These minutes are Approved and Final. Full Board review and decision took place at the May 20 & 21, 2014 Regular Meeting of the Board.

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

## MINUTES OF THE MEETING
## April 8, 2014

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

**BOARD MEMBER ABSENT:**
Gary Buchanan

**LEGISLATIVE LIAISONS PRESENT:**
Senator Dave Lewis
Representative Kelly McCarthy

**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
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
Eron Krpan, Investment Data Analyst
Herb Kulow, MCMB, Portfolio Manager, In-State Loan Program
Tammy Lindgren, Investment Accountant
April Madden, Investment Accountant
Gayle Moon, CPA, Financial Manager
Rande Muffick, CFA, Portfolio Manager, Public Equities
Mary Noack, Network Administrator
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
Dan Zarling, CFA, Director of Research

**GUESTS:**
Becky Gratsinger, CFA, RVK, Inc.
Jim Voytko, RVK, Inc.
Brad Sanders, Bureau Chief, State Procurement Bureau
Rick Dorvall, Contracts Officer, State Procurement Bureau

**CALL TO ORDER**

Board Chairman Mark Noennig called the regular meeting of the Board of Investments (Board) to order at 9:15 AM. As noted above, a quorum of Board Members was present. Board Member Gary Buchanan was absent.

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

Chairman Noennig called for any corrections or revisions to the Board minutes from the February 25-26, 2014 Board meeting. Member Marilyn Ryan had one change under PERS/TRS updates. Under TRS comments, strike the last sentence and replace with "Legislation to increase funding from the University System to fund retirement benefits failed to pass."

> Board Member Jack Prothero made a Motion to approve the February 25-26, 2014, Board Meeting minutes as amended. Member Sheena Wilson seconded the Motion. The Motion carried 8-0.

## ADMINISTRATIVE BUSINESS

Audit Committee Report

Audit Committee Chairman Jon Satre reported on the Audit Committee Meeting held prior to the regular Board Meeting and stated that staff briefed the Committee on current emergency and disaster preparedness procedures which staff reviews and revises regularly. He congratulated staff for taking a proactive approach.

Loan Committee Report

The Loan Committee met prior to the Board meeting. Committee Chairman Jack Prothero reported the Committee approved one INTERCAP loan to Flathead County in the amount of $2 million for a ten (10) year term to refinance the capital lease for 12 county building HVAC systems. No Board approval is needed. The Committee also approved a $5,024,000 interim loan to the City of Deer Lodge in anticipation of U.S. Department of Agriculture (USDA) Rural Development Services (RD) long term financing for improvements to its wastewater treatment plant. The one (1) year term loan will be in the form of a general obligation bond anticipation note (BAN). The Committee recommends approval.

> Member Jack Prothero made a Motion to approve the $5,024,000 interim loan to the City of Deer Lodge. Member Quinton Nyman seconded the Motion. The Motion carried 8-0.

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

Member Marilyn Ryan reported the TRS actuary Cavanaugh Macdonald Consulting, LLC will present to the TRS Board at the May 2014 meeting. Work on the 2015 budget is ongoing. Complex changes in the Governmental Accounting Standards Board (GASB) guidelines will affect reporting requirements for counties and school districts and TRS will be very involved assisting them to become compliant. The new computer system update is going well and is on schedule. The benefit module has been tested and was flawless.

Member Sheena Wilson reported PERS interviewed three outstanding candidates for the executive director position last Friday. They expect to announce the new director within a week to 10 days.

Legislative Liaisons Comments

Representative Kelly McCarthy had nothing to report.

Senator Dave Lewis reported the Senate leadership has conducted preliminary discussions with the State Administration and Veterans' Affair Interim Committee (SAVA). Senator Lewis also noted there have been discussions regarding the public broadcast of most major state Boards, with the exception of TRS, PERS and MBOI. While most Boards meet at the Capitol where equipment is installed, the legislature may choose to take up the issue and propose options for ensuring all Boards have the same public media access.

Senator Lewis supported the original HB 144 in 2001 enacting the broadcast of legislative and administrative proceedings (sponsored by then Representative Mark Noennig) and added estimates for viewership are high. The original bill did not include any exemptions, but rather provided authorization of the broadcasting. Chairman Noennig added the original intent of the law was that broadcasts would expand to include more meetings over time.

