

**COMPTROLLER'S
INVESTMENT ADVISORY BOARD MEETING
Wednesday, March 7, 2012
*Minutes***

The Comptroller's Investment Advisory Board (the "Board") met at 10 a.m. on Wednesday, March 7, 2012 at the LBJ State Office Building, 111 E. 17th Street, Room 114, Austin, Texas.

Board Members Present

Comptroller Susan Combs, Tucker Bridwell, Laurie Dotter, Jim Hille, Steve Strake, Adolpho Telles and Scott Wise.

Board Members Absent

None.

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; Erin Corley, Private Markets Analyst; Lalo Torres, Investment Analyst; Perry Wang, Risk Analyst; Wai Yee Cheng, Portfolio Manager; Adam Levine, Portfolio Manager; Nora Arredondo, Special Projects Coordinator; Gena Minjares, Director of General Ledger Accounting; Victor Scott, Director of Financial Reporting; Laura Montoya, Director of Administration; Jorge de Lafuente, Investment Analyst; and Brandy Bianco, Graphic Designer.

Additional Participants

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

Call to Order

Comptroller Susan Combs declared that a quorum was present and called the meeting to order at 10:12 a.m.

Comptroller Combs 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 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 December 9, 2011 Meeting (Tab 1)

Mr. Jim Hille made a motion to accept and approve the minutes of the December 9, 2011 Comptroller's Investment Advisory Board meeting. The motion was seconded by Mr. Tucker Bridwell and unanimously approved by the Board.

Recommended Revisions to Comptroller's Investment Policy (Tab 2)

Mr. Mike Samples reviewed a recommended revision to the Comptroller's investment policy pursuant to the investment of the treasury pool. He explained that current policy requires that any corporate bonds bought by the Trust Company be issued by companies organized and operated in the U.S. The Trust Company would like the Board to consider removing that restriction. They would like the amended policy to reflect that corporate debt securities be issued by an entity with total assets in excess of \$1 billion and whose maturity does not exceed five years from the time of purchase.

The Trust Company currently is able to buy AAA rated Canadian "covered bonds" which produce yields approximately 0.50% higher than AA+ rated U.S. treasuries with similar maturities. These covered bonds are issued by Canadian banks and the bonds are collateralized by Canadian residential mortgages. The Canadian banks hold the mortgages on their balances sheets and in the event that any of the loans supporting the bonds become non-performing, the banks replace them with performing loans. The Trust Company is able to buy and allocate them as asset backed securities but they would like to allocate them as corporate securities were it not for the U.S. domiciled restriction. Mr. Samples stated by grouping them as corporates, the Trust Company would be able to reduce the treasury's exposure to lower rated securities without sacrificing yield. Notwithstanding the intent of the policy change to allow for greater investment in Canadian securities, the Board discussed potential unintended consequences of a blanket removal of the U.S. domiciled restriction on corporate securities. Comptroller Combs directed the Trust Company to revise the language amending the policy to achieve its intended objective while, at the same time, addressing the Board's concerns. She asked that the staff work with Board members to resolve concerns and produce a final version for her adoption.

Macroeconomic Outlook and Review of Treasury Pool (Tab 3)

Mr. Mike Samples presented his perspective on economic growth. He reported that the U.S. economic recovery was slightly stronger than in previous quarters. The housing market was beginning to stabilize and unemployment showed slight signs of improvement. As previously reported, the U.S. economy is slowly healing and continues to improve at a slow pace. The ongoing economic uncertainty in the European markets continues to be a concern. Mr. Samples explained that the Bush administration tax cuts, payroll tax cuts, and the extension of unemployment benefits are scheduled to expire in the near future. He does not expect the Federal Reserve (the "Fed") to raise interest rates in the near future. He believes it will be 2-3 years before the Fed raises rates. He also stated that current economic growth was running at an annualized rate of approximately 2%.

Mr. Samples reviewed the Treasury Pool portfolio asset summary as of January 31, 2012 and stated that the value of the Pool was approximately \$25 billion and had \$70 million in unrealized gains. The net yield as of January 31, 2012 was approximately 0.52%. He stated his team was seeking options to add a few more basis points to the pool as they replaced maturing assets. Mr. Samples reviewed the charts behind Tab 3 and noted that U.S. Treasury securities now account for approximately 65% of the portfolio and that he was still not favoring agency securities. 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.

