

**MONTANA BOARD OF INVESTMENTS
DEPARTMENT OF COMMERCE**

**2401 Colonial Drive, 3rd Floor
Helena, Montana
August 19 & 20, 2008**

MINUTES

BOARD MEMBERS PRESENT:

Terry Moore, Chairman
Teresa Cohea
Karl Englund
Maureen Fleming
John Paull
Jack Prothero
Jon Satre
Jim Turcotte
Senator Dan Weinberg

BOARD MEMBERS ABSENT:

Elouise Cobell
Representative Tom McGillvray

STAFF PRESENT:

Jason Brent, Investment Analyst	Jon Putnam, Investment Analyst
Geri Burton, Deputy Director	Nancy Rivera, Credit Analyst
Richard Cooley, CFA, Portfolio Manager	John Romasko, Fixed Income Investment Analyst
Kim Dallas, Program Assistant/Board Secretary	Nathan Sax, CFA, Portfolio Manager
Tim House, Chief of Investment Operations	Clifford A. Sheets, CFA, Chief Investment Officer
Ed Kelley, Portfolio Manager	Jon Shoen, Investment Analyst
Teri Kolnik, Equity Investment Analyst	Carroll South, Executive Director
Herb Kulow, Portfolio Manager	Steve Strong, Investment Analyst
Gayle Moon, Accounting Fiscal Manager	Louise Welsh, Bond Program Officer
Rande Muffick, CFA, Portfolio Manager	Dan Zarling, CFA, Director of Research

GUESTS:

Jim Voytko, R.V. Kuhns and Associates
Becky Gratsinger, R.V. Kuhns and Associates
Peter Madsen, R.V. Kuhns and Associates
George Holewyne, Director Client Services, Vaughn Nelson Investment Management
Chris Wallis, Senior Portfolio Manager, Vaughn Nelson Investment Management
Michael Schroer, Managing Partner, CIO, Renaissance Investment Management
Carey Kruer, Director Client Services, Renaissance Investment Management

CALL TO ORDER

Chairman Moore called the regular meeting of the Board of Investments (Board) to order at 1:00 p.m. in the conference room at 2401 Colonial Drive, 3rd Floor, Helena, Montana. As noted above, the meeting convened with eight members of the Board present. Member Elouise Cobell and Member Tom McGillvray were absent.

Motion: Member Jon Satre motioned for approval of the May 13 & 14, 2008 minutes and the July 31, 2008 Special Conference Call Meeting minutes; Member Jack Prothero seconded the motion and the motion was passed 8-0.

ADMINISTRATIVE BUSINESS

Chairman Moore presented the following Administrative Business:

Human Resources Committee Report

Member Terry Cohea, Human Resource Committee Chairperson, reported that the Committee has reviewed the Exempt Employee Job Profile for the Fixed Income Portfolio Manager position. Member Cohea reported that the duty and responsibility of overseeing External Managers has been added to the Job Profile.

Motion: Member Terry Cohea motioned for approval of the Exempt Employee Job Profile for the Fixed Income Portfolio Manager position on behalf of the Human Resource Committee. Member Maureen Fleming seconded the motion and the motion was passed 8-0.

Audit Committee Report – No Report.

Loan Committee Report

Member Jack Prothero, Loan Committee Chairperson, reported that the Loan Committee approved an INTERCAP Loan Program request via conference call on June 19, 2008. The loan is less than \$5 millions dollars and requires only Loan Committee approval. The Loan Committee authorized staff to proceed with processing and closing this loan using the Board's standard Bond Program Office procedures:

Borrower: MSU - Bozeman
Board Loan Amount: \$4,000,000
Term: 10 Years
Purpose: To finance costs associated with renovating the Cooley Microbiological Laboratories.

Public Comment

Chairman Moore called for Public Comment of Board-Related Items. *No Public Comment made.*

EXECUTIVE DIRECTOR REPORTS

Executive Order No. 35-2008

Mr. Carroll South, Executive Director, presented Executive Order 35-2008. This Executive Order encourages Boards, Councils and Commissions to conserve energy by utilizing teleconference technology when possible.

After reviewing the Executive Order, the Board agrees that the current schedule of one meeting per quarter (4 meetings per year) seems to be very sufficient and works well. If the Board determines a need for

additional “in-person” meetings, a meeting will be scheduled. The Board will continue to meet by conference call as needed.

