COMPTROLLER'S INVESTMENT ADVISORY BOARD MEETING
Thursday, September 8, 2011
Minutes

The Comptroller's Investment Advisory Board (the "Board") met at 10 a.m. on Thursday, September 8, 2011 at the LBJ State Office Building, 111 E. 17th Street, Room 114, Austin, Texas.

Board Members Present

Comptroller Susan Combs, Laurie Dotter, Jim Hille, and Adolpho Telles.

Board Members via Teleconference

Tucker Bridwell.

Board Members Absent

Steve Strake and Scott Wise.

Comptroller of Public Accounts Staff Present

Martin Hubert, Deputy Comptroller.

Texas Treasury Safekeeping Trust Company ("Trust Company") Staff Present

Paul Ballard, Chief Executive Officer and Chief Investment Officer ("CEO"); Danny Sachnowitz, Deputy Director and Deputy Chief Investment Officer; Frank Zahn, Chief Financial Officer; Mike Samples, Director of Internal Investments; Marianne S. Dwight, General Counsel; John Wright, Assistant General Counsel; Michael Anderson, Compliance Officer; Byron Beasley, Private Markets Manager; J. Germenis, Public Markets Manager; Michael Leifeste, Real Estate Portfolio Manager; Lalo Torres, Investment Analyst; Perry Wang, Risk Analyst; Wai Yee Cheng, Portfolio Manager; Adam Levine, Portfolio Manager; Erin Corley, Private Markets Analyst; Nora Arredondo, Special Projects Coordinator; Gena Minjares, Director of General Ledger Accounting; Victor Scott, Director of Financial Reporting; Laura Montoya, Director of Administrative Services; Jorge de Lafuente, Investment Accountant; and Ruth Baker, Director of Information Technology.

Others

George Tarlas, Asset Consulting Group ("ACG"); Rick Pokorny and Paul Finlayson, Northern Trust.

Call to Order

Comptroller Susan Combs declared that a quorum was present and called the meeting to order at 10:04 a.m.

Comptroller Combs read a statement regarding the Dodd-Frank Wall Street Reform and Consumer Protection Act which requires municipal advisors to register with the SEC. The SEC's temporary ruling resulted in a disagreement over what constitutes a municipal advisor. The Comptroller's office does not believe the usual activities of this board constitute municipal advisory activities and they are working with the Attorney General's office to clarify its application. Comptroller Combs asked the Trust Company's General Counsel, Marianne Dwight, to monitor the board'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 of June 14, 2011 Meeting (Tab 1)

Ms. Laurie Dotter made a motion to accept and approve the minutes of the June 14, 2011 Comptroller's Investment Advisory Board meeting. The motion was seconded by Mr. Adolpho Telles and unanimously approved.

Discussion and Recommend Modifications to Endowment Investment Policy (Tab 5)

Comptroller Combs stated that since this board was advisory and to ensure it does not cross over into anything that could be interpreted as municipal advisory in nature, that no formal vote would be taken on this item. She asked the Board to discuss the proposed modifications and stated that she wanted to get an informal sense from the board about its comfort with the modifications which were being recommended by staff and whether it felt other changes were appropriate.

Mr. Paul Finlayson of Northern Trust reviewed the presentation related to creating private equity and real asset benchmarks that more closely represent the investment opportunity sets for the Trust Company private equity and real assets investment programs. He explained that the private equity benchmark was created using the Thomson Reuters Venture Economics pooled composite index taking the composite from each vintage year tied to the portfolio's vintage year exposure and weighted quarterly by the Trust Company portfolio residual values. Mr. Finlayson then presented the recommended real assets benchmark, which uses data from the National Council for Real Estate Investment Funds ("NCREIF"). He presented the results of the work Northern Trust did on behalf of the Trust Company to determine which benchmarks were the best fit for the portfolios. Mr. Rick Pokorny explained further the real estate benchmarking and reviewed the real estate index correlation and return as of June 30, 2011 using the various blends.

Mr. Paul Ballard and Mr. Danny Sachnowitz reviewed the recommended benchmark changes to the Investment Policy of the Texas Endowment Funds as presented in the draft behind Tab 5, section two. For enhanced return real estate, a market weighted blend was recommended instead of the custom blend set out in the document behind Tab 5. The Board recommended adding another section XI to describe all asset strategies. Ms. Laurie Dotter suggested adding language explaining that benchmarks represented returns that were "net of fees."

Comptroller Combs polled the Board informally and the members indicated their agreement with the recommended changes as presented by the Trust Company behind Tab 5 with the understanding that the benchmark for enhanced return real estate would be a market weighted blend and that a section XI containing asset strategy descriptions would be added, and further, that it would be noted that benchmark return targets were net of fees.

Capital Markets Outlook and Discussion (Tab 2)

Mr. George Tarlas of ACG presented an economic update for the period ending July 31, 2011. He reported that ACG believes the economy will continue to grow at a slow pace for the next 12-18 months. ACG believes there will not be a double dip recession. The combination of a decision by Standard & Poor's to strip the U.S. government of its AAA credit rating and the ongoing debt crisis in Europe has impacted economic growth; now slower than previously expected. Unemployment in the U.S. continues to be a concern and minimal improvement is forecasted. The housing market remains depressed and is expected to be an economic drag for the next 12-24 months. Mr. Tarlas recapped market and sector returns for the period ending July 31, 2011 as illustrated in the presentation behind Tab 2. He reported that high yielding securities were performing better than treasuries; however, in August, investors were moving back into the relative safety of U.S. government debt. The second round of quantitative easing ("QE2") largely concluded at the end June but the effects are expected to lag by 6-12 months. In August, Federal reserve Chairman Ben Bernanke indicated that the economy had not deteriorated enough to warrant immediate stimulus measures. ACG continues to believe that this challenging environment requires investors to be opportunistic and to seek investment managers with the ability to take advantage of changing market conditions.

