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November 30, 2011

**MEMORANDUM**

**TO:** Senator John Arthur Smith, Chairman and LFC Members  
**FROM:** Charles Kasscieh, Economist, LFC  
**SUBJECT:** LFC Report of Investment Performance – FY12 First Quarter

**INVESTMENT PERFORMANCE HIGHLIGHTS:**

- Including investment returns, contributions and distributions, the state's aggregate fund value showed a loss in the last quarter. The total value of the funds as of September 30, 2011 is \$32.3 billion, down \$4 billion or 11% from June 30, 2011.
- All funds had negative investment results for the quarter ending September 30<sup>th</sup> 2011. ERB lost 7.9 percent of its value while PERA and both SIC funds lost over 10 percent of their values during the turbulent quarter.
- This poor performance has a direct correlation to the equity markets. High allocation to domestic and international equity played a huge role for the funds during the first quarter of FY12. Equities, an asset class, fared poorly in the recent past. As a result, all funds began reducing their exposure to equities.
- ERB core fixed income composite produced positive gains in the first quarter of FY12 while their total fixed income composite was slightly down. Both SIC and PERA had positive gains for their total fixed income composites.
- Peer rankings were mixed; ERB improved its rankings on all four time periods, the one-quarter, one-year, five-year and 10-year. PERA remained in the 99<sup>th</sup> percentile for the five year, and dropped in ranking for the one-year but improved for the quarter compared with peers. SIC's funds both improved in the one-quarter rankings compared to peers and dropped rankings in the one and five –year rankings.
- The public markets experienced a downturn during the first quarter of FY12. The equities markets got hit the hardest while yields on fixed income in the long term have come down. Currently yields for short and long term assets are at all-time lows.

## MARKET SUMMARY FOR QUARTER 1 FY12

After a string of solid quarters for the US economy, the first quarter of the FY 12 started off poorly. Some contributing factors to the poor performance include a slowing growth in the U.S. due to political uncertainty, the Euro-Zone crisis, and threats in the developing world. These factors will continue a trend of high market volatility. The equity markets declined and fixed income yields remained very low during this quarter. This has made it difficult for investors.

Current Asset Values\* (millions)  
For Quarter and Year Ending September 30, 2011

|                           | ERB     | PERA     | LGPF     | STPF    | TOTAL    |
|---------------------------|---------|----------|----------|---------|----------|
| Current Asset Value       | \$8,682 | \$10,831 | \$9,546  | \$3,225 | \$32,285 |
| Value Change* - Quarter   | -\$831  | -\$1,303 | -\$1,142 | -\$716  | -\$3,991 |
| Percent Change* - Quarter | -8.73%  | -10.74%  | -10.68%  | -18.17% | -11%     |
| Value Change* - Year      | -\$122  | -\$235   | -\$1     | -\$366  | -\$724   |
| Percent Change* - Year    | -1.38%  | -2.13%   | -0.01%   | -10.19% | -2.19%   |
| <b>Investment Returns</b> |         |          |          |         |          |
| Quarter 1 FY 12           | -7.90%  | -10.27%  | -10.60%  | -10.21% | -        |
| Calendar Year-to-Date     | -3.20%  | -5.89%   | -5.80%   | -4.76%  | -        |
| One- Year Return          | 1.80%   | 0.25%    | 0.84%    | 1.88%   | -        |

\*Changes include investment returns, contributions and distributions.

## FUND ASSET VALUES

With the events that unfolded during the last quarter, which included the US debt problem and Greece's possible bankruptcy, the equity markets were impacted significantly. The losses sustained during 2008-2009 market collapse were gained back over the last several quarters only to see them mostly wiped out. The aggregate fund value totals \$32.3 billion as of September 30, 2011, down \$4 billion or over 11 percent from three months ago. The aggregate fund value dropped \$724 million over a 12 month period, a two-percent decline. See appendix B for additional information

## PERFORMANCE SUMMARY

**The Education Retirement Board.** ERB gained \$163 million over the last 12-months from investment results. This was offset by the excess of benefit payments and other expenditures exceeding contributions by \$285 million. The net effect was a decline in the fund balance of \$122 million. For Q1 of FY12, ERB lost nearly 8 percent due to investment results. Investment results coupled with the net effect of payments exceeding contributions resulted in fund assets decreasing \$831 million dollars. International Equity was the worst performing asset class in the ERB fund although domestic equity contributed the most to the drop in value due to the larger allocation in the latter category. ERB's underweighting in equities helped them do well compared to their peers. Despite the large losses suffered over the quarter, there were a few asset classes that performed well over the last three months. Core Fixed Income, Private Equity and Real Estate all produced gains however underperforming the benchmark. The bright spot of the quarter was the Global Asset Allocation. They currently are overweight in this asset class but this produced a gain while the benchmark suffered a loss.

