

The Education Trust Board of New Mexico



THE HONORABLE SUSANA MARTINEZ
GOVERNOR OF NEW MEXICO

DR. JOSÉ Z. GARCIA, CABINET SECRETARY
NEW MEXICO HIGHER EDUCATION DEPARTMENT

BOARD MEMBERS
DR. JOSÉ Z. GARCIA, CHAIRMAN
ROBERT J. DESIDERIO, VICE-CHAIR
ROBBIE HEYMAN, ESQ.
TREVOR SERRAO

Meeting Minutes of May 22, 2013, 1:00 p.m.

New Mexico Higher Education Department
5201 Eagle Rock NE, Suite 1A
Albuquerque NM 87113

Board Members in Attendance

Dr. José Garcia, Chairman
Robert Desiderio, Vice-Chair
Trevor Serrao, Member

APPROVED

Board Members Absent

Robbie Heyman

Other Individuals in Attendance

Kevin Deiters - Executive Director
Angela Gallegos - Board Secretary
David Mathews - HED Attorney
Helen Atkeson – Partner, Hogan Lovells US LLP
Bill Raynor - OppenheimerFunds
Ken Henry - OppenheimerFunds
Steve Dombrower - OppenheimerFunds
Michael Kotlarz - OppenheimerFunds
Laton Spahr - OppenheimerFunds
Jeremy Thiessen - Pension Consulting Alliance
Andrea Feirstein - AKF Consulting Group
Kristina Martinez - Rothstein Law Firm
Yvonne Gonzales - Court Reporter

AGENDA

1) CALL TO ORDER

Chairman Garcia called the meeting to order at 1:01 p.m. Board Secretary Angela Gallegos called the roll and announced that three of four members were present and that a quorum existed.

2) PUBLIC COMMENT

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

3) APPROVAL OF AGENDA

Chairman Garcia called for a motion to amend the order of the agenda to enable the Board to go into Executive Session before it considers the approval of the minutes.

Mr. Desiderio made a motion to approve the amended agenda and move into executive session. Mr. Serrao seconded the motion. The amended agenda was approved unanimously.

4) EXECUTIVE SESSION – discuss program litigation

Chairman Garcia stated the Board is moving into Executive Session at 1:03 p.m. to discuss program litigation.

Chairman Garcia announced that the Board had returned to open session at 2:03 p.m. and that no action was taken in Executive Session.

5) MEETING MINUTES OF THE MARCH 21, 2013 BOARD MEETING

Chairman Garcia called for a motion to approve the minutes of the March 21, 2013 Board meeting.

Mr. Serrao made a motion to approve the minutes of the March 21, 2013 Board meeting. Mr. Desiderio seconded the motion. The minutes of the March 21, 2013 Board meeting were approved unanimously.

6) OUTSIDE COUNSEL REPORT – Helen Atkeson, Hogan Lovells US LLP

Chairman Garcia called upon Helen Atkeson for the outside counsel's report.

Ms. Atkeson provided an overview of her May 20, 2013 memorandum covering the services provided by Hogan Lovells US LLP since the March meeting. Ms. Atkeson stated she assisted Mr. Deiters with the review of the Supplement to the Scholar's Edge Plan Description, marketing materials, brochures and a revised application to reflect the new individual fund portfolios and option for rebalancing ("Portfolio Allocator") approved by the Board at the December 5, 2012 meeting.

Ms. Atkeson reported that, in response to the findings of the REDW audit regarding the controls in place for OFI and its subcontractors, Brown Brothers Harriman & Co ("BBH") and Citibank, Mr. Deiters scheduled a Denver site visit in April and requested information relating to these third party administrative and custodial

arrangements. She reviewed the contracts and other information regarding these arrangements and attended meetings held as part of the site visit. Ms. Atkeson concluded that a more detailed understanding of these third party arrangements and the respective functions was established as a result of the information obtained at these meetings.

Chairman Garcia called on Mr. Deiters to comment on the Denver site visit.

Mr. Deiters stated that he had a much better understanding of the relationships and the internal controls in place between BBH, Citibank and Oppenheimer. He advised the Board that a New York site visit to review the investment end of the operations is being scheduled for this summer.

