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
February 24 - 25, 2015

BOARD MEMBERS PRESENT:

Mark Noennig, Chairman
Kathy Bessette
Terry Cohea
Karl Englund
Quinton Nyman
Jack Prothero
Marilyn Ryan
Jon Satre
Sheena Wilson

LEGISLATIVE LIAISONS:

Senator Bob Keenan (present 2/24/15)
(Representative Kelly McCarthy was absent)

STAFF PRESENT:

Polly Boutin, Associate 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
Gayle Moon, CPA, Financial Manager
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:

Governor Steve Bullock
Jim Voytko, RVK, Inc.
Mark Higgins, CFA, RVK, Inc.
Jonathan Kowolik, RVK, Inc.
Tim Burton, Montana League of Cities and Towns
Ronda Wiggers, Montana City Treasurers Association
Harold Blattie, MT Association of Counties
Meg O'Leary, Director, Department of Commerce

BOARD MEMBER ROUNDTABLE

Informal discussion and introductions of return Board Member Terry Cohea and newly appointed Legislative Liaison Senator Bob Keenan.

CALL TO ORDER

Board Chairman Mark Noennig called the regular meeting of the Board of Investments (Board) to order at 11:26 AM. As noted above, a quorum of Board Members was present.

CONSULTANT REPORT

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

Mr. Jim Voytko presented the market overview for the quarter ending December 31, 2014. The Fed funds rate remains near zero and many analysts are suggesting rates could remain low for years. Oil prices have suffered the biggest and quickest collapse in recent investment history, pressuring high yield borrowers in the energy sector. The effect on airlines and automakers, which are heavy users of oil and gas, has been spectacular. Oil price declines are also having a major geopolitical impact, particularly in Venezuela, which is highly dependent on robust oil prices to balance their budget.

Break-even inflation over 10 years, as analyzed by looking at the TIPS Rate, points toward modest inflation expectations. An implied inflation rate of 1.68% over 10 years is very low by historical standards. Weaker than historical global growth expectations presents a continued return challenge. For pension plans, getting 7.75% may be tough.

In terms of recent history, the 1, 3 and 5 year annualized returns generated by several asset classes substantially exceeded the expected rate of return. This is good news for PERS and TRS in terms of funded status. In terms of relative performance, compared to the total fund benchmark, the fund has underperformed. However, this is almost entirely driven by the private equity portfolio, which historically lags the public equity markets. As bull markets mature, private equity returns tend to catch up. The relative returns are not a cause of concern.

Relative to peers, the PERS ranking is exceptional, as the 1, 3 and 5 years rankings are 6, 1 and 2, respectively. Additionally, looking at the 10-year number, the fund is now ranking above median. This is one of the first times showing a material change to the 10-year numbers and it is exceptional to see the 10-year, long term sustained record. Additionally, the 10-year results did not require unusual levels of risk. In fact, the plan has taken less risk than peers, while generating a higher return.

Mr. Voytko next reviewed the portfolio equity beta. With the rising stock market and corresponding equity risk, the portfolio equity exposure has remained stable over time. In summary, the portfolio has performed well without ramping up exposure to the rapidly rising stock market.

Member Englund observed the fund rankings are comparable over the 1, 3, 5 and 7 year periods, however there was a huge jump in the 10-year performance from September to December 2014, and asked how one quarter can account for such a large difference.

Mr. Voytko explained as one quarter rolls off, it will affect performance; however, this is the first time one quarter has had such a major effect.

Mr. Higgins added the difference in the median, such as the recent good quarter and a bad quarter rolling off, also reflects the narrow margins for peer comparisons. Often a very few basis points of performance can move the rankings up or down.

Mr. Voytko concluded that performance continues to improve and that it can be attributed to several factors. First, after the fiduciary audit, changes in governance were implemented, including internal personnel and a reorganization conducted by staff. MBOI has adhered to these changes, which have led to prudent decisions on asset allocation, manager selection, and other investment decisions that have added value to the portfolio. This strategy has produced strong results.

Mr. Mark Higgins followed Mr. Voytko with a review of asset class composite returns. Net of fees, performance for the different asset class composites is similar to the past. Domestic equity absolute return over 3 years is 26% annualized and 15.4% annualized over 5 years. Over 3 years, domestic equity has outperformed the S&P 1500, a credit to the strategy of having a passive core in more efficient markets and focusing active management in less efficient sub asset classes. Absolute returns in international markets are less attractive than domestic markets. Thus, the heavier allocation to domestic equity vs. international has helped overall portfolio returns. The Retirement Fund Bond Pool (RFBP) has been very strong overall. Overall, the fund has done well with both internal management and external managers. There is one manager undergoing some organizational changes, which caused concern, but overall, performance has improved substantially.

The Trust Fund Investment Pool (TFIP) has a very similar picture, showing strong returns. The Montana Real Estate Pool (MTRP) has struggled over the long term, primarily due to the timing of entering the asset class; however, the pool has been recovering nicely in recent years and exceeded the benchmark by 77 basis points over 1 year. Real estate also serves as a valuable diversifier.

The Short Term Investment Pool (STIP) is performing well on a comparative basis, and managed to generate a 10-basis point return vs. the benchmark. The Montana Private Equity Pool (MPEP) absolute return over 10 years far exceeds any other asset class in the portfolio. Private equity continues to lag the benchmark due to the premium target of 400 basis points, but long-term returns remain very attractive.

In summary, Mr. Higgins concluded that a portfolio will never be perfect, but the MBOI portfolio has performed very well. Further, the structure changes have been appropriate and are showing positive early signs.

Member Prothero suggested looking at benchmarks for the next Board meeting or an upcoming meeting as it is a common Board discussion.

Mr. Higgins stated for a traditional asset class portfolio, appropriate benchmarks are being used. Private equity and real estate are both very tough assets to match up to an appropriate benchmark.

Executive Director Ewer added each November, staff reviews benchmarks and presents a very detailed presentation to the Board.

ADMINISTRATIVE BUSINESS

Board Chairman Noennig welcomed new Board member Terry Cohea, and welcomed her back to the Board. The Chairman asked for public comment. There was none.

Chairman Noennig asked for comments or revisions to the minutes of the November 2014 Board meeting.

> Member Sheena Wilson made a motion to approve the minutes of the November 2014 Board Meeting. Member Jon Satre seconded. The motion passed unanimously.

Audit Committee Report

Audit Committee Chairman Jon Satre presented a brief review of the meeting; most Board Members attended. The Committee considered revisions to the STIP program protocol, and decided to require authorization for each municipality staff member who has access to conduct transactions in the program. The Committee will write draft authorization wording to review at the next Audit Committee meeting. The Committee reviewed the 2015 Systematic Work and Education plan. A subcommittee will review the BOI Annual Report to see if updates are appropriate to the content and format. The Annual Report has not undergone changes for many years and may benefit from updating.

The Internal Control testing schedule with external auditor Galusha, Higgins & Galusha was approved and is moving forward. The Fiscal Year 2014 Financial Compliance Audit was clean and there were no recommendations. The Legislative Audit Committee meeting is scheduled for March 5, 2015 at the Capitol from 4:00-6:30 pm.

