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

Meeting Minutes of February 20, 2015
New Mexico Higher Education Dept., 5201 Eagle Rock Rd. Suite 1A Albuquerque, NM

Board Members in Attendance
Dr. Barbara Damron - Chairman
Mark Jarmie – Member
Trevor Serrao – Member (By Phone)
Robert Desiderio - Vice Chairman

Other Individuals in Attendance
Kevin Deiters - Executive Director
Theodore Miller – ETB Staff
David Mathews - HED Attorney
Helen Atkeson - Partner, Hogan Lovells US LLP
Kay Ceserani - Pension Consulting Alliance
Eric White - Pension Consulting Alliance
Bill Raynor - OppenheimerFunds
Ken Henry – OppenheimerFunds
Yvonne Gonzalez - Court Reporter

APPROVED
Vera Lyons
Board Secretary
6-4-15

AGENDA

1) CALL TO ORDER

Chairman Damron called the meeting to order at 1:08 p.m. Board Executive Director Kevin Deiters called the roll and announced that four of four Board members were present and that a quorum existed.

2) PUBLIC COMMENT

Chairman Damron called for public comment. There was no public comment.

3) APPROVAL OF AGENDA

General Counsel Mathews advised the Board that the closed session under Agenda item 7 was no longer needed.

Chairman Damron called for a motion to approve the agenda after the removal of Agenda item 7.

The motion was made by Mr. Jarmie and seconded by Vice-Chairman Desiderio. The motion was approved by unanimous consent.

4) OPENING COMMENTS AND INTRODUCTIONS – Dr. Barbara Damron, Chairman

Chairman Damron introduced Mr. Theodore Miller and she announced, who had been hired on January 31, 2015, as the Executive Director. Mr. Miller briefed the Board on his working experience and he stated that he looking forward to working for the Board.

5) MEETING MINUTES OF THE DECEMBER 11, 2014 BOARD MEETING – discussion and possible action

Chairman Damron called for a motion to approve the minutes of the meeting of December 11, 2014.

The motion was made by Vice Chairman Desiderio and seconded by Mr. Jarmie.

The motion was approved with three votes to approve and one abstention. Dr. Damron abstained from the vote because she was not at the meeting of December 11, 2014.

6) MEETING MINUTES OF THE DECEMBER 31, 2014 BOARD MEETING – discussion and possible action

Chairman Damron called for a motion to approve the minutes of the meeting of December 31, 2014.

The motion was made by Vice Chairman Desiderio and seconded by Mr. Jarmie.

The motion was approved with three votes to approve and one abstention. Dr. Damron abstained from the vote because she was not at the meeting of December 31, 2014.

7) CLOSED SESSION PURSUANT TO NMSA 10-15-1(H) TO DISCUSS THE COLLEGE SAVINGS PLAN PROGRAM MANAGEMENT AGREEMENT

This item was removed from the Agenda pursuant to Board action during Agenda item 3.

8) COLLEGE SAVINGS PAN PROGRAM MANAGEMENT AGREEMENT – discussion and possible action, Helen Atkeson, Hogan Lovells US LLP

Ms. Atkeson reported that the Agenda Items 7 and 8 were included in the Agenda while the Staff was in the midst of its discussions with the State regarding the approval of Program Manager Agreement. She explained that the Agreement has since been awarded and she asked Mr. Mathews to update the Board regarding the determination by the State that the Agreement was not subject to the Procurement Code.

Mr. Mathews responded that the Department of Finance and Administration (DFA) decided that they did not need approve this Agreement because no expenditure of state money was involved. He reported the contract had been lingering at DFA since early January and that he contacted Paul Kippert and requested a determination. Mr. Kippert reviewed the Agreement and he determined that it was not subject to the Procurement Code because the contractor would not receive payments from the State.

Mr. Mathews reported that Mr. Deiters awarded the contract during the previous week (February 18, 2015).

Mr. Deiters explained to the Board that added a hand-written comment to the signature page of the Agreement reflecting Mr. Kippert's determination that the Agreement was not subject to DFA approval. He also recommend that Board and OppenheimerFunds work together to remove unnecessary boilerplate provisions from the Agreement.

Chairman Damron instructed the Staff to work with OppenheimerFunds to remove unnecessary boilerplate provisions from the Agreement and to prepare an Amendment for Board consideration.

9) Outside Counsel Report - Helen Atkeson, Hogan Lovells US LLP

Ms. Atkeson provided an overview of her Outside Counsel Report, dated February 18, 2015, which summarizes federal and state legislation affecting IRC 529.

