ACTION SUMMARY

INVESTMENT COMMITTEE

April 23, 2015

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MINUTES OF THE

NEW MEXICO EDUCATIONAL RETIREMENT BOARD

INVESTMENT COMMITTEE

April 23, 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
Mr. Larry Magid [by telephone]
Dr. Beulah Woodfin

Members Excused:
None.

Staff Present:
Ms. Jan Goodwin, Executive Director
Mr. Bob Jacksha, CIO
Mr. Steve Neel, Deputy CIO
Mr. Mark Canavan, Real Assets Portfolio Manager
Ms. Kay Chippeaux, Fixed Income Portfolio Manager
Ms. Christine Ortega, Investment Financial Analyst
Mr. Aaron Armstrong, Portfolio Manager
Mr. Robert Quinlan, Intern

Others Present:
Ms. Judith S. Beatty, Recorder
Mr. Allan Martin, NEPC
Mr. Brent Burnett, RAPM
Mr. Howard Kaplan, RAPM

b. Approval of Agenda

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

c. Approval of Minutes of 3/26/15

[Moved down on the agenda.]

d. Introduction of Guests

Consultants and staff were acknowledged.

2. EMERGING MARKET DEBT SEARCH PROCESS

[Presenters: Kay Chippeaux and NEPC consultant Allan Martin]

Ms. Chippeaux presented staff's recommendation that the Investment Committee 1) approve a six-month extension through December 31, 2015, of the Pictet Asset Management Limited contract dated July 25, 2011; and 2) approve an emerging market debt manager search and that the procurement procedure be through a publicly advertised RFP.

Ms. Chippeaux briefed the committee on staff's plan to modify the emerging market debt (EMD) strategy within the portfolio.

Ms. Chippeaux stated that, in 2011, ERB hired two EMD managers: Pictet and EMSO. At the time of the investment, ERB felt that investing in EMD using local currency would provide the best performance. ERB made the Pictet investment in a separately managed account, and they invest in local currency denominated debt. ERB's investment in EMSO is through an open-ended contract, and staff expects to bring forward a recommendation for the EMSO investment in May.

Ms. Chippeaux stated that ERB has a current asset allocation target of 2 percent in the EMD space, and its current actual allocation is 1.7 percent.

Ms. Chippeaux said the proposed change in the EMD investment mandate would allow the investment manager the flexibility to invest in either or both local currency or external debt because they perform very differently over time. An active manager with a flexible mandate would therefore be expected to take advantages of the differences in performance.

Ms. Chippeaux said staff proposes selecting one or more managers in this space who would invest in both local and hard currency debt. She noted that NEPC maintains a Focused Placement List (FPL) of investment managers, but staff recognizes that the Board prefers that the ERB use the RFP as the search method. She said staff believes there are a sufficient number of investment managers that this would be an appropriate use of the RFP process.

Mr. Martin said NEPC estimates that there are about 40 managers who would reply to a search, but only about 20 would be large enough, and with a sufficient track record, for the ERB to consider. He noted that NEPC's FPL list has six. While the RFP process is long and involved for staff – three to four months -- in this instance NEPC does not think there is any urgency or need to move more quickly, and in fact, there could be an advantage to waiting in terms of potentially improved performance.

Ms. Cameron moved that the Investment Committee approve a six-month extension of the Pictet Asset Management Limited contract to expire on December 31, 2015. Dr. Woodfin seconded the motion, which passed unanimously by voice vote.

Dr. Woodfin moved that the Investment Committee authorize the Investment staff to use a Request for Proposal procurement method in selecting an emerging market debt managers. Ms. Cameron seconded the motion.

Dr. Woodfin asked if this would be a single manager, or might there be multiple managers.

Ms. Chippeaux responded that she would prefer a single manager, but sometimes there can be excellent proposals from more than one manager, in which case staff might want to split it differently.

The motion passed unanimously by voice vote.

1. c. **Approval of Minutes of 3/26/15**

Dr. Woodfin moved approval of the minutes of the March 26 meeting, as submitted. Ms. Cameron seconded the motion, which passed unanimously by voice vote.

