State of New Mexico
LEGISLATIVE FINANCE COMMITTEE

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November 25, 2015

LFC INVESTMENT REPORT FOR THE QUARTER ENDING SEPTEMBER 30, 2015

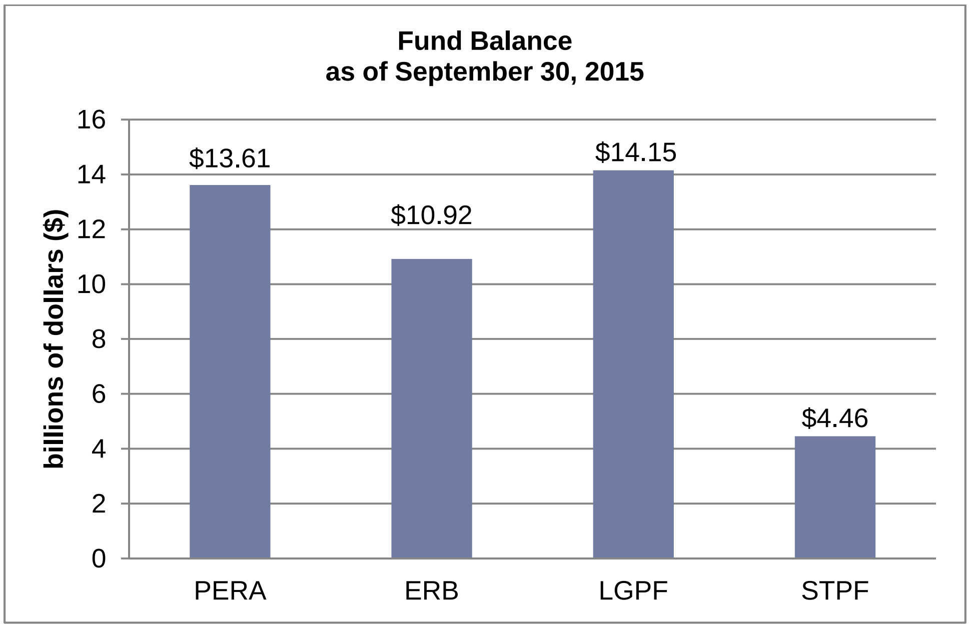
This report details the comparative investment performance of the three investment agencies: the Educational Retirement Board (ERB), the Public Employees Retirement Association (PERA), and the State Investment Council (SIC). The report outlines how the returns generated by these agencies differed from that of the archetypical public investment fund and how management and consultants added or subtracted value. As long-term performance is an important metric, this report includes fund returns and comparative rankings for the one, three, five, and ten-year periods and risk metrics for the quarter ended September 30th, one, three and five-year periods.

Market Environment.

- The U.S. Federal Reserve announced at the September meeting it would hold interest rates at the current level. Fed Chair Janet Yellen stated weak global economic data as the primary culprit for holding rates in place. The Fed will reevaluate rate levels during its upcoming meeting in December.
- Strong concerns over China's economic slowdown rippled through global markets. China's central bank devalued the yuan in an attempt to stimulate their economy. This move resulted in a sell-off in the Chinese stock market; while globally, losses grew for beaten-down commodities markets.
- During the quarter, the U.S. continued to see solid jobs growth nationally and strong real GDP expansion of 3.9% year-over-year while consumer inflation continued to hover at historically low levels.
- Crude oil futures fell over 30% during the quarter, ending at $45.09/barrel, deepening the trend for the energy market dislocation.
- The U.S. stock market was down during the quarter -6.91%, the first negative quarter in over three years, ending the longest positive run since the late nineties.
- The broad market decline has driven investors to seek out lower-risk fixed income assets and U.S. Treasuries which have performed well during the quarter. As a result, bond yields have become lower and spreads of higher risk credits have widened.
- The U.S. dollar has been strong against benchmark global currencies, which led to improved performance for dollar-based investors. Emerging markets currencies remained depressed against the U.S. dollar.

