

MINUTES OF THE
NEW MEXICO EDUCATIONAL RETIREMENT BOARD
INVESTMENT COMMITTEE

February 22, 2007

CALL TO ORDER

A Regular Meeting of the New Mexico Educational Retirement Board Investment Committee convened 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.

A quorum was present, as follows:

Members Present:

Mr. Bruce Malott, Chair
Mr. James B. Lewis
Mr. Jeffrey M. Riggs

Members Excused:

Mr. Gary B. Bland

Other ERB Members Present:

None.

Legal Counsel Present:

Mr. Robert Shulman

Staff Present:

Ms. Selma Arnold, Financial Analyst
Mr. Frank C. Foy, Deputy Chief Investment Officer
Mr. Bob Jacksha, Chief Investment Officer
Ms. Shari LaCome, Executive Admin. Assistant
Mr. Steve Neel, Portfolio Manager
Ms. LeAnne Larrañaga-Ruffy, Investment Officer
Mr. Greg Trujillo, IT Network Specialist

Others Present:

Mr. Allan Martin, New England Pension Consultants
[See sign-in sheet.]

APPROVAL OF AGENDA

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

DECEMBER 2006 PERFORMANCE REPORT: ALLAN MARTIN, NEPC

Mr. Martin reviewed the report entitled, "Investment Performance: Fourth Calendar Quarter 2006."

Mr. Martin noted that, since the last quarter, the S&P was up another 2.5+%. He said the economic expansion that began in 2001 is continuing; in the fourth quarter, GDP growth, at 3.5%, was actually higher than the third quarter. He added, though, that the prevailing feeling is that the economy will gradually cool down and will grow at a slower pace.

Mr. Martin stated that value continued to outperform growth — growth companies averaged 9.1% and the value companies 22.2%. He said this was important because ERB policy currently has a targeted overweight to growth, which is generally not good. He recommended a review of this policy target.

In reviewing alternative benchmarks, Mr. Martin noted that the REIT portfolio was up 36% — so real estate vehicles did extraordinarily well. He said private equity was up 22.5%, and while hedge funds were all over the map, the ERB tends to be in the equity market neutral hedge funds, and these were at 7.6%. He said this was about where they should be — the idea here is to lock in a return that is very stable. He added that the move into this area, as opposed to staying in bonds, has shown an immediate benefit in terms of a higher return and much less volatility.

Mr. Martin reported that, as of 12/31/06, the Fund was just shy of \$9 billion; as of this week, it is at \$9.2 billion.

Mr. Martin reported investment gains of \$1.24 billion with \$536 million of that occurring in the Fourth Quarter, and the net outflow for the year was \$42 million — a very positive cash flow.

Mr. Martin noted that, for the five-year period, the Fund returned 8.7% per year, which was slightly behind the policy index and in the 43rd percentile of all public funds, or in the second quartile. He said the one-year results, however, were spectacular, at 16.1% for the year for the total portfolio, and well ahead of the policy despite some disappointing manager results. He said the Fund ranked in the 6th percentile of all public funds, beating PERA and the SIC.

Continuing, Mr. Martin stated that this good market, combined with the fact that the ERB's asset allocation calls for 5% in private equity, has resulted in an overweight to equity exposure of 65.1% versus 58%. He noted that the ERB has 46.2% of its total assets in U.S. Equity, and its range for U.S. Equity in its policy is 35% to 45%. He explained that, at this point, the ERB has only put .5% of its private equity money to work toward its 5% target, "and that's not anybody not doing their job or being a bad person. It's just the fact that it takes time to get the private equity money invested, and a lot of it is sitting in the equity bucket pending that investment. So it is an issue that the Investment Committee and the Board should be aware of."

Mr. Jacksha said he spoke with Mr. Bland about this issue today and stated that it was not a question of should the ERB rebalance, but to which point there should be a rebalancing.

In reviewing a Performance Attribution graph, Mr. Martin said manager impact was not good — the numbers basically said there would have been little difference had the ERB decided to index its manager results as opposed to have active managers.

Noting that the Legislative Session was underway, Mr. Riggs said he suspected the Senate Finance Committee would be interested in knowing how much the ERB failed to gain because of manager performance.

Mr. Martin responded that he would work up some figures for Mr. Riggs to present. He added that the numbers were considerably better in June 2006, prior to these last two quarters.

Mr. Martin said a lot of what the ERB is seeing is in the traditional large cap and core areas, and people are indexing or going to portable alpha and moving away from active managers because there has been great disappointment year in and year out.

