ACTION SUMMARY

EDUCATIONAL RETIREMENT BOARD

INVESTMENT COMMITTEE

March 12, 2009

MINUTES OF THE

NEW MEXICO EDUCATIONAL RETIREMENT BOARD

INVESTMENT COMMITTEE

March 12, 2009

CALL TO ORDER

A meeting of the New Mexico Educational Retirement Board Investment Committee was called to order on this date at approximately 2:10 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. Gary B. Bland [teleconference]
Ms. Jan Goodwin [teleconference]

Members Excused:
Mr. James B. Lewis

Other ERB Members Present:
None.

Legal Counsel Present:
None.

Staff Present:
Mr. Bob Jacksha, Chief Investment Officer
Ms. LeAnne Larrañaga-Ruffy, Investment Officer
Mr. Steve Neel, Portfolio Manager

Others Present:
Mr. Holland Gary, Aldus Equity
Mr. Saul Meyer, Aldus Equity
Mr. Allan Martin, NEPC
Mr. Steve Gruber, ORG Real Property

APPROVAL OF AGENDA

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

APPROVAL OF MINUTES: February 11, 2009

Ms. Goodwin moved approval of the February 11 Minutes, as submitted. Mr. Bland seconded the motion, which passed by voice vote.

PRIVATE EQUITY UPDATE

Mr. Neel reported that ERB has executed a contract with Veronis Suhler Stevenson, which was a mezzanine deal approved in December, and is still in negotiations with Sevin Rosen and Lee Equity. He said NGP, the most recent commitment, is in the queue.

Mr. Neel said current committed capital is about $720 million among 25 separate partnerships that include co-investments with Aldus and BlackRock Equity. He added that the ERB has called capital with Aldus only at this point.

Mr. Jacksha reported that the ERB is experiencing difficulty negotiating terms with Alterna. He stated that staff plans to set a deadline in the near future on negotiations which, if not met, will render the deal null and void and require the fund to come back through the process.

Mr. Jacksha said Mitigation Banking is not likely to close anytime in the near future, unless there is a change in economic conditions, because most of the deal flow has gone away.

Mr. Neel also reported that ERB staff has been working with Aldus on some terms with commitments going forward, some of them economic and some potentially non-economic.

PRIVATE EQUITY: APPROVE PRIVATE EQUITY INVESTMENTS

Mr. Meyer reviewed the 2009 Allocation Plan, reflecting a decrease in Buyout and Venture Capital and a slight increase in Mezzanine and Special Situations.

Mr. Malott asked Aldus to discuss opportunities in the marketplace.

Mr. Meyer responded that Aldus generally feels "pretty ecstatic" in that the ERB has a young portfolio and Aldus has avoided making sector bets and moving with trends in the market, particularly with respect to the emphasis on buyouts for the past couple of years. He commented that Aldus stuck to its knitting and kept the mezzanine allocations where they were, even though there was general consensus in the market that people should be spending more and more money on buyouts. He commented that the real carnage has been in megafunds, and ERB has done only one. He said he wasn't sure there were many other investors who could say that—so with the exception of Apollo, the ERB has avoided all of the big mezzanines.

Mr. Meyer said the ERB has a very young portfolio with some funds invested in the tough vintage years, but there is a lot of dry powder within the commitments that have been made—and now the ERB will have a portfolio with a massive amount of exposure in the two or three very good vintage years going forward.

Mr. Meyer stressed that the key to success is sticking to the ERB's allocation policy—as long as there are no big bets in any direction, the ERB will be in a great position to outperform.

Mr. Jacksha commented that he didn't disagree with anything Mr. Meyer had said, but cautioned that the ERB will be seeing write-downs and some "ugly numbers" in terms of what has been invested once the December 31 numbers come in.

Mr. Jacksha said staff agrees with Aldus that this is a good time to be in the market, however.

Mr. Malott concurred and agreed with Aldus's philosophy of "slow and steady wins the race, and stick to your knitting."

Lexington Partners VII, L.P.

Lexington partner Nick Harris was present with principal Tom Newby.