In December 2014, Congress passed the Achieving a Better Life Experience (ABLE) Act of 2014. The ABLE Act enacted a new 529A code section which sets forth the basis on which tax-advantaged savings accounts can be established for individuals declared disabled prior to the age of 26. The legislation is modeled after Section 529 and provides federal tax advantages for "qualified disability expenses" similar to the advantages provided by Section 529 for "qualified higher education expenses."

Ms. Atkeson presented the Board with an overview of New Mexico House Bill 467 which proposes to establish an ABLE program for New Mexico residents and for the residents of any state which contracts with New Mexico for access to the program. She reported the bill provides for the ABLE program to be created and administered by the State investment Council.

Ms. Atkeson also reported that President Obama dropped his proposal to roll back the tax-benefits of 529 college savings plans and that the Congress responded by introducing H.R. 529 and S. 335 to enhance 529 plans.

10) BOARD ADMINISTRATIVE RULES AND BY-LAWS- discussion and possible action, Helen Atkeson, Hogan Lovells US LLP and David Mathews, General Counsel

Chairman Damron called upon Ms. Atkeson and Mr. Mathews to update the Board on its Administrative Rules and By-Laws.

Mr. Mathews began the presentation by discussing the Administrative Rules and the process for their amendment. He explained that the Rules were adopted when the Board's prepaid tuition plan was in place and they need to be amended. Ms. Atkeson also pointed out that amendment of the Education Trust Act in 2014 made many of the existing administrative rules obsolete.

In his discussion of the By-Laws, Mr. Mathews stated that was not aware of any legal requirement for public boards in New Mexico to adopt By-Laws and that it was his recommendation that the Board repeal them at a later meeting.

Chairman Damron directed the Staff to draft proposed amendments to the Administrative Rules for consideration by the Board at a later meeting.

11) Open Meetings Resolution –discussion and possible action, David Mathews, General Counsel

Chairman Damron called upon Mr. Mathews to present the 2014 Open Meetings Resolution.

Mr. Mathews presented to the Board the annual Open Meetings Resolution for 2015. He explained that he it was the same as the 2014 resolution with the proposed meeting dates added at the end.

In response to a question from Chairman Damron, Mr. Mathews confirmed that Board adopts the resolution at the first meeting of the year.

Chairman Damron called for a motion to adopt the 2015 Open Meetings Resolution.

The motion was made by Vice-Chairman Desiderio and seconded by Mr. Serrao. The motion was approved by unanimous consent.

12) INVESTMENT POLICY STATEMENT AND MONITORING GUIDELINES – discussion and possible action – Kay Ceserani, Pension Consulting Alliance, Inc.

Chairman Damron called upon Kay Ceserani with Pension Consulting Alliance and Mr. Miller to present the Investment Policy Statement and Monitoring Guidelines.

Mr. Miller provided an overview the Education Trust Act and the New Mexico Prudent Investor Act and their impact upon the Board's investment policies.

Ms. Ceserani directed the Board's attention to the Investment Policy Statement and she described the following four main tenants of the policy.

- To provide the objectives of the guidelines;
- To define the roles of the parties involved;
- To define permitted investments; and
- To outline how you will monitor performance.

She discussed several changes to the policy that she would recommend to Board. The first change pertained to defining the term "full market cycle" in the stated objective of including underlying mutual funds that are in the top half of their peer universe over a full market cycle. Ms. Ceserani proposed that the Policy define a "full market cycle" as a three to five year period.

Mr. Miller asked Ms. Ceserani to explain the basis for this recommendation.

Eric White responded that it markets are driven by certain bias or themes (such as the tech-bubble). Investors need to recognize that no manager will do will in every market cycle. Mr. White described how the existing policy recognizes that managers will have periods of under-performance. He explained that PCA was recommending a three to five year period because that is typically the length of these market cycles; however, this should not be locked in stone. Investors need to consider if a manager still represents a good quality manager and whether periods of under-performance are consistent with a manager's philosophy and process.

Mr. Deiters asked Mr. White to discuss the interplay of an investment with the other investments in a portfolio and the importance of not focusing on an investment independently. Mr. White responded that Oppenheimer had done a very good job of selecting investments that complement one-another and he gave the example of how you might have a large-cap value manager outperform during one period and a large-cap growth manager outperform in another.

Mr. Jarmie asked if the Board had the ability to remove an underperforming fund regardless of the market-cycle. Ms. Ceserani responded by pointing out that this section of the policy pertained to the selection of an investment and it does not cover the monitoring or removal of funds.

Mr. White commented that it was very difficult for an investment consultant to determine if a fund is underperforming because of a consistency with its philosophy and process or because of poor stock selection or style drift. He referenced recent organization changes at PIMCO as "red-flag" that could cause an investor to quickly replace an investment.

