NEW MEXICO

PUBLIC EMPLOYEES RETIREMENT BOARD

INVESTMENTS COMMITTEE MEETING

January 28, 2016

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, Senator Fabian Chavez Jr. Board Room, Santa Fe, New Mexico.

1. & 2. Roll call proceeded the Pledge of Allegiance and indicated the presence of a quorum as follows:

Members Present:
Dan Mayfield, Chair
Patricia French
Cathy Townes
Dan Esquibel

Member(s) Excused:
None

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

Staff Members Present:
Wayne Propst, Executive Director
Susan Pittard, Chief of Staff-General Counsel
Jon Grabel, Chief Investment Officer
Greg Trujillo, Deputy Director/Chief Information Officer
Renada Peery-Galon, ASD Director
Karen Risku, Deputy General Counsel
Jude Perez, Deputy CIO
Joaquin Lujan, Director of Rates and Credit
LeAnne Larrañaga-Ruffy, Portfolio Manager
Danna Varela, Executive Assistant
Mark Montoya, Financial Analyst
Kristin Varela, Portfolio Manager
Emily Lopez, Financial Specialist
Karyn Lujan, Deferred Compensation Plan Manager
Christine Ortega, Portfolio Manager

Others Present:

Paul Lium, Nationwide
Jamie Feidler, Cliffwater
Thomas Toth, Wilshire
Emily Melton, DFJ Venture Capital
Jake Reynolds TCV
Nathan Sanders, TCV
Casey Padilla, AFSCME
Connie Durr, AFSCME

2. APPROVAL OF AGENDA

Ms. French moved to approve the agenda as presented. Her motion was seconded by Ms. Townes and passed by unanimous voice vote.

3. APPROVAL OF CONSENT AGENDA

Ms. French noted for the record that she reviewed the minutes of the December 8, 2015 meeting and found them accurate and complete.

Ms. French moved to approve the consent agenda and Mr. Esquibel seconded. The motion passed by unanimous voice vote.

4. CURRENT BUSINESS

A. Chief Investment Officer's Report

1. Investment Performance – December 2015

PERA CIO Jon Grabel said the plan ended December at $13.9 billion, down 1.05 percent. From a cash perspective the fund balance was down $178 million. Fiscal year to date the plan is down 2.75 percent. January has not provided any relief with preliminary results that the PERA fund is down an estimated $500 million through mid-January.

Mr. Grabel reviewed the asset category returns for December. Domestic equities, international equities, fixed income/core portfolio, and fixed income plus were all down. The absolute return portfolio/hedge funds were up 25 basis points but the results of that portfolio lag a month. All private assets are reported with a month to quarter lag. The real estate portfolio was up 1.44 percent for the month. In terms of the lagging, approximately half of the real estate portfolio is private and is lagged by one quarter. The other half is in REITs and has a real time valuation. Fiscal year to date, real estate is PERA's best performing asset category up 7.62 percent. Real assets are down 1.89 percent year to date with private real assets making up 70 percent of that composite; this lags by one quarter. Real assets are PERA's worst category in terms of return for the fiscal year, down 15.2 percent. He noted that it is a relatively small composite about $430 million. This composite is underweight; with a target of 7 percent it is at 3 percent.

The committee congratulated Mr. Grabel on his recent TV appearance.

2. Cash Plan Update

Mr. Grabel said the change in fund balance was down about $178 million. The month finished with a little over $300 million in cash. The report reflects a separation between contributions and benefits. The separation reflects that PERA is a mature plan and excluding investments PERA is cash flow negative. In the current environment the difference between managing pension and managing endowments is magnified because PERA's liabilities continue to grow.

Mr. Grabel reviewed the inflow of cash with $15 million from an overlay associated with the previous alpha account that is winding down. PERA received $44 million in private asset distributions and redemptions from hedge funds along with $60 million in employer and employee contributions. He reviewed the uses of cash to include $90 million to pay benefits and refunds, $3 million in operational expenses and $49 million for private asset capital calls. He noted there is more money going out for private asset and that is good.

