These minutes are Approved and Final. Full Board review and decision took place at the February 26 & 27, 2013 Regular Meeting of the Board.

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

MINUTES OF THE MEETING
November 13 - 14, 2012

BOARD MEMBERS PRESENT:

Gary Buchanan, Chairman
David Aageson
Bob Bugni
Karl Englund
Mark Noennig
Quinton Nyman
Jack Prothero
Jon Satre

BOARD MEMBER ABSENT:

Jim Turcotte

LEGISLATIVE LIAISONS PRESENT:

Representative Franke Wilmer – Present November 13, Arrived 2:00 PM, Absent November 14
Senator Ed Buttrey – Present November 13, Absent November 14

STAFF PRESENT:

Jason Brent, CFA, Alternative Investments Analyst
Polly Boutin, Accountant
Geri Burton, Deputy Director
Richard Cooley, CFA, Portfolio Manager, Fixed Income/STIP
Dana Chapman, Board Secretary
Frank Cornwell, CPA, Deputy Financial Manager
Roberta Diaz, Accountant
David Ewer, Executive Director
Julie Flynn, Bond Program Officer
Tim House, Investment Operations Chief
Ethan Hurley, Portfolio Manager, Alternative Investments
Ed Kelly, Alternative Investments Analyst
Herb Kulow, MCMB, Portfolio Manager, In-State Loan Program
April Madden, Accountant
Gayle Moon, CPA, Financial Manager
Rande Muffick, CFA, Portfolio Manager, Public Equities
Chris Phillips DeFranco, CFA, Investment Staff
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, Fixed Income
Clifford A. Sheets, CFA, Chief Investment Officer
Steve Strong, Equity Investment Analyst
Louise Welsh, Senior Bond Program Officer
Dan Zarling, CFA, Director of Research

GUESTS:

Jim Voytko, RV Kuhns and Associates
Mark Higgins, RV Kuhns and Associates
Roxanne Minnehan, Public Employees' Retirement System
David Senn, Teachers' Retirement System
Diane Paauwe, Piper Jaffray
John Harrington, Legislative Audit Division

CALL TO ORDER

Board Chairman Gary Buchanan called the regular meeting of the Board of Investments (Board) to order at 11:15 AM in the Board Room on the third floor at 2401 Colonial Drive, Helena, Montana. As noted above, a quorum of Board Members was present. Member Jim Turcotte was absent. Representative Franke Wilmer arrived at 2:00 PM.

> Board Member Bob Bugni made a Motion to approve the Minutes of the October 4, 2012 Board Meeting; Member Jon Satre seconded the Motion. The Motion was carried 8-0.

Chairman Buchanan asked for public comment. There was no public comment.

ADMINISTRATIVE BUSINESS

Audit Committee Report

Audit Committee Chairman Jim Turcotte was absent. Committee Member Jon Satre reported on the three items discussed at the Committee Meeting held prior to the regular Board Meeting. First, staff was asked to report on revisions in pool performance results for FY 2012 as it related to errors made by State Street Bank due to the omission of some cash flows affecting performance in certain pools. Second, the Performance Audit for FY 2012 has been delayed due to Legislative Audit personnel changes. The Audit is expected to commence in March 2013 or later. Third, the Financial Compliance audit will be completed in December 2012. The Annual Report will also be completed by the December 31 deadline. The Committee also voted to accept Staff's recommendation to participate in the Pfizer class action as part of a large investor group rather than as part of the class action. Member Noennig inquired about fees associated with the action. Executive Director Ewer advised fees are on a contingency basis and participating as part of the larger investor group will not hinder later possible participation as a member of the class action.

Loan Committee Report

The Loan Committee met prior to the Board meeting. Committee Chairman Jack Prothero reported there were no commercial loans requiring Committee approval. Ms. Louise Welsh presented two INTERCAP loans. The Committee approved a $1,600,000 loan to the Town of West Yellowstone in the form of a resort tax revenue bond over a period of 13 years to finance the construction of a town hall. INTERCAP is the sole funding source for the project. Repayment of the loan will come from resort tax revenue. The Committee also approved a $4,350,000 loan to the Board of Regents of Higher Education of the State of Montana on behalf of Montana State University (MSU), Bozeman, to finance the costs of an energy retrofit project using energy performance contracting over a 15 year term. The University is contributing $4,750,000 from its Residence Hall/University Food Service and Family Student Housing Funds (Pledged Funds) toward the total project cost of $9,100,000. Repayment will come from the University's surplus net revenue of its Pledged Funds. The Committee approved the two INTERCAP loans.

The Committee also approved the following staff recommendations: to issue INTERCAP bonds in an amount up to $12 million with a term of 25 years; authorization to acquire up to $10 million in Bond Anticipation Notes (BAN); adopt Preliminary Resolution No. 230; authorize the current finance team to issue/underwrite the bonds; and accept continuation of the current enhancement "guaranty" fee. Detailed information will be provided during the INTERCAP report.

Human Resource Committee Report

The Human Resource Committee also met prior to the Board meeting. Committee Chair Karl Englund reported the Committee reviewed and discussed the annual performance appraisals for exempt staff. The Committee agreed it has been a good first year for Executive Director, David Ewer. There was also a decision made not to recommend any pay changes for exempt staff at this time.

EXECUTIVE DIRECTOR'S REPORT

Overall Comments
The Board, at the October 4 meeting, requested Member Jon Satre act as representative for the Investment Consultant Committee contract negotiations with RV Kuhns and Associates. After meeting with senior staff, Member Satre visited with Mr. Jim Voytko to clarify and coordinate staff and Board expectations going forward. Together they came up with four points as detailed in Executive Director Ewer's November 13, 2012 memo:

1. The consultant provides independent and timely advice and information to the Board (as a collective body) regardless of any potential staff disagreement.
2. The consultant is expected, if necessary, to be pro-active in counseling the full Board on any matter the consultant believes is important enough to merit its attention, again, irrespective of any potential staff position to the contrary.
3. On a semi-annual basis, the consultant will provide a presentation on any matter desired, e.g. best practices, governance, what other state pension systems are doing, following up on a Board suggested topic, trend investments, or risk management, etc.
4. The consultant is expected to be a resource for providing material, seminars or other training opportunities for Board member education.

