Minutes

Arkansas Teacher Retirement System
Board of Trustees

December 8, 2003

The Board of Trustees of the Arkansas Teacher Retirement System met in regular session on Monday, December 8, 2003 at 9:00 a.m. The meeting was held in the ATRS Board Room, Arkansas Teacher Retirement Building, 1400 West Third Street, Little Rock, Arkansas.

Members of the Board Present:
Linda Parsons, Chair
John Fortenberry, Vice Chair
Monty Betts
Winfred Clardy
Hazel Coleman
Charles Dyer
Dr. Paul Fair
Ann Harbison
Betty McGuire
Robin Nichols
Ellen Terry
Gus Wingfield

Members of the Board Absent:
Robert H. "Bunny" Adcock
Tom Courtway
Jim Wood

Staff Present
David R. Malone, Executive Director
Julie M. Cabe, Deputy Director
Debbie White
Wayne Greathouse

Guests Present
Lori Crosley, EnnisKnupp
Stephen Cummings, EnnisKnupp
P.J. Kelly, EnnisKnupp
Bobbye Davis, Dept. of Education
Lloyd Black, ARTA
Linda Riley, ARTA
Roda Harlan, Wilbur D. Mills Co-Op
Robert Horton, Smith Barney
Bill Hazel, Eubel Brady & Suttman
Jim McGuire, Trustee spouse

I. Roll Call

Debbie White, of the ATRS staff recorded the roll and Minutes.

II. Approval of Agenda

The Executive Director advised that State Street was not able to fly out of Boston, due to weather conditions and would not be available for the 3:45 presentation before the board. That Agenda item was removed. Hazel Coleman made the motion to approve the amended Agenda and Betty McGuire seconded the motion, which passed.

III. Public Comments on Agenda Items

No comments were submitted.

IV. Consultant's Report – by EnnisKnupp, *Lori Crosley, Stephen Cummings, P.J. Kelly*

EnnisKnupp representatives presented the monthly performance report, went over some guideline changes for BlackRock, international manager search status, private equity review, real estate review and a directed trade/recapture analysis that was done on the brokers that ATRS investment managers have used over the last twelve months.

P.J. Kelly presented a recommendation to change a BlackRock Guideline to modify the non-U.S. exposure policy. *(See attachment 1, page 3 of these Minutes).* In regard to bonds issued, the percentage should read as follows: "The greater of 1% or 2 times the percentage weighting in the Lehman Universal Index in bonds issued by any single entity domiciled in a country not included in the J.P. Morgan Government Bond Index." Charles Dyer made a motion to approve the recommended guideline change. Betty McGuire seconded the motion, which was approved.

Gus Wingfield made a motion to hire ***Wellington*** as an international core manager. Betty McGuire seconded the motion, which was approved. Ann Harbison made the motion to hire ***Capital Guardian*** as an international core manager. Hazel Coleman seconded the motion. After a brief discussion regarding Capital Guardian's presentation, Winfred Clardy called for the question. The vote indicated approval of the motion.

Dr. Fair made a motion to split equally the funds which Govett and Putnam previously managed and transfer them to Wellington and Capital Guardian. The motion was seconded by Ann Harbison and was unanimously approved.

Betty McGuire made a motion to approve an extension in the investment period, with amendments to the existing partnership agreement with ***Blackstone Mezzanine Partners*** as presented by EnnisKnupp. *(see attachment 2 of these Minutes, memorandum to David Malone, dated 12/5/03).* After discussion on the management fee and closing cost offset, Betty McGuire made a motion to approve the extension with the proposed new terms. Ann Harbison seconded the motion. The vote indicated five (5) FOR the motion, three (3) AGAINST, one (1) ABSTAINED. (At the time of the vote, Mr. Dyer, Gus Wingfield and Monty Betts were absent due to a scheduling conflict.) The motion failed.

Dr. Fair made a motion to authorize the Executive Director to choose and negotiate a contract with one or two firms as suggested by EnnisKnupp *(see attachment 3 of these Minutes, page 1.1 from Ennis Knupp's executive summary of their Commission Recapture Evaluation)* for a Commission Recapture program for the ATRS portfolio. John Fortenberry seconded the motion, which was approved.

