State of New Mexico
LEGISLATIVE FINANCE COMMITTEE

325 Don Gaspar, Suite 101 • Santa Fe, NM 87501
Phone: (505) 986-4550 • Fax: (505) 986-4545

David Abbey
Director

LFC INVESTMENT REPORT FOR THE QUARTER ENDING SEPTEMBER 30, 2013

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. Long-term performance is an important metric, and therefore this report includes fund returns and comparative rankings for the one-year, three-year, five-year, and ten-year periods and attribution analysis for the one and three-year periods in addition to the quarter.

The Trust Universe Comparison Service (TUCS) reports strong gains for global stock markets in the third quarter of 2013 despite considerable headwinds on multiple political fronts, as well as continued investor uncertainty as to when the U.S. Federal Reserve will finally start to unwind its accommodative monetary policies. The U.S. economy's recovery from the Great Recession has picked up some steam in the first half of 2013; real Gross Domestic Product grew at an annual 2.5 percent rate in the second quarter of 2013, up sharply from the (revised) 1.1 percent growth seen in the first quarter. Future growth prospects remained fragile as lawmakers in Washington grappled over budget issues, including the funding of the Affordable Care Act, which resulted in a partial shutdown of the federal government as of October 1st. Inflation at the consumer level remained relatively slow.

The TUCS notes the U.S. stock market, represented by the Wilshire 5000 Total Market Index, posted a total return of 6.03 percent during the third quarter, despite pulling back 2.16 percent from its record high close on September 18. The quarter started with an impressive 5.44 percent gain in July; concerns over the Federal Reserve's possible tapering of its quantitative easing programs caused stocks to fall -2.88 percent in August. September found investors rallying once the Fed committed to continuing its monetary policy, but concerns over the government shutdown led to a late-quarter pullback and a 3.55 percent return for stocks in September. Bond yields moved upward in July, picking up momentum in August and peaking in early September; the ten-year U.S. Treasury yield hit 2.98 percent on September 5, its highest level since July 2011. Global stock markets enjoyed strong performance overall for the third quarter; emerging market stock performance trailed that of developed market stocks.

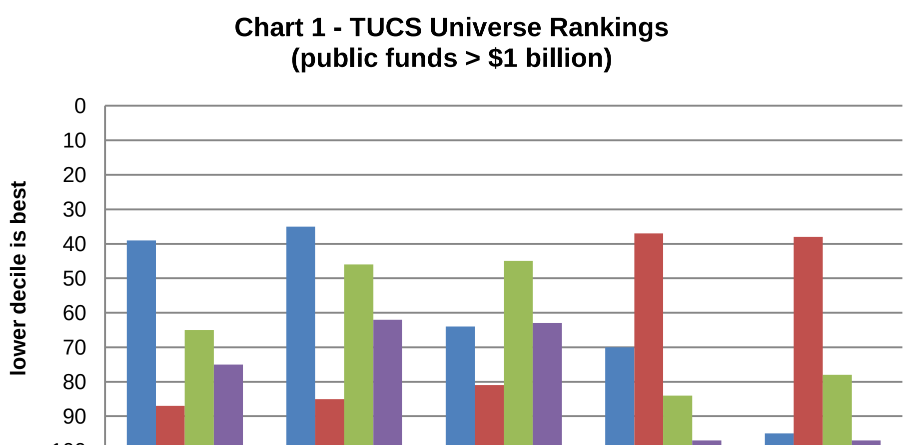
Returns and Ending Balances. Table 1 shows the respective funds' ending balances and compares the investment agencies' returns for the quarter and the one, three, five, and ten-year periods. The annual target returns for the three investment agencies are around 7.5 to 7.75 percent. Although the agencies' returns for the quarter fall below the target, the one- and three-year returns exceed the target. Five and ten-year returns include lesser investment performance in the aftermath of the recession, and are therefore lower.

Table 1				
Returns and Ending Balances as of September 30, 2013				
Returns (%)	PERA	ERB	LGPF	STPF
Quarter	5.21	3.37	4.39	4.24
1-Year	13.42	9.77	12.86	12.16
3-Year	9.87	8.95	10.35	9.94
5-Year	7.55	8.30	7.03	5.96
10-Year	6.66	7.66	7.13	6.44
Ending Balance ($B)	13.40	10.37	12.68	4.29

Source: Agency Investment Reports

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. The difference in return between the two is a rough approximation of the opportunity cost of these initiatives.

