

MINUTES OF THE
NEW MEXICO EDUCATIONAL RETIREMENT BOARD
REGULAR MEETING

October 26, 2007

A Regular 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.

ROLL CALL – QUORUM PRESENT:

Members Present:

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

Members Excused:

Dr. Veronica Garcia

Legal Counsel Present:

Mr. Robert Shulman, Staff Attorney

Staff Present:

Ms. Patrice Armstrong, Human Resource Manager
Mr. Frank C. Foy, Deputy Chief Investment Officer
Mr. Bob Jacksha, Chief Investment Officer
Ms. Linda Kissko, Executive Admin. Assistant
Ms. LeAnne Larrañaga-Ruffy, Investment Officer
Mr. Steve Moreno, Benefits Manager
Mr. Jeff Riggs, Acting Director
Mr. Paul Swanson, Member Services
Mr. Greg Trujillo, IT Director

Others Present:

Mr. Allan Martin, New England Pension Consultants
Ms. Vickie Brown, Treasurer's Office
Ms. Judith Beatty, Recorder
[Also see sign-in sheet]

a. Approval of Agenda

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

b. Approval of Minutes: August 24, 2007

Ms. Cameron moved approval of the Minutes of the August 24 meeting, as submitted. Mr. Goff seconded the motion, which passed by voice vote.

c. Introduction of Guests

Guests were introduced.

INVESTMENT REPORTS — BOB JACKSHA

a. September Flash Report: Bob Jacksha

Mr. Jacksha noted strong performance in the Fund for the one-month, three-month and twelve-month periods, with returns at 3.18% (in contrast to the median public fund's 2.5%), 2.05% and 14.9% respectively.

In reviewing returns on the equity side, Mr. Jacksha said the Investment Committee interviewed finalists yesterday in the Large Cap space and decided to replace ICAP. He also noted that BGI has been having problems with the Enhanced index, and staff will shortly place them on a watch list.

Mr. Jacksha stated that International continued to do well across the board, whether that be emerging markets or the developed markets, with annual numbers of 30% to 50%. He commented that Barings, the new manager, is doing a tremendous job so far, running almost 500 bp over the index for the three-month period as well as 500 bp over for the month.

Mr. Malott expressed concern about Alliance's underperformance (relative to the benchmark) in the Emerging Markets Value space for the 12-month period, and Mr. Jacksha said he would talk with them, and would also take another look at their underperformance (although slighter) in the Growth space.

Mr. Jacksha reported that Fixed Income also did well thanks to the Fed Funds rate cut, including both the high yield (which did the best) and investment grade. In the latter space, he said WAMCO is having some underperformance and staff is watching them.

Mr. Jacksha said REITs also did well for the month and they are now back in positive territory for the three-month and twelve-month periods. He said the rate cut helped them significantly, and they have reached the ERB's 5% target.

Mr. Jacksha stated that performance for the Absolute Return Strategy was bad in August, and there was improvement in September. He said the average was around 2+%. He added that virtually all hedge funds or fund-of-funds had a bad month in August, and none of the strategies worked particularly well.

Responding to questioning from Mr. Goff on the latest information on Vanderbilt, Mr. Jacksha said he met with them last week at the SIC offices along with SIC staff. He said Vanderbilt went over their portfolio, and they are having discussions with an outside group about having them come in and value the portfolio. He said their estimate is that the value is down substantially from where it was. He stated that the ERB bought in at \$15 a share, and Vanderbilt is conservatively estimating a price of \$1-\$4 per share. He added, though, that the ERB has about \$40 million invested, which has little impact, if any, on the portfolio.

Mr. Jacksha explained that there is no market to sell these shares, since they are not publicly traded; and if the ERB could find a seller, it would be at a substantial discount, and he did not think that would make sense.

Mr. Malott stated that he has recommended to Mr. Jacksha that the ERB mark it to zero, since there is no market.

Mr. Jacksha agreed to write off all of the investment on the June 30 numbers.

