

NEW MEXICO

PUBLIC EMPLOYEES RETIREMENT BOARD

INVESTMENTS COMMITTEE MEETING

January 26, 2017

This meeting of the Public Employees Retirement Board Investments Committee was called to order by Chair John Melia 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 of Allegiance was followed by roll call by Executive Director Wayne Propst and indicated a quorum was established with the following members present:

Members Present:

John Melia, Chair
Dan Esquibel
Jackie Kohlasch
James Maxon
Loretta Naranjo Lopez

Member(s) Absent:

John Reynolds, Vice Chair

Other Board Members Present:

Claudia Armijo
Patricia French
Dan Mayfield
Cathy Townes

Staff Members Present:

Wayne Propst, Executive Director
Susan Pittard, Chief of Staff/General Counsel
Jon Grabel, Chief Investment Officer
Greg Trujillo, Deputy Director
Jude Perez, Deputy CIO
Renada Peery-Galon, ASD Director
Joaquin Lujan, Director of Rates and Credit
Trish Winter, Executive Assistant
Misty Braswell, Assistant General Counsel
Dana David, Assistant General Counsel
LeAnne Larrañaga-Ruffy, Director of Equity
Lalleh Dayeny, Investments Division
Karyn Lujan, Deferred Compensation Plan Manager
Kristin Varela, Portfolio Manager

Emily Lopez, Financial Specialist
Christine Ortega, Portfolio Manager

Others Present:

Jamie Feidler, Cliffwater
Paul Lium, Nationwide
Thomas Toth, Wilshire
Jeffrey Chavez, Sarofim Realty Advisors
John W. Carl, Sarofim Realty Advisors
W. Scott Robinson, Sarofim Realty Advisors
Stuart Fiertz, Cheyne Capital
Ravi Stickney, Cheyne Capital
Eva Sierkierski, Cheyne Capital
Al Galpern, Sarofim Realty Partners
David Welp, Eaton Partners
Don Wencewiz, AFSCME Retirees

Chair Melia deferred to PERA Board Chair Mayfield who recognized former PERA Chair French for her contribution to the PERA membership and awarded her a plaque and flowers.

2. APPROVAL OF AGENDA

Mr. Esquibel moved to approve the agenda as presented. His motion was seconded by Ms. Kohlasch and passed by voice vote.

3. APPROVAL OF CONSENT AGENDA

Chair Melia said he reviewed the minutes and they appear accurate.

Mr. Esquibel moved to approve the consent agenda. Ms. Kohlasch seconded and the motion passed without opposition.

4. CURRENT BUSINESS

A. Chief Investment Officer's Report

1. Investment Performance – December 2016

PERA CIO Jon Grabel said as of the end of calendar year 2016 the fund balance was \$14.3 billion. December was a strong month with the fund up 1.36 percent net of fees and expenses. The net fund increase following payment of benefits and expenses was \$140 million. As it relates to calendar year 2016, notwithstanding the significant capital markets volatility, the fund was on target and up a net of 7.26 percent. As it relates to fiscal year to date, the fund is up net 3.69 percent tracking slightly ahead of the actuarial target. As it relates to performance versus the benchmark, there will be considerable tracking error. Currently, the fund is overweight equities and core fixed

income. The difference between the benchmark return and the actual return is more a function of the overweights and the relative underweights of real assets and credits as opposed to any skill or alpha associated with the implementation of the portfolio.

Mr. Grabel reviewed the monthly asset category returns and noted that MLPs were the best performing strategy in 2016 and the worst performing strategy in 2015.

2. Cash Plan Update

Mr. Grabel said the change in the fund balance for the month was \$140 million. He reviewed the sources of capital for the month which included \$378 million from the equity implementation plan, \$60 million from illiquid asset distributions, and \$48 million employer/employee contributions. Uses of cash include \$95 million to pay benefits and refunds – as a mature pension plan PERA is cash flow negative – \$3 million for operational expenses, \$78 million for illiquid asset capital calls, and \$175 million for the credit implementation plan.

