ACTION SUMMARY

STATE INVESTMENT COUNCIL

January 24, 2012

MINUTES OF THE

NEW MEXICO STATE INVESTMENT COUNCIL

Santa Fe, New Mexico

January 24, 2012

1. OPENING MATTERS

a. Introduction of Guests and Roll Call: Quorum Present

A regular meeting of the New Mexico State Investment Council was called to order on this date at 9:00 a.m. in the Governor's Cabinet Room, State Capitol, Santa Fe, New Mexico.

Members Present:
Mr. Douglas M. Brown, Public Member, Vice Chair
The Honorable James B. Lewis, State Treasurer
The Honorable Ray Powell, Commissioner of Public Lands [arriving 10:15 a.m.]
Dr. Thomas Clifford, Secretary Designate, DFA
Mr. Peter Frank, Public Member
Mr. Harold Lavender, Public Member
Mr. Michael Martin, Public Member
Mr. Leonard Lee Rawson, Public Member
Mr. Scott Smart, Public Member

Members Excused:
None.

Assistant Attorney General Present:
Ms. Tania Maestas

Staff Present:
Mr. Steven K. Moise, State Investment Officer
Mr. Robert "Vince" Smith, Deputy State Investment Officer
Mr. Greg Kulka, Director of Private Equity
Mr. Evan Land, General Counsel
Mr. Charles Wollmann, Director of Communications
Ms. Kerri Segell, Executive Assistant

Guests Present:
[See Guest List]

b. Approval of Agenda

Vice Chair Brown stated that a break would be called at approximately 10:30 a.m.

Treasurer Lewis moved approval of the Agenda, as amended. Dr. Clifford seconded the motion, which passed unanimously by voice vote.

d. Approval of Minutes: December 27, 2011

Dr. Clifford stated that the discussion about difficulties with this year's audit was not reflected under the Audit Committee Report (pp. 13-14), and asked that the minutes be amended to reflect his comments.

Vice Chair Brown said Dr. Clifford could make those comments now or later under the Audit Committee Report, and Dr. Clifford said he would make the comments now.

Dr. Clifford said there were several deficiencies in the audit process this year for the SIC; he learned about this through a review with his Controller. Dr. Clifford indicates:

-- The audit was late, and as a consequence it contributed to the state's CAFR being late.

-- The audit was probably very expensive to produce because private contractors had to be brought in to perform functions that staff should have been performing throughout the year.

-- During the process, it was discovered that staff's audit preparation was totally inadequate. The CFO had not been performing necessary duties to prepare for the audit, and that information had not previously been reported to the Audit Committee or SIC.

-- It is still not clear why the external auditor was not able to identify these weaknesses throughout the year. It should have been their function to do that, and it is also not clear why that information wasn't given to the Audit Committee.

-- The SIC needs a complete revision of its approach to processes and procedures and personnel to address these deficiencies going forward. These responsibilities fall on the Audit Committee, the CFO, State Investment Officer, and the Council as a whole.

Vice Chair Brown recommended that the December 27 minutes be approved contingent upon insertion of Dr. Clifford's concerns under Audit Committee Report (pp. 13-14). Dr. Clifford indicated that he would provide a memorandum to SIC staff detailing his concerns.

Mr. Frank stated that Dr. Clifford's comments were fair and appropriate. He said the Audit Committee recognizes those issues and is dealing with them as best it can. He stated that one concern is that the state process calls for the audit to be done completely after the fact, which is not consistent with good corporate practice – auditors should be employed and working throughout the year. He said the Audit Committee has met with the State Auditor to discuss ways of rectifying this issue.

Mr. Lavender moved approval of the December 27 Minutes, contingent on the forthcoming memo from Dr. Clifford. Mr. Rawson seconded the motion, which passed unanimously by voice vote.

3. <u>STATE INVESTMENT OFFICER'S REPORT</u> (Steve Moise)

<u>Investment Matters</u>

-- NAV as of last night was $14.781 billion.

-- Vince Smith will give an investment staff hiring update later in this meeting. Three positions have been approved and are being sourced.

-- Mr. Smith and the investment team are working with the Investment Committee and RV Kuhns on a redraft of the investment policy.

-- The monthly investment report format is being restructured and streamlined.

-- The RFP process for various investment managers is moving along smoothly.

<u>Council-related matters</u>

-- Hewitt EnnisKnupp is conducting interviews to assist the SIC with strategic planning, and lead Nancy Williams is putting together recommendations.

-- February SIC and committee meetings:

a. Investment – Wednesday 2/8 at 10:00 a.m., SIC offices
b. PEIAC – Monday 2/27 at 2:00 p.m., SIC offices
c. SIC – Tuesday 2/28 at 9:00 a.m., Cabinet Room
d. Audit – Tuesday 2/28 at 7:30 a.m., Governor's conference room
e. Governance – Friday 2/17 at 10:30 a.m., SIC offices

<u>Office administration</u>

-- Mr. Moise will address the interim CFO report in depth later in the agenda.

External relations

-- Mr. Wollmann will present an update on legislative matters affecting the SIC. Mr. Wollmann and Mr. Land have done a fine job of drafting and submitting financial impact reports in response to the bills the SIC has asked to weigh in on.

-- The SIC's attempt to change the 15 percent restriction on international investments has been referred to three Senate committees. Mr. Moise will meet later today with Sen. Cisneros, the bill sponsor, and perhaps others to see if there is a way to move this forward.

