Ratified at the March 11, 2014 Investment Committee Meeting

NEW MEXICO

PUBLIC EMPLOYEES RETIREMENT BOARD

INVESTMENTS COMMITTEE MEETING

February 11, 2014

This meeting of the Public Employees Retirement Board Investments Committee was called to order by Chair Dan Mayfield, at 9:00 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**: Following the Pledge of Allegiance, roll was called by Executive Director Wayne Propst and a quorum was established with the following members present:

Members Present:
Dan Mayfield, Chair
Patricia French
James Lewis
Stewart Logan

Member(s) Excused:
Roman Jimenez, Vice Chair
Jackie Kohlasch

Other Board Members Present:
Dan Esquibel - Municipal
Paula Fisher - State
Louis Martinez - Municipal
Loretta Naranjo-Lopez - Retiree
John Reynolds - State

Staff Members Present:
Wayne Propst, Executive Director
Susan Pittard, General Counsel/Chief of Staff
Sylvia Barela, ASD Director
Judy Olson, Executive Assistant
Jonathan Grabel, CIO
Julian Baca, Deputy CIO
Karen Risku, Assistant General Counsel
Greg Trujillo, Deputy Director
LeAnne Larrañaga-Ruffy, Portfolio Manager
Christina Keyes, Portfolio Manager
Roderick Ventura, Assistant General Counsel
Jason Goeller, Portfolio Manager
Joaquin Lujan, Portfolio Manager

JoAnn Garcia, Deferred Compensation Program Manager
Sonam Rapten, Financial Analyst

Others Present:
Jamie Feidler, Cliffwater
Devon Muir, Mercer
Katie Jamgochian, Mercer
Michael Schlachter, Wilshire
Stephen Marshall, Wilshire
Paul Lium, Nationwide

2. APPROVAL OF AGENDA

Mr. Lewis moved to approve the agenda as published. His motion was seconded by Ms. French and passed by unanimous [4-0] voice vote.

3. APPROVAL OF CONSENT AGENDA

Chair Mayfield indicated that he reviewed the minutes of the previous meeting.

Mr. Logan moved to approve the consent agenda. Mr. Lewis seconded and the consent agenda was unanimously [4-0] approved.

4. CURRENT BUSINESS

A. Chief Investment Officer's Report

1. Preliminary Investment Performance Summary – January 2014

Jonathan Grabel, Chief Investment Officer, said the portfolio was down by preliminary estimates approximately 144 basis points for the month. That was attributed to equity markets being down and the fact the portfolio has a high concentration in equity. As a large institutional investor, Mr. Grabel cautioned not to read too much into the performance of securities especially during the duration of a month. Fiscal year to date the portfolio is ahead of its actuarial target (7.75 percent) and is up 9.3 percent. Mr. Grabel noted fixed income was up 2.2 percent. Regarding alternative portfolio which makes up 17 percent of the portfolio it is too early to have January numbers.

Mr. Grabel noted there were no major outliers as it relates to manager performance.

2. Cash Plan Update

Mr. Grabel reviewed the cash and noted the major events for the month in terms cash sources and uses were: $50 million redemption from a hedge fund which was split and reinvested between fixed income and equity; however the policy range was breached in regards to US equities and international equities and the portfolio was rebalanced to

address that issue. He said it was important that the portfolio be rebalanced for consistency with the strategic asset allocation.

3. Other Updates

Mr. Grabel reported that individuals from staff, Cliffwater and the Board visited two finalists for the MLP RFP. The meetings were productive and the MLP (Master Limited Partnership RFP committee will be making a recommendation at the Board's February 27th meeting.

In regards to the outstanding GTAA (Global Tactical Asset Allocation) RFP, Mr. Grabel said 23 responses were received. Following review by staff and Wilshire and with the approval of the Board Chair and Investments Committee Chair it was determined that the GTAA RFP would be cancelled.

Regarding PERA's security lending portfolio, Mr. Grabel said at the end of January the unrealized losses were reduced by $400,000 to $500,000. Staff will continue to monitor the portfolio with the intention of providing an educational session on securities lending in the spring.

Mr. Grabel said the staff work plan, while somewhat aspirational, highlights the fact that staff wants to position the plan to have the best returns with the least amount of risk. The goal in implementing the plan is to work with the Board to make it practical and implementable. The work plan was divided into three components: operational, core portfolio and the alternatives portfolio.

