EDUCATIONAL RETIREMENT BOARD

INVESTMENT COMMITTEE

February 13, 2014

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NEXT MEETING: MARCH 13
MINUTES OF THE
NEW MEXICO EDUCATIONAL RETIREMENT BOARD
INVESTMENT COMMITTEE

February 13, 2014

1.  a. Call to Order – Quorum Present

A meeting of the New Mexico Educational Retirement Board Investment Committee was called to order on this date at 12:00 p.m. in the Educational Retirement Board Conference Room, 6201 Uptown Boulevard, N.E., Ste. 203, Albuquerque, New Mexico.

Members Present:
Mr. H. Russell Goff, Chair
Ms. Mary Lou Cameron
Mr. Larry Magid

Members Excused:
Dr. Thomas McGuckin

Staff Present:
Ms. Jan Goodwin, Executive Director
Mr. Rick Scroggins, Deputy Executive Director
Mr. Chris Bulman, General Counsel
Mr. Bob Jacksha, CIO
Mr. Mark Canavan, Real Estate Portfolio Manager
Ms. Kay Chippeaux, Portfolio Manager
Mr. Steve Neel, Deputy CIO
Mr. Alan Myers, Investment Financial Analyst
Mr. Jude Perez, Portfolio Manager

Others Present:
Mr. Dan LeBeau, NEPC
Ms. Judith Beatty, Recorder

b. Approval of Agenda

Ms. Cameron moved approval of the agenda, as presented. Mr. Magid seconded the motion, which passed unanimously by voice vote.
c. Approval of Minutes: January 23, 2014

Ms. Cameron moved approval of the January 23 minutes, as submitted. Mr. Goff seconded the motion, which passed unanimously by voice vote.

d. Introduction of Guests

Guests were introduced.

2. MARATHON EUROPEAN CREDIT FUND II – OPPORTUNISTIC CREDIT

Ms. Chippeaux and Mr. LeBeau addressed this item.

Mr. LeBeau stated that NEPC supports staff’s recommendation to investment $150 million in the Marathon European Credit Opportunity Fund II (“ECO II”).

Mr. LeBeau noted that the ERB committed $200 million to Marathon’s European Credit Opportunity Fund (“ECO I”), and to date all but $15 million has been called. For the two-year period ending December 31, 2013, ECO I returned 13.5 percent to the ERB, net of fees.

Mr. LeBeau noted that, while NEPC has not approved ECO II officially through the NEPC Due Diligence Committee, NEPC supports the additional investment because of the ERB’s existing relationship with the firm. Additionally, ERB is receiving favorable terms.

Mr. LeBeau noted that ECO II will have a somewhat different investment structure in that they can invest up to 50 percent of the fund in nonperforming commercial real estate debt, while in ECO I it was up to 25 percent. He stated that an investment in nonperforming commercial real estate debt may mean taking over management of the property at the back end in the event of default. NEPC had some questions about this because Marathon attempted this strategy in the early 2000s and ended up taking over several properties. NEPC is not able to get a clear reading of the new team’s track record because the individual members were previously with large organizations, including Bank of America. Mr. LeBeau added, however, that NEPC has a strong opinion of Marathon’s credit investment capabilities and has a significant amount of client exposure to ECO I. Also, NEPC feels that there are very strong opportunities to add value in European real estate debt.

Mr. Jacksha noted that ECO I included a pool of nonperforming German loans that has thus far worked out very well. In ECO I, Marathon cast a very wide net that allowed them to look at a host of opportunities. He said Marathon apparently sees more commercial opportunity on the real estate side for ECO II, but pointed out that they still have the flexibility to focus on other opportunities as they develop over the next few years.

Responding to Ms. Goodwin, Mr. LeBeau said the real estate background of the team members coming from Bank of America is European.

Responding to Chairman Goff, Mr. Jacksha clarified that that the due diligence has in fact been done; it just has not gone through NEPC’s process to be approved as an FPL (Focused Placement List) manager.
Mr. LeBeau said that was correct. He said the FPL list consists of approved managers for broad distribution across NEPC’s client base. He stressed that NEPC has done all of the required due diligence and NEPC is very comfortable with Marathon as a manager.

