MINUTES OF THE
NEW MEXICO EDUCATIONAL RETIREMENT BOARD
INVESTMENT COMMITTEE

May 23, 2011

CALL TO ORDER

A meeting of the New Mexico Educational Retirement Board Investment Committee was called to order on this date at approximately 12:45 p.m. in the Educational Retirement Board Room, 6201 Uptown Boulevard, N.E., Ste. 203, Albuquerque, New Mexico.

A quorum was present:

Members Present:
Mr. H. Russell Goff, Chair
Ms. Jan Goodwin
Dr. Beulah Woodfin

Members Excused:
Dr. Gautam Vora

Legal Counsel Present:
Mr. Chris Schatzman

Other ERB Members Present:
Ms. Mary Lou Cameron

Staff Present:
Mr. Mark Canavan, Real Estate Portfolio Manager
Mr. Bob Jacksha, CIO
Ms. LeAnne Larrañaga-Ruffy, Investment Officer
Ms. Christine Ortega, Investment Financial Analyst
Mr. Jude Perez, Portfolio Manager

Others Present:
Mr. Frank Barbarino, NEPC [by telephone]
Mr. A. J. Forte, DFA Analyst
Mr. Steve Gruber, ORG
Mr. Howard Kaplan, ORG
Mr. Allan Martin, NEPC
APPROVAL OF AGENDA

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

APPROVAL OF MINUTES: April 14, 2011

Ms. Goodwin moved approval of the April 14 Minutes, as submitted. Dr. Woodfin seconded the motion, which passed by voice vote.

REAL ESTATE INVESTMENT APPROVAL: ORG & STAFF

a. Prudential Senior Housing Partners IV

Mr. Canavan introduced Prudential Real Estate Investors (PREI) managing director Noah Levy and principal Mark Oczkus.

Mr. Canavan said ERB staff recommends an investment of $50 million in Prudential Senior Housing Partners IV, subject to negotiation of final terms and conditions.

Mr. Oczkus and Mr. Levy made a slide presentation.

-- PREI is the second largest manager of U.S. tax-exempt real estate assets with $27 billion in gross assets under management.

-- They have 250+ U.S. employees in the real estate management group, including 102 investment professionals. There are 19 people on the research team, 12 in the U.S.

-- They are organized along portfolio management teams, including the senior housing group.

Mr. Levy stated that Senior Housing Partners is a series of dedicated closed-end funds designed to take advantage of opportunities in the growing senior housing industry.

Mr. Levy said this is a relatively new space that presents an interesting opportunity:

-- Attractive risk-adjusted returns driven by solid current income can be achieved by employing a flexible investment strategy targeting specific segments of the senior housing market.
Senior housing offers opportunities for higher returns with investments in an industry less likely to track the general real estate cycle. PREI believes senior housing can perform well even in an economic slowdown.

Demand is supported by powerful demographic trends, while supply is constrained. This is a relatively small industry that has not had access, until recent years, to the kind of institutional capital that PREI represents.

The current operating fundamentals are holding up relatively well and performed well during the recently experienced down cycle.

In today’s changing debt markets, PREI expects to see attractive opportunities for equity and possibly mezzanine investments.

A wide range of experience operators are in need of capital to expand their growing businesses.

Mr. Levy stated that, for PREI, “senior housing” refers to housing and services for people generally 75 or older who no longer desire or are unable to live on their own. He said PREI focuses on residential, private pay segments of the senior housing industry that bridge the gap between self sufficiency in the home and dependency in a more regulated institutional setting.

Mr. Levy noted that growth in senior housing construction starts has declined substantially and there continues to be constraints on new supply; yet, there are 19 million 75+ seniors in the U.S. and demand growth will rise rapidly over the next ten years.

Mr. Levy reviewed the track records of the first three funds:

- SHP I IRR since inception (after fees): 16.44%.

- SHP II IRR since inception (after fees): 29.83%.

- SHP III IRR since inception (after fees): 0.12%. This fund has gone through a tough cycle, going from 19.74% returns in 2007 to -11% returns in 2008; however, returns are now stabilizing. The fund should break even when it ends in another 3-4 years.

Mr. Levy stated that Fund IV’s investment strategy would be essentially the same as SHP I, II and III:

- Continued focus on independent and assisted living using flexible investment structures.

