ACTION SUMMARY

INVESTMENT COMMITTEE

January 21, 2016

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MINUTES OF THE

NEW MEXICO EDUCATIONAL RETIREMENT BOARD

INVESTMENT COMMITTEE

January 21, 2016

1. a. Call to Order

A meeting of the New Mexico Educational Retirement Board Investment Committee was called to order on this date at 1:00 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
Mr. Larry Magid
Dr. Beulah Woodfin

Members Excused:
Ms. Mary Lou Cameron

Staff Present:
Ms. Jan Goodwin, Executive Director
Mr. Rick Scroggins, Deputy Executive Director
Mr. Bob Jacksha, CIO
Mr. Steve Neel, Deputy CIO
Ms. Kay Chippeaux, Fixed Income Portfolio Manager
Ms. Rita Lopez, Investment Financial Analyst
Mr. Aaron Armstrong, Portfolio Manager

Others Present:
Mr. Allan Martin, NEPC
Mr. Kevin Tatlow, Top Tier
Mr. Brent Burnett, RAPM
Ms. Judith Beatty, Recorder

b. Approval of Agenda

Mr. Magid moved to approve the agenda, as published. Dr. Woodfin seconded the motion, which passed unanimously by voice vote.

c. **Approval of Minutes: December 10, 2015**

Mr. Magid moved approval of the December 10 minutes, as submitted. Dr. Woodfin seconded the motion, which passed unanimously by voice vote.

d. **Approval of Minutes: December 14, 2015**

Mr. Magid moved approval of the December 14 minutes, as submitted. Dr. Woodfin seconded the motion, which passed unanimously by voice vote.

3. **Introduction of Guests**

Mr. Neel introduced Storm Davis, an intern from UNM who is working with the investment team.

2. **INDUSTRY VENTURES PLATFORM INVESTMENT – PRIVATE EQUITY**

[Presenters: Steve Neel and Top Tier consultant Kevin Tatlow.]

Mr. Neel presented staff's recommendation of a $45 million commitment to Industry Ventures Secondary Fund VIII and a $30 million commitment to Industry Ventures Partnership Holdings IV.

Mr. Neel noted that staff would also be recommending a $50 million commitment to Siguler Guff Secondary Opportunities Fund I. While Industry Ventures is involved in venture opportunities at the beginning of the private equity ecosystem, Siguler Guff, by contrast, focuses at the end of the private equity spectrum in both distressed and special situations opportunities. He commented that it is a nice contrast to have both of these managers at the same committee meeting, as their styles are complementary.

Mr. Neel discussed the history of secondaries and why staff finds them so compelling. He commented that secondary managers have the ability to diversify across vintage years, sector strategies and so forth; and secondary managers normally execute at a discount to net asset value. He noted that the ERB has invested in other secondary funds, including Lexington and W Capital.

- Industry Ventures Secondary Fund VIII is targeting $425 million for its fifth institutional fund focused on secondary investments. The fund will focus on venture capital backed companies in technology and other industries where venture capital is active. Industry Ventures is a value-oriented investor and will invest in late stage venture capital backed companies using a flexible approach that includes secondary direct investments, secondary fund interests and special purpose vehicles.

- Industry Ventures Partnership Holdings IV is targeting $200 million for its fourth fund focused on venture capital investments managed by small venture capital funds. The fund will focus on building a diversified fund of funds portfolio of direct fund commitments, early secondary fund interests, special purpose funds and co-investments.

Mr. Tatlow noted that, in 2008, about 4-5 percent of all funds raised were transactions in the secondary market; this has risen to 8-10 percent today. He noted that the ERB portfolio is very sensible, with a core manager who is one of the best at buying giant portfolios complemented by a variety of managers specializing in smaller niche markets. Top Tier feels that, as the secondary market becomes increasingly competitive, these smaller niche managers will add value. The niche secondary players are expected to outperform the bigger core managers because they have more expertise, and there is less competition with the smaller transactions.

Mr. Neel noted that the ERB has previous commitments with Industry Ventures as well as Siguler Guff.

Industry Ventures founder and CEO Hans Swildens, and managing director Roland Reynolds, appeared before the committee and made a presentation.

[Representatives left the meeting.]

