April 7, 2010

MEMORANDUM

TO: Representative Luciano "Lucky" Varela, LFC Chair
Legislative Finance Committee Members

FROM: Dan White, LFC Financial Economist
Michelle Aubel, LFC Fiscal Analyst II

SUBJECT: LFC Report of Investment Performance – FY2010 Second Quarter

Investment Performance Highlights:

- All state investment agencies were able to achieve quarterly returns in excess of internal benchmarks during the second quarter of FY10. However, only the Land Grant Permanent Fund (LGPF) and the Educational Retirement Board (ERB) were able to outperform five-year benchmarks.

- The State Investment Council (SIC) managed Land Grant and Severance Tax Permanent Funds (LGPF and STPF) outperformed internal benchmarks and peers in the second quarter of FY10 by 60 and 30 basis points (bps[1]) respectively. Overall LGPF and STPF returns presented in this report reflect unrealized gains/losses from securities lending.

- PERA continued its outperformance for the second quarter, beating its internal benchmark by 117 bps and ranking in the 9th percentile. The fund is still significantly trailing long-term benchmarks, including its five-year benchmark by 160 bps.

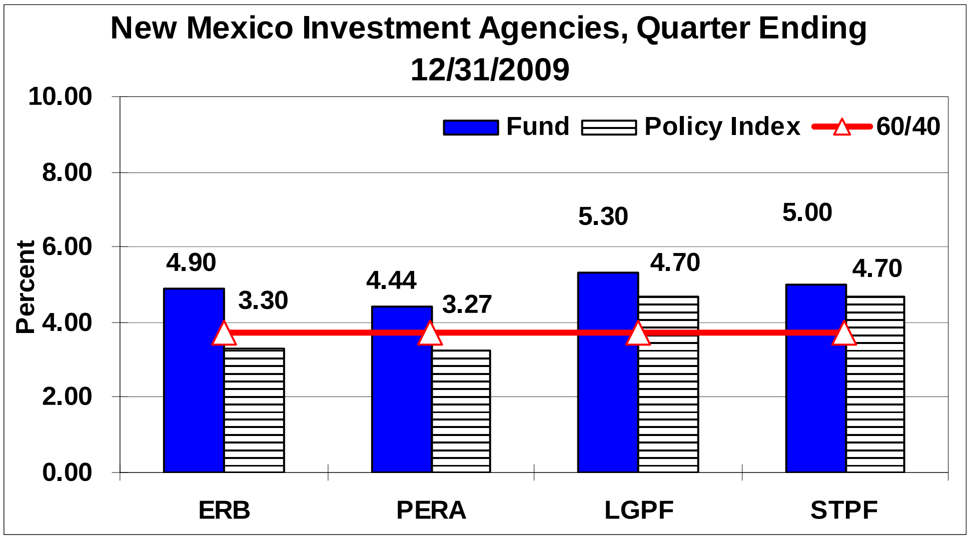
- For the third consecutive quarter ERB outperformed its policy benchmark, this time by 160 bps, causing the fund to shoot up to the 5th percentile in peer rankings. More importantly, the fund continues to surpass its one-year and five-year benchmarks as well, improving period rankings to the 4th percentile and 18th percentile, respectively. ERB is currently the only New Mexico fund beating its quarterly, one-year, and five-year benchmarks.

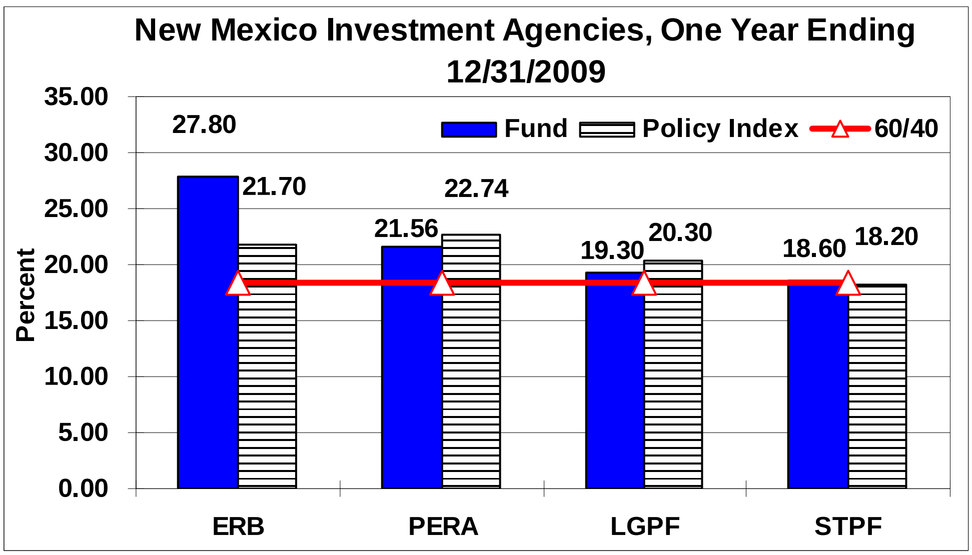
- Peer rankings improved dramatically for all funds in the quarterly to one-year range. However, long-term rankings remain extremely low particularly for both permanent funds and PERA (See Page 4).

