NEW MEXICO

PUBLIC EMPLOYEES RETIREMENT BOARD

INVESTMENTS COMMITTEE MEETING

August 25, 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 Senator Fabian Chavez Jr. Board Room, PERA Building, 33 Plaza La Prensa, Santa Fe, New Mexico.

1. The Pledge Allegiance preceded roll call by Executive Director Wayne Propst and a quorum was established with the following members present:

Members Present:
Dan Esquibel, Chair
Dan Mayfield, Vice Chair
Paula Fisher
Patricia French
Loretta Naranjo Lopez
John Reynolds [10:45 arrival]

Member(s) Excused:
None

Other Board Members Present:
John Melia
Cathy Townes
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
Jude Perez, Deputy CIO
Karen Risku, Deputy General Counsel
Renada Peery-Galon, ASD Director
Joaquin Lujan, Director of Rates and Credit
Trish Winter, Executive Assistant
David Dana, Assistant General Counsel
Natalie Cordova, Chief Financial Officer

LeAnne Larrañaga-Ruffy, Director of Equity
Misty Braswell, Assistant General Counsel
Lalleh Dayeny, Investments Division
Karyn Lujan, Deferred Compensation Plan Manager
Kristin Varela, Portfolio Manager
Emily Lopez, Financial Specialist
Christine Ortega, Portfolio Manager
Mark Montoya, Investments Division

Others Present:
Jamie Feidler, Cliffwater
Tom Toth, Wilshire
Paul Lium, Nationwide
Frank Tang, FountainVest Partners [*via video telephony technology*]
Matilda Wong, FountainVest Partners [*via video telephony technology*]
Geoffrey Regnery, Harrison Street Real Estate Partners
Christopher Merrill, Harrison Street Real Estate Partners
Drew Pinson, BlackRock
Sam Weiss, BlackRock

2. APPROVAL OF AGENDA

Ms. Fisher moved to approve the agenda as presented. Her motion was seconded by Ms. French and passed by unanimous [5-0] voice vote. [Mr. Reynolds was not present for this action.]

3. APPROVAL OF CONSENT AGENDA

Ms. French moved to approve the consent agenda. Ms. Fisher seconded and the motion passed without opposition. [Mr. Reynolds was not present for this action.]

4. CURRENT BUSINESS

A. Chief Investment Officer's Report

1. Investment Performance – July 2016

PERA CIO Jon Grabel said July, the first month of the fiscal year, was a "great month." The fund finished the month with $14.4 billion, up 2.69 percent net of fees. The fund balance increased by over $326 million. At this point in the fiscal year, the fund is ahead of its actuarial hurdle, the first time since 2015 that has occurred.

Until the asset allocation is more fully implemented within the category bands there will be a period of a significant tracking error. Calendar year 2016, the fund is up 6.22 percent. Mr. Grabel reviewed the asset categories: global equities were up 4.12 percent, global public equities were up 4.54 percent; hedged equities down by 14 basis points and private equity was up 96 basis points. The risk mitigation portfolio was up 66 basis points and continues to perform very well. Credit was up 94 basis points; liquid credit was up 1.62 percent, emerging market debt was down 1.09 percent and illiquid credit was down 24 basis points. Real assets were up 2.15 percent,

2. Cash Plan Update

The change in the fund balance was up $326 million for the month, noted Mr. Grabel. The month ended with approximately $369 million in cash. He reviewed the sources which included $5 million from an old portable alpha program, $43 million from illiquid assts – redemptions and distributions, and $46 million employer/employee contributions. As a mature pension, the outflows are greater than inflow and in July $94 million was used to pay benefits and refunds. The monthly average benefit payments during the previous fiscal year were $87 million. The increase is a function of two things: more retirees and the COLA. The COLA is about $.15 million per month.

Mr. Grabel noted $1 million in operational expenses and $28 million in capital calls for illiquid assets.