The Committee reviewed Executive Director David Ewer's draft response letter to the Legislative Audit's follow-up letter dated February 17, 2015 regarding implementation of recommendations included in the prior year Legislative Performance Audit that was presented to the Legislative Audit Committee in February 2014. The Committee approved the recommended draft letter language as written.

> Committee Chairman Jon Satre made a motion to approve Executive Director Ewer's response to the Legislative Audit Division. Member Sheena Wilson seconded the motion. The motion passed unanimously.

Human Resource Committee Report

Human Resource Committee Chairman Karl Englund presented items discussed in the meeting. Financial Manager Gayle Moon has announced her retirement, effective March 31, 2015. Procedures to fill the position have been started and Executive Director Ewer will lead the process. The state has implemented new hiring procedures which may streamline the hiring process. The Committee had no action items.

Loan Committee Report

Loan Committee Chairman Jack Prothero presented items discussed in the meeting. The Committee approved two Bond Program loans presented by Ms. Louise Welsh: one to Montana Department of Transportation (MDT) for $2.75 million for purchase of new vehicles for the State Motor Pool (SMP), and the other to the City of Chinook for $2.237 million for improvements to its water system.

The Committee reviewed two loans presented by Mr. Herb Kulow for the In-State Loan Program. The first loan was reapproved to Pheasant Run Apartments I, LLC in the amount of $3,495,200 on an 80% participation with First Interstate Bank, Billings, (total loan amount of $4,369,000), for a 15 year term. The loan was originally presented and approved at the August 20, 2014 Board Meeting, for $3,508,000 (80% participation, total loan amount $4,385,000) for a term of 20 years. The original loan was withdrawn February 2, 2014.

The second loan is an infrastructure loan, technically to Cascade County; however, the loan will be used by Loenbro, Inc. to construct a new building in Great Falls. The company provides integrated pipeline services to the oil and gas industry. The loan is for $7.499 million and the loan collateral is the building and a cash reserve. The Committee is recommending approval by the full Board.

> Committee Chairman Jack Prothero made a motion to approve the $7,499,000 infrastructure loan to Cascade County. Member Terry Cohea seconded. The motion passed unanimously.

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

PERS representative Sheena Wilson reported that the PERS Board audited their actuary and the report had a few good suggestions, but overall, the review was good and in accordance with best standards. On the legislative front, PERS is playing defense on some issues. PERS bills are moving along smoothly, including the standard tax bill, presented each legislative session, to comply with tax law changes. One bill affecting the Defined Contribution (DC) plan would be beneficial and there is a referendum to scuttle the whole retirement plan and change the DC plan.

Chairman Mark Noennig asked for an update on the PERS Guaranteed Annual Benefit Adjustment (GABA) litigation. Member Wilson stated the case has been presented and is awaiting a ruling by Judge Reynolds.

TRS representative Marilyn Ryan reported that Daniel Trost has been appointed to the TRS Board. The Board is moving forward on plan goals, including the new computer system that is continuing in right direction; several modules are in place. In the legislature, a couple of housekeeping bills are moving forward. TRS testified as an informational witness regarding IRS Immunity, and a couple of other bills which were of concern have been tabled. The yearly review of Executive Director Shawn Graham has been completed and is positive. The annual report was determined to be in compliance with the IRS. The TRS GABA litigation is scheduled for court sometime in March 2015.

Legislative Liaison Comments

New Board Legislative Liaison Senator Bob Keenan was not in attendance having departed for the Capitol and Representative Kelly McCarthy was absent.

EXECUTIVE DIRECTOR'S REPORT

Overall Comments

Executive Director David Ewer reviewed follow-up requests from the last Board Meeting. The quarterly cost report is included in Tab 2 and the monthly snapshot, which provides an overview of the portfolio, is now included in the Board packet and also distributed to the Board monthly.

Ethics Policy – state law requires all Board and staff members to sign the policy annually. All staff has signed the policy and Board Members have a copy of the policy with signature page included in the meeting packet. Board members are asked to read, review and return the signature page.

The Audit Committee reviewed STIP protocol in the meeting held prior to the Board Meeting.

Annual Report and Financial Statements – The Legislative Audit Division's Financial Compliance Audit for MBOI for the Fiscal Year Ending June 20, 2014 is schedule to be presented to the Legislative Audit Committee meeting March 5, 2015 in Room 472 at the Capitol.

Custodial Bank Contract Update

Deputy Director Geri Burton provided an update on the custodial bank contract. Progress continues on the custodial contract, along with the other associated contracts. Staff participated in a conference call finalizing the different documents this week, including a transfer agent agreement and a securities lending authorization agreement. The new STIP portal launched on February 12, which required a contract amendment to the current custodial bank contract. Different teams at State Street are working on the different contract components. The contract extension for the current contract is in place until March 31. Staff is hoping to finalize all parts of the contract next week or the week after.

Legislative Update

Executive Director Ewer presented the legislative update:

- The Appropriations Subcommittee has voted to approve the BOI rates as submitted and is awaiting the Governor's approval.
- House Bill 347, proposing changes to the Board's composition and education requirements, was tabled in the Business and Labor Committee and missed transmittal deadline.
- House Bill 453 would statutorily allow the Board of Hail Insurance to secure a line of credit or loan of up to $100,000 from BOI; the bill has been transmitted to the Senate; the outcome is not known.
- Senator Cliff Larsen has sponsored Senate Bill 380 to increase from $30 to $40 million the amount of funds available from the Permanent Coal Tax Trust Fund to fund the Veterans' Home Loan Mortgage Program. The bill is still alive.
- Senate Bill 113 allows for long-term investments by local governments, within narrow parameters, for funds received due to an event or action such as a legal settlement. The invested funds must equal a minimum of $10 million and be invested in pools or investments not otherwise prohibited by law. The Governor has signed the bill.
- Senate Bill 124 will require BOI, among other boards, to record Board meetings, including a good faith effort to record on video and submit within one business day for web viewing or television broadcast on the system at the State Capitol. The bill appears headed for easy passage.

Member Sheena Wilson noted PERS is already recording and posting the audio recordings of PERS Board meetings divided into five segments, and have posted the audio from the last three meetings.

Executive Director Ewer stated staff will need guidance from the Board on implementation of the statute. The law does not give the option of audio or video but states a good faith effort is required to provide video.

Member Marilyn Ryan added that TRS is also posting audio of their Board meetings on the TRS website.

MONTANA LOAN PROGRAMS

In-State Loan Program

Mr. Herb Kulow presented the Montana Loan Program Report. The outstanding loan portfolio balance is $102,145,198 as of the end of January, after a $560,000 deduction for the Vann's property in Lolo. There are six reservations outstanding, totaling $57,028,000, and six committed loans totaling $4,151,500. One loan in the amount of $1,246,094 is past due, the result of the Vann's bankruptcy, a Bozeman lease which was not extended; the bank is in the process of foreclosing. The Lolo property is leased with an option to buy, and if sold, the proceeds will be enough to make the debt whole.

The outstanding residential loan portfolio balance is $10,185,253 as of 1/31/15 with eight loans past due totaling $372,296. All past due loans are FHA guaranteed.