Mr. Gary presented Aldus's recommendation of a $45 million commitment in Lexington Capital Partners VII, a $5 billion diversified secondary fund that will be investing across all strategies and geographies in private equity. He said the group has a long history in this space, with overall gross returns of 19% net in their prior funds. He said the firm was established in 1996 and has managed over seven private equity secondary funds, with strong consistent performance. He stated that the Fund's team is outstanding and extremely cohesive: composed of over 50 investment professionals, 39 are dedicated to the secondary space.

Mr. Gary said a confluence of factors is presenting opportunities in the secondary space. He said the mark-to-market rules will cause fluctuations in valuations, but a major factor is the denominator effect and some of the liquidity issues that investors are facing that are leading to forced sales in the secondary space.

Mr. Gary stated that the diligence piece is crucial to the secondary investment strategy in order to develop an accurate and independent valuation. He said the group has a long history of doing that well and consistently.

Mr. Gary stated that Aldus likes this opportunity because the Fund will have within it components in buyout, venture, domestic, international and mezzanine, offering a range of asset choices.

Mr. Gary reviewed Lexington's track record dating back to Fund I. He said there are almost 15% net returns over the entire portfolio, and almost all capital deployed to date has been returned with significant unrealized value remaining.

Mr. Malott asked how Fund VI (in which the ERB is invested) is doing, and Mr. Meyer responded that returns are at 1.6% net and 7.7% gross as of September 30.

Mr. Harris added that their audited financials normally appear about the first week of March because it takes that long to collect the 230 underlying audits. He said they have done some sampling and have called a lot of the underlying GP sponsors to hear what their write-downs will be, and those will be in the 15-25% range—about 20% at the midpoint—which means the 7.7% gross IRR will be closer to plus or minus 7%.

Mr. Malott asked if anyone has evaluated the markdowns of private equity in comparison to the markets themselves in terms of accuracy. He said he was raising this question because Lexington's September numbers seem on the high side when compared to the downturn in the equity markets.

Mr. Harris responded that, generally speaking, private equity markdowns do not correlate very well to public either on the way up or down, because they tend to lag in both directions. With the FAS 157 valuation rules coming into play, he commented, "If you were to ask me if 15-25% is fair, I don't think we're educated or smart enough to really know if that's fair. It's too new and uncertain right now."

Mr. Harris also clarified for Mr. Meyer that the mega buyout funds make up 12% of Fund VI, so they are underexposed.

Mr. Gary noted in the report's benchmark review that Fund VI was comfortably above median, recognizing that the marks will continue to change within the benchmarks and the funds—but there is consistent top quartile performance in the prior funds.

Mr. Harris noted that Lexington VI is a $3.8 billion fund which has committed $3.5 billion, leaving $300 million left to invest; however, of that, only about $2.7 billion has actually been called, so the Fund still has $1.1 billion to be deployed in this more favorable environment.

Mr. Harris assured Mr. Malott that the $300 million left in Fund VI will be completely spent before Fund VII spends its first dollar. He said there will be no overlap.

Mr. Harris presented slides.

Mr. Neel asked how much discounts figure into returns and performance going forward.

Mr. Harris responded that there are four components in secondary funds, although they have never capitalized on the fourth, which is leverage. Addressing the other three components, he said the biggest contributor to Lexington's return is the discount; the second is that Lexington almost always outperforms the original investor in a fund because the IRR wasn't running in the first five years; and the third is underlying fund performance—however the fund is performing in year five, those are the returns Lexington will bring in, and they can't change the outcome going forward. He said Lexington is exposed to the same write-downs as the original investor, so the discount offers a lot of cushion against them.

Mr. Meyer asked Mr. Harris to discuss the prospects for Fund VI given the 4% discount in 2006, its vintage year, as opposed to discounts in the 50% range as of the fourth quarter 2008.

Mr. Harris responded that their current best guess for the Fund's ultimate lifetime performance is a 1.4x to 1.7x net multiple to its investors. He commented that Lexington VI bought in very expensive times, as they were coming up the liquidity curve during the buyout periods—it was a very challenging environment to be buying. He said they participated in direct company portfolio spinouts; for instance, Bank of America was selling its venture capital unit and bringing along its VC assets, and Lexington invested $60 million in that transaction.

Mr. Harris said Lexington plans to invest a pretty small percentage of the direct spinout deals in Fund VII because the pricing on the partnerships is so attractive. He said they think Lexington VII will look a lot more like Lexington V just because of where they are in the cycle.

