Investments and Pensions Oversight Committee

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Considerations for Investment Operations Consolidation

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Investment Agency Consolidation?

- As of June 30, 2015, the investing Agencies (ERB, PERA, SIC, and STO, aka "the Agencies") manage $50 billion in aggregate.

- While a consolidation of the Agencies may seem to be an attractive way to reduce expenses, benefits are likely to be minimal and may be outweighed by disadvantages.

- In any case, a rational plan for consolidation would require an amendment to the New Mexico Constitution.

Why a Constitutional Change?

- To fully realize any expense reductions, the funds would have to use common investment consultants and managers, and have common, or at least similar policies.
- The constitution establishes the ERB and PERA retirement funds as trust funds, and designates the respective retirement boards as the sole trustees and fiduciaries of the funds. The constitution gives similar authority to the State Investment Officer and the Council. The Treasurer is a constitutional executive officer.
- The boards have separate consultants, managers and staff. It is likely they would choose to continue to exercise their fiduciary duty by choosing the groups and individuals and establishing investment policies to carry out each Agency's mission in the best way possible.
- Thus, as long as there are separate fiduciaries for each agency, it is unlikely any consolidation could be achieved.

SIC Constitutional Language

“Article XII. Sec. 7. [Investment of permanent school fund]

A. As used in this section, "fund" means the permanent school fund described in Article 12, Section 2 of this constitution and all other permanent funds derived from lands granted or confirmed to the state by the act of congress of June 20, 1910, entitled "An act to enable the people of New Mexico to form a constitution and state government and be admitted into the union on an equal footing with the original states".

B. The fund shall be invested by the ***state investment officer*** *in accordance with policy regulations promulgated by the* ***state investment council*** *.*

C. In making investments, the ***state investment officer****, under the supervision of the* ***state investment council*** *, shall invest and manage the fund in accordance with the Uniform Prudent Investor Act”.*

ERB and PERA Constitutional Language

"Article XX. Sec. 22. [Public employees and educational retirement systems trust funds; ….

*B. 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."*

As long as this language remains in force, the Boards *cannot* legally cede their sole and exclusive fiduciary duty for the investment of the trust funds to a new consolidated entity.

Further Considerations

- While a well structured consolidation *may* result in some savings in expenses, those savings are likely to be far less than expected.
  - Consultants and managers charge fees based on the amount of assets under management. While there may be some discount for the consolidated asset size, each contractor will charge more to mange the larger amount of assets in a consolidated entity.
  - There may be some consolidation of internal staff, but given the increased workload for a consolidated entity, those reductions would be minimal. In any case, staff expense is inconsequential compared to contractor fees.

- The transition to a consolidated Agency would be disruptive and require additional expenses and resources.

