

MINUTES OF THE
NEW MEXICO EDUCATIONAL RETIREMENT BOARD
INVESTMENT COMMITTEE

July 9, 2009

CALL TO ORDER

A meeting of the New Mexico Educational Retirement Board Investment Committee was called to order on this date at approximately 2:00 p.m. in the Educational Retirement Board Room, 6201 Uptown Boulevard, N.E., Ste. 203, Albuquerque, New Mexico.

A quorum was present:

Members Present:

Mr. Bruce Malott, Chair
Mr. H. Russell Goff
Ms. Jan Goodwin

Members Excused:

Mr. Gary B. Bland

Other ERB Members Present:

Dr. Beulah Woodfin

Legal Counsel Present:

None.

Staff Present:

Mr. Mark Canavan [teleconference]
Mr. Bob Jacksha, Chief Investment Officer
Ms. LeAnne Larrañaga-Ruffy, Investment Officer
Mr. Steve Neel, Portfolio Manager
Mr. Jeff Riggs, Deputy Director

Others Present:

Mr. Kevin Tatlow, NEPC
Mr. Steve Gruber, ORG
Mr. Tom DeFranco, Courtland Partners

APPROVAL OF AGENDA

Upon motion by Ms. Goodwin, seconded by Mr. Goff, the Agenda was approved by voice vote as published.

APPROVAL OF MINUTES: May 14 and June 25, 2009

Ms. Goodwin moved approval of the May 14 and June 25 Minutes, as submitted. Mr. Goff seconded the motion, which passed by voice vote.

INFRASTRUCTURE: QUARTERLY REVIEW

Tom DeFranco, Consultant and Director of Infrastructure Investments with Courtland Partners, presented an update on Citi Infrastructure Investors and Alinda Infrastructure Fund II. [Presentation is on file at ERB Investment offices.]

Mr. DeFranco noted that ERB is the only B class investor in the Fund, and Mr. Canavan heads the B class investors.

Citi

In reviewing Citi Investment Team departures, Mr. Canavan reported that Michael Froman, formerly the head of alternative investments for Citigroup, left to take a position in the Obama Cabinet, and Juan Bejar, who co-headed the Infrastructure Fund with Felicity Gates, left on June 11. Because of Mr. Bejar's departure, he said the Limited Partners voted to suspend new investment activity in the Fund for the next 90 days, and also developed a list of 14 bullet points for Citi to address. He said a conference call took place yesterday, and most of the LPs were pleased with what they heard.

Mr. Canavan commented that apparently Mr. Bejar was uncomfortable working with the more democratic structure of a large organization where the LPs have a tremendous amount of influence over what happens with the Fund. He said Citigroup is searching for a replacement, and the head of the Fund is now Felicity Gates, who is seen by most of the LPs as an exceptional intellect and an exceptional investor. He said the LPs feel that this issue will be resolved within the next 90-120 days.

Mr. Canavan stated that the assets in the Fund continue to do well, and Kelda (U.K. water treatment facility) and YVR Airport Services are doing particularly well.

Referring to Mr. Canavan's remarks that this deal allows the LPs to have a lot of input, Mr. Malott asked if there is any risk where the ERB may find itself perceived as a general partner.

Mr. Canavan responded that, when the ERB originally looked at investing in the Fund, staff asked Foster Pepper to provide a line of demarcation relative to the ERB's distance from the Fund to make sure it remains an LP. He said the extent to which the ERB is involved in the decision making process is not something Foster Pepper believes is crossing the line into a GP relationship. He said there are certain levels of control the ERB cannot exercise and Foster Pepper was fairly comfortable with the differentiation as outlined in the LPA.

Mr. Jacksha added that the LPs have votes or control when there are exceptions to the investment policy of the fund; and while the ERB may voice its opinion on a typical deal, it doesn't have actual control of it.

Mr. DeFranco noted that Citi has called about \$20.7 million, leaving \$21 million left to fund. With investment activity under suspension, he said Courtland would later provide an update on what Citi's plans are once investment activity resumes.

Mr. DeFranco said broken deals include Pennsylvania Turnpike, Chicago Midway Airport and London Gatwick Airport.

Mr. DeFranco stated that, in addition to investments in Kelda and YVR, Citi has invested in Itinere, a group of seven toll roads in Spain. He said that Citi should receive a good return on this investment.

