

These minutes are Approved and Final. Full Board review and decision took place at the May 22 & 23, 2012 Regular Meeting of the Board.

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

**MINUTES OF THE MEETING
April 3, 2012**

BOARD MEMBERS PRESENT:

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

LEGISLATIVE LIAISONS ABSENT:

Senator Joe Balyeat
Representative Franke Wilmer

STAFF PRESENT:

Carol Ann Augustine, Board Secretary	Rande Muffick, CFA, Portfolio Manager, Public Equities
Jason Brent, CFA, Alternative Investments Analyst	Mary Noack, Network Administrator
Geri Burton, Deputy Director	Chris Phillips DeFranco, CFA, Investment Staff
Richard Cooley, CFA, Portfolio Manager, Fixed Income/STIP	Jon Putnam, CFA, FRM, Fixed Income Investment Analyst
David Ewer, Executive Director	John Romasko, CFA, CPA, Fixed Income Investment Analyst
Tim House, Investment Operations Chief	Nathan Sax, CFA, Portfolio Manager, Fixed Income
Ethan Hurley, Portfolio Manager, Alternative Investments	Clifford A. Sheets, CFA, Chief Investment Officer
Ed Kelly, Alternative Investments Analyst	Steve Strong, Equity Investment Analyst
Herb Kulow, MCMB, Portfolio Manager, In-State Loan Program	Dan Zarling, CFA, Director of Research
Gayle Moon, CPA, Financial Manager	

GUESTS:

Norma Buchanan
Becky Gratsinger, RV Kuhns and Associates
Dave Senn, Teachers' Retirement System
Jim Voytko, RV Kuhns and Associates
Kris Wilkinson, Legislative Fiscal Division

These minutes are Approved and Final. Full Board review and decision took place at the May 22 & 23, 2012 Regular Meeting of the Board.

CALL TO ORDER

Board Chairman Gary Buchanan called the regular meeting of the Board of Investments (Board) to order at 9:00 AM in the Board Room on the third floor at 2401 Colonial Drive, Helena, Montana. As noted above, a quorum of Board Members was present.

Chairman Buchanan asked that the February 21-22, 2012 Board Meeting Minutes be revised to reflect the following in the "April Meeting" section:

"..... Several other Board Members offered ideas and suggestions to be covered at the April or other Board Meetings, including the current structure of investment pools and potential changes; a view of where the markets are and where they are going; the role of the Board regarding the actuarial return assumption on pension funds, contributions, and maximizing returns; review of the IFS study; and taking another look at hedge funds.

Board Member Jack Prothero made a Motion to approve the Minutes of the February 21-22, 2012 Board Meeting as revised; Member Jon Satre seconded the Motion. The Motion was carried 9-0.

Investment Consultant Sub-Committee

Board Chairman Gary Buchanan reported that Board Member Karl Englund will Chair the newly formed Investment Consultant Sub-Committee. Chairman Buchanan will serve on the Committee as well as Board Members Jack Prothero, Jon Satre, Bob Bugni, and Jim Turcotte.

Member Jack Prothero mentioned that he read the Integrity in State Government study and saw that Montana's pension fund management was rated F. He asked staff to report back at the next meeting the reason for this.

Public Comment

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

EXECUTIVE DIRECTOR GENERAL COMMENTS

Mr. David Ewer told the Board that he and Chairman Buchanan have added two meetings to the Board's yearly calendar. Today's meeting and the one in October will not be like the typical quarterly meetings, but will involve in depth coverage of certain topics. Normally, Board decisions won't be made at these two meetings; however, there may be times when they are required. Mr. Ewer stated this will be addressed in the systematic Work Plan that he will present later in the agenda.

BOI'S HIERARCHY OF RESPONSIBILITIES

Mr. Jim Voytko introduced this topic by explaining that the Hierarchy of Responsibilities is prepared by RV Kuhns & Associates, Inc. to assist Board chairs in governance and compliance related issues. It includes comprehensive duties and addresses the many missions of the Board of Investments. Annual work plans are suggested for programs, allowing Board and staff to focus on potential issues before they arise. Broad responsibilities are separated into three general categories:

Level I	Duties directly performed by the Board and not delegated
Level II	Items for Board review
Level III	Duties performed by staff, background activities

Board Chairman Gary Buchanan asked if the Board approves the BOI budget. Mr. David Ewer stated this has not been a past practice. Many years ago, a short budget summary was presented to the Board for their review by the previous Executive Director and Mr. Ewer expects to follow that procedure. The Department of Commerce presents the BOI budget on our behalf. Chairman Buchanan stated the Board will follow the Governance Manual on budget procedures and hierarchy.

Mr. Ewer proposed changing the wording in the fourth box of the pyramid to say, "Analysis of Asset Allocation and Monte Carlo" rather than the current wording to clarify that the joint Board/staff responsibility on asset allocation is analysis and the Board reserves to itself the decision to change asset ranges. Chairman Buchanan asked staff to review the Hierarchy of Responsibilities to make sure it is in line with the Governance Policy.