V. Money Manager Reports

After lunch, the following managers presented their annual reports:

Credit/Suisse First Boston
ING-Aeltus
Western Assets
Oak Hill Capital Partners

VI. Adjournment

With no further business to be heard by the Board, the meeting was adjourned without objection.

Debbie White

Debbie White, Project Analyst

D R Malone

David R. Malone, Executive Director

Linda Parsons

Linda Parsons, Chair

Date of Approval 2-3-04

ENNISKNUPP

MEMORANDUM

To: Board and Staff
Arkansas Teacher Retirement System
From: Patrick Kelly, CFA
Paul Kirby
Date: December 5, 2003

Re: BlackRock Guideline Revision – Modification to Non-U.S. Exposure Limits

BlackRock has asked the Arkansas Teacher Retirement System to consider a modification to the investment guidelines for the Core PLUS portfolio the firm manages on behalf of the ATRS. The essence of the modification is to allow BlackRock more flexibility to implement the firm's investment strategy in the portfolio. Specifically, BlackRock is requesting a broader guideline as it relates to non-U.S. exposure.

As per the original guidelines, the manager is limited to investing a maximum portfolio allocation of ***"1% in bonds issued by any single entity domiciled in a country not included in the J.P. Morgan Government Bond Index."*** The J.P. Morgan Government Bond Index is commonly used as a gauge for those countries viewed as being developed, well-established economies, with a limited amount of additional country risk above that taken in the United States. The guideline, therefore, attempts to limit the investment manager's exposure to any one of the more risky foreign markets, including those of emerging market countries.

This guideline, however, impedes BlackRock's complete implementation of its current investment strategy, a portion of which calls for an allocation to Mexico that falls beyond the 1% maximum dictated above. Furthermore, Mexican bonds currently represent greater than 1% of the manager's benchmark, the Lehman Brothers Aggregate Bond Index, but are not included in the J.P. Morgan Government Bond Index. BlackRock, therefore, is prohibited from not only fully implementing its investment strategy, but also prohibited from creating a portfolio fully representative of its performance benchmark. BlackRock has been in contact with EnnisKnupp in an attempt to determine the most practical manner to address this issue.

The suggested revision to the manager's guidelines is to replace the language in bold and italics above with ***"The greater of 1% or 2 times the percentage weighting in the Lehman Aggregate Index in bonds issued by any single entity domiciled in a country not included in the J.P. Morgan Government Bond Index."*** This guideline modification will keep the spirit of the original risk limits, while at the same time allowing the manager to implement its strategy at only a marginally greater-than-Index position. We therefore recommend the ATRS accept BlackRock's suggested investment guideline revision.

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- DRAFT -
FIXED INCOME PORTFOLIO GUIDELINES FOR BLACKROCK FINANCIAL MANAGMENT FOR THE ARKANSAS TEACHER RETIREMENT SYSTEM (ATRS)
(Adopted August 13, 2003)
(Revised December 5, 2003)

These investment guidelines extend the "Statement of Investment Policy for the Arkansas Teacher Retirement System" as amended and revised.

Investment managers appointed to execute the policy will invest pension assets in accordance with the assigned investment guidelines, but apply their own judgments concerning relative investment values. In particular, investment managers are accorded full discretion, within policy limits, to (1) select individual securities, (2) make decisions as to the allocation to cash equivalents and (3) diversify pension assets.

OBJECTIVE
The goal of the core plus fixed income portfolio is to provide above-average total return in a manner that is consistent with the typical rate-of-return volatility exhibited by broad market fixed income portfolios.

The fixed income portfolio should be broadly diversified across markets, sectors, securities, and maturities in a manner consistent with accepted standards of prudence.

The portfolio must be managed in accordance with the following guidelines and restrictions.

BENCHMARK
The portfolio will be benchmarked to the Lehman Brothers Aggregate Bond Index.

RISK CONTROL
The total portfolio may invest in the following types of securities, subject to the restrictions listed below.

