

**TOBACCO SETTLEMENT PERMANENT TRUST ACCOUNT INVESTMENT  
ADVISORY COMMITTEE  
Friday, October 8, 2010  
Minutes**

The Tobacco Settlement Permanent Trust Account Investment Advisory Committee (the “**Committee**”) met on Friday, October 8, 2010 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; Judge Dan Gattis; Judge Wayne Gent; Noe Hinojosa; Faraz Khan; Joe McComb; Chuck Norris; and Judge David Silva.

**Committee Members Absent**

Commissioner Roger Galvan and Phillip Rivera.

**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; John Wright, Deputy General Counsel; Byron Beasley, Private Markets Manager; Adam Levine, Portfolio Manager; J. Germenis, Manager of Marketable Investments; Victor Scott, Director of Financial Reporting and Nora Arredondo, Special Projects Coordinator; .

**Additional Participants Present**

George Tarlas, 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 10:02 a.m.

**Approval of Minutes (Tab 1)**

*Motion was made by Judge Dan Gattis to approve the June 11, 2010 meeting minutes. The motion was seconded by Judge Wayne Gent and unanimously approved.*

**Discussion and Possible Action Regarding Distribution Stabilization Account Rule (Tab 2)**

Mr. Paul Ballard began the presentation with a discussion of the Distribution Stabilization Account (“DSA”) and its purpose as outlined behind Tab 2. He explained the unprecedented 24% decline in value in 2008 and the 15% return in 2009 still left the Trust Account below the calculated corpus value. When the value of the Trust is less than corpus, only current earnings and withdrawals from the DSA may be used to meet distribution needs. The DSA was used to supplement previous distributions and depleted by approximately 57% since 2008. The Committee asked Mr. Ballard and staff to propose amendments to the Texas Administrative Code, Title 34, Part 1, Chapter 18; Rule §18.2 (“Rule”) that specifically deals with Trust Account distributions. The Committee wanted to address limits to withdrawals that would ensure the DSA retain a balance for future needs and also consider a way to add additional funds to the DSA. The Trust Company staff and Committee members reviewed and discussed the proposed amendments.

*The Committee resolved to recommend and approve amendment of the Rule to the Comptroller as discussed. A motion was made by Judge Wayne Gent and seconded by Judge Dan Gattis. The motion was unanimously approved.*

### **Capital Markets Outlook and Discussion (Tab 3)**

Mr. George Tarlas of ACG presented an economic update and reviewed the second quarter to date. He reported that although the financial markets had improved in the last twelve months, they remained uncertain and still faced many macroeconomic challenges. May and June proved to be difficult months; however, July and September demonstrated stronger economic growth. The corporate environment experienced a strong second quarter earning period. Lagging economic indicators such as unemployment and housing had shown minimal improvement. The national unemployment rate was 9.6%. Economic growth was reported at approximately 1.6% for the quarter. ACG expects a low growth economic environment in the United States and Western Europe for the remainder of 2010 and into 2011. They believe the next twelve months will be a subdued inflationary environment and interest rates are expected to remain low. ACG believes that this challenging environment requires investors to be opportunistic and to seek managers with the ability to take advantage of changing market conditions.

Mr. Tarlas reviewed asset class rankings as of the third quarter of 2010 behind Tab 2. ACG believes emerging markets will continue to grow robustly but fixed income markets present more of a challenge in the event of a rising interest rate environment. ACG continues to view absolute return strategies favorably. They offer greater inflation protection. Mr. Tarlas explained that the strategies implemented by ACG and the Trust Company are not restricted to one currency or one country. He commented that the portfolio positions reflected these observations and expectations.

### **Presentation and Discussion of Investment Performance for Period ending 6/30/2010 (Tab 5)**

Mr. Rick Pokorny of Northern Trust reviewed the investment performance and stated that quarterly and annual rates of return for the portfolio were competitive in this volatile economic environment. He reported that as of June 30, 2010 the portfolio's total rate of return was approximately -3.88% and surpassed the policy benchmark. Currently, the portfolio was outperforming the benchmark as well. He explained how the private equity portfolio drove the positive return and had a 3.5% return for the quarter. Mr. Pokorny discussed how the portfolio took on less risk than the policy benchmark yet still outperformed the benchmark. Although the portfolio outperformed the policy benchmark, it lagged behind other public pension funds due to the significantly different asset allocation and risk exposure. Mr. Ballard explained that in terms of exposure to equities, the portfolio had a 38% allocation to equities, including 10% of that in hedged equity. Most pension funds have 65%-75% exposure to equities. Mr. Pokorny expected the estimated return for the quarter ending September 30, 2010 to be approximately 7%. The portfolio Sharpe Ratio ranked in the second quartile relative to other plans greater than 1 billion dollars for the year.

### **Endowment Portfolio Update and Related Matters (Tab 4 & handout)**

Mr. Ballard reviewed the endowment portfolio report behind Tab 3. He reviewed current versus phased-in target allocations as of June 30, 2010 and as of October 1, 2010. He reported that the portfolio was in alignment with asset allocation targets and in compliance with asset allocation policy. As of June 30, 2010, the total portfolio value was approximately \$1.86 billion and as of the meeting date the value was approximately \$1.98 billion.

Mr. Ballard presented an economic overview. Currently the economy was in the second economic easing phase. He reported that approximately one-half of U.S. debt was held by non U.S. investors. He expects the U.S. dollar to decline. He also reported that one-third of global gross domestic product ("GDP") was attributed to emerging markets and two-thirds of the growth in global GDP was attributable to emerging

markets. Mr. Ballard explained the diversification and evolution of the asset allocations in the portfolio as illustrated in the handout. He explained current commitments to the various fund managers. He reported that the portfolio performance was in line with expectations, given the current economic conditions.

#### **Discussion of Next Meeting and Agenda Items**

Committee members will be contacted to determine the best date for the next meeting in March 2011.

#### **Public Comment**

None.

#### **Adjourn**

*Motion was made by Judge Wayne Gent to adjourn the meeting. Motion was seconded by Mr. Noe Hinojosa and unanimously approved. The meeting adjourned at 12:56 pm.*