State of New Mexico
LEGISLATIVE FINANCE COMMITTEE

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LFC INVESTMENT REPORT FOR THE QUARTER ENDING MARCH 31, 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. Although the attribution analysis included in this report concentrates on the quarter, long term performance is indeed the most important metric. Therefore this report shows fund returns and comparative rankings for the one-year, three-year and five-year periods as well.

The U.S. stock market got off to a strong start in 2013, with the S&P 500 index returning 10.6 percent in the first quarter on the back of improving U.S. labor and housing market data and continued accommodative monetary policy of the Federal Reserve. Stocks rose in all three months of the quarter, but showed their largest gains in January when they were up 5.4 percent. The Wilshire Trust Universe Comparison Service reported treasury yields rose over the first two months of the first quarter as investors rotated out of low-yielding treasuries into equities or lower-quality, higher-yield bonds. The automatic spending cuts of sequestration beginning March 1 spurred investors to return to the safety of treasuries, resulting in lower yields in March.

Returns and Ending Balances. Table 1 shows ending balances and compares the investment agencies' percentage returns for the quarter and the one-year, three-year, and five-year periods with the S&P 500, a stock market index based on the 500 leading companies publicly traded in the U.S. stock market. The high return of this index indicates U.S. stocks fared well in the quarter. This asset class makes up only a portion of the more diversified portfolios of the investment agencies, contributing to their returns being below the level of the S&P 500. The annual target returns for the three investment agencies are around 7.5 to 7.75 percent.

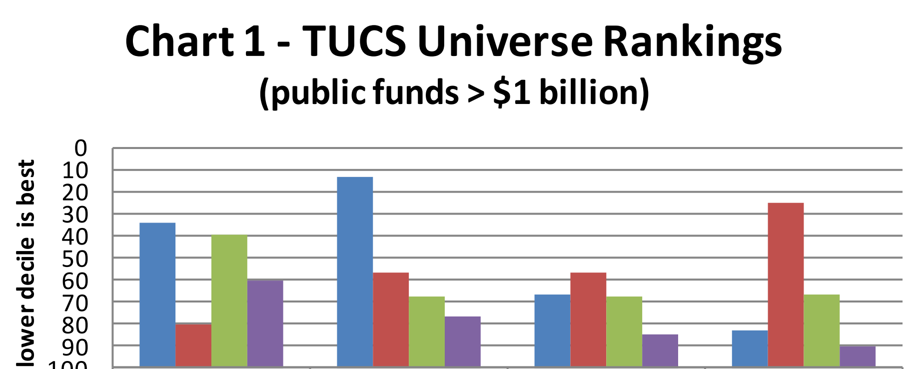
Table 1
Returns and Ending Balances as of March 31, 2013

Returns (%)	PERA	ERB	LGPF	STPF	S&P 500
Quarter	5.38	3.95	4.98	4.55	10.61
1-Year	11.16	10.19	9.77	9.2	13.95
3-Year	9.04	9.32	9	8.33	12.67
5-Year	3.71	5.65	4.53	3.44	5.81
Ending Balance ($B)	13.046	10.212	12.031	4.173	

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, annually, three and five year periods. A lower rank (1st is best) denotes a 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.



	Quarter	1 Year	3 Year	5 Year
PERA	34	13	67	83
ERB	80	57	57	25
LGPF	40	68	68	67
STPF	60	77	85	90

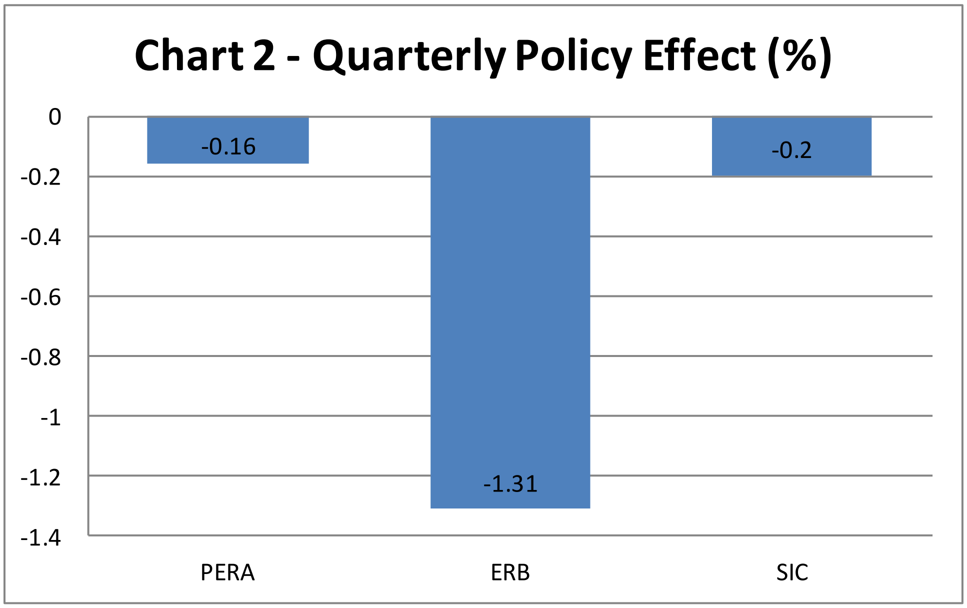
For the quarter, PERA ranked in the 34th percentile, lower than the ranking of its one-year performance, but better than its longer-term results. The PERA's five-year ranking remains in the lowest fifth of all funds in the universe, yet the fund's short-term performance has improved its long term ranking compared to the previous quarter (94th percentile).