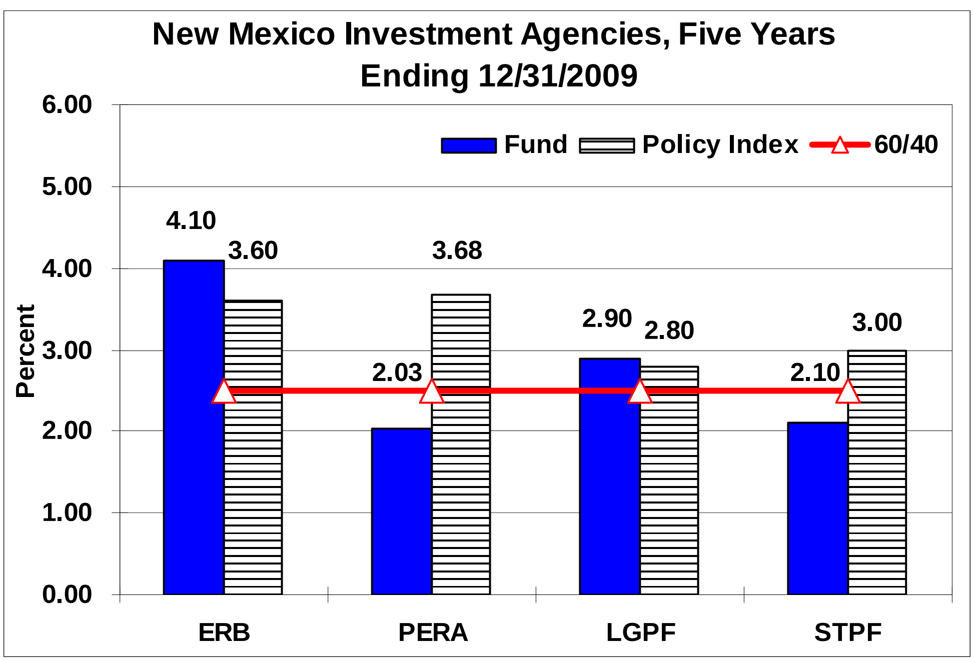
- This quarter's special focus section highlights legislation passed during the 2010 regular session intended to reform the SIC.

[1] Basis Points (bps) represent a hundredth of one percent. For example, if the LGPF has underperformed its quarterly benchmark by 170 bps, then it has underperformed by 1.7%. One bps equals approximately $907 thousand for the LGPF, $355 thousand for the STPF, $828 thousand for the ERB, and $1.1 million for PERA.

OVERALL FUND PERFORMANCES vs. RELATIVE BENCHMARKS







FUND ASSET VALUES

Total asset values for all funds rebounded by more than $1.25 billion in the second quarter of FY10. Three of the four funds saw quarterly asset increases of more than 4 percent, with the STPF only increasing 3.5 percent. The STPF was also the worst performing fund relative to quarterly benchmarks. Over the past twelve months total combined asset values have seen a substantial rebound of nearly $5 billion. However, total assets are still more than $7 billion below FY08 highs. Reported asset values reflect contributions and distributions in addition to investment returns.

Current Asset Values (millions)
For Quarter and Year Ending December 31, 2009

Quarterly	ERB	PERA*	LGPF	STPF	TOTAL
Current Asset Values (12/31/09)	$ 8,278	$ 10,597	$ 9,073	$ 3,549	$ 31,496
Value Change (Previous Quarter)	356	414	396	119	1,285
Percent Change	4.5%	4.1%	4.6%	3.5%	4.3%

Annual	ERB	PERA*	LGPF	STPF	TOTAL
Ending Asset Values (12/31/09)	$ 8,278	$ 10,597	$ 9,073	$ 3,549	$ 31,496
Value Change (Year Ago)	1,676.5	1,669.0	1,219.7	391.8	4,957.0
Percent Change	25.4%	18.7%	15.5%	12.4%	18.7%

*Excludes assets held at STO

ACTUAL VS. TARGET ASSET ALLOCATIONS

With the exception of the LGPF, all funds' alternative allocations were higher than their targets. For the pension funds, this may represent the implementation of new long-term allocation strategies. As for the STPF however, similar to last quarter, this over-allocation may still be due to the "denominator effect" caused by a rapid decrease in overall fund values and lagged alternative valuations. Given time these allocations should come back into line with target levels.

Table 2
Fund Asset Allocation Detail, Quarter Ending December 31, 2009

	ERB*		PERA		LGPF		STPF	
	Actual	Target**	Actual	Target**	Actual	Target	Actual	Target
US Equity	**26.4%**	**40.0%**	**38.6%**	**35.0%**	**50.8%**	**51.0%**	**51.0%**	**48.0%**
International Equity	**19.3%**	**20.0%**	**23.7%**	**25.0%**	**9.2%**	**10.0%**	**11.4%**	**10.0%**
Fixed Income	**32.2%**	**29.0%**	**23.5%**	**25.0%**	**17.5%**	**15.0%**	**3.1%**	**11.0%**
Total Alternatives	**14.2%**	**11.0%**	**13.4%**	**15.0%**	**22.4%**	**24.0%**	**33.6%**	**31.0%**
Private Equity	2.5%	1.0%	1.9%	2.5%	8.7%	6.0%	15.1%	12.0%
Real Estate/Real Assets	5.3%	5.0%	4.2%	5.0%	3.3%	3.0%	4.2%	3.0%
Absolute Return	6.4%	5.0%	7.3%	7.5%	10.4%	15.0%	9.6%	15.0%
ETI	N/A	0.0%	N/A	0.0%	0.0%	0.0%	4.7%	1.0%
Global Asset Allocation	**4.8%**	**0.0%**	**N/A**	**0.0%**	**N/A**	**0.0%**	**N/A**	**0.0%**
Cash Equivalents	**3.0%**	**0.0%**	**0.8%**	**0.0%**	**0.3%**	**0.0%**	**1.0%**	**0.0%**
Total Fund %	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**

**ERB is is adopting a new asset allocation mix that will raise its commitment to alternatives to 35% and correspondingly reduce equity and fixed income asset classes.*

***Due to the long implementation period for some alternatives, both PERA and ERB have adopted interim targets.*

LONG-TERM PERFORMANCE RELATIVE TO PEERS

Peer Percentile Rankings*

	1 Year	5 Year	10 Year
ERB	4	18	87
PERA	32	96	76
LGPF	33	71	76
STPF	43	88	83

* Percentile rankings (1 is highest) for ERB and PERA relative to U.S. Public Funds. Permanent Funds relative to U.S. Endowment Funds.

All funds have now moved into the top half of their peer groups from a one-year performance standpoint. ERB's performance has improved dramatically over the past six months and the fund now ranks in the top 4 percent of all U.S. public funds for the past year. ERB is also the only New Mexico fund to rank higher than 50th for the past five-years, all other funds rank well in the second half of their peer groups for the past five-years. All funds, including ERB are also ranked in the last quartile relative to peers for the past ten years.

ECONOMIC AND FINANCIAL MARKET ENVIRONMENT

The second quarter of FY10 saw more moderate growth than the previous quarter, however generally all major asset classes saw positive quarterly performances. Domestic equity indices in particular saw steady growth with the Standard & Poor's 500 Index gaining approximately 6 percent for the quarter. International equity indices saw slightly less growth than domestic during the quarter, however for the year developed and emerging indices saw gains in excess of 31 percent and 78 percent respectively.