Mr. Bland stated that he was not present when Vanderbilt met with SIC staff. He asked if they see valuation as the problem, or is there actual asset loss.

Mr. Jacksha responded that the problem was triggered when Moody's just came out and downgraded the vast majority of 2006, 2007 and some 2005 issued subprime home equity paper, which makes up the collateral for these asset-backed securities and the CDOs. He explained that, when they get downgraded far enough, it trips triggers in the structure and cuts off the cash flow to the equity tranche and moves it to the AAA tranche, and that is what is happening in this case. He said the equity will definitely not get cash flows for the immediate future, and Vanderbilt is assuming that they will never get them — although they could.

Offering some perspective on this \$40 million investment, Mr. Malott pointed out that the ERB can make or break \$200 million in the Fund on any given day. He said the ERB

will obviously do everything possible to get the money back; but even if it is marked to zero, the impact (\$40 million out of \$9 billion) would be almost infinitesimal on the Fund's annual returns.

b. Private Equity/Real Estate Investment Committee Report – Bob Jacksha

Mr. Jacksha reported that the Private Equity and Real Estate Committees held a combined meeting in October and unanimously approved two staff- and advisor-recommended real estate investments at \$25 million each.

Mr. Jacksha said the first, Guggenheim Structured Real Estate Fund III, will invest primarily in commercial real estate debt. He said Guggenheim has been investing for a number of years and has done very well, and this is their third fund. He added that the fact that they are in the debt market means the ERB will be getting cash flow in the form of interest payment and some principal payments, and this will help the J-curve in the early part of the real estate program.

Mr. Jacksha stated that the second investment is in Greenfield Acquisition Partners V. He said the team has been together for a number of years, and most of them have gone through Funds I, II, III and IV together. He stated that Greenfield invests mainly in real estate equity in a value-added approach, i.e., they take smaller deals that are off the radar of the major real estate funds, such as air cargo facilities, assisted living facilities and limited service hotels. He stated that all of their previous funds have returned about 20%. He said staff likes this strategy of not picking core real estate right now, since it can be expensive.

Mr. Jacksha stated that the Committee also unanimously approved a \$10 million commitment in KH Growth Equity Fund, L.P. He said this is similar to venture capital but involves somewhat more seasoned businesses with revenue.

There were no questions from the Board on these investments.

c. Large Cap Value Manager RFP Update — Bob Jacksha

Mr. Foy stated that ICAP has been the ERB's large cap value manager for about five years ago, and three years ago they were put on watch because of poor performance. He said staff decided to take another look at ICAP when it issued an RFP for \$525 million a few weeks ago.

Mr. Foy stated that there were 38 responses to the RFP, and three finalists were interviewed at yesterday's Investment Committee meeting. He said the three finalists were ICAP, Brandywine Global and Westwood Partners, and all three gave very good presentations. He commented that the Committee ultimately chose Brandywine as ICAP's replacement after extensive discussion.

Mr. Bland moved to approve Brandywine Global as large cap value manager and to terminate ICAP. Ms. Cameron seconded the motion.

Mr. Malott noted that ICAP, as incumbent, was favored because there is a cost to transitioning the money to another manager. He added, though, that ICAP's yield has been the direct result of a lot of overseas investments, which the other two candidates did not have. He said ICAP's performance fell off significantly when these overseas investments were isolated, however, and ICAP was eliminated from consideration. He said the Committee gave the two other candidates tied scores, and what broke the tie was the fact that Brandywine's fee was about 27 bp and Westwood's was 29 bp — a difference of about \$250,000 a year.

The motion then passed by voice vote.

d. Infrastructure Investment Policy —Bob Jacksha

Mr. Jacksha noted that this policy, which was presented at the ERB Retreat, parallels the policy for real estate and for private equity. He said the consultants, working with staff, will do due diligence on private equity investments, and these will mainly be in the form of limited partnerships. He said this will then go the Private Equity and Real Estate Committee for a presentation and vote, and subsequently those actions will be reported to the Board.