Mr. Voytko relayed that staff and Board members were very cooperative and acknowledged that RV Kuhns is expected to be a future resource for outside educational opportunities. He also advised that he, Ms. Becky Gratsinger, Mr. Mark Higgins and the junior staff had a discussion and agreed they have an almost unlimited supply of topics they could present and encouraged Board and staff to bring requests to them. It was agreed that protocol going forward will be for the Board Chairman to act as liaison for information or educational requests to RV Kuhns. Chairman Buchanan agreed, although he noted he would confer with Executive Director Ewer on these items.

Executive Director Ewer advised he will continue to pass along information on educational conferences and other resources available to the Board.

As directed by Chairman Buchanan, quarterly costs have been included in the Board materials. Executive Director Ewer noted quarterly data will be volatile due to fluctuations in costs pertaining to the external managers based on market changes, or simply the timing recognition of some fees.

Chairman Buchanan suggested fee discussions will be ongoing in line with the long term goal of reducing basis point costs overall.

After a brief discussion on the parameters for the cost report, it was decided by consensus to report the costs to the Board quarterly going forward rather than spend staff time going back and compiling historical data. The data will be kept for future comparisons, allowing consideration of fluctuations which occur on a yearly basis. The CEM Benchmarking Study will also provide valuable information; however, the study covers only the pension investments. The Board will use the reporting to determine trends and to help reduce costs where possible.

Executive Director Ewer reviewed the function and purpose of Resolutions 217 and 218. Resolution 217 designates the Executive Director as agent to deal with all investment firms in connection with Board accounts, as well as granting authority to open and close those accounts and to designate authorized personnel who can act on behalf of the Board to execute transactions with authorized accounts. Designated investment firms and authorized staff shown in Appendix A of Resolution 217 are presented annually to the Board along with a report on all added and deleted authorized staff and investment firms occurring in the past year.

Resolution 218 designates the transfer of authority and duties of the Executive Director, due to incapacitation or temporary absence from the office, to the Deputy Director. Further, should the Deputy Director be unable to fulfill the duties in the absence of the Executive Director, the Chief Investment Officer is designated to act in the official capacity.

Executive Director Ewer made note of the Governor's recent memo regarding public participation in agency decisions per 2-3-103, MCA. The memo details the public's right to participate in decisions of government and serves as a reminder to accommodate the public's opportunity to participate in Board Meetings. The Board has been compliant in offering public comment at meetings and will continue to be mindful to do so.

Legislative Liaison Senator Ed Buttrey gave a brief update on legislative matters. Leadership decisions and committee assignments have not been made yet. The Governor's budget has been submitted to Governor Elect Bullock. Legislators will be in Helena to begin meetings and new legislator orientations this week. Revisions in the general budget are expected and the unfunded liability of pensions is a high priority. Member Bugni reported the PERS Board has voted to compare their plan to the Governor's plan, which does not address raising contributions, coal tax funding and employer contributions, as the PERS plan does.

Senator Buttrey confirmed there are a lot of plans to address pension issues.

Executive Director Ewer presented the draft 2013 Board Meeting Calendar. Chairman Buchanan proposed the May 2013 meeting be held in Billings, or another city, to allow for local community participation, and to move the proposed dates to May 29 and 30 to allow the Board to take advantage of educational opportunities which are scheduled for the prior week. Member Jack Prothero noted that any newly appointed Board Members will need Board orientation which can be scheduled after appointment by the new administration.

The 2013 Board Schedule was approved by consensus and dates will be posted on the Board Meeting web page.

Diane Paauwe, Piper Jaffray & Co. and Julie Flynn, newly hired Bond Program Officer were introduced.

MONTANA LOAN PROGRAMS

Commercial and Residential Portfolio Reports

Mr. Herb Kulow reported the commercial loan portfolio continues to decline. All banks are required to write a letter of justification when they request to buy back a mortgage, detailing the benefit to the borrowers.

Mr. Kulow reported Senator Larson is attempting to increase the funding limit from $15 million to $50 million for the Veterans' Home Loan Program during the upcoming legislative session, which would have a significant impact on the program.

Mr. Kulow also noted all past due loans are still within reasonable ranges.

Executive Director Ewer clarified for Senator Buttrey that the Commercial Loan Program's purpose is for economic development and is capped by statute at 25% of the Coal Tax Trust

Fund. Retaining loans through refinancing is not a goal as it does not qualify as economic development. Senator Buttrey will meet with Mr. Kulow after the Board Meeting to discuss the program in more detail.

Chairman Buchanan stated the program has a good history since inception 25 years ago, with almost ¾ of a billion in economic development. Mr. Kulow added there has been only one loan default, in 2000. He also noted any extra funding added to the Veterans' Home Loan Program is a separate allocation and would not impact the 25% ceiling of the Coal Tax Trust Fund.

Mr. Kulow further explained creating more efficiency may qualify as economic development and that job creation is not the only consideration. He also pointed out that for the Value-Added Business Loan Program, there is a minimum requirement of creating or retaining 10 jobs.

Bond Program Reports

Activity Report

Ms. Louise Welsh introduced Ms. Julie Flynn a new Bond Program Officer for INTERCAP. Ms. Welsh reviewed the quarterly Activity Summary report and presented the staff approved loans. With $44 million in pending loan commitments there is a need for additional bonds.

The Loan Committee approved two loans. The first loan is to MSU Bozeman for energy retrofitting of several buildings in the amount of $4,350,000 for a term of 15 years. The loan is in the form of a general promise to pay and the University is contributing $4,750,000 for a total project cost of $9,100,000. The second loan is to the Town of West Yellowstone to finance construction of a town hall in the amount of $1,600,000 for a term of 13 years. The loan is in the form of a resort tax revenue bond and will be paid back by resort tax revenue. INTERCAP is the sole funding source for the project.

