4Q2011 IAC Meeting Materials

IAC Meeting – February 21, 2012

Hedge Fund Discussion Follow-up Presentation

MINNESOTA STATE BOARD OF INVESTMENT

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

DATE: February 21, 2012

TO: Members of the Investment Advisory Council

FROM: Teri Richardson

SUBJECT: Follow-up to Hedge Fund Discussion at November 22, 2011 Meeting

During the November 22, 2011 Investment Advisory Council (IAC) meeting, the IAC and SBI staff held a lengthy discussion on the use of hedge funds. The discussion began with some brief background on the size of the hedge fund market, and the broad categories of hedge fund strategies. The discussion then moved to the definition of "hedge fund" and the philosophies of the IAC members about the use of hedge funds.

The group agreed that hedge funds are not an asset class and are better understood in the context of active management strategies. The funds can be used with the objective of improving the active implementation risk/reward characteristics of an asset class.

The group concluded that the SBI needs to research the following for additional discussion with the IAC:

1. Determine if an acceptable program could be implemented within the constitutional and statutory requirements of the state of Minnesota, and

2. Determine if there are funds that meet the legal requirements and the objective of improving the active management risk/reward characteristics of the SBI's equity and fixed income portfolios.

Also, the SBI recognizes it does not have the resources needed to implement a hedge fund program. The SBI would need additional personnel, legal review resources, consulting expertise, risk management tools, and monitoring and reporting capabilities. To determine the resources needed, the SBI would first need to evaluate the alternatives available to use to implement a hedge fund program.

Constitutional and Statutory Requirements
The constitution and statutes of Minnesota prohibit the SBI from engaging in any activity which creates general liability. The use of leverage within a portfolio, which is common in many hedge fund strategies, could violate this requirement. The SBI typically invests in separately managed accounts that are managed for the SBI only (the assets are not commingled with the assets of other investors), and the SBI owns the securities in the accounts. This structure would not meet constitutional requirements for strategies that use leverage. Excluding strategies that incorporate leverage, or restricting the hedge fund investment managers use of leverage would severely limit the options available to the SBI.

Many hedge funds are structured as limited partnerships. In this structure, investors own units of the fund which is invested on behalf of multiple investors. This structure limits the liability to the investors and is a structure that would comply with the requirements of the Minnesota constitution. (SBI invests in private equity via limited partnerships.) However, limited partnerships are subject to additional statutory requirements. The participation of the SBI in a limited partnership is limited to 20% and there must be at least four other unrelated investors in the fund. Additional advantages and disadvantages of limited partnerships relative to separately managed accounts are shown in **Exhibit A**.

The requirements of the laws and constitution of the State of Minnesota present a challenge to investing in hedge funds, but these requirements do not prevent such investments.

Hedge Fund Strategies
Strategies with the objective of improving the risk/reward characteristics of equity and fixed income portfolios are common. Examples include long/short equity funds and distressed debt funds. In preliminary research, we found examples of managers of funds with the desired objectives that offered limited partnership structures. Additional research is needed to determine if the universe of managers that meet structure and objective criteria is sufficient.

Buy vs. Build Implementation
As mentioned, the SBI would need to add resources to be able to establish a hedge fund program. The amount and type of resources is dependent on how the SBI would implement this program. The options range from complete outsourcing or "buying" the resources for all aspects of building and maintaining the program to "building" the infrastructure needed to manage all aspects of the program internally. **Exhibit B** is a summary of some of the options listed in order of ease of implementation. The three options shown represent the easiest option, the most involved option and one option (not the only option) between the extremes. The ease of implementation and need for resources are dependent on which aspects will be outsourced.

Summary and Next Steps

The SBI staff believes that the state constitution and statutes do not prohibit the SBI from investing in hedge fund strategies, and strategies that meet the investment objectives are available. The next steps are to assess the available universe, and to further explore the infrastructure needed to implement a program, and research the alternatives available to the SBI. The following information will be provided at the next IAC meeting:

1. Information about funds that would meet SBI criteria

2. A more detailed description of the resources needed to manage a hedge fund program, and the advantages and disadvantages of outsourcing vs. internal

3. Information on consultants and vendors that provide the services related to managing the program

4. Estimated relative costs of implementation options

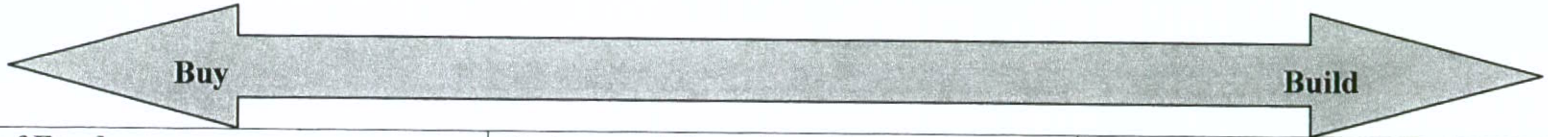
5. The potential for these strategies to make a meaningful contribution to the overall SBI portfolio

6. Assessment of the issues related to public fund investment in these strategies

Exhibit A

	Commingled Limited Partnership Funds	Separately Managed Accounts
Description	• Investor owns units of the fund • The fund is invested on behalf of several investors	• Investor owns the securities directly • Fund is invested on behalf of a single investor and is customized to reflect the requirements of the investor
Advantages	• Complies with Minnesota constitution due to limited liability • Audited financial statements are prepared annually • Standardized reporting process • May offer better liquidity	• Most transparency to holdings • Ability to customize terms and fees • Ability to customize strategy • No risk of redemptions by other investors • Not subject to statutory requirements for limited partnerships
Disadvantages	• No customization of terms or guidelines • Less transparency • Risk of redemptions by other fund investors • Subject to statutory requirement to be no more than 20% of fund and at least four other investors (SBI must have the right to liquidate investments if it becomes more than 20% of the fund or if there are less than four other investors)	• Generally will not meet requirements of Minnesota constitution

Exhibit B



Fund of Funds	Outsourced Consultant/Management	Internally Managed Program
All aspects of fund selection, legal, monitoring, risk management, custody and reporting are the responsibility of the fund of funds manager	Consultant is responsible for legal, monitoring, risk management, reporting and manager selection based on direction of investor	Staff is responsible for all aspects of fund selection, legal, manager monitoring, risk management, custody, and reporting
• Requires the least development of internal resources • Could be implemented in the least amount of time • Can be used to learn with the intent of transitioning responsibilities to more customized solutions and staff input • Offers little or no flexibility to customize to client specifications • Little control over ongoing management of the funds • The most expensive – 40bps to 100 bps plus incentive fees of 5% to 10% of profits over a cash benchmark (in addition to fees of underlying funds)	• Offers some customization and flexibility • Requires some development of internal resources to approve, administer and monitor the hedge fund portfolio holdings • Could also serve as learning opportunity for internal staff • Estimated cost of 30bps to 50 bps (in addition to fees of underlying funds)	• Offers the most flexibility • Requires substantial development of internal resources • Requires the largest number of staff with the most specialized skills