## EXECUTIVE DIRECTOR'S REPORT

Overall Comments

Executive Director David Ewer presented his Executive Director's memo. He advised the request by Member Buchanan regarding competitive bidding for selection of the INTERCAP bond finance team will be covered under Tab 8 during the INTERCAP Loan Program presentation.

Executive Director Ewer reported a settlement has been agreed upon in the Tribune lawsuit in which MBOI was one of many defendants. The plaintiffs, creditors in the Tribune bankruptcy, claimed stock holders were unduly enriched when they received proceeds from the buyout of the company. Staff conferred with Board Chairman Noennig and legal counsel, who agreed the total settlement cost of approximately $25,000, is a good business decision when faced with the ongoing costs of continuing to defend the suit, as well as the possibility of an adverse decision.

The Department of Commerce is updating the Commerce website templates. The project roll out is expected to be completed by late summer or early fall.

Executive Director Ewer stated the Board's Governance Manual does not currently provide any reference to the Board's Education Policy. Staff recommends revising the language in the Governance Manual by adding a reference to the Education Policy on page 4, section 10, Systematic Work and Education Plan and incorporating the Education Policy as Appendix M. The Education Policy states that RVK, Inc. will provide educational presentations to the Board twice annually and each Board meeting will have relevant education and training as part of the 24-month Systematic Work and Education Plan.

Information on educational opportunities from outside resources or for possible conference attendance will be shared with the Board as they become available. There has been no notice this year about the Annual Market Makers Conference, and there is no information posted on the IFE website. Copies of the latest edition of *Barron's Dictionary of Finance and Financial Terms* have been ordered for each Board member and six copies of Nate Silver's *The Signal and The Noise Why So Many Predictions Fail-But Some Don't* are available for Board members.

Policy Reviews

Executive Director Ewer stated all policies are reviewed annually and any recommended changes must come before the Board for approval.

Staff is recommending revisions to the Governance Manual as follows:

Index page correction: Appendix I – Resolution 218, change *Deputy Director* to *Executive Director*
Page 3, add language:

> *Section 1. C) – Municipal Lending Programs – The Board manages programs under the Municipal Finance Consolidation Act, primarily through the INTERCAP program.*

Page 5, Section 10 – Systematic Work and Education Plan, add language:

> *The Board Education Policy, addressing the importance of the Systematic Work and Education Plan, is attached as Appendix M.*

Page 8, Section 3 – Chief Investment Officer, add wording:
*...and attached hereto as Appendix L.*

Board Member Jack Prothero made a Motion to approve the changes to the Governance Manual as proposed. Member Kathy Bessette seconded the Motion. The Motion carried 8-0.

Staff recommends incorporating the Board Education Policy into the Governance Manual by reference as Appendix M, and revising language in the Board Education Policy by adding a new Section 3 (and renumbering previous Section 3 as Section 4):

***3. SYSTEMATIC WORK AND EDUCATION PLAN***

*A. In order to educate, review and in all respects, assist Board Members in fulfilling their fiduciary role, Board Members will be provided on-going training and education on investment related topics and Board Operations through the Systematic Work and Education Plan (See Section 10 in the Board's Governance Manual).*

Member Sheena Wilson made a Motion to approve staff recommended changes to the Board Education Policy and incorporating it into the Governance Manual. Member Marilyn Ryan seconded the Motion. The Motion carried 8-0.

## POLICY REVIEWS

Investment Policy Statement Review and Proposed Changes
Mr. Cliff Sheets presented six investment policy statements for which staff is proposing revisions. Two fixed income investment policy statements: Trust Fund Investment Pool (TFIB) and Core Internal Bond Portfolio (CIBP) have identical minor language changes on page 3 deleting "Recent exposures by sector for the portfolio and benchmark index are shown for reference" as it is no longer applicable.

The Montana Private Equity Pool (MPEP) Investment Policy Statement has two changes on page 3 Strategies and Limitations deleting "and Corporate" under Buyout and adding subcategories "Distressed, for control, special situations and co-investments." Buyout policy range will be revised from 40%-75% to 50%-80%. Responding to a question from Chairman Noennig, Mr. Sheets stated the range adjustment allows for flexibility in the heavier allocated Buyout, which is currently nearing the 75% ceiling on the range.