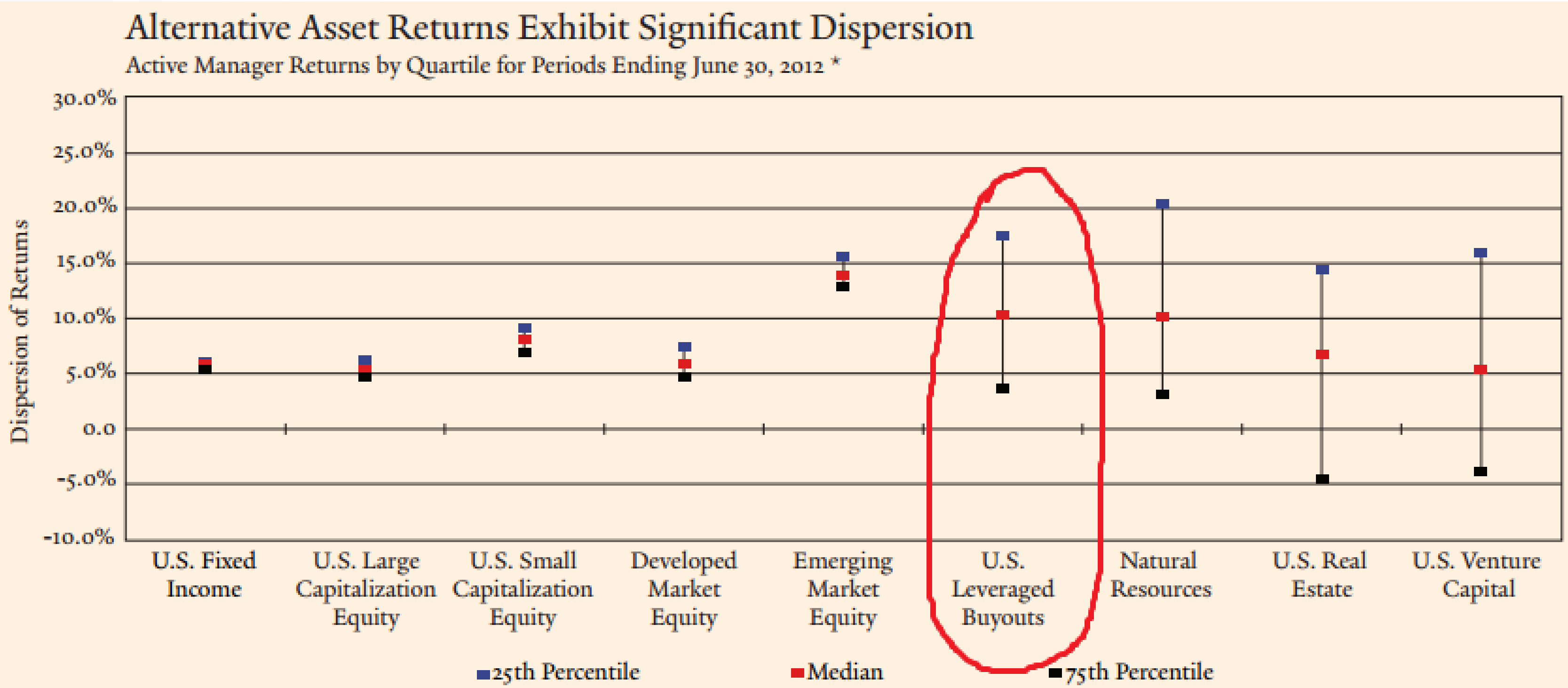
Mission Specific Investing

- As we have previously discussed, each Agency follows a strategy to fulfill a specific mission. The mission of the State Treasurer is quite different from that of SIC and SIC's mission differs from ERB's, etc.
- The difference results in a variety of strategic asset allocations (SAA) and the methods employed in implementing those allocations.
- For instance, ERB has adopted an SAA that is significantly lower in public equity exposure than SIC or PERA, and it is wholly different than the State Treasurer, who invests only in short term, liquid funds. Further, ERB has allocated a substantial amount of assets to internal management. PERA and SIC have chosen to hire outside managers for all investments.
- One Agency or one governing body is unlikely to be able to adequately address the various missions of the funds.

Performance Considerations

- Many investment managers and strategies have limited capacity.
- ERB has been able to take advantage of some of these investments, which has been additive to our overall performance.
- A larger entity would not be able to make these investments if the goal of expense reduction is to be met. The average investment size would have to be larger to realize any economies of scale.
- A larger entity could choose to make smaller investments, but this would require more staff to monitor a larger number of investments and negate any fee savings from “volume discounts.”

Wider Dispersion in Private Assets



* Fixed income and marketable equity performance based on annualized ten-year returns of BNY Mellon manager universes, adjusted for fees.
Venture capital, LBO, real estate, and natural resources returns based on annualized since-inception IRRs of Cambridge Associates manager universes.

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Diversification Considerations

- Diversification is a key tenet of investment theory and practice.
- From the perspective of the “State of New Mexico’s Portfolio,” a consolidation would result in less diversification in asset allocation and investment staff, thus increasing risk.
- In summary, consolidation may result in some expense reduction, but that benefit could be more than offset by a reduction in return and an increase in risk.
- As previously discussed, return and risk are the two most important investment considerations. A third order consideration is cost structure.

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