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LFC INVESTMENT REPORT FOR THE QUARTER ENDING JUNE 30, 2012

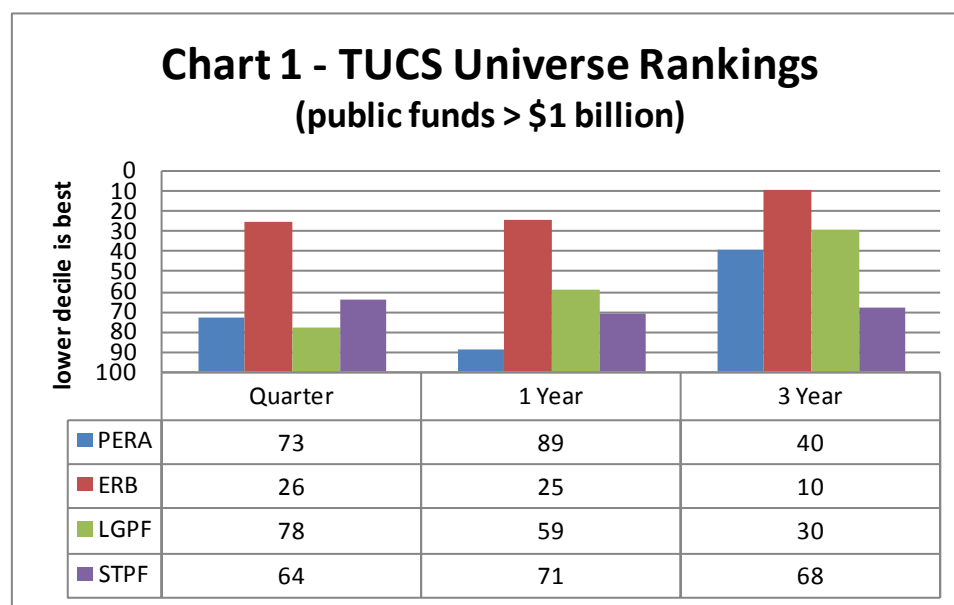
This report details the comparative investment performance of the three investment agencies: the Educational Retirement Board (ERB), the Public Employees Retirement Association (PERA), and the State Investment Council (SIC). It explains how the returns generated by the three investment agencies differed from that of the archetypical fund and how their management and consultants added or subtracted value. While this report concentrates on the quarter and can serve as a baseline, long term performance is indeed the most important metric. Therefore this report includes a three-year analysis of PERA's investment performance. Future reports will focus on other investment agencies.

Table 1 shows percentage returns and ending balances. 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.

Table 1

Returns and Ending Balances for the Quarter Ending June 30, 2012				
	PERA	ERB	LGPF	STPF
Return (%)	-2.06	-0.96	-2.16	-1.84
Ending Balance (\$B)	11.744	9.417	10.727	3.767

Chart 1 shows peer total return rankings for the agencies' large funds for the quarter, annually, and over a three year period. 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 64 public funds with more than \$1 billion in assets.



For the quarter, PERA ranked in the 73rd percentile, better than their one-year results, but below their second-quartile three-year performance. ERB returned a performance in the second quartile, consistent with their one-year performance. ERB's three-year performance remains outstanding, in the tenth percentile. Of the three agencies, SIC (LGPF/STPF) recorded the lowest return for the quarter and ranked below average in one-year performance for both permanent funds. The SIC's three-year average ranked in the top third for the LGPF and in the bottom third for the STPF. With the exception of the SIC's returns for the STPF, all three agencies performed above the median fund over the last three years.

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 best in the first 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.

