Oregon Investment Council
MINUTES
September 28, 2005

The Oregon Investment Council was called to order at 9:03 a.m. by Gerard Drummond.

<u>OIC Members Present</u>: Paul Cleary, Gerard Drummond, Katy Durant, Randall Edwards, Mark Gardiner and Richard Solomon.

<u>Staff Present</u>: Darren Bond, Brad Child, Inga Deckert, Jay Fewel, Linda Haglund, Norma Harvey, Andy Hayes, John Kreft, Kevin Max, Mike Mueller, Kevin Nordhill, Heidi Rawe, Kate Richardson, Ron Schmitz, McKenzie Tennent and Judy Whaley-Fultz.

<u>Consultants Present</u>: Mike Beasley, Strategic Investment Solutions (SIS)
John Meier, Strategic Investment Solutions
Tara Blackburn, Pacific Corporate Group (PCG)
Marc Weiss, Pension Consulting Alliance (PCA)
Allan Emkin, Pension Consulting Alliance

<u>Legal Counsel</u>: D. Kevin Carlson, Oregon Department of Justice

I. Review and Approval of Minutes – July 27, 2005

MOTION: Randall Edwards moved approval of the July 27, 2005 OIC Minutes. The motion was seconded by Katy Durant and passed unanimously by the Council.

II. Wellspring Capital Partners IV, L.P. – Presentation & Recommendation

Jay Fewel reviewed the existing OPERF relationship with Wellspring Capital Management. Wellspring Capital Partners IV is being organized by the General Partner to follow the same investment strategy employed successfully throughout its previous funds to make value-oriented, control equity investments in companies in need of operational and financial rejuvenation, principally in North America. Wellspring has indicated that the Fund will have a targeted size of $750 million with a hard cap of $1 billion. Wellspring is opportunistic and evaluates investment opportunities in a wide range of industries with a primary focus on consumer products, manufacturing, retail, distribution and business and consumer services. The Fund will seek to invest in under-managed or underperforming companies with strong, defensible business franchises where the opportunity exists to significantly improve profitability and cash flow. The Fund will generally make equity investments between $25 million and $150 million in such middle market special situations and restructurings with enterprise values ranging from $100 million to $500 million.

Mr. Fewel introduced Greg Feldman, principal, of Wellspring Capital Management. Mr. Feldman addressed the Council and noted that Wellspring targets basic industries such as: consumer products, manufacturing, retail, business and consumer services and distribution. He outlined Wellspring value creation through deal sourcing, due diligence and post-investment involvement. He discussed the performance of Fund II and answered questions from the Council.

Jay Fewel and Tara Blackburn answered Council questions regarding the possibility of increasing the commitment from $75 million to $100 million. Ms. Blackburn advised the Council that the fund was currently oversubscribed. Mr. Fewel noted that he would attempt to negotiate a larger commitment.

MOTION: Richard Solomon moved that the OIC authorize a commitment of up to $100 million to Wellspring Capital Partners IV, L.P. Said commitment is subject to the satisfactory negotiation of the requisite legal documents by legal counsel working in concert with OST Staff and PCG. The motion was seconded by Randall Edwards and passed unanimously by the Council.

III. Real Estate Policy 4.04.01

Ron Schmitz noted that, previously when the Heritage Fields Co-Investment opportunity was approved, staff and Council discussed the desirability of writing a co-investment policy similar in concept to the non-mandate policy then in place for direct property portfolio. During the process, it was discovered that the existing real estate committee language actually allows for and creates most of the flexibility needed for co-investments.

Mr. Schmitz outlined recommended changes to existing policy 4.04.01 and answered questions from the Council

MOTION: Randall Edwards moved approval of staff recommended changes to OIC Policy 4.04.01. The motion was seconded by Richard Solomon and passed unanimously by the Council.

IV. Starwood Hospitality Fund I, L.P. - Presentation & Recommendation

Katy Durant noted that she may have a potential conflict of interest with this agenda item because she and her husband have an ownership interest in a hotel in Portland, Oregon, for which Starwood provides management and has some equity interest. She further noted that she had previously spoken to D. Kevin Carlson of the Oregon Department of Justice. Mr. Carlson advised the Council that there was not an “actual” conflict. Principals from Starwood

Hospitality Fund noted that there was no conflict due to the fact that the Starwood Management "name only" is registered to the Starwood management company and there is no direct managerial relationship.