The Montana Real Estate Pool (MTRP) Investment Policy Statement has one minor change on page 5, under the Benchmark section, clarifying the benchmark is net of fees.

The Montana International Equity Pool (MTIP) Investment Policy Statement revisions add a description and table detailing tracking error on page 2, under Risk Management, and revises the allocation ranges on page 3, widening the small cap range from 10%-16% to 8%-16%, and reduces the Dedicated Emerging Market range from 2%-10% to 0%-5%. These changes reflect recent minor changes to the structure of the pool.

The proposed changes to the Montana Public Retirement Plans Investment Policy Statement are to Schedule A, on page 4, for the changes to the International Equity Pool and Private Equity Pool sub-component ranges already discussed.

Chairman Mark Noennig called for a motion to approve proposed changes to the six Investment Policy Statements as presented.

Member Jack Prothero made a Motion to approve staff recommended changes to the Investment Policy statements as presented. Member Kathy Bessette seconded the Motion. The Motion carried 8-0.

Commercial Loan Policy Review and Proposed Changes
Mr. Herb Kulow presented proposed revisions to the Commercial Loan Policy, the Infrastructure Loan Policy and the Value Added Loan Policy. Changes to the policies reflect the January 1, 2014 policy change by the National Uniform Standards of Professional Appraisal Practices (USPAP) regarding new appraisal requirements. The new restrictions replace a Summary (self-contained) Appraisal with Restricted Appraisals, which are meant for the client's use only and may not be shared by a third party, such as MBOI, and full Appraisal Reports, which must include the analysis and rationale for the appraiser's basis for conclusions, and may be shared with third parties. Language under the Appraisal sections of each policy are revised stating MBOI requires an Appraisal Report as defined by the USPAP for all loans where the total loan amount is over $250,000. Restricted Appraisals will not be accepted.

Member Jack Prothero made a Motion to approve staff recommended changes to the three Commercial Loan Policies as presented. Member Sheena Wilson seconded the Motion. The Motion carried 8-0.

## CUSTODIAL BANK RFP

Executive Director David Ewer reported staff has been meeting weekly to work on the draft proposal of the custodial bank Request for Proposal (RFP). Others involved in the process include Jonathan Kowolik from RVK, Inc. and Brad Sanders, Bureau Chief and Rick Dorvall, Contracts Officer, from the Procurement Bureau. Executive Director Ewer reviewed the functions of the custodial bank:

- Hold custody of the state's investments/assets, sometimes through a depository trust
- Prime processing entity, all incoming and outgoing transactions
- Operational tracking entity
- Book of record and performance record for the State of Montana
    - Tracking of private equity assets; labor intensive and complex long term tracking utilizing Private Edge software (additional fee is paid)
- Securities lending

Responding to a question from Member Karl Englund regarding the process involved with private equity, Mr. Ethan Hurley explained once a commitment is made, the general partner makes the request for funds which goes to both State Street Bank and MBOI. All involved parties are notified and MBOI accounting and investment staff review and then sign off on the capital call notice, at which time it is entered into the system. State Street Bank waits for staff approval before processing. Ms. Gayle Moon stated State Street Bank processes the transaction through the Private Edge module.

Mr. Cliff Sheets added returns are calculated using Private Edge which shows the cash flow record.

Executive Director Ewer stated the RFP process has substantial complexity and follows the structure laid out by the Procurement Bureau. The scope of services and required qualifications are detailed. Policy requires 20% of the total points must be based on the bid price. The RFP requests bids for all services and also for securities lending specifically. State law allows for a seven year contract, an initial four year contract, which is then renewable annually for three years.

Mr. Brad Sanders stated it is a very structured process with the criteria set up to facilitate judging of the responses received. Substantial development has evolved during the process and the final product is good and meets procurement requirements.

Executive Director Ewer advised the consensus scoring committee will be comprised of Executive Director Ewer, Deputy Director Geri Burton, Chief Investment Officer Cliff Sheets, Financial Manager

Gayle Moon and Associate Financial Manager Polly Boutin. The consensus scoring proceeding is open to the public.

