State of New Mexico
LEGISLATIVE FINANCE COMMITTEE

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LFC INVESTMENT REPORT FOR THE QUARTER ENDING JUNE 30, 2013

This report details the comparative investment performance of the three investment agencies: the Educational Retirement Board (ERB), the Public Employees Retirement Association (PERA), and the State Investment Council (SIC). It explains how the returns generated by the three investment agencies differed from that of the archetypical fund and how their management and consultants added or subtracted value. Long term performance is an important metric, and therefore this report includes fund returns and comparative rankings for the one-year, three-year and five-year periods and attribution analysis for the one-year period in addition to the quarter.

Hints of an eventual end to low borrowing rates sent interest rates jumping upward and caused equity markets to dip in late June, providing a volatile end to an otherwise fairly strong second quarter of 2013 for U.S. equities. The U.S. stock market, represented by the Wilshire 5000 Total Market Index, posted a total return of 2.77% during the second quarter; the S&P 500 returned 2.92% for the quarter. Solid gains in April and May propelled U.S. stocks to notch an impressive 13.97% advance through the midpoint of calendar 2013, the best first half of a calendar year since 1998. The second quarter of 2013 found the European Union still struggling with political uncertainty in Greece as well as lackluster economic expansion and/or recession throughout the region. The announced wind-down of the Fed's long-lived programs of accommodative lending sent markets reeling worldwide. Emerging market performance continues to be held back by concerns over China's slowing domestic economy.

<u>Returns and Ending Balances</u>. Table 1 shows the respective funds' ending balances and compares the investment agencies' returns for the quarter and the one-year, three-year, and five-year periods. The annual target returns for the three investment agencies are around 7.5 to 7.75 percent. Although the agencies' returns for the quarter fall below the target, the one- and three-year returns exceed the target returns. Five-year returns include lesser investment performance in the aftermath of the recession, and therefore fall below the targets

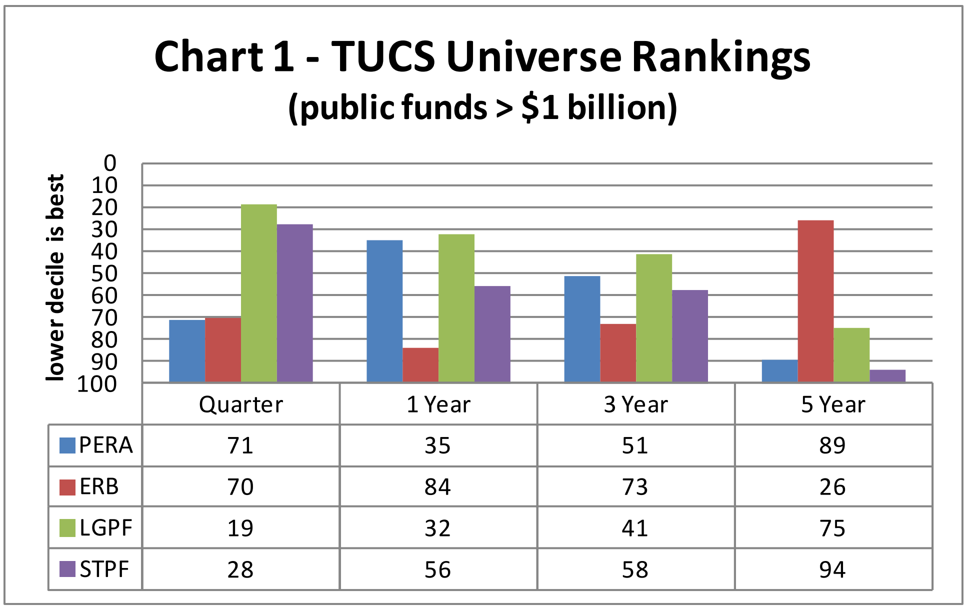
Table 1
Returns and Ending Balances as of June 30, 2013