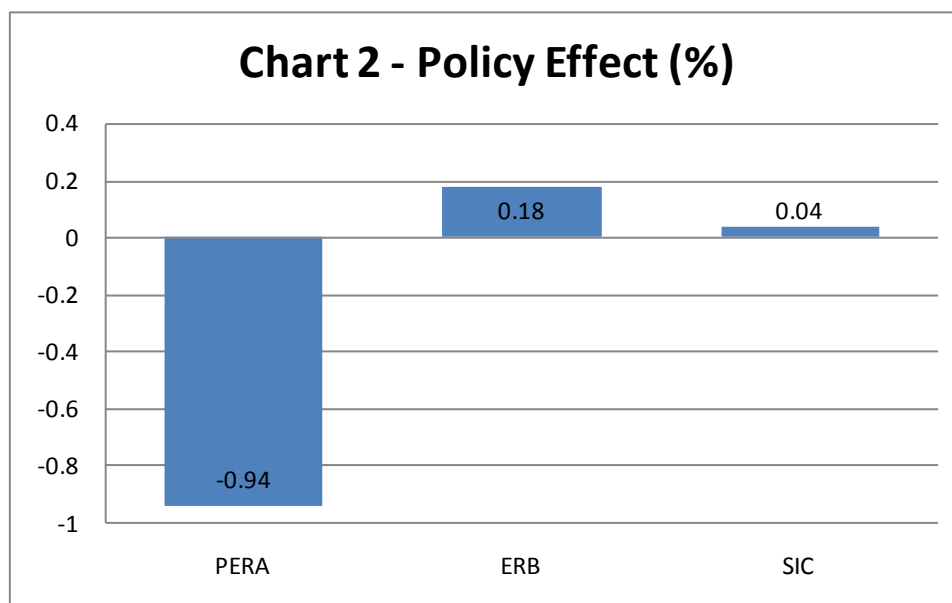
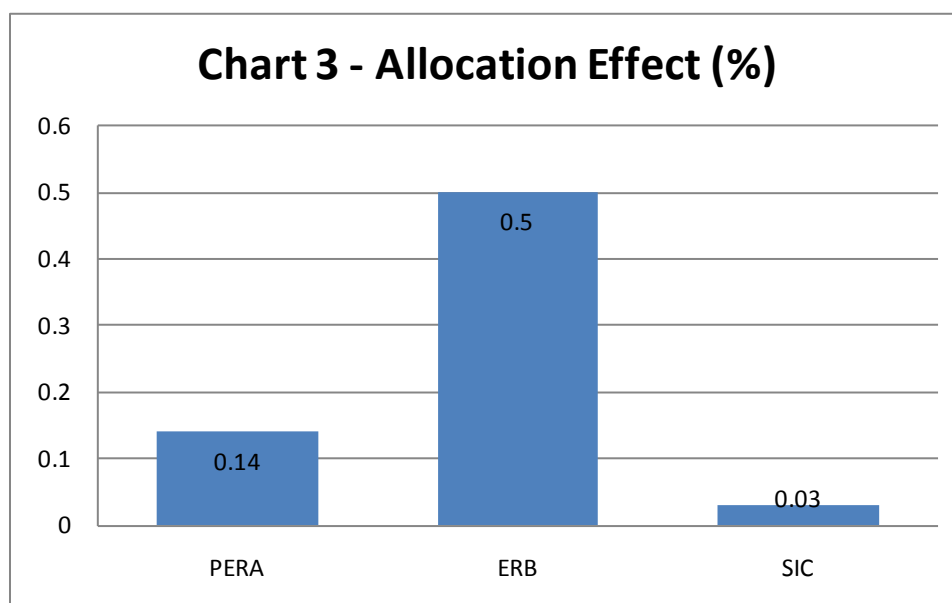


