NEW MEXICO
PUBLIC EMPLOYEES RETIREMENT ASSOCIATION
INVESTMENT COMMITTEE
September 27, 2018

This meeting of the Public Employees Retirement Investment Committee was called to order by Dan Mayfield, Vice 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 followed the Pledge of Allegiance and indicated the presence of a quorum as follows:

Members Present:
John Melia, Chair [9:10 arrival]
Dan Mayfield, Vice Chair
Dan Esquibel
James Maxon [9:15 arrival]
Jackie Kohlasch

Member(s) Absent:
None

Other Board Members Present:
Loretta Naranjo Lopez
Claudia Armijo
Natalie Cordova
Patricia French
Cathy Townes
Maggie Toulouse-Oliver

Staff Members Present:
Wayne Propst, Executive Director
Susan Pittard, Chief of Staff/General Counsel
Dominic Garcia, Chief Investments Officer
Karen Risku, Deputy General Counsel
Dana David, Assistant General Counsel
Renada Peery-Galon, Administrator Services Director
Kristin Varela, Deputy CIO
Joaquin Lujan, Portfolio Manager
Trish Winter, Executive Assistant
LeAnne Larrañaga-Ruffy, Director of Equity
Christine Ortega, Portfolio Manager

Staff Members Present (cont.)
Anna Williams, Chief Financial Officer
Anna Murphy, Portfolio Manager
Emily Lopez, Financial Specialist
Mark Montoya, Investments Department
Christina Perea, Outreach Division Director PERA
Christina Gauthier, PERA

Others Present:
Heather Christopher, Albourne
Mark White, Albourne
Tom Toth, Wilshire Associates
Lenora Chavez, Retiree
Paul Lium, Nationwide
Ernest Marquez, Automated Election Services
Henry R. Romero, Las Lunas
Todd M. Sanchez, Retiree
Phil Sanchez, Retiree
Laura Heese, ICMA-RC
Matt Pruitt, ICMA-RC
Bill Hyde, Retiree
Lee Gruana, Retiree
Don Wencewicz, AFSCME Retiree
John Rivera, Retiree (RPE)
Annette Arvizu, RPE
Joseph Luna, RPE
Gerald Chavez, RPE
Eva Lujan, AFSCME Retiree
Ronnie Freyburger, Retiree NMSHTD
Steve Neel, NM ERB
Eva Lujan, Retiree

2. Approval of Agenda

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

3. Approval of Consent Agenda

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

4. Current Business

A. PERA Internal Investment Process

CIO Dominic Garcia said he and Deputy CIO Varela will outline in detail staff's investment-related processing procedures. At a high level, the strategic goals are to:

- Maintain appropriate strategic asset allocation to meet the actuarial discount rate assumption over the long run
- Work toward 30-year funding period of unfunded actuarial accrued liability
- Meet 10-year annualized returns to equal or exceed the policy benchmark
- Achieve a total investment cost at or below 85 basis points

Mr. Garcia reviewed the investment principles that staff adhere to to meet the overall goals to create a steady, compounding return that minimizes uncompensated risk. That includes focus on allocating risk, separate alpha and beta, effectively managing costs, instituting comprehensive risk management and keeping a long-term view. Those principles are turned into action which is the division's action. He outlined how the process works with the Board, Investment Committee, staff and consultants, starting with the strategic direction, planning, manager selection, implementation, as well as monitoring the entire process. He divided the strategic planning into annual plans, semi-annual updates and the quarterly strategic letter with a review and market outlook.

Ms. Varela reviewed the manager selection process starting with identifying the portfolio need and the components that support that need. She noted that staff conducts this in collaboration with manager selection consultants. These decisions are made in accordance with the strategic asset allocation, risk budget and the procurement policy. Dividing the process into five components/stages, Ms. Varela said the first is a standard request for data/information from perspective investment managers. She noted that the illiquid side is slightly different. Stage 2 is the collection of the received information; quantitative screening occurs on the liquid side. There is review of key points and collected data. Stage 3 employs key templates to evaluate the information obtained in the first two stages to determine how the manager would fit within PERA's risk budget. Operational due diligence starts. Within Stage 4 the semi-finalists are interviewed and site visits occur. All of the data is written up and provided within Stage 5 internal reviews which lead to the CIO approval to take forward. Following the completion of all legal and business related items final approval occurs.

Mr. Garcia reminded the Committee that they are trying to be diversified around risk (equity risk, core bond risk, credit risk and inflation-sensitive risk) which results in an enhanced beta portfolio. In alpha, the active management piece is seeking to earn an excess return over the strategic allocation.