Chairman Garcia seconded the remarks of Mr. Deiters stating that it was a useful meeting and he learned a good deal about the complexities involved in administering a program of this size.

7) COLLEGE SAVINGS INDUSTRY UPDATE – Andrea Feirstein, AKF Consulting Group

Chairman Garcia called on Andrea Feirstein to give an update on the college savings industry.

Ms. Feirstein updated the Board on her report entitled *College Savings Industry Update of May 22, 2013*. She reported that 529 Plans continue to grow while New Mexico's position in the industry is relatively unchanged. The Education Plan asset growth mirrors national growth at 16.6 percent with Scholars Edge growth slightly less robust but still very strong at 9.9 percent.

Ms. Feirstein reported that the industry continues to remain very competitive in terms of fees and it will have an active calendar coming up over the next two years in terms of solicitations and renewals of program management engagements.

Ms. Feirstein stated that Morningstar continues to attempt to define the market standard for the college savings industry. She reported that ratings have been generally consistent across plans and managers and that Scholar's Edge has remained Average/Neutral over the last three years.

Ms. Feirstein advised the Board that Morningstar rated Oppenheimer Funds' New Mexico and Illinois Advisor-sold Plans as "Neutral". Morningstar gave each of the plans a "Negative" rating for investment performance. She also commented on the price differential between the two plans. While The Education Plan is not rated by Morningstar, the Illinois Bright Start Plan is Bronze rated with a "Positive" Price rating. The Education Plan's average fees appear to be well behind the fees of the Illinois Bright Start plan.

8) SCHOLAR'S EDGE PROGRAM UPDATE – Steve Dombrower, OFIPI

Chairman Garcia called upon Steve Dombrower with OFIPI to provide the Board with an update on the new investment options in Scholar's Edge that were implemented on May 13, 2013.

Mr. Dombrower reported on the new investment options in Scholar's Edge that were launched by Oppenheimer on May 13. Mr. Dombrower credited the team at Oppenheimer with the successful rollout and development of new marketing materials and an updated website. He provided the Board with an

overview of the 15 new investment options and the new option for investors to build customized portfolios with automatic rebalancing.

Mr. Dombrower described how OppenheimerFunds made its website easier for advisors to access 529 plan product information online without having to log-in to its site. He also explained that they will illustrate mathematically, in the brochure and across the marketing materials, that saving for college will actually decrease out-of-pocket college costs over time.

Mr. Dombrower stated that they are training the tens of thousands of financial advisors that sell OppenheimerFunds how to sell the concept that college can be attainable and affordable with a "start early and save often" approach.

9) PROGRAM MANAGER REPORT

a. Marketing Report – Bill Raynor, OFIPI

Chairman Garcia called on Mr. Raynor to provide the Marketing Report.

Mr. Raynor summarized account and marketing information in the *OFI Private Investments – New Mexico 529 Quarterly Report for the Period Ending March 31, 2013*. He reported that The Education Plan (TEP) is increasing state penetration. One of the challenges for TEP is how to compete on a national basis without this being a wholesale national program.

Mr. Raynor provided a follow-up to a question raised by Chairman Garcia at the last meeting about rollovers. He reported that Nevada (12 percent), Maine (10 percent) and Virginia (10 percent) were the top three states receiving rollovers of TEP assets. Mr. Raynor explained that Utah and Virginia offer investment options that are equal to or cheaper than the investment options available under the TEP plan. He could not explain the volume of roll-overs to Maine because it is relatively expensive and it is not a national direct-sold plan.

Mr. Raynor then discussed the turnover in the advisor community and its impact on rollovers for Scholar's Edge. Mr. Raynor reported that 21 percent of the roll-overs out of Scholar's Edge were transferred to College America (Virginia), which is the largest advisor-sold plan in the United States, and 11 percent are transfers to the New York plan. He also identified a trend of assets moving from advisor-sold plans to lower-cost direct-sold plans, including in Nevada and New Hampshire.