Securities Monitoring Litigation Services - Decision

Mr. Carroll South, Executive Director, presented staff recommendation that Bernstein Litowitz Berger & Grossman and Barrack, Rodos & Bacine be hired for Securities Monitoring/Litigation Services subject to successful contract negotiations.

A Request for Proposal (RFP) was issued on March 24, 2008 and twenty four responses were received.

Motion: Member Maureen Fleming moved for approval of staff recommendation as presented; Member Jon Satre seconded the motion and the motion was passed 8-0.

Hedge Fund Of Funds Request For Proposal Update

Mr. Carroll South provided a verbal update on the Hedge Fund of Funds Request for Proposal (RFP). The RFP was issued on August 6th and will close on September 19th.

Socially Responsible Investing – Decision

Mr. Carroll South provided a detailed and in-depth report on Socially Responsible Investing. Socially Responsible (SR) investing is a term that has evolved into a broad category of investment philosophies that are intended to: influence country/company policies; impact certain products/services; impact the environment; and/or impact certain demographical groups or geographical areas. Targets of SR investing may be:

- **Countries** – Countries whose policies and conduct are perceived to be unacceptable.
- **Company Negative** – Companies with policies/products that are perceived to be socially unacceptable.
- **Company Positive** - Businesses that: are considered good corporate citizens with adequate corporate governance; are considered environmentally “green” with little impact on the environment; primarily focus on healthy products or manufacture products that improve the environment, conserve energy, and reduce fossil fuel consumption.
- **Products/Services Negative** – Products/services that are perceived to be harmful to persons or the environment.
- **Products/Services Positive** – Products/services that improve the environment, reduce waste, reduce energy consumption, improve living conditions, and in general are perceived to benefit society.
- **Demographic/Geographic Positive** – Sometimes referred to as economically-targeted investing.
- **Green Investing Positive** – As global warming has become a major topic of discussion, there has been increasing focus on “green” investing, which involves investing in companies whose primary focus is improving the environment.

There are two ways in which SR investing is practiced – positive and negative. The general theory is to reward good behavior and discourage bad behavior as it relates to company policies, company products/services, or company operations in countries with policies and conduct perceived to be socially unacceptable. In the case of companies providing products/services the SR investor believes harmful to society or the environment, the investor may simply choose to not invest, based on the belief that its investment would be used to provide the products/services.

The most recent examples of negative SR investment activity are the divestitures by several public funds in companies that operate in Sudan or Iran. A product-specific example of negative SR investing occurred in 2000 when the two large California pension funds sold all their investments in tobacco companies.

Generally, SR investors in the public equity markets would screen the universe of stocks against certain criteria important to them. The screens may be used positively (to invest in the company) or negatively (to not invest or divest in the company). There are several ways in which SR investors may attempt to change or encourage company policies:

- 1) Don't invest in a publicly-traded company.
- 2) Divest (sell) existing investments in a publicly-traded company.
- 3) Invest in the company and if necessary use that investment as a tool to improve the company policies.
- 4) Invest in private equity funds or publicly-traded companies dedicated to green and/or economically-targeted investments.

If a SR investor does not like a company's policies or products/services it may choose to not purchase its stock or to sell the stock it owns. If an SR investor chooses not to invest in a company because of its primary products/services, such as tobacco or alcohol, the company will still continue to provide the products/services. While the two California pension funds (the largest public pension funds in the US) divested all tobacco stocks in 2000 that action did not impact the companies' ability to manufacture and sell tobacco products.

There are usually many publically-traded domestic and international companies providing the same product/service. A SR investor would, after a financial analysis of company prospects, likely choose to invest in those companies whose social and environmental policies are most in tune with its own beliefs and values as opposed to investing in a competitor whose financial outlook was similar. Even if the SR investor was not totally happy with the company's policies, it may purchase its stock to become an active shareholder and a force for change.

