

**MONTANA BOARD OF INVESTMENTS
DEPARTMENT OF COMMERCE**

**2401 Colonial Drive, 3rd Floor
Helena, Montana
Thursday, October 21, 2004**

MINUTES

BOARD MEMBERS PRESENT:

**Dick Anderson, Chairman
Dennis Beams
Karen Fagg
Maureen Fleming
Jay Klawon
Joel Long
Terry Moore
Tim Ryan
Calvin Wilson**

BOARD MEMBERS ABSENT: None

STAFF PRESENT:

**Robert T. Bugni, CFA, Chief Investment Officer - Interim
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:

**Gordon Hoven, Piper Jaffray
Tom Welsh, Pioneer Federal Savings, Dillon
Dave Gibson, Governor's Office
Mike Arpey, Credit Suisse First Boston
Michelle Barstad, Montana Facility Finance Authority**

CALL TO ORDER

Chairman Anderson called the regular meeting of the Board of Investments (Board) to order at 9:00 a.m. in the conference room at 2401 Colonial Drive, 3rd Floor, Helena, Montana. As noted above, the meeting convened with nine members of the Board present.

Member Beams motioned for approval of the September 16, 2004 minutes; Member Wilson seconded the motion and the motion was passed 9-0.

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

Residential Mortgage Program Policy

At the June 14, 2004 regular meeting of the board, the Board voted to terminate the Residential Loan Program. At the August 26, 2004 Regular meeting of the Board, the Board voted to reinstate the Program and requested staff to consider the revised parameters for the Program. The Program is funded by the Public Employees' Retirement System and the Teachers' Retirement System.

Mr. Carroll South presented the following staff recommended parameters. Staff recommends that the parameters of the Program closely parallel the parameters of other secondary mortgage purchasers so the differentiating factor is pricing (interest rates). Pricing would be used to control volume to maintain the Mortgage portfolio within the asset allocation range established by the Board.

The following parameters will be set for the Residential Loan Program:

Asset Allocation Range - the range for residential mortgages would be up to 4.0 percent of the PERS and TRS portfolio at fair value. The mortgage portfolio would be maintained within that range by adjusting the rates relative to other secondary mortgage purchases.

Pricing - Rates will be set weekly based on Freddie Mac Single-Family rates accessible via the Bloomberg Financial System. Mortgage Program staff will recommend rates for the week to the Chief Investment Officer who will set the rates.

Floor - the 6.0 percent floor would be removed. If secondary market rates are significantly below 6.0 percent when the floor is removed, rates would be set sufficiently high relative to the market to ensure that we are not inundated with volume.

Fees - To align the Program more closely with the secondary mortgage market, the reservation fee would be removed and "mandatory delivery" would be required. The rate would be increased to compensate the elimination of the fee. A penalty of up to 50 basis points of the committed amount could be imposed if the mortgage package was delivered late or not at all.

Reservations - "Block" reservations (lenders locking a block of funding at a given rate) will be eliminated. Reservation must be tied to specific mortgages. Reservations for mortgages on homes already constructed will be limited to 30 to 60 days. The current 120-day reservation will be eliminated. Reservations for mortgages on homes under construction will be available for 180 to 240 days. Thirty day extensions for mortgages on homes under construction will be available up to a maximum of 360 days at a yield established by the Board.

Rate Buy - Downs - This option would not be available under current market conditions. If market conditions change and this option is desirable, staff will bring the policy to the Board for approval.

Assumptions - Loan assumptions will not be permitted for conventional loans (non FHA/VA loans). Assumptions for FHA and VA loans will be permitted.

Loan - to - Value - Loan - to - Value requirement for second home mortgages will decrease from 70.0 percent to 65.0 percent to compensate for the additional risk of default inherent in second homes.

Escrow Accounts - Escrow account requirements for taxes and insurance will be based on Freddie Mac Policy.

Jumbo (non conforming) loans - Uninsured non-conforming loans up to a maximum of \$500,000 will require a 65.0 percent loan-to-value ratio. Current policy requires a 50.0 percent loan-to-value ratio. Current policy requires a 50.0 percent loan-to-value ratio for uninsured non-conforming loans between \$400,001 and \$500,000.