**The Public Employee Retirement Association.** The PERA Fund dropped in value \$1.3 billion over the last 12 months, with the most damage to performance happening during the first quarter of FY12. As in the case of ERB, PERA's International Equity mandates suffered the largest absolute percent drop. However, active management contributed to outperformance of the asset class on a relative basis. PERA allocates nearly 50 percent of total assets to domestic and international equity, which contributed significantly to the quarter's losses. The Fund's allocation in fixed income produced an absolute gain but fell short of the benchmark.

**The New Mexico State Investment Council.** The Land Grant Permanent Fund (LGPF) and the Severance Tax Permanent Fund (STPF), the State Investment Council's two major funds, lost a combined \$1.9 billion in Q1 of FY12. The STPF fell over 11 percent in value in the quarter while the LGPF fell nearly 11 percent, these values include distributions, contributions and investment returns. Compared to this time a year ago, the LGPF remained relatively the same as compared to a year ago. The total aggregate of SIC funds saw a gain in Core Bonds; however it was far below the benchmark return. SIC did outperform in absolute returns (hedge funds) although this asset class fell in value. Both domestic and international equity sustained large losses. Compared to PERA and ERB, SIC has the highest allocation to equities. Domestic equity, the largest asset class for SIC performed poorly.

SIC's large cap active pool impaired the performance of the funds. The two largest external managers Thornburg and Clearbridge finished the quarter as the bottom feeders compared to their peers. Thornburg has a history of underperforming and finished the first quarter with a peer rank of 99 (one being the highest) falling behind the S&P 500, their benchmark, by 760 basis points. The S&P 500 finished the quarter down nearly 14 percent. Clearbridge has historically performed with exception of this year. This year's performance has brought down the results of their three-year and five-year returns. As detailed below in appendix A, SIC's internal managers were slightly behind the benchmark for the most recent period. Over a longer term, they have performed far better than their external counterparts.

## **PERFORMANCE RELATIVE TO PEERS**

Peer rankings are generated by using rates of returns data. Comparing performance to peers can shed insight into how policy decisions impact short and long term results. Consistent underperformance relative to peers suggests a failure to execute modern portfolio management effectively as well as the inability to hire good managers. ERB made improvements in all four peer-ranking time periods; this includes the one-quarter, one-year, five-year and 10-year. Most notably, ERB has remained in the top quartile for the past five-years compared to their peers. PERA increased one-quarter comparison slightly while their one-year dropped significantly. PERA funds remained in the 99<sup>th</sup> percentile for the five year ranking. PERA remains stuck in the bottom 10 percent for the five-year comparison, still unable to overcome impacts from poor past manager underperformance that contributed to the fund's decline of \$4.2 billion during FY08-FY09. While the permanent funds peer rankings of 60<sup>th</sup> and 50<sup>th</sup> percentile for the LGPF and STPF are improvements over the previous quarter, peer comparisons worsened in other time periods. The permanent funds did slip from their one-year rankings versus their peers. The LGPF dropped to the 44<sup>th</sup> percentile from the 17<sup>th</sup> percentile and the STPF fell to the 24<sup>th</sup> percentile from the 16<sup>th</sup> percentile.

**Peer Percentile Rankings\***

|             | <b>QTR</b> | <b>1 Year</b> | <b>5 Year</b> | <b>10 year</b> |
|-------------|------------|---------------|---------------|----------------|
| <b>ERB</b>  | 23         | 60            | 21            | 42             |
| <b>PERA</b> | 82         | 79            | 99            | 91             |
| <b>LGPF</b> | 60         | 44            | 77            | 59             |
| <b>STPF</b> | 50         | 24            | 92            | 79             |

\* Percentile rankings (1 is highest) for ERB and PERA relative to U.S. Public Funds.  
Permanent Funds ranked relative to U.S. Endowment Funds.

**ACTUAL VS. TARGET ASSET ALLOCATIONS**

The target asset allocations shown below represent each fund’s plan structure. FY2011 saw a bull market, and the funds were all able to take advantage of their overweight positions in equities early in the year. The funds have begun to take a more risk adverse approach which has their asset allocation for equities under their targets. Despite taking a risk adverse approach, the first quarter of FY12 equities which hold a major position in all the funds saw major declines. SIC is engaged in moving assets between classes, however this does take some time. Another risk adverse move was the funds keeping money in cash to lower their exposure to risks associated with securities.

