

NEW MEXICO
PUBLIC EMPLOYEES RETIREMENT BOARD
INVESTMENTS COMMITTEE MEETING

June 30, 2016

This meeting of the Public Employees Retirement Board Investments Committee was called to order by Chair Dan Esquibel at approximately 9:48 a.m. on the above-cited date in the PERA Building, Senator Fabian Chavez, Jr. Board Room, 33 Plaza La Prensa, Santa Fe, New Mexico.

1. Executive Director Wayne Propst called roll and a quorum was established with the following members present:

Members Present:

Dan Esquibel, Chair
Dan Mayfield, Vice Chair
Paula Fisher
John Reynolds
Patricia French
Loretta Naranjo Lopez

Member(s) Excused:

None

Other Board Members Present:

James Maxon
Brad Winter
John Melia
Tim Eichenberg
Cathy Townes
Jackie Kohlasch

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
Karen Risku, Deputy General Counsel
Renada Peery-Galon, ASD Director
David Dana, Assistant General Counsel
Joaquin Lujan, Director of Rates and Credit

LeAnne Larrañaga-Ruffy, Director of Equity
Mark Montoya, Financial Analyst
Kristin Varela, Portfolio Manager - Real Returns
Emily Lopez, Financial Specialist
Karyn Lujan, Deferred Compensation Plan Manager
Christine Ortega, Portfolio Manager

Others Present:

Eileen Neill, Wilshire
Tom Toth, Wilshire
Jerome C. Silvey, Starwood
Jamie Feidler, Cliffwater
Paul Lium, Nationwide
John Garrett, Cavanaugh Macdonald

2. APPROVAL OF AGENDA

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

3. APPROVAL OF CONSENT AGENDA

Chair Esquibel stated he reviewed the minutes and found them to be accurate and in order.

Mr. Reynolds moved to approve the consent agenda. Ms. French seconded and the motion passed without opposition.

4. CURRENT BUSINESS

A. Chief Investment Officer's Report

1. Investment Performance – April 2016

PERA CIO Jon Grabel said the fund finished the month of May with \$14 billion. The performance of the fund was up 11 basis points, net of all fees and expenses. Notwithstanding the positive investment performance, the fund balance was down \$81 million. He reminded the Committee that PERA is a mature pension fund, cash flow negative with benefit payments exceeding contributions by approximately \$500,000,000. The investment gains for the month were up \$50 million which was not enough to cover the expenses.

Mr. Grabel said fiscal year to date through May the fund was relatively flat, down approximately 2 basis points. The Brexit vote caused a major dislocation to global markets. The ACWI was down 4.8 percent – a dramatic drop. Following the vote, risk assets were down across geographies, strategies, currencies, etc. The “Brexit” was more than a UK event and he noted that US industries were down. Associated with the drop was a flight to quality with government bonds rallying dramatically. There was an estimated loss of \$3 trillion in equity markets from June 24th through June 27th.

“Ironically, \$3 trillion is roughly the equivalent to the gross domestic product of the United Kingdom...the fifth largest economy in the world.”

Mr. Grabel emphasized that the Brexit further illuminated the benefits of diversification. PERA’s losses were mitigated by its broadly diversified portfolio. PERA’s downside protection comes from asset allocation, not its money managers.

Mr. Grabel noted that the performance results are presented in the format of the new strategic asset allocation with a reduction in asset categories from eight to four. He recognized the investment team for their work on the format. He reviewed the results of the month by category.

Chair Esquibel lauded the BoardEffect Portal as a very effective, efficient tool for obtaining Board-related materials.

2. Cash Plan Update

Mr. Grabel said the May ended with approximately \$384 million in cash. Cash accounts are at BNY Mellon, Corporate Action, STO (State Treasurer), and the Overlay program. He reviewed the sources of funds which included \$4 million from the old portable alpha program, \$33 million from illiquid asset distributions, and \$58 million in employer/employee contributions. Uses of cash included \$93 million to pay benefits and refunds, \$3 million for operational expenses and \$27 million for illiquid asset capital calls.