Mr. Bland asked Mr. Jacksha why he chose Macquarie Global Infrastructure as the Public Infrastructure benchmark, and Mr. Jacksha responded that the choice of benchmark is very limited, unlike that of the equity market. He said staff tried to find one that was indicative of the infrastructure return market, and Macquarie has been a big player in this.

Asked to comment, Mr. Martin said there are a number of indices, and he has not reviewed these in detail. He said they are all flawed, but NEPC will look at them and see if one stands out as better than the others.

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

e. Quarterly Commission Report — Bob Jacksha

Mr. Jacksha stated that copies of this report were in the Board packet, and show that the ERB and its money managers are using a lot of different brokers, and trading is not concentrated with any one or two particular groups. He noted that the report now includes an international page.

f. Asset Allocation Study —Allan Martin

Mr. Jacksha reported that he and Mr. Martin have been working on different views of an asset allocation, and of changing some of the constraints and including new asset classes. He said today's report reflects the results of that work.

As background, Mr. Martin said the ERB did an asset liability study last year and in February 2006 adopted a new asset allocation structure. He said the primary difference historically was the inclusion of hedge funds at a 5% level, private equity at a 5% level, and real estate moving into more traditional real estate investment as opposed to REITs, which is what the ERB currently has.

Mr. Martin stated that August hedge fund results were disappointing; however, year-to-date numbers, including August, reflect that the composite hedge fund portfolio generated 6.4% against 90-day T-bills, plus 200 basis points, at 4.9%. Mr. Martin stated that NEPC sees the month of August as aberrational, and the September numbers bear that out. He stressed that the strategy is not designed to work every month, but is designed to work over lengthy periods of time.

Mr. Martin noted that Texas Teachers is moving one-third of its \$122 billion in assets into alternative vehicles such as hedge funds over the next two to three years. He said this movement toward diversification is happening, and it will continue to happen, although there will be hiccups.

Responding to a point raised by Ms. Cameron about negative press on some hedge fund investments, Mr. Martin stated that there are clearly bad hedge funds as well as good hedge funds, and tarring the entire strategy with the brush of a couple of failures would be unfortunate. He pointed out that San Diego County, which took a \$180 million write-off on a hedge fund, still performed as one of the top hedge funds in the country. He reminded the Board that the ERB is not exposed to any particular hedge fund because it is in fund-of-funds.

Mr. Martin stated that this Board's most important responsibility is to determine the appropriate asset classes in which to invest the funds, and the mix of those funds. He said the typical methodology for that determination is through an "efficient frontier analysis." He said this process involves forecasting returns for the various asset classes the ERB is interested in, variability, and how the asset classes move together. He stated that it is a mathematical fact that if the asset classes do not move together, there is benefit in adding asset classes.

Mr. Martin spent the next few minutes reviewing the impacts (expected returns) of asset allocation choices under various mixes.

Mr. Martin noted that Mr. Jacksha was recommending Mix A Prime (page 7 of presentation). He said the difference between Mix A and Mix B (page 11) is that, under B, Emerging Markets have a maximum of 7% rather than 10%, Private Equity is limited

to 7%, and total international exposure is limited to 75% of domestic exposure instead of 80%.

Mr. Jacksha said the first consideration is whether the Board is comfortable with the limits in Mix A: namely, in the Alternative Assets category, Private Equity is boosted from 5% to 10%; Real Estate stays the same; Real Assets is added at 5%; and Hedge Funds goes from a 5% target to 10% (in Absolute Return Strategies, the ERB is already at about 8%). He said these are the key changes along with the addition of Global Tactical (Global Asset Allocation — GAA), and a potential increase to International.

Mr. Lewis asked how often the ERB should look at rebalancing this model, and what is its duration.

Mr. Martin responded that the ERB should review it annually, although that doesn't automatically mean there should be changes made. On the other hand, he said, the ERB may want to add an asset class to the portfolio and/or it may also want to determine whether any of the previously applied constraints should be loosened up a bit.

