

NEW MEXICO
PUBLIC EMPLOYEES RETIREMENT BOARD
INVESTMENTS COMMITTEE MEETING

February 10, 2015

This meeting of the Public Employees Retirement Board Investments Committee was called to order by Board Chair Patty French, 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:** Executive Director Wayne Propst called roll following the Pledge of Allegiance and a quorum was established with the following members present:

Members Present:

Dan Mayfield, Chair
Roman Jimenez, Vice Chair
Dan Esquibel
Patricia French
Stewart Logan
Louis Martinez

Member(s) Excused:

None

Other Board Members Present:

Tim Eichenberg
Jackie Kohlasch
Paula Fisher

Staff Members Present:

Wayne Propst, Executive Director
Susan Pittard, Chief of Staff/General Counsel
Jonathan Grabel, Chief Investment Officer
Sylvia Barela, ASD Director
Greg Trujillo, Deputy Director
Julian Baca, Deputy CIO
Judy Olson, Executive Assistant
Karen Risku, Deputy General Counsel
Roderick Ventura, Assistant General Counsel
Claudia Armijo, Assistant General Counsel
Greg Portillos, Chief Information Officer
LeAnne Larrañaga-Ruffy, Portfolio Manager
Joaquin Lujan, Portfolio Manager
Christina Keyes, Portfolio Manager

Mark Montoya, Financial Analyst
Jude Perez, Portfolio Manager
Kristen Varela, Financial Analyst

Others Present:

Jamie Feidler, Cliffwater
Tom Toth, Wilshire
Paul Lium, Nationwide
Jeffrey Ferrell, Athyrium [via Skype]

2. **APPROVAL OF AGENDA**

The agenda was approved by consensus.

3. **APPROVAL OF CONSENT AGENDA**

Ms. Logan moved to approve the consent agenda. Mr. Esquibel seconded and the consent agenda was unanimously [6-0] approved.

4. **CURRENT BUSINESS**

A. **Information Item: High Yield Request for Information Minimum Qualifications and Timeline**

Jonathan Grabel, Chief Investment Officer, said this is the second part of the fixed income plus allocation. This will be an RFI for global high yield.

Joaquin Lujan, portfolio manager for rates and credit, said this is the core plus component of the new strategic asset allocation which is 5 percent of the portfolio, of which 25 percent (\$180 million) of that is the global high yield component. The high yield universe contains 300 managers and meeting the MQs reduced the number to 100. He expected they would be reviewing 36 managers and looking at qualitative measures.

Mr. Lujan reviewed the timeline starting with the release of the RFI in early March and closing with the acceptance of response on March 20th. Evaluations will begin with the appointed evaluation committee.

Responding to Mr. Martinez, Mr. Lujan said it is possible that PERA will go with one manager.

B. **Action Item: Alternative Asset Recommendation for Approval to be Funded According to the Cash Plan and Subject to Legal Review by General Counsel:**

1. **Recommendation to Commit up to \$65 Million to Athyrium Opportunities Fund II, L.P., a Structured Credit Healthcare Fund in the Private Equity Portfolio**

*[Exhibit 1: Staff recommendation re: Athyrium, 1/10/15;
Exhibit 2: Cliffwater report; Exhibit 3: Athyrium Report, 2/15]*

Mr. Grabel said Jeffrey Ferrell, Athyrium's founder and principal, will be joining the IC via Skype.

Mr. Lujan said this is a credit structure healthcare fund and the strategy is high single digit to mid-teen strategy, with risk well protected on a number of fronts. Athyrium has a 0 percent loss ratio. He referred to the staff's report that outlined the process staff and Cliffwater made before bringing this recommendation forth.

