

**MONTANA BOARD OF INVESTMENTS
DEPARTMENT OF COMMERCE**

**2401 Colonial Drive, 3rd Floor
Helena, Montana
Thursday, August 26, 2004**

MINUTES

BOARD MEMBERS PRESENT:

Dick Anderson, Chairman
Dennis Beams
Karen Fagg
Maureen Fleming
Joel Long
Terry Moore
Calvin Wilson

BOARD MEMBERS ABSENT:

Tim Ryan
Jay Klawon

STAFF PRESENT:

Robert T. Bugni, CFA, Senior Investment Officer
Geri Burton, Deputy Director
Richard Cooley, CFA, Senior Investment Officer
Kimberly Dallas, Program Assistant
David Ewer, Senior Portfolio Manager
Edward Kelly, Assistant Investment Officer
Herbert Kulow, Senior Portfolio Manager
Rande Muffick, CFA, Assistant Investment Officer
Delrene Rasmussen, Assistant Investment Officer
Carroll V. South, Executive Director
Louise Welsh, Bond Program Officer

GUESTS:

Ms. Gordon Hoven, Piper Jaffray
Mr. Michael Day, Emerald BioAgriculture Corp.
Ms. Jody Brandt, Department of Revenue
Mr. Don Hoffman, Department of Revenue
Mr. Jeff Brandt, Department of Revenue
Mr. Scott Hoversland, Department of Commerce, Board of Housing
Mr. Kathy Clark, First Security Bank, West Yellowstone
Mr. Keith L. Colbo, Montana Independent Bankers
Ms. Kris Ford, Principal and Project Manager, Ennis Knupp
Mr. Greg Pritz, Principal, Ennis Knupp
Mr. Jay Plaherty, Senior Investment Analyst, Ennis Knupp
Mr. Francis X. Lilly, President, Independent Fiduciary Services

Mr. Steven M. Harding, Vice President, Independent Fiduciary Services
Mr. Terry Dennison, CPA, Principal, Mercer Consultants
Mr. Roderick B. Crane, JD, Principal, Mercer Consultants
Mr. Russel Kuhns, CEO, RV Kuhns
Ms. Becky Gratsinger, President, RV Kuhns
Mr. Jim Voytko, Senior Consultant, RV Kuhns
Mr. Dan Yates, Senior Consultant, RV Kuhns
Ms. Jeanne Wolf, Department of Administration Procurement Bureau

CALL TO ORDER

Chairman Anderson called the regular meeting of the Board of Investments (Board) to order at 8:35 a.m. in the conference room at 2401 Colonial Drive, 3rd Floor, Helena, Montana. As noted above, the meeting convened with seven members of the Board present. Member Ryan and Member Klawon were absent.

Member Moore motioned for approval of the June 14, 2004 minutes; Member Beams seconded the motion and the motion was passed 7-0.

PUBLIC COMMENT - Public Comment on Board-Related Items

Chairman Anderson called for Public Comment of Board-Related Items. No Public Comment was made.

EXECUTIVE DIRECTOR REPORTS

Department of Revenue Loan Increase Request

Mr. Carroll South presented a request from the Department of Revenue (Department) requesting the remainder of the funds approved by the 2003 Legislature for the POINTS Computer System replacement project, IRIS. These funds would allow the Department to proceed with adding additional tax types to the system which will result in savings and expedite the elimination of POINTS. The requested loan increase will permit the Department to implement Phase II which will add individual income and corporate income taxes to the system.

Staff recommends that the Board authorize an increase of \$6,688,025 to the Department's \$10,311,975 loan from the Coal Tax Trust, bringing the total loan amount to \$17.0 million.

Member Fleming moved for approval of this recommendation; Member Wilson seconded the motion and the motion was passed 7-0.

Emerald Bio Science & Tech Loan Modification

Mr. Carroll South presented to the Board a staff recommended Loan Re-Structuring Agreement between the Montana Board of Investments and Emerald Bio Agriculture Corporation. Emerald Bio has requested extensions of the maturity dates of its outstanding convertible debentures February 2002 through December 2003, and those extensions have been granted by staff.

Staff has negotiated with the company a restructuring agreement that converts the remaining \$861,013 in outstanding principal to a promissory note with principal and interest payments beginning on September 1, 2004. The new loan will be at the commercial loan rate of 7.50 percent with a 25-year term and any interest due on the convertible debentures will be waived.