Mr. Grabel highlighted a chart showing the actual asset category weights per the Board’s prior approved strategic asset allocation compared to the actual – the targets compared to the actuals – and the differences. He noted that it takes time to prudently implement a strategic asset allocation.

3. Other Updates

Mr. Grabel provided the following updates:

- A recommendation for the Listed Infrastructure will be provided today
- The mandate, \$400+ million for the Multi-Strategy Credit, is being bifurcated into two groups. The Group 1 recommendations are anticipated in July with Group 2 in August
- A risk report, based on the old strategic asset allocation, that reviews every security from the bottom up has been provided and every 20 months it should be expected that the plan is down by at least 3.88 percent

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 \$75 Million to Starwood XI Management, LP**

[Exhibit 1: PERA Staff Report re: Starwood, 6/30/16; Exhibit 2: Cliffwater Report, 6/30/16; Exhibit 3: Starwood Global

Opportunity fund XI, 6/30/16]

Kristin Varela, Portfolio Manager - Real Returns, said staff recommends a commitment of up to \$75 million to Starwood Global Opportunity Fund XI, an illiquid real estate partnership with a focus on global opportunistic real estate investing which will be held in PERA's illiquid real estate allocation of the real assets portfolio.

PERA made its first investment with Starwood in the 2008 Fund VIII. Starwood has effectively delivered on that investment and contributed to returns in the real estate portfolio. PERA has also invested in Funds IX and Fund X.

Ms. Varela said this investment will move illiquid real estate close to the newly approved 20 percent target. Currently, real assets accounts for 8.4 percent of the total fund on a funded basis and within the real asset portfolio, illiquid real estate constitutes 22 percent. She discussed Starwood's plans for Fund XI which is \$6 billion in commitments with a goal of investing in approximately 50 to 60 transactions located primarily in North America and Europe with a targeted net IRR of 14 percent to 16 percent with a term of 10 to 13 years.

Jerome Silvery, Starwood, said the firm started in 1991 and he joined in 1993 as the CFO and he still holds that position as well as Executive VP. They have over \$51 billion in assets under management and have predominantly been focused on opportunistic real estate investing. Other Starwood businesses are synergistic with opportunistic real estate strategies. Over the past 26 years, Starwood has earned a 31 gross IRR for its limited partners.

Referring to Fund XI, Mr. Silvery said they will have the first close at the end of the month and are targeting \$6 billion with a gross return between 17 and 20 and a net return of 14 percent to 16 percent.

Mr. Silvery provided an overview of PERA's investments within Funds VIII, IX and X. Starwood is in the process of finalizing the investments for Fund X with 41 assets closed to date which are generating a 22 percent IRR with approximately 11 percent of that total return from operating profits. Fund IX has 56 investments and is on track for a 32 percent asset level return within the fund. Two-thirds of Fund IX has been distributed back with 45 of the original 56 assets left in the fund. 120 percent of invested capital has been distributed from Fund VIII and there are 32 of the original assets left. He discussed the leverage used on the funds highlighting that excessive leverage has not been used to generate the returns.

Mr. Silvery said the question of whether PERA has too much Starwood exposure may be asked. He answered that by the time the capital has been called and Fund XI is fully invested, PERA will have approximately 170 percent of Fund VIII's investment back; 150 percent of Fund IX's investment and approximately one-third of the investment back in Fund X.

Mr. Silvery said Starwood has four offices and 2,200 total employees. The primary focus is US and Europe. They have not made a European commitment in seven months which was attributed to Brexit. Referring to remaining assets in Europe, Mr. Silvery said they have no or minimal foreign exchange loss. Often with events like

Brexit, the banks make financing difficult and in anticipation of that, Starwood refinanced or extended its loan terms through at least 2018.