3. Market Perspectives

Mr. Grabel quotes Winston Churchill, "Never let a good crisis go to waste," and said that is a good perspective for PERA to have in the current environment. Rather than crisis, this is a correction. In bull markets investors may become complacent where skill is confused with attendance in the market. He said this period offers PERA the opportunity to challenge itself in terms of this market correction. Rather than focusing on managers he recommended a focus on the plan. He reminded the committee that 90 percent of the focus needs to be on asset allocation, with 7 percent on implementation and 3 percent on manager selection. The mapping between the asset allocation study and the PERA fund will be further refined. He hoped to spend more of the committee's time on asset category investment strategy reviews.

4. Other Updates

Mr. Grabel provided the following updates:

- Listed infrastructure RFP was posted January 5th
- Education sessions are ongoing with staff and the Board
- The Investment Division will be fully staffed next week
- An update on securities lending is included within the packet
- Kleinwort Benson, one of PERA's international equity small cap mangers managing $180 million for PERA, had a change of control. There is no change in the team nor investment philosophy
- PERA is hosting an open house on February 16th for 15 MBA students of UNM's Anderson School of Business. The CFA Society of NM will be the sponsor and provide lunch for the students
- Using a New York City commissioned operational review as a template, PERA's Investment Division will be reviewing its operations and investment organization

Ms. French recognized AFSCME Statewide director Connie Durr and AFSCME state president Casey Padilla in the audience.

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

LeAnne Larrañaga-Ruffy, Portfolio Manager, said staff and the consultants are presented two recommendations for the private equity portfolio. PERA's private equity portfolio currently has an allocation of 21 percent to venture capital with 10 percent in early stage and 11 percent in late stage. The two funds being presented will complement the current private equity portfolio by continuing PERA's commitment with two existing managers to provide diversification and help reduce a proliferation of managers.

1. Recommendation to Commit up to $25 Million to DFJ Venture XII, LP
[Exhibit 1: Staff recommendation re: DFJ; Exhibit 2: Cliffwater report re: DFJ; Exhibit 3: DFJ Report]

Ms. Larrañaga-Ruffy said staff recommends committing up to $25 million to DFJ, an early-stage venture capital fund. PERA has a commitment to DFJ Fund X.

Emily Melton, DFJ Partner, thanked PERA for their past support in Fund X and the consideration of Fund XII. Fund XII is a $325 million early-stage fund. The companies are new and DFJ will be a hands-on investor/collaborator. As technology investors, DFJ focuses on three categories – consumer, enterprise and disruptive/scientific breakthroughs or major shifts in technology.

The firm has been in existence for 30 years and she discussed the team in detail. DFJ has a track record of success which provides leverage with companies wanting to work with them. Ms. Melton spoke about brand importance, DFJ's recognition recognizable and their relationship with Stanford's engineering school. Their investment strategy, according to Ms. Melton, is to seek out extraordinary entrepreneurs, target markets with explosive growth potential, do the work necessary to find the right investment, accept a high degree of risk, actively partner to reduce risk, and aim to invest at the earliest stages with smaller investments and actively provide additional investments as conviction is gained.

Ms. Melton said DFJ invests in things that will probably not be talked about for the next 7 to 10 years. They foresee technological advances in genomics and synthetic biology and access to space as great opportunities.

In response to Mr. Esquibel's question of whether early-stage could be in a bubble, Ms. Melton said timing is what is important. One does not want to be too early nor too late in technological advances. There have been equity bubbles with private valuation too high for a number of technology companies. She expected advances in the use of technology as a platform to drive new drugs and drug discovery. Access to data is particularly important in healthcare with compelling opportunities.

In terms of disruptive technologies, Mr. Esquibel mentioned Uber and asked about its impact on existing industry. Ms. Melton said DFJ considers regulatory risk very carefully.

