NEW MEXICO

PUBLIC EMPLOYEES RETIREMENT BOARD

INVESTMENTS COMMITTEE MEETING

May 26, 2016

This meeting of the Public Employees Retirement Board Investments Committee was called to order by Chair Dan Esquibel at approximately 9:00 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. Roll call was preceded by the Pledge of Allegiance. 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

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
Dana David, Assistant General Counsel
Joaquin Lujan, Director of Rates and Credit
LeAnne Larrañaga-Ruffy, Portfolio Manager
Mark Montoya, Financial Analyst
Kristin Varela, Portfolio Manager

Emily Lopez, Financial Specialist
Karyn Lujan, Deferred Compensation Plan Manager
Christine Ortega, Portfolio Manager

Others Present:
Thomas Toth, Wilshire
Jamie Feidler, Cliffwater
Paul Lium, Nationwide
Dale Lattanzio, DRC Capital
Rob Hurlbut, Agriculture Capital Management
Tom Avinelis, Agriculture Capital Management

2. APPROVAL OF AGENDA

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

3. APPROVAL OF CONSENT AGENDA

Ms. French said she reviewed the minutes which she accessed as accurate and in order.

Ms. Fisher moved to approve the consent agenda. Mr. Reynolds 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 up 1.1 percent net of fees with a fund balance of $14.1 billion. Notwithstanding two very strong consecutive months, the fund is down 13 basis points for the fiscal year. Since February, the fund has begun to recover with the fund balance up approximately $1.1 billion. He indicated it was unlikely the fund would achieve the 7.75 percent for the fiscal year.

Next month's investment performance report will contain the new asset allocation – four constructed categories as opposed to the current eight categories. For April, public equities were up, domestic equities were up 69 basis points and international equities were up 2.31 percent. Real estate was the sole asset category that was down for the month. Real assets is up 1.27 percent which is a real change – the price of oil has increased dramatically. He reminded the Committee that alternative assets lag by a quarter. MLPs, one of the strategies within real assets, were up 11.77 percent for the month, calendar year-to-date they are up 4.88 percent. Mr. Grabel said "rebalancing is the only form of marketing timing," that he supports.

2. Cash Plan Update

Mr. Grabel said the change in fund balance was positive $112 million. There was approximately $476 million in cash at month end. Cash accounts are at BNY Mellon, STO (State Treasurer), Overlay program and Corporate Action. There were significant redemptions that came through during April. He reviewed the sources of funds which included $24 million from the old portable alpha program, $25 million from private asset distributions, $66 million from hedge fund redemptions, $52 million from employer/employee contributions, and $3 million from corporation actions. Uses of cash included $91 million to pay benefits and refunds, $3 million for operational expenses and $34 million for private 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 actual – and the differences.

Referring to the overlay, Mr. Grabel said calendar year-to-date it's up $52.6 million. He emphasized that in this year where the fund balance is down 13 basis points to make $52.6 million by using cash is meaningful.

3. Other Updates

Mr. Grabel provided the following updates:

- *Institutional Investor* Magazine named LeAnne Larrañaga-Ruffy the best private equity investor for public pension plans in the country
- A new risk report from a securities perspective based on the previous strategic asset allocation was included in Committee packet based on VAR (value at risk)
- A new format has been introduced for staff investment recommendations which contains more analytics, charts, etc. making the recommendation more "digestible"
- The Listed Infrastructure RFP evaluation committee has a site visit planned and they are preparing a recommendation for the June Board meeting
- The Multi-Strategy Credit RFP evaluation committee anticipates a recommendation at the July Board meeting
- An education session focused on peer ranking is tentatively scheduled following the June Board meeting
- A discussion regarding the actuarial rate of return is scheduled for the June Board meeting with a follow-up recommendation to lower the actuarial return in July

Karyn Lujan wrote a feature in the current *Round the Roundhouse* on the recent awards that Ms. Larrañaga-Ruffy and Mr. Perez received and Mr. Grabel offered to email it to the Board.