The Veterans' Administration Home Loan Program has 155 loans totaling $26,379,048 as of 1/31/15. There is one loan past due for $195,863. The remaining available funds under the VA program total $3,620,951 and there are 6 reserved loans totaling $1,177,751. Principal reduction payments received each month total approximately $55,000 and some loans are paying off early. At the current pace, there will be $140,000 to $150,000 available to re-loan. The average loan size is $170,000, meaning one loan per month could be funded at the current payoff rate. Three VA loans are included on the past due report. BOI and Board of Housing staff (BOH) are scheduled to meet to discuss federal regulations for the program. The rate of return yield is 1.55% on 155 outstanding VA loans.

Member Jack Prothero asked if there is a risk of realizing a loss in the portfolio, due to the past due loans. Mr. Kulow stated although there is a slight chance of a loss on the guaranteed past due loans, a loss is unlikely at this time.

Governor Steve Bullock spoke briefly at the meeting, thanking Ms. Gayle Moon for her many years of dedicated service as a valued state employee. Chairman Mark Noennig presented Ms. Moon with a plaque commemorating her many years of service. Ms. Moon is retiring from her position as BOI's Financial Manager on March 31, 2015.

BOND PROGRAM REPORTS

Activity Report

Ms. Louise Welsh reported the annual remarketing of INTERCAP bonds has been completed. Bond rates increased from 16 basis points last year to 23 basis points this year, consequently the loan interest rate to borrowers increased from 1% to 1.25%.

Ms. Welsh reviewed the quarterly Activity Summary Report and presented the staff approved loans. This quarter 13 loans were closed and nine applications were approved; there are three pending loans. Blankenship Rural Fire District in Columbia Falls is brand new to the program. The Town of Moore and the Town of Hysham have both returned after a long absence. The Loan Committee approved loans to Montana Department of Transportation (MDT) and the City of Chinook for $2,750,000 and $2,237,000, respectively. Ongoing projects: the MSU Ballroom is coming along and the City of Libby Flower Creek Dam is progressing. Ms. Welsh has web links available to view the progress of both projects.

INVESTMENT ACTIVITIES/REPORTS

Retirement System Asset Allocation Report

Changes in quarterly asset allocation weightings were relatively minor, driven by relative performance differences and transaction activity in fixed income, private equity and real estate. Transactions included $30 million injected into fixed income. The total equity allocation went up slightly by 0.3% to 67%, mostly due to good performance from domestic stocks and private equity while international equity decreased noticeably by 0.8% due to poor performance (-3.43%). Sales were relatively minor in the public equity pools; $6 million was added to MTIP and less than one million of MDEP was sold. The Private Equity allocation was down slightly for the quarter to 10.7%, due mostly to a withdrawal of excess liquidity while the return was positive at 1.3% for quarter. The fixed income allocation increased by 0.2% to 22.5%, barely at the bottom of the range, reflecting the combination of purchases and good performance at 1.8% for the quarter. The real estate allocation was down slightly at 8.6%, reflecting a sale of $23 million to remove excess liquidity from the pool while the real estate return was strong at 2.8% for the quarter.

Overall transaction activity was a net sale of about $5 million from the longer-term asset pools; cash allocation was down slightly to 1.9% for the quarter. As of 9/30/14, Police and Firefighters' plans had excess cash due to mid-September cash infusions to the plans. This excess cash was invested as of October 1, which accounts for most of the quarterly change in the allocation to cash.

Mr. Sheets reviewed asset allocation comparisons to peers in the State Street public fund universe which includes public defined benefit plans with assets between $3-20 billion who have at least 30% in equity exposure. The public fund universe cohorts change every quarter, so comparisons from quarter to quarter vary. The RVK peer comparison universe represents 38 different plans, while this State Street universe includes 33 plans. Referring to the asset classes, total equity means total public equity; the median is 53%, and BOI's weight is slightly above median. For U.S. public equity the two large pension plans, and essentially all nine plans, contain a 40% domestic equity allocation, clearly above the median. International equity totals 16%, compared to a median at just under 20%. Comparing recent returns for domestic equity vs. international stock, the domestic bias has been a strong benefit for the portfolio over the last several years.

Comparing fixed income, BOI is very close to the peer median. The BOI composition for fixed income is slightly different; the main difference is the inclusion of high yield exposure. Staff took steps in 2009 to add high yield as an asset class, which was optimal timing given the relative value presented at the time. Later in 2009, additional high yield assets were added.

Mr. Jim Voytko noted the addition of high yield assets did not represent a big bet and the high yield exposure has been an incrementally positive strategy.

Mr. Sheets continued, BOI is below the peer median for cash, but with near zero return on cash, it is beneficial to stay at the lower end of the range. The real estate allocation is clearly over the median, close to the first quartile, at 8.6%, and private equity is slightly below the median weight, partly due to the recent secondary sale. It is important to note however, that the median exposure to private equity has drifted up over time, from 2-3 years ago.

Member Englund asked if the intention is to continue to keep international equity low in the range.

Mr. Sheets stated international assets overall have not been sold, but rather moderate purchases of international equity have been made. In 2014, domestic equities sales were made as compared to purchases of $20 million of international equities. Historically, transactions have involved selling assets that have increased the most in value and purchasing assets that have performed the worst.

Mr. Sheets added the middle of the approved allocation ranges for domestic equity and international equity are 36% and 18% respectively, or a 2 to 1 ratio. At 40% and 16%, BOI is clearly biased to domestic equity. If there was a motivation to shift funds from domestic to international, that could be done; however, at this time there is no compelling reason for such a move. Observing world economic conditions, which in turn influence stock prices, there is no better profit generator than the U.S. at this time. It is difficult to project, with confidence, if it would be better to take $1 billion in U.S. assets and invest them in Europe instead. While there may be some change over the long-term, now there does not appear to be enough change in the fundamentals to favor international. Sometimes capital markets do not behave the way investors think they should, given economic fundamentals. If capital flows start moving more into international stocks, our relative performance could suffer given our exposure difference vs. peers. Currently, there is no convincing argument to make a big bet in non-U.S. stocks.

Mr. Muffick agreed, at this time a move is not justified.

Mr. Sheets reviewed the State Street return comparisons for the quarter ending December 31, 2014. Absolute returns are double digits over the last 5-year period; although peer rankings are a bit weaker; in the top decile, not ranked number one as with the RVK peer comparisons in recent periods. Over 10 years, BOI is at the median and the 7-year comparison is slightly higher compared to RVK's peer comparisons. If performance is in in the top half consistently, the long-term numbers drift up. Hopefully, this trend will continue; however, comparative results are not likely to continue this positively.

Responding to a question from Member Englund, Mr. Sheets stated because the 33 reporting funds are anonymous plans in the universe with no transparency of the participants, the data could reflect a different 33 than the constituents in the prior quarter. Therefore, snapshots from quarter to quarter cannot be compared directly and some plans may not even have a 10-year track record. Overall, the data show BOI is doing well vs. peers.

Absolute numbers can sometimes color peer rankings. If return windows are very narrow, one basis point can bump a fund from the 2nd to 3rd quartile, and a few basis points can make a dramatic difference. BOI performance data looks good and continues to improve vs. peer comparisons. Over time, slight portfolio adjustments have culminated in a positive result.

