NEW MEXICO EDUCATIONAL RETIREMENT BOARD

RETREAT

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March 24, 2016

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MINUTES OF THE

NEW MEXICO EDUCATIONAL RETIREMENT BOARD

RETREAT

March 24, 2016

ROLL CALL: QUORUM PRESENT

The New Mexico Educational Retirement Board Retreat was called to order on this date at 12:00 p.m. in the Educational Retirement Board Room, 6201 Uptown Boulevard, N.E., Ste. 203, Albuquerque, New Mexico. A quorum was present.

Members Present:
Ms. Mary Lou Cameron, Chairwoman
Mr. H. Russell Goff, Vice Chairman
Mr. Hipolito J. Aguilar, Secretary
The Hon. Tim Eichenberg, State Treasurer
Mr. Larry Magid
Dr. Beulah M. Woodfin [by telephone]

Members Excused:
None.

Legal Counsel Present:
Mr. Chris Bulman, General Counsel

Staff Present:
Ms. Jan Goodwin, Executive Director
Mr. Rick Scroggins, Deputy Director
Mr. Bob Jacksha, CIO
Ms. Margaret Riquelmy, Executive Assistant

Others Present:
Ms. Judith Beatty, Recorder

1. EXECUTIVE SESSION – LIMITED PERSONNEL MATTER
(session closed pursuant to NMSA 1978, Section 10-15-1(H)(2)

Chairwoman Cameron moved that the Board go into executive session for the purpose of discussing a limited personnel matter. Mr. Goff seconded the motion, which passed on the following roll call vote:

For: Chairwoman Cameron; Mr. Goff; Mr. Aguilar; Mr. Eichenberg; Mr. Magid; Dr. Woodfin.

Against: None.

[Executive Session 12:10 p.m. – 1:30 p.m.]

Chairwoman Cameron stated that the only matter discussed in executive session was a limited personnel matter, as permitted by the Open Meetings Act.

2. ACTION FROM EXECUTIVE SESSION

None.

3. PROCEDURAL ITEMS:

a. Roll Call/Ascertain Quorum

[Previously addressed.]

b. Approval of Retreat Agenda

Mr. Goff moved for approval of the agenda, as published. Mr. Aguilar seconded the motion, which passed unanimously by voice vote.

c. Introduction of Guests

Guests were introduced.

4. BOARD AND INVESTMENTS GOVERNANCE: PAUL MATSON, EXECUTIVE DIRECTOR, ARIZONA STATE RETIREMENT SYSTEM

Mr. Matson stated that he was previously chief investment officer of the Arizona State Retirement System (ASRS) and is now their executive director.

Mr. Matson said ASRS is a $33 billion fund, and approximately 30 percent of the fund's assets are managed in house. The Canadian model is to invest predominantly with internal staff, while the U.S. model has grown up to be very different; 20 years ago, it was very rare to have internal investment management.

Mr. Matson stated that ASRS spent a great deal of time on governance and made the following determinations:

-- Its governance model, where the board of directors not only made the decisions but also had oversight over them, was not optimal.

-- The board was allocating its time to micro issues such as hiring small cap managers instead of focusing on the more important macro issues, e.g., doing 30-year projections, analyzing risk, and looking at sustainability issues.

Mr. Matson stressed that only experts should make the decisions, and they should have fulltime capacity and not part-time capacity to make those decisions.

Mr. Matson said ASRS now has a model where the most macro level decisions are made by the board, with anything under that managed by staff; and the board co-manages strategic planning with the director.

Mr. Matson said that, on the investment side, this had the most significant impact, where the board simply approves an asset allocation "schematic." All decisions on implementation (hiring and firing managers, moving money between managers, tactically repositioning the portfolio) are managed by staff. This allows significantly more resource and time allocation among staff members, and motivating staff members on issues that are important but are not drivers of ultimate sustainability. The board gets reports about rates of return at the macro level (not manager level) and any risk metrics and can certainly request other reports.

Mr. Matson suggested the following steps for implementation:

-- There should be at least two "champions": a staff member (probably the director) and a board member willing to allocate the extra time for this and do whatever is necessary to "move the ball."

-- Be prepared and willing to leapfrog. There is ample academic evidence, Internet accessibility and ample information to help go from a fairly good decision to an excellent decision.

-- Use outside consultants only to the extent that it will add value. This is not a requirement, because NMERB staff and board members already have the expertise and skillsets.

-- Documentation of goals.