B. <u>Action Item</u>: 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 DRC European Real Estate Debt Fund III, LP
[Exhibit 1: PERA Staff Report, 5/26/16; Exhibit 2: Cliffwater

Report, 5/26/16; Exhibit 3: DRC Capital report]

Mr. Grabel disclosed his brother in-law has served as general counsel for the Duet Group. In 2012, DRC spun out from the Duet Group. Duet and DRC have no continuing relationship. PERA's original investment with DRC was in 2013 and Mr. Grabel arrived at PERA in 2014.

Joaquin Lujan, Director of Rates and Credit, said both Cliffwater and PERA staff jointly recommend committing up to $75 million to DRC's ERED Fund III. This real estate debt fund will originate commercial real estate loans that are collateralized by core Western European commercial properties. The strategy targets a 12 percent to 14 percent gross IRR with a 7 percent per annum cash yield over the life of its eight-year term.

PERA previously committed $46 million to ERED Fund II in 2013. The reasons to invest is it fits the portfolio and anticipates diversification benefits and other essential ingredients.

Dale Lattanzio, DRC Capital Managing Partner, said the firm was formed in 2008 to take advantage of a market change in Europe. European banks were withdrawing from commercial property lending and DRC set up a business to fill the gap. Since 2008 DRC has invested more than £1 billion into the sector. DRC typically makes mezzanine loans up to a maximum of 80 percent loan-to-value ratio – across the two funds it is approximately 70 percent. The other loans are high yield senior loans that are bridge loans in form and shorter in duration.

The firm is owned by three partners of whom he is one. He reviewed the DRC team.

Mr. Lattanzio discussed Basel II, which has caused a reduction in commercial property lending which that created an opportunity. The banks' withdrawal from the commercial market has opened opportunities for pension fund capital and private funds. He anticipated within the next few years the European banks will make up 45 percent of the loans to commercial properties similar to the U.S. He discussed how they access the market by directly originating the loan and knowing the borrowers and having repeat relationships with borrowers as well as having developed expertise across northwest Europe.

Mr. Lattanzio reviewed Fund I which received 13.3 percent IRR for investors to date. Fund II is similar to Fund I and is demonstrative of the fact DRC is able to generate returns in an improving market without taking more risk. Overall, DRC has maintained returns by introducing early repayment fees and other fees to the borrowers which have benefitted Fund II. He reviewed the 10 percent coupon and the fees charged to borrowers which further bolster DRC's earnings. These are high yield cash flowing strategies that generate income straightaway for investors.

Chair Esquibel asked about defaults and Mr. Lattanzio said there have been two, however, more was recovered than the principal balance of the loans.

Mr. Lattanzio provided an example of how they create an investment and the channel in which they invest. DRC does not buy debt from intermediaries who have already pre-packaged it and taken out the profit. DRC originates it directly and preserves at least 200 basis points for investors.

Upon Ms. French's request, Jamie Fiedler, Cliffwater, reviewed an actual investment within DRC's portfolio. Project Green is a current investment in Fund II. The loan is secured by one of the only two superregional shopping malls in the Dublin area, which was being refinanced by its owner, a multinational bank. DRC originated the loan based on its relationships in the community.

Referring to the UK's EU referendum, Mr. Lattanzio said if they were to leave, there would be short-term currency volatility.

Of PERA's $46 million committed to Fund II, Mr. Lattanzio said 90 percent is invested.

Mr. Reynolds asked whether this fund was its own asset class within the PERA fund. Mr. Lujan responded that this fits into credit which is 15 percent of the portfolio and fall under the illiquid private debt category. The target is $322 million and PERA has committed $267 million.

Mr. Reynolds asked whether any metrics were used to examine manager diversification. Mr. Lujan noted that the strategy and underlying holdings are important metrics. The returns that are produced through this strategy are almost independent of the environment.

Mr. Grabel added that these vehicles have a limited life. In terms of the procedures for alternative assets there are maximums in terms of concentration in any one manager's fund.

Mr. Reynolds said from his perspective he questions additional investments in DRC who may have a significant portion of the private credit managers in Europe. Mr. Feidler said it is a unique opportunity set and he opined that it should not be spread out over a number of players and instead focus on the best.

