ACTION SUMMARY

INVESTMENT COMMITTEE

September 21, 2015

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MINUTES OF THE

NEW MEXICO EDUCATIONAL RETIREMENT BOARD

INVESTMENT COMMITTEE

September 21, 2015

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
Ms. Mary Lou Cameron [by telephone]
Mr. Larry Magid
Dr. Beulah Woodfin

Members Excused:
None.

Staff Present:
Ms. Jan Goodwin, Executive Director
Mr. Bob Jacksha, CIO
Mr. Mark Canavan, Real Estate Portfolio Manager
Mr. Steve Neel, Deputy CIO
Mr. Pete Werner, Fixed Income Portfolio Manager
Ms. Kay Chippeaux, Fixed Income Portfolio Manager
Mr. Alan Myers, Investment Financial Analyst
Mr. Aaron Armstrong, Portfolio Manager

Others Present:
Mr. Dan LeBeau, NEPC
Mr. Asif Hussain, Caledon Capital Management
Ms. Ashley Ng, Caledon Capital Management
Mr. Kevin Tatlow, Top Tier
Ms. Charmaine Clair for Judith Beatty, Recorder

b. Approval of Agenda

The agenda was reordered.

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

c. **Approval of Minutes: July 23, 2015**

Dr. Woodfin moved to approve the minutes of the July 23 meeting, as submitted. Mr. Magid seconded the motion, which passed unanimously by voice vote.

d. **Introduction of Guests**

None.

2. REVIEW FIXED INCOME POLICY REVISIONS

[Presenters: Pete Werner and Kay Chippeaux.]

Mr. Werner stated that, in the year since the new Fixed Income Policy was adopted, staff has made additional changes to simplify and streamline it as well as eliminate any redundancy. He presented the highlights.

Dr. Woodfin moved that the Investment Committee recommend Board approval of the revisions to the Fixed Income Policy. Mr. Magid seconded the motion, which passed unanimously by voice vote.

Mr. Jacksha said this would go to the Board on October 23 for final action.

3. PINNACLE SMALL/MID CAP EQUITY CONTRACT

[Presenters: Kay Chippeaux and NEPC consultant Dan LeBeau.]

Ms. Chippeaux requested approval to renew a contract for Pinnacle Associates, one of the NMERB's small/mid cap U.S. equity managers. Staff benchmarked this investment against the Russell 2500 Growth Index, and just over four years ago invested approximately $100 million. Since then, the NMERB has withdrawn $60 million, and that investment now stands at about $120 million. She said this contract is up for one two-year renewal, according to the procurement policy.

Ms. Chippeaux said she met with the Pinnacle team in New York and last month had a telephone conference with them. They are on NEPC's Focused Placement List, and senior portfolio manager Peter Marron emphasized that their philosophy, process and team have not changed and they remain convinced that they can provide alpha for the NMERB portfolio. She said she concurs with NEPC's recommendation to extend the contract.

Mr. LeBeau said this is a preferred strategy within the small/mid cap growth space for NEPC and is one of the higher conviction names that is on a list of anywhere from eight to ten managers or strategies on that list. Right now, the research consultant covering this space has cited Pinnacle as one or two of the top names in this space.

Mr. LeBeau commented that this is a portfolio that combines views of cyclical growth stocks and sustainable growth stocks with an often long-term hold period, and so they are willing to ride through some of the swings in the market. This often leads to a more volatile portfolio than the index with more tracking error than many of its peers. When NEPC did the search and retained Pinnacle originally, that was one of the elements they found most attractive about them, which is that there could be periods when they underperformed the benchmark, but their long-term hold approach, balancing the two kinds of growth stocks, will ultimately reflect outperformance. While recent results have been more disappointing, a snapshot of the three-year period ending June 30 shows the portfolio has outperformed the benchmark by about 1 percent and ranks in the top 10 percent of the peer universe.

Dr. Woodfin moved that the Investment Committee approve a two-year extension of the Pinnacle Associates Limited small and mid-cap equity management contract. The contract extension is subject to New Mexico State law, Educational Retirement Board policies, Educational Retirement Board approval for placement agents and negotiation of final terms and conditions, and completion of appropriate paperwork. Mr. Magid seconded the motion, which passed by unanimous voice vote.

