

**MINUTES OF THE**  
**NEW MEXICO EDUCATIONAL RETIREMENT BOARD**  
**INVESTMENT COMMITTEE**

January 8, 2009

**CALL TO ORDER – NO QUORUM**

An information session of the New Mexico Educational Retirement Board Investment Committee was called to order on this date at approximately 2:05 p.m. in the Educational Retirement Board Room, 6201 Uptown Boulevard, N.E., Ste. 203, Albuquerque, New Mexico.

A quorum was not present, and the meeting was conducted as an informational session.

**Members Present:**

Mr. James B. Lewis, Acting Chair  
Ms. Jan Goodwin

**Members Excused:**

Mr. Bruce Malott, Chair  
Mr. Gary B. Bland

**Other ERB Members Present:**

None.

**Legal Counsel Present:**

Mr. Chris Schatzman

**Staff Present:**

Mr. Mark Canavan, Portfolio Manager  
Mr. Bob Jacksha, Chief Investment Officer  
Ms. LeAnne Larrañaga-Ruffy, Investment Officer  
Mr. Steve Neel, Portfolio Manager  
Mr. Jeffrey Riggs, Deputy Director  
Mr. Greg Trujillo, IT Director

**Others Present:**

Mr. Allan Martin, NEPC  
Ms. Michelle Aubel, LFC

## **APPROVAL OF AGENDA**

[Deferred.]

## **APPROVAL OF MINUTES: December 10, 2009**

[Deferred.]

## **NOVEMBER FLASH REPORT**

Mr. Jacksha reported that the Total Fund Composite for the one year ending November 30 was (30.6%), while the Policy Index (had the ERB just put money in the indices in the weight specified by the policy) would have returned (30.2%).

Mr. Jacksha said the Allocation Index reflects that the ERB gained 400 basis points by being off of the policy allocation; however, the managers (primarily WAMCO) took away 440 basis points over that time period. He noted that WAMCO underperformed by 15.72% (almost 1600 basis points) over the 12 months. Additionally, he said, Mellon and Alliance Bernstein, managers in the EAFE space, show significant underperformance.

Mr. Lewis asked if December figures are in yet for the hedge funds, and Mr. Neel responded that preliminary December figures appear to reflect some leveling out—certainly not the precipitous drops being experienced in October and November.

## **CHANGE IN FEBRUARY 2009 DATE**

Committee members discussed changing the February 12 meeting date to February 10 or February 11 to achieve a quorum.

Committee members also discussed what time Investment Committee meetings should routinely begin.

[In later discussion, Committee members agreed to start the meetings at 1:00 p.m. whenever possible.]

## **ABSOLUTE RETURN STRATEGIES: AUSTIN CAPITAL MANAGEMENT: UPDATE**

Mr. Jacksha referred to Mr. Neel's memorandum to the Investment Committee, informing the Committee that Austin Capital Management's Safe Harbor Fund (ACM) retained approximately a 7.5% exposure to Madoff Investment Securities through Tremont's Rye Select Broad Market Fund, representing an exposure to the NMERB of approximately \$9.7 million.

The memorandum explained that Bernard Madoff was alleged to have perpetrated one of the largest frauds in Wall Street history, and said that staff concurred with NEPC's recommendation to conditionally redeem from ACM's Safe Harbor Fund and that NMERB and NEPC will conduct an on-site due diligence visit at ACM and recommend continuing or else canceling the redemption.

Joining the proceedings at this time was Jay Van Ert, ACM's portfolio manager, who distributed a slide presentation.

Mr. Van Ert pointed to two notebooks that he said represented a sampling of ACM's work with Madoff, and included their notes, the analysis they did, the audited statements of Madoff, and many other documents. He said they were available as source documents to the ERB.

As background, Mr. Van Ert said Austin Capital has been in business for 15 years, and Safe Harbor Fund was incepted in 1996. He said the investment with Madoff was made through Tremont, a well-known multibillion dollar company in the alternative asset space, specifically through Broad Market Prime, of which Tremont is general partner. He said the investment was made in 1997 in the Safe Harbor Fund as well as their sister fund, the All Seasons Fund, to which there is no exposure. He said they have continued the investment since then, and it has been a core investment in the portfolio and represents roughly 6% of ACM's assets.

