MINNESOTA STATE BOARD OF INVESTMENT

60 Empire Drive
Suite 355
St. Paul, MN 55103
(651) 296-3328
FAX (651) 296-9572
E-mail:
minn.sbi@state.mn.us
www.sbi.state.mn.us

DATE: November 24, 2009

FROM: State Board of Investment

SUBJECT: Report on Investment Consultant Activities

The provisions of Minnesota Statutes, Section 11A.27 require the State Board of Investment to file with the Legislative Reference Library a report on investment consultant activities.

The State Board of Investment (SBI) contracts with Nuveen Investment Solutions, Inc., formerly Richards & Tierney, Chicago, Illinois and PCA, Studio City, California for certain investment consulting services. Nuveen serves as the SBI's general consultant, and PCA serves as the SBI's special projects consultant. The current contracts with these consultants, effective July 1, 2007 to June 30, 2012, call for payment of $370,000 to Nuveen annually and $40,000 to PCA annually.

During the period November 1, 2007 through October 31, 2008, Nuveen was involved in the following projects:

- Availability to the Board, staff and Investment Advisory Council to provide perspective, counsel and input on relevant investment related issues.
- Background information for evaluating the federal government's Public Private Investment Program (PPIP).

Attached is an example of the work product provided.

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DATE: May 20, 2009

TO: Members, Investment Advisory Council

FROM: Howard Bicker

SUBJECT: Proposed Fixed Income Investment

In March 2009, the U.S. Treasury Department announced the Public-Private Investment Program (PPIP) which is designed to purchase mortgage-backed securities and whole loans from the balance sheets of U.S. financial institutions. Staff talked with a number of fixed income managers to gather information about the program.

All the information related to this program, however, is not yet available. What is known is that at least five investment managers will be selected by the government in late May to run the program. The investment managers will then raise approximately $75 billion to $100 billion of capital from investors. This capital will be matched dollar for dollar by the government. The government will also provide additional capital to leverage the programs. It is anticipated that the program to purchase asset backed bonds, called the Legacy Securities Program, will be provided leverage up to a 1 to 1 basis. The program to purchase whole loans, called the Legacy Loan Program, will receive additional capital to leverage purchases up to a 6 to 1 basis.

These programs could provide the SBI with very attractive fixed income returns in the range of 15% to 20%. Any investment made by the Board would have no liquidity for at least three years. It is currently anticipated the SBI would get its money back in about 5 to 7 years.

Staff suggests the SBI consider investing in the Legacy Securities Program due to its lower level of risk. Staff recommends the SBI consider investing one percent of the Combined Funds, approximately $300 million, in the program with assets coming from the fixed income portfolio. The structure of the investment vehicle will be in the form of a limited partnership with monitoring and reporting conducted by the fixed income program. (See **Attachment A** for further background information.)

Staff has been informed by a number of organizations that the fund-raising for these investments will be completed by July or early August. Therefore, if the SBI would like to participate in these programs, the Board will need to approve action at the June meeting. However, staff does not have, at this time, all the information related to the programs. Staff suggests that if there is not sufficient time to bring the issue to the Board, a meeting of the Administrative Committee will be called to review and approve details of any recommendations.

RECOMMENDATION:

Staff requests that the Board approve an investment of up to one percent of the Combined Funds assets with one or more managers in the Legacy Securities Program of the U.S. Treasury Public-Private Investment Program. The assets would come from the current fixed income portfolio. After staff has completed its due diligence of the program and has determined if it is an appropriate investment for the SBI, if time allows, staff will bring a detailed recommendation to the Board in September for final approval. If there is not time to bring a recommendation to the Board, a meeting of the Administrative Committee will be called to review and approve staff recommendations.

ATTACHMENT A

Public-Private Investment Program (PPIP)

Program Overview

The Public-Private Investment Program (PPIP) was introduced by the U.S. Treasury Department in March 2009. The focus of this government-sponsored program is to attract investments of $75 billion to $100 billion and provide financing for investments up to $1 trillion in the loan and securities markets. Private investors will have the opportunity to receive a dollar-for-dollar match of government funds, in addition to term, non-recourse financing, toward the purchase of "legacy" loans and securities currently valued at distressed prices.

