SPECIAL MEETING OF THE
MONTANA BOARD OF INVESTMENTS
DEPARTMENT OF COMMERCE

2401 Colonial Drive, 3rd Floor
Helena, Montana

July 14, 2011

<u>AGENDA</u>

I.	**CALL TO ORDER**		**11:00 AM**
	A.	Roll Call	
	B.	Approval of the May 18 and 19, 2011 Meeting Minutes	
	C.	Administrative Business	**11:05 AM**
		1. Human Resource Committee Report – Board Decision	
		2. Board Educational Policy – Discussion – Board Decision	
	D.	Public Comment on issues within Board Jurisdiction	**11:50 AM**
II.	**LUNCH DELIVERED**		**12:00 PM**
III.	**ALTERNATIVE INVESTMENTS – INFORMATIONAL/QUESTIONS**		**12:30 PM**
	A.	Alternative Investments – R.V. Kuhns & Associates (Handout)	
	B.	Private Equity Investments – Carroll South, Executive Director	
	C.	Real Estate Investments – Clifford Sheets, Chief Investment Officer	
IV.	**ADJOURNMENT - APPROXIMATE**		**3:00 PM**

The Board of Investments makes reasonable accommodations for any known disability that may interfere with a person's ability to participate in public meetings. Persons needing an accommodations must notify the Board (call 444-0001) or write to P.O. Box 200126, Helena, Montana 59620) no later than three days prior to the meeting to allow adequate time to make needed arrangements.

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MONTANA BOARD OF INVESTMENTS
DEPARTMENT OF COMMERCE
2401 Colonial Drive, 3rd Floor
Helena, Montana

MINUTES OF THE MEETING
May 18-19, 2011

BOARD MEMBERS PRESENT:
Gary Buchanan, Chairman
Terry Cohea
Karl Englund
Patrick McKittrick
Quinton Nyman
Jack Prothero
Jon Satre
Senator Joe Balyeat

BOARD MEMBERS ABSENT:
Elouise Cobell
Jim Turcotte

STAFF PRESENT:
Carol Ann Augustine, Board Secretary
Jason Brent, Investment Analyst
Geri Burton, Deputy Director
Richard Cooley, CFA, Portfolio Manager
Tim House, Investment Operations Chief
Ed Kelly, Alternative Investment Analyst
Teri Kolnik, Alternative Investment Analyst
Herb Kulow, Portfolio Manager
Rande Muffick, CFA, Portfolio Manager
Jon Putnam, CFA, FRM, Fixed Income Investment Analyst
Nancy Rivera, Credit Analyst
John Romasko, CFA, CPA, Fixed Income Investment Analyst
Nathan Sax, CFA, Portfolio Manager
Clifford A. Sheets, CFA, Chief Investment Officer
Carroll South, Executive Director
Steve Strong, Equity Investment Analyst
Louise Welsh, Bond Program Officer
Dan Zarling, CFA, Director of Research

GUESTS:
Trevor Graham, Hansberger Global Investors
Mark Higgins, RV Kuhns & Associates
Gordon Hoven, Piper Jaffray
Roxanne Minnehan, Public Employee Retirement Administration
John O'Donnell, Montlake Capital
Evelyn Orley, Hansberger Global Investors
Dave Senn, Teachers' Retirement System
Tom Tibbles, Hansberger Global Investors
Jim Voytko, RV Kuhns & Associates

CALL TO ORDER

Chairman Gary Buchanan called the regular meeting of the Board of Investments (Board) to order at 12:30 p.m. in the Board Room on the third floor at 2401 Colonial Drive, Helena, Montana. As noted above, a quorum of Board Members was present.

Newly appointed Board Members Gary Buchanan and Quinton Nyman introduced themselves to the Board. Chairman Buchanan told the Board that he has many business dealings and went on the record as separating his business from the Board's business.

> Member Karl Englund made a Motion to approve the Minutes of the February 2011 Board Meeting; Member Terry Cohea seconded the Motion. The Motion was carried 7-0.
>
> Member Karl Englund made a Motion to approve the Minutes of the May 13, 2010 Joint Board of Investments/Public Employees Retirement Administration/ Teachers' Retirement System Meeting Minutes; Member Terry Cohea seconded the Motion. The Motion was carried 7-0.

ADMINISTRATIVE BUSINESS

Board Committees
Chairman Gary Buchanan made the following Board Committee appointments:

Loan Committee	Audit Committee	Human Resource Committee
Jack Prothero, Chair	Jim Turcotte, Chair	Karl Englund, Chair
Terry Cohea	Patrick McKittrick	Quinton Nyman
Patrick McKittrick	Jon Satre	Jack Prothero
Jim Turcotte		Jon Satre

Chairman Buchanan reported that the Human Resource Committee will meet at 4:30 p.m. today, May 18, 2011; the Audit Committee meeting has been postponed; and the Loan Committee report will be given tomorrow, May 19, 2011.

Future Board Meeting Dates
Chairman Buchanan confirmed the August 16-17, 2011 meeting dates.

Chairman Buchanan announced that Member Elouise Cobell will be resigning from the Board due to health issues. Member Karl Englund asked that the Minutes reflect Member Cobell's years of service to the Board and to the State of Montana, including her work on the long-running Indian trust class action lawsuit and remarkable success with the landmark $3.4 billion settlement.

Public Comment
Chairman Gary Buchanan called for public comment on Board issues. There was no public comment.

EXECUTIVE DIRECTOR'S REPORT

Legislative Update
Mr. Carroll South reported on the final disposition of legislation he has been tracking through the 2011 Legislative Session. State employees have had no salary increases for the past two years

and will receive no increases during the next two years. Retirement system changes will apply to new hires only, thus not affecting the unfunded liability of the systems.

Board Orientation Document
Mr. Carroll South presented the report that was distributed at the Board Orientation April 29, 2011. Mr. South then gave a brief overview of the Board of Investments as outlined in the Orientation document.

Alternative Investments Manager Vacancy-Hire
Mr. South informed the Board that Mr. Jon Shoen, the Board's Alternative Investment Manager resigned effective May 13, 2011. Mr. South requested authorization from the Board to fill this position. Chairman Gary Buchanan tabled this item until after the private equity presentation to the Board.

Chairman Buchanan inquired about training opportunities for the Board. There was limited discussion of how the process of vetting conference opportunities had worked in the past. Mr. Sheets explained that RV Kuhns had drafted a Board Member Education Policy in consultation with Member Fleming; however, it was not finalized at the February meeting. This proposed policy discusses several training opportunities that go beyond conferences. It was suggested that the policy memo be considered at the August meeting. The Board will review the proposed Board Education Policy and determine how to proceed.

QUARTERLY PERFORMANCE REPORTS

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

Pension Funds and Investment Pools
Mr. Jim Voytko and Mr. Mark Higgins introduced themselves to the new Board Members and gave a brief overview of RV Kuhns & Associates and its relationship with the Board.

Mr. Mark Higgins provided an overview of the current market environment and portfolio performance for the quarter ended March 31, 2011.

INVESTMENT ACTIVITIES/REPORTS

Retirement System Asset Allocation Report
Mr. Clifford Sheets presented the Retirement Systems Asset Allocation Report for the quarter ending March 31, 2011. Overall pension assets rose 3.7%, up $274M due to the strong performance of public equity markets. It was a fairly volatile quarter with spikes in oil and gas; additional distress in the European sovereign debt markets; and the disaster in Japan having a large impact. Our total equity allocation decreased slightly to 67.9% from 68.4%, reflecting $129M in total sales of domestic stocks during the quarter from both MDEP and MPEP.

The fixed allocation was down by 0.3% for the quarter; real estate was up by 0.4%; and cash was up by .5%, reflecting sales in the long term pools net of benefit payments.

Comparison to State Street Public Fund Universe
Mr. Sheets reviewed a comparison of the two large pension plans to the State Street public fund universe in terms of relative performance and asset allocation as a supplement to the RV Kuhns public fund universe return comparison. During this review he also showed the asset allocation mix compared to the R.V. Kuhns survey of public plans as an additional comparison.

Public Asset Pool Reviews

Domestic Equity (MDEP)
Mr. Rande Muffick reported on the Montana Domestic Equity Pool as of March 31, 2011, including a summary of recent market trends. Mr. Muffick stated that our pools are recovering and adding value along with the market.

International Equity (MTIP)
Mr. Muffick presented the Montana International Equity Pool Report for the period ending March 31, 2011 and reviewed market trends during the quarter.

Public Equity External Managers Watch List
Mr. Rande Muffick reported that two managers, Batterymarch International LC and Acadian International LC, were removed from the Watch List during the quarter and one manager, Columbus Circle, was added; there were no terminations.

Manager	**Style Bucket**	**Reason**	**$ Invested (mil)**	**Inclusion Date**
Western Asset	Domestic - LC Enhanced	Performance, Tracking Error	$154	March 2008
Martin Currie	International – LC Growth	Performance, Risk Controls	$105	February 2009
Analytic Investors	Domestic - 130/30	Performance, Process	$110	May 2010
Artio Global	International – LC Core	Performance, Philosophy	$121	November 2010
BlackRock Int AlphaTilts	International – LC Core	Personnel, Model and Process	$112	November 2010
Columbus Circle	Domestic – LC Growth	Performance, Process	$148	May 2011

ADJOURNED
The meeting was adjourned for the day at 4:42 p.m.