<u>Fixed Income</u>
Mr. Nathan Sax presented the fixed income report for the quarter ending December 31, 2014. Interest rates fell in 2014 despite expectations that rates would continue to rise as they did in 2013. Oil prices have dropped, with a midyear dramatic decline, and commodities dropped globally as well. Investors fled away from corporate bonds to treasuries due to weaker economies in Europe, and a flight to quality continued through January of this year. Real GDP was 2.5% last year, approximately the same rate of growth as the prior two years. The EU has had less than 1% growth, and some countries are experiencing deflation. Inflation has fallen all over the world and Wall Street has taken down their forecast. The U.S. dollar experienced a big rally last year and because of the strong dollar and easier monetary policy in Europe; money has come into the U.S. It appears as though the U.S. is moving in the opposite direction from Europe, and with talk about raising U.S. interest rates, the European Union is talking about more quantitative easing.

The fixed income allocation is within all policy ranges for both the external and internally managed portfolios; 8.6% for the Retirement Fund Bond Pool (RFBP), the policy is between 0-10%; and the Trust Fund Bond Pool (TFBP) is currently at the high end of the range. Duration is roughly neutral for the internally managed bond pool as well as in the Trust Fund Investment Pool (TFIP).

Mr. Sax reviewed performance figures for the RFBP and TFIP, which over 5 years have averaged 158 and 159 basis points respectively, over the index annualized. Quarter to date and year to date performance are even with the index, but longer term shows good outperformance over the index. The RFBP ranking vs. peers is in the second quartile over 1, 3 and 5 years, but ranks in the first quartile over quarter-to-date and year-to-date.

Assets for the Core Internal Bond Pool (CIBP) are 77% managed internally and the other 23% is divided among external managers Reams, Aberdeen, Post and Neuberger Berman. Aberdeen is in the third quartile peer ranking for 3 and 5 years; they have had some problems with non-dollar compounds.

Neuberger Berman performed at the 37th percentile over 3 years; Post ranked at the 3rd, 5th and 7th percentile over the 1, 3 and 5-year periods. Reams is still outperforming over long term and has a good chance of coming back; they took a big bet that failed to work out. The CIBP returned 6.82% over one year, compared to the index return of 5.97%, placing in the top quartile; over 5 years, the pool is ranked in the top quartile at 16th.

The 10-year Treasury yield fell by 86 basis points last year.

Mr. Sax reviewed the external managers watch list. Reams Asset Management remains on the list due to total return, which has lagged the benchmark for 6 quarters and trailed by 109 basis points for 2014. However, they did beat the benchmark for the second half of 2014.

Short Term Investment Pool, State Fund Insurance & Treasurer's Fund

Mr. Rich Cooley gave an overview of the Short Term Investment Pool (STIP) for the quarter ending December 31, 2014. Money markets did not change much over the quarter. The biggest change is the potential for the Federal Reserve to begin raising interest rates over the next year, expected around September.

There was some movement in the 1 to 5 year area of the Treasury curve, although the money markets have not moved yet. Interest rates may not rise until next year. LIBOR rates ticked up just a couple of basis points. The STIP portfolio meets all policy criteria for liquidity and average days to maturity at 48 days; policy limit is 60 days.

The current STIP yield is 13 basis points, a slight increase over last quarter at 10 basis points. The portfolio increased by $240 million over last quarter. For STIP performance ending 12/31/14, the reserve is starting to drag on returns over the long-term, although the three-year return is still above the benchmark.

A new table is included in the Board materials showing the STIP reserve account balance and an accounting of the SIVs (Structured Investment Vehicles). The impact of adding to the reserve over the fourth quarter, $10,000 per day, is equal to 16 basis points of average yield on the STIP balance of $2.3 billion.

The institutional money funds held in STIP, with low fees and a yield from 6 to 13 basis points, helps boost return, moving the yield on STIP back up to 13 basis points; still competitive when compared to institutional money market funds.

The outstanding balance of the SIVs decreased from $34.5 to $31.9 million over the quarter, and the reserve account balance increased from $25.5 to $26.5 million, an increase of $1 million for the quarter. At the current rate, the reserve will equal the outstanding SIV balance sometime in the next calendar year. The ultimate resolution of the SIVs is unknown at this time. It is impossible to predict ultimately how much will be received on the SIVs; which have paid down substantially from the original liability of $140 million; $21 million (15%) was written off initially, which reduced the original amount. There is a reasonable chance the outstanding balance of the SIVs will pay off fully, but it will take several years. The reserve fund built up faster when interest rates were higher. The reserve serves as insurance for the SIVs, but also as insurance against any future losses.

Mr. Sheets noted the SIV exposure may or may not recover; however, over the long term, in addition to the legacy assets, the reserve conservatively should equal at least $25 million.

Mr. Sheets added that staff analyzed the portfolio quality and historical default rates to reach an appropriate amount for the reserve fund. These factors will be revisited and reevaluated on a regular basis, and changes to deposits for the reserve fund will be adjusted accordingly, to ensure the STIP yield is kept competitive. The amount could be dialed down, but due to the SIV uncertainty, staff is not inclined to make adjustments for the time being. Market conditions and short-term rates will be monitored as well to determine any future changes.

Responding to a question from Member Karl Englund, Mr. Sheets stated the STIP investment policy statement acknowledges the reserve fund, but allows for flexibility in market changes over time. Even with the reserve fund in place, there are no guarantees a loss will not occur. However, a position can be sold at a loss if necessary, utilizing the reserve is a proactive way to cut losses. Management of STIP has evolved over the last seven years.

Member Satre agreed with the need for the reserve, as long as there are measures to keep it at an appropriate level, since the STIP participant base pays for it.

Mr. Sheets stated if things continue favorably two years out, the reserve contribution rate can be dialed down. It is a dynamic process; at some point, the legacy assets need to be addressed, but as long as they have value, it is best to utilize flexibility and not to write them off. The reserve could be credited back to STIP yield if needed. Staff will continue to monitor.

Mr. Sheets added that per the Board's request, the STIP reserve account tables will be included with each Board packet. The yield comparison vs. institutional money funds is important. The MBOI yield of 13 basis points is at the same level where most institutional money funds are, retail funds are currently at about one basis point. Keeping a competitive yield is important, but reducing investment risk is also important.

Executive Director Ewer stated MBOI has been fortunate that the legislative auditors have not recommended a write off, allowing retention of an asset of limited value. Eight years after the financial crisis, there are still lingering effects. There have been some complaints that STIP yields are too low, since historically it performed much better than banks for many years. However, STIP is a money market fund. The overhang left by the SIVs is still bigger than reserve fund balance. Until that threshold is met, portfolio managers must still have the option to blow out of a bad investment; it is public knowledge that MBOI maintains the reserve fund.

Member Jack Prothero noted if customers see BOI has a reserve fund set up, it is a positive.

Mr. Rich Cooley gave an overview of the Treasurer's Fund for the quarter ending December 31, 2014. The fund purchased $10 million in securities in the fourth quarter; there will be opportunities to buy additional securities as rates go up. The average yield on the securities purchased has increased to 92 basis points for the fund.

Mr. Cooley presented an overview of State Fund Insurance for the quarter ending December 31, 2014. The effective duration is shorter than the benchmark; corporate spreads widened by 19 basis points over the quarter to 217 at end of quarter. The account performance at 12/31/14 for the fixed income portion outperformed the benchmark by 10 basis points for the quarter and 61 basis points for the year. Purchases for the quarter included $2 million in corporate bonds, $30 million of governments, and $6 million of sales in equity units. The real estate allocation continues to be beneficial for total fund return. The STIP balance was 2.5% at quarter end, policy range is 1-5%; and corporate holdings rated less than A were at 23%, the policy ceiling is 25%.

