

These minutes are Approved and Final. Full Board review and decision took place at the November 18, 2014 Regular Meeting of the Board.

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

**MINUTES OF THE MEETING
October 7, 2014**

BOARD MEMBERS PRESENT:

Mark Noennig, Chairman
Kathy Bessette
Karl Englund
Quinton Nyman
Jack Prothero
Gary Buchanan
Jon Satre
Sheena Wilson

BOARD MEMBER ABSENT:

Marilyn Ryan

LEGISLATIVE LIAISONS PRESENT:

Senator Dave Lewis
Representative Kelly McCarthy

STAFF PRESENT:

Polly Boutin, Associate Financial Manager	Herb Kulow, CMB,
Jason Brent, CFA,	Portfolio Manager, In-State Loan Program
Alternative Investments Analyst	April Madden, Investment Accountant
Geri Burton, Deputy Director	Savannah McCormack, Admin. Assistant
Dana Chapman, Board Secretary	Gayle Moon, CPA, Financial Manager
Richard Cooley, CFA, Portfolio Manager,	Rande Muffick, CFA, Portfolio Manager,
Fixed Income/STIP	Public Equities
Frank Cornwell, CPA,	Kelsey Poore, CPA, Investment Accountant
Associate Financial Manager	Jon Putnam, CFA, FRM, Fixed Income
Craig Coulter, Alternative Investments Analyst	Investment Analyst
Roberta Diaz, Investment Accountant	John Romasko, CFA, Fixed Income
David Ewer, Executive Director	Investment Analyst
Julie Flynn, Bond Program Officer	Nathan Sax, CFA, Portfolio Manager,
Tim House, Equity Analyst/Investment	Fixed Income
Operations Chief	Clifford A. Sheets, CFA,
Ethan Hurley, CAIA, Portfolio Manager,	Chief Investment Officer
Alternative Equities	Steve Strong, Equity Investment Analyst
Ed Kelly, Alternative Investments Analyst	Louise Welsh, Senior Bond Program Officer
Eron Krpan, Investment Data Analyst	Maria Wise, Admin. Assistant
Tammy Lindgren, Investment Accountant	Dan Zarling, CFA, Director of Research

GUESTS:

Mark Higgins, CFA, RVK, Inc.
Jim Voytko, RVK, Inc.
Sheri Scurr, Legislative Services Division
Janice Muller, Teachers' Retirement System
Daniel Trost, Teachers' Retirement System
Shawn Graham, Teachers' Retirement System
Chris Low, Chief Economist - FTN Financial
Glenn Scolnik, Chairman - HKW
Luke Phenicie, Partner - HKW

CALL TO ORDER

Board Chairman Mark Noennig called the regular meeting of the Board of Investments (Board) to order at 8:46 AM. As noted above, a quorum of Board Members was present. Board Member Marilyn Ryan was absent. Board Chairman Noennig asked for public comment. There was no public comment.

ADMINISTRATIVE BUSINESS

Loan Committee Report

The Loan Committee met prior to the Board meeting. Committee Chairman Jack Prothero reported the Committee approved an INTERCAP loan increase to the City of Libby for an additional amount of \$490,000, bringing the total loan amount to \$3,690,000. The loan will serve as long-term financing to replace the Flower Creek Dam. The increase is due to higher wage rates and costs to transport concrete over a greater distance.

Public Employees' Retirement System (PERS) and Teachers' Retirement System (TRS) Updates

Member Marilyn Ryan was absent and Member Sheena Wilson had nothing new to report for PERS.

Legislative Liaisons Comments

Representative Kelly McCarthy had nothing to report.

Senator Dave Lewis reported the State Administration and Veterans' Affairs Interim Committee (SAVA) is scheduled to meet Monday, November 17, 2014 in Room 137 at the Capitol. The Committee will discuss employee contributions vs. income.

GLOBAL & NATIONAL ECONOMIC OUTLOOK **CHRIS LOW, CHIEF ECONOMIST, FTN FINANCIAL**

Executive Director David Ewer asked Mr. Nathan Sax to introduce Mr. Chris Low. Mr. Sax stated Mr. Chris Low has 25 years of experience tracking the U.S. economy. Staff has monthly contact with Mr. Low.

Mr. Low presented his outlook on the economy looking ahead to the next year.

- The Fed has an optimistic forecast for the economy.
- The economy is stronger, but the evidence is absent in GDP growth and the Fed's goal is to limit inflation to 2%.
- Job growth looks good, but the job market has changed; companies have increased the use of temporary and part-time employees at low wage rates.
- The average workweek for 2012-2013 was 30 hours – above 29.5 hours/week, employers must provide health insurance – the cut off for coverage under the Affordable Health Care Act.
- Income inequality continues, the 99% depends on salaries; Fed policy has hurt the 99%.
- Home starts continue to suffer from the glut of single family homes all over the country.
- Increased regulations make it more difficult to buy homes and multi-family construction is primarily done by large companies that can afford to self-finance, compared to single-family construction of one house at a time.
- Government spending cuts were huge in 2009 and remained flat in 2012. Spending is increasing, but defense budgets are still seeing cuts.
- New Fed Chair Janet Yellen faces unprecedented challenges and may be less than transparent about the Fed's intentions.