CALL TO ORDER – Day 2
May 19, 2011

Chairman Gary Buchanan reconvened the meeting Thursday, May 19, 2011 at 8:33 a.m. with seven members of the Board present. Chairman Buchanan introduced Senator Joe Balyeat, newly appointed as legislative liaison to the Board.

ADMINISTRATIVE BUSINESS

Public Comment
Chairman Gary Buchanan called for public comment on Board issues. There was no public comment.

Human Resource Committee Report
HR Committee Chairman Karl Englund reported that the HR Committee discussed the exempt position vacancy of Alternative Investments Manager. Action will be taken on this item later in the agenda.

> Member Karl Englund made a Motion to authorize Board staff to fill the Alternative Investments Manager position and approve salary within the approved salary range for that position; Member Terry Cohea seconded the Motion. The Motion was carried 7-0.

Member Englund then turned the floor over to Mr. Carroll South, who announced his retirement at the end of the year. The HR Committee will launch an extensive search to hire a new Executive Director before Mr. South leaves, so that the two may work together for an effective transition.

Member Karl Englund suggested drafting a letter on behalf of the Board to thank past Board Member Maureen Fleming for her service to the Board. Chairman Buchanan added that we might invite her to come to a Board meeting to offer recognition.

The Board will also send a letter to Member Elouise Cobell when she has officially resigned from the Board.

Dates for the next Board Meeting were confirmed to be August 16 and 17, 2011. Chairman Buchanan chose to defer scheduling any other meetings, and stated that he will schedule a Special Board Meeting in June to discuss retirement funds and strategies.

INVESTMENT ACTIVITIES/REPORTS, continued

Public Asset Pool Reviews

Fixed Income

Mr. Cliff Sheets gave a brief review of the history of management of the fixed income asset class at the Board after yesterday's discussion about Retirement Funds Bond Pool performance. Mr. Sheets reviewed the performance history of the Pool, the allocation decision made to add externally-managed non-core portfolios in 2008, and performance compared to peer asset class returns.

Mr. Nathan Sax presented the Fixed Income overview and strategy for the Retirement and Trust Fund Bond Pools.

Mr. Sax also presented the Below Investment Grade Fixed Income Holdings report.

Mr. Richard Cooley reported on the Short Term Investment Pool, State Fund Insurance and Treasurer's Fund portfolios.

Private Asset Pool Reviews

Private Equity (MPEP)

Mr. Cliff Sheets presented a comprehensive overview of the private equity portfolio, including quarterly cash flow; total exposure by strategy; market value exposure by industry; total exposure by geography; total exposure by investment vehicle; periodic return comparison; and LPs by family of funds.

Two new fund commitments were made since the February 2011 Board Meeting.

Fund Name	Vintage	Subclass	Sector	Amount	Date
Centerbridge Capital Partners II, L.P.	2011	Buyout	Diverse	$25M	01/31/11
American Securities Partners VI, L.P.	2011	Buyout	Diverse	$35M	04/22/11

Real Estate (MTRP)
Due to time constraints, the following private edge reports were not presented verbally but are included in the Board packet: quarterly cash flow; total exposure by strategy; market value exposure by property type; total exposure by geography; time weighted and internal rates of return; and the portfolio status report. The following funding and commitment decisions were presented in the packet but not discussed.

Fund Name	Pool	Subclass	Sector	Amount	Date Funded (Core) or Date of Decision
TIAA-CREF Asset Management Core Property Fund, LP	TFIP	Core	Diverse	$1 M	4/1/11
TIAA-CREF Asset Management Core Property Fund, LP	TFIP	Core	Diverse	$1 M	5/1/11
Molpus Woodlands Fund III	MTRP	Timber	Domestic	$50 M	02/01/11
RMS US Forest Growth Fund III	MTRP	Timber	Domestic	$25 M	03/15/11
Landmark Partners RE Partners VI, LP	MTRP	Secondary	Diverse	$20 M	03/16/11

Partnership Focus Lists
Due to time constraints, changes to the MPEP and MTRP Focus Lists were not presented.

EXTERNAL MANAGER PRESENTATION

Hansberger Global Investors
Mr. Rande Muffick introduced Mr. Tom Tibbles, Chief Investment Officer; Mr. Trevor Graham, Senior Vice President of Research, and Ms. Evelyn Orley, Senior Vice President of Marketing, who reviewed their firm and management style. Hansberger Global is an international equity manager.

MONTANA LOAN PROGRAMS

Commercial and Residential Portfolios Report
Mr. Herb Kulow reported that the Montana Board of Investments has been awarded approved lender status with the USDA Rural Development's Business and Industry Guarantee Program. This will allow a lower interest rate to the borrower and provide diversification within our infrastructure loans.

Mr. Kulow told the Board that as of April 30, 2011 commercial loans totaled $161,106,236 and yielded 5.54%. Delinquent loans will be current by the end of the month.

The residential loan portfolio declined slightly, with a balance of $28,199,479. There are no outstanding reservations.

Loan Committee Report
Loan Committee Chairman Jack Prothero reported that the Loan Committee reviewed and approved one Montana Loan Program loan request. The Loan Committee authorized staff to

proceed with processing and closing this loan using the Board's standard Loan Program procedures.

Borrower:	King Development & Land Co., LLC
Type of Loan	Participation Loan
Lender:	First Interstate Bank, Billings
Purpose:	Construction of 24,066 sq. ft. free standing retail building
Board Loan Amount:	$1,170,040
Term:	20 Years

The Loan Committee also reviewed and recommended full Board approval of the following loan:

Borrower:	J & D Limited Family Partnership and J.C. Billion, Inc., Bozeman
Type of Loan	Participation Loan
Lender:	Bank of Montana, Missoula
Purpose:	Construction of three auto dealerships and a car wash.
LC Approval Date:	May 18, 2011
Board Loan Amount:	$7,680,000
Term:	20 Years

> Loan Committee Chairman Jack Prothero made a Motion to approve the loan to J & D Limited Family Partnership and J.C. Billion, Inc., Bozeman; Member Jon Satre seconded the Motion. The Motion was carried 6-0; Member Karl Englund abstained.

BOND PROGRAM

Activity Report
Ms. Louise Welsh presented the INTERCAP report for the period January 1 through March 31, 2011. Year to date commitments total $27,071,702 with $9,900,721 funded. Total loans outstanding are $71,280,609; bonds outstanding are $95,530,000.

Ms. Welsh informed the Board that the Board's credit enhancement report is available on the Electronic Municipal Market Access website. Chairman Buchanan requested a copy of this report.

Staff Approved Loans Report
The Board reviewed this report for the period January 1 through March 31, 2011.

Borrower:	Town of Sunburst
Purpose:	Purchase garbage truck
Staff Approval Date	January 14, 2011
Board Loan Amount:	$28,050
Other Funding Sources:	$0
Total Project Cost:	$28,050
Term:	5 years

Borrower:	City of Three Forks
Purpose:	Construct a 30X40 office/storage building at city fairgrounds
Staff Approval Date	January 14, 2011

Board Loan Amount:	$48,000
Other Funding Sources:	$0
Total Project Cost:	$48,000
Term:	10 years
Borrower:	Sheavers Creek Lake Co. Water & Sewer District (Bigfork)
Purpose:	Final costs to complete the water storage tank and waterline improvements project
Staff Approval Date	February 1, 2011
Board Loan Amount:	$ 25,000
Other Funding Sources:	$1,961,400
Total Project Cost:	$1,986,400
Term:	10 years

Borrower:	Dept. of Natural Resources and Conservation (DNRC)
Purpose:	Interim financing in anticipation of receiving Drinking Water State Revolving Fund (DWSRF) Loan Program loan repayments
Staff Approval Date:	February 4, 2011
Board Loan Amount:	$1,000,000
Other Funding Sources:	$0
Total Project Cost:	$1,000,000
Term:	3 years

Borrower:	Ravalli County
Purpose:	Purchase sheriff vehicles
Staff Approval Date:	February 14, 2011
Board Loan Amount:	$300,000
Other Funding Sources:	$0
Total Project Cost:	$300,000
Term:	5 years

Borrower:	City of Libby
Purpose:	Interim loan in anticipation of Rural Development (RD) long term financing for wastewater system improvements
Staff Approval Date:	February 25, 2011
Board Loan Amount:	$ 678,000
Other Funding Sources:	$ 542,000
Total Project Cost:	$1,220,000
Term:	2 years

Borrower:	Crystal Springs Yellowstone Co. W&S District (Billings)
Purpose:	Preliminary engineering report
Staff Approval Date:	March 7, 2011
Board Loan Amount:	$40,000
Other Funding Sources:	$ 6,000
Total Project Cost:	$46,000
Term:	6 years

Borrower:	City of Miles City
Purpose:	Purchase police vehicles
Staff Approval Date:	March 17, 2011
Board Loan Amount:	$53,500
Other Funding Sources:	$0
Total Project Cost:	$53,500
Term:	3 years

MONTANA UNIVERSITY SYSTEM

Borrower:	University of Montana-Missoula
Purpose:	UM's Broadcast Media Center (Montana Public Radio) KUFM fundraising soft/hardware
Staff Approval Date	February 28, 2011
Board Loan Amount:	$38,500
Other Funding Sources:	$25,000
Total Project Cost:	$63,500
Term:	5 years

Borrower:	MSU-Bozeman
Purpose:	American Disabilities Act (ADA) accessibility projects
Staff Approval Date	March 8, 2011
Board Loan Amount:	$ 773,000
Other Funding Sources:	$ 263,000
Total Project Cost:	$1,036,000
Term:	6 years

<u>Loan Committee E-Mail Approved Loans</u>
The Loan Committee approved the following loans by email February 9 through May 19, 2011.

