MINUTES OF THE

NEW MEXICO EDUCATIONAL RETIREMENT BOARD

INVESTMENT COMMITTEE

July 24, 2008

CALL TO ORDER

A Regular Meeting of the New Mexico Educational Retirement Board Investment Committee was called to order on this date at approximately 2:05 p.m. in the Educational Retirement Board Room, 6201 Uptown Boulevard, N.E., Ste. 203, Albuquerque, New Mexico.

A quorum was not present:

Members Present:
Ms. Jan Goodwin
Mr. James B. Lewis, Acting Chair

Members Excused:
Mr. Bruce Malott, Chair
Mr. Gary B. Bland

Other ERB Members Present:
None.

Legal Counsel Present:
None.

Staff Present:
Mr. Bob Jacksha, CIO
Ms. LeAnne Larrañaga-Ruffy, Investment Officer
Mr. Steve Neel, Portfolio Manager
Mr. Jeffrey Riggs, Deputy Director
Mr. Greg Trujillo, IT Director

Others Present:
Mr. Allan Martin, New England Pension Consultants
Mr. Jeff Markarian, New England Pension Consultants

[Because a quorum was not present, the Committee proceeded with non-action items on the Agenda.]

OPENING REMARKS BY MR. JACKSHA AND NEPC

Mr. Jacksha explained that Goldman Sachs will present the idea of a note structure that is linked to emerging markets equities, basically an index, and the structure is designed to outperform the index over a fairly wide range of scenarios. He said the return is capped somewhere in the 20-30% range (depending on the structure), and the ERB will have to decide whether it is willing to give up that upside. He said if the market goes up 40%, for instance, the ERB wouldn't earn all of it, but if the market didn't do as well over the one year period, the ERB would then do better than the market.

Mr. Martin reported that there were 31 responses to the RFP for an investment manager or managers to provide services for an active Non-U.S. Emerging Markets Equity mandate in a separately managed account in the amount of $300 million. He said NEPC worked with Mr. Jacksha, Ms. Larrañaga-Ruffy and staff and winnowed the number down to two, Batterymarch Financial Management, Inc. and Robeco Group, N.V.

Mr. Martin stated that what came out of this process was a structure with an active long-only growth manager for emerging markets plus an active long-only value manager for emerging markets, plus a core emerging markets manager that was either top-down or had a more quantitative process. He said this would create diversity in style; and because the markets are so nervous right now, the issue was whether this was the right time to put more money into emerging markets. He said the idea of a note was introduced, where the ERB would protect itself on the downside and then pay for that protection by giving up some of the upside.

In looking at the value managers versus Alliance, Mr. Martin said NEPC found Alliance to be superior; however, in looking at the growth managers versus Alliance, Alliance hasn't performed as well relatively, but they have made some changes to their process. He added that, given the high cost of changing managers in this market, NEPC and staff agreed that maintaining the relationship with Alliance was the best value, with Robeco and Batterymarch being the best core managers.

GOLDMAN SACHS

Goldman representative Karen Fang appeared before the Committee with colleagues Richard Barnett and Andy Brown and presented slides.

After discussing the outlook for emerging markets, and how the universe of active managers has performed versus the ERB's investment criteria, Ms. Fang presented two structures customized by Goldman Sachs to meet the ERB's needs.

Ms. Fang reviewed the "Buffered Outperformance" structure, which is designed to provide outperformance comparable to the top performing active managers, and offers partial downside protection if the index falls, and on the upside would provide additional return if the index is to increase. In reviewing the formulaic structure payout at maturity in 12 months, she said if the total return of the underlier (EEM, iShares MSCI Emerging Markets Index Fund) is positive, the return is 100% of notional plus the total return of the underlier multiplied by 1.5x up to a total return of about 25.95%. She stated that, if the total return of the underlier is 0% to –7%, the return is 100% of notional; and if the total return of the underlier is less than –7%, the return is 100% of notional plus the total return of the underlier plus 7%.