Peer Total Return Rankings. Chart 1 shows peer total return rankings for the agencies' large funds for the quarter, one, three, five, and ten-year periods. A lower rank (1st is best) denotes 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 75 public funds with more than $1 billion in assets.



	3rd Quarter	1 Year	3 Year	5 Year	10 Year
PERA	39	35	64	70	95
ERB	87	85	81	37	38
LGPF	65	46	45	84	78
STPF	75	62	63	97	97

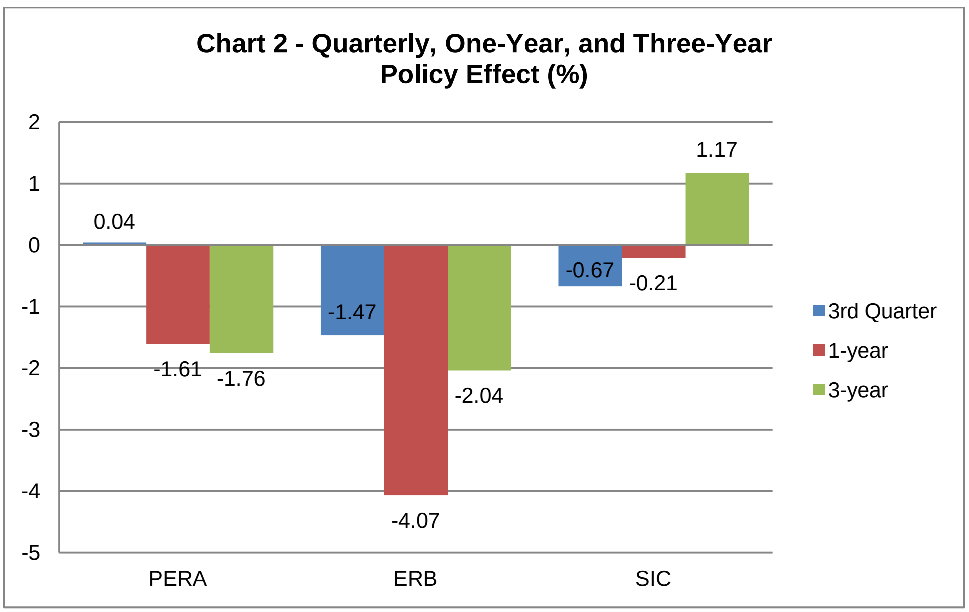
For the quarter, PERA ranked in the second quartile, slightly lower than the ranking of its one-year performance, but better than its ranking over the last three, five, and ten years. PERA's ten-year ranking remains in the lowest fifth of all funds in the universe.

ERB returned a quarterly performance in the fourth quartile; its one- and three-year performance rankings are also subpar. The fund's five and ten-year ranking is just outside of the first quartile, a lower ranking than in the previous quarter (37th and 38th percentile, respectively).

Both funds invested by SIC saw a significant lower performance in the current quarter compared to the previous quarter. The Land Grant Permanent Fund's quarterly performance was in the 65th percentile, below its performance in the 46th percentile in the one-year and 45th percentile in the three-year term, but better than its long-term ranking. The Severance Tax Permanent Fund's quarterly ranking is on the bottom edge of the third quartile, below results seen in one- and three- year periods but still higher than the five and ten-year 97th percentile rankings. As noted in the previous quarter, the SIC restructured its portfolio by changing its asset allocation and individual managers in an effort to improve returns while lowering risk.

<u>Attribution Analysis</u>. 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, if risky domestic assets such as U.S. stocks (equities) performed well, 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 a 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 to allow uniformity and consistency across the three funds. The TUCS median return is gross of the allocation and manager effects, and the measure is therefore a rough estimate of the policy effect. (The investment agencies' policy target allocations are included in Figure 1, on page 7 of this report.)

PERA's policy allocation returned 0.04 percent more than the median fund in the quarter, 1.61 and 1.76 percent less during the one and three-year average, respectively. PERA has adopted new policy targets that raised the domestic equity target from 27 to 29 percent, lowered the international equity target from 27 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. The SIC's policy allocation delivered 67 basis points below the median fund in the quarter, and 21 basis points below the median fund during the year. However, the policy delivered 117 basis points above the median fund in the three-year term. 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 quarterly policy index performed 147 basis points below the TUCS median fund performance, and the policy effect over the last year was -407 basis points. ERB notes the large effect for the one-year period is mainly due to the agency's lower policy weight in equities in general, and particularly in domestic equities, which performed well during the year. Further, ERB has a higher policy weight to emerging markets whose performance trailed that of developed markets, causing the higher allocation to hurt returns.

