NEW MEXICO

PUBLIC EMPLOYEES RETIREMENT BOARD

INVESTMENTS COMMITTEE MEETING

July 8, 2014

This meeting of the Public Employees Retirement Board Investments Committee was called to order by Chair Dan Mayfield, at approximately 9:00 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:
Dan Mayfield, Chair
Roman Jimenez, Vice Chair
Patricia French
Jackie Kohlasch
James Lewis
Stewart Logan

Member(s) Excused:
None

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

Staff Members Present:
Wayne Propst, Executive Director
Susan Pittard, General Counsel
Jonathan Grabel, Chief Investment Officer
Sylvia Barela, ASD Director
Greg Trujillo, Deputy Director
Karen Risku, Deputy General Counsel
Ron Venture, Assistant General Counsel
Julian Baca, Deputy CIO
Judy Olson, Executive Assistant
Patricia Thaxton, Liaison Officer
LeAnne Larrañaga-Ruffy, Portfolio Manager
Joaquin Lujan, Portfolio Manager
Christina Keyes, Portfolio Manager
Mark Montoya, Portfolio Manager

Others Present:
Jamie Feidler, Cliffwater
Tom Toth, Wilshire
Paul Lium, Nationwide
Lynn Alexander, Kelso Investment Associates
Phil Berney, Kelso Investment Associates
Frank Loverro, Kelso Partner
Jerome Silvey, Starwood Capital Group
Barbara Pardo, PERA retiree

2. APPROVAL OF AGENDA

Ms. French moved to approve the agenda as published. Her motion was seconded by Mr. Lewis and passed by unanimous [6-0] voice vote.

3. APPROVAL OF CONSENT AGENDA

Mr. Jimenez moved to approve the consent agenda. Mr. Lewis seconded and the consent agenda was unanimously [6-0] approved.

4. CURRENT BUSINESS

A. Chief Investment Officer's Report

1. Preliminary Investment Performance Summary – June 2014

Jonathan Grabel, Chief Investment Officer, noted that June ends fiscal year 14 and he will be presenting preliminary numbers. June reached a high watermark of $14.6 billion. The estimated fiscal year returns were 17.05 percent. With an actuarial assumption of 7.75 percent, 17 percent is fantastic number. The recently approved asset allocations will, when implemented, provide greater diversity in the portfolio and continue to improve the fund's performance. He said the new asset allocation policy is prudent in multiple dimensions: better diversifies risk, expands asset categories and alternative assets in terms of cash flow, volatility and risk profile.

Mr. Grabel noted that all asset categories were up during June.

Mr. Lewis asked how the political environment in the Middle East and Russia/Ukraine could impact the fund. Mr. Grabel said while it is troubling on the human level the direct impact on the PERA fund is de minimis. The capitalization of the Ukraine market is equivalent to the median company in the S&P 500. Russia is perhaps the 20th largest stock market in the world so it is less a direct impact and more ancillary/indirect. It is the portion of the portfolio that staff will continue to monitor.

Mr. Grabel suggested discussing the market psychology of the events in the Middle East or Ukraine could be a valuable retreat topic.

2. Cash Plan Update

Mr. Grabel said a net transfer of $40 million was made to the State Treasurer's Office to pay benefits. There was also a $35 million transfer into the new MLP allocation. He reviewed the sources of cash.

The new cash management/equalization program contract is being reviewed by the Legal Department and is not yet funded.

Ms. French requested that staff add the Parametric Clifton cash equalization program to the monthly update.

3. Other Updates

Mr. Grabel said the new strategic asset allocation will be discussed at the retreat in the context of the investment policy statement.

Staff is working on the MQs for the custodian bank RFP. He estimated a six-month timeframe to issue and award an RFP.

B. Information Item: Quarterly Securities Lending Update

Julian Baca, Deputy CIO, said as of June 2014 the loan balance was $447 million. There is a $600 million limit to be loaned at any given time. Since JP Morgan took over the program in April 2011 the program has generated $11.278 million. The split with JP Morgan is 90/10, PERA 90 percent, JP Morgan 10 percent.

The unrealized losses are $9,753,223, a reduction of approximately $3 million or 20 percent reduction from the previous quarter. The Board made a decision in 2013 to apply the program income to pay down unrealized losses and legacy securities continue to pay down which is helping the program.

Mr. Baca lauded the Board's patience in maintaining a conservative portfolio.

Mr. Baca noted that the Board approved the JP Morgan contract extension for an additional two years in May 2014. The contract expires June 30, 2016 to coincide with the custody bank contract also with JP Morgan.