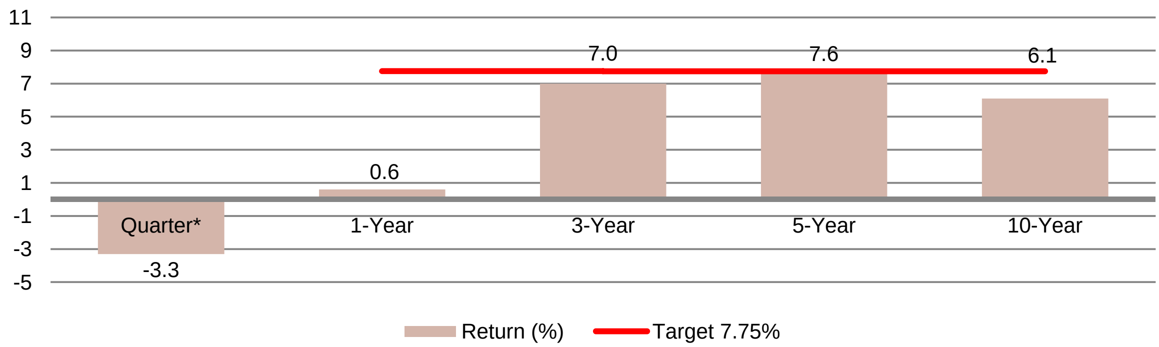
Market Environment as of September 30, 2015				
Index Returns (%)	**Q3 2015**	**1 Year**	**5 Years**	**10 Years**
S&P 500	-6.44	-0.61	13.34	6.80
Wilshire 5000	-6.91	-0.38	13.17	6.97
Russell 3000	-7.25	-0.49	13.28	6.92
Dow Jones Industrial	-6.98	-2.10	11.37	7.18
MSCI EAFE	-10.23	-8.66	3.98	2.97
Barclays Govt/Credit	1.20	2.73	3.09	4.61

Returns and Ending Balances. The table below summarizes the ending balances for the quarter September 30, 2015 as well as the agencies' investment returns for the quarter and for the one, three, five, and ten-year periods, on the following page.

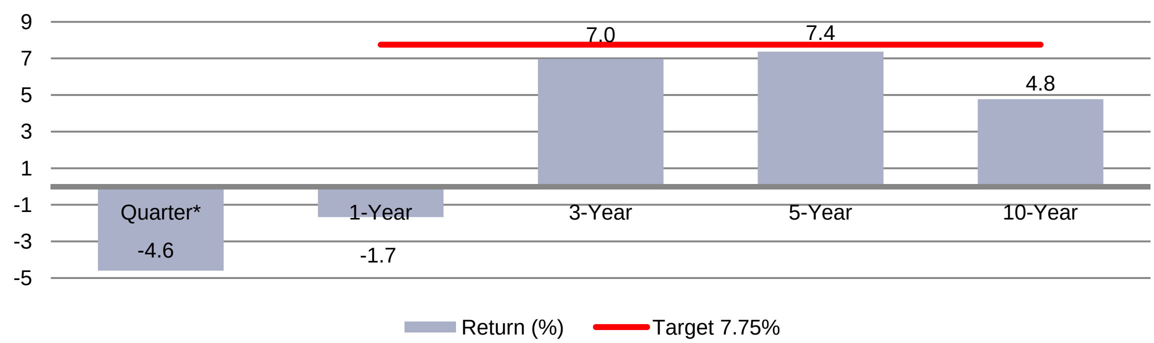


During the first quarter of the fiscal year, all of the agencies' investments have had difficulty maintaining fund balances. The agencies have struggled to meet their return targets, which are set at 7.5 percent for SIC and 7.75 percent for ERB and PERA. The short term one year period was especially sensitive volatility in global markets and a continued drop in the oil market which has diminished investment balances. The longer investment periods reflect the economic and market post-recession recovery. Ten-year returns fall short of long-term targets because they reflect challenged investment performance during the global financial crisis. Long range performance also reflects narrow investment portfolio diversification through alternative asset investments given the policy restrictions in place at the time. All three investment agencies have actively pursued diversifying and creating depth in their respective portfolios to permit fewer investment losses during secular periods of broad market swings and volatility.

