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F I S C A L I M P A C T R E P O R T

SPONSOR Keller **ORIGINAL DATE** 01/27/14
LAST UPDATED 02/19/14 **HB**

SHORT TITLE Land Grant Fund Care & Investments, CA **SJR** 4/aSRC/aHVEC

ANALYST van Moorsel

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY14	**FY15**	**FY16**	**FY17**	**FY18**		
0.0	0.0	$53,434.6	$58,213.4	$62,031.0	Recurring	General Fund
0.0	0.0	$10,944.4	$11,923.2	$12,705.1	Recurring	Other LGPF Beneficiaries
0.0	**0.0**	**$64,379.0**	**$70,136.6**	**$74,736.1**	**Recurring**	**Total**
See "Fiscal Implications," below						

(Parenthesis ( ) Indicate Revenue Decreases)

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY14	FY15	FY16	3 Year Total Cost	Recurring or Nonrecurring	Fund Affected
Total		$46.0		$46.0	Nonrecurring	General Fund

(Parenthesis ( ) Indicate Expenditure Decreases)

SOURCES OF INFORMATION
LFC Files

Responses Received From
State Investment Council (SIC)

SUMMARY

Synopsis of HVEC Amendment

The House Voters and Elections Committee amendment to Senate Joint Resolution 4 permits the State Investment Council to approve continuation of the additional 0.5 percent distribution from the Land Grant Permanent Fund.

*****This amendment could contribute to a significant increase in the fiscal impact.*****

The House Voters and Elections Committee Amendment increases the threshold for the five-year average market value of the fund below which the additional distribution would be automatically suspended from $5.8 billion to ten billion.

Synopsis of SRC Amendment

The Senate Rules Committee amendment specifies that the LGPF must be managed under the Uniform Prudent Investment Act or its successor act.

Synopsis of Original Bill

Senate Joint Resolution 4 proposes an amendment to Article, XII, Section 7 of the Constitution of New Mexico, to require that the State Investment Council invest and manage the land grant permanent fund (LGPF) in accordance with the Uniform Prudent Investor Act. The proposed amendment would also strike the provision that no more than 15 percent of the book value of the fund may be invested in international securities at any one time.

The amendment proposed by this resolution shall be submitted to the people for their approval or rejection at the next general election or at any special election prior to that date that may be called for that purpose.

FISCAL IMPLICATIONS

The HVEC amendment permits the SIC to approve continuation of the additional 0.5 percent distribution from the Land Grant Permanent Fund. The revenue impact table assumes the distribution is continued, and the additional distributions are compared to the current constitutional provisions that end the additional distribution at the end of FY16.

The impact of the HVEC amendment to SJR 4 was estimated by assuming annual contributions into the fund are equal to the three-year average of royalties paid. Investment returns are assumed to be the State Investment Council's (SIC) long-term target of 7.5 percent, less 50 basis points for management fees. Holding these inputs constant, the effect of the increased distribution can be estimated, as shown in the revenue table above.

In the short term, additional contributions from the LGPF will produce more revenue to the general fund and other LGPF constitutional beneficiaries, primarily public education, the largest of the beneficiaries accounting for approximately 83 percent of the distribution from the fund. In the long term, and taking into consideration fund contributions from the oil and gas revenues, as well as expectations for general inflation and fluctuations in investment income, this proposal increases the risk that the LGPF will not be able to continue to deliver the same benefits to the general fund and other beneficiaries as the fund does today.

This increased distribution will result in a reduced fund balance over time. The additional distributions (estimated to total $209 million for FY17-FY19) would reduce the balance in the fund available for investment, and (assuming positive returns on investment) reduce further growth in the fund. By 2020, the corpus of the fund is diminished by $368 million, and ten years after that, the negative impact has grown to nearly $1.81 billion. Further, beginning in FY24, the size of the excess distribution proposed in HJR 3 over the current distribution begins to diminish.

The five-year average of the year-end market value of the balance in the fund is not estimated to fall below the minimum $10.0 billion level, thus suspending the additional distribution.

The approximate cost per constitutional amendment is $46 thousand. The costs include publishing the amendments in newspapers statewide, publishing the voter guide, and recording and broadcasting the constitutional amendments in Native American languages on radio.

