

BOARD OF INVESTMENTS INVESTMENT POLICY STATEMENT
MONTANA PRIVATE EQUITY POOL (MPEP)

This policy is effective immediately upon adoption and supercedes all previous Montana Private Equity Pool (MPEP) policies.

INTRODUCTION

The purpose of this policy statement is to provide investment objectives, strategies, and constraints for private equity investments, which are consolidated into the Montana Private Equity Pool (MPEP). The statement provides a basis on which to invest in private equity partnerships and enables the participants to monitor the progress of private equity investments made on their behalf. MPEP investments are managed by external managers with the expertise and experience to prudently manage these types of investments.

OBJECTIVES

Attaining enhanced investment returns from private equity investments while diversifying investment risk is the strategic objective of the MPEP. The objectives include the following components:

- Achieve diversification benefits by investing pension fund portfolios in non-traditional (i.e. equity and fixed income) capital markets
- Diversify the asset mix of pension fund portfolios across domestic and international private equity partnerships in order to achieve higher risk-adjusted portfolio returns
- Achieve superior incremental asset-class investment returns
- Ancillary strategic objectives associated with private equity investments include, but are not limited to the following:
 - a. Develop secondary market capabilities to prudently either divest private equity assets prior to maturity or liquidation or invest in established partnerships in the secondary market
 - b. Establish key general partner relationships that may enhance partnership and direct investment opportunities

Return Requirement: There is no generally accepted benchmark index for private equity performance comparisons. Characteristically, private equity partnership investments are impacted by the “J-curve effect, in which fees and transaction costs create negative returns during the initial investment years before distributions are realized. Private equity investing requires a long time horizon in order to realize the value created by the creation or restructuring of private companies.

- The performance objective for MPEP is the achievement of long-term net returns (after management fees and general partner’s carried interest) above a benchmark reflecting public equity market returns plus an appropriate premium to compensate for the higher degree of risk.
- The benchmark established for the MPEP is an annualized rate of return 400 basis points above the Standard & Poor’s 1500 Index which is a proxy for the broad domestic stock market.

Risk Tolerance: Private equity investments incur a higher degree of risk with a higher return potential than traditional equity investments. Portfolio diversification of risk is achieved through multiple partnership relationships and investments diversified by time, stage of financing, industry sector, investment size and geographical region. Private equity investments typically have a low correlation relative to other investment asset classes and should contribute to the reduction of risk and the enhancement of returns on a total investment portfolio basis. The private equity investment program utilizes fund-of-funds and direct partnership investment management strategies that have similar risk tolerance requirements.

BOARD OF INVESTMENTS INVESTMENT POLICY STATEMENT
MONTANA PRIVATE EQUITY POOL (MPEP)

CONSTRAINTS

Liquidity: Private equity investments are extremely illiquid and participation in these investments is limited to the nine pension funds.

Time Horizon: Private equity investments are classified as long-term in nature. Private equity investment fund positions represent 7 to 10 year commitments usually characterized by capital calls occurring during years 1 through 5 with final termination of the investment typically scheduled after 10 years. The final term may be increased in one-year increments up to 13 years.

Tax Considerations: Since the investments are made exclusively for the pension funds, there are no tax implications applicable to the MPEP. However, partnerships in which MPEP invests may be structured to minimize tax implications for private investors.

Legal: Legal constraints on the management of investment funds for the State of Montana are defined in MCA 17-6-201. Unified investment program - general provisions:

The unified investment program directed by Article VIII, section 13, of the Montana constitution to be provided for public funds must be administered by the Board of Investments in accordance with the prudent expert principle, which requires any investment manager to:

- (a) discharge his duties with the care, skill, prudence, and diligence, under the circumstances then prevailing, that a prudent person acting in a like capacity with the same resources and familiar with like matters exercises in the conduct of an enterprise of like character with like aims;
- (b) diversify holdings of each fund to minimize the risk of loss and maximize the rate of return, unless under the circumstances it is clearly prudent not to do so, and;
- (c) discharge his duties solely in the interest of and for the benefit of the funds.

Client Preferences:

- MCA section 17-6-201 (3)(b) states...“The Board is urged under the prudent expert principle to invest up to three percent (3%) of retirement funds in Venture Capital companies. Whenever possible, preferences should be given to investments in those Venture Capital companies which demonstrate an interest in making investments in Montana.”
- These preferences shall be incorporated into all partnership agreement documents.

RESPONSIBILITIES AND DELEGATION

Board: The Board shall approve and revise the MPEP Investment Policy Statement as necessary, oversee MPEP performance, delegate decision making to staff as appropriate and authorize investment and other decisions not delegated to Staff. The Board delegates to Staff the authority to screen, evaluate and select private equity managers who meet the due diligence guidelines of this policy.