Capital Markets Outlook and Discussion (Tab 4)

Mr. George Tarlas recapped the economic events that occurred in 2011. He explained that during this third year of economic recovery, global markets were highly volatile. The European debt crisis ultimately spread to core economies in Germany and France. Emerging markets battled inflation for most of 2011 by tightening monetary policy which resulted in modest growth reduction. In 2011, the lagging housing industry coupled with high unemployment continued to depress U.S. economic growth. However, modest yet steady improvement throughout the year presented an optimistic view that a double dip recession would be avoided. Domestically, the U.S. economy continued its slow but steady rebound from the 2008 downturn. Consumer spending remained a key component of U.S. economic growth, representing approximately 70% of gross domestic product. Mr. Tarlas stated that ACG expects that the European debt issues will continue to hinder the global economy. ACG also expects 2% - 2.5% domestic economic growth. ACG does not expect the Fed to increase interest rates for the next 2 to 3 years.

Mr. Tarlas reviewed the broad asset class performance “quilt” chart and summarized performance of asset classes from 2002-2011. In short, investors turned to the relative safety of U.S. government bonds and the defensive sectors within large cap equities in 2011 to protect themselves from global economic uncertainty.

Mr. Tarlas explained ACG’s investment themes they consider most relevant today and most likely in the next 3 to 5 years. Their investment strategies include focusing on portfolio diversification, maintaining and/or enhancing exposure to fast growing regions such as emerging markets, maintaining diversified global fixed income exposure with focus on real yields, and to consider increasing exposure to equity markets.

Asset class relative rankings for the first quarter of 2012 were summarized by Mr. Tarlas. He reported a few changes in the tactical outlook for the quarter. U.S. high yield and emerging market fixed income moved from neutral to overweight, U.S. small cap equity moved from underweight to neutral and cash was taken to underweight.

Lunch speaker presentation behind Tab 5.

Endowment Portfolio Update and Related Matters (Tab 6)

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 December 31, 2011 the portfolio value was approximately \$3.09 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 fourth quarter of 2011, which conformed to the new asset allocation policy that became effective October 1. Mr. Sachnowitz continued the review of the various asset strategies and the portfolio’s diversification. He and Mr. Ballard reviewed each asset class and informed the Board of new and terminated managers. Mr. Ballard discussed the possibility of adding additional private equity exposure and the possibility of implementing via secondary funds. Mr. Wise suggested that activist managers be considered as a mechanism to gain exposure to a similar value proposition offered by private equity managers, but in a more liquid format.

Mr. Sachnowitz explained how the portfolio performed relative to its benchmark. He also reported that the portfolio performance was in line with expectations, given the current economic conditions. Mr. Ballard explained the stress test scenarios as they relate to performance in a crisis relative to policy portfolio and absolute numbers. He reviewed the policy compliance checklist demonstrating that the portfolio was in compliance with the investment policy. Mr. Sachnowitz reported that the portfolio’s VaR (“Value at

Risk”) was well below that of more traditional balanced institutional portfolios and that this low risk profile had been particularly beneficial this quarter.

Endowment Funds Investment Performance Review for the Quarter Ending December 31, 2011 and Related Matters (Tab 7)

Mr. Rick Pokorny of Northern Trust reviewed the investment performance of the endowment funds for the period ending December 31, 2011. The portfolio return was approximately 1.65% for the quarter and outperformed its policy benchmark. Mr. Pokorny reported that the portfolio grew by approximately \$41 million and the portfolio value was approximately \$3.093 billion. All four sectors of the portfolio had positive returns. Overall the portfolio outperformed the policy benchmark for the quarter by approximately 0.4%. Each sector’s performance was reviewed in further detail.

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 currently, the stock market was in positive territory and the portfolio should also be experiencing a positive return.

Discussion of Next Meeting and Agenda Items

The next meeting will be scheduled for June 5, 2012. Mr. Ballard will send a memo to the Board regarding the suggested investment policy revision.

Public Comment

None.

Adjourn

The meeting adjourned at 1:58 p.m.