Mr. Raynor advised that he and Mr. Dombrower would work with Mr. Deiters to analyze the information he has received and develop a strategy to reduce the number of roll-overs from the New Mexico plans.

b. Quarterly Investment Performance Report – Ken Henry, OFIPI

Mr. Ken Henry of Oppenheimer Funds provided the Board with a summary of the *OFI Private Investments – The Education Plan & Scholar's Edge Portfolio Performance Report for the Period Ending March 31, 2013*.

Mr. Henry stated that the equity investments in the TEP plan slightly underperformed during the quarter. He provided the Board with a brief review of the Main Street Fund and Main Street Small and Mid-Cap Fund.

Mr. Henry directed the Board's attention to the International Growth Fund and he stated that the fund continues to perform well over virtually every time period. He stated that the Thornburg International Value fund has struggled over the past year and underperformed by 260 basis points during the quarter.

In his report on the fixed income investments, Mr. Henry reminded the Board that it added the Senior Floating Rate Fund to the investments in December by reallocating \$120 million assets from two funds benchmarked to Barclay's Aggregate Bond Index. The Senior Floating Rate Fund had a positive return of 235 basis points during the quarter, whereas the Barclay's Aggregate Bond Index had a negative return of 12 basis points. As a result of the Board's reallocation of these portfolios, participants have \$2.75 million more in plan assets.

Mr. Henry explained that there were similar total return numbers in the high single digits for investments in Scholar's Edge. The returns for the portfolios in Scholar's Edge were equal to or outperformed the blended benchmarks. This performance results from the addition of the Senior Floating Rate Fund and some international bond assets. In addition, Mr. Henry highlighted the MainStay High Yield Fund as another example of a fund adding absolute return to the Scholar's Edge portfolios. Although the fund underperformed its benchmark during the quarter because of its conservative nature, it added an absolute return of 2.6 percent during a quarter when fixed income was relatively flat.

Mr. Henry referred to Ms. Feirstein's presentation regarding Morningstar's review of investment performance for Scholar's Edge using five-year performance numbers. Performance during this period was impacted by the negative performance of the Core Bond Fund and the Scholar's Edge portfolios were in the 90th percentile (the bottom 10 percent performance). In comparison, Mr. Henry cited a survey by Joe Hurley and Savingforcollege.com that used a different methodology to calculate performance. In this study, using performance for the one-year period ending March 31, 2013, Scholar's Edge was in the top-half of the ranked plans and, using performance for a three-year period, was near the top-third of all ranked plans.

Mr. Desiderio asked Mr. Henry if the investment returns cited in his report for Scholar's Edge were net of fees while the benchmark indices do not have fees. Mr. Henry confirmed that the returns were net of fees. In a follow-up question, Mr. Desiderio asked if the negative variances between a fund's performance and its benchmark were overstated due to the impact of the fees. Mr. Henry agreed.

10) INVESTMENT CONSULTANT QUARTERLY REVIEW - Jeremy Thiessen, Pension Consulting Alliance, Inc.

Chairman Garcia called on Mr. Thiessen to report on investment performance for the quarter ending March 31, 2013.

Mr. Thiessen provided a review of his report, "*New Mexico College Savings Program Investment Performance Monitoring Reports*" for the quarter ending March 31, 2013. He provided the Board with an overview of the capital markets and the relative performance of leading indicators.

Mr. Thiessen began his presentation on the performance of underlying funds by stating that there was not a lot of change during the quarter. He pointed out the under-performance of two funds on the Watch List, the Oppenheimer Capital Appreciation Fund and the Oppenheimer Value Fund (which are in both TEP and Scholar's Edge), and he reminded the Board that it would receive presentations by these fund managers later during the meeting. He stated that the Capital Appreciation Fund has seen modest improvement over the same period while the Value Fund remained flat. Mr. Thiessen also reported that there was one additional Scholar's Edge fund on the Watch List, the Mainstay MAP Fund, which had outperformed its rolling 12 month benchmark by 25 basis points.

11) **WATCH LIST** - discussion and possible action – Jeremy Thiessen, Pension Consulting Alliance, Inc.

Mr. Thiessen provided the Board with an overview of his "*Watch Status*" Update memorandum dated May 6, 2013. He reported that he had no changes for the watch list and the three funds on the Watch List (Oppenheimer Capital Appreciation Fund; Oppenheimer Value Fund; and MainStay MAP Fund) should remain on watch with no additions.