Mr. Magid moved that the Investment Committee approve a commitment of $30 million to Industry Ventures Partnership Holdings IV, L.P. The commitment 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. In addition, the Investment Committee grants staff discretion to invest an additional amount, not to exceed $10 million, in secondary partnership interests offered by other limited partners in the fund, should they become available from time to time, under the Right of First Refusal of the limited partnership agreement for this fund.

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

Mr. Magid moved that the Investment Committee approve a commitment of $45 million to Industry Ventures Secondary VIII, L.P. The commitment 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. In addition, the Investment Committee grants staff discretion to invest an additional amount, not to exceed $10 million, in secondary partnership interests offered by other limited partners in the fund, should they become available from time to time, under the Right of First Refusal of the limited partnership agreement for this fund.

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

3. SIGULER GUFF SECONDARY OPPORTUNITIES FUND – PRIVATE EQUITY

[Presenters: Steve Neel and Top Tier consultant Kevin Tatlow.]

Mr. Neel presented staff's recommendation of a $50 million commitment to Siguler Guff Secondary Opportunities Fund I, L.P. ("SOF"), which will focus on niche secondary investments in distressed private equity opportunities.

Mr. Neel noted that NMERB committed to a Siguler Guff separately managed account in November 2014. It was a $50 million separate account that has done very well. To date, it has invested 125 percent of the assets, with a 1.5x return and a net IRR well into the triple digits.

Mr. Neel said SOF is focused in distressed and special situations sub strategies, where they have deep domain expertise. They are very well known for their international and emerging market investments with their BRIC funds. In addition, they are raising their sixth or seventh distressed opportunities fund, so have a long lineage in working with general partners where they would be underwriting those opportunities.

Mr. Neel stated that the NMERB negotiated with Siguler Guff for an overflow fund, with very favorable terms.

Mr. Tatlow added that this is a first fund, but they have been doing it within the distressed fund of funds platform since 2010.

Siguler Guff representatives Tony Cusano and Matt Brewer appeared before the committee and made a presentation.

[Representatives left the meeting.]

Dr. Woodfin moved that the Investment Committee approve a commitment of $50 million to Siguler Guff Secondary Opportunities Fund, L.P. and an additional $20 million to the Siguler Guff Overflow Co-Investment Fund. The commitment 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. In addition, the Investment Committee grants staff discretion to invest an additional amount, not to exceed $10 million, in secondary partnership interests offered by other limited partners in the fund, should they become available from time to time, under the Right of First Refusal of the limited partnership agreement for this fund.

Mr. Magid seconded the motion, which passed unanimously by voice vote.

4. PACING PLAN – PRIVATE EQUITY

[Presenters: Steve Neel and Top Tier consultant Kevin Tatlow.]

Mr. Neel and Mr. Tatlow presented highlights of the pacing plan for 2016-2017.

- NMERB can continue to invest at $325 million per year
- Currently an 11 percent policy target allocation with a 0-18 percent range
- Investments will continue at the same pace as last year, but the model should be revised annually or following significant changes in market conditions
- In the last year, the private equity portfolio has outperformed the rest of the NMERB portfolio, so the target is being reached more quickly. There is a small target overshoot of under 2 percent if NMERB maintains the current level of commitments.

Mr. Tatlow said they have backed down in the modeling a bit on private equity assumptions. Returns from equities are a little low, and there has been a long equity market run, so long-term assumptions are on the conservative side at a 1.7x multiple and about a 13.5 percent net IRR.

- Buyout – US and European transactions have been taking place at multiples near historic highs. More equity in transactions today than in prior cycle, so anticipate lower risk and lower return
- Venture – recent venture liquidity has sustained fundraising and high late stage valuations. Focus on early stage where valuations look the most attractive
- Distressed – expect to see distress in certain sectors. Currently opportunities unfolding in energy sector. Identify partners well suited for opportunistic strategies
- Secondaries – the secondary market continues to have high levels of available capital and low discounts. Focus on firms that are doing niche transactions or are proven to be highly disciplined.

Mr. Jacksha said NEPC will be looking at asset liability in March and may consider tweaking the target in private equity from 11 percent to 12 percent; and depending on how the distressed market looks, there may be an opportunity to shift the mix somewhat.