-- SIC staff met with the House Appropriation & Finance Committee on January 11 to discuss inflows to the STPF from the severance taxes collected each year. The Committee asked that SIC staff work with State Board of Finance staff to discuss changes to the severance tax inflows into the fund and to decide whether any recommendations are appropriate.

-- Mr. Moise and Mr. Smith met with the State Board of Finance last week, where Mr. Smith made a presentation regarding inflows and changes which might affect the Permanent Fund.

3. INVESTMENT MATTERS: DISCUSSION OR VOTE

a. Investment performance report/activity summary (Vince Smith & RV Kuhns)

Mr. Smith stated that RV Kuhns' report for the month ended November 30, 2011, was reviewed at the last meeting. He said the December figures are not yet available, but that December was essentially an extension of November, with weaker performance in the equity markets and weak performance among the active managers. He said that trend has turned around in January, with ClearBridge and Thornburg both exceeding their benchmarks by more than 300 basis points, month to date.

Mr. Smith reviewed his monthly investment summary, which focused on the question of investment risk in the current market environment and the ability to achieve the necessary returns going forward.

Mr. Smith reviewed a series of risk and return charts prepared by RVK for the 1, 3, 5 and 10 year periods ending in November 2011. He noted that, for the 5- and 10-year periods, the degree of riskiness in the assets purchased did not really affect the rate of return. He referred to a 10-year risk and return chart for the same period based on the assumptions made in the asset allocation study, with a composite total return projected at 7.5%.

Concluding his report, Mr. Smith said the SIC should continue to take investment risk, but in different assets than those that have historically been in the portfolio, including real return assets. He said the SIC is well on its way to making that move.

Mr. Smith stated that, if the SIC can move from its current average risk premium of 1.79% for the 10-year period to about 2.5% to 3%, and can get interest rates up to 4.5% for the 10-year period, it can achieve a 7.5% return. He said there is roughly a 95% chance that rates will hit 4% at some point in the next 10 years.

b. Investment Committee report (Tom Clifford & Smith)

Mr. Smith reported on IC activities:

-- Recommended approval of an investment in PIMCO DiSCO II.

-- Discussed investment policy, best practices, and manager evaluation principles.

-- Discussed liquidation portion of absolute return portfolio.

c. Fixed Income: PIMCO DiSCO II (RV Kuhns, Smith)

Mr. Smith stated that SIO staff, RV Kuhns, and the Council Investment Committee are recommending a $100 million investment in the Pacific Investment Management Co. (PIMCO) Distressed Senior Credit Opportunities Fund II (DiSCO II).

PIMCO senior vice president Michael Chandra and Carrie Peterson, vice president of mortgage products, appeared before the Council and made a presentation.

Mr. Chandra said PIMCO is encouraging its clients to look for ways to capitalize on some of the dislocations in the financial markets and to earn a somewhat higher return, but in a risk-controlled manner that doesn't have a high degree of correlation with equity risk.

Ms. Peterson stated that DiSCO II was launched in October 2011, but the DiSCO strategy has a much longer history. The original DiSCO fund was launched in the spring of 2008 to capitalize on massive deleveraging of the global financial system and give investors the opportunity to be attractively compensated for providing liquidity as the deleveraging took place and bearing mark-to-market volatility. She said the original fund has been largely liquidated, concluding in December 2011, producing a 1.4x multiple and a since-inception net IRR of 11%, outperforming the targeted return of LIBOR + 6%-9% (net of fees).

Responding to Dr. Clifford, Ms. Peterson said these investments are in securities backed by consumer assets, with predominant exposure in private label (non agency) residential mortgage-backed securities; but there is also exposure to private student loans, auto loans, credit cards, and commercial real estate loans. She said the non-agency mortgage exposure is about 70%.

Mr. Chandra added that these securities are primarily at the top of the capital structure, so there is minimal credit risk.

Dr. Clifford asked what the regional distribution of the assets is, and Ms. Peterson responded that she does not have a specific breakdown, but she would assume that the largest exposures would be in California, Florida and areas of the market that people have heard discussion about. When PIMCO purchases these securities, however, they do a very in-depth analysis and include expectations of policy changes and future price depreciation -- in their base case analysis, they assume another 10% decline over the next two years in the housing market, and an additional 20% decline in the market as part of their downside scenario.

Mr. Smith clarified that these securities are pools of mortgages and PIMCO tends to purchase the top two tranches, which are relatively secure.

Responding to Mr. Frank about mortgage renegotiation risk in the portfolio, Ms. Peterson said PIMCO definitely looks at policy risk. She said there have been a lot of announcements in the market over the last couple of years, and they incorporate that in their analysis and build into their assumptions that there will be future defaults, prepayments and write-downs of principal.

Mr. Frank noted that DiSCO II is buying a tranche of mortgages, most of which has been owned for a period of time by DiSCO I. He asked if PIMCO has a measure of actual results on that portfolio against projections for the few years they have owned it.

Ms. Peterson responded that the underlying cash flows have performed at or better than their base case expectations.

Mr. Smith asked Mr. Chandra to explain to the Council why DiSCO II is buying assets from DiSCO I.

Mr. Chandra responded that the original DiSCO fund had a three-year life, so has run out of time. He said the portfolio right now has a carry, or yield, of 12%, so as long as these securities continue to pay down over time, they believe they can earn 10-12% net-of-fee returns.

Dr. Clifford questioned why PIMCO expects such good returns going forward given that when the first fund was initiated in 2008, these were deeply discounted assets and hence the excellent performance. Additionally, the SIC would be purchasing some of the same assets that have essentially over-performed for the past three years and it would seem questionable that this trend would continue.

