

ACTION SUMMARY

INVESTMENT COMMITTEE

May 28, 2015

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MINUTES OF THE
NEW MEXICO EDUCATIONAL RETIREMENT BOARD
INVESTMENT COMMITTEE

May 28, 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
Dr. Beulah Woodfin

Members Excused:

None.

Staff Present:

Ms. Jan Goodwin, Executive Director
Mr. Bob Jacksha, CIO
Mr. Steve Neel, Deputy CIO
Ms. Kay Chippeaux, Fixed Income Portfolio Manager
Mr. Alan Meyers, Financial Analyst
Mr. Aaron Armstrong, Portfolio Manager
Mr. Robert Quinlan, Intern

Others Present:

Ms. Judith S. Beatty, Recorder
Mr. Allan Martin, NEPC
Mr. Kevin Tatlow, Top Tier

b. Approval of Agenda

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

c. Approval of Minutes of 4/23/15

Dr. Woodfin moved for approval of the April 23 minutes, as submitted. Ms. Cameron seconded the motion, which passed unanimously by voice vote.

d. Introduction of Guests

Consultants and staff were acknowledged.

2. EDISON PARTNERS VIII (PRIVATE EQUITY)

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

Mr. Neel stated that staff is recommending a commitment of \$40 million to Edison Partners Fund VIII.

-- The ERB committed \$30 million to Fund VII in 2011; as of 3/31/15, the fund has returned a net IRR of 25 percent with a 1.7x multiple.

-- Edison is a growth equity manager primarily focused in the Acela Corridor, which is the region between Washington, D.C. and Boston.

-- Fund VIII is targeting a \$250 million fund raise with a \$300 million cap in four main sectors: Enterprise 2.0; Financial Technology (Fintech); Healthcare IT; and Interactive Marketing & Digital Media.

-- Fund VIII is expected to have 22-26 portfolio companies with initial investments of \$4 million to \$12 million. Edison's initial equity ownership will be 30-35 percent. Portfolio company revenue growth rates are anticipated at 30+ percent. Each individual portfolio company will be underwritten to between a 2.5x and 3.5x return, and entire fund return target is 20+ percent net IRR with a 3.0x multiple return back to investors.

Responding to Dr. Woodfin, Mr. Neel stated that John Martinson was the founding partner of Edison Ventures, and he and his brother, Ross, are transitioning out but will continue to have a relationship with the firm. John Martinson's focus will be on mentoring and grooming younger investment professionals. He will not participate in Fund VIII and has transitioned his management responsibilities to Chris Sugden over the past several years.

Mr. Neel reviewed fee and expense sharing information.

Mr. Neel stated that the staff is asking for additional authority to purchase secondary LP interests in Edison, should they become available from existing LP's. This could allow the ERB to add incremental value to the portfolio. He noted that Top Tier has a long history in underwriting secondary transactions and may underwrite up to four transactions as part of their contract with the ERB.

-- There are eight individuals on the Edison investment team in offices in Princeton, New York, Washington D.C. and Ohio (satellite office).

-- There are a total of 22 team members across the Edison platform. The investment committee has five individuals, and all investment decisions must be approved by at least four of the members.

Mr. Neel stated that Edison normally does not have more than 50 percent of the equity, which is normally the case in growth equity commitments. At entry, it is 30-35 percent, with the current owners working alongside Edison; and on one or two occasions, there may be other institutions. Over time, Edison's percentage of the equity increases through founders' equity purchases and secondary purchases.

Mr. Tatlow noted the last two Edison funds (Fund VI and Fund VII) are expected to come in very close to their targets.

Edison Chief Marketing Officer and Partner Kelly Ford and Managing Partner Chris Sugden appeared before the committee and made a presentation.

Responding to Dr. Woodfin, Mr. Sugden said Edison has 15 professionals and 7 people in the back office. Of the seven, three are administrative professionals and there is a portfolio controller and a portfolio accountant. He said they have implemented a couple of pieces of technology that they highly recommend to other GPs. From a portfolio perspective, the system allows highly detailed tracking of revenue, EBITDA, cash flow, etc.

[Representatives left the meeting.]

Ms. Goodwin commented that one of the things she likes about Edison is that they know what size fund works for them. Their last two funds have been the same size, which is a good sign of discipline. Mr. Jacksha agreed, adding that it is rare to see funds not increase their size with each subsequent fund.

