ACTION SUMMARY

INVESTMENT COMMITTEE

May 26, 2016

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MINUTES OF THE

NEW MEXICO EDUCATIONAL RETIREMENT BOARD

INVESTMENT COMMITTEE

May 26, 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 12:30 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
Dr. Beulah Woodfin [by telephone]

Members Excused:
None

Staff Present:
Ms. Jan Goodwin, Executive Director
Mr. Bob Jacksha, CIO
Ms. Kay Chippeaux, Fixed Income Portfolio Manager
Mr. Rod Ventura, General Counsel
Mr. Alan Myers, Financial Analyst
Mr. Mark Canavan, Real Assets Portfolio Manager
Mr. Aaron Armstrong, Portfolio Manager
Ms. Margaret Riquelmy, Executive Assistant

Others Present:
Mr. Allan Martin, NEPC
Mr. Siddique Haq, NEPC [by telephone)
Mr. Oliver Fadly, NEPC [by telephone}
Mr. Steve Gruber, RAPM
Mr. Brent Burnett, RAPM
Ms. Judith Beatty, Recorder

b. Approval of Agenda

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

c. **<u>Approval of Minutes</u>: April 21, 2016**

Dr. Woodfin moved approval of the April 21 minutes, as submitted. Mr. Magid seconded the motion, which passed unanimously by voice vote.

d. **<u>Introduction of Guests</u>**

Chairman Goff welcomed staff and guests.

2. **<u>GSO CAPITAL OPPORTUNITIES FUND III – OPPORTUNISTIC CREDIT</u>**

[Presenters: Kay Chippeaux and NEPC consultant Allan Martin. On the telephone: NEPC consultants Oliver Fadly and Siddique Haq.]

Ms. Chippeaux presented staff's recommendation for a $125 million commitment to GSO Capital Opportunities Fund III, which is targeting $5 billion.

Ms. Chippeaux said the NMERB invested with this manager in September 2011 in a separately managed account. They were doing unlevered senior secured direct lending investments for NMERB, but the spreads have come in so far on that product that they have not made an investment in the NMERB's account since 2013. The account is unwinding and NMERB expects to exit it later this year.

Ms. Chippeaux said NMERB likes how this manager invests in this space. The current opportunity focuses on providing capital structuring solutions for upper middle market and large cap size performing companies. Because of their size, experience and geographical focus, GSO expects to offer different structuring solutions to these companies depending on individual need. The fund should benefit from very few competitors in that space, and NMERB expects to generate premiums for illiquidity and complexity risk. The fund will invest in the US and Europe.

Ms. Chippeaux stated that this fund fits very well in the NMERB's opportunistic credit bucket. GSO expects to take advantage of situations in corporate credit with the lack of availability of capital to certain types and sizes of companies. NMERB likes how this fits in its strategy, geography, and liquidity constraints in the portfolio.

Mr. Martin commented that the NMERB has a 20 percent allocation in private debt, and it has done very well. GSO was one of the managers originally hired by NMERB to do the larger transactions in leveraged buyout activities. They are a large firm with broad resources, and NEPC feels they are well qualified to undertake this activity.

Messrs. Fadly and Haq discussed the due diligence process, which involved multiple telephone calls and on-site meetings, as well as the advantages of this commitment. NEPC likes this manager because of their ability to be flexible in a market like this one, moving up and down the capital structure, unlike traditional mezzanine and subordinated debt managers who are stuck within that part of the capital structure. Being part of the Blackstone platform allows them to leverage resources and capabilities to identify potential opportunities, and their brand name enables them to source good deals. Further, there is not a lot of competition in this space. Finally, the members of the team have been together for a long time and work together very well in terms of how they approach the market in this space.

GSO Capital representatives Rob Petrini (managing director) and Tao Bu (client relations/marketing) appeared before the committee and made a presentation.

[Mr. Petrini and Ms. Bu left the room.]

Mr. Jacksha said the NMERB has had an existing relationship with GSO through a separate account, as discussed in staff's presentation. While it started out initially quite well, that opportunity faded; and to their credit, they decided not to invest and not take the fees, etc. Mr. Jacksha said he appreciated that disciplined approach. He added that he has visited GSO a couple of times in New York, and his impression has always been that they are a good, solid credit shop.

