

STATE INVESTMENT COUNCIL
MEETING

FY13
SIGNED MINUTES

July 24, 2012

ACTION SUMMARY

STATE INVESTMENT COUNCIL

July 24, 2012

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MINUTES OF THE
NEW MEXICO STATE INVESTMENT COUNCIL

Santa Fe, New Mexico

July 24, 2012

1. OPENING MATTERS

a. Roll call and introduction of guests: quorum present

A regular meeting of the New Mexico State Investment Council was called to order by Governor Susana Martinez, Chair, on this date at 9:15 a.m. in the Governor's Cabinet Room, State Capitol, Santa Fe, NM.

Members Present:

The Honorable Susana Martinez, Governor
The Honorable James B. Lewis, State Treasurer
Dr. Thomas Clifford, Secretary, DFA
Ms. Linda Eitzen, Public Member
Mr. Harold Lavender, Public Member
Mr. Peter Frank, Public Member [elected Vice Chair during proceedings]
Mr. Michael Martin, Public Member [by telephone]
Mr. Leonard Lee Rawson, Public Member
Mr. Scott Smart, Public Member [by telephone]

Members Absent:

The Honorable Ray Powell, Commissioner of Public Lands

Attorney General Representative:

Ms. Tania Maestas

Staff Present:

Mr. Steven K. Moise, State Investment Officer
Mr. Vince Smith, Deputy State Investment Officer
Mr. Evan Land, General Counsel
Mr. Brent Shipp, Chief Financial Officer
Mr. Greg Kulka, Director of Private Equity
Mr. Charles Wollmann, Director of Communications
Ms. Kerri Segell, Executive Assistant
Ms. Lisa Bacon, Investment Analyst

Guests Present:

[See Sign-in Sheet.]

b. Approval of Agenda

Upon motion by Mr. Rawson, seconded by Mr. Frank, the Agenda was approved by unanimous voice vote, as published.

c. Approval of minutes: June 26, 2012

Dr. Clifford observed from the minutes that additional Council members were needed on the Audit Committee. He volunteered to move from the Council Investment Committee to the Audit Committee.

Mr. Lavender moved that Dr. Clifford move from the CIC to the Audit Committee. Mr. Rawson seconded the motion, which passed unanimously by voice vote.

Mr. Rawson moved approval of the June 26 minutes, as submitted. Mr. Frank seconded the motion, which passed unanimously by voice vote.

2. STATE INVESTMENT OFFICER'S REPORT (Steve Moise)

Investment matters

- NAV as of this morning was \$15.248 billion.
- Packet contains memorandum spotlighting role of CFO/ASD Brent Shipp.
- Staff and consultants have spent July doing on-site due diligence, interviewing and visiting the offices of potential international equities managers.
- Thanks to Council members for extensive input on Investment Policy, to be voted on today.
- Manager/consultant fee analysis is being wrapped up and the hope is to have it available next month for review.

Council matters

- August SIC & committee meetings:
 - a. Investment – Wednesday, 8/15 at 10:00 a.m., SIC offices.
 - b. SIC – Tuesday 8/28 at 9:00 a.m., Cabinet Room
 - c. Audit – Monday 8/27 @ 9:00 a.m., SIC offices

d. Governance – Friday 8/17 at 10:00 a.m., SIC offices

-- CIC had two continuing education presentations this past month on the topics of timber and infrastructure investments.

Office Administration

-- The search continues for a real return director. An administrative accountant has been identified and Mr. Shipp is working with SPO to hire this individual. Hiring of a deputy general counsel remains under consideration.

-- FY13 budgetary needs were discussed with the Audit Committee yesterday. The SIC will need to process a BAR and could need a special appropriation in the upcoming session.

-- CliftonLarsenAllen audit contract has been approved.

-- E-forms process has been implemented with JPMorgan. Although capital calls and distributions are automated through this system, nothing occurs without staff review.

External relations

-- Discussion about a legislative agenda has begun and Mr. Lavender and Mr. Rawson have offered to assist staff in the process.

-- Mr. Smith and Mr. Wollmann made a presentation at the NMRHCA's annual retreat in Red River on July 12. RHCA is the SIC's largest client.

-- Tobacco Settlement Revenue Oversight Committee has asked staff to provide data on what the Tobacco Fund corpus would be had they swept only 50% of what they are entitled to sweep each year.

Dr. Clifford stated it would be inappropriate for SIC staff to perform analysis of this nature, and that it should be referred to DFA and LFC staff to work together and respond to this request. Staff indicated it would respond with basic data and forward the analysis request.