Mr. Low stated that 2014 suffered from weak U.S. growth and weaker global markets. The Fed's optimistic outlook and premature normalization may lead to slow growth, and if rates are increased too soon, lower inflation and lower long-term rates can be expected. This might also lead to a retracing back to easier monetary policy.

PRIVATE EQUITY – A GENERAL PARTNER’S PERSPECTIVE
GLENN SCOLNIK, CHAIRMAN, & LUKE PHENICIE, PARTNER
HAMMOND, KENNEDY, WHITNEY & CO., INC. (HKW)

Mr. Ethan Hurley introduced Mr. Glenn Scolnik and Mr. Luke Phenicie of HKW. MBOI committed \$20 million to HKW's Fund IV, a 2012 vintage fund.

Mr. Scolnik stated HKW was founded in 1903 and focuses on the lower end of the middle markets which historically have outperformed the larger markets. The company goal is to hold an investment for five years; capital calls are done only as needed. Institutional investors such as HKW generally prefer a five-year time period, although winners are often sold sooner, and slow growers kept longer.

The company's core strategy has remained consistent, investing in markets growing faster than GDP and opportunities with under-marketed companies. As a preferred buyer, HKW works closely with onsite management teams, which maintain day-to-day control and are generally kept intact, although occasionally a CEO is replaced. Together they invest capital and set goals for the company including financial projections. Hostile takeovers are not used.

Operational improvements are made, which tend to make companies more attractive and provide greater opportunities upon exiting. Investment deals are sourced directly by HKW investment professionals, which helps keep prices down. The professional team at HKW conducts exhaustive due diligence, including behavioral interviews. Weak skills or a lack of integrity would kill a potential deal. The firm controls management, the level of debt, strategy and the exit timing.

Mr. Phenicie added partnering with good management teams and not overpaying are vital. It is important to create value and grow equity, not just reduce debt. Investments must be gauged over the long term, with a five-year exit strategy, and less focus on quarter-to-quarter returns. Structurally, a strategy for aligning the interests of the limited partners and the general partners is used.

INVESTMENT GOVERNANCE BEST PRACTICES – RVK, INC.

Mr. Mark Higgins, CFA, Becky Gratsinger, CFA and Mr. Jim Voytko, RVK, Inc.

The Board requested that RVK, Inc. compare how MBOI stacks up to other institutional pension boards and the associated challenges faced by other boards. Mr. Higgins stated the most challenging aspects the Board faces are assessing staff performance, determining priority issues and understanding investment terms/lingo. The least challenging aspects included the ability to stay on task during Board meetings, understanding the role of the Board and managing conflicts of interest.

Responding to a question from Member Buchanan, Mr. Voytko stated conflicts of interest sometimes occur on a board when individuals represent two groups, such as an individual retiree who represents all beneficiaries, or if the board structure, as determined by statute, creates a conflict. Mr. Voytko added these issues sometimes crop up with boards, but have not created issues for the MBOI Board.

Mr. Higgins summarized the competency of MBOI's Board:

- Good understanding of the Board's role and priorities, with a focus on plan participants and beneficiaries.
- Thorough understanding of asset allocation.
- Clear understanding of benchmarks.
- Comprehensive grasp of the role of alternative equities in the portfolio.
- A solid knowledge base of public equities, international equities and fixed income.
- Consistent Board and Committee membership and a highly functioning relationship with a stable, professional staff.
- Efficient system for conducting meetings using a structured agenda, with open discussion, effective decision making and execution.
- Comprehensive Board materials distributed well in advance of meetings.
- Diligent monitoring of performance and outside managers.
- Utilizing a rolling work plan.

Mr. Voytko stated while there is always room for improvement, the Board is highly functional. The Board should maintain its current disciplines and continue flexibility and openness to future strategy and policy changes as needed. The comprehensive orientation for new Board members should include continuing members, and educational sessions on topics such as risk management should be continued.

MONTANA RETIREMENT SYSTEMS

Mr. Shawn Graham, Executive Director, TRS

Mr. Shawn Graham presented an overview of the Teachers' Retirement System. Mr. Graham has been in the position of executive director for approximately one year, succeeding Mr. David Senn in the position after his retirement. Established in 1937, the system now has over 18,000 members; 14,000 are currently receiving benefits.

TRS is a defined benefit plan and each year an actuarial evaluation is completed to determine the financial position of the fund. The financial outlook of the plan is healthy, aided in part by action taken in the 2013 legislative session. The TRS Board is comprised of six members, all appointed by the governor, and four must be teachers. The pension administration computer system is undergoing an overhaul replacing the old legacy system which has been in place for 20 years. The new system is custom built and is converting to a web based technology. The conversion is going well with a completion target of June 30, 2016.