Jeffrey Ferrell apologized that he wasn't able to be in attendance as airports in the east coast have been closed because of the weather. Athyrium is one of the few healthcare fixed income investors operating in the middle market. They have an exclusive focus on healthcare/life sciences related investments and do so based on income oriented structures. They provide growth capital for commercial staged companies and are able to generate income for their investors. The mature fund that they are operating today is generating 9.6 percent cash yield and overall a 30 percent net return to the investors – a meaningful return from upside participation. Principally, Athyrium could be seen as a credit business. The demand for healthcare products and services is fundamental and stable. The loans are established in a manner that income is generated from the first quarter and creates a nice J-curve profile for investors. He said the healthcare sector is very complicated with regulations and science. His team is very specialized in that all they do is healthcare investments. Mr. Ferrell himself is a bio-chemistry Harvard graduate. The team is very stable and is unique in its credit mindset with the skills of a traditional private equity firm.

The firm finances the small- medium-sized companies that have existing commercial businesses and helps them to compete and expand in the market. Athyrium has operated through the credit crisis and has had a steady performance. They apply a traditional private equity model to financing the healthcare sector. He said they frequently back management teams, entrepreneurs, board members, scientists; and, frequently partner with equity sponsors to help them grow their companies.

Mr. Ferrell said they care about the underlying collateral of the companies in which they invest. He discussed royalty streams and said they like them from a collateral point of view. Once they understand the downside case of a company, they generally structure for a contractual return with recent deals between 10 percent to 11 percent. How to participate in the upside of the business is also a concern. Almost all of their business transactions are within the United States – most all of the innovation in healthcare is occurring in the United States.

Mr. Ferrell said they are in the last stages of Fund II with the same strategies as the previous funds. The largest investors are Ontario Teachers, University of Michigan, etc. They expect to complete the closing at \$850 million and the terms are fairly standard private equity terms.

Ms. French commended staff for the bullet points within their report. She requested a breakdown of the management fees.

Mr. Ferrell said the fee is basically 1.5 percent of committed capital during the investment period of the fund. Once the investment period of the fund ends the fee will go down to the lower of either costs or NAV which is a standard format. At this time they are using more industry standards.

Jamie Feidler, Cliffwater, said the change between paying on committed capital during the investment period and then switching to actual invested capital is very standard. The only deviation was on how things were charged during that harvest period. Mr. Feidler said the fees overall are quite reasonable for the strategy.

Mr. Logan asked how the Affordable Care Act influenced their investment strategy. Mr. Ferrell responded that Athyrium cares most about predictable cash flows which ACA has provided. While the legislation is large and important, it is also very slow moving. In general they make investments that are five years or less. Cost containment and lower costs will be important as everyone has healthcare.

Mr. Ferrell clarified that the services they invest in include laboratory services, services that support pharmaceuticals; he noted that his team is very heavy on the technical science skill set.

Mr. Grabel said with the regulatory reforms with Dodd-Frank and the Volcker Rules, banks are not allowed to keep this type of capital on their balance sheets. Mr. Ferrell concurred adding Dodd-Frank makes it virtually impossible for banks in the US to do this. The only group that can do what Athyrium does are private equity funds and hedge funds.

Ms. Fisher asked whether the sourcing relationships that Athyrium has would lead to bonuses. Mr. Ferrell said the industry is large and complex and for some of the more intermediate transactions there might be an investment banker involved who would usually be compensated by the other side. Athyrium conducts add on acquisitions for their portfolio companies and frequently a “finder” would collect a fee of 1 percent to 1.5 percent of the aggregate transaction value. He said they view the fees as any other expense they incur when creating a portfolio.

Mr. Esquibel moved to recommend to the Board that PERA Commit up to \$65 Million to Athyrium Opportunities Fund II, L.P., a Structured Credit Healthcare Fund in the Private Equity Portfolio investment as recommended by staff. Mr. Jimenez seconded and the motion passed by unanimous [6-0] voice vote.

- C. **Action Item: International Equity Structure Recommendation**
[Exhibit 4: Wilshire International Equity recommendations, dated 2/15;
Exhibit 5: Staff memo re: Recommendations International Equity]

Mr. Grabel said this is a follow up from the analysis of the international equity structure.