Referring to the rebalancing report, Mr. Grabel said the trading amounts reported are consistent with the actions approved by the Board with the implementation plan of each asset category.

3. Other Updates

Referring to a “quilt” chart, Mr. Grabel said the chart shows investment strategies and the relative performance over a five-year period. The chart delineates that there are no clear trend between any two given years and supports rebalancing and avoiding market timing. Diversification is the best risk portfolio management strategy.

He provided the following updates:

- RFP: REITs is underway with the evaluation committee planning to make a recommendation at the February Board meeting. There is a pending low-volatility equity RFP and its MQs and timelines will be discussed later today
- The risk report, which lags a month, shows that the new strategic asset allocation has had a tremendous impact on the monthly plan value with risk being down and the contribution to risk from global equity
- The security lending report indicates PERA is earning a monthly gross of \$760,000. The earnings pay for PERA’s custody bank fees which are approximately \$1 million annually
- Watchlist: TimesSquare Smid cap growth is on watch for underperformance, although over 11 years they have returned net 11.31 percent. Linsalata private equity was added last month for qualitative measures and reports quarterly
- The new liquid consultants’ contracts are in process
- A new compliance officer position has been posted with the State Personnel Office

Mr. Grabel noted that throughout the transition process Cliffwater continues to serve as a fiduciary and recommendations that will come before the committee have been in process for an extended period of time. He praised Jamie Fielder for his

professionalism throughout the transition.

B. Action Items: 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 \$150 Million to Sarofim Realty Advisors, for an illiquid real estate fund of one**
[Exhibit 1: Staff recommendation re: Sarofim; Exhibit 2: Cliffwater Report; Exhibit 3: Sarofim Report]

Kristin Varela, Portfolio Manager of Real Assets, said the recommendation is to commit up to \$150 million to Sarofim Realty Advisors, a separate account manager who would be utilized in PERA's illiquid real estate space to acquire and manage core and core plus properties exclusively for PERA. She reviewed the portfolio and demonstrated how this strategy fits. If approved this will be the first core real estate fund in the portfolio and increase the illiquid real estate portfolio to 12.6 percent from its current 10 percent. Ms. Varela highlighted the characteristics of a core portfolio. She noted that the primary investment objective with Sarofim is to target need-based grocery anchored retail located in secondary cities that display strong macroeconomic drivers. The expectation is five to ten separate properties within the portfolio.

C.A. Galpern, President and CEO, Sarofim, said the company has been a long-standing separate account manager and has invested \$3 billion in equity with total returns IRRs of 17.5 percent. The team is focused on risk mitigation, with the clients' best interest first and Sarofim co-invests 10 percent of the equity. He commented on their consistency in earning 17 percent gross IRR and the length of relationships with their clients.

Jeff Chavez, Sarofim, identified their activities in the retail space with the placement of \$490 million of equity. There were 16 projects in 10 different markets with a 16.8 percent IRR.

John Carl, Sarofim, reviewed the firm's strategy to build a portfolio with a sustainable core of retail properties with a geographic diversification across the US. The target will be daily need centers or grocery-anchored centers.

Mr. Galpern said the asset is held from five to seven years and has a functional life of 20 to 40 years. Mr. Chavez said annually they conduct a wholesale analysis on their properties and there are some assets that they have held for 20 years.

Mr. Carl reviewed a property in Nashville that they have owned with an average occupancy of 97 to 100 percent over a 10-year period. Sarofim buys very safe cash flow – these are the lowest risks assets in the retail spectrum.

Scott Robinson, Sarofim, reviewed the multi-family investment and noted they have been very active in this arena over the past six years with 16 different projects of

which 15 have been sold. Along with the millennials there are aging baby boomers looking to downsize and get equity out of their homes. The suburban multi-family structures offer larger living spaces with a more affordable price. They will be targeting the destination public school districts to buy properties.

Mr. Feidler said Sarofim has a very long real estate history and manages separate accounts. They have been more specialized in the separate account management space. The team and firm is very stable and manages assets on behalf of 10 separate accounts.

