VERMONT PENSION INVESTMENT COMMITTEE

October 30, 2008

VPIC Members Present:
STEPHEN RAUH, CHAIR, VMERS Governor's Delegate, term expiring June 30, 2010
JEB SPAULDING, VICE-CHAIR, VT State Treasurer
JOSEPH MACKEY, VSTRS Representative, term expiring June 30, 2011
WARREN WHITNEY, VSERS Representative, term expiring June 30, 2012
DICK JOHANNESEN, Governor's Delegate, term expiring June 30, 2010
MICHAEL K. SMITH, Governor's Delegate, term expiring June 30, 2012

VPIC Member(s) *Absent*:
None

VPIC Alternate Members Present:
STEVEN JEFFREY, VMERS *Alternate*, term expiring June 30, 2010
ROBERT HOOPER, VSERS *Alternate*, term expiring June 30, 2012
JON HARRIS, VSTRS *Alternate*, term expiring June 30, 2011
VAUGHN ALTEMUS, *Alternate* Governor's Delegate, term expiring June 30, 2010

VPIC *Alternate* Members *Absent*:
None

Also attending:
David Minot, Director of Finance and Investments
Bill Griffin, Chief Assistant Attorney General
Jaye Pershing-Johnson, Assistant Attorney General
Chris Levell and Kevin Kondry, NEPC
Linda Deliduka, Association of Retired Teachers
Kingman Penniman, KDP Advisor
Investment Managers and Custodian Bank Representatives

CALL TO ORDER:

The Chair, Steve Rauh, called the Thursday, October 30, 2008, meeting to order at 8:33 a.m., which was held in the 4TH Floor Conference Room, 109 State Street, Montpelier, VT.

ITEM 1: Agenda Approval

The Committee had no objection to the agenda.

ITEM 2: Committee Action Items

A. Approve the Minutes of:

- August 25, 2008 – Regular Meeting
- August 26, 2008 – Regular Meeting
- September 10, 2008 – Conference Call Meeting
- October 14, 2008 – Conference Call Meeting

On a motion by Mr. Smith seconded by Mr. Mackey, the Committee unanimously voted to approve the minutes of August 25, 2008, the minutes of August 26, 2008, and the minutes of September 10, 2008, all as submitted, and the minutes of October 14, 2008, with three edits: Committee Discussion Items Item 1 A, last line of the first paragraph "through" is replaced with "for"; Item 1 C the entire last sentence of the first paragraph beginning "He also advised…" is stricken; and Item D in the motion at the end "acceptation" is replace with "exception.

B. ETI RFP Update/Fact Finding and Recommendation

Mr. Minot reported that Community Capital was informed by letter that their proposal was turned down by the VPIC, and that the Vermont Community Loan Fund declined the opportunity to submit a proposal with an annual rate reset due a lapse in their current lending authority and possible concerns with borrowers being able to enter into a rate resetting borrowing.

Mr. Minot reported that an email communication was sent to the VHFA informing them that the proposal for funding energy loans was turned down due to the complexities of administering incremental draws of funding. The email further indicated that the PAC loans and alternative mortgage loans have a high degree of difficulty in establishing fair pricing due to their private, non-rated status. The email went on to suggest that if these loans could be issued in a publicly tradable security noting that a rating would be constructive, there could perhaps be the basis for a third party evaluation pricing of these securities and further consideration by the VPIC. If the VHFA is able to offer the basis for an effective pricing mechanism, a further proposal may be made in the November VPIC meetings.

C. Investor Network on Climate Risk

Mr. Spaulding asked that the VPIC support participation in the Investor Network on Climate Risk (INCR) with respect to voting of proxies by allowing the Office of the Treasurer, on behalf of the VPIC, to participate in sponsoring or co-sponsoring shareholder resolutions and reporting annually at the November VPIC meeting on activities and results of participation.

Mr. Mackey made a motion seconded by Steve Rauh, to authorize the Office of the State Treasurer to participate in the INCR and its Global Warming Shareholders Campaign on behalf of the VPIC, including the sponsorship or co-sponsorship of shareholder resolutions on the topic, and to report annually at the November meeting on activities and results of participation.

There was a discussion of the motion relating to the VPIC or the Office of the Treasurer having this voting authority and issues of the VPIC having knowledge of voting decisions.

With no objections, the motion was tabled.