Member Klawon expressed his concern that neither pension fund representative was present for the August meeting and vote to reinstate the loan program. Additionally, Mr. Klawon is concerned that this program is not a prudent investment. The prudent investment decision should be based on return to the pension funds.

Member Ryan also stated that he is concerned about the fiduciary responsibility of the loan program. The Board of Investments, on behalf of the Teachers' Retirement System and Public Employees' Retirement System, to buy mortgages at a 5 percent rate, is a concern of how these two funds are going to be actuarially sound. Mr. Ryan shares Mr. Klawon's concern recognizing that the only participant's in the loan program are the two largest trusts; Teachers' Retirement System and Public Employees' Retirement System that take care of the largest block of public employees.

Member Beams expressed his concern regarding raising and lowering the rates based on staff capabilities. Raising and lowering the rate based on staffing resources is counter intuitive.

Mr. Bob Bugni was then asked to give his thoughts on the discussion taking place. Mr. Bugni states the concern would be the reinvestment rate risk. There is no way to get away from this. Staff should not buy a lot of mortgages during a high interest rate environment because as the rates go back down, homeowners would exercise the option of refinancing. The cap of 4 percent would limit the risk of the program, charging market rates and never less than market rates. All of the policy statements have been revised and Mr. Bugni is comfortable with the revisions that have been made. Mr. Bugni states that he is comfortable with the Program as it is now.

Member Fagg complimented staff on the great job that they have done on analyzing the program, determining what some of the problem areas were and making recommendation, limiting the risk to 4 percent and as Mr. Bugni stated, making the program work. It is appreciated that the entire staff worked together to come up with a program that everyone is comfortable with.

Member Fleming motioned for approval of the recommendations made by staff and adoption of the revised Mortgage Loan Program Policy. Member Moore stated that he has expressed concern with some of the previous discussion that has taken place, but the way this policy is drafted and the way that Mr. Bugni has expressed that it will be managed as an asset class and what is best for the fund will become the driver, not what the demand is in the market place, Mr. Moore feels much better that this will be the discipline around the program and what is best for the pension funds. Member Wilson seconded the motion and the motion was passed 8-1. Member Klawon voted "No".

Consultant Schedule

Mr. South presented the schedule for the consultants, September 1, 2004 to February 28, 2005.

Regional Private Equity Fund

Mr. South updated the Board on the Regional Private Equity fund. At the September 16, 2004 meeting, the Board heard a presentation from Credit Suisse First Boston (CSFB) regarding the viability of and opportunities for the creation of a regional "fund-of-funds" investment vehicle. The Board requested that staff conduct further research on the concept and provide the Board with specific details and a recommendation at the October Board Meeting.

Staff has worked with CSFB representatives to develop terms and conditions for a regional fund. The concept is to "lower the radar" and thereby raise the visibility of Montana businesses in need of capital to venture capital firms that may otherwise overlook them.

Mr. South presented staff recommendation that the Board commit \$25.0 million to the Fund subject to staff negotiation of a satisfactory agreement with CSFB. That agreement must include precise language regarding how CSFB would ensure a "regional" focus for the Fund. Given that its role would be a "fund of funds" manager rather than making direct investments in Montana and regional businesses, we are unclear at this time how this "focus" would be guaranteed. Staff must be convinced that there is a practical way to address this issue and that appropriate language is

included in any agreement.

Further, there would be no guarantee that a significant portion of the Board's commitment would be invested in Montana businesses. The entire premise for the creation of a regional fund is to "lower the radar", making Montana businesses more visible to venture capital funds. While these funds may spend considerable time in Montana scrutinizing businesses that may need equity financing, neither Board staff nor CSFB as the General Partner will attempt to influence their decision to invest.

For this Fund to be considered prudent as required by state law, investment decisions must be based on return to the pension funds, rather than economic development. To the extent that Montana businesses receive funding as a result of the creation of the Fund, the state's economy will benefit, while the state's retirement funds receive a return on their investment commensurate with the risk inherent in venture capital investing.

Member Ryan motioned for approval of staff recommendation; Member Fleming seconded the motion and the motion was passed 9-0.