Operational plans include:

- Issue an RFP to better evaluate whether the timeliness and accuracy of the information from PERA's custodian can be improved
- Develop a new performance dashboard for the Board's perusal providing better information for evaluation
- Review and recognize the importance of portfolio rebalancing
- Examine cash drag recognizing the necessity to fund capital calls, pension benefits and manager fees
- Consider cash overlays or futures as cash alternatives
- Measure and deliberate the goals of the initiatives
- Provide Board education in advance of all recommendations to better deliberate the pros and cons of any recommendations

Core Portfolio:

- Start strategic allocation study
- Analyze and equity structure with an eye on reducing fees
- Analyze the fixed income portfolio which comprises 26 percent of PERA's asset

Alternatives Portfolio:

- The goal for this year is a higher sharp ratio portfolio, maximize returns and review the correlations.

In response to Mr. Lewis' concern about the market itself in terms of reallocating how much weight is given to the market itself, the question is how do you weigh that? Mr. Grabel said market volatility has crept up and it is difficult not to respond to the immediacy of changing markets; however, the asset allocation is predicated upon the best estimates of the advisors. He said it is incumbent on the Board, staff and advisors to apply our best judgment against the math. Mr. Grabel discussed capturing some of the bigger macro long-term trends.

What are the plans to obtain better fees? asked Mr. Lewis. Mr. Grabel said a low-cost portfolio to reduce fees is not the goal but rather to maximize the risk adjusted/fee adjusted returns and make sure that the exposures cannot be replicated through an index or liquid alternative.

Mr. Grabel said he tends to think more about the plan as whole – liabilities, duties to the members and the macro performance. The goal is to enhance our investment policy statement and focus on the strategic asset allocation.

Ms. French commended Mr. Grabel on the aggressiveness of the work plan.

B. <u>Informational Item</u>

1. PIMCO – Core Plus Fixed Income

LeAnne Larrañaga-Ruffy, Portfolio Manager, said PERA staff as well as Wilshire were notified of three departures and a series of firm changes to address the vacancies. The most notable departure is that of Mohammed El-Erian, CEO/co-CIO resigned. Bill Gross, CIO and founder of the firm, appointed six deputy CIOs thus creating potential successors.

Staff and Wilshire advise monitoring PIMCO but no other action at this point, stated Ms. Larrañaga-Ruffy.

Michael Schlachter, Wilshire, said PIMCO has senior staff leave throughout the year. He said PIMCO is a very competitive, hard-driving work place with Bill Gross setting the pace. PIMCO has a dependence on Mr. Gross as the face of organization and Mr. Schlachter said the appointment of six deputies is a good thing for the firm that perhaps reduces some of the risk in terms of Mr. Gross's longevity.

Ms. French questioned the low rating Wilshire gave PIMCO on portfolio construction and Mr. Schlachter responded it had to do with the size of PIMCO and their leaning towards a macro-economic manager.

Responding to Mr. Logan, Mr. Schlachter said he did not expect Mr. El-Erian's departure to affect the portfolio returns. The fixed income portfolio is under the internal management of Bill Gross.

C. <u>Action</u>: Large Cap US Equity

1. **Recommendation to allow the CS McKee contract to expire (6/30/14). Proceeds will be placed in the SSgA Russell 1000 index fund**
2. **Terminate Northern Trust Russell 1000 Growth, transferring proceeds to the SSgA Russell 1000 Index fund**

Ms. Larrañaga-Ruffy directed the Committee to the recommendations by staff and Wilshire regarding the two managers. She noted that CS McKee has been formally on watch since November 2013 and reviewed closely by staff since a large personnel turnover in the past year. PERA can terminate any contract with 30-day notice and staff recommends immediate termination.

Staff also recommends removing the large cap growth exposure by terminating the Northern Trust R1000 growth index. This allocation was originally funded to offset the value style that CS McKee was hired to provide.

Mr. Schlachter referred to a graph which illustrates that CS McKee is virtually a core manager – beyond the performance issue and personnel turnover – Wilshire's concern is they are a large cap value manager.

Ms. Larrañaga-Ruffy said PERA would discuss transition with its bench of transition managers and report findings back to the Committee. Mr. Schlachter said moving from an active portfolio to an index should be a fairly seamless transition. He identified the CS McKee account as the biggest contributor to the portfolio's growth bias and that it was an uncompensated risk.

Mr. Lewis moved to approve staff recommendations. Ms. French seconded. The motion passed by unanimous [4-0] voice vote.

D. <u>Action Item</u>: 2014 AIA Commitment Budget

[*Exhibit 1: Cliffwater report; Exhibit 2: Private Asset Commitment Activity*]

Jamie Feidler identified the 2014 commitment budgets for the private assets. These vehicles manage cash flow differently than traditional managers. Money pledged to a partnership is typically drawn down over a period of three to five years to invest. When investments are realized the cash is distributed back to the fund investors. This cash flow dynamic requires additional planning to reach the target.