Brad Child reviewed staff recommendations for the proposed investment and co-investment. He introduced Elizabeth Behnke and J. Marc Perrin of Starwood Capital Group. Starwood Capital Hospitality Fund I is a closed end fund with a strategy of investing in hotels on a global basis. The fund will have a flexible mandate, allowing it to acquire both equity and debt investments in hotel assets and hotel related assets such as resorts, extended stay hotels, time shares and other lodging facilities. The total fund size will be approximately $850 million. Target markets will be the United States, Western Europe and Asia.

Ms. Behnke and Mr. Perrin reviewed the background of the firm and outlined the strengths:

- ❖ Outstanding Performance
- ❖ Experienced Team
- ❖ Unique Hotel Experience
- ❖ Unique Worldwide Insight and Access
- ❖ Exceptional Capital Markets Expertise
- ❖ Distinctive Corporate Transactions Experience

Discussion followed regarding performance, investment strategy and the Starwood team. Ms. Behnke and Mr. Perrin outlined current hotel opportunities in Europe, Asia and the U.S. Several corporate transactions were reviewed.

Mr. Perrin outlined the Groupe Taittinger Co-investment opportunity and answered questions from the Council.

Brad Child and Marc Weiss answered questions from the Council regarding other investors, structure and fees.

MOTION: Randall Edwards moved that the OIC authorize a $50 million commitment to Starwood Capital Hospitality Fund I, L.P and up to a $25 million commitment for the acquisition of Groupe Taittinger as a co-investment with Starwood Hospitality Fund I and its affiliate, Starwood Opportunity Fund VII. Such commitment is subject to satisfactory review by staff and DOJ of the fund documents. The motion was seconded by Richard Solomon and passed unanimously by the Council.

V. Diamond Castle Partners IV, L.P. – Presentation & Recommendation

Jay Fewel addressed the Council and reviewed the recommended new investment. He introduced Larry Schloss and Mike Ranger of Diamond Castle

Partners. Diamond Castle Partners IV, L.P. is being formed by Diamond Castle Holdings, LLC to continue the investment strategy successfully employed in three prior funds, each raised, invested and managed on the Donaldson, Lufkin & Jenrette, Inc. platform as well as the Credit Suisse First Boston merchant banking platform when CSFB acquired DLJ in 2000. Larry Schloss, the former Chairman of Donaldson, Lufkin & Jenrette Merchant Banking Partners, LLC is the Chairman and Chief Executive Officer of Diamond Castle Holdings. Mr. Schloss is further joined by Andy Rush, Mike Ranger, Ari Benacerraf and David Wittels, all from his former DLJ team. These Principals played material leadership roles in raising, managing and/or investing all the three prior funds while at DLJ and CSFB. Of the 111 investments made in those three funds starting in 1993, the Principals played a lead role in twenty-five of them, totaling $2.7 billion of invested capital. As of May 31, 2004 which is when the team officially left DLJ/CSFB, these investments produced a net total value multiple and a net IRR of 1.5x and 120.3%, respectively. The overall IRR is positively biased by the performance of the Principal-led investments in the first DLJ fund. Excluding investments in the first fund and looking at a composite of investments within the following two funds, the Diamond Castle team's overall performance still produced a net total value multiple and IRR of 1.4x and 15.0%, respectively.

Mr. Schloss and Mr. Ranger outlined highlights of Diamond Castle Partners IV, L.P. as follows:

- $1.75 billion private equity fund; U.S. buyouts, growth capital and structured equity.
- Led by Larry Schloss, the former Chief Executive Officer of CSFB Private Equity, Inc. ($32 billion of private equity funds under management).
- Five Principals of Diamond Castle were key members of DLJ's and CSFB's successful LBO business, comprising a majority of the investment committee for U.S. investments for the $5.4 billion DLJ Merchant Banking Partners III, L.P.
- Since the mid- 1980's, the principals have developed a shared culture, values and investment philosophy.
- Proven investment approach utilizing Operating Partners.
- Focused on power and pipelines, financial services, media and telecom and healthcare. Also opportunistic.
- Demonstrated ability to independently generate deal flow.
- $53 million (3%) capital commitment by DC Principals.

Discussion followed regarding investment performance, investment strategy, and proven investment approach. Mr. Schloss and Mr. Ranger answered questions from the Council.

Jay Fewel and Tara Blackburn discussed the proposed investment, answered questions regarding terms and conditions and the key man issue.