Mr. Jamie restated his question by asking Mr. White to confirm that the Board was not locked in to the three-to-five year cycle. Ms. Ceserani confirmed that the Board was not locked into keeping an underperforming fund because of the three-to-five year cycle and that she explained that its primary purpose was to serve as a trigger for additional review and monitoring by the investment consultant.

Ms. Ceserani said that PCA would also recommend a change to the derivative section of the Policy to tighten the language pertaining to the process used in monitoring the exposure of underlying funds to the derivatives and leverage. The updated policy will clarify that the investment consultant will conduct a derivative review on a semi-annual basis and that once a year they will ask fund managers to certify that they are compliance with the Board's investment policy.

Mr. Deiters asked Ms. Ceserani to describe the difficulties involved in monitoring derivative exposures in mutual funds. She replied that the primary problem is that the information needed to monitor derivative exposures is not readily available because it is only made public on an annual or semi-annual basis.

Ken Henry commented that it is important to understand that for a retail mutual fund that the prospectus is the legal document that controls the fund and that no single investor can change the prospectus rules for how a fund is managed. The Board has the option to remove an underlying fund from the program if it does not conform to the investment policy; however, it cannot direct the fund to change its structure.

Ms. Ceserani continued her presentation by providing a summary of proposed changes to the Monitoring Guidelines. As discussed in previous Board meetings, she will remove references to multi-fund and aged-based portfolios because PCA monitors the performance of underlining funds and not the investment portfolios. They will also clarify how PCA assigns a performance status for an underlying fund and provide additional language on how an underlying fund may be placed on the watch list for "qualitative" reasons. Lastly, PCA will proposed language on restoring a fund into the program after it has been removed by the Board for under-performance.

Ms. Ceserani provided an example of how a fund is monitored over three different rolling time periods and she described the process that PCA follows when a fund is on the watch list.

She used the Oppenheimer Value Fund as an example of fund that reflects a special situation not identified in the Guidelines. The Value Fund has been on the Watch list for over 30 months; however, the fund's portfolio manager was changed approximately 18-months ago and he changed the fund's investment strategy and replaced most of the stocks in the portfolio. The Board interviewed the portfolio manager and decided to stick with the fund; however, the Watch-List reports do not differentiate between the performance before and after the portfolio manager change.

Chairman Damron asked Ms. Ceserani for the percentage of funds on the Watch-list. Ms. Ceserani replied that in her experience that a third of all managers are on watch.

Ms. Ceserani discussed the complexity of replacing a fund in the program because of the commitment to the single fund family and because of the limited number of funds that can be considered for inclusion in the 529 program. She described one of the consequences of selecting an outside fund as higher costs.

Ms. Atkeson followed up Ms. Ceserani's comments about the use of outside funds by pointing out the contractual commitments that the Board has made to use Oppenheimer funds (70% of total assets under management).

Dr. Damron asked if the Board had any prohibited investments. Mr. Deiters responded that the Board did not have any prohibited investments and he directed the Board's attention to page 6 of the Investment Policy.

Mr. Jarmie commented that he had concerns about the underperformance of the Value Fund and that he would like to see options at the March meeting. Ms. Ceserani agreed to work with Oppenheimer Funds to bring options to the Board for consideration.

13) DERIVATIVE REVIEW OF UNDERLYING FUNDS - discussion and possible action –Kay Ceserani, Pension Consulting Alliance, Inc.

Chairman Damron called upon Kay Ceserani to present the Derivative Review of Underlying Funds.

Ms. Ceserani provided on overview of her report entitled *Underlying Fund Derivative Exposure*, dated February 20, 2015. She explained the Board's investment policy requires PCA to review each fund manager's use of leverage and to conduct an additional review for any fund where the assets-to-net assets ration exceeds 110%.

Ms. Ceserani identified the following funds with an assets-to-net assets ratio that is near or exceeds 110%:

- American Century Diversified Bond Fund (110.2%);
- Dreyfus Bond Market Index Fund (111.3%);
- Oppenheimer Limited-term Government Fund (123.5%); and
- Oppenheimer Global Strategic Income Fund (109.6%).

Ms. Ceserani reported that PCA's further analysis found that all the responding funds were utilizing derivatives and that the gross assets-to-net assets ratio for all of the funds under review were above the 110% threshold due to their exposure to TBAs (To-Be-Announced Mortgage Contracts).

She advised that PCA does not have the same level of concern with regards to TBA exposure relative to other forms of derivative securities because TBA contracts are backed by government guaranteed mortgage pools and provide significant liquidity to the agency mortgage backed securities market.