Mr. Feidler reviewed the commitment recommendations as follows: Private equity partnerships, $290 million for 2104 vintage year; Real Asset partnerships, $200 million for 2014 vintage year and; Real Estate partnerships, $80 million for 2014 vintage year. The first draw down a fund makes to invest is called the vintage year.

Mr. Feidler reviewed the private asset commitment activities of 2013, vintage year 2013 or those approved in 2013. He noted that the recommendation is really for $169 million of new commitments to private assets and the remainder has already been approved. Cliffwater intends on introducing between four and six new partnerships and individual commitment sizes would range between $30 million and $50 million each.

Mr. Feidler reviewed the current allocation targets in the alternative asset portfolio.

Ms. French moved to approve the 2014 AIA commitment budget as presented. Her motion was seconded by Mr. Lewis and passed by unanimous [4-0] voice vote.

E. <u>Informational Item</u>: Q2 FY14 Performance Review
[*Exhibit 3: Wilshire Q2 FY14 report; Exhibit 4: Wilshire Numbers in Context report*]

Mr. Schlachter discussed the economic overview stating that the Federal Reserve was purchasing $85 billion of securities monthly to keep rates low and support the economy. That stimulus began its taper down a few months ago and last week the reduction was set at $65 billion a month. He discussed the difference between long-term investors and short-term investors and how the short-term investor may depend on zero interest rates to finance leveraged investment decisions. While long-term investors that think in 5-, 10-, 20-, 50-, or 100-year increments a strong economy with reasonable interest rates is a great thing.

Mr. Schlachter noted that March 9, 2009 was the market bottom and in the past five years the markets have been up 150 percent, almost 200 percent off the soft market bottoms. He noted that the bond market is pricing consistently strong results. He characterized the bond market investor as the most pessimistic just wanting their investment back with interest. Regarding stocks, Mr. Schlachter did not expect to the see the 33 percent annual returns continue.

REIT yield is very low right now and real estate in general is very expensive. While real estate depicts a strong economic recovery, Mr. Schlachter said that drives the price higher.

Mr. Schlachter reviewed the unemployment status, consumption and economic growth and offered a comparison of the Great Depression and the 2008 fiscal crisis. He pointed out that today consumption exceeds income growth – people are spending more than they make.

In any strong market, stated Mr. Schlachter, there is still going to be a bad period and he reviewed periodic declines in the past five years.

Focusing on the15 percent vacancy rate in commercial office space, Mr. Schlachter noted there has been a period of four years of expansion/absorption which is a long-term indicator of a positive trend.

F. <u>Informational Item</u>: Q2 FY14 Performance Review
[*Exhibit 5: Mercer, Q4 2013 Defined Contribution Performance Evaluation*]

Devon Muir, Mercer, using a schematic showed the 20+ options in the plan that is arranged through various tiers. Tier 1 is the lifecycle funds which are built with a target date retirement and become progressively more conservative as the retirement date nears. Tier 2 is the passive core array of low-cost index options. Tier 3 is the active core array of options. Tier 4 is an extended choice which adds additional diversified opportunities.

Mr. Muir said the year was good for the program and assets were increased to $470 million which was a $23 million increase over the quarters. He attributed the increase to market appreciation in gains and contributions of $6.5 million.

In terms of popularity, the stable value fund has 29.1 percent of the participants, New Mexico LifeCycles, 18 percent.

Mr. Muir noted that in mid-February the Vanguard Total International Stock Index will be transitioned to a lower cost share class, the Institutional share class.

Referring to the lifecycle funds, Mr. Muir said the funds are not performing as well as others. The Board's direction in 2008-2009 was to build the funds conservatively and that posture has not helped the portfolio over the past five years. Staff and Mercer will be meeting to discuss the plans in general.

Mr. Muir provided a performance breakdown of the different tiers and independent performance within each tier. He isolated the Calvert Equity portfolio fund and noted concern about the cohesion of the management team.

There is not a watch list in PERA's Deferred Comp policy. Mr. Muir said the Committee wants to discuss whether a watch list would be in the agency's best interest. He added that Mercer does closely monitor the managers.