- Return target 10% to 13% after fees with no more than 50% leverage.
Same investment team and similar investment guidelines with less potential forward/development risk.

SHP IV domestic clients will invest through a traditional LP or a partnership with an insurance company separate account. Targeted size up to $600 million; Prudential will co-invest $50 million. Term: 10 years.

Mr. Levy said the first close is scheduled for June 30, 2011.

Dr. Woodfin referred to a map of SHP portfolio properties in the U.S. and observed a shift in geographical focus between Fund I and Fund II.

Mr. Levy responded that they look at the assets, market and operator, before making an investment – all three elements have to be present. He said different deals came up at different times; for instance, there were many opportunities in California in Fund I that didn’t exist in Fund II.

Responding to Mr. Canavan, Mr. Levy said he would expect no more than 15% of the equity in Fund IV would be invested in CCRCs (Continuing Care Retirement Communities). He commented that CCRCs are tricky to invest in because they are very dependent on the reselling of units.

Ms. Goodwin asked how sensitive their projected returns are to interest rates. Mr. Levy responded that this is a higher operating leverage business, so it can be sensitive in the model. He said interest rates themselves do not hit the models as much as the assumptions around rent growth and occupancy, but it isn’t altered very much if the spread between cap rate and interest rates stay in sync. Today they are at the bottom of a cycle, and interest rates are going up. He sees this as a buying opportunity, as a lot of loans will roll over in 2012-2014 and will not “pencil” anymore because of higher interest rates, which means higher cap rates. He said a property may be running very well and be just overcapitalized, which he sees as a buying opportunity – in other words, it can work well for them either way.

Mr. Canavan reviewed the terms of the deal, which he said were very favorable with a 1.15% management fee and an acquisition fee of 75 basis points. He said the carry is tiered, so there is no reimbursement to the manager until after an 8% rate of return. He said there is a 25% return to the GP above a 13% net IRR.

Mr. Canavan noted that, while all other property types (office, retail, multi-family and hotels) experienced negative rent growth during the worst of the economic downturn, senior housing rents grew 3%, an impressive statistic.

Mr. Canavan also stated that tenants of senior housing are not susceptible to losing their jobs in economic downturns, and often choose to move into these communities for social reasons, to be in close proximity to social services, and because of health concerns – all
exceptionally strong motivations to remain in place. He said this means income returns from
senior housing tend to be relatively stable when compared to other real estate sectors.

Dr. Woodfin moved that the Investment Committee approve a $50 million
commitment to Prudential Senior Housing Partners IV, L.P., 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.

Ms. Goodwin seconded the motion, which passed by voice vote.

OPPORTUNISTIC CREDIT INVESTMENT APPROVAL: NEPC & STAFF

a. Waterfall Eden Fund
b. Waterfall Victoria Fund

NEPC advisors Allan Martin and Frank Barbarino (by telephone) were present.

Mr. Martin stated that the ERB has roughly a target for its credit allocation of about $1.9
billion – a significant part of the total portfolio designed to take advantage of the ongoing
circumstances in the credit market that lead to an imbalance between supply and demand. He
said there is ongoing reticence by banks to lend, and CIT (now bankrupt) and GE Capital and
the hedge funds are no longer in the market.

Mr. Martin stated that Waterfall has a couple of funds that are considered opportunistic
hedge fund or private equity style. NEPC is recommending a total investment of $250
million between the two, which are managed by the same management company. He said one
buys whole loans from banks, with the idea of renegotiating terms to allow people to stay in
their homes; and the other provides financing to asset-backed securities.

Mr. Martin stated that there are approximately 942,000 units of defaulted mortgages
owned by banks, with another million expected, and the banks are getting increasing pressure
to do something with those – so the market opportunity becomes riper as time goes on.

Mr. Barbarino presented highlights from NEPC’s memorandum.

-- As a result of market inefficiencies and the overhang from the credit crisis of 2008-
2009, there remain significant opportunities in the less liquid areas of the non-investment
grade ABS and loan markets.

-- There remains a significant imbalance between supply and demand in this space.