Ms. Ceserani concluded her presentation by stating that PCA does not have any concerns and that it believes the funds under review have been operating within the NMETB investment policies as it relates to the use of derivatives.

14) COLLEGE SAVINGS PROGRAM PORTFOLIO AND ASSET ALLOCATION REVIEW- discussion and possible action- Ken Henry, Vice President, OppenheimerFunds and Kay Ceserani, Pension Consulting Alliance, Inc.

Ken Henry provided the Board with on overview of his report entitled *New Mexico 529 Asset Allocation & Glide Paths*, dated February 20, 2015.

He noted that the existing New Mexico College Savings Plan, both the Education Plan and Scholar's Edge, have a single age-based glide path consisting of six age bands.

Mr. Henry pointed out the equity allocations of the age-based portfolios have been more aggressive than the 529 industry averages for the first three age-bands and equal to or more conservative than the industry averages for the final three age bands. He stated that Oppenheimer has been comfortable with those higher allocations during the early age-based bands because investors can generate higher earnings. For the last three age bands, the equity allocations have been more conservative than the industry averages because of the shorter time frames involved as students approach or are in their school years.

Mr. Henry stated that Oppenheimer recommended adding two additional glide paths to TEP and Scholar's Edge in order to appeal to consumers with lower risk tolerances- for a total of three glide paths. These would be called the Aggressive, Moderate and Conservative Age-Based Portfolio Choices.

This new structure appears in approximately 40% of the current college savings plans in the marketplace, and permits less aggressive investors to select from more conservative asset allocation options.

He also stated that Oppenheimer recommended the addition of two more portfolios to the current Custom Choice Portfolios under each plan – for a total of eight Custom Choice Portfolios. These two new portfolios would be called the Fixed Income Portfolio and the Low Duration Fixed Income Portfolio. Again, these are more conservative than the current Custom Choice Portfolios.

He stated that each Age-Based Portfolio ultimately consists of one of the Custom Choice Portfolios. For example, the Aggressive Newborn to Age 5 Portfolio consists of the Custom Choice Aggressive Portfolio, and the Moderate Newborn to Age 5 Portfolio consists of the Moderately Aggressive Custom Choice Portfolio. He noted that this is a very efficient and cost effective way to offer the different Portfolios.

Current investors in the College Savings Programs will remain in their current Portfolios at the start of the new investment program, but will have the option of changing to the new Portfolios.

Ms. Atkeson noted that the changes to the Portfolios and any changes to Underlying funds in those Portfolios would need to be communicated to investors. Mr. Henry noted that changes in Underlying Funds is something that has happened before in the Programs, and that there is a process in place to notify investors of such changes.

Dr. Damron asked whether or not the additional complexity of the investment lineup would discourage investors from investing in the Programs. Mr. Raynor replied that for the advisor-sold product this should not be a problem, as the advisor can help the investor make choices. As for the direct-sold product, he noted that nearly 40% of college savings plans have this kind of structure, and he was not aware of any significant difficulties experienced by investors in those plans.

Ms. Ceserani of Pension Consulting Alliance then began PCA's review of the proposed changes to the Portfolios. She noted the following changes to the Portfolios:

1. The addition of two new static options, the Fixed Income and Low Duration Portfolios;
2. The addition of two new Age-Based tracks;
3. A slight increase in International Equity exposure, and;
4. Changing the Money Market Portfolio to a Short Duration Portfolio.

She stated that the PCA analysis of the three Age-Based tracks shows that each one performs as expected for aggressive, moderate and conservative asset allocations. She noted that PCA did not have any concerns about the new tracks, and that it is a good thing to increase investor choice with regard to risk tolerance.

Mr. White reiterated the idea that added choice for different risk tolerances is a good idea, and that in his experience with other states 529 plans he had not seen any reduction in participation by investors as a result.

Dr. Damron asked for a motion to accept the new Portfolio structures. Mr. Desiderio so moved. Mr. Jarmie seconded the motion. Dr. Damron called for a vote on the motion and it was approved unanimously.

15) FY 2014 FINANCIAL AUDIT REPORT – Javier Machuca and Alan Demir, REDW, LLC

Dr. Damron called upon Mr. Machuca and Mr. Demir to present the Financial Audit Report for FY2014. Mr. Machuca commented that REDW had received great support from the custodian of the Education Trust assets. He then introduced Mr. Demir to discuss the status of the audit.

Mr. Demir noted that the audit was complete and had been submitted to the state auditor on time. It had been approved and was released to the public. REDW issued a qualified opinion with regard to the program administration fund and an unqualified opinion with regard to the Education Trust fund.