3. **BP FUND I (NATURAL RESOURCES)**

[Presenters: Mark Canavan and RAPM consultant Brent Burnett]

Mr. Canavan presented staff's recommendation of a $30 million commitment to BP Natural Gas Opportunity Partners, L.P., provided that the fund has at least $230 million in committed capital, including the ERB commitment. The Fund is sponsored by BP Capital, the energy investment firm of T. Boone Pickens. Mr. Pickens will own 50% of the General Partner of the Fund, with the Fund management team owning the remaining 50%.

Mr. Canavan stated that the strategy is to move energy use from high BTU (British Thermal Units) usage to natural gas, which is a more efficient use. He stated that current practice is to truck diesel in to the oil production fields in order to power equipment, while flaring off natural gas that instead could be used to cycle into an engine and create electrical generation. He noted that natural gas is also cleaner.

Mr. Canavan stated that Mr. Pickens is 86 years of age. Because the fund has a 10-15 year life, he acts in an advisory capacity but continues to meet with the team. Mr. Canavan stated that the due diligence process has taken two years in order to make sure that milestones have been hit and because it was Mr. Pickens who drove the prior track record rather than the team.

Mr. Burnett said the primary theme is that the price differential between oil and gas is very different from the energy differential. A single barrel of oil will produce about 5.8 million BTUs of energy, while natural gas is priced in million BTUs as well; so the price differential from gas to oil should be about 5.8 times the cost of an MMBtu of gas. With gas at $2.75 to $3.00 and oil at $55 a barrel, the differential is wildly out of whack relative to the energy equivalent of those two commodities, and it is projected to be that way for a very long time. He said the driving force behind is this strategy is that there are lots of companies that recognize that natural gas is a much cleaner and cheaper alternative to them for fuel, but they don't have opportunities to switch easily from using diesel or oil-based fuels to natural gas. He said this strategy will create opportunities for these companies to switch more easily to a natural gas substitute.

Mr. Burnett said RAPM has been watching this team for a couple of years,but has moved cautiously given that it is a first time fund. They now have four investments in the fund and have demonstrated an ability to source these opportunities. He added that this is a very nice hedge to the other energy exposures that the ERB has in the portfolio.

Dr. Woodfin noted that the ERB recently invested in a company that is involved in midstream energy production, and asked if this is a competing organization, or is the market big enough for all of them.

Mr. Burnett responded that the ERB did invest in Five Point Capital. He said he feels the market is big enough, adding that the companies are involved in different basins, and it is also on a size that is quite a bit smaller than the midstream assets that Five Point is targeting. With BP, midstream is expected to be about 25 percent of the strategy, and will be complementary to Five Point most of the time, which is not to say that there will be a small overlap at times.

Mr. Canavan stated that McCarvill Capital Partners was employed as a placement agent by BP Capital Partners in this proposed investment. In addition, Mr. Pickens and his organization have made campaign contributions to Susana Martinez, but the BP Capital Partners individual team members have not.

Mr. Canavan introduced BP Capital Partners representatives Alex Szewczyk and Loren Soetenga, who made a presentation. Also present was placement agent Tom DeFranco.

Responding to Ms. Goodwin, Mr. Szewczyk stated that their barrier to entry is the ability to use unprocessed natural gas directly from the well. In this case, the processing cost has been taken out of it, and so their units have a big cost advantage versus competitors in the marketplace.

Dr. Woodfin asked if there will still be a demand for this type of technology if the price of oil goes back up to its previous levels. Mr. Szewczyk responded yes. He said the strategy succeeds because natural gas continues to be much cheaper than the alternative, which is usually crude oil.

[Representatives left the room.]

Chairman Goff asked if this investment would be affected with the loss of T. Boone Pickens, and Mr. Canavan responded that this was actually Alex Szewczyk's design and concept, and is a standalone business. He said Mr. Pickens does not have control or a formal vote, although he acts as a mentor to the team and has a substantial investment in this fund. Mr. Burnett clarified that Mr. Pickens is not a key person in the fund, and though he is one vote on the investment committee, he holds no veto power.

Mr. Jacksha commented that this is a unique fund with a unique angle, and recommended approval.