▪ U.S. Government bonds ▪ U.S. corporate bonds ▪ Mortgage-backed securities ▪ Asset-backed securities ▪ Bonds and preferred stock convertible into common stock ▪ Preferred stock ▪ Municipal bonds ▪ Structured notes ▪ Cash equivalents ▪ Closed end bond funds	▪ Derivative mortgage-backed securities ▪ U.S. dollar denominated bonds of developed non-U.S. issuers ▪ U.S. dollar denominated bonds of emerging non-U.S. issuers ▪ Private placement bonds ▪ Rule 144(a) securities ▪ Commercial mortgage-backed securities ▪ Capital notes/Preferred trust certificates ▪ Commingled funds investing in fixed income securities

RESTRICTIONS

The total portfolio must comply with the restrictions listed below on the basis of both percentage of assets and percentage contribution to total portfolio duration.

SECURITY TYPE QUALIFICATIONS

Futures, options and forward contracts are not allowed.

Structured notes are permitted provided that the note's investment characteristics are of a fixed income nature.

Preferred stock and bonds convertible into common stock are permitted provided that they exhibit bond-like characteristics.

The portfolio may purchase securities on a when issued basis or for forward delivery.

The portfolio may enter into covered dollar rolls on mortgage securities. Covered agreements will be defined as a sale and simultaneous purchase (for forward settlement) whereby the trade date cash balance must remain positive for the life of the roll (until the forward purchase settles).

Cash equivalent investments are defined as any security that has an effective duration under one year, a weighted average life of less than one year, and spread duration under one year.

INTEREST RATE SENSITIVITY

The effective duration of the total fixed income portfolio will remain within +/- 20% of the effective duration of the Lehman Brothers Aggregate Bond Index.

CREDIT QUALITY

The total fixed income portfolio will maintain a minimum average credit quality rating of A. Issues that are un-rated by any major credit rating agency shall be rated by the investment manager, who shall compare an unrated bond's fundamental financial characteristics with those of rated bonds to determine the appropriate rating.

Bonds rated investment grade by either Moody's or Standard & Poor's must comprise at least 90% of the total portfolio.

The portfolio's below-investment grade holdings are limited to a maximum of 1% in any single issuer.

NON-U.S. EXPOSURE

Non-U.S. bonds shall not exceed 20% of the total portfolio. Investments in non-U.S. bonds must be U.S. dollar denominated. Examples of securities included in this restriction include the following:

▪ Non-U.S. sovereign bonds ▪ Non-U.S. non-sovereign bonds ▪ Structured notes linked to non-U.S. markets ▪ Non-U.S. BlackRock commingled fund	▪ Emerging market sovereign bonds ▪ Emerging market non-sovereign bonds ▪ Supranational bonds

5% in bonds issued by entities not domiciled in the J.P. Morgan Government Bond Index. This restriction is meant to limit the portfolio's emerging market exposure to no more than 5%.

~~1% in bonds issued by any single entity domiciled in a country not included in the J.P. Morgan Government Bond Index.~~

The greater of 1% or 2 times the percentage weighting in the Lehman Aggregate Index in bonds issued by any single entity domiciled in a country not included in the J.P. Morgan Government Bond Index.

ADDITIONAL SECTOR AND POSITION LIMITS

To the extent that the portfolio holds an allocation to non-investment grade emerging market bonds, that exposure shall also count against the total portfolio's 10% high yield maximum and 20% non-U.S. maximum.

Privately placed securities, excluding 144(a) securities, shall not exceed 5% of the total portfolio.

Mortgage-backed securities that a manager classifies as exhibiting unusually high interest rate sensitivity relative to typical U.S. Government agency mortgage pass-through issues shall not exceed 5% of the total portfolio. Examples of securities likely to qualify as "highly interest rate sensitive" include IOs, POs and inverse floaters.

Preferred stock and bonds convertible into common stock shall not exceed 5% of the total portfolio.

Excluding U.S. government and agency issues the portfolio is limited to a 5% allocation in any single investment grade issuer.