Ms. Varela said once the CIO has signed off on the manager, a manager activity report is presented to the Investment Committee. She outlined the ongoing monitoring that staff performs on the managers and the internal staff meetings. The Investment Committee is provided monthly and quarterly performance and risk reporting, annual risk budget updates and semi-annual manager selection consultant updates.

Mr. Garcia discussed the PRISM (Portfolio, Risk, Implementation and Strategy Meeting) meetings that staff holds as monthly internal oversight. The process amongst staff occurs at this meeting for operations, portfolio management and consultants. Legal staff also participates. An agenda of a typical meeting was provided.

Regarding enhancement to the process, Mr. Garcia said it is a never-ending process. The monitoring process will be improved with a conviction rating matrix. Roles and responsibilities are further enhanced with accountability in governance. Staff will hold an off-site planning retreat with a focus on 2019 prioritization.

Ms. Varela provided a high level review of Rockpoint Growth & Income Fund III as a case study for management selection. The review started with Stage 1, the request for information, and moved through to the final stage of staff proposal, operational review and consultant recommendations. She highlighted the amount of information that PERA uses to make recommendations.

Mr. Garcia said the process takes between three to five months. He offered to calculate the number of staff hours to lead to a recommendation.

Ms. Armijo thanked staff for an excellent presentation and said she hoped there was enough staff to use the vast information available to PERA. Mr. Garcia said Investments has requested three additional staff based on an analysis of resources.

Ms. French agreed with Ms. Armijo that the presentation was valuable. She asked that Board presentations include what the manager has made for PERA rather than just meeting the benchmark. Mr. Garcia said staff will continue to improve on their results tracking with more detail.

B. Performance and Risk Update (2018 Fiscal Year End)

Mr. Garcia announced that Anna Murphy passed level 3 of the CFA and will be a CFA charterholder. He congratulated her on her achievement and she received a round of applause.

Ms. Murphy framed her presentation through the lens of PERA's risk budget. The risk budget is the way staff informs the Board of how they plan to spend risk using expectations for passive and active risk contributions. This way the realized results can be compared to the established plan. She spoke of the importance to budget risk. Adverse passive returns could have serious implications to the long-term solvency of the plan. "We don't have risk to spare in our expenditure." She said a risk budget is an appropriate constraint that requires precision and efficiency in that expenditure.

Ms. Murphy reviewed the total fund risk budget noting that beta is providing 5.75 percent of the 6.76 percent return expectation and virtually all of the risk. In addition to beta's 10 percent, 1.5 percent is expected in tracking risk.

Ms. Murphy noted that PERA was more efficient than the target return in terms of the units of active return received per unit of active risk. This equates to $240 million in value added over the policy portfolio over the fiscal year. She reviewed the total fund versus the reference portfolio – 58 percent global equity and 42 percent US core fixed income, which could be passively and easily implemented. She discussed how volatility translates into a variability of results.

Ms. French asked about bonds. Tom Toth, Wilshire, said currently the portfolio has an allocation of 21 percent to core fixed income, approximately $3 billion, and the expected return is 3.9 percent. The bonds offer liquidity and ballast in the portfolio. Volatility in the core fixed income portfolio is around 5 percent while equity securities the volatility is about 17 percent. Ms. Murphy highlighted the diversification and ballast component of the bond portfolio.

Ms. Naranjo Lopez said if PERA was investing right the Board would not be in the position to make decisions regarding benefit structures.

Ms. Murphy noted that the fiscal year within less than 1/2 percentage point of the target weights of the four major composite. The portfolio is being tracked against two benchmarks: the policy benchmark and the dynamic benchmarks which are included in Wilshire's reports. The portfolio experienced 3.5 percent volatility, less than the model and less than the policy portfolio, resulting in a doubling of the Sharpe ratio which demonstrates the efficiency the portfolio creates in received return in excess of cash relative to a unit of risk. She reviewed the market environment in which the fund realized the risk performance. The first half of FY18 was the Goldilocks market and in the last half Goldilocks interrupted. She mentioned trade wars as an elevator of risk.

Regarding dispersion among asset classes, Ms. Murphy illustrated it with US equity and emerging market risk assets. The spread between the asset classes was 20 percent in September. Using a graph to highlight volatility, Ms. Murphy emphasized the importance of keeping a long-term perspective. She noted it was 10 years since the failure of Lehmann Brothers, the failure to pass TARP through Congress and the most tumultuous times in the market causing an 800-point fall in the Dow wiping out $1.2 trillion. The market has been a slow, sluggish recovery over the past 10 years.