Staff: Staff assigned to the MPEP will be responsible to:

- Make recommendations to the Board concerning MPEP Strategy, Annual Plan and Investment Policy changes
- Manage day-to-day operations, delegate work to external resources as appropriate, and oversee all due diligence activity
- Screen, evaluate and select private equity managers who meet the due diligence guidelines of this

BOARD OF INVESTMENTS INVESTMENT POLICY STATEMENT
MONTANA PRIVATE EQUITY POOL (MPEP)

policy and inform the Board at its next meeting: 1) which managers were selected; 2) what due diligence was performed prior to the selection of the manager; and 3) how the selection of the manager fulfills the strategy and objectives of MPEP.

- Monitor and report to the Board the performance of the MPEP and the individual managers in the MPEP
- Manage on an ongoing basis any external resources and notify the Board of any changes in these resources
- Report any deviations from this Policy to the Board

External Resources: With Board approval, external resources may be retained to serve as an extension of investment staff.

PROGRAM ELEMENTS

General Approach: Staff shall manage the MPEP investments with a disciplined and opportunistic approach and as a consolidated entity in conformance with the criteria established for both Fund-of-Funds managers and direct partnership investing.

Program Annual Plan: Staff shall review the MPEP annually and prepare an Annual Plan for presentation to the Board for approval. The Annual Plan shall incorporate an analysis of economic and market conditions as well as a review of the existing portfolio and what progress has been made towards the asset allocation target for MPEP. The Annual Plan shall specify future priorities, costs, resource requirements, strategy enhancements and other objectives for the MPEP.

Program Strategy The MPEP Strategy shall be revised periodically as appropriate and updated annually through the Annual Plan. The Strategy shall include, but not be limited to, the following components:

- Goals and objectives
- Structure and management of MPEP
- Strategic approach to the asset class and sub-classes
- Roles and responsibilities, and
- Resource requirements

Portfolio Management: Assets shall be managed externally by qualified Fund-of-Funds managers and/or Direct Limited Partnerships. Fund-of-Funds managers may be chosen to manage assets where particular expertise is required and cannot be provided by Staff or where the Fund-of-Funds manager can cost-effectively provide relevant information/assistance to Staff in the selection of Direct Limited Partnership investments.

Portfolio Performance: Staff shall continually review MPEP investments for compliance and performance relative to the following:

- Provisions of the Annual Plan
- Pace and timing of investment commitments, funding and return of capital;
- Diversity of sectors (industry, geographical, investment style, and others as appropriate)
- Stated objectives specific to the investment;

BOARD OF INVESTMENTS INVESTMENT POLICY STATEMENT
MONTANA PRIVATE EQUITY POOL (MPEP)

- The benchmark established for the MPEP

Risk Management: Private Equity investments may involve the following risks:

- **Financial Risk:** These investments may employ financial leverage (debt) leading to a higher degree of volatility in investment returns. Buyout strategies are characterized by the use of significant levels of debt in their capital structures.
- **Operating and Business Risk:** These investments typically involve above average operating and business risk, due to risks associated with the development of new products, new business models, new markets or inexperienced management teams.
- **Market Liquidity:** These investments lack liquidity and typically have time horizons of 10 to 13 years. Secondary markets for such investments are limited and often are handled via an auction process.
- **Valuation Risk:** Given the illiquid nature of private equity investments, partnership reporting of asset valuations shall be evaluated to determine if an appropriate valuation discipline is being followed.
- **Structure Risk:** These investments involve extensive legal documents which must be reviewed by legal counsel as part of the due diligence process.
- **Country Risk:** Investing in global alternative investments include all of the risks associated with this particular asset class along with political, economic, and currency risks associated with investing outside of the U.S.
- **Vintage Risk:** Refers to the variability of private equity commitments by vintage year, i.e. the year of first capital drawdown over time.
- **Manager Risk:** This risk is composed of two elements, the exposure within an individual partnership and the exposure to the number of general partners in the MPEP portfolio.
- **Industry Risk:** Private equity firms are permitted to invest in a wide variety of industries without many restrictions. Diversification across industries is the means by which this risk is controlled in a private equity portfolio.

INVESTMENT CLASSIFICATIONS

Private equity investments typically classified as follows:

- **Buyout and Corporate:** Investments in leveraged buyouts, management buyouts, debt restructuring, or other acquisition strategies and financial restructurings strategies.
- **Venture Capital:** Investments in relatively small but rapidly growing private companies in various stages of development
- **Distressed:** Either debt or equity securities in troubled companies are purchased and held while the investment manager negotiates with the bankruptcy court. As a workout plan is put into action, the value of the distressed securities appreciates and can be profitably liquidated.
- **Mezzanine:** Privately negotiated subordinated debt investments, usually with an equity warrant attached at a relatively low cost.
- **Special Situations:** Typically, specific industry strategies, unconventional investment opportunities are so classified

BOARD OF INVESTMENTS INVESTMENT POLICY STATEMENT
MONTANA PRIVATE EQUITY POOL (MPEP)

