MINUTES OF THE
NEW MEXICO STATE INVESTMENT COUNCIL
Santa Fe, New Mexico
February 22, 2005

ROLL CALL

A regular meeting of the New Mexico State Investment Council was called to order on this date at approximately 9:15 a.m. in the Governor’s Cabinet of the State Capitol Building, Santa Fe, New Mexico.

Introduction of Guests followed Roll Call:

Members Present:
Mr. Gary B. Bland, State Investment Officer
Mr. Patrick Lyons, Commissioner of Public Lands
Mr. Robert Vigil, State Treasurer
Mr. Andrew Davis, Public Member
Mr. David Harris, Public Member
Mr. Ike Kalangis, Public Member
Mr. Michael Stanford, Public Member

Members Excused:
Hon. Bill Richardson, Governor of New Mexico
Mr. James C. Jimenez, Secretary, DFA

Legal Counsel Present:
Mr. Zachary Shandler, Attorney General’s Office

Staff Present:
Mr. Julian Baca
Ms. Lorri Espinosa
Mr. Stephen Jerge
Mr. Greg Kulka
Mr. Scott Smith
Mr. Charles Wollmann

Guests Present:
[See Guest List.]
INTRODUCTION OF GUESTS

Following introduction of guests, Tom Bonafair, a member of the Private Equity Investment Advisory Committee, introduced former SEC chairman Arthur Levitt. Mr. Bonafair commented, “In my judgment, he is a giant in the financial industry, particularly when it comes to protecting the rights of the small investor…. and he is a remarkable man who has stood by his principles.”

APPROVAL OF AGENDA

Mr. Davis moved approval of the Agenda, as published. Mr. Kalangis seconded the motion, which passed 7-0 by voice vote.

APPROVAL OF MINUTES: January 25, 2005

Upon motion by Mr. Davis, seconded by Mr. Stanford, the Minutes of the January 25 meeting were approved, as submitted, 7-0 by voice vote.

ADDRESS ON CORPORATE GOVERNANCE BY ARTHUR LEVITT

Mr. Levitt stated that, although retired, he remains involved in a number of activities, including being advisor to The Carlyle Group and the City of San Diego, consultant to the National Hockey League, and a director of the Bloomberg Communications Company, for which he does a weekly TV/radio show.

Mr. Levitt said he has a particular interest in what the SIC does, because his father was New York State Controller for 24 years, his mother was a schoolteacher for 38 years, “and I grew up learning about the primacy of the pension holders, of the importance of my mother’s retirement and what it meant to her. When my father became State Controller, it was like a parish priest becoming pope in our family, and his tenure was marked by fierce dedication to nonpartisan principles, placing the interests of the pensioners ahead of all political considerations. When New York City was about to go broke, they importuned him to dedicate the resources of the State Retirement Fund and the Teachers Retirement Fund, over which he was the sole custodian, to invest in New York City bonds, and he refused to do so. And he created a terrible fight. He prevailed; he was obviously right in maintaining those principles.”
“A lot’s happened in New York since that time. The notion of keeping investments apolitical has largely disappeared, and the kinds of investments you see in their portfolio, and the kinds of investments you see in portfolios similar to that all over the country, have at least a semi-social purpose character. Now, I have no problem with societal interests, obviously; but I do have a problem personally where they don’t represent the best bottom-line deal for the recipients of that pension. And when the State of New York buys into certain funds that we simply would not invest in prudently, when they make judgments that are political judgments, when the staff of CalPERS, for instance, has made certain recommendations about certain issues, and their board overturns them, I have a problem with that. I don’t think their pension holders are being well served by that. I understand those problems, and I think very few of us are immune from them. I’d be glad to enter a dialogue with all of you about this; it deals with certain special issues.

“For nearly fifty years, this Council has looked to the future, taking the natural wealth of New Mexico and investing it to ensure that New Mexicans can benefit from this bounty for generations to come. And you’ve done well, and your commitment to the people of New Mexico and the Land of Enchantment can’t be questioned….

“My concern about the individual investors of America has been the erosion of ethical values in corporate America, which is not unique to the past fifteen years; we’ve had other periods often fueled by the same events — fueled by a runaway bull market, where virtually all the gatekeepers were asleep at the switch. It wasn’t just Arthur Andersen and Enron. It’s too easy to pass it off on Arthur Andersen, and their demise I regard as a national economic tragedy that did not have to happen. The government put them out of business, and we’re all paying a price for that today. But the lawyers, the regulators, the boards of directors, the rating agencies, the standard-setters were all asleep at the switch, and all conspired to bring about that event and the WorldComs and the Adelphias and those that are yet to come.

