

MINUTES OF THE
NEW MEXICO EDUCATIONAL RETIREMENT BOARD
INVESTMENT COMMITTEE

December 6, 2007

CALL TO ORDER

A Regular Meeting of the New Mexico Educational Retirement Board Investment Committee was called to order on this date at approximately 2:00 p.m. in the Educational Retirement Board Room, 6201 Uptown Boulevard, N.E., Ste. 203, Albuquerque, New Mexico.

A quorum was not present:

Members Present:

Mr. Bruce Malott, Chair

Mr. Gary B. Bland [joined proceedings by teleconference at 3:15 p.m.]

Mr. Jeffrey M. Riggs

Members Excused:

Mr. James B. Lewis

Other ERB Members Present:

None.

Legal Counsel Present:

None.

Staff Present:

Ms. Selma Arnold, Financial Analyst

Mr. Robert Cardon, Internal Auditor

Mr. Frank C. Foy, Deputy Chief Investment Officer

Mr. Bob Jacksha, Chief Investment Officer

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

SEPTEMBER PERFORMANCE REVIEW: ALLAN MARTIN

Mr. Martin stated that, as of 9-30-07, the value of the portfolio was \$9.583 billion. He said this has been followed by a very turbulent November, during which time the S&P gave up the entire 9% it had advanced during the year, although yesterday it went up to about 6.5% for the year. He said the portfolio was worth \$9.483 billion yesterday, representing a loss of about \$100 million in capital appreciation since this report was issued.

Mr. Martin pointed out that while 9% of the economy, which is associated with autos and housing, is in a very deep recession, the other 91% of the economy is doing quite well. He added that most people feel that the dip in housing and autos will drag down the full economy, but the question is whether consumers will cut back on their spending, and most prognosticators do not think that will happen and that there will be modest economic growth.

In discussing an overview of the market as of 9-30-07, Mr. Martin noted a very good year in the equity markets and a great year (which continues) in international, particularly in emerging markets. He said the year has also been good in private equity and real estate; however, market neutral hedge funds have not done well for the quarter. He stated that the ERB went into that with an expectation and belief — which still holds — that it would outperform T-Bills by 200 basis points or more. He said that wasn't true for the quarter, because August was the worst single month in hedge fund history; and for the year, HFRI MKT Neutral Hedge Funds were at 6%, and 90-day T-Bills + 2% were at 7.3%. He commented that the strategy at a macro level would appear to have stumbled, but the ERB's numbers are better than that for the year notwithstanding the results for the quarter.

Presenting highlights, Mr. Martin said the Fund experienced a gross investment gain of \$1.3 billion over the last 12 months, easily outpacing the net distributions, and \$193 million of that came in the quarter — so the quarter was certainly not the best in the year, but it was still positive.

Mr. Martin stated that for the five years ending 9-30-07, the Fund returned 14.5% per annum: a little behind its policy index, yet ranking impressively in the 28th percentile of the ICC Public Funds Universe. [As of 9-30-07, the ICC Public Funds Universe consisted of 192 total funds with a market value of \$802 billion.]

Mr. Malott observed that the Fund returned 15.1% for the year, ranking it in the 52nd percentile of public funds. He asked why so many public funds were doing better than the ERB.

Mr. Martin responded that the ERB has moved from being almost fully dependent on equities and bonds to a more diversified strategy; and while in the

long run that will help the ERB, in a period where the markets have run away on the upside, it is dampened in some sense. He also stated that in a number of programs (particularly in private equity), the ERB is in the beginning stages of investing and thus is early in the J-curve. He said this is compounded by the fact that the private equity portfolio contains Vanderbilt, which has not been a good investment.

On the Vanderbilt issue, Mr. Jacksha said staff is breaking that out separately from the portfolio to get a realistic look at the effect of Vanderbilt versus real private equity. He stated that Vanderbilt has been priced by a third party, Keefe Bruyette & Woods, at 49 cents a share, so writing it down to zero is not far off.

In reviewing fund growth, Mr. Martin noted that private equity makes up 0.8% of the Fund's total assets. He said there have been discussions with Aldus about increasing the pace as well as looking at co-investment programs.

Mr. Jacksha stated that the ERB has asked NEPC to act as its private equity consultant in the case of co-investment funds, because Aldus is one of the candidates.

