AGENDA ITEM 10Aiii.
MINUTES OF THE MAY 23, 2012 MEETING OF THE INVESTMENT COMMITTEE AND INVESTMENT ADVISORY PANEL

MINUTES OF A MEETING
OF THE
ILLINOIS STUDENT ASSISTANCE COMMISSION
INVESTMENT COMMITTEE
AND
INVESTMENT ADVISORY PANEL

May 23, 2012

Michael A. Bilandic Building
Room 505
160 N. LaSalle St.
Chicago, IL

COMMITTEE MEMBERS PRESENT:	Mark Donovan Kevin Huber
COMMITTEE MEMBERS ABSENT:	Verett Mims
INVESTMENT ADVISORY PANEL MEMBERS PRESENT:	Karen Kissel Patrick Rea Joy Winterfield Paul Hagy
INVESTMENT ADVISORY PANEL MEMBERS ABSENT:	Louis Paster Jeanna Cullins
COMMISSIONERS PRESENT:	Kym Hubbard, Commission Chair
STAFF PRESENT:	Eric Zarnikow, Executive Director Kent Custer, Chief Investment Officer Anita Geter, Director, Internal Audit Nicholas O'Keefe, Associate General Counsel John Samuels, Chief Marketing & Communications Officer Debora Calcara, Commission Secretary
PUBLIC PRESENT:	Ryan Ball, Callan Associates, Inc. Richard Day, Citizen Eugene Podkaminer, Callan Associates, Inc. Joe Reynoso, Reynoso Asset Management LLC Daniel Welker, JP Morgan Asset Management Brianne Weymouth, Callan Associates, Inc.

Item 1. Announcements

Mr. Custer opened the joint Investment Advisory Panel and Investment Committee meeting at 12:04 p.m. asking that a roll call be taken, which established a quorum was present for both the Investment Advisory Panel and the Investment Committee. He thanked everyone for taking time out of their schedules to lend their expertise to the important work ahead of them.

Mr. Custer reminded the members that some of the actions taken today by the Investment Committee will be subject to approval by the full Commission.

Mr. Custer stated that what he is presenting to the group today is very much a collaborative process and he is open to feedback and ideas to incorporate into the actions taken, however, the end result and recommendations, specifically those with his name on them, reflect his opinion and he takes full responsibility for it in the future.

Mr. Custer explained to the group the specific statutory requirement that the Investment Advisory Panel is charged with and noted from time to time he will bring the Investment Advisory Panel and the Investment Committee together rather than having the information filtered through him.

Item 2. Minutes of the January 27, 2012 Joint Investment Advisory Panel and Investment Committee Meeting

Mr. Donovan **MOVED THAT** the minutes from the January 27, 2012 joint meeting of the Investment Advisory Panel and Investment Committee be approved. Mr. Huber seconded the motion, which was unanimously approved.

Item 3. Minutes of the February 23, 2012 Investment Committee Meeting

Mr. Huber **MOVED THAT** the minutes from the February 23, 2012 meeting of the Investment Committee be approved. Mr. Donovan seconded the motion, which was approved.

Item 4. College Illinois!® Prepaid Tuition Program FY 2011 Annual Report

Mr. Custer reiterated to the panel members that the statute states that the Investment Advisory Panel is to annually review and advise the Commission on provisions of the strategic investment plan and annual report. Therefore, he noted for the record that all panel members had received a copy of the annual report under separate cover and asked if they had comments they would like to be noted into the record. There were no comments noted at this time.

Item 5. Investment Performance Update

Mr. Custer introduced Mr. Ryan Ball, Vice President, Chicago Consulting Office and Ms. Brianne Weymouth, Vice President, Chicago Consulting Office, with Callan Associates. Ms. Weymouth provided the group with a brief overview of the investments for the first quarter of the year.

Starting with a brief overview of the markets in the first quarter, Ms. Weymouth noted that it was a risk-on quarter with a run up in both domestic and international equity markets. Ms. Weymouth then began a review of ISAC managers starting with the domestic equity portfolio which she noted was indexed and all the managers performed in line with their respective index. Mr. Huber asked for an explanation regarding modest underperformance from Rhumbline. Mr. Custer stated that was due to the timing of cash flows.

Continuing the portfolio review, Ms. Weymouth stated that the international equity composite underperformed, like non-U.S. equity managers during the quarter. She then commented on the underperformance of Harris/Pyrford and Ativo and the outperformance of Madison Square Investors.