“And the job right now is not to beat up on business and say that we are a country filled with corruption and venality and that our business leaders are a bunch of crooks. They aren’t. But all of us, including our investors, who believe that the brokers who saw every decision they make work out, the analysts saw every stock they recommended go up in price, the companies that were underwritten at a hundred times nothing, and investors who bought into that saw them rise to three hundred times nothing — well, they deserved to lose their money, and we are now paying the price for that.

“Is it all behind us? Can we rest easy now that the SEC budget has been trebled, now that Eliot Spitzer has mounted his campaign, now that other state securities regulators have gotten into the act? No, we’re always going to have a
certain amount of wrongdoing and a certain amount of corruption. But the culture of the boardroom has changed in America. I’ve served on many, many boards of public and private companies, and, by and large, they operated under a culture of seduction. You didn’t go on a board unless you knew the chairman; you didn’t go on a board unless you knew the other members. But if you ask yourselves, if we went back fourteen years and you were invited to go on the board of a Fortune 50 company that would pay you $100,000 a year, that would meet in luxurious places, sending you to the meetings on corporate aircraft, you probably would have listened very carefully to an invitation from the management of Enron to go on that board. And it was a culture that was fraternal, and that’s just wrong.

“A board has to represent a natural tension between the interests of the board and the interests of the management and the interests of the shareholders. And you, as custodians of state funds, have got to understand the nexus between good governance and good results, and there is a clear nexus of companies that operate under a culture of seduction and companies where the boards are truly independent, that respect the difference between management and board lines of control but nevertheless operate under a culture of skepticism. There has been a tremendous power shift in the boardroom. Clearly, the audit committees are the controlling factors in most well run companies in America today. The audit committees pick the auditors. The auditors are no longer subservient to managements. I’ve been at board meetings where the auditors have come in and presented a problem, and management just ran all over them on that issue. Doesn’t happen very often today. And what’s really unique is that this has taken place in private companies and in nonprofits as well. I’m on the board of the Rand Corporation in Santa Monica. Our audit committee used to meet for 15 minutes twice a year up until four years ago. We now meet four times a year for three hours. This is a nonprofit. And this is being mimicked all over America today, and I think that’s healthy.

“You as the investors have got to have conversations with your gatekeepers, with your investment advisors and ask them the tough questions, that I think are entirely appropriate for you to ask them, about what is good governance. Good governance is not a situation where the board of directors is interfering with management; that’s poor governance, in my judgment. What’s happened in the past five years in America has given rise to enormous costs in terms of evaluating whether corporate managements are complying appropriately with Sarbanes-Oxley, where the boards are truly independent, where their mutual funds are doing the right things. The key word here is balance. I don’t consider this some kind of cowboy mentality where investors will run roughshod over corporate America, but I do think there are legitimate areas of conflict that must be debated.

“I personally believe the battle being fought today to roll back the FASB — that’s the independent accounting standard setters — efforts to account for stock
options is wrongheaded. The biggest problem we have in America today is restoring public confidence in the business community. You can’t have great markets if those markets lack public confidence. Most of the really good companies in the United States have already decided to expense stock options. The downside of expensing them is nonexistent, in my judgment. The issue has been decided; to fight it today is absolutely wrongheaded, and to see Congress rolling over the FASB — there’s a bill in Congress that would roll back the FASB’s recommendation — I think would be totally outrageous.

“There are two issues in America that defy the political process. One is closing military bases. Congress cannot do this. You have to do it independently, and we’ve done it successfully independently. And the other is setting accounting standards. Once you get Congress into the act of setting accounting standards, you’ve created a hopeless political mishmash. So I hope that the FASB’s independence will be fiercely protected. The efforts to roll back Sarbanes-Oxley at the present time I believe also represent an assault on the public interest. There is no piece of legislation that I’ve ever seen on either the state or federal landscape that doesn’t have unintended consequences. Obviously, Sarbanes-Oxley has some of those consequences, but we’ve got to give it time to work, and some of the aspects of it are terribly important. So I think the efforts of the Chamber of Commerce, and some of this you may not even have heard of, to roll back certain SEC initiatives, are just wrong. We shouldn’t have a situation with the business community on one side, the SEC on the other side, the institutional investors on the third side, all fighting one another. Investors are going to lose in that scheme. The Chamber of Commerce has opposed an SEC regulation to have mutual funds mandated to have independent directors as the head of their boards. One of your members, Mr. Davis, has already on his own made that change in the structure of his board. But for the Chamber to oppose the SEC on something as arcane as this just goes against investor interests. The scandals of this era have empowered institutional investors.

