

**Oregon Investment Council
MINUTES
April 24, 2002**

The Oregon Investment Council was called to order at 9:00 a.m. by Gerard Drummond.

OIC Members Present: Jerry Bidwell, Gerard Drummond, Randall Edwards, Mark Gardiner, Diana Goldschmidt, and James Voytko.

Staff Present: Rhonda Bachmann, Doug Bovee, Jay Fewel, Steve Gruber, Linda Haglund, Norma Harvey, Curt Hartinger, Brooks Hogle, John Kreft, Perrin Lim, Michael Mueller, Kevin Nordhill and Cesar Porte.

Consultants Present: John Ilkiw, Frank Russell Company
Greg Nordquist, Frank Russell Company
Tara Blackburn, Pacific Corporate Group
Bret Biggart, Pacific Corporate Group
Neil Rue, Pension Consulting Alliance
Randall Doser, Compass Advisors

Legal Counsel: Dee Carlson, Oregon State Attorney General's Office

I. Review and Approval of Minutes - 3/20/2002 & 4/10/2002

MOTION: Randall Edwards moved approval of the 3/20/2002 & 4/10/2002 minutes. The motion was seconded by Mark Gardiner and passed unanimously.

II. Alternative Equity Annual Review

Jay Fewel and Tara Blackburn addressed the council regarding the Pacific Corporate Group (PCG) Alternative Equity Annual Review, including a broad based discussion on the private equity market place. Mr. Fewel noted that the PCG annual review usually accompanies the year-end annual report, but has been delayed due to a heightened sensitivity of certain accounting issues. He further noted that the final report should be available within the next few weeks and that the numbers in the report presented today are current and reflect year end valuations. Attention was brought to the proposed policy change at the end of the review and the hopes that the council will be "back to business" regarding re-ups and some new attractive funds. Mr. Fewel stated that the fund is well positioned to move forward and is currently within target range at approximately 11% as of 12/31/01.

Tara Blackburn outlined the private equity allocation of the OPERF portfolio. She presented data including a private equity allocation 5-year review, OPERF portfolio yearly commitments by vintage year and private equity cash flow analysis. Discussion followed regarding unfunded commitments in the \$3+ billion range including the most recent (still unfunded) Kohlberg, Kravis & Roberts (KKR) Millennium Commitment of \$1 billion. Commitments going forward were analyzed and Ms. Blackburn noted that OPERF was working towards a mature, self-funding portfolio.

The \$750 million projected annual budget portfolio pacing was addressed and noted to be revisited annually. The pace of private equity investing since 9/11/01 was considered as well as commitments and realizations.

Ms. Blackburn presented performance charts for December 31, 2001 with time-weighted and dollar-weighted returns. She provided performance charts of historical private equity returns by strategy.

Mr. Fewel discussed a survey with the participation of twenty large public funds that have private equity exposure. Of those twenty, three had the same benchmark and the balance had different benchmarks. There was no consensus of opinion and the premium varied. Diana Goldschmidt requested a copy of the survey and inquired about OPERF's expected premium. Mr. Fewel gave an answer of 300 basis points and a discussion followed regarding setting the benchmark premium. Ms. Blackburn presented information regarding private market benchmarks and time-weighted VS dollar-weighted returns.

Current and future investments became the topic of a brief discussion as well as KKR. An OPERF peer comparison chart was presented as well as a peer comparison of OPERF against corporate finance, venture capital and special situation funds.

A request was made to Ms. Blackburn to e-mail a report with unfunded commitments to the OIC. This has now been added to the Annual Report.

A 2002 preview of OPERF's top 10 active exposures as of December 31, 2001 was presented and discussed as well as potential follow-on funds and new deals in corporate finance venture capital and special situations. Ms. Blackburn emphasized PCG's focus on identified inefficiencies in the asset class.

Earnings reporting of private equity was discussed and how it factors into the earnings credited to the PERS account. Mr. Drummond made a request to consider the addition of peer group comparisons to the PCG reports.

Ms. Blackburn noted that, over all, the fund fared well compared to peers in the difficult year of 2001 in the private equity marketplace.