Mr. Jacksha added that he personally wouldn't want to be making major changes every year, although there could be minor adjustments depending on market conditions. He said the rate of innovation in the financial markets is also quite high, and there may be a new asset class to look at in the future.

Mr. Lewis stressed the need to educate ERB members, legislators and others on these new strategies, because people are accustomed to the more traditional idea of fixed income and equity investments. He commented that he is frequently questioned by people about these issues, and asked what Mr. Martin and staff would recommend.

Mr. Martin responded that the simplest answer is, "We as fiduciaries want to earn the highest possible rate of return to secure pension assets at a reasonable level of risk. Is there a better mix of the assets we're already invested in, or are new things coming along that offer opportunity? We should challenge ourselves to think about those things. At the end of the day, this whole focus is getting the best return for a level of risk, and that's a good fiduciary's role, and you can't do that if you put all your money in stocks and bonds."

Ms. Cameron pointed out that, at one time, the ERB was being asked why it couldn't invest in these new strategies and asset classes, and now it can, because legislators thought it would enhance returns.

Mr. Lewis asked Mr. Jacksha which frontier point in Mix A (page 9) would he recommend, and Mr. Jacksha responded that he would recommend .73, referred to on page 7 as "A Prime."

Mr. Bland commented that the SIC is also looking at new asset classes and will likely come to similar conclusions.

As discussion continued, Mr. Martin pointed out that the entire process laid out today revolves around how to make the best decisions in the face of uncertainty, since no one can predict the future, and is directly based on the theory that won Harry Markowitz a 1990 Nobel Prize in Economics. He said that theory sought to prove that a diversified or “optimal” portfolio — one that mixes assets so as to maximize return and minimize risk — could be practical.

Mr. Lewis moved approval of staff recommendations to adopt A Prime (.73). Mr. Bland seconded the motion.

Mr. Jacksha pointed out that the numbers have been laid out in great precision to two decimal places, and obviously those would be rounded off, e.g., 23.4% would be rounded off to 23%, etc.

Mr. Jacksha said it will take time to implement this mix, especially in terms of private equity and the like. He added that he views this as part of an overall revision of the policy, and he plans to do a major rewrite and bring it forward before the end of the year.

The motion passed 5-1 by voice vote, with Dr. Turner dissenting.

CONSENT AGENDA – BOARD TRAVEL

[Deferred to later in meeting.]

REFUND INTEREST RATES — JEFF RIGGS

Mr. Riggs noted that the Board generally reviews the interest rate every August, although this year the review is scheduled for today’s meeting. He said the Board last year decided not to make any change to the refund rate.

Mr. Moreno stated that, until 2003, the interest rate was based on the five year average rate of return, and the Legislature gave the Board authority to set the interest rate. He said the new procedure was apparently adopted in June 2003, but the minutes from that meeting are missing. He stated that, based on his notes, the Board was going to review the interest rates in June every year based on the Treasury bond rates as of 6/30 and then determine whether they should raise or lower the rate based on that information.

Mr. Malott and Dr. Turner said that was what they recalled, as well.

Mr. Moreno also recalled that, in 2004, the Board changed the interest rate based on the Treasury bond rates; and in 2005 and 2006, the rate remained unchanged.

Responding to questioning from Mr. Malott, Mr. Moreno and Mr. Riggs said the current regular rate in non-retiree deaths is 3.72%, the retiree death rate is 3.94%, and as of 6/30/07 the five-year rate is 4.92% and the ten-year rate is 5.03%.

Ms. Cameron commented on concerns expressed by some people that the rate is too low.

Mr. Malott said he pointed out last year that it seemed inappropriate to be increasing benefits when the Fund had a \$4 billion deficit, especially when retirees hadn't had a COLA in many years, and he feels somewhat the same way today.

Dr. Turner said she was personally conflicted about this. She stated that the Board should set a policy and then just follow it every year. She commented that there is a big gap between 3.72% and 4.92%, and asked Mr. Moreno how much money is involved.

