

MINUTES OF THE
NEW MEXICO EDUCATIONAL RETIREMENT BOARD

INVESTMENT COMMITTEE

September 10, 2009

CALL TO ORDER

A meeting of the New Mexico Educational Retirement Board Investment Committee was called to order on this date at approximately 9:15 a.m. at the Prairie Star Restaurant, 288 Prairie Star Road, Santa Ana Pueblo, New Mexico.

A quorum was present, as follows:

Members Present:

Mr. Bruce Malott, Chair
Mr. H. Russell Goff
Ms. Jan Goodwin

Members Excused:

Mr. Gary B. Bland

Other ERB Members Present:

Ms. Mary Lou Cameron
Mr. James B. Lewis
Dr. Beulah Woodfin

Legal Counsel Present:

Mr. Chris Schatzman

Staff Present:

Mr. Bob Jacksha, Chief Investment Officer
Ms. LeAnne Larrañaga-Ruffy, Investment Officer
Mr. Steve Neel, Portfolio Manager
Mr. Jeff Riggs, Deputy Director
Mr. Greg Trujillo, IT Director

Others Present:

Mr. Allan Martin, NEPC
Mr. Bryan Schneider [teleconference]

APPROVAL OF AGENDA

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

APPROVAL OF MINUTES: August 13, 2009

Mr. Goff moved approval of the August 13 Minutes, as submitted. Ms. Goodwin seconded the motion, which passed by voice vote.

FIXED INCOME: GOLDENTREE CLO DEBT INVESTMENT OPPORTUNITY

Mr. Jacksha stated that the Investment Division staff feels that the opportunity presented in the current CLO market conditions is a good one, and recommends an investment of \$50 million, plus fees and expenses, in a separate account with GoldenTree.

GoldenTree representatives Frank Benevento, Christopher Cereghino and Joe Naggarr appeared before the Committee. Mr. Benevento stated that GoldenTree has about \$10.5 billion under management, most of it in levered credit.

Mr. Benevento said that, while the levered credit market has moved very rapidly, GoldenTree feels that this underlying asset class has not moved at the same pace, presenting a "very quick strike opportunity." Because there is a very narrow window during which this can be exploited, he said GoldenTree is limiting the amount of capital to put to work and will not be talking with any other investors after presenting this opportunity to the ERB.

Mr. Cereghino reviewed a slide presentation.

Mr. Cereghino explained that a CLO is a securitization of a pool of corporate loans—typically 10 to 150 in this closed end vehicle—generally rated anywhere from BB to B. He said the first process of establishing a CLO is setting up a Special Purpose Vehicle and hiring an investment manager. He said the SPV then raises debt and equity capital. He said transactions tend to be \$300-\$500 million in size.

Discussing a \$500 million transaction as an example, Mr. Cereghino said the SPV purchases a diversified pool of corporate loans, with the equity tranche bearing the first risk of loss (\$40 million), BB-rated tranche holders bearing the second risk of loss (\$20 million) and moving up through the line until one reaches the AAA tranches. He said the range between the senior AAA and junior AAA tranches represents about 75% of any single transaction.

Noting that the underlying loans are B rated, Mr. Malott asked how GoldenTree is able to have an AAA-rated tranche.

Mr. Cereghino responded that the rating agencies model up pools of these assets looking at historical default and recovery rates to see how many defaults can happen while still maintaining an AAA rating.

Mr. Benevento further explained that the AAA tranche is over-collateralized by the underlying B and BB assets, but the value of the assets exceeds the AAA tranche; therefore, it mitigates the risk.

Mr. Jacksha referred to a CDO/CLO capital structure illustration in staff's memo, noting that the losses flow up the capital structure, with the equity tranche absorbing all of the losses until it is exhausted, then flowing up to BBB debt tranche, etc.—so there is subordination that protects the more senior classes from taking losses as the normal amount of defaults occur.