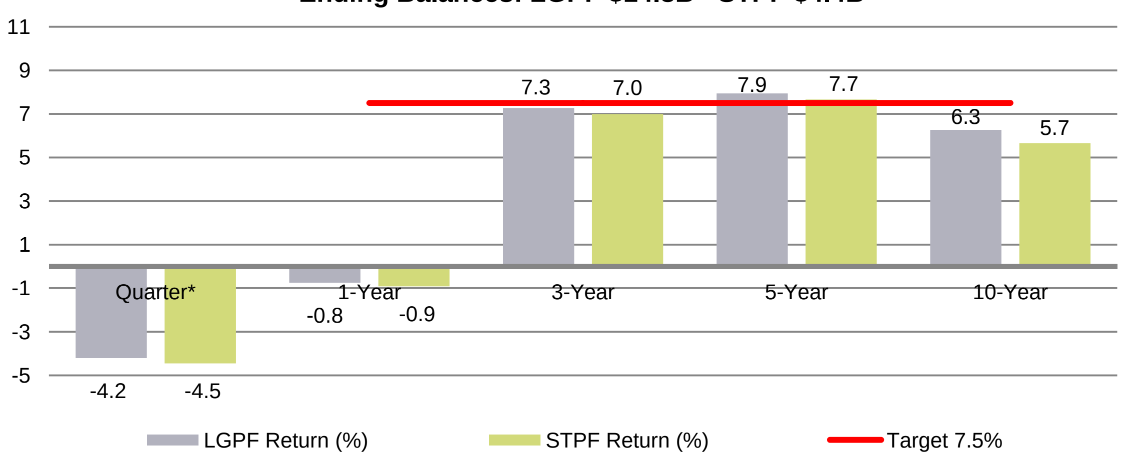
ERB Total Portfolio Returns
as of September 30, 2015 - Ending Balance: $10.9B



PERA Total Portfolio Returns
as of September 30, 2015 - Ending Balance: $13.6B



SIC Total Portfolio Returns
as of September 30, 2015
Ending Balances: LGPF $14.8B - STPF $4.4B



The Severance Tax Permanent Fund (STPF) and Land Grant Permanent Fund (LGPF) are managed by SIC and therefore shown separately. A portion of the STPF is invested in economically targeted investments (ETIs) that typically perform below-market because the investments are not targeted solely at delivering returns. SIC states that ETIs' reduced levels of expected financial return are justified in statute by the expected economic development benefits that the investment is expected to deliver. The LGPF does not have ETIs 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.

Investment Portfolio Policy Objectives.

PERA's investment policy states that the pension fund's primary objective is to prudently invest assets in order to meet statutory obligations to its members. The fund's assets are managed to reflect its unique liabilities and funding resources, incorporating accepted investment theory, prudent levels of risk and reliable, empirical evidence. The actuarial assumed target rate of return is the key actuarial assumption affecting future funding rates and payment of pension obligations. Investment performance that exceeds or underperforms the target rate may materially impact future funding rates.

