The Education Trust Board of New Mexico

THE HONORABLE SUSANA MARTINEZ
GOVERNOR OF NEW MEXICO

DR. BARBARA DAMRON, CABINET SECRETARY
NEW MEXICO HIGHER EDUCATION DEPARTMENT

BOARD MEMBERS
DR. BARBARA DAMRON, CHAIR
ROBERT J. DESIDERIO, VICE-CHAIR
DR. JOSE Z. GARCIA
DAVID JANSEN
MARK JARMIE
EXECUTIVE DIRECTOR
THEODORE MILLER

Meeting Minutes of May 26, 2017
1121 4th Street NW Albuquerque, NM 87102

Board Members in Attendance
Dr. Barbara Damron – Chair
Robert Desiderio -- Vice Chair
Dr. Jose Garcia – Member
David Jansen – Member
Mark Jarmie – Member

Board Staff in Attendance
Theodore Miller -- Executive Director ETB
Vera Lyons – Board Secretary

Other Individuals in Attendance
Helen Atkeson -- Partner, Hogan Lovells US LLP (by telephone)
Kurt Sommer -- Sommer Udall
Kay Ceserani, Pension Consulting Alliance, LLC
Del Esparza – Esparza Advertising
Andrea Feirstein – AKF Consulting
Michelle Nelson -- Court Reporter

APPROVED
Vera Lyons
Board Secretary
8/30/2017

1) CALL TO ORDER

Vice Chair Desiderio called the meeting to order at 9:00 AM. He noted that the Chair, Dr. Damron would join the meeting shortly.

2) PUBLIC COMMENT

The Vice Chair called for public comment. There being none, he moved on to the next agenda item.

3) APPROVAL OF AGENDA

Mr. Desiderio noted the agenda as presented to the board and asked if there was any comment on the agenda. There being none, he called for a motion to approve the agenda as presented. Dr. Garcia so moved, and Mr. Jansen seconded the motion. The motion passed unanimously.

4) NM 529 BY THE NUMBERS – A CLOSER LOOK

Mr. Miller led off by reminding the board of the presentation he and Ms. Ceserani gave in the January meeting entitled "NM 529 by the Numbers". At that time the board asked to see revenue projections for the program based on the projections that had been prepared with regard to net accounts and net contributions in the program.

Mr. Miller and Ms. Ceserani had prepared these revenue projections. Mr. Miller reviewed the history of asset and account data for the program, in particular the large increase in accounts and assets that OppenheimerFunds received in 2008 as a result of the exit of New York Life from the 529 program. In effect OppenheimerFunds' assets and accounts were doubled in a single quarter. He then moved forward to the projections for the program.

Based on the average rate of loss of accounts for the prior three years the projections show a loss of 18% of total accounts between 2016 and 2020. There is a projected loss of an additional 30% of accounts between 2020 and 2025.

Mr. Miller attributed this continuing loss to the ability of OppenheimerFunds as a firm to sell a sufficient number of accounts to overcome not only the loss of older accounts generated by OppenheimerFunds, but also the loss of older accounts from the former New York Life relationship.

He observed that the data indicate that with the current program design and marketing efforts OppenheimerFunds has the ability to sell about 6,000 new accounts per year. This figure would be lower but for the 500 accounts generated each year by the National Junior Honor Society Outstanding Achievement Award Program. Responding to a question from Mr. Jarmie, Ms. Ceserani noted that the data also highlight the shift from the advisor sold

program to the direct sold program. This is a national trend, but the OppenheimerFunds has been particularly affected. Ms. Feirstein concurred with this assessment against the industry as a whole.

(At this point, 9:25 AM, Dr. Damron joined the meeting.)

Mr. Miller noted that the New York Life accounts had created a large bulge of accounts in a narrow age band. These accounts helped cushion the program somewhat, and up until 2012 accounts were growing overall although account growth was slowing. Unfortunately the New York Life accounts had been rolling off for several years. 45% of these accounts had left by 2012 and 66% by 2016. The sales efforts by OppenheimerFunds had not been strong, and as a result there is a paucity of accounts in the younger age bands.