Mr. South states "I can not overstate enough the fiduciary responsibility that this Board has as to how pension funds are to be managed." The Board is mandated by state law to manage the Program using the "prudent expert principle", which requires an investment manager to:

- (a) discharge the duties with the care, skill, prudence, and diligence, under the circumstances then prevailing, that a prudent person acting in a like capacity with the same resources and familiar with like matters exercises in the conduct of an enterprise of a like character with like aims;
- (b) diversify the holdings of each fund within the unified investment program to minimize the risk of loss and to maximize the rate of return unless, under the circumstances, it is clearly prudent not to do so; and
- (c) discharge the duties solely in the interest of and for the benefit of the funds forming the unified investment program.

Letter (c) of the principle leaves little doubt that the Board must act "solely" in the interest of and for the benefit of the funds it invests.

Any SR investing activity undertaken by the Board would utilize pension funds because these are the only funds over which the Board has total discretion. As of June 30, 2007, there were 81,731 active and retired members of the nine pension funds. The protected status of the pension funds is clearly spelled out in the state Constitution:

Section 15. Public retirement system assets. (1) Public retirement systems shall be funded on an actuarially sound basis. Public retirement system assets, including income and actuarially required contributions, shall not be encumbered, diverted, reduced, or terminated and shall be held in trust to provide benefits to participants and their beneficiaries and to defray administrative expenses.

This language protects the state's pension funds as "trust" assets – off limits to any legislative or investment activity that would diminish the trusts. The assets include contributions by state/local government entities and active employees, as well as investment income. Once these various funding sources are deposited in the pension accounts they lose their identity and become an integral part of the trusts, the investment of which is the Board's sole responsibility. When considering whether SR investing might conflict with its fiduciary responsibilities, the Board must consider its impact on pension beneficiaries.

Mr. South presented the following staff recommendations:

1. Staff recommends that the Board not consider negative SR investing and resist any external pressure to do so. Given the rigorous constitutionally-mandated fiduciary responsibilities imposed on the Board, it must at all times base its investment policies, processes, and decisions in the best interests of the pension beneficiaries. Reducing the investment universe through screens or other methods will only serve to distract the Board from its primary mission of enhancing pension fund performance.
2. Staff recommends that the Board become more proactive as a shareholder in those companies whose stock is held as a strategic investment. This "proactive" process would require staff and consultant to create a corporate governance policy integral to a comprehensive proxy voting policy that represents best practices and present these policies for Board approval at a future meeting. The process would also require that the Board hire an external vendor to vote all Board proxies, rather than permitting the external equity managers to vote as is the current policy.

An enhanced proxy policy was recommended by Independent Fiduciary Services when it conducted a comprehensive review of Board operations, processes, and policies.

Chairman Moore asked Mr. Jim Voytko to proceed with the Socially Responsible Investing presentation prepared by R.V. Kuhns.

Mr. Voytko reported that Proxy voting is the primary forum through which shareowners participate in the governance of corporations. Corporate management seeks affirmation and approval of existing and new policies from shareowners. Proxy voting equals investor involvement in the governance of the entities owned by the Fund. Public fund fiduciaries, including investment managers, are required to vote proxies in the best interest of plan participants and beneficiaries.

Mr. Voytko presented 4 options for Proxy Voting:

- Option 1:** Board delegates to each investment manager the complete authority and obligation to vote the fund's proxies.
- Option 2:** Board approves a customized proxy voting policy and asks each manager to vote according to the policy.
- Option 3:** Board approves a customized proxy voting policy and asks MBOI Staff to vote according to the policy.
- Option 4:** Board engages the services of an external proxy voting agent. The Board's viewpoints can be applied through (a) the development of a voting policy that reflects the Board's specific views, or (b) the adoption of a "pre-packaged" set of proxy policies offered by a proxy voting service.

There are assumptions, pros and cons relative to all of these options.

Confirmation of how Montana Board of Investments proxies are currently being cast is essential. This data is a critical element in the Board's consideration of any proxy policy revision. R.V. Kuhns & Associates recommends that the Board perform a comprehensive survey of proxy policies used by managers. R.V.

Kuhns & Associates will perform the survey on the Board's behalf and summarize those findings and develop a recommendation to be presented at a future board meeting.

Senator Dan Weinberg spoke on the Socially Responsible Investing topic. Mr. Weinberg thanked Chairman Moore, Mr. South and Mr. Voytko for researching the topic and bringing the topic to the table. He expressed his pleasure that the Board is discussing this issue and that the Board is pursuing the positive SR investing direction of paying attention to the kind of investor citizens we are.

