These minutes are Approved and Final. Full Board review and decision took place at the April 2, 2013 Regular Meeting of the Board.

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

MINUTES OF THE MEETING
February 26 - 27, 2013

BOARD MEMBERS PRESENT:

Mark Noennig, Chairman
Kathy Bessette
Gary Buchanan
Bob Bugni
Karl Englund
Quinton Nyman
Jack Prothero
Marilyn Ryan
Jon Satre

LEGISLATIVE LIAISONS:

Senator Ed Buttrey – Absent
Representative Franke Wilmer – Present February 26, arrived 9:00 AM, February 27, 2013

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
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, 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:

Becky Gratsinger, RV Kuhns and Associates
Jim Voytko, RV Kuhns and Associates
Mark Higgins, RV Kuhns and Associates
David Senn, Teachers' Retirement System
John Harrington, Legislative Audit Division
Mark Barry, Montana State Fund
Wayne Dykstra, Board Member, Montana State Fund
Rene Silverthorne, Controller, Montana State Fund

CALL TO ORDER

Board Chairman Mark Noennig called the regular meeting of the Board of Investments (Board) to order at 11:40 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. Senator Ed Buttrey was absent.

> Board Member Jack Prothero made a Motion to approve the Minutes of the November 13 & 14, 2012 Board Meeting; Member Jon Satre seconded the Motion. The Motion was carried 9-0.
>
> Board Member Jack Prothero made a Motion to approve the Minutes of the Board Conference call special meeting on February 12, 2013. Member Jon Satre seconded the Motion. The Motion was carried 9-0.

Chairman Noennig noted the presence of newly appointed Board Members Kathy Bessette and Marilyn Ryan and asked each Board member to give a brief introduction of themselves and their background. Marilyn Ryan is the Board's Teachers' Retirement System (TRS) representative and Kathy Bessette represents agriculture.

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

Chairman Noennig stated Commerce Director Meg O'Leary is unable to attend this meeting, but will attend a future meeting as her schedule permits.

ADMINISTRATIVE BUSINESS

Audit Committee Report

Audit Committee Chair Jon Satre reported on the items discussed at the Committee Meeting held prior to the regular Board Meeting. The Fiscal Year 2012 Financial-Compliance Audit prepared by the Legislative Audit Division is completed. The legislative performance audit is in process. Preparation work is ongoing and onsite work will commence in a month or two. The Committee also discussed emergency preparedness and received an update regarding the Securities and Exchange Commission foreign exchange issue with State Street Bank. Greg Gould from Luxan and Murfitt gave an update on the Pfizer class action lawsuit which MBOI is participating in.

Loan Committee Report

The Loan Committee met prior to the Board meeting. Committee Chair Jack Prothero reported the Committee approved one INTERCAP loan to Flathead Valley Community College in the amount of $2.4 million over a term of 10 years to finance costs for construction of a Nursing and Health Services Building. The Committee also approved one commercial loan in the amount of $1,407,058 to Paulson Enterprises, LLC over a 25 year term for construction of new office and laboratory buildings.

Human Resource Committee Report

The Human Resource Committee also met prior to the Board meeting. Committee Chair Karl Englund reported the Committee agreed to defer the review of staff salaries to a later date.

EXECUTIVE DIRECTOR'S REPORT

Overall Comments

Executive Director Ewer advised the Board's Fiscal Year 2012 Annual Report and financial statements were delivered to the Governor's office by calendar year end as required by law. The report and financial statements are posted on the web site.

The 2013 quarterly cost report is included in the Board packet and shows the most recent quarter and previous quarter costs.

Mr. Ewer also presented the Fiscal Year 2013 Work Plan which covers the next 24 months and systematically reviews issues likely to come before the Board during that time period. The Work Plan has a breakdown of items to be covered at each meeting including special agenda items. There are currently six Board meetings per calendar year.

Mr. Ewer advised staff is planning client outreach at the August meeting and will invite key state program officers who have significant trust or other monies invested with the Board.

Mr. Ewer noted the Board's Code of Ethics, which is reviewed annually, is included in the Board packet. As stated in the Governance Manual, the Code of Ethics is to be signed annually by staff and Board members. Staff has all signed for 2013.

The most significant Board related issue before the 2013 Legislature is the Board's budget which went to the Governor without changes. Pensions continue to be a major issue. Staff made a presentation before the select committee on state pensions, which meets regularly. Additional information requests have been received from legislative staff.

Member Karl Englund inquired where we are in the budget process. Executive Director Ewer noted there is still a long way to go until second reading. The Commerce (Board) budget did make it out of committee intact.

Representative Franke Wilmer advised the transmittal deadline for appropriation bills is March 28th. The 90 day session is scheduled to conclude April 27th but there is discussion about wrapping up sooner. The pay plan and retirement bills will be in the mix until the very end of the session.