Mr. Martin reviewed individual manager performance under domestic equity and international equity.

Mr. Martin noted that, under Small Cap Equity, the ERB has a targeted over-allocation to growth, which is unusual and is on the advice of the ERB's prior advisor. He commented that he found this surprising only in that most of the literature would either argue in favor of balancing or overweighting in value. He said that target has impacted the numbers on the negative and should be addressed.

In reviewing a Hedge Funds Composite for the month of December, Mr. Martin noted that 90-Day T-Bills + 3 was .69%, the Lehman Aggregate was down .58%,

and the ERB's Hedge Fund Composite was up 1.5% — much stronger than was expected.

Mr. Martin commented, "The important thing about the hedge funds is we're not trying to shoot the lights out, we're not trying to make 15%, we're trying to earn cash plus 3% very, very reliably."

Mr. Jacksha reported that preliminary numbers on January hedge funds reflect 1+% for the month. Mr. Neel added that Gottex performed the best at 2.3% for the month while Benchmark Plus was at about .8%.

On the issue of active managers vs. indexing, Mr. Lewis asked Mr. Martin if there was a "magical time."

Mr. Martin responded that there are times when indexes outperform managers, but it was difficult to call. He said there are consultants who tell their clients to index everything, although most consultants have points in between. He said NEPC's view is that, in large cap, core and perhaps high yield, traditional long-only managers cannot outperform all the time, "so in those spaces, either give up the game and index, or explore portable alpha strategies where you can take an alpha from an area where you think it's reliable and move it into that space and earn a premium over the index at the index level of risk." He said that was becoming the new consensus, "whether it's a false consensus because everybody's writing about it, or else people have just figured out there is a better way to manage money."

Continuing, Mr. Martin said NEPC believes there enough inefficiencies in small cap, international and emerging that there are managers who will do well in the foreseeable future, assuming the ERB can pick some good ones. He added that it is hard to pick the good ones, but NEPC thinks there is an easier game to play in that space than in large cap.

Mr. Lewis asked Mr. Martin if performance-based fees have been considered.

Mr. Martin responded that, for a while, performance-based fees were "very de rigueur," and PERA uses them a lot. He explained, "If your performance-based fee gets you a lower fee, then I think they're a useful device to have. We've had many cases where managers, basically to protect their bottom line, have MFNs (Most Favored Nation), so you hire them, you give them \$100 million, the fee is 75 basis points. You say, 'But we're your largest account, we want a discount,' and they say, 'I'm sorry, we're an ethical firm, we've signed this agreement with all our other accounts that we won't give anybody a better fee than 75 basis points.' And so you're at loggerheads.

"You can negotiate performance fees. The MFNs don't apply because every performance fee is unique, and the interesting thing about performance fees is that

the manager gets paid a performance fee if he outperforms his bogie. So in general when you adopt them, if the manager underperforms, you don't have to pay him. Now, I'd rather fire him if he underperforms than pay him less than I would have paid him, so we think performance fees are very useful tools to negotiate with managers, but they don't necessarily get you lower fees. If they perform on the other side, you pay higher fees, too. So we don't think they're a panacea and that all of our fees should be performance fees."

He noted that, in the search Mr. Foy is conducting for international, the ERB has asked for both.

Asked by Mr. Malott to comment, Mr. Jacksha said, "I look at it in the framework of where should you use portable alpha. And in a place where there isn't a lot of alpha you can generate in a large cap of very liquid assets, that's a place where you should look at that application. And I look at portable alpha as an index plus, and that's where I would tend to use them." He added that, with respect to manager hiring, staff was leaving it open to portable alpha proposals, and he thought some of that would be used on the large cap and core.

Mr. Malott remarked that, at some point, he thought the Board should make a decision that says, "We're not going to do this unless there is a portable alpha strategy attached to it... At some point, I think this Board needs to decide on a go-forward basis, not on a case-by-case basis, but to say this is the philosophy of this Board — if there's no alpha generation, then there's no fee.... Rather than keep dwelling on it, we should just make a decision and execute that decision for a couple of years and then reevaluate it."

Mr. Jacksha responded that, generally speaking, it is very difficult to add much over the index in these efficient markets, and the ERB should consider other alternatives — and to him, portable alpha rose to the top.

Mr. Malott added that he thought the Legislature would find ERB's requests for money a lot more palatable under this scenario.

