These minutes are Approved and Final. Full Board review and decision took place at the May 19, 2015 Regular Meeting of the Board.

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

MINUTES OF THE MEETING
April 7, 2015

BOARD MEMBERS PRESENT:
Mark Noennig, Chairman
Kathy Bessette
Terry Cohea
Karl Englund
Jack Prothero
Marilyn Ryan
Jon Satre
Sheena Wilson

BOARD MEMBERS ABSENT:
Quinton Nyman

LEGISLATIVE LIAISONS:
Senator Bob Keenan and
Representative Kelly McCarthy were absent

STAFF PRESENT:

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

GUESTS:
Jim Voytko, RVK, Inc.
Mark Higgins, CFA, RVK, Inc.
Meg O'Leary, Director, Department of Commerce
Michelle Barstad, Montana Facility Finance Authority

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 Quinton Nyman and Board Liaisons Senator Bob Keenan and Representative Kelly McCarthy were absent. Chairman Noennig called for public comment. There was no public comment. Executive Director Ewer advised the minutes from both the February 24-25 and this meeting will be presented at the May Board Meeting.

Chairman Noennig recognized Mr. Herb Kulow for outstanding achievement regarding the recent City of Great Falls/Loenbro, Inc. Board loan and presented a framed letter received from the Great Falls City Commissioners expressing their great appreciation for Mr. Kulow's extensive contribution to the complicated process involved with completing the loan.

ADMINISTRATIVE BUSINESS

Loan Committee Report

Loan Committee Chairman Jack Prothero presented items discussed in the meeting. The Committee approved three INTERCAP loans.

- City of Stevensville - Increase request from $800,000 to $1.25 million interim loan in anticipation of United States Department of Agriculture (USDA) Rural Development long term financing for its wastewater improvement project. The loan increase is primarily due to higher than expected costs for specialized electrical equipment.
- Livingston Elementary School - a loan for $1.348 million to finance building improvements in the school district over a term of four years.
- Department of Natural Resources and Conservation (DNRC) - $3 million interim loan in anticipation of issuing general obligation bonds for its Drinking Water State Revolving Fund (DWSRF) Loan Program. Financing will be for a term of three years; however, loans are usually paid off before the length of the term.

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

PERS representative Sheena Wilson reported that the PERS managed to get their bills through the legislature; a few have been signed by the governor. The referenda proposals have died. These included a bill to replace the defined benefit plan and with a 401 program. The contracts for IT are ongoing and Ron Baldwin, State Chief Information Officer, is assisting with contract negotiations; glitches have bumped the original schedule for the computer system upgrade. Member Wilson announced that Member Marilyn Ryan will be inducted into the MEA-MFT Hall of Fame.

TRS representative Marilyn Ryan reported the TRS actuary review by Cavanaugh Macdonald has been completed; the peer review will be done in May. TRS did fairly well at the legislature; housekeeping bill, HB 85 passed. SB 124, the meeting video/audio bill is a concern financially; TRS has been providing audio of board meetings on the TRS website for the past several meetings. There were repeat bills addressing reforms, such as SB 141, which allows retirees to work in the system, with certain restrictions, without jeopardizing retirement benefits. This affects coaches in particular, as retirees like to continue coaching; however, there is a concern of compliance with IRS regulations. There is no financial impact to the system, only the IRS compliance question. Otherwise, legislatively there were no bills of concern.

CONSULTANT REPORT

RVK, Inc. – Mr. Jim Voytko and Mr. Mark Higgins, CFA

Mr. Jim Voytko stated RVK has two presentations for the Board, Asset Allocation Study & Capital Markets Assumptions and Investment Committee Best Practices.

Asset Allocation Study & Capital Markets Assumptions

Mr. Voytko presented the Asset Allocation Study & Capital Markets Assumptions. Consultants and institutional investors seek to approach the investing process through a disciplined process to build

portfolios with different investment exposures, utilizing an expected basis to produce the best outcome. The process incorporates mathematical exposition of the value of diversification, but also incorporates assessment over the long term, looking ahead 10 to 15 years. MVO, Mean Variance Optimization, is widely used for institutional portfolios, but it has drawbacks such as not accounting for liquidity and headline risk that are not captured by the process. However flawed, MVO has little competition and it is a disciplined process. The most valuable aspect of the MVO is the emphasis on the value of diversification and requires looking simultaneously at all assets together and their interrelation to each other.

The modeling process looks at all asset classes, specifically:

1. Expected risk - how volatile values are likely to be in future;
2. Past history and a judgement of future expectations for return; and
3. Correlations - how asset classes behave differently relative to each other.

In response to major events, such as a decline in interest rates, different asset classes will behave a certain way in relation to each other. The shorter the time period, the more likely estimates will be wrong. Trends are more likely to be revealed over time; therefore, long-term forecasts have more validity. A rule of thumb is a 10+ year forecast; although there are multi asset products, which use shorter forecasts of three to five years.

RVK reviews the capital market assumptions annually: the expected behavior of asset classes, history, current market circumstances and expectations for the future.

First, the RVK capital markets research team estimates the risks and returns for different classes; then the triangulation group ensures estimates are not in conflict with each other for the different asset classes. For example, interest rate expectations, if rates are forecast to rise, fixed income projections must be in concert with that. For asset allocation, it is far more important to be relatively accurate with assumptions, the relation of asset classes to each other, rather than be accurate for any one class. It is vital for consultants to use the same capital market assumptions for all clients. Uniformity within RVK is important and includes two lively team meetings, discussing the proposals of each.