There are two separate programs in the PPIP:

- Legacy Loans Program
- Legacy Securities Program

The purpose of the Legacy Loans Program is to cleanse bank balance sheets of troubled legacy loans while providing attractive terms for investment to the private sector. Public-private investment funds will be set up to purchase asset pools on a discrete basis. The U.S. Treasury will match private capital dollar-for-dollar (1:1 ratio) in a separate investment vehicle which will acquire assets alongside the private capital funds on a pro-rata basis. Then, the Term Asset-Backed Loans Facility (TALF) will provide term, non-recourse financing to the fund for asset purchases to provide leverage up to a 6 to 1 ratio.

The purpose of the Legacy Securities Program is to fund purchases of distressed securities to take devalued securities off bank balance sheets and to jump-start the securitization market. Taxpayer money will be combined with capital raised by select asset managers to buy mortgage-related assets, including non-agency RMBS and CMBS. The Treasury will provide capital on a dollar-for-dollar (1:1) basis and invest in a separate investment vehicle which will acquire assets alongside the private capital funds on a pro-rata basis. This fund is also eligible for term, non-recourse financing provided by the TALF to provide leverage in the range of a 0.5:1 to 1:1 ratio. The Treasury will select five or more managers to operate a Legacy Securities fund.

The financing provided by the TALF will be on a 10 year term and will come with a 25 basis point fee. This financing will be repaid on a pro-rata basis as cash flows from the investments are received.

A Proposed Fund Set-up

One of SBI's fixed income managers submitted a proposal to the U.S. Government to operate a Legacy Securities fund. The fund would be a limited partnership fund with the following features:

- There would be an initial three year investment lockup period.
- The manager would look to raise about $7 billion of private capital and match it with taxpayer money. This $14-15 billion would be levered up to 1x for a total fund of $25-30 billion.
- The fund would target a return of 20%.
- A 25 basis point fee on the TALF financing would be passed on to investors in addition to a 25 basis point upfront management fee, resulting in a total 50 basis point fee. (Other managers may propose a different management fee.)
- Profit sharing will take place after the investors receive 100% of their principal back plus a 10% return. After that threshold has been achieved, additional returns will be split 80/20 with the manager taking 20%.

INVESTMENT ADVISORY COUNCIL REPORT

DATE: September 22, 2009

TO: Members, State Board Investment

FROM: Members, Investment Advisory Council

The Investment Advisory Council met on Wednesday, August 19, 2009 to consider the following agenda items:

- Review the manager performance for the period ending June 30, 2009.
- Investment Manager update, Domestic Equity.
- Update on PPIP Program.
- Asset allocation for the Voluntary Statewide Volunteer Firefighter Plan.

Action is required by the SBI on the last item.

INFORMATION ITEMS:

1. Review the manager performance for the period ending June 30, 2009.

- *Domestic Equity Program*

For the period ending June 30, 2009, the **Domestic Equity Program** outperformed for the quarter and underperformed over all other time periods.

Time period	Total Program	Russell 3000
Quarter	17.2%	16.8%
1 Year	-26.9%	-26.6%
3 Years	-8.7%	-8.3%
5 Years	-2.1%	-1.8%

The performance evaluation reports for the domestic equity managers start on the **blue page A-1** of this Tab.

- *Fixed Income Program*

For the period ending June 30, 2009, the **Fixed Income Program** outperformed for the quarter and underperformed over all other time periods.

Time period	Total Program	Barclays Capital Aggregate
Quarter	5.3%	1.8%
1 Year	2.5%	6.0%
3 Years	4.3%	6.4%
5 Years	4.0%	5.0%

The performance evaluation reports for the fixed income managers start on the **blue page A-91** of this Tab.

- *International Equity Program*

For the period ending June 30, 2009, the **International Equity Program** underperformed over the quarter and the year, and matched the benchmark over the three and five-year time periods.

Time Period	Total Program	Int'l Equity Asset Class Target*
Quarter	27.0%	27.6%
1 Year	-31.0%	-30.9%
3 Year	-5.7%	-5.7%
5 Year	4.5%	4.5%

* Since 10/1/07 the International Equity asset class target is the Standard MSCI ACWI ex U.S. (net). From 10/1/07 to 5/31/08, the International Equity asset class target was the Provisional Standard MSCI ACWI ex U.S. (net). From 10/1/03 to 9/30/07, the target was the MSCI ACWI Free ex. U.S. (net).

