NEW MEXICO

PUBLIC EMPLOYEES RETIREMENT BOARD

INVESTMENTS COMMITTEE MEETING

March 11, 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**: 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:
Dan Mayfield, Chair
Roman Jimenez, Vice Chair
Patricia French
Stewart Logan
Dan Esquibel [appointed following Mr. Jimenez' early departure]

Member(s) Excused:
Jackie Kohlasch
James Lewis

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

Staff Members Present:
Wayne Propst, Executive Director
Susan Pittard, General Counsel/Chief of Staff
Greg Trujillo, Deputy Director
Sylvia Barela, ASD Director
Judy Olson, Executive Assistant
Jonathan Grabel, CIO
Julian Baca, Deputy CIO
Karen Risku, Assistant General Counsel
Roderick Ventura, Assistant General Counsel
LeAnne Larrañaga-Ruffy, Portfolio Manager
Christina Keyes, Portfolio Manager
Jason Goeller, Portfolio Manager
Joaquin Lujan, Portfolio Manager
Mark Montoya, Financial Specialist
JoAnn Garcia, Deferred Compensation Program Manager

Others Present:
Jamie Feidler, Cliffwater
Michael Schlachter, Wilshire
Paul Lium, Nationwide
Dennis McCanless, EnCap Flatrock
Matt Crystal, EnCap Flatrock
Pam Palermo, NM DOH
Jenny Smith, DOH/ER Survey Unit

2. APPROVAL OF AGENDA

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

3. APPROVAL OF CONSENT AGENDA

Chair Mayfield indicated that he reviewed the minutes of the previous meeting and found them to be accurate and complete.

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 – February 2014

Jonathan Grabel, Chief Investment Officer, said the numbers are preliminary and will be finalized for the March Board meeting. The plan was up for February hitting a new high of $14.3 billion. On a preliminary basis, this yielded 3.6 percent for February and recovered the losses incurred during January. Mr. Grabel said fiscal year to date, the plan is up in excess of 12.7 percent. Equities and fixed income had very strong performance for February. Commodities were up 5 percent during the month, however, it is a relatively small exposure at $100 million for the portfolio.

2. Cash Plan Update

Mr. Grabel said the month ended with a cash balance of $178 million, however, that number is inclusive of approximate $75 million in benefit payments which are posted the last Friday of the month. The balance was actually $103 million. The major item to note during the month was that $40 million was taken from the most overweight asset categories which was international equities. Historically, staff has taken cash from the most overweight asset category.

3. Other Updates

Mr. Grabel reported that securities lending will be on the April agenda to provide a quarterly detailed update. At the end of February the losses were reduced by $265,000 demonstrating unrealized losses of $14.9 million.

Staff is working on a list of all agency investment-related reports – monthly quarterly, annually – as well as reports from the custodian bank and two consultants. He anticipated the list will be ready at the April IC meeting.

Two equity managers – CS McKee and Northern Trust – were terminated in February and bids were received from PERA's transition managers; and Blackrock was the low bidder. The goal is to finish the transition by the end of the month. Transitioning portfolios is a commodity business and Mr. Grabel said Blackrock provided a good bid.

Mr. Grabel said an investment orientation session for new board members was very successful and staff was available to provide additional sessions.

Responding to Ms. French's question of who on staff will be assigned to interact with the custody bank, Ms. Grabel said staff interacts with JP Morgan Chase on a daily basis and they are working with HR to have the newly vacated position classified and posted. Julian Baca, Deputy CIO, said JP Morgan has made changes for PERA but given their platform it may make sense to look at another custody bank. Mr. Grabel emphasized that PERA's assets are safe.

B. <u>Informational Item</u>: Deferred Comp Plan Review
[*Exhibit 1: New Mexico Deferred Compensation Plan 4th Quarter 2013 Plan Review*]

Paul Lium, Nationwide Retirement Solutions, referred to a question posed at the last meeting regarding rollover numbers. He said the numbers are within industry standards. The total number of plan participants is 17,677 and of those, 11,458 are contributing.

JoAnn Garcia, Deferred Compensation Program Manager, said they were working on a rollover brochure to educate participants.

Mr. Lium discussed the new share class for Vanguard which will reduce the management expense and mentioned new and promoted Nationwide staff.

C. Discussion & Action Item: Asset/Liability/Allocation Structure
[*Exhibit 2: PERA Asset Allocation 2014 Analysis and Recommendation, 3/11/14; Exhibit 3: Wilshire, Asset Allocation Analysis and Recommendation 3/11/14*]

Mr. Grabel acknowledged very good discussions have occurred regarding the asset allocation for the plan. He recognized staff, the Board and advisors for their thoughtful analysis.

Mr. Grabel reviewed the process for the asset allocation study and noted that since the last fully implemented asset allocation study (December 2009) there has been a lot of change in the capital markets as well as within PERA The fund balance is 33 percent bigger and the performance of different asset categories has changed dramatically. He reviewed PERA's investment policy. He highlighted that the policy established that the target allocation will be reviewed annually for reasonableness relative to significant economic and market changes or to changes in the fund's long-term goals and objectives. A formal asset allocation study should be conducted at least every three years to verify or amend the targets.