The portfolio's combined allocation to the security types listed below may not exceed 25%.
Bonds not receiving an investment-grade rating from either Moody's or Standard & Poor's

Bonds issued by non-U.S. entities

Emerging market debt

Preferred stock and bonds convertible into common stock

Privately placed debt, excluding 144(a) securities

Mortgage-backed securities that a manager classifies as exhibiting unusually high interest rate sensitivity relative to typical U.S. Government agency mortgage pass-through issues

PERFORMANCE MEASUREMENT

The portfolio's return is expected to exceed the return of the Lehman Brothers Aggregate Bond Index over a full market cycle (approximately 5 years), net of fees and expenses.

The portfolio's performance is also expected to compare favorably to that of the Index on a risk-adjusted basis.

FEE SCHEDULE

ATRS shall pay Manager a fee to be computed as follows:

25 Basis points (.25%) on the first	$ 100 million (U.S.);
20 Basis points (.20%) on the next	$ 100 million (U.S.);
17.5 Basis points (.175%) on the next	$ 100 million (U.S.);
15 Basis points (.15%) on the next	$ 200 million (U.S.);
10 Basis points (.10%) on amounts over	$ 500 million (U.S.).

ENNISKNUPP

MEMORANDUM

To: David Malone
Executive Director
Arkansas Teacher Retirement System (ATRS)
From: *Lori Crosley*
Steve Cummings, CFA
Patrick Kelly, CFA
Date: December 5, 2003

Re: Blackstone Mezzanine Partners Proposal for Investment Period Extension and Amendments to Existing Partnership Agreement

Blackstone Mezzanine Partners (BMP) does not expect to invest the remaining committed capital by the end of the current investment period. As such, BMP has proposed to extend the original five year investment period, that is scheduled to end October 23, 2004, for one additional year ("extension period") ending instead on October 22, 2005. To date, the fund has called \$542 million of the total \$1.19 billion committed, or 49.3%, leaving \$648 million of capital remaining to be called. BMP expects to call an additional \$100 million by the end of January 2004 to be invested in four transactions that have already been awarded to BMP. ATRS' capital commitment is currently \$100 million, 44% has been drawn, leaving \$55.6 million unfunded.

Terms of the Extension

The limited partners received a letter dated November 18th detailing the proposed amendments to the original agreement as a result of the proposed extension period. Below is a summary of the changes to the original agreement and how ATRS will be affected.

<u>Change to the Management Fee and Closing Cost Offset</u>: Under the current partnership agreement, ATRS pays a 1.5% management fee on *committed capital* for the original investment period through 2004, and 1% of invested capital thereafter. As an offset to the management fee, ATRS receives 80% of the closing costs[1] as an offset to the management fee. If ATRS agrees to the proposed amendment, ATRS will pay a 1% management fee on *invested capital* and receive *40%* of the closing fees from deals closed through 2005, and 0% thereafter. Invested capital is calculated as the lesser of book or cost less distributions.

[1] Fees collected by the general partner from portfolio companies at closing and passed on to the limited partners as an off-set to the management fee.

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The change in the calculation of the management fee is only beneficial to ATRS as long as the invested capital is less than 1.5 times the total committed capital, or for ATRS *$150 million, through 2005*. Even though ATRS' invested capital is currently valued at $37.8 million, the value of the invested capital should grow as the remaining unfunded capital is called. ATRS can also expect that the life of the fund will be extended beyond the ten year term due to the investment period extension. Furthermore, the value of the closing fee offset will be equal to the original value only if all the remaining committed capital is invested over the next two years. BMP fully expects to have all the committed capital invested by 2005; therefore this change will not affect ATRS as long as BMP meets that date.

Introduction of Leverage: BMP appears to be concerned about meeting return expectations, and as such, has proposed that the fund execute a bank loan, secured by 50% of the limited partners' outstanding commitments, and use a 50/50 combination of equity and debt to finance the remaining deals. This means the commitment by ATRS will be reduced by 50% and replaced by the loan. If the investments go well, the ATRS will reduce their commitment by about 50% without giving up return. Because the loan is secured by the other 50% of the remaining commitments of the limited partners, the limited partners would be responsible to make 100% of the remaining capital commitments if 1) loan covenants are triggered and additional equity is required and/or 2) the proceeds upon liquidation of the portfolio company do not cover the loan payoff amount. Since the interest expense is paid for at the partnership level, the limited partners' share (80%) of the interest expense will be subtracted from distributions paid to the limited partners from the partnership, thus reducing proceeds to ATRS on deals made under the bank facility.

