

PUBLIC AGENDA ITEM – #20b

20b. Review and Discussion of Private Equity Program and Review, Discussion and Consideration of Proposed Changes to Private Equity Policies and Procedures and the Proposed Annual Tactical Plan for Fiscal Year 2010

August 25, 2009

BACKGROUND:

The Employees’ Retirement System of Texas (ERS) has determined that, over the long term, inclusion of private equity and debt investments (herein after referred to collectively as “private equity”) would enhance ERS’ expected portfolio investment characteristics. Specifically, as a result of the possibility of enhanced rates of return over publicly traded securities and returns that have low correlation with those associated with other major asset classes, the use of private equity investments tends to increase the portfolio’s overall long-term expected real return, and reduce year-to-year portfolio volatility.

At the joint meeting of the Board of Trustees and Investment Advisory Committee on August 19, 2008, the Board of Trustees approved a target allocation of 8 percent for private equity. Staff will provide a review of ERS’ private equity program at least annually.

Prior to Fiscal Year 2009, ERS had invested in five private equity funds with commitments totaling approximately \$379 million. Fiscal year-to-date 2009 (through June 30, 2009), ERS private equity has closed on nine funds with commitments totaling approximately \$697 million. Since inception, ERS has committed \$1.077 billion to private equity investments.

ERS Private Equity - Deals Closed (Inception through June 30, 2009)				
Fund #	Fund Name	ERS FY	Strategy	Initial Commitment (USD)
1	Texas Growth III - 1998 Trust	FY'98	US - Buyout/Venture Capital	\$ 100,000,000
2	Southwest Opportunity Partners	FY'07	US - Lower Middle Market Buyout	\$ 73,085,106
3	New Mountain Partners III	FY'08	US - Middle Market Buyout	\$ 60,000,000
4	Carlyle Partners V	FY'08	US - Large Market Buyout	\$ 100,000,000
5	Advent International GPE VI-C ⁽¹⁾	FY'08	Europe & US - Middle Market Buyout	\$ 46,341,900
6	Brazos Equity Fund III	FY'09	US - Lower Middle Market Buyout	\$ 37,500,000
7	Wind Point Partners VII	FY'09	US - Middle Market Buyout	\$ 65,000,000
8	CVC European Equity Partners V ⁽¹⁾	FY'09	Europe - Large Market Buyout	\$ 110,476,281
9	Charterhouse Capital Partners IX ⁽¹⁾	FY'09	Europe - Middle Market Buyout	\$ 74,427,900
10	Hellman & Friedman Capital Partners VII	FY'09	US & Europe - Large Market Buyout	\$ 100,000,000
11	Navis Asia Fund VI	FY'09	Asia - Lower Middle Market Buyout	\$ 60,000,000
12	TA XI	FY'09	US & Europe - Middle Market Growth Equity	\$ 100,000,000
13	TA SDF III	FY'09	US & Europe - Middle Market Mezzanine	\$ 50,000,000
14	Riverside RCAF V	FY'09	US - Small Market Buyout	\$ 100,000,000
Total Commitment - Since Inception:				\$ 1,076,831,187
Total Commitment - FY'09 (through June 30, 2009):				\$ 697,404,181

Footnote:

1) Euro/USD exchange rates as of 06/30/2009: 1.4043

Total – Capital Called:	\$ 199,638,398
Total – Uncalled Commitments:	\$ 877,192,789
Total – NAV (Net Asset Value):	\$ 110,503,914
Total – Economic Exposure: ⁽²⁾	\$ 987,696,703
Total – Distributions:	\$ 112,765,722

Footnote:

2) Economic Exposure equals NAV plus Uncalled Commitments

ERS private equity team has developed an active deal pipeline with the assistance of Altius Associates. During fiscal year 2009 (through June 30th), ERS Private Equity has participated in over 100 meetings/conference calls with private equity general partners and placement agents. Staff has conducted over 14 extensive due diligence trips, yielding nine fund commitments.

As of March 31, 2009, the most recent period for private equity quarterly financial statements, ERS' invested net asset value (NAV) totaled \$89.3 million. Since the ERS private equity portfolio is still immature, it is fully expected that the NAV will materially increase over the coming years as existing and future funds begin investing our committed capital.

Given the young nature of the ERS private equity program, the various diversification metrics, i.e., strategy, industry, geography, general partner, are still evolving. However, over the next several years, the ERS private equity team fully expects its risk management metrics will move closer to its stated goals.

During the current fiscal year, the private equity team has been heavily focused on getting the program up-and-running. Staff has been working diligently to develop relationships with top quartile general partners around the world and have visited numerous general partners in the US, Europe (two full due diligence trips to date), Asia and Latin America. ERS staff worked closely with Altius Associates on identifying the optimal funds for ERS investment, including buyout, growth equity, mezzanine, secondaries, turnaround/restructuring, and distressed debt funds.

ERS private equity, with Board approval last February, opportunistically increased its fiscal year 2009 target commitment from \$700 million to \$1 billion (with a \$1.25 billion commitment hard-cap). It is anticipated that ERS will complete fiscal year 2009 with commitments to 12 funds totaling \$950 million.