3. Other Updates

Mr. Grabel provided the following updates:

- RFP: Illiquid Investment Consultant – 12 responses were received and the evaluation committee will meet today
- The monthly risk report highlights the increased volatility in the capital markets as a result of the UK referendum; 85 percent of the fund's risk is through global equity; an underweight to China was shown as well as the contribution of risk at 1 percent – China is a net positive for the portfolio from a diversification standpoint
- Dedicated Managed Accounts (DMAs) approved last month is a strategy that may require additional 3rd party providers. As separate entities DMAs require audits, insurance, licenses, compliance in reporting, etc. and may require an RFP for "corporate secretarial services." Staff will provide additional updates to the DMA implementation recommendation

Board Chair French said she saw great advantages to the DMAs and requested that Mr. Grabel, his staff and the IC chair continue to flesh out the issues. Mr. Grabel pointed out that regardless of who the DMA provider is the corporate secretarial services will still be required another RFP. BNY Mellon is the appropriate party to serve as the custodian. Operational aspects require an incremental 3rd party.

- Regarding the real estate credit mandate to Quadrant with an investment up to $70 million in a comingled limited partnership – Quadrant was unable to raise sufficient capital and will fund was abandoned

B. <u>Information Item</u>: Q4 FY16 Performance Review

[Exhibit 1: Wilshire, Q4 FY15 Performance Review; Exhibit 2: Wilshire, Numbers in Context 2Q16]

Tom Toth, Wilshire, referred to the actual and policy target noting it will take time to get closer to the target causing a tracking error between the portfolio's performance and that of the policy. He concurred with Mr. Grabel's earlier comments that reallocations and finding the appropriate instruments take time. As PERA moves through the nine step transition period the distance between allocation and target will diminish. The new asset allocation will be less reliant on global equity returns and has a lower contribution to risk from equity.

Mr. Toth referred to a "quilt" chart that looks at the performance of various components of the capital markets on a year-by-year basis and then annualized over a five-year basis. The key takeaway is the benefit of diversification. He pointed out that in 2015 MLPs were the worst performing segment of capital markets and in 2016 MLPs have been the best performers. He mentioned the challenges of a low return environment which he attributed to a low interest rate and discussed the rate of interest rate increases. Market expectations for inflation remain muted and the market is very policy driven which reinforces a patient implementation schedule.

C. <u>Action Items</u>: 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 $85 Million to FountainVest China Capital Partners III, LP (Via video telephony technology) [*Exhibit 3: Staff recommendation re: FountainVest; Exhibit 4: Cliffwater Report; Exhibit 5: FountainVest Report*]

LeAnne Larrañaga-Ruffy, Director of Equity, introduced the recommendation to invest up to $85 million to FountainVest China Capital Partners Fund III, an illiquid growth private equity partnership with a focus on key sectors in China. This recommendation will further diversify the private equity portfolio and add to the non-US exposure.

Frank Tang, CEO of FountainVest, thanked the Committee for their interest and for the opportunity to discuss the fund. He provided his personal history: born in Shanghai, received an MBA at Columbia University, worked for Goldman Sachs in Hong Kong, led the investment efforts in China for Temasek Holdings - an investment company owned by the Government of Singapore, and in 2007 he and his partners co-founded FountainVest.

Also present via Skype for FountainVest was Matilda Wong who joined the team in 2012 to head investor relations and serve as chief of staff.

Mr. Tang reviewed their report highlighting the team's seasoned experience with many of them working together at Goldman Sachs. He discussed the tremendous growth in the Chinese market and said FountainVest is focused primarily on the private sector companies because this is the new energy for the Chinese economy. The private sector is very hard working and because they lack funding there is a huge opportunity for the prime equity investors to help these companies grow by providing new capital to increase their scale.

Mr. Tang said the focus for funds I, II and now III has been consistently on growth and the private sector in China. He discussed the first fund which was raised in 2008 with $950 million and includes CalPERS and other pension funds as investors. In 2012 the second fund raised $1.35 billion with 35 investors. Fund III is in its final closing.