Alinda II

Mr. DeFranco reported that \$12 million has been called out of the ERB's \$50 million commitment and \$400,000 has been returned to date. He stated that Alinda is still fundraising, with a final close scheduled at the end of October, and they expect to reach at least \$3.5 billion. He said they originally expected to raise \$5 billion, but seem to be doing very well with new investors and investors re-upping from Fund I.

Mr. DeFranco said fund investments include Santa Paula Water (California), Binnenlandse Container Terminals (Netherlands) and Regency Intrastate Gas System (Louisiana). He said the investment pipeline includes possibly taking two electric utility companies private.

Mr. DeFranco noted that Fund I is producing a 10% current yield and they have acquired 87% long-term financing for all of their assets. He said Fund II has already returned 6%, and Alinda states that it will take about three years to be 75% invested, with any remaining monies to be used for follow-on investments.

DeFranco stated that Fund III will be cheaper fee-wise, and the ERB should benefit as they go on and become more efficient at what they are doing and meet their objectives.

Alternata

Mr. DeFranco reported that, after the ERB approved committing \$25 million to Alternata on October 23, 2008, Alternata reduced its fundraising target from \$1 billion to about \$500 million. He noted that Courtland's recommendation required Alternata to raise \$500 million before ERB would invest in the fund, but Alternata has not been able to raise it.

Mr. DeFranco stated that Texas Teachers committed \$200 million with the condition that they end their fundraising by August 13. He said that, as of early this week, Alternata has raised \$320 million, and Courtland feels it is unrealistic to expect them to raise another \$180 million in one month.

Mr. DeFranco said two issues exist: 1) Alternata is not doing well on the fundraising (more a sign of the market rather than anybody's opinion of them as a management team); and 2) Alternata refuses to reduce the management fee from 2% to 1.5% despite fundraising difficulties in the current market. Mr. DeFranco said Courtland negotiated them down to 180 basis points, and then Alternata refused to budge.

Mr. DeFranco said Courtland therefore has withdrawn its recommendation, and Mr. Canavan informed Alternata two days ago that the ERB was withdrawing its commitment.

Looking forward to next year, Mr. DeFranco said there are some opportunities out there, but this is a good time to be on the sidelines given valuations and the lack of credit availability.

Mr. DeFranco reviewed existing infrastructure demands on a global basis, now at an estimated \$41 trillion, with Asia making up \$15 trillion. He said Courtland has almost \$1 billion invested in China on the real estate side and does an active amount of due diligence for that; however, doing due diligence for ERB without the assistance of another Courtland client coming in could be expensive.

Mr. DeFranco asked for feedback from the Investment Committee on whether it was opposed to investing in China. He commented that there are some compelling investment opportunities there, and offered to investigate further and bring back information at a later date.

Mr. DeFranco stated that there are a number of Asian infrastructure funds coming into play—Asia comprising China and India in this case—and Courtland may be able to negotiate attractive fees for an international fund. Should the ERB be interested, he said Courtland would do due diligence on two or three funds to put together a matrix on management teams and strategy. He said it would be a good way to diversify the portfolio, but there is no rush to do that.

Mr. Malott commented that the biggest risk would appear to be the legal stability involved in contracting with a government.

Mr. DeFranco said that was correct. He said Asia is working hard to facilitate foreign investment, however, to help stimulate their economy.

Mr. Malott commented that the risk involved is the stability of a government to continue on that course, however, so the decision the ERB should make is how much exposure it wants. He added, though, that this presents a great opportunity and the ERB would be foolish not to invest in growing countries.

With respect to the issue of placement agents, Mr. DeFranco said Courtland has no relationships with any placement agents. He said Alinda II used their internal staff, and while they have used placement agents for certain clients, they have not used them with Courtland. He said Citi also used internal staff.

Mr. DeFranco said Courtland is taking this very seriously and its due diligence questionnaires will include disclosure questions on the nature of relationships, whether it be by giving Courtland the contract or through agreements.

Mr. Jacksha said ERB staff is comfortable that it has gotten good disclosure from Courtland.

REAL ESTATE: UPDATE ON SECONDARY OPPORTUNITY FUND

ORG adviser Steve Gruber advised the Committee on ORG's activities in the Secondary Opportunity Fund. He said they raised \$25 million from the ERB and \$40 million from Arizona Public Safety, and have now tiered the market into funding segments:

-- A primary fund, where investors commit \$10 million to the fund, no investments have been made and no capital has been called. This is approximately 20% of ORG's pipeline, and investors pay \$1 million to the fund and ORG assumes the \$9 million liability.