Mr. Weinberg provided the following statistics:

- The SRI market has grown rapidly during the past 12 years – from \$639 billion in 1995 to 2.71 trillion in 2007. That is 10.8% of the \$25.1 trillion dollars under professional money management in the US in 2007 was invested in an SRI manner.
- Employees are seeking SRI options for retirement plan investments. Over 300 million investors are interested in retirement plan funds that integrate investment returns with quality of life issues. In 2005, 68% of employees who did not have an SRI option indicated that they would invest in one if it was offered. This information is according to CALPERS.
- In reference to the liability aspect of limiting the universe of investments, to what degree are fiduciaries liable? In response to a letter from CALPERS, the Dept. of Labor has clearly stated that fiduciaries can legally pursue an SRI investment strategy.

Mr. Weinberg introduced one recommendation for consideration – Make a space in the Board's Asset Allocation for Socially Responsible Investing. Hire an SRI manager to manage the allocation and watch the results over a period of time. If after that time period the allocation is making money, increase the allocation and if the allocation is not successful, then get rid of it.

Motion: Chairman Moore stated that it is the consensus of the Board that staff, with the assistance of R.V. Kuhns & Associates, move forward immediately with the recommendations of staff to undertake the survey and return with further recommendations.

Member Fleming stated that she is in favor of Mr. Weinberg's suggestion of a possible allocation to SRI investing.

Chairman Moore inquired as to how SRI would be integrated in to the Asset Allocation Policy.

Mr. Voytko responded that the integration could be further looked at and considered once the survey is complete and that R.V. Kuhns & Associates will poll other pension funds to determine if there are other funds that have an SRI asset allocation.

(A complete copy of Mr. South's report and the Socially Responsible Investing Report prepared by R.V. Kuhns & Associates is kept on file with the documents of this meeting)

QUARTERLY PERFORMANCE REPORT

(A complete copy of this report is kept on file with the documents of this meeting)

The Quarterly Performance Report for the period ending June 30, 2008 was presented.

INVESTMENT ACTIVITY

Asset Allocation Report

Mr. Cliff Sheets presented the Retirement Systems Asset Allocation Report as of June 30, 2008.

Private Equity (MPEP)

Mr. Ed Kelly presented March 31, 2008 reports by Private Edge showing by strategy the total exposure by market value and outstanding commitments and the Portfolio Holdings Performance Report, holdings as of June 30, 2008 and investment briefs for the Montana Private Equity Portfolio for commitments made since the last Board meeting, as shown below.

<u>Fund Name</u>	<u>Vintage</u>	<u>Subclass</u>	<u>Amount</u>	<u>Date</u>
Lexington Middle Market Investors II	2008	Secondary	\$10 M	6/20/08
HarbourVest / Dover St. VII	2008	Secondary	\$20 M	7/02/08
Odyssey Investment Partners IV	2008	Buyout	\$20 M	7/25/08
First Reserve Fund XII	2008	Buyout	\$25 M	7/28/08
Total New Commitments			\$75M	

Real Estate (MTRP)

Mr. Ed Kelly presented March 31, 2007 reports by Private Edge showing the real estate fund commitments made to date and holdings as of June 30, 2008. There were no new investment commitments made by staff since the May Board meeting to report.

Domestic Equity (MDEP)

Mr. Rande Muffick presented the Montana Domestic Equity Pool Report as of June 30, 2008 and a summary of recent market trends.

International Equity (MTIP)

Mr. Rande Muffick presented the Montana International Equity Pool Report for the period ending June 30, 2008 and discussed market trends during the quarter.

Public Equity External Managers Watch List

Mr. Rande Muffick presented the External Managers Watch List – Quarterly Update. The Watch List criteria were established in accordance with the Montana Board of Investments Public Equity Manager Evaluation Policy, adopted by the Board on May 14, 2008.

<u>Manager</u>	<u>Style Bucket</u>	<u>Reason</u>	<u>Inclusion Date</u>
Goldman Sachs	Domestic – LC Enhanced	Performance, Personnel	March 2008
NorthPointe	Domestic – SC Growth	Performance	August 2008
Principal Global	International – LC Growth	Performance	March 2008
Western Asset	Domestic - LC Enhanced	Performance, Tracking Error	March 2008

Fixed Income

Mr. Nathan Sax presented the Fixed Income Overview and Strategy and the External Manager Update.