“Whenever there is panic in the marketplace or dislocation of capital...it’s an opportunity for funds like ours to buy assets at a discounted value,” stated Mr. Silvery. Thus, Brexit could provide interesting opportunities for Fund XI in Europe.

Mr. Silvery said Starwood runs the largest commercial real estate mortgage REIT in the United States, Starwood Property Trust on the NY Stock Exchange, and a smaller version in Europe that is listed on the London Stock Exchange. He reviewed some of their side businesses that are all similar to real estate in that they create cash flows off of assets.

Mr. Silvery said Starwood has the second largest market-rate multi-family apartment portfolio in the United States. Starwood has created different silos that provide expertise to focus on the different real estate classes, underwrite them well and thus be able to execute well. He discussed Starwood’s hotel branch which is one of the largest hotel/motel operators in the world. Many of their assets have been sold to Chinese life insurance companies who are the most aggressive buyers.

Mr. Mayfield moved to recommend a commitment up to \$75 million to Starwood XI Management according to the cash plan and subject to legal review by General Counsel. Mr. Reynolds seconded and the motion passed without opposition.

C. Action and Information Items: Strategic Asset Allocation (SAA) Implementation

1. Information Item: Update on SAA Implementation

Mr. Grabel said implementation is a priority of staff. This month global equity will be discussed and he anticipated discussing credit in July.

2. Action Item: Public Equity Implementation Plan

*[Exhibit 4: Staff Investment Recommendation – Global Equity;
Exhibit 5: Wilshire Global Equity Transition]*

LeAnne Larrañaga-Ruffy, Director of Equity, said PERA’s new SSA reduced the global equity allocation from 54.3 percent to 43.5 percent of the total fund. Staff and Wilshire recommend combining the two index funds into one – the ACWI IMI. Bids were requested from the two current index providers and State Street came in with the low bid along with the most consistent track record. Combining the two indexes into one will help rebalancing as well as reducing the annual fee by more than \$100,000 annually. She noted that the staff memo *[Exhibit 4]* did not reflect the correct fee which was negotiated this morning. Also, a new global low volatility equity portfolio is being added at about 4.4 percent of the total equity. Staff and the consultant recommend using a transition manager to passively implement this before the RFI/RFP process begins.

Tom Toth, Wilshire, emphasized the strategic rationale for the move is to provide a more balanced risk profile for the total portfolio. This change will provide cost savings

as well as rebalancing simplification along with a low volatility exposure. Any changes in illiquid assets will be handled on an ongoing basis per the normal Board process. He reviewed a nine-step process to rebalancing that will mitigate the risk of market timing with each step reducing the global equity by \$190 million.

Mr. Grabel said the Board will be made aware of the completion of each tranche which will be reflected in the cash plan.

Historically, PERA has worked with a transition manager and Mr. Grabel said a transition manager will help avoid market timing and trading expenses. It is much more efficient to use a transition manager.

Responding to Mr. Reynolds' question, Mr. Toth said the total portfolio is shifting into more illiquid asset classes; however, the liquidity that remains is very material and well in excess of any liquidity required to meet benefit payments on a regular basis.

Ms. Larrañaga-Ruffy anticipated the project would be completed within a nine-month period. Staff will be providing monthly updates on the process.

Mr. Mayfield moved to recommend that the Board approve the public equity implementation plan. Mr. Reynolds seconded and the motion passed by unanimous [5-0] voice vote. [Ms. French was not present for this action.]

D. Information Item: Actuarial Experience Study

*[Exhibit 6: Cavanaugh Macdonald, Study of Economic Assumptions
6/30/16]*

John Garrett, Cavanaugh Macdonald, said Cavanaugh is providing more frequent economic experience studies to match up with the Board's consideration of allocations. The components of economic assumptions include rate of price inflation, real rate of investment return and real rate of wage increase.