Returns (%)	PERA	ERB	LGPF	STPF
Quarter	-0.22	-0.18	0.96	0.80
1-Year	13.26	11.05	13.27	12.15
3-Year	11.39	10.72	11.78	11.28
5-Year	3.82	5.80	4.47	3.37
Ending Balance ($B)	12.94	10.13	12.13	4.16

Source: Agency Investment Reports

The returns and balances of the Severance Tax Permanent Fund (STPF) and Land Grant Permanent Fund (LGPF) are shown separately. A portion of the STPF is invested in economically targeted investments that yield below market returns; the LGPF does not have economically targeted investments in its portfolio and so is a better gauge of SIC's performance. The difference in return between the two is a rough approximation of the opportunity cost of these initiatives.

Peer Total Return Rankings. Chart 1 shows peer total return rankings for the agencies' large funds for the quarter, annually, three and five year periods. A lower rank (1st is best) denotes a better performance when compared to other funds. All of the comparisons are made using the Wilshire Trust Universe Comparison Service (TUCS), a benchmark for the performance and allocation of institutional assets that includes approximately 67 public funds with more than $1 billion in assets.



	Quarter	1 Year	3 Year	5 Year
PERA	71	35	51	89
ERB	70	84	73	26
LGPF	19	32	41	75
STPF	28	56	58	94

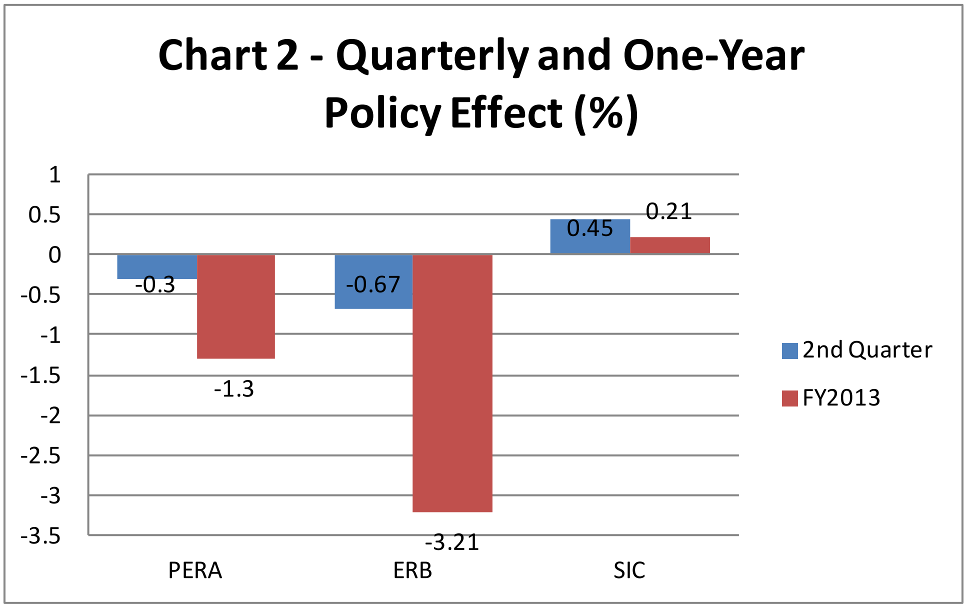
For the quarter, PERA ranked in the third quartile, lower than the ranking of its one- and three-year performance, but better than its ranking over the last five years. The PERA's five-year ranking remains in the lowest fifth of all funds in the universe.

ERB returned a quarterly performance similar to PERA's in the third quartile; its one- and three-year performance rankings are also subpar. The fund's five-year ranking is just outside of the first quartile, a slightly lower ranking than in the previous quarter (25th percentile).

Both funds invested by SIC fared well in the quarter. The Land Grant Permanent Fund's ranking for the quarter is in the top fifth, compared with the 75th percentile in the five-year term. The Severance Tax Permanent Fund's quarterly ranking, is in the top third, well above its 5-year ranking in the 94th percentile. The SIC notes it has restructured its portfolio over the past three years by changing its asset allocation and individual managers in an effort to improve returns while lowering risk. The agency adds its one- and three-year returns reflect this restructuring, while the 5-year number also reflects two years of its prior investment policy.