Mr. Miller then showed the board projections for program assets in scenarios that assumed market growth of assets from a + 5% annual growth rate to a -5% annual growth rate. Assuming no market growth over the period, assets will drop below $2 billion in 2020 and below $1.5 billion in 2023. Ms. Ceserani reminded the board that the OppenheimerFunds contract is over at the end of FY2020.

Mr. Miller then reviewed the projections for ETB program revenue, based on the projections for program assets. Assuming no market growth in assets, revenues will fall below $2 million in 2020 and below $1.5 million in 2023. The effect of this revenue decline would cause the program to scale back its marketing expenses and discontinue any sponsorship or grant programs. The most significant effect would be that the program would be less attractive to potential bidders when it came time to rebid the program manager contract in 2020.

Even under the best case, which would be average market growth of 5% annually, the program would become overly reliant on market returns while experiencing continued erosion of the account base. At some point market returns will not be able to overcome continued account loss. Mr. Jarmie asked whether asset declines or account declines was the more serious issue. Mr. Miller noted that the decline in accounts was the more serious. Mr. Jarmie agreed.

5) REVIEW OF OPPENHEIMER FEE AND INVESTMENT PROPOSAL

Mr. Miller then moved on to review the current OppenheimerFunds fee and

investment proposal. He referred to Morningstar data that showed the move nationally to a smoother glidepath for age-based funds. Morningstar views such glidepaths with more than a 10% equity drop down between portfolios negatively. Ms. Feirstein noted that the Morningstar data was almost a year old and that more funds had likely moved to smooth their glidepaths.

He referred to Morningstar data that showed fee data for age-based portfolios. The data was for all age-based funds, index age-based fund and blended age-based funds. He noted that Morningstar charts an asset weighted average fee for these investment. Advisor sold plans still averaged in excess of 100 bps, but the fees are on the decline over time. Direct-sold blended plans averaged 43 bps for top-quartile plans, and direct-sold index plans averaged about 18 bps. He noted that the current TEP index product was around 70 bps and the index product in the 30-35 bps range. These were clearly not competitive. On the advisor side our plan was at about 112 bps.

Mr. Miller noted the continuing downward pressure on fees in the 529 space as well as the investment industry as a whole. This trend is further exacerbated by the implications of the Department of Labor rule regarding fiduciary liability of financial advisors with regard to retirement plans. He noted that lawyers could well seek to extend the same theories out to other investment programs such as 529.

Mr. Miller noted the extraordinary delays that occurred in getting OppenheimerFunds to respond to a request to negotiate to make the program's fees and investments more competitive. The process had taken 5 quarters with frequent delays due to the three management reorganizations of the 529 business at OppenheimerFunds within a 9 month period.

A proposal was received in March of this year. This proposal was reviewed by PCA and ETB staff. Mr. Miller noted that the proposal did smooth the glidepaths for the age-based portfolios by increasing the number of age bands from 6 to 10. This would bring the program into line with the Morningstar preference and current industry trends.

The proposal also contemplated removing the Dreyfus and TIAA index funds in TEP and replacing them with Vanguard funds. This removed relatively high cost index product along with OppenheimerFunds "fee "wrappers" and third party sub transfer agent of recordkeeping fees.

ETB's goals have been to price TEP products, particularly the TEP index products, more competitively, eliminate "wrap" fees and third party fee arrangements, improve portfolio diversity and remove some "anomalies" in the percentage

allocations to certain cash and fixed income funds in the TEP portfolios and to bring the SE and TEP investment offerings more in line with each other – primarily by restructuring the TEP asset allocation portfolios to resemble more closely the SE asset allocation portfolios. In addition ETB has sought to reduce/eliminate so-called small account fees on non-resident accounts with less than $10,000 in assets.

The OppenheimerFunds proposal did not address the issue of increased diversification, nor did it address the anomalies in the cash and fixed income allocations or the portfolio alignment issue.

The OppenheimerFunds proposal also would eliminate the growth and balanced age-based tracks in SE while leaving the aggressive age-based track. It would also reduce the TEP age-based tracks to two – the current aggressive and growth tracks. Mr. Miller noted that the proposal would rename the current growth track as the balanced track. He did not agree with this renaming nor with the 80% allocation to equities.