Price inflation is difficult because there is a dramatic difference between expectations short term and long term. It is currently 3 percent and the recommendation is 10 years at 2.25 percent. Real rate of return is 4.75 percent and the recommendation is 5 percent. No change is recommended for the real rate of wage inflation at .5 percent. There is a recommended change in investment rate of return from the current 7.75 percent to 7.25 percent and a drop in wage inflation and payroll growth.

Mr. Garrett said they review the data and assumptions received from Wilshire. Referring to the investment rate of return and capital market assumptions, he said that analysis is used to develop arithmetic means, geometric means and standard deviation which provide an analysis of real rates of return by percentile. Cavanaugh is comfortable with a recommendation to 5 percent for the real rate of return and then combined with price inflation, the net investment return recommended for use is the first 10 years at 7.25 percent and after 7.75 percent. This provides a very tool for PERA to set future discount rates. He reiterated the need to keep payroll growth in step with wage inflation. He recalled that the 2043 funded status of the program was 108 percent. Assuming a zero

percent return for 2016, the new 2043 ratio is 91.7 percent. The recommended assumptions are projected to have a funded ratio of 80.7 percent 2043. He noted that PERA solvency is still improving; however, it is improving more slowly than before.

Mr. Garrett said the market returns have pulled PERA away from 2043 for full solvency.

Chair Esquibel asked how the discount rates impact PERA's solvency and Mr. Garrett said these are assumptions based less on return than on investment. There is a set stable amount from contributions which means it will take longer to get to 100 percent funded.

Mr. Propst noted that SB27 did not include a specific target date. The Board set 2043 as its target for 100 percent funded level.

Mr. Grabel said the actuaries' report is for discussion.

Ms. Naranjo Lopez said the membership has been informed that at 2043 the PERA plan would be 100 percent funded or higher. She said this information brings up many questions; should members be concerned that COLAs will be further reduced?

Mr. Garrett said the message was the fund expected, based on the SB27 changes that it would be 100 percent by 2043. These are projections and things could be better than what is projected. Currently, the plan is taking on some negative experience.

Ms. Naranjo Lopez expressed concern regarding the actuaries' recommendations. Mr. Grabel said her concern furthers the case to lower the rate of return assumption. The return over the past three years is 5.28 percent rather than the 2013 7.75 percent. The target of 2043 was predicated upon an average of 7.75 percent.

Mr. Garrett pointed out that every year is a new year of experience that will modify the 2043 expectation. Three out of the last five years have brought on more negative experience.

Mr. Grabel pointed out that the Board has been proactive: first, with the new strategic asset allocation with a higher return/lower risk portfolio, and second by more accurately reflecting the liability.

Chair Esquibel suggested bringing the money managers who have underperformed before the Board to discuss how it is they are making money and PERA is not.

Mr. Reynolds requested additional education on the proposed assumptions based on the first 10 years and the period following that. He asked how these assumptions compared with peer pensions. He suggested that the actuary provide a recommendation that contains an alternative.

Mr. Garrett said the median plans assumed the discount rate would be 7.755 percent, slightly above PERA's 7.75 percent. He saw no advantage to being ahead of the trend.

5. **OTHER BUSINESS**

None was presented.

6. **ADJOURNMENT**

With a motion and a second to adjourn, having completed the agenda and with no further business to come before the committee, Chair Esquibel declared this meeting adjourned at 11:51 a.m.

Approved by:



Dan Esquibel, Chair
Investments Committee

ATTEST:



Wayne Propst, Executive Director

Exhibits:

Exhibit 1: PERA Staff Report re: Starwood, 6/30/16

Exhibit 2: Cliffwater Report, 6/30/16

Exhibit 3: Starwood Global Opportunity Fund XI, 6/30/16

Exhibit 4: Staff Investment Recommendation – Global Equity

Exhibit 5: Wilshire Global Equity Transition

Exhibit 6: Cavanaugh Macdonald, Study of Economic Assumptions 6/30/16