-- Mr. Moise will present to Albuquerque's Economic Forum tomorrow.

Governor Martinez asked Mr. Moise to include the history and purpose of the permanent fund in his presentation. She expressed concern about regular efforts by various entities to chip away at this fund and use the proceeds for other purposes.

Dr. Clifford asked Mr. Moise to also point out that the oil and gas industry is a major source of revenue for the general fund through payment of taxes and royalties, etc.; and

as those resources are depleted over time, the distributions from the permanent fund become all the more important.

3. INVESTMENT MATTERS: GENERAL, REAL ESTATE, PRIVATE EQUITY, DISCUSSION OR VOTE

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

-- Equities aided total fund absolute performance in June. However, with returns of 3.66% and 5.30%, both US and non-US equity composites trailed their benchmarks.

-- Active large cap equity composite returned 3.78% in June, trailing the S&P 500 Index return by 34 basis points. In June, Brown Brothers Harriman was funded as part of the large cap active composite.

-- Small/mid cap equity composite returned 3.37% in June, 27 basis points below the Russell 2500 Index. Denver Investments continued to struggle, returning -0.31% and trailing their benchmark by 221 basis points.

-- In June, the core bond pool returned 0.71%, 46 basis points above the Barclay's US Universal Bond Index. All of the core bond managers outperformed the benchmark in June.

Dr. Clifford observed from the May report that the SIC looks significantly over-allocated in private equity in the STPF.

Mr. Smith responded that the allocation is still within range. He explained that the SIC is still in the process of unitizing the private equity pool, and in another month or so, will be able to rebalance between the LGPF and the STPE on a limited basis....

Mr. Rawson noted that the Severance Tax Total Fund allocation excludes ETIs and asked that a table be included listing their value.

Mr. Rawson and Mr. Frank questioned why the NMPEIP is characterized as an ETI when it is an allocation to private equity and should be held to the same commercial standard as the SIC's other private equity investments.

Mr. Smith responded that he would consult with staff and report back.

Mr. Smith asked SIC members to take the time to read "The Realization," a report authored by Joseph Azelby, head of JP Morgan's Global Real Assets Group. The article notes that investors who make a structural shift toward higher real asset allocations are likely to have better investment outcomes than those who do not. Mr. Smith said Mr. Azelby is available to address the Council if they desire a presentation.

Dr. Clifford said he would like RV Kuhns' perspective on this article, and in particular the correlation matrix that is presented, as a lot of data in the report appears to be proprietary.

Mr. Lavender pointed out that the Council does not have to make these investments, but armed with the information in the article, it would be better able to make an informed decision to invest, or not to invest, in these opportunities as they arise.

Ms. Beard commented that RV Kuhns has been advocating diversification for years and embraces the basic concepts in Mr. Azelby's report.

b. Investment Committee report & RFP update (Tom Clifford & Smith)

Mr. Smith reported on the CIC meeting, held about two weeks ago.

-- Heard educational presentations on timber and energy from Townsend Group and EIG, respectively.

-- Reviewed the real estate performance report.

-- Heard a recommendation from Kay Chippeaux to terminate the relationship with Stone Tower.

-- Reviewed the RFP status report.

c. General Investment Policy (RV Kuhns & Smith)

RV Kuhns adviser Marcia Beard stated that feedback from Council members has been incorporated into the draft policy.

Ms. Beard circulated a page of "pending comments on investment policy," developed by RV Kuhns, summarizing comments by Dr. Clifford and Mr. Rawson. While most of Dr. Clifford's comments were incorporated in the draft, Mr. Rawson's comments were submitted after the draft was emailed to members.

Ms. Beard said Ms. Eitzen raised a question about how to treat the internally managed portfolio. Ms. Beard said this question should be added to the one-page list. [In later discussion, Mr. Smith clarified that the internally managed portfolio is now at about \$400 million, or 3% of the overall portfolio, and is subject to the same guidelines, reporting requirements and valuation as the externally managed portfolios.]

Responding to concerns expressed by Dr. Clifford about the importance of periodically evaluating risk, Mr. Frank commented that there are several new Council members who were not part of the discussion when the Council adopted the asset

allocation last fall. He suggested that it would be useful to go back and revisit the asset allocation analysis – not to amend it, but to remind the Council of the rationale behind the underlying decisions, which took months of review and discussion.

Ms. Beard stated that RV Kuhns does a quarterly risk analysis for the Council that will now include a look at the peer universe and the best and worst performing funds.