“You, your counterparts at CalPERS, New York State, at TIAA-CREF, on whose board I sit — have a vast opportunity today to change the investor landscape and change it for the better. If you sit back and let this opportunity pass, if you don’t flex your muscles in terms of getting what’s right for your investors, what’s right for America, you will have passed up the greatest opportunity we have to collectively restore public confidence in our system, to protect the rights of individual investors and the people who benefit from your resources and your judgment and your wisdom and your commitment. So you’ve got a lot of pressures on you; I’m well aware of that, but I feel very strongly about these issues.”

This concluded Mr. Levitt’s presentation, and he stood for questions.
Mr. Bland asked Mr. Levitt what other entities besides TIAA-CREF are taking a leadership role in protecting shareholders.

Mr. Levitt responded that some state funds are doing a better job than others — he could perhaps name four or five, but the Council of Institutional Investors "does a pretty good job in that regard."

Mr. Bland commented that the SIO tends to largely rely on its investment managers to make investment decisions, seeing proxy decisions as an integral part of that, and prefers not to interfere without guidance from the Attorney General’s Office. He asked Mr. Levitt if Congress, given recent events, should involve itself in mandating corporate governance policies, including proxy voting policies.

Mr. Levitt responded, "I don’t think Congress should get involved because you’d really politicize the process. I’d want Congress to stay as far out of this as possible. I think it would be legitimate for you to consider not the whole landscape, but embrace certain issues of independence and governance that you believe are important to you."

Mr. Levitt suggested convening a daylong meeting with a cluster of investment managers to get general guidelines from them on how they vote proxies and how governance relates to performance. He said he would be pleased to set up such a presentation.

In discussion, Mr. Levitt said the under-funding of pensions "is on the track now, and it will be a worst situation than the banking scandal a few years ago… It is almost criminal, and Congress’s willingness to go along with that and deceive the American public about the pension assumptions is really a national scandal."

Mr. Davis commented that the hedge fund community is a direct competitor for funds and for investment talent, and asked Mr. Levitt if the hedge fund community would be “the next shoe” to fall after mutual funds — in other words, did he have a sense of how regulation over hedge funds would improve over periods of time.

Mr. Levitt responded that, as someone who ran a large brokerage firm as well as a stock exchange, "my experience has been that, as soon as the flavor of the month appears and everybody goes into it, watch out. Today, almost anybody I know that has been fired from a brokerage firm or is fresh out of business school, what’s he or she doing for a living? They’re working for a hedge fund or a private equity firm. So that tells me be careful.

"I think hedge funds represent a very positive influence in our markets, but also a very dangerous factor in not overseeing them. I think the SEC’s approach
is not to be heavy-handed in terms of over-regulating hedge funds, but, rather, to call for disclosure and for the right to inspect those funds. Right now, I don’t think we should go much further than that…. I do believe you will see hedge funds go out of business, lots of them, but I don’t think it represents a systemic risk, in my judgment.

“With private equity funds, everyone and his uncle has started a private equity fund, and I think you’ve got to be very careful about the kinds of private equity funds that you invest in. My own personal view of the markets, and I’m an investor and I’m heavily involved with Carlyle, so I speak with a certain amount of bias, but I don’t know that lots of money is going to be made on stock markets in the next ten years, and when friends are always asking me how to invest, I think, don’t pick individual stocks — fire your broker and invest in a low management fee index fund. I think that’s the way to play the equity game, and I think private equity involving international investments and real estate and a host of things that private equity does, that’s a pretty good place to be, as well.

“I’m not afraid of systemic danger of under-regulation of hedge funds. I think we’re doing what we should be doing, and not much more is necessary right now.”

Mr. Davis asked Mr. Levitt if he thought it possible to “cookie-cut” an appropriate technique or style for managing corporate governance. He cited Berkshire Hathaway as a tremendously successful example of corporate governance with poor ISS scores.

Mr. Levitt responded, “You cannot set a formula and say this company does it and this company does not. And this is where CalPERS went off the tracks, and I discussed this with them. You’ve got to pick your fights… and CalPERS lost some measure of credibility when they attacked Warren Buffett. He’s not perfect and he’s not an angel, but he’s one of the best we’ve had, and there shouldn’t be a formulaic approach to what governance is. It’s the spirit of governance.”

