Investment Advisory Panel Meeting
June 18, 2008
12:00 p.m.
James R. Thompson Center
Chicago, Illinois

Attendees: Mike Mann
Susan Keegan
Andrew Davis
Frank Bello
Kim Lee
Nancy Stephens
Pat Krolak
Debora Calcara

Via Telephone: George Clam
Ingrid Stafford
Ed Madden

Mr. Davis opened the meeting at 12:00 p.m. indicating that the meetings of the *College Illinois!* Investment Advisory Panel will now be conducted in accordance with the Open Meetings Act and therefore, the meeting today is being audio taped and Ms. Calcara will serve as secretary to this panel as well as secretary to the Commission.

Continuing, Mr. Davis announced that Randy Erford has left the agency after 10 years with the *College Illinois!* program and within that timeframe the program has grown to a billion dollars in assets and approximately 55,000 contracts. Mr. Erford did a fine job and Mr. Davis was very appreciative of his efforts, but it was his judgment that the program needed new leadership.

Mr. Davis then introduced the new Chief Investment Officer (CIO), Frank Bello and gave a brief overview of Mr. Bello's experience in the investment field.

Mr. Davis continued by giving a brief update on the state of the agency, which included the success of the *College Illinois!* 2007-2008 enrollment period having a 10% increase in sales. He applauded the hard work of staff for the increase in sales.

Mr. Bello then took the opportunity to briefly speak and encouraged the panel to bring their ideas and information to him at anytime, stating his door is always open.

Mr. Bello indicated that the panel and staff together today will review the investment policy and discuss the changes that have been made. He did inform the panel that the Chairman of the Commission has appointed an Investment Committee of the Commission that will provide advice and guidance to the CIO on issues related to the *College Illinois!* Investments.

Ms. Stafford asked if a new Program Director will be hired or is the position being eliminated. Mr. Davis indicated that it is a work in progress.

Continuing to review the changes that have been made to the policy, Mr. Bello indicated that a new section has been added called the investment agreements, which would require the investment managers to sign the form agreeing to the rules and regulations of the policy. He stated that new language has also been added to address internal controls and conflicts of interest.

Reviewing the current asset allocation structure, Mr. Bello stated that the fixed income target is currently 24% with a maximum of 35%, domestic equity is 55% with a maximum of 60% and a 10% allocation to international equity. He stated that they would like to have a direct investment that will not exceed the 30% of the 5% overall allocation to the private equity portion of the fund.

Mr. Mann suggested including a statement saying that of a $15 million direct private equity, no more than 5% of that can be in one company, which would be no more than $750,000. Mr. Bello stated that it is clarified in the guidelines for the direct investment. Mr. Davis indicated that with the cost of due diligence and oversight needed for a direct equity investment being high compared to S&P funds, to make it cost effective he feels it needs to be more.

Ms. Stafford inquired as to the type of direct investments he feels the fund would have an opportunity to invest in. She feels even investing in fund-to-funds is a commitment to due diligence and to venture further into a direct investment would take considerable due diligence. She also inquired if there are State of Illinois pensions or investment plans doing direct investments. Mr. Bello indicated that the direct funds he has been involved with were done with an investment manager and the companies were experiencing tremendous growth opportunities. He stated that the direct investments done by the *College Illinois!* fund would only be around $15 million and the due diligence will be done with the same prudent requirements, as well as using an outside financial advisor, and the Commission having the ultimate approval of the investment.

Mr. Davis suggested the program look at sources such as the Ford Foundation or the MacArthur Foundation and follow the type of investments they are doing and "piggy back" their due diligence efforts.

Ms. Stafford suggested that if the fund was to invest in private equity or private alternative, it be limited to fund-to-fund approach. She indicated that the Northwestern University endowment is at $7 billion and there is no direct investment because of the tremendous due diligence that is needed. Her concern was that to have a direct investment of a specific company is not in alignment with what the fund should be doing. She stated that a foundation or endowment has an infinite timeline whereas the prepaid fund has a finite timeline of 15 to 20 years. She stated that she is uncomfortable with putting the direct investment reference in the policy and more comfortable with an exposure to alternatives and a fund-to-fund.

Mr. Clam agreed with Ms. Stafford and feels it is more practical to have venture capital firms and allow the due diligence to focus on the quality of those firms and the success of the past rather than to try and interpret individual deals that may be beyond our capabilities. He feels it would strain the fund's resources.