The interest charged by the bank is expected to be approximately prime, currently 4.0%, plus 1.25%, or 5.25%. The use of leverage is common among other mezzanine sponsors and will enable BMP to compete more effectively and possibly even improve gross returns to the partnership. Although typically leverage increases the *risk/return profile, the proposed BMP facility* will not increase the risk of individual deals; however, it could change the expected cash flows by the limited partners.

The proposed bank loan will not relieve the limited partners from potentially meeting their obligation to contribute all of their committed capital. In other words, the value of ATRS' outstanding commitment to the fund will not be reduced. However, the timing of contributions will be based on additional factors.

Other Changes to the Partnership/Investment Advisory Agreement: BMP is also proposing clarification to the partnership/investment advisory agreement as it relates to defaulting partners under the bank facility (partnership agreement; paragraph 3.5.3), as well as, an amendment to the investment advisory agreement, paragraph 15.9, which is intended to comply with recent IRS regulation that states, "*Partnerships are deemed tax shelters unless the limited partners are free to disclose the tax treatment and tax structure of the Partnership*". Neither of these changes to the original agreement will have a negative impact on ATRS' partnership unit.

Decision to Extend

Each limited partner will be able to elect whether to participate in the extension of the investment period. Therefore, ATRS should assess both BMP's performance and their ability to execute successfully on the remainder of the fund, in order to review its commitment to the fund and make an independent decision.

Overall Performance of the General Partner: Through September 30, 2003, BMP's realized investments (three) have generated a 29% gross annual rate of return. The fund had two material write-downs in 2003, HQ Global Workplaces and iPCS. As of the end of 3Q2003, the unrealized investments are valued such that the current gross IRR on the remaining deals is 7.6% gross, putting the total fund performance at 10.3% gross, or 2.2% net of fees and expenses. As such, BMP's performance relative to other vintage 1999 mezzanine funds is below the median fund in the Venture Economics database through 2Q2003. Although their performance appears to be below average, it is important to note that the universe used to compare BMP's performance is small. There were only six mezzanine funds raised in 1999, and three of those, including BMP, raised enough capital to compete for upper middle market deals (transactions utilizing >$30 million of debt financing).

