MINUTES
of the
SECOND MEETING
of the
INVESTMENTS OVERSIGHT COMMITTEE

July 2, 2010
State Capitol
Santa Fe

The second meeting of the Investments Oversight Committee for the 2010 interim was called to order by Representative John A. Heaton, chair, on Friday, July 2, 2010, at 9:15 a.m. at the State Capitol in Santa Fe.

Present
Rep. John A. Heaton, Chair
Sen. George K. Munoz, Vice Chair
Rep. Donald E. Bratton
Sen. Timothy M. Keller
Rep. Larry A. Larrañaga
Sen. Carroll H. Leavell
Rep. Henry Kiki Saavedra
Sen. John M. Sapien
Rep. Jim R. Trujillo
Rep. Luciano "Lucky" Varela

Absent
Sen. Tim Eichenberg
Sen. Steven P. Neville

Advisory Members
Rep. Andrew J. Barreras
Rep. Miguel P. Garcia
Rep. Roberto "Bobby" J. Gonzales
Sen. Stuart Ingle
Rep. Patricia A. Lundstrom
Sen. Mary Kay Papen
Rep. Jane E. Powdrell-Culbert

Sen. Carlos R. Cisneros
Sen. William H. Payne
Sen. John C. Ryan
Sen. Michael S. Sanchez
Sen. John Arthur Smith
Rep. Sheryl Williams Stapleton
Rep. Shirley A. Tyler
Rep. Richard D. Vigil
Sen. Peter Wirth

Staff
Tom Pollard, Legislative Council Service (LCS)
Doris Faust, LCS
Claudia Armijo, LCS

Guests
The guest list is located in the meeting file.

Handouts

Handouts and written testimony are in the meeting file.

Friday, July 2

Representative Heaton welcomed the committee members and guests. He advised the members that the meeting would be audiocast and that future meetings would likely be webcast. Consequently, he asked the members to keep side conversations to a minimum. Next, he requested that the members introduce themselves, which they did.

State Investment Council (SIC): Recent Reforms in Board Governance; Investment Policy and Investment Operations Management; New Legislation; the EnnisKnupp Fiduciary Review; Other Agency Initiatives

Steven Moise, state investment officer (SIO), addressed the committee. He began by providing an overview of events, performance and changes that have taken place at the SIC during the past 90 days. He told the members that the mission of the SIC is to ensure generational equity to all New Mexicans through prudence and excellent investment performance. Due to the downturn and fluctuations in the market, achieving excellent investment performance has been difficult in the recent past. The SIC has adjusted its allocation model in an attempt to even out the consequences of the market swings and to achieve better performance. Mr. Moise advised the members that everything that he would speak to them about has an impact on investment performance.

Mr. Moise stated that the SIC had collaborated with the Public Employees Retirement Association (PERA) and the Educational Retirement Board (ERB). He opined that the agencies must communicate with each other, and that is what they have been doing. He also noted that Senate Bill 18 changed the way the SIO is appointed by the SIC and that the council itself has changed. He added that the council members have been working diligently and have held program meetings in Santa Fe recently, with some members traveling long distances, demonstrating a major commitment to serving the State of New Mexico. He stated that the governance of the SIC has changed internally. In the past, there was no investment committee, and, now, there are two internal committees, one composed of SIC staff and the other of council members and one SIC staff member. The committees have been working over the past few months and still have more work to complete. They are developing charters and are operating the organization like a business. Mr. Moise stated that the SIC would appreciate the legislature reviewing the charters and making helpful observations and suggestions. He added that there are three committees formed by the council. Those committees focus on investments, audits and governance. Each committee has a long list of tasks to be completed, and the committees are working with the SIC staff. He assured committee members that the SIC is not trying to create a bureaucracy; rather, it is trying to work as a business model and manage the permanent funds in a respectful manner. Mr. Moise reminded the members that the State Personnel Office (SPO) had conducted a two-month review of the SIC office. He stated that he received the report from the SPO recently. It was his opinion that the SPO had done a great job in its review. He said that he would review the report and then meet with the SPO staff the following week to discuss any additional work that might be completed and any changes that may be made as a result of the review.

Mr. Moise told the members that the asset allocation model that he had mentioned earlier was adopted by the SIC in May. He noted that equities exposure was reduced, hedge funds were reduced and the SIC was reviewing its overall investment policy. He said that the committee can expect updates on any changes in policy as they occur.

Next, Mr. Moise said that the SIC has issued several requests for proposals (RFPs), one in connection with legal recoveries. He explained that the SIC received a number of responses to the RFPs and will make a decision at its July meeting regarding the possibility of recovering money that was inappropriately paid to replacement agents and recovering losses in that area.