Member Bugni inquired on the sunset timeline for the Town of West Yellowstone's resort tax. Executive Director Ewer noted there is not a statutory risk, as the term of the loan is less than the expiration of the resort tax ordinance. Additionally, there is a loan stipulation requiring the Board's written permission before they can take on more debt backed by the resort tax.

Staff approved loans are listed below:

Borrower:	Smith Valley School District #89 (Kalispell)
Purpose:	Replace flooring, exterior doors, cabinetry, etc.
Staff Approval Date:	July 16, 2012
Board Loan Amount:	$30,000.00
Other Funding Sources:	N/A
Total Project Cost:	$30,000.00
Term:	15 years

Borrower:	City of Whitefish
Purpose:	Skating rink improvements
Staff Approval Date:	July 23, 2012
Board Loan Amount:	$140,000.00
Other Funding Sources:	N/A
Total Project Cost:	$140,000.00
Term:	5 years

Borrower:	City of Columbia Falls
Purpose:	2012 Pumper Truck
Staff Approval Date:	August 9, 2012
Board Loan Amount:	$115,365.00
Other Funding Sources:	$205,763.00
Total Project Cost:	$321,128.00
Term:	10 years

Borrower:	City of Three Forks
Purpose:	Used John Deere Grader
Staff Approval Date:	August 10, 2012
Board Loan Amount:	$25,000.00
Other Funding Sources:	N/A
Total Project Cost:	$25,000.00
Term:	3 years

Borrower:	Hebgen Basin Fire District (West Yellowstone)
Purpose:	Purchase Station 3 & construct Station 4
Staff Approval Date:	August 21, 2012
Board Loan Amount:	$345,000.00
Other Funding Sources:	N/A
Total Project Cost:	$345,000.00
Term:	10 years

Borrower:	Savage Elementary School District #7J
Purpose:	Heating/cooling system upgrade and asbestos abatement
Staff Approval Date:	August 23, 2012
Board Loan Amount:	$ 600,000.00
Other Funding Sources:	$ 864,383.00
Total Project Cost:	$1,464,383.00
Term:	10 years

Borrower:	Montana City School District #27
Purpose:	Septic system repair and replacement
Staff Approval Date:	August 23, 2012
Board Loan Amount:	$ 55,600.00
Other Funding Sources:	$ 73,935.00
Total Project Cost:	$129,535.00
Term:	15 years

Borrower:	Arlee Elementary School District #JT 8
Purpose:	Legal claim settlement
Staff Approval Date:	September 6, 2012
Board Loan Amount:	$ 90,000.00
Other Funding Sources:	$ 50,000.00
Total Project Cost:	$140,000.00
Term:	5 years

Borrower:	Mission Mountain Country Club/Lake Co. Water & Sewer District (Ronan)
Purpose:	Purchase/installation of water meters/pits and replacing the pump house/main pump
Staff Approval Date:	September 12, 2012
Board Loan Amount:	$60,000.00
Other Funding Sources:	$10,000.00
Total Project Cost:	$70,000.00
Term:	15 years

Borrower:	Park County Rural Fire District (Livingston)
Purpose:	Station improvements
Staff Approval Date:	September 26, 2012
Board Loan Amount:	$200,000.00
Other Funding Sources:	$200,000.00
Total Project Cost:	$400,000.00
Term:	15 years

Borrower:	Wilsall Rural Fire District
Purpose:	New fire truck
Staff Approval Date:	September 27, 2012
Board Loan Amount:	$30,000.00
Other Funding Sources:	$10,000.00
Total Project Cost:	$40,000.00
Term:	3 years

The Loan Committee approved loans are listed below:

Borrower:	Town of West Yellowstone
Purpose:	Town Hall Construction
LC Approval Date:	November 13, 2012
Board Loan Amount:	$1,600,000
Other Funding Sources:	$0
Total Project Cost :	$1,600,000
Term:	13 years

Borrower:	Montana Board of Regents (BOR) on behalf of Montana State University - Bozeman
Purpose:	Energy Retrofit Project
LC Approval Date:	November 13, 2012
Board Loan Amount:	$4,350,000
Other Funding Sources:	$4,750,000
Total Project Cost :	$9,100,000
Term:	15 years

Ms. Welsh presented the request for up to $12 million in additional INTERCAP bonds and a request for a Bond Anticipation Note (BAN) for up to $10 million from the Coal Tax Trust Fund as a bridge loan in anticipation of the new bond issue as approved by the Loan Committee. The

Committee approved utilizing the current finance team for the new bond issue but directed staff to look at future options with the possibility of issuing a Request for Proposal (RFP). Staff seeks full Board approval on Loan Committee approved items pertaining to the new bond issue.

Executive Director Ewer reviewed the INTERCAP program and the costs and benefits of the Board's guaranty of over $220 million in INTERCAP and Montana Facility Finance Authority (the "Authority") bonds. He also commented on the Board being rated by Moody's and FITCH. He noted that staff will present more on the Authority at a later date. After a brief presentation, the five recommendations contained in the staff memorandum on this matter were taken up by the Board.

> Member Jack Prothero made a Motion to authorize staff to take steps as deemed necessary to issue up to $12 million in INTERCAP bonds for a term of 25 years. Member Satre seconded. The motion passed 8-0.
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> Member Prothero made a Motion to accept staff recommendation to authorize the Board to acquire up to $10 million in Bond Anticipation Notes (BAN) held within the Coal Tax Trust Fund, the outstanding of which shall bear interest at the daily STIP rate as may be adjusted from time to time, or the current INTERCAP bond rate, whichever is higher. Member Aageson seconded. The motion passed 8-0.
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> Member Prothero made a motion to adopt INTERCAP Preliminary Resolution No. 230. Member Aageson seconded the motion. The motion passed 8-0.
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> Member Prothero made a motion to authorize the current INTERCAP Program finance team to provide the expertise to issue/underwrite the bonds and accept the proposed budget for the new bond issue. Member Aageson seconded the motion. The motion passed 8-0.
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> Member Prothero made a motion directing staff, as part of the work plan, to research market availability of long term options for bond underwriting expertise, including the possibility of issuing a RFP if research determines it necessary. Member Aageson seconded the motion. The motion passed 8-0.