PENSION ASSET ALLOCATION DISCUSSION

Evolution of Current Allocation Mix

In explaining how we got to where we are now, Mr. Cliff Sheets reported that the pension plans' current asset allocation mix is the result of past Board decisions. These decisions were made at the strategic level and are incorporated in the policies that govern the pension plans and the various investment pools.

In 2005 the Board contracted with RV Kuhns and Associates, and they conducted the first Asset Allocation Study in early 2006. Significant changes were made as a result of that study. The Board commenced a broad diversification effort, both at the plan level in terms of various asset class choices, as well as within the individual asset classes. Some of the major changes included the decision to add real estate as a new asset class beginning in 2006; a reduction in the fixed income allocation and broadening of fixed income exposures to include the high yield sector; changes in the ranges for domestic and international stocks; a change in the framework for international stocks from a regional orientation to a broad market focus, including emerging markets; and, an increase in the allocation to private equity assets. Other asset class considerations included the decision not to invest in hedge fund-of-funds or commodities, and to make an allocation to timberland which is included as part of the real estate pool.

In conclusion, Mr. Sheets showed the current pension policy asset allocation map which refers to asset pool ranges as well as policy exposures to underlying types of investments within the pools.

Risk and Return Considerations

Mr. Jim Voytko discussed the concept of "risk" and its various interpretations, summarizing that investing boils down to taking risks and getting compensatory returns for it. He then went on to discuss the importance of diversification as a way to manage risk and optimize return within a portfolio consisting of many asset class exposures. The use of Mean Variance Optimization was discussed as a framework for thinking about diversification and the goal of attaining the highest possible returns for a given level of risk. In this context risk is measured as the expected volatility of returns for an asset class or portfolio, and high levels of risk will erode the long-term returns of a portfolio given a compounding effect. The correlation of asset returns was noted as a critical element in the structuring of efficient portfolios in this sense. Mr. Voytko concluded this section of the discussion by explaining that asset allocation is the primary driver of portfolio returns and the effect of individual manager selection is unlikely to override the impact of the allocation mix.

Strategic Allocation vs. Tactical

Mr. Cliff Sheets presented tactical allocation as decisions having a shorter timeframe than strategic allocation decisions, and might involve deviation outside of established strategic allocation ranges. He then went on to discuss the challenges to success in making such allocation changes, suggesting these only be considered in the event of extreme market misvaluations.

The Board Meeting was adjourned for lunch from 12:00-12:32 PM.

Mr. Sheets returned to the presentation and discussed the kinds of allocation shifts that are routinely implemented by staff, some of which are forced to meet liquidity needs or react to market changes. He explained that these changes are relatively minor and are made within the confines of the strategic allocation ranges established by the Board. He reviewed three past examples of tactical allocations that staff has made. These included allocation decisions made within an asset pool, such as the initiation of our high yield exposure; the addition to the real estate allocation in 2010 via core funds; and the increases and decreases periodically made in public equity exposure.

Mr. Cliff Sheets stated that the biggest investment challenge is the ability to make decisions on a forward-looking basis. Mr. Jim Voytko added that the Board has given the CIO the authority to do what is best for our portfolio. Board Member Karl Englund asked if the CIO and staff have enough flexibility to make changes within the allocations set by the Board. Mr. Sheets answered affirmatively and stated allocation decisions are conducted within the bounds set by the Board.

Allocation Alternatives – Pros and Cons

Ms. Becky Gratsinger reviewed the use of Mean Variance Optimization (MVO) Analysis as a framework for considering various asset mix alternatives and their implications for expected returns and risks. The current allocation mix was shown in juxtaposition with the unconstrained portfolios that were very conservative, more aggressive, and less liquid. Monte Carlo simulation was used as a way to show the probabilities of achieving various returns over long time periods while highlighting the short term downside risks of each allocation alternative. She then went on to introduce a constrained version of alternative efficient portfolios generated via MVO while noting the key considerations when setting a target allocation. Later, Mr. Sheets summarized the key takeaways from the MVO analysis.

There was a lengthy discussion at this point regarding the implications for future expected returns. Mr. Voytko noted that the assumed return is directly linked to the calculation of the actuarial required contribution, however in Montana, because contributions are set by the Legislature, this link has been severed. Board Member Turcotte noted the Legislature's past reluctance to fund required contributions.

Chairman Buchanan said we are encouraged that the Legislature may agree to increase the contribution to the Public Employees' Retirement System (PERS). Board Member Karl Englund thanked the investment staff for the time and effort that went into preparing this most comprehensive report, and the other Board Members were in agreement.

2012 WORK PLAN

Mr. David Ewer presented the 2012 Work Plan which includes proposed topics to be covered at the Board Meetings throughout the year. Mr. Ewer stated that the Work Plan was prepared based on Board Member comments received at the February 2012 meeting. The Work Plan provides for the Board to meet six times during the year. The two additional meetings will be

dedicated to specific subjects not covered at the quarterly meetings, and the quarterly meetings will continue to provide performance reports to the Board. Mr. Ewer reported that according to the Work Plan the budget will be presented at the August Board Meeting.