Member Fleming moved for approval of this recommendation; Member Beams seconded the motion and the motion was passed 7-0.

Soft Dollar Report/Discussion

Mr. Carroll South presented an in-depth analysis of the current soft dollar agreements, including which brokers are used for these agreements, which funds pay the commissions, and how services purchased with soft dollars are used

and by whom.

Staff has transitioned all Bloomberg services from soft dollars to the operational budget, and the process of transitioning many of the less expensive soft dollar services will take place over a period of time, approximately 3 years. The following reasons explain this process:

- 1) Because fixed income and externally-managed account brokers are not used for soft dollar purchases, MTCP bears the entire cost for these services. The MTCP portfolio manager must carefully track the brokers used throughout the year to ensure that adequate commissions are paid to the soft dollar brokers. During Fiscal 2004, soft dollar commissions comprised 32.0 percent of all MTCP commissions. This large commission allocation for soft dollar purchases reduces the commissions available for full-service brokers.
- 2) Because fixed-income accounts use many of these services purchased by MTCP commissions, fixed-income accounts are not sharing proportionately in the cost of these services.
- 3) The cost of these services is included in the purchase/sale price of MTCP securities rather than recorded as expenditures. To the extent that these costs are not reflected in our operational budget our actual management costs are understated by that amount.
- 4) If for any reason, the Securities and Exchange Commission prohibits or restricts the use of soft dollars; all services funded in this manner will be at risk.

The Board concurs with staff's decision to transition services from soft dollars to the operational budget and directed staff to proceed.

Broker Allocation Process

Mr. Carroll South presented staff recommendation that the MTCP commission allocation process be eliminated and that the MTCP manager have the same flexibility as other internal and external managers to choose the brokers best suited for specific transactions.

MTCP pays \$0.05 per share for all full-service brokers, despite the level of service provided by the broker. The commissions paid add to the cost of stocks purchased and is subtracted from the proceeds when stocks are sold, thereby impacting the return.

Member Moore said that broker selection should be a competitive process and if in-state investment firms can provide the same level of services as out-of-state brokers the in-state firms should be given preference.

Member Wilson moved for approval of this recommendation; Member Fleming seconded the motion and the motion was passed 7-0.

Investment Policy Statement Procedures

Mr. Carroll South presented a request regarding the Investment Policy Statements. The policies are presented to the Board for approval either on a one-year or a two-year cycle, depending upon the size and complexity of the fund. This process takes place whether or not changes are being recommended by staff

Staff is requesting that Investment Policies be presented to the Board for approval only when revisions are recommended, or when new funds are created. This process change means that once approved, the Investment Policies will remain "as is" until revisions are suggested and approved by the Board at a public meeting. The Investment Policies will have a "revised date" in the header which will correspond to the Board meeting date at which the policies were last approved.

In addition, the Investment Policy Statements will be posted to the website in order to be more accessible to clients and the public.

The Board concurs with staff's request regarding Investment Policy Statements but would like to see the Investment

Policies occasionally to refresh their memories.

External Investment Manager Report

Mr. Carroll South presented a report and provided information on the three external international equity managers and the domestic enhanced index manager.

As Trustees of the constitutionally-created Unified Investment Program, Board Members have the sole responsibility for administering the Program in accordance with the prudent expert principle.

Staff recently reviewed the active external managers to ensure that they are managing the portfolios assigned to them as they stated they would when hired and staff also reviewed the methods they employ to "beat" the benchmarks.

The Board's three active international equity managers are:

1. Pырford International - Staff review shows that Pырford is managing the portfolio as it stated it would in the response to the RFP and is in compliance with its contract with the Board.
2. Schroders Asset Management - Staff review shows that Schroders is managing the portfolio as it stated it would in the response to the RFP and is in compliance with its contract with the Board.
3. Nomura Asset Management - Staff review shows that Nomura is managing the portfolio as it stated it would in the response to the RFP and is in compliance with its contract with the Board.

Dimension Fund Advisors (DFA) was hired to manage the non-large cap enhanced index. Staff has reviewed the management of this account and has determined that DFA appears to be in compliance with contract provisions.

Staff will continue to monitor external manager activities to ensure that the portfolios are managed as stated when hired and that full compliance with the contract provisions is being followed.