Member Prothero thanked Executive Director David Ewer, Deputy Director Geri Burton and Senior Bond Program Officer Louise Welsh for compiling the comprehensive packet.

Ms. Welsh reported on one delinquency. The Town of Sunburst is $34,000 overdue due to a special improvement district bond for street improvements which experienced a cost overrun. They borrowed enterprise funds using assessments coming in to pay contractors. The Town of Sunburst is in the process of obtaining a bank loan to cover the additional costs and they are expected to bring the INTERCAP loan current next week.

INVESTMENT ACTIVITIES/REPORTS

Retirement System Asset Allocation Report

Mr. Cliff Sheets presented the asset allocation report for the quarter ending September 30, 2012 for the nine pension funds. Valuation went up by 3.8%, or $300 million over the quarter. The increase reflected positive returns across the various asset classes. Public stocks had a strong quarter after weakness during the prior quarter. Domestic stocks were up 6.3% and International up 7.3%; fixed income had a strong quarter with an increase of 2.7%; real estate was up 2.4% and private equity was weakest at 0.3% due in part to the one quarter lag typical of underlying valuations. As a result of primarily market changes, the allocation to public equities increased slightly, as did the total equity exposure. Transactions included a net reduction in fixed income and an addition to real estate, with the allocations decreasing and increasing, respectively.

Member Bugni asked if there was any concern considering the RFBP is close to the bottom of the 22-32% range and if more flexibility of the range was needed. Mr. Sheets stated it's not a constraint at this time and the pool has not dipped below the bottom of the range as of yet. If stocks surge there is the possibility market dilution could cause the pool to dip below the allotted range; however, if that were to occur it would prompt a reallocation to reduce public stocks and add to fixed income per the discipline of staying within the policy ranges. He added that any discussion of lowering the fixed income allocations should not be considered in isolation, but rather in the context of the broader asset allocation policy. Mr. Jim Voytko noted RV Kuhns and Associates are now working on their 2013 return forecast for the various asset classes which may include a further reduction in fixed income return expectations. Mr. Sheets stated there will be a fixed income presentation and discussion later in the agenda, and that expected return is only one objective of this asset class.

Mr. Sheets concluded by noting there were high cash balances in the Police and Firefighters funds at the end of the quarter due to the annual lump sum contributions from insurance premium taxes that typically occur in September.

Comparison to State Street Public Fund Universe

Mr. Sheets presented the State Street Bank allocation and universe comparison charts. A slight overweight in public equities relative to peers has helped performance, as well as a higher allocation in domestic stocks over international during the past year. Equities and fixed income are more accurately reflected in the data than real estate and private equities where we are most likely in the 2nd quartile vs. peers.

Member Bugni congratulated staff on the top quartile performance for three year returns and inquired of Mr. Sheets what he thought were the most likely contributing factors.

Mr. Sheets attributed the strong returns to a combination of strong private equity returns and the turn in real estate after stabilizing in late 2009, and our overweight position in domestic stocks vs. international stocks compared to peers. While the total equities allocation is comparable to our peers, this overweight position in domestic holdings certainly helped.

There was a general discussion about the pension returns over the last 10 years, and the improvement in the absolute return as well as an improvement in relative performance compared to the 10 year rolling period in prior years. Mr. Voytko noted that the 2001-2002 tech bubble rolled off the 10-year returns as well, which made a substantial difference. Mr. Sheets added March 2003 goes back to the bottom of the prior bear market and the S&P has recovered, so it is just a function of time frames.

Chairman Buchanan asked what factors in the first fiscal quarter may have an effect on the longer period returns. Mr. Sheets advised international stocks improved while private equity is more subdued this quarter. Stocks are off 3.5% to 4% so far in the current quarter, but the calendar year to date is tracking positive.

Chairman Buchanan asked about the difference in the 3 year numbers for TRS and PERS. Mr. Sheets stated the 2 basis points higher return for TRS is due to holding less cash. TRS has been more cash negative as contributions and income are below outgoing benefits. Mr. Voytko added that over time the liability differences will increase between PERS and TRS creating challenges which will continue to be a complicated issue.

Fixed Income

Mr. Nathan Sax presented the Fixed Income overview. The third quarter bond market had lots of movement but ended where it started. Corporate bonds were up and Europe is still a factor. The Federal Reserve Board announced QE3+, its third major quantitative easing program, on September 13, allowing the program to remain open ended.

Core internal was up 209 basis points versus the benchmark index over 3 years. Reams and Artio outperformed their benchmarks over this time frame as well. High yield continues to outperform investment grade bonds for the calendar year-to-date, and our two managers here have beaten their benchmark, though Post's relative return remains weak for the one and three year periods.

Member Prothero asked what the forecast on inflation was. Mr. Sax replied there is a lot of money sloshing around, but inflation has not been an issue so far; however, deflation is a possibility. Institutions are paying down their debt and not taking on new debt, which is the same scenario with consumers who currently have an aversion to debt.

Chairman Buchanan thanked Mr. Sax, Mr. Romasko and Mr. Putnam.

Fixed Income External Manager Watch List

Mr. Sax presented the manager watch list. Post Advisors remain on the list. Ranked at the 83rd percentile for 2011, they are now ranked 12th for the calendar year. The visit with them last month was impressive and the pattern of recovery seems to be holding.

Manager	Strategy	Reason	Amount Invested ($ millions)	Inclusion Date
Post Advisors	Public High Yield	Performance	$58 RFBP $104 TFIP	February, 2012

Short Term Investment Pool, State Fund Insurance and Treasurer's Fund Report

Mr. Richard Cooley reported market conditions remain the same as last quarter. LIBOR rates are down 10 basis points which reflects a better feel for credit quality and Europe. STIP remains well diversified. This quarter $23 million in corporates and $70 million in Yankee CDs were purchased. Agencies have been reduced from 25% to 18% due to maturities; the two year spread on agencies is very low at about 20 basis points.

Member Prothero asked if there was an increased risk of default. Mr. Cooley stated while you would think there would be an increase in risk, direct risk has not risen. The Fed buying securities has helped.