Mr. Van Ert said Tremont had an account that was separately managed by Madoff Securities, and that is where the loss occurred. He stated that ACM has had its investment in Tremont over the past 12 years because Tremont also gave ACM an independent source for looking into the Bernie Madoff situation, and ACM picked up some benefits from that. He said one of the things ACM picked up through this investment was an audit by KPMG, which is the auditor for the Rye Select Broad Market Prime, where the ERB's investment is.

Mr. Van Ert stated that the notebooks contain a decade of analysis on ACM's investment plus the audited financial statements of Rye Broad Market Prime by KPMG. He said page 3 contains a simple balance sheet. He pointed out that KPMG attested to the assets that were within the investment vehicle, and those assets

were spelled out by lot numbers, and the assets were a series of Treasury bills. He said ACM took comfort in the fact that the assets, for a portion of the time, went to cash. He said that was done on an annual basis. He said ACM's audits reflect KPMG's balance sheets listing nothing but a series of Treasuries that equal the exact amount of investments in the Fund.

Mr. Van Ert said Bank of New York [BONY] was administrator of this Fund, so when Austin Capital made an investment into this Fund, Citco, ACM's administrator, would wire the money to BONY, which would then wire the money to Tremont Broad Market Fund, which would then put the money in the private account managed by Madoff. He said other people with significant roles were Tremont themselves, which had a team of people devoted to accounting and record keeping and the analysis of Madoff Securities; and Madoff Securities itself, which was a very regulated entity.

Mr. Van Ert said Bernie Madoff was well known in the industry and at one time served as chairman of NASDAQ, and FINRA/SIPC were the regulatory agencies. He stated that the SEC has had eight separate audits of Madoff and was in the Madoff office eight separate times. He said ACM did not know at the time that two of the audits were specifically focused on identifying a potential fraud, where information was given to the SEC but not disclosed to the investment public. He stated that, as recently as late summer of 2007, the SEC did a full audit of Madoff Securities specifically looking for fraud and came away without finding any such evidence and wrote an opinion clearing them of those allegations.

Mr. Van Ert remarked that one of the realities of this situation is that this fraud may have been going on for a very long period of time and may even predate ACM's investment.

Mr. Jacksha asked Mr. Van Ert how this fraud may have been perpetrated, since this would be important to know in trying to track down and identify the assets in order to try to recover them.

Mr. Van Ert responded that this will be the discovery over the next year or more. He said ACM, as part of its ongoing due diligence process, had a consistent relationship on the investment side and the risk management side with both the Madoff Securities side and the Tremont side. He commented that it is interesting to look at this investment because ACM was able to get trade level detail here as part of the standards it has set for transparency. He stated that ACM's analysts went to the offices of Broad Market Prime and Madoff Securities, and at Madoff they actually sat at the trading desk and saw trade orders executed and reviewed the trade tickets that were generated from ACM's accounts, as they were also able to do in their analysis of Tremont. He said they did the work for every month in 2007 and several months in 2008, and calculated the return the trade tickets would have generated, and then compared the return to what was actually generated and

reported to ACM from Tremont. In each and every case, he said, they correlated completely—so the fraud itself occurred behind the trade ticket generation process. He commented that getting transparency on a trade level basis from a hedge fund puts it at the upper echelon of transparency.

Mr. Van Ert said he personally believed the trade tickets were being fabricated, as were the reports to the DTC.

Mr. Van Ert stated that he believed that, in this case, Madoff Securities acted as custodian of the assets for Madoff Investments, and was fabricating the source documents that were being used for the accountants—in other words, those securities were not there on 12-31-2007 and likely not there beforehand.

Ms. Goodwin asked Mr. Van Ert if he was also saying that the trades being witnessed were not actually happening, and Mr. Van Ert responded yes.

Mr. Jacksha pointed out that most if not all of those trades were initiated by Madoff Investments through Madoff Securities, and the custody of the assets, if there were any assets, were also with Madoff Securities, so nothing ever left Madoff.

Mr. Van Ert commented that when one associates guilt with Madoff at the investment vehicle, one automatically supposes guilt at the broker-dealer. He said ACM actually took comfort in the regulated broker-dealer and who Bernie Madoff was in the marketplace. He pointed out that others do this as well. He said ING has the same type of relationship, and D.E. Shaw and Farallon have a similar relationship. He said these are some of the larger and better-known hedge funds and financial corporations in the country; and while he wasn't saying that Madoff was at their level, it was just a little bit beneath it. He said ACM sees a need for independence from the asset custodian level from the investment level that is now obvious that wasn't obvious a few weeks ago.