Out-of-State Travel

Member Fagg moved to delegate responsibility for out-of-state travel approval for staff to Executive Director Carroll South. The Board will approve travel requests submitted by Board Members and the Executive Director. Member Long seconded the motion and the motion was passed 7-0.

BOND PROGRAM

Activity Report

The Board reviewed this report for the period ending July 31, 2004.

Staff Approved Loans Report

Ms. Louise Welsh reported that:

Borrower: Seeley Lake Rural Fire District

Purpose: To finance the purchase of a new water tender.

Staff Approval Date June 3, 2004

Board Loan Amount: \$40,000

Term: 7 Years

Borrower: City of Choteau

Purpose: To finance the purchase of solid waste equipment.

Staff Approval Date June 9, 2004

Board Loan Amount: \$50,000

Term: 4 Years

Borrower: Lewis & Clark County

Purpose: To finance costs associated with the Fawn Meadow Estates Rural Improvement District.

Staff Approval Date June 9, 2004

Board Loan Amount: \$16,477

Term: 10 Years

Borrower: Yellowstone County

Purpose: To finance the purchase of a junk vehicle tow truck.

Staff Approval Date June 15, 2004

Board Loan Amount: \$35,000

Term: 4 Years

Borrower: Choteau County District Hospital dba Missouri River Medical Center, Fort Benton

Purpose: To finance costs associated with purchasing and installing a wander guard system, water heater and an air conditioning unit for the laboratory.

Staff Approval Date June 15, 2004

Board Loan Amount: \$20,312

Term: 5 Years

Borrower: Lewis & Clark County

Purpose: To finance costs associated with the Munger Road Rural Improvement District.

Staff Approval Date June 23, 2004

Board Loan Amount: \$13,553

Term: 10 Years

Borrower: City of Laurel

Purpose: To purchase a used 1998 Remax 4000 Asphalt Reclaimer.

Staff Approval Date July 1, 2004

Board Loan Amount: \$59,900

Term: 3 Years

Borrower: Town of Flaxville

Purpose: To finance the costs associated with water system improvements.

Staff Approval Date July 9, 2004

Board Loan Amount: \$61,100

Term: 10 Years

Borrower: Town of Clyde Park

Purpose: To finance costs associated with purchasing and installing accounting/utility software.

Staff Approval Date July 9, 2004

Board Loan Amount: \$7,600

Term: 3 Years

Borrower: Golden Valley County

Purpose: To purchase a new sheriff vehicle.

Staff Approval Date July 16, 2004

Board Loan Amount: \$23,590

Term: 3 Years

Borrower: City of Helena

Purpose: To finance costs associated with golf course pond improvements.

Staff Approval Date July 26, 2004

Board Loan Amount: \$62,901

Term: 10 Years

Borrower: Custer County District High School (Miles City)

Purpose: To finance costs associated with a boiler and lighting efficiency retrofit.

Staff Approval Date July 27, 2004

Board Loan Amount: \$200,000

Term: 10 Years

has been approved by staff.

INTERCAP

Ms. Louise Welsh presented staff's recommendation that the Board authorize staff to proceed with processing and closing the following loans using the Board's standard Bond Program Office procedures:

Borrower: Montana Department of Transportation

Board Loan Amount: \$346,294

Term: \$261,783 - 5 Years, \$18,514 - 6 Years, \$65,997 - 7 Years

Purpose: To finance vehicle purchases for its Motor Pool.

Borrower: Missoula County

Board Loan Amount: \$356,256

Term: 5 Years

Purpose: To finance the purchase of elections equipment.

Borrower: Gallatin County

Board Loan Amount: \$700,000

Term: 10 Years

Purpose: To finance costs associated with constructing a re-entry facility.

Member Fleming moved for approval of this recommendation; Member Fagg seconded the motion and the motion was passed 7-0.

CHIEF INVESTMENT OFFICER REPORTS

Total Fund Overview

Mr. Bob Bugni, Chief Investment Officer - Interim, presented to the Board a report "Total Fund Overview" as of June 30, 2004. This report included Total Funds for Fiscal years 2000, 2001, 2002, 2003 and 2004. Fiscal year 2004 showed \$9.60 billion total funds.