Mr. Magid asked Mr. Matson what model is normally seen in public pension funds. Mr. Matson responded that the most common model in the United States is boards of non-investment experts that make final decisions on asset allocation, tactical changes to asset allocation, migration of money, and selection of external managers. Over time, the model has evolved and there are now professional pension funds (such as the NMERB) that have a complement of investment experts and where the board is responsible for high level understanding of actuarial, governance, budgetary, legislative and other macro issues. He said it does not make sense to engage a complement of investment experts who do not have the authority to make decisions, with the board making decisions that have marginal value compared to what needs to be contemplated for a successful organization.

Mr. Matson said the director and staff should not have decision-making authority on the following: hiring and firing of external auditors, external actuaries, and the key investment consultant who reports numbers to the board.

Mr. Matson said staff would hire and fire all other consultants, modify any asset allocation targets, hire external managers, hire investment staff, and determine investment strategies and how to best implement the strategic asset allocation.

Responding to Mr. Goff, Mr. Matson stated that their board has nine individuals and three committees. They have a board committee on external affairs (e.g., legislation), an operations committee and an investment committee. The investment committee reviews whether execution is appropriate, and does not advise on managers or asset allocation.

Responding to Chairwoman Cameron, Mr. Matson said the investment committee meets six times a year. Four times a year, the agenda will include a topic of what the portfolio looks like, what decisions has the staff made, what are the risks. The chief investment officer will offer his opinion, and the external consultant will offer theirs. This also happens quarterly at the board level.

Mr. Matson said one area that ASRS feels should be a staff decision rather than a board decision, but which it has not acted on, is the strategic asset allocation. He said he is comfortable with this slight deviation from the model, however, because it wasn't the board that came up with it – the board was relying on the consultant and staff.

Mr. Matson discussed a document titled, "Arizona State Retirement System Investment Beliefs."

Mr. Eichenberg asked how many fund managers ASRS has and how do they allocate their resources.

Mr. Matson responded that there are about six portfolios being managed in house, which is 30 percent of the fund. Of the remaining 70 percent, which is managed externally, 50 percent is in public market stocks and bonds, allocated among about 14-16 investment managers. He said 20 percent is in private markets, which are real estate, opportunistic debt, private debt and private equity. They have several hundred investments, which is too many because the model that they utilized when they introduced those asset classes was a different one. Their goal is to reduce that significantly.

5. DISCUSSION OF OPTIONS AND THEIR APPLICATIONS – GREG JOHNSEN, DIRECTOR, INSTITUTIONAL PORTFOLIO MANAGER, PARAMETRIC; AND DAN RYAN, MANAGING DIRECTOR, CLIENT RELATIONSHIP MANAGEMENT

Mr. Johnsen and Mr. Ryan made a presentation titled, “Options Overview.” The presentation discussed the basics of options, what options are, how they are priced and how they are used in various portfolios. The presentation also included a discussion of how an options strategy can be built into an investment portfolio.

6. INVESTMENT STAFF COMPENSATION – BOB JACKSHA, CHIEF INVESTMENT OFFICER

Mr. Jacksha stated that this agenda item is in follow up to a discussion with the Board at a previous meeting when the Board indicated interest in pursuing incentive compensation.

Ms. Goodwin reviewed an article from the Harvard Business Review titled, “How Netflix Reinvented HR.” She noted that Netflix does not believe in paying performance bonuses but believes in having the compensation be fair so they can attract and retain the best people.

Ms. Goodwin commented that, with performance compensation, one of the problems is how to get that right. For example, in the public pension world, compensation would be based on long-term performance of three, five or even ten years. If the last five years were fantastic, and the payout is in the following year when the numbers happen to be down, the public perception is that staff is getting huge bonuses in a bad year.

Ms. Goodwin stated that she, Mr. Scroggins and Mr. Jacksha mulled this over and thought perhaps the most straightforward thing to do is have the compensation be right and get it closer to the market levels.

Mr. Jacksha reviewed the McLagan 2015 US Public Funds Compensation Survey, which surveys public funds, including the NMERB. He noted highlights from the 2014 results.

Mr. Jacksha noted that the salary of the Executive Director is in the bottom quartile (40th out of 44), and that this is the case across the board for the Deputy Director, CIO, CFO, chief legal officer, investment staff and others. In many cases, the salaries are dead last.

Mr. Jacksha commented that this is obviously a concern, and the NMERB would like to be competitive with its peer group of other public funds and state funds.

Dr. Woodfin asked Ms. Goodwin how this situation might be remedied.

Ms. Goodwin responded that, with board direction, staff would propose to the State Personnel Office that NMERB initiate a trial project that would compensate staff members fairly compared to peers. She said NMERB would like to begin this trial project with the fixed income portfolio managers, working over the next couple of years to get them as close to the median salary for that position as possible. NMERB would then begin work on another staff position, such as the Deputy CIOs. She added that reclassifying these positions to exempt status (rather than the current classified status) would allow more flexibility with the pay ranges.

