

**LEGISLATIVE EDUCATION STUDY COMMITTEE  
BILL ANALYSIS**

**Bill Number:** SJR 1aa

**51st Legislature, 1st Session, 2013**

**Tracking Number:** .190287.2SA

**Short Title:** Land Grant Permanent Fund Changes, CA

**Sponsor(s):** Senator Carlos R. Cisneros

**Analyst:** Kevin Force

**Date:** March 25, 2013

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**ENDORSED BY THE INVESTMENTS AND PENSIONS OVERSIGHT COMMITTEE**

**AS AMENDED**

**The Senate Floor Amendment strikes, in their entirety, the Senate Judiciary Committee amendments.**

**The Senate Judiciary Committee amendments:**

- **strike Section 1, Paragraph D regarding the Legislature’s ability to establish criteria for investing the Permanent Land Grant Fund if the criteria are enacted by a three-fourths vote of members of both houses.**

**Original Bill Summary:**

SJR 1 is endorsed by the Investments and Pensions Oversight Committee.

SJR 1 proposes to amend Article 12, Section 7 of the Constitution of New Mexico regarding conditions and restrictions placed on the State Investment Council (SIC) when performing their duties to properly manage and safeguard the investments of New Mexico:

- The proposed amendment strikes language, which directs the council to apply the “Prudent Man Rule” in the exercise of their fiduciary duties when managing investments for the Land Grant Permanent Fund (LGPF), in favor of direction to “invest and manage the fund in accordance with the *Uniform Prudent Investor Act*.” (see “Background,” below.)
- SJR 1 strikes restrictions placed upon potential investments of the fund. Specifically, it removes the following restrictions:
  - no more than 65 percent of the book value of the fund shall be invested in corporate stock;
  - no more than 10 percent of the voting stock of a corporation may be held;
  - stocks eligible for purchase must be listed upon a national stock exchange or included in a nationally recognized list of stocks; and
  - no more than 15 percent of the value of the fund may be invested in international securities at any single time.

## **Original Fiscal Impact:**

According to the Fiscal Impact Report (FIR) from the Legislative Finance Committee (LFC), previous analyses by the Secretary of State indicate that the cost of placing an amendment to the state constitution on the ballot is about \$48,000.

## **Original Fiscal Issues:**

According to the SIC:

- Costs associated with not amending the constitution as proposed are indeterminate, but those costs seriously impact the prudent investment of the funds in a much greater magnitude by artificially depressing returns over time, especially during times of economic growth. For example, even 1.0 percent outperformance on a billion dollars is \$10.0 million in value.
- The most significant limitation on investments addressed by SJR 1 is the 15 percent cap on investments in international securities. For example:
  - in calendar year 2012, the S&P 500 and Russell 3000 indices produced returns of 16 percent and 16.4 percent returns);
  - developed and emerging market international indices returned 17.8 percent and 18.2 percent, respectively;
  - the SIC had domestic equity exposure of more than \$8.3 billion, compared to capped international allocations of \$2.4 billion; and
  - had the 15 percent restriction not been in place, even a slight shift in allocation, (putting SIC closer to its institutional peers) would potentially have added tens of millions in returns to the LGPF.
- Many institutional investors now have targeted international allocations upward of 20 percent, and have been rewarded for this strategy, for the most part.
- The following annualized return numbers are based on reporting as of December 31, 2012, and compare benchmark indexes for the S&P 500, MSCI International Developed and MSCI International Emerging stock indexes:

	<b>1-Year</b>	<b>3-Years</b>	<b>5-Years</b>	<b>10Yrs</b>
<b>S&amp;P 500 Index</b>	<b>16.00</b>	<b>10.87</b>	<b>1.66</b>	<b>7.10</b>
<b>MSCI EAFE Index (Intl Dev)</b>	<b>17.78</b>	<b>3.56</b>	<b>-2.67</b>	<b>8.21</b>
<b>MSCI Emg Mkts Index (Intl)</b>	<b>18.22</b>	<b>4.66</b>	<b>-0.92</b>	<b>16.52</b>

(Note that, while international markets can be more volatile in the short term, over the course of the last decade, they typically have provided greater returns.)

## **Substantive Issues:**

The (arguably) outdated “Prudent Man Rule” standard of care imposed on the SIC by the constitution, in conflict with more recently amended statute, may put the SIC in the position of being prevented from properly fulfilling their role as fiduciaries to the LGPF and the people of New Mexico. According to the SIC:

- SJR 1 would permit the council to exercise greater discretion in meeting the long-term goals of the LGPF; SIC would be able to act solely on the prudence of market opportunities; and
- the current, direct conflict between the *Uniform Prudent Investor Act* and the older, lesser standard found in the constitution, of necessity, would be resolved in favor of the constitutional provision.