The breakdown of these funds is:

Retirement Funds 62%

Other Funds 14%

Other Trust Funds 10%

Coal Tax Trust 7%

Insurance Funds 7%

Breakdown of Asset Type:

Domestic Stocks: \$2.90 billion

International Stocks: \$0.86

Private Equity: \$0.25

Fixed Income: \$3.77

Montana Loans: \$0.34

STIP: \$1.48

Total \$9.60 billion

Retirement Funds - Peer Comparisons and Asset Allocation

Mr. Bob Bugni reported that the Montana Board of Investments are very similar to its peers with the exception of equity real estate. This asset class has some unique characteristics along with advantages and disadvantages. It would be logical for the consultant to provide feed back on this asset class.

In addition, Mr. Bugni presented the Retirement Funds Asset Allocation Plan. The report states 1) that the retirement assets were \$5.8 billion on July 31, 2004 or 62 percent of total assets and 2) studies have proven that at least 80 percent of total return is generated from asset allocation.

Mr. Bugni also reported to the Board on staffing resources and responsibilities. The 3 senior staff people, Bob Bugni, Rich Cooley and Ed Kelly have 24 years combined with the Board of Investments. \$7.3 billion or 76 percent of total assets are managed with only one professional investment staff support person. Mr. Bugni addresses preparing for the future and development of the next generation of portfolio managers and investment staff to support the Board of Investments.

LOAN PROGRAMS

Residential Mortgage Loan Program

At the June 14, 2004 Board Meeting, the Board voted 5 - 4 in favor of discontinuing the Residential Mortgage Loan Program. At the request of the Chairman, the Residential Loan Program has been placed on the agenda for reconsideration and decision.

Ms. Delrene Rasmussen presented two recommendations to the Board:

1. Staff requests that the Board reconsider its vote to discontinue the residential loan program passed on June 14, 2004, and
2. Staff also recommends that the program be offered on a continual basis and that the "floor" be eliminated.

In addition, Ms. Rasmussen's memo included reasons for the request to continue the program. The reasons stated are as follows:

" The Board has a knowledgeable, dependable and experienced staff in place with a good relationship with Montana lenders.

" The enclosed letters indicate that local servicing within the State of Montana is important to the lenders and their customers. Lenders consider it a benefit to retain servicing, which allows them to cross-sell other products.

" BOI staff understands the rural nature of the Montana market. Secondary markets located in the metropolitan areas do not. The lenders have told us that they prefer to work with the Board. They showed their preference in 2002 when the BOI residential portfolio grew to \$325 million. There was an active secondary market at that time and the Montana lenders chose to do business with the Board.

" During the last seven years, the portfolio has yielded stable and dependable earnings with immaterial past dues and no losses. The average weighted interest rate on the portfolio, according to our accounting system, was 6.877% for the period ending June 30, 2004.

" Because of the concern with the out-dated residential accounting system (AOD), staff is exploring an alternative to upgrade the processing with the Board of Housing (BOH) computer system. BOH has an updated, enhanced AOD system.

In conclusion, staff requests that the Residential Mortgage Loan Program be reconsidered and to allow it to continue to serve the people of Montana.

Mr. Bob Bugni presented an analysis of the risks and rewards inherent in the Program. Advantages of the Program are:

- " Less credit risk and interest rate risk than the Retirement Funds Bond Pool;
- " Underwriting results have been superior.

Disadvantages to the Program are:

" The total rate of return has been less than the return on the Retirement Funds Bond Pool (RFBP). For the 5-year period ending 6/30/04, the return was 7.31 percent compared to 8.20 percent for the RFPB. Since State Street started calculating Montana loan returns (May 1997), the return has been 7.36-7.46 percent compared to 8.11 percent for the RFBP.

" The reinvestment risk is high since the homeowner has the option to call us when interest rates decline. Since 2002, the loan portfolio paid down from \$320 million to \$120 million and we had to reinvest the proceeds at significantly lower yields.

" High cost per dollar invested.

" Requires a long-term commitment since it may be costly or prohibitive to liquidate the whole portfolio.

The biggest risk to the retirement fund portfolio from this program is that the loans are purchased in a higher interest rate environment and then the payoffs are reinvested in a lower interest rate environment.

Member Fagg motioned to reconsider the discontinuation of the Residential Mortgage Loan Program; Member Fleming seconded the motion and the motion was passed 7-0.