Examining all types of investment exposure seen in institutional portfolios makes triangulation difficult. Returns, standard deviation (risk), direction of rates and changes expected in the future, over the next 10+ years, are all analyzed. Comparing 2014 to estimates for 2015, very few changes are expected, therefore projections for the coming year have relatively few changes.

Member Jack Prothero asked why the equity long-term return is closer to 7% than 9%.

Mr. Voytko stated during the capital markets assumption process, you look at history, current circumstances and expectations for the future. Current circumstances are different than most of the past year circumstances. Valuation metrics are close to their peak, therefore, from today forward you look at the return line from a higher level of valuation, the tactical realization as to where we are today. To look at 9% would be ignoring the starting point. Back in 2009, estimates were raised above the historical return due to the GFC (Global Financial Crisis).

RVK has performed the capital market assumptions exercise for 11 years, allowing for a historic track record. Estimates have been very realistic. The RVK outlook is slightly more conservative than others' estimates, although a bit less conservative this time around. Others have lower expectations for equities, for example 4-5%. The level of expectation is important, but so is the correlation of asset classes to each other.

Mr. Voytko stated each asset class has a set of models; some are statistically based, some judgement based. For example, with private equity, historical returns are considered, but also the spread between private and public equity as well. Consideration is given to leveraging and valuations for private equity; if companies are highly valued, pressure on return is modestly lowered. BOI has an aggressive benchmark. When reviewing benchmarks, they should be judged on appropriateness. If benchmarks are unrealistically high, you fail vs. the benchmark, even when succeeding in absolute returns.

Likewise, an easy benchmark can bias investing decisions, affecting the amount allocated to the asset class.

Member Prothero asked if, according to the data, the 7.75% actuarial goal will likely be met.
Mr. Voytko explained the data does not suggest the actuarial rate of return will never be met; but today it will be a challenge and difficult to reach without taking an unusual amount of risk. The data is reassessed annually. The GFC reset the clock; back in 2009 to 2010, it was easy to meet the benchmark. If the assumption is right, the question is how much risk are you willing to take to achieve the 7.75%. If you take actuarial benchmark risk, you could fall behind for a year or two, by not taking the higher risk. Rather than lower the assumed rate of return, it may help to consider raising contributions, if it appears year over year you will fail to meet your benchmark.

Mr. Higgins noted actuaries look at the long term; inflation risks are low for the 10-20 year forecast.

Mr. Voytko added boards face challenges. If you wait too long to take action, you have to play catch up. The assumed rate of return is an important driver of the contribution stream into pension funds. For capital appreciation, and interest rates, we are assuming at some point there will be normalization of short-term interest rates. The Fed has proposed a 2% inflation outlook, although it is unclear how that will be accomplished, it is the goal.

Member Englund asked for an explanation of the 18.35% standard deviation.

Mr. Voytko explained, for the expected return of any given year, you assess the probability of expected return and the standard deviation measures how wide of an assumption the outcome is likely to be. A low standard deviation, for example cash, means you will not get cash rates at 7%, but neither will you get -2%; while equity could produce a negative return.

The standard deviation is calculated using historic data, but also subjective data; judgement, is a bigger piece of the pie than history. The globalization of the capital market changes over time, so recent history is more heavily weighted.

Financial economics are built on the principal that the higher the risk presented to the investor, the higher the expected returns should be. Equities fluctuate, but over the long term, returns are higher. Private equity does not exhibit that much risk, but comes with liquidity risk, valuation challenges and return lags. High yield, real estate and hedge funds have moderate risk in terms of volatility, producing moderate returns and providing moderate diversification. High yield is starting to act more like equities. Small cap provides less diversification, but acts as a return engine, although higher risk in a portfolio in pursuit of higher returns. Risk is not bad and generally comes with higher returns.

GTAA, (Global Tactical Asset Allocation), is not an asset class like equity, fixed income or real estate; it is a collection of multi asset class products or blended products. GTAA and hedge funds are engineered asset classes, packaged together, and can move further up or lower on the risk chain. It is not a true asset class, but can include almost all types of assets, packaged differently.

Some boards do not spend enough time focusing on asset allocation, yet it is so important. It is difficult to spend time on because it is complex and lacks an ability to assess and evaluate people. That explains why managers are considered; asset allocation is just ideas and so is harder to grasp.

As an example of the importance of asset allocation, a $1 billion fund in 2008, overweight in equity by 5%, results in a $179 million loss; a loss so big that managers executing equity would have to outperform by 400 basis points to make up for it. Managers are important, but their effect on a portfolio can be swamped by minor change in asset allocation. It is hard to figure the right asset allocation mix, knowing that in some market circumstances, asset allocation could carry you forward, or back. The high equity exposure over the last five years, a difficult choice, has been a major factor of growth for the portfolio. Asset allocation has a powerful influence and drives returns. Estimates show 80-82% of return is due to asset allocation, although some studies show it is closer to 100%.

In summary, it is important to not only look at risk in terms of potential downside; risk does real harm to absolute returns over the long run. Risk has implications for cumulative returns over time.