Mr. Harris commented that Lexington sees a "perfect storm" right now because all of the competition is reduced, supply is significantly up, and dry powder is very low.

Mr. Jacksha asked when Lexington anticipates Fund VI will be done, and Mr. Harris responded late summer 2009.

Discussing management fees, Mr. Harris said that if Lexington takes deal fees, it is 100% off the management fee.

Mr. Neel asked Mr. Harris to discuss the management fee on primaries, since there may be some concern that this is a management fee on top of another management fee.

Mr. Harris responded that: 1) the 50 basis points on Fund VII is the same as the 50 basis points on Fund VI primaries; 2) Lexington would rather spend the money on secondaries than primaries, because it is a financial loss for them to do them—but they do primaries to help augment relationships with general partner sponsors that can lead to future secondary volume; and 3) on the secondary side of their business, they are also taking fee on fee on fee—if they are buying a secondary interest in Company A they are still taking 1-and-10, and if they make a primary new fund commitment to Company B, they are taking 50-and-0 but they are still paying them, so the effect is the same. He added that they have a hard cap of 10% that they can allocate to the new primary fund commitments; and in their last two funds they have used the full 10%, but they do not expect to use the full 10% in Fund VII because they may not need it.

Ms. Goodwin moved that the Investment Committee approve a commitment of $45 million plus any notional interest to Lexington Capital Partners VII, L.P. The commitment shall not exceed 20% of the committed capital of the fund, and is subject to New Mexico state law, Educational Retirement Board policies and negotiations of final terms and conditions and completion of appropriate paperwork.

Mr. Bland seconded the motion, which passed by voice vote.

ABSOLUTE RETURN STRATEGIES—REALLOCATION TO BENCHMARK PLUS & PLAN FOR NEW FUND-OF-HEDGE-FUND ALLOCATION

Mr. Neel reviewed a proposed liquidity schedule for Austin Capital Management and Topiary Trust, which is winding down its fund.

Mr. Neel stated that the ERB has already received $43 million from Topiary Trust and additional amounts are anticipated from them in May and August.

Mr. Neel said the ERB is trying to work its way through a formal schedule with Austin, which is working with another client regarding the liquidity pieces.

Mr. Neel said the ERB will need to look at one more manager depending on how the ERB wants to slice this pie. He said staff particularly likes Common Sense, located in Portland. He referred to a correlation matrix prepared by NEPC to include some of the ERB's existing managers, Common Sense, and the HFR Fund of Fund Index. He noted that Common Sense's performance last year was very respectable at –3.5% for the year.

Mr. Neel said staff will be bringing managers before the Committee within the next 60 days to look at various allocations.

Mr. Jacksha noted that the ERB has already gotten about $44 million in cash back from Deutsch Bank/Topiary and staff is potentially thinking about reallocating it to Benchmark Plus, an existing fund. He said the ERB has three other managers: Gottex, Benchmark, and TAG, which is a smaller fund.

Referring to the correlation matrix, Mr. Martin commented that, when the ERB has funds-of-funds with 40-80 underlying funds, finding funds-of-funds without significant overlap is a challenge. He noted that Common Sense's correlations to the other managers and to the aggregate are in the 30's, 40's and 50's, whereas the other managers are in the 80's and 90's. He said Common Sense has performed well, and there is not an overlap with the existing managers to a great degree, so it tends to provide diversified benefits against the ERB's existing fund-of-funds managers.

Mr. Jacksha noted that staff has started having discussions with providers of services for fund-of-funds and direct fund investing. He staff is looking at firms that can provide the due diligence, prepare reports, do monitoring, etc., since there is not enough staff to do this in house. He said potentially there would be a core of fund-of-funds and then they would add some direct funds at a lower cost.

Mr. Malott asked Mr. Martin what the savings is on fees, and Mr. Martin responded that the hedge fund-of-funds fee historically has been 2-and-20, and they pay the underlying managers—so the top level of fees in effect goes away.

Mr. Martin said the fees to the outside consultant would be in the 10-30 basis point range.

Mr. Jacksha said staff has already interviewed one candidate and is very impressed.