With no further questions, Mr. Esquibel moved to recommend a commitment of up to \$150 million to Sarofim Realty Advisors to manage a dedicated fund to invest in core plus real estate, to be funded according to PERA's Cash Plan, subject to approval of legal documentation by General Counsel. Mr. Maxon seconded and the motion passed by unanimous [5-0] voice vote.

2. Recommendation to Commit up to \$90 Million to Cheyne Real Estate Credit Holdings Fund V, LP
[Exhibit 4: Staff Recommendation re: Cheyne; Exhibit 2: Cliffwater report; Exhibit 5: Cheyne Report]

Joaquin Lujan, Director of Rates and Credit, said the recommendation is commit up to \$90 million to Cheyne Real Estate Credit Holdings Fund V, an opportunistic real estate credit fund. Cheyne will invest in self-originated commercial and residential real estate primarily in the UK and Germany. This strategy will target a 15 percent net IRR with a 4 percent cash yield. The fund will feature a three-year investment period and a six-year final term with a one-year optional extension. If this recommendation is approved, it will be a new relationship for PERA.

Stuart Fiertz, Cheyne, said they are a London-based alternative manager with a staff of 140, founded in 2000 by him and his partner who are both still actively involved. Their investor base is primarily pension fund oriented with a history of investors from Europe and the Middle East and increasingly in the US.

Mr. Fiertz referred to a change in the composition of the types of lenders in the UK market. With the shift from bank lending to alternative lenders, Cheyne sees opportunity. The UK market remains heavily dislocated with a favorable imbalance with a supply of credit and demand. Currently, there are \$750 billion in real estate loans that need to be refinanced over the next few years in the UK and Germany providing a wide opportunity set for Cheyne.

Ravi Stickney, Cheyne, provided his professional background noting he joined Cheyne in 2008 with a mandate to opportunistically analyze and buy in predominantly commercial mortgage-backed securities secured in the UK and Germany. The overall thesis is to be opportunistic as the times change. Over the past eight years, Cheyne has

deployed over 1.4 billion of capital across private credit and 921 million in MBS. To date, the realized IRR is 13 percent. The firm invests in different instrument types to include senior debt, mezzanine debt, structured credit, preferred equity/shareholder debt, and special situations. He said Cheyne is the market leader in structured credit and MBS in Europe. He discussed their key investment principles which include capital preservation, credit protection, and self-origination of its private credit positions.

Mr. Stickney said they look for non-cyclical asset types that include affordable homes, student housing, health care for the aging population in the UK and the necessary accommodations and office buildings.

Regarding Brexit, Mr. Stickney said the uncertainty has lifted and the UK will be leaving the European trading block. There is volatility and repricing in the UK real estate market.

Mr. Fiertz said Cheyne has always taken into account environmental, social and government factors in the underwriting process and have recently signed on to the UN-PRI (United Nations Principles for Responsible Investment).

Mr. Feidler discussed the fees and offsets as very common closed-end comingled fund being raised for private investments. The fund itself has a stated term which is the full life of the fund as well as a stated investment period. The investment period or call period is three years which is shorter than most other funds. The typical private equity structure is a five-year investment period with a ten-year term; however, Cheyne has a three-year investment period with a six-year term.

Mr. Lujan highlighted the self-originated nature of Cheyne's strategy which originates loans on collateral that they know, value and monitor.

Mr. Feidler said the firm is not wedded to one strategy and can take advantage of the marketplace. He noted that this firm understands real estate and real estate investing as well as debt or credit investing. Cliffwater likes the strategy, the approach and the skill set they bring.

Mr. Maxon moved to recommend a commitment of up to \$90 million to Cheyne Real Estate Credit Holdings Fund V, Opportunistic, a private partnership focused on real estate related credit investment in the UK and Germany, to be funded according to PERA's Cash Plan, subject to approval of legal documentation by General Counsel. Ms. Kohlasch seconded and the motion passed by unanimous [5-0] voice vote.