The performance evaluation reports for the international equity managers start on the **blue page A-105** of this Tab.

2. **Update on RiverSource Investments/Kenwood Capital Management.**

The SBI hired RiverSource Investments/Kenwood Capital Management (Kenwood) in January 2004 to manage a small-cap domestic equity portfolio. Kenwood was a joint venture affiliate with RiverSource Investments and was founded in 1998. Kenwood had six investment professionals and was located in Minneapolis.

Kenwood notified staff on June 25, 2009 that the firm would end business operations on July 31, 2009. Due to Kenwood's decision to close, the Minnesota State Board of Investment (SBI) elected to liquidate this account with Kenwood effective July 7, 2009.

Kenwood's decision to discontinue normal business operations and the liquidation of the account ended the responsibility of Kenwood to provide the SBI with investment management services.

3. **Update on PPIP Program.**

During the June 10, 2009 Board meeting, the Board granted conditional authority to the SBI Staff to invest up to one percent of the Combined Funds (approximately $350 million) in the Public-Private Investment Partnership (PPIP.) The authority was conditional because details of the program were not available at that time, and the investment managers to be appointed by the government had not been announced. If staff ultimately decided to recommend investment in one or more PPIP funds, but an IAC and/or Board meeting would not take place in time to meet fund closing deadlines, the SBI Administrative Committee would be called to hear the recommendation.

Since that time, the details of the program were announced and Staff has done extensive research on the managers and the funds available for investment. Based on this research, Staff does not recommend pursuing this opportunity. The following is a review of the PPIP program, along with the information used to reach this conclusion.

Background

The PPIP is designed to draw private capital into the commercial and residential mortgage-backed securities market to help cleanse bank balance sheets of these securities, and to improve the market for these securities. Many of the targeted securities are commercial and residential mortgage-backed securities that are currently valued below what many asset managers have deemed "fair value". This is due to the massive deleveraging during the second half of 2008 which drove down the market value of almost every kind of asset-backed security.

The Federal Government will match each dollar of private capital raised for the PPIP. The asset managers will then have the option to borrow additional funds from the U.S. Treasury Department.

Update
The official announcement of the nine PPIP managers was made July 8 (see **Attachment A.**) The Treasury gave each manager 12 weeks to raise $1.1 billion for the PPIP. The funds will be structured as limited partnerships with very limited liquidity. Cash distributions to limited partners (SBI) are expected to start in year five with final liquidation in eight to ten years.

Since the announcement, staff has spoken with six of the managers to gather detailed information on the PPIP funds they will offer. A general comment that has been expressed by the managers is the Treasury has announced a number of programs over the past year. After these programs have been implemented, the Government has "changed the rules." This is an ongoing concern.

Availability
Based on discussions with potential managers, staff learned that most of the managers will use the same basic strategy together with similar fund and fee structures (see **Attachment B**.) The maximum amount an investor can commit to a PPIP fund is 19.9% (about $200 million) of the $1.1 billion fund. However, some of the asset managers will be launching a retail PPIP investment as well as an institutional investment. Staff spoke with six of the firms about their PPIP and would recommend only two based on numerous factors including investment process, staff, fees, capacity, and current relationship. Since Staff is confident in only two of the PPIP managers, it is unlikely the SBI would be able to make a meaningful commitment of the Combined Funds.

Leverage
Another important detail discovered during the research is that the amount of leverage that will be used in the program is unknown. As mentioned, each PPIP asset manager has the option to lever the combined $2.2 billion in equity for the program up to one time to create $4.4 billion of buying power. However, the Treasury has also given the asset managers the option to switch from the 1:1 leverage option to a 0.5:1 leverage option, but then use the Term Asset-Backed Loan Facility (TALF) to further leverage the portfolio up to a 5:1 basis. Once capital has been committed, the investor has no say in how much leverage will be used.

Expected Returns
The PPIP has been advertised as a fixed income investment option with the potential for 15% or greater returns. This estimate is based on the assumption that banks, insurance companies, etc. will sell these discounted securities to PPIP managers at current prices. However, since the announcement of the PPIP in March and the announcement of the managers for the program in July, these asset prices have rallied. There is a risk the holders of these securities might continue to hold them while waiting for the prices to improve further as a result of the PPIP. Staff is skeptical about the ability of the PPIP asset managers to buy securities at prices necessary to produce the kind of returns advertised.