Ms. Fang reviewed the "Buy/Write" structure, which provides a higher degree of confidence in outperformance. In reviewing the payout at maturity in 12 months, she said there will be guaranteed outperformance of 3%, whether the index is up or down, up to a cap of 37% (34% underlier cap plus 3% coupon).

Ms. Fang stated that, based on their understanding of the ERB's criteria, Goldman feels that the Buy/Write structure would be the best fit with ETF as underlier with a $100+ million investment initially.

At the conclusion of the presentation, Mr. Jacksha asked Committee members to ask themselves what might be an acceptable outcome, should emerging markets accelerate over the next year, in exchange for lesser returns under either of the two proposed structures.

BATTERYMARCH FINANCIAL MANAGEMENT, INC.

Tim Stanton, director of U.S. Institutional Sales, and David Lazenby, director and emerging markets senior portfolio manager, appeared before the Committee and presented slides.

Mr. Stanton said Batterymarch was founded in 1969 and has been investing in emerging markets since 1987. He said Mr. Lazenby was part of the team that launched this product, and has been instrumental in working on the design and the investment process.

Mr. Stanton said Batterymarch doesn't believe in the style game in emerging markets—they run a core investment process with elements of growth and value because they believe that is how to win in the longer term. He said their history is steeped in quantitative investing, and their approach is fundamentally driven; they look at the underlying fundamentals of each company everyday and supplement the stock selection process with on-the-ground research. He said Mr. Lazenby and his team of five portfolio managers and an analyst each have country responsibility, and they travel to those countries and meet with the companies. He said that, if there is information lacking from the quantitative investment process, they will supplement the process through a fundamental analysis.

Mr. Stanton stated that Batterymarch's performance last year was up 49% versus the benchmark, which was around 40%, and there were three corrections greater than 10% where they outperformed the benchmark. He said the portfolio this year is down about 13%, but they are still 70 basis points ahead of benchmark—so they are risk controlled and able to add value consistently over time.

Mr. Stanton said Batterymarch has been owned by Legg Mason since 1995, but Batterymarch operates independently from them.

Mr. Stanton stressed that, while Mr. Lazenby is director and senior PM, he is part of the team and the team meets weekly and shares ideas.

Mr. Lazenby stated that Batterymarch analyzes 1,750+ emerging markets stocks everyday, but because there are different levels of development and sophistication in the emerging markets, and there are some companies where data isn't readily available, they combine the fundamental insights of a team of experienced managers with the output of the quantitative systems. He referred to a chart of rolling five year returns of the Batterymarch Global Emerging Markets Equity Composite contrasted with MSCI Emerging Markets and noted that Batterymarch has consistently generated outperformance. He reviewed a three-year annualized risk and return table and pointed out that the up capture for Batterymarch versus the MSCI EM index was 115.2%, and for the down capture was 99.8%. He said this was after Batterymarch changed its strategy following the 2002-2004 period when there was unusual performance volatility in the market. He added that, if the chart were changed to include the year prior to their making portfolio construction changes, the numbers would be slightly down.

Mr. Lazenby reviewed Batterymarch's quantitative analysis process in developing the relative ranking of the attractiveness of a stock. He said the stocks ranking at the top of the list (20%) are chosen for further fundamental analysis, e.g., is there macro risk, political risk or late-breaking information that the model does not have. He said those insights are incorporated into an "opinion" with a ranking from 1 to 5, and those are combined with the quantitative score to re-percentile the list. He said the final ranking goes into the portfolio construction.

Mr. Markarian asked if every stock in the portfolio has an opinion, and Mr. Lazenby responded that every stock that ends up in the portfolio has some sort of opinion, although the majority of the opinions across the whole universe are "neutral." He said typically it is less than 20% of the time that they have a non-neutral opinion on a stock in the universe, let alone the portfolio. He said it is typically less than 10% of the universe that has a non-neutral opinion that is also directionally different from what the quantitative model is already saying; i.e., typically less than 10% of the universe is being impacted by the fundamental insights from the portfolio management team, which is a recognition that the quantitative model has been consistently successful across time, particularly in the broad and deep markets of the emerging markets universe.

