

**TOBACCO SETTLEMENT PERMANENT TRUST ACCOUNT INVESTMENT
ADVISORY COMMITTEE
Friday, October 19, 2012
*Minutes***

The Tobacco Settlement Permanent Trust Account Investment Advisory Committee (the “**Committee**”) met on Friday, October 28, 2012 at 10:00 a.m. in Room 320, Rusk State Office Building, 208 E. 10th Street, Austin, Texas.

Committee Members Present

Stuart Ford, Chairman; Roy Browning, Jr.; Peggy Deming; Commissioner Roger Galvan; Judge Wayne Gent; Fred Greene; Chuck Norris; and Judge David Silva;

Committee Members Absent

Judge Mike Brown; Judge Dan Gattis; and Noe Hinojosa.

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, Assistant General Counsel; Jorge de LaFuente, Investment Analyst; J. Germenis, Public Markets Manager; Byron Beasley, Private Markets Manager; Victor Scott, Director of Financial Reporting; Michael Anderson, Compliance Officer; Laura Montoya, Director of Administration; 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 10:03 a.m.

Chairman Ford read a statement regarding a temporary ruling on the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) requiring that municipal advisors register with the SEC. The temporary ruling resulted in a disagreement over the definition of municipal advisory services. 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 Ms. Peggy Deming to approve the March 23, 2012 meeting minutes. The motion was seconded by Judge David Silva and unanimously approved.

Discussion of 2013 Annual Distribution (handout)

Mr. Paul Ballard began the discussion with a review of the “Corpus vs. Market Value” handout. He explained that at the end of the third quarter of 2012, the market value of the Trust was approximately \$2.077 billion and the expected adjusted corpus value for 2012 is approximately \$2.205. He explained that the statute prohibits spending Trust corpus. When market value of the Trust is less than adjusted corpus value only income may be distributed. But it may be supplemented with a withdrawal from the distribution stabilization account (“DSA”). He reminded the Committee that last year \$50 million was distributed which was comprised of \$26 million in income plus a \$24 million withdrawal from the DSA. As of September 30, 2012, the income was approximately \$29 million and was expected to increase by year end. He reminded the Committee that a letter had been sent to hospital district beneficiaries at the time the 2012 distribution was made cautioning them not to expect the same distribution or more in 2013. When asked why income was higher than last year, Mr. Ballard reported that the alternative fixed income portfolio had performed better and that the private credit portfolio was becoming more mature and beginning to produce more income this year. The Committee will decide on the amount of the 2013 distribution at its next meeting.

Capital Markets Outlook and Discussion (Tab 2)

Mr. George Tarlas of ACG presented a capital markets update and reviewed the third quarter to date. He reported that the S&P 500 and the Russell 2000, which reflect the domestic stock market, are each up approximately 30% over the last twelve months. Year to date, all the equity markets were positive, well into the double digits; however, U.S. treasuries have not performed as well. Mr. Tarlas stated that ACG anticipates slow economic growth in the U.S. of about 1-2%, against a backdrop of tremendous global uncertainty. Emerging markets economies are expected to grow at a rate of 5-6%. Mr. Tarlas explained that the Federal Reserve was conducting its third round of quantitative easing (“QE3”) and that they had indicated they were not going to raise short term interest rates until 2015. Mr. Tarlas explained that the best way to mitigate risks in these uncertain economic times is diversification and seeking managers who have the ability to adapt to changing market conditions. The Trust Company continues to focus on portfolio diversification, maintaining and/or enhancing exposure to fast growing regions such as emerging markets, and maintaining a diversified global fixed income portfolio with a focus on real yields.

Mr. Tarlas reviewed asset class relative tactical rankings and the general performance of various sectors of the portfolio for the third quarter of 2012. He reported that U.S. large cap equities had remained resilient in the wake of the European debt crisis and the struggling U.S. economy. Emerging market debt has been one of the best performing fixed income categories in 2012. Mr. Tarlas reported one change to the tactical outlook for the quarter. As a result of its recent outperformance, the emerging market fixed income asset class was being changed from an overweight to a neutral recommended weighting.

Endowment Portfolio Update and Related Matters (Tab 3)

Mr. Ballard began the presentation by reviewing the difference between economic and credit cycles and discussed the fact that the developed economies of the world were in the deleveraging phase of the credit cycle. He discussed the fragile state of the European economic union. He also explained that two global conditions were driving investment themes: the deleveraging of developed debtor nations and growth in developing creditor nations. Current investment themes that will inform ongoing portfolio construction activity are expectations of moderate growth in developed economies marked by continued credit dislocations as the deleveraging process continues. Further, that unprecedented monetary stimulus ultimately presented inflation risks. Also, that higher economic growth was expected to be found in emerging economies. He explained how the portfolio was structured consistent with the investment themes and was built with significant downside protection yet with the ability to participate in up markets.

Mr. Ballard presented an overview of the endowment portfolio and reported that it was in compliance with the investment policy. As of June 30, 2012 the portfolio value was approximately \$1.99 billion. He reviewed the portfolio characteristics and explained how the portfolio was diversified geographically. Mr. Ballard reported on each investment strategy of the portfolio. He reviewed with the Committee the performance of the portfolio's investment managers. Mr. Ballard explained how the portfolio was better protected from interest rate risk and produced twice the yield of the portfolio's fixed-income benchmark, the broad market Barclays Multiverse index. Mr. Danny Sachnowitz discussed new managers added to the portfolio as well as managers from whom investments had been redeemed. A handout was distributed that summarized the private debt portfolio. Private debt was one of the best performing asset classes in the portfolio in the last year. During the discussion, Mr. Fred Greene asked for a breakdown of the distributions showing how much was comprised of income and how much was return of capital.

Mr. Ballard reviewed the Value at Risk analysis and stated that the portfolio's performance was on target and in line with expectations.

Presentation and Discussion of Investment Performance for the Period Ending 6/30/12 (Tab 5)

Mr. Rick Pokorny of Northern Trust reviewed the investment performance of the endowment funds for the period ending June 30, 2012. The portfolio return was approximately -1.54% for the quarter, which was a half percent behind the benchmark; however, longer term results demonstrated that the portfolio had outperformed its benchmark. From inception to date, the portfolio has outperformed its benchmark by approximately 30 basis points. He reported that the second quarter proved to be a difficult market environment for equities. Generally, equities were punished and fixed income generally did well. Mr. Pokorny reviewed each asset class in further detail.

For the month of July, Mr. Pokorny reported that the portfolio was up 1.3% and for August it was up 1.6%. He stated that the expected third quarter return may be as much as 4.5%.

Discussion of Next Meeting and Agenda Items

Committee members will be contacted to determine the best date for the next meeting in March 2013, when a vote on the annual distribution will be taken.

Public Comment

None.

Adjourn

The meeting was adjourned at 12:17 p.m.