NEW MEXICO

PUBLIC EMPLOYEES RETIREMENT BOARD

INVESTMENTS COMMITTEE MEETING

November 20, 2014

This meeting of the Public Employees Retirement Board Investments Committee was called to order by Chair Dan Mayfield, at approximately 9:10 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**: The Pledge of Allegiance preceded roll which 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
Treasurer James B. Lewis
Stewart Logan

Member(s) Excused:
Jackie Kohlasch

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

Staff Members Present:
Wayne Propst, Executive Director
Susan Pittard, Chief of Staff/General Counsel
Jonathan Grabel, Chief Investment Officer
Sylvia Barela, ASD Director
Karen Risku, Deputy General Counsel
Julia Baca, Deputy CIO
Rod Ventura, Assistant General Counsel
Judy Olson, Executive Assistant
LeAnne Larrañaga-Ruffy, Portfolio Manager
Joaquin Lujan, Portfolio Manager
Christina Keyes, Portfolio Manager
Mark Montoya, Portfolio Manager

Natalie Cordova, Comptroller
Jude Perez, Portfolio Manager
Claudia Armijo, Assistant General Counsel

Others Present:
Jamie Feidler, Cliffwater
Tom Toth, Wilshire
Paul Lium, Nationwide
Dexter Paine, Paine & Partners
Kevin Schwartz, Pain & Partners
Chris Merrill, Harrison Street
Geoff Regnery, Harrison Street
Jessica Bundy, REDW
Steve Cogan, REDW

2. APPROVAL OF AGENDA

Ms. French moved to approve the agenda as published. Her motion was seconded by Treasurer Lewis and passed by unanimous [4-0] voice vote. [Mr. Logan was not present for this action.]

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. [Mr. Logan was not present for this action and arrived shortly thereafter.]

4. CURRENT BUSINESS

A. Chief Investment Officer's Report

1. Preliminary Investment Performance Summary – October 2014

Jonathan Grabel, Chief Investment Officer, presented the JP Morgan preliminary numbers for October. The fund balance for October was at $14.5 billion up 81 basis points for the month. The increase hides tremendous volatility and mixed indicators that occurred during the month. Regarding the energy sector, Mr. Grabel stated it was down 10 percent during October. That will provide a boost to consumer spending which makes up 2/3 of the US gross domestic product. With the price of a barrel down, marginal energy investments cannot occur. In terms of what it means to PERA, exposure has been reduced to the direct commodity. However, the real asset portfolio contains approximately $600 million invested in real assets of which 85 percent of those commitments are to energy. The energy sector makes up approximately 8.5 percent of the global equity markets (ACWI).

Mr. Grabel said the low cost of oil further exemplifies the importance of prudent diversification not only across asset classification but within asset categories.

Mr. Esquibel asked how many investments are duplicated in different categories which would cause a domino effect of diminishing returns on PERA's investments. Mr. Grabel said PERA is using more analytics to parse through every manager's portfolio to look at the PERA plan on a whole. Wilshire's Compass will help with data analytics. He said there is overlap and provided examples of that in an index fund with a weighting to energy versus an energy fund.

Mr. Grabel noted that equities were up with domestics performing the best. Fixed income was up and at this point it is too early to know how alternative assets performed. He highlighted that it was a tough month for some of PERA's hedge funds within the portable alpha program and absolute return program.

2. Cash Plan Update

Mr. Grabel said the preliminary estimate in the change of the fund balance was approximately \$95 million during October. The month ended with \$337 million in cash, higher than typical; however, it is higher because of the domestic equity rebalancing. PERA is re-allocating \$1.5 billion over a six-month period. The cash overlay program generated \$5 million incremental in cash for October. He outlined the sources of cash and uses of cash: benefits and manager fees at \$40 million and transition to fixed income plus transition account managed by BlackRock at \$100 million. There were outflows for capital calls and a transfer of \$19 million for the overlay buffers, cash overlay and portable alpha.

3. Other Updates

Mr. Grabel reported on the recent JP Morgan communication regarding a foreign exchange settlement with various regulators around the world for approximately \$1 billion. JP Morgan and six other banks were accused of manipulating foreign exchange markets/benchmarks. He noted that foreign exchange is one of the largest financial markets in the world with daily trade volumes of \$5.3 trillion.

PERA has a significant number of investments that are not based in US dollars and JP Morgan is used as the custody bank to process foreign exchange trades. Mr. Grabel said this strengthens his confidence in issuing the custody bank RFP.