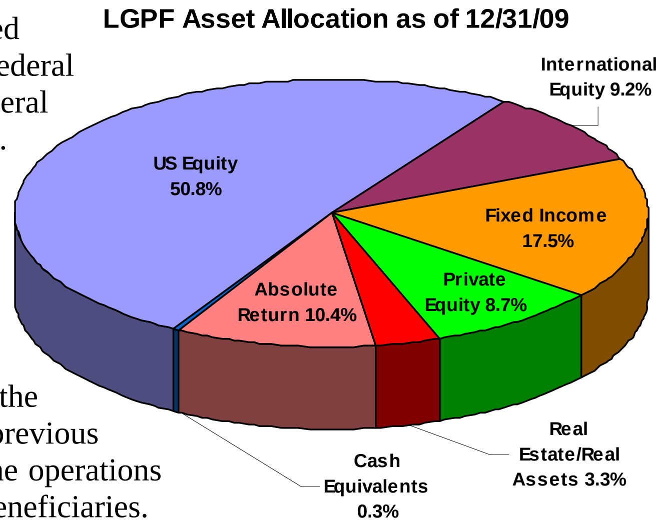
Fixed income indices also saw steady growth for the quarter, adding to their already solid annual performances. The Barclay's Aggregate Index added 0.2 percent for the quarter resulting in gains of 5.9 percent for the year. High yield indices showed the most strength both for the quarter and year. The Barclay's High Yield Index finished the year with gains of more than 58 percent.

With the exception of the NCRIEF property index, all alternative indices showed positive quarterly returns as well. Real Estate Investment Trusts (REITs) in particular have rebounded from their historic lows and produced returns in excess of 28 percent for the year. Returns on this asset class are still negative for three-year and five-year time frames however.

Since the end of the second quarter the economy has shown glimmers of hope. Industrial production in particular has shown strength, having increased the past eight consecutive months. The Federal Open Market Committee's (FOMC) March 16th statement suggested gradual improvement throughout overall economic conditions but the committee maintained its position that current conditions still "warrant exceptionally low levels of the federal funds rate for an extended period." Thus far inflation indicators have remained relatively subdued supporting the FOMC's position. Excluding food and energy, the Producer Price (PPI) and Consumer Price (CPI) Indices have increased a modest 1.0% and 1.3% over the past 12 months respectively. As of March 19th, futures markets were not predicting the FOMC to increase rates until late summer at the earliest.

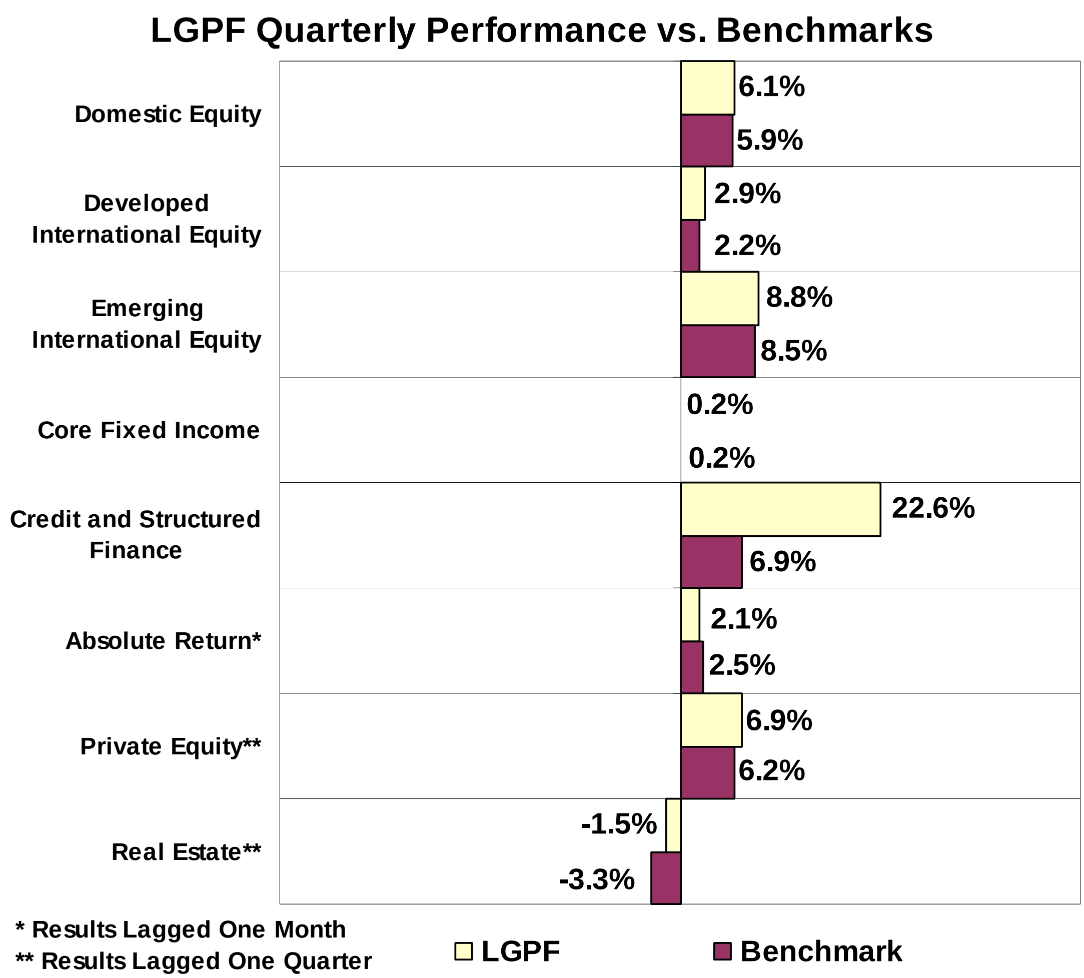
Land Grant Permanent Fund (LGPF)

Fund Objective: The LGPF is derived from proceeds of sales of state and federal public lands and royalties from mineral and timber production on state lands. The fund is invested by the state investment officer according to the Prudent Investor Act seeking to preserve capital for future generations of New Mexicans. The fund makes annual distributions to the general fund of 5.8 percent of the average ending balance from the previous five calendar years, which support the operations of public schools and various other beneficiaries.