Mr. Magid and Dr. Woodfin wondered if Edison has enough staff, given the large number of deals.

Mr. Tatlow responded that the team has built a substantial platform to cater to the needs of its portfolio companies. The "Edison Edge" platform includes a huge network of people who have been in their portfolio companies in the past, and those people actively participate, including occasional help on diligence. They generally have two board seats, and one goes to someone in their network.

Mr. Jacksha commented that Edison has a stable team with a planned succession, which is proceeding in an orderly fashion. The managing partners have an average of ten years with the firm.

Dr. Woodfin moved that the Investment Committee approve a commitment of \$40 million to Edison Partners VIII, L.P. The commitment is subject to New Mexico State Law, Educational Retirement Board policies, Educational Retirement Board approval for placement agencies 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 \$15 million, in secondary partnership interest in Fund VII and/or Fund VIII. Mr. Magid seconded the motion.

Mr. Neel stated that Edison disclosed that no placement agent was used in this transaction, nor has there been any relevant campaign contributions.

The motion passed unanimously by voice vote.

3. EMERGING MARKET DEBT CHANGE – EMSO (OP. CREDIT)

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

Ms. Chippeaux presented staff's recommendation to transition the assets that are currently invested in the EMSO Fund to the EMSO Saguaro Fund, a 1.5x levered version of the flagship EMSO Fund.

Ms. Chippeaux said EMSO Partners currently manages \$83 million on behalf of the ERB through its flagship EMSO Fund as part of the ERB's allocation to emerging market debt. EMSO is one of the ERB's two managers in this space.

Ms. Chippeaux noted that the Board selected EMSO in July 2011 as part of the long-term asset allocation changes that were made that year. At that time, the Board added emerging market debt as an asset class, which is now 2 percent of the current asset allocation. During that implementation phase, the Board elected to have two pieces to emerging market debt: an alpha piece and a beta piece. The beta was meant to be a low volatility, local currency and track very closely to the benchmark; and the alpha component (where EMSO comes in) was meant to be an alpha provider in all kinds of different credit cycles.

Ms. Chippeaux stated that, at the time EMSO was selected, it was a wholly owned subsidiary of Citigroup, and as part of Dodd-Frank, Citigroup was required to divest itself of this investment. EMSO has since made the transition to a wholly employee owned company, a process that took about 18 months, during which time EMSO was able to buy back the Citigroup owned portion of the company.

Ms. Chippeaux said the EMSO strategy has not changed substantially since 2011. They take a very global economic view of what is going on around the world, and then apply it to their selection of countries and securities. They do a very thorough bottoms-up view of the securities that are selected. EMSO looks for undervalued securities that perhaps don't have good research coverage or might have complexity that other investment managers don't understand or are unwilling to look at. EMSO looks for mispricing due to these types of situations.

Ms. Chippeaux said EMSO uses hedging to hedge interest rates, currency and credit and they can use it to reduce risk and to enhance returns as well.

Ms. Chippeaux said most of the investment team remains in place from 2011, including founder Mark Franklin. One of the senior portfolio members, Ben Sarano, has been with EMSO since 2004 and will make a presentation to the committee today.

Ms. Chippeaux noted that EMSO started the Saguaro Fund in November 2011. She said staff feels the ERB can get better returns by accepting a little bit more volatility, and are excited about the opportunity to get into this fund. She noted that over 50 percent of the assets of the firm are

now in the Saguaro Fund, and the percentage of the EMSO Fund that the ERB is currently invested in continues to shrink.

Mr. Jacksha noted that the Saguaro Fund is a 1.5x levered version of EMSO, but explained that this isn't a reference to applying to borrowed money; it is more the position sizing that is the leverage.

Mr. Martin commented that NEPC likes EMSO as a manager, adding that performance has been "surprisingly good" in the current economic environment. He reviewed a table of how EMSO and Saguaro performed against the indices in the emerging market debt space. The annualized return of Saguaro was substantially higher than EMSO, and the annualized standard deviation was much lower in volatility. In addition, the annualized Sharpe ratio and annualized Sortino ratio show Saguaro with much higher efficiency than the existing product in this space.

