MINUTES OF THE

NEW MEXICO EDUCATIONAL RETIREMENT BOARD

INVESTMENT COMMITTEE

September 23, 2008

CALL TO ORDER

A meeting of the New Mexico Educational Retirement Board Investment Committee was called to order on this date at approximately 12:10 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
Ms. Jan Goodwin
Mr. James B. Lewis [arriving 12:10]

Members Excused:
Mr. Gary B. Bland

Other ERB Members Present:
Mr. H. Russell Goff
Dr. Beulah Woodfin

Legal Counsel Present:
None.

Staff Present:
Mr. Mark Canavan, Portfolio Manager
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

APPROVAL OF AGENDA

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

APPROVAL OF MINUTES: July 24, 2008

Mr. Lewis moved approval of the July 24 minutes, as submitted. Ms. Goodwin seconded the motion, which passed by voice vote.

FLASH REPORT, AUGUST 2008

Mr. Jacksha reported that the Fund was slightly down for August at -0.19%.

Mr. Jacksha said BGI has corrected the deficiency they had in terms of performance, and while they underperformed for the month, now their 3-month and 12-month performance is positive to their benchmark. He said staff recommends that they be removed from the watch list.

Mr. Jacksha reported that Lehman Brothers called staff on the day that the Lehman failure was announced and said they were still in business, everybody was at their desks, and it was business as usual for their asset management. He said obviously this situation will change if personnel leave in great numbers, and staff will keep a close eye on that.

With respect to the potential U.S. Treasury bailout of financial companies and the possibility that it may compete with PIMCO's distressed strategy, Mr. Jacksha said PIMCO is not sure what will happen, but thinks it will be generally good for the fund and may result in the fund drawing down capital and buying securities more quickly than it otherwise would have. He commented that there is no bid on a lot of mortgage-backed paper, so if the government steps in with some sort of bailout, at least it will establish some sort of flow and there will be a market that actually works again. He said things are not trading right now because there is no liquidity.

Mr. Jacksha added that, if the government steps in and buys up all of these securities, PIMCO always has the option of not drawing capital.

Mr. Malott commented that counterparties are also experiencing failures, and asked Mr. Jacksha to discuss the repercussions.

Mr. Jacksha responded that it is not a big issue in securities lending, because the Fund gets collateral when it lends out its securities, and the collateral always exceeds the value of what is being lent out—at least on the day the transaction is initiated, but repricing takes place daily as necessary. He said the ERB had some loans on with Lehman, and those have been unwound successfully—the ERB got its securities back and gave them their cash back.

Mr. Jacksha stated that another area of counterparty risk would be in some of the hedge funds which are using derivatives.

Mr. Neel said he has queried the managers, and there is some exposure, but it is minor—20 basis points at the high end.

Mr. Jacksha added that a lot of managers were scrambling over the weekend to unwind these exposures before the announcement came up, and generally most of that has successfully taken place. He said it raises the question as to who the next counterparty is and what their stability is, because the transaction has to be transferred.

CURRENT INVESTMENT MARKET ENVIRONMENT

Mr. Jacksha reported that the market was down about 160 points on the Dow today, and over the last few weeks there have been swings of nearly 4% in the Dow and the S&P on a daily basis, up one day and down the next. He said the market is trading on news, anxiety, and even rumors. He stated that the Fund closed yesterday with roughly $8.3 billion in assets, putting the Fund down 4% for the fiscal year to date.

Mr. Jacksha stated that the ERB is sitting on more cash than normal, with about $255 million, not counting what is in the individual manager accounts. He said $127 million of that will be used by the emerging markets transition, which will start on September 30, and he is now wondering whether the ERB should continue to hold a bit more cash than it usually does.

Mr. Jacksha noted that the ERB is still above its long-term target for equities and was at 49% as of yesterday with a long-term target at 45%.

On the issue of commodities, Mr. Jacksha said Mr. Bland has indicated in legislative meetings that he is very much opposed to public entities investing in foodstuffs and energy, which is the bulk of commodities. Mr. Jacksha said he doesn't think it is necessary to invest in commodities, and he would be quite satisfied putting more in infrastructure and perhaps natural resources as a substitute. He added that he would like to hear Mr. Bland's views, though, before the ERB puts this to a vote.

Addressing the volatility of the markets, Mr. Malott asked Mr. Jacksha if he thought it would be appropriate to put a hedge on the whole equity side.

Mr. Jacksha responded that the VIX (volatility) Index is very high at the current time, meaning that buying puts and calls is more expensive because the market is pricing in a wider range of potential outcomes.

Mr. Martin added that these put and call options by definition are limited in scope and it is a short-term strategy, and while it has worked for the SIC for the year to date, the SIC's exposure to equity is much higher than that of the ERB. He said his personal view is that the ERB is on the right path because it has already reduced the size of its equity exposure.