5. INFRASTRUCTURE CO-INVESTMENT FUND MODIFICATION

[Presenters: Mark Canavan and Caledon consultants Asif Hussain and Ashley Ng.]

Mr. Canavan stated that, when the Infrastructure Co-investment Fund was initially presented for review, it contemplated that 0-20 percent of the portfolio was to be set aside for greenfield investments, and 80-100 percent for brownfield investments. He said staff is requesting that those restrictions be removed, as the Infrastructure Policy Statement does not contain those limitations and only suggests that greenfield assets in the portfolio be monitored and reported.

Mr. Canavan said he personally feels that buying core assets right now in a historically low interest rate environment, since the core assets behave more like very high quality bonds, would create a fairly significant impact on those assets should interest rates rise. With so much capital chasing greenfield assets after they are built and finalized, they should be sold into the core capital market at fairly good multiples.

Responding to Mr. Magid, Mr. Hussain said the three assets in the portfolio are all greenfield in the construction stage, so they haven't disposed of anything yet. If in three or four years those were divested and the market remained unchanged, Caledon is hopeful it would be able to find good greenfield opportunities at that time. Mr. Canavan added that the fund managers the NMERB is invested with are slowly beginning to liquidate some of their positions.

Dr. Woodfin moved that the Investment Committee approve the modification of the investment guidelines for the Infrastructure Co-Investment Fund to eliminate the restrictions on greenfield versus brownfield investments. Mr. Magid seconded the motion, which passed unanimously by voice vote.

8. OTHER INVESTMENT REPORTS AND DISCUSSIONS

Infrastructure Portfolio Quarterly Performance Measurement – Q2

[Presenters: Mark Canavan and Caledon consultants Asif Hussain and Ashley Ng.]

Mr. Canavan presented highlights.

-- Portfolio fair value: $167.4 million

-- Unfunded investment commitments: $195.8 million (includes investments in the co-investment platform not yet been called)

-- Total exposure: $363 million

-- Total number of fund investments: 7

-- Total number of direct investments: 3

-- Net IRR since inception: 2.8 percent

Mr. Canavan reviewed portfolio cash flows and performance details. He noted that the Caledon Andromeda investments show a gross IRR of 48.3 percent and a net IRR of 25 percent. He said this is largely due to a rapid increase in valuation on the Carlsbad desalination plant investment, so it is expected this number will gradually decrease with returns ultimately in the 14 to 19 percent range.

4. ZM CAPITAL FUND II, L.P. – PRIVATE EQUITY

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

Mr. Neel presented staff's recommendation of a $40 million commitment to Zelnick Media Capital Partners II, L.P. ("ZM.") He said ZM is focused in the media and entertainment business.

In discussing how this deal was sourced, Mr. Neel said the NMERB sits on the Veronis Suhler Stevenson (VSS) advisory board. He stated that VSS was the debt piece of ZM's very profitable Cast & Crew investment, where the NMERB did exceptionally well at a 6x multiple. The equity sponsor of this transaction was ZM, and the NMERB reached out to them.

-- The Zelnick group, the manager of ZM Capital, is comprised of two separate disciplines. While partners Strauss Zelnick and Karl Slatoff are very focused operationally, with backgrounds in the media and entertainment business, the other part of the group is focused on investment banking disciplines.

-- ZM is raising approximately $400 million for its second fund to make control buyout investments. They will invest $40 million to $80 million in companies with enterprise values between $50 million and $500 million. Targeted returns are at 3x to 4x multiples with IRRs in the 30 percent range.

Mr. Tatlow discussed the pros and cons of this opportunity.

-- Fund I is a 2008 vintage fund that is currently tracking at nearly 3x, with two deals fully realized and three partially realized.

-- The depth of the relationships and sector expertise within the team is a very positive asset. For a fund of this size, there is a great deal of talent and experience within the organization.

-- NMERB definitely expects to see co-investment opportunities, based on the fund size.

-- Concerns about a concentrated portfolio.

Ms. Goodwin asked if Zelnick would need to increase their staff, since they have such a hands-on approach. Mr. Tatlow responded that they are sufficiently staffed for this fund at the current time, although they will be adding people at the junior level. They are also expected to move from their legacy portfolio into new commitments over time. Mr. Neel added that most of the legacy portfolio is moving toward liquidity. He said five partners and eight portfolio companies is a reasonable ratio.