Mr. Sanders noted scoring committee members each score the submissions individually, then discuss as a group and come to a final consensus score.

Mr. Jim Voytko stated Mr. Jonathan Kowolik has extensive experience with custodial bank RFP's and provided substantial input throughout the process working with MBOI staff. Presenting specific details of the services you are requesting is very important to ensure you receive the detailed responses required to determine the best candidate. It is vital to have all the necessary information to make an informed decision when choosing a custodial bank.

Responding to a question from Chairman Noennig, Deputy Director Burton stated the current RFP requests more information in the performance and analytics and foreign exchange sections, as compared to the 2007 RFP. Executive Director Ewer added the changes weren't substantive. He noted it was important to ask the respondents to include the procedures used to comply with the latest requirements of the Governmental Accounting Standards Board (GASB) regulations.

Mr. Voytko stated that asking for a seven year commitment to a business relationship may allow for more competitive bidding. It's vital to be certain about the entity you will have a long term relationship with, as changing custodial banks is an expensive and arduous process. The goal is to achieve a high quality of service and a detailed RFP ensures sufficient information is collected to make an informed decision.

Ms. Becky Gratsinger noted it is very much a scale business with literally only a handful of qualified banks, and all of them are expected to respond to the RFP.

Member Prothero asked if past issues played a role in how the RFP was written.

Ms. Moon stated staff is comfortable with the language in Appendix A, which addresses staff, tenure and who will service the account. Mr. Ewer added that personnel sent by the finalists to make their presentation are required to be the same staff who will handle the account. State Street Bank comes to Helena to meet with MBOI staff three times each year and the meetings are vital to resolving any problem areas.

Deputy Director Burton stated the timeline allows for a six week response period for applicants which includes an informal pre-proposal conference call for interested parties to ask questions and a formal question and answer period. The questions and responses will be posted on the Procurement Bureau's web site for all interested parties to view.

Executive Director Ewer stated staff is recommending Board approval to allow staff to finalize the RFP and issue it in the next few days. Staff will select the finalists and invite them to travel to Helena to make their presentations. Staff will then determine the finalist and present a recommendation to the full Board at its August 2014 meeting. The total possible score is 1000; 700 for the first step which is allocated between 200 for the bid price and 500 for the content of the submitted information packet. The final 300 points is reserved for scoring the onsite presentations.

Responding to a question from Member Wilson, Mr. Sanders stated the available options at that time are to award the contract or cancel the RFP, which would require issuing another RFP.

Chairman Noennig asked if a holdover of State Street Bank's contract is allowed if a contract is not awarded. Executive Director Ewer stated that is not an option as the full allowable seven year term of State Street Bank's contract expires October 31, 2014. Mr. Sanders added the options are limited and if awarded, the contract must go to the high scorer.

Executive Director Ewer asked for Board approval to allow staff to go forward with issuing the RFP and that Board staff, in conjunction with Procurement Bureau staff, proceed with the scoring process and present the recommended finalist to the full Board at the August 2014 Board meeting.

> Member Karl Englund made a Motion to approve staff going forward with the RFP process as presented. Member Sheena Wilson seconded the Motion. The Motion carried 8-0.

## CONSULTANT REPORT – TERMINATED MANAGER REVIEW

Ms. Becky Gratsinger, CFA, and Mr. Jim Voytko, RVK, Inc.
Ms. Gratsinger stated looking back at managers who have been terminated is a useful exercise to perform and is instructive on manager selection. The time frame of some terminations has not been long as the restructuring of the domestic and international pools is recent, but the information is still useful.

Mr. Voytko added it's too easy to look at the buy/sell record, but it does not reflect an accurate picture. More than half of the terminated managers were terminated due to structural changes rather than for performance reasons, the shift in the level of active management and reducing quantitative in favor of more fundamental oriented funds. The review included a total of 16 terminated managers. Only eight had a three year track record and none had a five year history since termination.