Mr. Grabel said it is a balancing act between manager proliferations. He noted the best form of diligence is by being an existing investor in the fund.

Mr. Mayfield asked about currency risk and Mr. Lujan responded there is some risk because valuations are always moving as a matter of relative value. Because the fund has an eight-year life cycle it is ameliorated.

PERA converts all investments back to dollars. The basis of accounting for DRC is in pounds, stated Mr. Grabel.

Mr. Melia noted that Cliffwater's reports on both of today's investment recommendation are that the general partners do not have a substantial equity interest in either of the funds. Mr. Feidler said the typical threshold Cliffwater likes to see is a 1 percent commitment by the general partners which means the senior managers are investing their own money with those of their investors, the other limited partners. DRC is a younger firm and their .6 percent investment does constitute a material investment vis-à-vis for their personal net worth.

Ms. French moved to recommend to the Board a commitment of $75 million to DRC ERED Fund II subject to legal review by general counsel. Ms. Fisher seconded and the motion passed by unanimous [6-0] voice vote.

2. Recommendation to Commit up to $40 Million to Agriculture Capital Management (ACM)Fund II, LLC
[Exhibit 4: PERA Staff Report, 5/26/16; Exhibit 2: Cliffwater Report, 5/26/16; Exhibit 5: ACM report]

Kristin Varela, portfolio manager, real returns, said this commitment will be a in liquid real assets partnership focused on farm land investment generating yield through development, harvesting and processing of permanent groups. ACM intends to invest in farmland and food processing assets located in the western U.S. The fund is targeting $400 million of capital commitments and is expecting to invest in 8 to 12 assets over their four-year investment period. ACM will target a 13 percent to 15 percent gross IRR over the life of their fund.

Ms. Varela said the current real asset portfolio is highly concentrated in growth oriented energy exposure. The natural resource exposure is around 20 percent of the total real assets portfolio and liquid real assets which are exclusively MLPs make up 8 percent of allocation. Given those concentrations, there is a need for diversification of risk and mitigation volatility in the portfolio. Agricultural has been identified as a favorable strategy that could benefit the portfolio.

Ms. Varela highlighted the attributes of an agricultural strategy and where it fits within the total real assets portfolio. This will be within illiquid real assets.

Rob Hurlbut, ACM Principal, said four years ago ACM developed a strategy that highlights the opportunities within food, specifically the permanent crop sector. He recited ACM's vision and strategy "to invest in farmland and food processing assets with the aim to build customer driven, vertically integrated, appropriately scaled and regenerative operations that support the planet and the communities in which we operate." In terms of being customer driven, ACM is farming what people want to eat and they work effectively with larger retailers.

One needs to be a processor as well as farmer. They emphasize processing as in collecting and packaging food in way that can be delivered to the end customer. ACM invests in those processing assets to ensure food safety and quality. From a philosophical perspective, Mr. Hurlbut said they approach the entire structure with an aim towards sustainability and regenerative production.

Tom Avinelis, ACM Principal, reviewed their management committee mentioning that he has over 35 years in farming, and has built, managed and developed over 14,000 acres of permanent crops as well as packing facilities and marketing operations. Mr. Hurlbut reviewed his professional experience which included many different roles at Nestles.

Mr. Avinelis said the first close in Fund I occurred during the first quarter of 2014 and between that time and now ACM has closed 11 different projects. Eighty-five percent of Fund I has been deployed and the balance of investments are under consideration. Mr. Hurlbut reviewed the 11 assets within Fund I that fall within California and Oregon and all three crop types – citrus, blueberries and nuts.

ACM focuses on sustainability, stated Mr. Hurlbut, which will return real value to its investors. He mentioned increasing soil organics, water savings, tracking native species biodiversity and sequesting almost a metric ton of carbon.

Mr. Hurbut said ACM has examined over $1 billion in assets and acquired $200 million. ACM has completed deals as large as $80 million and small as $5 million. There is an expectation that average will increase with Fund II.

Mr. Avinelis reviewed the four areas of risk management: water, environment, crop type and food safety.