Mr. Cereghino said a typical AAA tranche might have 25% of the subordination, which means one could experience a 50% default rate with a 15% recovery rate before experiencing loss. He said there are other structural features in a CLO that divert cash flows from the most junior tranches to the senior tranches whenever the portfolio starts to become distressed.

Mr. Cereghino stated that there is no residential or consumer risk in this particular portfolio. He said typically the pools are made up of 90-95% first lien senior secured loans.

Mr. Naggar said GoldenTree reviews every portfolio, whether GoldenTree or another manager manages it, in order to evaluate the debt and the margin of safety. He said they do not rely on the rating agencies or other managers' ability to understand the market.

Mr. Lewis asked Mr. Naggar to further clarify what he meant by saying that GoldenTree does not rely on the rating agencies.

Mr. Naggar responded that rating agencies are helpful in pinpointing the general location of something within the capital structure that GoldenTree is looking at, but the rating agencies in a lot of cases don't necessarily differentiate as well as he can when looking at the different tranches and analyzing outcomes. He explained that there might be 1,000 different transactions in the CLO universe, and he can find an AA-rated transaction that looks like junior AAA-rated transaction, and he can find an A-rated transaction that looks more like a B rating—so relying on the rating agencies in doing an analysis is not a good way to go and part of the reason why this opportunity exists in the first place.

Mr. Cereghino said GoldenTree believes that, as loan prices stabilize, the risk premiums currently demanded in the CLO debt market will contract, generating attractive returns for investors. He said their base assumption is that the spreads demanded by AAA Jr., AAA, AA, A and BBB investors will contract to LIBOR + 150, 500, 700, 1200 and 1700 respectively, and that this will play out over a 12-24 month period.

Mr. Malott asked what would be the black swan event that would cause these assumptions to not work.

Mr. Naggar responded that GoldenTree believes that the market is cheap relative to expectations of the GDP and general market recovery, and it would not be a problem if the GDP were at 2% or even 1% in 2010, but a negative 1% would translate to higher default rates and lower recovery rates and would throw this structure out of balance. He said that if they experience an extended "first quarter of 2009" for a year or two, that would be a very tough market for this asset class.

Mr. Naggar noted that the highest default rate for one year was in 1933, when it hit 15.7%. He said an A-rated tranche under this CLO structure could take 18% defaults for two years running, then 5% thereafter for the life of the CLO—so it could take worse than what happened in 1933 for multiple years and still deliver interest and principal, but if it gets worse than that, there is a risk.

Mr. Naggar stated that GoldenTree feels it has a competitive advantage in cherry-picking better portfolios and better capital structures that does not exist in the buyer base right now. He said GoldenTree was the first mover in setting up systems in looking at this asset class properly, and very few people look at it in the same way, which is to combine the asset and liability side of the equation. He said GoldenTree invests millions of dollars in systems to help them articulate relative value in the CLO universe.

NEPC advisor Allan Martin discussed NEPC's recommendation that the ERB take advantage of this opportunity with a \$50 million commitment.

Mr. Martin stated that another client of NEPC, who has a far more significant percentage of their overall portfolio in this distressed credit, has GoldenTree as an existing manager of bank debt. He said that client, working with GoldenTree, recognized this opportunity and that client was the initial investor in this strategy.

Mr. Martin said the benefit the ERB gets from that is NEPC has done extensive due diligence on GoldenTree—not only has NEPC visited with them a number of times, but so has NEPC's other client, which has the best staff he has worked with. Furthermore, he said, the other client employs a third party accounting firm that also does due diligence.

Mr. Martin said NEPC likes this concept and believes it has merit. He said GoldenTree has the capability to be successful here because they have two of the necessary skill-sets: 1) they understand the underlying instruments (bank debt and leveraged loans that comprise the asset); and 2) they understand the structures of the CLO.