In reviewing a chart reflecting the ERB's performance versus the median public fund into how much of that was policy impact, allocation impact and manager impact, Mr. Martin noted that manager outperformance over the five year period was virtually zero— so the ERB would have been better off to index all of its managers over a five-year period.

Mr. Martin reviewed a performance summary in domestic equity and noted that the total U.S. equity composite returned 13.6% for the 3-year period versus 13.7% for the Russell 3000 and 14.5% for the ICC Equity Funds median. He said this puts the ERB at a little worse than median, so the active management associated with equities has not been a very positive factor.

Mr. Malott pointed out that if the ERB had bought the Russell 3000 for the 3-year period without going with managers, it would have been 10 basis points better off. Mr. Martin agreed, adding that this was before the ERB paid fees.

In reviewing large cap results, Mr. Martin noted that BGI has been the laggard in this area and is on the watch list. He said he and Mr. Foy will be visiting them at the end of next week.

Mr. Martin noted that the ERB is approximately at the index in non-U.S. equities over the 5-year period, but over the 3-year period it is significantly better than the index, and very significantly so in the 1-year period.

In discussing the fixed income performance summary, Mr. Martin said the ERB managed this money in-house for many years and generally outperformed the

indices over that period. He said that was restructured a couple of years ago; and in that period, Lehman was chosen to be index-like, Fidelity was chosen to be slightly higher octane, and WAMCO was chosen to be the value-added manager. He added that, while this was nicely reflected in the 2006 year-end results, activities in the bond market in the last six months have created a situation where none of the managers is doing as well as the aggregate index.

Mr. Martin stated that, while Fidelity and Lehman each had 5.0% results for the 1-year period, WAMCO's were 3.8% largely because of a disproportionate exposure to mortgages.

Mr. Malott asked the record to reflect that he spoke with Garrett Thornburg recently, who told him that the MBS market in the last two weeks has been worse than ever. Mr. Jacksha commented that this would be reflected in WAMCO's performance.

Mr. Martin commented that WAMCO is a good firm; they haven't lost people, and they have a methodology. He said he, Mr. Jacksha and Mr. Foy have talked about options for fixed income; for instance, perhaps some or all of it could be brought back in house. He said there are many portable alpha strategies available to look at.

In reviewing the performance summary for alternatives, Mr. Martin noted -8.8% returns for HFV for the quarter. He said there are some real concerns about this manager, and Mr. Neel and Mr. Jacksha have both visited their offices, as has NEPC's hedge fund analyst Jason Dubrovay and State Investment Officer Adam Levine. He stated that, as HFV described the problem at the September Investment Committee retreat, they acknowledged that they had allowed over-concentration to happen in Integra, a good-performing fund; so he and Messrs. Neel, Jacksha, Levine and Dubrovay spent a lot of time talking with them about risk management practices, "and neither I nor anybody else likes what we heard." He said they focus on the Sharpe ratio, which the ERB focuses on for liquid assets and the total portfolio, but he would argue that the Sharpe ratio is less relevant for hedge funds. Mr. Martin said Messrs. Jacksha, Neel and Levine had the benefit of going to Austin after they visited HFV, since HFV is headquartered in Texas as well, and the difference was like night in day in terms of quality of personnel and depth of risk management technology.

Mr. Martin noted that the hedge fund portfolio had approximate 10% returns for the calendar YTD through November, while the equity market for the same period was flat. He commented that the strategy in absolute returns is good and appropriate. He said there may be an execution issue associated with HFV, which staff will be exploring.

OCTOBER FLASH REPORT: BOB JACKSHA

Mr. Jacksha reviewed the October Flash Report, reflecting a 13.9% return for the 12-month period and 5.9% for the quarter, slightly behind the benchmark.

FIXED INCOME MANAGEMENT OPTIONS

Mr. Jacksha stated that a couple of options for dealing with underperforming outside managers in fixed income are: 1) look at portable alpha strategies in core fixed income (high yield); or 2) manage the money internally.

Mr. Jacksha commented that managing this part of the portfolio in house would not be difficult because he and Mr. Foy both have backgrounds in it. He added that, given that the ERB is paying its managers about \$1.6 million a year before performance fees, it could certainly do it in house for less.

Mr. Malott recommended waiting until the end of the first quarter of next year to see if there is any improvement and then begin discussion on internally managing the money.