Dr. Woodfin observed that Messrs. Zelnick and Slatoff are intimately involved in Take-Two Interactive, holding leadership positions with three years remaining on their management contracts with the firm. She asked Mr. Tatlow if there were any concerns about what appeared to be a significant time commitment.

Mr. Tatlow responded that Top Tier expects this will be like a typical portfolio company, with the partners moving on and working with the more active portfolio companies over time. He added that they have the ability to leave at any time.

Mr. Neel introduced Zelnick representatives Strauss Zelnick, Andrew Vogel, Sheila Dharmarajan and Ben Shriner, who made a presentation.

[Representatives left the meeting.]

Dr. Woodfin moved that the Investment Committee approve a commitment of $40 million to ZMC Capital Fund II LP. 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, staff will be granted 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 by unanimous voice vote.

6. PROCUREMENT FOR FIXED INCOME SOFTWARE

[Presenter: Alan Myers.]

Mr. Myers stated that the fixed income portfolio includes pools of adjustable rate mortgages as well as floating rate corporate bonds, and these securities adjust in line with their payment schedule, which is either monthly or quarterly. Currently, there is no effective way to update the rates, so staff can only correct the books when the NMERB exceeds the principal and/or interest payments. There are also corporate actions that occur on a monthly basis for a number of investments, including calls, redemptions, exchanges, name changes, and so forth, and staff is posting these transactions manually.

Mr. Myers said staff is requesting that the Investment Committee approve an amendment to the contract with QED to include Corporate Action Services to facilitate the adjustable rates and floaters, as well as provide a more automated service. He said the cost will be about $600 a month, depending on the number of investments that require processing. He said this additional service would cost approximately $600 a month. He added that QED is renegotiating the contract with IVC, the provider of information, and there is a good chance the cost will be reduced over time.

Ms. Cameron moved that the Investment Committee approve an amendment to the contract with QED to include Corporate Action Services. These additional services are needed in order to more efficiently maintain NMERB's Fixed Income portfolio on the NMERB internal accounting system. Dr. Woodfin seconded the motion, which passed by unanimous voice vote.

7. DISCUSSION OF INVESTMENT COMMITTEE GOVERNANCE

[Presenter: NEPC consultant Dan LeBeau.]

Mr. LeBeau said NEPC has prepared a slide presentation on what good governance means, along with examples of what approaches some other peers are taking in terms of delegating more authority. He commented that there is slowly growing trend among public funds to delegate more authority, whether at a subcommittee or even at the staffing level, which NEPC thinks is ideal.

Mr. LeBeau noted that the NMERB has been gradually changing its own governance structure. More than two years ago, the Investment Committee recommended investments to the Board for final approval, and now approves investments and reports them to the Board. NEPC feels some extra steps could be taken to delegate more authority, if that is what the Board wishes, as part of the trend among pension funds nationally.

Mr. LeBeau stressed that NEPC is not advocating any particular approach, here, but has a lot of perspective on the governance issue and has been talking with its clients over the past couple of years about it. He added that not every board accepts these types of concepts, with some boards preferring to be very hands-on even to the point of some micromanagement.

-- Roles and responsibilities in good governance need to be clearly defined among staff, consultants (generalist or specialty), the Board and any subcommittees.

-- There needs to be well defined "risk tolerances" of the Board so that staff can implement the strategy based on those risk tolerances. NEPC often finds there is a lot of discussion at the board level about risk tolerances, but often nothing is put down in writing on how they want to monitor risk in the portfolio.

Ms. Cameron commented that this is very timely, because the NMERB's auditor recently contacted her and wanted to know what actions the Board has taken on risk in particular.

Mr. LeBeau responded that, for the handful of NEPC clients that have gone down the path where staff is implementing the entire program, it has caused NEPC on the investment side to have to provide a lot more information to outside auditors. He said NEPC has been more engaged with auditors over the past couple of years than it has historically.

-- Studies suggest that the value-add associated with good governance is in the range of 200-300 basis points. With several of NEPC's clients, where roles and responsibilities are clearly defined for staff and the trustees, it makes for a much smoother decision making process and for much more streamlined discussions at meetings.