Tom Toth, Wilshire, reviewed the current investment structure as well as Wilshire's recommendations. He highlighted that the broad index exposure in the portfolio will be increased from 55 percent to 65 percent. The recommendation eliminates the style specific index (SSgA EAFE Growth) which is currently at 10 percent. That EAFE growth exposure would be shifted into the broader index. Additionally, the two developed managers, Kleinworth Benson and MFS, their weights will be equalized at 6 percent. Wilshire proposes at a later date presenting an analysis of Kleinworth Benson to determine whether they are the right money manager to fill that spot. The other change is for the small cap managers to equalize those allocations as well and keeping the exposure in small cap consistent with the prior structure.

Mr. Toth mentioned the regional weights within the proposed portfolio are very similar to the current structure. There is neither a strong overweight nor underweight to any of the international regions. The new portfolio will be style neutral and moderately improved from where it currently is. The total risk and volatility will be lower than the current portfolio and index.

Mr. Toth reviewed the implementation timeline and noted that the changes are not as drastic as the domestic equity portfolio and will be accomplished in three steps. The fees go up slightly from 19.3 to 19.8.

In response to Chair Mayfield's question regarding withdrawal penalties from State Street Growth, Mr. Toth said the liquidity is very high for the index fund and he thought not. There is market risk with all transitions because it requires buying and selling.

Mr. Jimenez moved to approve the recommendations for the International Equity Structure. His motion was seconded by Mr. Logan and passed by unanimous [6-0] voice vote.

C. Information Item: Q2 FY15 Investment Performance Review

Mr. Toth said at the end of 2014 the total fund market value was \$14.3 billion. He reviewed a graph of the actual invested capital compared to the new strategic targets. He referred to the total fund asset allocation versus public plans over \$1 billion and noted PERA's total equity allocation is slightly below the median allocation, while fixed income is slightly above the median. PERA's lower ranking within the universe for the total fund performance can be attributed to asset allocation.

Mr. Toth highlighted that the portfolio had a strong relative performance across the board through a 5-year timeframe. Over the past year, the fund was up 5.8 percent and outperformed its policy index by 30 basis points. Over the past few years, PERA's

Sharpe ratio – the risk adjusted return statistics – has been slightly ahead of the index Sharpe ratio.

Mr. Toth reviewed the portfolio composites noting that domestic equities, from an active management standpoint, were the one area that struggled. The portfolio held more small cap stocks than the index and those stocks struggled through the year with large caps doing sustainably better. The domestic equities portfolio style tilt is being corrected to mitigate risk going forward. International equity struggled due to currency fluctuations but from an active standpoint it added value.

Mr. Toth referred to the asset class assumption in the Number in Context report. He said the expectation of return and risk are updated periodically. Across most of the asset classes the expected returns continue to fall. There has been a steady decline in market forecasts for inflation from 2.25 to 1.07, a projected decline of over half a percent over the next 10 years and that has a direct impact in terms of pricing and capital market assets across the board.

5. **OTHER BUSINESS**

None was presented.

6. **ADJOURNMENT**

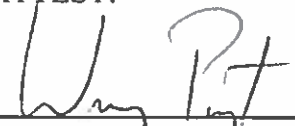
Having completed the agenda, and with no further business to come before this Committee, Chair Mayfield declared this meeting was adjourned at 10:35 a.m.

Approved by:


Dan Mayfield, Chair
Investments Committee

Vice-Chair

ATTEST:


Wayne Propst, Executive Director

Attached Exhibits:

Exhibit 1: Staff recommendation re: Athyrium dated 1/10/15

Exhibit 2: Cliffwater report

Exhibit 3: Athyrium Report dated 2/15

Exhibit 4: Wilshire International Equity recommendations, dated 2/15

Exhibit 5: Staff memo re: Recommendations International Equity