Ms. French asked about the timing issues regarding Fund XI and PERA. Ms. Larrañaga-Ruffy said this fund opened in 2014 when PERA was going through a staff transition and decided not to invest in XI. Mr. Grabel added that PERA must never sacrifice its process when making a commitment.

Mr. Esquibel moved to recommend the $25 million commitment to DFJ Venture XII, LP, to be funded according to the cash plan and subject to legal review by General Counsel. Ms. French seconded and the motion passed by unanimous [4-0] voice vote.

2. Recommendation to Commit up to $65 Million to TCV IX Fund, LP
[Exhibit 4: Staff recommendation re: TCV; Exhibit 2: Cliffwater report re: TCV; Exhibit 5: TCV Report]

Ms. Larrañaga-Ruffy said PERA has a commitment to TCV's fund VII and did not invest in fund VIII because of timing that would not allow PERA's to conduct its thorough process.

Mr. Esquibel said he read through the materials and was prepared to introduce a motion. He said this fund is an overlap investment with this firm coming in for at a later stage.

Mr. Esquibel moved to recommend a commitment up to $65 million to TCV IX Fund, to be funded according to the cash plan and subject to legal review by General Counsel. Chair Mayfield seconded and the motion carried by 3-0 voice vote. Ms. French was not present for this action.

Ms. Larrañaga-Ruffy thanked TCV general partners Jake Reynolds and Nathan Sanders for attending today's meeting.

Mr. Esquibel asked the TCV representatives whether this is a bubble. Mr. Reynolds said there is an over exuberance in capital markets with regards to technology valuations. He said TCV works hard to navigate from those groups and at some level they avoid Silicon Valley companies. He acknowledged there has been a dramatic influx of capital in the technology markets by those who have not historically been focused technology investors. He agreed with Ms. Melton that the changes in technology are very exciting and there will be winners as a result.

C. <u>Information Item</u>: High Yield Update – Fixed Income Plus

Mr. Grabel noted that high yield is a relatively new addition to the portfolio and is part of the 5 percent fixed income plus allocation. Guggenheim was selected last year to serve as PERA's manager.

Joaquin Lujan, Director of Rates and Credit, defined high yield issuers as the corporate equivalent to individuals with low FICO (Fair Isaac Corporation) scores – not the Apples and the Dells. They tend to have more debt on their balance sheets and therefore have to issue at higher yields. High Yield constitutes about 15 percent of the overall corporate bond market after material growth over the past 15 years. The asset category is referred to as rates and credit, not fixed income. Fixed income is not the monolithic asset class as it had been. The inherent risk in investment grade bonds is that of an interest rate risk. High yield bonds are much more sensitive to credit risk – the risk is whether the borrower is going to earn enough revenue or generate enough cash flow to back its debt obligation.

High yield risk is less akin to that of the US Treasury, stated Mr. Lujan and more like that of an equity. Over time high yield is lowly correlated to investment grade bonds. High yield has a medium to high correlation to equity. The point is asset allocation. The three critical components of any asset category decision are the expected returns, the expected volatility and the expected correlation. High yield adds considerable real and measurable diversification to the fund as a whole.

Tom Toth, Wilshire, said the expected total return averaged over a 10-year period is 6.35 percent. The expected cash yield absent any default would be 8.6 percent for the universe as a whole and then minus the defaults and plus in the recovery rate which is how the expected total return is developed. The average maturity for high yield bonds is within the four-year range.

Mr. Grabel said one of the differences between high yield than a core bond portfolio is the companies that issue high yield often will call in their bonds/buy them back from investors earlier.

Mr. Toth noted the total risk number is 10 percent for high yield and to put that in perspective he noted that global equity has an expected return of 6.7 percent with an expected risk of 17.1 percent.