Ms. Varela confirmed this will be PERA's first investment with ACM.

In response to Mr. Reynolds' question regarding due diligence, Mr. Grabel said one of the aspects of doing diligence today that is very different than in the past is the existence of the "virtual data rooms." There is a great deal of data that exists in the cloud about the managers that are evaluated. He noted that staff is not permitted to travel outside of the U.S.

Mr. Feidler said Cliffwater visits all managers in order to perform diligence. He noted that with this manager they did visit some farmland.

Mr. Grabel assured the Committee that PERA staff is very efficient in regard to due diligence travel and Ms. Varela is beyond efficient.

Ms. French said she was surprised ACM was reviewed in what she considered a short period of time. Mr. Grabel said there are instances where diligence takes years and other instances where it can be accomplished quickly. The identification of agricultural managers began years ago.

Mr. Mayfield moved to recommend to the Board a commitment of $40 million to ACM Fund II, LLC, subject to legal review by general counsel. Ms. French seconded.

Ms. Fisher asked whether California's drought condition would affect the investment. Mr. Avinelis said that is one of the key components to their due diligence. There needs to be multiple sources of water and those are well evaluated by ACM. Another factor is ACM invests in high value crops allowing the opportunity to pay more for the asset of water.

Mr. Avinelis said in California and Oregon they use third-party water consultants that evaluate the superiority of water rights. In addition to that, ACM looks for the most efficient use of the water.

The motion passed by unanimous [6-0] voice vote.

C. **Information Item: Q3 FY16 Performance Review**
[Exhibit 6: Wilshire, Q3 FY16 Investment Performance Review; Exhibit 7: Wilshire, Numbers in Context – 1Q16]

Tom Toth, Wilshire Managing Director, reviewed a "quilt chart" which is an ordinal ranking of returns across different asset categories. The key take-away from the chart is that there is no distinctive pattern that emerges showing the benefits of being diversified across asset classes. He reviewed key economic indicators which included the change in inflation over the past 12 months. An update on asset class returns marked the decline in expectations for core fixed income. One of the big shifts in the asset allocation is a reduction in core and global fixed income moving towards more credit oriented and real asset oriented investments. Referring to the shift from risk mitigating fixed income towards more credit oriented fixed income, Mr. Toth provided figures that better illustrated that point.

Mr. Toth pointed out that private equity is increasing moderately. The pricing is relatively elevated on both the leveraged buy-out and the venture capital sides. This underlines the need to be very measured in implementation. Referring to private equity U.S. debt markets, Mr. Toth pointed out that the loan volume has remained flat over time and the amount of debt put on the buy-outs has fallen over the last three years. From a private debt standpoint, the risk adjusted return for that area of capital markets could be fairly attractive going forward.

Using Wilshire's annual state funding study, Mr. Toth showed the median expected return for these plans is at 6.2 percent which a median expected level of risk of 12.3 percent. The recently approved strategic asset allocation has an expected return level of 6.95 percent with an expected risk level of 10.6 percent.

D. **Information Item: Strategic Asset Allocation implementation plan** *[Exhibit 8: PERA Staff Implementation Plan]*

Mr. Grabel reviewed where the portfolio is today versus the new targets and the component parts of the four asset categories: global equity, risk reduction/mitigation, credit oriented and real assets.

Global equity incurred the biggest reduction, a decrease from 54.3 percent to 43.5 percent. Global public equity is being reduced from 42.9 percent to 28.3 percent which is expected to significantly reduce the volatility in the portfolio. A new asset, global low volatility equity, will have 4.4 percent. Hedged equity remains relatively the same at 2.2 percent and private equity increased from 7 percent to 8.6 percent.

Mr. Grabel said the transition in global equities will take a long time and needs to be measured and methodical to avoid a market impact. As part of the rebalancing the U.S. will go up modestly but that is relative since the total exposures are going down.

Risk reduction and mitigation decreases from 26.1 percent of the total portfolio to 21.5 percent. Cash is included in this category and there will be $50 million that will be excluded from the overlay. There were slight reductions in the two components – global cored fixed income and domestic core fixed income. The implementation will take time to prudently rebalance.