C. Action Item: Update to the Global Equity Implementation Plan
[Exhibit 6: Staff memo re: Implementation Plan; Exhibit 7: Wilshire memo]

LeAnne Larrañaga-Ruffy, Director of Equity, said global low-volatility equity was added to the global equity portfolio at 4.4 percent or approximately \$700 million.

The purpose of low-volatility is to reduce sensitivity to market volatility. BlackRock was approved as the transition manager to implement the global low-volatility mandate passively to gain exposure prior to the RFP process. Staff and Wilshire are recommending 70 percent passive and 30 percent active – approximately \$210 million to active.

Thomas Toth, Wilshire, reminded the Committee that the most important decision that the Board makes is that of asset allocation. He discussed the investment structure which is the manner in which a particular strategy is implemented – how much passive and how much active exposure is desired. The active strategies can add value over and above the market and on the negative side they can also underperform the market. It is also necessary to determine the benchmark and conduct a philosophical analysis.

The recommendation as presented by Mr. Toth was to tilt the active portion of the global low volatility equity implementation towards option overlay strategies and create an investment structure of 70 percent passive and 30 percent active.

Ms. Kohlasch introduced a motion to update the global equity implementation plan as proposed by staff and Wilshire. Mr. Maxon seconded and the motion passed by unanimous voice vote. [Mr. Esquibel was not present for this action.]

D. Information Item: Global Low-Volatility Equity RFP MQs and Timeline

Ms. Larrañaga-Ruffy reviewed the MQs that are consistent with other PERA RFPs and said the release date will be February 1, 2017. The scope of work identifies a long-only global low volatility equity portfolio and/or equity option overlay based strategies. The RFP will be posted on the PERA website. It is anticipated the contract will be awarded and funded by July 1, 2017.

E. Information Item: Currency Exposure Overview

Christine Ortega, Portfolio Manager of Investment Operations, provided an overview of the research she conducted regarding currency exposure. PERA's portfolio has several accounts which are denominated in foreign currencies. These add risk to the portfolio and affect returns. The impact of currency exposure for international investors may be neutral or substantial. The current environment is that of a low return and PERA is focused on mitigating risk.

Ms. Ortega reviewed how PERA works to remove currency risk from returns by accepting the risk as part of investing in non-US assets. PERA does not seek to actively manage currency exposure at this time. PERA's international fixed income managers do hedge foreign currency exposure.

Mr. Toth referred to the optimal hedge ratio as another quantitative framework for deciding how much of the currency exposure should be hedged. Currency risk can be a diversifier.

Ms. Ortega discussed the three currency hedging strategies: passive, active, and hybrid or dynamic. PERA had active managers and discontinued that program. PERA could issue a non-binding RFP to solicit solutions and ideas to address currency risk. She noted that as with all investing, currency hedging has its own risks and costs.

Chair Melia asked what staff was recommending and Mr. Grabel responded that currency is a tough topic because the return is expected to be neutral over time. He said the costs and risks of an active manager do not outweigh the potential benefits. A passive approach to eliminating some of volatility in the portfolio may benefit the plan as a whole. Not knowing all the solutions and costs, he said PERA may benefit from an RFP and the evaluation process would be a comprehensive diligence exercise.

Given that this is a low return environment, Mr. Grabel said protecting the fund from losing money is that much more important.

5. **OTHER BUSINESS**

None was presented

6. **ADJOURNMENT**

Having completed the agenda, Ms. Naranjo Lopez moved to adjourn and Ms. Kohlasch seconded. Chair Melia declared this meeting adjourned at 11:02 a.m.

Approved by:


John Melia, Chair
Investments Committee

ATTEST:


Wayne Probst, Executive Director

Attached Exhibits:

- Exhibit 1: Staff recommendation re: Sarofim*
- Exhibit 2: Cliffwater Report*
- Exhibit 3: Sarofim Report*
- Exhibit 4: Staff Recommendation re: Cheyne*
- Exhibit 5: Cheyne Report*
- Exhibit 6: Staff memo re: Implementation Plan*
- Exhibit 7: Wilshire memo re: Implementation Plan*