Mr. Cooley reviewed State Fund performance for the quarter ending December 31, 2014 and noted the real estate allocation now totals $81.3 million. The portfolio is well diversified. According to State Street performance data, the one-year total fund return is 5% with 11.53% return for equities, adding substantially to total fund return, although international equity was a bit of a drag. Real estate returned 11.55% for the calendar year; adding equity and real estate has increased return and increased diversification of the fund.

<u>Montana Domestic Equity Pool (MDEP)</u>
Mr. Rande Muffick presented the Montana Domestic Equity Pool (MDEP) report for the quarter ending December 31, 2014. As RVK mentioned, active managers had a difficult year industrywide; over 70% of

active portfolios did not beat their benchmarks for 2014. MDEP performed pretty well over the last year.

For one year, the domestic equity pool was behind the benchmark by 80 basis which reflected our managers; however, the pool outperformed by 23 basis points for past 3 years ended 12/31/14. The time frame included the domestic equity pool restructuring. Peer group comparisons are positive for the pool, ranked in the top quartile at the 18^{th} percentile for both the 1 and 5-year periods.
MDEP differs from peers with higher passive than active for large cap allocation. The strategy has paid off, as active managers have struggled. Large cap active managers, particularly in 130/30, have done well. A lot of plans gave up on 130/30 during the financial crisis, but it has paid off, particularly with JP Morgan, the largest manager. Portfolio midcaps and small caps have struggled recently, but have performed better overall than other small and midcaps; manager selections are key.

Member Englund asked if there were recent concerns with pool performance.

Mr. Muffick stated the long-term numbers are still intact and there is no reason for particular concern or cause for alarm. Artisan and TimesSquare are still two good managers; they are not breaking from their style. In general, only 11% of midcap managers beat their benchmarks in 2014.

Mr. Higgins added REITS have helped to drag down small caps and midcaps as well.

Mr. Muffick stated a move away from utilities, which managers think are overvalued, has had a negative impact.

Mr. Sheets added BOI hired additional active small and mid-cap managers in May 2013 and over the first year the new managers performed well out of the box outperforming the incumbent. Hiring new managers at the right time helped comparative returns. The weighting had a bit more of small cap than the benchmark, which was a drag on returns.

Mr. Muffick noted the pool is doing well, and non-large cap manager performance should begin to pick up. January to date is showing improvement.

<u>Montana International Equity Pool (MTIP)</u>
Mr. Rande Muffick presented the Montana International Equity Pool (MTIP) report for the quarter ending December 31, 2014. Active management had difficulty in the international arena as well. For BOI's active managers, three out of four large cap portfolios and two out of three small cap portfolios outperformed their benchmark.

Mr. Muffick noted peer group comparisons for the international pool are not the greatest, but are improving. One-year ranking is at the 63^{rd} percentile; the ACWI managers invest in emerging markets, therefore any time emerging markets do not do well, peer comparisons suffer. Over the long term, the international pool is faring better vs. benchmark, but not so well compared to peers. International peer group performance varies according to type of manager. Active management has picked up, but some of MBOI's large cap managers are struggling; they will be retained for a time and will hopefully show improvement before terminating. Staff has waited for Alliance Bernstein to come back with a stellar year, but so far that has not happened; although they had a stealth rally and the one-year number outperformed the benchmark by 2.23%; and over three years, they beat the benchmark by 25 basis points. Therefore, MBOI's strategy to be patient and retain this manager during the past few years has actually paid off.

All three large cap managers in the international pool continue to struggle and Martin Currie lost a portfolio manager. Going forward, staff is looking for more consistency from a performance standpoint; managers that perform more closely to the benchmark or outperform the benchmark. Staff is currently in conversations with two large cap growth managers and one large cap value manager. Reviewing the contracts with fee structures has taken longer than expected. The three firms under consideration are larger with more attorneys on staff and the proposed contract adjustments and changes are more numerous than anticipated. Assuming the contracts go forward, staff expects to fund the three new managers this spring. Funding of slightly less than $300 million is anticipated, split between the three managers.

Responding to a question from Member Satre, Mr. Muffick stated there are transition costs when moving from manager to manager, but a lot depends on the amount of overlap between the portfolios of the outgoing managers and the new managers. The transition manager provides a pre-trade analysis and estimates the cost.

Mr. Sheets added the cost estimate is a guess and is unknown until the day the trades are transacted. Staff provides the transition manager with an account of existing holdings, which is compared to the wish list of the incoming managers.

Responding to a question from Member Englund, Mr. Muffick explained working with the transition manager, they provide a time line of a couple weeks after the contracts are signed and work with the managers. The legacy stocks are transferred over and the new stocks purchased.

Mr. Sheets added the actual trading/transition is completed in one or two days, with longer time needed for small and mid-caps; however, the buying and selling are done in short order. The transitions are planned for month-end to enable new managers a fresh inception date for performance tracking. A calm market day helps.

Chairman Noennig asked how the transition manager fees are calculated.

Mr. Muffick stated the transition manager typically charges 1.25 pennies per share traded. BOI pays any opportunity cost as well, depending on money transactions. Market fluctuation costs can amount to more compared to the transition manager fees.

Mr. Sheets added larger cap stocks have a much tighter bid/ask spread, and international stocks can vary more. The bid price, what the market will pay, and the asking price, usually differ by a very slim margin.

Mr. Muffick stated ideally on $300 million in transactions, the cost is under 10 basis points, or $300,000.

<u>Public Equity External Manager Watch List</u>
Mr. Muffick reviewed the Public Equity External Manager Watch List, which is growing. It includes the three international managers which staff is planning to transition from.

Mr. Sheets noted the three managers are aware they have been on the watch list for a long time, and so a transition will not come as a surprise. Mr. Muffick added recent discussions with managers during regularly scheduled conference calls have also indicated upcoming changes.

Mr. Sheets added large managers lose accounts all the time; and while some owners are stealthier, BOI adheres to a process and there is no real need to act quickly.

Mr. Muffick added all prior managers that have been terminated acted in a very professional manner and it is in their best interest to do so; they have a reputation to uphold.

Chairman Noennig noted if a manager is performing poorly, termination does not come as a total surprise.

Mr. Sheets added every manager BOI has terminated has larger problems.
Executive Director Ewer stated the Board is scheduled in 2016 to have a general discussion on equities. Transitions are tough and there is a lot of work involved, conducting searches and the vetting process and contract negotiations a can be long complicated process. When the equity presentations are made to the Board, the issues will be discussed at length.

Mr. Muffick continued reviewing the watch list. Voya Investments has been added to the list due to the lead portfolio manager retiring, but otherwise, there are no concerns. Artisan has also been added to the list. They had a really bad year, underperforming the benchmark by 700 basis points; although they are still outperforming the benchmark over the long term. Another addition to the watch list is the Alliance Bernstein domestic small cap growth manager. They had a very bad year; staff will pay particular attention to them going forward. They had some bad stock picks along the way; however, they are sticking to their strategy.