China's growing sectors are very diverse, encompassing online travel booking, online retail, film, private healthcare and education to name a few. The slower growing sectors include mining, cement, steel that are related to infrastructure spending that China has relied upon, stated Mr. Tang. FountainVest has been successful at picking the right sectors that need capital for growth. Twenty years ago, China's private sector was illegal and made up zero percent of the market. Today the private sector makes up 41 percent and in the past five years the size of the existing companies have nearly doubled. He discussed the age of the private company founders and the succession challenges that these Chinese firms face. He reminded the committee that all of these founders are first generation entrepreneurs – the market was opened in the 1980s and all of the entrepreneurs have only one child – this increases buy-out opportunities.

Mr. Tang discussed the firm's overall framework for investments with a focus on healthcare and lifestyles which drives the Chinese economy. He highlighted the 350 IMAX Cinemas in China and its tremendous success. In the next few months that market will exceed the US and Canada markets. Opportunities in healthcare, media advertising and advanced machinery were emphasized.

Concluding his presentation, Mr. Tang discussed how FountainVest works with the companies they invest to improve their operations.

Chair Esquibel found fault with the video telephony sound and asked why the managers did not appear in person. Mr. Grabel remarked on the travel demands from Hong Kong to New Mexico.

Chair Esquibel said he understood that the Chinese economy is slowing down and that concerned him in that the proposed investments focus on excess income. In response, Mr. Grabel said there is a secular shift in the China from an industrial to a consumption economy. China continues to grow at a rate of 7 percent a year whereas the US is around 2 percent. As the second largest economy in the world, China has an enormous emerging middle class and mass affluence. Mr. Grabel said the sectors presented by FountainVest are illiquid and precluded from the public markets. Further, over the life of this fund 70 percent of the owners of the top 500 companies in China will be looking for a liquidity or retirement event, thus providing ample opportunity for a corporate transition to a private equity firm.

Ms. Fisher asked about the company's lack of a personal trading policy. Mr. Tang said there is a compliance policy in place that bans any insider trading within the firm and there is a no trade list controlled by the firm's general counsel. FountainVest employees are required annually to sign an affirmation of the insider trading policies.

Jamie Feidler, Cliffwater, noted that FountainVest has both policies and procedures as it relates to personal trading and rated an A in operational scores from Cliffwater.

Ms. French expressed her frustration that she was unable to hear the presentation and was surprised that the managers did not feel it was worthwhile to be physically present. She indicated she would not be voting in favor of the allocation for those reasons.

Ms. Naranjo Lopez said in today's technological world she appreciated having the manager present via Skype; however, the volume could have been better.

Mr. Feidler said there is currency risk with any non-US denominated fund. Mr. Tang pointed out that the fund is denominated in US dollars.

Ms. Larrañaga-Ruffy indicated that FountainVest partners were putting in 2.5 percent of the capital in Fund III.

A question was raised regarding disaster recovery and business continuity. Mr. Tang said they have three offices, Beijing, Shanghai, and Hong Kong, with expert staff and are well prepared for any disaster.

Mr. Mayfield moved to recommend approval of a commitment up to $85 million to FountainVest China Capital Partners III, LP, funded according to the cash plan and subject to legal review by General Counsel. Ms. Naranjo Lopez seconded and the motion passed by majority [4-1] voice vote with Ms. French voting against and Mr. Reynolds not present.

To avoid future complications, Chair Esquibel recommended that the managers physically appear before the committee

2. Recommendation to Commit up to $75 Million to Harrison Street Real Estate Partners VI, LP
[*Exhibit 6: Staff Recommendation re: Harrison Street; Exhibit 7: Harrison Street report; Exhibit 4: Cliffwater report*]

Kristin Varela, Real Returns Portfolio Manager, said this is a recommendation for an illiquid real estate partnership within the real assets portfolio. The recommendation would increase the real assets allocation to 9 percent of the total. The target is 20 percent. This fund focuses on opportunistic investments in demographically driven need-based real estate through the sectors of education, healthcare and storage within the US. The fund is projected to reach a targeted IRR of 15 percent over the fund's 10-year lifespan.