5. INVESTMENT POLICY REVISION

Mr. Jacksha reviewed a suggested amendment to the Investment Policy:

7. NMERB recognizes that management fees are an important consideration, but NMERB also recognizes that fees are secondary in importance to return and risk goals. Fees are a component of the net return of an investment, but a potentially small savings in fees can easily be outweighed by the performance of different managers or different asset classes. Fees are highest in alternative asset classes. Research has shown that the dispersion of returns between managers is highest in these alternatives. Thus, a relatively small savings in fees can easily be offset by a large differential in return caused by manager or asset class choices. Minimizing fees must be secondary to striking the proper return/risk profile for the investment portfolio and secondary to manager quality and capability. Nonetheless, Staff will seek to negotiate fees that are standard market rates or lower for managers in the asset class in question. While some fee savings may be achieved, this policy recognizes that reducing fees is not always possible, depending upon the supply/demand dynamics for a specific asset class and specific managers. Staff may recommend an investment that carries higher than standard fees, but must present sound rationale in support of the recommendation. NMERB will present the Board with an annual fiscal year report detailing management fees, expenses and incentive fees paid to managers summarized by asset class.

Mr. Magid moved that the Investment Committee recommend approval to the Educational Retirement Board of the change to the Investment Policy regarding management fees as part of the Investment Philosophy. Dr. Woodfin seconded the motion, which passed unanimously by voice vote.

6. MLP ENERGY SEARCH – REAL ASSETS

[Presenters: Bob Jacksha and RAPM consultant Brent Burnett.]

Mr. Jacksha stated that staff and RAPM have done a pre-screening of the Master Limited Partner (MLP) universe in preparation for a Request for Information (RFI) and have identified firms with institutional MLP management capabilities for further evaluation. Today, the committee is being asked to authorize investment staff to use the information from the recently conducted RFI process to bring in a finalist or finalists to the committee at a future date.

Mr. Burnett said RAPM thinks the MLPs are attractive and complementary to what the NMERB has in the portfolio, and the entry price valuation of them today is much better than it has been. There has not been the fundamental deterioration in the midstream MLPs that has been seen in the upstream commodity-price related MLPs.

Mr. Burnett said these are MLPs that gather, process, store, refine hybrid carbons, and are not upstream MLPs that are actually developing and producing the commodities. He said these companies move the commodity from point A to point B through pipeline infrastructure, compression infrastructure and refining infrastructure. Their business model is very different from an upstream producer in that they are paid for moving product from point A to point B, and those contracts are not based on what the commodity price is doing. Despite that business model, RAPM has seen their performance over the last 18 months come down in line with commodity prices and with companies with direct commodity price exposure.

Mr. Burnett said staff and RAPM looked at 60 of the largest MLPs and some of their key fundamental operating metrics. Despite a 50 percent correction in their share prices and commodity price, their margins and distribution coverage levels have been maintained with only a slight increase in debt. RAPM feels that their operating fundamentals are still very sound and yet their share prices have experienced very dramatic corrections.

Mr. Burnett stated that, historically speaking, MLPs have had a correlation to commodity prices of .28 over a 15-20 year period; and yet, in the last 18 months, it has gone upwards of 90 percent, so there has been what RAPM feels is a decoupling from their fundamentals relative to their share prices. For an asset class that RAPM feels is a good long-term addition to a portfolio, the entry point today looks much more attractive than it did two to three years ago, when valuations in those securities reflected distribution growth rates that seemed unsustainable.

Addressing a point raised by Mr. Jacksha about whether the operating fundamentals of these companies would be affected if there were a sustained low commodity price environment, Mr. Burnett said it could, but they have not seen that yet. Based on information released in January by the eight largest MLPs, the outlook is much more positive than was expected.

Mr. Martin noted that, historically, the MLPs have built new pipelines and that could go away. He asked how that affects the investment thesis.