Mr. Lavender expressed concern over the suggestion that the State Investment Officer's position is an unnecessary addition to that of the Chief Investment Officer. He questioned how the CIO would single-handedly be capable of overseeing the management of a \$15 billion portfolio along with the administrative work necessary to manage the State Investment Office.

Mr. Frank stated that any suggestion of this has been deleted from the policy, and it was agreed at the last meeting that this topic would be addressed on a future Council agenda as part of a discussion about organization of the State Investment Office.

Ms. Beard explained that the State Investment Officer's position was removed from the Roles and Responsibilities section as part of restructuring the policy. She added that, with most public funds, Mr. Moise's position would be classified as executive director and Mr. Smith as chief investment officer.

There was consensus that items 5-10 were acceptable and should be incorporated in the policy:

5. The policy should address how we will mark-to-market our illiquid investments, and how we will evaluate the mark-to-market procedures.
6. Qualitative Factors Resulting in Watch List Additions: It seems to me that points 1, 2 and 3 are very significant and should be considered a breach requiring termination.
7. Qualitative Factors Resulting in Watch List Additions: I still disagree with automatically removing a firm based on "one period of rolling, three year returns."
8. Qualitative Factors Resulting in Watch List Additions, last sentence: suggest ending the sentence after "...authority of the NMSIC," deleting the balance of the sentence. This language requires another step, although prudent, it may not be best to require it in all situations.
9. Investment Manager Termination Guidelines, last paragraph: Delete requirement for documentation and subsequent language regarding intent. Certainly this is ideal, but it could restrict the NMSIC from taking swift action when unusual circumstances require it.
10. General Investment Restrictions and Guidelines, E: "Without prior

Staff approval,” I would suggest requiring the approval of CIC, with the NMSIC at the next meeting.

Mr. Lavender moved approval of the General Investment Policy, incorporating the comments and changes discussed today, with the amendments as noted. Mr. Frank seconded the motion, which passed unanimously by voice vote.

d. Real return implementation update (Smith, RV Kuhns)

Mr. Smith reviewed an update of the real return portfolio.

Mr. Martin observed that the asset allocation includes inflation-related bonds and currency, including TIPS. He asked how staff will monitor potential over-allocation in these asset classes because external fund managers may also be investing in the same areas.

Mr. Smith responded that TIPS are a viable investment for the fixed income managers; and while there is not much of an allocation there now, those allocations are limited through the investment management agreements with the SIC. He said TIPS investments in the fixed income portfolio are viewed as a manager-driven tactical allocation against the fixed allocation to TIPS in the Barclay’s Capital Universal Benchmark that is assigned to those managers. The allocation in the real return portfolio is a directed investment with targeted long-term exposure.

Mr. Martin asked staff to advise the Council before making an allocation to those particular sectors so members can evaluate how much there is with existing managers.

e. Real estate Q1 2012 performance review (Townsend Group)

Townsend Group adviser Jack Koch made a presentation, with the following highlights:

-- As of 1Q12 SIC targets a 6.0% allocation to real estate. The Council’s 1Q12 market value represents 4.3% of total fund assets. In May the Council approved an increase to 7%.

-- Consistent with the slow moving recovery in real estate fundamentals, the portfolio’s quarter-over-quarter gross performance continues to provide positive performance:

- Q1 2012: 2.4%; Q4 2011: 4.3%; Q3 2011: 1.2%; Q2 2011: 3.7%.
- Year Ending 1Q12: 11.9% gross, 10.7% net
- Year Ending 1Q12: NFI-ODCE: 14.7% gross, 13.6% net

-- Portfolio underperformance versus the NFI-ODCE benchmark over the trailing 5-year period can be attributed to: (i) a lack of exposure until recently high quality core investments; (ii) over exposure to higher risk, non-core investments; and (iii) investment concentration in poor performing vintage years. Addressing these legacy issues has been the driver of portfolio activity over the past several quarters.

-- The portfolio outperforms the NCREIF/Townsend portfolio weighted benchmark over the 5-year period ending 1Q12. This benchmark compares SIC's performance to the investable universe of funds.

-- SIC received \$7.0 million in total distributions during 1Q12 and \$73.5 million over the 1-year period.

-- Townsend and staff continue to evaluate new core (strategic) and non-core (tactical) investment opportunities. First priority was to build out the strategic portfolio by year end 2012 with a secondary focus on investment in tactical opportunities to take advantage of higher returning investments given the current market environment.

f. Fixed Income: Stone Tower disposition (Kay Chippeaux)

Ms. Chippeaux presented staff's recommendation to terminate the Stone Tower Loan Value Recovery Fund, primarily to address near-term liquidity for the credit opportunistic portfolio (Credit and Structured Finance Pool).