Mr. Davis indicated that it would serve the purpose of the fund to have a certain amount of flexibility and the amount of money that would be invested is small relative to the size of the overall fund. He reminded the members of the panel that the decision to place the money falls directly on the Commissioners. He feels the fund has enormous unmet need in the State and with future potential sales the fund could easily be at $5 or $10 billion and entering a direct investment could provide the tools to reach that level.

Mr. Davis reassured Ms. Keegan that the decision to make a direct investment lies directly with the Commission members. Mr. Mann asked Mr. Davis to communicate the panel's concern about a direct investment to the Commission. Mr. Davis agreed and stated that it is accurate to say that there is a strong sense that caution is warranted and some lack of enthusiasm at this point for moving down this path. He reassured Ms. Keegan that that the investment wouldn't be done unless it was risk weighted appropriate.

The Panel and staff continued to review the changes made to the policy. Mr. Bello stated that staff will continue to work closely with the panel going forward to continue to make the policy reflect the goal of the fund. Mr. Bello then turned the meeting over to Mr. Krolak to review the asset allocation.

Mr. Krolak stated that to produce the asset allocation study, Marquette Associates designed an entirely proprietary piece of software that simulates possible returns of the capital market, it simulates cash flows of both the fund and illiquid asset classes, such as private equity and infrastructure in this case, over a 10-year period.

Mr. Krolak stated that currently the fund consists of 35% bonds, 15% large cap core, 12% large cap value, 13% large cap growth, 10% small cap core, 5% small cap value, and 10% international.

Mr. Krolak described proposed portfolio A, which is the target portfolio according to the investment policy guidelines, that incorporates a 5% position in bank loans, 5% position in open ended real estate and a 5% position to private equity fund to fund.

Mr. Krolak described portfolio B, the first real change from the target, which maintains bonds at 20% of the overall portfolio and effectively having the current portfolio, 20% position in equity and maintain a 5% position in TIPS.

Mr. Krolak described portfolio C, that he classified as probably the best option. It is a 15% traditional bond portfolio, 5% in bank loans, 10% in large cap core, 10% large cap value, 5% large cap growth and adding some mid cap in the form of mid cap growth, decreasing small cap core position, so you are reducing your overall small cap position in the portfolio to 5%, 5%

in small cap value, 10% international as we have now, increasing international up to a total of 15%, but having 5% of that position being in small cap international.

Mr. Krolak then referred to portfolio D, which reflects building the alternative allocation to private equity infrastructure over about nine years. He indicated that at the end of ten years the average fund would have a projected market value of $1.4 billion, assuming no new contracts were being sold. He stated the fund would still grow and meet its actuarial needs and would actually exceed the actuarial needs based on the liability assumptions developed by the actuary, Rick Kaye. The assumption is that the fund would be 124% funded in 10 years with this simulation.

Ms. Keegan asked how portfolio D differs from version C from last year. Mr. Krolak stated portfolio D is recommending that the fund move more towards alternative space.

Mr. Krolak then referred to portfolio E, which is the replacement of bank loans with TIPS. Portfolio D and E are effectively the same and present the same essential risk return characteristics.

Mr. Krolak recommends portfolio D or E taking into consideration the Commission's preference of not investing in bank loans and the Commission's enthusiasm for TIPS. Mr. Davis does not feel there is an actuarial difference between portfolio D and E. With the encouragement of the Panel in mind, he is anticipating that staff will "dig in" and do more due diligence related to alternative investments.

Mr. Davis explained how the process would work on the Commission approving the policy and then moving forward step by step. Mr. Bello stated that staff is comfortable with staying with portfolio E over time.

Prior to adjourning the meeting, Mr. Davis noted that within the first three weeks of Mr. Bello joining the program, he has negotiated reduced fees with the fund investment managers and saved the fund $500,000 per year.

Ms. Lee stated that to comply with the Open Meetings Act, the Investment Advisory Panel should meet in conjunction with the Commission at least once per year. She suggested that the Panel meet with the Commission at its meeting tentatively scheduled for January 30, 2009 meeting and then again individually as a Panel on June 12, 2009.

The meeting adjourned at 3:00 p.m.

Respectfully submitted,

Debora A. Calcara

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Secretary to the Commission