Mr. Bland stated that he continues to believe that investing directly in a hedge fund does not make good sense. He commented that hedge funds by and large do not protect on the downside, which is why the ERB got into them in the first place; they do not hedge; and they are strategy dependent, yet if one were to look at all of the hedge funds in the portfolio in aggregate, it looks like one large hedge fund. He said that he was not comfortable that any of these funds have demonstrated that they have gone outside of the standard investment model. He stated that the ERB ends up paying exorbitant fees for what it could probably do internally directly with managers with 25 basis points or less.

Mr. Martin agreed that the history Mr. Bland has observed over the last three years would certainly suggest on the surface that hedge funds have not diversified and have gone down a lot; and the largest component to that drop has been the global de-leveraging phenomenon. He added that January has been the first month in a while where there is some stability in the credit markets—and while the equity markets were off 8.4%, hedge fund returns for the ERB so far range from 1.65% up to 6.3% positive. He commented that he feels they do diversify, and when the ERB sees the removal of the de-leveraging variable, that will reemerge and add value.

Mr. Bland said he disagreed. He stated that the SIC has most of February's numbers and most of them are down or are up fractionally, and March will not be any better.

Mr. Martin said he was saying was that the bad months were occasioned by an unprecedented meltdown in global liquidity, and that has to recover; and when that factor is removed, the underlying thesis still works.

Mr. Jacksha said he was not suggesting that the ERB take money out of existing equity investments and reallocate it here—this was just reinvesting money coming back to the ERB.

Mr. Bland stated that he would support whatever decision Mr. Jacksha made, but he was not comfortable with the marginal value of adding a consultant and then going into individual hedge funds.

Mr. Jacksha said the question is what to do with the $44 million in cash. He said it can sit in cash or be rolled back into fund-of-funds. He added that the ERB already has $140 million in cash, however, so doesn't really need more.

Mr. Bland suggested putting it in an index fund.

Mr. Malott commented that the direct investment idea does concern him.

Mr. Bland questioned staff's decision to continue to support Benchmark Plus.

Mr. Martin noted that the one year ending January 31 reflects Austin at –23.2% and Benchmark at –20.4%.

Mr. Martin stated that NEPC made a couple of visits to Benchmark on behalf of another client and reviewed of their operations, due diligence and compliance processes starting in September 2007. He said that concern was expressed to Benchmark Plus, NEPC met with them six months later, and over the last year they have hired 3-4 people in their operations, due diligence and control area and have added the former CIO of Arizona Public Safety. He said his sense is that they have substantially improved that capability, and he is much more comfortable with their organization and their skill-set than he was a year ago.

Mr. Martin commented that, of the managers in the portfolio, he feels Benchmark is the strongest and is the most likely to experience significant recovery bounce-back as the de-leveraging situation stabilizes.

Mr. Bland discussed why the SIC fired Benchmark. He stated that, if Benchmark has indeed changed its organization, then they should be brought back to the Investment Committee for another evaluation before receiving any reallocation money.

Following additional discussion, Mr. Jacksha recommended holding the $44 million, skipping Benchmark altogether, and looking at three new hedge fund-of-funds to interview in the next 60 to 90 days.

Mr. Jacksha stated that staff will continue with the process of moving toward direct fund investing.

Mr. Malott said direct fund investments should be a Board decision given that this is a new strategy.

INTERNATIONAL EQUITIES—MELLON CAPITAL PERFORMANCE REVIEW

Mellon representatives presenting this performance review were Richard Forster, senior client service officer; Greg Lindsey, business development director; and Jonathan Xiong, portfolio manager and global strategist.

Mr. Forster said he would be retiring at the end of this month and Mr. Lindsey, a 20-year veteran of Mellon, will step into the job.

Mr. Forster presented slides.

Mr. Forster noted that Mellon had $152 billion in assets under management at the end of 2008; and like most firms and plans, that was down from a peak of about

$240 billion at the end of 2007. He said the assets being managed for the ERB, which broadly falls into their global alpha strategy, have fallen from $41 billion to $19 billion. He said 55% of this is from the market itself and 40-45% is client redemptions.

