Tobacco Settlement Permanent Trust Account Investment Advisory Committee

Friday, March 25, 2011

Minutes

The Tobacco Settlement Permanent Trust Account Investment Advisory Committee (the "**Committee**") met on Friday, March 25, 2011 at 10:00 a.m. in Room 320, Rusk State Office Building, 208 E. 10th Street, Austin, Texas.

Committee Members Present

Stuart Ford,Chairman; Peggy Deming; Commissioner Roger Galvan; Judge Wayne Gent; Noe Hinojosa; Faraz Khan; Joe McComb; and Chuck Norris.

Committee Members Absent

Judge Mike Brown; Judge David Silva; and Judge Dan Gattis.

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; Michael Leifeste, Real Estate Portfolio Manager; Erin Corley, Investment Analyst; Victor Scott, Director of Financial Reporting; Michael Anderson, Compliance Officer; and Nora Arredondo, Special Projects Coordinator.

Additional Participants Present

Lester Sprouse, Padgett, Stratemann & Co.; Joe Nugent, 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 10:07 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 of what a municipal advisor is. 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 Mr. Chuck Norris to approve the October 8, 2010 meeting minutes. The motion was seconded by Judge Wayne Gent and unanimously approved.

Presentation of Annual Audit (Handout)

Mr. Lester Sprouse 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, 2010. Net assets held in trust were approximately $2.09 billion as of December 31, 2010. Mr. Sprouse affirmed that the account had been managed in compliance with the Investment Policy and the Distribution Policy. No audit adjustments were made, nor was a management letter issued.

The Committee discussed the distribution calculation process further as it relates to the revised distribution policy that became effective March 24, 2011. Mr. Sprouse explained that the audit attests to the calculation process not the decided distribution amount since it has yet to be determined. The Committee suggested adding clarifying language and a range of distribution possibilities to future audits. Mr. Sprouse agreed.

A motion was made by Mr. Chuck Norris to approve the audited financials as presented by Padgett, Stratemann & Co. The motion was seconded by Ms. Faraz Khan and unanimously approved.

Presentation of Current Market Value vs. Invested Corpus (Tab 3)

Mr. Ballard reviewed the presentation of the calculations that determine the maximum allowable distribution from the Trust. He noted that the market value at year-end was approximately $22 million less than the inflation adjusted corpus value. As a result, the distribution can only come from net earnings and may be supplemented by funds from the distribution stabilization account ("DSA").

Discussion Regarding Distribution Stabilization Account Rule (Tab 4 & handout)

A handout was distributed of the amended Trust Account Distribution Rule that had been posted in the Texas Register. No comments were received on the proposed rule. The Committee approved the rule change in its previous meeting. To summarize, the Rule allows the Committee discretion to contribute current earnings back to the DSA and also limits withdrawals from the DSA to half of its balance, which ensures a positive balance in the account.

Discussion and Approval of Annual Trust Distribution (Tab 5)

Mr. Ballard reviewed the updated Trust Account Distribution presentation. He explained that when the market value is less than the calculated corpus value, only current earnings may be distributed and that the distribution may be supplemented with up to 50% of the balance in the DSA. He stated that current 2010 earnings were $61 million and 50% of the DSA was $22 million; therefore, the maximum distribution that could be made in 2011 would be $83 million. The new administrative rule provides that not all of the current earnings must be distributed; some may be contributed to the DSA. 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 the four distribution options as presented by the Trust Company in the presentation behind Tab 4. Option 1 matches the 2010 distribution of $46 million and adds the $15 million in remaining earnings to the DSA. Option 2 increases the 2010 distribution to $51 million; an increase of 10% over the prior year, and adds the remaining $10 million in earnings to the DSA. Option 3 distributes all current earnings of $61 million, and adds nothing to the DSA. Option 4 distributes the maximum amount of $83 million, requiring a withdrawal of $22 million from the DSA. The Committee discussed the options and decided on option 2.

A motion was made by Mr. Chuck Norris to approve option 2: to distribute approximately $51 million to the political subdivisions and add approximately $10 million to the DSA. The motion was seconded by Mr. Noe Hinojosa and unanimously approved.

Capital Markets Outlook and Discussion (Tab 2 & handout)

Mr. Tom Janisch of ACG presented an economic update and reviewed the fourth quarter to date. He stated that ACG anticipates slow to moderate economic growth against a backdrop of tremendous global uncertainty. He reported that month to date, the markets were slightly negative, but year to date returns were positive. U.S. economic growth for 2011 is projected to be 3.1% and the five year expected inflation rate has risen to 2%.

Mr. Janisch reviewed asset class relative tactical rankings for the first quarter of 2011. He reported that the only change in asset class rankings was to take emerging market equity from an overweight to a neutral weighting. While ACG continues to expect high growth in emerging markets over the long term, the exceptionally high returns earned over the past 12-24 months are unlikely to continue over the near term. Mr. Janisch also noted the primary risks in emerging markets were currently higher inflation and monetary policy tightening. He commented that the portfolio was positioned properly for these expectations.