Comparing the BOI end of year portfolio with a considerably more conservative one, more fixed income and less equity and private equity, and a more aggressive portfolio, illustrates expected return in relation to the risk taken. This is helpful when analyzing potential range strategy options and plan liabilities. Comparing the low volatility model with an 11.28% standard deviation, sufficient returns are not produced.

The current BOI allocation at 12/31/14 for public equity is over 56%, when private equity is added, it totals 67.2%, a relatively high exposure. Portfolio allocation is viewed statistically and with common sense; how the portfolio is weighted for growth potential. If assets are protected too well, earnings go down.

The statistical outcome for BOI, each yearly return is 6.89% with a volatility of 13%, not unusual numbers, and matches with the mainstream. Expected return over 10 years is positive, and close to the expected return for the portfolio, but still falls a bit short of the assumed rate of return.

Equity mainly drives volatility, but it is necessary to earn returns. Beta must be monitored and BOI beta has been rock steady for 5-6 years; years ago, equity beta spiked and so did the downside risk.

Liquidity risk matters and the liquidity metric makes up for what the MVO does not determine. If 100% of assets are invested in private equity with lots of capital calls, there is no liquidity to pay benefits with, and so there is a limit to how much illiquidity a portfolio can afford. BOI has a very liquid portfolio, even though it contains private equity. The risk of too little liquidity is having to sell severely depressed assets to get liquidity if costs are not covered, consequently, liquidity must be tracked. The S&P 500 is used as the equity beta benchmark.

Mr. Voytko reviewed the Monte Carlo Simulation results. Comparing the BOI portfolio against more conservative and aggressive models, you can determine what percentage of the time the target 7.75% return can be achieved for each. It is important to remember, if the expected return is less than 7.75%, it does not mean that you will not make actuarial, it is the median return, so there is a 50/50 chance. The 7.75% target over any given one-year period, subdued assumptions does not take 50% to 48% likelihood of making your return. Not taking excessive risk helps prevent a penalty for volatility. Over the long-term, the probability of the 7.75% return steadily marches down. Assumptions are done annually. The 50/50 is the actual probability, when adding the accepted shortfall due to not taking additional risk.

Member Prothero asked about the likelihood of attaining the 7.75% actuarial rate over the long term.

Mr. Voytko stated markets can change and probabilities change, so the question is how much risk is acceptable year after year; the need to raise contributions at some point to make up the difference must be considered. RVK recommends periodically reviewing liabilities in relation to contributions and asset allocation. He added it takes time for volatility to create a long-term penalty and it is important to remember it is acceptable to run a small amount of actuarial risk, but if you wait too long, it becomes a contribution shortfall, which must be made up, with interest, to catch up.

Member Satre asked Mr. Sheets if he had any comments on the subject. Mr. Sheets stated that he is skeptical about the MVO process because of its inherent shortcomings; however, he respects the general message that given valuations, future returns are likely to be lower than those enjoyed over the last five years. As for the idea that implied returns from asset allocation may suggest contributions should be increased, it is not realistic in that the legislature controls the level of contributions and benefits. BOI structures the portfolio for the long term and it is difficult to predict if the actuarial return assumption will be met in the future. Looking at recent history alone is not a good predictor of long-term returns and asset allocation is a long-term game. The risks of the assets and liquidity needs of the plans must be recognized and allocations can be managed through regular rebalancing; even real

estate and private equity can be adjusted over time. Yet, we have to work within a system where the actuarial variables of contribution and benefit policy are controlled by a legislative process that does not look over the long term. Over the long term, asset allocation choices made within the framework are designed to attain the needed return, and looking back over the past 21 fiscal years shows that it is possible. Staff's job is to recognize the risks we are taking and execute as best we can.

Investment Committee Best Practices

Mr. Mark Higgins presented the RVK Investment Committee Best Practices study, which was completed in February 2015. The report summarizes several challenges associated with serving as a member of an Investment Board, as well as profiles several practical solutions. The report leverages extensive secondary research, primary research involving interviews with more than 30 investment committees, and two surveys of investment professionals.

Mr. Higgins began by explaining how the report is organized according to four common types of challenges that investment Boards experience. These include:

- Defining the Scope of Authority
- Board/Committee Member Selection
- Maintaining Strategic Continuity
- Optimizing Decision Making and Execution

One of the potential tactics highlighted in the RVK Research was Trustee Reviews. Member Englund stated the Legislative Audit reported Board members we were not performing reviews of each other, as required in the Human Resource Committee Charter; consequently, the Charter was revised.

Mr. Voytko stated Board Members are appointed by the governor, not recruited by other Board members. BOI uses a process of self-evaluation.

Mr. Higgins then proceeded to review several insights within each section of the report. With regard to defining the scope of authority, Mr. Higgins indicated that BOI does a good job, both in terms of strategy and documentation. Overall, the BOI delegates appropriately and clearly to staff and consultants.

Moving on to the member selection section, Mr. Higgins noted the pros and cons associated with board size. Given that the BOI is on the upper end of the recommended size range, there are issues of which they should maintain awareness. For example, managing conversations and staying on topic can be more challenging with large boards. The BOI has some effective tactics for ensuring that this is handled effectively, such as using the work plan to keep the Board on track. Member Englund noted the Stanford study reported the bulk of recommendations related to board member attributes were behavioral in nature. He also noted that one of the strengths of BOI's Board is the statutory requirements drawing members from certain backgrounds who are not serving to advocate for their particular field of interest. Mr. Higgins concurred that behavioral attributes are important, but that the critical roles outlined in the RVK study are also helpful to think about. In particular, he noted that having members who serve as advocates for the beneficiaries (i.e., mission representatives) and members who have experience managing multi-asset class portfolios can be very helpful.