Asked what he thought of Eliot Spitzer and others like him, Mr. Levitt said he thought Mr. Spitzer had performed a great public service, and he would strenuously oppose efforts to do away with state regulation of the investment business and leave it up to the feds: “We need the cop on the beat. We need the individual in the trenches. And we need a cooperative effort between the SEC and state securities regulators to adequately protect investors. Most people think that the SEC or Eliot Spitzer has a legion of investigators out there routing out wrongdoing. They don’t; 85 percent of the cases of the SEC come from tips.”

Commissioner Lyons asked Mr. Levitt to discuss his relationship with Federal Reserve Chairman Alan Greenspan and the interest rate environment.
Mr. Levitt responded that interest rates will go up, and he has huge respect for Mr. Greenspan, whom he has known for 40 years, although he thought his support of President Bush’s proposed tax cuts was wrong, given that Mr. Bush is “the greatest deficit creator in the history of this country.”

Commissioner Lyons asked Mr. Levitt to comment on recent efforts to remove the legal list and go with the Prudent Investor rule.

Mr. Levitt responded that he thought that an appropriate move to make, in general, but comes with a much greater responsibility: “You’ve had a great shield… and you’ve been protected. You’re going to lose that protection, and maybe it’s not you, but it’s your successors who are going to face some problems because they didn’t do the right thing. And I think the risks to your fund are much greater by keeping a shield at a time when the landscape has changed so dramatically."

Responding to additional questioning from Commissioner Lyons, Mr. Levitt said he would oppose any efforts that would deny investors the right to protect themselves by having to pay litigation costs should they lose a suit, because that would effectively disenfranchise poor investors who most need the protection. Mr. Levitt said investors in America have three basic protections: self regulation of the stock exchanges; the enforcement arm of the SEC, and private rights of action, or the right of citizens to sue. He said he thought the system of having trial lawyers benefit at the expense of investors could be improved, but he would do it very carefully. He commented, “I have intimate knowledge of just about every market in the world, and with all of our problems, we still have the best regulated, the fairest, the most liquid markets in the history of the world, even with our very litigious society.”

**DISCUSSION AND VOTE ON REVISED TRADE APPROVAL POLICY.**

Mr. Kulka called attention to a draft and final version of the Trade Approval Policy, which is what the SIC uses for trading within the agency. He said that, generally speaking, a trade must be executed by a portfolio manager and then approved by someone else, and this policy breaks down the different kinds of trades and who must give approval. Mr. Kulka explained that the Director of Equities has been eliminated from the Equity Trades category, since the job title is obsolete, and that is the sole change.

Mr. Kalangis moved acceptance of the revised Trade Approval Policy for the SIC Investment Division. Mr. Stanford seconded the motion and it passed 7-0 by voice vote.
DISCUSSION AND VOTE ON EMPEIRIA CAPITAL FUND, L.P.

Marcellus Taylor, associate with Aldus Equity Partners, introduced Empeiria Capital Fund founding partner Alan Menkes. He said Aldus is recommending a $25 million investment in this Fund.

Mr. Taylor stated that Aldus’ due diligence has revealed that Empeiria “is one of the strongest and most experienced middle market private equity firms in the marketplace today.” He said the team consists of investment professionals hailing from Hicks Muse, The Carlyle Group and Thomas Weisel Partners, and there is a significant amount of cohesion among team members, which Aldus found particularly attractive, notwithstanding the fact that this is their first institutional fund.

Mr. Taylor continued, “From an investment focus standpoint, consistent with our strategy on reducing risk for the entire portfolio, we like the fact that they have a value-driven model that’s focused on investing at the lower end of the middle market. What’s attractive about that strategy is that it encompasses much less competition that a lot of the larger mega buyout firms face in terms of pursuing deals.” He said they have been investing in private equity transactions since the early 1990s to the tune of over $900 million in 25 platform companies, and have achieved top quartile performance throughout the life of their investments, generating historical returns of some 35%.

Mr. Taylor stated that there are four partners, two of them operating partners and two of them deal partners. He said the two operating partners have very strong fundamental operating experience and “cut their teeth” at companies such as Rockwell International, Litton Industries, ITT and others.

Speaking to the fact that this fund has a much lower risk investment model because of less competition, Mr. Taylor said this results in lower valuations “and the fact that they maintain an operating approach to improving value for the portfolio companies results in them not having to rely on financial engineering.”

Mr. Taylor stated that this investment is consistent with Aldus’ focus on shifting capital away from more speculative VC investments and into models like Empeiria’s, and from a portfolio management standpoint “this will make a nice fit for the portfolio.”

Mr. Menkes provided a brief overview of the fund. He said Empeiria plans to focus on lower-end middle market companies with $10-$30 million of operating income.
Mr. Davis stated that he did not attend the PEIAC meeting when Empeiria was discussed, so could not speak to this recommendation.