Ms. Peterson responded that the first fund was an actively managed portfolio, so as securities tightened in, they would sell out of them and reinvest into new securities. Additionally, as there has been increased market stress, the spreads in these securities remain at and often above the levels when PIMCO launched the first fund. She said they have tended to sell out of those areas of the market where there has been rapid spread tightening and then reinvest into other areas. When the first fund was winding down, they bought more investments within the European ABS market, but as they made the transition to DiSCO II, they felt those securities weren't the best investment and sold most of them off.

Responding to Dr. Clifford and Mr. Frank, Ms. Peterson said PIMCO feels the market opportunity is about $3 billion, and the fund size is currently at $1.7 billion and should reach $2 billion to $2.5 billion. She said 95% of the assets purchased from DiSCO I were $1.5 billion to $1.6 billion, and they have dry powder. She said European bank sales over the next year will serve as a source of new investment opportunities.

Mr. Smith asked what the re-up rate is from Fund I to Fund II, and Ms. Peterson said 52% of investors moved from DiSCO I to DiSCO II. She said there were a variety of reasons why the rest didn't make the move, but often it was they had already reallocated in anticipation of the unwinding of this strategy into other PIMCO vehicles. She said PIMCO launched a more distressed mortgage-related fund last year, and several of the large investors moved into that vehicle. Also, when PIMCO started speaking to investors last summer, it coincided with a rapid increase in volatility in the market, and some decided to de-risk their portfolios.

Mr. Chandra noted that the ERB invested $300 million in DiSCO I and recently committed $200 million to the second fund.

Vice Chair Brown asked how PIMCO is addressing the risk of collectability due to structural or documentation problems in mortgages that were hastily drawn up with insufficient and often faulty paperwork.

Mr. Chandra responded that their due diligence process includes looking at servicers, as some in the industry do a better job than others in collecting on principal and interest payments. Also, PIMCO has participated on behalf of its investors on lawsuits where they felt the trustee wasn't doing their fiduciary duty.

Ms. Peterson said PIMCO plans to close Fund II in March 2012.

Mr. Smart commented that it was believed for a period of time that the upper level tranches were risk free, but those ultimately ceased to be risk free as a result of problems created in the mortgage industry. He asked why this investment vehicle has escaped that.

Mr. Chandra responded that PIMCO isn't investing in the subprime end of the market, and it is also purchasing these securities at 60-70 cents on the dollar, so even if they take a 5-cent haircut from the original $100 par value, they can still realize a significant appreciation assuming the delinquencies don't exceed the purchase price.

Mr. Frank moved that, based on the recommendation of the Council Investment Committee and advisor RV Kuhns, the State Investment Council approve a $100 million commitment to the Pacific Investment Management Co. (PIMCO) Distressed Senior Credit Opportunities (DiSCO) Fund II, subject to the final partnership agreement being

consistent with New Mexico State law and State Investment Council policies and successful negotiation of final terms and conditions by staff.

Mr. Lavender seconded the motion.

Mr. Rawson expressed concern that investing in this fund could put the SIC in an awkward position because the fund is domiciled in Cayman, and there is a negative view right now at the national level of corporations and wealthy individuals housing their money in offshore banks.

Ms. Peterson responded that the fund has two ways of investing, one through PIMCO's master feeder fund, which is a Delaware structure, and the second is through a Cayman feeder.

Mr. Chandra said the documents sent to the SIC were for the onshore master feeder, which is the Delaware fund.

The motion passed by majority voice vote, with Mr. Smart voting against.

Mr. Smart said he was not sure there has been a full correction in the mortgage markets.

[Commissioner Powell joined the proceedings.]

d. <u>Real estate: 3rd quarter 2011 performance report</u> (Townsend)

Townsend Group advisors Jack Koch and Cara Wood made a presentation.

<u>Real estate market overview</u>

-- The low return environment in the fixed income markets has provided strong demand for core, income-producing real estate as a yield alternative.

-- The current yield spread for stabilized assets is approximately 500 basis points over the 10 year Treasury (vs. long-term average of 330 basis points).

-- Investor demand remains very strong for high quality assets in both debt and equity markets, but has not rebound in the non-strategic markets and properties, providing an opportunity for a return premium for investors willing to accept increased cash flow volatility.

-- Loss of construction jobs over the last 3 years may be viewed as a positive for the real estate investor because supply of new properties has fallen precipitously from previous levels.

<u>Portfolio highlights</u>

-- SIC currently targets a 5.0% allocation to real estate. SIC's current market value represents 4.5% of total plan assets.

-- The portfolio's quarter-over-quarter gross performance continues to show signs of value recovery underway in real estate, although pace appears to be decelerating.

-- Material portfolio underperformance versus the NFI-ODCE benchmark over the trailing 5-year period can be attributed to underexposure to high quality core investments; overexposure to higher risk, non-core investments; and investment concentration in poor performing vintage years.

-- SIC received $40.7 million in distributions from the existing funds during Q3 and $64.3 million over the one-year period.

-- Townsend and staff continue to evaluate new core (strategic) and non-core (tactical) investment opportunities in the market with a priority on building out the strategic portfolio by year-end 2012.

-- Subsequent to quarter end, SIC committed $150 million to UBS Trumbull Property Fund and $75 million to Jamestown Premier Property Fund.