Member Jack Prothero asked if there were any surprises this time in the legislature. Representative Wilmer stated that having served in two closely divided legislative sessions, the climate is more civil this session and not as many extreme bills have been introduced.

Executive Director Ewer encouraged Board Members to take advantage of training opportunities as they become available. He will continue to pass on relative training information as he receives it.

MONTANA LOAN PROGRAMS

Commercial and Residential Portfolio Reports

Mr. Herb Kulow reported that past due numbers for both the commercial and residential loan portfolios look good and are much better than the national averages.

Member Englund asked for an update on the Veterans' Home Loan Program. Mr. Kulow noted the bill proposed by Senator Cliff Larsen to allocate an additional $15 million to the program is moving along in the legislature. Loan applications continue to come in to the Board of Housing which manages the program. The 1.55% average yield to the Coal Tax Trust goes into the general fund and to date there have been no delinquencies.

Bond Program Reports

Activity Report

Ms. Louise Welsh presented the quarterly Activity Summary report and noted there were a couple of spikes due to larger loans. The new bond rate for the year has been set at 22 basis points.

Member England inquired why there seems to be a lack of applications from the eastern part of the state.

Ms. Welsh noted there are pending applications for Sidney, Savage Schools and Ritchey. Ms. Welsh added staff will be conducting a program informational workshop in Glendive this spring and will coordinate project site visits on the same trip.

Staff approved loans are listed below:

Borrower:	Park County
Purpose:	Construct a Search and Rescue Operations Building
Staff Approval Date:	October 3, 2012
Board Loan Amount:	$700,000
Other Funding Sources:	$0
Total Project Cost:	$700,000
Term:	15 Years

Borrower:	City of Forsyth
Purpose:	Municipal pool improvements
Staff Approval Date:	October 5, 2012
Board Loan Amount:	$137,800
Other Funding Sources:	$0
Total Project Cost:	$137,800
Term:	10 Years

Borrower:	Corvallis Rural Fire District
Purpose:	Refinance a fire engine
Staff Approval Date	November 7, 2012
Board Loan Amount:	$120,360
Other Funding Sources:	$0
Total Project Cost:	$120,360
Term:	4 years

Borrower:	Corvallis Rural Fire District
Purpose:	Refinance two fire stations
Staff Approval Date	November 7, 2012
Board Loan Amount:	$627,648
Other Funding Sources:	$0
Total Project Cost:	$627,648
Term:	10 years

Borrower:	Florence Rural Fire District
Purpose:	Construct a satellite fire station
Staff Approval Date	November 8, 2012
Board Loan Amount:	$300,000
Other Funding Sources:	$0
Total Project Cost:	$300,000
Term:	15 years

Borrower:	Town of Geraldine
Purpose:	Street and sidewalk project
Staff Approval Date	November 14, 2012
Board Loan Amount:	$30,000
Other Funding Sources:	$39,812
Total Project Cost:	$69,812
Term:	10 years

Borrower:	Town of Big Sandy
Purpose:	Wastewater sludge removal
Staff Approval Date	November 19, 2012
Board Loan Amount:	$71,000
Other Funding Sources:	$0
Total Project Cost:	$71,000
Term:	6 years

Borrower:	Reed Point School District
Purpose:	Maintenance vehicle and equipment
Staff Approval Date	November 26, 2012
Board Loan Amount:	$20,000
Other Funding Sources:	$0
Total Project Cost:	$20,000
Term:	3 years
Borrower:	Choteau County Hospital District dba Missouri River Medical Center (Fort Benton)
Purpose:	Replace roof and purchase equipment/software
Staff Approval Date	November 29, 2012
Board Loan Amount:	$ 107,178
Other Funding Sources:	$ 22,500
Total Project Cost:	$ 129,678
Term:	4 years

Borrower:	Bainville Public School District #64D
Purpose:	Remodel school building
Staff Approval Date	December 11, 2012
Board Loan Amount:	$ 800,000
Other Funding Sources:	$ 100,000
Total Project Cost:	$ 900,000
Term:	5 years

Borrower:	Darby Rural Fire District
Purpose:	Purchase a new fire engine
Staff Approval Date	December 13, 2012
Board Loan Amount:	$ 88,481
Other Funding Sources:	$ 78,099
Total Project Cost:	$ 166,580
Term:	10 years

Borrower:	City of Kalispell
Purpose:	Purchase several pieces of equipment and vehicles
Staff Approval Date	December 14, 2012
Board Loan Amount:	$375,000
Other Funding Sources:	$0
Total Project Cost:	$375,000
Term:	5 years

