MINUTES
of the
SECOND MEETING
of the
INVESTMENTS OVERSIGHT COMMITTEE

July 6-7, 2009
Room 307, State Capitol
Santa Fe, NM

The second meeting of the Investments Oversight Committee (IOC) for the 2009 interim was called to order by Representative John A. Heaton, chair, at 10:14 a.m. on July 6, 2009 in Room 307 of the State Capitol in Santa Fe.

Present
Rep. John A. Heaton, Chair
Rep. Donald E. Bratton
Sen. Tim Eichenberg
Sen. Timothy M. Keller
Rep. Henry Kiki Saavedra
Sen. John M. Sapien
Rep. Jim R. Trujillo
Rep. Luciano "Lucky" Varela

Absent
Sen. John Arthur Smith, Vice Chair
Rep. Larry A. Larrañaga
Sen. Carroll H. Leavell
Sen. Steven P. Neville

Advisory Members
Rep. Andrew J. Barreras
Sen. Carlos R. Cisneros
Rep. Miguel P. Garcia
Rep. Roberto "Bobby" J. Gonzales
Rep. Jane E. Powdrell-Culbert
Rep. Sheryl Williams Stapleton
Rep. Shirley A. Tyler
Rep. Richard D. Vigil
Sen. Stuart Ingle
Rep. Patricia A. Lundstrom
Sen. Mary Kay Papen
Sen. William H. Payne
Sen. John C. Ryan
Sen. Michael S. Sanchez
Sen. Peter Wirth

Staff
Tom Pollard, Legislative Council Service (LCS)
Doris Faust, LCS
Sebastian Dunlap, LCS
Michael Calderon, LCS

Guests
The guest list is in the original meeting file.

Handouts

Handouts from the meeting are in the original meeting file.

Monday, July 6

Public Employees Retirement Association (PERA) Deferred Compensation Plans: Update on Investment Performance and Recent Program Activities — Joanne Garcia, Deferred Compensation Program Manager, PERA; Kurt Weber, Deputy Executive Director for Operations, PERA; Lou Moreno, Regional Vice President, Nationwide Retirement Solutions.

Mr. Moreno presented a brief history of New Mexico's deferred compensation plan. The plan was started in the early 1970s and was primarily offered and administered by insurance companies using insurance-based products. In 1997, the PERA "unbundled" the insurance annuity products and converted to more flexible, less costly direct mutual investment products. An independent investment advisor was hired to assist the PERA in selecting and monitoring plan investment options. Plan administrators were switched from commission-based compensation to salary-based compensation. In 2004, the plan was expanded to include a loan option. In 2005, a self-directed brokerage account option was implemented and life-cycle portfolios were implemented.

Mr. Moreno stated that as of March 31, 2009, plan assets totaled $269 million. Quarterly contributions average $9 million and quarterly distributions average $862,000. There are 15,604 plan participants, a 7% increase since March 31, 2008. Quarterly fees for plan participants include the third-party administrator fee of $14.75/quarter, the investment consultant fee of $1.26/quarter and the PERA administrative fee of $1.22/quarter.

Mr. Moreno explained that there are currently six life-cycle portfolios — the most recent enrolled 927 new plans in the last three quarters. The self-directed brokerage account option opened the trading menu to include all available investments except alternative investments in January 2009. As for the loan program, interest is charged at the prime rate plus 1%. Up to five years are allowed to repay a general purpose loan and 15 years are allowed for purchase of a primary residence. Tax-deferred transfers can be used to purchase service credit in the defined benefit plans administered by the PERA and/or the Educational Retirement Board (ERB). Rollovers are allowed from other plans, including 457(b), 401(k) (private sector plan where employer matching is involved), 403(b) and 401(a) (employer contribution, or IRA).

In response to a question by committee members regarding how employees are "educated" on benefits and plans, Mr. Moreno responded that group presentations and one-on-one consultations are conducted on a regular basis. Education strategies for both urban and rural participants have been expanded through four regional offices. A state-specific web site provides information and participant account information — www.newmexico457dc.com — for the benefit of the plan participants.

