Minutes Approved at the May 29, 2014 PERA Board Meeting

NEW MEXICO

PUBLIC EMPLOYEES RETIREMENT ASSOCIATION

BOARD MEETING

April 24, 2014

This meeting of the Public Employees Retirement Board was called to order by Patricia French, Chair, at approximately 9:00 a.m. on the above-cited date at the PERA Building, Fabian Chavez Board Room, 33 Plaza La Prensa, Santa Fe, New Mexico.

2. ROLL CALL

Following the Pledge of Allegiance, roll was called by Executive Director Wayne Propst and a quorum was established with the following members present:

Members Present:
Patricia French, Chair - Municipal
Danny Mayfield, Vice Chair - Retiree
Paula Fisher - State
Dan Esquibel - Municipal
Jackie Kohlasch - State
Stewart Logan – County
Louis Martinez - Municipal
Loretta Naranjo-Lopez – Retiree
John Reynolds- State

Member(s) Excused:
Dianna Duran - *Ex-officio*
James Lewis - *Ex-officio*
Roman Jimenez

Staff Members Present:
Wayne Propst, Executive Director
Susan Pittard, General Counsel
Jonathan Grabel, Chief Investment Officer
Greg Trujillo, Deputy Director
Sylvia Barela, Administrative Services Director
Karen Risku, Assistant General Counsel
Julian Baca, Deputy CIO
Judy Olson, Executive Assistant
Joaquin Lujan, Portfolio Manager
LeAnne Larrañaga-Ruffy, Portfolio Manager
Christina Keyes, Portfolio Manager
Sonam Rapten, Financial Analyst
Mark Montoya, Financial Specialist
JoAnn Garcia, Deferred Compensation Program Manager

Others Present:
Jamie Feidler, Cliffwater
Tom Toth, Wilshire Associates
Paul Lium, Nationwide
Eric Jagelka, BlackRock
Chris Woida, BlackRock
Oscar Arévalo, AOC
Artie Pepin, AOC
Anne Hanika-Ortiz, LFC
Michael Collins, Prudential
Steve Ahrens, Prudential
Donald Aline, CWA

3. APPROVAL OF AGENDA

Mr. Logan introduced the following motion:

"RESOLVED, that the PERA Board approve the agenda."

Mr. Mayfield seconded and the motion carried by unanimous [7-0] voice vote. [Ms. Fisher and Mr. Reynolds were not present for this action.]

4. APPROVAL OF CONSENT AGENDA

[*Exhibit 1: Consent Agenda*]

Chair French indicated that she reviewed the minutes and they were complete and accurate.

Ms. Mayfield introduced the following motion:

"RESOLVED, that the PERA Board approve the consent agenda."

Mr. Logan seconded and the motion carried by unanimous [7-0] voice vote. [Ms. Fisher and Mr. Reynolds were not present for this action and arrived shortly thereafter.]

5. CURRENT BUSINESS

A. Discussion by Administrative Office of the Courts (AOC) on Reform to the JRA and MRA Plans

Executive Director Propst thanked the State's judges and magistrates and staff at the Administrative Office of the Courts. He recognized the work of Mr. Arévalo and Mr. Pepin in the success of comprehensive pension reform for the Magistrate and Judicial plans. If the rest of the fiscal year continues at 12 percent return, the JRA and MRA plans are projected to be funded at over 100 percent in 2043. This demonstrates that the bills that were passed constituted serious reform and hopefully have placed these plans on the path to solvency.

The Board commended the AOC and PERA staff for their tremendous effort. The judges and magistrates were also recognized for their contribution in supporting the pension reform.

Chair French said PERA will be sending a letter under her signature recognizing the work done by the AOC and expressing PERA's appreciation.

Art Pepin, AOC Director, said Justice Bosson, was the point person for the Supreme Court, thanked PERA Board and its staff. He pointed out that the measures put into the bills are serious reform measures – benefits were given up and contributions increased – and he was pleased the Governor signed off on the bills.

Oscar Arévalo, AOC Fiscal Services Director, said pension reform relates to values. He said the collaboration and cooperation that occurred for the passage of this serious reform was noteworthy.