Mr. Janisch next discussed three economic themes developed by ACG and the Trust Company staff that will drive positioning of the portfolio over the next 2 to 5 years. Theme 1 anticipates a moderate growth environment in developed markets. In response, the portfolio should increase its allocation to the higher growth emerging market countries. Theme 2 anticipates continued dislocations in credit markets and an uncertain interest rate environment. In response, the portfolio should increase its allocation to alternative credit managers that invest in, for example, mezzanine debt and direct lending where capital is expected to be scarce. It should allocate to specialist distressed credit managers, and utilize managers able to tactically shift between strategies like non-US bank debt, bank loans, convertible and high yield bonds as market conditions change. Theme 3 forecasts higher inflation. In response, the portfolio should seek strategies to capitalize on expected rising inflation in emerging economies, protect from domestic inflation by increasing its allocation to real assets like gold and commodities, allocate to inflation linked securities and to infrastructure funds whose revenues ratchet up along with inflation.

Review and Discussion of the Asset Allocation Targets and Benchmarks (Tab 7)

Mr. Paul Ballard and Mr. Danny Sachnowitz reviewed the three asset allocation mixes considered within the new asset allocation policy. They explained that the mixes represented different approaches to implement the policy. Each was expected to produce a slightly different return and present different levels of risk, expressed as the volatility of their returns. When combined, the risk and return characteristics are expressed as a Sharpe ratio, which represents the amount of return the portfolio was expected to earn for each unit of risk taken. The higher the Sharpe ratio, the more efficiently the portfolio is believed to be positioned. Mix number 2 is expected to produce the highest Sharpe ratio and was favored by the Trust Company. It increases the allocation to less liquid strategies like hedge funds, private equity, private debt, and real estate. Mr. Ballard noted that the liquidity needs of the fund were well known and could be easily be accommodated by mix 2.

The Committee discussed the differences among the three portfolio mixes. Mr. Ballard and Mr. Sachnowitz described the various risk measures used in the analysis, including simulated performances during past crisis events. Mr. Ballard stated that mix 2 should do a better job preserving value than the current targeted mix. Mr. Ballard discussed the long-term capital market assumptions for the asset classes included in the analysis.

Endowment Portfolio Update and Related Matters (Tab 6)

Mr. Ballard presented an overview of the endowment portfolio and reported that it was in compliance with the investment policy. As of December 31, 2010 the portfolio value was approximately $2.07 billion and was in alignment with its asset allocation targets. Mr. Sachnowitz compared the actual vs. target allocations for the 4th quarter of 2010 and as of March 8, 2011. Mr. Sachnowitz reviewed the various asset classes and discussed with the Committee new managers added to the portfolio. He reported that the portfolio performance was in line with expectations, given the current economic conditions. The policy compliance checklist was reviewed and it was noted that the portfolio was in full compliance with requirements.

Mr. Ballard continued the review of returns and performance of specific asset classes. He updated the Committee on two hedge fund managers, Level Global and Diamondback, which had received subpoenas by the SEC in regards to potentially inappropriate trading. The managers were cooperating and no charges had been filed. Mr. Ballard stated the Trust Company and its consultants monitored both managers carefully and evaluated any changes in their organizations, redemptions by clients, and their ongoing viability as investment managers in order to manage any potential risks to the endowment. He reported that Level Global had opted to return all capital to external investors and that the Trust Company should receive its remaining redemptions the first of the month. He also reported that Diamondback had taken steps to enhance its compliance monitoring systems. He noted that there had been some redemptions from Diamondback. Mr. Ballard reported that Shumway Capital was also closing and would no longer manage outside capital.

Presentation and Discussion of Investment Performance for the Period Ending 12/31/10 (Tab 8)

Mr. Rick Pokorny of Northern Trust reviewed the investment performance of the endowment funds for the period ending December 31, 2010. The portfolio return was approximately 4.67% for the quarter which represented an approximate $144 million increase in the value of the fund. The fund produced a return of 10.35% for the calendar year. For the two months ending February 2011, the portfolio return was approximately 2.35% representing an additional $47 million increase. The portfolio experienced an overall positive result while assuming less risk than its peers. The Sharpe ratio outperformed its benchmark.

Legislative Update

Mr. Ballard informed the Committee that in an effort to help reduce the budget deficit, the Texas Legislature was looking at all endowment funds. He stated that the Tobacco Endowment fund was established by a federal court order and remained under federal court jurisdiction. The settlement that created this fund specifically states the legislature may not appropriate these funds.

Discussion of Next Meeting and Agenda Items

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

Public Comment

None.

Adjourn

The meeting was adjourned at 12:54pm.