

MINUTES OF THE
NEW MEXICO EDUCATIONAL RETIREMENT BOARD
INVESTMENT COMMITTEE

October 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 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
Ms. Jan Goodwin
Mr. James B. Lewis

Members Excused:

None.

Other ERB Members Present:

Mr. H. Russell Goff

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

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: July 9 and September 23, 2008

Ms. Goodwin moved approval of the July 9 and September 23 minutes, as submitted. Mr. Bland seconded the motion, which passed by voice vote.

ALTERNA INFRASTRUCTURE FUND

Thomas DeFranco, consultant with Courtland Partners, was present. Harry Toll, Jim Furnivall and Eric Press, three of Alterna's four principals, were present by teleconference.

Mr. DeFranco said Courtland recommends this Fund based on the strength of the management team, which worked together for 18 years at Citigroup before the start of this fund in January 2007. He noted that three of the four principals are former engineers. He said Courtland thinks they have impressive experience in acquiring core capital assets, and they have a proven track record: while at Citigroup they established a track record with a 20% IRR, 13% current yield and a 2x multiple. He said projected returns for the Alterna Infrastructure Fund are similar to those.

Mr. DeFranco said Courtland feels that current market conditions are only becoming more appealing for what Alterna desires to accomplish. He said the fact that Alterna is an independently owned entity prevents any types of conflicts of interest or any unnecessary exposure to risk that are seen with funds that are sponsored by publicly traded financial institutions.

Mr. DeFranco said Courtland's concerns relate to the asset class as a whole in terms of exit strategies because of political and regulatory issues that are common to the asset class. He said there are also issues regarding management fees and catch-up fees that Courtland is continuing to negotiate. He recommended that the \$25 million allocation be contingent upon Alterna's ability to raise \$500 million for the close. He said they are seeking a target fund size of \$1 billion with a \$1.5 billion hard cap, and are confident they will hit that.

Mr. DeFranco stated that asset prices are coming down and asset owners are finding themselves in trouble because there has been too much leverage on investments they have made. He said funds that are flush with cash have an

opportunity to buy these assets at a discount to market value. He stated that they are also able to obtain these at lower levels, which will hopefully increase the long term returns. He added that Alterna will be focusing on the transportation, energy and industrial sectors, which Alterna feels confident will have to continue regardless of economic conditions.

Mr. Toll said the team's Citigroup business grew from its start in the mid 1980s into a \$2.4 billion portfolio that controlled about \$7 billion in assets, with a 13% cash yield, a 26% IRR and a 2.2x multiple. He said the portfolio remained stable despite numerous shocks to the system because it was designed to be stable, and total losses were less than \$1 million.

Mr. Toll said the business was founded on a concept of the strategy of decoupling the risk performance in the portfolio from the natural cycles that are inherent in capital industries. At various points in these industry cycles, he said Alterna hedges out cyclical risk and replaces it with long-term operating agreements with lots of cash flow from credit-worthy industrial counterparties—so if the markets are weak when the original agreements end, they have enough cash to continue to deploy investments.

Mr. Toll said that, in more normal market conditions, where they would be targeting around 3:1 leverage in their transactions, they can produce IRRs in the 20+% range; and in environments where markets are normal and fairly stable and where they do not put that kind of leverage on, their history says a good benchmark for very low-levered or semi-unlevered IRRs is in the 16% range. He stated that, in today's market, where leverage opportunities are limited, they are seeing numerous opportunities but do not need as much leverage, and in some cases need no leverage at all, to reach or exceed their hurdles.

Mr. Jacksha observed that Alterna's geography chart shows a small percentage in South America and Africa and a somewhat larger percentage in Australasia. He asked how Alterna handles the sovereign risk in some of these countries.

Mr. Toll responded that Alterna's geographic focus is 80% OECD with a 20% cap on non-OECD countries. He explained that this is written into the terms of the Fund because some of the large international companies have operations of various kinds in non-OECD countries. Furthermore, he said that some structures under which Alterna might execute an investment might have some element that has to go through the non-OECD jurisdiction.

Mr. Furnivall discussed the pipeline of opportunities that Alterna has been seeing, which has been particularly robust during the past 60 days. He said the quality and quantity of these opportunities has resulted in Alterna raising some of their IRR hurdles.