Ms. Chippeaux said she met with GSO several times when they had the separately managed account and again this spring during the due diligence for this particular fund. She said she is very impressed with their ability to manage credit but also by the way they have successfully used their footprint with their sourcing of deals and managing of deals. She said GSO is a world-class organization with a sustainable business model, and they have shown they can do this type of investing in different kinds of markets and can withstand all of the market volatility that the NMERB has seen. The management team is very high quality, and they look to structure deals that work very well for the company but also where they maintain control, so that they can sit on creditor committees or have what they call "fulcrum security," where they have control over what happens if the credit goes bad. She said they also have a very good risk reward for the types of investments they do and the type of return seen in their prior funds.

Ms. Cameron moved that the Investment Committee approve a commitment of $125 million to GSO Capital Opportunities Fund III, 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. Dr. Woodfin seconded the motion, which passed unanimously by voice vote.

3. REAL ESTATE AND NATURAL RESOURCES PERFORMANCE REPORT

[Presenters: Mark Canavan and RAPM consultant Steve Gruber.]

Mr. Canavan presented this report, with the following highlights:

-- As of December 31, 2015, NMERB had a total portfolio value of $11,110,179,605 and net asset value of the real estate portfolio was $811,800,861, and net asset value for the natural resources portfolio was $248,881,231.

-- As of December 31, 2015, NMERB had $396,536,412 of committed but uncalled allocations to private real estate managers and $253,578,147 of committed but uncalled allocations to Natural Resources managers.

-- Public Real Estate net IRR since inception is 12.91 percent.

-- Private Real Estate net IRR since inception is 10.32 percent.

-- Natural Resources net IRR since inception is 5.09 percent.

4. REAL ASSET CO-INVESTMENT FUND II – REAL ESTATE AND NATURAL RESOURCES

[Presenters: Mark Canavan and RAPM consultants Steve Gruber and Brent Burnett.]

Mr. Canavan presented staff's recommendation to create a second co-investment fund of $100 million to invest in real assets as opportunities arise. NMERB's commitment will be $99.5 million, with RAPM committing $500,000.

As background, Mr. Canavan stated that, in 2007, NMERB established an allocation to Real Assets with Real Estate and Infrastructure as part of the overall allocation. In 2008, the Real Assets program was expanded to include Natural Resources. Early in the life of the program, staff began exploring opportunities to invest outside the private equity fund model to deploy capital more cost effectively by investing directly, alongside proven managers (co-investing) and/or buying LP interests from institutions needing liquidity. In 2009, the NMERB created a secondary investment vehicle and appointed Mr. Gruber's group to be the manager of that fund. Specifically, NMERB also created a model where it only looked at investments with groups where NMERB could potentially consider doing a fund investment over time with people it already had a relationship with and could buy a secondary piece from, or to build relationships in the future. This limited the universe and avoided the possibility of a small staff being overwhelmed with transactions. In 2012, NMERB created Caledon Andromeda Investments, LP to co-invest in infrastructure assets. The creation of NMERB's RAPM-NM co-investment program followed in 2013 with an initial $80 million fund size.

Mr. Canavan said the performance of these funds has been good, although RAPM-NM Secondary Opportunity Fund is performing below target currently with a since-inception IRR of 9.6 percent, down from 16.49 percent at year-end in 2014. The decay in return is due to one energy related asset pulling back in that particular fund; but as it recovers, the secondary fund will also recover.

Mr. Canavan stated that NMERB's private equity net IRRs are 17.77 percent and 12.67 percent for the BR/ERB I and BR/ERB II funds respectively. For infrastructure, the since-inception net IRR for the Andromeda infrastructure co-investment fund is 14 percent, and NMERB's real asset co-investment fund (RNCF I) has a high 34.2 percent rate of return that should trend into the mid to high teens. Overall, NMERB's co-investment programs are tracking well and costing significantly less than standard private equity fund structures.

Mr. Canavan stated that the relationship with RAPM began in the last half of 2007 under the name of the predecessor firm ORG Real Property. Seeking better customer service, a more dynamic and robust consulting relationship, and wanting access to leading edge investment analytics, NMERB staff was supportive of the creation of a new firm. Since that time, RAPM has delivered on each of its promises, grown to a staff of ten, and built a solid, state-of-the-art consultancy with state-of-the-art performance metrics.

Mr. Gruber and Mr. Burnett made a presentation. He stated that RAPM currently manages $800 million in single investor co-investment and secondary funds for large state pension funds while advising on another $2.8 billion of real asset fund and separate account assets as a non-discretionary consultant.