In addition, ERS hired two new Private Equity Portfolio Managers to assist the Director of Private Equity in developing a world class private equity program.

Under current assumptions, the ERS private equity program is forecasted to reach its long-term allocation target NAV of 8 percent (of the ERS global portfolio NAV) in 2015. This is two years earlier than was forecasted during the private equity presentation to the Board on August 19, 2008.

In summary, the ERS private equity program is moving ahead as planned. The current market dislocations, global economic slowdown, and denominator effect, impacting most other private equity investors, should greatly benefit ERS over the next one to two years as we gain access to some of the top private equity funds in the world as we ramp up our private equity program.

Private Equity Policies and Procedures:

In accordance with the Private Equity Policies and Procedures approved by the Employees Retirement System of Texas (ERS) Board of Trustees (Board) at its May 22, 2007 meeting. Staff is recommending revisions to those policies as outlined below:

(1) Staff is recommending (i) language modification to Appendix B – Private Equity Partnership Evaluation Criteria by adding Section 9 – Consideration of Emerging Managers and (ii) adding a new Appendix C - Placement Agent Procedures.

(i) Appendix B: Section 9 – Consideration of Emerging Managers. Staff is recommending that this new section be added to the ERS Private Equity Policies and Procedures because effective September 1, 2009, ERS must make a good faith effort to award contracts to or acquire services from qualified emerging managers when acquiring financial services. An emerging fund manager is defined as a private professional investment manager with assets under management of not more than \$2 billion. Private financial services include: consulting, investment advising, brokerage services, hedge fund investment, private equity fund investment, and real estate investment. Note, in 2009, the 81st Legislature of Texas passed, and the Governor signed into law, House Bill 2559, which added Section 815.103 to Texas Government Code relating to such good faith effort by ERS' Board.

(ii) Appendix C – Placement Agent Procedures and Political Contributions Policies and Procedures. Staff is recommending that this new section be added to the ERS Private Equity Policies and Procedures because of noted problems in the private equity placement agent market, such as the recent New York Common Retirement Fund “pay to play” scandal. The substance of this appendix is to require ERS’ advisors and private equity general partners and their respective placement agents to be transparent and accountable when sourcing ERS private equity investments. ERS will require broad, timely, and updated disclosure of all private equity general partner placement agent relations, compensation and fees, and also political contributions to Texas elected officials. The goal of these procedures is to help ensure that ERS private equity investment decisions are made exclusively on the merits of the investment opportunity.

Annual Tactical Plan for Fiscal Year 2010

(2) Staff is charged with preparing and presenting to the Board for its review and approval an Annual Tactical Plan (“Plan”). The proposed Plan, to be included in the private equity policy document as new Appendix A. Appendix A of the current private equity policy document is a tactical plan guideline used by staff to prepare the first private equity tactical plan document and is no longer necessary.

The proposed FY 2010 Annual tactical Plan is included with this agenda item under Exhibit B and reviews the current status of the private equity portfolio, recent historical and prospective, market conditions and proposes the steps to be taken over the next 12 months to implement the private equity program. These steps include the types and number of

partnerships to be sought as well as any other actions or considerations germane to the success of the program.

Specifically, staff is recommending that the FY 2010 Private Equity Annual Tactical Plan target a commitment of \$600 million (with a range of +/- 25% or \$450-750 million). This targeted commitment is a decrease of \$400 million from the FY 09 revised target of \$1 billion. The commitment decrease is primarily due to the lower ERS total fund market value.

In addition, staff will be targeting nine to 14 new fund commitments in strategies principally in buyouts, secondaries and distressed debt funds. Geographic focus will continue to be principally the US and Europe and secondarily the rest of the world. This request has been reviewed by and is supported by ERS' private equity advisor, Altius Associates.

STAFF RECOMMENDATION:

The staff recommended motion is attached to this agenda item.

ATTACHMENTS – 2

Exhibit A – Private Equity Policies and Procedures

Exhibit B – Private Equity Annual Tactical Plan for Fiscal Year 2010

PROPOSED ACTION - #20b

20b. Review and Discussion of Private Equity Program and Review, Discussion and Consideration of Proposed Changes to Private Equity Policies and Procedures and the Proposed Annual Tactical Plan for Fiscal Year 2010

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The ERS staff recommends the following motion to the Investment Advisory Committee:

I move that the Investment Advisory Committee recommend that the Board of Trustees of the Employees Retirement System of Texas approve the updated ERS Private Equity Policies and Procedures as presented in Exhibit A.

I further move that the Investment Advisory Committee recommend that the Board of Trustees of the Employees Retirement System of Texas approve as Appendix A to the ERS Private Equity Policies and Procedures, the FY 2010 Private Equity Annual Tactical Plan as presented in Exhibit B.

Contingent upon adoption of the above motion by the Investment Advisory Committee, staff recommends the following motion to the Board of Trustees:

I move that the Board of Trustees of the Employees Retirement System of Texas approve the updated ERS Private Equity Policies and Procedures as presented in Exhibit A.

I further move that the Board of Trustees of the Employees Retirement System of Texas approve as Appendix A to the ERS Private Equity Policies and Procedures, the FY 2010 Private Equity Annual Tactical Plan as presented in Exhibit B.