Borrower:	Town of Medicine Lake
Purpose:	Preliminary engineering report – wastewater
Staff Approval Date	December 20, 2012
Board Loan Amount:	$40,000
Other Funding Sources:	$0
Total Project Cost:	$40,000
Term:	3 years

Borrower:	Toole County
Purpose:	Digitize County Records
Staff Approval Date	December 26, 2012
Board Loan Amount:	$277,347
Other Funding Sources:	$0
Total Project Cost:	$277,347
Term:	5 years

Borrower:	Toole County
Purpose:	Purchase truck/trailer and two motor graders
Staff Approval Date	December 26, 2012
Board Loan Amount:	$447,156
Other Funding Sources:	$271,000
Total Project Cost:	$718,156
Term:	7 years

Borrower:	Toole County
Purpose:	Repave airport taxiway and construct hangar
Staff Approval Date	December 26, 2012
Board Loan Amount:	$ 145,394
Other Funding Sources:	$ 1,868,543
Total Project Cost:	$ 2,013,937
Term:	10 years

Borrower:	Toole County
Purpose:	Purchase maintenance truck
Staff Approval Date	December 26, 2012
Board Loan Amount:	$18,038
Other Funding Sources:	$0
Total Project Cost:	$18,038
Term:	6 years

MONTANA UNIVERSITY SYSTEM

Borrower:	University of Montana – Missoula
Purpose:	Purchase and install IT equipment
Staff Approval Date	November 20, 2012
Board Loan Amount:	$401,625
Other Funding Sources:	$364,160
Total Project Cost:	$765,785
Term:	3 years

CONSULTANT REPORT

RV Kuhns & Associates

Ms. Becky Gratsinger and Mr. Mark Higgins presented an overview of capital markets and investment performance for the quarter ending December 31, 2012. Ms. Gratsinger began the report by discussing recent economic and capital market developments. Overall, international assets produced strong returns while bonds did not fare as well during the fourth quarter. Real Estate (NCREIF) produced good across the board returns. The debt ceiling issue continues to impact markets and historically low interest rates continue to translate into very low bond returns. Inflation concerns loom on the horizon; however, have not materialized yet. Abundant monetary stimulation by the Fed has continued given the absence of any meaningful rise in inflation thus far.

Ms. Gratsinger reviewed the Annual Asset Class Performance and noted the different class performances comparing 2010 to 2011. For 2012, the best results were realized in the international small cap arena with financials leading the way. The Middle East region was in negative territory, but results were positive everywhere else including emerging markets. Financials accounted for a significant 24-25% of non-US markets and investors are embracing risk in equity and bond markets. Cash returns remain non-existent.

The $8.2 billion retirement plans show a very strong one year net return of 13.2% and realized a better return while taking less investment risk versus the overall peer universe with less volatility when taking all factors into account.

Member Buchanan noted the retirement return versus the benchmark show a negative 180 bp and asked where return was given back.

Mr. Cliff Sheets offered the private equity benchmark of S&P 1500 plus 4% caused the rolled up returns to be lower. Given the private equity pool underperformed its benchmark by almost 20 percent for the one-year period, and an approximate average weight of 13%, this would explain much of the plan underperformance. The custom benchmark for the retirement plans simply reflects the underlying pool benchmarks rolled up to reflect the actual asset allocation. The lag associated with private equity resulted in a very high public return hurdle for the one year period since it ended 9/30/12.

Ms. Gratsinger added equity market updraft and downdraft will both show a lag influence on private equities.

Member Prothero asked for an update on peers in asset allocation.

Ms. Gratsinger remarked that her firm has just updated its asset assumptions and fixed income return expectations have been lowered and the outlook for equities is more positive but volatility will still be a factor, especially if there is a return to fear mode. Equities have recovered a lot and the market is flirting with the 14,000 mark. Europe could still be an issue as emerging markets and other alternatives are getting a second look. Hedge funds have suffered. The lag in private equity valuations is reflected in MBOI's returns whereas some groups estimate returns to compensate for the lag.

Mr. Mark Higgins reviewed the Domestic Equity Pool. The roster of active managers has been reduced in accordance with the recent policy changes. The pool comprises 65% passive equities. T. Rowe Price has been a consistently good large cap core manager; however three analysts recently left the firm all at once. While they continue to have a deep team they will be monitored to alert for any changes. Analytic Investors' strategy, as a quant-based manager has not worked well during the bear market but they have recovered in the last two years. Artisan Partners have outperformed by 312 basis points since inception. Times Square has also done well; they were under close watch previously but they have recovered and are pretty solid. Alliance Bernstein, a small cap growth manager, has not performed well, but it's early yet.