Ms. Chippeaux noted that the current portfolio, prior to this liquidation, is at about \$700 million, while the long-term target is \$660 million and the short-term target is \$830 million. Staff wants to position the portfolio such that it can change the size of the pool and, as the asset allocation plan is phased in, allow flexibility as credit opportunities arise. She noted that assets in this pool are generally illiquid, and a portion of any new investments will have to be in vehicles or with a manager that is very nimble and liquid. She said staff plans to recommend a manager in the near future.

Ms. Chippeaux said Stone Tower, which deals chiefly in bank loans, recently was purchased by Apollo Corporate Credit Fund, which acquired Stone Tower to gain a team with expertise in bank loans. She added that Stone Tower just lost one of their co-portfolio managers with no immediate plan to replace that person; and there is also a lot of volatility in loan prices, which creates volatility in this fund valuation. She stated that staff believes that the current assets would be better deployed under a different structure that is more liquid and flexible.

Based on the recommendation of the Council Investment Committee and SIC staff, Mr. Lavender moved that the SIC terminate the current agreement with and redeem its investment in Stone Tower Corporate Credit Fund (which was recently acquired by the Apollo Corporate Credit Fund). Mr. Rawson seconded the motion, which passed unanimously by voice vote.

g. NM private equity program reporting items (informational)

[Informational item on calls and distributions in the NMPEIP.]

**4. FINANCE MATTERS: COMMITTEE & INFORMATIONAL REPORTS:
DISCUSSION OR VOTE**

a. Audit Committee report (Peter Frank)

Mr. Frank reported that the Committee met yesterday for a couple of hours, with all members present along with Dr. Clifford.

-- Discussed outsourcing the internal audit and got a progress report that most of seven audit objectives set for the preliminary work have been accomplished. The report should be received in the next few weeks.

-- External auditor, CliftonLarsenAllen, is ready to go and a pre-audit meeting will be held.

-- The Committee discussed next year's budget. Increased performance by managers has increased fees, and fees can also be higher based on the SIC's increased outsourcing to external managers. Because the SIC's planning and strategy was not taken into account in the budgetary process for FY12, and the SIC was not part of the discussion when the budget was developed, there are concerns about the adequacy of the FY13 budget.

-- General ledger process is moving well with implementation of a shorter-term and smaller scale system.

-- Issues with Moss Adams additional fees have been resolved and they will be paid approximately \$15,000 (versus their request for \$51,000).

-- Reviewed Audit Committee dashboard.

-- Major discussion on set of meetings to be held on valuation. A very large portion of the SIC's assets (about \$4 billion) is valued on a subjective or qualitative basis versus public market quotes. The Committee wants to understand this complex process better and plans to invite the CIC to participate in some of these sessions.

b. CFO report (Brent Shipp)

-- SIC is well within budget for FY12.

-- Expenditures are going to go up substantially in FY13, much of it due to the increasing use of external managers. The SIC could require a special appropriation and will need a BAR.

-- The hiring process for an administrative accountant is currently underway with SPO.

Mr. Rawson stressed the need to move the audit process up so the audit work is being done during the year being audited rather than afterwards.

Mr. Frank agreed. In the commercial world, audits are always begun during the year under audit and then the audit is wrapped up at the end of that year. This provides much better control and better risk reduction, as well as better communication with the auditors. Under the current system, the State Auditor approves a list of auditors for state agencies in March or April, when the fiscal year is almost over.

Mr. Moise noted that he and members of the Audit Committee and staff met with the State Auditor's Office several months ago and expressed their frustration with this process and timing, and made suggestions.

Dr. Clifford said he would meet with Controller Ricky Bejarano to discuss how this process can be adjusted.

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

a. Governance Committee report (Scott Smart)

Mr. Smart reviewed topics discussed by the Committee at its July 20 meeting.

-- Committee agreed on vice chair selection process.

- Members desiring to be vice chair make their names known, followed by voice vote.
- If more than two individuals express interest, the first voice vote will serve to eliminate person with lowest number of votes. Next vote will determine vice chair.

-- Vice chair should work closely with the chair and chair meetings as necessary. Chair and vice chair should have a lead role in the creation of agendas. Vice chair should be liaison between staff and chair, as necessary.

-- Ex officio members should not serve as vice chair because of time commitment issues.

- Proxy voting should not be allowed.
- Advisory/public members of committees should not be allowed to vote.
- Committee will work with HEK to develop tool for evaluation of Council members.

Ms. Eitzen noted that Audit Committee members who are not Council members are in fact allowed to vote.