Mr. Jacksha said another consideration in large cap S&P 500 types of investments is a 130-30 or a 120-20 strategy, although he hadn't researched this thoroughly.

Mr. Martin responded that there are firms that employ this strategy effectively, including BGI, which is under contract with the ERB. He added that the ERB's procurement policy would probably allow it to change their mandate, and he thought that would be a good thing to look at.

Mr. Jacksha suggested that a combination of long/short on the large cap would be appropriate — portable alpha for part of it, and perhaps some 120-20 or 130-30 for the other part.

Mr. Malott asked staff to include discussion on the April agenda regarding philosophy on manager fees and that the Investment Committee make a recommendation to the Board at that time. He said he would like the Investment Committee to recommend to the Board that it decide on a direction to take and then execute a plan.

Mr. Martin distributed a memorandum providing a detailed review of the performance of Franklin (small cap growth), ICAP (large cap value) and Goldman (large cap growth), focusing on investment process, performance and attrition, and organizational structure. He recommended a search be conducted to replace Franklin and ICAP, but that Goldman's performance be reviewed in six months.

JANUARY FLASH PERFORMANCE REPORT: BOB JACKSHA

Mr. Jacksha distributed the January Monthly Flash Investment Report.

Committee members commended Mr. Jacksha on the new format.

ASSET ALLOCATION STUDY: ALLAN MARTIN, NEPC/BOB JACKSHA

Mr. Martin stated that he would be reviewing with staff (and Investment Committee members, if they wished to participate) how NEPC would look at changing the asset allocation that the Board adopted about a year ago. He said the purpose would be to deal with the slow buildup of private equity and concern about overall equity exposure.

Mr. Martin reviewed NEPC's report on the 2007 Asset Allocation.

Mr. Jacksha pointed out that the process would not preclude any of the alternative strategies just discussed, such as portable alpha. He said the Committee also might want to look at different asset allocation options within certain constraints, and then pick points it is comfortable with in the spectrum of risk and return. He stated that the idea was to start a dialogue, get feedback, and move forward.

Upon Mr. Malott's recommendation, staff agreed to schedule a March meeting dedicated to asset allocation.

On another matter, Mr. Jacksha stated that rebalancing was a more immediate concern because the ERB was over its limit. He said the policy allows the Committee to grant a temporary waiver on that, although he was not necessarily suggesting that and would rather look at rebalancing. He said the question was to what point, and suggested that the Committee discuss this at the March meeting.

Mr. Jacksha said another option was to purchase some software that would be helpful in rebalancing, which Mr. Martin would discuss.

Mr. Martin stated that a firm called M-Cubed has been developing a series of rebalancing rules and a historic database to test them out, and their advocacy is to use a model that has economic relationships in it and can be used as a guide in the rebalancing process. He said this tool provides value in "intelligent rebalancing" instead of "rules-based rebalancing," and can be designed by using historical data and then back-testing it to see whether someone would have done better with this system or with a rules-based system.

Mr. Martin stated that NEPC implemented this software about a year and a half ago, and it has added 140 basis points a year during that period to the total portfolio.

Mr. Malott asked what the arguments would be against purchasing this software, and Mr. Martin responded that it cost about \$60,000 when NEPC purchased it, and it would also cost some staff resources to look at it.

Mr. Jacksha said he believed the software could be put to use by the ERB, and he would like to look at it and use it as a tool in the future for rebalancing.

Mr. Jacksha was asked to look at the software and return with a recommendation.

Mr. Jacksha noted that ERB policy is silent on where to rebalance to, but at this point he would recommend rebalancing back to the targets.

Committee members agreed with Mr. Jacksha's recommendation.

Mr. Jacksha noted that the target envisions 5% in private equity, so the question is where the extra 5% should go, and he would look into some possibilities.

Mr. Jacksha said he would ask Aldus for a cash forecast, and would look at rebalancing to the target, and it was an open decision right now exactly where the assets would go, but some (the part not needed for liquidity) would go to hedge fund-of-funds.

HEDGE FUND RISK REPORTS: ALLAN MARTIN, NEPC

Mr. Martin reviewed an abbreviated sample report to give the Committee an idea of the level of tracking involved with hedge funds.

UPCOMING RFP'S/RFI'S — ERB STAFF

Mr. Foy referred to a 10-year comparison of manager performance of Fidelity, Cap Guardian, Goldman Sachs, Rothschild, Franklin and ICAP. He said all of these managers have contracts coming due in the next couple of months.