Next, Ms. Weymouth stated that the fixed-income portfolio outperformed the index and peers for the quarter. There was a common theme among managers to be overweight corporate bonds and CMBS and this performed well during this risk-on quarter. She also noted that Pugh Capital was voted one of the top fixed-income managers by Emerging Manager Monthly.

Ms. Weymouth explained that the valuations for real estate, infrastructure and private equity are lagged and then called attention to a lower valuation for Camelot in the private equity portfolio due to dilution associated with the raising of new capital at Fisker Automotive. She recalled that this decline followed a sharp increase in the prior quarter. Mr. Custer interjected that the Fisker was a dilution issue as the stock was actually sold at somewhat higher levels. Responding to questions from Ms. Winterfield and Mr. Hagy, regarding the size of the Fisker investment relative to the Camelot investment, Mr. Custer noted that is was about 60% of the fund in September, but should be less now. Mr. Ball provided additional clarification that Fisker was the only investment in the Camelot Co-investment fund.

Ms. Weymouth then reviewed performance of the hedge funds. The Reynoso Options Arbitrage Portfolio was positive for the quarter while longer-term performance has been negative which is not out of the ordinary for this investment style during a sharp run up in the S&P 500. Neuberger Berman was up 2.3 percent, which was in line with expectations, but slightly lagged a peer group of diversified fund of funds. Balestra underperformed for the quarter. They are a global macro manager with a long bet on gold and a low correlation to the stock market. Pinnacle Natural Resources was about in line with their benchmark and showed positive performance for the longer term.

Concluding her remarks, Ms. Weymouth stated that the total fund performance was 4 percent in the first quarter and ranked down at the 91 percentile of public defined benefit sponsors, which provided the closest universe for comparison. Mr. Ball noted short term performance for the total fund is skewed down due to the number of illiquid investments with lagged performance and the fact that some of these funds are early in their life.

Responding to a question from Ms. Winterfield regarding fund performance versus peers, Mr. Ball highlighted ranking charts which showed the fund with unfavorable relative rankings versus peers for the past quarter, strong performance for the fiscal year, and performance trailing the peer groups somewhat for three- and five-year periods.

Mr. Hagy asked for clarification regarding the frequency of valuation for the hedge funds. Ms. Weymouth noted that hedge funds were valued monthly. Mr. Ball added that Reynoso was a direct investment and performance is current. The other three are fund-of-funds and are lagged.

Mr. Hagy then asked if the historical volatility is consistent with expectations for the hedge funds. Mr. Custer stated that volatility was within his expectations for a global diversified hedge fund portfolio and added that he would characterize the hedge fund portfolio as risk mitigating for the overall fund.

Mr. Huber noted the strong performance of the private equity funds and asked about the valuation of the portfolios and the comfort level with these valuations. Mr. Custer responded that the strong performance in the Camelot funds was driven by appreciation of Fisker Automotive as subsequent equity offerings were at higher prices. Mr. Custer also noted the strong performance of Portfolio Advisors and the timing benefits of buying private equity in the secondary market.

Additional discussion ensued regarding valuation policies and potential peer benchmarking in private equity.

Item 6. Procurement

6a. Approval Passive Domestic Equity Manager Selection

Mr. Custer stated that when he arrived at ISAC his first urgent task was to prepare a Request For Proposal (RFP) for the passive domestic equity manager. He explained the procurement process which was involved for the manager selection with an end result of Rhumbline coming out ahead in both the passive domestic equity all-cap and the large-cap portfolio.

Mr. Custer explained that the motion must be made by the Investment Committee as the Investment Advisory Panel serves only in an advisory capacity.

With no comments or questions regarding the hiring of Rhumbline, Mr. Custer asked for a motion.

Mr. Huber **SO MOVED** that the Investment Committee approve the hiring of Rhumbline Advisors for the passive domestic equity large-cap and all-cap mandates subject to Commission ratification at its next regularly scheduled meeting. Mr. Donovan seconded the motion, which was approved.

6b. Extension of Fixed Income Investment Management Services

Mr. Custer explained that three core fixed-income managers' (C.S. McKee Investment Managers, Pugh Capital Management and Piedmont Investment Advisors) contracts are expiring at the end of June 2012. He indicated an RFP will be issued, but due to the extensive process that is required, action needs to be taken prior to the expiration of these contracts. Mr. Custer stated that ISAC's Deputy General Counsel, Ms. Salas, suggested that a sole-source one-year contract be issued for these managers. He stated this will provide the time needed to review the asset allocation study and determine what is actually needed in this category. He outlined the process taken to issue the sole-source contract, including the holding of a public hearing, which resulted in no questions or comments. He stated that the State of Illinois procurement has approved one-year contracts extending from June 2012 to June 2013 for each of the three managers noted above.