Mr. Bland, a member of the PEIAC Committee, recalled that the Committee did not express any concerns about this investment, and that he and member Tom Bonafair were strongly in favor of Empeiria's approach to individual management organizations and thought this investment would provide balance to the portfolio.

Mr. Taylor noted that Aldus discovered some concerns in the course of their due diligence, however. He added, “Any time you’re investing in a first-time fund, there are naturally going to be some concerns about the level of continuity that exists within that fund, but that was mitigated in our minds by the fact that this team has been investing together collectively since the early 1990s, and the fact that they’ve actively led investments of more than $900 million some 20 different platform companies, and have a track record that gave us a lot of comfort that they’re well prepared to manage this fund successfully.”

Mr. Davis observed that the breakdown in investment performance in Aldus’ report reflected a period when a lot of investments were made in technology at what would appear to be the worst time for that, at least in terms of the results.

Mr. Menkes explained that he was co-heading a private equity group at Thomas Weisel Partners at the time, which raised a $1.3 billion fund in 1999. He said, "Frankly, I think one of the reasons a number of us left was that we felt that the model wasn’t conducive to being able to say, we’re not going to invest any capital during this period of time, because the model that had originally been set up was that we were all partners of the firm and not of the fund. The majority of the economics in the fund resided with bankers and traders and sales professionals, and there was a significant amount of pressure in that model to deploy some capital. I can say that we turned down a hell of a lot more than we invested, and the pace was fairly active, but we probably turned down nine out of ten opportunities that we saw."

Mr. Bland moved approval of a recommendation to commit $25 million from the National Private Equity Program to Empeiria Capital Partners, L.P., subject to negotiation of final terms and conditions and completion of appropriate paperwork. Mr. Vigil seconded the motion.

Mr. Bland commented that the caveat that the PEIAC/SIC regularly includes in their investment recommendations (“subject to negotiation of final terms and conditions and completion of appropriate paperwork”) can sometimes become a protracted process — the terms and conditions of some investments recommended several months ago are still being negotiated by the consultants.

The motion passed 7-0 by voice vote.
DISCUSSION AND VOTE ON BRIDGEPOINT EUROPE, III, L.P.

Marcellus Taylor, associate with Aldus Equity Partners, introduced Graham Dewhirst, a partner from Bridgepoint Capital Partners, a European-focused private equity firm based in the U.K.

Mr. Taylor said Bridgepoint “is regarded as one of the premier pan-European middle market private equity firms in the country,” with more than 40 investment professionals operating out of two offices in the U.K. and offices in Italy, Germany, France, Spain and Sweden. He said Bridgepoint invests opportunistically across the entire Western European continent.

Mr. Taylor stated that, although Bridgepoint is focused on the middle market—a space that Aldus recommends in terms of less competition—they are raising €2 billion in capital for their third institutional fund. He added that, although Bridgepoint doesn’t target specific allocation percentages in specific countries, they have an opportunistic approach that results in “a very diversified basket of investments across various countries and various industries.”

Addressing their track record, Mr. Taylor said Bridgepoint has invested €4.0 billion in the European middle market over the last 14 years: “What we really liked about this group is they have demonstrated a strong ability to drive exits. They’ve actually exited out over 200 different investments, with an IRR of over 29%, which clearly puts them in the top quartile for their respective vintage year performance.”

Mr. Taylor said Aldus also found the cohesiveness of the team to be “incredibly attractive”—Bridgepoint has 18 partners and 18 directors, and all of the partners have an average of 17 years in the firm. He said Bridgepoint was named “Middle Market Buyout Firm of the Year” by a leading European private equity publication.

Addressing the portfolio, Mr. Taylor stated, “We want to invest internationally in terms of the private equity portfolio, and really felt like Bridgepoint provides the best conduit for us, tapping into a diverse portfolio, largely because of the pan-European approach.” He said Bridgepoint has a very active investment model, taking an operational approach to improving the underlying performance of their portfolio companies.

Mr. Taylor said, “When you think about diversity of investments, less competition and lower valuation and a very strong proactive approach on driving value, we think those are all of the attributes that are consistent with what we’re looking for in terms of investing the portfolio. For the international budget, which
is what we’re filling with this particular investment, we think Bridgepoint surely is a best of breed investor.”

Mr. Dewhirst provided a brief overview of Bridgepoint. He said Bridgepoint has been in the private equity business since 1984, and he is a “relative newcomer,” joining the firm in 1988. He said, “We are a firm that has very much stuck to what we believe we’re very good at, which is investing in the middle market.”