Liquidity
Based on the conversations Staff had with various PPIP managers, the SBI would not begin receiving significant principal repayments until after the Treasury loan for the leverage has been fully amortized, something that could take approximately five years or longer. Therefore, a commitment to the PPIP would lock up capital for six to eight years or longer depending on cash flows.

Summary
After extensive review, staff's recommendation is to not pursue PPIP investment for the following reasons:

- There continues to be some concern that the terms may change over time.
- Staff would recommend working with only two of the managers offering PPIP funds. Therefore, it would be difficult to make a meaningful investment of the Combined Funds.
- The level of leverage is unknown.
- Projected returns may be difficult for managers to achieve if pricing for the securities continues to improve.
- The funds are not liquid.

Based on the factors outlined above, the Investment Advisory Council supports Staff's decision to not pursue PPIP investment.

ACTION ITEM:

4. Asset Allocation for the Voluntary Statewide Volunteer Firefighter Plan.

Legislation was enacted during the 2009 Legislative session to establish a Voluntary Statewide Volunteer Firefighter Plan. The assets of the plan will be managed by the State Board of Investment using a combination of the options in the Supplemental Investment Fund. Asset allocation for the Plan is to be determined by the SBI. Staff considered the following three factors in determining the appropriate asset allocation for the Plan:

- The funding rate for the Plan is 6%
- The Plan distributes benefits in lump sums
- There will not be cost sharing among the townships and cities that participate in this plan.

Staff analyzed expected returns and volatility based on the published expected return/volatility assumptions of several investment management firms and consultants (see **Attachment C.**)

Based on liquidity needs, and volatility, staff believes an asset allocation of 35% to U.S. equity, 15% to international equity, 45% to fixed income and 5% to cash (Scenario D) would be appropriate for the Plan. This information was presented to the Statewide Volunteer Firefighter Retirement Plan Advisory Board on August 6, 2009. The Advisory Board voted to support the proposed asset allocation.

RECOMMENDATION:

The IAC recommends the Board approve the following asset allocation for the Voluntary Statewide Volunteer Firefighter Plan:

U.S. Equity	**35%**
International Equity	**15%**
Fixed Income	**45%**
Cash	**5%**
Total	**100%**

ATTACHMENT A

PPIP Managers		
PPIP Manager	***Discussed Program with SBI***	***Current Relationship***
Western Asset Management LP	YES	SBI Fixed Income Manager
Blackrock Inc.	YES	SBI Fixed Income Manager
Invesco Ltd.	YES	SBI International Equity Manager
Marathon Asset Management LP	YES	None
Oaktree Capital Management LP	NO	None
TCW Group Inc.	YES	SBI Private Equity Manager
Wellington Management Co.	NO	None
AllianceBernstein LP	YES	SBI Domestic and International Equity Manager
Angelo Gordon & Co. and GE Capital Real Estate	NO	None

