Date: July 10, 2013

MEMORANDUM

TO: Investments and Pensions Oversight Committee

FROM: Peter B. van Moorsel, Economist

SUBJECT: New Mexico Investment Agency Strategic Asset Allocation and Investment Performance

This memorandum summarizes asset allocation strategies, an important aspect of institutional investments managed by the state's investment agencies: the Public Employees Retirement Association (PERA), the Educational Retirement Board (ERB), and the State Investment Council (SIC). Each of the three investment agencies has adopted an investment policy that delineates its investment philosophy, objectives, guidelines, and practices. The policies are influenced by the agencies' missions – the ERB and the PERA manage pension funds, and their investment policies and target returns reflect their obligations to their members, while the SIC's investment policy and target return reflect the prescribed annual distributions to fund beneficiaries.

An investment policy prescribes the agency's strategic asset allocation targets and outlines its re-balancing strategy. Asset allocation is an important factor in determining returns for an investment portfolio. Asset allocation is based on the principle that different assets perform diversely in different market and economic conditions. Different asset classes offer returns that are not perfectly correlated, and diversification therefore reduces the overall risk in terms of the variability of returns. An essential responsibility of the fund's trustees, the strategic asset allocation creates an asset mix that balances expected risk and return in the long term. The investment agencies periodically conduct asset/liability studies to determine the extent to which the long-term asset allocation is consistent with the funds' liabilities, generally at least once every three years.

The agencies' allocation strategies establish weights, ranges, and benchmarks for each asset class, including public equities (domestic and international), fixed income assets, and alternative assets such as real estate, private equity, hedge funds, or real assets. The minimum and maximum allocations provide a range within which assets may fluctuate. ERB's policy calls for an asset allocation plan that is expected to achieve the ERB's assumed overall rate of return on fund investments of 7.75 percent. PERA's long term investment return target is also 7.75 percent, while the SIC's target is 7.5 percent.

Figure 1 depicts the allocation targets adopted by the state's three investment agencies. The table shows PERA's policy calls for the greatest exposure to equities (49 percent), domestic and foreign, followed by the SIC, (46 percent), and ERB, whose policy calls for the least exposure to equities (37 percent) in favor of other assets. It is important to note that each of the three funds may have varying strategies and asset allocation targets within the asset classes indicated in Figure 1. For example, ERB's policy calls for its domestic equity portfolio to include 20 percent large cap equities, and 2 percent small/mid cap. Its international equity target allocation is five percent developed markets and ten percent emerging markets. Because the agencies have different strategies and call for different allocations within asset classes, their policies include different benchmarks.