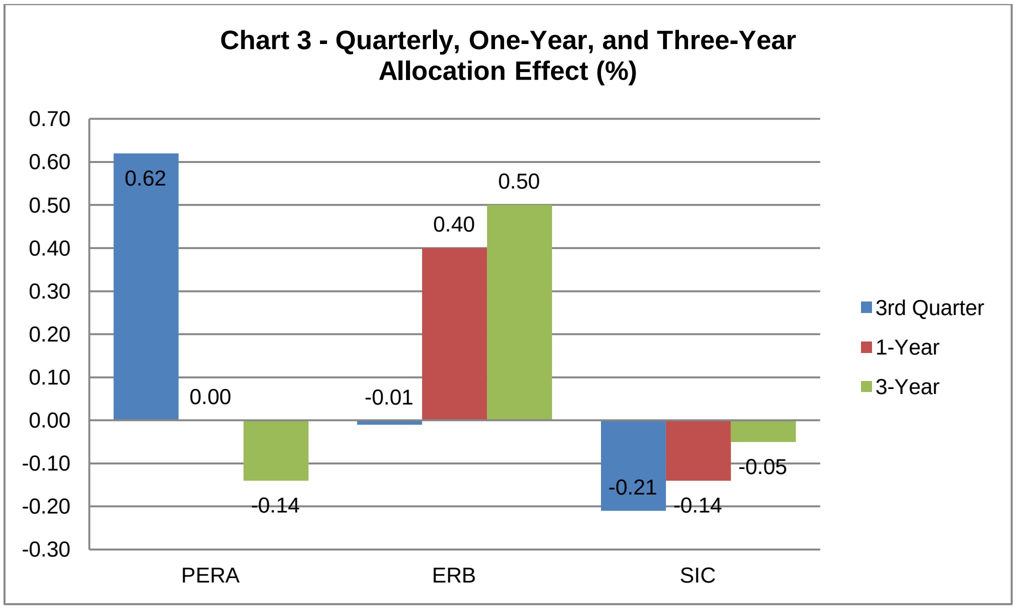
Quarterly Allocation Effect. The second way that a fund's return can be affected is by deviation from asset allocations called for by policy. As a matter of practice, investment officers are constantly confronted with allocation decisions when transitioning or rebalancing portfolio managers or asset classes. Asset prices and values can vary in the short run, causing the allocation toward an asset class to drift from its long term target. Almost all rebalancing policies contain some flexibility for staff or the chief investment officer to operate within set boundaries. The three funds constantly see contributions coming in and distributions going out. Further, cash is being generated in some portions of the portfolio, and called or used in others, which can also cause asset allocations to deviate from policy. The investment officer may have the option of letting 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. Rebalancing 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 for the quarter, one-year, three-year, and five-year periods.

PERA gained 62 basis points during the quarter due to an underweight in international and domestic equities offset by a lag effect of having no liquid assets. In the previous quarter, the overweight to international equity was the largest contributor to an allocation effect of negative 14 basis points. As PERA's allocation transitions from international equity to liquid assets, this overweight should decrease.

ERB's 3rd quarter allocation effect was -10 basis points. The ERB's one-year allocation effect of 40 basis points resulted from value added by deviation from allocation targets in opportunistic credit and core fixed income, and offset by value lost in U.S. large cap stocks and foreign developed market equities.