Borrower:	City of Ronan
Purpose:	Interim loan in anticipation of Rural Development (RD) long term financing for water system improvements
LC Approval Date:	February 15, 2011
Board Loan Amount:	$2,528,000
Other Funding Sources:	$2,285,000
Total Project Cost :	$4,813,000
Term:	2 years

Borrower:	Town of Stevensville
Purpose:	Interim loan in anticipation of Rural Development (RD) long term financing for water system improvements
LC Approval Date:	February 15, 2011

Board Loan Amount:	$3,000,000
Other Funding Sources:	$2,000,000
Total Project Cost :	$5,000,000
Term:	1 year

Borrower:	Department of Natural Resources and Conservation (DNRC)
Purpose:	Interim loan in anticipation of issuing State of Montana Coal Severance Tax (CST) Bonds for its Renewable Resource Grant & Loan (RRGL) Program
LC Approval Date:	March 24, 2011
Board Loan Amount:	$2,000,000
Other Funding Sources:	$0
Total Project Cost :	$2,000,000
Term:	3 years

ADJOURNMENT

There being no further business, Chairman Buchanan adjourned the meeting at 12:17 p.m.

Next Meeting
The next regular meeting of the Board will be August 16 and 17, 2011 in Helena, Montana.

Complete copies of all reports presented to the Board are on file with the Board of Investments.

BOARD OF INVESTMENTS

APPROVE:________________________________
Gary Buchanan, Chairman

ATTEST:__________________________________
Carroll South, Executive Director

DATE: ___________________________________

MBOI:caa
6/8/11

Montana Board of Investments

Board Education Policy

Last Revised: June 10, 2011

Return to Meeting Agenda

I. PURPOSE

The purpose of this Board Education Policy is to establish guidelines and procedures for members of the Montana Board of Investments (Board) that recognize and affirm the importance of education to the success of fulfilling their fiduciary responsibilities.

II. POLICY OBJECTIVES

1. All Board Members will be able to leverage continuing education opportunities to maintain the knowledge they need to carry out their fiduciary responsibilities and engage in effective group discussion, debate and decision making with regard to the Unified Investment Program.

2. Newly appointed Board Members will be provided with the general introductory knowledge they need to enable them to effectively participate in Board and Committee deliberations in a timely manner.

3. Board Members will have the opportunity to learn through networking with the Trustees of other public retirement systems and learn of alternate approaches to common issues and problems.

III. ASSUMPTIONS AND PRINCIPLES

1. Board Members are responsible for making policy decisions affecting all major aspects of the Unified Investment Program. They, therefore, should acquire an appropriate level of knowledge of all significant facets of the investment management process rather than specializing in particular areas.

2. A variety of educational methods are necessary and appropriate since no single, educational method is optimal.

3. The Board Education Policy is not intended to dictate that Board Members attend only specific conferences or programs. Although a list is included in this Policy as a reference, the Policy is a framework for the types of opportunities that the Board Members should use in their fiduciary education.

IV. POLICY GUIDELINES

1. GENERAL PROVISIONS

A. All Board Members are encouraged to develop and maintain their knowledge and understanding of the issues involved in the policy direction and management of the Montana Board of Investments throughout their terms as Board Members.

B. Board Members are encouraged to develop an appropriate level of knowledge across a broad spectrum of issues, including:

i. Governance and fiduciary duty
ii. State law and constitution as it relates to the Board's mission
iii. Actuarial policies and pension funding
iv. Best practices in total fund, asset class composite and investment manager monitoring, funding and decision-making
v. Key institutional investment management concepts, including, but not limited to:
  a. Portfolio management theory and strategies
  b. Asset class attributes and investment strategies
  c. Performance evaluation concepts

C. Board Members are encouraged to assist in evaluating and taking advantage of appropriate educational tools, which may include, but are not limited to:

i. External conferences, seminars, workshops, roundtables, courses or similar vehicles
ii. In-house presentations by the Board's service providers, staff, or non-affiliated investment experts
iii. Relevant periodicals, trade journals, textbooks, electronic media, etc.

D. The Board Chair shall review and evaluate available educational conferences and bring to the attention of the Board those they believe are appropriate. Board Members may also bring forward appropriate educational conferences for consideration.

E. Standards for determining the appropriateness of a potential educational opportunity shall include:

i. The extent to which the opportunity is expected to provide Board Members with the knowledge they need to carry out their roles and responsibilities, and

ii. The expected return on investment of the program, taking into account the expected educational benefits weighed against the expected costs, such as travel, lodging and related expenses.

F. Board Members are encouraged to assist in identifying the educational vehicles that best meet their needs, and to attempt to meet the following minimum goals:

i. Secure an appropriate level of knowledge in each of the areas listed in Section B of this Policy; and

ii. Attend one external conference annually, preferably one that is (1) highly relevant to current investment issues before the board and/or, (2) specifically dealing with public fund issues, and (3) additive to external education events attended by fellow Board Members.

Due diligence activities such as meetings with existing or prospective service providers shall not substitute for other educational programs.

G. The Board shall establish an annual budget to cover the cost of providing continuing fiduciary education for its Board Members. The Board shall reimburse, as permitted by state law/policy Board members for all reasonable and necessary expenses incurred in attending educational programs encouraged hereunder as provided in this Policy.

H. Each Board Member shall report to the Board in writing, on the most important knowledge or information gained from the conference/seminar/workshop attended and recommend whether to attend in the future.

2. BOARD MEMBER ORIENTATION PROGRAM

A. An orientation program will be formalized and maintained for the benefit of new Board Members.

B. All new Board Members shall be required to participate in the orientation program within 45 days of appointment.

C. The aim of the orientation program is to ensure that new Board Members are in a position to contribute fully to Board and Committee deliberations and effectively carry out their fiduciary duties as soon as possible after joining the Board.

D. The orientation program shall include:

i. In-person introduction to Board management and staff

ii. A tour of the staff office

iii. An orientation handbook, which is presented to Board Members via an orientation seminar. The handbook and accompanying seminar should cover the following:
   a. The Board's Governance Policy
   b. Governing state law and constitution
   c. Roles and responsibilities of Board Members, Committees and staff
   d. Copies of Board and general operating policies and procedures
   e. Most recent Annual Report and Financial Statements
   f. Most recent Pension Actuarial Valuation Reports and Asset Liability Study
   g. Most recent Investment performance report
   h. The Board's budget
   i. Functional organization chart
   j. Names and telephone numbers of other Board Members and Staff

iv. A briefing by Board staff on the management and history of the Board of Investments

3. ATTENDANCE AT CONFERENCES AND SEMINARS

A. Illustrative examples of conferences that Board Members may consider attending would include:

   i. Council of Institutional Investors (CII)
   ii. Institutional Investor Conference on Alternative Investments
   iii. Institutional Investor Conference on Fund Management
   iv. International Foundation of Employee Benefit Plans
   v. Portfolio Concepts and Management sponsored by the Wharton School, University of Pennsylvania (Wharton)
   vi. Public Pension Investment Management Program (SACRS)
   vii. Semi-annual conference sponsored by the State Association of County Retirement Systems (SACRS)

B. Board Members wishing to attend other conferences or seminars will submit their request to the Board Chair for approval.

C. In attending external conferences, preference will be given to those sponsored by educational institutions or pension industry associations as opposed to conferences with agendas that are largely determined and executed by current or potential vendors of the Board.

D. Expenses of attending a Professional Conference by a Board Member who attends the Professional Conference in his or her own professional capacity shall not be reimbursed by the Board. Only with the permission of the Board Chari may a Board Member attend a Professional Conference in his or her capacity as a Board Member.

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MEMORANDUM

Montana Board of Investments
Department of Commerce
2401 Colonial Drive, 3rd Floor
Helena, MT 59601 (406) 444-0001

To: Board Members

From: Carroll South, Executive Director

Date: July 14, 2011

Subject: Pension Fund Private Equity Investments

What are Private Equity Investments?

The term "Private Equity" is used to broadly define investments in private equity, rather than publicly-traded equity. Traditionally, there have been two major types of private equity funds:

Buy-out funds – Buy-out funds seek to purchase established companies in an attempt to make them more valuable by increasing efficiencies, cutting costs, expanding markets, and replacing management if necessary. These purchases often involve publicly-traded companies, but may involve segments of a public company, or a closely held private company. The term "Leveraged Buy-Outs" (LBO) is usually used to describe these funds because borrowed funds are often used to assist in financing the purchase. These investments first caught the general public's attention when Kohlberg, Kravis & Roberts (KKR) purchased RJR Nabisco in 1989 for $31.1 billion. At the time, this purchase was by far the largest LBO in history and became somewhat notorious when a movie, Barbarians at the Gate, was based on the activities surrounding the purchase.