Mr. Neel asked Mr. Van Ert if he has a thesis regarding some of the exchange-traded transactions in terms of transparency.

Mr. Van Ert responded that he believed they were not entered in the Exchange; that being said, ACM has several hedge fund managers in their All Seasons Fund (not the Safe Harbor Fund), completely separate from ACM, that deal with Madoff in a market making capacity on a day-to-day basis and have been doing so for more than ten years without a problem. He said they are not part of this issue, but he thought Madoff was doing some business appropriately and then some related business not appropriately, or not doing the business at all.

Mr. Van Ert said it was very humbling, and a quandary, to look at actual trade tickets with DTC stamped on them and realize that wasn't a sufficient level of analysis for ACM to do, and that it has to do more.

Mr. Lewis said somebody had to fill the trade tickets out and he was assuming the collateral had to be there and verified.

Mr. Van Ert responded that ACM was looking at the actual trade tickets and then relying on the audited financial statements. He said the step that wasn't taken was finding a way to tick and tie and verify the trade tickets with actual market trades.

Mr. Van Ert said ACM plans to create an independent position within ACM whose function for him and Chief Risk Officer Kyle McDaniel will be to pre-assume fraud in every manager they look at. He said this is a new standard, and ACM will be one of the first to adopt it.

Mr. Van Ert stated that Mr. Madoff always had an active flow in and out of the account, but during the period when several hedge funds-of-funds and other investors needed to draw capital, he was no longer balanced and was in a net redemption area. He said this put him in the position where he didn't have the cash to percolate his Ponzi scheme, and he ran out of cash.

Mr. Van Ert said ACM looks at its risk guidelines annually every January and tries to ladder them up each time, and in January 2008 challenged all of its hedge funds, including Madoff, with a new standard of transparency. He stated that, while Madoff previously let ACM simply look at the trade tickets, this time ACM wanted to take them. He stated that the head of ACM's due diligence team spent all day in Madoff's office on February 29, and several other people had multiple meetings with Madoff to get more transparency through 2008, and they were successful and then ACM invested more money after withholding investing in the first quarter with Madoff.

Mr. Martin commented that ACM's core strategy was not a high risk strategy. He asked him where he thought the money went.

Mr. Van Ert responded that he did not know. He said about \$870 million has been found, but if it has been an ongoing Ponzi scheme for two decades, maybe that is all they will find.

Mr. Schatzman asked if ACM has a program of modeling the returns of different strategies in funds that they invest in against benchmarks to determine whether the return is an outlier, such as Madoff, and Mr. Van Ert responded yes.

Mr. Schatzman asked if ACM monitors reported volumes.

Mr. Van Ert responded yes. He said those analyses are included in the notebooks he had brought with him.

Mr. Van Ert said it has been stated in the press that there is no way this investment strategy could have been perpetrated because of insufficient volume. He said they are looking only at the listed options, however, and not the equities that were purchased or the over-the-counter options that were a very large part of this, and they are assuming all of the assets were invested all of the time. He said this is a market timing strategy, however, so in some months Madoff was 30% invested, in other months zero, etc. He stated that, when ACM's risk management group did their analysis, they were looking at options traded in a given month in the teens, which ACM was comfortable with.

Mr. Schatzman asked if it was accurate to say that there is no standard in the industry of going to the other side to see if a trade actually occurred with the counterparties, and Mr. Van Ert said that was accurate.

Mr. Schatzman said he understood that people believed Madoff was doing some trading through European counterparties, and asked if ACM has thought about how to implement an audit on the other side as well as restrict transactions with entities where there is insufficient transparency on the other side.

Mr. Van Ert responded that there may be some reticence by the other side, and he was not sure how successful ACM would be, but this will be a heightened area of focus in ACM's due diligence.

Mr. Schatzman asked how ACM would decide that the risk reward was great enough to move forward anyway in a country where transparency was an issue for ACM.

Mr. Van Ert responded that ACM looks to the custodian in many cases to verify that the physical assets are there, and that would give some level of comfort.

Mr. Van Ert noted that ACM is looking at having its operational due diligence group break off and become independent of their risk management group—in essence, form a “trifecta.” He said currently their operational due diligence group has complete veto power over investments; and while they will not compromise that, they may structure it out so it is more independent.

