

**MINUTES OF THE**  
**NEW MEXICO EDUCATIONAL RETIREMENT BOARD**  
**INVESTMENT COMMITTEE**

**September 27, 2007**

A meeting of the New Mexico Educational Retirement Board Investment Committee commenced on this date at approximately 9:00 a.m. in the conference rooms of the Sandia Resort Hotel, 30 Rainbow Road, N.E., Albuquerque, New Mexico.

A quorum was *not present* until the arrival of Mr. Riggs at 11:30 a.m.:

**Members Present:**

Mr. Bruce Malott, Chair [excused 9:30-11:10 a.m.]  
Mr. James B. Lewis  
Mr. Jeffrey M. Riggs [arriving 11:30 a.m.]

**Members Excused:**

Mr. Gary B. Bland

**Other ERB Members Present:**

Dr. Pauline Turner

**Legal Counsel Present:**

Mr. Robert Shulman

**Staff Present:**

Ms. Patrice Armstrong, Human Resource Manager  
Mr. Frank C. Foy, Deputy Chief Investment Officer  
Mr. Bob Jacksha, Chief Investment Officer  
Ms. Linda Kisko, Executive Admin. Assistant  
Ms. LeAnne Larrañaga-Ruffy, Investment Officer  
Mr. Steve Neel, Portfolio Manager  
Mr. Greg Trujillo, IT Director

**Others Present:**

Mr. Allan Martin, New England Pension Consultants  
Ms. Judith Beatty, Recorder  
[Also see sign-in sheet]

## **REVIEW OF HFV HEDGE FUND — PERFORMANCE AND RISK CONTROLS: STAFF AND HFV**

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Mr. Jacksha stated that representatives from Hunt Financial Ventures (HFV) and Excelsior Capital Management were present to discuss hedge fund activity in August.

Mr. Jacksha said staff has prepared a memorandum regarding the hedge fund issue and risk controls in place going forward.

HFV President Jeffrey Cagnina and HFV COO Steve W. Caple appeared before the Committee with James White, Jr., managing partner with Excelsior Capital Management and advisor to the HFV investment committee.

Mr. Cagnina stated that HFV now has a very clear picture of what happened in August, where they had very bad performance. He said they would review what happened in the market and how HFV responded to those events from a risk management standpoint, including some of the enhancements that they have since put into place. He said they would also review strategy allocations pre-August and post-August.

Mr. White said what they saw in August was a continuation of markets being on edge due to the subprime concerns. He said the Federal Open Market Committee maintained a bias towards inflation risks even though they verbally acknowledged that their downside growth risks had increased as a result of these financial market gyrations.

Mr. White stated that one notable event in August was that money market funds previously thought to be very safe fell into question after Sentinel Management Group suspended redemptions, and that sent a shockwave through the markets; and combined with that, there was a lot of speculation that Countrywide mortgages could face a liquidity crisis and could fail.

Mr. White said the most important catalytic event occurred on August 16, after the market closed, when St. Louis Fed Governor Poole made a statement that the credit crisis didn't really affect the real economy and it was not the Fed's responsibility to bail out financial markets. He said this was, in effect, a verbal takeaway of the Greenspan 'put' that had been out there, which was that the Fed would come in and provide liquidity in rough times. Following that announcement, he said, there was a massive overnight unwind in the carry currencies (currencies people use to borrow at lower rates of interest and invest in risky assets). He stated that this 4-5 Standard deviation move hadn't been seen in decades in some of these currencies, and the credit turmoil in the financial markets intensified as the

worry about what other banks had on their balance sheets spread through financial institutions.

Mr. White stated that this big move in the currencies left little room for hedgers to be able to operate G10 currencies. He said US equity markets followed suit and there was a massive flight to quality that ensued, and liquidity dried up across the board. He said this was especially true in OTC derivative markets, which had been relatively liquid in previous currency crises, and then banks and dealers attempted to reduce risk by stepping back.

Mr. White stated that there was a lot of fear in the financial markets then, and he didn't think many people realized how bad it got — and if the Fed had not lowered the discount rate 50 basis points, there could have been a severe financial calamity. He said this enabled Bank of America to borrow at the discount window and invest directly into Countrywide in a \$2 billion convertible offering. He stated that this news sent some confidence through the market and caused massive short covering in the equity markets, and the currencies immediately reversed direction.

