

MINUTES OF THE
NEW MEXICO EDUCATIONAL RETIREMENT BOARD

INVESTMENT COMMITTEE

November 20, 2008

CALL TO ORDER

A meeting of the New Mexico Educational Retirement Board Investment Committee was called to order on this date at approximately 1:15 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 [teleconference]
Ms. Jan Goodwin
Mr. James B. Lewis [teleconference]

Members Excused:

None.

Other ERB Members Present:

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

Others Present:

Mr. Allan Martin, New England Pension Consultants

APPROVAL OF AGENDA

Staff requested that the October monthly investment report be removed from the Agenda because the data had not been received from Northern Trust.

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

APPROVAL OF MINUTES: October 23, 2008

Ms. Goodwin moved approval of the October 23 minutes, as submitted. Mr. Lewis seconded the motion, which passed by voice vote.

PRIVATE EQUITY UPDATE: NMERB STAFF

Mr. Neel said the ERB has commitments of about \$500 million, and all of the traditional partnerships have been executed. He said the coinvestments should be executed within the next few days, and staff is in discussions with BlackRock. He stated that capital has been called by all of the traditional private equity partnerships with the exception of Clayton, Dubilier & Rice.

PRIVATE EQUITY: APPROVE PRIVATE EQUITY INVESTMENTS

a) Sevin Rosen Fund X, L.P.

Aldus Equity Associate Saul Meyer clarified that Aldus's Investment Memorandum should state that the recommendation was for \$30 million—\$20 million from 2008 and an additional \$10 million from 2009. He said Aldus wants to make sure the ERB has a significant position in this Fund, given its stature in the venture space and because Aldus does not see these very often.

Mr. Meyer presented the November 2008 Allocation Plan.

Aldus Equity Associate Holland Gary reviewed Aldus's recommendation of this \$30 million commitment to Sevin Rosen, a Dallas-based venture capital firm focused exclusively on early stage investing, and this tenth fund has a target capitalization of \$300 million. He stated that Sevin Rosen dates back to 1992 in terms of track record, and back to the 1980s in terms of experience and brand name. He said this group has consistently focused on early stage investments, and Fund X will invest in 25 to 30 early stage companies operating in thematically targeted technology, media and telecom subsectors.

Mr. Gary stated that the team executing the investments in Fund X will be coming from Fund IX, and will be augmented by an additional group of professionals specifically designed to address the refined strategy set out in Fund X. He said Fund X was essentially raised in 2006, at which time the firm underwent an internal dialogue, acknowledging how the venture space had changed, refining strategy and articulating the best way to move forward with that Fund. He said Aldus dug into this because there has been some turnover—four of the partners out of the California office will not go forward with Fund X, but they will continue to maintain their responsibilities for the portfolio companies in the prior Fund. He stated that this was an amicable separation.

Mr. Gary said Aldus was very impressed with how Sevin Rosen handled this transition; rather than close the fund and then execute personnel changes, they chose to take a step back, essentially return the money, work through the personnel changes, and then go back to the LPs with a fully formed team that would be the appropriate group going forward. He commented that Aldus saw this as responsible and “LP friendly.”

Mr. Gary stated that Aldus finds that the carried interest ownership is equitably spread across the Sevin Rosen partners, and that their carry allocation is impressively egalitarian. He noted that every General Partner is allocated an identical 13% of the carried interest and every Partner is allocated an identical 4.4%, irrespective of tenure. He commented that this speaks specifically to the heavily team-oriented component of their strategy, in part in reaction to a number of the changes within the venture space where there have been a lot of individually driven or personality-driven investment strategies.

Mr. Gary said their capital efficient approach to early stage investing is core. He stated that, as fund sizes in the venture space have continued to grow along with the evaluation of companies, and where multiple rounds of capital have continued to go into businesses, there has been an erosion of the discipline required to drive solid returns, particularly within the early stage space. He said this group has taken pains to identify a strategy that looks where the majority of the capital isn't, but also takes a disciplined approach to dropping capital into these businesses, setting out clearly articulated milestones. He stated that, while there are some early write-offs, a lot of them are of the smaller size. He said this speaks to their capital efficiencies, which is being able to drive to an exit in an environment that is primarily M&A driven as opposed to the IPO market, and being able to get to an appropriate exit of a limited size rather than continually streaming capital to keep a company alive.

Mr. Gary stated that Aldus evaluated derivative funds including the Texas Partners' investments continuing from Fund IX, as well as the investment performance of the three new partners. He said that, in aggregate, Texas Partners have generated a 62.2% gross IRR and 2.5x investment multiple on \$575 million of

invested capital. He said the investment performance of the three new partners shows them to be equally high caliber investors.