Attribution Analysis. There are three basic ways that a fund's returns can differ from the average: the policy, allocation, and manager effects.

Quarterly Policy Effect. A fund can have a long-term policy allocation (known as the "policy index") target that has a more or less aggressive proportion of risky assets such as stocks. For example, risky domestic assets such as US stocks (equities) performed well in the quarter. Accordingly, an index that has more domestic equities should outperform the average. Measured in isolation, such a change in performance is known as the "policy effect," and it is an essential responsibility of the fund's trustees.



The most appropriate measurement of a policy allocation benchmark is comparison to a defined peer group. Chart 2 shows the funds' policy effect as measured by comparing the funds' policy indices to the TUCS median fund actual return to allow uniformity and consistency across the three funds. The TUCS median return is gross of the allocation and manager effects, and the measure is therefore a rough estimate of the policy effect. (The investment agencies' policy target allocations included in Figure 1, on page 7 of this report.)

In isolation, PERA's policy allocation returned 0.3 percent less than the median fund in the quarter, and 1.3 percent less during FY13. PERA has adopted new policy targets that raised the domestic equity target from 27 to 29 percent, lowered the international equity target from 27 to 20 percent, lowered the absolute return asset target from 9 percent to 7 percent and added a "liquid alpha" allocation of 5 percent, which had no share of the portfolio allocation at the end of the quarter.

The SIC's LGPF policy calls for a 37 percent allocation toward domestic equities, and a 15 percent allocation toward non-U.S. equities. The SIC's policy allocation delivered returns 45 basis points above the median fund in the quarter, and 21 basis points above the median fund during FY13. The SIC's ongoing portfolio restructuring toward a less risky position has seen the investment agency reduce its historically high concentration of public equities.

In contrast to both PERA's and SIC's policies, ERB's policy calls for a lesser exposure to equities (40 percent) in favor of fixed income assets. ERB's policy index performed 321 basis points below the TUCS median fund performance. This large effect for the one-year period is mainly due to ERB's lower policy weight in equities in general, and particularly in domestic equities, which performed spectacularly well during the year. Further, ERB has a higher policy weight to emerging markets equity which performed poorly, so the higher allocation hurt returns.

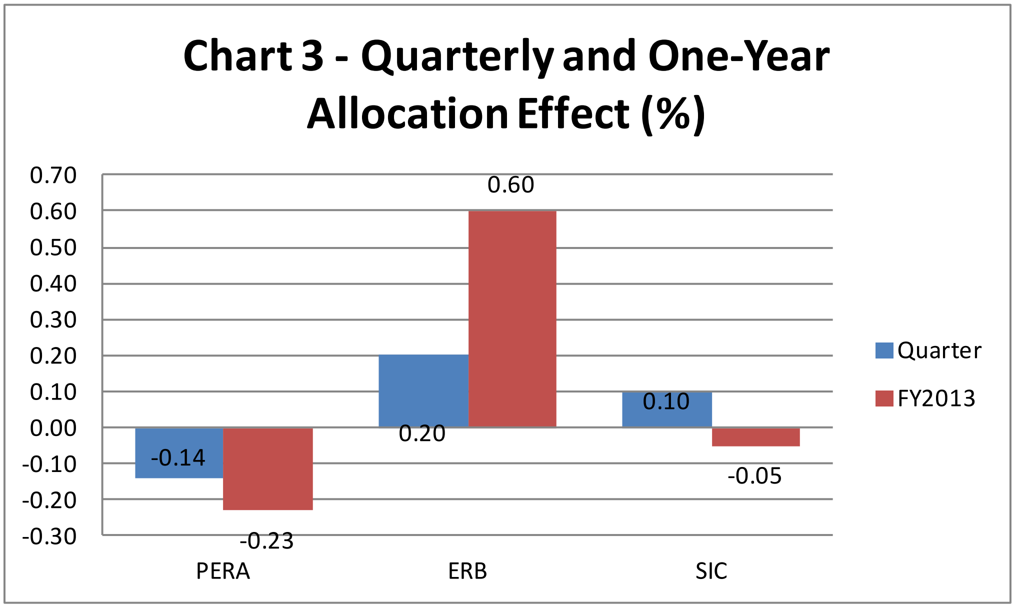
Quarterly Allocation Effect. The second way that a fund's return can be affected is by deviation from asset allocations called for by policy. As a matter of practice, investment officers are constantly confronted with allocation decisions when transitioning or rebalancing portfolio managers or asset classes. Asset prices and values can vary in the short run, causing the allocation toward an asset class to drift from its long term target. Almost all rebalancing policies contain some flexibility for staff or the chief investment officer CIO to operate within set boundaries. The three funds constantly see contributions coming in and distributions going out. Further, cash is being generated in some portions of the portfolio, and called or used in others, which can also cause assed allocations to deviate from policy. The investment officer may have the option of letting money sit in cash or incurring the cost of temporarily covering the allocation through the futures market or some other avenue, depending on policy authority. Rebalancing authority afforded the chief investment officer is dictated by investment policy, resulting in differing degrees of authority delegated by each fund.