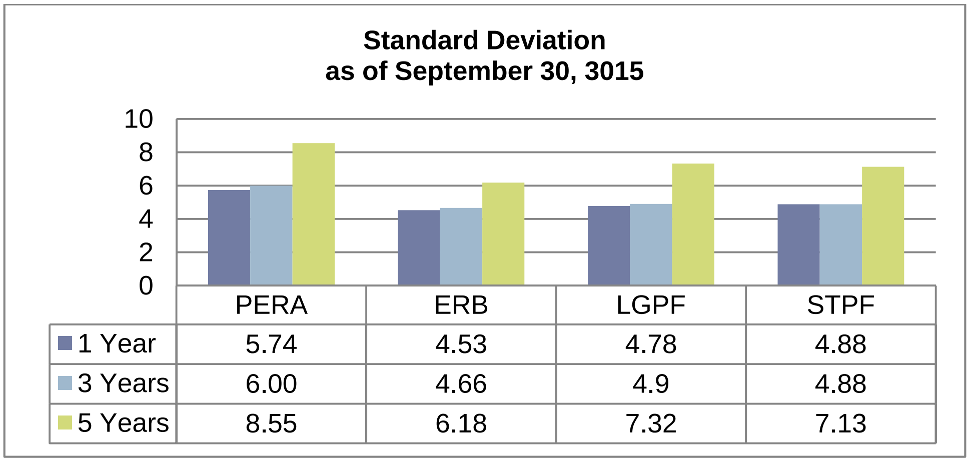
ERB's investment philosophy and techniques are based upon a set of widely accepted investment models. ERB is focused on the prudent investment and management of its members' contributions to the retirement fund, utilizing techniques tempered by experience and knowledge. The investment goal is to earn an inflation-adjusted return sufficient to attain the target funding level over a long term period.

SIC's investment goals are to preserve the permanent endowment funds and to provide for current and future beneficiaries by growing the funds at a rate to keep pace with inflation to maintain value over a long-term time horizon. SIC seeks to manage the funds to ensure that future generations receive the same or greater benefits as current beneficiaries, while maximizing current distributions through time to provide current revenue sources to the state's general fund. Total return, which includes realized and unrealized gains, plus income, less expenses, is the primary goal of the funds.

Risk Metrics.

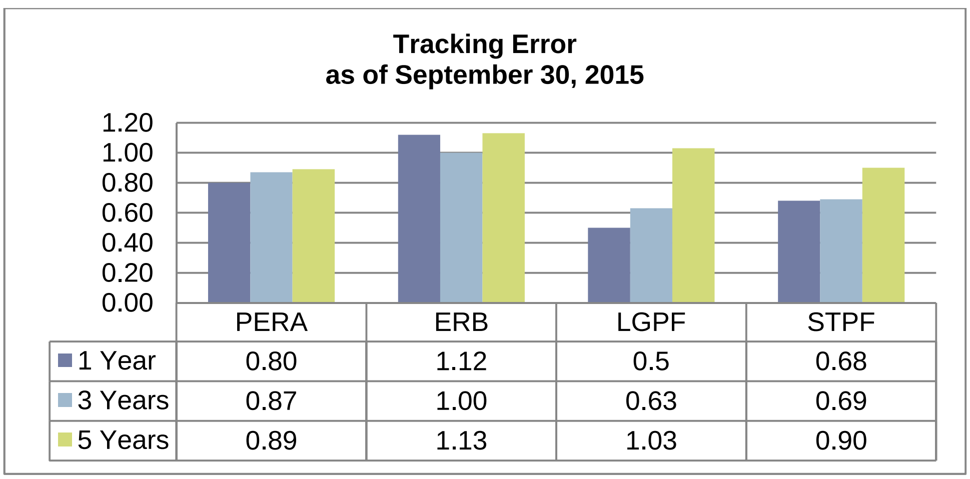
Risk is an inherent component of investing in financial markets. As risk of an investment fund is a function of the strategic asset allocation, it is prudent to keep the risk levels within tolerant levels to achieve the overall goals of the plan. To evaluate the impact that risk plays in an investment portfolio, there are a few key measures which may be utilized.

- Standard deviation is used to gauge the variability of returns around a mean of distribution. Standard deviation is typically applied to the rate of return of a portfolio to measure the overall volatility. A higher standard deviation number is expected for more volatile investments, while a lower number would be associated with low volatility investments.
- Reviewing the table below, all of the portfolios experienced lower volatility over the one and three year time periods. The PERA portfolio reported the highest sensitivity, while ERB's exposure was more muted. The five year period saw stronger volatility overall for the investment funds. This may be attributed in part to broad global macro events impacting the portfolios more directly during this time period as well as larger holdings in absolute return (hedge fund) investments.