Mr. Furnivall said the three areas of opportunity that Alterna looks at are: distressed sellers, which tend to be financial institutions or industrial corporations that have liquidity or earnings needs that motivate them to liquidate parts of their portfolio or assets that are non-core to their business; direct deals, where Alterna has relationships with asset owners or enterprises that want to use the assets for productive purposes; and trigger deals, which are ideas that are generated entirely within Alterna's shop where Alterna triggers an event in order to create the opportunity.

Mr. Press stated that Alterna is seeing a vast number of assets being put up for sale with attractive uses. He commented that they have not seen opportunities like this since the mid 1980s. He added that this is not meant to be an opportunistic distress fund, although clearly they will take advantage of opportunities when they see them.

Mr. Bland asked what the exit strategy is on the assets at the very end of the fund.

Mr. Furnivall responded that, as a general rule, the cycles in these assets are all less than ten years, so sometime between now and the end of the fund, there will be an opportunity where the asset values will be above their "intrinsic value." He said that, when the market is frothy and an asset gets sufficiently above its intrinsic value, Alterna tries to extend out the underlying usage agreement as far as possible. He commented that what happens as a result of this strategy is that many times the user will ask for an option to purchase the asset at the end of the agreement for a specified price. He pointed out that the user is going to pay Alterna the highest possible option value at that point as well as enter into some very long cash flow agreements, which makes the transaction itself very liquid as Alterna heads toward the end of the transaction, and much of the value has been captured by cash flow. He said the part not captured by cash flow ends up trading in a fairly transparent market where the valuations can be well known.

Mr. Furnivall said Alterna has a two-year option period at the end of the Fund in the event assets are below intrinsic value and more time is needed for recovery.

Mr. Furnivall also noted that if the user doesn't want to enter into an extended usage agreement, Alterna may go to alternative users to extend out the usage agreement; or if the market for that asset is frothy, Alterna has no problem in selling the asset with its underlying cash flow at that point.

Mr. Jacksha asked what Alterna's fallback position would be after the extensions are exercised and the asset, for whatever reason, is not readily saleable.

Mr. Furnivall responded that they would consider monetizing the cash flow in a long term usage agreement associated with that asset. He said they could sell it to banks or other investors with an appetite for fixed income.

Mr. Malott asked if there would be an opportunity for the ERB to be a buyer of those cash flows, and Mr. Furnivall responded that clearly the LPs can be buyers. He said these assets are fairly transparent in valuation, so Alterna can establish prices and divvy the assets up among those people who want to stay in for a longer period of time.

Mr. Jacksha recommended approval of this investment. He said the strategy looks like a good fit in the current market.

Mr. Bland moved that the Investment Committee approve a commitment of \$25 million to Alterna Infrastructure Fund, subject to and contingent upon New Mexico state law, Educational Retirement Board policies and negotiation of final terms and conditions and completion of appropriate paperwork.

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

SEPTEMBER FLASH REPORT

Mr. Jacksha reported that the Fund is down 15.4% for the 12-month period, and for the month is down 6.74%. By contrast, he said the S&P 500 is down almost 9% for the month, and down 22% for the 12-month period.

Mr. Jacksha said Post has performed very well relative to the index, and is up 450 basis points for the 12 months.

Mr. Jacksha also noted that, while the investment grade market has been up, WAMCO has been down 10% relative to that market.

Mr. Jacksha stated that hedge fund returns have been better than equities but they are down 4.6% for the calendar year to date.

COMMODITIES INVESTMENTS

Mr. Jacksha asked the Investment Committee for guidance on commodities investments in light of recent discussion about whether or not to include commodities in the ERB's real assets allocations.

Mr. Jacksha stated that he was not strongly in favor of including commodities in the ERB's real asset bucket.

Mr. Bland stated that he thought it was bad public policy for public funds to get involved in either energy or food commodities in terms of speculation. He said commodities can be very volatile, as evidenced by the fact that oil is about half of what it was just two months ago.

To back up Mr. Bland's point, Mr. Jacksha distributed a chart reflecting that the Dow Jones-AIG Index was at about 238 on 7-2-08, and today it is 45% lower.

Mr. Jacksha said the appeal for going into commodities, historically speaking, is that there is a low or negative correlation with the financial markets, which provides a hedge against risk.

Mr. Martin said the investment case for real assets, which also applies to commodities, is twofold: it is a diversifier against equity risk; and in different environmental regimes, commodities are a participant in a rising inflation environment whereas bonds typically do badly in that environment, and stocks on average do not do well either if the inflation is not anticipated.