EMSO representatives Donald Lucardi and Ben Sarano appeared before the committee and made a presentation.

[Mr. Lucardi and Mr. Sarano left the meeting.]

Mr. Jacksha reminded the committee that this is not a major change in investment strategy; rather, it is more like adjusting a manager's guidelines. This is a manager the ERB likes, and staff and NEPC feel this strategy will do better than the current one.

Dr. Woodfin moved that the Investment Committee approve the change of the current investment in the EMSO Fund to the EMSO Saguaro Fund managed by EMSO Partners Limited subject to New Mexico state law, Educational Retirement Board policies, negotiation of final terms and conditions, and completion of appropriate paperwork. Mr. Magid seconded the motion, which passed unanimously by voice vote.

[Break.]

4. PIMCO DISCO II CONTRACT (OP. CREDIT)

Mr. Jacksha stated that policy requires the Investment Committee to review investment management contracts every four years for certain types of assets that do not have a fixed term or termination date.

Ms. Chippeaux said staff is recommending that the Investment Committee approve the continuation of investment manager services for a period of four years for the PIMCO Distressed Senior Credit Opportunities Fund II. This investment is in the opportunistic credit allocation of the portfolio.

Ms. Chippeaux said the fund was started in late 2011 as a rollover of the same Fund I, which had a three-year term. The ERB was invested in Fund I as well.

Ms. Chippeaux said the investment thesis for both funds was that they would get returns from undervalued senior structured credit, and that included current income and capital appreciation

from commercial mortgage securities, asset backed securities, and non-agency residential mortgage backed securities. The fund uses some leverage for these returns, as did Fund I.

Ms. Chippeaux said the original investment in Fund II was \$200 million initially with an additional \$50 million invested later. In the last nine months, the ERB has withdrawn \$125 million from this fund. Approximate market value now, after withdrawals, is \$290 million. She said there is a 17.4 percent annualized return since inception.

Ms. Chippeaux said PIMCO has advised the ERB that it should now expect 7-9 percent net returns going forward because the opportunity is reduced. She commented that these are very senior secured assets with very low risk, so the returns are very decent for the amount of risk involved. She added that the ERB is quite ready to take down all the capital, but doesn't have a place to reinvest it within opportunistic credit, so staff is asking the committee to approve a four-year continuation of the investment.

Ms. Chippeaux stated that continued fund withdrawal requests are expected over the next 18-24 months as the ERB gets other capital call requirements from other funds that the ERB has committed to previously.

Mr. Jacksha added that the ERB looks at this as one of the sources of funding in addition to things the ERB has already invested in, and for new things it invests in that might have capital calls.

Dr. Woodfin asked if the ERB could completely withdraw from this fund in less than the four years, and Mr. Jacksha responded yes. While there are certain restrictions on withdrawals, he was comfortable the ERB would likely get what it asked for each time.

Ms. Cameron moved that the Investment Committee approve the continuation of the investment in the PIMCO Distressed Senior Credit Opportunities Fund II, L.P. for a period of four years ending October 7, 2019. Dr. Woodfin seconded the motion, which passed unanimously by voice vote.

5. WATERFALL EDEN AND VICTORIA CONTRACTS (OP. CREDIT)

Mr. Jacksha stated that policy requires the Investment Committee to review investment management contracts every four years for certain types of assets that do not have a fixed term or termination date.

Ms. Chippeaux said staff is recommending that the ERB Investment Committee approve the continuation of investment manager services for a period of four years for the Waterfall Eden Fund, the Waterfall Victoria Fund and the Sutherland REIT. These investments are in the opportunistic credit allocation of the portfolio.

Ms. Chippeaux stated that, in 2011, the ERB invested in two Waterfall Asset Management funds, the Eden and Victoria funds. Both of them are managed by two of the most experienced structured credit investors in the industry, Tom Capasse and Jack Ross, who have more than 50 years combined in this industry, and founded Waterfall in 2005.

Ms. Chippeaux stated that the Eden Fund invests in high yield esoteric asset backed securities, providing the Eden Fund with an illiquidity premium as well as current returns and capital appreciation. The manager is allowed to apply some leverage. The ERB's investment was \$150 million, which is now at \$236 million, and they have produced solid double digit returns.