Venture Capital Funds – Venture capital funds invest primarily in non-public, less mature companies that are perceived to have high growth potential that can be enhanced by "hands-on" type management skills provided by the funds' managers. The funds seek to invest sufficient amounts in the company to exert some type of control and provide managerial and/or technical expertise. The managers of the funds often sit on the company boards. Perhaps the most visible example of this type of investment involves Google, in which a consortium of venture capital funds invested in June 1999. In August 2004 Google went public with a market capitalization of $23.0 billion.

Private equity programs also often contain similar long-term, partnership-based investment vehicles with private equity-like features targeting distressed companies, infrastructure, and real assets (e.g., energy, minerals, etc.). There are also so-called "secondary" funds that specialize in purchasing investments in other private equity funds from the original investors in the secondary market. Most funds are configured as closed-end Limited Partnership Agreements in which Limited Partners make a "commitment" of capital that is drawn down over a three to five year investment period. When fund managers make an investment, they must have some type of successful exit strategy in mind. At the end of the fund's life, its success is measured by the initial price paid for its investments and the price at which investments are sold. There are two ways in which private equity investments are made – either through direct investment in individual partnerships, or through a "fund-of-funds" manager that selects and invests in the individual partnerships.

Why Does the Board Invest in Private Equity Investments?

The Board of Investments (Board) made its first investment in private equity in fiscal year 1988. The Board's 1988 Annual Report reflects the following activity:

"Leveraged Buy-outs – To participate in the rapidly growing and highly rewarding leverage buy-out activity, the Board committed $25.3 million of pension fund assets to investment in the Kohlberg Kravis Roberts Companies (KKR) funds. KKR, widely recognized as the leader in arranging leveraged buy-outs, raised in excess of $5 billion for its 1987 fund.

Venture Capital – On January 28, 1988, the Board allocated $10 million of assets from the Teachers' and Public Employees' Retirement Systems to venture capital for the purpose of diversification. Venture capital investments are high risk investments with large expected returns over a five to ten year horizon. First Chicago Investment Advisors was selected by the Board to manage the $10 million venture capital allocation."

State law encourages the investment of pension funds in venture capital as follows***:***

> ***"The board is urged under the prudent expert principle to invest up to 3% of retirement funds in venture capital companies. Whenever possible, preference should be given to investments in those venture capital companies that demonstrate an interest in making investments in Montana."***

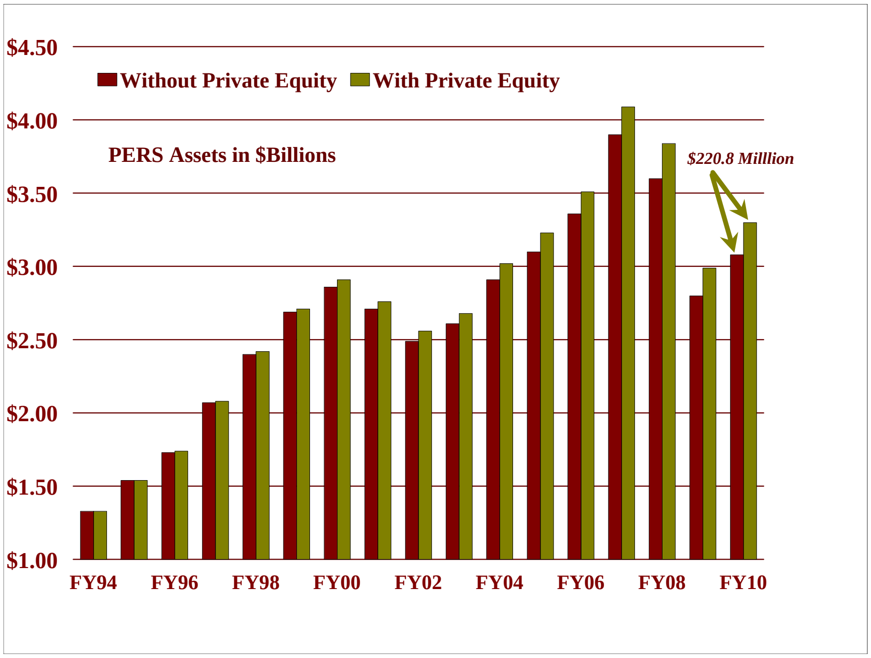
Total Capital Commitments	**$**	**1,912,388,174**
Capital Called (Out)		**1,337,479,614**
Capital Distributed (In)		**1,006,057,458**
Ending Market Value (As Of 12/31/2010)		**957,929,266**
Remaining Commitment (To Be Called)		**508,308,640**

The adjacent table shows the Board's Private Equity activity since the program's inception. Of $1.9 billion in total commitments, $1.3 billion has been drawn down, and $1.0 billion returned. As of December 31, 2010, the remaining investments have a market value of $958 million and there was $508.3 million in committed capital not yet drawn down.

Did the Board's Investment in Private Equity Add Value to Pension Fund Assets?

The Board's decision to invest in private equity has added value to pension fund assets. The value added since 1988 cannot be quantified because the Board did not begin calculating individual asset class returns for all assets until fiscal 1995. However, from fiscal year 1995 through fiscal year 2010, the pension funds' private equity annualized returns were significantly higher than returns on their stocks or bonds. Additional value was also added during the period as the Board ramped up pension fund private equity exposure from 2.0 percent to 13.0 percent of assets. The Board's annual benchmark for private equity investments is the broad domestic stock index plus 4.0 percent.

The adjacent chart depicts the value that private equity investments have added to the Public Employees' Retirement System (PERS) assets based on actual investment experience since fiscal year 1995. The calculation assumes that the $29.3 million invested in private equity investments at the beginning of the period was reallocated to the domestic stock portfolio and the additional contributions made to private equity during the period were instead added to the domestic stock portfolio.



Based on actual investment performance during the period, the value of the PERS assets at June 30, 2010 would have been $220.8 million less if the private equity assets had been reallocated to domestic stock. Given that PERS assets comprise half of total state pension assets and all nine plans were similarly invested, total pension assets would have been $441.6 million less without the private equity investments.

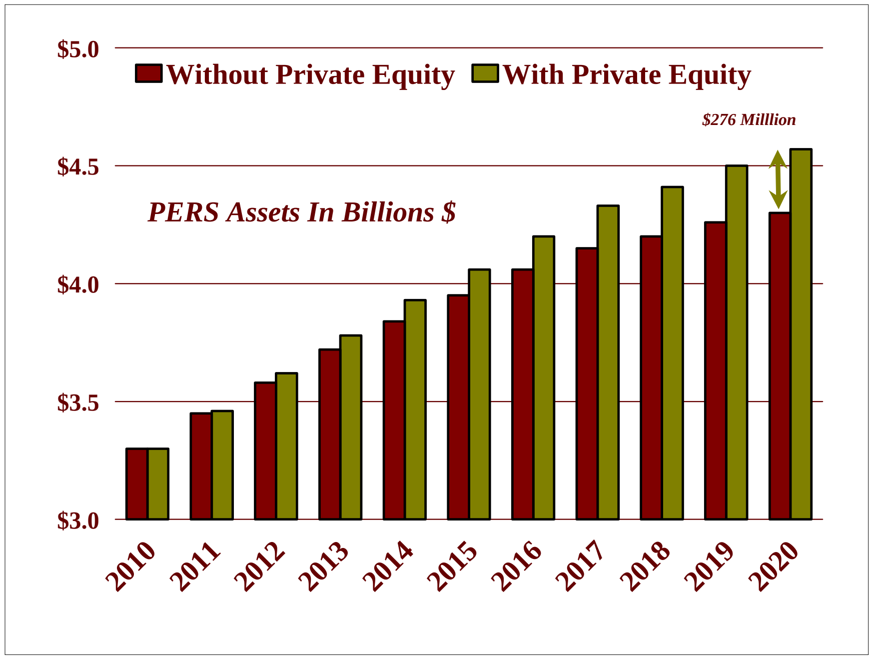
Will Private Equity Investments Add Value to Pension Fund Assets in the Future?

The reasons for investing in private equity have not changed since the Board made its initial investments. The investments serve to diversify the pension portfolios while generating returns in excess of the public equity markets. The excess return is critical in the Board's effort to generate the 7.75 percent annual return assumptions of the pension funds. If the return assumptions are not met, the pension funds' unfunded liabilities will increase.

The adjacent table depicts pension fund allocations and expected annual arithmetic investment returns for each of the asset classes as published in the December 2010 Teachers' Retirement System (TRS) Asset/Liability Study conducted by the Board's consultant. The Board-approved range for pension fund private equity is 9-15 percent, while the approved range for domestic stock and international stock is 30-50 percent and 15-30 percent respectively. The Board has also established a maximum range of 60-70 percent of total equities, which includes both public and private equity.

Asset Class	9/30/2010 Allocation	Expected Return
Domestic Stock	35.5%	8.15%
International Stock	18.6%	8.60%
Private Equity	12.4%	12.25%
Core Bonds	24.9%	5.00%
High Yield Bonds	2.4%	7.00%
Real Estate	5.8%	8.35%
Cash	0.3%	3.00%
Total	**100.00%**	**7.93%**

To demonstrate the positive impact private equity investments may have on the future value of pension fund assets, the adjacent graph depicts a scenario with and without private equity investments based on the allocations and expected returns in the preceding table. The chart methodology reallocates the 12.4 percent private equity allocation of the PERS portfolio equally to domestic and international stock. The projected growth in assets is adjusted to reflect negative cash flow as estimated by the PERS actuary through fiscal year 2020. Throughout the period, total equity exposure remains at 67.0 percent.



