October 1, 2004

MEMORANDUM

TO: Legislative Finance Committee Strategic Planning and Investment Subcommittee Members

FROM: Olivia Padilla-Jackson, LFC Economist
Robert Cardon, DFA Budget Analyst

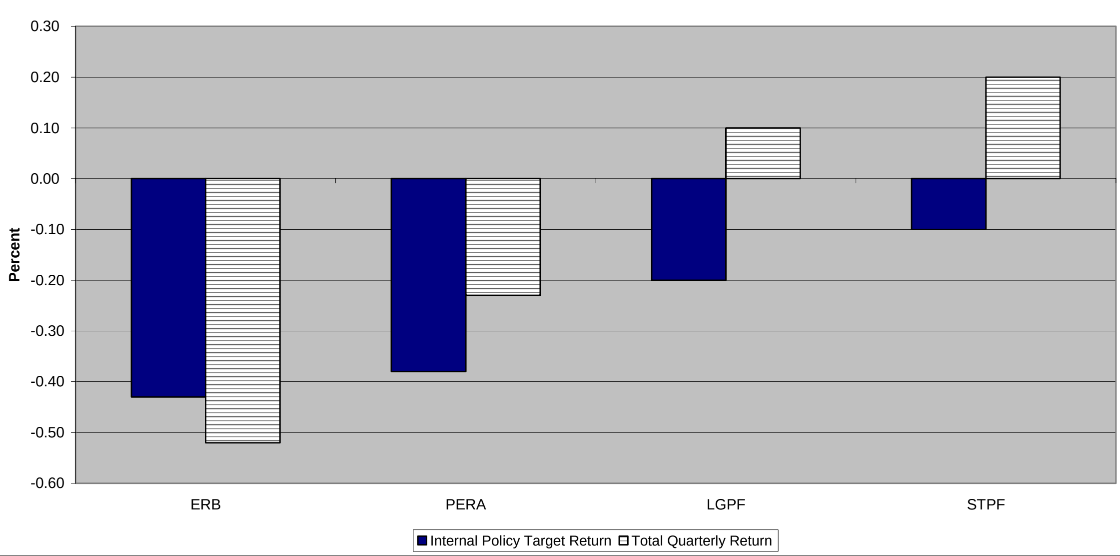
SUBJECT: Joint Report of Investment Performance – FY2004 Fourth Quarter

This report is a joint effort between LFC and DFA investment oversight staff, as per the Accountability in Government Act.

SUMMARY OF FUND PERFORMANCE

Performance for the investment programs deteriorated in the final quarter of fiscal year 2004, with returns slowing relative to those in the previous three quarters. Returns for the investment programs ranged between -0.5 percent to 0.2 percent. The permanent funds (Land Grant Permanent Fund and Severance Tax Permanent Fund) outperformed the retirement funds (PERA and ERB), marking positive returns for the quarter and exceeded their internal policy targets (a mix of various indices). The retirement funds experienced negative returns, with PERA exceeding its policy target and ERB slightly underperforming its policy target.

Figure 1
New Mexico State Investments FY2004 Fourth Quarter Returns



For the full fiscal year 2004, however, all investment programs showed double digit returns, marking the highest annual returns since 1999 (1998 for ERB).

FUND ASSET VALUES

Table 1 presents changes in asset values for the quarter and fiscal year ending June 30. The value changes include contributions and disbursements in addition to investment returns. The value for each of the four funds declined modestly in the fourth quarter. For fiscal year 2004, the value of every fund grew, with the funds' combined asset value growing over $3 billion. PERA saw the largest gain of over $1 billion.

Table 1
Current Asset Values (millions)
For Quarter and Year Ending June 30, 2004

Quarterly	**ERB**	**PERA**	**LGPF**	**STPF**
Current Asset Values (06/30/04)	6,868.7	9,369.8	7,636.4	3,621.2
Value Change (Previous Qtr)	(49.5)	(37.5)	(24.3)	(22.7)
Percent Change	-0.7%	-0.4%	-0.3%	-0.6%

Annual	**ERB**	**PERA**	**LGPF**	**STPF**
Change (Year Ago)	818.4	1,223.5	828.8	298.0
Change (Percent)	13.5%	15.0%	12.2%	9.0%

ECONOMIC AND FINANCIAL MARKET ENVIRONMENT

The quarter ending June 30 saw U.S. economic growth moderate to 3.3 percent, from 4.5 percent in the pervious quarter, as personal consumption slowed and the trade balance worsened. During the quarter, the Federal Reserve continued to raise interest rates, somewhat discounting the quarterly performance as a "soft patch". Most market participants expect the Federal Funds rate to reach 2.00 percent by the end of the year. The Federal Reserve increased the interest rates by 0.25 percent to 1.75 percent at its last policy meeting in September.