Following up on Mr. Malott's question about a black swan event, Mr. Martin said nobody can say that there will not be default rates of worse than 18%—it has never happened before, but it could happen given these distressing economic times. If that happens, he said, the ERB might actually lose money; but by comparison, there would be “horrendous” returns to the equity market. He commented that this wasn't perfect, but the structure will give the ERB a layer of protection should there be a serious relapse in the economy.

Mr. Goff asked Mr. Jacksha to expand on his memorandum to the Committee describing the differences between Vanderbilt and GoldenTree.

Mr. Jacksha responded that, for the whole CDO/CLO issue, the problem was not the structure of a CDO vehicle; it was the underlying collateral, and in Vanderbilt's case those were subprime mortgage-backed bonds. He said Vanderbilt was buying at the very bottom of the capital structure, which is the piece that absorbs the losses first, so when the losses from the subprime mortgage-backed bonds came in much higher than expected, it essentially obliterated that tranche. By comparison, he said GoldenTree is dealing with senior bank loans issued to corporations that are in first position in security on the assets of those corporations.

Mr. Jacksha also noted that Vanderbilt was in the equity tranche (first loss and thus highest risk tranche), while GoldenTree will look higher up in the capital structure and buy protected bonds rather than the equity piece, which affords more protection and is a safer investment.

Mr. Jacksha said the Vanderbilt investment was done pretty much at the top of the market cycle, and turned out to be overpriced. On the other hand, he said, GoldenTree is near or at the bottom of the market cycle and pricing is discounted.

Mr. Jacksha stated that Vanderbilt had a lower expected return than GoldenTree now has, which could be as high as 40%.

Mr. Martin noted that GoldenTree also manages CLOs. He asked if that creates issues for GoldenTree in running this product in terms of being shown attractive deals, etc.

Mr. Naggat responded that GoldenTree also accepts calls from other high yield managers or other people who invest in GoldenTree's CLOs, and when they focus

on that investment class, they treat those investors those the same way. He said this is just market protocol. He said there has not been a single time where they had any issue talking with direct competitors in other spaces.

GoldenTree representatives stated that there was no current or pending litigation issue that the ERB should be made aware of.

Mr. Malott indicated that he would prefer that approval of this commitment be unanimous from both the Investment Committee and the ERB Board, or else it should not be authorized.

Mr. Martin said GoldenTree did originate this idea with one of NEPC's clients, but NEPC did visit and interview a couple of other managers with this capability. He said NEPC's clear opinion is that GoldenTree is superior to the other managers interviewed and is the clear choice.

Mr. Jacksha stated that Investment staff has not yet had an opportunity to visit GoldenTree's offices because of the timing of this investment. He said Mark Canavan will be in New York next week and could visit their offices at that time.

Ms. Goodwin moved that the Investment Committee approve a commitment of \$50 million plus fees and expenses to a GoldenTree CLO separate account. The commitment is subject to New Mexico state law, Educational Retirement Board policies and negotiation of final terms and conditions and completion of appropriate documents.

Mr. Goff seconded the motion.

Mr. Jacksha agreed that Mr. Canavan would make a site visit to GoldenTree's offices in New York

The motion passed unanimously by roll call vote, with Mr. Malott, Ms. Goodwin and Mr. Goff voting in favor of the motion.

**PRIVATE EQUITY (CO-INVESTMENT)—BLACKROCK MANDATE
INCREASE
AND ESTABLISHMENT OF LLC**

[NEPC advisor Bryan Schneider was present by teleconference.]

Mr. Neel and Foster Pepper representative Bob Perez appeared before the Committee.

Mr. Neel stated that, as part of the process for unwinding the Erasmus NMERB Co-investment program (Aldus), ERB staff has been in negotiations with ERB's other co-investment manager to assume the monitoring of investments made under the Aldus co-investment mandate. He said staff is asking the Investment Committee to approve an increase in the BlackRock Co-Investment mandate to include investments made under the Erasmus NMERB Co-Investment Fund that include any follow on investments, expenses and management fees.