-- This is an asset liability business, not an asset management business. The Board's role is risk oversight and setting risk parameters rather than performance maximization. It is staff's role to maximize performance based on those predetermined risk tolerance levels of the Board.

-- Pension plans must be managed for the long term.

-- Quality of the board and staff is crucial, especially a tenured staff that is compensated such that they won't leave at some point in the future. One of the bigger challenges within the public funds world is staff retention, where they can make more money on the private side than in the public sector. Top talent in the space is scarce, so it is important to hang onto that talent for the long term. Some clients have set up compensation programs to incentivize staff.

Dr. Woodfin noted that the Ennis Knupp study recommended that the NMERB Board have full control over compensation.

Ms. Goodwin suggested having a discussion with the State Personnel Office's new Executive Director about doing a pilot project.

Mr. Jacksha commented that at least half of public plans have incentive compensation. Mr. LeBeau agreed, adding that this is trending up.

Mr. LeBeau reviewed the traditional board-directed approach along with four best practices approaches:

- Approach A, based on Ontario Teachers Pension Plan. The board is only involved in manager selection if the recommendation is over a certain dollar amount. One client of NEPC sets the minimum at $75 million. Staff's authority to select managers for mandates is up to a set dollar amount.

- Approach B, based on Missouri State Employees Retirement System, similar to Ontario approach, but board has no role in manager selection. Investment consultant, working with the CIO and executive director, makes the buy or sell decision for the plan. The CIO, working with the investment consultant, works with staff for idea generation to bring potential managers forward, and often it is the executive director who is the representative for the board in that capacity. They may not be involved in the due diligence process but are involved in the ultimate decision making process for that investment.

- Approach C, which NEPC feels is the best approach. In the case of Arizona State ($35 billion plan with ten staff members), the board and investment committee approve manager selection policy. There is also a well-defined monitoring policy to see how managers have done relative to expectations. The general investment consultant acts as fiduciary oversight advisor, working with staff on asset allocation and policy implementation, but has no say in investment manager searches. Under the board investment committee, there is a staff asset class committee established for private markets, and another staff asset class committee for private markets. In the case of the private market group, the private equity person will source an idea and do all of the due diligence work on it, and then call an internal private markets committee meeting (staff, CIO, executive director, plus the specialty consultant on the PE side, plus the general investment consultant, who acts as a "fly on the wall" but checks the boxes and answer questions). Staff makes a recommendation to the rest of staff. The director and CIO are present, and there is a motion made by other staff members to approve the investment. That concludes the approval process, and funding can begin the next day.

Mr. LeBeau commented that one of the reasons the IC chair at Arizona State wanted to get this structure in place was to insulate the board from any outside influences and to protect the plan in the future. Under this new construct, NEPC has less involvement in the investment decision-making process, but is more involved in the due diligence stage. Last year, NEPC was present at 36 meetings of varying length.

Dr. Woodfin asked Ms. Goodwin how the stakeholders might feel about a situation that would give the decision making to staff as opposed to the Board, whose members are largely selected from the stakeholder groups.

Ms. Goodwin responded that all of the conversations she has had with the NMERB stakeholders have been focused on questions about the operations side – how to maintain the sustainability of the fund and Return to Work issues.

Dr. Woodfin asked if IPOC would see Board members as abandoning their fiduciary responsibility by not being more directly involved in investment decisions.

Ms. Goodwin responded that, at last week's IPOC meeting, there was discussion about the fact that there is no best asset allocation that everyone should follow. She said she also feels this applies to governance, noting Mr. LeBeau's earlier comments in this presentation that the Board is responsible for setting policy, and staff is responsible for implementing policy. She suggested that the Board's fiduciary attorney, Ian Lanoff, be invited to discuss this further with the Board.

Committee members agreed to discuss this further at the November meeting.

5. <u>OTHER INVESTMENT REPORTS AND DISCUSSIONS</u> (Cont'd)

Mr. Jacksha reviewed a schedule of the buys and sells in the equity portfolio.

9. <u>NEXT MEETING: THURSDAY, OCTOBER 22, 2015 AT 12:00</u>

Mr. Jacksha distributed a draft agenda. He said the meeting could go past 5:00 p.m.

<u>ADJOURN</u>

Its business completed, the Investment Committee adjourned the meeting at 4:15 p.m.

Accepted by:

H Russell Goff

H. Russell Goff, Chairman