Mr. Dewhirst said that Fund III, which could be a little higher than €2 billion, will all go into 25 to 30 different middle market businesses, with a spread of geographies and a spread of industries that will provide the desired diversification.

Mr. Davis reported that the PEIAC spent a reasonable amount of time discussing this investment, and he had a couple of concerns.

Mr. Davis said the term “pan-European investment firm” seems to imply that Bridgepoint will have partners based in different countries who, “despite the lack of opportunity in that country at a particular point in time, may be trying to force a deal through because it’ll make his or her record look better.” He noted, though, that Aldus refers to Bridgepoint “as a single European team,” and asked for clarification.

Mr. Dewhirst responded by citing Mr. Taylor’s point that Bridgepoint does not pre-allocate its fund market to market, so there could well be relatively long periods where Bridgepoint, as a group, does not find the right quality opportunity. He pointed out, for instance, that Bridgepoint just completed its first deal in the Nordic market after spending three years looking at almost all of the middle market deals available there and concluding that none was appropriate.

Mr. Dewhirst also stated that Bridgepoint “shares everything, so that if we have a part of our business that are not making investments, that’s not a concern for them because they will have a share of the fund as a whole to reward performance. And that’s something that’s been in place in Bridgepoint for a long time, and we hope, through that, it actually eliminates this sort of pent-up feeling which inevitably people get that they want to do deals, they want to feel they’re contributing. If we don’t have the right deals in this particular market, we won’t do them.”

Mr. Taylor said he and Saul Meyer went to Europe to conduct due diligence on Bridgepoint, and visited their offices in Italy, where there has been a huge influx of capital for investments solely in the Italian market, making the private equity market there very competitive. He said, “We wanted to understand how they’re going to respond in the event that it’s just not prudent to invest in that
market, and what we found really attractive was the fact that they actually cross staff deals across countries, so if there is a situation where they’re on the sidelines in one particular country, that team isn’t sitting idle; they’re actually working on deals in other parts of the Continent, so there is really a true spirit of a one-firm approach.”

Mr. Davis pointed out that 94 of Bridgepoint’s 97 recent realizations have been sales to other companies instead of IPOs, which seemed surprising yet impressive, particularly when coupled with the fact that Bridgeport focuses more on the operations of a business than just trying to lever up the returns. He commented that he found this “remarkably unique.”

Mr. Dewhirst agreed that this was unique, but added the caveat that Bridgepoint invests in middle market size transactions, so if they buy a business valued at $100 million and double it by the time of exit, it still isn’t big enough for an IPO. He said Bridgepoint builds businesses for strategic acquirers, not to undertake an IPO.

Commissioner Lyons asked what the SIC’s portfolio limitation is on international investments, and Mr. Bland clarified that this investment doesn’t fall under the limitations of private equity diversification constraints. He added that, if the SIC wished, it could allocate the entire 6% private equity piece of the portfolio into overseas investments, although certainly that is not consistent with the approved private equity policy guidelines.

Mr. Taylor stressed that Aldus would never recommend that anyway: “What we’re trying to do is increase the overall risk-adjusted returns for the portfolio, so in this environment where the U.S. is actually experiencing some period of distress, having some portion of your portfolio invested internationally actually makes a lot of sense. What we’ve recommended for this particular portfolio is a 10%-20% allocation [of the 6%] to private equity buyout funds that are based internationally and have the bulk of their investments geared toward Western Europe.”

Commissioner Lyons asked what percentage this investment would be out of the total package of private equity, and Mr. Bland responded about 4%.

Mr. Bland pointed out that the State Investment Council inherited a large group of primarily venture capital funds of various sizes, and Aldus is now diversifying the portfolio to move it into more “cash-generating” funds and trying to balance the portfolio with some international balance and exposure in an effort to mitigate risk.
Commissioner Lyons asked what the exchange rate is today, and Mr. Kulka responded that the €30 million recommendation for this fund is equal to about $40 million.

Mr. Bland said the recommended commitment would be in euros, however.

Mr. Bland moved approval of a recommendation to commit €30 million from the National Private Equity Program to Bridgepoint Europe III, L.P. subject to negotiation of final terms and conditions and completion of appropriate paperwork. Mr. Davis seconded the motion and it passed 6-0 by voice vote. [Mr. Vigil was not present during this action.]

INVESTMENT PERFORMANCE FOR 2004: NEW ENGLAND PENSION CONSULTANTS

Mr. Bland reported that NEPC’s contract is about to expire, and the SIO will be issuing an RFP in April. He pointed out that, of the national consulting firms that have been brought before the SEC or questioned by New York State Attorney General Eliot Spitzer or some other legal entity, New England Pension Consultants has yet to be brought up in terms of perceived or actual improprieties. He congratulated NEPC and stated that SIC staff plans to “weigh in heavily on the ethical standards issue when we evaluate that contract.”