Based on the expected annual future returns of the various asset classes shown in the preceding table, the value of the PERS assets at fiscal year-end 2020 would be $276 million less if domestic and international stocks were substituted for private equity. Given that PERS assets comprise half of total state pension assets and all nine plans are similarly invested, the total pension assets would be $552 million less if private equity was excluded from the asset mix.

What are the Risks of Private Equity Investments?

Every pension fund investment has a certain degree of risk attached to it, either an intrinsic investment risk, or a potential risk to the pension fund if the investment does not generate sufficient return to adequately fund benefits. US Government long-term bonds have interest rate risk, while corporate bonds have both interest rate and default risk. Public equities have volatility risks and the risk of company bankruptcy which would eliminate the value of the investment. US Government 90-day Treasury Bills, while considered to be the safest investment in terms of inherent risk, pose a risk to the pension fund due to expected returns well below the actuarial return requirements of 7.75 percent annually. While there may be no investment loss with these "safe" investments, if they comprise a significant portion of the portfolio, pension fund asset growth will be greatly reduced. The reduced growth could lead to a risk of fund insolvency, which would have to be compensated for by cash infusions and/or increased contributions.

Because private equity returns are expected to exceed returns on other investments in the pension fund portfolios, it follows that there is a "risk" premium – the risk investors are willing to bear to earn higher returns. The implied risk premium could be considered compensation for the following:

Illiquidity Risk – Private equity investments are long term commitments that cannot be easily traded or sold. Other investments in the pension portfolios must provide the liquidity to pay benefits and meet other demands for necessary cash. To date, this has not been a problem with Montana's pension fund portfolios because other asset classes have provided sufficient liquidity. The Board has been able to capitalize on the illiquidity risk by investing in specialized "secondary" funds created specifically to purchase these investments at a discount from other investors who want or need to sell their fund interests.

Uncertain Cash Flows **–** While cash flow uncertainty may or may not be a significant concern, investors must be aware that they cannot count on incoming cash flows to pay bills and may have to meet capital calls when cash is not readily available. The private equity fund structure requires that the investor commit funds up front without knowing when the commitment will be called. Cash must be available when it is called or the investor will be in default of the agreement. After a private equity fund begins to mature, cash is distributed back to the investor but the investor cannot predict or control either the size or timing of the distributions. Fortunately, the Board manages a seasoned private equity portfolio with maturing funds returning cash while newer funds are requesting capital. The unpredictability of cash flows in and out of private equity requires that Board staff conduct pacing studies to determine how much to commit each year to keep private equity investments in the Board-approved range for pension funds.

Manager Risk **–** As with public security managers, there is always a risk that an underperforming private equity manager will be selected. And, unlike public security managers who can be terminated in five days without cause, the private equity relationship is long-term and may last as long as 12 to 15 years. Short of extraordinary circumstances, investors cannot back out of the commitment, and an early exit typically requires a sale of their interest to other investors (often at a steep discount). While the Board has a rigorous due diligence process when selecting private equity managers, no process is failsafe. There is a significant difference in performance between top tier and bottom tier managers in private equity. Because the top tier managers are in demand by larger pension funds, it may be difficult for smaller funds to gain access. Although the Board is a small fund and cannot compete with its peers based on commitment size, it has a long stable relationship with many private equity managers and has been successful in accessing top performing managers.

Timing Risk **–** As with investments in public securities, there are timing risks involved with private equity investments. Returns can be markedly different for investments made in different vintage years. In investment jargon a "vintage" year is the year in which fund-raising is closed and the manager begins drawing down commitments and making investments. Because no one can predict in advance which vintage year will be better than others, the Board lessens this risk by systematically committing to funds each year – a type of "dollar cost" averaging for private equity funds.

Transparency Risk **–** Private equity investments are significantly less transparent than public equity investments. Public equity investments managed by the Board's external managers are held in custody at the Board's custodial bank, which prices these investments daily. The holdings reports are downloaded daily from the bank and Board staff may peruse them and consult with the managers at will. The underlying investments in private equity funds are, for the most part, not publicly-traded and staff must rely on audited financial statements and other information provided by the managers to conduct due diligence. Staff depends upon the private equity manager to fairly price the underlying assets and requires that each manager submit its pricing methodology for staff review. A final check on the accuracy of a manager's asset pricing occurs when the asset is sold. If the sale price is close to the value placed on it by the manager, the pricing has been within an appropriate tolerance. At the end of a private equity fund's life when all assets have been sold, it is the actual sale price of the assets that determines the final performance of the fund.

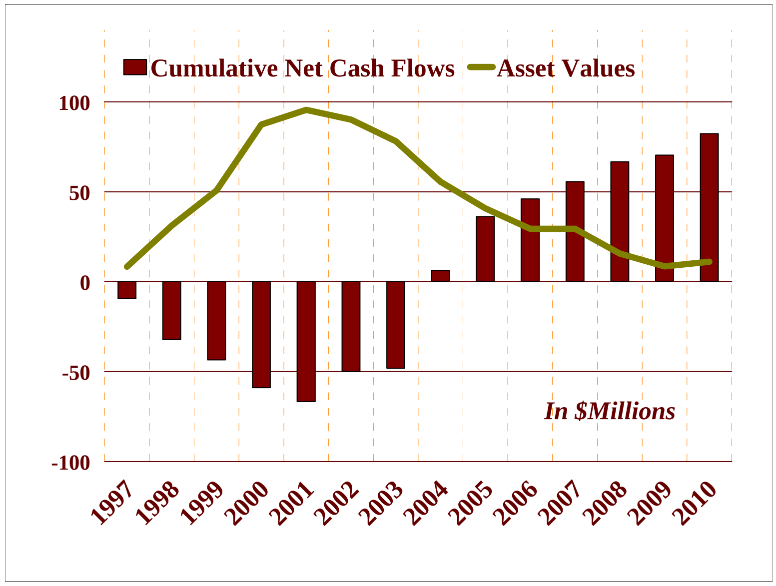
What about Private Equity Fees?

Private equity managers charge higher fees than public equity mangers for two reasons. First, it is a matter of supply and demand. As long as institutional investors are willing to pay private equity managers higher fees to generate returns in excess of public equity returns, there is no incentive for the managers to lower their fees. If institutional investors were not willing to pay the higher fees, the private equity managers would either reduce their fees or cease doing business.

Second, there is another more practical reason for higher private equity fees. Private equity management is more labor intensive than is public equity management. Rather than trading stocks on public markets for which extensive information is readily available, private equity managers must: scout for investments opportunities; conduct extensive due diligence on the investment; and negotiate a price and ownership details. If the investment is a purchase of a company, the manager must engage with company management in an effort to make it more valuable before negotiating a sale. But, before they can do any of this they must raise funds by securing financial commitments from investors. If the fund uses leverage, they must also line up loans from bond investors and/or financial institutions. In addition to the costs of acquisition and management, the manager must also devise a successful exit strategy or sale of the investment within the timeframe of the fund's life.

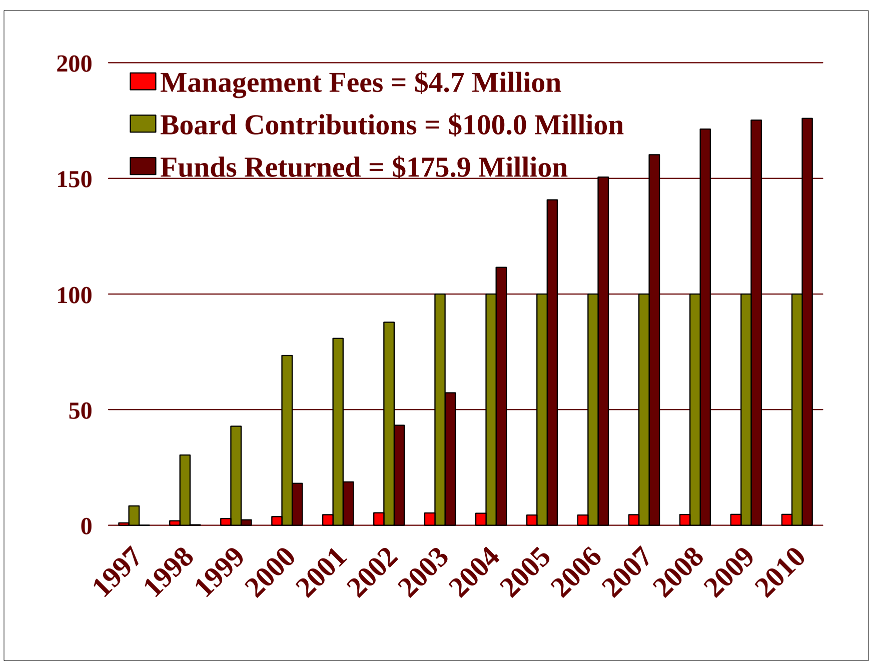
Private and public equity manager fees are based on different methodologies. Most public equity manager fees are based on the market value of the assets under management, or a combination of a set fee and a performance fee that kicks in above a certain performance threshold. When the value of the assets under management falls, the manager's fee falls. When the value of the assets under management rises, the manager's fee rises. By contrast, private equity manager fees are much more stable and are initially charged against the total committed amount, regardless of how much of the commitment has been drawn and invested. After the commitment has been partially or totally drawn down, the fee may be based on the amount actually invested.

