

NEW MEXICO
PUBLIC EMPLOYEES RETIREMENT BOARD
INVESTMENTS COMMITTEE MEETING

October 27, 2016

This meeting of the Public Employees Retirement Board Investments Committee was called to order by Chair Dan Esquibel at approximately 10:15 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 indicating a quorum was established with the following members present:

Members Present:

Dan Esquibel, Chair
Paula Fisher
Patricia French
Loretta Naranjo Lopez

Member(s) Excused:

Dan Mayfield, Vice Chair
John Reynolds

Other Board Members Present:

James Maxon
John Melia
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
Karen Risku, Deputy General Counsel
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
David Dana, Assistant General Counsel
LeAnne Larrañaga-Ruffy, Director of Equity
Mark Montoya, Investments Division
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

Alain Rauscher, Antin

Sébastien Lecaudey, Antin

Lee Landrum, Tennenbaum

Howard Levkowitz, Tennenbaum

Mike Beggy, BNY Mellon

Matt Kaufmann, BNY Mellon

Mike McDermott, BNY Mellon

2. APPROVAL OF AGENDA

Ms. French moved to approve the agenda as presented. Her motion was seconded by Ms. Fisher and passed by voice vote.

3. APPROVAL OF CONSENT AGENDA

Chair Esquibel said he reviewed the minutes and they appear to be in order. Ms. French moved to approve the consent agenda. Ms. Naranjo Lopez seconded and the motion passed without opposition.

4. CURRENT BUSINESS

A. Chief Investment Officer's Report

1. Investment Performance – September 2016

PERA CIO Jon Grabel provided the results for the end of September and the end of the first fiscal quarter. The month finished with a fund balance of \$14.5 billion, up 43 basis points, net of fees and expenses. The fund balance increased by a net \$17 million for the month. As it relates for the end of first fiscal quarter, FY 17 is off to a great start, up 3.69 percent net, more than 50 percent of the 7.25 threshold. October has been a tough month but the fund is still ahead of its actuarial pacing.

Mr. Grabel reminded the Committee that there will be significant tracking errors during the implementation process for the new strategic asset allocation. Quarter to date, that fund is positive in terms of value add by 30 basis points; however, the value add or loss really is a reflection of the overweight to equity and core fixed income and underweight to credit and real assets.

Starting with global equities, PERA's largest asset category, Mr. Grabel reviewed returns: global equities were up 72 basis points for the month and 5.42 percent for the quarter. During the quarter there was outperformance from international as opposed to US. He noted that 89 percent of PERA's global equity portfolio is public equity. The risk reduction portfolio was down 5 basis points for the month and up 58 basis points for the quarter with a slight outperformance from the global allocation compared to the US component. Credit was up 46 basis points for the month and up 3.08 percent for the

quarter. The real assets portfolio was up 16 basis points for the month and up 3.95 percent for the quarter. All of PERA's asset categories did very well for the quarter. The illiquid real assets category was up 8.15 percent for the quarter. There is a quarter lag in terms of performance reporting.

2. Cash Plan Update

Mr. Grabel said September ended with approximately \$438 million in cash. He reviewed the sources of capital for the month which included \$239 million from the equity implementation plan, \$28 million inflow from illiquid asset distributions, and \$53 million employer/employee contributions. Uses of cash include \$96 million to pay benefits and refunds, \$1 million for operational expenses, \$66 million for illiquid asset capital calls, \$80 million for a real asset implementation, and \$14 million for credit implementation.

Referring to the rebalancing report, Mr. Grabel said the report is based upon the implementation plan for all the asset categories. Global equity had a net reduction of \$239 million; however, that is inclusive of a \$684 million reduction in public equity and an increase of \$328 million to the global equity index, combined with \$117 million index to build out the low-volatility equity account. The risk reduction/mitigation category with \$145 million reflects an increase in cash. He reminded the Board that all of the cash is invested in the overlay program which during the first quarter was up \$3.9 million and since inception in October 2014 the program is up \$58 million. He noted that last year, which was a tough year for investments, PERA made \$90 million and this program has been instrumental to performance. Credit was up \$14 million which went to the high yield Guggenheim program.