Ms. Varela noted that PERA and Harrison have an existing relationship with a commitment of $40 million to Fund V which has contributed significantly to the portfolio.

Christopher Merrill, Harrison Street, said the firm was founded over a decade ago and at that time the focus was on risk management and investment in social infrastructure. They focus on off-campus facilities for students where housing is needed.

Additionally there is a need for senior housing – independent, assisted living and memory care – and outpatient-type medical facilities. Self-storage facilities do well in good and bad times and is a low-cost business.

Mr. Merrill said the asset classes they invest in performed well during the global financial crisis. There is a long-term demand for these assets. They have assets in 45 states with over 600 properties and a team of experts. Institutional investors see the benefit of the resiliency. Fund VI will be the same size as Fund V even though the capital investor interest has been tremendous.

Mr. Merrill thanked PERA for their partnership with Harrison Street.

In response to Mr. Mayfield's question, Mr. Merrill said they do not operate any of the assets and have local property development leasing companies they work with.

Ms. Varela said Fund V has not been completely drawn down. Mr. Merrill said over 80 percent has been committed. Geoffrey Regnery, Harrison Street , said a capital call is occurring this week that takes Fund V to 65 percent call and just shy of 90 percent committed.

Ms. French moved to recommend approval of a commitment up to $75 million to Harrison Street Real Estate Partners VI, LP, funded according to the cash plan and subject to legal review by General Counsel. Ms. Naranjo Lopez seconded and the motion passed by unanimous [6-0] voice vote.

D. <u>Action and Information Items</u>: Strategic Asset Allocation (SAA) Implementation [*Exhibit 8: Staff SAA recommendations; Exhibit 4:Cliffwater Report*]

1. **<u>Information Item</u>: Update on SAA Implementation**
2. **<u>Action Item</u>: Real Assets Implementation Plan**

Ms. Varela said real assets is significantly under-allocated. Currently, it is 8.6 percent of the total fund and the target allocation is 20 percent. She reviewed the implementation plan for each of the real asset positions to attain the desired SAA position: liquid real estate, illiquid real estate, illiquid real assets, liquid real assets, and market-neutral strategies.

The recommendations are as follows:

Liquid real estate: Maintain current overweight
Illiquid real estate: Continuation of capital commitments
Liquid real assets: Rebalance MLP position to target allocation
Illiquid real assets: Utilization of newly approved Listed Infrastructure Strategy and a continuation of capital commitments
Market-neutral strategies: Maintain current overweight

Ms. Varela said this portfolio presents certain challenges because it is so underweighted. She noted that 85 percent of the investments are slated to be illiquid. It is the most concentrated portfolio, and there are few managers to allocate this capital to.

The portfolio completion strategy would be dedicated directly to real assets, broadly diversified and highly liquid. If all the proposed plans were fully implemented, the portfolio would reach 14 percent which, while not the target is within the lower range. A great deal of the rebalancing could be completed to reach the minimum 14 percent range within four to six months.

Mr. Mayfield moved to approve the real assets implementation plan. His motion was seconded by Ms. Fisher and passed by unanimous [6-0] voice vote.

E. <u>Information Item</u>: Real Assets Portfolio Review
[Exhibit 4: Cliffwater report]

Mr. Feidler provided an overall review of the real assets portfolio noting its role to generate current income, provide capital appreciation, increase portfolio diversification and provide a hedge against inflation. This is a broad asset category and is diversified among the five categories that Ms. Varela reviewed during discussion of the implementation plan. The SAA redefined real assets to create a broader portfolio and combine existing asset classes into this more broadly defined bucket. It was important to note no new sub-asset classes were created.