The fiscal impact of SJR 4 is indeterminate, as it would depend on any change in portfolio allocation and the investment performance in those asset classes whose allocation would be changed pursuant to removal of the international cap. The SIC notes not amending the constitution would impact the prudent investment of the funds, citing as an example the fact that a one percent outperformance on a billion dollars equals $10,000,000 in annual value. In the last ten years (as of 11/30/13) the Russell 3000 Index has produced annualized returns of 8.09 percent; the international MSCI Emerging Market Index produced annualized returns of 12.11 percent. The SIC had US equity exposure of more than $6.7 billion, compared with the capped international allocation of $2.6 billion. Had this restriction not been in place, even a slight shift in allocation, which would put SIC closer to its institutional peers, would potentially have significantly to the returns on investment of the LGPF over that period.

Increases in investment returns would help to support high LGPF market values, and would subsequently contribute to higher distributions from that fund to its beneficiaries, including the general fund. The LGPF distribution is a significant general fund revenue source, estimated to be nearly $490 million in FY15.

SIGNIFICANT ISSUES

A 2003 constitutional amendment provided for 0.8 percent additional distribution of the LGPF from FY06 through FY12, and a 0.5 percent additional distribution from FY13 through FY16. The 2003 constitutional amendment required that the additional distribution from the permanent school fund be used to implement educational reforms. The proposed amendment would make the additional 0.5 percent distribution permanent.

The decision to deplete an endowment is a policy decision rather than a financial dictum or "best practice." The question is whether the benefits of the expenditures will outweigh the benefits of greater income tomorrow. Below is a preliminary investment performance summary for the LGPF as of November, 2013. The financial market volatility during the 2008-09 crisis continues to impact return averages, with the LGPF not achieving its 7.5 percent annualized return target for any long-term time period.

Returns as of 11/30/13	**1-Year**	**3-Years**	**5-Years**	**10-Years**	**15-Years**
Land Grant Total Fund Composite – Gross	**16.27**	**10.68**	**12.40**	**6.98**	**5.76**

In addition to extremely strong investment returns over the last 5 years, the SIC's relative performance has improved among its peers, climbing from low 4th quartile to top third and above median for one, two, three, four, and five-year periods.

While last year's performance was more than double its annual investment target, such performance is not something the SIC anticipates with consistency moving forward. Even with the bounce back from the 2008 financial meltdown, the LGPF's annualized returns for longer time periods of 10 and 15 years show investment returns far below the annual target of 7.5 percent. Depending on LGPF inflows from the State Land Office, the rate of inflation (anticipated to grow), and investment returns, it is a reasonable assumption that under the 7% distribution rate contemplated by SJR12, the LGPF would have suffered damage to its corpus over many of the previous 10 or 15 years.

The fiscal crisis of 2008/2009 has vividly shown the impact of a market downturn when combined with an aggressive spending policy and/or impaired funding matrix. The differences in the LGPF and Severance Tax Permanent Fund (STPF) offer a prime example of this:

The SIC notes Institutional funds with broken or substandard endowment models not only have a far greater challenge in meeting long-term maintenance and growth goals, they are also far more susceptible to being damaged or even crippled by a market shock incident, which investors have experienced twice in just the past 15 years.

It has been suggested that to counter an increased spending policy, the SIC may have to take an equally aggressive investment approach to be able to maintain the corpus of the fund. The past few years the SIC has taken the opposite approach however, reducing its annual return target to a more conservative and realistic 7.5% return, from the previous 8.5%.

The decision to increase diversification and lower investment risk (and reduce risk-adjusted return target) was based on an extensive asset allocation study, guidance of investment consultants, and also mirrored many institutional investors around the country. Assuming current distributions, average market returns, low to mild inflation rates, and continued strong contributions from oil and gas, the SIC believes it can continue to maintain or slightly grow the inflation-adjusted value of the LGPF over time, so that it may provide the same or greater dollar for dollar benefit to tomorrow's generations of New Mexicans as it does to those today. Changes to any of those variables (returns, inflation, inflows or distributions), materially increases the risk that the LGPF will not be able to perform as a permanent endowment is intended to.

The SIC provides other basic issues to consider, relative to the permanency of the LGPF and best practices in deployment and use of such permanent endowments and trust funds:

- The LGPF is a permanent endowment fund. Nationally, permanent endowments follow generally accepted distribution policies/spending policies. The most widely followed policy allows annual distributions of three to five percent of the corpus/principal of the fund.
- Some state funds prohibit increased distributions altogether; others only allow increases for extreme emergency situations for which other funding is not available.
- As the principal of the LGPF grows, annual distributions will automatically increase – even if the percent distributed remains the same. <u>Educational institutions and early childhood programs will benefit from those increased amounts.</u>
- The principal of the fund must increase in order to offset potential inflationary impact.
- The principal of the fund must increase in anticipation of inevitable (in the LGPF's case) diminished contributions due to the finite nature of our state natural resources.