MOTION: Randall Edwards moved that the OIC authorize a $100 million commitment to Diamond Castle Partners IV, L.P. Said commitment is subject to the satisfactory negotiation of the requisite legal documents by legal counsel working in concert with OST Staff. The motion was seconded by Katy Durant and passed unanimously by the Council.

VI. Equity Portfolio Recommendations

Jay Fewel, Kevin Nordhill and Mike Beasley presented the Public Equity Review and recommendations. Mr. Fewel noted that in 2004, the OIC elected to move away from annual, formal reviews of each asset class. Instead, staff and consultants continually monitor the various asset classes and individual managers using a variety of tools, and make recommendations as deemed necessary.

Kevin Nordhill outlined the proposed changes to Nicholas Applegate and the termination of two T. Rowe Price products, one in the OPERF portfolio and one in the Higher Education Endowment Fund.

Discussion followed regarding the frequency of the review rotation, quarterly watchlist reports and justification for retaining poorly performing managers. Questions from the OIC were answered by Mr. Fewel, Mr. Nordhill, Mr. Beasley and Allan Emkin.

Questions regarding the performance of Wells Capital were addressed by staff.

MOTION: Richard Solomon moved that the OIC approve the following staff recommendations:

1. Change the Nicholas Applegate Mini-Cap Growth product's benchmark from the Russell 2000 Growth index to the new Russell Microcap index.
2. Terminate the T. Rowe Price Global Mainstream Equities product in the OPERF IEF. Amend OIC Policy 4.05.12 Appendix D, reallocating the target allocation from T. Rowe Price among the other active managers. Authorize staff to rebalance the T. Rowe Price assets as deemed appropriate within the OIC Policy target ranges for managers.
3. Terminate the T. Rowe Price Foreign Equity Fund in the Higher Education Endowment Fund. Retain Arrowstreet as the non-US equity manager. Authorize staff to rebalance assets within the Higher Education Endowment Fund within the OIC Policy target ranges.

The motion was seconded by Randall Edwards and passed unanimously by the Council.

Mr. Fewel updated the Council regarding Alliance Capital Management and the previously Enron-embedded, underperforming portfolio. He noted that even though the three, four and five numbers are still lagging, the last one and two year numbers are improving. He noted that some managers can address their underperformance and add value in the appropriate markets.

VII. Russell Investment Group – Policy Implementation Overlay Manager

Mike Mueller noted that beginning in late 1998, the OIC elected to have State Street Bank Trust, through State Street Global Advisors (SSgA), implement an equity manager cash equitization program. Through this program, daily, excess manager cash is invested through two different commingled investment vehicles. For domestic equities, excess cash is equitized through SSgA's Stock Performance Index Futures Fund (SPIFF) and for international equities, through their International Stock Performance Index Futures Fund (ISPIFF). The respective benchmarks for the funds are the S&P 500 Index and the MSCI EAFE Index.

Treasury staff investigated the marketplace for more sophisticated policy implementation providers, with the help of SIS. This process culminated in the issuance of a Request for Proposals in July of this year. Three responses were received and independently scored.

The Russell Investment Group scored highest and is being recommended to the OIC. The Russell Investment Group currently manages overlay strategies for 25 external clients representing assets in excess of $165 billion.

Mr. Mueller introduced Mike Thomas and Lisa Murphy of the Russell Investment Group. Mr. Thomas and Ms. Murphy outlined the policy implementation strategy and summarized their program as follows:

- Overlay frictional cash with underweight asset class (rebalatization)
  - Rebalance towards policy targets at little to no incremental trading cost
  - Expanded definition of "frictional" cash
- Manage monthly cash flow needs
  - Monitor and ensure adequate cash reserves for cash flows
  - Recommend and facilitate efficient raising of cash (e.g. unit exchanges)
  - Ensure this cash gains market exposure as described above
- Implement rebalancing policy
  - Use most cost efficient means to implement existing rebalancing policy

Mr. Thomas outlined the expected improvement after implementation and answered questions from the Council.

Mike Mueller and Mike Beasley discussed staff recommendations, answered questions from the Council and reviewed a report from Russell outlining the investment strategy, the implementation process and a summary of the program.

MOTION: Randall Edwards moved that the OIC retain the Russell Investment Group for a policy implementation cash overlay program to better align OPERF's actual investment exposures with the OIC's strategic asset allocation policy, by monitoring, daily, excess manager and OPERF frictional cash and overlaying, through futures contracts and other means, the required exposures. The motion was seconded by Katy Durant and passed unanimously by the Council.

*It was noted that Agenda Item No. 9 on the agenda would be moved ahead.