INVESTMENT PROCESS

Minimum Requirements/Investment Styles

- Managers shall demonstrate relevant experience in or directly applicable to the market in which they propose to invest
- Managers shall demonstrate that they are specifically qualified to pursue the proposed strategy in the market in which they propose to invest
- Managers shall demonstrate the requisite skills and experience necessary to execute successfully the proposed strategy, including evidence from similar endeavors of their ability to work successfully with Limited Partners
- Managers shall dedicate sufficient time and effort to the proposed opportunity and make, within the context of the particular investment, a meaningful personal financial commitment
- The Manager's proposed strategy and business plan shall be set forth in sufficient detail to permit substantive and meaningful review of the opportunity, verification of the investment concept, and of the risk factors
- The risk/reward trade-off in the particular market in which the Manager proposes to invest shall be attractive based on reasonable assumptions.

Evaluation Criteria: Evaluation factors include:

- Conformance to the MPEP Program Strategy, Annual Plan, and the Objectives
- Uniqueness of the investment strategy relative to existing Managers
- Integrity and experience of the key principals, employees and the reputation of the firm
- Quality of the partnership corporate governance, including controls and reporting systems
- Relationships with other Limited Partners, particularly public investment boards
- Past financial performance
- Appropriateness of terms and conditions and alignment of interests of the firm's principals with the Limited Partners
- Reasonable ratio of committed capital by the managing principals

Due Diligence A due-diligence review by Staff and any external resources utilized by Staff shall include at least the following;

- Face to face discussions with the managing principals of the Partnership under review for investment
- Review and analysis of all pertinent offering documents including: offering memorandum, subscription agreements, private placement memorandums and operative investment agreements
- Consideration of potential conflicts of interest, if any, posed by the proposed investment and prior investments and activities of the firm
- Review and analysis of the investment concept, including entry and exit strategies and terms including fees, principal participation and structure
- Review and analysis of the appropriateness of the proposed investment with the MPEP Strategy, Annual Plan, and Guidelines
- Review of news articles and public reports regarding the partnership and its managing principals, prior investments, and investment strategy
- Review and Analysis of the partnership investment performance record including both prior and current investments
- Consideration of relative size of the proposed investment relative to the partnership's prior investment funds and distribution of investment responsibilities between managing principals.

BOARD OF INVESTMENTS INVESTMENT POLICY STATEMENT
MONTANA PRIVATE EQUITY POOL (MPEP)

- Investigation of special terms and conditions, management fees and legal “side letter” agreements with past and present investors
- Determining the ability and stability of the management team and the investment organization
- Review disclosure of any lawsuits, litigation involving the general partner, its principals, employees and prior funds.

BOARD OF INVESTMENTS INVESTMENT POLICY STATEMENT
MONTANA PRIVATE EQUITY POOL (MPEP)

MONITORING AND REPORTING

Monitoring

- Staff shall monitor both individual Managers within MPEP and overall performance of MPEP
- Staff shall assess the performance of Managers relative to the following criteria:
 1. Objectives established by the Managers or the principals managing the investment relative to their stated performance objectives
 2. Degree of risk undertaken
 3. Performance comparisons to other managers with similar investment styles and/or within the same vintage year.
 4. The MPEP performance versus the selected benchmark

Reporting

- Managers shall submit periodic reports to facilitate Staff's monitoring of the Managers' conformance to MPEP policy and performance objectives
- Staff shall provide quarterly and annual reports to the Board that include the results of such monitoring of Managers

BACKGROUND INFORMATION

The Board approved the creation of MPEP at the April 4, 2002 Board meeting and the pool was created on May 1, 2002.

MONTANA PRIVATE EQUITY POOL (MPEP)

MPEP Asset Allocation (At Committed Value)

	<u>June</u> <u>2002</u>	<u>June</u> <u>2003</u>	<u>June</u> <u>2004</u>	<u>MPEP</u> <u>Range</u>	<u>MPEP</u> <u>Target</u>
<u>Asset Classification</u>					
Leveraged Buyouts	74.5%	62.2%	56.1%	40.0% - 75.0%	58.0%
Venture Capital	16.0%	13.3%	18.8%	10.0% - 50.0%	19.0%
Mezzanine Financing	2.3%	1.4%	2.5%	0.0% - 10.0%	2.0%
Distressed Securities	1.3%	18.8%	12.9%	0.0% - 40.0%	10.0%
Special Situations	<u>0.8%</u>	<u>1.3%</u>	<u>5.9%</u>	<u>0.0%</u> - <u>10.0%</u>	<u>7.0%</u>
<i>SubTotal</i>	<u>95.0%</u>	<u>97.0%</u>	<u>96.3%</u>	<u>0.0%</u> - <u>0.0%</u>	<u>96.0%</u>
Short Term Futures Fund	5.0%	3.0%	3.7%	100.0% - 100.0%	4.0%
MPEP Total	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>