Two proposals are on the legislative agenda for the 2015 Legislative Session. One housekeeping item will revise general provisions required for TRS to comply with IRS requirements. The other bill is the supplemental contribution bill of the Montana University System Retirement Plan (MUSRP). The Board is required to periodically review the supplemental contribution rate on TIAA-CREF salaries necessary to pay off the unfunded liability created when MUS faculty were no longer required to be members of TRS.

Mr. Graham noted Member Marilyn Ryan provides the TRS Board with regular updates and they receive monthly performance reports, as well as cash flow projections from Mr. Sheets.

Mr. Dore Schwinden, Executive Director, PERS

Mr. Dore Schwinden presented an overview of PERS. Mr. Schwinden been executive director of PERS for five months. Member Sheena Wilson is the MBOI Board representative for PERS. Established in 1945, there are 10 plans administered by PERS; eight are defined benefit plans, one is a defined contribution plan and there is one 457 plan. Annual payments to beneficiaries totals \$320 million. Two bills are slated for the 2015 legislative session to address funding of the Sheriff's and Game Warden's retirement plans.

The defined contribution plan was added in 2002. New employees have 12 months to decide whether to participate in the defined contribution or defined benefit plans; after that, the choice is irrevocable. Participants in the defined contribution as well as deferred compensation plans have a large selection of choices for investments. The average monthly benefit for retirees is \$1216. Most employees are not taking sufficient steps to improve their retirement and only 13% have specific plans for retirement. Personal savings and additional resources, such as additional 457 accounts, are important when considering future financial and health insurance needs.

PERS is also in the process of upgrading the current computer system, which will include the availability of new portals.

Executive Director Ewer asked for comments on the implications of GASB 67.

Mr. Shawn Graham noted that GASB 67 concerns the funding of retirement systems in relation to assets and liabilities. The total pension liability minus the assets of a plan will now show as the actual liability on the balance sheet with footnotes. Retirement benefits are guaranteed by the state and contributions are set in statute. The actuarial assumption for the next four years remains at 7%.

Ms. Gayle Moon added that staff has requested State Street Bank calculate a time weighted return, which will be forwarded to TRS and PERS when it becomes available.

BOARD STRUCTURE, GOVERNANCE & CHALLENGES

Mr. Jim Voytko, Ms. Betsy Gratsinger, CFA and Mr. Mark Higgins, CFA, RVK, Inc.

Mr. Voytko explained the different models used by pension funds:

- Integrated – management of the assets is combined with administration of benefits;
- Board of Investment model – benefits administration is separate from asset management; and
- Either structure – in conjunction with a formal investment committee

Mr. Voytko stated the management of state asset plans varies widely and can include defined contribution, college savings, workers comp, endowments and economic development funds. Fiduciary structures also vary widely; sometimes there is a single fiduciary, but more often is a board, which can be elected by membership or appointed, or a combination of both. No one has found the perfect board structure, and over time, the different types of board structures have increased. Plan structure and governance determine board size and composition, member confirmation processes and investment parameters, as well as adherence to federal and state regulatory requirements.

Mr. Voytko added the prudent investor rule is the umbrella rule, and includes variations such as the prudent person rule or the prudent expert rule.

Responding to a question from Representative Kelly, Mr. Voytko stated foreign policy considerations or geopolitically motivated restrictions can have a large impact. California scrapped similar fund restrictions after determining they would cost hundreds of millions.

Boards can experience issues resulting in disagreements over passionate or contentious issues. In particular, chair selection or contested governor appointments can cause conflict. Board engagement and participation, requiring substantial effort for no pay, can also be challenging. Prioritizing how boards spend meeting time, transparency, use of executive sessions and consistency of delegation over the long term can also cause issues.

In general, assumed rate of return is declining over time and boards are taking on more risk. Investment policies vs. actuarial rate of return, benchmarks and the frequency of investment performance reviews and assessments of risk, must all be addressed. Boards struggle with foreign policy considerations, economic factors, socially responsible investing, and decisions regarding preferred vendors and/or managers.

Summarizing, Mr. Voytko noted the MBOI Board exhibits good overall behavioral characteristics. The Board is highly functioning with a good investment structure and an awareness of plan beneficiaries. The Board practices good delegation, seeks expert advice, and understands arm's length transactions.

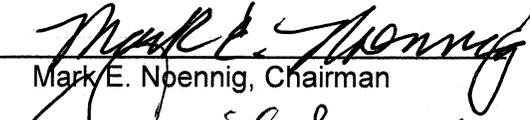
Mr. Voytko suggested that going forward the Board improve risk profile awareness as it relates to returns, keep mindful of negative behavioral factors, such as focusing on past performance or succumbing to a herding mentality. He encouraged continued use of detailed agendas, transparency of Board minutes and proper delegation of authority.

Next Meeting

The next regular meeting of the Board will be November 18, 2014, 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, Chairman

ATTEST: 
David Ewer, Executive Director

DATE: November 18, 2014

MBOI:drc
11/17/14