### **Background:**

When making investments, the standard of care currently imposed upon the SIC by Article 12, Section 7 of the Constitution of New Mexico is known as the “Prudent Man Rule.” Under this rule, fiduciaries are required to invest trust assets as a “prudent man” would invest his *own* property, considering the following factors:

- the needs of beneficiaries;
- the need to preserve the corpus of the trust; and
- the amount and regularity of income.

Under this rule, a fiduciary must consider each investment upon its own merits, without necessarily considering the effect of each investment upon an investor’s total portfolio, with speculative investments disfavored.

Since the inception of the “Prudent Man Rule,” different investment practices, investment products, and the effects of a global economy have become both more prevalent and more significant. Reflecting these changing conditions, in 1992, the *Uniform Prudent Investor Act* was adopted by the American Law Institute’s Third Restatement of the Law of Trusts. The act applies what may be known as the “Prudent Investor Rule,” which, reflecting a fiduciary duty more focused on the welfare of an investor’s total portfolio, might allow speculative or other investments that, of themselves, would not necessarily yield the greater return, but would incur greater benefit to the entirety of the portfolio. It differs from the Prudent Man Rule in four particular ways:<sup>1</sup>

- A trust account’s entire investment portfolio is considered when determining the prudence of an individual investment, so that a fiduciary would not be held liable for individual investment losses so long as the investment, at the time of acquisition, is consistent with the overall portfolio objectives.
- Diversification is explicitly required as a duty for prudent fiduciary investing.
- No category or type of investment is deemed inherently imprudent. Rather, suitability to the trust account’s purposes and beneficiaries’ needs is the determining factor. However, while the fiduciary is now encouraged to develop greater flexibility in overall portfolio management, speculation and outright risk taking is not sanctioned by the rule, and remain subject to criticism and possible liability.
- A fiduciary is permitted to delegate investment management and other functions to third parties.

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<sup>1</sup> Federal Deposit Insurance Corporation  
[http://www.fdic.gov/regulations/examinations/trustmanual/section\\_3/fdic\\_section\\_3-asset\\_management.html](http://www.fdic.gov/regulations/examinations/trustmanual/section_3/fdic_section_3-asset_management.html)

In 1995, the Legislature adopted the *Uniform Prudent Investor Act*,<sup>2</sup> but the pertinent sections of the Constitution of New Mexico have not yet been amended. SJR 1 proposes to remedy that lack.

According to the SIC:

- Although the direct impact of removing the international investment cap from the LGPF is indeterminate, failure to remove the cap could result in limited or artificially depressed investment returns over time, especially during times of market expansion.
- While the original intent of the constitutional limitation on international investment is not fully understood today, it is believed that when it was put in place, international investments were viewed as highly volatile.
- The artificial 15 percent cap may unintentionally restrict the SIC from making the most prudent and productive, and least risky investment decisions to achieve its mandate.
- In the 2012 legislative session, a constitutional amendment was proposed that would have retained the cap on international investments, but at a higher level of 25 percent:
  - SJR 4 (2012) passed five committees and the Senate, time ran out when it was being considered by the House;
  - SJR 4 was criticized, and even opposed, by some legislators who preferred the elimination of the cap, as is currently proposed, and placement of full fiduciary responsibility on the SIC, as intended by statute, and as a matter of best investment practices.
- In January of 2010, Ernest Knupp presented the SIC with the findings of their independent operational and fiduciary review,<sup>3</sup> specifically noting the conflict between existing statute and Article 12, Section 7 of the Constitution of New Mexico, and recommended that it be resolved soon, particularly since, in a conflict between statute and constitution, the constitutional provisions prevail.

### **Committee Referrals:**

SRC/SJC/SFC/HVEC

### **Related Bills:**

SB 9aaaa *State Investment Council Changes*

SJR 3aa *Land Grant Fund Balance & Distribution, CA*

HJR 10a *Land Grant Fund Distribution, CA*

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<sup>2</sup> Sections 45-7-601 through 45-7-612, NMSA 1978.

<sup>3</sup> <http://www.sic.state.nm.us/PDF%20files/1-11-10%20SIC%20Index%20&%20Minutes%20-%20Final.pdf>