B. <u>Investments Division</u>
Chief Investment Officer's Performance Report

Jonathan Grabel, Chief Investment Officer, reviewed the performance for March and the first calendar quarter for 2014. He identified the packet reports and noted that the plan was up for the month as well as the quarter. The calendar quarter ended with $14.25 billion, a net increase of $10 million and a new high watermark. The plan was up 37 basis points for the month and 1.87 percent for the quarter. Given that the plan's actuarial hurdle is 7.75 percent the plan has seen a very positive actuarial experience.

There is positive performance across most asset categories for March. Public equities, over 56 percent of total assets and the principal driver for the plan performance, experienced increasing volatility during March. He attributed the volatility to the potential loss of Federal Reserve subsidy in the market. Public equities are beginning to underperform for the plan as a whole. He identified the underperformers.

In response to Mr. Esquibel's question regarding the effect of Russia and Ukraine on PERA's portfolio, Mr. Grabel said Russian equities are not the principal driver of the plan. He offered to provide the actual PERA equity in Russian listed stocks at a future meeting. The volatility of political risk and other factors is baked into PERA's asset allocation.

Chair French requested that anything negative be displayed in red on the reports.

International equities were up 60 basis points for the month and outperformed US equities, stated Mr. Grabel. The strongest performer was Schroder International small cap across the entire portfolio and up 30.6 percent fiscal year-to-date. He noted that PERA has a relatively small investment with the firm of $100 million and given management turnover Schroder is currently on watch.

PERA's fixed income portfolio is up 1.82 percent for the quarter. PERA's global multi-sector allocation provided the strongest performance. The alternatives portfolio had a strong performance for March, up 81 basis points. For the quarter the alternatives were up over 4 percent and that substantially exceeded the performance of the traditional assets which were up 1.43 percent. However, fiscal year to date, traditional assets are performing better than alternatives – traditionals at 13.5 percent compared to alternatives at 9.7 percent. Further evidencing the need for a diversified portfolio.

Noting that hedge funds were down 61 basis points in March, Mr. Grabel said this provides an opportunity to revisit the composition of the absolute return allocations with Cliffwater. Real assets and real estate were up for the month and up over 6 percent for the quarter.

In terms of rebalancing, Mr. Grabel said there was a net transfer of $35 million for the month to the State Treasurer's Office to make benefit payments. The source of the funds was from a $30 million reduction in the S&P futures, the overlay to the portable alpha program.

At the end of March, all of PERA's asset categories were within their policy bands/targets.

Staff is in the final stages of reviewing contracts for the allocation to MLPs and fundings are expected to be made in May.

Staff is soliciting bids from the transition managers regarding cash equitization.

High Frequency Trading

Mr. Grabel said what motivated this discussion is a recent piece on *60 Minutes* regarding Michael Lewis' new book *Flash Boys* and the author's assertion that the "US stock market is rigged" and the culprit is high frequency trading (HFT). HFT is a set of machine-to-machine high speed trading techniques. It is estimated that 50 percent to 70 percent of all trades are made via HFT programs. Mr. Lewis attacked latency arbitrage by which different people and firms receive market data at different times.

To put the Lewis book in context, Mr. Grabel said PERA does incur a transaction cost for every investment strategy. Transaction costs are inherent in how the strategic asset allocation is implemented. All transaction costs are monitored on a standalone basis. All the numbers the Board reviews include transaction costs.

Mr. Grabel noted that public equities are highly efficient and trading costs have gone down substantially since the 1970s. Examples of public equity and private equity transaction costs were reviewed.

Following the *60 Minutes* segment, staff reached out to all of PERA's managers and across the board the managers are focused on trade execution. They monitor their trading, staff monitors their trading, Cliffwater and Wilshire monitor their trading. As the managers' margins

go down they have to trade well in order for them to make money.

Mr. Grabel noted that half of PERA's public equity portfolio is indexed. The volume of trades is much lower across those accounts and that drives down the total transaction costs within the portfolio.

