# V DRAFT #2

## Consolidation of SIC, ERB and PERA Investment Functions:

## ERB Staff Commentary

Introduction: Potential savings and efficiencies from the consolidation of investment functions are highly dependent upon the structure and governance of a New Mexico consolidated investment agency (NMCIA). This discussion presumes that the Boards of the various funds (SIC, ERB and PERA; "the funds") retain asset allocation and investment policy approval decisions but delegate virtually all other investment responsibilities to the governing Board of the NMCIA including selection of consultants and managers as well as staffing and budgetary issues of the NMCIA. It is presumed that the governing Board is structured along the lines of the presentation on slide #1. This structure allows each Board to retain fiduciary authority and responsibility, albeit in a shared role. It would not be practicable or advisable to have the NMCIA reporting independently to each of the three funds Boards. Chaos is virtually guaranteed under this approach.

For potential efficiencies to be realized there must be some common elements in investment policy and consultants. This would facilitate the pooling of investment accounts where applicable which offers the best potential for savings.

Based on these assumptions, we have listed the following pros and cons:

Pros:

- Potential cost savings in management fees, systems expense and salaries. These are difficult to estimate, but would fall in the following categories:
    - External manager fees could be reduced by selectively moving assets to internal management.
    - Where assets are not managed internally, a larger mandate given to an external manager could result in a lower overall fee if the manager uses a tiered fee structure. This benefit is mitigated by the fact that each individual investment entity is large enough to already garner some of the benefits of these fee structures. This presumes that all three funds (PERA, ERB and SIC) share common managers for their assets under the consolidated investment agency (NMCIA).
    - A NMCIA may have increased leverage in negotiating financial terms with managers. There is some potential saving in this area as the combined assets of three funds speaking as one carries more weight. Some of these benefits are already being realized, however, as ERB and SIC have used this strategy on a limited number of alternative investment partnerships where there is joint participation. This benefit can accrue to some extent to the funds as they are

currently structured, without combining agencies. This would require a higher level of cooperation and coordination among the existing agencies.
    - A few systems from outside contractors are currently duplicated (or triplicated) in the three investment departments. For instance, both SIC and ERB have separate contracts with QED. Presumably, a consolidated entity would have one contract at a lower combined cost.
    - Reduced headcount. There could be some small reduction in headcount by eliminating positions. Combining the three groups into one does not however mean that staff could be cut by 2/3rds. Potential reductions would be much less than this. Reductions are mitigated by the fact that each investment division is currently part of a larger agency. Each of the agencies has administrative staff that covers the entire agency. For example, ERB has a human resource function that covers the entire agency. A new NMCIA would require its own staff in the human resource area, while ERB would still have a need for its own human resource staff. This is the case with other administrative functions and staff as well. Ultimately, net staff reductions would at most be minimal.
- Improved results could be an outgrowth of adopting the best practices and best personnel from each existing investment entity….or not. See “cons”.

<u>Cons:</u>

- The governing body (Board or Council) would have to cede a measure of control to a separate governing body for the NMCIA. It is **<u>NOT</u>** practicable to have the NMCIA being governed by all three full Boards. There are many questions involving the level of control each Board might retain and the level of service each Board would receive. It would seem most effective to allow the Board of each fund to appoint a given number of individuals (perhaps three) to form a governing Board for the NMCIA. In this way, each fund would have equal voice in the governance of the NMCIA.
- While there are potential cost savings, the level of savings is not likely to be as high as one might think. Consolidating the three investment groups into one will not result in a 2/3 reduction of expenses. It will be far less for a number of reasons:
    - While headcount could possibly be reduced, it is likely that some individual salaries would have to increase; with more assets under management for investment professionals and more people under management on the administrative/supervisory function, responsibility will be increased and it is likely higher compensation would be required.
- The Economically targeted investment (ETI) programs of the SIC would need to remain under the control of the Investment Council. The goals and operating parameters of these activities are different from funds focused solely on investment performance. To include them in the NMCIA would detract from the focus on investment performance, and ultimately detract from results. It is important to maintain a strict focus on

investment performance by the entire staff to achieve the best results possible. The ETI programs consume a disproportionate amount of time, resources and effort.

- Poor investment performance could result if the NMCIA is structured improperly. If, rather than the best practices and best personnel approach is taken, a "least common denominator" approach, with the goal of preserving every employees current position and current suboptimal practices is undertaken as a compromise, investment performance is likely to suffer. If this is to be the approach, there is no question the State is better off with the status quo.

It is likely that a consolidation of investment functions as discussed above would require legislative changes to make it clear that the various Boards would be within their fiduciary duty delegating investment authority to a NMCIA.

Note the ERB General Counsel has pointed out an issue regarding a potential consolidation:
NM Constitution, art. XX, sec. 22 (B) states that the "retirement board of the public employees retirement system and the board of the educational retirement system shall be the trustees for their respective systems and have *the sole and exclusive* fiduciary duty and responsibility for administration and investment of the trust fund held by their respective systems." (emphasis added). Initially, the use of the phrase "sole and exclusive" does not indicate that a "shared role" in a consolidated investment management entity could be done without a constitutional amendment. A consolidated agency possibly could be created without an amendment, with ERB and PERA agreeing that the agency could manage the respective funds, were the two boards to retain their "sole and exclusive" responsibility over investment of their respective funds (i.e., each establishing their own investment policies and giving direction to the investment managers for their own funds). This issue should be addressed when considering any legislation proposing to consolidate ERB's and PERA's investment functions and may warrant review by the New Mexico Attorney General.