Mr. Moreno responded that, based on the 6/30 actuarial report, about \$36 million was refunded for the prior year to about 8,000 members, and that included death and regular refunds.

Mr. Moreno stated that the Board is required to make a decision on the interest rate each calendar year, or by December 2007 in this case.

Dr. Turner asked what staff would recommend, and Mr. Moreno responded that he has been with the ERB for 12 years; and as supervisor of the refund unit, he deals with a lot of people who are very upset when they apply for a refund and learn that the interest rate is decided by the Board each year. He said people's perception is that the Fund is making a lot of money. From a personal standpoint, he said, since interest doesn't accrue on these contributions, the ERB isn't paying the employer's share, and that money is being used to enhance the Fund, he thought it fairer to tell people that the interest rate is based on the bond rate.

Mr. Goff agreed with Dr. Turner that it would make more sense to develop a policy and follow it every year.

Mr. Malott pointed out that the current rates are very generous and higher than what someone would get if they put the money into a savings account, and that was his objection. He said perhaps the Board could consider 80% of those numbers instead—so the Board could still have a policy, but the calculation would be a bit lower and therefore not so negatively impact the Fund.

Dr. Turner moved that the Board go back to the original position, which is to pay the interest rate based on the 6/30 five-year Treasury rate, which is 4.92%. Mr. Goff seconded the motion, which passed on the following roll call vote:

For: Ms. Cameron; Mr. Bland; Dr. Turner; Mr. Goff.

Against: Mr. Malott.

Abstaining: Mr. Lewis.

[In explaining his vote, Mr. Lewis explained that he had stepped away from the proceedings and had only heard the tail end of the discussion.]

Mr. Riggs said he would meet with Mr. Shulman and return with a policy recommendation.

DISABILITY RETIREMENTS

a. New Applicants (Permanent & Continuing)

Ms. Cameron moved for approval. Mr. Goff seconded the motion, which passed by voice vote.

b. COLAS

None.

AGE & SERVICE RETIREMENTS

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

REPORT ON MEETINGS OF RETIREE HEALTH CARE AUTHORITY BOARD — ROBERT SHULMAN

Reporting on the upcoming Retiree Health Care Authority Board meeting of November 2, Mr. Shulman said there is a push to get the trust fund to be called an irrevocable trust (based on the new GASB rules), and that requires a statutory change.

Mr. Shulman noted some objections and fears in the last Legislative Session that this would create additional property rights that the State was not willing to take on. When asked for a legal opinion, the Attorney General's Office said they first wanted to

see the legislation and have the Legislative Council Service write it, so this is in limbo right now.

Mr. Shulman said there is also discussion about the Governor's proposal to create healthcare for everybody in New Mexico, and that would include combining many of the agencies and groups that provide healthcare including Retiree Health Care, NM Public School Insurance Authority and APS. He stated that the idea is not to change the benefits but to coordinate it better. He commented that this will be a big issue in the next Session.

Mr. Shulman stated that Retiree Health Care is still working on coming up with an information system and will have to come up with a custom-created system because the existing ones they have looked at will not work for them.

CONSENT AGENDA — BOARD TRAVEL

Mr. Lewis requested authorization to attend a training session on benchmarking and infrastructure on November 29-30 in New York. He estimated the cost at approximately \$3,000.

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

DIRECTOR'S REPORT

a. Update on Audit Report — Debbie Martinez/Greg Trujillo

Mr. Malott reported that he had a telephone conference last week with the auditors and learned that problems with the SHARE program have caused a delay in coming up with a trial balance. He said the government clients at his firm are having the same problem.

Mr. Malott stated that another conference call is scheduled for October 31, and conference calls will be scheduled every week to make sure things are on track to the extent possible.

Mr. Trujillo reported that IT auditor Nishant Agrawal, who was on site October 9-14, has indicated that all of the problems found last year have now been satisfactorily addressed. He said some very minor findings are expected, but may be so incidental that they may not appear in the final report.