Mr. Martin asked if RAPM's role as a discretionary adviser as well as a manager presents conflicts in transactions allocations to different client accounts, and how does RAPM address those.

Mr. Gruber responded that RAPM has an allocation policy, and the first test of a co-investment is who sourced it and who is the underlying manager in their portfolio of clients and funds. As an example, NMERB is RAPM's sole client in Saris Regis, so any opportunity that comes in through Saris Regis comes to New Mexico first. Lone Star is another example of a bigger fund, but they are so large that the odds of a co-investment coming through would be very limited. If a co-investment were to come through Lone Star, however, RAPM would work through a pro rata allocation of that opportunity, but the chances are in a firm of RAPM's size, with about ten clients, the timing often makes these rather unique to one fund. RAPM has done a couple of energy deals recently that they've shared with clients and they have never been capped out on size. Were they capped out, they would just do a pro rata allocation.

Mr. Burnett said RAPM always make clear that a co-investment does not precede a fund investment or vice versa; they are always done in isolation. Some of RAPM's 21 co-investments have ultimately led to investments because RAPM has been so impressed by the deal sponsor and the strategy, but most have not. He said there has never been a situation where RAPM has had to allocate capital across clients because there was a capacity constraint. This is because it was either very clear through their allocation policy whom it came through and whom it belonged to, or there was ample capacity across their client base.

Messrs. Gruber and Burnett left the room.

Mr. Jacksha stated that Mr. Canavan's report nicely summarizes what the NMERB's history has been with co-investment funds, and these funds, including RAPM, have done well for NMERB. Staff continues to like these structures because of the lower fees, but even more important is the ability to be selective in doing deals with having the consultant and staff look at them.

Mr. Magid moved that the Investment Committee approve the creation of a new co-investment vehicle, managed by Real Assets Portfolio Management, for real assets with a commitment of $99.5 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. Ms. Cameron seconded the motion, which passed unanimously by voice vote.

5. ISS CONTRACT

[Presenter: Alan Myers]

Mr. Myers stated that the NMERB's contract with Institutional Shareholder Services (ISS) for Class Action Litigation services is up for renewal at the end of June. ISS has agreed to extend the contract for an additional two years, with no change in price, at $35,000 annually. At this time, there are no issues that would justify seeking a new vendor, and he would therefore recommend extending the contract for an additional two years.

Ms. Cameron moved that the Investment Committee approve the extension of the Institutional Shareholder Services contract for Class Action Litigation services for an additional two years with the understanding that the fee charged for these services will not change. The commitment is subject to

New Mexico State Law, Educational Retirement Board policies, and negotiation of final terms and conditions, and completion of appropriate paperwork. Mr. Magid seconded the motion, which passed unanimously by voice vote.

6. SMALL INVESTMENT-RELATED PURCHASE APPROVALS

Mr. Jacksha stated that, since the latest revision of the Investment Services Procurement Policy, staff has been bringing every small contract to the Investment Committee for approval. In reviewing the policy, staff noted that several of these contracts have been for amounts that fall under the small investment-related purchases, ranging from $2,000 per year to $29,000 per year. The upper limit for a small investment-related purchase is currently $60,000, as set by state statute.

Mr. Jacksha said staff will be stepping back on this practice, and going forward, several of the investment services contracts will be approved by the Executive Director on an annual basis, as provided in the Investment Services Procurement Policy, Section E., Selection of Service Providers. He said staff will provide the Investment Committee with a list of those approvals on an annual basis as an information item.

7. INVESTMENT GOVERNANCE RECOMMENDATION

Mr. Jacksha said he has prepared a brief memo regarding NMERB investment governance, outlining what the current process is. The current process is as follows:

1. Investment staff and consultants conduct due diligence and present recommendations and reports to the Investment Committee (IC).
2. In addition, managers make presentations at IC meeting.
3. IC reviews information and takes a formal approval vote.
4. Investments are monitored on an ongoing basis by staff and consultants with periodic reports to the IC and Board.
5. Manager terminations and replacements are also approved by the IC.
6. Selection of consultants follows the same process of staff recommendation and IC approval, with the exception of the general consultant. Board approval is required for the general consultant.

Mr. Jacksha said a feasible alternative to the current process would be to delegate some level of authority to staff to perform functions listed in 1-3, 5 and 6 above.

Mr. Jacksha stated that he wasn't advocating one way or another, but wanted to give the committee a framework to have a discussion on this.