Ms. Naranjo Lopez asked if money was moved into equity during FY 18. Ms. Murphy responded PERA moved money out of equities and the reason was to reach the long-term strategic asset allocation. The benchmarks are established in the Investment Policy Statement.

Ms. Naranjo Lopez asked whose job it was to select the benchmark and Ms. Varela responded it was the Board's.

Ms. Naranjo Lopez asked why the State Auditor does not report on PERA's performance and whether that was something that could be done. Ms. Varela said the State Auditor annually reviews PERA's financials. Performance reporting has varying degrees of oversight and was recently presented to the Board. The custody bank monitors and calculates actual cash flow, assets and valuations. That information is forwarded to Wilshire who also calculates independently, and finally goes to the Board. She offered to discuss the reconciliation process in greater detail if desired. Ms. Naranjo Lopez said that should have been provided today.

Stating she was very impressed with Ms. Murphy, Ms. Naranjo Lopez introduced a motion to give Ms. Murphy at least $10 million to invest for the next year. If that performance exceeds that of PERA, then Ms. Murphy should be considered to serve as co-CIO. Ms. Murphy thanked Ms. Naranjo Lopez for her confidence and said it was her pleasure to serve the membership.

Chair Melia pointed out that the motion was out of order as Ms. Naranjo Lopez is not a member of the committee.

Mr. Toth discussed the link between the macro environment and capital market performance to the current portfolio positioning and the outlook going forward. There are strong economics, unemployment is down, high consumer confidence, elevated housing prices with accelerated growth in the US. Generally speaking there are strong fundamentals. Inflation has remained relatively contained although it has started to move higher. The strong fundamentals have led to elevated valuations across asset classes. He noted that equity markets have had outstanding performances, US equities in particular. Some of the supports for the solid economic fundamentals are changing and he cited the central bank policy around the world. Interest rates have increased and should act as a headwind for economic activity going forward as borrowing costs are higher and the expected return for any project needs to meet that higher hurdle.

Regarding expectations, Mr. Toth said they have increased for fixed income and increased moderately for real equities. The spread for what is expected for equity and fixed income and real assets has tightened.

Mr. Esquibel thanked staff for their thorough reporting.

Ms. Naranjo Lopez asked whether there were other risk models and if so she suggested staff consider changing the current model to address the funding gap. Mr. Toth said the strategic investment plan was developed to work at closing the gap by allocating risk and improving the portfolio results.

In response to Dr. Kohlasch, Mr. Toth said the quarterly performance report was provided for information and Ms. Murphy's report addressed those results.

Ms. Naranjo Lopez requested that staff provide information on the expected return for each category and any products that offer 8 percent or higher. Mr. Garcia said staff has examined higher returns and concluded that for the next 10 years there is no asset that has greater than 8 percent expected return.

C. Semi-Annual Consultant Report: Real Assets

Mark White, Albourne, reminded the Committee that strategy with real assets is to construct an inflation sensitive portfolio that will provide a degree of protection to the broader diversified portfolio during periods of unanticipated inflation, enhance long-term overall performance and reduce overall risk.

Mr. White provided an overview of the portfolio since inception in 2007. During that time

PERA has invested approximately $3.289 billion across 39 vehicles. The portfolio has reached its target and is considered an immature portfolio due to recent shifts. It will take time for the illiquid assets to counterbalance the impacts of the liquid assets. Illiquid assets typically take two to three years to reach full allocation and the profiles are realized from five to nine years beyond that, depending on strategy. Once the assets are rotated the portfolio is considered mature and the true performance profile will be apparent.

Since 2016, there has been a rapid acceleration of bringing the portfolio up to the target weight of 13 percent. In fact, currently there is a slight overshoot of 13.8 percent allocation. He attributed that to the recent allocations to liquid strategies. During the allocation cycles of 2016, 2017 and 2018 the disruption to the flow of this portfolio will take a couple of years to correct. He expected future allocation decisions for the next few years to be light on illiquid allocations because of the portfolio's maturity cycle. He reviewed the exposures by sub strategies by identifying the targets: energy, 43 percent, infrastructure, 19 percent, agriculture, 19 percent and liquid real assets, 19 percent. Currently the portfolio has illiquid strategies that are taking time to move, i.e., TIPs and MLPs. The TIPs and MLPs act as cash reserves designed to provide the necessary inflation protection. He noted that they may not meet the return profile.

One of the biggest mistakes that boards and investment staff make, opined Mr. White, is looking to have a mismatch between cash reserve and the allocation decision. He discussed vintage year risk which is too many eggs in one basket in a particular year achieving the same beta profile. It was noted that most of the portfolio's exposure is in the US.