Mr. Jacksha said he and Ms. Chippeaux spent time talking with NEPC analysts about some of the other European focused funds. For various reasons, ERB decided it wanted to stay with Marathon. He said some of the other funds were not strictly European-focused. Ms. Chippeaux added that some of the funds have a narrow niche, and ERB wanted a broader focus. Furthermore, some funds are fairly new to Europe, and the fact that Marathon has a longtime presence there was a big plus for the ERB. Mr. Jacksha said this doesn’t preclude the ERB looking at some of those other funds in the future to complement Marathon, but at the current time he feels Marathon is the best fit for the ERB.

Ms. Chippeaux noted that the opportunistic credit portfolio’s exposure is about 60 percent in US assets across all of the funds. As the ERB is a better seller of its US assets, it is trying to rotate the portfolio to give it more European exposure. Managers who come to visit the ERB have said that the flood of investments they expected to see two years ago hasn’t happened, but they are now seeing a lot more activity from the banks and more willingness on their part to sell assets. There is also a greater amount of deleveraging as loans come due and the banks are unwilling to do refinancing – Marathon and other managers are seeing great opportunity here.

Ms. Chippeaux noted that Marathon completed the required paperwork and indicated that they had made no campaign contributions and did not use third party placement agents.

Marathon Partner and COO Andrew Rabinowitz and Managing Director Charles Byrne appeared before the committee and made a presentation.

Mr. Jacksha asked if Marathon anticipates a larger investment in commercial real estate in ECO II than in ECO I.

Mr. Rabinowitz responded that they would have the ability to invest in more assets being sold from the banks. He said the best opportunities to date and going forward will be from the asset deleveraging the banks will be forced to do in the next year to 18 months through AQR (the European bank Asset Quality Review process) and from regulatory requirements of Basel III and the Central Bank of Europe. Because of the timeframe that they have, they no longer have two, three or four years to sell assets – the window will be much tighter because the results of the AQR will be public, and a bank does not want to have a poor asset quality test.

Mr. Jacksha asked Mr. Rabinowitz to discuss the commercial real estate team.

Mr. Rabinowitz responded that, about two and a half years ago, they had 12-13 professionals in Europe and another 8-10 professionals in New York that were focused on Europe. As Marathon was building the portfolio and got more exposure to commercial real estate in Germany, they decided to supplement their team with three professionals from Germany who have had their entire careers in real estate and come from private equity backgrounds. He said they have a 30-person team that focuses on real estate related assets and most of the team is now fully integrated with the German team that was hired.
Mr. Jacksha asked if Marathon has been able to offer any of its LPs or investors co-investments in ECO I; if so, the ERB would be interested in discussing the opportunity. Mr. Rabinowitz responded that this topic is slated for discussion with their advisory committee.

[Marathon representatives left the room.]

Mr. Jacksha stated that the ERB likes the fact that it is on the ECO I advisory committee, since it offers a bit more visibility, but Marathon has been very forthcoming with the ERB and very transparent. He noted Mr. Rabinowitz’s remarks during the presentation that Marathon is not a macro investor, which means they really get into the details of each deal and company, and they do very good credit work. He said there are very good opportunities in Europe, and this is the manager in the ERB portfolio with the broadest reach in terms of strategy, but they are also more geographically focused than some of the others.

Ms. Chippeaux noted that Marathon has a longtime presence in Europe and has a lot of professionals and contacts there, which allows them to cherry-pick deals. Their ability to see relative value in the different strategies gives them an edge over their competitors.

Ms. Cameron moved that the Investment Committee approve a commitment of $150 million to Marathon European Credit Fund II, Opportunistic Credit. The commitment is subject to New Mexico state law, Educational Retirement Board policies and negotiation of final terms and conditions and completion of appropriate paperwork. Mr. Magid seconded the motion, which passed unanimously by voice vote.

3. **BLACKROCK/ERB TACTICAL OPPORTUNITIES FUND I – PRIVATE EQUITY**

[NEPC consultant Sean Gill was present on the telephone.]

Mr. Neel presented staff’s recommendation of a $100 million commitment to the BlackRock/ERB Tactical Opportunities Fund I (BR/ERB-TAC).