Mr. Lujan noted that PERA sought a manager for this mandate in 2015. Guggenheim Investments Partners was selected with a fund of $183 million paid out in three tranches over 2015. He noted that Guggenheim was positioned within the asset allocation. They have a small exposure to preferred equity which is allowed by PERA. Guggenheim is within its position of the Board's approved asset allocation. High yield is performing according to the expectations within the asset allocation model.

Mr. Toth referred to the long-term versus short-term results and noted the shorter term shows the effects of liquidity in the market.

D. Information Item: MLP (Master Limited Partnership) Update – Real Assets

Kristin Varela, Portfolio Manager, reported that MLPs have experienced tremendous declines in the last year and are PERA's worse performing asset class in the portfolio. Ms. Varela defined an MLP as an equity investment in publicly traded partnerships, engaged in the transportation, storage, processing and production of natural resources. There are non-energy related MLPs that engage in financial services, real estate and miscellaneous infrastructure assets. MLPs offer a positive tax benefit to US investors. There are approximately 120 MLPs in the market with $320 billion.

Within PERA's portfolio there is one MLP, Harvest Fund Advisors funded at $156.4 million. They make up 1 percent of the total fund, 25 percent of the real assets portfolio and have a current market value of $108 million.

Fiscal year to date, Ms. Varela noted that Harvest was down 27 percent; inception to date they are down 19.5 percent. Harvest is in line with the index. The loss is large and other factors are being reviewed within the portfolio.

In response to Mr. Esquibel's concern about the dropping price of oil, Ms. Varela said MLPs are investing in energy infrastructure, not actual crude production, and there is still a need for that infrastructure and the fundamentals are strong.

Jamie Feidler, Cliffwater, said they did not expect to see a surge in the price of oil.

Mr. Grabel noted that MLPs have been impacted by the price of crude as well as the retail appetite.

Mr. Feidler said from the time of PERA's first investment with Harvest the price of crude oil has fallen about 70 percent. The fundamentals in MLPs remain solid. These are essential infrastructure assets.

Ms. Varela said staff and the consultant recommend holding the position, continuing to review market fundamentals, keeping constant with the managers and tracking cash flow in and out of the strategies. Mr. Feidler said Harvest is a good manager and PERA is appropriately positioned with MLPs.

Mr. Esquibel asked what would trigger PERA getting out of the MLPs. Mr. Grabel said if the IRS ruled that MLPs are not a valid structure that would be an immediate sell. If there is mass flight from the managers and their asset size is too low for it to be deemed an institutional category that too is an immediate sell. At this time, Mr. Grabel said "we do not need to run for the door."

E. Information Item: Private Asset Commitment Pace for

Calendar Year 2016

[Exhibit 2: Cliffwater Report – Tab 3, page 2]

Mr. Feidler reviewed the 2016 private asset commitment budgets for making new commitments to private equity vehicles; private real estate and private real asset funds. He noted that the investments are shown in vintage year and the commitment is provided as the GP calls the capital.

The targeted commitments for 2016 vintage year private equity partnerships are as follows: Private equity is up to $402 million with four to six new partnerships; real asset partnerships is up to $300 million with five to seven new partnerships; and, real estate partnerships is $139 million with an expectation of two new partnerships.

Ms. French asked if it was more prudent to invest with existing partners rather than new partners. Mr. Feidler said PERA has begun reinvesting with existing partners and consolidating manager relationships.

Mr. Grabel said when PERA began its commitments in private equity they were approximately $20 million, whereas today the commitments are much larger with concentrated positions and more conviction.

5. OTHER BUSINESS

None was presented.

6. ADJOURNMENT

Chair Mayfield declared this meeting adjourned at 11:25 a.m.

Approved by:

Dan Mayfield, Chair
Investments Committee

ATTEST:

Wayne Propst, Executive Director

Attached Exhibits:
Exhibit 1: Staff recommendation re: DFJ
Exhibit 2: Cliffwater report re: DFJ
Exhibit 3: DFJ Report

Exhibit 4: Staff recommendation re: TCVExhibit 5: TCV Report