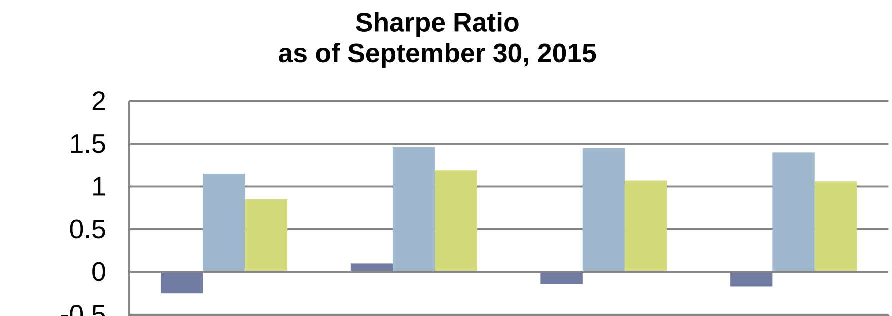
	PERA	ERB	LGPF	STPF
1 Year	5.74	4.53	4.78	4.88
3 Years	6.00	4.66	4.9	4.88
5 Years	8.55	6.18	7.32	7.13

- After reviewing the standard deviation, the tracking error outlines the difference between the return of the investment portfolio and the benchmark.
- Over the last three years, the implementation of revised asset allocations for the portfolios have begun to take effect as seen in the tracking error reported below. The portfolios show risk profiles that are not identical to their benchmarks, reflecting the investment skill of managers hired.



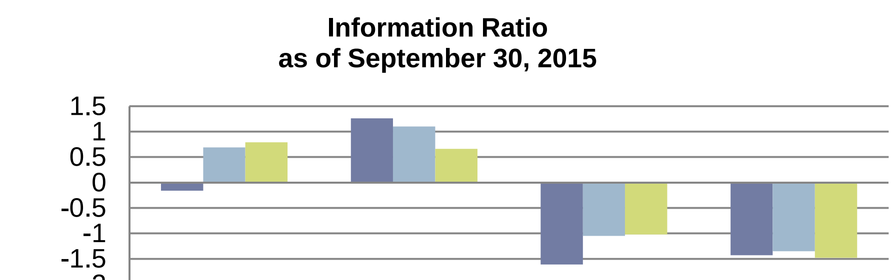
	PERA	ERB	LGPF	STPF
1 Year	0.80	1.12	0.5	0.68
3 Years	0.87	1.00	0.63	0.69
5 Years	0.89	1.13	1.03	0.90

- The Sharpe ratio is a risk-adjusted measure that is calculated by using the standard deviation and the fund's excess return to evaluate reward per unit of risk. The higher the ratio, the better the risk-adjusted performance for the investment fund.
- PERA, LGPF and STPF have had a difficult start to the fiscal year, while ERB was slightly positive in risk-adjusted performance. The three and five year periods reflect positive performance for higher risk, alternative investments during a time when the economic recovery was gaining momentum. ERB, LGPF and STPF performed well during the three year period in particular.



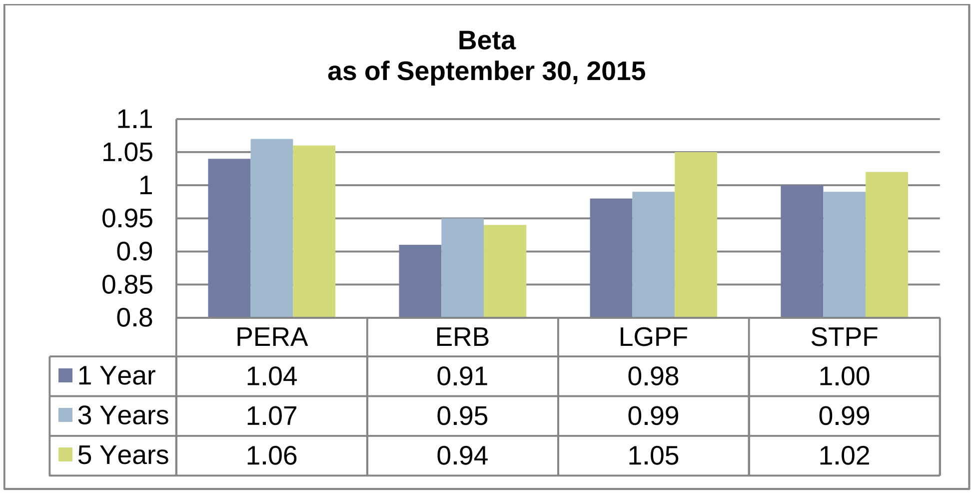
	PERA	ERB	LGPF	STPF
1 Year	-0.25	0.10	-0.14	-0.17
3 Years	1.15	1.46	1.45	1.40
5 Years	0.85	1.19	1.07	1.06