<u>Montana Private Equity Pool (MPEP)</u>
Mr. Ethan Hurley presented the Montana Private Equity Pool report for the quarter ending September 30, 2014. One new commitment was made since the last board meeting is shown in the table below:

Fund Name	Vintage	Subclass	Sector	Amount	Date
American Securities Partners VII, LP	2015	Buyout	Diversified	$20M	12/5/2014

Staff committed $20 million to American Securities Partners VII, LP, a known manager. MPEP had another positive cash flow quarter. The portfolio is broadly diversified, highly buyout centric, and diversified by industry exposure. Geographic exposure remains highly North American centric, a very deliberate strategy that will be maintained.

The Investment vehicle exposure is mostly through direct primary partnership commitments; this will continue to rise as the fund of funds exposure continues to decrease.

Mr. Sheets added there is a small amount of energy, although not a huge portion, in the portfolio.

Mr. Hurley stated energy is broadly diversified; with the recent secondary sale, energy was trimmed some in the First Reserve sale; the net effect is still to be determined, depending on where levels of distress show themselves in energy. In the near term, the focus lies with mid to downstream portions of the supply chain, i.e. consumption. Now is a good time to take harder look at the energy sector in general, opportunity may arise. BOI activity over the last one to two years includes substantial new commitments that have yet to be drawn down and may lead to new opportunities.

Mr. Hurley reviewed the State Street Global periodic return comparison. Net of fees the IRR (Internal Rate of Return) since inception is 12.69%.

Responding to a question from Member Satre, Mr. Hurley stated as a mature private equity program, it should continue to be self-funding. For the immediate future, it should be a tempered portfolio with continued drawdowns and should remain cash flow positive.

However, this is highly unpredictable and is highly dependent on the general partner's ability to sell investments, and make investments.

Mr. Sheets added to avoid any misrepresentation, the cash flow does not include the secondary sales.

Member Terry Cohea inquired what happened to the assets received from secondary sale.

Mr. Sheets stated they were not used immediately to go back into private equity; it was not used to ramp up the regular commitment activity.

Executive Director Ewer noted the secondary sale did affect the private equity allocation downward.

Member Englund asked about the fluctuation of vintage year as shown on the State Street report.

Mr. Sheets noted the portfolio was much more concentrated in each individual year, and the Board portfolio was skewed towards venture capital in the 1990's which benefited us at the time.

Mr. Hurley added that vintage year metrics vary greatly from year to year. In 2013, the IRR comparison was 8.22% for State Street Private Equity Index relative to BOI's at -13.45%.

Mr. Sheets explained activity in equity markets had an effect and it is important to see how the portfolio is performing on a multiple and IRR basis. The pace of investing and new funds vs. the index all have an effect. For private debt, there has been good performance; BOI has not been a regular, every year investor, but rather has invested more in strategies just going into recessions, so timing is a factor.

Mr. Hurley added for private debt, BOI is underweight relative to the benchmark and the index.

Montana Real Estate Pool (MTRP)

Mr. Hurley presented the Montana Real Estate Pool (MTRP) report for the quarter ending September 30, 2014. Real Estate added $10 million each to Stockbridge Value Fund II, LP and CBRE Strategic Partners, U.S. Value 7, LP. Both are existing managers BOI committed to relatively early, and then added to the positions late in 2014. Only non-core funds did not have a positive cash flow quarter. Portfolio exposure by strategy is broadly diversified and the Montana owned buildings are included. Geographic exposure is diverse, with no attempt to mirror the index. Property is diversified between core managers and individual managers and is conservatively leveraged. Real estate is recovering and continues in a positive direction.

Fund Name	Vintage	Subclass	Sector	Amount	Date
Stockbridge Value Fund, II, LP	2014	Value Add	Diverse	Add'l $10M	12/10/2014
CBRE Strategic Partners US Value 7, LP	2014	Value Add	Diverse	Add'l $10M	12/10/2014

Partnership Focus List

There were no changes to the Partnership Focus List since the last Board meeting.

Member Englund asked for an assessment on the success of investing in timber.

Mr. Hurley stated timber has been a good investment; a great diversifier, with some capital appreciation, and it should do well going forward. A lot of things are coming together, which should lead to a strong timber market, and timber prices are going up.

Mr. Sheets noted timberland was added to real estate because that was the best place to include it. Timber has long-term stable returns with a decent income component. In terms of the pool, it has been a performance detractor in comparison with the benchmark of commercial real estate, which uses a core real estate fund industry that has been on fire. Timber has been a drag on the pool return; however it is a good diversifier. Mr. Hurley added timber did dilute the real estate pool by 85 basis points for the one year period ending 9/30/14.

ADJOURNMENT

Being no further business, the meeting adjourned at 4:23 PM.

BOARD MEETING - DAY 2

An informal round table of Board members and RVK, Inc. staff preceded the call to order.

CALL TO ORDER

Board Vice Chairman Karl Englund called the regular meeting of the Board of Investments (Board) to order at 8:30 AM. As noted above, a quorum of Board Members was present. Senator Bob Keenan did not attend day two of the meeting. Vice Chairman Englund called for public comment. There was no public comment. (Chairman Noennig joined the meeting late.)

Executive Director David Ewer noted the roundtable provided the opportunity for Board members to offer their thoughts to investment consultant RVK, Inc. Currently RVK is scheduled to present a topic to be determined at the April Board meeting. A blank slate at this point, the Board has the opportunity to suggest what members would like to see in the way of education and training. For the April and October meeting time is set aside for education and other pertinent issues in general.

Member Prothero asked Mr. Higgins if there are any outstanding issues at the Board level not currently addressed that should be.

Mr. Higgins responded performance is very strong and things seem to be running very smoothly. One topic RVK would like to explore at the April meeting is the recently published best practices study. RVK conducted research, including several surveys, and interviewed more than 30 investment committees. Two issues that arose were selecting/transitioning new members and running effective meetings. However, BOI has no glaring issues in terms of what is missing. After almost six years, issues that have come up have been dealt with, such as the adjustments made to MDEP and MTIP. It may be helpful in April to take a look at best practices and have a discussion. Mr. Higgins noted the study is not on the RVK website, but it is available for distribution.

Member Jon Satre inquired about the recent oil markets prices and how the volatility may affect BOI.

Mr. Higgins stated it would not have an impact, since it is a short-term situation and not something that warrants action. External managers will take actions in response to the market; however, the Board outlook should be for the long term. The short-term market movement, the drop in oil, is not something to base decisions on.

Mr. Sheets agreed; observing the history of oil, periodic drops or spikes of 40% to 60% have occurred which the market weathers. It is the job of the managers to manage security selection. If managers hold an energy company that is overleveraged, they will have to deal with it, as more companies are put under stress in a low price environment.

The question at a Board level is, do we want to adjust asset holdings because of declining oil prices? It is hard to estimate, but there are managers in our pools who are always looking at opportunities and seeking better buying opportunities in energy. BOI has downside risk, but there are managers on the job looking for opportunities in the energy field. This area is too tactical for an action by the Board.

Mr. Higgins added the managers probably are taking advantage of incremental benefits vs. cost. Allocating staff for a very small area of the portfolio has real costs but may have little impact.

Member Marilyn Ryan asked Mr. Higgins if the big institutions have to address social or environmental investment issues.