With regard to decision making and execution, Mr. Higgins noted that BOI operates effectively and efficiently. He noted that the BOI is organized with a set agenda and distributes effective meeting materials well in advance of meetings. In addition, member engagement, which is a common challenge for many investment committees and boards, does not appear to be a problem at the BOI. Meetings are well attended and the Board is engaged.

Executive Director Ewer added the Board of Investments could have been titled "and economic development" drawing the representation from that. Pensions will always dominate, but BOI is not just pension centric; there are economic development components. Board composition requires agriculture and labor representatives, but the Board's mission is more than just investments.

Mr. Higgins concluded that overall the BOI is performing well, and is in fact included in our study as one of five profiled best practices. He encouraged BOI members to use the study as future reference should several of the challenges become an issue with the BOI.

EXECUTIVE DIRECTOR'S REPORT

Overall Comments
Executive Director David Ewer presented his executive director's memo.

STIP Participation Draft Proposal
Old Business: The Audit Committee heard staff's presentation of the implementation of the new STIP web portal and staff has proposed a draft resolution to participate in STIP. The draft resolution and exhibits are in the Board packet. Staff recommends circulating the draft resolution for comments.

Member Satre stated the resolution accomplishes the goal of having participants reauthorized over a period of time.

Executive Director Ewer stated the draft resolution calls for STIP participants to reaffirm annually the representatives authorized for STIP transactions. Details are yet to be worked out what steps would be taken if at some point a participant fails to comply with protocol. Initially, the period for implementing the new system would allow a year for participants to get in compliance.

> Member Jack Prothero made a motion to approve the draft Resolution Authorizing Participation in the Short Term Investment Pool and to circulate the draft to STIP customers for a comment period. Member Kathy Bessette seconded the motion.
>
> Executive Director Ewer clarified the draft will initially go to the three representatives of the Montana Association of Counties, the Montana League of Cities and Towns and the Montana City Treasurers Association to allow them to distribute and receive feedback from members. Staff expects the final resolution will be ready to present to the Board at the May or August meetings before it is rolled out to all STIP customers.
>
> The motion was approved.

Executive Director Ewer asked for Board guidance on the quarterly cost report. Staff time required for producing the report is at least 16 hours and it provides limited value.

After a brief discussion, by consensus, staff will continue to include the cost report quarterly; however, the topic may be revisited in the future.

2015 Legislative Update
Executive Director Ewer gave a brief legislative update.

- House Bill 2 has been approved. BOI rates and charges have been approved as submitted in the governor's budget.
- No movement has been made yet on Board Member appointments.
- HB 453, the hail insurance bill, was gutted and tabled in committee.
- HB 610, the student loan bill, states BOI will create a student loan refinancing program and will utilize prudent underwriting to seek to provide savings to students and families. The bill sponsor has acknowledged in testimony, and the fiscal note states, the aim is to avoid economic harm to the Permanent Coal Tax Trust Fund. The bill allows loaning up to $40 million dollars. Operationally, there will be an RFP (Request for Proposal) for an originator who can monitor loans and set a price so the effective yield does not undermine the Coal Severance Tax. Demand from students and lending authorities is unknown at this time.
- SB 113 permitting long-term investments of local funds is now law. Staff is currently in talks with Butte regarding investment of the $15 million EPA Arco settlement.
- SB 124, which requires public access to Board meeting proceedings via audio/video, was signed into law by the governor last week. Staff is asking the Board for guidance. The bill

covers the Board of Investments, PERS, TRS, The Board of Public Education and the Board of Regents of Higher Education and stipulates a good faith effort must be made to record in video format. The boards must provide public access within one business day via the state broadcast system or website availability. In the case of telephone conferences, which are occasionally necessary, video would still be required. A legal opinion may be needed as to the recording of calls, which must be disclosed to all participants, and whether committee meetings fall within the requirements of the law.

After a short discussion, Executive Director Ewer clarified the video will not replace the need for written minutes as comprehensive minutes are vital. Some agencies do not have comprehensive representative minutes.

Member Englund added when conducting legislative research, written minutes provide a much better record and avoids the need for producing a transcript of audio or video records or searching through hours of audio/video.

Executive Director Ewer added if a Board Meeting is held in another city, which sometimes occurs, staff would strive to meet the letter of the law and produce the required video.

Custodial Bank Contract
Executive Director Ewer reported the custodial bank contract with State Street Bank has been signed and he thanked Deputy Director Geri Burton and staff for all their hard work during the long process.

Securities Lending – Cash Collateral Update
Executive Director Ewer asked Mr. Cliff Sheets to provide the update. Mr. Sheets noted at the last meeting there was a securities lending discussion which included education and a review of BOI history. Staff presented details on a planned sale of duration assets in the collateral pool, a legacy asset, scheduled to occur in the first quarter. The sale occurred in March and the expected realized loss was within expectations. BOI had to sign an amendment to the State Street security lending agreement enabling the sale. Due to the expected loss, BOI provided cash for liquidity to transition the loans into the cash pool. BOI reserved earnings from pension and non-pension accounts, a little less than one month of earnings, from pensions. The sale came in at $199,000. The non-pension loss came in at $26,000, less than the $32,000 expected, therefore the reserves set aside were more than enough and in fact the accounts were rebated the excess.