Mr. Forster stated that the ERB is in the EB International Equity Alpha Plus Fund, which tries to add value to the International EAFE Index by taking long-short positions in country bond, stock and currency markets. He said the Fund was at $33 million at the end of February. He said that the account is down 62.5% since its inception (6-30-07), of which 54% (of the 62.5%) is due to the decline in the EAFE Index; and Mellon's active decisions detracted another 8.5%. He apologized on behalf of Mellon.

Mr. Forster said the process itself has a very long term track record, and Mr. Xiong would recap the process and describe how Mellon has attempted to improve upon the process during these volatile market conditions to ensure that a drawdown doesn't happen again.

Mr. Xiong discussed what the Global Alpha/GTAA Strategy is designed to do. He said the investment process seeks to profit from relative mispricings across the world's stock, bond and currency markets, and the strategy actively overweights undervalued assets and underweights overvalued assets. He said this creates a higher return potential per unit compared to traditional active management, and provides an alpha source uncorrelated with traditional equity and fixed income portfolios.

Mr. Xiong said Mellon employs four main ways to add alpha: 1) they make a global stock vs. bond decision, which they tactically shift between asset classes; 2) they make a decision across country equity markets, long and short, and only employ this on index levels and there is no individual stock picking and they do not employ credit bonds; 3) they make a decision on bond vs. bond; and 4) they make a currency decision.

Mr. Xiong said Mellon does not override their process, and as a quantitative manager, they do not employ technical momentum trading style strategies. He said everything they do is from a fundamental economic theory perspective.

Referring to Mr. Forster's point that Mellon's active decisions caused additional detraction, Mr. Jacksha asked what factors in the system contributed to that.

Mr. Xiong reviewed a performance analysis on page 14. He stated that 2007 underperformance and 2008 underperformance could be attributed to two major components: the global stock vs. bond allocation was down 885 basis points in 2008 (Mellon was overweighted in stocks and underweighted in bonds); and the currency allocation was down in 2007 and 2008 by 481 basis points and 307 basis points respectively.

Mr. Xiong also stated that, when the ERB initially invested on June 30, 2007, Mellon was neutral on global equities. He said they had an overweight on during the two previous years and took it off on June 30, 2007, and went to slightly short global equities at that point.

Mr. Xiong said the subprime debacle then occurred and Mellon started to see some attractive pricing relative to fixed income in equities toward the end of 2007, and then they began purchasing global equities as an overweight relative to fixed income; and 75-80% of their underperformance occurred in September and October 2007.

Mr. Xiong said Mellon today continues to hold their overweight to global equities and underweight to fixed income.

Speaking to the detractor of currencies, Mr. Xiong referred to page 18 and said the detractor in 2007 was because of Mellon's underweight in commodity currencies such as the Norwegian krone, Canadian dollar and Australian dollar. He said they had overvaluations in these currencies that they hadn't seen in their process for 20-30 years, and they held onto this position throughout 2007 and 2008. He said their PPP valuation models were showing at extreme levels. He commented that this was the biggest detractor from their currency performance in 2007. He stated that, when the commodity bubble burst in June and July 2008, they made all of their alpha back from this particular signal in relative PPP misvaluation, but they were underperforming in their other component when they used the carry trade. He said the carry trade has been underperforming for the last 18 months, more or less, because of deleveraging in the marketplace, repatriation and a lot of trades being taken off that were levered from the carry side after the credit situation resolved.

Mr. Bland asked what Mellon did right in 2008, and Mr. Xiong responded that the cross-country bond selection in long-short sovereign bonds added about 186 basis points in 2008. He said their cross-country equity allocation was slightly down, about 176 basis points, and the two detractors were the directional bets. He said that Mellon takes a fundamental value approach and valuation last year didn't work in September and October.

Mr. Xiong reviewed Mellon's global alpha account record and noted that, over a full market cycle, the strategy has delivered excess returns (alpha), and each of their alpha sources has added value over time.

Mr. Xiong stated that Mellon had a positive December and January, with some downturn in February and then a return to positive in March. He said the extreme events in September and October resulted in significant drawdown; but as things have returned to "somewhat normalcy, if you want to call it that, from a credit perspective and a capital market trading perspective, our strategy has stabilized and has added value since that point in time."