Chair Esquibel asked whether the State's rebudgeting has an effect on PERA. Mr. Grabel said PERA will be presenting its FY18 budget to the LFC today. Mr. Propst said one of the bills during the special session did include a reduction of the monthly disbursement to the Legislative Plan from \$200,000 to \$75,000 per month. In terms of the operating budget there has not been an impact.

3. Other Updates

Mr. Grabel provided the following updates:

- RFP: Illiquid Investment Consultant. The evaluation committee has interviewed the six semi-finalists. The list has been narrowed to three and the diligence is being scheduled on those finalists
- A risk report, which lags a month, shows that the monthly plan value at risk is down to 3.3 percent. Last month it was 5.2 percent
- The security lending quarterly report indicates that the fund is making \$300,000 a month

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 €65 Million to Antin Infrastructure Partners III, LP

[Exhibit 1: Staff recommendation re: Antin; Exhibit 2: Cliffwater Report; Exhibit 3: Antin Report]

Kristin Varela, portfolio manager of real assets, said the recommendation is to commit up to €65 million which as of today's conversion rate would be about \$71 million to Antin Infrastructure III. This would be an illiquid real asset partnership within the real assets portfolio. Antin is targeting €3 billion to continue their focus on small to middle market brownfield infrastructure investments in Europe. They are expected to target a 15 percent IRR over the life of the fund with a 5 percent per year cash yield on the portfolio. This is a new partnership for PERA and will complement the existing managers in the current portfolio.

The current infrastructure portfolio largely consists of large core infrastructure assets of which 65 percent are located in North America. An allocation to this fund would further diversify PERA's infrastructure exposure. Antin has a long-term track record of strong performance and the strategy is executed by a highly regarded investment team.

Sébastien Lecaudey, representing Antin, thanked PERA for the opportunity to present their fund. He provided an overview of the firm's management team noting they are 100 percent owned by the partners. They currently manage two funds for an aggregate amount of €3.8 billion which is about \$4.2 billion. He noted that brownfield investments eliminate the construction risk and will include energy, telecom, transport and social facilities (clinics, funeral services, nursing homes, etc). The 64-member Antin team is composed of 21 nationalities and 11 languages are spoken. He discussed Antin's long-term approach to sourcing through operational value add and capital management. Also explained was Antin's decision making process which includes an investment committee, agreement by the majority of the nine partners and agreement between the two partners to formally commit the funding to the project. Every quarter the entire firm holds a portfolio review, and external independent valuations and audits are performed.

Mr. Lecaudey emphasized that the firm's discipline makes them very selective in their investments and they use tax and legal, financing, and external advisers throughout the process. He noted there was a large flow of liquidity trying to enter the infrastructure space in Europe, there is a large supply of opportunities in infrastructure, and there are constant trends – technology, climate change, trade patterns, etc. – impacting these opportunities.

Alain Rauscher, a representative of Antin, provided an overview of Funds I and II's performance noting they were both very diverse with significant returns. Fund I is in its advanced exit mode and Fund II significantly deployed with 83 percent committed in the two years' post-final close. Fund III was launched in mid-July 2016 with the first close scheduled in December 2016.

Ms. French asked about an investment that is valued below cost. Mr. Rauscher said that is an investment in Spain and it is currently in arbitration. A decision is expected by June 2017.

Responding to Chair Esquibel's question of how this investment would fit into PERA's current portfolio with energy. Ms. Varela stated that currently PERA's exposure is upstream oil and gas. Antin is in infrastructure and will provide diversification within the portfolio as a long-term predictable cash flow.

Mr. Grabel pointed out that these investments will be in Europe whereas the majority of the current real assets portfolio is in the United States.

Ms. Varela said Cliffwater began its diligence on Antin Fund II in early 2013 and has been in continuous conversations since then as well as tracking the portfolios. Ms. Feidler noted that due diligence can only start once fund raising begins.

With no further questions, Ms. French moved to recommend a commitment of up to €65 million to Antin Infrastructure Partners III, LP a private real estate partnership focused on European infrastructure investments to be funded according to PERA's cash plan subject to approval of legal documentation by general counsel. Ms. Naranjo Lopez seconded and the motion passed without opposition.