Mr. Higgins stated generally RVK does not have an opinion, but will assist clients if social investing is pursued. Usually it is endowments making those choices, i.e. eliminating all fossil fuels from investments. The feasibility, logistically, is the more restrictions you implement, the more difficult the investing is; although the issue does come up occasionally.

Mr. Jonathan Kowolik added within corporate governance, or with proxies, it can be a popular theme. The question is whether the motivation is consistent with fiduciary duties of producing optimal returns with the most effective risk profile. Results are mixed and depend on the individual portfolios and the issues in play. RVK, as a firm, expresses no opinion on it; however, if a board feels strongly, the investment merits must be analyzed.

Member Englund noted often investment headlines report boards are trending this way or that, or cutting back on private equity for instance, it would be helpful to have useful information for the long term, any new trends the Board may want to consider.

Mr. Higgins stated it is best to be cautious of headlines. RVK produces an annual public fund survey, which 100 funds contribute to, then summarizes data to assess allocation, fees, funding ratios, etc.
Mr. Kowolik added peer comparisons offer a perspective and it is beneficial to look at peers, but it is important to look at motivating investment themes; there are many ways to achieve success in that respect; higher investment return may come with a higher level of risk. Comparing what peers are doing is only a small piece of the process.

Member Prothero stated it would be helpful to have RVK help to strategically look at the next 3-4 years or 10 years, since investments are considered long term. Considerations for long range planning could be helpful.

Mr. Higgins stated he would discuss potential topics with Executive Director Ewer; for the April meeting a review of the best practices study is an option, with Board discussion.

Executive Director Ewer stated there are fewer training opportunities and fewer conferences available to Board members that are affordable and not vender driven. It would be helpful to hear options if RVK becomes aware of conferences that meet the Board's criteria, as well as suggestions for speakers to bring in.

MONTANA REAL ESTATE HOLDINGS

Board Real Estate Holdings in Montana, Deputy Director Geri Burton
Deputy Director Geri Burton presented a review of the Board's real estate holdings. The 24-month Strategic Work and Education plan calls for a review of the Montana properties every two years, the last review was at the Board's May 2013 meeting in Billings. The Board owns five properties; all are managed as investments for the retirement plans. Initially, the buildings were held equally in TRS and PERS; in 2011, the properties were transferred to MTRP to benefit all nine pension funds.

The properties include four office buildings, three in Helena and one in Bozeman, and one undeveloped lot in Helena. The Board entered into property ownership when looking for space to lease for BOI offices. At that time, BOI offices were located in a building in downtown Helena and the building was for sale. The owner approached the Board about purchasing the building; however, the Board was not interested. The Board authorized staff to pursue other building options. In 1996, the Board authorized the purchase of its first building, located in downtown Helena on Park Avenue. Staff planned to move into the Park Avenue building; however, it was later determined they would not. The Park Avenue building houses four state agencies and one private tenant; most of the tenants have been leasing space in the building for over 10 years.

All BOI owned buildings are in good condition, maintained well and the tenants tend to stay. One private tenant in the Park Avenue building left in the summer of 2013 as they outgrew their space. This was the first time in recent history there was a vacancy in this building. Revenue income was temporarily affected due to the vacancy. A state agency moved into the vacated space in December 2013, after BOI staff negotiated a 10 year lease with the state agency.

Over $650,000 has been invested into the Park Avenue building over the last few years. New variable air volume units and a new boiler were installed, as well as an electrical upgrade completed. Additionally, signage was updated and improvements were made to the parking lot. The building was built in 1984.

In 1997, the Board authorized the purchase of land to build the Colonial Drive building. The building was completed in 1999 and two state agencies and one private tenant moved in. The original two state agencies are still leasing space in the building. A vacancy occurred on the first floor in August 2013 when the private tenant's lease expired and BOI decided not to renew the lease. Revenues were temporarily down due to the vacancy. Staff worked with the state and negotiated a 10-year lease with DPHHS to occupy the vacated space. Building improvements completed over the past few years at the Colonial Drive building total about $650,000. The building is completely full with DPHHS on the first and second floor and DPHHS and BOI on the third floor. Initial building leases were for 15 years; the recent leases are for 10 years.

Base rent plus expenses increase by 2% annually, which is written into the leases. BOI as landlord pays utilities, cleaning services, etc.

Improvements to the Colonial building include a $230,000 remodeling project on the second and third floors; $230,000 was invested for a new chiller and cooling tower; and a boiler replacement project was completed at the end of 2014. A new card reader system for building entry, which is tied into the state system, was also installed in 2014. The card reader system records building entry and is set up on a timed lock.

In 1999, the Board was approached by the Department of Administration to construct a building in Bozeman to co-locate four state agencies. The building was constructed on state school trust land; the Board has a 40-year lease on the land. Construction was completed in 2004 and the four state agencies that originally moved into the building remain as tenants. The original leases expire in 2019. Building improvements over the past few years include a curb/gutter project and a back patio/awning project. The building is located about five blocks from the 19th Street exit.

The final building is located in Helena and was purchased by PERS as an investment in 1969 and to house their offices. In 2000, the state issued a corrective deed to name the Board as owner of the building. PERS occupied the building until they moved into the Board's Park Avenue building.

Two state agencies currently lease space in the building; the Department of Justice has been in the building since 2002 and just recently, the Department of Fish Wildlife and Parks moved in. The building is older but has not required a lot of improvements. Recent improvements included replacing the windows, back doors and a new roof and HVAC unit. Total cost was a little over $100,000.

The last property is undeveloped land southwest of the Colonial building and behind the Red Lion Colonial Inn. The land was purchased during construction of the Colonial Drive building in anticipation of needing more space. There are currently no plans to sell or construct on the land.

Responding to a question from Member Prothero, Deputy Director Burton stated there have been inquiries in the past to construct on the property; it is a nice plot of open land, but the access is not great and the adjoining road is a bus access road to Smith School. Access from the other side of the Colonial Inn is located in a residential area. Staff plans to keep it as open land for the time being. Management of the buildings takes a lot of staff time and maintaining the open space is desirable.

Executive Director Ewer added open space continues to be more valuable; it is an interesting space, next to a public school and has an access problem. If BOI were to sell, ideally it would go to the City of Helena or the Helena School District.

Deputy Director Burton advised the land has no improvements and it has not been appraised in recent years; however, in 2011 when it was transferred to the pension funds, the value was placed at $222,000, figured on cost plus gain in value.

All properties are managed by Executive Properties Services in Billings and they act as the main point of contact; however, BOI staff continues to be very involved in the management of the properties.

SECURITIES LENDING

Securities Lending – Jonathan Kowolik, RVK, Inc. and Cliff Sheets, CFA, CIO
Mr. Sheets noted Mr. Jonathan Kowolik will provide an overview of security lending which is part of the 24 month Systematic Work and Education Plan. The broad terms of securities lending were provided to the Board two years ago, as part of the ongoing effort to keep the Board informed.

Mr. Kowolik provided an overview explaining what securities lending is, why it is done and specific aspects that fiduciaries should be informed about, such as ongoing monitoring. Securities lending is a commonly used investment practice used by institutional investors to provide incremental income. It is a reasonable activity for institutional investors, within a proper framework. Material income can be generated, but there are meaningful investment risks through the cash collateral aspect. The practice can involve substantial investments as well, and they are broken down on financial statements.

