PUBLIC SAFETY PERSONNEL RETIREMENT SYSTEM
BOARD OF TRUSTEES INVESTMENT COMMITTEE MEETING
February 23, 2011

MINUTES

Members Present:  Ms Lori Roediger, Trustee, Chairperson  
                 Mr. Tim Dunne, Trustee  
                 Ms. Randie Stein, Trustee

Others Present:  Mr. Paul Corens, Alternatives Investment Analyst
                 Mr. Mark Steed, Senior Analyst
                 Mr. Shan Chen, Investment Analyst
                 Mr. Don Stracke, Sr. Consultant, NEPC
                 Mr. Tom Cawkwell, Partner, Albourne America, LLC
                 Mr. Jay Rose, Partner, StepStone Group
                 Mr. Marc Lieberman, Partner, Kutak Rock

1. Call to Order

Chairperson Lori Roediger called the meeting to order at 10:00 a.m.

2. Review, discussion and possible approval of Investment Committee Minutes from the January 26, 2011 meeting.

This item was tabled.

3. Report by Investment Department Staff and discussion regarding the Month Ended and Fiscal Year-to-Date performance/portfolio update.

Mr. Steed reported that as of January 31 the Trust was up about 80 basis points (gross of fees) and the benchmark was up about 100 basis points; so there was a slight underperformance of 20 basis points. He said the equities’ portfolio underperformed which is expected in this bull market since the portfolio is positioned such that there are some managers investing in active shorts. He said that long term, the Investment Staff thinks it is the right position for the portfolio. He pointed out that the private equity portfolio also underperformed its benchmark; but that the private equity valuations had not yet been received and that Staff expects to pick up some ground once those are received but there will be a time lag.

Ms. Roediger asked if the Investment Staff anticipates making any shifts in the allocation to any one sector. Mr. Steed indicated not at this time. Mr. Stracke added that their idea is to look at the asset allocation next year since it was done last year and the focus has been on implementing the plan and putting more active management to work in the areas that were primarily passive.
4. Presentation by Investment Department Staff, StepStone Group and representatives of the Cortec Group or their affiliates and discussion and possible Recommendation regarding a possible investment of up to $30 million in the Cortec Group Fund V, L.P. or appropriate feeders, blockers, or associated or parallel funds of same.

Mr. Chen gave a brief overview of the Cortec Group which was founded in 1984. The firm seeks to make controlling investments in buyouts and recapitalization of profitable lower middle-market businesses where Cortec can add value. He said that, based on the due diligence conducted by the Investment Staff and StepStone on the firm, the Investment Staff is recommending and investment of up to $30 million in the Cortec Group Fund V to be included in the Private Equity portfolio.

Mr. Rose reported that StepStone began tracking this firm over a year ago, knowing their performance had been quite strong. He said that, as more and more private equity firms are starting to have not only deal and transaction professionals but also in-house operating expertise, this type of platform is looking very appealing. He said the firm is lead by six partners, three of whom are managing partners. He said on average they have had about 12 years together which reflects great tenure as they have already worked through a generational transfer that started back in 2000. He said StepStone analyzed Funds III and IV in their due diligence efforts but they did look back to the inception of the team and found the track record with respect to returns to be quite strong. He said their strategy is buy and build lower middle market profitable companies where they seek to invest $25 to $100 million in equity. The targeted industries are manufacturing, distribution and specialty service type businesses focusing on enterprises with values of $30 million up to about $300 million. This strategy is consistent with what they have done in Funds III and IV; so there will be no change in the strategy they will use for Fund V. He said their inception-to-date returns on an annualized basis have been about 45% net with a multiple of 1.9x. He said if you look at just Funds III and IV, the track record has produced a net annualized rate of return of about 21% as of June 30, 2010 and that is a net total value multiple of 1.8x. He said StepStone looked at the terms and conditions for Fund V and wants to point out that the limited partnership agreement is better than the market norm as far as being “L.P. friendly.” He added that there is a 100% management fee off-set or credit for any ancillary deal transaction or monitoring fees.

Messrs. David Schnadig and Jeffrey Lipsitz, Managing Partners, Cortec Group gave an overview and highlighted what differentiates their business model from others. He said their strategy is to buy good companies that have specific areas of value added opportunity. The characteristics they look for include: 1) ownership transition where they facilitate the transition from an entrepreneur looking to retire who does not have an infrastructure or team set up to take over; 2) flat businesses that need a strategy change which often goes hand-in-hand with a senior management change; and 3) businesses that have grown rapidly but do not have the infrastructure, processes, or personnel to take them to the next level. He said they are a U.S. centric investor in the lower middle market and they market their capability to invest in these types of businesses, using their operating experience and knowledge base to take on these risks, which they do not see as major, in order to generate out sized returns relative to the market.