ERB returned a performance at approximately the bottom fifth, slightly worse than its one- and three-year performance rankings. The fund's short term performance dragged down the five-year ranking compared to the previous quarter (18th percentile), though it remains in the top quarter.

Both funds invested by SIC fared better in the quarter than in the long term. The Land Grant Permanent Fund's ranking for the quarter is in the 40th percentile, compared with the 67th percentile in the five-year term. The Severance Tax Permanent Fund's quarterly ranking, while still below the median in the 60th percentile, is better than the 5-year ranking in the 90th percentile. The SIC notes that for both the one-year and three year periods, the quarters rolling off had top-decile performance, while the most recent quarter that rolled-on was second quartile. This caused a reduction in ranking for those periods compared with the previous quarter.

Attribution Analysis. 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, risky domestic assets such as US stocks (equities) performed well in the quarter. Accordingly, 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 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. The TUCS median return is gross of the allocation and manager effects, and the measure is therefore a rough estimate of the policy effect. However, this report uses the TUCS for this measure to allow uniformity and consistency across the three funds. In isolation, PERA's policy allocation returned 16 basis points less than the median fund. PERA adopted new policy targets during the previous quarter 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 returns 20 basis points 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. Stocks performed well in the quarter, and ERB's less risky policy contributed to its policy index performing 131 basis points below the median fund performance.

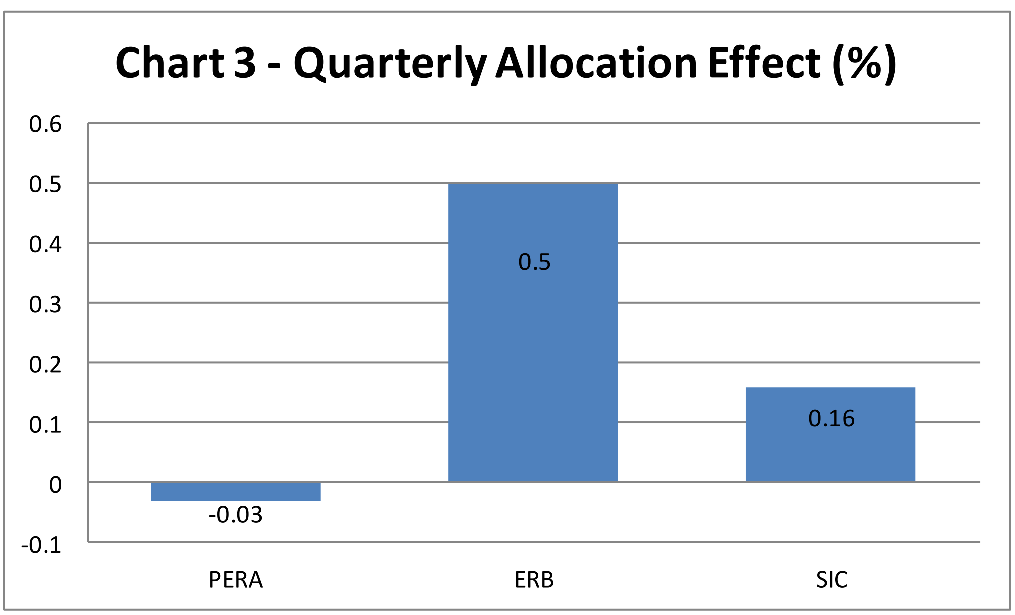
Quarterly Allocation Effect. The second way that a fund's return can be affected is by tactically shifting assets away from the proportions called for by policy. For example, an investment officer might have had a bearish view of the stock market during the second quarter and used his authority to temporarily reduce a fund's risky assets to less than what is specified in policy. Because stocks had a strong quarter, increasing risky assets would have been a good market call and would have contributed to fund performance. As a matter of practice, investment officers are constantly confronted with allocation decisions when transitioning or rebalancing portfolio managers or asset classes. The investment officer may have the option of letting the 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. It is important to note that tactical investment 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; one fund lost value by deviating from its policy index, albeit only slightly. PERA lost three basis points from the market effect of underweight in international equities relative to policy targets, partially offset by added value from an overweight in real assets.