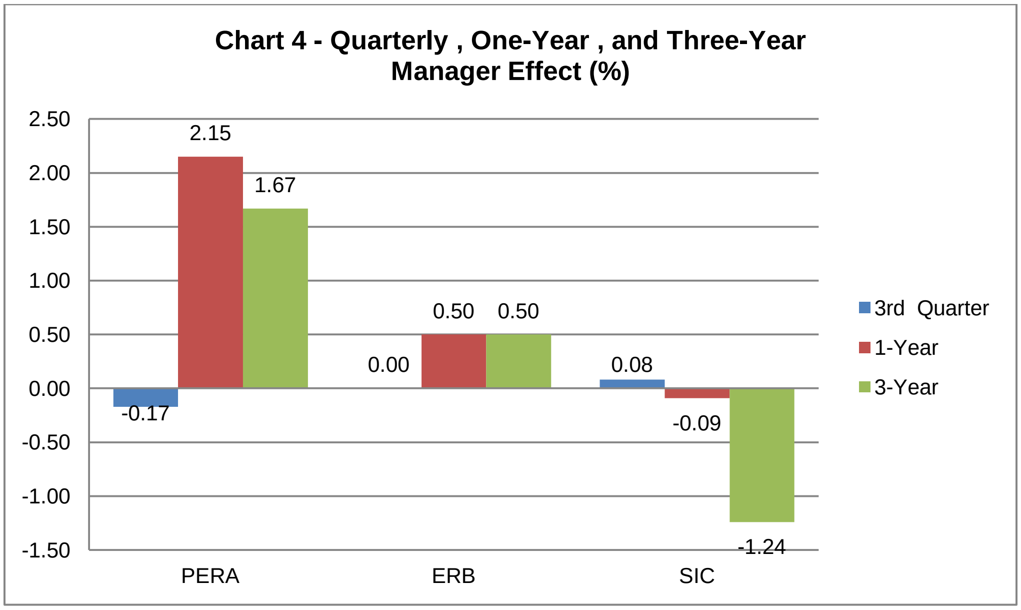
During the quarter, SIC's return was 21 basis points lower due to deviations including underweight to non-U.S. equity and underweight fixed income, which offset value gained due to overweight U.S. equity. The one-year policy effect for the SIC was -14 basis points. Value added by underweights to non-U.S. equity and real returns nearly offset lost value from overweight to fixed income assets. SIC notes that funds seek to minimize the magnitude of the allocation effect as deviations from policy do not tend to occur intentionally in an effort to increase returns.



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."

Chart 4 shows manager effects for all three agencies during the quarter, one-year, and three-year periods. PERA's managers contributed to a manager effect of -17 basis points; the SIC[1] showed a gain of 8 basis points; and ERB's manager effect remained at zero. During the one-year period, two of the agencies' managers added value. PERA's 2.15 percent manager effect was realized in domestic equities and fixed income assets. ERB's managers gained 0.5 percent, largely in the opportunistic credit asset class, which offset value lost in global asset allocation. The SIC one-year manager effect was -9 basis points. Value added in fixed income, real return, and absolute return assets did not offset value lost in non-US and private equity and real estate. The SIC adds manager value added was negative in emerging markets primarily due to transition costs in restructuring the portfolio from legacy managers to new managers.

[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.



Summary. The market environment and the funds' quarterly performance can be summarized as follows:

- After weaker performance across most asset classes in the 2nd quarter, global stock markets saw strong gains in the face of significant investor uncertainty caused by political obstacles. The economy has gained forward momentum in part by early signs real GDP has grown faster than expected and by an acknowledgement of the Federal Reserve that additional work is needed on their behalf to aid in the recovery process
- The U.S. stock market, represented by the Wilshire 5000 Total Market Index, posted a total return of 6.03 percent during the third quarter despite pulling back 2.16 percent from its record high close on September 18
- Despite small returns in the third quarter of calendar year 2013, all three agencies' one-year investment returns exceeded their respective long-term, target returns (Table 1).
- PERA's quarterly returns were in the top third of peer funds. Returns were aided by a positive allocation effect. The fund's one-year performance was in the 35th percentile. During the one and three-year periods, PERA's investment officials added value through active management, which offset lost value from deviation from allocation targets
- ERB performance was driven by an investment policy that calls for a lesser exposure to equities in favor of fixed income assets. This less risky policy contributed to returns in the bottom third of peer funds in the quarter. Stocks performed well in the one-year period, and ERB's lower exposure to equities resulted in the fund ranking in the 88th percentile of peer funds. Value was added by deviations from this policy and by asset selection by the ERB's investment managers
- Investment returns of the LGPF and the STPF ranked in the 65th and 75th percentiles, respectively. This ranking is worse than the one- and three-year terms, but better than its long term ranking. The SIC adds its rankings reflect the constitutional restriction allocation toward international equity investments, noting 85 percent of peer funds have higher allocations to this asset class, an index of which returned 11/36 percent in the quarter.