C. Information Item: Mid-year Private Assets Commitment Budget Update [*Exhibit 1: Cliffwater Report*]

Jamie Feidler, Cliffwater, said this informational item reviews the Board's commitments for vintage year 2014 versus its commitment budgets. Private asset commitments require a capital budgeting process. The budget serves as a planning tool and provides a road map for building out the private assets portfolio. Mr. Feidler

reviewed the budgeted amounts approved by the Board in February 2014 for private equity, real assets, and real estate. The budget was created with the current asset allocation and a new budget and new pacing will be required for the new asset targets.

Mr. Grabel noted that funding was below pace; however, the goal is to be prudent and make commitments in the context of the market environment. The market is difficult to be making commitments in because there are many plans increasing their alternative asset budget. These commitments are 10 plus years and a bad buy decision should be avoided.

Mr. Feidler pointed out that a lot of capital is being raised, not because the opportunities are the best but because there is a lot of money. The market requires patience.

Mr. Grabel said there is generally a 10-day period to provide capital for a call and that is one of factors of PERA's liquidity threshold. The projection for unfunded commitments is monitored along with the return of capital. During fiscal year 14 there has been parity between capital calls and distributions.

D. <u>Action Item</u>: Alternative Asset recommendations for approval, to be funded according to the cash plan and subject to legal review by general counsel:

1. Recommendation to commit up to $60 million to Kelso Investment Associates IX, LP, a middle-market buyout fund for the Private Equity portfolio

[*Exhibit 2: Kelso Report; Exhibit 3: Staff report; re: Kelso; Exhibit 1: Cliffwater Report; re: Kelso*]

Joaquin Lujan, portfolio manager, said staff conducts its due diligence in concert with Cliffwater. Fund IX will own approximately 15 to 20 private equity assets dominantly domiciled in North America. Kelso projects a relatively stable 12 percent to 17 percent net IRR for this 10 to 12-year holding period fund.

Mr. Lujan reviewed PERA's current private equity portfolio noting there were 865 companies within the portfolio. Since 2006, 505 companies have been sold and the profits back to PERA were $345 million. He explained that what the portfolio holds and what has been received in profits is greater than what has been invested generating a net IRR of 10.28 percent.

Mr. Lujan said the differentiating aspect of Kelso is that Kelso's founder created the employee stock option plan/program which aligns the management of public companies with the stock owners and investors.

Ms. French commended staff on their well-prepared report.

Mr. Lujan noted that this fund will provide a different exposure than PERA

currently has in the public equity portfolio. Kelso's niche is North America. In regard to alignment or skin-in-the-game, Mr. Lujan said Kelso will be putting $500 million of their own money into the $2.5 billion fund. Typically, a firm will invest 2 percent to 3 percent in the fund. While historical performance is very important, it is not the end-all for PERA. What's important with Kelso is PERA's existing relationship in Fund VIII and with this recommendation, PERA will have roughly make up 8 percent of Kelso's investors.

Frank Loverro, Kelso partner, said when Kelso makes a capital call down for an investment, capital is obtained from the partners and all limited partners. When the investment is exited capital is return to limited partners on a transaction to transaction basis.

Lynn Alexander, Kelso partner and investor relations, said the firm has enjoyed a long-standing relationship with Cliffwater and said Mr. Baca has been very diligent in the review of Fund IX.

Phil Berney, President, Kelso, discussed the employee stock ownership plan (ESOP) as a component of the way the firm approaches investments. Louie Kelso, founder of Kelso, believes that if shareholders, management and labor are all pulling the oar in the same direction there will be a better outcome. He said the alignment Kelso creates with its management, shareholders, and labor creates interesting investments for all involved. Kelso strives to create long dated returns over significant time periods with outstanding rates of return.

Mr. Berney reviewed the Kelso team that he referred to as cohesive and experienced with 15 managing directors and 22 investment professionals. He noted that the youngest investment directors have an average of 16 years at Kelso creating a very deep bench. The team is stable and he noted that the most tenured partners are significant investors.

Mr. Loverro discussed Kelso's investment strategy which is to find inefficiencies in the efficient and competitive market in which they invest. Kelso takes advantage of their 33-year history which he referred to as Kelso's edge. The fact Kelso has had no employee turnover insures relationships and that Kelso has so much skin-in-the-game or an owner's mindset is critical to their success.

Kelso has developed deep expertise across multiple industries and provides diversification.

Mr. Berney reviewed the firm's track history since 1981. He noted that in this eighth fund very young and multiple investments will occur. The firm has a gross IRR of 32 percent and a net of 23 percent.