Mr. Tarlas reviewed the asset class relative tactical allocation rankings illustrated in the stop-light charts behind Tab 2. He explained a few changes in the tactical outlook for the quarter. Non-U.S. core fixed income went from neutral to underweight and emerging market equity went from neutral back to overweight.

Economic Outlook and Review of Treasury Pool (Tab 3)

Mr. Mike Samples reviewed the Treasury Pool portfolio asset summary as of July 31, 2011 and stated that the value of the Pool was approximately $28.9 billion. As of the current date the Pool has approximately $67 million in unrealized gains. The net yield as of July 31, 2011 was approximately 0.48%. He stated that there were no good opportunities to replace the portfolio's maturing, higher yielding assets with those of similar quality offering equal or better yields. Mr. Samples reviewed the charts behind Tab 3 and noted that U.S. Treasury securities now account for approximately 57% of the portfolio. He reviewed comparative benchmark yields and stated that the yield on the Treasury Pool exceeded most of its benchmarks but was slightly lagging its custom benchmark for the quarter and the twelve month period.

Mr. Samples presented his perspective on economic growth. He reported that the economic recovery was occurring slower than most had expected. Job growth and the housing market continue to show weaknesses. He does not expect the Federal Reserve to begin raising interest rates until 2013.

Mr. Samples reported that Congress reached an agreement to increase the debt ceiling. Soon after, Standard and Poor's downgraded the credit rating of long-term U.S. government bonds for the first time in the country's history. World markets as well as the three major indexes in the U.S. then experienced their most volatile week since the 2008 financial crisis.

Endowment Portfolio Update and Related Matters (Tab 4)

Mr. Ballard presented the Board an overview of the endowment portfolio and reported that it was in compliance with the asset allocation and investment policies. As of June 30, 2011 the portfolio value was approximately $3.3 billion and was in alignment with its asset allocation targets. Mr. Ballard and Mr. Sachnowitz discussed the portfolio's liquidity profile and pointed out that the portfolio remained very liquid. Mr. Sachnowitz compared the actual vs. target asset allocations as of the end of the first quarter of 2011 and as of August 29, 2011. He noted that the asset classes were currently very near their target ranges. He also reviewed the new target allocations that will be in place on October 1, 2011 in conformance with the newly adopted asset allocation policy.

Mr. Ballard stated that the absolute return portion of the portfolio was outperforming it benchmarks. In particular, Bridgewater Pure Alpha reported outstanding returns; up 7% in August. Mr. Ballard informed the Board that Diamondback had been notified by the Securities and Exchange Commission that they were no longer under investigation and that they were not being charged with misconduct. Further, that the general partner was paying all costs related to the concluded investigation. And finally, that their strong compliance system continued to give the staff and its consultants confidence that they were taking all appropriate precautions to avoid insider trading risks.

Mr. Sachnowitz continued the review of the various asset classes and informed the Board of new managers added to the portfolio. He reported that in the hedged equity portion of the portfolio, $24 million was redeemed from the Oaktree Value Opportunities Fund as of June 30, 2011 and K2 was now fully redeemed. He reported that the portfolio performance was in line with expectations, given the current economic conditions. He reviewed the policy compliance checklist demonstrating that the portfolio was in compliance with the investment policy. Mr. Sachnowitz also reported that the portfolio's VaR ("Value at Risk") was well below that of a more traditional balanced institutional portfolio and this low risk profile had been particularly beneficial in July and August.

Mr. Adam Levine, Trust Company risk strategist summarized the principles behind the active risk management framework being developed by the Trust Company. He explained that although diversification is critical to a portfolio, true risk diversification presents significant challenges. An active risk management framework will be designed to augment the asset allocation process and enhance the ability to adapt to changing conditions. Mr. Levine reviewed the implementation processes as explained in his report behind Tab 4.

Endowment Funds Investment Performance Review for the Quarter Ending June 30, 2011 and Related Matters (Tab 6)

Mr. Pokorny of Northern Trust reviewed the investment performance of the endowment funds for the period ending June 30, 2011. The portfolio return was approximately .51% for the quarter which was largely attributed to the 4.29% return in the enhanced return portion of the portfolio. He reported that direct hedge funds outperformed the comparable funds of hedge funds in the portfolio. Overall the portfolio outperformed the policy benchmark for the quarter.

Mr. Pokorny reviewed the endowment portfolio's returns versus a universe of other public funds and endowments and foundations with asset values greater than $1 billion tracked in the Northern Trust database. The portfolio experienced an overall positive result while assuming less risk than its peers. The portfolio produced a Sharpe ratio greater than its benchmark for the one and two-year periods.

Mr. Pokorny reported that in July, while in a down market, the portfolio was up approximately .10% and the benchmark was down approximately -.17%.

Discussion of Next Meeting and Agenda Items

The next meeting will be scheduled in December 2011. No new agenda items.

Public Comment

None.

Adjourn

The meeting adjourned at 2:14 p.m.