Mr. Feidler said PERA has seen outperformance in each of the five buckets over the last three- and five-year periods. He reviewed the characteristic of each of the sub-portfolios.

F. <u>Action Item</u>: Approval of Updated Procurement Policy
[Exhibit 9: Procurement Policy]

Chair Esquibel pointed out that the policy will be reviewed again to revise Section 12.

Noting that the committee has discussed this issue in depth in the past, Mr. Mayfield moved to approve the updated Procurement Policy. Ms. Naranjo Lopez seconded and the motion passed by unanimous [6-0] voice vote.

G. <u>Information Item</u>: Transition Management Education Presentation

Sam Weiss, BlackRock, said he has been working with PERA over two years through BlackRock's management team. He noted that BlackRock has been working for PERA over 20 years providing a variety of services and he thanked PERA for that relationship. BlackRock's business is very healthy with a reported 2^{nd} quarter of $4.9 trillion managed across asset classes. He mentioned their risk management monitoring system, Aladdin, which monitors exposure on the entire $4.9 trillion. Aladdin is utilized by third-parties to include sovereign governments, insurance companies and pension plans. The business experienced an annual 13 percent growth.

Referring to alternative investments, Mr. Weiss said BlackRock conducted a survey with its client base which revealed over half were planning to increase allocations to alternatives.

Drew Pinson, BlackRock, said there are two different ways to reallocate a portfolio when moving from one manager to another: request the existing manager to sell the investment and provide the cash to the new manager; or engage a transition manager/team who serves during in-between period. BlackRock's transition team consists of 56 individuals. The process involves taking over the existing assets, physically trading them into the desired assets and then passing off the portfolio to the new manager(s). The transition manager will reduce costs, reduce risk and operational burden on the investment staff. For PERA asset reallocation is the consideration. There are costs associated when trading a large number of securities that require management. Operational complexities require coordination and exposure when shifting assets requires appropriate management. Mr. Pinson said a transition manager reports on what occurred during the allocation period.

Mr. Pinson said one of the issues in rebalancing a portfolio, especially one of institutional size, is the possibility for exorbitant costs. A transition manager should bring expertise to trade positions and be able to appropriately source the liquidity. BlackRock seeks the best prices and maximizes the positions that are being sold and buys positions at the lowest price. He noted that size matters and BlackRock has that which provides greater discounts to PERA.

The transition manager will minimize the time period between movements and make sure the plan is in the right exposure at the right time. Mr. Pinson discussed the formula used to measure performance and implementation shortfall for transitions. BlackRock develops a pre-transition cost estimate which is compared to the actual transition performance.

BlackRock has accomplished four large transitions for PERA totaling $6 billion in notional value. Across those four transitions, Mr. Pinson said that BlackRock has produced an economic savings versus the estimated cost of $9.3 million.

Responding to Chair Esquibel's question regarding fees, Mr. Pinson said it varies by asset class but is no greater than 4 basis points of traded value.

5. OTHER BUSINESS

None was presented.

6. ADJOURNMENT

With a motion and a second to adjourn, and having completed the agenda, Chair Esquibel declared this meeting adjourned at 11:25 a.m.

Approved by:

Dan Esquibel, Chair
Investments Committee

ATTEST:

Wayne Propst, Executive Director

<u>Attached Exhibits</u>:
Exhibit 1: Wilshire, Q4 FY15 Performance Review
Exhibit 2: Wilshire, Numbers in Context 2Q16
Exhibit 3: Staff recommendation re: FountainVest
Exhibit 4: Cliffwater Report
Exhibit 5: FountainVest Report
Exhibit 6: Staff Recommendation re: Harrison Street
Exhibit 7: Harrison Street report
Exhibit 8: Staff SAA recommendations
Exhibit 9: Procurement Policy