Mr. Berney said Kelso believes in transparency and provides to Cliffwater as well as all limited partners company by company buildup of each company's performance and

ultimately what the return of the fund will be.

Ms. Alexander said Fund IX is expected to raise $2.5 billion of which 20 percent will come from Kelso. This fund has an innovative fee structure further promoting their strong alignment. The fee structure on an absolute basis will result in lower management fees by 15 percent to 30 percent compared to a more traditional fee structure. On a relative basis the fee structure will add 3 percent to 10 percent in net IRR in the early years of the fund.

Mr. Logan moved to accept and forward staff recommendation to the Board that PERA commit up to $60 million to Kelso Investment Associate IX, LP. Ms. French seconded and the motion passed by unanimous [6-0] voice vote.

Chair Mayfield thanked the firm for providing a glossary within their report.

1. **Recommendation to commit up to $60 million to Starwood Global Opportunity Fund X, LP, an opportunistic real estate fund for the Real Estate portfolio**
   [*Exhibit 4: Starwood Global Report; Exhibit 5: Staff report; re: Starwood Global; Exhibit 1: Cliffwater Report; re: Starwood Global*]

Mr. Lujan introduced Jerome Silvey, Executive Vice President and CFO of Starwood Capital Group. Mr. Silvey provided a presentation describing their investment program and its performance over the past 23 years. The firm has $36 billion in assets under management and has averaged 32 percent gross IRR since inception. He said that has been generated with a modest leverage. Starwood will raise between $4 billion and $5 billion for this fund. PERA has invested in Starwood's past two funds a total of $50 million and they are expected to deliver a 23 percent gross IRR for both funds.

Mr. Silvey said the firm intends to double the investor's capital over the management timeframe. He said they also target to generate a strong current yield coming off the portfolio. The ninth fund has been generating a 10 percent return. Even if they are unsuccessful in creating value and the asset is sold for what they paid for it, Mr. Silvey said they still will have generated a 10 percent overall return for limited partners.

Mr. Silvey reviewed the organization noting they recently bought special servicing groups which focus on special distressed loans in the US and Europe. He reviewed an analysis of their business lines that are synergistic to their opportunistic strategy. Starwood runs the largest commercial mortgage REIT in the US and gains a great deal of data from that firm. They have a focused group on hotels which is a very different property than commercial office properties. He outlined their competitive advantages relative to their peers, noting they have a hands-on focus on real estate.

The firm's philosophy is to buy below replacement cost, utilize appropriate leverage, investing when new supply is low and constructing diversified portfolios.

Diversification reduces the risk for the limited partners. This fund will focus on distressed real estate predominately in Europe, value-add assets and corporate transactions/restructuring and acquisitions.

Mr. Silvey reviewed Fund X that has a $4 billion to $5 billion target. The first close came last week in the amount of $2.1 billion of capital commitments. Starwood is targeting to complete fund raising by year-end. He anticipated the investments would be 50/50 US and Europe.

Mr. Silvey said the returns he presented were gross rather than net. Fund VIII is 95 percent drawdown while Fund IX is 70 percent drawdown. The firm makes capital calls on the quarter and he explained how that amount is determined and in so doing allows for accurate and forecastable capital calls.

In regard to distress real estate, Mr. Lewis asked whether Florida still provides opportunities. Mr. Silvey said Starwood is positive on Florida because corporations are leaving higher tax rate jurisdictions and moving to zero tax rate jurisdictions – Texas and Florida in particular. Toyota recently relocated from California to Texas. He said that Florida has provided very strong returns. Currently, there are many new construction projects underway which reduces the values. Discount to replacement cost is an important component to Starwood's investment. While the discount to replacement cost is high in Detroit the economic growth is still minimal.

Mr. Logan moved to accept and forward staff recommendation to commit up to $60 million to Starwood Global Opportunity Fund X, LP. Ms. French seconded and the motion passed by unanimous [6-0] voice vote.

5. OTHER BUSINESS

None was brought forward.

6. ADJOURNMENT

Having completed the agenda, and with no further business to come before this Committee, Chair Mayfield declared this meeting was adjourned at 11:00 a.m.

Approved by:

8/12/14

Dan Mayfield, Chair
Investments Committee

ATTEST:

Wayne Propst, Executive Director

Attached Exhibits:
Exhibit 1: Cliffwater Report
Exhibit 2: Kelso Report
Exhibit 3: Staff report; re: Kelso
Exhibit 4: Starwood Global Opportunity report
Exhibit 5: Staff report; re: Starwood