Tom Toth, Wilshire, pointed out that Wilshire's qualitative assessment of all of PERA's managers includes an explicit implementation component. That includes evaluating the systems that they use to trade, talking to their traders, ascertaining how orders are sent into the market, etc. Stating transaction cost is an important component to PERA's returns, Mr. Grabel said that Cliffwater also conducts that assessment.

Putting the transaction fees into context, Mr. Grabel said in 2013 the plan was up 17 percent and public equity up over 20 percent. To give back a couple hundred thousand dollars is a relatively immaterial number in the grand scheme of the investment gains that the plan had. There is no investment strategy that is frictionless.

Mr. Grabel said the debate Mr. Lewis' appearance on *60 Minutes* and his book have fostered is healthy. In terms of efficiency gains, he said there was more fertile ground than front running and HFT.

Mr. Martinez appreciated the discussion and the fact that staff did not dismiss the concern. He asked staff to address whether the market was "rigged." Mr. Grabel said "rigged" is a dangerous word. Market inefficiencies are the premise behind investments and PERA pays its managers to extract economic rents from those market inefficiencies. The US public stock markets have a flaw/inefficiency that Mr. Lewis pointed out, stated Mr. Grabel. For a financial market to work there will always be a profit incentive for people to try to extract economic gain from inefficiencies.

Mr. Logan suggested HFT is the modern equivalent of a market maker done in a more efficient manner and is able to lower costs at the same and it benefits PERA. Mr. Grabel pointed out there is no single type of HFT.

Speaking from her experience in taxes, Ms. Kohlasch compared the market inefficiency to finding a loophole in the tax code.

Chair French offered to forward the link to the *60 Minutes* piece to those desiring to see it.

2. <u>Action Item</u>: Asset Allocation Recommendation
[*Exhibit 2: Asset Allocation Options*]

Mr. Mayfield, chair of the Investment Committee, stated this item has been discussed for a few months and the recommendation is the option with increased expected returns without increased risks. He introduced the following motion:

"RESOLVED, that the PERA Board approve Optimal Portfolio Alternative 2."

Chair French seconded.

Mr. Reynolds pointed out that alternative 2 relies on assumptions on the various asset classes. He noted that Wilshire ran the model with constraints on certain asset classes. He asked Wilshire to explain how the model performs if run unconstrained. Mr. Toth said in the absence of any constraints, depending on the risk level picked from the efficient frontier it will tend to gravitate to the alternative asset classes because the mathematical trade-off between risk and return is fairly high with those assumptions. Removing all of the qualitative constraints which were used in the asset allocation presentation the vast majority of the portfolio tends to gravitate to alternative assets.

Mr. Grabel pointed out that this is a combination of art and science. Constraints are put in place for liquidity. PERA pays out approximately $1 billion annually in benefits. Staff is exceedingly conscious that the construct of the model is designed to meet the liquidity needs of the plan.

Mr. Reynolds said he recognized that the fund was overweight in riskier asset categories and generally he accepts the recommendation; however, the model favors asset classes that he questioned how favorable those assets have been in PERA for the past. He said he hoped there will be an ongoing discussion about asset allocations.

The motion passed by unanimous [9-0] voice vote.

3. Quarterly Securities Lending Update

Deputy CIO Julian Baca reviewed the collateral balance, loan balance, total income and PERA income after JP Morgan has been paid. The principal balance as of March 31st was $515 million and the unrealized loss in the same period was $12.6 million which is down by $3 million from the end of the year due to market movement as well as the new practice to use the income from the collateral reinvestment pool to pay down the unrealized loss.

4. Securities Lending 101 Education Session

Sylvia E. Lee, JP Morgan - Securities Lending, said she has been covering PERA's account since May 2011 in which time the account has earned close to $9 million in revenue. Securities lending in general is an overlay investment strategy that enhances the core investment strategy in equities and fixed income. It can be used to add incremental alpha or to offset expenses. Ms. Lee said the majority of plans greater than $10 million participate in a lending program. Historically, returns for large pension plans have been positive even over difficult years. She outlined how the mechanics of securities lending in two parts the loan portion and the investment of the collateral. She outlined the investment guidelines that were drafted by PERA that outline lendable asset: treasuries, commercial paper, and time deposits within certain

parameters. She noted that generally speaking, less liquid securities attract higher borrowing demand.

Ms. Lee said JPM's strategy is to buy and hold until maturity. Those investments earn a yield and that return in addition to the fee that is earned on the loan added together are the revenue earned from the securities lending program. That revenue is split 90:10, 90 to PERA and 10 to JPM. She discussed the indemnification provided by JPM, and an additional credit analysis done on the cash collateral side.

Responding to questions raised by Mr. Reynolds, Ms. Lee confirmed that PERA will lend up to $600 million worth of securities. In terms of how that amount compares with other institutions, she said PERA's lending limit is on the lower side. PERA has impaired legacy assets and there is risk on the reinvestment of cash collateral.

Mr. Grabel noted that during the 2008/2009 financial crisis when the collateral pool was impaired that was true across the sector. A lot of pension plans switched custody banks, security lending agents and changed collateral guidelines.

In regard to the unrealized losses, Mr. Baca said the income from the program is being used to pay down those unrealized losses. Ms. Lee anticipated it would take four years to pay down the losses based on last year's revenue.

5. <u>Action Item</u>: Transition Management

a. Recommendation to Remove State Street Global Markets from Watch List

LeAnne Larrañaga-Ruffy, portfolio manager, advised the Board that at April's Investment Committee meeting staff and Wilshire recommended and the committee approved removing State Street from the operational watch list. State Street was placed on watch because of an issue in the UK where there was an alleged overcharge to transition clients. At that time, PERA had three other transition managers; however, one of the managers discontinued its transition business leaving two managers.

Ms. Larrañaga-Ruffy said staff has had several discussions with State Street and along with Wilshire, believe they should be removed from the watch list.

Mr. Mayfield introduced the following motion:

"RESOLVED, that the PERA remove State Street from the watch list."

Mr. Reynolds seconded and the motion passed by unanimous [8-0] voice vote. [Mr. Logan was not present for this action.]

6. <u>Presentations</u>: Fixed Income Investment Managers

Ms. Larrañaga-Ruffy said PERA has six fixed income managers: two core, three core

plus and one global. The total fixed income portfolio is $3.6 billion, 27 percent of the total fund.

a. BlackRock, CoreActive Fixed Income

Ms. Larrañaga-Ruffy introduced BlackRock noting they currently manage $726 million which is 19.7 percent of the fixed income composite and 6.2 percent of the total fund. PERA has been in this strategy with BlackRock since November 2006. BlackRock is also managing a passive REITs and TIPs portfolio and has a position on the transition manager bench.

Eric Jagelka, BlackRock, reviewed the assets PERA currently has with BlackRock and said the total relationship is just under $800 million. He reviewed a snapshot of the firm and how it is positioned in terms of the various asset classes and the services provided to clients. At a firm level, BlackRock has $4.33 trillion in assets. BlackRock has a robust offering of products and a robust and diverse client base.

Chris Woida, BlackRock, provided an overview of the fixed income markets, how the portfolio is currently positioned and recent performance. Generally, BlackRock will take risk if they think they will be compensated for that. Performance is judged in terms of risk adjusted returns. As a diversifier in fixed income they generally "zig" when their peers "zag." BlackRock tries to be consistent across all different kinds of markets.

Mr. Woida provided a recap of the model-based fixed income team with Tim Webb as the CIO. BlackRock's philosophy is that of a systematic research driven process to identify alpha and a portfolio construction team that is responsible for the appropriate market beta incorporating the alpha as a separate process. Aside from one change the team remains constant.

In terms of recent performance, Mr. Woida said after the difficult 2013 period, the portfolio is doing better. The three-year and five-year numbers were consistent with what Wilshire reported; however, the most recent quarter requires further reconciliation which BlackRock is conducting. This portfolio does not take significant interest rate bets and during the first quarter it stayed close to the index duration. Quantitative easing has created a steep yield curve. During this quarter there was strong performance in the allocation strategy. Last year there was an unperformance in second and third quarters when the market was introduced to the Fed's tapering.

Mr. Woida discussed the portfolio's characteristics highlighting duration and said they were trying to out-yield the benchmark. The portfolio seeks to build in high quality diversification. The average credit rating of the portfolio is similar to that of the benchmark. He outlined how the portfolio has evolved in the past few months.

Responding to the Chair's question about Wilshire's scoring of BlackRock, Mr. Toth said 2.5 is considered average and the concern about the organization is around asset size and recent acquisitions that have rapidly expanded the level of assets under management. That introduces questions and he reiterated that 2.5 is not an alarming score.

Mr. Grabel opined that BlackRock was a tier one firm.

b. Prudential, Core Plus Fixed Income

Ms. Larrañaga-Ruffy said Prudential currently has $664 million – 18 percent of the fixed income composite and 5.7 percent of the total fund. Prudential has managed this strategy since June 2012 for PERA.

Steven Ahrens, Prudential, said last month they sent out a press release introducing two new members of the team. The firm has $405 billion in assets under management. He noted a change in the portfolio manager and a backup portfolio manager is ready to step up to the senior team.

Mike Collins, Prudential, said the team works together closely with in-depth strategy meetings to generate key investment themes and best ideas of risk-adjusted return opportunities. He discussed the firm's market rate view. Being long duration will benefit the portfolio. Mr. Collins said the firm is less bearish regarding rising interest rates.

Mr. Collins reviewed the investment portfolio highlighting that the portfolio returned 2.8 percent for the first quarter of 2014 while the benchmark returned 1.8 percent. Over the past 12 months through 3/31/14, the benchmark shows close to a zero return which he attributed to rising rates. During that period the portfolio was able to outperform the benchmark by 1.5 percent. Since inception 6/1/12, the portfolio has generated a 4+ percent return. Mr. Collins discussed the diversity of the alpha the firm generates.

Generally speaking, an overweight to the credit sectors has outperformed. Having an overweight in the financial sector of the corporate bond market and an underweight in the industrial sector has been positive attribute to the portfolio.

Mr. Collins said the portfolio and team are well positioned for the future.

Mr. Reynolds asked where this portfolio would be placed in the new strategic allocation plan and Mr. Grabel responded it is something that staff and the consultants will have to return to the Board to discuss in terms of how the implementation needs to map closer to the strategic allocations.

C. Fiscal Year 2015 Operating Budget Update

Administrative Services Director Sylvia Barela said because the FY15 operating budget instructions and database released by DFA followed the April Audit & Budget Committee meeting, the operating budget for FY15 is being presented to the full Board as an information item. The total operating budget for FY15 personal services and employee benefits is $6,023,500 which includes the three expansion positions and a 3 percent cost of living increase for all PERA employees. Contractual services category is $33,317,500. And, category 400, Other, is travel and miscellaneous operating expenses at $1,073,600 for FY15. PERA's total operating budget for FY15 is $40,414,600. The operating budget is due at DFA and LFC May 1st.

Stating she was very involved in social justice, Ms. Naranjo-Lopez requested information on staff compensation. She also requested information on the allocations for Board members to attend trainings and asked that that information be provided in written form for discussion at the next Audit & Budget Committee meeting.

Chair French asked that the information from the new Board member orientation be provided to Ms. Naranjo-Lopez.

D. Executive Director's Report

Mr. Propst highlighted a new graph showing FY 14 contributions, investment income and employer/employee contributions that illustrates the amount of money that is transferred from the investment portfolio to pay retiree benefits. He reported that the $2.8 million information system upgrade is close to complete.

The Board congratulated Joaquin Lujan on his recent marriage to Monica Varela.

6. OTHER BUSINESS

None was offered.

7. ADJOURNMENT

Having completed the agenda and with no further business to come before the Board, Chair French declared this meeting adjourned at 12:30 p.m.

Approved by:

Patricia French
Chair, PERA Board

ATTEST:

Wayne Propst, Executive Director

Attached Exhibits:
Exhibit 1: Consent Agenda
Exhibit 2: Asset Allocation Recommendations