College Illinois! Investment Advisory Panel Meeting

May 28, 2009

James R. Thompson Center
100 W. Randolph St.
Chicago, Illinois

Attendees:	Susan Keegan Alex Rorke Ed Donnellan Andrew Davis Frank Bello George Egan Kim Lee Debora Calcara Pat Krolak Mary Pat Burns
Via Telephone:	George Clam Mike Mann

Mr. Davis introduced two new panel members, Mr. Alexander Rorke and Mr. Edward Donnellan after which all present introduced them. He also introduced Ms. Mary Pat Burns who he invited to observe the meeting. Ms. Burns will be working with staff on RFP's and contracts in association with some asset managers. He also introduced Mr. George Egan, a new staff member who is Director of Portfolio Management of Direct Investments for College Illinois! 529 Prepaid Tuition Program. He thanked the members of the panel for their involvement and their personal time they devote to the program.

Mr. Pat Krolak, with Marquette and Associates, stated that this fiscal year has been a challenge to say the least. He then gave a general overview of the market this past year.

Mr. Krolak stated that through April 2009 the fund year to date was down a negative 18%, which outperformed the policy benchmark, due in part to rebalancing, but also making adjustments over the year, terminating a number of managers, and focusing more on passive management rather than active management. He then gave a report on the individual manager performances.

Mr. Bello stated that the fund's asset allocation is currently overweight in bonds, which right now is good. Ms. Keegan stated that in 2007 the panel discussed making a change but decided to take the middle of the road, which has turned out to be a good move.

Mr. Krolak stated that they did not force managers to sell, which was key in the performance of the fund during the volatile time and was a positive decision.

Mr. Bello stated that the asset management fee, as a percentage of the total assets, is now at 14 basis points. Mr. Krolak stated that for a fund this size the average fees are normally around 35 basis points.

Responding to an inquiry from Mr. Mann, Mr. Krolak stated that the fund does receive a 7% dividend check from the investment in Shorebank, which is recorded in the funds cash account. Mr. Davis reminded the panel that the fund has the right, but not an obligation, to buy another $2.5 million worth of stock in Shorebank. Responding to Mr. Mann, Mr. Davis stated they have received no feedback from the recent article written about Shorebank in Crain's Business. He stated that he has met with the Chairman of Shorebank and believes that they have both the management capability and the plan needed to raise additional capital in order to shore up their ratios. Mr. Bello stated that he also spoke with the CFO who has indicated that the bank will need to raise $50 - $75 million in additional capital in order to survive this downturn in the economy, which has placed many of the small community banks in this position.

Mr. Bello referred to articles that had been sent to the panel, one from JPMorgan Chase called Non-Normality of Market Returns. Mr. Bello stated that these articles indicate that everyone is looking at their risk models. He indicated that staff has been meeting with and taking a thorough look at the fund managers and the assets they are holding.

Mr. Krolak indicated that minor changes have been made to the policy including definitions, addition of staff members, committees, and the other primary area was adjustments to the asset allocations and how it is communicated, how staff came to the target allocation and also the actual asset allocation itself.

He reviewed the definitions that have been added to the policy as well as the listed professionals retained by the Commission and staff working with the fund. He stated that a new committee called the Portfolio Committee has been formed which consists of the Executive Director, the Chief Investment Officer and the Director of Portfolio Management and Direct Investments, which meets informally each month to review the portfolio asset allocation to bring the fund in line with its target allocation.

Continuing, Mr. Krolak indicated that a rewording of the investment agreements has been clarified. Mr. Bello stated that this would ensure that respondents to RFP's and those who manage money on behalf of the fund will be transparent. He stated that if a manager is paying an underlining broker or third party, they need to disclose it and not double up the fees.

Ms. Burns informed the panel that the legislature has just passed a law, which has been signed by the Governor, which states that all public pension funds shall prohibit payments to third party marketing firms, so in compliance with your policy that information would have to be disclosed. She stated that this policy doesn't prohibit the third party marketing like the Illinois Legislature is requiring, but only states to disclose it.

Mr. Davis believes it serves the fund best to require that a firm disclose if they are paying a third party marketing fee. Mr. Krolak agreed that the best rule of practice as opposed to completely limiting it is to disclose it.

After discussion on scenarios of disclosure, Mr. Krolak moved onto the target allocation in the policy. Mr. Bello stated that staff is seeking the panel's input as to the asset allocation structure that staff have put in the policy. He stated they are recommending fixed income target be roughly 30%, which it is currently at 48%. He stated that they believe that real estate is actually an asset class that provides inflation protection.