Executive Director Ewer added the sale cleans up some notes on the footnotes to the financial statements.

All Policy Review

Executive Director Ewer stated this is the fourth year conducting the annual policy reviews. Policy and precision matter and the review is in line with the Board's strong governance. According to the 24 Month Strategic Work and Education Plan, each April staff reviews policies and brings any recommended revisions before the Board.

Governance Policy – Communications Delegation
Executive Director Ewer recommended deleting language in the Governance Policy, Article III, Section 5, Communication Delegation:

> *The Executive Director shall serve as the exclusive spokesperson for the Board when communicating with the Legislature, the Governor, the public, and the media, unless the Board Chairperson determines that, in certain situations, it would be more appropriate for the Chairperson or a selected Board Member to serve as the spokesperson.*

Executive Director Ewer stated restricting the role of sole spokesperson for the Board is no longer relevant due to the strength of the management team and capable staff.

Member Wilson moved to remove Section 5, from Article III, of the Governance Policy. Member Jon Satre seconded.

Following a brief discussion, the Board directed Executive Director Ewer that rather than delete the language, to compose alternative language addressing the designation of communication delegation to present to the Board for consideration at a future meeting.

Governance Policy - Audit Committee Charter

Executive Director Ewer presented options for language revisions to the Audit Committee Charter. The current Charter language includes "independence" and "financial literacy" as requirements; however, there is no definition set out clarifying the requirements. The governor appoints Board members, seven must be informed and experienced in the subject of investments. Staff is recommending three possible alternative options for the Charter language clarifying the Chairman appoints the Committee Members and Chair:

1. The Board Chairman will appoint Committee Members and the Committee Chair striving to have a membership that is both independent and financially literate and also having financial reporting or auditing expertise. (Closest option to existing language.)
2. The Board Chairman will appoint Committee Members and the Committee Chair qualified to perform the duties of the Committee as set forth in this Charter. (Closest option to language similar to the other committee selection language.)
3. Strike the non-conforming language.

Member Sheena Wilson moved to replace the current Audit Committee Charter language with Option 2. Member Jon Satre seconded. The motion carried.

Custodial Bank Services - New Policy

Executive Director Ewer presented a new Custodial Bank Policy for custodial bank services to be added to the Governance Policy as Appendix N (draft included in the Board Packet). The Policy acknowledges the specific custodial bank relationship and includes items taken from the most recent RFP stating the custodial bank minimum requirements, including important attributes of the functions a custodial bank performs. Staff recommends approval of the Policy and inclusion as Appendix N within the Governance Manual.

Member Marilyn Ryan moved to adopt the Custodial Bank Policy as Appendix N to the Governance Manual as presented by staff. Member Wilson seconded. The motion carried.

Investment Policy Statement Review

Mr. Cliff Sheets presented proposed investment policy statement revisions as summarized in his Investment Policy Changes Memo. Staff is recommending revisions to three independent investment policy statements (IPS). There are no material changes and all are housekeeping in nature.

- The Montana Real Estate Pool (MTRP) Policy is revised to remove language describing different strategies regarding net of inflation, and the table showing ranges by strategy types and a footnote on inflation. The old language is an exception to all other policies since we do not reference expected returns adjusted for inflation. Mr. Hurley suggested the revision, to clean up and take out the inflation adjusted return language.
- Permanent Coal Trust IPS revises language and updates the allocation of Coal Tax revenues to the Permanent Fund vs. the sub funds. Only half of coal tax revenues go to the Permanent Trust. The table on page 3 updates the actual allocation and page 2 revises a new dollar figure, $40 million, to reflect a change in law from this legislative session increasing the allocation to the Montana Veterans' Home Loan Mortgage Program.

- Noxious Weed Trust IPS was quite outdated. Originally, the fund had individual securities and STIP, but individual bonds are no longer used, and the STIP balance was stripped out of this trust account and so the references were removed from policy.
- Cash Investments - Another risk highlighted by the Legislative Auditors was the universal recognition of cash credit risk. All applicable policies that have cash exposure will have boilerplate language added. The new language should mitigate any statement of concern by the Auditors for failing to address cash credit risk.

Executive Director Ewer provided some background. The Board's Audit committee empowered staff to revise the footnotes to contain fewer provocative statements and is aware that BOI staff is beginning the proactive effort to clean up the footnotes. Legislative Audit staff will be consulted to work with BOI through the process to correct the footnote items of concern and staff may come before the Board at a future time with more possible changes.

Mr. Sheets advised the asset class review of fixed income and a discussion of the two major bond pools, RFBP and TFIP, are scheduled for the May Board Meeting.

> Member Kathy Bessette moved to adopt changes to the three Investment Policy Statements and to accept the addition of the cash risk language to the affected policies as presented by staff. Member Terry Cohea seconded. The motion carried.

<u>Veterans' Home Loan Mortgage Policy - Revision</u>
Mr. Herb Kulow presented one change to the Policy adding the language: "The appraiser's predominant value will be an additional consideration, on a case-by-case basis" under the Property Eligibility section of the policy. Not a calculated number, the median is determined by the appraiser's consideration of the properties within the appraisal "neighborhood." Predominant is the median, rather than the lower of cost or appraisal. Utilizing predominant value could prevent exposure on loans more likely to default, resulting in a loss.