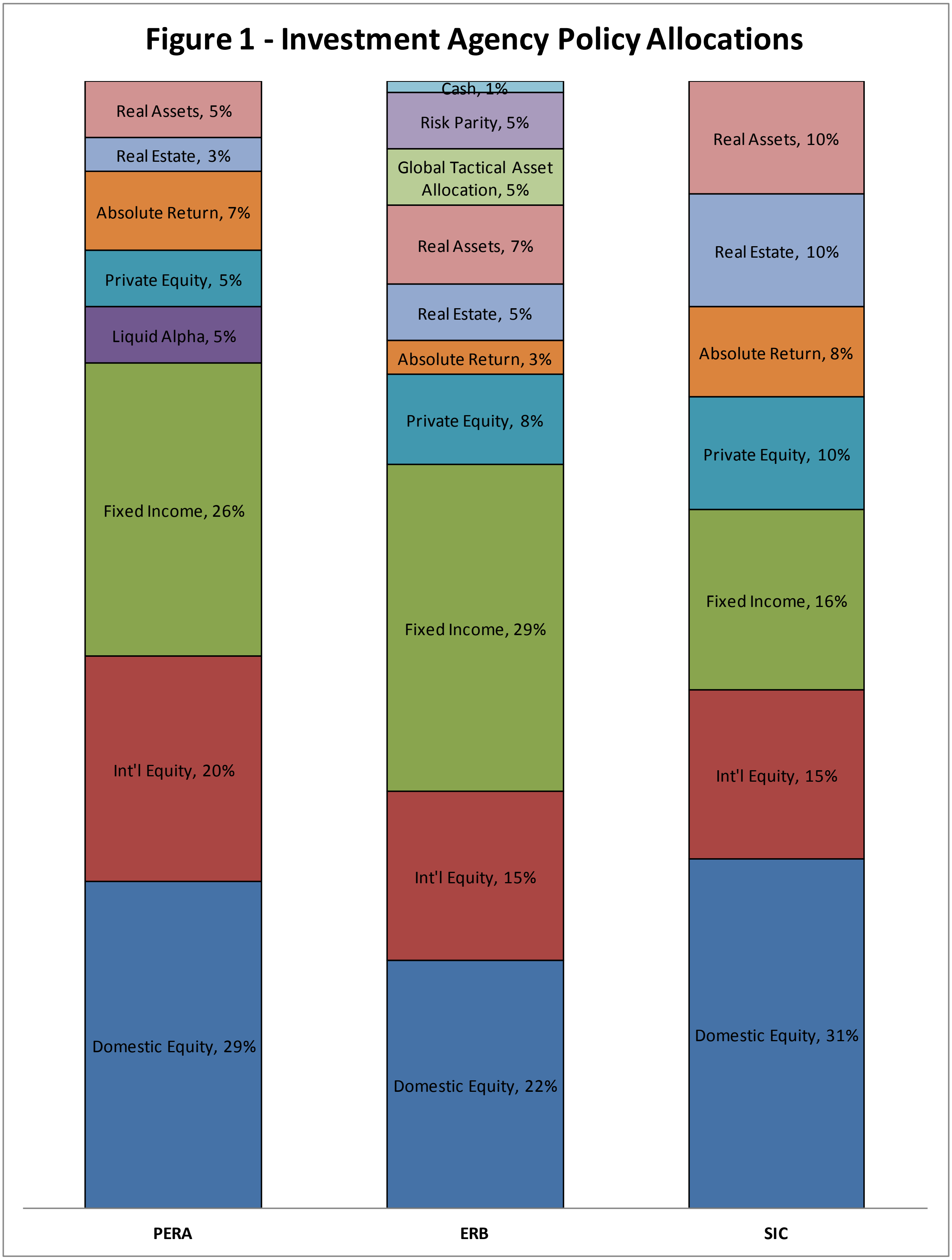
Figure 1 - Investment Agency Policy Allocations
Real Assets, 5%
Real Estate, 3%
Absolute Return, 7%
Private Equity, 5%
Liquid Alpha, 5%
Fixed Income, 26%
Int'l Equity, 20%
Domestic Equity, 29%
Cash, 1%
Risk Parity, 5%
Global Tactical Asset Allocation, 5%
Real Assets, 7%
Real Estate, 5%
Absolute Return, 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

The funds' policy benchmarks for a given period are calculated by multiplying the investment performance of the asset class benchmarks with the fund's asset allocation targets. Figure 2 compares the performance of the agencies' policy indices to fund performance for the one-year period ending March 31, 2013.

Figure 2 - Fund Performance Compared with Policy Index for the Year Ending March 31, 2013 (%)

	PERA	ERB	SIC
Investment Return	11.16	10.2	9.77
Policy Index	9.18	8.9	10.4
Excess Return	1.98	1.3	-0.63
Median TUCS Return	10.42	10.42	10.42
Policy Effect	-1.24	-1.52	-0.02

A fund's long-term policy allocation target can have a more or less aggressive proportion of risky assets such as stocks. For example, if risky domestic assets such as US stocks (equities) performed well in a given period, an index that has more domestic equities should outperform the average. Differences between funds' policy weights are often the most significant factor in explaining differences in relative total return performance. Measured in isolation, such a change in performance is known as the "policy effect."

An appropriate measurement of a policy allocation benchmark is comparison to a defined peer group. Figure 2 shows the funds' policy effect as measured by comparing the funds' policy indices to the Wilshire Trust Universe Comparison Service (TUCS) median fund actual return. The TUCS provides a benchmark for the performance and allocation of institutional assets that includes approximately 75 public funds with more than $1 billion in assets. Using the TUCS for this measure allows uniformity and consistency when comparing the three funds. In isolation, PERA's policy allocation returned 1.24 percent less than the median fund. PERA adopted new policy targets during the previous quarter that raised the domestic equity target from 27 percent to 29 percent, lowered the international equity target from 27 percent 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. In the last year the SIC's policy allocation delivered returns 0.02 percent below the median fund. 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 less risky policy contributed to its policy index performing 1.52 percent below the median fund performance.

Depending on the asset class, investment agencies seek to maximize investment returns by indexing the asset class or attempting to gain excess returns through asset management. Some asset classes, such as equities and fixed income assets, offer little opportunity for investment gains through asset management, and indexing these types of asset classes is more cost effective. However, potential exists for investment returns due to manager skill in certain asset classes, such as opportunistic credit and private equity. Investment agencies will hire asset managers to attempt to maximize investment gains in these classes, which comes at the cost of external manager fees. These mechanics of the fee payments for public versus private asset managers differ: external investment fees can be reported on-budget or off-budget depending on asset class. The PERA, ERB, and SIC will present their respective asset management fee structures individually.