On a percentage basis, credit oriented is the largest basket in the portfolio. It is increasing from 6.3 percent to 15 percent. There are no new sub- asset categories and the sub-asset categories are all increasing. There will be no new managers for emerging market debt. The hedged credit portfolio will probably be restructured and managers consolidated. To reach the 6 percent in illiquid credit a pacing schedule of $25 million per year will continue until 2019.

Real assets is increased from 13.3 percent to 20 percent. There are no new sub-asset categories and this covers liquid and illiquid, real assets, real estate, and market neutral hedge funds. The hedge funds remain the same although staff will look to consolidate the number of managers.

Mr. Grabel said throughout the implementation process the Committee and Board will receive detailed updates. Starting in June the reports will reflect the new strategic asset allocation. He discussed the importance of utilizing a transition manager.

D. <u>Information Item</u>: Alternative Consultant Request for Proposal Minimum Qualifications and Timeline

Mr. Grabel said the Board embarked on a fee study which better aligned its portfolio and is obtaining better investment money manager fees and issued an RFP for a new custody bank which is providing better service at a lower rate.

Recently CEM Benchmarking, a service that provides comprehensive benchmarking reports with a universe of 170 funds with plan sizes ranging between $400 million and $300 billion provided a series of analyses. As it relates to consulting, which PERA's cost is 1.9 basis points compares with the CEM benchmark to the median which is 6 basis points or 1/3 of what PERA pays and the U.S. average of 1 basis point.

Mr. Grabel mentioned Texas Teachers discloses what they pay every money manager by name and every vendor by name and amount. They are a $130 billion plan and their total investment consulting fees are $3.9 million, compared to PERA's fees of $2.7 million. He said to be responsive to PERA's stakeholders the fees should be reviewed. Of PERA's $2.7 million, approximately 72 percent is paid for alternative assets.

The RFP before the Committee is for illiquid assets and covers private assets and hedge strategies across three buckets in the portfolio: global equity, credit and real assets. The RFP will be posted June 1st and the deadline for submissions will be July 15th. The RFP is for a consultant and cannot be a money manager. Mr. Grabel said this party should be a fiduciary.

Chair Esquibel requested templates of past RFPs for comparison purposes. Mr. Grabel offered to supply those and noted that all of PERA RFPs are posted on the website.

Ms. French asked about the requirement to "attend partnership annual meetings, and, where appropriate, serve on advisory boards," and what was the intent? Mr. Grabel said when PERA makes commitments to limited partnerships they may delegate serving on an advisory committee to Cliffwater. With 60 LP relationships having their annual meetings at the same time, it is impossible for PERA to attend them. Part of monitoring the portfolio for illiquid assets is a function of getting to know the GPs.

Ms. French recommended amending the RFP under B.4.c., to state at a minimum attend one Investment meeting and Board meeting a month.

Mr. Reynolds asked what percentage of the fund this consultant would be advising on. Mr. Grabel said it was approximately 25 percent. This is currently 72 percent of PERA's consulting fees. He said the timeline was typical of PERA's RFPs and he anticipated a new contract to be in effect in December. He said he would like to go in to the legislative session with reduced fees.

5. OTHER BUSINESS

None was presented.

6. ADJOURNMENT

Having completed the agenda and with no further business to come before the committee, Chair Esquibel declared this meeting adjourned at 11:40 a.m.

Approved by:

Dan Esquibel, Chair
Investments Committee

ATTEST:

Wayne Propst, Executive Director

Exhibits:

Exhibit 1: PERA Staff Report Re: DRC Capital, 5/26/16
Exhibit 2: Cliffwater Report, 5/26/16
Exhibit 3: DRC Capital report
Exhibit 4: PERA Staff Report Re: ACM, 5/26/16
Exhibit 5: ACM report
Exhibit 6: Wilshire, Q3 FY16 Investment Performance Review
Exhibit 7: Wilshire, Numbers in Context – 1Q16
Exhibit 8: PERA Staff Implementation Plan, 5/26/16