Mr. Cooley reported the Treasurer's Fund totaled $924 million at September 30th with current securities holdings of $34 million. There were no securities transactions this quarter.

State Fund Insurance value at quarter end is $1.3 billion. The portfolio is overweight in agencies, asset backed securities (ABS), commercial mortgage backed securities (CMBS) and remains underweight in Treasuries versus its index benchmark. Asset backed securities have been increased over the last quarter. The total fixed income portion outperformed the benchmark by 69 basis points, and has outperformed by 210 basis points over the last year and 143 basis points over three years. The range for equities is set by the client at 8-12% and is currently 11.36% of the total and by policy is restricted to investment in index funds. By statute the equity limit is set at 25%.

Mr. Cooley advised staff will be meeting with State Fund on Friday and hope to have recommendations at the February Board Meeting. Mr. Sheets added the account has grown as premiums have outpaced losses paid out and those premiums have to be discounted. The high book yield has allowed premiums to decrease a little, but the buffer will decline. Mr. Cooley noted the current 4% book yield will decline by 25 basis points per year for 2013 and 2014, sinking to 3.5% in two years.

Mr. Voytko offered that this workers compensation issue is common. The key is the asset liability stance; writing more policies or taking on riskier clients all have to be taken into consideration.

Executive Director Ewer noted at $1.3 Billion, State Fund makes up 10% of the Board's fiduciary assets. Over the years, staff has discussed alternatives for asset allocation but ultimately rely on the client. Mr. Sheets added efforts to increase investment income on the margins are needed without taking on undue risk in order to mitigate the decline in the book yield of the bond holdings. Risk and policy restrictions need to be reviewed and credit risk for the fund is already high given the exposure to corporate bonds and some downgrades over time. A review of asset allocation will be presented to the Board at the February meeting.

Mr. Voytko offered there is a risk if liabilities and assets are not well matched. He added RV Kuhns could provide an educational presentation as they have done for other work comp plans.

<u>Montana Domestic Equity Pool (MDEP)</u>
Mr. Rande Muffick presented the Montana Domestic Equity Pool for the quarter ending September 30, 2012. The U.S. equity market had a great quarter. The pool restructuring transition to increase large cap passive stocks went well. All current weightings are within the new ranges approved at the May Board Meeting. Further diversification into small and mid caps is expected. The next step of the transition is underway and the research team has done preliminary due diligence and has met with RV Kuhns. In the next step, staff and RV Kuhns will discuss 15 small and mid-cap managers. The strategy is to continue to look for managers with a growth and value emphasis for small and mid-cap, and less emphasis on core options. The team expects to choose one to two managers each for small and mid-cap, one each for growth and value. Several aspects will be looked at for potential managers, such as fees compared to current managers, whether or not they are open, and a focus on finding managers that complement existing managers. The recent restructuring has had a positive effect on the quarter. While a bit overweight in small and mid-caps, there are grey areas as some mid-caps carry small caps, and some small caps include mid-caps.

<u>Montana International Equity Pool (MTIP)</u>
Mr. Muffick reported on the Montana International Pool for the quarter ending September 30, 2012. The objective to reduce active management within large caps was performed in the third week in October. The transition amounted to $216 million and included the termination of Batterymarch International Large Cap Core and BlackRock International Alpha Tilts to complete the first stage in the restructuring process. As the transition was performed in October, the quarter end report does not reflect the changes. BlackRock handled the transition. As always, there are transition costs when moving to a target portfolio as well as commissions and taxes. The overall cost total amounted to 25 basis points, or $524,838. The transition manager estimates the expected costs pre-transition. Actual costs varied 3 basis points from the estimate. Costs are kept in mind when considering termination of managers. The international markets had a great quarter in general, due in part to the central bank, news on Greece has subsided and China. The third quarter didn't struggle as much as past quarters. The transition of the portfolio should translate into tracking closer to the benchmark in the current quarter and going forward.

Member Satre thanked Mr. Muffick and Mr. Sheets and the rest of the transition team. Chairman Buchanan echoed that sentiment and noted it's been a very busy year for staff.

Public Equity External Manager Watch List

Mr. Muffick stated there were no changes to the public equity watch list in the third quarter. Martin Currie has improved but they still lag behind the benchmark longer term. They have a new lead person managing the portfolio in the last year that has been out to visit, but it's too early to remove them from the list. Alliance Bernstein is still a concern as they continue to struggle. Their investments assume risks in troubled companies which have potential and are not in danger of going out of business. However the strategy has yet to pay off.

PUBLIC EQUITIES MANAGER WATCH LIST

November 2012

Manager	Style Bucket	Reason	$ Invested (mil)	Inclusion Date
Martin Currie	International – LC Growth	Performance, Risk Controls	$100	February 2009
Alliance Bernstein	International – LC Value	Performance	$93	August 2012

PENSION BOARD REPORTS

Public Employees Retirement System Annual Report

Chairman Buchanan introduced Roxanne Minnehan of the Public Employees' Retirement System. Ms. Minnehan gave an overview of PERS. Eight retirement plans are included. PERS is required to have an actuarial report every year, the cost of which is funded by employee and employer contributions. Of the eight funds, four are actuarially sound, Judges, Firefighters, Police and Volunteer Firefighters. Liabilities increased for all plans and funded rates decreased for all except Game Wardens.

The PERS Board is proposing six bills for the 2013 legislature: 1. Housekeeping revisions; 2. IRS Federal regulation changes; 3. Adjustments to retirement age; 4. Funding bill requesting employer contributions increase going forward; 5. Third try on submitting a bill addressing retirees hired back as working retirees at state employment not contributing into the defined benefit plan.

Member Bugni added there are several separate funding bills expected to be introduced. The governor's bill increases by 1% employer contributions for employees and a 1% employee contribution increase. Use of excess Coal Tax Revenue is also proposed, but only for PERS. Separation of state and local governments is proposed so each would be treated as separate systems with Coal Tax only going towards state, not local governments. Excess Coal Tax currently goes into the General Fund.

Member Satre asked if passage of all bills would solve pension fund issues.

