NEW MEXICO

PUBLIC EMPLOYEES RETIREMENT ASSOCIATION

INVESTMENT COMMITTEE

May 31, 2018

This meeting of the Public Employees Retirement Investment Committee was called to order by John Melia, Chair, at approximately 9:00 a.m. on the above-cited date at the PERA Building, Senator Fabian Chavez, Jr. Board Room, 33 Plaza la Prensa, Santa Fe, New Mexico.

1. Roll Call

Roll call occurred following the Pledge of Allegiance and indicated the presence of a quorum as follows:

Members Present:
John Melia, Chair
James Maxon
Jackie Kohlasch
Dan Mayfield, Vice Chair [9:25 arrival]

Member(s) Excused:
Dan Esquibel

Other Board Members Present:
Loretta Naranjo Lopez
Claudia Armijo
Natalie Cordova
Tim Eichenberg
Patricia French

Staff Members Present:
Susan Pittard, Chief of Staff/General Counsel
Greg Trujillo, Deputy Director
Karen Risku, Deputy General Counsel
Dominic Garcia, Chief Investments Officer
Dana David, Assistant General Counsel
Kristin Varela, Deputy CIO
Joaquin Lujan, Portfolio Manager
Trish Winter, Executive Assistant
LeAnne Larrañaga-Ruffy, Director of Equity
Karyn Lujan, Deferred Compensation Plan Manager
Christine Ortega, Portfolio Manager
Anna Williams, Chief Financial Officer
Anna Murphy, Portfolio Manager
Emily Lopez, Financial Specialist
Mark Montoya, Investments Department

Others Present:
Tom Toth, Wilshire Associates
Mike Krems, TorreyCove
John Garrett, Cavanaugh Macdonald
Jonathan Craven, Cavanaugh Macdonald
Don Wencewicz, AFSCME Retiree
Thomas Rey, CLA
Jack Broder, AFSCME
Louis C. Trujillo, AFD RA
Edward Abeyta, AFD RA

2. Approval of Agenda

Mr. Maxon moved to approve the agenda. Dr. Kohlasch seconded and the motion passed by unanimous [3-0] voice vote. [Mr. Mayfield was not present for this action.]

3. Approval of Consent Agenda

Chair Melia said he reviewed the minutes and found them accurate and complete.

Mr. Maxon moved to approve the consent agenda and Dr. Kohlasch seconded. The motion passed by unanimous [3-0] voice vote. [Mr. Mayfield was not present for this action.]

4. Current Business

A. Chief Investment Officer's Report

Prior to starting his report, CIO Dominic Garcia informed the Board that as requested, he had books written by Michael Mauboussin for them.

In an effort to be responsive to the Board's concerns, Mr. Garcia re-presented a slide entitled "a more robust operating model" that outlined PERA's mission, plus pension best practices, to equal value creation. Building a fully sustainable retirement system requires a holistic approach. It requires more than a strong asset portfolio. The entire system/organization must be strong. The goals before PERA are to build a strategic asset allocation to meet the discount rate; work towards 2043 funding period of UAAL; and meet ten-year annualized returns/produce alpha to equal or exceed the policy benchmark. These three goals guide staff, stated Mr. Garcia.

Mr. Garcia addressed the question of "how pensions across the country got to where they are today." Looking back at 20 years of stock returns, bond returns and a combination of both, it becomes evident that from the 1980s through the 90s, stocks and bonds did really well -- in fact, stated Mr. Garcia, a portfolio of just bonds met the numbers necessary to exceed the benchmark. During that period, many pension plans found themselves with a surplus and increased benefits. PERA also increased benefits across plans by increasing the pension factor and grandfathered-in the cost. 1998 marked the last time PERA increased benefits by increasing the pension factor to 3 percent. Following that increase, came the 2002 dot-com bubble and in 2008 the housing bubble and credit crisis. Since the increase in benefits in 1998, PERA has returned 6.3 percent. In answer to how pensions got to where they are today, it was a series of events:

- Increased benefits while there was a surplus
- Two big losses
- Failure to meet hurdle and increased costs

The forecast for returns for the next few years is modest to low. He reviewed a 10-year forecast produced by Wilshire that illustrated no traditional mix of stocks and bonds will return 7 percent. Mr. Garcia said there is evidence that the U.S. is entering a "late cycle economy" which is characterized by tighter liquidity, slowing growth and asset prices falling. PERA has a challenge to improve its returns with an understanding of how PERA is in its current situation.

Mr. Garcia said to have a good probability to meet actuarial rate of return PERA needs to prudently and efficiently grow its market beta. Staff along with Wilshire have developed a series of portfolio enhancements for a strategic allocation and active management while maintaining the current risk profile. Staff has more workshops planned on risk balance that hopefully will result in a Board-approved recommendation to enhance the beta portfolio. Staff will be looking to further diversity of the portfolio and be less reliant on equities.