Mr. Schatzman commented that much has been made about how Friebling & Horowitz, a three-person accounting firm operating out of a tiny space in New York City, could have handled an operation as large as Bernard L. Madoff Investment Securities. He asked if ACM's due diligence in Tremont, and behind that Madoff and its structure, also looked at the audit firm, and what did ACM do in addition to looking at KPMG.

In addition to Mr. Schatzman's questions, Mr. Jacksha asked what entity Friehling & Horowitz was auditing.

Mr. Van Ert responded that it was the general partner of Madoff Securities, the broker-dealer, so they were basically auditing Bernie Madoff's holding company. He said that a hedge fund will have a general partner, and the general partner's balance sheet will be simple, with office furniture, leases, etc., and that is where Friehling & Horowitz was spending its time. He said ACM is audited by Rothstein Kass at that level. He added that there was a period of time several years ago when ACM wasn't audited at all, because their investors never looked to see how many chairs they had, etc. He stated that the real issue is whether the GP is profitable and can continue to operate their business.

Mr. Schatzman asked if ACM was looking at the report generated by KPMG or were they looking at the underlying documents reportedly looked at by KPMG.

Mr. Van Ert responded that they were looking at the KPMG report and not behind that, and realize they must find a way to challenge the audit reports going forward. He commented that the ramifications are considerable.

Mr. Jacksha said apparently it is more common than he thought, but in this case Madoff Securities was acting as broker-dealer and was also custodian for essentially the same group and controlled by the same group, Madoff Investments. He said maybe the ERB wants to go to all of its funds-of-funds and say that if they have any situations like this, the ERB wants no part of it. He commented that one of the things the ERB always took some comfort in was that with a hedge fund-of-funds, there was a third party administrator. He said obviously that didn't do any good when other things were happening below and there was no third party administrator, although BONY was administrator. He asked what BONY's function was in this case.

Mr. Van Ert responded that BONY received aggregated capital and put it into Broad Market Prime, received capital back from Broad Market Prime, but they did not do any verification.

Mr. Lewis asked if there is any possibility of recovering money from this investment; and if so, over what period of time might that happen.

Mr. Van Ert responded yes. He said a class action suit has already been filed against Tremont, and ACM will decide whether or not to join it; or more likely, since they have legal support through KeyCorp, they may pursue this independently on behalf of their limited partners.

Mr. Van Ert said Tremont maintains a separate team whose sole function is to manage and work with Madoff Securities to ensure the validity of these investments. He stated that Tremont is owned by Oppenheimer, which is owned by Mass Mutual. He said one of the interesting things about Tremont is it was purchased by Mass Mutual three years ago, and Mass Mutual went through a complete and full due diligence with Tremont, with this being the centerpiece of their due diligence. He said Mass Mutual got comfortable with the relationship between Tremont and Madoff because it was generating the majority of the assets of the firm they bought, so they went ahead with the purchase.

On a second issue, Mr. Van Ert noted that other funds like Tremont were audited by PricewaterhouseCoopers and Ernst & Young and BDO International, and all of those firms have standards for auditing alternative investments, and all of those standards include verification of those assets with an emphasis on verification if the entity is related; in other words, has the same relationship that Madoff has—it heightens their level of responsibility. He said those firms will be in a position to explain their actions.

On a third issue, Mr. Van Ert said there is a concept called “fraudulent conveyance” which means no one can be enriched by the fraudulent acts of others. He said that includes those who didn’t perpetrate the fraud but benefited from it. He commented that the implications are interesting in terms of Madoff and Broad Market Prime. He said the concept says one can go backwards in time and recoup dollars that people have received who benefited from the fraud. He said the implication here is people who redeemed out of Broad Market Prime.

Mr. Schatzman asked Mr. Van Ert asked what other avenues are being pursued for asset recovery, including SIPC.

Mr. Van Ert responded that he didn’t think ACM would recover much through SIPC, where the payout on claims is limited to \$100,000 or \$500,000.

Mr. Van Ert stated that there are some questions regarding fraudulent conveyance, i.e., is ACM on the opposite site, has it retracted money over the past year, and might that be a liability to the fund. He said that is not the case. He stated that he personally approved \$97 million worth of investment in Broad Market Prime during 2008 beginning in March after their February due diligence meetings; so if anyone is going to benefit from fraudulent conveyance, ACM would be in that category and certainly wouldn’t be in the category of making restitution.

Mr. Schatzman asked Mr. Van Ert if ACM made withdrawals prior to 2008, and Mr. Van Ert responded it may have been \$1-\$2 million “years back.”