LOAN PROGRAMS

Commercial Loan Pricing

Mr. Herb Kulow presented staff recommendation, with concurrence from Mr. Bugni, that the Federal Home Loan Bank, Seattle, Intermediate/Long Term amortizing interest rate be used as the index for setting the commercial loan interest rates. Member Beams moved for approval of staff recommendation; Member Moore seconded the motion and the motion was passed 9-0.

Thompson Co-Gen Collateral Release Request

Mr. Herb Kulow presented a request from First Interstate Bank requesting the release of \$1,000,000 of pledged securities in Thompson River Co-Gen, LLC. Staff recommends approval of the release of \$1,000,000 pledged securities, with the following requirements:

" BOI will require the lender obtain certification from the Montana Department of Natural Resources and Conservation and the Montana Department of Environmental Quality that all required "final" permits are in place and that the plant meets each department's standards for a co-generation power plant and that there are no outstanding uncorrected violations of environmental laws, regulations or permitting.

" BOI will not participate in the project until the project has been operating and sending electricity to NorthWestern Energy for a minimum of three months. NorthWestern Energy will certify that the generation and transmission of power by Thompson River Co-Gen, LLC meets all of the requirements of the Power Purchase Agreement as amended.

" Lender will provide a certification from the project engineer that the plant has been built according to plans and specifications.

" The lender will certify that there is no outstanding unresolved litigation involving the borrower or the project.

Member Fleming moved for approval of staff recommendation; Member Klawon seconded the motion and the motion passed 8-0. Member Ryan abstained from the vote.

Coal Tax Loan Program Activity Report

Ms. Delrene Rasmussen presented and the Board reviewed this report for August.

Pension Mortgage Program Activity Report

Ms. Delrene Rasmussen presented and the Board reviewed this report for August.

BOND PROGRAM

Activity Report

The Board reviewed this report for the period ending September 30, 2004.

Staff Approved Loans Report

Ms. Louise Welsh reported that:

Borrower: City of Kalispell

Purpose: Two Projects:

1) \$46,500 - To finance costs associated with building a public bathroom/shelter; and

2) \$45,200 - To purchase a tractor and a mower.

Staff Approval Date September 7, 2004

Board Loan Amount: \$91,700

Term: 5 Years

Borrower: Town of Jordan

Purpose: In anticipation of Rural Development Long term financing for water system improvements.

Staff Approval Date September 7, 2004

Board Loan Amount: \$200,000

Term: 1 Year

Borrower: Dayton/Lake County Water and Sewer District

Purpose: To finance a portion of the costs associated with a preliminary engineering report.

Staff Approval Date September 9, 2004

Board Loan Amount: \$2,732

Term: 3 Years

Borrower: Arlee/Lake County Water and Sewer District increase request

Purpose: This increase is in expectation of construction cost overruns.

Staff Approval Date September 14, 2004

Board Loan Amount: \$50,000 increase to original \$742,100 loan request; \$792,100 total

Term: 2 Years

Borrower: City of Lewistown

Purpose: To purchase enhance 9-1-1 equipment.

Staff Approval Date September 29, 2004

Board Loan Amount: \$108,999

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: Department of Natural Resources and Conservation (DNRC)

Board Loan Amount: \$2,000,000

Term: 2 Years

Purpose: Interim loan in anticipation of issuing state general obligation bonds.

Borrower: Shreaver's Creek Water & Sewer District - increase request

Board Loan Amount: \$296,600 increase to original \$178,400; \$475,000 total

Term: 2 Years

Purpose: Anticipation of USDA Rural Development long - term financing.

Borrower: Gallatin Solid Waste Management District

Board Loan Amount: \$700,000

Term: 10 Years

Purpose: To finance costs associated with vehicle/equipment purchases and scale house improvements.

Borrower: City of Shelby
Board Loan Amount: \$560,000
Term: 10 Years
Purpose: To finance various vehicle/equipment purchases.

Member Moore moved for approval of this recommendation; Member Ryan seconded the motion and the motion was passed 9-0.