- The information ratio evaluates the ratio of portfolio returns above the benchmark to the volatility of the returns. The ability of the manager to generate excess returns against the benchmark is reviewed as well as their consistency in performance. The higher the information ratio, the more consistent the manager. ERB has increasingly performed well against their benchmark while LGPF and STPF have struggled.



	PERA	ERB	LGPF	STPF
1 Year	-0.16	1.26	-1.61	-1.43
3 Years	0.69	1.10	-1.05	-1.35
5 Years	0.79	0.66	-1.02	-1.48

- The beta of a portfolio signifies the volatility of the portfolio versus the investment market. If the beta is approximately equal to '1', then there is a very strong correlation between the portfolio and the movements of the market. If the beta is lower than '1', then the portfolio will be less volatile than the market.
- ERB's portfolio has performed consistently with lower volatility and lower correlation with broad market swings. The impact of global macro events, particularly in emerging markets, combined with the drop in oil pricing have brought turbulence to state's investment portfolios over the last five years as seen in reported betas above '1'.



	PERA	ERB	LGPF	STPF
1 Year	1.04	0.91	0.98	1.00
3 Years	1.07	0.95	0.99	0.99
5 Years	1.06	0.94	1.05	1.02

<u>Peer Total Return Rankings</u>.

The following table shows net-of-fees peer total return rankings for the agencies' large funds for the quarter, one, three, five, and ten-year periods. A lower rank (1st is best) denotes better performance when compared to other public funds within a comparable investment universe. These comparisons are completed by the Wilshire Trust Universe Comparison Service (TUCS), a benchmark service which evaluates the performance and allocation of institutional investment assets. New Mexico's investment agencies are evaluated alongside approximately 50 public funds with more than $1 billion in assets. SIC notes not all of its investments report returns net-of-fees[1].

During the first quarter, the four funds improved over the quarter prior. Overall the returns varied for the periods reviewed and fell across a broad range of rankings when compared against comparable funds in the universe. ERB ranked at the 13th percentile, performing very well and above LGPF, STPF and PERA which ranked at the 34th, 44th and 51st percentiles respectively. Over the course of the fiscal one-year, ERB outperformed and ranked high in the 20th percentile, exceeding the ranking of LGPF and STPF which ended in the 56th and 65th percentile respectively, while PERA slowly improved in the 77th percentile. Over the longer ten-year period ERB has performed well towards meeting its long term investment goals.