The difference between the funds' temporary and long-term allocation is known as the "allocation effect" and is interpreted as investment return added or lost. Chart 3 shows the quarterly effect graphically for the quarter and for FY13.

PERA lost 14 basis points during the quarter due to an overweight to international equity. During FY13, the overweight to international equity was the largest contributor to an allocation effect of negative 23 basis points. PERA reports the overweight exists because it has not yet funded its allocation to liquid alpha.

ERB's second-quarter return increased 20 basis points due to underweight fixed income and non-U.S. emerging markets in a quarter where these asset classes did not perform well. The ERB's FY13 allocation effect of 60 basis points resulted from value added by deviation from allocation targets in private equity, global asset allocation, small/mid cap equities, and opportunistic credit.

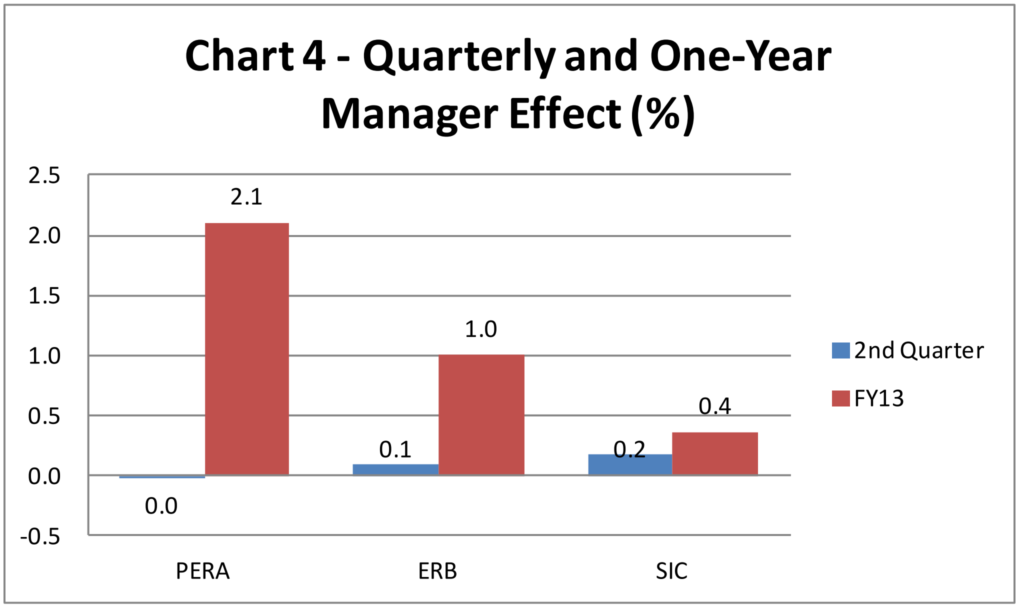
During the quarter, SIC's return was 10 basis points higher due to deviations including underweight to non-U.S. equity and underweight real return, which offset value lost due to overweight fixed income assets. The FY13 policy effect for the SIC was -5 basis points. Value added by underweights to non-U.S. equity and real return nearly offset lost value from overweight to fixed income assets.