Fund Performance vs. Policy Benchmarks

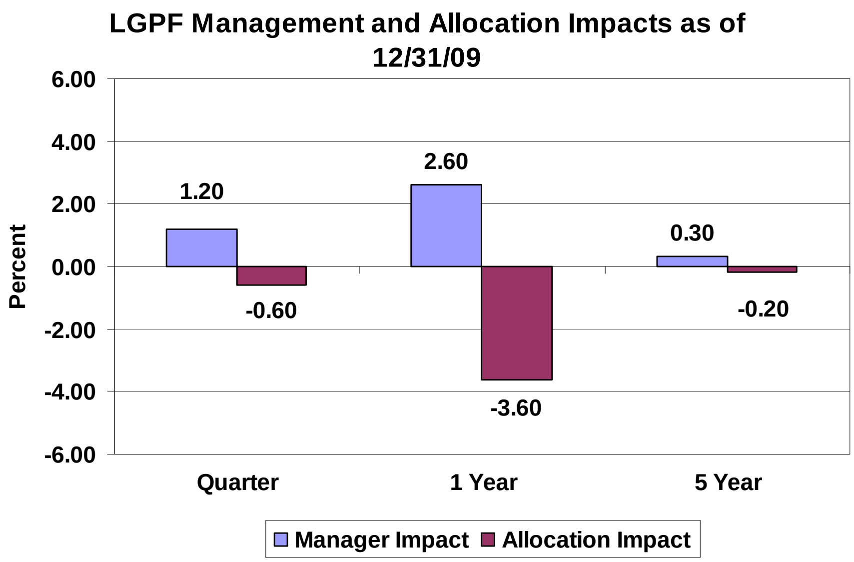
Quarter			1 Year			5 Year		
Fund	Benchmark	Ranking	Fund	Benchmark	Ranking	Fund	Benchmark	Ranking
5.30%	4.70%	4	19.30%	20.30%	47	2.90%	2.80%	86
Median Fund Performance		3.50%	Median Fund Performance		18.80%	Median Fund Performance		4.20%



Overview: The LGPF outperformed its quarterly policy benchmark by 60 bps during the second quarter of FY10[2], good enough to rank the fund in the 4th percentile relative to peers. This performance is in stark contrast to the last two quarters which saw underperformance relative to benchmarks and peers. The fund is still however trailing both benchmarks and peers from a one-year standpoint, but slightly outperforming benchmarks from a five-year standpoint. The fund's ten-year return of 2.6 percent, though higher than most benchmarks, is still well below the 8.5 percent used to forecast future distributions to the general fund.

During the quarter the fund outperformed throughout the majority of major asset classes with the exception of absolute return. Absolute return has lagged its benchmark throughout much of the past year. This underperformance was mitigated however to a large extent due to the fact that it was underweighted relative to its target allocation during the quarter. Despite being underweighted relative to its long-term target, the allocation was still in compliance with the fund's investment policy as it was within the policy range of 5 percent to 20 percent. One of the findings in the recently conducted Independent Operating and Fiduciary Review (IOFR) by Ennis Knupp was that these ranges may be to large to properly ensure effective asset allocations. Credit and structured finance assets proved to be the best performers during the quarter both in absolute terms and relative to benchmarks. These gains partially offset substantial losses suffered throughout the asset class over the past five years. Relative to its benchmark the asset class outperformed by nearly 16 percent, however such benchmarks are difficult to develop given the distressed nature of a majority of these assets.

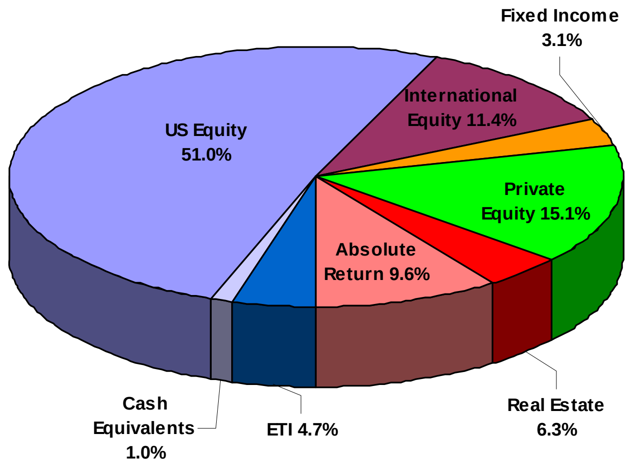
Management and Allocation Impacts: In the second quarter of FY10, active management gained 120 bps for the fund while asset allocation cost the fund 60 bps. The magnitude of this quarter's positive performance caused the fund's one-year management impact to turn definitively positive despite poor manager performances during the first quarter. Asset allocation has continued to be a drag on overall fund performance. An allocation review has been continuously delayed at the SIC due to a number of administrative issues.



[2] LGPF overall returns include unrealized gains/losses from securities lending, however individual asset class returns shown in the chart on Page 5 do not.

Severance Tax Permanent Fund (STPF)