Mr. Grabel identified liquid alpha as the major change not implemented in 2010. He said liquid alpha is a tactical strategy that was established at 0 to 7 percent in terms of target bands.

Mr. Grabel identified goal of the analysis is to position the fund to attain the actuarial return target of 7.75 percent in order to meet the obligations of the membership. He referred to the Sharpe ratio which is a measure of return divided by risk.

Mr. Grabel said staff recommends implementation of Alternative 2 which is the optimal scenario. It is not a wholesale change but rather builds on the success of PERA's portfolio and the major changes/improvements is it reduces the public equity footprint, increases private equity exposure, and rebalances the public equity portfolio to be more market neutral. A new category, fixed income plus, provides more opportunistic credit. These changes would increase the expected return over a 10-year period from 7.07 to 7.25 and reduce the risk from 11.73 to 11.17 – a higher Sharpe ratio portfolio.

Michael Schlachter, Wilshire, said based on stock and bond return assumptions, the alternative investments help to inflate some of the expected return. The plan has improved in the past eight months and is far healthier. To illustrate PERA's dependency on investment returns, he noted that in 2025+ annual benefits payments will be $1.5 billion to $2 billion annually.

Ms. Schlachter said Wilshire can support alternatives 1, 2, or 3. He said the options were more efficient than the current asset allocation mix. Alternatives 1 and 2 are the two most valid choices. Alternative 1 matches the current level of expected return in the current target asset allocation. Alternative 1 reduces risk by a full percentage point or 90 basis points which he highlighted as "a tremendous improvement" that meaningfully reduces risk. Alternative 2 keeps risk constant and adds more return.

Mr. Schlachter reviewed the changes required within the asset allocation to shift to Alternative 1 or 2.

Ms. Naranjo-Lopez asked why the recommended alternative shows a limit in high yield bonds. Mr. Schlachter said high yield was reduced to 5 percent given that it's a relatively new asset class investment for PERA. Fixed income plus investment pose unique risks because they are more equity-like than fixed income-like.

Mr. Schlachter said the core fixed income portfolio could be reduced if there was a concern of a rising rate environment, however, where the money is moved will increase risk. He pointed out that Alternatives 3 and 4 present the potential for harm.

Jamie Fielder, Cliffwater, reminded the Committee that alternatives are capped at a total allocation of 23 percent.

Mr. Esquibel asked about the cost the fund would incur in making these asset allocation changes. Mr. Schlachter said there would be costs for the public assets as well as cost for an RFP, etc. Mr. Grabel said none of the alternatives are wholesale revisions of the strategic asset allocation and he characterized the proposed modifications as on the margin.

Mr. Schlachter identified the largest cause of risk in the current portfolio as the US/non-US allocation. A home-country bias is very common but not efficient and places an uncompensated risk within the portfolio.

Mr. Schlachter said the Committee needs to determine their risk tolerance. Increasing risk has potential consequences. The higher risk in Alternative 3 will pay off in the course of 10 years, but the risk tolerance of the trustees needs to be considered.

Noting that Alternatives 1, 2 and 3 are better than the current asset allocation, Mr. Jimenez said the question is risk versus reward. Alternatives 2 and 3, which may generate more return, will result in more potential risk.

Mr. Grabel said staff recognizes that Alternatives 1, 2 and 3 are all within the efficient frontier; however, staff's focus was to not increase the plan risk and recommends Alternative 2. Staff will develop a pacing schedule to implement whichever alternative is selected by the Board.

Mr. Schlachter guestimated it would take up to three months to make the allocations noting that opportunistic fixed income would require an RPF-based search and take more time. Market opportunity availability dictates investments in the alternative asset portfolio. Rebalancing US to non-US equities would be relatively easy.

Ms. Naranjo-Lopez thanked the consultant and staff for their thorough review and explanation on the alternatives.

Mr. Schlachter said depending on the outcome of the structure of asset allocation the actual structure of the underlying assets will be fleshed out accordingly.

Ms. French moved to defer action on this item until the absent committee members are present next month. Mr. Logan seconded.

Under discussion, Mr. Jimenez said the committee has been briefed on this item for two months and he was prepared to forward a recommendation to the Board. He understood that Mr. Lewis talked to staff and had no pending questions.

Ms. French said as long-term investors she felt an additional 30 days would not hamper that goal. She understood that there was no golden parachute that would be missed by postponing action.

Mr. Grabel said he talked to Mr. Lewis last week and his focus was on sufficient liquidity and the removal of the home-country bias.

Mr. Esquibel favored postponing action until the alternatives were fully vetted.

Ms. French asked whether waiting would be a problem and without being able to look into the future, Mr. Grabel could only say that the PERA's current portfolio is not within the efficient frontier.

Mr. Propst asked about the duration the portfolio has been off the efficient frontier. Mr. Schlachter said he knew the plan has been off for the eight months Wilshire has been with PERA. He said while the target is diversified, the plan is concentrated because capital has not been deployed into the various allocations.

Mr. Propst appreciated the cooperation and collaboration that has occurred amongst staff and the two consultants.