Members of the committee asked questions regarding the qualifications of plan representatives. Mr. Moreno stated that all plan representatives making presentations are fully certified and accredited and are salaried employees of Nationwide Retirement Solutions. He stated also that plan participants are made aware of alternatives to the tax-deferred accounts, e.g., Roth IRAs, that there is no "fixed return" option offered to plan participants and that the active management options carry no additional fees beyond the quarterly fees discussed.

Mr. Weber discussed emphasizing to participants the need for well-diversified asset allocation. Mr. Moreno informed the committee that 38% of new participants are choosing the life-cycle portfolio option managed by the investment consultant.

The ERB: Educational Retirement Fund Governance, Policies and Processes — Jan Goodwin, Executive Director, ERB, and Bob Jacksha, Chief Investment Officer, ERB.

Ms. Goodwin discussed board of directors membership and the investment committee, audit committee and disability review committee established by the board. She discussed the role and responsibilities of the board of directors, which are in Sections 22-11-6, 22-11-7 and 22-11-13 NMSA 1978.

Ms. Goodwin discussed the role and responsibilities of the chief investment officer for the ERB, Mr. Jacksha, who is generally responsible for managing and monitoring the ERB's investment portfolio. She presented a summary of the investment roles of the board, the general investment advisor, specialty advisors for alternative investments and the custodial bank and described the process that is used by the board and staff to select consultants and advisors. She also referred the committee to a more detailed account to be found in the February 2006 publication titled: NM ERB - Investment Goals, Objectives and Policies. She explained that a draft of an update to the publication was submitted to the ERB in June 2009.

Mr. Jacksha reported on the investment returns from the most recent asset allocation adopted by the ERB in 2007. Estimates at that time of what returns would be over the last two years have not been met, and a new asset allocation study is underway.

In response to questions by the committee regarding the source of the projections of investment earnings, Mr. Jacksha stated that they are provided by the general investment advisor, NEPC, based on what various investment alternatives have done in the past and taking into account the current economic environment and the outlook for the future.

Senator Sapien suggested to the representatives of the ERB that they might examine alternative asset allocation models used by other investment funds.

Committee members had questions regarding whether the hiring of firms providing investment advice to the ERB was conducted by outside firms. Mr. Jacksha responded by stating that third-party firms do not hire any of the ERB's investment advisors. Mr. Jacksha estimated that the ERB currently employs approximately 40 investment managers.

In response to a question from the committee regarding whether there has been consideration of reducing the number of managers at the ERB, Mr. Jacksha stated that it was the role of the general consultant to present information on the optimum number of asset classes and managers.

Discussions of Requests for Information from the State Investment Council and the ERB — Mr. Dunlap and Mr. Pollard.

Mr. Dunlap stated that the IOC has no subpoena power. The authority to subpoena is an investigative power extended by the legislature. This power can be extended by a single house resolution, a joint resolution or by statute. For example, the legislature has given subpoena power by statute to the Legislative Finance Committee but not to the New Mexico Legislative Council or the committees it creates.

Mr. Dunlap stated that although the IOC lacks subpoena power, it can request information under the federal Freedom of Information Act. These requests, however, may be prohibited by policy or denied based on the assertion that the release of requested information would interfere with law enforcement proceedings.

In response to a question by Representative Heaton, Mr. Dunlap stated that the LCS's request for the contents of the subpoena had been denied and that there was no information to indicate that the information requested by the subpoena had been delivered to those persons seeking it.

The committee requested that Paula Tackett, director, LCS, be asked to attend tomorrow's meeting to provide an update on the status of the review of the ERB and other New Mexico investment funds being commissioned by the Legislative Council and the State Board of Finance.

The committee recessed at 4:11 p.m.

<u>Tuesday, July 7</u>

Representative Heaton called the second day of the meeting to order at 9:15 a.m. on Tuesday, July 7, 2009.

Overview of Public Investment Fund Governance: Common and Best Practices Among the States — Steven Harding, Managing Director and Senior Vice President, and Phyllis Taylor, Vice President, Independent Fiduciary Services, Inc.