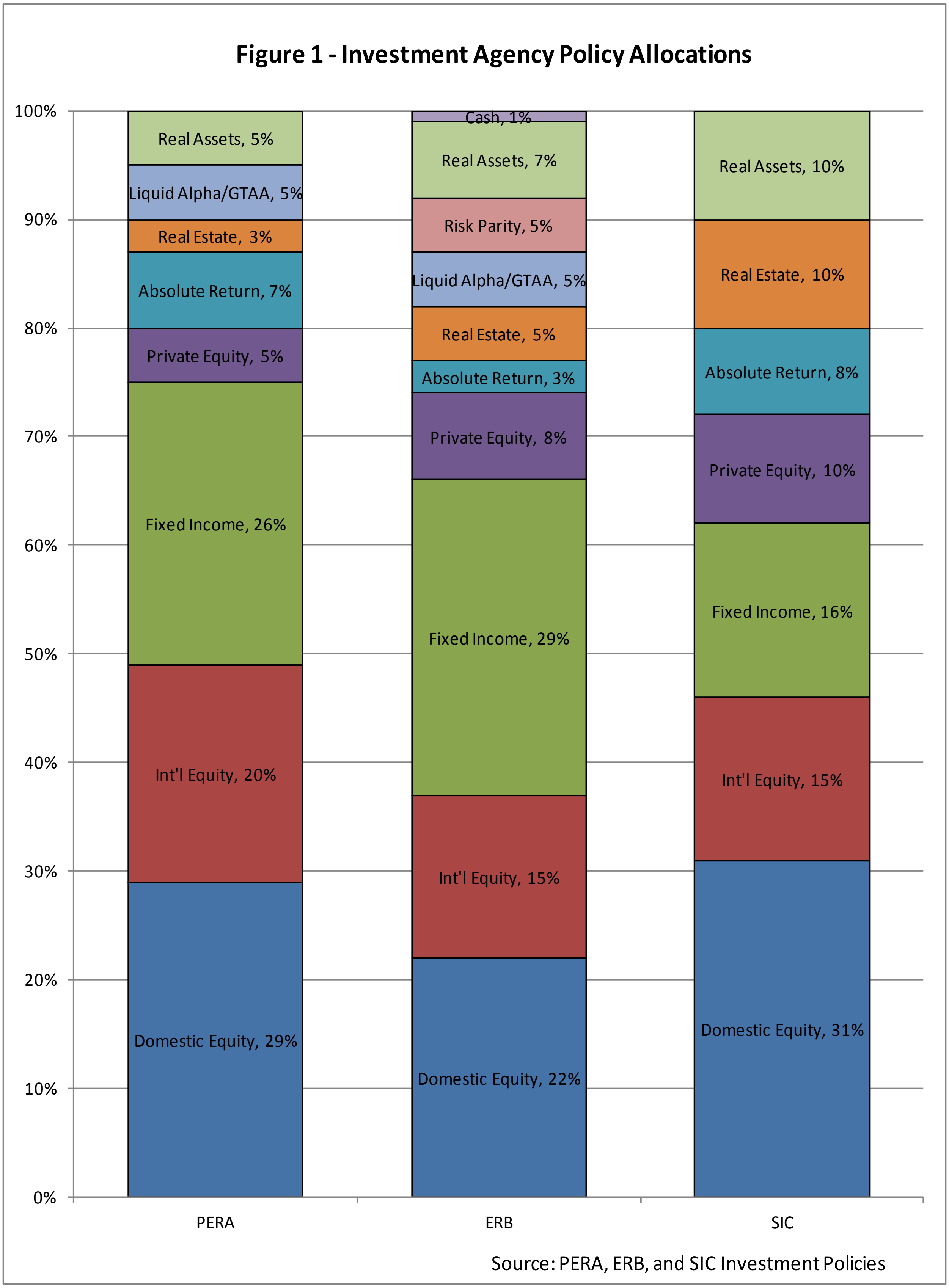


Figure 1 - Investment Agency Policy Allocations
100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
Real Assets, 5%
Liquid Alpha/GTAA, 5%
Real Estate, 3%
Absolute Return, 7%
Private Equity, 5%
Fixed Income, 26%
Int'l Equity, 20%
Domestic Equity, 29%
Cash, 1%
Real Assets, 7%
Risk Parity, 5%
Liquid Alpha/GTAA, 5%
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
Source: PERA, ERB, and SIC Investment Policies