STPF Asset Allocation as of 12/31/09

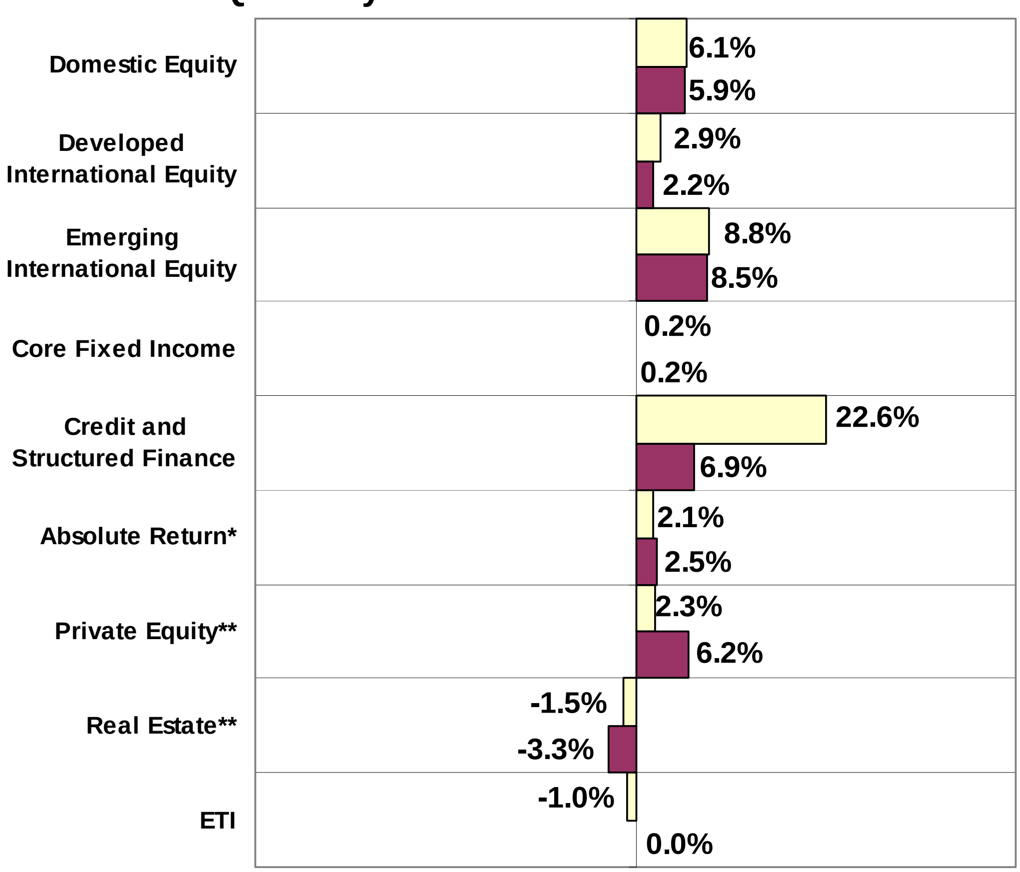


Fund Objective: The STPF receives contributions from the portion of severance tax proceeds not required for retirement of severance tax bonds. The fund is invested by the state investment officer under the Prudent Investor Act seeking to preserve capital for future generations of New Mexicans. The fund currently makes annual general fund distributions consisting of 4.7 percent of the average ending balance from the previous five calendar years.

Fund Performance vs. Policy Benchmarks

Quarter			1 Year			5 Year		
Fund	Benchmark	Ranking	Fund	Benchmark	Ranking	Fund	Benchmark	Ranking
5.00%	4.70%	8	18.60%	18.20%	54	2.10%	3.00%	92
Median Fund Performance		3.50%	Median Fund Performance		18.80%	Median Fund Performance		4.20%

STPF Quarterly Performance vs. Benchmarks



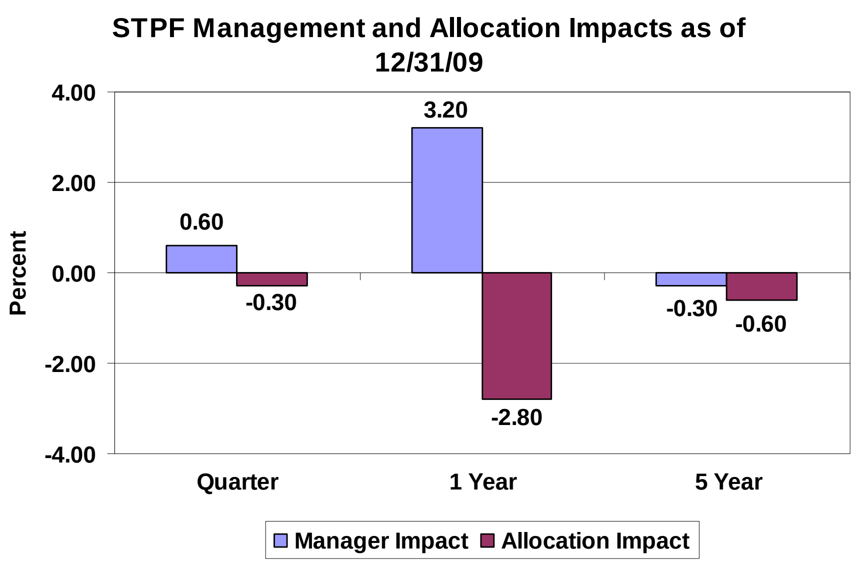
** Results Lagged Two Months
*** Results Yet to be Reported

Overview: The STPF outperformed its quarterly policy benchmark by 30 bps, good enough to rank the fund in the 8th percentile versus its peers[3]. The quarterly outperformance, coupled with the dropping of a bad quarter, was enough to significantly improve the fund's one-year returns relative to both benchmarks and peers. The fund still ranks in the 92nd percentile versus peers from a five-year standpoint. The fund's ten-year return of 2.2 percent is still well below all benchmarks including the 8.5 percent used to forecast future distributions to the general fund.

As always the performance of the STPF was similar to the LGPF with two major exceptions; private equity, and economically targeted investments (ETI). Due to various legislative mandates designed to stimulate economic activity within the state, the STPF is required to carry a much higher number of alternative investments in its portfolio, often times as "differential rate investments" which by definition earn less than a market rate. These programs include the zero-interest film loan program, and the New Mexico Private Equity Investment Program (NMPEIP), a mandatory investment into the New Mexico Small Business Investment Corporation (SBIC), and a number of others. In fact, the only substantial difference between the asset allocations of the two permanent funds is the inclusion of these investments.

Primarily as a result of these investments, the STPF has consistently underperformed the LGPF for all time-periods. Over the past five years the differences between the two funds' annualized returns has been approximately 90 bps excluding unrealized gains/losses associated with securities lending. Because these funds make annual distributions to the state general fund, this means that the decreased performance of 90 bps has a direct negative effect on state general fund revenues.

Management and Allocation Impacts: In the second quarter of FY10, active management gained 60 bps for the fund while asset allocation cost the fund 30 bps. The impacts of the investment programs discussed above can be seen clearly in the fund's five-year impacts. The management and allocation impacts are 50 bps and 40 bps lower than the LGPF for the same time period.

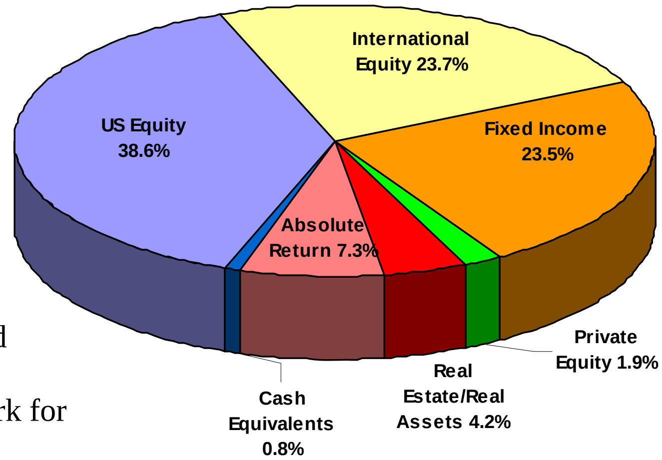


[3] STPF overall returns include unrealized gains/losses from securities lending, however individual asset class returns shown in the chart on Page 7 do not.

Public Employees Retirement Association (PERA)

Fund Objective: PERA administers 31 pension plans covering state and local government employees, volunteer firefighters, judges, magistrates and legislators to provide secure retirement. The fund is invested according to the "prudent investor rule" and results are reported in the aggregate. The fund has an 8 percent long-term actuarial benchmark for funding purposes.

PERA Asset Allocation as of 12/31/09

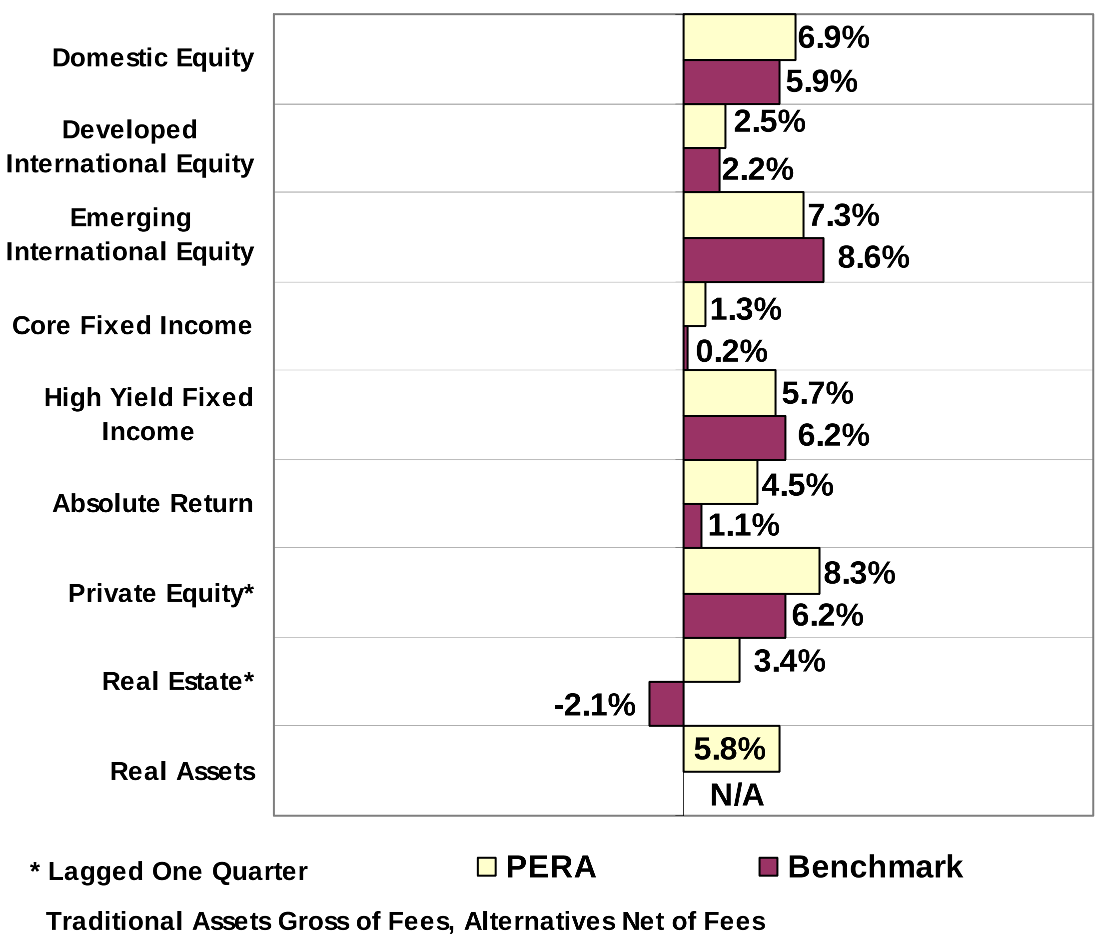


Fund Performance vs. Relative Benchmarks*

1 Year			5 Year			10 Year		
Fund	Benchmark	Ranking	Fund	Benchmark	Ranking	Fund	Benchmark	Ranking
21.56%	22.74%	32	2.03%	3.68%	96	3.48%	3.24%	76
Median Fund Performance		19.07%	Median Fund Performance		3.81%	Median Fund Performance		4.11%

*PERA also has a long-term 8% actuarial benchmark for funding purposes.