Member Fagg motioned to reinstate the Program and direct staff to report at the September meeting with their recommendation on the "floor", asset allocation and management of the program; Member Fleming seconded the motion.

Those Members voting "Yea" are voting in favor of the motion; those Members voting "Nay" are against the motion.

Dennis Beams - "Nay" Karen Fagg - "Yea"
Maureen Fleming - "Yea" Joel Long - "Yea"
Terry Moore - "Nay" Calvin Wilson - "Yea"
Dick Anderson - "Yea"

Motion passes, 5 "Yea" to 2 "Nay". Member Ryan and Member Klawon were not present.

Coal Tax Loan Program Activity Report

The Board reviewed this report for May and June.

Pension Mortgage Program Activity Report

The Board reviewed this report for May and June.

ADJOURNMENT

Chairman Anderson, as presiding officer, determined that the demands of individual privacy clearly exceed the merits of public disclosure, as such; the regular meeting was adjourned and went into a Closed Executive session at 11:30 a.m.

CALL TO ORDER

The meeting was reconvened at 12:45 p.m.

PRESENTATIONS - RFP Candidates

In attendance:

Maureen Fleming Dennis Beams Terry Moore Jeanne Wolf
Dick Anderson Calvin Wilson Karen Fagg Joel Long
Jay Klawon Carroll South Rande Muffick Bob Bugni
Rich Cooley John Romasko Geri Burton Kim Dallas

The order of the presentations in the Request For Proposal process is:

1. Ennis Knupp
2. Independent Fiduciary Services
3. Mercer
4. RV Kuhns

Three of the firms were present at the time the Board reviewed and scored the candidates. Mercer was not present. The scoring process is a public meeting, open to all RFP Candidates, however the candidates may observe, no questions may be asked or comments made.

Extensive discussion took place regarding the scoring of the oral presentations. The scoring committee, made up of Maureen Fleming, Terry Moore and Dennis Beams scored on a consensus scoring process. Each presenter was scored

on the following with 25 points available in each category:

Category A: Thoroughness of the Presentation

Category B: Ability to Articulate Offeror's Capabilities

Category C: Ability to Answer Evaluation Committee Questions

The following scores were awarded to the RFP Candidate:

Ennis Knupp:

Category A: 20 points

Category B: 22 points

Category C: 22 points

Independent Fiduciary Services:

Category A: 20 points

Category B: 25 points

Category C: 20 points

Mercer:

Category A: 15 points

Category B: 22 points

Category C: 10 points

RV Kuhns:

Category A: 25 points

Category B: 20 points

Category C: 25 points

Total scores of each candidate at the completion of Steps One and Two of the Evaluation Criteria:

Ennis Knupp: 667.00 points

Mercer: 721.38 points

Ennis Knupp: 741.62 points

Independent Fiduciary Services: 725.85 points

Scoring of the Reference Check category was not complete at the conclusion of the Presentation/Oral Interview category. The Board directed Geri Burton to complete the reference check process and then report to the Scoring Committee the findings. The Scoring Committee will complete the scoring process and advise the Department of Administration, Procurement Bureau of their final decision. All scores will be verified by the Procurement Bureau and the finalists will then be notified. A copy of the minutes of the RFP Candidate Review Open Meeting, held Wednesday, August 25, 2004 is part of this document.

INVESTMENT ACTIVITY

Domestic Equity Presentation

Mr. Rande Muffick was scheduled to present to the Board a report on Portfolio Management Recommendations. Due to the lateness of the day, and members having to leave to return home, the Chairman directed Rande to give his presentation at the September 16 meeting.

In addition to the postponement of the Domestic Equity Presentation, the Board asked Mr. Bob Bugni, Chief Investment Officer - Interim if there are any Investment Activity reports or Investments Strategies requiring immediate attention by the Board. Mr. Bugni assured the Board that the Investment Managers are proceeding as normal and expected. The Board directed staff to proceed as usual.

NEXT MEETING

The next regularly scheduled meeting of the Board will be September 16, 2004 in Bozeman.

ADJOURNMENT

There being no further business, the meeting was adjourned at 6:45 p.m.

BOARD OF INVESTMENTS

APPROVE:

Dick Anderson, Chairman

ATTEST:

Carroll South, Executive Director

DATE: