

ACTION SUMMARY

INVESTMENT COMMITTEE

August 25, 2016

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MINUTES OF THE
NEW MEXICO EDUCATIONAL RETIREMENT BOARD
INVESTMENT COMMITTEE

August 25, 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 12:05 p.m. in the Educational Retirement Board Conference Room, 6201 Uptown Boulevard, N.E., Ste. 203, Albuquerque, New Mexico.

Members Present:

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

Members Excused:

None

Staff Present:

Ms. Jan Goodwin, Executive Director
Mr. Bob Jacksha, CIO
Mr. Steve Neel, Deputy CIO, Alternative Investments
Mr. Mark Canavan, Real Assets Portfolio Manager
Ms. Kay Chippeaux, Deputy CIO, Public Markets and Credit
Mr. Aaron Armstrong, Portfolio Manager
Ms. Margaret Riquelmy, Executive Assistant

Others Present:

Mr. Kevin Tatlow, Top Tier
Mr. Dan LeBeau, NEPC
Mr. Aarish Patell, NEPC (by telephone)
Ms. Judith Beatty, Recorder

b. Approval of Agenda

Ms. Cameron moved approval of the agenda, as published. Mr. Magid seconded the motion, which passed unanimously by voice vote.

c. Approval of Minutes: July 21, 2016

Ms. Cameron moved approval of the July 21 minutes, as submitted. Mr. Magid seconded the motion, which passed unanimously by voice vote.

d. Introduction of Guests

Chairman Goff welcomed staff and NEPC consultant Dan LeBeau.

2. Z CAPITAL STRATEGIC PARTNERSHIP – PRIVATE EQUITY

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

Mr. Neel presented staff's recommendation of a \$50 million commitment to Z Capital Credit Tactical Fund I (CTAC). This is a recommitment to an existing relationship the NMERB has; in 2013, it committed \$40 million to Z Capital Partners Fund II, a distressed for control private equity fund. In 2014, the NMERB added \$9 million to that investment. To date, both commitments have returned a net IRR of about 30 percent.

-- The return profile for this fund is a 1.5x multiple with a net IRR of 15 percent. Z Capital is targeting \$500 million with a \$750 million ceiling for CTAC.

-- Z Capital will invest in broadly syndicated senior loans in dislocated sectors. Z Capital believes the credit markets are beginning to experience heightened volatility, dislocation and contraction, which will create opportunities to invest in leveraged credit borrowers.

-- The fund relies heavily on its proprietary database, ZAPP ("Z Analytics Portfolio Platform"), for its sourcing and diligence capabilities.

-- The NMERB partnered with Z Capital to launch this strategy and negotiated a number of investor friendly provisions. In addition to the \$50 million commitment, NMERB will establish a sidecar vehicle for overflow co-investment in the fund at attractive terms. Also included is credit research support to assist in the private equity underwriting process.

Mr. Tatlow commented that this is a nice fit into the portfolio. While the portfolio has distressed trading and distressed for control strategies, it does not have anything that is opportunistic in nature like this, and Top Tier feels this is an appropriate time for it.

Z Capital partners Bill Monagle, Andrew Curtis, Jim Zenni (CEO and founder), and Dave DeMilt appeared before the committee and made a presentation.

Ms. Goodwin asked if there are any sectors they prefer to lend into, or stay away from. Mr. Curtis responded that they look for strong downside protection, which leads them to asset-rich industries, although they are generally agnostic.

Ms. Goodwin asked what efforts Z Capital is making to improve diversification of their staff. Mr. Zenni responded that they have "remarkable" diversity and are very proud of it.

[Representatives left the room.]

Mr. Jacksha said he likes the fact that this offers downside protection, but also has the potential to contribute to returns on the upside. He said staff knows Z Capital well, and the NMERB is on their advisory board. He congratulated Mr. Neel and Mr. Tatlow for negotiating attractive terms and taking a proactive approach in putting this fund together.