Mr. Thiessen explained that during past twelve months that the Oppenheimer Capital Appreciation Fund has been on watch, it has underperformed its benchmark by 1.2 percent and that, during the 11 month period that the Oppenheimer Value Fund has been on the watch list, it has underperformed its benchmark by 4.1 percent.

The remaining fund on the Watch List, the MainStay MAP Fund, has outperformed its benchmark by 1.7 percent during the six-months that it has been on watch. Mr. Thiessen stated that PCA believes that this fund can be removed from the Watch List in the next quarter or two if this performance trend continues.

Mr. Thiessen discussed the provision of the Monitoring Procedures and Criteria that calls upon the investment consultant to come back to the Board with a recommendation within 12-to-18 months of a fund's placement on the Watch List. As part of that process, he asked the portfolio managers for the Oppenheimer Capital Appreciation Fund and the Oppenheimer Value Fund to make a presentation to the Board.

Mr. Henry introduced Mr. Michael Kotlarz, Co-Portfolio Manager, to present on behalf of the Oppenheimer Capital Appreciation Fund.

Mr. Kotlarz introduced himself to the Board and provided a summary of his professional experience. Mr. Kotlarz provided an overview of the fund's philosophy and investment process. He explained that they are a long-term strategic, high-quality growth manager whose goal is to participate in up-markets while offering capital preservation in down markets. Mr. Kotlarz also stated the fund's philosophy that quality outperforms over the course of a business cycle.

Mr. Kotlarz addressed concerns about the fund's performance by acknowledging the long-term under-performance of the fund. He stated that the fund is starting to slowly improve and that MorningStar has rated the fund with a below average risk ratio relative to its peers.

Mr. Kotlarz pointed out this was a difficult market for high-quality companies because people are buying lower quality companies just to get a higher yield. Mr. Kotlarz concluded his presentation with his opinion that we were entering the part of the business cycle where the fund's holdings of blue chip stocks can differentiate themselves.

Mr. Desiderio asked Mr. Kotlarz to explain the rating system used on the chart on page 39 of the report. Mr. Kotlarz explained that it demonstrates the performance by companies when the economy is decelerating. Mr. Kotlarz pointed out that the average growth fund has a rating of about a "B" while the Oppenheimer Capital Appreciation Fund has an average rating of about an "A-".

Mr. Henry asked Mr. Kotlarz to clarify that, although the average company in the Oppenheimer Capital Appreciation Fund has an average rating of "A-", the Fund also owns stocks in companies with higher and lower ratings that could profit during other market periods. Mr. Kotlarz agreed with Mr. Henry's statement.

Chairman Garcia asked Mr. Kotlarz to describe the current stage of the business cycle and if that is a factor in the Board's decision to continue to invest plan assets in the Oppenheimer Capital Appreciation Fund. Mr. Kotlarz responded that we were in the mid-cycle of this business cycle with the U.S. on solid economic footing, Europe in a state of trying to stabilize, and China in a state of slow growth.

Following up on the question raised by Chairman Garcia, Mr. Thiessen ask Mr. Kotlarz to explain what needs to happen for the stocks held by the Oppenheimer Capital Appreciation Fund to outperform. Chairman Garcia concurred with Mr. Thiessen's question and asked Mr. Kotlarz how the Board should have confidence in the Fund going forward.

Mr. Kotlarz responded that we needed to see continued solid growth in the U.S. economy, stabilization in Europe, and a continued soft landing in China. He also expressed concern that additional amounts of quantitative easing by the Federal Reserve could present issues for the Fund.

Chairman Garcia asked about the impact of inflation. Mr. Kotlarz explained that higher quality funds outperform during inflationary periods and that higher inflation would put more pressure on the Federal Reserve relative to their interest rate policy.

After a recess of nine minutes, Chairman Garcia called for the presentation by the Oppenheimer Value Fund manager.

Mr. Henry reported that Oppenheimer Senior Management replaced the Oppenheimer Value Fund management team and hired Laton Spahr as the Fund's manager in February. He stated that the Oppenheimer Value Fund is essentially a new product with a different approach and a new management team.