Mr. Machuca noted that the statewide cash balance in the SHARE system general ledger accounts have not been reconciled to the State General Fund Investment Pool since the implementation of SHARE in July, 2006. As of June 30, 2014 The Education Trust Board had $863,762 invested in the State General Fund Investment Pool. Due to the lack of reconciliation between the data on the SHARE system and the State General Fund Investment Pool, REDW felt it necessary to qualify its audit opinion with regard to the Education Trust Board.

Mr. Machuca stated that the qualified opinion was due to the overall problem with the SHARE reconciliation and not to anything under the Education Trust Board's control.

Mr. Demur also noted the excellent cooperation of the Education Trust Board's management and staff during the audit. He discussed four major adjustments:

1. An adjustment to equity at the beginning of the year;
2. Adjustments for fees that go back and forth between the Board and OppenheimerFunds;
3. Adjustments to the scholarship balance, and;
4. An adjustment for a $500,000 check from OppenheimerFunds to the Board.

Mr. Demir pointed out a material weakness in the FY2014 audit. Due to a lack of internal control procedures, the financial information produced by the SHARE system was not reliable and significant audit adjustments were necessary.

He also noted a significant deficiency in the overspending of the Other Cost budget category in the administrative fund by $572,306. Procedures need to be put in place to prevent expenditures in excess of budget. He noted that the overall budget was not overspent, but that a budget adjustment could be done to avoid this type of deficiency in the future. In addition, revenues estimates were not budgeted. Revenues should be budgeted.

Dr. Damron noted that the Board was trying to hire a financial coordinator to assist the executive director with financial matters such as those mentioned by the auditors.

16) FY 2015 AUDIT CONTRACT WITH REDW, LLC; discussion and possible action – Kevin Deiters, Executive Director

Mr. Demir then presented REDW's audit proposal for FY2015. Unless there are significant differences in the number of Portfolios or other extenuating circumstances, REDW proposed a fee of $70,093 plus $4,907 in gross receipts tax –totaling $75,000.

Dr. Damron called for a motion to accept the REDW audit proposal for FY2015. Mr. Desiderio made the motion and Mr. Jarmie seconded the motion. The vote was unanimous in favor of accepting the proposal.

17) REQUEST FOR PROPOSAL FOR FIDUCIARY SERVICES; discussion and possible action – Kevin Deiters, Executive Director

Mr. Deiters then asked for approval from the Board to issue a request for proposal for Fiduciary Services. The scope of duties would include:

1. Fiduciary audit;
2. Fiduciary training;
3. Outsourcing interim management, and;
4. Evaluation of executive management candidates.

He noted that this should enable the Board to develop an on-going training program and implement a formal third-party review of its processes. Most importantly, the Board could have access to interim professional management during any extended vacancy of the Executive Director position.

Dr. Damron called for a motion. Mr. Desiderio made the motion and Mr. Jarmie seconded the motion. The vote in favor of the proposal was unanimous.

18) REQUEST FOR PROPOSAL FOR MARKETING SERVICES; discussion and possible action – Kevin Deiters, Executive Director

Next Mr. Deiters asked for approval from the Board to issue a request for proposal for college savings outreach and marketing services.

Mr. Deiters noted that the new contract with the Program Manager called for the Program Manager to provide $150,000 each year for in-state marketing efforts. The scope of duties would include:

1. Developing and executing a multi-year marketing plan dedicated to promoting TEP across the varied population in New Mexico with the goal of increasing participation by New Mexico residents;
2. Organizing and managing a marketing outreach campaign, including outreach to low and moderate income residents of New Mexico;
3. Providing dedicated field representatives available to market TEP to employers and community groups within New Mexico, and providing other in-State marketing initiatives and assistance as determined by the Board;
4. Developing benchmarks and research to measure the effectiveness of outreach efforts, and;
5. Reporting to the Board each quarter on the marketing efforts.

Dr. Damron called for a motion to approve the issuance of the request for proposal. Mr. Jarmie made the motion and Mr. Desiderio seconded the motion. The vote was unanimous to approve the issuance of the request for proposal.

19) EXECUTIVE DIRECTOR'S REPORT – Kevin Deiters, Executive Director

Mr. Deiters then presented the Administrative Fund Balance to the Board as of January 29, 2015. He noted the balance was $5,293,082.57.

20) ADJOURNMENT

There being no further business to come before the Board, Dr. Damron asked for a motion to adjourn. Mr. Serrao made the motion and Mr. Jarmie seconded the motion. The vote was unanimous to adjourn at 4:02 PM.