Mr. Xiong also commented that Mellon's assumptions are that market participants are in the markets to seek profits, long-term or short-term; however, after these most recent events, Mellon realizes there could be extended periods of time with extreme irrationality that could hurt certain processes Mellon has in those underlying assumptions.

Continuing, Mr. Xiong described components that Mellon has added to control risk better: in April 2008, they added a component called "the revision of rate expectations," and since then have added a significant amount of alpha to the currency process. In May, he said they added a "residual earnings growth model," and that has also added value. He said Mellon implemented two more enhancements into the currency process in October: current account relative to GDP imbalances in anticipation of intense stimulus spending in U.S.; and in periods of uncertainty and sustained volatility, they will dial down their carry signal by roughly half, and will dial up their carry signal by 1.5 when they see certainty in the marketplace.

In terms of adding alpha going forward, Mr. Xiong said the biggest risk budget in Mellon's portfolio is in their cross country equity market selection, followed by their cross country bond allocation— even in periods of stress during the past two years, both components have been positive. He stated that, because of the dislocation in the markets last year, they expect those to revert back first but do not need the equity markets to recover for this to happen—because they are going long-short, the mean reversion should happen on a relative value basis first, even if directional doesn't happen.

Mr. Bland asked Mellon to share their thoughts, if they plan to keep this portfolio, on working for 5 basis points until the delta is recovered.

Mr. Forster responded that they could certainly discuss alternatives. He said they sent Mr. Jacksha an alternative performance based fee, but 5 basis points would be very thin—basically it would be an index fee. He added that Mellon certainly wants to work on getting a fee the ERB is comfortable with.

Mr. Malott asked what the current fee is, and Mr. Jacksha responded 80 basis points flat fee.

Mr. Jacksha said ERB staff went to all of the managers and asked for reduced fees, and he hasn't evaluated all of them.

Mr. Malott asked Mellon to sharpen their pencils and come back with the lowest fee possible for a period of time until their predictions start to materialize. He stated that he would expect a significant fee reduction from Mellon.

Mr. Jacksha said staff could establish a watermark where the fee would increase.

REAL ESTATE—SECONDARY PROGRAM: STEVE GRUBER, ORG

Mr. Jacksha explained that Mr. Gruber is proposing that ORG do a secondary fund for the ERB and for another client in a commingled fund. He said he would like advice from the Committee on what process to follow: for instance, should it be handled like the private equity co-investment funds, with the consultant proposing a fund for the ERB. He said NEPC could do a third party evaluation for the ERB.

Mr. Bland said he would support Mr. Jacksha's proposal. He commented that this is a good niche.

Mr. Gruber stated that ORG is structuring this so that the ERB has an opt-out on any individual investment, so each of the clients investing has the equivalent of a separate account. He said ORG would get 50 basis points on invested capital; would co-invest alongside the ERB at 1%, and would get 3% over 10%. He said ORG "wants to be able to eat its own cooking alongside our clients."

Mr. Bland said he liked this fee proposal very much.

[Mr. Bland excused himself from the proceedings.]

Mr. Gruber presented slides.

Mr. Malott asked what the size of the fund would be.

Mr. Gruber responded that ORG has a commitment from Arizona Public Safety (an ORG client) from $25-$50 million, and hopes to get a commitment from the ERB, which would be treated in aggregate as a fund—so the ERB will get its share of each deal on a pro rata basis. He said ORG thinks it will get a non-ORG client for another $50 million.

Mr. Gruber said the investment period is two years.

Mr. Martin said Arizona Public Safety is a client of NEPC, and voted to approve this fund contingent upon NEPC deeming ORG qualified to do this and that the pricing made sense. Mr. Martin commented that he has a very high opinion of ORG.

Mr. Jacksha asked the Committee if staff should bring forward other qualified candidates. He said he personally did not see the need.

Mr. Malott commented that the ERB has already vetted ORG and has a relationship with them, and trusts them. He asked Ms. Goodwin for her input.

Ms. Goodwin responded that she is comfortable with the proposal.

JANUARY FLASH REPORT—ERB STAFF

Mr. Jacksha reviewed the January Flash Report.

ADJOURN

Its business completed, the Investment Committee adjourned the meeting at approximately 4:30 p.m.

Accepted by:

Mr. Bruce Malott, Chair