Securities are borrowed to fill various needs, commonly to facilitate trade settlement; e.g. by market makers needing to obtain a security for delivery. Another reason is to facilitate the creation of short positions, it is mechanically necessary to borrow a security to then sell short, with a speculative view the security will go down. The security will be sold with a future obligation to return it; a prime broker helps the speculator, (for example, a long/short manager), to borrow the security, and such speculator is then obliged to return it (or a repurchased security) to the prime broker.

Temporary ownership can also be sought for tax purposes depending on how income is treated. An example would include differential tax withholding: a local participant in that country may receive the full dividend without withholding while Montana would be subject to withholding, partially recaptured through potential reclaims. Through lending its securities to local market participants over dividend date, Montana can get the tax benefits of tax treaties earlier, and may receive advance credit of its income due.

Mechanically, securities lending tends to operate as follows: Through a prime broker, an entity seeks to borrow and sell short (for example), estimating that the security price will go down; they borrow the 300,000 (hypothetical security value) from another market participant (such as Montana) through its agent (such as State Street) who requires that the prime broker post a margin of collateral of 102% for domestic securities and 105% for international securities. The collateral is delivered in cash or securities to State Street Bank. An interest rate is set on the cash collateral, known as “a rebate rate,” and effectively on a daily basis State Street pays interest to the borrower on cash collateral. State Street invests the cash to earn more than the rebate paid on collateral; ideally to earn more interest on the security than is paid out on the rebate. The collateral is marked to market daily by State Street.

Transactions are generally done on an overnight basis, renewed daily, and the beneficial owner (such as Montana or its managers) has the right to sell the loaned security, therefore the prime broker must return the security to facilitate the settlement. In the U.S., the security must be returned within three days; loans of specific terms can be negotiated as well, while providing sufficient liquidity.

Mr. Kowolik explained you would not lend out a security if doing so required the payment of a higher rebate rate than the yield on invested cash and that transactions in volatile rate environments are a risk factor.

Mr. Sheets added international tax issues are complicated and some security lending is done to benefit from different tax treatment of dividend income by the local taxing authorities. Securities lending does not avoid the negative impact of international tax withholding requirements on U.S. investors in certain countries; however, by lending a stock out to a party that pays a lower or no tax on dividend income, it provides a mechanism to offset the tax impact. An example of this dividend arbitrage strategy is when a borrower of BOI stock obtains temporary ownership of a security, such as when a local French entity borrows shares in a French company they are technically owner for the time period when the stock pays a dividend and would receive that dividend. If the tax they pay on that dividend is less than what the BOI would pay, they only need to compensate BOI for the net amount due a U.S. investor, which would be less than they received, enabling a profit from having borrowed the stock. Another common motivation to borrow shares is to enable the borrower to vote for a critical shareholder issue such as a merger decision that is put to shareholders.

When State Street Bank and a borrower enter into a transaction, State Street collects the collateral and indemnifies BOI against borrower default. If the borrower defaults, State Street must use the collateral to buy securities on the open market to replace the loaned security. State Street pays the difference if replacing the security costs them more than the value of the collateral.

Mr. Sheets stated State Street pursues the borrower in the event of default on a security loan. For bonds, it may be difficult to replace a particular bond if it is not returned. During the Lehman Brothers meltdown in September 2008, State Street was successful in retrieving bonds that had been loaned to Lehman, with the exception of one government agency bond. However, State Street liquidated collateral and replaced it with a comparable asset, which was actually a better security in that it was more liquid than the original. The process does work, but of course requires that you have collateral that can be liquidated if necessary.

State Street Bank is responsible for lending activity as BOI's agent. They manage the activities to line up borrowers, shuffle assets, take collateral and invest it. BOI splits the earnings with State Street 80/20. They are at risk as they indemnify BOI against borrower default.

Mr. Kowolik reviewed what can go wrong and how risk can be mitigated. Borrowers can default or fail to return a security or they go bankrupt. Mitigation of this risk involves lending securities only to highly creditworthy borrowers, as determined with an agent. Additionally, you can limit who you lend to, and collateral is marked to market daily to avoid a position where the loaned security appreciates without receiving additional collateral. Regulatory discussions on securities lending are ongoing and further changes are expected in the industry; terms of indemnification could change things. Financial transaction errors, failure to mark to market, failure to have a security returned, collateral investment losses or a market crash are all considerations. Cash can return less from the rebate than paid in interest, creating a negative income environment; the lending agent would retain its portion of the negative income as income is split and thus they will share the hit.

In the case of Lehman Brothers, it was a default; the client is generally not indemnified on investment losses. Thus, non-performance or nonpayment also poses a financial investment risk to the fund. Best practice dictates having prudently conservative investment policies on cash collateral, knowing the risks, maintaining appropriate exposure sizes, imposing issuer limits, asset class limits, and appropriately monitoring collateral. Liquidity and marketability are key factors.

Mr. Kowolik stated regular monitoring is required and is done at BOI. Good management of the program and the production of material incremental income as returns can and do justify the risk of program. Securities lending can and does deliver incremental return, risk is consistent with the program design and ongoing review is justified.

Executive Director Ewer added securities lending is complicated. There is a potential to suffer collateral losses and BOI has to a very small degree. However, the income received back in 2008 was $12 million from securities lending. While there were issues with collateral, in the order of magnitude, the income earned covered the cost of the losses.

Mr. Sheets acknowledged concerns, noting the worst experience happened in 2007 to 2009 and there were some hard lessons learned at that time. In the wake of the global financial crisis, securities lending programs came under a lot of scrutiny, not just from asset owners, but from regulators given borrower indemnification issues.

BOI came through the stressful period quite well. There are risks and rewards in a securities lending program. When the risks were significant, rewards went up. Strong demand arose for certain securities that previously had little demand. In a historical context, it was considered a benign behind-the-scenes program but a lot of risks were taken and collateral managers made some mistakes.

In the State Street collateral pools there remain a handful of securities trading less than par; but over six years the unrealized losses on legacy problem assets have declined significantly.

Mr. Kowolik reviewed the history of securities lending earnings. In 2008 and 2009, income increased with earnings of $12.3 million in calendar 2008 with $2.4 billion in assets out on loan on average during that year. After the troubled years of 2007-2009 when income went up, earnings declined in the subsequent three years.

Responding to a question from Member Ryan, Mr. Sheets explained instead of cash, a borrower can give collateral in the form of other securities which are marked to market each day. However, we place limits on the type of securities collateral accepted such as permitting corporate bonds as collateral only if they have an AA rating. There is not necessarily higher risk whether collateral is in the form of cash or securities, although securities must be sold; but it is not an issue if the collateral is high quality and liquid.

Executive Director Ewer reviewed Board member requests for “to do” items for the next Board meeting:

1. The comprehensive benchmark review will be in November.
2. RVK, Inc. has slots for education for the April and October meetings; subjects to be determined.
3. At the next Board meeting, April 7, committees will not meet unless items come up.
4. Member Satre advised some members of the Audit Committee will meet with staff on an ad hoc basis to revamp the Annual Report.

Being no further business, the meeting was adjourned at 11:19 AM.

<u>Next Meeting</u>
The next regular meeting of the Board will be April 7, 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
4/13/15