MINNESOTA STATE BOARD OF INVESTMENT

Board Members:

Governor
Tim Pawlenty

State Auditor
Rebecca Otto

Secretary of State
Mark Ritchie

Attorney General
Lori Swanson

Executive Director:

Howard J. Bicker

60 Empire Drive
Suite 355
St. Paul, MN 55103
(651) 296-3328
FAX (651) 296-9572
E-mail:
minn.sbi@state.mn.us
www.sbi.state.mn.us

An Equal Opportunity Employer

DATE: November 18, 2009

TO: Members, Investment Advisory Committee

FROM: Tammy Brusehaver TB
PatC Ammann PA.

SUBJECT: Review of Mellon Capital Management's large cap core mandate, a domestic equity manager

Organization

Franklin Portfolio Associates (Franklin) was hired in April 1989 to manage a large cap core domestic equity portfolio. Franklin's parent company, Mellon Financial Corporation, merged with The Bank of New York in July 2007 to create The Bank of New York Mellon Corporation. On January 1, 2009, Franklin merged with its sister company, Mellon Capital Asset Management, and changed its name to Mellon.

Since some of the strategies of the firms overlap, Mellon Boston and Mellon San Francisco have been working on combining their products. While several key decisions have been made, they continue to work through the final details.

Six people were let go from Mellon Boston as a result of the merger: three from the international equity strategy (which was a new product and only had seed money) and one from each of the IT, Operations and Sales departments.

Paul Healey, President and COO, left in June of 2009 due to redundancies in his role in the Boston office with the personnel in the San Francisco office. There have been no other personnel losses from the investment team in Boston.

SBI staff met with Mellon Capital Management on November 9, 2009. They discussed loss of assets, underperformance and organizational concerns. Staff continues to monitor the firm closely as they determine the final details of the combined firms. The loss of a $1.2 billion large cap core account in the third quarter resulted in SBI's account being the largest and a significant portion of the large cap product.

Philosophy and Process

Both Mellon Capital offices (Boston and San Francisco) separately manage a quantitative domestic equity product based on fundamental concepts. Both models include measures of valuation, momentum/sentiment, and earnings quality as core elements. Currently, individual factors are being evaluated for effectiveness and final inclusion into an integrated model to be launched in March of 2010.

Loss of Assets

The large cap core domestic equity strategy has seen a decline in assets from over $7 billion in FY2007 to $395 million in 3Q09. Net asset flows out of the strategy are as follows:

Time Period	Assets Lost (M)	Total Product Assets (M)*
FY2007	$103	$7,010
FY2008	$2,003	$3,510
FY2009	$361	$1,580
3Q2009	$1,290	$395

*other losses due to market impact and inflows/outflows from contributions and withdrawals

Performance
Investment performance provided below:

	Periods Ending September, 2009				
Name	3Q09	One year	Three years	Five years	Since inception 4/89
Mellon Capital	15.2	-13.8	-9.1	-1.1	8.5
Russell 1000	16.1	-6.1	-5.1	1.5	8.9

	Calendar Year Ending				
Name	2008	2007	2006	2005	2004
Mellon Capital	-40.7	2.4	20.4	3.4	15.7
Russell 1000	-37.6	5.8	15.5	6.3	11.4

Recommendation:
Due to the loss of assets and underperformance, staff recommends that the SBI terminate the relationship with Mellon Capital Management, large cap core portfolio, for investment management services.

Note:
At this time, staff is not making a recommendation related to Mellon's semi-passive mandate with the SBI. While the underperformance and merger developments continue to be carefully followed, there has not been a significant loss of assets in this mandate. Staff continues to monitor the firm closely as they determine the final details of the combined firms.