**Fund Asset Allocation Detail, Quarter Ending September 30, 2011**

|                                | <b>ERB*</b>   |                 | <b>PERA*</b>  |                 | <b>LGPF*</b>  |               | <b>STPF*</b>  |               |
|--------------------------------|---------------|-----------------|---------------|-----------------|---------------|---------------|---------------|---------------|
|                                | <b>Actual</b> | <b>Target**</b> | <b>Actual</b> | <b>Target**</b> | <b>Actual</b> | <b>Target</b> | <b>Actual</b> | <b>Target</b> |
| <b>US Equity</b>               | 23.9%         | 25.0%           | 25.0%         | 27.0%           | 41.7%         | 45.0%         | 41.8%         | 45.0%         |
| <b>International Equity</b>    | 13.4%         | 15.0%           | 23.7%         | 27.0%           | 13.4%         | 15.0%         | 13.3%         | 15.0%         |
| <b>Fixed Income</b>            | 36.0%         | 27.0%           | 29.2%         | 26.0%           | 23.1%         | 20.0%         | 18.6%         | 20.0%         |
| <b>Total Alternatives</b>      | 25.3%         | 27.0%           | 21.0%         | 20.0%           | 23.0%         | 20.0%         | 25.6%         | 20.0%         |
| <b>Private Equity</b>          | 5.1%          | 7.0%            | 3.8%          | 5.0%            | 10.6%         | 10.0%         | 15.2%         | 10.0%         |
| <b>Real Estate/Real Assets</b> | 6.4%          | 12.0%           | 7.3%          | 6.0%            | 4.1%          | 5.0%          | 5.9%          | 5.0%          |
| <b>Absolute Return</b>         | 7.4%          | 8.0%            | 9.8%          | 9.0%            | 6.3%          | 5.0%          | 4.6%          | 5.0%          |
| <b>Other</b>                   |               |                 |               |                 |               |               |               |               |
| <b>Global Asset Allocation</b> | 6.4%          | 5.0%            |               |                 |               |               |               |               |
| <b>ETI***</b>                  |               |                 |               |                 |               |               |               |               |
| <b>Cash Equivalents</b>        | 1.4%          | 1.0%            | 0.8%          | 0.0%            | 0.8%          | 0.0%          | 0.7%          | 0.0%          |
| <b>Total Fund %</b>            | 100%          | 100%            | 100%          | 100%            | 100%          | 100%          | 100%          | 100%          |

\*All funds are reducing exposure to equities and increasing other asset allocations.

\*\*Due to the long implementation period for some alternatives, both PERA and ERB have adopted interim targets.

\*\*\*ETI: Economically targeted investments include state private equity.

**LONG TERM PERFORMANCE SUMMARY**

Despite strong investment gains for FY10 and FY11, longer term returns remain below the newly set targets of 7.75 percent for the pension plans and 8 percent for the permanent funds needed to fund obligations. Additionally, the State Investment Council lowered their target returns from 8.5 percent to 7.5 percent. With these decreases in expected investment returns, the investment pools will need additional sources of funding to offset their distributions to ensure these pools continue to grow.

## Appendix A

|                                 | Q1 FY12 Returns | CY 11   | 3-years | 5-years | CY2010 | CY2009 | CY2008  |
|---------------------------------|-----------------|---------|---------|---------|--------|--------|---------|
| SIC Managed                     | -15.07%         | -9.15%  | 4.77%   | 1.47%   | 16.15% | 33.60% | -34.64% |
| S&P 500 Index                   | -13.87%         | -8.68%  | 1.23%   | -1.18%  | 15.06% | 26.46% | -37.00% |
| Difference                      | -1.20%          | -0.47%  | 3.54%   | 2.65%   | 1.09%  | 7.14%  | 2.36%   |
| SIC Large Cap External Managers |                 |         |         |         |        |        |         |
|                                 | -25.93%         | -27.15% | -1.22%  | -2.63%  | 15.96% | 46.17% | -35.56% |
| S&P 500 Index                   | -13.87%         | -8.68%  | 1.23%   | -1.18%  | 15.06% | 26.46% | -37.00% |
| Difference                      | -12.06%         | -18.47% | -2.45%  | -1.45%  | 0.90%  | 19.71% | 1.44%   |
| Thornburg                       | -21.47%         | -17.28% | 0.80%   | -1.60%  | 10.57% | 45.70% | -41.45% |
| S&P 500 Index                   | -13.87%         | -8.68%  | 1.23%   | -1.18%  | 15.06% | 26.46% | -37.00% |
| Difference                      | -7.60%          | -8.60%  | -0.43%  | -0.42%  | -4.49% | 19.24% | -4.45%  |

\*benchmarks are highlighted in gray