Referring to a recent \$8 billion investment by CalPERS in commodities and its effect on the market, Mr. Martin commented that, when investors pile in and pile out, clearly it destabilizes commodities; however, it is less clear what the effect is when there is measured participation by market experts who are in it for the long haul.

Mr. Bland said U.S. investors were starving out many parts of the world by driving up the price of rice, and he thought it unethical and morally reprehensible for a public fund to participate in that.

Mr. Lewis asked Mr. Bland to comment on this in light of the ERB's fiduciary responsibility.

Mr. Bland responded that the Prudent Person Rule entrusts the ERB to invest, but it can choose not to invest at any time, and it is not imprudent if it gets a lower return than someone else—it is only imprudent if the investment is done carelessly, stupidly, callously or in one's own interest. He said the bottom line is to achieve the optimum combination of risk and return when possible, and other things can be taken into consideration along with that.

Mr. Jacksha stated that he fully supports the ERB having 5% in real assets as a diversifier, and it doesn't have to include commodities. He stated that, if the monies were deployed among infrastructure and natural resources, the ERB would get most, if not all, of the benefits it would get if it were to include commodities.

Mr. Martin concurred that the ERB could drop commodities out of real assets and still have a meaningful real asset commitment.

Mr. Martin pointed out, however, that one of the ERB's challenges in its overall asset allocation is to reduce its equity exposure and bond exposure, and it is raising money for private equity, real estate and real assets. He said commodities, good, bad or otherwise, are liquid—and one of the things NEPC wants to explore with the ERB is the message of diversification. He stated that, had the ERB reached the targets in its plan, it would have been much more protected from this down market; and had 5% had been in real assets, it would have taken 5% out of the equity portfolio.

Mr. Martin agreed with Mr. Bland that the returns would have depended on the commodities invested in, had the ERB been invested in commodities. He added that there are some real asset strategies that involve TIPs and commodities; and because they are liquid, the money can be put to work faster. He said there are workarounds, however, if the ERB is opposed to investing in commodities.

Mr. Martin agreed that public funds have destabilized the market, and while a responsible investor making an allocation for the long haul might initially create an imbalance, he felt it would be mitigated over time.

Mr. Bland said the problem is that the dynamic of the market today is a different dynamic than has ever existed before.

The Investment Committee agreed by consensus that the ERB would not invest in commodities.

Mr. Jacksha proposed, as an alternative, reallocating the monies into infrastructure and natural resources at about 2.5% to 3% each.

Committee members agreed with this proposal.

GTAA RFP

Mr. Martin distributed a prospective procurement schedule for the GTAA (Global Tactical Asset Allocation), which was in response to the ERB agreeing last November to allocate 5% into GTAA.

Mr. Martin said the ERB would hire a manager, provide the manager with the ERB's target policy benchmarks, and the manager would overweight or underweight the various asset allocations and manage them to create value.

Mr. Martin stated that there would potentially be 15-20 potential responders to the RFP.

Mr. Malott suggested issuing an RFQ instead in the interest of time. He noted that the contract under the RFP scenario would not begin until March 2009.

Mr. Jacksha said he would support that option.

Committee members agreed that an RFQ would make more sense.

ASSET ALLOCATION

Mr. Jacksha distributed charts measuring bear markets peak to trough and historically what has happened in various markets when recovery has kicked in. He noted that the S&P 500 was down about 45% earlier today, peak to trough, which is very near the largest post World War II bear market, which was 49% down.

Mr. Jacksha asked the Committee to consider looking at temporarily altering from the long term asset allocation policy to take advantage of this trend by moving more funds into equities. He stated that the policy calls for 45% in equities, and yesterday the ERB was 44.8% in equities.

Mr. Martin suggested that, in order to recover, the ERB should probably put a bit more risk into the portfolio given the 8% return requirement for the Fund.

Mr. Bland said he would submit that, if the ERB were to restart its asset allocation study from today's levels, ranges would be higher.

Mr. Martin commented that equities are trading at 15 times earnings, which is at early 1990's levels.

Mr. Malott suggested that this discussion be carried forward into tomorrow's Board meeting.

PROXY REPORTING — QUARTERS ENDED JUNE & SEPTEMBER 2008

Mr. Lewis moved for approval. Ms. Goodwin seconded the motion, which passed by voice vote.

OTHER INVESTMENT REPORTS

None.

ADJOURN

Its business completed, the Investment Committee adjourned the meeting at approximately 4:00 p.m.

Accepted by:

Mr. Bruce Malott, Chair