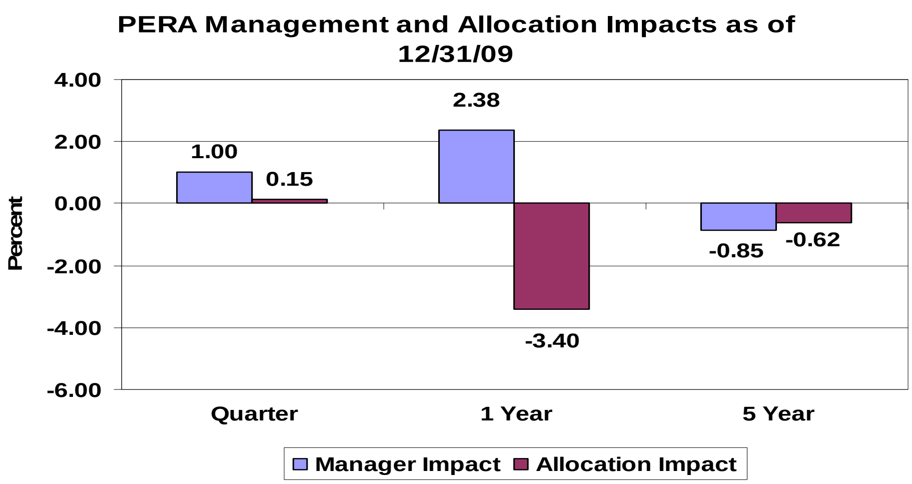
PERA Quarterly Performance vs. Benchmarks



Overview: PERA continued its outperformance for the second quarter, beating its internal benchmark by 117 bps and ranking in the 9th percentile. The median public fund yielded 3.64 percent for the quarter with a range of 1.95 percent to 4.54 percent. While drastically improving to the 32nd quartile for one-year relative performance, the fund's longer-term rankings remain in the bottom quartile of its U.S. peers. More importantly, the long term returns remain far short of the 8 percent that the fund's investments must earn over the long term to generate sufficient funds to pay benefits. This gap, generated by two years of substantial losses, remains a key concern despite the strong results so far demonstrated in FY10.

As an asset class, alternative assets outperformed their collective benchmarks by 419 bps, adding positive momentum through their 13.4 percent portfolio allocation. Of the total 100 bps added by active management, 23 bps were accounted for by hedge funds. The remaining 77 bps of added value are split evenly between domestic equity managers and core fixed income manager performance. A slight overweight in domestic stocks also contributed to the overall performance for the quarter. High yield fixed income and emerging market equity managers continued to falter, with the emerging equity composite falling 130 bps below its benchmark. All asset classes produced positive absolute returns for this period.

Management and Allocation Impacts: The chart shows that the negative impact of active management characterizing PERA's returns through 2008 have been completely reversed during the last six months. As of June 30, 2009, the one-year manager impact was -5.04 percent. However, allocation impacts due to missing upturns in domestic and international equity markets through strategic reductions in 2009, as well as prior manager underperformance earlier in the decade, continue to weigh down attributions.



June 30, 2009 Actuarial Valuation. As expected, the funding status of PERA declined due to investment losses. The funded ratio for the prior year was 93%.

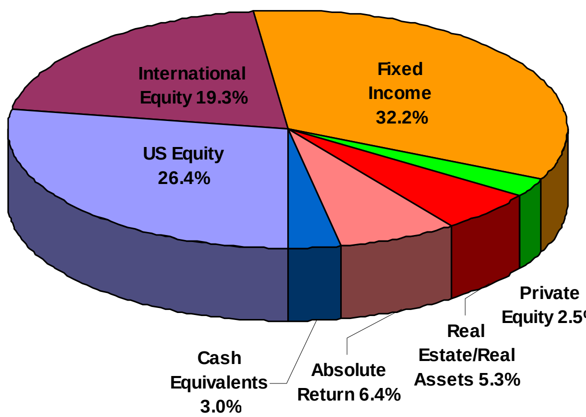
Actuarial Status as of June 30, 2009			
	Fund	**Benchmark**	**Rating**
Funded Ratio*	84%	80%	Y
Trend	⇩	Due to decline in asset values.	

*Funded ratio: actuarial value of assets compared to actuarial value of obligations.

Educational Retirement Board (ERB)

Fund Objective: ERB administers a defined benefit pension plan for public school and higher education employees. The fund is invested according to the "prudent investor rule" to ensure retirement benefits. The fund has an 8% long-term actuarial benchmark for funding purposes.

ERB Asset Allocation as of 12/31/09

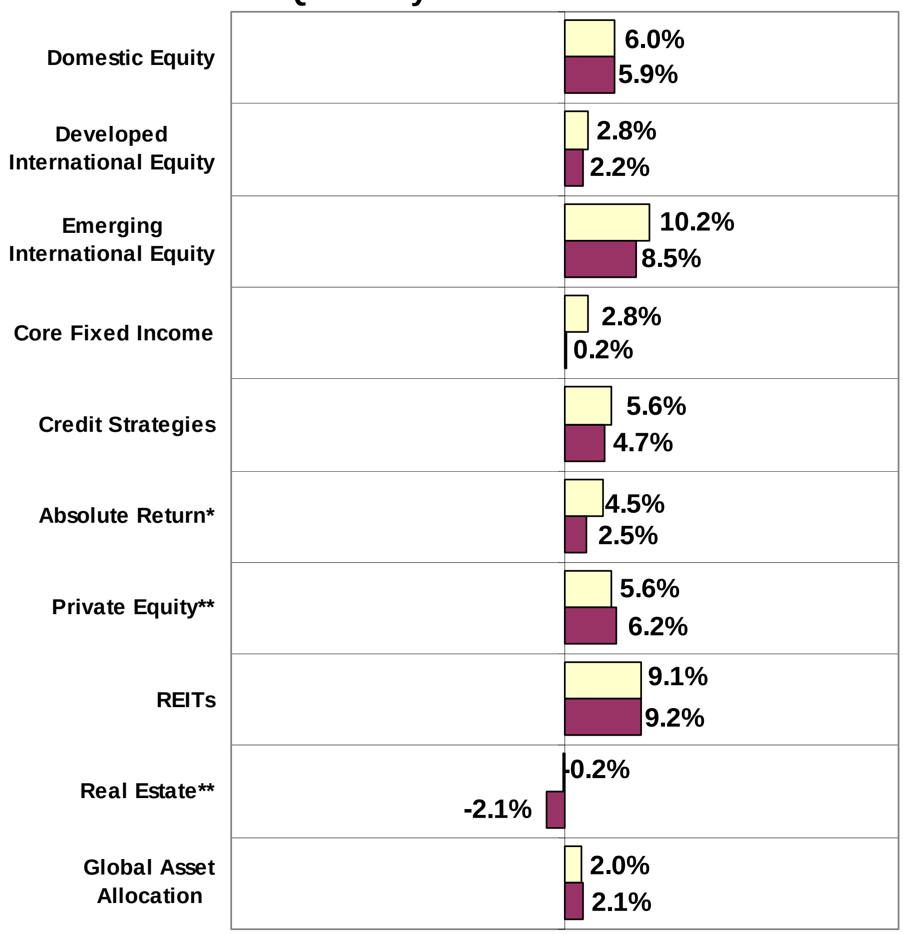


Fund Performance vs. Policy Benchmarks*

1 Year			5 Year			10 Year		
Fund	Benchmark	Ranking	Fund	Benchmark	Ranking	Fund	Benchmark	Ranking
27.80%	21.70%	4	4.10%	3.60%	18	2.70%	3.70%	87
Median Fund Performance		18.20%	Median Fund Performance		3.30%	Median Fund Performance		3.30%

*ERB also has an 8% actuarial benchmark for funding purposes.