Mr. Grabel highlighted the following points:

- The reduction in the unrealized losses in the securities lending program continues with an additional \$300,000 in October. The current unamortized losses are \$7 million
- Staff and consultants will continue to present asset category structure analysis to the Board

B. Information Item: Request for Proposal/Request for Information Update

Mr. Grabel said staff is working on a calendar for presentation at the December IC meeting on the status of the RFP and RFIs and he presented the following oral report:

- Custody Bank RFP – 4 responses were received. Evaluation committee reviews are underway with the target of a recommendation before the Board in December
- Emerging Market Debt RFP – 22 responses were received. Evaluation committee to meet early December
- Portable Alpha RFP - Staff recommends a traditional published RFP process because of the nuance of the sector
- Fixed Income Plus: High Yield Bank Loans – Early 2015 discussion on MQs. The recommendation is for an RFI
- Fixed Income Plus: Distressed Credits – 2015 and exposure is currently being built through the transition account
- International Equity: Emerging Markets – Current contract with Parametric expires 6/30/15 and a RFI is recommend
- International Equity: Small Cap – Current contract with Principal expires 9/30/15 and a RFI is recommended

C. Action Item: 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 $50 million to Paine & Partners IV, LP, a Private Asset Investment Following a Dedicated Agribusiness Investment Strategy in the Real Assets Portfolio

[*Exhibit 1: Paine & Partners Report; Exhibit 2: Staff report; re: Paine & Partners; Exhibit 3: Cliffwater Report; re: Paine & Partners*]

Christina Keyes, portfolio manager, said staff and Cliffwater are presenting a recommendation to commit up to $50 million with Paine & Partners Fund IV. She said this is an agribusiness firm, a subsector of agriculture exclusively devoted to investing up and down the food product and ag services value chain – from farm to fork. This is a new relationship for PERA and staff began due diligence in March 2014. At this point, Cliffwater and PERA are making this recommendation. The fund is targeting $800 million and closes in December 2014. The fund has a traditional fee structure and an 8 percent preferred return. She introduced the Paine & Partners representatives present.

Dexter Paine, Founder and CEO, said they buy operating businesses. They do not buy farmland, and do not trade in or buy commodities. The businesses owned by Paine

& Partners have a targeted IRR of 20 percent to 25 percent. He provided an overview of the firm's senior management noting the team consists of individuals who ran ag businesses. The firm's track record indicates a 70 percent gross IRR, 2.2 times return on invested capital and no realized losses. The firm finds places within the value chain that have very attractive returns and that is their focus.

Kevin Schwartz, Founder and President, discussed the industry stating approximately 9 percent of total global output is in agribusiness. The industry has grown more rapidly than most other industry segments that draw institutional capital. Agribusiness is more stable than most other industries as was realized during the global financial crisis. People will continue to eat and buy food, stated Mr. Paine.

Mr. Schwartz said as people around the world gain greater affluence they eat more protein, fresh fruits and vegetables. He mentioned the expected water deficit, and climate change. The demand is positive but the supply side has constraints. To increase productivity in the agriculture value chain is a great opportunity that has been proven effective throughout history.

Mr. Schwartz reviewed areas of crop production Paine & Partners invests in: high value crops, i.e., an Australia fresh produce company that grows berries in tunnels, indoor mushrooms and glasshouse tomatoes, all protected crops.

Mr. Esquibel asked how spoilage/disease was dealt with in farm raised fish in order to protect the investment. Mr. Paine said they favor farm fish because it is the most efficient way to produce animal protein and they invest in a company that uses expired farm fish to make fish meal. In regard to the issue of disease, farm fish is a relatively new industry (30 years) and what may have been an issue 10 years ago is significantly less today. With 70 percent of the world covered in water it is a good endeavor to figure out how to grow food there.

Mr. Schwartz pointed out that the key to Paine's strategy is diversification which is accomplished by geography, crop type, protein type, etc.

Mr. Paine said for the past five years Paine & Partners has been investing exclusively in the agribusiness.

Mr. Esquibel asked about a previous investment in a German car company and Mr. Paine said the investment was seven years ago and ultimately failed.

Mr. Schwartz said there were very few private equity firms that invest in food/agribusiness and Paine & Partner is the leader. He explained how they create their own investment opportunities through their investment process and active management. He discussed Verdesian Life Sciences, a company that Paine & Partners built in plant health and nutrition as an example of their thesis driven strategies.