SMALL CAP TRANSITION UPDATE: FRANK FOY

Mr. Foy reported that, after requesting estimates from six different firms, the ERB hired Bear Stearns as transition manager to transfer assets from Franklin to Perimeter and Wells. He distributed a transition cost comparison chart reflecting Bear Stearns' estimated cost of 30.1 basis points followed by the actual cost, which was 87 basis points — 50 points more than anticipated — or a total of \$2 million to transfer about \$215 million in securities.

Mr. Foy said staff asked Bear Stearns how they could miss their target by such a wide mark, and their response was that there were five companies that were very illiquid that they were unable to get at the prices they thought they could.

Mr. Foy commented that he was very disappointed at these results and would probably not use Bear Stearns again.

Mr. Foy said another bidder said it would take them 30 days to liquidate the portfolio, but he had contracts that would not allow that much time.

Mr. Jacksha added that they didn't start the transition process with 30 days to spare because they didn't think they had to. He said they plan to start the transition process earlier in the future where small caps or emerging markets are involved.

LARGE CAP VALUE MANAGER CONTRACT: FRANK FOY

Mr. Foy reported that ICAP has been terminated and Brandywine has been hired. He commented that it took only a couple of days to negotiate the contract with Brandywine, which was very speedy. He said the contract will start on December 14.

Mr. Foy said State Street was hired to do the transition, and they started and concluded the trading yesterday.

SUDAN DIVESTMENT: BOB JACKSHA

Mr. Jacksha stated that the SIC decided last month to adopt a policy of divesting from companies that are doing business with the Sudanese government and not to invest in those companies anymore.

Mr. Jacksha stated that 17-18 states in the U.S. have thus far passed legislation to force funds to divest, and New Mexico is not yet one of those at this point. He said it will probably be discussed at the Legislature, but he personally would prefer that the ERB control its own fate with this.

Mr. Jacksha said he would recommend that the ERB adopt a policy of divesting.

Mr. Martin reported that the ERB has three holdings: China Petroleum & Chemical, held by Alliance Bernstein Value, and Weatherford International, an oil supply company that is in the S&P 500. He said Weatherford is in the ERB's Large Cap Equity Index Fund, and Goldman Sachs holds an amount. He said the total amount involved is \$12 million.

Mr. Martin said NEPC has estimated that, if the ERB sells this stock, its manager will want to replace it, so the ERB will pay money to have the manager sell it and then buy a replacement. He estimated that transaction costs all told would be roughly \$400,000.

Mr. Martin stated that \$12 million is .19% of the ERB total portfolio.

Mr. Jacksha said he was not advocating this approach for the S&P, since it would be extremely complicated to start excluding stocks from that index.

[Mr. Bland joined the proceedings by telephone.]

Mr. Martin said he suspected the managers would request a letter from the ERB directing them to sell the security, and they may or may not want an adjustment to the index.

Mr. Jacksha stated that the Sudan Divestment Task Force has issued a list of Tier One, Tier Two and Tier Three stocks, which the SIC is using and he would propose the ERB use as well. He said Tier One represents the worst offenders, and the Task Force recommends divesting from all of them. He said the Task Force wants to continue to engage in dialogue with the companies in the second tier, and is not advocating selling them; and Tier Three is not a concern.

Mr. Malott stated that the managers involved are so far away from the index at this point that he did not think they were in a position to negotiate anything. He said they should find a stock that is comparable and get closer to the index, "and we'll talk about it."

Mr. Martin asked if the Committee is considering a policy to have the managers not hold securities associated with the government of Sudan, or it is considering a broader policy, and Mr. Malott responded only Tier One securities in the Sudan Divestment Task Force document. Mr. Jacksha said the document is updated quarterly, and these updates will be communicated to the managers.

No one on the Committee, staff, or in the audience expressed objection to adoption of this policy.

Mr. Martin commented that certainly the Sudanese government and what is happening there is horrendous, but the mechanism to deal with that is the federal government, but the federal government is not taking any action, and people are therefore turning to the ERB to use its retiree money to express dissatisfaction with this. He commented that this is less effective than dealing with it through the political process itself.

Mr. Malott said this is a morally repugnant situation, and he strongly suspected that if the ERB were to ask the members to vote on this, they would want the ERB to adopt the policy. He said he has gotten phone calls from people who are concerned.

ADJOURN

Its business completed, the Investment Committee adjourned the meeting at approximately 3:30 p.m.

Accepted by:

Mr. Bruce Malott, Chair