Mr. Egan provided the panel with a document on GSA Leased Buildings, which is a separate asset class. He indicated that they have been presented with an investment in an FBI building in Kentucky which staff feel would be an interesting investment for the portfolio. He stated that it is not just a building, but more like a government bond that is guaranteed payment by the Federal government, which could range from 7-1/2 to 8-1/2% yield. He indicated that should this policy be brought to the Commission at its June meeting for approval, staff would issue an RFP to focus on these types of assets.

Mr. Clam inquired if this investment would require appropriation from the federal government to pay the lease. Ms. Lee indicated that this type of information will be obtained during the due diligence performed on the investment.

Mr. Rorke stated that he felt that this type of investment would not be considered an asset allocation for real estate, but more of a federal contract. Mr. Davis indicated that this has yet to be determined since this is a new type of investment.

Mr. Mann is concerned that investing 10% as recommended in the policy is a little high for a new investment such as this and would be more comfortable if the 10%, $80 million, were not directed all toward one building. Mr. Davis indicated that this type of investment tend to require large sums at one time and feels the risk is better having it invested with the federal government rather than split the same amount into retail type of buildings.

Mr. Clam stated that due diligence will need to be done to clearly define the lease terms and make sure that you are getting your principal back over the life of the lease rather than on a residual basis at the end.

Mr. Egan clarified that this will be a fund that is being invested in rather than the purchase of a building since the program is not allowed to own real estate directly and it simplifies the process to have a fund managed by a real estate professional than to directly own property.

Continuing to review the policy, Mr. Bello indicated that the allocation for domestic and international equity exposure has been lowered to 23% on the target basis. Mr. Egan stated that the newly formed Portfolio Committee is continuing to look at the targets and in some cases look to move away from the targets with opportunities being made available in real estate, infrastructure and private equity funds.

Mr. Krolak stated that private equity and infrastructure were previously approved allocations, however, the change here is that there is a higher allocation within that core of alternative assets such as private equity (direct and fund of funds) and Hedge Funds.

Responding to Ms. Keegan, Mr. Davis stated the program's funded ratio is at 70% and in order to regain the loss the fund sustained, staff will make the best decisions possible when investing. He stated that there may be no control over the market, but there is control of the sale of new contracts and these new contracts are priced higher for this enrollment period due to the increase in tuition and a premium built into the price of the contract, which will help to cure the actuarial shortfall. Also, payments on new contracts are required to be made earlier than in past years, therefore having new cash available sooner to invest. Mr. Krolak stated that investments are not made with the intent to make up actuarial deficit, but he stated that they try at the very least to achieve the actuarial rate of return on a regular basis.

Mr. Mann asked that staff perform due diligence to make the alternative investments as transparent as possible to avoid scrutiny on any particular investment.

Continuing, Mr. Krolak reviewed the changes in the guidelines made to the policy, which includes the timeframe in which a manager can hold bonds before they are required to sell. He stated that when downgrading a manager must notify the consultant and the Chief Investment Officer and can hold only 20% of the overall portfolio, which will give them flexibility of not being required to sell in a downturn in the markets. He indicated another major change to the guidelines is allowing managers to hold a reasonable amount of cash and in-house staff will be monitoring this activity closely to ensure this flexibility is not being abused.

Mr. Krolak stated that the guidelines for the U. S. equity managers have been consolidated into a single set thus having one guideline for all versus the previous nine.

The next major change made to the policy Mr. Krolak said was in the managing of TIPS. He stated that this is being handled effectively internally and this will give staff guidelines to follow on how to purchase. He indicated that staff would be required to solicit at least two bids from a qualified broker, compare prices with industry sources and have the purchase approved by the Chief Investment Officer. He indicated a report of purchases would be provided to the Portfolio Committee as an additional oversight. He briefly reviewed the remaining minor changes made to the policy.

There was also discussion regarding the use of Options based portfolio management strategies as a means to reduce volatility in the equity portion of the fund. Such strategies will have to meet the guidelines set forth in the Investment policy.

Ms. Keegan confirmed for Mr. Mann that the Investment Advisory Panel is advisory only and is not required to take action on the items discussed.

Mr. Bello informed the panel that the new custodian, Northern Trust, has been approved and is awaiting final sign off from the State Treasurer. He also stated that the Commission approved several infrastructure managers at the last Commission meeting and that legal documents are in process to allocate money to Allinda Infrastructure Fund.

Mr. Bello stated that an RFP for two asset classes, real estate and private equity, has been issued and it is his hope to launch an RFP for hedge fund to fund in July to begin the hedge fund allocation. He stated that the soundness study is expected to be done this summer; he reminded the panel that this soundness study is the foundation to setting the pricing of contracts. He stated that the next regular meeting of the Commission will be held on June 26 and all panel members are welcome to attend.

Mr. Davis thanked all panel members for giving their time and attention to the program.

Respectfully submitted,

Debora A. Calcara
Secretary to the Commission