D. Policy on Contract Amendments/Renewals and RFPs

Mr. Rauh, Mr. Griffin and other members of the VPIC discussed approval and execution of routine contract amendments and contract renewals involving matters such as extending contract duration and revised maximum fees payable to the investment managers.

On a motion by Mr. Mackey seconded by Mr. Spaulding, the Committee unanimously voted to approve that the VPIC Chair, or in the Chair's absence the Vice Chair, shall have the authority to execute routine amendments of investment manager contracts. This authority shall apply to amendments that extend the contract term and increase the maximum fee amounts and to similar amendments of a routine nature that do not change the investment mandate or transfer assets to or from a manager.

<u>ITEM 3:</u> Overview of Manager Presentations – NEPC

Mr. Kondry reviewed the performance of Logan Circle Core Plus Fixed Income (unfavorable relative to benchmark) and Post Advisory Group (favorable performance relative to benchmark). Mr. Levell stated NEPC's belief that credit spread instruments present an opportunity for recovery and appreciation, and along these lines supported retention of Logan Circle in its investment manager role.

<u>ITEM 4:</u> Manager Presentations

<u>Logan Circle Partners:</u> Ryan Brist, Chief Investment Officer, and David Prince, Client Service Officer, appeared before the Committee. Mr. Brist presented attribution analysis for the firm's underperformance, which related primarily to bond sector weightings that are divergent from weightings in the Lehman Aggregate Bond benchmark. He presented a case for maintaining positions in credit spread fixed income securities, focusing on the extraordinary yield spreads of these instruments versus treasuries.

<u>Post Advisory:</u> Allan Schweitzer, Managing Director and Portfolio Manager, and Ralph Canada, Director Relationship Management, appeared before the Committee. Mr. Canada reviewed changes at the firm and new employment contracts for Larry Post and Allen Schweitzer. Mr. Schweitzer reviewed macro (economic) and micro (company level) considerations for the VPIC portfolio, and presented attribution for the portfolio outperformance of the benchmark as being related to the firm's research capabilities.

<u>ITEM 5:</u> **Discuss Presentations**

- **Guest – Kingman Penniman, KDP Investment Advisors - Montpelier**

Mr. Penniman presented a case in favor of high yield, bank loan and other credit spread instruments emphasizing the current extraordinary spread versus defaults relationship. He stated his belief that when the current credit crunch is resolved, these spreads will drop providing a substantial opportunity for total return. He particularly emphasized the advantages of investing in bank loans, given that they are obligations of companies of similar credit to high yield companies but offer collateral protection as well.

There was discussion of KDP's staff, which comprises 34 employees in Montpelier.

<u>ITEM 6:</u> **State Street Bank & Trust Company**

- **Securities lending Program and Risk Review**
- **Quality D Review**

Pat Donohoe, Vice President Client Services, John McGuire, Vice President Account Management (Securities Finance) and Tom Motley, Vice President U.S. Cash Management (State Street Global Advisors) appeared before the Committee.

John McGuire reviewed the structure and mechanics of securities lending highlighting the risks taken by the lender (VPIC) versus the agent (State Street). Principal risks to the lender relate to investment risk in the investment pool that the borrower's cash collateral is invested in. In the VPIC-State Street lending agreement, the agent takes the risk of a borrower default of securities return through indemnity to the VPIC.

Tom Motley discussed the holdings in the Quality D portfolio (collateral investment pool). While there is some price degradation due conditions in the current credit securities markets, all of the Quality D securities are fully performing and none are impaired. Mr. Motley reviewed the research activities undertaken by State Street relating to this portfolio that mitigate investment risk. There was a discussion regarding options relating to continued participation in the securities lending program and use of the Quality D investment portfolio. Due to price degradation in the Quality D portfolio, which has a portfolio market price of approximately 96% of amortized cost (contributions adjusted for amortized principal), customers are constrained from withdrawing funds in cash and 100% on the dollar. State Street policy is that withdrawals at this time are only being provided with in-kind securities which in aggregate would realize in a sale an approximate 4% discount under current market conditions. Based on current market conditions, there was general agreement that continuing in the program as currently structured is favored.

ITEM 7: **VPIC Investment Strategy - NEPC**

- **Performance Update/Manager Reviews**

Mr. Levell and Mr. Kondry discussed the differences in investment approach between Post and Logan Circle. Post emphasizes bottoms-up company level research, while Logan Circle uses a more macro category perspective.