Ms. Minnehan responded, no, however the governor's plan makes the most progress.

Teachers' Retirement System Annual Report

Mr. David Senn presented the Teachers' Retirement System report. Mr. Senn reviewed the two types of plans, the Defined Benefit (DB) Plan which is based on years of service and average final contribution where the state takes on the burden of any investment risk decisions; and the Defined Contribution (DC) Plan which is a savings plan that pays benefits based on account balance where the participants take on the burden of risk for investment decisions. The unfunded liability would require a 4.89% increase in contributions to reach policy parameters, although there have been improvements. If the legislature does not take action, TRS would require a yearly return of 9% to erase the unfunded liability. Assuming a 7.75% rate of return, assets will be depleted by 2054.

Proposed changes are in the works and most new hires will have changes to benefits and/or deductions. Current members would see a 1% contribution increase at July 1, 2013, employers will make a onetime contribution of $14.7 million from fund reserves, and state of Montana will make an annual $25 million payment to TRS from land trust revenues. New members as of July 1, 2013 would see the most changes including a contribution rate of 8.15% including triggers to increase or decrease depending on fund health, and an increase of retirement age both for full and early retirement options.

Additional issues to be addressed in the upcoming legislative session include breaks in service of 180 days for retirees before they are eligible to return, proposed adjustments needed to comply with IRS guidelines and issues with the university system who aren't part of the normal system.

ADJOURNED

Chairman Buchanan adjourned the Meeting for the day at 4:45 PM.

CALL TO ORDER – Day 2
November 14, 2012

Board Chairman Gary Buchanan reconvened the meeting Wednesday, November 14, 2012 at 8:03 AM with seven members of the Board present; Member Quinton Nyman arrived at 9:27 AM. Member Jim Turcotte and Legislative Liaisons Representative Franke Wilmer and Senator Ed Buttrey were absent.

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

Private Asset Pool Reviews

Montana Private Equity Pool (MPEP)
Mr. Ethan Hurley presented the private equity report for the quarter ended September 30, 2012. Mr. Hurley reported distributions have dropped off but there are still sufficient distributions that net cash flow remained positive for the quarter. The bulk of exposure is to buyouts at 54.9%. There is no active attempt to underweight or overweight by industry or geography, although the majority of holdings are U.S. and Canada. Vehicle exposure is at 64% direct exposure, which is the preferred option, where possible, to minimize fees. In response to a question from Chairman Buchanan as to any investments made in Montana, regional fund Highway 12 has made an investment in Missoula and has now wrapped up the investment phase of their fund. The pool returns generated since inception are 1.42 times investment and a 12.35 IRR.

Mr. Hurley summarized the four new commitments made since the August Board meeting. These are outlined in the table below.

Fund Name	Vintage	Subclass	Sector	Amount	Date
Sterling Partners IV, LP	2012	Buyout	Diverse	$20M	8/16/12
Audax Private Equity Fund IV, LP	2012	Buyout	Diverse	$25M	9/13/12
NB Strategic Co-Investment Partners II, LP	2012	Buyout	Diverse	$20M	9/13/12
Dover Street VIII, LP	2012	Secondaries	Diverse	Add'l $10M	10/11/12

Responding to a question from Chairman Buchanan, Mr. Hurley noted we do not generally have the leverage to negotiate on fees; however, it is possible at a future date that could change.

Mr. Sheets added the allocation decision is the primary consideration in selecting funds, and the higher cost structure of private equity funds is, the price of admission with this asset class. However, if there are two comparable options available for investment with different fee levels, the lower fee option is chosen. From a portfolio standpoint, returns over the long run are considered, so fees are not the only consideration. For secondary funds where underlying investments are further along in the life cycle and the J curve can be mitigated, those would also be considerations. Debt funds have a shallower J curve, but can translate into lower overall returns. As the retirement funds mature, adjustments in the types of strategies used will be made.

Member England asked for clarification on what qualifies as a secondary fund.

Mr. Hurley explained on a direct commitment we are initial investors, while with a secondary fund, the funding cycle for the underlying funds is already underway and we take on the funding obligation. Fund of funds investments can involve both direct investments and secondary investments.

Mr. Sheets added that in the life cycle of a fund the GP must consider the value of company investments already held if they are to acquire a secondary interest in a fund. In 2008 and 2009 some existing interests in immature funds were being given away as a way to avoid future capital call obligations due to deficient liquidity on the part of some investors. It is common for secondary managers to invest in funds which are already into years 2 to 5 of the life of the fund.

Mr. Hurley noted relative to the J curve, the pool has experienced relatively more net capital calls compared to similar investor peers. Mr. Sheets added there is no attempt at aligning the portfolio strategically vs. peers and overall portfolio performance has been good.

Montana Real Estate Pool (MTRP)

Mr. Hurley presented an overview of the real estate reports for the quarter ending September 30, 2012. The real estate pool continues to experience negative cash flows as heavy cash calls are ongoing.

Member Prothero asked for clarification regarding the Montana owned buildings.

Ms. Geri Burton explained the three Helena properties and the Bozeman property are managed by Executive Properties, Billings. Ms. Burton works with them and with tenants regarding leases, vacancies and building projects.

Mr. Hurley continued the pool is well diversified geographically and in regards to market value exposure. Real estate continues to deliver positive returns. Responding to a question from Member Bugni, Mr. Hurley advised cap rates have seen some compression on core properties, while value added properties have been less predictable.

Mr. Sheets added real estate is still seeing a tail wind which can be seen in the purchase queues of $1 to $2 billion in size for the largest core funds. Investors follow returns and we have seen positive returns the past two years with a growing tendency now for investors to consider higher risk investments. The last new core investment added to the pool was in 2010, but staff continues to invest in value added funds.

Mr. Hurley reported $40 million in new commitments since August: $20 million in The Realty Associates Fund X, LP and $20 million in CBRE Strategic Partners US Value 6, LP. The relationship with CBRE is new. A blue chip, value added manager, they had 30% already invested prior to our commitment. They focus on value enhancements, rehabs and then sell to a core funds.

