NEW MEXICO

PUBLIC EMPLOYEES RETIREMENT BOARD

INVESTMENTS COMMITTEE MEETING

July 27, 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 confirming a quorum with the following members present:

Members Present:
John Melia, Chair
John Reynolds, Vice Chair
Loretta Naranjo Lopez
Jackie Kohlasch

Member(s) Absent:
Dan Esquibel
James Maxon

Other Board Members Present:
Claudia Armijo
Dan Mayfield
Maggie Toulouse Oliver

Staff Members Present:
Wayne Propst, Executive Director
Susan Pittard, Chief of Staff/General Counsel
Greg Trujillo, Deputy Director
Karen Risku, Deputy General Counsel
Jude Pérez, Interim CIO
Renada Peery-Galon, ASD Director
Dana David, Assistant General Counsel
Joaquin Lujan, Director of Rates and Credit
Trish Winter, Executive Assistant
LeAnne Larrañaga-Ruffy, Director of Equity
Karyn Lujan, Deferred Compensation Plan Manager
Kristin Varela, Portfolio Manager of Real Returns
Christine Ortega, Portfolio Manager
Mark Montoya, Investment Division
Anna Murphy, Compliance Officer
Isaac Olaoye, Financial Analyst
Emily Lopez, Financial Specialist

Others Present:
D.L. Heshley, FOP
Paul Lium, Nationwide

Mark White, Albourne
Heather Christopher, Albourne
Tom Toth, Wilshire

2. APPROVAL OF AGENDA

Ms. Kohlasch moved to approve the agenda as presented. Mr. Reynolds seconded and the motion passed by unanimous [4-0] voice vote.

3. APPROVAL OF CONSENT AGENDA
June 29, 2017 Investments Committee minutes

Chair Melia said he reviewed the minutes of the June meeting and found them to be complete and correct.

Ms. Kohlasch 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 – June 2017

PERA Interim CIO Jude Pérez said the fund finished June and the fiscal year with a balance of $15 billion. For the month, the fund was up 33 basis points, net of fees, and the fund balance down $1 million. He noted that the assets eroded due to increased benefit payments, including the 2017 cost-of-living adjustment increase to payroll. For the fiscal year-to-date the fund is up 11.13 percent, net of fees, ahead of the actuarial target pacing.

Over the last fiscal year, the fund increased its return by 10.64 percent and a new strategic asset allocation was implemented.

Mr. Pérez said tracking errors will continue because the strategic asset allocation targets have not yet been achieved.

2. Cash Plan Update

Mr. Pérez said the cash balance at BNYMellon was up approximately $145 million and the month finished with approximately $677 million in cash. He reminded the Committee that the cash is equitized through the overlay program and not causing a cash drag. He reviewed the sources and uses of cash during June. Approximately $97 million was used to pay benefits and refunds, $3 million for operational expenses and $29 million for illiquid asset capital calls.

The fund continues to be underweight in real assets and as the strategic asset allocation plan is implemented that will correct.

3. Other Updates

Mr. Pérez provided the following updates:

- RFPs:
    - Low-volatility: a recommendation is on today's agenda
    - Currency Hedging: still on hold
    - Emerging Market Equity: will be reviewed by the evaluation committee after the meeting
    - Real Assets Portfolio Completion Strategy: will be reviewed by the evaluation committee after the meeting

Mr. Pérez congratulated Anna Murphy for passing Level II of the CFA (Certified Financial Analyst). He compared the achievement of passing all three levels of the CFA to that of a Ph.D. in finance and she received a round of applause.

B. Action Items: Global Low Volatility Equity Active recommendation

LeAnne Larrañaga-Ruff, Director of Equity, thanked the evaluation committee for their work on the RFP. She reviewed the recommendation from the evaluation committee to hire Neuberger Berman for the active portion of the mandate and increase the allocation to up to 50 percent of the total global low volatility mandate. Staff and the consultant also recommend that the runner-up, USB Asset Management, be placed on the bench of approved investment managers and utilize BlackRock for purposes of transitioning assets. The allocation for global low volatility equity is targeted at 4.4 percent. The intent of this portfolio is to reduce the absolute risk in the global equity portfolio and provide protection on the downside.

Ms. Larrañaga-Ruffy reviewed the RFP process which began with the issuance date of January 27, 2017. In terms of the recommendation, Neuberger Berman is a private, independent, employee-owned firm that has been managing assets since 1939. This product has been managed by the firm since 2011. Although staff will continue to negotiate fees until the contract is signed, Ms. Larrañaga-Ruffy said the fees are very attractive.

Tom Toth, Wilshire, said the strategy provides an option overlay that gives exposure to two risk premiums: equity risk premium and volatility risk premium. These overlay strategies have exhibited about 30 percent less risk than the broader equity market.

Both Neuberger Berman and UBS are well-regarded firms with substantial assets under management. Mr. Toth said the strategic purpose of this recommendation is not necessarily to enhance return in all market environments but instead to tailor the portfolio to a lower risk profile. Both Neuberger and UBS have exhibited significantly less risk. He reviewed the allocation recommendation and pros and cons for the two managers. The pros are very similar regarding risk adjusted returns. Neuberger received a very high rating from Wilshire.

Chair Melia asked evaluation committee member Kohlasch how she found the new evaluation checklist and process as a whole. Ms. Kohlasch said the only change was the checklist, which she found useful. She was still able to ask questions and while she didn't have a vote at the evaluation committee level, she does at the Board level.

In regards to the PERA global low volatility equity, Mr. Reynolds moved to:

1) Utilize the investment management services of Neuberger Berman for the active portion of the mandate equal to up to 2.2 percent of the total fund;
2) Approve an allocation of up to 50 percent for the active portion of the global low volatility mandates;
3) Approve UBS Asset Management as a secondary strategy to remain on PERA's bench of approved investment managers for possible utilization of services in the future and as approved by the Board; and,
4) Utilize BlackRock for purposes of transition of assets within the global equity portfolio.

Ms. Kohlasch seconded and the motion passed by unanimous voice vote.

C. <u>Information Item</u>: Real Assets Portfolio Review

Kristin Varela, Senior Portfolio Manager, Real Assets, introduced the Albourne representatives. Mark White, Albourne, pointed out that PERA is relatively early in the implementation of the real asset program into the PERA portfolio. Real assets came into favor after the global financial crisis of 2008 as CIOs and investment professionals tried to find better ways to protect pension plans through diversification. Real assets has been around forever; what is new is the institutional implementation of the asset class. Real assets offers portfolio diversification, return enhancement, structural improvements and cost reductions of return profiles, inflation participation and forward data profiles. Real assets supports economic growth. He reviewed the cash flow characteristics of the portfolio since the inception of real asset portfolio. As of March 31, 2017, the portfolio has $779 million in net asset value (NAV), exclusive of the real estate component, which is 5.7 percent of the total plan; there is $1.470 million committed capital to 31 different real asset vehicles; contributed capital is $981 million; and the portfolio has generated an IRR of 5.2 percent. He discussed the J-curve of the asset class noting it takes time before funds start to produce cash.

Mr. White said the portfolio appears to have three distinct periods: early vintage years 2007-2009; slower build-out years between 2009-2013; and current build-out years 2013 to present. The early vintage is 12.5 percent of the current NAV which will influence the return profile. The slower build-out of 22.5 percent will also create a risk that is being addressed and the 2013 to present investments is only 52 percent drawn. He reviewed the dips that have occurred in the portfolio since 2009 and highlighted the high energy weighting in the portfolio.

In general, stated Mr. White, most of PERA's managers are in the not material/early phase. Overall, the vast majority of the managers have been outperforming relative to the comparative vintage years. He noted that the allocations in 2014/15 will have the greatest influence over the next two years. He reviewed the manager exposures.

Mr. Reynolds asked whether the illiquid funds that are not accessible force PERA to liquidate liquid funds. Mr. Pérez said staff and the consultant are very cognizant of the fund's liquidity and monitor it closely. He said 75 percent of the fund could be liquidated within a two-week period. Mr. Reynolds said the benefits gained from illiquid assets should also be closely monitored.

Mr. White said the Plan understands its liquidity requirements. One of the benefits from real asset portfolios is investments with associated cash flow.

Mr. White reviewed the cash flow characteristics of the real assets portfolio and highlighted the cash from illiquid investments. Typically, the cash distribution is 25 percent to 35 percent of the portfolio coming back each calendar year. PERA's real assets program is considered young and it will be another four to five years before the favorable cash flow characteristic is realized.

Mr. White said most assets are returning distributions, dividends or cash payments. The portfolio could be better balanced for risk – drawdown sensitive, systematic equity risk, energy exposure and cyclicality. The goals are to reduce commodity risk and focus on value added agriculture.

Ms. Naranjo Lopez asked whether there was a strategy for consideration of social and environmental impacts regarding agricultural investments. Ms. Varela said PERA does not have a specific ESG (Environmental, Social and Governance) mandate. However, within real estate, it is possible to take into account ESG assets and staff and the consultant conduct a thorough ESG review. She said many of the managers in agricultural are interested in regenerative farming.

Mr. White said ESG is very important to Albourne. With the influx of institutional capital to an agricultural investment there is typically an upgrade to the associated chemical storage and better control of water courses. From an investment perspective, higher ESG standards are always beneficial to the investment.

Heather Christopher, Albourne, reviewed PERA's real estate portfolio. The portfolio has a net IRR of 12 percent. She noted that PERA staff has been working towards rebalancing the portfolio. Beginning in 2012, the portfolio's IRR has been fairly consistent at 12 percent and has been in line with its custom benchmark. She reviewed the performance by exposure: opportunistic, value added, and other being liquid real estate. The portfolio is currently in line with its target for opportunistic based on market value. Staff is working to add lower risk styles, such as core and value added to the portfolio to balance to the targets.

Ms. Varela noted that PERA has been utilizing its liquid real estate exposures to manage its target profiles. Deploying large amounts of capital to the liquid space is difficult. The REIT portfolio has been restructured to serve as a proxy/funding mechanism while staff works to meet goals.

Ms. Christopher reviewed the exposures by vintage year, region and property type. There is a large allocation in the US which reduces currency risk and there is a large allocation to "other" which reflects PERA's large allocation to liquid real estate which has investments that are untraditional. The four traditional real estate types – office, industrial, multi-family, and retail – are well represented. Peer wise, PERA's current exposure to "office" is on the lower end while "other" is on the high end.

Regarding asset style, Ms. Christopher said PERA's portfolio is the inverse of most of the peer set which has a higher exposure to core. Ms. Varela said PERA has been introducing more core into the portfolio since 2017.

Ms. Christopher said the portfolio is growing its allocation to real estate and the actual allocation to liquid real estate grew in 2017 because it was used as a placeholder. The prior allocation to BlackRock, LaSalle and Morgan Stanley will come off the books and go to DFA and Security Capital which will change the overall vintage year allocations. There have been eight years of continuous growth and fundamentals have been very good but that cannot continue. When rents decline the first asset class that will register with will be hospitality; therefore, hospitality has to be closely monitored as a recession approaches.

Ms. Christopher noted that 2014 through 2017 vintage years will have a disproportionate impact on the portfolio due to their larger commitment sizes.

5. OTHER BUSINESS

None was offered.

6. ADJOURNMENT

Having completed the agenda, Chair Melia declared this meeting adjourned at 10:45 a.m.

Approved by:

John Melia, Chair
Investments Committee

ATTEST:

Wayne Propst, Executive Director