Responding to a question from Chairman Noennig, Mr. Kulow provided an example:

> The VA guarantees 25% of the original sale amount of a property. On a property with a loan of $200,000, 25% equals a guarantee of $50,000. However, if predominant value is $155,000 and the property appraises for that amount, BOI would receive 85% of $155,000 + $50,000 for the guarantee, (totaling $181,750) and therefore may not be enough to cover a loss.

Mr. Kulow explained as a prudent investor, financing the most expensive home in a neighborhood when predominant value is considerably less increases risk. Concerned with future market conditions, comparable sales on a market downturn can differ considerably.

Mr. Kulow added the BOI Montana Veterans' Home Loan Mortgage program is not a federal VA program, but rather is funded out of the Coal Tax. The VA program allows a borrower to add closing fees/costs to the loan amount, allowing an upside down loan. BOI had half dozen loans that allowed fees to be added to the loan amount. Staff approached Senator Larsen to request an adjustment to the maximum loan amount in the bill. BOI retains the option to deny the full loan amount under the program.

Member Jack Prothero added BOI acts as an investor rather than the lender.

> Member Karl Englund moved to adopt changes the Montana Veterans' Home Loan Mortgage Policy as presented by staff. Member Kathy Bessette seconded. The motion carried.

Board as a Rated Credit

Executive Director Ewer noted this item is presented to the Board every two years. If the BOI guarantee is ever activated, there is a large guarantee resting on the Coal Severance Tax.

Ms. Louise Welsh presented an overview of the Board's designation as a rated credit and how it is a benefit to Montana by providing the credit enhancement or "guaranty." Under the Municipal Finance Consolidation Act (MFCA), the Board has the power to issue bonds and create a capital reserve, to assist local governments, guarantee the bonds and provide liquidity. The law also provides the Board the authority to charge fees for its services. A separate law authorizes the Board to guaranty loans made by the Montana Facility Finance Authority (MFFA). Exhibit A included in the Board Packet provides excerpts of the relevant laws, resolutions and investment statements and policies giving the Board the ability to issue and guaranty bonds.

The Board capped the bond issuance at $190 million for each program, $380 million total, for INTERCAP and MFFA. The Board's guarantee commitment is currently ~$200 million. The Board prefers to keep the guaranty closer to $120 million each. The Board's $380 million guaranty cap should not be confused with the Board's cap of $190 million bonds issued under 17-5-1608, MCA. The guaranty falls under the Board's purview to determine investments for the Unified Investment Program.

Using the Board's nationally-recognized rating and guaranty opens the way for INTERCAP and MFFA bond issuance at lower interest rates and low cost that ultimately pass on to the program borrowers. These borrowers would have been unable to access the bond market without the Board's guaranty and, due to the majority being small in size, would not have access to bond insurance or letters of credit even when those types of enhancements were readily available prior to the financial meltdown in 2008.

Ms. Welsh referred to Exhibit B, which lists the outstanding bonds with the Board's guaranty: ~$93 million for MFFA and ~$106 million for INTERCAP. The Board enhances both INTERCAP and MFFA, but the credit support for the two programs is different. The Board agreed to replenish both programs' bond reserve funds to ensure debt service repayment. The Board agreed to purchase tendered INTERCAP bonds that were not successfully remarketed; the Board does not enhance the MFFA bonds this way. The tendered bonds guaranty consists of eight INTERCAP bonds that are included in the pool of money available to loan out. The Board agrees to purchase, at present, $160,445,000, over the short term, if needed. The interest rate is 23 basis points on the INTERCAP bonds for this year. Both INTERCAP and MFFA programs own substantial bond reserves. Neither program has had to call on reserve funds. All program borrowers are current in payment.

The current Legislative session is contemplating SB 411 to close the Montana Developmental Center (MDC) located in the city of Boulder. MFFA's MDC bond has a Board guaranty; however, according to the MFFA Executive Director, as part of the fiscal note, the bonds are to be paid off prior to closure, so there is no risk to the Board.

The Board's Governance Manual references Resolution 219, which authorizes the Executive Director to implement the guarantee to back bonds and identifies which funds may be used. If the guaranty is called upon, STIP would be used first.

The Treasurer's Fund, Permanent Coal Trust STIP and TFIP, and Treasure State Endowment TFIP sub funds of the Coal Severance Tax Trust Fund, all are backups for the guarantee. As of March 2015, the Treasurer's Fund has ~$945 million and the designated Permanent Coal sub funds ~$637 million for a total of ~$1.59 billion as backing, which helps with the bond ratings. The Board resources provide seven times the coverage with ample liquidity to purchase tendered bonds.

The guarantee is the Board's choice; the full Board has ultimate approval authority. Resolution 219 specifies the Board approve each bond guaranty via resolution. The Board currently charges a onetime fee for this guaranty. INTERCAP has paid $1.5 million in fees and MFFA $2.3 million; fees go into the

Permanent Coal Trust. The fee considers the term of guarantee, the structure of the bond, and the organization (governmental or non-profit). The last $12 million INTERCAP bond issued for a 25 year term paid 130 basis points per $1000; a fee of $156,000. Ms. Welsh referred to Exhibit E for the Fee Schedule.