Ms. Gratsinger stated the key drivers in terminating a manager are not strictly performance and relate to overall structural and/or strategic changes. Other factors driving a termination include a change in organizational structure or manager philosophy or style, and a departure of key personnel. The process of evaluating managers is subject to behavior biases, such as an emphasis of short term returns over long term performance; the tendency of groups to prefer action over inaction and to take more extreme measures than an individual might in the same circumstances; a comfort level with current holdings which may prevent decisions to change; and a group bias to follow the lead of stronger or more dominant personalities.

Ms. Gratsinger noted of the 16 terminated managers, ten were domestic managers, six were international managers and a total of 12 were terminated for structural reasons rather than performance. Mr. Voytko added although the data is limited by the short time frame, trailing three year figures show the retained managers have performed better than those terminated.

Responding to a question from Chairman Noennig, Mr. Voytko stated you will never win with all of your choices; however, the fund restructuring was conducted to improve overall fund value and the fund performance has improved since the changes were implemented.

Mr. Cliff Sheets added the restructuring changes are recent. The Montana Domestic Equity Pool (MDEP) changes were transitioned in summer 2012 and some of the Montana International Equity Pool (MTIP) changes occurred as recently as two months ago. Now that the process has been completed, while it is still early, the recent performance of the two pools has been good. The restructuring considered the portfolio as a whole and will be monitored over time to measure whether the changes live up to expectations.

## INVESTMENT MANAGER ACTIONS

Montana International Equity Pool (MTIP) Small Cap Manager Transition
Mr. Rande Muffick reported the second and final phase of the Montana International Equity Pool (MTIP) restructuring, approved by the Board at the August 2012 Board meeting, has been completed. During phase one, a large allocation of actively managed large cap investments were transitioned into the large cap passive portfolio. In phase two, two new small cap managers, one growth and one value, have been hired and have received initial funding. The new managers, Franklin Templeton

International Small Cap Value and American Century International Small Cap Growth, were initially funded at $40 million and $30 million respectively. Due to the illiquid nature of small caps, the transition was logistically challenging and took three days to complete. The overall cost of the transition on the $70 million was approximately $209,000, or 30 basis points of market value. The transition was managed by BlackRock Transition Management who estimated the cost would be 40 basis points. Franklin Templeton generally requires a $50 million minimum investment, but agreed to the initial amount of $40 million given the potential growth of the account. Over the long term, value stocks are generally expected to provide higher returns compared with growth stocks, thus staff allocated a larger portion to value.

Member Englund asked Mr. Muffick to explain the mechanics of the transaction.

Mr. Muffick explained a lot of preliminary work goes into a transition. Upon hire of the new managers, State Street Bank provides a new account number. Funding comes from cash proceeds of the large cap index fund; first through the purchase of futures, then individual stocks are purchased vs. the sale of the futures. These stocks are then moved to the new managers' accounts to be managed at their discretion as of the effective date of the transition. Mr. Sheets added the transition agreement is signed with the transition manager who then works with the new managers throughout the process. The new managers provide a "wish list" to the transition manager. Funding the new managers is done specifically to limit market exposure and avoid any opportunity costs, keeping the money fully invested throughout the process which helps keep transition costs as low as possible. A global manager is necessary to handle the purchase of small cap stocks from around the world in the currency of the different countries. Upon the completion date of all transactions, the new managers are free to buy/sell as they choose and that is when the clock on performance begins for the managers.

<u>Montana Private Equity Pool (MPEP) Update</u>
Mr. Cliff Sheets provided an update on pending transactions regarding sales of specific Limited Partnership (LP) interests of funds held by MBOI. Mr. Ethan Hurley stated marketing of the eight funds managed by four different general partners was conducted and approximately 40 bids were received. Last week proceeds of $60 million were received and an additional $30 million is due at the end of June. In a separate sale, $36 million is expected at the end of April. The total net asset value of the funds as of September 30, 2013 totaled $127 million.

Mr. Sheets noted the sales were pursued due to the current valuation perspective and good market timing in terms of strong demand and ample dry powder among secondary funds which resulted in the premium bids received. Mr. Sheets added the process is labor intensive and costly to execute. Considering the uniqueness of the asset class, it makes sense to act when the normal market illiquidity is low, which seems to be the case recently. Often secondary offerings are sold at a discount, such as with newer or troubled funds. We received a net premium to the most recent NAV's of the funds being sold.