Turning to the International Equity Pool managers, Alliance Bernstein international value has a highly volatile return pattern and it is appropriate to have them on the watch list. Martin Currie made some needed changes and Hansberger has trailed the market for five years, and tends to perform better in an up market.

Mr. Higgins reviewed fixed income manager performance for the quarter ending December 31, 2012, and noted the addition of high yield managers has helped returns. Post Advisors is off the watch list and they are showing a good recovery. Artio was acquired by Aberdeen two weeks ago giving perceptual stability; they liked the bond team.

State Fund – Real Estate Allocation/Investment Policy Change

Mr. Cliff Sheets, Mr. Rich Cooley and Mark Barry, VP, Corporate Support for Montana State Fund presented the proposed policy change for State Fund. Mr. Cooley presented the proposed revised investment policy statement for Board approval. Discussions by staff with State Fund have been ongoing for the past year to consider portfolio diversification options as low interest rates have led to a decrease in book yield of the bond portfolio. Staff is recommending and State Fund has agreed that the addition of core real estate to the fund will help offset the decline in book yield and increase diversification of the fund. The core real estate target will be set by policy at 5% of the total portfolio with a range between 3%-7%.

Mr. Sheets explained that with the erosion of book yield many options were considered including high yield and long term bonds. Core real estate funds encompass retail, commercial office, multi-family and industrial properties. Property income while not contractually mandated should allow for attractive dividend distributions. Additional advantages include mitigation of inflation to some extent and appreciation of the assets value as well as the added diversification. Drawbacks include limited liquidity and susceptibility to economic downturns.

Member Satre asked if real estate is subject to the J curve effect.Mr. Sheets advised investments will be made into existing portfolios, not start-ups or closed end funds which would be affected by the J curve. Real estate is still recovering and demand for core properties remains strong so now is a good time to initiate an investment in real estate. Economic conditions do not suggest any immediate risks that would cause a decline in the real estate market.

Mr. Mark Barry offered that by statute, State Fund must work with MBOI. The hardening of the market in 2000 meant a decrease in the number of policies written as the recession hit businesses. Premiums and investment income account for the only income, both of which have declined. Raising capital is not allowed. Business is restricted to one state, Montana, and insurance must be offered to all businesses in the state. After considering the available options, State Fund is in agreement to add core real estate into the portfolio.

Mr. Sheets requested the Board's approval of staff's recommended changes to the State Fund Investment Policy Statement adding the new asset class of core real estate and approving the asset range.

> Board Member Gary Buchanan made a Motion to approve the revised State Fund Insurance Investment Policy Statement to add core real estate with a target of 5% of the total portfolio and a range of +/-2% or 3%-7%. Member Karl Englund seconded the Motion. The Motion was carried 9-0.

INVESTMENT ACTIVITIES/REPORTS

Retirement System Asset Allocation Report

Mr. Cliff Sheets presented the asset allocation report for the quarter ending December 31, 2012 for the nine pension funds. Positive returns increased valuation nearly $83 million over the quarter. The increase reflected a positive return increase of .8% for international equity compared with a 1% decline for domestic equity, the weakest of all pools for the quarter. Private equity increased 0.2% despite $12 million in sales due to a positive return; fixed income was down slightly 0.2%, due to weaker returns. Real Estate increased 0.3% due to purchases of $29 million into the pool. The monthly withdrawals are averaging $46 million each month which comes from some asset sales, contributions, and asset pool income from fixed income and stock dividends producing negative cash flow overall each month. The average related sales required to meet costs is approximately $5 million per month. The amount of asset liquidation required will likely increase over time.

Comparison to State Street Public Fund Universe

Mr. Sheets presented the State Street Bank asset allocation and performance comparison charts and introduced a new chart using data from the Trust Universe Comparison Service (TUCS). The new chart compares the allocation to the major asset classes and shows the range of exposures to each broken into high, median and low, for funds with total assets over $5 billion. MBOI's public stock allocation is slightly above the median, combining both domestic and international stocks, while fixed income is slightly lower, and both real estate and private equity are above the median. Hedge funds remain at zero compared to other fund holdings with a low near zero to a high at 9.56%, however only about one-fourth of the funds surveyed had an exposure here. The public funds universe performance comparison for funds of $1 billion and above show MBOI in the median return range.

Member Bob Bugni noted the difference in peer comparison fund sizes as R.V. Kuhns utilizes comparisons with funds of $3 billion and above, while the TUCS uses $5 billion and above and the State Street Bank universe uses funds of $1 billion and over.

Mr. Sheets noted the smaller asset size in the State Street performance comparison captures more observations and staff will be exploring more standardized reports in the future.