-- Historically the “natural” buyers of ABS are insurance companies, hedge funds and
bank proprietary trading desks. Many of these buyers have left the market and are now
focused on buying only investment grade paper.
Non-investment grade ABS space includes traditional sectors such as auto loans, student loans, and residential or commercial mortgage loans as well as non-traditional ABS sectors such as aircraft and equipment leases. Non-traditional ABS is particularly attractive now due to the reduction in the natural buyer base for these securities.

The credit crisis also resulted in a large number of residential mortgages defaults and thus a supply of non-performing residential mortgage backed loans and securities. This has created an opportunity for buyers of these loans who can purchase and work out these loans through negotiation with borrowers.

The involvement of the government in these restructuring programs has not resulted in any significant resolution to the problem, and banks are being forced to seek out third party managers for a solution.

Mr. Barbarino stated that NEPC and staff agreed that the allocation could incorporate managers representing two of the most attractive areas of opportunity: Non-Investment Grade Asset Backed Securities; and Residential Whole Loans. This group of managers was narrowed to a smaller sub-set of six managers and ultimately to Waterfall.

Mr. Barbarino said NEPC and staff have visited Waterfall to look at their processes and systems, and have been very impressed by the team. NEPC's process included onsite due diligence visits, a review of each fund's documentation, reference checks, and development of a scoring matrix.

Waterfall Asset Management representatives Tom Capasse, Jack Ross and Andre Cuerington made a presentation.

Mr. Ross stated that he and Mr. Capasse are intimately involved in every loan package, bond and investment that goes in the portfolio.

**Waterfall Eden Fund**

The largest part of the asset-backed market is non-agency mortgages, also known as sub-prime mortgages ($2 trillion).

All risk assets have moved significantly from the lows of March 2009 to today. High yield bonds are up 66%, leveraged loans 62%, RMBS (sub-prime mortgage bonds) 42%. Non-traditional ABS is up only 20% -- a much more muted rally. From second quarter 2009 lows, non-traditional ABS rallied less than other fixed income sectors and now offers less relative value.

Waterfall Eden Fund makes money primarily from cash flows, which means the volatility of their strategy is muted.
--- 75%-80% of the ABS market is floating rate, which means the coupon on the bonds will reset every month once the LIBOR rate starts to go up.

--- Prepayments are expected to pick up in the ABS market.

--- Tighter underwriting/appraisals has resulted in more credit support, which means "strong ABS vintage."

--- April 2011 returns were 1.99%, which puts the Fund up 8% YTD.

Waterfall Victoria Fund

--- Residential housing is usually 17% of GDP, and is now only 6%, and the cycle is becoming less correlated with the capital markets.

--- There are $11 trillion of mortgages in the U.S., of which 10% are delinquent. Waterfall estimates that about $250 million of that is for sale and will generate sales of $20-$50 billion over the next 3-6 years.

--- About 400 buyers represent $85 billion of capital. The "tier one" buyers (larger managers with $100+ million of AUM) own their own loan servicing companies. In the last year, the trading market has become bifurcated with these big sellers doing large auctions of $200+ million to the big private equity firms.

--- Those deals are trading 5-10 points higher in price, or a 9-12% yield versus the middle market of 13-18%. This is because a firm with its own servicer pays up for the servicing fees that go to the GP. Waterfall continues to focus on the smaller negotiated transactions with community and regional banks.

--- Waterfall focuses on underserved niches within the residential non-performing market, e.g., small balance commercial loans. These are under $1 million secured by a first lien, and are multi-family mixed use guaranteed by local owners. The market is estimated at $500 billion with about 15% delinquent.

--- Homeowner retention drives returns. Waterfall right-sizes a loan to match reduced borrower income.

--- 12-month rolling returns at the first quarter 2011 = 14.4%.

Committee members spent several minutes discussing the two funds.

Mr. Jacksha noted that the Eden Fund had assets of $312 million as of 4/30/11; and ERB policy says the ERB cannot be more than 30% of a single active management product. In addition to the $312 million in the Fund, there are separate accounts that Waterfall runs in the ABS area that are another $700 million. Added together, they come to $1 billion. He stated
that, in comparing this to how the ERB looks at a public equity manager, the ERB is always in a separate account, and is looking at similar strategies that are in a bunch of other separate accounts or funds. He said he thought this a reasonable interpretation of the language in the current policy, adding that this restriction will be taken out of the new policy.