Mr. Custer noted that all three managers have a core style and that they are very close to the benchmark. Mr. Custer further stated that Callan did not have any concerns with these managers. Mr. Ball affirmed this and noted that the discussion was driven by procurement rules and not any concerns with the managers. Finally, Mr. Custer stated that he anticipates starting a search process for fixed income managers relatively quickly.

Responding to Mr. Huber's inquiry as to whether there are too many core managers, Mr. Custer stated that he would agree and that for the next investment policy he was expanding the guidelines to include core plus mandates based off Callan Associate's template.

Mr. Custer asked for a motion from the Investment Committee to enter into one-year contracts with each of C.S. McKee Investment Managers, Pugh Capital Management and Piedmont Investment Advisors, subject to approval by the Commission at its next regularly scheduled meeting. Mr. Donovan **SO MOVED** and Mr. Huber seconded, which was approved.

Mr. Custer then moved to item eight in order to discuss the asset allocation study prior to agenda item seven, which is the review of the investment policy.

Item 8. Review Asset Allocation Study

Mr. Ball stated that when Callan Associates was hired as investment advisor, they were asked to first conduct an asset allocation study to not only look at the current asset allocation, but to look at how that is impacted by what is projected by the program's actuary to be the liabilities.

Mr. Podkaminer, Vice President for Capital Markets Research with Callan Associates, reviewed in detail the Asset Allocation Study with the Investment Advisory Panel and the Investment Committee. Mr. Podkaminer noted that Callan updates their capital market assumptions every year and that the expected returns has declined for each of the past two years such that achieving a 7.5% return at a reasonable level of risk may be very difficult. Further in his discussion, Mr. Podkaminer noted that based on Callan's capital market assumptions the current ISAC portfolio mix would be expected to return 6.93 percent with a standard deviation of 13.49 percent. He noted that this volatility needs to be looked at and perhaps reduced.

Responding to Ms. Winterfield, Mr. Zarnikow stated that the asset allocation study is a means of informing the Panel about what should be considered from an investment policy perspective and what the mix of investments should be. He stated that it should be kept in mind that the investment policy is reviewed each year and approved by the Commission, so any decisions made are not permanent and can be changed during the next annual review cycle. He stated that the Commission is focused on mending the prepaid tuition program, not ending it, and therefore are focused on the right strategies to do that. He stated that the Commission plans to reopen contract sales and are planning a holistic fix, which will require having an investment strategy to reflect that.

Mr. Podkaminer concluded his comments with a review of projections for various contract sales scenarios. He noted that in a scenario selling 3,500 contracts a year, the risk tolerance and liquidity horizon similar to what we have now is more or less appropriate. However, if there is no new revenue, they would advise a sharp reduction in risk for the portfolio and an increase in liquidity.

Mr. Custer reviewed his Chief Investment Officer (CIO) Memorandum regarding the asset allocation as provided in the agenda materials. He referred to his recommendations on targets which are long-term and interim targets and the rebalancing ranges as detailed on page four of the CIO Memorandum in the agenda item. Clarifying for Mr. Zarnikow, Mr. Custer stated that his recommendation will ultimately be the same as what is reflected in the investment policy.

Discussion was held on whether his recommendation is driven by restarting contract sales or from a practical viewpoint. Mr. Custer stated that practical realities were a key driver as well as the potential risk and costs of moving into fixed income investments. Mr. Zarnikow noted that it's the two things coming together and that we will know a lot more about our ability to mend the plan over the next 6-12 months. Chair Hubbard stated that the overall goal is to increase liquidity and decrease risk. She stated that they support Mr. Custer's assumption as to where to start and that the asset allocation can be revisited, but the glide path is certainly going to continue down the scale of becoming less risky and more liquid.

Mr. Huber **SO MOVED** that the Investment Committee accept the asset allocation recommendations as presented by the Chief Investment Officer. Mr. Donovan seconded the motion, which was approved.

Item 7. Review Draft Revisions to College Illinois! Prepaid Tuition Program Investment Policy

Mr. Custer referred to the CIO Memorandum in the agenda materials outlining the key changes and considerations to the investment policy.

Responding to Mr. Huber, Mr. Custer stated that the policy has built-in protections so within all of the alternative asset classes there is a prohibition for any new search activity subject to the full Commission approval and there is also an additional prohibition on any kind of investment in concentrated secondary private equity.