Member Satre asked if the funds chosen for sale were troubled funds or ones we were looking to eliminate or funds for which there is a high demand.

Mr. Sheets stated funds chosen for sale were among those we would not be pursuing an ongoing strategic relationship with and were not "troubled." Some were deemed popular and did enjoy high demand. Madison Dearborn, a buyout manager, is a fund we did not plan to re-up with. Also, First Reserve funds represent an energy strategy which we did not plan on re-investing with in their next offered fund. The driver of the decision to sell some of our private equity exposure was not to change the allocation per se of private equity. Last year our actual private equity allocation fell in a range of 12-13% which fell to 11.8% at 12/31/13 due to strong stock market returns and the denominator effect. The current policy range is 9%-15%. After the fund sales are completed, the estimated private equity allocation will be approximately 10.4%, all other things being equal. This provides a cushion, should there be any general decline in public stock markets which would likely result in an increase in the private equity allocation weight.

Mr. Sheets noted total cash after completion of the sales will be at about 2%, well within the cash range of 1%-5%. Some of the cash may be used to bolster fixed income which remains at the low end of the range.

Senator Lewis asked what the current estimated monthly cash payout is to cover retirement benefits.

Mr. Sheets stated $51.7 million was calculated at year end for monthly payouts. A large amount of cash is received each month from contributions and income. Mr. Jim Voytko added that as an aging plan, payouts will continue to increase over time.

## MONTANA INTERNATIONAL EQUITY POOL ASSET CLASS REVIEW

Mr. Cliff Sheets, CFA, CIO and Mr. Rande Muffick, CFA, Portfolio Manager - Public Equities
Mr. Sheets began by presenting an allocation overview of the Montana International Equity Pool (MTIP). The asset class accounts for $1.7 billion and is the third largest asset class. International Equities make up half the amount of domestic equities. The asset allocation range is 14%-22% with a current level of 17.6%. The asset class is generally expected to produce high positive returns over the long term and is highly liquid and as well as highly volatile.

Mr. Muffick then went on to explain the history and composition of the pool. The benchmark for MTIP was switched to the MSCI ACWI ex-U.S. IMI, as of March 1, 2014 when the new small cap managers were funded. The new benchmark contains a greater amount of small cap stocks, which over the long term are expected to provide higher returns and better growth prospects than large caps. The benchmark ratio is 87.2% large caps and 12.8% small caps. As of March 14, 2014 the MTIP allocation to small caps is 11.2%. Small cap stocks include those companies with a market cap of $3 billion or less. Of the four small cap managers, three are active managers and one manages an index fund.

The structure of MTIP at March 14, 2014 is composed of value, core and growth equities. The portfolio contains comingled and separate accounts, which provide more control through investment guidelines spelled out in manager contracts; and index funds, where purchases are in units of a commingled fund. Index funds are structured to reduce tracking error by mirroring the benchmark. Emerging market index funds have a higher expected tracking error of approximately 30 basis points given the greater volatility of these stocks.

When structuring a portfolio, diversification of managers and how they correlate to each other is key. By choosing managers with different styles, methodology, passive vs. active, downside or upside capture profiles, the pool return stream is smoothed out over time. With actively managed large caps it is more difficult to outperform the benchmark; therefore a higher allocation to passively managed large cap holdings is desired. An overweight position of small caps is generally preferred due to the expected outperformance over large caps over time.

In June 2009 the transition to increase passive holdings was initiated and then increased again in the second half of 2011 with the termination of Artio. The structural cost effective approach is to pay fees where they have the best chance of adding returns. Fees from June 2012 through the end of 2013 were reduced on an absolute and basis point basis even as market value increased. Fees will be higher with the addition of new small cap managers but will remain lower than previous costs. The annual CEM report monitors fees and the next report should reflect reduced fees vs. peers due to restructuring the portfolio. The most recent CEM study showed MBOI had lower fees than peers and a 5%-7% lower allocation to actively managed assets. The result is expected to show less tracking error while paying less in overall fees.