There was a discussion of the possibility of adding bank loans to either the Post or Logan Circle portfolios. It was agreed that documentation from both Logan Circle and Post should be obtained to evaluate whether the VPIC will be able to enter into a bank loan program agreement. There was an accompanying discussion of appropriate risks to be taken in a core fixed income portfolio.

In an overall review of VPIC performance, NEPC advised that all asset classes have suffered and that there has been virtually "no place to hide" over the past several months. This has been a particularly poor period for active management. The VPIC's recent performance as presented in a recent NEPC call with VPIC members was reviewed. In particular, Oppenheimer's portable alpha product in the fixed income allocation was reviewed; due to poor absolute and relative performance, they have temporarily suspended the alpha portion of the investment.

- **Rebalancing Strategy**

Mr. Levell suggested that going forward VPIC should accept investment risk as the risk-reward relationship is currently attractive. Concern remains regarding equity securities. This implies looking for ways to increase the risk budget without increasing equities (such as could be possible with Bridgewater). NEPC did not recommend a quicker funding of emerging markets equities (stay on present course of 1% every six months). While credit spread bonds are favored, NEPC recommended tabling rebalancing for now and reconsidering it again in the November VPIC meetings.

- **Actuarial Assumptions/Funding Status of Plans**

Mr. Levell commented on the recently produced actuarial reports for each of the three state retirement systems. He stated that an 8.25% rate of return is achievable, and that looking forward over a 30 year period, investment returns should be excellent.

He noted that the systems since June 30 have seen an asset decline in the area of 30%. On a smoothing basis (smoothing assets over a five year period) the three systems funding ratios have declined in the area of 4%. On a marked to markets basis, this decline is much higher. While viewing marked to market funding levels should be considered, it should not be a basis of establishing contributions; the contributions would be too jagged or volatile.

- **Liability-Driven Investment Strategies**

Mr. Levell discussed LDI strategies including marked to market funding assessments used in corporate pension plans, which do not impact public plans (although GASB sometimes follows FASB). He emphasized that LDI does not imply 100% investment in bonds.

Mr. Levell pointed out that a standard balanced portfolio has two risks: 1) equity risks and 2) a less than 100% match of assets and liabilities. There was a discussion of duration as a measure of interest rate risk to the ability of assets to meet liabilities.

ITEM 8: **Committee Discussion Items**

A. Investment Policy Guidelines

Due to limited time, investment policy guidelines were briefly discussed, noting that the issues of 1) policy guidelines content and 2) changing policy guidelines to allow for engagement of new investment managers and investment strategies.

B. Proxy Voting Guidelines

Due to limited time, proxy guidelines were not discussed at this meeting. Proxy voting services were discussed during the report from the Director of Finance and Investments.

C. Funding Schedule for Open Commitments

Based on concerns for funding future real estate investments due to limited liquidity from existing real estate managers, it was agreed that Mr. Minot and Ms. Johnson should create a contract/commitment closing schedule and report back to the Committee in November.

D. VPIC Member Contact with Managers

Not discussed.

ITEM 9: **Director of Finance and Investments Report**

Mr. Minot discussed the items in his report. He added that an RFP to solicit bidders for proxy voting services (currently done by ISS/Riskmetrics) was imminent, and that the RFP and selection process would be administered by the Treasurer's Office. He also added that Green Mountain Capital is asking for an additional and final year of partnership operation, and that the VPIC will be asked to vote on this in the November meeting.

ITEM 10: **Any Other Business to Come Before the Committee**

Mr. Spaulding noted that the performance of the managers picked for asset diversification have done poorly in the current credit environment, noting that he had confidence in the NEPC team advising the VPIC. Mr. Levell said that these managers were expected to do well in a bad, but not extremely bad investment environment, and that the only managers to do well recently took unusual risks to do so.

Mr. Spaulding also brought up the topic of Vermont based money managers and VPIC assets. He suggested that the VPIC consider reorienting the ETI program towards engagement of Vermont based money managers.

Adjournment:

Hearing no other business or objection, **at 5:10 p.m. the Chair declared the meeting adjourned.**

Next meeting Date:

The next meetings are scheduled for Monday, November 24, 2008, and Tuesday, November 25, 2008.

Respectfully submitted,
David Minot, Director of Finance and Investments