Fixed Income

Mr. Nathan Sax presented the Fixed Income overview. Interest rates rose moderately in the fourth quarter, although they have been up and back several times over the quarter. GDP for the quarter was down 0.1% due to a decline in defense spending. The issue of the so called fiscal cliff has now moved on to the issue of automatic cuts or sequestration and in May the debt ceiling debate is looming, all considerations for both the internal and externally managed portfolios. Corporate bond spreads have narrowed over the past year and the world economy has calmed. While fixed income returns are expected to continue to fall liquidity needs dictate the need to continue with a 25% allocation.

All fixed income external managers outperformed this quarter and are ranked in the first or second quartile over three years. Post Advisors and Neuberger Berman own no treasuries as they are high yield managers. For 2012 an underweight in US Treasuries and an overweight position in corporate bonds worked in our favor. Together the nearly ¾ internally and ¼ externally managed core bond portfolio has outperformed by 188 basis points over three years and is ranked 6th overall since inception.

Aberdeen has recently purchased Artio Global, a positive move. They have offices in London and Philadelphia and $300 billion in assets.

Fixed Income External Manager Watch List

Mr. Sax reported Post Advisors has been removed from the watch list following a great year. Monitoring will continue but the worst appears to be over.

Member Prothero noted the board materials did not include the report on internally-managed non-investment grade holdings. Mr. Sheets responded that it was removed from the materials at the last meeting but will be available for future meetings.

Member Bugni noted Reams and Artio have the same performance as the internally managed portfolio at significantly higher cost and questioned the value. Given the long term track record of the internal management of fixed income assets he asked if it is prudent to pay higher fees rather than having the internal team managing these assets.

Mr. Sax advised both managers are more specialized and are taking higher risk and do not correlate to each other or the internally managed fixed income. Mr. Sheets added the fixed income diversification concept was introduced in 2008 to provide external resources not available with in house expertise and this reason is still true. Over time, we may outperform these managers, although that was not the case in 2012, net of fees. At some future point the assets may be moved in house, however there is no compelling reason to do so at this time, adding the core plus and high yield manager additions in 2009 added unique capabilities.

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

Mr. Richard Cooley reported spreads are compressed and low rates continue to suppress STIP the yield. Agency exposure continues to diminish and been reduced from 19% to 11% this quarter. Short term rates are still coming down as is the LIBOR rate. Portfolio yield is down 2-3 basis points. This quarter $55 million in corporates and $70 million in Yankee CDs were purchased.

Member Buchanan suggested inviting STIP participants from Yellowstone County and City of Billings to the May Board meeting in Billings. Mr. Cooley suggested including City of Laurel representatives as well.

Mr. Cooley stated there were no changes in the Treasurer's Fund over last quarter.

Mr. Cooley reported the State Fund Insurance portfolio value at quarter end December 31, 2012 is $1.3 billion. The quarter saw lower rates and tighter spreads and fund duration remains slightly shorter than the benchmark this quarter. The portfolio is underweight Treasuries and overweight in agencies, asset backed securities (ABS) and commercial mortgage backed securities (CMBS) versus its index benchmark. The total fixed income portion of the account outperformed by 34 basis points for the fourth quarter and outperformed by 226 basis points over the past year.

Member Satre asked if adding the real estate allocation to State Fund signals future changes in allocation.

Mr. Sheets stated no major changes in allocation are planned at this time although equity levels may be reassessed at a later date. Responding to a question from Member Satre as to how beneficial the addition of real estate would be, Mr. Sheets responded while it will help mitigate the decline, the issue of the ongoing decline in book yield requires a long time to move the portfolio as maturities roll off, unless market yields rise significantly. Projections indicate a drop of 25 basis points per year over the next two years. Mr. Cooley noted the aversion to risk of capital narrows the available options to stem this decline.

Mr. Jim Voytko added that the insurance industry is highly regulated and assets need to be available should they be needed for premium payers if losses are incurred. Additional options such as tiered rates and increased premiums are other alternatives to managing the business.

Montana Domestic Equity Pool (MDEP)

Mr. Rande Muffick reported on the Montana Domestic Equity Pool (MDEP) for the quarter ending December 31, 2012. Stocks have rallied over the past four years and although it's been a bumpy ride, overall the market is recovering well. The S&P 1500 has returned 7.51% over ten years. Generally when public equities do well, pensions do well.

The first stage of the recent restructuring, the increase of large cap stocks into passive index funds has occurred and the second stage of increased diversification to small and midcap stocks is underway. Contract negotiations are in the process with two managers, a small cap growth and a small cap value. Initial funding of $20-$25 million for each manager is expected at the end of March, comparable to Alliance Bernstein last year. In the search for growth/value midcap managers three finalists are in consideration with a decision expected soon. The search for midcap growth managers is challenging and continues. Track records are lacking or styles are too similar to provide the needed complement to the other manager.