The motion to defer action for 30 days passed by majority [3-1] voice vote with Mr. Jimenez voting against.

D. <u>Educational Items</u>: Cash Equitization/Securitization
[*Exhibit 4: Staff presentation: Increase Case Flexibility, Decrease Cash Drag*]

Mr. Grabel said PERA averages an operating cash balance of $275 million: $50 million in JPM short-term investment fund (STIF); $75 million is in State's Treasurer's Office (STO) and $150 million is in underutilized cash balance. He said there is a cost to an uninvested $275 million. This is referred to as a cash drag. The cost to PERA of sitting on cash for a year is $44.8 million.

Mr. Grabel discussed the using cash equitization to reduce cash drag and have sufficient cash to pay managers and benefits. Cash equitization utilizes derivatives/futures which replicates the traditional portfolio of public stocks and core fixed income. He reviewed the mechanics of cash equitization that would eliminate the cash drag. The program can be achieved for three or four basis points.

Ms. French congratulated Mr. Grabel on bringing this plan to the Board. She asked General Counsel Pittard to determine whether this requires formal action and that it be properly noticed for the meeting.

Mr. Grabel said he could return to the IC with a plan at its April meeting.

E. <u>Action Item</u>: Alternative Assets recommendation for approval, to be funded according to the cash plan and subject to review by General Counsel:

1. Recommendation to invest up to $45 million in EnCap Flatrock Midstream Fund III, LP, an energy infrastructure fund for the Real Assets portfolio
[*Exhibit 5: Cliffwater report; Exhibit 6:Staff report re: EnCap; Exhibit 7: EnCap presentation*]

Christina Keyes, Portfolio Manager, reviewed the recommendation to invest up to $45 million in EnCap Flatrock Midstream Fund III. The intention of Fund III is to focus on North American natural resource basins which are currently lacking in the required infrastructure for gathering, treating and processing of hydrocarbons. The fund will make investments in assets or companies providing midstream services for natural gas, natural gas liquids, and crude oil. The fund will target providing growth capital to investments averaging about $150 million to $250 million per transaction within eight to 12 platform companies. The full commitment period is expected to be two to three years and an estimated hold period per deal of three to seven years.

Ms. Keyes noted that Flatrock's strategy is differentiated from other real asset investments in the portfolio in that it is intended to capitalize on the tremendous need for additional investment in the infrastructure space related to domestic engineering. The investment offers a component of inflation protection given that cash flows are stable and are correlated to consumption rather than commodity pricing.

Mr. Feidler said most of PERA's exposure is in upstream energy which is the exploration and extraction of oil and natural gas out of the ground. Once out of the ground it is transported and that is referred to as the midstream section. Flatrock focuses on the building of the infrastructure.

Dennis McCanless, EnCap, said they put money behind teams that pick up production at the wellhead, treat it for impurities/create a marketable product and then move it to a downstream market. EnCap is building long-term assets to incubate the opportunity for the next higher bidder which is typically the MLP. He said EnCap does a lot of work on the upfront of success and evaluate the risk around the reservoir.

Ms. Keyes reviewed the key points that make this a compelling investment opportunity for the portfolio complementing what PERA already has in its energy investments. PERA is currently invested in EnCap funds VII, VIII and IX which are all focused on the upstream sector.

Matt Crystal, EnCap, said the firm has been in existence for 26 years and raised a total of 17 funds totaling $18 billion. EnCap has backed over 210 portfolio companies and has gone full cycle with 160 of those. He discussed the relationship with Flatrock.

With Mr. Jimenez' early departure and having lost a quorum, Chair Mayfield appointed Mr. Esquibel to serve on the committee

Mr. McCanless discussed the teams they have backed, the firm's resources and how they assist in team success.

Mr. Logan asked whether PERA has any downstream investments and Mr. Feidler responded there is downstream exposure but no explicitly downstream focus. The majority of PERA's exposure is upstream.

Mr. Stewart moved to recommend to the Board that PERA invest up to $45 million in EnCap Flatrock Midstream Fund III. Mr. Esquibel seconded. Ms. French noted that any approval would be subject to approval of legal documentation by PERA's general counsel. The motion passed by unanimous [4-0] voice vote.

5. OTHER BUSINESS

None was brought forward.

6. ADJOURNMENT

Having completed the agenda, and upon motion by Mr. Stewart and second by Ms. French, Chair Mayfield declared this meeting was adjourned at 12:10 p.m.

Approved by:

Roman Jimenez, Vice Chair
Investments Committee

ATTEST:

Wayne Propst, Executive Director

Attached Exhibits:
Exhibit 1: New Mexico Deferred Compensation Plan 4th Quarter 2013 Plan
Exhibit 2: PERA Asset Allocation 2014 Analysis and Recommendation, 3/11/14
Exhibit 3: Wilshire, Asset Allocation Analysis and Recommendation 3/11/14
Exhibit 4: Staff presentation: Increase Case Flexibility, Decrease Cash Drag
Exhibit 5: Cliffwater report re: EnCap
Exhibit 6: Staff report re: EnCap
Exhibit 7: EnCap presentation