A Policy discussion followed regarding the existing OIC Policy 4.06.01 Alternative Equity Investments – Portfolio Standards & Procedures within OPERF. Staff recommended changing the benchmark from the S&P 500 plus 500 basis points to the Russell 3000 plus 300 basis points. Mr. Fewel recommended adding more venture capital to the portfolio going forward, reviewing distressed and secondary partnership interests as well.

Jim Voytko led a brief discussion regarding the size of our private equity bet inside our overall asset allocation for the fund, the underweighted venture capital, the overweight of buyouts and special situations, the concentration on KKR and the increasing youth of the portfolio.

PCG's due diligence process was outlined and discussed.

Mr. Drummond recommended staying with 500 bps since that has represented 1st or 2nd quartile performance historically. Mike Mueller stated that the governance document already reflects the Russell 3000 + 500 and that the request for policy change is in order to make this policy consistent with that requirement.

MOTION: Randall Edwards moved to change the benchmark in OIC Policy 4.06.01 to the Russell 3000 plus 500 basis points, to conform with the governance documents. The motion was seconded by Diana Goldschmidt and passed unanimously.

Jay Fewel noted that there has been some discussion in the past regarding the Alternative Equity Sub-Committee and the possibility of placing an OIC member on the committee. He requested direction from the council and outlined three possible options:

- 1) Leave the policy as is.
- 2) Add an OIC member and make it a four-member committee.
- 3) Add an OIC member and drop one existing member.

Mr. Fewel noted that currently the Alternative Equity Sub-Committee consists of the Senior Equity Investment Officer, the Director of Investments and the Deputy State Treasurer. He also noted that for anything to pass there must be total unanimity and that materials are furnished to the OIC two weeks in advance of the meeting date, with the provision that any OIC member can object to the deal and bring the partnership before the OIC.

Mr. Drummond asked if there were any volunteers from the OIC wishing to serve on the Alternative Equity Sub-Committee. There were none. Mr. Drummond noted that he was satisfied with the process as is.

Mark Gardiner expressed discomfort with the existing process.

MOTION: Mark Gardiner moved to add an OIC member to the Alternative Equity Sub-Committee.

Discussion followed and Dee Carlson noted that the Alternative Equity Sub-Committee is not a committee composed of the OIC but merely an organizational structure within the investment support staff, a group to which the OIC delegates minor commitments.

The motion died for lack of second.

Diana Goldschmidt left the meeting at 11:15am

III. Internal Fixed Income Portfolio Transition

Perrin Lim addressed the OIC and noted that Bill Unverzagt could not be here for personal reasons. Mr. Lim expressed the necessity to address the remaining \$2.1 billion of PERS money currently being internally managed. Mr. Lim began his employment with the State in January and has split his time 50%/50% between the Oregon Short Term Fund and Fixed Income. He has met with four of the five generalist/core plus managers (and has spoken with the fifth). He expressed his comfort with the investment professionals and capabilities of the groups. He stated that the State of Oregon is a high profile account for each of these managers and they are providing a level of service beyond expectation.

Staff's recommendations:

- ❖ Distribute the remaining 2.1 billion to the current group of managers.
- ❖ Investment policy is the same for all managers and they may strategically and opportunistically overweight or underweight specialty or extended sectors, such as high yield, at their discretion.
- ❖ No compelling case at this time to deviate from the council's current generalist strategy.
- ❖ Review manager performance over a two-year horizon.

Mr. Lim discussed the aspects of the current portfolio with the Council and noted the mismatch with the index it is measured against due to the fact that over the last two years Mr. Unverzagt has prepared it to be dispersed. The process of liquidation of current assets was discussed and the costs associated that process.

Discussion followed regarding day-one measurement of performance on the portion distributed to generalists.

Greg Nordquist presented information and joined the discussion with input from Frank Russell Company regarding the recommendation of specialist managers. Mr. Nordquist explained Russell's Investment philosophy regarding

fixed income. He presented charts and information representing generalist VS specialist strategies, advantages, disadvantages and three-year rolling top-quartile excess returns as well as a hypothetical specialist structure comparison.

John Ilkiw and Neil Rue commented on the generalist VS specialist discussion.