Responding to a question from Member Satre, Executive Director Ewer stated the acting Chief Investment Officer two decades ago set the fees and they are still relevant. Staff is not recommending a change in fee schedules.

Member Bessette added as a local representative, projects were completed that never would have been affordable, were it not for the INTERCAP program.

Executive Director Ewer noted the rate is great to borrowers at 1.25% with no prepayment penalty.

Executive Director Ewer acknowledged to the Board that the MFFA Executive Director Michelle Barstad was present.

MFFA Executive Director Barstad reported 2007 was a very busy time for the program. However, most projects looking for financing are now steering towards USDA and it is unlikely MFFA will have any projects in the next year coming before the Board.

Member Englund asked why borrowers are not seeking out MFFA financing.

Ms. Barstad stated in the market place, the priority has been on other projects, such as implementing the Affordable Care Act and electronic medical records. Board enhancement has been used by mid-tier hospitals and most have completed their projects. No large projects are expected in the near future that would seek access the MFFA program. Smaller projects are accomplished through other programs and going out for a bond issue is a complicated, expensive and involved process.

Ms. Welsh stated the Board's credit rating is based on an assessment of fiscal capacity of the Board, its total leverage, and the relative size of outstanding and new proposed debt versus the funds available for guaranty. Moody's Investor Services rating long term is AA3 and VMIG1 short term. Fitch is AA- long term F1+ short term. The short-term rating for both agencies is the highest possible on their scales. The programs offer great services to entities that would not otherwise be able to borrow. There has never been a default, although there was a past due last year that resolved within a few months and has been current in payment since.

Mr. Prothero noted the strengths and weaknesses show we are doing well and Montana's transparency helps when it comes to rating agencies.

In-State Loan Program

Mr. Herb Kulow thanked the Board and staff for the recognition and framed Cascade County Commissioner letter. Mr. Kulow also recognized Ms. Maria Wise and Ms. Savannah McCormack for all their help in putting the presentation together.

Mr. Kulow provided a summary of the In-State Loan Program history.

- 1971 – The Legislature established the original Board of Investments.
- 1983 – The Legislature allocated 25% of the Coal Tax Trust Revenue to In-State Investments.
- 1984 – The Legislature added the two pension representatives to the Board and increased the Board size from five to seven.
- 1985 – The Legislature prohibited the Board from direct loaning and capped the participation with financial institutions at 80%, and created Science and Technology.

- 1987 – The Legislature abolished the original Economic Development Board (MEDB) and the original Board of Investments and created the current Montana Board of Investments (BOI) and transferred all staff and duties to BOI.
- 1991 – The Legislature created a new program encouraging BOI to invest 25% of the Coal Tax and created the job creation program, which applies to participated guaranteed direct infrastructure loans. As of March 31, 2015, the corpus of the Coal Tax Trust is $925 million, which allows $231 million maximum to lend under the program. The legislature also enacted the incentive to financial institutions for small business loan participation.

Member Satre inquired what happens if a borrower fails to create the number of jobs they stated.

Mr. Kulow stated staff receives a job report that tracks the time period to create the required number of jobs. The Infrastructure program allows four years to create the jobs. Policy states if 10 or more jobs are lost, the Board may increase the interest rate. For example, if a borrower creates 200 jobs, and then lays off 150, they are still eligible, as the maximum discount is based on 50. Each job allowance is for a salary of $36,835, not including benefits, and each of the 50 must make $36,385. If they lay off 9, since policy states 10 or more, they are still within policy limits. Ideally, a borrower gets healthy and they increase the job count again. Otherwise, they must compensate the state for the loss of jobs, which happened in one situation. A borrower must add at least 15 jobs to get the lowest rate.

Mr. Kulow stated all job credits are by statute, and there is no time limit on the job creation, the law is silent on it. If a lender recommends postponing payments for a troubled credit, we can do that and/or we can grant leniency.

- 1995 – The Legislature created the Infrastructure Loan Program and allocated $50 million of Coal Tax Trust and designated BOI as a direct lender under the program.
- 1997 – The Legislature abolished Science and Technology. The program peaked at $17 million in 1998 and the current remaining balance is $10.1 million. Most loans were written off and in 1999 the loans were transferred from the Department of Commerce to BOI to oversee and manage the remaining loans. In 2012, $1.4 million of Science and Technology balances were written down. Considering the valuation of the businesses, another mark down may be needed.
- 2001 – The Legislature created Value Added Loan Program and allocated $50 million.
- 2003 – The Legislature created IRP (Intermediary Relending Program) and the Seasoned Loan Program.
- 2007 – The Legislature increased the Infrastructure Loan Program from $50 to $80 million and increased the Value Added from $50 to $70 million. The percentage of the In-State Loan Program loans to the Coal Tax Trust topped out at 24.9% of the maximum 25% Coal Tax. As a hard cap, no more funds were allowed for the program. Lenders contacted the legislature, which kept the allocation at 25%, however the cap is now a soft cap.
- 2011 – The Legislature allocated $15 million for the Veteran's Home Loan Mortgage Program, and in 2013 allocated another $15 million. The current 2015 legislative session has proposed HB 380 which allocates an additional $10 million, bringing the total to $40 million. The program has been relatively successful.
- 2015 – The Legislature has introduced HB 610, which refinances Montana student loans, and designates BOI as the administrator. As of April 1, the bill was in the Education and Cultural Resource Committee.