Mr. Jacksha said the general language in the requested motion has been changed slightly. In the last sentence, which 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, “right of first refusal” has been removed.

Mr. Neel commented that this queues discussion scheduled later on today’s agenda, when the committee will be asked to grant staff the authority to bid on a secondary LP interest in a firm staff knows very well. The motion will allow staff to add capital, and sometimes there is time sensitivity involved and there isn’t time to return to the committee for approval.

Ms. Cameron moved that the Investment Committee approve a commitment of \$50 million to Z Capital Credit Tactical Fund, L.P. and \$50 million to an associated co-investment sidecar vehicle. 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. Mr. Magid seconded the motion, which passed unanimously by voice vote.

3. LONE STAR X – OPPORTUNISTIC CREDIT AND REAL ESTATE

[Presenters: Kay Chippeaux and NEPC consultants Dan LeBeau and (on phone) Aarish Patell]

Ms. Chippeaux stated that she and Mark Canavan are bringing Lone Star Fund X to the committee for approval for each of the investment portfolios – real estate for Mr. Canavan and opportunistic credit for her. She said this fund has an investment style that could fit in either of their portfolios. Rather than saying that they couldn’t find a place for this type of investment, Mr. Jacksha has implemented a policy whereby the NMERB can make the investment in both or either of the portfolios.

Ms. Chippeaux stated that there are 13 different managers in 19 different funds in opportunistic credit. The largest and most liquid is about one-fourth of the credit portfolio. Except for the two internally managed portfolios, it is also the largest manager in the total portfolio, weighing in at about 5.5 percent. Assuming all of the current and contemplated Lone Star funds were fully funded, Lone Star would represent slightly more than 10 percent of the opportunistic credit portfolio, and Lone Star would be slightly less than 10 percent of the real estate portfolio and about 3 percent of the total portfolio.

Ms. Chippeaux stated that, in addition, the opportunistic credit portfolio is well diversified as to types of investments, quantity of managers, and geographic location of the investments. The liquidity ladder in opportunistic credit is still fairly robust because of the maturity of the portfolio and because there is a variety of liquidity constraints among the managers.

Ms. Chippeaux stated that Lone Star VII has an IRR of 50 percent; Lone Star VIII, 27 percent; Lone Star IX (still in its early stages), 11 percent; and Lone Star Real Estate II, 31 percent.

Ms. Chippeaux said she and Mr. Canavan serve on the advisory committees of all of the Lone Star funds in which NMERB is invested. The committees meet telephonically three times a year and in person once a year. She said the annual meetings, which staff attends in person, give staff a very deep dive into the investments of each fund.

Mr. Patell presented an overview of Lone Star and this latest fund, Fund X.

-- The fund will target investments that capitalize on market dislocations where conservative underwriting can be used to acquire investments at a significant discount.

-- The fund will target investments in a broad range of financial and other opportunistic investment assets (other than commercial real estate investments), including, but not limited to, investments consisting predominantly of any of the following: single family residential real estate; non-performing and sub-performing single-family residential real estate secured debt, corporate debt, and consumer debt; control investments in financially oriented or other operating companies; and securitized products relating to single-family residential real estate, corporate debt or consumer debt.

-- The fund will target investments in global opportunities in North America, Latin America, Europe and Asia-Pacific.

-- The fund will seek to achieve, on an aggregate basis, a targeted investment-level gross return of 25 percent.

-- The fund is targeting \$6 billion with an unestablished hard cap.