-- The aged primary fund, which is 40-60% invested and committed, but also up to 50% uncalled and uncommitted. This is a huge segment of the market.

Mr. Gruber reported that real estate debt and equity valuations have been slaughtered in the last nine months. In the U.S., since the collapse of Lehman Brothers in September 2008, he said ORG has seen values that are generally down 30-40% across all property types in most markets. He said real estate fundamentals are declining across the board with the exception of Washington, D.C., where the Hyatt Regency is one of the best performing hotels in the country.

Mr. Gruber said real estate strategies with any near-term debt maturity are facing significant refinance challenges, and ORG thinks it is pretty early in the pricing cycle on this. Although still early in the cycle, he said ORG thinks this is a great time to be allocating capital to the managers who are demonstrating patience and skill. He said there is no doubt that it will take three to five years to sort through the manager universe, however, as many of the legacy issues embedded in some of the older funds will take these managers down.

REAL ESTATE: APPROVE REAL ESTATE INVESTMENTS

1. Lone Star Funds

Mr. Gruber introduced Lone Star Funds founder John Grayken.

Mr. Gruber stated that he managed a \$3 billion portfolio for the State of Oregon from 1998 to 2005 and in that period allocated \$1+ billion to Mr. Grayken's investment funds. He also noted that all of the ORG he advises have invested in Lone Star Fund VI. He said Mr. Grayken is currently raising Fund VII with a focus on residential and commercial distressed debt and commercial real estate equity.

Mr. Gruber's report to the Committee stated that Lone Star was seeking to raise \$10 billion each in two separate funds:

Fund VII: Fund VII intends to invest in a broad range of global opportunities, including investments in single family residential debt products, secured and unsecured corporate debt, consumer debt products, value investments in asset risk and financially oriented operating companies, and operating companies with significant tangible assets through the acquisition of portfolios of assets and entry level debt and/or equity. The acquisition efforts for Fund VII are focused on opportunities in the U.S., Western Europe and Japan.

Real Estate Fund II: RE Fund II will invest in global opportunistic and value investments in commercial real estate where the intention is to take title or control and actively manage, reposition, improve or otherwise add value to the assets. Commercial real estate investments targeted by the RE Fund II include investments in secured and unsecured debt, high leverage debt financing, real estate related

debt and equity assets, operating companies and securities, commercial real estate portfolios, single assets, CMBS, joint ventures, development opportunities, tax exempt bonds and limited partnership interests. The acquisition efforts for RE Fund II are focused on opportunities in the U.S., Western Europe and Japan.

Mr. Grayken stated that he founded Lone Star in 1995 to manage institutional money, and since then Lone Star has raised and invested \$24 billion of equity and has bought about \$65 billion worth of assets around the world.

[Slide presentations on Lone Star Fund VII and Lone Star Real Estate Fund II are on file in ERB Investment offices.]

Mr. Grayken said the market that Lone Star sees going forward is the biggest distressed market that he has ever seen. He stated that the IMF is estimating that the total credit loss on loans will be \$4.1 trillion. He contrasted this with a total credit loss of \$250 billion in the RTC crisis, which in today's dollars would be \$400 billion.

Mr. Jacksha asked Mr. Grayken how Lone Star stands in its fundraising, and Mr. Grayken responded that it is a difficult environment, but he felt Lone Star would be fully subscribed in both funds at \$10 billion each.

Mr. Gruber stated that Lone Star has not used placement agents in connection with ERB.

Mr. Goff moved that the Investment Committee approve a commitment of \$25 million plus fees and expenses to Lone Star Real Estate Fund II, L.P., subject to and contingent upon New Mexico state law, Educational Retirement Board policies and negotiation of final terms and conditions and completion of appropriate paperwork.

Ms. Goodwin seconded the motion, which passed by voice vote.

Ms. Goodwin moved that the Investment Committee approve a commitment of \$25 million plus fees and expenses to Lone Star Fund VII, L.P. subject to and contingent upon New Mexico state law, Educational Retirement Board policies and negotiation of final terms and conditions and completion of appropriate paperwork.

Mr. Goff seconded the motion, which passed by voice vote.

2. Lionstone Cash Flow Real Estate, L.P.

Mr. Gruber introduced Lionstone Principal Jim Hime and Partner Glenn Lowenstein. He stated that Lionstone's investment strategy is at the exact opposite end of the spectrum from what Lone Star does because it involves seller distress but is not a distressed real estate play. He said ORG is proposing with Lionstone to go out into the market and buy the absolute best properties that it can, but from distressed sellers. He said ORG believes they will be able to buy high quality real estate more cheaply in this environment than would otherwise be the case.