Sevin Rosen General Partners Dr. Jon Bayless and John Jagers appeared before the Committee and presented slides.

Dr. Bayless said he has been with the firm since its inception in 1981 and has seen at least two venture capital industry cycles since then. He commented that when there is a down cycle in the economy, there are a lot of opportunities for new ventures and startups as talent gets dislocated from larger companies and people with ideas want to form businesses.

Mr. Jagers said Sevin Rosen is focusing on four sectors at the current time: network transition in the U.S., from circuit switching to IP; technology in the delivery of healthcare services; high performance computing, and energy technology.

Mr. Martin asked how important was the availability of credit in developing their strategies.

Mr. Jagers responded that most of the companies they deal with are very early stage and have little or no credit, so very little leverage is required.

Mr. Neel observed that Fund X will have 25-30 portfolio companies, and Funds VIII and IX have around 35-40. He asked how Sevin Rosen manages so many board seats.

Mr. Jagers responded that they are not passive investors and sit on the boards of all of their companies. He said roughly 40% of the boards in Funds VIII and IX are handled by Sevin Rosen's former partners in California. He said the rest equals an average board load of five or six for the partners going forward. He stated that, provided the turnover rate is relatively consistent with new companies on board, that does not fluctuate much.

Ms. Goodwin moved that the Investment Committee approve a commitment of \$30 million plus any notional interest to Sevin Rosen Fund X, LP. The commitment shall not exceed 20% of the committed capital of the fund, and is subject to 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.

HEDGE FUND REVIEW AND COMMITTEE ACTION: NEPC AND ERB STAFF

a) Gottex Market Neutral and Market Neutral Plus

Gottex Senior Managing Director Richard Leibovitch and Managing Director George Yepes appeared before the Committee and presented third quarter results.

Mr. Leibovitch reported that the Market Neutral Fund, on a year to date basis through the third quarter, was down 20.7% on the 2x levered basis. He said the Market Neutral Plus was down 17% on the 2x levered basis. He said this compares to the unlevered returns in the Fund, which were approximately 8.5% and 7% respectively.

Mr. Leibovitch said these returns did not reflect October results. He said the unlevered Fund was down roughly 6%; therefore, the levered class should be down 13% or so. He said the returns of the 2x levered basis could be compared with the equity markets.

Putting this in context, Mr. Leibovitch presented bar chart YTD returns versus benchmark indices and pointed out that, on a relative basis, returns were slightly better than most hedge fund indices, and were somewhat better relative to most peer universes.

Mr. Leibovitch said one reason why the Fund failed to outperform the industry was because of an idiosyncratic problem they had in the Fund with one of their positions. He stated that they had to mark an investment down in September by 90% when a counterparty in one of the hedge fund transactions committed fraud in a PONSI scheme. He said Gottex is trying to recover the value of these investments.

Mr. Leibovitch stated that the Fund was positioned in an appropriate risk controlled manner, with 2% in Market Neutral and 1% in Market Neutral Plus, and Gottex essentially wrote the position down. He said Gottex has spent a lot of time with NEPC reviewing the due diligence undertaken by Gottex.

Mr. Malott asked Mr. Leibovitch why investors in general didn't get the neutrality they thought they would get.

Mr. Leibovitch responded that the driver of all of the problems in financial markets today is not the equity markets—the true problem is the credit markets have lost value, and that has dragged the equity markets along with it. He said every financial asset in the world has lost value from stocks and bonds to real

hard assets—cars, homes, etc.—so when there is such an extreme crisis, everything starts to correlate with one another and it is impossible to break up the relationship between the equity markets and hedge funds strategies.

Mr. Leibovitch said market neutral hedge funds buy assets and then hedge a part of the market risk with derivatives or something that goes short. He stated that all of the long assets that are bought, whether stocks or bonds, have dropped in value, but the shorts have not gone down with that, so there has been a complete breakdown between how long positions and short positions behave. He said this has resulted in significant losses.

Mr. Leibovitch commented that the only strategy that has made money in hedge funds is to be outright short, and few do that as a strategy because it is not a viable long-term way to make money.

Mr. Bland commented that hedge funds do not anticipate and they do not hedge, “and you finally learned the lesson that sometimes your shorts go down not as much as your longs go down? I find that an unacceptable answer.” He said the SIC is letting go hedge fund managers who are down more than 20%, since most of them are down less than that.