Ms. Chippeaux stated that, when staff compared Lone Star to similar managers, staff thought they were very smart about how they use leverage. They manage leverage in some ways by warehousing and prefunding investments because they are able to use the capital commitments to get financing. In addition, they take some of the loans and re-securitize them and then sell the more senior pieces of these securitizations. She added that the size of the funds can be a real distraction, but in other ways it is a positive. She said a lot of banks might want to do a very large deal, discreetly and quietly, and know they can approach a manager like Lone Star because it has the backing and the ability to get it done. She commented that Lone Star has many years of experience in doing these kinds of deals – Lone Star X is almost identical to Lone Star IX and very similar to Lone Star VIII, so they know exactly what they need to underwrite the deals, have a lot of experience to do it, and have ownership in the servicing companies that allows them to make better underwriting decisions. She said they have proven, through their returns, that they have a plan that really works. In addition, they have developed partnerships that help them with origination.

Benjamin Sarly, Lone Star director of investor relations, and founder and CEO John P. Grayken (on the phone) made a presentation.

[Representatives left the meeting.]

Mr. Jacksha noted that one of the characteristics of these funds is that they do turn the money quickly. With a total commitment of approximately \$500 million, the NMERB has current exposure (based on market value) of about \$120 million, and a couple of the early funds are almost completely wound down. The NMERB is generally not 100 percent invested in these funds at any one time, but its exposure is not that big and is not a concern for him.

Mr. Magid moved that the Investment Committee approve a commitment of \$150 million, one hundred dollars to Lone Star Fund X, L.P. The commitment will be allocated in the amount of \$100 million to the Opportunistic Credit Portfolio and \$50 million one hundred dollars to Real Estate. 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. Ms. Cameron seconded the motion, which passed unanimously by voice vote.

4. INFRASTRUCTURE POLICY REVISION – INFRASTRUCTURE

[Presenters: Mark Canavan and Caledon Capital Management consultants Noi Spyrtatos and Asif Hussain.]

Mr. Hussain stated that Caledon and NMERB investment staff are recommending revisions to the Infrastructure Policy Statement, which is reviewed annually. The policy statement was originally approved in September 2007 and was last updated in March 2012.

-- Under Investment Structures and Vehicles, Public Equity and Public Debt ranges have been updated to provide more flexibility.

-- The proposed revised policy statement includes an increased allocation to co-investment/direct investments to 50% to accommodate a re-up to Caledon Andromeda Investments LP and continue the successful deployment of capital to this category, which reduces overall fees and enhances portfolio construction. This has necessitated changes to Investment Vehicle Exposure Ranges. In the ranges, Public Infrastructure Securities have been removed and replaced with Separate Accounts.

-- Ranges for portfolio liquidity have been removed and instead will be monitored by Caledon and investment staff and depend on structure-specific considerations.

-- A new category ("core-plus") has been added to Investment and Portfolio Risk/Return Ranges, and return expectations have been updated to reflect current market conditions. Policy range targets have been updated to accommodate the new category.

-- Geographic policy ranges have been updated to better reflect likely exposures to Australia/New Zealand.

Mr. Magid moved that the Investment Committee recommend the Board approve the revised Infrastructure Policy as presented. Ms. Cameron seconded the motion, which passed unanimously by voice vote.

5. CALEDON CO-INVESTMENT FUND – INFRASTRUCTURE

[Presenters: Mark Canavan and Caledon consultants Noi Spyrtos and Asif Hussain.]

Mr. Canavan stated that staff was recommending that the Investment Committee approve the creation of a new co-investment vehicle for infrastructure, with a commitment of \$100 million, with Caledon as general partner. He noted that the NMERB began creating these types of funds in 2009, with the Blackrock/ERB Co-investment Fund. Shortly after that, NMERB created a secondary opportunity fund with Real Asset Portfolio Management (RAPM) on the real estate/real asset side with \$40 million, which was followed by an NMERB co-investment vehicle with Caledon as the general partner (Caledon Andromeda Investments). He said NMERB subsequently created a co-investment vehicle with RAPM for real estate and natural resources. He said the net IRRs for the secondary fund and the real asset fund run by RAPM are 9.59 percent and 29.45 percent respectively; and for the Caledon Andromeda infrastructure fund, the net return is 33.2 percent. He commented that this is an exceptionally high return for an infrastructure fund and it is because of a highly successful investment in the Carlsbad Desalination Project. He said typical returns in infrastructure assets are closer to 9 to 12 percent net.