NEPC partner Allan Martin reviewed the fourth quarter 2004 investment report.

Mr. Martin remarked that 2004 was a good but not spectacular year economically: the GDP was up 4%, retail sales were up strongly, business investment started to revive, at year end oil prices had dropped into the 40s and then picked back up, the Fed increased interest rates twice in the fourth quarter, the deficit exceeded $400 billion, and the dollar had declined significantly versus foreign currencies.

Mr. Martin said equity and bond markets did quite well in the fourth quarter, with expectations of a continued recovery. He noted that the S&P 500 for the quarter was up 9.2% (not annualized), and the State was rewarded in that quarter for taking risks, including in the emerging markets, which were up 17.2% for the quarter, making emerging markets the number one performing market for the second year in a row. He noted that most of the returns to the State were generated in the fourth quarter.

Looking at bonds, Mr. Martin noted that the Lehman Bros. Aggregate in the fourth quarter generated 1%, or about 4% annualized. He said, "Essentially what you got out of longer bonds was the coupon, and that is our sense of what’s
going to happen going forward; as interest rates rise, you will not experience capital gains in bonds. You will essentially earn the coupon, and the level of coupons is roughly in the 4% range."

Mr. Martin said that would impact the SIC’s strategy because it has to earn about 8.6% nominal in order to make the 5.7% payout. He added, “To make 8.6%, if equities are expected to return, pick a number — our view is maybe 9%, although some of you may think higher…. but even if you say 9.5%, with bonds at 4%, it’s very difficult if you’re confined to domestic equities and domestic bonds to earn 8.6% real.”

Mr. Martin said the combined funds now stand at $12.433 billion, having generated investment gains of almost $1.2 billion for the year, with $242 million in net distributions, for a net growth of over $900 million for the year.

Mr. Martin said the net investment gains in the fourth quarter totaled $900 million, so it was a very strong year.

Mr. Martin said the Land Grant Permanent Fund was at $8.176 billion and the Severance Tax Permanent Fund at $3.815 billion, representing 96% of the total fund assets that the SIC oversees. He stated that the other 20 participating funds from around the State include Retiree Health, Tobacco, ENMU, and others.

Mr. Martin said the LGPF returned 10.8% for the year, and the STPF generated 10.7% over the same period; and on a quarterly basis, the LGPF generated 8% and the STPF returned 8.2%. He stated that both funds experienced positive results from active management for the quarter, which is a result not seen for a while.

Mr. Harris asked Mr. Bland what the fund corpus was when he took office, and Mr. Bland recalled it was $9.3 billion at the end of 2002.

Mr. Harris asked if the underlying assumptions used to support the increased distribution formula presented to the Legislature were still valid, and Mr. Bland responded yes, and that staff anticipates a five year annualized return of 8.5%.

Mr. Martin reviewed supplemental charts detailing asset allocation versus target in both the LGPF and the STPF. He noted that LGPF has 57% in equities as of 12/31/04, and the long-term target is 55%. He added that total equity would be closer to 55% if so-called equity cash held by managers in large cap equity were included. He also noted that the private equity target for the LGPF is 6%, and it is currently at 3.7%.

Mr. Martin noted that the STPF has a total private equity target of 12% (6% in the National Program and 6% in the New Mexico Program).
Mr. Martin also stated that the SIC received approval from last year’s Legislature to go up to 10% in hedge funds, but only in the STPF.

Mr. Bland added that normally these assets are commingled, but in this case the management structure will have to be reorganized and staff will be working with NEPC on a new asset allocation budget for hedge funds.

Mr. Martin noted that the State paid $26 million in fees, but that only translates to 20 basis points in terms of asset values. He commented that most large public funds are at 40-50 basis points, so the SIC “runs a very tight ship in terms of what it pays its managers.”

In discussing the strategy of the State Land Office, Commission Lyons commented, “We’ve taken the attitude that we’re kind of open for business.” He said the SLO raised $333 million in the first year, $360 million in the second, and now they are at $390 million, and they expect that trend to continue upward as long as natural gas prices and oil prices continue to rise. He said the SLO is also diversifying commercial investments and focusing on hard rock mining in particular.

Mr. Bland clarified that these figures are for both the STPF and the LGPF, since severance taxes are dependent on the vagaries of natural gas and oil prices.