G. <u>Informational Item</u>: Asset Allocation/Liability Discussion
[*Exhibit 6: Wilshire – Asset Allocation Analysis and Recommendation*]

Mr. Schlachter said asset allocation and the determination of the strategic

allocation are the single largest drivers in the difference in return among various pension systems. Studies have shown up to 95 percent in return differences comes down to allocations. The discussion of what is the appropriate asset allocation is very important and with the new PERA CIO now is a good time to hold that discussion.

Stephen Marshall, Wilshire, asset allocation group leader, said it cannot be overemphasized that asset allocation is the most important portfolio decision to be made. Wilshire recommends asset allocation review every three to five years and certainly at the beginning of consultant relationships. Wilshire will present alternatives to better improve the risk return tradeoff in the portfolio. He described how they created the optimal portfolio with the input of PERA's actuary team (Cavanaugh Macdonald) and the asset class assumptions.

Mr. Schlachter noted that the risk number is a projection, not an exact science. The goal is create a portfolio with a better distribution of outcomes. He noted that the assumptions were robust and very close to those of Cliffwater.

Along with the asset and liability sides there are also the constraints, stated Mr. Marshall. The portfolio needs to realistic with logical constraints. He reviewed the current actual and current targets noting the difference between the two. Even though the portfolio is 54 percent in equities, that equity allocation makes up 82 percent of the portfolio's volatility. He hoped to address that in the optimization portfolio alternatives [*See page 10, Exhibit 6*] and demonstrate a more efficient portfolio.

Mr. Schlachter said that the alternative asset classes are recommended to be constrained to 23 percent does not significantly increase illiquidity. He noted that PERA has a portable alpha program in its US equity program and a dedicated hedge fund portfolio in the absolute return strategy.

Mr. Marshall said the difference in the actuary's price inflation assumption and that of Wilshire's is related to the duration that the two review.

Referring to the alternatives, Mr. Marshall said Alternative 1 can reduce the portfolio's volatility by 90 basis points with no reduction in returns. Alternative 2 can increase respected returns by 20 basis points without increasing volatility. Alternatives 3 and 4 add more basis points but the increase in volatility is higher at a 1:1 ratio. Each increment of expected return will cost more in volatility.

Mr. Marshall said Wilshire is recommending either Alternative 1 or 2 with 1 having the same level of expected return with less risk and 2 has the same level of risk with more return. To maximize return and close the funded gap, Alternative 2 is the best selection. If the desire is to reduce risk and maintain the returns, Alternative 1 is the correct alternative.

Mr. Grabel noted that Alternative 1, the risk reducing alternative, shows increasing fixed income from 25 percent to 37 percent and he asked the consultants to

discuss that in the context that interest rates may be rising.

Mr. Schlachter said he actually favored Alternative 2, however, increasing interest rates will be a slow process. Alternative 1 increases core real estate by 6 percent and that would be the rate sensitive portion of the portfolio. Both 1 and 2 increase fixed income plus sector investment – high yield, emerging markets, bank loans, distressed debt – which will survive fairly well in a rising rate environment.

Mr. Logan asked about the reduction in US equities and Mr. Schlachter said international equities are increased and mitigate a home-country bias. Currently the portfolio has an overweight in US stocks at the expense of non-US stocks. The alternatives provide a more equal global allocation. The other reason is to shift risk in a more diversified manner to private equity, real estate and real assets.

Mr. Marshall said following the optimization review the liabilities and assets are projected out over a 10-year period with all the correlations and volatilities to get a distribution of how the different alternatives will perform.

Mr. Schlachter reviewed to a funded ratio chart that illustrates the possible width of the distribution amongst the different alternatives.

Mr. Lewis asked that the study be forwarded to the actuary before a recommendation is forwarded to the Board. He thanked the consultants for their presentation.

Chair Mayfield recommended additional discussion of this item until the next IC meeting thereby allowing adequate review time for staff and the Board.

Ms. Naranjo-Lopez agreed that staff's recommendation was valuable and said she wanted less hedge fund exposure.

5. OTHER BUSINESS

None was brought forward.

6. ADJOURNMENT

Having completed the agenda, and upon motion by Mr. Lewis and second by Ms. French, Chair Mayfield declared this meeting was adjourned at 11:52 a.m.

Approved by:

Dan Mayfield, Chair
Investments Committee

ATTEST:

Wayne Propst, Executive Director

Attached Exhibits:

Exhibit 1: Cliffwater report
Exhibit 2: Private Asset Commitment Activity
Exhibit 3: Wilshire Q2 FY14 report
Exhibit 4: Wilshire Numbers in Context report
Exhibit 5: Mercer, Q4 2013 Defined Contribution Performance Evaluation
Exhibit 6: Wilshire – Asset Allocation Analysis and Recommendation