Mr. Cagnina pointed out that, up until July, HFV Multi-Strategy Fund was up 6.75% net of all fees, and was performing as expected and as designed, with standard deviations of 3.93%. He pointed out that the Fund was up 18.45% over the previous 19 months (when they started out with the ERB) with volatility slightly under 3%.

Mr. Malott asked exactly what the loss was in August, and Mr. Cagnini responded that, with the exception of one manager (Integra), HFVMS performed in line with its peers in August, down 2.42%. He commented that this was a relief to HFVMS, to know that the risk management that they have in place across the breadth of the Fund performed as expected.

Mr. Jacksha pointed out that August was one of the worst months in history for hedge funds; overall, the ERB's hedge funds were down about 3%, and HFVMS was an outlier at 8+%.

Dr. Turner asked what the 8% amounted to in dollars, and Mr. Cagnini responded that HFVMS had \$50 million invested, so the 8% would be about \$4 million.

Mr. Malott asked what percentage of the Fund Integra represents, and Mr. Cagnini responded that it was representing 18%, and it is currently representing under 14%. He said HFVMS brought it down on October 1 by 6.4%, and over the next 2-3 months they expect to bring it down another 2.5% to 3%.

Mr. Malott asked how much HFV's risk management allows them to have in one fund, and Mr. Cagnini responded up to 12% in any one single strategy, and that strategy can consist of five managers, or it can consist of one manager, etc.

Mr. Cagnini acknowledged that the 12% ceiling is a new policy; prior to that, they had a soft guideline of no more than 20% to a manager, but it had to be historically a low-volatility manager with a track record of five years or more, and with breadth in terms of assets under management. He said this Fund was just that — it had \$700 million under management and a track record going back to 1999 that was profitable 90% of the time. He said their volatility was under 3%, as well.

Mr. Malott commented that clearly the ERB's other funds did not have a loss of this size, and asked what kind of "bets" Integra was making.

Mr. Cagnini responded that Integra wasn't doing anything different in August than they had done in any month for the previous five years that HFV was invested with them. He referred the Committee to a chart detailing Integra's investment process, which he described as very rigorous. He commented that it wasn't so much the "bets" they made, but that they were victims of their own risk management. He said that, in August, when they went into the market as usual with their first strategy of delta hedging, they were essentially "whipsawed" when the market went into a tailspin. He said that forced them into their second strategy, which was opportunistically going into the options market to find opportunities to hedge. He said the trouble was that all of the traditional market participants in currencies (the dealers) moved away from the market, liquidity dried up and there were no bids to buy or sell as a result. He said the whipsaw continued for the next ten days. He commented, "Had they just sat on their hands — and they wouldn't do this — could they have prevented this? Yes."

Mr. Cagnini pointed out that, when the ERB first invested with HFV, HFV allocated half of the \$100 million with TAG Relative Value Fund, which performed in line (-2.46%) for the month of August 2007 and roughly 4.3% for the year. He stated that this dampened the impact and blended performance in August was -5.38%.

Mr. Cagnini discussed HFVMS's post-August 2007 risk management enhancements, including technical improvements to their VAR analysis, broadening scenario and stress testing, revising allocation guidelines, and deepening their dialogue with emerging managers with respect to position limits, leverage, liquidity and stop losses.

Mr. Caple discussed enhancements made to their risk management team. He said Michael Terry, their risk management director, recently took another position in New York, and HFV has filled this vacancy with Steve Pomerantz, a veteran risk management professional with 20+ years of experience. He said Mr. Pomerantz

has a doctorate in mathematics in nonlinear partial differential equations from Cal Berkeley and a bachelors in mathematics from CUNY.

Mr. Cagnini reviewed a risk management analysis showing how the Fund would perform given certain allocations to any given strategy and how it would perform specifically with respect to the Sharpe Ratio.

Mr. White reviewed the market outlook for Excelsior, an anchor fund. He said they have a long volatility profile so do well when historic events take place. He commented that their liquidity concerns have been addressed and they are now in a bit of a “sugar high” in the financial markets.