Going forward, MTIP may receive funds from domestic equities for more international exposure. The long term bias calls for a small cap weighting of -2% to +4% vs. the benchmark and the emerging market weighting of -2% to +2% vs. the benchmark. Exposure to emerging markets will remain passive following staff's decision not to hire an active emerging market manager. Staff determined the hire of an emerging market manager would not be a good fit at this time.

The current structure with the addition of the new managers will be monitored for performance. Changes regarding underperforming large cap managers may be considered in the future.

Ms. Becky Gratsinger stated several clients have also taken a small cap overweight approach which makes sense. MBOI does have emerging market exposure through current managers and the overall portfolio structure is solid. Mr. Jim Voytko added now that the new structure is in place, patience and monitoring is suggested for the time being.

## BOND PROGRAM

INTERCAP Mission Overview Presentation, Louise Welsh, Senior Bond Program Officer
Ms. Louise Welsh presented an overview of the INTERCAP program. The INTERCAP program is an enterprise fund providing services to public entities for a fee. The Municipal Finance Consolidation Act (MFCA) (MCA 17-5-16) grants the legal authority to lend to eligible government units, to sell bonds to fund INTERCAP loans and to independently hire underwriters, attorneys, and trustees and designates the Board guaranty for MFCA bond repayment. The Board guaranty is capped at $190 million and the Board may charge a fee for its services.

INTERCAP has never suffered a loss in its 27 year history. The annual remarketing for the currently ~$106 million in outstanding bonds with terms of 20 and 25 years occurred in February. The bonds received a high quality/low risk rating of AA3 VMIG1 and were oversubscribed. That resulted in the ability to push the bond rate down to 16 basis points and allow INTERCAP to maintain the low 1% loan rate to borrowers for another year. The loan rate to the borrower changes annually on February 16.

The Board has the authority to hire the finance team therefore the state procurement process does not apply. The finance team, many of whom have been part of the team since the creation of INTERCAP in 1987, is made up of Piper Jaffray & Co., D.A. Davidson & Co. of Great Falls, Jackson, Murdo & Grant, P.C. of Helena, Luxan & Murfitt, PLLP of Helena, Dorsey & Whitney, LLP, of Missoula and U.S. Bank, N.A. as trustee. The team has performed well at a reasonable cost marketing INTERCAP bonds which have a unique nature requiring the need to provide detailed information of how they work (story bonds) to investors.

The Board asked staff to consider in their opinion if a change to a competitive bid of the finance team services was necessary. Staff considered it and do not think a change is necessary. Staff is also satisfied with the performance of the remarketers and do not see a need to change that facet of the team either. This is shown in the consistently low loan rate to the borrower that recovers all the fees associated with remarketing the bonds and program administration.

INTERCAP serves local governments, state agencies and universities. There are no origination fees and no prepayment penalties. Loan repayments are due semi-annually on February 15 and August 15 to facilitate the program bond holder payments which are due on March 1 and September 1. Principal repayments go back into the pool of funds available to loan.

The program enables economic improvement which in turn enhances Montana's image. The many appreciative notes from borrowers who have used the program show the INTERCAP program continues to be a low cost, easy to use option for the many state and local government agencies that use it.

Responding to a question from Representative Kelly McCarthy about the variation of interest rates from year to year, Ms. Welsh responded the pool is remarketed and re-priced each year. Funds in excess of what is on loan are invested to generate income up to the bond yield. Income received from the funds on deposit over the bond yield is rebated to the Federal Government.

## RECAP

Executive Director Ewer noted one request from Member Sheena Wilson during the Audit Committee meeting regarding emergency procedures. Member Wilson asked if there are available options to provide essential services for MBOI staff if the need should arise during a disaster situation.

Chairman Noennig stated Member Gary Buchanan has asked that he be provided a spot on the agenda for the May Board meeting to share his ideas regarding Board education and training.

There being no further business, the meeting was adjourned at 2:50 PM.

Next Meeting
The next regular meeting of the Board will be May 20 - 21, 2014 in Helena, Montana.

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

**BOARD OF INVESTMENTS**

APPROVE: Mark E. Noennig
Mark E. Noennig, Chairman

ATTEST: David Ewer
David Ewer, Executive Director

DATE: May 21, 2014

MBOI:drc
5/5/14