Ms. Chippeaux said the Victoria Fund invests in non-performing residential whole mortgage loans. The returns have come from loan modification, refinancing, short sales and foreclosures. The ERB invested \$100 million in this strategy, which is now \$136 million. They spun off some of the assets into the Sutherland Real Estate Investment Trust. Sutherland and Victoria fund returns combined are 10 percent. She said they expect to take the Sutherland REIT public later this year.

Ms. Chippeaux stated that she and Mr. Jacksha had a call recently with the Waterfall management about the continuation of both of these funds, and feel there are a lot of assets that fit right in the wheelhouse of Waterfall. She noted that the ABS market right now has about \$2.5 trillion of assets, of which 42 percent is in high yield ABS. Because of the type and amount of product that is still available for investment by Waterfall, staff wants to continue to have this investment in the portfolio.

Ms. Cameron moved that the Investment Committee approve the continuation of the investments in the Waterfall Funds for a period of four years ending August 1, 2019. Dr. Woodfin seconded the motion, which passed unanimously by voice vote.

6. PROXY VOTING REPORT

Citing Carl Icahn's "vulture capitalist" investing strategy, Woodfin asked if it would be helpful for the ERB to adopt a policy that it would support management against any attempts to manipulate the price of a company's stock and then strip the company.

Mr. Jacksha stated that the Proxy Voting Policy states, "Each individual issue will be reviewed to determine if it is in the shareholder's best interest." He said the rationale in the strategy cited by Dr. Woodfin is that often a group will say a company is not making a decent return on their investment and therefore they think the company should dividend out the money. By policy, the ERB has to look at those on an individual case-by-case basis. He added that, in some instances, such a move may be warranted and so it would not be in the ERB's interest to amend the policy.

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

7. Q1 2015 PERFORMANCE REPORT

Mr. Martin presented this report.

Mr. Martin stated that, since the report was generated, the S&P is up about 2.5 percent. The first quarter itself saw another overall gain in U.S. equities, but it was very anemic, so the S&P in the quarter was up 1 percent. This is very consistent with what NEPC has been saying about lower returns going forward. He commented that, in March, the S&P was down another 1.58 percent; and because the ERB is no longer focused on the equity market, the ERB's March returns were up "more than any other fund I know of, and I know of only two funds that were up at all."

-- For the year ending March 31, the fund experienced a net investment gain of \$851 million, which includes a net investment gain of \$246 million during the first calendar quarter. Assets increased from \$10.9 billion twelve months ago to \$11.4 billion on March 31, with \$309 million in net distributions during the year.

-- The fund returned 7.8 percent, outperforming the policy index by 1.4 percent and ranking in the 19th percentile of its peers.

[Report concluded.]

The committee reviewed a press release titled, "ERB Ranked #1 in Long-Term Performance," for publication this week. The press release noted that the fund has reached a high point of \$11.4 billion and that, over the last 30 years, the ERB's investment portfolio has returned approximately 10.2 percent per year, exceeding its 7.75 percent annual return target. The press release stated that the ERB is now the top performing pension fund in the nation in its relevant peer universe for the 30 years ending March 31, 2015.

8. QUARTERLY COMMISSION REPORT

[Informational item.]

9. OTHER INVESTMENT REPORTS AND DISCUSSION

Mr. Jacksha reported that the ERB completed the EM equity transition this month and has transferred the existing balance, plus an additional \$50 million, from Robeco to Parametric.

Mr. Jacksha distributed and discussed an article by CEM Benchmarking. A New York Times article that was republished by NASRA, related to this, said "South Carolina says that all the other funds are missing half of the expenses in their reporting." Mr. Jacksha said staff disagrees; what South Carolina does is report all of the money collected by the GP, which includes fees from limited partners and portfolio companies. He commented that this is fine if that's what South Carolina wants to measure; however, the ERB only measures the fees it pays.

Mr. Jacksha said he did agree, however, with the title of CEM's article, which was, "The Time Has Come for Standardized Total Cost Disclosure for Private Equity."


10. NEXT MEETING: THURSDAY, JUNE 11, 2015

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

ADJOURN

Its business completed, the Investment Committee adjourned the meeting at 4:35 p.m.

Accepted by:

A handwritten signature in cursive script, appearing to read "H. Russell Goff", is written over a horizontal line.

H. Russell Goff, Chairman