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-- BlackRock is the ERB’s co-investment partner and has posted top quartile returns, with nearly a 20 percent net IRR to date.

-- The primary objective of the Fund is to provide the ERB private equity program with flexibility to commit to primary funds in difficult-to-access general partners, geographies, sectors and strategies.

-- The Fund may opportunistically commit to secondary investments of existing limited partnership interests and to direct co-investments. Some of the strategies the Fund may incorporate include emerging markets, mezzanine/credit, energy, emerging managers and special situations.

Mr. Neel distributed a graph reflecting that 80 percent of the ERB portfolio’s exposure is in North America. The residual of the exposure in private equity is almost exclusively in Western Europe. Gaining meaningful exposure in China and emerging markets has been very difficult for the ERB.
Since 1998, BlackRock has committed approximately $1 billion into emerging markets and Asian markets. As of 2013, they have committed to 36 separate GPs, 54 separate commitments, and have had secondary investments and co-investments, so have a long tenure in emerging markets and in Asia specifically.

The Fund has been structured as a fund-of-one where ERB is the sole investor, along with a 1 percent commitment from the GP.

Similar to the ERB’s current co-investment program, all investments in the Fund will require staff approval. All primary commitments will be accounted for in the strategic plan. A primary commitment in an Asian fund will be reduced by that amount in the strategic plan that was discussed in January 2014.

This mandate is drafted to include co-investments, secondaries and credit opportunities, but will not be the main focus of the fund.

Unlike most fund-of-funds and primary funds, fees will only be on invested capital.

Mr. Gill said individual investment opportunities would be presented to ERB staff, which will have the ability to veto or accept them while continuing to maintain a portfolio that makes sense for the ERB. This particular structure will allow the ERB to gain access to opportunities that it otherwise would not have access to.

Mr. Neel pointed out that if the ERB gets a meaningful commitment to a top tier Asian fund, for instance, and it comes back with a subsequent fund, the ERB has the potential to go to them directly rather than through this vehicle.

BlackRock representatives Leo Chenette and Stephen Kelly appeared before the committee and made a presentation.

[BlackRock representatives left the room.]

Mr. Neel stated that the ERB has a $100 million commitment to BR/ERB Co-Investment Fund I, which is completely invested or reserved, and in 2013 the ERB committed an additional $100 million for a subsequent Fund II, which continues the existing mandate of Fund I. Approximately $5.6 million has been called in Fund II, and returns in Fund I have been very good at about 20 percent net.

Mr. Jacksha commented that the ERB also gets a lot of extra value talking to BlackRock because of their perspective on private equity markets and managers.

Responding to a request from Chairman Goff, Mr. Neel agreed to provide a brief update on the progress of the fund as part of the quarterly private equity program report.

Ms. Cameron moved that the Investment Committee approve a commitment of $100 million to BR/ERB Tactical Opportunities Fund I, L.P. The commitment is subject to New Mexico state law, Educational Retirement Board policies and negotiation of final terms and conditions and
completion of appropriate paperwork. Mr. Magid seconded the motion, which passed unanimously by voice vote.

[Break.]

4. BAIN CAPITAL FUND XI, L.P. – PRIVATE EQUITY

Mr. Neel presented staff’s recommendation of a $40 million investment in Bain Capital Fund XI, L.P.

-- Bain Capital specializes in a mix of investments across industries and stages. The mix includes buyouts, growth equity, distressed and operationally transformative investments. Bain specializes in investing in companies that are characterized by complexity from either a diligence or operational perspective.

-- Bain will target 20 equity investments in the range of $200 million to $500 million.

Mr. Perez discussed the due diligence process, which included a two-day workshop and interviews with 11 managers.

Ms. Goodwin noted that Bain’s last two funds had mediocre performance, and asked how this fund would be different.

Mr. Perez responded that Bain is a strong organization; and while they strayed from their usual discipline in the last two funds, he feels this is a “comeback fund” and will show better performance. In addition, their last few funds charged very high, above market fees. The high fees depressed net returns to investors. The current fund has lower fees that are in line with the market.

Mr. Neel stated that Bain deployed $11 billion of capital in Funds IX and X between 2006 and 2008 in growth strategies, which could not have been at a worse time. Even in light of that very bad market environment, the outcome of Fund IX will be very respectable.