Mr. Foy stated that Fidelity has outperformed their index by 1.8% for one year, 1.6% for two years, 1.3% for three years, and 93 basis points since inception. He said, based on the fact that they have outperformed their benchmark and are doing well for the ERB, staff would recommend extending their contract.

Mr. Foy stated that Cap Guardian has underperformed by 481 basis points for one year, outperformed by 143 basis points for two years, underperformed by 80 basis points for three years, underperformed by 53 for five years, outperformed by 367 for ten years, and since inception (12 years) they have outperformed by 396. He said staff has issued an RFP for this mandate, but instead of issuing one for an international core portfolio, staff has decided to split that into value and growth managers. He added that Cap Guardian has been informed that they can rebid on this RFP.

Mr. Foy stated that Goldman Sachs has outperformed for one year by 99 basis points, underperformed for two years by .72, and underperformed by .23 for three years, and since inception have underperformed by .48. He stated that, given NEPC's recommendation, and that their style may be coming back into favor, staff was recommending extension of the contract for six months to a year.

Mr. Foy stated that Rothschild has outperformed by 113 basis points for one year, 308 for two years, 163 for five years, and since inception have underperformed by 40. He said this was a firm that underperformed their benchmark by 900 basis points for the first year, so have recouped all but 40 of the 900. He recommended extending the contract for two years.

Mr. Foy stated that Franklin, a small cap growth manager, started out ahead by 300-400 basis points, and in the last one year were under by 300 basis points, two years under by 69 and three years by 128. He recommended issuing an RFP.

Mr. Foy stated that ICAP, the large cap value manager, had their contract extended for a year, but most recently underperformed by 100 basis points, for two

years outperformed by roughly 200 basis points, and for three years were under by 8. He said since inception they are down by 159, so staff was recommending issuing an RFP because of the change in ownership and possible management structure changes.

Mr. Foy reviewed an RFP schedule for each of the three searches.

Mr. Neel said staff would also be issuing an RFI for a real estate consultant, and reviewed the schedule. Mr. Jacksha added that this would be published in FundFire and P&I Daily rather than locally in the *Albuquerque Journal*. He said staff would send the RFI to known contacts in the business and announce it on the Web site. He stated that perhaps a half dozen people were expected to contact the ERB.

Mr. Lewis asked if the RFP and RFI schedule would have any impact on rebalancing the portfolio, and Mr. Jacksha responded that they would do the rebalancing now; in addition, there was some rebalancing to be done on the value and growth side to balance that out, and to the extent that staff does not take care of that in the normal rebalance, they would seek to do that when they reallocate money to managers.

EXTENSION OF EXISTING CONTRACTS — ERB STAFF

Mr. Foy reviewed the following recommendations, noting that some contracts would be extended six months in order to allow the proper timeframe for issuing an RFP:

<u>Company</u>	<u>Contract Expires</u>	<u>Mandate</u>	
JP Morgan	5/1/07	International	Terminated 1/31/07
Fidelity	5/1/07	International	Extend 2 years
Cap Guardian	5/1/07	International	Extend 6 months/RFP
Goldman Sachs	7/1/07	L. Cap Growth	Extend 1 year
Rothschild	8/1/07	Sm. Cap Value	Extend 2 years
Franklin	8/1/07	Sm. Cap Growth	Extend 6 months/RFP
ICAP	8/1/07	L. Cap Value	Extend 6 months/RFP
BGI		8/1/07	Enhanced LC
		Index	Extend 2 years

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

COMMISSION SUMMARY REPORTS — ERB STAFF

Abbreviated versions of Commission Summary Reports were in the packet, reflecting how much each broker was paid for the quarter for fixed income and equities.

PROXY REPORT — ERB STAFF

Mr. Foy said this 120-page report was emailed to Investment Committee members.

Mr. Foy reported that Selma Arnold now handled all of the proxy reports.

Mr. Malott asked Ms. Arnold if the agent hired to do the research on these proxies is doing their job, and Ms. Arnold responded that the research does indicate why they are recommending not to go with the standard blessing of management of certain companies, and ERB staff does defer to those recommendations. She said there have not been any problems with it to date.

Mr. Jacksha clarified that some of the ERB's managers vote the proxies themselves (small cap and international).

Mr. Lewis moved to accept the report. Mr. Riggs seconded the motion, which passed by voice vote.

ADJOURN

Its business completed, the Investment Committee ended the meeting at approximately 4:00 p.m.

Accepted by:

Mr. Bruce Malott, Chair