Mr. Martin stated that the ERB developed a long-term strategy two years ago recognizing that, with 70+% of the portfolio in equity, it was overly dependent on stocks and bonds for returns. He said the ERB is still high: as of June, it was 10% over on equity, about right on international and about 10% over on fixed income, and under in real assets, private equity, and hedge funds. He added that, while the portfolio went down $150 million in a single day yesterday, two thirds of which was equity, the ERB is working toward getting its equity exposure in line with its new long term target.

Mr. Malott asked if it is appropriate to continue down the path of securities lending, in light of the risk of the markets, or should the ERB shut the program down.

Mr. Jacksha responded that he would not recommend shutting it down. He commented that a conservatively-run securities lending program is appropriate; because the ERB's risk is on the reinvestment side, it just has to be sure to buy high quality credit.

Mr. Jacksha said there is very low risk to the lending side in a securities lending program, rather the main source of potential is on the reinvestment side. The cash has to be invested to earn a return. He said this means buying short term assets, commercial paper, repurchase transactions, etc.—very short-term, liquid, and what is generally regarded as safe, although lately there is more uncertainty in short term securities. He said they are nonetheless high quality short-term assets.

Mr. Martin added that there are three sources of risk in a securities lending program: 1) the person to whom you've lent your security doesn't get it back to you. The ERB has the collateral, however, and the lender indemnifies the ERB for that risk. 2) A manager sells the security that's on loan and it doesn't get returned in order to make a good settlement, and so the investor is out the interest they would have received on the cash from the sale. The lender indemnifies that. 3) The broker gives collateral on the security, but in order to get the security back, the collateral has to be returned. The collateral is now invested in a fund run by the lending agent that is mismatched against the Fed Funds rebate rate that the broker is being paid, so if one invests in securities that default, there is a collateral deficiency, and the investor then has to write the check because the securities lender will not.

Mr. Martin said he would suggest that the ERB very carefully go through the collateral in its securities lending program. ERB has two defenses as a plan sponsor: 1) did Wachovia, ERB's securities lending agent, invest the securities in accordance with the guideline and 2) many times the lender commingles the assets in a pool, and when a state asks for its securities back, the lender has to sell the units within the pool to pay the collateral back. He sells the "good stuff" and the state, as residual owner of the pool, ends up owning more of the "bad stuff." This is a fiduciary suit the state will win, because the lender disadvantaged the state.

Mr. Martin pointed out that the ERB has an option to withdraw the securities, but should look at the collateral pool first to see if it is safe.

Mr. Jacksha said staff has reviewed it with Wachovia, and while there were a couple of securities that were a concern but are expected to work themselves out satisfactorily, Wachovia has been very responsive to the ERB in notifying staff right away when there is an issue.

Mr. Malott asked Mr. Jacksha if there are other significant risks the ERB should be looking at in its current situation.

Mr. Jacksha responded that the ERB's exposure to the equity market is the biggest issue.

Mr. Jacksha stated that, given the uncertainty in the market, putting on an option-based hedge would be very expensive.

Mr. Neel noted that the hedge fund managers are having difficulty on the short selling end, as well, and they are unable to quantify the impact created by the new SEC rule.

Mr. Martin added that hedge fund managers have not experienced personnel losses or any outright blowups. He said the ERB is in fund-of-funds, so is protected by diversification, but returns have not been good this year. On the other hand, he said, when compared to the returns in the equity market, hedge fund numbers were comparatively better.

Mr. Jacksha noted that, calendar year to date, total hedge funds are down about –3.7%. Mr. Martin commented that the hedge funds clearly have not delivered the anticipated LIBOR+2% that the ERB expected going into this strategy. He said there is a big debate going on now on whether or not this negative performance is a harbinger of worse things to come, or is it an extreme market condition. He stated that strategies that are leveraged-based do more poorly, however, so this is not unexpected of hedge funds by and large. He said that de-leveraging cannot really continue—it can persist for a while, but the entire global financial system relies on leverage to some degree, so it can't go on forever.

Mr. Martin stated that he would therefore argue that hedge funds are secularly problematic right now, but would continue to be viable. He said hedge funds have had their best periods historically after a time of turmoil that has caused prices to drop and create more value. He said he would advise the ERB to continue on its current path of making sure its individual hedge fund managers have an explanation of where their exposures are.

Mr. Martin said NEPC had a big call with PIMCO about a week ago—it was the weekend that Lehman went under. He said PIMCO had about 350 positions with Lehman, and they brought their entire staff in over the weekend, and by Monday morning they had recharacterized every one of those positions. He commented that the ERB wants to have a manager like this at the helm, since not all managers might have reacted with such capability, scope and understanding.