Mr. Frank said that was correct, but that practice will have to change based on the decision by the Council at the last meeting to not allow the advisory/public members on the CIC to vote, and wishes expressed by the Governor that this be the case for all advisory/public members on committees. He observed from the CIC's July 11 meeting notes, however, that concurrence from those members is reflected, which is very important. While they were not part of the official vote, their views are being recognized in the minutes.

Mr. Lavender moved to adopt the process for selection of Vice Chair, as noted. Ms. Eitzen seconded the motion, which passed unanimously by voice vote.

b. Vice-Chair Selection (Smart)

Mr. Rawson and Mr. Frank indicated their interest in serving as Vice Chair.

Mr. Frank was selected as Vice Chair based on the following roll call vote:

Voting for Mr. Frank: Mr. Frank; Ms. Eitzen; Mr. Lavender; Treasurer Lewis; Mr. Smart.

Voting for Mr. Rawson: Dr. Clifford; Mr. Martin; Mr. Rawson; Governor Martinez.

c. Litigation Committee selection (Evan Land)

Ms. Eitzen and Mr. Frank volunteered to serve on the Litigation Committee along with the Governor's Office, represented by general counsel Jessica Hernandez.

Governor Martinez moved to appoint Ms. Eitzen, Mr. Frank and the Governor's Office to the Litigation Committee. Mr. Lavender seconded the motion, which passed unanimously by voice vote.

6. CLOSING MATTERS

a. Old or new business (Vice Chair)

None.

b. Next SIC meeting date: Tuesday, August 28, 9 am, Santa Fe, NM

7. PUBLIC COMMENT PERIOD (Vice Chair)

Kay Lynde Grotbeck, citizen

Ms. Grotbeck noted that the Council some years ago went to policymaking rather than rulemaking. The problem is that the latter has citizen input requirement, while policymaking doesn't. She suggested that the Council address her concerns by posting any draft policy on the SIC website for 30 days and asking for citizen input.

Ms. Grotbeck said she read an article in the July 16 issue of the *Albuquerque Journal* entitled "Venture Investment Recovering Erratically," and she found the article obtuse because the SIC's reporting is obtuse, which is a concern to her.

Ms. Grotbeck said she disagreed with the SIC's decision to invest in alternatives and thought the investment approved at the June meeting in an Asia fund was very risky.

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

- a. §10-15-1(H)(7) Ongoing or pending litigation: legal strategy**
- b. §10-15-1(H)(2): Personnel Matters: employee hiring and retention**

Governor Martinez suggested that a litigation status report (part of item a) be given in open session.

Mr. Land reported that the SIC continues to aggressively pursue recoveries, and in the last four years has been the only entity to recover monies for the funds, although there have been no settlements this month. He noted that every dollar recovered is another dollar to fund state government and education, and it has been his recommendation that the SIC not permit recoveries to be diluted in any way in accordance with its fiduciary duties.

Mr. Land stated that every SIC defendant and every claim remains in play – this is significant: no parties or claims have escaped the SIC's case and been dismissed with prejudice. The SIC will take every opportunity to amend and supplement allegations and apply pressure on defendants; and in fact did that last week, filing an amended complaint again to tighten the net. He added that the SIC also filed a motion last week regarding additional service safeguards.

[Treasurer Lewis excused himself from the meeting.]

Mr. Rawson moved that the SIC enter executive session, pursuant to NMSA 1978 Section 10-15-1(H)(7), to discuss legal strategy; and to discuss as allowed under Section 10-15-1(H)(2), Limited Personnel items: employee hiring and retention. Mr. Martin seconded the motion, which passed on the following roll call vote:

For: Governor Martinez; Dr. Clifford; Mr. Frank; Ms. Eitzen; Mr. Lavender; Mr. Martin; Mr. Rawson; Mr. Smart.

Against: None.

[Council was in executive session from 12:05 to 12:40 p.m.]

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

For: Governor Martinez; Dr. Clifford; Mr. Frank; Ms. Eitzen; Mr. Lavender; Mr. Martin; Mr. Rawson; Mr. Smart.

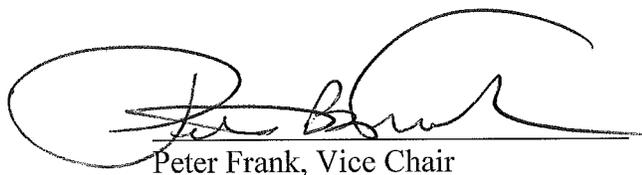
Against: None.

It was affirmed 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 12:45 p.m.

Approved by:



Peter Frank, Vice Chair