Although private equity management fees may vary from one fund to another, they are commonly referred to as "2" and "20" - a 1.5 percent or 2.0 percent management fee on the total commitment and a 20.0 percent portion of the profits. The manager is usually not permitted to take any of the profits until the investors in the fund achieve a "preferred" return on their investment of 7.0 percent to 8.0 percent. This front-loaded fee structure results in what is called a "J" curve investment return. Because the management fees are charged on the total committed amount before any investments occur, the fees are a drag on performance during the early years and there is usually a negative return. Once the committed amount is invested and underlying investments begin to grow in value, the performance should turn positive. The more successful the investments the sharper the vertical part of the J curve will be later in the fund's life. Given this unique performance curve it is important that investors not measure the success of a private equity fund by its performance in the early years, but rather over the full investment cycle of the fund.

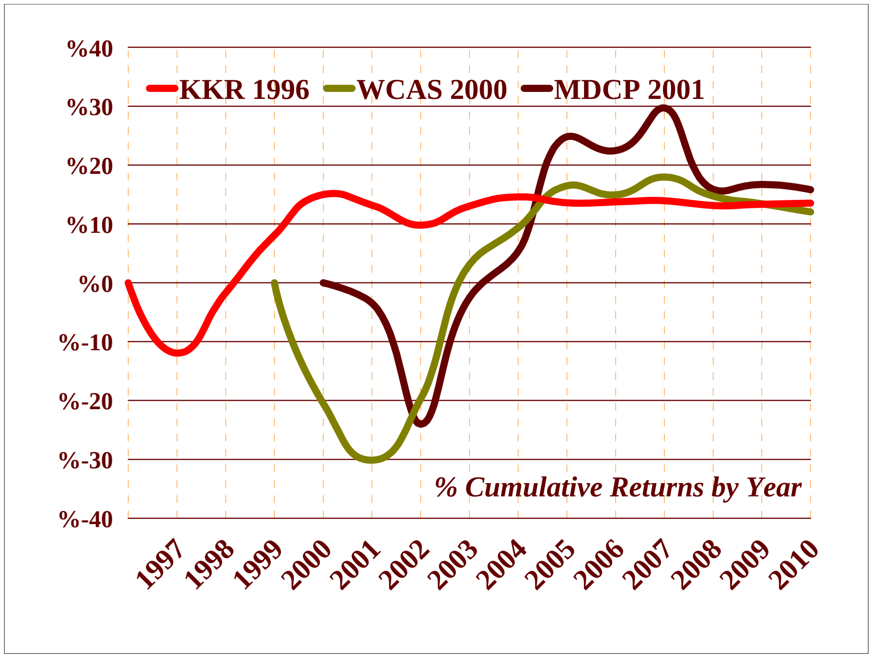


It may be helpful to view a graphic display of how cash flows are disbursed and returned to private equity investors. The adjacent chart depicts investment activity in the KKR 1996 leveraged buy-out fund to which the Board committed $100.0 million in fiscal year 1997. The bars represent the cumulative net cash flows each year (outgoing cash netted against incoming cash) and the line depicts the asset value of the investment purchased with the cash drawn from the Board's commitment. In the early years of the fund the net cash flow is negative as fees are paid and the cash is called to purchase assets. The asset value of the investments peaked when the negative cumulative net cash flow was greatest and began to decline as assets were liquidated and cash returned to the Board. As of December 31, 2010 the remaining assets were valued at $13.2 million. When the final assets are sold, the cash will be distributed to the Board.

Managing a seasoned private equity portfolio partially offsets negative cash flows as mature funds are returning cash while new funds are calling capital. Because the Board's portfolio was created in 1988, there were funds returning cash in 1996 while the KKR 1996 fund drew down the Board's commitment. When a private equity portfolio is initially created all cash flows are negative.



A different perspective is achieved by viewing the individual cumulative cash flows in and out (not netted) of this same fund depicted in the adjacent chart. The outflow peaked in 2003 when the Board's entire $100.0 million commitment had been called. A minimal amount of funds were returned in the first three years. Beginning in 2000 the managers began liquidating assets and returning funds to investors. The $4.7 million in management fees was paid from Board funds in addition to the commitment and is depicted by the red bars. There will be additional funds returned as the remaining $13.2 million in assets is liquidated. As of December 31, 2010 the fund had an internal rate of return of 13.5 percent since inception.



The adjacent chart depicts the so-called "J" curve of three actual funds in the Board's private equity portfolio. The WCAS 2000 fund is the Welsh, Carson, Anderson & Stowe IX Fund and the MDCP 2001 is the Madison Dearborn Capital Partners IV Fund. The Board committed $100.0 million to the KKR fund and $25.0 million to each of the others. The drop in returns from 2007 to 2008 in the WCAS and MDCP funds was due to write downs of assets during the financial crises. The KKR fund was minimally affected because most of the assets had been liquidated and the cash returned to investors prior to the financial crisis. The chart illustrates why it is important for investors not to judge the ultimate success of a fund by its performance in the early years.

Summary

The Board's decision to begin investing in private equity in 1988 has added value to pension fund assets. With the extra returns these investments have generated, the pension fund assets are greater than they would have been if the same amount had been invested in domestic stock. During the 23-year period to December 31, 2010, the Standard & Poor's 500 Index returned 9.48 percent annually, while the private equity portfolio had an internal rate of return of 12.43 percent during the same period. Based on the forward-looking asset return assumptions provided by the Board's consultant, investing in private equity increases the probability of meeting the actuarial required return of the pension funds.

Board staff has become proficient in vetting and monitoring private equity managers and has been able to gain access to top tier managers. Because of the Board's systematic efforts to maintain and build the portfolio, the current portfolio is broadly diversified by strategy, vintage year, and manager. Having a mature portfolio flattens the "J" curve of the total private equity portfolio because cash is being returned to the portfolio to assist in funding new commitments.

While management fees are higher for private equity than public equities, what is more important is how much value the investor has left after paying the fees. The internal rate of return calculation made by the custodial bank for private equity investments are net of all fees and accurately depicts the actual return on investment. At the end of a private equity fund's life, what really matters is how much cash was invested and how much cash was returned after the fees were paid.

Finally, in addition to the return benefit offered by this asset class, the investment in private equity has provided a diversification benefit. This is partly a function of the diverse number and types of underlying economic exposures represented by the funds and the fact that private equity fund valuations don't move in lock-step with the public equity markets.

MEMORANDUM

Montana Board of Investments
Department of Commerce
2401 Colonial Drive, 3rd Floor
Helena, MT 59601 (406) 444-0001

To: Board Members

From: Clifford A. Sheets, CFA, Chief Investment Officer

Date: July 14, 2011

Subject: Real Estate Investments

After the May 2011, Montana Board of Investments (Board) meeting the Chairman asked that a review and description of our real estate investment program be provided. The purpose of this memo is to outline the history of the Board's decision to invest in real estate, the rationale for doing so, and a brief discussion of the current portfolio and market conditions.

History

In February 2006 the Board's then-new general investment consultant, R.V. Kuhns, made a broad educational presentation that covered the spectrum of asset classes typically considered by public pension plans. At that time, when the diversification initiative was first considered, the fact that Montana's pension funds had virtually no exposure to the real estate asset class was recognized as a notable difference when compared to peers.

In the consultant's presentation it was noted that the "best practice" of diversification is across asset classes, within asset classes, and by strategy/manager. The Board's pension asset allocations were compared with public fund peers as represented in the R.V. Kuhns public fund survey at the time. This showed the median public fund had a real estate allocation of 5.4 percent while Montana's pension funds had a miniscule exposure of less than 0.5 percent through direct in-state property investments held in the two largest pension funds.

A recommendation was made by staff at that meeting, and the Board approved a preliminary allocation and manager search to obtain exposure to this asset class. The approval was requested so that the ground work for adding exposure to real estate could be expedited. The following excerpt from the minutes of the February 17, 2006 meeting reflects the approval of an allocation to the real estate asset class:

Mr. Cliff Sheets presented to the Board staff recommendation to approve a preliminary allocation and manager search for exposure to the Real Estate asset class. Real estate represents a large asset class with *many unique characteristics that make it an ideal diversification tool. The most important characteristics are the low correlation to traditional public securities, a general ability to hold value in an inflationary environment, and relatively high income returns for core real estate. Member Turcotte moved for approval of staff continuing to pursue the Real Estate asset class; Member Fleming seconded the motion and the motion was passed 6-0.*

Further, the recommendation stated: *"This real estate program will be one part of the broader plan to further diversify retirement plan assets to enhance the return prospects and lower overall risk to the portfolio."*

At the next Board meeting on April 26, 2006, staff provided an update on plans to initiate exposure to real estate and a formal request was made to create a real estate investment pool to facilitate pension fund investments in the asset class. At that time discussion included expanding the scope of our general investment consultant contract as a means of engaging a specialty, non-discretionary real estate consultant to assist us in the development of a real estate portfolio. The idea was to utilize the real estate consultant to assist us in evaluating the available closed-end funds in the market, and to utilize R.V. Kuhns' services in selecting core commingled funds. In that discussion, a preliminary target allocation was suggested of between five and ten percent, pending the completion of an asset allocation study. It was also suggested that the investments be made over the next 2 ½ years given the importance of time diversification after a period of strong returns earlier in the decade and the logistical challenge of getting funds invested, particularly in core funds which had significant purchase queues at the time.