Mr. Martin noted that the LGPF has earned 2.3% per annum over five years, which would rank it in the 71st percentile of all endowment funds, which is not very impressive — the LGPF would like to be at least in the upper half if not further up. He pointed out that the LGPF would still be in the 71st percentile if it simply followed the asset allocation policy and indexed everything else. He commented to the SIC, “Part of your issue isn’t how you pick your managers; it’s the constraints to your policy that don’t let you take advantage of some of the higher returning asset classes.”

Mr. Martin noted that the STPF did 2.4% per annum over five years, which has to do with the fact that the STPF has been in private equity, which did reasonably well over this period.

In reviewing performance attribution (allocation impact/manager impact), Mr. Martin pointed out that, for the first time in many quarters, the SIC has a significant out-performance of its selected managers, and this also holds true for the year. He stated that, while the performance is still negative over three years, “the biggest single factor driving your underperformance of managers has been the large cap active portfolio that was managed in house, that generally did relatively poorly, and you’ll see that over long periods of time — 200 basis points
a year for ten years. That has been the biggest drag to your performance. You’ve done two things to mitigate that: one, it’s no longer $4 billion, it’s $1 billion, so the weighted average component of that is smaller; and two, certainly there’s been an improvement for the year, and if that’s sustainable, that’s a very attractive result."

To illustrate why the LGPF is in the 71st percentile of all endowment funds, Mr. Martin said he prepared a chart comparing the LGPF to the San Bernardino County Employee Retirement Fund (SBCERA), a $4.5 billion fund where he also acts as advisor, so one can assume that they receive the same advice that the SIC does, generally speaking.

Mr. Martin noted that SBCERA received a 13.8% return in 2004 against the LGPF’s 10.8%, and there were a number of reasons for that; among them, SBCERA has 5.8% in real estate (against a targeted 10%) and 4.5% in hedge funds (against a targeted 5%), while the LGPF has zero in both categories. He explained that SBCERA, unlike the SIC, was able to make a decision on hedge fund investments without going to their legislature for authorization.

Mr. Martin also pointed out that SBCERA had 8% in high yield bonds, which is the range where most public funds are right now because they are very attractive in this environment; however, the SIC could only go to 3% in high yield. He also noted that SBCERA is at 20% in non-U.S. equity with another 6% of non-dollar bonds, while the SIC is capped at 15%.

Mr. Martin called the Council’s attention to the one year standard deviation percentages in the LGPF’s portfolio (12.6%) versus SBCERA’s (9.5%) and commented, “The reality is, the riskiness of their portfolio is lower than the riskiness of your portfolio because the asset classes they added, while on an individual basis appear to be risky, when you put them into the portfolio, they’re diversifying assets and they actually mitigate the risk in the portfolio.”

Mr. Martin noted that legislation is now being proposed to remove the legal list — right now, because of the constraints imposed by the Legislature on the SIC, it is forced to put most of its assets into domestic equities and bonds — and of all the asset classes listed, bonds are probably the least attractive in terms of the long-term outlook on returns.

Mr. Kalangis remarked that having hedge funds going forward would have much more impact than they would have in the past because of interest rates.

Mr. Martin agreed. He said, “The kind of hedge funds you’re looking at are called market neutral. We’d expect 6% to 8% return, very little volatility, and low correlation with other asset classes. It’ll take a chunk of the fixed income allocation and give you better returns, more stability, and, as interest rates rise
because market-neutral funds have a short component, they have exposure to T-bills going up.”

In discussion, Commissioner Lyons said he would try to garner additional support for this legislation.

Referring to the performance summary of the managers in domestic equity, Mr. Martin stated that while all of the asset classes, with the exception of the International Developed Market Pool and High Yield, performed at or above their indices for the last quarter of 2004 (a result the SIC hasn’t seen for a long time), the results of the individual managers were mixed.

Mr. Martin pointed out that, in looking at the core group, SIC Large Cap Active, the internally managed portfolio, was the best performing manager for the quarter at 10.7%, or at the 12th percentile; and for the year, 11.4% versus the Index’s 10.9%. He commented that he has not seen that result in the four years he has been advisor to the SIC.

Mr. Martin said the bottom line in Large Cap is that there are too many managers involved and that number should be reduced, which would result in better fees and more focus.

STATE INVESTMENT OFFICER’S REPORT

[Included in previous item.]

OLD BUSINESS

None.

NEW BUSINESS

None.
ADJOURNMENT

Its business completed, the State Investment Council adjourned the meeting at approximately 12:00 p.m.

Approved by:

Hon. Bill Richardson, Governor

Respectfully submitted:

Judith S. Beatty, Council Reporter