Ms. Goodwin moved that the Investment Committee recommend to the New Mexico Educational Retirement Board approval of a contract to invest $150 million in the Waterfall Eden 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.

Dr. Woodfin seconded the motion, which passed by voice vote.

Ms. Goodwin moved that the Investment Committee recommend to the New Mexico Educational Retirement Board approval of a contract to invest $100 million in the Waterfall Victoria 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.

Dr. Woodfin seconded the motion.

Responding to Dr. Woodfin, Mr. Martin said 17% of the Fund’s total assets are in opportunistic lending, with another $700 million remaining. He noted that PIMCO-DISCO will be selling off its assets at the end of the year and will be paying the ERB back.

The motion passed by voice vote.

[Break.]

PROXY VOTING REPORT

Dr. Woodfin moved for approval. Ms. Goodwin seconded the motion, which passed by voice vote.

REAL ESTATE AND NATURAL RESOURCES PERFORMANCE REPORT – Q4 2010: ORG AND STAFF

Real Estate

Mr. Gruber made a presentation with the following highlights:

-- Real estate experienced a fairly good recovery in 2010. Value declines are up to 40% off the peak (2007) to the trough (2009) but transaction volume is thin.
Even with a 20% decline across the board, most of the properties levered 60-70% in the 2005-2007 time period cannot get loans without the borrowers re-equitizing their position in those properties, so there is tremendous opportunity coming up.

- ORG feels the industry does not have the capacity to recapitalize the coming wave of maturities.

- The next several years should offer an attractive flow of opportunities:

  - Overleveraged borrowers are trying to buy back their loans at a discount;
  
  - There are distressed investors who need to recapitalize their existing position or are buying the loan outright and converting to fee title interest; and
  
  - Banks today are selling more than in the past, and this flow is just starting.

- Rather than bet on job recovery in the multifamily housing market, where apartments are trading in the 4-5% cap rate range, ORG is betting on the demographic wave in the senior housing space. On the multifamily side, turnover is 67% in an average year; in senior housing, (75 and older) the average stay is 4 years.

- A tremendous wave of loans is coming due; $2 trillion of commercial real estate debt will mature within the next five years. There are not enough organized funds with capital to address this.

Reporting on portfolio performance, Mr. Gruber said ORG has $115 million invested, and most of the managers do not have a long track record at this point. For the 1 year (as of 12/31/10), the private real estate portfolio shows 24.3% returns versus the NCREIF Benchmark of 13.1%. On an annualized basis since inception, returns are at −0.4% versus the NCREIF Benchmark of −4.2%, He said the numbers will continue to improve over time.

Reviewing the NMERB commitment history, Mr. Gruber said the most disappointing is the AMB industrial commitments ORG made. By being industrial in port markets, he said ORG felt it was being defensive; however, the timing was poor.

Mr. Canavan noted that the ERB bought a secondary partnership position in High Star at roughly $12 million, and it just distributed $3 million. He said the markup on NAV is about $20 million, so the ERB has made $7-$8 million on this in a very short period of time.

**Natural Resources**

Mr. Kaplan made a report on the natural resource allocation (timber, agriculture and mitigation banking).
-- The timber fund, with 9.6% 1-year returns as of 12/31/10, significantly outperformed the NCREIF Timberland Benchmark and slightly exceeded the 50/50 Blend, which is the benchmark for the natural resources category.

-- In the pipeline: a mix of agricultural and timber funds. Mitigation banking space has been filled.

-- Renewable natural resources investments produce more stable returns than other asset classes; there is a low correlation to other asset classes to lower overall portfolio volatility; total returns are competitive with other “alternative” investments; and returns can provide a hedge against inflation.

-- 2011 implementation plan: increased $300 million allocation, and $100 million in commitments forecast over remainder of 2011.

INFRASTRUCTURE PERFORMANCE REPORT – Q4 2010:
COURTLAND & STAFF

[Deferred.]

OTHER INVESTMENT REPORTS

Mr. Jacksha made a status report on contracts being worked on by staff.

ADJOURN

Its business completed, the Investment Committee adjourned the meeting at 3:45 p.m.

Accepted by:

H. Russell Goff, Chair