Mr. Neel summarized his report, which stated that Bain Capital was founded in 1984 with a distinct approach to private equity investing, and its approach involved identifying investment opportunities and working hands-on with management teams to grow and manage their business. As strategic and operational consultants, Bain believed their skills could have an impact when coupled with an ownership role in the companies they invested in. In this context, Bain could work side-by-side with management teams over a multiyear period to drive long-term value creation. Bain’s approach is as an operational manager, which involves a combination of fundamental business analysis, strong management and hands-on engagement that improves the profits and value of a business.

Mr. Neel stated that staff adjusted Bain Capital’s performance for their new economic structure, giving Fund IX a first quartile ranking. He said Fund X is an immature portfolio, with the average age of companies at 2.5 years and the average holding period at 4-5 years.

Mr. Neel also noted that 10 percent of Fund XI will consist of money committed by the GP.
Bain Capital representatives Phil Loughlin and Steve Radakovich appeared before the committee and made a presentation.

[Bain Capital representatives left the room.]

Mr. Jacksha commented that, in buyouts, staff wants to see more of an operational bias than what is called "financial engineering." Staff feels it is much easier to more consistently make money by buying a company, improving operations and fixing what needs to be fixed, which is what Bain Capital does, rather than just adding financial leverage to a company and hoping for a good outcome. He said Bain has a big and experienced team and he likes to see a significant investment by a GP group, and in this case there is certainly an alignment of interest. He said the fee structure has been adjusted to market rates.

Ms. Cameron moved that the Investment Committee approve a commitment of $40 million plus any notional interest to Bain Capital Fund XI, L.P. The commitment shall not exceed 20 percent of the committed capital of the fund and is subject to New Mexico state law, Educational Retirement Board policies, Educational Retirement Board approval for placement agents, and negotiation of final terms and conditions and completion of appropriate paperwork. Mr. Magid seconded the motion, which passed unanimously by voice vote.

5. STATE STREET COMMISSION RECAPTURE CONTRACT

Mr. Jacksha stated that commission recapture is somewhat antiquated and no longer applies to the ERB. In 2007, the ERB entered into an agreement with State Street Global Markets to participate in a commission recapture program, which calls for SSGM to rebate to the ERB 90 percent of the equity commissions received in excess of the participating brokers’ execution-only rates. Because of technological innovations and more competitive execution rates, the current rebate averages less than $600 per month with only one investment manager participating in the program.

Mr. Jacksha stated that this program is no longer cost effective for the ERB, and recommended that the agreement for this program with State Street Global Markets be terminated.

Mr. Magid moved that the Investment Committee approve the termination of the current agreement with State Street Global Markets for the commission recapture program. Ms. Cameron seconded the motion, which passed unanimously by voice vote.

6. LEGAL SERVICES RFP

Mr. Bulman stated that the ERB currently contracts with Foster Pepper PLLC and K&L Gates LLP to provide investment-related services. He said these contracts expire on June 30, 2014, and are subject to the Board’s Investment Services Procurement Policy. In addition, the Investment Committee must determine which procurement method should be used to continue to obtain these services. He noted that the preferred method is to issue an RFP.
Because there are a significant number of highly qualified providers of investment-related legal services, Mr. Bulman recommended that the Investment Committee direct staff to issue an RFP.

Ms. Cameron moved that staff be directed to issue an RFP to procure investment-related legal services. Mr. Magid seconded the motion, which passed unanimously by voice vote.

7. OTHER INVESTMENT REPORTS AND DISCUSSIONS

Mr. Canavan presented status report on agricultural and other real assets in the portfolio.

Mr. Jacksha noted that NEPC presents quarterly reports on the whole portfolio to the Board, and also does it on individual allocations in the private markets. Given the long-term life of these programs, he suggested scaling the discussion reports back to twice a year at the committee level while continuing to issue the written reports on a regular basis as before.

Committee members agreed with this suggestion.

8. NEXT MEETING: THURSDAY, MARCH 13, 2014

The meeting was tentatively scheduled for 12:00 p.m.

ADJOURN

Its business completed, the Investment Committee adjourned the meeting at 3:00 p.m.

Accepted by:

H. Russell Goff, Chairman