In discussing country allocation, Mr. Lazenby said it is still true that emerging markets have a significant element of performance driven by sovereign factors; in their case, because they are essentially bottom-up in orientation, they still rely on aggregation of stock level beta at the value level and the growth level. He said they aggregate the data stock-by-stock up to the country level to see if the stocks in South Korea have a better combination of value and growth than the stocks in Taiwan, for example. He said they combine that with technical indicators at the index level, and then factor in the opinions.

Noting Mr. Lazenby's remarks that about 10% of the stocks have a different directional opinion than the model, Mr. Markarian asked how that plays out at the country level.

Mr. Lazenby responded that each of the portfolio management team members has the opportunity to place an opinion on a country. As director, he said his opinion is double-weighted relative to anyone else's, as is that of the portfolio manager of a specific country. He stated that, when combined together, there is a non-neutral weight on almost every country, but in total it ends up being relatively equal-weighted before the countries are ranked.

Mr. Lazenby discussed their portfolio construction/stock weighting rules that are applied to make sure they have a diversified risk-controlled portfolio. He pointed out that they do not want unduly large bets—whether they be macro bets by country industry group, or whether they be specific stock bets that will overwhelm the effectiveness of the equal-weighted stock selection process over time. At the country level, he said they allow themselves to overweight or underweight 5% versus the index level—so at the extreme, if they like a country and its stocks are outperforming, they build an overweight position that can bump up against a 5% overweight versus the index. He said Brazil, for instance, which is 16% of the index, can get up to 21% or go as low as 11%. He said many of the smaller countries—there are currently seven that are greater than 5% of the MSCI EM Index, and the rest of the countries are below that threshold. He said if they don't find attractive stocks, they can theoretically be out of those countries because that is a level of risk they are comfortable taking. He said there is the same level of risk at the industry level plus or minus 5%.

Mr. Jacksha asked Mr. Lazenby where Batterymarch stands with the BRIC countries in terms of overweights and underweights.

Mr. Lazenby referred to a representative portfolio profile which showed Russia as the biggest overweight at about 2%, and China near the bottom at –2%, with Brazil still being slightly positive after being their biggest overweight for several years, and India underweighted by about 50 basis points.

Mr. Stanton reviewed the fee schedule and said their fee with a $300 million mandate would be 77 basis points. He also reviewed a performance-base fee schedule.

[Break.]

ROBECO GROUP N.V.

Robeco Institutional Portfolio Manager Alex Neve, a member of Robeco's Rotterdam-based emerging markets team, and Public Funds Marketing director William Supple appeared before the Committee and presented slides.

Mr. Supple said he is based in Robeco's Boston office and works with a partner in the San Francisco office, where together they handle about 40 clients with $6.5 billion in assets for public fund clients in North America.

Mr. Supple said Robeco's emerging markets equity strategy is significant in three ways.

Mr. Supple said they believe country allocation in emerging markets is of utmost importance, as is underweighting and overweighting, and they do this in a systematic monthly fashion and have been doing it for 14 years. He said the three senior-most managers on the team comprise their "country allocation committee."

Mr. Supple said they have an experienced and long-tenured team: Wim-Hein Pals, lead manager (Korea, Malaysia) was co-founder of the strategy and has been with Robeco since inception (14 years), and the number two and number three persons, Paul Van Homelen (South America, Turkey, Israel) and Jaap Van Der Hart (Taiwan, China), have seven and nine years respectively.

Mr. Supple said they combine quantitative and fundamental research, having added the quantitative stock model in 2001. He stated that they equal-weight the stock selection process on both sides, and this has provided better returns in the last seven to eight years. He said this has also dampened volatility for their clients.

Mr. Supple reviewed a chart of Robeco Emerging Markets Equity annualized returns over a ten-year period versus the MSCI EM Index. He noted returns ahead of the benchmark consistently. He added that, even in this year's tough market with the market down almost 12%, they are down just below 6%.