Mr. Harding began his presentation by saying that he and Ms Taylor were present before the committee to provide information, not a consultation on specific steps that the State of New Mexico could or should take. Any implementation of areas discussed would have to occur based on the facts of each case — not a blanket or universal application to all funds. He stated that none of the New Mexico funds had been reviewed by him prior to this meeting — thus, his would be a general discussion.

Mr. Harding described his firm and stated that its three primary business areas are: operational reviews of investment funds' program and practices; general retainer consulting regarding investment decision-making (e.g., asset allocation, manager selection, performance evaluation, etc.); and acting as a fiduciary decision-maker for institutional investors, replacing regular decision-makers who have a potential conflict of interest. He stated further that his presentation would focus on the practices of state and local government plans, which are created by state statute and thus vary widely from state to state and are not covered by the federal Employee Retirement Income Security Act of 1974.

Mr. Harding stated that "best practices" are best viewed in a holistic manner that includes a number of aspects: compliance with legal and regulatory requirements; internal control assessment and reporting; enterprise risk management; reporting and monitoring practices; transparency and accountability; and strong governance framework. He indicated that one of the most important best practices is that trustees, fund staff, external managers and investment consultants act as fiduciaries. The duties of the fiduciary are to act solely in the interest of the fund, act as a prudent or expert person, diversify assets, maximize returns, minimize risk and act in accordance with law and plan documents.

Mr. Harding stated that a well-designed governance structure is a prerequisite to the success of funds and their boards. He described common approaches to governance, including the respective roles of the governing board, staff and consultants. He suggested that a good governance structure includes a written governance policy with sufficient monitoring, accountability and transparency and clear delineation of the respective roles and responsibilities of key participants: boards of trustees, investment staff and service providers and what was delegable and non-delegable by boards. Delegable functions include investment management, custody securities trading, some hiring/firing and some performance evaluation. Among non-delegable functions are the establishment of an investment policy; setting investment guidelines and benchmarks; evaluating the performance of delegates; establishing governance and self-evaluation. He also discussed various aspects of risk management within fund governance, including the role of the board, audit committee, internal auditor and external auditor.

In response to a question by committee members regarding the use of actuarial soundness as a factor in setting investment policy, Mr. Harding stated that a board of directors has the fiduciary responsibility to set policy based on the maintenance of actuarial soundness and not solely the protection of benefits, even if the board's duty is to represent current or future beneficiaries of the fund.

The committee asked questions regarding best practices to establish necessary checks and balances and relative responsibilities of the governor, board members, legal counsel, staff and managers as a fund moves from traditional stocks and bonds into the private equity arena. Mr.

Harding answered that this is a developing area, with no adopted best practices by the National Association of Pension Administrators, but that it is a very important area due to the necessity of establishing an effective working relationship between the fund and the private equity partnership, much more so than in the case of traditional fund investing.

In response to a question from the committee regarding whether actuarial soundness is always a moving target, Mr. Harding answered that the actuary is a key service provider to the pension fund, with an analysis of actuarial soundness done every year. Further, it is a best practice to have another actuarial firm come in and evaluate the work of the primary actuary every five years.

Committee members asked questions regarding the role of custodial banks. Mr. Harding answered that custodial banks may or may not have a fiduciary role based on whether they take an active or passive role in the investing function. A best practice is to have the custodial bank sign on to be a fiduciary.

Committee members asked questions regarding the optimum number of board members for a pension or investment fund. Mr. Harding answered that, according to a recent survey by the New York state pension fund, the average board size was nine members, but more important than the number is the expertise of board members. Many training programs are available for board members, but one has to be very careful that the content is sufficient. Mr. Harding added that it is important to build a competent staff to support the board rather than relying too heavily on outside consultants.

The presenters were asked their view of the assumption of 8% as a long-term investment return. Mr. Harding stated that the expected rate of return varies greatly by fund and is highly uncertain, but that assumptions between 7% and 8% are still reasonable. Pension plans are funds with a very long time. There is a danger of making problems worse by overreacting, even in downturns of the magnitude being faced, because selling in a low period might create a catastrophe in itself.

As requested, Raul Burciaga, LCS, appeared on behalf of Ms. Tackett to give the committee a brief update on the upcoming operational review of the investment funds that is being commissioned by the Legislative Council and the State Board of Finance. He stated that a request for proposals had been issued and the selection process was in progress, with work to commence in late September.

The question was asked whether the selection of the firm conducting the review would be based solely on price. Mr. Burciaga answered that cost is only one consideration, accounting for 15% to 20% of the selection criteria.

Questions were asked by the committee regarding the estimated cost of the review. Mr. Burciaga said that he was not at liberty to discuss price as this was a point of negotiation, but that negotiations would be finalized by the end of the month, the price would become public, work would start in late September and the report would be ready by early December.

Overview of Public Fund Investment Performance Measurement and Monitoring: Common and Best Practices Among the States — Allan Martin, Partner, NEPC.

Mr. Martin began his discussion of investment fund performance by presenting a number of alternative measurements of fund performance: performance relative to other "peer" funds, performance compared to accepted benchmarks and performance on a risk-adjusted basis.

Mr. Martin continued his presentation with an explanation of investment performance gross of fees and net of fees. Performance gross of fees represents performance after trading costs, but prior to the deduction of investment management fees. This measurement allows all investment managers to be compared on the same level. Mutual fund performance should be "grossed-up" to evaluate actual fund portfolio performance. Performance net of fees allows evaluation of investment manager returns to clients. He stated that hedge funds should only be measured net of fees.

Mr. Martin introduced the concept of time-weighted rate of return, which measures over a given time period by linking the returns for each sub-period, giving equal weight to each sub-period. This measure is independent of the amount invested in each sub-period, is most appropriate for investments in public stock and bond funds and is less appropriate for measuring private equity or partnership investments, especially over shorter time periods.

Mr. Martin followed with a discussion of dollar weighted returns, which represents the return on the average dollar invested. This measure takes into account the impact of cash outflows to the fund, including the initial investments and additional investments, and cash inflows, including profits taken during the period and the ending value of the investment. In order to measure the value of an investment before a project's termination, an estimation of value must be made, which can be very difficult for illiquid, private investments. Also, returns to private equity investments should only be measured for comparable "vintages", due to the manner in which these investments mature.

Mr. Martin then moved to a discussion of investment performance benchmarks to measure performance in absolute terms and to measure relative performance of active managers versus passive managers or performance relative to market indices or peers. He stated that performance reporting should answer the following questions: 1) On the basis of risk and return, how did a fund do relative to its peers? 2) How effective was the fund's investment policy regarding asset class weights (measured by a policy index)? 3) What was the effect of deviating from the policy weights (measured by an allocation index)? and 4) How effective were investment managers (measured by subtracting the allocation index from total returns)?

Mr. Martin discussed the development of peer group performance comparisons by developing an appropriate universe of similar portfolios with similar asset classes and management strategies. He then discussed the importance of quantifying risk and measuring it along with investment returns to make the most valid peer group comparison. He stated that volatility of returns, measured as standard deviations around an average return, is many times a good proxy for risk. He described the Sharpe Ratio, the Sortino Ratio and the Information Ratio as examples of measurements of risk-adjusted return.

Mr. Martin continued by describing the special challenges involved in measuring the performance of "alternative" investments, including private equity and real estate, which are valued based on an appraisal of their "fair value".

He then summarized the State Investment Council, First Quarter 2009 Investment Report, as a case study in performance reporting.

The committee had questions concerning what drives or should drive the asset allocation mix. Mr. Martin answered that the decision-makers should base their asset allocation on the long-run performance of individual asset classes and a mix of classes that provide diversification, i.e., that do not move together in response to the business cycle. The decisions on absolute and relative performance of asset classes should be based on a thorough review of all available financial history, weeding out non-representative periods. He stated that rather than try to "time" the business cycle, the investor should make investment policy decisions on five- to seven-year time horizons and focus efforts on hiring the best qualified investment staff and fund managers.

The question was asked whether, given a decision to invest in the private equity market, investment funds should be limited to firms with a definite potential to go public within a reasonable period of time.

Mr. Martin answered that the investor should have a definite plan as to when private equity investments are expected to go public and should have adequate diversification among investment alternatives to lower overall risk.

The meeting adjourned at 5:00 p.m.