Dr. Woodfin said she endorsed this proposal.

Mr. Jacksha said the Board might want to consider creating a compensation committee made up of Board members.

Ms. Goodwin commented that Mr. Jacksha has polled his staff about the possibility of being reclassified to exempt status, and the idea was met with enthusiasm with the understanding that the protections of being in the classified system (as far as terminations) would no longer exist.

Mr. Eichenberg said he faces a similar issue with his staff. He would like to raise their compensation to competitive rates, but there is always the issue of New Mexico being at the bottom in many categories, including salaries. He wondered if there were data comparing NMERB salaries with the same positions in New Mexico.

Ms. Goodwin stated that there were a number of ways that NMERB could distinguish itself from other state investing agencies in New Mexico. First of all, NMERB is the only entity that does internal asset management, which saves the NMERB a considerable amount of money. In addition, the NMERB performance and volatility numbers are much better than any of the other state investing agencies, which does not include the State Treasurer's Office, which focuses on absolute return and the state's liquidity needs as opposed to long-term sustainability.

Ms. Goodwin noted that NMERB investment staff people are in demand, regularly receiving calls from recruiters who can offer thousands of dollars of more in annual salary.

Dr. Woodfin commented that it is in the interest of good management to prevent turnover on staff, and that should be a priority. She said development of some kind of a program to include this argument and others presented today would make sense.

Ms. Goodwin said she and Mr. Jacksha would put together a plan outline and present it at the April board meeting.

7. TRANSPARENCY IN INVESTMENT REPORTING – JAN GOODWIN, EXECUTIVE DIRECTOR

Ms. Goodwin stated that financial and accounting transparency is a very prominent topic today, especially in the public pension sector. She said this is partly because the amounts of money involved are so large and the issues have been politicized because so many public pension funds have substantial unfunded liabilities.

Ms. Goodwin said she would summarize the articles in the board packet, discuss NMERB's current approach to financial and accounting reporting transparency, and present a template on how NMERB would proceed with improving that.

Highlights from Ms. Goodwin's comments:

-- Both the article and the brief ("Making State Pension Investments More Transparent") were written by Pew Charitable Trust staff members. It is important to remember that they are not an unbiased source. The John and Laura Arnold Foundation, a prominent advocate for the repeal of public sector defined benefit pension plans, is a major donor to Pew's initiatives regarding public pension plans. Nevertheless, some of their comments are valid and worth considering.

-- The article by Susan Urahn ("The Transparency That Public Pensions Need") focuses on the lack of transparency associated with alternative investments. Many alternative investments have higher management fees associated with them than investments in traditional asset classes such as stocks and bonds. Historically ERB has found that the returns on alternative investments justify the higher fees. In addition, they also add diversification to our portfolio, which helps returns in volatile markets.

-- Urahn points out that many funds report performance gross of fees, which results in a rosier number. NMERB has traditionally reported performance both gross and net of fees. She also notes that performance fees, which can be a significant component of total fees, can be substantial. The NMERB annually reports to the Board as well as the Investments and Pension Oversight Committee what it has paid out in base management fees as well as performance fees. NMERB will include this information in its financial statements as part of Management Discussion and Analysis.

-- The position brief by Greg Mennis examines transparency practices throughout the United States by gathering data on asset allocation, performance and fees from the 73 largest state sponsored pension funds. He recommends that states and funds:

- Adopt comprehensive fee-reporting standards, such as those proposed by the Institutional Limited Partners Association's Fee Transparency Initiative (highlighted in the Urahn article)
- Make investment policy statements transparent and accessible
- Disclose bottom-line performance, both net and gross of fees
- Expand reporting to include longer tem performance results
- Report results by asset class, net and gross of fees

-- NMERB is already doing the last four of these recommendations and is investigating what it needs to do to comply with the first.

Ms. Goodwin noted that the NMERB's proposal incorporates many of the practices used by the Missouri State Employees Retirement System (MOSERS), which is the system Urahn commended in her article. Ms. Goodwin presented a comparison of information provided by NMERB with details from MOSERS's June 30, 2015, Comprehensive Annual Financial Report.

Concluding her report, Ms. Goodwin stated that it is crucial to have the right balance of information for the Board and members in dealing with transparency, which the NMERB strives to reach through its investment policy and reporting.

8. <u>ADJOURN</u>

Its business completed, the Educational Retirement Board adjourned the meeting at 4:25 p.m.

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Russell Goff, Vice Chairman

ATTEST:

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Hipolito J. Aguilar, Secretary