Quarterly Manager Effect. The third way that value can be added or subtracted from a fund is through the use of active management. For example, a fund can buy a security such as the institutional version of the Standard & Poor's Depository Receipts (SPDRS) commonly used by retail investors. These securities are composed of a relatively fixed basket of securities that track the S&P 500 index. Alternatively, the fund can employ a manager who will trade individual securities given his attitude about the prospects of individual stocks. This is known as "active" investing. The difference between the return of the index and the portfolio of the active manager is known as the "manager effect."

As Chart 4 shows, manager effects for all three agencies were minimal during the quarter. During FY13, however, the three agencies' managers added value. PERA's 2.1 percent manager effect was realized in domestic equities and fixed income assets. ERB's managers gained one percent due to the manager effect, largely in the opportunistic credit asset class, which offset value lost in global asset allocation. The SIC manager effect for FY13 was 36 basis points, resulting from value added in fixed income assets and, to a lesser extent, in real return assets[1].

[1] The SIC notes that its net-of-fees performance analysis is based upon an estimate of SIC's investment performance developed by RV Kuhns.



Summary. The market environment and the funds' quarterly performance can be summarized as follows:

- After strong performance across most asset classes in the 1st quarter, markets were roiled by indications the Fed would taper its bond-buying program earlier than expected, and concern that growth is slowing in China and across the emerging markets.
- Virtually all markets were down in May and June, and traditional hedging assets, such as treasuries, have not worked. Emerging markets equity and debt have struggled.
- Despite small returns in the second quarter of calendar year 2013, all three agencies' FY13 investment returns exceeded their respective target returns for FY13 Chart 1).
- Using the TUCS, it is possible to rank the funds against the same universe.
- PERA's quarterly returns were in the bottom third of peer funds. However, its FY13 performance was in the 35th percentile. During the year, PERA's managers added value its managers, which offset lost value from deviation from allocation targets.
- ERB performance was driven by an investment policy that calls for a lesser exposure to equities in favor of fixed income assets. This less risky policy contributed to returns in the bottom third of peer funds in the quarter. Stocks performed strongly in the one-year period, and ERB's lower exposure to equities resulted in the fund ranking in the 85th percentile of peer funds. Value was added by deviations from this policy, and asset selection by the ERB's investment managers.
- SIC quarterly investment of the Land Grant Permanent Fund and the Severance Tax Permanent Fund performed above the median fund, ranking in the 19th and 28th percentiles, respectively. During FY13, the Land Grant Permanent Fund's returns remained in the top third, boosted by a 36 basis point manager effect.