While the quarter saw continued signs of improving corporate profits, investors reportedly remain cautious over the sustainability of these profits, rising interest rates, and geo-political developments. In this environment, equity market growth moderated and bonds experienced losses. After outperforming U.S. equities in the previous quarter, international equities underperformed this quarter, declining slightly and emerging markets saw double digit losses. For the year, U.S. equities rose 21 percent, while international and emerging markets rose 32 and 33 percent, respectively.

ASSET ALLOCATION

With the exception of the STPF, all funds increased their exposure to U.S. equities over the quarter and all funds (including STPF) are overweight in equities, ranging from 0.6 to 5 percentage points above their allocation targets. Alternatively, all funds were underweighted in bonds relative to their benchmarks, which lost over 2 percent.

- ERB increased its allocation in international equities by 2.7 percentage points. This also helps explain ERB's underperformance for the quarter.

- PERA underwent fixed income portfolio restructuring and a manager transition (See "Current Issues" for more detail). Due to the restructuring, PERA invested $151 million in high yield bonds, marking its first high yield investment.

Table 2
Fund Asset Allocation Detail, Quarter Ending June 30, 2004 (Percent)

Asset Class	ERB		PERA		STPF		LFPF	
	Actual	Target	Actual	Target	Actual	Target	Actual	Target
US Equity	46.5%	46.0%	46.6%		56.7%		57.4%	
REIT	4.8%	5.0%						
Total US Equity	**51.3%**	**51.0%**	**46.6%**	**42.0%**	**56.7%**	**55.0%**	**57.4%**	**55.0%**
International Equity	**20.1%**	**20.0%**	**18.3%**	**18.0%**	**8.6%**	**10.0%**	**8.4%**	**10.0%**
Fixed Income								
U.S. Fixed Income (Core)	19.7%	30.0%	32.9%	40.0%	26.1%	27.0%	28.6%	29.0%
U.S. High Yield Bonds	5.1%	0.0%	1.6%	n/a	2.9%	3.0%	2.8%	3.0%
TIPS	3.8%		0.0%	0.0%				
ETI's*	N/A	N/A	N/A	N/A	1.9%	1.0%	N/A	N/A
Total Fixed Income	**28.6%**	**29.0%**	**34.6%**	**40.0%**	**30.9%**	**31.0%**	**31.4%**	**32.0%**
Private Equity**	N/A	**n/a**	**n/a**	**n/a**	**3.6%**	**4.0%**	**2.7%**	**3.0%**
Real Estate	N/A	**n/a**	**n/a**	**n/a**	**0.0%**	**0.0%**	**0.0%**	**0.0%**
Cash Equivalents	**0.0%**	**0.0%**	**0.6%**	**0.0%**	**0.2%**	**0.0%**	**0.1%**	**0.0%**
Total Fund %	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**

** ETI stands for economically targeted investments*
*** Performance for Venture Capital is reported on a 3 to 4-month lag*

FUND PERFORMANCE DETAIL

Table 3 below shows detailed fund performance for the quarter and year ending June 30. The table also provides the return for market benchmarks that the investment agencies agreed to in September 2002 (note, these benchmarks are distinct from the individual fund policy targets, which are also included in the table).

<u>Quarterly Performance.</u>

- For the quarter, both ERB missed its policy targets by 0.1 percentage points. Using the fund value as of June 30, this amounts to approximately -$6 million. PERA exceeded its target by 0.2 percentage points, translating to $14 million.

- Both LGPF and STPF exceeded their policy targets by 0.3 percentage points, which amounts to approximately $23 million and $11 million.

Table 3
Fund Performance Detail
Quarter Ended June 30, 2004 (Percent)