Fund Name	Vintage	Subclass	Property Type	Amount	Date
The Realty Associate Fund X, LP	2012	Value – Add	Diverse	$20M	8/15/12
CBRE Strategic Partners US Value 6 LP	2011	Value – Add	Diverse	$20M	10/31/12

Partnership Focus List

There were no changes to the MPEP or MTRP Focus lists since the August 2012 Board Meeting.

CONSULTANT REPORT

RV Kuhns & Associates

Mr. Mark Higgins and Mr. Jim Voytko presented an overview of capital markets and Investment Performance for the quarter ending September 30, 2012. Mr. Higgins began the report by discussing recent economic and capital market developments. Overall, most asset classes produced strong returns during the third quarter. Asset values were bolstered by positive economic developments, such as solid job growth in the U.S., moderately positive GDP growth, strengthening of the U.S. housing market, and continued support from ongoing quantitative easing by the Federal Reserve. Mr. Higgins noted that while returns across most asset classes were strongly positive for the year, several significant economic headwinds and risks remain on a forward-looking basis.

Mr. Voytko followed Mr. Higgins with a review of investment performance for the MTBOI pension funds. Mr. Voytko framed the report by explaining four dimensions with which the Board should gauge fund performance. The four dimensions are:

1. Performance relative to the increase in expected benefit payments;
2. Performance relative to internal benchmarks and internal expectations;
3. Performance relative to peers; and
4. Performance relative to the amount of risk taken.

The relative performance of the pension funds along each of these dimensions was summarized as follows:

1. **Return Relative to Benefit Payments** – The 10 year return for the various pension plans was approximately 7.25% over the past 10 years. This return is reasonably close to the actuarially assumed return despite the significant drag of the financial crisis of 2008 and 2009. Over a 1-year and 3-year period, the total fund returns comfortably exceeded the actuarial required return; however, over a five year period, the return of just 1.58% significantly underperformed. The five year return was highly impacted by the 2008/2009 financial crisis.
2. **Relative to Internal Benchmarks and Expectations** – Compared to the internal benchmark, the portfolio outperformed by 10 basis points over 10 years, but trailed slightly over a 3-, 5-, and 7-year horizon. The underperformance of the domestic and international equity portfolios contributed heavily to the short term underperformance of the total fund, but Mr. Voytko expressed his belief that the recent restructuring of these portfolios could have a positive impact in the future.
3. **Relative to Peers** – Comparing to peers is difficult as there are no perfect peer groups. Compared with funds over $3 billion, which is considered a reasonable proxy for the MTBOI pension funds, the fund ranked in the 70th percentile over 10 years, 51st percentile over 5 years, and 21st percentile over three years. In summary, performance is satisfactory over the medium term and has improved dramatically over the prior 10 years.
4. **Relative to Risk Taken** – Overall, the MTBOI pension funds have produced attractive risk-adjusted returns. The Sharp ratio, which is a measure of risk-adjusted returns, is in the 29th percentile over three years and 46th percentile over seven years. Structural improvement of the portfolio is reflected in the 3 and 5 year data.

Mr. Voytko proceeded to discuss the performance of the specific asset class pools. Mr. Voytko reported that despite trailing the domestic equity benchmark over the trailing three years, The Montana Domestic Equity Pool ranks in the 37th percentile relative to domestic equity pools at other public plans. The Montana International Pool has not fared as well as domestic equity relative to both the benchmark and peers. Both the Retirement Funds Bond Pool and Trust

Funds Investment Pool have provided attractive returns over all trailing periods relative to both the benchmark and peers.

In response to several questions from Board members, Mr. Voytko discussed the Montana Private Equity Pool in the greatest depth. Several Board members questioned whether the 400 basis point expected premium over public markets is too high. Mr. Voytko suggested looking at the private equity benchmark next year. Mr. Ewer added benchmark review is an item on the Work Plan.

Fixed Income Management Review

Fixed Income Review

Mr. Cliff Sheets and Mr. Nathan Sax presented the Fixed Income Review. Mr. Jon Putnam and Mr. John Romasko were thanked for their help in compiling the presentation. Mr. Sheets advised later in the agenda the Board would be asked to approve proposed changes in the STIP investment policy statement. Fixed income management is a core competency of MBOI. A mixed variety of accounts use the fixed income pools; the Retirement Funds Bond Pool (RFBP) is utilized by the pension funds, and the Trust Funds Investment Pool (TFIP) is used by the Coal Tax Trust Fund and other trust accounts, and STIP is the cash account. Of the $7.7 billion in fixed income funds, the bulk, $6.8 billion, is managed internally. The small amount managed externally is mostly for funds requiring specific expertise.

Mr. Sax stated fixed income goals are total return, the change in price plus income; diversification vs. equity; and liquidity, which is key. The correlation of returns is low with equities, but positive. And while bonds can be volatile, they are much less so than stocks. The benchmark used is Barclays U.S. Aggregate Index, created in 1986, which most pension funds use. There have been changes to the index sector weightings over the past four years. Securitized was 43.7% and is now 32.7%; and the Treasury weighting is up from 25% to 36%; and agencies such as Fannie Mae and Freddie Mac are down. Credit quality is also down.

The overweight in non-core holdings of high yield and below investment grade holdings to seek out increased returns has been a strategic risk and is not intended as a permanent strategy, but rather as a function of current market conditions.

With the internally managed portfolio held by the Retirement Funds Bond Pool, the investment philosophy is risk constrained and deviations from the benchmark are kept within the constraints of policy. This limits volatility but also reduces the chance of outperforming or underperforming the benchmark by significant amounts. Tracking error has decreased since 2008.

Liquidity is important to enable flexibility in rebalancing and meeting benefit needs when the capital markets, particularly the stock markets, are stressed. Historically dealers would carry bonds in inventory and present an ongoing bid in the market but that is no longer an option for most dealers given capital and risk constraints.

Responding to a question from Member Prothero, Mr. Sax listed some of the fixed income brokers currently being used: JP Morgan Securities, Inc., Cantor Fitzgerald, Raymond James Financial, Inc., D.A. Davidson & Co., KeyBanc Capital Markets and CRT Capital Group, LLC. Competitive and accurate pricing are considered when choosing new brokers and all new brokers must be approved by staff. The list includes a mixture of primary and regional dealers and the complete list can be found in Resolution 217, Appendix A.