Mr. Drummond suggested acceptance of staff recommendations for the present time and revisiting the possibility of using specialists in the future. The Frank Russell Company was invited to present a menu of specialist managers and their track records, including information on the Russell higher ranked specialists at a future meeting.

Mr. Nordquist noted that a formal Fixed Income Annual Review was due in July and that Russell could include a hypothetical specialist structure comparison in that review.

MOTION: Gerard Drummond moved that \$2.1 billion be allocated among the existing generalists as recommended by staff and to benchmark the execution of those bonds to the existing managers starting on day one on their reception of the bonds they receive. Randall Edwards seconded the motion and it passed unanimously.

IV. Draft Proxy Voting Policy Discussion

Jay Fewel, Kevin Nordhill and John Ilkiw addressed the Council in a proxy voting policy discussion. Mr. Nordhill gave an overview of the current policy and discussed the fiduciary responsibilities of the Council citing ERISA, DOL and AIMR standards. He presented options for the future, stressed the economic value of voting proxies and outlined the standards incorporated into the draft policy. The outcome of a recent manager poll on a variety of proxy issues was presented for discussion. Mr. Nordhill noted that most managers have a policy in place to vote all proxies, managers generally vote with management, and managers vote proxies in a manner that maximizes shareholder value. Most managers use proxy voting services, such as Institutional Shareholder Service (ISS). Mr. Nordhill further noted that some organizations handle all proxy voting internally.

Peer comparisons were made with other large public funds and their proxy procedures. The majority do not vote proxies “in-house” unless they manage equities internally.

Mr. Nordhill outlined the three options presented to the Council.

Mike Mueller offered a sample copy of CALPERS proxy voting policy and reminded the Council that they employ a staff of seven devoted only to proxy voting. He noted that public funds have not proven the enhancement in value

by in-house proxy voting. He further noted that it may be beneficial to examine the guidelines of other large funds and synthesize the most useful elements.

Mr. Drummond agreed and suggested looking into the process of other large funds. John Ilkiw suggested contacting the Council of Institutional Investors (CII), of which the Treasury is a member, and hosting a workshop for examination of issues and governance.

Neil Rue joined the discussion of the economic value of proxies. He noted that large public funds such as CALPERS and CALSTRS are leading the way in terms of developing guidelines and policies for creating audit committees and developing parameters of delegation. Mr. Mueller noted that both funds manage significant equity securities in-house.

Mark Gardiner requested that the representatives from SEIU and OPEU present their views.

Denack Murphy of the Service Employees International Union, Local 503 and Joe DiNicola of the Oregon Public Employees Union presented corporate governance recommendations to the Council and outlined areas of concern. They urged the Council to adopt Staff recommended option #2 as the most effective. They were also in agreement with the suggestion to consult ISS and CII in order to view the full menu of services and options available.

Randall Edwards requested a workshop specifically to explore proxy voting, such that the Council can implement whatever strategy is desired by the next proxy season of 2003.

Kevin Nordhill suggested that the OIC direct staff to remove the "Investment Manager Policy Summary" section and adopt it without that section.

MOTION: Mark Gardiner moved adoption of attachment 4, Staff Proposed Policy 4.05.06 removing the section entitled INVESTMENT MANAGER POLICY SUMMARY. The motion was seconded by Jerry Bidwell and passed unanimously.

V. Model Performance Reporting Wrap-up

Due to pressing time sensitive issues, Mr. Drummond expressed a preference to postpone Mr. Ilkiw's presentation and asked for a brief session at the next meeting. Mr. Ilkiw stressed the need for a decision to keep on refining the prototype and indicated that he would address the issue at the next meeting. He urged Council members to contact him in the interim with any questions or suggestions.

VI. Asset Allocation 3/31/2002

- a. Oregon Public Employees
- b. SAIF Corporation
- c. Common School Fund

Mike Mueller noted that subsequent to March 31st the PERS cash was up to over \$600 million, requiring \$400 million to be transferred into EAFE International Equity, which was low relative to its target.

VII. Calendar - Future Agenda Items

VIII. Public Comments

There were no comments from the public.

The meeting adjourned at 1:15pm.

Respectfully submitted,

Norma Harvey
Investment Analyst