Seeing no further questions or comments from the Investment Advisory Panel or the Investment Committee regarding the Investment Policy as provided in the agenda materials, Mr. Custer asked for a motion from the Investment Committee to approve.

Mr. Donovan **SO MOVED** that the Investment Committee approve the Investment Policy as provided in the agenda materials. Mr. Huber seconded the motion, which was approved.

Item 9. Review Absolute Return Structure Study

Mr. Custer stated that at the request of ISAC, Callan Associates has performed an absolute return asset class structure study.

Mr. Ball reviewed in detail the Hedge Fund Program Structure Evaluation as provided to the Investment Advisory Panel and the Investment Committee in the agenda materials. He outlined their proposal where the "Neuberger Berman piece, which tends to be more diversified, less volatile, is your core, and Balestra and Pinnacle, the two managers that are, again, as we would call them more divergent, offsetting strategies are a smaller portion, and Reynoso would not have an allocation". Mr. Ball stated that, in general, Callan does not support direct hedge fund investments, noting that there is an extra level of due diligence expertise needed that Callan hasn't tried to staff.

Mr. Custer then provided an overview of the CIO Memorandum provided in the agenda materials. He called attention to risk statistics which showed that all of ISAC's hedge fund investments were less risky than public equities in terms of volatility and drawdown. Additionally, he noted the relatively higher equity correlation for Neuberger Berman and the larger drawdown in 2008. He stated that his recommendation is to leave the Neuberger Diversified Arbitrage as is, but that he would like to take Balestra Spectrum II and Pinnacle Natural Resources down to $30 million each. Mr. Custer acknowledged a modest difference of opinion with Callan.

Ms. Winterfield asked Mr. Custer if the proceeds from reducing the hedge funds would be put in public equities. Mr. Custer responded that proceeds would be used to fund cash flow needs and would not be transferring to public equities. Ms. Winterfied then asked Mr. Ball where he would have each fund end up. Mr. Ball responded "50 percent Neuberger, 25 percent Pinnacle, 25 percent Balestra, in whatever that dollar amount is.

Mr. Custer stated that Callan Associates has recommended the termination of Reynoso Options Arbitrage Fund due to their small size. Mr. Custer recalled Reynoso's exhibited investment skill, diversifying down-market protection, and that they are minority owned, which is a goal of ISAC. He stated that this provides a diversifying investment option for ISAC and also noted monthly liquidity terms and transparency as mitigating factors. Finally, Mr. Custer noted that exposure has been cut in half from $20 million at the beginning of the year.

Mr. Custer then introduced Mr. Joe Reynoso for any questions and then indicated he would like to maintain the current allocation and bring Mr. Reynoso back to the meeting in August to talk about his portfolio and decide whether to keep the fund at that time. Mr. Custer again acknowledged a difference of opinion with Callan and asked for any questions.

Mr. Huber expressed concern regarding the low returns from Neuberger and about the potential negative perception from stakeholders on the term "hedge fund". He asked for support as to why hedge funds are needed. Mr. Custer stated that the hedge fund portfolio has similar return expectations to equities and will be a return driver while providing diversification of the portfolio to reduce the drawdown in difficult economic times. However, Mr. Custer indicated criticism of the Neuberger Diversified Arbitrage fund as they have been highly correlated to equities in the past, but that they were working to reduce that correlation in the future.

Mr. Custer then asked for a motion from the Investment Committee to accept the recommendations as presented in the CIO Memorandum.

Mr. Huber **SO MOVED** that the Investment Committee accept the recommendations as presented in the CIO Memorandum regarding the absolute return study and specifically to move towards equal weighting with Balestra Spectrum II and Pinnacle Natural Resources and Neuberger Diversified Arbitrage, maintaining current exposure to Reynoso Options Arbitrage Fund subject to future consideration, not contribute additional monies to any hedge fund, gradually reduce Balestra Spectrum II and Pinnacle Natural Resources to approximately $30 million each to fund the program cash flow needs. Mr. Donovan seconded the motion, which was approved.

Seeing no further questions or comments, Mr. Custer asked for a motion to adjourn. Mr. Donovan **SO MOVED** that the May 23, 2012 meeting of the Investment Advisory Panel and Investment Committee be adjourned. Mr. Huber seconded the motion, which was approved. The meeting adjourned at 2:01 p.m.

Respectfully submitted,

Debora A. Calcara

Debora A. Calcara
Secretary to the Commission