Mr. Sax noted the fixed income team meets weekly to gauge the market and the credit analysts have an increased role. Member Prothero asked for suggestions in reading material which may be beneficial to the Board. Mr. Sax replied there are a lot of market research newsletters out there and Mr. Higgins added Pioneering Portfolio Management is a good one. Other good resources are the PIMCO.com newsletter, Wilshire Axiom and the external managers are also helpful and Gimme Credit, which is independent.

Chairman Buchanan remarked the educational resources being provided the Board are good and have been helpful and added Pensions & Investments is a good resource.

Mr. Sax reported that costs are low at 2.4 basis points for the $1.4 billion core internal bond portfolio. Costs are low compared to other asset classes and are being controlled well. There are economies of scale that apply given the total amount of fixed income assets managed internally which helps keep costs low for the pension assets alone.

The bond pool policies will be reviewed and any recommended changes will be presented to the Board in 2013.

STIP Management Review

Mr. Rich Cooley presented the STIP Management Review. The three objectives of STIP are:

1. Preserve Principal
2. Liquidity
3. Provide return

The STIP Investment Policy was last revised in 2007. Liquidity requirements, approved credit lists and risk constraints were implemented. The STIP reserve cushion for realized losses was initiated and staff is recommending the cushion become permanent to STIP. The current balance in the STIP reserve is $12.6 million.

Member Satre asked how funds are added to the reserve.

Mr. Cooley stated additions come from withholding some income, realized gains on sales and income from former SIV-related issues.

Executive Director Ewer added the reserve fund gives portfolio managers needed flexibility. Mr. Voytko added from the customer's point of view it is good for them, as the market value is backed by the reserve.

Mr. Cooley stated STIP is well diversified with 70% of holdings top tier rated at AA or better. The Weighted Average Maturity (WAM) is currently 41.5 days; and is set by policy at a maximum of 60 days. STIP performance has consistently produced competitive returns, due in part to low management fees. Since the financial crisis the supply of money market securities has decreased. Corporations are moving away from reliance on commercial paper, Fannie Mae and Freddie Mac have reduced their debt levels and bank ratings have dropped. STIP strategy has shifted to account for market changes such as increasing longer term securities, restricting European bank holdings and the addition of Canadian and Australian banks. Longer term maturities help raise the return, while money markets still provide needed liquidity.

Mr. Sheets stated the unique return profile and diversification needs, as well as liquidity needs of fixed income pools have been managed well and efficiently by internal staff with very low costs which helps returns.

STIP Investment Policy – Proposed Revisions

Mr. Sheets summarized the proposed changes to the STIP Investment Policy Statement:

- Acknowledge the reserve which is maintained to offset any potential realized losses in the portfolio.

- Reduce the minimum rating requirement for certain credit related obligations which is a reflection of recent ratings downgrades to the banking sector.
- Remove the reference to SIV's as the product no longer exists and BOI holdings of former SIV's have either been restructured or the underlying securities have been distributed to us.
- Clarify the maximum maturity on floating rate securities is two years rather than implying it in the context of the "2a 7 like" reference.

Staff recommends the Board approve the revised STIP Investment Policy Statement.

> Member Prothero moved the Board approve the revised STIP Investment Policy Statement as presented. Member Bugni seconded. The motion passed 7-0. Chairman Buchanan abstained citing his role in serving clients who invest in STIP. Member Turcotte was absent.

<u>East Helena Compensation Fund – Investment Policy Statement (New)</u>
Mr. Sheets presented the new policy of the East Helena Compensation Fund. The fund is set up to serve the client, Department of Justice – Natural Resource Damage Program (NRD), to implement the restoration and oversight of environmental cleanup on and around the former site of the ASARCO smelter in East Helena

> Member Prothero moved the Board approve the East Helena Compensation Fund Investment Policy Statement as presented. Member Nyman seconded. The motion passed 8-0. Member Turcotte was absent.

Member Bugni raised for discussion the issue of the Montana Constitution not allowing equity type investments in non-retirement accounts. Senator Cocchiarella tried during the last legislative session to bring this issue forward. When considering the long term trust funds, does the Board have a fiduciary duty to bring this issue forward again, as yields continue to go lower and lower? If so, what steps, if any, should be taken by the Board? State Fund sought equity exposure to improve returns and eventually received it when policy was revised to allow up to 25% of the fund be invested in equities. Other states are looking at making similar changes.

Member Karl Englund suggested the timing is too late if looking at this issue for potential action during the 2013 legislature as the session will be starting soon. Perhaps at a later time the issue can be addressed, and it may take a session or two.

Member Noennig noted it is not a function of the Board to change the Montana Constitution.

Chairman Buchanan added that while the issue is a valid concern, discussions relating to the Coal Tax Trust can become political issues. And although it has been an ongoing issue, 3 or 4 years ago during the financial crisis the idea would have been a hard sell.

Member Bugni agreed this has been an ongoing issue for years and suggested he approach Senator Lewis as he may be in agreement with making changes.

Member Englund stated that as an issue which has been discussed previously, at length, extensive ground preparation work would be required to line up support long before the session begins. Member Noennig concurred that any major legislation must have support lined up far ahead of the legislature convening.

Executive Director Ewer suggested that while the Board functioning as an expert witness on this issue is appropriate, advocating for legislation is quite different. The Board must be cognizant of its role as opposed to the legislature and their role as policy makers.

ADJOURNMENT

Chairman Buchanan expressed thanks to staff for all their hard work. There being no further business, the meeting was adjourned at 11:25 AM.

Next Meeting
The next regular meeting of the Board will be Tuesday and Wednesday, February 26-27, 2013 in Helena, Montana.

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

BOARD OF INVESTMENTS

APPROVE: Mark E. Noennig

Mark Noennig, Chairman

ATTEST:

David Ewer, Executive Director

DATE: February 26, 2013

MBOI:drc
1/7/13