Fiscal year returns reflect the first stage of the portfolio changes with closer tracking to the benchmark including some outperformance. The decision to overweight small and midcap stocks by both external managers and internal staff has added value.

Artisan Partners and TimesSquare Capital Management have struggled in the short term, both being out of favor; however, long term returns look good. Alliance Bernstein, hired last spring for small cap growth, has struggled due in part to the timing of the hire. In general, MDEP is improving, up 27 basis points year to date.

Montana International Equity Pool (MTIP)

Mr. Muffick reported on the Montana International Pool (MTIP) for the quarter ending December 31, 2012. The restructuring of MTIP approved by the Board last August is underway. The shift of large cap stocks into a passive index holding and the utilization of active managers for small cap and emerging markets where they are more likely to outperform should result in lower fees and increased performance. The move to large cap passive was completed in October and phase two, searching for small cap managers is underway.

Member Buchanan asked what the costs were to implement the move of assets.

Mr. Muffick stated the final total for BlackRock which handled the transition totaled approximately 8 basis points. The international pool has tracked closer to the benchmark since the changes and both MTIP and MDEP should track closer to the benchmark going forward.

Public Equity External Manager Watch List

Mr. Muffick stated the watch list has dwindled since the termination of several managers. Martin Currie has been removed due to improved performance. Their new portfolio manager has made a difference and turned things around. Alliance Bernstein remains on the list. Their deep value strategy assuming the risk of the distressed companies they invest in has been a struggle; however they do have comeback potential.

PUBLIC EQUITIES MANAGER WATCH LIST
February 2013

Manager	Style Bucket	Reason	$ Invested (mil)	Inclusion Date
Alliance Bernstein	International – LC Value	Performance	$99.5	August 2012

Private Asset Pool Reviews

Montana Private Equity Pool (MPEP)
Mr. Cliff Sheets presented the private equity report for the quarter ended December 31, 2012 as Mr. Ethan Hurley was absent. Mr. Sheets reported there is still significant cash distribution activity which showed a net positive cash flow for the fourth quarter. Two thirds of the exposure is in buy outs and the pool is well diversified by strategy and manager. Geographically 83% of holdings are in North America, the U.S. and Canada. Access to the best international investments is limited. Fund of funds make up 23.7% of the pool and will decline over time as the strategy to invest directly and escape umbrella fees will continue. Cash flows can be erratic and the five year returns still reflect the bear market. Private equity has done well in the last year; reporting lags one quarter.

Member Buchanan asked why Montlake Capital was not included on the watch list.Mr. Sheets stated they had a bad vintage year but are expected to improve, and do not have the kind of problems deserving of watch list inclusion.

Mr. Sheets summarized the one new commitment made since the August Board meeting, outlined in the table below. White Deer Energy comes with a strong GP and they have been quite successful. Their first fund raised $1 billion easily. Our initial commitment was $30 million but we were cut back to $20 million due to fund popularity. There were a lot of returning limited partners. Mr. Hurley learned about the fund while in Arizona and worked on accelerating the process to ensure inclusion of our commitment. The fee structure is typical and the general partners are investing a significant amount of their own cash.

Fund Name	Vintage	Subclass	Sector	Amount	Date
White Deer Energy II, LP	2013	Buyout	Energy	$20M	1/25/13

Montana Real Estate Pool (MTRP)
Mr. Sheets presented the real estate report for the quarter ended December 31, 2012. Capital calls continue to outpace distributions although distributions are picking up slightly. Returns were fairly strong for the quarter as real estate market conditions continue to show signs of improvement. There have been no new real estate commitments since November, although there will be one presented at the next Board meeting. CBRE has a $20 million commitment, although no cash has been called yet.

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

Responding to a question from Member Prothero asking if real estate markets in general are improving, Mr. Sheets noted for recent commitments invested in the last two years it's too soon to tell. Value added is the main focus now and surprisingly core prices have continued to improve.

ADJOURNED

Chairman Noennig adjourned the Meeting for the day at 5:03 PM.

CALL TO ORDER – Day 2
February 27, 2012

Board Chairman Mark Noennig reconvened the meeting Wednesday, February 27, 2013 at 8:32 AM. Representative Franke Wilmer arrived at 9:00 AM. Chairman Noennig called for public comment; there was no public comment.

Securities Lending

Securities Lending, Mr. Clifford Sheets, CFA and R.V. Kuhns & Associates.
Mr. Cliff Sheets and Mr. Jim Voytko presented a detailed overview of securities lending. Securities lending is a common practice among institutional investors and provides added income on the owned securities by lending them to borrowers who need additional inventory to settle sales. The transfer of the assets to the borrower is protected by collateral in the form of cash or securities equal to 102% of the value for domestic, or 105% of value for international securities. The otherwise idle securities usually generate between 3-5 basis points, squeezing more return out of investments. This relatively small margin can boost overall fund ranking.