Mr. Jacksha noted a caveat in the motion for approval, which is that the fund have at least $230 million in committed capital, including the ERB's investment. He said BP has assured the ERB it will reach that level.

Ms. Cameron moved that the Investment Committee approve a commitment of $30 million to BP Natural Gas Opportunity Partners, L.P., provided that the fund has at least $230 million in committed capital, including the ERB commitment. 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 provisions of the limited partnership agreement for this fund. Dr. Woodfin seconded the motion, which passed unanimously by voice vote.

4. EIP FUND III (NATURAL RESOURCES)

[Presenters: Mark Canavan and RAPM consultant Howard Kaplan]

Mr. Canavan presented staff's recommendation of a $50 million commitment to Ecosystem Investment Partners 3 (EIP 3). This is a follow-on investment for the ERB, which invested in EIP 2. The general partner is currently raising $200 million for the fund, which has a net IRR target of 13+ percent.

Mr. Canavan stated that, under the Clean Water Act and the Endangered Species Act of 1972 and 1973 respectively, anyone impacting certain protected environments, habitats or waterways has to mitigate the impacts caused to the environment. He discussed the evolution of the Acts over time and changes that were made by regulators to carry out the intent of these laws after developers found ways to circumvent them. Over time, environmentalists came up with a better solution, which was to restore large tracts of land, put them into a conservation easement, and obtain credits from regulatory agencies for that. EIP is at the forefront of institutionalizing this emerging industry, and fund returns are derived from the sale of the credits.

Mr. Jacksha noted that, in terms of competition, there are a number of players that are regional and do very small projects, and none of those have the national scope that EIP would.

Due to the potential retirement of Mr. Danforth, staff underwrote this from the perspective of the team without Mr. Danforth. Staff and RAPM are comfortable that the team will do exceptionally well going forward, as it is doing currently.

EIP managing partners Fred Danforth and Nick Dilks appeared before the committee and made a presentation.

Dr. Woodfin asked what EIP does with properties once they have been restored.

Mr. Dilks responded that EIP is required to encumber the land with a conservation easement. It does not transfer EIP's ownership, but states that no one in the future can reverse the restoration and the protection that EIP has done. After that, EIP needs to dispose of the properties. He said sometimes it is a parks department or a wildlife preservation group that buys the properties; and in other instances, EIP has sold land to recreational groups that want to use the property to hunt, fish and recreate. They cannot ever develop it, mine it or reverse the restoration. Because in most cases EIP has taken the property from a traditional commercial use and converted it to recreational land, the property itself diminishes in value, but it is the sale of the credit that generates the return.

Responding to Mr. Magid, Mr. Dilks stated that "entitlement" is the term EIP uses at the moment the property has achieved approval from the Army Corps of Engineers to become a mitigation bank. EIP signs a "mitigation banking instrument" with the Army Corps that defines all of the things that are required of EIP in order to generate credits, and puts requirements on the Army Corps as to when they need to release the credits for sale.

Responding to a question from Mr. Magid about how political the process is in working with the Army Corps of Engineers, Mr. Dilks said that they are "amazingly un-political" and have been pretty good at keeping a distance from any pressure to make policy changes. He commented that EIP finds them to be quite consistent, and the rules are fairly well set out. He said he, Murray Starkel, David Urban and others on the team have a lot of experience working with the Army Corps of Engineers, and that experience and knowledge is a barrier to entry in their business for a lot of people who would like to be in this business but do not know how to manage those regulatory relationships.

Mr. Danforth added that EIP is doing the largest projects that have ever been done in this type of work, and there are economies of scale and efficiencies in what they do, and there are also very significant ecological benefits to the scale at which they operate. He said this scale is noticeable, and they have found that relationships in new districts and geographies of the Army Corps of Engineers have been immediately influenced by EIP's reputation and comments from other Army Corps districts. He said this is a terrific benefit. He added that having Murray Starkel, a former Army Corps deputy district commander, on their team has been extremely helpful.

Mr. Martin asked if there are actions that a Congress that seems to be hostile to environmental protection – such as the repeal of the Clean Water Act – could take that could materially impact EIP's success going forward.