Next, Mr. Moise stated that the SIC had just completed negotiations of an agreement with a film consultant, Peter Beckham. He added that Mr. Beckham's compensation and scope of service will be reduced. He noted that Mr. Beckham would be coordinating an audit program for the SIC regarding its film industry business. He said that the film industry members do not always respond fully unless an audit is conducted; so, the SIC is asking Mr. Beckham to engage the services of a film auditor to review the various films that receive funding and to determine whether each film has a probable chance of being profitable.

Next, he explained that the SIC is searching for hedge fund managers and managers of fixed income portfolios. The SIC terminated six managers in May and June based, primarily on their performance and on overcompensation and for general personnel changes. The assets subject to the funds handled by managers that have been terminated will be reallocated in accordance with the newly adopted asset allocation model.

With regard to legal investigations, the FBI continues to request interviews with SIC staff. The SIC is working with the Risk Management Division of the General Services Department to provide counsel for those who need it. He noted that the SIC has ongoing litigation involving Countrywide and the Region Two Housing Authority. He added that the Countrywide litigation is very complex, there is a mediator involved and the litigation remains unresolved. He noted that, if necessary, the SIC would go to trial against Countrywide this fall. In conclusion, he said that the lawsuits are costing the State of New Mexico a great deal of money.

Mr. Moise told the members that the SIC had received a response from the state's insurance agent concerning how the state might save money by purchasing insurance. The SIC is currently reviewing the response. He also noted that the SIC has completed its change to using JP Morgan as its custody agent.

Mr. Moise next spoke about the land grant permanent funds, noting that the target rate of return for the funds is 8.5% gross of fees. He said that the SIC is analyzing the probability of achieving this target rate. Additionally, the SIC is searching for a deputy for investments and is using a search firm based out of Ohio. He noted that the SIC is pleased with the work of the

Ohio-based search firm thus far and hopes to select someone within the next 60 days.

Turning to legislative matters, Mr. Moise said that the SIC is looking at the impact of Senate Bill 18 (2010) and is developing recommendations, which will be brought forth for the next legislative session. He added that the SIC is reviewing internal versus external management of its funds. It has asked a consultant to do an initial analysis and provide the SIC with data so that its staff can review and then make possible recommendations to the SIC regarding which funds should be managed internally and which externally.

There was a brief discussion among the members, and many members thanked Mr. Moise for his all-inclusive attitude and preparation when appearing before the committee. Some members asked questions regarding the SIC interaction with the attorney general on legal matters, specifically any possible recovery of lost fees. Mr. Moise said that he had met with Attorney General Gary King on three occasions over the past 90 days. He added that the Attorney General's Office is cooperating with the SIC in terms of searching for recovery counsel and regarding the issue of participation in a class action suit for recovery. He noted that the SIC legal staff would be leading the recovery effort.

Mr. Moise advised the members that he is looking very carefully at the internal operations of the SIC office. He said that how much, if any, money might be recovered as a result of litigation is difficult to assess. He noted that the SIC has spent over $11 million in legal fees in the past year. He added that the SIC does not want to repeat that type of expenditure, but it could happen. He said that $5 million has been spent in the past year on the Countrywide litigation, noting that it was not risk management money, but came out of the SIC budget. In response to questions concerning how the SIC will pay for the legal expenses directed toward recovery, Mr. Moise said that the SIC is issuing RFPs for legal services on a contingency fee basis. The attorney general has concurred that the SIC can pay an appropriate contingency fee, which will not provide a windfall for the chosen legal firm.

Some committee members inquired as to the SIC's ability to charge those who request the production of documents pertinent to the investigation. Charles Wollman, the SIC's public information officer, said that the SIC cannot charge for the document production pursuant to New Mexico public records law. He further clarified that it can charge for costs it deems excessive, noting that many of the requests for documents number in the hundreds to the millions. He said that the SIC can charge up to $1.00 per page, but that amount does not cover the costs associated with copying, storing on a database and producing the documents resulting from the numerous requests. Members asked if Mr. Wollman knew the total cost for the production of all the information. He said that he could not estimate the cost; however, he noted that the SIC is trying to work with requesters to shrink the requests down to a manageable size. He said that some of the requests have been so broad that the SIC has had to go to court to decipher exactly what it needed to provide.

There was a brief discussion regarding the 8.5% benchmark target of the SIC for its investments. Some members questioned the validity of the benchmark. Mr. Moise noted that it is being studied, and there is a reasonable chance that a reduction could be recommended. He added that the losses from the Countrywide deal exceed $100 million. When asked by members if the legal counsel representing the SIC in the Countrywide litigation was working on a contingency basis, Mr. Moise replied that it was not. The discussion continued and emphasized some members' concerns regarding the SIC governance statute as it applies to individuals selecting their own legal counsel, which is then paid for by the state. There was a discussion about obtaining an insurance policy for the payment of such legal fees. Mr. Moise stated that the SIC intends to review its legal representation policy to reduce its exposure to legal fees. He added that the policy review should be ready for action by the council at its July 27 meeting.