Mr. Richard Cooley presented the Short-Term Investment Pool, State Fund Insurance and Treasurer's Fund Portfolio Reports and the Below Investment Grade Holdings Report.

Mr. Nathan Sax reported that two managers each for Core Plus and High Yield assignments have been chosen. The Core Plus managers are Artio Global Investors and Reams Asset Management Company. The High Yield managers are Post Advisory Group and Lehman Asset Management. The Investment Management Agreements and Guidelines are expected to be final and executed by the end of August.

Mr. Rich Cooley provided an update to the Board on the Short Term Investment Pool (STIP). Mr. Cooley reported that the STIP portfolio is currently well diversified and is operating within all the new guidelines adopted by the Board in February 2008.

Securities Lending Report

Mr. Cliff Sheets provided an in-depth report on Securities Lending.

State Street Bank is the master custodian and acts as the security lending agent on behalf of the Board of Investments. The income earned is split 80/20 between the Board of Investments and State Street Bank. The income earned represents an incremental return on assets.

There are risks associated with Securities Lending; however State Street Bank (SSB) acts to mitigate those risks as part of its actions as agent. As the agent, SSB selects borrowers and is able to screen out the weaker credits; manages collateral (can increase required margin and type of collateral accepted); manages cash collateral and invests it, and has recently acted to reduce investment risk. Most importantly, SSB indemnifies the Board of Investments against loss from borrower default, though not from investment losses suffered in the cash collateral pools.

The Board has seen a significant increase in securities lending income during fiscal year '08. Compared to fiscal year '07, there has been almost an 8-fold increase, to \$7.4 million dollars. The increase is driven by several factors: (1) More lendable securities due to the restructuring of the Montana International Equity Pool (MTIP) in 2006; (2) The change to allow certain securities as collateral versus accepting cash collateral only; (3) A higher demand for securities, both stocks and bonds and especially agency securities, and therefore a higher negotiated (demand) spread with borrowers and higher utilization (higher proportion out of loan); and (4) Higher reinvestment spreads, due to wider spreads earned by the collateral pool investments.

In conclusion, Mr. Sheets stated that the expectations are for demand spreads to slowly decrease with reinvestment spreads holding up as long as there is an ongoing credit crunch. An overall slight downward trend in earnings may occur during the current fiscal year, but much will depend on stress in the money markets.

ADJOURNED

The meeting adjourned for the day at 5:50 p.m.

CALL TO ORDER

The meeting was reconvened Wednesday, August 20, 2008 at 8:00 a.m. with eight members of the Board present. Member Elouise Cobell and Member Tom McGillvray were absent.

PRESENTATIONS

Vaughan Nelson Investment Management

Mr. Rande Muffick introduced Mr. Chris Wallis and Mr. George Holewyne. Mr. Wallis and Mr. Holewyne reviewed their firm and management style. Vaughan Nelson Investment Management manages a small-cap growth account held in the Domestic Equity Pool.

Renaissance Investment Management

Mr. Rande Muffick introduced Mr. Michael Schroer and Mr. Carey Kruer. Mr. Schroer and Mr. Kruer reviewed their firm and management style. Renaissance Investment Management manages a large cap growth account held in the Domestic Equity Pool.

R.V. Kuhns and Associates

Ms. Becky Gratsinger and Mr. Peter Madsen provided to the Board an educational session on Commodity Investing. The educational presentation included information on:

Commodities Background

- Commodities include goods, such as energy, livestock, grains, precious metals, industrial metals.
- Investments are generally made indirectly through futures, swaps, and structured notes.
- Low correlation to traditional asset classes.
- Exposure to commodities can be either actively managed or passively managed through derivatives.

Returns

- Commodities have exhibited strong positive returns over recent years, but the returns can be very volatile year-to-year and have experienced large negative returns at times as well.
- Over the longer horizon commodity and developed market equity returns are similar.
- The three sources of commodity returns were discussed:
 - The price appreciation/depreciation of the underlying commodities.
 - “Roll” returns.
 - Cash collateral returns.