Mr. Malott asked Mr. Martin if there are other opportunities the ERB should be seizing or letting go of. He asked Mr. Martin to comment on the solution that has been put forth by the federal government and what the likely outcome is.

Mr. Martin responded that, if what Treasury Secretary Paulson described actually happens quickly, he would be optimistic that it would help. He said it needs to be reasonably bold and confined in order to work, and his concern is that it could get bogged down in Congress with special interest add-ons, etc.

Mr. Martin commented that, if this isn't resolved soon, market volatility will continue. He said prices will drop until there is some clear view that there is someone that will start buying, and he didn't think that has been reached yet in the real estate market. He stated that it will therefore have to happen through third party intervention.

Mr. Jacksha agreed that the plan (now at $700 billion) would help the markets and restore some confidence and liquidity, but it will make the deficit a lot larger, and the implications of that are a big question.

On whether there are opportunities the ERB should be seizing because of the market, Mr. Martin said interest rates will have to rise, and the spread on risk assets, if done right, may contract. He said it has a little bit in mortgages already. He said investing in risk assets is the right thing to be doing, and the question is when to start doing that. He noted that the ERB has already started that with its distressed strategies piece, and the timing should prove to be right—PIMCO has drawn $120 million of the ERB's $300 million already, so they have been buying assets, and if the government bails it out, the ERB will get even better returns than PIMCO anticipated.

Mr. Martin said he thought the ERB's strategy was a good one to begin with, and where the strategy has not worked, the ERB should endeavor to do them a bit more timely—real assets, for example, and the hedge fund piece. He said he didn't have a good answer with respect to REITs, which is where the ERB's real estate exposure sits. He said REITs are down 9% at this point in the portfolio.

Mr. Jacksha said the original plan is to have REITs until they are supplanted by private real estate, where the ERB has so far made $130 million in commitments with about half of that drawn.

Mr. Canavan said he has spoken with Steve Gruber at ORG about the real estate market. He stated that normally an investor might be looking at apartments, because people will go to apartments when they can't buy a house. He added, though, that condos are now being converted back into apartments, so there is an influx in that market and an impact on developers and builders. He stated that Mr. Gruber is not in a big hurry to enter that market.

Mr. Canavan stated that the deployment period for most of the real estate funds is 2-3 years, and so investments made during 2008-2010 may bear fruit.

Responding to questioning from Mr. Lewis, Mr. Jacksha said he feels that managers need at least 12 months to prove out their strategy, and in the short run there is a lot of underperformance partly because of uncertainty in the markets. He said there are issues in fixed income, and WAMCO had shown signs of recovery until the markets became so volatile; however, if the securities end up being money good, WAMCO will snap back very dramatically once the markets stabilize.

Mr. Jacksha stated that the biggest underperformers (versus the benchmark) are the two small cap growth managers, Wells and Perimeter, and both will argue that their underperformance is due to the market volatility.

Addressing opportunities going forward, Mr. Neel pointed out that the ERB has about $100-$120 million in total commitments with four or five managers in the leveraged buyout or distressed space, so there may be a great opportunity to seize the day in that area. He said the ERB also has sizable commitments with Levine Leichtman and Apollo.

Mr. Canavan added that he has asked for more infrastructure money because everything is being repriced globally, and assuming another $1 trillion will be added to the national debt with the impending bailout, entities are going to be strapped for cash in infrastructure projects. He said the ERB is somewhat on the front end of that wave, so there should be a lot of opportunity.

Mr. Jacksha commented that he and Mr. Canavan have been discussing infrastructure investment for a while now, and he finds this an interesting asset class. He said the biggest argument he hears against infrastructure investment is: who do you then sell it to? He questioned, though, whether as a long-term entity he should be concerned about selling it if he can collect a 12% return every year. He said the ERB is an ongoing fund, so doesn't really have to sell an infrastructure investment unless it wants to.

Mr. Jacksha agreed with Dr. Woodfin that infrastructure investment is not risk free; for instance, someone could build a competing highway, or the local governmental entity might pass a law saying the ERB can't own it anymore. He said there also maintenance costs.

Ms. Goodwin said she and Mr. Riggs attended a NASRA conference last month where there was an excellent presentation by someone from NEPC about infrastructure investment. She asked that copies be made available to Board members.

Mr. Jacksha said inflation reduction is a goal in real assets. He said the components of infrastructure include concrete, steel and other commodities that should move in the same direction as inflation, so as replacement costs go up, so does the value of the asset.

ADJOURN

Its business completed, the Investment Committee adjourned the meeting at approximately 1:30 p.m.

Accepted by:

Mr. Bruce Malott, Chair