Chart 2 shows the funds' policy effect as measured by comparing the funds' policy indices to the TUCS median fund actual return. The TUCS median return is gross of the allocation and manager effects, and the measure is therefore a rough estimate of the policy effect. However, this report uses the TUCS for this measure to allow uniformity and consistency across the three funds. In isolation, PERA's policy allocation yielded 94 basis points less than the median fund because their policy calls for more equities (27 percent domestic and 27 percent international) than does the median fund. The SIC's LGPF policy calls for a 40 percent allocation toward domestic equities, and a 15 percent allocation toward non-U.S. equities. The SIC's policy allocation delivered returns 4 basis above the median fund. It should be noted that SIC is undergoing a restructuring of its investment portfolio that includes a change in its asset allocation policy to a more conservative exposure toward U.S. equities in favor of less volatile assets. 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. This less risky policy contributed to ERB policy index performing 18 basis points above the median fund performance during a quarter when the market rewarded less risky assets. Also noteworthy is that the policy effects for all three agencies differ from the previous quarter, when the market rewarded risk.

Quarterly Allocation Effect. The second way that a fund's return can be affected is by tactically shifting assets away from the proportions called for by policy. This is a measure of the value added from a chief investment officer. For example, an investment officer might have had a bearish view of the stock market during the second quarter and used his authority to temporarily reduce a fund's risky assets to less than what is specified in policy. Since stocks had a poor quarter, reducing risky assets would have been a good market call and would have contributed to fund performance. As a matter of practice, investment officers are constantly confronted with allocation decisions when transitioning or rebalancing portfolio managers or asset classes. The investment officer may have the option of letting the 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. It is important to note that tactical investment authority afforded the chief

investment officer is dictated by investment policy, resulting in differing degrees of authority delegated by each fund.

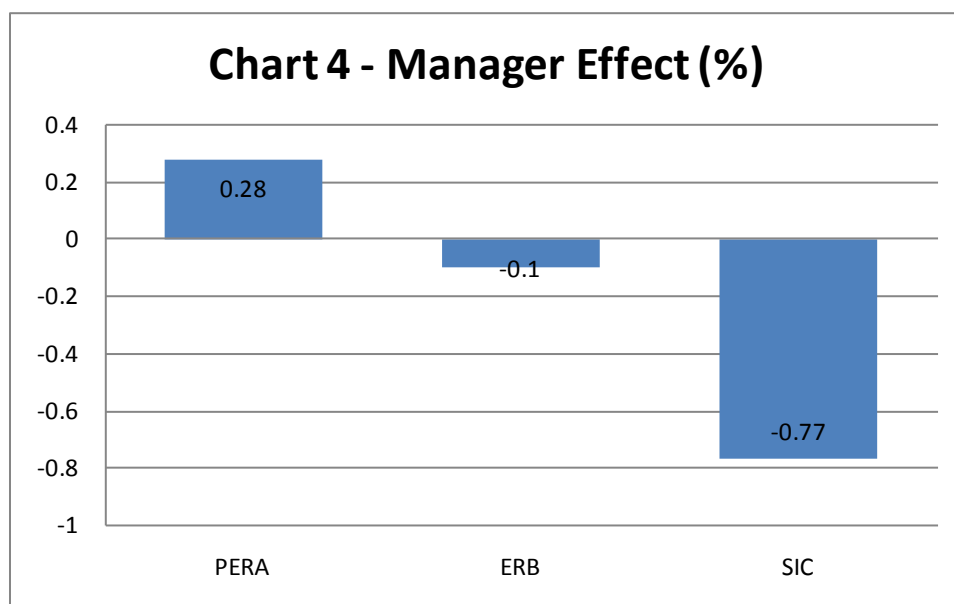
The difference between the funds' temporary and long-term allocation is known as the "allocation effect" and is interpreted as investment return added or lost. Chart 3 shows the quarterly effect graphically; all three funds gained value by deviating from their policy index. PERA gained 14 basis points from the market effect of an underweight in international equities and a slight overweight in real estate. ERB's return was 0.5 percent higher due to rebalancing decisions; and SIC's return was slightly higher (0.03 percent) by deviating from policy by being underweight in international equity, which performed poorly in the quarter. However, much of the value SIC gained by this deviation from policy was eroded by an underweight in real estate, contributing to the small net effect. SIC notes that structural underweight to real estate and real return asset classes exists in the SIC portfolio as the fund implements its change in asset allocation. SIC adds that this underweight should be resolved over the next several quarters. Allocation gains or losses occur constantly – asset proportions vary against targets because of market price changes and incoming and outgoing cash flows, which are also variable.