ERB's return increased 50 basis points due to overweight domestic equities and underweight foreign equities in a quarter where domestic equity indices outperformed non-U.S. by a wide margin. Further allocation effects resulted from underweight core fixed income and overweight opportunistic credit relative to interim policy targets.

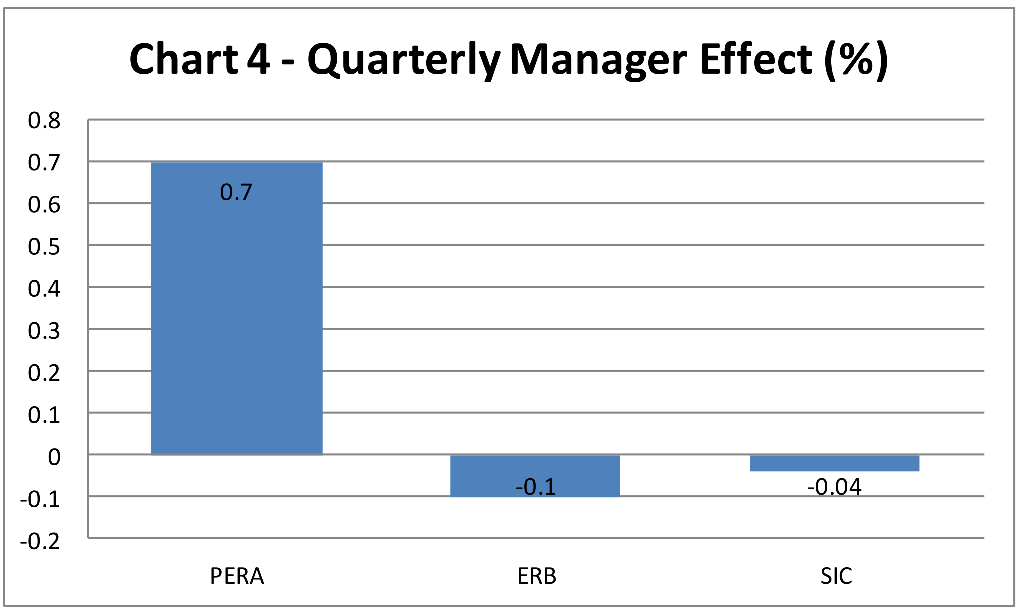
SIC's return was 16 basis points higher due to deviations from policy due to a slight underweight in foreign equity and underweight in real estate and real assets. These positive effects were offset by overweight in fixed income assets relative to policy targets.

Allocation gains or losses occur constantly – asset proportions vary against targets because of market price changes and incoming and outgoing cash flows, which are also variable.



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."

As Chart 4 shows, PERA's managers added the most value during the quarter. Of the 70 basis point manager effect, 37 bps were from fixed income assets, 21 bps from domestic equity, and 7 bps from international equities. ERB's managers lost value in domestic and international equities, private equities, absolute return, and real assets. Value added in the fixed income and real estate asset classes offset some of the lost value, resulting in the -10 basis point manager effect. The SIC manager effect for the quarter was negative four basis points, resulting from value lost in U.S. equities and real estate, largely offset by value added in private equities and fixed income assets[1].



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

- Stocks were positive in the U.S. while non-U.S. stock markets were mixed. Developed markets were up approximately 5 percent for the quarter while emerging markets fell by more than 1.5 percent.
- In the U.S., the S&P 500 index gained 10.6 percent compared to a loss of 0.4 percent in the fourth quarter of 2012.

[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.

- Using the TUCS, it is possible to rank the funds against the same universe. PERA's return was above average for the quarter, nearly in the top third, due its investment policy and positive contribution from manager performance.
- 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 was penalized in a quarter where U.S. equities performed well. Value was added by slight deviations from this policy, however.
- Also noteworthy is that during the quarter, ERB was chosen as the "mid-sized public plan of the year" for 2013 by the Money Management Intelligence Letter, an industry publication.
- SIC quarterly investment of the Land Grant Permanent Fund performed above the median fund. The investment agency's policy produced slightly less than the median fund. Asset allocation contributed slightly to performance, while the fund's managers resulted in a slight loss of value.
- PERA was the only one who had an above average ranking for the quarter and the year while all three agencies were below average for the three-year ranking. ERB was the only one who was above average for the five-year ranking.
- Several investment plans are increasing their external active management. This type of management has a greater cost than passive investment or internal management and leads to the question of whether the higher cost of active investment really leads to a greater return on investment than passive investment.