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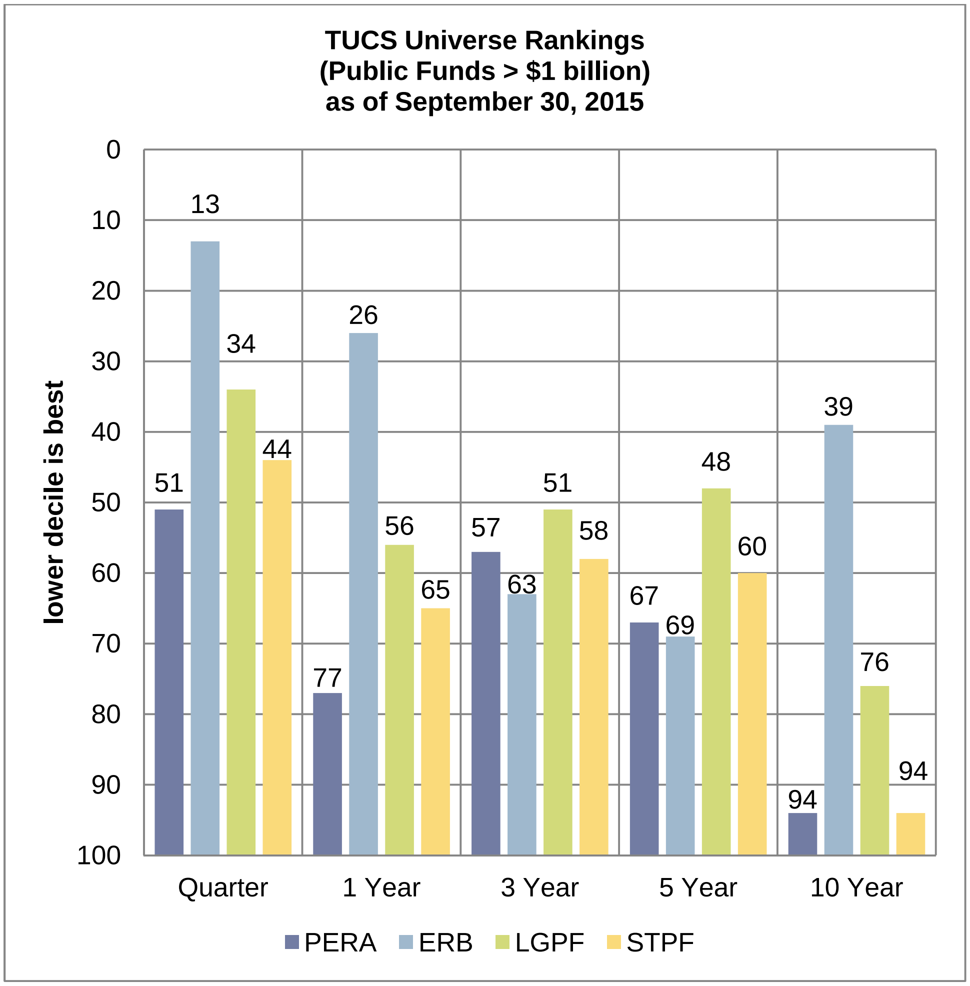
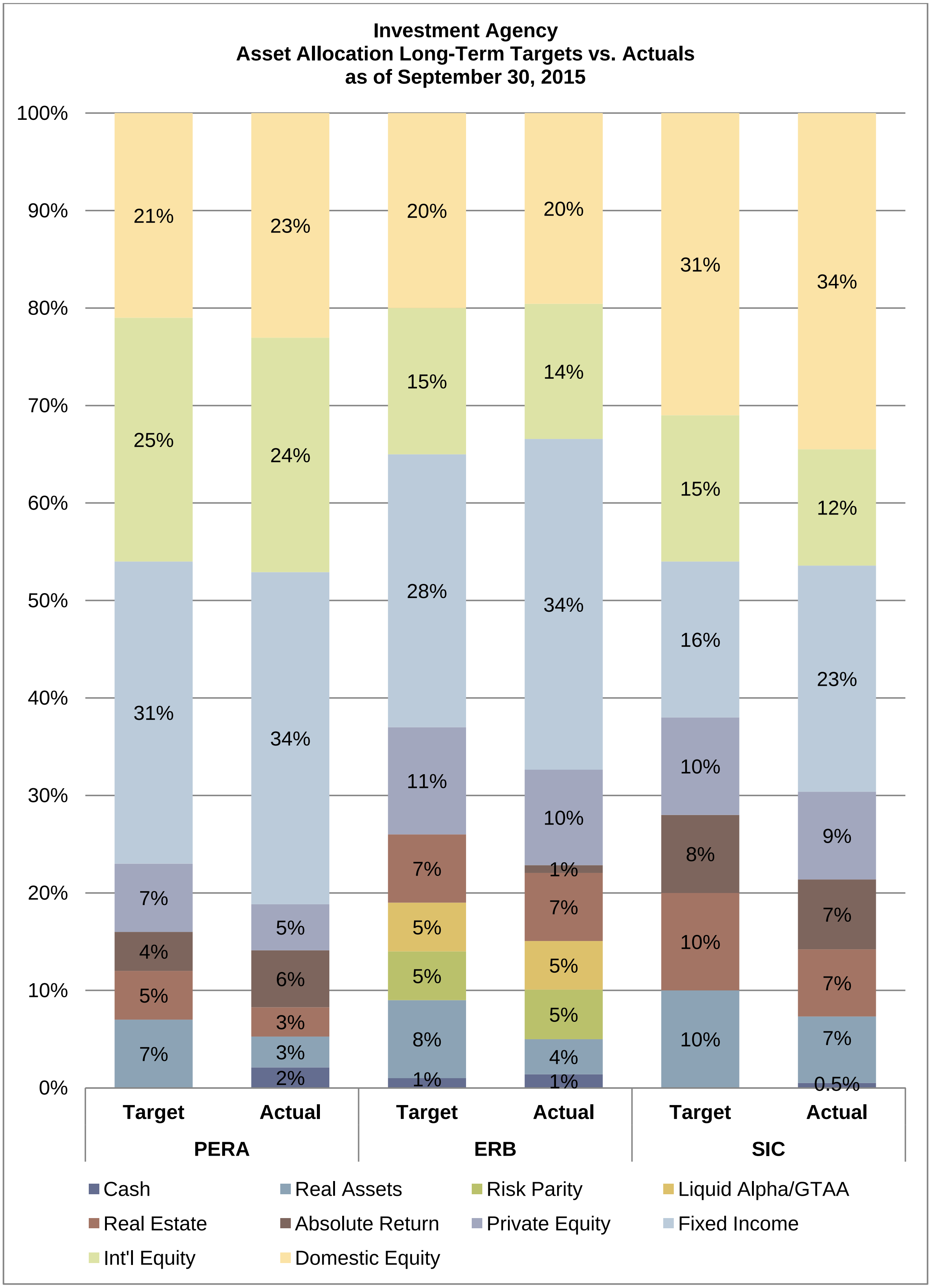
[1] In those cases, SIC's primary investment consultant (RVK) manually adjusts the returns by applying generic costs by asset class, a common practice performed by at least 95 percent of the funds included in TUCS. As SIC's investment advisor, RVK does not have access to the active versus passive mix for any individual fund within the universe, SIC acknowledges in some cases the application of a generic fee could represent an estimated adjustment. The rankings reported in the table reflect gross of fees for LGPF and STPF.



Staff from all three investment agencies acknowledge their respective performance rankings in the long-term are impacted by policy limitations of their asset allocations during the measured time periods and by extreme economic conditions during the great recession. As the agencies adjusted their investment policies to permit diversified portfolios through the inclusion of alternative investments, the volatility of equity markets had a stronger impact on their returns. As long as the investment agencies meet or exceed their annual return targets in the short- and mid-terms, there is an expectation their long-term (10 years and greater) performance rankings will improve over time.


Investment Agency
Asset Allocation Long-Term Targets vs. Actuals
as of September 30, 2015
100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
21%
25%
31%
7%
4%
5%
7%
23%
24%
34%
5%
6%
3%
3%
2%
20%
15%
28%
11%
7%
5%
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8%
1%
20%
14%
34%
10%
1%
7%
5%
5%
4%
1%
31%
15%
16%
10%
8%
10%
10%
34%
12%
23%
9%
7%
7%
7%
0.5%
Target
Actual
Target
Actual
Target
Actual
PERA
ERB
SIC
Cash
Real Assets
Risk Parity
Liquid Alpha/GTAA
Real Estate
Absolute Return
Private Equity
Fixed Income
Int'l Equity
Domestic Equity