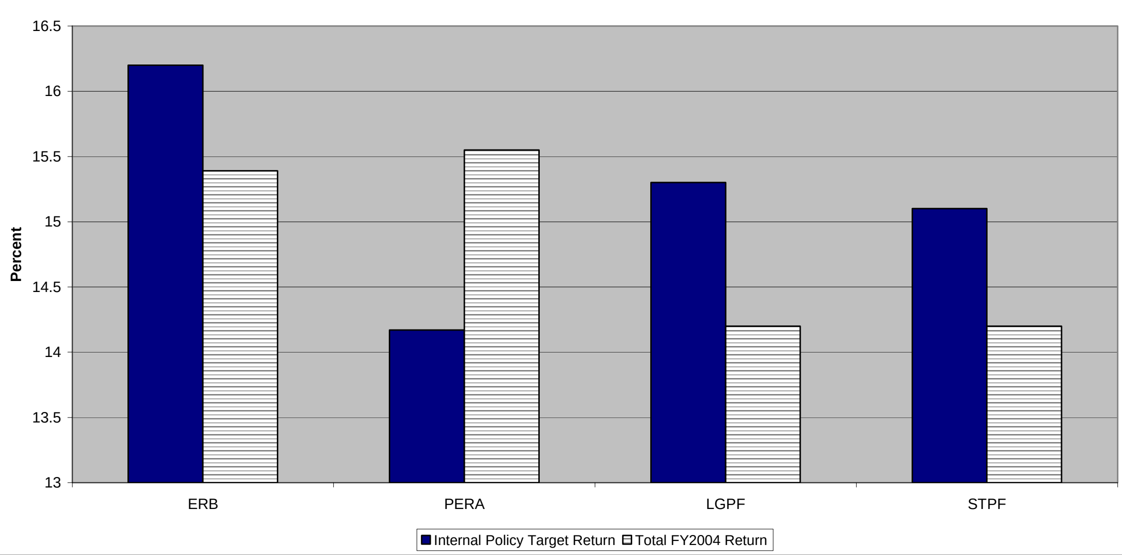
Asset Class	**Benchmark****	**ERB**	**PERA**	**LGPF**	**STPF**
U.S. Equity (Russell 3000)	*1.30*	1.38	1.72	1.30	1.30
U.S. Fixed Income (LB Aggregate)	*-2.40*	-2.75	-2.39	-2.00	-2.00
U.S. High Yield Bonds (LB HY)	*-1.00*	n/a		-1.40	-1.40
International Equity (MSCI EAFE)	*0.20*	-1.80	-1.14	1.40	1.40
Emerging Market Equity (Emerging Markets Equity)	*-9.60*		n/a	-6.80	-6.80
Private Equity/Venture Capital (Cambridge Venture Capital)	1.20	n/a	n/a	0.30	0.30
Economically Targeted Investments (90 day T-bill)	*0.20*	n/a	n/a	0.20	0.20
Cash Equivalents (90 day T-bill)	*0.20*	n/a	0.96	0.30	0.30
Individual Fund Policy Target		-0.43	-0.38	-0.20	-0.10
Total Fund Return		**-0.52**	**-0.23**	**0.10**	**0.20**

Fiscal Year Performance.

- For fiscal year 2004, ERB underperformed its policy target by 0.8 percentage points, worth approximately -$56 million. Importantly, PERA was the only fund that outperformed its policy target for the fiscal year, with an annual return that was 1.4 percentage points higher than its target. The additional return amounted to approximately $129 million.

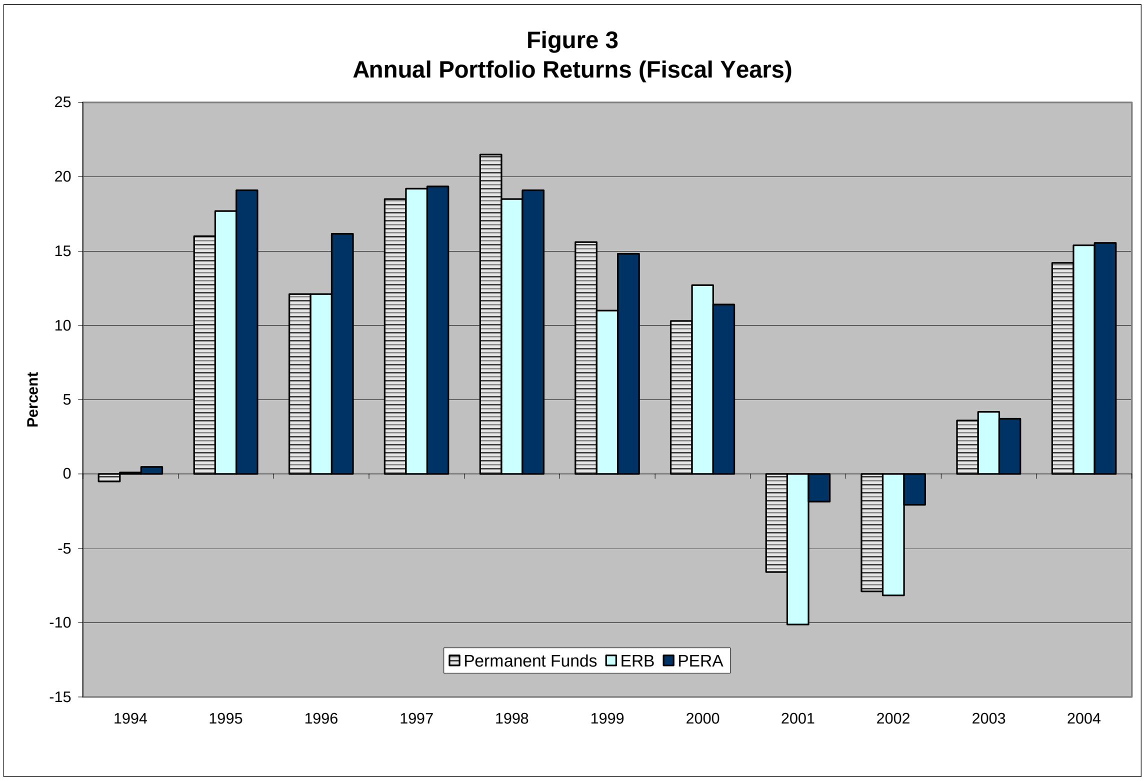
- For fiscal year 2004, LGPF underperformed its policy target by -1.1 percentage points, equaling -$84 million, while STPF underperformed its policy target by 0.9 percentage points, equaling approximately -$33 million.