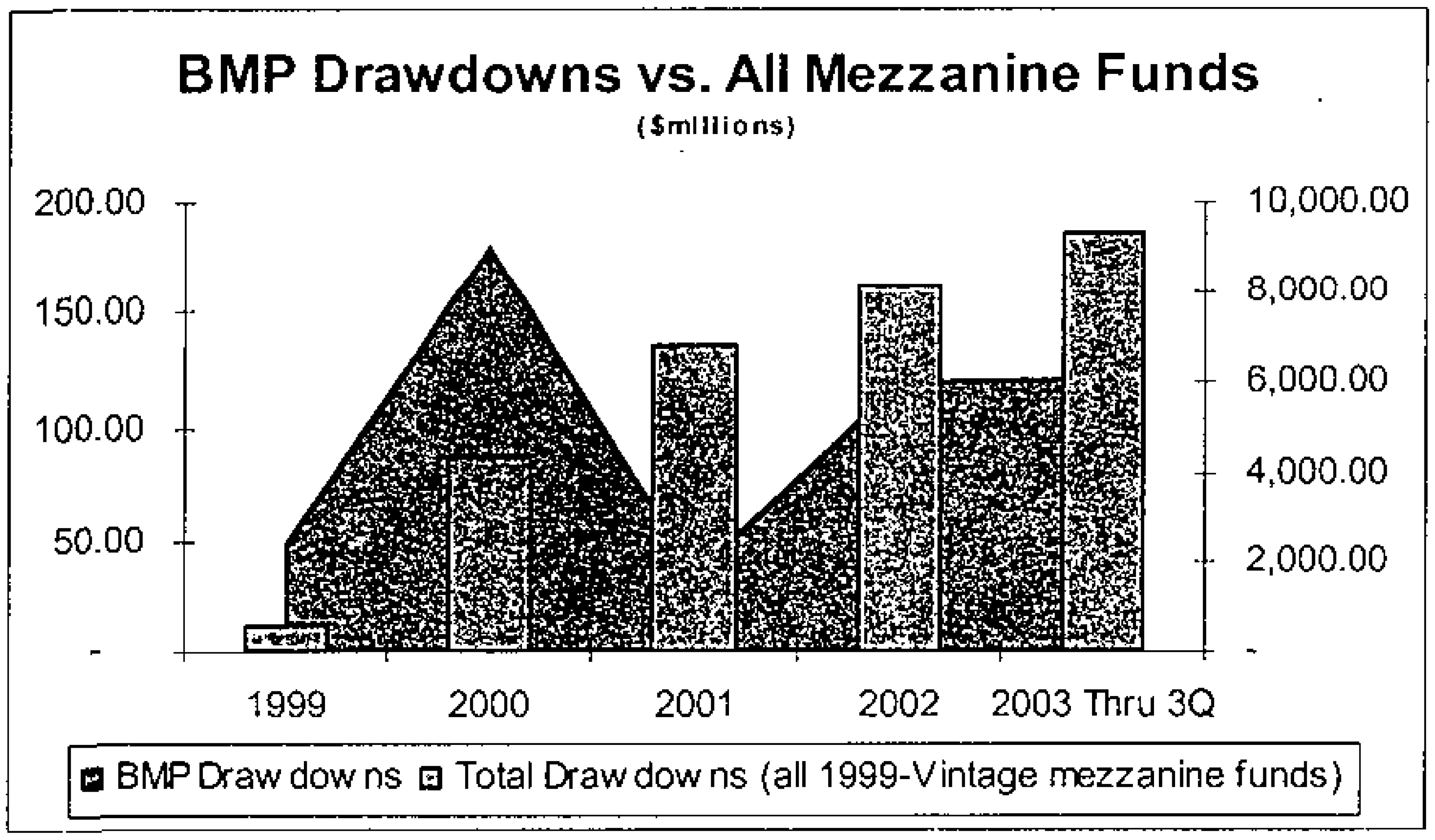
In addition to return performance, it is important for ATRS to evaluate whether BMP has adhered to their stated investment objectives, and whether they are straying from their investment approach to response to the difficult market for middle market deals and increased competition from non-mezzanine debt providers (like hedge funds, insurance companies, banks lenders and publicly traded finance companies). Despite the weak economic environment and resulting poor deal flow, BMP has confirmed with EnnisKnupp that they remain committed to their fundamental investment precepts:

1. Seek to invest in deals with a lead financial sponsor (such as a leveraged buyout fund or investment bank, who is able to invest a major portion of the equity and take a control position in the deal), or in publicly traded companies
2. Create a fund with broad industry coverage
3. Provide a diversified portfolio
4. Focus on credit quality, and
5. Emphasis on companies with strong management

Relative to these stated investment objectives; EnnisKnupp makes the following observations:

- As of September 2003, all of the deals that BMP invested in included a lead financial sponsor. BMP is represented on the board on 12 of the 16 current portfolio companies, including the unsecured creditors committees on the two companies in bankruptcy.
- Although the fund's average investment is $29 million, they have not been able to obtain broad industry diversification: almost 50% of the fund is in three industries, manufacturing, leisure and retail. The diversification may improve as the fund makes new investments.

- BMP's deal pace in 2003 has been flat relative to all 1999 vintage mezzanine funds. When asked, BMP partners confirmed at their recent Advisory Council meeting that despite the lack of deals that meet their criteria, they have been steadfast in their focus on credit quality. EnnisKnupp does not have any reason to believe this to be a false statement, however, it is too early to verify.



Ability to Execute: BMP recognizes that the mezzanine landscape has changed since the inception of this fund. The general partner has committed partner resources to expand their relationships with a focused group of financial sponsors in order to capture more deal flow. They feel this will enable BMP to compete more effectively against other mezzanine/debt providers. Furthermore, the use of leverage allows BMP to remain selective with potential deals, by allowing BMP the ability to maintain their investment objectives versus taking on riskier deals in search of higher returns.