Responding to questioning from Mr. Neel on the due diligence process, Mr. Van Ert said Tremont gives ACM incremental insight and oversight that ACM wouldn’t

have if it didn't use them, which is why they are willing to pay the extra fee to go through Tremont.

Mr. Van Ert also stated that, in 1997 when the Safe Harbor Fund and All Season Fund initially made this investment, ACM was too small of a player to get an audience with Madoff. He said Bernie Madoff tended to use someone like Tremont to aggregate investors and Tremont and Madoff have conversations on a weekly basis. He said ACM would get greater exposure to Madoff through Tremont as a result, and viewed it as a way to get better information and oversight.

Mr. Jacksha reiterated his concern that the ERB may be invested in other hedge funds where there is also an in-house trading situation, and proposed that the ERB approach all of its fund managers and stress that the ERB wants no part of them because it makes no sense not to have the usual safeguards in place. He said the ERB's other investment accounts have a third party custodian, and this is the way business is normally done and is supposed to be done.

Mr. Canavan said he would echo Mr. Jacksha's sentiments.

Mr. Lewis asked Mr. Van Ert if he thought there were other Madoffs out there perpetrating Ponzi schemes on investors.

Mr. Van Ert responded that the result of ACM's research would say no. He said each year they have increased their standard, and would be increasing it again in 2009.

Noting that there is solid speculation that some of the hedge funds may be running their own small scale Ponzi schemes, Mr. Schatzman asked what ACM is doing in terms of looking at the hedge fund practices, strategies and even their individual investments.

Mr. Van Ert responded that there are several strategies that fall into that category. He said ACM generally hasn't the issue of those complicated strategies in its portfolio, and has avoided them for 15 years.

Mr. Van Ert said he believed half of the hedge funds would go out of business.

Noting that Mr. Van Ert had indicated that there seems to be a lot of opportunity out there, Mr. Lewis asked what this Committee should tell the rest of the ERB Board, the public and the Legislature when they ask about hedge funds.

Mr. Van Ert responded that nothing is immune to what has happened over the past 12 months, and ACM will be down approximately 9% in the month of December (which includes the Madoff issue) and will be down 24% or more for 2008. He stated that, had all of the money been put into Treasuries, the result

would have been better, and in equities it would have been considerably worse. He pointed out, though, that for 13 years ACM has delivered risk-adjusted returns that have been "extraordinarily additive" to all of the portfolios they have been in, and they feel they can deliver in the future.

Mr. Lewis said the ERB has a fiduciary responsibility to analyze what happened, and asked Mr. Van Ert to work with Mr. Schatzman in terms of the contents of the documentation he had brought with him to this meeting.

Mr. Van Ert left the proceedings.

Mr. Martin reviewed NEPC's memorandum to NEPC clients informing them that NEPC has placed Austin Capital Management on "client review status," and suggesting that current investors consider a conditional redemption.

**Following discussion, there was informal consensus that a letter of redemption would be issued pending further legal review.**

#### **INVESTMENT MANAGER FEES**

Mr. Martin reviewed NEPC's Investment Management Fees report.

Committee members discussed negotiating a lower fee with Earnest, manager in U.S. Small Cap Growth, jointly with the SIC.

Mr. Jacksha distributed and reviewed Absolute Return Strategy Manager fees.

Mr. Martin commented that the ERB will not be paying incentive fees on any of these managers for the next year or two because of market performance.

#### **OTHER INVESTMENT REPORTS**

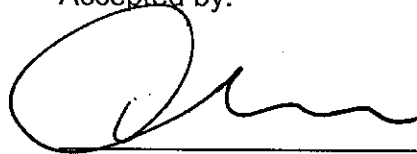
Mr. Neel reported that Topiary is going out of the hedge fund-of-fund business and the ERB has \$85-\$90 million of exposure. He said Topiary is contacting its underlying hedge funds for liquidity provisions and will be providing a liquidity schedule to the ERB.

Mr. Jacksha said two contracts are up for renewal and would require a Board vote: Post, and Pyramis (international account). He recommended extending both.

**CONCLUSION OF INFORMATION SESSION**

The session concluded at approximately 4:45 p.m.

Accepted by:

A handwritten signature in black ink, appearing to be "Bruce Malott", written over a horizontal line.

Mr. Bruce Malott, Chair

*ED Approved by  
Committee*