Mr. Neel said the Investment Committee is also being asked to authorize the establishment of an LLC as a transition vehicle to BlackRock.

Mr. Perez stated that staff is proposing that the new GP be a single member LLC with the ERB as that member. He said the new GP/LLC will dissolve the Erasmus Fund and transfer the two existing investments to BlackRock, which will manage the investments, and then the LLC will be dissolved.

Dr. Woodfin said she recently read an article in *The Wall Street Journal* stating that the China Investment Corporation is getting into the distressed debt markets and is looking into BlackRock and Lone Star. She wondered if that type of a major investment would have any influence or effect on the ERB's involvement with BlackRock.

Mr. Jacksha responded that he did not believe it would affect what the ERB was doing at all. He said Lone Star has a fund that the ERB has invested in, so China would join that as an LP alongside the ERB, which really wouldn't affect what they were doing. He said he was not that familiar with BlackRock's situation, but he assumed they were talking about a similar thing, where it was either part of a limited partnership or a separate account.

Ms. Goodwin moved that the Investment Committee approve an increase in the BlackRock Co-Investment mandate to include investments made under the Erasmus NMERB Co-Investment Fund that include any follow on investments, expenses and management fees. This approval is subject to New Mexico state law, Educational Retirement Board policies and negotiation of final terms and conditions and completion of appropriate paperwork.

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

Ms. Goodwin moved that the Investment Committee approve the establishment of a single member LLC as part of the dissolution of the Erasmus NMERB Co-Investment Fund. This approval is subject to New Mexico state law, Educational Retirement Board policies and negotiation of final terms and conditions and completion of appropriate paperwork.

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

ABSOLUTE RETURN STRATEGIES: GOTTEX DUE DILIGENCE REPORT

Mr. Jacksha distributed copies of a September 2009 Due Diligence Report on Gottex Market Neutral and Market Neutral Plus, which had been prepared by Mr. Neel, Mr. Perez of the Foster Pepper law firm, and Bryan Schneider of NEPC.

Mr. Jacksha said he, Mr. Neel, Mr. Perez and Mr. Schneider all agree that they would like the ERB to continue its relationship with Gottex.

Referring to the resignation of Thomas Petters, who is alleged to have perpetrated a massive purchase order financing Ponzi scheme, Mr. Malott asked what Gottex's response was to the question of how this managed to slip under their radar.

Mr. Perez responded that the funds managed by Gottex never invested directly in Petters, but invested in independent hedge funds that provided financing to Petters-related transactions. He said Gottex did their due diligence on the hedge fund, but not on Petters. He stated that Gottex, in looking back on this, was forthright in discussing a series of things they overlooked and that should have sent up red flags for them. He said a factor arguing in Gottex's favor is that they had previously invested in Petters entities and had cashed out completely, so they had a track record of redeeming their investments with profits and without glitches or problems.

Ms. Goodwin asked if appropriate measures have been put in place in Gottex's due diligence process to avoid this kind of situation from happening in the future.

Mr. Neel responded that this was one of the focus areas of ERB staff's inquiry, and was addressed on page 8 of staff's due diligence report.

Mr. Neel said he also queried hedge funds that recently had been redeemed from by Gottex, and asked them about the rigor of Gottex's due diligence process. He said the responses seem to indicate a high regard for Gottex as an organization, especially in their due diligence process, scoring a 7.5 on a 10 point scale.

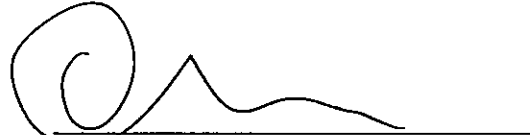
OTHER INVESTMENT REPORTS

None.

ADJOURN

Its business completed, the Investment Committee adjourned the meeting at approximately 10:25 a.m.

Accepted by:

A handwritten signature in black ink, consisting of a large, stylized initial 'B' followed by a series of connected loops and a long horizontal tail stroke.

Mr. Bruce Malott, Chair