

**TOBACCO SETTLEMENT PERMANENT TRUST ACCOUNT INVESTMENT  
ADVISORY COMMITTEE  
Wednesday, March 27, 2013  
*Minutes***

The Tobacco Settlement Permanent Trust Account Investment Advisory Committee (the “**Committee**”) met on Wednesday, March 27, 2013 at 10:00 a.m. in Room 320, Rusk State Office Building, 208 E. 10<sup>th</sup> Street, Austin, Texas.

**Committee Members Present**

Stuart Ford, Chairman; Judge Mike Brown; Roy Browning; Peggy Deming; Commissioner Roger Galvan; Judge Dan Gattis; Judge Wayne Gent; Fred Greene; Noe Hinojosa; and Chuck Norris.

**Committee Members Absent**

Judge David Silva.

**Texas Treasury Safekeeping Trust Company (“Trust Company”) Staff Members Present**

Paul Ballard, Chief Executive Officer and Chief Investment Officer; Danny Sachnowitz, Deputy Chief Investment Officer; Frank Zahn, Chief Financial Officer; Marianne S. Dwight, General Counsel; Byron Beasley, Private Markets Manager; Michael Leifeste, Real Estate Portfolio Manager; Victor Scott, Director of Financial Reporting; Michael Anderson, Compliance Officer; Gena Minjares, Director of General Ledger Accounting; Jorge de LaFuente, Investment Analyst; Laura Montoya, Director of Administration; and Nora Arredondo, Special Projects Coordinator.

**Additional Participants Present**

Mike O’Brien, Padgett, Stratemann & Co.; Tom Janisch, Asset Consulting Group (“ACG”); and Rick Pokorny, Northern Trust Company.

**Call to Order**

Chairman Stuart Ford declared that a quorum was present and called the meeting to order at 10:05 a.m.

Chairman Ford read a statement regarding the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) that requires municipal advisors to register with the SEC. The temporary ruling resulted in a disagreement over the definition of what constitutes a municipal advisor. The Comptroller’s office does not believe the usual activities of this committee constitute municipal advisory activities and they are working with the Attorney General’s office to clarify its application. Chairman Ford asked the Trust Company’s General Counsel, Marianne Dwight, to monitor the committee’s discussions and to advise them to stop if they began to engage in anything that would be considered municipal advisory activities

**Approval of Minutes (Tab 1)**

*A motion was made by Peggy Deming to approve the October 19, 2012 meeting minutes. The motion was seconded by Judge Wayne Gent and unanimously approved.*

### **Presentation of Annual Audit (Handout)**

Mr. Mike O'Brien reported that Padgett, Stratemann & Co. issued an unqualified audit opinion with respect to the Tobacco Settlement Permanent Trust Account ("Account") for the year ending December 31, 2012. In reviewing the basic financial statements, Mr. O'Brien stated that the Trust Company has added the distribution stabilization account ("DSA") history to this report. He reported that net assets held in trust were approximately \$2.12 billion as of December 31, 2012. Mr. O'Brien affirmed that the account had been managed in compliance with the Investment Policy and the Distribution Policy. No audit adjustments were recorded during the audit engagement, nor was a management letter issued.

Mr. O'Brien reviewed the distribution calculation process as described in the distribution attestation report. He explained that the audit attests to the calculation process not the decided distribution amount since it has yet to be determined.

### **Capital Markets Outlook and Discussion (Tab 2)**

Mr. Tom Janisch of ACG presented an economic overview of 2012. He reported that in the Federal Reserve's (the "Fed") December statement, the Fed said it would keep interest rates near zero as long as the jobless rate was above 6.5%. Unemployment has been above 7.8% since 2009 and economists do not expect a significant decrease before the end of 2013. The Fed remains committed to its quantitative easing program and Chairman Bernanke indicated that the level of bond buying may be reduced if there is further evidence of sustainable gains in the job market. Mr. Janisch explained that the housing and job markets have showed strengthening in the previous quarter, but ACG expects slow domestic economic growth at a rate of approximately 2% - 2.5% for the next few years. European markets face additional uncertainty following the banking crisis in Cypress, the turmoil of the Italian elections, and the high unemployment rate of 26% in Spain. There was some economic improvement in the German economy.

Mr. Janisch reviewed the broad market returns for the period ending February 28, 2013. He stated that the equity markets were doing well and ACG continues to believe that emerging markets present the largest opportunity for growth. Asset class relative rankings for the first quarter of 2013 were summarized by Mr. Janisch. He stressed that the absolute return / opportunistic credit asset class was overweight because the portfolio wants to participate in the market but have appropriate risk management. ACG believes there is not a lot of opportunity in the fixed income market. He reported one change to the tactical outlook for the quarter. The U.S. core fixed income asset class was changed from neutral to underweight.