Ms. Cameron commended Mr. Trujillo and Mr. Swanson on turning the ERB Web site into something very user-friendly and full of helpful information.

b. Summary ARP Data

Mr. Riggs stated that, in accordance with discussion at the last meeting, staff has prepared summary data on the number of ARP members by institution, average salary, and what percentage of the workforce in each institution is in ARP.

Mr. Malott noted that one of the concerns expressed at the last meeting was the number of highly compensated people at these institutions. He observed that there are 1,631 ARP members in total, or 7.03% of the workforce, with an average salary of \$83,500.

Mr. Malott asked staff to tweak the report to reflect how many higher ed people are actually in the Fund and what their average salary is.

c. Retreat Evaluation Feedback

Mr. Riggs reported that, based on the questionnaires that were turned in, people were especially impressed by the overall investment outlook as well as the introduction to commodities and the 1-30-30 discussion in portable alpha. He said people liked the venue, too.

Dr. Turner commented that Board members were not given an opportunity to interact with each other, and there was also no opportunity to interact with the various speakers. She suggested tweaking the format to allow that. She said it became uncomfortable after a while having to sit and listen to speaker after speaker with no variation.

Mr. Malott said he thought it was the best ERB retreat he had attended to date.

Mr. Jacksha agreed with Dr. Turner and said he would aim for some variety next time.

Mr. Goff stated that he would like to see some more interaction with the Board members at the next retreat.

Mr. Lewis said he thought the speakers were outstanding and the introduction to commodities was great, but hoped the next retreat would be attended by everyone on the Board.

Mr. Malott noted that Board members were offered copies of a book from the speaker, but have not received it.

Mr. Martin responded that he and Mr. Jacksha had to carefully go through the New Mexico Statutes to ensure that this was appropriate and that Board members were not

being compromised by being given a book. He said there was no impropriety in accepting a book in this case.

On that note, Mr. Lewis asked for an update on ethics rules and gifting, and Mr. Malott asked Mr. Shulman to make a presentation to the Board at the next meeting on this topic.

d. Miscellaneous

Mr. Riggs said that, in follow up to discussion at the last meeting regarding reporting problems by DFA and APS, he was pleased to report that those issues have been cleared up and neither of those entities is on refund hold any longer.

Mr. Lewis thanked Mr. Trujillo, Mr. Riggs and staff for their assistance at the State Treasurer's Office with its disaster recovery plan.

NEXT MEETING DECEMBER 7, 2007— ALBUQUERQUE

EXECUTIVE SESSION

Mr. Malott asked the Board to go into Executive Session to discuss potential litigation.

Dr. Turner so moved. Ms. Cameron seconded the motion, which passed on the following roll call vote:

For: Mr. Malott; Ms. Cameron; Mr. Bland; Dr. Turner; Mr. Goff; Mr. Lewis

Against: None.

[The Board was in Executive Session from 10:50 a.m. until 11:00 a.m.]

Mr. Malott reported that nothing was discussed in the meeting other than those issues which might affect potential litigation.

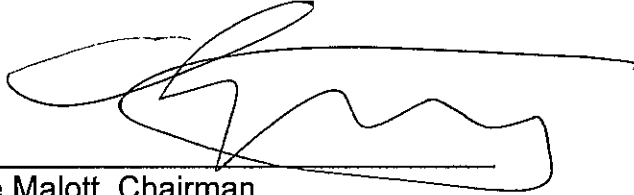
Mr. Bland moved to come out of Executive Session. Ms. Cameron seconded the motion, which passed on the following roll call vote:

For: Mr. Malott; Ms. Cameron; Mr. Bland; Dr. Turner; Mr. Goff; Mr. Lewis

Against: None.

ADJOURN

Its business completed, the Educational Retirement Board adjourned the meeting at approximately 11:00 a.m.



Bruce Malott, Chairman

ATTEST:

Gary B. Bland, Secretary