Mr. Lipsitz said they interact very frequently with their teams and visit their companies
monthly for a day and a half. They will spend the first afternoon trying to understand the bigger picture issues. The next day, they meet for eight hours typically with all the key functional area reports and they review everything, area-by-area. He said they interact frequently, both via phone and onsite, in order to remain close to their portfolio companies and drive change so they can create bigger, better businesses with strong management teams that either financial or strategic buyers will want to acquire.

An area where they have specific expertise is medical products and services. They focus on low tech medical devices and products. They do not buy hospitals, but rather businesses that distribute catheters or thera-bands and bio freeze, as examples. They focus typically on a single patient use consumable at a gross margin of between 70% and 90% that is used every time a procedure is done. They have been increasingly looking at the services sector but they are looking at ways whereby they can add value based upon the operating experience that they have.

They discussed their alignment of interest and identified some investors in the fund. They said they will be closing at over $500 million later in the week and hope that the Trust will be participating in that final closing.

Ms. Roediger asked if the manufacturing between here and China is ever switched around. Mr. Schnadig responded that they have switched that role around a number of times. He said in some cases a company is already manufacturing or sourcing product overseas and they have been aggressive in shifting that, seeking in the process the highest quality with lowest global cost wherever that may be found. In some cases they do have companies in their portfolio that operate their own facilities; but that is the exception not the rule.

Ms. Stein asked them to discuss the average time it takes for them to exit from a company they have gone into and also discuss the range of returns they have had with their various funds. Mr. Schnadig responded that the average hold period is about 4 ½ years but it has been as short as 2 ½ years and as long as 8 or 9 years. It really depends upon whether there is cyclical exposure or if everything lines up. Mr. Lipsitz said that their returns have been very consistent, with the exception of their Fund II. That Fund was the transitional Fund which lead a number of people to the door and that was facilitated by self-assessment and strategy change.

Mr. Dunne asked if they acquire their deals by auction or if they are brought to them. Mr. Schnadig responded that deals are always brought to them. They have six dedicated people who go out and source investment opportunities. Deals brought to them through brokers or investment banker type sellers tend to be acquired through auction as they seek multiple buyers. They typically see between 300 to 400 new platform investment opportunities per year that meet their criteria and then they visit a sub-section of those to determine if the business has the specific types of opportunities where Cortec can add value.

Mr. Dunne asked if they are seeing less competition in the last two years. Mr. Schnadig responded yes and they have been able to raise money relatively easily because their track record has been good. He said they are hoping there will be less competition over the next five years.
5. Presentation by Investment Department Staff, Albourne America LLC and representatives of Red Kite Explorer or their affiliates, and discussion and possible Recommendation regarding a possible investment of up to $40 million in the Red Kite Explorer Fund, L.P. or appropriate feeders, blockers, or associated or parallel funds of same.

Mr. Corens presented a brief overview of the Red Kite Explorer Fund, a focused strategy that is designed to achieve superior risk adjusted returns with a low correlation to other asset classes. Red Kite is a metals merchant which purchases, ships, processes, stores, finances and sells physical metal. He said that the fund is a mining private finance fund designed to finance new and existing mining operations. The fund implements its strategy by structuring private loans secured by metal offtake agreements, physical metals or hard assets such as equipment or real estate. The fund returned 24% in 2009. Staff is recommending this fund for an investment of up to $40 million with that investment allocated to the Real Asset portfolio.

Mr. Tom Cawkwell, Albourne America, stated that Albourne does support an investment of up to $40 million in the Red Kite Explorer fund; they think it will enhance the Trust’s commodities portfolio. He said Albourne’s commodities team has known the principals at Red Kite for the last 10 years, prior to the founding of Red Kite, and they have spent time validating the structure of the team, the market opportunity, and the competitive environment. He said they are doing business in a large market with limited competition and in the current environment there is an increasing demand for capital which Red Kite is well placed to provide.

Messrs. Chris von Strasser and Oskar Lewnowski, of Red Kite Explorer presented an overview of their investment strategy and the background on their firm. They also discussed why they are in a position to offer their services and why there is so relatively little competition in their space. He said they provide mining companies with a time tested funding solution which is called offtake financing which is basically a service with two components – metal offtakes and financing arrangements. These are very closely related. He pointed out that there are about 4000 junior mining companies in the world and around 2300 of them are public. Many of them are located very far from the users; so the smaller mines have historically relied upon the merchants or the large mining companies to help them sell their metal to the global market which they do not have the infrastructure or capability to access on their own. That time tested relationship is called an offtake agreement. Red Kite enters into offtake agreements with the junior mines whereby Red Kite promises to provide some form of transportation, be it a truck, rail car or barge, at the mine on a regular periodic basis to ship all the metal the mine produces and sell it on their behalf. These agreements are for all the metal the mine produces and extends for the “life-of-the-mine”
which is typically 8 to 15 years. They do not guarantee a price for the metal but rather a margin.