Mr. Kulow stated the In-State loan program manages nine programs:

- Value Added – Terms and conditions are set by legislature, up to 1% of the Coal Tax Trust is allowed and requires a 25% down payment of the loan amount. Term of the loans is restricted to 15 years, and no bonuses are allowed while the loan is outstanding, except for ethanol plants.

- IRP (Intermediary Relending Program) – The legislature allocated $5 million to the program, another direct loan program matched by Federal funds. The match ratio can be 2 to 1, or 3 to 1. The statutory interest rate is set at 2% and the federal rate is 1%. Currently there is a $3.3 million outstanding loan balance, low on funds, but it is a revolving program.
- Seasoned Loans – Used for economic development units, which participate with BOI.
- Link Deposit Loans – The program has not been used recently. In an increasing interest rate environment, demand may pick up. BOI deposits $500,000 to a bank at fixed interest rate and the deposit is linked to the loan for the term of loan. Banks have sufficient liquidity and there is no demand for the program. Anything over the FDIC allowed amount must be pledged.
- Science and Technology – Discontinued. BOI manages the active loan portfolio.
- Non-Guaranteed and Guaranteed Participation Loans – Up to 25% of the Coal Tax Trust, the balance totaled $930 million as of March 31, 2015. Lending of funds up to 10% of the Trust for any one borrower is allowed. The Board has approved most of these loans, including $36 million for a malting plant in Great Falls. Participation up to 80% with the lender is allowed. The lender services the loans and interest rates are based on the Federal Home Loan Seattle.
- Infrastructure – Loans are sized by the number of jobs created; loans are made to municipal units as a direct loan and require the creation of at least 15 jobs. A use fee is paid to the local government and the fee can be deducted from state of Montana income tax as a tax credit.
- Veterans' Home Loan Mortgage Program – Current loan interest is 2.25%, the Board of Housing administers the program and charges BOI a fee of 50 basis points, leaving the BOI return at 1.75% that goes into the General Fund. A down payment of only $2,500 is required of borrowers. The outstanding balance is $26 million. The Board of Housing processes the loans through electronic underwriting and the loan must approve with no exceptions. According to BOI policy, no exceptions are allowed.

Member Englund asked if banks do the heavy lifting on participation loans,

Mr. Kulow responded the banker contacts BOI staff ahead of time and they do the paperwork. The loan must be approved on the bank's end before submission to BOI.

Member Englund asked about the Bank of Montana, the Home Health Missoula project.

Mr. Kulow advised the project will take 6-9 months and he has met with the bank. One possibility is to combine an infrastructure loan in conjunction with a participation loan. It is an ongoing process from the ground up on these types of projects.

Mr. Kulow compared outstanding portfolio loan balances from 2014 vs. 2004; the guaranteed portions have run off considerably, and infrastructure has increased considerably.

Mr. Kulow reviewed the outstanding loans by geographic regions and noted when the programs transitioned from Rules to policy the programs became much more user friendly. The portfolio decreased from 2008-2009 due to a dramatic increase in liquidity levels at banks. Many banks would buy back participated loans, but they had to show how the borrower benefited in order for BOI to approve the buyback. BOI does not do refinances.

Mr. Kulow noted interest rates have come down as compared to prime rate and that the interest rates on the guaranteed participations are 40 basis points less than the direct participation interest rates.

Regarding past due loans, BOI has outperformed banks in the state of Montana with only two charge offs in 2002 for Pasta Montana, and there was a charge off of $62,279.95 on the Vann's Lolo property in 2014. As of the end of January, there were no past due loans.

In 2005, the Residential Loan Program contracted with BOH to service all residential loans that use retirement funds. The portfolio peaked at $324 million and is down to $9 million as of the end of March due to the dramatic decrease in residential interest rates. For the past due comparisons to Montana for

residential loans, the percent of past due increases as the portfolio decreases. Most loans are FHA guaranteed.

Member Englund commented the Loan Committee does a great job and Mr. Kulow and Ms. Welsh both received glowing reviews in conversations with Missoula lenders, as did BOI in general.

Executive Director Ewer stated looking ahead to the May Board Meeting, staff will present a deep dive on fixed income, and as with the meeting two years ago, staff will reach out to and invite participation with the fixed income trust clientele, including State Fund as the largest client ($1.4 billion). Lunch will be provided. Staff will bring recommendations on compensation for exempt staff before the Human Resource Committee.

Executive Director Ewer added educational options in the form of conferences for Board members are lacking and he encouraged Board members to alert staff if they come across opportunities that seem relevant.

Member Wilson noted FundFire is informative and educational and there is a lot of information available.

To Do:
Executive Director Ewer recapped the to do's for the next meeting:

- The Governance Manual Policy, Article III, Section 5, on Communications Delegation will be rewritten and a revised version brought before the Board.
- The Cost Report will continue to be included in the Board Packet.
- Further guidance on the new video recording requirement for Board meetings will be discussed in further detail.
- Minutes for both February and April Board meetings will be presented at the next meeting.

Being no further business, the meeting was adjourned at 3:43 PM.

Next Meeting

The next regular meeting of the Board will be May 19 - 20, 2015 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: _____

MBOI:drc
4/28/15