Mr. Gruber's report to the Committee stated that Lionstone was formed to acquire assets that produce steady cash flow and that benefit from locations that have been proven over time to maintain occupancy better than competitive properties located in the same overall market and submarket. The investment objective is for the Fund to acquire a portfolio of properties that produce a minimum net 8.0% per annum leveraged return on invested equity from cash flow over a ten-year holding period. The CFRE Manager will target acquisitions that over the portfolio construction period result in a national and geographically diversified portfolio of office, industrial, retail and multifamily assets.

Messrs. Lowenstein and Hime presented slides. [Presentation is on file with ERB Investment offices.]

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Mr. Gruber added that there is no catch-up and there is no fee on committed capital.

Mr. Gruber said ORG sees this as a competitive fee structure that is completely oriented around whether they are generating cash flow that is distributable to the investors.

Mr. Gruber said that the staffing within Lionstone generated the most discussion within ORG in connection with this investment. Lionstone now has 40 people in the company, although when ORG originally negotiated the fee structure for Cash Flow in 2002, there were only three people in the organization. He stated that Mr. Lowenstein was previously CIO for Hines, one of the largest real estate developers in the world; however, Hines is a commercial real estate company that focuses on office, mixed use and some industrial, but generally no multifamily. He said Lionstone's Cash Flow Real Estate strategy includes all four real estate types, though, and Mr. Gruber's partners had concerns over whether there was multifamily expertise within Lionstone.

Mr. Gruber said Lionstone is now seeking to bring someone with multifamily expertise. He stated that he and Mr. Canavan concur that it will typically take two or

three months to get through the documents, and then Lionstone has to bring in the other investors, so they will very likely have someone on board at that point. If they don't, he said, the ERB can decline to sign the paperwork.

Mr. Gruber noted that all of Lionstone's investors have re-upped with them since inception of the firm, so there is a high degree of confidence within their investor base.

Mr. Gruber said no placement agents were involved in this investment.

Mr. Lowenstein said Lionstone has never used a placement agent and never will.

Mr. Goff moved that the Investment Committee approve a commitment of \$30 million plus fees and expenses to Lionstone Cash Flow Real Estate, L.P. subject to and contingent upon New Mexico state law, Educational Retirement Board policies and negotiation of final terms and conditions and completion of appropriate paperwork.

Ms. Goodwin seconded the motion, which passed by voice vote.

[Break.]

PRIVATE EQUITY: VALIDATE PRIVATE EQUITY INVESTMENTS

Mr. Neel stated that the Committee approved a \$30 million investment in NGP Energy Technology Partners II in February 2009, and it was in the queue when the ERB terminated its relationship with Aldus Equity. He stated that all of the Aldus investment recommendations would be reevaluated that have been approved by the investment committee, but were yet to be fully executed..

Mr. Neel asked the Committee to validate this commitment at a \$20 million level to track more consistently with the ERB's current pacing plan.

Mr. Neel clarified that there were no placement agents involved. He referred to documents in the packet generated by NGP ETP stating that none of the members of the investment team have made any political contributions to any New Mexico elected official in the past five years, nor have any of the NGP ETP investment team made any payments to any elected or appointed officeholder or any official or employee, or agent or contractor of the State of New Mexico.

Mr. Neel did note that one of the investment partners resides in Santa Fe and was active politically on both sides of the aisle.

NEPC adviser Kevin Tatlow reported that NEPC did due diligence on NGP Energy Technology Partners II, including performing a thorough on-site visit and looking through all of their internal memos on investments and their monitoring work. He said NEPC also reviewed the prior advisor's due diligence work. He stated that NEPC supports the recommendation.

Mr. Goff moved that the Investment Committee approve a commitment of \$20 million plus any notional interest to NGP Energy Technology Partners II, L.P. The commitment shall not exceed 20% of the committed capital of the fund and is subject to New Mexico state law, Educational Retirement Board policies and negotiation of final terms and conditions and completion of appropriate paperwork.

Ms. Goodwin seconded the motion, which passed by voice vote.

OTHER INVESTMENT REPORTS

Mr. Jacksha reported that March-June has been a very good quarter, and he is expecting low double digit returns.

ADJOURN

Its business completed, the Investment Committee adjourned the meeting at approximately 4:05 p.m.

Accepted by:

Russell Goff, Acting Chair.
~~Mr. Bruce Malott, Chair~~
Russell Goff.