*IX. Common School Fund – Annual Review

Mike Mueller and Ann Hanus presented the Common School Fund (CSF) Annual Review to the Council. The Common School Fund ("the Fund" or "CSF") receives funds generated by timber sales, waterway leasing and other activities, conducted by the Department of State Lands (DSL). Investment returns generated by the CSF are used to provide benefits to Oregon's K-12 schools based on biennial distributions from the Fund. Ms. Hanus reviewed the history and purpose of the Common School Fund and outlined recent developments on a Department of State Lands map.

Mike Mueller and Mike Beasley reviewed staff recommendations and discussed asset allocation.

MOTION: Mark Gardiner moved approval of the following staff recommendations:
Recommendation #1 - Given the long investment horizon of the Common School Fund (i.e., in perpetuity) and the favorable experience and risk/return characteristics of enhanced index investing, staff recommends shifting the entire equity portion of the Fund from passive to enhanced indexing, as follows:

From: BGI Russell 3000 Index Fund
To: BGI Russell 3000 Alpha Tilts Fund
From: BGI MSCI EAFE Index Fund
To: BGI International Alpha Tilts Fund (MSCI World Ex-US)

The transition of the assets will be accomplished in the most cost efficient manner, maintaining the overall target allocation of 50% domestic equity and 20% international equity.
Recommendation #2 - Given the long investment horizon of the Common School Fund and the increased investment opportunity set available in a Core Plus fixed income mandate, staff recommends shifting the investment

mandates of Western and Wellington from a Core mandate to Core Plus, with a LB Universal benchmark.
The motion was seconded by Richard Solomon and passed unanimously by the Council.

VIII. OPERF Opportunity Portfolio – Policy 4.01.19

Ron Schmitz and Mike Beasley presented finalized policy language for an Opportunity Portfolio allocation within OPERF. It was noted that OIC and consultant suggestions and comments had been incorporated into the new language.

MOTION: Mark Gardiner moved approval of the creation of an Opportunity Portfolio with a targeted allocation of 0% and a maximum exposure of up to 3% of OPERF assets. The motion was seconded by Randall Edwards and passed unanimously by the Council.

X. Cost Effectiveness Measurement, Inc. (CEM) – OPERF Annual Review

Mike Mueller and Bruce Hopkins presented the Cost Effectiveness Measurement (CEM), Inc. OPERF Annual Cost Study. This cost analysis was performed by CEM for the four years ended December 31, 2004.

Beginning last year, Treasury staff provided the OIC an independent assessment of the various costs paid for the management of OPERF (e.g., management fees, custody fees, consulting fees, staff costs, etc.), and how those costs (and the resultant performance) compared to other institutional investors.

Mr. Hopkins presented a benchmarking report comparing OPERF cost and return performance to CEM's extensive pension performance database. The following topics were reviewed:

- Policy Return – The 4-year Policy Return was 4.2%. This compares to the U.S. median of 4.4% and the peer median of 4.2%.
- Implementation Value Added – The 4-year Implementation Value Added was 0.9%. This was above the U.S. median of 0.6% and above the peer median of 0.5%.
- Implementation Risk – The 4-year Implementation Risk was 1.4%. This was equal to the U.S. median of 1.4% and close to the peer median of 1.3%.
- Costs – The Total Cost of 30.2 bps was below Benchmark Costs of 38.5 bps. This suggests that the fund was low cost. OPERF was low cost primarily because it paid less for Private Equity.
- Cost Effectiveness – For 2004 OPERF was in the positive value added, low cost quadrant of the Cost Effectiveness Chart.

Mr. Hopkins and Mr. Mueller answered questions from the Council.

XI. Litigation Update – Executive Session ORS 192.660(1)(h)

Fred Boss, Chief Counsel, Civil Enforcement for the Oregon Department of Justice and Robert Stoll of Stoll Stoll Berne Lokting & Shlachter presented a litigation update to the Council. The Oregon Investment Council entered into Executive Session ORS 192.660(1)(h) from 2:19 pm to 2:23 pm.

XII. Asset Allocations & NAV Updates

Ron Schmitz reported that asset allocation and NAV updates are all within policy parameters.

XIII. Calendar – Future Agenda Items

Ron Schmitz discussed the forward agenda items as well as the November 2nd OIC Workshop agenda.

XIV. Public Comment

There were no comments from the public

The meeting adjourned at 2:37 p.m.

Respectfully submitted,

Norma Harvey
Investment Coordinator