Chairman Goff wondered about transparency. If staff is holding meetings and making decisions that previously were in a public meeting, how would members of the public and the NMERB constituency feel about that. Mr. Jacksha responded that the NMERB would never withhold the results of those staff decisions from the public. He said perhaps the information could be transmitted through press releases.

Ms. Goodwin stated that the information could be posted on the website, too.

Responding to Ms. Goodwin, Mr. Martin stated that the Arizona State Retirement System does not post the results of staff's investment decisions. He said he is not aware of any backlash or questions raised about that, but added that the laws about transparency vary from state to state.

Dr. Woodfin said that, were she continuing on the board, she would be very concerned about the curtailment of the trustees' fiduciary duty. She said she felt the trustees needed to be more involved in order to adequately exercise their fiduciary duty; and it would be a public perception, as well. She added that it is great to reduce the workload of the board members, however.

Mr. Jacksha said this goes to item #3. He commented that it is mainly a public perception, because the NMERB could still distribute all of the information that it currently distributes so the trustees would still be in the information loop; and ultimately, if they did have an objection, they could raise it before action is taken. He agreed that there is the potential of the public perception that the trustees are less involved, though.

Ms. Goodwin said this goes to the issue of what is the appropriate role of the trustees, as there is a wide range of thought on that. She suggested this be discussed in the upcoming strategic planning session.

Committee members discussed holding a board work session with participation from Paul Matson of the Arizona State Retirement System (ASRS); the ASRS chairman of the Board of Trustees; and Ian Lanoff.

Mr. Martin noted that "fiduciary duties" do not require the board to make every decision, but, rather, to have a process for making the decisions. With ASRS, the process for asset allocation is a board responsibility, and they hear the proposals and make the decisions. On manager selection, that board has designed a process that delegates the responsibility to staff and they have a system for monitoring the process. When their board meetings happen every quarter, the board hears a complete report on how the manager selection process worked; so they hear a full description of how many meetings were held, the number of managers selected, what procedures were followed, etc.

In terms of trustee involvement, Mr. Martin said the Arizona board only hears from him and CIO Paul Matson, which means the board does not have any significant exposure to the staff members. Mr. Jacksha commented that this could be a disadvantage for the NMERB, because staff would not be interacting with trustees as much. Ms. Goodwin pointed out, though, that there are other mechanisms for that to happen. For instance, on a quarterly or semiannual basis, Mr. Canavan, Mr. Neel and Ms. Chippeaux can present status reports to the board.

8. Q1 2016 PROXY VOTING REPORT

Mr. Jacksha commented that, more and more often, he is seeing a recommendation from ISS to vote against a director candidate because the board ignored a majority shareholder vote on a certain item, and the board hasn't taken any action to address shareholder concerns.

Dr. Woodfin moved to accept the Proxy Voting Report. Ms. Cameron seconded the motion, which passed unanimously by voice vote.

9. Q1 2016 COMMISSION REPORT

[Informational item.]

10. OTHER INVESTMENT REPORTS AND DISCUSSIONS

Mr. Martin presented this report, with the following highlights:

-- Over the past 3 years, the Fund returned 6.0% per annum, outperforming the policy index by 1.0% and ranking in the 57th percentile of its peer group.

-- For the year ending March 31, 2016, the Fund experienced a net investment gain of $44.8 million, which includes a net investment gain of $124.1 million during the quarter. Assets decreased from $11.4 billion 12 months ago to $11.1 billion on March 31, with $336.4 million in net distributions during the year. The Fund retuned 0.4%, outperforming the policy index by 70 basis points and ranking in the 16th percentile of its peers.

Mr. Martin stated that, as anticipated in this lower-return market environment, the longer-term returns for the NMERB and all of its peers have eroded. While the total fund had a return of 9.1% 30 years out, the 20 year return is at 6.9% and the 10 year return is at 5.6%.

Mr. Jacksha commented that, if depressed conditions like this continue, the NMERB will probably have to think about lowering the assumed rate.

11. NEXT MEETING: THURSDAY, JUNE 23, 2016 AT 1:00 P.M.

Committee members and staff expressed their appreciation for Dr. Woodfin's contributions over the years and said she would be missed.

ADJOURN

Its business completed, the Investment Committee adjourned the meeting at 3:00 p.m.

Accepted by:

H Russell Goff

H. Russell Goff, Chairman