- Even if the investment returns plus annual contributions to the fund increase, reducing the principal is arguably not prudent. The fund was established (and should be held inviolate) to assure intergenerational equity. Contributions from New Mexico's public lands and their resources will decrease over time; minerals are depleting resources and the revenues they generate must become part of the principal of the endowment so investment earnings can provide funding for education and other needs in the years after the resources are exhausted.
- If distributions from the permanent funds were increased to the suggested level, the SIC, as fiduciaries for the fund, would be required to accept increased investment risk in order to achieve the returns necessary to permit that level of payout. Council Members and SIC staff could be exposed to personal liability by accepting such risk. Fund assets/principal could be subject to sub-optimal returns as a result of incurring such risk.

The original resolution was endorsed by the Investments and Pensions Oversight Committee.

The SIC notes current statute places a higher standard of care (Uniform Prudent Investment Act) on fund management than does the constitution (businessmen of ordinary prudence). This joint resolution seeks to address this conflict, and to allow the State Investment Officer and the SIC, as fiduciaries to the LGPF, to carry out their required duties.

The primary investment change being sought in this amendment allows the SIC, as fiduciaries and investment experts, to invest the LGPF in international investments at an appropriate level of risk and reward to meet the long term return goals of the fund. The SIC is currently restricted by the current 15 percent cap on international equities, and SIC notes it has had to structure the portfolio accordingly, sometimes in a non-optimal manner.

The SIC provides the following points for consideration:

- Since restructuring by the Legislature in 2010 to remove undue political influence from the SIC, the council and its 11 members have been a balanced, thoughtful and engaged organization, comprised of three elected officials, four Governor's appointees and four legislative appointees. These members are charged with guiding and protecting the second largest sovereign wealth fund in the country, and all take their fiduciary duty seriously.
- From a macro-economic point of view, since the international cap was previously put in place the investment markets have changed, and a "global economy" has emerged.
- More than half of investment opportunity is now found in global equity overseas.
- Most of the world's Gross Domestic Product is generated internationally.
- The best economic growth rates are available outside the US, in rapidly growing and emerging economies. That economic growth is the "raw material" of investment returns.
- Foreign market investment opportunities exist in fixed income, real estate and private equity (each of these an asset class the SIC currently invests in) in increasing amounts with competitive, and often better, expected returns than in the US.
- By prudency as well as statute, the SIC is required to diversify its investments, and since the Council has reached its 15 percent international cap, the constitution restricts the SIC's fulfillment of prudent investment standards. Diversification of assets is a critical component of risk control in portfolio construction and the LGPF portfolio could be better diversified with increased access to the international investment markets.
- SIC lags most peer funds in this regard, with the majority of institutional investors allocating more than 15 percent of their portfolios internationally. As of the third quarter 2013, PERA

had structured its portfolio with more than 24 percent, while ERB's exposure was 16 percent. Both also have significant exposure to global fixed income securities and other global investment strategies. Neither fund has a constitutional or statutory cap like the SIC.

PERFORMANCE IMPLICATIONS

The SIC adds that, although direct impact of removing the international investment cap from the LGPF is indeterminate, failure to remove the cap could result in limited or depressed investment returns for the LGPF over time, especially during times of economic growth and market expansion. Today and during the recent decade, many institutional investors have targeted international allocations upward of 20 percent, and for the most part they have been rewarded for this strategy. The following annualized return numbers are based on 11/30/13 reporting, and compare benchmark indexes for the Russell 3000, MSCI International Developed and MSCI International Emerging stock indexes.

While international markets are more volatile in the short term, over the last decade, they may have provided greater returns to investors.

	1-Year	3-Year	5-Year	10-Year
Russell 3000 Index	31.71	17.79	18.54	8.09
MSCI EAFE Index (Intl Dev)	24.84	10.46	13.42	7.56
MSCI Emg Mkts Index (Intl)	3.66	.70	16.87	12.11

ADMINISTRATIVE IMPLICATIONS

SIC reports, pending approval by voters in the next general election that it would explore whether additional international investments were appropriate at that time, to meet the long-term investment goals of the LGPF. The Council would not be bound by any mandate to invest additional capital overseas, but would act solely on the prudence of the market opportunity at the time.

Does the bill meet the Legislative Finance Committee tax policy principles?

1. **Adequacy**: Revenue should be adequate to fund needed government services.
2. **Efficiency**: Tax base should be as broad as possible and avoid excess reliance on one tax.
3. **Equity**: Different taxpayers should be treated fairly.
4. **Simplicity**: Collection should be simple and easily understood.
5. **Accountability**: Preferences should be easy to monitor and evaluate

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