The discussion returned to the 8.5% gross of fees rate of return targeted by the SIC. Some members asked if it would be beneficial to bring all of the state's investments together, creating economies of scale. Mr. Moise noted that the EnnisKnupp study mentioned that scenario as a possibility, and it was a point deserving of further study.

Mr. Moise next turned to the subject of the EnnisKnupp fiduciary review completed for the SIC. He advised the members that the review included a total of 82 recommendations, six of which have been addressed by the passage of Senate Bill 18, leaving 76 other recommendations remaining. Of those remaining recommendations, two have been completed through the work of the SIC and the committees, and about 23 are currently being addressed and may be revised. He noted that there were 28 recommendations that are not under active consideration by the SIC and will be subject to partial action or additional review or require a statutory change. He assured the members that none of the 82 recommendations are being ignored. His comments were followed by a brief discussion regarding how the SIC is prioritizing its evaluations and actions concerning the recommendations. Mr. Moise noted that, in his recollection, the priorities were established by EnnisKnupp. He noted that any action would likely be completed within the next 12 months. This led to some questions from the members regarding the SIC and its internal and external managers.

In closing, Mr. Moise advised the members that the 15% limit on international investments is a limitation that the SIC would like to change and that it will probably be seeking legislation to accomplish such a change.

Overview of the SIC's Economically Targeted Investment Program: Specific Program Components and Investment and Economic Returns for Individual Projects

Mr. Moise introduced Greg Kulka, director of private equity and economically targeted investments for the SIC. Mr. Kulka has been with the SIC for nearly nine years and is responsible for the international and New Mexico private equity programs, as well as the film program. Referring to the handout, Mr. Kulka noted that the first page contained a list of all the outstanding film projects. The total amount outstanding is just over $97 million in loans, with the total capacity being 6% of the fund total, according to statute. Mr. Kulka explained that, pursuant to policy, when a film is approved for a loan, the approval is good for nine months. If something happens and the film project cannot meet the nine-month requirements for the loan, it will not close. Currently, the remaining capacity is $81 million. He added that a list of all the loans that have matured or been paid off is included in the handout. He noted that $147 million has been expended on the loans. A list of loans that were approved but never closed and an accounting estimating the economic impact resulting from the loans are also in the handout. He noted that one of the requirements for receiving a film loan is that 60% or more of the production crew must be composed of New Mexico residents. Additionally, it is required that 85% or more of the film be shot in New Mexico.

There was a discussion among the members concerning whether providing 0% loans is impacting the state in a positive fiscal manner. Some members asked if the state is getting profits on the back end after the movies are released. Mr. Kulka said that the state receives a percentage that is applied to the adjusted gross profit of the films. The exact amount is negotiated on a contract-by-contract basis. Mr. Kulka opined that the real reason filmmakers are coming to New Mexico is for the tax credit. He said that the limit placed on film loans is $15 million, generally making it useful when applied to a film with a $15 million to $20 million budget. Usually, this means an independent film. He said that there has been an ongoing effort to participate in larger budget films, but those films generally get funding through studios and have plenty of access to financing. He highlighted the fact that the movie *The Book of Eli*, which grossed about $120 million and is a film the state was able to participate in, will likely reap good returns as a result of that participation. When asked how long New Mexico can anticipate receiving money, Mr. Kulka said the state could still be receiving checks 25 years from now.

The members discussed whether the state could achieve a better benefit if interest is charged on film industry loans. Many members voiced their desire to have more information, enabling a better understanding of the true economic impact of the film loan project, particularly as it relates to job creation. When asked whether the film loans are a good investment, Mr. Moise declined to answer, saying that it was a legislative decision to create film loan statutory provisions and that the SIC merely implements those provisions. Some members noted that perhaps the film loan policy needs to be scrutinized, particularly in economic times when the legislature could be asking taxpayers to pay more in taxes. It was noted that in the recent *Governing Magazine*, many states are beginning to question the economic returns from film industry incentives. Mr. Moise pointed out that the film loans are not mandated by statute; rather, they are allowed. The point was made that statutory changes created the Private Equity Investment Advisory Committee (PEIAC), which has not yet been constituted. Mr. Moise said that the SIC is in the process of naming the members and that Mike Martin has agreed to be the chair. Some committee members suggested that any future film loans be placed on hold until the PEIAC can assess each film project. Finally, upon questioning, Mr. Kulka said that there have been no loan defaults on any of the film loan projects.

The committee recessed for lunch.