Chairman Gary Buchanan asked to move discussion of the pension funds' actuarial status and asset allocation to the May Board Meeting. Mr. Dave Senn of the Teachers' Retirement System said it could possibly be done in October but the information would not be available in May. Chairman Buchanan added that he would like to hear more from the Board's internal portfolio managers, as well as hearing from other staff on new topics and more asset classes. The Board had no changes to the Work Plan.

UPDATE ON PENSION COSTS, FY 2011 AND TO-DATE

Mr. David Ewer presented the history of asset management costs for the pension plans and asked how the Board wants to go forward regarding fees, noting that the current mix of assets is different from five years ago and more expensive as a result of the changes in asset exposures and implementation methods (i.e., less internally-managed). For fiscal 2011, 32 of the 57 basis points total cost can be attributed to private equity and real estate. He then commented that private equity in particular has made a significantly higher return contribution vs. public equities during the Board's experience with this asset class.

Board Member Bob Bugni cited his recent memo to the Board regarding five year performance numbers in public equity. Mr. Bugni questioned whether it makes sense to continue to pay for active management. Mr. David Ewer stated that staff recommendations on restructuring of domestic public equities will be included on the May Meeting agenda. Mr. Jim Voytko added that portfolio objectives and the desired structure considerations should come first, with fees being second. He also noted how net-of-fee returns, risk and execution costs are all linked, but how they are addressed matters. He then went on to discuss a paradigm that first addresses portfolio returns and risk objectives and strives to achieve those at competitive costs versus a paradigm that first sets a cost budget and then determines asset class investment exposures and their associated returns and risk levels within that constraint.

MANAGER ADDITIONS

Staff Report on New Public and Private Equity Managers

Mr. Rande Muffick reported on the results of the manager search for a domestic small cap growth equity manager. Alliance Bernstein has been selected and offers an experienced management team and an excellent long-term performance record. The portfolio will be managed based upon a fundamental rather than quantitative philosophy. Board staff invested \$25 million with the new manager and negotiated a 10% reduction in fees.

Mr. Muffick stated that the addition of Alliance Bernstein complements our current value manager, Vaughn Nelson.

Staff used an in house database to identify top performing managers with a strong performance record over one, three and five year periods. Holdings-based and returns-based analysis was completed on the top four managers, telephone interviews were conducted and the selected manager was invited to meet with BOI staff in person. Mr. David Ewer pointed out that this manager search represents the new due diligence process rather than the historical request for proposal (RFP) process that existed prior to the February change in the Board's Governance Manual.

These minutes are Approved and Final. Full Board review and decision took place at the May 22 & 23, 2012 Regular Meeting of the Board.

Mr. Ethan Hurley reported on the addition of four private equity managers and a commitment of \$85 million since the February 21-22, 2012 Board Meeting.

Fund Name	Vintage	Subclass	Sector	Amount	Decision Date
Centerbridge Special Credit Partners II, LP	2012	Non-control Distressed Debt	Diverse	\$20M	2/15/2012
Axiom Asia Private Capital Fund III, LP	2012	Buyout, Growth Capital and Venture Capital	Diverse	\$25M	2/16/2012
Tenaya Capital VI, LP	2012	Venture Capital	Technology	\$20M	3/1/2012
Pangaea Two, LP	2012	Growth Equity	Diverse	\$20M	3/15/2012

Public Manager Due Diligence Checklist

Mr. Cliff Sheets presented the due diligence process for hiring public asset managers, both equity and fixed income. The process for staff includes accessing manager databases, looking at historic performance, reviewing quantitative measures to assess the manager's performance, conducting personal interviews and seeking input from RV Kuhns. Mr. Sheets told the Board that Mr. Muffick's memo presented earlier in the agenda provided documentation of the steps taken that led to the decision to hire Alliance Bernstein. Mr. Dan Zarling added that working papers are kept by staff throughout the due diligence process.

ANNOUNCEMENTS

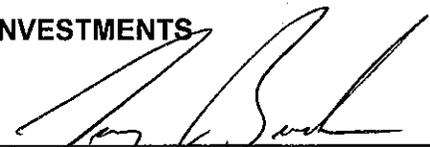
Chairman Gary Buchanan announced that the next Board Meeting will be May 22-23, 2012 in Helena. The Human Resource and Loan Committees will meet in May, but not the Audit Committee. The RFP Committee will also meet in May to look at the first draft preparation.

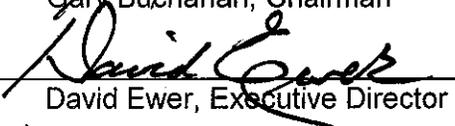
ADJOURNMENT

There being no further business, Chairman Buchanan adjourned the meeting at 3:47 PM.

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

BOARD OF INVESTMENTS

APPROVE: 
Gary Buchanan, Chairman

ATTEST: 
David Ewer, Executive Director

DATE: May 22, 2012

MBOI:caa
4/17/12