Mr. Esquibel asked about the firm's investment in drip irrigation and Mr. Paine stated after studying the shortage of water they determined irrigation was the best way to make money off the shortage. They bought Eurodrip which produces drip irrigation that when used by a farmer uses 50 percent less water than flow irrigation. It also is an effective means to deliver plant nutrients, fertilizers, etc., directly to the plant.

Acknowledging that Paine & Partners wants to make money for its limited partners and investors, Mr. Paine said they are also very focused on sustainability.

Based on the consultant and staff's recommendation and the information provided, Mr. Jimenez moved to commit up to $50 million to Paine & Partners IV, LP, a private asset partnership focused on investments in food and agriculture companies, to be funded according to PERA's cash plan, subject to approval of legal documentation by General Counsel. His motion was seconded by Mr. Lewis.

Ms. French requested additional information regarding the fees especially "offset to management fees." Jamie Feidler, Cliffwater, advised the Committee that if Cliffwater was uncomfortable with any of the terms the investment would never come before them. Paine & Partners' terms are considered fairly standard and fairly good. The management fee is an annual fee and the 20 percent is to the general partner/Paine & Partners participating in any profits generated. The offset is LP favorable and protects against payment of double fees. A no-fault termination allows either party to terminate. Again, it is an LP-friendly term. The termination cannot be triggered until after the first year passes beyond the fund's final closing.

Mr. Logan asked how the firm covers its losses. Mr. Paine said before the firm gets any money, 100 percent of the investment must be repaid, both good and bad deals, plus an 80 percent return. Incentive fees are not obtained until all of the capital has been invested plus the 80 percent return which is typical in the private equity sector.

Mr. Martinez asked whether there would be larger investors in Fund IV and whether they would have an advantage over PERA. Mr. Paine responded that every investor has the same fees and same rights. He noted that they have larger investors.

Mr. Paine confirmed that the other three funds were successful and in the past 17 years there has been a 24 percent gross IRR.

The motion passed by unanimous [5-0] voice vote.

2. **Recommendation to commit up to $45 million to Harrison Street Real Estate Partners V, LP, an Opportunistic Real Estate Investment in the Real Estate Portfolio**
[*Exhibit 4: Harrison Street Report; Exhibit 5: Staff report; re: Harrison; Exhibit 3: Cliffwater Report*]

Joaquin Lujan, Portfolio Manager, said this fund will invest in education, healthcare and storage related assets. Staff has been reviewing the fund for over a year.

He introduced the representatives of the firm.

Chris Merrill, CEO, Harrison Street Real Estate Partners, provided an overview of the firm stating they manage over $7 billion in real estate and have been in existence for over a decade. They target demographic need-based real estate which currently consists of education, healthcare and storage related real estate. Education is off campus student housing. In the healthcare space it's medical offices, senior housing and self storage properties. Mr. Merrill said they have acquired and developed over 400 properties.

Mr. Merrill said 70 percent to 80 percent of students live off campus and Harrison is acquiring and building purpose-built assets for these students. The campus dormitories are aging and students are looking for off campus living. The apartments are leased to the student with a parent guarantee for a 12-month period. That segment makes up 35 percent of their investment.

Healthcare is predominantly medical office buildings on or close to hospital campuses. Even in a down market people are still going to the doctor. The retention ratio of the average doctor is 80+ percent versus the typical office tenant which is far less. Senior housing is a broad category and allows for many different investments. Harrison invests within the middle segment: private paid – assistant living/memory care.

Mr. Merrill said self-storage is considered an extension of the home and even in a down market people do not get rid of their storage.

Mr. Merrill said the investments are small, $7 million to $8 million of equity per property. He clarified that they didn't make a lot of money in the downturn but capital was preserved.

The firm has 70 people and Mr. Merrill said in today's market there is tremendous demand for the real estate they invest in.

Mr. Jimenez moved to commit up to $45 million to Harrison Street Real Estate Partners V, LP, a private partnership focused on opportunistic real estate investments, to be funded according to PERA's cash plan, subject to approval of legal documentation by General Counsel. His motion was seconded by Mr. Lewis.

A discussion ensued regarding the compensation of the fund to the Harrison team.

The motion passed by unanimous [5-0] voice vote.