Mr. Canavan discussed the terms and conditions of this co-investment vehicle.

Mr. Hussain and Ms. Spyrtos made a presentation.

Committee members discussed the importance of regularly informing the members, through the newsletter, about infrastructure and real assets investments the NMERB is making in the U.S.

Mr. Jacksha said staff feels that co-investment is a very good general vehicle for the NMERB. The fees are lower, there is greater selectivity, and it has been a very successful strategy to date.

Mr. Canavan commented that the NMERB is fortunate to work with Caledon, which has a very talented team.

Ms. Cameron moved that the Investment Committee approve the creation of a new co-investment vehicle for infrastructure with a commitment of \$100 million. 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. Mr. Magid seconded the motion, which passed unanimously by voice vote.

6. SECONDARY LP INTEREST PURCHASE – PRIVATE EQUITY

Mr. Neel said the NMERB sits on the advisory board of Edison Fund VII and Edison Fund VIII. Edison Partners is a leading growth equity investor in rapidly growing software and technology-enabled companies, and for nearly 30 years has consistently delivered top quartile returns in multiple market conditions. Last week, the managing partner indicated that one of their LPs is seeking liquidity for a \$15 million commitment.

Mr. Neel noted that, as part of their contractual relationship with NMERB, Top Tier Capital Partners is required to perform up to two secondary underwritings per year. If approved, this would be the first underwriting for 2016 and would be completed in conjunction with NMERB staff.

Mr. Neel stated that staff is requesting authority to evaluate and execute on the LP secondary interest if the return is accretive to the existing private equity program.

Mr. Neel said Fund VII has a 21 percent net IRR to date with a 1.6x multiple.

Mr. Magid moved that the Investment Committee authorize the staff, in conjunction with Top Tier Capital Partners, to bid on secondary LP interest in Edison Ventures Fund VII in the amount of \$15 million of original face value. 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. Ms. Cameron seconded the motion, which passed unanimously by voice vote.

7. INVESTMENT POLICY REVISION

Mr. Jacksha reviewed the final changes to the Investment Policy document, to be presented for final approval at tomorrow's board meeting.

Mr. Jacksha said the major changes were to revise the asset allocation table (as discussed at the last board meeting), to add language to the Diversifying Assets category, pulling in GTAA and Risk Parity under the General category, and adding an Other category. The strategies and asset classes included under "Other" may include (but are not limited to) reinsurance, royalty strategies, litigation finance, risk premia strategies other than risk parity, and certain hedge fund strategies.

Ms. Cameron moved that the Investment Committee recommend the board approve the revised Investment Policy Statement, as presented. Mr. Magid seconded the motion, which passed unanimously by voice vote.

8. Q2 PROXY VOTING REPORT

Mr. Jacksha presented this report.

Ms. Cameron moved acceptance of the Proxy Voting Report. Mr. Magid seconded the motion, which passed unanimously by voice vote.

9. Q2 COMMISSION REPORT

[Informational item.]

10. OTHER REPORTS AND DISCUSSION

Mr. Jacksha commented that the fund had a good month in July, ending at about 2.5 percent, with balances up to \$11.7 billion. This is the highest the NMERB has ever ended a month on, so this was very good news.

Ms. Goodwin discussed next week's IPOC hearing, which would focus on what the state could do for its citizens who weren't part of a pension plan.

Ms. Goodwin said she and PERA Executive Director Wayne Propst have been asked to make presentations on their funds' impact on the New Mexico economy.

11. NEXT MEETING: THURSDAY, SEPTEMBER 22, 2016

The meeting was scheduled at 1:00 p.m.

ADJOURN

Its business completed, the Investment Committee adjourned the meeting at 3:40 p.m.

Accepted by:



H. Russell Goff, Chairman