

**TOBACCO SETTLEMENT PERMANENT TRUST ACCOUNT INVESTMENT
ADVISORY COMMITTEE
Friday, October 28, 2011
*Minutes***

The Tobacco Settlement Permanent Trust Account Investment Advisory Committee (the “**Committee**”) met on Friday, October 28, 2011 at 10:00 a.m. in Room 320, Rusk State Office Building, 208 E. 10th Street, Austin, Texas.

Committee Members Present

Stuart Ford, Chairman; Roy Browning, Jr.; Peggy Deming; Judge Wayne Gent; Judge Dan Gattis; and Chuck Norris.

Committee Members Absent

Judge Mike Brown; Judge David Silva; Fred Greene; Noe Hinojosa; and Commissioner Roger Galvan.

Texas Treasury Safekeeping Trust Company (“Trust Company”) Staff Members Present

Paul Ballard, Chief Executive Officer and Chief Investment Officer; Danny Sachnowitz, Deputy Chief Investment Officer; Frank Zahn, Chief Financial Officer; Marianne S. Dwight, General Counsel; J. Germenis, Public Markets Manager; Wai Yee Cheng, Portfolio Manager; Byron Beasley, Private Markets Manager; Michael Leifeste, Real Estate Portfolio Manager; Erin Corley, Investment Analyst; Victor Scott, Director of Financial Reporting; Michael Anderson, Compliance Officer; Laura Montoya, Director of Administration; Perry Wang, Risk Analyst; and Nora Arredondo, Special Projects Coordinator.

Additional Participants Present

George Tarlas, Asset Consulting Group (“ACG”); and Rick Pokorny, Northern Trust Company.

Call to Order

Chairman Stuart Ford declared that a quorum was present and called the meeting to order at 10:10 a.m.

Chairman Ford read a statement regarding a temporary ruling on the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) requiring that municipal advisors register with the SEC. The temporary ruling resulted in a disagreement over the definition of municipal advisory services. The Comptroller’s office does not believe the usual activities of this committee constitute municipal advisory activities and they are working with the Attorney General’s office to clarify its application. Chairman Ford asked the Trust Company’s General Counsel, Marianne Dwight, to monitor the committee’s discussions and to advise them to stop if they began to engage in anything that would be considered municipal advisory activities

Approval of Minutes (Tab 1)

A motion was made by Mr. Chuck Norris to approve the March 25, 2011 meeting minutes. The motion was seconded by Peggy Deming and unanimously approved.

Capital Markets Outlook and Discussion (Tab 2)

Mr. George Tarlas of ACG presented an economic update and reviewed the third quarter to date. He began with an update on the global economy and reported that European Union leaders had agreed to increase the European Financial Stability Facility fund to one trillion euros. Markets reacted positively. The Dow surged almost 340 points on October 27th. In Japan, economic growth is expected to accelerate as the nation begins to rebuild after the natural disaster in March. Mr. Tarlas stated that ACG anticipates slow economic growth in the U.S. of about 2%, against a backdrop of tremendous global uncertainty. They expect interest rates to remain low for the remainder of 2011 and into 2012. ACG projects emerging markets will grow at almost three times the rate of developed markets. ACG believes that this challenging environment requires investors to be opportunistic and to seek managers with the ability to adapt to changing market conditions. He commented that the portfolio was positioned properly given these expectations.

Mr. Tarlas reviewed asset class relative tactical rankings for the third quarter of 2011. He reported that the only changes in asset class rankings were to take emerging market equity from a neutral to an overweight position and non-U.S. core fixed income from neutral to underweight. While ACG continues to expect high growth in emerging markets over the long term, the exceptionally high returns earned over the past 12-24 months are unlikely to continue over the near term. He explained that large cap stocks outperformed small cap stocks which may signal a turn in the market. Mr. Tarlas reported that since the last Committee meeting, Standard and Poor's had downgraded the U.S government AAA credit rating to AA+.

Review Updated Endowment Investment Policy (Tab 3)

Mr. Paul Ballard presented an overview of the revisions to the Endowment Investment Policy that became effective on October 1, 2011. He explained that the investment policy had been modified to incorporate the new asset mix presented at the previous meeting. He stated that the revised mix was expected to produce a superior risk adjusted return for the endowment and to provide the flexibility needed to be opportunistic in this more volatile and difficult investment environment. He further reviewed the policy portfolio asset allocation targets and benchmarks.

Endowment Portfolio Update and Related Matters (Tab 4 & handout)

Mr. Ballard began the presentation by reviewing economic, credit, and deleveraging cycles of the economy. He explained that developed debtor nations are deleveraging and that emerging creditor nations are continuing to grow. These two global macroeconomic imbalances are driven by these cycles. Current investment themes that will inform ongoing portfolio construction activity are expectations of moderate growth in developed economies, continued credit dislocations as the deleveraging process continues, and inflation risks presented, in part, by unprecedented monetary stimulus.

Mr. Ballard then presented an overview of the endowment portfolio and reported that it was in compliance with the investment policy. As of June 30, 2011 the portfolio value was approximately \$2.1 billion. Mr. Danny Sachnowitz reviewed a handout that reflected the new target allocations that became effective as of October 1, and noted that the portfolio was in line with the new investment policy.

Mr. Sachnowitz reviewed the various asset classes and discussed new managers added to the portfolio. He reported that the investment in high yield fixed income manager, Fountain Capital, had been fully redeemed. Mr. Ballard noted that Pure Alpha, the global macro hedge fund managed by Bridgewater, had performed exceptionally well and had increased in value approximately 75% since the initial investment was made in November 2009. He reported that an additional \$30 million was going to be allocated to Bridgewater. Mr. Ballard reported that performance was in line with expectations, given the current economic conditions. He reviewed the chart illustrating the liquidity position of the portfolio.

Mr. Sachnowitz reported that the SEC had exonerated equity long/short manager, Diamondback, of any wrong doing.

Presentation and Discussion of Investment Performance for the Period Ending 6/30/11 (Tab 5)

Mr. Rick Pokorny of Northern Trust reviewed the investment performance of the endowment funds for the period ending June 30, 2011. The portfolio return was approximately .55% for the quarter and was ahead of its benchmark. Year to date the fund produced a return of 3.51%. He reported that the second quarter proved to be a difficult market environment for equities. Generally, risk was punished. Mr. Pokorny noted that the enhanced return portion of the portfolio had produced a return of over 4%. For the quarter ending September 30, 2011, Mr. Pokorny reported that the portfolio return was -6.38%, but that it had outperformed its benchmark by 2.5%. Overall the portfolio assumed less risk than its peers and the Sharpe ratio was greater than that of its benchmark.

Discussion of 2012 Annual Distribution (handout)

Mr. Sachnowitz began the discussion about the estimated 2012 distribution with a review of the handout listing total distributions and contributions to the account. Fifty one million dollars were distributed to beneficiaries in 2011 and a \$10 million contribution was made to the Distribution Stabilization Account (“DSA”) bringing the balance in the DSA account to approximately \$54 million. Mr. Sachnowitz stated that 2011 earnings were estimated to be approximately \$24 million. Mr. Ballard explained that last year’s distribution of \$51 million could be matched by paying out earnings of \$24 million plus \$27 million from the DSA, constituting half of its remaining balance. He indicated that a larger distribution was unlikely. The Committee will decide on the amount of the 2012 distribution at its next meeting.

Discussion of Next Meeting and Agenda Items

Committee members will be contacted to determine the best date for the next meeting in March 2012, when a vote on the annual distribution will be taken.

Public Comment

None.

Adjourn

The meeting was adjourned at 12:21 p.m.