Mr. Smith commented that the change in this portfolio over the last six months has been significant. He said that, when Townsend came on board, the portfolio was 3.1% of assets and 100% value-add in non-core investments that had performed terribly – and now the portfolio has several good core funds, is almost at 5%, and is headed toward the 10% target allocation.

Mr. Smith said the Japan fund, which will be brought to the Council Investment Committee in a couple of weeks, will take a bite out of the 15% allocation limit in international.

Mr. Frank asked how the 15% is calculated, and General Counsel Evan Land responded that looking strictly at where a fund is domiciled does not give the whole picture, so staff looks at dollar-denominated issues to comply with the spirit of the statute.

Mr. Moise said it would appear that the Legislature is not yet prepared to pass a bill raising the 15% limitation.

Mr. Rawson read the Constitutionallanguage as follows: "Not more than 15% of the book value of the fund may be invested in international securities at any one time."

Council members commented that securities are generally defined as stocks and bonds, and technically many international funds are not in that category.

Mr. Land said the SIC has taken a cautious approach thus far, looking at the spirit of the law, since the Legislature may not have understood the securitization component at the time it was passed. Assuming they did, however, he said there is a good faith argument that certain assets do not fall under that.

Council members agreed to schedule further discussion on this topic and then decide whether or not to seek a formal opinion from the Attorney General.

[Break.]

e. <u>Prudent investor standard</u> (Smith)

Mr. Smith summarized his memorandum, written in response to a question from a PEIAC member, on the meaning of the Prudent Investor Rule. He stressed that this was not a legal opinion, but a practitioner's view.

-- The Uniform Prudent Investor Act (UPIA), on which New Mexico's Prudent Investor Rule is based, is the standard among fiduciaries for funds that the SIC is responsible for. Forty-four states adopted this in 2004 when it was finalized; other states adopted portions of it, with the most common giving fiduciaries the ability to delegate investment decisions to staffs and consultants.

-- If the SIC delegates investment decisions to professional staff or consultants, along with it goes a higher standard of prudence when those decisions are made.

-- The predecessor to the UPIA is the Prudent Man Rule, which has its basis in common law from the 1800s. The main point of the changes the UPIA made to the Prudent Man Rule was to allow councils and boards to use modern portfolio theory to guide investment decisions and to identify that a "risk versus return" analysis is a central consideration of fiduciaries.

-- The UPIA highlights the importance of investment committees and boards or councils in spending their time and energy on policy, guidelines, ranges, benchmarks, limitations, expectations, and in developing and employing effective monitoring and oversight practices. These are of increased importance over the Prudent Man Rule, where avoiding "risky" investments is the primary concern, and where investment and management functions may not be delegated.

Dr. Clifford said the SIC can say it has had a bad experience with a certain asset or fund or manager, but views this as a manageable level of risk in the overall context of the entire portfolio. He said he can understand the need to move away from focusing on individual assets, but a lot of information is lost and the specificity that is needed to make decisions is lost, and so an aggregation problem can result and there can be a long-term impact from making a bad decision.

Vice Chair Brown responded that it is up to the Council to continue to keep its eye on individual portfolio decisions, and he thought this Council was accustomed to being very accountable in its approach.

Dr. Clifford commented that the SIC's track record is not that good in many ways, though, and all of that has been under the Uniform Prudent Investor Act. He said he wasn't speaking to this Council necessarily.

Mr. Frank agreed that the track record over the last 15 years has been quite poor, but there has been a radical change in the last two years with new management and a new structure. He stressed that this was a very different SIC.

Dr. Clifford said his point was that, as the SIC moves its focus from individual investments to the portfolio as a whole, it increases the obligation both of the staff and of the Council to make information available to really understand the portfolio. He said he was not sure the SIC always had that information and he personally wasn't comfortable with it.

Vice Chair Brown said he did not think the Council saw the adoption of the Uniform Prudent Investor Act as a license for complacency in its duties.

Mr. Lavender stated that he has been a member of the SIC for five months and feels he has been adequately educated about investments under consideration; if one reads the material that is provided and asks questions, it is sufficient to evaluate individual investments within the overall framework. He added that he thought it important that staff continue to enlighten the Council on how a particular investment fits into the portfolio so it can understand what degree of risk, if any, can be taken.

Ms. Beard said RVK is working on the investment policy rewrite and the Uniform Prudent Investor Act standards will appear in all areas of the policy going forward, making it very clear what the Council needs to do as fiduciary.

Responding to Treasurer Lewis, Mr. Smith said the Council can delegate certain tasks to committees and subcommittees and require recommendations from them.

f. <u>Non-US equity structure</u> (Smith & RV Kuhns)

RV Kuhns consultants Marcia Beard and John McLaughlin made this presentation.

-- Currently the SIC has a 50/50 split between developed and emerging markets within non-US equity.

-- Because of the 15% statutory imitation, the SIC portfolio looks very different from what would be typically seen with another large institutional investor or public fund. The main distinction is that, relative to a broad international equity benchmark, the SIC has a much higher allocation to emerging market equities.

-- Absent this restriction, the ideal portfolio would have the following ideals (which are very similar to the large cap portfolio):

- Offer reliable "beta" exposure to the non-US equity asset class.
- Be diversified by market capitalization and offer representation (as the market does) to large, medium and small companies, and developed & emerging countries.
- Be relatively style-neutral.
- Pursue active management where it will be rewarded.
- Provide downside protection in event market declines.
- Have a manager lineup that offers uncorrelated excess returns.
- Have competitive fees.

Considerations if restriction remains unchanged

-- If Constitutional restriction remains, RVK believes the Fund's overweight to emerging markets has investment merit.

-- In determining how large an overweight would be optimal, RVK created a regression model that evaluated which baskets of US, non-developed US and emerging market equities best tracked global equity returns.

-- The following observations emerged:

- The optimal allocation to emerging markets has increased on average over time.
- Optimal weight to emerging as percentage of non-US equity has shown a large range over time.
- As such, optimal range should be a qualitative decision based more on current market conditions, the current investment opportunity set and access to competent managers.

Ms. Beard said RV Kuhns believes the SIC should delegate this qualitative decision to staff and then monitor it.

Vice Chair Brown observed that the pie charts reflecting global equity benchmark comparisons did not include the new submerging markets category (Greece, Ireland and Portugal), which are in the so-called developed markets and thus thought to be less risky, more mature and more predictable. In the existing marketplace, however, they are not, as recent events have essentially eliminated the emerging versus developed dichotomy.

Mr. McLaughlin said Greece and Portugal remain in the developed category in the small cap space, and Vice Chair Brown's point is valid from the perspective of a sovereign issuer that is issuing debt. When one looks at equities within those countries, however, in terms of implementation decisions, an international equity manager will look at the revenue from those countries to determine whether the demand is local or outside of their local markets.

Mr. Smith added that countries like Greece, Ireland and Portugal make up about 10% of the developed index.

Mr. Martin commented that the SIC's historical allocation to international equities isn't truly known – the SIC has private equity funds, hedge funds, etc. that are investing outside of the US, and many domestic companies have a large percentage of their sales overseas. He said it will be exceedingly difficult to separate out those cash flows in order to do the calculations.

Mr. Smith added that, when the SIC invests in these emerging market companies, they tend to get a much higher share of the revenues and profits from the local markets.

Mr. McLaughlin reviewed RV Kuhns' recommendations:

Assuming constitutional limit remains unchanged, RVK recommends:

1. Delegate non-US emerging vs. developed allocation decisions to staff.

2. Evaluate optimal share of active vs. passive strategies.

3. Have current non-US managers compete in searches.

4. Evaluate currency hedging policies (i.e., should portfolio be fully hedged, fully unhedged, or partially hedged).

Assuming constitutional limit is amended, RVK recommends:

1. Institute the MSCI ACW IMI as the non-US equity portfolio's policy benchmark and structure the portfolio accordingly: evaluate developed/ emerging market split and establish explicit ranges for each; promote style neutrality.

2. Evaluate optimal share of active vs. passive strategies.

3. Have current non-US managers compete in searches.

4. Evaluate currency hedging policies (i.e., should portfolio be fully hedged, fully unhedged, or partially hedged).

g. Follow up investment items: Absolute return; RFP update (Smith)

These reports were in the packet.

There was no discussion.

4. <u>INVESTMENT MATTERS, PRIVATE EQUITY: DISCUSSION OR VOTE</u>

a. <u>PEIAC Report</u> (Mike Martin)

Mr. Martin reviewed Committee discussion and action taken at yesterday's meeting:

-- Briefly discussed the draft New Mexico National Private Equity policies.

-- By the end of March, JP Morgan's numbers will be reconciled with Invient.

-- Recommended approval of a $75 million commitment to Ares Corporate Opportunities Fund IV.

-- Reviewed the National Private Equity Program Q3 performance report.

-- Reviewed the New Mexico Private Equity Program Q3 performance report.

-- Discussed the need to have the same benchmarks for venture capital in the national and New Mexico programs.

-- Spent about 90 minutes in an educational seminar on ILPA principles.

b. <u>2012 National Private Equity Investment Plan</u> (LP Capital)

LPCA advisors Allen Waldrop and Richard Pugmire presented this report.

-- Focus in 2012 will be to continue executing on the strategic objectives of enhancing returns by focusing on high quality core relationships; making concentrated commitments to fewer managers ($350 million to $450 million commitments per year in near term, six to eight managers per year); and improving diversification by strategy and geography.

-- About 80% of the portfolio is US-focused at the current time. There are some interesting European and Asian opportunities and these will be brought forward based on staff's guidance.

-- LPCA will continue to evaluate the options for non-core funds, including whether SIC decides to proceed with the secondary sale of the legacy assets, manage them differently, or hold them and let them run off.

c. <u>Ares Corporate Opportunities Fund IV, L.P.</u>

Mr. Waldrop introduced David Kaplan, co-head of the private equity group and a member of the executive committee of Ares Management, who made a presentation, with the following highlights:

-- ACOF IV will be the fourth private equity fund of Ares Management, with a target fund size of $4 billion, largely in line with ACOF III at $3.5 billion. The GP is putting up $200 million of its own capital into the fund.

-- This will be Mr. Kaplan's eighth private equity fund; four were at Apollo, and this will be the fourth at Ares. ACOF IV is a continuation of Ares' "flexible capital" approach to private equity, with about 50% distressed for control.

-- Ares targets high quality, under-capitalized middle market companies that have not fully exploited their growth opportunities.

-- Ares has the ability to pursue a range of transaction types in both majority and shared control situations. Where other traditional private equity funds may be restricted by charter or capabilities, Ares pursues a range of investments and is able to stay active and disciplined in all market environments.

-- The Ares Management platform is a highly functional network of 200+ investment professionals covering investments in 1,100+ companies across 30+ industries.

-- The Ares Private Equity Group has been recognized as most consistent U.S. buyout manager by Prequin (August 2011). ACOF III ranks #3 out of 319 funds tracked by Prequin for the 2006-2008 vintages and ranks #1 out of 40 funds published by CalPERS for the 2008 vintage.

-- Ares manages three distinct but complementary investment groups in public debt, private debt and public equity. They believe the scale and synergies created by their $47 billion platform provide their 480 employees, with offices around the globe, with differentiated sourcing and informational opportunities.

-- ACOF III, in which the SIC has a $50 million investment, is showing a 39% gross IRR through 12-31-11 and a 28% net IRR. There are no issues with any companies in the fund to date. Ares has another $600-$700 million to invest in this fund before starting up Fund IV.

Mr. Martin stated that General Counsel Evan Land had a disclosure issue to discuss.

Mr. Land said he supports the recommendation of PEIAC and LPCA and that Ares is the kind of firm the SIC should be looking at for potential investment opportunity. He also stated that no principal or member of Ares has ever been fined or penalized, but their name has arisen in New York and also in New Mexico in connection with litigation.

Mr. Land stated that, in 2003, the New York Common Retirement Fund invested with Ares and placement agent fees were paid to Wetherly Capital, a "bad actor" in New Mexico, and New Mexico is involved in litigation against individuals connected with Wetherly. He said the New York Attorney General issued an opinion stating that Ares had no knowledge of that, and the fact that Wetherly paid about $250,000 to Hank Morris was not an Ares wrongdoing, but the

NY Attorney General forced Ares, and Ares agreed, to be part of their pension fund code of conduct going forward. He noted that New York has since re-upped with Ares and is a strong proponent of Ares.

Mr. Land stated that, with respect to New Mexico, Aldus Equity recommended the SIC's investment in Ares Credit Opportunity Fund III, and it is not fair to tar Ares with the same brush just because Aldus recommended them – other funds Aldus recommended have performed well. He said he is not commenting on existing lawsuits from third parties that have different damage allegations, claims and assertions, so this is not an opinion as to any other lawsuits, and the SIC does not have a lawsuit pending. In New Mexico, however, Wetherly was paid a placement agent fee in 2006, but it was associated with Darius and Kirk Anderson and had nothing to do with Ares.

Mr. Land said the SIC has looked into this and is not aware of any payments by the Andersons to any politically connected individual or firm, but given the backdrop of some cloudy allegations that exist with respect to prior practices, the SIC has taken a very hard look at Ares. He said it is very important to staff, the PEIAC and LPCA to vet these groups that come before the Council consistent with prudent investor requirements.

At. Dr. Clifford's request, Mr. Kaplan reviewed a buyout transaction by Ares involving General Nutrition Centers.

Dr. Clifford suggested that perhaps the SIC should start asking funds to provide statistical information on employment impact.

Vice Chair Brown said a more appropriate question is whether a fund is a company builder as opposed to a company exploiter. He suggested that this be part of the discussion going forward in considering new investments.

Mr. Martin moved that, based on the recommendation of the Private Equity Investment Advisory Committee and LP Capital Advisors, the SIC approve a $75 million commitment from the National Private Equity Program to Ares Corporate Opportunities Fund IV, L.P. (the "Fund"), not to exceed 20% of the total capital commitments of the Fund and subject to and contingent upon New Mexico state law, New Mexico State Investment Council policies, and negotiation of final terms and conditions and completion of appropriate paperwork.

Mr. Frank seconded the motion, which passed by majority voice vote, with Dr. Clifford abstaining.

d. <u>National Private Equity Program 3rd quarter performance</u> (LPCA)

-- Q3 was a difficult quarter for private equity. The S&P 500 was down about 13%.

-- Overall, the private equity portfolio since inception has generated 1.3x contributed capital to the program for a 11.2% net IRR.

-- LPCA benchmarked the funds by category in each vintage year to their respective benchmarks in each vintage year from Thomson Venture Economics to show relative performance of NM SIC's portfolio versus broader market. Private equity performance has performed above median in most of the vintage years for the last 10 years.

-- In both quarters, distributions exceeded contributions. In 2011, $38 million more was received than sent out to the private equity funds. The only other time this has happened in the last 10 years was in 2005.

-- Approximately 47% of the private equity portfolio's exposure (net asset value plus unfunded commitments) is in funds with vintage years between 2005 and 2007. The lack of new commitments in 2009 and 2010 is why distributions outpaced contributions in 2011. As the program has gotten restarted and the SIC is committing to new funds, those contributions will start to come back.

-- Generally the portfolio is within strategy targets.

-- Geography diversification is below target in Asia and Emerging Markets (target of 10% to 20%) and above target in North America (target of 60% to 70%).

e. NM Private Equity Program 3rd quarter performance report (Sun Mountain Capital)

Sun Mountain Capital advisor Brian Birk presented an update on the New Mexico Private Equity Investment Program (NMPEIP).

-- The NMPEIP was established in 1993 to make investments into private equity funds which in turn invest into NM-based companies. For many years the program was managed as a differential rate (below market rate) program and returns were substantially below the NM national private equity program returns. Sun Mountain, after taking over in 2004, began managing the program with financial returns as the primary focus.

-- No third party marketers or placement agents have ever been used with Sun Mountain as advisor, and no placement fees have been paid.

-- Program financial performance is improving steadily. Since 2009, Program IRR since inception has improved from –12.3% to –5.4%. Since 2004, NMPEIP investments have outperformed the national program's venture investments.

Mr. Birk distributed a list of partnership commitments since inception using the Thomson Venture Capital Median benchmark, consistent with that used by LPCA. Based on that metric, performance from 1993 to 2003 shows that returns are third and fourth quartile with the exception of one year. Since 2004, two of the four years were in the second quartile and two were in the third quartile.

-- Program impact on NM is substantial: 28 funds have received commitments and invested in 63 New Mexico-based companies. Capital multiplier of 6.6x has resulted in $1.7+ billion of capital invested into NM companies.

-- Currently the average employee of a New Mexico-based portfolio company of funds in the NMPEIP earns $73,961 versus the $33,837 earned by the average New Mexico employee.

-- CEOs of NM-based NMPEIP portfolio companies are compensated at levels below the national averages. In NM, base salaries for CEOs for venture-backed companies earned an average of $158,429 versus nationwide base salaries of $247,950.

Responding to Mr. Rawson, Mr. Kulka said the NMSU investment program was terminated by NMSU and they returned the money ($3.8 million) in mid 2011. He said the securities were sold and the cash was put back in the Severance Tax Permanent Fund.

5. FINANCE MATTERS: COMMITTEE & INFORMATIONAL REPORTS: DISCUSSION OR VOTE

a. Audit Committee Report (Peter Frank)

-- The external audit is complete and the report will be available on the SIC website.

-- The Audit Committee met with the State Auditor last week to discuss the timing of the process for the external audit and continuous audit requirement. The Committee is working with the State Auditor to make this a more effective process that will increase assurances that the SIC has controls and the proper auditing is taking place. The current process can be significantly improved and the Committee is hopeful that the necessary changes will be approved.

-- The SIO is working with QED to install the general ledger system. The complexity and size of the SIC's specialized reporting and accounting requirements was underestimated by QED, but the process is moving forward.

-- The Audit Committee is moving aggressively to find a new CFO and is prepared to make an offer to a candidate with outstanding credentials.

Mr. Frank said that Dr. Clifford's remarks at the beginning of today's meeting were appropriate and understood. He said the Audit Committee is as upset and concerned as Dr. Clifford is about the issues that have surfaced, as is the State Investment Officer and State Investment Office.

Mr. Frank said the Committee intends to put procedures in place to ensure that this does not reoccur and has an eight-point program in place:

-- The first and most important step is to hire a competent and high quality CFO who can bring expertise and integrity to the operation.

-- The second step is to have a proper timetable with the external auditor, and the fact that the process was off synch is a function of the way the contracting has been done in the past by the state. The Committee is working with the State Auditor to improve this situation.

-- The Committee has also started an aggressive outsourced internal audit program, which is moving a bit more slowly than desired, but is nonetheless is moving forward.

-- The continuous audit requirement that exists now is a statutory requirement and has not been very effective, and the Committee is working with the State Auditor to improve that situation.

-- The results of Hewitt EnnisKnupp's review haven't been received, but that will provide the Committee with more recommendations for changes that should be put in place.

-- The Committee expects to implement numerous procedural improvements using the new CFO, ideas from the Audit Committee and from the internal audit program.

-- The Committee hopes to ultimately have the general ledger tied to SHARE.

-- The Committee is using competent consultants and is very appreciative of REDW's assistance and recommendations, and also appreciates the assistance of SIO management staff.

b. <u>Interim CFO report</u> (Moise)

With the assistance of DFA analyst A.J. Forte, Mr. Moise reported that the SIC has submitted a budget adjustment request, the second submitted within the past four or five months. He explained that the requests for payment of prior year expenses out of the prior year budget were not timely submitted, and the State Investment Office discovered that several months ago with respect to a $280,000 invoice from Prudential. He said a budget request was submitted for $300,000, which was approved, and the invoice was paid.

Mr. Moise said that, since then, additional invoices were discovered that were not timely entered in the system, and an additional BAR has been requested in the amount of $500,000.

Mr. Moise stated that this problem will not happen again, and a task list has been written up for the new CFO, once hired.

Mr. Moise stated that a CFO candidate was in the SIC offices last week for a series of interviews, and Hudepohl & Associates has been asked to be prepared to extend an offer letter to this individual after background checks are completed.

Mr. Moise stated that several resumes have been received from candidates for administrative accountant, who will be hired by the new CFO.

Mr. Moise discussed the FY 2012 budget projection, which was reviewed in depth this morning by the Audit Committee. He said one particular invoice, which was submitted several months late, may not be paid.

Mr. Rawson asked that more details on this transaction be shared in executive session.

6. GOVERNANCE MATTERS: COMMITTEE & INFORMATIONAL REPORTS: DISCUSSION OR VOTE

a. Governance Committee report (Scott Smart)

Mr. Smart reported that the Governance Committee met last Friday and addressed the following issues:

-- Agreed not to allow proxy attendance at committee meetings.

-- Discussed the severance tax white paper and offered suggestions.

-- Tabled the open door policy.

Mr. Martin said he wanted to reiterate his recommendation, which he understood the Governance Committee was to look into, that the SIC meet twice a year outside of the Santa Fe-Albuquerque area.

b. 2012 SIC-related legislation (Charles Wollmann)

Mr. Wollmann reviewed the highlights of an updated 1/20/12 legislative summary that was emailed to SIC members last Friday.

Mr. Wollmann said he would provide an additional update at the February 2 special SIC meeting.

In discussion on SB 53 (SIC membership and authority changes), Mr. Rawson said the language refers to two classes of members, public members and members, and he did not know if that was significant. He said he would raise the same issue on the appointment process, i.e., when does his two year term technically end – is it at the time of his appointment, is it when he is confirmed, is it January 1, etc. He said there is a lot of gray area, and suggested that it might make sense to have a term end on a certain date so it is clear.

Vice Chair Brown said he would like clarity on the current membership duration issue. He said it is not clear when SIC member terms are up.

Mr. Land said staff agrees with the Legislative Council Service's opinion that the two-year term begins from the date of the first meeting that they are eligible to attend.

Mr. Rawson stated that the language also states that the member shall serve until their replacement is confirmed by the Senate, so someone may have to serve past the end of their term until the Legislature is in session.

Vice Chair Brown asked Attorney General representative Tania Maestas to provide clarification in writing.

7. CLOSING MATTERS

a. Old or new business (Brown)

Commissioner Powell said he had requested at the last meeting that staff provide a list of management fees to him.

b. Next SIC meeting date: Thursday, February 2, 11:00 a.m., Santa Fe

8. PUBLIC COMMENT PERIOD (Brown)

Kay Lynde Grotbeck, citizen

-- The SIC should make no investments with any company that has a questionable issue in their background or has had any connection to a third party player. She was disappointed that no one asked questions today when Ares Opportunity Fund IV made a presentation. She thought Mr. Land gave a very good description of the issues.

-- The 2/24/09 PEIAC meeting minutes show that one reason the last Ares fund was recommended for approval was because "Aldus gave their approval." She believes Aldus and Ares were "joined together when they made their presentation to CalPERS."

-- PIMCO has accounts in the Caymans and even though this isn't the fund the SIC will invest in, it should be taken into consideration anyway. She is tired of this kind of thing.

-- The December 31 newspaper has an article stating that UBS was one of five companies that paid a $743 million fine in NY for the CDR question, which is the same question New Mexico was looking at when Governor Richardson withdrew turned down the job of Secretary of Commerce in the Obama cabinet.

-- It is still not clear how much New Mexico taxpayer money is put into various private equity investments.

-- People are questioning the ability of the Educational Retirement Board to achieve a 7.75% return, so how can the SIC expect to get a 7.5% return.

<u>Victor Marshall</u>

Mr. Marshall submitted the latest filing in the Frank Foy Austin case that included a partial transcript of a September 2006 meeting of the managers of Aldus Equity, attended by defendants Saul Meyer, Richard Ellman, Matthew O'Reilly and Marcellus Taylor. Mr. Marshall additionally submitted and played for the SIC a disc with portions of the audio of this meeting, which the SIC already possessed.

Mr. Marshall said he has not accused Douglas Brown of knowing about these kickbacks, but four witnesses will purportedly testify that Mr. Brown actively supported all of these "bad investments" when Mr. Bland or Mr. Malott recommended them. He said that the complaint states Mr. Brown was appointed Dean of the Anderson School as a reward for going along with these investments, but said it is very plausible that Mr. Brown did not know about the kickbacks.

Mr. Brown said he wished to clarify that he was solicited for the job by someone unknown – somebody at the University submitted his name in nomination – and there were 53 applicants. He said he went through a four-month vetting process, was chosen as one of the final three, and went through two days of meetings with 18 different groups. He was chosen by a 78% vote of the faculty and at no point was there any influence of the Governor – and the faculty would have vigorously resisted any such influence.

<u>Frank Foy</u>

-- Mr. Foy stated: he was opposed to the hiring of Aldus Equity by the ERB because they were incompetent, and they had been hired by the SIC, which creates a lack of diversification, and in fact they did put the ERB into the same investments.

-- Mr. Foy argued that Douglas Brown was a participant in the selection and hiring of many of the consultants, hedge funds and private investment managers at the SIC and the ERB when he was acting State Treasurer.

-- Mr. Foy argued that Mr. Brown should recuse himself from any pay-to-play discussions that the SIC engages in because he was a board member of the SIC and ERB when many certain deals occurred and he voted for many questionable investments.

-- Mr. Foy asserted that Mr. Brown was appointed Dean of the Anderson School as a reward for going along with many of these investments.

9. VOTE TO ENTER EXECUTIVE SESSION PURSUANT TO NMSA 1978:

a. §10-15-1(H)(7) Ongoing or Pending Litigation & Investigations: Placement Fees

b. §10-15-1(H)(2): Limited personnel matters: Accounting and investment positions

Mr. Frank moved that the State Investment Council enter Executive Session, pursuant to NMSA 1978 Section 10-15-1(H) and Section 10-15-1(H)2 for the purposes stated in Items 8a and b. Mr. Rawson seconded the motion, which passed on the following roll call vote:

For: Mr. Brown; Dr. Clifford; Mr. Frank; Mr. Lavender; Treasurer Lewis; Mr. Martin; Commissioner Powell; Mr. Rawson; Mr. Smart.

Against: None.

[The SIC was in Executive Session from 1:20 to 2:10 p.m.]

Mr. Martin moved to come out of Executive Session. Mr. Lavender seconded the motion, which passed on the following roll call vote:

For: Mr. Brown; Mr. Frank; Mr. Lavender; Mr. Martin; Commissioner Powell; Mr. Rawson; Mr. Smart.

Against: None.

Vice Chair Brown attested that the only matters discussed in Executive Session were those listed on the Agenda.

9. ADJOURNMENT

Its business completed, the State Investment Council adjourned the meeting at approximately 2:10 p.m.

Approved by:

Douglas M. Brown, Vice Chair