ATTACHMENT B

PPIP Manager Comparison

	Blackrock	*Western*	*AllianceBernstein*	*TCW*	*Invesco*	*Marathon*
Minority Partner	Utendahl Capital Management, LP - will have discretion over 5% of assets	RLJ Co. - fund raiser and compliance w/Treasury guidelines 51% owner of RLJ/Western	Greenfield Advisors, LLC Rialto Capital Management, LLC Altura Capital Group, LLC	N/A	WL Ross & Co. - primarily a fund raiser	Blaylock Robert Van, LLC - primarily a fund raiser
Fee Structure	25 bp Mgmt Fee* + financing** 80/20 GP/LP catch-up 80/20 LP/GP carried interest 2.5% Treasury Warrants	100 bp Mgmt Fee + financing** 85/15 GP/LP catch-up 85/15 LP/GP carried interest 2.5% Treasury Warrants	100 bp Mgmt Fee + financing** 82.5/17.5 LP/GP incentive fee *No catch-up provision 2.5% Treasury Warrants	200 bp Mgmt Fee + financing** 80/20 LP/GP carried interest *No catch-up 2.5% Treasury Warrants	100 bp Mgmt Fee + financing** 80/20 LP/GP carried interest *No catch-up mentioned 2.5% Treasury Warrants	100 bp Mgmt Fee + financing** 90 bp Mgmt Fee if you committ more than $25 million 85/15 LP/GP carried interest *No catch-up, 2.5% UST Warrants
Preferred Return	10%	10%	8%	6%	8%	7%
Minimum Investment	$20 million	Not stated	$10 million	$1 million	$25 million	$1 million
Maximum Investment	$100 million (19.9% of total fund)	~$200 million (19.9% of total fund)	~$100 million (9.9% of total fund)	~$200 million (19.9% of total fund)	~$200 million (19.9% of total fund)	~$200 million (19.9% of total fund)
Fund structure	$500 million Inst'l Fund $500 million Retail Fund Will seek 1:1 leverage option but Manager has option to go from 1:1 leverage down to 0.5:1 and use TALF to increase to 5:1	$1.1B Inst'l fund also launching a mortgage REIT Will seek 1:1 leverage option but Manager has option to go from 1:1 leverage down to 0.5:1 and use TALF to increase to 5:1	$1.1B all Inst'l Will seek 1:1 leverage option but Manager has option to go from 1:1 leverage down to 0.5:1 and use TALF to increase to 5:1	$1.1B Inst'l fund Will seek 1:1 leverage but Manager has option to go from 1:1 leverage down to 0.5:1 and use TALF to increase to 5:1	Seeking agg. Commitments of $2.1B after $1B commitment from WL Ross & Co. Manager has option to go from 1:1 leverage down to 0.5:1 and use TALF to increase to 5:1	$1.1B all Inst'l Fund Will seek 1:1 leverage option and is willing to put in contract language stating they will not seek additional leverage
Initial Closing	August 5, 2009	Not stated	September 15, 2009	Not stated	Not stated	Mid-September
IRR Target	15-18% (net)	20+% gross	20+% gross	20+% gross	20+% gross 18% net	18-20% net
Term	8 years with 2 1-year optional extensions	3-5 year with 8 year max and 2 1-year optional extensions	8 years with 2 1-year optional extensions	8 years with 2 1-year optional extensions	8 years with 2 1-year optional extensions	5 years 8 year max 2 1-year optional extensions

*25 bp fee on contributed capital + 25 bp on the loan from the U.S. Treasury

**Financing on the Treasury loan will be 3 month LIBOR + 100 bp

--In addition to reviewing term sheets, we held conference calls with Blackrock, Western, TCW, and AllianceBernstein about their PPIFs

ATTACHMENT C

Sample Asset Allocations for Voluntary Fire Fund Account

Asset Allocations

Asset Class	Scenario A	Scenario B	Scenario C	Scenario D	Scenario E	Scenario F	Scenario G	SBI
Domestic Equity	30%	50%	40%	35%	35%	45%	40%	45%
International Equity	10%	0%	10%	15%	20%	15%	25%	15%
Bonds	55%	45%	45%	45%	40%	35%	30%	18%
Cash	5%	5%	5%	5%	5%	5%	5%	2%
Alternatives	NA	NA	NA	NA	NA	NA	NA	20%

Results

	Scenario A	Scenario B	Scenario C	Scenario D	Scenario E	Scenario F	Scenario G	SBI
Wilshire								
Expected Return	7.20	7.53	7.59	7.61	7.82	7.97	8.19	9.70
Expected Risk	7.44	8.92	8.72	8.66	9.29	10.01	10.66	12.66
Mercer								
Expected Return	6.47	6.75	6.85	6.88	7.10	7.23	7.47	8.22
Expected Risk	7.95	9.91	9.39	9.23	9.87	10.75	11.32	13.41
JP Morgan								
Expected Return	7.61	7.92	7.99	8.02	8.23	8.37	8.60	9.24
Expected Risk	7.90	9.97	9.70	9.63	10.5	11.49	12.32	14.34
Internal 2008								
Expected Return	7.52	7.72	7.83	7.89	8.09	8.18	8.42	8.92
Expected Risk	8.09	9.64	9.27	9.11	9.60	10.43	10.84	12.81
BGI								
Expected Return	7.34	7.63	7.68	7.70	7.89	8.03	8.23	8.94
Expected Risk	7.52	9.48	8.99	8.77	9.32	10.31	10.69	14.09
Goldman Sachs								
Expected Return	7.19	7.54	7.55	7.55	7.72	7.88	8.03	8.96
Expected Risk	8.52	10.78	10.35	10.18	10.96	12.07	12.71	15.15