Figure 2
New Mexico State Investments FY2004 Annual Returns



Fiscal year 2004 returns surpassed historic levels, with ERB, PERA, and the Permanent Funds recording 15.4, 15.6, and 14.2 percent, respectively (distinct from Table 1, percent change in value). This compares with the 10-year average return for ERB, PERA, and the Permanent

Funds of 8.4, 10.5, and 8.8 percent, respectively (See Figure 3). The above trend performance can largely be attributed to significant equity market gains.



RISK PROFILES

Investors can gauge risk by looking at the standard deviation, which measures the funds' expected variability from the return. The higher the standard deviation, the higher the risk associated with that portfolio. Keep in mind that while diversification can reduce variability, the marginal benefit of additional diversification decreases after so many new securities are added. At no point can risk be eliminated totally (i.e. market risk).

- The investment funds have had very similar risk profiles over the past ten years, though the permanent funds tend to have slightly higher standard deviations.

Table 4

Risk Profiles as shown by Standard Deviations

	ERB	PERA	LGPF	STPF
Last Year**	8.07	7.6	6.3	6.3
3 Year	14.4	12.4	12.9	12.8
5 Year	13.65	11.1	11.7	11.8
10 Year	11.47	10.2	10.4	10.4

* Standard deviation measures the fund's expected variability (deviation) from the expected return

** Due to the fact that one year standard deviation numbers include very few observations, SIC investment consultant recommends not placing a significant emphasis on these numbers.

MANAGEMENT PERFORMANCE

The performance relative to the internal targets can be attributed to either management or asset allocation. For the year ending June 30, ERB investment management was responsible for 86 percent of the underperformance relative to the internal target. PERA enjoyed a positive manager effect, which was responsible for 29 percent of the outperformance versus the target, while LGPF and STPF manager impact contributed to 82 and 100 percent of the annual underperformance, respectively.

- SIC internally managed fund performance for the quarter was mixed. The SIC Large Cap Active fund slightly underperformed the SIC Large Cap Index for the quarter, and has underperformed the index by 2.7 and 3.4 percentage points for the last one and five years, respectively. The internally managed pools slightly outperformed the benchmark for most other asset classes.

- It should also be noted that while SIC has been increasing its allocation in private equity investments, private equity returned -2.8 percent in fiscal year 2004 and has underperformed the overall fund return for the past four years. On a longer term basis (10 years), however, private equity has outperformed the overall fund return by almost 15 percentage points.

CURRENT ISSUES

PERA. According to PERA staff, the manager transition and portfolio restructuring that took place in mid June affected over $1.1 billion in assets. The restructuring replaced one manager in the core plus mandate, Reams, with Western Asset (another core plus manager), reduced the allocation to core plus manager Fiduciary and mortgage managers, and added two new mandates, high yield and core. The entire restructuring moved $510 million from previous manager Reams, $325 million from Fiduciary, $100 million from the intermediate index (Barclays), $100 million total from mortgage managers Smith Breeden and Goldman Sachs, and $75 million from cash to fund new manager Western Asset. The restructuring also established two new mandates including core with Smith Breeden and high yield with Loomis Sayles.

ERB. ERB placed JP Morgan Fleming, an international equity manager, and Rothschild Asset Management, a small cap equity manager, on a watch list for possible removal. Over the past year, the value added from JP Morgan Fleming and Rothschild was -4.5 and -3.9 percent, respectively.

State Investment Council. Over the quarter, the State Investment Council considered investing $50 million in the construction of a natural gas pipeline that would have connected with major interstate pipelines in the San Juan Basin area. In addition to a fixed annual return of 6 percent, the investment promised to increase natural gas production by as much as 500 Mcf/day. The investment proposal attracted much media and legislative attention. Ultimately, the SIC decided against it due to noncompliance with SIC policies.

OPJ:RC/yr