, substantially outperformed the EAFE Growth benchmark, with three-year returns at 25+% and five-year returns at about 20%. He said the Committee was impressed by the team of analysts and portfolio managers and their deep resources. He stated that the Committee also liked their approach in managing international, in that they take into account not only individual stock selection but also the effects of different countries' markets.

The motion passed by voice vote. [Dr. Garcia was not present during this action.]

RETIREE HEALTH CARE AUTHORITY REPORT: ROBERT SHULMAN

Mr. Shulman reported that the RHCA had their regular meeting on April 6, and a number of issues were discussed.

Mr. Shulman said the audit presented to the RHCA was a qualified audit; because of procedural problems and a deeply flawed information system, it is impossible to discern exactly what the accounts receivable are, which is obviously fundamental to any organization's finances. He said the good news is that the RHCA board and staff are on top of the situation and have started to prepare information for another audit.

Mr. Shulman said an RFP will be issued shortly as well to get a new information system for the RHCA.

Mr. Shulman also reported that the actuarial reports have wildly differed over the past couple of years with respect to unfunded liability and the health of the fund, even though the actuary hasn't changed in that time. He said there will be an audit of the actuary as a result of this. He added that the new GASB rules are going to make the unfunded liability even worse because RHCA was unable to get the Legislature to turn the fund into an irrevocable trust.

2006 AUDIT REPORT — DEBBIE MARTINEZ/JULIA PETTY

Mr. Malott said this item would be deferred because the State Auditor has not accepted the audit report at this point.

Mr. Bland stated that the reason behind this is largely because of a backlog and change in staff.

AGE AND SERVICE RETIREMENTS

Mr. Lewis moved for approval. Mr. Bland seconded the motion, which passed by voice vote.

DISABILITY RETIREMENTS

- a. **New Applicants (Permanent & Continuing)**
- b. **Appeals**

Mr. Goff moved for approval. Mr. Bland seconded the motion, which passed by voice vote. [Dr. Garcia was not present during this action.]

GOVERNANCE AND ORGANIZATIONAL STRUCTURE: BRUCE MALOTT

Mr. Malott stated that Ms. Cameron was expected to be on a conference call at this point in order to participate in this item, but there have been technical difficulties with the phone system and Ms. Cameron has requested that this item be postponed to the next meeting.

EXECUTIVE DIRECTOR SEARCH

[Deferred. See previous item.]

2008 OPERATING BUDGET — PATRICE ARMSTRONG

Ms. Armstrong reported that copies of the FY 2008 operating budget have been distributed, and overall, the ERB is in good shape.

DIRECTOR'S REPORT [Cont'd]

a. Report on 2007 Legislation — Robert Shulman

Mr. Shulman reported that no legislation was passed this year that directly affected the ERB, with the exception of a House Memorial calling for a study to see about combining PERA and ERB. He added that he was not sure there was understanding that combining them would not automatically make the benefits the same, and there are legal issues, financial issues, constitutional issues, practical issues and numerous other issues involved.

b. Customer Service Survey — Paul Swanson

Mr. Swanson reviewed a office visit Customer Satisfaction Survey as well as more detailed draft survey that would involve randomly calling 600-800 retirees and new members.

Mr. Goff complimented Mr. Swanson. He said he has had the pleasure of working with him for the last three years at the pre-retirement workshops, and he does an outstanding job.

NEXT MEETING — JUNE 22, 2007 — ALBUQUERQUE

EXECUTIVE SESSION

None.

Its business completed, the Educational Retirement Board adjourned the meeting at approximately 4:10 p.m.



Bruce Malott, Chairman

ATTEST:

Mary Lou Cameron, Vice Chair
For Gary B. Bland, Secretary