Mr. White said they feel housing is still a problem — credit conditions have actually tightened despite the rate cut, and they think consumer confidence will decline because of the overall sentiments in the market.

Mr. White also pointed out that there is an unprecedented pileup of LBO financings. He said the threat of bad loans is very real, even if the supply is taken out. He said they are seeing that the average leverage on private equity deals is about 6.6 times 2007 cash flow, and now they have seen that structured finance has really been exposed as fraudulent, in that they have made bad credit seem like good credit by taking subprime loans and talking rating agencies into putting a AAA stamp on it. He stated that this has caused the end user to step away from the market, and the question remains: Who will bear the ultimate risk in this market? He said it is the banks at the current time.

Mr. White commented that the unraveling of financial leverage generally coincides with the late stages of an economic cycle; economic statistics are starting to turn south, and there are worries about unemployment and the role of the consumer. He said this could cause the Fed to cut even more aggressively to avoid a recession, and maybe it is possible to avoid a hard landing or even a recession.

Mr. White stated that Excelsior sees a new paradigm of increased volatility in the markets; and while he didn't think people would see the volatility index of the CBOE in Chicago, which was trading around 10% — Excelsior thinks the new low will be more like in the mid teens, and volatility has come down way too much in the wake of the rate cut, and debt and equity markets are going to move around as risky assets continue to be re-priced.

Mr. White commented that it is nice to have this rate cut, and they are certainly in a situation where some bad things could happen and volatility could increase, so volatility has to be addressed in everyone's portfolio.

Commenting on the subprime issue, Mr. Jacksha said there are two dimensions. He said the first is a direct exposure, where there a mortgage-backed security is

backed by subprime, but that is not a major concern to the ERB portfolio because the ERB does not own very much of this.

Mr. Jacksha said the bigger concern is on the whole portfolio as risk has been re-priced across the board, with its resulting effect on the commercial paper market. He said that is also much harder to quantify because so much depends on market psychology in the short run.

Responding to questioning from Mr. Lewis, Mr. Neel pointed out that HFV's performance year to date is down about 150 basis points, because their performance was exemplary January-July. He added that, when anticipated performance in September is factored in, they may be down around 50 basis points. He commented that, in the context of the entire hedge fund portfolio, year to date the ERB is up around 450-460 basis points, which is 150 basis points above their benchmark.

Mr. Lewis commented that there is a lot of fear, anxiety and frustration out there, and the ERB has a fiduciary responsibility to all of the participants in the ERB Fund, and they will be asking questions.

Mr. White stated that, in volatility trading, no one knows what the catalyst is going to be although certainly the underlying conditions are known. He said whether or not the U.S. is approaching the end of an economic cycle is unknown and it really depends on the Fed and their ability to act.

Mr. White said that one of the good things is that, because of all the liquidity that has been injected in the short run, the London Interbank Offered Rate (LIBOR) had an extra 40-50 basis points tacked onto it in August. He said this rate should track T-bills fairly closely. He said that has come down since then, which is a very good sign — it means that banks are starting to trust each other, and that is a positive liquidity indication.

Mr. Lewis asked Mr. Jacksha to comment on the strategy being proposed today.

Mr. Jacksha responded that the lower limits on the strategy concentration will serve the ERB well going forward. He said staff is not making a recommendation on any changes in allocation at this point, although they will certainly continue to monitor the performance of HFV as they do all of the fund-of-funds. He added, "But I think this is a positive step."

Allan Martin, NEPC Consultants, said he would echo that as well as Mr. Neel's remarks. He said they implemented strategy using market-neutral/fund-of-funds a year ago, and the intent of that was to provide protection in extreme times — they weren't looking for hedge funds that would be up 20% and have high volatility. He stated, "The overall strategy that was implemented is essentially doing that and has

done it through perhaps the worst month in the history of hedge funds, so I think the overall strategy continues to serve us well. We have a manager within that strategy that, as they have described, has had a disappointment. In a situation like that, you're always disappointed because it happened. The question is: Do they understand why it happened? Did they do something about it? And is the action they're taking likely to result in better performance going forward?