D. <u>Information Item</u>: Q1 FY15 Performance Review
[*Exhibit 6: Wilshire Report – Numbers in Context*]

Tom Toth, Wilshire, provided 2014 asset class assumptions noting that changes versus year-end expectations have come down. He reviewed key economic indicators in that the economy is gradually improving. Inflation remains contained just under 2 percent. Consumer sentiment has improved and the unemployment rate continues to decline. In terms of overall GDP growth it has been challenging.

Mr. Toth noted that food prices have been trending higher and transportation has materially contracted. The decrease in energy prices should have a positive impact on economic growth but not nearly as much as it would have had years ago.

The 2nd Quarter marked the official five-year anniversary since the end of the last recession, stated Mr. Toth. The growth coming out of that recession has been moderate at 2.2 percent versus the 30-year average of 2.7 percent. He attributed it to the reduced growth in personal consumption because of consumer deleveraging and a more difficult employment environment. However, discretionary spending has rebounded to the 2006 level. Housing has also continued to recover.

Mr. Toth noted that at this point, the US has recovered all the jobs lost at the recession; however, new jobs have not been added during that period.

E. <u>Information Item</u>: Fixed Income Structure Analysis
[Exhibit 7: Wilshire report]

Mr. Grabel said this is predicated on retreat discussions about how to better align PERA's fixed income structure with the strategic asset allocation and insure that the managers' mandates are consistent with the Board's mandates for them.

Mr. Toth provided a review of how the portfolio is currently situated with both core managers and exposure to the plus sector. This segment of the portfolio acts as a counterweight to the more volatile portions of the portfolio. He reviewed the sector weightings in the portfolio. A number of PERA managers have material weights to the plus sectors, i.e., Franklin Templeton, Manulife. The new asset allocation will delineate exposure to the plus sectors more explicitly. Plus sectors include US high yield, emerging market debt, and other securitized lending (ABS/CMBS). Mr. Toth presented a summary of the current mandates the managers are working under.

By making allocation changes, Mr. Toth said there could be a positive impact on the portfolio. He provided model alternatives moving four US focused managers with cored guidelines. Maintaining Manulife and Franklin Templeton's global focus with core guidelines is recommended. He then reviewed fixed income duration and quality charts. The current composite has a lower quality tilt and a slightly lower portfolio effective duration.

Using Alternative 1 which changes the mandates from core plus to core and changes 15 percent global opportunistic to global core improves the portfolio to be more interest rate neutral relative to the benchmark, stated Mr. Toth. He reviewed the current composite versus the model's risk exposure.

Responding to Mr. Esquibel's question, Mr. Grabel said it was impossible to avoid indirect overexposure in the capital markets. Businesses are interrelated and it is impossible to isolate the impact of inflation, currencies, interest rates. Analytically, it is possible to review through the securities that reside with the custody bank and identify common risk factors and look to minimize those risks and insure the investment guidelines are consistent with the mandates.

The next steps include engaging the managers in fee negotiations and amend the Investment Policy Statement to replace the Barclays Multiverse with the Barclays Global Aggregate benchmark.

F. <u>Information Item</u>: Portable Alpha Request for Proposal Minimum Qualification

Mr. Grabel said this recommendation follows Mr. Feidler's presentation regarding the primer about portable alpha.

Jude Perez, Portfolio Manager, discussed the RFP timeline starting with a December 1, 2014 release date. The deadline for submission following submission of written questions and meeting the MQs was scheduled for January 20, 2015. He anticipated the award of the contract in April 2015. He reviewed the goals and MQs. He anticipated 15 responses.

The current mandate is $550 million; however, following the reduction of the domestic equity structure he anticipated the allocation at $400 million.

5. <u>OTHER BUSINESS</u>

None was brought forward.

6. <u>ADJOURNMENT</u>

Having completed the agenda, and with no further business to come before this Committee, Chair Mayfield declared this meeting was adjourned at 11:30 a.m.

Approved by:

Dan Mayfield, Chair
Investments Committee

ATTEST:

Wayne Propst, Executive Director

Attached Exhibits:

Exhibit 1: Paine & Partners Report
Exhibit 2: Staff report; re: Paine & Partners
Exhibit 3: Cliffwater Report; re: Paine & Partners and Harrison Street
Exhibit 4: Harrison Street Report
Exhibit 5: Staff report; re: Harrison
Exhibit 6: Wilshire Report – Numbers in Context
Exhibit 7: Wilshire report – Fixed Income Structure Analysis