ERB Quarterly Performance vs. Benchmarks



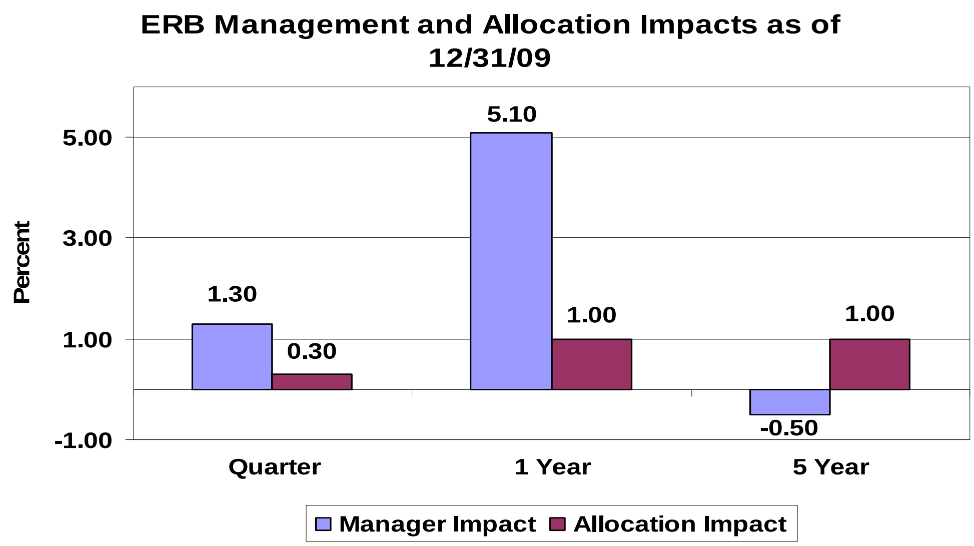
* Results Lagged One Month

** Results Lagged One Quarter

Overview: For the third consecutive quarter ERB outperformed its policy benchmark, this time by 160 bps, causing the fund to shoot up to the 5th percentile in peer rankings. More importantly, the fund continues to surpass its one-year and five-year benchmarks as well, improving period rankings to the 4th percentile and 18th percentile, respectively. However, the quarter's 10-year return declined from September's return of 3.5 percent to 2.7 percent with an 87th percentile ranking, suggesting that the quarter dropped off from ten years ago was even more robust than the October–December period for 2009. Concerns regarding the fund's long-term solvency, though mitigated by the solid performances of the past three quarters, are still significant.

Fixed income sustained its stellar performance, producing results 260 bps over the benchmark. The strategic allocation to credit strategies made in the second quarter of FY09 continues to perform extremely well with a 7.5 percent absolute return, 730 bps above the core fixed income benchmark of 0.2 percent. Posting a 2.8 percent gain, WAMCo (Western Assets) -- a core manager that took on additional exposure to subprime debt prior to the collapse of the credit markets in 2008 -- is finally improving its performance but remains 130 bps below its benchmark since inception. ERB has discussed liquidating this manager once asset values rebound. Contrary to PERA, the emerging market equity asset class contributed to the fund's relative outperformance with all three managers beating their respective benchmarks by a collective 160 bps for the quarter. At 4.5 percent, ERB's absolute return fund-of-fund portfolio returned the same as PERA's direct hedge fund portfolio and also helped bolster relative performance.

Management and Allocation Impacts: The second quarter reversed the one-year negative active manager impact of -290 bps recorded in September 2009 to an impressive 510 bps.



June 30, 2009 Actuarial Valuation. As expected, the funding status of ERB declined due to investment losses. The funded ratio for the prior year was 71.5%.

Actuarial Status as of June 30, 2009			
	Fund	Benchmark	Rating
Funded Ratio*	67.5%	80%	R
Trend	⇩	Due to decline in asset values.	

*Funded ratio: actuarial value of assets compared to actuarial value of obligations.

SPECIAL FOCUS: STATE INVESTMENT COUNCIL REFORM

Recently, the state has seen a great deal of turmoil in its investing agencies in terms of both performance and reputation. Chapter 14 (Senate Finance Committee substitute for Senate Bills 18, 218 and 238, as amended) addresses some of these issues by making a number of changes to the council's makeup and council member conduct requirements. Some of the proposals in Chapter 14 reflect recommendations made in an Independent Operating and Fiduciary Review (IOFR) performed by institutional investment advisor Ennis Knupp and Associates on behalf of the Legislative Council and State Board of Finance. However, a number of key recommendations made in the IOFR were amended out of the final legislation.

Chapter 14 changes the governance of the State Investment Council (SIC). The IOFR stated with respect to SIC that the governor's current "amount of influence is greater than that of most other funds," and should be "balanced by including legislative appointees on the Council or increasing the number of ex-officio members who are not part of the executive branch." Under the new statute, the governor will still appoint the most members. SIC members would now also fall under the Governmental Conflict Act as opposed to the Conflict of Interest Act. Under the newly enacted legislation the makeup of the SIC is such that:

- Five of 11 members will be the governor and direct governor appointees,
- Four of 11 members will be legislative appointees, and
- Two of 11 members will be ex-officio elected officials.

Under the new statute the governor will also remain chairman of the council. The IOFR performed by Ennis Knupp reported that national best practices are for council members to independently elect a chairman and vice-chairman from amongst themselves as opposed to having a de-facto chair set in statute. Therefore, while some of the new statutory changes go a long way in bringing the state in line with national best practices, the legislature may need to continue to monitor the governance of all state investment funds as national investment controversies continue to persist.