Mr. Sheets noted securities lending is not without risks. The borrower can default or the collateral can lose value and require additional cash to cover repayment. Additionally, securities lending can tie up your assets which limits flexibility in making allocation moves. During the financial crisis, the stretch for more yield on cash collateral caused default losses in many securities lending programs, though not at State Street. Highly rated short term securities were held in cash collateral pools to try and realize more return. The sudden market downturn and subsequent downgrade of securities caused maturities to be extended out and they traded at less than par even for non-asset backed holdings.

When cash collateral pools were frozen due to the rush on the part of some asset owners to leave the program, State Street Bank was pressured to separate out less liquid or more troubled securities into separate cash collateral pools and so a liquidity pool and duration pool were set up separately. State Street Bank allowed some clients out of the program and although they made some mistakes handling the crisis, they fared better than most. MBOI did not leave the program and consequently didn't suffer any realized losses. Mr. Sheets noted our exposure to the duration component of the cash collateral pools is limited and relative exposure has decreased. Securities lending has become more closely monitored over the past three and a half years and now includes an annual review as part of the work plan.

Member Prothero asked how State Street Bank has performed in general and regarding security lending in particular.

Mr. Sheets stated having State Street Bank as our agent was beneficial during the market crisis. While they had some problems, they did a better job investing the collateral pools. Mr. Voytko noted the actions to split the collateral pools were reasonable given the circumstances, and added that by not leaving the program and forcing a loss on unrealized losses, most assets regained value. Over time there is a small possibility of loss but any loss will be offset by earnings.

Mr. Voytko presented the financial review of securities lending. Earnings were under $1 million in 2006 increasing to a peak of $12 million in 2008. As demand has diminished earnings have decreased but remain substantially higher than 2006 levels. Income of $2 million translates into an additional 3 basis points.

Mr. Sheets explained that through the custodial program with State Street Bank, we agree to lend until such time as the decision is made to no longer participate. We can direct that certain funds be excluded from security lending and also have the ability to set the quality standards of collateral or limit amounts or types of collateral used.

Member Karl Englund inquired the advantages of using a custodial bank vs. an outside agent.

Mr. Voytko noted there are advantages to having the custodian handle it, additionally those services are often bundled with other services. He added State Street Bank handled the financial crisis better than most.

Member Jon Satre asked if the recent changes in asset allocation of large cap investments to more passive holdings would affect the ability to participate in security lending.

Mr. Sheets explained that theoretically the move to more passive holdings should reduce security lending; however, most large caps are not in high demand, rather small and mid cap stocks have a higher demand. Over time the switch to passive holdings will restrict securities lending but the impact will be limited. Mr. Sheets added participating in securities lending involves minimum risk when you consider the big picture of other risks. Next year when the custodial bank search is conducted securities lending will be a consideration which will be addressed at the time of the search.

Benchmarks

Benchmarks, R.V. Kuhns & Associates, Inc.
Mr. Jim Voytko presented the benchmarking overview. The report was brought about by Board request. He relayed the question of how do you measure performance as truck metaphor. What do you need it for? What are you measuring? What are its costs, speed, load bearing ability, safety considerations, and how does it compare to others? A benchmark requires the consideration of all elements to give a complete portfolio performance picture. Mr. Mark Higgins explained the criteria for benchmark measurement follows the CFA Criteria for an Effective Benchmark:

1. Specified in advance
2. Appropriate
3. Measurable, you have to be able to determine
4. Unambiguous, you need to know the content
5. Reflective of the current available investment options
6. Accountable
7. Investable

An example of a benchmark which meets the above criteria is the S&P 500 Index. The benchmark contains holdings of common stock in large and mid-cap companies that covers about 75% of the U.S. public equities.

Mr. Higgins continued the current actuarial rate is 7.75%. Measurements are made against standardized market indices, peer ranking where Montana is measured against the universe of funds greater than $3 billion, comparisons to the target allocation index as well as the actual fund allocation are all measured. Periodic cost comparisons versus the peer universe are also conducted to determine if expenses are in line with the actual value received for those fees.

Mr. Voytko noted the Montana custom benchmark has changed over time, so performance is measured by the previous benchmarks. He reviewed the factors of controllability which staff and Board are able to use to affect outcome of performance. The areas which are most controllable are strategic asset allocation, maintaining sufficient diversity to attain an optimal risk/return ratio, manager selection and the corresponding investment costs of return versus value.