Commodity Indices

- Index oriented investing in commodities is a popular method.
- Different methods for replicating exposure to commodity indices were discussed.
- Index construction is highly varied across vendors.
 - Index differences create potentially conflicting definitions of commodity market beta.

Implementation Choices

Different management choices for gaining exposure to commodities were discussed, ranging from passive to active strategies, and including over-the-counter and exchange-listed instruments. Fees associated with the different types of management choices were also discussed.

Summary

- Commodities have historically provided an equity like return, and low correlations with traditional asset classes such as stocks and bonds.
- Volatility of the asset class justifies a phased approach to gaining exposure for investors new to this market.
- A limited allocation of assets may deliver a meaningful impact through diversification.
- Myriad of choices for implementation.
- Implementation decision based on return objectives, resources for monitoring, and risk tolerance.

After the presentation Chairman Moore expressed appreciation to R.V. Kuhns for presenting a good summary of this asset category for the Board’s educational benefit. He then asked Mr. Sheets where he viewed this subject in terms of consideration in an asset allocation context.

Mr. Sheets commented that we should not be in any particular hurry to consider a commodities allocation given the pending consideration of hedge funds. Further, it was his view that commodities are not likely to do very well in a global economic slowdown that is likely to have disinflationary tendencies. Longer term, it deserves consideration for diversification sake but near-term we should be cautious about losing money for the sake of diversification.

The Board took no action and no decisions were made.

BOND PROGRAM

Activity Report

The Board reviewed this report for the period ending June 30, 2008.

Staff Approved Loans Report

Ms. Louise Welsh reported that the following loans have been approved by staff during the period of May 1 – June 30, 2008:

Borrower:	Ravalli County
Purpose:	To finance public safety vehicles
Staff Approval Date	May 19, 2008
Board Loan Amount:	\$165,000.00
Term:	5 years

Borrower:	Pondera County
Purpose:	To purchase a building for a senior center
Staff Approval Date	June 6, 2008
Board Loan Amount:	\$89,550.00
Term:	10 years

Borrower:	Sanders County
Purpose:	To finance costs associated with upgrading the County Fairgrounds arena holding pens
Staff Approval Date	June 12, 2008
Board Loan Amount:	\$143,911.53
Term:	10 years

<u>Commitment Date</u>	<u>Borrower</u>	<u>Project Description</u>	<u>Amount</u>
5/5/08	MSU-Bozeman	IT Infrastructure Replacement Plan - Intermediate Frame Campus Network Infrastructure	\$663,372.00
5/5/08	MSU-Bozeman	IT Infra. Replacement Plan - Banner Equipment Upgrade	\$597,357.00
5/6/08	MSU- Bozeman	IT Infra. Replacement Plan - Banner Disaster Recovery	\$62,544.00
6/06/08	MSU-Bozeman	IT Infra. Replacement Plan - IDF Upgrade	\$150,000.00
6/9/08	MSU-Bozeman	IT Infra. Replacement Plan - Network Building Wiring	\$163,000.00
6/18/08	MSU- Billings	Relocate College of Technology Soccer Field	\$725,000.00
6/19/08	U of M-Western	Life Safety Improvements to P.E. Complex	\$300,000.00

MONTANA LOAN PROGRAMS

Commercial and Residential Portfolios Report

Mr. Herb Kulow presented and the Board reviewed this report for the period ending July 31, 2008.

In addition, Mr. Kulow reported that the Board met via Conference call on July 31, 2008 and approved (with a vote of 6 – 0; Member Moore, Member Cobell and Member Fleming were absent), a value-added loan to Summit Aeronautics Group, LLC with Board of Investments exposure of \$2,625,000. At the same time, the Board also approved (with a vote of 6 – 0; Member Moore, Member Cobell and Member Fleming were absent), a future funding for Summit Aeronautics Group LLC under the value-added loan program in a Board of Investments maximum participation amount of \$750,000.

NEXT MEETING

The next regularly scheduled meeting of the Board will be November 12 & 13, 2008 in Bozeman, MT.

ADJOURNMENT

There being no further business, the meeting was adjourned at 11:25 a.m.

BOARD OF INVESTMENTS

APPROVE: _____
Terry Moore, Chairman

ATTEST: _____
Carroll South, Executive Director

DATE: _____