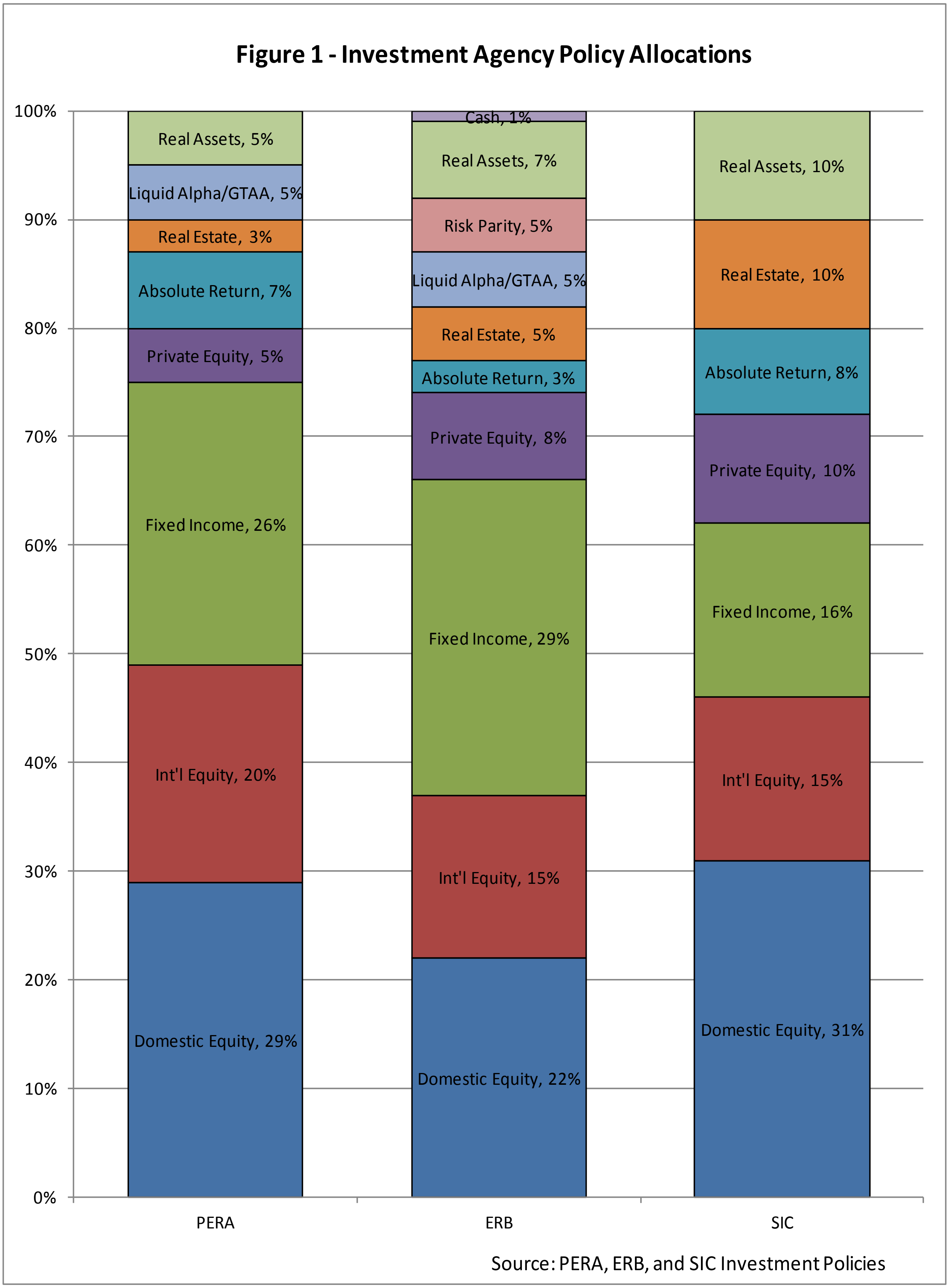


Figure 1 - Investment Agency Policy Allocations
100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
Real Assets, 5%
Liquid Alpha/GTAA, 5%
Real Estate, 3%
Absolute Return, 7%
Private Equity, 5%
Fixed Income, 26%
Int'l Equity, 20%
Domestic Equity, 29%
Cash, 1%
Real Assets, 7%
Risk Parity, 5%
Liquid Alpha/GTAA, 5%
Real Estate, 5%
Absolute Return, 3%
Private Equity, 8%
Fixed Income, 29%
Int'l Equity, 15%
Domestic Equity, 22%
Real Assets, 10%
Real Estate, 10%
Absolute Return, 8%
Private Equity, 10%
Fixed Income, 16%
Int'l Equity, 15%
Domestic Equity, 31%
PERA
ERB
SIC
Source: PERA, ERB, and SIC Investment Policies