Mr. Voytko concluded tactical asset allocation where MBOI could establish a target allocation and compare the actual allocation index versus target allocation index to gauge whether deviations from target had a positive or negative impact is not currently used. Of the current performance evaluation measurements, this is the only area where a potential adjustment could be made. However, selling securities to raise cash or how much high yield to have are tactical to some extent. Many funds have a policy portfolio model rather than utilizing ranges for each asset. There will be an agenda item discussing asset allocation in more detail at the April 2, 2013 Board meeting. Asset ranges will be included in the discussion.

Executive Director David Ewer noted the current practice utilized for asset allocation is the use of ranges for each asset class. When using a policy portfolio model, a rise in assets necessitates a stronger rebalance factor. When the market experiences an updraft or downdraft ranges allow for more flexibility rather than an immediate need to rebalance. Staff would be restricted with such a narrow policy demanding frequent rebalancing.

Member Prothero asked if there is a concern about the wideness of asset allocation ranges.

Mr. Voytko stated the ranges were implemented years ago and nothing jumps out as being too wide or narrow.

Mr. Cliff Sheets added there have been no issues with the range width as the practice has been to remain near the midpoint of the total equity range. In 2006 staff considered becoming more similar to the global equity market and potentially increasing international and decreasing domestic stocks and therefore ranges were kept wide to allow for flexibility to go more globally without having to revise the asset allocation policy. In June 2012 the wide range of the international portfolio allowed flexibility as the portfolio came close to the low end of the range when markets declined.

Mr. Higgins explained the comparison to peer groups is not a perfect proxy, but does offer value. The BNY Mellon data base is for a peer group greater than $3 billion and has improved in quality. The comparison to "all public funds" varies due to late reporting by some funds and some are not included if the data is suspect before compiling the data. The drawback is that although fund size is comparable, the variations in asset allocation and the differences in funded status of the funds vary the data. Mr. Voytko added the only true comparison would be a mirror image fund; however, even a fund the same size is not necessarily a good criterion as risk tolerance and cash flow issues could be quite varied. Managers and asset allocation and fund operations are all areas where measurement is valid.

Mr. Sheets added peer benchmarking has its flaws as we do not know the plans asset allocation, some are restricted to fixed income. The peer universe is not transparent, although CEM does look at the different asset allocation mixes. Utilizing the State Street Bank peer universe gives additional context. Another factor is the one quarter lag of private equity which can make a significant difference. Any one year has a lot of volatility with multiple dimensions to measure, so all areas need to be looked at.

Mr. Voytko added the quarter to date will change the most, but the one, three and five year returns have a smoothing effect.

Mr. Higgins stated composite indices are best to measure traditional asset classes of equity and fixed income. The equity composite is valuable to measure manager performance by comparing to broad market indices and helped to weed out underperforming managers. The fixed income composite measures internal staff performance of the internally managed portfolios for security selection and style tilts. Private equity varies widely and is the most challenging to find a benchmark for. Private equity is illiquid and generally a 3-5% premium is used; MBOI uses 4%, which is high, but average. The short term horizon is fairly meaningless and it takes five, to seven, to ten years to account for the reporting lag. The private equity S&P 1500 plus 4% which is used is not an investible benchmark and therefore doesn't meet the threshold for benchmark criteria, but over ten years is useful.

Mr. Higgins continued all managers have their own benchmarks which we hold them accountable to. Mr. Voytko added underperformance may or may not be the symptom of a larger problem and needs to be looked at in depth. Sometimes managers pick an inappropriate benchmark, and even high performers will miss the mark some years.

Member Bugni asked if there is a trend of other funds moving assets to passive holdings and putting more focus on costs.

Mr. Voytko affirmed that seems to be a trend for public funds although the reasoning is not clear. Alternatives are also creeping up, perhaps looking for higher returns or to lower exposure to the market. The markets are driven by central bank action in pricing risk assets.

Mr. Higgins explained the actual allocation index for the Public Employees' Retirement measures all manager benchmarks and rolls up to the weighted average of our asset allocation so the manager effectiveness can be measured. For 2011 cost comparisons, MBOI has slightly lower than average costs. In conclusion, MBOI has a good framework for performance evaluation which is appropriately interpreted.

Wrap Up – To Do

Executive Director Ewer reviewed items to be completed for the next Board meeting. The Below Investment Grade worksheet will be included in future Board packets. Staff will contact Yellowstone County and invite local government officials as well as local bankers to the May 29-30, 2013 Board meeting to be held in Billings.

Public Comment

Chairman Noennig called for public comment on Board issues. There was no public comment.

ADJOURNMENT

There being no further business, the meeting was adjourned at 11:05 AM.

Next Meeting

The next regular meeting of the Board is a one day meeting and will be Tuesday, April 2, 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
David Ewer, Executive Director

DATE: April 9, 2013

MBOI:drc
4/3/13