Mr. Spahr introduced himself to the Board and provided a summary of his professional experience. He explained his philosophy of looking for companies that will generate excess returns because of unanticipated acceleration and return of investment capital. He explained that he does not focus on earnings or revenues but on the efficiency of capital within a business.

Mr. Spahr described the investment process for the Oppenheimer Value Fund. On average, they hold stocks for three to four years and that from an asset allocation standpoint they won't deviate from the market. He stated that the fund is "quality agnostic" and they do not believe there is an environment that should cause the Fund to systematically underperform for more than a couple of quarters.

Mr. Thiessen asked Mr. Spahr if his strategy was independent of macro-economic trends. Mr. Spahr responded that the profile of his portfolios will change over a rolling five-year period and he will make changes as opportunities present themselves over certain points of time. He further stated that it was his job to outperform the market, and not necessarily make a call on equity versus bonds.

Mr. Thiessen asked if a new management team was in place and if they had completed their initial portfolio changes. Mr. Spahr responded that he had replaced 85 percent of the management team and has completed his initial changes to the portfolio.

Mr. Thiessen concluded his Watch List presentation with a recommendation to the Board that the Oppenheimer Capital Appreciation, Oppenheimer Value Fund and MainStay MAP remain on the Watch List in accordance with the Monitoring Procedures and Criteria, with no additions to the Watch List.

Chairman Garcia called for a motion to adopt the investment consultant's recommendation to maintain the Oppenheimer Capital Appreciation Fund, Oppenheimer Value Fund and the MainStay MAP Fund on the Watch List.

Mr. Desiderio moved to adopt the investment consultant's recommendation to maintain the Oppenheimer Capital Appreciation Fund, the Oppenheimer Value Fund, and the MainStay MAP Fund on the Watch List. The motion was seconded by Mr. Serrao and approved unanimously.

12) EDUCATION TRUST BOARD SCHOLARSHIPS – discussion and possible action – Kevin Deiters, Executive Director

Chairman Garcia stated that he would like to establish a committee to make recommendations to the Board at the August meeting about the Board's scholarship program. Several options have been discussed and he said that he was personally interested in pursuing a Native American scholarship program.

Chairman Garcia advised the Board that he would appoint the members of the committee in the next few days. Mr. Serrao agreed to serve on the committee.

13) FY 2014 ETB BUDGET – discussion and possible action – Kevin Deiters, Executive Director

Chairman Garcia called on Mr. Deiters to provide an update on the Education Trust Board administrative budget for Fiscal Year 2014.

Mr. Deiters presented his May 21, 2013, Memorandum on the Education Trust Board Administrative Budget for FY 2014. He informed the Board that the State Legislature did not formally consider this budget request during the 2013 Legislative Session.

Mr. Deiters explained that he would transfer any unexpended funds from the 2013 operating budget before transferring additional funds from the administrative account. He also stated that he would move funds between the categories and that the ETB would start paying HED for rent and other services.

Mr. Desiderio moved to approve the FY 2014 ETB Budget. Chairman Garcia seconded the motion. The motion was approved unanimously.

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

Chairman Garcia called on Kevin Deiters to provide the Executive Director's report.

Mr. Deiters summarized his *Executive Director's Report* of May 21, 2013 detailing administrative expenses, program fees, and OppenheimerFunds site visit handouts. Mr. Deiters reported that the administrative fund had a balance of \$7.9 million as of May 6, 2013 and that the Board is current in payments to OppenheimerFunds for marketing.

Mr. Deiters reported that the Board will conduct a site visit of OppenheimerFunds in New York City on July 17th and 18th to review investment operations and to meet with fund managers.

15) **ADJOURNMENT**

Chairman Garcia called for a motion to adjourn the meeting.

Mr. Serrao moved to adjourn the meeting. Mr. Desiderio seconded the motion. The motion was approved unanimously.

Chairman Garcia adjourned the meeting at 5:15 p.m.

Approved by Education Trust Board

August 13 _____, 2013 Meeting

Angela M. Gallegos

Angela M. Gallegos, Board Secretary