Liquidity Plans for Market Downturn

Investments & Pensions Oversight Committee

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SIC NEW MEXICO STATE INVESTMENT COUNCIL

What is "Liquidity"?

Portfolio liquidity can mean several different things.
Four types of liquidity as identified by the State Investment Council:

- Asset Liquidity – How easily (or not) an asset can be sold for cash.
- "Natural" Liquidity – Refers to cash income and cash inflows as well as distributions and fundings.
- "Normal" Liquidity – Refers to liquidity available in "normal" market environments and conditions. Essentially the combination of Asset Liquidity and Natural Liquidity.
- "Crisis" Liquidity – In serious market downturns, the liquidity picture changes – often drastically.

This presentation focuses on Crisis Liquidity.

"Crisis" Market Liquidity

In a "crisis" market, we can expect the following with respect to portfolio liquidity:

- Sources of liquidity will dry up materially:
  - Asset liquidity is restricted, in a practical sense, to fixed income assets.
  - Cash income may fall.
  - Inflows from the Land Office (LGPF) and the severance tax revenues (STPF) may fall.
  - Non-income cash inflows from the private portfolios may fall.

- Uses of liquidity will increase:
  - Distributions remain roughly level.
  - Capital flows from the private asset portfolio remain roughly neutral.
  - "Rebalancing" becomes a significant issue.
  - Opportunity: risk assets can become quite cheap, offering high future rates of return.

Liquidity 1.0 – NMSIC 2017 Liquidity Study

The Council studied liquidity needs in a modeled -35% stock market drawdown with a partial recovery over an 18-month period. The result guided the Council to target approximately 10% of investments ($2.5 billion) in assets that are easily liquidated to support expected liquidity needs in a crisis.

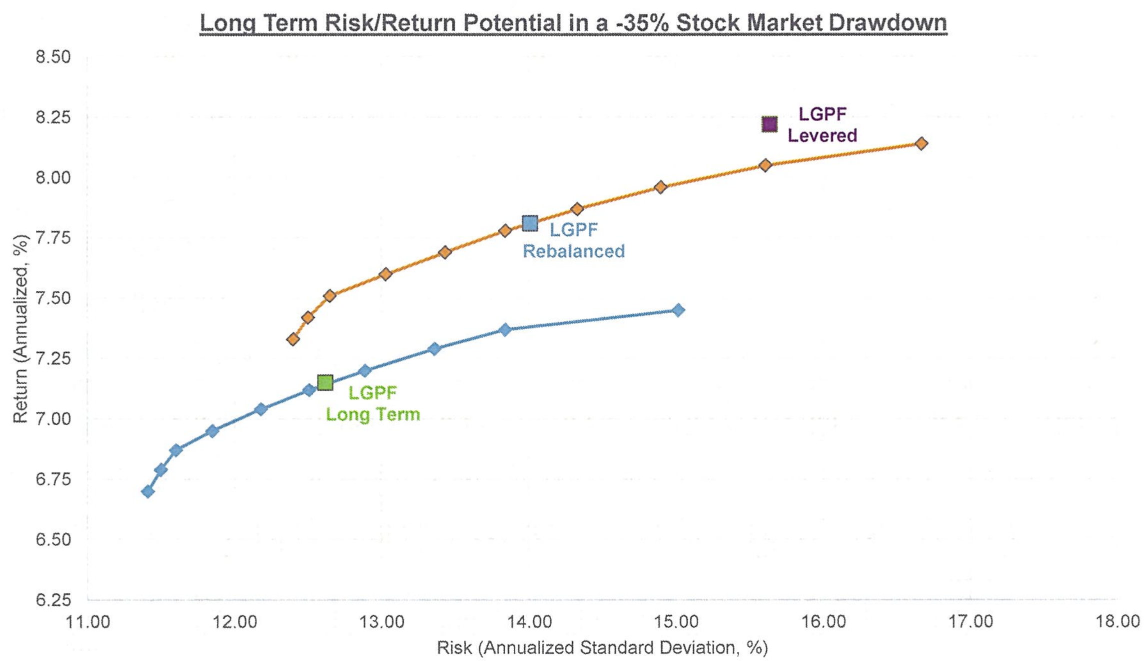
Land Grant Permanent Fund "Crisis" Liquidity		
Liquidity Sources:		$3,390
Cash Income (1)	$473	
Land Office Contribution (2)	$444	
Non-Income Inv Distributions (3)	$520	
Fixed Income Liquidation (Plug)	**$1,953**	
Liquidity Uses:		$3,390
Beneficiary Distributions	$675	
Investment Capital Calls (4)	$692	
Cash Investment Mngt Fees (5)	$48	
Rebalancing (modeled)	$1,300	
"Opportunity"	$675	
		Fund %
LGPF Net Asset Value (12/2016)	$15,000	**13.0%**

Notes: Adjustments made to refect a "crisis" market:
(1) Cash income reduced by 10%
(2) Land Office contribution reduced by 20%
(3) Non-income investment distribution reduced by 35%
(4) Investment capital calls reduced by 25%
(5) Cash investment management fees reduced by 10%

Riding the Curve: The Importance of Liquidity in a Downturn

As indicated in the previous tables, most of the portfolio's liquidity holdings will be needed to buy publicly-traded equity as rebalancing is executed. Another, smaller, portion is expected to be deployed into "opportunities" that are expected to appear. Two positive effects are expected to result. First, with equities (and risk assets generally) at lower prices, future expected rate of return rises. That's the shift that can be seen below in the chart, moving from the green risk/return curve to the orange risk/return curve. Second, by "spending" the low-risk/low return liquidity holdings on higher-risk/higher return assets, the portfolio shifts further out on the risk/return curve at an opportune time.

Increasingly, public funds are investigating the use of leverage at the portfolio level, and we've plotted the LGPF risk/return potential using 10% leverage below, as an illustration (the Council has not authorized use of leverage at this time).



Broad Investment Strategy

Late Cycle and Downturn (Recession)

We believe that the U.S. economy and global financial markets entered the "Late Cycle" phase of this economic cycle around Q1 of 2018.

Each economic and market cycle is different, and each cycle must be respected for its particular or unique characteristics. Generally, however, as the economy and investment markets enter Late Cycle, traditionally-structured institutional investment portfolios such as ours (growth-oriented, equity-oriented) can benefit from a few broad strategies:

- Reduce exposure to publicly-traded equity;
- Build income generation with income-producing assets; and
- Raise and structure liquidity.

As the cycle moves toward/into Recession and risk markets turn down into "bear market" territory (stocks down 20-35%) or into "crisis" territory (>35% decline):

- Begin to deploy liquidity--in keeping with pre-set rebalancing policy– into stocks/equity investments;
- Look for other dislocations and opportunities in other asset classes; and
- Constantly assess and re-assess liquidity needs versus liquidity position and equity exposure relative to long-term targets.

An increasing number of large public funds are studying, considering or actually deploying portfolio-level leverage. Some purposes include:

- To diversify away from publicly-traded equity exposure without "losing their place" on the risk curve;
- To increase fixed income investments (which provide downside protection) relative to publicly-traded equity investments, without reducing equity investments; and
- Tactically during the downturn, through the rebalancing process, "pushing out" on the risk curve while markets are down and offering very good future return potential.