CHIEF INVESTMENT OFFICER REPORTS

Permanent Coal Tax Trust Fund Guaranty Request

Mr. Bob Bugni and Ms. Michelle Barstad presented a request from the Montana Facility Finance Authority (MFFA) requesting the Montana Board of Investments use the Permanent Coal Tax Trust Fund to guarantee bonds and provide surety bonds in an amount up to \$10 million for the Montana Children's Home and Hospital; and an amount up to \$4.5 million for the Marias Medical Center. MCA 90-7-317 through 90-7-320 authorizes the Board to guarantee bonds for MFFA.

Member Ryan moved for approval of this request as presented; Member Fleming seconded the motion and the motion was passed 9-0.

Asset Allocation Plan - Retirement Funds

Mr. Bob Bugni, Chief Investment Officer, presented the Asset Allocation report for September 30, 2004 transactions.

Investment Policy Statements

In addition, Mr. Bugni presented the Investment Policy Statements for the Teachers' Retirement System and the Public Employee Retirement System and the Seven Smaller Retirement Systems. Member Long moved for approval of the Investment Policy Statements as presented; Member Fagg seconded the motion and the motion was passed 9-0.

Mr. Bugni presented the Investment Policy Statement for the Montana Domestic Equity Pool. Member Moore moved for approval of the Investment Policy Statements as presented; Member Long seconded the motion and the motion was passed 9-0.

Mr. Bugni presented the Investment Policy Statement for the Montana International Equity Pool. Member Fagg moved for approval of the Investment Policy Statements as presented; Member Beams seconded the motion and the motion was passed 9-0.

INVESTMENT ACTIVITY

Montcomp

Mr. Rande Muffick presented August transactions, the holdings report as of August 31, 2004 and the current investment strategy. Member Fleming moved for approval of the Montcomp strategy as presented; Member Klawon seconded the motion and the motion was passed 8-0. Member Ryan was not present to vote.

Montana Private Equity Pool (MPEP)

Mr. Bob Bugni presented the MPEP Plan for fiscal year 2005, and the August transactions and the holdings report as of August 31, 2004.

International Investment

Mr. Richard Cooley presented the MTIP Overview as of October 12, 2004.

Presentation - Dimensional Fund Advisors

Mr. Damon Fisher and Ms. Karen Umland presented to the Board and staff a report on international small cap investing.

International Small Cap Recommendation

Mr. Rich Cooley presented to the Board staff recommendation to fund an approved 10% allocation to Small Cap by

expanding the mandate with Dimensional Fund Advisors (DFA) to include the DFA International Small Company strategy. Member Klawon moved for approval of the staff recommendation as presented; Member Wilson seconded the motion and the motion was passed 9-0.

Intermediate Funds

Mr. Rich Cooley also presented the August Treasurer's Fund Transactions and Holdings Report, and the August State Fund Transactions and Holdings Report and the current investment strategy for both of these funds. Member Long moved for approval of the Treasurer's Fund and State Fund strategy as presented; Member Beams seconded the motion and the motion was passed 8-0. Member Fleming was not present to vote.

Long Term Funds

Mr. Rich Cooley presented August Fixed Income transactions, and the current investment strategy. Member Klawon moved for approval of the Fixed Income strategy as presented; Member Ryan seconded the motion and the motion was passed 8-0. Member Fleming was not present to vote.

In addition, Mr. Cooley presented the Non-Investment Grade Holdings Report; the Retirement Funds Bond Pool Holdings and the Trust Funds Bond Pool Holdings as of September 30, 2004.

INVESTMENT ACTIVITY - FYI Items

The following Investment Activity reports were presented and available for informational purposes. None of these items requires Board action.

" Montcomp Portfolio Additions:

" Teva Pharmaceuticals " Dominion Resources

" STIP Transactions/Holdings Report

" Security Lending Report

" Market Perspectives

NEXT MEETING

The next regularly scheduled meeting of the Board will be December 2, 2004.

ADJOURNMENT

There being no further business, the meeting was adjourned at 4:30 p.m.

BOARD OF INVESTMENTS

APPROVE: Dick Anderson, Chairman

ATTEST: Carroll South, Executive Director

DATE: