Ratified at the May 13, 2014 Investments Committee Meeting

# NEW MEXICO

# PUBLIC EMPLOYEES RETIREMENT BOARD

# INVESTMENTS COMMITTEE MEETING

## April 8, 2014

This meeting of the Public Employees Retirement Board Investments Committee was called to order by Vice Chair Roman Jimenez, at approximately 10:30 a.m. on the above-cited date in the PERA Building, 33 Plaza La Prensa, Fabian Chavez Board Room, Santa Fe, New Mexico.

1. **ROLL CALL**: Roll was called by Executive Director Wayne Propst and a quorum was established with the following members present:

**Members Present:**
Roman Jimenez, Vice Chair
Patricia French
James Lewis
Stewart Logan

**Member(s) Excused:**
Dan Mayfield, Chair
Jackie Kohlasch

**Other Board Members Present:**
Paula Fisher
Loretta Naranjo-Lopez
John Reynolds
Louis Martinez

**Staff Present:**
Wayne Propst, Executive Director
Susan Pittard, General Counsel/Chief of Staff
Jonathan Grabel, Chief Investments Officer
Sylvia Barela, ASD Director
Judy Olson, Executive Assistant
Karen Risku, Assistant General Counsel
Greg Trujillo, Deputy Director
LeAnne Larrañaga-Ruffy, Portfolio Manager
Roderick Ventura, Assistant General Counsel
Jason Goeller, Portfolio Manager
Joaquin Lujan, Portfolio Manager
Sonam Rapten, Financial Analyst
Mark Montoya, Financial Specialist

**Others Present**:
Jamie Feidler, Cliffwater
Michael Schlachter, Wilshire
Kat Brophy, Los Alamos County
C. Hust, NM DOH
Donald Alire, SWA
Jean Smith, NM DOH
Melissa L. Gonzales, DOH/ERD
Jennifer Suter, DOH EPI Survey Unit
Ermelina Romero, DOH EPI
B. Raymond, Self
Cindy Coda, Self
Lany Weaver, Self

Congratulations were forwarded to Chair Mayfield on the birth of his grandchild.

## 2. APPROVAL OF AGENDA

Mr. Lewis moved to approve the agenda as published. His motion was seconded by Ms. French and passed by unanimous [4-0] voice vote.

## 3. APPROVAL OF CONSENT AGENDA

Ms. French moved to approve the consent agenda. Mr. Jimenez seconded and the consent agenda was unanimously [4-0] approved.

## 4. CURRENT BUSINESS

### A. Chief Investment Officer's Report

#### 1. Preliminary Investment Performance Summary – March 2014

Jonathan Grabel, Chief Investment Officer, announced that Jason Goeller will be leaving PERA and joining Thornburg Asset Management. He thanked him for his tremendous contribution to PERA. Mr. Jimenez acknowledged Mr. Goeller's professionalism, as did Ms. French.

Mr. Grabel said the numbers are preliminary and the final numbers will be available at the April Board meeting. The report provides a "flash" as to what the portfolio looks like at the end of the prior month. He reviewed what the preliminary numbers revealed: the fund was up 16 basis points for March, fiscal year to date the fund is up 12.74 percent and, equities were up for the month. Mr. Grabel noted that the year to date numbers merit review.

When a manager is appearing before the Board providing a performance report, Ms. French requested that staff provide the most up-to-date number-related information on that manager.

### 2. Cash Plan Update

Mr. Grabel said the cash plan report has been modified to provide actual year to date, estimated and projected numbers for the balance of the year. Two additional tables were provided the describe the estimated changes in values during the current month and the strategic asset allocation with the actual as a target and the variance. This will provide the Board with clearer information.

During the month, there was a net transfer of $35 million to the STO to help pay benefits. $30 million of that transfer came from a redemption/rebalancing of the US equities portfolio. As March is the end of a calendar quarter, Mr. Grabel noted other changes in cash; private equity managers increased their capital call and manager fees.

The month ended with $158 million in cash inclusive of $96 million in the STO; however, $80 million is wired on the last Friday of the month to pay benefits.

### 3. Other Updates

Mr. Grabel reported that:

- Unrealized losses from the securities lending portfolio have been reduced from $15.6 million to $12.6 million
- MLP commitments were approved at $140 million at the last Board meeting and implementation has begun but no funding has occurred

## B. Information Item: Annual Hedge Fund Review

Jamie Fiedler, Cliffwater, pointed out that PERA uses hedge funds in two capacities: absolute returns and portable alpha. Both contain diversified portfolios of hedge funds but are constructed differently and have different objectives. The absolute return is a collection of hedge funds and hedge fund strategies in one portfolio with the goal of generating positive returns over long periods of time and that produce absolute returns over the long run, and reduce volatility for the overall PERA portfolio. That contrasts with the purpose of the portable alpha portfolio that has a separate element in which a portfolio of hedge funds has overlaid full exposure to the S&P 500. The goal of the portable alpha portfolio is to track, in PERA's case, the performance of domestic equities through the S&P 500 but outperform – generating alpha over equities.

Mr. Feidler reviewed the annualized returns through February 28, 2014 net of all fees: manager and Cliffwater fees. He noted that managers take a management fee plus a percentage of the profits. The absolute return portfolio shows strong outperformance across recent and multi-year periods. Relative to other hedge fund programs, PERA's portfolio is outperforming for the one-, three- and five-year periods and the outperformance has been significance. Mr. Feidler reviewed the benchmarks used for comparison purposes. Since inception, the portfolio is trailing because of the 2008 financial crisis.

There are currently 25 active funds in the absolute return portfolio. Generally speaking, Mr. Feidler said there was good performance in terms of absolute return as well as risk adjusted returns.

Ms. Naranjo-Lopez recommended a more in-depth look at the managers, specifically Elliott because "we shouldn't be investing with people that want to destroy pension plans."

Mr. Feidler pointed out that the outperformance of PERA's portfolio versus the Fund to Funds Index is 239 or 2.39 percent. He agreed with Mr. Logan and Ms. Naranjo-Lopez' that a review of the managers and associated fees could be beneficial.

Performance is what matters, stated Mr. Feidler, however, it is important to review the portfolio characteristics, allocations across strategies and across the globe. The portfolio is appropriately diversified.

Mr. Feidler discussed the portfolio's total market exposure to the markets in which the portfolio is invested, taking into account the notional exposure of all the derivatives in the portfolio and leverage.

The return driver for the portable alpha portfolio is the passive exposure to the S&P 500, stated Mr. Feidler. He noted that PERA changed its benchmark last year to add a 1 percent spread to the S&P 500. Over the trailing one-, three- and five-year periods, and since inception PERA has, net of all fees including those of Cliffwater, outperformed. The financial crisis had a tremendous impact on this portfolio but sticking with it has paid off.

The portfolio has 15 hedge funds and specifically excludes equity long-short.

Mr. Feidler said the anticipation is that hedge funds will deliver alpha, which is the anticipation for all investments. Since inception the alpha return is 1.5 percent.

Mr. Logan asked if PERA could have saved money and raised returns had it pared down or consolidated the number of managers within the separate funds of the hedge fund portfolio. Mr. Feidler said with hindsight he would say trims would have been marginal. There will not be a fee savings by having fewer funds. Fees in hedge funds are different from traditional investments. He supported the same balance across strategies which creates a well rounded portfolio.

Mr. Grabel said the biggest driver of plan fees is asset allocation, e.g., substituting public equity for private equity fees would go up.

**C. Action Item: Asset Allocation Recommendation**
[*Exhibit 1: Staff Asset allocation 4/18/14 recommendation*]

Mr. Grabel presented staff's recommendation, based upon the previous presentations by Wilshire, which is Scenario 2. Scenario 2 increases the expected return without increasing expected risk; it reduces the expected risk of the plan compared to today's current actual allocation; there is sufficient liquidity to pay benefits; it decreases public equity exposure globally; it creates a market-neutral public equity portfolio and provides a higher Sharpe ratio (return divided by risk) compared to both current target and actual allocations.

Mr. Grabel reviewed the changes in the current target and current actual with the implementation of Scenario 2. The biggest change is reducing the US equity exposure from 29 percent to 21.1 percent. Fixed income plus sectors would be added at 5 percent and further diversify the plan. This scenario reduces the absolute return allocation from 7 percent to 4 percent. He also reviewed the reduction in contributions to asset volatility with Scenario 2.

Mr. Grabel provided a comparison of Scenario 2 with the three other scenarios further strengthening the staff recommendation.

Ms. French requested confirmation that eliminating the home bias was the correct action. Michael Schlachter, Wilshire, said last year the when US markets were up the bias served PERA well. Thinking in long-term cycles there is no reason the US should continue to outperform non-US markets. He noted that companies compete globally. Over a long period of time the highest returning portfolio is one that capitalizes on every opportunity rather a subset of opportunities.

Mr. Logan asked if the hedge fund exposure could remain higher than 7.2 percent and still meet PERA's liquidity needs. Mr. Grabel said as part of an asset allocation compared to a benchmark, hedge funds had an excess contribution; however, traditional assets have over the past five years outperformed alternative assets.

Mr. Schlachter said the reduction in hedge funds corresponds to the fact that the overall alternative asset exposure was capped at 23 percent to maintain liquidity.

Mr. Lewis said he appreciates the optimization concept, removing the home-country bias and looking at where future growth is. He asked whether Scenario 2 was also Wilshire's choice.

Mr. Schlachter responded that they could support either Scenario 1 or 2 because they both decrease risk at the same level of return. He said the selection is based on the Board's risk tolerance. Scenario 2 in that regard is the best choice for increasing return and not increasing risk. The fact that the portfolio is performing above the target 7.75 percent, Scenario 1 takes risk off the table.

Mr. Grabel said applying the math, Scenario 2 gets the portfolio closer to 7.75 percent.

Mr. Martinez asked how long the fund would be locked into the strategy if approved. Mr. Grabel said PERA's investment policy states that the Board will review asset allocation on an annual basis and conduct an asset allocation study no less frequently than every third year.

Ms. French said typically the Board reviews the asset allocations at its retreat.

Mr. Jimenez supported the concept of optimizing returns with reduced risk and introduced a motion to recommend the approval of Scenario 2 to the Board. Mr. Lewis seconded and the motion passed by unanimous [4-0] voice vote.

**D. Information & Discussion Item: Update on Implementation and Contracting for Cash Equitization/Securitization**

General Counsel/Chief of Staff Susan Pittard said at a previous IC meeting staff was tasked to present to the IC options regarding cash equitization/securitization initiatives presented by Mr. Grabel. Ms. Pittard advised the Committee that PERA's investment contracts are exempt from the State's Procurement Code and instead use its own which provides the option of utilizing existing incumbent providers for similar or other services if they were procured by the RFP process and are providing satisfactory services under their existing mandate.

Ms. Pittard said PERA has a transition bench providing services pursuant to an RFP issued in 2011. Following discussion with Mr. Grabel and Mr. Baca it was determined that the transition bench managers are the optimal providers of this service.

Ms. Pittard said staff proposes bringing this item back before the Committee as an action item that delineates fees. Action would require a super majority (9 affirmative votes) of the Board. Staff will contact the transition managers and solicit bids for presentation.

Recognizing the service will be provided on a fee basis, Mr. Lewis asked whether there was an industry standard fee. Mr. Grabel said the standard is typically 3 or 4 basis points.

**E. Information Item: Manager Updates**

**1. NTGI Russell 1000 Growth/CS McKee Transition Update**

Ms. Larrañaga-Ruffy reminded the Committee that the Board approved the termination of CS McKee and Northern Trust Large Cap Growth. Those managers received their 30-day notice and during that time Wilshire solicited bids from the two active transition managers. BlackRock was chosen as the lower cost manager. The transition began on March 24th and the securities were transferred to the SSgA R1000 account at JPMorgan custody on March 28th.

BlackRock provided a post-trade report revealing that the transaction costs were 4 basis points equaling $316,000 and 1 point better than originally estimated.

**2. JP Morgan US Small Cap Growth Team Update**

Ms. Larrañaga-Ruffy said staff was informed that the CIO of the Growth and Small Cap Divisions of JP Morgan Asset Management will be departing to join BlackRock. Lead portfolio manager Eytan Shapiro was promoted to the vacated CIO position. Staff and Wilshire will monitor the situation and recommend no action at this point. She noted that she will be in New York and meet with the manager during the month.

Mr. Schlachter said while Mr. Shapiro's promotion is a good thing, Wilshire has concerns that the new senior management responsibilities may distract him from managing the portfolio. Wilshire will continue to monitor the situation and see what JP Morgan's plan is.

Mr. Grabel pointed out that with the implementation of the new strategic asset allocation there will be a reduction in the US public equity portfolio and that provides an opportunity to review the full bench of public equity managers.

Ms. French asked that Mr. Schlachter's observations regarding staffing be one of the questions Ms. Larrañaga-Ruffy poses to the manager.

Ms. Fisher expressed concern that PERA's portfolio may slip through the cracks during this staffing transition and Mr. Grabel pointed out that JP Morgan is one of the largest financial institutions in the world and in a firm that size there are plenty of ranks to fill the position.

**<u>Information & Action Item</u>: Transition Management**

1. **Staff Opinion on Size and Composition of Transition Management Bench**
2. **Recommendation to Remove State Street Global Markets from Watch List**

Ms. Larrañaga-Ruffy said staff and Wilshire recommend removing State Street from the watch list. The manager was placed on watch in 2011 in response to allegations that their UK division overcharged transition clients. At that time, PERA had four transition managers; currently PERA has only three including State Street.

In January 2014, State Street reached a settlement and staff believes they should be removed from the watch list.

In response to Ms. French's question as to whether Mr. Grabel agreed with the staff memo. He said yes, and referred to the volume of assets and number of mandates State Street has moved. He said they are clearly still in business and comparable to

BlackRock.

Mr. Schlachter pointed out that the manager for transition purposes is selected from the bench on a competitive bidding basis.

Ms. Fisher said she would prefer to keep the manager on watch for an additional quarter.

Mr. Logan moved to recommend to the Board that State Street Global Markets be removed from the watch list. Mr. Jimenez seconded and the motion passed by unanimous [4-0] voice vote.

### G. Information Item: Staff Reporting Update

Mr. Grabel reviewed a report that delineated the number and frequency of reports that the Investments Division generates. He said staff is focused on delivering quality information to the Board. He reviewed the existing reports that were being updated and improved and four new reports that are in development. Staff will work with the Board to further refine staff reporting. He said he looked forward to reporting on risk adjustment performance on the plan as whole.

## 5. OTHER BUSINESS

Ms. French said Mr. Logan has been instrumental in recommending the development of a subcommittee to review manager fees. She appointed the following individuals to the subcommittee: Mr. Logan, Mr. Mayfield, and Mr. Lewis.

## 6. ADJOURNMENT

Having completed the agenda, and upon motion by Ms. French and second by Mr. Lewis, Vice Chair Jimenez declared this meeting adjourned at 12:25 p.m.

Approved by:

Roman Jimenez, Vice Chair
Investments Committee

ATTEST:

Wayne Propst, Executive Director

Attached Exhibits:
*Exhibit 1: Staff Asset Allocation 4/18/14 recommendation*