At the August 24, 2006 Board meeting, R.V. Kuhns made an additional presentation which provided an educational follow-up on real estate and private equity investments, and a brief discussion of the asset allocation study and progress in further diversifying pension investments. Also in attendance at that meeting was Courtland Partners, a real estate consultant which had been engaged by R.V. Kuhns to assist us in selecting real estate investment opportunities as we began to invest.

Diversification Benefits of Real Estate

At the May 18, 2006 meeting R.V. Kuhns presented an Asset Allocation study conducted in conjunction with the Asset Liability study done for the TRS plan. The study included the various asset assumptions used which encompassed the return, risk (as measured by volatility of returns) and the correlation across asset classes. The return and risk assumptions at the time for the primary asset classes in which the Board already had exposure, in addition to real estate, are shown in the following table:

Asset Class	Return Assumption	Risk Assumption (std. dev.)
Large Cap US Stocks	8.00%	17.00%
Large Cap Int'l Stocks	8.25%	18.00%
Fixed Income	5.20%	6.33%
Private Equity	12.75%	32.00%
Real Estate	7.50%	9.50%

The assumption at that time was that real estate had only a 30 percent correlation with large capitalization US stocks. This "diversification benefit" was clearly one of the appealing attributes of the asset class and a primary reason for recommending investment. As stated in the initial educational presentation to the Board in February, 2006, R.V. Kuhns explained that *"Any asset class whose risk (volatility) tends to follow patterns that are different than the other investments in the portfolio will smooth the growth path of the overall portfolio;"* and *"Over time a portfolio following a smoother, less volatile path compounds value at a faster rate."* It was correctly observed that the largest risk exposure in the portfolio was equity risk and that an allocation to real estate would act to mitigate the volatility associated with that exposure.

After review of the Asset Liability study, a minimum real estate target allocation of 5 percent was approved by the Board, in the context of a 3-8 percent range presented in the study. Subsequently a 5-8 percent range was utilized in asset allocation studies, and the most recent Asset Liability study conducted in late 2010 expanded this range to 5-9 percent. The maximum of 9 percent was utilized in the study as a practical limit even though the Board had approved an allocation policy range of 5-10 percent in August, 2010. The increase in the top of the range was made with the introduction of timberland as an additional real estate diversifier to be held within the real estate pool at a limit of 2 percent of pension assets.

Formation of Real Estate Investment Portfolio

At the August 2006 Board meeting the Real Estate Investment Guidelines were presented and approved by the Board. This de facto policy statement was drafted by Courtland Partners with input by staff, and acted as the initial framework for building the real estate portfolio. The document outlined the various types of real estate funds that would be considered, both open-end and closed-end, and categorized the funds as core, value-added, and opportunistic depending on the underlying risks assumed.

The lowest real estate risk category, core funds, represents an equity investment in operating and substantially-leased institutional quality real estate in the traditional property types (apartment, office, retail, industrial and hotel). The return profile of core funds over time consists of approximately two-thirds income plus one-third appreciation which typically matches or exceeds inflation.

Value-added real estate funds hold equity or debt interests in assets requiring rehabilitation, redevelopment, development, lease-up or repositioning. Value-added investments frequently involve the repositioning of distressed assets (i.e., not fully leased and operating). Holdings may also include non-traditional property types (e.g., student housing) which may contain greater risk. Value-added returns are typically more dependent on appreciation than core returns.

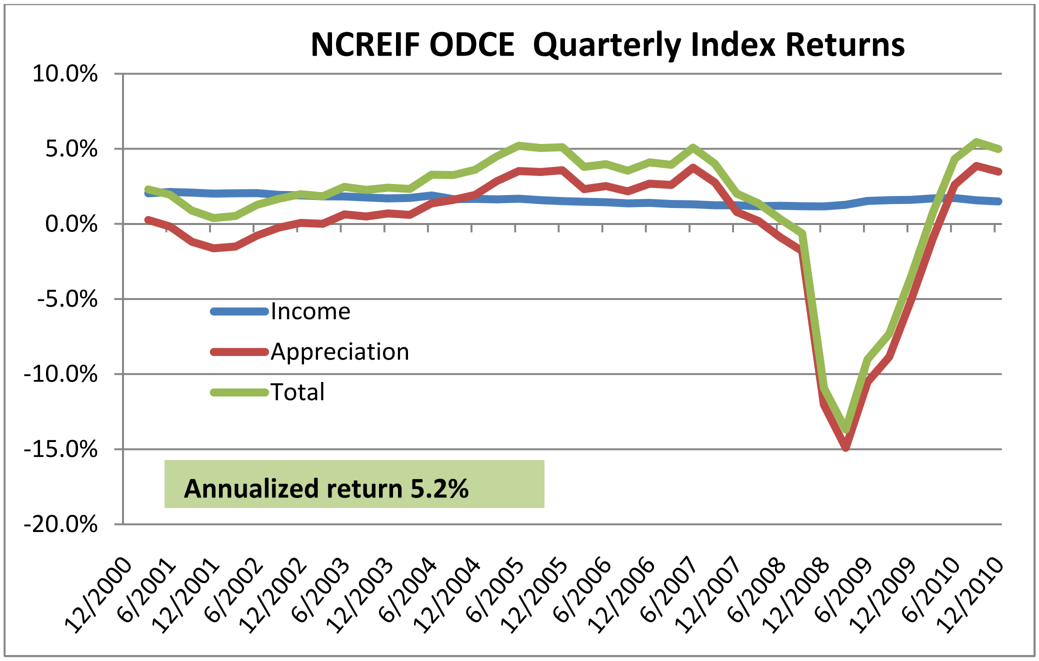
The highest real estate risk category, opportunistic funds, represents equity or debt investment in real estate properties, operating companies, and other investment vehicles involving significant investment risk. Risks may include those associated with impaired real estate, financial restructuring, and other risks associated with real estate related markets, such as securitized assets. Investment may also be made in non-traditional property types (e.g., self-storage) which typically contain greater risk. Opportunistic returns typically depend on even greater appreciation than value-added returns and in many cases investments are originated with minimal income in place.

The real estate policy also set forth diversification guidelines in terms of the range of exposure to each fund type defined by risk category, as well as underlying real estate fundamentals such as regional exposure and property type. Leverage, or using borrowed funds in addition to the equity investment in paying for an asset, was also discussed as an important risk factor and limits were imposed for core and non-core funds, and the overall portfolio. It was also recognized that the guidelines were designed to reflect the long-term policy expectations and should not be applied to the real estate portfolio in the early stages of program development.

After the pool structure was approved by the Board in April, 2006, the pool was initially funded with $30 million in June 2006, though actual investments did not begin to settle in the pool until the third quarter. The plan at the time was to average into the real estate market with an objective of reaching a 5 percent target by the end of 2008. Manager interviews began with several closed-end value-add and opportunistic funds in late July of that year, with introductions through Courtland Partners which also participated in the interviews. At about the same time, staff worked with R.V. Kuhns in vetting potential core fund managers, and narrowed down the field to four firms and scheduled interviews in September 2006.

Market Returns

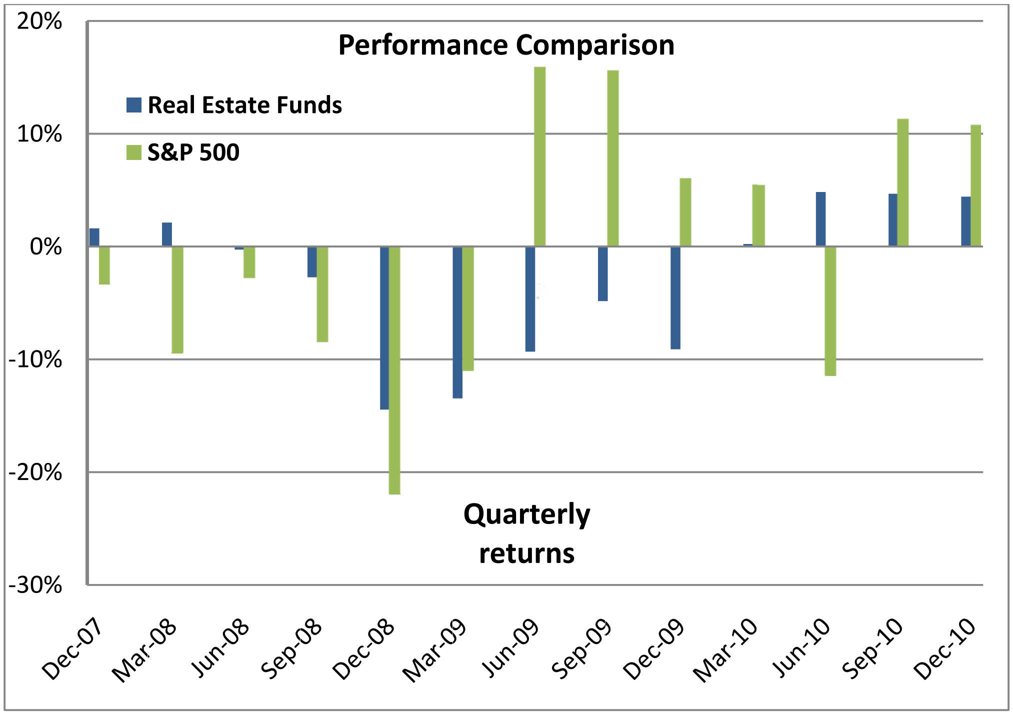
Real estate returns were positive and rising during the first half of the past decade, as exhibited in the following graph. This graph portrays the quarterly returns of the index for core real estate funds for the ten years ended 12/31/10. It shows the income component of the underlying real estate assets was fairly steady during this timeframe, despite the increased volatility and downturn of values during ’08-’09. The annualized return for this index over this period was 5.2 percent, which compares to U.S. stock returns of 1.4 percent as measured by the S&P 500.