Mr. Dilks responded that, as long as there is a desire to have both environmental protection and development, the mitigation construct is always there. He said there are policy changes from time to time, which EIP is always on top of, but there would have to be a fundamental shift in what has been in place for 50 years for there to be a significant impact.

Mr. Jacksha noted that this was a concern when the ERB invested in Fund 2, i.e., would it have to rely on regulations from the government that may go away. Staff's findings were that there is an extremely low risk that any changes in the regulatory environment could get to the point where they do not allow EIP to operate.

[Representatives left the room.]

Mr. Jacksha stated that this is a repeat manager for the ERB; they have done well on their first project, and he was very impressed with their team when he visited their offices. He said staff recommends approval.

Mr. Martin asked how Mr. Jacksha looks at an investment with a slightly lower return compared to private equity, longer timeframe to maturity, and sensitivity to a changing regulatory environment, versus a shorter-term investment with a projected higher rate of return. Mr. Jacksha responded that this offers good diversification and is not subject to the fluctuations of the stock market. He also stated that he likes the fact that it is fairly long term because the ERB is a long-term fund, and permanent or long-term investments therefore fit the ERB very well. He added that, as the ERB has seen, this is starting to generate cash flow and that will continue.

Dr. Woodfin moved that the Investment Committee approve a commitment of $50 million to Ecosystem Investment Partners Fund III. 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 provisions of the limited partnership agreement for this fund. Ms. Cameron seconded the motion, which passed unanimously by voice vote.

5. Q4 INFRASTRUCTURE PERFORMANCE REPORT

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

Mr. Canavan reported that the restructuring of Citi Infrastructure Partners, now called Gateway Infrastructure, has been completed.

Mr. Canavan reported that the fair value of the portfolio in Q4 was $139 million, with unfunded investments of $222 million. Total number of funded investments is seven, with one direct investment. The total rate of return since inception is 2.4 percent, largely due to events that transpired with Citi Infrastructure Partners.

Ms. Spyratos and Mr. Hussain reported on investments in the portfolio.

Mr. Jacksha noted that the ERB/Caledon have been looking at some co-investment deals.

Mr. Hussain commented that flow has been surprisingly strong over the last six months. In the last quarter, Caledon closed on two opportunities, one in energy, and the other in power generation. He said both are greenfield investment opportunities, and that is where Caledon is seeing a lot of value lately. It is very competitive right now for already-existing assets, so their focus has been more on finding opportunities to build new infrastructure.

6. PORTFOLIO POSITIONING DISCUSSION

Mr. Jacksha stated that this discussion is mainly around what the ERB's allocation to equity is and its perception of risk in the markets.

Mr. Jacksha stated that the ERB's target is 35 percent public equities. As the markets have gone up over the last couple of years or so, the ERB has occasionally sold off pieces of the equity portfolio, but has always kept the allocation a little bit above the target. The ERB has recently reversed that position and is currently at about 34.5 percent, and intends to stay closer to the target in the near future. He said there are a couple of reasons for this. While quantitative easing and low rates have supported market prices, most people would argue it has inflated them. With the cessation of QE, however, the support is no longer there to the extent it used to be.

Mr. Jacksha distributed some research pieces from State Street. He noted that State Street's "Tail Risk Monitor," which measures fragility and turbulence in the markets, has been moved into an "Alert" position. He said this does not mean the market will go up or down, but says that the market is riskier than it has been. He said ERB has sold off some equities and has about $500 million in cash. While this is more cash than the ERB normally has, it is within the policy boundaries of 0-10 percent.

Mr. Martin commented that this is a cautious period, and the ERB is already well diversified and protected on the downside, and this will allow a bit more cushion.

7. OTHER INVESTMENT REPORTS AND DISCUSSIONS

Mr. Jacksha said staff has reviewed the responses to the RFP that was issued for a real estate and natural resources advisor, and that staff would be recommending one firm at the June Investment Committee meeting.

8. NEXT MEETING: THURSDAY, MAY 28, 2015

The committee agreed to schedule the meeting at 1:00 p.m.

ADJOURN

Its business completed, the Investment Committee adjourned the meeting at 4:10 p.m.

Accepted by:

H. Russell Goff

H. Russell Goff, Chairman