### **Endowment Portfolio Update and Related Matters (Tab 3)**

Mr. Paul Ballard presented an overview of the endowment portfolio and reported that it was in compliance with the investment policy. As of December 31, 2012 the portfolio value was approximately \$2.12 billion and was in alignment with its asset allocation targets. Mr. Ballard explained the cautious economic outlook the Trust Company had in relation to the portfolio positioning. He reviewed the portfolio's asset allocation evolution. Mr. Ballard reviewed the portfolio characteristics and stated that the portfolio was very liquid. He compared the actual vs. the target allocations for the 4<sup>th</sup> quarter of 2012. Mr. Ballard reviewed the various asset classes and discussed with the Committee new managers added to the portfolio and explained managers removed from the portfolio. Mr. Danny Sachnowitz discussed the portfolio strategies being managed by PIMCO and Stone Harbor. Mr. Ballard discussed plans to over-weight the private debt component of the portfolio. In the alternative fixed income sector, a decision had been made to redeem from Element Capital and Rock Creek Zilker. Mr. Ballard explained the real assets portion of the portfolio and its role in inflation protection. He also explained that the Value at Risk (VaR) for the portfolio was 3.2% and in line with expectations. In conclusion, Mr. Ballard reported that the portfolio performance was within expectations, given the current economic conditions.

#### **Presentation and Discussion of Investment Performance for the Period Ending 12/31/12 (Tab 4)**

Mr. Rick Pokorny of Northern Trust reviewed the investment performance of the endowment funds for the period ending December 31, 2012. The portfolio return was approximately 1.97% for the quarter and outperformed the benchmark rate of 1.61%. Each of the four assets classes had a positive return. Mr. Pokorny explained in further detail the performance of each asset class. He reported that from inception to date, the portfolio has outperformed its benchmark. The portfolio experienced an overall positive result while assuming less risk than its peers. The Sharpe ratio outperformed its benchmark.

#### **Legislative Update**

None to report regarding the Tobacco fund.

#### **Discussion and Approval of Annual Trust Distribution (Tab 5)**

Mr. Ballard led the discussion and explained that the Trust Company is keeping the portfolio target average rate of return at 8.0%. He reviewed the purpose of the DSA and explained that the DSA could be drawn against to supplement distributions when a normal distribution would require expending corpus or the Trust value is less than the corpus value. He stated that the current balance in the DSA is approximately \$30 million and as of December 31, 2012, the Trust value stood at approximately \$2.12 billion, which is less than inflation-adjusted corpus (\$2.194 billion). Earnings for 2012 were \$46 million and 50% of the DSA was \$15 million; therefore, the maximum distribution that could be made would be \$61 million. He explained that the administrative rule provides that not all of the current earnings must be distributed; some may be contributed to the DSA. When determining the distribution amount, Mr. Ballard reminded the Committee that the investment objective is to provide a predictable, stable stream of distributions, ensure that the inflation adjusted value of the distributions are maintained over the long term, and also ensure that the inflation adjusted value of the corpus (after distributions and fund expenses) is maintained over the long run.

Mr. Ballard reviewed three distribution options as outlined by the Trust Company in the presentation behind Tab 5. Option 1 would allow for the maximum distribution of \$61 million which would deplete the DSA by \$15 million and leave \$15 million in the DSA. Option 2 would match the 2012 distribution of approximately \$50 million, depleting the DSA by \$4 million and leaving \$26 million in the DSA. Option 3 would be to distribute less than options 1 and 2, impacting the DSA if at all. The Committee discussed the options and suggested that the distribution should be slightly less than the previous year which would send a message to the beneficiaries that uncertainties and volatility still exist in the market place. The Committee agreed to option #2. Chairman Stuart Ford was asked to send a cautionary letter to the trust beneficiaries explaining the circumstances and advising them of the Committee's intent to have stable distributions in the future given the economic uncertainty, and focusing on rebuilding the DSA.

***A motion was made by Fred Greene to distribute approximately \$50 million to the political subdivisions. The motion was seconded by Judge Mike Brown and unanimously approved by the Committee.***

**Discussion of Next Meeting and Agenda Items**

Committee members will be contacted to determine the best date for the next meeting in October 2013.

**Public Comment**

None.

**Adjourn**

*Judge Wayne Gent made a motion for adjournment. The motion was seconded by Fred Greene and unanimously approved. The meeting was adjourned at 12:35pm.*