NCREIF Open-End Diversified Core Index (Gross) (Asset Wtd Avg)

In hindsight, the timing for initiating an investment in real estate was poor. However, the focus then was one of diversifying into a new asset class which would benefit the long-term return profile of the pension plans. As it turned out, all "risk assets," or anything other than U.S. Treasury securities, suffered during the recession and financial crisis that began in late 2007. Without detailing the evolution of the entire financial crisis, the markets suffered horrific downturns, in a pattern that reflected an unprecedented level of correlation in the wake of dramatic market illiquidity, particularly after Lehman declared bankruptcy in September, 2008.

Commercial real estate assets suffered during the downturn, although with a timing lag. The lagged return expectation was stated in the February, 2006 educational presentation: "*Real Estate demand tends to lag the economy*." Since real estate demand is by its nature driven by space requirements, the pattern of real estate vacancy and rental rates tends to move in tandem with employment trends. Factoring in credit market conditions, given the leverage inherent in most real estate markets, and investor risk aversion or risk seeking behavior, returns for real estate can be quite volatile. The degree of the decline was exacerbated by the magnitude of economic downturn, and in turn a surge in vacancies as layoffs increased, and less so by an overbuilding problem as often occurred in prior real estate cycles. The downturn in real estate returns indeed lagged those of many other risk assets, and has also lagged on the upside. The following graph shows the quarterly change in value for the composite of the funds held at the time in our real estate pool versus stocks as portrayed by the S&P 500.



Market Outlook

Currently real estate values are still showing appreciation as the economic recovery continues, albeit at a grudgingly slow pace. The drivers of real estate performance, as noted earlier, are vacancy and rental rates, combined with the discount rate buyers are willing to apply to a property's income stream, or "cap" rates. Despite stubbornly high unemployment the market has exhibited a classic rebound with the highest quality properties located in the largest gateway cities recovering first. Investors have shifted from shunning real estate back to one of accumulating exposure, particularly with core properties, the least risky type of real estate investment. The core open-end funds saw purchase queues form during late 2010 and early 2011, confirming the return of institutional dollars to real estate. The closed-end non-core funds have also rebounded as their underlying property values stabilize and access to debt improves.

The general performance improvement for real estate is continuing this year and should be increasingly apparent in returns for the Montana Real Estate Portfolio (MTRP). The data shown below is limited to our core fund exposures for the first quarter of 2011.

	Periods ended 3/31/11	
	Quarter	One Yr.
MTRP Core Portfolio (Wtd. Avg.)	3.8%	18.8%
ODCE* index (before fees)	4.0%	20.1%
NPI** (unleveraged)	3.4%	16.0%

*Open-end diversified core equity index

**NCREIF Property Index

The outlook has clearly turned positive based on the May, 2011 consensus forecast survey of the Pension Real Estate Association (PREA) which reflects responses by sixteen national real estate management companies. The average return forecast on a national level for all property types for 2011 to 2015 is shown below:

Total return (including income) per year	9.7%
Income return per year	6.2%
Appreciation return per year	3.4%

The following comments summarized the outlook represented in the survey:

> "Following a strong Q1, with the NCREIF Property Index (NPI) reporting a 3.36% total return, the average forecaster continues to call for a healthy 2011, albeit at a slightly slower pace. Going forward, returns are expected to gradually decrease in 2012 and 2013, although the average forecast indicates that the market is expected to remain healthy.…return expectations for 2011 have been on a continuous upward trend for the last year as the strength of the NPI has continued to surprise and forecasters have become increasingly bullish."

These forecasts pertain to the NCREIF Property Index which represents unlevered real estate returns. Varying degrees of leverage are used by all of our managers, even the core managers to a limited extent. Leverage, when applied wisely, is likely to amplify these positive returns.

The outlook for non-core real estate fund performance is more ambiguous. Performance reporting for the value-add and opportunistic funds (non-core) for the first quarter 2011 will not be available until late July given the typical reporting lag. Yet based on the trends being seen in core real estate and the general stabilization or improvement in fundamentals cited by many of our non-core managers, a positive performance is expected this year in these funds as well. These funds are much more dependent on individual manager success in buying undervalued real estate, managing a property to enhance its value and then selling it for a gain. With our seasoned fund holdings, from vintage '06-'07 in particular, performance will be dependent on the managers' ability to reduce debt, and maintain or improve operating income through higher occupancy or higher rental rates, which remains a challenge given the slow pace of economic recovery. The crux of their success will depend on employment growth. As one of our value-add managers stated in their first quarter fund report:

> "Property fundamentals in many markets have shown signs of improvement, but we will not see wide improvement in fundamentals until employment growth supports the absorption of space across all property sectors. Consequently, we anticipate the operating environment will remain challenging throughout 2011."

The fundraising environment for non-core managers remains difficult despite the general improvement being seen in fundamentals and the strong appetite among investors for core real estate. The ability to raise new funds is expected to gradually improve, though many of the survivors will raise smaller funds than during the heydays of the mid-00's. R.V. Kuhns' makes the following statement in their 2011 asset allocation assumption paper regarding non-core real estate:

> "Average vintage '05-'07 non-core funds have experienced significant losses, given weaker than expected operating performance (rents, occupancy, etc.) compounded by high degrees of leverage. However, vintage 2010 and 2011 non-core vehicles are expected to benefit from lower asset pricing, especially for operationally or capital-stressed deals."

Current Asset Assumptions

While the expectation for commercial real estate returns is generally positive for 2011, we must take a longer term perspective in considering the merits of this asset class. The 2011 asset assumptions for real estate by R.V. Kuhns show the following return and risk assumptions.

	Return (arithmetic)	Risk (std. dev.)
Core Real Estate	7.00%	12.50%
Non-Core Real Estate	10.00%	21.50%

The return assumption for core remained the same as in 2010, however the volatility assumption was increased by two percent to reflect their view of a historical bias caused by appraisal based "smoothing." The non-core assumption reflects a combination of value-add and opportunistic categories using a 70/30 mix.

These return assumptions appear reasonable for the long term, even though the short term outlook may be more positive, yet the correlation of real estate returns with other asset classes is perhaps more important and goes to the heart of the initial allocation decision. The correlation assumptions with the other primary asset classes held in the pension funds is shown in the table below.

	Broad US Equity	Broad Int'l Equity	Fixed Income (inter.)	Private Equity
Core Real Estate	0.31	0.39	(0.04)	0.45
Non-Core Real Estate	0.25	0.26	(0.04)	0.40

The real estate asset class can certainly be volatile, but no more so than any of our other "risk assets" and yet it has the lowest correlation with any of our other major asset exposures.

Another consideration in investing in real estate is the potential benefit it would offer if the economy were to experience a high level of inflation. Traditionally real estate is often viewed as an inflation hedge by virtue of the ability to raise rents and higher replacement costs that occur in an inflationary environment. This consideration, in addition to the income benefit, were the primary factors considered by the Board when approving the use of core real estate for the Trust Funds Investment Pool in May, 2009 and is also addressed in the Board's governing law:

> ***"In discharging its duties, the board shall consider the preservation of purchasing power of capital during periods of high monetary inflation".***

Lastly, another aspect of the real estate asset class is its ability to generate income. This is particularly true of the core funds, but value-add strategies are also expected to derive a significant portion of their return over time from the income generated from underlying properties once stabilized. This attribute will become increasingly important to the pension funds given their negative cash flow status and increasing dependence on portfolio income to pay benefits.

Summary

Real estate has been an asset class in which the Board has invested for a relatively short time, and to date the experience has been mixed. Poor returns commenced shortly after the inception of the program and were exacerbated by the financial crisis and depth of the recession. Yet, returns were no worse than those for most other "risk assets" and performance did not move in lock step with our largest portfolio exposure, public equity. Now we appear to be in a recovery phase and the outlook for real estate returns is positive. As with all "risk assets," an ongoing economic recovery will be critical to maintaining that positive momentum.

The reasons for investing in real estate have not changed since the Board made its initial investment. Real estate serves to diversify the pension portfolios while generating returns that are competitive with the other asset classes in which we invest. The diversification benefit is especially critical over the long term in the Board's effort to meet the 7.75 percent annual actuarial return assumption of the pension funds.