Referring to his employment history with Wisconsin, the only fully-funded pension system in the U.S., Mr. Garcia said a fully sustainable system requires a strong plan design, a holistic organizational approach and a mission-centric approach. Assets are an important component but not the only factor.

Ms. Cordova asked whether the current investment rate of return assumption is unrealistic. Mr. Garcia said for the next 10-year period there is a clear disconnect and even over 20 years it will be difficult to achieve.

Tom Toth, Wilshire, suggested it would be useful for the Board to understand current discussions by other public pension systems around the country regarding target rates of return and discount rates. He said this is a challenge all large plans are facing. The investment environment is challenging and during this "late cycle economy" it will be particularly acute over the next few years.

Ms. Naranjo Lopez requested a study evidencing that the recommendation presented by staff and the consultant is the right way to address the $5 billion unfunded liability gap. She said staff was presenting information years ahead and "we want to know what you're going to do today not what you're doing in the future."

Chair Melia said if the gap cannot be closed through investing, it appears obvious that the answer is the Board needs to make tough decisions about increasing contributions and/or cutting benefits.

Ms. Naranjo Lopez said she disagreed with the Chair and said, "we're not doing the investment that we should be doing" and a more in-depth analysis is required.

B. Investment Division Updates

Mr. Garcia announced that Kristin Varela has been appointed as PERA's Deputy CIO. He commended Ms. Varela and said she is a hardworking, dedicated professional.

Ms. Varela said it was an honor to work for PERA and that she was thankful for the new opportunity to serve as Deputy CIO. In response to the Board's request, Ms. Varela said additional information regarding manager selection, cash plan, etc. has been included within the Board portal platform.

1. Cash Plan & Rebalance Update

Ms. Varela noted that the monthly performance summaries were provided for both March and April 2018. In April, the fund closed at $15.43 billion. Combining March and April, PERA paid $195 million in benefits; $113 million was transferred from the custody bank to the STO to cover benefits. Ms. Varela reviewed the cash flow data and noted that for the two-month period the fund had $104 million for call for illiquid capital contributes and received $88 million from liquid distributions.

For both months, Ms. Varela said the fund has held at its target strategic asset allocation.

2. Manager Selection Activity Report

Ms. Varela reminded the Committee of the rigorous manager selection process. She noted that the operational due diligence function had been conducted by the consultant and now PERA staff is conducting an overall audit of that process. She provided a summary of the manager(s), liquid and illiquid, in the evaluation pipeline and identified what stage of review they were in.

Within the non-US equity, Staff launched a Request for Information ("RFI") process, due to upcoming contract expirations of the incumbent manager line-up. The process, resulted in the following manager selection activities, as proposed to the CIO by the Alpha Team:

- Terminate the current contract between PERA and current small cap growth manager, RBC, effective 5/1/2018;
- Allow the current contract between PERA and EAFE value manager Kleinwort Benson Investors to expire, due to poor historical alpha, low information ratio and negative stock selection over 3 years;
- Continue the relationship with MFS Asset Management at the current allocation of $175 million; and
- Utilize the investment management services of Acadian Asset Management for the Non-US Large Cap mandate equal to an initial allocation of approximately $270 million, to be funded by the redemptions of KBI and RBC.

Non-US Large Cap's mandate will increase to 2.9 percent from the current 2.3 percent. She discussed how the team identified Acadian as the best manager and indicated where global equity fits within PERA's strategic diversification. She also provided a detailed overview of the RFI process and the summaries of the finalist managers. The changes are fee positive for PERA; fee information was provided and identified as confidential.

Regarding illiquid investments, Ms. Varela reviewed the $50 million commitment to Patria, Private Equity Fund VI. This company operates in Brazil and Latin America. Patria invests in what are referred to as “basic needs:” healthcare, food and beverages, agribusiness and logistics. The fund will target a 25 percent gross IRR. This manager will provide overall favorable contributions to the portfolio as well as complementary exposure in terms of geography.

As a comingled illiquid investment product, Ms. Varela said fee negotiations are limited. Ms. Naranjo Lopez recommended that staff negotiate to lower the fees with all of PERA’s managers.

Ms. Varela was congratulated for her new position.

3. Securities Lending Update – Q1 2018

This information was provided within the Board packet.

C. Performance and Risk Update

Anna Murphy, Portfolio Manager, presented a graph illustrating the late cycle dynamics in the market. While volatility has stabilized, it is at a higher level than the historical low of 2017. The Treasury yields are further evidence of the late stage cycle. She discussed how yield moves and adjusts based on market demands for bonds – yield moves inversely with the bond price. She noted a trend of a rise in the equity market since 2009 and the flattening of the Treasury yield curve. She reviewed a chart of asset class performance through this calendar year. Commodities outperformed all other asset classes in the policy benchmark to date. Asset classes that performed least well are real estate and bond proxies that tend to struggle where interest rates are rising and the rate of growth is slowing. However, PERA experienced significant capital preservation from its private real estate investments – year-to-date over 12 percent net of fees. By maintaining target weights PERA has minimized the effect of drifting and instead gained from all strategies that go into the portfolio and provided excess performance.

She concluded with the following points:

- The fund outperformed its policy benchmark by 112 basis points for calendar year-to-date, 176 basis points for the fiscal year and 168 basis points for the one-year period, net of fees
- The fund has delivered approximately $268 million in value added over the policy benchmark for fiscal year to date
- For the one-year period, the fund has experienced less volatility than the policy index/benchmark and is within the risk budget parameters approved by the Board in March 2018

She noted that 75 percent of the fund’s risk is in global equity.

D. <u>Action Item</u>: Approve Reference Portfolio

Mr. Toth said a reference portfolio is, bottom line, a simple, straightforward portfolio made up of relatively generic assets that provide diversification and can be implemented in a cost-effective manner. The use of the portfolio should be in line with PERA’s long-term time horizons and be relevant as a global investor. He explained how the portfolio was developed and provided the following recommendations and observations:

- Utilize a reference portfolio that targets the same total risk level as the current portfolio: indicative of the risk tolerance of the Board and return seeking, but cognizant of continued risk concentration
- PERA's current portfolio has an expected risk of 10.5 percent inclusive of beta risk, structure/liquidity, and manager active risk
- The reference portfolio will have a target weight of 58 percent for global equity and 42 percent for core fixed income

Mr. Garcia pointed out that the reference portfolio will enhance comparisons and strengthen the benchmarks.

Ms. French asked whether staff was considering increasing risk to facilitate greater returns. Mr. Garcia reminded Ms. French the risk budget as approved by the Board set a total risk of 10.5 percent and staff is working within that range to enhance returns. He stated the risk budget will be reviewed by the Board on an annual basis.

Mr. Maxon moved to approve the reference portfolio. Mr. Mayfield seconded and the motion passed by 3-0 voice vote. [Dr. Kohlasch was not present for this action.]

E. Semi-Annual Consultant Report

1. Private Equity

Mr. Garcia said as part of the governance update, Mike Krems of TorreyCove, PERA's private equity consultant, and LeAnne Larrañaga-Ruffy, Director of Equity will provide an update.

Ms. Larrañaga-Ruffy said the Board and staff have taken ownership of the private equity portfolio which has resulted in higher returns. The managers are being held accountable and show results on a risk adjusted basis. The Board made the decision to be illiquid within global equities and staff is monitoring to ensure that decision is benefitting PERA. The portfolio has been diversified geographically and commitments to smaller funds have been accomplished. Staff is driving terms and searching creative structures to deploy capital. She said staff works with TorreyCove to share ideas and search for the best strategies. Ms. Larrañaga-Ruffy reviewed the advantages of private equity and PERA's strategy in this sector.

Mr. Krems reviewed a chart depicting fundraising activities in the private equity market with the amount of committed capital. The overall trend shows there is a lot of committed capital that is looking for companies. He highlighted the upward trajectory of pricing. When managers find investment opportunities they call the committed capital. Since inception of PERA's private equity portfolio, they have committed just under $2 billion to 48 funds and 32 managers; $956 million has been called and contributed for investments; distributions have totaled $645 million/67 percent of contributions and $791 million of value remains unrealized. In September 2017, PERA had 5.2 percent of its overall fund in private equity. The target is 8.7 percent.

Mr. Krems compared PERA's industry, geographic and leverage exposures to MSCI

ACWI. A chart was displayed that depicted PERA's private equity performance as among the highest performers of similarly sized public pension funds in TorreyCove's database over one-, three-, five- and ten-year periods. PERA's private equity portfolio has generated a net IRR of 12.7 percent and is positioned well with strong existing relationships with top-tier managers.

TorreyCove and staff will continue to work together to review existing relationships in the context of the new risk construct, seek co-investments which is a strategy to manage fees, consider secondaries which is the sale of the portfolio into the secondary market, and/or investing in the secondary market and separate account structures.

Ms. Naranjo Lopez thanked the consultant for the excellent presentation and positive report. She asked about socially responsible investing and environmental/social governance considerations.

Ms. Armijo said she too found the presentation informative as she did with the other presentations provided this morning. She asked whether private equity always carries more debt. Mr. Krems responded that historically private equity uses more leverage in financing companies than a public equivalent.

Ms. French recalled when PERA was not permitted to invest in alternative investments and was pleased with the revenues generated. Ms. Larrañaga-Ruffy said PERA has been investing in private equity since 2006.

F. Preliminary Draft Experience Study Results

Jonathan Craven, Cavanaugh Macdonald, said while actuaries are usually involved on the liability side of pension sides, they need to discount all of the projected benefit payments that are predicted the plan will pay out. To accomplish that the actuary looks at the expected investment return assumptions to discount the liabilities to ensure they grow at the same rate. The economic assumptions include price inflation, real rate of investment return and real rate of wage increase. He reviewed the price inflation noting the trend had been going down but recently it has begun picking up. Interest rates have gone up in anticipation of inflation.

Cavanaugh Macdonald is recommending 2.5 percent on the price inflation assumption. John Garrett noted that the Fed uses a different measure for inflation which tracks slightly lower than what the actuary uses.

Mr. Craven said based on Wilshire's 2018 10-year capital market assumptions and combining those assumptions with the standard deviation, they develop return assumptions over different time periods. Assumptions are then graphed based on the actual returns since 1998.

The investment return assumption is used to discount the liabilities. Under the current assumptions, the real rate of return was 5 percent. Mr. Craven said they are now recommending lowering that to 4.75 percent. The price inflation was increased to 2.5 percent which brings the nominal investment rate of return to7.25 percent.

In response to a question by Mr. Mayfield, Mr. Garrett said the 1990s' plan benefit improvements cost the liability curve to grow faster creating a steeper curve and the assets have not been performing at the required level. It is much harder to close the gap because the benefits accrue faster. Even the 8.5 percent returns that PERA has achieved over the past few years have not changed the outcome. Mr. Craven added that as a mature plan, PERA has negative cash flow with more cash going out than coming in. Mr. Garrett noted that PERA has a statutory rate and is approximately 3 percent light to improve the UAAL. With a closer recovery than anticipated from the 2009 event, Mr. Garrett said dropping the discount rate is a step in the right direction.

Mr. Garrett said that 129 public pension plans were surveyed and nearly three-fourths have reduced their investment return assumption since 2010 resulting in a decline in the average return assumption from 7.91 percent to 7.36 percent.

Mr. Craven said the expected salary increase of active employees is used in the payroll growth assumptions which are used in the projections. The recommendation is to lower the real wage growth from 50 basis points to 25 basis points with a wage inflation measure of 2.75 percent. Mr. Garrett said they try to use the same wage inflation measure across all of PERA's plans. Basically, they seek to find a mid-point of expectations where over time gains and losses offset so the contribution to the UAAL is minimized.

Ms. Naranjo Lopez said the Board has been adjusting its rate of return and perhaps an analysis of PERA's investment methods was warranted. She said not enough information was provided in the experience study for her to accept a recommendation.

Mr. Garrett noted that economic assumption changes occur for many public pension plans on an annual basis. While a lower assumption might initially increase the liability measures but the UAAL measure should be more stable.

Mr. Craven said the world has changed since the financial crisis and expected returns going forward just aren't there. As actuaries they must lower expectations to line the liabilities up with the expectation of the asset returns.

Mr. Garrett said the plan is not getting enough in to pay the level of benefits that is expected with all the assumptions combined. To change that, either more money has to come through contributions or expectations of what the benefits are going to be in the future years has to be reduced.

Ms. Cordova asked whether SB27 lessened the negative impact. Mr. Garrett said there have been good as well as bad returns since then and the legislation provided a remarkable chance at solvency.

The demographic assumptions include rates of mortality, retirement, disability, termination and pay increases/salary scale. These are the assumptions regarding the people within the plan. The rate of mortality is considered the most important because it has the greatest impact on the measure of liability, stated Mr. Garrett. New Mexico is in the bottom quartile of life expectancy which can be attributed to higher obesity. He noted that male mortality is improving in national statistics while female rates have increased. Disability creates a very small impact to the overall liability.

Mr. Garrett said this was a preliminary review of the experience study.

G. WageWorks Litigation Update

Dana David, Assistant General Counsel, presented information regarding action PERA took in conjunction with the Office of the Attorney General to hire the law firm of Barrack, Rodos and Bacine to represent PERA in a class action litigation currently pending in the U.S. District Court for the Northern District of California against a company called WageWorks.

PERA decided to participate in this case because the facts were particularly strong and there is a reasonable belief that PERA may recover a substantial amount of the projected $623,000 in losses. The Barrack law firm filed a motion on behalf of PERA and two other government pension plans to serve as lead plaintiff.

Mr. David directed the Committee to a memo providing additional data and offered to stand for questions of which there were none.

5. Other Business

None was presented.

6. Adjournment

Having completed the agenda and upon motion by Mr. Mayfield and second by Dr. Kohlasch, Chair Melia declared this meeting adjourned at 11:50 a.m.

Approved by:

John Melia, Chair
PERA Investments Committee

ATTEST:

Wayne Propst, Executive Director