Ms. Stein asked what the downside risk is. Mr. von Strasser responded that the downside risk is in the second part of the equation. He said there is minimal risk in the offtake because there is relatively little capital invested. He said 95% to 97% of the fund’s capital goes into the financing aspect of the equation and there is where the risk is. Mines go to them because they need “completion financing” of typically $30 to $100 million to complete the project and reach production. By the time they come into the project, numerous geologists have been hired to understand exactly what the reserve base is so there is not much exploration risk. The risk they are taking is execution risk. The basic question is can the management team get the proven reserve out of the ground in an economic way in a reasonable period of time? Since they are at the mine on a regular basis picking up the metal, they know about the slightest issue with regard to quantity or quality early on; so the offtake is a great early warning indicator of what is going on with the loan.

Ms. Roediger asked how they hedge. Mr. von Strasser responded that they hedge through the basic commodity markets. They may own the metal for one to sixty days while they are refining it and that is the period of time they are hedging the price to insure their margin.

Mr. Lewnowski said that the metals merchant community is a tight knit fraternity, the structure and membership of which has not changed materially for decades. He said it is a relationship driven business in which the certainty of competent execution is as essential as overall pricing. Red Kite is one of the largest metals managers in the world with approximately $621 million in assets. He said they have been in business for a long time and, since the community is really small and tight knit, they have a fairly good network and can identify who will be the right management team for a particular type of condition.

Ms. Roediger asked if they are a traditional financial institution and what do they ask for by way of collateral. Mr. Lewnowski responded that their primary competitors are what they call the other barge local merchants of the world because you have to be able to offer the offtake part and typically a bank or other funding source would not be able to offer that. They compete against large companies that have formidable metals departments.

Mr. Dunne asked where they tend to focus geographically. Mr. Lewnowski responded that they tend to focus on politically stable countries. They have done deals in Peru, Canada, the Midwest, Australia, and South Africa and are currently looking at an opportunity in Sonora, Mexico. Those constitute about 80% of the markets that they focus on, based on the kind of risk and returns they are looking to deliver.

Mr. Dunne asked if they have their own refineries. Mr. Lewnowski responded that they are “asset-light” and do not have their own refineries, trucks or warehouses. He said they use some of the largest trucking companies and refineries. Since Red Kite is one of the largest companies, they can negotiate volume discounts.

Ms. Stein asked how big their staff is. Mr. Lewnowski responded that the fund has 43 people on staff, nine of whom are back-office personnel involved in shipping heavy metals around the world. That team has an average of 21 years of experience only doing back office. Ms. Stein asked is any of their mines are located in Arizona. Mr. Lewnowski responded yes.
6. Update by the Chief Investment Officer regarding the Fourth Calendar Quarter/Second Fiscal Quarter Performance Update.

This item was tabled.


The Compliance Auditor will report at the full Board meeting. Mr. Steed reported that in the Fixed Income section of the meeting materials, it was reported that the portfolio was out of compliance. He said there is a quality policy that states that 75% of the assets should be rated above A and when the report was prepared, there was a typographical error indicating the portfolio was at 73.5% but that percentage of asset was really at 75.25% and the portfolio is in compliance.

8. Report by Investment Department Staff and/or legal counsel and discussion regarding recent developments and legal issues (including settlement discussions) involving the Trust’s custodians, lenders, securities lending agents, vendors, advisors, investments or investment managers or joint venturers (as well as any investments managed by the Trust’s investment managers or joint venturers). The Board of Trustees may vote to discuss this matter in Executive Session pursuant to A.R.S. §§ 38-431.03(A)(3),(4) and (7), as set forth in item 9.

9. Executive Session for Legal Matters. Discussion with legal counsel for legal advice, and discussion with and instruction to legal counsel regarding legal issues, and settlement discussions, if any, arising in connection with the Arizona PSPRS Trust’s real estate, private equity, hedge and other investments, including those

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<td>To recommend to the Board an investment of up to $40 million in the Red Kite Explorer Fund, L.P. or appropriate feeders, blockers, or associated or parallel funds of same.</td>
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Recommendation: At 11:07 a.m.

Recommendation:

Moved by: Tim Dunne
Seconded by: Randie Stein
Discussion:
In Favor: Unanimous
Motion Passes: Passes

In Favor: Unanimous
Motion Passes: Passes
managed (or formerly managed) by the Pivotal Group, ApexCapital Management, and Desert Troon Limited, pursuant to A.R.S. §§ 38-431.03(A)(3), (4) and (7), and including claims raised by Millard and Scott Seldin with respect to an indirect investment in Anthology.

b. Discussion with and instruction to legal counsel regarding legal issues pertaining to the Trust’s advisors, contractors, agents, employees, trustees and vendors.  
   (Estimated time: 5 minutes; 11:18 – 11:23 a.m.)

An Executive session was not convened.

10. Call to the Public

No members of the public came forward to speak.

11. Schedule next meeting

The next Investment Committee meeting was scheduled for March 30, 2011 at 10:00 a.m.

12. Adjournment

The meeting was adjourned at 11:12 a.m.

Ms. Lori Roediger, Trustee, Chairperson  Mr. Tim Dunne, Trustee

Ms. Randie Stein, Trustee