Mr. Leibovitch stated that hedge funds have had to adapt to the current market environment over the last few months, now that financing has disappeared, and they have had to sell in an illiquid market. He said hedge funds have subsequently de-levered. He stated that, if the market continues to go down, there will not be the same magnitude of losses as before. If the market goes up, he said, yields of 15-20% will be generated because so much loss has already been taken in the market.

Mr. Jacksha stated that staff’s biggest disappointment is that this was viewed as a market neutral absolute return strategy for the ERB. He added that he and Mr. Neel have wrestled with whether the 2x levered class is the right place to be, if the ERB is going to be in the fund-of-funds at all, and asked Mr. Leibovitch to respond.

Mr. Leibovitch responded that this is a more aggressive investment than being unlevered, and ultimately it comes down to the ERB’s risk threshold. He pointed out, though, that the ERB has made it this far through the crisis, and the question is whether or not this is the time to exit this investment.

As a follow up question, Mr. Jacksha asked what the cost of this leverage is, and has it been affected in cost and availability by the general credit situation.

Mr. Leibovitch responded that the cost of the leverage has historically been around LIBOR + 100. He noted that LIBOR is now down to 1%, so the cost of leverage in absolute dollar terms is actually very low, which is a good thing. He said

the availability is shrinking, however—banks don't want to do this business anymore, and the cost is likely to go up as these lines get renewed, because they won't be renewed at the same spread level. He said the spread will probably go to 200 basis points on average.

Given the chaos in the industry these days, Mr. Jacksha asked if there is any more negotiating room with individual funds on their fees going forward.

Mr. Leibovitch responded that because of the illiquidity in the market and the volume of redemptions, a lot of hedge funds are now offering investors a choice: either they liquidate an investment, or they ask the investor to sign up for a one-year locked period with reduced fees.

Messrs. Leibovitch and Yepes left the proceedings.

Mr. Bland stated that SIC will be demanding that hedge fund managers either suspend fees or else be terminated.

Mr. Malott agreed that the ERB should be renegotiating fees. He commented that the ERB could get the same results leveraging its own debt.

Mr. Jacksha said staff agrees that there should be fee reductions negotiated across the board.

Dr. Woodfin asked if there are any hedge fund managers who are being successful in this environment.

Mr. Jacksha responded that there are, because there is a wide diversion of strategies and of performance, although the vast preponderance of hedge funds are down.

STAFF REPORT ON NOVEMBER 19, 2008, HEDGE FUND OF FUNDS REVIEW

Mr. Jacksha said a memorandum to the Committee discusses the idea of going into individual hedge funds and reducing some of the fund-of-funds to get there. He stated that credit strategies such as bank debt and related securities is one area that might be explored.

Mr. Bland cautioned that the detail, staff time and effort involved in going into an individual fund, and being right on the strategy, is very complicated.

Mr. Bland said he was very frustrated over what he saw as ineptitude among many fund-of-funds managers, and thought a culling process was called for. He

stated that many of these managers, including Gottex, are advising that investors simply wait things out—but it could take years for things to improve.

Mr. Jacksha agreed with Mr. Bland on the idea of individual funds. He said ERB was nowhere near being ready to go into that and what concerned him the most was the ongoing monitoring aspect.

Mr. Bland commented, however, that he thought Mr. Jacksha's personal abilities—and those of his staff to come up to speed with him—were probably greater in investing directly in one-partnership funds with \$200-\$300 million pieces of distressed debt. He said he felt the ERB could do that better internally.

Mr. Martin said there are a number of long-only options in bank debt without going into hedge funds.

Mr. Jacksha added that, whatever the bucket, staff can certainly look at more of the distressed credit strategies, particularly in bank loans. He stated that he and Mr. Martin have agreed that the biggest question is where the money should come from, because everything looks cheap right now. He said maybe the ERB should reduce some of its holdings in the hedge funds.

Mr. Bland concurred. He said it didn't make any difference where the money was taken from in this process, because if there is going to be any recovery in this market, it will come after bank debt unfreezes.

Mr. Malott asked if pension obligation bonds were an option, and Mr. Jacksha said it would not be possible to sell them at a reasonable interest rate in the current market. He said he would advocate pension obligation bonds if it were possible to obtain cheap locked-in leverage to buy these cheap assets.

Following up on earlier discussion, Mr. Jacksha agreed that, instead of going out and participating in an existing fund with high fees, it would make sense to for the ERB to explore the idea of having its own fund at \$200 million and to negotiate with a manager to run it.

A. CONSERVATION FORESTRY — ORG & ERB STAFF

B. NMERB MITIGATION BANKING FUND — ORG & ERB STAFF

Mr. Canavan stated that staff has done extensive research, interviewing and analysis in the real estate sector, and today is recommending investments in funds that are somewhat defensive. He said staff has been looking for assets that have the ability to have variable cost structures so they can adjust the cost of the funds and absorb expenses.

Mr. Canavan said Conservation Forestry is a timber deal where the asset purchase price and risk is mitigated by the conservation groups involved in these transactions. He stated that the Nature Conservancy will at times want to take a piece of land in conjunction with a timber group, and set aside that land with an environmental or conservation easement and are willing to pay for the right to do that. He said that helps offset expenses for the timber group.

Mr. Canavan stated that Mitigation Banking is a fund created specifically for the ERB in conjunction with Greenfield Land Partners. He noted that the underlying premise is that EPA regulations require that development has to mitigate environmental impact in terms of wetlands and water resources, and this has turned into a market over time, where a person or group can purchase a large plot of land, restore and rehabilitate it, and be certified to have environmental credits on the space that can subsequently sold to others who need them.

Howard Kaplan and Steve Gruber of ORG appeared before the Committee.

Mr. Kaplan said both of these groups present market solutions to environmental issues, which is an emerging trend; and in so doing, they are able to elevate their returns and bring incremental excess return with less overall risk.

Mr. Kaplan said that, in the timber area, ORG has looked at 10-12 different managers with various strategies in the Southeastern U.S., Pacific Northwest and in South America, utilizing varieties of Southern yellow pine, Douglas fir and eucalyptus; but after looking at all these managers, what makes this Conservation Forestry group different from the others is that they have engaged conservation groups on a partner basis, getting on the same side of the table with them instead of being adversaries. As a result of this strategy, he said, they have brought together an unusual blend of diverse skills in these different areas, in forestry, finance, business management and conservation.

Conservation Forestry founder John Tomlin appeared before the Committee with associates Paul Young and Kent Gilges, and presented slides.

Following the presentation, Mr. Jacksha said one of the things that appeals to staff about this investment is the risk mitigation by working with the conservation groups and monetizing values, rather than speculating on future land prices. He said this is an attractive component in this economic climate.

Ms. Goodwin moved that the Investment Committee approve a commitment of \$25 million, plus any notional interest, into Conservation Forestry Capital II. This commitment shall not exceed 20% of the committed capital of the fund and is 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.

[Mr. Lewis excused himself from the proceedings.]

Mr. Kaplan introduced Dean Sotter, COO with Greenfield Partners.

Mr. Kaplan said the ERB has already invested in Greenfield Acquisition Partners V.

Mr. Kaplan noted that, even under reduced market assumptions, the returns are attractive. He said some of the strengths in this area are: the timing to leave residential construction; regulators favor large efficient bank projects; financing infrastructure is yet to be developed; the markets are inefficient; and they have an experienced partner in a mitigation specialist.

Mr. Sotter presented slides.

Mr. Gruber explained that the strategy here is to invest up to \$25 million alongside Greenfield, and ORG will put up to \$5 million into any one investment until it builds a diversified national portfolio of mitigation banks. He stated that, because ORG will put 20% of the money up to \$5 million with a sole investor, it is as though they have a 20% position in a fund. He added that, because ORG went to Greenfield with this proposal originally and with their partner, they were able to eliminate the idea of a commitment fee—so they only pay fees on investment capital over time.

Mr. Sotter pointed out that Greenfield Land Partners II is a \$400 million fund, and part of the fund will do transactions such as described today. He said the sole purpose of their fund is not to do wetlands mitigation deals, however; they invest in all sorts of land transactions. He said they have a significant residential component and a commercial component, but to the extent that they have within those transactions wetlands mitigation opportunities, they will bring them to this new fund.

Mr. Gruber said there is no cherry-picking—they are in every deal.

Ms. Goodwin moved that the Investment Committee approve a commitment of \$25 million, plus any notional interest, into New Mexico ERB Mitigation Banking Fund. This commitment shall not exceed 20% of the committed capital of the fund, and is 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. Bland seconded the motion, which passed by voice vote.

ADJOURN

Its business completed, the Investment Committee adjourned the meeting at approximately 3:50 p.m.

Accepted by:

A handwritten signature in black ink, consisting of a large, stylized initial 'B' followed by a horizontal line extending to the right.

Mr. Bruce Malott, Chair