2. Recommendation to Commit up to \$200 Million to Tennenbaum Capital Partners, for a direct lending Fund of One [*Exhibit 4: Staff Recommendation re: Tennenbaum; Exhibit 2: Cliffwater report; Exhibit 5: Tennenbaum Report*]

Joaquin Lujan, Director of Rates and Credit, said the recommendation is for Tennenbaum to manage a US middle-market direct lending strategy through a Fund of One. This is consistent with the Board retreat education session to originate private debt to middle-market companies through first-lien and unitranche loans as well as other mechanisms. The strategy will target a net 9 percent to 12 percent IRR with a 6 percent to 9 percent cash yield. When fully invested, this commitment will fill PERA's strategic asset allocation plan's private debt allocation.

Howard Levkowitz, a Tennenbaum representative, thanked the Committee for their time and for providing the opportunity to manage PERA's assets. The firm has 80 people with offices in southern and northern California and New York. Since inception, the firm has executed two basic strategies: a focus on credit and direct lending and special situations investing which enhances the direct lending business. The firm functions as one team, one firm working across all investments utilizing all its expertise. Over 20 years, the firm has made over \$16.5 billion in investments in 450 companies.

Mr. Levkowitz explained direct lending as conceived by Tennenbaum, as primarily lending to middle-market North American businesses. The loans are typically those that these businesses cannot obtain from the banking system for a variety of reasons

– out of favor sector, lack of analyst coverage or unusual characteristics. Since the financial crisis the need for Tennenbaum’s service has grown. Within their direct lending strategy, Tennenbaum has made over 330 loans totaling over \$9.3 billion with a gross return of 12.7 percent with a 1.4 percent loss ratio – lower than a typical bank loss.

Tennenbaum operates in 19 industry groups creating a very diverse portfolio. In the past when one needed a loan they would approach a bank or perhaps an insurance company. Today, there are broadly syndicated loans, middle-market syndicated loans which Tennenbaum occasionally participates in, and mid-market private loans which is Tennenbaum’s real strength. Most of the loans Tennenbaum is making are the loanee’s only loan or participating with a small group of lenders to provide the needed capital.

Mr. Levkowitz said Tennenbaum has contracts, agreements for payback and interest and are first in line/senior secured and floating rate. He provided a loan case study with a business overview, the firm’s approach, the situation and the outcome.

Lee Landrum, a Tennenbaum representative, reviewed the firm’s track record highlighting the cumulative loss ratio of 1.41 percent on the entire \$9.3 billion over more than 16 years. He highlighted that there are a number of investors like PERA within similar vehicles with Tennenbaum today. Direct lending offers a floating rate, covenants and lender protections, senior secured at the top of the capital structure with a higher yield generally. There are concentration limits on any individual borrowing as well as limits on any individual industry.

Chair Esquibel asked whether there would be any overlaps in other PERA asset investments. Mr. Lujan said there is very little overlap and what is being offered is a separately managed account that can be custom-tailored.

In response to Chair Esquibel’s question regarding bankruptcy, Mr. Levkowitz said it starts with good underwriting and knowing how to work through a process to protect the firm. He said Tennenbaum has been through well over 50 bankruptcies and restructurings. It often takes the lead and can maximize value and protect itself by being first in line with a loan and a lien. They have been able to minimize out-of-pocket expenses in an effective manner.

Mr. Landrum said bankruptcies are far less prevalent in their direct lending strategy and more prevalent in the special situation strategy.

Mr. Grabel noted that the firm’s cumulative loss ratio over 16 years is 1.41 percent. He added that the general partner has a profit share and makes their incentive compensation only after the investor’s cost of capital and expenses are paid back. This investment is not targeting distress but rather performing companies.

Mr. Landrum said CNO has a passive minority investment in Tennenbaum. They are interested in returns and will provide institutional money for growth. Mr. Feidler said Cliffwater talked with CNO to understand their motivation. He assured the Board that Cliffwater was firmly committed in this recommendation as they are in any recommendation they support.

Mr. Lujan reported that most vehicles in the private asset space have a 2 percent

management fee and 20 percent profit share, PERA will pay a 1 percent management fee on invested capital and 12.5 percent carry versus 20 percent.