Summary

Based on conversations with BMP and information collected from the manager, EnnisKnupp concludes that BMP has adhered to their stated investment philosophy, but achieved below-average returns in a vintage year that produced mediocre cumulative returns for mezzanine partnerships overall. BMP has not yet and probably will not be able to achieve the targeted 20% return that the manager anticipated earning with the partnership investments at the onset. If ATRS decides to extend the investment period and accept the proposed amendments, ATRS will be faced with taking on additional liquidity risk as a result of extended cash flows and will need to decide if the revised expected investment return of the fund justifies granting an extension. Also, the ATRS' has above-average exposure to private equity investments, and this lends an opportunity to reduce future commitments, albeit small, without defaulting on the partnership agreement.

General Mezzanine Market Information

Mezzanine Fund Performance 1980 - 2002

Performance Reports

Cumulative Vintage Year Performance as of 6/30/2003

Mezzanine Funds

Calculation Type : IRR (net of management fees)

Vintage Year	Num	Avg	Cap Wtd Avg	Pooled Avg	Max	Upper	Med	Lower	Min
1980-83 (less than 3 funds)									
1985 (less than 3 funds)									
1986	4	7	6.8	6.9	9.4	8.3	7.2	5.7	4.4
1987 (less than 3 funds)									
1988	4	12	11.6	11.7	13.5	12.7	11.8	11.4	10.9
1989 (less than 3 funds)									
1990 (less than 3 funds)									
1991 (less than 3 funds)									
1992	3	8.5	6.5	5	12.4	11.7	10.9	6.5	2
1993	4	10.6	10.1	11.1	14.5	14.2	10.5	6.9	6.8
1994 (less than 3 funds)									
1996	6	6.1	4.7	5.5	14.9	11.1	6.7	0	-2.9
1997	7	14.1	13.3	11.8	57	13.4	9.1	5.1	-4.6
1998	8	1.8	6.7	8.3	17.6	13.8	6.6	-6.4	-30.8
1999	6	-0.2	5.4	6.4	10.4	10.3	2.4	-2.2	-24.4
2000	5	-9.9	-14.2	-18.7	8.4	3.3	1.1	0	-62.5
2001	4	-5.7	-3.7	-2.1	2.4	2.3	0.4	-13.7	-25.9
2002	3	-2.6	-3.8	-0.1	4.5	4.2	3.9	-6.1	-16.1

Source: Thomson Financial Venture Economics / NVCA

Note: Data is continuously updated and is therefore subject to change.

 Type: Summary Performance Report

Percentile Rankings

Percentile Analysis Report

Mezzanine

Cumulative IRR as of 6/30/2003

Percentile Group	Percentile Value
100.00th percentile	57.01
90.00th percentile	16.4
80.00th percentile	13.39
70.00th percentile	11.07
60.00th percentile	9.53
50.00th percentile	7.07
40.00th percentile	4.56
30.00th percentile	2.33
20.00th percentile	0.01
10.00th percentile	-6.08
0.00th percentile	-62.53

Source : Thomson Financial Venture Economics / NVCA

Type : Summary Performance Report

Note : Data is continuously updated and is therefore subject to change.

EXECUTIVE SUMMARY

The Arkansas Teacher Retirement System (ATRS) has requested EnnisKnupp evaluate suitable commission recapture agents for the fund's equity portfolios.

For clients that engage in commission recapture we strongly recommend that the plan's fiduciaries:

- Remain knowledgeable about the operations of commission recapture programs and industry standards regarding rebate rates and utilization rates
- Make it clear to their investment managers that the commissions are plan assets and belong to the plan, not the manager
- Make it clear to the investment managers that they have a fiduciary obligation to obtain "best execution" as their primary objective
- Are diligent in monitoring and accounting for the commission recapture plan

Based on our research of commission recapture service providers, and our review of ATRS's current transaction flow and commissions charged by brokers utilized by ATRS managers, we have included the following vendors in the evaluation:

- Abel Noser
- Bank of New York
- Frank Russell
- State Street

We look forward to discussing this report with you.