Referring to the new risk regime that PERA is expanding, Mr. White said the responsibility of any investment staff is to look at achieving the policy objectives in the most cost effective and prudent manner possible. Mr. White referred to a PME (public market equivalent) illustration that shows the real asset portfolio is achieving those objectives and has added 2 percent value.

Mr. White said the portfolio has realized its shift to liquid strategies, with room for tactical allocations. However, the adjustment requires adaptation of the pacing program to ensure vintage year diversification remains intact until the ratio of liquid and illiquid strategies stabilizes. He said one cannot rush into a target allocation. As part of this process, PERA is reviewing existing relationships and reallocating to those that provide a strategic relationship or tactical allocation that are with the current risk parameters. He said liquid strategies will be used to fund undrawn commitments of tactical allocations – careful attention to the allocation pools and target allocations. There will be an increase in diversification with complementary strategic allocation such as to agriculture and a greater emphasis on co-investments and managed accounts to improve fee loads and allow for more responsive tactical decisions.

Heather Christopher, Albourne, reviewed the real estate portions of the real assets portfolio offering a definition: that investments in or backed by physical assets, predominantly commercial or residential uses. Real estate provides diversification, yield generation, return enhancement opportunities and participation in inflation. Real estate also offers an alignment between investors and fund managers. Similar to real assets, the strategy is to pursue globally diverse opportunities which have attractive risk-adjusted returns. The investment vehicles include commingled funds for core relationships and separate accounts for smaller funds, emerging markets and other opportunities. The ultimate objective is to provide a premium over the policy index through the utilization of illiquid investments and active management. She reviewed the performances of private and public real estate.

Referring to the portfolio review, Ms. Christopher said PERA's first investment was in 2007 and since that time PERA has committed $1.8 billion to real estate across 26 active investment with 15 managers. Currently there is a net asset value on a fair value basis of $1.043 billion which is 6.8 percent of the total pension value. The target is 7 percent. She noted that during 2017, PERA made two new commitments to public real estate totaling $280 million. Additionally, money was moved from three real estate securities managers: BlackRock, La Salle and Morgan Stanley. The portfolio appreciated by $86 million during the year and there were five new commitments to private real estate in 2017. She highlighted that staff has been successful in using liquid real estate as a placeholder to real estate and is drawing it down into illiquid real estate strategies. Staff has made progress in reaching the targets and has carefully selected managers.

Ms. Christopher compared PERA's portfolio relative to the policy index and noted it was fairly close across the different parameters. PERA's portfolio is 83 percent invested in North America. Using a graph for comparison of PERA and its peers, Ms. Christopher noted that PERA is the newest to start its allocation of peers. PERA's real estate composite has outperformed its benchmark throughout the 1-, 3-, 5- and 10-year periods.

Although there are varying degrees of pessimism, Mr. Garcia said a low return environment is projected for the next the 10 years. The biggest challenge in going forward is building a portfolio to meet the actuarial return. Staff has presented the Committee and Board a path that creates greater opportunities to reach those returns. The enhancement is more of an evolution to the portfolio and correlates better to PERA's liability.

Ms. Naranjo thanked the consultants for their presentation. She noted that this was slated as a general membership Board meeting and the IC should have followed the Board meeting for the membership's sake.

D. Investment Division Updates

1. Cash Plan & Rebalance Update

Appreciating Ms. Naranjo Lopez' observation about the membership in attendance, Chair Melia requested that staff quickly summarize item D.

Ms. Varela said the information presented was posted on the Board's portal. She noted that July ended with $15.5 billion for the fund. The fund distributes $55 million into the operating account to pay benefits monthly.

2. Manager Selection Activity Report

Ms. Varela said the manager selection report was provided on the portal and she highlighted the pipeline to liquid assets. Liquid asset small cap and liquid high yield have both been executed. Risk balance has been added to the pipeline and is in response to the Board's approval of the multi-risk allocation. The illiquid side has had a great deal of activity with follow-on investments with six managers.

3. Securities Lending Update – Q2 2018

Support materials for this item were also posted on the portal and Ms. Varela offered to respond to questions.

Ms. Naranjo Lopez said she had questions that she would email to Ms. Varela rather than keep the membership waiting.

5. Other Business

None was presented.

6. Adjournment

Having completed the agenda and upon motion by Mr. Mayfield and second by Mr. Maxon, Chair Melia declared this meeting adjourned at 11:25 a.m.

Approved by:

John Melia, Chair
PERA Investments Committee

ATTEST:

Wayne Propst, Executive Director