With no further questions, Ms. Fisher introduced a motion to recommend to the Board a commitment up to \$200 million to Tennenbaum Capital Partners, for a direct lending Fund of One to be funded according to PERA's cash plan subject to approval of legal documentation by general counsel. Ms. French seconded and the motion passed without opposition.

C. Custody Bank Update from Bank of New York Mellon
[Exhibit 6: BNY Mellon report]

Christine Ortega, portfolio manager of investment operations, indicated that the custody bank provides essential services for PERA, the investment managers and consultants. The custody bank is one of PERA's most critical vendors and they work closely with staff to ensure the day-to-day investment activity works smoothly.

Ms. Ortega said the BNY Mellon team has proven to be responsive to staff requests and helpful in assisting the operations team.

Mike Beggy, BNY Mellon, identified his role as service director; and he oversees the day-to-day operations of the relationship. He defined trust and custody as safekeeping PERA's assets, valuation for accurate reporting, and facilitation of the investment process.

Matt Kaufmann, BNY Mellon, said his division serves as the performance and risk analytics part of the custody bank allowing the investment team to better understand any portfolio risk. They provide performance measurement – daily unaudited performance, monthly audited performance, manager performance comparison, monthly security level and indexes, and monthly custom benchmark calculations – performance attribution, universe comparison, global analytics, risk view, compliance and private investment support to see underlying holdings.

Mr. Beggy explained that trust and custody constitute one aspect of the relationship requiring accurate valuation which is Mr. Kaufman's team's responsibility.

Mike McDermott, manager of the client service area within global securities lending, said securities lending takes the stocks and bonds and lends them out temporarily to approved borrowers (brokers, dealers and banks) in exchange for approved collateral with margin. The goal in doing that is to create incremental revenue to offset custody fees and other administrative expenses, doing so in a transparent manner. Large custodians make natural security lending agents because the assets are available in safe keeping. It is a service with that dovetails the custody services.

Mr. McDermott said BNY Mellon is the largest securities lending firm in the industry, with north of \$3 trillion lendable assets and approximately \$334 billion on loan daily with 104 approved borrowers. He discussed BNY Mellon's dual location within the

states which served them well when Hurricane Sandy hit New York. They experienced no interruptions because of their Pittsburg office.

Last fiscal year, BNY Mellon earned \$2.3 million for PERA in fee revenue.

Mr. Beggy thanked the Committee for their relationship with BNY Mellon.

Mr. Grabel said the report and types of information available from BNY Mellon are sophisticated and easily accessible.

D. Review: Investment Management Fees FY16

Mr. Grabel said this information takes tremendous effort to gather and he lauded Ms. Ortega and Mark Montoya for their diligence. This report format was developed in 2015 for an IPOC report with ERB, PERA and SIC all reporting the information in the same format. Management fees are 36 basis points of the total portfolio. Two years ago it was 59 basis points indicating a 24 percent reduction in two years. He said the reduction is tremendous. For a \$14.5 billion plan, one basis point is \$1.45 million; every basis point matters, stated Mr. Grabel.

Mr. Grabel noted that the annual cost does not include carried interest/profit share. He reminded the Committee that not all fees are bad. Some fees are goal aligned with the managers and they make a difference. He added that the PERA's portfolio is better positioned than it was two years ago. It has lowered cost structure, it is better diversified and has a better risk return quotient.

Ms. French said the Board greatly appreciates staff's hard work.

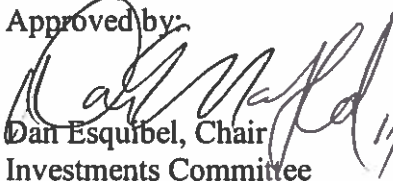
5. OTHER BUSINESS

None was presented.

6. ADJOURNMENT

Having completed the agenda, Chair Esquibel declared this meeting adjourned at 11:10 a.m.

Approved by:


Dan Esquibel, Chair
Investments Committee

ATTEST:


Wayne Propst, Executive Director

Attached Exhibits:

Exhibit 1: Staff recommendation re: Antin

Exhibit 2: Cliffwater Report

Exhibit 3: Antin Report

Exhibit 4: Staff Recommendation re: Tennenbaum

Exhibit 5: Tennenbaum Report

Exhibit 6: BNY Mellon report