Mr. Supple reviewed the investment team members on slide 7 and said he likes to clarify for people in the U.S./North America that the organizational structure in Rotterdam, where Robeco is located, is somewhat different. He said the investment team, aside from the top three members, is comprised of people who are considered more like analysts in North America. He said each has responsibility for their own country and geography: they select the stocks with the approval of the senior people within their own geographic regions, so they are part of the portfolio management family.

Mr. Supple also reviewed the ten-member quantitative research team, which is headed by Thierry Post, Ph.D. and three others. He said Robeco is one of the leaders in Europe in quantitative investing, and they are one of the pioneers in developing that in emerging markets.

Mr. Neve discussed Robeco's decision-making process. He said that, on a daily basis, the team discusses all of the data that comes from emerging market countries. He said they follow 26 emerging market countries fundamentally. He stated that there are numerous data points coming out on a daily basis ranging from political events to inflation numbers. He said the team discusses all of this as a group, assigns scores, and feeds the information into their database.

Mr. Neve stated that the team does weekly stock selection. He said they split the team into two sub-teams in order to make the stock selections: 1) Asia Team, and 2) Latin America, Europe, Middle East, Africa (LatEMEA) Team.

Mr. Neve said there is also a monthly country allocation meeting, where decisions are made on allocation of country weights by the three most senior team members.

Mr. Neve also stated that there is a monthly portfolio evaluation, where all team members discuss company meetings and risk management, and review quantitative models for stock and country selection.

Addressing the first step of the review process, Mr. Neve stated that the team takes a fundamental approach to country allocation and assign scores on five factors: macro-environment and political risk; earnings expectations; valuation; technical analysis; and sentiment and demand/supply. He said they added a quantitative model in 2004 in order to analyze more countries (32) than would be possible to follow fundamentally. He said the quant model is considered a "second opinion."

Mr. Neve reviewed the framework Robeco uses in making a country allocation, using Brazil as an example.

In discussing stock selection, Mr. Neve said Robeco analyzes about 300 to 350 names on a fundamental basis, while the quantitative model looks at 1,200 names.

In the course of reviewing Robeco's fundamental analysis process, Mr. Neve said Robeco sends out a proprietary survey every two years to the entire universe of companies they cover and then scores those emerging markets companies on corporate governance.

Mr. Neve reviewed a risk management chart reflecting that Robeco limits its portfolio to 130-160 names, with individual country exposure at +/-5% relative to the benchmark, with individual stock exposure at +/-2% relative to the benchmark, and a 5% maximum cash position.

At the conclusion of the presentation, Mr. Supple said Robeco has submitted a flat fee as well as a performance-based fee schedule that he thought extremely aggressive and indicative of how much Robeco wants to join the ERB's stable of managers.

Ms. Goodwin observed that two people on the investment team have been in those positions for less than a year, and asked if they were replacing people who had left, or were additional members.

Mr. Neve responded that the last departure from the senior investment team was in 2005, when a member decided to become a fulltime homemaker. He said their junior portfolio managers (who are more like analysts in the U.S.) make up the rest of the investment team and are rotated from other areas of the company. He said Robeco seldom brings people in from outside unless it offers a rare opportunity to bring in another country, and most recently they brought in Dimitri Chatzoudis, who previously was the lead portfolio manager of the global emerging market product at ABN AMRO.

Mr. Jacksha asked if Robeco has a view on the performance of emerging markets in the next year or two.

Mr. Neve responded that they have a pretty positive view at the moment, which is supported by Robeco's quant models, one of which projects whether global developed markets should be overweighted versus emerging markets. He said the model just turned positive in March of this year in favor of earnings growth in emerging markets; and while it is still early, historically the model has done well 55% of the time.

DISCUSSION

Mr. Martin spent several minutes reviewing NEPC's analyses of Robeco and Batterymarch.

The Committee reached consensus to drop the idea of the structured note (Goldman Sachs).

CONCLUSION OF SESSION

The session concluded at 5:00 p.m.

Accepted by:

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James Lewis, Acting Chair