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, PERA's managers' added 0.28 percent to return, and managers for ERB and SIC reduced returns by 0.10 percent and 0.77 percent, respectively. The majority of the value added by PERA's managers was in the fixed income and absolute return asset classes, while the managers' stock selection in the domestic equity asset class contributed to lost value.

SIC's manager value lost was largely in U.S. equities, followed by non-U.S. equities. Although the manager effect for SIC was positive in the previous quarter, this effect turned around in the second quarter as stock selection lost 77 basis points in value¹. The SIC notes that it is in the process of replacing its external managers as a result of its portfolio restructuring. Among the changes is a transition to more external management, which SIC explains is due to understaffed in-house management, reducing the size of the in-house portfolio from \$4 billion to \$400 million. For the quarter, the SIC's managed large cap equity pool missed the S&P 500 index by 249 basis points, one quarter after outperforming its benchmark by 272 basis points.



The funds' 4th quarter performance can be summarized as follows:

- Using the TUCS, it is possible to rank the funds against the same universe.
- PERA's return was below average for the quarter. A strategic asset allocation that emphasizes equities put the fund at a disadvantage in a quarter where the market did not reward risk. PERA's temporary deviation from long-term allocation targets due to market impact, as well as value added by its active investment management offset some of the negative impacts from a higher-than-peers equity allocation, limiting losses to 2.06 percent.
- ERB turned in a performance that was above average because their emphasis on less risky assets minimized losses in a quarter where such assets performed poorly. The slight loss of value due to active investment management was partially offset by the portfolio's deviation from policy allocation targets.

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.

- SIC quarterly performance was well below average for the same reason that the plan performed well in the previous quarter. The investment agency's portfolio was exposed to domestic and international equities, which performed poorly in the quarter. Modest value added from deviation from the policy allocation targets were more than offset by value lost due to the manager effect, contributing to a quarterly investment loss of 2.16 percent.

PERA Long-term Analysis. Each quarter, this report focuses on one of the three investment agencies to assess its one-year and three-year investment performance. Last quarter's report focused on the ERB, while next quarter's report will address the SIC. Chart 5 of this quarter's report shows PERA's performance for the quarter, year-to-date, and three-year periods. In terms of policy, compared with the TUCS, PERA shows lost value for the quarter, the year, and the three-year period. PERA attributes much of its underperformance relative to peers to a larger exposure to non-U.S. equities, an asset class that returned 7.57 percent for the last three years at a time when the Russell 3000, an index of U.S. stocks, returned 16.73 percent.

With respect to allocation, PERA shows little value added or gained in the quarter and one-year periods. Over three years, the allocation effect resulted in 23 basis points in lost value. This lost value was incurred by deviation from policy targets resulting from an underweight in international equities and a slight overweight in fixed income assets.

The manager effect shows that stock selection resulted in added value in the quarter, year, and three-year periods ending June 30. Net of fees², PERA's managers added 1.4 percent to investment returns over the last three years. Selection of fixed income assets contributed 97 basis points in value, and selection of domestic equities contributed another 46 basis points.

The efficient market hypothesis raises questions about the efficacy of active management in U.S. large cap equities, which is an efficient market. The hypothesis asserts that financial markets are "informationally efficient," implying that one cannot consistently achieve returns in excess of average market returns on a risk-adjusted basis, given the information available at the time the investment is made. Next quarter's report will attempt to test the usefulness of this hypothesis when evaluating the performance of the three agencies' funds.

² PERA notes that all calculations are gross of fees prior to January 1, 2010, and that the three-year analysis therefore reflects blended gross/net of fees data.

Chart 5 - PERA Long-term Analysis