Mr. Burnett responded that, previously, MLPs have had distribution growth rates anywhere from 12 to 15 percent, and RAPM feels that will drop to about 5-6 percent. With lower commodity prices, there would not be the massive development component to their strategies that were seen before. Even with prices where they are today, most of the largest MLPs have a backlog of development projects that are still economical. How they choose to fund those can be different; they can fund those through issuing new equity, taking on debt, or even using internally generated cash flow, and this would reduce the distributions. RAPM thinks that, with the distribution growth rate dropping to 5 percent going forward, at today's prices it is still a pretty attractive yield.

Mr. Magid moved that the Investment Committee authorize the investment staff to use the information from the recently conducted Request for Information process to select finalists for a Master Limited Partnership investment mandate. Dr. Woodfin seconded the motion, which passed unanimously by voice vote.

7. U.S. SMALL/MID CAP EQUITY INVESTMENT MANAGER SEARCH

[Presenters: Kay Chippeaux and NEPC consultant Allan Martin.]

Ms. Chippeaux stated that NMERB hired Lord, Abbett & Co. as a U.S. small/mid cap equity manager in the value space about six years ago. Their initial four-year investment contract was extended in 2014 for an additional two years. As of December 31, they now manage about $120 million of the NMERB's U.S. small/mid cap portfolio.

Ms. Chippeaux said investment staff and NEPC had a discussion about the structure of the equity portfolio, and they have all agreed that they want to maintain the current structure; and in particular, the allocation in this area with the value tilt for a small/mid cap equity manager.

Ms. Chippeaux stated that, under the NMERB's investment services procurement policy, Lord, Abbett in July 2016 would reach the term limit under that original search for investment manager. The NMERB is required to do a new search for an investment manager. She said she would like to mention the NMERB would probably invite Lord, Abbett to respond, as staff has been pleased with their performance over the past couple of years.

Ms. Chippeaux said staff recommends that the Investment Committee use the Request for Proposals process, as this particular manager search lends itself very well to that process, as there are a lot of well qualified investment managers in this space. It will be very competitive and thorough, and staff feels this will help the NMERB select the best manager in this space going forward.

Ms. Chippeaux said they would expect to bring the finalist to the Investment Committee at the May 2016 meeting.

Mr. Martin noted that the NMERB has roughly 10 percent of its domestic equity allocation in small cap, which is where the market is and where NEPC feels it should be. Within that allocation, the NMERB could choose to index, but NEPC feels that active management in this space "more than pays its freight." He said the NMERB could also choose to put it all with a core manager or break it down into a growth manager and value manager. The data NEPC has looked at would suggest that the NMERB is better off with a growth manager and a value manager, and Lord, Abbett has proved itself with solid outperformance over five years in this space.

Mr. Magid moved that the Investment Committee authorize the investment staff to use a Request for Proposal procurement method in the selection of an investment manager for U.S. small/mid cap value equities.

8. UPDATE ON INVESTMENT STAFF COMPENSATION PROJECT

Mr. Jacksha said that, at a previous Board meeting, there was a discussion about pursuing incentive compensation for the investment staff. In discussion, staff took a broader view of the topic and defined it as "competitive compensation," whether that is delivered through an incentive or as base compensation.

Ms. Goodwin distributed and discussed a Harvard Business Review article titled, "How Netflix Reinvented HR," by Patty McCord. The Netflix model has not been used in New Mexico, which is not to say it shouldn't be considered.

Ms. Goodwin noted that, in order to pay people competitive salaries under this model under the existing system, the NMERB might have to have more staff people be exempt rather than classified. She said Mr. Jacksha has had preliminary conversations with staff, and staff is comfortable with it.

Mr. Jacksha distributed some information from an annual survey of state funds. The NMERB participates in this survey every year. He referred to a detailed breakdown of positions, reflecting that the NMERB falls well under the median in all areas and dead last in several areas. In all other categories, the NMERB falls last or close to last.

Committee members agreed to add this matter to the February 25 Board Retreat agenda.

9. OTHER INVESTMENT REPORTS AND DISCUSSIONS

Mr. Jacksha distributed a list of recent buys and sells in the equity markets as of January 20, 2016.

10. NEXT MEETING: THURSDAY, FEBRUARY 25, 2016

The meeting was scheduled at 9:00 a.m., to be followed by the Board Retreat at 1:00 p.m.

ADJOURN

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

Accepted by:

H Russell Goff

H. Russell Goff, Chairman