Representative Heaton reconvened the meeting at 1:30 p.m. The members were directed to the handout, prepared by Sun Mountain Capital, providing an update on the New Mexico Private Equity Investment Program. Mr. Kulka said that $250.5 million has been drawn against the statutory cap of $319.4 million. He added that there has been a freeze on new commitments and that the freeze was instituted in the fourth quarter of 2008 due to market volatility and declining market valuations, which continued through 2009. He opined that he is optimistic that the program could begin making new commitments by the third quarter of 2010. Mr. Kulka told the committee that financial performance has been negatively impacted by the market conditions. He said the private equity markets generally lag behind public markets by six to nine months, as private investors digest the effect of market conditions at a slower pace than public market investors. Mr. Kulka directed the members' attention to the handout, which indicates that the program performance has consistently exceeded its benchmarks since 2004. He also noted that the handout illustrates the significant impact of the New Mexico Private Equity Investment Program. The handout also lists the seven New Mexico companies that have been funded by the program. Some members asked for more information about those companies; for example, how many employees they have and what the companies' financial values are. There was some speculation that some of the information sought could be considered proprietary in nature or inappropriate for public disclosure. Most members agreed that it is critical to have information regarding companies in which the state is investing.

Paul Goblet, New Mexico Small Business Investment Corporation (SBIC), noted that he had come before the committee four years ago and welcomed the opportunity to speak again. He reminded the members that the SBIC was created by legislation in 2000. He said that the SBIC now gets $47 million, or 1%, of the severance tax fund. He added that the SBIC is structured like the SIC, with six public board members appointed by the governor. He added that the goal of the SBIC is to be a cost-effective conduit of capital for small business, noting that it does not make direct investments. He told the members that the average loan amount is $11,000, and the largest loan was for $300,000. Again, the discussion turned toward the topic of the proprietary information and disclosure concerning businesses that have benefited from loans and programs such as those offered by the SBIC.

ERB: Recent Reforms in Board Governance; Investment Policy and Investment Operations Management; New Legislation; the EnnisKnupp Fiduciary Review; Other Agency Initiatives

Jan Goodwin, executive director of the ERB, led a discussion regarding the EnnisKnupp ERB-related recommendations. She began by noting that there were no recommendations made regarding the membership composition of the ERB board. However, EnnisKnupp offered 57 recommendations, which the ERB staff has been reviewing and analyzing. Referring to the handout, Ms. Goodwin highlighted the pertinent recommendations. She noted that the ERB already conducts fiduciary training on a regular basis. One of the recommendations was that the ERB should seek a statutory provision that would revive an exception to the Open Meetings Act regarding discussions of investment of private equities. However, Ms. Goodwin told the members that it is the position of the ERB, at this time, that the recommendation not be pursued. She also said that it had been recommended that the ERB no longer be subject to the state personnel rules relating to hiring practices and that the ERB be removed from the budgetary authority of the legislature.

There was a general discussion regarding the recommendations made by EnnisKnupp.

Some members noted that the recommendations seemed broad and applicable to virtually any state agency. Ms. Goodwin noted that some of the recommendation concepts involved policies that were already in place at the ERB, but EnnisKnupp recommended that the ERB more clearly spell out those policies.

PERA: Recent Reforms in Board Governance; Investment Policy and Investment Operations Management; New Legislation; the EnnisKnupp Fiduciary Review; Other Agency Initiatives

Terry Slattery, executive director of the PERA, introduced some of the PERA board members that were present in the audience. He told the members that there were no recent reforms to the PERA board governance, but that training had been held at the board's recent retreat. The training involved the use of an independent fiduciary services firm that provided the board's training at the end of May 2010. He summarized the details of the training by noting that there was a difference between a named fiduciary and a deemed fiduciary and compliance with the fiduciary responsibility. He said that the training emphasized the concepts of loyalty to the plan, the system and the members, as well as the duty to act in a prudent manner and follow the rules, the statute and any policies in place. He also stated that a failure to comply with fiduciary duties is, by definition, a breach of fiduciary duty.

On the subject of EnnisKnupp's recommendations pertaining to investment policies, Mr. Slattery noted that the PERA had strengthened its investment policies, citing a decrease in its exposure to public equities from 60% to 54%. He said that the PERA is searching for new managers, specifically, a small cap manager, and later, a large cap manager. As a result of the EnnisKnupp study, the PERA received 49 recommendations, 42 of which the board is either in agreement with or considering.

There was a discussion concerning part-time temporary employees returning to work at the state agencies. Mr. Slattery explained that the way the law is written, there is no distinguishing difference in hiring employees back on a part-time or full-time basis; the employee must suspend the employee's pension. He added that perhaps this was an unintended consequence of the statutory change. The PERA's legal counsel recommended that the legislature consider reinstating an earnings cap of $25,000 per year so that agencies could hire personnel, such as crossing guards, swimming pool employees, poll workers and similar types of employees.

Representative Heaton adjourned the meeting at 4:00 p.m.