"I found the 20% limit a little worrisome to begin with; I like the analysis they did to say perhaps a 12% limit is more prudent.... and I like the fact that they have 11% in cash.... There's lots of opportunity out there to go back up, and so people that have cash and can apply that money prudently can regain a lot of the ground lost."

### **ASSET ALLOCATION REVIEW — STAFF AND NEPC**

[Mr. Lewis chaired this portion of the meeting in the absence of Mr. Malott.]

Dr. Turner stated that she was uncomfortable with the idea of hearing a report on asset allocation with only one of four Investment Committee members present.

Mr. Lewis stated that Mr. Malott was planning to return to the proceedings within 30-45 minutes. He explained that Mr. Bland was at a special meeting of the State Investment Council which was scheduled just last month, after the Investment Committee meeting was scheduled; and Mr. Riggs was attending the PERA meeting, where there are five positions open and there is voting activity taking place.

Mr. Lewis stated that he had to make a decision on which of the three meetings he was going to attend, and committed himself to the Investment Committee meeting first. He said he thought the Investment Committee going forward should simply decide not to meet unless a quorum is going to be present; otherwise, a special meeting should be scheduled. He added, though, that it is difficult to cancel a meeting when it has been set up two or three months in advance, out-of-town people are expected, and the meeting has been advertised.

Mr. Jacksha commented that asset allocation is one of the most important issues that the Board and staff will address and shouldn't be undertaken lightly. He said today's review will be a preliminary discussion about how the process works and what some of the options are, including some new ones.

Mr. Martin noted that the ERB adopted its current targets in February 2006, and there was a fairly significant departure from what had been happening historically: They added some asset classes the ERB hadn't been invested in before (private equity and market neutral hedge funds), they changed the characterization of the real estate portfolio, and they reduced some of the exposure to core bonds and

equities. He stated that, in the year or so since this has been adopted, the ERB has hired a third party private equity advisor and a real estate advisor, and has funded the allocation to market neutral hedge funds — so at this point, it makes sense to look at the portfolio directionally going forward, which is something that he and Mr. Jacksha have been discussing for a few weeks.

Mr. Martin stated that, in his view, the review process involved in changing the portfolio last time around did not receive an ample airing. He said, "Today's meeting is to add transparency to the process to make sure everyone knows what's behind the recommendation that will be forthcoming at a subsequent meeting."

Mr. Martin presented his 2007 Asset Allocation report, which was included in the Committee packet.

In subsequent discussion, Dr. Turner said she would be interested in hearing a Board discussion on the idea of social investing; for instance, not investing in China.

Mr. Martin responded that there are funds that do not invest in Iran, Darfur, the Sudan and China, and there can be consequences to this, but certain discussion is warranted.

[Break 10:45 – 11:00.]

### **INFRASTRUCTURE INVESTMENT POLICY — COURTLAND**

[Mr. Malott and Mr. Riggs joined the proceedings in the course of this presentation.]

Courtland representatives Steve Novick, Dan Krivinskas and Roman Nemtsov distributed and presented their Infrastructure Policy Statement report.

Mr. Krivinskas explained that infrastructure investments predominantly include equity, loan, hybrid or other economic interests in assets such as transportation, energy, utilities, communications, water and social assets (e.g., hospitals, schools, prisons).

Mr. Jacksha stated that the responsibilities outlined in this policy were written to parallel what the ERB already does in private equity and real estate.

Mr. Jacksha noted that this was a pilot allocation. He said the current \$50 million allocation in real estate is insufficient to create any impact in this area — so the amount will either have to be increased or the idea abandoned.

[With the arrival of Mr. Riggs at this point, quorum was achieved.]

**AUGUST FLASH REPORT — STAFF**

Mr. Jacksha reviewed the August Flash Report, noting that August was a volatile month in terms of trading patterns.

Mr. Martin noted that WAMCO is the ERB's most aggressive manager, but an aggressive style has not worked well during this recent period in the market.

**PROXY REPORT — STAFF**

Staff noted that the proxy report was emailed for the March and June quarters.

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

**ADJOURN**

Its business completed, the Investment Committee adjourned the meeting at approximately 11:45 a.m.

Accepted by:

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Mr. Bruce Malott, Chair

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