Mr. Miller advised the board that this was a work in progress, and that no decisions were to be made at the meeting. This was informational only.

He then addressed the proposed fees. He noted that both TEP index and TEP Blended would have reduced fees due to the use of lower cost index funds in each and the removal of "wrap" fees in TEP Blended. He believed that further negotiation would reduce the proposed fees further.

Ms. Ceserani then discussed the proposed fund line up for SE. She noted the addition of the Oppenheimer Capital Income Fund, the Developing Markets Fund and the Total Return Bond Fund. Mr. Miller noted that overall fees would remain about the same in SE.

Mr. Miller then referred to the proposed reduction to one age-based track in SE. He noted that OppenheimerFunds wanted to be able to enter into omnibus accounting relationships with large brokers. Having three age-based tracks was inhibiting this from happening due to complexity and added cost on the brokers' systems.

Ms. Ceserani then made some observations about the proposal. She regarded the smoothing of the age-based glidepaths as positive. She noted that the aggressive glidepath now started at 90% equity as opposed to 100%. PCA was lukewarm to this proposed change.

OppenheimerFunds failed to consider any new asset classes to further diversify

the portfolios. They also failed to place the different investment programs in alignment between the plans. In addition, no work was done on a review of the standalone funds in SE.

She was also troubled by the shift in the TEP age-based balanced track from 60% equity to 80% equity. She did not think that the increase in return justified the added risk.

She also noted the discrepancies between the plans with regard to exposure to international stocks, including emerging markets. There remained discrepancies between the plans with regard to fixed income investments as well. In addition the overall diversification of the portfolios is greater in SE than in TEP.

Overall there was an increase in the number of portfolios in the glidepaths, but nothing innovative in the underlying structure of the investments. She thought that the asset allocation group at OppenheimerFunds had not been involved in a significant way in the redesign other than to review the smoothing of the glidepaths.

Mr. Jarmie asked whether OppenheimerFunds was simply following trends and as a result lagging the market. Ms. Ceserani concurred. OppenheimerFunds has repeatedly been asked by ETB staff to become more innovative, but has not done so. That is evident in the current proposal.

Dr. Garcia noted that OppenheimerFunds' response appeared to be perfunctory. Ms. Ceserani noted that in the past the firm had gotten away with doing very little except following the marketplace.

Dr. Garcia asked if OppenheimerFunds was planning to exit the 529 business. Ms. Ceserani observed that 529 certainly did not seem to be a priority for the firm.

Mr. Miller noted that the board members going on the due diligence trip to New York would have the opportunity to ask these questions directly of OppenheimerFunds management.

He also mentioned that this lack of innovation was the motive behind entering into a small contract with PCA to look at strategic asset allocation. He gave a brief overview of the concept, and noted that PCA would prepare a report for the board. If the board approved a second contract could be made to do the necessary analysis.
Mr. Miller hoped that OppenheimerFunds would be willing to engage in the execution of such a strategy and not delay matters for another year.

Dr. Garcia noted that this was a very important step in the life of the board. He also observed that the revenue stream from the program seemed to be in a continued decline. Dr. Damron stated that the investment world including the 529 world was constantly changing, and that it could pass the program by if nothing was done.

6) **CLOSED SESSION PURSUANT TO NMSA 10-15-1(H)(6) AND (7) TO DISCUSS CONTRACT AND LEGAL MATTERS**

Dr. Damron called for a motion to go into closed session. Mr. Jarmie so moved and Dr. Garcia seconded the motion. The board members were then separately polled on the motion. Each member voted in the affirmative. The board went into Closed Session at 10:45 AM to discuss contract and legal matters pursuant to NMSA 10-15-1(H)(6) AND (7). At 2:30 PM the Chair asked for a motion to return to open session. Mr. Jarmie so moved. Dr. Garcia seconded the motion. The vote was unanimous to return to open session. Mr. Sommer affirmed that no other matters were discussed and no action was taken in the closed session.

7) **ADJOURNMENT**

Dr. Damron called for a motion to adjourn. Vice Chair Desiderio so moved. Mr. Jansen seconded the motion. The vote to adjourn was unanimous. The meeting adjourned at 2:31 PM.